# Islamic Finance in Southeast Asia: Strategic Context and Trends

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**Abstract**

*The aim of this article is to examine the strategic context—evolving geo-financial landscape—and transformative trends underpinning the growth of the Islamic finance industry in Southeast Asia. Understanding the strategic context and trends of the Islamic finance industry in Southeast Asia can be considered a basic necessity for those tracking current and emerging developments of Islamic finance instruments, innovation, and institutions across the industry as a whole. The article identifies the major financial players—petrodollar investors and Asian banks—that have shaped the strategic context of the Islamic finance industry, and specifically the role of petrodollar investors in diversifying the flow of capital assets and liquidity toward Asia has facilitated growing inter-linkages between Asia and the Middle East. It also examines the growth of the Islamic finance industry in Malaysia, a global leader and stakeholder, and in Singapore, a regional player with a global brand, and identifies the transformative trends and key challenges shaping the Islamic finance industry in Asia.*

## Islamic Finance in Southeast Asia: Strategic Context and Trends

The aim of this article is to examine the strategic context – evolving geo-financial landscape – and transformative trends underpinning the growth of the Islamic finance industry in Southeast Asia. With assets of the global Islamic finance industry projected to reach $1.6 trillion by 2012[1], understanding the strategic context and trends of the Islamic finance industry in Southeast Asia can be considered a basic necessity for those tracking current and emerging developments of Islamic finance instruments, innovation, and institutions across the industry as a whole. With oil money having propelled the trajectory of the global Islamic finance industry's 15-20 percent average annual growth over the past decade and with the industry's current total assets estimated to exceed US$ 1 trillion, petrodollar investors from the Gulf Cooperation Council (GCC)[2] have been seeking investment opportunities in Asia and other emerging markets. This trend gained discernible momentum in the wake of September 11 and has becoming increasingly salient, according to industry projections.[3] As the Islamic finance industry expands its reach and depth, the approaches practitioners and policymakers use to manage the intersection between

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competition and regulation will be shaped by intersecting forces that are currently transforming the international financial system.

This article is divided into three sections. The first section identifies the major financial players—petrodollar investors and Asian banks—that have been shaping the evolution of the Islamic finance industry. The role of petrodollar investors in diversifying the flow of capital assets and liquidity toward Asia has facilitated growing inter-linkages between Asia and the Middle East. The growth of the Islamic finance industry in Malaysia, a global leader and stakeholder, and in Singapore, a regional player with a global brand, is the focus of section two. The last section examines transformative trends and key challenges shaping the Islamic finance industry in Asia.

## I. Islamic Finance in a Strategic Context

From Dubai to Brunei, Malaysia to Morocco, Muslims account for approximately 15% of the world's population, roughly 1.5 billion. As a global phenomenon, the growth of Islamic finance reflects an increasing demand for Shariah-compliant products ranging from retail banking and mortgages to insurance and securities in regions with high concentrations of Muslim communities. According to Figure 1, the Islamic finance industry is flourishing in Muslim-majority regions—represented by different shades of the color green—most prominently in the Middle East and Southeast Asia, and is gaining a foothold in countries with a high concentration of Muslim-minority communities throughout Europe, Africa, and South Asia. The expansion of Islamic capital markets has been fueled in large part by shifts in international capital markets.

