MALAYSIA
Islamic Finance & Financial Inclusion
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<tr>
<td>AAOIFI</td>
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<td>ACE Market</td>
<td>Access, Certainty, Efficiency market</td>
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<td>AFI</td>
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<td>JAKIM</td>
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<td>JAWHAR</td>
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<td>OIC</td>
<td>Organisation of Islamic Cooperation</td>
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<td>YWM</td>
<td>Yayasan Wakaf Malaysia</td>
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**PRINCIPLES OF ISLAMIC FINANCE**

**Prohibition of interest (Riba):** The premium (interest) that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension. (i) *Riba al-Fadl:* Riba in hand-to-hand or barter exchange. (ii) *Riba al-Nasi‘ah:* Riba in money-to-money exchange provided exchange is delayed or deferred and additional charge is associated with such deferment.

**Prohibition of speculative behavior (Gharar):** Uncertainty in contractual terms and conditions is forbidden. However, risk-taking is allowed when all the terms and conditions are clear and known to all parties.

**Ban on financing certain economic sectors:** Financing of industries deemed unlawful by shari‘ah—such as liquor, pork, and gambling—is forbidden.

**The profit- and loss-sharing principle:** Parties to a financial transaction must share in the risks and rewards attached to it.

**The asset-backing principle:** Each financial transaction must refer to a shari‘ah-compliant tangible assets (like real estate) and/or intangible assets like usufruct (e.g., leasehold rights) or services (e.g., toll road concessions);

**Takaful (Islamic Social Solidarity Scheme):** *Takaful* is an arrangement for joint guarantee, whereby a group of participants agrees to support one another jointly for losses arising from identified risks. Under this arrangement, participants contribute a sum of money as a commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage.

**Retakaful:** A form of Islamic reinsurance that operates on the takaful model.

**Kafalah:** A contract of guarantee used to provide assurance as to performance or liabilities.

**Qard al-Hasan:** Interest-free loan.

**Wakala (Agency):** A contract whereby someone appoints another to act on his/her behalf for a fee.

**Ar-Rahn (Islamic Pawn Broking):** A contract that makes something as a guarantee to the completion of settlement of a debt. Usually, the contract is asked by the creditor to the debtor during the commencement of the contract to avoid default from the debtor of not paying the debt.
Vocabulary of Islamic Finance

**Sukuk (certificates of ownership):** Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) the assets of particular projects.

**Profit-Sharing Investment Account (PSIA):** PSIA refers to a deposit product based on the principle of *mudarabah* (profit-sharing contract) where the IAH and the Islamic banking institution agree to share the profits generated from an underlying pool of assets funded by PSIA on a pre-agreed ratio, while losses may be borne by the IAH, shared between the bank’s shareholders or borne entirely by the latter.

**Rabb-Al-Mal:** Capital owner/investor. In a *mudarabah* contract the person who invests the capital (the capital owner or financier).
Executive Summary
Executive Summary

The main purpose of this report is to explore the role Islamic finance has played in furthering financial inclusion in Malaysia, with a view to drawing key lessons of experience. Given Malaysia’s success in the development of Islamic finance, these lessons will be useful to policy makers and regulators in other Islamic finance jurisdictions as they make efforts to enhance Islamic financial inclusion. The study will also be relevant to development practitioners involved in providing technical assistance and advisory services to their client countries on different ways to foster financial inclusion and improve the contribution of the financial sector to growth and poverty reduction.

The report is composed of 5 chapters that assess the critical components of financial inclusion and begins with a macro-level assessment of key inclusion and Islamic finance indicators in Malaysia (chapter 1); analyses the country’s regulatory structures on which inclusion has been based (chapter 2); identifies its institutional enablers (chapter 3); specifies prime consumer protection measures (chapter 4) and enunciates the impact that digitalization and Islamic financial technology (‘FinTech’) have had in increasing inclusion.

Malaysia has emerged as a leader amongst its ASEAN, OIC, and upper middle-income country peers in the attainment of financial inclusion and in the development of its Islamic finance industry. Greater research is required to determine the extent to which policies that were designed to foster the growth of Islamic finance led to greater financial inclusion and policies to promote greater financial inclusion led to the strengthening of Islamic finance.

Deliberate policymaking and the creation of various institutions have cultivated Islamic finance as an important source of financial inclusion, especially amongst segments of the population that were reluctant to engage in conventional finance for religious reasons. These efforts date to the 1960s and have expanded steadily, such that by 2011 (the period for which Findex financial inclusion data commenced), Islamic finance was already well-established in Malaysia.

The degree of causality between the growth of Islamic finance and greater financial inclusion cannot be conclusively established. From a policy perspective, it can be concluded that both promoting financial inclusion and fostering Islamic finance have led to positive development outcomes for Malaysia.

As Malaysia pursues the “last mile” of financial inclusion, religious objections to financial participation appear to have essentially been eliminated. The remaining barriers, such as the absence of adequate funds and relatives owning accounts, are not religious in nature. It thus appears that attaining even higher levels of financial participation does not specifically require supporting Islamic finance, but rather making finance (both Islamic and conventional) more accessible and better understood. This may include ongoing emphasis on financial literacy, FinTech, and other mechanisms to reach the remaining segment of the population not yet financially included.

The data suggests that Malaysia has essentially removed religious considerations as a barrier to financial inclusion and has likely done so through its cultivation of Islamic finance. In this respect, Malaysia can serve as a model for countries on how to make finance accessible to all by fostering financial practices that are consistent with the religious beliefs of the population. The model applies not only to OIC countries and Islamic finance, but also to all countries and faith groups.
Malaysia also offers an important lesson for countries that are committed to developing their Islamic finance sector: achieving overall financial inclusion will also help advance Islamic finance. While many have recognized that Malaysia is a leader in global Islamic finance, they may not yet be aware of how overall financial inclusion across the country has helped Islamic finance thrive. Malaysia’s comprehensive regulatory frameworks for both conventional and Islamic finance have furthered financial inclusion.

Strong leadership from financial regulators has been key to driving financial inclusion in Malaysia. These regulatory initiatives have covered banking, takaful/insurance, capital markets and alternative finance and have been marked by coordination among different government ministries, departments and agencies over a period of time. The initiatives have also been implemented with clear, targeted action plans and accurate tracking of milestones which has contributed significantly to the country’s high Findex score.

Islamic social finance, historically, has also played a central role in providing access to finance to entrepreneurs. Both regulation and legislation have played an important role in promoting social finance. The SC has passed regulation that enables waqf funds to be used for social development while 5 out of Malaysia’s 13 states have enacted waqf-specific legislation.

Similar engagements are required between financial regulators, financial institutions, and SIRCs in maximizing the potential of Islamic social finance to support sustainable development. The future lies in continued financial product innovation, embedding digital financial services, data management and capacity building for financial management. All these areas can be jointly developed between regulators and market participants.

A trio of institutions that have been fundamental to financial inclusion in Malaysia. TH introduced a culture of thrift among Malay Muslims by incentivizing them to save for the pilgrimage to Makkah. Effectively tapping religious beliefs became an avenue for greater participation in the financial system. PNB addressed economic inequality among the population that appeared to have an ethnic bearing. By providing preferential share allocations for Bumiputeras in blue-chip companies through PNB’s funds, it redistributed wealth through affirmative action and enabled more Malays to directly profit from the country’s economic success. Finally, FELDA allowed land ownership among Malays by providing them with designated holdings to cultivate where they were paid wages until title was transferred to them.

The corporatization of SIRCs in the early 1990s was a key development that considerably improved zakat collections. Equally significant has been the melding of waqf interests between SIRCs and Islamic banks to benefit socially important sectors such as health and education. Such wealth redistribution is essential to the cause of financial inclusion and should be combined with the creation of institutions that enable wealth accumulation as described above.

However, regardless of the success of the above-mentioned institutions, countries must be mindful of the impact of race or religion-based policies on growth and competitiveness. The Malaysian experience accentuates the need for better corporate governance and transparency in order to minimize rent seeking and the misappropriation of wealth. Also, affirmative action policies promulgated on the basis of reducing income disparities may cause excessive protectionism to the detriment of international competitiveness. Consequently, it is imperative that every country determines its own balance between the role of the state and market and implements effective redistribution policies to achieve this equilibrium. Malaysia’s success
Executive Summary

has brought it closer to achieving developed nation status but in order to preserve its gains, it must ensure that prosperity is shared not concentrated, funding and support are based on merit not privilege and critically, the rule of law prevails.

Investor confidence and trust in a well-functioning market for financial services promotes financial stability, innovation and inclusion in the long-term. IFIs are subject to 2 types of consumer protection. Firstly, they must follow standard rules of full disclosure and transparency in relation to their products and services which is common to all financial institutions. Secondly, IFIs have a fiduciary duty to ensure that all their products are shari’ah compliant and in conformity with the applicable shari’ah governance framework.

Malaysia uses a standardized, comprehensive framework for all consumer and investor protection, which covers both Islamic and conventional products and services. The framework includes transparency and disclosure requirements, the fairness of terms in the financial contract, data protection, and privacy in addition to complaints and dispute resolution mechanisms. Additionally, financial regulators, in collaboration with the MOE and industry stakeholders, have participated aggressively in raising consumer awareness and financial literacy among various segments of the population. This has resulted in the creation of dedicated institutions and a slew of policy initiatives that have collectively raised confidence in the system and promoted financial inclusion.

Findex 2017 states that access to cell phones and the internet is driving access to and the use of financial services globally. In addition, advances in digital financial services inclusive of payments, savings, credit and insurance products are key to improving financial inclusion.

The use of FinTech has enabled a resurgence of Islamic social finance and institutions like LZNK are at the vanguard of using technology to enhance zakat collections. The available technology, especially blockchain, enhances transparency and reduces information asymmetry. Consequently, Muslims have greater confidence in making donations either in the form of zakat, waqf or sadaqah using the FinTech platform or application. Considering the considerable unrealized potential of zakat and waqf, technology’s contribution can assist poverty alleviation and build the required infrastructure to achieve SDGs.

Despite Malaysia’s gains in the application of FinTech towards financial inclusion, 3 primary issues remain to be addressed. These concern bridging the technology gap between generations so that senior citizens and lower income segments can avail the full benefits of the digital economy; transferring the automation of SMEs into digitization such that there are tangible gains in their processes and developing the halal economy which requires the evolution of digital platforms to automate processes beyond payments and financing systems and greater innovation from Islamic FinTechs.

Malaysia provides an example of high financial inclusion based upon sustained policy continuity and co-ordination between the government, public and private sectors. This has produced a raft of policies, frameworks and regulation that has furthered inclusion and has been bolstered by the creation of dedicated institutions. In addition, major regulatory entities have taken ownership of the process and been at the forefront of promoting financial inclusion. Integral to this multi-pronged approach has also been the effective leveraging of FinTech which has provided easier and cheaper access to the financial system and revived Islamic social finance. Consequently, Malaysia presents an effective template to achieve significant levels of financial inclusion that can be successfully adapted by peer countries.
CHAPTER 1

Evolution of Islamic Financial Inclusion in Malaysia
1.1 Overview and Introduction

Malaysia has been highly successful in attaining “financial inclusion,” which represents an individual’s access to and use of formal financial services. Among all Malaysian adults, the vast majority either has an account at a bank or another type of financial institution or reports personally using a mobile money service in the past twelve months.¹ Malaysia also scores favorably on several metrics of financial inclusion in comparison to regional and global peer groups. Increasing access to financial services holds the promise of helping to reduce poverty and improve development outcomes by enabling consumers of financial services to smooth consumption, start or expand a business, boost productivity, cope with risk, increase or diversify household income, and facilitate female empowerment.

Malaysia has also been highly successful in developing its Islamic finance sector. Despite being home to approximately 2% of the global Muslim population, Malaysia accounts for over 20% of global Islamic finance assets.² Islamic finance in Malaysia spans a full range of financial services: consumer and business banking, investment funds, insurance, capital markets activities, and newer ventures involving the use of FinTech such as ECF and P2P lending.³ The success of Islamic finance in Malaysia also demonstrates how an Islamic financial system can operate alongside a conventional system.

Islamic finance offers, from a conceptual perspective, institutions and mechanisms that support financial inclusion. In the commercial (for-profit) Islamic finance sector, these include removing religious barriers to financial engagement, offering savings and investment products, and offering access to financing for business and consumer needs. These have largely sought to replicate the products and services available from the conventional financial sector. In the social finance sector (zakat, awqaf, etc.), Islamic finance offers mechanisms that allow for access to funds and capital formation. A noteworthy feature of zakat is that it has traditionally involved cash transfers, which could help bring the poor into the formal financial system. Awqaf, particularly “cash awqaf,” offers a mechanism by which social enterprises can enjoy capital formation and engage in the financial system.⁴

Despite the strides made in Malaysia with regard to both financial inclusion and Islamic finance, the data suggests that Islamic finance could still go further in achieving financial inclusion in Malaysia. Financial inclusion survey data from Global Findex shows that 85% of Malaysians age 15+ have a bank account at a financial institution, and that 70% have made a withdrawal from an account in the last year, suggesting that many (up to 30%) use their accounts only for savings and do not use bank accounts for day-to-day withdrawals for regular expenses. Furthermore, surveys note that a small portion of the population still cites religious concerns as a barrier to engaging in the financial sector⁵ (although other barriers to financial inclusion are more prevalent), suggesting that either (a) Islamic financial institutions do not yet reach the full population, or (b) there remains a lack of awareness on availability of Islamic financial products which are compliant with Islamic principles and the differences between conventional and Islamic financial products.

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³ See section 5.5 in chapter 5.
⁴ See sections 2.4.2 (a) and 2.5 in chapter 2 and section 3.10 in chapter 3.
⁵ Findex, 2017.
Data from BNM’s Demand Side Survey 2018 provides insight on this question. That survey included questions to individuals who only had accounts with TH / ASN (key savings NBFI discussed later in this report) and no bank accounts. Amongst these respondents, 70% stated that they needed only one savings account, with TH / ASN being sufficient. 55% of respondents stated that their sole purpose for saving was for Hajj (thus negating any need for another account beyond TH); and 31% stated a preference for a pure Islamic product. In the overall BNM Demand Side Survey 2018, no respondents cited religion as their reason for not having an account at a financial institution. This data suggests that Islamic NBFI are extending the reach of the formal financial system to individuals and families that otherwise might not engage with it.

The role of Islamic finance in financial inclusion is particularly noteworthy in light of the demographics of poverty in Malaysia. The 2012 incidence of poverty amongst Bumiputera Malaysians was 2.2%, as compared to 1.8% for Indian Malaysians and 0.3% for Chinese Malaysians. As the Bumiputera, who are overwhelmingly Muslim, comprise a disproportionate share of the poor, Islamic finance may be seen as playing a key role in helping uplift the poorest segment of the population through inclusion in the financial system.

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6 Bank Negara Malaysia Demand Side Survey 2018.
7 Department of Statistics Malaysia, available at: https://www.dosm.gov.my/v1/index.php?r=column/cone&menu_id=UIDUxjUxWUoOL3FEaWZmUVg4ZFOzZy09
Islamic finance has also played an important role in financing SMEs. Bank Negara Malaysia data indicates that, in 2019, 28.5% of SME financing in the country was provided by Islamic banks. Although the BNM data did not examine this question, it can safely be assumed in the current analysis that at least some SME borrowers would not have borrowed if there were no Islamic facilities. BNM's Demand Side Survey 2018 again provides indirect support for this assumption, as it found that 31% of individuals who held accounts solely at TH / ASN did so due to a preference for a pure Islamic product. To the extent that there are SME owners with similar preferences, it can be assumed that the availability of Islamic SME lending is essential to their participation.

1.2 Malaysia as a Leader in Financial Inclusion

The 2017 Global Findex database represents the world’s most comprehensive data set on how adults age 15 and above access accounts, make payments, save, borrow, and manage risk. The database is produced by the World Bank, using survey data collected in collaboration with Gallup, Inc., and with funding from the Bill & Melinda Gates Foundation. The Findex database focuses on the financial inclusion of individuals and households, rather than businesses and SMEs. Analysis conducted from this data should thus be seen to apply to individuals and households rather than firms and commercial enterprises.

The most recent survey of over 150,000 people was conducted in 2017 and covers over 140 economies representing more than 97% of the world’s population. Among the economies covered are 9 of the 10 members of the ASEAN and 43 of the 57 members of the OIC, 2 intergovernmental organizations of which Malaysia is a member. Also included are 38 economies, including Malaysia, that the World Bank classifies as upper middle income. To assess Malaysia’s performance in achieving financial inclusion, we compare it below with these 3 peer groups.

The Findex database defines “financial inclusion” as access to and use of formal financial services, such as bank accounts and digital payments. Financial inclusion has many potential development benefits, as it can help improve people’s income-earning potential (thus reducing poverty), improve their ability to manage risk, enable resilience and security during tough times, lower the cost of receiving payments, allow people to increase spending on necessities, promote savings, encourage business and personal investment for future growth, boost productivity, and facilitate female empowerment. For governments, financial inclusion can...
reduce corruption and improve efficiency by, for example, improving tax collection and ensuring that social welfare transfers reach their intended recipients with a minimum of leakage and administrative costs.

**Malaysia has achieved a high level of financial inclusion among the countries in the Findex database and compares favorably to its fellow ASEAN and OIC members and upper middle-income economies.**

The database contains nearly 800 indicators of engagement with financial systems. In this section, an illustrative sample of 8 indicators will be examined:

1) The percentage of respondents who either (a) report having an account (by themselves or together with someone else) at a bank or another type of formal, regulated financial institution, such as a credit union, a cooperative, or a microfinance institution, or (b) report personally using a mobile money service (not linked to a financial institution) in the past twelve months. This is an indicator of a threshold level of formal engagement with financial institutions. Accounts can provide a safe and convenient way to store money, build savings for the future, pay bills, access credit, make purchases, and send or receive remittances. The remaining indicators considered below illustrate specific examples of the usage of financial services.

2) The percentage of respondents who report receiving any money from an employer in the past twelve months, in the form of a salary or wages for doing work, directly into a financial institution account or into a card. Countries with higher levels of financial inclusion will tend to have populations that receive income through institutional channels rather than as cash payments.

3) Among respondents reporting receiving any money from an employer in the past twelve months in the form of a salary or wages for doing work, the percentage who report receiving this money directly into a financial institution account or into a card. Since not every adult is employed for pay, and employment can provide the means and need for engaging with the financial system, this metric looks at the method of receiving pay among those who did work.

4) The percentage of respondents who report saving or setting aside any money at a bank or another type of financial institution in the past twelve months. Saving money with an institution as opposed to keeping it at home (“under the mattress”) or in the form of livestock or jewelry indicates trust in the financial system and a willingness to invest through formal means.

5) The percentage of respondents who report having a debit card. This metric was used because having a debit card is an important sign that an individual is able to engage in formal payments.

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13 In the Findex methodology, “People using a mobile money account linked to their financial institution are considered to have an account at a financial institution.” Findex 2017, page 18. Furthermore, “Data on adults with an account at a financial institution also include respondents who reported having a debit card in their own name, … receiving wages, government transfers, a public sector pension, or payments for the sale of agricultural products into a financial institution account in the past 12 months; paying utility bills or school fees from a financial institution account in the past 12 months; or receiving wages or government transfers into a card (which is assumed either to be linked to an account or to support a card-based account) in the past 12 months.” The Findex database defines a formal financial institution to include “all types of financial institutions that offer deposit, checking, and savings accounts—including banks, credit unions, microfinance institutions, and post offices—and that fall under prudential regulation by a government body. The definition does not include nonbank financial institutions such as pension funds, retirement accounts, insurance companies, or equity holdings such as stocks.” Findex 2017, page 32, note 1.
6) The percentage of respondents who report having a credit card. This metric was used because, beyond having a debit card, having a credit card requires a deeper level of engagement with the financial system such that an account holder is deemed eligible for credit.

7) The percentage of respondents who report using a debit or credit card to make a purchase in the past twelve months. Consumer credit and non-cash forms of payment are a sign that financial inclusion has penetrated daily life, in a way beyond the more sporadic engagement with financial institutions that typifies long-term savings or the deposit of periodic paychecks; and

8) The percentage of respondents who report borrowing any money from a bank or another type of financial institution, or using a credit card, in the past twelve months. The extension of credit to consumers and small businesses is a sign of a financial market’s sophistication, as this activity often requires mechanisms for credit evaluation and debt servicing, and sometimes a secondary market for consumer loan assets that lenders wish to dispose of, to be in place.

The figure below summarizes Malaysia’s relative standing in financial inclusion across three comparison sets: ASEAN Member Countries, OIC Member Countries, and Upper Middle-Income Countries:

![Malaysia’s Financial Inclusion Compared with ASEAN, OIC, and Upper Middle-Income Countries](image)

As illustrated in the figure above, Malaysia compares favorably across all three comparison sets with its fellow ASEAN, OIC, and Upper Middle-Income countries. Across the eight metrics considered, Malaysia is above the 65th percentile and often exceeds the 80th percentile. It is thus consistently in the top quartile and never below the top third of its peer groups.

The proceeding discussion will address each of these comparison sets in further detail.
1.2.1 Malaysia and ASEAN Members

Data comparing Malaysia to ASEAN members will illustrate Malaysia’s leading position among its regional peer group when it comes to financial inclusion.

<table>
<thead>
<tr>
<th>Country</th>
<th>Have an Account</th>
<th>Wages Paid into Account or Card</th>
<th>Wages Paid into Account or Card, Among Wage Earners</th>
<th>Saved at a Financial Institution</th>
<th>Have a Debit Card</th>
<th>Have a Credit Card</th>
<th>Used a Debit or Credit Card</th>
<th>Borrowed from a Financial Institution</th>
<th>Have an Account and Made no Deposits or Withdrawals in the Past Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>22%</td>
<td>3%</td>
<td>10%</td>
<td>5%</td>
<td>7%</td>
<td>1%</td>
<td>27%</td>
<td>5%</td>
<td>14%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>49%</td>
<td>9%</td>
<td>24%</td>
<td>22%</td>
<td>31%</td>
<td>2%</td>
<td>12%</td>
<td>18%</td>
<td>15%</td>
</tr>
<tr>
<td>Laos</td>
<td>29%</td>
<td>5%</td>
<td>18%</td>
<td>18%</td>
<td>13%</td>
<td>1%</td>
<td>2%</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>85%</td>
<td>28%</td>
<td>72%</td>
<td>38%</td>
<td>74%</td>
<td>21%</td>
<td>39%</td>
<td>23%</td>
<td>16%</td>
</tr>
<tr>
<td>Myanmar</td>
<td>26%</td>
<td>2%</td>
<td>5%</td>
<td>8%</td>
<td>5%</td>
<td>0%</td>
<td>19%</td>
<td>10%</td>
<td>14%</td>
</tr>
<tr>
<td>Philippines</td>
<td>34%</td>
<td>11%</td>
<td>28%</td>
<td>12%</td>
<td>21%</td>
<td>2%</td>
<td>5%</td>
<td>11%</td>
<td>5%</td>
</tr>
<tr>
<td>Singapore</td>
<td>98%</td>
<td>57%</td>
<td>96%</td>
<td>67%</td>
<td>92%</td>
<td>49%</td>
<td>77%</td>
<td>47%</td>
<td>4%</td>
</tr>
<tr>
<td>Thailand</td>
<td>82%</td>
<td>18%</td>
<td>48%</td>
<td>39%</td>
<td>60%</td>
<td>10%</td>
<td>21%</td>
<td>20%</td>
<td>16%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>31%</td>
<td>10%</td>
<td>36%</td>
<td>14%</td>
<td>27%</td>
<td>4%</td>
<td>6%</td>
<td>22%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Several observations are pertinent here. The vast majority of Malaysian adults, or 85%, have an account with a financial institution or used a mobile money service in the past twelve months. This is close to the figure for Singapore, a densely settled city-state that is an international banking center with an extremely high level of economic development, and far exceeds the figures for most of Malaysia’s neighboring countries. Malaysia is also second only to Singapore, and significantly ahead of other ASEAN members, in having salary and wage payments channeled through financial institutions and in having a populace with access to, and willingness to undertake, card-based payments.

