**The Legal Framework of Conversion from Development Financial Institution to Islamic Development Financial Institution in Malaysia under Development Financial Institution Act 2002**

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**Abstract.** Effective on 31st January 2016, Development Financial Institutions (Amendments) Act 2015 (Act 618) introduced major amendments to Development Financial Institution Act 2002 (DFIA 2002) for enhancement of the legal and regulatory framework for Development Financial Institutions (DFIs) in Malaysia. The new Part IIIA DFIA 2002 inserts Shariah Requirement to realign with the provisions of Part IV Islamic Financial Services Act (IFSA 2013). Prior to these amendments, the conversion of Bank Pertanian Malaysia Berhad (Agrobank) to Islamic DFIs on 1st July 2015 were previously regulated under the ambit of Section 129 DFIA 2002. At the date of conversion, the remaining conventional loan assets of Agrobank amounting to RM59.2 million were permitted to be treated as Non-Shariah Assets where its income has to be recorded as liability and to be channelled to charity. This paper tries to analyze the current laws and regulations regulating conversion of DFIs to Islamic DFIs under DFIA 2002 and the legal issues and challenges faced by DFIs on conversion. This study also gathers information from library research and webinars related to this topic. The study finds Bank Simpanan Nasional (BSN), SME Development Bank Berhad (SME Bank), Bank Pembangunan Malaysia Berhad (Bank Pembangunan) and Export-Import Bank of Malaysia Berhad (Exim Bank) have to obtain written regulatory approval from Bank Negara Malaysia (BNM) to convert from Islamic Banking Window under Section 33B(1)(b) to Islamic DFIs under Section 33B(1)(a) DFIA 2002 with permission that certain percentage of unconverted conventional loan assets remain as Non-Shariah assets and become liabilities after conversion. This study shows that Section 33B(1),(2) and (3) DFIA 2002 incorporate the new stringent requirements for conversion of entire business of DFIs with literal interpretation that 100% of its assets must be in accordance with Shariah.

**Keywords:** Legal Framework, Conversion, Development Financial Institutions, Development Financial Institutions Act 2002

1. Introduction

In the year 2020, Islamic banking industry remains resilient and continues to post a health growth despite the challenge of pandemic crisis. According to BNM's Annual Report 2020, the market share of Islamic banking assets and Islamic financing form 34.2% and 41.0% respectively of the total industry size. In 2020, the annual growth of Islamic financing in Malaysia was recorded at 8.5%, much higher than 0.5% growth rate of the conventional counterpart. Total Islamic financing reached RM817.4 billion at the end of 2020 from RM753.61 billion in 2019 and total Islamic deposits and investment accounts reached RM889.95 billion at the end of 2020 from RM826.2 billion in 2019 (BNM,2020).

The positive growth includes contribution of Development Financial Institutions (DFIs) in Islamic Banking Industry (BNM,2020) whereby two DFIs namely Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat) and Bank Pertanian Malaysia Berhad (Agrobank) are entirely carrying on business and activity in accordance with Shariah. Bank Rakyat is recognized as the second largest Islamic financial institution in Malaysia in terms of asset size amounting to RM111.75 billion (Bank Rakyat,2020). The total assets of Agrobank remained strong with an increase of 4.0% to RM18.2 billion in 2020 compared to RM16.9 billion in 2019 (Agrobank,2020). While the other four (4) DFIs; Bank Simpanan Nasional (BSN), SME Development Bank Berhad (SME Bank), Bank Pembangunan Malaysia Berhad (Bank Pembangunan) and Export-Import Bank of Malaysia Berhad (Exim Bank) carrying on Islamic Banking Business as Islamic Banking Window in addition to its existing conventional business.

The principal activities of these DFIs in development banking include strategies and efforts to continuously enhance Islamic Banking portfolio together with the existing conventional related financial services.

This paper tries to analyze the laws and regulation regulating conversion of DFIs to Islamic DFIs under Development Financial Institution Act 2002. Furthermore, this study aims to investigate the issues and challenges faced by DFIs for conversion to achieve its objectives. For that reason, this paper aims to provide suitable recommendation for the establishment Islamic DFIs under Section 33B(1)(a) DFIA 2002 to support conversion of DFIs to Islamic DFIs.

