

Malaysia as an International Islamic Financial Centre: Development and Prospects

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ABSTRACT

The Malaysia International Islamic Financial Centre or the MIFC initiative is the bedrock of Malaysia's aspiration to be a vibrant centre of Islamic banking and finance. It is an up hill task for Malaysia to compete for the lead position with other established international financial centers (IFC)s. However, with Malaysia's achievement in many pioneering and innovative products and services in Islamic banking and finance may elude their ambitious aim? Many studies conducted by researchers have explained the formation of IFC using different approaches. One such study was conducted by Kindleberger who uses the historical approach. Therefore this study attempts to explain the formation of an International Islamic Financial Centre (IIFC) from the functional and Islamic perspective. The functional perspective was a conceptual framework postulated by Crane et al (1995) who headed the Global Financial system Project of the Harvard Business School. The basis of the research lies on the dynamic performance of the functions which will lead to new institutional arrangements. This framework underlines the importance of functions that preceded institutions. An additional function included in the study is the Shari'ah Advisory Council (SAC) which attest to the importance of Islamic viewpoint in the successful implementation of the MIFC initiative.

Keywords: International Islamic Financial Centre, Islamic Banking, Islamic Finance, Islamic Capital Market, Islamic Insurance, Financial Centre, International Financial Centre

Introduction

In the 9th Malaysia Plan for the period 2006 to 2010, the Malaysian government has outlined its strategy to establish Malaysia as an International Islamic Financial Centre (IIFC) (Malaysia, 2006). In August 2006, Dr. Zeti as the Governor of Bank Negara Malaysia (BNM), the central bank of Malaysia, made the announcement in her speech and named it the Malaysia International Islamic Financial Centre initiative or MIFC. Razif (2006), the deputy governor of BNM, amplified further in his speech that by adopting the MIFC initiative as a global brand will enhance Malaysia's position as "a vibrant, innovative and competitive international Islamic financial services industry". Judging from the seriousness of the tone of both speakers, Malaysia is asserting herself as the forerunner in Islamic banking and finance. Thus, it is pertinent at this stage to assess Malaysia's prospect as one of the important IIFCs in the world.

Many studies have acknowledged the important role of financial centres in accessing capital from an agglomeration of financial institutions that serve the needs of depositors and investors. Beginning with a pioneering study by Kindleberger's (1974), who attempts to explain the formation of financial centre from the historical perspective, there was a burgeoning literature on financial centres in general, and individual centres, many of which are located outside Europe and North America. These literature discussed from various perspectives; (Jao,1993) citing (McCarthy,1979) from the teleological point of view, (Jao,1980,1988) from the functional perspective, (Dufey and Giddy, 1978) study on the classification of IFC, (Park,1982) from the functional and geographical perspective, (Gorositiaga,1984) study on the historical and neo-Marxist perspective.

Adding to the extant of the literature, this paper employs a conceptual framework from the functional perspective in an IIFC environment. This paper adopts the conceptual framework postulated by the Global Financial System Project of the Harvard Business School (Crane *et al* ,1995). Crane *et al* (1995) posit that the basis of their research lies on the dynamic performance of the functions which will lead to new institutional arrangements. This framework underlines the importance of functions that preceded institutions.

Therefore the objective of this paper is to analyze Malaysia's position as an IIFC from functional and Islamic perspectives. This paper is divided into five sections. The first section, as discussed above, touches on the introduction. The second section will provide the literature review with a brief overview of the philosophical foundation of an Islamic financial system, the conceptual model of the parallelism or dualism policy in the financial system of Malaysia and the functional perspective of an IIFC. The third section examines the financial structure and development of Islamic banking and finance in Malaysia. The fourth section discusses the main functions of an IIFC in light of discussing their role in the MIFC initiative. The last section will present the prospects and a critical assessment of Malaysia's position as an IIFC.

Literature Review

This section presents the literature review that discusses the issue of definition, the philosophical foundation of an Islamic financial system, a conceptual model of an IIFC, and a functional perspective of an IIFC.

The Issue of Definition

An obvious starting point is to define what exactly is meant by the term international financial centre (IFC). A financial centre is “an agglomeration of financial firms, particularly devoted to the raising and administration of capital” (Yee, 2006). An agglomeration is often equated with the gathering or an assembly of different financial institutions and non-financial institutions to serve the needs of investors and depositors in a location or centre. Scholey (1987) adds that a financial centre is a “metropolitan area that has a high concentration of financial institutions and where the financial transactions of a given country or region are centralized.” Through centralization, the purpose of its establishment is achieved – efficiency in communication and a variety of cost savings through specialization and economies of scale.

As extension of domestic financial centers, an international financial centre (IFC) is established. These domestic centers usually offer the greatest convenience in terms of institutional communications, geographic locations and financial services and other variety of services. It is then recognized as an IFC to facilitate trade with other countries. Traditionally, the main function of an IFC was “principally net suppliers of capital to foreign borrowers”. However the traditional nature of financial centers was significantly altered with the introduction of Euromarkets after the 1960s, an “entrepot-type” and an offshore financial transaction (Scholey, 1987). A new phenomenon of adopting an effective internationalization of credit further challenged the traditional role of an IFC. It eliminates the earlier requirement to be the net supplier of domestic capital. Hence relatively unknown part of the world such as Nassau (the Bahamas), Singapore, Hong Kong and Luxemburg, became known as an established international banking centre. As recent as the late 1990s, countries from the Middle East such as Kuwait, Bahrain, Dubai and emerging markets like Malaysia, South Korea and Taiwan has made their ambition known to be IFCs.

Philosophical Foundation

The basic philosophical foundation of an Islamic financial system is structured on the *Shari'ah* or the Islamic Law; and the governing economic, political and cultural aspects of Islamic societies. The *Shari'ah* outlines in detail rules derived from the *Quran* and their explanations and implementations by the Prophet Muhammad (PBUH), commonly known as the *Sunnah*. Islamic jurisprudence scholars provide further contextual elaboration of the rules found in the *Quran* and *Sunnah*. In 1990, the late Jaffar bin Hussein, the former governor of BNM, emphasized that “the Islamic Financial system is based on Islamic principles and philosophy whereby the system itself is an integral part of Islam” (IRTI, 1995). Similarly, the formation of an IIFC follows the same principle of gradual implementation but successful realization of an Islamic financial system in Malaysia (Zeti, 2004). Therefore, it is apt to highlight the main principles in the review of literature.

The six basic principles of an Islamic financial system, as presented by Zamir Iqbal (1997), can be summarized as follows:

i) Prohibition of *Riba*

Prohibition of *riba*, which literally means “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales” is the central tenet of the system. Therefore, any positive, fixed, predetermined rate tied to the maturity and the amount of principal viz; guaranteed regardless of the performance of the investment is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” that is widely practiced.

Central to the argument for the prohibition are issues of social justice, equality and property rights. According to Islamic Law, profit earning is encouraged but interest charging is however forbidden. This is so as profits derived from lawful earning generate the creation of additional wealth and leads to successful entrepreneurship. On the other hand, interest on loans made by business operations is accrued irrespective of their income. Thus a losing business operation which does not generate the creation of wealth may lead to a failed venture. Similarly, social justice demands that borrower and lenders share rewards as well as losses in an equitable manner; and the process of wealth accumulation and distribution in the economy is fair and representative of true productivity.

ii) Risk Sharing

The prohibition of interest allows suppliers of funds to become investors instead of creditors. Thus sharing business risks in return for shares of the profits will bring about an ideal partnership between the capital provider and the entrepreneur.

iii) Money as “potential” capital

Money is treated as “potential” capital. In other words, it becomes actual capital only when it combines other resources to undertake a productive activity. Islam recognizes the time value of money, only when it is an actual capital and not when it is only a “potential” capital.

iv) Prohibition of speculative behavior

An Islamic financial system discourages hoarding and prohibits transaction featuring extreme uncertainties, gambling and risks.

v) Sanctity of Contract

Islam upholds contractual obligations and the disclosure of information as a sacred duty. These features are intended to reduce the risk of asymmetric information and moral hazards.

