

The role of Bank Negara Malaysia in limiting imprudent consumption

Muhammad Adli Musa*

Abstract: This study identifies the role that Bank Negara Malaysia plays in regulating imprudent consumption. In doing so, the author reviews the Guidelines on Responsible Financing introduced by the Bank in 2012 to regulate the consumer credit market. Since consumers are highly dependent on credit to purchase what they desire, the Bank tightened lending procedures. The author also argues that despite the claimed ethical superiority of Islamic finance, there is no apparent difference when it comes to providing loans (or rather financing) to consumers. The findings of this study suggest that such procedures reduced the growth of household borrowing and consumer loans/financing. As such, the study concludes that Bank Negara Malaysia has an effective role to play in limiting the negative effects of imprudent consumption.

Keywords: Bank Negara Malaysia; consumerism; imprudent consumption; Islamic finance; responsible financing.

Abstrak: Kajian ini mengenal pasti peranan yang dimainkan oleh Bank Negara Malaysia dalam mengawal selia kepenggunaan tidak berhemah. Penulis menganalisis Garis Panduan untuk Pembiayaan Bertanggungjawab yang berkuat kuasa kepada tahun 2012 untuk mengawal pasaran kredit pengguna. Memandangkan pengguna amat bergantung pada pinjaman untuk membiayai perbelanjaan, Bank Negara Malaysia telah memperketat prosedur pinjaman/pembiayaan. Walaupun kewangan Islam dikatakan lebih beretika, penulis berpendapat bahawa tiada banyak perbezaan antara institusi perbankan Islam dan konvensional dalam memberikan kemudahan pinjaman (atau lebih tepat pembiayaan) kepada pengguna. Kajian ini mendapati bahawa langkah yang diperkenalkan ini telah mengurangkan kadar perkembangan

* Muhammad Adli Musa is a Lecturer in the Department of Qur'an and Sunnah, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University Malaysia (IIUM), Malaysia. Email: adlimusa@iium.edu.my.

pinjaman and pembiayaan pengguna. Ini menunjukkan bahawa Bank Negara Malaysia mempunyai peranan yang berkesan dalam mengatasi kesan negatif kepenggunaan tidak berhemah.

Kata Kunci: Bank Negara Malaysia, kepenggunaan; kepenggunaan tidak berhemah; kewangan Islam; pembiayaan bertanggungjawab.

This article looks at the role of regulators in managing consumer credit offered by financial institutions. In the financial market, consumers are spoilt for choice. There are a plethora of products and services for them to choose from. On the pretext that consumers are sometimes vulnerable and offered easy access to credit facilities, they might make wrong choices that could have serious repercussions on their financial standing in the long term. Regulators play a crucial role in putting checks on the consumer credit market in order to ensure that financial institutions offer financing products in the best interests of the consumers. Regulators are also in the position to impose rules, regulations and guidelines that would control the levels of household indebtedness. Financial crises are testimonies of the negative effects that deregulated consumer lending may inflict upon the financial system as a whole. The measures introduced by Bank Negara Malaysia, for instance, the introduction of the *Guidelines on Responsible Financing*, serve as a good example of how regulators can play an effective role in supervising the offering of consumer credit.

In the past, Muslims were reluctant to subscribe to various financial products and services, often only engaging in financial transactions out of necessity (*ḍarūrah*), because of the imposition of interest, which is widely considered as *ribā*¹ (usury), underlying most financial contracts. The entrance of Islamic financial products and services into the global financial market has given Muslims the opportunity to engage in financial transactions in a *ḥalāl* (permissible) or *Sharī'ah*-compliant way. Financial innovation and engineering on the part of Islamic financial institutions have enabled Muslims to engage in various financial transactions, which are underlined by contracts deemed *Sharī'ah*-compliant. Most financial transactions offered by conventional financial institutions, are now offered by their Islamic counterparts. Mirakhor and Smolo (2013, pp. 29-30), for example, observe that architects of the current Islamic financial system along with *Sharī'ah* scholars successfully developed “a rich array of synthetic and structured products all of which, in one

form or another, are replicated, retrofitted or reverse engineered from conventional finance.” Thus, there now seems to be no reason for Muslims to shun financial products and services on religious grounds.

