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# ORIGINAL ARTICLE

## Islamic Finance in Australia: A Critical Analysis from Taxation and Prudential Standards' Perspectives

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**ABSTRACT**

Islamic finance is still at the nascent stage in Australia. Furthermore, there have been reservations as to how and to what extent the systems of governance at State and Federal level should adapt in light of the intricacies faced by both local institutions offering Islamic financial services (IIFS) and prospective Islamic investors from overseas looking to invest their petrodollars in Australia. This paper takes a contextual and critical look at the current legal and regulatory framework with special focus on taxation and prudential standards. It also explores the perspectives of the principal stakeholders whose collective views and interests will determine the approach the Australian government, is likely to take in respect of Islamic finance.

***Key words:*** Islamic finance, regulatory framework, taxation, prudential standards, level playing field.

### Introduction

Islamic finance industry has experienced a remarkable growth during the past two decades. It has become a major source of wealth creation and a vehicle for investment in major financial centres of the world. More than 350 Islamic banks and financial institutions are operating in over 60 countries in different regions including Europe, Americas, South Asia, Middle East, Africa and Australia (Ahmad, 2010). The current size of global Islamic finance industry assets is approaching US $1 trillion, and is expected to reach US$ 4 trillion by 2020 (Khanna, 2010). These impressive data have stimulated local interest, but a certain 'mystique' and scepticism continues to nag Islamic banking and finance in Australia. Conservative inclinations and a preference for tight regulation have not facilitated entry of the IBF rollercoaster into Australia.

This paper seeks to explore these perceptions and to see how they have changed, if at all, following the global finance crisis (GFC) and its aftermath. The review is socio-legal, paying attention to cultural and political contexts. It draws its primary data from structured interviews with representatives from three major Australian banks namely National Australia Bank (NAB), Westpac Institutional Bank (WIB) and Commonwealth Bank of Ausralia (CBA), with leading industrial associations - the Australian Financial Markets Association (AFMA) and the Investment Financial Services Association (IFSA), local Islamic Finance Service Providers (IFSPs) - both corporations (the Muslim Community Cooperative Australia - MCCA) and individual financial planners, as well as being informed by informal discussions with the Australian Prudential Regulation Authority (APRA). In combination with written reports, conference proceedings and other academic work, the material from interviews and discussions provide insight on Australia's approach to and policy framework for IBF.

The paper is divided into four broad sections. Section II rviews literature on IBF in Australia. Section III introduces IBF and discusses the rules of transaction in Islamic legal system around which particular Islamic products are based. Section IV details Australia's social and regulatory environments, with a view to providing structure and context to local developments. Section V sets out the perspectives of Australia's financial players and how they regard IBF 'on the ground' and where they see its future. Section VI the perceptions of the financial players, such as Islamic finance industry, banks, Islamic retailers as well as the government. Section VII summarises the paper, presents some recommendations and concludes.

This paper is not a critique of IBF, nor of any of its products, on its own terms or otherwise. Rather it is a study of adaptation and change, and part of the continuing story of the spread of Islamic Law and Islamic culture in the Asia-Pacific region with a particular focus on Australia. Although the majority of source materials

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

*Literature Review:*

There is a scarcity of theoretical and empirical literature on Islamic finance in Australia since the emergence of the Islamic financial services industry in 1989. An initiative to conduct research on Islamic finance in Australia was first undertaken by Kandil (1997). He pinpointed the problem areas that were encountered and has proposed some remedies along with suggestions for a more competitive and efficient Islamic financial institution in Australia.

Post-1997, a number of other research on Islamic finance in Australia has been conducted. Halabi (2000), for instance, made a comparative analysis between the Muslim Community Cooperative Australia Limited (MCCA) and Bendigo Bank - an Australian community-focused bank – and in his study it was found that both are surprisingly similar. The history of the MCCA's development over the period 1989-1999 as a community-based project was also described by Saeed (2001). Mirza and Halabi (2003) further reported on why the Muslim community in Australia feels uncomfortable with the use of the Western financial system and discussed why *riba*-free banking is likely to flourish in Australia in the future. Studies related to customers' perceptions towards Islamic banking and finance in Australia were undertaken by Nathie (2007).

More recent research on Islamic finance in Australia has focused on: the extent of divergence in the practice of Islamic financing from the *Shari`ah* (Ahmad, 2009); challenges and opportunities of Islamic investment in Australia using the Malaysian model (Nathie, 2008); and Islamic finance in Australia from mathematical and computer modelling of dynamical systems' perspectives (Skully, 2009). Among the above work Ahmad's work (2009) is 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 Shari`ah laws and state/federal regulations.

As part of the Australia's growing interest in accommodating Islamic financial products and services in Australia, the Australian government released a seminal publication on Islamic finance in early 2010 (Austrade, 2010). The purpose of this publication was to raise public awareness of Islamic finance and to promote opportunities for Islamic finance in Australia.

*What is Islamic Finance?:*

The Islamic financial system is an integral part of Islamic law that can only be understood in the context of Islamic attitudes towards ethics, wealth distribution, social and economic justice, and the role of society or the state. Principles encouraging risk sharing, individual rights and duties, property rights and the sanctity of contracts are all part of the Islamic code underlying the banking system. Muslims believe that human beings are Allah's representatives on the earth who act accordingly as His trustees. The absolute ownership of Man's property is not recognised in Islam. Therefore, transactions in Islamic legal financial system should be carried out in both individual and corporate levels in accordance with the Shari`ah. Individual interest is not the *sine qua non* in this system rather the interest of the public is based on bottom-line considerations (PMBF, 1995).