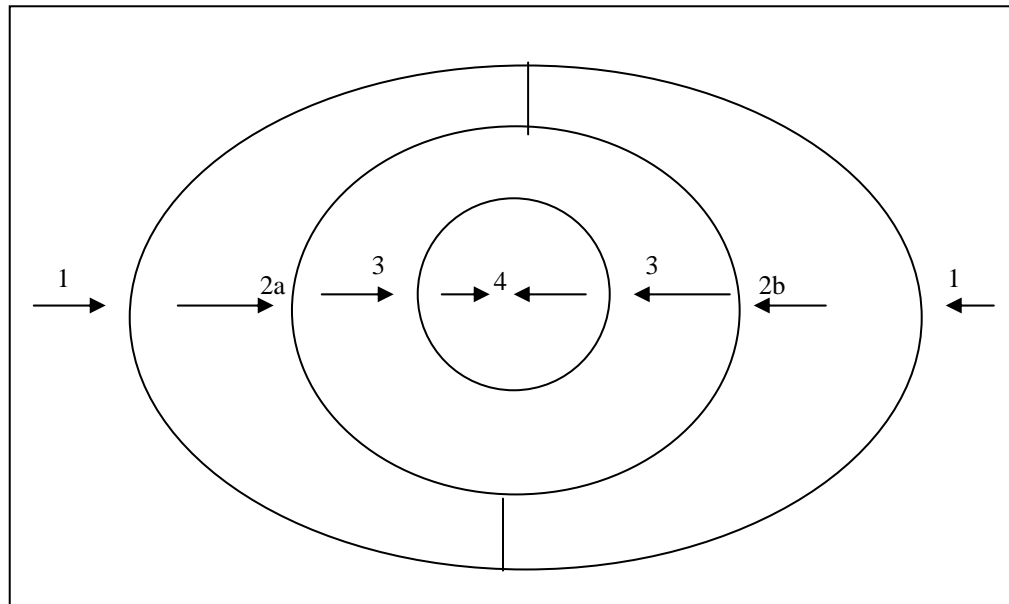
vi) *Shari’ah*-approved activities

Only business activities that do not violate the rules of *Shari’ah* qualify for investment. Therefore, any investment in unethical businesses dealing with alcohol, gambling and casinos are prohibited.

A Conceptual Model of an IIFC

The idea of this conceptual model is derived from Tan (2002) and Steiner & Steiner (2000). The conceptual model, shown in figure 1, highlights the parallelism or dualism policy in the financial system of Malaysia. In contrast, as neither noted by Nor (2002), other OIC countries treat Islamic finance merely as a special case amidst the general system with the exception of some countries namely Sudan, Iran and Pakistan where the entire system is Islamic.

Figure 1: A conceptual model



- 2. Dualism / Parallelism
- 2a. Conventional System
- 2b. Islamic System with *Shari'ah*
- 3. Privatization
- 4. Market for capital (IIFC)

The model consists of six concepts, represented by concentric circles. The outer circle represents globalization; financial liberalization and information technology are three main concepts that encompass the others. Moving inwards is dualism or parallelism viz: the provision of both conventional and Islamic system which is demarcated by a thin line and is the prerequisite for the successful implementation of the market for capital. The next circle represents the concept of privatization that is regarded as the growth engine that drives the Malaysian economy. Finally, at the core of the model is the market for capital which acts as the fuel to sustain the successful implementation of the financial system.

i) Globalization

Globalization is a term that reflects the liberalization of trade and finance, the international flow of communication, goods and people within compressed time and space across national boundaries. IMF (1997) termed it as “predominantly an economic concept” that is characterized by “market ideology” (Currie, 1998). In this study, globalization incorporates the financial liberalization and integration, information technology, and the global market for capital.

As such the concept of globalization has a considerable impact on the IIFC and offers both opportunity and threats for Malaysia.

From the Islamic perspective, Mustapha (1999) expounds that Islam has encouraged cross-border trade and investment since its early days and treats the world as a single entity separated by artificial borders only for the limited purposes of preserving each race, culture and heritage. Therefore, globalization was applicable even during then and had flourished until the banking system created by the West in the 16th century was able to outstrip the highly sophisticated international financial network that had supported the trade between Muslim communities. Hence the action taken by the Malaysian government in the 1999 financial crisis, particularly in the exchange control measures was fundamentally Islamic. Furthermore, preventing the ringgit from being traded as a commodity, at the mercy of the unscrupulous speculators and manipulators who apparently intended to undermine the Malaysian economy, was an act in line with the Islamic teaching of justice necessarily done to defend the country from further serious economic harm.

In a similar vein, the Malaysian government's view on the issue of globalization with regards to the Islamic financial system is that the interconnectivity and globalized world does not permit Malaysia to insulate the Islamic financial system from the conventional ones and it is more pragmatic to form strategic alliances with other jurisdiction of the Gulf states, the subcontinent, the South East Asian countries and even the West (Nor, 2002).

ii) Financial Liberalization

Financial liberalization, usually referred to as the “McKinnon-Shaw framework,” according to Chen and Ng (1999), stress that financial sector growth as a key element in promoting economic development. As an alternative strategy for financial sector development, interest rate resumes its role as the efficient rationing device of financial resources. Therefore, the dualism policy in the financial system allows the government not to rely solely on equilibrium interest rate as it is not the main factor that will determine the successful implementation of the liberalization program. Chen and Ng(1999) reason that a prudential banking and supervision is much needed and crucial to prevent bank failures that could jeopardize the stability and integrity of the banking system.

iii) Information Technology

Information technology has been described as the medium that facilitates the global flow of trade, finance, media, people and communication (Cunningham and Jacka,1996). Jones (1998) postulates that information technology will facilitate globalization. Globalization, in turn, enhances the growth of information technology. Furthermore, Sethi and Olson (1991) highlight the creation of a transnational environment and a global marketplace marked by the presence of multi-national and global corporations through information technology. In the area of finance, Miller and Vanhooose (2001) affirm that the development of cybertechnologies which refer to computer-based techniques for savers, investors, traders, producers, and governments, has fundamentally altered the landscape. Cybertechnologies have produced as much international

interdependence as can be seen today. The growth in world trade has resulted in the increasing volume of financial flows across borders made possible through cybertechnologies.

Malaysia's stand towards this revolution or the so-called "third wave economy" is consistent with the diversification policy that it has adopted through its various Malaysia Plans. The declaration of information technology as the next engine to lead Malaysian economic growth (Malaysia,1996), attests to the seriousness of the government in its effort to sustain its competitiveness in the dynamic global market environment.

iv) Privatization

Privatization involves the participation of private corporations providing public services which were previously run by government sectors. It is now largely accepted as the nation's instrument of economic management that replaces the failure of public institutions which had also relieved the financial constraints faced by the government during the recession of the late 1970's and early 1980's. The privatization policy which was drafted in the early 1980's proved to be successful due to its innovativeness to tie in with the country's economic policy (Uzir, 1996). The sheer size of the public sector necessitates substantial requirement for financial resources in order for privatization to take place. Nor (2002) argues that in Malaysia, the earlier phases of the development of Islamic finance was predominantly led by the government which will be in the next phase, pass the baton to the private economic agents and intermediaries who will in turn, develop the Islamic finance by innovation and adaptation amidst the dynamic growth of the Islamic capital market. This will much increase the role of various intermediaries and cause the stock exchange to mobilize both debt and equity market. Hence, an IIFC acts as a catalyst to foreign investors to place their excess fund in a country that agglomerate both conventional and Islamic financial institutions.

v) Market for Capital

Saber(1996) in his book discusses an appropriate definition of capital and security. He maintains that capital is not money. Money viz: cash, is itself not capital. It becomes capital only when it is thrown into the process of production. The cash stashed inside a mattress or in a safe deposit box is money, not capital, because it would forever remain quantitatively unchanged. However, participation in a perpetual profit-generating operation of capital turns the money into capital. In turn, the exchange of money with receipt becomes investment and the receipts become a security.

In the financial system, a financial market is a place where, a system through which, securities are created and transferred (Blake, 2000). It can be classified into five distinct areas. Firstly, the physical and the over-the-counter (OTC) market which refers to the trading of securities and includes shares, bonds and money market both in a physical market and over-the-counter using a system of computer screens and telephones. Secondly, the term continuous and call market. A continuous market operates on the basis of continuity where securities are traded during opening hours any time the markets open as opposed to call market where securities are traded at specific times during opening hours.

The third area is the money and capital market which refers to the maturities of securities traded in the markets. Money markets deal in securities with maturity of less than a year, whereas capital markets deal in those with more than one year to maturity. Fourthly, the primary and secondary market which allows investment banks to bring a new company to floatation through a process of issuing shares on the primary market called the initial public offer (IPO), followed by trading of existing securities in the secondary market. In other words, the primary market refers to the new issues market and the secondary market refers to the trading of existing securities in the market. Lastly, the stock market refers to the prices of securities in the secondary market determined by market-makers of those securities. After the security has been issued, it exists in the marketplace until it matures and is redeemed. The stock market allows a security to be sold to a willing buyer at a price accepted by both parties.

Blake (2000) further discusses the importance of understanding the characteristics of a market to gauge the costs and risks of the market. Thus, a market in a particular country is said to have breadth if it has a substantial volume of both buy and sell orders at an agreed price or the equilibrium price. A thin market on the other hand, is one which has few buyers and sellers. A highly liquid market is one with substantial breadth. A market is known to have depth when there is a small change in the market which indicates less risk incurred by market-makers on their inventories. As opposed to a deep market, a shallow market is where the changes in the price are higher, resulting in high risks and greater volatility to the market. A market is said to be resilient if the flow of buy and sell orders do not dry up whenever the price changes. In other words, market-makers will not be faced with an inventory of unsaleable securities at a small price change because they are willing to charge a smaller spread.

