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Rich potential in emerging markets

As more of the world's 1.6bn Muslims start to use banks, many will want to do so in line with their religion, says **David Oakley**

Islamic finance is taking tentative steps towards regaining its mantle as one of the fastest growing asset classes in the world. In spite of the continuing aftershocks of the financial crisis and the Dubai debt standstill, the industry is expanding in many emerging markets and introducing new standards that should help develop products and attract investors.

Although it is not seeing anything like the growth it experienced before the financial crisis, the sector has expanded, even as other markets have been swamped by Europe's sovereign debt crisis.

Assets in Islamic finance rose to $822bn by the end of 2009, an increase of 29 per cent compared with the end of 2008, according to Maris Strategies, the research and advisory group. Anecdotal evidence suggests it has continued to grow this year, as more institutions gain Islamic licences.

The driver of this growth is retail banking, which is attracting more interest not just in the world's two biggest hubs of Islamic finance in the Middle East and south-east Asia, but in China, Russia and Africa.

Joe DiVanna, managing director of Maris Strategies and one of the foremost experts in *sharia*-compliant finance that bans interest payments in line with Islamic law, says growth is inevitable in these emerging market countries.

This is because vast numbers of their populations do not use banks, which makes them ideal potential customers for a relatively new form of banking that started out as an experimental venture in the 1960s.

As an indicator of this potential, Mr DiVanna points to the fact that of the 1.6bn Muslims in the world, only 14 per cent use banks. By comparison, 92 per cent of US households use banks: in the UK it is 95 per cent.

Figures from the Statistical, Economic and Social Research and Training Centre for Islamic Countries (Sesric), support this thesis too. While Islamic finance represents just 1 per cent of the global financial system, the Muslim world accounts for 7.6 per cent of nominal gross domestic product. Growth among the 57 Muslim nations is also much higher than in the rest of the world, Sesric adds.

As these Muslim and emerging nations become more sophisticated, more of their citizens are bound to start using banks and financial institutions, with many wanting to do so in line with their religion.

Khalid Hamad, chairman of the International Islamic Financial Market and another leading figure in the industry, agrees with Mr DiVanna's optimism, although he emphasises that the industry is still in its early stages of develop-

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Plenty of room for growth

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ment. Mr Hamad, who is also executive director of banking supervision at the Central Bank of Bahrain, says: "Islamic finance has made progress, but it has only been around in a meaningful way for about 30 years and its possibilities have not yet been fully explored."

However, there has been progress in the market in a number of economies. First, China, the new powerhouse of the global economy, which has 83m Muslim residents, is starting to wake up to the opportunities that could present themselves in this field of finance.

It awarded its first licence for Islamic banking to Bank of Ningxia in September last year and now a number of the country's biggest conventional banks are also reported to be looking at how they can create or offer Islam-compliant products.