Furthermore, since Islamic finance operates alongside conventional finance, where the latter is obviously dominant, the only evident difference between them is that the former has to find ways to offer products and services in a way deemed to be *Sharī‘ah*-compliant. This means that the products and services offered by Islamic banks (IBs) must comply with the legal or *fiqhī* requirements of the *Sharī‘ah*. The approach taken by most Islamic finance practitioners is to ensure that *fiqh al-mu‘āmalāt* stipulations are not violated. Islamic finance has been described as a prohibition-driven industry, whereby any elements which violate *Sharī‘ah* in relation to financial transactions are removed or replaced with *Sharī‘ah* acceptable rules (el-Gamal, 2006, p. 8). Although the forefathers of modern Islamic economics envisioned Islamic finance to predominantly offer products and services on the basis of profit/loss-risk-sharing underlined by *mushārah* (joint-partnership) and *muḍārah* (silent-partnership) (see Siddiqi, 1983), most financial transactions employ *murābahah* (mark-up sale) and other arrangements such as *tawarruq* (monetisation), and *ijārah* (lease) etc.²

Consumerism and Islam

Consumerism is “the cultural expression and manifestation of the apparently ubiquitous act of consumption” (Miles, 1998, p. 4). It is often fuelled by marketing efforts. Although marketing provides useful information for consumers, more often than not its main goal is to entice people to purchase products regardless of whether they need them or not. Marketing which encompasses branding and advertising strategies entice consumers to desire and eventually buy or subscribe to products and services which they find appealing. Although economists argue that consumers are *homo economicus*, who would act rationally to maximise utility, there are evidences which suggest that they do not necessarily make rational decisions. In a free market, consumers are supposedly free to make choices. However, unconsciously, marketing efforts influence their choices and there are times when they make bad choices for themselves. Consumers do not only make decisions based on what they know, their feelings also play a role in decision making (Ubel, 2009, pp. vii-xii).

Khan (1994, pp. 14-15) suggests that in capitalist economies, consumers have the freedom to purchase anything they like. However, they are often influenced and tempted by various marketing techniques to purchase things that they questionably need. Ubel (2009, p. ix) also makes a similar observation and points out the various harmful consequences of flawed decisions when capitalism meets human nature. The ‘invisible hand’ which is supposed to ensure market efficiency in a capitalist economy has not restrained people from wasteful consumption (Ubel, 2009, p. ix). The assumption that consumers are sovereign is losing ground as marketing techniques adopted by corporations are capable of dictating what is good for them and as a result, they are psychologically forced to purchase things that they do not need. The finance industry also facilitates consumers to spend recklessly by providing products and services that would satisfy their desire for more goods (Khan, 1994, p. 102). It is feared that Islamic finance paves the way for Muslims to be “Western-style consumerists, while still feeling true to their faith” (Nasr, 2009, p. 31).

The Islamic worldview dictates that the affluent should voluntarily forego some of their luxuries and assist in improving the economic conditions of others. The Prophet emphasised simple living and discouraged people from excessive luxuries. But this does not mean that Islam demands that people live a life of deprivation and misery if they can afford a better standard of living. Islam envisions an egalitarian society where socio-economic inequality is a lot less than what is observed in capitalistic societies. Only when the inequality gap has shrunk should the society as a whole move to higher socio-economic level. *Taqwā* or God-consciousness built upon the Unity of God (*tawhīd*) diverts people away from acquisitiveness to sustainable efforts aimed at spiritual self-enrichment and social improvement. Low consumption economy seems to be the kind of economy which is in harmony with Islamic ethos (Khan, 1994, pp. 14-15). Islam also discourages indebtedness unless it is necessary (Ahmed, 2011, p. 6). Thus subscribing to debt-based financing products to acquire essentials might be justifiable. However, entering into debt-based contracts for other purposes which are deemed unnecessary is highly discouraged (Mohammad Hatta & Izzi Dien, 2014, p. 53).

Sharī'ah-compliant consumer financing

Consumer loans are basically lending given to consumers for personal, family or household purposes, or for consumable items such as vehicles

and houses, which are provided on the basis of the borrower's integrity and ability to pay. A loan is essentially a debt provided by one entity to another entity at an interest rate. Formally, loans and the principal amount borrowed are formally documented, the interest rate and date of repayment are also specified. Consumer finance, on the other hand, is the division of retail banking that deals with lending money to consumers, which includes a variety of loans such as credit cards, mortgages, vehicle and housing loans, and loans for other personal use.