Given the above attitude of Islam towards mankind, the core principles underlying Islamic financial system revolve around the concept of equity and fairness. Islamic financing is characterised with not just obtaining benefits or maximisation of profits but also seeking promotion of social justice and moral economy. The philosophy of transaction in Islamic law stems from a set of rules and laws referred to as the Shari`ah, governing economic, social, political, and cultural aspects of Islamic societies (Khan, 1992). These rules and regulations administer the rights and obligations of those involved in the financial markets. They also may form the basis of regulation and legislation pertaining to financial markets.

The rules of transaction in Islamic legal system can be summarised as follows.

*Riba-Free Transactions:*

As the *riba* is prohibited in Islam all types of financial contracts and transactions are required to be free from *riba* (Ziauddin & Khan, 1983). The jurists base this banning on arguments of social justice, equality, and property rights. Social justice demands that borrowers and lenders share both rewards and losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity. The question of *riba* has been addressed in literature of Islamic finance with much elaboration and there is a near consensus about the meaning and implications of *riba*.

*Transactions Free From Gharar:*

All forms of contracts and transactions must be free from *gharar* or excessive uncertainty (Al-Quran, 6:151-152). This implies that contracting under conditions of excessive uncertainty is not permissible. Contracting under *gharar* is similar to gambling. The Prophetic *hadith*, in addition to prohibiting gambling or games of chance, also prohibits trading in *gharar*. Islamic scholars have identified the conditions and highlighted situations that involve excessive uncertainty and consequently, outlaw a contract.[i] Also, transactions should be devoid of any ignorance from both parties. Therefore, contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions.

The Hanafi School of Islamic Jurisprudence defines *gharar* as "that whose consequences are hidden". While the Shafi`i legal School defines *gharar* as "that which admits two possibilities, with the less desirable one being more likely". The Hanbali School defines it as "that whose consequences are unknown" or "that which is undeliverable, whether it exists or not". On the other hand, the Zahiri School says that "g*harar* is where the buyer does not know what he bought, or the seller does not know what he sold". The contemporary Islamic legal scholar Mustafa Al-Zarqa states that "*gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling".

There are a number of *ahadith* that forbid trading in *gharar* or transactions that are based on *gharar*. Jurists have sought many complete definitions of the term. They also came up with the concept of *gharar yasir* or minor risk.[ii] What *gharar* is, exactly, was never fully decided upon by the Muslim jurists. This was mainly due to the complication of having to decide what is, and is not a minor risk. Derivatives instruments such as stock options have only become common relatively in recent times. Some IBs provide brokerage services for stock trading and perhaps even for derivatives trading.

*Contracts Void of Qimar and Maysir:*

The Qur'an and the *Sunnah* explicitly forbid gains made from gambling (Al-Jassas. 1994) [iii] or *Qimar* [iv] i.e. games of chance (Ibn`Abidin, 1987). An uninformed speculation (*Maysir)*[v] in its worst form is also akin to gambling. The term speculation always involves an attempt to predict the future outcome of an event. But the process may or may not be backed by collection, analysis and interpretation of relevant information. The relevant experts in financial institutions will assume risk after making a proper assessment of risk using the required information. All business decisions involve speculation in this sense. It is only the gross absence of value-relevant information or conditions of excessive uncertainty that makes speculation akin to a game of chance and hence, forbidden.

*Sanctity of Contracts:*

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. It also provides basic liberty to enter into transactions (Al-Qur'an, 2:275).Involvement of an element of compulsion for either of the parties invalidates the contract (Al-Qur'an, 4:29). However, this basic rule does not entail uncontrolled liberty to contract and may be given up when there is a transaction with other rules and regulations requiring unequivocal rulings.

*Non-Interference in Price Fixation:*

Islam envisages a free market where prices are determined by forces of demand and supply. There should be no interference in the price formation process even by the regulators. However, some scholars admit of its permissibility which is subject to the condition that price fixation is intended to combat cases of market irregularities caused by impairing the conditions of free competition (Obaidullah, 2002). It is an obligation that the forces of demand and supply should be real and free from any artificial component. Islam therefore, disapproves any efforts to manipulate prices through causing fake scarcity of supply. Similarly, any attempt to bid up the prices by creating artificial demand is considered unethical and thus illegitimate (Abu Da'ud, H.2990). Such an action of bidding up the price without an intention to take delivery is not permissible.

*Fair Prices of Commodities:*

Prices that are an outcome of free play of forces of demand and supply without any intervention or manipulation are believed to be fair. However, in cases where pricing is based on a valuation exercise the difference between the price at which a transaction is executed and the fair price (which is determined by the valuation experts) will make transaction null and void (Obaidullah, 2002).

*Release of Adequate Information:*

Release of inaccurate information as well as hiding crucial information breach the rules of Islamic business ethics. As such, transactions must be free from any falsification in order to be considered Islamic. The institution of a transparent market is therefore, rather important and transactions should be executed within the market after taking into account all relevant information. Given this, Islamic business ethics necessitate that all information pertinent to expected cash flows and asset appraisal should be equally available to all investors/shareholders in the market (Azmi, n.d.).

*Devoid of Harm:*

This refers to the possibility of a third party being unfavourably affected by a contract between two parties. If a contract between two parties carried out with their mutual consent is detrimental to the interests of a third party, then it may enjoy certain rights and obligations (Bakar, 2003).

Now one may question in this regard that how to prioritise various rules of Islamic financial transactions mentioned above should there be a conflict. The Islamic legal financial system has a clear scheme of priorities in legislation. Where there is a clear injunction in the Qur'an, for example, in the form of prohibition of interest and games of chance, these must be observed at all costs. Next in importance are the rules that follow from the *Sunnah a*nd *'Ijma`* or consensus, in that order (Obaidullah, 2002).

