
Regulating Islamic Banking: A Malaysian Perspective

by Assoc. Prof. Nafis Alam and Lokesh Gupta

James Madison once said, “*If men were angels, no government would be necessary*”. Madison’s view has direct implications for efficient bank supervisory and strong regulatory strategies. On the onset of the 2007–08 subprime crisis, the banking systems across the globe were left exposed to financial tsunami due to over-expansion and excessive risk concentrations.

In recent years, the banking systems around the globe have been going through some of the most intense criticism and scrutiny. In part, many believe the lack of regulations and supervisory structures has brought the world to a brink of financial collapse, while on the other side of that coin many believed the years of prosperity the world had experienced just prior to the collapse were largely in part due to the deregulation or lack of regulation, hence a near free market with regard to the financial sector¹ (Reinhart and Rogoff, 2008; Brunnermeier & Pederson, 2009 and Alam, 2012).

Banking regulations can generally be defined as the framework controlling the creation, operation and liquidation of banks in an economy. These regulations are put in place by central banks and finance ministries and control is usually exerted through monitoring carried out by specialised banking supervisory authorities. Spong (2000)² from the Federal Reserve Bank of Kansas City highlights a few important reasons for introducing bank regulations. The most basic reason for introducing regulations is to protect depositors from undue risks to their deposits. Businesses and individuals alike hold significant portions of their funds in banks and there are valid concerns with regards to the protection of their funds. As a result, authorities respond to such concerns with regulations as an attempt to protect the bank depositors.

Meanwhile, with the amount of transactions conducted daily by businesses and individuals, a stable framework is required to ensure smooth and acceptable methods of the payment system are in place. Bank regulations try to provide this stable framework which seeks to ensure certainty and safety to users of the banking payment system, and this in turn is critical for the well-being of the economy. Moreover, apart from maintaining public confidence, banking regulations also try to create a regulatory environment

¹ Reinhart, C., & Rogoff, R. (2008) This Time is Different: A Panoramic View of Eight Centuries of Financial Crises. NBER: Working Paper no. 13882.
Brunnermeier, M. and Pedersen, L. (2009) Market Liquidity and Funding Liquidity. *Review of Financial Studies* 22: 2201–2238.
Alam, N. (2012) Does Banking Regulation Affect Banking Efficiency? A Survey of Dual Banking Systems. *Journal of International Banking Law and Regulation* 27(6): 231–238.

² Spong, K. (2000) Banking Regulation: Its Purposes, Implementation, and Effects. Federal Reserve Bank of Kansas City, Kansas City: MO.



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where banks are expected to be efficient and competitive; and are also expected to provide reasonable levels of banking services throughout the economy. The traditional view of the impact of bank regulations is that higher capital requirements will have a positive effect on the banking sector. Bank regulations and supervision can take the form of detailed and precise prescriptive rules under which all banks operate in the given territory. For example, activity restriction rules may specify which banking activities can be undertaken to reduce risk and prevent bankruptcy. If such rules do not truly reflect the risks involved they could unintentionally induce banks to involve in unprofitable and risky ventures.

Another aspect of banking is the recent rise of Islamic finance. While the rest of the world and industry continue on with the business of arguing as to what level of banking regulations is needed, in many corners of the world a different type of banking system is on the rise. Islamic finance encompasses a wide array of concepts from fully fledged financial institutions to normal financial institutions having an Islamic financing arm that offers saving schemes, loans or bonds commonly known as Sukuk.

However, like every system that is theological based, Islamic finance is open to interpretation and that can vary between different regions. The Islamic finance industry has also been riddled with many issues, many of which boil down to lack of proper supervision, and lack of compliance and regulatory measures. However Islamic Financial Markets are among the fastest growing financial products in the world. This will see further growth in years to come as more and more countries are embarking on Islamic banking and discovering the benefits of using Islamic finance over conventional financing schemes. As highlighted by Rehman and Perry (2011)³, “while many of the conventional banks suffered major losses in the aftermath of the sub-prime mortgage crisis, most banks following the Islamic system were largely profitable”. However, there exist some dark clouds over the horizon for Islamic banking to be accepted universally as a mainstream. It would mostly be seen as an alternative.