The prohibition of *ribā* does not allow IBs to extend interest bearing loans. If IBs were to offer loans, it would have to be free of interest. As such, IBs offer various financing products to meet the demands of consumers who would like to purchase consumable items on credit. Basically, IBs and conventional financial institutions offer similar consumer financing products, but the former uses different underlying contracts to ensure that the product is *Sharī'ah* compliant. IBs thus enable consumers to purchase houses, vehicles and acquire cash for personal use within the confines of the *Sharī'ah*.

In the following paragraphs, I will briefly describe the contracts utilised by IBs in providing financing to consumers. It will be evident that the end-result of such contracts bears similarities with loans provided by conventional banks.

To enable consumers to purchase houses, IBs utilise various *Sharī'ah* compliant contracts such as *bay' bi-thaman ājil* (deferred payment sale), *tawarruq*, *mushārahah mutanāqishah* (diminishing partnership) or *ijārah muntahiyah bi-al-tamlīk* (lease ended with ownership). *Bay' bi-thaman ājil* is a sale and purchase transaction for the financing of assets on a deferred and an instalment basis with a pre-agreed payment period where the sale price will include a profit margin. *Tawarruq* based on commodity *murābahah* is also used in home financing, in which an IB would purchase a commodity from a broker, and then sell the commodity acquired to the consumer at an agreed selling price which includes a profit margin for the IB. The customer pays this price to the IB on a deferred and an instalment basis. Acting as a sales agent for the consumer, the bank then sells the commodity to a different broker on behalf of the consumer. The proceeds of the sale of the commodity will then be used to pay the purchase price for the property to the developer/seller. Another common mode of house financing is *mushārahah*

mutanāqīshah or diminishing partnership. This is a partnership arrangement where the consumer promises to buy the equity share of the bank gradually until the title equity is fully transferred to him. This transaction begins with the formation of a partnership between the consumer and the bank, after which buying and selling of the equity takes place between the two partners. *Ijārah muntahiyah bi-al-tamīk* is another mode of home financing offered by Islamic banks. It is a lease contract which concludes with ownership of the property.

Vehicle financing is provided by IBs through either *bay' bi-thaman ājil* or *al-ijārah thumma al-bay'* (lease followed with sale) which is similar to hire purchase transactions or *murābahah* (mark-up sale). *Bay' bi-thaman ājil* has been explained in the paragraph above, and it works in similar ways whether the asset is a house or a car. In an *al-ijārah thumma al-bay'* transaction, the IB purchases the vehicle and becomes its owner and subsequently leases it to the customer. Upon settlement of the rentals, a purchase agreement will automatically be executed, thus transferring the ownership of the vehicle from the bank to the customer. Another mode of vehicle financing is through *murābahah* where an IB will purchase the vehicle specified by the customer upon the promise that he will purchase the car from the bank at higher price on a deferred payment basis.

Personal financing transactions are carried out by IBs using either *bay' īnah*, *tawarruq* or *bay' salam* contracts. To obtain cash on the basis of *bay' īnah*, an IB sells goods to the consumer on a deferred and an installment basis. The consumer then sells back the goods to the bank at a lower price on cash basis. Another mode of personal financing is via *tawarruq*, which has been discussed earlier. In this mode of financing, an IB purchases commodity from a broker on cash basis, then sells the commodity to the consumer on a on a deferred and an installment basis at an agreed price which includes the cost price plus profit margin. The consumer subsequently appoints the IB as his agent to sell the commodity to a different broker on cash basis. The IB then sells the commodity to this broker on behalf of the customer and he obtains the cash proceeds of the sale. Another contract which is used to facilitate personal financing is *bay' salam* which is essentially a contract where advance cash payment is made for goods to be delivered on a deferred basis. In general, the consumer undertakes to deliver/supply a specified tangible asset to an IB at a mutually agreed future date in exchange for

an advance price fully paid on the spot by the bank. More specifically, the consumer and the IB enters into a *bay' salam* contract where he agrees to sell an agreed quantity of commodity to be delivered on a future date to the IB in return for cash on the spot. The IB pays the consumer the agreed price of the commodity. A broker undertakes to sell the commodity from time to time on a regular basis to the consumer, which then will be delivered to the bank. The consumer will authorise the bank through an agency agreement to debit his account on the agreed intervals for the amount required to purchase the commodity from the broker. On the agreed dates, the broker will deliver/supply the commodity to the bank. This commodity purchase by the consumer will continue until the bank receives the full quantity of the commodity as specified upon signing the contract.