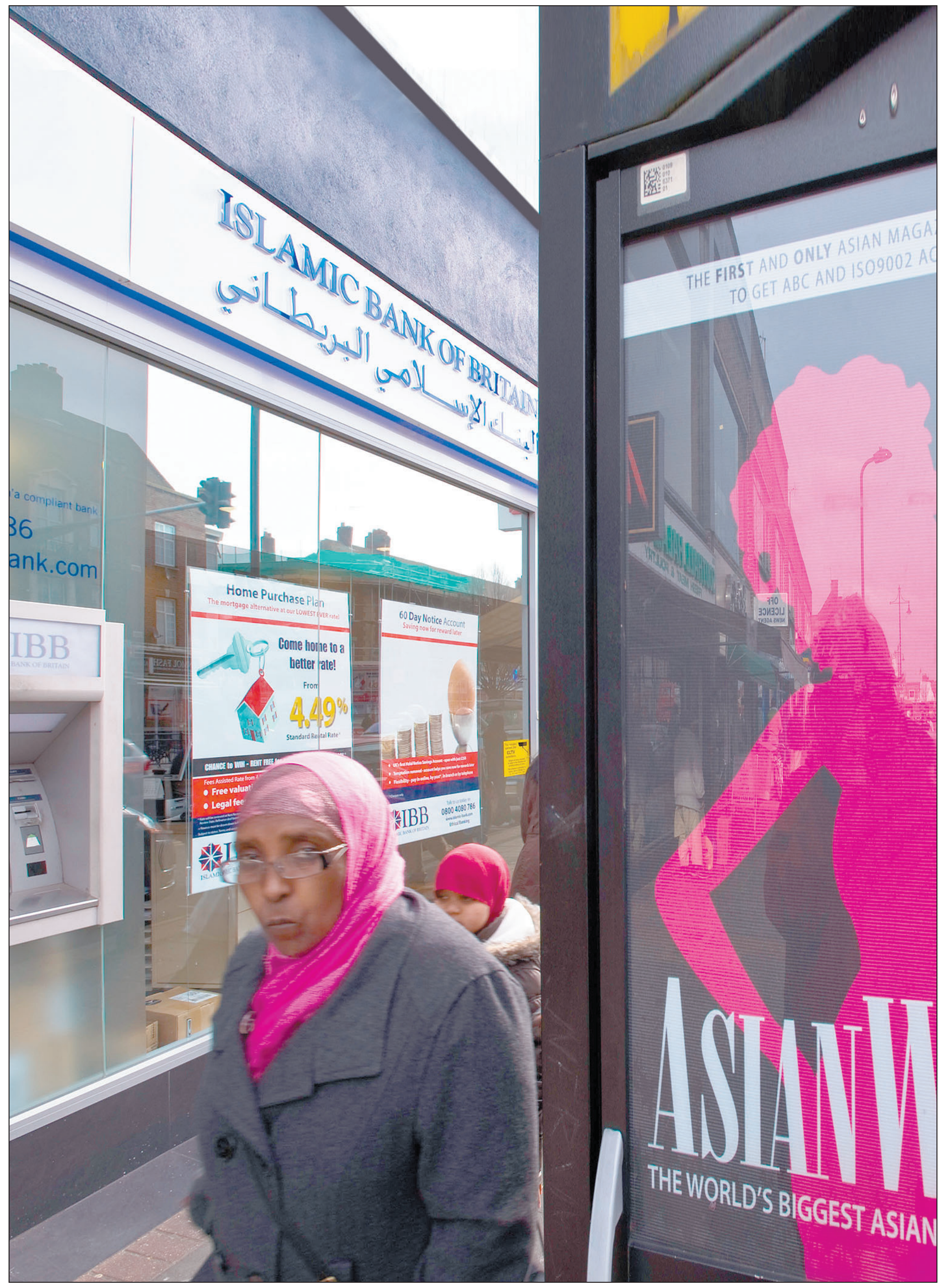
Second, Russian investors and financiers are increasingly looking at ways to develop sharia-compliant products and develop the industry.

Finally, Africa, which has long posed the biggest challenge for investors, is starting to look as if it could even challenge the main centres of the industry, although this is probably a long way off.

Mr DiVanna says: "There are great hopes for growth in Africa. This is a continent where people are starting to open bank accounts for the first time. For example, Kenya is looking to expand its banking system and Islamic finance. About 80 per cent of customers have never used banking services before."

This month, Njuguna Ndung'u, governor of the Central Bank of Kenya, said the country had made adjustments to its banking sector to let Islamic finance institutions set up and prosper. However, analysts are mindful of the setbacks since the financial crisis, which has stalled the corporate and investment banking side of many Islamic financial groups.

The fallout from the Dubai debt standstill and debate over the evolution of the *sukuk*, or Islamic bond, market also raise uncertainties. Although many commentators expect the *sukuk* market to see further growth this year, hopes that more western issuers might consider raising money through these bonds have failed to materialise.



