

ACCOMMODATING ISLAMIC BANKING AND FINANCE IN AUSTRALIA

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I INTRODUCTION

Although still in its infancy and small in comparison with its US\$200 trillion conventional cousin,¹ Islamic banking and finance ('IBF') has become a growth area in recent years and according to conservative estimates is expected to have almost US\$2.8 trillion in assets by 2015.² Perceived by its advocates as not only halal (Islamically lawful) but also a safer investment option in the wake of the global financial crisis, it has continued to post 15 to 20 per cent annual growth rates.³ These impressive data have stimulated local interest, but reservations persist in Australia. Conservative inclinations and a preference for tight regulation have not facilitated entry of IBF into Australia in general, and New South Wales ('NSW') in particular.⁴

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1 See Eddie Yue, *Islamic Finance – Its Potential to Bring New Economic Growth to Hong Kong* (27 November 2008) Bank of International Settlements

<<http://www.bis.org/search/?q=Eddie+Yue+2008&adv=1>>.

2 See Dana El Baltaji, 'Bahrain Sees Market in Islamic Paper', *Sydney Morning Herald* (Sydney), 21 July 2010, 8. Moody's Investor Services expects the market to grow to US\$5 trillion: cf Alexandra Cain, 'Islamic Finance', *Australian Financial Review* (Melbourne), 7 July 2010. Notwithstanding these projected growth rates, there is still some concern surrounding the Islamic bonds ('sukuk') market in the Gulf Cooperation Council (GCC) following some recent high profile defaults. The Malaysian sukuk market, however, looks to be going from strength to strength: Shaheen Pasha and Rachna Uppal, 'Sukuk Loses Shine for Traditional Gulf Issuers', *The Daily Star* (London), 30 July 2010.

3 See 'UBS Sees Growth in Islamic Finance', *Reuters* (online), 16 April 2009 <<http://www.reuters.com/article/idUSTRE53E4WW20090416>>.

4 According to Alex Regan, the head of Islamic Finance at Mallesons Stephen Jaques, 'several days of structuring sessions with potential clients discussing potential transactions often end with them thinking that it's too difficult in Australia': Marian Edmunds, 'Changes Needed to Attract Worldwide Muslim Investment', *Australian Financial Review* (Melbourne), 7 July 2010, 2.

In addition to providing a general review of IBF from a legal perspective, this paper sets out the regulatory framework and assesses the extent to which it obstructs the development of IBF in Australia. It also explores the possibility of, and options for, reform in the context of regional and global moves to accommodate this growing phenomenon.

The paper is divided into four broad sections. Part II introduces Islamic Law and IBF. It also explains essential concepts, including the principal contractual forms (nominate contracts) around which particular Islamic products are based. Parts III and IV detail Australia's social and regulatory environments, and explain particular difficulties encountered by Islamic Finance Service Providers ('IFSPs'), with a focus on taxation rules and prudential standards. Part V discusses local and regional developments as well as possible templates for legal reform.

Although the majority of source materials for the industry are in Arabic,⁵ there is a burgeoning supply of materials also in English which are referred to below and provided for ease of reference.

II WHAT IS ISLAMIC BANKING AND FINANCE?

In brief, IBF refers to a modern system of banking and finance adapted⁶ to comply with Islamic legal rules found in the Holy *Qur'an*, the Prophet's Sunnah (his living example and sayings) or *ahadith* (ie Prophetic traditions) and juristic interpretation of those sources (the totality of which is referred to as the 'Sharia'). In some cases, these rules are extracted 'as is' from explicit verses of the *Qur'an* and/or authenticated explicit *ahadith*, with the literal (*dzahir*) or primary meaning of the words taking precedence over any inferred (*baṭin/khafiyy*) or secondary meaning. In other cases, namely where no explicit text exists or there are conflicts of textual authority, jurists deduce the 'correct' ruling through a complex process known as *ijtihad*. This interpretative process is necessarily speculative (*dzanni*) and comprises ranking and categorising *Qur'anic* and Sunnatic texts in relation to each other, as well as drawing analogies from known cases (*qiyas*) and definitive text (*nass qaṭ'i*). It also may entail, depending on the preference of the particular scholar, giving consideration to the public interest (*maṣlahah*), preventing or blocking the means of legitimising illegal ends (*sadd adh-dhara'i*), operating presumptions (*istishab*), equity (*istihsan*), prevailing

5 My principal source for the section on Islamic reasoning is Abdullah Muḥammad Al-Haṭṭab al-Ra'ini al-Maliki, *Qurrah al-'Ain bi-Sharḥ Waraqat Imam al-Haramayn* (Dar al-Mashari'ah, 2001), the famous explanation of Al-Juwayni's *Al-Waraqat*, a primer in *Usul al-Fiqh*. For the Sharia sections on IBF, see Wahbah al-Zuhayli, *Al-Fiqh al-Islami wa 'Adillatuh* (Dar al-Fikr, 1997, 4th ed) vol 5, and the English translation (Wahbah al-Zuhayli, *Islamic Jurisprudence and its Proofs* (Mahmoud El-Gamal trans, Dar al-Fikr, 1997) are also useful, if not exclusive, resources.

6 In other words, IBF is a subset of the conventional banking and finance industry: Mohammed Amin, 'Would Islamic Finance Have Prevented the Global Financial Crisis' (Speech delivered at the La Trobe University Islamic Banking and Finance Symposium, Melbourne, 6 July 2009).

custom (*ʿurf*), legal maxims (*qawāʿid al-fiqhiyyah*) and the essential values underlying the Sharia (*maqāsid al-Shariʿah*).⁷

Although initially speculative, ijtihadic rulings become definitive and binding (on scholars, practitioners and the lay population) when the top scholars of any period (*al-mujtahidun al-muṭlaqun*) unanimously agree upon a matter (*al-ijmaʿ*), either explicitly (*qawli*) or by their silence (*sukuti*). However, where consensus fails to emerge (evident in many instances of Islamic transactional law), individual juridical differences (*ikhtilaf*) remain on the record indefinitely, with each eponymous scholar's legal opinion providing an alternative, and equally valid source of law. These opinions are then extended or qualified by scholars of a lower status (*ashab al-wujuh*), which are all then ranked by other scholars (*ahl al-tarjih*) according to their strength of evidence (in terms of authentication) and grounding in Islam's primary texts (the *Qur'an* and Sunnah).⁸

Over several centuries, this interpretive process has evolved into 'legal schools of thought' (*al-madhahib*), comprising the works of the titular head of each school (*mujtahid muṭlaq*), his students of an equivalent rank with similar methodologies (*mujtahidun muntasibun*), and of the subsequent glossators (*ahl al-tarjih*). The corpus of their writings is collectively known in the non-Muslim world as the 'classical tradition' or *fiqh*⁹ and are sources for the majority of Islamic legal rulings (*ahkam*) given by an Islamic judge (*qadi*) and the isolated opinions (*fatawa*) of an Islamic juris-consult (*mufti*).

Technically, there is, and has been, no limit on the number of juridical schools, though for Sunni Muslims (by far the majority), four have come to predominate: the Hanafi (after Abu Hanifah [Nuʿman ibn Thabit], *d* 150 AH/772 CE), Maliki (Malik ibn Anas, *d* 179 AH/801 CE), Shafi'i (Muhammad ibn Idris, *d* 204 AH/826 CE) and Hanbali (Ahmad ibn Hanbal, *d* 241 AH/863 CE). For the Shi'ah, the Ja'fari school (attributed to Abu Ja'far al-Sadiq, *d* 198 AH/820 CE) is the most widespread.

The national legislated laws of some contemporary Muslim states may reflect the doctrinal positions of one school more than others. The Jordanian Civil Code, for example, is an adaptation of the Ottoman (and Hanafi) *Majallat al-Ahkam al-ʿAdliyyah*, the first attempt to codify Islamic civil laws (*muʿamalat*), and the United Arab Emirates Civil Code largely expresses Maliki doctrine. However, many modern Muslim states, and the intellectuals/jurists who help draft their

7 For a more detailed account of the methods by which Islamic rules and judgments are formed (*usul al-fiqh*), see Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Islamic Texts Society, 3rd revised ed, 2003), ch 4, 9, 12–16.

8 See Yossef Rapoport, 'Legal Diversity in the Age of Taqlid: The Four Chief Qadis under the Mamluks' (2003) 10 *Islamic Law and Society* 210.

9 Technically, *fiqh* refers to the substantive rules derived from the religious sources: Wael B Hallaq, *Shari'a: Theory, Practice, Transformations* (Cambridge University Press, 2009) 3. Western scholarship on Islamic law traditionally has focussed on the 'classical tradition' as their objects of inquiry rather than the more modern variants. For examples of this genre, see Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press, 1964); N J Coulson, *A History of Islamic Law* (Edinburgh University Press, 1964); Bernard Lewis, *Islam in History: Ideas, People and Events in the Middle East* (Open Court Publishing, 2nd ed, 1993).

laws or guidelines, rarely feel bound to one school and choose eclectically between them (a process called *'takhayyur'*) or form novel opinions 'patching' one opinion (often less well-known) onto another (a practice termed *'talfiq'*) to legitimate a practice that might otherwise be prohibited by one or more of the schools.¹⁰ Whether one speaks of juristic opinions found in the *fiqh* or the attempts by Muslim states to give them legislative effect (*Tashri' Islami*, or Islamic Law), the reality is one of internal pluralism and manifest diversity.¹¹

IBF, and the juristic debates that surround it, is a product of this dynamic diversity. It is not a conceptual fossil excavated from a medieval mercantile archive, but an attempt to re-engineer rules found in Islamic texts to a modern business environment. As an applied discipline originating in a secular framework, its Islamic credentials have sometimes been questioned and remain a matter of heated debate.¹² Nevertheless, its operators, financial engineers and bankers, by working with and getting approval from Islamic jurists on their Sharia Advisory Boards ('SABs'), which is essential for any putative IFSP, are constantly trying to fashion new products that are consistent in their eyes with Islamic teachings.

Islamic banking is often stereotyped as 'interest-free' banking, a phrase that does not convey its adaptability, detail, nor commercial reality.¹³ Nevertheless, it captures the message of social justice and freedom from exploitation which the industry wears on its ethical sleeves.¹⁴ According to the primary sources, classical literature and modern commentators, lending in Islam (*Qard Hasan*) is a charitable undertaking and intended to help a person in need.¹⁵ Legally, once lenders provide money to borrowers, they are no longer the owners of the money lent and relinquish all rights to an additional charge, with the borrower guaranteeing only to repay the capital sum.¹⁶

Lending with interest falls foul of the prohibition of *al-riba* found in both the *Qur'an* and Sunnah.

