

REGULATORY CHALLENGES AND OPPORTUNITIES: A CASE OF AUSTRALIA

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ABSTRACT

Islamic finance in Australia has witnessed the rapid growth since it was first introduced in 1989 with the Muslim Community Cooperative Australia (MCCA). The operation of Islamic Financial Services Providers in Australia is still subject to basically the same laws and regulations as their conventional counterparts and applies the same conventional interest-based framework for regulatory and supervisory activities, although Islamic finance is different from conventional finance in many aspects. The absence of a legal and regulatory framework supportive for Islamic finance in Australia is seen as a major obstacle towards its effective and smooth functioning. Therefore, the study suggests the Australian regulatory regime to develop appropriate regulations to make Islamic finance a truly viable alternative for banking and finance based on religious and ethical considerations for Muslims living in Australia. It also recommends that a fully fledged Islamic bank be established along the lines of the community's strong desire and growing demand. In this connection, the study suggests that steps be taken to introduce legislation in the Australian Parliament for strengthening the country's Islamic financial market system.

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 (a) the issues related to Islamic finance practice in the Australian legal and regulatory context, (b) the compliance requirements of Islamic Financial Services Providers (herein after IFSPs) in Australia, and (c) institutional risk management of Islamic Financial Institutions (herein after IFIs). 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 (herein after IBs) and IFIs for a considerable period of time, in addition to his active involvement with at least two of IFSPs in Australia.

One of the main conclusions is that Australia being a country with a highly diversified and multicultural society there is a strong desire and growing demand among and from nearly 350,000 Muslims living in this country, for a fully fledged Islamic bank (herein after IB) to function, and the Superannuation and investment funds to establish in line with the tenets of the Shari`ah. This would not only help strengthen the Australian economy through creating an opportunity to bring in significant foreign direct investments into Australia but also build up its existing trade and economic ties with the neighbouring Muslim countries. We believe the Australian government should take necessary steps to enable these growing opportunities to be pursued in this country. It is therefore, recommended that the relevant regulations may be developed by the Australian regulatory regime so as to make Islamic finance a viable alternative system of financing for Muslims in Australia.

Another research problem of this study indicates that due to the unfamiliarity of the relatively new Islamic financial system, IFSPs in Australia have not been able to play the expected role in the development of Australian

economy through mobilising funds and attracting more customers. In this connection, it is suggested that IFSPs would take an intensified program to familiarise the public and policy makers with an overview of the Islamic finance and of the financial services and products they use in Australia.

It is also recommended that IFSPs' conventional counterparts in Australia such as National Australia Bank Limited (NAB), Australia and New Zealand Banking Group Limited (ANZ), Westpac Banking Corporation, Commonwealth Bank of Australia (CBA), St George Bank Limited and other similar banks introduce Islamic retail banking services side by side with conventional banking facilities being offered to prospective customers, since other global banking institutes such as HSBC (Honk Kong and Shanghai Banking Corporation), Citibank, Standard Chartered Bank have already entered these markets in a significant manner through their trans-national banking subsidiaries.

This study is divided into a number of sections. The organisation of these sections is as follows: 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 developmental and regulatory issues of Islamic finance in Australia. Section 3 examines the compliance requirements of IFSPs in Australia. This includes prudential standard requirements, compliance with core principles, disclosure and transparency requirements and consumer credit code of Islamic finance in Australia. Section 4 concludes the paper with the summary and analytical findings of the study followed by an analysis of the implications of those findings for the field of modern Islamic finance in Australia from the perspectives of laws, regulations and practice. It also offers 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 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: n.d.). 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 of the characteristics of IBs, and also of the review of their compliance with Islamic principles (Wilson, n.d. 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 to ensure 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 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 (ECB: 2006).

In the light of the above, like conventional financing, 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 has its own risk characteristics. The specific risks associated in operations of Islamic finance therefore needs to be identified, to ensure its prudential regulation is adequately addressed. This is to ensure the 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 sector¹ 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 (The Treasury of Australia: 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 operate in line with the precepts of 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: 2008).

¹ The financial sector of Australia includes: banks, permanent building societies, credit unions, life or general insurance companies, general government enterprises, superannuation schemes, corporations. These are registered under the Financial Corporations Act 1974 (including Finance Companies and General Financiers).

The regulatory framework is based around three central agencies: the Reserve Bank of Australia (RBA);² the Australian Prudential Regulation Authority (APRA);³ and the Australian Securities and Investments Commission (ASIC).⁴ 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.⁵ However, the Department of Fair Trading administer the Consumer Credit Code 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.⁶

The Government's legislative framework provides scope for self-regulation by the main securities and derivatives markets - the Australian Stock Exchange Limited (ASX)⁷ and the Sydney Futures Exchange (SFE)⁸ 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.⁹ 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 due 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 to the Australian housing industry (Halabi: 2000).

2 The RBA is responsible for the objectives of monetary policy, overall financial system stability, and the regulation of the payments system. Also, payments system policy is carried out by the Payments System Board (PSB) within the RBA.

3 The APRA is responsible for the prudential supervision of deposit-taking institutions, life and general insurance companies, and superannuation funds. Prudential regulation administered by the APRA is applied where financial risks cannot be satisfactorily managed in the market, and where concerns about financial security are utmost.

