Regulatory Impediments to Islamic Finance: The UK and Australia Compared

Abu Umar Faruq Ahmad

Abstract

The purpose of this paper is to contrast regulatory impediments to Islamic finance in the UK and Australia in relation to providing Islamic finance products, and also to consider how the relevant laws of Australia may be improved in light of the English laws with the aim of promoting a level playing field. To this end, it reviews Islamic finance laws in both UK and Australia, and examines the measures that are in place to protect stakeholders who use funds provided by Islamic financial services providers (IFSPs). Having been compared the relevant laws of the two countries the study concludes that Australian law pertaining to Islamic finance industry could be improved by removing regulatory barriers to the industry and helping it to improve awareness. The paper attempts to make comparison of English and Australian Islamic financial transactions to promote a level playing field for stakeholders. It recommends that since the principles of Islamic finance differ from its conventional counterparts a separate legal framework should be established to facilitate its growth and development in the Australian financial market.

I. INTRODUCTION

1.1 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. As per the report released by Kuwait Finance House Research, there are more than 600 Islamic financial institutes operating in more than 75 countries (KT, 2013), while Islamic finance industry has grown at a strong rate of 15.0% - 20.0% annually over the past decade. The Islamic banking industry currently constitutes only 1.6% of the total assets of the top 50 largest banks in the world though the industry witnessed robust growth (totalling $66.2 trillion) at the end of

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1 Dr. Abu Umar Faruq Ahmad is Senior Researcher of International Shari'ah Research Academy for Islamic Finance (ISRA), Malaysia. He also currently chairs the Shari'ah Advisory Board at Islamic Cooperative Finance Australia Ltd. and Shari'ah Supervisory Committee of Australian Muslim welfare Centre Inc.
of 2011. The report indicates while about 80.0% of Islamic banking assets are in the Middle East, Asia represents a significant market with Malaysia having the largest market share of 9.6%, being Indonesia witnessed the strongest growth (of 48.6%), followed by Pakistan (34.4%).

The Muslims are considered as the largest religious minority in the highly diversified multicultural Australia. According to the 2011 census conducted by the Australian Bureau of Statistics, in Australia Islam is the fourth largest religious grouping, after all forms of Christianity, no religion and Buddhism. Out of a total general population of 22.6 million scattered across its nine States, 1.5%, which represents total 340,000 profess Islam (ABS 2011). As the primary market for Islamic finance, the Muslim community’s asset base is not strong. The demand for Islamic finance products among Australian Muslims is greater than the available supply (Ahmad & Hassan, 2011).

On the other hand, the US think-tank Pew Forum on Religion and Public Life 2010 report on ‘Muslim Networks and Movements in Western Europe’ put the current figure of British Muslims at 2,869,000, which is equivalent to 4.6% of the population. In absolute terms, the UK has the third largest Muslim community on the continent, after Germany (4,119,000) and France (3,574,000). The UK’s Muslim population is set to rise from 2.9m now to 5.6m in 2030 - up from 2% of the UK population to 4.6%, as per the estimation made by the Forum (Rogers, 2011). The size and infancy of the Muslim community may be a factor in the growth of Islamic finance.

1.2 Objectives
The purpose of this paper is to contrast regulatory impediments to Islamic finance in the UK and Australia in relation to providing Islamic finance products, and considers how the laws of Australia may be improved in light of the English laws with the aim of promoting a level playing field. To achieve this objective the study reviews Islamic finance laws in both UK and Australia, and examines the measures that are in place (or not) to protect stakeholders who use funds provided by Islamic financial services providers (IFSPs). The paper also seeks to argue that since the principles Islamic finance differ from its conventional counterparts a separate legal framework should be established to facilitate its growth and development in the Australian financial market.

II. THE GLOBAL PROSPECTIVE OF THE UK AND AUSTRALIAN ISLAMIC FINANCE

2.1 The UK and Australia as global potential hub for Islamic finance
The UK has enjoyed an in-built advantage in its attempt to become the hub of Islamic finance in Europe. This is due to English law often being the governing law of international Islamic finance transactions. There may be a Swiss bank and a Middle Eastern counterparty wanting to enter into an Islamic finance transaction (Lawrence, 2012). However, they may well choose to use English law to structure their documentation in order to give flexibility and certainty to both sides. Similarly, as the market continues to grow, there is a real opportunity for Australia to position itself as the Islamic finance hub for the Asia Pacific region. Australia is ideally positioned to challenge Malaysia and Indonesia as a financial hub for this rapidly growing industry.

