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# The Impact of COVID-19 Outbreak towards Islamic Banking: The Case of Malaysia

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***ABSTRACT***

Coronavirus disease (COVID-19) is a new infectious disease which has affected most countries all over the world including Malaysia. As the cases were growing tremendously, the Government of Malaysia has implemented a preventive measure to prohibit movement and mass assembly nationwide which is known as Movement Control Order (MCO). During this period, all the business activities are suspended and this has resulted in an estimated total loss of MYR 63 billion. Even though banking sector is one of the essential services that are allowed to be in operation during this outbreak, this sector is still being affected due to slow economic activities. Hence, this paper aims to study the impact of COVID-19 outbreak towards the banking industry specifically in Islamic banking sector as Malaysia is one of the global Islamic finance hubs in the world. This study envisages to contribute knowledge for researchers and policy makers to understand the direct and indirect impacts of the pandemic to the banking system either internally or externally.

*Keywords: Impact, Coronavirus, Islamic Banking, Malaysia, COVID-19 outbreak*

## INTRODUCTION

Over the years, there are many infectious diseases have been found and some of them have become worst nightmare when they spread beyond a particular region and finally become pandemic. In March 2020, the World Health Organization (WHO) has declared COVID-19 as the latest pandemic and to date, there is no vaccine or specific antiviral to treat COVID-19 patients (WHO, 2020). The pandemic of COVID-19 has shaken up the daily life of millions of people all over the world as well as slowing down the global economy, movement and businesses. Many industries have been severely affected such as travel and tourism, leisure, transportation, manufacturing, oil and gas, retails, export-oriented, construction, banking and many more. However, there are certain industries such as consumer technology, e-commerce and health care industries that boom instead, during the pandemic due to high demand from people. In this paper, we will focus to study the profound consequences of this pandemic towards banking system particularly in Islamic banking industry. The banking sector is among the affected industry since the abrupt enforcement of the Movement Control Order (MCO) by the Malaysian government has put various economic sectors in threat.

On 18 March 2020, Movement Control Order (MCO) has been initiated by Malaysian government as part of the initiatives to control the transmission of COVID-19 infection. This MCO has been extended three times until 12 May 2020 (MDBC, 2020). Next, starting from 13 May 2020, Malaysia moved into Conditional Movement Control Order (CMCO) until 9 June 2020 while on 10 June 2020 until 31 August 2020, once again, Malaysia moved into Recovery Movement Control Order (RMCO) and has been extended until 31 December 2020. This long journey of MCO has imposed a number of challenges towards the businesses such as low customer flow as well as financial source for staffs' salary and rental payment. According to the Department of Statistics Malaysia, as of 1 May 2020, 67.8% of the total 4,094 Malaysian companies responded no sales or revenue during the MCO period. When the businesses are unable to operate, they cannot sustain and thus increase the job losses in Malaysia. Eventually, as the companies or Small and Medium Enterprises (SMEs) perform poorly, this situation will upset the banks performance as well since they are the core customers for the banks. Another alarming fact is, The Prime Minister of Malaysia, Tan Sri Muhyiddin Yassin in his special televised address in conjunction with the Labour Day, mentioned that Malaysia has incurred an estimated total loss of MYR 63 billion as all the business activities were suspended since the MCO came into force on March 18 (Povera et al.,2020).

As for economy recovery process, the Malaysian government has issued PRIHATIN Economic Stimulus Package worth MYR250 billion. This package also highlighted the banks initiatives to provide financial aids either for businesses or individuals such as emergency loans to support the SMEs, as well as flexibility for repayments of existing loans in addition to a decrease in the Overnight Policy Rate (OPR). In Malaysia, the regulatory and supervisory measures issued by the government during the pandemic has affected the financial institutions including banking industry in terms of loan growth, earning liquidity and provision (Khoo, 2020). Therefore, this paper aims to highlight the main impacts on the banking industry due to the COVID-19 outbreak particularly in Islamic banks as Malaysia is one of the global Islamic finance hubs in the world. As to date, there is lack of research done to study the impact of the pandemic on banking system especially in the Islamic banking scope. Thus, the main contribution of this paper is to cater the scarcity of studies done on this topic since COVID-19 is a novel issue that hits the world recently.

