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**Islamic Financial Market Development:  
The Malaysian Strategy**

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**By**

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## **Introduction and the early phases of development of the Islamic financial system**

Assalamu'alaikum wrb

Alhamdulillah, we thank Allah swt that we are able to meet today in a Malaysia that is peaceful, prosperous and dynamic. In the context of our conference today, we in Malaysia look back and find in our short history of 45 years since independence, that our nation's development has for a large part occurred within and in spite of the legacy of the conventional financial system of the colonial masters. Perhaps, this is a good starting point to remind us that financial systems do not exist in a vacuum. **Even a less than ideal system is able to facilitate development, as long as the overall system of institutional environment is conducive.** Thus, as **Ibn Khaldun** reminds us in his **Muqaddimah**, social justice, the rule of law, property rights, a culture of tolerance and co-operation among the various constituents, a willingness to innovate, and economic strategies that target growth and development with equity are all crucial and inter-dependent elements that form the enabling environment to strive for success, both in this world and in the next.

Along with our efforts of pursuing well-rounded development in a multi-religious environment, Malaysia also adopted the approach of gradually implementing a dual financial system, i.e. an Islamic financial system in parallel with the conventional system. Today, we are beginning to see the maturing of the Islamic financial system to a more usable and pragmatic system that goes beyond the textbooks and theories that were popular in the 1970s and 1980s. The growth and development of the Islamic financial system in Malaysia owes its success mainly to two individuals. One is **Dr. Mahathir Mohamad**, the Prime Minister. Not many today realize that one of the first actions that Dr. Mahathir took on becoming the Prime Minister in 1981 was to set up a National Steering Committee to implement Islamic banking in Malaysia. **At every stage of the development of the Islamic financial system in Malaysia, Dr. Mahathir's support was the crucial element that made the difference.** The other individual is the late **Tan Sri Jaafar Hussein**, who was the Governor of the Central Bank from 1985 to 1994. Tan Sri Jaafar took upon himself the responsibility to implement a dual system of banking, one Islamic the other conventional, both equally comprehensive.

I wish to quickly revisit the evolution of the Islamic financial system in Malaysia. First came the initial period of **familiarisation (1983-1992)**. This was an exploratory, almost experimental stage, where Bank Islam Malaysia was set up in 1983 under a new Islamic Banking Act. We proceeded cautiously and conservatively, and rightly so, as those were early days and one slip-up could have spelled the end of public confidence in the Islamic financial system. Over the next decade, Bank Islam Malaysia and Takaful Malaysia grew from strength

to strength. Islamic banking was no longer regarded as a novelty or as a quaint notion; even non-Muslims started banking with Bank Islam Malaysia.

With this confidence, came **the next stage, that of mainstream acceptance and pervasiveness (1993-2001)**. No longer was Islamic finance the sole domain of Bank Islam Malaysia; the entire financial system began to use and apply Islamic financial principles. I need not go through the many statistics that demonstrate the growing pervasiveness and acceptance of the Islamic financial markets since I am sure that would be covered over the next two days.

### **The Next Phase: Islamic Finance as a Competitive Advantage**

Thus, with almost two decades of development, I believe the Islamic financial system in Malaysia stands on the threshold of its next phase. Before going into what I believe this next phase should be, perhaps, we should take a step or two back to look at the broad canvas of Islamic finance in the international arena, in order gauge where we should be heading and what needs to be done to get there.

If we are to look at the Islamic financial system, it is natural that we look at the core of Islam itself. It is well understood that, unlike many other religious systems, we see Islam as a *deen*, or as a complete way of life. Beyond basic religious beliefs and practices, Islam shows us how to best conduct ourselves in everyday matters. This code of best conduct is called the Shariah, and it is the basis of the Islamic financial system.

But the Shariah has been put there not as a set of rituals to make life difficult. It serves several important purposes. Firstly, the Shariah is a means for us to approach and seek the pleasure of the Creator.

Secondly, a positive side effect of complying with Shariah is that it brings about human success and harmony – allowing man to attain excellence. It is through the strong adherence of the Shariah that the Muslims of earlier generations achieved their magnificence and global success. Thus, the Islamic financial system, being a part of this Shariah system, ought to be treated in the same light.