2.1.1 The United Kingdom
The UK ranks ninth globally amongst countries providing Islamic finance services, which makes it the leading Western country and Europe’s premier Islamic finance center with USD 19 billion of reported assets (TheCityUK, 2011). London has been providing Islamic financial services for 30 years, but in recent years the industry has started to attain a greater profile. This higher profile results from the following four main factors (Kan, C., 2012):

The first is leadership, demonstrated by the UK government being the first mover in the West to create an advantageous fiscal and regulatory framework to enable Islamic finance, by introducing legislation that gives a level playing field for Islamic finance. A key change to the fiscal and regulatory framework in 2003 was the removal of double taxation on Islamic mortgages and an extension of tax relief on Islamic mortgages to companies and individuals, making investing in real estate more attractive. This has helped broaden the market for Islamic products for both Shariah-compliant institutions and firms with ‘Islamic windows’.
The second factor is the strong basis of education, training and thought leadership originating from the UK, with a variety of qualifications and courses run by different professional institutes. On the commercial side, there is a host of Islamic banks and institutions providing retail, investment banking, and real estate and broader asset management services. London has quality assets which have historically provided a home for Gulf liquidity. Britain’s Islamic banking sector is now bigger than that of Pakistan. A total of 22 banks, 5 of which are fully Shariah-compliant namely the Bank of London the Middle East European Islamic Investment Bank, Gatehouse Bank, Islamic Bank of Britain and QIB UK serve the local market. Another 17 leading institutions including Barclays, RBS and Lloyds Banking Group have set up special branches or subsidiary firms for Islamic finance clients (TheCityUK, 2011). That is the largest number of banks for Muslims of any western country. The third, London itself is a global financial centre with a strong capital market, which has attracted a number of global sukuk to list on the London Stock Exchange (LSE) platform. Four major listing platforms are currently battling for dominance of the lucrative and fast-growing sukuk market such as London (London Stock Exchange), Kuala Lumpur (Bursa Malaysia), Dubai (Nasdaq Dubai), and Luxembourg (Luxembourg Stock Exchange). The LSE is currently leading the game globally as it offers listing as well as trading, whereas other domiciles like Luxembourg are primary listing domiciles with no trading. Reduced costs are also part of the attraction. The fourth factor which should support the development of Islamic finance in the UK is as the demographics of the local Muslim population. Muslims in the UK have a combined spending power of GBP 21 billion and save about GBP 1 billion a year, which shows the significant potential for the market. Given that, the prospects of Islamic finance in the UK look good, although the industry-wide context seems hardly favourable.

2.1.2 Commonwealth of Australia

Despite the remarkable growth and development of Islamic banks and financial institutions over the last few decades in other comparable developed countries with minority Muslim population, their expansion in Australia is very slow though steady (Ahmad & Hassan, 2011). Currently there are two Islamic financial institutions (IFIs), the Muslim Community Cooperative Australia Limited (MCCA) and Islamic Cooperative Finance Australia Ltd (ICFA), which operate on the principles of co-operative. The Iskan Finance Pty Ltd. has also been providing Islamic financial services in the country. Although another financial institute namely the Kuwait Finance House (Australia) Pty Ltd. which is recently licensed to provide financial services in the country it did not commence its operation yet. Neither of the above mentioned IFIs has a banking licence to operate as a bank (Ahmad 2010).

Australia’s financial services industry is one of the world’s most sophisticated, competitive and innovative industries. The World Economic Forum’s Financial Development Report 2009 ranked Australia as the second most developed financial centre in the world, behind the UK, but ahead of the United States (Austrade, 2010). This is primarily due to the stability of its financial institutions over the last three years, and also due to the size and sophistication of Australia’s pool of managed funds which is the fourth largest in the world and the largest in Asia. Moreover, the competitiveness of Australia’s financial services sector offers great opportunities for Islamic banks and financial institutions to do business in this country, or to export their products to Asia from a strong, stable and extremely well regulated regional base. It also presents opportunities for Australian-based banks and financial institutions to develop Islamic finance products for domestic and international markets.

In 2010, the Australian Financial Centre Forum has released its report on Australia as a financial centre which is commonly known as the Johnson Report. The Report was commissioned by the Government in September 2008, as part of its commitment to secure Australia’s future as a leading financial service centre. The report concludes that Australia has arguably the most efficient and competitive financial sector in the Asia-Pacific region, but that there are opportunities to expand its exports and imports of financial services and hence maximise the benefits flowing to the Australian workforce and Australian consumers of financial products. The report also made a range of important recommendations, including the following specific steps to ensure Islamic finance is enabled in Australia (AFCF, 2010).

First, the report recommends the removal of regulatory barriers to the development of Islamic finance products in Australia. Secondly, a recommendation that the Board of Taxation consider whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance. Austrian Government has accepted the Johnson report’s recommendation that Islamic products with regulatory frameworks, including taxation systems, needing to
accommodate Shariah compliant financing and investment products, should be taxed on the same basis as non-Islamic products. In principle, Islamic financing products structured with pre agreed profit mark ups and splits should therefore be taxed as non-Islamic financing products with an interest component. The Board of Taxation has been asked by the Government to undertake a review to ensure that Australia’s tax laws do not inhibit the expansion of Islamic finance, banking and insurance products in the Australian market (AFCF, 2010).