10 See Hallaq, above n 9, 448–9.

11 See Rapoport, above n 8.

12 See Mervyn K Lewis, 'Comparing Islamic and Christian Attitudes to Usury' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 65, 78; Muhammad Anwar, 'Islamicity of Banking and Modes of Islamic Banking' [2003] *Arab Law Quarterly*, 62; Mahmoud A El-Gamal, *Islamic Finance – Law, Economics and Practice* (Cambridge University Press, 2006); Mahmoud A El-Gamal, *Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering* (May 2007) Rice University <<http://www.ruf.rice.edu/~elgamal/files/Incoherence.pdf>>; Haider Ala Hamoudi, 'The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law' (2008) 56 *American Journal of Comparative Law* 423; Madzlan Hussain, *Demystifying Islamic Finance – Correcting Misconceptions, Advancing Value Propositions* (Zaid Ibrahim, 2010) 9.

13 See Hussain, above n 12, 15.

14 For an example of writings that evoke this 'spirit': see M Umer Chapra, *Islam and Economic Development: A Strategy for Development with Justice and Stability* (Adam Publishers, 2007).

15 See Monzer Kahf and Tariqullah Khan, *Principles of Islamic Financing: A Survey*, 8–9 <http://monzer.kahf.com/books/english/islamic_financing_survey.pdf>.

16 *Ibid* 2.

Linguistically, '*riba*' means 'excess' but in the Sharia it refers to particular types of 'unlawful gain'.¹⁷ Lending for profit, or with other conditions attached that commercially benefit the lender, is strictly prohibited – even if the rate charged was couched in terms of a penalty for unauthorised borrowing or for a late payment. Some Islamic banks circumvent this prohibition by imposing a fixed charge for persistent late payments and then donating sums received to charity, so as not to benefit directly from the additional charge. But in theory, the banks should be lenient and allow debtors to reschedule their debt without any further payments and certainly should refrain from making charges routine.¹⁸ Opportunist lending is viewed as unfair, whether the borrower is an entrepreneur seeking to start up a business – as only the lender is guaranteed a financial return¹⁹ – or a borrower with a particular need, because the lender could exploit the former's vulnerability.²⁰

Concern for the vulnerable is also evident in Islamic proscriptions of gambling (*maysir*) and contracts with excessive risk (*gharar*). Although the hand of paternalism is not unique to Islamic law (as gambling contracts are also unenforceable under common law), their combined effect renders illegal conventional insurance²¹ and, according to some interpretations, also the stock market.²² Neither are without utility or benefit, but the harm and potential losses are regarded as more significant than any incidental gain.

In addition to protecting the weak and the feckless from themselves, Sharia transactional law (*al-mu'amalat*) imposes rules on all parties to make sure deals are fair, transparent and conducted with scrupulous honesty. These rules include requiring visual sighting of tangible assets (or at least describing them explicitly), revealing defects concealed or otherwise, and in the case of cost-plus trust sales (the *Murabahah*; see below), informing even as to the amount of profit.²³ There should also be certainty and a genuine agreement, with each party knowing precisely what they are buying and the price they are paying at the time of

17 Other forms of *riba* pertain to bartering gold, silver and certain foodstuffs: see Nabil A Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge University Press, 2nd ed, 1986) 13–14.

18 The Shariah Advisory Council for the Central Bank of Malaysia (Bank Negara Malaysia) and the Securities Commission of Malaysia generally permits *ta'widh* (or compensation), across the financial sectors, where late penalties are agreed at the time of contracting, set at rates no greater than 1 per cent of arrears and not compounded: Shariah Advisory Council, *Resolutions of the Securities Commission Shari'ah Advisory Council* (2007) Securities Commission of Malaysia, 125 <<http://www.sc.com.my/main.asp?pageid=626&menuid=782>>.

19 See M Mansour Khan and M Ishaq Bhatti, *Developments in Islamic Banking: The Case of Pakistan* (Palgrave MacMillan, 2008), 1–2.

20 See Saleh, above n 17, 11.

21 See Latifa M Algaoud and Mervyn K Lewis, 'Islamic Critique of Conventional Financing' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 38, 40.

22 See Seif El-Din Tag El-Din and M Kabir Hassan, 'Islam and Speculation in the Stock Exchange' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 240.

23 This does not mean prices can be capped, as there are specific and confirmed sayings of the Prophet Muḥammad to the contrary.

contracting. The schools of Islamic law go so far as to require particular verbal formats (*siyagh*), especially where the item has a high financial value, in order to minimise acrimony and misunderstandings among the parties to the deal. All traders should also own what they exchange, or at least have that authority from the owner, exchange only what is physically in their possession and control and, with limited exceptions,²⁴ avoid agreeing to purchase an item yet to exist. Selling ‘short’ and ‘futures’ contracts, until recently accepted practices and prevalent in conventional financial markets,²⁵ are generally prohibited (*haram*) in Islam.

According to Islamic economists, commercial gains should be linked tangibly to the actual production of goods and services and not derived synthetically from mere sales on financial markets. Lawful gains can be obtained by charging fees, leasing, trading of assets and profit and loss investment activities.²⁶ So Islamic banks are allowed to charge fees for looking after their client’s money (through a concept called *wadī’ah*), for remitting funds (*hawālah*) and when participating in financial transactions on their client’s behalf (*wakālah*).

In respect of leasing (*ijarah*), it has the same rationale and operates in similar fashion to a conventional lease, except that responsibility for maintenance and Islamic insurance²⁷ rests with the lessor. Islamic hire-purchase (*ijarah wa iqtina*) is a core business of any Islamic bank, allowing individuals, small businesses and large corporations to rent a movable or immovable asset with the option to purchase the asset at the end of the lease.²⁸ In order to avoid the Islamically prohibited ‘sale within a sale’, the parties prepare separate legal documentation for the tenancy agreement and the option to purchase,²⁹ and avoid (formally at least) stipulating the making of the lease contingent upon making the agreement to purchase.

24 Two exceptions to this principle are the *salam* (pre-paid agricultural supply contracts) and *istisnā’a* (contracts to manufacture), respectively. The former, a ‘futures’ contract, was an established and approved practice at the time of Prophet Muḥammad. The latter is permitted by some of the schools through analogy.

25 Germany has led the way in pre-empting a review of short-selling in Europe, when, on 2 July 2010, the Merkel Government approved a ban on naked short-selling on Euro-area government bonds. See Carla Main, ‘EU Pension Debate, German Short-Selling Ban, GM Stock Bonuses: Compliance’ *Bloomberg* (online), 6 July 2010 <<http://www.bloomberg.com/news/2010-07-06/eu-pension-debate-german-short-selling-ban-gm-stock-bonuses-compliance.html>>.

26 Abbas Mirakhor and Iqbal Zaidi, ‘Profit and Loss Sharing Contracts in Islamic Finance’ in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 49, 52.

27 Islamic insurance (*Takful*) is a mutual fund in which members donate one portion of their premium to a common pool of funds from which fellow members draw to secure themselves from specified risks. See Nik Norzrul Thani, Mohamed Ridza Abdullah and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance* (Sweet & Maxwell, 2nd ed, 2010) 215–221. The other portion of their premium is commonly invested in a profit and loss investment account on a *mudḡrabah* basis, see below nn 36–40.

28 See Seif I Tag El-Din and N Irwani Abdullah, ‘Issues of Implementing Islamic Hire Purchase in Dual Banking Systems: Malaysia’s Experience’ (2007) 49(2) *Thunderbird International Business Review* 225.

29 See Mohammad Hashim Kamali, ‘Shari’ah Issues of Islamic Leasing: Perspectives of the Lessor’ (Paper presented at International Islamic Leasing Conference, Kuwait, 24–5 April 2005) cited in Abu Umar Faruq Ahmad, *Theory and Practice of Islamic Finance: Case Analysis from Australia* (Brown Walker Press, 2010) 219. See El-Gamal, *Islamic Finance – Law, Economics and Practice*, above n 12, 99.

The most popular transaction, accounting for approximately 80 per cent of all transactions in IBF,³⁰ is the *murabahah* or cost-plus sale. Typically, this involves two contracts in which the banker or financier purchases an item at the request of a customer who promises to purchase the asset from the bank at cost price plus a mutually agreed premium. Rarely is full payment made on the spot, so Islamic bankers and financiers combine the *murabahah* with a payment deferral (permitted by consensus)³¹ to produce the Islamic financial instrument known as *bai' bi thaman 'ajil* or *bai' mu'ajjal*.³² The result is a transaction which is sometimes said to mirror a fixed interest loan. The *murabahah* is an extremely flexible instrument and can be used at the retail level for home and car financing, and at the wholesale level for raising capital. The asset, the subject of the *murabahah*, is often real estate, metals, oil or sugar, but it can be any item so long as it is not expressly prohibited by the Sharia, such as pork, pornography and alcohol.

In order to give liquidity to their markets and for short-term financing, IFSPs also make use of same item sale-repurchase with or without an intermediary depending on the particular jurisdiction. In Malaysia and South-East Asia more generally, Islamic financiers use the latter (*bai' al 'inah*) and in the countries of the Gulf Cooperation Council ('GCC'), the former (*tawarruq*).³³ Both practices entail a client selling a permissible item to a financier at cash price who sells it back to the client on credit for a sum equivalent to the principal amount plus a profit margin, as in a classical form of *murabahah*.

Musharakah (*shirkah*, in the classical literature) refers to contractual partnerships in which joint capital is exploited and any ensuing profits and losses shared between the partners. The modern IBF industry tends to allow unlimited partnerships in which the partners contractually determine the precise shares of the profits in excess or below their actual proportionate financial contribution, with the losses fixed according to that proportionate share.³⁴ There is a general expectation that each partner will and can contribute in the management and

30 This has been the case since the inception of modern Islamic banking instigated by Sami Hasan Humud, *Tatwir al-A'mal al-Masrafiyyah bima yattafiqu wa al-Shari'ah al-Islamiyyah* (Dar al-Ittihad al-'Arabi, 1st ed, 1976) cited in Kahf and Khan, above n 15, 26–7.

31 Although the concept is permissible by consensus, the industrial application and documentation is problematic and has proved contentious in Malaysian courts. See *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd* [2008] 5 MLJ 631; *Bank Islam Malaysia Bhd v Lim Kok Hoe* [2009] 6 CLJ 22; *Bank Islam Malaysia Bhd v Azhar bin Osman* [2010] 5 CLJ 54.

32 These alternative Arabic terms (their use depends on the jurisdiction) both indicate the payment has been deferred.

33 This facility is expressly permitted by the Shariah Advisory Council of the Central Bank of Malaysia. The Fiqh Academy of the Organisation of the Islamic Conference ('OIC') and the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI'), the major regulatory body for countries in the GCC, expressly prohibit *al-'inah* but permit *tawarruq*, with conditions. Their different approaches originate in doctrinal differences between the classical schools of Islamic thought and jurisprudence: see El-Gamal, *Islamic Finance – Law, Economics and Practice*, above n 12, 70–3.

