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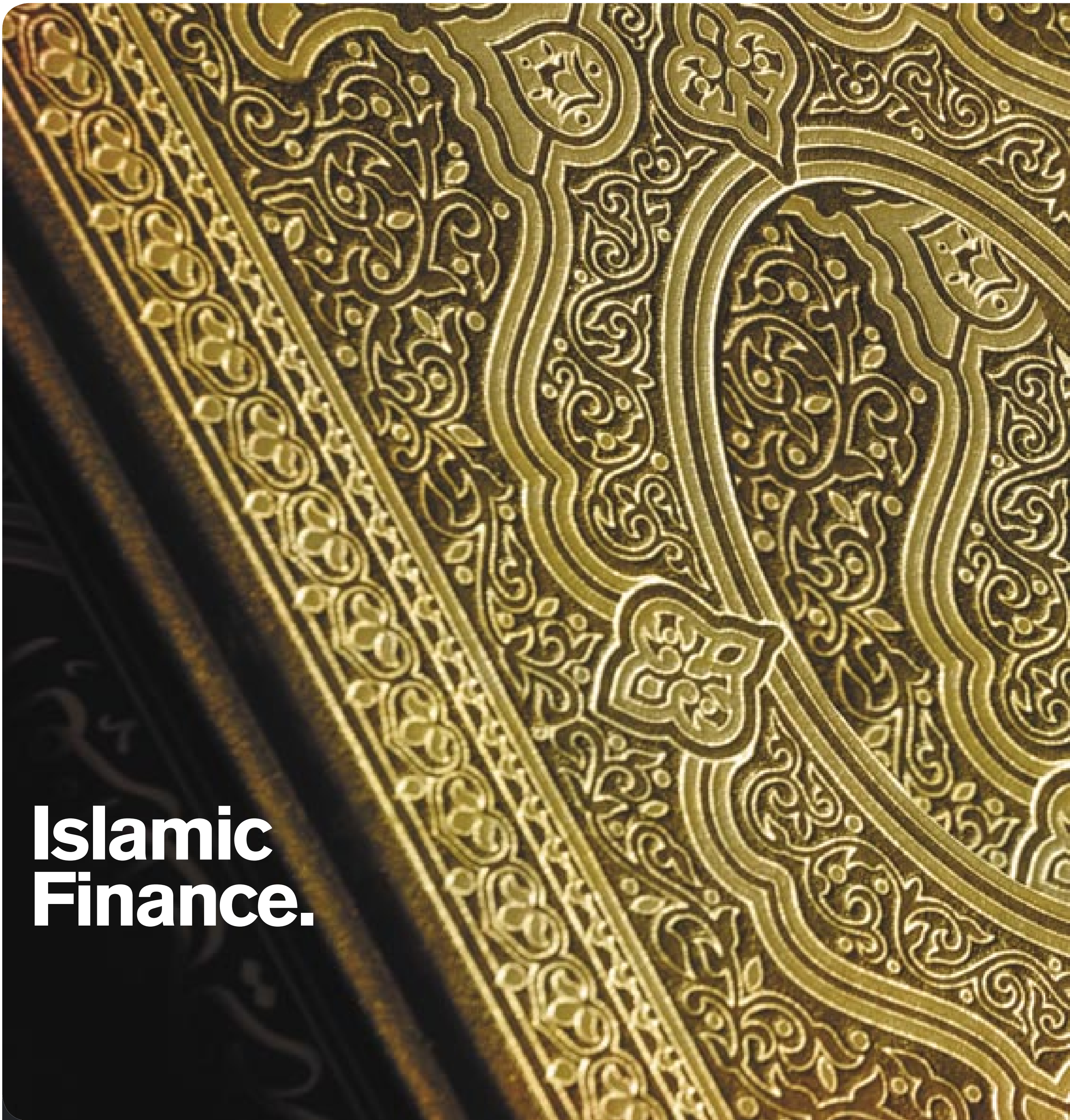

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Glossary

ISLAMIC TERM	DEFINITION
Fatwa	A legal opinion issued by an Islamic law specialist on a specific issue
Gharar	Ambiguity, uncertainty
Halal	Permissible, lawful
Haram	Prohibited, forbidden
Ijara	A lease agreement where the bank as the lessor earns profit by charging rental on the asset leased to the customer
Mudaraba	An investment agreement between an investor (providing capital) and entrepreneur (providing management expertise) with profits being shared on a pre-determined ratio and losses being borne by the investor only
Murabaha	Sale of goods for deferred payment by an Islamic financial institution to a customer for cost plus an agreed profit mark-up
Musharaka	Partnership agreement between two parties where profits are shared on a pre-agreed ratio and losses are shared in proportion to the capital contributed
Riba	Usury, interest. It covers any return of money on money – whether the interest is fixed or floating, simple or compounded
Shariah	The set of rules derived from the holy Quran and the sayings and acts (the Sunnah) of the Prophet Mohammed as well as the opinions of qualified Muslim scholars
Shariah advisor	An independent professional trained Islamic scholar who advises an Islamic financial institution on the compliance of its products and activities with the Shariah
Sukuk	The Islamic equivalent of bonds that represent ownership in an underlying asset or project or venture
Takaful	A form of mutual insurance involving a group of individuals paying money into a fund, which is then used to cover payouts to members of the group when a claim is made

About this Publication

The purpose of this publication is to raise public awareness of Islamic finance in Australia and to promote opportunities for Islamic finance in Australia. This publication does not seek to examine potential tax issues and legislation relating to Shariah-compliant financial products.

Acknowledgments

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Contents

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SATURDAY - 28 JANUARY
في 3 أشهر
داخل العدد
في قطاع النفط المصري
متأثرة بالعوامل السياسية

Executive Summary

Global development of Islamic finance

Islamic finance is one of the fastest growing segments of the global financial services industry. Shariah-compliant financial assets have been growing at over 10 per cent per annum over the past 10 years.[1] Measured by Shariah-compliant assets of financial institutions, the global Islamic finance industry is estimated at US$822 billion in 2009.[2]

Growth is being driven by the following factors:

- **petrodollar liquidity:** Foreign investment plays an important role for petrodollar investors, whose domestic economies and financial systems are too small to absorb all capital from oil export revenues. This presents significant opportunities for the Islamic banking and finance industry. Petrodollar liquidity is expected to remain high over the long term due to the finite supply of oil reserves;
- **Muslim population:** Relatively rapid Muslim population growth worldwide and rising living standards will see increased demand for Islamic finance;
- **low penetration levels:** In spite of growth in the Islamic banking and finance industry, there remains a lack of depth across asset classes and products, signifying untapped potential. There is considerable scope for further development of Islamic banking and finance in countries such as Indonesia, India and Pakistan, which have the largest Muslim populations in the world; and
- **ethical character and financial stability of Islamic financial products:** Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) and a risk profile that will also appeal to a wider ethical investor pool.

Currently, the Middle East and South East Asia are the primary locations for Islamic capital. In particular, the United Arab Emirates, Bahrain and Malaysia are seen as the main centres of Islamic finance, with significant activity also taking place in the United Kingdom and more recently in Europe, Africa and Indonesia.[3]

The demand for Islamic finance has not been matched by supply despite the rapid growth in the sector in recent years. An increase in supply is necessary to meet current and expected demand.

Opportunities in Australia

Islamic finance has considerable potential to become an important element in Australia's aspirations to be a global financial services centre in the region. It has the potential to facilitate further innovation and competition in the wholesale and retail banking sectors and to support the Australian Government's commitment towards credit market diversification.

Australia's growing trade linkages with Asia reflect the demand for Australian commodities from developing countries such as China and India. Of the top 10 trading partners, eight are in the Asia Pacific Region with China and Japan being the country's top two-way trading partners.

Continued growth in major Asian economies will result in a need to develop resources-related services and infrastructure, which are ideal assets for some forms of Islamic financing, such as Sukuk, Mudaraba, Murabaha and Ijarah. Australia is well positioned to structure and offer such instruments as part of financing packages for resources-related development.

Australia's Muslim population of 365,000 (1.7 per cent of the total population),[4] exceeds the combined Muslim population of Hong Kong and Japan and is more than half of that of Singapore. Australia's political stability and geographic position, especially its proximity to the large Muslim populations of the Asia Pacific where 62 per cent or 972.5 million of the world total Muslim population resides,[5] present an important base to service this fast growing sector in the global financial services market.

Australia's attractiveness as a financial centre is supported by a sizeable domestic economy and financial market. The nation has the fourth largest economy in the Asia Pacific (after Japan, China and India). Australia's finance and insurance industries generate around 8.1 per cent or A$82 billion of real gross value added.[6]

1 Standard & Poor's, *Islamic Finance Outlook 2009*, 12 May 2009, p.5.
2 The Banker, *Top 500 Islamic Financial Institutions*, November 2009.
3 IFSL, *Islamic Finance 2009*, February 2009; The Banker, 'Banker survey shows the growth in Islamic finance,' 28 October 2009.
4 Australian Bureau of Statistics 2006 Census.
5 Pew Research Centre, *Mapping the Global Muslim Population – A Report on the Size and Distribution of the World's Muslim Population*, October 2009.
6 Australian Bureau of Statistics (ABS), cat. no. 5206.0, *National Income, Expenditure and Product*, March Quarter 2009, Times Series Workbook, Table 6.

Australia's financial sector has remained strong, continuing to develop as a regional and global centre during the global economic downturn. In *The Financial Development Report 2009*, the World Economic Forum (WEF) ranked Australia the second among 55 of the world's leading financial systems and capital markets. This is up from 11th place in 2008 and ahead of the US, Singapore and Hong Kong.

Australia's deep and diverse financial markets have attracted global institutions and service providers to establish operations in Australia.

Access to the nation's highly skilled and multilingual workforce, advanced business and information technology infrastructure, sound regulation regime and enviable lifestyle, have enabled investors to capture both domestic and regional opportunities in financial markets.

Australia is well placed to take advantage of the Islamic finance opportunity, with widely recognised strengths in retail and commercial banking and experience in infrastructure, property, resources and agricultural financing.

Specific opportunities for Australia include:

- attracting foreign full-fledged Islamic banks and conventional bank Islamic windows to establish operations in Australia;
- attracting investment in Australian assets and businesses from overseas Shariah investors and tapping into new funding sources through Sukuk and other securitised issues;
- Australian-based banks providing from Australia a range of Shariah-compliant investment and financing products and services to Islamic banks, corporations, institutions and high net worth individuals in the Asia Pacific and the Gulf regions;
- fund managers establishing Shariah-compliant funds for Asian and Gulf institutional and high net worth individual investors;
- local exchanges providing an Islamic listings platform for domestic and international issuers of Shariah-compliant instruments;
- provision by Australian-based financial institutions of Shariah-compliant/ethical financial services and products to Muslim and non-Muslim customers in Australia;
- Australian-headquartered banks and insurance companies exporting Islamic financial services through windows as they grow their operations into Asia; and
- Australian-based financial firms, professional services providers and educational institutions exporting their services into Asia and the Gulf.

Australian Federal and state governments recognise that growth of Islamic finance in Australia requires supportive government policies. It is important that there is:

- a level taxation, legal and regulatory playing field for Islamic and non-Islamic finance. Taxation must be responsive and enabling but non-preferential;
- strong promotion and facilitation through government investment attraction and export promotion agencies;
- government engagement with the private sector in achieving Islamic finance objectives, identifying impediments to, and opportunities for growth;
- a focus on deepening Islamic finance skills – education, training, attainment of relevant qualifications – and on access to appropriate Shariah scholars; and
- growth in Islamic finance professional services providers.

Global Development of Islamic Finance

What is Islamic finance?

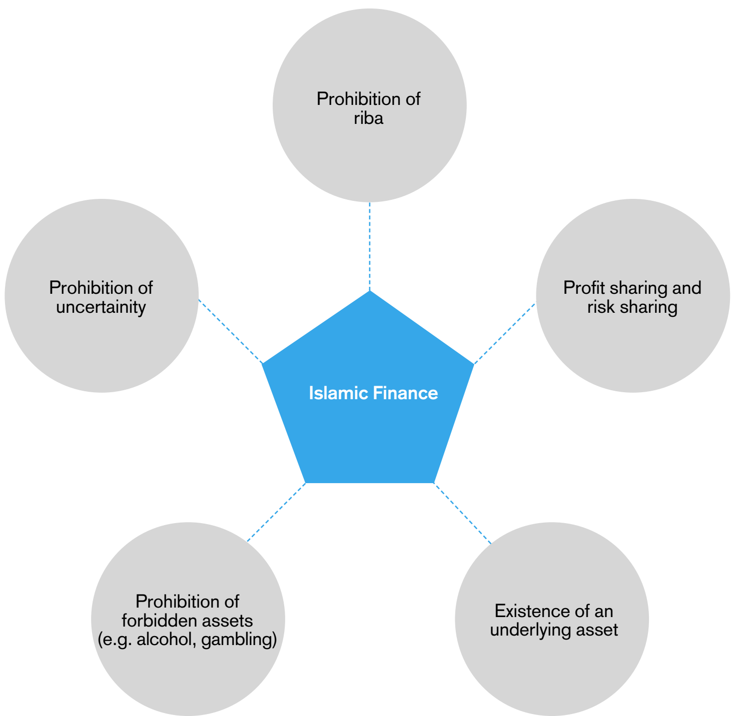
Islamic finance is finance activity that is consistent with the principles of Islamic law or the Shariah. Islamic law is sourced from the text of the Quran, and the sayings and acts (the Sunnah) of the Prophet Mohammed.

The Shariah provides guidance or principal rules that include coverage of a Muslim's economic activity, such as property dealing and wealth creation. The Shariah explains in detail ethical concepts in use of money and capital, the relationship between risk and profit, and the social responsibilities of financial institutions.

There are some key principles underlying the provision of Islamic finance, as shown in the figure below. One key principle is the prohibition of interest (riba). In Islamic finance, rather than interest, a yield from the deployment of money or capital generally arises in the form of profit and loss sharing from an investment activity or a profit or fee from sale of asset or lease of asset.

Other principles include the prohibition of uncertainty in contractual terms and conditions, prohibition of investment in or financing of banned products and services such as alcohol, gambling, pork and pornography, and a requirement that all financial transactions are underpinned by an identifiable tangible asset.

