

Islamic Microfinance: A Case Study of Australia

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Abstract

Microfinance services are commonly viewed for those traditionally considered non bankable. Microfinance tool can be adapted in every environment, based on the local needs and economic situation. In Australia, Islamic microfinance enterprises that mostly rely on their shareholders' savings proved to be very successful in providing microfinance to their clientele. The study offers an introduction to the emergence and development of Islamic microfinance in Australia. It also studies the current realities of the Islamic financial system of Australia from the perspective of the theories of modern financial intermediation and Islamic microfinance contracting. It explains the key role of Islamic Microfinance Services Providers (IMSPs) in Australia in fulfilling the microfinance needs of Muslim community. The study concludes that IMSPs in Australia can proliferate in microfinance if they gradually advance towards undertaking more creative microfinance techniques to suit the financial needs of their clientele to facilitate their desired contribution in microfinance.

1. INTRODUCTION

The objective of this study is to examine the viability of Islamic financial institutions (hereinafter referred to IFIs) vis-a-vis their microfinance facilities in the interest-based economy of Australia, which contradicts the ideals of Islamic financial system. The examination has been carried out within the general framework of Islamic financial principles and precepts.

Given the above objective, this study offers an introduction to the emergence and development of Islamic microfinance in Australia, focusing the needs of financing a large and growing Muslim community in line with their Islamic tenets. It also studies the current realities of the Islamic financial system of Australia from the perspective of the theories of modern financial intermediation and Islamic microfinance contracting. The study explains the key role of IMSPs in Australia in fulfilling the

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microfinance needs of Muslim community. It also evaluates the Islamic microfinance techniques used by the IMSPs of Australia.

The study is limited in scope in a sense that it is not a comparative study of Islamic financial system with doctrines of other religions, ideologies and systems. Within this spectrum it reviews the functions and practice of Australian IMSPs in particular in Islamic microfinance.

2. ISLAMIC FINANCIAL SYSTEM: A BACKDROP

Islam is not merely a religion; it provides for Muslims, a complete code catering for all fields of human existence, individual and social, material and moral, economic and political, legal and cultural, national and international.³

It is a comprehensive way of life, religious and secular; it is a set of beliefs and a way of worship; it is a vast and integrated system of laws; it is a culture and civilisation; it is an economic system and commercial norm; it is a polity and method of governance; it is a society and a family conduct; it is a spiritual and human totality; thus worldly and other worldly.⁴

The *Shari`ah*, which is the body of Islamic Law, is not a codified law. It is an abstract form of law capable of adaptation, development and further interpretation. The *Shari`ah* does not prescribe general principles of law. Instead, it claims to deal with and cover specific cases or transactions and sets out rules that govern them. It is derived from two primary sources, the Qur'an (the transcription of God's message to the Prophet Mohammad - pbuh) and the *Sunnah* (the word and living tradition of the Prophet Mohammad - pbuh), in addition to two dependent sources, namely *Ijma`* and *Qiyas* which are meant to provide interpretation, and thereby facilitate future development and implementation of the Islamic judicial system. *Qiyas* is the deductive analogy by which a jurist applies to a new case a ruling made previously in similar case. *Ijma`* is the consensus of the scholars of Islamic laws. It is through this principle that democracy makes its impact on the conduct of Islamic polity. While it opens up law to popular opinion, it is a conservative exercise as the consensus has to be by a very large proportion of the scholars.

The recent surge of religious consciousness or Islamic revival amongst the Muslims has provided the drive towards implementing and adopting Islamic principles in financial transactions. In other words, an outcome of this revival is the emergence of a new discipline, i.e. Islamic Finance. This discipline is based on the knowledge and application of the injunctions and norms of *Shari`ah* which prevent injustice in the

3 See, Jansen, G.H. 1979. *Militant Islam*, London: Pan Books, p. 5.

4 Pervez, Imtiyaz. 1994. "Islamic Banking and Finance" in S. Nazim Ali and Naseem N. Ali et al (eds.), *Information Sources on Islamic Banking and Economics 1980-1990*, London: Kegan Paul International, p.9.

acquisition, management and disposal of material sources. To this end, in an attempt to purify assets in the eyes of Islam, Muslims are seeking a greater balance between their lives in the modern technological world and their religious faith and beliefs.

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions, is the prohibition of all sources of unjustified enrichment and the prohibition of dealing in transactions that contain excessive risk or speculation. Accordingly, Islamic scholars have deduced from the *Shari`ah* three principles which distinguish Islamic finance from its conventional counterpart. These are briefly as follows:

The Prohibition of Riba or interest/usury

The prohibition of Riba or interest/usury is clearly the most significant principle of Islamic Finance. Riba translates literally from Arabic as “an increase, growth or accumulation”. In Islam, lending money should not generate unjustified income. As a *Shari`ah* term, it refers to the premium that must be paid by the borrower to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

Riba represents, in the Islamic economic system, a prominent source of unjustified advantage. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since *Shari`ah* does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value.

Profit and Loss Sharing (PLS)

PLS financing is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that the Muslims do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the PLS-financier's share in profit is the person's effort and the risk he carries, since his profit would have been impossible without the investment. Similarly, if the investment has made a loss, his money would bear the loss.

Gharar or Ambiguity and Speculation

Any transaction that involves *Gharar* is prohibited. Parties to a contract must have actual knowledge of the ‘subject matter’ of the contract and its implications. An example of an agreement tainted with *Gharar* is an agreement to sell goods which have been already lost.

