



Public Hearing on Inquiry into Trade and Investment Relations with countries of the Middle East

Tuesday 9th September 2014

Location: Northcott Room, Sydney Masonic Centre 66 Goulburn Street, Sydney.

Time: 11.30am

Organisation: Bank of Sydney

Representatives: Julie Elliott, CEO & Ashley Bakes, Head of International Trade

Paper discussing Sharia Banking in response to questions asked during the Public Hearing

I. Background

As part of the Federal Government's inquiry into Trade and Investment Relations with countries of the Middle East, Bank of Sydney provided a submission on their capability and appeared at a Public Hearing on Tuesday 9th September in which the CEO presented an opening statement on the Bank's views on the region and opportunities for Government involvement from a banking and finance perspective. Subsequently, the Federal Government requested a paper discussing Sharia Banking.

a. Bank of Sydney

Bank of Sydney has been operating in Australia under a full Banking Licence since April 2001. Our parent company is the Bank of Beirut. Our Vision is to be Australia's only true relationship bank. We have 16 branches in Sydney, Melbourne and Adelaide. We offer competitive retail and commercial banking products. We also specialise in International Trade Finance with an in-depth understanding of Global Markets and in particular strong experience in Middle Eastern, North African and Mediterranean regions.

Within this context Bank of Sydney have a diverse Australian customer base, predominantly from a Greek or Middle Eastern heritage with varying religious backgrounds including Muslims. However, Bank of Sydney do not practice Sharia Banking today.

II. Sharia Banking

a. Overview of Sharia Banking – what it is and is not

i. What it is

Islamic finance is the term used to describe investments that comply with the principles of sharia - hence the term, Sharia Banking. Standard and Poor's provide a succinct summary of the five pillars of Islamic Finance as: ban on interest; ban on uncertainty or speculation, ban on financing certain economic sectors, the profit and loss sharing principle and the asset backing principle. However it would be too simplistic to take these as literal and guidance is often sought from sharia scholars as to the interpretation of these principles and interpretations may vary between Islamic schools of thought.

The most well known prohibition of Islamic finance is the prohibition of riba, which is broadly translated as the charging or paying of interest. In practical terms this means that conventional finance products are structured differently to achieve the same investment outcomes such as housing finance and investments. There are a large number of financial structures including murabahah (cost plus profit sale), tawarruq (cash finance sale), istisna (purchase order), salam (forward sale), musharakah (profit and loss sharing partnership), musharakah mutanaqisah (diminishing partnership), mudarabah (profit sharing partnership), ijarah (operating lease), ijarah muntahiah bi tamlik (finance lease), sukuk (Islamic bond), takaful (insurance) and wakalah (agency).

The most common financial structures are:

- Murabahah (cost plus profit sale) – equivalent to conventional fixed rate mortgage - 80% of all transactions in Islamic Banking and Finance
 - It is the banker that purchases the asset outright. They then sell the asset to the customer at cost plus a profit to be repaid over a specified period of time

- It involves two contracts in which the banker purchases an item at the request of a customer who promises to purchase the asset from the bank at cost price plus a mutually agreed premium.
- It is a flexible instrument that can be used at the retail level for home and car financing and at the wholesale level for raising capital
- The asset can be any item so long as it is not expressly prohibited by the Sharia such as pork, pornography and alcohol amongst others.
- Musharakah mutanaqisah (diminishing partnership) – this is the preferred method of Islamic home finance in Australia with Muslim Community Cooperative Australia (MCCA).
 - The banker and the customer jointly acquire the asset with the customer gradually increasing beneficial interest in the financed asset until securing full ownership at the end of the contractual period. Until the remaining portion is redeemed, the banker leases its share to the customer by charging rent periodically. The periodic rents are shared and change in proportion to the extent of the customer's share.
- Sukuk (Islamic bond)
 - Trust or investment certificates representing proportionate or undivided shares in the profits or revenues of large enterprises. Unlike conventional bonds, certificate holders are generally the owners of a portion of the underlying asset and share in the success or failure of the enterprise. The sukuk cannot be sold on the secondary market because of the prohibitions surrounding debt sales in the Sharia.
 - It is considered an equity investment rather than a debt.

ii. What it is not

UNPROFITABLE

Sharia principles do not prohibit a bank in an Islamic finance transaction from making a profit, rental or other return on its asset or investment. This means that a number of contemporary structuring techniques have developed that allow banks to structure transactions and products in a way that closely replicates the economics of conventional loans and products.

