

**FINANCIAL CONSUMER PROTECTION AND ITS
APPLICATION IN TAKAFUL OPERATIONS IN
MALAYSIA**

BY

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ABSTRACT

This study investigated the financial consumer protection mechanism within takaful operations in Malaysia and the ways it could be improved to better protect the financial consumers. The scope of this study is confined to unsuitable products and unfair treatment risks according to the categorization of risks in consumer protection by Nienhaus (2016). International standards on financial consumer protection were reviewed to formulate the themes of the study. The financial consumer protection principles were also extracted from the two main sources of Shariah: namely Quran and Sunnah. They were scrutinized to determine which principles apply to this study based on comparison with the findings obtained from the study. Semi-structured interviews were conducted to gain insight into the practice of financial consumer protection throughout the takaful operations in Malaysia. The insight from the interview was further complemented with the analysis of relevant documents. The findings of the study were derived from the data collection indicated that the regulatory landscape of Islamic finance in Malaysia is prudently regulated by Bank Negara Malaysia (BNM), covering aspects such as disclosure and transparency, fair treatment, and business conduct, as well as complaints handling and redress mechanism. Financial awareness and understanding which complement financial consumer protection initiatives in improving the efficiency, transparency, competition as well as access to the retail financial market was also found in the study. The study acknowledged tremendous effort that has been made for the protection of the financial consumers. However, looking at the low level of financial awareness and understanding of the consumers or takaful participants, there is room for TOs to further improve their financial consumer protection mechanism. The study also highlighted on TOs' role in elevating the level of financial awareness and understanding among consumers in Malaysia. Lastly, the study proposed practical recommendations for the improvement of financial consumer protection mechanism for the takaful industry in Malaysia.

ملخص البحث

بحثت هذه الدراسة في آلية حماية المستهلك المالي ضمن عمليات التكافل في ماليزيا والطرق التي يمكن من خلالها تحسين هذه العمليات لتوفير حماية أفضل للمستهلكين الماليين. يقتصر نطاق هذه الدراسة على المنتجات غير المناسبة ومخاطر العلاج غير العادلة وفقاً لتصنيف المخاطر في حماية المستهلك بواسطة نينهاوس (2016). تمت مراجعة المعايير الدولية لحماية المستهلك المالي لصياغة محاور الدراسة. كما تم استخلاص مبادئ حماية المستهلك المالي من المصدرين الرئيسيين للشريعة وهما القرآن والسنة؛ وفحصها لتحديد المبادئ التي تنطبق على هذه الدراسة بناءً على المقارنة مع النتائج التي تم الحصول عليها. تم إجراء المقابلات شبه المنظمة لاكتساب نظرة ثاقبة لممارسة الحماية المالية للمستهلك في جميع عمليات التكافل في ماليزيا. كما تم استكمال الرؤية من المقابلة بتحليل الوثائق ذات الصلة. استمدت نتائج الدراسة من جمع البيانات التي أشارت إلى أن المشهد التنظيمي للتمويل الإسلامي في ماليزيا ينظم بحكمة من قبل البنك المركزي الماليزي (BNM)، ويغطي عدة جوانب مثل الإفصاح والشفافية، والمعاملة العادلة، وسلوك العمل، وكذلك معالجة الشكاوى وآلية الإنصاف. كما أثبتت الدراسة وجود الوعي المالي والفهم الذي يكمل مبادرات حماية المستهلك المالي في تحسين الكفاءة والشفافية والمنافسة وكذلك الوصول إلى سوق التجزئة المالية. أقرت الدراسة بالجهود الهائلة التي تم بذلها لحماية المستهلكين الماليين. ومع ذلك، وبالنظر إلى المستوى المنخفض للوعي المالي وفهم المستهلكين أو المشاركين في برنامج التكافل، يوجد متسع لكوادر العمل لمواصلة تحسين آلية حماية المستهلك المالية الخاصة بهم. كما سلطت الدراسة الضوء على دور مشغلي التكافل في رفع مستوى الوعي المالي والفهم بين المستهلكين في ماليزيا. وأخيراً اقترحت الدراسة توصيات عملية لتحسين آلية حماية المستهلك المالي لصناعة التكافل في ماليزيا.