KEY PRINCIPLES UNDERLYING ISLAMIC FINANCE



An Islamic bank wishing to conduct financial activity in compliance with the Shariah will look to a Shariah scholar for guidance. Shariah scholars may belong to a particular Islamic school of thought, and they may interpret Islamic law in varying ways, reflecting different Shariah regulatory frameworks. There are notable differences of such nature between the Gulf and South East Asia. For example, Shariah interpretation in Malaysia based on the Shafi'i school of law may allow a two-party sale and buy-back transaction for cash financing. However, scholars in other regions do not allow this practice.

Financial institutions involved in Islamic finance will normally establish a Shariah supervisory board or committee (Shariah board or committee) which will determine if the institution's financial products are Shariah-compliant. The board will oversee the institution's financial product and service structures and will issue a fatwa or formal pronouncement on Shariah-compliance when the product or service is taken to market.

In some countries with significant Muslim populations, Shariah-compliance is required by legislation (such as Sudan and Iran) while in others national legislation is silent on the matter (such as the UK and Singapore).

While designed to meet the specific religious requirements of Muslim customers, Islamic banking and finance is not restricted to Muslims. Islamic financial transactions can be undertaken between Muslims and non-Muslims. An Islamic finance product can be attractive to non-Muslim investors for its commercial features as well as its underlying ethical and socially responsible character.

Types of Islamic Financial Products and Services

Islamic finance covers a range of financial services and markets similar to conventional finance, such as banking, capital markets, insurance, asset management and advisory services. Key Islamic financial products and services are as follows:

- **Murabaha:** A form of asset financing where an Islamic Finance Institution (IFI) purchases an asset and then sells it to its client at a higher price (ie mark-up sale) with deferred payment terms. The interest that would ordinarily be paid by the client in a conventional loan – and which would constitute the bank's profit — is replaced by the difference between the purchase price and the sale price;
- **Mudaraba:** A form of limited partnership where an investor (the silent partner) gives money to an entrepreneur for investing in a commercial enterprise. The profits generated by the investment are shared between the partners in a pre-determined ratio. The losses are borne only by the investor;
- **Musharaka:** Unlike a Mudaraba transaction, both partners in Musharaka must contribute capital to the partnership. Both partners or one of them may manage the venture or alternatively both may appoint a third party manager to manage the investment. While profits may be shared in a pre-determined ratio, losses are shared in proportion to the capital contributed;
- **Ijara:** Similar to a hire-purchase, the bank purchases the asset and allows the customer to use it for an agreed period and for an agreed rent;
- **Sukuk:** Shariah-compliant financial certificates of investment that are similar to asset-backed bonds; and
- **Takaful:** Similar to a mutual insurance arrangement, a group of individuals pay money into a Takaful fund, which is then used to cover payouts to members of the group when a claim is made.

(Refer to Appendix A for further details of these Islamic financial products and services.)

To illustrate some of the differences between Islamic banks and conventional banks, below is an outline of the treatment of common banking products – the residential mortgage and deposits – under Islamic law:

- **Residential mortgage using a Murabaha contract:**[7] An Islamic bank would buy the property and subsequently sell it at a higher price to the home buyer, with that higher price being payable in instalments, without interest. This involves several transactions each of which may be taxed.
- **Deposits:** Islamic banks can offer profit-sharing investment accounts (PSIAs) to their customers.[8] The terms and conditions of PSIAs provide for depositors being entitled to receive a share of the bank's profits, but they may be obliged to bear potential losses pertaining to their investment (but not always as an Islamic bank may bear the loss on its own accord to sustain the customer base).

Types of Islamic Finance Delivery Models

The main types of organisational structures or delivery models for the provision of Islamic finance products, in order of decreasing preference from a Shariah perspective, are:

- **full-fledged Islamic banks:** this refers to a wholly Islamic banking institution that operates as a stand alone entity. Full-fledged banks offer only Islamic products and typically have a full range of products compared to an Islamic window of a conventional bank. A full-fledged Islamic bank would be capital funded and set up from Shariah-compliant funds, although it could also have been converted from a conventional bank operation into an Islamic bank. All transactions within a full-fledged Islamic bank would need to be Shariah-compliant (including treasury and risk management operations);

7 There are other forms of residential mortgage, for example, the diminishing Musharaka (illustrated in Appendix A).
8 There are other forms of deposits, such as Wadiah (trusteeship), and Qard (loan from customer).

- **Islamic subsidiary:** a conventional institution operates a separate subsidiary so that the distribution and operational infrastructure is completely separate from the conventional bank. The Islamic product range will generally be broader than an Islamic window (see below). Typically, only Islamic products are provided although a customer relationship may be managed by both conventional and Islamic sides of a bank. Significantly, capital funding (at least initially) is provided by the parent company on the basis of Shariah approved contracts; and
- **Islamic window:** a term used to describe conventional banking institutions that offer Islamic products through their main distribution networks e.g. branches providing both conventional and Islamic banking and financial products. There are Shariah restrictions around co-mingling of funds, so funds, accounts and reporting must be maintained separately. This effectively means the Islamic window operates as a separate entity, but infrastructure, processes and operations are shared. Islamic windows are typically situated at the lower end of the Shariah-compliance scale.[9]

Historical development

The first modern IFIs emerged in the 1960s and 1970s. Since then, Islamic banking and finance has spread to a large number of Muslim countries, including the Gulf Co-operation Council (GCC) states,[10] Malaysia and the Arab world at large.

Islamic finance grew through the 1980s with traditional retail and commercial banking activity (including trade finance) gradually being re-cast in Shariah-compliant forms. This took place particularly in the GCC states and in Malaysia. Since then, Islamic financial products have grown in range and sophistication to include capital market, insurance and funds management products.

By the 1980s, Iran, Sudan and Pakistan had mandated Islamic banking and finance systems, although mandatory implementation in Pakistan has been postponed. The GCC and Malaysia have been most active in developing dual systems where Islamic and non-Islamic financial institutions operate alongside each other. In the GCC, Bahrain took the lead in developing an Islamic banking system.

Since the end of the 20th century, European banks have grown their Islamic finance operations across the Gulf and Asia. In 2002, the UK Government adopted a policy to facilitate the growth of Islamic finance and the growth of the UK as an international Islamic finance centre. An increasing number of countries in Europe and Asia have followed suit.

(Refer to Appendix B for description of the key countries involved in the Islamic banking and finance industry outside of the Middle East.)

The global financial crisis and Islamic finance

Islamic banks have not been completely insulated from the global financial crisis (GFC).[11] In particular, IFIs have been exposed to the downturn in the real estate sector, primarily due to the requirement that transactions are backed by tangible assets.

However, IFIs have been more resilient to the GFC than conventional banks. The strength in Islamic finance is derived from the prohibition of selling of something which one does not own (for example short-selling is generally prohibited under the Shariah)[12] and a requirement of profit sharing and risk sharing between an IFI and the customer, which entails appropriate due diligence and the integration of the risks associated with the real investment activity into the financial transaction. IFIs also tend to avoid speculative investments (such as derivatives) which insulates the parties from excessive risk exposures.[13] A 2009 survey by The Banker shows that Shariah-compliant assets held by the world's top 500 IFIs reached US$822 billion in 2009 from US$639 billion in 2008, an increase of 28.6 per cent during the GFC.[14]

9 Datamonitor, 'Islamic Banking Core Systems: The Western European Opportunity', March 2009, pp.10-11.
10 GCC states include: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
11 Standard & Poor's, *Islamic Finance Outlook 2009*, p.17.
12 Note, there are exceptions such as the "Arboon" short sale.
13 Rarick, C, 'Islamic Finance: A Viable Alternative in the Global Financial Market?', Purdue University Calumet, January 2009.
14 The Banker, *Top 500 Islamic Financial Institutions*, 28 October 2009.

Demand for Islamic Finance

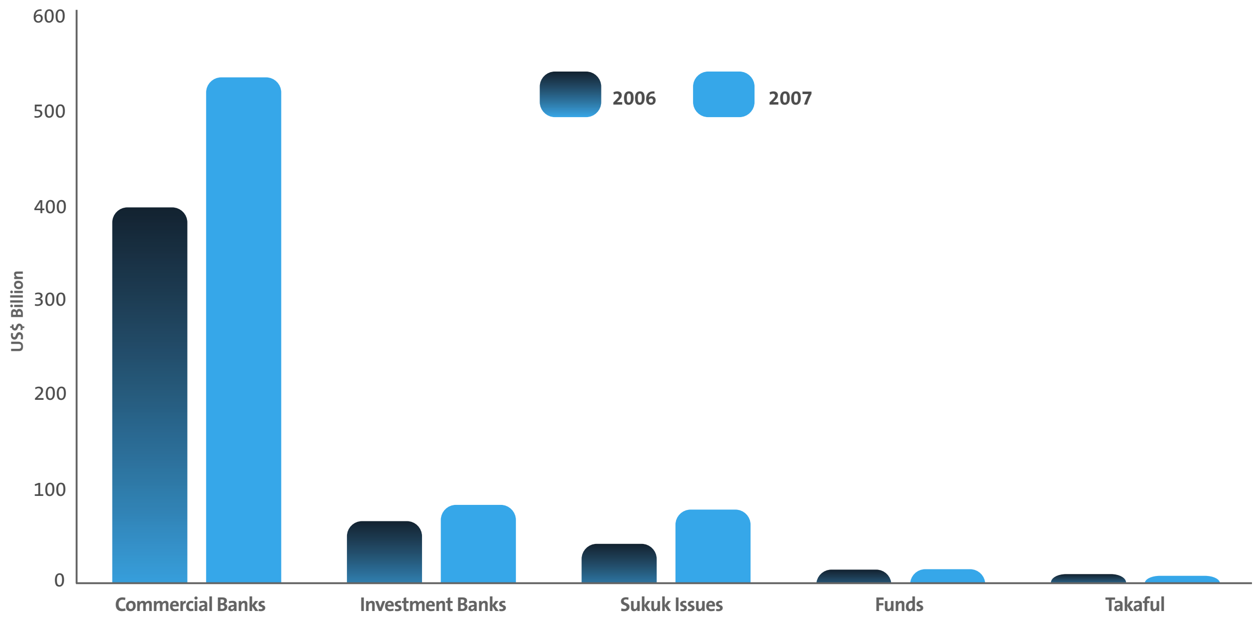
Size of the market

Globally, Shariah-compliant financial assets have been growing at over 10 per cent per annum over the past 10 years.[15]

Measured by Shariah-compliant assets of financial institutions, the global Islamic finance industry is estimated at US$822 billion in 2009. Global Shariah-compliant assets are projected to reach US$1 trillion in 2010[16] and US$1.6 trillion by 2012.[17]

Islamic commercial banks account for the bulk of assets, with investment banks and Sukuk issues making up most of the remainder.

BREAKDOWN OF GLOBAL ISLAMIC FINANCIAL ASSETS HELD, 2006-07



Source: IFSL, *Islamic Finance 2009*, February 2009

15 Standard & Poor's, *Islamic Finance Outlook 2009*, 12 May 2009, p.5.
16 The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.3.
17 Oliver Wyman, 'The Next Chapter in Islamic Finance: Higher Rewards But Higher Risks,' 6 April 2009.

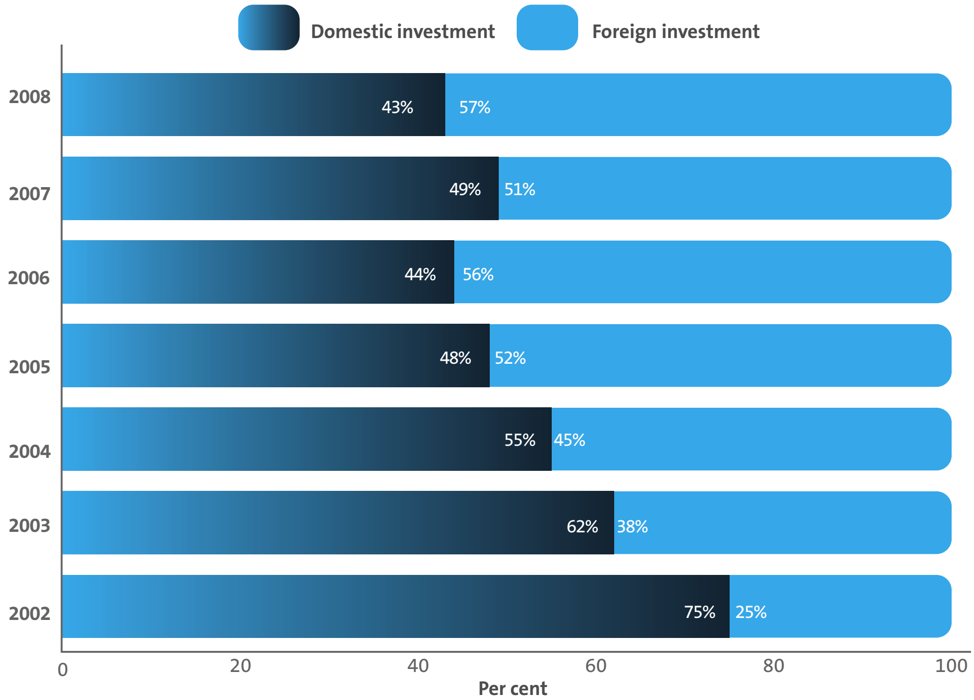
Demand for Islamic finance

Petrodollars

Oil exporting countries experienced substantial revenues in the first half of 2008, as petroleum prices reached a record high of over US$145 per barrel in July.[18] This windfall enabled the countries' central banks, sovereign wealth funds, high net worth individuals and other petrodollar investors to invest more than US$1.3 trillion in foreign financial assets in 2008 – a 58 per cent increase over the previous year.[19]

Foreign investment plays an important role for petrodollar investors, whose domestic economies and financial systems may be too small or not sufficiently diverse to absorb all their capital. As the figure below shows, foreign investment has been increasing as a proportion of total investment by petrodollar investors. This has significant implications for the Islamic banking and finance industry, whose religious underpinnings are attractive to Muslims from oil rich countries.

BREAKDOWN BETWEEN NEW DOMESTIC AND FOREIGN INVESTMENT BY PETRODOLLAR COUNTRIES, END OF 2008



Source: McKinsey Global Institute, 'The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis', July 2009

Petrodollar foreign investment activity has been minimal since the GFC escalated in September 2008 as oil prices traded as low as US$35 a barrel in February 2009.[20] However, oil prices have rebounded and wealth accumulated when oil prices were high in the past few years has meant that financial flexibility of petrodollar investors remains strong.

