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**ISLAMIZING THE MALAYSIAN ECONOMY:
THE POLITICS BEHIND DEVELOPING A MALAYSIAN
SYARIAH ECONOMY**

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Abstract:

Malaysia has developed and is maturing a dual, *syariah* and conventional economy. This thesis examines the politics behind developing the *syariah* economy in Malaysia. What were the driving forces making the development of the Malaysian *syariah* economy a national initiative? And, how and why were these forces involved in developing related laws, regulations, and policies? The aim of this study is to illustrate how, collectively, otherwise distinct events and actions to Islamize Malaysia created a religiously based economic system in Malaysia – one that is modern, political, and runs in parallel with secular political, economic and social administration.

Key words: *syariah* economy; Islamic banking and finance; Bumiputera, Malaysian development; socioeconomic development; *syariah* economic legal and regulatory development

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Table of Contents

1. Introduction	5
1.1. Purpose and Research Questions	5
1.2. Theoretical Discussion	6
1.2.1. Consociationalism	6
1.2.2. Political Interest	7
1.2.3. The ‘Spirit’ of Capitalism	7
1.3. Method and Selection of Material	9
1.3.1. Design of the Study	9
1.3.2. Methodological Reliability and Validity and Selection of Material	9
1.4. Ethical Considerations	11
1.5. Disposition	11
2. Considering Culture – Developing the <i>Syariah</i> Economy in Malaysia	12
2.1. Malaysian <i>Syariah</i> Economy: Organization, Developments, and Key Concepts	12
2.2. The Malaysian Islamic revival	14
2.2.1. Islamic Reform	14
2.2.2. Political History of the Islamic Revival	17
2.2.3. Economic Development and Islam	21
2.3. Discussion	23
3. Instituting Foundations	25
3.1. The Mahathir Era, Anwar Ibrahim, ABIM, and UMNO	25
3.2. Regulations Establishing <i>Syariah</i> Financial Institutions	26
3.3. Islamization of the Government Machinery	31
3.4. Vision 2020	34
3.5. Discussion	36
4. Institutional Building, Activity Generation, and Market Vibrancy	39
4.1. Malaysian <i>Syariah</i> Economy Enters the Global Marketplace	39
4.2. Surviving Financial Crisis and Political Turmoil	43

4.3. Discussion	45
5. Conclusion	48
References	51
Appendix A: Interview Questionnaire	57

1. Introduction

The Islamization of Southeast Asia, in particular, Indonesia and Malaysia has been my impetus for pursuing this program in Asian Studies. My academic advisor guided my research to a phenomenon highly developed in Southeast Asia, (but active globally) the *syariah* economy. My initial thesis proposals were designed to contrast the established Malaysian *syariah* economy with the comparatively young Indonesian *syariah* economy. My goal was to understand why the two states' sectors had developed differently, and the unique aspects of each state's Islamization process. In order to keep within scope, I chose to focus on the case of Malaysian Islamization and the development of its *syariah* economy until 2000. Recognizing that the politics behind the development of the Malaysian *syariah* economy has a long and eventful history, I have expanded the scope of this study slightly to accommodate important facts, events, and analyses.

The Malaysian *syariah* economy is rooted in cultural vibrancy, and a fine example of the dynamic that has evolved between Malaysian civil society, government, and economic forces. Considering culture is critical in nation building and economic development. Malaysia's main ethnic groups are the Malaysian Chinese, Indian, and Malay otherwise known as Bumiputera. The Bumiputera are synonymous with 'Malay' and 'Malay Muslim' as the state constitutionally defines the Bumiputera (Malay) as Muslim. In its history prior to, and after independence from Britain, Malaysia has battled with ethnic conflict driven by racial, socioeconomic, and religious issues. The brunt of conflict has centered on socioeconomic inequity between the Malaysian Chinese and Bumiputera and had a defining impact on the way that Malaysia designed its governance. This study examines Islamization in Malaysia, its relationship to Bumiputera economic development, to the Government of Malaysia (GOM), and in building a *syariah* economic system able to compete in the global market.

1.1. Purpose and Research Questions

This thesis examines the genesis of the *syariah* economy within the broader scope of Malaysia's political and economic Islamization. While there is a significant amount of research on the distinct aspects of Islamization in Malaysia, discussed within this thesis, there is a research gap in understanding how Islamization as a whole – political, social, and economic -

came together over time to develop a distinctly Islamic financial sector. Aiming to fill this gap, this study provides a historical analysis of the events that set the stage and established the *syariah* economy.

This study is guided by two questions:

- What were the driving forces making the development of the Malaysian *syariah* economy a national initiative?
- How and why were these forces involved in developing related laws, regulations, and policies?

1.2. Theoretical Discussion

The historical analysis is guided by both Arend Lijphart's consociational framework and Max Weber's discussion on political interest and the 'spirit' of capitalism.

1.2.1. Consociationalism

This study uses consociationalism to better understand how and why Malaysia's leadership developed Islamization policies, specifically the initiative to establish a *syariah* economy. Consociationalism is a power-sharing theory used to describe political actions taken by leadership to keep the peace in, and stabilize a (often deeply) divided society. Consociationalism can be used to describe political groups or governments, democratic or non-democratic. In the case of Malaysia, the population is divided along both ethnic and religious lines.

Arend Lijphart, the political theorist most predominantly associated with consociationalism, has identified Malaysia as a consociational democracy in his two main literary works: *Democracy in Plural Societies* (1977) and *Thinking about Democracy: Power Sharing and Majority Rule in Theory and Practice* (2002). Lijphart identifies four defining aspects of consociational democracy: a grand coalition of the different groups of society, mutual veto in policy making, representational proportionality, and segmental autonomy (i.e. cultural vice political autonomy) (Lijphart, 1977; Lijphart, 2002). Consociational democracy is present when

“centrifugal tendencies inherent in a plural society are counteracted by the cooperative attitudes and behavior of the leaders of the different segments of the population” (Lijphart, 1977:1). The study will use consociationalism in discussing Malaysian inter-ethnic bargaining and negotiating in three cases: Malaysia’s independence, in response to the May 13th 1969 ethnic rioting, and in Malaysia’s development planning.

1.2.2. Political Leadership

This study uses Weber’s *Politics as a Vocation* to discuss the “interests in the distribution, maintenance or transfer of power” in Malaysia (Weber in Gerth, 1948:78). It also uses Weber’s definition of politics, understood not as “any kind of independent leadership in action” but rather the “leadership, or influencing of leadership of a political association, hence today, of a state” to describe the driving forces making the development of the Malaysian *syariah* economy a national initiative (Weber in Gerth, 1948:78).

The dynamic between Malaysian leadership, bureaucracy, party politics, and civil society organizations played a significant role in energizing Islamization policies. Weber defines the state as being marked by different forms of political domination. This study will discuss the relationships of domination between the leader and his/her constituency, and the leader or party and its bureaucratic administration (Weber in Gerth, 1948). This study will use these relationships to analyze the Mahathir administration’s interests in harnessing the Islamic revival, developing Islamization policies, and establishing the *syariah* economy.

1.2.3. The ‘Spirit’ of Capitalism

Max Weber’s discussion on the spirit of capitalism in *The Protestant Ethic and the “Spirit” of Capitalism* is useful for better understanding the relationship between secularism and religiosity as they relate to capitalism. His theoretical analysis centers on the relationship between traditional economic players, and the evolution of capitalism enshrined with Protestant values to a secular capitalism based on rationalism.

The “traditionalist” to Weber, is a person content with achieving a level of productivity that meets his/her traditional means. Weber’s traditionalist saw work as something “morally neutral...on account of the constant danger of clashing with the Church’s ban on usury” (Weber, 2002:25). The traditionalist worker or entrepreneur does not harbor the total devotion to their vocation that the capitalist does, the difference, therefore is in the ‘spirit’ of labor. To Weber’s modern capitalist, the traditionalist is considered “backwardness”, because they seek to maintain their status quo lifestyle, not striving to improve efficiency or productivity, expanding employment and development opportunities for the community or state in which they live (Weber, 2002:25).

Weber argues that to the ‘spirit’ of capitalism “a well developed sense of responsibility is absolutely indispensable, along with a general attitude which, at least during working time, does not continually seek ways of earning the usual wage with the maximum ease and the minimum effort, but performs the work as through it were an absolute end in itself – a ‘calling” (Weber, 2002:18). Weber frames this ‘calling’ as being the result of a religious upbringing, and as giving the worker the ability to rise out of traditionalist backwardness and adapt to new methods of increasing productivity.

Spiritual motivation is an inherent quality of capitalist enterprise (Weber, 2002). He describes it as an ethic of discipline resulting in a process of rationalization, and driven by competition from entrepreneurs or workers with similar values and ethics (Weber, 2002). Weber explains that the ethical and moral qualities that mark the ‘spirit’ of capitalism encourage and promote community development. The spirit of capitalism is a form of spiritual idealism that involves “creating employment for numerous people and contributing to the economic prosperity (in the capitalist sense of demography and trade) of one’s hometown is a source of pleasure and pride to the modern entrepreneur and helps to give him [or her] an ‘enjoyment’ of life which is undoubtedly founded on ‘idealism’...in contrast to the hand-to-mouth existence” of the traditionalist worker (Weber, 2002:26). The reason why I use a framework termed “Protestant Ethic” to help understand how and why Islamization and the *syariah* economy formed, is because the mores and ethics that he uses to describe the ‘spirit’ of capitalism mirror the Islamic principles of the *syariah* economy.

1.3. Method and Selection of Material

1.3.1. Design of the Study

The aim of this study is to illustrate how, collectively, otherwise distinct events and actions to Islamize Malaysia created a religiously based economic system in Malaysia – one that is modern, political, and runs in parallel with secular political, economic and social administration. It analyses the “economic impact of political actions and political impact of economic actions” in Malaysia beginning with the grass roots Malay intellectualism that started the Islamic revival and evolved over subsequent generations of Malaysian Muslims (Ghosh, 1999:3). The turbulent debate on Islamic reform that emerged between the youth groups and Muslim traditionalists in the 1950s and 1960 sparked the Islamic revival. The debate was grounded in a struggle to define first the type of Islam that Malaysia should practice and then in a struggle to promote the Islamization of public administration. During Malaysia’s independence, an intense period of cultural, religious, and political awakening, Bumiputera rallied around their Muslim identity, promoting their political, social, and economic interests through Islamization.

This study begins with a history of the Islamic revival and description of the elements and organization of the Malaysian *syariah* economy. After providing this contextual background, it focuses on the development of the *syariah* economy through the Mahathir era, and two periods of development, ‘instituting foundations’ 1983-1993, and ‘institutional building, activity generation and market vibrancy’ 1993-2000, as defined by Bank Negara Malaysia’s (BNM, central bank) Malaysian International Islamic Financial Center (MIFC) (MIFC, 2009).

1.3.2. Methodological Reliability and Validity and Selection of Material

Primary data collected for the study included official legislative text, mission statements, speeches, economic and development indicators, industry data, plans and strategies, opinion pieces, brochures on business operations, and religious, economic, and political issue papers. I received these from GOM websites, interviews, and from research conducted at INCIEF, the research wing of MIFC. The GOM’s ministries, banks, and departments are fairly transparent,

posting financial reports, national legislation, speeches, statistics, and development plans on their websites, accessible to the public and available in Bahasa Melayu and English.