34 Mirakhor and Zaidi, above n 26, 51; M Iqbal and P Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave MacMillan, 2005) 20.

operation of the scheme, but where there are sleeping partners, the latter can only receive a proportionate return on their investment.³⁵

Musharakah mutanaqisah or diminishing partnership is a contemporary adaptation of the *musharakah* nominate contract and used predominantly, if not exclusively, in Islamic home financing. It is prevalent in the Middle East, UK, US and Canada and, until recently, the preferred method of Islamic home finance in Australia through the Muslim Community Council of Australia ('MCCA'). Like the contemporary *murabahah*, it is a composite combining the Islamic concepts of partnership and leasing. The financier and the client jointly acquire the asset (*shirkat al-milk*), with the customer gradually increasing beneficial interest in the financed asset until securing full ownership at the end of the contractual period. Until the remaining portion is redeemed, the financier leases its share to the client by charging rent periodically. The periodic rents are shared and change in proportion to the extent of the customer's share.

Mudharabah (or *qirad*) is the 'theoretical workhorse'³⁶ of Islamic finance. It is a special type of partnership in which the capital owner (*rabb al-mal*), necessarily a sleeping partner in this case, advances money to an investment manager (*mudharib*) to trade with it³⁷ and in which they share the profits according to a contractually agreed ratio. There is no need to set up a company. Losses are borne solely by the capital owner, with the investment manager risking only his labour and time. *Mudharabah* contracts are used in two ways by Islamic banks (often termed 'two-tier *mudharabah*'). First, with the bank as the *mudharib* and the depositor as *rabb al-mal*. The bank receives the money under a contract of safekeeping (*wadi'ah*), and then invests the depositor's money (with his consent, formally obtained when opening the Islamic bank account) in various schemes.³⁸ Second, with the bank as the *rabb al-mal*, providing start-up capital to an entrepreneur. Yet in this instance, the bank will often require collateral (*rahn*) and impose conditions on the client.³⁹ In both instances, profits (supposing there are any) will be shared between the bank and the client, according to their prior agreement, and will take the place of the interest paid or received by a conventional bank. While this offers the investor potentially greater returns than they would receive via an interest rate, the *mudharabah* contract also exposes the investor to the risk of loss – so even a customer's original deposits may not be guaranteed.⁴⁰

35 Iqbal and Molyneux, above n 34.

36 El-Gamal, *Islamic Finance – Law, Economics and Practice*, above n 12, 120.

37 This is the position of the Shafi'i and Maliki schools. The Hanafi School allows *mudharabah* contracts for manufacturing: see Saleh, above n 17, 104.

38 These can be general investment funds, where the bank chooses precisely where to invest; or specific investment funds where the investor is given a choice as to which projects he wants to invest in. See: Saleh, above n 17, 102; Iqbal and Molyneux, above n 34, 21–2.

39 See Saleh, above n 17.

40 See *ibid* 106. However, this has not stopped some Islamic banks utilising 'liberal' interpretations in an attempt to guarantee profits in order to mirror the returns investors obtain in conventional banks: see Humayon A Dar, 'Incentive Compatibility of Islamic Financing' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 85.

As the risk is 'skewed' in favour of investment managers in *mudārabah* contracts,⁴¹ much relies upon their honesty and trustworthiness.⁴² A trust (*amin*), therefore, is imposed upon them and they should comply with the express terms of the specific *mudārabah* entered into, if any, or with the implied terms of the *mudārabah* law in their absence. The general rule is that the *mudārib* should exercise the same degree of caution which any prudent person would in those circumstances – but the schools of Islamic law have interpreted this rule differently in light of local merchant custom (*urf*).⁴³ This means that the standards of prudence required of the *mudārib* can vary from region to region, where there are no requirements stipulated in the *mudārabah* contract.

Sukuk (plural of *sakk*, meaning a deed or cheque) are normally referred to as 'Islamic bonds', but better described as trust or investment certificates⁴⁴ representing proportionate or undivided shares in the profits or revenues of large enterprises.⁴⁵ Unlike conventional bonds, certificate holders are (or should be)⁴⁶ true owners of a portion of the underlying asset⁴⁷ and share in the actual success or failure of the enterprise. There are a wide variety of legal structures for *sukuk*⁴⁸ and can be based on *ijarah*, *murabahah*, *musharakah* or *mudārabah* concepts. Where, however, the underlying contract is a *murabahah*, the *sukuk* cannot be sold on the secondary market because of the prohibitions surrounding debt sales in the Sharia.⁴⁹

41 Dar, above n 40.

42 Iqbal and Molyneux, above n 34, 21.

43 See Saleh, above n 17, 107.

44 The main standards setting agency across the GCC, the AAOIFI, defines *sukuk* as: 'certificates of equal value representing receipt of the value of the certificates, which value is applied to a planned and designated use, common title to shares and rights in tangible assets, usufructs and services, equity of a given project, or equity of a special investment activity': Michael J T McMillen, 'Islamic Project Finance' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 200, 227.

45 Muhammad Taqi Uthmani, 'Sukuk and Their Contemporary Applications' (Speech delivered at the AAOIFI, November 2007) <<http://www.scribd.com/doc/31788013/Sukuk-and-Their-Contemporary-Applications-by-SHEIKH-MUHAMMAD-TAQI-USMANI>>.

46 According to the Sharia Guidelines issued by AAOIFI in 2008, sukuk holders should be 'true owners' and share in the liabilities as well as the benefits of ownership: cited in Tan Wan Yean, *Sukuk: Issues and the Way Forward* (21 September 2010) International Lawyers Network <http://www.iln.com/articles/pub_1674.pdf>.

47 This means legal and beneficial ownership and so should not be confused with company shares in western markets that merely grant the right to a return from shares: *ibid* 3. In other words, the sukuk should be 'asset-backed' rather than 'asset-based' However, the predominant practice of many sukuk issuers has been to transfer beneficial ownership only so as to mirror conventional unsecured bonds: see Khalid Howladar, *The Future of Sukuk: Substance Over Form* (31 May 2009) CPI Financial <<http://www.cpifinancial.net/v2/fa.aspx?v=0&aid=260&sec=Islamic%20Finance>>.

48 Current AAOIFI guidelines provide 14 eligible asset classes: cf McMillen, above n 44, 228. For further details, including the Shari'ah standards issued by AAOIFI, see AAOIFI, *AAOIFI Key Publications* <<http://www.aoifi.com/keypublications.html>>.

49 Where a sukuk consists of a mixed portfolio and one of the projects is based upon a *murabaha*, IFSPs have tended to permit sale of that sukuk on the secondary market where the *murabaha* comprised only a small proportion of the overall portfolio; AAOIFI above n 48, 3–4.

III ISLAMIC BANKING AND FINANCE IN THE AUSTRALIAN CONTEXT

A Determining the Market for IBF in Australia and the Regulatory Challenge

Although there are 17 approved foreign banks and a number of foreign subsidiaries, including the Arab Bank and HSBC, in Australia,⁵⁰ none of them nor any of the high street banks, offer Islamic ‘windows’. Both the Arab Bank and HSBC have Islamic subsidiaries outside Australia, but do not offer any Islamic products locally. The only foreign subsidiary offering Islamic financial services is Kuwait Finance House (located in Melbourne). Currently, there are only three Australian organisations offering finance products to the local retail sector⁵¹ labelled ‘Sharia Compliant’: the MCCA,⁵² Islamic Co-operative Finance Australia Limited (‘ICFAL’),⁵³ and Iskan Finance.⁵⁴ In terms of Islamic fund management, there exists Crescent Investments, and LM Investment Ltd, a conventional income funds manager, which launched its ‘Australian Alif Fund’ in May 2009, the first global onshore Islamic investment fund in Australia.⁵⁵

One reason for the relative absence of a large-scale retail facility is the size and capacity of the Australian Muslim market. Although there is a combined Muslim population of 236 million in neighbouring South-East Asia, the number of Muslims in Australia remains very small. Out of a total of 22 million scattered across nine states, only 1.5 per cent (340 000) profess Islam, with the majority living in NSW and Victoria.⁵⁶ In recent years, there has been a big percentage increase in the numbers of migrants arriving from North Africa and the Middle East,⁵⁷ but it is likely Muslims are no more than 2 per cent of the current total

50 See Australian Prudential Regulation Authority, *Foreign Subsidiary Banks* (8 April 2011) <<http://www.apra.gov.au/adi/adilist.cfm#FSB>>.

51 For a detailed analysis and critique of the practical operations and products offered by these three organisations, see Abu Umar Faruq Ahmad, *Theory and Practice of Islamic Finance: Case Analysis from Australia* (Brown Walker Press, 2010). This is a development of the author’s PhD thesis and based primarily on materials and data obtained in 2004. Although out of date, it provides a useful starting point for understanding the challenges for local operatives in the IBF sector in terms of compliance with both Sharia laws and state and federal regulations.

52 MCCA Islamic Finance & Investments, *Home Page* (20 May 2011) <<http://www.mcca.com.au>>.

53 Islamic Co-operative Finance Australia Limited, *About Us* <http://www.icfal.com.au/about_us.htm>.

54 Iskan Finance, *About Iskan* <<http://www.iskan.com.au/about-iskan.aspx>>.

55 See LM Investment Management Limited, *Home Page* <<http://www.lmaustralia.com>>.

56 Department of Immigration and Citizenship (Cth), *Muslims in Australia – A Snapshot* <http://www.immi.gov.au/media/publications/multicultural/pdf_doc/Muslims_in_Australia_snapshot.pdf>.

57 Department of Immigration and Citizenship (Cth), *Fact Sheet 2 – Key Facts in Immigration* <<http://www.immi.gov.au/media/fact-sheets/02key.htm>>.

Australian population.⁵⁸ Moreover, many of the Muslim community in Australia suffer social marginalisation and economic disadvantage, with higher unemployment rates and lower wages than the wider population.⁵⁹ They might find the often relatively high price of IBF retail products prohibitive.⁶⁰

Empirical research on attitudes towards IBF has been limited, in Australia as well as elsewhere. Only two known studies have been carried out to date, and only one on individual customers' attitudes, by Rammal and Zurbruegg.⁶¹ Their research was carried out in Adelaide in June 2004 and showed genuine interest amongst practising Muslims in the idea of Islamic banking products – but a lack of familiarity with Islamic brands and understanding of Islamic principles of financing.⁶² The other study by Jalaluddin in 1999⁶³ surveyed the attitudes towards profit and loss finance methods of 385 small businesses and 80 financial institutions in Sydney. He noted that 60 per cent of his small business respondents (the majority of whom were non-Muslim) expressed an interest in profit and loss (ie, *mudārabah*) financial arrangements and more than 40 per cent of the financial institutions were prepared to lend on that basis.

