

Islamic Banking – Borrowing and Investing out of Haraam’s Wayⁱ

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Between the 8th to 12th centuries the flowering of its faith and culture made Islam the leading ‘civilizer’ of this period. Islam was at the core of commercial, academic, intellectual and artistic advances. The vast trade routes which were dominated by Islam’s adherents raised the need for innovative instruments, or in today’s parlance, ‘products’ of finance. In this era, Muslim traders introduced to Europe concepts of finance originating in the Islamic states. These included negotiable instruments, the partnership, the body corporate and agency. From the 13th century onwards the west’s uptake of these concepts and relationships underpinned and accelerated the great expeditionary and argosy fleets of the Renaissance and the Enlightenment. In the context of the current global tensions there is no small irony in the assertion that Islam should be credited with the invention of capitalism.

In modern times Islamic finance has re-emerged as a major force in global credit flows. Islamic finance now gains its impetus from offering an alternative to the western banking model which does not conform to the precepts of Islamic law ‘*Sharia*’ as derived from the Qur’an by Islamic scholars. Conduct or things which comply with *Sharia* are ‘*halal*’ and conversely, ‘*haraam*’.

Currently, over 20 percent of the world’s population professes the Muslim faith. As Australia’s Muslim population continues to grow, understanding and offering Islamic banking and financial services is crucial to the local industry. In July 2009, Assistant Treasurer, Nick Sherry, announced the Federal Government’s commitment to overcoming regulatory framework hurdles with a view to enabling the formation of the country’s first retail Islamic bank. He said “*with over 340,00 Muslims in*

Australia, the offering of retail Islamic finance products contributes to fostering social inclusion, by enabling Australian Muslims to access products that may be more consistent with their principles and beliefs as well as widening the choice of products for non-Muslims”ⁱⁱⁱ.

In attempting to develop a legal framework that will accommodate Islamic banking practices, government and business leaders also seek to draw investment from offshore Islamic institutions. The global market utilizing *halal* products is reportedly worth \$US 1 trillion approximately and growing at a rate of 15 to 20 per cent per annum^{iv}. As has been advocated by former Liberal Party leader and Global DC Chairman, Dr John Hewson, potential exists for Australia to emerge as an Islamic banking hub in the Asia Pacific region^v. Chris Bowen, the federal Minister for Financial Services, has made similar statements and cited Australia’s proximity to Indonesia and Malaysia. *“The majority of the world’s Islamic population lives in Asia, and Singapore and Kuala Lumpur are trying to corner this market for themselves and I think Australia can play a role. Even if we only take a small percentage of the market it could generate a lot of wealth and a lot of jobs in Australia.”^{vi}*

This article explains the main features of Islamic banking practices and highlights some of the various statutory and conceptual hurdles that need to be addressed as Australia seeks to attract investment from Asia and the Middle East^{vii}.

The main features of Islamic Banking

Islamic banking refers to the practice of investing money according to the tenets of Sharia. One of the most prominent and important features of Islamic banking is the Qur’anic prohibition on the receipt and payment of interest, referred to in Arabic as ‘*riba*’, which is considered exploitative.

“Those who charge riba are in the same position as those controlled by the devil’s influence. This is because they claim that riba is the same as commerce. However, God permits commerce, and prohibits riba. Thus, whoever heeds this commandment from his Lord, and refrains from riba, he may keep his past earnings, and his judgment rests with God. As for those who persist in riba, they incur Hell, wherein they abide forever.”^{viii}

As all the operations of Islamic financial institutions must be free from interest, the relationship between an Islamic bank and its client is based on participatory profit / loss sharing. A bank will provide its customers with funds on the basis that it shares a portion of both the rewards and risks assumed by the customer. Returns for the bank are therefore reliant upon the financial success of its customers rather than on payments calculated by reference to financial market interest rates. The notion that an investor is entitled to a return without putting money at risk is rejected in Sharia. It is only the combination of effort, capital and risk that justifies a return on investment.^{ix}

The prohibition on *riba* is informed by the fundamental Qur'anic requirement that resources be used productively and in a socially beneficial manner. Financial resources must be used constructively in order to generate further wealth through appropriate investments. Islamic principles do not, however, recognise money as a commodity (like, for instance, oil and wheat) and do not believe that it has an inherent ability to rise in value.^x

Islamic financial institutions will only provide capital for ventures that do not contravene Islamic law. Finance will not be made available for entities involved in the production and distribution of alcohol, gambling, weapons or pornography.