Over the last fourteen centuries banking and finance have developed dramatically and various scholars have endeavoured to explain how, in practice, finance and business should be undertaken in accordance with the Islamic faith. The first thorough studies

of Muslim scholars devoted to the establishment of IFIs appeared in the 1940s. Although Muslim-owned banks were established in the 1920s and 1930s, they adopted similar practices to conventional banks. In the 1940s and 1950s, several experiments with small Islamic banks were undertaken in Malaysia and Pakistan. However, the 'modern era' of Islamic finance began in the 1960's with the foundation of the pioneering 'social bank' in the Egyptian village of Mit Ghamr. It follows the establishment of the Inter-Governmental Islamic Development Bank (IsDB) in Jeddah in 1975, and a number of commercial Islamic Banks such as the Dubai Islamic Bank, the Kuwait Finance House and the Bahrain Islamic Bank in the 1970s and 1980s. Commercial banks have also realised the potential of this new field, and a number of major worldwide institutions have grasped Islamic banking as a significant mechanism for more diversified growth.

3. MICROFINANCE: ISLAMIC PERSPECTIVES

3.1 The basic principles of Microfinance

Microfinance is constituted by a range of financial services for people who are traditionally considered non bankable, mainly because they lack the guarantees that can protect a financial institution against a loss risk.

The true revolution of microfinance is that this tool gives a chance to people who were denied the access to the financial market opens new perspectives and empowers people who can finally carry out their own projects and ideas with their own resources, and escape assistance, subsidies and dependence. Microfinance experiences all around the world have now definitely proved that the poor demand a wide range of financial services, are willing to bear the expenses related to them and are absolutely bankable. The target group of microfinance⁵ is not constituted by the poorest of the poor, who need other interventions such as food and health security,

5 According to the Consultative Group to Assist the Poor (CGAP), the clients of microfinance - female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs—fall into four poverty levels: destitute, extreme poor, moderate poor, and vulnerable non-poor. While repayment capacity, collateral availability, and data availability vary across these categories, methodologies and operational structures have been developed that meet the financial needs of these client groups in a sustainable manner. More formal and mainstream financial services including collateral-based credit, payment services, and credit card accounts may suit the moderate poor. Financial services and delivery mechanisms for the extreme and moderate poor may utilize group structures or more flexible forms of collateral and loan analysis. The client group for a given financial service provider is primarily determined by its mission, institutional form, and methodology. Banks that scale down to serve the poor tend to reach only the moderate poor. Credit union clients range from the moderate poor to the vulnerable non-poor, although this varies by region and type of credit union. NGOs, informal savings and loan groups, and community savings and credit associations have a wide range of client profiles.

but those poor who live at the border of the so called poverty line. Those who could reach more easily a decent quality of life and who have entrepreneurial ideas but lack access to formal finance.⁶

Beginning in the 1950s, development projects began to introduce subsidized credit programs targeted at specific communities. These subsidized schemes were rarely successful. Rural development banks suffered massive erosion of their capital base due to subsidized lending rates and poor repayment discipline and the funds did not always reach the poor, often ending up concentrated in the hands of better-off farmers. In the 1970s, experimental programs in Bangladesh, Brazil, and a few other countries extended tiny loans to groups of poor women to investment in micro-businesses. This type of micro-enterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all members. Through the 1980s and 1990s, micro-credit programs throughout the world improved upon the original methodologies and bucked conventional wisdom about financing the poor. First, it showed that poor people, especially women, had excellent repayment rates among the better programs, rates that were better than the formal financial sectors of most developing countries. Second, the poor were willing and able to pay interest rates that allowed microfinance institutes (MFIs) to cover their costs.

These two features - high repayment and cost-recovery interest rates - permitted some MFIs to achieve long-term sustainability and reach large numbers of clients. In fact, the promise of microfinance as a strategy that combines massive outreach, far-reaching impact, and financial sustainability makes it unique among development interventions.⁷

Microfinance is considered a very effective development tool: for this reason, year 2005 has been declared by the General Secretary of the United Nations "International Year of Micro-credit". Microfinance is also a very flexible tool that can be adapted in every environment, based on the local needs and economic and financial situation. For example, in Asia group micro-lending proved to be very effective, while in Egypt or in Brazil beneficiaries prefer individual lending. One more example: MFIs and NGOs (Non Governmental Organisations) in India mostly rely on savings collection to support their institution and become sustainable while in Egypt they are forbidden by law to collect savings. Microfinance can be effective both in the South of the

6 These people usually do not lack finance in a broad sense: they can borrow money from friends, relatives or local money lenders, but of course they cannot access a wider and safer range of services. They need a formal financial institution to rely on, to ask not only for credit but also saving or insurance services, to deal with on a transparent basis (usury is usually a high risk for these people). Microfinance is filling this vacuum, the gap that until a few decades ago kept these people away from the realization of their own projects.

7 See, Consultative Group to Assist the Poor (CGAP) Web site, retrieved December 29, 2006 from: www.cgap.org

world and in Western countries, equally characterized by financial and social exclusion.⁸

Following this logic, microfinance can easily be adapted to certain cultural environments, such as countries characterized by a majority of Muslims that follow the Islamic law. Moreover, the similarities in the principles of the two make microfinance easier to expand in those countries, giving life to the new hybrid reality of Islamic microfinance.

A few studies have been carried out on the subject and experience on the field is still relatively small, but it proves to have huge potentialities both to fight against poverty financial and social exclusion and to enlarge and enrich the basin of clients of financial institutions in developing countries with an Islamic cultural substratum.⁹

3.2 *Islamic Microfinance*

Islamic convictions on the responsibility go well beyond mere profitability goals and coincide with the renewed perception on business recently at stake within the most advanced sectors of western business and civil societies. Far from the limits imposed by neo-classical thought, this new wave implies new sorts of responsibilities on behalf of the company falling under the rubric of corporate social responsibility (Ferro, 2005). As its ultimate goal is the maximization of social benefits as opposed to profit maximization, through the creation of healthier financial institutions that can provide effective financial services also as grass roots levels, some authors (Al Harran, 1996) argue that Islamic finance, if inserted in a new paradigm, could be a viable alternative to the socio – economic crisis lived by the Western paradigm.

As stated before, a relatively few studies and a few experiences on the field are concentrated on Islamic microfinance.