The remainder of this paper is organized as follows. The next section will discuss the literature review related to this study, followed by the discussion. Finally, the conclusion and limitation of this study are highlighted in the last section.

## LITERATURE REVIEW

### Coronavirus Disease (COVID-19) in Malaysia

The origin of the COVID-19 started in Wuhan City, Hubei Province, China back on 12 December 2019 and in few months, it has spread beyond the Chinese borders and affected more than 163 countries globally including Malaysia. According to Shah et al. (2020), on 25 January

2020, Malaysia recorded the first case of COVID-19 involving three Chinese citizens who entered Johor Bharu via Singapore. The first Malaysian tested positive for COVID-19 was reported on February 4, 2020. He is a 41 year-old male Malaysian, with a travelling history to Singapore from 16 to 23 January 2020 for an international meeting that included attendees from China (Bernama,2020b). Meanwhile, a 40-year old female Malaysian was reported positive for COVID-19 on February 6, 2020 and she became the first COVID-19 case in Malaysia who contracted the virus via local transmission (Elengoe,2020). She had no travel history to infected areas, however, she is the younger sister of the 41-year old man confirmed as positive with the virus on the February 4, 2020. Subsequently, Malaysia reported its first sporadic case of COVID-19 on March 12, 2020 where the infected person neither travelled to an affected area nor had contact with an infected person (Arumugam, 2020). In March 2020, the COVID-19 cases rise significantly when a religious mass gathering took place in Sri Petaling Mosque with 16,000 people participated from various countries. Consequently, Malaysia was marked as the highest number of positive COVID-19 cases in South East Asia (Elengoe, 2020; Aziz NA et al.,2020).

The Ministry of Health (MOH) played a vital role to control COVID-19 spread by disseminating the accurate information about the infection to the public via various channels such as MOH websites, social media such as Facebook, Crisis Preparedness and Response Centre (CPRC) hotlines, press releases and live press conferences by Director General of Health. This is important as to keep the community well-informed and to ensure maximum readiness to contain the spread of the virus. Due to the novel characteristics of the virus, it caused the COVID-19 situation changes frequently, hence the MOH has to quickly develop Standard Operating Procedures (SOPs) for the reference of the health care workers and the public. The MOH in its effort to encounter an acceleration of cases that was estimated to peak in the middle of April, has set up a provisional hospital in the Agro Exposition Park Serdang (MAEPS) in coordination with the National Disaster Management Agency (Shah et al.,2020). This temporary hospital served as a quarantine and treatment centre for low-risk patients, which equipped with 604 beds, computers, televisions, WiFi connection and some other basic facilities to be used by patients and medical staffs.

**Islamic Banking in Malaysia**

According to the statistic issued by the Central Bank of Malaysia (BNM), there are sixteen Islamic banks operating in Malaysia under the supervision of BNM. Full list of these Islamic Banks can be referred in Table 1 under Discussion Section of this paper. Currently, Malaysia has three local full-fledged Islamic banks, five foreign owned entities and eight conventional banks who have established Islamic subsidiaries. Rapid liberalisation in the Islamic finance industry and supported by a facilitative business environment has encouraged foreign financial institutions to make Malaysia their destination of choice to conduct Islamic banking business (BNM,n.d.-b).

In general, Islamic banking refers to a banking system that complies with Islamic law or known as Shariah law. Unlike the conventional banking system, the Islamic banking system operates as an interest-free institution and any business transaction and trade activities that involve interest (*riba*), gambling (maisir) and speculative trading (gharar) are prohibited. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset. Besides promoting a fair profit and loss sharing between parties involved, Islamic banking promote *zakat* (alms tax), prohibit monopoly, and encourage cooperation for the benefit of society and support the development of all *Halal* aspects of business (Thambiah *et al*, 2011). Similar to conventional banks, Islamic banks also offer a range of financial services and products but they must be Shariah compliant.

Islamic banks in Malaysia keep on growing rapidly since their establishment in 1983. Over the past 10 years, the Malaysian Islamic banking industry's financing had more than quadrupled, standing at RM611 billion as at the end of December 2019 (end December 2009: RM134 billion) and making up 35% of total loans (end December 2009: 17%) (RAM Ratings,2020). Thus, the Islamic banking industry is largely expected to attain BNM's Islamic financing target of 40% of total loans by 2020, as per BNM's Financial Sector Blueprint 2011-2020. Notably, the Malaysia Islamic banking industry has broadened in terms of maturity, breadth and sophistication over the years.