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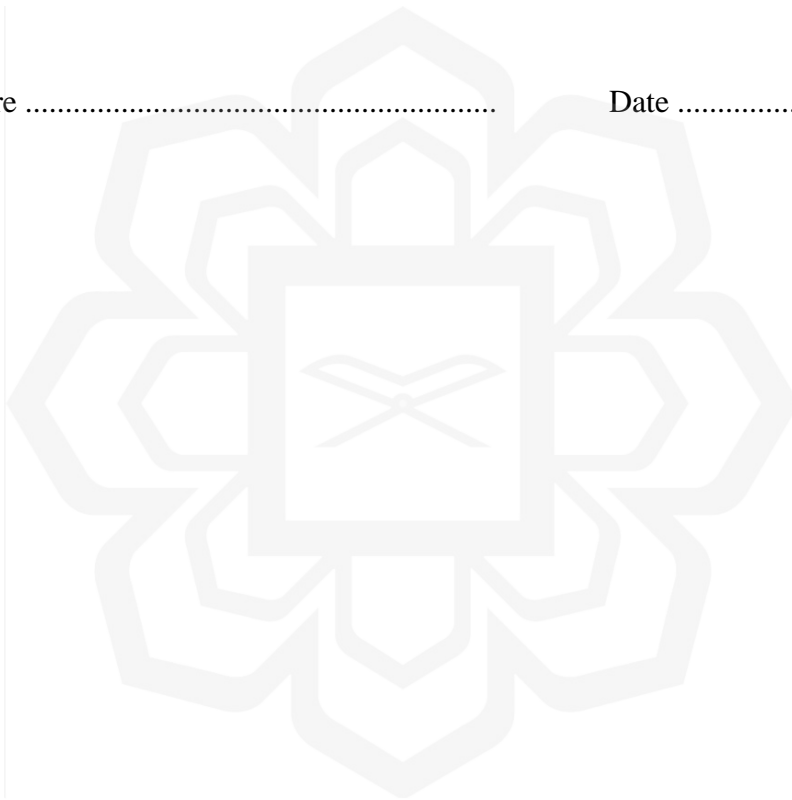
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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature Date





My husband, Azmuddin b. Razali

My children, Umair & Ashwaq

and

My parents, Muhammad Nasir b. Hanifah &

Noor Sheena Chang binti Abdullah

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Consumers constitute the largest economic group in any economy. All other economic activities revolve around consumers. Producers and sellers constantly develop their goods and services according to what the consumers want and what they need. The purchasing power of consumers has the influence to determine the success of a business. This conforms to the concept of Consumer's Sovereignty. This concept is a set of societal arrangements in which the consumers have the influence to define their wants and the opportunity to satisfy those wants at prices slightly higher than the costs offered by providers for their offering (Averitt & Lande, 1997). Even though many businesses claim that customers are their priority and portray as customer oriented in their marketing; in reality, customers are always exploited in various ways and they sometimes do not realise it (Maholo, 2016).

Consumer protection for financial services was not prominent until the global financial crisis that sparked in 2007 – 2008. This incident was a wakeup call that shed light on the importance of financial consumer protection (Organisation for Economic Co-operation and Development [OECD], 2009). Since then, authorities and international standard-setters across the globe, such as the Basel Committee on Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS), have increased the consumer protection mechanism in their regulatory framework. Additionally, the OECD and the Group of Twenty (G20) had issued the G20 High-level Principles on

Financial Consumer Protection as a response to the prominence of financial consumer protection (Lukonga, 2015; Nienhaus, 2015). The World Bank’s 2013 Global Survey on Consumer Protection and Financial literacy revealed that financial regulators were increasingly dedicating their focus and resources on financial consumer protection (The World Bank, 2014a). The formation of upcoming regulatory policies for the banking and insurance industry in other countries has begun integrating consumer protection element to ensure sustainable financial markets (Milanova & Schreiber, 2017). Indeed, the collapse of the economy and financial markets has triggered many investigations to further probe into ethical issues (Al-Aidaros et al., 2013).

In Malaysia, multiple laws have been enforced under different ministries to provide consumer protection (Zakuan et al., 2013). Table 1-1 illustrates a brief example of several ministries and their administration of several acts.

Table 1.1 Government enforcement agencies and laws on consumer protection

Enforcement agency	Laws
Ministry of Domestic Trade and Consumer Affairs	Consumer Protection Act 1999, Hire-Purchase Act 1967, Price Control and Anti-Profiteering Act 2011
Ministry of Housing and Local Government	Housing Development (Control and Licensing) Act 1966
Ministry of Finance	Islamic Financial Services Act 2013, Financial Services Act 2013

Source: Adapted from Zakuan et al., (2013)

Based on Table 1-1, the two primary acts deliberated in this study are the Consumer Protection Act (CPA 1999) and the Islamic Financial Services Act (IFSA 2013). The Bank Negara Malaysia (BNM, 2011), which is a federal agency of the Ministry of Finance, asserted that financial consumer protection played an imperative role in contributing towards a sound, stable, and competitive financial sector in Malaysia.

