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THE MALAYSIAN JOURNEY: BECOMING A GLOBAL HUB FOR ISLAMIC FINANCE

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ABSTRACT

This report provides an insight into Malaysia's journey of becoming one of the world's most developed Islamic finance markets. The intent is not only to document the trail of history and initiatives but also to highlight the significance of Malaysian aspiration towards inclusive growth, and economic and social justice. Reading through, one can appreciate the strong-will and enthusiasm of Malaysian leaders and its people to becoming a high-income nation through a better and more stable financial system. Also, drawing inspiration from the work of Thomson L. Friedman, *Thank You for Being Late—An Optimist's Guide to Thriving in the Age of Accelerations*, this report postulates the opportunities through Islamic finance to address serious global issues such as inequality, climate change and digital disruption.

Keywords: Islamic banking, Islamic finance, Islamic economics, Education, Malaysia

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Research Center for Islamic Economics (IKAM) which was established within ILKE Association for Science, Culture and Education in 2016, aims at promoting a new perspective in economic theorizing and its application enabling. IKAM, which organizes theoretical and empirical research, publications and , education and training activities, aims at supporting researchers, business world and policymakers with its research initiatives. Thus, IKAM hosts many activities in the field of Islamic Economics to introduce and increase acceptability of the field in public. In this context, IKAM reports; a serial publication, is an attempt to share the research results in the field of Islamic economics.

Impetus for the Birth of Islamic Finance in Malaysia

Malaysia has undergone a series of economic transformation since gaining independence in 1957. From being overly dependent on a limited range of commodities, the country has evolved over the years through various economic and transformation plans. Now Malaysia is proud to be part of upper middle income nations, brand as one the success stories and at times known as Tiger of Asia. Today, the country is a home to diverse ethnic groups—Malay, Chinese and Indians, a democratic nation where people live in harmony, participate in free elections and engage in various economic activities. No doubt, the country is where it is now through reform and advancement of the domestic financial system in all aspects; banking, capital market, insurance and non-banking financial institutions. These institutions have played an important catalytic role in facilitating business transactions and channelling capital to productive investments. The anecdote can be drawn from the work of Ang and McKibbin (2007), wherein it shows that financial sector development is a pivotal element of economic growth in Malaysia.

Despite several setbacks in the 1997-1998 Asian financial crisis and 2007-2008 global financial meltdown, Malaysian economy has grown from strength to strength. Driven by strong domestic demand and robust financial system, the real annual gross domestic product (GDP) growth averaged 5.5 per cent and real income per capita grew by almost 6 per cent per annum over the past nearly twenty years. Malaysia has no reason but to be enormously proud of its economic achievements. These figures not only exceed its regional peers' average but are also higher than some advanced economies. According to Christine Lagarde of the International Monetary Fund (IMF), the ingredients for Malaysia's economic prosperity could be the government's strenuous efforts to boost productivity growth by improving governance and tackling corruption, investing in high-quality education and increasing labour force participation of women.[1]

Nevertheless, Malaysia still faces perennial hurdles to long-term success. Among others, human resources shortage in key industries, intense regional competition for foreign investment and commodity price fluctuation pose a challenge. But perhaps the most worrying of all is that the country seems to be caught in the lengthy battle to uplift itself from a "middle-income trap". To escape from this threat of stagnation would be the only way for Malaysia to realise its ambitious goal—to reach high-income status by 2024, as projected by the World Bank.[2] To do so, according to Koen and Rahuman (2016) of The Organisation for Economic Co-operation and Development (OECD), Economic Department, Malaysia needs to put a greater emphasis on promoting more inclusive and balanced growth.

A cursory glance at our past shows that the constructive efforts began when the New Economic Policy was introduced by the government, which sought to raise income and reduce absolute poverty.[3] The policy, a first on many initiatives was to promote balance and inclusive growth and was targeted at dissipating the public dissent and pressure over the widening income and wealth disparities between Malays or *Bumiputera* (the indigenous native group) and the non-Malays. The target was to achieve balanced economic development (i.e., reduced ethnic identification with particular economic function). Unfortunately, the 30 per cent economic ownership by *Bumiputera* was far from attainable. The presumption claimed by many pundits, was the reluctance of *Bumiputera* who vastly were Muslims to take part in the economic programs introduced under the Policy that were accompanied with *riba*'-based financing facilities (e.g., conventional loans). The demurral, alluded in Borhan (2005), was manifested by the propensity of Muslims to opt for alternative transactions that are more aligned with the teachings of Islam, such as the practice of buying and selling of goods on mark-up prices.

To respond to this, the government first proposed the establishment of The Pilgrims Management and Fund Board of Malaysia or *Tabung Haji*, as a precursor for the country's practice of savings and investment that are not contrary to Shariah principles. *Tabung Haji,* whose main function is to manage and cater for the needs of Muslims in Malaysia to perform pilgrimage, was originated from The Pilgrims Saving Corporation that was incorporated in August 1962, and it was subsequently launched on September 30, 1963. Six years later, in 1969, the Corporation was merged with the Pilgrims Affairs Office which had been in operation since 1951 in Penang giving birth to the Pilgrims Management and Fund Board under the Laws of Malaysia Act 8, the Pilgrims Management and Fund Board 1969 and Act A 168 of the Pilgrims Management and Fund Board (Amendment 1973).

The establishment of Tabung Haji was pertinent in providing a viable, sustainable and Islamic form of deposits at times where many of the rural Malays were practicing traditional forms of savings such as hoarding cash at home, and purchasing precious metals, buffaloes and land. Consequently, these forms of savings not only failed to facilitate the accumulation of capital but the savers also suffered losses in the value of their capital.[4] Tabung Haji operations are in fact similar, in certain circumstances, to an Islamic bank's operation. Deposits are considered as *wadiah* or interest-free deposits for safekeeping and equity investment are nearly identical to *musharakah* financing (Cizakca, 2011). The profits derived from the investment are distributed among the depositors in the form of a bonus after deduction of operating costs and *zakat* from them.

Over the years, Tabung Haji has evolved into one of the largest government linked investment companies with Asset Under Management (AUM) approximately reaching USD 20 billion. Today, Tabung Haji is not only responsible for the management of funds of its depositors, but actively involves in various economic activities through its subsidiaries including Islamic Banking and Takaful. Tabung Haji has been and will always be a beacon of hope for Islamic finance. It epitomizes the vision of Islamic finance and evidently shows that risk-sharing finance is indeed a viable banking solution.

First Islamic Bank

Eager to overcome this impediment and to see the pro-*Bumiputera* agenda comes to success, the government also insisted upon the need of having a banking system that was in line with Shariah. In fact, the government's commitment was partially reinvigorated by the Islamic Resurgence that rose in the Middle East in 1970s and the Iranian Revolution, also known as the Islamic Revolution of 1979, which saw the need to rule the country with serious consideration towards adhering to Islamic principles and values.[5] Inspired by these international events, the Islamisation movement in Malaysia rapidly gained support in Malaysia as many of Malay Muslim student leaders graduated and entered politics, including Anwar Ibrahim who joined the ruling party, giving momentum to the demand for the establishment of the country's first Islamic bank.

