



Legal and regulatory issues of Islamic finance in Australia

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Abstract

Purpose – The purpose of this paper is to contribute to the existing body of work in the area of Islamic finance by examining the regulation of Islamic finance in Australia.

Design/methodology/approach – The method employed in this paper is a mixture of direct observation from legal and regulatory perspectives and authors' personal experience, curiosity, and association with this industry.

Findings – In Australia, where Muslims are minorities and full-fledged Islamic banks are absent, it is expected that regulatory authorities would ensure there is a level playing field, so that neither Islamic financial services providers (IFSPs) nor conventional financial institutions are disadvantaged. They have also been expected to approve and monitor Islamic financial products, including those offered by Islamic managed funds.

Research limitations/implications – The study is undertaken through the *Shari'ah*, where law, finance, economics, and business form a single dimension only, even though a very significant one. No attempt is made to evaluate the economic efficiency and profitability or otherwise, of IFSPs in Australia. Also, the approach for the study is not supplemented by any empirical work (e.g. by quantitative analysis of data or by survey or other qualitative methodologies).

Practical implications – The paper practically examines: the impact of banking and financial services regulation on Islamic banking and financing practice in Australia; and what further legislative measures and changes are needed to accommodate Islamic financing practice into Australian society to make it a truly viable alternative system of financing for Muslims in Australia.

Originality/value – Examination of the issues of the study is originally undertaken through one of the authors' personal expertise and working experience with some IFSPs in Australia, aiming at developing the relevant regulations by the Australian regulatory regime to make Islamic finance a viable alternative system of financing for Muslims in Australia.

Keywords Regulation, Law, Finance, Banking, Islam, Australia

Paper type Research paper

1. Introduction

The paper seeks to contribute to the existing body of work in the area of Islamic finance by examining the regulation of Islamic Finance in Australia in terms of certainty of transactions between participants in the system, and institutional risk management of Islamic Financial Institutions (IFIs). The methodology chosen for the study is through the *Shari'ah*, where law, finance, economics, and business form a single dimension only, even though a very significant one. Examination of the issues of this study is undertaken through the literature in the relevant field, as well as the personal expertise and working experience of one of its authors with several Islamic banks (IBs) and IFIs



for a considerable period of time, in addition to his active involvement with at least two of Islamic financial services providers (IFSPs) in Australia.

This study is divided into a number of sections. Following an Introduction, Section 2 provides an overview of the issues of Islamic finance practice in the Australian legal context. To this end, it discusses the regulatory issues of Islamic finance in Australia. Section 3 examines the compliance requirements of IFSPs in Australia. Section 4 delineates the prospective of Islamic finance in Australia. Section 5 concludes with some suggestions and recommendations for the research.

2. Islamic finance practice in the Australian legal context

2.1 *The regulatory regime for Islamic finance in Australia*

An appropriate legal and regulatory framework is a basic requirement for establishing and operating sound financial institutions and markets. Like the Common law and Civil law systems, the *Shari'ah* offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking, and company laws appropriate for the implementation of Islamic banking (Institute of Islamic Banking and Insurance, n.d.) and financial contracts do not exist in many countries. For example, in most countries, the Islamic banking and financial contracts are treated as buying and selling properties and hence are taxed twice. In some countries like the UK and Singapore, double stamp duty on some Islamic home finance schemes has been abolished so as to provide tax neutrality (IRTI and IFSB, 2006). Conventional financial laws also narrow the scope of activities of IFIs within conventional limits. In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and companies' laws in several countries require suitable modifications to provide a level playing field for IBs (Ahmad, 2004). Furthermore, international acceptance of Islamic financial contracts requires them to be *Shari'ah* compatible as well as acceptable under the major legal regimes such as common law and civil law systems.

The IFIs, by their nature, are subject to the same regulatory infrastructure which applies to conventional financial institutions, taking into consideration the characteristics of IBs, and also the review of their compliance with Islamic principles (Wilson, 2003, p. 2). The regulatory framework for Islamic banking and finance is necessary for the benefit of the banks' account holders (such as investment accounts, current accounts, etc.), shareholders, other stakeholders and the community at large. The regulatory regime and the public have an interest in ensuring an efficient banking system and averting systemic risk leading to bankruptcy. Likewise, IBs and IFSPs have an interest in ensuring not only that the bank is financially sound but also that their internal financial involvement is strictly in accordance with the *Shari'ah*. The reason which lies behind all these is that a sound financial system is a key factor in achieving economic and political stability as well as sustainable growth in both developed and underdeveloped economies. On the contrary, the weak financial systems are bound to break down in periods of economic distress, causing severe distress in other economies and heavily damaging otherwise healthy financial systems. Given this, the authoritative legal and regulatory bodies in any country are needed in order to enhance the stability of the key elements of the financial system. Some of the elements of structural regulation would include the establishment of measures of capital adequacy and of the riskiness of portfolios, setting deposit insurance schemes and the

enforcement of regulatory standards for disclosure of information (European Central Bank, 2006).