Following the global trend in financial consumer protection, the Malaysian financial sector blueprint (2011 – 2020) had incorporated consumer empowerment as one of the key enablers for the progress of the financial sector in Malaysia. The initiatives undertaken by the BNM mainly focused on two aspects; (1) bolstering business conduct regulations, and (2) establishing extensive institutional arrangements to manage consumer enquiries, complaints, and redress.

Deploying a holistic system of consumer protection has been proven to reduce the number of complaints across the financial system. In order to achieve that, consumer issues need to be addressed with appropriate regulations and enforcement actions. This requires the analysis of consumer complaints to identify areas of concern and trends in market practices (Alliance for Financial Inclusion [AFI], 2010). It is integral to highlight that not all consumers have the capacity to make the right financial decisions for themselves, which makes it important for the government to step in and introduce laws that protect the vulnerability of consumers in such circumstances (Cartwright, 2015). Therefore, appropriate regulations need to be put in place to encourage fair and responsible practices among financial service providers (FSPs), which in turn, will enhance the protection for financial consumers (BNM, 2011).

Malaysia is among the very few countries that provide explicit guidance in the regulations governing consumer protection for Islamic financial products, apart from Oman and Bahrain (Lukonga, 2015). Although the efforts in providing consumer protection by BNM are commendable, there is still a need to provide a specific consumer protection regulation for each Islamic finance component (e.g., Islamic banking, takaful, and Islamic capital market). This is because; each component has different kinds of products with various underlying contracts to cater to a range of consumer needs.

While the literature seems to focus on consumer protection for the Islamic banking sector, this creates an opportunity for the researcher to venture into the takaful sector. The importance of having such a specific framework is in line with the efforts of international bodies, such as the Islamic Financial Services Board (IFSB). The IFSB had acknowledged the importance of consumer protection as the organisation had specifically incorporated “consumer protection in takaful” as one of the main aspects in its projects for the IFSB strategic performance plan for 2016-2018 (IFSB, 2016, p. 27). This ascertains that the study of consumer protection for the takaful industry is indeed important.

1.2 STATEMENT OF THE PROBLEM

Although the majority of the population in Malaysia are Muslims, the takaful penetration rate is lower than the conventional insurance market penetration rate¹.

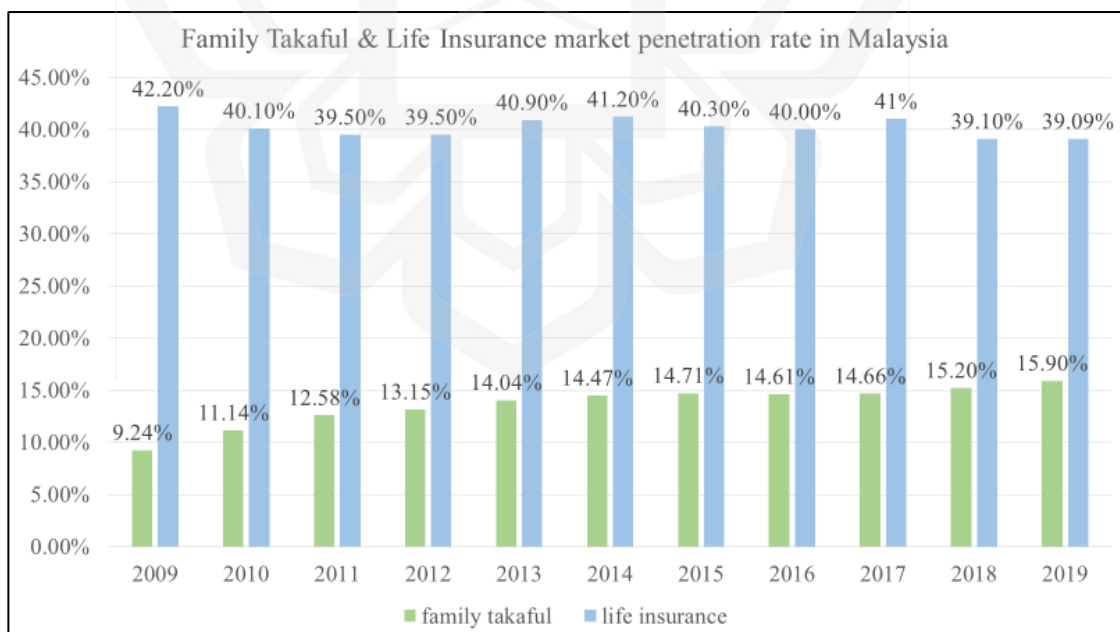


Figure 1.1: Family Takaful & Life Insurance market penetration rate in Malaysia

¹ Market penetration rate is the total number of life insurance policies/ family takaful certificates divided by the total Malaysian population (Malaysian Takaful Association [MTA], 2014, p. 33)