As part of its regulatory and supervisory framework, BNM monitors the activities and financial performance of DFIs to ensure that DFIs perform their mandated roles in a prudent manner, supported by strong corporate governance and best practices. BNM reported in Financial Stability and Payment System Report 2015 that amendments to the DFIA which came into effect on 31 January 2016 was a continuing efforts for an effective legal framework for DFIs in Malaysia. The amendments aim to better support the DFIs’ specific mandates in a sustainable manner and reflect the important role of DFIs in supporting Malaysia’s socio-economic development and inclusive growth (BNM,2015).

1. Literature Review
   1. Development Financial Institutions in Malaysia

DFIs have roles and mandates which are linked directly to the country's national development objectives. This is evidenced from the establishment of DFIs with specific purposes to promote development of identified sectors, ranging from industrial and agriculture sectors to areas such as export promotion, infrastructure development as well as the small and medium enterprises (SMEs) (BNM,2005). The establishment of each DFI is affected by the Act of Parliament to regulate its business and activity related to mandated role provided by the Act. For example, Bank Pertanian Malaysia was established by Bank Pertanian Malaysia Act 1969 and subsequently repealed by Bank Pertanian Malaysia Berhad Act 2008 for its corporatization (Agrobank,2019). Bank Simpanan Nasional was incorporated on 1 December 1974, under the Bank Simpanan Nasional Act 1974, which replaced the Post Office Savings Bank set up in 1948 (BSN, 2019).

Prior to 2002, DFIs were not regulated and supervised by BNM. The issuance of Financial Sector Master Plan in 2001 marked the turning point that led to the strategic recommendation for the formation of proper regulatory framework of DFIs in Malaysia. Effective from 2002, the prescribed Development Financial Institutions (DFIs) in Malaysia are regulated and supervised within the purview of BNM. The governing law that regulates the prescribed DFIs is Development Financial Institutions Act 2002 (DFIA 2002), which came into force on the 15 February 2002 by virtue of PU (B) 51/2002.

The legal and regulatory framework continued to be enhanced in congruent with the common objectives of Economic Transformation Programme (ETP) and the Financial Sector Blueprint 2011-2020 that envisage further transformation of DFIs’ capacity and capability to support their mandated roles. BNM published the Financial Sector Blueprint (Blueprint) on 21 December 2011 and one of the focus areas under the Blueprint was internalisation of Islamic finance.

There are limited literature studies on the Development Financial Institutions (DFIs) in Malaysia (Aminul, 2012; Aminul, 2015). In addition to the limitation of the literature review, the term DFIs has been interchangeable used to denote the Non-Bank Financial Intermediaries (NBFIs) as mentioned by Aminul and Jamil (2011) and it is also referred to as Non-Bank Financial Institutions. Furthermore, the list of DFIs mentioned in each study may include DFIs regulated under DFIA 2002 and other DFIs which are not gazetted under the Act and it was not clearly defined by the researcher(s). Based on this observation, this paper will be focused on the prescribed DFIs listed and gazetted under Development Financial Institutions Act 2002 (DFIA 2002) regulated by BNM and the definition of DFIs and prescribed institutions as defined thereto. This study is crucial as it will fill the gap on the literatures related to DFIA 2002.

This article discusses new rules and requirements for the operation of DFIs provided by the amended Act and analyses its impact on the business of DFIs in Malaysia.

It is suggested that Regulatory Framework for Islamic Banking and Finance in Malaysia is modern and comprehensive after the enactment of IFSA 2013 and Financial Services Act 2013 (FSA 2013) (Sheila,2013). Nonetheless one can question whether the regulatory framework for DFIs in Malaysia is comprehensive enough after the amendments to DFIA 2002, to what extend it is consistent with the provisions under IFSA 2013, and whether it can achieve its objectives in regulating the Islamic banking business activities (Yaacob,2013). This study proposes to bridge this gap with specific focus on the laws regulations regulating conversion of DFIs. It also meant to fill the research gap of the available literatures pertaining to DFIs and DFIA 2002.