In the light of the above, like conventional financing, the Islamic finance industry needs to be supported by a strong regulatory and supervisory framework. This is to ensure that the operations of the IFIs are sound and not a source of susceptibility to the banking system. Apart from a common legal and regulatory framework to a large extent, the IFIs in most jurisdictions should be governed by the same regulatory framework that is applied to operations of conventional finance, reinforced by the Islamic legal framework and the Islamic accounting standards. However, as the regulatory framework of conventional finance is premised on an interest-based debtor-creditor relationship, the regulatory framework for conventional finance is built to assess and mitigate risks arising from loan-based financial transactions. Islamic finance is different in term of its underlying philosophy on the prohibition of interest. This in turn shapes the nature of the financial transactions that have their own risk characteristics. The specific risks associated with operations of Islamic finance therefore need to be identified, to ensure its prudential regulation is adequately addressed. This is to ensure greater transparencies and disclosure as well as a strong legal and judiciary system, reinforced by the strong *Shari'ah* governance for IFIs.

The legal and regulatory framework of the financial sector in Australia covers banks, non-banks deposit-taking institutions, investment banks, collective investment managers, securities and futures exchanges, clearing houses, securities and futures dealers and brokers, and insurance and superannuation entities (Australian Treasury, n.d.). There is no formal legal and regulatory framework or infrastructure in existence in Australia for guiding and supervising the functions of IBs and other IFIs which operate in line with the precepts of the Islamic legal system. Australia's financial sector regulatory framework reflects a considered approach by government to prudential supervision and is based upon the international standards put forward by the Basel Committee of the Bank for International Settlements (Ahmad, 2007).

The regulatory framework is based around three central agencies: the Reserve Bank of Australia (n.d.); the Australian Prudential Regulation Authority (APRA); and the Australian Securities and Investments Commission (ASIC). The co-ordinating body for these agencies is the Council of Financial Regulators (Australian Bankers' Association, n.d.). It contributes to the efficiency and effectiveness of financial regulation by providing a high-level forum for co-operation and collaboration among its members (APRA). However, the Department of Fair Trading administers The Consumer Credit Code (n.d.) in relation to the conduct of the credit facilities. In relation to bank mergers and/or expansion applications; ASIC regulates company takeovers under the Corporations Act. The Australian Consumer Credit Code (ACCC) also enjoys the right to play a role in the competition issues relating to the merger.

The Government's legislative framework provides scope for self-regulation by the main securities and derivatives markets – the Australian Stock Exchange Limited (ASX) and the Sydney Futures Exchange subject to oversight by ASIC. These exchanges have Memoranda of Understanding with ASIC which elaborate on their respective roles as set out in the Corporations Law.

Although under Subsection 9(3) of the Banking Act 1959 an authority to carry on all kinds of banking business in Australia was granted by the APRA to the Muslim Community Credit Union Limited (MCCU) in December 1999, subsequently its license

was withdrawn in August 2002 when it became apparent that its funds were not enough to sustain operations. Once the APRA granted authorisation to MCCU to carry on banking business, the ability to bring scale and order to the field of Islamic housing finance was achieved. On a more positive note, the similarities between Australia's new community banks (which have emerged largely owing to the closure of traditional branches in smaller towns and funded and operated by local townspeople) and community-based Islamic co-operative financial institutions are making it easier for IBs to make an inroad into the Australian housing industry (Halabi, 2000).

2.2 Legal and regulatory challenges of Islamic finance in Australia

Despite the remarkable growth and development of IBs and IFIs globally over the last few decades, their expansion in Australia has been slow and steady. Several factors are hampering the Australian expansion of IBs. These include *inter alia* the lack of understanding and standards on Islamic finance products, the absence of a standard rate of return in IFIs and the difficulty of classifying risk-sharing funds placed in these institutions. However, these challenges need to be tackled in order to set the future path on sound footing.

The embargo on receiving and paying *riba* under the *Shari'ah* resulted in some remarkable challenges and impediments. The Australian banking system is primarily based, as in most countries, on a Western banking tradition, which is founded on the receipt and payment of interest and this applies to the regulatory system as well.

There are also quite a lot more subtle impediments to many of the more common products and instruments used by the *Shari'ah* compliant financial services providers. More may become perceptible as the Islamic finance industry grows in Australia. A brief discussion on these issues and challenges follows.

2.2.1 Legal and regulatory issues. Since Islamic finance is still in state of infancy in Australia, it has been facing a number of problems and challenges, which can be identified as operational problems. The present section of the study demonstrates some of the issues and challenges that come with introducing Islamic finance into Australian financial market in the following sections.