Retrospectively, Bumiputera Economic Congress was held in 1980 by the country's largest political party at that time, the United Malays National Organisation (UMNO), to discuss the need for investing and mobilizing funds of Malay Muslims according to Islamic rules. In conjunction to this, National Seminar on the Concept of Development that took place at Universiti Kebangsaan Malaysia in March 1981 issued a resolution demanding the government to proceed with drafting a designated law on banking based on Shariah principles.[6] Following the resolution, the then prime minister, Mahathir Mohamad, appointed a National Steering Committee for the purpose of undertaking a detailed study about the possibility of setting up the first Islamic bank in aspects of operation, legislation and finance. Chaired by Raja Tun Mohar Raja Badiozzaman, the Committee submitted its recommendations in July 1982 which were approved by the government. As a result, the Islamic Banking Act was approved by the Parliament and the Senate at the end of 1982 before it was gazetted in 1983.[7] Among others, the Act specifies requirements related to licensing, duties, control and supervision of Islamic banks. Without a fear of upsetting the applecart of conventional banking, the enactment of the Act enabled the country's first full-fledged Islamic bank, Bank Islam Malaysia Berhad (BIMB), to be incorporated in March 1983. Commencing its operation four months later in July 1983, BIMB had an approved capital of RM500 million and paid capital of RM80 million approximately.[8]

BIMB was given a 'grace period' of 10 years from 1983 to 1993 to be a sole provider of Islamic banking services in the country. This exclusive right to operate was meant to help BIMB to gain its market capitalization and build up its customer portfolios without facing competitive pressure from other local and foreign banks that were much more experienced and far better capitalised. This decision was well paid off as BIMB was able to achieve annual growth rate of 48 per cent during that period. Ten years later, BIMB's assets continued to grow up to RM13.7 billion in 2003 from RM325.5 million in 1984 with an average increase of 16.3 per cent per annum. And, with its business operations expanded rapidly throughout the country, BIMB owned 84 branches and had over 2,000 employees in 2003 as compared to 6 branches and around 270 employees in 1984.

Post-grace period, to spur Islamic finance development in Malaysia, the government initiated steps to increase competition in order to enhance the efficiency of Islamic banking. Interest-free Banking Scheme was introduced in March 1993 to allow conventional banks to offer Islamic banking services. Central bank of Malaysia or Bank Negara Malaysia (BNM issued a guideline on the Scheme stipulating requirements for conventional banks to venture into Islamic banking business. The banks were required to create a designated Islamic Banking Unit (so called as "Islamic window") to keep their funds raised for the purpose of Shariah compliant financing activities. At the onset, only three conventional banks, namely Malayan Banking Berhad, Bank Bumiputera Malaysia Berhad and United Malayan Banking Corporation participated. Nonetheless, the Scheme gained momentum and the number of commercial banks offering Islamic banking services rose up to 11 in 1993 and 25 in 1998, but later declined in 2006 to 14 due to the restructuring program post Asian Financial Crisis, as shown in *Table 1*. Today, financing provided by Islamic banks in Malaysia, on average, grows up to double-digit percentage every year (see *Table 2*).

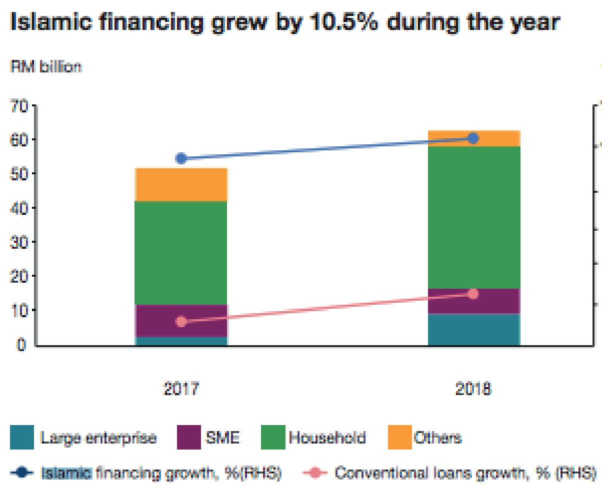
Fast forward, there were no other fully fledged Islamic banks in Malaysia from incorporation of BIMB in 1983 till the establishment of Bank Muamalat Malaysia Berhad (BMMB) in 1999. The formation of the country's second fully fledged Islamic banks was a result of a merger between the Islamic banking arms of Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce Malaysia Berhad (BOCB).

Table 1.
Number of Banks Offering Islamic Banking Services in Malaysia

	1983-92	1993	1998	2002	2006	2018
Banking Institutions	1	21	49	36	27	-
Commercial Banks	0	11	25	8	14	26
Finance Companies	0	7	18	0	10	-
Merchant Banks	0	2	5	4	3	-
Islamic Banks	1	1	1	9	2	16
Discount Houses	0	0	0	6	7	-

Source: Nakagawa (2009) and Author's Own

Table 2.
Growth of the Malaysian Islamic Banking Industry



Source: Bank Negara Malaysia's Financial Stability and Payment Systems Report 2018

Development in Other Financial Institutions

In a related development, the Takaful Act that lays out guidelines for establishing and operating Takaful companies was enacted in 1984, intended at helping the Islamic banks to effectively manage risks associated with Islamic transactions and their business operations without engaging with conventional insurance.[9] Meanwhile, in capital markets, the Government Investment Act was enacted in 1983 to enable the issuance of government papers and bonds based on Shariah principles. The government investment certificate (GIC) was first time offered on the basis of qard hassan (benevolent loan), and later was issued based on the Shariah contract of bay' al-inah. On the equity side, following the formation of Islamic Capital Market Unit[10] and the appointment of Shariah Advisory Council (SAC) members[11] in 1996, the Securities Commission of Malaysia (SC) introduced a list of Shariah-approved securities that were traded at the Kuala Lumpur Stock Exchange (KLSE) (now known as Bursa Malaysia) in the subsequent year. As Islamic securities gained sizeable market shares, the

Malaysia Securities Exchange Berhad (now known as Bursa Malaysia Securities Berhad) launched the country's first Islamic equity index, called the KLSE Shariah Index, in 1999 that tracked the performance of all Main Board shares that were on the Shariah-compliant securities list. On the other hand, the Malaysian leadership in the issuance of Shariah-compliant fixed instruments had begun since the world's first corporate sukuk was inaugurated in the country back in 1990 by Shell MDS (M) Sdn Bhd worth USD125 million (equivalent to RM525 million), issued in the local currency. Later, Khazanah Nasional Berhad launched a zero-coupon Khazanah Murabahah Bond based on Shariah contracts of murabahah and bay' al-dayn in 1997.

Financial Sector Masterplan (FSMP)

The 1997 Asian Currency Crisis was indeed another turning point for the Malaysian Islamic finance industry. The industry directly benefited from the post crisis government efforts to remould the country's entire financial system into a competitive, resilient and dynamic one. BNM launched the Financial Sector Masterplan (FSMP) in March 2001 to further build the capacity of Islamic banks and Takaful operators to compete more effectively and to solidify their industry presence. Prior to that, the level of market penetration of Islamic banks and Takaful operators was 6.9 per cent in terms of bank assets and 2 per cent in terms of Takaful participation over the total population, respectively, which implied enormous potentials untapped in both sectors. Besides, the Malaysian Islamic banks and Takaful operators faced obstacles in becoming market leaders, including: (i) increased competition as a result of globalisation and financial liberalisation; (ii) frequent use of disruptive technology; and (iii) well-informed users demanding more sophisticated financial products. To provide solutions to these problems and thus contributing significantly to the effectiveness and efficiency of the country's Islamic financial system, the FSMP proposed several recommendations addressing issues of institutional capacity building, financial infrastructure development and provision of regulatory frameworks.