IBs also offer *Sharī'ah* contract based credit cards on the basis of *tawarruq* and *bay' 'inah* which have appeared in the discussions above. Besides these contracts, some IBs depend on the concept of *ujrah*. Based on *ujrah*, the bank will provide credit facility to the customer through a credit card account and charges a fee (*ujrah*) for such services. The consumer is then obliged to pay the fees in accordance with usage of the card. The bank will vary fees in accordance to maintaining the account which has been used by the consumer through the credit card issued to him. Another way in which IBs offer *Sharī'ah*-compliant credit cards is by employing three contract structures: *kafālah*, *wakālah* and *qard*. Under the *kafālah* contract, the IB guarantees payments to merchants and other third parties on behalf of the card holder. Under *wakālah*, the IB is considered as the card holder's agent, and pays merchants and other third parties on his behalf, with a promise to provide him with a loan to pay the amount accrued resulting from the use of the card. The bank then acts as a lender, which is characterised by *qard*, and the consumer is liable to immediately return the amount of funds utilised.

Marketing of consumer financing products by Islamic financial institutions

Just like their conventional counterparts, IBs engage in marketing efforts to promote their products and services. Yap (2011, pp. 235-237) argues that marketing strategies which highlight the Islamicness of financial products and services are "superfluous at best and deceptive at worst" as most are similar to conventional products, in which the economic end-result is the same. He also observes that current marketing practices of IBs

depart from the religious ideals of Islamic finance, which has diminished the uniqueness of Islamic finance. The focus has been on promoting debt-based banking products rather than profit/loss-risk-sharing arrangements. Rates of return of profit rates of these *Sharī'ah* debt-based products are promoted to customers, drawing them to compare those rates with interest rates for conventional products. This marketing approach has consciously or unconsciously led to consumers evaluating the attractiveness of Islamic banking on the same basis they would evaluate conventional banking. It has also resulted in the perceived parity of the two banking systems and consumers unable to differentiate between them. The failure to distinguish Islamic banking from conventional banking would deter consumers from being more acquainted with *Sharī'ah* principles underlying Islamic finance and render religiosity less relevant to the marketing of Islamic banking products and services.

Bank Negara Malaysia's role in regulating consumer loans

A combination of market discipline and prudential regulation is required to promote effective and stable financial markets. Stability is achieved through progressive development of sustainable, robust and sound financial institutions and financial infrastructure. Effective functioning of a financial system depends on *inter alia* the users believing that there is adequate control over the conduct of participants offering their products and services (Islamic Financial Services Board, 2009, p. 1). Regulators play an important role in ensuring that those participants do not exploit end users of their products and services.

Bank Negara Malaysia is cognisant of the fact that household debt in Malaysia has been on the rise, and that this could contribute to systemic risk as evident from the financial crisis, which witnessed the rise in subprime mortgage lending as a result of substantive deregulation of the features and terms of consumer loans. Bank Negara Malaysia is also aware of the information gaps that exist between financial institutions and consumers due to the growing complexity of financial products. Bank Negara Malaysia (2011a, pp. 21-22) is responsible to regulate and supervise the market conduct of financial institutions in its effort to strengthen consumer protection by addressing information asymmetries between financial institutions and consumers, and “setting clear expectations on fair, responsible and transparent practices by financial institutions in their dealings with consumers.”

In its 2010 Financial Stability and Payment Systems Report, Bank Negara Malaysia outlined six initiatives to “further strengthen the existing consumer protection and market conduct regime” (Bank Negara Malaysia, 2011a, p. 24) in essentially regulating and supervising consumer lending/financing, which would mitigate systemic risk:

1. Address specific expectations on responsible conduct by financial institutions in the retail financing segment, which aims to promote more rigorous and consistent practices in considering the factors that should be taken into account in conducting assessments of whether a financing product is affordable and suitable given the consumer’s financial circumstances;
2. Refine disclosure requirements where appropriate, in order to encourage consumers to focus on key risks, for instance by using more illustrative disclosures, greater standardisation of how key terms are presented etc.;
3. Strengthen institutional arrangements for the regulation and supervision of market conduct that includes enhancing existing inter-agency coordination arrangements to promote consistent approaches to regulating and supervising retail financing activities;
4. Conduct thematic and focused supervisory reviews of market conduct practice of financial institutions in selected areas to identify behavioural biases that might increase systemic risks through industry-wide assessments of retail financing practices, covering incentive systems, the terms of consumer lending/financing and retail investments products, and the way in which they are marketed to consumers;
5. Intensify consumer financial education efforts to promote responsible borrowing decisions; and
6. Further develop and leverage the credit infrastructure to promote a healthy credit culture among consumers.