Looking ahead, petrodollar investors are positioned for future growth, and Asia in particular is expected to benefit from this growth. In a range of scenarios analysed by McKinsey Global Institute, it was estimated that petrodollar investors' foreign assets could reach nearly US$9 trillion by 2013.[21]

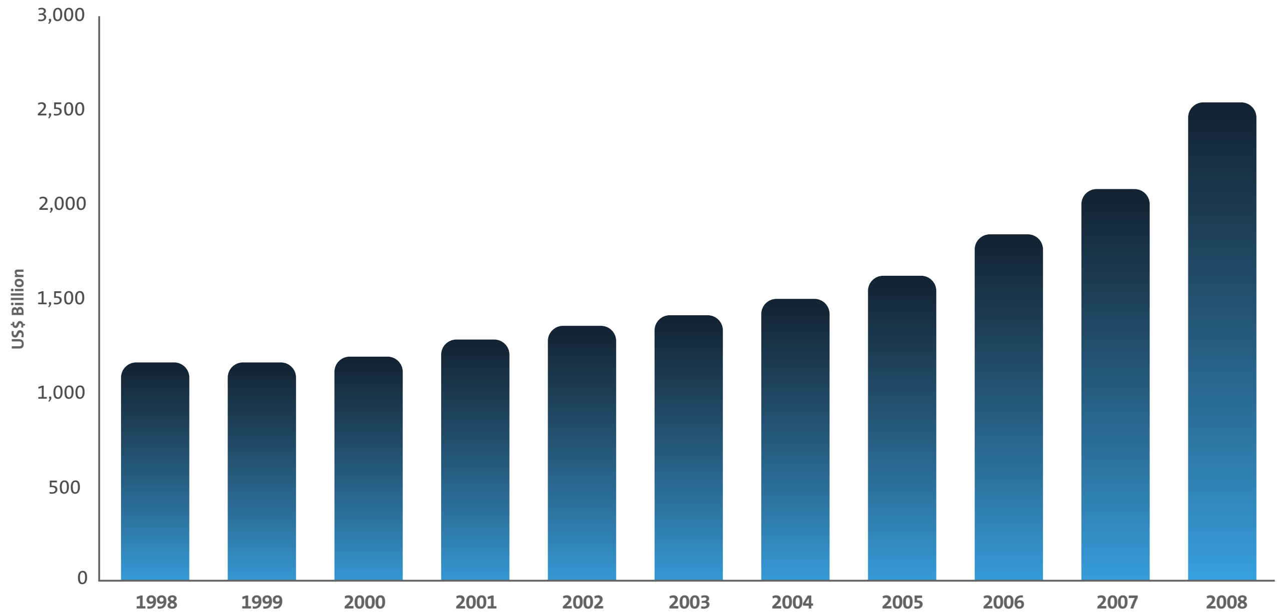
Sovereign Wealth Funds (SWFs)

SWFs are one channel through which governments deploy their financial assets.[22]

SWFs fall into one of two major categories: commodity funds and non-commodity funds. Commodity funds are funded predominantly from oil exports, with gas and mineral revenue also representing important sources. Assets of SWFs originating from commodity exports doubled during the past decade to reach US$2.5 trillion at the end of 2008.[23]

18 McKinsey Global Institute, 'The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis', July 2009, p.11.
19 Ibid.
20 Australian Bureau of Agricultural and Resource Economics, *Australian Commodities*, vol 16 no 2 June quarter 2009.
21 McKinsey Global Institute, 'The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis', July 2009, p.12.
22 Funds are generally the result of current account surpluses from exports of oil and other commodities or manufactured goods, fiscal surpluses, public savings, privatisation receipts or pension reserves.
23 IFSL, *Sovereign Wealth Funds 2009*, March 2009, pp.4-5.

SIZE OF OIL EXPORTING COUNTRIES' ASSETS IN SWFS, END OF 2008



IFSL estimates.

Source: IFSL, *Sovereign Wealth Funds 2009*, March 2009.

International Financial Services London (IFSL) estimates that SWFs from commodities will increase to more than US$3.5 trillion by 2015.[24] The Sovereign Wealth Fund Institute reports that oil and gas related SWFs account for 60 per cent of total SWFs by funding source. Of the total global SWFs market, the Middle East and Asia are responsible for a total of 75 per cent (37 per cent and 38 per cent respectively), while Europe, the Americas and others account for the remaining 25 per cent.[25]

SWFs from Muslim countries are predominantly conventional investors, and may not necessarily seek to invest in Islamic financial products exclusively given the relative lack of products and liquidity. However, as the Islamic financial market deepens, there should be a shift towards Islamic financial products. In fact, there has been a recent trend for these SWFs to allocate part of their assets specifically to Shariah-compliant investments.

SOVEREIGN WEALTH FUNDS – MARKET SHARE BY COUNTRY[1]

	Total (US$bn)	% share
China	927.1	24.3
United Arab Emirates	676.5	17.8
Norway	445	11.7
Saudi Arabia	436.3	11.5
Singapore	369.5	9.7
Kuwait	202.8	5.3
Russia	168	4.4
Libya	70	1.8
Qatar	65	1.7
Australia	49.3	1.3
Others	399.1	10.5
Total	**3,808.6**	**100**

1 Updated December 2009 by SWF Institute

Source: SWF Institute, December 2009; Austrade estimates.

24 IFSL, *Sovereign Wealth Funds 2009*, March 2009, p.5.
25 SWF Institute, December 2009, http://www.swfinstitute.org/funds.php.

LARGEST SWFs BY ASSETS UNDER MANAGEMENT[1]

	Assets under management (US$bn)	Country	Inception Year	Source
Abu Dhabi Investment Authority	627	UAE	1976	Commodity
Government Pension Fund – Global	445	Norway	1990	Commodity
SAMA Foreign Holdings	431	Saudi Arabia	n/a	Commodity
SAFE Investment Company	347.1	China	n/a	Non-commodity
China Investment Corporation	288.8	China	2007	Non-commodity
Government of Singapore Investment Corp.	247.5	Singapore	1981	Non-commodity
Kuwait Investment Authority	202.8	Kuwait	1953	Commodity
National Welfare Fund	168.0	Russia	2008	Commodity
National Social Security Fund	146.5	China	2000	Non-commodity
Hong Kong Monetary Authority Investment Portfolio	139.7	China – Hong Kong	1993	Non-commodity
Temasek Holdings	122	Singaopre	1974	Non-commodity
Libyan Investment Authority	70	Libya	2006	Commodity
Qatar Investment Authority	65	Qatar	2005	Commodity
Australian Future Fund	49.3	Australia	2004	Non-commodity

1 Updated December 2009 by SWF Institute

Source: SWF Institute, December 2009, http://www.swfinstitute.org/funds.php.

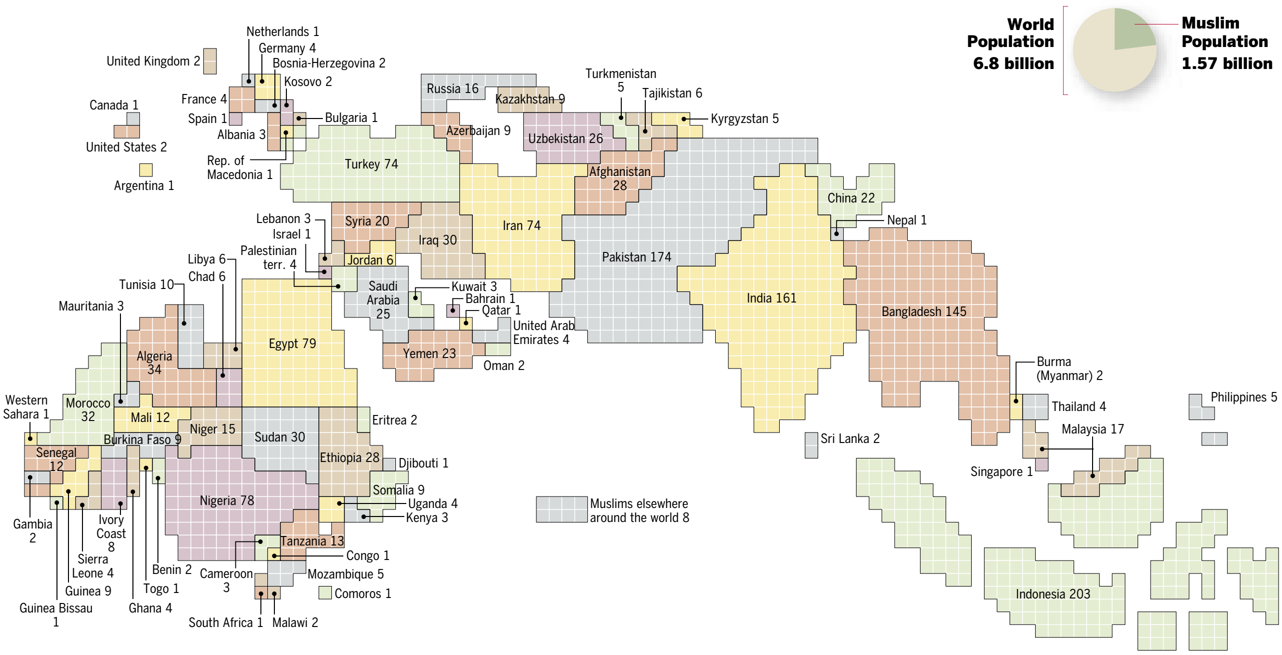
Muslim Population

There are 1.57 billion Muslims world-wide, representing approximately 23 per cent of an estimated global population of 6.8 billion in 2009. However Islamic finance represents just 1 per cent of global financial assets.[26] This reflects two factors:

- Muslim countries, on average, have a lower GDP per capita than the OECD countries, whose populations are the main owners of financial assets. However, in recent years significant economic growth has been occurring in some Muslim countries such as Indonesia, and this trend towards better economic performance is expected to continue; and
- Muslims have been relatively willing to use conventional finance.

WORLD DISTRIBUTION OF MUSLIM POPULATION

This 'weighted' map of the world shows each country's relative size based on its Muslim population. Figures are rounded to the nearest million.



Mapping the Global Muslim Population, Pew Research Center's Forum on Religion & Public Life, © 2009, Pew Research Center http://pewforum.org/. http://pewforum.org/docs/?DocID=450.

26 Pew Research Centre, *Mapping the Global Muslim Population – A Report on the Size and Distribution of the World's Muslim Population*, October 2009.

Factors driving future growth of Islamic finance

Dynamic growth in Islamic finance will be driven by the following.

- **Rising oil revenue and strong economic growth of the Gulf:** In the past few years, economic growth in the GCC has been robust on the back of higher oil prices. The GCC holds around half of the world's known oil reserves, and oil earnings account for 70 per cent of the GCC's exports and revenues.[27]

  The substantial petrodollar liquidity in the Gulf economies has meant that petrodollar investors are increasingly seeking to invest in offshore assets, a proportion of which is sought in the form of Shariah-compliant financial assets. In addition, the GCC is planning massive infrastructure and construction spending of US$1.4 trillion from 2009-2015 which will require financing.[28]

- **Demand from Muslim and non-Muslim investors:** Investors from the Middle East and Asia are increasingly seeking to invest in products that are compliant with their religious beliefs. Surveys suggest that half of the Muslims world-wide would opt for Islamic finance if given a competitive alternative to conventional services.[29]

  Conventional borrowers are also seeking to diversify their investor base, particularly if access to wholesale funding sources remains constrained post the GFC.

- **Low penetration levels:** In spite of the growth in the Islamic banking and finance industry, there remains a lack of depth across asset classes and products, signifying untapped potential.[30] In particular, countries such as Indonesia, India and Pakistan which have the largest Muslim populations in the world are not considered to have well-developed Islamic banking and finance industries.

- **Ethical character and financial stability of products:** Islamic finance is attracting attention in a world of increasing corporate social responsibility. IFIs have not invested in impaired asset classes that have hampered many conventional banks' financial profiles and performance recently. According to Standard & Poor's, Islamic commercial banks recorded a ratio of liquid assets to total assets of 19.9 per cent at 30 September 2008, and although this ratio declined in the first quarter of 2008, it remained adequate.[31]

27 RREEF, 'Understanding Shariah Investment', June 2008, p.14.
28 McKinsey Global Institute, 'The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Faring in the Financial Crisis', July 2009, p.22.
29 Oliver Wyman, 'The Next Chapter in Islamic Finance: Higher Rewards But Higher Risks,' 6 April 2009.
30 RREEF, 'Understanding Shariah Investment', June 2008, p.24.
31 Standard & Poor's, *Islamic Finance Outlook 2009,* 12 May 2009, p.9.

Supply of Islamic Finance

The demand for Islamic finance has not been matched by supply. This is evident in the low penetration of Islamic finance in the global banking industry considering the potential market size.

An increase in supply is necessary to meet demand. This increase should have two important effects:

- an increase in the level of awareness of Shariah-compliant products and services, since in many countries, including Muslim countries, the level of awareness and understanding is low;[32] and
- a larger number of providers will lead to increased competition in the marketplace with improved product innovation and pricing.[33]

Type of Islamic financial institutions

IFIs have taken the form of commercial banks, investment banks, insurance companies, funds management companies and other financial services companies. Current estimates of the total number of IFIs world-wide range from 400 to 600.[34]

In Asia, the most prominent IFIs are currently found in Malaysia, such as Bank Rakyat, Maybank Islamic Berhad, BIMB Holdings, CIMB Islamic Bank Berhad and Public Bank Islamic Berhad. Of the global conventional banks operating in Asia, HSBC Amanah, the Islamic finance division of HSBC established in 1998, has a high profile operation as does Standard Chartered Bank through Standard Chartered Saadiq.

Key countries for Islamic capital

On a regional basis, the Middle East and Asia are the primary locations for Islamic capital. In particular, the UAE, Bahrain and Malaysia are seen as the main centres of Islamic finance, with significant activity also taking place in London.