4 The ASIC is responsible for corporate regulation, market integrity, disclosure and other consumer protection issues.

5 See "The Council of Financial Regulators", available on Australian Prudential Regulation Authority website at: <http://www.apra.gov.au/Policy/The-Council-of-Financial-Regulators.cfm> (accessed March 12, 2006).

6 Currently, merger of Australia's main in-country banks is prohibited, by the so-called "Four Pillars" ban. The industry has been lobbying against this restriction, and meanwhile global competitors like HSBC and GE have moved in, including with offers of sub prime loans. See for details, *The Asian Banker Journal*, November 15, 2004, available on Journal's website at: <https://www.theasianbanker.com/A556C5/homepage.nsf> (accessed May 27, 2006).

7 The Australian Stock Exchange Limited (ASX) was formed in 1987 through the amalgamation of six independent stock exchanges that formerly operated in the State capital cities. It was originally a mutual organisation of stockbrokers, which become a listed company in 1996 through passing legislation by the Australian Parliament. It operates Australia's primary national stock exchange for equities, derivatives and fixed interest securities. For more elaboration See "ASX Overview and Structure", available on ASX website at: http://www.asx.com.au/shareholder/13/asxoverview_as3.shtml

8 The SFE listed on the Australian Stock Exchange on 16 April 2002. It offers the financial market community trading products for investment and risk management, disseminates real-time and historical trading market data and provides centralised clearing, settlement and depository services for both derivative and cash products. In 2006 the SFE merged with the Australian Stock Exchange. The merged company operates under the name "Australian Securities Exchange". See SFE Corporation Limited website at: <http://www.sfe.com.au/homepage/index.htm>

9 Under paragraph 9(4) (a) of the of the Banking Act 1959, the APRA imposed on the MCCU the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15% at all times among other conditions.

2.1.1 The Development of Legal Framework of Islamic Finance

The legal framework and regulatory standards are important elements in the development and growth of the Islamic financial services industry. 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.

Although Islamic finance is different from conventional finance in terms of its mission, objectives and practice, operations of IFIs in Australia is still subject to basically the same laws and regulations as their conventional peers and apply the same Western interest-based framework for regulatory and supervisory activities. A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed in this country (Ahmad & Ahmad: 2007). This is indeed essential as the absence of such a supportive framework obstructs Islamic finance in its effective and smooth functioning in accordance with Islamic principles. Thus, in order to support the operational soundness, Islamic banking and finance should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities, and are different from the conventional ones.

It is true that a few set of regulations have been developed and foundations for regulatory instruments have been laid by the Australian banking regulatory authorities in this regard, but it did not make any substantial steps towards developing effective services and operation of Islamic finance that comply the tenets of the Shari`ah. The regulations which have been developed at this stage to facilitate IFSPs' practices in Australia in line with the principles of the Shari`ah without violating the laws of the land are mentioned as under:

2.1.1.1 Exemption of Double Stamp Duty

In order to be treated Islamic home financing similar to conventional home loans with regards to the payments of stamp duty the Victorian Legislative Assembly and Legislative Council has recently approved the amendments to Victoria's Duties Act 2000 on October 7 and 14, 2004 respectively. In the above example, the amendments would exempt the second transfer of title from stamp duty, thereby placing the Islamic alternative on an equal footing with a conventional mortgage. The amendments also introduce other stamp-duty exemptions to make a range of different Islamic financial products practical. The purpose of the Victorian Parliament in enacting this legislation is clear. In the words of the amendment (MCCA: 2005, p.1):

“(It) ensures that persons who enter into Islamic financial arrangements are treated on an equal footing with people who enter into conventional mortgages”.

The amendment which came into operation on October 19, 2004 after the day it received Royal Assent, is a major breakthrough for Muslim customers of IFSPs of Australia as it will help to make the mortgage market fairer and more accessible to the Muslim community in Australia. According to MCCA's General Manager Dr Abdul Rahim Ghause (MCCA: 2005, pp.2-3):

“The amendment will not only enable Muslims to practice their religious beliefs but also make the market more competitive, allow greater innovation in products by financial institutions and attract investments from international institutions”.

MCCA has also approached other states to seek exemption from double stamp duty. In New South Wales, Office of State Revenue, NSW Treasury is looking into the matter seriously and it is expected that positive responses be achieved very soon.

One of the key requirements of Islamic finance is that a financial institution must justify its profit under an Islamic loan agreement by sharing risk with the customer in the underlying property in some cases, this could be the land that is the subject of the finance or it may be the beneficial interest in that land. At some point, the financial institution must therefore, take ownership of the property. In all States of Australia including Victoria the transfer of property will be subject to the imposition of a tax known as transfer duty. In a typical Islamic finance, ownership of the property will move at least twice; first to the financial institution and then to the customer which results in multiple payments of transfer duty. This makes the cost of Shari`ah compliant housing finance expensive and in some cases, commercially unviable. On the contrary, in conventional mortgage a customer pays a single amount of transfer duty in such a transaction.