Guidelines on responsible finance

Bank Negara Malaysia issued *Guidelines on Responsible Financing* which took effect on 1st January 2012 in its effort to “promote better protection for financial consumers and a sustainable credit market that contributes towards preserving financial and macro-economic stability” (Bank Negara Malaysia, 2011b). The guidelines stipulate that financial

institutions are required to assess the borrower's ability to afford financing facilities based on a prudent debt service ratio. In assessing affordability, financial institutions must make appropriate enquiries into a prospective borrower's income after statutory deductions for tax and Employees Provident Fund (EPF), and after considering all debt obligations (Bank Negara Malaysia, 2011b).

The aim of this guideline is to encourage sound borrowing decisions by consumers through better engagements with financial institutions that will help consumers carefully consider their ability to service all their debt obligations without recourse to further debt or substantial hardship. The guidelines also clearly expect that financial institutions ensure customers are treated fairly in the sales, marketing and administration of financing facilities. Consumers should also be provided with information that would make them understand the full implications of a borrowing decision (Bank Negara Malaysia, 2011b).

The guidelines were issued as it was observed that the practices of financial institutions in assessing the suitability and affordability of financing products for retail consumers varied and in some cases were inadequate. Marketing efforts undertaken by financial institutions to promote financing products were also inadequate in taking into account long term and best interests of the consumers. A combination of easier access to credit and an increasingly competitive and innovative credit market calls for the financial institutions to adopt responsible financing practices. Financial institutions are expected to assist consumers in making informed borrowing decisions that would promote a resilient household sector, which would then contribute to sustainable growth and financial stability (Bank Negara Malaysia, 2012, p. 1).

The guidelines are applicable to the following financing products, which would fall under consumer loans/financing (Bank Negara Malaysia, 2012, p. 2):

1. Home financing products;
2. Personal financing products, including overdraft facilities;
3. Vehicle financing products;
4. Credit and charge card products; and
5. Financing products for the purchase of securities except share margin financing governed by Bursa Malaysia rules.

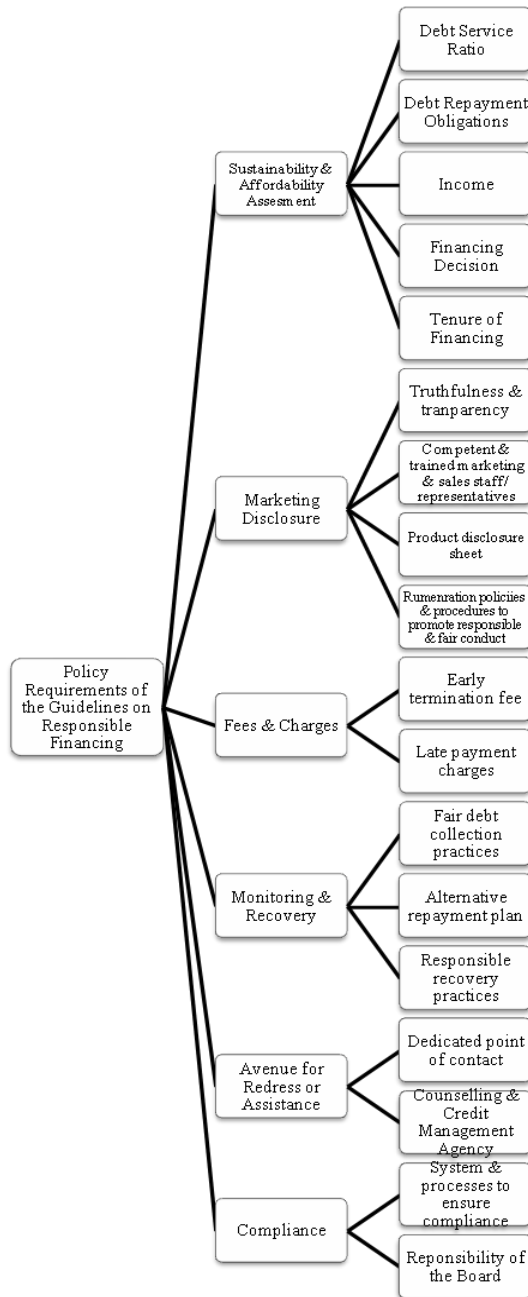


Diagram 1: Policy and compliance requirements of the guidelines on responsible financing

The policy requirements of the guidelines cover six main areas, namely: (i) suitability and affordability assessment; (ii) marketing and disclosure; (iii) fees and charges; (iv) monitoring and recovery; (v) avenue and redress for assistance; and (vi) compliance (Bank Negara Malaysia, 2012, pp. 4-18). Diagram 1 illustrates these policy requirements and their subsequent compliance requirements.