Where Malaysia is in the middle of the pack among its regional peers is in the realm of saving at, and borrowing from, financial institutions. Some 38% of Malaysian adults reported saving at a financial institution, a figure comparable to the 39% for Thailand, a country with a materially lower level of economic development and per capita income, and not much higher than the 22% for Indonesia, a much less developed country that the World Bank classifies as “lower middle income” (as opposed to “upper middle income” for Malaysia and Thailand). In addition, Malaysians report borrowing or using a credit card at around the

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14 In tables in this chapter, blank cells indicate that the Findex database did not have data for the given country on the relevant metric.
same rate as people in many nations much less developed than Malaysia: Cambodia, Indonesia, Myanmar, Thailand, and Vietnam.  

Further, it is noted that Malaysia (along with Thailand) has the highest percentage (16%) of respondents reporting that they have an account but have not made a deposit or withdrawal in the past year. Earlier, it was noted that up to 30% of respondents in Malaysia may have accounts but only be using them for savings because they have not made any withdrawals in the past year. These data suggest that a meaningful segment of the population may be included in the financial system but also be relatively under-engaged in it. Having an account but rarely using it may suggest that the account holder has been included in the formal financial system but is not regularly availing of its benefits for payments, savings, investments, and credit. As four ASEAN countries (Malaysia, Thailand, Indonesia, and Myanmar) report 10% or more of respondents having an account but no recent deposits or withdrawals, the challenge of under-engagement may be common across the region. It may likely be that, in these four countries, at least 10% of account holders reap only limited benefits of being part of the formal financial system.

Overall, however, the ASEAN data support the conclusion that Malaysia has achieved a relatively high level of financial inclusion. It ranked in second place on 6 of the 8 metrics, behind high-income Singapore, and a close third place on the other two metrics (saving at and borrowing from a financial institution).

1.2.2 Malaysia and OIC Members

Data comparing Malaysia to OIC member states paint a similar portrait, as the following table shows.

<table>
<thead>
<tr>
<th>Country</th>
<th>Have an Account</th>
<th>Wages Paid into Account or Card</th>
<th>Wages Paid into Account or Card, Among Wage Earners</th>
<th>Saved at a Financial Institution</th>
<th>Have a Debit Card</th>
<th>Have a Credit Card</th>
<th>Used a Debit or Credit Card</th>
<th>Borrowed from a Financial Institution</th>
<th>Have an Account and Made no Deposits or Withdrawals in the Past Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Afghanistan</td>
<td>15%</td>
<td>6%</td>
<td>34%</td>
<td>4%</td>
<td>3%</td>
<td>1%</td>
<td>4%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Albania</td>
<td>40%</td>
<td>16%</td>
<td>66%</td>
<td>9%</td>
<td>27%</td>
<td>8%</td>
<td>8%</td>
<td>13%</td>
<td>7%</td>
</tr>
<tr>
<td>Algeria</td>
<td>43%</td>
<td>8%</td>
<td>46%</td>
<td>11%</td>
<td>20%</td>
<td>3%</td>
<td>5%</td>
<td>5%</td>
<td>14%</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>29%</td>
<td>13%</td>
<td>43%</td>
<td>5%</td>
<td>25%</td>
<td>5%</td>
<td>7%</td>
<td>15%</td>
<td>2%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>83%</td>
<td>50%</td>
<td>75%</td>
<td>31%</td>
<td>80%</td>
<td>30%</td>
<td>61%</td>
<td>36%</td>
<td>5%</td>
</tr>
</tbody>
</table>

15 It should be noted that in two of these five nations, Cambodia and Myanmar, penetration of debit and credit cards is extremely low. The borrowing percentage that is reported for these nations is likely a result of underwritten loans rather than credit lines consumers on plastic carry around with them. If these somewhat anomalous data points are excluded, Malaysia ranks similarly to its middle-income ASEAN peers.
## Chapter 1: Evolution of Islamic Financial Inclusion in Malaysia

<table>
<thead>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>50%</td>
<td>3%</td>
<td>22%</td>
<td>10%</td>
<td>6%</td>
<td>0%</td>
<td>9%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Benin</td>
<td>38%</td>
<td>6%</td>
<td>36%</td>
<td>10%</td>
<td>11%</td>
<td>6%</td>
<td>6%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>43%</td>
<td>5%</td>
<td>30%</td>
<td>12%</td>
<td>12%</td>
<td>5%</td>
<td>4%</td>
<td>10%</td>
<td>3%</td>
</tr>
<tr>
<td>Cameroon</td>
<td>35%</td>
<td>5%</td>
<td>25%</td>
<td>11%</td>
<td>11%</td>
<td>3%</td>
<td>3%</td>
<td>8%</td>
<td>7%</td>
</tr>
<tr>
<td>Chad</td>
<td>22%</td>
<td>3%</td>
<td>23%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>4%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Cote d’Ivoire</td>
<td>41%</td>
<td>3%</td>
<td>20%</td>
<td>6%</td>
<td>7%</td>
<td>1%</td>
<td>3%</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>33%</td>
<td>10%</td>
<td>33%</td>
<td>6%</td>
<td>25%</td>
<td>3%</td>
<td>4%</td>
<td>9%</td>
<td>7%</td>
</tr>
<tr>
<td>Gabon</td>
<td>59%</td>
<td>9%</td>
<td>27%</td>
<td>13%</td>
<td>16%</td>
<td>6%</td>
<td>8%</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>Guinea</td>
<td>23%</td>
<td>3%</td>
<td>23%</td>
<td>6%</td>
<td>7%</td>
<td>3%</td>
<td>6%</td>
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Of the 43 OIC nations (out of 57) for which the Findex database has 2017 data on the metrics examined here, Malaysia ranks no lower than seventh on any metric. These metrics were wages being paid into an account or a card, use of a debit or credit card to make a purchase, and having borrowed or used a credit card. On all 3 of these metrics, Malaysia was bested by several wealthy Persian Gulf countries with large expatriate worker populations that typically need to access the financial system in order to send remittances to their home countries. If the special circumstances of these nations are taken into account, Malaysia ranks even more highly.

On the other 5 metrics examined, Malaysia was ranked in or near the top decile among OIC members. For example, it was first out of all OIC members in the percentage of adults who saved at a financial institution; the next three spots were held by high-income countries. It was also in third place in the percentage of adults with a financial account or usage of a mobile money service in the past twelve months, bested only slightly by Iran and the highly developed UAE. It likewise was near the top in debit- and credit-card penetration rates, again outdone chiefly by wealthy Middle Eastern oil exporters.

1.2.3 Malaysia and Upper Middle-Income Countries

A final peer group comparison is made with Malaysia’s fellow upper middle-income countries. In the calendar year 2016, the World Bank classified an economy as upper middle income if its gross national income per capita, calculated under the World Bank’s methodology, was between $3,956 and $12,235. The 2017 Findex database contains data for 38 such countries, as follows.

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<th>Wages Paid into Account or Card</th>
<th>Wages Paid into Account or Card, Among Wage Earners</th>
<th>Saved at a Financial Institution</th>
<th>Have a Debit Card</th>
<th>Have a Credit Card</th>
<th>Used a Debit or Credit Card</th>
<th>Borrowed from a Financial Institution</th>
<th>Have an Account and Made no Deposits or Withdrawals in the Past Year</th>
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16 The World Bank uses the “Atlas method” instead of simple exchange rates to convert each country’s income figures to U.S. dollars. The objective of this method is “to reduce the impact of exchange rate fluctuations in the cross-country comparison of national incomes.” For more, see https://datahelpdesk.worldbank.org/knowledgebase/articles/378832-what-is-the-world-bank-atlas-method.
### Chapter 1: Evolution of Islamic Financial Inclusion in Malaysia

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Malaysia again scores impressively compared to its global peers at similar levels of economic development. On each of the 8 metrics of financial inclusion discussed in this section, Malaysia is above the global average for upper middle-income countries. On half of the 8 metrics, Malaysia is in the top 7 among 38 nations. Particularly notable are its second-place showing in the percentage of adults who save at a financial institution, third-place showing in debit card ownership, and fourth-place showing in the percentage of adults who have a financial institution account (the most fundamental measure of financial inclusion).

Malaysia's lowest ranking was fourteenth, on the percentage of people who received wages into a financial institution account, although even here its outcome of 28% was substantially better than the peer group average of 19%. Several countries which outrank Malaysia in this metric, including Belarus, Kazakhstan, Russia, and Turkmenistan, are Former Soviet Union (FSU) countries.

1.2.4 Additional Data on Malaysia

Data from the Malaysian central bank, Bank Negara Malaysia (BNM), corroborate the conclusion drawn from the World Bank’s Findex database that Malaysia has achieved a high level of financial inclusion. For example, BNM reports that as of 2019, some 96% of adults had at least one type of regulated deposit account, enabling them to save, withdraw money, access automated teller machines, and make payments by electronic means nationwide. The BNM figure for regulated deposit accounts is comparable to the 85% figure given by the Findex database for possession of a financial account or usage of a mobile money service in 2017. Moreover, the BNM figure of 96% for 2019 was improved from the already high level of 87% as of the end of 2011. In addition, Malaysia averaged over 3 deposit accounts per adult, likely a sign of the presence of “power users” within the financial system who have multiple accounts for specialized purposes. Furthermore, 40% of Malaysian adults, according to BNM data for 2019, had at least one type of regulated credit account, and the number of loan accounts per adult in that year was just over 0.8. Both metrics indicate widespread access to leverage and a willingness to use the financial system as a force multiplier for capital.17

Despite the advanced state of financial inclusion in Malaysia, an academic survey conducted by scholars at Universiti Putra Malaysia and Universiti Teknologi MARA published in 2018 entitled “A Preliminary Evaluation of Financial Literacy in Malaysia” found that Malaysians are “not fully equipped with sufficient financial knowledge to make informed decisions regarding their financial affairs.” The survey covered key personal finance matters such as cash flow management, credit management, savings and investment, retirement planning, risk management, Islamic financial products, estate planning, and financial institutions. The Malaysian government acknowledges that work remains to be done in this regard, and is undertaking efforts to further boost financial literacy and promote financial inclusion. In 2019, a group of Malaysian government agencies led by BNM and the SC issued the “National Strategy for Financial Literacy 2019-2023.” This initiative aims to educate Malaysians on topics such as

budgeting, spending, saving, investing, and guarding against financial fraud and abuse. Its priorities include expanding financial education for elementary and secondary school children, increasing access to financial management information, boosting long-term financial and retirement planning, and encouraging Malaysians to build and safeguard their wealth. All of these objectives should promote greater usage of the formal financial system, thereby increasing financial inclusion.

1.3 Malaysia as a Global Leader in Islamic Finance

Malaysia is a global leader in Islamic finance. The overall breadth and depth of Malaysia’s Islamic finance ecosystem is among the best in the world, from the number and variety of its Islamic financial institutions, their profitability and resilience, to its sophisticated regulatory system for Islamic finance. Other key characteristics of the Malaysian market include innovation to meet market demands and embrace technological developments, and industry leadership in Islamic finance, which has influence worldwide. Both quantitative and qualitative measures of Malaysia’s Islamic finance leadership will be illustrated below.

This section will principally rely on two sources of data and observations; other sources will be cited where appropriate. First, the IFDR is a leading source for the current state of the Islamic finance industry, encompassing data from over one hundred countries worldwide and current as of the end of 2018. The IFDR is produced by Refinitiv, a global provider of financial markets data and risk assessment tools. Refinitiv was formerly part of Thomson Reuters, the multinational news and media conglomerate. The ICD, a branch of the Islamic Development Bank Group, assists in the preparation of this report.

Second, the IFSISR covers in detail 3 key sectors of Islamic finance: Islamic banking, Islamic capital markets (which includes sukuk and Islamic funds), and takaful. The IFSISR covers the size and resilience of recent developments in, and regulations affecting these sectors, embracing several dozen jurisdictions worldwide that account for nearly all global activity in Islamic finance. The IFSISR is published by the IFSB, an international standard-setting organization based in Malaysia whose members include regulatory and supervisory authorities, intergovernmental organizations (including the World Bank), and private-sector participants in the Islamic financial industry (including financial institutions, professional services firms, and industry bodies), which collectively operate in 57 jurisdictions. The IFSB’s stated aim is to “promote and enhance the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.”

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23 IFSISR 2019, “About the Islamic Financial Services Board (IFSB).”
The 2019 edition of the IFDR summarizes the state of the Islamic finance industry in 131 countries, which collectively have nearly fifteen hundred Islamic financial institutions and Islamic finance assets of over $2.5 trillion. The IFDR's key country-level metric is known as the IFDI. Based solely on data obtained from public sources, the IFDI is a single number that measures the development of the Islamic finance industry in a given country by weighting 5 key factors, each of which has a number of sub-factors:

1) Quantitative development, covering the size and performance of Islamic banks, takaful, Islamic financial institutions other than banks and takaful operators (such as investment companies, lessors, and microfinance institutions), sukuk, and Islamic funds;

2) Knowledge, covering the number of educational institutions offering courses, qualifications, or degrees on Islamic finance, and the number of research papers and peer-reviewed journal articles produced by such institutions;

3) Governance, covering the regulatory landscape applicable to Islamic finance, shari’ah governance, and corporate governance in general;

4) CSR, covering the amount of CSR funds (such as charity and interest-free loans) disbursed and disclosure on eleven different CSR activities; and

5) Awareness, measured by the number of seminars, conferences, and news items on Islamic finance.
Malaysia topped all countries covered in the 2019 edition of the IFDR, with an IFDI score of 115 (the maximum was 200). This was well ahead of the IFDI value of 71 for the second-place finisher, Bahrain, which in turn was closely followed by a cluster of seven countries that achieved scores of between 50 and 70. Malaysia also ranked first among all nations in 4 sub-indicators: quantitative development, knowledge, governance, and awareness. It lagged only in CSR, where it placed eleventh, good for the top decile among 131 countries.

1.3.1 Quantitative Measures of Malaysia’s Islamic Finance Leadership

Malaysia’s Islamic finance assets of $521 billion ranked third globally, close behind 2 nations with much larger Muslim populations than Malaysia’s approximately 20 million: Iran (575 billion assets, 80 million Muslims) and Saudi Arabia (541 billion, 30 million). Malaysia’s performance in the 5 sub-segments of the Islamic finance market tracked by the IFDR is noteworthy at every turn. This is summarized in the table below.

<table>
<thead>
<tr>
<th>Islamic Finance Sector</th>
<th>Malaysia Assets</th>
<th>Malaysia Global Rank by Assets</th>
<th>Malaysia Assets, Share of World Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$521 billion</td>
<td>3</td>
<td>20.6%</td>
</tr>
<tr>
<td>Banking</td>
<td>$214 billion</td>
<td>3</td>
<td>12.2%</td>
</tr>
<tr>
<td>Takaful</td>
<td>$9 billion</td>
<td>3</td>
<td>19.6%</td>
</tr>
<tr>
<td>Other financial institutions</td>
<td>$52 billion</td>
<td>1</td>
<td>37.1%</td>
</tr>
<tr>
<td>Sukuk</td>
<td>$219 billion</td>
<td>1</td>
<td>46.6%</td>
</tr>
<tr>
<td>Funds</td>
<td>$27 billion</td>
<td>2</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

A discussion of these data points will illustrate Malaysia’s global leadership in Islamic finance. The IFDR reports that Malaysia had 38 Islamic banks (including windows) in 2018, a close second in the world behind Iran with 42, and its Islamic banking assets of $214 billion were good for third place worldwide behind Iran and Saudi Arabia and amounted to roughly one-eighth of all Islamic banking assets worldwide. The IFSISR paints a similar portrait, reporting that within Malaysia, over a quarter of banking assets are Islamic, representing a domestic market share that is sixth highest in the world. This high degree of penetration has led the IFSB to classify Islamic finance as systemically important in Malaysia, making it one of 12 countries where Islamic finance has this designation. It is notable that Malaysia’s Islamic banking sector caters mainly

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24 This is inclusive of all assets in Iran’s financial system on the assumption that the entire country adheres to a fully shari’ah compliant system.

25 IFSISR 2019, page 10-11. In Iran and Sudan, the market share in 2018 was 100%. Rounding out the top five ahead of Malaysia were Brunei (64%), Saudi Arabia (52%), and Kuwait (41%). The Malaysian figure stood at 26.5%. This figure covered only Islamic banks regulated by the Malaysian central bank. When “development financial institutions” regulated by the Malaysian Finance Ministry are included, the domestic market share for Islamic finance rises to almost 30%.
to households (as opposed to financing of businesses). Personal borrowers received 58% of the Islamic financing in existence in Malaysia in 2018, the highest percentage among 9 countries examined on this metric in the IFSISR, indicating broad penetration of the industry throughout society.\(^{26}\) Malaysia’s Islamic banking sector is also rather healthy, recording, year after year, a return on equity typically in the low teens and enjoying a ratio of non-performing financing to total financing of under 2%.\(^{27}\)

The IFDR notes that Malaysia likewise had the third largest takaful market in the world by value, with total assets of $9 billion (nearly 20% of the total across all IFDR countries) spread over 20 takaful operators. Over 18% of the total premiums collected in the Malaysian insurance industry in 2018 were from takaful contributions.\(^{28}\) Furthermore, Malaysia led all nations in assets managed by other Islamic financial institutions, at $52 billion across 24 such institutions, good for 37% of the world total by asset value. This sector consists of Islamic financial institutions that are not Islamic banks or takaful companies. For example, financing, mortgage, leasing, and factoring companies are included in this category.\(^{29}\)

In the sukuk market, Malaysia’s status is particularly impressive, with the IFDR reporting that Malaysia accounted for 47% of the world’s sukuk value outstanding in 2018 ($219 billion out of $470 billion) and 74% of the number of sukuk outstanding (2,136 out of 2,887). Compared to distant second-place finisher Saudi Arabia, Malaysia has more than double the amount of sukuk by value and more than 10 times the number of sukuk contracts outstanding. Malaysia was the largest sovereign issuer of sukuk as well as home to the largest corporate sukuk issuances, with a 33% and 40% share of the global market in 2018.\(^{30}\) The Malaysian securities regulator has announced a plan to open sukuk markets to retail investors, promoting a virtuous cycle of greater investor demand encouraging more sukuk issuances, and a deeper sukuk market drawing in more potential investors. Malaysia was also home to the world’s first “green sukuk” issuance, when a renewable energy company originated a sukuk in 2017. Malaysia has provided official support for green sukuk, including by allowing the tax deductibility of issuance costs, tax exemptions for investors, and grants to issuers to fund external review fees.\(^{31}\)

Finally, in Islamic funds, a category that includes shari‘ah-compliant mutual funds, exchange-traded funds, insurance funds, and pension funds, Malaysia is in second place globally in the value of outstanding Islamic funds ($27 billion), accounting for a quarter of the global assets under management by such funds, and in first place by number of funds (425).

### 1.3.2 Qualitative Measures of Malaysia’s Islamic Finance Leadership

From a qualitative perspective, too, Malaysia emerges as a global leader in Islamic finance. This is evident on a number of fronts: regulation and governance, including official support for the development of the Islamic finance industry; the range and scope of Islamic financial institutions; technological developments; and education and industry conferences.

\(^{26}\) IFSISR 2019, page 62.
\(^{27}\) IFSISR 2019, pages 58, 65.
\(^{28}\) IFSISR 2019, page 30.
\(^{29}\) IFDR 2019, page 36.
\(^{30}\) IFSISR 2019, pages 19-20. It should be noted that much sukuk is issued in local currency and targets the domestic rather than international market.
\(^{31}\) IFSISR 2019, page 20; IFDR 2019, page 42.
Chapter 1: Evolution of Islamic Financial Inclusion in Malaysia

For example, Malaysia enjoys an advanced regulatory system with centralized governance on Islamic finance matters. Malaysia has a comprehensive Islamic finance regulatory framework that covers all six sectors of the industry: accounting, Islamic banking, shari’ah governance, takaful, sukuk, and Islamic funds. Malaysia is one of only 6 countries in this position; the other 38 countries that have some Islamic finance regulation fail to cover one or more of these 6 segments of the industry.\(^{32}\)

Malaysia also leads the world in the number of shari’ah scholars (192) and is in third place in the number of Islamic finance institutions that have at least 3 shari’ah scholars (50), close behind Kuwait and Saudi Arabia at 55 and 54 respectively. The latter measure is an indicator of the sophistication of a country’s shari’ah governance at the financial institution level, as a board with more members can benefit from multiple sources of expertise and experience. In addition, decisions made by a larger, deliberative board are more likely to be carefully considered than those made in isolation by one or two scholars acting alone.

The Malaysian government and central bank have taken an active role in supporting and regulating the Islamic finance industry in Malaysia. In 1997, the Malaysian central bank established a council of scholars\(^{33}\) (the Shari’ah Advisory Council, or SAC) to advise it on Islamic religious law matters relating to Islamic finance.\(^{34}\) Over 100 resolutions of the SAC, along with supporting reasoning, have been published online, on topics as diverse as financing techniques, insurance, Islamic legal concepts relevant to finance, financial products, institutional support for financial systems (e.g., deposit insurance), accounting issues, and other matters. Under a Malaysian law enacted in 2009, the SAC is the sole authoritative body on Islamic legal matters relating to finance in Malaysia. Its resolutions are binding on all Islamic financial institutions, courts, and arbitrators in Malaysia. This law was recently confirmed by the Federal Court of Malaysia, the highest court in the country, which ruled in April 2019 that the SAC’s decisions can bind civil courts even though the SAC is not a judicial body. The Federal Court’s decision ensures that dispute resolution in Malaysia, whether conducted through the courts or by arbitration, can occur under a single set of principles and interpretations of Islamic law.\(^{35}\)

The discussion in the previous sub-section (“Quantitative Measures of Malaysia’s Islamic Finance Leadership”) highlighted the range and number of Islamic financial institutions present in Malaysia, from numerous banks and asset managers to takaful companies and sukuk issuers. One unique aspect of Malaysia’s Islamic finance landscape is the TH.\(^{36}\) The latter is a statutory body created by the Malaysian federal government in 1963 that enables Malaysians to save and invest for Hajj, the pilgrimage to Makkah required once in a lifetime for Muslims. The pilgrimage is sometimes called “the journey of a lifetime,” and many people save for years or decades to amass the necessary funds. TH has more than 9 million depositors in Malaysia, and one of TH’s objectives is to invest deposited funds in a manner permitted by Islam and with a competitive return.

TH is but one example of the policy efforts undertaken by the Malaysian government to enhance financial inclusion. BNM has also promoted a multi-bank platform known as the IAP,\(^{37}\) which enables the

\(^{32}\) IFDR 2019, page 52.
\(^{33}\) See section 2.1 in chapter 2.
\(^{35}\) IFDR 2019, page 51.
\(^{36}\) See section 3.8.1 in chapter 3.
\(^{37}\) See section 3.9 in chapter 3.
funding of projects through investment accounts at member banks. Individual, corporate, and institutional investors can fund shari’ah-compliant investment accounts held at participating Islamic banks, which use such funds to facilitate the financing of business ventures. The banks are responsible for typical banking and investment management functions, such as providing disclosures to account holders, conducting a suitability assessment on individual investors, performing due diligence, and monitoring a financed party’s use of funds.\footnote{38}

The Islamic finance industry in Malaysia has embraced and been responsive to technological innovation in myriad ways.\footnote{39} For example, Malaysia has seen the first use in the world of a blockchain crowdfunding platform to address waqf funding and information. This platform allows waqf boards and corporations that desire to improve their CSR disclosure to publish the details of the projects that they would like to fund, and then allows an organization (which could be an Islamic financial institution whose core competency is in a non-waqf area of finance) that sets up a waqf to source donations, fund projects, and keep donors informed about the use of their funds. Shari’ah scholars in Malaysia have also discussed Islamic rulings related to cryptocurrencies, and government regulators are considering regulations related to coin offerings and digital asset exchanges.\footnote{40}

In 2016, the Malaysian central bank established the FTEG\footnote{41} with the stated aim of “formulating and enhancing regulatory policies to facilitate the adoption of technological innovations in the Malaysian financial services industry.” Among the FTEG’s initiatives is a “regulatory sandbox” whereby a financial institution can experiment with a financial technology innovation in a live environment, without running afoul of laws or regulations designed for the status quo.\footnote{42}

In 2019, Malaysia made progress on regulating takaful “aggregators” (essentially, insurance brokers that provide platforms to enable potential customers to compare prices and purchase insurance policies). Some takaful operators in Malaysia also accept online payment systems that provide shari’ah-compliant payment options to policyholders.\footnote{43}

A fourth qualitative dimension of Malaysia’s leadership in the Islamic finance industry revolves around education and industry bodies. Malaysia has the third-highest number of Islamic finance education providers in the world, at 62 institutions, close behind the UK’s 72 and neighboring Indonesia’s 355. Malaysia was also second globally in the number of Islamic finance degree providers, with such 39 institutions, bested only by neighboring Indonesia (186), whose Muslim population is over ten times larger. Moreover, Malaysia is in first place in the number of English-language Islamic finance research papers and peer-reviewed journal articles published between 2016 and 2018, and Malaysia was the most commonly covered country in Islamic finance research papers published in 2018.\footnote{44} Malaysia was also a pioneer in establishing INCEIF,
a university focused on Islamic finance that was formed in 2005 and granted university status in 2006. Malaysia’s leadership in research and scholarship has also enabled it to produce in-depth publications on the development of its Islamic finance sector, such as the volume *Islamic Finance in Malaysia* (Abdul Karim, 2017).