The FSMP has catapult the success of Islamic banking. In the first phase of its implementation, the Islamic banking market share increased to account for 9.7 per cent (2000: 6.9 per cent) of total assets, 10.4 per cent (2000: 7.4 per cent) of total deposits and 10.3 per cent (2000: 5.3%) of total financing of the whole banking system. The Takaful business also expanded rapidly to constitute 5.7 per cent (2000: 3.9 per cent) of total assets and 6.0% (2000: 3.9 per cent) of total contributions of the insurance industry. In continuation of the Masterplan, the Malaysian Financial Sector Blueprint 2011-2010 was then launched, that set out a target to increase the amount of Islamic finance assets under management up to 40 per cent of the total assets by 2020.

The road to develop a comprehensive Islamic financial system in Malaysia was also paved by strengthening the auxiliary institutions. For example, the Association of Islamic Banking Institutions of Malaysia (AIBIM) and the Malaysia International Islamic Financial Centre (MIFC) were established in 2000 and 2006, respectively, mainly to promote sound Islamic banking practices in the country. Malaysia also hosts a number of international standard-setting and other organisations related to Islamic finance such as the Islamic Financial Services Board (IFSB) and the International Islamic Liquidity Management Corporation (IILM).

Financial Sector Openness

Notwithstanding, the astounding growth of the Malaysian Islamic banking industry is also due to the Central Bank's decision to liberalise the country's banking sector by opening up the market to foreign competition. Among the earliest foreign banks to enter were Al Rajhi Banking & Investment Corporation (Malaysia) Berhad, Kuwait Finance House (Malaysia) Berhad and Asian Finance Bank Berhad in 2004. Since then, as shown in Figures 1 and 2, the share of foreign Islamic banks to the total bank assets and total number of banks in Malaysia, although relatively very small, continued to increase, while the opposite trend was observed for conventional foreign banks. This was partly due to the establishment of Islamic foreign subsidiaries by multinational banks in the country including HSBC Holdings PLC, Standard Chartered PLC and Oversea-Chinese Banking Corporation (OCBC) Limited, namely HSBC Amanah Berhad, Standard Chartered Saadiq and OCBC Al-Amin Bank Berhad, respectively in year 2008.

Concomitantly, BNM had announced that license would be given to conventional banks to set up their Islamic bank subsidiaries. Among the first banking groups to launch their Islamic subsidiaries were the RHB Group, Commerce Group, Hong Leong Group and AmBank Group that incorporated RHB Islamic Bank Berhad, Commerce Tijari Bank Berhad, Hong Leong Islamic Bank, and AmBank Islamic Bank, respectively.

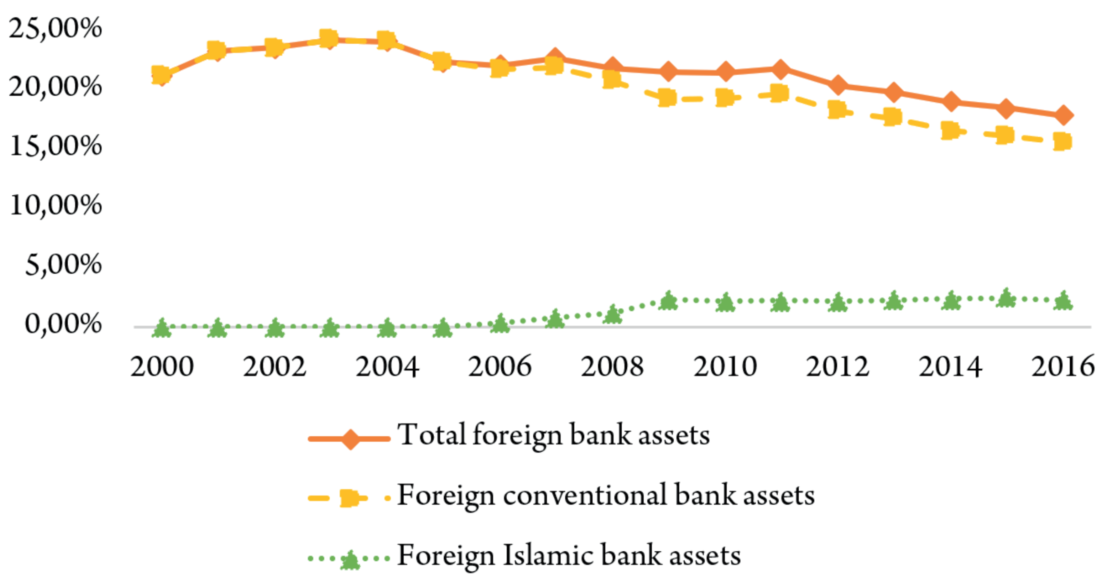


Figure 1. The Level of Foreign Bank Presence in Malaysia in Terms of Bank Assets

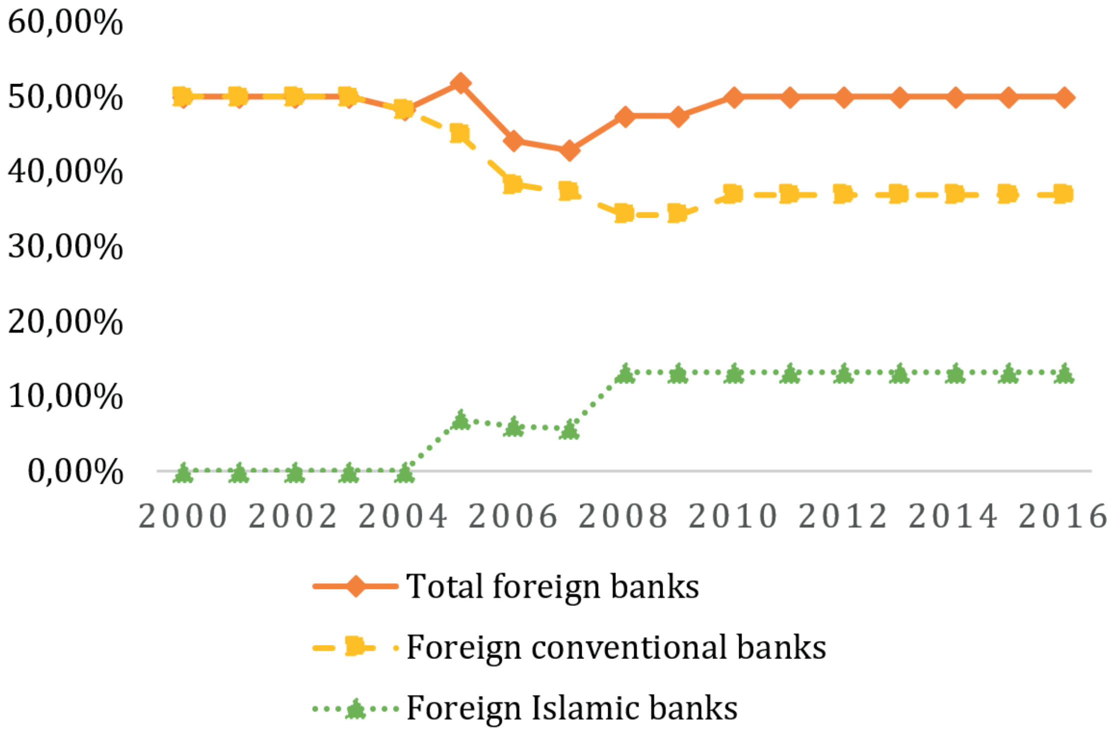


Figure 2. The Level of Foreign Bank Presence in Malaysia in Terms of Bank Number
Note: Data are from Fitch Connect and the missing ones (Alliance Bank Malaysia Berhad for year 2000 and 2001) are interpolated.

