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EMBRACING FINTECH BY SHARI'A FRATERNITY

Financial technology or fintech is currently the hottest subject being discussed within the financial industry. Numerous events were organised, articles drafted and posting shared discussing the potentials and disruptions fintech brings to the financial industry. Fintech is the result of the advancement of technology and its application into the everyday human life. Professor Klaus Schwab, Founder and Executive Chairman of the World Economic Forum in his book 'The Fourth Industrial Revolution' describes that the world is currently going through the Fourth Industrial Revolution. According to him, it is a revolution driven by range of new technologies which are fusing the physical, digital and biological world. It will impact disciplines, economies and industries including the everyday human lifestyle. In the financial industry space, this has resulted in the rise of financial technology. Technology has enable new players to offer financial products and services, which are currently being offered by existing players. They are also offering new services. The fintech players are promising more competitive cost, better customer experience and greater efficiency.

The Fourth Revolution

Professor Klaus Schwab also noted that 'Platform strategies, combined with the need to be more customer-centric and to enhance products with data, are shifting many industries from a focus on selling products to delivering services. An increasing number of consumers no longer purchase and own physical objects, but rather pay for the delivery of the underlying service which they access via a digital platform'[1]. He noted that "this shift is a power a powerful one and allows for more transparent, sustainable models of exchanging value in the economy". According to him it will create "challenges in how we define ownership and how we interact with the increasingly powerful platforms that provide these services at scale. He identified among the 'Deep Shift' would be 'Bitcoin and the Blockchain"[2]. The elements described by Professor Klaus are already being felt in the financial industry. We are inundated with financial

1. Schwab, Klaus The Fourth Industrial Revolution at page 58
2. Schwab, Klaus – ibid at page 155

technology news and developments on daily basis. There are fintech developments almost everywhere on the globe. New fintech platforms and block-chain initiatives were introduced and announced. Fintech is fast becoming the new norm for the financial industry.

It is pushing the industry into a transformation phase, which could result in the role of the incumbent players being redefined. The financial industry model is largely an intermediation business. Fintech is challenging this model by removing the need to have an intermediary. For the Islamic finance industry, fintech could provide a leverage for the industry by embracing it as one of its growth strategy. But it could potentially stifle growth of the industry, if its existing stakeholders do not respond to this technology disruption accordingly and in a timely manner. Therefore, existing market players, particularly its leaders, would need to respond proactively and decide strategically how to effectively capitalise fintech. It is no longer asking whether to embrace fintech or to shun it. It is to determine how extensive the industry should embrace it.

Regulators Response

Malaysia financial industry is regulated by two key regulators namely Bank Negara Malaysia (BNM) and Securities Commission Malaysia (SC) with each mandated to oversee the financial services market and capital market, respectively. Comprehensive regulations namely the Central Bank of Malaysia Act, Securities Commission Act, Financial Services Act, Islamic Financial Services Act, Developmental Financial Institutions Act and Capital Market and Services Act were enacted to support these regulators. Besides regulating, they also play active developmental roles and have issued relevant documents aimed at spurring the development of the industry. Developmental plans such as Financial Market Masterplan, Financial Market Blueprint and Capital Market Masterplan 1 and 2 as well as the recently issued Fund and Wealth Management Blueprint were drafted to chart directions for both the conventional and Islamic financial and capital market.

Both regulators have put Islamic finance as key focus and have established dedicated divisions to facilitate the development of the industry. Naturally, the focus of Islamic finance development is confined within their area of mandate. However, despite having different mandate, one of the key strengths, which has enabled Malaysia to be one of the leading Islamic finance market is the strong collaboration between the two regulators. Changing market environment due to the rise of fintech may require rethinking on the regulatory framework by all regulators. It has also impacted the approach in developing the Islamic finance industry. Malaysian regulators have responded swiftly and in some instances, have been ahead of the curve.