Between the most complete researches on the topic, Dhumale and Sapcanin (1999) drafted a technical note in which they tried to analyse how to combine Islamic banking with microfinance. They took into consideration the three main instruments of Islamic finance (*mudaraba*, *musharaka* and *murabaha*) trying to use them as tools to design a successful microfinance program.

A *Mudaraba Model*: The microfinance program and the micro enterprise are partners, with the program investing money and the micro-entrepreneur investing in labour. The micro-entrepreneur is rewarded for his/her work and shares the profit while the program only shares the profit. Of course the model presents a series of difficulties, given most of all by the fact that micro entrepreneurs usually do not keep

8 Viganò L. a cura di. 2004. “La microfinanza in Europa”, Giuffrè ed., Milano.

9 Segrado, Chiara. 2005. “Islamic Microfinance and Socially Responsible Investments”, A case study, University of Torino.

accurate accountability which makes it more difficult to establish the exact share of profit. As stated before, these models are complicated to understand, manage and handle which implies that those who are involved need specific training on the issues. For this reason, and for an easier management of the profit sharing scheme, the *mudaraba* model might be more straightforward for businesses with a longer profit cycle.

A *Murabaha Model*: Under such contract, the microfinance program buys goods and resells them to the micro enterprises for the cost of the goods plus a mark-up for administrative costs. The borrower often pays for the goods in equal instalments, and the microfinance program owns the goods until the last instalment is paid.

A *Murabaha Model Example: Hodeidah Microfinance Programme, Yemen.*

Although traditional banking products have been available in Yemen for many years (and are still the predominant type of finance), many people, especially the poor, have been reluctant to take credit, in part due to religious beliefs.

This is one of the main reasons why the Hodeidah Microfinance Programme (hereinafter referred to as HMFP) was implemented in 1997, in Hodeidah, a port city with a population of nearly half a million. It is characterized by an active economy based on trading, fishing, food production, small industries, handicrafts and transportation. In the early 1990s, during and after the Gulf War, many families returned to this city from Saudi Arabia and other Gulf States. Now, roughly 30 percent of the total population in Hodeidah are returnees, a key market segment for HMFP. Much of the population has conservative Islamic beliefs. The population studied showed a clear preference for the methodologies of Islamic banking in terms of receiving credit.

HMFP is the first microfinance project of its kind in Yemen and consequently has had to develop its human resources itself. It had 1770 active clients as of June 2000, 23 percent of whom were women and \$350,000 in outstanding loans. The average loan size is 38,000 Yemeni Rial (YR) (\$240 US dollars). There is a cycle of loans the clients go through but each level has a wide scope. The first loan can be up to 50000 YR (\$300 US). The maximum loan for the final level is 250,000 YR (\$1500 US). HMFP uses a group-based methodology. Group members are not confined to the same loan amounts or the same activities, although loan amounts need to be within the range of the cycle set by HMFP. There is also a small percentage of individual loans (10 percent).

The procedure is as follows: upon receipt of the loan application, the credit officer investigates the group and does feasibility study for their activities. From this study, the officer can estimate the precise loan amount. If the feasibility study is positive, the client should identify items (commodities/equipment) needed from the wholesaler and negotiate a price. The credit officer then purchases items from that source and

resells them immediately at that price to the client. HMFP has two elements of accounting/finance, which differ from most microfinance organisations. Both have implications for content of financial statements. The first is capitalization of the service charge expected upon disbursement, which affects the balance sheet. The second is the absence of the “principle of interest” on outstanding loan balances affecting yield on the portfolio and thus income earned.

Range, in his study (2004), underlines how the prohibition of Riba in Islamic finance does not constitute an obstacle in building sound microfinance products; on the contrary, the side effects of an Islamic foundation could probably enhance it. These effects are: the high rate of return (compared to a fixed interest rate), the holistic approach in supporting businesses and productive activities, a more effective mobilization of excess resources, a fairer society.

4. ISLAMIC FINANCE: AN AUSTRALIAN PERSPECTIVE

The prospective demand for the Islamic financial market in Australia is uncertain and difficult to measure. As far as the number of Muslim population in Australia is concerned there are 340,392 Muslims in Australia, being Islam is the third largest religion after Christianity and Buddhism, representing 1.7% of the population.¹⁰ The Australian Muslim community is drawn from more than 70 different countries,¹¹ is ethnically and linguistically diverse, and geographically scattered, making the marketing of Islamic financial products a major challenge. Though the national demand for Islamic finance is uncertain, in specific geographic areas, several institutions offer Islamic financial services in response to local demands.¹² Local Muslims and non-Muslims can now invest and borrow in interest free transactions according to the tenets of the Shari`ah. In July 2003 the *Weekend Australian* reported that the then Prime Minister John Howard had endorsed a shared partnership scheme between home buyers and banks which was very similar to schemes already being used by IFIs.¹³ In addition, a report published in *The Australian* on October 20, 2006 disclosed that National Australia Bank (NAB) will look at introducing Islamic financing into its product range to capture an “untapped” market that could be worth millions of dollars. It also declared offering a \$25,000 post-graduate scholarship to a

10 Australian Bureau of Statistics: 2006 Census Data – Religious Affiliation, available online at: <http://www.abs.gov.au> (accessed June 30, 2007).

11 Australian Government, Department of Foreign Affairs and Trade. n.d. “Islam in Australia”, available on DFAT Website at: <http://www.dfat.gov.au/publications/terrorism/chapter3.html>, (accessed August 12, 2007).