Malaysia led all countries in the number of Islamic finance events conducted in 2018, hosting approximately 20% of the Islamic finance conferences and seminars that occurred that year. Malaysia was also in the top 5 nations in the number of Islamic finance news items published in 2018. Among the gatherings that occur in Malaysia are the Global Islamic Finance Forum, the World Islamic Economic Forum (alternating with non-Malaysian locations), and the SC-OCIS Roundtable on Islamic Finance, a joint conference held by the SC and the Oxford Centre for Islamic Studies (alternating between Malaysia and the UK).

Finally, Malaysia is home to the IFSB, which, as noted earlier, sets and recommends regulatory standards for the Islamic finance worldwide, on key topics such as risk management, capital adequacy, corporate governance, and stress testing. Among the more prominent members of the IFSB are the central banks of China, Iran, Malaysia itself, Saudi Arabia, Singapore, the UAE, and the UK; the Dubai Financial Services Authority; the International Monetary Fund and the World Bank; and large Islamic financial institutions from throughout the world.

### 1.4 The Role of Islamic Finance in Promoting Financial Inclusion

In principle, Islamic finance should promote financial inclusion, through the removal of religious barriers, the sharing of risk, and social finance. This section will explore each dimension in which Islamic finance can increase access to and use of formal financial services.

#### 1.4.1 Removal of Religious Barriers

The Findex database reports the percentage of adults in each country covered who do not have a financial account. It also reports the percentage of non-account holders who do not have a financial account due to religious reasons. From these 2 metrics, one can derive the percentage of all adults in a given country who remain outside the financial system on religious grounds. The table below presents this data for selected OIC members: the 2 nations with the highest and lowest figures, Malaysia, and 7 other OIC members with large populations.

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47 IFDR 2019, page 64.
Table 5: No Financial Account Due to Religious Reasons, Selected OIC Members

<table>
<thead>
<tr>
<th>Country</th>
<th>No Financial Institution Account Due to Religious Reasons</th>
<th>OIC Rank (out of 42)</th>
<th>Estimated Number of Adults Without Financial Institution Account Due to Religious Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Niger</td>
<td>17.9%</td>
<td>42</td>
<td>1.5 million</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>13.9%</td>
<td>41</td>
<td>2.0 million</td>
</tr>
<tr>
<td>Pakistan</td>
<td>10.3%</td>
<td>39</td>
<td>13.9 million</td>
</tr>
<tr>
<td>Turkey</td>
<td>6.1%</td>
<td>30</td>
<td>3.5 million</td>
</tr>
<tr>
<td>Egypt</td>
<td>3.1%</td>
<td>18</td>
<td>1.8 million</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.7%</td>
<td>15</td>
<td>4.9 million</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>2.5%</td>
<td>14</td>
<td>2.9 million</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2.0%</td>
<td>10</td>
<td>0.5 million</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1.6%</td>
<td>9</td>
<td>0.4 million</td>
</tr>
<tr>
<td>Nigeria</td>
<td>1.5%</td>
<td>6</td>
<td>1.5 million</td>
</tr>
<tr>
<td>UAE</td>
<td>0.7%</td>
<td>2</td>
<td>&lt; 0.1 million</td>
</tr>
<tr>
<td>Kuwait</td>
<td>0.5%</td>
<td>1</td>
<td>&lt; 0.1 million</td>
</tr>
</tbody>
</table>

Only 1.6% of all Malaysian adults are excluded from the formal financial system due to self-reported religious reasons. This figure is extremely low on an absolute basis, and Malaysia is ninth on this metric, putting it in the top quartile, among the 42 OIC countries for which data are available. It is also below the same figure for Saudi Arabia (2.0%), around half the proportion of Egyptian adults who remain unbanked on religious grounds (3.1%), and less than one-sixth the measure for Pakistan (10.3%). The only major countries where a smaller fraction of adults lacks a financial institution account for religious reasons are Nigeria, where only half the population is Muslim, and the UAE and Kuwait, which are very wealthy countries with highly developed Islamic finance sectors.

The absolute number of people excluded from the formal financial system in these 12 nations because of religious concerns is considerable. The World Bank publishes estimates of the population of these countries as well as of the percentage of the population that is 15 and older. From these figures and the percentages in the table above for adults who are outside the formal financial system due to religious reasons, one can deduce that approximately 33 million adults across these nations are potential candidates for financial inclusion through a form of finance to which they would not object on religious

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48 For Iran, no figure is available for the percentage of non-account holders who do not have an account for religious reasons. Since only 6% of the entire population is without a financial account, and Islamic finance plays a significant role in the Iranian financial system, the percentage of the entire population that remains outside the financial system on religious grounds is likely very small. Nonetheless, in the absence of hard data, Iran is not included in the discussion in this section.

49 See https://data.worldbank.org/indicator/SP.POP.TOTL (total population) and https://data.worldbank.org/indicator/SP.POP.0014.TO.ZS (child percentage of population, from which the adult percentage can be derived).
grounds. The largest numbers of excluded adults appear to be in Pakistan, Indonesia, and Turkey, where nearly 14 million, 5 million, and 4 million adults, respectively, do not have a financial account on religious grounds.

In Malaysia, only approximately 400,000 adults fall into the category of adults excluded from the financial system on self-reported religious grounds. Given the multifaith nature of Malaysian society, one open question is whether all of these adults are Muslim. Global data indicate that people sometimes have religious objections to the financial system even if they are not Muslim; for example, in Botswana and Peru (both of whose Muslim populations are under 1% of the total population), around 8-9% of the total adult population lacks a financial account due to religious reasons.

Across the OIC nations examined, however, it appears that Islamic finance can play a considerable role in promoting financial inclusion. Whether the issue is a lack of a well-developed Islamic finance sector, access to Islamic financial institutions, awareness of such institutions, trust in the religious adequacy of such institutions, or simply some other reason, would also be a useful topic to explore in depth. Malaysia’s development of a sophisticated Islamic finance sector may explain its strong performance relative to other OIC countries in reducing religious barriers to financial inclusion.
1.4.2 Sharing of Risk

Risk-sharing has been identified by Mirakhor and others as a central feature of Islamic finance. Risk-sharing has been defined as a “substitute to risk transfer and risk shifting in promoting financial stability, sustainable growth and equitable sharing of prosperity.” Proponents of the concept see conventional finance as transferring risk from lenders to borrowers, increasing instability and inequity. They call for asset-based financing as a more stable and fair form of finance.

In a 2012 document known as the Kuala Lumpur Declaration, a set of leading scholars convened by ISRA, IRTI, and the University of Durham declared risk-sharing to be “a salient characteristic of Islamic financial transactions,” and further asserted a “principle that liability is inseparable from the right to profit.” The Declaration called on governments and other stakeholders to adopt more genuine forms of risk-sharing in the Islamic finance sector.

In principle, Islamic financiers make decisions based on the value of assets and projects, rather than the creditworthiness of the borrower. In theory, this focus on assets rather than an individual credit history should enhance financial inclusion because a lender’s decision would be based on the value of the asset and not the wealth of the borrower. The financing would be collateralized by the asset without, in principle, recourse to the other assets of the borrower. This approach differs from unsecured personal lending in a conventional context, for which an individual’s credit history is the sole consideration. Each of the core Islamic finance contracts introduces an element of risk-sharing that shifts a financing party’s focus away from the individual and toward the project being financed:

1) Murabaha: The financier takes ownership of an asset (even if briefly) prior to reselling it to the client. The sale contract discloses the financier’s cost and profit margin.

2) Ijara: The financier leases the asset to the client, maintaining ownership of the asset for the duration of the lease and possibly beyond.

3) Mudaraba: The financier and the client form a joint venture, with the former taking investment or performance risk and the latter responsible for managing the project. Profits are shared between the parties, while losses are borne entirely by the financier.

4) Istisna’a: The financier takes risk on the client’s ability to deliver the asset or complete the service. For example, a business that wishes to renovate its offices agrees to engage an Islamic bank to do so,

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53 See section 2.1 in chapter 2.
55 Ibid., page 3.
56 Ibid., page 24.
and the bank finds a contractor (which is its client here) to complete the work. The spread between what the bank receives from the business and what it pays to the contractor represents its profit and is subject to the risk that the contractor will not perform.\footnote{Ibid., page 21.}

5) Musharaka: The financier (as well as the client) takes equity risk. Both parties contribute capital, with profits shared based on an agreed ratio and losses shared based on capital contributions.\footnote{Ibid., page 40.}

All of these contracts involve an asset, service, or business venture of some kind.\footnote{Note that the Kuala Lumpur Declaration states that risk-sharing “is not only exemplified in equity-based contracts like musharakah and mudarabah, but even in exchange contracts, such as sales and leasing, whereby risk is shared by virtue of possession.”}

1.4.3 Social Finance\footnote{See section 2.5 in chapter 2 and section 3.10 in chapter 3.}

“Islamic social finance” refers to financing methods that are intended for social benefit. Examples include zakat (alms), sadaqah (charity), qard al-hasan (interest-free loans), and waqf (plural awqaf, endowments). Zakat is also widely practiced, for example, while the Findex database reports that only about one-third of Egyptian adults and about half of Indonesian adults have an account with a financial institution, about 70% of Muslims in Egypt and 98% of Muslims in Indonesia report giving zakat.\footnote{Aamir A. Rehman. “Islamic finance for social good: Sustainable development in Islamic social finance.” United Nations Development Programme. Blog post, January 23, 2019. Available at: https://www.undp.org/content/undp/en/home/blog/2019/IFN_ANNUAL_GUIDE_2019_Islamic_Social_Finance.html; Aamir A. Rehman and Francine Pickup. “Zakat for the SDGs.” United Nations Development Programme. Blog post, September 7, 2018. Available at https://www.undp.org/content/undp/en/home/blog/2018/zakat-for-the-sdgs.html.}

Zakat promotes financial inclusion by requiring the wealthy to give annual alms to those in need. Importantly, zakat has traditionally been a direct transfer of cash or goods to the recipient (rather than providing a service to the recipient). Thus, the cash or goods become the property of the recipient, allowing them to participate—even in a modest way—in the financial economy. This is an important way in which zakat may more directly enhance financial inclusion than other forms of philanthropy that do not entail cash transfers. Although providing charity is not conventionally seen as financial inclusion, zakat may often be a notable exception when it entails cash transfers and involves establishing bank accounts or other formal means to receive and use the funds. Unlike charitable giving through a food bank, for example, zakat generally involves giving cash to the recipient which often is deposited in a bank account with a formal financial institution. Sadaqah often serves a similar function.

Awqaf endowments may be established for any charitable purpose. Awqaf have traditionally been in the form of real estate, with land and buildings used for charitable purposes such as education, feeding the poor, or providing religious services. Awqaf can, however, also be used for more direct methods of financial inclusion such as (a) making cash payments to needy individuals from the proceeds of the endowment or
(b) providing means of livelihood such as land, livestock, or equipment through which beneficiaries may participate in the financial economy.

1.5 Barriers to Financial Inclusion

The sections above have shown how Malaysia is a leader in both financial inclusion and Islamic finance and have explained how the presence of Islamic finance and the development of Islamic financial products can promote financial inclusion in Malaysia. Despite the thriving status of Islamic finance in Malaysia, real or perceived religious barriers to financial inclusion still exist. The proportion of Muslims in Malaysia who have voluntarily shunned formal banking activities because of their religious beliefs is low, but not zero. Malaysians without a financial account are more likely to cite other reasons, however, for a lack of financial inclusion.

The Findex database contains survey results for 8 potential reasons cited for not having an account with a financial institution. Respondents could cite more than 1 reason, other than the eighth reason (lack of need for formal financial services), which could be cited only if it was the sole reason. The sum of the first 7 reasons for a given country can, therefore, add up to more than 100%. Data is available on the percentage of respondents without a financial institution account who report not having one:

1) For religious reasons;
2) Because financial institutions are too far away;
3) Because financial services are too expensive;
4) Because they lack the documentation needed to open one, such as an identity card, a wage slip, or the like;
5) Because they do not trust financial institutions;
6) Because they do not have enough money to use a financial institution account;
7) Because someone else in their family already has an account; or
8) Only because they have no need for formal financial services (this reason could not be given in conjunction with another).

Data is available for all such reasons for all ASEAN and OIC countries examined in this section, except for Singapore and Iran, where the percentage of people without a financial institution account is 2% and 6% respectively. These are the only two ASEAN or OIC nations with single-digit values for this metric, and it is likely that the sample size of non-accountholders was too small to provide further breakdown by rationale. For completeness, however, these countries have been included in the tables that follow.

1.5.1 Barriers in Malaysia and ASEAN Members

The table below presents 2017 data on these metrics from the Findex database for Malaysia and other ASEAN members. Noted in the first data column is the percentage of respondents in a given nation without a financial institution account, to highlight the scale of this segment.
## Table 6: Reported Barriers to Financial Inclusion, Selected ASEAN Members

<table>
<thead>
<tr>
<th>Country</th>
<th>No Financial Institution Account</th>
<th>Religious Reasons</th>
<th>Distance</th>
<th>Cost</th>
<th>Lack of Documentation</th>
<th>Lack of Trust</th>
<th>Lack of Money to Use Account</th>
<th>Relative Already Has Account</th>
<th>No Need for Formal Financial Services (sole reason)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>78%</td>
<td>14%</td>
<td>31%</td>
<td>26%</td>
<td>32%</td>
<td>19%</td>
<td>72%</td>
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<tr>
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<td>51%</td>
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<td>33%</td>
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<td>Malaysia</td>
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<td>28%</td>
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<td>Thailand</td>
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<td>12%</td>
<td>8%</td>
<td>57%</td>
<td>59%</td>
<td>3%</td>
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<tr>
<td>Vietnam</td>
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<td>12%</td>
<td>15%</td>
<td>8%</td>
<td>45%</td>
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</table>

The data above lend themselves to some notable observations. Among the two Muslim-majority countries in the ASEAN for which data is available, Indonesia and Malaysia, people in Malaysia who lacked financial institution accounts were far more likely (11%) to cite religion as a concern than their counterparts in Indonesia (5%).\(^{63}\) This is so despite the much more highly developed state of the Islamic finance industry in Malaysia, and could reflect a stricter approach to Islamic stipulations on finance among Malaysians than among Indonesians. In both countries, however, religion was the least likely reason cited (among reasons that could be cited in tandem) for not having a financial institution account. For example, distance to financial institutions and the cost of financial services were cited by roughly triple the proportion of Malaysians who pointed to religious concerns. Likewise, Indonesians did not lack for other reasons to remain outside the formal financial system.

The picture is similar when all ASEAN nations are considered. Data exists for six other ASEAN nations across the landscape of seven potential reasons not to have an account (other than a lack of need for formal financial services, which, other than in Vietnam, was given as the sole reason by a negligible proportion of non-accaountholders).\(^{64}\) In 4 of these 6 countries, religious concerns were the least likely rationale for not having an account. Only in Cambodia (14% for religion, 13% for a relative already having an account) and Myanmar (3% for religion, 2% for a lack of trust in financial institutions) did religious reasons come in second-to-last, and then only by a slight margin. The most important barrier to

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\(^{63}\) Since overall account ownership in Malaysia (85%) was much higher than in Indonesia (49%), the percentage of all respondents in these countries who lacked an account for religious reasons was a miniscule 2% and 3%, respectively. The 11% and 5% figures discussed in the text for Malaysia and Indonesia, respectively, refer to just the 15% of Malaysians and the 51% of Indonesians who do not have a financial institution account.

\(^{64}\) No data are available for Singapore, probably because only 2% of respondents there do not have a financial institution account, making the sample size of non-accaountholders too small to robustly ascertain the underlying causes for lack of financial inclusion.
financial inclusion across the region is typically a perception of insufficient funds to use a financial account. On average across ASEAN, this rationale was given by more than double the percentage of people who reported any other barrier to financial inclusion. It was followed by a combination of distance to financial institutions, the cost of financial services, a lack of necessary documentation to open an account, and a lack of need for direct access to the formal financial system because a family member already has an account. Religious reasons and a lack of trust in financial institutions were the least cited.

A couple of interesting observations about Malaysia can be further made. Whereas 49% of Malaysians without a financial institution account reported not having enough money as a reason to use such an account, in most other ASEAN members this metric was above 70%. This could be owing to the country’s relative wealth, and it could also be a result of efforts by financial institutions to show Malaysians, even poor ones, that one does not need large amounts of money to maintain a financial institution account. Second, Malaysia had the highest percentage of those without accounts citing lack of trust in financial institutions (28%) as a factor.

Overall, the data do not show religious barriers to financial inclusion to be the principal challenge in any ASEAN member. Other factors, which the presence and further development of Islamic finance could help address, prove much more central.

### 1.5.2 Barriers in Malaysia and OIC Members

*Table 7: Reported Barriers to Financial Inclusion, Selected OIC Members*

<table>
<thead>
<tr>
<th>Country</th>
<th>No Financial Institution Account</th>
<th>Religious Reasons</th>
<th>Distance</th>
<th>Cost</th>
<th>Lack of Documentation</th>
<th>Lack of Trust</th>
<th>Lack of Money to Use Account</th>
<th>Relative Already Has Account</th>
<th>No Need for Formal Financial Services (sole reason)</th>
</tr>
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## Chapter 1: Evolution of Islamic Financial Inclusion in Malaysia

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</table>
A similar conclusion emerges when one looks at the survey data for OIC members. Despite these economies usually having majority-Muslim populations and much less developed Islamic financial industries than Malaysia, the percentage of people who lack an account for religious reasons is often material (but typically smaller than other factors). On average across the OIC, about 10% of non-accountholders cited religious concerns. The highest percentage citing religious reasons for not having an account was 20% (Niger) and the lowest was 2% (Uzbekistan). In Turkey, one of the largest economies among OIC members, 31% of the population reported not having a bank account and, of these, 19% cited religious reasons.

Across OIC members, just as was the case across ASEAN members, a lack of funds to use an account was by far the leading reason, given by well over 50% of OIC respondents. This figure reached over 80% in some nations, such as heavily Muslim Afghanistan and Egypt, whose respective percentages for religious reasons were 16% and 5%. Lack of funds was followed by the same reasons seen in the ASEAN region: distance, cost, lack of documentation, and having a relative with an account.

In no country were religious concerns the most commonly given reason for not having a financial account. In 27 of the 42 nations with survey data, religion ranked last among the 7 primary reasons people reported for not having a financial institution account. As noted earlier, Malaysia was in this group of 27. Of the other 15 nations, in 9, religious reasons were near the bottom in prevalence, just a few percentage points above the least likely reason(s). In 8 of the 42 OIC members, 15% or more of the population without bank accounts reported religious concerns: Niger (21%), Turkey (19%), Jordan (18%), Afghanistan (16%), Tajikistan (16%), Libya (15%), Tunisia (15%), and the West Bank & Gaza Strip (15%). In these counties, religious concerns were nonetheless outstripped by concerns over a lack of funds or by another family member already having a financial account.

1.6 Recommendations for Further Research

Given the data on financial inclusion and the existence in Malaysia of a well-developed Islamic financial industry, one could argue that religious barriers to financial inclusion has been well-addressed in Malaysia. The limited presence of religious barriers can be seen as a success for both financial inclusion and Islamic finance in Malaysia.

The data also suggest that those who wish to achieve greater financial inclusion by means of Islamic finance should investigate how Islamic finance can address the other reasons that respondents cite for a lack of access to the formal financial system. For example, having insufficient funds to make use of an account could be addressed by either lowering minimum deposit thresholds or raising awareness amongst the public that such thresholds are in fact quite low. It could be that potential customers are excluding themselves from the financial system based on a misperception of what level of minimum balance they need to obtain.

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65 In both countries, financial inclusion is quite low. Only 15% of Afghans and 33% of Egyptians surveyed reported having a financial institution account. The comparable figure for Malaysia is 85%.
Marketing could be directed to relatives of current account holders to dispel the perception that one financial account per family is enough. Such marketing could also help alleviate the gender gap in account ownership, which is often high in OIC member states. Encouraging individual ownership of financial assets can help empower more vulnerable adults (including women and elders) to make independent financial decisions to protect their interests.

It is recommended that further research be undertaken to help clarify the relationship between financial inclusion and Islamic finance. A first key question that could be explored is how many people in Malaysia who currently engage with the financial system would continue to do so if there were no Islamic finance options. Historical trends could also be observed, if there were data (or if surveys could be conducted) on how the growth of Islamic finance in Malaysia over the past thirty years has caused, rather than merely coincided with, greater numbers of people to engage with the formal financial system. Understanding this question would help quantify the contribution that Islamic finance has made to financial inclusion in the country.

A second area to explore would be under-engagement due to religious concerns. For example, there could be users of financial services who maintain a deposit account but do not borrow due to religious concerns. There could also be potential investors who, out of a perception of a lack of religiously acceptable investment opportunities, maintain large cash reserves or store their wealth in asset classes outside the financial system, such as land, livestock, or jewelry. Under-engagement may be especially important to explore as Malaysia has a relatively high segment of the population who report having accounts and not having used them for deposits or withdrawals in the past year. Importantly, increased engagement need not be in the form of debt – especially if households are already indebted through informal lending. Rather, engagement can be in the form of investment accounts, term deposits, and other products and services that protect and grow wealth.

A third area of inquiry could center on practical steps to overcome perceived religious barriers to financial inclusion in Malaysia. For example, religious scholars who are centrally located in the capital (and may not be known to the general public) could partner with local religious leaders who are better positioned to conduct outreach to unbanked individuals with whom they directly interact. It may be that local religious leaders are better positioned to assuage the concerns of those who remain unbanked for religious reasons.

The areas of future inquiry above could also take into account geographic and demographic segmentation. Regions and demographic groups that currently lag in financial inclusion could be studied with additional focus, so as to identify and address the remaining barriers in an already inclusive country. Analysis could also study the role of Islamic finance in enhancing access to the financial system for populations who may not be motivated by religious factors but rather by financial considerations, convenience, or other factors.

66 In Malaysia, the gender gap, or the percentage of men with a financial account minus the percentage of women with a financial account, was 6% in 2017, according to the Findex database. In the five largest OIC members by population, the gap was 29% in Bangladesh, 12% in Egypt, -5% in Indonesia (women were more likely than men to have financial accounts), 24% in Nigeria, and 28% in Pakistan. The gender gap in high income Western countries averages 0-1%. 
1.7 Conclusion: Linking Islamic Finance and Financial Inclusion in Malaysia

The available data allows us to conclude that (1) Malaysia is a leader amongst its ASEAN, OIC, and upper middle-income country peers in the attainment of financial inclusion and (2) Malaysia is also a leader globally in the attainment of a thriving Islamic finance sector. The preceding recommendations for further research would help establish to what extent (a) Malaysia’s policies to foster Islamic finance led to greater financial inclusion and (b) to what extent Malaysia’s policies to foster greater financial inclusion led to a stronger Islamic finance.

Subsequent chapters will provide case studies and examples of how policy initiatives, ranging from regulation to industry promotion to the establishment of institutions, have consistently attempted to cultivate Islamic finance as a means for financial inclusion. These efforts date to the 1960s and expanded steadily, such that by 2011 (the period for which Findex financial inclusion data becomes available), Islamic finance was already well-established in Malaysia. The examples of policy and institutional efforts discussed later in the report would support a hypothesis that promoting Islamic finance was a factor in attaining higher financial inclusion – especially amongst segments of the population that were reluctant to engage in conventional finance for religious reasons.