I conducted interviews from April 2009 through January 2010 and used a standardized questionnaire to guide interviews, comparing the similarities and differences from notes taken during these conversations.¹ These notes are primarily handwritten accounts of the conversation; only one interviewee allowed me to tape-record our conversation. I used these experts to guide my research, conducting interviews to elicit critical and varied viewpoints on milestones, key actors, and organizations influencing the development of the *syariah* sector. Applying the snowball effect, I used interviews to gain leads and direction for follow-on research and contacts. Interviewees' accounts were not used for statistical data, but were recognized as subjective accounts of history, to be cross-checked by primary source data and academic literature. I use points raised in interviews indirectly in this study, and while not directly quoted, they are present throughout. These discussions framed the topics and ideas discussed, supported by cited primary and secondary materials.

I chose interviewees based on their profession, targeting experts with experience in *syariah* banking and finance, law, judiciary, *syariah* economic think tanks, *syariah* business administration, and academia. The interviewees represented different generations of Malaysians, something that unexpectedly proved useful for my analysis. I met with interviewees in their offices or at neutral locations such as University libraries to arrange a suitable environment for a productive interview. Interviewees' personal collections and recommendations have been of great help in guiding my research and providing materials otherwise unavailable to the public.

I collected and reviewed academic literature and materials focused on Islam in Malaysian politics, economy, and culture from university libraries and interviewees' personal collections. I have all together consulted four libraries: Center for East and Southeast Asian Studies Library at Lund University, INCEIF Library in Kuala Lumpur, ISEAS Library in Singapore, and UKM University Library in Bangi, Selangor.

¹ See Appendix A

1.4. Ethical Considerations

Ethical considerations were a serious concern in gaining access to institutions and in conducting interviews and drawing information from experts in the field. Before conducting interviews or conversations I received informed consent. I briefed each interviewee on my name and affiliated institution (Lund University), that information from our conversation would be incorporated into my thesis, the topic of my thesis, and that the interviewee (at their choosing) could remain anonymous or attributed based on their direction. They could select which information from the interview or conversation they did or did not want to be attributed to their name or institution and could choose the interview method – conversation only, written notes, or a tape recorded conversation. This published version of my thesis reflects the explicit directions and allowed limits of attribution directed by my interviewees.

1.5. Disposition

Chapter 1 provides the introduction. Chapter 2 presents an overview of *syariah* economic principles and organization in Malaysia, and provides a historical analysis of the Islamic revival's impact on Malaysian civil society, economy, and politics. Chapter 3 discusses the Malaysian government's role in establishing Islamization policies and the legal authorities that created *syariah* economic institutions. Chapter 4 analyses the way the *syariah* economy matured, and how entering the global market fundamentally changed the way the sector was governed and regulated domestically. Chapter 5 provides a concluding discussion.

2. Considering Culture – Islam, Politics, and Economy in Malaysia

2.1. Malaysian *Syariah* Economy: Organization, Developments, and Key Concepts

The Association of Islamic Banking Institutions Malaysia (AIBIM) defines *syariah* banking as:

“Islamic Banking in the modern world, generally aims to promote and develop the application of Islamic principles, law and traditions to transactions of financial, banking and related business affairs... [and] to promote investment companies to be engaged in such business activities that are acceptable and consistent within the *Shari’ah* precept. Islamic banks, by doing so, will safeguard the Islamic communities and societies from activities that are forbidden in Islam.

Justice is such an indispensable ingredient of the Islamic faith that it is impossible to perceive the ideal Muslim society where justice has not been established. Islam wishes to eradicate from human society all traces of *zulm*, a comprehensive Islamic term referring to all forms of inequity injustice, exploitation, oppression and wrongdoing whereby a person either deprives others of their rights or does not fulfill his obligations towards them” (AIBIM, 2010b).

This section provides an overview of the authorities governing the *syariah* economy, guiding principles, and the most common financial mechanisms used in *syariah* commerce.

The laws establishing the *syariah* banking, *takaful* (*syariah*-compliant insurance) and capital markets provide the foundations for the *syariah* economy and its institutions. The Islamic Banking Act (1983, IBA) provided “for the licensing and regulation of Islamic banking business” (BNM, 1983). The *Takaful* Act (1984) authorized and provided regulation for *takaful* business (BNM, 1984). The Banking and Financial Institution Act (1989, BAFIA) provided “new laws for the licensing and regulation of institutions carrying on banking, finance company, merchant banking, discount house and money-broking businesses, for the regulation of institutions carrying on certain other financial businesses” (BNM, 1989). In Section 124, BAFIA states that the law does not “prohibit or restrict any licensed institution from carrying on Islamic banking business or Islamic financial business” the *Syariah* Advisory Council responsibility for

regulating and overseeing *syariah*-compliance in *syariah* banks (BNM, 1989). The *syariah* banking sector operates under these three authorities (BNM, 1984).

The *syariah* capital market in Malaysia operates under the Securities Commission Act (1993, SCA) and is overseen by the Malaysian Securities Commission (SC), reporting to the Minister of Finance (SC, 2010). SCA Section 18 established the SC's *Syariah* Advisory Council (SAC) to regulate and oversee *syariah*-compliance in the *syariah* capital market (SC, 2010; MIFC, 2004; MIFC, 2009). The *syariah* capital market includes the *syariah* equity market, debt market, derivatives and futures market, and interbank money market (Hassan, 2009a). Other non-banking and finance *syariah* markets include development institutions, microfinance initiatives, venture capital, and private equity (Hassan, 2009a).

In the *syariah economy*, the product and transaction (primary or secondary) must be *syariah*-compliant. The difference between the *syariah* economy and the conventional economy is that in the *syariah* economy, *riba* (usury), and *gharar* (risk) are *batil* (invalid) and *haram* (forbidden), as explained in the Qur'an and *hadith*. *Riba* is a term debated among the *ulama* (religious scholars), but commonly accepted as usury or interest (interest is referred to as usury because it is banned, and therefore considered usury). There are three basic forms of *riba*: *Riba al-fadl* (money exchanged in unequal amounts) *Riba al-nasiah* (changing the total amount due on a loan based on overdue or prepaid loans – penalty or incentive) and the most *haram*, *Riba al-jahiliyyah* (charging a penalty for an overdue payment) which has two subsets: *Amhilni azidka* (a penalty fee) or *Da wa taajjal* (financial incentive for early payment) (El-Gamal, 2000).²

As there is no globally standardized definition for *riba* it is defined by domestic jurisdiction or *Syariah* Advisory Councils. *Syariah* economists and authorities vary widely on a definition or measure of *riba*. Definitions range from *riba* as all forms of interest to only certain (even more debated) forms of bank interest (both considered usury), to those that do not define *riba* as interest at all, but also vary on their definition of usury (Saeed, 2008:314-318). *Gharar* is less contested; examples include financial insurance (non-*takaful*) and derivatives (conventional

² Hadith: Muslim Abu Said Al-Khudriy: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is *Riba*” (El-Gamal, 2000:3).

forwards, futures, options, etc.) (El-Gamal, 2000).³ *Syariah* economic institutions avoid *haram* activities and promote the *halal* (permitted or *syariah*-compliant) attributes. *Halal* banking and finance activities include *sukuk* (*syariah*-compliant securities, bonds), *murabahah* (commercial transaction where goods are sold at a cost plus an agreed upon profit margin), *al-bai' bithaman ajil* (credit sales), *ijarah* (property leasing), *musyarakah* (joint-venture financing), *mudharabah* (profit and loss sharing (PLS) contracts), and *salam* and *istisna* (*syariah*-compliant forwards) (El-Gamal, 2000).

Syariah-compliant equity financing is a form of a PLS partnership whereby the decisions of the stock holders and the business officials are agreed upon and transparent. The idea is that the risk level is *halal* because it is an investment in businesses vetted for *syariah*-compliance (Saeed, 2008; El-Gamal, 2000). Profits made from *syariah* equity investment are not synonymous with interest. The *syariah*-compliant alternative to conventional insurance is termed *takaful*, a form of cooperative insurance where a pool of funds are collected, used for insurance purposes, and invested in *halal* investments (El-Gamal, 2000; Venardos, 2005).

2.2. The Malaysian Islamic Revival

2.2.1. Islamic Reform

Islam has a long and established history in Malaysia. This section studies the early Islamic revival, from the seeds of Islamic reform to the maturation of Islam as a central part of the Malay identity.

Scholars and traders from the Indian subcontinent and the Middle East introduced the *Shafi'i* school of Islam to Malaysia in the 1300s. Until the period of British colonization (18th-20th ce), Islam was administered at the village level, and considered the religion of the state by the Malay sultanate. Efforts by the Sultanates and British colonizers in the early 20th century to

³ Hadith: "Muslim 'Abu-Said Al-Khudriy the Prophet has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver" (El-Gamal, 2000:3).

politicize and bureaucratize Islam sparked calls from Muslims for Islamic reform; Muslims saw Islam used as a tool of the state. Muslims mobilized to re-think the fundamentals of Islam, looking to the origins of their religion for spiritual and moral guidance.

Reformist debate took place in gatherings of the *ummah* (Muslim community) and through domestic and foreign religious journals, brought back by Malay students returning from Cairo, Egypt. Reformists popularized the Egyptian Salafiyyah teachings of Muhammad Abduh “relaying nationalist and pan-Islamic sentiments to Malaya” (Means, 2009:22). The reformist movement (*Islah*) was divided into two groups: the modernist youth group *Kaum Muda* and the traditionalist elders, the *Kaum Tua*. Highly critical of each other, the *Kaum Muda* declared the *Kaum Tua* “the real obstacles to Malay progress” and the *Kaum Tua* declared the *Kaum Muda* “radicals” (Means, 2009:23). Concerned about their level of socioeconomic development in relation to other ethnic groups in Malaya, the Bumiputera sided with *Kaum Muda*’s youth Islamic modernism, using their discourse in forming a political and social identity around Islam.

The lineage of mentoring, education, and theological education shaped the evolution of the Islamic revival movement. *Kaum Muda*’s mentors such as Dr. Burhanuddin al-Helmy Mohd Noor and Zainal Abidin Haji Ahmad (Za’aba) influenced future political and religious leaders including Yusuf Rawa (PAS⁴) and Syad Nasir Ismail (UMNO⁵).

Dakwah (Islamic propagation or mission) organizations became the most influential vehicle for revivalist efforts to Islamize Malaysia. The government also became active in establishing *dakwah* organizations, arguably an early attempt to monitor, control, and frame the direction of the Islamic revival. Prime Minister (PM) Tunku Abdul Rahman established the *Persatuan Kebajikan Islam Malaysia* (PERKIM, Islamic Welfare Organization) in 1960 as a ‘non-partisan’ *dakwah* organization formed to care for recent converts to Islam; UMNO set up a number of good-will *dakwah* organizations to support Muslims at the community level (Hassan, 2003).

In the spirit of *Kaum Muda*, Muslim youth associations continued to play a considerable role, at civil and political levels, in promoting Islamization in Malaysia. Many of the youth and

⁴ *Parti Islam Se Malaya* - Pan Malayan Islamic Organization

⁵ *Pertubuhan Kebangsaan Melayu Bersatu* - United Malays National Organization

student members would later work in government, economic, or political sectors, carrying the ideas of these groups into roles of responsibility and power. The primary Muslim youth organizations in Malaysia are *Persatuan Kebangsaan Pelajar Islam Malaysia* (1961, PKPIM, National Islamic Students Association of Malaysia) and *Angkatan Belia Islam Malaysia* (1971, ABIM). Both were established by Muslim students at Malaysian Universities, and proliferated rapidly among the Muslim educated youth.

