

Development of Islamic Finance in Fintech



by Nurul Husna Ahmad

Financial technology, or fintech for short, is a term used to describe innovations of technology in financial services. The goals of fintech are to uplift the financial well-being of individuals and businesses, foster sustainable growth of financial sectors and to maximise the use of technology in providing efficient financial services and solutions to financial consumers. Fintech continues to evolve in the digital age and is gradually growing in Malaysia, and Islamic finance cannot escape this evolution as more and more financial customers demand digital financial services. This article briefly discusses the latest development of Islamic financing transactions via fintech, with a focus on peer-to-peer (P2P) financing and digital banks.

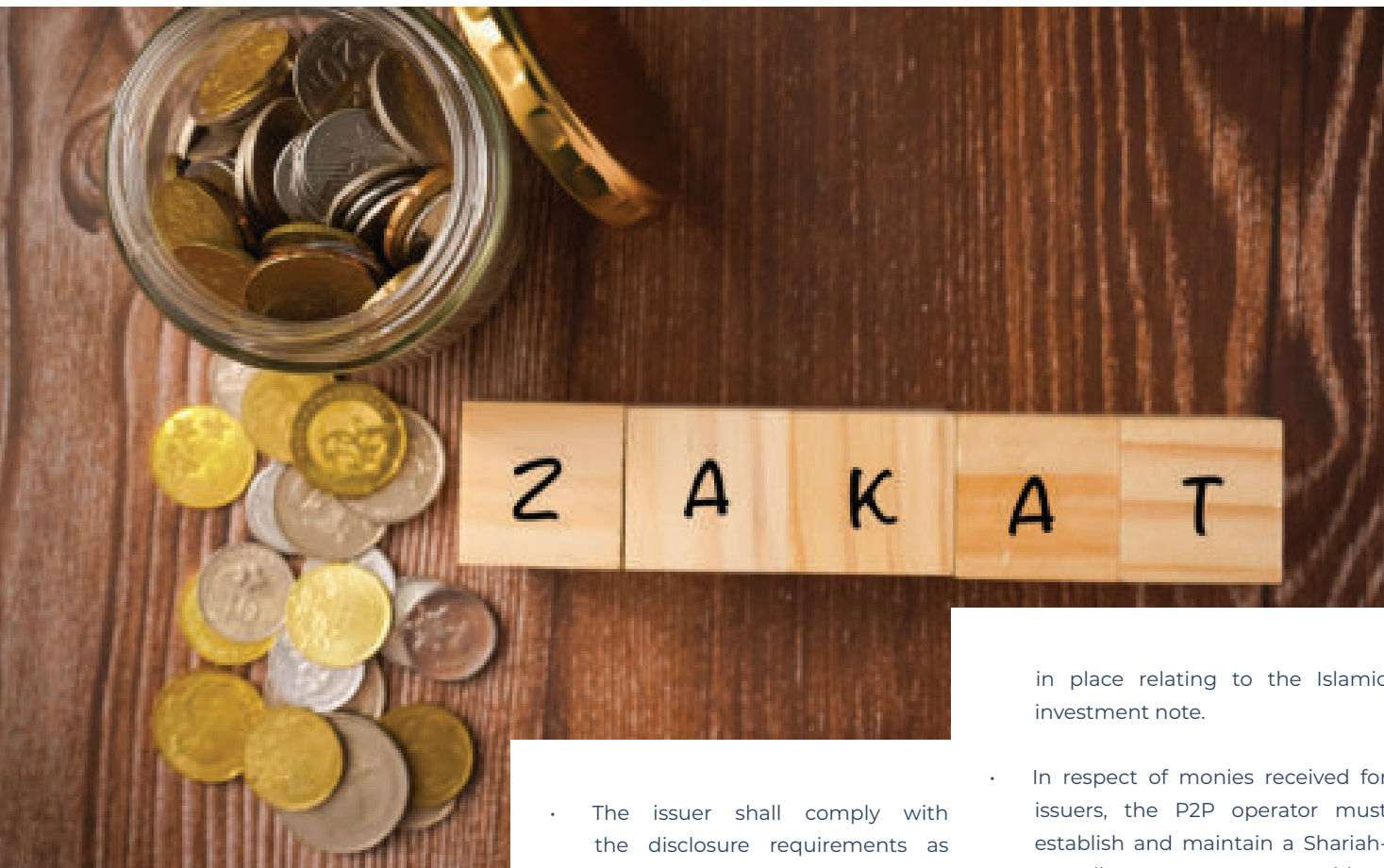
(1) Islamic P2P financing — Securities Commission's Guidelines on Recognized Markets (revised 6 January 2021)