*Islamic Banking and Finance and the Australian Social Context:*

An important factor when considering the long-term viability of IBF, especially in developing a local retail product, is the size of the relevant market. Although the industry has a potential appeal across religious boundaries, the most obvious consumers of IBF products are Muslims. 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 general population of 22.6 million scattered across 9 states, only 1.5% (340,000) profess Islam, with the majority living in New South Wales (NSW) and Victoria (ABS, 2011). In recent years, there has been a big percentage increase in the numbers of migrants arriving from North Africa and the Middle East, but it is likely Muslims are no more than 2% of the current total Australian population (Phillips**,** 2007).

Further, it should not be assumed all, or even a majority of this population would be consumers of IBF products. 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 (Ozolins, 2008).[vi] Secondly, 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). The Muslim population is ethnically diverse: Turkish, Palestinian, Malay, Lebanese, Iraqi, Indonesian, Egyptian, Bangladeshi Bosnian, Albanian, African and Afghan, Pakistani, and each have their own organisations run on ethnic lines (DFAT, 2010). The majority are likely to subscribe to being 'Hanafi' (e.g. Turks, Bosnians, Pakistanis, Bangladeshis and Albanians) or 'Shafi'i' (Lebanese, Egyptians and Indonesians), but no systemic study of *madhhab* affiliation has been conducted in Australia, nor to what extent these affiliations impact upon individual practice and their understandings of IBF. The only empirical research to date was carried out in Adelaide in June 2004 showing 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 (Rammal and Zurbruegg (2007). Thirdly, many of the Muslim community suffer social marginalisation and economic disadvantage, with higher unemployment rates and lower wages than the wider population, and would not have the financial capital to utilise IBF products even if they were interested (Ata, 2009).

The small size of the domestic Muslim market is not the only social factor impacting on how Australia accommodates IBF. An "Islamic" industry entering and organising in Australia with official approval appears threatening to many Australians. Anti-Islamic sentiment is not new and goes back to the time of the Afghan Cameleers in the nineteenth century, but has been fanned in modern times by Islamist terror attacks since 9/11, and especially since the murder of 202 civilians, including 88 Australians in a bombing of a Bali nightclub in 2002 (Saniotis, 2004). That sparked close government scrutiny of Muslim communities under anti-terror laws and an understandable concern Islamic financial entities might be used to launder money to terrorist organisations overseas.

*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. The regulatory and supervisory framework of the financial sector in Australia covers banks, non-banks deposit-taking institutions, investment banks, collective investment managers, securities and futures exchanges, clearing houses, securities and futures dealers and brokers, and insurance and superannuation entities (The Treasury, 2008). There is no formal legal and regulatory framework or infrastructure in existence in Australia for guiding and supervising the functions of IBs and other IFIs operate in line with the precepts of Islamic legal system. Australia's financial sector regulatory framework reflects a considered approach by government to prudential supervision and is based upon the international standards put forward by the Basel Committee of the Bank for International Settlements (Ahmad and Hassan, 2007).

As the Table 1 below shows the regulatory and supervisory framework is based around three central agencies ("the three pillars"): the Reserve Bank of Australia (RBA); the Australian Prudential Regulation Authority (APRA); and the Australian Securities and Investments Commission (ASIC).

*Reserve Bank of Australia (RBA):*

The RBA retains responsibility for monetary policy and for overall financial system stability. Its task is to help ensure that shocks to any part of the financial system do not ultimately threaten the health of the Australian economy. Given that a safe and robust payments system has been recognised as being vitally important to financial stability, another of the RBA's key roles is in the regulation of the payments system, overseen by a Payments System Board within the RBA. The Board tends to treat its powers as 'reserve powers' to be exercised if other methods of persuasion and implementation prove ineffective. The RBA is also responsible for conducting settlement accounts of the participants in the payments system in a 'real-time' gross settlement system. Its involvement in the system allows the RBA to quickly identify any emerging liquidity pressures. The RBA retains the discretionary role of 'lender of last resort' for emergency liquidity support in the event of threats to financial stability (Nicoll et el, 2007).

*Australian Prudential Regulation Authority (APRA):*

APRA is responsible for the prudential regulation and depositor protection of banks, credit unions and building societies under the Banking Act, as well as insurance companies and superannuation funds. APRA's mission is to establish and enforce prudential standards and practices so that, under all reasonable circumstances, financial promises made by the institutions supervised are met within a stable, efficient and competitive financial system. APRA also acts as the national statistical agency for the Australian financial sector, and plays a role in preserving the integrity of Australia's retirement incomes policy. As such, it encourages and promotes prudent behaviour by regulated institutions so as to reduce the likelihood that they will be unable to meet their obligations to their depositors and beneficiaries. It does this, for example, by setting minimum standards for capitalisation and liquidity, and by measuring the risk associated with individual entities. Furthermore, APRA has a role when the position of a financial institution has become unviable. In this role, it has clearer and stronger powers to act in the interests of depositors than were previously available (in the case of Banks) to the RBA. APRA has extensive powers of investigation, intervention and administration. For example, it has the power to revoke licenses, to make prudential standards or issue enforceable directions, and to resolve the situation of authorised deposit-taking institutions in difficulty (Nicoll et el, 2007).