**Impact of COVID-19 on banking system**

The previous paper discussed about the effects of COVID-19 outbreak on the acceptance and development of branchless banking in Iran (Shahabi et al.,2020). Besides, there was a working paper by Seelye and Ziegler (2020) to study the major impacts of COVID-19 on banking industry in the United States as their government has made various efforts to shore up the economy which included many temporary and permanent rule changes by the banking regulators that directly impact the banks.

## DISCUSSION

This section will discuss the impacts of COVID-19 outbreak towards Islamic banking industry specifically in Malaysia either internally (to the bank itself) or externally (to the banks' customers).

**Moratorium serves benefits for bank loans borrowers**

Malaysia became the first country to introduce a six-month moratorium when the Prime Minister Tan Sri Muhyiddin Yassin announced this financial relief measure in late March 2020 (Bedi & Tan, 2020) Accordingly, Malaysian banks granted an automatic, six-month moratorium on all financing repayments (except credit card balances) by individuals and SMEs, with effect from 1 April 2020 until end of September 2020. During this moratorium period, a borrower is not obliged to make monthly debt repayments to the banks. The moratorium was expected to provide a breather to Islamic banks as this initiative benefitting around 70% of the Islamic banking industry's total financing (RAM Ratings,2020). This initiative was designed to relieve the burden of those directly affected by the pandemic and to keep cash within households. Besides Malaysia, there are many other countries that introduced various forms of moratorium including Singapore, Indonesia, the Philippines, Thailand, the United Kingdom, Canada, Italy and the United States ((Bedi & Tan, 2020).

In reacting to the moratorium announcement, many Islamic banks in Malaysia have taken proactive action to deal with their customers regarding the moratorium package. They started to contact their customers to provide clarity about the moratorium on Islamic hire purchase and Islamic fixed rates financing products. These include to provide advice on the specific matters such as changes in terms, which may include revised instalments, amounts to be paid once the six months' moratorium is over and also the revised tenure (The Star, 2020a). As an evidence, Bank Rakyat which is the largest Islamic cooperative bank in Malaysia has granted its customers a moratorium on repayment totaling up to RM6 billion (Bernama, 2020a). The bank has about 900,000 shareholders where 70% of them come from B40 household income group. In Malaysia, B40 group represents the bottom 40% of income earners among Malaysian citizens. Although the loan repayments involved a huge amount for the Bank Rakyat, the assistance was necessary in order to help those impacted by the COVID-19 outbreak. Other than that, Bank Islam Malaysia Bhd (BIMB) showed that 95% of their customers opt for the six-month moratorium facility. Meanwhile, the balance of customers were servicing their financing as usual (The Star, 2020b). This scenario indicates that many individuals and businesses in Malaysia were affected by COVID-19 and they really need the moratorium facility.

**Special tax treatment on the moratorium interest/profit**

On July 29, the Prime Minister announced another three-month loan moratorium extension up to December 2020 for individuals who have lost job and income due to the pandemic. This moratorium extension moves towards a more targeted assistance approach which will focus on customers from the hardest-hit sectors such as travel, tourism and hospitality. This moratorium facility however, will impact the banks' liquidity as loan repayments are part of the core business of these banks. Banking analysts say that generally, a moratorium does not really affect the profitability of a bank, but it may impact their cash flows (Tan, 2020). This in turn is due to the change in financing terms and because of this change, there could be a one-off loss for banks. Finance Minister Tengku Datuk Seri Zafrul Abdul Aziz estimated that the banking sector would incur losses of RM6.4 billion from the six-month moratorium period from April to September (Goh,2020b). Although the borrowers do not need to make payments to the banks during the moratorium period, financial institutions continue to accrue interest income, even if that income has not been received but this accrued interest income will still be taxable. Therefore, in order to ease the cash flow burden on banks, the government subsequently has granted the special tax treatment on the moratorium interest by taxing the interest on a receipt basis.