In the Malaysian context, understanding the different types of market and classifying them according to its characteristics will allow investors to be either “information motivated” or “liquidity-motivated”. This will drive further the interest to be more involved in the successful implementation of realizing Malaysia’s vision as an IIFC.

vi) Dualism or Parallelism in the Financial System

The unique concept of dualism in the financial system adopted by Malaysia is a deviation from the conventional system. Some Muslim countries such as Sudan, Iran and Pakistan have transformed their financial system into an Islamic system and this is construed to be idealistic rather than an alternative system. Some Muslim countries treat Islamic finance as a special case of the general system reflecting a lackadaisical attitude towards it and an apparent lack of foresight of its benefits to the Muslim world.

Promoting the dualism concept allows Malaysia to adopt best practices of the conventional system through good corporate governance, openness, transparency, accountability and uniform regulation. At the same time, the government takes cognizance of the need to develop a comprehensive parallel system where capital is intermediated to the best use based on the principles of *Shari’ah*.

According to institutional theories such as DiMaggio and Powell (1991), the successful implementation of the concept of dualism or parallelism in Malaysia is largely due to specific forces namely coercive force and mimetic force.

Coercive force refers to both formal and informal pressures upon which organizations are dependent. In this study, the state viz; the Malaysian government is a major coercive force which has instituted a competitive environment and infrastructure for information technology and financial institutions. Enforcement by a regulative body and best practices in corporate governance allows the concept of dualism to be carried out successfully.

Mimetic force denotes copying or modeling successful behaviors or structures. Efficiency in copying existing conventional sophisticated financial instruments may overwhelm the desire to develop every Islamic financial product from scratch. Other factors that play a pivotal role in this force are the government policies towards globalization, privatization and financial liberalization that can adapt to Malaysia's planning.

vii) International Islamic Financial Centre – Historical and Functional perspective

Kindleberger (1974), lamented that “the formation of financial centres is no longer studied in economics” and has taken the task to trace the formation of financial centre from the historical perspective. His study suggests that prior to 1870, there were a large number of cities providing regional and global financial services, but none greatly dominated the others. Kindleberger (1974) contends that the period after 1870 saw London as the dominant IFC in the world and remained so until the outbreak of World War I in 1914. After the war, New York replaced London as the dominant IFC until after World War II. However, London regained the status as the preferred IFC when the US governments adopted the restrictive regulations on US banks which hampered their ability to offer competitive rates on deposits. (Kaufman, 2000) observes that with the development of the Eurodollar and Eurocurrency markets in financial centres in the early 1970, allowing dollar deposits and loans to be offered at banks outside the U.S., has resulted in a large volume of international financial activity shifted back to London.

In his study, Kindleberger (1974) propounds a theory that forms a framework to determine the suitability of individual cities as financial centres. His staple theory highlights several major factors that he deems necessary in establishing a financial centre. Firstly, sovereign finance is a factor to consider because of the need of funding personal spending habits and war activities. Secondly, commercial finance is another factor which includes funding of trade and shipping. In the eighteenth and nineteenth centuries, financial firms began to facilitate trade through the issuance of short terms, low interest loans. Hence, with trade, it provided a ready market for financial service firms to start short-term loans.

Thirdly, the government finance is another factor that has seen the changes in the governmental power from the feudalism towards national governments. Loaning to the aristocracy was ceased. Bankers and financiers switched to raising capital for government through the issuance of bonds or other mechanism. Fourthly, the factor relating to transportation finance particularly canals and railroads. With increased transportation finance, in the form of direct finance of chartered transport companies or funding of government efforts, it enhances trade and provides

opportunity for financial firms to lend to highly profitable ventures. Due to the nature of the projects that are long term, locating near to the projects is a prudent move to safeguard and protect their investment. Naturally, where transportation networks are headquartered, so too are the firms that fund them.

Fifthly, another pertinent factor is the industrial finance. Through industrial finance, there exist a co-location with industrial firms to allow the management of cash reserves for industrial conglomerates and lending of capital to the same industrial conglomerates. Therefore, more industry might lead to more financial firms located around them. This in turn necessitates financial firms to co-locate. Finally, the personal finances factor. This factor was seen as the most powerful forces in economics. Innovative financial instruments were created to attract personal savings and personal loans allowing financial firms to be located around population centres.

In a highly developed setting such as New York or London, Kindleberger (1974) lists the money market into three broad categories. First is the money market with many specialized segments for “specialized paper, acceptances, collateral loans, treasury bills etc.” Second is the capital market catering to both the government and private sector which deals in “new issues and secondary distribution”. Third is the trading in commodities, foreign exchange and insurance. These functions are initially carried out locally and extend to a national centre. As the market achieves a certain level of critical mass it is elevated at regional level and subsequently to an international level. Thus, on hindsight, the ramification of the money market as discussed by Kindleberger (1974) is being crystallized by the Malaysian government in a form of the MIFC initiative.

An equally important study conducted by Crane *et al* (1995) from the Harvard Business School on the “Global Financial System” outlines the functional perspective that explains the dynamic performance of the functions which lead to a new institutional arrangement. Crane *et al* (1995) claim that understanding the performance of the functions and how the performance is changing are key aspects towards a better appreciation of evolution of a financial institution, in general, and a financial system in particular. In other words, using the functional perspective will better explain the changing nature of the financial markets.

Merton and Bodie (1995) state six core functions perform by a financial system within a financial centre. Firstly, on the methods of clearing and settling payments to facilitate trade which refer to the function of the foreign exchange services provided by an IFC. Secondly, to allow transfer of resources through time, across borders and among industries refer to the role of an IFC in providing international banking facilities. Thirdly, is to provide a mechanism for the pooling of resources and for subdividing the shares among enterprises. This third function covers the fund management aspects relating to direct finance in an international setting. Fourthly is to provide risk management facilities that include insurance and reinsurance. Fifthly, is to provide price information to help co-ordinate decentralized decision-making in various sectors of the economy. Lastly, is to provide ways of dealing with the incentive problems arising from asymmetric information. The discussion on the last two functions, albeit their importance to the success of a financial centre is outside the scope of the study.

A unique function to be included in this study is the role of the National *Shari'ah* Advisory Council (NSAC). This council oversees matter relating to financial activities that are in compliance with the principles of *Shari'ah*. NSAC is the “nerve centre” of an IIFC without which, it represents only in “form” rather than “substance”. As some established conventional IFCs assert that their foray into Islamic Finance is specifically to add to the “financial suite”(Channel News Asia, 2007) offered to investors and depositors and “to jump into the bandwagon” to gain a market share of the huge potential market estimated at US300 billion and growing at a rate of 20% per annum.(Zeti, 2006)

In Asia, similar studies on IFCs were conducted to shed light into the relevant contributions of financial centres located outside Europe and North America. One such study was conducted by Jao (1993) who underlines Hong Kong’s evolution as an IFC which is characterized by its “functional and integrated” approach. Functional because the financial sector generates substantial income and employment and integrated due to its flexibility in allowing financial institutions to engage in both onshore and offshore business, whether denominated in local or foreign currencies. Other study includes Ng (1998) who compares Hong Kong and Singapore as IFCs from the functional perspective. Four functions were incorporated in his study and the results indicate that both Hong Kong and Singapore play a complementary role to be slotted as the second IFC, after Tokyo, in the Asia Pacific region. Thus, adopting Ng’s (1998) work and the inclusion of the NSAC as a prerequisite function in the establishment of an IIFC, will add a new dimension in understanding the formation of financial centers from the Islamic perspective.

FINANCIAL STRUCTURE AND DEVELOPMENT

This section examines the historical background of the Malaysia’s financial structure and development from the 1970s to the present .

Table 1: Structure of Malaysia’s Financial System (As at 31 December 2005)

	Total Assets (RMbil)	No.	Year Established
Banking System	1,280.8		1959
Commercial Banks	842.4		1959
Finance Companies	26.9		1969
Merchant Banks	46.6		1970
Islamic Banks	43.6		1983
Discount Houses	26.0		1959
Foreign Bank Representative Offices			
Non-Bank Financial Intermediaries	627.7		
Employee’s Provident Fund	263.9		1951
Other provident and Pension funds	56.8		
Life Insurance Funds	83.7		1988
General Insurance Funds	18.8		1988
Development Finance Institutions	100.1		1959-2005
Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat, SME Bank,Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Pilgrims Fund Board, Credit Guarantee Corporation, Sabah Credit Corporation, Malaysia Industrial Development Corporation (Sabah) Sendirian Bhd			
Other Financial Intermediaries	104.4		1959 - 2005
Amanah Saham Nasional Berhad (ASNB), Amanah Saham Mara Berhad			

Cooperatives Societies, Leasing Companies, Factoring Companies, and housing credit institutions (Cagamas (Secondary Mortgage Finance), Borneo Housing Mortgage Finance Berhad and Malaysia Building Society Berhad)			
Islamic Insurance (Takaful)			1984
Unit Trust Companies			1959
Islamic Unit Trust			
Capital Market			
Bursa Malaysia			1973
Islamic Money Market			1994
Malaysia Exchange of Securities Dealing and Automated Quotations Berhad (MESDAQ)			1997
Malaysia Derivatives Exchange			2001
Kuala Lumpur Commodity Exchange(KLCE)			1980
Malaysia Monetary Exchange(MME)			1996
Kuala Lumpur Options and Financial Futures Exchange (KLOFFE)			1995
Labuan Offshore Financial Services Authority(LOFSA)			1990
Venture Capital Companies			1984
Regulatory Authorities			
Bank Negara Malaysia (Central Bank)			1959
Securities Commission			1993
National <i>Shari'ah</i> Advisory Council			1997
<i>Shar'iah</i> Advisory Council			1996
Rating Agencies			
Rating Agencies Malaysia			1990
Malaysia Rating Corporation			1995
Source: Bank Negara Malaysia			

Historical Background

BNM, the Central Bank of Malaysia, was set up in 1959. It inherited a rudimentary financial system with limited regulation and earned the formidable task to catapult a robust and sound financial system (Ong,1999). The initial task is to set into motion the process of institutional building (see table 1). The next task was to exercise its power to regulate all banking and licensed financial institutions involved in credit and finance under the Banking and financial Institutions Act, 1989(BAFIA). An equally uphill task faced by the BNM was to realize the successful implementation of the ten-year Financial Sector Masterplan(FSMP) unveiled in 2000 which acts as a roadmap for the future development of the financial system in Malaysia.