Australia’s acceptance of the Johnson report’s recommendations on regulatory changes and tax reform to facilitate Islamic finance means Australia will be among the first OECD countries to conduct this kind of system-wide review. It is true that the UK has acted on a few discrete areas, but the review that was announced by the Australian government considered to be thoroughly comprehensive. Islamic finance is a rapidly growing part of the global financial system and Australia is in an excellent position capitalise on that growth. Australia’s acceptance of the Johnson report’s recommendations is to ensure that the country’s system does not unfairly disadvantage or preclude such instruments.

This will have a dual advantage, if Australia’s tax system continues down the path of accommodating this type of finance it will serve the country in terms of capital attraction, jobs and growth. Fostering Islamic finance in Australia would also pave the way to open up new education and training opportunities for its universities and tertiary institutions. Furthermore, it would serve the Islamic world both as another option to deliver a strong and diversified investment portfolio and as a critical stepping stone into the broader Asia-Pacific.

In another development, in May 2010 the then Assistant Treasurer launched a book entitled Demystifying Islamic Finance - Correcting Misconceptions, Advancing Value Propositions. At the launch the then Assistant Treasurer said:

We are taking a keen interest in ensuring there are no impediments to the development of Islamic finance in this country, to allow market forces to operate freely. This is in line with our commitment to foster an open and competitive financial system, and a socially inclusive environment for all Australians. We also recognize that Islamic finance has great potential for creating jobs and wealth.

III. THE REGULATORY FRAMEWORK FOR ISLAMIC FINANCE IN THE UK

3.1 The Financial Services Authority (FSA): The UK’s Single Statutory Authority

The UK’s Financial Services Authority has been vested with responsibility by the Parliament under the Financial Services and Markets Act 2000 (FSMA), to regulate the financial services and markets of the country. It is accountable to Treasury Ministers and through them to Parliament. Its aim is to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.

The FSA is directly responsible for the regulation of whole of its financial system as the Bank of England Act 1998 now transfers from the Bank of England to the Financial Services Authority the Bank’s former banking supervision functions. Given this responsibility, the FSA is the single UK statutory regulator who regulates the whole range of banking, insurance and investment products. It is also the UK competent authority (the Listing Authority) for the admission of securities to the official list.

The FSA has the following four statutory objectives under the Act (FSMA 2000) within that framework of objectives, the legislation gives regulators a considerable degree of flexibility to adapt and amend regulations to meet the objectives.

1. maintaining confidence in the financial system;
2. promoting public understanding of the financial system;
3. securing the appropriate degree of protection for consumers; and
4. reducing financial crime.

3.2 Conditions for Authorisation of Islamic Banks

Historically the regulatory view of Islamic Banks in the UK was that, while it is a perfectly acceptable mode of financing, it did not fit within the UK definition of a bank. It did not take deposits within the definition of banking legislation. Banks seek to provide capital certainty for their depositors, primarily through investment in fixed rate instruments, which are highly liquid and may provide cover for day-to-day losses arising from banking business, whereas Islamic Banking is based on the concept of Profit/Loss Sharing (PLS) between customer and the bank. Of course, the PLS has no guaranteed return. However, in order to be authorised under the FSA’s requirements in
the UK new applicants whether they are Islamic Banks or conventional ones must meet five conditions - what they call threshold conditions - for authorisation as an institution entitled to take deposits in the country. Schedule 6 to the Financial Services and Markets Act 2000 and COND which set out the threshold conditions in full, are as follows (FSA, 2006).

1. **Threshold Condition 1**: Legal status. This sets out a number of conditions for legal form. A credit union by definition will comply.

2. **Threshold Condition 2**: Location of offices. A regulated UK credit union must have its head office and registered office in the UK. This requirement is aimed at ensuring that firms are organised in a way that can be effectively supervised.

3. **Threshold Condition 3**: Close links. This condition requires the FSA to be satisfied that it can effectively supervise a firm, taking into account the structure of the group to which it belongs or the other firms to which it has close links. This will have little relevance to credit unions because of the way they are constituted.

4. **Threshold Condition 4**: Adequate resources. The adequate resources condition has a wide meaning. The FSA will interpret the term ‘adequate’ as meaning sufficient in terms of quantity, quality and availability, and ‘resources’ as including all financial resources, non-financial resources and means of managing its resources; for example, capital, provisions against liabilities, liquidity and human resources. … The FSA will consider whether a credit union is ready, willing and organised to comply with these requirements when assessing if it has adequate resources for the purposes of this threshold condition.

5. **Threshold Condition 5**: Suitability. Essentially, this condition requires the FSA to be satisfied that a credit union is ‘fit and proper’ to be authorised and permitted to carry on the relevant activities. It will therefore have regard to all relevant matters. These will include whether there are any indications that the firm will not be able to meet its debts as they fall due, and whether the firm has taken reasonable steps to identify and measure any risks of regulatory concern.

Some of the conditions mentioned above, such as the legal status of a bank, its location etc., are entirely straightforward. No bank should have difficulty meeting them. The two key conditions are that a bank must have adequate resources and must have reasonable systems and controls to manage the type of business it wishes to undertake in a reasonably sound and prudent way. That will include systems to guard against money laundering.

