Abstract

Islamic Financial Institutions serve as a substantial potential opportunity for the Australian economy given the steady growth of the Islamic banking, its closeness to the 60% of the Muslim who reside in the Asian countries and Australian Federal Government’s ‘Asian Century Strategy’. Though Islamic financial institutions have expanded significantly over the recent two decades in Australia, they face a laissez faire market, which failed to address their particular regulatory needs. Operating in a conventional banking favoured environment without special regulatory treatment, the Islamic financial institutions may give in to competition at the risk of jeopardising Shari’ah compliance in Australia. Taking a risk-based perspective, a responsive regulatory system is developed, incorporating self-regulation such as the IFSB Standards, a black-letter laws and the hybrid, responsive to the business characteristics and corporate governance. A Seven-stage model was also developed to operationalise the responsive regulatory framework. This study may shed light on the development of Islamic Financial Institutions to be introduced into a new market in the advanced economies similar to Australia.

Keywords

Responsive regulation, Islamic financial institutions, case study

Executive summary

The purpose of this paper was to identify the unmet regulatory needs of Islamic financial institutions in Australia and to develop policy options to cater to such unmet needs on the condition that no negative externalities were to incur to the existing financial service providers. Given the uniqueness of the Islamic financial institutions, this report challenged the extant ‘one size fits all’ regulatory model in the Australian financial service sector by proposing a new responsive regulatory framework which has a strong focus on the interests of stakeholders rather than shareholders. Furthermore, the paper argues that the responsive regulatory model yields more efficient outcomes in regulatory enforcement comparing to the other alternatives.

The paper analysed the demand and supply of Islamic finance in the global context and identified the potential opportunities for Australia. Then the paper went on to review the current financial regulatory and governance system in Australia (Figure 1) and identified the regulatory gap for Islamic financial institutions.

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After taking both the distinct features of the Islamic financial institutions and their unmet financing needs into consideration, it is recommended that the proposed responsive regulatory framework would be the most suitable option due to its economic efficiency, suitability, accountability and sustainability features. A seven-stage model (Figure 4) is developed accordingly to operationalise the responsive regulatory model (Figure 3). The establishment of the Shariah Supervisory Board has been used as an example to illustrate how the proposed models may be applied to the improvement of governance and regulation of Islamic financial institutions in Australia.

**Figure**: A Seven-Stage Responsive Regulatory Model for Islamic Financial Institutions in Australia

1. **Introduction**

Abdul who come from an Islamic background in Australia is keen with establishing an Islamic financial service company to serve people with similar religious belief like him. He did not realise how few Islamic finance service providers are in Australia. He approached an Australian commercial banker David who comes from a Western background. David intends to introduce Islamic finance into his company. But both David and Abdul are not clear about the regulations that they may face and how they can lobby for a more pleasant regulatory environment. This paper intends to help David and Abdul to understand the regulation and propose a better regulatory framework to cater to the fast-growing Islamic financial service sector in Australia. Hence our research questions for this paper are:

i. How is the Islamic service sector regulated in Australia?; and,

ii. Given that the Islamic finance market is still premature in Australia, how should it be better regulated?

This paper aims to understand and develop a regulatory reform framework for Islamic finance sector in Australia. Acknowledging the heterogeneity of Islamic finance under different jurisdictions, this study is only scoped down to the analysis of development of Islamic finance in Australia. The case study adopts a problem-oriented method, with a
particular interest in identifying the major regulatory challenges facing Islamic finance in Australia and in developing solutions to these problems.

The paper proceeds as follows, the rest of the section summarised the global development of the Islamic finance, identified opportunities for Islamic finance in Australia, reviewed Australian governments’ supportive policies toward the Islamic finance and evaluates the regulation of the financial service providers in Australia. Section 2 reported the findings from the case study, including the shifting of the governance paradigm from the shareholder hegemony to a stakeholder interest, as well as that of the regulation from the ‘one size fits all’ model to a responsive regulation framework. Section 3 discussed the application of the proposed policy option based on two examples, corporate governance and stamp duty. Section 4 concluded with acknowledgement of the limitation of this study, recommendations and proposition of future research direction.