At first blush, this might seem to be a relatively insignificant development, of interest only to a religious minority in Victoria. But it is more than that. It may represent the embryonic stages of an Islamic financial sector in Australia. Therefore, the exemption of double stamp duty is of vital importance for numerous reasons. Firstly, the obstacles of committed Muslims’ access to Shari`ah compliant finance are minimised. In the absence of this exemption, the previous law of paying multiple transfer duty had an adverse effect in a sense that Muslims having strong religious beliefs had limited recourses to Islamic system of housing finance. Secondly, this is the first piece of legislation recognising the Islamic finance industry in Australia a global industry with more than US\$360 billion in assets (Wilson: 2006, p.8).

2.1.1.2 Exemption of the Use of the Word ‘Interest’

The use of the word ‘interest’ is a product of the Australian regulatory regime under the Uniform Consumer Credit Code (UCCC). As such, the IFIs in Australia are legally bound to mention it in several contracts documents of housing finance in order to inform the customers that this is mandatory under Australian law. In order to reflect the Shari`ah compliant transactions in which interest is not present, MCCA has been working with the UCCC management committee to enact a Federal legislation to exempt from having to use the word ‘interest’ in all Shari`ah compliant products. It is progressing very well and the legislation is in the final stages of being enacted to law. This legislative change will facilitate Muslims in Australia for increasing adherence to their religious beliefs as well as practices with conformity of interest free Islamic financial system (Ghouse: 2004).

Having developed the necessary legal structures, there are still a number of hurdles which need to be overcome for the market to fully develop. They are summarised as under:

(a) Under current regulations on lease agreements, the product has to be 100% risk weighted whereas a conventional mortgage has a risk weighting of only 50% and;

(b) Unlike a conventional mortgage, the proposed product under Australian law would require two sets of solicitors as there are two conveyances. IFSPs however, are seeking an exemption from the requirements to have a second set of solicitors.

The obstacles hindering growth in this sector are surmountable. Double stamp duty was one such obstacle that has recently been overcome in Victoria only. Double stamp duty was payable due to the fact that the Shari`ah compliant structures involve a double conveyance (one at the time of the purchase from the current vendor and another one when the property is transferred to the customer when the finance has been repaid). Historically, this has made the Shari`ah compliant home financing prohibitively expensive, but the law has recently been amended in some States to reflect the reality of the scheme and only a single stamp duty charge is now payable.

2.2 Legal and Regulatory Challenges of Islamic Finance in Australia

Despite the remarkable growth and development of IBs and IFIs in the globe 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 are needed 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 is specified as under.

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 Islamic Financial Institution (IFI) to operate as a full 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 license from the APRA under the section 66 of the *Banking*

Act 1959.¹⁰ 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.¹¹

2.2.1.2 Regulatory Change

The absence of a regulatory and legal framework to support 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 the Shari`ah compliant home financing already exist, various legal hurdles make them 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 Basel I and Basel 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.¹² 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 Mortgage Lending Law

The conventional business of mortgage lending is highly efficient and strictly regulated in Australia. Part and parcel of the formality in mortgage lending is a very strong culture of disclosure and consumer protection codified by the Federal Government and various States and Territories. It is enforced by several law enforcement as well as consumer protection agencies. Therefore, layered over the real estate process is a specific flow of paper and documentation that is designed to present to consumers the cost of lending, the terms of lending, and the overall timeliness of communication as well as quality.

10 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*. See "Banking Act 1959 Consent to Use Restricted Expressions", available on APRA website at: <http://www.apra.gov.au/Legislation/Banking-Act-1959-CONSENT-TO-USE-RESTRICTED-EXPRESSIONS.cfm>

11 It was previously mentioned in this study that the APRA had granted the Muslim Community Credit Union Limited (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% at all times.

12 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.

2.2.1.5 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 & 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 United States, Freddie Mac has developed secondary markets for Islamic mortgage¹³ (Hameed: 2007, pp.10-15).

2.2.1.6 Exclusion from Lender of Last Resort Function

A related impediment is that IFSPs in Australia are, by their unique character excluded from the lender of last resort function. The Reserve Bank of Australia being the central Bank of the country by tradition stands behind the conventional banking and financial system to offer liquidity, lending to banks if the system is short of funds. IFSPs in Australia may not be able to get advantage of this because of the interest payments due on loans which are outlawed by the Shari`ah.

2.2.1.7 Absence of Interest-free Pension Funds

¹³ Some Islamic legal scholars object to the term 'Islamic mortgage', arguing that the concept of a 'mortgage' brings to mind a conventional mortgage and its inherent unfairness to defaulting borrowers. The government of UK has, as a consequence, referred to 'home purchase plans' when referring to some types of Islamic mortgages.

Australia's pension funds are known as Superannuation funds which are the mandatory provident funds for individual pensions. Australian law currently mandates that at least 9 percent of every employee's wages or salaries are paid into a pension fund which, in most cases, cannot be accessed until the person retires at the age of 65 (Andrew: 2007) . The problem at the moment is quite simple i.e. none of the superannuation funds currently being offered to the public are Shari`ah compliant.¹⁴ The pension funds are typically invested in broad index-type products and include interest receipts. This means that devout Muslims need to either try to calculate how much of the returns to their superannuation funds are due to Islamically unlawful activities and then give that amount to charitable causes or try to manage their superannuation by themselves. The first option is difficult, if not impossible, and the second is expensive and time-consuming.

