CHAPTER 1

Australia

Islamic Finance Down Under

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Islamic finance currently plays a very small role in the Australian financial sector. With Muslims accounting for more than 476,000, or just 2.2 percent, of the population, its retail presence is likely to remain quite small. The potential lies instead with the growth of foreign investment. Australia has the fourth largest fund management industry in the world but it has only recently started to offer Islamic products. This business could easily be expanded to appeal to overseas investors as well as locals.

Similarly, on the funding side, Australia's substantial infrastructure funding requirements, as well as those of its massive resource development industry, could be filled at least in part through *sukuk* issues directed at offshore investors. More flexible regulatory and taxation measures would greatly facilitate these developments. The Australian government has at least made positive statements toward this end, but so far it has done nothing to loosen the existing restraints.

This chapter discusses Australia's Islamic finance industry and its possibilities, focusing specifically on asset management, tax and accounting, retail finance, microfinance, *takaful* and re-*takaful*, issuances and *sukuk*, the debt capital market, the equity capital market, regulatory issues, cross-border financing, and the future.

ASSET MANAGEMENT

Australia has an active and growing conventional fund management industry. With assets of some A$1.7 billion in 2013, it is already the fourth largest in the world. It is a strong supporter of the United Nations Principles for Responsible Investment; therefore, socially responsible managed investments are popular with local investors. Since Shari'ah-compliant funds follow some of the same principles, Shari'ah-based funds would seem to have some attraction. Only a few managers, however, offer such products. Some of these so far are MCCA, Crescent Wealth, Hyperion Fund Management, LM Australia, and the Brisbane Islamic Investment Fund.

MCCA, as explained later in the retail section, manages the MCCA Income Fund. When it was created in 2009, it claimed to be the first Shari'ah-compliant investment fund in Australia. The fund allows retail investors to purchase as little as A$500 of a diversified portfolio of Shari'ah-compliant home loan mortgages and also provides a funding mechanism for MCCA to arrange new lending. The fund earned its members a low risk return of 5.11 percent in 2011–2012—an attractive investment for any individual Muslim's self-managed superannuation funds. This is an important market because overall self-managed funds account for one-third of the assets of Australian superannuation funds.

Crescent Wealth was created specifically to offer Shari'ah-compliant investment products to both local and overseas investors. Its funds have been developed and managed under the supervision of the International Shari'ah Supervisory Board of Amanie Islamic Finance Consultancy and Education as well as the Australian Investment and Securities Commission. The Westpac Bank–affiliated Asgard investment platform now offers four Crescent investment products through its eWRAP investment account and superannuation programs. These include the Crescent Australian Equity Fund, the Crescent Islamic Cash Management Fund, the Crescent Diversified Property Fund, the Crescent International Equity Fund, and a Shari'ah-compliant superannuation fund, the Crescent Wealth Superannuation Fund.

The Crescent Australian Equity Fund is the best-known local product. It was launched in July 2011 to provide a Shari'ah investment vehicle for Australian equities. After screening some 2,000 listed companies through the Australian Securities Exchange (ASX), Crescent Wealth helped create its own ASX Islamic index, now known as the Thomson Reuters Crescent Wealth Islamic Australia Index. The specific share purchases are selected from a population of some 142 firms, which compose roughly 55 percent of the ASX's overall market capitalisation. Its major investments as of August 2013 included Woodside Petroleum, BHP Billiton, Rio Tinto, and Slater & Gordon. A major insurer, Aon Hewitt, was one of the initial seed investors in the fund, and Sigma Funds Management serves as a subadvisor for the actual day-to-day management of the investments.

The Crescent Islamic Cash Management Fund was created on May 27, 2012, in conjunction with the Bank of London and the Middle East to invest in *sukuk* and other Islamic liquidity products. Any short-term deposits are placed offshore with HSBC Amanah. Its asset allocations can vary, but its intention is to hold roughly half in long-term investments and the rest in Islamic bank terms deposits. In August 2013, the mix was actually 30 and 70 percent, respectively.

The Crescent Diversified Property Fund was seeded on February 22, 2013, and complements Crescent's equity funds with a more Shari'ah-based income-focused investment option. Crescent Wealth is the manager, but it is also advised by Freehold Investments and Evergreen Capital Partners. The fund has planned an asset allocation of up to 50 percent in unlisted property securities, 45 percent in listed property securities, and 5 percent in cash. Its main holdings in August 2013 included the Westfield Retail Trust, Stockland Property Trust, Bunnings Warehouse Property Trust, CFS Retail Property Trust, and the Commonwealth Property Trust.