The proper institutions having been established, the legislative body now in place and the future of the financial sector well planned, the establishment of the Securities Commission (SC) in 1993 added a new dimension to the financial sector.

Under the Securities Commission Act 1993, the SC assumed responsibility in regulating the capital market beginning March 1 of that year. Its major role lie in the areas of promoting and maintaining fair, efficient, secure and transparent securities and futures markets and facilitating orderly development of an innovative and competitive capital market (SC,2000).

With the mandate given by the government to broaden and deepen the capital market, the SC has embarked on several initiatives that involve both the conventional and Islamic capital market. The successful implementation of Islamic capital market (ICM) in Malaysia was due to the

government's commitment; next, the interest and commitment shown by investors and issuers upon the success of the Islamic Banking Scheme (IBS); and finally, the presence of an available pool of experts from industry participants and Islamic scholars who are willing to discuss on issues in a manner that would benefit the market. Over and above these success elements, creative ideas and innovations are constantly injected by the SC to vitalize the ICM.

Before BNM set up the National *Shari'ah* Advisory Council (NSAC) in 1997 to standardize the regulatory functions of the *Shari'ah* related policies, the SC has initiated an informal group called the Islamic Instruments Study Group (IISG). This group was initiated to encourage healthy dialogues, debates and discussion on issues and challenges faced by the ICM between Islamic scholars and industry participants. IISG was later established in 1996 as a formal advisory body known as *Shari'ah* Advisory Council (SAC). The dynamism and openness on the part of the members of the SAC has contributed to the tremendous progress of the ICM. The four main activities that have been successfully carried out; increasing the universality of Islamic financial instruments, reviewing biannually all permissible counters on the Kuala Lumpur Stock Exchange (KLSE0, now known as Bursa Malaysia, issuing the first benchmark bond based on the Islamic principles and assigning a member of the steering committee to develop an Islamic Accounting standards.

To instill greater confidence among Muslim investors on the financial instruments in ICM, SAC published the book "Resolutions of the Securities Commission – *Shari'ah* Advisory Council" which lists down all the resolutions passed by the SAC. The book highlights all matters pertaining to the *Shari'ah* rulings of the financial instruments and services introduced in the ICM to counter general misconceptions and aspersions cast on the Islamization of ICM.

In accordance with the FSMP that charts the future direction of the financial sector, the SC unveiled its Capital Market Masterplan (CMP) in February 2001 with visions that the CMP would act as an impetus to the long-term economic objectives, develop a highly efficient conduit for the mobilization of funds and adopt a supportive, strong and facilitative regulatory framework for the smooth running of the capital market in Malaysia.

Upon analyzing the systematic set up and the gradual implementation of the regulatory bodies for both Islamic Banking (IB) and Takaful industry and the ICM, it is noteworthy to analyze the establishment of these industries as early as the 1960's.

Establishment of an Islamic Bank

The establishment of the Pilgrims Fund Board (PFB) in 1969 has spurred local interest in the field of Islamic Banking and Finance. The success story of the PFB as the first Islamic financial institution in Malaysia, has accelerated the Malaysian government's effort to Islamize the banking and insurance industry. It initiated the enactment of the Islamic Banking Act (IBA) 1983 and the Government Investment Act (GIA) 1983 to facilitate the establishment of the first fully-pledged Islamic Bank in Malaysia. In July 1983, Bank Islam Malaysia Berhad (BIMB) was established. Operating without any competition, for 10 years had made it possible for the bank to grow and develop many of its products. The government acted upon the GIA 1983, issued government bonds or the Government Investment Issues (GII) based on *Shari'ah* to allow BIMB

to meet liquidity requirement and to park its idle temporary funds (Rustam, 2002). With a modest deposit of RM91mil in BIMB at the end of 1983, the amount increased to RM479mil at the end of 1985. For the same period, loans and assets started off with RM45mil and RM171 respectively. The trend for loans and assets, as at end of 1985, shows an increased to RM355 and RM584 respectively (Malaysia, 1986).

Establishment of Islamic Insurance (Takaful)

As an important sub-sector of the financial system, the establishment of the Islamic insurance coexisting with Islamic Bank is a prudent step undertaken by the Malaysian government (BNM,2000). Through the enactment of the Takaful Act 1984, the first Islamic insurance company, *Syarikat Takaful Malaysia Bhd* (STMB), was established within a year. A second company, *Takaful Nasional Sdn. Bhd* was formed in 1993 and added a new dimension to the insurance industry based on *Shari'ah* principles.

Under the administration of the BNM, the regulatory body of the Takaful Act 1984, the takaful industry has seen tremendous growth in its core activities namely, the Family and General Takaful. During the Sixth Malaysia Plan period, the assets of the *takaful* industry increased significantly by 36.8% from RM38.2 mil in 1990 to RM182.7 million by 1995 (Malaysia , 1995). BNM steps up further to boost the takaful industry by unveiling a five-year strategic plan in 1998. This plan outlines the government seriousness to pursue the strategies that will spur the development of the *takaful* industry (BNM,2000) To achieve this, *Takaful Nasional* (2000) recommends that the *takaful* industry engage in an aggressive approach to investment in *Shari'ah* compliant products with prudent and best practices in risk management. Pursuant to this, BNM embarked on measures to enhance the regulatory framework and financial surveillance of takaful operators, including reviewing the Takaful Act 1984 and developing accounting standards, model accounts and financial statements for takaful business (BNM, 2000). This further accentuates takaful industry's significant role as an important contributor to the Malaysian market for capital.

Introduction of Dual Banking

Outlining the gradual approach undertaken by BNM for the successful implementation of the parallelism or dual banking system in Malaysia, Awang Adek (1999) explains that the monopolistic years from 1983 to 1990 had allowed BIMB to operate in smoothly without a single competition to hinder the progress in implementing Islamic Banking (IB) in Malaysia. The developing years from 1990 to 1994 was a milestone in the history of IB. In 1990, the visionary governor of the BNM, the late Jaffar Hussein, expressed his dream of seeing IB functioning as a full-fledged financial system alongside the conventional system (Nor, 1995). In realizing Jaffar's dream, necessary amendments were made to the existing Banking and Financial Institutions Act 1989 (BAFIA) in 1993 and again in 1996 to legalize conventional banks to operate IB windows or the Islamic Banking Scheme (IBS). This has allowed the entrance of a large number of other financial institutions offering IBS and prompted Rustam (2002) to regard it as the most effective and efficient way to disseminate IB a the lowest cost, within the shortest time. This assertion is evidently reported in the 8th Malaysia Plan where the total assets of the Islamic Banking sector

grew rapidly by 51.7% from RM6.2billion in 1995 to RM47.1billion by the end of 2000. With deposits mobilized from RM4.9billion to RM35.9billion over the same period. (Malaysia, 2001)

Awang Adek (1999) emphasizes that the take-off years from 1994 to 2000 offered an optimistic future of IBS. The BNM has played a central role in providing adequate Islamic financial infrastructure such as the enactment of the Islamic Banking Act 1983 and the amendments to the BAFIA 1989; the regulatory framework which streamlines the financial disclosure through working closely with the Malaysian Accounting Standards Board (MASB) in studying various accounting standard developed by the Accounting Auditing Organization for Islamic Financial Institutions (AAOFI); erecting firewall in the payment system for IBS; and most notably, the establishment of the National Shari'ah Advisory Council in 1997. Therefore, in a nutshell, riding on the successful implementation of IBS and a favorable Islamic financial infrastructure, the government believes that the concept of dualism can also be applied to the capital market.

In the conceptual model, the market for capital includes the financial market which consists of two distinct markets. According to Rose (2000), these two markets are divided into the money market and the capital market. These two markets may be viewed as channels which a vast flow of loan able funds moves. These funds are continually being drawn upon by demanders and continually being replenished by suppliers (Rose, 2000). Similarly in Malaysia, the SC divides the ICM into two main markets: the equity and Islamic debt market (Rustam, 2002). While the money market is not covered in this scope of this study, it is worthwhile to look into briefly, the establishment of the Islamic Money Market (IMM) in Malaysia and its role in the making of short-term loans.