2.2.1.1 Problem of operating as a bank. A major regulatory problem faced by IFSPs in Australia is getting approval from the APRA for an IFI to operate as a fully fledged bank normally would in taking deposits. Like many countries, Australian law generally does not permit taking deposits without having a license from the appropriate authority. In order to carry on banking business, a financial institution has to obtain a license from the APRA under the Section 66 of the Banking Act 1959[1]. These licences are not easy to get and have to have detailed examinations by the regulator of the proposed financial institution, with the typical application period taking up to 18 months[2].

2.2.1.2 Regulatory change. The absence of a regulatory and legal framework to support an Islamic banking system is a major drawback in the proper implementation of Islamic financial practices in Australia. The main problems in this regard seem to be a result of two separate pieces of legislation. For housing loans, there is the double stamp duty problem. In Victoria, at least, this problem has been dealt with, though it has not been dealt with yet in other jurisdictions.

Although *Shari'ah* compliant home financing already exists, various legal hurdles makes it relatively expensive. Therefore, regulatory changes would make it easier and

cheaper for Muslims in Australia to get financial products that do not conflict with their beliefs. This would in turn help to make home-ownership more accessible and affordable for Australia's most significant religious minority.

2.2.1.3 The incompatibility of the Basel accords. The apparent incompatibility of the current Basels I and II accords with Islamic finance are also issues in Australian regulation. The Australian prudential regulations that are essentially administered by the APRA follow the current Basel I standards, and are in the process of changing over to the Basel II standards[3]. Since neither of these makes provision for *Shari'ah* compliance internationally, this has not yet been addressed in Australia. Also, there have been no applications to the regulator to confront the issue as of yet (APRA, 2006).

2.2.1.4 The burden of additional stamp duty on Islamic home financing. In the simplest of many possible examples of a typical Islamic financial arrangement, the financier would buy the property and resell it to the customer at a profit on a deferred payment basis over a fixed period. This requires legal title in the property to be transferred twice: once to the financier, and subsequently to the customer, which means there is double stamp duty to pay. In all States of Australia, except for Victoria, the problem of double stamp duty payment on Islamic housing finance exists. Indeed, it is an obstacle in Islamic housing finance, because in Islam, the payment or receipt of interest is strictly forbidden. Islamic housing finance relies on the involvement of a financier who buys the property, and then sells it on to the buyer and collects instalment payments (similar to traditional mortgage payments) for the repayment of the capital. Instead of charging interest, the financier often sells the property for the same price but then charges additional profit/rent on it for a specified period of time. Stamp duty is, therefore, charged twice – as the ownership of the property transfers twice – first to the financier, and then to the ultimate buyer. This has necessarily been reflected in the price of the Islamic housing finance. Re-financing also presents a problem because the old lender has to sell the property to the new lender and thus incur another charge of stamp duty.

If overseas experience is any guide, recent legislative amendments to Victoria's Duties Act 2000 is considered a very small step in a potentially lucrative direction, whereas, in Western countries, Islamic financial markets are growing at astonishing rates. Britain passed legislation facilitating Islamic consumer finance in 2001, before which its Islamic financial sector was, in effect, non-existent. According to independent market analyst Datamonitor's latest research in the UK alone, the Islamic consumer finance industry would be worth £4.6 billion (\$12 billion) by 2007-2008 (Ahmad and Hassan, 2006). By generating various Islamic banking products, major multinational banks such as Deutsche Bank, Citibank, and especially HSBC have been beneficiaries of this boom. Meanwhile, in the USA, Freddie Mac has developed secondary markets for Islamic mortgage.

2.2.1.5 Absence of Islamic insurance. Insurance is another area where a void currently exists in Australia. While there have been several attempts to establish Islamic insurance funds, notably during the 1990s, these do not seem to have succeeded because of the regulatory constraints they had faced.

2.2.2 *Australian legal concern.* Under the Consumer Credit Code (the Code), credit is advanced if there is a charge for the credit, whether or not that charge is in the form of interest. Where the *Shari'ah* compliant methods of finance do invoke the Code, complications in complying with the Code can arise from the lending structure used.

Muslim Community Cooperative Australia (MCCA) (2004) and David (2007a) has lobbied the Victorian Government for a serious consideration of how to maintain consumer protection like the Code without hindering the development of the *Shari'ah* compliant lending. In 2003, MCCA had over \$20 million committed to home lending arrangements. It also reported having hundreds of potential borrowers waiting for *Shari'ah* compliant finance so they could purchase a home. The Code assumes that most credit will be advanced in return for an annual percentage rate of interest. Where consumer credit involves profit in the form of interest but this profit cannot bear an "interest" label, compliance problems thus arise (Consumer Credit Review, 2006, p. 160).

The options for dealing with such an issue include amending large parts of the Code to accommodate quasi-interest charges, issuing an exemption from all or most of the Code for *Shari'ah* compliant lending, introducing a separate regulatory scheme for *Shari'ah* compliant lending or relying on non-specific consumer protection such as the Fair Trading Act.