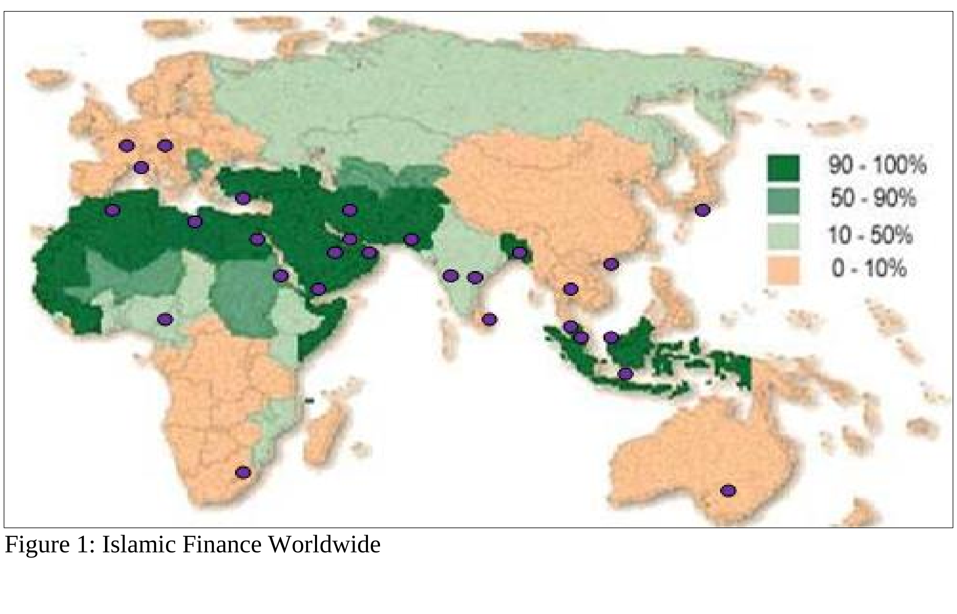


Figure 1: Islamic Finance Worldwide

Over the past decade, a confluence of forces in capital markets has been gradually transforming the global financial landscape, resulting in diversification of capital concentration from the US and Europe to Asia and other emerging markets, such as the Middle East and North Africa (MENA). These forces have found agency through four groups of power brokers—petrodollars investors, Asian central banks, hedge funds, and private equity—whose aggregate assets nearly tripled in 2000, collectively reaching US$ 8.4 trillion at the end of 2006.[4] According to a McKinsey Global Institute (MGI) study, "Petrodollar investors and Asian central banks are not only huge investors in financial markets but also new sources of liquidity for global capital markets. Hedge funds and private equity are new types of financial intermediaries that offer investors diversification by seeking returns that are uncorrelated with returns on public equity and debt markets."[5] Of the four major power brokers, petrodollar investors hold the largest share of assets ranging between US$ 3.4-3.8 billion in foreign financial assets.[6] A closer examination of the composition and role of petrodollar investors reveals how these entities are responding to undulations in market conditions and concurrently shaping developments in the Islamic finance field.

Petrodollar investors, mostly concentrated in the GCC countries, come in six categories as characterized by MGI[7]: 1) **Central banks**, which invest in foreign assets in the interest of stabilizing their currencies against balance of payment fluctuations and with stability, not maximization of returns, as the primary investment objective; 2) **Sovereign wealth funds**, or state-owned investment funds, whose mandate is to invest oil surpluses in global financial assets, usually in the form of diversified portfolios—equity, fixed income, real estate, bank deposits, and alternative investments, including hedge funds and private equity. The Abu Dhabi Investment Authority (ADIA) is the largest sovereign wealth fund among oil exporters with reported total assets of US$ 875 billion; 3) **Government investment corporations**, which, unlike sovereign wealth funds, invest directly into domestic and foreign corporate assets. Such corporations include the Dubai International Capital (DIC), Istithmar, and Mubadala; 4) **High net worth individuals (HNWI)**, whose wealth is concentrated predominantly in petrodollar countries and is invested through financial intermediaries and have highly diversified asset allocations; 5) **Government-controlled companies,** which receive direct or indirect government funding and then invest in companies abroad, such as the acquisition of GE's plastics unit by Saudi Basic Industries (Basic) and Dubai's DP World's purchase of British Ferry conglomerate P&O; and 6) **Private companies**, which use retained earnings and capital growth to finance foreign investments, such as Kuwait's Mobile Telecommunications Company, National Bank of Kuwait, and Egypt's Orascom Group.

Seeking diverse destinations for long-term investments, petrodollar investors view Asia's economic liberalization, favorable regulatory environment, and highly-experienced pool of expertise on finance as appealing features for robust return on investment. "Asia is home to the most economically dynamic pack of economies in the world, a sizable Muslim population, and two ascendant economic powers—China and India—with serious long-term energy needs. The energy-rich gulf states want to diversify their economies and are looking for high-return investments outside the Middle East to recycle a gargantuan sum of petrodollars."[8] The focus on Asia suggests ongoing prospects for expanding economic linkages between the Middle East and Asia. In 2005-06 alone, according to UBS, the GCC announced investment projects in Asian infrastructure worth US $155 billion, Chinese initial public offerings (IPOs) and Asian real estate; GCC flows into Asia are in the same order of magnitude of those into MENA, at around US $60 billion, or 11 percent of the total (US$ 530 billion) from 2002-06.[9] With capital flows between the GCC and Asia amounting to US$ 15 billion annually, it could reach US$ 290 billion by 2020 if the growth rate from 2001 to 2005 is sustained.[10] Furthermore, the infusion of capital from petrodollar investors into Asia has contributed to the accelerated growth of Southeast Asia's Islamic finance industry over the past two decades. As of 2006 the total Islamic finance market was worth US $500 billion, of which US $70 billion were sukuk (Islamic bonds); Standard and Poor's estimates that by 2010 the sukuk market will grow to US $170 billion and the overall Islamic financing market to US $4 trillion.[11]