Establishment of the Islamic Money Market

The Islamic money market (IMM) was established in January 1994 and it was regarded as the first of its kind in this region (Rustam, 2002). According to BNM, the IMM was established solely as a system that allows banks to obtain funds from another bank as a source of funding or investment of its short-term funds on the basis of *Mudharabah* (profit-sharing) principles. In other words, based on the principle of the conventional inter-bank loan or investment, the *Mudharabah* inter-bank investment allows banks with surplus units to invest in deficit units of other banks based on the *Shari'ah* principles of *Mudharabah*. This *Mudharabah* inter-bank investment acts as a vehicle to trade Islamic papers such as the short term instruments like the Islamic Acceptance Bills (IAB), Bank Negara Negotiable Notes (BNNN) among others. In other words, with the introduction of IMM, it permits economic units to manage their liquidity positions as in the case of the IBS in Malaysia. In 2005, the stable liquidity position in the inter-bank money market has led to a steady turnover volume of RM21billion as well as stabilizing the rate of return of the *Mudharabah* inter-bank investment transaction at an indicative overnight rate of return of 2.6 per cent (BNM, 2006).

The Islamic Capital Market

Conventionally, the term capital market refers to the institutions that provide a channel for the borrowing and lending of long-term funds (over one year) (Rose 2000). In general the ICM is

defined by the SC as a market where activities carried out do not conflict with the Muslims' conscience and Islam. *Shari'ah*, as the governing religious law, ensures strict conformity with its law in ICM transaction. All transaction should be free from the involvement of activities prohibited in Islam and free from prohibited elements such as usury (*riba*), gambling (*maisir*) and ambiguity (*gharar*). Wilson (personal communication, October 5, 2001), a prominent scholar in Islamic thought, adds that ICM is a market where securities traded are acceptable under the *Shari'ah* law and trading methods are *halal*, which implies transparency and clear implementation of Islamic law.

In Malaysia, the SC is the regulatory body of the ICM under the Securities Commission Act 1993. The SAC was formed to advise SC on matters pertaining to the systematic development of a comprehensive ICM as well as to serve as the focal point of reference on all issues relating to the ICM and *Shari'ah* (Mohd Munir, 1996). The ICM is divided into two distinct markets viz; the equity market and the Islamic debt market (Wan, 2001; Rustam, 2002). As Malaysia adopts the concept of dualism, the Derivatives Market is included for the immediate plan by SC to be *Shari'ah*-compliant in 2003 (New Straits Times/Business Times, 12 August 2002).

i) The Equity Market

Under the equity market, Rustam (2002) divides the market into four main components. Firstly, the Islamic unit trusts which forms only a small portion of the entire unit trust industry enjoys government confidence of a rapid growth in the years ahead (Mahathir, 2002). Secondly, the initiative by the SC to access securities floated in the KLSE, now called BURSA Malaysia (BM) and MESDAQ as approved securities allows Muslims to invest in a more Islamic environment. With strict general criteria to conform to the *Shari'ah* and the definition of ICM the approved or "purified" list is updated twice yearly to ensure transparency and total compliant to the SAC ruling. Thirdly, the introduction of the Kuala Lumpur Stock Exchange *Shari'ah* Index (KLSI) in 1999 allows investor to track the performance of the *Shari'ah* approved securities. This KLSI acts as a barometer to ensure that Muslim investors acted according to the precepts of the Islamic Law. Lastly, Islamic stock broking companies were formed to facilitate the necessary transaction to trade and invest in the SAC approved counter in the stock market.

ii) The Debt Market

The second market is the debt market. In conventional term, Rose (2000) pointed out two main components of the debt market; notes and bonds. Notes refer to a shorter-term debt obligation issued by a business firm, individual, or unit of government to borrow money with a time maturity that usually does not exceed five years. Bonds refer to debt obligations issued by a business form or unit of government that covers several years, usually over five years.

The range of borrowers covers families and individuals, government and most importantly business of all sizes that issue long-term IOUs to cover the purchase of equipment and the construction of new facilities, the suppliers of the capital market funds are financial institutions such as insurance companies, mutual funds, security dealers and pension funds. The suppliers of funds available in the ICM in Malaysia include savings in Pilgrimage Fund Board (PFB) and

funds invested in the *bumiputra* (indigenous Malays) savings vehicle such as *Amanah Saham Bumiputra* and assets of the *takaful* industry.

In Malaysia, the concept of dualism is acceptable in the debt market and it is referred to as securities debt market and loan market (Azmi, 2002). The study of the securities debt market comprises three areas, namely the Cagamas Bonds and Notes, Malaysian Government Securities and the most important, the Private Debt Securities (PDS). Azmi (2002) demarcates the conventional PDS from Islamic Private Debt Securities (IPDS) through the definition of IPDS as “securities issued by company (called the issuer) the investor (financier) to evidence in indebtedness arising from the earlier transaction that is based on Islamic principles.” The IPDS comes under the definition of “debenture” as extracted from the SC (Amendment) Act 2000. Thus, debenture includes debenture stocks, bonds, draft or any other bills of exchange. In Islamic term it is known as *shahadah al-dayn* (certificate of debt) or *sukuk* (certificate).

As far as the development of the IPDS is concerned, Daud (1997) reasons that Malaysia has adopted a process of securitization where illiquid assets are transformed into a tradable security, suggesting that through securitization, debt is tradable on the secondary market. Wan (1995) argues that through securitization, borrowers have direct access to the capital markets and lenders are able to liquidate their positions and opt for better investment opportunities. He mentions that there are two types of securitization in Malaysia, namely debt and asset-backed securitization.

Debt securitization refers to the issuance of securities substituted for debt arising out of financing facilities – such as the first IPDS issued in 1990 for Shell MDS – based on an underlying transaction which necessarily involves an element of commodity or the equivalent (Daud, 1997). As mentioned by Azmi (2002) the selling price arising from this contract refers to certificated of debt or *shahadah al-dayn*.

On the other hand, asset securitization refers to the issuance of asset-backed securities. Wan (1995) further explains that asset-backed securities for IPDS refer to the process of securitization involving two elements of debts. The first debt arises from the securitization of the Islamic house-financing assets purchased from the financial institutions. In the case of the RM30 million Cagamas *mudarabah* Bonds issued by Cagamas Berhad in 1994, the first debt involved the *Bay Bi Thaman Ajil* (BBA) (deferred payment) financing extended by BIMB to its customers. The second element was the issuance of *al-mudarabah* bonds by Cagamas to financial institutions participating in the *mudarabah* call for raising funds to finance the purchase of an identified pool of BIMB’s house-financing debt (Wan, 1995). Therefore, under the concept of *mudarabah* (profit sharing), both holders of Cagamas bond and Cagamas itself will share the profits generated from the acquired pool of debt and the income earned from the reinvestment of reflow of funds from the pool based on a predetermined ratio (Wan,1995). At present, many innovative financing instruments have been introduced in Malaysia and naturally affirms Malaysia’s prospect as the likely candidate to be the centre for Islamic banking and finance.

Establishment of Rating Agencies

In 1990, the Rating Agency Malaysia Berhad (RAM) was established and followed by the formation of another independent rating agency – Malaysian Rating Agency Berhad (MARC). The functions of these two independent rating agencies are to create transparency and instill market confidence in the rating of bonds and financial institutions. RAM (2002) noted that since its establishment, it has played a pivotal role in the development of the conventional PDS and IPDS market. RAM (2002) argues that although there are considerable interest in the IPDS in Malaysia, there are jurists in other parts of the world, especially the Middle East, who allege that there are some Islamic debt papers issued in Malaysia which seem to involve transactions that admit ‘back door’ interest. Due this flaw, they have not been comfortable with the concepts and have vehemently attacked the practice.

In addition, the absence of harmony in the interpretation of *Shari’ah* for some IPDS issued in Malaysia hampers the government’s effort in attracting potential funds from the Middle East. Thus the government seriously undertakes a proactive approach to address this problem. Relevant agencies were assigned to introduce innovative products that are able to convince Middle East investors to invest. This positive stance has proven to be successful when Malaysia offers the world’s first *sukuk* (certificate) globally at US\$600million and received overwhelming response from global investors.

The Derivatives Market

According to Culp (2002), derivatives, another non-traditional securities that has captured nearly US\$400 trillion in derivatives outstanding at year-end 2000, is a great testimony to the effectiveness of these instruments. Derivatives were dubbed by Rose (2000) “among the newest kinds of the financial assets.” A derivative transaction as defined by Culp (2002) is a “a bilateral contract whose value is derived from the value of some underlying asset, reference rate, or index”. In conventional term, Culp (2002) adds that derivatives which are primarily used for risk transfer can be an effective tool to be used in fine-tuning the risk transfer process so that specific risk can be targeted for disposition by the firm.