The existence of *Shari'ah* compliant lending to finance home purchase, along with the potential for growth in this market, leads to questions about the Code's capacity to continue to regulate all consumer credit. Although the Code was designed to accommodate product flexibility and to apply to all consumer credit, the diversification and sophistication of the market since the Code's inception mean that emerging products and trends challenge its effectiveness. Sometimes, the challenge is a new product such as *Shari'ah* compliant loans; at other times, the challenge arises from the development of new or the redevelopment of existing products, such as the recent trend to use promissory notes in small amount lending, the renewed activity in reverse mortgages and the seeming rise in resort to consumer leases.

If *Shari'ah* compliant loans were to be treated differently from other lending, difficult judgements would need to be made, for example: What is the definition of a *Shari'ah* compliant loan? What other religions practised in Australia have special lending requirements? What happens when non-Muslims want *Shari'ah* compliant loans?

For the time being, there is no prospect of *Shari'ah* compliant lending being exempted from the Code. The question will then arise: could departure from the universality of the Code be warranted on other grounds? For example, where full compliance with the Code inhibits the provision of low-cost loans to vulnerable and disadvantaged consumers?

3. Compliance requirements for Islamic finance in Australia

Compliance requirements for the Islamic financial sector in Australia are not different from those which apply to the conventional financial sector. Given this, Islamic finance in Australia is subject to complying with the same requirements set by the regulatory and supervisory regime for the conventional banking and finance industry. In this context, the Australian regulatory regime regulates those Islamic institutions that conduct banking and financial activities in parallel with the conventional financial institutions. While it is an absolute that fair and strict regulation is the prime objective of the regime, it is also an objective shared by all the institutions licensed by the relevant authority, including the IFIs themselves. However, owing to the explicit and distinctive features of Islamic financial products and services, its operations entail

unique risks that require adjustments in the capital adequacy ratios, more disclosures and transparency, and other modifications of prudential and supervision norms. These are discussed under the following main headlines.

3.1 Prudential standard requirements of Islamic finance

The fundamental role of the regulators is “prudential” – making sure that banks and other financial institutions are run in a prudent manner. Confidence is instilled by creating the true protections and imposing strict supervision. A number of monitoring mechanisms – prudential ratios, accounting, auditing, and disclosure rules – are available and have far-reaching implications. Besides, prudential regulation and effective supervision boost the efficiency of financial institutions. It also promotes freedom of markets by protecting the rights of users of the financial services, especially depositors. It ensures a level playing field and equal competitive opportunity to the market participants through the applications of best practices and offering support to financial institutions at times of need. Owing to its relative infancy and the special nature of its liabilities and assets, credible and more supportive supervision and regulation of IBs and IFIs is needed (Warde, 2000, p. 196).

Islamic financial services in Australia apply the same prudential regulatory standards to be complied with as those applied by their conventional counterparts. For instance, the instruments used by Australian IFSPs (such as hire purchase and sale and leaseback) are exactly the same, and come under the same Australian laws and regulations (Newsome, 2006). The reason is that generally as firms in which financial institutions take stakes, greater transparency, along with strengthened corporate governance, are necessary.

3.2 Compliance with core principles

The unique characteristics of the Islamic financial services industry require the development of a legislative and supervisory infrastructure that adequately addresses its compliance requirements. The most important of these requirements are the existence of a *Shari’ah* Supervisory Board (SSB); a management that is committed to Islamic financial concepts; safeguarding of investors’ funds from negligence, trespass, and fraud; and compliance with standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[4].

At the heart of the development and growth of the Islamic financial services industry is the compliance with Islamic core principles. The development of an Islamic financial system that is able to contribute towards stability and balanced global growth needs for its development to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, strong *Shari’ah* framework and an efficient judiciary system that promotes confidence and soundness in the Islamic financial system.

There is a need to have an independent SSB for any IB and IFI, and that SSB should consist of highly qualified scholars having considerable experience with and knowledge of modern financial transactions. The SSB will serve as the central point for *Shari’ah* matters in relation to Islamic products, instruments and services. The SSB’s role is to approve and authorise all Islamic products and services currently practised, as well as any new products developed by the bank and financial institution. It is important that the SSB introduces a culture of self-regulation within the IB and IFI,

to foster a strong sense of commitment to the *Shari'ah* values which could be achieved in various ways. For example, this could be realised through a code of ethics adopted by the individual bank and self-certification by the practitioners of the principles of the *Shari'ah* (Khan, 2007, pp. 285-307).

The IFIs in Australia, as mentioned earlier in this study, to a large extent are governed by the same regulatory framework that is applied to conventional banking and financing operations reinforced by the compliance to the *Shari'ah* framework. The strict adherence to the *Shari'ah* is of paramount importance for such institutions in order to serve as a check and balance to ensure that the management and operations of the IFIs do not deviate from the Islamic principles in the formulation of their policies. Therefore, the financial reporting by an IFI is required to provide the necessary disclosure to report on the conformity of its operations with the *Shari'ah* principles. These will promote the foundations for building public confidence and assurance that the Islamic financial products and services are *Shari'ah* compliant.