ESTABLISHED TO SUPPORT CRIMINAL ACTIVITY

In the current social and political climate, the Islamic faith is often tarnished with negative connotations and misconceptions. As part of that faith, Islamic finance often suffers from the same misconceptions, particularly the mistaken belief that Islamic finance is used to spread terrorism.

Terrorism is a criminal activity that neither conventional western financing nor Islamic financing support. Sharia compliant products are no more susceptible to misuse than conventional western financing. Islamic banks worldwide – like conventional banks – have to adhere to stringent legal, regulatory and compliance requirements designed to prevent such activities.

EXCLUSIVE TO MUSLIMS

Generally there is no prerequisite for an entity or person entering into an Islamic Finance transaction to be a Muslim. Evidence from Malaysia and Singapore indicates a substantial take-up of Islamic Finance products from non-Muslims attracted by the fair terms and the quality of Islamic products.

A DISADVANTAGE TO AUSTRALIANS

Sharia Banking at its most fundamental level is simply a different way of structuring financial products to achieve the same investment outcomes. By enabling Sharia Banking, the Federal & State Governments would be providing a greater choice for all Australians in financial products and a range comparable to our Asian counterparts.

A TAX AVOIDANCE SCHEME

The changes sought to enable Sharia Banking are not to exempt Sharia Banking from tax but to exempt it from the penalties of double tax. For example, our current legislation in NSW would mean a Murabahah (cost plus profit sale) – equivalent to a conventional fixed rate mortgage - would be charged Stamp duty twice in contrast to the conventional fixed rate mortgage. The changes in State legislation required to ensure those entering a Murabahah finance transaction were not penalised with a double stamp duty charge would be the recognition of Sharia Banking products.

To date, Victoria is the only state to recognise the potential for Islamic finance contracts to incur double stamp duty. In 2004, Victoria introduced legislative amendments so that a 'cost plus' arrangement is treated as one transaction rather than two thereby avoiding double duty. Victoria also recognised the principle of profit sharing and allows Islamic contracts to avoid the use of such terms as interest, which are not permitted under Sharia Law.

III. Retail Sharia Banking in Australia

The retail market for Sharia Banking products is small and a niche segment for the Australian banking sector with the Australian Muslim population only around 400,000. A significant proportion of which suffer social marginalisation and economic disadvantage with higher unemployment rates and lower wages than the broader population. In addition, consumer research in June 2004 by Rammal & Zurbruegg ⁽¹⁾ indicates that many practising Muslims lack an understanding of the Islamic principles of financing and Islamic brands and therefore tend to bank using conventional banking products.

There are a small number of providers however none hold a banking license:

- Muslim Community Cooperative Australia (MCCA) established in 1989
 - o first Australian Islamic finance provider in Australia
 - o Approximately \$425million worth of finance written or managed by it.
- Islamic Cooperative Finance Australia established in 1998
- Iskan Finance Pty Ltd – established in 2001
 - o aims to meet the home financing needs of the Australian Muslim community
- Crescent Investments – wealth management including superannuation
- LM Investments Ltd - a conventional income funds manager which launched its Australian ALif Fund May 2009, the first global onshore Islamic investment fund in Australia

They all work within the existing regulatory environment to provide Sharia compliant finance products. However, they are to some extent hand-strung by the lack of parity of taxation between conventional and Islamic financing.

Evidence would suggest they currently satisfy local demand. Whilst the products are not exclusive to Muslims, Australians propensity for conventional banking such as variable rather than fixed home loans can not be accommodated in Sharia Banking lending.