TOP 10 COUNTRIES BY VALUE OF SHARIAH-COMPLIANT ASSETS, 2009

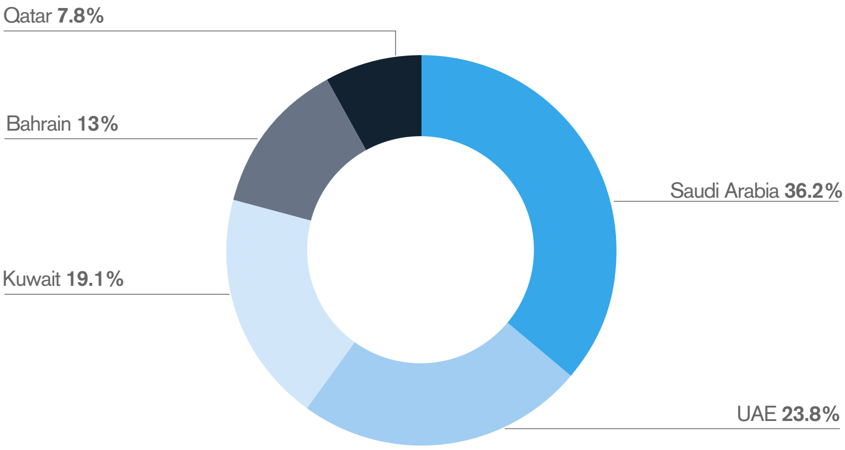
Rank	Country	Shariah-compliant assets US$bn
1	Iran	293.2
2	Saudi Arabia	127.9
3	Malaysia	86.5
4	United Arab Emirates	84.0
5	Kuwait	67.6
6	Bahrain	46.2
7	Qatar	27.5
8	United Kingdom	19.4
9	Turkey	17.8
10	Bangladesh	7.5

Source: The Banker, *Top 500 Islamic Financial Institutions,* November 2009, p.4.

The three figures on the next page show the geographical distribution of reported Shariah-compliant assets.

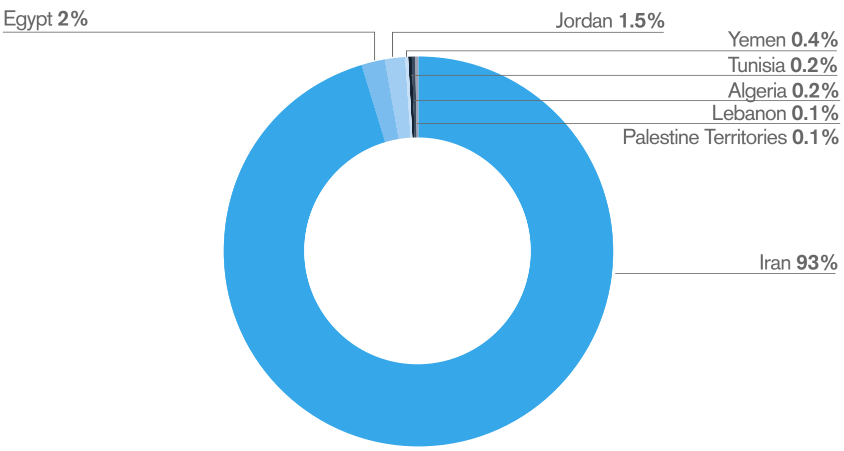
32 Booz & Company, 'Islamic Banking: How Do Islamic Banks Compete in an Increasingly Competitive Environment', 2009.
33 Ibid.
34 The Banker, *Top 500 Islamic Financial Institutions,* November 2009, p.2.

GEOGRAPHICAL DISTRIBUTION OF REPORTED SHARIAH ASSETS, GCC, 2009



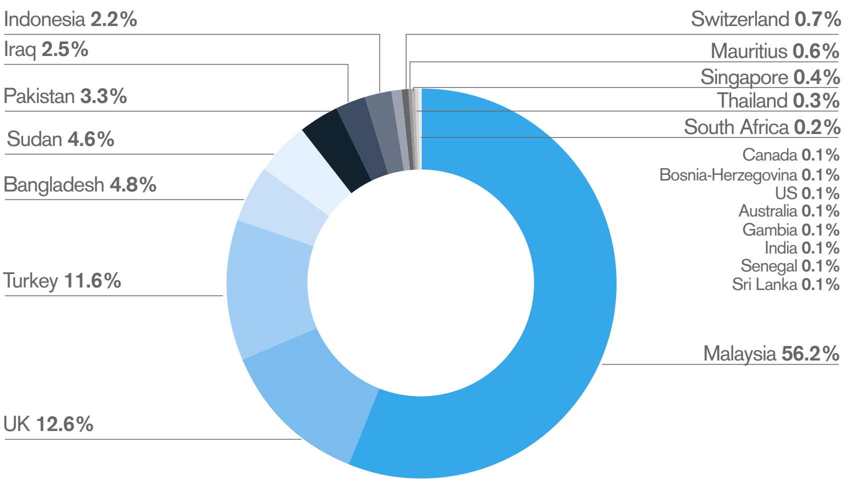
The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.26.

GEOGRAPHICAL DISTRIBUTION OF REPORTED SHARIAH ASSETS, NON-GCC MENA, 2009



The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.26.

GEOGRAPHICAL DISTRIBUTION OF REPORTED SHARIAH ASSETS, NON-MENA GLOBAL, 2009



The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.26.

(Refer to Appendix B for a description of the key countries involved in the Islamic banking and finance industry outside of the Middle East).

International Self-Regulation

IFIs, like conventional financial institutions, are regulated by national authorities which are aligned with international standard-setting bodies such as the Bank for International Settlements. Two international bodies have been established to interact with and complement conventional regulation and to establish best practice on issues specific to IFIs.

Islamic Financial Services Board (IFSB)

The IFSB was established in 2002 to promote and facilitate the integration of the Islamic finance industry into the global financial system by producing prudential standards for Islamic finance which complement existing international standards for the conventional finance industry. It covers banking, capital markets and insurance. The IFSB is headquartered in Kuala Lumpur, Malaysia.

The nine founding members of the IFSB were the Islamic Development Bank (IDB) and the central banks of Bahrain, Indonesia, Iran, Kuwait, Pakistan, Saudi Arabia, Sudan and Malaysia. As of November 2009 there were 193 members of the IFSB – 49 regulatory and supervisory bodies, six international inter-governmental organisations (including The World Bank, International Monetary Fund, Bank for International Settlements and Asian Development Bank) and 138 industry stakeholders.

The IFSB has to date issued 12 standards, guidelines and technical notes in the following Islamic finance areas: risk management, capital adequacy, corporate governance, supervisory review processes, transparency and market discipline, ratings, money markets, governance for collective investment schemes, governance for Takaful operations, conduct of business for institutions offering Islamic financial services, and Shariah governance systems. The IFSB is also working on a new solvency of Takaful standard.

As with other international standard setting organisations, the IFSB does not have the power to enforce the implementation of its standards and guidelines.

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

The AAOIFI was established in 1990 and is headquartered in Bahrain. Its main purpose is to issue accounting and auditing standards and governance norms within the Islamic finance sector.

As an independent international organisation, the AAOIFI is supported by institutional members (200 members from 45 countries) including central banks, IFIs and other participants in the international Islamic banking and finance industry.

AAOIFI standards have now been adopted by IFIs in many countries such as Bahrain, UAE-Dubai, Jordan, Lebanon, Qatar, Sudan and Syria. The standards cover accounting, auditing, corporate governance, capital adequacy and ethics. Future standards will include corporate social responsibility and presentation and disclosure.

While the AAOIFI has introduced a range of accounting standards, many IFIs are required to report to the market in accordance with local Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). The treatment of Islamic products under local GAAP or IFRS may well differ from their treatment under Islamic principles. An external auditor of IFIs requires skill sets and experience that some accounting organisations may not possess.

Challenges for Islamic Finance Providers

The emerging Islamic finance industry faces a number of challenges.

- **Liquidity:** Liquidity is one of the most critical issues for IFIs as only a small secondary market exists to enable them to manage their liquidity. For example, in the Sukuk market investors can end up holding their assets for longer than they intended because of secondary market illiquidity.[35] Also, it can be difficult to find a new Sukuk instrument if the investor disposes of their existing Sukuk, as demand is often greater than supply.

  Moreover, IFIs' instruments for managing liquidity are scarce compared with those of conventional counterparts. For example, it is difficult for an IFI to use hedging instruments such as derivatives as they are generally forbidden.[36]

  The GCC secondary market for bonds and Sukuk is developing more liquidity.[37] A key development to address the liquidity issue has been the formation of the International Islamic Financial Market (IIFM) in Bahrain, whose aim is to create and standardise financial instruments to meet the liquidity needs of IFIs around the world. In addition, some leading Islamic banks have set up bilateral agreements with their respective central banks in order to address this weakness.[38]

- **Lack of standardisation:** A broad product range and relatively low transaction volumes mean that documents for Islamic financial products tend to be tailor-made for individual transactions.[39] Fortunately, the costs associated with this lack of standardisation should decrease as transaction volumes increase and various industry bodies take steps to speed up the standardisation process.

- **Lack of awareness:** Consumers lack knowledge about Islamic financial products and IFIs need to work harder than their conventional counterparts to educate people.[40]

- **Skills shortage:** The shortage of skilled human resources is becoming a concern for the industry and the strong growth in Islamic finance also means that having and maintaining qualified staff is challenging.

  This may result in management discontinuity and ultimately damage the creditworthiness of an IFI. On a positive note, some professional qualifications in Islamic finance have been developed recently, and this should ease pressure on the industry in the medium term.

- **Varying interpretations of Islamic law, often fuelled by different Shariah regulatory frameworks:** IFIs have little latitude when implementing the opinions of their Shariah advisors, and the advice itself can vary between advisors. While the AAOIFI will help drive rule standardisation and convergence, interpretation by individual scholars will always play a role.[41]

- **Reputation risk:** It is important for IFIs to constantly ensure that their Islamic products are truly Shariah-compliant for a sustainable business model. For example, criticism of a Sukuk issuance featuring a guaranteed buy-back clause as contravening the Shariah led to a massive reduction in issuance volumes in late 2007 and early 2008 due to confusion in the market.[42]

- **Need for regulatory (including tax) reforms:** This is particularly important for countries that currently only have tax regulations for a conventional finance and banking system. Successful introduction of Islamic finance to a market will require tax neutrality as compared to the tax treatment of conventional products.

- **Asset concentration exposure to real estate sector:** According to the Shariah, all transactions must be backed by a tangible asset and so exposure to the real estate sector is common for IFIs. Standard & Poor's noted that real estate financing in the Gulf grew considerably over the past three years, and estimates that the total direct exposure of rated IFIs to the real estate sector is around 20 per cent of total loans.[43] This makes IFIs vulnerable to a correction in this sector, as has been the case with the GFC.

35 Accenture, 'Islamic Finance: From Niche to Mainstream', 2009, p.9.
36 Standard & Poor's, *Islamic Finance Outlook 2009*, 12 May 2009, p.14.
37 Ryan, N, 'The Rise and Rise of Islamic Finance', *The Market*, February 2008, p.33.
38 For example, the Al Rahji Bank has an investment portfolio which can be repurchased with the Saudi Arabia Monetary Authority.
39 RREEF, 'Understanding Shariah Investment', June 2008, p.9.
40 Accenture, 'Islamic Finance: From Niche to Mainstream', 2009, p.9.
41 Ibid.
42 Oliver Wyman, 'The Next Chapter in Islamic Finance: Higher Rewards But Higher Risks,' 6 April 2009.
43 Standard & Poor's, *Islamic Finance Outlook 2009*, 12 May 2009, p.11.

Opportunities in Australia

Islamic finance is still a nascent industry in Australia but has great potential for development given Australia's abundant resources and its strategic location in, and strong trade links with, the fastest growing region in the world. It has the potential to facilitate further innovation and competition in the wholesale and retail banking sectors and to support the Australian Government's commitment towards credit market diversification.

Specific opportunities in Australia

- Attracting foreign full-fledged Islamic banks and conventional bank Islamic windows to establish operations in Australia;
- Attracting investment in Australian assets and businesses from overseas Shariah investors and tapping into new funding sources through Sukuk and other securitised issues;
- Australian-based banks providing from Australia a range of Shariah-compliant investment and financing products and services to Islamic banks, corporations, institutions and high net worth individuals in the Asia Pacific and the Gulf regions. These products and services could encompass:
  - treasury and capital markets, including Islamic inter-bank liquidity, and structuring, arranging and underwriting debt issues;
  - corporate and asset finance, e.g. real estate, trade, lease finance; and
  - innovative structured financial and risk management instruments;
- Fund managers establishing Shariah-compliant funds, for example equity funds, but also alternative asset classes such as real estate, commodity, private equity, and infrastructure, for Asian and Gulf institutional and high net worth individual investors;
- Local exchanges providing an Islamic listings platform for domestic and international issuers of Shariah-compliant instruments;
- Provision by Australian-based financial institutions of Shariah-compliant/ethical financial services and products to Muslim and non-Muslim customers in Australia;
- Australian-headquartered banks and insurance companies exporting Islamic financial services through windows as they grow their operations into Asia; and
- Australian financial firms, professional services providers and education institutions exporting their services into Asia and the Gulf.

Wholesale banking and finance

Australia has one of the world's largest economic resources of commodities. There is a strong need to develop resources-related services and infrastructure due to the demand for Australian commodities from developing countries such as China and India. This positions Australia well for Islamic financing instruments such as Sukuk, Mudaraba, Murabaha and Ijarah.

The following section provides an overview of some key industry sectors with good opportunities for Islamic finance investment in Australia.

Agribusiness

Agriculture is considered an attractive asset class by many wholesale and institutional investors, fund managers and high net worth investors because of the imbalance of demand and supply of food. A number of factors, including population growth, the rapid increase in affluence level in developing countries, the increased consumption and diversion of food crops for biofuel production and for intensive feeding of livestock in recent years, have led to a sharp increase in demand for agricultural commodities and effects on food prices. This situation creates opportunities for investment in agriculture.

Australia's diverse climate, rainfall patterns and soil types sustain a wide range of agribusiness enterprises, including tropical and temperate horticulture, inland and coastal aquaculture, the production of grains, oilseeds and fibres, grazing and feed lotting of livestock, thoroughbred breeding, forestry and the production of timber products.

Australia's agriculture sector enjoys several advantages. Its geographic isolation and leading quarantine and monitoring regime help preserve a reputation for high quality production. Proximity to Asian economies, extensive free trade agreements and counter-seasonal production for the northern hemisphere means that trans-national companies sourcing from Australia can deliver produce throughout the year, assisting with driving demand for Australia's products in world markets.