In relation to the first policy requirement, financial institutions are expected to develop financing products which suit consumers' needs and circumstances. Affordability of a financial product is defined as the ability of the consumer to make repayments in full throughout the course of financing without recourse to debt relief or substantial hardship (Bank Negara Malaysia, 2012, p. 4). To assess affordability, financial institutions must observe a prudent Debt Service Ratio (DSR) which is computed as follows:

$$DSR = \frac{\text{all outstanding debt repayment obligations from banks and non banks}}{\text{income after statutory deductions (i.e. tax, EPF etc.)}}$$

To accurately compute DSR, financial institutions must conduct a thorough check on the customer's overall indebtedness, by obtaining information on any outstanding debt obligations, including both secured and unsecured financing from all financial service providers and other non-bank entities that provide credit facilities. This is achieved by referring to the Central Credit Reference Information System (CCRIS), making specific inquiries from the customer regarding financing not covered by CCRIS, and making the customer aware of the duty to disclose essential and correct information in the financing application and the consequences of not doing so. The amount included in the debt repayment obligations should reflect the scheduled repayment of principal and interest/profit, and where discounted interest/profit rates are applicable in the early part of a financing plan, the highest applicable rate should be used (Bank Negara Malaysia, 2012, pp. 5-6). To determine income in computing DSR, financial institutions must enquire into the sources and amount of income. In cases where variable income is taken into account, the financial institution must evaluate the variability for at least three months and only include a prudent portion of the average amount in their assessment. In situations where customers are not permanently employed or are self-employed,

financial institutions must evaluate the stability of the primary sources of income by requiring the customer to provide evidence of income over a period of at least 6 months. Such information must be verified against reliable sources which are independent of the customer. If discrepancies exist, financial institutions must perform further verification or reject the customer's application (Bank Negara Malaysia, 2012, pp. 6-8). The financial institution must also allow sufficient buffers for expenditures and contingencies, taking into account the relevant circumstances of the customer, which may include appropriate consideration of the nature of employment, number of dependents, location of residents and other relevant factors that may affect the customer's level of expenditure. The basis for any financing decision must be properly documented and backed with the necessary documents that support the decision. Financial institutions should not solely consider collateral in extending financing to a customer who has otherwise been assessed unable to afford the financing (Bank Negara Malaysia, 2012, pp. 8-9). A longer tenure of financing may enhance affordability in the short-term, but overall increases the debt burden of the customer and expose him to higher risk in the long term. Vehicle financing should not exceed 9 years (Bank Negara Malaysia, 2012, pp. 8-9). Bank Negara Malaysia (2013b) stipulates that the maximum tenures for the purchase of residential and non-residential properties and personal financing are 35 years and 10 years, respectively.

Financial institutions are also expected to ensure that marketing materials on financing products are clear, fair and not misleading or deceptive. They must prominently display critical information that would likely affect consumers' borrowing decisions. Sales and marketing staff/representatives are required to take into consideration the interests and circumstance of the customer by investigating his financial requirements and situation to ensure that the financing product offered meets his needs. They are also required to provide a product disclosure sheet (PDS) to facilitate comparison and decision-making by consumers. The PDS must be provided to the customer upon entering into the financing contract if there is any material change in the information. The customer must be made aware of the importance of reading and understanding the PDS. The PDS must clearly contain information related to the effective annual financing rate, any applicable fees and charges, and the total repayment amount and total interest

cost/profit, which would allow customers to make comparisons with similar products offered by other financial institutions. The minimum requirement is that sales and marketing staff/representatives explain the key terms affecting the customer's obligations, impact of an increase in financing rate on the monthly instalment and total repayment amount in cases where the financing rate is not fixed, incurred fees and charges – be they recurring or one off, responsibility and obligations of customers, and the consequences of defaulting on any repayments. Prior to entering into a financing contract, customers should be advised to read and understand information pertaining to the key features and associated obligations of the financing product. They must also be given a reasonable opportunity to read the pre-contractual information and ask any questions about the financing product at hand. Financial institutions must ensure that their sales and marketing staff/representatives do not harass, unduly pressure or inappropriately entice consumers into signing up for a financing product. It is the duty of financial institutions to ensure that they are properly trained and competent in carrying out their functions. Remuneration policies and procedures must promote fair and responsible conduct. Financial institutions are also expected to deal firmly and expediently with any mis-selling of financial products and provide appropriate remedies to affected customers (Bank Negara Malaysia, 2012, pp. 10-13).

