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CHALLENGES AND OPPORTUNITIES OF ISLAMIC DIGITAL BANKS IN MALAYSIA

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Abstract

Digital banks are also known as virtual banks, neo-banks, or challenger banks are different from traditional banks as digital banks predominantly deliver banking services through digital channels with a minimal brick-and-mortar presence. Since 2020, Bank Negara Malaysia (BNM) has issued a licensing framework for the establishment of the first five digital banks in Malaysia, which is expected to be in the first quarter of 2022. The first Islamic digital bank was established in Saudi Arabia and followed by United Arab Emirates (UAE). Malaysia could also potentially join Saudi Arabia and UAE as Maybank and CIMB, both established Malaysian banks with large Islamic windows are said to be suitable candidates for the first Islamic digital banking in Malaysia. The emergence of digital banking is also an opportunity for Islamic banks that comes amidst slower growth in the industry over the past three years. This article analyzes the challenges and opportunities of the establishment of the first Islamic digital banks in Malaysia, focusing on the regulatory framework. This study aims to examine the advantages of digital banking as compared to traditional banking, analyze the challenges of adopting Shariah-compliant Islamic digital banks, and suggest solutions to solve the problem arising from the challenges. This study uses pure doctrinal research using the exploratory method and references have been made to relevant legislations, legal articles, and case law. This study identified several challenges such as customer protection, licensing and security issues, money laundering, and cyber security but few opportunities of digital banks such as efficient, cost-effective, and customer-centric.

Keywords: Challenges, Islamic, Digital, Banks, Framework.

INTRODUCTION

The industrial revolution has caused deviations in our way of working, living, and mingling with others (Razak et al., 2020). A new industry in banking and finance called the "Fintech industry" has emerged and exploded around the world of digital revolution 4.0, Fintech industry has now become a focus of the existing banking and finance industry (Ali et al., 2019) with the advancement of information and communication technology that has transformed many industries from manual-based to automatic-based activity and from offline to online transaction inclusive the financial industry.

As digital banking is becoming important in the banking industry, especially after the Covid-19 Pandemic, many traditional banks had responded to this phenomenon by establishing digital banking, where banks digitized all traditional transactions and services in an application in order to make their service more reliable, accessible and convenient to their customers (Faridah & Jabbar, 2021). Not only in western countries but the adoption of digitalization is also significantly high in the Islamic finance industry in Islamic counties, especially in the Middle East. For example, Bahrain is trying to become a leader through a partnership of Bahrain Islamic Bank with Bahrain Fintech Bay, and the establishment of the first shariah-compliant digital bank (Kavuri & Milne, 2019). Islamic banking is required to capture the phenomenon of digital acceleration whereby there are public expectations for fast, efficient, and secure financial services that can be done from anywhere. Islamic banks are also demanded to make adaptations to compete with conventional banks or new start-ups in the banking sector (Ikhwan & Rusydiana, 2022).

Similar to other countries, Malaysia is also committed to establishing its first digital banks in its jurisdiction, by being the first country that expressly seeks to establish a regulatory framework for Islamic digital banks by specifically including Islamic digital banks in the Central Bank of Malaysia (CBM)'s Licensing Framework (Faridah & Jabbar, 2021). Last year, CBM released the Exposure Draft on Licensing Framework for Digital Banks on December 27, 2019. Followed by the announcement, CBM has planned to open the market to non-bank players with the issuance of 5 digital bank licenses to pump innovation of technology into the nation's financial sector. This decision has aimed to increase the financial inclusion rate among Malaysians and to cover the unserved or under-served segments in the market including the Small and Medium Enterprises (SME).

However, due to the COVID-19 pandemic, the formation of this proposed framework has been delayed, where the upcoming stage of releasing the final policy document and the application process was pushed to a later date. This study found that the scientific literature that discusses Islamic digital banking has been published quite a lot whole over the world, but still with different tendencies, so it is interesting to conduct research to see where the trend of research results in the form of published and indexed papers is. Therefore, this study shall discuss the challenges and opportunities of Islamic digital banking from Malaysia's perspective.

LITERATURE REVIEW

As an impact of the technology, banks must become digitized and discussed a challenge as becoming a digital bank demands new services focused upon 21st-century technologies (Skinner, 2014). Digital banking has changed the dynamics of banking consumers and their corporate relationships with the banks. The concept of the digital bank is not merely online banking, internet banking, or mobile banking where only certain aspects of banking such as money transfers and bill payments are digitized. In digital banking, every activity and transaction undertaken by the banks and their customers is fully digitized (Faridah, 2021).