In line with the socio-economic foundation of Islamic financial practice^{xi}, the concept of *caveat emptor* is not recognized without further qualification^{xii}. Similarly, some Islamic banks offer benevolent interest-free loans (in the form of a '*qard hasan*') to members of the community facing financial hardship and in an emergency situation. Rather than receiving interest, it is believed that a lender who offers a *qard hasan* will reap the bounteous rewards of Allah.^{xiii}

To ensure adherence to these underlying Islamic principles, most Islamic banks (and Islamic banking arms of western banks) are governed by a supervisory board of Muslim scholars that analyse the institution's methods and operations. If any violations are revealed, the Board will correct them and identify halal alternatives. Boards do differ in their appraisals of various banking products, facilities and practices.

In an organisational chart, the Sharia Board functions as an advisory wing beside the board of directors. The significance of the Sharia Board in auditing policies and practices will be stated in the bank's establishment contract. In some institutions, the Sharia Board has the authority to contradict decisions of the board of directors. In the United Arab Emirates, members of the Sharia Board are attached to the Ministry of Justice and Islamic Affairs. In Iran, Pakistan and Sudan the overall banking system is Sharia compliant and, in those countries, the central bank contains a Supreme Sharia Board which controls all pertinent affairs.^{xiv}

Islamic Banking instruments

As Islamic banks and instruments take their place in local development and form part of mainstream lending activities, a whole range of complex issues will arise which must be understood and addressed by all who participate in this practice area. Not least among these issues will be the perspective that Australian courts bring to bear on interpreting Islamic banking instruments.

A range of Sharia-compliant and commercially sustainable contracts has been developed by financial institutions engaged in Islamic finance. The most common contractual relationships are described in broad terms below.

Wadiah

An Islamic bank is permitted to hold deposit funds as the safe keeper of a customer's funds. As the bank is not permitted to pay *riba* a customer may receive, at the bank's discretion, a sum as '*hibah*' or gift from the bank in appreciation of being permitted to use the customer's funds in its banking operations. A bank becomes attractive to depositors if it has a history as a regular distributor of profits as *hiba*.

Mudaraba

The '*mudaraba*' contract engages two parties and, in a retail banking context, can be applied to fund business ventures. The arrangement operates on the basis that one party, the '*rabb al-mal*' provides capital whilst the other, the '*mudarab*' provides skill

or labour. If the combined input generates a profit, it is shared between both parties. Any loss is borne solely by the capital provider. It is similar to a joint venture arrangement, the distinction being that a bank using customer investment funds provides capital. The *mudaraba* has widespread use in Middle East in the development of large scale infrastructure projects. On a lesser scale it is most commonly used for trade financing of inventory.

Mudaraba contracts form the basis for several Islamic investment funds. Pursuant to such an arrangement, customers subscribe to the fund by way of capital contributions and the bank, using its investment skill, invests in suitable ventures. The bank will deduct management fees and any realised profits will be distributed to customers in a proportion determined at the outset.^{xv}

The *mudaraba* contract presents a significant risk management challenge to the *rabb al-mal* as losses are not recoverable from the *mudarab* unless negligence or breach of contract can be established^{xvi}.

Musharaka

Like a *mudaraba* contract, the '*musharaka*' instrument is based on Islamic principles of participatory profit sharing. *Musharaka*, literally sharing, differs from a *mudaraba* in that both losses and profits are shared. It operates similarly to a partnership. A *musharaka* arrangement can be used to provide venture capital or project finance and the Islamic banking institution will, with its customer, usually create a special purpose vehicle. Although not all parties are required to participate in the management of the venture, each will hold an agreed percentage of the share capital. Profit will be divided in a proportion determined by the agreement. There is, of course, no guarantee that the venture will generate a profit and any loss must be assumed strictly in accordance with the ratio of capital contribution.