12 At present, the IMFSPs are mainly located in Victoria and New South Wales in Australia.

13 Hussein, Jamila. 2006. “Islam’s Shariah and Australian law”, The Brisbane Institute, February, available online at: http://www.brisinst.org.au/resources/brisbane_institute_shariah.html, (accessed January 4, 2007).

member of the Muslim community for the year 2007 to further NAB's understanding of Islamic banking.¹⁴

There are currently three key IMSPs in Australia that offer these services; typically *Murabaha*, *Ijara*, and *Musharaka* financing, which are generally used to purchase cars, homes, consumer durables and small businesses. Besides, the concept of Islamic finance is comparatively new in Australian society, and thus it has not been fully understood even by many Australian Muslims. Consequently, there is a need for both Muslims and non-Muslims to be informed on how the practices of IMSPs in Australia differ from conventional ones especially in the three major areas of housing, motor vehicles, and consumer goods financing in Australia. It is expected that such a process will provide the incentive needed for conventional finance providers to consider establishing Islamic banking branches and subsidiaries in Australia and to access this layer of funds for their competitive use.

While insignificant in comparison with the major financial services providers in Australia, the Australian IMSPs are now playing an important role,¹⁵ and their customers¹⁶ now include non-Muslims interested in the services provided by these institutions.¹⁷ In the aftermath of the Asian economic trauma, Australia stands out as an investment opportunity as well as a financial centre. Through using IMSPs' financial services and investment vehicles their customers can reinforce the message that they are significant players in the global services economy. Consequently, in recent years, some international financial institutions like HSBC and Citibank are considering the introduction of Islamic banking branches and subsidiaries in

14 Kerbaj, Richard. 2006. "NAB eyes 'untapped' Islamic finance market", *The Australian*, available online at: <http://www.theaustralian.news.com.au/story/0,20867,20612928-2702,00.html> (accessed January 4, 2007).

15 According to a recent report provided by the Muslim Community Cooperative Australia Ltd. (MCCA) - one of Australia's leading IMFSPs, its overall financial performance for the year 2003-2004 has been remarkable in comparison to the previous financial year. By June 2004, MCCA had a total of 5,824 active members and on average more than 60 new members were registered every month. In the financial year ending 30th June 2004, its revenues increased by 19.45%, profit from ordinary activities grew by 50.64%, total assets increased 11.22%, net asset had increased by 4.89% and there was an increase in share capital by 4.74%. See MCCA, "Financial Highlights for the Year Ended 30th June 2004", Treasurer's Report.

16 The two synonyms 'customers' and 'customers' have been used interchangeably and referred to the same persons/entities throughout this study although there seems to be a slight technical difference between the two as 'customers' are transaction-based and thus they are transient and mercurial associations, while the 'customers' are relationship-based and as such are long-term associations.

17 Saeed, Abdullah. 2001. "The Muslim Community Cooperative of Australia as an Islamic Financial Service Provider", Abdullah Saeed and Shahram Akbarzadeh (eds.), *Muslim Communities in Australia*, Sydney: University of New South Wales Press. p.189.

Australia.¹⁸ ANZ Banking Group Limited - a major Australia and New Zealand based international financial services group has already been offering Islamic financial services in some Muslim countries. In addition, it established special Islamic banking counters or branches in Western countries to capture these significant funds.¹⁹

In response to the needs of this large and growing community mainly for microfinance, the Islamic finance emerged through establishment of the Muslim Community Co-operative Australia Limited, better known as MCCA in 1989. Although a few other IMSPs are providing their services the MCCA is the largest in its kind in this country and it caters for microfinance needs of Muslims looking based on religious principles. In spite of the fact that the MCCA and other IMSPs who claim to operate in line with the principles of *Shari`ah* have seemingly been operating successfully and playing an increasing role in community development and the country's economic growth,²⁰ there has been little comprehensive research on Islamic microfinance in Australia. This provides a proper field of study since to the researcher's knowledge; it has not been tackled before so extensively, as it deserves.

5. ISLAMIC MICROFINANCE SERVICES PROVIDERS IN AUSTRALIA: AN OVERVIEW

The leading IMSPs that conducting their functions in Australia are as follows:²¹

1. Muslim Community Co-operative (Australia) Limited,

18 Datamonitor Report. 2004. Australian Mortgages 2004, September, Datamonitor Website, available at: www.datamonitor.com/~ee1532b3e34d4986932858d8d0acf4ac~/Products/Free/Report/DMFS1726/010DMFS1726.pdf (accessed September 12, 2006).

19 The ANZ Group is originated in the UK in 1835 when the Bank of Australia was established by Royal Charter. ANZ in the UK now operates as a division of the Australia and New Zealand Banking Group Limited and is regulated by FSA (Financial Services Authority) in conduct of its investment business. Islamic finance is one of its major products. See for details, "ANZ United Kingdom – Country Information", available online at: <http://www.anz.com/uk/countryinfo.asp>

20 According to a recent report provided by the Muslim Community Cooperative Australia Ltd. (MCCA) - one of Australia's leading Islamic Microfinance Services Providers, its overall financial performance for the year 2003-2004 has been remarkable in comparison to the previous financial year. By June 2004, the MCCA had a total of 5,824 active members and on average more than 60 new members were registered every month. In the financial year ending 30th June 2004, its revenues increased by 19.45%, profit from ordinary activities grew by 50.64%, total assets increased 11.22%, net asset had increased by 4.89% and there was an increase in share capital by 4.74%. See, MCCA, "Financial Highlights for the Year Ended 30th June 2004", Treasurer's Report.

21 See for more elucidation, A.U. F. Ahmad and A.B. R. Ahmad. 2007. "Islamic Micro and Medium Sized Enterprises (MMEs) Finance: The Case Study of Australia", 1st International Conference on Inclusive Islamic Financial Sector Development Proceedings, Brunei. pp.816-844.

2. Islamic Co-operative Finance Australia Limited,
3. Iskan Finance Pty Limited.

5.1 *Muslim Community Co-operative (Australia) Limited*

MCCA is a non-bank financier based on unique system that recognises and meets the community's religious needs. It also spouses a philosophy of providing finance on a fairer and more equitable basis, which in the long-term should be better for society at large. Based in two major cities of Australia, Melbourne and Sydney, MCCA serves the diverse needs of all consumers and was recently honoured with the 2006 Australian Business Award for Small and Medium Enterprises (SMEs) in the categories of *Enterprise* and *Community Contribution* for community service and community reinvestment.²² Its membership is open to all, whether Muslims or non-Muslims. Anyone who is interested in alternatives to interest-based finance is encouraged to become a member.