The Crescent International Equity Fund was also seeded on February 22, 2013, for Shari'ah investing in overseas equities. It is managed by the Malaysian arm of a well-established U.S.-based Islamic fund manager, Saturna Capital. The latter's U.S. funds hold a five-star Morningstar ranking.

The Crescent Wealth Superannuation Fund was created on May 22, 2013, to allow Muslims to invest in a public-offer Islamic product rather than being forced to create their own self-managed superannuation fund and then have to select their own Shari'ah investments. The availability of such a product is important because employers are required by law to make a contribution equal to 9.25 percent of their employees' salaries into a superannuation fund. For amounts of less than $250,000, a self-managed fund would be much more expensive than most public-offer ones.

Hyperion Asset Managers is a Brisbane-based funds manager that created the Hyperion Australian Equity Islamic Fund in 2010. It uses an Islamic screen to create an acceptable Shari'ah investment population of Australian listed shares, from which it selects the best investments, following a value-growth high-conviction approach. It was designed for offshore investors seeking an exposure in Australian equities rather than for local investors and was therefore established in Bahrain rather than Australia. As of August 2013, it was still listed by the Central Bank of Bahrain as being approved locally as a collective investment.

The LM Australia Alif Fund was launched in 2009 to provide a Shari'ah-compliant income stream from a diversified portfolio of Australian-based real estate holdings. These include industrial and retail properties, retirement housing, and some real estate development. It was designed to attract offshore investment from Asia and the Middle East with Amanie Solutions of Dubai as its Shari'ah advisor. Unfortunately, its manager, LM Australia, suffered some financial problems and is now in liquidation.

The Brisbane Islamic Investment Fund (BIIF) is a wholesale Australian unit trust created to invest in small and medium unlisted businesses. Its target industries include manufacturing and services, energy and resources, real estate, solar and clean energy, livestock, and tourism following Islamic principles. Its initial investments are planned for, but not limited to, Queensland and Indonesia. Like a venture capital company, it addresses the potential liquidity problems with such investments by requiring any units purchased to be held for at least seven years and dealing mainly with institutional investors from Malaysia, Indonesia, and the Middle East. It was launched on January 6, 2014, by an Australian firm, Business Custodians Limited, which also serves as BIIF's manager and trustee. Its Islamic matters are overseen by the Australian Shari'ah Board for Islamic Finance of the Australian Centre for Islamic Financial Studies. Though not yet involved in Islamic funds management, the National Australia Bank (NAB), through its nabInvest operations, owns a majority interest in a Singapore joint venture with Oxley Capital Group and Mitsui called nabInvest Oxley Singapore. The firm manages conventional real estate trusts in Singapore, of which the Cambridge Industrial Trust is the best known. It is sometimes suggested, however, that it may create an Islamic property trust as part of its offerings.

In the future, the asset management business may change considerably as a result of the recent progress with the so-called Asian Passport for investment funds. This would allow funds approved in one country to be offered to residents in other member countries. Australian managers would gain access to other markets, and the Australian market would also be opened for overseas Islamic products to be offered locally. If it is successful, the major existing local providers will undoubtedly move quickly to offer their own competing products.

TAX AND ACCOUNTING

Taxation is a critical aspect of most financing decisions. Unfortunately, the Australian government as yet has taken no action to address the problems that Australia's conventional tax system may present for a successful Islamic finance industry. The Board of Taxation conducted a review of these matters and in 2010 published an excellent document, *Review of the Taxation Treatment of Islamic Finance*.[1] It identified a number of problems with the existing system and included case studies to illustrate their effect. This report served as a discussion paper on which the public could comment. The board then finalised its views and submitted its recommendations to the government in June 2011.

More than two years have passed, but the government has neither released these recommendations nor indicated how it might respond to them. The change of government in September 2013 may delay the process even further, since, like its predecessor, it has been concerned mainly with increasing tax revenues rather than improving financial sector efficiency. Some of the key areas for change include stamp duty, capital gains tax and interest deductibility, and withholding tax.

Stamp duty is charged on the purchase of tangible assets; the duty on real estate purchases is one of the most important sources of state government revenue. The amount is determined as a scaled percentage of the underlying value and can cost thousands of dollars even on a normal house purchase. With any Islamic financing technique based on an asset purchase and resale, the client would thus be hit with two sets of stamp duty: one when the financier purchases the asset and again at the end when the financier sells it to the client. Besides effective double taxing, an added problem is that with a long-term mortgage, the second part of the transaction may be charged at the asset's then much higher deemed value. The Victorian government removed this double taxation in 2004 but remains the only state to have done so. Other approaches, such as gifts or placement of the asset in the client's name as the owner, are also used instead to minimise the effect.