This tax concession is basically allowing banks to defer the taxability of the interest income on such loans until they have received the interest income from customers. Some impacts of the blanket six-month moratorium and three-month extension to targeted borrowers are likely to be cushioned by this special tax treatment. As the Income Tax (Special Treatment for Interest on Loan) Regulations 2020 has been gazetted on 25 August 2020 and will be in effect from year of assessment 2020 onwards (Yh Tan, 2020), all licensed banks, licensed investment banks, licensed Islamic banks and prescribed development financial institutions (DFIs) regulated by Bank Negara Malaysia (BNM) are eligible for this special tax treatment. The regulation provides that the interest/profit shall not constitute the gross income of that financial institution in the basis period for that year of assessment in respect of interest/profit due and payable from loans or financings during moratorium program under PRIHATIN Economic Stimulus Package (Hasil,2020).

**The lower Overnight Policy Rate (OPR) affected Islamic Banks performance**

Recently, Bank Negara Malaysia (BNM) through its Monetary Policy Committee has cut the overnight policy rate (OPR) by 25 basis points to 1.75% as one of the ways to help speed the economic recovery which was affected by COVID-19 pandemic. This OPR remained at 1.75% until September 2020 with the ceiling and floor rates were correspondingly reduced to 2% and 1.50% respectively (The Star, 2020b). The reduction in OPR provides several impacts to the public as well as to the banks. A lower OPR would cause the local banks to adjust their base lending rate (BLR) and base financing rate (BFR). Indirectly, this will affect the interest rate whereby the costs of borrowing or refinancing an existing loan would be lower. Consequently, the banks would adjust the interest rate for existing floating rate loans resulted in reduction in borrowers' monthly payment or installments. Because of this, the new loans also would follow the current low rates.

On the other hands, a lower OPR also signifies that interest rates for saving account and investment in fixed deposit account will be reduced as well. In other words, the investors would receive lower return from their investment in banks as compared to before. According to BNM, the economic activities in Malaysia have begun to recover and contracted sharply in the second quarter of the year after the gradual and progressive re-opening of the economy since early May 2020 after the MCO. Therefore, the reduction in the OPR provides additional policy stimulus to accelerate the pace of economic recovery due to COVID-19 pandemic (BNM, 2020c). Table 1 shows the base rate for all the Islamic banks in Malaysia as at 6 August 2020 after the reduction in OPR.

**Table 1: Base Rates, Base Financing Rates and Indicative Effective Lending Rates of Islamic Banks in Malaysia as at 6 August 2020.**

| No. | Islamic Financial Institution | Base Rate (%) | Base Financing Rate (%) | Indicative Effective Lending Rate (%) |
|---|---|---|---|---|
| 1. | Affin Islamic Bank Berhad | 2.70 | 5.56 | 3.30 |
| 2. | Al Rajhi Banking & Investment Corporation (Malaysia) Berhad | 2.85 | 5.75 | 4.20 |
| 3. | Alliance Islamic Bank Berhad | 2.57 | 5.42 | 3.11 |
| 4. | AmBank Islamic Berhad | 2.60 | 5.45 | 3.25 |
| 5. | Bank Islam Malaysia Berhad | 2.52 | 5.47 | 3.25 |
| 6. | Bank Muamalat Malaysia Berhad | 2.56 | 5.56 | 3.56 |
| 7. | CIMB Islamic Bank Berhad | 2.75 | 5.60 | 3.50 |
| 8. | Hong Leong Islamic Bank Berhad | 2.63 | 5.64 | 3.35 |
| 9. | HSBC Amanah Malaysia Berhad | 2.39 | 5.49 | 3.50 |
| 10. | Kuwait Finance House (Malaysia) Berhad | 2.25 | 6.14 | 3.30 |
| 11. | Maybank Islamic Berhad | 1.75 | 5.40 | 3.25 |
| 12. | MBSB Bank Berhad | 2.65 | 5.50 | 3.20 |
| 13. | OCBC Al-Amin Bank Berhad | 2.58 | 5.52 | 3.45 |
| 14. | Public Islamic Bank Berhad | 2.27 | 5.47 | 3.10 |
| 15. | RHB Islamic Bank Berhad | 2.50 | 5.45 | 3.50 |
| 16. | Standard Chartered Saadiq Berhad | 2.27 | 5.45 | 3.50 |