1.1. Global development of Islamic finance

Islamic finance is one of the fastest growing segments of the global financial services industry. Shariah-compliant financial assets have been growing at over 10 per cent per annum over the past 10 years. Measured by Shariah-compliant assets of financial institutions, the global Islamic finance industry is estimated at US$822 billion in 2009 (Austrade 2010).

Austrade (2010) identifying the following factors pertinent to the growth mentioned thereof:

- petrodollar liquidity: Foreign investment plays an important role for petrodollar investors, whose domestic economies and financial systems are too small to absorb all capital from oil export revenues. This presents significant opportunities for the Islamic banking and finance industry. Petrodollar liquidity is expected to remain high over the long term due to the finite supply of oil reserves;
- Muslim population: Relatively rapid Muslim population growth worldwide and rising living standards will see increased demand for Islamic finance;
- low penetration levels: In spite of growth in the Islamic banking and finance industry, there remains a lack of depth across asset classes and products, signifying untapped potential. There is considerable scope for further development of Islamic banking and finance in countries such as Indonesia, India and Pakistan, which have the largest Muslim populations in the world; and
- ethical character and financial stability of Islamic financial products: Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) and a risk profile that will also appeal to a wider ethical investor pool.

Currently, the Middle East and South East Asia are the primary locations for Islamic capital. In particular, the United Arab Emirates, Bahrain and Malaysia are seen as the main centres of Islamic finance, with significant activity also taking place in the United Kingdom and more recently in Europe, Africa and Indonesia.
The demand for Islamic finance has not been matched by supply despite the rapid growth in the sector in recent years. An increase in supply is necessary to meet current and expected demand.

1.2. Opportunities of Islamic finance in Australia

Islamic finance has considerable potential to become an important element in Australia’s aspirations to be a global financial services centre in the region. It has the potential to facilitate further innovation and competition in the wholesale and retail banking sectors and to support the Australian Government’s commitment towards credit market diversification.

Australia’s growing trade linkages with Asia reflect the demand for Australian commodities from developing countries such as China and India. Of the top 10 trading partners, eight are in the Asia Pacific Region with China and Japan being the country’s top two-way trading partners.

Continued growth in major Asian economies will result in a need to develop resources-related services and infrastructure, which are ideal assets for some forms of Islamic financing, such as Sukuk, Mudaraba, Murabaha and Ijarah. Australia is well positioned to structure and offer such instruments as part of financing packages for resources-related development.

Australia’s Muslim population of 365,000 (1.7 per cent of the total population), exceeds the combined Muslim population of Hong Kong and Japan and is more than half of that of Singapore. Australia’s political stability and geographic position, especially its proximity to the large Muslim populations of the Asia Pacific where 62 per cent or 972.5 million of the world total Muslim population resides, present an important base to service this fast growing sector in the global financial services market (ABS 2010).

Australia’s attractiveness as a financial centre is supported by a sizeable domestic economy and financial market. The nation has the fourth largest economy in the Asia Pacific (after Japan, China and India). Australia’s finance and insurance industries generate around 8.1 per cent or A$82 billion of real gross value added (Austrade 2010).

Australia is well placed to take advantage of the Islamic finance opportunity, with widely recognised strengths in retail and commercial banking and experience in infrastructure, property, resources and agricultural financing.

Specific opportunities for Australia include:

- attracting foreign full-fledged Islamic banks and conventional bank Islamic windows to establish operations in Australia;
- attracting investment in Australian assets and businesses from overseas Shariah investors and tapping into new funding sources through Sukuk and other securitised issues;
• Australian-based banks providing from Australia a range of Shariah-compliant investment and financing products and services to Islamic banks, corporations, institutions and high net worth individuals in the Asia Pacific and the Gulf regions;
• fund managers establishing Shariah-compliant funds for Asian and Gulf institutional and high net worth individual investors;
• local exchanges providing an Islamic listings platform for domestic and international issuers of Shariah-compliant instruments;
• provision by Australian-based financial institutions of Shariah-compliant/ethical financial services and products to Muslim and non-Muslim customers in Australia;
• Australian-headquartered banks and insurance companies exporting Islamic financial services through windows as they grow their operations into Asia; and
• Australian-based financial firms, professional services providers and educational institutions exporting their services into Asia and the Gulf.