Bank branch: London is the main hub for Islamic finance outside the Muslim world Alamy

Many analysts say the market needs more sovereign *sukuk* to give it some impetus. Although this is happening in the traditionally strong Islamic finance centres of Bahrain and Malaysia, other governments are failing to issue these bonds.

Certainly, progress on this front among the western economies appears to have stalled, with doubts that the UK will introduce a sovereign *sukuk* and few western companies seeking to issue *sharia*-compliant debt. The UK government needs to rediscover its appetite for developing this market. Should the UK issue a sovereign *sukuk*, this would almost certainly encourage corporates to turn to this market too.

General Electric, the US conglomerate, launched the first Islamic bond by a western industrial company at the end of last year, but since then there has been very little activity.

However, London still remains the main hub for this kind of finance outside of the Muslim world. Germany, France and Luxembourg are also keen to develop Islamic finance, but are a long way behind London.

A big growth area is likely to be in the small-to-medium business market (SMEs), which could give Islamic finance a fresh vibrancy and pave the way for more entrepreneurs in the developing world. "This is one area we need to develop," says Mr DiVanna.

> One of the most important developments has been the creation of standardised documentation

Mr Hamad adds: "Providing financial services for SMEs can open up huge business opportunities for Islamic finance."

On a more technical front, one of the most important developments has been the creation of the first worldwide standardised documentation for privately negotiated Islamic derivatives. This paves the way for much greater use of hedging in Islamic finance.

The move by the International Swaps and Derivatives Association in March should help codify individual transactions that need approval by *sharia* scholars.

Such a pan-Islamic document should also help consolidate interpretations of Islamic law. This would make hedging easier and accelerate product development.

The failure to standardise has been a drag on growth and highlights the industry's infancy compared with conventional finance.

Mr Hamad says: "This took almost two years of sometimes complex discussion between banks and authorities in several countries to standardise definitions and terms and overall documents."

The next step should be the launch of the first proper *sharia* hedging products. That would represent a landmark. "Significant interest is being shown in this because Islamic finance has now reached the stage where it really needs hedging instruments," he says.

These would not be used for speculation, but for managing risk, which is vital to help the sector expand further.

Industry 'strays too far from its roots'

By the book: experts expect innovation will be cautious and new products will adhere more closely to Islamic law Alamy

Products

Innovation slows after backlash from scholars, says **Robin Wigglesworth**

Modern Islamic finance has come a long way since it started as a modest, experimental venture in the Egyptian town of Mit Ghamr in the 1960s. It encompasses a wide range of products and services that aim to reconcile conventional finance and Islamic law.

Innovation has exploded in the past five years in particular, but rather than being led by "indigenous" Islamic banks, most products have been developed by the structured finance teams of western investment banks such as Deutsche Bank and the Islamic arms of institutions such as HSBC, Standard Chartered and Citigroup.

Many have then licensed their inventions to fully Islamic banks, particularly in the Gulf, where few have had the capacity to structure their own product range.

From profit-sharing accounts and crude products, Islamic finance now spans derivatives, bonds, fund management, credit cards, car loans and even basic hedge funds – all of which use often complex structures to circumvent the Islamic ban on interest.

While the industry has a product range comparable in many areas to conventional finance, Islamic bankers say that there are still gaps in some crucial areas.

The main shortfalls are in derivatives and fixed income, bankers say. Product development in these areas has been complicated by a prohibition on interest by *sharia* (Islamic law) and its requirement for real assets to be transferred as part of any transaction.

Some progress has been made. Longer-dated debt – in the form of Islamic bonds, or *sukuk* – is a staple of many *sharia*-compliant financial institutions' portfolio, even though maturities seldom stretch further than five years and the market has recently been rattled by several defaults.

The International Swaps and Derivatives Association (ISDA) and the Bahrain-based International Islamic Financial Market (IIFM) have recently launched a standardised master agreement for Islamic derivatives which could pave the way for the greater use of hedging in the sector.