Just as the Shariah is a means to an end, so too is the Islamic financial system. **The implementation of an Islamic financial system is not the end goal. It is, in fact, a means and tool of competitive advantage for the ummah's success, including economic success.**

Earlier in the paper, I mentioned how the conventional system, within our overall development model, had served us well, and how the Malaysian economy has grown by leaps and bounds over the years. We are, however, today facing

several challenges. As an ambitious nation, we are not satisfied with the current level of achievement. Our Vision 2020 necessitates us to grow our GDP by 8 times between 1990 and 2020. With these growth targets, the productivity of capital becomes especially important. And this where I believe one of the many strengths of the Islamic financial system lies.

Let me now return to my earlier summary of the stages of development of the Islamic financial system in Malaysia. **While the first phase was that of discovery, and the second phase was that of acceptance, I believe in this current phase, beginning in 2002, we will need to increasingly use Islamic financial principles as a tool of competitive advantage. While this is particularly true for Malaysia, this is generally true also for the Islamic nations as a whole. We can define the term Islamic nations as the 56 countries who are members of the OIC.**

Let me explain that I mean by the term **competitive advantage**. The conventional financial system has been in existence for over 600 years. While, undoubtedly the conventional system has been instrumental in the development and growth of many countries, this growth has not been equitable. The conventional financial system has now produced **358 billionaires**, while keeping **1.3 billion people living in absolute deprivation**. There is certainly a need for a more equitable financial system. **The ultimate objective of the Islamic financial system, both domestically and internationally, will be to design and put in place an economic system supportive of economic justice.** We have the competitive advantage to do it because Islamic values are rooted in goodness and justice. Of course, to achieve the objectives of Phase III will require a radical altering of the dominant culture and the restructuring of many important institutions.

For Islamic finance to meet its objectives in Phase III, a number of pre-conditions are necessary. First, Islamic finance in the international arena will have to be developed into **a genuine parallel system. At present, only in Malaysia does Islamic finance functions parallel to the conventional system.** In the other OIC countries (except Sudan, Iran and Pakistan where the entire system is Islamic), Islamic finance is treated merely as a special case of the general system; it is not yet a genuinely alternative system. We, of course, can and must adopt the best practises of the conventional system, such as openness, transparency, accountability and uniform regulations, but we must, at the same time, develop a comprehensive parallel system, where capital is intermediated to the best use based on Islamic values.

Second, while in the first two phases, bankers were in the vanguard leading the development of Islamic finance, in the third phase **leaders in the capital market will have to play a prominent role.** The bankers have done an excellent job during the nascent period of Islamic banking, but one unfortunate effect of the prominent role of bankers during early period Islamic banking is that many of the existing Islamic products are skewed towards **debt-based instruments, where collateral is still important.**

As we know, in most third world countries, an important reason for the lack of entrepreneurial development is the absence of capital being intermediated to the needy as they lack collateral and banks rarely look at the viability of projects alone. With the capital market experts playing an important role from hereon in the development of Islamic finance, we can start promoting, in a bigger way, **equity-based instruments.** And even in the case of debt-based instruments, the emphasis must be on project viability rather than collateral.

Third, we have seen, especially in Phase II, **many western banking institutions rushing into the business of Islamic finance, and, in some respect, they appear to have taken control of the development of the industry.** This is partly due to the absence of drive from the Muslim financial institutions themselves. We should continue to welcome the western financial institutions playing an important role in the development of Islamic finance, since they can provide greater depth and reach for the Islamic products, based on their sheer size and network. However, **the leadership role of Islamic finance will have to be taken over by home-grown Muslim financial institutions, so that Islamic finance can be developed in the spirit of Islam, in order to achieve equity, social justice and creating a moral economy.**

Fourth, **home-grown Islamic financial institutions should attract first class talent to work for them, and they should pay whatever it takes to attract them.** At present, first class Muslim talent is found mainly in the Islamic financial departments of Western banking institutions. In Phase III, where Islamic financial products must come to the market place as a tool of competitive advantage, **it is of the highest priority that our home-grown Islamic financial intermediaries are led and driven by individuals who possess the highest standards of intellectual fire-power and creativity, who are well versed in conventional finance but yet firmly grounded in an Islamic core; fully committed to the principles of promoting social justice and a moral economy through the promotion of Islamic-based finance.**

This group must necessarily rise from within the ummah itself, as the agenda is multifold and it would need the full involvement of all players in the market place and it needs to be firmly rooted and close to the aspirations of the ummah. This group of homegrown and high-end institutions will need the full cooperation and understanding of the Governments and regulators in providing the enabling environment, as well as the cooperation of committed consumers, investors and issuers who together form the pipeline of capital intermediation. It would be a challenge to attract the best minds and souls to this endeavour, but I believe, insyaAllah, with the right environment, such as that we have provided in Malaysia, and which other Islamic countries should also provide, this next phase of homegrown, high-end and innovative Islamic financial institutions can take root and eventually bloom.

