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Reviewing Malaysia's Islamic financial system and its way forward

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THE year 2003 marks the 20th anniversary of the setting up of the first Islamic bank in Malaysia, namely Bank Islam Malaysia Bhd.

Such an important anniversary calls for reflection on what we have achieved over two decades and where do we go from here.

Ibn Khaldun reminds us in his Muqaddimah (opening remark) that social justice, rules of laws, property rights, a culture of tolerance and cooperation among various constituents, a willingness to innovate and economic strategies which 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.

In the context of our pursuit of a well-rounded development in a multi-religious environment, Malaysia adopted the approach of gradually implementing a dual financial system - an Islamic financial system functioning in parallel with the conventional one. Today, we are beginning to see the maturing of the Islamic financial system into a more usable and pragmatic system that goes beyond the textbooks and theories which 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 Prime Minister Datuk Seri Dr Mahathir Mohamad. Not many today realise that one of the first actions Dr Mahathir took upon becoming Prime Minister in 1981 was to set up a National Steering Committee to implement Islamic banking in Malaysia.

In the early 1980s, Islamic banking was considered a quaint idea and not many leaders of Islamic countries had the guts to implement Islamic banking.

Dr Mahathir saw the potential of Islamic banking even then, and he made the brave decision to implement Islamic banking in Malaysia with the setting up of Bank Islam in 1983. The rest is history. 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 Bank Negara Malaysia from 1985 to 1994. Jaafar took upon himself the responsibility to implement a dual system of banking, Islamic and conventional, both equally comprehensive.

I wish to quickly re-visit the evolution of the Islamic financial system in Malaysia. First came the initial period of familiarisation (1983-1992). This was an exploratory, almost experimental, stagewhen Bank Islam 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 and Takaful Malaysia Bhd grew from strength to strength. Islamic banking was no longer regarded as a novelty or a quaint notion - even non-Muslims started banking with Bank Islam.

With this confidence, came the next stage, that of mainstream acceptance and pervasiveness (1993-2002). No longer was Islamic finance the sole domain of Bank Islam - the entire financial system began to use and apply Islamic financial principles. During this phase, the dual system of banking took root in Malaysia. The dual system continues to be a unique feature of the implementation of Islamic banking among Muslim nations. No other country had adopted this strategy so far.

The next phase - Islamic finance as a competitive advantage

With two decades of development behind it, I believe the Islamic financial system in Malaysia stands on the threshold of its next phase. Before going into this next phase, perhaps, we should take a step or two back to look at the broad canvas of Islamic finance in the international arena in order to 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. Islam is a deen, a complete way of life. Beyond basic religious beliefs and practices, Islam shows us how to best conduct ourselves in everyday matters. The code of best conducts is called the Syariah - the basis of the Islamic financial system.

The Syariah has been put there not as a set of rituals to make life difficult. It serves several important purposes. Firstly, the Syariah is a means to approach and seek the pleasure of the Creator. Secondly, the Syariah brings about human success and harmony - allowing men to attain excellence. It is through the strong adherence to the Syariah that Muslims of earlier generations achieved their magnificence and global success. Thus, the Islamic financial system, being part of this Syariah system, ought to be treated in the same light.

Just as the Syariah 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 a tool of competitive advantage for the ummah's success, including economic success.

While the first phase was that of discovery, and the second phase was that of acceptance, I believe in this current phase, beginning 2003, we will need to increasingly use Muslim financial principles as a tool of competitive advantage. While this is particularly true for Malaysia, this is also generally true for Islamic nations as a whole. We can define the term Muslim nations as the 57 countries which are members of the

Organisation of Islamic Countries (OIC).

Let me explain what is meant by competitive advantage. The conventional financial system has been in existence for over 600 years. While, undoubtedly the system has been instrumental in the development and growth of many countries, the growth has not been equitable. The conventional 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 an Islamic financial system, both domestically and internationally, would 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 the current phase, a number of pre-conditions are necessary. First, Islamic finance in the international arena will have to be developed into a genuine parallel system. Currently, only in Malaysia does Islamic finance functions parallel to the conventional system. In OIC nations - 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.

Second, while in the first two phases, bankers were in the vanguard leading the development of Islamic finance, in Phase III, 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 of 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 developments 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, that any Western banking appears to be playing an increasing role in the development of Islamic banking. This is partly due to the absence of drives from Islamic 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 Islamic 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 talents to work for them, and they should pay whatever it takes to
attract them. Currently, first-class Muslim talents are 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 on the Islamic core - fully committed to the principles of
promoting social justice and a moral economy through the promotion of
Islamic-based finance.

To that talents that are now working with high compensation packages
for
conventional banks, we should provide every opportunity for them to have
significant equity participation in Islamic financial ventures in our
own
country, that would allow them to concurrently monetise their ideas. As
an
ummah, we must then move to ensure that these home-grown ventures engage
in the international arena with both Muslims and non-Muslims. After all,
Islam has commanded us to know each other and cooperate 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 one in many
ways.
The Islamic system is a just and equitable system that promotes win-win
relationships among economic agents. For example, the relationship
between
financiers and users of capital is based on cooperation 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. In the Quran and the examples of the Prophet SAW (peace be upon him), we are bestowed with a 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, we must be able to adapt it for the required purpose. Creativity and constructive thinking are therefore the keys.

The roots of the conventional or secular financial system were developed in another era and based on different 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 Islam and Syariah.

We are living in an era that is, of course, unique, where the underlying conditions of the world are quite different. The Muslim ummah live under different circumstances. It is quite clear that some form of adaptation is necessary to apply Syariah 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.

I must emphasise, of course, that it is not wrong to adapt from other systems as long as the root values and principles are compatible 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, hand-picking what to use and what to reject based on the teachings of Islam.

The challenge to innovate and adapt, while remaining true to Islamic core principles, is crucial 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 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 borrowers. It is, perhaps, no surprise that there is some cynicism today 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 (interest). 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 cooperation based on a more equitable risk- and reward-sharing. The acid test must be products that are genuinely superior to the conventional ones, 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.

Strategic alliances

The international Islamic financial community is now ready, after more than three decades of development, to venture into the next phase of greater cross-border cooperation. 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, South-East Asia and indeed the West as well as 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 cooperation 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.

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 (1993-2002), is now to be used as a strategic developmental tool to our nation's and the ummah's advantage.

We must understand that we are implementing the Islamic financial system not for ritualistic purposes, but as a source of competitive advantage and a catalyst for greater growth and success for the ummah as a whole, in

line with our vicegerent role commanded upon us. Islam was sent down to liberate, not to shackle us.

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.

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