The guidelines also stipulate that any early termination fee imposed on the customer for repaying/paying the financing in part or in full during the lock-in period shall reflect a reasonable estimate of the costs incurred by the financial institution as a direct result of early termination, and should not penalise or prevent the customer from switching or closing a financing account. The fee shall not include consideration of loss of profit that would have been received if the financing continues until the end of the lock in period or financing tenure and marketing or other costs associated with attracting new customers. The financial contract must not stipulate any term which gives the financial institution a unilateral right to vary an early termination fee or the circumstances in which the fee applies. Financial institutions must not add the charges for late payment to the outstanding amount in arrears for computing interest/profit due and any payments made by the customer should be firstly allocated to clearing any instalments in arrears before any fees and charges. For credit card facilities, financial institutions are required

to allocate the payments received to firstly settle the balances attracting the highest interest (Bank Negara Malaysia, 2012, pp. 13-14).

Bank Negara Malaysia (2012, pp. 15-16) expects financial institutions to fairly treat and take into consideration the circumstances of the customer who is unable to make repayments due to illness, unemployment and other reasonable causes. To do so, financial institutions should have clear policies and procedures that would assist such customers to meet their financial obligation. Upon detection of early signs of repayment difficulty, financial institutions should contact the customer promptly and inform them of the importance of engaging with them early to discuss alternative repayment measures to speedily address financial difficulties. Financial institutions are expected to offer an alternative repayment plan that is appropriate to the customer's difficult circumstances and financial situation, with the aim of genuinely resolving his repayment restraints. The alternative repayment plan however, should not unreasonably increase the customer's payment obligation and financial difficulty, and he must be given adequate information to understand the implication of the proposed plan. In cases where the customer continues to be in default, financial institutions should make him aware of the possible recovery actions such as legal and foreclosure proceedings, of which the costs will be borne by him. Generally, foreclosures are initiated only when other reasonable attempts to reach a resolution prove unsuccessful and even in such cases, financial institutions should give the opportunity to the customer to conduct a private sale before foreclosing in the event that such would have favourable prospects. The customer must also be informed that he will be liable for any shortfall after foreclosure proceedings.

Financial institutions should establish a dedicated point of contact for customers facing repayment difficulties and clearly communicate its contact details to all customers. Staff dealing with such customers must be appropriately trained to explain and provide advice on options and avenues available to assist them in resolving their repayment difficulties. Customers must also be informed of the Counselling and Credit Management Agency established by Bank Negara Malaysia to provide free services on money management, credit counselling, financial education and debt restructuring for individuals (Bank Negara Malaysia, 2012, pp. 16-17).

Bank Negara Malaysia (2012) requires financial institutions to have in place and be able to demonstrate the effective functioning of systems and procedures for ensuring compliance with the guidelines. Any material non-compliance with the guidelines must be escalated to the Senior Management and the Board along with action plans to rectify the non-compliance. Ultimately, the Board is responsible to ensure that appropriate actions are undertaken to address any deficiencies in the conduct of the financial institution's retail financing business which would potentially expose it to financial and reputational risks.

Implications of regulation

The guidelines elaborated in detail contain implicit implications for financial institutions in particular and consumers in general. Financial institutions are expected to comply with the guidelines which would be in the best interest of consumers. Bank Negara Malaysia (2013a, p. 13) reports that the growth of household borrowings after the introduction of the guidelines in 2012 was 13%, compared to 13.4% in 2011. The growth of household borrowing reduced to 11.7% in 2013 (Bank Negara Malaysia, 2014, p. 15) and further declined to 9.9% in 2014 (Bank Negara Malaysia, 2015, p. 3).