However, Obiyathullah (1999) defines a derivative instrument as simply a financial instrument or an asset that derives its value from the value of some other underlying asset. He argues that with the vast potential that can be reaped from this exciting range of instrument, ignoring it will be a loss to the Islamic banking and finance industry which is lacking in the generation of innovative *Shari’ah*-compliant financial instruments. Three main instruments that is viable for ICM are the forwards, futures and options.

In his book on the analysis of futures and options, Kamali (2000) reasons that derivatives such as futures and options enable producers, merchants and suppliers to plan their production and marketing activities, He further argues that if the expected result of the standard interpretation of the *Shari’ah* is “allowed to continue”, it would decelerate further development of Islamic finance as a whole and retard efforts to allow financial institutions in the Muslim world to enhance and diversify their own resources.

In this respect, the Malaysian government has initiated the establishment of the Kuala Lumpur Commodity Exchange (KLCE) in 1980 under the provision of the commodities Futures Trading Act 1980. Although it is a relatively thin market, the government anticipates the potential of derivatives through the establishment of the Kuala Lumpur Options and Financial Futures exchange (KLOFFE) in 1995 which was legislated under the Futures Industry Act 1993. Simplifying the trading of derivatives under one roof has led the government to integrate all derivatives exchange into one. The establishment of Malaysia Derivatives Exchange (MDEX) in 2002 was in fact quite timely. MDEX offers a large array of derivatives products and services including KLSE composite Index Futures and Options, Crude Palm Oil futures and Kuala Lumpur Inter-Bank Offered Rate Futures.

Establishment of LOFSA

The establishment of Labuan Offshore Financial Services Authority (LOFSA) in 2002 demonstrates Malaysia's seriousness in projecting itself as the forerunner of the centre for international Islamic finance. LOFSA is used as a platform to make headway in "spurring the development of Islamic banking and financial activities such as *retakaful* business, developing and strengthening the capital market, e-commerce and other ancillary activities"(LOFSA, 2002)

In establishing Labuan as the International Offshore Financial Center (IOFC), Mahathir (2002) reemphasizes the need to broaden on-line trading activities to keep up with the new economy and increase the distribution channels and transaction volume. Thus, Labuan International Financial Exchange (LFX), was set up in 2002 for the sole purpose of leveraging on the information technology. It was regarded as the only one-stop web-based financial exchange in the region and assigned the task to further accelerate its on-line trading activities to propel the ICM further into the global scene.

In the other global front, the International Islamic Financial Market (IIFM) Board was formed in 2002 in Bahrain to facilitate the Islamic financial market development. It outlines the regulatory framework for the IIFM based on *Shari'ah* principles (Rustam, 2002). The founding members include Malaysia as the key player for the successful implementation of the IIFM. The harmonization of the accounting standards based on *Shari'ah* principles known as the Accounting & auditing Organization for Islamic financial Institutions (AAOIFI) set up in 1991 in Bahrain allows financial institutions to streamline their accounting standard to those outlined by the AAOIFI (Munir, 1996).

The establishment of the Islamic Financial Service Board (IFSB) was a milestone in the history of Malaysia's conscientious effort at establishing itself as the key player in the ICM and Islamic banking and finance. Formed in Nov 2002 with headquarters in Malaysia, the IFSB serves as an association for central banks, monetary authorities and other institutions that is responsible for the regulation and supervision of the Islamic financial services industry (IFSB,2002). Its establishment completes the infrastructure needed to realize Malaysia's aspiration to be the centre for Islamic banking and finance.

International Islamic Financial Centre

To realize the goal of becoming an IIFC, Malaysia has utilized almost every basic infrastructure in order to function as one of the effective centers. To gauge how far Malaysia has lived up to the criteria, a comparison with an established international financial centre was done. London was chosen because it has the largest share of many international markets (IFSL, 2002) as compared to New York, Tokyo and Singapore.

IFSL (2002) articulates that London has a significant presence in many international markets such as; foreign equity trading, international bond issuance and secondary trading, foreign exchange dealing, marine and aviation insurance and cross-border bank lending. Several factors are used to underpin London's status as an international financial centre.

Firstly, with hundreds of years of its establishment, London has the history of openness combined with a relatively easy access to markets and a tradition of welcoming foreign firms. Secondly, sustaining its trading culture which spans over a century ago puts the UK as the dominant world trading center. Thirdly, London is able to bring about a concentration of firms in one location contributing to economies of scale. There was improved flow of information, greater liquidity, enhanced efficiency in organized market and the concentration of support service help to reduce costs.

Fourthly, the presence of high quality professional and support services such as accounting, actuarial, legal and IR creates plenty if synergy in the financial market. Fifthly, London provides excellent infrastructure such as substantial physical assets, particularly office accommodation and efficient telecommunication services. The next factor is the promotion of innovation which was facilitated by the trading culture and the wealth of expertise. The seventh factor is inculcating market confidence through a positive perception of a proportionate approach to London's regulatory climate, which further facilitates innovation. Finally, the wide use of the English language attracts significant number of foreign firms to London.

It is interesting to note that London is promoting itself as the leading international centre for specialized banking and investment products, particularly in Islamic banking and finance. There are about 20 banks in London that supply financial and investment products on Islamic principles, more than are based in the rest of Western Europe put together (IFSL, 2002). This naturally becomes the greatest attraction for the Arab community. Apart from this historical link factor and the limited access to financial markets in other Islamic countries further affirm their preference for London.

In such a scenario, Malaysia is to emerge with concerted openness while adopting a positive attitude towards making the success story of London as the center for international finance and icon against which to measure up her performance and standard in her bid to establish herself as an international center of Islamic banking and finance. Only through consistent policies and by constantly promoting innovativeness will Malaysia be able to fill the slot for the financial centre in the Asia Pacific (Montes and Tan, 1999) and becomes the leading international Islamic financial center.

A FUNCTIONAL PERSPECTIVE

This section will elaborate further the four main functions as propounded by Merton and Bordie (1995) and the function of a *Shar'iah* Advisory Council (SAC) to affirm Malaysia's position as the leading IIFC.

Foreign Exchange Services

Ng (1998) asserts that an international financial centre cannot be developed without a foreign exchange market. This is evidently shown by London, New York, Tokyo, Hong Kong and Singapore. Montes and Tan (1999) reiterate that Malaysia is still lacking behind other international financial centers in many areas and in order to fill the slot in the Asia Pacific region, Malaysia has to introduce new measures that will be a focus for investors to utilize the foreign exchange services offered by the offshore center such as LOFSA or the onshore Kuala Lumpur Foreign Exchange Market.

Malaysia also has to embrace some of the intermediary practices relating to foreign exchange services that have been successfully implemented by Singapore. The first practice is regarding the trading activity in the region. Countries in South-East Asian region traded the commodities they produced in US dollars. Therefore these transactions constitute the supply of US dollars and Singapore capitalized on this transaction as the exchange centre. Secondly, it relates to the export-oriented industries in the Asian region. With many multinationals dominated by the US and Japan, transaction of imports of electronic components and export of finished electronics products are carried out in either US dollars or yen terms. Thirdly is regarding the direct or indirect pegging of US dollars to the country's currency and the intervention currency for foreign exchange market deals in the US dollars. As a result, the US dollars was traded at approximately 80% of the transaction conducted in this region and the Japanese yen ranks second for the remaining 20% of the currency used (BIS,1995).

Thus taking note of this trading phenomena and capitalizing on LOFSA strategic position, emulating Singapore's strategic move may cause concern to Singapore. After all, Singapore has regarded LOFSA as a threat to them in the quest to be the leading centre in providing foreign exchange services (Ng, 1998). However it is interesting to note that after the government's announcement of the shift in exchange rate regime in July 2005, the Kuala Lumpur interbank foreign exchange market experienced an increase in the volume estimated at RM 650 billion for the share of US dollar – ringgit transaction to 93.3% of the total transaction. This figure is a far cry from the estimated volume of interbank transaction in the Kuala Lumpur Foreign Exchange Market transacted at estimated value worth around RM1,400 billion in 1997 (BNM,2006)

International Banking Facilities

Another equally important function of an IIFC is the capacity to facilitate international financial intermediation and extending direct finance through the provision of issuing and underwriting facilities.

Malaysia has undergone a series of consolidation and rationalization exercises and the number of domestic banking institutions decreases from 54 to 10 banking groups (Malaysia, 2006). The rationale behind this consolidation exercise is two folds; to refocus on further improving productivity and competitiveness and to benefit from economies of scale. It was reported that total assets and liabilities of the banking system has expanded at an average annual rate of 7.8 per cent to RM959.4 billion and 8.1 percent to RM693,425mil respectively as at end of 2005 (Malaysia, 2006).

From the perspective of the Islamic Financial System, the Islamic Banking industry grew at an average annual rate of 18.9 per cent in terms of its assets, passing the RM100 billion threshold (Zeti, 2006) This vast increase only represent 11.3 per cent of total assets of the banking system as at end of 2005, up from 6.9 per cent in 2000. The growth of the total deposits in the Islamic banking institutions was 11.7 per cent of the total deposits of the banking sector.