Capital gains tax has a similar effect as stamp duty in the sense that the tax may be assessed at the end of transfer of the asset financed. Again, there are ways to address the latter problem, but it is not always certain that they will actually work when implemented later. The best approach, though bothersome, for avoiding later problems is to obtain a special private ruling from the Australian Taxation Office on each Islamic transaction.

Although the tax deductibility of interest payments is well established under Australian law, it is not so clear how some Islamic finance payments would be treated. The classification as interest is also important for withholding-tax purposes. If offshore investors receive what is considered interest for tax purposes, then they are assessed with a 10 percent withholding tax. If they are viewed otherwise by the Taxation Office, the tax would be much higher.

There is no suggestion that Islamic products require or should deserve any special taxation treatments or concessions as such. Rather, they should be judged, as the Board of Taxation's review explained, "on their economic substance rather than form." So when an Islamic product is the economic equivalent of a conventional finance one, then "the tax treatment of the two products should be the same." Since the Australian Taxation Office's own taxation of financial arrangements argues this very position for any product, the tax treatment should not be such a problem that it cannot be overcome.

RETAIL FINANCE

The retail market for Islamic finance is the oldest component of the Australian industry and was created by local Muslims to service their community. There are now three main institutions: MCCA Limited, Islamic Co-operative Finance Australia, and Iskan Finance.

MCCA Limited was the first of these retail finance providers and now operates through offices in both Victoria and New South Wales. It was initially established as cooperative body in 1989 and established a credit union affiliate in 2000. These structures proved difficult when regulatory reform continued to increase their compliance costs. In 2008 the MCCA obtained an Australian financial services licence instead and today operates mainly as the manager of a related investment vehicle, the MCCA Income Fund. MCCA, as the fund's manager, will help borrowers obtain

Islamic-structured mortgage financing and the mortgages then acquired by the fund. As mentioned earlier, MCCA clients can also invest directly in this mortgage pool and so assist MCCA in providing more Shari'ah-compliant mortgage financing as well as an appropriate source of income. The cooperative business is gradually running down its operations and will eventually close.

Islamic Co-operative Finance Australia (ICFA) also provides retail finance based on Islamic principles to clients in New South Wales. Its housing and vehicle finance are provided through a range of Islamic products, of which a shared equity scheme is the most common. Some small business loans are also possible. The ICFA also operates some affiliated funds: a Haji Fund for Mecca pilgrimages, a children's education fund, and a *zakat* (wealth tax) fund.

Iskan Finance is a finance company that offers Islamic-structured mortgages and lease finance in partnership with some normally conventional lenders. Its home financing operates mainly using *murabahah* and *ijara* funding structures. It also involves funding community housing projects and some business lending.

MICROFINANCE

There is no doubt that small microfinance activities are being conducted informally through local mosques in Australia.

The only formal activity is operated under the umbrella of the No Interest Loans Scheme (NILS). Although it certainly sounds like an Islamic finance program, it is really a much larger community-based program to help low-income borrowers acquire essential household goods and services. Loans of up to A$1,200 are available for 12 to 18 months. NAB is the major funder of the program, with a total commitment of A$130 million. Other partners—the Australian government, various state governments, and other benefactors—have allowed the program to serve more than 400 local communities throughout Australia. Although the NAB is a conventional bank, it does fund a range of nonprofit activities in support of local communities, of which NILS is a key component. Since the program was designed to be interest-free, it was not difficult for Shari'ah advisors to structure a Shari'ah-compliant loan documentation and disbursement program. So a number of these community-based NILS units are now run by local Islamic community groups in each state with the technical support of the Good Shephed Youth and Family Services program. The Islamic Council of Victoria, for example, operates the Qard Hassan Victoria operations of NILS in Victoria.

TAKAFUL AND *RE-TAKAFUL*

There are no *takaful* or re-*takaful* insurance companies operating in Australia. Cooperative insurers were once common here within the local conventional insurance market, but most have since been converted into for-profit corporate structures. There are no obvious barriers to a *takaful* approach, but there have been no public announcements of any attempt to establish local operations.

The 2012 acquisition by the Insurance Australia Group's Malaysian joint venture, AMG Insurance, of a major Malaysian insurer, Kurnia Insurans, has now made the

Insurance Australia Group (IAG) a major player in Malaysian insurance. The IAG management has indicated an interest in obtaining a Malaysian *takaful* licence should one become available. If this happens, then this expertise might eventually find itself applied to Australia, if not other countries such as Indonesia.