A form of residential property mortgage may also be entered into using a *musharaka* contract. The intending land owner and financial institution form a partnership and share the risk of the asset by holding the property as tenants in common. Equity in the property is shared in proportion to the funds that each has contributed to the transaction. The financial institution will rent out its share of the property to its

partner at a rate determined by fair market value. In order to avoid hybridisation with a lending concept which is *haraam*, a second contract will then be entered into that attends to the final sale of the asset. The terms of this contract will set out the final purchase price in conjunction with a series of fixed instalments. As the intending land owner pays instalments to the bank, the proportionate share of the equity in the property is adjusted.^{xvii}

Murabaha

A '*murabaha*' contract is sometimes referred to as an Islamic mortgage. It is a cost plus arrangement in which a financial institution purchases an agreed property which it then resells to its customer. The uplifted resale price is paid in instalments. Sharia requires the financial institution to inform its customer of the cost that was incurred in acquiring the property.

The *murabaha* is used primarily in circumstances where a mortgage backed loan would be used in the acquisition of real property. It is similar to a contract of sale on terms, however, there is a significant distinction in that under a *murabaha* contract the purchaser is entitled to an immediate transfer of title, whereas under a terms contract, title is usually not conveyed until all instalments of the purchase price have been paid. A *murabaha* contract, or '*tawarruq*' is offered by some Islamic financiers for the purchase of commodities. At *tawarruq* does not have general acceptance amongst Islamic scholars as often it does not involve the transfer of title in the goods^{xviii}.

Ijara

An '*ijara*' contract is equivalent to a conventional lease or hire-purchase arrangement and is also founded on a cost plus profit basis. The *ijara* provides the '*usufruct*', or right to use and enjoy, in an asset to the customer. A bank will purchase an asset and lease it to its customer with an agreed profit element attached. In some instances, the financial institution may transfer ownership of the asset to the lessee upon completion of the contract. It is commonly used for the financing of personal property and business equipment. It may be used to acquire real property.

Rahn

Security for finance may be supported by the customer's '*rahn*' or pledge of tangible property. Ideally the security property is put in the possession of the bank. Some

jurisdictions will permit satisfaction of this rule by certificates of title, invoices and insurance certificates to be deposited with the financier.

Sukuk

The offering of bonds by Islamic banks is particularly problematic as this instrument is traditionally considered a strong indicator of prevailing economic conditions hence the abiding concern with the 'bond rate'. The interest, or coupon, offered by reserve banks on bonds issued by them on behalf of governments is a marker which is readily understood by participants in finance markets. Like a bond, 'sukuk' may, depending on its terms, be traded on secondary markets but it differs from bonds which are essentially a promise to repay a debt. *Sukuk*, or financial certificates, is an investment in a transaction which is Sharia compliant and is therefore an investment in an asset. It may take the form of an interest in the business created by a *musahraka* contract - '*sukuk al musharaka*'. It is appropriately used to fund construction costs. The structure involves the financier creating a special purpose vehicle (SPV). The funds required to complete the development are raised by the issuing of certificates by the non-financier party to investors. The non-financier party buys the SPV assets in instalments repayable as agreed under the *musharaka* contract. These payments are distributed to the holders of certificates as investment returns. The non-financier party is obliged to have paid all of its obligations under the *musharaka* upon the maturity of the *sukuk*.

Potential legal obstacles

The central focus of the Australian banking system is the receipt and payment of interest and commercial and regulatory frameworks have been developed to support this paradigm. The prohibition on *riba* therefore creates a series of unique challenges.