In his inaugural speech at the Global Islamic Finance Forum 5.0, Muhammad bin Ibrahim, Governor of BNM, set the tone on how to respond to the rise of fintech and its impact on Islamic finance. He stated that "In Islamic finance... fintech has immense potential to be the next game changer. It offers opportunities for industry players to radically transform operational models by adopting digitisation strategies that will be able to deliver much greater scale or alternatively, a high degree of specialisation. It also opens up new possibilities for improving efficiencies, reducing wastage and enhancing the customer experience. All of this adds up to stronger market positioning and financial performance".

The statement essentially sums up the proactive position of BNM in relation to fintech. The central bank is embracing it and most importantly sees the importance of Islamic finance players to leverage on technology as its growth strategy. BNM was swift in its response to fintech by establishing the Financial Technology Enabler Group (FTEG)[3]. FTEG is tasked to formulate and enhance regulatory policies with the aim to facilitate adoption of technological innovation by Malaysia's market players. The group will also act as the dedicated point for all queries related to fintech including regulatory matters.

The group first key deliverable was the issuance of the Financial Technology Regulatory Sandbox Framework (Sandbox Framework), after a month of consultation period[4]. The sandbox allows experimentation of fintech solution in a live environment and subject to the relevant safeguards and regulatory requirements. The framework reflects BNM's endeavour to balance between promoting innovation, preserving financial stability and protecting consumers' interest. It should be noted that BNM is not the first regulator to issue a sandbox regulatory framework. However, the framework expressly states that as part of the risk assessment process, it will ensure that innovative solutions for Islamic financial services be consistent with prevailing Shari'a standards. Although it is a relatively unassuming provision, it carries significant impact as it is the first sandbox framework that expressly acknowledged Islamic financial services. This could potentially be the first jurisdiction that clearly recognises the value proposition of fintech for Islamic finance.

A similar stand was echoed by SC. Its Chairman, Ranjit Ajit Singh said that technology is the potential solutions for markets to fully serve its economic role whilst being purposeful and accessible to consumer and business, whom together constitute the real economy and form the backbone of our future prosperity. He believed that technology will transform the capabilities of financial market and will "disrupt the traditional value chain of business with breathtaking speed"[5]. Towards this end, the SC has established aFINity@SC to drive network of fintech stakeholders to accelerate growth and innovation as well as to nurture a fintech ecosystem. Through aFINity@SC, the regulator aims to engage stakeholders in charting Malaysia's fintech agenda.

Besides aFINity@SC, the SC has also established relevant regulatory frameworks for equity crowdfunding and peer-to-peer (p2p) financing platforms through its Guidelines on Recognized Markets. The SC has since announced 6 registered crowdfunding platforms[6] and 6 p2p financing platform operators[7]. The SC is the first regulator in the ASEAN region to regulate p2p financing industry. One of the p2p financing operations given approval to operate was EthisKapital, making it the first Islamic p2p platform in the world to receive an approval from the regulator.

Islamic Finance and Technology

Currently, the industry is awaiting for the first fintech company to be given the approval by BNM to operate within the sandbox framework. However, even before the formation of FTEG and the issuance of the Regulatory Sandbox Framework, BNM has supported the establishment of the Investment Account Platform (IAP). A consortium of 6 Islamic banks via Raeed

3. Bank Negara Malaysia Press Release – 16 June 2016 - Establishment of Financial Technology Enabler Group
4. Bank Negara Malaysia Press Release – 18 Oct 2016 - Financial Technology Regulatory Sandbox Framework
5. Ranjit Ajit Singh, World Capital Market Symposium 2015
6. Securities Commission Malaysia Press Release – 10 June 2015 - SC Advances Greater Inclusivity in Market Based Financing : Six Equity Crowdfunding Platforms Registered
7. Securities Commission Malaysia Press Release - 3 November 2016 - SC Announces Six Peer-to-Peer Financing Operators : Malaysia first in ASEAN to regulate P2P Financing

Holdings launched IAP. The conceptualisation of the idea and its implementation was undertaken by the industry with close consultation with BNM. Although the idea behind IAP was mooted and conceptualised by BNM, IAP is a commercial proposition. Islamic banks were invited to take an equity stake in the holding company and their decisions were based on their own commercial judgment. The IAP was developed to provide a new growth platform for Islamic banking industry, to address financing gap of the SMEs sector and to allow investors investment opportunities in new asset classes.