* 1. Development Financial Institutions Act 2002

DFIA 2002 is an Act that gives statutory authority to BNM to regulate and supervise DFIs in Malaysia. Section 3 of DFIA 2002 defines DFIs to mean “an institution which carries on any activity, whether for profit or otherwise, with or without any Government funding, with the purpose of promoting development in the industrial, agricultural, commercial or other economic sector, including the provision of capital or other financing facility” (DFIA, 2002). The term “development” refers in DFIA 2002 includes “the commencement of any new industrial, agricultural, commercial or other economic venture or the expansion or improvement of any such existing venture” (DFIA,2002).

Under DFIA 2002, selected DFIs has to be prescribed and gazetted under the law to be placed under the purview of BNM. Prescribed institution further means “a development financial institution which is prescribed by the Minister of Finance under subsection 2(1) of DFIA 2002” (DFIA,2002). This mark the major difference between DFIs and other commercial Banks and investments banks licensed under the Financial Services Act 2013 (FSA 2013) and other Islamic Banks and International Islamic banks licensed under the IFSA 2013. The licenses are issued by Minister of Finance empowered under the FSA 2013 and IFSA 2013 who may, in circumstances permitted under the FSA or the IFSA. On the other hand, DFIs are not licensed institutions to operate and carrying on conventional and Islamic Banking and finance business.

The Minister of Finance is given the authority under Section 2(1) of the Act to prescribe any DFIs to be regulated and supervised under DFIA 2002 on the recommendation of BNM as provided under Section 2(2). Upon prescription by Minister of Finance and recommendation by BNM, an order will be published in the Gazette and issued to the prescribed DFIs. According to BNM, DFIA 2002 is structured to allow flexible application of the Act on selected DFI or on specific role.

Secondly, DFIA 2002 empowers BNM to be the administrator and regulatory body of the Act which serves as the centralized supervisory body for DFIs. BNM aims at ensuring effective and dynamic supervision of DFIs.

Thirdly, DFIA 2002 provides several mechanisms to enable BNM to monitor the role and objectives of DFIs. Among others, DFIA 2002 requires DFIs to submit their proposed business and development activities and projected sources of funding on an annual basis to BNM. In addition, BNM is empowered to specify lending activities of the DFIs. DFIA 2002 also provides a mechanism to monitor the management of Government-allocated funds to ensure that the funds are prudently utilised for their specified purposes.

Fourthly, DFIA 2002 emphasized on efficient management and effective corporate governance by prescribing the procedures for the appointment of directors and Chief Executive Officer. The Act also provides adequate mechanism to enhance disclosure of information in a timely and transparent manner. This is aimed at harnessing sufficient check and management.

Fifthly, DFIA 2002 provides a comprehensive supervision mechanism which incorporates prudential rules, on-site supervision, reporting requirements and disclosure standards. It also provides the regulator with the necessary powers to deal with any mismanagement and malpractices.

Sixthly, DFIA 2002 provides the mechanism to strengthen the financial position of DFIs through the specification of prudential requirements such as in the management of assets, capital and liquidity management.

* 1. The provision of laws governing Islamic Banking Business of DFIs under DFIA 2002 prior to its amendment

It is important to note that the Islamic banking business and Islamic financial business carried out by DFIs was previously regulated under the ambit of Section 129 DFIA 2002 prior to its amendments effective in 2016.

Section 129(1) of the Act is a statutory provision of the law that give permission to DFIs to carry out Islamic Banking Business as Islamic Banking Window with approval of BNM. Section 129 (2) of the Act further provides that the Islamic banking business or Islamic financial business carried on by DFIs shall be subject to the provision of DFIA 2002. Under Section 129(3) of the Act, BNM may issue directions to DFIs on matters relating to Islamic banking business or any other Islamic financial business and DFIs shall comply with the BNM’s written direction.

Pursuant Section 129(4) of the Act, DFIs may seek the advice of the Syariah Advisory Council on the operations of carrying on Islamic banking business or Islamic financial business in order to ensure that it does not involve any element which is not approved by the religion of Islam. Section 129(5) specified that the term Islamic banking business referred to in this Act shall has the same meaning assigned to it by the Islamic Banking Act 1983 and the term Islamic financial business shall mean any Islamic financial business, the aims and operations of which do not involve any element which is not approved by the religion of Islam.