2.2.1.8 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 for 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. MCCA 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, thus compliance problems 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

¹⁴ Nevertheless, an amendment to the Financial Services Reform Bill (FSRB) requiring superannuation funds and funds managers to disclose their policy on ethical investment has been passed by the Australian Parliament in 28 August, 2001. The amendment will require all financial services product disclosure statements to outline "the extent, if any, to which labour standards, environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment". The legislation is not fully *Shari`ah*-compliant though it creates an imperative for the investment community to get up to speed on socially responsible investment. See for this amendment, Ethical Investment Association of Australia (EIA), "FSRB Enforces Ethical Transparency", Media Release, 28 August 2001, available online at: <http://www.asria.org/pro/news&events/FSRBdisclosureLeg.htm> (accessed January 21, 2007).

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: 1) What is the definition of a Shari`ah compliant loan? 2) What other religions practised in Australia have special lending requirements? 3) 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?

2.2.3 Islamic Legal Concerns

Apart from the above mentioned legal, regulatory and other related concerns, there are some operational problems and issues confronting Islamic finance in Australia. Like other countries where Muslims are minorities namely, the USA, UK, France and Germany (Jenkins: 2007), several leading Islamic legal scholars were also involved in different aspects of the development of Islamic housing contract in Australia. This was applied mainly by the Muslim Community Co-operative (Australia) Ltd. as the pioneer IFI in developing Islamic financial products in conformity with the Australian legal environment. All were in agreement with the style and philosophy of the relevant countries' consumer disclosures and protections in cases where the Islamic legal scholars were acquiescent to advising consumers of the purpose of the law and avoiding a controversy over matters that are non-contractual.

Scholars of the Shari`ah, however, have a number of issues, which are significant to them when determining whether or not a contract complies with the rules of the Shari`ah:

2.2.3.1 Single Contract – No Amalgamation

In accordance with the Australian Law of contract, it is possible to combine contracts. As far as the Islamic law is concerned, the majority of scholars do not allow the combining of more than one contract into single contract. For instance, a contract of sale and lease may not be combined into a single contract.

2.2.3.2 A Promise is not Equal to Contract

Although most Australian courts will find a promise to be contract¹⁵ the Islamic legal scholars distinguish between the two.¹⁶ The result is that an Islamic financial relationship may be entered into Australia with a greater legal attachment than if it were entered into a purely Islamic environment.

2.2.3.3 Form and Asset Orientation

Although the Islamic legal scholars are very much concerned with the substance of a contract, their initial point of evaluation is the form. This has, in part, to do with the categorisation of commercial contracts in Islamic legal analysis. Since the distinguishing substantial matter in the Shari`ah is the existence and sale of a non-monetary asset the convergence between form and substance is that for a profit, financial transaction must involve an asset, not money.

2.2.3.4 Property Taxes and Assessments

The Shari`ah rules require that the owner of property pay property taxes. In the case of leased property, the cost to the owner may be recovered in the rent, even as a form of supplemental or additional rent. In an Australian consumer transaction the borrower or lease-to-own tenant is normally responsible for paying taxes (Harvey and Koliou: 2003, pp.544-546). There is no regulatory barrier to structuring payments as mandated by the Shari`ah.

2.2.3.5 Casualty Insurance

As with taxes and assessments, Islamic law requires that the owner of property pay the cost of casualty insurance. Flood, hazard and liability insurance have the same treatment in the Shari`ah and Australian regulations. On the face of it, such insurance, in the absence of *Takaful* is contrary to Islamic rules. But, neither securitisation, nor investment will occur without some form of protection of the property from various disasters, natural or man-made. The Shari`ah experts have permitted conventional insurance in this circumstance on the basis of *darurah* or necessity.

2.2.3.6 Statutory Interest

In Australian conventional banks accounts as well as in certain pre-paid expenses must accrue interest. Typically, it accrues at a very low rate. The ruling of Islamic legal scholars is that consumer must donate this to charity with no personal benefit. Therefore, the consumer is may not count the donation as either *zakah* or *sadaqaat*.¹⁷

2.2.3.7 The Use of the Term 'Interest'

15 In *Ward v Byham* [49] a promise to make a child happy was accepted as sufficient consideration in contract formation. For more information on this See <http://www.murdoch.edu.au/elaw/issues/v1n3/clarke13.html>

16 A promise by one party, without some form of consideration being extended by the other party, does not result in a contract or other enforceable obligation, regardless of the sincerity of the promise. Although each party must extend consideration to the other in order to form a contract, the value of the consideration need not be equal.

17 The root meaning of Arabic term *Zakah* comes from Z-K-W, meaning 'growth' and 'development', while the root meaning of *Sadaqaat* comes from the root S-D-Q, meaning truth and power. Although both of these terms are interchangeably used in the Qur'an to mean the compulsory charity the *Sadaqah* (singular of *Sadaqaat*) is also used in some places for voluntary charity. *Zakah* is exclusively meant for compulsory charity, which is a fixed share of income or property that every Muslim must pay as tax or charity, for the welfare of the needy. See for instance Al-Qur'an, 2:215, 3:134, 7:156, and 9: 60.