The degree of causality between the two phenomena – both of which are commendable – cannot conclusively be established. From a policy perspective, it may nonetheless be sufficient to conclude that both promoting financial inclusion and fostering Islamic finance have led to positive development outcomes for Malaysia.

As Malaysia pursues the “last mile” of financial inclusion, religious objections to financial participation appear to have essentially been eliminated. The remaining barriers, discussed in detail earlier in this chapter, are not religious in nature. It thus appears that attaining even higher levels of financial participation does not specifically require supporting Islamic finance, but rather making finance (both Islamic and conventional) more accessible and better understood. This may include ongoing emphasis on financial literacy, FinTech, and other mechanisms to reach the remaining segment of the population not yet financially included.

Malaysia offers a powerful example to peer countries. The data suggest that Malaysia has essentially removed religious considerations as a barrier to financial inclusion and has likely done so through its cultivation of Islamic finance. In this respect, Malaysia can serve as a model for countries on how to make finance accessible to all by fostering financial practices that are consistent with the religious beliefs of the population. The model applies not only to OIC countries and Islamic finance, but also to all countries and faith groups.

Malaysia likewise offers an important lesson for countries that are committed to developing their Islamic finance sector: achieving overall financial inclusion will also help advance Islamic finance. While many have recognized that Malaysia is a leader in global Islamic finance, they may not yet be aware of how overall financial inclusion across the country has helped Islamic finance thrive.
CHAPTER 2

Regulatory Foundations for Islamic Financial Inclusion
2.1 Overview

The definition of financial inclusion, according to Islamic finance, is not limited to how adults save, invest, borrow, make payments, and manage risk. It also embeds notions of risk-sharing and redistribution of wealth as well as inheritance rules specified in the Qur’an. The potential universe of customers for Islamic financial services can be categorized into user and non-user groups. Non-users may not be able to access the financial system (involuntary exclusion) or may opt-out of the financial system (voluntary exclusion). The financially excluded do not have access to the financial system because they do not have enough income or present too high a lending risk. Certain segments of the population are subject to social, religious, ethnic, gender, or other discrimination; and/or the informational and contractual framework might prevent financial institutions from reaching out to certain segments because outreach may be too costly to be commercially viable.

Islamic finance has a two-pronged approach to address the issue of financial inclusion. It offers several risk-sharing financing instruments that provide a viable alternative to conventional debt-based financing. These include shari’ah compliant microfinance, SME financing and micro-insurance (takaful). In addition, it offers a number of unique redistributive instruments such as zakat, sadaqah, waqf and qard al-hasan that complement risk-sharing instruments and can play a vital role in alleviating poverty and enhancing the financial inclusion of the population’s low-income segments.

Malaysia, with a dual banking system, has leveraged both Islamic and conventional financial instruments in deepening financial inclusion. Islamic finance has benefitted from efforts taken by the Malaysian government in building an ecosystem to support MSMEs in accessing finance. BNM formulated strategies to address financial inclusion in both the Financial Sector Masterplan (2000-2010) and the Financial Sector Blueprint (2011-2020). These two documents have provided not only a comprehensive diagnostic of problems preventing financial inclusion and overall financial sector development but also established a set of specific policy actions to address them. The plans have contributed to creating and consolidating a comprehensive ecosystem of financial institutions serving households, enterprises, and the overall economy. Also, they have provided support to foster financial services to the under-served population living in areas where no branches or agents of financial institutions exist.

The SC plays a significant role in ensuring a robust framework that continues to facilitate growth for the country’s economic prosperity. The SC’s strategic priorities include widening and broadening access to financing and investment solutions covering retail and MSMEs, consistent with the objectives of financial inclusion. The Capital Market Masterplan (2000-2010) and Capital Market Masterplan 2 (2011-2020) has prepared a conducive business environment for the development of venture capital and private equity industries, equity crowdfunding and peer-to-peer lending as well as an investment opportunity for retail investors either through collective investment scheme, retail sukuk/bond or digital investment management. Additionally, the SC’s SRI strategies also aim to provide financing for small and local community projects.

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67 Economic Development and Islamic Finance, the World Bank (2013), Zamir Iqbal and Abbas Mirakhor.
69 See Section 1.4.2 in chapter 1.
70 See section 1.4.3 in chapter 1.
2.2 Malaysian Islamic Finance Regulatory Structures

Malaysia’s approach to the regulation of Islamic finance is an integrated one. While the Islamic financial system is governed by its own specific legal structures, it is also subject to many regulations similar to those of the conventional system with which it exists in parallel.

The regulation and supervision of Islamic banking institutions and takaful operators in Malaysia are governed by the IFSA 2013. The latter replaced the Islamic Banking Act, 1983 and the Takaful Act, 1984. These acts fall under the purview of BNM, which regulates and supervises the Islamic banking and takaful sectors. IFSA aims to strengthen the regulation of IFIs, Islamic money markets, foreign exchange markets, and payment system and includes specific regulations for consumer protection.\(^{72}\)

In the Islamic capital market, the SC under the CMSA is responsible for issuing licenses to market intermediaries and guidelines on the offering of Islamic securities. Matters related to the offshore finance industry in Labuan are regulated by the Labuan FSA.

IFSA emphasizes a total shari’ah compliance effort of the Islamic finance industry through 4 dimensions, namely: (i) shari’ah governance framework; (ii) shari’ah standards for each contract used in Islamic financial transactions; (iii) pre-emptive measures to address issues of concern within IFIs that may affect the interests of depositors and policyholders; and (iv) the effective and efficient functioning of Islamic financial intermediation.\(^{73}\)

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\(^{72}\) Please see Chapter 4 for more detail on consumer protection.

The unique feature of IFSA vis-à-vis the FSA is the requirement for Islamic banks to segregate the moneys placed by customers into either (1) Islamic deposits or (2) investment accounts. The former treats the placement as risk free; hence, its principal is guaranteed and the latter treats the placement as risk-sharing where the placement is no longer protected/guaranteed. IFSA provides the platform for Islamic banks to evolve their traditional role of financial intermediation (based on risk-transfer paradigm) to investment intermediation (based on risk-sharing paradigm).  

Malaysia, in 2011, adopted a two-tier shari’ah governance framework comprising a centralized SAC at the central bank (established under the CBA, 2009) and an internal Shari’ah Committee formed in each IFI. All the shari’ah issues related to banking and takaful are under the central bank. The SC covers matters related to capital markets including equity crowdfunding and peer-to-peer lending and also maintains its own SAC.

![Shari'ah Governance Framework Model for Islamic Financial Institutions](https://www.bnm.gov.my/guidelines_old/05_shariah/02_Shariah_Governance_Framework_20101026.pdf)

**FIGURE 2: Shari’ah Governance Framework Model for Islamic Financial Institutions**

Source: Bank Negara Malaysia  

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2.3 Malaysia’s Financial Inclusion Framework

Under the FSBP 2011-2020, BNM has designed a comprehensive Financial Inclusion Framework, setting precise and measurable outcomes, strategies, and actions to advance financial inclusion as shown in Figure 3.

**FIGURE 3: Malaysia’s Financial Inclusion Framework**

- **Vision**: An inclusive financial system that best serves all members of society, including the underserved, to have access to and usage of quality, affordable essential financial services to satisfy their needs towards shared prosperity.

- **Desired outcomes**:
  - Convenient accessibility
  - High take-up
  - Responsible usage
  - High satisfaction

- **Broad strategies**:
  1. Innovative channels
  2. Innovative products & services
  3. Effective financial institutions & infrastructure
  4. Well informed & responsible underserved

- **10 action plans to achieve the mandate**:
  1. Introduce agent banking
  2. Leverage technology-based innovative channels
  3. Introduce flexible microfinancing
  4. Introduce micro-savings product
  5. Introduce micro-insurance/takaful
  6. Strengthen development financial institutions’ capabilities
  7. Organise structured training programmes in financial inclusion
  8. Introduce framework for measurement and Financial inclusion index
  9. Collaborate with non-governmental organisations for capacity building programmes
  10. Improve financial literacy

The Framework with 10 action plans aims to achieve four main outcomes, namely, convenient accessibility, high take-up, responsible usage and high satisfaction.

Access to financial services in Malaysia remains high with financial access points present in all 144 districts and 97% of the 886 sub-districts with a population of at least 2,000. This expansion in the number of access points nationwide provides 99% of Malaysians with convenient access to safe, reliable and affordable financial services. This achievement was in large part due to the establishment of agent banking in 2012 and an enhancement of the regulation affecting agent banking in 2015 which allows agents to facilitate the opening of saving accounts on behalf of financial institutions via online real-time systems and biometric identity verification.

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As at end-2018, more than 6,200 agent banks have been established nationwide, with 167.5 million transactions amounting to RM14 billion facilitated by agent banks. Another important development that has intensified since 2011 has been the expansion of internet banking and mobile banking. Key findings of BNM’s Demand Side Survey 2018 highlighted an improved take-up of financial products and greater usage of digital channels.

Note 80
Note 81


For those who do not use mobile and internet banking, the reasons are mainly due to lack of interest, not knowing how to use these channels and perceived security concerns. Awareness of mobile and internet banking by rural communities is 73% compared to urban communities at 84%.
2.4 Key Institutional Financial Inclusion Initiatives

A World Bank Report in 2016\(^2\) briefly highlighted several key initiatives required for financial inclusion. The actions taken by Malaysian institutions in developing the building blocks for financial inclusion can be summarized as follows:

2.4.1 BNM

a) Reform of DFIs. In 2002, the DFIA was enacted. Through this new legislation, BNM was granted the oversight responsibility to ensure that the 6 DFIs performed their mandates according to sound corporate governance and financial and business practices. In relation to BSN, its mandate was revised to re-focus on mobilizing savings in underserved areas and promoting microfinance. The Agricultural Bank (Agrobank) was mandated to serve the agricultural sector in a sustainable way. DFIs also have an important role in contributing to a higher utilization of financial services given their specific socio-economic objectives. This includes supporting the development of SMEs, the agricultural sector and cooperatives through the provision of inclusive financial services. In 2018, the BNM collaborated with the World Bank and DFIs to develop an enhanced performance measurement framework for DFIs. The new framework aims to capture the broader contributions of DFIs by moving beyond the narrow focus of financing growth indicators, and integrates developmental KPIs to measure the socio-economic impact of DFIs’ operations.\(^3\)

b) Establishment of a Credit Bureau. One of the challenges that Malaysia faced in the aftermath of the Asian financial crisis was that there was no reliable credit history on individual borrowers. Given that the lack of credit information could be a barrier to accessing formal financial services, BNM led the initiative to establish a credit bureau. In 2001, the CCRIS was established to collect credit information from all regulated financial institutions. In 2015, the CCRIS captured credit information on 9 million borrowers. Additional efforts to collect information from major non-bank credit providers are taking place.

c) Guidelines for Basic Banking Services. In 2005, BNM issued the Guideline for Basic Banking Services. Through this new regulation all commercial banks were required to provide basic banking services and ensure that all segments of the population had access to deposit and transaction services at low cost, and received reasonable savings rates. The main features of basic savings and current accounts were that a low minimum initial deposit was established and that users could have access to free over-the-counter services as well as ATMs.

d) Deposit insurance. In 2005, Malaysia also established the PIDM. The latter was mandated to insure both deposits and benefit payments under insurance and takaful in case of banks’ and insurance companies’ failure. PIDM protects deposits up to US$62,500 per depositor per bank and up to US$125,000 per policyholder in insurance and takaful benefits. The safety net is provided with no charge to users and it is activated automatically.

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\(^3\) Bank Negara Malaysia, Financial Stability and Payment Systems Report 2018
e) **Consumer protection agency.** A well-functioning financial sector has a transparent dispute resolution mechanism. The FMB was established in 2005 to ensure that all financial services consumers had access to an independent, and impartial dispute resolution scheme which created an institution to deal with complaints on the services or products of the financial institutions. In addition, a credit counseling and debt management agency, AKPK was established in 2006 to provide counseling on all financial related topics and assist indebted individuals to work on loan repayment schemes.\(^84\)

In 2006, the Consumer and Market Conduct Department was also established by the BNM and is responsible for formulating and implementing policies that promote fair and responsible treatment of consumers by financial institutions, especially in regard to observance of complaints handling, debt collection, financing, imposition of fees and charges, and provision of credit cards. To ensure that financial services users have access to advisory and resolution facilities, BNMLINK\(^85\) was established as a centralized point of contact for the public to address any type of inquiry related to the provision of services or products of the financial sector.\(^86\)

In 2016, the FMB was transformed into the OFS and appointed by BNM as the operator of the Financial Ombudsman Scheme.\(^87\)

f) **Strengthening the mandate of BNM in financial inclusion.** Given the institutional arrangements that have occurred between 2000-2008, BNM had to strengthen its legal mandate and accountability in implementing the financial inclusion agenda. One of the key initiatives that contributed to this effort was the CBA, 2009.\(^88\) The latter explicitly stated that one of the primary functions of BNM was to develop and promote an inclusive financial system. Given this mandate, BNM has been the leading agency that is accountable for promoting policies directed to promoting financial inclusion in the country.

g) **Consumer education.**\(^89\) An important component of BNM’s strategy to promote financial inclusion is the consumer education and protection framework. Financial institutions in Malaysia are required to comply with a set of disclosure requirements that aim to ensure that information disseminated to financial services users is not only timely, but easy to understand and accurate. Consumers are empowered with both the knowledge and the skills to make good financial decisions through financial education. The programs\(^90\) were developed by BNM, AKPK, and the financial sector industry. These programs provide awareness to consumers on the risks involved in using various financial products, as well as on the benefits. One distinctive component of the protection framework is that the financial institutions are responsible for assessing the suitability of a product for a potential user. Therefore, all participating financial intermediaries are expected to behave responsibly in the provision of financial services.

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84 See section 4.3 in chapter 4.
85 BNMLINK provides face-to-face customer service to walk-in visitors on general enquiries and public complaints. Bank Negara established TELELINK, which allows the public to access these advisory services by telephone. MobileLINK extends BNMLINK’s advisory services in Malaysia using a mobile customer service bus equipped with supporting facilities and technologies.
86 See section 4.8 in chapter 4.
87 Ibid.
88 The CBA 2009 replaced the previous Act of 1958.
89 See sections 4.2-4.7 in chapter 4 for discussion on financial literacy and consumer education.
90 Within these programs, POWER!, introduced in 2011, targets young individuals and new borrowers with the aim of providing them with the skills to effectively manage their finances.
h) **Introducing mySalam as a national health protection scheme.** The scheme aims to provide 3.8 million B40 individuals and their spouses with free takaful health protection. This initiative is through a collaboration with an insurance provider, Great Eastern Holdings, which contributed initial seed funding of RM2 billion to the mySalam trust fund. This collaboration is an exemplary instance of a credible Public-Private Partnership model aimed at building a better social protection network for the population. All eligible individuals are notified via SMS that they are covered under the Scheme. This Scheme provides a RM8,000 one-off/lumpsum payment if they are diagnosed with any one of the 36 critical illnesses, including cancer, heart disease, muscular dystrophy, and Alzheimer’s. Also, the mySalam scheme provides an income replacement payment of RM50 per day to those who receive treatment at any government hospital for a maximum of 14 days, or RM700 annually.

i) **Regulatory framework for FinTech to support financial inclusion.** BNM launched the Financial Technology Regulatory Sandbox Framework and ICTF to provide an environment conducive to the deployment of FinTech solutions. FinTech has played a significant role in advancing DFS that refers to financial services accessed and delivered through digital channels. The latter includes the internet, mobile phones (both smartphones and digital feature phones), ATMs, point-of-sale terminals, and near field communication enabled devices, chips, and any other digital system.

j) **The establishment of financing advisory services (Khidmat Nasihat Pembiayaan - MyKNP).** MyKNP aims to improve financing applicants’ experience, including providing a greater understanding of the factors affecting their financing application as well as help in raising their eligibility for future financing. MyKNP also advises on ways to improve eligibility for financing in the future as well as providing information on alternative financing for SMEs or alternative solutions for homebuyers. MyKNP is jointly managed by AKPK and CGC.

k) **Strengthening the roles of the CGC in providing a guarantee and access to finance for MSMEs.** The CGC provides a guarantee to strengthen the credit profile of MSMEs’ financing with financial institutions, direct financing for business start-ups, women entrepreneurs, Bumiputera (indigenously-owned businesses) financing, funding to expand as well as grow businesses and contract financing. The CGC also provides credit information and credit rating services, assisting MSMEs to build a credit history and track record.

l) **The CGC and Dun & Bradstreet established Credit Bureau Malaysia (formerly known as SME Credit Bureau),** the first credit bureau for SMEs in Malaysia to provide credit information and credit rating services, assisting MSMEs to build a credit history and track record. The CGC has also established imSME (www.imsme.com.my) to facilitate MSMEs in securing the financing/loan by matching them with the best financing facility available in the market. imSME is Malaysia’s first online SME financing/loan referral platform launched in February 2018. imSME is wholly owned and managed by the CGC and is supported by BNM as well as other participating financial institutions. There are 25 financial institutions including 5 development financial institutions, 3 agencies and 12 alternative financiers participating in imSME.

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91 B40 have a mean income of RM2,537 and a median income of RM2,629.
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2.4.2 SC

a) **Guidelines to facilitate ECF and P2P lending.** Under this framework, ECF is a new form of fundraising that allows start-ups or other smaller enterprises to obtain capital through small equity investments from relatively large numbers of investors, using online portals to publicize and facilitate such offers to retail investors. With ECF, investors have the opportunity to diversify their investments beyond traditional asset classes. Additionally, P2P financing allows businesses to borrow and investors to lend capital through online platforms registered by the SC. The latter has approved 10 ECF and 8 P2P companies, including Ethis Ventures, which is the only entity that offers Islamic ECF. As at end-December 2019, the ECF and P2P financing market has provided close to RM706.4 million of alternative financing for nearly 8,182 MSMEs.92

b) **DIM framework, which incorporates innovative technologies into the fund management business, to allow the offering of automated discretionary portfolio management services to investors including retail.** Digital investment managers can replicate many of the activities performed by traditional fund managers through online access. DIM aims to provide investors with a more convenient, affordable, and accessible channel to manage and grow their wealth. To reinforce investor protection, specific conduct requirements that are commensurate with the distinctive characteristics of this new business model have been set out.

The board has been made accountable for the governance of the digital investment management business by ensuring that the requisite technology capabilities are in place, including identification of the competent person within the company who has sufficient understanding of the risks and rules of the algorithm applied. Additionally, the risk management framework is required to be sufficiently robust to manage the risks associated with the offering of automated discretionary portfolio management services, including cybersecurity resilience. All outcomes produced by the algorithm are required to be consistent with the digital investment manager’s strategy, and written policies are needed to monitor and regularly test the algorithm employed. All of these corporate governance measures have been put in place to provide additional comfort to potential investors. 3 robo-advisors have been approved by the SC, including Wahed Investment, which is the first Islamic robo-advisory platform in Malaysia.

2.4.3 Bursa Malaysia

Bursa Malaysia introduced Leading Entrepreneur Accelerator Platform (LEAP) in 2017 to provide SMEs greater access to the capital market. The LEAP Market is intended to broaden the funding options available to companies that are too small to list on the Main Market or the ACE Market.93 The market is positioned to fill the gap between the capital market and start-ups and is also a platform for companies to showcase their business. Due to the inherent risks of investing in young companies, the LEAP Market is only open to investors categorized as ‘sophisticated’. The LEAP Market offers private equity risk and returns with public market transparency. The framework for the LEAP Market is premised on three key guiding principles, which are cost efficiency, appropriate regulations for SMEs, and a qualified market for sophisticated investors.

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92 Capital Markets Malaysia, [https://www.capitalmarketsmalaysia.com/](https://www.capitalmarketsmalaysia.com/)

93 ACE Market is a sponsor-driven market designed for companies with growth prospects. Prior to August 2009, it was known as the MESDAQ Market. Sponsors must assess suitability of the potential issuers, taking into consideration attributes such as business prospects, corporate conduct and adequacy of internal control.
2.5 Islamic Social Finance and Financial Inclusion

Zakat, waqf, and sadaqah are tools for the redistribution of wealth and can be used to address the basic needs of the extremely poor and the destitute. By focusing on the lowest income segments of society, these practices seek to create a social safety net, enabling greater financial inclusion to occur.

2.5.1 Zakat

Zakat (mandatory levy)
Zakat is one of the key pillars of Islam and is ordained to mobilize funds for the welfare of the poor. Its collection was enforced by governments in early Islamic history.

Waqf (endowment)
A waqf is a trust established when the contributor endows the stream of income accruing to a property for a charitable purpose in perpetuity.

Qard al-hasan (benevolent loan free of any charge)
Qard al-hasan, a loan mentioned in the Qur’an as “beautifull” (hasan), is a voluntary loan, without any expectation by the creditor of any return on the principal.

Sadaqah (recommended contributions)
Sadaqah is intended to redeem the rights of the less privileged in society. Sadaqat is the plural of the term sadaqah, a derivative of the root meaning truthfulness and sincerity.

Zakat is a mandatory requirement for all Muslims that meet a minimum level of wealth and are required to donate 2.5% of their accumulated wealth annually. The report of the UNHCR\(^95\) estimated that the current zakat donated worldwide stands at $76 billion, which is modest in the context of $1.7 trillion in wealth held by high net worth individuals in the Middle East. The annual potential of zakat could be as much as $1 trillion per year, and the value of awqaf assets is likely far more than the $2.5 trillion of commercial Islamic finance assets worldwide.\(^96\)

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94 See section 1.4.3 in chapter 1.
95 UNHCR, Zakat Program 2019 Report, Dubai UAE.
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2.5.2 Waqf

Throughout Islamic history, waqf has also been a significant provider of social services that are today financed by the state. These services include the provision of education, healthcare, infrastructure development, as well as social assistance to the poor and vulnerable. Waqf institutions have also supported improvements in income and wealth equality as wealthy individuals and families released property into the service of people who deserved the support of others. Several innovative financial instruments have been developed in maximizing the utilization of waqf assets such as waqf-linked sovereign sukuk issued by Indonesia at $6.57 million, the issuance of $390 million sukuk to finance the Zam-Zam Tower in Saudi Arabia, cash waqf managed by IFIs in Malaysia and Bangladesh as well as waqf-related shares in Kuwait. Additionally, waqf immovable assets in Singapore and Malaysia are valued at $543.9 million and $286 million respectively.

BNM, in advocating sustainable finance, has introduced the VBI framework for IFIs in Malaysia. The VBI will guide IFIs to adopt the elements of financing which focuses on the triple bottom line, namely social, environmental (or ecological) and financial. Thus, strengthening the role of waqf through the banking framework could be one of the strategies to meet the VBI’s objectives. Many IFIs comprising both Malaysian and international banks offer internet banking services for the collection of waqf funds. BMMB, for instance, announced that the accumulated waqf funds which launched in 2017 had surpassed RM20 million in 2018. More than RM12 million has also been distributed in 2018 to fund academic buildings, classrooms, mobile clinics, dialysis machines, hospital equipment, and investment.

97 Ibid.
100 BMMB, CIMB Islamic Bank, BIMB, MIB, AmIslamic Bank, Hong Leong Islamic Bank, Public Islamic Bank Berhad, RHB Islamic Bank, Affin Islamic Bank, Bank Kerjasama Rakyat and Kuwait KFH.
2.6 Regulatory Framework for Islamic Social Finance in Malaysia

The 13 states in Malaysia govern their zakat and waqf institutions independently under their respective state enactments while in the 3 federal territories they are governed by one federal law. Out of the 13 states, 5 have enacted specific waqf laws: Johor, Selangor, Negeri Sembilan, Terengganu and Malacca. The remaining states and the federal territories have enacted waqf provisions in their general administrative laws.102

The Malaysian government had established the JAWHAR in 2004 to coordinate the zakat and waqf development in every state. A government backed waqf foundation was formed in July 2008 known as YWM. It was set up under the Trustees Incorporation Act 1952 as the national waqf entity. YWM’s functions include the collection of waqf funds, development of existing and new waqf assets, implementation of welfare and social programs honoring the intentions of Waqf donors, undertaking investment programs to sustain disbursements to waqf beneficiaries, and promotion of YWM’s activities.