Sources: Malaysian Takaful Association (MTA) annual reports (2015, 2016, 2017, 2018, 2019), Malaysian Takaful Dynamics by Ernst & Young & MTA (2015), Life Insurance Association of Malaysia (LIAM) Annual Report (2019), RAM Ratings (2017) and Department of Statistics Malaysia (2019)

Figure 1-1 depicts that the family takaful penetration rate was at least four times less than the life insurance penetration rate in 2009, and the gap between both penetration rates slowly decreased until in 2019, where the family takaful penetration rate was nearly half of the life insurance penetration rate. Although the improvement in family takaful penetration rate appears promising, the number of surrendered family takaful certificates continued to rise since 2009, as portrayed in Figure 1-2.

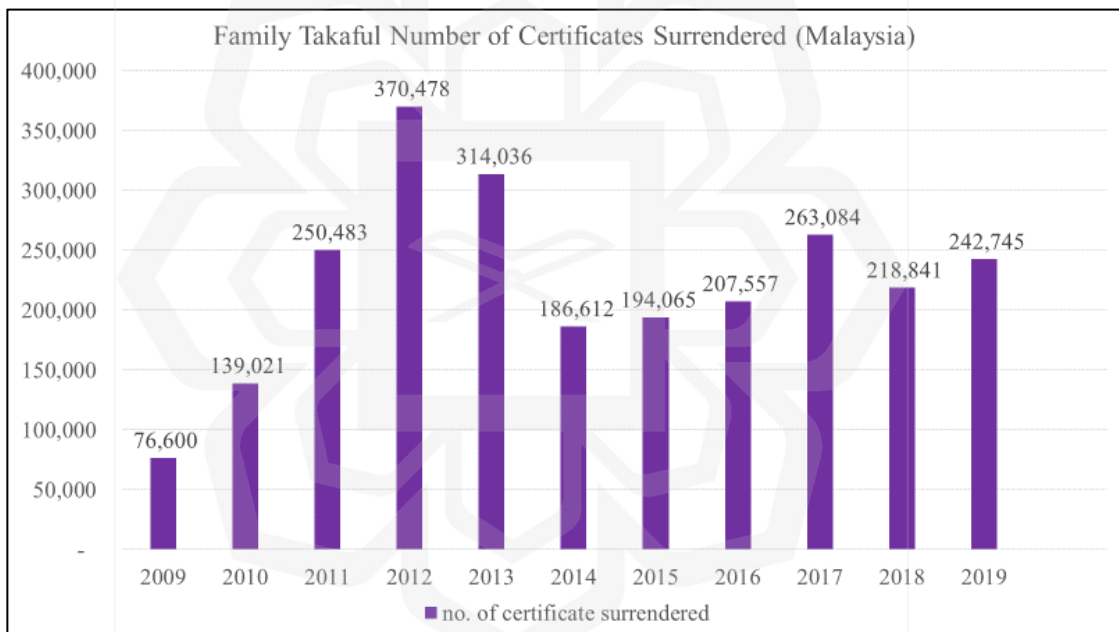


Figure 1.2: Family Takaful number of certificates surrendered
 Source: 4.8.8: Family Takaful: No. of Certificates Terminated of Direct Takaful Operators, Monthly Highlights and Statistics December 2018, BNM website²

Evidently, the takaful industry failed in retaining its consumers or takaful participants and it might signal a lack of trust in family takaful products. The highest number was

² Retrieved from BNM website: https://www.bnm.gov.my/index.php?ch=en_publication&pg=en_msb&ac=287&en&uc=2, assessed on 30th November 2020

recorded in 2013 with 370,478 of certificates being surrendered, while the past four years (2016-2019) displayed an average of 233,057 certificates being surrendered. This number excludes certificates terminated due to death, maturity, and expiry. Low market penetration, combined with high volumes of surrendered certificates despite strong government support, indicates that more work is sought to enhance the takaful sector in Malaysia.