Alongside the FSMP, the Capital Market Masterplan (CMP) was introduced in 2000 by the SC with an objective, among others, to establish Malaysia as an international Islamic capital market centre. The 10-year plan facilitated the development of a wide range of competitive Islamic capital market products. Moreover, the CMP significantly contributed to the phenomenal growth of the Malaysian Islamic capital market with its size that grew at a rate of 13.6 per cent per annum to reach RM1.42 trillion as at end December 2012, as shown in Figure 3.[12] Later, it was succeeded by the country's second Capital Masterplan (CMP2) that was launched in 2011, outlining long-term strategies to guide the development of the Malaysian Islamic capital market with a specific focus given on enhanc - ing operational infrastructure , promoting Shariah -based investments and encouraging international alliance in Shariah research and product development. With the strategic guidance, it is anticipated that the Islamic capital market in Malaysia will grow at an average rate of 10.6 per cent per annum, over the next 10 years until 2020.

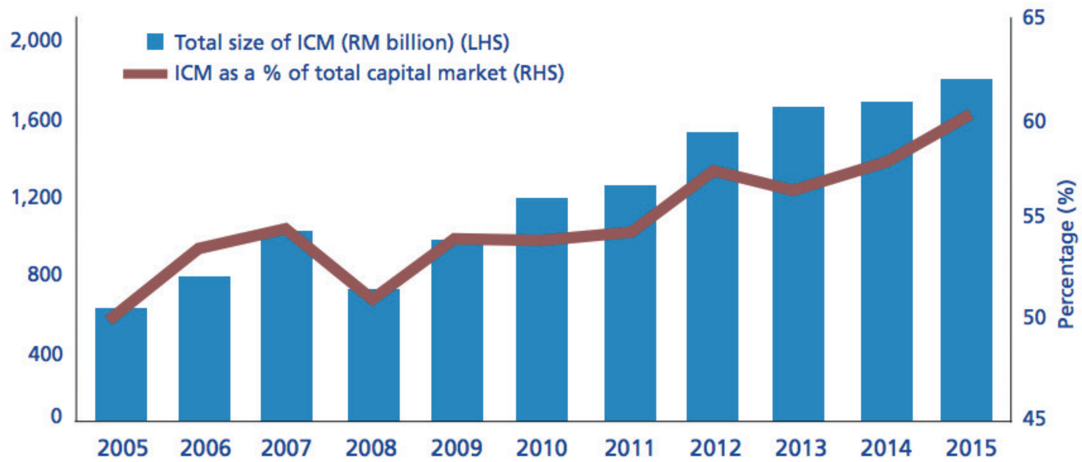


Figure 3. Size of Islamic Capital Market in Malaysia, Source: Securities Commission (2016)

Islamic Economics and Finance Education

The availability of a large, educated and skilled workforce is imperative to building a sustainable Islamic finance industry and ecosystem. According to the MIFC report (2017), human intellectual capital is one of the key factors that maintain the competitiveness and performance of the industry. Fortunately, Malaysia recognises the importance of producing world class talent to spearhead various institutions and agencies within the Islamic finance ecosystem. As such, the government and in particular Central Bank of Malaysia have invested substantially to attain this objective.

Several academic and research institutions were created in the recent years to increase human capital and intellectual resources in Islamic finance such as the Islamic Banking and Finance Institute Malaysia (IBFIM), International Centre for Education in Islamic Finance (INCEIF), the International Shariah Research Academy for Islamic Finance (ISRA) and Finance Accreditation Agency (FAA). Interestingly, these institutions were established by the Central Bank of Malaysia to enhance the quality of talent development in technical rigour, industry relevance and high level of professionalism. These newly established entities complement the many government and private universities which are already offering either academic or professional qualifications in Islamic finance and economics or related domains of knowledge. These include the well known universities such as International Islamic University Malaysia (IIUM) and Universiti Sains Islam Malaysia (USIM).

A fact of matter that is worth highlighting is the existential of strong partnership between academia and industry in Malaysia. Various agencies such AIBIM, Security Industry Development Corporation (SIDC) and Association of Shari'ah Advisors (ASAS) are supporting this initiative by continuously engaging in research, training and consulting. Notwithstanding, there are still many pertinent matters that require attention of the policymakers such as curriculum standardisation, international collaboration body, improvement in the quality publications and assistance to emerging countries in Islamic economic and finance education (Nu'man and Ali, 2016).

Table 3.
Summary of the Development of Islamic Financial System in Malaysia

Year	Key Events
1983	The Islamic Banking Act 1983 came into effect Establishment of the first full-fledged Islamic bank, BIMB
1984	Establishment of the first Takaful operator, STMB
1993	Interest-free Banking Scheme or Islamic Banking Scheme was introduced
1994	Establishment of Islamic Inter-bank Money Market (IIMM) Formation of dual banking system
1997	The Shariah Advisory Board for Islamic banks and Takaful companies was formed
1999	Establishment of the second full-fledged Islamic bank, BMMB
2000	Establishment of Association of Islamic Banking Institutions of Malaysia (AIBIM)
2001	The Financial Sector Master Plan (FSMP) 2001-2010 The Islamic Banking and Finance Institute Malaysia (IBFIM) was incorporated to produce high competent and well-trained talent in the Islamic finance industry
2003	Call for the setting up of 'Islamic subsidiary' by BNM Legal reforms to enhance the efficiency of Islamic banks: High Court judges preside over matters relating to Islamic banking and finance Law Review Committee was set up at the central bank level The Shariah Advisory Council was formed at BNM
2005	Hong Leong Islamic Bank was incorporated as Islamic subsidiary on 28 March 2005 The International Centre for Education in Islamic Finance (INCEIF) was set up by Bank Negara Malaysia to develop human capital for the global Islamic finance industry
2006	Affin Islamic Bank Berhad and EONCAP Islamic Bank commenced business operations on 1 April 2006 AmIslamic Bank started its operations on 1 May 2006 Kuwait Finance House officially started operating on 17 February 2006 Al-Rajhi Bank set up its first overseas operations in Malaysia in October 2006 Asian Finance Bank Berhad was incorporated on 28 November 2005, and its first branch was opened on 19 January 2007 Establishment of the Malaysia International Islamic Financial Centre (MIFC)
2008	Maybank Islamic Bank Berhad began to operate
2010	Issuance of the Malaysia's Financial Sector Blueprint 2011-2020 Inaugural global Wakalah sukuk by Government of Malaysia

2011	World's first China Renminbi denominated "Emas" sukuk by Khazanah Nasional
2012	World's largest Shariah-compliant IPO listed on Bursa Malaysia by Felda Global Ventures World's single largest sukuk issuance, by PLUS RM 30.6 billion.
2013	Danainfra Malaysia's first Exchange Traded Bonds and Sukuk (ETBS) International Islamic Liquidity management Corporation (the IILM) Inaugural USD-denominated short-term sukuk USD 490 million. The first Shariah retail product by a foreign fund manager, Aberdeen Islamic Asset Management.
2014	Launch of Sustainable and Responsible Investment (SRI) Sukuk Framework by Securities Commission Malaysia.
2015	First Sustainable and Responsible Investment (SRI) Sukuk Ihsan by Khazanah Nasional Berhad.
2016	CIMB Principal Islamic launched Malaysia's first Global Sukuk Fund under UCITS structure.
2017	Launch of Five-year Islamic Fund and Wealth Management Blueprint Issuance of world's first Green Sukuk.