Waqf appeared in the Islamic capital market regulatory framework in 2015 when the SC issued Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework. Chapter 7 of these Guidelines incorporates provisions, including tax incentives, pertaining to SRI sukuk. Waqf properties and assets as well as any projects that undertake the development of waqf assets are deemed to be part

102 Raja Muhd Alias, Tunku Alina, 2011 Unleashing the Potential of the Waqf as an Economic Institutions in Malaysia: Policy, Legal and Economic Reforms, INCEIF.
of the SRI eligible sector. The Guidelines thus promote the issuance of sukuk for the development of waqf assets. In 2017, the SC issued the Islamic Fund and Wealth Management Blueprint. The Blueprint caters to potential waqf vehicles for social development, public good and wealth distribution as well as increasing the level of sustainable waqf assets through fund management or capital raising.

In 2015, Labuan established LIWF under the Labuan Islamic Financial Services and Securities Act 2010. Its purpose is to hold waqf properties on trust with the objective of managing them for identified beneficiaries in accordance with the principles of waqf.

### 2.7 Conclusion

Islamic finance in Malaysia has benefitted from the comprehensive regulatory frameworks and initiatives taken by public and private sector institutions in relation to increasing financial inclusion. These initiatives cover banking, takaful/insurance, capital markets and alternative finance and have been marked by policy continuity and co-ordination among different government ministries, departments and agencies over a period of time. Additionally, the existing framework for Islamic social finance has been effectively leveraged in connecting waqf, zakat and sadaqah with financial institutions to enhance their reach and fund collection. Several examples of successful institutions have been presented as templates that hold relevance internationally.

**Strong leadership from financial regulators has been key to driving financial inclusion in Malaysia.** The financial inclusion framework led by BNM with clear, targeted action plans and accurate tracking of milestones has contributed significantly to the country’s high Findex score. In addition, the SC and Bursa Malaysia have successfully created a conducive business environment for micro and SMEs to access funding from capital markets. Hospitable regulatory regimes have been intrinsic to the creation of an effective ecosystem that promotes financial inclusion and involves the CGC, Credit Bureau, Consumer Protection Agency and deposit insurance as some of its critical components.

**Islamic social finance, historically, has also played a central role in providing access to finance to entrepreneurs.** For instance, the MAIWP in collaboration with BIMB and SME Corp., will pilot a specific program to support the B40 segment in generating sustainable income and achieving financial resilience (iTEKAD) beginning May 2020. The initial program optimizes zakat and microfinancing arrangements and will include cash waqf in the later stages. The implementation of the program involves onboarding and educating recipients as well as monitoring successful outcomes. Similar engagements are required between the financial regulators, financial institutions, and SIRCs in maximizing the potential of Islamic social finance to support sustainable development. Financial product innovation, embedding digital financial services, data management, capacity building for financial management are among the key areas that can be jointly developed between regulators and market participants.

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CHAPTER 3

Institutional Enablers of Islamic Financial Inclusion
3.1 Role of State in Promoting Inclusion

The success of the Malaysian financial system and its journey from an economic backwater to an upper middle-income economy has attracted the attention of many policy experts and economic pundits. The remarkable growth in the past 60 years signifies the excellent work of the Malaysian government and relevant authorities in formulating and implementing many effective policies. The continuous efforts towards increasing financial inclusion and literacy have benefited millions of Malaysians and remains as one of the pivotal strategies to improve the well-being of destitute, underprivileged and B40 communities.104 105

Unlike many other Muslim countries, the policies for financial inclusion in Malaysia have revolved around race and religion with the aim of alleviating poverty and redressing economic and social inequality. In the 1960s, while Bumiputeras106 comprised more than 60% of the Malaysian population, their holdings of publicly listed companies totaled only 2%. Besides, reflecting past colonial employment patterns, the majority of Bumiputeras (approximately 68%) were employed in traditional sectors, especially in agricultural and plantation activities, while the remaining third were employed in modern sectors which were dominated by other ethnicities.

This apparent mismatch in employment and corporate ownership was translated into low average household income for Bumiputeras (RM172 per month, which was almost half the amount earned by Indians and Chinese at RM304 and RM394 per month, respectively) and a high incidence of poverty (65% of this segment comprised Bumiputeras while Indians and Chinese accounted for 39% and 26%, respectively). Consequently, this socio-economic imbalance led to unattended physical ailments and racial disharmony.107

3.2 Religion as an Incentive to Save

A cursory glance at history shows that the concentrated efforts to promote inclusion can be traced back to the late 1950s with the establishment of a pilgrimage fund commonly known as TH.108 The intent was to inculcate a culture of thrift among Muslims, many of whom were saving for pilgrimage through the accumulation of illiquid assets such as land and cattle or were literally placing their funds


106 The term ‘Bumiputra’ or in its literal definition, ‘Son of the Soil’, refers to Malays and other indigenous ethnic groups in both Peninsular Malaysia and Sabah and Sarawak. This term was first introduced by the former Prime Minister, Tun Abdul Razak, when he launched the NEP in highlighting the need to strengthen the ‘special position’ of the Malays and native people as provided in Article 153 of the Malaysian Constitution.

107 PNB, A Model for ‘Creation & Redistribution of Wealth’ - Building a Distinctive World-Class Investment House.

108 “Pilgrims Economy Improvement Plan” (Command.22, 1962) explains that the traditional methods and practices of saving at that time were in fact detrimental not only to the Malay Muslims but also the national economy at large. For instance, the use of land as a form of saving was harmful from the economic point of view because it leads to sub-division of paddy land and rubber smallholdings, neglect, poor treatments of tenant farmers and fragmented farms. (Mohamed Eskandar Shah and Seho Mirzet, “Tabung Haji Run-up to Islamic Finance in Malaysia,” in Islamic Finance in Malaysia, ed. Mohamed Ariff (Kuala Lumpur: Pearson Malaysia, 2017), 27-54.)
under the mattress. These forms of saving were prone to external shocks, with the possibility of losing the entire fund due to natural disasters or theft. Moreover, many Muslims were staying away from interest-based institutions. Thus, the government incentivized Muslims to save by providing them with a religious motive, facilitating a culture of saving and enhancing financial inclusion.

3.3 Affirmative Action for Bumiputeras

In the 1970s, the policy on inclusion shifted from merely providing access to financial services to a greater participation in economic activities. Malaysia’s NEP was announced in 1970 as a response to the political crisis of May 1969. The government realized that one of the causes of the discontent was a great wealth divide between the major races in Malaysia, especially between the indigenous Bumiputeras and the non-Bumiputeras. The policy had twin objectives — it sought to ‘eradicate poverty’ and ‘restructure society’ to eliminate the identification of race with economic function. Some may argue that the policy was biased towards the Malay Bumiputeras and associated with affirmative action. Notwithstanding the criticism, the government felt that the intervention was necessary and the role of the state was imperative to redress economic disparities. Consequently, the intervention resulted in significantly greater Bumiputeras wealth, education opportunities and increased representation among professionals. The Bumiputeras wealth increased significantly from 4% in 1970 to about 20% in 1997 amid the growth of overall per capita GNP.

3.4 Key Institution Building Under the NEP

The structural shift in policy under the NEP exhorted the government to take some high-level initiatives such as the establishment of PNB and FELDA. The establishment of these 2 institutions represented the most significant initiatives to increase the participation of Bumiputeras in business and economic activities as Malays were given preferential access to stocks and land through various schemes launched by these institutions. For instance, FELDA was founded to handle the resettlement of Malay rural poor into newly developed areas. The majority of FELDA participants are Bumiputeras, wherein they were given land to cultivate cash crops. Each participant had access to 4ha to 6ha of land to cultivate either rubber or oil palm and paid wages until their crops matured and after a certain period, the land title was transferred to them.

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109 Apart from NEP, the Malaysian government established free-trade zones in the early 70s to attract and promote export-oriented industries. The policy had a significant impact on the financial development of Malaysia and strengthened the role of financial institutions, particularly banking (James, B Ang, “Financial Development and the FDI-Growth Nexus: The Malaysian Experience,” Applied Economics 41 no. 3 (2007): 1595-1601, DOI: 10.1080/00036840701222553.). The strong economic growth in that period created many new jobs, contributing to increased financial inclusion.


112 The policy also contributed to a greater number of Bumiputera professionals, where percentage of accountants doubled from 7% to 14%, engineers from 7% to 35%, doctors from 4% to 28% and finally architect from 4% to 24% – “Malaysian New Economic Policy,” last modified December 13, 2019 - https://en.wikipedia.org/wiki/Malaysian_New_Economic_Policy

Meanwhile, PNB also known as NEC was established in 1978 to enrich the lives of Malaysians, particularly the Bumiputeras through indirect ownership of listed and non-listed companies. Its presence provided easy access to capital markets for the masses and made Bumiputeras shareholders in virtually all listed companies.¹¹⁴ ¹¹⁵

3.5 Introduction of Shari’ah Compliant Banking

The success of these policies in the 1960s and 70s, and the desire to see the pro-Bumiputera agenda come to fruition, propelled the government’s efforts for greater financial inclusion. However, there was reluctance on the part of the predominantly Muslim Bumiputeras to participate in any program that included riba-based financing facilities (e.g., conventional loans).¹¹⁶ Consequently, there was a need to create a parallel banking system that was shari’ah compliant. The establishment of Bank Islam in 1983 was considered to be the beginning of a new era of Islamic banking in Malaysia and paved the way for the establishment of many Islamic institutions spanning takaful, asset management and capital markets. In 1983, a law was enacted to legally recognize Islamic banking and signified the commitment of the state to address the issue of voluntary exclusion from the financial system for religious reasons.

3.6 Other Initiatives to Increase Financial Inclusion

Malaysia continued to push financial inclusion by introducing many initiatives with more specific objectives such as microfinance and access to credit for SMEs. Many of these initiatives were directed towards young entrepreneurs and low-income citizens. For instance, in the 1980s, Malaysia offered micro loans through AIM to the poor to assist them in setting up microenterprises. This was then continued with the establishment of YUM and The Economic Fund for TEKUN. All these initiatives have also attracted significant involvement from the private sector and benefited more than one million microenterprises in the country.¹¹⁷

¹¹⁴ The scheme was structured to alleviate the risk averseness of most Malaysian investors. Although, the investors could also experience losses if values fell, through prudent management and preferential access to initial public offerings (PNB) managed to consistently provide high returns to attract more Malay customers. The preferential access was provided to accelerate Bumiputera ownership of share capital in Malaysia’s corporate sector.

¹¹⁵ See section 3.8 for detailed discussion.


3.7 Initiatives by BNM – Developing Institutions and Islamic Finance

In addition to the afore-mentioned initiatives, BNM enhanced the role of DFIs, promoting greater access to and take up of financial services by the underserved individuals and MSMEs. In particular, three retail DFIs, BSN, Agrobank and Bank Rakyat were identified to drive financial inclusion by supporting the development of the underserved individuals, MSMEs, agriculture sector and cooperatives sector. Agrobank and Bank Rakyat are full-fledged Islamic financial institutions.

BNM has also identified Islamic finance as a key enabler for financial inclusion, in line with the aspiration of the country to become a developed nation that promotes shared prosperity. Partnering with the industry, BNM has consistently advanced the positive socio-economic impact of Islamic finance. For instance, several Islamic banks introduced cash waqf as a product for their clients to provide extra resources to undertake social welfare-related initiatives.

The commitment of BNM to promote financial inclusion was also demonstrated at both the regional and global level. In collaboration, with AFI, the BNM undertakes key roles to promote and advocate financial inclusion in prime policy areas - i.e., global standards and proportionate regulation, consumer empowerment and market conduct, financial inclusion data and national strategy, digital
financial services and SME finance. Consequently, BNM has played a pivotal role and underpins Malaysia’s accomplishments in attaining a high rate of financial inclusion.

3.8 Role of Prominent Institutions

While the state and its regulators have been fundamental to ensuring high financial inclusion, as mentioned above, several prominent institutions have also played a significant role. Despite the profit motive being the raison d’être of their existence, these institutions were indirectly mandated to uplift the well-being of all Malaysians, and in particular, the Bumiputera. For the sake of brevity, the chapter focuses only on TH, PNB and FELDA. These institutions embody the success stories of financial inclusion in Malaysia.

3.8.1 TH

Conceived in 1959 by the former Vice-Chancellor of the University of Malaya, Professor Emeritus Ungku Aziz, TH aimed at financing and organizing the obligatory pilgrimage to Makkah. Ungku Aziz pointed out that the traditional form of saving at that time was detrimental to Malay Muslims. He argued that the way savings were accumulated was economically harmful and produced undesirable outcomes. For instance, the use of land could lead to sub-divisions of paddy land and small holdings of rubber, neglect, poor treatment of tenant farmers and fragmented farms. Thus, he contended that saving in the form of cash was more desirable although this may create large caches of idle cash.

The establishment of TH was a significant milestone as it provided an avenue for saving to many Malay Muslims, in particular those who were living in isolated rural communities without access to banking services. More importantly, it provided an opportunity for participants to have access to financial services with small deposits. Savers (commonly known as participants) would normally contribute token amounts from RM1 to RM10 per month over a period of 10 to 25 years into their savings accounts with TH. The amount would later be invested in shares, providing an opportunity to small savers to benefit from the profitability of listed firms. Ungku Aziz’s ideas of providing saving opportunities for Muslims to perform Hajj eventually translated into a mass public mechanism to mobilize funding from depositors and investors, especially from the larger segments of the population. The number of depositors increased from 1,000 in 1963 to nearly 540,000 within the first 20 years of TH’s establishment. In fact, the size of deposits increased exponentially and reached nearly RM230 million within the same period which translated in a CAGR of 31%.


119 In addition to its financial inclusion objectives, the government established a number of institutions to address inter-ethnic wealth inequality. For instance, PHB was established to enable the Bumiputeras to benefit from rising commercial property prices in prime areas. The investment scheme of PHB is akin to ASN launched by PNB in 1981 wherein the investors subscribe for each unit at a price of RM 1.00.

120 Ungku Abdul Aziz bin Ungku Abdul Hamid is a member of the royal family of the State of Johor and in recognition to his excellence service to the nation, he was honored with the title of Professor Diraja (Royal Professor).

121 Pilgrims Economy Improvement Plan (Command. 22, 1962).
Ungku Agi’s versatile idea changed savings practices and also increased the participation of small savers in capital market activities. He provided an opportunity for the savers to benefit from the continued growth of the Malaysian economy with a minimum knowledge of investment. In addition, saving in TH is shari’ah compliant and fully guaranteed by the Malaysia government. The depositors do not have to worry about losing their principal while earning very competitive returns. In fact, the consistent return and a deposit guarantee make TH a unique and preferable institution among Malay Muslims for placement of deposits.

3.8.1.1 TH Financial Performance

**FIGURE 7: Depositors and Deposits, 1963-2018**

122 In the context of risk-return framework, TH provides one of the best saving products in Malaysia. A principal guaranteed deposit with return up to 10%. Also, depositors do not have to worry about non-shari’ah compliant risk and are exempted from tax on their return.

123 Depositors, deposits and bonus rates are sourced from Lembaga T.H. (2013) and Malaysian GDP growth and bank deposit rates were obtained from the World Bank (2015). The graphs were sourced from Shah, M.E and Seho, M., “Tabung Haji Run-up to Islamic Finance in Malaysia”, in Islamic Finance in Malaysia, ed. Mohamed Ariff (Kuala Lumpur: Pearson Malaysia, 2017), 27-54.)
TH has benefited millions of depositors over the past 60 years. As the size of deposits continued to increase, TH has become a large investment fund with an estimated size of nearly RM70 billion. This has transformed the institution from a pure deposit-taker into one of the largest GLICs. Today, TH has significant exposures in many major industries in Malaysia encompassing plantation, properties, trading, travel and many more. A humble beginning to promote saving for pilgrimage has now become a multi-billion-ringgit investment enterprise.

3.8.1.2 Furthering Financial Inclusion and Islamic Finance

The remarkable achievement of TH is also reflected in its role to support Malaysia’s economic development. The significant liquidity generated through the deposits supports the issuance of Islamic instruments to finance funding requirements either at company (TH) or project level. In addition, a number of big infrastructure projects have been financed with TH’s liquidity. The presence of TH and its shari’ah compliant nature of operations has also provided choice to potential participants who had hitherto abstained from the financial system due to religious reasons.

TH’s impact has not been limited to the capital market. It has also promoted the growth of Islamic banking as the majority shareholder of BIMB, the largest full-fledged Islamic bank in Malaysia. The dynamic evolution of TH over the years provides anecdotal evidence that capital formation can occur successfully at all levels, including the underserved and underprivileged. Notwithstanding its recent

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125 For instance, TH has a stake in TH Heavy Engineering Berhad and Express Rail Link Sdn Bhd. The former involves construction and fabrication of oil and gas offshore structures and the latter in construction and management of express railway systems. Source: Tabung Haji Annual Report, 2017.
turmoil\textsuperscript{126} at the institution, remains intrinsic to supporting financial inclusion and furthering economic growth. In fact, the success of TH enabled the government to launch an extremely successful entity that created investment opportunities for the mass public – PNB.

3.8.2 PNB

PNB was established in 1978 to increase economic participation of all Malaysians, especially the Bumiputera. PNB offered investment opportunities in unit investment trusts while allowing investors to participate with a token minimum investment, further promoting financial inclusion. ASN,\textsuperscript{127} the first unit trust scheme of PNB was launched in 1981 as a major vehicle for implementing the transfer of corporate assets held under trusteeship to the Bumiputera.\textsuperscript{128} The intent was to increase equity ownership of Malays up to 30% of the total value of listed companies,\textsuperscript{129} as part of the NEP’s aim of creating a share-owning class among the Bumiputera. The government created an institution designed to encourage Malay participation in corporations and to assuage traditional fears of losses given the risk averse nature of Malay society. The government also wanted to promote long-term investments and avoid speculative profit-making, envisaging PNB as a vehicle to both increase and sustain economic participation. The aim was to create a less disparate society with shared prosperity.

3.8.2.1 PNB Financial Performance and Products

\textbf{FIGURE 9: PNB’s Assets under Management as of 2018}

<table>
<thead>
<tr>
<th>Year</th>
<th>Proprietary (RM Billion)</th>
<th>UTFs (RM Billion)</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>2.9</td>
<td>0.6</td>
<td>7.8%</td>
</tr>
<tr>
<td>1990</td>
<td>6.3</td>
<td>12.7</td>
<td>17.7%</td>
</tr>
<tr>
<td>2000</td>
<td>21.6</td>
<td>35.9</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>26.5</td>
<td>123.9</td>
<td></td>
</tr>
<tr>
<td>Nov 30, 2018</td>
<td>46.1</td>
<td>249.1</td>
<td></td>
</tr>
<tr>
<td>CAGR</td>
<td>12.7%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: PNB A Model for Creation & Redistribution of Wealth-PNB, 2019

\textsuperscript{126} Despite the astounding success of TH, its recent troubles can affect its sustainability. Due to a lack of robust corporate governance which resulted in poor financial management, TH has required a government bailout. TH had to transfer assets worth RM19.6 billion to a special purpose vehicle formed by the Ministry of Finance for the rehabilitation of these assets. The market value of these assets was marginally lower than their purchase price and the resultant loss was borne by the government to restore the financial health of TH. Nazuin Zulaikha Kamarulzaman, “Govt to bear RM10.3 billion Losses in Tabung Haji Rescue Plan,” The Edge Financial Daily, November 15, 2019, https://www.theedgemarkets.com/article/govt-bear-rm103b-losses-tabung-haji-rescue-plan.

\textsuperscript{127} Investors can participate in this scheme with a minimum investment of RM10 and daily redemption is allowed.


\textsuperscript{129} In 1970, the Bumiputera share ownership of corporate equities was 2%, while the non-Bumiputera owned 36% and foreign ownership was 62%.
Similar to TH, PNB experienced exponential growth with assets under management (AUMs) growing from RM3.5 billion in 1981 to RM295 billion in 2018 at a CAGR of 12.7%. Total dividends and bonuses paid out to unit holders rose from RM75.4 million in 1981 to a cumulative RM15 billion in 2018. The huge success of ASN led to the launch of ASB which became PNB’s most successful product. ASB catered only to Bumiputeras and allowed them to borrow in order to fund their investments in the scheme. The introduction of ASB changed the dynamics of product offerings from PNB as ASN was no longer fixed at RM1.00 and floated according to its market value. Meanwhile, ASB obtained the benefit of being a principal-guaranteed investment.

Later in 2000, PNB began to offer products to non-Malay investors through a designated fund, ASM, as financial inclusion expanded its focus. The government realized that the entire population, regardless of ethnicity, required uplifting. Nonetheless, PNB remains the custodian of Malay corporate share ownership and it continues to aim to achieve 30% Malay ownership of all listed companies. In addition, shari’ah compliant investments have also been promoted since 2017 in order to further encourage Malay participation.

Today, PNB is considered as the template for a state-sponsored investment company with its size positioning it as the second largest GLIC after the EPF. PNB in 2018 had 13.7 million accounts opened by Malaysians (more than one third of population) with 236 billion units in circulation. Moreover, PNB holds sizeable stakes in many of Malaysia’s largest companies such as Maybank and Sime Darby that are integral to the country’s continued development.

### 3.8.2.2 Social Development Programs of PNB

PNB has also pursued social programs to enhance the country’s educational level, employees’ skill base and financial literacy. The institution has offered scholarships for chartered accountant programs in which more than 1,000 candidates have enrolled in order to achieve its objective to have 1,000 Bumiputera chartered accountants by 2022. In addition, PNB has sponsored more than 3,000 students since its establishment to pursue their studies at the top global and local universities. As for strengthening employability, PNB’s Graduate Executive Trainee Program offers 12-month classroom and on-the-job training courses and has had more than 2,000 participants trained since its inception in 1981. PNB also conducts various financial literacy programs targeting the masses, the largest of which — Minggu Saham Amanah Malaysia — has attracted 3.8 million visitors since inception. Free financial planning seminars are also held daily across the country and have attracted around 750,000 participants since inception.

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3.8.3 FELDA

In addition to promoting financial inclusion through greater access to savings and investments, the government has also acted to increase inclusivity among the rural community. The FELDA scheme, launched in 1956, allowed participants to participate in agriculture businesses, particularly those related to palm oil and rubber. Every participant was given a plot of land for them to cultivate, and eventually the land ownership was transferred to them. The program was successful in improving agricultural productivity, creating a major source of employment in rural community development. More importantly, it allowed farmers to own their land and an appreciating asset which could also be used as collateral if financing was required from financial institutions.

Moreover, the holistic concept of inclusive development contributed to government efforts in reducing poverty and creating equal economic opportunities and accessibility to all levels of society. The targeted population enjoyed access to better housing, health, security and infrastructure. Sutton and Buang (1995) assert that FELDA’s programs that provide training and education have successfully increased the social mobility of farmers’ second generation. In summary, FELDA proved effective in the development of rural communities and could provide a viable template for other countries to follow.

3.8.4 Malaysia Co-operative Societies Commission

Savings and Credit Co-operatives, often referred to as SACCOs, are user-owned financial intermediaries. They have helped expand financial services in rural areas in developing countries and now represent a sizable proportion of the micro and rural finance industry. There are a range of policy tools that can support SACCOs, including capacity-building programs at the national or local levels to increase financial literacy for SACCO members.

In Malaysia, the National Co-operative Policy 2002 – 2010 was introduced to provide a conducive environment for an orderly and structured development of the cooperative movement. The policy was implemented through programs which included business development, access to financial resources, inculcation of entrepreneurial culture and enhancing the laws for regulation and supervision of cooperatives. The cooperative network continues to expand with the formation of different types of entities focused on consumer, agriculture, housing, transportation, industrial, construction and services. In addition, there are also cooperatives which undertake various business activities and are categorized as multi-purpose cooperatives. The membership of these institutions comprises civil servants, employees of statutory bodies, private sector workers, pensioners, graduates, students, residents of housing estates, small-time businessmen, fishermen, farmers, estate workers, professionals and others.