As a major exporter of agricultural produce and services, more than two thirds of agricultural commodities produced on Australian farms are exported each year. Among the agribusiness export industries, the average proportion of production exported ranges from 98 per cent for wool to 51 per cent for dairy products. In 2007-08 the value of farm exports was A$27 billion. The gross value of total Australian agricultural production in 2007-08 was A$43.3 billion, an increase of 20 per cent from 2006-07, driven mainly by increased crop production and higher average prices in 2007-08.[44]

Mineral Resources

Australia has the world's largest reserves of mineral sands (rutile and zircon), lead, nickel, silver, uranium and zinc. It is the world's largest producer of bauxite and alumina (using the Economic Demonstrated Reserves (EDR) measure), the second largest producer of zinc and lead, and the third largest producer of iron ore and uranium.[45]

MAJOR MINERAL RESOURCES IN AUSTRALIA

Commodity	Unit	World Ranking EDR	Economic Resources
Bauxite	Gt	2	6.2
Black Coal	Gt	6	39.2
Brown Coal	Gt	1	37.2
Copper	Mt	2	77.8
Gold	t	2	6,255
Iron Ore	Gt	3	24.0
Lead	Mt	1	26.8
Nickel	Mt	1	26.4
Silver	Kt	1	61.4
Tantalum	Kt	2	51
Uranium	Kt	1	1,163
Zinc	Mt	1	53.1
Zircon	Mt	1	39.1

Source: Geoscience Australia, *Australia's Identified Mineral Resources (AIMR) 2009*.

44 ABS, *Australian commodity statistics 2008; 2007-08 Value of Agricultural Commodities Produced, Australia*, 29 July 2009.
45 Geoscience Australia, *Australia's Identified Mineral Resources 2009*, released 15 December 2009, Canberra.

Mining and minerals activity currently comprises approximately 8 per cent of the Australian economy, and 40 per cent of exports. The sector is expanding, driven primarily by huge demand for raw materials from China and other parts of Asia. Earnings from Australia's mineral resources exports increased by 37 per cent to A$159.7 billion in 2008-09, reflecting primarily higher contract prices for bulk commodities and the effect of a 16 per cent fall in the value of the Australian dollar.[46]

MINERAL RESOURCES UNIT EXPORT RETURNS[1]

	2007-08				2008-09[2]			
	Sept	Dec	Mar	June	Sept	Dec	Mar	June
Energy minerals	212.6	221.0	235.8	325.7	429.0	526.4	431.8	289.1
Metals and other minerals	211.2	207.7	217.2	234.1	249.2	272.4	251.6	204.1
Total mineral resources	**214.2**	**214.6**	**223.0**	**270.5**	**322.1**	**372.9**	**311.0**	**239.1**

1 Base: 1994-95 = 100

2 Preliminary

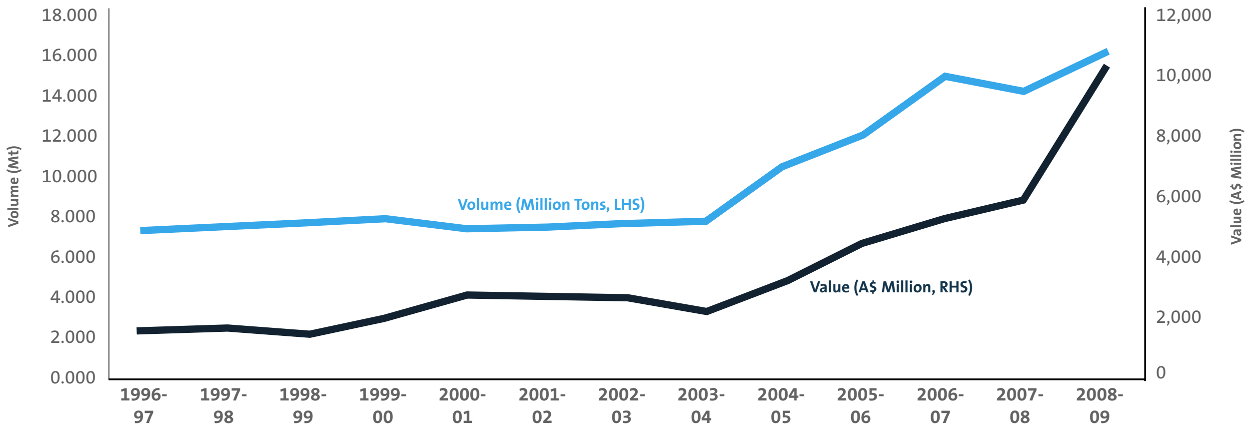
Source: Australian Bureau of Agricultural and Resource Economics (ABARE), Australian Mineral Statistics, June Quarter 2009.

Oil and Gas

Australia is a significant producer of petroleum products, with the major areas of production located offshore. Australia's oil and condensate production for 2007-08 was 161.6 million barrels (or 443,000 barrels per day). Crude oil production is equivalent to around 70 per cent of refinery feedstock, meaning Australia is a net importer of crude oil. Around 78 per cent of Australia's refined product consumption is sourced from domestic refineries. However, more than 60 per cent of Australia's crude oil production is exported, resulting in 70 per cent of refinery feedstock being sourced from imports. In contrast, Australia is a net exporter of LPG, exporting around 60 per cent of its annual LPG production.

Australia has substantial natural gas resources, with total proved and probable reserves standing at around 52,000PJ. Many of these reserves are located off the north-west coast of Australia or in the Timor Sea, with more than 55 per cent of natural gas reserves lying in large offshore basins off the coast of Western Australia. As a source of export income and as a domestic energy source, natural gas is becoming increasingly important for Australia. The value of Australian LNG exports was A$5.9 billion in 2007-08 and, with future expansions to Australia's LNG capacity, LNG exports are expected to continue increasing over the next five years. Australia's major LNG trading partners include Japan, Chinese Taipei, the Republic of Korea and China. With future expansions to Australia's LNG capacity, LNG trade with countries such as India and the United States is likely.[47]

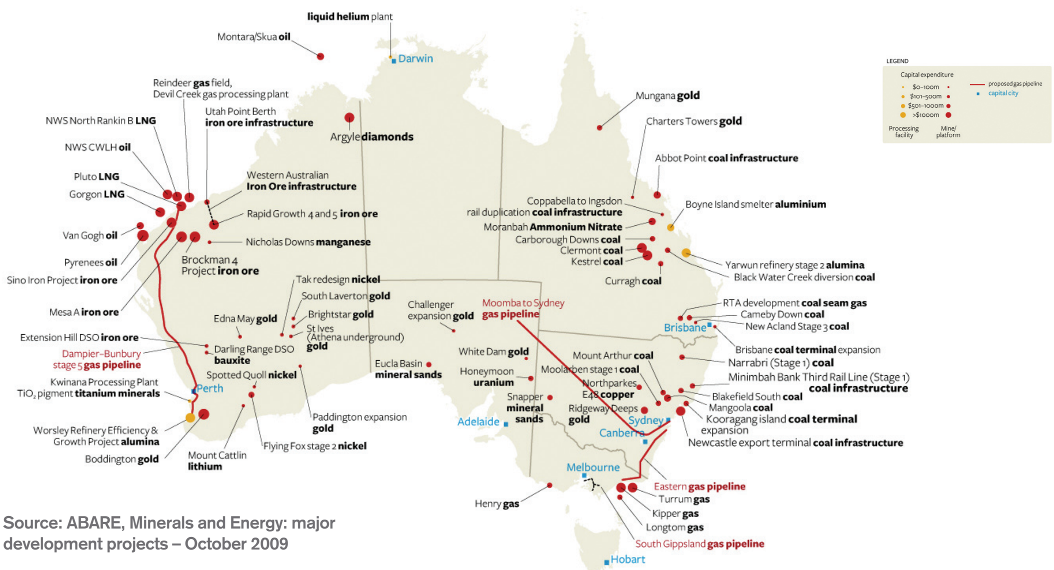
AUSTRALIAN LNG EXPORTS



Source: ABARE, Australian Commodities Statistics 2009, Australian Commodities – September quarter 2009.

46 Australian Bureau of Agricultural and Resource Economics, *Australian Mineral Statistics*, June Quarter 2009.
47 ABARE, *Energy in Australia 2009*, April 2009.

ADVANCED MINERALS AND ENERGY PROJECTS OCTOBER 2009



Source: ABARE, Minerals and Energy: major development projects – October 2009

Infrastructure

Australia is widely recognised as a global leader and innovator in infrastructure financing and has had a long engagement in the development and reform of the infrastructure sector beginning with the privatisations of the late 1980s and early 1990s and extensive experience with public/private partnerships.

Australia, together with the UK and Canada, has been a 'first mover' in applying its expertise in complex financial engineering to infrastructure funding and development solutions. Australia has also taken the lead in the establishment and development of dedicated listed and unlisted infrastructure fund vehicles.

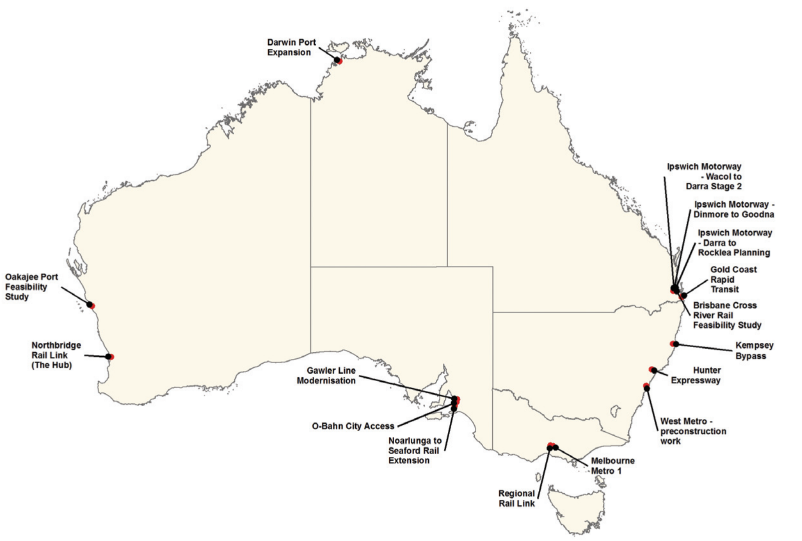
Expertise in this area includes experience in asset selection, management and structuring of project risk, arrangement of domestic and international debt and equity finance, underwriting, project finance, asset and fund management.

Infrastructure is emerging as a distinct asset class and one that is of growing interest to pension funds and the wider institutional investment sector.

In 2008, the Government established Infrastructure Australia to coordinate a national approach to Australia's future infrastructure needs. The agency has completed an audit of the nation's economic assets and identified key themes to drive development of Australia's infrastructure. These include broadband, energy grids, port productivity and land transport, public transport, and water supply.

Continued strong demand means the Government is keen for more foreign companies to enter the infrastructure development market, both to increase competition and relieve construction bottlenecks.

MAJOR INFRASTRUCTURE PROJECTS IN AUSTRALIA



Source: Department of Infrastructure, Transport, Regional Development and Local Government 2009, Major Infrastructure Projects 2009, Department of Infrastructure, Transport, Regional Development and Local Government, Canberra.

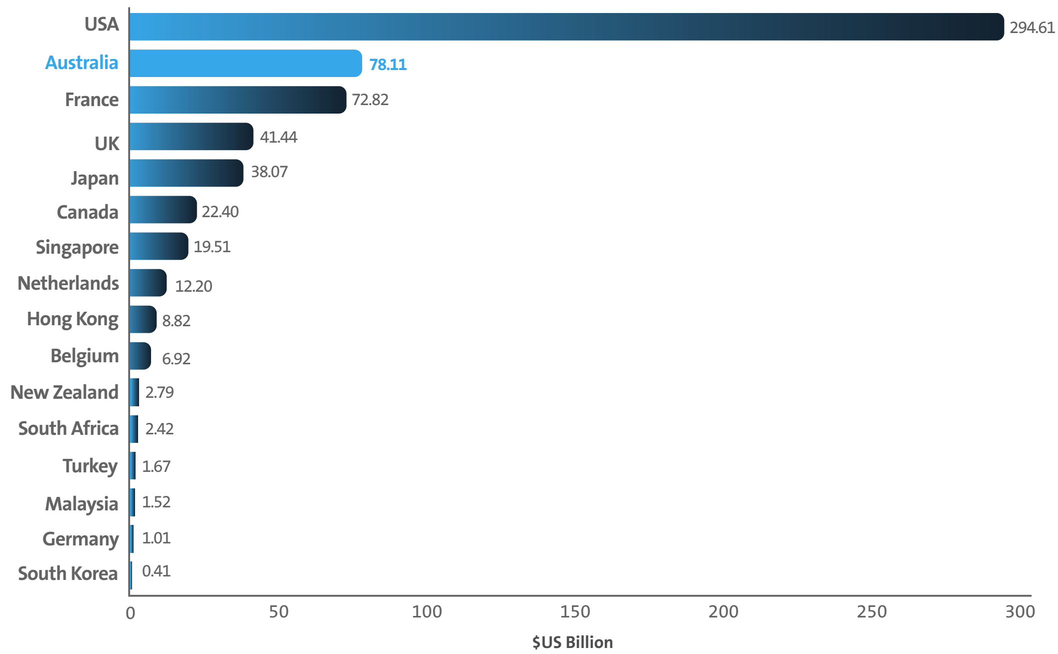
Property

Securitised property plays a valuable role in providing Australians with access to commercial property and the capital to develop and own the nation's office, retail, industrial, hotel and social infrastructure assets.

In 2008, the industry comprised total assets of just over A$400 billion in more than 1,000 different funds across A-REITs, A-REIT securities funds and unlisted property funds including property syndicates and mortgage schemes.

Australia is recognised as having the world's largest REIT market outside the US. Its total market capitalisation is estimated to exceed US$78 billion, which is more than the combined value of that in Japan, Singapore, Hong Kong, Malaysia and South Korea.