The latter study suggests policy makers should look beyond the actual numbers of the Muslim population when determining the potential market; IBF is

58 Further, it should not be assumed all, or even a majority of this population would be consumers of IBF products. Religious motivation is not always the determining factor. First, while persons may identify themselves as 'Muslim', they may not pursue the religion as a complete way of life, preferring secular lifestyles and conventional methods of doing business and arranging finance. There are no figures of 'strict observers' as opposed to 'nominal believers', but the relationship between doctrine and practice is as complex in Australia as elsewhere. See Uldis Ozolins, 'Diaspora, Islam, Australia: Reflections on Australian Arab Case Studies' (2008) 32 *Journal of Australian Studies* 207. Further, even practising Muslims can receive mixed messages on the benefits of IBF because of ethnic or linguistic differences, or due to opposition from religious factions (as IBF issues are frequently contested). Pakistan, for example, is regarded as one of the founding fathers of the IBF industry and one of the largest Muslim countries in the world. The majority of its population, however, has yet to embrace IBF wholeheartedly: see Hussain Gulzar Rammal, 'Islamic Banking in Pakistan: Past, Present and Future' (2010) 7(29) *Islamic Finance News* 13. See also Khan and Bhatti, above n 19, 181.

59 See Abe W Ata, *Us and Them: Muslim-Christian Relations and Cultural Harmony in Australia* (Australia Academic Press, 2009) 14–15; Janet Phillips, *Muslim Australians* (6 March 2007) Parliament of Australia <http://www.aph.gov.au/library/INTGUIDE/sp/muslim_australians.htm>.

60 Low income has been cited as a factor for not taking up Islamic finance in other jurisdictions: see Y Zainuddin, N Jahyd and T Ramayah, 'Perception of Islamic Banking: Does it Differ Among Users and Non Users' (2004) 6(3) *Jurnal Manajemen dan Bisnis* 221, cited in A H Gait and A C Worthington, 'An Empirical Survey of Individual Consumer, Business Firm and Financial Institution Attitudes towards Islamic Methods' (Working Paper, School of Accounting and Finance, University of Wollongong, 2007–08) 7 <<http://ro.uow.edu.au/acffinwp/8>>.

61 See Hussain Gulzar Rammal and Ralf Zurbruegg, 'Awareness of Islamic Banking Products Among Muslims: The Case of Australia' (2007) 12 *Journal of Financial Services Marketing* 65. For a case study of IBF in Australia: see Abdullah Saeed, 'The Muslim Community Cooperative of Australia as an Islamic Financial Service Provider' in Abdullah Saeed and Shahram Akbarzadeh (eds), *Muslim Communities in Australia* (UNSW Press, 2001) 188.

62 Rammal and Zurbruegg, above n 61, 71–2.

63 Abul Jalaluddin, *Attitudes of Australian Small Business Firms and Financial Institutions towards the Profit/Loss Sharing Method of Finance* (PhD Thesis, University of Wollongong, 1999). See also A Jalaluddin and M Metwally, 'Profit/Loss Sharing: An Alternative Method of Financing Small Businesses in Australia' (1999) 11 *Middle East Business and Economic Review* 8.

not just for Muslims.⁶⁴ Evidence from Malaysia indicates a substantial take-up from non-Muslims attracted by the fair terms and quality of Islamic products.⁶⁵ Also in Singapore, more than half of Singapore's OCBC Al-Amin Islamic Bank's customers are non-Muslim.⁶⁶

Foreign Islamic banks or local banks through Islamic 'windows', however, are likely to require more positive evidence before entering the Islamic retail sector in Australia.⁶⁷ Singapore has a population of more than 500 000 Muslims but only OCBC, Maybank and the Islamic Bank of Asia ('IB Asia')⁶⁸ offer a retail product to service that community. Although Islamic wholesale commercial banking, wealth management and capital markets continue to grow, Islamic retail banking has been neglected. Local commentators believe this is because there is no official data on the demographics of the Muslim population in Singapore.⁶⁹ More data is also required in Australia that would better indicate the capacity and desire of Muslim communities to patronise Islamic banking services and products.

According to Thani, Abdullah and Hassan,⁷⁰ the IBF sector requires more than a receptive market; it also needs an enabling legal environment for both the retail and wholesale markets to prosper. In their analysis of the experiences of several countries, key factors in the successful development of IBF have been: clear policy decisions and directions coordinated by local financial regulations; legislation establishing, licensing and supervising institutions offering IBF services and clarifying the difference with conventional services; comprehensive and precise mechanisms that ensure systemic Sharia compliance, supervised by qualified Sharia scholars as part of a Sharia Advisory Board (SAB); taxation-friendly frameworks which enable IBF providers to compete effectively with providers of conventional finance; supporting infrastructures, including accounting standards and human resource development; and participation in

64 See Hussain, above n 12, 8.

65 See Angelo Venardos, *Islamic Banking and Finance in South East Asia – Part 2: Its Development and Future* (2005) Intellitrain, 1
<http://www.intellitrain.biz/articles/exp_islamic%20banking%20&%20finance%20in%20sea_pt2.pdf>.
The prevalence of non-Muslim investors in Malaysia's AmIslamic Bank was also confirmed by:
Interview with Mahdi Murad, Executive Director of AmBank (Kuala Lumpur, 13 August 2009);
Interview with Jamaiyah Mohammed Nor, General Manager, AmIslamic Bank (Kuala Lumpur, 13 August 2009).

66 See 'More Non-Muslims Trying Islamic Banking: OCBC' *Business Times* (online), 1 December 2008
<http://www.btimes.com.my/Current_News/BTIMES/articles/20081201152232/Article/>.

67 Interviews with Emmanuel Alfieris, Head of Financial Institutions and Trade, Global Transactional Banking Westpac Institutional Bank (31 July 2009); Rodney Maddock, Executive General Manager, Group Strategy Development, Commonwealth Bank (27 August 2009); Imran Lum, Community and Development Manager, National Australia Bank (Melbourne, 7 October 2009) confirmed the major banks had investigated the viability of a retail product but concluded there was an insufficient market.

68 IB Asia received a full banking licence from the Monetary Authority of Singapore ('MAS') and was launched on 7 May 2007. The bank comprises 22 Middle Eastern investors from prominent families and groups in the GCC. See Nik Norzrul Thani, Mohamed Ridza Abdullah and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance* (Sweet & Maxwell Asia, 2nd ed, 2010) 326.

69 Feature, 'On the Right Track', *Finance Asia Magazine* (Hong Kong), May 2011, 44.

70 See Thani, Abdullah and Hassan, above n 68.

global initiatives, such as the Islamic Financial Services Board.⁷¹ The following section, therefore, takes a look at the Australian regulatory framework to see to what extent it meets these core criteria. A particular focus will be on the prudential and taxation arrangements.

IV THE REGULATORY FRAMEWORK

A The Regulators: Role and Function

Like many Western economies, Australia utilises a combination of market and government mechanisms to regulate the banking and finance industries.⁷² Government involvement operates to prevent market failure and also to facilitate efficient running of the markets.⁷³ Australia uses three government regulatory agencies at the federal level: the Australian Prudential Regulation Authority ('APRA'); the Australian Securities and Investment Commission ('ASIC') and the Reserve Bank of Australia ('RBA').

APRA enforces prudential legislation and is charged specifically with protecting the interests of depositors, insurance policy holders and superannuation fund members.⁷⁴ Islamic deposit-taking institutions, such as banks and cooperatives, and those running *Takaful* (Islamic insurance) operations, therefore, would have to deal with APRA. Under the *Banking Act 1959* (Cth), APRA can exert a significant degree of supervisory control through insertion of conditions requiring the holder of a licence to comply with any of its inquiries or directives.

Islamic fund managers and issuers of *sukuk* would have to deal with ASIC. It exercises jurisdiction in matters that would fall outside the competency of APRA, such as supervision of financial securities, financial instruments and stock exchanges. Like APRA, it has considerable scope to supervise IFSPs through the conditions it imposes on its licensees and the need for self-reporting of breaches. ASIC's responsibilities fall under the *Corporations Act 2001* (Cth) and are concerned more with market integrity in general and consumer protection. It has civil and criminal jurisdiction,⁷⁵ has powers to investigate corporations,⁷⁶ inspect books,⁷⁷ call witnesses,⁷⁸ require disclosure on the detail of financial products,⁷⁹

71 Ibid 41–2.

72 For more in-depth description and analysis of the current framework than is provided below, see Sheelagh McCracken and Anna Everett, *Everett and McCracken's Banking and Financial Institutions Law* (Thomson Reuters, 7th ed, 2009).

73 Financial System Inquiry (Cth), *Financial System Inquiry Final Report* (1997) 14.

74 *Australian Prudential Regulation Act 1998* (Cth), as amended by the *Australian Prudential Regulation Authority Amendment Act 2003* (Cth).

75 *Australian Securities and Investments Commission Act 2001* (Cth) ss 49–50 ('ASIC Act').

76 *ASIC Act* s 13.

77 *ASIC Act* ss 28–39B.

78 *ASIC Act* ss 19–27.

79 *ASIC Act* ss 40–1, 43, 47–8.

and hold public hearings.⁸⁰ ASIC, therefore, has considerably more powers than APRA and is the main policing body of the financial services industry. This includes cross-border surveillance activities, both in traditional overseas markets (UK, Europe and US) and more locally, such as in Indonesia.⁸¹

The RBA, formally independent of the Federal Government, decides on monetary policy (in much the same way as the Bank of England) and works to ensure stability of the financial system as a whole. Its responsibilities are covered by the *Reserve Bank Act 1959* (Cth). Since 1998, it has not been involved with prudential regulation of banks or other deposit-taking institutions.

In addition to supervision from government regulators, IBF service providers have to comply with directives from their market regulators, who are themselves subject to directives from ASIC and the overall supervision of the Minister.⁸² Market regulators are empowered by the Federal Government to issue market licences, and have additional rights to notification and assistance from financial service providers in relation to the specific matters stated in the *Corporations Act*.⁸³ Currently, there are 15 licensed domestic financial markets,⁸⁴ but the primary market in securities and derivatives is provided by the Australian Securities Exchange. Market licences are granted by the Minister on application to and with advice from ASIC. To obtain and maintain a licence, the operator must comply with certain statutory obligations and membership requirements as well as adopt particular structures. The latter includes: applying as a body corporate; having compensation regimes for retail clients, as well as formal arrangements with ASIC to avoid conflicts of interest. The Minister might also attach conditions to a licence in addition to issuing particular directives with which a licensee is statutorily bound to comply. It is the primary responsibility of the market licensee to supervise the activities of its participants, and ensure that business is carried on fairly, with transparency and in an orderly manner.⁸⁵ This includes ensuring arrangements for handling of conflicts, monitoring conduct and enforcing compliance with the market's rules. Failure to comply with the rules can result in cancellation of the licence and, in more serious cases of infringement, investigation and prosecution by ASIC.⁸⁶

80 *ASIC Act* ss 51–4.

81 See ASIC, *ASIC Annual Report, 2008–9* (2009) 33–4 <[http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Annual_Report_08-09_full.pdf/\\$file/ASIC_Annual_Report_08-09_full.pdf](http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Annual_Report_08-09_full.pdf/$file/ASIC_Annual_Report_08-09_full.pdf)>.