Advocating Islamization in efforts to develop and modernize Malaysia, ABIM and PKPIM criticized the government for not doing enough to consider Islamist values in social and economic policy. Vocal at the youth and community level, these youth groups spread positive and practical messages about the benefits of Islamization, receiving tremendous support from the Muslim *ummah* at large as a result. In 1972, Anwar Ibrahim was appointed Secretary General and in 1974 president of ABIM; he was the charismatic leadership and popularizing force behind ABIM, propelling it into a powerful civil organization and Islamic lobby among Malaysian youth until he decided to become a member of UMNO and enter federal level politics in the Mahathir administration (ABIM, 2010).

The overall Islamist dynamic of the late 1960s through the 1980s was vibrant; Muslims expressed their identity publically and as a symbol of their ethnic and nationalist pride and *dakwah* organizations flourished, amplified by Islam's popularity. The Malaysian government stepped up its Islamization efforts in the early 1970s, sponsoring a number of cabinet level offices and national Islamization policies. In 1968, the *Majlis Raja-Raja* (Council of Rulers), established the *Majlis Kegangsaan Bagi Hal Ehwal Ugama Islam Malaysia* (Secretariat of the Malaysian National Council for Islamic Affairs) based in the Prime Minister's Office (PMO) and in 1971 the GOM established the National Cultural Congress (NCC) to incorporate Islamic morals in all sectors of Malaysian governance (JAKIM, 2006; Funston, 2006).

The GOM also sponsored the *Institut Dakwah dan Latihan Islam* (INDAH, Islamic Propagation and Training Institute) and *Pusat Penyelidikan Islam* (PPI, Islamic Research Center) (Islam, 2005). Sealing its commitment to Islamization, the GOM assigned a Deputy Minister to the Malaysian National Council for Islamic Affairs in 1973. GOM made the Council a full-Ministry in 1997, a demonstration that the GOM considered the administration of Islam to be a federal priority (Funston, 2006).

2.2.2. Political History of the Malaysian Islamic Revival

The period of planning around Malaya's independence from 1949 to 1957 defined the future role of Malays and Islam in politics, economy, and Malaysian society. This was an incubatory time for political party, coalition, alliance, and social mobilization and formation.

During the WWII Japanese occupation and the return of the British after WWII the Bumiputera realized that the immigrant communities, especially the Malaysian Chinese, were dominating the economy. This sparked concern among the Bumiputera about their future prospects for economic development and share of the national economy (Mohd. Nor, 1999). Prior to Malaya's independence in 1957, Malayan society experienced a period of intense ethnic bargaining between Malaya's Bumiputera, Chinese, Indian, and other groups, over economic and political share. The Bumiputera demanded a solution to Malay economic inequity, preference in development policies and economic access, and government Islamization policies and initiatives in the independent Malaya.

The 1940s and 50s were rife with political mobilization marked by the rise, fall, and coalition of political parties. Each party vied for power by promoting the interests of certain ethnic and religious groups. Current political coalitions and alliances reflect these early attempts and political bargaining along ethnic lines. The predominantly Malay *Pertubuhan Kebangsaan Melayu Bersatu* (1946, United Malays National Organization, UMNO) fast became the dominant political party prior to, and after Malayan Independence. UMNO was part of the multi-ethnic coalition, the Alliance (later renamed Barisan Nasional) that has remained the single majority coalition in Malaya, and later Malaysia. *Bangsa Malaysia* (Malaysian Nation) was the foundation for UMNO's platform, and "remained focused on the role and position of Malays as Malaya's dominant indigenous group" (Hassan, 2003:99).

In building coalitions and forming alliances, Malaysian political parties had to make a "distinction between political and cultural loyalty" (Mohd. Nor, 1999:28). This meant that while each party represented the distinct interests of a particular ethnic or cultural group, the coalition followed a unified, negotiated coalition platform and vision. Tunku Abdul Rahman led UMNO's efforts in forming the Alliance (renamed *Barisan Nasional* (BN) in 1979) with the Malaysian

Chinese Association (MCA, led by Tan Cheng Lock) and other non-Malay parties (Mohd. Nor, 1999; Mutalib, 2008). Tunku Abdul Rahman later became independent Malaya's first Prime Minister.

The Islamist *Persatuan Islam Sa-Tanah Melayu*, later renamed *Parti Islam Se Malaya* (1951, PAS, Pan Malayan Islamic Organization) became the leading opposition party. The party was formed from former members of UMNO's religious department "but during its early years underwent a metamorphosis from which it emerged as a composite of a number of different interests" (Funston, 2006:56). These included former members of *Hizbul Muslimin* and other failed political parties.

The Communities Liaison Committee (CLC) was established in 1949 to negotiate inter-ethnic bargaining in pre-independence governance planning (Mohd. Nor, 1999). The CLC was composed of "six Malays, six Chinese, and one representative each from the Indian, Ceylonese, Eurasian, and European" population (Mohd. Nor, 1999:25). Dato' Onn led Malay representatives and Tan Cheng Lock led Chinese representatives. Decisions made by the CLC were not legally binding. The CLC forwarded resolutions, determined from candid closed-door inter-ethnic debates to the Federal Legislative Council for review and incorporation into drafts of the Constitution (Mohd. Nor, 1999).

The Constitutional Commission, dubbed the 'Reid Commission' (1952-1957), was led by the British justice, Lord Reid, made up of multi-ethnic, multi-national representatives and representatives from the Alliance, and tasked by the transition authority to draft the Constitution for independent Malaya (Mohd. Nor, 1999). The Reid Commission conducted traveling interviews and consultations within Malaya and receiving input via memoranda to gather information on Malayan needs and interests, incorporating feedback into the drafting process. The Reid Commission and the CLC were the two "occasions when the process of consultation and bargaining took place" (Mohd. Nor, 1999:29).

The Alliance's prominent position in Malayan politics was largely due to its inter-ethnic makeup and Malay dominated UMNO leadership. During 1952 to 1957, the Reid Commission tapped UMNO and the Alliance to be the leading coalition in the newly formed government.

Winning small but significant gains in local elections during the mid-1950s, PAS set itself up to be the Alliance's primary opposition, and competed with UMNO for the Muslim vote.

The Alliance issued a memorandum to the Reid Commission, petitioning for Constitutional provisions declaring Islam the religion of the state and guarantees that Islam would be administered at the state level in the independent Malaya (Funston, 2006). Dr. Burhanuddin al Helmy and Zulkiflee Muhammad, grandfathers of the Islamic revival had criticized Western and foreign dominance over the Malayan economy and culture, and called for Malays to take control of their national economic structure, trade relations, and national development planning. As it represented the diverse strata of the Malaysian population, especially ethnic Malay interests, the Alliance memorandum held considerable weight in influencing how powers were divided at the state and federal level, and in establishing a leading role for Islam in the independent Malaya (Mohd. Nor, 1999).

The Reid Commission produced the *Report to the Federation of Malaya Constitutional Commission* (specially mentioning the Alliance memorandum) in February 1957 and the Federal Constitution of Malaya was ratified 27 August, 1957. The Constitution declared Islam as the religion of Malaya, secured traditional Malay religious administration, authorized state and federal funding of Islamist organizations and activities and granted the *Yang di-Pertuan Agong* (the five-year rotating chair of the Council of Rulers) authority over the religion of Islam (Fealy and Hooker, 2006). The provision declaring Islam to be the national religion was a tremendous breakthrough for the Islamic revivalist movement.

Malaysia was expanding economically and territorially. The Federation of Malaya united into Malaysia in 1963 with the territorial expansion outside of peninsular Malaysia to Sabah and Sarawak. Socioeconomic status was still unofficially defined along ethnic lines; inequities and tensions were growing between the "haves" and "have-nots" (Hassan, 2009b). Islamization took priority rapidly as the Islamic revivalists increased political activism, calling for a balanced (spiritual, material) approach to economic growth in response to growing social and income inequity driven by urbanization and import substitution industrialization (ISI) policies.

Deadly ethnic riots erupted 13 May 1969 after a contentious 1969 general elections ignited Malaysian Chinese-Malay tension. This incident had the most profound effect on

Malaysian political, social, and economic policy of any single conflict event in its post-independence history. The Prime Minister suspended parliament, detained rioters under the Internal Security Act (ISA), and created the National Operations Council (NOC) to govern Malaysia until the ethnic disparities were resolved. Thereafter, the Prime Minister formed the National Consultative Council (NCC) made up of political parties, the governing coalition, and key leaders from each ethnic group in relative proportion to their share of the Malaysian population.

The goal of the political and economic committees was to “reflect the whole national ethos of Malaysia,” debating the causes and solutions to threats to national unity forming policies aimed at increasing national unity through reducing economic inequities (Mohd. Nor, 1999:33). The 1969 racial riots and the period of government lockdown zeroed Malaysia in on the needs and concerns of the underdeveloped and underprivileged Malay, and caused political turnover. PM Tunku Abdul Rahman resigned in 1970 (in part because of the ethnic riots) and Tun Abdul Razak assumed power over UMNO and the GOM.

PM Tunku Abdul Rahman had been an important figure in the Malaysian Islamization process, and at least in part because of his efforts, the Islamic revival blossomed domestically and after his resignation, became active internationally. Rahman was integral in setting up the multinational Organization of the Islamic Conference (OIC) serving as its first Secretary General and Malaysia hosted the 5th Islamic Foreign Ministers Conference of the OIC in 1974. The OIC was formed to build network of Muslim states, and foster social, economic and political development among Muslim states, through Islamic values and principles. He was a founding father of the Islamic Development Bank (IsDB) set up in 1975 by the OIC. The IsDB was formed to provide *syariah*-compliant development assistance to Muslim communities in member nations (IsDB, 2010a; Islam, 2005; Thani, 2003). The IsDB demonstrated that a bank could function and operate on a global scale according to *syariah* principles.

In 1974 the GOM founded the *Yasin Dakwah Islamiah* (Islamic *Dakwah* Foundation Malaysia YADIM) to organize *dakwah* groups and activities and reallocated the National Council for Islamic Affairs (MKI) to the Prime Minister’s Department under the new name *Bhagian Ugama* (Division of Religious Affairs) (Hassan, 2009b; JAKIM, 2006). In establishing the MKI, the government signaled that it was aware of the political implications of the social

power of the Islamic revival movement. The threat of social mobilization became more apparent during the 1979 Islamic revolution in Iran; balancing Islamization became a national priority. The Islamic revolution in Iran increased and escalated “Islamic consciousness in Malaysia” (Thani, 2003:12).

2.2.3. Economic Developments and Islam

This section describes the major economic developments and policies considering Islam, related to the future development of the *syariah* economic sector, and Malay Muslim (Bumiputera) development.

In the 1950s, the GOM implemented major economic reforms, allotting more economic privileges to the Bumiputera while formulating short and long term plans to develop and modernize the national economy. Initial actions to kick-start the Malayan economy included industrialization initiatives (late 1950s) and efforts to generate private funds to invest in infrastructure and commercial expansion (Ariff, 1998). Early GOM economic policies focused on stabilization in lieu of more progressive modernization policies involving expansion, and more exposure to the global market and foreign direct investment (FDI).

By the authority of the Central Bank of Malaya Ordinance 1958, GOM established Bank Negara Malaysia (BNM), Malaya’s central bank to manage the wealth of the nation and regulate the banking sector. BNM provided the “impetus for development of the financial market infrastructure including capital market”, although the capital market was established under the authority of the Securities Commission (Hassan, 2009b:15). In 1983 BNM was assigned to lead the design of the dual banking structure and legal and regulatory framework establishing the *syariah* economy (Hassan, 2009b; BNM, 2010).

Import substitution industrialization (ISI) was continued sparingly from the British administration to achieve two goals: develop citizens’ technical and professional skills and close the equity gap in terms of “income, services and educational opportunities” (Hassan, 2009b:62). These policies prompted urban migration; cities were modernized and new towns were created.