MCCA is considered "the largest provider of specialized financial services in Australia that comply with both conventional credit laws and Islamic requirements".²³ Established in February 1989 with ten members and a starting capital of A\$22,300, MCCA's members stand now over 9,000 in Victoria and New South Wales.²⁴ According to updated information provided by MCCA in its official webpage:

"We have since become the largest and most widely recognised Australian provider of Islamic finance and investment services with 6,900+ member shareholders and more than \$240 Million in financial accommodations currently managed".²⁵

Currently, MCCA originates A\$100 million a year in Islamic home finance and manages a finance book of Islamic home finance and equipment assets in excess of A\$250 million.²⁶ As a corporate that is "majority owned by Australian Muslims,

22The Enterprise category acknowledges business that have shown the "initiative and willingness to undertake bold new ventures", while Community Contribution recognises "those who demonstrate examples of policies or projects that positively impact on the community and generate outcomes that have a long time benefit". See "New ratings", Australian Business Awards, available online at: http://www.newratings.com/analyst_news/article_1422447.html (accessed January 9, 2007). See also, MCCA Newsletter, January 2007.

23 MCCA Media Release, accessed on November 16, 2006 from: <http://www.mcca.com.au/UserFiles/061116%20MCCA%20ABA%20Press%20Release.pdf>

24 Ibid.

25 See Muslim Community Co-operative (Australia) Ltd website, accessed October 01, 2007 at: http://www.mcca.com.au/page.php?id=housing&product_id=8

26 In Australian dollar. The Australian dollar's ISO 4217 code is AUD but it has been abbreviated with the dollar sign A\$ in this study to distinguish it from other dollar-denominated currencies.

MCCA is now the most recognised and trusted brand within the Islamic finance market in Australia".²⁷ In addition to its consumer finance offerings, it co-developed Australia's first and only Islamic public offer ASX listed equities investment product, the Crescent Ethical managed discretionary account service.²⁸

MCCA's principal managed funds are of the following types: '*Ijara*, *Murabaha*, '*Ijara Muntahia Bittamleek* (IMB), *Tamleek*, '*Ijara wa Iqtina*, *Qard Hasan* and *Mudaraba*.²⁹ Among these products MCCA's fund under the '*Ijara* mode is provided for residential house financing only and for property construction. While financing under *Murabaha* is managed for both residential and commercial purposes. MCCA's IMB, a relatively new product which was initially named as Sale to Lease (S2L) is now used for residential and commercial financing. On the other hand MCCA's *Tamleek* is used for funding residential properties only. The *Murabaha* and '*Ijara wa Iqtina* products are used for motor vehicles and other commodity financing. The *Qard Hasan* (interest free loan) is made from the pooled donations of the members and are generally granted to those who are facing an emergency personal crisis. *Mudaraba* is used for joint partnership investment in MCCA, while the *Musharaka* product is used for equity investment in MCCA and Crescent Ethical MDA Services.³⁰ The *Musharaka* was initially used by MCCA for home financing under the product name Shared Equity Rental (SER).³¹ To the author's knowledge it is not in use any more by MCCA for home financing.

In fact MCCA's Shared Equity Rental (SER) Scheme under *Musharaka* looks akin to the model announced by the Australian Prime Ministerial Taskforce on home ownership in June 2003, in which the homeowner and a bank or other mortgage lender would co-own a home. Under the proposal, the financier would own about 30% of the home's value – reducing the amount of the homebuyer's mortgage and making it easier for people to buy a home.³² In keeping with the Islamic principle that the financier and the buyer should share the risk and reward of the venture, MCCA takes an equity stake in the property and buyer pays monthly rent with a capital repayment component – eventually to assume full ownership.

27 See K. Dawud David, supra note 332.

28 Ibid.

29 See MCCA website, supra note 337.

30 See MCCA website, supra note 337.

31 This product was applied as a Diminishing Partnership (DP). In home financing under DP the customer forms a partnership with the financial institution for the purchase of a property. The financial institution rents out their part of the property to the customer and receives compensation in the form of rent, which is based on a mutually agreed fair market value. Any amount paid above the rental value increases the share of the customer in the property and reduces the share of the financial institution.

32 Prime Minister John Howard said that he was particularly concerned about young home buyers struggling to afford properties in Melbourne and Sydney. However, some commentators have criticised the proposal, saying that a real danger is negative equity where the house is sold for less than the amount outstanding.

So far as the activities and purposes of MCCA are concerned, the following summary given by Peter Moody of the Australian Taxation Office is worthy of mention.

- a. A place for the advancement of the principles of the Muslim faith, and the evolution of a ‘community’ that overlooks its members and shareholders. MCCA funds can be, and are used to help those in need within the community. Donations are received and applied for this purpose. A separate fund has been created for this end, and is known as the Qard Hasan Fund.
- b. To operate as a housing co-operative that assists with the purchase of mainly residential properties for and on behalf of its shareholders. The purchase of other asset classes is undertaken in a similar fashion, mostly the purchase of motor vehicles, computers, and some limited business finance. The purpose of the provision of this facility is solely centered around the Muslim doctrine that forbids the payment of interest. MCCA charges an upfront ‘administrative’ charge for their involvement, but thereafter, the loan is interest free. This conforms to all the requirements of their religion, and such transactions are held to be Halal, which means that they are ‘allowable’ under Muslim doctrine. Repayments under these types of transactions are known as repayments of Murabaha.
- c. To accept funds and issue shares in the co-operative from time to time, and to distribute the trading surplus of the co-operative back to the members in the form of dividends”.³³

However, MCCA itself underscores its core purpose in its official website as follows:

“to provide goods and services to members in accordance with Islamic law and the principles of co-operation”.