ISSUANCES AND *SUKUK*

There have been no direct *sukuk* issues in Australia, but several local institutions have had some involvement elsewhere. The most public of these is a Malaysia-based rising by SGI-Mitabu, a joint venture between the Australian-based Solar Guys and Mitabu Australia. The SGI-Mitabu A$150 million *sukuk* issue in early 2013 is part of a capital rising to finance the A$500 million building of a 250-million-watt solar power plant in Indonesia. The issue was raised through Malaysia's offshore financial centre, the International Business and Financial Centre, in Labuan. As the funding is raised outside Australia—and, more important, so is its revenue stream—it avoids any taxation issues that a local Australian issue might involve.

Similarly, offshore there are often rumours of various Australian banks considering *sukuk* issues to diversify their long-term capital sources to include more funding from Asia and the Middle East. NAB is most often mentioned as possibly conducting a small, perhaps US$500 million *sukuk* issue being used to test the waters. It is not known how the Australian Prudential Regulation Authority might view these issues.

The Macquarie Group's operations in the Middle East offer another potential for an Australian involvement in Islamic finance. Its current offerings include banking, fund management, and advisory work in Dubai as well as its ADCB Macquarie Corporate Finance and ABCB Macquarie Infrastructure Fund joint ventures with the Abu Dhabi Commercial Bank. These ventures are intended to provide structured finance, to include Islamic products like *sukuk* for clients in the Middle East. In 2009, for example, Macquarie provided Gulf Finance House with US$100 million in financing by way of a convertible *murabahah* issue.

Within the Australian domestic market, it is known that NAB has for some time included some *sukuk* investments as part of its own internal debt securities portfolios, but it has not become an issuer itself. Also on the local front, the Kuwait Finance House has had a small local subsidiary, Kuwait Finance House (Australia), located in Melbourne for some years, and in 2013, the Shari'ah advisory group, Amanie Advisors, opened its own office in Melbourne. The potential for future Islamic finance business certainly seems reinforced by their presence. In 2012 the Malaysian-based CIMB Group acquired the Royal Bank of Scotland's Australian business and thus further expanded the range of well-established Islamic finance players with an active presence in Australia. Whether CIMB will turn its attention here to Islamic finance, however, remains to be seen.

DEBT CAPITAL MARKETS

Although there have been no *sukuk* issues yet in Australia, Shari'ah-compliant capital market funding is available.

The most obvious is the long-established nonbank mortgage lender FirstMac. It has played a market funding role for the MCCA mortgage pool for many years and is said to be eager to securitise its pool of Shari'ah-compliant home mortgages by way of a Shari'ah-compliant debt issue.

The Westpac Banking Corporation has also introduced the Special Interbank Placements for Islamic Financial Institutions program as part of its own funding activities. This uses physical commodities as the basis for sale and repurchase agreements with Islamic institutions. So, for example, Westpac might buy a quantity of iron ore on the institution's behalf and then resell it under a profit-sharing agreement.

The greatest potential remains for a sovereign issuer to have an Australian dollar–denominated debt issue in the so-called local kangaroo bond market. These raisings are quite large and are confined to high-credit quality issuers. In July 2013, an Indonesian government official was quoted as considering such an issue but did not indicate whether it might be Islamic. It seems possible that the prestige of a jumbo sovereign issue would serve as a strong incentive for the new Australian government to address any of the remaining uncertainties to make it possible. Once resolved, this would open the market to subsequent issuers.

EQUITY CAPITAL MARKETS

As mentioned earlier, there are a number of fund managers offering Islamic-compliant Australian equities and other investments to potential clients. With some 2,162 listed companies, the ASX offers a wide range of choices, particularly within the mining sector.

There is no specific Islamic market, but the Thomson Reuters Crescent Wealth Islamic Australia Index provides a clear range of choices for potential Muslim investors. It can also serve as a benchmark for clients to compare their performance with that of this part of the Australian market.

REGULATORY ISSUES

Australian financial institutions are subject to the controls of two regulators: the Australian Prudential Regulation Authority (APRA), for prudential regulation, and the Australian Securities and Investment Commission (ASIC) for market conduct and client interaction. This means that banks, other deposit-taking companies, and insurance companies must obtain their initial authorisation from and subsequently report to both. Fund managers and securities issues are under just ASIC.