Rural areas developed to attract and facilitate economic activity and investment. This was a period of radical social and economic change.

The commercial sector experienced high levels of growth as a result of these policies (Hassan, 2009b:62). Islamic revivalists blamed these policies for causing the ‘uneven development’ that marked the 1960s. Economic inequities accelerated towards the end of the 1960s, “a portion of Malay ‘have-nots’ chose to react to capitalist inequities through Islam. This is because Islam, in the Malay mind, is associated with the quest for justice”; in this case justice meant understanding how, through Islam, the Bumiputera could seek a just mode of economic development balancing material gain with social wellbeing (Muzaffar, 1987:16-17). Revivalists took action, calling for policy reform aimed at balancing economic, cultural and spiritual development.

PM Tun Razak announced the New Economic Policy (NEP) in 1971. The Policy answered revivalist calls for balanced development addressing economic inequity:

“Accelerating the process of restructuring Malaysian society to correct economic imbalance, so as to reduce and eventually eliminate the identification of race with economic function. Programmes for this purpose included the modernization of rural life, the rapid and balanced development of urban activities, the establishment of new growth centres and the creation of a Malay commercial and industrial community in all categories and at all levels of operation. The objective was to ensure that Malays and other indigenous people become full partners in all aspects of the economic life of the nation” (*Pendapatan Dan Pengagihan*, Income and Distribution, EPU, 1999).

The NEP was a controversial policy, criticized as institutionalizing affirmative action, preferential to Malays, and later, as ineffective in raising the Bumiputera economic status.

Two GOM initiatives that had a tremendous impact on the future of the commercial sector and *syariah* economy were the Kuala Lumpur Stock Exchange (1973, KLSE) and Securities Industry Act (1976). They provided the institutional and legal foundations for the Malaysian capital market. At the end of the 1970s, Malaysia was on a path to economic

development and had made modifications to its development plans that acknowledged how critical cultural considerations are to socioeconomic progress.

2.3. Discussion

Malays mobilized through Islam to develop their Malay-nationalistic group identity. Using Islam as a representation of their interests in the intense consociational ethnic bargaining that took place during independence, Malays made every effort to negotiate, and at times, demand an equitable share of the economy, political representation, and cultural consideration in the newly formed Malaya. Islam was so fundamental to the Malay ethnic identity that it was the principal qualification that they lobbied for, and that the government granted, when the Bumiputera were negotiating a greater share of the economy and a balanced development. The Islamic revival proved to be very much a ‘bottom-up’ mobilization for Islamization; Muslims were involved in civil society groups and these groups were active in mobilizing the public and the government to respond or be aware of public trends and interests.

The study shows that the transition authority, during the CLC and Reid Commission, and the independent Government of Malaysia, during the May 13th ethnic riots employs consociational techniques as a means to stabilize social turbulence and negotiate peace. It could be argued that inter-ethnic concerns must be constantly negotiated and re-negotiated to maintain social order and political power. The economic condition of the people, especially the Bumiputera, was at the core of Malaysian social strife. PM Tunku Rahman’s government may have paid too much focus on raw economic growth to achieve development, and not enough on social wellbeing, to include culture and religion – a shortcoming that arguably cost him his leadership.

PM Tunku Rahman’s actions to halt Malaysian public administration and policy in its tracks after the May 13th ethnic riots, and engage the government in closed-door, candid discussions set the tone for Malaysian governance in the decades to come. The outcome of these discussions was a government, lead by the majority coalition UMNO, that retained a

parliamentary majority (until the present) made up of parties representing the autonomous interests of Malaysia's ethnic and groups. Each party serves the interests of its ethnically distinct constituency, but at the coalition level, and at parliament, engages in a constant process of negotiation. PAS's emergence as UMNO's political competitor for the Malay Muslim constituency encouraged this dynamic. Competition within a constituency means that political leadership has to demonstrate that it serves the interests of its people. The May 13th ethnic riots, coupled with the competition over the Bumiputera constituency created an environment where UMNO and the Alliance coalition consistently re-negotiated and monitored social and ethnic needs and tensions in order to retain a parliamentary majority through serving the interests of the people.

Malaysia has acknowledged its Islamist and Malay leanings, at the federal level, through Constitutional provisions and through its development policies such as the NEP. The government administered its Islamization policies in strict accordance with all segments of the Malaysian population in mind. The policy goal was that no Islamization policy would exclude or discriminate against a non-Muslim or non-Malay. The *syariah* economy, a direct result of the Islamization policies, was negotiated to work within *syariah* principles, but also to be inclusive of both Muslim and non-Muslim customers and employees, as evident in the dual conventional-*syariah* structure of the national economy. The two sectors operate simultaneously, under the similar federally administered legal code, and are open to licensed domestic and foreign investors (regardless of ethnic or religious affiliation).

3. Instituting Foundations

3.1. The Mahathir Era, Anwar Ibrahim, ABIM, and UMNO

In 1981 PM Tun Abdul Razak (UMNO) chose his Minister of Trade, Dr. Mahathir bin Mohamad to be his successor (Means, 2009:30). With the objective of harnessing Islam's political force, PM Mahathir held a seminar entitled, *The Concept of Development in Islam*. Based on the seminar's recommendations, PM Mahathir established oversight committees for "law, economics, education, science and technology" sectors (Means, 2009:30). Khoo Boo Tiek, author of *Mahathirism* argues that Mahathir's immediate actions to control and frame Islamization was motivated by "an intense desire to locate Islam at the heart of the Malaysian social-political orbit and to contribute to the resurgence of Islam as an intellectual and cultural force" (Liow, 2009:46). In feat of political strategy, PM Mahathir drew Anwar Ibrahim, *dakwah* activist and leader of the youth group ABIM (highly critical of both UMNO and government efforts to Islamize Malaysia), into politics. Anwar left ABIM to become a member of UMNO in 1982.

UMNO's strategy was to use Anwar to harness the tremendous social force of Islam, incorporating it into functional institutions. Anwar brought a considerable force of civil society to BN and the GOM - a benefit and vulnerability, as the support that came with Anwar was attracted to his charismatic leadership and ideological leanings. This support would follow Anwar in his departure from UMNO in 1998, destabilizing the majority coalition. In 1982 Mahathir issued the official Islamization policy for the civil service, *Dasar Penerapan Nilainilai Islam*. It was "intended as a government initiative towards securing balanced material and spiritual development" (Hassan, 2003:100).

During this period "UMNO...integrated some of the Islamic slogans, symbols, technologies and concepts that were popularized by ABIM...into its own Islamic discourses...to strike chords with the *dakwah* people and enhance its Islamic credentials in the eyes of PAS" (Hassan, 2009b:74-75). Dr. Mahathir drew on Anwar Ibrahim's knowledge of *dakwah* trends and

initiatives to develop policies to “inculcate” Islamic values into government policy and public institutions (Funston, 2006:59).⁶

Recognizing that Anwar’s position in UMNO and Malaysian politics provided valuable political capital, ABIM changed its discourse and modus operandi. ABIM realized that it had political will behind their push for Islamization; forming strategic political alliances could increase both GOM’s and ABIM’s ability to affect Islamization. During the 1980s, ABIM focused its discourse on balancing economic development with spiritual and cultural development, a theme continued from the 1960s-70s (Hassan, 2009b; Ching, 2008; Jomo, 1999; Ariff, 1998).

3.2. Regulations Establishing *Syariah* Financial Institutions

A series of events culminated in PM Mahathir creating the National Steering Committee on Islamic Banking, tasked to create the institutional foundations for the *Syariah* economy in Malaysia.

ABIM established the *Koperasi Belia Islam* (KBI, 1977) a *syariah*-compliant financial cooperative, to demonstrate the potential for the *syariah* economic institutions to be competitive with conventional economic institutions (Hassan, 2009b). This was accomplished under the leadership of Anwar Ibrahim. It was apparent that one of the first initiatives that Anwar Ibrahim would take on as Finance Minister in 1991 would be the development of federally administered legislation to regulate the *syariah* economy (Thani, 2003:12; PNB, 2010).

In 1980, mirroring ABIM’s *syariah*-compliant cooperative initiative, the Bumiputera Economic Congress challenged the GOM to authorize the Pilgrims Management Fund Board (1969) to create a *syariah* bank “in order to mobilize the funds of Muslims” (Thani, 2003:13). In response, the Pilgrimage Management Fund Board conducted a study measuring the viability of instituting a *syariah* economy in Malaysia (Thani, 2003). The “Chief Executive of the Board attended the International Seminar on Islamic Banking and Insurance...in June 1981,” returning

⁶ For example, the International Islamic University was established outside of Kuala Lumpur.

with a tremendous amount of information and research (Thani, 2003:14). At the 1981 seminar *The Concept of Development in Islam*, participants including intellectuals, government, and industry representatives passed a resolution to develop federal legislation to establish *syariah* banking, *takaful*, and finance institutions (Thani, 2003:14).

As a result of the seminar, the Development Bank of Malaysia held a meeting (1981) attended by (among others) officials from the Development Bank of Malaysia, the Pilgrims Management Fund Board, PERKIM, and Bank Bumiputera Malaysia Bhd. This meeting resolved to create the *Study Group on Islamic Bank*, to conduct research and outreach to the International Association of Islamic Banks, and Islamic banks located globally (Thani, 2003). The Pilgrimage Fund Board's *Meeting of the Financial Advisory Board* (1981) discussed the issue of establishing a *syariah*-compliant bank (Thani, 2003). On 10 July 1981, the Study Group and Financial Advisory Board met to coalesce efforts and issue recommendations to the GOM on forming *syariah* banking architecture. Thereafter, the Board presented the combined proposal to PM Mahathir (Thani, 2003; Yakcop, 2002). On 30 July 1981, PM Mahathir formed the *National Steering Committee on Islamic Banking*, responsible for forming the institutional foundations for the *syariah* economy (Yakcop, 2002).

Like his predecessors, PM Mahathir was actively involved in the international network of Muslim states and Islamist organizations. At the multinational level, the IsDB board of governors held their 3rd annual general meeting; resolving to establish the Islamic Research and Training Institute (IRTI) (IsDB, 2010c; Thani, 2003). IRTI's mission is to provide its services to IsDB member and non-member countries "to help bring their economic, financial, and banking activities into conformity with *Shari'ah* and to further economic development and cooperation" (IsDB, 2010c). This meant that for the first time, the international *syariah* economic community had a mechanism to bring local *syariah* economic practices into a research and training institute that aimed create a global vision of *syariah* economic operations and training standards.

In the General Meeting of the Regional Islamic Council for Southeast Asia and the Pacific (RISEAP) PM Mahathir announced:

It is always our intention to play an active role in the Islamic *dakwah* movement, both locally and internationally. It is our policy to be closely associated with Islamic nations

and to support Islamic causes. In this regard we believe that our participation should not only be active but also truly effective in the true sense of the word...We in Malaysia will continue to do everything within our means to assist in the struggle of the Muslim ummah, for the right to live the life of true Muslims (Mahathir bin Mohamad in Means, 2009:32-33).

While Mahathir was beginning efforts to establish the Malaysian *syariah* economy, he was reaching out to the global and regional *ummah* (Muslim community) to understand trends, activities and issues, feeding them into his domestic Islamization efforts.