In the context of the UK’s increasingly integrated financial services industry, in which distinctions, between banks, building societies, investment intermediaries, insurance companies and so on, have become increasingly blurred, with the argument for moving away from a fragmented supervisory and regulatory structure (in which banks were separately regulated), to a centralised form of regulatory control under the Financial Services Authority.

### 3.3 Banks Offering Islamic Financial Services in the UK: A Short Profile

Ten major global banks operating in the UK have set up units to provide Islamic financial services. They have been joined by no fewer than 12 Islamic banks, giving the UK more than four times the number of banks offering Islamic Financial Services than any other country in the West. Among these the UK Islamic banks are relatively recently established in comparison with other conventional banks that offer Shariah compliant products and services. The following are the banks that are currently offering Shariah compliant financial services in the UK.

#### 3.3.1 Islamic Bank of Britain (IBB)

Islamic Bank of Britain (IBB) became the first Islamic bank in the Western world when it opened its first branch on the bustling Edgware Road in central London. It has since pioneered Islamic retail banking in the UK and launched a wide range of products, including bank accounts, financing products and Treasury facilities. The bank was also the first to introduce Islamic business banking to the UK, and now offers a wide range of institutional and business banking products and services, including commercial property finance and accounts specifically designed for Masjids (mosques). It has been owned by Qatar International Islamic Bank since 1st June 201. The Bank has about seven branches throughout the country and is headquartered in Birmingham. It recently opened a new branch in West Yorkshire, with further openings planned in 2012.

#### 3.3.2 European Islamic Investment Bank (EIIB)

In 2005 the founders of the Islamic Bank of Britain (IBB) identified a market opportunity to create a new-style Islamic investment bank in London, leveraging London’s leadership in financial services and its high regulatory standards. After extensive research, the European Islamic Investment Bank was founded, and in March 2006 the Financial Services Authority (FSA) authorized EIIB to become the first Islamic investment bank in the UK.
3.3.3 Bank of London and the Middle East (BLME)
The Bank of London and The Middle East PLC (BLME) is dedicated to offering Shariah-compliant investment and financing products to financial institutions, corporate and high net-worth individuals in Europe and the MENA region. It launched in July 2007 as a stand-alone, wholesale Shariah compliant bank after obtaining FSA authorization.

3.3.4 Gatehouse Bank
The Gatehouse Bank was formed in 2007 under Kuwaiti ownership. Gatehouse has a reputation and specialisation in the real estate sector. The Bank has partnered with others in new ventures: GNL Insurance, the world’s first Islamic compliant insurance broker; and GSH Kuwait, a real estate advisory firm.

3.3.5 ABC International Bank
Alburaq is the brand name through which ABC International Bank offers Shariah compliant banking products in the UK, particularly specializing in home and property finance. Since its launch less than three years ago, Alburaq has built up one of the widest varieties of innovative Shariah-compliant home finance products available anywhere.

3.3.6 DDCAP Ltd
DDCAP Ltd is a joint venture between the Dawnay, Day Group and ICAP Private Group Ltd (IPGL). DDCAP is focused on the Islamic financial sector and has responsibility for its shareholders’ strategic business initiatives in the Islamic marketplace. In 2007 it won two Euro money Islamic Finance Awards, for Best Liquidity Manager and Best Commodities House. It is a Founder Shareholder in Islamic Bank of Britain PLC, the first Islamic bank licensed in the UK for more than a decade.

3.3.7 HSBC Amanah
HSBC Amanah acted as Sole Arranger of a US$5 billion Trust Certificate Programme for Abu Dhabi Islamic Bank (ADIB) and Sole Lead Manager and Sole Bookrunner for the debut US$800 million five-year sukuk issue under the programme. The sukuk are rated ‘A2’ by Moody’s and ‘A’ by Fitch, in line with the corporate ratings of ADIB. HSBC’s Corporate Trust and Loan Agency acted as Agent for the issue.

IV. POLICY OBJECTIVES OF THE UK LEGISLATION

4.1 Key Objectives of Financial Regulations in the UK
Under the UK’s existing regulatory environment many of individual Muslims are able to choose from a range of Shariah-compliant financial products, all of which must meet the following three key objectives (Foot, 2003).

1. The products and firms involved must meet the basic European Union (EU) Directive requirements that are set in place to protect consumers and investors.
2. Those involved - whether as shareholders or customers - must understand what exactly is being offered. [There will only be long-term damage to the cause if unrealistic expectations are created of what can be achieved.]
3. Those providing the services must be wholly professional and competent in what they do. There can be no benefit to anyone (and certainly neither to devout Muslims nor to regulators!) from the slightest suggestion that the probity and competence with which Shariah-compliant products are provided are in any way less than those of conventional financial products.

Government support and a favourable regulatory environment are encouraging Islamic banks to set up operations in the UK. The establishment of an enabling fiscal and regulatory framework in the UK for Islamic Finance since 2003 has resulted in a number of advantages:

* The removal of double tax on Islamic mortgages and the extension of tax relief on Islamic mortgages to companies, as well as to individuals;
* Reform of arrangements for issues of debt so that returns and income payments can be treated as if it were interest. This makes London a more attractive location for issuing and trading sukuk;
* Initiatives by the FSA to ensure that regulatory treatment of Islamic Finance are consistent with its statutory objectives and principles.