Bank Negara Malaysia (2013a, p. 16) reports that:

Bank lending practices have remained sound, and were further strengthened following the implementation of the Guidelines on Responsible Financing which came into effect on 1 January 2012. Banks have been more thorough in assessing affordability to ensure that households who borrow, particularly in the lower-income group, have the capacity to repay the debt throughout the financing tenure without substantial hardship. This was observed in the more prudent buffers provided by banks in the computation of debt service ratios, improved processes and documentation for income verification, and enhancements to customer acceptance criteria. The Bank, through its supervisory oversight, continued to maintain close monitoring on the extent to which incidences of credit exceptions (loans approved outside a bank's credit acceptance criteria) were occurring in banks. This led to actions taken by some banks to further strengthen existing policies, procedures and governance for credit exceptions. A number of banks also reviewed

existing retail credit score cards to capture additional and more granular information to improve risk profiling and monitoring by borrower segments grouped by age, income, debt service ratio, location of property and employment. The low delinquency ratios for household loans have also been supported by an efficient collection process in place within the banking institutions. This enabled banks to take early debt rehabilitation and recovery measures. During the year, the Bank found that the controls within the banks for this purpose were adequate.

The Edge Financial Daily published an article on 2nd July 2012 which acknowledged that the introduction of the guideline by Bank Negara Malaysia has had an effect on personal loans/financing. Goh (2012) in her article suggests that personal loan approval has declined due to the increased documentation and more diligence on the part of financial institutions in processing personal loans/financing. The personal loan/financing segment is lucrative for financial institutions as it provides good margin. The guidelines also had an impact on loans/financing for vehicles, where car sales dropped due to tighter credit conditions (Lim, 2012). RAM Ratings Services (2013) views positively the initiatives taken by Bank Negara Malaysia to manage the levels of household debt, which would improve longer-term financial stability. RAM Ratings Services (2013) also notes that such initiatives would not have much impact on financial institutions as their lending practices are generally in line with the prescribed regulatory parameters. It must be noted however, that low income earners are most affected by these measures as financing products are less affordable to them. For example, the Real Estate and Housing Developers Association (REHDA) points out that the affordable housing segment is most affected by the measures introduced by Bank Negara Malaysia as borrowers are likely to be less affluent, with lower income and disproportionately higher expenditure (Mahalingam, 2012).

A reading of Bank Muamalat Malaysia Berhad's (2014) Annual Report reveals that the growth of consumer financing in 2014 stood at 16% compared to 30% the previous year. Nonetheless, despite the measures introduced by Bank Negara Malaysia to curb rising household indebtedness and speculation on property prices, Bank Muamalat Malaysia Bhd's home financing grew by 25% in 2014 compared to 21% and 18% in 2013 and 2012 respectively. In relation to personal

financing, the bank adopts a more rigorous criteria in line with Bank Negara Malaysia's policies to reduce household indebtedness, which resulted in a growth of only 10% in 2014 as opposed to 51% the previous year. The growth of vehicle financing dropped by 3% in 2014, from 11% in the previous year to 8% (Bank Muamalat Malaysia Bhd, 2014, pp. 59-61).

Concluding remarks

The preceding discussions have demonstrated the role that regulators can play in supervising and regulating the consumer credit market. Financial institutions, be they conventional or Islamic, are profit-driven corporations and when the best interests of the consumers are in conflict with the best interests of the shareholders, the latter often gains an upper hand. Regulators, therefore, come into play by introducing measures that would take the consumers' best interests into consideration. Failure to do so would have negative effects on a country's financial stability and expose its financial system to systemic risk. Overall, the idea that the promotion of prudent lending practices by financial institutions, coupled with consumer education, has the potential to contain the increase in household indebtedness is re-emphasised.

The fact that Islamic financing products are arguably similar to conventional financing products calls for more innovation on the part of Islamic finance scholars and practitioners. A *Sharī'ah*-based financial system might offer a better alternative if ethical principles of the *Sharī'ah* are given due emphasis as that given to *fiqh al-mu'āmalāt*. Islamic financial institutions, particularly Islamic banks, have to move away from controversial and questionable modes of financial intermediation and strike a balance between equity and debt financing. The current developments in the Malaysian Islamic financial industry necessitate an objective shift from pre-determined rates of return financing products to profit/loss-and-risk sharing modes of financing.

Endnotes

1. For a better understanding of *ribā* to Islamic banking, see Saeed (1996) and Saleh (1992).

2. This has been described as a “pragmatic shift”, which demonstrates the flexibility in the interpretation and application of Islamic legal principles adopted by the majority of Islamic bankers, from the profit/loss-and-risk-sharing to mark-up based contracts in Islamic banking. See Saeed (2004, pp.116-123).

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