82 Ministers administering the *ASIC Act* are found by referring to Administrative Arrangements Order, published in the Gazette. In this context, it would refer to the Parliamentary Secretary to the Treasurer (currently, David Bradbury): see Department of Treasury (Cth), *Ministerial Responsibilities within the Treasury Portfolio* <<http://parlsec.treasurer.gov.au/DisplayDocs.aspx?doc=portfolio.htm&PageID=091&min=djb>>.

83 *Corporations Act 2001* (Cth) ss 792–4.

84 See ASIC, *Licensed Domestic Financial Markets Operating in Australia* <<http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Licensed%20domestic%20financial%20markets%20operating%20in%20Australia>>.

85 *Corporations Act 2001* (Cth) s 792A.

86 *ASIC Act* ss 13, 49.

Currently, there is no mechanism in Australia that would compel IBF providers to comply with regulations and directions of the international Islamic regulatory bodies, whether directly or indirectly. There are two international standards-setting bodies: the Islamic Financial Services Board ('IFSB') and the AAOIFI. The former is an association of central banks, monetary authorities and other institutions responsible for regulation and supervision of Islamic financial services. Its primary purpose is to set and harmonise standards for supervision and regulation internationally that are consistent with Sharia principles.⁸⁷ The IFSB also liaises and coordinates with standards-setting bodies from the conventional sector to promote stability and disseminate best practices. One of its most important functions to date has been the adaptation of Basel II (and now III) on capital adequacy requirements to IBF providers.⁸⁸

The AAOIFI is an autonomous international Islamic organisation which prepares accounting, auditing, governance, ethics and Sharia standards for IBF service providers. Its members are drawn from certain Islamic financial institutions and *fiqh* academies, including the Fiqh Academy of the Organisation of the Islamic Conference (OIC). The AAOIFI complements the IFSB through the setting and harmonising of Sharia standards.⁸⁹

The rulings, standards and guidelines of both organisations are voluntary in nature but have been incorporated (directly and indirectly) into the domestic laws of some jurisdictions. In both Dubai and Bahrain, for example, the rulings of the AAOIFI are incorporated into local law.⁹⁰ In Malaysia, on the other hand, they serve as benchmarks for general Sharia compliance, though ultimately decisions are left to the Sharia Advisory Councils of the Malaysian Central Bank and the Malaysian Securities Commission, respectively.⁹¹ The Malaysian Central Bank, as Malaysia's prudential authority, also takes into account the guidelines issued by the IFSB when issuing its own guidelines on appropriate governance and supervisory frameworks for IBF service providers (though is not technically bound).⁹²

In line with the suggestions of Thani, Abdullah and Hassan, amending current Australian legislation to require the Australian regulators to refer to the standards of AAOIFI, and the IFSB in particular, would fill an important gap in the Australian context and facilitate further development.

B The Regulatory Legislation

The principal piece of legislation with which all financial service providers across all states must comply is the *Corporations Act 2001* (Cth). Matters

87 Thani, Abdullah and Hassan, above n 68, 28–9.

88 Ibid 105, 347–52.

89 Ibid 29.

90 Ibid 346–7.

91 Ibid. Further, under Malaysian law, local courts must refer to the Sharia Advisory Council for any ruling concerning Sharia matters; there is no residual discretion given to the court: *Central Bank of Malaysia Act 2009* (Malaysia) ss 56–7.

92 Thani, Abdullah and Hassan, above n 68, 114.

relating to companies under its purview include: issuance of shares and debentures, managed investment schemes, continuous disclosure and fundraising. In addition, the Act covers: the licensing of financial markets, financial service providers, and clearing and settlement facilities; compensation regimes; financial product disclosure; and conduct in relation to financial products. The problem for IFSPs, is that as their products often involve multiple investors, they could be regarded as a 'management investment schemes' and required to register with ASIC.⁹³

In addition to the *Corporations Act 2001* (Cth), there is consumer credit legislation with which IFSPs would have to comply even though their services might be described more accurately as 'equity-based' rather than 'debt-based'. Islamic banks, for example, operate more like managed funds than a so-called bank, as they invest the depositor's money in equities which do not have a fixed return. This is also true in respect of Islamic financing for home purchases and cars based on *musharakah* principles, such as the diminishing *musharakah*. As for financing based upon a *murabahah* nominate contract, however, this would be founded on a debt so the Australian authorities would regard them as de facto credit arrangements, and thus subject to the *National Consumer Credit Protection Act 2009* (Cth) ('*NCCPA*'). This legislation applies to all financial institutions, including building societies and credit unions. The crux of the legislation is to protect consumers, and it requires full disclosure. If complaints arise as to unfairness, contracts can be re-opened and reviewed judicially. As part of the disclosure regime, the *NCCPA* requires financial institutions to state specifically the 'credit charge' or annual rate of interest charged in return for the home finance. In an Islamic Home Finance package, therefore, the 'rents' payable would need to state the degree of 'profit' remitted periodically to the provider, which they are obliged to label as 'interest' in their legal documentation.⁹⁴ They must also show how their rates compare with similar providers. The problem for local Islamic financial service providers is that Islamic finance has often been more expensive than a similar conventional product and so not only may their charges appear uncompetitive, but the required labelling will also undercut their marketing of an Islamic 'interest-free' product.⁹⁵

If an IFSP intended to set up a 'banking business', it is also subject to the *Banking Act 1959* (Cth). In order to be a 'bank' within the terms of the legislation, the institution must receive deposits and make advances; there is no requirement that the institution must pay or impose interest. On that basis, there is no insurmountable obstacle for an Islamic institution to becoming a 'bank'

93 Johnson Report, below n 133, 97.

94 *NCCPA* sch 1 pt 2 div 1 ss 17(3)–(6).

95 For more detail on this issue, see Ahmad, above n 29, 166–8. The MCCA also allude to this difficulty on their website and explain that being required under Australian law to label a financial return as 'interest' does not mean that it is in Islamic teachings – it is the nature of the return that matters (which they maintain is 'profit'), and not its form. See also the Factsheet for Amlak and Tamleek: MCCA, *Consumer Finance* <<http://www.mcca.com.au/Pages/ConsumerFinancing.html>>.

under Australian law. The key issues that block such institutions from receiving a banking licence relate to: (i) absence of guarantees over the principal sum deposited; (ii) capital adequacy requirements under the Basel II formula; and (iii) possible absence of a local SAB and conflicts of interest.

As to the first issue, the participants in an Islamic bank will view all deposit, savings and investment accounts as a *mudharabah* where profits and losses are shared. In principle, therefore, neither the original deposit nor returns on the invested funds can be guaranteed. Bank Islam in Malaysia, for example, provides a return to simple deposit account holders by way of gift (*hibah*), but stops short of guaranteeing any specific sum.⁹⁶ Yet the regulator in Australia would insist on guarantee of the deposits as a minimum. One way around this would be to take the approach of the Islamic Bank of Britain ('IBB'). The IBB followed the UK's mandatory deposit and return structure, but gave Muslim investors the choice to reject acceptance of payments in respect of those bank assurances where application of the Sharia would have precluded such payments.⁹⁷ The regulator secures the guarantee, but Sharia compliance rests on the religious ethics of the account holders. Given the religious motivation of most participants and accounts' holders, this voluntarist compromise could work. However, if Islamic banks attracted a more diverse client base interested more in the financial return than the religious ethic, a client's insistence on return of the deposit could be a problem; at least from the perspective of the Sharia (as forwarding the payment would assist in the commission of a sin).

In relation to the second issue, the Capital Adequacy Requirement ('CAR') is one of the key 'pillars' of the Basel II framework which APRA is required to apply to all banks, including Islamic banks, in the interests of Australian depositors.⁹⁸ This requires banks to hold a *minimum* amount of capital to protect them and their investors from categories of risk and to have their own internal supervisory structures to ensure maintaining of adequate capital and the presence of policies and processes commensurate with their particular risk profile.⁹⁹ The exact amount of capital is at the discretion of the regulators and will depend on their perception of the bank's risk profile; the greater the perceived risk, the higher the amount. However, the higher the amount, the less funds are made available for investment and the more difficult for banks, especially the smaller institutions, to compete. It is essential, therefore, for the regulator to apply the 'right' formula and to match the CAR to a bank's true risk profile; leaning too

96 See Bank Islam, *Wadiah Savings Account-i* <<http://www.bankislam.com.my/en/Pages/WadiahSavingsAccount-i.aspx?tabs=1>>.

97 Michael J T McMillen, 'Securities Laws, Enforceability and Sukuk' in Rifaat Ahmed Abdel Karim and Madzlan Mohamad Hussein (eds), *Islamic Finance: Surveys on Global Legal Issues and Challenges* (Islamic Financial Services Board, 2008) 69, 77.

98 Maryanne Loughnan and Douglas Drummond, 'Borrowing and Investing Out of Haraam's Way' (2010) 48(4) *Law Society Journal* 63.

99 Hennie Van Greuning and Zamir Iqbal, 'Risk Analysis for Islamic Banks' (World Bank, 2008) 222–3, 231–2.

much one way or the other could have disastrous consequences for the bank or its depositors.¹⁰⁰

The problem for potential Islamic banks is that the regulator may regard them as more prone to risk and impose a penal capital requirement because of the way they operate. Like any other bank, Islamic banks work in a competitive environment so they tend to pay market-related returns to their account holders. In practice, Islamic banks stabilise profit payouts through a Profitisation Equalisation Reserve ('PER') and cover periodic losses through the accumulated funds of an Investment Risk Reserve ('IRR').¹⁰¹ The former consists of appropriations drawn from the profits of both the bank shareholders and the account holders. The latter comprises the profits of account holders only after deducting bank management fees and their contractually agreed profit. However, where asset returns are low or there are losses, because of competitive pressures the bank may also transfer some of its own additional resources to the PER. It may also voluntarily reduce its own share in the *mudharabah* arrangement to absorb the losses or drops in profits. As a result, market or commercial risk is displaced from the account holders to the shareholders of the bank.¹⁰²

The difficulty for the regulator, then, is how to estimate or measure this 'displaced commercial risk' and how much capital they should ask the Islamic bank to set aside to protect against such exposure.¹⁰³ Both AAOIFI, based in Bahrain, and the Islamic Financial Services Board ('IFSB') in Kuala Lumpur have their suggested guidelines and formulas for determining the CAR in the context of Islamic banking practices,¹⁰⁴ and would likely be referred to by APRA. However, they would not be able to fix a ratio for Islamic banks generally as it will depend ultimately on the adopted policies of the particular Islamic bank in question (namely, to what extent they will agree to absorb the losses) and the availability of historical data on the performance of their assets.

The need for Australian institutions to have a locally vetted SAB, without conflicts of interest, might also be a stumbling block. In the IBF industry in general, there is a relative scarcity of scholars with sufficient knowledge and experience of IBF.¹⁰⁵ The problem is accentuated in Australia because of the small Muslim population and the numbers of scholars in the local community. The same scholars frequently sit on multiple Sharia Advisory Boards and assume several roles, giving advice on Sharia compliance as well as performing an audit.