1.3. Australian governments’ supportive policies toward Islamic finance

Australian Federal and state governments recognise that growth of Islamic finance in Australia requires supportive government policies. It is important that there is (NSW Government 2009):
• a level taxation, legal and regulatory playing field for Islamic and non-Islamic finance. Taxation must be responsive and enabling but non-preferential;
• strong promotion and facilitation through government investment attraction and export promotion agencies;
• government engagement with the private sector in achieving Islamic finance objectives, identifying impediments to, and opportunities for growth;
• a focus on deepening Islamic finance skills – education, training, attainment of relevant qualifications – and on access to appropriate Shariah scholars; and
• growth in Islamic finance professional services providers.

1.4. Regulatory and governance framework of the financial service sector in Australia

The government regulation and corporate governance of the financial service providers are intertwined in the Australian context. Government regulation can be defined as (1) a principle, rule or law designed to control or govern conduct of people and business; (2) the way a particular regulation is implemented in practice. This definition incorporates not only legislation and formal regulation, but also quasi-regulation, for example, a code of conduct or advisory instruments (Banks 2006).

Corporate governance can be defined as:
The system of regulating and overseeing corporate conduct and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities ...) who can be affected by the corporation’s conduct, in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation (Du Plessis, Bagaric et al. 2010, p. 10).
Thus corporate governance is not simply a product of government regulation. Companies have inherent incentives to establish governance procedures to demonstrate their bona fides to investors, in order to attract capital. Executives also have incentives to deliver good performance to maintain their professional reputations. But rules can reinforce such incentives and diminish the risk of a loss of confidence in a market resulting from poor behaviour of a few.

However, as it is evident in Figure 1, the religious component of the governance of the Islamic financial service companies has been largely ignored. The identified gap signals two questions: 1. Does the ‘one size fits all’ model work? And, 2. If not, what are the alternatives? Answers to these two questions will be provided in the following sections.

![Figure 1: The regulatory and governance framework of the financial service sector in Australia](image)

2. Findings and Discussion

Legislation for the regulation of financial services is developed by the Commonwealth. The Australian Securities and Investments Commission (ASIC) implements and administers the
law. Many financial services are also regulated by the Australian Prudential Regulation Authority (APRA).

 ASIC administers the Corporations Act 2001, which requires people who carry on a business of providing financial services to hold an Australian Financial Services (AFS) licence (unless they are covered by an exemption or are authorised as a representative of an AFS licence holder).

 Islamic financial products are regulated in the same way as any other financial product in Australia. Regulation is generally in terms of product approvals, disclosure and accounting standards, standards for intermediaries (i.e. stockbrokers), as well as regulation of non-banking entities such as collective investment schemes. Regulation of the finance sector is designed to maximise market efficiency, with minimal regulatory intervention to protect investors.

 In Australia, the regulators treat Islamic financial services providers as a normal financial company; hence there are no shariah law-binding requirements (Figure 1). The complexity of the regulatory compliance requirements is only contingent on whether the company is listed on the stock exchange. Obviously, the regulators have yet to be educated about the fundamentals of Shariah law and Islamic finance.

 Regulation to protect investors is limited to conduct and disclosure requirements imposed on AFS licence holders. Licensees authorised to provide advice about financial products are required to meet certain minimum legislative standards when advising clients. The National Consumer Credit Protection Act 2009 (Cth) is designed to provide additional safeguards and protections for consumers to the process of obtaining credit in Australia. This covers all types of consumer credit from credit cards to mortgages.

 APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. In essence, APRA ensures that regulated entities honour the financial promises made to beneficiaries. It creates and administers an extensive set of prudential standards to give regulated entities extensive guidance in matters such as risk management and minimum capital levels. Recent decades in Australia has witnessed the shift of the regulatory reform from ‘one-size fits all’ model to a responsive regulatory paradigm. At the same time, the governance reform extended the shareholder hegemony model to the stakeholder model, which takes into account not only the shareholders, but also other stakeholders such as employees, customers, investors, community, suppliers and industry associations.