Despite the current volatility in international capital markets, Southeast Asian governments and financial institutions recognize the strategic importance of tapping into the enormous potential of Islamic capital markets and are taking a long-term perspective by investing in developing products and services to attract Middle East capital investments. For Middle East investors, the Asia-Pacific region has become more attractive than the West. With assets valued at $68.4 billion, Malaysia already has the world's third biggest Islamic banking market after Iran and Saudi Arabia, and investors from Saudi Arabia, United Arab Emirates, Bahrain, and Qatar are now channeling funds to developing countries such as China, India, and Indonesia.[12]

The strategic context in which the global Islamic finance industry is developing can be characterized by a growing trend toward diversification on the part of petrodollar investors in seeking viable investment opportunities throughout Asia and identifying countries where conditions – established regulatory framework, deep financial expertise, socio-political domestic stability, vibrant local demand, and efficient institutional processes – are conducive to building and expanding operations. The following section explores in greater depth the forces and factors shaping the sphere of Islamic finance activities in Southeast Asia.

## II. Southeast Asia Islamic Finance Sphere

The diversity of Southeast Asia's people, languages, histories, and religions has shaped the emergence of a Southeast Asian "brand" of Islamic finance. Of the world's total Muslim population of 1.5 billion, 250 million are concentrated in Southeast Asia. Islam entered Southeast Asia through Muslim traders from India and West Asia between the 12th and 13th centuries. The Sufis had a particularly strong influence in the expansion of Islam across Southeast Asia. With a mystic quality and tolerance for coexistence with earlier animist, Hindu, and Buddhist beliefs and rituals, Sufism availed Southeast Asians a practical way to reify Islam in their local context, which laid the foundation for the rise of Muslim centers of learning and interaction across the archipelago.[13] Among Sunni Islam's four schools of Islamic jurisprudence (fiqh) – Hanafi, Maliki, Hanbali, and Shafi'i – the Shafi'i school is most prevalent in Southeast Asia and is the official school of law (madhab) of the governments of Malaysia and Brunei Darussalam. The Indonesian government adheres to Shafi'i madhab for Indonesia's Compilation of Shariah (Islamic law). Imam Shafi'i developed a systematic methodology in interpreting Islamic law, yet sought to strike a balance between tradition and pragmatism.


Figure 2: Southeast Asia Islamic Finance Sphere

In contemporary Southeast Asia, divergent interpretations and applications of Islam in each country reflect an amalgam of Shafi'i Islam with indigenous cultural norms, values, and practices, which over the centuries has spawned a tolerant, pluralistic form of Islam throughout most parts of Southeast Asia. This pragmatic, yet deep-rooted practice of Islam is an integral element in the fabric of Southeast Asia political culture. In Malaysia – a secular country – political Islam is ubiquitous in national governance. Under the leadership of Mohammad Mahatir, Malaysia's prime minister from 1983-2003, Islamic scholars (ulama) and Islamic jurists (fuqaha) were charged with providing practical and innovative interpretations (itjitihad) of Islamic law with a view of advancing Malaysia's national economic development. "The Malaysian brand of Islam does not fit typical Western perceptions and stereotypes…It is fused with other influences (nationalism, capitalism, 'Asian values') producing a unique ideology of development. Rather than being an obstacle to change, religion was to be an engine of growth and modernization and a tool to promote financial innovation."[14]

This top-down, centralized nature of leadership serves as a pivotal driving force behind the rapid growth of the Islamic finance industry in the region. The governments of Malaysia and Singapore are formulating and implementing coherent, multi-sectoral, and local-global strategies in framing regulations and standards that facilitate a marketplace sustainable to the industry's expansion. Malaysia is considered a key player in Islamic finance innovation and expertise, and Singapore is aggressively expanding its capabilities as a first-choice Islamic finance services provider. Both countries' strategies for positioning themselves as prominent players in attracting liquidity serve as bellwethers of how the industry is developing in the region and globally. Let us take a closer look at developments in Malaysia and Singapore.