Digital bank also known as a virtual bank, neo bank, or internet-only bank is defined as a bank with products and services provided in digital form, its clients daily communicate digitally and the bank's infrastructure is optimized for real-time digital interactions, and the corporate culture implies fast decision-making and technological changes (Petrova et al., 2020). There are several characteristics of digital banking. Firstly, digital banking creates value for its customers. Digital banks can leverage data on customers' purchasing and spending habits to develop a few meaningful insights via anticipated analytics. Customized and individualized offers can be developed by the digital bank to maintain a deep relationship with its customers. Digital banks must offer digital services that are responsive, smart, and personalized to customer needs at any time. The major focus of the digital bank is the prominent customer experience, within its digital revolution strategy, to ensure customer loyalty is always achieved Many previous researchers have done research analyzing Islamic digital banks as challenges and opportunities to Islamic banking in Malaysia. For example, Adha et al., (2021) concluded three (3) legal challenges embed shariah requirements, fraud, and cybersecurity, and personal data protection However, this article will focus on other challenges and opportunities of Islamic digital banks in Malaysia.

METHODOLOGY

This study uses pure doctrinal research using the exploratory method (or positive or normative analysis). A doctrinal legal approach is an extremely valid, purposeful methodology, which carries both a scholarly and practical currency. It has a long and established history (Kilcommins, 2016). Doctrinal research is described as research with the formulation of legal 'doctrines' through the analysis of legal rules. Doctrinal research is thus firstly a description of the current law but turns to interpretation when the current law is applied in practice when opinions about the current law are provided by professionals and academics (Coetsee & Buys, 2017). Reference to relevant legislation, legal articles, and case law shall be made in this study.

RESULT AND DISCUSSION

In implementing digital technology, Islamic banking must also focus on its main services. This, of course, brings various kinds of challenges because it is not easy to change the entire system and arrangement of Islamic banking in a moment. However, the existence of digital technology encourages the establishment of healthy cooperation and competitiveness between Islamic and conventional banking.

Challenges of Islamic Digital Bank in Malaysia

1. Lack of Customer Protection

Since Malaysia is also a pioneer in the Islamic finance industry, it is also important to analyze the necessity of having a new regulatory framework to ensure the supervisory authorities can continue to fulfil the goals of Islamic digital banks. In this regard, the cross-country experience can be taken, whether to adopt a minimal alterations approach (such as in the United Kingdom, where all deposit-taking institutions are required to comply with broadly the same set of regulations but with some minor requirements for institutions offering Islamic products or to adopt a dual approach where the authorities issue separate specific regulations for Islamic digital banks such as Bahrain (Sole, 2007).

2. Data Protection Issue

Malaysia passed the Personal Data Protection Act 2010 ('PDPA') on 2 June 2010. Section 4 of PDPA defines personal data as any information in respect of commercial transactions that is: Being processed wholly or partly by means of equipment operating automatically in response to instructions given for that purpose Recorded with the intention that it should wholly or partly be processed by means of such equipment or Recorded as part of a relevant filing system or with the intention that it should form part of a relevant filing system, and, in each case ... that relates directly or indirectly to a data subject, who is identified or identifiable from that information or from that and other information in possession of a data user. Personal data includes any sensitive personal data or expression of opinion about the data subject but does not include any credit report under the Credit Reporting Agencies Act 2010 (Ab. Hamid etc 2021).

Ong (2012) observed that there is no specific guidance under PDPA to identify the mode of obtaining consent from the customer whether it should be express (including oral or written) or implied consent. In view that the law is silent about this issue, it may open the opportunity for the responsible party to abuse the data of the customers. In this context, it is essential to determine whether banks indeed, as data users, comply with the legal requirements of PDPA in dealing with personal data and, if so, to what extent they protect the privacy and interests of data subjects in their commercial transactions (Mohamed Yusof et al., 2016).

3. Licensing

Malaysia's Islamic financial system has been regarded as one of the world's most comprehensive systems (Lajis et al., 2015). The main regulation to regulate the financial system is the Central Bank of Malaysia Act 2009 (CBMA) (formerly the Central Bank of Malaysia Act 1958) which provides for the continued existence of the Central Bank of Malaysia and the administration, objects functions, and powers of the central bank, for consequential or incidental matters. Islamic banks are under the Central Bank of Malaysia's authority and supervision and it is the same as other banks and financial institutions carrying out Islamic banking business. The legal basis for the Islamic banking business operation in Malaysia is the Islamic Financial Services Act 2013 (IFSA) and Financial Services Act 2013 (FSA).