The abolishment of Section 129 of DFIA 2002 was effective on 31st January 2016 with the insertion of new Shariah Requirements under Part IIIA of DFIA 2002 on Islamic Financial Business. DFIs are not required under DFIA 2002 to obtain license under IFSA 2013 to carry out Islamic banking business and Islamic financial business because of its unique nature as regulated under DFIA 2002. The requirement on incorporation of Islamic bank is not applicable to DFIs. It is observed that, there is no specific guideline issued on the process of conversion and transformation of DFIs into Islamic DFIs. It is subject to internal policy and strategic direction of the respective DFIs within its Corporate Governance Framework and upon seeking Shariah advice from its Shariah Committee (Exim Bank,2020).

In regulating and supervising the DFIs, BNM is recognising the unique characteristics and functions of the DFIs, where the relevant stakeholders and ministries of the respective DFIs continue to be accorded the responsibility to provide broad policy direction on the strategic roles and targeted sectors supported by each institution.

* 1. Amendments to Development Financial Institutions Act 2002 in 2015

Development Financial Institutions (Amendment) Act 2015 (Act 618) is an Act to amend DFIA 2002 effective on 31st January 2016. Major amendments to DFIA 2002 have been enforced to DFIs focusing on the enhanced areas and new areas. There are three (3) enhanced areas incorporated in DFIA 2002; (i) Corporate Governance, (ii) Business activities of DFIs, and (iii) Regulatory oversight. The new areas include (i) Shariah governance, (ii) Business conduct and consumer protection, (iii) Enforcement framework (BNM,2015).

The enhanced regulatory framework for DFIs shall continue to preserve DFIs unique characteristics in meeting its socio-economic mandates whilst maintaining its operational safety and soundness. In addition, the changes made also keep abreast with the changes in other regulatory laws governing financial institutions (BNM,2015).

Act 618 amended DFIA 2002 amongst other by inserting the new Part IIIA on Islamic Financial Business that gives permission to DFIs to carry on entire business or activity in accordance with Shariah under Section 33B(1)(a) or Islamic Banking Window under Section 33B(1)(b) with the prior written approval of the BNM. The new Part IIIA also provides that DFI shall ensure that its business, affairs and activities are in compliance with Shariah at all times and shall, if it becomes aware of any non-compliance, notify the BNM of the fact, cease from carrying on such business, affairs or activities and submit a plan to rectify the non-compliance. The new Part IIIA empowers the BNM to specify, in accordance with the advice of the Shariah Advisory Council, standards on Shariah matters which require the ascertainment of Islamic law by the Shariah Advisory Council. The highlights of the two (2) changes made to the Act are as follows:

**Table 1.** The highlights of two (2) new areas inserted in DFIA 2002

Source: Authors’ Selection

|  |  |  |
| --- | --- | --- |
| Shariah requirements | | |
| 1 | To ensure that the Islamic business activities of the DFIs comply with the same Shariah requirements as imposed on Islamic banks under the Islamic Financial Services Act 2013 | Part IIIA: Section 33A-33N prescribe the Shariah requirements on areas which include Shariah compliance and Shariah governance as well as audit on Shariah matters. |
| Regulatory enforcement framework | | |
| 2 | Provide a wider range of enforcement actions with the ability to respond effectively to non-compliance. This is to ensure that there is consistency in the financial services regulatory enforcement framework. | Part VIIIA & Part VIIIB: Section 106A-106Lincorporate broad and enabling provisions on penalty framework which encompass: (i) Administrative penalties, and (ii) Civil penalties, (iii) Criminal penalties |

In order to ensure that the Islamic business activities of the DFIs comply with the same Shariah requirements as imposed on Islamic banks under Part IV IFSA 2013, new Part IIIA DFIA 2002 incorporates the same provisions on Shariah Compliance, Shariah Governance and Audit on Shariah Compliance equivalent to IFSA 2013. The requirements of Section 33B and 33C DFIA 2002 are specific provision for DFIs to regulate the establishment of Islamic DFIs under Section 33(1)(a) and to regulate the business and activity of Islamic Banking Window by DFIs with approval of DFIs. This study finds that these new requirements are effective on 31st January 2016 to realign with IFSA 2013 as described in Table 2.