The National Steering Committee on Islamic Banking issued its final report to the GOM on 5 July 1982; GOM accepted the recommendations (Thani, 2003). Recommendations included: “the prohibition of Riba...management of Islamic banks based on Islamic acts and practices (Mu’amalah Islamiah), [and] avoidance of the activities contrary to the interest of the Muslim *ummah*” (Thani, 2003:15-16). The recommendations were intentionally broad, allowing for interpretation and debate. Bank Negara Malaysia (BNM) was responsible for designing “dedicated Acts for Islamic banking, *takaful* and *shariah* compliant government funding” (MIFC, 2010c).

The Islamic Banking Act (1983, IBA) and *Takaful* Act (1984) provided the foundation for *syariah*-compliant banking institutions. The GOM-administered *Syariah* and Civil Law Coordination Committee proposed establishing more laws, especially for the “administration of property” (Hamayotsu, 2003:69-71). The IBA and *Takaful* Act did not replace the conventional banking and insurance sectors, but rather operated under a dual-banking system.

These laws enacted within the dual-banking system were federally administered, falling under the jurisdiction of common law courts, not *syariah* courts. A possible reason being that the *syariah* economy welcomed both Muslim and non-Muslim customers; non-Muslims are not held accountable to *syariah* law, administered at the state level. Federal administration allowed the sector to expand into the global marketplace and encouraged foreign investment. Defining *syariah* principles in a non-*syariah* court presented complications in *syariah* financial disputes. Lawyers and judges within this system were not necessarily trained in *syariah* principles. The *Syariah* Advisory Council had limited authority to affect judgments. Malaysia addressed this

shortfall by encouraging and ultimately requiring training in *syariah* principles and expanding the powers of the National SAC (1997) in 2009.

Enacting the IBA required amendments to the following legislation: Banking Act 1973, Companies Act 1965, Central Bank of Malaysia Ordinance 1958, and Finance Companies Act 1969, all to provision licensing and regulatory measures for the *syariah* bank (BNM, 1983). The IBA is divided into seven parts. It defines the requirements for licensing domestic and international Islamic banks and establishes a *Syariah* Advisory Council for the *syariah* bank (BNM, 1983). Part III defines capital adequacy and reporting requirements (including those for international Islamic banks in Malaysia) and Part IV requires banks to report to BNM activities and events of significant risk to the operation of the bank (BNM, 1983). Part V outlines restrictions for *syariah* business and licensing requirements and qualifications for international banks registering as an Islamic bank (BNM, 1983). Part VI gave the Minister of Finance responsibility for federal regulation and oversight (via BNM) of the *syariah* banking sector (BNM, 1983).

The IBA meant that for the first time in its history, Malaysia could officially license and establish a *syariah* bank, and its assets and operations were protected and regulated by federal authorities. It set the limits and structure of the Islamic Bank, but still did not define *riba*, *gharar*, or other *haram* practices the *syariah* economy; the only mention of “interest” made reference to the amendment of Banking Act, 1973), subsection (4)(a) and (b), deleting the words “interest charge” and “interest” (respectively). It left the interpretation of Islamic principles to the *Syariah* Advisory Councils’ discretion.

The IBA does not sufficiently define *syariah* contract law; only one reference is made in Part VII 52. (2)(c) giving BNM authority to issue regulation relating to contracts (BNM, 1983). The lack of defined contract law for the *syariah* sector is a critical liability because *syariah*-compliant financial mechanisms are by design more reliant on contracts than the conventional sector. Undefined contract law specific to *syariah* institutions and transactions leaves the sector vulnerable to handicaps such as double taxation and misinterpretation of disputes involving *syariah* commercial transactions (Dusuki, 2009).

The first Malaysian *syariah* bank licensed under the IBA (and Companies Act (1965)), Bank Islam Malaysia Bhd. (BIMB), was established with government backing on 1 March 1983 (MIFC, 2010c; MIFC, 2010b; MIFC, 2009 Thani, 2003). Conventional banks began to test the waters, issuing *syariah*-compliant services, regulated by BNM and the SAC (Thani, 2003; Reuters, 2009). MIFC describes the vital elements that BNM identified in its strategy to develop the *syariah* banking system as, “a large number of players; a broad variety of instruments; and an Islamic money market....an Islamic banking system must also reflect the socioeconomic values in Islam, and must be Islamic in both substance and form” (MIFC, 2010c).

The Government Investment Act (1983) provided the legal basis for the government to issue Government Investment Certificates (GIC). The GIC is a non-interest bearing certificate “*Qardh al-Hassan* (benevolent loan)...to enable the government to undertake projects or provide services to the benefit of the nation” (Thani, 2003:21). The government was stimulating the newly developed *syariah* financial market to fund public infrastructure and development projects. The Securities Industry Act (1973, SIA) was amended in 1983 to include provisions for *syariah*-compliant investments (Ching, 2008; SC, 1991). This provided a more solid foundation for *syariah* finance to operate domestically and internationally. Aiming to pump-prime FDI and domestic commerce, the GOM announced the Privatization Policy (1983) (Hassan, 2010).

Designed according to recommendations from the Task Force on the Study for the Establishment of an Islamic Insurance Company in 1981, the GOM enacted the *Takaful* Act in 1984 (*Takaful-Malaysia*, 2009).⁷ As part of BIMB, BNM licensed *Syarikat Takaful Malaysia Berhad* (*Takaful-Malaysia*) 29 November 1984; it commenced operations 22 July 1985, and launched by PM Mahathir 2 August 1985 (*Takaful-Malaysia*, 2009).

MIFC guidelines describe *Takaful* as a form of cooperative insurance, designed as a combination of *mudharabah* (PLS) and *wakalah* (agency) models (MIFC, 2010d). It is based on the *tabarru* concept which means members’ donations collect in a common fund used to provide a financial safety net for certain covered accidents and emergencies. The difference between conventional and *takaful* insurance has to do with the way the funding pool is invested; *takaful*

⁷ “The Task Force in its report concluded that a *takaful* company based on the principle of al-mudharabah would be a viable venture in view that its participants would have the opportunity to save, invest and earn profits based on this principle” (*Takaful-Malaysia*, 1999).

avoids *riba*, *gharar*, or *masir* (MIFC, 2010d). The GOM enacted the Banking and Financial Institutions Act (1989 BAFIA) allowing any licensed and BNM-approved banking and financial institution (conventional and *syariah*) to conduct *syariah*-compliant business, regulated by *Syariah* Advisory Council (Shariff, 2009; BNM, 1989).

The IBA (1983), *Takaful* Act (1984), SIA amendment (1983), BAFIA (1989) and Privatization Policy (1983) indicate a policy shift towards instituting the legal and regulatory foundations for a privatized economy; however, the GOM did continue to protect certain infant sectors of the economy (such as the *syariah* economy) until they were able to operate independently.

3.3. Islamization of the Government Machinery

The Malay Muslim middle class grew during the 1970s through the 1990s, becoming more politically and economically active and aware. The GOM targeted this Muslim middle class to staff, manage, and patronize *syariah* economic institutions. One of the primary objectives of the NEP was to reduce the economic inequity between ethnic groups in order to remove associations of socioeconomic condition with ethnic groups. The growing middle class was the realization of these goals. Dr. Dato' Sharifah Hassan suggested that the education, training, banking, *takaful*, and finance institutions associated with the *syariah* economy were designed in part to provide economic opportunities for Malay Muslims to lead the development and management of this niche market (Hassan, 2010).

PM Mahathir announced his intent to “Islamize government machinery” in 1984, describing “the inculcation of Islamic values in government...the laws of the nation although not Islamic based, can be used so long as they do not come into conflict with Islamic principles” (Mahathir bin Mohamad in Islam, 2005:126). This meant that the government machinery would not become Islamic, but would adhere to Islamist principles so long as they did not discriminate other ethnic groups. The *Bahagian Ugama* (Division of Religious Affairs) became the *Bahagian*

Hal Ehwal Islam (Division of Islamic Affairs) in 1984, and PM Mahathir created the Islamic Development Foundation, in alignment with his statement of intent (Funston, 2006; Liow, 2009).

Initially, the marketing strategy for *syariah* banking targeted the Malay Muslim rural population, traditionally customers of conventional banks and financial institutions. This spurred competition between *syariah* and conventional institutions. The *syariah* bank thrived, mostly because of competitive loan rates (mortgages and auto loans). By the late 1980s BIMB was the “third largest bank” in Malaysia (Liow, 2009:55). The initiative creating the *syariah* economy was so successful for UMNO that its “contributions to Malaysia's Muslim community” were recognized by PAS, a political win for UMNO (Liow, 2009:55).

Malaysia experienced a severe recession in the mid-1980s, leading to economic policy reforms. The Fifth Malaysia Plan (MP5 1986-1990) and post-recession reforms increased the role of foreign direct investment (FDI); the result was that Malaysia’s high growth rates resumed (Jomo, 1999).⁸ GOM publically reiterated its commitment to Bumiputera development, and many policies remained, but unofficially let the market dictate competition and economic winners; FDI was one of them. The *syariah* economy benefitted from privatization. While the Malay seemed apprehensive that FDI would take their share of the economy, the success of the *syariah* economy gave the Bumiputera a competitive edge in the domestic and global market. Foreign banking and finance corporations establishing operations in Malaysia grew interested in the potential market value of the *syariah* economy, domestically, and globally. The high growth rates of the *syariah* economy coupled with its competitive edge on conventional debt products did not go unnoticed.

The Supreme Court, led by the Chief Justice of Malaysia, assumed total domestic authority over appeals cases in 1985, previously held in London at the Privy Council (Redzuan et al., 2007). The implication for the *syariah* economy is that the Federal court, now totally administered by a strong and competent domestic judiciary, could evolve to consider the legal needs of the *syariah* economy. Priorities included training judicial officials in *syariah* economic principles in order to better represent *syariah* commercial disputes. This development also meant

⁸ “Economic liberalization, massive ringgit depreciation, economic liberalization, privatization, improved official support for the private sector, increased investment incentives, regressive supply side oriented tax reforms, vision 2020...Significant tendency towards economic liberalization or the voluntary structural adjustments encouraged by the Breton Woods institutions from the eighties” (Jomo, 1999:85-86).

that the GOM had greater legal control to implement its Islamization policy, calling “for greater mobilization of economic and financial resources...to develop existing Islamic institutions or to construct new ones to make Islam and Islamic identity more conspicuous” (Hassan, 2009b:75).

In 1986 PM Mahathir issued *The Challenge*. The document called on the Bumiputera to seek social and economic development with, or through Islamic values (Hassan, 2003). One ‘challenge’ was in choosing the appropriate way to practice Islam (as there were many). The GOM remedied this in 1986, amending the Constitution to declare *Sunni Islam* the Islamic sect of Malaysian Muslims (Hassan, 2003).

Muslims and non-Muslims alike had the opportunity to work within the *syariah* economic sector. Chandra Muzaffar argues that the *syariah* economy is problematic for the middle class (as a whole) “it may abolish interest but, given the capitalist structure of the economy, the bank, like other commercial banks will continue to mobilize the savings of the ordinary people for investments that will earn high profits, which will...benefit those in the middle and upper” classes (Muzaffar, 1987:82). The *syariah* economy, adhering to privatization policies, competing with foreign banks backed by global corporations, and launched into the global market, operated via a *syariah*-compliant profit motive, adhering to *syariah* principles.

Nawab Haider Naqvi and Muzaffar argue that the “abolition of interest in a capitalist economy without other fundamental changes can only lead to greater injustices and inequities” (Muzaffar, 1987:82). Interest (as usury) may have been abolished in name, but in practice, products like *murabahah* allow the bank to add charges or mark-ups (defined in a contract) in providing financial services. This meant that through transaction mark-ups, banks earn a profit and cover operational costs, something necessary when competing for business with conventional banks. FDI presented a real threat to GOM efforts to reduce Bumiputera socioeconomic inequity as foreign banks and companies entered the *syariah* economy (designed by GOM to be a Malay-dominated economic sector). It was up to the Bumiputera to build on the competitive edge granted by GOM development policies.