With the 5 companies appointed to become the first digital banks in Malaysia, it is expected that BNM to provide a comprehensive regulatory licensing framework to facilitate the management of these new players. On 31 December 2020, BNM has introduced The Licensing Framework for Digital Banks policy document ("Licensing Framework") was issued by Bank Negara Malaysia ("BNM") to encourage applicants to apply for licensing, however after the successful applicants been announced in 2022, the immediate focus of BNM is to ensure that digital banks can begin operations without delay so that they start delivering on their promised value propositions to serve the needs of the unserved and underserved segments.

4. Cyber Security

Digital banking might bring new opportunities for criminals to commit crimes online and cause bankers as well as customers to be the victims. Online fraud or scams is one of the most common cybercrimes that is faced by people, especially during the time of the pandemic. It happens when important information such as bank account details are stolen by criminals through using fake emails, websites, or messages (Santoso, 2012). Nevertheless, the government in Malaysia has taken some actions to prevent fraudulent crimes and protect customers on digital banking by implementing several legislations. Firstly, the Malaysian Penal Code (Penal Code) can be enforced to punish the criminal for online fraud or scam by prosecuting them under the offense of cheating as prescribed in Section 420 of the Penal Code. As an illustration, the offender who obtains online banking information by deceiving the victims and causing financial losses to them can be guilty of cheating under Section 420 of the Penal Code.

5. Money Laundering & Terrorism Financing

According to Article 6 of the UN Convention against Transnational Organized Crime, money laundering is defined as follows: The conversion or transfer of property, knowing that such property is the proceeds of crime, for the purpose of concealing or disguising the illicit origin of the property or of helping any person who is involved in the commission of the predicate offense to evade the legal consequences of his or her action; or the concealment or disguise of the true nature, source, location, disposition, movement or ownership of or rights with respect to the property, knowing that such property is the proceeds of crime.

The adoption of digital banking allows banking customers to continue their activities by logging in with their digital profile information on any device including tablet, computer, or phone. This system basically encourages financial criminals to conduct money laundering transactions without going to banks quickly from anywhere and this will be easier in digital banking as the actual person who accesses the financial institution account can hide his / her identity with this system. Criminals will prefer to do money laundering through digital platforms.

In 2018, BNM has issued the Anti-Money Laundering and Counter Financing of Terrorism Policy for Digital Currencies (Sector 6). The policy aims to ensure that effective measures are in place against money laundering and terrorism financing risks associated with the use of digital currencies and to increase the transparency of digital currency activities in Malaysia.

Opportunities of Islamic Digital Bank in Malaysia

Digitalizing Islamic banking will bring numerous opportunities for the growth of the industry. Being digitized will help Islamic banks to respond to altering customer structure and expectations as well as to the consequential disintermediation due to competition from new entrant non-bank Islamic financial services providers. Richer insights will be put into business decision-making due to the availability and processing of more granular data about customers' preferences and dispositions. Digitalizing Islamic banking will also enhance access to financing by the micro, small and medium enterprises (MSMEs), and support value-based intermediation among offering many other benefits, as follows:

1. Efficiency

The adoption of the digital banking revolution boosts efficiency in transactions and operations. Digital banking allows more transactions by either a customer through the bank or several customers through the bank. Customers are able to interact digitally with banks without taking a queue to cater to their needs through digital banking. In other words, the customers who have something to deal with, do not have to approach the bank branches as they can access the digital platform whenever and wherever they wish to do so. With digital banks, the bank's daily operation shifts from physical to digital. The bank can entertain and serve the customer one-to-one through their online customer service. Since it is instant feedback or inquiry from the customer, the bank is able to assist the customers in a fast and effective manner. Therefore, Islamic digital banks can compete with the conventional ones to offer a speedier and more convenient service to their clients.

2. Convenient

Knowing Your Customer (KYC) rules require the physical presence of customers who wish to open a bank account at the bank to show their passport and utility bills in which the regulation of this process is done by Bank Negara Malaysia. This is the usual practice in conventional banks. In digital banking, e-KYC is implemented. e-KYC allows customers on board from time to time digitally regardless of location. e-KYC eases bank customers who usually have to visit physical bank branches to open bank accounts as with the technology being adopted, the identification and verification process can be done online.