The completion of the rationalization and consolidation exercise of the banking system has paved way for the government to bring forward the liberalization of the Islamic banking sector from 2007 to 2004 with the issuance of three leading foreign Islamic financial institutions. As at the end of 2005, seven domestic banking groups were accorded approval to establish an Islamic subsidiary under the commercial banking arm. The number of the full fledged Islamic banks increased from two to six in 2005. With consolidation, there was a corresponding decrease in the number of conventional banking institutions participating in the IBS. Out of 14 finance companies in 2000, only one offered IBS as at the end of 2005. Meanwhile the merchant banks refocused their banking operations and are no longer required to maintain dedicated IB (Malaysia, 2006).

As of January 2007, Malaysia's financial sector had 1 Universal Bank (local), 9 Anchor Banks (local commercial) and 13 commercial banks (foreign), 51 Offshore Banks and branches in Labuan, 13 investment banks, 11 Islamic Banks (8 local and 3 foreign), 13 Development Finance Institutions, 4 discount houses, 8 money brokers, 18 license money lenders, 5 bank representative offices, 35 stock broking companies, 36 unit trust management companies, 84 insurance companies, 6 reinsurance companies and 7 *Takaful* operators (Bank Negara 2007)

Despite the consolidation exercise, both the conventional local banks and Islamic banks are relatively small compared to foreign banks. However, with the implementation of the FSMP and the CMP running as schedule, the financial sector will see a positive growth in the near future.

In the international front, LOFSA has increased its efforts to promote Labuan as an International Offshore Financial Centre (IOFC). Since its inception, Labuan has attracted a total of 5,152 offshore companies originated from 93 different countries of which 53 per cent were from the ASEAN and Pacific regions. Others include the Far East (16 per cent), Americas (15 per cent), Europe (14 per cent) and Middle East (2 per cent). As at end of 2005, there were six Islamic banks, including two foreign Islamic banks established on the island (Malaysia, 2006).

The Fund Management Industry

The fund management industry in Malaysia is at an infant stage. With the MIFC initiative, the government has stepped up its effort to push Malaysia to be the centre for “fund and wealth management” in Islamic finance. Although Malaysia has started late in the fund management industry, there was some positive indicators that will chart a new direction for the industry. The SC reports that as at Dec 2005, the total funds managed by licensed fund management companies in Malaysia registered an increase of 11.4% to RM127.22 billion as compared to 2004 (SC, 2007). The main source of funds under management are the unit trust funds worth RM99.92 billion as at end of 2005 which represents more than 78% of the total funds under management. In 2005, a closer look at the proportion of the Net Asset Value (NAV) of Islamic unit trusts to the overall unit trust industry reveals that it only represent 8.6 per cent at RM8.49 billion out of RM98.9 billion. However, this figure shows a positive increase of 25% from the previous year, 2004, standing at RM6.76 billion.

In order to promote Malaysia as the center for Islamic finance, the government has to spell out the vision to be the world premier fund and wealth management centre over the next five to 10 years. With the target set to attract investors and managing global investments particularly from the Middle Eastern countries, Malaysia is set to take centre stage. Ultimately the target set will realize the objective of developing Malaysia as the hub of fund and wealth management in Islamic finance.

Bond Market

The development of the bond market in Malaysia has accelerated after the Asian financial crisis. Malaysia was not spared the crisis. The banking sector which was heavily exposed to the financial crisis in 1997 was very cautious in extending new credits. The post-crisis period saw the loan growth at less than the targeted 8 percent as proposed by the government. The sudden upsurge of short term capital inflow which was unhedged and triggered by the massive outflow of funds, Malaysia was caught off guard. The situation was aggravated by the double mismatch of maturity and currency. Thus, debt securities are increasingly seen as an alternative source of capital that may help business reduce the over-dependence on commercial bank intermediated financing and avoid resorting to short-term capital to finance long-term development projects. As such the private sector’s participation in the new financing mode will determine the next growth engine for the economy. Initially there was a clear structural deficiency in the issuance process which took one bond issue at least nine to twelve month to complete. The government realizes the lack of structured procedure in the issuance process and has taken several measures which include:

- centralising the regulation of the corporate bond market with the Securities Commission (SC)
- To ensure that efforts to develop the bond market are well-coordinated, a high-level National Bond Market Committee (NBMC) was established by the government in 1999. The role of the NBMC is to provide overall policy direction for the orderly development of the bond market and to identify and recommend appropriate implementation strategies.

- The establishment of a reliable and efficient benchmark yield curve - A benchmark yield curve was constructed out of large and liquid, sovereign-credit bond issuances by the government in accordance with a transparent auction calendar to provide ease and accuracy in the pricing of corporate bonds.
- Widening the issuer and investor base - For sustenance in bond market development by providing a virtual platform for the meeting of issuers (in their search for the most competitive and practical fund raising alternative to meet their specific needs) and investors (in their search for a diversity of investments).
- Improving liquidity in the secondary market - Includes efforts to enhance market infrastructure, trading and operational procedures for the creation of an organised and active bond market which is efficient and effective towards promoting and attracting active primary as well as secondary market activity.
- Facilitating the introduction of risk management instruments - To provide an avenue for issuers and investors to hedge their respective exposures to the bond market in a most effective and timely manner. (SC,2007)

Having laid the foundation for the successful implementation of the bond market, Malaysia appears to gain the liquidity requirement for critical mass. The bond market registers total net funds mobilized amounting to RM35.4 billion for the year 2005. The total bond outstanding shows an increasing trend from RM278billion in 2001 to RM398billion in 2005 which accounts for 80.4% of the Malaysian Gross Domestic Product (GDP) (BNM, 2006).

Islamic Capital Market

The Islamic Capital Market (ICM) runs in parallel with the conventional system and the Malaysian government aspiration to be the centre for Islamic capital market has gain global recognition and attention. In Malaysia, the ICM is under the regulatory body of the SC.

In 2005, after two reviews were conducted on listed companies in the Bursa, 110 securities were added in the *Shari'ah* compliant securities or the SAC list, while 19 securities were removed. As at end 2005, there were 857 *Shari'ah* compliant securities approved or over 85% of the total listed securities on the Bursa, an increase from 787 or 83% of the total listed securities. (SC, 2006).The Kuala Lumpur *Shari'ah* Index (KLSI) is the benchmark for the SAC list and as at end 2005, the KLSI comprised 508 *Shari'ah*-compliant securities with a market capitalization of RM400billion or more than 60% of the total market capitalization (SC,2006).

In November 2005, the SC has made a significant milestone in setting a global benchmark for the development of Islamic REITs. Under the Islamic bond market, there was considerable growth in the past years. In 2002, the Islamic bonds issued were valued at RM17.5billion. However as at end 2005, the Islamic bond market shows an increase to 77 bonds approved valued at RM43.32 billion out of the total 126 bonds approved valued at RM60.66 billion. This increase indicates a high Compounded Annual Growth Rate (CAGR) of 28.3% as compared to the total CAGR of 14.5% for total bond issued for the ten-year period (SC, 2006).

The Risk Management Industry

The emergence of innovative financial instruments in a form of risk management in the late 1980s and 1990s has driven the Malaysian government to introduce new measures to cater to the

need of the industry. Although the establishment of the Kuala Lumpur Commodity Exchange (KLCE) in 1980 received a lukewarm response, due to the relatively thin market, the government perseveres and introduced a “one-stop” centre for the trading of derivatives. The Malaysia Derivatives Exchange (MDEX), set up in 2002, has performed modestly and opened new avenues to minimize risk exposure arising from volatility of interest rates, exchange rates and securities prices (Ng, 1998).

The next leap that the Malaysian government has undertaken was the demutualization exercise and the Kuala Lumpur Stock Exchange was renamed Bursa Malaysia Berhad in April 2004. Therefore MDEX becomes an entity to Bursa Malaysia and renamed Bursa Malaysia Derivatives Berhad. Under the new arrangement, the Derivatives Exchange trades nine instruments in all, comprising KLCI Futures and Options; interest rate futures; Crude Palm Oil and Kernel Oil Futures; 3-Year, 5-Year and 10-Year Malaysia Government Securities Futures; Single Stock Futures and Ethylene OTC Futures Contract. The trading performance remains high for the third consecutive year since 2003 and Bursa Derivatives registered 2.5 million contracts in 2005 (Bursa 2007).

The Insurance and Re-insurance Industry

A pertinent area in risk management industry is the insurance and re-insurance sector. This sector provides cover for risk exposure against potential losses with respect to property, liabilities and human capital. In Malaysia, the insurance industry has seen tremendous progress and expansion. As of end 2005, assets of the insurance industry have increased to RM100 billion and net contributions in the insurance sector have surpassed RM23 billion. Registering similar growth is the *takaful* industry that chalks net contributions to RM1.3 billion in 2005 with an increase in the share of the total insurance industry at 5.4 per cent. The total assets of the *takaful* industry rose to RM5.9 billion in 2005 representing 5.7 per cent of the total assets in the insurance sector. Dr. Zeti (2006c) emphasizes that this phenomenal growth is largely due to “a transformation of the industry in terms of the distribution systems, product diversity, sophistication of business models and practices, and the state of the art technological advances.” Most importantly, this sector is an important source of funds to the capital market, particularly in the corporate and debt securities. In 2005 alone, this institutional investor has invested over RM49 billion in the capital market.