***Malaysia: Global Leader and Stakeholder***

The roots of Malaysia's Islamic finance industry were established with the founding of the Muslim Pilgrims Saving Corporation in 1963 to help Malays save for performing the *haj*, the annual pilgrimage of Muslims to Mecca. With its evolution into the Pilgrims Management and Fund Board, or popularly known at Tabung Haji, Malaysia's Islamic finance industry is the product of the country's diverse history and culture as well as the Malaysian government's systematic integration of Islamic finance into the national economic development plan that was formally implemented as the National Economic Policy in the early 1970s and in a subsequent related series of national growth plans. In 2001 Bank Negara Malaysia – Malaysia's central bank – announced Malaysia's Financial Sector Master Plan, which essentially provided a roadmap for restructuring Malaysia's financial system. As a key component of the Financial Sector Master Plan, Islamic finance and takaful (insurance) were identified as primary sectors for development.[15] In 2002 Malaysia's Securities Commission launched the Capital Markets Master Plan to establish regulatory standards, framework, and environment conducive to market competitiveness and efficiency.[16] Since 2001 Malaysia has made high-impact strides in developing its national Islamic finance industry and establishing itself as a global industry leader. Malaysia's pioneering initiatives in the field—such as issuing the world's first global sovereign sukuk in 2002 and the landmark issuance of the exchangeable sukuk in 2006 by Khazanah National, the Malaysian sovereign wealth management group and the inaugural ringgit denominated sukuk issue by the International Finance Corporation—have positioned Malaysia as an increasingly sought-after provider of industry expertise.

Malaysia's Islamic finance field currently has 17 Islamic banks (of which four are foreign) and eight takaful operators. Maybank is the country's largest Islamic banking service provider with $6.4 billion in Shariah-compliant assets, followed by Bank Islam Malaysia, the second largest bank in the region. Other Malaysian banks include Hong Leong Islamic Bank, HSBC Malaysia, EON Bank, Affin Bank, Alliance Bank, OCBC Malaysia, Southern Bank, SME Bank, Standard Chartered Bank Malaysia, CIMB Group, and Kuwait Finance House Malaysia.[17] According to Bank Negara Malaysia, the country accounts for 61.4 percent of outstanding global sukuk bonds in volume of assets, and 76 percent of the new sukuk issuance by value; it has the world's largest Islamic unit trust industry, with 134 trust funds with a net asset of more than $5 billion, and more than 86 percent of securities listed on Bursa Malaysia are Shariah-compliant—at the end of 2007, this represented a market capitalization of $213 billion, 64 percent of total market capitalization.[18]

The Malaysian government's efforts toward further market liberalization to create an environment attractive to foreign investment in the Malaysian bonk market and to position Malaysia as a center for origination, distribution, and trading of sukuk have included a 10-year tax exemption (up to 2016) for local players to set up Islamic business units and for foreign Islamic banks and international takaful businesses, a tax exemption up to 2016 on the management fees received by fund managers for managing Islamic funds, and withholding tax exemptions on profits received from sukuk issued in country.[19] Profits or income received by non-residents for investments in ringgit and non-ringgit Islamic securities issued in Malaysia are exempted from withholding tax; moreover, the government has granted tax neutrality measures to accommodate the sukuk issuance.[20] In 2007 Malaysia issued new licenses to select foreign Islamic financial institutions, such as the Kuwait Finance House, the Saudi-backed Al Rajhi Bank and the Asian Finance Bank Berhad, supported by shareholders representing Qatar Islamic Bank, RUSD Investment Bank of Saudi Arabia and the Global Investment House of Kuwait. As Figure 3 indicates, although the GCC still maintains the lion's share of total assets, Malaysia's Islamic finance growth trajectory over the past five years is projected to be on par with the United Arab Emirates over the 2005-2010 time horizons.