Source: Author's own

Current Situation of Malaysia in IFB

Over the years Malaysia has developed a comprehensive Islamic finance marketplace as illustrated in Figure 4. Various agencies and institutions have been established in the past 30 years to position Malaysia as one the most vibrant marketplace for Islamic finance. Equipped with robust regulatory framework and supported by thriving demand for Shariah compliant products, Malaysia at present is best known for hosting one of the world's most comprehensive and developed Islamic financial ecosystems, according to Thomson Reuters's Global Islamic Finance Development Indicator (IFDI) 2018 as is shown in Figure 5. The continuous commitment and support from Malaysian government is further spurring the industry's growth. Indeed, in the recent launching of Malaysia Shared Prosperity Vision 2030, Islamic finance has been identified as one of the core pillars to promote inclusive and sustainable growth.

Figure 4. The Landscape of Islamic Finance in Malaysia, *Source:* MIFC's (2018)

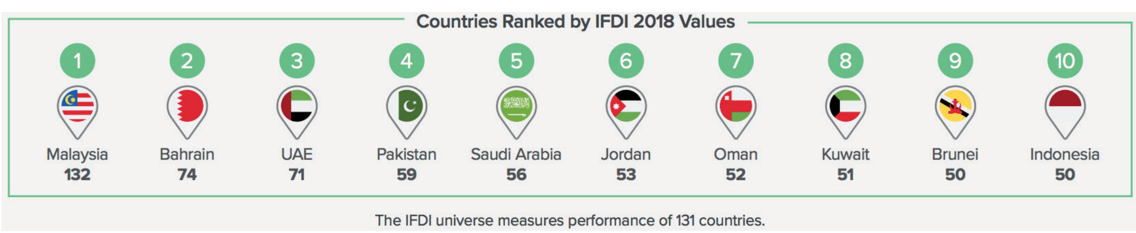


Figure 5. Ten Countries with the Most Developed Islamic Finance Markets

Source: Thomson Reuters's IFDI (2018)

Evidently, the success of Islamic Finance in Malaysia is substantiated by recent statistics provided by BNM (2019), wherein the total financing by Islamic financial institutions grew by 10.5 per cent to RM668.7 billion in 2018 from RM605.5 billion in 2017. This had further increased the share of Islamic financing as proportion of total banking sector financing to 36.6 per cent in 2018, as compared to 34.9 per cent in 2017. With respect to size, Malaysia was included in the list of twelve jurisdictions with systemically important Islamic banking industry that accounts for almost 92 per cent of the global Islamic banking assets (Islamic Financial Services Board, 2019).[13] Furthermore, on the funding side, Islamic deposits and investment accounts saw an expansion of 10.2% to RM742.3 billion in 2018 from RM672.6 billion in 2017.

In line with the success of Islamic banking, strong demand for Shariah-compliant protection solutions seems to sustain growth in Takaful industry. In 2018, the combined net contributions of family and general takaful business grew 15.9 per cent to RM9.56 billion from RM8.3 billion in the previous year. Correspondingly, the market share of the country's Takaful industry in terms of net premiums and contributions rose to 16.6 per cent in 2018 from 15.2 per cent in 2017. To top all these successes, Malaysia dominates the international Sukuk markets as the country's market share represented 51 per cent of the USD396 of total global outstanding Sukuk in 2017 and recently took the top spot in global Sukuk issuance with USD13.9 billion or 35.1 per cent of USD39.5 billion issued in the first quarter of 2019. Also, Malaysia positions itself as a leading international provider of Islamic wealth management services where 32 per cent of the global Islamic funds were domiciled in the country, second largest only after Saudi Arabia (37 per cent) as of 2017 (Islamic Financial Services Board, 2019).

Islamic Finance and the Future of Malaysia

Today, with less than 1 percent of Malaysian households living in extreme poverty, the government's focus has shifted towards a more challenging agenda; addressing the well-being of the poorest 40 per cent of the population ("the bottom 40") (World Bank, 2018). Beset by high cost of living and mounting financial obligations, this low-income group remains highly vulnerable to economic shocks and market uncertainties. Despite a declining trend, past figures provide an alarming glimpse into the gap between the rich and poor in Malaysia.[14] Looking at closing this income gap, the government has identified Islamic finance as an indispensable tool to build resilience for the bottom 40, and the entire economy in general.

Malaysia is also aiming to become a developed nation in the near future. As such, the aspiration to build an economic model that promotes inclusion and balanced growth deems to favour the implementation of Islamic finance in attaining this noble endeavour.

The value proposition of Islamic finance resonates with the country's aim and intent. Nonetheless, the country realises it's facing a new set of challenges to catapult itself to a new level, to become the envy of the world and to lead the Muslim world. No doubt, as a trading nation, the obstacles and challenges of Malaysia are not only originating internally but also externally. Notwithstanding, the Malaysian leaders and its people are ready to embrace the new world. The new blueprint of Shared Prosperity Vision 2030 has clearly charted Malaysian plans to deal with the three largest forces on the planet—Moore's law (i.e., technology), 'the Market' (i.e., globalisation) and Mother Nature (i.e., climate change)—as described by Thomson L. Friedman in his book, Thank You for Being Late—An Optimist's Guide to Thriving in the Age of Accelerations.

To proceed, this article comments on how Islamic finance can contribute to prepare the country against these three largest forces. We argue that by productively engaging with these fast-accelerating and economically disruptive forces that have reshaped the world that we live in, Islamic finance is able to expedite Malaysia's progress towards a developed nation with inclusive and equitable growth (i.e., narrowed income disparity).

Islamic Finance and Technology

Friedman shrewdly pointed out that technology evolves so fast at a rate that any change or innovation "can outpace the capacity of the average human being and our societal structures to adapt and absorb them" (Friedman, 2017, p. 32). Given this fact, he then mentioned that it is not necessary that we should just pause hopelessly, but rather have to understand it and then engross ourselves in, wholly. This is the same exact message delivered by the Malaysian Prime Minister, Tun Dr. Mahathir Mohamad as he called upon Islamic banking and finance players in the country not to underestimate the potential disruptions of financial technology (henceforth called "fintech") when delivering his keynote address at the 15th Kuala Lumpur Islamic Finance Forum 2019.

Not as vexatious as it sounds, disruptive technology can swing both ways. Simply put, penetration by fintech in the Islamic finance space may positively contribute to the evolution of the Islamic finance products and services offering. For instance, leveraging on the internet, mobile devices, social media interaction, big data analytics and artificial intelligence enables the Malaysian Islamic banks to give a superior customer experience (i.e., more automated and user-friendly financing and payment facilities) and lowers financial transaction costs.

A very popular example of advancing the adoption of technology among Islamic banks in Malaysia is the operationalisation of Investment Account Platform (IAP) in 2016. Initially launched in participation from, a consortium of six Islamic banks[15], IAP functions similar to many fintech platforms such as crowdfunding and peer-to-peer (P2P) lending where it serves as a platform for mobilising funds from investors—who may channel their money through the participating Islamic banks' investment account products—to finance viable ventures. With IAP in place, several key functions of Islamic banks in managing investment accounts (e.g., giving options to investors to place funds that match their risk appetite, customer due diligence and continuous monitoring on ventures etc.) are embedded within its system, thus enabling investment account products to be delivered in a more efficient and effective manner. Figure 6 illustrates the mechanics of IAP. A year after its establishment, funds raised through IAP listings quadrupled to RM95.3 million, supporting four ventures (BNM, 2018). The promise of IAP to raise more funds in the coming years is immense as a recent survey conducted by BNM reveals that almost 60 per cent of small and medium-sized enterprises (SMEs) are not aware of the availability of such website-based multi-bank fundraising platform (BNM, 2019). Other than regulator-driven IAP, there is also a growing number of Islamic or Muslim-focused crowdfunding platforms in Malaysia. Among others is Ethis Ventures, the Malaysian arm of Singapore-based Ethis Group, which was recently awarded with the very first Islamic equity crowdfunding license by Malaysia's SC. With that, the company expects to launch a brand new Shariah-compliant platform, called Ethis Equity, in the first quarter of 2020, aiming at helping SMEs raise funds in the country. Best known for its impact investing focused on social housing projects in Indonesia, the company also develops and operates an associate group of other ethical platforms in Malaysia, including GlobalSadaqah platform that matches Islamic social finance funds (e.g., zakat, waqf and sadaqah) with high-impact charity campaigns, and Skolafund platform that matches deserving underprivileged students wishing to pursue a tertiary education with potential funders (i.e., micro scholarship). In the same vein, Finterra Technologies Sdn Bhd has introduced the "Finterra Endowment/Waqf Chain", the world's first and only platform that provides solutions to raise and manage waqf funds via smart contract ecosystem and blockchain technology.