**Table 2.** Realignment of the new Part IIIA DFIA 2002 with Part IV IFSA 2013. Source: Authors based on DFIA 2002 and IFSA 2013

|  |  |  |
| --- | --- | --- |
| IFSA 2013  Part IV | DFIA 2002  Part IIIA | Provisions on new Shariah Requirements under Part IIIA DFIA 2002 to realign with Part IV IFSA 2013 |
| Sec 27 | Sec 33A | Interpretation and application |
| - | Sec 33B | DFIs are permitted to carry on business or activity in accordance with Shariah |
| - | Sec 33C | Requirement on DFIs approved under paragraph 33B(1)(b) |
| Sec 28 | Sec 33D | Duty to ensure compliance with Shariah |
| Sec 29 | Sec 33E | Power of the Bank to specify standards on Shariah matters |
| Sec 30 | Sec 33F | Establishment of Shariah Committee |
| Sec 31 | Sec 33G | Appointment of Shariah Committee member |
| Sec 32 | Sec 33H | Functions and duties of Shariah Committee and its members |
| Sec 33 | Sec 33I | Cessation as member of Shariah Committee |
| Sec 34 | Sec 33J | Notice of cessation as member of Shariah Committee |
| Sec 35 | Sec 33K | Information to be provided to Shariah Committee |
| Sec 36 | Sec 33L | Qualified privilege and duty of confidentiality |
| Sec 37 | Sec 33M | Appointment of person by prescribed institution to conduct audit on Shariah Compliance |
| Sec 38 | Sec 33N | Appointment of person by Bank to conduct audit on Shariah Compliance |

The comparative provision between Section 129 DFIA 2002 (before its amendments) and Section 33B (after amendments in 2015) are described in the following Table:

**Table 3.** Comparison between the new Section 33B DFIA 2002 and previous Section 129 DFIA 2002. Source: Authors

|  |  |
| --- | --- |
| **The new Section 33B DFIA 2002**  Effective Date : 31st January 2016 | **The old Section 129 DFIA 2002**  Effective Date : 15th February 2002  Deleted on 31st January 2016 |
| Section 33B(1)(a): Establishment of Islamic DFIs with approval of BNM.  Section 33B(1)(b): Establishment of Islamic Banking Window by DFIs with approval of BNM. | There is no provision on establishment of DFIs as full-fledged Islamic DFIs |
| Section 33B(2): Power of BNM to impose conditions for establishment of Islamic DFIs and Islamic Banking Window | There is no specific provision on imposition of conditions by BNM. |
| Section 33B(3): Conversion of DFIs from Section 33B(1)(b) to Section33B(1)(a) shall be subject to written approval of BNM. | There is no express statutory requirement on conversion subject to approval of DFIs and any conditions imposed by BNM. |
| Section 33B(4): Criminal offence on conviction shall be liable to imprisonment for a term not exceeding ten years or to a fine not exceeding fifty million ringgit or to both. | There is no provision on criminal offence on any contravention of Shariah Requirements. |

It is evidenced from the achievement of SME Bank in 2019 where 95.9% of its Islamic Banking business comprises from Islamic Banking portfolio but still remain as Islamic Banking window under Section 33B(1)(b) DFIA 2002.

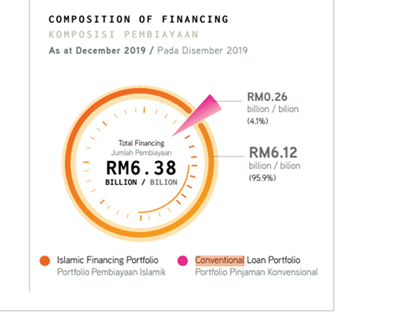


Fig. 2. Composition of Financing as at December 2019 in SME Bank Malaysia

Source: Annual Report SME Bank (2019)

Therefore, the amendments to DFIA 2002 have imposed the stringent requirements in order to realign with provision of IFSA 2013. The study conducted by ISRA in 2020 proposed a framework for conversion with limitation to DFIs issues on conversion considering the unique characteristics of DFIs (ISRA,2020).