 There is no single or enduring best-practice model for corporate governance: different approaches and combinations of approaches can promote alignment and trust, while company structures and market expectations change over time. Indeed, the diversity of companies makes flexible governance arrangements highly desirable — one size is unlikely to fit all. In addition, regulations designed to promote alignment and accountability, if they are excessively prescriptive, have the potential to impede the ability of managers to manage. To accommodate diversity and to balance objectives, Australia’s corporate governance
framework has accordingly evolved over time, combining ‘black letter’ law with ‘soft’ law requirements, as well as other industry-based guidance.

Moreover, a properly designed regulatory regime catering to the needs of the Islamic financial service providers must imbed the Shariah principles in the regulation design and implementation, while taking into account the distinct features of the Islamic institutions. Hence, governance mechanisms related to the Islamic financial service companies should incorporate the internal governance and external governance (Gillan 2006). Internal governance may include the Shariah board, board of directors, sub-committees and internal control mechanisms such as internal audits; while external governance may include market control and regulation.

Of relevance to the internal governance of Islamic financial institutions are two prominent theories, one is the dominant Agency Theory and the other the Stakeholder Theory. While the regulatory options, with a particular interest in design and enforcement here, may include coercion via ‘black letter’ law (also known as the public ordering), self-regulation via ‘soft’ law (also known as private ordering) and internal governance, as well as the hybrid of the two options. These two paradigm shifts are discussed as follows.

2.1. Corporate governance: shareholders or stakeholders?

The Agency Theory originated from Jensen and Mackling (1976) who contends that firms are the nexus of the contracts. The essence of the agency problem is the separation of management and finance. Due to the incompleteness of contracts, managers withhold control over the residual control rights, which are not foreseeable ex ante. Thus, corporate governance concerns with managers putting constraints on themselves, or investors putting constraints on managers, so that the misallocation problem can be reduced and investors will be induced to provide more funds.

Freeman’s Stakeholder Theory intends to address three problems: (1) the problem of value creation and trade; (2) the problem of the ethics of capitalism; and (3) the problem of a managerial mindset (Freeman et al. 2010, p. 29). Freeman et al. (2010) holds that: (1) the basic objective of a firm is to create value for stakeholders; (2) business is a set of relationships among groups which have a stake in the business activities; (3) business is about how customers, suppliers, employees, financiers (such as stockholders, bondholders, banks, or investors), communities, and managers interact and create value. To understand a business is to know how these relationships work. In this context, the executive’s or entrepreneur’s job is to manage and shape these relationships. Hence, stakeholders are defined as customers, suppliers, employees, investors, communities, and managers who interact and create value for firms.

Li et al. (2012) find that Profit-sharing Investment Accounts (PSIAs) holders may suffer from lack of protection due to information asymmetry. Consequently, PSIAs-holders may expect a high risk premium by increasing the cost of capital, or may withdraw their deposit. Hence, corporate governance in Islamic financial service institutions should aim at protecting
investors’ rights as well, which warrants the appropriateness of the adoption of stakeholder theory.

2.2 Regulatory theories: public ordering vs. private ordering

Given that the Agency Theory’s omnipotent focus is on developing corporate governance mechanisms to solve the distributed shareholding problem in large corporations, it failed to consider the other stakeholders, particularly the Islamic beliefs. From a legal perspective, governance requirements deserve scrutiny on balancing the expectation of the Islamic financial service providers and that of the regulators.

McCahery and Vermeulen (2008) analysed corporate governance for non-listed companies and provides a detailed explanation of public ordering and private ordering. Public ordering is also called hard law, which cover the legal requirements, rules and regulations. Private Ordering is the process of setting up of social norms by parties involved in the regulated activity, and not by the State. Private Ordering aims to achieve public goals, such as efficiency, enhancing the market, and protecting rights. Private Ordering may include customised contracts and private arrangements amongst different stakeholders.