In an effort to promote fintech in Malaysia, the Securities Commission (SC) has introduced several new initiatives — one of it being the Guidelines on Recognized Markets (**Guidelines**), which set out, among others, the regulatory framework for P2P financing. The requirements of P2P financing platform are provided under Chapter 14 of the Guidelines.

The P2P framework enables eligible businesses and companies to access market-based financing to fund their projects or businesses via an electronic platform. In this regard, a P2P operator facilitates businesses or companies to raise funds from both retail and sophisticated investors through an online platform. A

P2P operator is not permitted to facilitate individuals seeking personal financing.

To become a P2P operator eligible to operate the P2P platform, the operator must be registered as a Recognized Market Operator pursuant to s 34 of the Capital Markets and Services Act 2007. Through the registered P2P platform, an investor may invest in an investment note or an Islamic investment note issued by businesses or companies for a specified tenure with the expectation of a predetermined financial return. In this regard, only a locally incorporated or registered sole proprietorship, partnership, limited liability partnership, private company and unlisted public company or any other type of entity as may be permitted by the SC is allowed to be hosted on a P2P platform. Entities prohibited from raising funds through a P2P platform include commercially or financially complex



structures (i.e. investment fund companies or financial institutions), public listed companies and their subsidiaries, companies with no specific business plan or the business plan is to merge or acquire an unidentified entity (i.e. blind pool), companies that propose to use the funds raised to provide loans/ financing or make investment in other entities or any other type of entity that is specified by the SC. Some of the salient requirements applicable to the issuer under the Guidelines are as follows:

- The issuer is not allowed to be hosted concurrently for the same purpose on multiple P2P platforms.
- The issuer is permitted to keep any amount which was raised through a hosting on a P2P platform, provided that the issuer must have raised at least 80 per cent of the target amount. However, the issuer is not allowed to keep any amount which exceeds the initial target amount.

- The issuer shall comply with the disclosure requirements as specified in the Guidelines which include submission of relevant information such as purpose of the investment note, details of the business plan and financial information of the business to the P2P operator and must ensure that all information submitted or disclosed to a P2P operator is true and accurate, and does not contain any information or statement which is false or misleading or from which there is a material omission.

In respect of Shariah-compliant financing offered via a P2P platform, this may be done via the execution or offering of the Islamic investment note through such P2P platform. In this regard, the P2P operator offering such Islamic investment note via the P2P platform is subject to a number of compliance requirements, including the following:

- The P2P operator has to ensure that there is an efficient and transparent risk scoring system

in place relating to the Islamic investment note.

- In respect of monies received for issuers, the P2P operator must establish and maintain a Shariah-compliant trust account with a licensed Islamic bank or the Islamic window of a licensed bank or licensed investment bank, for the purpose of the funds raised.
- The P2P operator may only release the funds to the issuer, provided that there is no material adverse change relating to the Islamic investment note during the offer period. In this regard, material adverse change may include discovery of a false or misleading statement in any disclosures relating to the Islamic investment note, discovery of a material omission of information required to be disclosed in relation to the Islamic investment note or there is a material change or development in the circumstances relating to the Islamic investment note.
- In respect of monies received from investors, the P2P operator shall establish and maintain in a licensed bank, one or more trust

accounts (which presumably must be Shariah-compliant trust accounts for Shariah-compliant P2P financing) designated for the monies received as payments to investors and ensure that the trust accounts are administered by an independent registered trustee. The investors' monies in such trust accounts shall not be withdrawn or dealt with except for the purpose of making payment to the issuer, investors or P2P operator or as directed by the SC or by any other enforcement agencies as provided under written law.