Source: Bank Negara Malaysia

## Special Relief Funds for SMEs customers

The global COVID-19 pandemic has undoubtedly caused a great economic downturn for most businesses, and SMEs are no exception. Banking institution is the main financing source for SMEs, that it provides more than 90% of total financing (BNM,n.d.-a). As such, the Malaysian government via BNM has taken initiatives such as providing financial aids in ensuring their survival during this hard times and also to cushion the domino impact of this outbreak, especially due to the limitation to continue operating during the MCO that took place for months. The financial aid from the banks involving billions of ringgit, in which interested SMEs could apply through commercial banks, Islamic banks and development financial institutions regulated by BNM. These participating financial institutions can also seek guarantee coverage from Credit Guarantee Corporation Malaysia Berhad (CGC) or Syarikat Jaminan Pembiayaan Perniagaan (SJPP) for these facilities.

The most notable BNM’s relief available for Malaysian SMEs which were affected by COVID-19 is Special Relief Fund (SRF). The objective of this fund is to help alleviate the short-term cash flow problems, so SMEs could remain in the industry as well as safeguarding jobs of the employees (BNM, 2020a). For this measure, the government has provided RM5 billion at a lower interest rate of 3.5% for 5.5 years, including six months moratorium on repayments. Participating financial institutions like Islamic banks will continue to process the applications received under this facility which is available until 31 December 2020, although there may be some delays in the applications and disbursements process due to the limitations arising from the MCO (BNM, 2020b).

**Restructuring of Islamic Financing Facility**

Islamic financial institutions (IFIs) also have taken some measures in restructuring of Islamic financing facility as a reaction to the COVID-19 crisis. A special meeting was conducted to discuss this issue and the Shariah Advisory Council (SAC) of BNM has made a ruling on the said practices (BNM, 2020d). The first initiative is the restructuring of the Islamic financing facility based on original Shariah contracts. This could be done by adding a supplementary clause that is cross referred to the terms of the existing agreement. A whole new agreement is required only if it involves application of a different Shariah contract, for example a shift from *musharakah mutanaqisah* to *ijarah,* or there is a combination of multiple financings based on various Shariah contracts into a new single one.

The second measure is the conversion of a conventional loan into an Islamic financing, where the IFIs are allowed to do so. However, the vice versa practice is not allowed. In the case where customer insists on converting to a conventional loan, it is beyond the IFIs' responsibility and control. Lastly is the treatment of compounding profit on restructuring. IFIs are prohibited to include any accrued profits from the original financing as the new principal amount of the restructured facility. The accrued profit is only allowed to be carried forward and added to the total debt obligation, but should be excluded in the calulation of the new profits. This is to avoid double counting of profit charges on debts.

**Business Continuity Management**

Other than those mentioned above, the revised banking operation hours due to Coronavirus outbreak is another evident impact on IFIs, specifically during the early MCO period. Being one of the essential services, banks could not afford to be completely closed even during the MCO period like other businesses. From 23 March to 31 March 2020 for example, most of the banks were still operating but with shortened hours, where they ended their operation at 3pm instead of the normal 5pm prior to the MCO (AIBIM, 2020). On 1 May 2020, the Ministry of Finance had issued Standard Operating Procedures (SOPs) for the financial services sector which is applicable to all financial services, including banking institutions, insurance/takaful institutions, development financial institutions, approved and registered intermediaries and agent banking. According to these SOPs, customers were highly encouraged to utilize both the self-service machine and digital platform in order to further minimize face-to-face contact.

Banks' staffs also were arranged to be working from home to reduce the risk of exposure to infection (Goh, 2020a). In response to this, Malayan Banking Bhd for instance, informed the media that 75% of their staffs were working from home while the remaining stayed on-site. Similarly, CIMB Group Holdings Bhd stated that they split their operations for both critical and non-critical as part of the strategies to ensure that their banking services remain operating smoothly and securely. Other banks including RHB Bank Bhd, Alliance Bank Malaysia Bhd, OCBC Bank (Malaysia) Bhd as well as Standard Chartered Bank Malaysia seemed to be taking the same measures. The staffs were still able to perform their roles remotely using Virtual Private Network (VPN) in accessing to the network and files, while meetings were conducted using live video conferences. Some of them have actually started the flexibility of mobile working even before the MCO, thus it is just the right time to enforce the practice to a wider segment of the organization.

