

**THEORY AND PRACTICE OF
MODERN ISLAMIC FINANCE**

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MODERN ISLAMIC FINANCE
THE CASE ANALYSIS FROM AUSTRALIA**

ABU UMAR FARUQ AHMAD



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*Theory and Practice of Modern Islamic Finance:
The Case Analysis from Australia*

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This book is dedicated to my most beloved parents,

Zainab Begum

&

Abu Tahir Muhammad Nazir

(have Allah's Mercy on their souls and grant them eternal happiness and peace in Paradise), without whose sole contribution I could not achieve anything in my life.



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ABOUT THE AUTHOR

Dr Abu Umar Faruq Ahmad, the author of this book, has proved himself as a brilliant student, an outstanding researcher and an excellent teacher in his area of specialisation. He obtained his first degree (Lissans) in Shari'ah from Islamic University of Madinah, Saudi Arabia in 1984, a Master of Laws (Honours) in Islamic Banking Law in 2003 from University of Western Sydney (UWS), Sydney, Australia, and a PhD in the Law of Islamic Finance with 'High Distinction' from UWS in 2008.

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WHAT'S IN THIS BOOK

Broadly, the subject-matter of this study is Islamic law and its practice in the operation and regulation of financial institutions in Australia. Special emphasis has been given to the compliance with Shari`ah law by the contemporary Islamic Financial Institutions (IFIs)/Islamic Financial Services Providers (IFSPs) operating in Australia, and the regulatory approach to their regulation. The study presents an analysis of different modes and products of Islamic finance quite persuasively by focusing on the requirements of financial products under Shari`ah law and the need for compliance with them by the institutions. The call for regulation of such institutions in line with the Shari`ah principles has also been critically examined by highlighting the problems and prospects of Islamic financial services in Australia. In doing so, the author has efficiently demonstrated his depth of knowledge of law relevant to both Islamic and conventional financing institutions, and has aptly distinguished them. The author has, through this book, demonstrated his ability to go very deeply into complicated legal issues and interpret them in their proper perspectives.

Discussions of the topics throughout the book are logically coherent and presented in plain language. A glossary of Arabic terms and terminologies added to the end of the book has been a useful tool for understanding the discussion. The illustration of various important points making reference to the primary and high quality secondary sources has significantly strengthened the arguments of the author. In sum, it is an insightful, well-researched, logically organised, and lucidly presented research work having overwhelming strengths and very limited weaknesses.

In chapter 1, the author has successfully identified the research problems at the outset of his in-depth study. The main concern is the divergence of Islamic financing practice from the traditional Shari`ah in Australia measured by reference to operations of the IFIs/IFSPs and characteristics of financial products offered by them. The measurement also touches upon the regulatory approach towards those institutions in Australia and relevant international standards and experience. The chapter provides international and national backgrounds to the operations and regulation of Islamic banking in the contemporary world in which the author describes the gradual de-

velopment of Islamic financing since its very inception. As regards justification for his research, it has been stated that Islamic finance has emerged as a potential area for further expansion of Australian trade with its neighbours such as Malaysia and Indonesia. The author argues that a regulatory regime in compliance with Shari`ah principles can significantly contribute to increasing domestic investment and attracting foreign capital especially from Muslim majority nations. An ultimate objective of the study has been spelt out as widening the use of Islamic finance by popularising purely Shari`ah compliant products and services, and facilitating the regulation of those institutions in line with Shari`ah principles in Australia. The author has rightly pointed out that the expected changes in the regulatory approach should aim to strike a balance between material and spiritual welfare and maximisation of social benefits. This chapter also includes the methodology followed in carrying out this comprehensive research and articulates the desired outcomes of this meticulous work. A concrete plan stated at the end of this chapter provides the readers with specific guidelines about the main issues to be dealt with subsequently in this study in a logical sequence. The author has thus efficiently organised this chapter by introducing various elementary issues of the study.

In chapter 2, the author introduces the sources of the Shari`ah as the legal system in Islam and offers a scholastic analysis of them. It makes a very significant part of the study in that, it is imperative to have adequate knowledge of Shari`ah in order to understand religio-legal nature of the provisions governing the practice of financing machines and their mechanisms permitted in Islam. The author has prudently elucidated the spirits of Shari`ah, and expounded its primary and secondary sources in their proper perspective. The author has critically analysed the validity of various sources and their acceptability in different schools of Islamic thoughts developed over time based mainly on four respected Muslim Imams. The author has expressed his own views with reasons on the validity of some secondary sources of Islamic law. Islamic terms have been coherently translated and explained, facilitating an understanding of those divine revelations and sometime complicated ideas in a manner that helps even a layman to grasp them quickly. Although this chapter presents basically a conceptual discussion, it indeed is an important part of the thesis.