Western banks are also meeting the demand for Islamic Finance Services through the expansion of their Islamic Finance offering.

4.2 Applying the Objectives of the UK’s Financial Regulations to Islamic Finance
The powers given to a bank within the EU are so considerable that, inevitably, regulators need to spend a good deal of time and effort with an applicant bank, trying
to establish whether indeed it has the capital, the systems and the competence to run the bank successfully. Most importantly, the regulator needs to spend considerably more time with a prospective bank testing out these strengths than it would have to do with a financial organisation that was set on providing a much more limited range of financial services.

Many Shariah-compliant financial products are provided within the EU by companies that are not banks. This is just as, in the conventional sector, many banks offer residential or commercial mortgages but there are, equally, many mortgage lenders who never have been and who have no interest in being a bank. Unlike the pre-1998 period, the Financial Services Authority being a single regulator are now responsible for the regulation of the whole range of banking, insurance and investment products in the UK. Therefore, the FSA is able to help address Muslim aspirations across the whole range of financial services.

4.3 Islamic Finance: The UK Requirements

For a loan to be a Shariah-compliant, the following common principles need to be observed.

First, the loan must be free from a requirement by the borrower to pay interest. This does not, however, mean that Shariah prohibits the concept of borrowing - rather the reverse, provided that the loan stimulates productivity in the economy, i.e. goods and services rather than the making of more money from money.

Second, the loan needs to demonstrate that the risks are shared fairly between the parties. A pre-determined return to the lender, regardless of whether the transaction makes a profit, will not be Shariah-compliant.

Third, the loan must provide assistance to society by helping in the production of trade services and most commodities. Certain commodities are strictly banned, such as pork or alcohol.

Fourth, no part of the loan must allow uncertainty. Loans relating to certain speculative deals will therefore not be allowed.

In compliance of the above requirements, the following four main types of Islamic financing schemes have been resorted to by providers of Islamic financial services in the UK.

1. Partnership Finance

Partnership Finance requires the lender to participate in the equity of the transaction. This scheme imposes undue risk for a bank.

2. Asset Finance

Asset finance involves the lender purchasing the asset back to back with a sale of the asset to the borrower at an increased price. This increased price reflects the interest otherwise payable, payment of such price being deferred. This scheme would give rise to double stamp duty as well as, in all probability, capital gains tax.

3. Ijarah Lease

The ijarah lease scheme requires the bank to acquire the property, leasing it to the borrower in return for a rental payment and then transferring it to the borrower once all payments have been paid. The bank must be responsible for major repairs and insurance, thus sharing the risk. By way of a separate management agreement, the borrower can be appointed as managing agent for the bank and, in that capacity, undertake repairs/insurance, reclaiming the cost from the occupational tenant, assuming the tenant of the occupational lease permits the landlord to reclaim such cost from that tenant. On the face of it, the ijarah lease arrangements also have stamp duty problems.

4. Mortgage

The first Shariah-compliant mortgage product in the UK was offered in 1997. Before legislation in 2003 to remove the double payment of stamp duty land tax on such products, however, the size of the market was limited and there were no other providers.

The financial institutions that have been offering Islamic financial products in the UK are Islamic Bank of Britain and Shariah-compliant units of HSBC and Lloyds TSB, Barclays Capital, ANZ Grindlays and West Bromwich Building Society. However, in recent years there have been a number of prominent developments in the UK Islamic finance market, and there is now considerable interest in developing and marketing a wide range of products. Shariah-compliant current accounts, savings accounts, and house purchase facilities are also now available.

There are currently two broad types of Shariah-compliant home purchase arrangements available in the UK: murabaha and ijarah. On 31 October 2004, the Financial Services Authority (FSA) assumed responsibility for the regulation of mortgages, including mortgage backed equity release products and murabaha.
However, neither home reversion plans nor ijarah products fall within the framework of financial services set out by the Financial Services and Markets Act 2000 and are therefore not within the scope of FSA regulation. The Government recently consulted on whether ijarah products should be included in the legislation to bring home reversion products into FSA regulation and the majority of respondents agreed that they should. Legislation to bring Home Reversion schemes into the scope of FSA regulation will be brought forward as soon as Parliamentary time allows.

The market in Shariah-compliant financial products is extremely dynamic, with the result that, providing the Financial Services Authority (FSA) gives approval, a range of new products are likely to be offered in the UK marketplace over the next few years. Given that legislation can only apply to the underlying contract in each transaction, some products (if they involve new forms of contract) will require legislation to remove inequality or uncertainty in tax treatment.

A review mechanism has been established to identify: the extent to which legislation has or has not succeeded in its objectives; the uptake of Shariah-compliant financial products by UK Muslims and other interested parties; remaining discrepancies in the tax treatment of these products; and the development of new Shariah-compliant financial products.