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132 PNB A Model for Creation & Redistribution of Wealth - PNB, 2019
133 By encouraging land ownership, the scheme also complemented PNB’s objectives which promoted share-ownership among Malays.
136 https://developmentfinance.un.org/achieving-financial-inclusion
Malaysia Co-operative Societies Commission was established in 2008 and acts as a regulator to supervise all cooperatives. It is responsible for the implementation of the National Co-operative Policy 2011 – 2020 which aims to achieve a 10% contribution to GNP in 2020, enhance the socio-economic status of members, focus on the natural environment and act as a responsible corporate citizen. As of December 2018, the total number of cooperative members was just over 6 million while total assets and turnover were RM139.7 million and RM40.3 million respectively.

**FIGURE 10:** Summary Statistic SACCOs 2014-2018 (MYR Million)

![Figure 10](attachment:figure10.png)

Source: Annual Report Malaysia Co-operative Societies Commission 2014-2018

### 3.9 Innovative Solutions in Promoting Financial Inclusion

There are a few solutions worthy of elaboration such as BNM’s IAP, ECF and P2P lending. Most of these solutions also operate within the ambit of risk sharing and in line with the principles of Islamic finance. As such, the instruments that are created are inherently less prone to crises because of their risk-sharing feature with reduced leverage and volatility.\(^{137}\)

IAP was launched in 2016 as a platform designed to channel funds from IAHs in Islamic banks to finance viable ventures and projects. Basically, the platform functions as a market that lists all ongoing projects which require funding, in addition to SMEs and other companies seeking financing. Islamic banks

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\(^{137}\) Risk sharing products are normally designed as equity products and do not increase the level of debt in the system. World Bank Report by M. Ayhan Kose, Peter Nagle, Franziska Ohnsorge and Naotaka Sugawara, “Global Waves of Debt, Causes and Consequences.”, 2020, [http://digitallibrary.in.one.un.org/TempPdfFiles/4649_1.pdf](http://digitallibrary.in.one.un.org/TempPdfFiles/4649_1.pdf) states that rising debt contributes to financial crises and subsequent output losses in many countries.
invest their account holders’ funds in the listed projects, subject to their own internal assessment, with all gains and losses accruing directly to the IAH. Currently, there are 6 Islamic banks participating in this scheme; Affin Islamic Bank Berhad, Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad, Maybank Islamic Berhad, Bank Kerjasama Malaysia Berhad and Bank Simpanan Nasional.

**Thriving on the initiatives of the SC,** ECFC and P2P are also becoming a popular way of raising funds. Currently there are 21 ECF and P2P registered platforms in Malaysia that have cumulatively raised RM587 million for some 1,600 MSMEs. Such platforms are providing an alternative investment opportunity to retail investors, increasing participation of the general public in capital markets by directly connecting the owners and users of capital.

**Notwithstanding,** pawnbroking is another innovative Islamic financial instrument that offers Malaysians access to finance. Pawning in Malaysia was started in 1992 under the MAIDAM and followed by Permodalan Kelantan Berhad. Then, on 21 August 1993, the MOF announced the establishment of an Islamic pawnbroking scheme named Skim Al-Rahnu through the collaboration of 3 institutions, namely BNM, the YaPEIM and Bank Rakyat. Apart from YaPEIM’s cooperative, several other cooperatives in most states also run this system. Customers who require short-term loans and have gold jewelry can consider pawning as a cheaper alternative to taking personal loans. It is available to locals and foreigners, be it Muslims or non-Muslims. The IFIs have the right to keep the pledged item after giving a loan to the customers. Borrowers have a choice, either to repay via lump sum or by monthly instalments.

The margin of finance is from a minimum of RM100 up to 60-70% of the value of the gold. If the borrower is unable to repay the loan, the borrower may be granted an extension of up to 3 months. If the borrower is unable to repay the loan within the stipulated time or after the extension, the pawned item will be auctioned off and any surplus less outstanding amount and charges would be returned to the borrower. Pawning is free from any *riba* or *gharar* (uncertainty) and is deemed to be *shari’ah* compliant. Borrowers will only need to pay the principal fee plus a safekeeping fee as agreed.

### 3.10 Islamic Social Finance Institutions

#### 3.10.1 Zakat

In the early 1990s, the SIRCQs had undergone various phases of development, especially in relation to their corporatization, which enabled them to embark on a new stage of management and development. It is notable that after corporatization, the collection of zakat has increased nearly tenfold between 1991-2006.

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138 See section 2.4.2 (a) in chapter 2.
Table 8: Value of Zakat Collection in Malaysia (RM Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Zakat Collection</th>
<th>Year</th>
<th>Zakat Collection</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>61</td>
<td>2003</td>
<td>408</td>
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<td>1992</td>
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<td>2004</td>
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<td>2013</td>
<td>2265</td>
</tr>
<tr>
<td>2002</td>
<td>374</td>
<td>2014</td>
<td>2457</td>
</tr>
</tbody>
</table>

Source: Abdalrahman Migdad 2019\(^{140}\) and JAWHAR 2017

The increase in the collection has also been caused by the adoption of other strategies to motivate and encourage Muslims to pay zakat. These have included promotions and awareness campaigns that have focused on increasing zakat collections from prospective contributors. The most successful zakat campaigns are conducted in December, as payment at the year-end is eligible for a tax rebate from the Inland Revenue Board. In some states, zakat payments are encouraged through advertisements on public transport and arranging buntings in public areas. Studies have suggested that an increased collection of zakat in Malaysia may have been caused by several factors such as easy payment methods (internet and mobile banking) and the effective privatization of zakat institutions.\(^{141}\)


\(^{141}\) Ibid.
Case Study 1:

Zakat Collection in Selangor

The zakat payment in Selangor can also be made via debit and credit cards, ATMs, online and mobile banking. The zakat Selangor has introduced E-Taisir since 2013, where the distribution of zakat to eligible recipients will be made through an identification card (MyKad). The zakat recipients can buy groceries at the selected supermarket, which has a POS terminal for E-Taisir. As of December 2019, 50,261 (91%) recipients received zakat funds from zakat Selangor through their bank account as well as 1,308 E-Taisir users. Due to the digitalization, the collection and distribution of zakat in Selangor has increased since 2014, as shown in the chart below:

**FIGURE 11: Collection & Distribution of Zakat in Selangor, Malaysia (RM Million)**

Source: Annual Report Zakat Selangor, 2018
3.10.2 Waqf

AIBIM has formed a platform called myWakaf to integrate waqf’s role into the Islamic banking framework. myWakaf comprises participation from six Islamic banks, namely Affin Islamic Bank Berhad, BIMB, Bank Rakyat, BMMB, MIB and RHB Islamic Bank Berhad. Under this arrangement, Islamic banks collaborate with SIRCs in developing the potential of waqf with the aim of economically empowering the people of Malaysia. A waqf fund has been mobilized from endowments provided by individuals and corporations and is being utilized for investments in education, health, and for economic empowerment. The latter refers to the utilization of the waqf fund to develop social facilities, promote educational activities in addition to providing scholarships and medical aid to poor people, displaced children and orphans.

The funds, available through participating bank branches, had exceeded RM1.5 million by September 2017. Therefore, in April 2019, myWakaf entered its second phase with the launching of the myWakaf portal, offering various channels of collection across the country. Donors may choose to subscribe through JomPAY or use the internet to transfer funds to their project of choice located in several states.

**FIGURE 12: Waqf Fund Structure**

- Lead Bank will be appointed in the Waqf Fund project and will be member of JMC.
- The others will be Participating Banks.
- Strategic Collaboration Agreement between the consortium.

Return from investment will be channeled to the waqf project and also to cover some operation cost.

All banks will open respective collection accounts, and the collected fund will be credited to the project main account at Lead Bank.

Source: myWakaf, 2019; AIBIM, 2019

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142 Association of Islamic Banks Malaysia, [https://www.mywakaf.com.my/](https://www.mywakaf.com.my/)
143 JomPAY is a national bill payment scheme that allows customers to pay bills conveniently and securely via the internet and mobile banking.
144 The projects include a hemodialysis service at the Tunku Fauziah Hospital in Perlis, a boat waqf project in Perak, the Islamic school in Negeri Sembilan, and the Al-Bait waqf fund in Sarawak. It is easier, more effective, and tax-exempt contributions (myWakaf, 2019; AIBIM, 2019).
Another effort undertaken by IFIs in connecting benefactors with the needy is through sadaqah (charity) accounts such as BIMB’s Sadaqah House, Alliance Islamic Bank’s SocioBIZ, and Affin Barakah Charity Account-i. Donations can be made via mobile and internet banking, and QR code. Affin Barakah Charity Account-i, for instance, has channeled approximately RM25.1 million from 2014 to 2018 to different causes and sectors of the underserved population, educational aid, settling of debts for eligible individual recipients and other charitable purposes.

3.11 Conclusion

Malaysia’s economic success is not just due to its rich natural resources but also well-coordinated policies in relation to financial inclusion that have been marked with continuity. Hitherto, the government had embarked on various mechanisms involving a myriad of institutions to promote greater inclusion in order to ensure that the populace benefits directly from financial institutions and the products that they offer.

The country has a few unique policies to offer to the rest of the world, particularly Muslim countries, as Malaysia has converted some of its problems into opportunities. The creation of TH enabled Malay Muslims to save and perform the pilgrimage to Makkah; PNB’s establishment addressed the need to restructure the economy and reduce ethnic economic inequalities. Also, the need for shari’ah banking and products propelled the development of Islamic banking and enhanced financial inclusion. Today, these institutions play a pivotal role in ensuring that the fruits of Malaysia’s economic success are equally shared by its citizens.

Malaysia has also successfully leveraged Islamic social finance through zakat and waqf institutions to redistribute wealth. These institutions fulfill religious obligations and enhance financial inclusion by complementing other initiatives that are led by the government. In order for financial inclusion to be effective, governments must create policies and institutions that enable both wealth accumulation and redistribution.

Notwithstanding the success of these institutions, countries have to be mindful of the impact of race or religion-based policies on growth and competitiveness. The Malaysian experience accentuates the need for better corporate governance and transparency in order to minimize rent seeking and the misappropriation of wealth. Also, affirmative action policies promulgated on the basis of reducing income disparities may cause excessive protectionism. This will be to the detriment of competition and may affect the country’s ability to compete both regionally and globally.

Malaysia provides a template for emerging economies to build an ecosystem that promotes financial inclusion. It is imperative that every country determines its own balance between the role of the state and market and implements effective redistribution policies to achieve this equilibrium. Malaysia’s success has brought it closer to achieving developed nation status but in order to preserve its gains, it must ensure that prosperity is shared not concentrated, funding and support are based on merit not privilege and critically, the rule of law prevails.
CHAPTER 4

Consumer and Investor Protection in Islamic Finance
4.1 Introduction

Effective consumer and investor protection, as well as increasing literacy, are essential elements of financial inclusion. The responsible delivery of financial services requires responsible market conduct by vendors and investor protection oversight by regulators. Investor confidence and trust in a well-functioning market for financial services promotes financial stability, innovation, and inclusion over the long term. With an increasingly digital environment to facilitate greater financial inclusion, the need for robust consumer financial protection and investment literacy is even more imperative. The effective implementation of policy measures helps build trust and maintains confidence in the financial system. This is fundamental to improving financial inclusion through increased consumer participation in formal financing, which, in turn, is essential for poverty alleviation and increased prosperity.

Consumer protection is about empowering consumers to make informed decisions about financial products and services, based on complete and accurate information provided by financial institutions. Consumers should be protected from unfair or deceptive practices and should also have access to effective recourse mechanisms for dispute resolution. Thus, the complexity for some customers and investors to fully comprehend shari’ah compliant products and services has prompted regulators to provide a robust regulatory framework for consumer and investor protection. For instance, conventional banks are only concerned with paying interest to depositors while customers in IFIs can place their funds in either deposits or PSIAs. Profits emanating from PSIAs are based upon a portfolio of underlying assets and shared between the customer and the IFI in a predetermined ratio. As profits are dependent upon the performance of the underlying assets.

underlying portfolio, returns cannot be fixed in advance. Theoretically, investors can suffer losses to the principal investment should the underlying assets perform poorly unless this is due to the willful negligence of the bank as the manager of these funds.\textsuperscript{146} It is critical that investors in PSIAs are aware of the risks to which they are exposed through appropriate consumer protection regulation.

**Islamic banks are subject to 2 types of consumer protection.** Firstly, they must follow standard rules of full disclosure and transparency in relation to their products and services which is common to all financial institutions. Secondly, IFIs have a fiduciary duty to ensure that all their products are shari'ah compliant and in conformity with the applicable shari'ah governance framework. Lukonga\textsuperscript{147} suggested the framework in Figure 13 for consumer protection in Islamic finance.

\textbf{FIGURE 13: A Framework for Consumer Protection in Islamic Finance}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{framework_consumer_protection.png}
\caption{A Framework for Consumer Protection in Islamic Finance}
\end{figure}

146 In practice, part of the credit and market risks of the investments are passed onto the IFI’s shareholders by the investors. This is termed as the ‘displaced commercial risk’ inherent to IFIs and may be partially shared between investors and the IFI or entirely assumed by the latter.

Users of Islamic financial services, therefore, need to understand the nature of shari’ah-compliant products as well as the risks they pose. Financial institutions, in turn, have an obligation to be transparent and make full disclosures about the products and services they offer. This is more important for Islamic finance, which has a religious dimension as a large number of consumers expect the financial institutions to adhere to the core principles of shari’ah in all their operations. Malaysia is one of the countries that provides explicit guidance for Islamic financial products in the regulations governing consumer protection.

Additionally, as international standard bodies, both AAOIFI\(^{148}\) and IFSB\(^{149}\) have issued standards and guidelines on disclosures, including all provisions on PSIs, differences between restricted and unrestricted IAHS as well as IFIs’ approach towards managing risks associated with such accounts. Given the quasi-investor status of IAHS, the integrity and transparency of the IFI’s accounting and financial reporting are also important. IAHS should have access to accurate and current information on the financial condition and performance of the IFI as well as verification of the shari’ah-compliance of its financing and investment operations. IAHS also need to know the basis for preparing the IFI’s financial statements, including the use of IFRS standards and, where applicable, standards prescribed by AAOIFI. In general, regulators should issue guidelines on aspects such as calculation of profits, a publication of statements on shari’ah-compliance, types of fees that may be charged, and the basis of charges. All fees and charges should be published at all branches and on websites. AAOIFI’s FAS Number 11 (1996) contains disclosure requirements for investment accounts, and its FAS 14 (2000) on investment funds provides a list of items for disclosure. Detailed guidance on the calculation of profit shares for IAHS was initially provided in AAOIFI FAS 6 but has now been transferred to FAS 27.\(^{150}\)

4.2 IFSB

The IFSB has issued a number of standards and guidelines on aspects relevant to consumer protection in Islamic finance. These include IFSB-4 on Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services; IFSB–6 on Governance of Islamic Collective Investment Schemes; and IFSB-9 on Conduct of Business Standards. There is also a joint publication by the IFSB/IOSCO and the SC on the Disclosure requirement for Islamic Capital Market (ICM) products released in 2013.\(^{151}\)

IFSB in 2019 issued a Technical Note on Financial Inclusion and Islamic Finance (TN–3).\(^{152}\) The TN–3 encourages the adoption of non-prudential guidelines that prohibit discrimination against marginalized segments of society. Service providers in financial inclusion activities must have transparent criteria regarding the eligibility of specific products and without any bias towards women, race, caste, religion or ethnicity. Shari’ah-compliant financial products and services are available to all as long as the activities of the contracting parties do not contravene the principles of shari’ah. Additionally, the TN also acknowledges the role of affirmative action policies that endeavor to address the gaps in the financial inclusion of marginalized segments.
Financial literacy is a key discussion in consumer protection under the TN-3, especially the additional information that is required in Islamic finance such as product structures and the varying rights of contracting parties (in relation to the underlying contracts) as guided by shari'ah. Thus, adequate disclosures and information transparency help in mitigating financial illiteracy and information asymmetry challenges. Furthermore, clear, standardized product disclosure sheets help in mitigating financial illiteracy. The product disclosure sheet – or its terms and conditions, at a minimum – should indicate the financial responsibility of the client in relation to the product being signed up for, including terms of regular instalment payments, profit/fee/commission to be charged by the service provider, any financial risks (e.g., for investment products), punitive measures in the event of non-payment, and dispute resolution mechanisms should differences arise.

The TN-3 strongly encourages jurisdictions to have in place recourse options specifically for financial inclusion clientele. These may be special tribunals or dispute resolution bodies established by the regulatory authority or by relevant ministries in the jurisdiction or an industry association and/or be supported by NGOs to provide guidance and welfare support to financial inclusion-tagged consumers. In addition, the supervisory authorities may regularly review complaints and grievances data filed at the tribunals/dispute resolution bodies to identify frequent dispute issues in financial inclusion activities. This review will serve as an important feedback mechanism to further improve upon consumer protection regulations and practices in financial inclusion activities on an ongoing basis.

153 Ibid.
4.3 BNM

BNM, especially after the Asian financial crisis of 1997, has taken several initiatives and strategies to strengthen the capacity of financial institutions, promoting financial education among consumers and to ensure that financial institutions are committed to fair market services. The key developments related to the consumer and market conduct framework have been summarized in Table 9 below:

<table>
<thead>
<tr>
<th>Consumer Empowerment</th>
<th>Market Conduct</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>Asian Financial Crisis</td>
</tr>
<tr>
<td>1999</td>
<td>Consumer Protection Act (CPA) 1999 was introduced</td>
</tr>
<tr>
<td>2001</td>
<td>Central Credit Reference Information System was created</td>
</tr>
<tr>
<td>2005</td>
<td>Commencement of walk-in public service centre. BNMLINK to provide financial advice to the public and businesses</td>
</tr>
<tr>
<td></td>
<td>Deposit Insurance Corporation was established</td>
</tr>
<tr>
<td></td>
<td>Financial Mediation Bureau commenced operations to redress consumers’ complaints against financial institutions under the supervision of the central bank</td>
</tr>
<tr>
<td>2006</td>
<td>Credit Counselling and Debt Management Agency (AKPK) was established</td>
</tr>
<tr>
<td></td>
<td>The central bank established the Consumer and Market Conduct Department (CMC)</td>
</tr>
<tr>
<td>2007</td>
<td>Global Financial Crisis</td>
</tr>
<tr>
<td>2008</td>
<td>BNM consolidates customer and complaint management into the Integrated Contact Centre (ICC)</td>
</tr>
<tr>
<td>2009</td>
<td>The establishment of shari’ah commercial court following the recommendation of Financial Sector Master Plan (2001-2010)</td>
</tr>
<tr>
<td>2010</td>
<td>Personal Data Protection Act (PDPA) 2010 is introduced</td>
</tr>
<tr>
<td>2013</td>
<td>Islamic Financial Services Act (IFSA) 2013 is introduced</td>
</tr>
</tbody>
</table>

154 A special division under the civil court to deal with Islamic banking and financial matters.
Chapter 4: Consumer and Investor Protection in Islamic Finance

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>POWER</strong> program launched that targets Malaysian adults</td>
</tr>
<tr>
<td>2015</td>
<td>Financial Capability and Inclusion Demand Side Survey launched by BNM to track the financial literacy levels in Malaysia</td>
</tr>
<tr>
<td>2016</td>
<td>BNM launched the FEN. The OFS commenced operations in October 2016, taking over the functions of the FMB.</td>
</tr>
<tr>
<td>2017</td>
<td>An Inter-Agency Steering Committee was formed in January 2017 under the FEN</td>
</tr>
</tbody>
</table>

Adapted from: Di Castri (2011) Hassan and Mohamad (2019)

The CBA 2009 mandated BNM as a regulator for banks, insurance companies, DFIs, IFIs, and payment systems. BNM is tasked with developing a financial sector including Islamic finance, consumer empowerment, and market conduct, as well as deepening financial inclusion. A risk-based approach has been adopted by BNM in consumer protection, which complements its efforts with financial education and market intelligence. Products and practices which constitute undue risk are highlighted to consumers, such as aggressive credit-card marketing or outsourcing debt collection.

BNM recognizes the importance of financial education in elevating financial literacy. Thus, the central bank has partnered with the FEN to expand the reach and coverage of financial education initiatives. The collaboration with the MOE to nurture financial literacy among the young has seen the progressive integration of financial education into the school curriculum up to the Secondary Two level, with an objective of integrating such education for all primary and secondary levels by 2021. The MOE’s commitment to ensure that financial education is implemented effectively in schools has shown encouraging results with teachers demonstrating greater confidence and knowledge of the subject. This has been supported by the inclusion of a financial literacy elective module for trainee teachers along with more tailored programs that are being rolled out by the MOE for teachers in service.

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156 BNM follows a risk-based supervision model using surveillance activities, complaints data, and statistical information to prioritize follow-up.


158 Primary education targets ages 7-12 while secondary focuses on ages 13-17.

4.4 SC

The SC launched InvestSmart in 2014 which sought to create greater investment awareness and initiated a financial literacy campaign to enable more informed retail participation in the capital markets. InvestSmart aims to allow investors to better comprehend the various products in the capital markets and know their rights and responsibilities as investors, as well as avenues for redress.

Another initiative by the SC is to introduce aFINity@SC which brings together the FinTech community and aims to assist stakeholders in accelerating innovative growth within the industry. Various programs have been conducted amongst the aFINity network to promote awareness of recent developments within the local and international FinTech industry.

4.5 FEN

FEN is an inter-agency grouping co-chaired by BNM and SC and with founding members comprising MOE, PIDM, EPF, AKPK and PNB. FEN was established in 2016 to serve as an inter-agency platform to increase the impact of financial education initiatives and identify new opportunities to elevate financial literacy among Malaysians through greater alignment, closer collaboration and a strong focus on impact assessments. The issuance of the Malaysia National Strategy for Financial Literacy (2019-2023) aims to elevate the level of financial literacy, promote responsible financial behavior and healthy attitudes towards financial management. The National Strategy led by FEN, has a holistic five-year plan which sets out strategic priorities and broad action plans to develop a financially literate nation.

BNM’s Financial Capability and Inclusion Demand Side Survey 2018 (FCI Survey 2018) reveals that the current state of financial literacy of Malaysians has room for improvement. The FCI Survey 2018 highlighted several concerns among Malaysians in the following areas: (i) level of financial knowledge; (ii) saving and budgeting; (iii) readiness for unexpected life events; and (iv) planning for retirement. The survey findings by AKPK on Financial Behavior and State of Financial Well-Being of Malaysian Working Adults 2018 and SC’s Assessment of Capital Markets through Malaysians Investors’ Perspective 2018 also found that financial education plays an important role in improving financial behavior. The National Strategy focuses on empowering Malaysians (i) to save, manage, and protect money; (ii) plan ahead, and ensure a sustainable future; and (iii) protect individuals from fraud and financial scams. The guiding principles that should be adopted to implement the National Strategy are:

1) Shared responsibility among stakeholders to improve the financial literacy of Malaysians. Collaboration enables the identification and remediating of financial vulnerabilities and optimizes resources to achieve synergies in the Strategy’s execution.

2) Development of inclusive and targeted financial education programs for Malaysians in all life stages. Literacy initiatives should take into account financial needs according to life stages, and by focusing on the most vulnerable groups.

160 Ibid.
3) Implementation of initiatives that encourage and empower Malaysians to take responsibility for their own financial well-being. A core principle advocated in the Strategy is ‘individual responsibility’.

**FIGURE 14: Overview of the Malaysian National Strategy for Financial Literacy**

Source: Financial Education Network 2019-2023

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162 Ibid
Chapter 4: Consumer and Investor Protection in Islamic Finance

4.6 IFSA 2013

IFSA 2013 has provided for regulation and supervision of IFIs, payment systems as well as oversight of the Islamic money and foreign exchange markets. This is in accordance with the objective of the BNM in promoting financial stability by safeguarding shari’ah-compliance. Another significant element in IFSA is consumer protection. Section 133 of IFSA defines a financial consumer as any person who is involved with any financial service or product for personal, domestic or household purposes or in connection with a small business as may be specified by BNM in standards of business conduct. Additionally, this definition also covers corporate bodies as this group also benefits from such services and products.