"Given the growing nature of the Islamic finance industry, the institutions operating on *sharia* principles can no longer afford to leave their positions unhedged," Khalid Hamad, chairman of the IIFM and executive director of banking supervision at the Central Bank of Bahrain, said at the time of the launch. "Hence, some key hedging products are becoming common across jurisdictions to mitigate risk."

> Bankers say the industry would benefit from more homogenous documentation and structures

But more needs to be done, bankers concede. It will take time before the ISDA-IIFM documentation is widely adopted and derivatives remain tricky and expensive to structure in accordance with *sharia*.

Shorter-term Islamic money markets also remain crude and underdeveloped, at least outside Malaysia, which stands somewhat apart from the rest of the industry due to an often more lenient *sharia* interpretation, experts say.

"Most [Islamic] bankers you talk to would say that liquidity management is their number one concern," says Daud Vicary Abdullah, head of Islamic finance at Deloitte. "There is no silver bullet. [Islamic money markets] just require time, hard work and political willingness to develop."

Yet innovation has slowed down significantly recently. The financial crisis coincided with a backlash from some senior *sharia* scholars in the Middle East, who felt that the industry had strayed too far from its roots and was mimicking conventional structures too closely, particularly in the *sukuk* sector.

"No one wants any fancy, exotic instruments any more, so innovation has slowed down," says Hussein Hassan, head of Islamic finance at Deutsche Bank. "People are now structuring products and transactions in line with more conservative *sharia* standards."

Bankers are focusing more on simplifying and standardising the vast swathe of existing products rather than conjuring up innovative ones.

Because of differences in *sharia* interpretation in many countries and regions – and competition between banks that were keen to make names for themselves as innovators – the Islamic finance market is highly fragmented.

Divergent views on Islamic law are inevitable, given Islam's global span and different schools of thought, but bankers say the industry would benefit greatly from more homogenous documentation and structures.

"We are no longer a niche industry. However, without standardisation we will not achieve scale," says Razi Fakih, deputy chief executive of HSBC Amanah, the British bank's Islamic arm. "Islamic finance would also benefit from more standardisation, not only in *sharia* but in the documentation of products."

Nonetheless, experts expect that innovation will continue – albeit more cautiously – and they predict that new products will adhere more closely to Islamic law.

"The industry is still on a learning curve, but I think equity-based products are going to lead the way now, as they fit better with the substance of Islamic finance," says Mr Abdullah.

"There is a genuine concern that the industry strayed too far from its roots and mimicked conventional finance too closely."

Industry once more at centre of attention


Palm Island developer Dubai World's debt crisis has made interest in hedge funds more pronounced as investors seek to get out of property and look to reallocate portfolios

Hedge funds

But fundamental difficulties have yet to be resolved, writes **Sam Jones**

For the past two years, the development of a *shariah*-compliant hedge fund industry – once one of the hottest topics at alternative investment conferences – has been on hold.

But as the asset management industry – and wealthy institutions and individuals in the Middle East – pick themselves up from the damage wrought by the financial crisis, the issue of whether an Islamic hedge fund industry is viable, or indeed even desirable, is being taken up again.

The notion is attractive not least because the past few months have seen a series of developments in *shariah* finance that go some way to overcoming many of the obstacles that had faced hedge funds looking to comply with Islamic strictures.

Secular trends in the asset management industry seem to be on the side of some form of Islamic hedge fund market too.

The field of *shariah* finance remains one of the fastest growing areas in the global finance industry, with estimates from analysts varying between 20 and 40 per cent growth annually for the next five years at least.

Furthermore, interest in hedge funds and alternative products in the Middle East in particular is on an upward trend.

According to a recent survey of institutional investors in the region by the consultancy Capintro, 36 per cent of respondents said they were planning to increase their hedge fund allocations, while a further 53 per cent said they intended to hold allocations steady.

If anything, the recent Dubai debt crisis, has made interest in hedge funds more pronounced. Many institutional investors in the region have seen property-linked holdings fall sharply in value and are looking to reallocate portfolios.