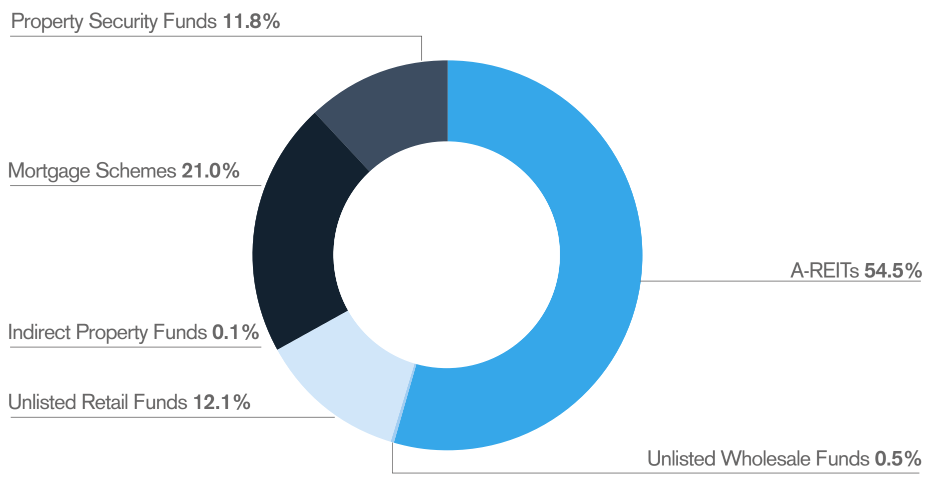
REAL ESTATE INVESTMENT TRUST (REIT) MARKET CAPITALISATION



Sources: Ernst & Young, *Global REIT Report 2008, Riding Out the Storm*; Austrade

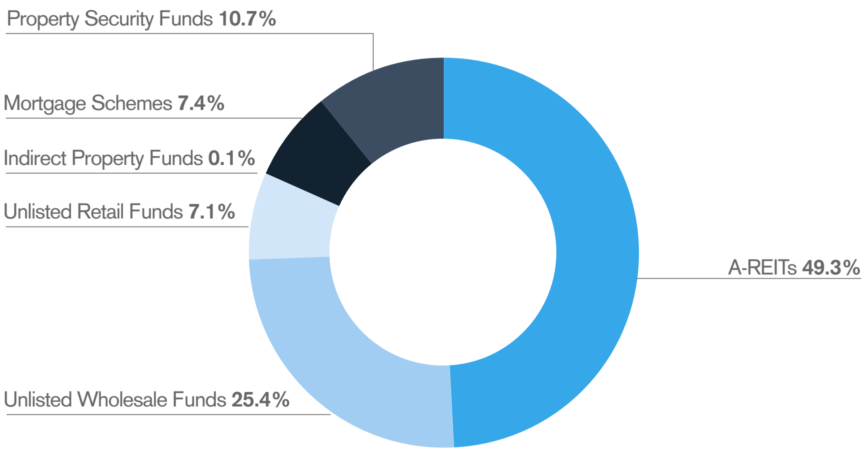
The industry has more than 1.3 million direct investors comprising retail, institutional and global investors. It has in excess of 11 million individual investors, if taking into account those investors who gain access to property indirectly through their investments in superannuation, or property funds being accessed through master trusts/wrap accounts and other feeder funds.

NUMBER OF INVESTORS IN AUSTRALIAN PROPERTY SECTOR



Sources: Property Council of Australia, *Australian Property Investment Industry*, June 2009; and PIR

TOTAL ASSETS IN AUSTRALIAN PROPERTY SECTOR ($M)



Property Council of Australia, *Australian Property Investment Industry*, June 2009; and PIR

The Australian property industry has grown four-fold in eight years, from just under A$100 billion in 2000 to more than A$400 billion in assets in 2008. Property's share of the superannuation pie in 2008 was 10 per cent.[48]

48 Property Council of Australia, *Australian Property Investment Industry*, June 2009.

Retail banking

The Australian retail banking sector is dominated by the four major domestic banks. As of October 2009, the big four held over 86 per cent of all banks' housing loans, 85 per cent of household credit cards, and 82 per cent of total household deposits in Australia.[49] Australian domestic regional banks, such as Suncorp-Metway, Bendigo and Adelaide Bank, the Bank of Queensland and AMP Bank have generally focused on providing services to regional and rural areas and undertaking well targeted marketing campaigns.

However, one of the biggest shifts in the Australian financial services landscape over the past two decades has been the steady rise of foreign banks. A number of foreign banks have also entered the retail banking market, targeting niche areas, and using innovative distribution platforms with products distributed through brokers or the Internet. They have achieved success by leveraging their natural competitive advantages, such as global brands, expertise, technology and connections. The major foreign banks operating in the retail banking market include ING Bank (has gained significant presence without branches or ATMs), Citigroup, HSBC, Rabobank (popular with rural customers) and Bank of China (targeting local Chinese communities, Chinese students in Australia, Chinese businesses in Australia, and Australia's business with trade and investment links to China).

With 365,000 Muslims in Australia as of 2006 and a fast growing Muslim population, Australia offers a modest base for opportunities at the retail banking level. The offering of retail Shariah-compliant finance products will enable Australian Muslims to access products that are more consistent with their principles and beliefs and contribute to fostering social inclusion. As an alternative financing option, Islamic finance will also widen the choice of products to all consumers and investors, especially to those who are interested in ethical finance, given the ban on investing in certain economic sectors, such as gambling, pornography, alcohol and armaments. The opportunity is not limited to the domestic Australian market but also to the region and the world.

Insurance

Australia's insurance industry ranks 12th globally in terms of premiums and fourth in the Asia Pacific region.[50] It is a largely mature market with a strong mix of domestic and foreign competitors. While the top three general insurance competitors in Australia are domestic firms, many of the next tier of companies are foreign owned, including global players such as Swiss Re, Munich Re, Allianz, Zurich, and AIG. In life insurance, foreign owned groups account for 27 percent of assets. Significant foreign competitors include ING, AXA, AIG, Norwich, Cuna Mutual, Zurich, Allianz and MetLife.

WORLD INSURANCE MARKETS – 2008

	World Ranking[1]	Country	Premium Volume US$ Billion	% Real Change 2007 to 2008	% Share of World Market	Penetration: % of Country's GDP	Density: Per Capita US$
North America	1	USA	1,240.6	-3.4	29.1	8.7	4,078
	9	Canada	105.2	1.3	2.5	7.0	3,171
Europe	3	UK	450.2	-13.0	10.5	15.7	6,858
	4	France	273.0	-9.3	6.4	9.2	4,131
	5	Germany	243.1	-1.3	5.7	6.6	2,919
	7	Italy	140.7	-10.9	3.3	5.9	2,264
	8	Netherlands	112.6	-0.2	2.6	12.9	6,850
	11	Spain	87.0	4.0	2.0	5.4	1,909
	15	Belgium	49.1	-2.6	1.2	9.1	4,299
	16	Switzerland	48.7	-0.9	1.1	9.9	6,379
	18	Ireland	44.9	NA	1.1	7.9	4,915
Asia Pacific	2	Japan	473.2	6.8	11.1	9.8	3,699
	6	China	140.8	31.4	3.3	3.3	105
	10	South Korea	97.0	-1.0	2.3	11.8	1,969
	12	**Australia**	**71.0**	**9.3**	**1.7**	**7.3**	**3,387**
	13	Taiwan	64.3	-1.5	1.5	16.2	2,788
	14	India	56.2	0.1	1.3	4.6	47
	24	Hong Kong	24.1	-6.5	0.6	11.2	3,310
	31	Singapore	16.5	2.2	0.4	7.8	3,179
	34	Malaysia	9.3	2.1	0.2	4.3	345
	35	Thailand	9.1	0.9	0.2	3.3	142
	39	Indonesia	6.9	-4.8	0.2	1.3	30
	41	New Zealand	6.6	1.9	0.2	5.2	1,569
	45	UAE	5.0	13.7	0.1	2.0	1,114
Other Countries			494.6	NA	11.6	NA	NA
World			**4,269.7**	**-2.0**	**100.0**	**7.1**	**640**

NA = Not Applicable
1 Countries are ranked by the US$ value of premium volume in 2008.
Sources: Swiss Re, Sigma No. 3/2009, *World Insurance in 2008*; Austrade

49 Australian Prudential Regulation Authority, *Monthly Banking Statistics*, October 2009 (issued 30 November 2009).
50 Swiss Re, Sigma No. 3/2009, *World Insurance in 2008*.

As at 30 June 2009, there were 133 private general insurers licensed to operate in Australia. Of these there were 116 direct insurers and 17 reinsurers. They managed A$94.2 billion in assets, an increase of A$3.1 billion (3.4 per cent) on the previous year.[51]

As with retail banking, Australia offers a modest base for opportunities in Takaful products for the domestic market. However, Australia is well positioned as a location to manufacture, risk assess and underwrite such products for the region based on its sophisticated market and strong actuarial skills. Australia is home to one of the largest pools of qualified actuaries in the region, with Australian qualifications being recognised globally as being equivalent to the US, UK and Canada.

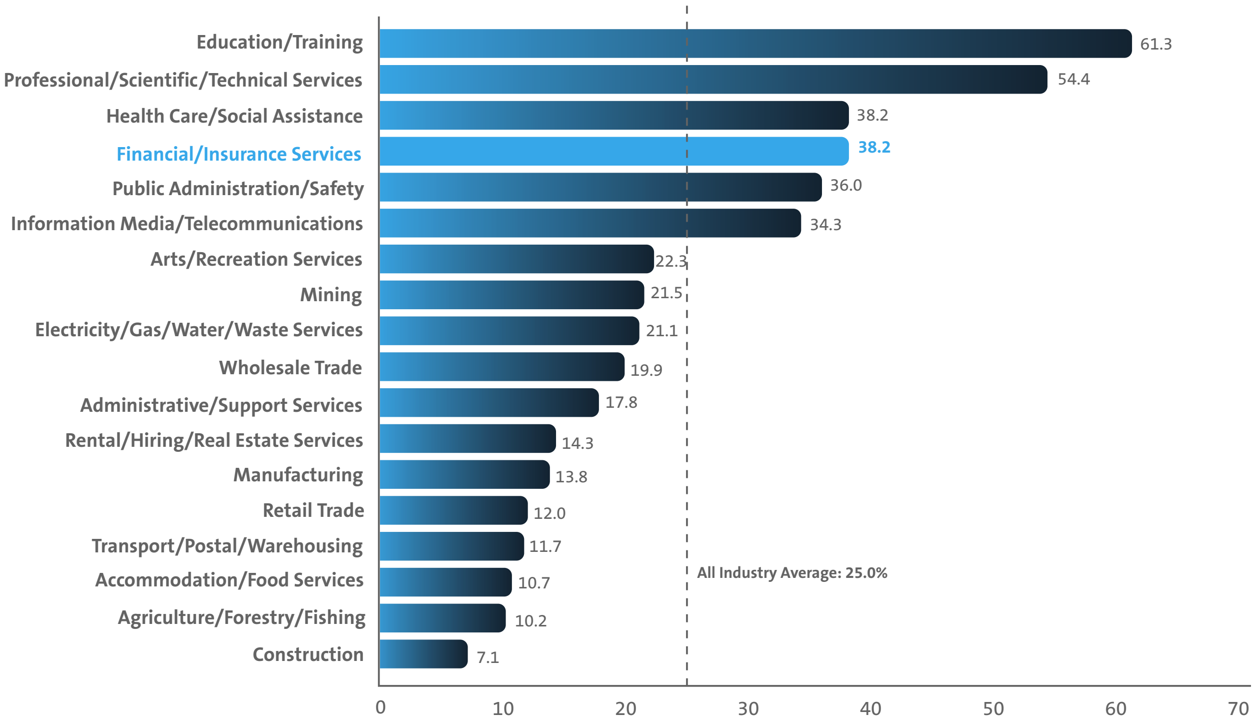
Education

The education services sector had been ranked Australia's third largest export since 2006. The latest ranking of Australia's top exports of goods and services show education services ranked fourth in 2008-09, behind coal, iron ore and gold. International education activity contributed A$17.2 billion in export income to the Australian economy, up from A$14.0 billion in the previous financial year.[52]

With less than 1 per cent of the world's population, Australia attracts 7.5 per cent of the world's foreign students.[53] China, India, Malaysia, Hong Kong and Singapore were the top five source countries/regions of all higher education in Australia enrolments in 2008.[54]

Australia is also a hub for financial services education in the region. The finance and insurance industry is one of Australia's most educated sectors, with almost 40 per cent of people employed in the industry having a Bachelor Degree or higher.

PERCENTAGE OF EMPLOYED PERSONS WITH TERTIARY EDUCATION BY INDUSTRY SECTOR[1], MAY 2008



1 In this statistical release, tertiary education refers to Bachelor Degree or higher.

Sources: Australian Bureau of Statistics, cat. no. 6227.0, Education and Work, May 2008 (released 26 November 2008); Austrade

Australia's financial services education capacity and its educational ties with the region provide a potential for developing the human resources required for an Islamic finance industry in Australia. For example, La Trobe University launched its Masters of Islamic Banking and Finance course in July 2009, the first course in Australia dedicated to Islamic banking and finance. The course will provide students with postgraduate training in the technical skills demanded by global Islamic capital markets and institutions. The Masters program is designed to appeal to international students from Asia wanting Islamic financial training in English as well as to local students who are keen to develop their career in this sector.

51 Australian Prudential Regulation Authority, *Half Yearly General Insurance Bulletin*, June 2009 (Revised 17 December 2009).
52 Australian Education International, Research Snapshot, Dec 2009: Export Income to Australia from Education Services in 2008-09.
53 Khalid Kocer, 2009, *The Global Financial Crisis and International Migration: Policy Implications for Australia*, Lowy Institute for International Policy, July 2009, p. 4.
54 Department of Education, Employment and Workplace Relations, Australia, Research Snapshot, International Student Enrolments in Higher Education in 2008, April 2009.

Facilitating the growth of Islamic finance in Australia

A key requirement for the development and growth of Islamic finance in Australia will be commitment from and supportive government policies by the Commonwealth and relevant state governments for Islamic finance in and from Australia. This involves a focus by governments on the domestic growth of Islamic finance, attraction of foreign Islamic finance operations to Australia, and the export of Islamic finance services and products from Australia.

Specifically the following will need to be addressed:

- government preparedness to ensure a level taxation, legal and regulatory playing field for both Islamic and non-Islamic finance. Taxation must be responsive and enabling but non-preferential;
- strong promotion and facilitation through government investment attraction and export promotion agencies;
- government engagement with the private sector in achieving Islamic finance objectives, to identify impediments to, and opportunities for, growth;
- a focus on deepening Islamic finance skills in key Australian cities – education, training, attainment of relevant qualifications – and on access to appropriate Islamic law scholars;
- encouraging the growth of Islamic finance professional service providers in key Australian cities; and
- government consideration of a future sovereign Sukuk issue.