Potentially there is further scope for business lending, interestingly a survey in 1999 by Jalaluddin ⁽²⁾ showed a strong interest from small businesses, the majority, non muslim, expressing an interest in profit and loss financial arrangements suited to Sharia Banking.

In addition, Sharia Banking products can be more costly due to the different structures from conventional banking. For a bank, the different product structure for Sharia banking would need to be accommodated with bespoke: processes, reporting, documentation, marketing and banker training.

DEVELOPMENT OF A SHARIA SUPERANNUATION SYSTEM

Currently we are aware of the Crescent Wealth Super Fund in Australia. They claim from data sourced from the Association of Superannuation Funds of Australia, that on average 25 – 40% of Australian super is invested in non-Islamic compliant assets. These include interest bearing products and shares in companies dealing in weapons, alcohol, gambling, high debt firms, tobacco and pork farming. Whilst the product structure looks very similar to conventional superannuation products, it maintains its sharia compliance by all its investments being approved by a Sharia Advisory Board. Although the bulk of the funds remain in Australia, the cash and fixed interest allocations are invested overseas in sharia compliant products.

IV. Institutional Sharia Banking in Australia

Australia, unlike its Asian counterparts or even the UK, have been unable to advance the regulatory changes needed that currently deter and to some extent penalise wholesale investment in Australia from the Islamic finance market. This is a substantial exclusion from our capital markets.

The 'Australia as a Financial Centre: Building on our Strengths (Johnson Report) released by the Federal Government in January 2010 stated 'the greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of sharia- compliant wholesale investment products.' The global market for Islamic finance is estimated to be around \$1.3 trillion and it is one of the fastest growing areas of the financial services industry operating in over 75 countries through 300 institutions. The growth has been largely driven by: petrodollar liquidity; the Muslim population; low penetration levels and the ethical character and financial stability of Islamic financial products. Notably during the Global Financial Crisis (GFC) the Islamic Finance market fared far better than its conventional counterpart. In the wake of the GFC, Islamic Banking and Finance continued to post 15-20% annual growth rates.

Over the years, major banks seemed to have been more opportunistic rather than systematic in their approach to Islamic Finance. The general impression by wholesale investors is it is considered 'too hard' especially from a tax perspective. Although not insurmountable, the tax considerations do cover: income tax, capital gains tax, GST, stamp duty and international aspects of the transaction.

A considerable amount of work has already been undertaken into the regulatory changes required by the Federal Government involving: Treasury, ATO, Austrade, the Department of Foreign Affairs and Trade; all leading industry bodies: ABA; IFSA,

AFMA, CPA, Taxation Institute of Australia as well as the major banks, legal and accounting firms. The recommended approach based on this work was to follow the UK model to ensure parity of regulation between conventional and Islamic finance. In 2011, the Board of Taxation completed a review taking into account the UK level playing field model.

The viability of the wholesale market for Islamic Finance is largely unquestioned, however the biggest hurdle the Federal Government faces is that regulatory clarity, a level playing field and potentially a framework of incentives (to compete with direct competitors in the region such as Malaysia, Singapore and Hong Kong) will tend to need separate legislation. This would lead to debate in Parliament, which in all likelihood would provoke sectarian sentiment against the Muslim community.

However this could be overcome by a balanced approach, one demonstrated by the UK that acknowledges the moderate Muslim community, in contrast to their tough approach to Islamic radicalism. Notably after the UK introduced regulatory changes including changes to the taxation of Islamic finance products they have become the leading non-muslim Islamic finance centre.

A good example of their balanced approach was recently reported in the UK media.

Source: The London Times, 18 September 2014

'UK Government attempts to balance a tough approach to Islamic radicalism with a desire to do business with moderate Muslims When Whitehall cut a landmark Sharia-compliant bond deal that was the first of its kind in Europe. The 200million pound sukuk came at the end of June and was the first issued by a country outside the traditional Muslim world. Legal experts say the move was designed to send a strong signal to Islamic investors that despite heightening conflicts in Iraq and Syria, the UK remains open for Islamic investment and financial products.'

V. References

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