3.3 Transparency and disclosure requirements

Transparency and disclosure is essential particularly in a rapidly changing environment. While the comprehensive and timely availability of financial information will increase market discipline, the disclosure of information needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information.

Closely related to disclosure requirements is the need to strengthen the framework for consumer protection to provide an avenue for redress due to lack of transparency. This is more relevant to Islamic finance, where Islamic financial transactions are not merely based on the lender and borrower relationship, as is the case in conventional banking. The move towards the adoption of the supervised market approach requires continuous efforts to enhance product disclosures. Enhanced financial disclosure needs to be complemented by customer education and awareness programs to elevate the level of financial literacy of consumers and businesses to be able to make informed financial decisions and inculcate market discipline amongst financial players. Enhanced awareness on the manner in which Islamic financial transactions are being conducted and Islamic financial contracts are being executed will not only strengthen the role of market discipline in driving IFIs towards ensuring *Shari'ah* compliance in the operations, but also contribute towards improving operational efficiency, strengthening risk management infrastructures and instituting sound and dynamic risk management practices (Governor of Bank Negara Malaysia, 2004a, b).

To further enhance transparency, proper accounting standards need to be in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of the banking institution. It must be ensured in IBs and IFIs that accounts are not only drawn in accordance with the international accounting standards but are also in line with Islamic principles. This is to enable the investors and supervisors to obtain the true and fair assessment of the Islamic institution's financial condition and the profitability of the business. The standards issued by the AAOIFI, including those issued on the role of the *Shari'ah* committee as well as the code of ethics that should govern the accountants and auditors of IFIs, have contributed towards improved quality of financial statements and reporting methodology of IFIs.

3.4 Consumer Credit Code of Islamic finance

The Consumer Credit Code governs all consumers' transactions taking place in Australia, including those carried out by IFSPs. The Code not only introduces standardisation, it also presents credit information in a clear and easy-to-understand format. Credit providers such as banks, building societies, credit unions, finance companies, and businesses, must tell the customers what their rights and obligations are in any credit arrangement. They are required by law to truthfully disclose all relevant information about consumers' arrangements, irrespective of the users of conventional or Islamic financial services, in a written contract, including interest rates, fees, commissions, and other information which in the past was often hidden (ACCC).

While the aim is to prevent many of the credit problems faced by consumers, the Code recognises that it is still important to protect consumers if they get into trouble. The Code requires that every consumer be given a written notice disclosing the terms and conditions of a credit agreement. Credit providers are required to be careful not to make contracts with consumers who would find it difficult to meet their repayments. A court can also order changes to a contract if it is considered unjust (Department of Foreign Affairs and Trade, Australia).

Under the UCCC, the use of the word "interest" is a product of the Australian regulatory regime. As such, the IFIs in Australia are legally obliged to mention this word in several contract documents of housing finance in order to inform the customers that this is mandatory under Australian law. However, in order to reflect the *Shari'ah* compliant transactions in which interest is not present, MCCA – the pioneer of IFSPs in Australia – has been working with the UCCC management committee to enact Federal legislation to be exempt from having to use the word "interest" in all *Shari'ah* compliant products. A letter circulated by MCCA (Ghouse, 2005) on September 27, 2004 in response to the Islamic Information and Support Centre of Australia's (IISCA) letter, comments as follows in this regard:

We have applied to the Uniform Consumer Credit Code (UCCC) Management Committee for exemption from using the word interest in all Shariah compliant products. It is progressing very well (IISCA, 2004).

The products used by Australian IFSPs comply with the financial regulation of the country. According to David (2007b), MCCA's Senior Manager, business and compliance:

In its suite of four Shariah certified home financing products, MCCA has two products which originate for securitisation through two of the largest non-bank RMBS issuers in Australia based on the Ijara method of asset financing. Both these home financing products carry structural elements that are comparative to conventional home mortgages namely, the use of a registered first mortgage as collateral, mandatory compliance with Australian credit and fair trading laws, industry standard credit assessment and credit management, and mortgage market driven pricing.

4. Islamic finance in Australia: growth and prospects

Islamic finance has emerged in recent decades as one of the most important developments in the financial world (Ayub, 2008). Since all affairs of Muslims, including economic, political, religious, and social fall under the jurisdiction of Islamic

legal system there has always been a demand for financial products and services that conform to the tenets of the *Shari'ah* (Lewis, 2006). With the development of viable Islamic alternatives to conventional finance, Muslims are beginning to find *Shari'ah* compliant solutions to their financial needs[5].

