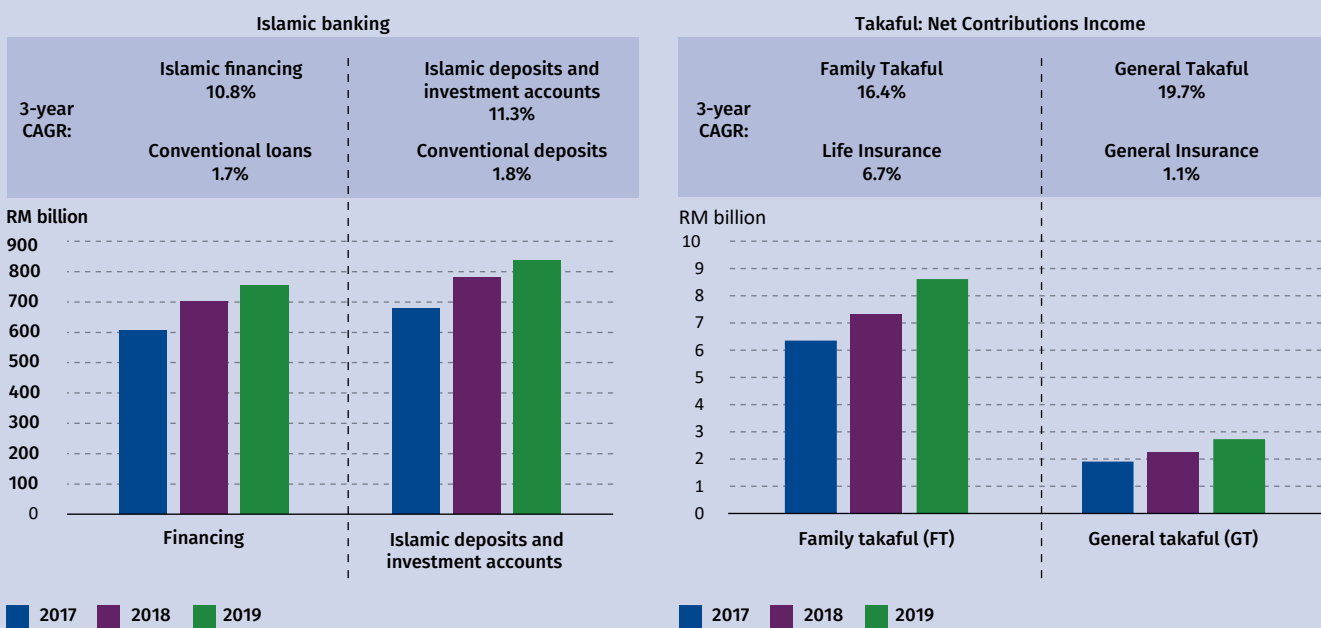


Transforming the Economy and Society through Islamic Finance

Islamic finance in Malaysia has become well-entrenched in the country’s dual financial system. Both conventional and Islamic financial systems remain important enablers of sustainable growth in the economy. The Islamic financial system has undergone significant transformation from its modest beginning. In the early years, the system was focused on providing basic banking services to promote financial inclusion among Muslims. It now has evolved into a comprehensive system that provides diverse financial solutions for households, businesses and governments.

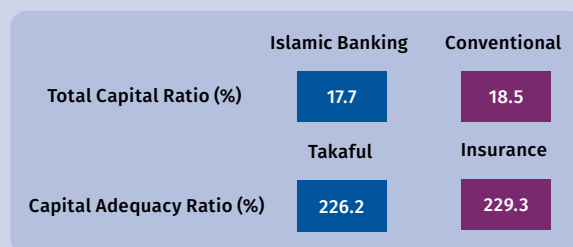
The growth of Islamic finance reflects a growing awareness and wider public acceptance of Islamic financial solutions as a competitive alternative to conventional finance with distinct value propositions. We also see a few financial institutions responding to the increased acceptance of Islamic finance by adopting “Islamic first” strategy at the group level. As a result, the Islamic financial system expanded at a faster pace than the conventional players (Chart 1). As at end 2019, financing by Islamic financial institutions accounted for 39.2% of total banking sector financing (2018: 37.7%). Total funds placed with Islamic banks now represent 38.0% of total banking sector deposits (2018: 36.6%). The share of takaful net contributions as a proportion of the total insurance and takaful business increased further to 18.3% (2018: 16.6%).

Chart 1: Growth of Islamic banking and takaful



The Islamic financial system has remained resilient under challenging economic and financial conditions. Financial soundness indicators are comparable to the conventional system (Diagram 1).