At the 1987 *Gemaputra* conference, the Bumiputera lobbied for economic liberalization to include ‘Malay-controlled business groups’ arguing “excessive intervention as slowing economic growth, and counterproductive to their interests” (Jomo, 1999:95). ABIM established

the Islamic Outreach program in 1987, providing community outreach, religious classes, health care and financial assistance to the needy (Hassan, 2009b). In 1988 the GOM took action to reorganize public corporations and increase privatization policies. “New management was brought in from the private sector and local and foreign private capital was injected through joint venture arrangements....the regulatory regime was liberalized to encourage direct foreign investment” but, the government continued to play an active role in planning and funding economic development (Wilson, 1999:125). The EPU issued the Privatization Master Plan in 1989, drastically reducing publically funded commercial development, and empowering the private sector.

Revolutionizing the global *syariah* economy, the IsDB established the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) on 26 February 1990 (Reuters, 2009; AAOIFI, 2009). The AAOIFI created an international standard for accounting and auditing. It did not fill the pressing need to standardize definitions of financial instruments and procedures, but it did provide a platform for future initiatives to form global standards for the *syariah* economy and marketplace (AAOIFI, 2009). While the GOM leaned towards economic growth, modernization initiatives, and a greater role for Malaysia in the global marketplace, civil society continued its push for balanced development, considering culture, and social wellbeing as being integral to material gain and modernization in Malaysia.

3.4. Vision 2020

Delivering the speech, *Malaysia: a Way Forward*, Dr. Mahathir announced the new development and modernization plan, Vision 2020, at the 1991 Malaysian Business Council Meeting, citing economic liberalization, increased efficiency, and competitiveness as principle objectives to modernization (EPU, 2010; Jomo, 1999). Aiming for full development by 2020 Vision 2020 policy reforms included: deregulating the market, privatizing public projects, and importantly, removing the ‘ethnic redistribution’ provisions formerly inserted in development plans of the NEP-era (Jomo, 1999).

The biggest challenge to the GOM was how to achieve the Vision 2020 goal of a modern and developed Malaysia while avoiding economic inequity and polarization among its population, especially along ethnic lines. Vision 2020 cultural considerations include dedication to a “just and caring society, mature democratic society, [and] sustainable development” (Ching, 2008:21). This meant that Vision 2020 required Malaysians to unify domestically, economically, in order to compete with the new dominant player – the global market and foreign investors.

Prior to developing the NEP-successor policy (The New Development Policy (NDP)) GOM formed the National Economic Consultative Council (NECC), comprised of members of political parties, commercial representatives, and members from Malaysia’s ethnic groups. The Council met between 1989 and 1991, issuing a report to the GOM 6 February 1991 (Mohd. Nor, 1999). In June 1991, the GOM announced the NDP (Mohd. Nor, 1999). This plan, spanning 1991-2000, recognized that Malay economic equity was not at the NEP goal of 30% ownership (EPU, 2010). The NDP retained most of the NEP policy goals, aiming to “strike an optimum balance between the goals of economic growth and equity; reduce social and economic inequality, ultimately eliminating imbalances within ethnicity...promote positive spiritual and social values” while building human capital and employment opportunities (Ching, 2008:19). This policy was designed to complement Vision 2020 and to continue efforts to build a strong middle class.

In the same year, 1991, GOM enacted the Securities Industries (Central Depositories) Act, regulating central depositories and securities deposits to central depositories. One of the first laws drafted in the fully dual-economy, the Act mentioned *syariah* banks (IBA, 1983) and conventional banks equally (SC, 1991).

PM Mahathir appointed Anwar Ibrahim Minister of Finance in 1991. He served until PM Mahathir appointed him Deputy PM in 1993. At the IsDB in 1992, Anwar expressed reservations about the regionalization of *syariah* economies, alerting member states to the investment potential of a globally networked *syariah* economy (Musalib, 1993). Anwar was calling for a more closely knit and standardized *syariah* economic community aimed at mutual development. Domestically, he showed this commitment to the global potential of the *syariah* economy by strengthening regulatory foundations and working to systematically prevent “corruption and

other nepotistic tendencies and loopholes” primarily focused at large-scale institutions (Mutalib, 1993:87).

The first era of MIFC’s *syariah* economic evolution and current development ended with two major developments. 17 January 1992, the BIMB was listed on the KLSE, and in the same year the GOM created the *Institut Kefahaman Islam Malaysia* (IKIM, Malaysian Institute of Islamic Understanding). IKIM was founded to “work with other national Islamic agencies to propagate “progressive” Islamic ties congruent with UMNO’s version of “modern Islam, or Islamic Modernism” and in support of the spiritual and Islamic values that PM Mahathir mentioned in his inaugural speech for Vision 2020. (Liow, 2009:52-53). These laws, regulations, policies and institutions provided the solid foundation necessary for the *syariah* economy to function. Further legal and regulatory developments were guided by more than a desire to lay the industry’s foundation; they were influenced by market factors and by efforts to keep *syariah* economic principles at the heart of transactions while competition with conventional financial institutions grew fierce.

3.5. Discussion

The driving forces making the development of the Malaysian *syariah* economy a national initiative during this period were, first, PM Mahathir’s political efforts to harness Islam and inculcate Islamic values in public policy and government administration. Second, the Islamic revival’s civil society was the most powerful driving force in creating the impetus for a *syariah* economy, *dakwah* organizations and especially youth groups such as ABIM pressured the government to act by creating their own *syariah* cooperatives. Third, when Anwar Ibrahim split from ABIM, joining UMNO, he brought the Islamic revival into the heart of Malaysian politics; the Ministry of Finance made significant efforts to expand and continually develop the *syariah* economy under his Ministry.

Fourth, the *syariah* economy was a global phenomenon. PM Mahathir, Anwar Ibrahim, and Malaysian civil society were very active in the global Muslim community. Recognizing the

syariah economy's market and potential for contributing to socioeconomic development, they made it an example for Islamist modernization. Lastly, the legal and institutional foundations (IBA, Takaful Act, SIA, GIC, and BAFIA) created by the government, through acts of Parliament and the Ministry of Finance were both driving forces making the *syariah* economy a national initiative and the necessary actions to make the sector operational at national and international levels.

Politically, the *syariah* economy was founded to serve four goals: appeal to the interests of the UMNO and BN Malay constituency, legitimize Mahathir and UMNO's leadership, build legal and regulatory frameworks to protect capital mobilized in syariah economic institutions, and generate jobs and commercial opportunities for Malay Muslims. The forthcoming government and civil society effort to develop the *syariah* economy was not an isolated phenomenon.

Mahathir's ability to affect Islamization in Malaysian demonstrates that the decisions made by leadership have a profound impact on the government and party system. Mahathir's leadership is what Weber terms the charismatic domination by virtue of legality. Political leaders seek power for a reason – to serve an aim such as an ideology, egoistic cause or simply to achieve power. The personality, aims, and driving nature of the leader, in this case, Mahathir, considerably influences Malaysian politics, defined as “independent leadership in action...the influencing of a leadership of a political association” (Weber, 1977).

Weber argues in a modern state, such as Malaysia, bureaucracy has a greater role in influencing the national economy, and is designed in such a way to integrate honor and integrity into their duties, while maintaining a sense of obedience to their leader or ruler (Weber, 1977). In Malaysia, we can see this evident in the Ministry of Finance's quality and speed in executing and building the *syariah* economic sector. As noted in Chapter 2, many of the Islamic revivalists and members of *dakwah* groups entered politics and bureaucratic employment; these civil servants arguably approached this task with a sense of professional and spiritual fulfillment and dedication.

Both civil society and the government pushed for modernization with Islam. The Islamic revival and all the organizations fueling it were responsible for driving Islamization and making

the development of the *syariah* economy an initiative. The government of Malaysia was responsible for inculcating Islamization into government policy, through PM Mahathir's intent to 'Islamize government machinery', (1984) and it was the driving force in making the *syariah* economy both a national initiative and a legally backed economic sector.

PM Mahathir may have issued the stamp of approval on creating the *syariah* economic sector, but it was the banking and financial bureaucracy who executed the initiative - the speed and solid foundation put forth by the bureaucracy in executing this task deserves mention. In designing and instituting the foundation for the *syariah* economy, civil servants, especially those who took part in the Islamic revival, felt a sense of integrity and honor in their work, a spiritual devotion to their vocation, and an increased sense of allegiance to their leader, both the Minister of Finance (Anwar Ibrahim, at one point), and Prime Minister Mahathir. Politically, it was a beneficial strategy to win the hearts and minds of civil servants.

The *syariah* economy's operations and core principles were based on the ideals found in the 'spirit' of capitalism, a work ethic driven by the desire to succeed in building an economy based on Muslim values, contributing to community development through generating employment opportunities, social enterprise, and the opportunity for Muslims to conduct commercial business according to their religious values. The Malaysian government subsidized the sector, using public infrastructure projects to inject the level of capital necessary into the infant industry so that it could grow, and eventually mature into a collection of independently functioning institutions. The privatization policy ultimately allowed the *syariah* economic industry players to mold the sector according to its religious determinations and provided the Bumiputera an opportunity for development and modernization through this competitive market.

Within the idea for a *syariah* economy, initially proposed by Islamic revivalists, PM Mahathir saw an opportunity for real gain, for the domestic economy, for Bumiputera development, for Malaysia's political and economic rank and power status among Muslim states, and for the purpose of bolstering and retaining his personal and party's political legitimacy. The *syariah* economy was a reaction to what Muslims in Malaysia saw as an imbalanced approach to economic development. It provided a mechanism for social and economic development that aimed to balance material gain with culture, religious values and ethics, and social well-being.

4. Institutional Building, Activity Generation, and Market Vibrancy

4.1. Malaysian *Syariah* Economy Enters the Global Marketplace

In the 1990s the *syariah* economy shifts focus from building legal and regulatory foundations to generating activity, market vibrancy and product innovation, and developing laws and regulations in reaction and anticipation to market developments. Profit maximization and the competitive domestic and global market challenged the financial sector's creativity in innovating products. *Syariah* Advisory Council oversight and regulation activities increased and became critical for maintaining institutional *syariah*-compliance, and the legitimacy of the *syariah* economy. The MIFC identified significant events, between 1993 and 2000, to include: "legislative amendments to allow window-concept; Establishment of National *Shariah* Advisory Council to expedite the expansion of products and services; [and] establishment of the Islamic interbank money market" (MIFC, 2010b). This section will discuss the cultural, political, and legal activities contributing to these developments.

The GOM passed the Securities Commission Act (1993), Anwar Ibrahim's last major legislative breakthrough as Finance Minister before becoming Deputy Prime Minister. The Securities Commission (SC) is responsible for overseeing and regulating the capital market, to include the *syariah* capital market, reporting to the Minister of Finance, and delivering its reports to Parliament (SC, 1993; SC, 2010; Hassan, 2009a).

In order to generate activity and market vibrancy, BNM had to create a mechanism to expand the market potential and exposure of *syariah* economic intuitions and services. Expanding the *syariah* investment potential to all licensed banks, BNM introducing *Skim Perbankan Tanpa Faedah* (1993, SPTF, Interest-Free Banking Scheme) (MIFC, 2010b). SPTF authorized conventional banks to open *syariah* "windows" offering *syariah* banking services and products in their branches (MIFC, 2010b). This initiative was seen by BNM as the most cost-effective, time-efficient way to proliferate *syariah* banking domestically (MIFC, 2010b).