In Malaysia, the exposure draft on e-KYC issued by Bank Negara Malaysia in December of 2019 laid down the requirement and guidelines for the implementation of e-KYC. Aside from e-KYC which does not require the bank to have branches, the digital bank has an alternative option to operate a direct customer-advisor service. In the digital era, customers usually cater to their needs through self-service which is direct and remote. Cash money is all automated through infrastructure like automated teller machines (ATM). Hence, 'sales and advice' is the only service left. Since 'sales and advice' is the only need for face-to-face interaction, automated online appointment systems are deployed and bank branches are no longer required. In other words, customers would manage nearly ninety out of a hundred percent of all bank operations themselves online and if they need any help.

3. Cost-Effective

During the 2019 pandemic, the government has encouraged banking customers in utilizing digital financial services and it is proven that this can save cost and contributes to cost-effectiveness (Agur et al, 2020; Naumenkova et al, 2019).

The digital banking revolution is cost-saving in the long run. It allows the digital bank to earn cost-effectively. One of the reasons for it being cost-saving is that tasks which are repetitive and dull in nature are automated. In other words, the costs spent to hire employees to do such jobs are saved due to the replacement of job tasks by technology. As the operation of digital banking is based on technology, the expenditure allocated for administrative and physical office purposes is reduced as customers can make their payments via online or electronically.

Since the tracking and transaction are done online, and usually recorded digitally either through a flash drive or through the cloud, and the payment evidence is no longer in paper or physical receipts form, digital banks are able to save material cost, postage cost, printing cost, and cost used for storage purposes. The reduced costs and efforts required by customers for shopping around and switching banks due to technology may erode Islamic Banks' brand advantage and make customers less sticky.

This will also have implications for the stickiness of deposits and investment accounts as cheap and stable sources of funding to Islamic Banks. This is because customers will be able to easily and frequently optimize their surplus balances by moving funds from lowly-remunerated transaction accounts to a more productive and higher rate of return paying accounts or investments. Moreover, digital banks that either hires lesser or no banking staff can also cover up the initial investment costs. From the customer's perspective, the customer is able to save their money on traveling to the physical branch bank. Since the service offered by digital banks is automated, customers do not have to pay a high service charge. Physical documents used for banking purposes will also be replaced digitally so customers can save lots of money over time.

4. Customer Centric

The digital banking revolution is customer-centric. As compared to the daily operation in traditional physical banks where banking staffs tend to make mistakes while they were doing similar tasks repetitively, digital banking automated the banking operation and minimize or eliminates errors made by humans. By automating the banking operation, bank employees who are equipped with the necessary skills and discretion can focus more on solving complex issues faced by the customers which cannot be solved digitally as well as advising customers one-to-one on the products or features provided by the digital bank. In other words, customers will be receiving advice given specifically to them based on their personal issues. Besides, the digital banking revolution gives customers the freedom to have a look or tender a signature on documents through mobile banking or online banking.

The process of applying for a loan or making a transaction is fast due to the digitization of banking services. Similarly, for the customer phone call service feature, customers are able to get instantaneous and fast replies through automated customer service driven by Artificial Intelligence (AI). This technology could also help to solve customers' disputes whereby the systems are able to evaluate and survey a customer's previous transaction with the bank and to search for resolution provided previously. Therefore, customers are provided with a better banking experience in the digital banking revolution.

Furthermore, the digital banking revolution allows more experts and data scientists in the technology field to join the digital banking industry. Their jobs are focused on improving customers' banking experiences by developing new digital banking services for bank customers. Customers will be served by these people who are well-equipped with the banking knowledge and skills for transforming and managing digital banks.

CONCLUSION

An effective Shariah governance system for maintaining Shariah compliance is the core of the Islamic banking business that differentiates it from conventional banking regardless of the platform through which products and services are provided. Government support for the digital transformation process has been very encouraging in numerous jurisdictions where Islamic banking is present. This is through providing guiding policy documents, a conducive environment, and the infrastructure needed for regulatory sandbox experiments. Building on experiences garnered specific to digital Islamic banking regulatory guidance on conduct requirements and operational matters relating to risk, data management, product and process compliance with Shariah, etc., is necessary to create justification for the distinct identity from the conventional digital banks. It should also be possible to support Islamic FinTech in developing partnerships with the Islamic Banks or providing a conducive regulatory environment for Islamic Banks to assist the growth of Islamic FinTech. Human capital development is a fundamentally important pillar for innovation to be successful. The digital transformation process requires highly specialized human capital and domain experts both for operation and regulation. Therefore, both regulators and providers of digital Islamic financial services will need to retrain and reskill existing talent even as they make efforts to attract new talents that fit the imminent transformation of the digital banking workforce.

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