1. Research Methodology

This study is a qualitative legal research which is based on the doctrinal legal research methodology (McConville & Chui, 2007)( Hutchinson, 2013). The method is used to analyse the provision of DFIA 2002 on conversion and the implications after its amendments in 2015.

This study is an exploratory study by examining the relevant BNM reports, DFIs Annual Report and Financial Statements as well as other primary and secondary data available in the internet and library. This study uses library research and interviews to explore the current laws and regulations regulating conversion of DFIs in Malaysia under DFIA 2002, legal issues and challenges on conversion. Data which are acquired from annual report, related journals, regulations and library research limited to the research area since the amendments of DFIA 2002 five years ago. The interviews are important to complement the findings from library research in order to present a more comprehensive discussion.

1. Finding and Discussion
   1. The conversion of DFIs in Malaysia under Development Financial Institution Act 2002

Currently, there are two DFIs listed as Islamic Financial Institution under Section 33B(1)(a) DFIA 2002; Bank Rakyat and Agrobank followed by four DFIs on the platform of Section 33B(1)(b) which are carrying on Islamic banking business in addition to conventional banking businesss.

There is a big gap on the percentage of Islamic Financing and the conventional loan that have yet to be converted to Islamic financing. As at 31st December 2020, 49.2% of Exim Bank’s financing portfolio comprises Islamic financing compared to 50.8% conventional loan porfolio. In the case of Bank Pembangunan, the milestones achieved in the year 2019, only 68.5% of its financing portfolio comprises Islamic financing (Bank Pembangunan,2019). BSN has received strong interest and support from the government and BNM towards facilitating the growth of Islamic Banking in which BSN had recorded a contribution of 72.3% from Islamic Financing and 65.0% from Islamic Deposits in 2019.

This achievement is far behind the SME Bank where the total Islamic financing portfolio of SME Bank has reached 95.9% compared to the remaining conventional loan portfolio at 4.1 % (SME Bank, 2019). The total assets of SME Bank grew in tandem with the profit before tax and zakat at 0.4% registering a total of RM9.87 billion in 2019 compared to RM9.83 billion in the previous year. Under SME Bank Tazkiya Project, the focus of transformation initiated by SME Bank into a full-fledged Islamic Development Bank is not only on the conversion of assets and liabilities but also on adopting a Shariah-compliant culture throughout its business activities (SME Bank,2019).

**Fig. 3.** The Total Islamic Financing Portfolio of DFIs as compared to the Remaining Conventional Loan

Source: Authors’ Selection based on Annual Report of DFIs 2019-2020

The above four (4) DFIs are committed to support Islamic Banking Industry in addition to its existing conventional business. However, BSN, Bank Pembangunan, Exim Bank and BSN have the big gap on the remaining conventional loan that have yet to be converted to Islamic Financing comprise 27.2%, 31.5% and 50.8% respectively. DFIs may have the specific focus and strategy to achieve its objective and target on conversion.

**Table 4.** List of DFIs under Section 33B(1)(b) and its Islamic Financing Portfolio as at December 2019

Source: Author’s Selection based on Annual Report of DFIs

|  |  |  |
| --- | --- | --- |
| DFIs under Section 33B(1)(b) | Islamic Financing Portfolio in 2019 | Conventional Loan Portfolio in 2019 |
| SME Bank | 95.9% | 4.1% |
| BSN | 72.3% | 27.7% |
| Bank Pembangunan | 68.5% | 31.5% |
| Exim Bank | 49.2% | 50.8% |

In order to achieve the long term objective, Exim Bank reaffirm its commitment to be a preferred DFI for Malaysian businesses growth with focus on Islamic Financing and Takaful by the year 2025 (Exim Bank,2020).

SME Bank still have 4.1% conventional loan portfolio to fulfill its main objectives on conversion and to provide better framework for full fledged Islamic Financial Institution. However, the interview confirmed that the word “entire” in Section 33B(1)(a) is very general as to connote the 100% percentage of Islamic Financing Portfolio required to be achieved by SME Bank and other DFIs.