State and Federal Commonwealth government agencies in Australia require home finance/mortgage to provide their customers with various standard disclosures and representations. These mandatory disclosures utilise standard lending terminology - such as 'interest', 'lender' and 'borrower' - that do not correspond to the nature of the Shari`ah compliant financial instruments and products. Furthermore, the government has yet to approve modifications to these disclosures to adapt them to these products and other transactions in which interest is not present.

2.2.3.8 Mortgages

There is no objection in the Shari`ah to the granting of a housing finance or deed of trust to secure a creditor or investor in their rights. Clearly, the language of such documents must flow with the underlying Shari`ah compliant agreements and procedures.

2.2.3.9 Late Payments

The penalty in late payment is forbidden in the Shari`ah as it is identical to the forbidden *riba*. But, the Islamic legal scholars have permitted that lenders and lessors may charge a flat fee commensurate with their costs of collection. There may not be any compounding of the fee: it is assessable one time per instance of delaying.¹⁸

2.2.3.10 Rent

The payment of money for the use of real or personal property is permissible. The rate or basis for the rent should be freely negotiated in a manner that is transparent to both lessor and lessee.

In fact, the above and many other considerations have been addressed by different quarters and a great number of Muslim Australians now enjoy an Islamically permissible contract whereby they occupy or acquire their homes. If the best conclusions are drawn from a number of experiments, then the numbers of Muslims benefiting from Islamic home acquisition programs will increase in an exponential manner to the tens, if not hundreds of thousands.

2.2.4 Other Related Issues

Aside from the above mentioned legal and regulatory issues there are some other related problems that hinder smooth functioning and potential growth of Islamic finance industry in Australia. Some of these issues may be discussed under the following headings.

2.2.4.1 Lack of Understanding on Islamic Finance

The first challenge is that many people - Muslims and non-Muslims alike do not understand what Islamic finance exactly is. Although the underlying principle is clear to many is that Islamic law does not allow to make money out of money and thus capital should accumulate from buying and selling and possession of real assets, there

¹⁸ Most scholars have ruled that, to serve as a deterrent to such as may wilfully delay payments, the financier may get the buyer to agree, at the time of the contract, to make a pre-specified donation to an agreed charity in case of late payment of monthly instalments. These scholars, however, caution that this device should be used to the minimum extent and only in cases where *Musharaka* or *Mudaraba* are not practicable for one reason or another.

does not appear to be a unified definition of an Islamic financial product. The key concern is that the respective Shari`ah Supervisory Board (herein after SSB) of the IB or IFI that in fact defines what is and is not Islamic financial product and it interprets transactions differently. This leads to an ambiguity about what is, and what is not Islamic product and good enough to conduct businesses, which in turn can complicate risk appraisal for both the bank and its customers. This ambiguity so far prevents standardisation and makes it difficult for regulators justifiably they would like to know precisely what it is they are authorising (Ainley: 1997, p.1).

2.2.4.2 Risk Analysis and Balance Sheet Management

The second problem for IFIs in Australian financial market is the risk analysis and balance sheet management. Like in any country, the challenge in formulating the risk management infrastructure in IFIs lies in having an accurate assessment of the various risk variants underlying the alternative modes of finance to provide for their effective quantification and management. On the asset side, the IFIs enter into different financing modes that have varying risk characteristics, ranging from the low risk sales and lease-based modes to the higher risk Equity-based modes of finance. Each of these modes of finance have a distinct intrinsic characteristic dictated by its underlying Shari`ah principle, and thus entail different risk profiles. An Equity-based finance may for example involve higher risks and therefore attract higher capital requirement. Likewise, the liability structure of IBs is characterised by two distinct categories of deposits: 1) demand deposits which are not subject to risks associated with banking business and for which the principal is guaranteed, and 2) investment deposits which involves risks and hence, is eligible to share the profits earned from the banking business (Aziz: 2006).

2.2.4.3 Absence of a Standard Rate of Return

A further regulatory challenge arises from the liability structure of IFIs is the determination of a standard rate of return for account holders. Unlike conventional finance practice where returns are pre-determined, profit-sharing depositors of IFIs know their returns at the maturity of the deposits. These returns are subject to the earnings of the assets that are shared between the IFIs and the profit-sharing depositors. In the event of loss, the depositor as the capital provider will bear the losses. As the deposits in Islamic finance practice for the most part are in the form of profit-sharing deposits, it places a higher degree of fiduciary risk on the management to ensure the funds are utilised in the most efficient manner (Securities Commission: 2007).

2.2.4.4 Difficulty in Classifying Risk Sharing Funds

Another complexity is how to classify risk sharing funds placed with IFSPs as the classification of these funds has implications for IBs' capital requirements. If these funds are capital certain they would be defined as bank deposits under Australian banking regulation. On the contrary, if they are defined as investments in a collective investment scheme they are not bank deposits (Zaher and Hassan: 2001, pp.155-199). On levels of adequate capital the Basel Committee on Banking Supervision (BCBS) envisages that all internationally active banks should be subject to the minimum capital requirements, and the Basle Standards have gained general recognition throughout the globe,

including Australia. However, a number of key regulatory issues pertaining to liquidity requirements remain unresolved, especially whether they should apply to all on-balance sheet funds; and how liquidity should be managed for funds which are held off-balance sheet. Yet, the basic issue as for any bank whether Islamic or conventional is how easily and quickly, and at what discount, assets can be turned into cash.