- The P2P operator is prohibited from providing direct or indirect financial assistance to investors or providing any funding to issuers for the purpose of investing in the Islamic investment note executed or offered on or through its platform.
- All issues, offers or invitations to subscribe to or purchase the Islamic investment note must be rated by the P2P operator who shall be accountable for the risk scoring mechanism and methodology employed, and the final risk scoring for the purchase of the Islamic investment note must be made available to the investor at the time of offer.
- The P2P operator is required to disclose and display prominently on its P2P platform, any relevant information relating to the P2P financing including the relevant information of the issuer, details on how the P2P platform facilitates the investor's investment and explanatory notes on the risk scoring mechanism, methodology and parameters.

As a Recognized Market Operator, the P2P operator offering Shariah-compliant P2P financing must also comply with the requirements relating

to the offering of Islamic Capital Market Products as specified in Chapter 12 of the Guidelines. The main requirement under Chapter 12 is the appointment of a Shariah adviser who may be an individual or a corporation registered with the SC, or a licensed Islamic bank or the Islamic window of a licensed bank or licensed investment bank. The roles of the appointed Shariah adviser are:

- (a) advising on compliance with Shariah principles relating to the offering of the Shariah-compliant P2P financing;
- (b) providing Shariah expertise and guidance on all matters, particularly in documentation, structuring and investment instruments and ensure compliance with relevant securities laws and guidelines issued by the SC;
- (c) ensuring that the applicable Shariah rulings, principles and concepts endorsed by the Shariah Advisory Council of the SC are complied with;
- (d) in the absence of any rulings, principles and concepts endorsed by the Shariah Advisory Council of the SC, applying *ijtihad* (intellectual reasoning) to ensure that all aspects relating to the offering of the Shariah-compliant P2P financing are in compliance with the Shariah; and
- (e) issuing a Shariah pronouncement which must include the basis and rationale for the pronouncement, the structure and mechanism of the Shariah-compliant P2P financing and the applicable Shariah rulings, principles and concepts used in the Shariah-compliant P2P financing.

The P2P operator must ensure that the name of the Shariah adviser appointed to advise on the offering of the Shariah-compliant P2P financing, and the information relating to the structure of the Shariah-compliant P2P financing, are disclosed to potential issuers and investors.

(2) Islamic Digital Banks — Bank Negara Malaysia's Licensing Framework for Digital Banks

Bank Negara Malaysia (BNM) has recently developed a Licensing Framework for Digital Banks (**Licensing Framework**) that enables licensed digital banks to offer banking products and services to the unserved and underserved market through digital or electronic means. Generally, the unserved and underserved segments are a group of individuals and businesses whose needs for financial products and services are not adequately served or met. In this regard, licensed digital banks are expected to identify their target unserved or underserved segments and leverage on technology, alternative data and in-depth understanding of customer behaviour in order to meet the needs of their target segment.

The existing licensed Islamic banks that have physical presence may apply to carry on Islamic digital banking business through a separate corporate body, such as their subsidiary or through a joint venture arrangement with another party. However, this does not preclude such existing licensed Islamic banks from digitalising their current business operations, which does not require the application of a separate licence under this Licensing Framework. The difference between the digitalisation of the current operation of such existing licensed Islamic bank and a full-fledged Islamic digital bank is in terms of the processes and platforms utilised. Legacy, paper-based products, services and processing are brought to the web through digitalisation by such

existing licensed Islamic banks, whereas the Islamic digital bank offers instant, fully automated financial products and services. While the financial products and services of both existing licensed Islamic banks and Islamic digital banks are similar, Islamic digital banks can offer new financial digital products and services such as cryptocurrencies. Despite having a digital platform to conduct its businesses and operation, a licensed Islamic digital bank is required to establish physically a registered office in Malaysia in line with s 46(1) of the Companies Act 2016. At a minimum, the establishment of a registered office should be sufficient to allow BNM to communicate with the licensed Islamic digital bank during the supervisory process, including for the purposes of examination and engagement with senior management and the board.