To that talent that are now working with high compensation packages for Western banks, we should provide every opportunity for them to have significant equity participation in Islamic financial ventures in our own countries, that would allow them to concurrently monetize their ideas and their ideals. As an ummah, we must then move to ensure that these homegrown ventures engage in the international arena with both Muslims and non-Muslims. After all, Islam has commanded us to know each other and to co-operate among our brethren ummah and we also have a duty to introduce to mankind at large the mercy that is inherent in the Islamic system. **There are many mechanisms for cooperation with varying advantages of providing increased scale and reach, while maintaining different degrees of control; from strategic alliances, joint ventures to outright mergers.**

It is clear to me that it is not just an article of faith that the Islamic financial system is superior to the conventional system in many ways. The Islamic system is a just and equitable system that promotes win-win relationships between economic agents. For example, the relationship between financiers and users of capital is based on co-operation and the equitable sharing of risks and rewards. It abhors oppressiveness and adversarial, asymmetric relationships. It is meant to be efficient in wealth distribution and, perhaps more importantly, the system demands that capital be used for productive purposes and abhors the hoarding of capital resources. All these are critical issues that have to be addressed in an economy that needs to grow fast.

### **Adaptation and innovation**

Islam was sent down as a mercy to mankind, and in the Quran and the examples of the Prophet s.a.w. we are bestowed with the full array of tools required for success. But the success of a tool depends on how well it is used and adapted to the task. **If we are to use this tool of Islamic finance that has been bestowed upon us, we must be able to adapt it for the required purpose. Creativity and constructive thinking are therefore key.**

The roots of the conventional or western financial system were developed in another era and based on a different system of values. **If we are to successfully use the Islamic financial system as a means of competitive advantage, we have to return to the root values and principles of the Islam and Shariah.**

We are living in an era that is, of course, unique where the underlying conditions of the world are quite different. The Islamic ummah lives under different circumstances. It is quite clear that some form of adaptation is necessary to apply Shariah principles in an Islamic financial system in today's world. Innovation, therefore, becomes necessary. Yet, at the same time, we should take great care that this innovation and adaptation should not budge from the core values and principles of Islam. A tree may have many branches but they necessarily sprout from a single set of roots.

Many are afraid of innovation, but I feel this fear is unfounded if we are clear about the root principles of Shariah. Form may vary, but substance should be maintained.

**Perhaps, what we should be more afraid of is the absence of innovation.** By failing to innovate, by being rigid in our interpretation and by being satisfied with blind adaptation of products from the conventional Western financial system, we may fall into the danger of building an Islamic financial system based on a tree rooted upon a different set of values. In form it looks different and "Islamic", but in substance, it is based on the same set of un-Islamic values.

I must emphasize, of course, that it is not wrong to adapt from another system as long as the root values and principles are not incompatible with Islam. As we know, classical Islamic scientists and scholars did not discover all knowledge from a zero base, but learned from the Greeks and Romans, among others, handpicking what to use and what to reject based on the core values and principles of Islam. As the Holy Prophet s.a.w. says in an oft-quoted hadith: "Wisdom is the lost asset of a Muslim; he is the most deserving of it wherever he finds it."

**The challenge to innovate and adapt, while remaining true to Islam's core principles, is a crucial one for the current phase of development.** The earlier phases of Islamic finance initially concentrated on a somewhat captive Muslim audience. These customers tend to, literally, bank on faith, often with little regard on the actual substance and competitiveness in terms of cost and service quality of the Islamic financial products. For example, we sometimes hear of Islamic mortgages that in effect cost considerably more than

conventional mortgages, compounded further by badly designed legal documentation that makes refinancing an economic impossibility for the borrower. It is perhaps no surprise that there is today some cynicism that many so-called Islamic products are merely poor quality substitutes of conventional products, dressed with an Islamic veneer.

This may be understandable, if not excusable, in the earlier phases of a nascent system in an overwhelming sea of *riba*. However, from hereon, the honeymoon would be increasingly over. Customers are justifiably getting more discerning. **The growth and continued relevance of the Islamic financial system necessarily rests on the ability of financial institutions and issuers to innovate structures and instruments that are closer in substance to the Islamic principles of justice and co-operation based on a more equitable risk and reward sharing.** The acid test must be products that are genuinely superior to the conventional instruments, in terms of its value proposition of quality and cost competitiveness. Further, as service establishments, we must also remind ourselves that basic business principles such as efficiency, customer and service orientation and ease-of-use are also basic Islamic principles.