The SPTF was "premised on a dual banking system; a fully fledged Islamic banking system operating on a parallel basis with a sophisticated conventional banking system" and was open to international banks licensed in Malaysia (Bakar, 2008:100). This was a creative marketing strategy for mobilizing capital by increasing the *syariah* economy's visibility and

accessibility. The demand and awareness created by SPTF was designed to attract foreign investment and spur demand, securing a place for the Malaysian *syariah* banking and finance sector in the global market.

The Ministry of Finance tasked the SC to “promote and develop the securities and futures markets in Malaysia” (MIFC, 2010a; MIFC, 2004). To strengthen this framework, GOM passed the Futures Industry Act (1993) to “provide for the establishment of futures exchanges, and to regulate trading in futures contracts”; all references to a “licensed bank” include “licensed Islamic bank” (SC 1994). Once the GOM had established the legal foundation for the *syariah* capital market, the SC began developing *sukuk* (*syariah*-compliant bond, equity) and *syariah* government investment certificates (GIC) markets (Hassan, 2009a).⁹

On 1 March 1994, *Cagamas Berhad* introduced Malaysia’s first global *sukuk* and the “world’s first mortgaged-based Islamic security”, the *Cagamas Mudharabah Sukuk*, to “finance the purchase of Islamic housing” (IIMM, 2010). The Arab Malaysian Unit Trust (AMMB) issued Malaysia’s first unit trust fund, *Tabung Ittikal* on 12 January 1993 (AMMB, 2010).

Many products innovated by *syariah* financial institutions mirrored conservative versions of products offered in the conventional financial institutions. A challenge to the SC and BNM was how to develop attractive and competitive banking and finance products unique to the *syariah* economy; BNM was active in this respect. In 1993 BNM created 21 *syariah*-compliant banking products in partnership with BIMB and licensed Malaysia’s second *takaful* company, *Takaful Nasional* (Thani, 2003).

The Ministry of Finance established the Islamic Interbank Money Market (1994, IIMM) providing a mechanism to allow “surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system” (IIMM, 2010). The IIMM linked the myriad of *syariah* economic institutions and “over 40 Islamic financial products and services” (MIFC, 2010b). In 1994, spearheading corporate

⁹ “Sukuk refers to trust certificates or participation securities that grant investors a share of the asset including the cash flow and risks that commensurate from such ownership. Similar to financial bonds in the conventional financial industry, sukuk are proof of ownership title and are utilized by financial institutions to raise cash. Both conventional bonds and sukuk are structured in tandem with physical assets that generate revenue....However, unlike a bond, sukuk can be designed from innovative applications of Islamic financial contracts” (MIFC, 2010).

development of the Islamic equity and derivatives market, BIMB created the first “fully fledged Islamic stock brokering company, BIMB Securities” (Hassan, 2009a:22).

The SC established the Securities Industry Development Corporation (1995, SIDC) to develop “regulators, company directors & market professionals” targeting the workforce active in domestic, regional, and international capital markets (SIDC, 2009; MIFC, 2009). SIDC also provided capital market training courses exclusively for *Bumiputera*, which included modules on *syariah* capital market legislation, operations, products, and *syariah* principles (SIDC, 2009, MIFC, 2009). SIDC held distinct workshops and seminars on *syariah* finance, but did not establish its first *Islamic Markets Program* until 2007 (SIDC, 2009). The focus on *syariah* capital market in the *Bumiputera* capital market training course was an intentional effort to attract *Bumiputera* into *syariah* capital market institutions and operations.

By the late 1990s, KLSE emerged as the largest stock exchange “in ASEAN, third in the Asia Pacific region after Tokyo and Hong Kong and the fourteenth largest in the world in terms of market capitalization” (Wilson, 1999:133).¹⁰ Malaysia attracted high levels of investment, especially foreign investment because its financial architecture was highly developed, designed according to the familiar common law structure, and the Ministry of Finance was vigilant in monitoring and enforcing laws and regulations in the commercial sector. This provided foreign and domestic investors with a sense of confidence in the system and insurance against commercial risk when conducting business within Malaysia.

The GOM was building on the foundation of the economy, making systematic improvements to modernize domestic commercial institutions. The government prioritized manufacturing in its economic planning, a *syariah*-compliant sector heavily financed by commercial banks in Malaysia (Wilson, 2009:133). The Seventh Malaysia Plan (MP7) and the 2nd Industrial Master Plan aimed at “maximizing intra-industry synergies” and “the private sector will spend over twice the amount which the state allocates” to physical infrastructure (Ariff, 1998:9, Wilson, 1999:128). *Syariah* banks were competing against conventional banks for loans to the growing manufacturing sector and infrastructure development projects.

¹⁰ Financial Times, 1996; World Bank, 1994; “The wealth of the KLSE in the mid-1990s exceeded RM243 billion, and the overall conventional/*syariah* bank savings to GDP ratio exceeded 84%” (Wilson, 199:125).

The Kuala Lumpur International Airport (KILA) project is an example of a GOM-backed privately financed initiative to stimulate growth in the *syariah* economy, using a combination of conventional and *syariah* loans (Wilson, 1999:129). The Ministry of Finance, establishing Ministry of Finance, Inc., (specifically for KILA development) issued RM4 billion in government-backed *sukuk* to fund the development project (Islam Bank, 2010). KLIA, Bhd. renegotiated its loans held in conventional accounts to get the more favorable terms offered by *syariah* banks. AMBank mentioned that this move by KLIA, Bhd. and Ministry of Finance Inc. demonstrated the value and competitiveness of *syariah* economic products, and because of the success of the RM4 billion issue it planned to issue more *sukuk* (Islam Bank, 2010) The fact that KLIA Bhd. refinanced because of the *syariah* financial sector's favorable terms is a significant breakthrough for the *syariah* economy's efforts to develop a competitive edge on conventional financial products. This was also a clear and public message from GOM to investors that *syariah* institutions could handle large investments and development projects, and was mature enough as an industry to compete with the conventional system.

In 1996, the GOM enacted the Directive on Islamic Financial Business in Labuan IBFC and the Labuan Offshore Financial Services Authority Act, 1996, establishing the Labuan Offshore Financial Institution (LOFI). The Act mandated that *syariah* banking and finance be kept separate from incorporated conventional institutions, approved by the Labuan Financial Services Authority (Labuan FSA), and regulated by the Labuan FSA *Syariah* Supervisory Council (SSC) (MIFC, 2010a). "Labuan was designated the country's offshore financial centre in 1990 with Labuan Financial Services Authority (Labuan FSA) being formed in 1996 as the regulator of the jurisdiction" (MIFC, 2010a).

Increasing market regulation, BNM, through the SPI (SPTF was renamed *Skim Perbankan Islam*, SPI in 1996) issued a "model financial statement" in October 1996 announcing that banks participating in SPI were required to "disclose banking operations (balance sheet and profit and loss account)" (AIBIM, 2010b; MIFC, 2010c). As the *syariah* economy grew and expanded, regulation and training became critical aspects of development, and were administered either directly or indirectly by the GOM. The GOM established the *Persatuan Institusi Institusi Islam Malaysia* (1996, AIMIM, Association of Interest Free Banking Institutions Malaysia), to

“promote and represent” education, training, and mutual business development interests through intra-industry (domestic and global) coordination and cooperation (AIBIM, 2010a).

In the first part of 1997, Malaysia’s dual economy was experiencing growth, and PM Mahathir was furthering Islamization policies. By mid-1997 the Asian Financial Crisis spread throughout East and Southeast Asia, ravaging economies, currencies, and financial markets and institutions. Malaysia did not go unscathed. As leader of the majority coalition, UMNO faced serious domestic criticism in the aftermath of the crisis calling into question “UMNO’s rule, with a focus on the issues of corruption, injustice and lack of democracy” (Funston, 2006:59). At the 1997 UMNO 40th General Assembly, PM Mahathir maintained dedication to promote *Bumiputera* development; “his political philosophy was that Malays can only progress if they embody the true Islamic spirit” (Hassan, 2003:101). Subsequently, PM Mahathir announced that the Islamic Affairs Division had been granted a full Ministerial appointment and renamed *Jabatan Kemajuan Islam Malaysia* (1997, JAKIM, the Malaysian Department of Islamic Development) (Funston, 2005; JAKIM, 2006).

Establishing the highest authority on *syariah*-compliance for any *syariah* banking institution, BNM established the National *Syariah* Advisory Council on Islamic Banking and *takaful* (1997, NSAC) to “streamline and harmonize the *syariah* interpretations among banks and *takaful* companies” and to “harmonize difference in opinion” (MIFC, 2010c; AIBIM, 2010b). Appointed by the Minister of Finance, NSAC members are responsible for overseeing and regulating *syariah*-compliance in *syariah* commercial operations, providing consultancy in legal disputes involving *syariah* economic institutions, and coordinating bank-level SACs (MIFC, 2010c). Establishing the NSAC improved the legitimacy of the *syariah* sector at the operational level and in resolving *syariah* commercial legal disputes.

4.2. Surviving Financial Crisis and Political Turmoil

By mid-August 1998, Malaysia experienced the worst effects of the East Asian Financial Crisis; the social backlash at the GOM was about as severe. MIFC reported that, “depreciation

by end-August 1998 in the ringgit by 40% against the United States Dollar from pre-crisis levels; the decline in the stock market as measured by the Kuala Lumpur Composite Index by 72% during the same period; the threefold increase in non-performing loans (“NPLs”) from 4.7% at the end of 1997 to 14.9% in November 1998; the contraction in the economy in 1998 by 7.4% (negative growth)” (BNM, 2004). Reacting to these conditions, the GOM enacted the *Pengurusan Danaharta Nasional Berhad* Act (1998) establishing the asset management company (AMC) *Danaharta*, to bail-out the amount of NPLs accumulating as a result of the crisis (BNM, 2003).

In the wake of the financial crisis, PM Mahathir removed his Deputy PM Anwar Ibrahim in 1998 on charges of corruption, un-Islamic behavior, and later, sodomy. This move created extreme political turmoil in UMNO, BN, and the GOM in general. Anwar started the Malaysian *Reformasi* (reform) movement, formed the *KeAdilan Party* (Justice Party), and formed a coalition opposition party to include PAS and the DAP under the name *Barisan Alternatif* (Alternative Front) (Mutalib, 2008). Anwar’s departure created two social and political groups: Anwar supporters, “Anwar/PAS camp” and Mahathir supporters, “Mahathir/UMNO camp” (Mutalib, 2008:29). During the 1999 General Elections, the impact of this conflict was felt by UMNO. “UMNO lost the majority Malay vote...to the Anwar/PAS collaboration” but managed to retain BN leadership through an increased turnout of support from its non-Muslim constituency, especially Chinese Malaysians (Mutalib, 2008:28). This political shuffle had ideological implications for Malaysia’s future – one divided by differing visions of the degree to which Malaysia should be Islamized.

The *syariah* economy, now fully launched into the global market remained largely unaffected by the political turmoil. In 1999, BNM issued the requirement that Islamic banking units (IBU) operating in the Islamic Banking Scheme (IBS) were required to “upgrade...into an Islamic Banking Division (IBD)” (Thani, 2003:18). BNM recognized that capital assets in the *syariah* banking sector had grown to a point that required increased oversight and operational capacity. BNM licensed Malaysia’s second fully Islamic bank in 1999, Bank *Muallamat* Malaysia Bhd., a sign that the *syariah* economy was healthy and had not only survived the financial crisis, but also continued to accumulate assets and expand operations.