Diagram 1: Selected financial soundness indicators as at 2019

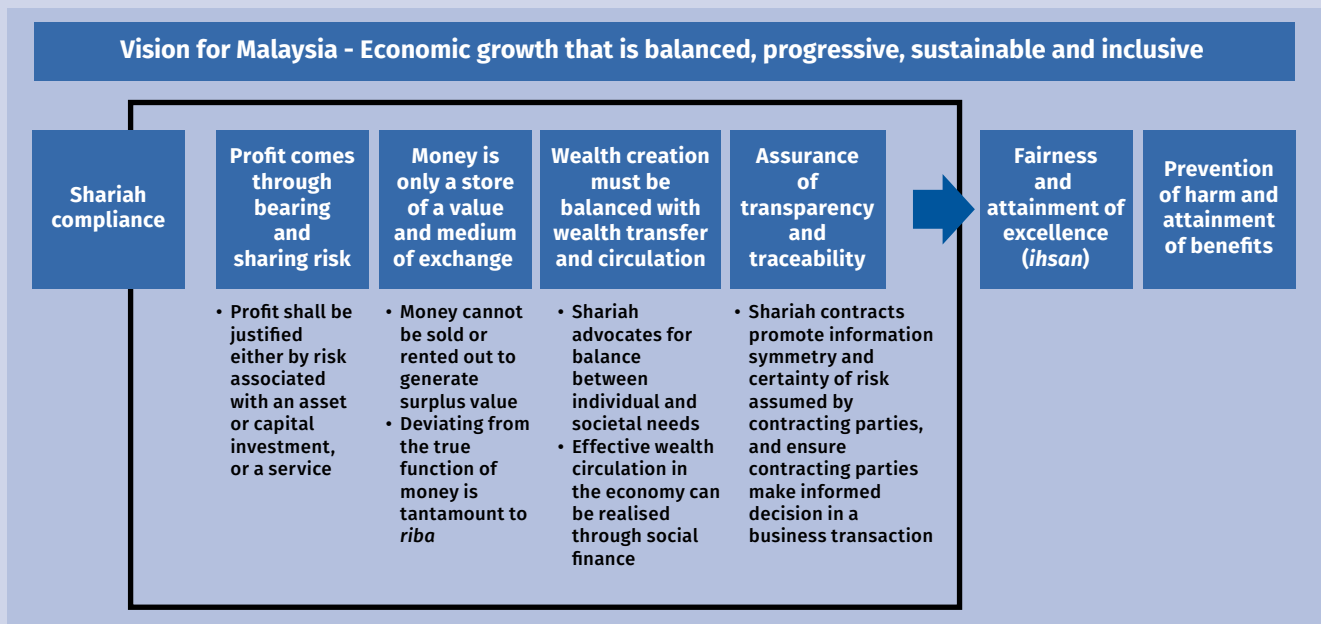


Strengthening the fundamentals of Islamic finance

As the Malaysian Islamic finance industry matures, we continue to focus efforts on further strengthening its fundamental values. This is intended to fully realise the beneficial impact of Shariah principles that underpin the provision of Shariah-compliant financial services. The Shariah Advisory Council (SAC) on Islamic Finance, as an advisor to the Bank on Shariah matters, plays an instrumental role in clarifying key fundamental Shariah principles that should be embedded in Islamic financial services (Diagram 2). While intrinsic to Islamic finance, these principles are universally applicable in finance towards realising a vision of economic growth that is balanced, sustainable and inclusive.