### **Private-sector led and the enabling environment**

While in the earlier phases much of development of Islamic finance was Government-led, the onus of the next phase now rests squarely with private economic agents and intermediaries. Innovation and adaptation must necessarily come from private economic agents. In the case of Malaysia, the Government has already provided a comprehensive enabling environment for the private sector to now take the lead.

### **Islamic financial system in an increasingly globalised world**

The Islamic financial system does not exist in a vacuum. We live in an interconnected and globalised world governed by non-Muslim superpowers, where Muslims are not entirely free to practise their ideals. Although we may sometimes think we can, it is impossible to entirely insulate one financial system from another. We must be pragmatic enough to realise that, under these circumstances, it will be a challenge to immediately implement an entirely Islamic financial system in all aspects. Instead, we should be prepared to consider an **incremental implementation strategy** and not fall into the trap of fanaticism and extremism. **Small, steady steps for the purpose of a greater win is indeed preferable to hasty, headlong but ultimately unsustainable charges.** This gradualist and more sustained approach, I believe, is of greater benefit to the ummah and society at large.



Within this incrementalist approach, I believe the international Islamic financial community is now ready, after some four decades of development, to venture into the next phase of greater cross-border co-operation. With the continuing global trend of cross-border mergers, local Islamic financial institutions increasingly suffer from diseconomies of scale. **Strategic alliances** by local Islamic financial institutions across several jurisdictions from the Gulf, to the sub-continent, to South East Asia and indeed to the West and other regions is one way to share product knowledge, distribution channels and other resources. **Many jurisdictions, including Malaysia and Labuan in particular, now offer attractive incentives and a fertile enabling environment for innovation and alliances to take place.**

We hope that the process of forming these cross-border alliances will draw the ummah closer, increasing co-operation and engagement in all fields, particularly in trade and capital flows. This must surely be one of Allah swt's challenge to us that He has willed that some of our Islamic nations are so overwhelmingly capital surplus, while others are so acutely capital-deficit. And within many countries too, this imbalance is replicated between the haves and have-nots.

### **Summary and conclusion**

In conclusion, I would like to summarise the points I have raised in this brief paper.

Firstly, the Islamic financial system in Malaysia is on the threshold of a new beginning. The same may be true in some other Islamic countries. The development of Islamic finance that began with a **period of discovery** (1983-1992), and was followed by **acceptance and pervasiveness** (1993-2001), is now to be used as a **strategic developmental tool** to our nation's and the ummah's advantage.

Secondly, we must ensure that we understand that we are implementing the Islamic financial system not for ritualistic purposes, but as a **source of competitive advantage and as a catalyst for greater growth and success for the ummah as a whole**, in line with our *khalifah* or vicegerent role commanded upon us. Islam was sent down to liberate us, not to shackle us.

Thirdly, in order to fully benefit from the infinite potential of the Islamic financial system, **innovation and creativity are essential**. Yet this innovation and creativity must be soundly based on the principles and values of Islam. Form may differ, but substance must be maintained. We must not be afraid of

innovation and creativity. Instead we must be afraid of complacency and the fear to innovate. When borrowing from other systems, we must always drill down to ascertain that the core values that are used to derive the particular instrument or transaction method conform to Islamic values.

Fourthly, while the first two phases of development were necessarily Government-led, **this current phase must be private sector led.** The Government's role will be more of a facilitator and to set the tone, as well as to provide a conducive environment. For private economic agents, the onus is now squarely upon them to innovate. There is every opportunity for them to do so, since the enabling and incentive mechanisms are in place and issuers and investors are all eagerly awaiting.

Finally, in implementing our strategies, **we must always be pragmatic** – not fanatic. We must realise that we do not live in a vacuum. Not only do most of us live in a multi-racial environment, we also live in a globalised and interconnected world dominated by non-Muslim superpowers. Gradual, and well thought out, yet consistent, incremental steps are better and far more lasting than abrupt and short-lived bursts of impulse.

Let me conclude by wishing you every success and I hope this conference will generate new enthusiasm as we face, perhaps, the most promising period in the development of the Islamic financial system.

Thank you.

Wabillahi taufik wal hidayah, wassalamualaikum.

*(Nor Mohamed Yakcop)  
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