What is more peculiar, though not surprising, is that during a time when the world's largest banks and financial institutions, have either collapsed or are in need of multi-billion dollar government funded bailouts, the IFIs are holding their ground well, although not completely immune to today's crisis. Despite this, growth rates of the global Islamic finance industry are estimated 15 percent annually. While the rising demand for *Shari'ah* compliant investments form an estimated 1.6 billion Muslims worldwide and Islamic assets are set to hit US\$1.4 trillion by 2010, it is projected that the Islamic financial system will soon be managing approximately 4 percent of the world's economy (Andreas *et al.*, 2008).

Meanwhile, Australia is making small inroads into this fast-growing sector in global finance, and with a growing Muslim population which makes up less than 2 percent of the population, it has potential to become a major centre for Islamic banking and finance. Islamic will co-exist with Islamic finance and contribute to conventional practice since Islamic models begin with the premise that the role of a financial institution is to promote the overall well being of society. Interestingly, Islamic finance in Australia has been growing rapidly since it was first introduced in 1989 with MCCA Limited[6]. Since then, a number of IFSPs have come into existence in the Australian financial services market during the past decade[7], and some international financial institutions are also considering the introduction of Islamic banking branches and subsidiaries (Mirza and Halabi, 2003; Kandil, 1997).

Owing to the global potential demand for Islamic banking and financial markets, as has been mentioned in this study earlier, and also Sydney's reputation for being the world's third busiest financial centre after New York and London (IMF, 2005), the prospective demand for the Islamic financial market seems to be very high. The number of Muslim population in Australia is 340,392, making Islam the third largest religion after Christianity and Buddhism, representing 1.7 percent of the population (Australian Bureau of Statistics (2006) Census Data). The Australian Muslim community is drawn from more than 70 different countries (Australian Government, Department of Foreign Affairs and Trade, n.d.), is ethnically and linguistically diverse, and geographically scattered. Local Muslims and non-Muslims can now invest and borrow in interest-free transactions according to the tenets of the *Shari'ah*.

In July 2003, *The Weekend Australian* reported that the then Prime Minister John Howard had endorsed a shared partnership scheme between home buyers and banks which was very similar to schemes already being used by IFIs (Hussein, 2006). In addition, a report published in *The Australian* on October 20, 2006 disclosed that National Australia Bank (NAB) will look at introducing Islamic financing into its product range to capture an "untapped" market that could be worth millions of dollars. It also declared offering an A\$25,000 post-graduate scholarship to a member of the Muslim community for the year 2007 to further NAB understanding of Islamic banking (Kerbaj, 2006). Furthermore, NAB was reported recently to be planning a A\$35 million investment in a *Shari'ah*-compliant listed industrial property trust.

Although insignificant in comparison with the major financial services providers in Australia[8], the Australian IFSPs are now playing an important role, and their

customers now include non-Muslims interested in the services provided by these institutions (Saeed, 2001). In the aftermath of the Asian economic trauma, Australia stands out as an investment opportunity as well as a financial centre. Through using IFSPs' financial services and investment vehicles, their customers can reinforce the message that they are significant players in the global services economy. Consequently, in recent years, some international financial institutions like HSBC and Citibank are considering the introduction of Islamic banking branches and subsidiaries in Australia (Datamonitor, 2004). ANZ Banking Group Limited – a major Australia and New Zealand based international financial services group – has already been offering Islamic financial services in some Muslim countries. In addition, it established special Islamic banking counters or branches in Western countries to capture these significant funds[9].

Given the geographical proximity of Australia to several Muslim majority nations, and given that some of its banks have the global presence to attract substantial business from the Middle East, Islamic finance is a well of untapped potential. There is extensive trade between Australia and neighbouring countries such as Malaysia and Indonesia, which have been making significant inroads into the Islamic financial landscape[10]. Australia has also good trade relations with the Middle East, particularly the Gulf States. A submission to the Joint Parliamentary Standing Committee on Foreign Affairs, Defence and Trade, on how to improve Australian business performance and maximise the opportunities for growth of its trade to Middle-Eastern countries, comments:

Islamic Banks throughout the Middle East and Malaysia, utilising the principles of Islamic banking and finance have proved successful over the years (Ayan, 2004).

The submission proceeds:

From an Australian perspective it is possible to approach these principles (*the principles of Islamic banking and finance*), particularly in relation to investment as ethical investment. From that point of view, ethical investments may be incorporated into a broader scheme or strategy of attracting investment funds from the Gulf States to Australia. It is very likely that such flexibility will enable Australia to capture a larger share of the investment outflow from these states than would otherwise be the case. Some investors may require validation by a Muslim knowledgeable in the field that their funds and the returns made on those funds have the ethical investment criteria and are in essence Halal (Ayan, 2004).