*Australian Securities and Investments Commission (ASIC):*

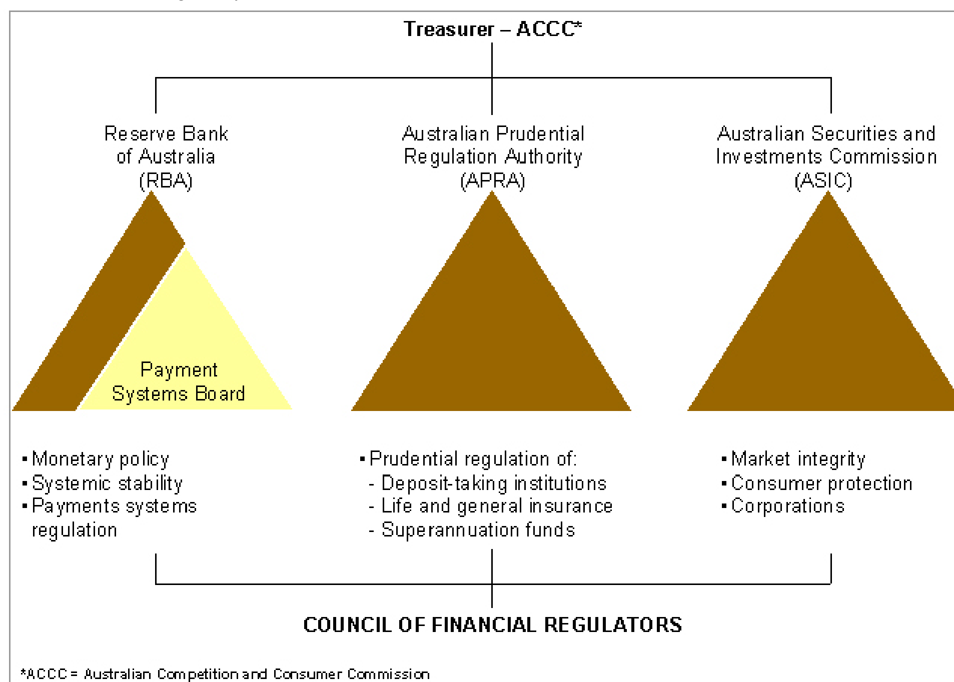
ASIC is Australia's corporate, markets and financial services regulator and supervises consumer protection in the financial services sector. It has responsibility for monitoring and reviewing the Electronic Funds Transfer Code of Conduct. ASIC is also responsible for registering companies, issuing Australian financial services licenses and monitoring fund raising. In relation to bank mergers and/or expansion applications; ASIC regulates company takeovers under the Corporations Act. The co-ordinating body for these agencies is the Council of Financial Regulators. It contributes to the efficiency and effectiveness of financial regulation by providing a high level forum for co-operation and collaboration among its members.

*Other Secondary Regulatory Agencies:*

Apart from the key regulatory agencies there are some other agencies that contribute to the efficiency and effectiveness of financial regulation in Australia. These include Australian Competition and Consumer Commission (ACCC), Australian Taxation Office (ATO), Australian Transaction Reports and Analysis Centre (AUSTRAC), Australian Securities Exchange (ASX), The Office of the Privacy Commissioner (OPC), Foreign

Investment Review Board (FIRB). Among these regulatory agencies the ACCC administers commonwealth competition, fair trading and consumer protection laws. The commission also controls mergers. The responsibility for financial services consumer protection, meanwhile, belongs to ASIC. While the ATO acts as the government's principal revenue collection agency. On the other hand, AUSTRAC is considered Australia's anti-money laundering and counter-terrorism financing regulator and specialist financial intelligence unit. The ASX operates the Australian Stock Exchange and Sydney Futures Exchange, as well as monitoring the compliance of market participants (brokers) and listed entities with its Operating Rules. Its market supervision function is under review. The OPC administers the Privacy Act and related legislation to protect personal information (including credit information). The FIRB examines proposals from foreign interests to undertake direct investment in Australia and makes recommendations to the government on whether those proposals are suitable for approval under the government's policy.

**Table 1:** Australia's Financial Regulatory Framework




Source: *KPG* Source: *Financial Institutions Performance Survey*; AXISS Australia ©

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

*C. The Regulatory Legislation:*

The principal piece of legislation with which all financial service providers across all states must comply is the *Corporations Act 2001.* Matters relating to companies under its purview include: issuance of shares and debentures; managed investment schemes, continuous disclosure and fundraising. In addition, the Act covers: licensing of financial markets, financial service providers, 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.

In addition to the *Corporations Act 2001*, 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 bank so-called, 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 (Cwth) 2009* (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.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 (Ahmad, 2009).

If an Islamic Financial Service Provider (IFSP) was intended to set up a 'banking business', it is also subject to the *Banking Act 1959*. 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' under Australian law. The key issues that block such institutions from receiving a banking licence relate to 1) absence of guarantees over the principal sum deposited; 2) capital adequacy requirements under the Basel II formula; and 3) possible absence of a local SAB. As to the first issue, from the perspective of the regulator, Islamic banks operate more like managed funds than a bank. The Islamic bank may well informally agree to guaranteeing the principal by 'topping up' the depositor's money by way of gift (*hiba*) but that might not be sufficiently concrete for the regulator. Also, it would not sit easily with the Islamic principle of sharing both the profits *and* the losses.

In relation to the second issue, the capital adequacy rule 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 (Loughnan and Drummond 2010). This requires banks to hold a *minimum* of 8% capital to protect them and their investors from market risk. The problem for potential Islamic banks is that the regulator may regard them as more prone to risk and impose a penal capital requirement. First, Islamic economists would prefer IFSPs to hold equities rather than debts when regulators are generally of the view banks should not hold equities in entities to which they also lend.Where the purpose of an Islamic financing arrangement (on *musharaka* or *muđaraba* principles) is other than securing the equivalent of a conventional mortgage, this would attract a 300-400 per cent risk weighting (depending on whether the client is public or private) adding substantially to the client's costs (Schoon, 2008). Second, it has been argued there are liquidity problems owing to insufficient diversification. Heavy reliance on established precedents in the texts of Islamic legal scholars (*fuqaha*) has restricted financial innovation rendering IFSPs more vulnerable to liquidity risk (El-Gamal, 2006).Third, uncertainties exist surrounding legal enforcement. The diversity of Islamic legal opinion is such that it is unclear which opinion would be held authoritative.[vii] Further, doubt remains over how secular courts (e.g. in Malaysia, the UK or Australia) will treat contracts drafted in accordance with Islamic Law.