100 See generally Simon Archer, Rifaat Ahmed Abdel Karim and Vasudevan Sundararajan, 'Supervisory, Regulatory, and Capital Adequacy Implications of Profit-sharing Investment Accounts in Islamic Finance' (2010) 1 *Journal of Islamic Accounting and Business Research* 10.

101 Ibid 12.

102 Ibid 15–16.

103 Ibid 18.

104 IFSB, *Published Standards* <<http://www.ifsb.org/published.php>>.

105 See Mohammed Abbas, 'Shortage of Scholars Troubles Islamic Banking', *New York Times* (online), 2 February 2008 <<http://www.nytimes.com/2008/01/22/business/worldbusiness/22iht-bank.4.9412578.html>>.

This can raise questions as to their independence.¹⁰⁶ Where they are very well-known figures, members of the SAB might be regarded as ‘shadow directors’ on the Boards of Islamic Banks and could bring them into conflict with the regulator.¹⁰⁷ Although there are global guidelines and prudential standards issued by the IFSB to mitigate such conflicts,¹⁰⁸ these are only voluntary in nature and so would require specific incorporation at the national level.

C Taxation

Perhaps of greatest importance for overseas IFSPs is Australia’s tax regulatory framework. Most relevant to potential Islamic financiers and investors are: stamp duty, mortgage tax, withholding tax (‘WT’), goods and services tax (‘GST’), income tax and capital gains tax (‘CGT’). All of the possible tax implications of IBF transactions are beyond the scope of this paper, but stamp duty, mortgage tax and WT are worthy of particular mention.¹⁰⁹

Stamp duty is a state-based tax, so the particular regime will depend with which state the IFSP is considering to deal. Because it is so financially lucrative to the states concerned, all states impose ad valorem duty on ‘dutiable property’ transactions which include absolute transfers in land, interests in land, business assets and shares in an unlisted (ie, not listed in a recognised exchange) company.

IBF transactions are not targeted deliberately for unequal treatment, but owing to the double transfer of a property in a common Islamic home purchase arrangement – for example, by way of *bai bi-thaman ‘ajil* (‘BBA’) or *musharakah mutanaqisah* (‘MM’) – they are penalised by double stamp duty. As a result of successful lobbying by the MCCA and reforms passed in 2004, Victoria took measures to ensure that *murabahah* and *musharakah* lease-sale arrangements would only incur stamp duty upon the initial transfer to the financial institution and not when the title is transferred to the ultimate

106 Hussain G Rammal and Lee Parker, ‘Audit and Governance in Islamic Banks: Selection and Training of Shari’ah Advisors’ (Paper presented at the Sixth Asia Pacific Interdisciplinary Research in Accounting Conference, Sydney, 11 July 2010) 27
<http://apira2010.econ.usyd.edu.au/conference_proceedings/APIRA-2010-268-Rammal-Audit-and-governance-in-Islamic-banks.pdf>.

107 See Johnson Report, below n 133, 98.

108 See IFSB, ‘IFSB 3 Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)’ (Published Standard No IFSB-3, Islamic Financial Services Board, December 2007) 3.

109 I owe a debt to the industry of my research assistant, Fadi Schmeissen of BT Financial Group, for much of this section on Australian taxation law.

consumer.¹¹⁰ For NSW, however, this form of ‘double stamp duty’¹¹¹ still applies and is passed on to the consumer, making it potentially uncompetitive.¹¹²

The financial impediments are exacerbated by the continuation of mortgage duty in NSW, though this is scheduled to be phased out in July 2012. The duty is payable on mortgages and charges which secure an ‘advance’. This is defined to include a loan or a transaction which is in substance a (de facto) loan, and would thereby encompass both the BBA and MM arrangements. Where, however, the charge is imposed to secure an option to purchase the land or goods, this will not be deemed an ‘advance’ and no mortgage duty will be payable.¹¹³ Where the exception does not apply, the amount of duty charged will be 0.4 per cent of the amount secured above \$16 000. This is payable by the mortgagor only.¹¹⁴ Given that the most popular form of *sukuk* is constructed upon ‘lease-sale’ arrangements (*sukuk ijarah*), this also represents a disincentive for a local *sukuk* issuance.¹¹⁵

An Islamic investor purchasing an Australian business would also be affected by stamp duty when the business assets are transferred. Queensland is the only State where duty would also be charged on the stock (if any) of the operating business.

Unlike stamp duty, WT is imposed at the federal level, and applies to payments of interest, dividends and royalties made by an Australian resident to a recipient overseas. It is a direct tax on foreign investment and is paid to the Australian Tax Office (‘ATO’) before exporting any of the profits overseas. It is charged at a flat rate of 10 per cent for interest, 15 per cent for dividends and 30 per cent for royalties. In the case of dividends, if there is no double taxation agreement between the two countries, the resident company or payer would need to pay 30 per cent WT.¹¹⁶ It should be noted that although a double taxation agreement exists between Australia and Malaysia,¹¹⁷ there are no double taxation agreements with the GCC, meaning that 30 per cent of the profit from dividends (in relation to corporate entities located in Australia) will need to be paid to the

110 *Duties Act 2000* (Vic) ss 57A–F.

111 The lifting of ‘double stamp duty’ mentioned in *Duties Act 1997* (NSW) s 18 and *Duties Act 2000* (Vic) s 17 refer to a single ‘dutiabale transaction’ which is effected by multiple documents. The Islamic arrangements clearly involve more than one transaction as many years may pass between the two transfers.

112 The problems of competitive pricing of Islamic products in predominantly non-Muslim jurisdictions have been examined by other writers: see Kilian Balz, ‘Islamic Finance for European Muslims: the Diversity Management of Shari’ah-Compliant Transactions’ (2007) 7 *Chicago Journal of International Law* 551, 556.

113 I am grateful to Andrew Boxall, a partner at Allens Arthur Robinson in Sydney, for clarifying this point and other difficulties relating to stamp duty.

114 See the most recent NSW government fact sheet: Office of State Revenue, NSW Treasury, *NSW Duties Rates* (July 2009) <http://www.osr.nsw.gov.au/lib/doc/factsheets/ofs_dut01.pdf>. See also *Duties Act 1997* (NSW) ss 32–3A which set out the rates of duty.

115 I am also grateful to Alex Regan, see above n 4, for this insight.

116 See John A Grieg, ‘Aspects of Interest Withholding Tax’ (1993) 3 *Revenue Law Journal* 27, 28.

117 *Convention between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 20 August 1980, [1981] ATS 16 (entered into force 26 June 1981).

ATO. In order to comply with ATO directions and the tax legislation, a person who is liable for WT must register with the ATO and make WT payments within the appropriate time frame, which differs depending on the size of the particular withholder.¹¹⁸

In terms of its application to IBF, section 128A(1AB) of the *Income Tax Assessment Act 1936* (Cth) ('ITAA36') has an extended definition of 'interest' to include payments: 'in the nature of interest', 'in substitution of interest' or dividends paid in respect of non-equity shares. As the majority of *murabahah* or *musharaka/ijarah* composite property deals are based on deferred payments, and tend to shadow their price rates (profit margins) or lease rents on the London Interbank Offered Rate ('LIBOR',¹¹⁹), any repayments made to the overseas financier are likely to be deemed 'interest' and thus subject to 10 per cent WT. Where the lending bank is from a country with whom Australia has a double taxation agreement with a 'financial institution' exemption clause, no WT will be payable.¹²⁰ In terms of any equity-based arrangements (*mudharabah/musharakah*), these are clearly subject to a minimum of 15 per cent deduction (where a double taxation agreement applies)¹²¹ and 30 per cent where the offshore investor is in the GCC.

There are exceptions to these restrictive arrangements. Dividends are not subject to WT if they have been franked in Australia. Offshore banking units are also exempt if they are borrowing from the international money markets (including from IFSPs). Similarly, WT would not apply if the IFSP, through its Special Purpose Vehicle ('SPV'), issued debentures or bonds and the issuance satisfied the 'public offer test'.¹²² This can be fulfilled in three ways: (i) by issuing the debentures to at least 10 persons who are not known or suspected to be associates of each other, and each of whom is carrying on a financing or securities investment business; (ii) issuing to at least 100 persons whom it was reasonable for the issuer to consider as having acquired debentures previously or other debt interests; or (iii) finally by listing the debentures on a stock exchange.¹²³

The last two exceptions are the most relevant for our purposes. In respect of the inter-bank financing market, if the mark-up in a *commodity murabahah* could

118 See *Taxation Administration Act 1953* (Cth) sch 1 ss 16–140.

119 This is a daily reference rate based on the interest rates at which banks borrow unsecured funds on the wholesale markets.

120 David Wood, 'Australian Taxation Developments', *Islamic Finance News* (online), 31 May 2011 <http://www.islamicfinancenews.com/listing_article_ID1.asp?nm_id=22431&searchid=>.

121 In a paper delivered by tax specialist David Wood, of Mallesons Stephen Jacques, it was argued that if the Islamic fund constituted a 'Management Investment Scheme' under the *Corporations Act 2001* (Cth), comprised 50 or more members, managed or controlled in Australia with an Australian trustee, the amount deducted could be reduced to 7.5 per cent. However, this would only apply if the amounts were distributed to residents of an information-exchange country and it was listed in the Tax Regulations. Islamic investors from Malaysia might comply, but not those from the GCC as GCC countries are unlisted: David Wood, 'Islamic Finance Taxation Considerations' (Paper presented at Islamic Banking and Finance Symposium, Melbourne, 6 July 2009).

122 *ITAA36* s 128F.

123 See also McCracken and Everett, above n 72, 122–3.

be classed as a 'debt' and if a contract of sale provides merely the 'form' rather than its 'economic substance', there is a good argument this would be deemed borrowing and thus exempt from WT. The third exception is especially relevant for the potential *sukuk* market in Australia if it can be shown the particular form of *sukuk* is a 'debenture' and in essence a 'debt'.¹²⁴ Where the issuance of a *sukuk* forms part of a 'financial arrangement,' as defined by s 974.130(1)(a) of the *Income Tax Assessment Act 1997* (Cth), that is where the purpose of the arrangement is to 'raise finance', and the financier has a non-contingent right to a return that is equal to or in excess of the financial benefit being provided to the Australian entity seeking the finance, the return to the financier would be classed as repayment of a 'debt'.¹²⁵ Where the financing scheme involves a lease (for example, *ijarah sukuk*), it would have to be shown in addition there is an obligation upon the lessee to acquire the property, in order for the lease not to be 'taken as' an operating lease.¹²⁶

There are problems with this analysis. First, in Islamic terms, an *ijarah sukuk* is not a debt-based contract. Rather, it is a claim to a proportionate share of the '*manfa'at*', or the usufruct of the asset and the rent it generates.¹²⁷ It is an equity investment rather than a debt.¹²⁸ The *sukuk* do not amount to a debt owed by the SPV. How, then, could *sukuk* certificates issued by the SPV evidence a debt? Second, if it is categorised as a 'debt-based' contract, is it not mislabelling an Islamic transaction and, once again, putting form before substance?¹²⁹ Third, by imposing a legal (as opposed to a 'moral') obligation to acquire the property, it runs directly into the problem over the enforceability in Islamic law of the undertaking (*wa'ad*) to purchase the asset at the inception of the *sukuk*

124 See *Corporations Act 2001* (Cth) s 9. It is not being suggested that certificates of other types of sukuk (13 according to AAOFI) should all be regarded as 'debentures' under Australian law. Each sukuk would have to be judged on its particular form and function as in the UK: see Michael Ainley et al, *Islamic Finance in the UK: Regulation and Challenges* (November 2007) United Kingdom Financial Services Authority <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf>.