The platform leverage on technology to deliver its mandate. It also showcased the flexibility of the Islamic Financial Services Act 2013 to accommodate new business model for Islamic banks. As a technology driven business model, substantial resources were allocated in the development of a robust system to support IAP. Before the establishment of IAP, another technology driven platform was already operating, which is Bursa Suq Al'Sila (BSAS). BSAS provided the commodities required by Islamic banks in Malaysia to undertake their commodity murabaha financing products. The backbone of the BSAS is the technology developed to support the commodity transactions. What is more crucial, BSAS could potentially be the first fintech platform that utilises Islamic smart contract anywhere in the world. In a similar light, the IAP could also potentially be developed into a key investment platform that utilises Islamic smart contract.

The foundation that was developed from BSAS and IAP should be capitalised by Malaysia to position itself as a serious fintech player. The platform strategies scenario as explained by Professor Schwab is already operating in Malaysia at the commercial level. Thus, Malaysia is in good position to 'leverage' its experience and its stakeholders to provide fintech value proposition for the global Islamic financial industry. The key question is how to move forward.

Holistic Approach to Fintech

The Malaysian Islamic finance industry is driven primarily by regulatory frameworks. Thus naturally, the playbook of the respective regulatory agencies is to work within its regulatory mandate. Each regulatory agency will establish its own operating model to serve its mandate like having its own Shari'a Advisory Council, dedicated team to oversee development of Islamic finance and setting up of relevant institutions to support Islamic finance. As discussed earlier, the cooperation between the two regulators have been very close. Regular engagements including bilateral meetings were held annually. Joint initiatives such as the Malaysia International Islamic Financial Centre (MIFC), Royal Award in Islamic Finance (RAIF), Law Harmonisation Committee and the Global Islamic Finance Forum were also undertaken jointly. In the area of Shari'a Advisory, there is a joint-committee between the Shari'a Advisory Council of BNM and SC to address Shari'a issues that impacted the financial and capital market.

When PwC released its fintech report, it was entitled "Blurred Lines: How Fintech is Shaping Financial Industry". The title aptly summarises the scenario in which existing financial players will be facing. Financial services industry is highly regulated and whilst regulations are put in place to ensure only fit and proper stakeholders are allowed to come in. It also resulted in a 'protective environment' for market players and thus shielding existing players from competitors. Regulatory lines also resulted in the market being superfluously segregated. In the past, this was the ideal regulatory framework. However, with fintech, this regulatory lines and barriers between existing players and non-players offering financial products and services are fast disappearing. PwC in the report concluded that one of fintech most powerful weapons is disintermediation.

As the landscape is changing and with disintermediation looming, for a market the size of Malaysia, perhaps it is timely that the fintech agenda be driven holistically. Here the collaboration between BNM and SC would be crucial in developing the fintech agenda. Although Malaysia is globally recognised as a leading Islamic finance jurisdictions, a robust fintech framework for Islamic finance would differentiate Malaysia with other aspiring jurisdictions. An initiative should be jointly undertaken to conduct a comprehensive review of the impact of fintech on the Malaysian Islamic finance industry. There should be an inter-agency group comprising representatives from BNM and SC to articulate the establishment of a fintech agenda. This would enable Malaysian Islamic finance industry to be ahead of other jurisdictions by providing its players with clear directions on what to be achieved.