These concerns give the impression that Islamic banks are inherently more risky than their conventional counterparts. But actual practice and more recent empirical research indicates some of these concerns and points of difference between conventional and Islamic banks may be exaggerated. In response to the first point, most IFSPs continue to avoid holding equities because of the additional costs of monitoring which many can ill-afford. As for liquidity risk, Shari`ah rules on gharar shielded many IFSPs from buying into the toxic assets that caused the GFC and subsequent 'liquidity crunch'. So much so, that Islamic banks' stocks performed better during the crisis than conventional banks' stocks (Beck et el, 2010). It is true that Shari`ah and legal uncertainty are problematic in certain cases, but arguably no more so than those conflicts of laws issues with which lawyers have become accustomed to deal in international business contexts.

APRA has stated that it recognises the problems of a 'one size fits all' policy, and is exercising discretion by applying the advanced Basel II approaches only to the largest of the Australian banks rather than to all authorised deposit-taking institutitions (ADIs).But how it would exercise its discretion should an application be made by an Islamic financial institution to become a bank remains to be seen.

The need for Australian institutions to have a locally vetted Shari`ah Advisory Board (SAB) might also be a stumbling block owing to the relative scarcity of local scholars with sufficient knowledge and experience of IBF and the pervasive (and possibly excessive) influence of those who do.Where they are very well-known figures, members of the SAB might be regarded as "Shadow Directors" on the Boards of Islamic Banks. This could bring them into conflict with the regulator. It would not be problematic for an overseas Islamic bank establishing a subsidiary in Australia to export its expertise and form a local SAB. It would be essential, however, that this subsidiary was individually responsible for policy making. If the SAB abdicated responsibility to its overseas Head Quarters, it could again come into conflict with the regulator. But the more likely and easier scenario for international institutions wanting to arrange Islamic financing in Australia would be to obtain a Shari˘ah sign off in KL or the Middle East using their SABs.

*D. 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.

Stamp duty is a s 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 of shares in an unlisted (i.e. 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 (e.g. by way of *Bai` Bi-Thaman 'Ajil* (BBA) or *Diminishing Musharaka* (DM) 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 *Murabaha* and *Musharaka* 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 consumer (*ss 57A-F, Duties Act 2000).* But for NSW this form of 'double stamp duty'[viii] still applies and is passed on to the consumer, making it potentially uncompetitive (Balz, 2007).

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 DM 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. Where the exception does not apply, the amount of duty charged will be 0.4% of the amount secured above $16,000. This is payable by the mortgagor only. Given that the most popular form of *Sukuk* is constructed upon 'lease-sale' arrangements (*Sukuk 'Ijara*), this also represents a disincentive for a local sukuk issuance.

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% for interest, 15% for dividends and 30% 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% WT (Grieg, 1993). It should be noted that although a double taxation agreement exists between Australia and Malaysia, there are no double taxation agreements with the GCC, meaning that 30% of the profit from dividends (in relation to corporate entities located in Australia) will need to be paid to the 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.

In terms of its application to IBF, the *Income Tax Assessment Act 1936,* s 128A(1AB) 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 *Murabaha* or *Musharaka/'Ijara* composite property deals are based on deferred payments, and shadow their price rates (profit margins) or lease rents on LIBOR, any re-payments made to the overseas financier are likely to be deemed 'interest' and thus subject to 10% WT. In terms of any equity-based arrangements (*Muđaraba/Musharaka*), these are clearly subject to a minimum of 15% deduction (where a double taxation agreement applies) and 30% 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' (s128F, *Income Tax Assessment Act 1936*). This can be fulfilled in three ways: 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; or 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 finally by listing the debentures on a stock exchange.

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 Murabaha* could be classed as a 'debt' and that 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' (Ainley et el, 2007). Where the issuance of a sukuk forms part of a 'financial arrangement,'as defined by the *Income Tax Assessment Act 1997*, s 974.130 (1)(a), 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' (Moghul, and Ahmed, (2003).Where the financing scheme involves a lease (e.g. '*Ijara 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.

There are problems with this analysis. First, in *Islamic* terms, an '*Ijara Sukuk* is not a debt-based contract.Rather, it is a claim to a proportionate share of the "*manfa`a*", or the usufruct of the asset and the rent it generates (Amin, 2008).It is an equity investment rather than a debt (Hassan (2009). 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? (El-Gamal, (2006).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 arrangement (Lukman, 2008). 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 (Amin, 2008). 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 (*hila*) 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 *hila* cannot be equated to the Hanbali objections of *Bay` al-`Ina*, *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 Shari`ah 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.

### *The Reception of IBF in Australia:*

The enhanced vulnerability to taxation measures in an already high taxation economy and the substantial regulatory standards, might explain why there are no Islamic banks in Australia, although there are 17 APRA-approved foreign banks and a number of foreign subsidiaries, including the Arab Bank and HSBC (APRA, 2011). None of the high street banks, including the big four: WIB, CIB, NAB and ANZ, 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 sector (Ahmad, 2009) and are labelled 'Shari`ah Compliant': MCCA, ICFAL, and Iskan Finance. In terms of Islamic fund management, there are 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 (LM, 2011).

The flurry of recent activity and interest in the IBF market reported in the Australian media indicates movement in the Australian financial markets, amongst some of its key players. But how uniform is that interest in IBF and, according to these market players, what factors are contributing to or inhibiting its development?