Given the above, there is a lot of potential that the Australian businessmen may leverage on Malaysia's comparative advantage in financial services to penetrate new markets in ASEAN and West Asia in the areas of Islamic financial services. Data indicate that in 2006, the Islamic banking system in Malaysia showed robust growth with high profitability. *Shari'ah*-compliant assets rose to US\$34 billion or 13 percent in terms of market share from less than 3 percent a decade ago. The Islamic debt market has progressed in much swifter fashion: Islamic corporate bonds now amount to US\$36 billion or 48 percent of the total corporate bonds in issue. In addition, Malaysia is well positioned to provide the linkages, through Islamic finance, to support the increasing trade flows between the Gulf States and the rest of the world. There is much potential in Islamic finance and Malaysia, which is a Muslim-majority country, is the place to explore these opportunities. Anticipating the increased interest in Islamic finance, Malaysia has put into place a

comprehensive Islamic financial system that includes best practices in legal and regulatory infrastructure, a diversity of market players and a wide range of products and services. Over the next ten years, Islamic banking in Malaysia is expected to command 20 percent market share *vis-à-vis* conventional banking. Therefore, banks in Australia should take these opportunities to use Malaysian banks as a channel to access Islamic banking and financial markets in Asia and other parts of the world, especially in West Asia.

Reynolds (2007a, b) from Klynveld, Peat, Marwick, and Goerdeler (KPMG)[11] says:

We could become a hub for the region over the next 10 to 20 years, because of our stable financial and political system. A major part of the market would be servicing the existing Muslim community here. To me, the larger potential, at this point in time at least, is servicing Muslims resident elsewhere, seeking investment opportunities. Islamic banking is the largest growing sector in the banking world, globally, and it will be big in Australia, purely because there is a demand. Within five years' time there will definitely be at least one IB operating in Australia, if not more, purely because there is a demand. Australia sits on the doorstep of the some of the largest Islamic regions in the world. Australian investors, given the time zone in which the market trades here, is of particular interest, and I think there's strong interest in this area of the market (Lannin, 2008).

The other area currently neglected is the potential for the sale of Australian-sourced financial products overseas. Australia offers well-established and stable political, regulatory, and judicial systems. Returns on investments in Australia have, over the long terms favoured by Islamic investors, been very high and much of the investment in Australia is in Halal products such as land, mining, and agriculture. The first company to issue products to investors globally is likely to encounter some regulatory hurdles, but they are also likely to tap into a deep and growing well of capital.

Except for the above potential of Islamic finance in Australia the following operational opportunities may also be explored (Masters, 2008):

- attracting foreign pure IBs and conventional banks' Islamic windows to establish new operations in Australia;
- Australian banks' operating as Islamic finance liquidity counter-parties for IBs in the region;
- Australian banks' advising and structuring Islamic products for corporations and governments in Australia and the rest of Asia;
- establishment and management of Islamic funds, including alternative asset classes, e.g. real estate, private equity, infrastructure, etc;
- expansion of ASX activities and services;
- growth of commodities' operations and services such as brokering, warehousing, advisory, etc;
- provision of domestic *Shari'ah*-compliant/ethical financial services and products to Muslim and non-Muslim customers in Australia; and
- Australian headquartered banks exporting Islamic financial services through windows as they grow their operations into Asia.

5. Suggestions and recommendations arising from the study

5.1 Recommendations

This study makes the following suggestions and recommendations for consideration by regulatory authorities for Islamic banking and finance in Australia:

- There is a strong desire and growing demand among and from Muslims for a fully fledged IB to function in line with the tenets of the *Shari'ah*. It is thus recommended that a fully fledged IB, along with the *Shari'ah* complaint Superannuation and investment funds, be established for nearly 350,000 Muslims living in Australia. We believe the Australian government should take necessary steps to enable these growing opportunities to be pursued in this country. In this connection, steps should be taken to introduce legislation in the Australian Parliament for strengthening this country's Islamic financial market system. Such a move to enact legislation by the lawmakers would contribute to the Muslim community in Australia finding a truly viable alternative for banking and finance based on religious and ethical considerations.
- The study recommends IFSPs' conventional counterparts such as NAB, CBA, ANZ, etc. to introduce *Shari'ah* compliant banking services side by side with conventional banking facilities being offered to prospective customers, since other global banking institutes such as HSBC, Citibank, Standard Chattered Bank have already entered these markets in a significant manner through their trans-national banking subsidiaries. Many of the global banks have Islamic finance divisions and the major centres for Islamic banking are in the Middle East, the UK, and South East Asia. Therefore, steps now may be taken to introduce and develop Islamic finance products in Australia.
- Currently all of IFSPs in Australia are providing investment facilities rather than retail banking services that are insufficient to meet the growing demands of the Muslim community. In order to attract more customers, the providing of both forms of banking to the communities' religious needs and economic development of the country, it is suggested that Islamic investment and retail banking facilities be integrated.
- The study recommends that the regulators in Australia introduce measures necessary to equalise the revenue duties liabilities of Islamic alternatives for interest-based mortgages, with a view to creating a level playing field for financial institutions and customers. Given the differing treatment of similar financial products under the different state regulatory systems, it is suggested that the government consider making changes to facilitate the levying of a single charge on what in effect is a single purchase.
- This study also suggests that a strenuous effort be made to educate people before establishing fully fledged IBs to provide *Shari'ah* compliant retail banking products and services, given the high level of ignorance of the underlying philosophy and nature of Islamic banking and finance among the general populace and those associated with the industry.