As government and business leaders encourage the formation of a domestic Islamic bank, our state and national regulatory systems may need adjustment to adequately protect depositors and mortgage holders. Similarly, if offshore institutions are invited to Australia, the taxation system should be modified to ensure Islamic products are treated on a par with the conventional western system. In July 2009 it was reported

that the first financial services mission from the United Arab Emirates met with Treasury officials in Canberra to encourage reform.^{xix}

The *murabaha* and *musharaka* contracts illustrate the existence of potential complications as Islamic banking practices are introduced to Australia. Both contracts involve a vendor transferring a capital item to an intermediary financial institution before it is passed on to an intending owner. This arrangement could therefore give rise to the imposition of two separate charges of stamp duty. This problem has, however, recently been rectified by legislative amendments in Victoria and *murabaha* and *musharaka* contracts will now be treated as a single transaction for duty purposes.^{xx} The application of section 17 of the *Duties Act 2000* (Vic) also prevents the imposition of double duty in the event that a transaction has been effected by more than one instrument. Similar amendments are being considered by other Australian states wishing to accommodate Sharia-compliant home finance contracts.

In the *Australian Property Law Journal*, Mr John Barry advises that contracts such as *murabaha* and *musharaka* can be classified as terms contracts for the purposes of the *Sale of Land Act 1962* (Vic). He suggests, however, that devout Muslims will not afford themselves the protection provided by this Act as a mortgage back would result in interest payments. To overcome this difficulty, lodging a caveat is recommended as it would appropriately protect the interests of Muslim mortgagees.^{xxi}

Another area of legal difficulty lies in an Islamic bank's inability to charge default interest if a client fails to honour payments. Although it is possible to levy a fee for a missed payment, compound interest cannot be added. Ultimately, however, a bank is able to reclaim the property should payment in arrears reach a certain point.^{xxii}

On a more systemic level, Islamic banking refers to its own set of regulatory issues relating to capital adequacy and accounting requirements. The Islamic Financial Services Board (IFSB) is the international body responsible for promoting and enhancing the stability of the Islamic financial services industry. There are differences between the IFSB's prudential standards and the approaches put forward by the Basel II framework which has been adopted as the basis of the Australian regulatory regime. Should an Islamic financial institution submit an application for a banking licence to

the Australian Prudential Regulation Authority (which implements the Basel II framework through its own prudential standards), the Authority will be required to ask whether the standards it enforces are compatible with the Islamic system.

The essential point of difference between the western and Islamic banking systems for the purpose of modelling prudential standards is assessing risk on debt capital versus equity capital. The standards applicable to western banks rely on the premise that, allowing for acceptable tolerances, there is certainty of a fixed rate of return on investment funds secured by a suitable ratio of debt to valued assets whereas Islamic banking poses a more problematic calculation of returns in a system of profit sharing from the utilisation of jointly owned assets. In recent history, until the advent of the Global Financial Crisis that emerged in mid-2007, there was a 'religious faith' in the reliability of the western banking model. This was sorely tested by the lack of transparency as to the nature and degree of risks assumed by the world's leading banks.

In any context, the success of a bank is critically dependent on first, its corporate governance and, secondly, the productivity and growth of the economies in which its loan funds are seeded. The challenge for Australian policy-makers is to adapt prudential standards which adequately safeguard investors in an Islamic banking model.

Conclusion

The regulatory framework hurdles that this article has addressed do not present as insurmountable obstacles. If the Federal government takes appropriate action to tackle these discrepancies, hundreds of thousands of Australian Muslims may have the option of becoming home owners without compromising their religious beliefs.

These inconsistencies should be addressed as a priority as a wave of Islamic financial activity is imminent. The Muslim Community Co-operative of Australia, with its base in Melbourne and over twenty years experience in providing Islamic financial services, has already announced its aspiration to become the nation's first retail Islamic bank. La Trobe University has recently begun offering a postgraduate Master

of Islamic Banking and Finance and some of the country's largest banks are well positioned to operate Islamic retail banking windows.

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ⁱⁱⁱ Quotation located in: Muslim Community Co-operative Australia Ltd. 2009. *MCCA reaffirms objective to become Australia's first Islamic retail bank* [Online]

Available at:

<http://www.mcca.com.au/UserFiles/File/MCCA%20Media%20Release%20-%20July%202009.pdf>

^{iv} Jimenez, K., 2009. Religious co-operative an ethical alternative, *The Australian*, [internet] 9 Sep.