4.4 How Islamic Finance Fit into the Current UK Regulatory System

As discussed earlier in this study that the FSA operates under a single piece of legislation that applies to all sectors, the Financial Services and Markets Act 2000. The FSA’s policy towards Islamic banks, and indeed any new or innovative financial services company, can be summed up simply as “no obstacles, no special favours”. The FSA is keen to promote a level playing field between conventional and Islamic providers. One thing the FSA is clear about is that it is a financial, not a religious, regulator (FSA, 2006).

One of the most important issues for the FSA is that of Islamic deposits. The UK legal definition of a deposit is: “a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties”. In other words, money placed on deposit must be capital certain. For a simple non-interest bearing account there is no problem. The bank safeguards the customer’s money and returns it when the terms of the account require it to do so. However with a savings account there is a potential conflict between UK law, which requires capital certainty, and Shariah law, which requires the customer to accept the risk of a loss in order to have the possibility of a return.

Islamic banks resolve this problem by offering full repayment of the investment but informing the customer how much should be repayable to comply with the risk-sharing formulation. This allows customers to choose not to accept full repayment if their religious convictions dictate otherwise.

V. THE UK TAX TREATMENT FOR ISLAMIC FINANCE

Under Shariah law the receipt and payment of interest is expressly forbidden and in order to ensure that this criteria is not breached financing arrangements are often structured such that they do not result in the payment of interest. This can, obviously, lead to difficulties with payments often being regarded for taxation purposes as a distribution as opposed to interest.

The UK Government is seeking to develop and support Islamic finance in the country as a policy of social inclusion and as part of its strategy to promote London as a ‘Western’ Islamic financial centre. In 2003, the UK launched a series of legislative amendments of its taxation, legal and regulatory regimes to ensure a level playing field between Islamic finance and conventional finance. The tax legislation does not mention the Shariah or use any Islamic finance terms. Instead, the legislation creates a set of definitions for use in UK tax law. For borrowing arrangements that fall within the definitions the legislation specifies how to determine the ‘finance cost’ and how that finance cost is treated by both the payer and recipient. Except for the bond alternative, one of the parties to the transaction must be a Financial Institution.

Broadly speaking, if the rules apply the finance cost is brought within the same tax rules as those that apply to interest. Similar changes were made to facilitate alternative deposit arrangements based on profit sharing arrangements. Essentially the law ensures that the return is taxed as if it were interest where it equates in substance to an interest like return. This required the ‘switching off’ of tax rules that might otherwise treat the return as a distribution.

In addition to the introduction of income tax rules for alternative finance arrangements to improve certainty of tax treatment, the UK introduced progressive changes to the incidence of stamp duty land tax to remove double taxation. Initially the changes were made for individuals entering into Islamic mortgage arrangements and then the rules were extended to equity sharing arrangements and companies. In
2007 changes were introduced to facilitate the issue of sukuk, or alternative finance investment bonds. The legislation seeks to apply the same tax treatment that would be applicable were the alternative finance investment bond to be a debt instrument. To achieve tax neutrality, further changes also were required to the stamp duty land tax and stamp duty reserve tax.

VI. THE RELEVANCE OF THE UK APPROACH TO THE AUSTRALIAN EXPERIENCE IN ISLAMIC FINANCE

Islamic finance in Australia has been growing rapidly since it was first introduced in 1989 with the Muslim Community Co-operative (Australia) Limited, better known as MCCA. Since then, a number of Islamic Financial Services Providers have come into existence in the Australian financial services market during the past decade and some international financial institutions are also considering the introduction of Islamic banking branches and subsidiaries. No formal legal and regulatory framework or infrastructure in existence in Australia for guiding and supervising the functions of Islamic financial institutions operate in line with the precepts of Shariah.

The legal and regulatory framework of the financial sector in Australia unlike in the UK consists of a multiplicity of bodies. These include: (1) the Reserve Bank of Australia (RBA); (2) the Australian Prudential Regulation Authority (APRA); and (3) the Australian Securities and Investments Commission (ASIC). The coordinating 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.

Under subsection 9(3) of the Banking Act 1959 an authority to carry on all kinds of banking business in Australia was granted by the Australian Prudential Regulation Authority (APRA) to the then Muslim Community Credit Union Limited (MCCU) in December 1999. Australia’s new community banks (which have emerged largely due to the closure of traditional branches in smaller towns and funded and operated by local townspeople), and community-based Islamic co-operative financial institutions were registered and given licenses to carry on cooperative businesses under the Cooperatives Act 1992.

Although Islamic finance is different from conventional one in terms of its missions, objectives and practice the operation of Islamic financial institutions in Australia is still subject to basically the same laws and regulations as their conventional peers, and apply the same conventional interest-based framework for regulatory and supervisory activities. Like the FSA in the UK, a uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed in Australia. This is a paramount need as the absence of such a supportive framework obstructs Islamic finance in its effective and smooth functioning in accordance with Islamic principles. Thus, in order to support the operational soundness, Islamic banking and finance should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities, and the elimination of a multiplicity of stamp duty and other transfer taxes. On this matter the UK model would be the best practice for Australia. While new regulations have been developed and foundations for regulatory instruments have been laid by the Australian banking regulatory authorities in this regard, it still has a long way to go compared to the United Kingdom.