Based on the previous research, legislation and regulation is one of the challenges towards conversion due to non-existence of comprehensive framework for the conversion (Shafii, Shahimi & Saaid, 2016). The supervisory authorities are faced with considerable regulatory issues and challenges that needs to be address to facilitate the Islamic banking industry (Rafay & Sadiq, 2015). A strategic plan for conversion must includes timeline, legal approval from regulatory authorities, management commitment and customers’ participation (Ahmad, 2020).

* 1. Issues and Challenges to Expedite the Conversion

There are issues and challenges faced by DFIs on conversion. The main challenges is the statutory requirement of law to obtain approval from BNM. It is observed that SME Bank is very closed to 100% conversion as 95.9% of its portfolio comprises from Islamic financing. Even though the gap of 4.1% on conventional loan portfolio is very small to be converted to Islamic financing, the approval of BNM has to be obtained prior to announcement as Islamic Banks. In 2017, State Bank of Pakistan issued Guidelines for Conversion of a Conventional Bank into an Islamic Bank with requirement that the bank would complete the conversion process within a maximum period of three years from the date of approval subject to extension of time (Pakistan 2017). However, currently there is no specific guidelines issued by BNM to support the conversion of DFIs to Islamic DFIs.

The second challenge is on changes of law. Bank Rakyat was benefited from the conversion prior to enactment of DFIA 2002 through the establishment of Islamic branch that completed in 2002. When DFIA 2002 enacted and came into effect on 15 January 2002, Section 129 regulates the Islamic Banking activity of DFIs. It has to be observed that the conversion of Agrobank to full fledged Islamic Bank was done under the ambit of Section 129 DFIA 2002 which is before the major amendments DFIA effective in 2016. Therefore, after Agrobank has successfully converted to Islamic DFIs in 2015, the amendment took effect and the remaining four (4) DFIs; Bank Pembangunan, BSN, Exim Bank and SME Bank shall be subject to Section 33B(1)(b) DFIA 2002, while Bank Rakyat and Agrobank fall under the ambit of Section 33B(1)(a) DFIA 2002.

The third challenge is to convert entirely the remaining conventional loan assets to Islamic Financing. SME Bank, Exim Bank, Bank Pembangunan and BSN have to meet the requirement of law and conditions of BNM to convert 100% entire business and activities according to Shariah. This study finds that at the announcement date of conversion of Agrobank into Islamic DFI in July 2015, the remaining conventional loan assets amounting to RM59.2 million were permitted to be treated as Non-Shariah Assets where its income has to be recorded as liability and to be channelled to charity (Agrobank, 2015). After 6 years of conversion of Agrobank, there are remaining conventional loan assets amounting to RM6,364,000 as at financial year end December 2020 which were reflected as Non Shariah Asset in the financial statements of Agrobank (Agrobank, 2020). The income earned from conventional loan and Non-Shahriah assets are treated as liabilities in line with Shariah requirements of giving it away as charitable amount.

**Table 5.** Non-Shariah Assets of Agrobank after Conversion to Islamics DFIs

Source: Author’s Selection based on Annual Report and Financial Statements of Agrobank

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2020 | 2019 | 2018 | 2017 | 2016 | 2015 |
| Non-Shariah Asset (NSA) | | | | | |
| 6,364,000 | 11,914,000 | 17,027,000 | 60,596,000 | 84,934,000 | 116,269,000 |
| Income earned from Non-Shariah Asset and channelled to charities | | | | | |
| 2,337,261 | 4,214,125 | 2,604,674 | 2,441,812 | 2,186,177 | 437,930 |

The fourth challenge is the lack of participation from high risk Customer involved in sectoral business agriculture, construction, import-export which the risk exposure is very high. The possible reason for this current situation is that the cooperation of the corporate customer is important to do complex documentation for the purpose of conversion of corporate loan. On the other hand, the cost and the fees is not attractive. If it cannot be said that the costs to conversion is high and then it falls back to the need and motivation of the customer for conversion.