In chapter 3, the author has critically discussed the application of the Shari`ah in the financing context. This seems to be crucial in that

it concentrates on the application of Shari`ah and pinpoints the differing views of various schools of Islamic jurisprudence. He has discussed views of firstly, Sunni and Shi`a juristic schools of Islamic law; and secondly, four schools under the Sunni main school on certain types of financing tools and methods. He provides a table showing “Schools of Islamic Law followed by Muslims in North America and the Middle East”, which is of course a good addition to his discussion of Islamic legal maxims of financial transactions have been clearly identified and their applications to permitted and forbidden acts have been duly emphasised. Referring to a renowned hadith, a primary source of Islamic law, the importance of intentions and acts in devotional and commercial contexts has been highlighted by reference to the relevant Shari`ah principles. With regard to the conflict between doubt and certainty in respect of Islamic dicta, it has been argued that certainty shall prevail over doubt in dealing with a controversial issue. The chapter also explains the rule of necessity in the light of the pertinent Islamic provisions. The role of custom in Shari`ah has also been discussed and shown that custom and usages can have decisive force subject to certain conditions. The chapter also focuses on the need for fair trading that should be free from, among other things, interest or excessive uncertainty. The last section of the chapter identifies Islamic modes of financing which include Equity-based and debt-based financing. The author has overall aptly presented his discussions in this chapter.

Chapter 4 deals with the regulatory aspects of financial markets. It focuses on the theories of financial regulation with particular reference to its theoretical frameworks, categories and key objectives. It commences with the meaning of regulation followed by its theoretical framework. In this regard three schools of thoughts prevailing in the mixed market economies such as Australia have been scholarly discussed in detail. They are: the public interest theory of regulation, the capture theory of regulation, and the economic theory of regulation. In doing so, the author relevantly refers to two prominent legal theories being normative legal theory and positive legal theory. Then the author moves on to the categories of regulation that include social regulation and economic regulation. He has basically provided brief notes on these categories and then has succinctly identified the objectives of financial regulation. Finally he has clearly summarised the positives and pitfalls of these theories in his concluding remarks.

Chapter 5 concentrates on the historical evolution of financial products. It covers both the conventional as well as Islamic financial

instruments. In discussing the conventional products the author has explained the concept of time value of money, contingent claims and negotiability of claims. With regard to Islamic products he has offered an enlightened discussion of the state of the art with reference to the significant differences that exist in different regions or sectors in terms of implementation of different modes of Islamic financing. All major points of such differences have been adeptly identified, and various conventional products and their Islamic alternatives have been methodically discussed side by side. He has successfully shown that Islamic finance offers viable alternatives to all financing modes currently being offered by conventional financial institutions. He has made a realistic prediction of a remarkable success of Islamic finance worldwide in the foreseeable future.

In chapter 6 the author turns from theoretical analysis to practical perspective. It looks into the Islamic finance practice in Australia in its territorial legal context. Emphasis has been given to the need for an appropriate legal and regulatory framework as a prerequisite to establishing and operating vibrant financial markets. Shari`ah, as a separate legal system, provides for its own legal and regulatory framework for commercial activities in general, and for financial markets in particular. At present, the IFIs in Australia have to comply with both the Australian common law regime and the principles of Shari`ah. It is expensive as well as inconvenient and thus an impediment to the growth of Islamic financing in Australia as argued by the author. He has also referred to some other jurisdictions such as the UK and Singapore, where the obligation to pay stamp duty by the Shari`ah compliant institutions or Islamic financial service providers has been abolished. The author recommends that the existing double stamp duty requirement be abolished in Australia; nevertheless the IFIs be strictly regulated in order to eliminate any susceptibility to the banking system, and to ensure their sound operation in line with the Shari`ah. The author has proficiently discussed the development of legal framework of Islamic finance, and has firmly discovered the issues that contradict the provisions of Shari`ah, and has also submitted some specific suggestions in order to ensure that IFIs are run in complete compliance with the relevant Islamic principles.

Chapter 7 is concerned about the compliance requirements for Islamic finance in Australia. It reveals that the present regulatory regime treats both conventional and Islamic finance alike in terms of compliance requirements. In other words, the same set of rules is

applied to these two distinctive types of financing. They are distinguished based mainly on: religious attachment, differential treatment of money, interest counting and risks sharing. The author has carried out a thorough and thoughtful examination of different aspects of regulatory roles and objectives, such as: prudential standard, effective legal and regulatory framework under Shari`ah and Basel core principles, improved corporate governance, effective risk management system, development of a dynamic Islamic financial system, and development of a vibrant Islamic financial markets, and the importance of compliance with the core principles of regulation. Finally, the chapter addresses the issue of consumer credit code from Islamic point of view. It is evident from the discussion that the author has effectively dealt with the main aspects of regulatory compliance, in terms of both the requirements under municipal law of Australia and those under Shari`ah, by detecting problems and providing suggestions for their elimination. He has eruditely shown both the Shari`ah requirements of compliance and the way of their implementation.