2.2.4.5 Problem of Accounting Standard

A subtle problem that conventional interest-based financial institutions have with IFSPs is the question of how to account for them. In most of the world, IAS 39 may be applied as it is called AASB 13919 in Australia.²⁰ The problem with Islamic finance is that it does not operate in the same way the arrangements will actually work if these standards are used, as most of the world's banks do. The risk sharing nature of many of the arrangements (Musharaka for example) means that they are possibly of the nature of a joint venture, but the precise balance of the risks and control transferred really matters. The definition of a joint venture in the standard²¹ makes it plain that there must be an element, not only of joint ownership, but also joint control. If there is no real control over the use of the asset by the bank, then is it a financial instrument, merely entitling them to a flow of revenue (say the rental income) or is it an equity ownership of the asset as they are entitled to a proportion of the unpaid, residual value? During the life of a Musharaka arrangement when does ownership and equity control really pass (Troshina: 2004)?

2.2.4.6 International Prospective

Another related problem is disregarding the potential for the sale of Australian-sourced financial products overseas. Australia offers very 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 Shari'ah compliant 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 (Andrew: 2007).

3. COMPLIANCE REQUIREMENTS FOR ISLAMIC FINANCE IN AUSTRALIA

Compliance requirements for Islamic financial sector in Australia are not different from those apply to the conventional financial sector. Given this, Islamic finance in Australia is subject to comply 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

¹⁹ AASB 139 (issued July 2004) included a free choice option to designate financial instruments at fair value through profit or loss. Under AASB 2005-4 the ability to designate financial assets and financial liabilities is restricted. See "Regulation Impact Statement", *AASB 2005-4 Amendments to Australian Accounting Standards*, available online at: http://www.aasb.com.au/public_docs/ES_RIS/RIS_AASB_2005-4.pdf (accessed March 19, 2006).

²⁰ The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's (FRC) strategic directives to adopt International Financial Reporting Standards [the Standards and Interpretations of the International Accounting Standards Board (IASB)] for application to reporting periods beginning on or after 1 January 2005 and to harmonise the requirements applicable to general purpose financial reports of public sector entities and those applicable to Government Finance Statistics. *Ibid*.

²¹ See International Accounting Standards (IAS) 31, "Financial Reporting of Investments in Joint Ventures", para 3, which says: "a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control".

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, due 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 boosts 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. Due 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: 200, p.196).

Islamic financial services in Australia apply the same prudential regulatory standards to be complied with 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. With regard to fulfilling the prudential standard requirements the following key areas are important for the development of the Islamic financial market in Australia.

3.1.1 Effective Legal, Regulatory and Supervisory Framework

To achieve the common goal of ensuring stability of any financial system an effective legal, regulatory and supervisory function is an indispensable and vital component of the financial infrastructure of that system. For the Islamic financial system, this infrastructure also needs to be consistent with the requirements of the Shari`ah principles which provide assurance that the strategic direction, the formulation of policies and the conduct of financial transactions are in compliance with the Shari`ah principles. The legal framework should also deal with supervisory issues, including the relevant regulatory agencies involved in the supervision of IFSPs. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.

While the conventional financial system is guided by the Basel core principles which delineates the minimum requirements for the supervisory regime, these principles need to be reviewed from the perspective of Islamic finance,

taking into account the unique characteristics and risks involved in products and services of IFSPs.²² A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for IBs. Such requirements need to reflect the risks that the banks undertake. The framework devised would need to incorporate fundamental Islamic concepts. Islamic banking operations therefore need to be governed by its own standards and best practices in parallel with the international best practice. While certain products in Islamic finance by their nature may not attract capital, the IFIs need to have a more rigorous risk management systems in managing the funds placed under this arrangement. In this regard, the risk management standard needs to specifically address this concern.

3.1.2 Improved Corporate Governance

Good Corporate Governance contributes towards maintaining market confidence and reinforcing transparency. It also upholds fairness and justice with respect to all stakeholders of the co-operative types of Islamic financial institutions like MCCA and ICFAL among IFSPs in Australia. Justice, it is said, should not only be done but be seen to be done and, accordingly, an element of the development of corporate governance is an ever-increasing demand for transparency. With the increasing emphasis on self-regulation under the Basel guidelines, corporate governance is becoming even more important in the overall regulatory framework for banks and financial institutions, including IFSPs. For corporate governance to work whether in Islamic finance or conventional, good corporate practices need to be inculcated and embedded in all aspects of the operations and at all levels within the organisation. Islamic corporate governance serves through its underlying principles of economic well-being of the community, justice, accountabilities and equitable distribution of income. Therefore, while the virtues of Islam always advocate good corporate governance, the challenge lies in its application.

3.1.3 Effective Risk Management System

In general, operation of Islamic banking and finance is characterised by a high degree of financial risks. In the absence of guaranteed returns on deposits, IFIs undertake risky operations in order to be able to make comparable returns to their customers. A successful risk management system is fundamental to decision-making efforts. The risk management system in Islamic institutions need to be able to address the distinguishing features of Islamic financing practice involving financial contracts and products which may lead to other risks in addition to credit risk. The sophistication of the respective risks in the Islamic financial products needs to be fully investigated and measured to provide for their effective evaluation and management.