The BNM, in its Financial Stability and Payment Systems Report, stipulated that the high surrender of takaful certificates and policies in these recent years is attributed to the over-emphasis on takaful contribution and insurance premium growth without sufficient regard to the interest of the takaful participants and policyholders, which led to some instances including offering products that did not match the needs or financial circumstances of the takaful participants and policyholders (BNM, 2016). This incident shows that the consumers are exposed to unsuitable product risk. Ostrowska-Dankiewicz (2017) identified several factors that triggered the customers to cancel their existing insurance policies, one of the factors include dissatisfaction of customers towards the insurance product. It was reported that one of the most frequent complaints of customers is related to the offering of inappropriate or unsuitable insurance policies. Life insurance is considered as one of the financial products with the potential to affect a substantial number of consumers in various national markets. One of the issues in life insurance that led to consumer detriment is mis-selling due to the insurance firm or their sales representative not always acting in the best interest of consumers (Muller et al., 2014). Mis-selling can include misleading advertising and aggressive sales tactics that lead to consumers being treated unfairly, thus exposing them to unfair treatment risk.

If consumers are not protected from unsuitable product and unfair treatment risks, their trust towards insurance and takaful products may slowly fade. Consumer

trust is a crucial element especially in the financial services due to its abstract nature (Chen, 2018) and it being an essential constituent to accomplish long-term relationship for business sustainability (Kennedy et al., 2001). Consumer trust is an important forerunner of consumer loyalty (Damtew & Pagidimarri, 2013). Takaful operators (TOs) need to earn consumer trust from their takaful participants in exchange for their loyalty, thus reducing the chances of certificate surrender.

Since the significance of consumer protection is more distinct in the Islamic financial industry due to its faith-based and value-oriented features (Oseni, 2017). Hence, an effective consumer protection framework should be deployed to ascertain the protection of consumer rights, and subsequently, increment in consumer trust and confidence towards the takaful industry in Malaysia. Consumer protection may be improved via government intervention through empowerment of consumers, as well as regulation and supervision of FSPs. Empowerment of consumers is usually associated with consumer education, awareness, and financial literacy. Consumer empowerment is an effective form of consumer protection, but it cannot stand alone and must be paired with the role of regulation to form a robust and comprehensive consumer protection mechanism. This is because; empowering consumers through education is a long-term process that entails proper assessment and measurement to achieve its effectiveness (Lobozynska, 2017).

In terms of regulation of FSPs, Malaysia already has its consumer protection laws in place, such as CPA 1999 and IFSA 2013. Nonetheless, Campbell, Jackson, Madrian, and Tufano (2011a) asserted that regulations for financial consumer protection do not reflect a one size fits all scenario. Different financial sectors (banking, capital market, and insurance) have different types of products and structures. Instead of treating consumer protection as a cross-sector issue, it needs to be tailored to specific

problems for a specific sector. Even within the same sector, such as insurance and takaful, consumer protection guidelines designed for conventional products would not sufficiently address consumer vulnerabilities arising from Islamic products (Lukonga, 2015).

Hence, upon exploring the financial consumer protection mechanism practiced by TOs, viable suggestions are prescribed in this study to enhance the financial consumer protection mechanism in the Malaysian takaful industry.

1.3 PURPOSE OF THE STUDY

This study investigated the practices of TOs in protecting financial consumers in Malaysia. Financial consumer protection is important for the stability of financial markets due to their positive correlation (Poliakh, 2018). This study had referred to the existing international standards, guidelines, and regulations for financial consumer protection as a guide to develop the themes derived from the study findings. Besides, this study examined the Shariah perspective on financial consumer protection. Semi-structured interviews were held to capture insights on how financial consumers were protected in the takaful operations. Data collected from the interviews on the practices of the TOs were analysed to enable the study in exploring how the financial consumer protection mechanism framework could be improved to enhance financial consumer protection for the takaful industry in Malaysia.

1.4 RESEARCH OBJECTIVES

The following objectives are outlined for this study purpose:

RO1: To identify the international standards, guidelines and regulation for financial consumer protection for the takaful industry in Malaysia.

RO2: To examine the Shariah perspective on financial consumer protection.

RO3: To investigate the practices of takaful operators in protecting financial consumers.

RO4: To explore how financial consumer protection mechanism can be improved in the takaful industry in Malaysia.

1.5 RESEARCH QUESTIONS

In relation to the above research objectives, this study addressed the following research questions:

RQ1: What are the existing international standards, guidelines and regulations on financial consumer protection particularly for the takaful industry in Malaysia?

RQ2: What is the basis of financial consumer protection from the Shari'ah perspective?

RQ3: (a) What are the practices of takaful operators in observing financial consumer protection?

(b) Why do the takaful operators employ such practices?

RQ4: How financial consumers can be better protected in the takaful industry in Malaysia?

In order to achieve the research objectives through the research questions listed above, this study had examined the practices undertaken by Malaysian TOs in observing financial consumer protection in their operations. Upon investigating the overall process of financial consumer protection, this study offers several recommendations to enhance financial consumer protection in the takaful industry.