### *The Perceptions of the Financial Players:*

#### *A. The Banks:*

All four big Australian banks (WIB, CBA, NAB and ANZ) have considered, through the setting up of special working groups, the viability and potential of IBF both at the retail and the wholesale level. The NAB has been at the forefront of much of the discussion on IBF and launched a number of projects, while former NAB Senior Executive, Ahmed Fahour, was at the helm. In addition to setting up its own working groups on IBF, the NAB was a co-sponsor of a symposium launching the La Trobe Masters program in Islamic finance held in Melbourne in July 2009. Further, in 2009 the NAB began offering a '*Qarđ Hasan*' product (Interest-free Loan Scheme) in Victoria, South Australia and NSW, as an extension of its already established 'Good Shepherd Program'.They also introduced the "Sheikh Fehmi El-Imam Scholarship" to assist students in furthering their postgraduate studies in finance and economics.

While external observers might regard these initiatives as relatively minor, they have not been without controversy. In particular, the *Qarđ Hasan* facility was misunderstood by sections of the non-Muslim community who thought Muslims were obtaining housing loans at preferential rates. This was followed by an outcry on local radio prompting clarification from the NAB that it was no more than a Shari`ah-compliant version of a scheme they already offered to the wider community, and it did not extend to housing finance. Further, the NAB pointed out the Imam Fehmi Scholarships were not reserved for Muslims only or for those wishing to study Islamic banking and finance, though the initiative was launched to strengthen links between the NAB and the Muslim Community. Despite its involvement with the local Muslim Community (especially in Victoria), the NAB has no plans for a retail (as opposed to a charitable) Islamic product offering nor has there been any talk of a wholesale product.

The primary interest of WIB in IBF has been at the wholesale level and in the interbank markets, identifying a strategic need to attract Asian and Middle Eastern investors. According to Emmanuel Alfieris, its Head of Financial Institutions & Trade and Global Transactional Banking, a perenial concern has been that Australians are not saving enough to fund their investment and consumption needs (Alferis, 2010). The majority of Australia's debt (57%) is funded by foreigners. Since the GFC and credit crunch, the source of those funds has increasingly been from Asia and the Middle Eastern petrol economies, and so banks like WIB had to make themselves more 'relevant'. He stated:

"When I went over strategy and looked at where our growth was coming from – in terms of trade flows, capital flows and remittances, I determined we had to explore Islamic banking" (Alferis, 2010).

The WIB had anticipated investment from Asian and Islamic entities in the Australian economy and re-organised WIB's corporate structure integrating its capital structure and property groups accordingly. It was thought that the combination of Australia's robust property sector, deep asset-based market, its growing population (natural and planned via migration programs), the compulsory government-backed superannuation scheme, a strong economy with low unemployment rates and a history of stable government, would make Australia a good destination for Islamic capital (Alferis, 2010).

In terms of actual engagement with Middle Eastern financial institutions, WIB has captured 80% of the flows coming out of Qatar and maintains strong banking relationships with the United Arab Emirates (UAE), along with other Islamic countries such as Malaysia and Indonesia, though much of the investment has been in 'conventional' rather than 'Islamic' products. So far, they have utilised only a limited range of Islamic financial instruments based on *Murabaha, Muđaraba* and *Wakala* contracts, and partnered Islamic financiers in a consortium in the occasional infrastructure project. The issuance of a *Sukuk*, it seems, also remains a long way off.

According to Alfieris, although there is great potential, the development of the IBF market in Australia has been hampered by regulatory issues (Alferis, 2010). Stamp duty, WT and Australian law's inconsistment treatment of equity and debt products may have caused Islamic capital to flow elsewhere. He says it is 'too hard for investors to stomach' when they know their Australian investment will be less 15% every time profits are sent home, in addition to the burden of paying double stamp duty (Alferis, 2010).

While WIB has shown interest in entering into the international and institutional Islamic market place, it does not share the same enthusiasm for local retail. For Alfieris, the total population of Muslims in Australia is too small, representing a maximum of 100,000 homes and a possible market share of considerably less because of competition (Alferis, 2010). Although the Muslim community might prefer Shari`ah compliant products, and Islam is one of the fastest growing religions in the country, the market is still not big enough for WIB to offer a retail product (Alferis, 2010).

As for CBA and ANZ, information provided shows neither one of them has an appetite for Islamic windows or for an Australian Islamic retail product. Offshore, however, ANZ holds a stake in the Malaysian bank AmBank and its Islamic subsidiary.

A local financial product developer with expertise in Shari`ah compliance and who advises the big four banks, confirmed their interest in IBF but stressed, in his view, that they are not rushing to embrace it. Although they are interested in 'profitable niches', they have become 'ultra conservative' since the GFC and worry about the costs and risks which IBF product development would entail. In particular, the product developer confirmed it is difficult to justify initial start-up costs for an Islamic product when the take-up from the Muslim community itself seems so uncertain. At the wholesale level, where the banks appear more engaged, attracting Islamic foreign direct investment (FDI) has been hampered by the current rules on repatriation of profits and WT.

*B. The Industry Associations:*

The leading industrial association of this sector is the Australian Financial Markets Association (AFMA) which promotes self-regulation of the financial markets and provides leadership on policy as well as a forum to discuss matters of concern to market participants. It represents 130 members, including the Australian banks,

securities' companies, leading brokers, fund managers and others. It also promotes Australia as a significant global centre for financial services (AFMA, 2010).

As part of its advocacy function, it set up a working group on IBF in 2009 when it looked like the Islamic markets had weathered the GFC financial tsunami and the Australian financial markets needed to look for further funding. The working group comprised a number of banks and advisory groups, including lawyers and tax consultants. Focusing on the inter-bank and wholesale market, its work has been to promote the development of an Islamic finance capital market and to ensure that there is a level playing field in terms of taxation and regulatory treatment for both conventional and Islamic financial products. Discussion has centred on the tax implications for generic *Commodity Murabaha* and *Sukuk 'Ijara*. Between members of the working group, they have not been able to discuss specific financial products for reasons of commercial sensitivity and an understandable reluctance to share information with local competitors. Rather, their priority has been to elicit a disciplined response from their members in relation to the issues and to get a detailed picture as to how a *Commodity Murabaha* and/ or *Sukuk 'Ijara* would look commercially together with their specific tax outcomes.