Figure 6. Mechanics of Investment Account Platform, *Source:* BNM (2016)

Without discounting the urgency for Islamic finance key players to invest in technology, this article propounds that the market hype of "frictionless always wins"[16]—heavy reliance of firms on technology to eliminate effort, steps and hassle or so called 'friction' and hence reduce transaction costs—may lead to the 'efficiency delusion'[17]. In other words, placing efficiency over other values by Islamic banks can be irrational, creating a lapse of ethical and social judgment in their lending decisions. For example, the application of Islamic smart contracts makes the automation and decentralization of time-consuming and complex execution of the entire traditional bank financing process possible, thus enables Islamic banks extend more credit at the lowest possible cost. However, this improved efficiency may not necessarily be transferred to the betterment of the society (i.e., more credit are channelled to profitable hard-information customers and less to more opaque socially-driven customers with soft information)—unless banks are willing to do so (by altering their existing credit scoring system). After all, reduction in transaction costs is all that matters to banks and has regularly proven to be a powerful way to influence firms' behaviour.[18] But instead, the only thing for sure, it does help banks in doing what they are best at—creating money out of thin air (i.e., excessive credit creation that violates the very objective of Islamic banking and finance in the first place).

Islamic Finance and 'The Market'

The second acceleration concerns globalisation or 'the Market', a phenomenon described by Friedman that makes the world even flatter than before. The global flows of information and hence commerce are today dramatically amplified, thanks to the advancement of technology. Such digital way of exchanging information and trading goods has made the world much more interdependent on all fronts—economically, politically and culturally. One way the government can encourage businesses to grow along this shift is by enhancing trade finance facilitation, which has remained largely untapped by Islamic banking institutions in the Muslim countries. Connectivity has been a weak spot for many Muslim countries for so many years. Considering the total trade of all 57 member countries of Organisation for Islamic Conference (OIC) in 2016 that amounted to a staggering USD3,062.4 billion, comprising of USD1,414.3 billion in exports and USD1,638.1 billion in imports, it does seem quite perplexing that the proportion of intra-OIC trade—represents the trade connectivity among Muslims—reached only to 19.3 per cent.

Whilst it is true that trade itself is not a panacea to a country's socio-economic ills, but if structured in a comprehensive manner (to streamline trade finance operations by utilising digital and e-commerce platforms), then it can unleash its true potential to contribute to equitable growth and poverty alleviation (i.e., providing more opportunities to the poor to participate in the real economy). Knowing this, BNM sets to encourage an expanded role of Islamic banks in facilitating trade finance in the near future. With the benefits of digitalisation of trade finance offerings, BNM aims for Shariah-compliant trade financing to support at least 10 per cent of the country's total trade in three years' time (BNM, 2017). The latest statistics by BNM show that, as of 2015, the Islamic finance industry currently represents only 3.4 per cent (RM50.3 billion), less than one third of the total sources of financing for trade amounting to RM1.48 trillion, as shown in Figure 7. The opportunity for Islamic finance to increase its share, however, remains certainly colossal as Malaysia's total trade continued to record a growth of 5.9 per cent to RM1.88 trillion in 2018 from RM1.77 trillion in 2017.

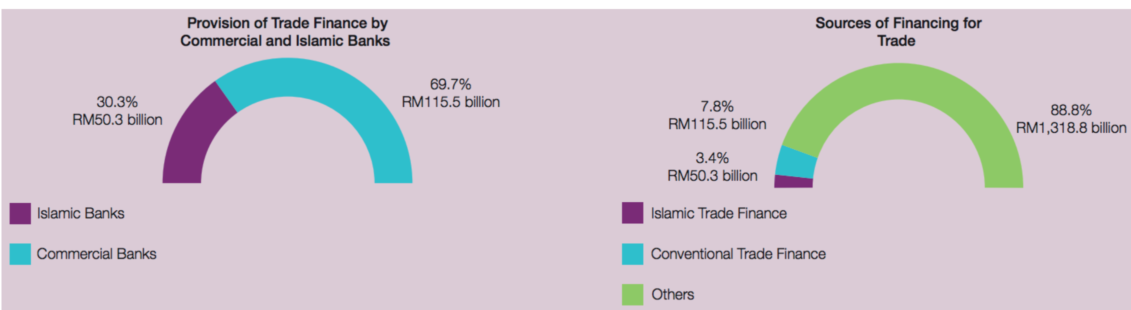


Figure 7. Trade Financing by Islamic Banks in Malaysia

Source: BNM's Financial Stability and Payment Systems Report 2016.

Furthermore, the halal industry in Malaysia is expected to flourish as a result of interconnectedness among Muslim countries created by technological disruptions in Islamic trade finance. The industry's potentials for Islamic finance to tap into are enormous as according to the State of the Global Islamic Economy Report 2018/2019 that Muslims spent USD 2.1 trillion across food, beverage and lifestyle sectors in 2017 and their spending on these items is forecasted to reach USD 3 trillion by 2023. While, in Malaysia, the government has undertaken key strategic initiatives across many aspects including regulation, finance, marketing and settlement to further develop the country's halal industry.

Many financial incentives are also introduced, such as, the profit rate subsidy of two per cent that was earmarked by the government in the 2019 Budget as part of an RM1 billion Shariah-compliant SME financing scheme to finance halal exporting companies. With these, the halal industry's contribution to the country's GDP is expected to increase to from 7.5 per cent in 2017 to 8.7 per cent in 2020.

Our take on what should be the Malaysian approach in manoeuvring through this 'market' force is that the country should view the need to encourage interconnectivity beyond manufacturing and trading goods moving forwards. Instead, the global acceleration may also take place through the exchange of ideas. One way to do so would be the government must be fully committed to empowering Islamic finance knowledge hubs such as INCEIF—which was recently awarded the prestigious accreditation by the Association to Advance Collegiate Schools of Business (AACSB), placing its academic programmes among top five per cent in the world—and other think tanks where people across borders meet and interact to look for solutions to the world's problems. Figure 8 shows INCEIF's contributions in Islamic finance talent development.