***Shari’ah* Advisory Council**

The last function is the role of the *Shari’ah* Advisory Council (SAC) which is included as part of the discussion on the functional perspective. The main functions of the *Sharia’ah* advisors are to advise on matters relating to products, documentation, structuring and investments. While some critics may argue that these *Sharia’ah* advisers are mere “rubber stamps” and are “engaged to advise” merely to reap exorbitant profits. Others believe that the effort that they have put in and the reward that they received, is the compensation for their contribution for the cause of the *Ummah*. Every new resolution made in a meeting, is a step taken towards eradicating all the *haram* (prohibited) elements in the financial transactions.

At SC level, the *Sharia'ah* advisers are appointed based on certain minimum criteria and requirements. In 2005, there were nine newly registered *Sharia'ah* advisers. As at end 2005, there was a total of 30 registered *Sharia'ah* advisers for *Sharia'ah* based unit trust funds.

PROSPECTS OF MALAYSIA'S POSITION AS AN IIFC

In assessing the prospects of Malaysia's position as an IIFC, it is prudent to reflect on several characteristics of a successful international financial centre. Tan and Chen (1999) outline several characteristics and Malaysia probably fulfills most if not all of them. Fundamentally, Malaysia has a politically stable environment governed by a coalition government comprising racial based parties of three major ethnic groups, namely, Malays, Chinese and Indians. With tolerance, the government can effectively carry out policies that will benefit the citizens. Malaysia has all along adopted strong economic fundamentals that bring prosperity to the nation. This in turn assists the government to carry out prudent monetary and fiscal policies. As a result the government adopts a gradual implementation of the state-of-the-art physical and financial infrastructure. The Prime Minister of Malaysia classifies the infrastructure in the country as a "first class" material.

In terms of location, Malaysia possesses good geographic location and appropriate time zone. Exercising best practices in accounting to meet the international standards is the order of the day. All regulatory laws are enacted and passed in the Parliament before it is carried out and implemented accordingly. In the financial sector the labor force is skilful with an acceptable level of proficiency in the English language.

Although Malaysia has improved and climbed up the corruption index in recent years, its political stability is the key strength in taking the leading position as an IIFC. Other strengths include the following;

- i) Successful and sophisticated offshore market such as LOFSA
- ii) Active and liquid foreign exchange market after the regime change in 2006
- iii) Respected, well-regarded and pro-active regulator
- iv) Financially sound and resilient banking sector
- v) Well-developed infrastructure including state-of-the-art information and communication technology (ICT) infrastructure, a sustainable Islamic financial infrastructure, an established legal and accounting framework, the highest corporate governance and compliance standards, and professional management.
- vi) Innovative and dynamic in Islamic banking and finance
- vii) An integrated stock and derivatives exchange which offers advantages such as lower transaction cost and more efficient and flexible funding from capital markets.
- viii) Pioneer in many Islamic banking and finance related product and services to offer to the world.

Malaysia has always adopted the principle of gradualism in her approach to Islamic banking and finance. This is in line with the philosophy of Islamic legislation. Kharoufa (2000) reiterates the point that Allah has adopted a step-by-step approach in ordaining His laws. This gradual approach will make it easy for people to follow and abide by them. Similarly, the Malaysian government adopted the step by step approach and introduces the dualism policy in a rather complex yet sophisticated financial system. Experiencing several ups and down in materializing their objectives as the centre for Islamic finance, the timely announcement by the governor of BNM was made when all the Islamic financial infrastructure are in place.

It takes twenty years of experimenting and implementing new and untested Islamic financial products and services. Finally, it is fortunate enough to observe the tremendous development of Islamic banking and finance. It follows that Malaysia blossoms to be accorded as a respectable country that dominates the world Islamic finance in the *sukuk* market. The Malaysian government is proactive in her approach to Islamic banking and finance and again pioneered the world's first Islamic RIET to be adopted and marketed in both the conventional and Islamic financial markets.

For many obvious reasons, driven by market demand and the lure of the market potential surpassing US\$300 billion with a yearly growth of 10 percent, many IFCs are fighting to grab a slice of the market share. Small country like Singapore has passed an amendment to the bill on banking to accommodate Islamic finance in the financial system and completes "the last of the financial suite". Efforts have been stepped up by Singapore to project itself as the centre for Islamic finance as early as in 2004. However, cynics may say that Singapore may have the financial prowess but the credibility in the Shari'ah ruling is questioned. Although Singapore seeks advised from prominent Shari'ah experts from all over the world, it needs more than skilful marketing strategy and convincing negotiation techniques to entice the Middle East investors. Muslims believe in credibility and integrity before they part their capital to invest. Believe in the Hereafter and religiosity inclination may probably win some Middle Eastern hearts to be potential investors of Malaysia. Therefore Malaysia has to consistently introduce new innovative products and services to steer the Muslim world to accept a better alternative to the existing questionable financial instruments.

CONCLUSION

Since the early 1960s, Malaysia has found a niche in the Islamic financial market when it first established *Tabung Haji*. This niche market was gradually nurtured by the Malaysian government to ensure that there is a certain level of understanding and knowledge of the niche market. The monopolistic years witnessed BIMB experimenting on several acceptable innovative financial instruments but many questionable ones. The "trial and error" period has to end and a critical mass has to be created to ensure that Islamic banking is relevant the new dynamic environment. The IBS is a new phenomenon to the general public but slowly and many embrace the new system.

After the onslaught of the financial crisis of 1997, the pragmatic BNM governor has a strong vision to develop Malaysia into a vibrant centre for Islamic banking and finance. Several master plans have been drawn for the financial sector and the *takaful* industry. As early as 2000, the

governor has included in her speech several fundamental ideas that will enable Malaysia to remain resilient and strong against all forms of competition. Her thoughts on addressing the issue of human capital in the banking and finance industry particularly in the area of *Fiqh muamalat* related field in Islamic banking and finance has paved way to the establishment of several institutions and the most recent one is International Centre for Education in Islamic Finance (INCEIF). This institution culminates the long drawn problem of generating qualified scholars in Islamic Shari'ah.

INCEIF is also part of the initiative that will help realize the goals of the MIFC initiative. The supply of human capital has to be from INCEIF that showcase the graduates' competency in addressing several *fiqh mu'amalat* issues raised by many Islamic scholars. This intellectual building will be an asset to Malaysia who will not only champion for the cause of the nation but also for the good of the Muslim *ummah*.

The MIFC initiative clearly amplifies the importance of functions over institutions. Functions are dynamic whereas institutions are static. This fact is clearly distinct in the consolidation exercise in the banking sector where many banks are forced to merge with either ten of the anchor banks. When financial institutions die off, functions still exist in different form – a small group of banks with huge financial resources, cost effective and bigger role and functions to compete with foreign banks.

Moreover, analyzing the underperforming function of foreign exchange services and introduces a similar business model such as the one that has been adopted by Singapore will add color to the dull activity in the foreign exchange market. Underpinning the important function of international banking facilities may assist Malaysia to be in the radar screen of potential investors from other parts of the world. Therefore, welcoming more but big foreign Islamic banks will create critical mass that will surpass the target set by the BNM.

The MIFC initiative has to look into seriously the effective and efficient functions of the fund management industry. In other words, after increasing the pool of funds in Malaysia, will there be enough assets or properties to be invested locally? What about the returns – favorable or otherwise. Again the functions of the risk management will not suffice by introducing the same product offered by the conventional risk management institutions. A new innovative idea has to be thought of in order to be different and distinct. In other words knowledge in product development is paramount in ensuring Malaysia's position as the centre for Islamic finance. The bond and insurance markets have not exercised their fullest potentials. Their functions are merely adopting and emulating the conventional product and services which are only aimed at maximizing profits and safeguarding the bottom line. Therefore a holistic approach has to be considered such as attempting to introduce controversial products and services that are quite similar to the conventional but has some element of uncertainty or *gharar*. Impermissibility aside, there must be a way out to address the issue through in-depth research of the authenticity of the *hadith* or justification from the Islamic scholars who have passed a decree on the subject matter. Disagreement may surface but ultimately the process of developing a so called controversial product will be a non-issue if the product development process is consistently carried out. Only then creativity and innovation will be inculcated among the scholars and more products will be introduced to the market.

Finally, the MIFC initiative is the finest example of a well thought plan by BNM. A dedicated MIFC unit has been in placed with the functions dictating the progress of the initiative. Malaysia will be able to face the stiff competition from other IFCs if the following are adhered:

- i) targets are drawn, similar to that of the FSMP and CMP.
- ii) competency level enhanced – training and professional development are emphasized
- iii) implementation, controls and follow up are consistently carried out.
- iv) constant assessment of the progress of the initiative and make changes where necessary.
- v) sincere and committed for the betterment of the *Ummah*.

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