In AFMA's discussions with the ATO at the end of 2009, it explored the scope of the new Taxation of Financial Arrangements (TOFA) regime [ix] in taking an 'economic substance' rather than 'form' approach to taxing transactions (ATO, 2011). This more sensible approach requires an analysis of the Islamic transaction's conventional equivalent. For example, the mark-up in a *Murabaha* transaction mirrors the fixed interest charge in conventional financing and may be 'deemed interest' for tax purposes. This means that the offshore financier (our Islamic investor) will have to pay IWT but the Australian client can offset the cost of that financing with the ATO. The ATO is considering how best to help the industry and may consider some form of administrative guidance in the near future. Capital raising through *Sukuk 'Ijara*, however, and the additional taxes (re GST and income tax) they would attract, is more complicated and may require new legislation. AFMA is hopeful this will occur and has received positive responses from the Federal Government, though no guarantees.

There has also been some interest in Islamic fund management. The peak body representing 135 fund managers, insurance companies and the pension industry is the Investment and Financial Services Association Ltd (IFSA). It provides similar functions and services as AFMA but for fund managers. In an interview, Martin Codina, Director of Policy for IFSA, stated IFSA's interest and concerns are different from the bankers and financiers.[x] It is interested in funds that will be invested in Australia (rather than the 'revolving door' envisaged by AFMA) and consider that the IBF market represents another opportunity for its members. In addition, it wants to facilitate the entry of the Muslim community into fund management and for them to access these funds in accordance with their beliefs. Although the differential tax treatment of Islamic products making them less competitive has concerned its members, its focus has been on prudential matters and the need for standardisation across the industry. As a market self-regulator, its job in relation to Islamic funds is to ensure that offerings are 'true to their label' and is in the process of producing some 'best practice' guidelines for fund managers wanting to know what it means to be "Shari`ah Compliant" in respect of the different asset classes. Its hope is that this initiative will be an indicator to offshore Islamic investors that Australia is taking IBF seriously and will have confidence that their funds will be invested 'Islamically". Incorporated within these guidelines will be the corporate debt-ratio tolerance level to be adopted in the Islamic filter and whether they should work with the most conservative or more flexible schemes using the respective Islamic indexes of Standard & Poors, Dow Jones and the FTSE as guides.

According to Codina, the biggest problem in achieving this endeavour is the diversity of Islamic Law or, as he puts it, 'the many flavours of Islamic thinking'. Australia does not have any recognized, state-sanctioned, body of Islamic scholars to say which interpretation of Shari'ah is the most accurate or authoritative in relation to Shari'ah compliant fund management. Nor are there many individuals widely recognized as "Islamic scholars". This remains problematic because in order to have credibility in the area, IFSPs must have SABs and secure the necessary Shari˘ah sign-off. Until sufficient expertise is developed locally, they will have to rely upon overseas scholars already providing advice to firms such as PricewaterhouseCoopers.

In spite of these difficulties, IFSA is hopeful that as a result of joint ventures and strategic alliances, more offshore funds will be invested locally in Shari`ah compliant funds. More specifically, Codina stated he would be surprised if within the next five years there are not at least five investment platforms offering Shari`ah compliant funds. [xi]

*C. Local Islamic Retailers:*

It will already be evident from the above discussion that the banks and industrial associations are looking primarily at IFSPs and IBF as a potentially rich source of FDI which they can tap. Their focus has been on the offshore market, not the retail sector nor even the local Muslim communities. To achieve a more balanced picture of the NSW and current Australian approach to IBF, I explore the perspectives of some of these local retail providers.

The biggest local provider is the MCCA (Ahmad, 2009). It was established in 1989 and has branches in both Melbourne and Sydney. It offers home consumer financing (residential housing and hire purchase) and wealth management for Muslims and non-Muslims in accordance with Islamic values and principles. Starting out with ten members and a capital of $22,300 it now has more than 7000 members in Victoria and NSW and $30,000,000 worth of assets on its balance sheets (Ahmad, 2009).

According to Chaaban Omran, former Managing Director of the MCCA, the uncertainty and mystery surrounding IBF and previous cynicism towards the industry is lifting. The GFC made conventional banks, financiers and government take a closer look at the current method of dealing with money and the potential of IBF as an economically viable alternative. It also made them revisit the obstacles the Australian regulatory and taxation system poses for Australia's nascent IBF industry. Stamp duty, income tax, CGT and land tax have been particular problems for the MCCA. They want to enable their clients to acquire property through Islamic partnerships (*musharaka*), but current legislation deems that arrangement an investment and taxes accordingly. Instead, the MCCA leases property to clients to comply with the regulatory framework and to minimise their tax liability.[xii] Some Australian MPs, such as Chris Bowen and Senator Nick Sherry, have 'championed the cause' at the governmental level to lift double stamp duty and the MCCA is hopeful of federal legislative change.[xiii] At the state level, however, premiers appear unwilling to budge.

In contrast to the banks and industry associations, Chaaban Omran, like others offering a retail product, regard the perceptions of the local Muslim population as 'very important'. He views the MCCA as an exclusive IFSP and assures all MCCA product offerings are vetted by its SAB and the few local Imams with relevant expertise. But that has not eliminated all community whispers questioning the 'Islamicity' of its products. In reply to a question concerning marketing efforts to the Muslim community, Chaaban Omran stated:

"MCCA has changed its strategy in looking for external funders – non-bank lenders... We didn't breach any (Islamic) laws, but it may have appeared that there were remnants of the conventional products and that flowed into the community generating some misunderstanding. The MCCA has sought to correct those misunderstandings by raising awareness of our current product, the underlying principles and the intent of the contract (Ahmad, 2009)."