A comprehensive report on the hedge fund industry conducted by the consultancy Casey Quirk and Bank of New York Mellon in April last year projected that money invested in hedge funds by Middle Eastern investors would rise to $194bn by 2013.

Fundamental problems remain, however.

By definition, a hedge fund is an unregulated investment vehicle open only to qualified investors that has free reign to pick and choose across the gamut of financial instruments and securities indiscriminately to reduce risk while delivering high returns.

Islamic finance, however, can be strictly prohibitive on certain types of financial practice.

Most notably, as far as hedge funds are concerned, shorting – a bet that aims to make money from the decline in value of a security – is banned.

Shorting is fundamental to almost every hedge fund strategy and is the main means by which hedge funds look to fulfil their generic mandate – as an investment class – delivering returns uncorrelated to regular markets.

Collecting interest, known as *riba*, is also proscribed, again reducing the investment universe open to hedge funds. And more generally, investments determined to be *maysir* or *gharar* – that is, speculative or involving unavoidable uncertainty – are to be shunned too.

As a result, successful *shariah*-compliant hedge funds have been almost exclusively focused on commodity markets. Funds that trade in commodities – tangible assets – face fewer restrictions under *shariah* law than those trading in more abstract financial instruments.

Such *shariah*-compliant commodity funds have, however, been successful.

Dubai Shariah Asset Management Kauthar runs four commodity funds, all of them *shariah*-compliant.

The company's flagship multi-strategy fund, which blends investments in its four underlying funds, has been one of the most successful fund-of-fund structures so far this year.

In 2009, the DSAM Kauthar commodity fund was up 41 per cent, not only marking it out as one of the best *shariah*-compliant investments that year but also one of the best hedge fund performers globally. The average hedge fund returned just over 20 per cent in 2009, according to industry indices.

Replicating such *shariah*-compliant successes in hedge funds that trade in assets other than commodities may not be as far off as many believe, however.

On 1 March, the International Swaps and Derivatives Association, the global trade body responsible for standard-setting in the derivatives market, issued the ISDA Ta'Hawwut agreement that will allow market participants to enter into derivative contracts that are *shariah*-compliant – and do so on a level playing field.

Such uniform standards, potentially open to a host of different types of financial trade, may finally unlock hundreds of previously prohibited markets to funds planning to make *shariah*-compliant investments.

The key in every instance will be for fund managers to persuade Islamic scholars that their investments are hedges rather than outright speculative positions.

One big question for investors must remain, however: even if it is possible to construct an Islamic hedge fund, will it be possible to run one that performs?

Uniform sharia standards may unlock hundreds of previously prohibited markets to funds

Sustained recovery expected in second half of the year

Sukuk

Anousha Sakoui reports on a slow return of confidence

When Dubai World, the state-owned conglomerate, asked creditors for a debt standstill last November, it shook global markets.

The announcement froze debt markets across the region. As negotiations between the debt-laden conglomerate and its international and local creditors have unfolded, confidence has started to rebuild.

It has, however, taken until recent weeks for the debt markets to reopen to Dubai-based issuers.

"There are a number financial and*sukuk* [Islamic bonds] restructurings going on in the region at the moment, with Dubai World being the most prominent," says Farmida Bi, a partner at Norton Rose, the international law firm.

"Investors are keen to see how these restructurings are concluded. In particular, the *sukuk* defaults last year gave rise to investor anxiety over whether they have taken credit risk on the asset or on the originator."

Spurred by progress over the Dubai World debt restructuring and the improving investor sentiment in the region, the state-owned Dubai Electricity and Water Authority (Dewa) was the first to reopen the bond market for issuers from the region last month.

The sale of $1bn of five-year bonds, yielding 8.5 per cent, attracted more than $11bn worth of orders. Dewa was able to price the deal lower than initially expected.