**iTEKAD Micro-financing Scheme**

A social finance programme has been introduced by participating Islamic banks in collaboration with some State Islamic Religious Councils (SIRCs) and implementation partners to further facilitate access to funding and help build entrepreneurship capability among B40 micro-entrepreneurs. Social finance such as zakat, waqf and sadaqah offer a significant potential to facilitate distribution of funds in a more balanced and inclusive manner. The programme is designed to mobilise social finance contributions towards providing seed capital that is packaged with micro-financing for eligible micro-entrepreneurs to start and grow business to generate sustainable income (BNM, 2020b). As a start, Bank Islam Malaysia Berhad (BIMB) has been the first participating Islamic bank to pilot the iTEKAD programme beginning May 2020. Bank Islam has been working together with Majlis Agama Islam Wilayah Persekutuan (MAIWP) and SME Corp Malaysia in the first phase of the programme. Through the collaboration, the recipients would receive structured entrepreneurship and financial management training. This is to ensure they receive a more holistic understanding, skills and knowledge in managing their business efficiently and sustainably. In addition to the funding of working capital, iTEKAD will use the zakat fund for the purchase of tools and equipment required for eligible recipients (NST Business, 2020).

## CONCLUSION

Many industries are severely affected during COVID-19 pandemic especially SMEs and unable to sustain which lead to the last option, file for bankruptcy. As for banks, there is a direct impact towards their business when their clients were in poor condition. This is because when the economy is weak, the non-performing loan (NPL) will be greater and thus, the banks will have to make loan loss provisions. Consequently, the banks need to look at the impact of the NPL in their capital capacity and liquidity in order to avoid from suffering loss in the long period (Yusof, 2020).

This paper discussed specifically the impacts of the COVID-19 outbreak towards Islamic banking in Malaysia either to the bank itself or to their customers. During MCO, only sectors that provide essential services are allowed to continue their operation and banking industry is one of them. Despite playing an important role in the economic growth, Islamic banking industry faced immense challenge during the pandemic.

Firstly, all banks in Malaysia including Islamic banks have offered an automatic moratorium on loan repayment for six months period starting from April 2020 to September 2020. For banks, this moratorium period is excluded when determining delinquency status. This would reduce the amount of provisioning expenses that would otherwise be required. RAM Ratings (2020) acknowledge that even the temporary leniency is warranted, the reported asset quality indicators would not be reflecting the industry's asset quality. The measures could mask the true extent of delinquencies and defer the crystallisation of credit risk to 2021 if borrowers' weaknesses extend beyond the payment holiday.

Secondly, although banks would not receive payments by eligible customers during the loan moratorium period, the banks still have to bring the deferred interest to tax. Thus, to be fair to the banks, the government subsequently announced a tax concession for banks on the loan or financing moratorium under special tax treatment.

Thirdly, COVID-19 has caused the Central Bank of Malaysia to reduce the BLR which lead to lower interest rate and affect the country's inflation. The lower interest rate is a problem to the banks as most of the customers will not deposit their money in a bank if the return is low. On the other hand, the lower interest rate will reduce the cost of borrowing and monthly commitment of loan repayments.

Besides the extension of the moratorium, the banks also offer to restructure and reschedule the financing repayment such as revising the monthly commitment and increase the tenure of the loan. The benefit of restructuring is, it will give flexibility to the borrowers to pay their commitments within their affordable budget.

The pandemic has also affected the banks' business operation. For instance, to be in line with the guidelines of prevention and control of infectious disease issued by the MOH, the banks were only allowed a minimum number of customers at the bank counters during MCO.

Furthermore, BNM strongly encourages the banks' customers to use electronic channels and avoid unnecessary trips to the branches for their own safety and health.
Finally, Islamic banks has offered several financial aids to their customers such as iTEKAD micro-financing scheme for micro-entrepreneurs and Special Relief Fund for those affected by the loss of their business income due to COVID-19.

This paper only reviewed the theoretical impacts of COVID-19 towards Islamic banking in Malaysia without presenting any quantitative analysis. Therefore, future research can apply a quantitative approach by analysing the data of all Islamic banks in Malaysia and examine their performance during the COVID-19 pandemic.

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