As a result of their efforts, he says the community are now more prepared to give them the 'benefit of the doubt' and to date, the MCCA continues to enjoy the largest market share of all current IFSPs in Australia.

Other than Islamic home finance and hire purchase market, attempts have also been made to invite the Muslim community to participate in the Australian equities market by offering Shari'ah compliant funds. The MCCA has its own ASIC approved fund. Crescent Investments Australasia is also developing retail products, including an Islamic Australian Superannuation Fund allowing the Muslim community to shift their pensions from conventional pension funds to an Islamic alternative applying stock market 'screens' approved by AAOIFI. But if previous experience is a guide, community capture will not be easy. In 2007, Ali Tabbouche, a local Business Development Manager, attempted to set up a Shari'ah compliant share fund with a link to superannuation funds.[xiv] This would have been based on the Dow Jones Islamic Index, cutting out the Australian portion. He met with AFIC, the NSW Islamic Council, Hazem El-Masri, the Principal of Rissala College in Haldon St, Lakemba, and with the former President of the Lebanese Muslim Association (based in Lakemba) at his offices in Auburn. Although Ali Tabbouche received support from some of the younger generation, the majority of the Imams and leaders of the community were sceptical and doubted the Islamic credentials of the Dow Jones methodology. "The Islamic world is tribal", he commented, and dropped the project because of insufficient community backing.

This anecdotal evidence does not prove a retail product will never be viable; pockets of Muslim communities may be very much in favour (Rammal and Zurbruegg, (2007). Positive media campaigns and community education programmes could boost support for IBF products notwithstanding some local community resistance. Further, the potential retail market could expand through effective marketing of Islamic products, possibly as 'ethical investments', in the non-Muslim communities. As Madzlan Hussain comments, IBF is not just for Muslims (Hussain, 2010). Evidence from Malaysia indicates a substantial take-up from non-Muslims who are attracted by the fair terms and quality of Islamic products. Sixty per cent of depositors in the Malaysian branch of Kuwait Finance House, for example, are non-Muslim. The prevalence of non-Muslim investors in Malaysia's AmIslamic Bank was also confirmed in an interview with the Executive Director of AmBank, Mahdi Murad, and the General Manager of AmIslamic Bank, Jamaiyah Mohammed Nor.[xv]Also in Singapore, more than half of Singapore's OCBC Al-Amin Islamic Bank's customers are non-Muslim (BT, 2011).

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. Singapore has a population of more than 500,000 Muslims but there is only OCBC which offers 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. Notwithstanding the possible conversion of MCCA's credit union into Australia's first Islamic bank, further expansion of the Islamic retail sector looks unlikely for

reasons similar to Singapore. More data is required that would better indicate the capacity and desire of Muslim communities across Australia to patronise Islamic banking services and products, especially in light of the ethnic and religious fragmentation.

*D. The Australian Government:*

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, as well as NSW and Victoria state governments had recognized the potential of IBF as a source of much-needed FDI and welcomed the visits of trade delegations from the Middle East (namely the UAE) and Malaysia. According to Kathryn Mathews, Director for Industry and Investment NSW, speaking on behalf of the NSW Government during the Malaysian visit late last year, 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. Similarly, John Masters (formerly a Partner at PricewaterhouseCoopers and an advisor to the Federal and NSW government on IBF) at the same 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 were 'very focused' 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,' in November 2009 (AFCF, 2009), which detailed the recommendations of a roundtable focused 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.[xvi] 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 (AFCF, 2009). In a recent media announcement in Abu Dhabi (26 April 2010) by Chris Bowen, the Minister for Financial Services, confirmed that the taxation issues are being considered by the Board of Taxation (Sherry, 2009). The Forum also recommended that a special committee be formed at the federal level to explore the issues under the Corporations Act in more detail and to removing any prohibitive barriers for IBF providers.

In addition to the 'Johnson Report', Austrade has produced its own publication: "Islamic Finance" (2010), 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. Re-iterating the 'Johnson Report', it states:

"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."

In summary, both State and Federal governments seem to support moves to accommodate IBF. But the emphasis is clearly on the wholesale market and the need to remove impediments to flows of Islamic FDI reaching Australia. The retail sector is very much a secondary concern.

*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 Shari`ah. 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.

Developments over the last two years, however, indicate that momentum is building to accommodate IBF across Australia. The banks, industrial associations, and State and Federal governments have observed a profitible 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 MoU between Australia and the Malaysian Government, and the active involvement of Austrade in the promotion of IBF in the region provides an excellent example of institutional interest. 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, preferring the UK "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 and Indonesia (and even Singapore) 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 case of Malaysia, they provide tax *incentives* to encourage inflows of Islamic FDI. When one adds to the equation that Malaysia and Indonesia share a common Islamic heritage with the Middle East, it will not be a surprise if the expected flows of Islamic FDI fail to materialise.

There is, of course, another dynamic. Just as with the UK, France, US and other Western economies, a nagging concern continues to surround the IBF industry in Australia and that lies in the "I" and "S" words. Cultural hostility in relation to talk of Islamic Law, witnessed in Europe over the wearing of the Islamic face veil (the *niqab*) and the building of Islamic minarets, is never far from the surface in Australia either and, in conjunction with concerns over immigration, can influence decisions taken at the political level. Although the local investment banks are becoming increasingly confident in the viability of an Islamic wholesale market, evidenced by WIB recently developing its own Islamic products, there is no guarantee the political environment will always remain supportive. The Islamic retail sector, in particular, should not be over-optimistic. Although ASIC has approved retail offerings recently, [xvii]Australia as a whole is following a twin-track approach, with the retail sector travelling on a much slower train.

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