"This time last year, bond issuance by both Abu Dhabi and Qatar, kick-started capital markets issuance in the region after the financial crisis," says Anzal Mohammed, head of Islamic finance at Allen & Overy, the law firm.

He says: "It seems we have come full circle since the announcement by Dubai World in November regarding its restructuring."

Sukuk specialists now question what the future holds for the Islamic finance market. "We have yet to see high-profile *sukuk* issues from the Gulf," says Mr Mohammed.

"There are a number of potential issues being worked on that we hope will restart the market, from sovereigns and sovereign-related issuers. The market remains nervous and somewhat uncertain as to where it goes from here."

Mr Mohammed is positive on the outlook for the market. "We believe that we will see a sustained recovery in the *sukuk* market in the second half of this year," he says.

Up to May 3, there was $2bn of Islamic issuance globally. Islamic bond issuance hit a high of $27.17bn internationally in 2007, with 100 issues.

The majority of issuance, however, this year has come from Malaysia with 13 deals.

There have only been a few deals from the Gulf, with Dar Al-Arkan Real Estate Development Company and Saudi Hollandi Bank issuing Islamic bonds.

Most recently, Saudi Electricity Company issued a *sukuk*. "The strong Islamic investor interest for Gulf Co-operation Council credits is evidenced by the Saudi Electricity Company transaction that has generated significant investor interest," says Mohammed Dawood, director in the global markets department of, HSBC, the UK bank.

However, iniatives to develop new markets for *sukuk* issuance outside the Gulf have stalled.

"There was speculation last year about a French *sukuk*, but we have had no formal announcements yet," says Ms Bi.

"We will also have to wait and see if the newly elected UK government will reconsider the *sukuk* issuance which was considered in 2008 but did not happen."


'We have come full circle since the Dubai World November restructuring announcement'
Anzal Mohammed, Allen & Overy

She adds that there has been comparatively little innovation in the Islamic capital markets in the last couple of years, because there have been fewer deals as a result of the financial crisis.

"What I am hoping for this year is that there will be steady growth. It would be nice to see a few corporate deals as well as sovereign rated issues," says Ms Bi.

Mr Dawood says financial institutions have a very sizeable amount of refinancing to be done. "There is about $26bn of Gulf Co-operation Council [financial institution] debt to be refinanced over the next 12 to 18 months.

Corporates and sovereigns are looking to the *sukuk* market for access to capital. We have several mandates and we see a strong outlook for the market this year. Liquidity in the region among Islamic investors is strong."

The spread on *sukuks* of some borrowers in the region are lower than their conventional bonds, indicating that the *sukuk* market offers companies lower costs.

"There is a lot of pent-up demand for strong credits," says Mr Dawood.

Another dynamic that will support supply is that several regional banks are converting to Islamic institutions and in certain regional jurisdictions these could soon outnumber conventional banks, says Mr Dawood.

Different documents: the International Swaps and Derivatives Association (ISDA), recently drafted a master agreement with standardised documentation for Islamic derivatives AFP

'In need of robust architecture'

Derivatives

Robin Wigglesworth reports on efforts at standardisation of documents

Structuring derivatives that comply with the principles of *sharia* has long been one of the most complex niches of Islamic finance. But it is an increasingly important one, as the industry continues to grow and risk management becomes vital.

Sharia scholars, who have to bless all products and services offered by Islamic banks, have often been reluctant to approve derivatives, because of Islam's bans on interest, speculation and unnecessary risk – *riba, maisir* and *gharar* in Arabic – and the requirement for real assets to underlie all transactions.

"The varying scholarly opinions in the world of Islamic jurisprudence on the legitimacy of derivatives has so far translated into a total ban on these instruments in some countries and actual implementation – albeit on a limited scale – in others," Moody's, the rating agency, noted in a recent report.

Nonetheless, while innovation has slowed in the wake of the international financial crisis and clerical criticism of some high-profile instruments, the structuring and use of Islamic derivatives is gradually gaining ground, experts say.