There is no obvious, or at least publicly stated, regulatory impediments to establishing Islamic financial institutions in Australia. The approval for banking licences is readily available for well-established foreign banks to establish branches or, if accepting local retail deposits is desired, then wholly owned Australian-incorporated banking subsidiaries. The difficulty, perhaps, is that APRA, the banking regulator, has not shown much interest in Islamic finance. This is certainly reflected in the fact that APRA has neither member nor observer status with the Islamic

Financial Service Board, and no Australian institutions are part of the Accounting and Auditing Organization for Islamic Financial Institutions. MCCA returned its credit union authorisation in 2002 after its dealing with APRA. Initially, credit unions were under a separate regulator. When APRA was created by a merger of three regulators, credit unions became approved deposit-taking institutions and so in the process came under the Banking Act. No special consideration was afforded for Islamic finance, and the 15 percent regulatory capital ratio APRA placed on MCCA considerably limited its loan growth. Of course, that was many years ago, and attitudes might be quite different today. It is nevertheless interesting that the Arab Bank Australia, the local subsidiary of the Lebanon-based Arab Bank, still does not offer Islamic finance locally, despite the obvious expertise available from its sister company, the Islamic International Arab Bank.

Recommendation 4.8 of *Australia as a Financial Centre: Building on our Strengths*, more commonly known as the Johnson Report, concluded that there were still some problems, and it called for "the removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a level playing field for such products."[2]

Some potential problems might include the possibility that certain Islamic financing products that involve multiple investors could be classified as managed investment schemes under the Corporations Act and be regulated accordingly. Similarly, to the extent that Shari'ah advisory boards could influence bank operations, the Johnson Report warned that their members might be considered as "shadow directors" of the banks concerned. Since these are not matters currently covered under the existing governance regulations, it is uncertain how APRA would approve their appointment or assess their skill sets.

On the positive side, the Australian government has at times made some very positive statements in support of Islamic finance, and there has been indirect progress in the overall fund management business with the potential start of the Asia Region Funds Passport program in 2016. This will allow licensed fund managers to offer a specific investment product approved in one country to have effective access to the other member countries without additional regulatory compliance requirements. Modelled along the lines of Europe's successful Undertakings for Collective Investment in Transferable Securities program, the pilot will initially cover only Australia, New Zealand, South Korea, and Singapore, but it will be expanded to others if the trial proves successful. While the Passport program would help Australian fund managers to sell their products elsewhere, Asian-based Islamic fund managers would also be allowed to sell their products in the Australian domestic market.

CROSS-BORDER FINANCING

As mentioned earlier, the major problem with cross-border Islamic financing involving Australia is the tax deductibility of profit-sharing payments to lenders as well as withholding issues when paying this money to overseas investors. Australian firms may find Islamic products more effective when the funds are both raised and invested outside Australia.

THE FUTURE

Australia has considerable financial expertise in investment banking, commercial banking, and fund management that could easily be applied to Islamic finance. Specialist Islamic finance programs at several local universities now produce graduates ready to meet its potential demands. The Johnson Report and the Board of Taxation review have identified the tax and regulatory changes that would allow the industry to flourish. Although the new Abbott Liberal-National government might be tempted to wait for its recently appointed Financial Systems Inquiry (headed by David Murray) to report, there is no justification for further delay.

As a previous government spokesman explained, "We see Islamic finance as a way of opening our capital and credit markets, enhancing competition and innovation, fostering social inclusion, and promoting greater engagement and integration in the Asia-Pacific."[3] It now remains for the new government to implement the required changes.

NOTES

1. Board of Taxation, *Review of the Taxation Treatment of Islamic Finance* (Canberra, Australia: Department of the Attorney General, 2010).
2. Australian Financial Centre Forum, *Australia as a Financial Centre: Building on Our Strengths* (Canberra, Australia: Department of the Attorney General, 2009).
3. Bernie Ripoll, "An Address to Amanie Australia Islamic Finance Forum," Melbourne, April 16, 2013.

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Skully has had a long-standing research interest in Islamic banking. He is a foundation member of Australia's Islam Node Network of academic researchers and an investigator in a large Australian Research Council linkage grant on Islamic finance. He has produced conference papers, book chapters, and refereed journal articles relating to aspects of the efficiency and governance of Islamic banking as well as other conference papers on Islamic banking in international perspective, Islamic microfinance, and Islamic pawnbroking. Skully is an editorial board member of the *International Journal of Islamic and Middle Eastern Finance and Management* and has supervised a PhD student to completion on Islamic finance.