125 This would mirror the position in English law. See also the unreported English High Court decision of *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV* (Unreported, England and Wales High Court, Tomlinson J, 13 February 2002) and the decision of the Court of Appeal in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 upholding *murabaha* and *ijarah* contracts but refusing to entertain arguments based upon the Sharia. For a commentary on the latter case from an Islamic perspective, see Nabil Salih, 'A Landmark Judgment of 23 January 2004 by the England and Wales Court of Appeal' (2004) 19 *Arab Law Quarterly* 1, 1–2. For a more critical account: see Mahmoud A El-Gamal, *Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering* (May 2007) Rice University <<http://www.jhfc.duke.edu/disc/events/documents/Incoherence.pdf>>.

126 See *Income Tax Assessment Act 1997* (Cth) s 974.130(4)(v).

127 Mohammed Amin, *The New UK Tax Law on Sukuk* (1 January 2008) New Horizon <<http://www.newhorizon-islamicbanking.com/index.cfm?section=academicarticles&ac>>.

128 See Megat Hizaïni Hassan, 'Sukuk are Equity, Demand Risks Must be Shared', *Reuters* (online), 5 November 2009 <<http://news.alibaba.com/article/detail/markets/100195348-1-opinion-sukuk-equity%252C-demand-risks-must.html>>.

129 See also the arguments developed by Mamoud A El-Gamal, *Islamic Finance – Law, Economics and Practice*, above n 12; Hamoudi, above n 12.

arrangement.¹³⁰ Fourth, it would seem that UK law does not view this *sukuk* as evidencing a debt but as rights of a beneficiary vis-a-vis the trustee.¹³¹ Although Australia has its own tax laws, it might refer to English law in the case of ambiguities and so the WT would remain payable.

It might be said in reply that this is merely a legal fiction (*hilah*) for navigating around secular Australian law which is depriving an Islamic entity a portion of its legitimate profit. The *maks* (trader's tax) does not receive legitimation in classical texts on Islamic law (hence why the GCC are largely 'tax free' economies), and so this *hilah* cannot be equated to the Hanbali objections of *bay' al-inah*, *tawarruq* and the like that were perceived as subverting Islamic prohibitions on *al-riba*. As to the 'obligation' to purchase the asset, where both parties are practising Muslims, they might understand that the mutual promises bind their 'conscience' and act upon that basis. If the party seeking financing was a non-Muslim, the Sharia difficulty would not be an issue where the enforceability of the undertaking was being determined in an Australian court. Under Australian law, the exchange of promises would amount to consideration and would be deemed binding.

V THE RESPONSE BY THE AUSTRALIAN GOVERNMENT AND PROSPECTS FOR REFORM

In the past couple of years, the Australian government, at state and federal levels, though non-committal, has explored and considered the possibility of removing tax disincentives and regulatory obstacles for IFSPs. Even before their most recent pronouncements, the federal government, as well as NSW and Victoria state governments had recognised the potential of IBF as a source of much needed foreign direct investment and welcomed the visits of trade delegations from the Middle East (namely the United Arab Emirates) and Malaysia. According to Kathryn Mathews, Director for Industry and Investment NSW, speaking on behalf of the NSW Government during a visit by a Malaysian Islamic Finance delegation to Sydney on 7 December 2009,¹³² tapping into IBF represented an opportunity for Australia, especially Sydney, to be a regional financial centre and a focus for innovative financial services. She confirmed the NSW Government was actively working towards a 'level playing field' for IBF alongside other models of finance. Interest, it seems is across party lines. In April 2011, the new NSW Government (through the NSW Better Regulation Office)

130 See Burhanuddin Lukman, 'Pergunaan Wa'ad Dalam Kontrak Buyu'Ijarah dan Syirkah: Adakah aplikasi boleh menjelaskan Kontrak Kewangan' (Paper presented at Shariah South-East Asia Intellectual Conference, Malaysia, 27-8 February 2008) <<http://www.isra.my/articles/islamic-banking/waad-undertaking.html>>.

131 Amin, above n 127.

132 Kathryn Matthews, (Speech delivered at the Malaysian Islamic Finance Centre Sydney Industry Seminar, Sydney, 7 December 2009).

continued with the approach of its predecessor, inviting submissions from industry players and consultants as to any potential regulatory hurdles.

As for the federal government, John Masters (formerly a partner at PricewaterhouseCoopers and an advisor to the federal and NSW governments on IBF), speaking at the same 2009 Malaysian delegation, expressed confidence that Australia would soon follow in the footsteps of the UK and that ASIC and APRA were both 'on board'. Taxation remained the biggest stumbling block for IBF and probably required enabling legislation, but the Commonwealth Treasury was 'very focussed' and had convened a number of seminars on the matter.

Recent statements from government ministers and government sponsored reports support this confidence. These acknowledge Australia's previously limited engagement with the Asia-Pacific region and a lack of cross-border import and export of financial services, despite Australia's strong domestic economy and the enormous potential benefit it could gain from such engagement. The 'Johnson Report',¹³³ in November 2009, which detailed the recommendations of a roundtable focussed on the taxation of Islamic finance, and comprising representatives of the Treasury, the ATO, Austrade, the Department of Foreign Affairs and Trade, the Australian Bankers Association and IFSA, concluded that Australia should follow a 'no obstacles but no special treatment' approach towards IBF. The Forum agreed with the UN Committee's Working Group that the 'legal approach' (taxing according to legal 'form') would produce anomalies in relation to Islamic financial instruments when compared with conventional products, and that an 'economic substance' approach should be preferred. At the state level, it recommended discriminatory stamp duties be amended and at the Commonwealth level, for Islamic *sukuk* to be exempted from WT in the same way as conventional bonds. At the same time, they recognised there were complexities deserving more serious attention and urged the matter be referred to the Board of Taxation.¹³⁴ In a media announcement in Abu Dhabi on 26 April 2010, Chris Bowen, the Minister for Financial Services, confirmed that the taxation issues were being considered by the Board of Taxation.¹³⁵ On 13 October 2010, the Board of Taxation duly published a detailed discussion paper inviting submissions from stakeholders and interested parties.¹³⁶ The Forum also recommended that a special committee be formed at the federal level to explore the issues under the *Corporations Act 2001*

133 Australian Financial Centre Forum (Cth), *Australia as a Financial Centre: Building on Our Strengths* (2009) ('Johnson Report').

134 Ibid 70–1 (Recommendation 3.6).

135 See Nick Sherry and Chris Bowen, 'Board of Taxation to Review Australia's Laws to Ensure Islamic Finance Market Can Expand' (Joint Media Release, No 76, 26 April 2010) <<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/076.htm&pageID=003&min=njsa&Year=&DocType=0>>. The Board of Taxation is due to complete its review for the federal government by June 2011. There is no date, however, for publication of its findings.

136 See Board of Taxation (Cth), *Review of the Taxation Treatment of Islamic Finance – Discussion Paper* (Discussion Paper, October 2010).

(Cth) in more detail and to removing any prohibitive barriers for IBF providers.¹³⁷

In addition to the Johnson Report, Austrade has produced its own publication, in which it explains Islamic products with a view to developing public awareness of the industry and to promote opportunities for Islamic finance in Australia.¹³⁸ Re-iterating the Johnson Report, it stated:

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

- a level taxation, legal and regulatory playing field for Islamic and non-Islamic finance. Taxation must be responsive and enabling but non-preferential;
- strong promotion and facilitation through government investment attraction and export promotion agencies;
- government engagement with the private sector in achieving Islamic finance objectives, identifying impediments to, and opportunities for growth;
- a focus on deepening Islamic finance skills – education, training, attainment of relevant qualifications – and on access to appropriate Shariah scholars; and
- growth in Islamic finance professional services providers.¹³⁹

In summary, both state and federal governments seem to support moves to accommodate IBF. The emphasis is clearly on the wholesale market and following the UK ‘level-playing field’ model.¹⁴⁰

A Towards an Alternative ‘Asian Model’?

The ‘level-playing field’ model seems to be based on the assumption that Australia’s natural assets, political and economic stability, geographical proximity to Asia and vibrant property sectors, among other attractions, would draw in Islamic investors inevitably, like a magnet, were it not for the regulatory obstacles already described.¹⁴¹ Although their removal would be a pre-requisite for further development of a local retail and wholesale IBF sector, it is doubtful, however, whether the preferred model would be sufficient to attract large quantities of Islamic petrodollars to Australia. First, investment in Australia is expensive because of the high level of the Australian dollar. Unless overseas Islamic investors already have large holdings of Australian dollars or the prospective financial returns are very high, increased transaction costs would militate against a major Australian investment.¹⁴² Second, there are alternative investment-friendly jurisdictions in Asia which have provided incentives, and not just a ‘level-playing field’ for IBF investment. Malaysia, in particular, has been

137 See Johnson Report, above n 133, 98 (Recommendation 4.8).

138 Austrade, *Islamic Finance* (Commonwealth of Australia, 2010).

139 Ibid 6.

140 For further detail on the UK approach, see Thani, Abdullah and Hassan, above n 68, 327–32.

141 Austrade, above n 138, 5–6.

142 According to Emmanuel Alfieris, Head of Financial Institutions & Trade, Global Transactional Banking, Westpac Institutional Bank, most overseas Islamic investors do not hold Australian dollars: Interview with Emmanuel Alfieris (Sydney, 31 July 2009). The deterrent effect of the high Australian dollar was also reiterated in round-table discussions at the *Islamic Finance News Roadshow*, Melbourne Exhibition Centre, 9 May 2011.

very aggressive in luring Islamic investors, especially to its offshore location in Labuan.¹⁴³ The *Labuan Offshore Business Activity Tax Act 1990* (Malaysia), as amended, came into force in February 2010, providing a tranche of tax benefits, including: advance tax rulings, withholding tax and stamp duty exemptions, and a right to be taxed under the *Income Tax Act 1967* (Malaysia) which also exempts from taxation capital gains and income derived from foreign sources.¹⁴⁴ In relation to Islamic fund management, the Malaysian government also took very pro-active measures and cut through potential layers of bureaucratic red tape. Under the *Labuan Financial Services and Securities Act 2009* (Malaysia), for example, private funds with less than 50 investors no longer need to seek the approval of the regulator, the Labuan Financial Services Authority.¹⁴⁵

Unlike Malaysia, Australia is not an Islamic country¹⁴⁶ with a majority Muslim population. An incentive-based approach, therefore, might not seem appropriate. The approaches of both Singapore and Hong Kong, countries with small Muslim populations like Australia, might be instructive.