According to a recent report published in the VIP News, the authorities from the Canadian and Kenyan central banks visited the FSA and met with representatives of the local banks who have taken the steps of staring Islamic banking operations like the Islamic Bank of Britain (IBB), ABC International Banks, Lloyds TSB and HSBC Amanah. These two central banks are planning to adopt the UK model for enabling investors to start Islamic banking practices in their own countries. They will also issue licenses in their countries for stand alone Islamic banks. Both the banks will then approach the market through private placements to raise further equity funding. Given the success of Islamic banking and finance practice under the existing legal and regulatory environment in the UK, and its growing global trends it is most important that consideration be given to the adoption of the UK model of regulatory framework for Islamic banking and finance into Australia. In this regard, regulations are needed to be developed by the Australian regulatory regime so as to make Islamic finance a viable alternative system of financing for Muslims in Australia. Some of the challenges confronting the regulation of Islamic banking and finance practice in Australia are the following.

The Acceptance of Interest

The deep-rooted acceptance of interest as a function of how the financial sector operates may be an obstacle in wider acceptance of Islamic finance. Australia is blessed with a profitable, stable financial sector in which the payment of interest plays a crucial part. Interest rates and bank charges are now important factors for customers in choosing where to invest, save and borrow from.
The attention paid by media outlets from non-Muslim countries to the Islamic finance sector in the Middle East and Malaysia stems in part from the novelty of a system in which interest is not used. An early report about Islamic finance on the Australian Broadcasting Corporation described banking without interest as seemingly like playing cricket without a bat - such is the accepted view on the link between interest and banking.

Given this, despite the huge growth in Islamic finance over the past three decades, the wider banking and finance sector may be reluctant to enter the sector, viewing a system that eschews interest as a niche market and even a gamble given that it operates outside the historically accepted conventions of the sector.

A Wait-and-see Approach
While the major global players in banking sector such as Citibank, HSBC and Standard Chartered in Malaysia; Deutsche Bank in Germany; and HSBC and Lloyds TSB in the UK have embraced Islamic finance, Australian banks appear to have taken a wait-and-see approach. The non-existence of an Australian bank offering Islamic finance products could also change once Islamic non-banking financial institutions like the MCCA negotiate the often complex regulatory frameworks that govern both state and federal financial operations.

The Size of the Muslim Community
The size and infancy of the Muslim community may be a factor in the growth of Islamic finance. With more than three hundred thousand members, the Muslim community in Australia makes up less than two per cent of the population. As the primary market for Islamic finance, the Muslim community’s asset base is not strong. The demand for Islamic finance products among Australian Muslims is greater than the available supply. This contrasts strongly with the United Kingdom, where a Muslim population of 1.6 million is serviced by at least two conventional banks with Islamic windows, and several stand-alone IBs.

Doubt Concerning Shariah Compliant Finance and Investment Products
Skepticism about Shariah compliant financing and investment products may be a further barrier to the growth of Islamic finance. Within Australia’s Muslim community there are those who are skeptical about (and in some cases downright hostile to) the first Islamic finance products available to Australian Muslims, questioning the validity of the Shariah-compliant label.

The Australian Bond University Professor Dr Ariff comments in this regard (Bahfen, 2008):

Many would say that the Islamic banks are not really different from conventional banks and that they are playing with words and semantics and so on and so forth - coming up with Arabic terms that sound very Islamic but if you scratch it, you will find that it’s not that different from conventional financial products. So such concerns do exist.

VII. CONCLUSION
With the above in mind this paper addresses the following legal and regulatory issues.
1. Whether the UK has remedied the problem of divergence of Islamic Finance from traditional Shariah.
2. The extent to which Islamic Banking has adapted itself to the UK Financial System to its practice.
3. Evaluation of the UK Financial Services Bill Proposals on Islamic Finance by reference to the Australian Banking and Finance Regulation.
4. The appropriateness of the new UK model for adoption into Australia.

1. In relation to the issue whether the UK has solved the problem of divergence of Islamic finance from traditional Shariah it is noteworthy that like elsewhere in the globe the sole responsibility of solving this sort of problems goes directly to respective Shariah Boards/Councils of the Banks and financial services providers. The following comments made by Michael Foot, the Managing Director of the FSA regarding the issue are worthy of mention.

We will no doubt continue to play that role in respect of sharia’a compliant products too (and in some case our rules will leave us no choice). However, I think it is also true to say that we shall be looking for help from experts wherever we can find them. And I should also add - though it is probably unnecessary for me to say this - we shall have neither the ability nor the desire to monitor a bank’s actual sharia’a compliance. That has to be something for the sharia’a board and for the institution itself.
Generally, it is under the jurisdictions of the Shariah Boards/Councils of respective Islamic Banks or the IFSPs to monitor their functions from a Shariah viewpoint and to evaluate every new transaction to make sure that it is Shariah-compliant. Yet the laws of Shariah are open to interpretation and Shariah Boards/Councils often have divergent views on key Shariah issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument. A document or structure may be accepted by one Shariah Board/Council but rejected by others.