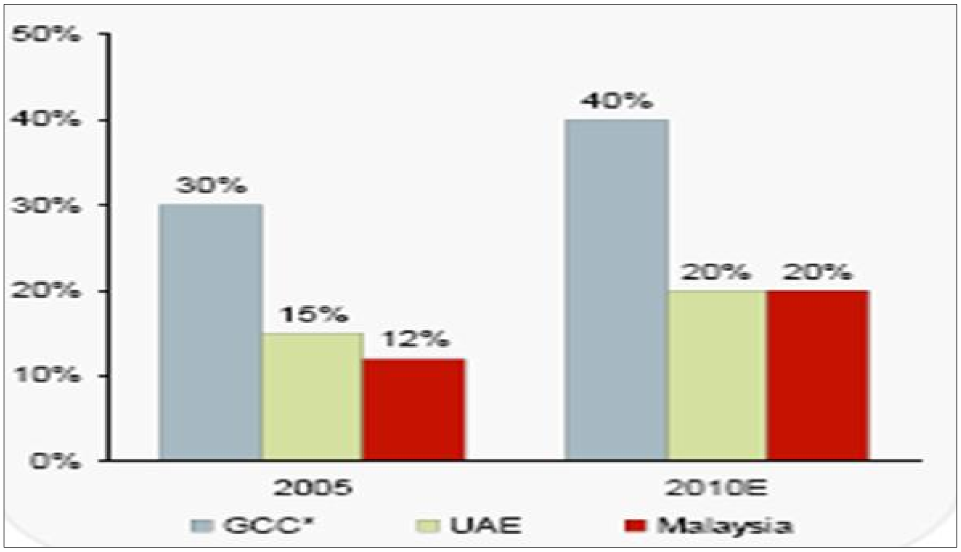


Figure 3: Islamic Banking Assets as a Proportion of Total

Source: INCEIF (The International Centre for Education Islamic Finance), Agil Natt, 2007

As a strategic step to extend Malaysia's reach as a global Islamic finance center, Bank Negara Malaysia (BNM) is establishing the Malaysia International Islamic Financial Centre (MIFC) as a Southeast Asian counterpart to the Dubai Islamic Financial Centre in the United Arab Emirates. Malaysia's impact on virtually all segments of the Islamic finance industry—product innovation, education and training, regulatory and legal expertise—is the result of the Malaysian government's leadership in branding Malaysia as a pivotal industry player and placing it strategically at the nexus of capital flows between the GCC and Asia.[21]

***Singapore: Regional Player, Global Brand***

As a globally-recognized financial center, Singapore is carving out a niche position in the Islamic finance industry. Tapping into the rapidly growing Islamic finance capital markets, the Monetary Authority of Singapore (MAS) has pursued a deliberate strategy in fostering a regulatory environment favorable to expanding the scope of Singapore's wealth, investment, and asset management expertise into the Islamic financial services sector. In response to the demand for Islamic finance tools in project financing, trade financing, capital raising, and investments in *Shariah*-compliant equity stocks and real estate products, MAS has made established regulatory measures allowing banks in Singapore to offer financing according to the *murabaha* concept.[22] Moreover, in 2005 MAS decided to waive the imposition of double stamp duties in Islamic transactions involving real estate and accorded the same concessionary tax treatment on income from Islamic bonds that are afforded to conventional banks.[23]

The launch of the Financial Times Stock Exchange (FTSE)-Singapore Stock Exchange (SGX) Asia Shariahh 100 Index Series in February of 2006 and the establishment of Islamic Bank of Asia in May of 2007 represented two critical steps in advancing Singapore's plans of entering the Islamic finance arena. The FTSE-SGX Asia Shariahh Index marked the first index of the series and was designed to represent the performance of *Shariah*-compliant companies in Japan, Singapore, Taiwan, Korea, and Hong Kong.[24] The Islamic Bank of Asia, a subsidiary of the Development Bank of Singapore Limited (DBS), has DBS as the major stakeholder along with 22 other investors from prominent families of the GCC countries. In 2009 the MAS launched its first S$ 200 million sukuk issuance (al-ijarah structured) to provide Shariah-compliant regulatory assets, marking Singapore as one of the few non-Muslim countries to enter the sukuk market.[25] DBS Chief Executive Jackson Tai said in a statement, "Singapore is becoming a convenient stopover for GCC investors and capital flows bound for Asia. Against this backdrop, the Islamic Bank of Asia is strategically well positioned not only at the financial crossroads of Asia, but also in Singapore, an Asian capital markets center renowned for its effective regulatory and corporate governance framework."[26]