IFSA, which emphasized the risk-sharing model, also introduced the Investment Account, which enables IFIs to offer true-sale credit financing instruments as well as a greater level of flexibility in terms of investment criteria. Hence, the customers can opt to place their funds between Islamic deposit and investment accounts. The structure of investment accounts offered reflects the actual performance of the underlying asset pool or business activity. Profit smoothing practices, however, are prohibited. Magalhães and Al-Saad (2013) have criticized profit smoothing techniques such as profit equalization reserve as “practices (which) impede the transparency and reliability of financial information, and severely constrain the investors from evaluating the bank’s actual performance.” Additionally, the priority of payment for investment account holders upon liquidation of the IFI is treated separately from Islamic deposit holders.

Financial Consumer Protection in IFSA includes standards on business conduct, prohibited activities, and the financial ombudsman scheme, which are all essential to safeguard the interests of consumers in Islamic banking. Such standards may include transparency and disclosure requirements, the fairness of terms in the financial contract, promotion of services or conduct recommendations, and advice on the suitability of services or products provided by IFIs in addition to specifying complaints and dispute resolution mechanisms. IFSA also imposes a penalty of imprisonment for a term not exceeding five years or a fine not exceeding ten million ringgits to those, including IFIs, who contravene the prohibition made by it. A World Bank report explained that essential pre-requisites for a sound consumer protection

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163 See section 2.2 in chapter 2.
168 Islamic deposits are confined to principal guaranteed by shari'ah contracts such as qard, wadiah and murabahah Investment Account is structured based on mudharabah, musharakah and wakalah contracts that do not provide guarantee of the return of principal nor a profit on investment.
172 Section 135 on “standards on business conduct.”
framework should include the following features: (i) disclosure and transparency; (ii) fair business conduct; (iii) data protection and privacy and (iv) redress or dispute resolution mechanisms. Additionally, IFSA forbids IFIs to coerce their financial consumers into purchasing bundled services or products.

Table 10 illustrates the 4 main elements of the financial consumer protection regulatory framework and the corresponding laws.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure and Transparency</td>
<td>Division 3, Section 72-75</td>
<td>Malaysian Code on Corporate Governance, issued by Securities Commission Malaysia (2017)</td>
</tr>
<tr>
<td>Data protection and privacy</td>
<td>Section 145</td>
<td>Persona Data Protection Act 2010</td>
</tr>
<tr>
<td>Complaints handling and dispute resolution mechanism</td>
<td>Section 138</td>
<td>Establishments of Ombudsman for Financial Services, BNMLINK, TELELINK, Complaint Units of Financial Institutions, and Credit Bureau</td>
</tr>
</tbody>
</table>

Source: Mohamad, N. N. and Hassan, R. (2019)

The SGF for IFIs, introduced in 2011, has played a critical role in supporting robust and orderly developments of the Islamic finance industry in Malaysia. In particular, the framework has led to the institutionalization of governance structures, policies and processes to promote end-to-end shari‘ah compliance in Islamic finance operations. The revised SGF, which will be effective starting April 1, 2020, emphasizes transparency and disclosure. The SGF has specific guidelines on the disclosures required by the IFI’s board and shari‘ah committee along with the disclosures that are needed to be made by IFIs on their shari‘ah governance policies and practices in their annual report. Such disclosures must include (a) disclosure by the board on its oversight accountability for shari‘ah governance implementation and the IFI’s overall compliance with shari‘ah; and (b) disclosure by the shari‘ah committee on its– (i) responsibilities relating to shari‘ah governance; and (ii) opinion on the state of the IFI’s compliance with shari‘ah. Thus, the revised Framework aims to strengthen expectations for effective shari‘ah governance arrangements that are well integrated with the IFI’s business and risk strategies. The SGF must be read together with other relevant BNM policy documents such as: (i) Corporate Governance; (ii) Fit and Proper Criteria; (iii) Compliance; (iv) Risk Governance; (v) Operational Risk; (vi) Outsourcing; (vii) Guidelines on Internal Audit Function of Licensed Institutions; (viii) Financial Reporting for Islamic Banking Institutions; (ix) Guidelines on Financial Reporting for Development Financial Institutions; and (x) Financial Reporting for Takaful Operators.

174 See section 2.2 in chapter 2.
4.7 Consumer Protection in BNM’s Takaful Regulatory Framework

BNM recently issued revised TOF which will be effective from July 1, 2020. The TOF is governed under the IFSA and aims to strengthen the governance of takaful operators, including how takaful funds are managed, to further safeguard the interest of takaful participants. The TOF will provide greater clarity on the use of multiple shari’ah standards in the models and structures of takaful. This TOF must be read together with the Guidelines on Product Transparency and Disclosure (31 May 2013); Shari’ah Governance Framework for Islamic Financial Institutions (22 October 2010); Risk-Based Capital Framework for Takaful Operators (17 December 2018); Guidelines on Valuation Basis for Liabilities of General Takaful Business (15 May 2012); Guidelines on Valuation Basis for Liabilities of Family Takaful Business (16 May 2012); Guidelines on Investment Management for Takaful Operators (29 April 2009); Appointed Actuary: Appointment and Duties (29 April 2014); Introduction of New Products by Insurers and Takaful Operators (15 May 2015); Investment-Linked Business (11 January 2019); Guidelines on Family Takaful Products (12 July 2007); and Guidelines on Medical and Health Takaful Business (17 September 2007).175

Additionally, BNM also implemented the Phase II of the motor tariff liberalization176 which has paved the way for greater differentiation in the pricing of motor insurance/takaful products as well as the introduction of new motor products and extensions of cover by insurers and takaful operators.177 In facilitating informed decisions by consumers when purchasing and renewing their motor cover, insurers and takaful operators are required to provide adequate disclosures of premiums/contributions and product features that can be easily compared both across products and insurers and takaful operators. Based on the product filings by insurers and takaful operators, an estimated 34% of policy owners/takaful participants also enjoyed lower premium rates of up to 15% from previously applicable tariff rates. Insurers and takaful operators also published and implemented the CSC to affirm their commitment to deliver consistently higher standards of customer service quality, a move that is expected to encourage healthy competition and further elevate service standards.178 BNM also introduced the BSC framework in 2018. The latter introduces changes to the remuneration structure of insurance and takaful intermediaries with the aim to align sales incentives with better quality sales and policy servicing by intermediaries. BNM also elaborated its expectations for intermediaries to be led by persons of integrity, credibility and competency through the publication of standards on Fit and Proper Criteria for Approved Persons in December 2018.179 These standards require intermediaries to assess and determine the fitness and propriety of individuals in oversight and management positions as well as FAR, guided by a set of criteria. Further enhancements were also made to the BCCILA offered by the Malaysian Insurance Institute. Revisions were made to existing topics covering business ethics, code of conduct and customer service excellence, in addition to new topics

176 The first phase of the Liberalization of the Motor and Fire Tariff was introduced on 1 July 2016. During this initial phase, insurers and takaful operators were given the flexibility to offer new motor products and add-on covers that were not defined under the existing tariff. From 1 July 2017 onwards, premium rates/takaful contributions for Motor Comprehensive; and Motor Third Party Fire and Theft products were liberalized where premium pricing/takaful contribution is determined by individual insurers and takaful operators.
introduced on technical standards for the investigation, verification and estimation of motor claims. The enhanced content aims to promote ethical conduct and raise the competency levels of new and existing loss adjusters in support of broader ongoing initiatives to improve claims handling processes for motor insurance/takaful. 

### 4.8 Dispute Support/Grievance Recourse

The OFS commenced operations in October 2016, taking over the functions of the FMB. OFS is the operator of the Financial Ombudsman Scheme approved by BNM pursuant to the Financial Services Act 2013 and IFSA. In resolving disputes, the OFS is guided by 6 internationally recognized principles, namely, the principle of independence, fairness and impartiality, accessibility, accountability, transparency and effectiveness.

Since its inception in 2016 until December 31, 2018, OFS has registered 2,470 cases, with insurance and takaful disputes accounting for almost two thirds of the cases received. OFS in 2018 handled a total of 10,178 enquiries and complaints. Of the 4,530 new complaints and enquiries received, 63% were on insurance and takaful related matters, 35% on banking matters and the remaining 2% on payment systems, broking business and financial advisory services. Of the total 4,530 new complaints, 761 (17%) were registered and the remaining were settled either at screening stage or were out of the jurisdiction of OFS e.g., customer service issues or insufficient documents.

OFS encourages an amicable settlement between the complainants and the FSP through negotiation, mediation and conciliation. 39% of the cases were resolved through amicable settlement and the remaining were issued with a recommendation or adjudicated by the Ombudsman.

![Figure 15: Disputes Registered by Sector](image)

**Source:** Ombudsman for Financial Services Annual Report 2018

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181 4,530 new enquiries and complaints received in 2018 and remaining 5,648 were repeating customers from previous years.
Life/family cases topped the list in 2018 (37%). A growing area of disputes for life insurance registered at OFS includes mis-selling of insurance/takaful products by sales intermediaries.
In 2018, OFS closed 863 cases of which 65% were done within 6 months from the date of registration. About 24% of the cases were settled within 3 months from the registration date. Factors such as the changing nature of cases received, the complaint-handling behavior/manner of the FSPs, as well as sufficiency of documents and evidence contributed to the overall time taken to resolve a dispute. Disposal of cases that took more than 6 months were commonly due to (i) obtaining further documents (medical and reassessment reports); and (ii) extension of time required by the complainant and the FSPs in achieving a settlement.

### Table 11: Turnaround time for outstanding cases (2018)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Insurance</th>
<th>Takaful</th>
<th>Commercial Banking</th>
<th>Islamic Banking</th>
<th>Payment System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1 month</td>
<td>78</td>
<td>26</td>
<td>31</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>1 to 2 months</td>
<td>33</td>
<td>6</td>
<td>13</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>2 to 3 months</td>
<td>29</td>
<td>2</td>
<td>14</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>3 to 4 months</td>
<td>19</td>
<td>5</td>
<td>11</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>4 to 6 months</td>
<td>15</td>
<td>8</td>
<td>11</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>6 to 9 months</td>
<td>7</td>
<td>1</td>
<td>8</td>
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<td>9 to 12 months</td>
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<tr>
<td>More than 12 months</td>
<td>0</td>
<td>1</td>
<td>0</td>
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</table>

Source: Ombudsman for Financial Services Annual Report 2018

As at 31 December 2018, OFS has 333 cases outstanding which were carried forward to 2019. Out of this, 231 cases were insurance and takaful disputes, and 102 cases were banking and payment systems disputes. For outstanding cases, 94% (314) of the cases were outstanding for less than 6 months from the date of registration and only 6% (19) of the cases exceeded 6 months. Most of the outstanding cases as at 31 December 2018 were newly registered cases in the last quarter of 2018.

Complaint Management and Advisory Services by BNMLINK\(^{183}\) offers an alternative avenue for consumers to seek redress or resolve disputes with banks. In 2018, BNMLINK and OFS handled 88% and 12%, respectively, out of 6,465 cases of second level complaints.\(^{184}\)

The CURE is a surveillance and profiling tool used by the BNM to promote the fair and effective management of complaints by FSPs. The latter are assessed against five key components of fair treatment in complaints management based on regulatory requirements as well as industry and international best practices which are illustrated in Figure 18. As CURE profiling is conducted biennially, assessments also cover a FSP’s performance against specific action plans and KPIs identified in the previous assessment.

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183 See section 2.4 in chapter 2 that discusses BNMLINK in more detail.
184 Second level complaints are complaints that fall within the jurisdiction of BNMLINK and OFS respectively, after consumers have complained to Financial Service Providers.
BNM continued to provide constructive feedback to FSPs based on its monitoring of their complaints handling processes and outcomes using CURE. Most FSPs within the banking industry continued to make progress in strengthening their oversight functions and operational management to ensure compliance with regulatory requirements and fair outcomes for financial consumers.

The establishment of SIDREC in Malaysia, aims to strengthen investor protection by providing access to redress and assistance to investors on any investment disputes. SIDREC acts on dispute resolution for monetary claims made by investors against capital market intermediaries who are SIDREC members, pertaining to any dealings or transactions involving capital market products and services. In 2018, SIDREC extended its purview by offering its services to investors and service providers on disputes in relation to claims exceeding RM250,000.

Upon receipt of a complaint, SIDREC will first assess the eligibility of the case and will deem a complaint as eligible if it: (i) is made against a member of SIDREC (ii) involves capital market products or services under SIDREC’s purview (iii) is brought by an individual investor or sole proprietor (iv) involves a claim of monetary loss and is under the Mandatory Scheme and falls within the maximum claim limit. SIDREC also receives enquiries from investors who wish to seek further clarification on the following matters:

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186 SIDREC Members are holders of Capital Markets and Services License (CMSL) or Registered Persons under the Capital Markets and Services Act 2007 (CMSA) who are authorised to carry out dealings in securities, derivatives, private retirement schemes (PRS) and fund management services. Available from: https://sidrec.com.my/sidrec-members/
187 A complaint will be classified as ineligible if it does not fulfil any of the above criteria or considered an "excluded dispute" under Rule 8 of SIDREC’s TOR. The TOR available from: https://sidrec.com.my/wp-content/uploads/2020/01/SIDREC_TOR_3rd_Revision_31_October_2017_Cif_1_December_2017.pdf
188 Mandatory Scheme for disputes involving claims not exceeding RM250,000; Voluntary Scheme for disputes involving claims exceeding RM250,000.
(i) dispute resolution services provided by SIDREC (ii) issues investors may experience in their investments in the capital market (iii) other general enquiries which may be related to the capital markets. The Figure below is the claims and enquiries received between 2014-2018.

![FIGURE 19: Claims and Enquiries](source: SIDREC Annual Report 2014-2018)

Overall, SIDREC managed a total of 95 eligible disputes in 2018 which included 12 eligible disputes brought forward from the previous year. SIDREC approach is based upon mediation from the commencement to closure of every case. This approach has proven effective as 97% (58 out of 60) of the eligible disputes which went through SIDREC’s resolution process in 2018 were settled at the case management stage (which involves claim investigation) or subsequently during mediation.

SIDREC aims to complete all its dispute resolutions within 90 working days upon receipt of the complete documentation and information on an eligible dispute. Of the 60 cases resolved in 2018, 88% (53 out of 60 eligible disputes) were resolved within the mandated timeline of 90 working days of receiving the complete documentation and information from the disputing parties. In the remaining 7 eligible disputes which were completed after the mandated timeline due to lack of cooperation received from the claimant

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189 A further breakdown of the status of the eligible disputes managed by SIDREC as at 31 December 2018 is as follows:
- Of the 60 eligible disputes, 47 (78%) were resolved during case management, 11 (18%) were resolved during mediation and 2 (4%) proceeded to adjudication.
- There were 3 eligible disputes considered “excluded disputes” as per Rule 8 of SIDREC’s TOR, after receiving further information from the respective claimants.
- 1 eligible dispute was terminated during the dispute resolution process due to non-compliance with the TOR.
- 11 eligible disputes were premature cases (they have not been referred to the members for an internal dispute resolution process prior to approaching SIDREC).
- 20 eligible disputes were carried forward to the following year (2019).
and member during the dispute resolution process, as well as the availability of parties for the mediation sessions and adjudication hearing.

### 4.9 Conclusion

Malaysia uses a standardized framework for all consumer and investor protection, which covers both Islamic and conventional financial products and services. The framework includes transparency and disclosure requirements, the fairness of terms in the financial contract, data protection, and privacy in addition to complaints and dispute resolution mechanisms.

Additionally, financial regulators, in collaboration with the MOE and industry stakeholders, have participated aggressively in raising consumer awareness and financial literacy among various segments of the population. With greater financial innovation and the growing complexity of financial products and services, it has become more important to equip financial consumers with the knowledge to make informed decisions with confidence. Strong policy coordination is required in building financial capability, elevating the level of literacy and promoting prudent financial management. More informed consumers and investors boost confidence and trust in a well-functioning market for financial services to promote financial stability, innovation, and inclusion over the long term.

Effective dispute resolution mechanisms function as an avenue to redress consumers’ complaints against financial institutions while enabling financial regulators and institutions to improve consumer protection regulations and practices, respectively, by reviewing the data of all filed complaints. In addition, IFSA which comprises the SGF and TOF, ensures that all banking and takaful products and services offered by IFIs remain shari’ah compliant.
CHAPTER 5

Broadening Access and Resilience in Digital Islamic Finance: Opportunities and Challenges
5.1 Introduction

The global digital revolution is having a significant impact in promoting financial inclusion. The findings from Findex 2017\(^{190}\) explicate that (i) digital technology, in particular, widespread access to cell phones and the internet is driving access to and the use of financial services; and (ii) advances in digital financial services, starting with digital payments and including saving, credit and insurance products delivered through digital platforms, are key to improving financial inclusion. Consequently, the advancement of technology, in particular FinTech, is becoming a linchpin in providing greater access to financial services, especially in the Muslim world.\(^{191}\)

The FinTech revolution is providing impetus to the growth of Islamic finance and its role of serving a core population of 1.8 billion Muslims world-wide.\(^{192}\) According to Findex, 72% of the population of OIC countries is unbanked which is significantly higher than the rest of the world.\(^{193}\) Considering that financial inclusion is essential for poverty alleviation, providing greater access to financial services is imperative. However, given the current state of the Islamic finance industry globally where it lacks critical mass and capability, immediate gains in accessibility may not be possible. Although the industry has experienced substantial growth since inception, its ability to enhance financial inclusion rests largely in developing innovative, FinTech-based solutions that will require the provision of much improved digital services by traditional vendors of financial services.

Therefore, the growth of digital financial services globally is enhancing the role of financial institutions through technology-enabled business models. Currently, digital financial services encompass digital payments such as card payments, e-wallet, digital lending, digital investment, digital insurance and digital remittance. The proliferation of these services is expected to serve the unbanked and underbanked population and provide them access to financial services. According to the e-Conomy 2019 report,\(^{194}\) digital payments alone are expected to exceed USD 1 trillion by 2025 in six South East Asian countries; Malaysia, Singapore, Indonesia, Thailand, Vietnam and the Philippines. Many financial institutions, particularly the larger banks are the first to adopt FinTech-enabled business models to expand their services and capture new market share. Moreover, several financial institutions are also embracing new business models by establishing partnerships with e-commerce and telecommunication companies. For instance, SME Bank Malaysia in partnership with JNJ Group has launched Odela, an e-commerce platform that provides access to a more systematic and informative solution for B2B activities.


\(^{191}\) Fintech and Islamic fintech have a common definition wherein it is a business that provides financial services using technologies. The only difference is that Islamic fintech deals with offering services and products that comply to Islamic law or Shariah. (Shabana M. Hasan. 2018. How to Understand Islamic Fintech in Simple Terms? [Online] Available from https://blog.ethis.co/understand-islamic-fintech-simple-terms/)


\(^{193}\) Ibid.

Chapter 5: Broadening Access and Resilience in Digital Islamic Finance: Opportunities and Challenges

FIGURE 20: Illustrating the Importance of Digital Financial Services in the Fragmented Landscape of Digital Economy

The development of FinTech-enabled businesses will be beneficial to the Muslim world as it has a young and increasingly technology savvy population. The median age of Muslims worldwide is 24 as compared to the global average of 32\(^{196}\) while 15 of top 50\(^{197}\) countries with the highest smartphone penetration are Islamic economies.\(^{198}\) These attributes combined with a strong governmental focus to develop the Islamic FinTech ecosystem and support from multilateral institutions point towards technology being a key driver to increase financial inclusion in the near future.

Malaysia’s success in achieving a high level of financial inclusion has been based on regulatory reform that also mandated regulators to become drivers of inclusion-based policies, creating thrift-related institutions and advancing the digital economy. The first two initiatives have been explored in chapters 2 and 3, while this chapter will discuss the third.

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195 Ibid.
198 Mobile phones reduce the need to travel long distances to a financial institution and improve affordability to financial products due to a lower cost of providing financial services. Thus, having a larger population that has access to smartphones will facilitate inclusion.
5.2 Leveraging Technology in Promoting Financial Inclusion

The role of technology is increasingly critical in promoting financial inclusion. In Malaysia, the internet and smartphones have high penetration rates within the local population, with 20.9 million smartphone users spending an average of over 8 hours a week on the internet.\(^{199}\)

In order to fully realize the aspiration of financial inclusion, BNM has issued an exposure draft on the Licensing Framework for a Digital Bank. Interested parties must show a commitment in driving financial inclusion, including ensuring quality access and responsible usage of financial services, particularly, the underserved and underprivileged.\(^{200}\) In addition, the recent initiative by the government to build a strong landscape for Malaysia's digital economy has resulted in making internet services more accessible to businesses and all individuals. For instance, greater accessibility of the internet has enabled financial institutions to set-up agent banking. Online, real-time systems allow banks to offer their financial services including payments, deposits and withdrawals to unserved and underserved segments without the need to have a physical presence in rural areas. According to a World Bank report,\(^{201}\) agent banking has been successful in advancing financial inclusion in Malaysia. Prior to the establishment of agent banking, only 46% of the sub-districts in Malaysia had access to financial services prior to the introduction of agent banking in 2012 which had increased to 97% by 2015.

The digital economy's vision seeks to remove all infrastructural barriers that prevent participation by companies such as SMEs. By addressing issues linked to the coverage and adoption of fixed broadband services amongst SMEs, Malaysia aims to unlock the potential of many untapped sectors of the digital economy.

The potential of Islamic FinTech is also being realized to play an important role in increasing financial inclusion. By utilizing technology for Islamic social finance initiatives\(^ {202}\) financial mobility policies can be implemented with more precision since the afore-mentioned initiatives are recipient-specific. Blockchain-based sukuk have also been introduced to alleviate poverty by focusing on impact financing.\(^ {203}\)

In the same vein, Islamic social financing concepts may be utilized to ensure that Malaysia’s digital infrastructure provides consistent and reliable broadband services to underprivileged business owners and impactful SMEs.\(^ {204}\) Since SMEs contributed 38.3% of the Malaysian GDP in 2018 amounting to RM521.7 billion and created 5.7 million jobs which is 64.7% of the country’s workforce empowering local SMEs will amalgamate financial inclusivity with micro and macroeconomic sustainability.\(^ {205}\)


\(^{201}\) Financial Inclusion in Malaysia: Distilling Lessons to Other Countries (May 2017).

\(^{202}\) See section 3.10 in chapter 3.


\(^{204}\) Establish a dedicated Islamic microfinance or waqf fund to provide funding for small and microbusiness to invest in digital infrastructure.

5.3 Government Initiatives to Promote the IDE

At the macro-level, the government has implemented an array of digital-friendly initiatives:

1) **Improving internet speed and access** - the price of fixed broadband was reduced substantially over 2015-2019 without comprising the speed. In fact, consumers now enjoy a higher broadband speed at the same cost, if not lower. According to a recent report published by the World Bank Group in Malaysia Economic Monitor, average fixed broadband speeds have accelerated by 3 times in the space of a year (2018-2019), inching closer to the standard of leading countries. The same report also pointed out the number of fixed broadband subscriptions with download speeds of more than 100 Mbps grew by a factor of 8 to 1.2 million subscribers in 2018.

2) **Institutional focus** - the government established MDEC, a new entity responsible for developing the digital business ecosystem. MDEC aims to drive the country’s digital economy by creating awareness of it, fostering talent to enter the field, and encouraging the adoption of digital technologies. The organization under its IDE pillar actively supports halal economy businesses through providing shari’ah certification and providing access to a network of venture capital investors. MDEC has partnered with BNM and UNCDF to establish the Digital Finance Innovation Hub. The Hub aims to accelerate innovation in digital financial services with new or improved solutions that empower the daily lives of low and moderate-income people. MDEC also has launched the accelerator initiative to provide FinTech start-ups with opportunities for local and foreign investments. The initiative also offers start-ups with the opportunity to collaborate with the local industry.

**MDEC also facilitates the development of start-ups that promote Malaysia’s aspiration to be a leading digital economy, especially among OIC countries.** In 2017, MDEC launched Mi’yar, a reference program created for start-ups, innovators and other ecosystem players as part of the initiatives to promote IDE. Consequently, many start-ups have begun to develop solutions to better access consumers, businesses and financial institutions using myriad digital technologies ranging from artificial intelligence to cyber security. Interestingly, a number of start-ups are focusing on the underprivileged and underserved market segments through initiatives such as waqf, sadaqah and zakat. Dominant in this segment are companies such as FinTerra and Ethis Ventures.