The Licensing Framework sets out the eligibility requirements and application procedures that must be complied with by an applicant intending to carry on Islamic digital banking business. In this regard, it may be noted that the existing framework for application of licences and approval process under ss 9 and 10 of the Islamic Financial Services Act 2013 (**IFSA**) and the Policy Document on Application Procedures for New Licences under the Financial Services Act 2013 and the Islamic Financial Services Act 2013 issued on 27 December 2019 (**Licensing Procedures**) are applicable for the application of an Islamic digital bank licence. In assessing the ability of the applicant for an Islamic digital banking licence, the applicant must have the requisite Shariah expertise to effectively carry on Islamic digital banking business. At the point of application for an Islamic digital banking licence from BNM, the applicant is required to observe the following:

- (a) Submission of business plan — a business plan that contains the information required under paragraph 12 of the

Licensing Procedures that covers a five-year period and the overall business plan shall, among others, be aligned with the requirements during the “foundational phase” and financial inclusion objectives of serving the unserved and/ or underserved segments identified by the applicant.

- (b) Submission of exit plan — an exit plan for the first five years of the applicant’s operations which is deemed necessary in the event that such business models prove to be unsustainable or ineffectual. In this regard, such an exit plan shall include, among others, potential management triggers for exiting the business, likely options and related measures to be taken for exiting that minimises disruption to its customers and the financial system, the sources of funding and liquidity for exit and the estimated timeframe to exit the business.

It may also be noted that the Licensing Framework acts a “foundational phase” for licensed Islamic digital banks to demonstrate their viability and operations. The “foundational phase” is for a period of up to five years from the commencement of the licensed Islamic digital bank’s operations. During this period, a licensed Islamic digital bank is allowed to operate with an asset limit of RM3 billion. To comply with the asset limit during the “foundational phase”, the licensed Islamic digital bank shall monitor its off-balance sheet items to ensure any potential crystallisation of off-balance sheet items into on-balance sheet items does not result in a total size of assets that exceed the asset limit. A licensed Islamic digital bank may submit an application to BNM for the foundational phase to end and for the business limitation to be uplifted after

three years from the commencement of its operations.

Notwithstanding the requirements for the “foundational phase” set out in the Licensing Framework, a licensed Islamic digital bank shall also comply with the regulatory requirements applicable to an existing licensed Islamic bank save and except for certain flexibilities granted to a licensed Islamic digital bank. Such flexibilities include requirements for capital adequacy, liquidity, stress testing, public disclosures and Shariah governance.

In respect of the Shariah governance, a licensed Islamic digital bank is required to comply with all the requirements specified in the Shariah Governance Policy Document, save and except for the requirements for composition of a Shariah Committee and frequency of annual Shariah Committee meeting. In this regard, the Shariah Committee of a licensed Islamic digital bank must consist of at least three members (in contrast with a minimum five members for existing licensed Islamic banks) and the Shariah Committee of a licensed Islamic digital bank must convene its meeting at least two times in a year (in contrast with at least once every two months for existing licensed Islamic banks). Other than the requirements specified in the Shariah Governance Policy Document, a licensed Islamic digital bank shall also comply with Shariah governance requirements under the existing provisions of the IFSA that apply to existing licensed Islamic banks which shall include:

- (a) the duty to ensure compliance with any ruling of the Shariah Advisory Council of BNM in respect of any particular aim and operation, business, affair or activity as specified in s 28 of the IFSA;
- (b) the duty to comply with standards (i.e. policy documents) specified by BNM

relating to Shariah matters as set out in s 29 of the IFSA; and

- (c) establishment of a Shariah Committee and other aspects including the appointment of Shariah Committee members, duties of Shariah Committee members and cessation of Shariah Committee members as specified from ss 30 to 36 of the IFSA.

(3) Challenges

As with the traditional offering of Islamic financial products and services, the application of fintech for Islamic financial services must be Shariah-compliant and as such, implementation of fintech in Islamic finance may be more strict/difficult compared to conventional fintech implementation. For P2P financing, issuers that are eligible to raise funds via P2P platforms may be unaware of the Shariah-compliant option. As may be seen above, the P2P operator and the issuer have a duty to ensure Shariah compliance and provide comprehensive details to ensure financing processes comply with Shariah standards.

Arguably, Islamic digital banks may not face similar challenges in view that the applicant would already have a Shariah governance structure in place as part of the requirements in applying for an Islamic digital bank licence. However, the growing application of fintech creates a more competitive market in the finance and banking industry and the financial customers are now spoilt for choice whereby they have the option to invest through the P2P platform and crowdfunding marketplace. This consequently creates a competitive market wherein traditional Islamic financial institutions may end up reducing their profit margins. **LH-AG**

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