Chapter 8 offers a critical analysis of financial instruments used by the Islamic financial service providers in Australia. It begins with the identification of the three leading Islamic institutions engaged in providing various financial services in Australia and the services offered by them. They are basically non-banking institutions. Their products are broadly split into two: Equity-based instruments and non-Equity-based (Debt-based) instruments. The author has argued that although the different kinds of Equity-based products currently in place are consistent with the Shari`ah given that they bear a strict rule of risk, profit, and loss sharing; the debt-based products, such as Murabaha, fall short of being an Islamic product in that they can easily accommodate a hidden interest rate and that they aim to make money from money which is prohibited in Islam. In his words, most financing practices that are debt-based, such as credit sales and leases, are mere relabelling of the interest forbidden in the Shari`ah. The Shari`ah permits fundamentally asset-based products instead. The author has very effectively demonstrated his critical thinking of the Islamic financial system and their 'commercial' interpretation by some Islamic financial service providers. He indicates that the Shari`ah Board which approves these Islamic non-compliant products may be biased in doing so simply because of their employment relationship with the institutions concerned. The neutrality of the author in dealing with the topic of research has been clearly expressed in this chapter. The discussion of a recent English case, *Is-*

Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and Others (2002) regarding Murabaha agreement, has been a very good insertion in this discussion.

Chapter 9 provides an analysis of the practice of modern Islamic finance in Australia in a comparative perspective, and aims to display the divergence from the principles of Shari`ah. It observes that although the Islamic finance emerged in Australia as elsewhere to tailor alternative financing mechanism perceivably for the Muslims committed to avoiding giving and taking interests, even though the IFSPs in practice equally serve non-Muslims indiscriminately. It discovers that some products, such as Equity-based ones, are economically beneficial, and they also squarely fall within the purview of the Shari`ah; but some others, mainly debt-based products such as Sale to Lease (S2L) product, reside far away from the Shari`ah principles. Different debt-based financial products have been appropriately compared with their conventional equivalents, which have uncovered the covered up interest element that diminishes the Islamic character of the products and thereby makes those products repellent in Shari`ah. This chapter contains a number of tables displaying the constructions and operations of both conventional and modern Islamic products. It examines the current debate amongst the idealists and pragmatists on the Islamic vis-à-vis non-Islamic nature and characteristics of debt-based products. The author has evidently ascertained the divergence from the Shari`ah in the IFSPs' practice of debt-based financial products where he largely agrees with the idealists' views of prohibition rather than that of pragmatists' adaptation. By way of conclusion, the author unequivocally claims that: 'Keeping in view all of the above violations of the Shari`ah made by IFSPs in Australia in their practice, their deals are not valid Murabaha transactions and are thus unlawful'. Such a confident and concrete conclusion reinforces the author's expertise and strength in this area of Shari`ah.

Chapter 10 focuses on the UK experience on Islamic finance with a view to importing their, practice into Australia. It details the growth, practice and extent of Islamic finance in the UK and the legal and regulatory framework fostering such finance in a Western developed country where Muslim populace constitutes a minority community. The author has highlighted the sympathetic as well as caring approach of the British Government towards the need and use of Islamic finance that has significantly contributed to the rapid growth of such finance in the U.K. The British Government has

been facilitating the expansion of Islamic finance by gradual amendments to law and regulatory considerations in an attempt to put both conventional and Islamic finance on the same footing as desired by the Muslims, and at the same time, by differing them in line with the Shari`ah principals where appropriate. As a result, Islamic finance has emerged as a crucial factor of their economy. Having regard to the benefits of legal reform in line with the Shari`ah, they are showing their commitment to continuing reforming initiatives for maximising Islamic finance in the U.K. as evident in the statements of the U.K. Chancellor of the Exchequer as quoted by the author in this chapter. The author's suggestions to adopt similar policies and to bring about necessary legal and regulatory reforms following the footsteps of the U.K. seem quite reasonable given the politico-legal relationship, demographic as well as economic similarities between these two nations.

In chapter 11 the author summarises whole study, enumerates the major findings and submits recommendations for adoption in order to accelerate Islamic finance in Australia. Specific reform proposals have been furnished arguing with reasons that they will enable the Muslim community to use external funds in compliance with their religious obligations, and will benefit the nation as a whole to achieve economic development further by attracting foreign capital. The author has reiterated the objectives of the study and repeated the shortcomings of the present mode of Islamic finance before submitting the final conclusions of his research.

The two-fold objectives include: conducting an analysis of the traditional Shari`ah and the practice of IFSPs in Australia; and creation of awareness and transparency about the financial products used by those IFSPs. The author in this concluding chapter has submitted eight specific recommendations for implementation based on the major findings across the study, and has underscored the need for the strict compliance with the Shari`ah both in operating financial institutions and in regulating those entities. The author has successfully identified the drawbacks and shortcomings of the existing IFSPs, and the lack of regulatory guidelines in the current legal and regulatory regimes in the light of Shari`ah. As a solution, the author has submitted specific suggestions to eliminate defects and shortfalls based on Islamic principles and their implementation in the UK. The issue of creating awareness and transparency has been given due emphasis by stressing the negative impacts of ignorance and potential positive outcomes of awareness and transparency.

Having regard to the overwhelming strength of this groundbreaking research which is manifestly free from any significant flaws, I have no hesitation to say that its publication may provide useful guidelines for dealing with the emerging issue of Islamic finance around the world.

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