Role of Shari'a Scholars

Whilst the collaboration of regulators is expected and inevitable, one key stakeholder must take on a greater role in the development of fintech for Islamic finance. They are the Shari'a scholars. Malaysia has a robust Shari'a governance framework. The Shari'a ecosystem is supported by relevant laws, which recognise the role of Shari'a fraternity. The Islamic Financial Services Act 2013 elevates the role of Shari'a committee of Islamic financial institutions by according higher regulatory expectations[8]. One fundamental focus of the Islamic Financial Services Act 2013 is to propel the role of Shari'a scholars. Their role is no longer merely providing support to the Islamic financial institutions. The expanded regulatory burdens are a recognition of their key role in the running of Islamic financial institutions.

In relation to fintech, it is crucial for Shari'a scholars to take a leading role in providing their assessment of the current developments. In his book 'Shariah Minds in Islamic Finance', Dr Daud Bakar explained that there have been proposals for the creation of an effective integrated platform using high technologies that can respond to all Shari'a queries. He takes the position that "Shari'a scholars may now need to work with companies that develop and provide high technology system and that artificial intelligence, despite its current limitation can be functional in all areas without any restrictions[9].

With such framework in place, Shari'a fraternity is in the position to contribute significantly to the development of fintech. BNM has already provided an opportunity for Islamic financial industry to participate in fintech development and the Shari'a fraternity should capitalise on this. One gap for developing fintech for Islamic finance is the discourse and applicable researches on fintech. However, key developments on block-chain and bit-coins, smart contract, artificial intelligence, big data, internet of things, for example have not been discussed extensively by the Shari'a fraternity.

A key area in which the fraternity could discuss and set directions would be in the application of Islamic smart contracts. Among the key initiatives by BNM with the introduction of IFSA was the development of Shari'a contract parameters. The parameters were drafted with extensive consultation with the industry and aimed at providing a standard guidance on operationalising and applying Shari'a contracts in Islamic finance[10]. These Shari'a parameters

8. Section 28(4) IFSA 2013 for example imposes monetary penalty of twenty-five million ringgit or imprisonment of eight years.
9. Bakar, Daud (2016). Shariah Minds in Islamic Finance.
10. Bank Negara Malaysia Notices & Announcements – 28 Dec 2009

could potentially be the basis for the development of standardised Islamic smart contracts. This is where Shari'a fraternity could take the lead in contributing to the fintech developments.

In addition, through establishments like ASAS and ISRA, they would be able to conduct researches to clearly address Shari'a positions on the relevant fintech developments. The expertise of various experts in fintech and Shari'a, should be pooled together and a task force should be established to tackle this challenge. ASAS is in the position to take this lead and hence should engage with key stakeholders in the fintech industry. One institution they could leverage on in driving this is the Islamic Financial Technology Alliance and government agencies such as MDEC in driving this. The focus should be on key fintech pillars namely smart contract, artificial intelligence, block-chain and internet of things. Key Shari'a leaders particularly those serving the Shari'a Advisory Council of BNM and SC should play the lead role. They should engage with BNM's FTEG and SC's aFINity to position fintech for Islamic finance as the key value proposition for Malaysia. They should also create awareness among the fraternity to build deeper understanding of fintech and its potential for Islamic.

Moving Forward

The speed of development in fintech is unprecedented. For example, Singapore, lead by the Monetary Authority of Singapore, has been very forward looking and proactive. They have signed collaborative arrangements on fintech and is exploring block-chain for interbank payments. Essentially, Singapore is bringing fintech into the mainstream. Most importantly, Singapore is investing into fintech to maintain its global edge in financial industry and has the ability to pool its resources to common direction in developing fintech. One edge which Malaysia could capitalise is to focus on fintech for Islamic finance. However, for this to be successful, it is crucial that the Shari'a fraternity is prepared and willing to embrace fintech. Here, the focus should be on how fintech can be leveraged to enhance Islamic finance and to see how it could facilitate in the growth strategy of Islamic financial institutions. However, the development of fintech in Islamic finance must be backed by a comprehensive body of Shari'a opinions and research works. In this regards, the readiness of Shari'a fraternity to embrace fintech is a crucial element for any Islamic finance jurisdiction to stay in the race of becoming the leader in Islamic finance.