It also stipulates that its vision is:

“to be the leading provider of specialised financial and wealth management services catering to the needs of Australian Muslims”.³⁴

5.2 Islamic Co-operative Finance Australia Limited

Islamic Co-operative Finance Australia Limited (ICFA) was officially endorsed and registered by the Registry of Co-operatives, Department of Fair Trading, the Government of the State of New South Wales, in May 1998 under the Co-operatives Act 1992 (NSW), sections 8, 9 and 10 to function as co-operative within the state of New South Wales.³⁵

33 See Hamdi, A. Abdul. 1999. “Islamic Banking System”, available online at: <http://www.mail-archive.com/indoze-net@cc.utas.edu.au/msg01221.html>

34 See MCCA website, supra note 337.

35 See Islamic Co-operative Finance Australia Limited website, available online at: http://www.icfal.com.au/about_us.html

The primary objectives of ICFA are:

- A. To provide methods of investment & finance opportunities for its members in line with Islamic principles (Halal): Equity Profit & Loss sharing concept, which is fair, simple and straightforward,
- B. Facilitate earning Halal income,
- C. Facilitate ownership of property (home, vehicle & other approved tangible assets),
- D. Facilitate performing social & religious obligations for Muslim members i.e., Zakah & Hajj and,
- E. Establish feasible joint venture or partnership deals with members & similar organisations".³⁶

At present, ICFA provides the following products and services for its members.

- A. Housing finance under *Murabaha*, *Musharaka* and *'Ijara wa 'Iqtina* financing schemes. It follows almost all the terms and conditions and procedures followed by MCCA for its house financing scheme.
- B. Vehicle finance under *Murabaha* and *'Ijara wa 'Iqtina* modes of finance.
- C. Buying consumer's durables for customers and reselling to them under the *Murabaha* mode of finance.
- D. Small business finance under *Musharaka* and *Murabaha* financing schemes.
- E. Hajj Fund under the *Mudaraba* mode of investment. Under this scheme a customer wishing to perform Hajj deposits money by installments to this fund over a specified period to be able to bear Hajj related expenses when the fund is matured. The accrued dividend is distributed among the participating members for the whole period of investment.
- F. Children Education Fund under the *Mudaraba* mode of investment. Under this arrangement ICFA provides financial facilities to cover the education expenses of the participating members' children during the later stage of high School and tertiary education. To meet eligibility criteria of an active membership provision a child under the age of 18 years pays at least 10% of the joining fee of A\$100 plus 10% of 5 shares (each share is valued at A\$100) and agrees to pay the remaining portion by equal installments during the first financial year. The maturity period of this fund package to be purchased must be at least 5 years.

36 Ibid. See also, Islamic Co-operative Finance Australia Limited, ICFAL at a Glance, (an undated brochure.)

G. *Zakah* Fund. Under this scheme ICFA acts on behalf of each member, if requested to calculate, collect and distribute *Zakah* to the poor and other deserving needy people as outlined in the Islamic Shari`ah.³⁷

H. Qard Hasan (Benevolent Fund).

As regards the membership requirements, any person residing in the State of New South Wales may be eligible to become a general member of ICFA by paying a one-off membership fee of A\$100 and an active member of ICFA by purchasing a minimum of 5 shares valued at A\$100 each. An active member is entitled to receive finance from ICFA's under the schemes mentioned above subject to the down payment of 20% of the total price of the house, commodity or other products under purchase.³⁸

5.3 *Iskan Finance Pty Limited*

Iskan Finance, as stated on its official website, is an Australian business established in 2001 by a group of Australian and Non-Australian Muslims with the core objective to pioneer, create and promote the most competitive Shari`ah compliant home facilitation programme possible for the Islamic community in Australia.³⁹ In 2002, Iskan Finance commenced business with its *Murabaha* Facilitation Programme and building on the success of this core home financing product, has developed its '*Ijara wa 'Iqtina* ("Lease to Purchase") facility. Both the *Murabaha* Facilitation Programme and the '*Ijara wa 'Iqtina* facility have been modelled on *fatwas*⁴⁰ issued by various Islamic scholars and on opinions that Iskan has sought from Al Azhar University in Egypt. At the same time, Iskan Finance has worked hard to ensure that the financing will have longevity and consistency of delivery by engineering both its funding products to comply with the Australian UCCC. In 2005 Iskan introduced a new product under the name "Tayseer-Ijara" for residential and commercial customers which replaced its previous product '*Ijara wa 'Iqtina*. In 2006, it introduced another product called *ultiMATE* Home Finance package offering a wider range for its customers. The reason given for this modification as it claimed was "to cater for the specific needs for our community".⁴¹

At a practical level, Iskan Finance has established links with a number of third party providers to service its customers. For instance, the custodian of Iskan's mortgages is Perpetual Trustee Australia Limited; mortgage insurance is provided by G. E.

37 See ICFAL website, see also *supra* note 347.

38 *Ibid.*

39 See Iskan Finance Pty Ltd. website, available at: <http://www.iskan.com.au/home.htm>

40 *Fatwas* are legal statements in Islam, issued by a scholar of Islamic laws, on a specific issue. They are asked for by judges or individuals, and are needed in cases where an issue of Islamic law and jurisprudence is undecided or uncertain. Lawsuits can be settled on the basis of a *fatwa*.