The fifth challenge lies in attracting the remaining conventional customer to participate in conversion scheme. There are some attractive promotion to the customer for example conversion scheme, free moving cost, media exposure and fund support from DFIs during the campaign period.

1. Conclusion

Development Financial Institutions in Malaysia are aiming towards conversion to Islamic DFIs to support the growth of Islamic Banking industry. Bank Pembangunan was aimed to become a full-fledged Islamic bank by 2020 (Bank Pembangunan,2019). Exim Bank has the long term objective to become Islamic DFIs by the year 2025 (Exim Bank,2020). SME Bank’s Islamic Financing Portfolio has reached 95.9% at the end of 2019 (SME Bank,2019). While BSN has strong support from government and BNM towards Islamic Banking Industry as 72.3% comprises Islamic Financing portfolio (BSN,2019).

BNM as a regulatory body has strengthened its legal and regulatory framework through the amendments of DFIA 2002 by inserting new provision of law under Section 33B(3) DFIA 2002 that prohibit conversion of a DFI under Section 33B(1)(b) DFIA 2002 to Islamic DFI under Section 33B(1)(a) without approval of BNM. Contravention of Section 33B(1) or (3) is tantamount to criminal offence under Section 33B(4) and shall on conviction be liable to imprisonment for a term not exceeding ten years or to a fine not exceeding fifty million ringgit or to both.

There are currently six DFIs gazetted as prescribed institution under DFIA 2002 and regulated by BNM. At the effective date of amendment on 31st January 2016, Bank Rakyat and Agrobank are the only two DFIs recognized as Islamic DFIs under Section 33B(1)(a) . The other four (4) DFIs remain carrying on Islamic Banking Business as Islamic Banking Window in addition to its existing conventional business under Section 33B(1)(b) DFIA 2002. The study finds after the year 2019, SME Bank, BSN, Bank Pembangunan and Exim Bank have strong Islamic Financing portfolio comprise 95.9%, 72.3%, 68.5 and 49.2% respectively towards conversion. This shows that DFIs have strong commitment to reach its objective to convert its entire business activities in accordance with Shariah under Section 33B(1)(a) DFIA 2002.

One of the main challenges to convert to Islamic DFIs is the new stringent requirement of Section 33B(1)(a) DFIA 2002 that impose a condition for conversion of entire business of DFIs with literal interpretation that 100% of its assets must be in accordance with Shariah. The statutory requirements of laws provides that the written approval of BNM must be obtained by DFIs subject to fulfillment of conditions that may be imposed by BNM to ensure that the Islamic business activities of the DFIs comply with the same Shariah requirements as imposed on Islamic banks under the Islamic Financial Services Act 2013.

The study finds that BNM has the full authority under the law as the regulatory body to give written approval to DFIs under Section 33B(1)(a),(2) and (3) for conversion of DFIs to Islamic DFIs with remaining conventional loan assets to be treated as Non-Shariah Assets and become liabilities of DFIs. Application of DFIs to become Islamic DFIs may be taken into consideration based on strong commitment of DFIs towards conversion that all business and activities are in accordance with Shariah and there are action plans to convert remaining conventional loan assets and liabilities within a reasonable period. There are valid reasons that these conventional loan assets and liabilities cannot be converted including impaired loan due to some acceptable reasons from Shariah perspective. For this condition, as long as Non-Shariah Assets are treated in accordance with Shariah requirements where the income earned from conventional loan are treated as liabilities in line with Shariah requirements of giving it away as charitable amount, it should be acceptable.

The study further finds the interpretation of the word "entire business" under the said statutory requirements of law as stipulated by DFIA 2002, should not be confined to strictly mean that entire or 100% assets and liabilities must be Islamic. It should also means that those remaining conventional loan assets and liabilities (within certain acceptable threshold) and their income are treated in line with Shariah. In substance, it still means that the entire business are operated in accordance with Shariah.

The issues of conversion of conventional loan to Islamic Financing portfolio have to be resolved on case to case basis to close the gap of financing portfolio towards 100% Islamic Financing. The supports from BNM for the specific guidelines and framework on conversion of DFIs and strong commitment from DFIs on conversion of the remaining conventional loan assets may expedite the conversion of DFIs in the future.

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