Government policies

The Australian Government is committed to an open and competitive financial system and a socially inclusive environment for all Australians. The Government sees the development of an Islamic finance industry in this country not only as having the potential to make a very positive contribution to achieving both of these principles, but also as being part of its effort to establish Australia as a financial centre in the region. The Government has already taken a number of initiatives to support this objective. The Australian and state governments are also working together to ensure that the regulatory framework and tax arrangements facilitate Islamic banking and finance in Australia.

APPENDIX A

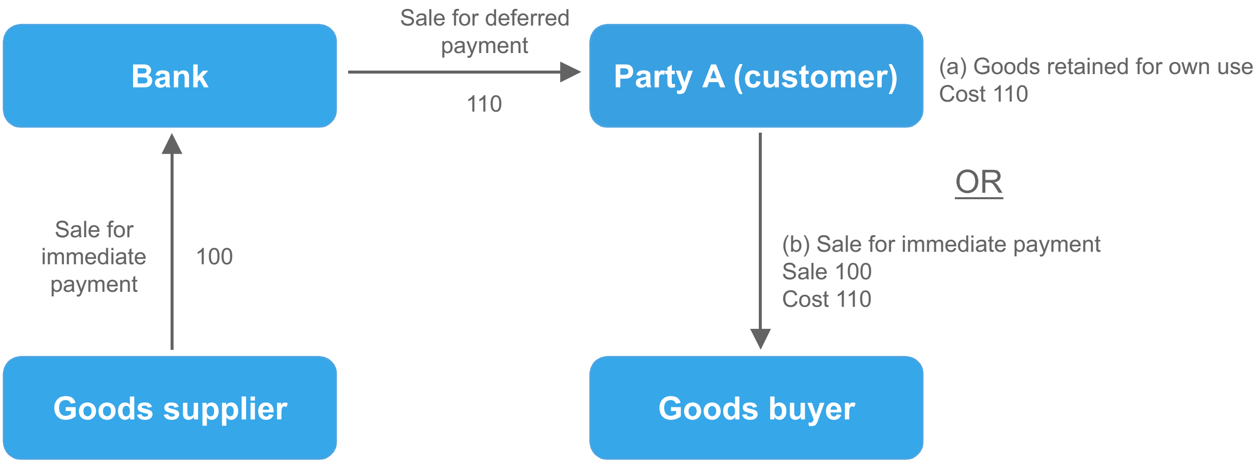
Explanation of key Islamic financial products and services

Murabaha

The Murabaha product is a form of financing often used to finance asset purchases. It is essentially a mark-up sale, involving a bank purchasing a given asset then selling it to the customer at a higher price with deferred payment terms. The customer may either retain the asset(s) for their own use (as shown in (a) in the figure below) or use the asset(s) to obtain cash finance (as shown in (b) in the below figure).

Murabaha differs from a bank loan in that the bank becomes the owner of the asset before selling it and is not paid interest but a return which is the difference between the original purchase price and sale price. Although the end result is the same, the transaction is considered Shariah-compliant as it involves a real asset and payment is provided for an economic activity provided by the bank, rather than for the money itself.

MURABAHA MECHANISM



Source: PwC UK

Where the customer has a desire for cash (as shown in (b) in the above figure), the goods are assets that can be sold very easily on acquisition with little difference between the bid/offer (buy/sell) spread e.g. a commodity such as copper.

In a Commodity Murabah (or Tawarruq), the customer instructs the bank to acquire a commodity and the bank re-sells the commodity to the customer with immediate delivery but deferred payment at an agreed deferred payment date. The sale price paid by the customer is a higher price (the spot price plus a mark-up). The customer immediately sells the commodity for cash to use in a business for example. Later, on the payment date, the customer pays the bank the sale price.

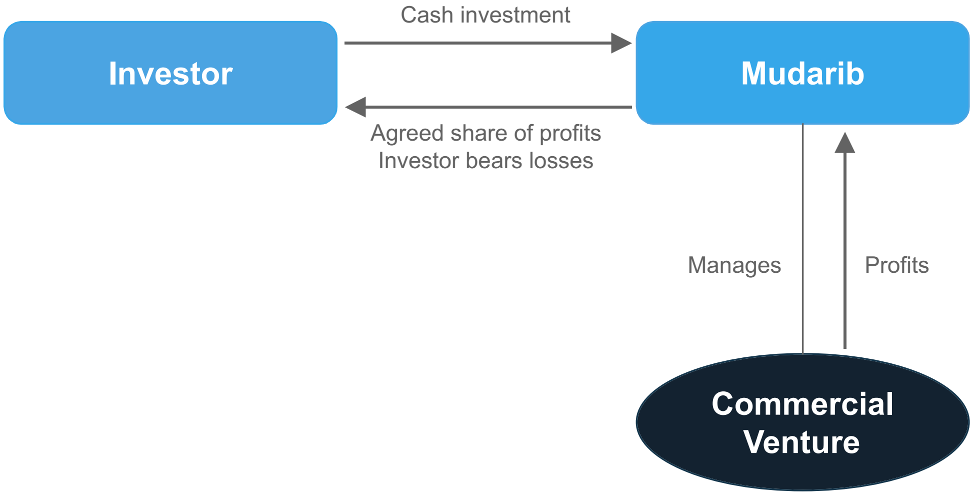
Note however that due to its synthetic nature, the permissibility of the Commodity Murabaha is debated among Shariah scholars and other asset-based transactions may be preferred when available.

Mudaraba

Mudaraba is a type of silent partnership in which an investor (rabb al-maal) provides capital and an entrepreneur (mudarib) provides management expertise and effort. Profits (excluding capital employed and business related expenses) are shared on pre-agreed terms, while all losses are borne by the investor and the entrepreneur is not compensated for his labour (see figure below).

This arrangement can be used in banking.[55] Islamic banks do not offer interest-paying deposit accounts. Instead, the customer can have a profit-sharing investment account (among other possible arrangements) whereby the bank will pay to the customer a proportion of its profits from investing the customer's money.

MUDARABA MECHANISM



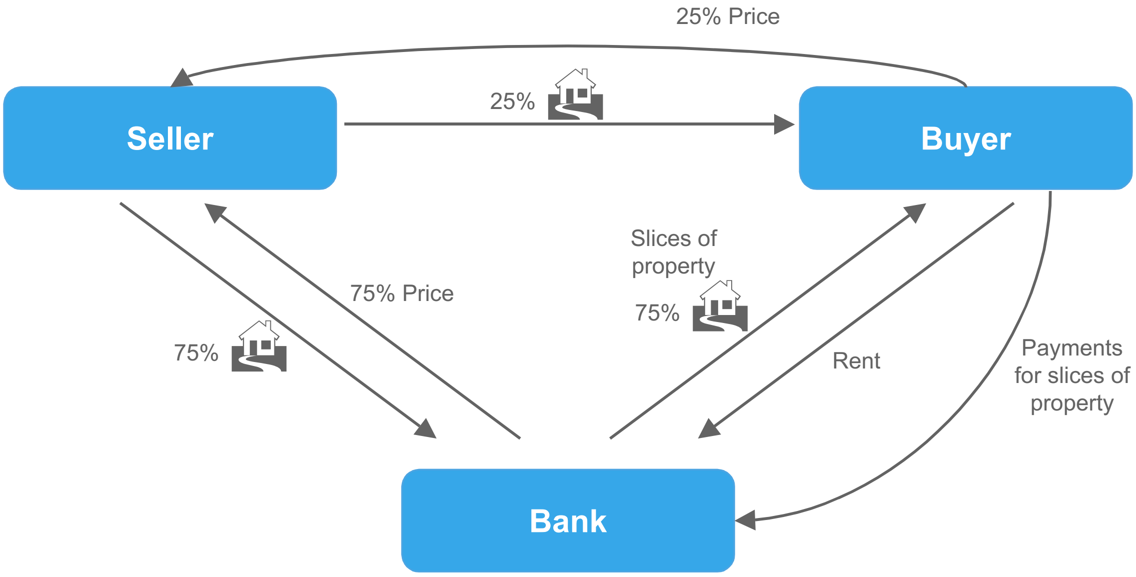
Source: Amin, M and Suleman, I, 'Islamic Finance: The Tax Adviser's Role', *Tax Adviser*, September 2008

Musharaka

A Musharaka transaction is essentially a partnership between the customer and the bank to invest capital in a joint entrepreneurial endeavour. Both parties agree to combine their assets (whether cash or contribution-in-kind) and share profits in any pre-agreed ratio, and losses in proportion to capital contributed.

A variation is the Musharaka Mutanaqisa or diminishing Musharaka, so called because the bank's participation diminishes over time as the customer essentially buys out the bank's share of the joint enterprise. The diminishing Musharaka can be used to structure a residential mortgage, as shown in the figure below.

DIMINISHING MUSHARAKA TRANSACTION WITH 25 PER CENT DEPOSIT



Source: Amin, M and Suleman, I, 'Islamic Finance: The Tax Adviser's Role', *Tax Adviser*, September 2008

55 It can be used for example in the Takaful model and in a type of Sukuk.

Ijara

An Ijara contract is essentially a lease, whereby the bank purchases the asset and allows the customer to use it in exchange for the payment of pre-determined rent for an agreed term. The bank retains ownership throughout and is the owner at the end of the contract. It may include an option for the lessee to buy the asset at the end of the lease, similar to the conventional hire-purchase.

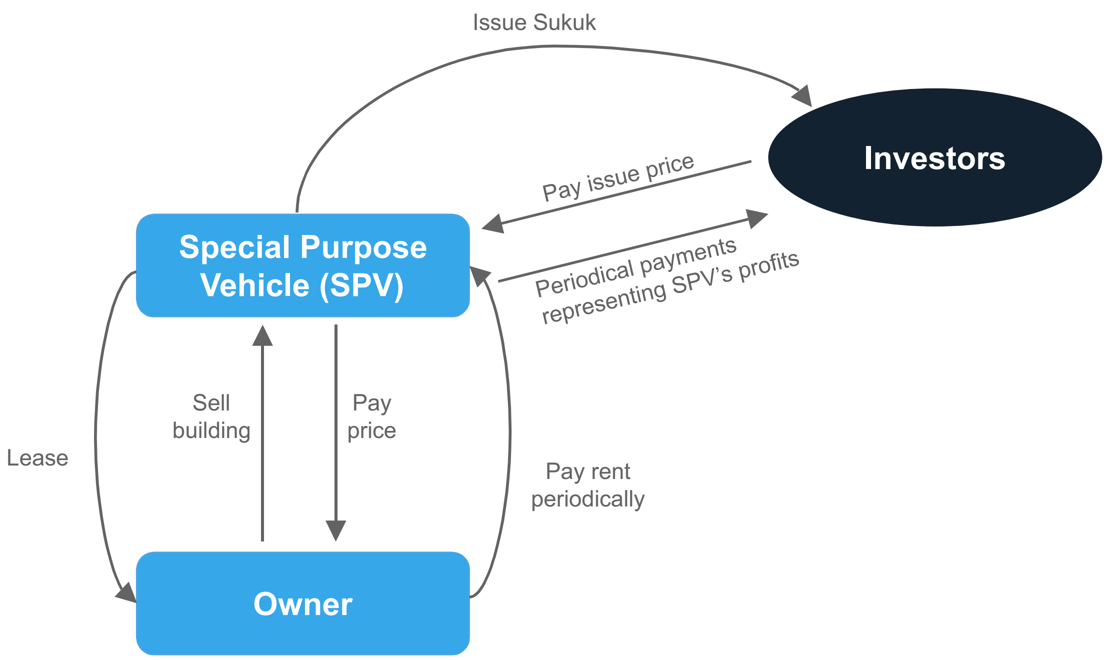
Sukuk

Sukuk are the Islamic equivalent of tradeable bonds, but unlike bonds which are debt-based instruments that pay interest, Sukuk are asset-backed or asset-based instruments and these underlying assets or investments will need to be Shariah-compliant.[56] Sukuk represent the ownership (actual or beneficial) by the Sukuk holders in an underlying asset. Returns are paid to the investors in line with their proportional ownership in that asset, and vary according to asset performance rather than the time elapsed.

Sukuk may be issued by governments or by private companies.

The figure below illustrates an example of a Sukuk transaction based on an underlying Ijara contract: if the owner of a building wishes to raise money from the capital markets, it could issue conventional bonds secured on the building. The Shariah-compliant equivalent involves the owner selling the building to a special purpose vehicle (SPV), which raises cash by issuing Sukuk to investors. The SPV then rents the asset back to the original owner, and distributes the rent received to the Sukuk holders. When the Sukuk expire, the owner will buy back the building and the SPV will distribute the sale proceeds to the Sukuk holders.

IJARA SUKUK



Source: Amin, M and Suleman, I, 'Islamic Finance: The Tax Adviser's Role', *Tax Adviser*, September 2008

56 In the case of a Sovereign Sukuk, the underlying asses (e.g. toll roads, utilities) will need to be permitted assets from a Shariah perspective.

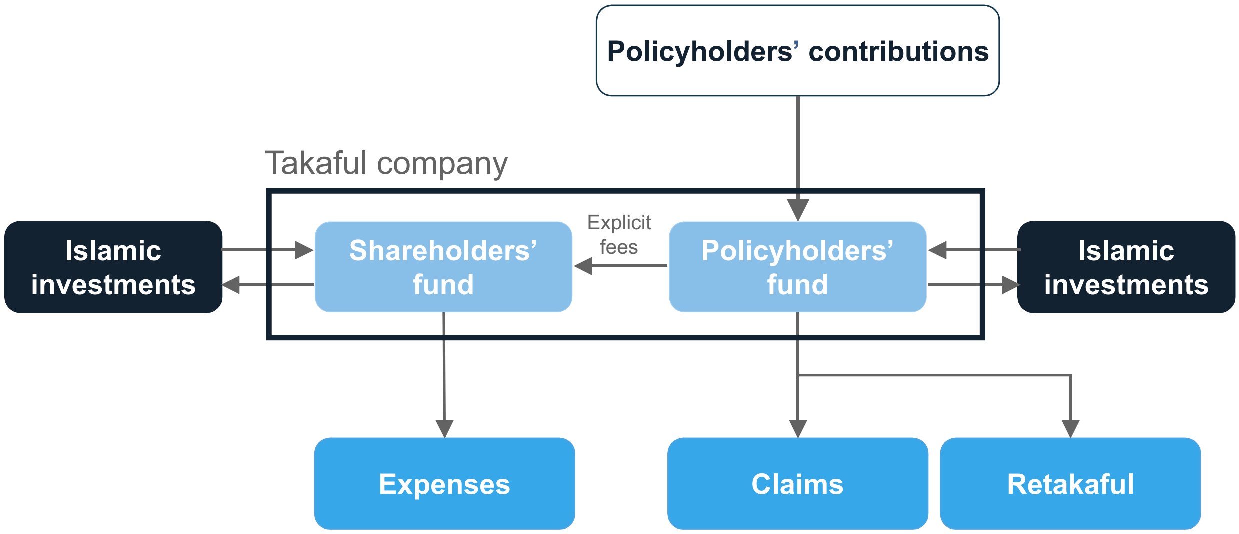
Takaful

Conventional insurance is generally prohibited by the Shariah due to 'gharar' (uncertainty) of the insured event occurring. However, the Shariah permits a form of mutual risk- pooling known as Takaful. This arrangement involves a group of individuals paying money into a fund, which is then used to cover payouts to members of the group when a claim is made.