Diagram 2: Intrinsic values in Islamic finance

Intrinsic values in Islamic finance aligned with economic and social aspirations



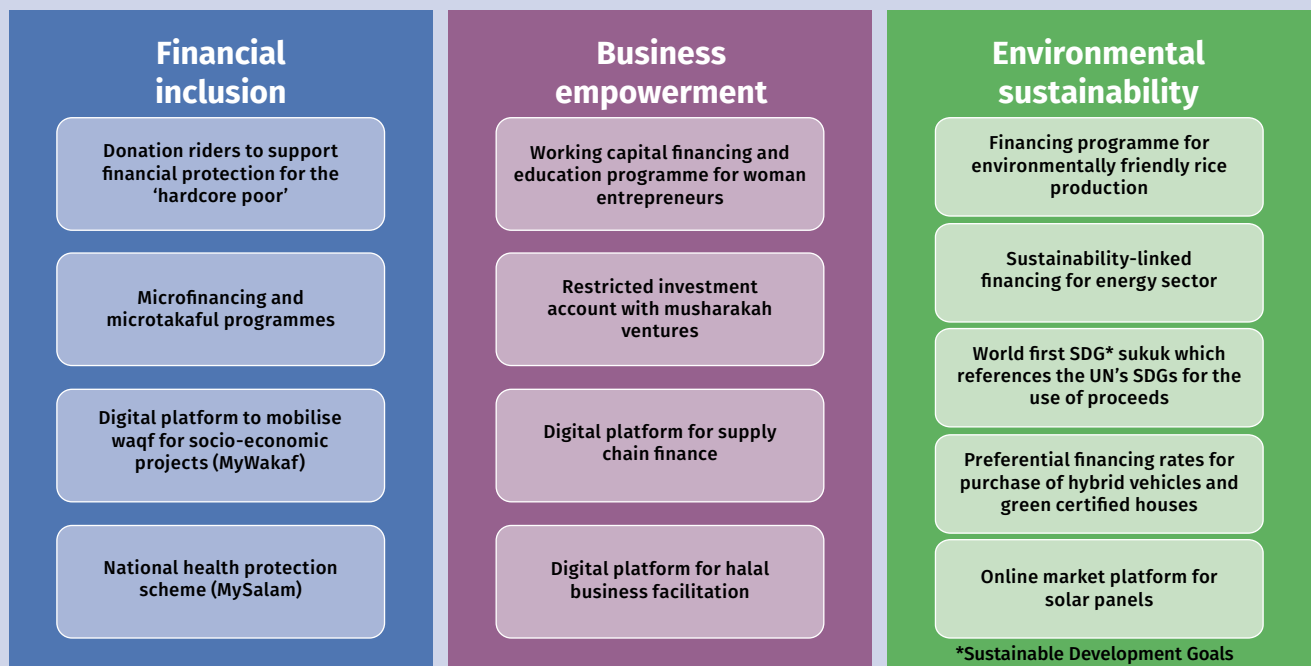
Advancing sustainable and inclusive finance

In recent years, Islamic banks and takaful operators have been offering new innovative solutions to promote financial inclusion, empower the community and entrepreneurs, and support Malaysia’s economic transition to a more environmentally sustainable economy (Diagram 3). These objectives are consistent with Shariah objectives (*Maqasid Shariah*) of promoting wealth sharing, stimulating economic productivity and safeguarding the environment.

As part of a strengthened focus on VBI, the Islamic banking and takaful industry has also been exploring the use of social finance instruments such as endowment (*waqf*), donation (*sadaqah*) and alms-giving (*zakat*) in the provision of financial services for those in greater need. The infusion of social finance contributions unlocks the potential to more effectively mobilise resources towards the provision of financing and financial protection to lower income segments in the form of seed-capital, working capital and takaful benefits. Beneficiaries of such programmes include *asnaf*¹ entrepreneurs and the ‘hardcore poor’ households. These financial programmes can have an important impact on promoting financial resilience and social well-being within society. Several pilot programmes are being piloted in collaboration with state governments and religious authorities. Their successful implementation, with strong support from all stakeholders and implementation partners, will serve as a model and catalyst for the further development of social finance in Malaysia.

¹ A group of people worthy of receiving *Zakat* contribution such as the destitute and poor.

Diagram 3: Value-based solutions delivering positive impact



Fostering linkages between Islamic finance and halal trade

There is a growing awareness and demand for goods and services produced based on the *halalan-toyyiban* (end-to-end Shariah compliance) principle, which calls for Shariah compliance to be observed throughout the entire production supply chain including distribution, marketing, and financing. The Islamic finance industry in Malaysia is well positioned to support halal industry development. Collectively, Islamic banks have pledged RM20 billion in funding for SMEs including businesses in the halal industry. A variety of financial solutions are available to address various business needs such as cash and liquidity management, working capital and investment, risk management and protection solutions, leasing of equipment and machineries as well as supply chain financing.

More customised solutions are now available to cater to the distinct needs of halal businesses including those in the food and beverage, pharmaceutical, cosmetics and modest fashion industries. The Bank has allowed Islamic financial institutions to pilot new financial solutions that can further expand Shariah-compliant trade finance facilities, for example, inventory management facility. This is facilitated by a more responsive regulatory framework that caters to the specific features and risks associated with Shariah contracts applied.

Upholding strong governance to promote stability

As the Islamic finance industry continues to push new frontiers, regulatory developments and governance arrangements must keep pace to promote the resilience of the Islamic financial system. In 2019, the Bank issued the strengthened Shariah Governance standards to reflect the growing complexity and scale of Islamic financial business. The standards raised expectations on the quality and effectiveness of governance arrangements within Islamic financial institutions to ensure Shariah compliance. This includes requiring Islamic financial institutions to demonstrate how they integrate Shariah governance considerations within their business and risk strategies, and promote sound Shariah compliance culture and environment. The standards also outline higher competency requirements for Shariah committee that commensurate with business needs. The new Shariah Governance standards will come into effect on 1 April 2020.

The Bank's SAC has also enhanced its decision-making framework to support its role as the leading authority for the ascertainment of Islamic law in Islamic financial business. In its decision-making process, the SAC will obtain broader practical perspectives to inform its deliberations. The basis underpinning each Shariah ruling is disclosed in greater detail to provide additional guidance for its implementation by Islamic financial institutions.