The requirement to manage the risks in Islamic financial services becomes more significant because of the unique peculiarities in the contracts. Basel II has, to a certain degree, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be absorbed by the IBs in terms of its product offering. One of the considerations that need to be addressed in assessing the risks associated with the IB is with regard to the capital charge on its investment accounts. Basel II does not address this unique feature in its framework.

²² See Governor of Bank Negara Malaysia (2004), speech at the 3rd Annual Islamic Finance Summit, "Ensuring Stability in The Islamic Financial System". London: 13 January, available on BNM website at: <http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=145&print=1> (accessed August 23, 2007).

Assets that are funded by monies in the investment account may not require the capital charge for the purpose of capital adequacy measurement except in the case of misconduct and negligence. Similarly, if the Islamic banking institutions were to be more engaged in the profit-sharing arrangement in its balance-sheets, it will require the IB to have a more rigorous risk management assessment and monitoring mechanism. While risk mitigation is desirable in Islamic finance, further improvements need to be made to the existing risk management framework (IRTI & IFSB: 2006, pp.21-27).

3.1.4 Development of a Dynamic Islamic Financial System

The Shari`ah which is an essential tool towards developing a dynamic Islamic financial industry should always be viewed as an enabler to innovation and creativity, rather than a constraint. Efforts, therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom. The collaboration among the Islamic legal scholars, practitioners, researchers and regulators to undertake in-depth studies and research to create new products will provide the fundamental foundation towards the development of a dynamic Islamic financial system.

3.1.5 Development of Comprehensive Legal Framework

An all-inclusive legal infrastructure is an important pre-condition to sustain the continued growth of Islamic banking and finance, which needs to cover both effective regulatory and substantive laws to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers that are equipped with sound knowledge and expertise in both the Shari`ah and civil laws to deal with such matters.

3.1.6 Development of Vibrant Islamic Financial Markets

The need of the time in the Islamic financial services in Australia is to steer the development of an Islamic financial system which would essentially include the key components comprising the capital market to provide an alternative source of financing, as well as to create broader and more diverse Islamic financial instruments for investors. The equity and bond markets will provide a more balanced allocation of financial and economic resources. This would result in a more efficient distribution of risks within the system, thus creating stability in the system. The equity and bond markets would also provide an avenue for raising long-term capital. With a wider spectrum of instruments in the market, fund managers would be able to manage their portfolios better and spread their risk according to their desired risk tolerance, thereby contributing toward greater stability.

In addition to the requirements mentioned above, to ensure an equal opportunity, a number of support facilities need to be provided to IFIs in compliance with the the Shari`ah including:

- i. Liquidity support such as lender of last resort facility;
- ii. Neutrality of capital requirements to be accorded to assets of IFSPs as compared to their conventional peers;
- iii. Return on deposits held with central banks;

- iv. Appropriate treatment of investment accounts for mandatory reserves and capital requirements;
- v. Investment opportunities in sovereign financial issuances;
- vi. Proper understanding of the Islamic banking services and their equal treatment with conventional products;
- vii. A clearer understanding of the Shari`ah governance structures and facilitating them further;
- viii. Extension of safety-net systems such as deposit protection;
- ix. Ensuring a supportive legal system, and
- x. Ensuring tax-neutrality for Islamic financial contracts.

3.2 Compliance with Core Principles

The unique characteristics of 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 existence of a SSB; a management that is committed to Islamic financial concepts; safeguarding of investors' fund from negligence, trespass, and fraud; and compliance with standards of the AAOIFI.²³

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 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

²³ The most significant Islamic financial institutions 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. There may have variations in interpretation and implementation from one *Shari`ah* Board to another, with a multiplicity of views on a specific issue. Nevertheless, Islamic legal scholars in this period strive to achieve a consensus on difficult and original issues, such as those involved in the development of new financial instruments and products.

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.²⁴

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 is to 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 were 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 are 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

24 See Governor of Bank Negara Malaysia (2004), speech at the IFSB Interactive Session on "The Future Prospects of the Islamic Financial Services Industry", Bali: 31 March, available on BNM website at: <http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=148>

by law to truthfully disclose all relevant information about consumers' arrangement 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.²⁵

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.²⁶

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 a Federal legislation to exempt from having to use the word 'interest' in all Shari`ah compliant products. A letter circulated by MCCA on September 27, 2004 in response to the Islamic Information and Support Centre of Australia (IISCA)'s letter comments the following in this regard (IISCA: 2004).

"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".

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

"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. SUMMARY, FINDINGS AND RECOMMENDATIONS

4.1 Summary and Findings of the Study

The objectives of this research project were two fold. The first aim was to suggest the Australian regulatory regime to develop appropriate regulations to make Islamic finance a truly viable alternative for banking and finance based on religious and ethical considerations for Muslims living in Australia. Secondly, to recommend that a fully fledged Islamic bank be established along the lines of the community's strong desire and growing demand. In this connection, it is suggested that steps be taken to introduce legislation in the Australian Parliament for strengthening

25 The Consumer Credit Code website, "How the Code will Benefit You ?", available online at: <http://www.creditcode.gov.au/display.asp?file=/content/consumer.htm>

26 See the Queensland Government, Department of Tourism, Fair Trading and Wine Industry Development (2007), "Payday Lenders", available on Office of Fair Trading website at: <http://www.fairtrading.qld.gov.au/oft/oftweb.nsf/Web+Pages/5AC30F969DE98B154A25708A00160A4D?OpenDocument>

the country's Islamic financial market system. In line with its objectives the investigations were carried out through conducting the following.