5.2 Suggestions for further research

The volume of research on Islamic banking and financial systems has considerably amplified over the past two decades. However, there are still many significant issues to

be critically examined. In relation to the theory and practice of Islamic finance in Australia, from legal and regulatory perspectives, which is the topic of the present study, there is more work to be done. The authors' research was limited to theoretical and technical analysis. It should be followed by empirical studies and tests. Within a few years, a sufficient volume of data on the Islamic banking and financial systems of Australia will be available, to make such studies practicable.

Apart from the topic of this study, there are other issues for further studies into legal and regulatory aspects of Islamic finance in Australia. An interesting area of future study relates to exploring the potential for launching *Shari'ah* compliant banking services by IFSPs' conventional counterparts such as NAB, ANZ, Westpac, CBA, St George Bank, etc. side by side with the conventional banking facilities they offer for the prospective customers. Other leading global banking institutes such as HSBC Amanah, Citibank, Standard Chattered Bank, Deutsche Bank, and UBS of Switzerland have already entered the markets to offer Islamic financing facilities in a significant manner through their trans-national banking subsidiaries.

Notes

1. Under Section 66 of the Banking Act 1959 (the "Act"), a person cannot use or assume a restricted word or expression in connection with their financial business without the consent of APRA. That means, by virtue of Section 66 of the Banking Act, a person (whether an individual, a body corporate or a body politic) must not use the expressions bank, banker, banking, credit union, credit society, and credit co-operative in relation to a financial business carried on by the person except as permitted by Section 66 of the Banking Act; or a consent in force under Section 66 of the Banking Act (APRA, 1959).
2. The APRA had granted the MCCU permission in December 1999 to carry on banking business. However, its license was withdrawn in August 2002 when it became apparent that its funds were not enough to sustain operations. The reason was that the APRA under paragraph 9(4) (a) of the "Act", imposed on the MCCU among other conditions the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15 percent at all times.
3. Basel II, also called The New Accord (correct full name is the International Convergence of Capital Measurement and Capital Standards – A Revised Framework) is the second Basel Accord and represents recommendations by bank supervisors and central bankers from the 13 countries making up the Basel Committee on Banking Supervision to revise the international standards for measuring the adequacy of a bank's capital. It was created to promote greater consistency in the way banks and banking regulators approach risk management across national borders.
4. The most significant IFIs have their own *Shari'ah* Supervisory/Advisory/Boards or Councils comprised of one or more Islamic scholars that have particular expertise in economic, legal, and financial transactions. These *Shari'ah* Boards/Councils often examine in detail both the structure of a proposed transaction or financial product and the documentation giving effect to that transaction or product.
5. Muslims in Islamic societies have traditionally viewed the *Shari'ah* as essential to their religious outlook. However, for Muslims living in non-Islamic societies the *Shari'ah* ceases to be relevant as law, but remains a source of personal ethics (for example, the avoidance of pork and alcohol, and the use of *Shari'ah*-compliant financial services).
6. With over 7,500 members, the MCCA offers a number of asset-based-like finance and investments products which essentially makes the acquisition of the property the main commodity rather than the loan itself.

7. Besides, MCCA other major players are Iskan Finance Pty Ltd, and Islamic Cooperative Finance Australia Limited. While Kuwait Finance House (KFH) (Australia) Pty Ltd, a part of the global KFH network in Kuwait and the world's second biggest IB, is considering entering into Australia. AmlIslamic Bank – Malaysia's third-largest Islamic lender with about \$2.94 billion of assets and a part of AMMB Holdings (Malaysia's fifth-largest banking group in terms of assets), is also considering a move into Australia as it seeks growth in non-traditional Islamic markets.
8. At present Islamic financial products account for a tiny proportion of Australia's banking sector. However, the MCCA which is the largest and most well-established IFSP in Australia and currently operates as a cooperative, envisages developing into a fully fledged IB within the next decade.
9. The ANZ Group is originated in the UK in 1835 when the Bank of Australia was established by Royal Charter. ANZ in the UK now operates as a division of the Australia and New Zealand Banking Group Limited and is regulated by Financial Services Authority in conduct of its investment business. Islamic finance is one of its major products. See for details, "ANZ United Kingdom – Country Information", available at: www.anz.com/uk/countryinfo.asp
10. For example, along with its Western-style banks, Malaysia has become the epicentre for Islamic-style financial services and has set the benchmark for Islamic banking in the Asia Pacific region (*The Australian*, 2007).
11. One of the largest professional services firms in the world, which employs over 136,500 people in a global network of member firms spanning over 145 countries. The roots of the name "KPMG" stem from four partners in the firms that merged to form KPMG – Klynveld, Peat, Marwick, and Goerdeler.

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