"There was a time when 'derivatives' was a dirty word for scholars, but they've come round to accepting them, as long as they are for hedging and not speculation," says Harris Irfan, head of Islamic products at Barclays Capital.

"They're still in their infancy, but we're starting to see them used more and more."

The most common Islamic product used to structure *sharia*-compliant derivatives are *wa'ad*, a type of unilateral promise, and *murabaha*, one of the most popular, which can be likened to a conventional "sale and deferred payment" structure.

"You use Islamic finance products such as *murabaha* and *wa'ad* like Lego to build derivative instruments that comply with *sharia*," says Priya Uberoi, director of Islamic derivatives at Clifford Chance.

"About half of Islamic derivatives use *murabaha*, and the rest are based on *wa'ad*, but there are other products out there that can be used. They just haven't been tapped yet."

Other products include *arbun*, which is similar to a conventional option, and *bai salaam*, which resembles forward contracts.

Existing types of Islamic derivatives include cross-currency swaps, foreign exchange options, total return swaps and profit rate swaps, the Islamic equivalent to an interest rate swap.

Lawyers, bankers and scholars have even managed to engineer Islamic credit default swaps, a *sharia*-compliant version of the popular conventional fixed income insurance product.

Islamic banks are banned from speculating in a credit default, but can in theory protect themselves against an Islamic bond failure.

> 'There was a time when derivatives was a dirty word for scholars but they've come around to accepting them'

Ms Uberoi says: "Islamic CDSs are still controversial, and the structures aren't perfect, but you can, with innovative thinking, probably replicate most conventional derivative structures."

However, the complexity, cost and disparate standards of Islamic derivatives – almost every industry institution uses its own structures and documentation – hampers their frequent use, experts say.

To stimulate the use of Islamic derivatives, the International Islamic Financial Market (IIFM), a Bahrain-based Islamic capital markets industry body, and the International Swaps and Derivatives Association (ISDA), recently drafted a "Tahawwut Master Agreement" with standardised documentation for Islamic derivatives.

In Malaysia, Bank Islam and Bank Mumalat Malaysia executed a pro-forma derivative master agreement for documentation of Islamic derivatives in 2006.

But Asian *sharia* standards are often seen as too lax for Middle East clerics, and the IIFM and ISDA hope their new documentation can be more widely adopted.

The Tahawwut Master Agreement has been blessed by the IIFM's board of *sharia* scholars, which includes some of the industry's most prominent and widely-respected clerics.

These include Sheikh Nizam of Bahrain and Sheikh Hussein Hamid Hassan from Egypt.

"The ISDA-IIFM documentation will bring more rigorous and robust architecture to the development of Islamic derivatives," says Ms Uberoi.

"It's a very new development, but a lot of Islamic banks are looking at how they can tailor their existing derivatives platform to fit with the master agreement," she says.

Bankers warn that it will take time before the Tahawwut documentation is widely adopted, as most banks have already spent a lot of time and effort on their own agreements and structures.

Hussein Hassan, head of Islamic finance at Deutsche Bank, explains: "If lot of banks move over to the IIFM-ISDA standards, it will help us toward some standardisation, but there will have to be a lot of effort on getting banks to use it."

Nonetheless, the implications of more widespread use of Islamic derivatives could be significant, experts say.

Sharia-compliant institutions would be able to hedge against currency movements, credit exposures, interest rate movements or even commodity inflation – all risk management tools that conventional banks take for granted.

"The golden principle of the *sharia* in human dealings is that all is permissible except that which is specifically prohibited," says Muddassir Siddiqui, a *sharia* scholar and head of Islamic finance at Denton Wilde Sapte, the law firm.

"There is a need for these products, and God would not give us a need without a way to fulfil it."