IBF in Singapore has developed rapidly in recent years. In addition to three retail offerings in the banking sector (IB Asia, OCBC and Maybank), HSBC Insurance (Singapore) manages substantial assets for *takaful* products and NTUC Income's 'Amanah Fund' operates the largest *takaful* fund in South-East Asia.¹⁴⁷ Singapore has also been successful in attracting a large number of Middle Eastern investors to their ethical investments and Sharia-compliant funds.¹⁴⁸ In 2008, for example, it was announced that Singapore's ARA Asset Management, working in partnership with Dubai Islamic Bank, had launched a US\$450 million Islamic Far Eastern Real Estate Fund.¹⁴⁹

While Singapore is firmly established as a regional financial hub and has benefited from the movement of offshore funds from Switzerland following the implementation of forced changes to its tax rules in 2003,¹⁵⁰ the country capitalised on its good fortune by facilitating the entry of IBF investors. The existing regulatory framework was amended to accommodate Islamic banks. Although section 30 of the *Banking Act* (Singapore, cap 19, 2001 rev ed) prohibited banks from trading, in 2005 a new regulation was passed (Regulation 22) exempting *murabahah* financing. In 2006, the *Banking (Amendment No 2) Regulations* (Singapore, cap 19, 2006 rev ed) was also introduced allowing banks to offer *murabahah* investment products. In 2007, Islamic investors were given

143 A framework of tax incentives and exemptions has also been established for the mainland: see Thani, Abdullah and Hassan, above n 68, 131–6.

144 Labuan International Business and Financial Centre, *Tax Benefits* <http://www.labuanibfc.my/cms/index.php?option=com_flexicontent&view=items&cid=64&id=114&Itemid=56&lang=en>.

145 Labuan International Business and Financial Centre, *Introduction* <http://www.labuanibfc.my/cms/index.php?option=com_flexicontent&view=items&cid=47&id=72&Itemid=104&lang=en>.

146 In the sense it is a member of the Organisation of the Islamic Conference.

147 See Angelo M Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World-Scientific Publishing Company, 2nd ed, 2006) 204–5.

148 See Thani, Abdullah and Hassan, above n 68, 326.

149 Ibid 327.

150 See Venardos, above n 147, 194–5.

the same protection as conventional depositors by putting their claims ahead of general unsecured creditors.¹⁵¹

At the same time, the Singapore government levelled the playing field for Islamic investors by amending its tax laws. In 2005, double stamp duties on real estate *murabahah* transactions were waived.¹⁵² Rules on GST and income tax for Sharia-compliant investments employing *murabahah*, *mudharabah* and *ijarah wa iqtina* methods were amended, with the effective returns 'deemed interest' for tax purposes.¹⁵³ Special consideration was also afforded to *sukuk* remitting stamp duty on immovable property if it was in excess of that chargeable under a conventional bond.¹⁵⁴ In order to further boost and encourage IBF investors, in 2008 the Finance Minister also announced a five per cent concessionary tax rate on income derived from qualifying Sharia-compliant activities, such as lending, fund management, insurance and re-insurance.¹⁵⁵ In addition, all investors were to receive tax exemption on income derived from qualifying *sukuk*.¹⁵⁶

To a certain extent, therefore, Singapore has done more than provide a level-playing field for IBF; the government has moved in the same direction as Malaysia by offering actual incentives. Nevertheless, there are still concerns that Singapore has not gone far enough, especially in terms of Sharia-compliance. Unlike Malaysia, the government has decided not to establish a Sharia regulatory body which could rule on whether or not products comply with Sharia. They have preferred to rely upon outside expertise and publications.¹⁵⁷ In the short-term, this makes sense because of the need to train up and acquire the necessary human resources to staff such a body. But in the long term, not having a local regulatory body could exacerbate 'Sharia risk' and undermine market confidence. There is always a possibility of divergent rulings in IBF because of the natural diversity of Islamic jurisprudence.

Although Muslims comprise only one per cent of its population and number less than 70 000 in total,¹⁵⁸ Hong Kong has embraced both the retail and wholesale Islamic markets. Several years ago, the Hong Kong government identified IBF as a necessary part of its strategy to develop Hong Kong as an international financial centre.¹⁵⁹ In 2007, the first Islamic retail fund was launched, the Hang Seng Islamic China Index Fund. The fund was screened by the Central Sharia Committee of HSBC Al-Amanah, approving the trust deed,

151 See Thani, Abdullah and Hassan, above n 68, 322.

152 Ibid 323.

153 Ibid 324.

154 Ibid.

155 Ibid 325.

156 Ibid.

157 Ibid 326.

158 Amiral B Nasir, 'Will Hong Kong Stand Up to the Competition?: Country Report' (2008) 5 *Islamic Finance News* <http://www.islamicfinancenews.com/listing_article_ID1.asp?nm_id=8493&searchid=>.

159 Eddie Yue, 'Hong Kong: The Natural Gateway to Islamic Finance in Asia – Current Developments' (Speech delivered at 2009 Asia Sukuk Summit, Hong Kong, 20 February 2009) <<http://www.bis.org/search/?q=Eddie+Yue+2008&adv=1>>.

explanatory memorandum and termsheet.¹⁶⁰ This laid the groundwork for a successful issuance. By the end of the year, the fund was heavily subscribed and had grown by 11.04 per cent, outperforming the Hang Seng Fund, its conventional counterpart, which had grown by only 7.1 per cent.¹⁶¹ In March 2008, this was quickly followed by a US\$550 million *sukuk* issuance that was also heavily over-subscribed.¹⁶² Later the same year, the Hong Kong Monetary Authority ('HKMA') granted permission to two foreign banks – Hong Leong Bank and CIMB Hong Kong (both Malaysian) – to operate Islamic banking 'windows'.¹⁶³

The speed by which these events took place was facilitated by a proactive government, keen to reduce taxation costs and remedy regulatory obstacles. Notwithstanding an already low taxation economy, the Hong Kong government still explored possible unfair treatment in its Comprehensive Tax Review, though it concluded IBF organisations operated without any additional penalties. Hong Kong's simple tax structure and flexibility enabled the regulator to grant tax exemptions upon application, providing a mechanism to reduce costs for IBF providers.¹⁶⁴

The HKMA has also liaised closely with overseas regulators, signing memoranda of understanding with the Dubai International Financial Centre Authority and the Dubai Financial Services Authority, to facilitate the establishment of suitable infrastructures for the development of Sharia-compliant products and to assist in capacity building for the development of Islamic capital markets, respectively.¹⁶⁵

As an additional incentive, Hong Kong is also a natural conduit into China, the world's fastest developing economy.

VI CONCLUSION

The existing regulatory set-up of banking and finance in Australia, as in all predominantly non-Muslim societies, has developed largely without regard for those wanting to organise their finances in accordance with Islamic Sharia. This has not stopped the emergence of local operators who, by and large, have successfully navigated the existing system notwithstanding the penalising impact and effect of some of those regulations, especially in the area of taxation. Even in the absence of any legislative or administrative changes, local Islamic financial engineers and planners will continue to structure their products in such a way as to maximise their profits as well as to secure a halal return.

160 Nasir, above n 158.

161 Ibid.

162 Martin Wheatley, (Speech delivered at the 2nd Islamic Finance News Roadshow, Hong Kong, 16 April 2009) <www.sfc.hk/sfc/doc/EN/speeches/speeches/09/mw_090416_if.pdf>.

163 Ibid.

164 Yue, above n 159.

165 Wheatley, above n 162.

Developments over the last two years, however, indicate that momentum is building to accommodate IBF across Australia. The banks, industry associations, and state and federal governments have observed a profitable niche from which Australia can benefit and are seeking to engage with the Middle East and Asia-Pacific regions in order to guarantee Australia's future prosperity. The recent memorandum of understanding between the Australian and the Malaysian governments, and the active involvement of Austrade in the promotion of IBF in the region provide further examples of this institutional interest.¹⁶⁶ In their private deliberations and public utterances, they realise the Australian regulatory system must change to accommodate the particular needs of IFSPs.

However, the legal change they propose is distinctly European in origin – the UK's 'level playing field' approach. This may prove to be a mistake in the long term as Australia is likely to become more dependent on the Asian economies. Malaysia, Singapore, Hong Kong and Indonesia (an under-developed market) have a competitive advantage over Australia in the battle for Middle Eastern (Islamic and conventional) petrodollars. They are not welfare-driven societies and tend to have much lower levels of taxation. And, as in the cases of Malaysia and Singapore, they provide tax incentives to encourage inflows of Islamic FDI. When historical links and cultural ties between South East Asia and the GCC countries are added to the equation, it should be apparent that Australia needs to do more than advertise its natural assets and level the playing field if substantial inflows of Islamic FDI are to materialise.

But herein lies the problem. Regulatory clarity, a level playing field and a framework of incentives will all probably require separate legislation to give them effect. This would necessitate a complex series of debates in Parliament which might provoke sectarian sentiment. Just as with the UK, France, US and even South Korea,¹⁶⁷ cultural tensions in Australia are never far away from the surface. Popular association of Islam with international terrorism, combined with concerns over asylum seekers and migrants from Muslim countries¹⁶⁸ can influence decisions taken at the political level. Although the local investment banks have been confident in the viability of an Islamic wholesale market,¹⁶⁹ further development depends on the broader political

166 For example, Austrade was one of the facilitators for the Global Islamic Finance Forum, held in Kuala Lumpur on 25–28 October 2010.

167 Government attempts to pass legislation to facilitate the issuance of a local sukuk were halted by local Christian Evangelist bodies: see Manirajan Ramasamy and Frances Yoon, 'South Korea to Learn from Malaysia on Islamic Finance', *Bloomberg Business Week* (online), 10 December 2010 <<http://www.businessweek.com/news/2010-12-10/south-korea-to-learn-from-malaysia-on-islamic-finance.html>>.

168 For an example, see Andrew Bolt, 'Keeping Appearances on Immigration', *Herald Sun* (online), 27 April 2011 <<http://www.heraldsun.com.au/opinion/keeping-up-appearances/story-e6frfifx-1226045217849>>.

169 See Eric Johnstone, 'Westpac Dips into Islamic Finance', *The Sydney Morning Herald* (online), 12 February 2011 <<http://www.smh.com.au/business/westpac-dips-into-islamic-finance-20100211-nv67.html>>.

environment and not just the goodwill of regulatory officials.¹⁷⁰ The Islamic retail sector, in particular, should not be over-optimistic. They might have to 'do it tough' for some time to come.

170 ASIC awarded Crescent Funds Management (Aust) Ltd on 30 November 2010 with a licence to operate financial products in both wholesale and retail, opening up Sharia Managed Funds to the Australian market for the first time: Crescent Investments Australasia, *Home Page* <<http://www.crescentinvestments.com.au/main/>>.