When it comes to the regulation of the Islamic banking sector, Malaysia stands out from rest of the competing nations in the dual banking (both Islamic and conventional banking running in parallel) system. The sophisticated Malaysian financial industry running both the conventional and Islamic finance in a parallel financial system calls for a need for more stable regulatory framework. On 30 June 2013, the Financial Services Act 2013 (“FSA”) and the Islamic Financial Services Act 2013 (“IFSA”) (collectively referred to as “Acts”) have come into effect by substituting and repealing the Banking and Financial Institutions Act 1989, Insurance Act 1996, Payment Systems Act 2003, Exchange Control Act 1953, Islamic Banking Act 1983 and Takaful Act 1984. The objectives of the Acts are to provide Bank Negara Malaysia (“BNM”), the Central Bank of Malaysia with greater powers to counter future risks to financial stability in the financial sector, increase consumer protection, promote competition in the broader financial services sector and step forward towards global trends in financial regulations. This marked another milestone for Malaysia as it introduced the IFSA and FSA to cater to the growing market of the country’s financial industry.

Since the scope of this article is on Islamic banking regulation, we will dwell on some key features of the IFSA. Under the IFSA, Islamic banks are now required to separate Islamic deposits with a principle guaranteed feature from investment accounts with a non-principle guaranteed feature. This distinction will allow Islamic banks to develop a wider range of products for both deposit and investment uses in order to meet the diverse needs of Islamic banking customers (both retail and corporate). To facilitate smooth implementation of the reclassification process and ensure relevant stakeholders interests are protected, BNM has formulated a transition plan to allow Islamic banks to complete the process which ended on June 2015 (two-year period from the enactment of IFSA). Additionally, the IFSA provides greater legal clarity on application of the various types of Shariah financial contracts, and ensure end-to-end compliance in full cycle of Islamic banking operations, eg investment accounts. From market conduct standpoint, the customers are able to clearly differentiate between products which are principal guaranteed with those which are not. On the deposit classification, Islamic banks can offer both products with principal guaranteed or non-principal guaranteed feature. However, Islamic banks are required to classify such products as either Islamic deposit which uses Shariah contracts with principal guaranteed feature or investment account which uses Shariah contracts with non-principal guaranteed feature.

The main purpose behind the introduction of the IFSA is to provide a stronger legal foundation to spur the growth of Islamic finance sector within the country. The market share of Islamic banks in the Malaysian banking sector has increased to 23% as of 1H2015 (IFSB, 2016). The IFSA further boosted the development of a legal platform for the development of Islamic finance in Malaysia which is reflected upon a comprehensive regulatory framework of the various Islamic financial contracts. The Acts also support the effective application of Shariah financial contracts in offering Islamic financial products and services. The introduction of the IFSA has marked a significant milestone in aligning the Shariah requirements of Islamic financial services in regulatory principles. The contract-based regulatory framework also gives BNM greater oversight and powers to further scrutinise financial holding companies and non-regulated entities who might pose a risk to financial stability. It is also believed that the IFSA will supplement improved investors’ protection as there are provisions that require banks to distinguish between deposits made for savings and those made for investments.

³ Rehman, S. and Perry, F. (2011) Globalization Of Islamic Finance: Myth Or Reality? *International Journal of Humanities and Social Science* 1:107–119

Another notable element of the IFSA is regarding the notification to the regulators on Shariah non-compliance. It is now legally obligatory upon an Islamic financial institution to immediately notify the regulator and its Shariah committee once it becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah. The Islamic financial institution is required to immediately cease from carrying on such business and from taking on any other similar business, affair or activity and within 30 days, and to submit to the regulator a plan on the rectification of the non-compliance. The IFSA empowers the regulator to carry out an assessment to determine the rectification has been carried through. Another distinct feature of the IFSA is that BNM is empowered to specify standards to give effect to the advice or rulings of the Shariah Advisory Council. The standards issued by the regulator are binding on all Islamic financial institutions authorised under the Act and on their directors, Chief Executive Officers and Shariah committee members who function as precursors for Shariah compliance in these institutions.

The IFSA was designed to address several loopholes afflicting the banking industry. With IFSA, Malaysia has achieved the distinction of the first country in the world to legislate Shariah governance which further cements Malaysia's position as the leading hub of Islamic finance regionally and globally.