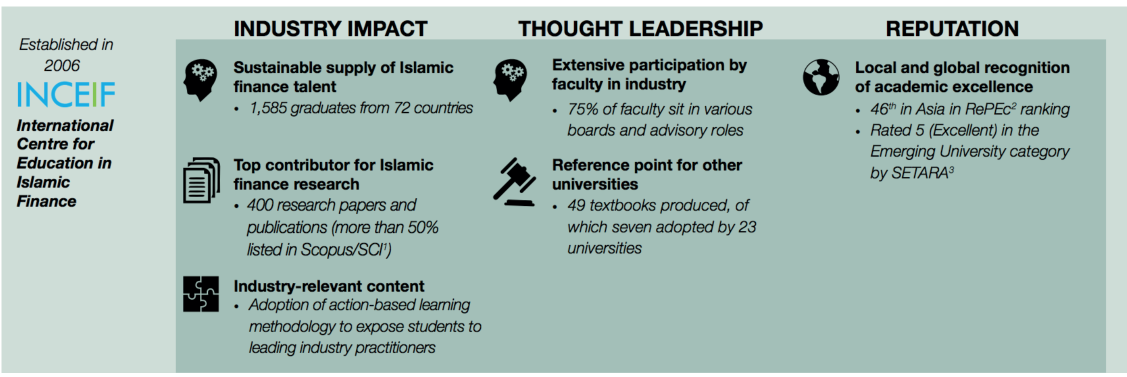


Figure 8. Contributions of INCEIF in Developing Talent for Islamic Finance

Source: BNM's Financial Stability and Payment Systems Report 2017

Islamic Finance and Climate Change

Recently being identified as one of the strategic areas of focus by Malaysia's Ministry of Energy, Science, Technology, Environment and Climate Change, Islamic finance sets to distinguish itself in the local financial landscape by investing in green. Moving along with this more sustainable direction, Islamic financial institutions are now urged to be more mindful about their influence over the extensive use Earth's resources (i.e., by channelling credits to fund certain unsustainable industries) that may cause speedy shocks to the global climate.

The Malaysian Islamic finance industry embarked on the process of 'greening' the country's economy when the SC launched the Sustainable and Responsible Investment (SRI) Sukuk Framework to facilitate the creation of a conducive ecosystem for green sukuk issuance and to promote greater utilisation of green sukuk as a fundraising channel to finance eligible SRI projects (e.g., natural resources, renewable energy and energy efficiency, community and economic development, waqf assets), as shown in Figure 9. Guided by this Framework, Malaysia marked a new milestone in the global green financing space with the inaugural issuance of the world's first green sukuk by Tadau Energy Sdn Bhd in July 2017. Cumulatively, there were five green sukuk issued as at April 2018 with an approved issuance size of RM3.7 billion, out of which, RM2.4 billion worth of proceeds have been utilised for financing renewable energy production and green building construction, as listed in Table 3.

Table 3.
Green Sukuk Issuance in Malaysia as at April 2018

Issuer	Program size (RM Million)	Issue date	Issued amount (RM Million)	Utilisation of proceeds
Tadau Energy Sdn Bhd	250	27 July 2017	250	To finance 50 megawatt (MW) solar power plants in Sabah.
Quantum Solar Park (Semenanjung) Sdn Bhd	1,000	6 October 2017	1,000	To finance three 50 MW solar power plants in Kedah, Melaka and Terengganu.
PNB Merdeka Ventures Sdn Bhd	2,000	29 December 2017	690	To fund an 83-storey office space, forming part of the Merdeka PNB 118 tower project in Kuala Lumpur.
Sinar Kamiri Sdn Bhd	245	30 January 2018	245	To finance 49 MW solar power plant in Perak.
UiTM Solar Power Sdn Bhd	240	27 April 2018	222.30	To finance 50 MW solar power plant in Pahang.

Source: SC-World Bank Group's Islamic Green Finance Report (2019)

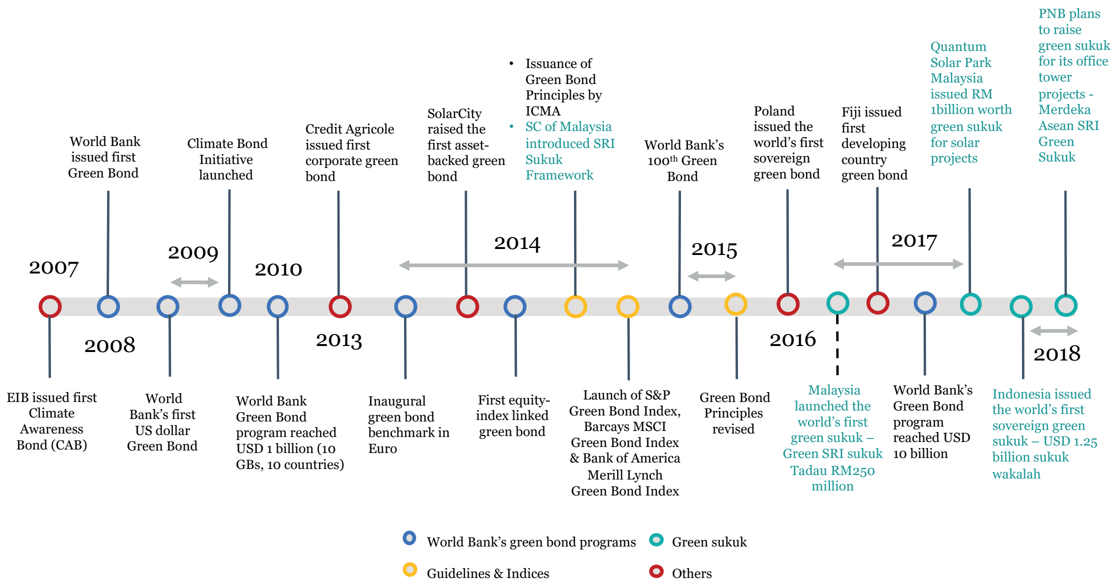


Figure 9. The Inception of the Malaysian Green Sukuk

Source: World Bank's Green Impact Report 2017, IFC's Green Bond Impact Report 2017, Climate Bonds Initiative's 2017 Report, MIFC, Authors' own.

Another solution offered by Islamic finance to realise Malaysia's pledge to the Nationally Determined Contribution to reduce greenhouse gas emissions intensity of GDP by 45 per cent before the year 2030 was the conceptualisation of Value-Based Intermediation (VBI) in July 2017. VBI encapsulates the industry's vision for Islamic banks to be more impact-driven, reinforcing the overarching intent of Shariah to promote good and prevent harm. Figure 10 illustrates the framework for BNM's VBI. As such, the Final Strategy Paper on VBI which focuses on strengthening the societal and environmental impacts of Islamic finance was issued by BNM and the VBI Community of Practitioners, an industry group comprising nine Islamic banks. In addition, two new tools were published for public consultation to facilitate the operationalisation of VBI, namely, the VBI Financing and Investment Impact Assessment Framework (VBIAF) and the VBI Scorecard. The VBIAF provides guidance to banks for assessing financing and investment options, taking into consideration their economic, social and environmental impacts, while the VBI Scorecard facilitates the implementation of impact-based performance measurement frameworks in Islamic financial institutions.

