Robust regulatory support is helping Malaysia retain its market-leading position in the sukuk market

Malaysian banks focus on core Islamic strengths as economic pressure mounts

The Islamic banking sector is set to maintain higher financing growth rates than their conventional peers.

When the central bank of Malaysia issued guidelines on value-based intermediation (VBI) in October 2018, it signified a heightened commitment to push the country's Islamic finance sector towards Shariah-compliant sustainable practices and products and help boost the share of Islamic banking assets in total banking assets to 40% by 2020 from 32% as of August 2018.

Designed as an intermediation function, VBI outlines practices, conduct and offerings that aim to produce a positive and sustainable impact and sets out a framework on how to incorporate environmental, social and corporate governance (ESG) values in business strategies, risk governance and operations. VBI aims to translate the Islamic principles it espouses into real banking products and services and update the frameworks for Islamic banking which have been in place since the 1980s.

Malaysia commands the lion's share of the global Islamic bond or sukuk market with a 48% market share as of end-2018

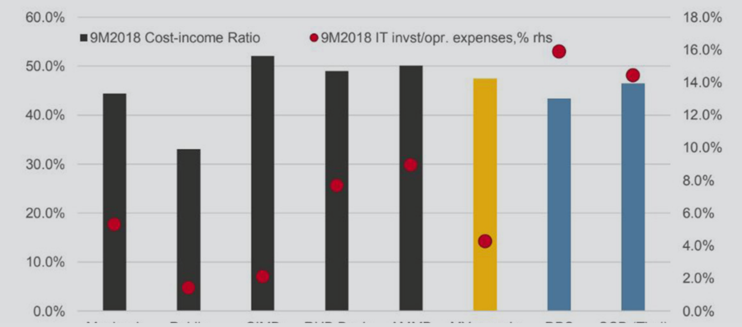
"VBI, focused on creating value and impact, is set to be one of the drivers of Islamic financial institutions," **Mohd Izazee Ismail**, Senior Vice President, Ratings at Malaysian Rating Corporation Berhad (MARC) told *Asian Banking & Finance.*

The latest regulatory initiative comes on the heels of the implementation of the sustainable and responsible investment (SRI) sukuk framework in 2014, which led to issuance of the world's first green Islamic bonds in Malaysia in 2017, data from Moody's Investors Service show. In 2016, the Investment Account Platform, the country's first bank-intermediated online platform for shariah financing and investment was also launched, signifying how regulators are throwing their full weight in support of the development of Islamic banking in the country.

"Much positivity already surrounds the various ongoing VBI initiatives. It is therefore reasonable to expect that there would be even more VBI measures launched in the near future, as well as heightened support and involvement of Islamic financial institutions given benefits accruing to the industry in general and the economy at large," said **Domenic Fuda**, Group Managing Director and CEO at Hong Leong Bank.

As the largest Islamic banking market in Asia-Pacific and third largest in the world, trailing only after Saudi Arabia and United Arab Emirates, Malaysia commands the lion's share in the global Islamic bond or sukuk market, accounting for half (51%) of the total $396b (RM1.6t) of total global outstanding sukuk in 2017, Deputy Finance

IT spending of Malaysian banks against regional peers



Source: S&P Global Ratings

Minister Datuk Amiruddin Hamzah said in a local media report. The headline figure softened mildly to 48.0% in end-2018, but still retains the country's market-leading position in the sukuk market, according to Izazee.

With heightened demand from a growing number of end-users and resources invested by companies scaling their Islamic operations, Islamic finance will continue to play a big role in Malaysia's financial landscape, said **Simon Chen**, Vice-President – Senior Analyst at Moody's Investors Service.

"The Islamic banking sector will maintain higher financing growth rates than conventional peers, because of the strong demand in this sector, and as large Malaysian banks continue to adopt an "Islamic-first" approach when marketing and offering new products to corporate and retail customers," he added. Moreover, the non-performing loan (NPL) ratios of Islamic banks trail behind conventional lenders, indicating a largely healthy asset quality unlike their counterparts in Indonesia which have relatively poorer asset quality due to their focus on retail and SME financing, Moody's said in an October report.

Keeping pace

Compared to their more developed regional peers like Singapore, however, most banks in Malaysia remain in the early stages of digitisation where lenders still have to build the necessary digital infrastructure, technical capabilities and human resources either through fintech partnerships or in-house tech teams. "The banks will not likely realise any material efficiency gains during the initial investment phase because these efforts require high investment levels and ongoing maintenance costs," said Chen.

Even as IT investments still translate as a medium-term recurring expense, its long-term benefits help in boosting its business case. "Digitisation of banking services through the integration of technology for the improvement of service delivery, as well as the provision of new offerings through partnerships with FinTechs would further boost the position of Islamic banks as the natural financing partners of Halal industries, for example," said Fuda.

In December 2018, an instant fund transfer service called DuItNow was launched to enable users to send money via mobile number. Customers need only perform a one-time registration to link their mobile number with their bank accounts. Users can also choose to connect their MyKad, MyPR identity card numbers, army or police numbers and passport to make transfers of up to $1,200 (RM5,000) for free.

Hong Leong Bank is one of the 14 local and foreign banks that offer DuItNow on its Internet and mobile banking channels as

Domenic Fuda

Mohd Izazee Ismail

Simon Chen

the bank recognised the value of open data in product and service customisation. "Although in its early stages currently, it is likely that the ability to draw information from a larger pool of data would also help banks establish better controls and contribute towards better compliance and fraud management practices," said Fuda. "We take pride in our ethos of being Digital-at-the-Core, adapting to changing environments and executing our digital transformation strategy. We conscientiously strive towards strengthening our digital offerings by re-imagining the banking journey of consumers and small & medium size businesses so that we can deliver more efficient and meaningful products and services."

The refined focus on cost efficiency is especially critical since banks in Malaysia face dimmer business prospects on the back of lingering economic uncertainties which is tipped to further drive weak loan growth down to 4-5% in 2019 from 5-6% growth achieved in 2018, Izazee of MARC said. Margins will also face pressure amidst tough competition for deposits whilst capital market activities are expected to remain soft.

"Banks will face subdued loan demand from businesses and households in their domestic and overseas markets because of weak sentiment. This dampened demand will curb profitability through weak revenue growth, persistent compression in net interest margins, and incrementally higher credit costs," warned Chen.

With bank margins set for limited upside in 2019 amidst high household and corporate sector indebtedness and property market imbalances, banks need to perfect the balancing act of keeping a tight lid on costs whilst shelling out for crucial IT investments that will ensure their sustainability in the long run. "Nevertheless, as the challenge for banks going forward is revenue growth, it is important that banks balance their fintech investments accordingly so as not to overburden their overall financial performance," concluded Izazee.