2. Regarding the issue of the extent to which Islamic Banking practice has adapted itself to integrate with the core Financial System of the UK, personally even if the regulator did not exist or did not require the conditions to be met to function as Islamic Banks they would in any case be necessary for the commercial success of the operation. So, it is of paramount importance for Islamic Banking and Finance to adapt itself to the mainstream of the core Financial System of the UK for their own interest. Albeit many of the financial products commonly used in the UK - for example, current accounts and savings products, such as investment funds or unit trusts, or borrowing through leasing or hire purchase products - already have some, at least, of the characteristics consistent with precepts of Shariah.

3. The above discussion of the UK Financial Services Bill Proposals on Islamic Finance and the existing Australian Banking and Finance Regulation in this paper has demonstrated that for example, the way the Australian Shariah-compliant housing finance product is structured would mean that stamp duty would be levied twice on a single property purchase. This additional levy would obviously make the product uncompetitive. Given this unfair treatment with the similar product in different financial systems under the same regulation this study suggests that the government should consider making changes to the stamp duty legislation to recognise this problem and facilitate the levying of a single charge on what in effect is a single purchase. In a similar way, the legal and regulatory authority should take many other measures so as to enable a like-for-like competitive product to be launched. The Australian legislative framework must also address the regulatory issues which so far discourage the launch of Islamic financial products.

4. In line with the legislation in the UK which has given ethical funds in a significant market advantage, an amendment to the Financial Services Reform Bill (FSRB) requiring superannuation funds and funds managers to disclose their policy on ethical investment, has been passed by the Australian Parliament in 28 August, 2001. The amendment will require all financial services product disclosure statements to outline the extent, if any, to which labour standards, environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment. (EIA, 2001)

The legislation creates an imperative for the investment community to get up to speed on socially responsible investment. Following the UK model a new Bill Proposal on Islamic Finance may also be adopted into Australia through passing legislation in the Parliament for strengthening Islamic financial market in Australia. If such legislation is passed by the lawmakers it would contribute to growing Muslim community in Australia to find a truly viable alternative for banking and finance based on religious and ethical considerations.

It may be argued that since Australian Muslim community avail of existing conventional interest-bearing products are unlikely to switch to the new Shariah-compliant products offered by the IFSPs of Australia. However, if the Shariah-compliant products are properly structured and competitively priced it is expected that many people would switch to get benefit from Islamic financial services. Certainly, new buyers would seriously explore these facilities. As the range and scope of these products builds up, the whole saving and borrowing patterns of Australian Muslims are likely to change. And as the volume of financing builds up the underlying ethical base of Islamic financial products would begin to make its mark on the market. At that point, many non-Muslims would also be attracted to these products. In time, these products may provide a valuable bridge between different communities and interest groups in Australia.

Furthermore, it is expected that if a better and more precise understanding of the Islamic financial products is made and the Muslim community in Australia are encouraged to develop a more consistent - and desirably more standardised - specification of the products they wish to introduce - then, the ways of fitting them into the Australian legal and regulatory framework could surely be found, on a par with its more traditional financial products.
The RBA is responsible for the objectives of monetary policy, overall financial system stability, and the regulation of the payments system. Also, payments system policy is carried out by the Payments System Board within the RBA.

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

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

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

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The Council of Financial Regulators, accessed electronically at APRA’s webpage:  
Abstract
This paper examines the use of Shariah compliant financial products in Islamic banking of Bangladesh. It also analyses the growth of Islamic banking in the country over the last five years. It has been assumed that use of Shariah compliant financial products is one of the causes of higher growth of Islamic banking industry. Secondary data, collected from govt. publications and annual reports of central bank, was analyzed. It has been found that the Shariah has been adapted to the Islamic banking with a view to minimizing the risk which reinforces the sustainable growth of the Islamic bank. The Shariah compliant financial products have risk sharing policy. It suggests assessing the capacity, productivity and business risks of the investment client of the bank. It helps to decrease the rate of business failure and increases overall economic well-being for achieving the Millennium Development Goals. The adaptation of Shariah has made the Islamic bank an intermediary trader between the bank’s client and the seller. It is markup profit that generates from the adaptation of Shariah principles of buying and selling to Islamic banking. The basis of adaptation is Istihsan. Adaptation of Shariah is necessary to be worthy representative of Islam. The Shariah may be adopted gradually in accordance with priorities. The study paved the way for further research on the attitude of bank customers’ and professional bankers’ towards the adaptation of Shariah to Islamic banking in Bangladesh and other countries.

Keywords: Adaptation, Shariah, Banking, Well-being, Istihsan, Attitude.

1. Introduction
An Islamic bank is defined by Organization of Islamic Conference (OIC) as “a financial and social institution whose statutes, rules and procedures expressly state its...