Arguably one of the biggest breakthroughs for the global *syariah* economy, Dow Jones launched the Dow Jones Islamic Market World in 1999 (DJIM World) Index, linking globally disparate *syariah* commercial entities into one marketplace self-described as the “first...premier...benchmark of investment performance for the global universe of *Shari’ah* compliant equities” (DJIM, 2010). IsDB opened a regional office in Kuala Lumpur in 1999, and with the goal to provide *syariah*-compliant development assistance to member states’ private sectors, established the Islamic Corporation for the Development of the Private Sector (ICD) (Thani, 1999; Thani, 2003).

Until he left office in 2003, PM Mahathir continued his dedication to merge efforts to Islamize and modernize Malaysia through his vision of “Islamic modernism”. PM Mahathir attempted “to reconcile Islam with notions of entrepreneurship, economic development, and an efficient Islamic work ethic” and “call for Malay Muslims to undergo a mental revolution and cultural transformation” (Liow, 2009:180-181). Political turmoil, driven by the Asian Financial Crisis and competition between UMNO and PAS for the Malay Muslim constituency, continued into the next decade. Built on a strong legal foundation and actively developed, regulated, and monitored by the Ministry of Finance, the *syariah* economy continued to attract investment and expand its operations and market reach.

4.3. Discussion

The driving forces developing the *syariah* economy at the national level during this period included first, the Securities Commission, resulting from the Securities Commission Act (1993), second, the SPTF (interest free banking scheme) establishing *syariah* ‘windows’ at bank branches, third, the National *Syariah* Advisory Council formed to regulate and coordinate *syariah* compliance, and fourth, the establishment of the IIMM, keeping the sector afloat. Market drivers included the SC establishing *syariah* compliant *sukuk*, securities and futures products (via the Futures Industry Act (1993), the KLSE, LOFSA, and DJIM providing investment opportunities, GOM using *syariah* banking and finance to fund large scale infrastructure

development projects, and an expanding capital base that allowed for institutional expansion (SC, 1994).

The government and Islamic revival stopped being the main driving forces in developing the *syariah* economy as a national initiative, and the fight for survival and competition in the domestic and global market began to drive product innovation, growth in capital, and institutional expansion. All of these developments required a shift in how the *syariah* economy was regulated and administrated. From this point on, civil society and government struggled to keep institutions, operations, and products *syariah*-compliant and spiritually, culturally focused to ensure the sector's legitimacy.

A system of checks and balances developed between the government, civil society, and the industry players. The government's focus was on the maintenance, development, and enforcement of legal and regulatory frameworks. Civil society was focused on keeping the *syariah* economy thriving as an example of modernization through Islam. Industry players focused on capital growth, market vibrancy, and product innovation (that pushed the envelope on *syariah* compliance), regulated closely by each bank's *Syariah* Advisory Council and the National *Syariah* Advisory Council.

The GOM still provided preferential industry access to the Bumiputera in the name of reducing inequity. The Bumiputra were targeted for training and skill-building programs in capital management, *takaful*, and banking training and skill-building programs. Public infrastructure projects made *syariah* banking a valuable contribution to society and in developing Malaysian communities, fulfilling its ethics and value-based principles. Entering the global market, *syariah* banking and finance institutions learned fast that in order to survive, they had to become competitive. FDI and Malaysian Chinese competition rapidly moving in to this market 'reserved' for the Bumiputera challenged the Bumiputera to compete. Their success or failure is determined by their work ethic, and is a reflection only of the legitimacy of their 'ownership' over this sector. The legitimacy of the *syariah* economy rests in its ability to maintain *syariah*-compliance in its operations, services, and products, regardless of whether it is run by Muslims or non-Muslims.

Product innovation was critical to the success of the *syariah* economy during this period. It drove market expansion, and allowed the sector to compete against high return product offerings in the conventional sector. *Sukuk* was a driving force in expanding the Malaysian *syariah* capital market internationally; *syariah* financial institutions did not pretend to be above the profit motive, but rather, sought profit and growth based on *syariah* principles, engineered to appeal to Muslims' ethics and values, and to conservative investors, regulated by the *Syariah* Advisory Council.

External markets were attracted to the conservative nature of *syariah* banking relative survivability during financial crises. Even the most prolific political figures were vulnerable to extreme crisis – social and economic. The East Asian Financial crisis shook up Malaysian politics, resulting in Anwar Ibrahim being removed and Mahathir resigning as Prime Minister. The Islamic revival, however, remained strong and well-established, and Islamic modernism continued into the future as Malaysia worked towards Vision 2020.

5. Conclusion

This thesis examined the genesis of the *syariah* economy within the broader scope of Malaysia's political and economic Islamization understanding how Islamization as a whole - political, social, and economic - came together over time to develop a distinctly Islamic financial sector. The study was guided by two questions seeking to elicit what forces drove making the development of the Malaysian *syariah* economy a national initiative, and how and why these forces were involved in developing related laws, regulations, and policies.

The findings are that the driving forces making the development of the Malaysian *syariah* economy a national initiative are a mixture of bottom-up mobilization and top-down public administration, but ultimately rooted in a drive to blend spirituality and religiosity with a capitalist work ethic contributing to national economic development. The Islamic reformists of the early 1900s sparked a generational debate over what type of Islam, and how Islam should be practiced in Malaysia. The *Kaum Muda* (youth modernists) and *Kaum Tua* (elder traditionalists) fueled this debate. The period of transition to independence gave the Bumiputera (synonymous with Malay and Malay Muslims, as all Malay are considered by the state to be Muslim) a chance to negotiate a share of the economy, of political power, gain preference in social development planning, and inculcate their religious and cultural values in public policy.

During the independence period, political leaders, community leaders, and political parties forming coalitions realized the importance of representing and negotiating the needs and interests of Malaysia's main ethnic groups, the Bumiputera, the Malaysian Chinese, and Malaysian Indians in what the study reveals shapes a period of democratic consociationalism. However, post-independence, economic development policies created an unequal socioeconomic environment, one that perpetuated stereotyping ethnicity with a level of socioeconomic development. The Bumiputera remained socially undeveloped, whereas the Malaysian Chinese remained socioeconomically strong, educated, and developing.

The Islamic revival mobilized to petition the government to seek a more balanced development strategy, one that sought spiritual, cultural, and material gain. The May 13th ethnic riots, based around ethnic tension over economic inequity, woke the government up to the threat that inequity posed to civic peace, governance, and sustainable development. Once again,

Lijphart's consociational methods were employed to re-negotiate ethnic interests in order to reinstitute social, political, and economic peace and stability, a process that Malaysia consistently employed from this point on to maintain awareness over areas of social tension. Islamization became a priority national initiative in developing the Bumiputera.

When Dr. Mahathir bin Mohamed became Prime Minister of Malaysia in 1981, he immediately harnessed the social and political capital of the Islamic revival, and energized Malaysia's public Islamization policies. His leadership can be described as both charismatic, based on promoting the ideological struggle of the Bumiputera, and legitimized by the parliamentary process and his leadership of UMNO. He convinced the *dakwah* youth leader, Anwar Ibrahim, to leave ABIM and join UMNO. This maneuver appealed, charismatically, to PM Mahathir and UMNO's Malay constituency and Malay civil servants. Later, Anwar Ibrahim became his finance minister, and his Deputy Prime Minister. Upon urging from ABIM, and the Pilgrims Management Fund Board, among others, and after seeing the potential for the sector to grow among a market of globally linked Muslim states, PM Mahathir approved the creation of a *syariah* economy and formed the 1981 National Steering Committee on Islamic Banking.

This reveals that it was civil society that drove the government to make the *syariah* economy a national initiative. The GOM was quick to establish the sector. The Ministry of Finance, and its Bank Negara Malaysia (central bank) laid the legal and regulatory foundations for the *syariah* banking (including *takaful* insurance) sector by 1989 (with most completed by 1984). The *syariah* capital market was up and running by 1993. During this time, and through 2000, three actors emerged as the driving forces for developing the *syariah* economy once it had become a national initiative, forming a system of checks and balances of industry growth, regulation and enforcement, and religious legitimacy. These were, respectively, the domestic and global market (and industry), the Malaysian government (Ministry of Finance, Securities Commission, Bank Negara Malaysia, *Syariah* Advisory Councils, and Parliament), and the Islamic revival's civil society organizations (to include *dakwah* groups).

The Islamic revival movement was the driving force in establishing the roots and developing the national impetus to create a *syariah* economy in Malaysia. Prime Minister Mahathir's government made building and developing the *syariah* economy a national initiative. Resolved from GOM's efforts to negotiate (i.e. through consociationalism) the interests of all

Malaysians, and create policies that benefit all citizens, the banking and finance institutions that resulted were patronized by all Malaysians, regardless of religious affiliation or ethnicity, contributing to the national economy. Government and non-government organizations supported the sector with creative and critical thought and initiatives on how to tweak financial mechanisms to increase competitiveness and profitability in line with *syariah* principles.

The *syariah* economy was constantly renegotiated and developed by GOM, the market, and Islamist civil society to reflect its needs, and to ensure that it was (and is) developing in compliance with *syariah* law, as overseen by the National *Syariah* Advisory Council. These opportunities were created by the efforts of the GOM, and other Muslim states to create a global network of *syariah*-compliant institutions, think tanks, and training centers, a multilateral development bank, expanded to aid *syariah* economic institutions, develop legal frameworks, and break down barriers to *syariah*-compliant commerce.

The development of the *syariah* economy in Malaysia has impacted the genesis of Islamization in Malaysia, injecting Islam as an active part of the economic life of Malaysians and as a valuable part of the Malaysian economy, inciting Weber's 'spirit' of capitalism into this new national economic initiative. It has provided employment opportunities for Muslims and non-Muslims alike, contributing to national development. As the sector matures, it will rely on the Malaysian bureaucracy for legal and regulatory development, and civil society to drive its theological mission and vision. But, due to its success, it can function independently of political leadership; new leadership will now have to harness not only the political power of the Islamic revival, but the economic and political power of the *syariah* economy.

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Appendix A: Interview Questionnaire

Politics of *Syariah* Banking and Finance Development in Malaysia:

What is the historical background (major developments/ issues/ events/ people) concerning:

- Central Bank of Malaysia Act 2009
- Islamic Banking Act 1983
- Takaful Act 1984
- Others?

What were the driving forces in making the *syariah* economy a national initiative? How and why did they participate in developing the *syariah* economy (legal, regulatory, policy, industry, etc.)?

- Sources of Foreign Aid? (Community or National/State)
- Middle Class
- Youth Organizations (ABIM – historical element)
- *Dakwah* groups?
- Role of National Mufti Council?
- Role of Supreme King?
- Role of State Sultan/ Raja/ Yang?
- Prime Minister? (Mahathir, Najib, etc.)
- Government Ministers?
- Muslim Organizations?
- Constituency?
- Religious leaders?
- Political party platform?
- Banks – private/public industry?
- International Muslim organizations – IFSB, OIC, etc.?
- Domestic NGOs and Associations?
- Are there other influences?

What drives the development of legal and regulatory frameworks and policy? Is it a top down or bottom up process? Or both?

What are the most powerful organizations or associations in Malaysia lobbying for *syariah* incorporation (or specifically *syariah* economy) in national and state legislation?

Do you perceive that *syariah* economic policies and laws are effectively:

- Socialized?
- Communicated?
- Reflect Muslim values?
- Regulate the industry?
- Protect the consumer?

- Function within the dual banking system?

Do you think that the current political system is responding well to the interests and values of Muslims? How? And, how could it improve?