Singapore's sound investment climate and stable governance system also appeal to high net worth individuals Muslim and non-Muslim—including Chinese and Indians—who are seeking alternative investment areas in Asia.[27] The demand for Islamic financial services is expected to rise exponentially with the Muslim population forecast to grow to 1.6 billion within the next 10 years and the increase in the wealth of high net worth individuals in the Middle East, which is expected to reach US$ 1.8 trillion by 2010.[28] Singapore is leveraging the capabilities of its multi-ethnic society, solid financial infrastructure, and geographic location as an entry point for GCC capital flows into Asia. In addition, the private sector is playing a vital role in spurring the domestic growth of Islamic finance products. According to Heng Swee Keng, the managing director of MAS, the growth of Islamic finance in Singapore "will be mostly driven by the private sector…the key is for the industry to assess where it can add value. Some possibilities would include wholesale financial services and asset management, where players here have deep expertise…We see interest not just in Islamic finance, but also in establishing better capital flow into Asia, within Asia and between Asia and the Middle East….what we seek to do is build on this trend so that it would benefit all sides in this process."[29] As a niche player in the Islamic Finance industry, Singapore's value added is to complement and augment Malaysia's efforts in making Southeast Asia a regional and global Islamic finance hub.[30]

## III. Outlook — Transformative Trends and Key Challenges

Since the 1970s to the present, the global development of the Islamic finance industry has undergone a series of fits and starts and was still considered an infant industry at the turn of the 21st century. The ascent of oil prices and petrodollar-driven investments accelerated the industry's expansion in the first half of this decade – a trend that was sustained concomitantly with robust economic growth in emerging markets and abundance of liquidity in global capital markets. The events of September 11 and US Congress legislation of the Patriot Act not only jolted the international community into re-assessing perceptions and relations between Muslim communities across the globe with the West, but also set in motion a re-orientation of Muslim commercial and investment activities toward Asia. Another vector fueling the trend of greater orientation toward Asia has emerged from the reverberations of the sub-prime mortgage crisis beginning in late 2007 along with the subsequent collapse of Lehman Brothers and financial enervation of major Wall St. financial institutions, such as Citigroup, JP Morgan Chase, and Merrill Lynch. The crisis has sparked vigorous debate within the Islamic finance industry as to whether the industry's inherently conservative investment practices and risk-sharing mechanisms could have averted or mitigated the effects of the global economic meltdown. While the full scope and intricate nuances of this debate are not the focal point of this paper, it is worth underscoring, however, that the debate reinforces the need to deepen confidence in the industry's ability to maintain sustainability, accountability, and transparency which, as articulated by Shamshad Akhtar, former governor of the State Bank of Pakistan, can be achieved in the following ways: strengthen risk-management systems, bolster regulatory infrastructure and frameworks, enhance Islamic regulatory standards to be consistent with international regulatory standards, which the Islamic Finance Services Board and Accounting and Auditing Organization for Islamic Financial Services are pursuing, launch consumer protection procedures, and promote greater financial diversification by encouraging financial innovation and Islamic capital market development.[31]

As for the outlook on the Islamic Finance industry in Southeast Asia, Zeti Akhtar Azziz, Governor of Bank Negara Malaysia, has called for the industry to develop a broader range of Islamic financial market instruments that include equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancements, Shariah-compliant risk mitigating instruments , and advocates the development of an Islamic derivatives market for hedging to support the development secondary markets are required to deepen the industry's infrastructure.[32] Looking ahead, as the industry continues to establish a regulatory infrastructure and become increasingly integrated into the global financial system, it would be well served to explore approaches toward training a new generation of experts and practitioners who understand how the Islamic legal system, Western common law, and international finance function in a global economic system, increasing dialogue between home and host regulators in harmonizing prudential standards, monitoring risk, and facilitating growth and sustainability, and facilitating exchanges between US, Southeast Asian, and Middle East legal experts, Shariah scholars, and industry practitioners for cross-fertilization of innovative ideas, products, and solutions.

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