At the outset, the paper investigated the practice and compliance requirements of Islamic finance in the Australian legal context. To this end, it discussed the developmental and regulatory issues of Islamic finance in Australia. Following that, it attempted to examine the compliance requirements of IFSPs in Australia. Finally, the study proposes to adopt a new bill proposal on Islamic Finance in a move to establish an Islamic Bank which would contribute to growing Muslim community in Australia to find a truly viable alternative for banking and finance based on religious and ethical considerations.

Given the above, the review and findings of the study that aimed at examining regulation and supervision of Islamic Financial Services Providers in Australia have been summarised as under:

1. There is no legal and regulatory framework in existence in Australia for guiding and supervising the functions of IFSPs to operate in line with the precepts of Islamic legal system. But the fact is that like their conventional counterparts the regulation of IFSPs is most effective where there is already a sound regulatory framework in place that provides for adequate reporting, monitoring of capital adequacy, risk management controls and customer disclosure. Given this, it is the regulatory authority which will address the issue of financial soundness. The IFIs in Australia were established in an environment where conventional financial services providers are already in the market. The crucial challenge in this regard is that IFSPs' customers must enjoy similar, although not necessarily the same, protection as customers of conventional financial institutions. At the same time, it is expected that regulatory authorities would ensure there is a level playing field, so that neither IFSPs nor conventional financial institutions are disadvantaged. In Australia where Muslims are minorities and full fledged IBs are absent, regulators have nevertheless been expected to approve and monitor Islamic financial products, including those offered by Islamic managed funds.

2. From a regulatory perspective the significant foundation is to accept that the fundamental principles of conventional financial markets regulation apply with equal force to Islamic financial markets. The key philosophies that distinguish conventional from Islamic financial markets may suggest that the regulatory building blocks for regulating Islamic finance need to be different from those used for conventional regulation, but in fact it is not indifferent from regulatory perspectives. The principles that strengthen conventional markets regulation are mainly designed to ensure that financial firms are able to deliver upon their promises - promises to cover policy holders' losses; or to repay investors or depositors upon particular terms agreed at the time of contract formation. Like other regulators, Australian regulatory authorities would like to be satisfied that Islamic financial markets have appropriate compliance and enforcement powers and practices; that the conventional and IFSPs are both in good standing with relevant international standard setters; and that they are committed to appropriate levels of information sharing and cooperation. If all of these hurdles can be overcome, obviously they can take comfort that differences of detail in regulatory approach will not prejudice consumers of the Shari`ah compliant products.

3. Islamic finance in Australia is still in its early stages. Because of the character of most of Australian immigrants, lots of incoming Muslims here have naturally been more worried with how to support their families than

with developing financial institutions. However, quite a few small financial enterprises have started; with at least three in operation at present. Some of them are currently limited to providing facilities with their shareholders and are not allowed to accept normal bank deposits as like in many countries, Australian law normally does not permit taking deposits without an appropriate license. While others work with a number of other providers and offers mortgage and leasing facilities.

4.2 Recommendations for the Study

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

1. There is a strong desire and growing demand among and from Muslims for a fully fledged Islamic bank to function in line with the tenets of the Shari`ah. It is thus recommended that a fully fledged Islamic bank along with the Shari`ah compliant 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 be taken to introduce legislation in the Australian Parliament for strengthening this country's Islamic financial market system. Such 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.

2. The study recommends IFSPs' conventional counterparts like NAB, CBA, ANZ etc. to introduce the 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.

3. Currently all of IFSPs in Australia are providing investment facilities rather than retail banking services that are insufficient to meet the growing demands of 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.

4. 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.

5. The co-operative nature of financial institutions among IFSPs may merge with each other for their future growth and development through attracting more capital and providing investment facilities. This will help expand Islamic finance that Australia's vibrant Muslim community could use comfortably as it would meet their religious as well as financial and market requirements.

6. 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. For example, it is not known to many people that one of the great successes and growth of Islamic banking lies in “its value-orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike”.²⁷ Also, since the Shari`ah contracts that are now used and advertised by IFSPs in Australia appear to be traditional mortgage contracts where the borrower takes the risk and the lender gets a fixed rate of return it is suggested that Muslim customers should be fully informed about the institutions with whom they enter into business relationships.

4.3 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 author’s research was somehow limited to theoretical and technical analysis. It should be followed by empirical studies and tests. Within a few years, 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 like NAB, ANZ, Westpac, CBA, St George Bank etc. side by side with the conventional banking facilities they offer for the prospective customers since 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.

²⁷ See for more information regarding this, “Status of Islamic Banking”, available on Islamic Banking website at: <http://www.islamic-banking.com/ibanking/statusib.php> (accessed July 12, 2007).

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