Available at: <http://www.theaustralian.com.au/business/wealth/religious-co-operative-an-ethical-alternative/story-e6frgad6-1225769688913>

[Accessed 4 February 2010].

^v Bell, A., 2009. Islamic banking tipped in 5 years, *The Canberra Times*, [internet] 7 Jul. Available at:

<http://www.canberratimes.com.au/news/world/world/general/islamic-banking-tipped-in-5-years/1560811.aspx>

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^{vi} Quotation located in: Hudson, P., 2009. Push for Islamic financial rescue, *Sydney Morning Herald*, [internet] 8 Jun.

Available at: <http://www.smh.com.au/national/push-for-islamic-financial-rescue-20090607-bzv6.html>

[Accessed 4 February 2010].

^{vii} The Australian Trade Commission (Austrade) has issued a key publication addressed to the Financial Services Sector on the topic of Islamic Finance available at:

<http://www.austrade.gov.au/Home/Financial-Services/default.aspx>

^{viii} Qu'ran 2:275

^{ix} Saeed, A. Akbarzadeh, S., 2001. *Muslim communities in Australia*. University of New South Wales: University of New South Wales Press Ltd p.192

^x O'Hare, C. Holmes, J. *An introduction to Islamic banking and finance*. The Middle East & North Africa Business Guide 2001/2002.

^{xi} Muslim Community Co-operative of Australia CEO, Nasser, is quoted in Saeed, A. Akbarzadeh, S., 2001. *Muslim communities in Australia*. University of New South Wales: University of New South Wales Press Ltd at p 200: "The basic difference is that, in Islam, finance and resources are there to serve people, not the other way around. That comes from our holy Book (Qur'an): God has created everything for you, to serve you. The materialistic approach is that if I am going to benefit materially, it can be at your expense; in Islam, that is not acceptable. This ensures social justice. This is the basic difference. The focus is on serving people, uplifting the standard of people, which is good in all spheres of life. The conventional system is providing a service for people but the service that is offered is focusing only on one side of life and that side is financial. It does not concern itself with social justice. Although there may be ethics involved, it relates only to the financial aspect. That, I think, is the basic difference."

^{xii} Guiding Principle 5 on conduct of business for institutions offering Islamic financial services, Islamic Financial Services Board <http://www.ifsb.org/standard/ifsb9.pdf>

^{xiii} Qu'ran 2:245 – "Who would grant Allah a good loan (Qard Hasan). "He will repay him many times over". It is Allah Who enriches and makes poor, and to Him you shall return".

^{xiv} Farah, A., 2009. *An introduction to Islamic Banking and Finance*. Ajman: Ajman Chamber of Commerce and Industry p. 88

^{xv} O'Hare, C. Holmes, J. *An introduction to Islamic banking and finance*. The Middle East & North Africa Business Guide 2001/2002.

^{xvi} For a commentary regarding the matters that an Islamic Bank might consider when providing *mudaraba* finance see paper by Mousa Z, Executive Manger, Domestic Investment & Marketing, Qatar Islamic Bank at http://www.financeinislam.com/article/1_35/1/415 [Accessed 24 March 2010].

^{xvii} Barry, J., 2007. Islamic property financing. *Australian Property Law Journal*, 15 APLJ 66.

^{xviii} See report 1 Feb. 2008 at: <http://www.arabianbusiness.com/509187-misused-murabaha-hurts-industry> [Accessed 24 March 2010].

^{xix} 2009. UAE Islamic finance mission visits Australia, *Emirates Finance News*, [internet] 15 Jul. Available at: <http://www.emiratesfn.com/news/newsfull.php?newid=285616> [Accessed 4 February 2010].

^{xx} Sections 57A – 57F of the Duties Act 2000 (Vic), as inserted by the State Taxation Acts (Amendment) Act 2004

^{xxi} Barry, J., 2007. Islamic property financing. *Australian Property Law Journal*, 15 APLJ 66.

^{xxii} Kadlec, K., 2009. A new way of lending in Australia, *Your Mortgage*, No. 93 p. 61