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206 The maximum speed of Malaysia’s broadband was only 100 Mbps - (World Bank Group, “Malaysia’s Digital Economy: A New Driver of Development,” 2018). However, Malaysians can now enjoy fixed broadband speed up to 300Mbps.


209 https://www.salaamgateway.com/SGIE19-20

210 See section 3.10 in Chapter 3.

211 See section 2.4.2 (a) on Ethis Ventures.

3) **Regulator** - BNM created the FTEG\(^{213}\) to support innovations that improve the quality, efficiency and accessibility of financial services in Malaysia.\(^{214}\) As mentioned above, BNM also issued an exposure draft on the ‘Licensing Framework for Digital Banks’ as part of improving inclusion.\(^{215}\)

4) **Government** - Malaysia also stepped up efforts to promote inclusivity through award-winning digital entrepreneurship programs such as eUsahawan and eRezeki. The former aims to mainstream digital entrepreneurship education among emerging and current micro entrepreneurs while the latter was designed to enable lower income groups to participate in the ‘gig’ or sharing economy. In addition, the MoF has launched the ‘e-Tunai rakyat’ (e-Cash people) initiative,\(^{216}\) wherein eligible citizens will receive RM30 through any of three participating e-Wallets (Touch ‘n Go, Boost and GrabPay). This is part of the government’s efforts to create a cashless society by increasing the number of digital payment users. This will also enable conditional cash transfers that only transfer cash if the recipient meets certain criteria and have been used internationally as an important tool to improve social welfare and reduce poverty.\(^{217}\)

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\(^{213}\) See section 1.3.2 in chapter 1.


\(^{215}\) See section 5.2 and 2.4.1 (i) in Chapter 2.

\(^{216}\) See section 5.6.

\(^{217}\) The Malaysian government has introduced a conditional cash transfer program ‘Bantuan Sara Hidup’ for those with household income less than RM4000. Digital transfers will definitely reduce the cost of transfer and the issues related to withdrawing money from financial institutions.
5.3.1 Challenges to IDE Growth

The efforts of the government to advance IDE and financial inclusion have begun to make an impact. Currently the contribution of the digital economy to Malaysia’s GDP is 18.5%, with a prediction that this share will increase to 21% by 2021. Nevertheless, Malaysia has a long way to go before fully realizing its potential from the digital economy. Despite a significant reduction in the fixed broadband price, many still cannot afford even the lowest package, hindering access to digital services and stymying the government’s efforts to increase inclusivity.

In addition to the affordability issue, Malaysia has to accelerate and increase investment in digital infrastructure. There is an urgent need to increase connectivity particularly among the rural community to enable digital services to reach their target markets with ease. Moreover, digitalization should also involve government services as there is a lack of policy direction in leveraging digital services to boost conditional cash transfers. The current mechanism of offering cash support to the deserving is subject to abuse and leakages. Although the e-Wallet initiative is laudable, its effectiveness must be assessed against specific, transparent metrics. Moreover, there is a pressing need to also expand the country’s core social welfare program by offering free meals for the under-privileged and extending the coverage of micro-insurance schemes.

Another area of concern is preparing the end-user to embrace modern technology and to understand the digital financial services that are being offered to them. Currently, there is an awareness gap in relation to the products offered by Islamic FinTech companies. The end-users are still comfortable with traditional product offerings from banks and established financial intuitions. A robust regulatory framework, customer protection and cybersecurity are key to building trust among the end-users to accept the new technologies. Also, the ongoing financial literacy initiatives must be supplemented by a greater emphasis on creating more tech savvy end-users, the latter must be given enough exposure to appreciate the products and services provided by Islamic FinTech vendors.

Moreover, a lack of standardization in shari’ah rulings across jurisdictions limits the acceptability of Islamic FinTech products. This reduces the potential market size and constrains scaling up of the technology. In addition, Islamic FinTech vendors are yet to fully leverage available technologies such as machine learning and artificial intelligence.

5.4 The Advantages of Digitization

Digital financial inclusion involves the deployment of cost-saving digital means to reach currently financially excluded and underserved populations. Unlike traditional financial services, there are a host of benefits accruing from advancing financial inclusion through digitization:

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219 The Malaysian government has introduced a microtakaful scheme ‘mySalam’ for those earning less than RM24,000 per annum. Nonetheless, the maximum coverage is only up to RM8,000 where the amount may be insufficient for those who are suffering with a critical illness.

Chapter 5: Broadening Access and Resilience in Digital Islamic Finance: Opportunities and Challenges

1) **Enhancing access to financial services** - A sizeable population in the Muslim world including Malaysia lives in rural areas with limited access to bank branches or ATMs. This increases dependence on family members or local money lenders to meet financing requirements, while savings are accumulated in earthen jars or stored under the mattress.\(^{221}\) Therefore, with the availability of internet or mobile services, access to formal financial services becomes easier and cheaper. Moreover, formal financial services have a variety of products to offer, coupled with proper financial advice.

2) **Reducing transaction costs** - Executing transactions using digital platforms lower transaction costs for both providers and customers.

3) **Improved security** - Having access to formal, digital financial services reduces the risk of loss and theft and also promotes economic empowerment by enabling asset accumulation.\(^{222}\)

A summary of academic research on the benefits of digitization substantiates that economic digitization in the form of bitcoin technology can help advance financial inclusion\(^{223}\) while the introduction of FinTech in Islamic banking has the potential to improve competitiveness and inclusiveness.\(^{224}\) In addition, digitization in the form of blockchain and smart contract technologies can help waqf institutions to improve their governance structures and enhance shari’ah compliance.\(^{225}\)

5.5 Using Digitization to Improve Financial Inclusion

Mobile-enabled payment technology has enabled holders of bank accounts (or FinTech account holders) to open, access and transact using their accounts anywhere and anytime as long they are connected to the server.\(^{226}\) Other FinTech applications such as open banking, P2P finance, ECF and blockchain provide solutions with improved applicability and accessibility that add to the potency of digital finance. For instance, BNM has established the IAP as the first Islamic P2P initiative established by a central bank.\(^{227}\) Also, SC has launched an ECF framework.\(^{228}\)

Over the years, a number of successful FinTech companies have emerged that are providing a range of services including payment systems, remittances, crowdfunding, lending and many more.

\(^{221}\) See section 3.8.1 in chapter 3.
\(^{222}\) Ibid
\(^{227}\) See section 3.9 in chapter 3.
\(^{228}\) See section 2.4.2 (a) in chapter 2.
Figure 21 provides a snapshot of all the existing FinTech companies that are operating in Malaysia.\textsuperscript{229} All of the mentioned companies are part of the FinTech ecosystem and are serving the underserved and underprivileged which have traditionally been neglected by mainstream financial institutions. The presence of FinTech is also driving the bigger players to become more innovative and advancing their digital services. Hence, FinTech is making the financial ecosystem more dynamic and less vulnerable to systemic shocks while also reducing reliance on bigger players.\textsuperscript{230}

**FIGURE 21: Malaysia FinTech Map**

A number of companies have made significant strides over the past few years. For the sake of brevity, this chapter highlights a few FinTech successes in Malaysia:

1) **ManagePay Systems Berhad ("MPay")** – a provider of end-to-end electronic payment ("e-Payment") solutions for banks and financial institutions, merchants and card issuers with operations in Malaysia. MPay processes transactions worth between RM150 million and RM200 million per year with subscribers exceeding one million.


Chapter 5: Broadening Access and Resilience in Digital Islamic Finance: Opportunities and Challenges

2) **Boost** – in the e-wallet space, Boost allows users to make payments without the hassle of carrying physical cash. It can be used almost anywhere, even in night markets and has over four million registered users.

3) **PitchIN** – an ECF platform that has a total market capitalization of over RM350 million. Since 2016, the company has raised funds for 24 deals through its platform and raised RM30 million.

4) **As-Sidq** – offers a halal financing application platform, mainly financing products using a Tawarruq-based commodity trading platform.

In addition, there are a few success stories from the public sector:

1) **LZNK** – adopts digital technologies to manage the collection and distribution of zakat. LZNK has developed a system that can track the collection and distribution of zakat without any time lag. The institution also has a complete database of recipients and a payment gateway to distribute zakat directly to the institution. As the system allows everyone to monitor the collection and distribution process, the increased trust has significantly improved donations. In 2013, total collections were approximately RM133 million, but in 2018 the amount increased to RM180 million out of which approximately RM80 million were distributed to the poor and destitute. For a poor, remote state like Kedah (located on the north of Peninsular Malaysia), an increase of this magnitude reflects the success of zakat distribution in alleviating the hardships of the underprivileged community. LZNK has also introduced the free foodbank, providing basic groceries for the needy in Kedah. LZNK’s successful application of technology has attracted the attention of both other state zakat institutions in Malaysia and international zakat organizations.

2) **e-Tunai Rakyat** – in an effort to promote a cashless society and boost the adoption of digital services, the Malaysian government is crediting RM30 to eligible Malaysians as a way to encourage e-wallet usage. Through this initiative, the government is targeting a total of 15 million Malaysians to use e-wallet for payments. The effort is a continuation of previous initiatives to increase financial inclusion as mobile payments are an effective means to access the underbanked. The government also believes that the increased use of mobile payments will improve the financial system’s efficiency and transparency, increase consumption and contribute to higher tax collection.

5.7 Areas for Further Consideration

Despite considerable progress in employing digital financial services, Malaysia still lags behind its neighboring countries. According to a report by Dinar Standard, Malaysia is ranked 5 based on the number of Islamic FinTech startups by country with only 7, compared to Indonesia with 31 in

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231 The CAGR for the increase in zakat collections between 2013 to 2018 is 6.2%. Source: zakatkedah.com.my

232 LZNK has been active in organizing international conferences and symposia. For instance, it has hosted Kedah Zakat International conferences in 2018 and 2019, attracting participation from local and international participants. Source: zakatkedah.com.my

Indonesia is also effectively utilizing FinTech to fund microfinance and institutions like Blossom Finance provide an example of this innovative approach. Blossom is using the amalgamation of sukuk and blockchain to raise funding for institutions such as Baitul Mal Wat Tamweel, one of the largest Islamic cooperatives in Indonesia.

5.8 Expanding Islamic Social Finance Through FinTech

As illustrated through LZNK’s example, Islamic FinTech is also becoming pivotal to the resurgence of Islamic social finance. The available technology, especially blockchain, enhances transparency and reduces information asymmetry. Consequently, Muslims have greater confidence in making donations either in the form of zakat, waqf or sadaqah using the FinTech platform or application. Considering the inordinate potential of zakat and waqf, technology’s contribution can assist poverty alleviation and build the required infrastructure to achieve SDGs. According to UNDP, zakat alone has an annual potential of up to USD 1 trillion if managed effectively.

5.9 Advancing Financial Literacy and Technology

Despite continuous efforts by the government, financial literacy remains low and therefore is an impediment to improving financial inclusion. This also presents a barrier to the effective marketing of FinTech products as the majority of the population lacks awareness about the offerings. Nevertheless, the government has introduced a slew of initiatives through various institutions to enhance the level of financial literacy and technology. Apart from the broad-based initiatives that have been discussed in this chapter, the government is pushing digital entrepreneurship, mainly through MDEC and SME Corporation to provide technical training, targeted business mentoring and partnerships with relevant parties. MDEC has initiated several initiatives for FinTech advancement.

It has launched a program called Orbit which has created a collaborative working space which serves as a nexus for local and foreign FinTech players, allowing start-ups to interact with industry leaders to facilitate product development and early market entry. MDEC also supports start-ups to enter a high-growth stage through its accelerator program. It has also partnered with a number of institutions of higher learning to deliver lectures and modules on FinTech.

SME Corp is driving SMEs to embrace digital technology and leverage off the financial services provided by FinTech companies. The belief is that a number of issues related to access to financing can be

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235 SME Corporation Malaysia (SME Corp. Malaysia) is the central coordinating agency under the Ministry of Entrepreneur Development and Co-operatives that coordinates the implementation of development programmes for SMEs across all related ministries and agencies. It acts as the central point of reference for research and data dissemination on SMEs and entrepreneurs, as well as providing business advisory services for SMEs.

236 https://theorbit.io/
resolved if SMEs tap into P2P and ECF. The FinTech Association of Malaysia is also preparing a playbook to boost the understanding of the masses on the subject.

5.10 Conclusion

Despite Malaysia’s success in driving the digitalization of financial services, the country has yet to realize the true potential of financial technology. The following issues need to be addressed:

1) **Technology and the Generation Gap** – the rapid growth of digitalization has increased the communication gap across generations. For senior citizens and the B40 segment, the dawn of the Internet of Things and the 5G era has not been kind. The growing gap of knowledge in using digital devices has not been bridged and this has displaced senior citizens who are left out of the digital landscape. Moreover, this digital gap can exacerbate the communication gap between digital natives and baby boomers. In addition, the income gap between urban and rural areas, and the disparity in education standards, will add to this problem. Therefore, a concentrated effort in improving financial literacy and education to reduce these gaps needs to be initiated by the government.

2) **SME Readiness** – Malaysia has been successful in getting SMEs to adopt computing to modernize their businesses as is evidenced by the majority of SMEs utilizing computers and the internet. However, the low level of process improvement shows that the SMEs are impeded in moving from computerization to digitalization. Consequently, policies should be put in place to enable the transfer of expertise and technology from SMEs in more digitally advanced economies. An improvement in digitizing SME processes will enable greater scale-ups, increase exports and create a more resilient sector and economy.

3) **Developing the Halal Economy** – as Malaysia strives to be a leader in the halal economy, there is a lack of digital platforms to automate processes (e.g., digitizing the process of halal stamping) which are imperative to make Malaysia a market leader. Collaborations between JAKIM, MTDC and HITeC can be considered to further this aim. Moving forward, in order to drive Islamic FinTech and digitalization forward, the focus should be expanded beyond financing and payment system solutions. This requires greater innovation on the part of Islamic FinTech companies. There is also a need to integrate Islamic financing, halal economy, sustainability and resource mobilization within the Islamic finance ecosystem.


Case Study 2:

National Identity Card Propels Financial Inclusion

The Malaysian identity card is the compulsory identification for every Malaysian citizens aged 12 and above. The current identity card, known as MyKad, was introduced by the National Registration Department of Malaysia in September 2001. Malaysia became the first country in the world to develop and use an identification card that incorporates both photo identification and fingerprint biometric data on a built-in computer chip embedded in a piece of plastic.

MyKad is the first smartcard in the world designed with six main functions: identification, driver’s license, passport information, health information, and an e-cash function. Today, MyKad enables the opening of bank accounts, as new customers are quickly validated upon the presentation of their MyKad. They can also utilize MyKad to have additional payment functions linked to their bank account and use it as an ATM card or an electronic means of payment nationwide.

MyKad security features include authentication using symmetric key cryptography, multi-layered operating systems with firewalls and a secure chip platform. MyKad incorporates 2 types of biometric technology for identification purposes that includes a color photograph of the card holder and a digital certificate.
6.1 Islamic Finance and Financial Inclusion

Malaysia has emerged as a leader amongst its ASEAN, OIC, and upper middle-income country peers in the attainment of financial inclusion and in the development of its Islamic finance industry. Greater research is required to determine the extent to which policies that were designed to foster the growth of Islamic finance led to greater financial inclusion and policies to promote greater financial inclusion led to the strengthening of Islamic finance.

Deliberate policymaking and the creation of various institutions have cultivated Islamic finance as an important source of financial inclusion, especially amongst segments of the population that were reluctant to engage in conventional finance for religious reasons. These efforts date to the 1960s and have expanded steadily, such that by 2011 (the period for which Findex financial inclusion data commenced), Islamic finance was already well-established in Malaysia.

The degree of causality between the growth of Islamic finance and greater financial inclusion cannot conclusively be established. From a policy perspective, it can be concluded that both promoting financial inclusion and fostering Islamic finance have led to positive development outcomes for Malaysia.

As Malaysia pursues the “last mile” of financial inclusion, religious objections to financial participation appear to have essentially been eliminated. The remaining barriers, such as the absence of adequate funds and relatives owning accounts, are not religious in nature. It thus appears that attaining even higher levels of financial participation does not specifically require supporting Islamic finance, but rather making finance (both Islamic and conventional) more accessible and better understood. This may include ongoing emphasis on financial literacy, FinTech, and other mechanisms to reach the remaining segment of the population not yet financially included.

Malaysia offers a valuable example to peer countries. The data suggests that Malaysia has essentially removed religious considerations as a barrier to financial inclusion and has likely done so through its cultivation of Islamic finance. In this respect, Malaysia can serve as a model for countries on how to make finance accessible to all by fostering financial practices that are consistent with the religious beliefs of the population. The model applies not only to OIC countries and Islamic finance, but also to all countries and faith groups.

Malaysia also offers an important lesson for countries that are committed to developing their Islamic finance sector: achieving overall financial inclusion will also help advance Islamic finance. While many have recognized that Malaysia is a leader in global Islamic finance, they may not yet be aware of how overall financial inclusion across the country has helped Islamic finance thrive.

6.2 Robust Regulatory Support

Strong leadership from financial regulators has been key to driving financial inclusion in Malaysia. These regulatory initiatives have covered banking, takaful/insurance, capital markets and alternative finance and have been marked by policy continuity and coordination among different government ministries, departments and agencies over a period of time. The initiatives have also been implemented with clear, targeted action plans and accurate tracking of milestones which has contributed significantly to the country’s high Findex score.
BNM has developed the Financial Inclusion Framework which was introduced as part of the Financial Sector Blueprint (2011-2020) and has also bolstered Islamic banking significantly by promulgating IFSA in 2013. The SC introduced 10-year masterplans for capital markets in 2000 and 2011 while Bursa Malaysia has encouraged entrepreneurship through initiatives such as LEAP. In addition, the SC and Bursa Malaysia have successfully created a conducive business environment for micro and SMEs to access funding from capital markets. Hospitable regulatory regimes have been intrinsic to the creation of an effective ecosystem that promotes financial inclusion and involves the CGC, Credit Bureau, Consumer Protection Agency and deposit insurance as some of its critical components.

Islamic social finance, historically, has also played a central role in providing access to finance to entrepreneurs. Both regulation and legislation have played an important role in promoting social finance. The SC has passed regulation that enables waqf funds to be used for social development while 5 out of Malaysia’s 13 states have enacted waqf-specific legislation.

Programs such as the MAIWP have also contributed to poverty alleviation and increasing financial inclusion. In collaboration with BIMB and SME Corp., the program specifically targets the B40 segment, aiming to achieve sustainable incomes and improve financial resilience. Such programs optimize zakat and microfinancing arrangements and also include cash waqf contributions. The implementation of these programs involves onboarding and educating recipients as well as monitoring successful outcomes.

Similar engagements are required between financial regulators, financial institutions, and SIRCs in maximizing the potential of Islamic social finance to support sustainable development. The future lies in continued financial product innovation, embedding digital financial services, data management and capacity building for financial management. All these areas can be jointly developed between regulators and market participants.

6.3 Strong Institutional Enablers

A trio of institutions have been fundamental to financial inclusion in Malaysia. TH introduced a culture of thrift among Malay Muslims by incentivizing them to save for the pilgrimage to Makkah. Effectively tapping religious beliefs became an avenue for greater participation in the financial system. PNB addressed economic inequality among the population that appeared to have an ethnic bearing. By providing preferential share allocations for Bumiputeras in blue-chip companies through PNB’s funds, it redistributed wealth through affirmative action and enabled more Malays to directly profit from the country’s economic success. Finally, FELDA allowed land ownership among Malays by providing them with designated holdings to cultivate where they were paid wages until title was transferred to them.

The desire to engage Bumiputeras with the financial system and their strong preference for usury-free financial products also propelled the development of Islamic finance, particularly by BNM. Savings and credit cooperatives (SACCOs) also played a central role in creating greater financial awareness among rural communities and becoming an important source for micro and rural finance.

The corporatization of SIRCs in the early 1990s was a key development that has considerably improved zakat collections. Equally significant has been the melding of waqf interests between SIRCs and Islamic banks through initiatives such as myWakaf. Here Islamic banks collaborate with religious authorities.
to develop waqf funds to benefit socially important sectors such as health and education. Such wealth redistribution is essential to the cause of financial inclusion and should be combined with the creation of institutions that enable wealth accumulation as described above. In successfully achieving this mix, Malaysia provides a template that can be emulated by its peer countries.

However, regardless of the success of the above-mentioned institutions, countries have to be mindful of the impact of race or religion-based policies on growth and competitiveness. The Malaysian experience accentuates the need for better corporate governance and transparency in order to minimize rent seeking and the misappropriation of wealth. Also, affirmative action policies promulgated on the basis of reducing income disparities may cause excessive protectionism to the detriment of international competitiveness. Consequently, it is imperative that every country determines its own balance between the role of the state and market and implements effective redistribution policies to achieve this equilibrium. Malaysia’s success has brought it closer to achieving developed nation status but in order to preserve its gains, it must ensure that prosperity is shared not concentrated, funding and support are based on merit not privilege and critically, the rule of law prevails.

6.4 Consumer Protection

Investor confidence and trust in a well-functioning market for financial services promotes financial stability, innovation and inclusion in the long-term. IFIs are subject to 2 types of consumer protection. Firstly, they must follow standard rules of full disclosure and transparency in relation to their products and services which is common to all financial institutions. Secondly, IFIs have a fiduciary duty to ensure that all their products are shari’ah compliant and in conformity with the applicable shari’ah governance framework.

Malaysia uses a standardized, comprehensive framework for all consumer and investor protection, which covers both Islamic and conventional products and services. The framework includes transparency and disclosure requirements, the fairness of terms in the financial contract, data protection, and privacy in addition to complaints and dispute resolution mechanisms. Additionally, financial regulators, in collaboration with the MOE and industry stakeholders, have participated aggressively in raising consumer awareness and financial literacy among various segments of the population.

With greater financial innovation and the growing complexity of financial products and services, it has become more important to equip financial consumers with the knowledge to make informed decisions with confidence. Strong policy coordination is required in building financial capability, elevating the level of literacy and promoting prudent financial management. More informed consumers and investors boost confidence and trust in a well-functioning market for financial services to promote financial stability, innovation, and inclusion over the long term.

Effective dispute resolution mechanisms function as an avenue to redress consumers’ complaints against financial institutions while enabling financial regulators and institutions to improve consumer protection regulations and practices, respectively, by reviewing the data of all filed complaints. In addition, IFSA ensures that all Islamic banking and takaful products and services offered by IFIs remain shari’ah compliant.
6.5 Digitalization and Islamic FinTech

Findex 2017 states that access to cell phones and the internet is driving access to and the use of financial services globally. In addition, advances in digital financial services inclusive of payments, savings, credit and insurance products are key to improving financial inclusion.

The use of FinTech has enabled a resurgence of Islamic social finance and institutions like LZNK are at the vanguard of using technology to enhance zakat collections. The available technology, especially blockchain, enhances transparency and reduces information asymmetry. Consequently, Muslims have greater confidence in making donations either in the form of zakat, waqf or sadaqah using the FinTech platform or application. Considering the considerable unrealized potential of zakat and waqf, technology’s contribution can assist poverty alleviation and build the required infrastructure to achieve SDGs.

Despite Malaysia’s gains in the application of FinTech towards financial inclusion, 3 primary issues remain to be addressed:

i) Bridging the technology gap between generations - to enable senior citizens and lower income segments access to the full benefits of the digital economy. The income gap between urban and rural areas, and the disparity in education standards will compound the problem. Therefore, a concentrated effort in improving financial literacy and education to reduce these gaps needs to be initiated by the government.

ii) SME readiness - transferring the automation of SMEs into digitization such that there are tangible gains in their processes. Policies should be put in place to enable the transfer of expertise and technology from SMEs in more digitally advanced economies. An improvement in digitizing SME processes will enable greater scale ups, increase exports and create a more resilient sector and economy.

iii) Developing the halal economy - requires the evolution of digital platforms to automate processes beyond payments and financing systems. This requires greater innovation on the part of Islamic FinTech companies and collaborations between JAKIM, MTDC and HiTeC can be considered to achieve this goal. There is also a need to better integrate Islamic financing, halal economy, sustainability and resource mobilization within the Islamic finance ecosystem.


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