The members of a Takaful insurance company are both insurers and insured. They own the funds, while the Takaful company acts as manager and receives compensation in the form of fees. The investments made with these funds must be Shariah-compliant.

A company operating a Takaful arrangement must keep the policyholders' funds separate from shareholders' funds. The policyholders' fund receives the contributions and pays out claims and any reTakaful (corresponding to reinsurance) payments. The shareholders' fund makes charges to the policyholders' fund for operating the Takaful arrangement, and is responsible for paying operating expenses.

TAKAFUL ARRANGEMENT



Source: Amin, M and Suleman, I, 'Islamic Finance: The Tax Adviser's Role', *Tax Adviser*, September 2008

APPENDIX B

Description of the key countries involved in the Islamic banking and finance industry outside of the Middle East

United Kingdom

The UK Government is seeking to develop and support Islamic finance in the country as a policy of social inclusion (the UK has around 1.647 million Muslims, or 2.7 per cent of its population)[57] and as part of its strategy to promote London as a 'Western' Islamic financial centre.

In 2003, the UK launched a series of legislative amendments of its taxation, legal and regulatory regimes to ensure a level playing field between Islamic finance and non-Islamic finance.

The tax legislation does not mention the Shariah or use any Islamic finance terms. Instead, the legislation creates a free standing set of definitions for use in UK tax law. For transactions which fall within these definitions, the legislation specifies how to determine the 'finance cost' and how that finance cost is treated by both the payer and recipient. Broadly speaking, the finance cost is brought within the same tax rules as those that apply to interest.[58]

There are currently five licensed banks in the UK that are full-fledged Islamic banks, with over 20 conventional banks with Islamic finance operations (for example, Barclays, HSBC, Lloyds TSB, UBS, Deutsche Bank, BNP Paribas) focussed on, inter alia, local retail opportunities, channelling surplus liquidity from the Gulf into Shariah-compliant 'Western' investment opportunities, and relevant financial engineering and advisory services.

Recently, the UK's first Islamic general insurance company was authorised by the UK regulator and there are now 18 Sukuk listed on the London Stock Exchange.

There is also a strong focus in London on growing Islamic finance education. Programs range from introductory and entry level courses, to postgraduate level study and continuing professional development programs, as well as Shariah scholar programs.

Malaysia

The Malaysian Islamic financial sector is seen as one of the most established in the world with well-developed Islamic finance infrastructure. In 2009, it was ranked the third largest Islamic financial market globally in terms of the value of Islamic finance assets (banking, Takaful and fund assets), or 10.5 per cent of global Islamic finance assets.[59] In 2009, there were a total of 17 Islamic banks in Malaysia, including 11 local Islamic banks, three foreign Islamic banks (Al Rajhi Bank, Asian Finance Bank and Kuwait Finance House) and three conventional bank Islamic windows (HSBC Amanah, Standard Chartered Saadiq and OCBC Al Amin). Malaysia also has eight Takaful operations – Takaful Malaysia, CIMB Aviva Takaful, Etiqa Takaful, Hong Leong Tokio Marine Takaful, HSBC Amanah Takaful (Malaysia), MAA Takaful, Prudential BSN Takaful, and Takaful Ikhlas, and three reTakaful operators – ACR Retakaful SEA, MNRB Retakaful and Munich Re Retakaful (Munich Re).[60]

The vast majority (88 per cent) of the locally listed securities are also Shariah-compliant.[61]

57 Pew Research Centre, *Mapping the Global Muslim Population – A Report on the Size and Distribution of the World's Muslim Population*, October 2009.
58 PwC, 'Taxation of Conventional and Shariah Compliant Mortgages', November 2008, p.9.
59 The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.4.
60 Malaysia International Islamic Financial Centre, Labuan International Business and Finance Centre, 'Opportunities Abound in Islamic Insurance Sector', Islamic Finance Asia, February/March 2009, p. 26.
61 Securities Commission of Malaysia's Annual Report 2008; CIMB, 2009, 'Islamic Finance: Growing Beyond the Borders', 1 July 2009.

Malaysia has been the main issuer in the Sukuk market worldwide. The Malaysian Sukuk market has achieved an average annual growth of 21 per cent between 2001 and 2008.[62] By the end of June 2009, Malaysia accounted for 62 per cent of total outstanding Sukuk (public and private) globally valued at US$66 billion.[63] In August 2009, Petroliam Nasional Berhad (Petronas) issued a US$1.5 billion Sukuk, the largest US$ global Sukuk after Dubai Port in 2007.

The Malaysian Government and industry are pursuing a strategy of developing the country as an international hub for Islamic banking and finance, encapsulated in the Malaysia International Islamic Financial Centre (MIFC) initiative. In addition, the Government has announced a range of tax initiatives, which include the following:

- a 10-year tax exemption (to 2016) for local players setting up Islamic business units, and for international Islamic banks and international Takaful operators;
- a tax exemption up to 2016 on the management fees received by fund managers for managing Islamic funds; and
- withholding tax exemptions on profits received from Sukuk issued in Malaysia.[64]

In April 2009, the Malaysian Government announced a series of measures liberalising the financial services sector, including allowing seven new foreign banks with 100 per cent foreign ownership to operate in Malaysia by 2012 and lifting foreign equity for existing domestic Islamic banks and investment banks and foreign ownership in insurance companies and Takaful firms from 49 per cent to 70 per cent.

On 17 August 2009, Malaysia officially commenced trading on the world's first fully Shariah-compliant international commodity trading platform named Bursa Suq Al-Sila (meaning commodities market in Arabic). Bursa Suq Al-Sila, formerly known as Commodity Murabahah House, is to facilitate commodity-based Islamic financing and investment transactions under the Shariah principles of Murabahah, Tawarruq (a sale of an asset to a purchaser on deferred payment) and Musawamah (price agreed through negotiation).[65]

Indonesia

Indonesia has the largest Muslim population in the world, with more than 88 per cent of the population (203 million people) being of the Islamic faith.[66] It is also the largest economy in South East Asia. These attributes present a prime opportunity for a domestic Islamic financial services market, however until recently Indonesia has been the 'sleeping giant' of the growing world of Islamic finance. In 2009, global Islamic financial assets were estimated at between US$822 billion, Indonesia owned only US$3.4 billion of this pool.[67]

Indonesia's slow progress has been in part a result of uncertainty in its regulatory and tax framework, which is in contrast to neighbouring Malaysia and Singapore which have already started to modify their regulatory environments in order to draw in Islamic investors. However, Indonesia has speeded up the progress recently. In 2008, the Indonesian parliament passed a Shariah banking law which allows foreigners to establish Islamic banks in partnership with local banks and also offers commercial banks the option of converting their business into Shariah-compliant banks. In September 2009, Indonesia's parliament passed a revised law on value added tax which scrapped double taxation on transactions in Islamic financial markets, Since August 2008, Indonesia has issued three sovereign Sukuk – the US$505 million rupiah-denominated Sukuk in August 2008, the US$461.2 million open-ended rupiah denominated retail Sukuk in February 2009, and the US$650 million foreign currency Sukuk in May 2009.[68]

Indonesia has set a target for Islamic finance to amount to 15 per cent of the country's banking assets by 2015. In 2008, the figure was just over 2 per cent.[69] It is also targeting Islamic banking growth of 40 per cent annually between 2008 and 2010 (Islamic financial assets increased by 35 per cent a year from 2004 to 2008).[70]

Currently there are five full-fledged Islamic commercial banks, and these are primarily focused on the small-to-medium sized enterprises (SME) market.

62 Bank Negara Malaysia and Securities Commission Malaysia, *Malaysian Debt Securities and Sukuk Market – A Guide for Issuers and Investors*, 2009.
63 Malaysia International Islamic Financial Centre, 'Business & Investment Opportunities in Islamic Finance,' November 2009.
64 PwC, 'Malaysia, Asia's Islamic Finance Hub', August 2008, p.61.
65 Bursa Malaysia, Media Release, *World's First Shari'ah-Based Commodity Trading Platform To Facilitate Islamic Finance Goes Live!*,http://bursa.listedcompany.com/newsroom/Media_Release_17Aug2009.pdf.
66 Pew Research Centre, *Mapping the Global Muslim Population – A Report on the Size and Distribution of the World's Muslim Population*, October 2009.
67 The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.4.
68 Nazneen Halim, 'A Strike for Indonesia', *Islamic Finance Asia*, June/July 2009.
69 'Jakarta Plays Catch Up', *Islamic Finance Asia*, Aug/Sep 2008.
70 Nicholas, K 2009, 'Islamic Finance Key to Asian Revival, Kuwait Finance House Says', Bloomberg, 29 July 2009.

Japan

The Japanese Government has focused on Islamic finance in recent years as part of a strategy to attract oil-money investment to the Japanese economy, and to achieve its objective of being a bridge between the world and Asia for financial flows.

With a Muslim population that is around 0.1 per cent of the total population, Japan's opportunity for Islamic finance lies in cross-border wholesale rather than local retail activity. As such, the Japanese market has focused on facilitating international Islamic finance transactions. For example:

- at the end of 2006 Japan's largest bank, Mitsubishi UFJ, forged an alliance with Malaysia's CIMB Group to provide Islamic financial investment banking services, such as issuing Islamic bonds, to Japanese companies operating in Malaysia;
- in November 2007 Kuwait's Boubyan Bank completed Japan's first property deal using Islamic financing valued at US$41 million. Boubyan used special purpose vehicles to buy and lease back the properties, working with Japanese asset management companies; and
- in May 2008 Toyota issued a Sukuk in the Malaysian market worth US$306 million for its Malaysian auto-leasing and loans business, until then financed with cash from local banks.

In addition, new Japanese equity indexes have been created to meet demand from Islamic investors for access to Japanese investment products that are Shariah-compliant. For example:

- the S&P Japan 500 Shariah;
- the S&P/TOPIX 150 (a subset of the S&P Japan 500 Shariah); and
- the FTSE Shariah Japan 100 Index.

Notwithstanding amendments to banking regulations in December 2008 that allows subsidiaries of Japanese banks to enjoy a relatively broader scope of business, the regulatory environment is considered by industry as inadequate. For example:

- Japanese banks themselves are still prohibited from entering into any Islamic finance structure which involves the acquisition of an asset; and
- while subsidiary companies may be lenders, they cannot be borrowers in Islamic finance transactions. This means Japanese banks cannot raise funds through Shariah-compliant structures.[71]

Singapore

Compared to its Malaysian neighbour, Singapore is a relatively new entrant into the Islamic finance market. Since around 2005, Singapore has been seeking to develop an Islamic finance industry by drawing on its strengths in wealth management, trade financing and capital markets. Its focus is on the wholesale sector in banking, funds management and insurance.

Examples of changes that have been implemented to facilitate the growth of Singapore as a regional hub for Islamic finance include:

- amendment of banking regulations to permit banks to undertake certain Islamic finance transactions, such as Musharaka financing and spot Murabaha transactions;
- subjecting Singapore-dollar Islamic bonds to equal tax, regulatory and liquidity treatment as government securities;
- creation of a level tax playing field for Islamic and conventional finance. For example, stamp duty on real property underlying a Sukuk, and GST are exacted on Islamic finance transactions in the same way as their equivalent conventional finance transactions; and
- implementation of a 5 per cent concessional tax rate to income derived from qualifying Shariah-compliant banking, funds management and insurance activities for a period of five years.

In addition, Singapore has focused on human capital aspects of education and training.

In 2007, Islamic Bank of Asia was established in Singapore after receiving official approval from the Monetary Authority of Singapore for a full banking licence. Currently there are six managers with nine Shariah-compliant funds registered in Singapore, with assets approaching US$500 million. A number of Malaysia and Gulf Islamic banks have also established Islamic finance operations and representative offices in Singapore.

Currently there are six managers with nine Shariah-compliant funds registered in Singapore, with assets approaching US$500 million. A number of Malaysia and Gulf Islamic banks have also established Islamic finance operations and representative offices in Singapore.

71 Clifford Chance, 'Islamic Finance – an Opportunity for Japanese banks', Summer 2009, p.10.

Hong Kong

Similar to Singapore, Hong Kong is a relatively new entrant into the Islamic finance market. It does not have a large Muslim population, but is seeking to capitalise on its niche position as a financial gateway to China to encourage Muslim investors who are keen to benefit from China's rapid economic growth. For example, Chinese enterprises listed on the Hong Kong stock exchange accounted for 16 per cent of all listed companies, but comprised 57 per cent of the exchange's total market capitalisation in June 2009.[72]

Some of the progress in the Hong Kong Islamic banking and finance industry include:

- in late 2007, Hang Seng Bank launched an Islamic China Index Fund;
- in March 2008, Malaysia's Khazanah Nasional Berhad issued a US$550 million Sukuk on the Hong Kong Stock Exchange;
- in August 2008, Hong Leong Bank was granted approval by the Hong Kong Monetary Authority to open the city's first Islamic finance banking window; and
- in December 2008, Singapore-listed Hong Kong company Noble Resources raised a Murabaha of US$80 million arranged by HSBC Amanah with the participation of Kuwait Finance House (Malaysia).

Currently the Hong Kong Government is in the process of clarifying the taxation treatment of Islamic finance products.

72 Hong Kong Exchange's website, accessed 8 August 2009, <http://www.hkex.com.hk/data/chidimen/chidimen.htm>.

Austrade

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