41 See Iskan Finance Pty Ltd. website, *supra* note 351.

Mortgage Insurance Services; and the Program Manager is RESIMAC Limited. Iskan has contracted with Advance Investment Securities Australia Pty Ltd to manage distribution of its facilities and strategic alliances have now been forged around Australia to service a growing customer base.⁴²

Iskan Finance believes its *Murabaha* Facilitation Program and its '*Ijara wa 'Iqtina* offer a sound foundation for a growing suite of financing products that are planned to service the Australian Muslim Community. Iskan's *Murabaha* Facilitation Program is designed to offer a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. It is a contract of sale between Iskan and its customer that establishes a fixed *Murabaha* price including a profit mark-up, secured by a mortgage. Under Iskan's *Murabaha* Property Facility Program, following settlement, Iskan's customer is the sole owner of the property and enjoys the full benefit of any capital gain in the property.⁴³

Iskan's '*Ijara wa 'Iqtina* financing model as it mentions on its website is designed to be a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. The model is based on the concept of 'leasing to purchase' a home. Iskan's customer agrees to lease the property and pay rent, either fortnightly or monthly. Rent is reset at twelve monthly intervals and each rental payment made increases the customers' equity, ultimately retiring Iskan's equity. Iskan customers have the option to retire the facility in part or full on yearly anniversary dates when the rental payments are reset.⁴⁴

The '*Ijara* facility is secured by a mortgage on the property. Under this scheme, Iskan customers are required to pay deposit of at least 5% toward the purchase price of the home and Iskan provides the balance. However, as Iskan customers do not need to open a savings account with Iskan, there is no lengthy waiting time to qualify. The '*Ijara* facility does not require the customer to enter into any partnership with Iskan and the customer enjoys the full benefit of any capital gain in the property. Like Iskan's *Murabaha* Property Facility, applying for an '*Ijara* facility is also simple. Most of the requirements of this program are stated on its website.⁴⁵

6. TECHNIQUES USED BY THE ISLAMIC MICROFINANCE SERVICES PROVIDERS IN AUSTRALIA: AN EVALUATION

The IMSPs in Australia although have seemingly been functioning in line with the central objective of Islamic finance to provide facilities and services to their clientele their practice need to be thoroughly investigated. As the nature of transactions of IFIs

42 Ibid.

43 Ibid.

44 Ibid.

45 Ibid.

look similar to their conventional counterparts, the functions of IFIs are almost the same as conventional financial system mainly in terms of accepting deposits from the depositors and operating functions of customers as agents as long as they do not contradict the principles permissible by *Shari`ah*. Given this, IFIs in Australia have adopted the traditional financing tools and procedures for their functions. These institutions apparently use following four conditions set by the Islamic scholars and are required to affect a valid contract in order to attract funds and to provide Islamic financing to their customers.

- a) A price that is agreed mutually and not under compulsion;
- b) Between parties that are sane and have the legal capacity to understand the implications of their actions;
- c) At the time of contracting, the subject matter of the contract be in existence and able to be delivered without uncertainty or deception;
- d) The contract must not be based upon a consideration that is itself prohibited under the *Shari`ah* (e.g. alcohol, gambling, construction of casino, weapons of mass destruction, pork products, etc.).

As against the wider scope of its investment, financing responsibilities and operations such as meeting the socio-economic objectives of Islam, safeguarding the interests of the investors by an efficient decision-making and management process etc., Islamic financial institution even at this stage has access to very limited modes of financing. However, the major microfinance techniques under which the IMSPs in Australia operate and provide services to their clientele are: *mudaraba*, *musharaka*, *murabaha*, *`ijara* and *qard hasan*.

6.1 Mudaraba or Trust Financing

Mudaraba is a form of partnership in which one partner provides the capital required for funding a project (known as *rabb-ul maal*), while the other party manages the investment using his expertise (known as *mudarib*). Although similar to a partnership, it does not require a company to be created, so long as the profits can be determined separately. Profits arising from the investment are distributed according to a fixed, pre-determined ratio. The loss in a *mudaraba* contract is carried by the capital-provider unless it was due to the negligence, misconduct or violation of the conditions pre-agreed upon by the provider of the capital.

In a *mudaraba*, the management of the investment is the sole responsibility of the *mudarib*, and all assets acquired by him are the sole possession of *rabb-ul maal*. However, the *mudaraba* contract eventually permits the *mudarib* to buy out the *rabb-ul maal's* investment and become the sole owner of the investment.

Mudaraba may be concluded between the Islamic financial institution, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee (not the English

law concept of trustee) of their funds, and its business-owner clients. In the latter case, the bank pays its depositors all profits received out of the investment, after deducting its intermediary fees. It may also be conducted between the financial institution's depositors as providers of funds and the Islamic financial institution as a *mudarib*.

6.2 Musharaka or Partnership Financing

Musharaka is often perceived as an old-fashioned financing technique confined in its application to small-scale investments. Although *musharaka* is substantially similar to the *mudaraba* contract it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment.

Profits are shared between partners on a pre-agreed ratio, but losses will be shared in the exact proportion to the capital invested by each party. This gives an incentive to invest wisely and take an active interest in the investment. Moreover, in *musharaka*, all partners are entitled to participate in the management of the investment, but are not necessarily required to do so. This explains why the profit-sharing ratio is left to be mutually agreed upon and may be different from the actual investment in the total capital.

In a typical *musharaka* between a bank and a customer (i.e., partner), at the time of distribution of profits, the customer pays the bank its share in the profits and also a pre-determined portion of his own profits, which then reduces the bank's shareholding in the investment. Eventually, the customer becomes the complete and sole owner of the investment.

6.3 Murabaha or Cost-plus Financing

Murabaha is the most popular form of Islamic financing techniques used by IFIs in Australia. Within a *Murabaha* contract, the financial institution agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then re-sells the assets or goods to its client with a mark-up profit. The client purchases the goods either against immediate payment or for a deferred payment.