Ahead of the game in local contest

Malaysia

But this is no time for complacency, says **Kevin Brown**

Kuala Lumpur's big role: Malaysia's total outstanding Islamic bonds amounted to $66bn at the end of last year AFP

Malaysia, which has a substantial lead in the competition to emerge as Asia's primary centre for Islamic finance, is facing increasing competition from Indonesia, the world's most populous Muslim nation, and other countries in the region.

However, experts say Malaysia's lead is so great and its ambitions so extensive that it is more likely to benefit than to lose from the attention being paid to the sector in other Asian capitals.

"Malaysia has a very internationalist view of its role in the financial system," says Hooman Sabeti-Rahmati, an Islamic finance expert in the Singapore office of the international law firm Allen & Overy.

"I think they have the ambition, they are developing the institutions, and they are far ahead of some of the people in the Gulf and elsewhere," he adds.

According to Bank Negara, the central bank, Malaysia's total outstanding *sukuk* amounted to $66bn at the end of last year, or 62 per cent of global outstanding issuance.

About 19 per cent of banking assets are *sharia*-compliant, as are 88 per cent of listed stocks on Bursa Malaysia, the Kuala Lumpur stock exchange.

The sector has strong government support, including a friendly tax regime and predictable regulation, which have provided a high degree of legal certainty for issuers and investors.

This mix, combined with government encouragement to state institutions to use Islamic financing whenever possible, has helped make Malaysia significantly more innovative than other jurisdictions.

Last year, for example, Bursa Malaysia launched the world's first *sharia*-compliant commodity trading platform, intended to provide a mechanism for Islamic banks to manage their liquidity.

Malaysia faces considerable potential competition, however. Neighbouring Singapore is much better established as an international finance centre and, while Muslims are in a small minority in the city-state, the Singapore government is keen to expand into Islamic products.

It changed its regulations last year to allow banks to undertake *musharaka* and *murabaha* transactions, and more recently issued guidelines on *istisna*, or project finance deals, and officials in both Hong Kong and South Korea have talked of facilitating Islamic financial instruments, especially *sukuk*.

Indonesia, the biggest economy in south-east Asia, also has ambitions to build an Islamic finance sector, and will be taken seriously because of its sheer size. "Indonesia has seen a renewed focus on Islamic finance and is building momentum," says David Vicary, global Islamic finance leader at Deloitte in London.

However, much of this activity may be less significant than it appears.

Few think Hong Kong and South Korea are likely to amount to more than niche players in Islamic finance, while Singapore's motivation is mainly to ensure that its growing financial centre has the capacity to deal with transactions of all sorts, conventional and Islamic.

Indonesia is a more powerful and long-term competitor, says Mr Sabeti-Rahmati, but the diffusion of authority that has grown up in the vast archipelago since its democratic revolution in 1998 militates against the rapid introduction of an effective Islamic financial system alongside the conventional one.

> The sector has strong government support, including a friendly tax regime and predictable regulation

"If this were happening 15 years ago and there was a central decision to facilitate Islamic finance it would just happen very readily. But nothing happens very quickly now in Indonesia because of the diffusion of authority there," says Mr Sabeti-Rahmati.

"That's why we have seen more of a piecemeal approach, he adds.

"For example a new law came into effect at the beginning of April to remove some of the tax impediments for *murabaha* transactions, but not for *sukuk*.

"There is no reason to remove it for one but not the other, but it just didn't happen in this particular round and no one knows when it might happen."

Raja Teh Maimunah, global head of Islamic markets at Bursa Malaysia, says the increasing activity in the sector in other south-east Asian countries is a "good" development.

"We need more players in the market, because we aspire to become an international financial centre and we can't quite be international if we're doing something on our own, so we need everybody to subscribe to this as well," she says.

"It assists Malaysia in a few ways. If you look at Indonesia, a number of our banks are there and our banks would have Islamic windows or branches. Growth and activity there would mean heightened business for our Malaysian banks.

"We don't look at Malaysia being a financial centre whereby [business] has to come and physically be present in Malaysia – the whole exportation of the technology of Malaysian Islamic finance is what we are looking at really."