Support for VBI from the industry players has gained momentum in the last couple of years. For instance, CIMB Islamic Bank Berhad and its parent company has offered preferential financing rates for the purchase of new hybrid vehicles and Green Building Index certified residential properties. More importantly, VBI is also consistent with global green initiatives that are in line with achieving the United Nation's (UN) Sustainable Development Goals (SDG). For example, the year 2018 witnessed the world's first SDG sukuk issuance by HSBC Amanah Berhad. Proceeds from this AAA-rated senior unsecured fixed rate sukuk issuance are mentioned in specific to be dedicated to finance projects contributing towards the attainment of several climate change-related UN SDGs.[19]

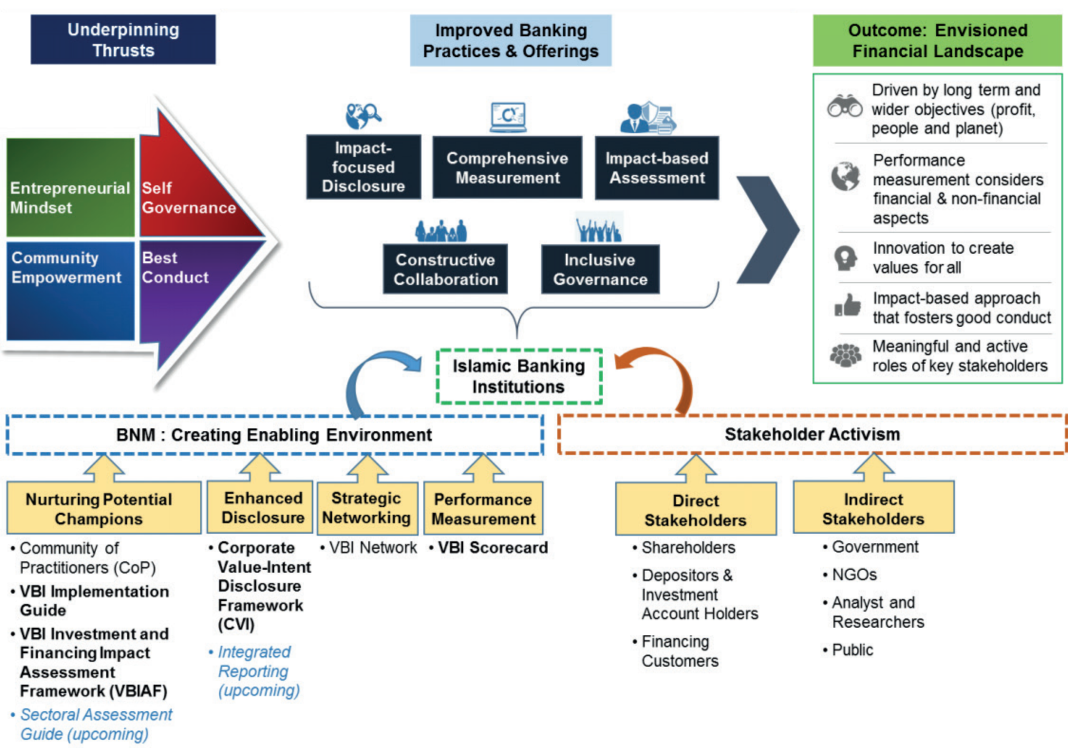


Figure 10. Framework of Value-Based Intermediation

Source: BNM's VBI Consultative Document (2019)

Conclusion

To sum up, while previous writings mostly ascribe the dawn of Islamic finance in Malaysia to the establishment of classical Islamic organisations such as the Pilgrims Fund Corporation or better known as Lembaga Tabung Haji[20], this article accentuates the people's aspiration to come together to build a better nation—especially in terms of inclusiveness and economic prosperity—being an important impetus to the birth of Islamic financial system in the country. Moreover, this article provides an insight into Malaysia's journey in becoming one of the world's most developed Islamic finance markets today. It reiterates the significance of the Malaysian people's aspiration to lead the country towards more inclusive growth and hence achieve economic prosperity by means of Islamic finance. Moving forward, in order to become a high-income nation and to pursue the agenda of empowering the bottom 40, this article further asserts that Islamic finance may provide avenues for the country to productively engage with the three largest market accelerations, namely, technology, globalisation and mother nature and hence more inclusive and equitable growth. It is worth mentioning that these accelerating forces have the ability not only to alter the ways the financial system works but also to distort customer's expectations and hence their demand and consumption patterns. Therefore, Islamic finance key players must not channel their resources merely looking for the best solutions to increase their efficiency, but also to understand how their customers' behaviour has evolved over time in order to thrive in the age of accelerations.

Notes

1 See Christine Lagarde's speech at "Special Engagement Session" hosted by Malaysia's TalentCorp, together with Universiti Malaya and Malaysian Economic Association, available at: https://www.imf.org/en/News/Articles/2019/06/23/sp062419-md-ingredients-for-malaysias-economic-prosperity#_edn1

2 See Kana (2019) for more details about Malaysia's aspiration to become a high-income country by 2020.

3 See Jomo (1990) for more details about Malaysia's New Economic Policy.

4 For details, please see Shah M.E. & Seho M. (2017) Tabung Haji Run-up to Islamic Finance in Malaysia, Islamic Finance in Malaysia.

5 See Richburg (1987) and Chandra (1988) for more details about the growing Islamization movement in Malaysia and its relation to the establishment of interest-free bank in the country.

6 See Cheah (1994) for more details about more details about early efforts taken to introduce an Islamic banking system in Malaysia.

7 Islamic banking is defined in the Islamic Banking Act 1983 as a 'banking business whose aims and operations do not involve any element which is not approved by the religion of Islam'.

8 Among the shareholders were the Ministry of Finance (RM30 million), Lembaga Urusan dan Tabung Haji (RM10 million), Pertubuhan Kebajikan Islam Malaysia (RM5 million), Majlis Agama Negeri (RM20 million), Foundations of Religious Affairs (RM3 million) and Federal Corporations (RM12 million).

9 Unlike conventional insurance, the practice of Takaful in Malaysia adheres to the principles of Shariah whereby a group of participants mutually agree among themselves to guarantee each other against defined loss or damage that may inflict upon any of them by contributing donation (*tabarru'*) to the takaful funds.

10 This unit comprised researchers trained in both Islamic jurisprudence and capital market practices to undertake research on product origination and Islamic capital market operations.

11 The SAC members of the SC comprised Islamic scholars, academicians and Islamic finance experts, whose role was to advise the SC on Shariah related matters for Islamic capital market activities.

12 Size of Islamic capital market is defined as the sum of total amount of Sukuk outstanding and the market capitalisation of Shariah-compliant equities.

13 Islamic Financial Services Board (2019) defines systemically important jurisdictions as those with market shares of Islamic banks (i.e., shares in the total domestic banking assets) at least 15 percent. Other than Iran and Sudan, where banking assets are fully Islamic, these countries among others include Brunei (61.8 per cent), Saudi Arabia (51.5 per cent), Kuwait (39.3 per cent), Qatar (25.7 per cent), Malaysia (24.9%), United Arab Emirates (20 per cent) and Bangladesh (19.8 per cent).

14 Gini coefficient, which measures income inequality in the country, had declined from 0.513 in 1970 to 0.399 in 2016, denoting improvement in income inequality in Malaysia over the past 46 years.

15 These banks are Affin Islamic Bank Bhd, Bank Islam Malaysia Bhd, Bank Muamalat Malaysia Bhd, Maybank Islamic Bhd, Bank Kerjasama Rakyat Malaysia Bhd and Bank Simpanan Nasional, which facilitated fund-raising exercises of RM20 million at the inception stage.

16 For more details, see David Pogue's (2019) article entitled "What's Changed Since My First Column for Scientific American" available at https://www.scientificamerican.com/article/whats-changed-since-my-first-column-for-scientific-american/

17 The term 'efficiency delusion' is linked to the quote by a famous English writer, Virginia Woolf, who said that "efficiency cuts the grass of the mind to its roots".

18 See the study of Hartzog and Selinger (2015) for more details.

19 The chosen UN SDGs include SDG 3 – Good Health and Well-Being, SDG 4 – Quality Education, SDG 6 – Clean Water and Sanitation, SDG 7 – Affordable and Clean Energy, SDG 9 – Industry, Innovation and Infrastructure, SDG 11 – Sustainable Cities and Communities and SDG 13 – Climate Action.

20 See Samad & Hassan (2006), Akram Laldin (2008) and Al Nasser & Muhammed (2013).

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