This financing technique is sometimes considered to be akin to conventional, interest-based finance. However, in theory, the mark-up profit is quite different in many respects. The mark-up is for the services the financial institution provides, namely, seeking out, locating and purchasing the required goods at the best price. Furthermore, the mark-up is not related to time since, if the client fails to pay a deferred payment on time, the mark-up does not increase due to delay and remains as pre-agreed. Most importantly, the financial institution owns the goods between the two sales and hence assumes both the title and the risk of the purchased goods, pending their resale to the client. This risk involves all risks normally contained in trading activities, in addition to the risk of not necessarily making the mark-up profit, or if the client does not purchase the goods from the financial institution and whether

he has a justifiable excuse for refusing to do so. However, a customer's promise to purchase the goods in a *Murabaha* is an ethically binding promise. Accordingly, the customer is bound to compensate the financial institution for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods.

The purchase of goods under the *Murabaha* contract may be funded by the Islamic financial institution either from its own funds, or from the funds of its depositors. In the latter case, the financial institution acts as its depositors' agent, retaining its fees from the mark-up profits. In such circumstances, the depositors will own the purchased goods during the period pending its resale, and therefore assume its risk.

6.4 *Ijara Financing or Leasing*

Ijara is defined as 'sale of right to utilise the goods for a specific period'.⁴⁶ The *Ijara* contract is very similar to the conventional lease. Under Islam leasing began as a trading activity and then much later became a mode of finance. *Ijara* is a contract under which the financial institution buys and leases out an asset or equipment required by its client for a rental fee. The jargon accorded to the financier, that is the financial institution, is 'lessor', and to the client, 'lessee'.

During a pre-determined period, the ownership of the asset remains in the hands of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented. Likewise, the lessor assumes the risk of ownership and in practice seeks to mitigate such risk by insuring the asset in its own name. Under an *Ijara* contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed interval. This is to ensure that the rental remains in line with prevailing market leasing rates and the residual value of the leased asset.

There are two kinds of *Ijara* contracts used by the financial institutions in Australia. The first is the *Ijara* or true lease, which represents an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. The second type is *Ijara wa Iqtina* (literally, 'higher purchase' or 'lease and ownership'). This is a lease whereby the lessee derived economic use and ultimate ownership on the nature of a higher purchase. This is equivalent to a financial lease, or a lease with a purchase option. The purchase option stems from either a portion of the rental being allocated to a capital savings account, or a pre-agreed balloon payment, at the end of lease. For example, an Islamic financial institution agrees to buy and rent a building, equipment or other facility for its client, in conjunction with an undertaking by the client to make incremental payment into an account. At the end of each year, profits are added

46 Al-Jaziri, 'Abdal-Rahman. Undated. Kitab al-Fiqh 'ala al-Madhahib al-'Arba'ah, Beirut: Dar al-Kutub al-'Ilmiyyah, pp. 86-87.

to the instalments paid until such time as the investment account contains the identical amount the financial institution paid to purchase the building equipment or facility. The client becomes owner of the financed equipment and the contract ends.

6.5 Qard Hasan Financing or Interest-free Loan

Qard Hasan is a benevolent type of loan provided by some of financial institutions in Australia free of any charge usually to the needy on humanitarian grounds if their resources allow providing such loans without unduly affecting their profitability for investors and shareholders. Under this type of Islamic finance, the client undertakes unconditional obligation to repay the amount loaned. Islamic financial institution has the right to ask for collateral to secure its exposure. It may also seek full recourse against the client for recovery of its amounts due from him.

7. SUMMARY, CONCLUSION AND RECOMMENDATIONS

Although IFIs operating in Australia are very small in terms of their size, assets, profitability, number of investors etc. the signs for their continued growth appear positive. With a view to the limited access to their data and information, and adequate information are not available in their official web sites and publications all relevant data and information of these IFIs could not be obtained to the researcher. Since all of the financial activities of these institutions are mostly involved in house financing they worked so far in a mainly benign economic climate, with rising property values. They have yet to be tested with a sharp fall in property values.

Another important consideration is that, unlike deposits, the shares of IFIs in Australia are not protected by regulators. So, MCCA and ICFA are not governed by the Australian Prudential Regulation Authority (APRA). As discussed earlier in this study the MCCU – an APRA-governed credit union which was supported by MCCA proved disastrous.

In pure financial terms, the MCCA and ICFA's shared equity arrangements appear not much attractive – and arguably, dearer than a conventional loan. It is therefore, surprising take-up of the product has been confined to devout Muslims. With all these realities, as the nature of IFIs is that they are based on profit sharing they should always carry the risk along with homeowners or other clients. At the same time, as they are based on the system that recognises and meets the communities' religious needs they have community involvement. Therefore, it is hoped that these IFIs will play a significant role in meeting the communities' religious needs and the economic development of Muslim community in Australia. Time will prove whether they will make lasting impact on multicultural society in Australia.

The author recommends decision-makers in IMSPs, Islamic financial cooperatives, relevant government authorities and Islamic micro-lenders that they cautiously

examine the following opportunities for the development of a healthy Islamic financial sector in Australia.

1. The considerable growth of the IMSPs in Australia can be achieved through Islamically accepted mortgage broker and possibly through a link with global wholesale banks such as HSBC Amanah Finance Citibank, etc.
2. The MCCA and ICFA may merge with each other for their future growth and development through attracting more capital.
3. At present all these IFIs are providing investment facilities rather than retail banking facilities, which is not enough. In order to attract more clientele thus providing the twin engines of fulfilling communities' religious needs and economic development of the country through microfinancing Islamic investment and retail banking facilities must be integrated.
4. More creative Islamic microfinance techniques need to be undertaken to suit the financial needs of individuals and groups to facilitate their contribution in community development in particular and the economic development of Australia at large.

The volume of research on Islamic microfinance has considerably amplified in recent years. However, there are still many significant issues to be critically examined. In relation to the theory and practice of Islamic microfinance in Australia, which is the topic of the author's research, there is more work to be done. The author's research was somehow limited to theoretical and technical analysis. It should be followed by empirical studies and tests. Within a few years, sufficient volume of data on the Islamic microfinance in Australia will be available, to make such studies practicable.

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

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