Incorporating self-regulation of the international regulatory requirements into the regulatory model (Figure 2), Islamic Financial Service providers who are members of the International Financial Service Board (IFSB) has to abide by the IFSB guidelines and The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) guidelines, as well as other industry/product specific regulatory guidelines whenever applicable, which are either ‘rule-based’ or ‘principle-based’ and requires ‘comply or explain’ compliance requirements. If a member organisation fails to comply with the guidelines, it has to explain why the regulatory requirements had not been met (or ‘if not, why not’).
2.3. Developing a responsive regulatory framework for Islamic finance sector in Australia

Given the complexity of the corporate governance issue in Islamic finance companies and the heterogeneity of Islamic companies at large, the hybrid approach which combines the public and private orderings, seems to be a better option. Specifically, regulators, Islamic finance companies, and the other stakeholders should make joint effects to solve governance problems in the operation of small corporations, detailed proposal will be presented as responsive regulation below.

Since the influential work of the Chicago school of economics in the 1960s and 70s, economists, lawyers and social scientists have been interested in government regulation and its efficacy (Stigler 1961, 1971). The international literature has been concerned with regulation that is both ‘effective’ and ‘responsive’ in order to ensure that government is attuned to differing motivations of regulated actors (Ayres and Braithwaite 1993). Much of the literature has argued for less government intervention and for the need to formulate efficient legal rules to foster an optimum environment in which small corporations can flourish.

The best regulatory strategy depends on context, regulatory culture, and history (Ayres and Braithwaite 1993, p.5). Cultural, social, economic and political imperatives are vital. In Australia, for example, the Hawke federal government introduced the notion of regulatory impact statements, and such statements are now commonplace in other contexts, such as
the environment: efficacious regulation should speak to the diverse objectives of regulated firms, industry associations, and individuals within them (Ayres and Braithwaite 1993).

The responsive regulatory system model builds on the McCathy and Vermeulen’s three pillars of regulation on governance of non-listed small businesses (2008 p. 12) and Ayres and Braithwaite’s responsive regulatory model (1993, p. 21). It advocates that the regulation of small corporations should not be ‘one size fits all’, but responsive to the contextual contingencies and responsive to the compliance responses from small corporations. Though the responsive regulatory pyramid was first developed to address the regulatory compliance issues by Ayres and Braithwaite, it offers an excellent opportunity to present the self-regulated corporate governance and coerced regulation in a continuum.

Proper corporate governance mechanisms may serve as a self-regulatory mechanism, which requires the least regulatory cost, sitting at the bottom of the ‘regulatory pyramid’ (Ayres and Braithwaite 1993). While government regulation serves as enforcement or coercion, and demands a significant amount of resource and efforts to comply with, sits at the top of the pyramid. The other private arrangements in the form of customised contracts, optional guidelines, good practices, and corporate governance system serve as self-regulatory mechanisms. The hybrid may involve interactions between the external environment and internal environment of the Islamic finance companies, including regulation of corporate governance, optional guidelines, CSR, social networks, public-private partnership. Such requirements are responsive to the size of the Islamic finance companies, the development stage on the business life cycle, the industry that Islamic finance company operate and business connections with the government and government agencies. Responsive regulatory system has a strong focus on generating incentives for regulatory compliance (Braithwaite 2006).

Given that the responsive regulatory framework has proven to be effective by a number of applications in regulatory design in Australia and overseas, for example, the Australian Taxation Office, it should replace the current ‘one size fits all’ model. It has to be implemented by joining the efforts of multiple parties, including the governments and their agencies, Islamic finance companies, industry associations and the community.
Different from the previous two models (as presented in Figure 1 and Figure 2), the proposed Responsive regulatory framework for Islamic finance companies incorporates the public ordering (through legislation and coercion), private ordering (through private arrangements) and the hybrid (through reactions to the regulation responsive of the contingencies such as firm size, development stage, and industry structure). One may see regulation as the external governance of corporate governance (Gillan 2006). Similarly, one can also view corporate governance as a special form of regulation - self-regulation. The proposed model has two ultimate objectives, one is to abide by the Shariah law, and the other is about optimising the stakeholders’ interests.

Comparing to the ‘coercion only’ regulatory model and the ‘self-regulation only’ model (or lass faire), the ‘responsive’ is able to engage the stakeholders at different stages hence may significantly reduce the monitoring and reporting costs. The responsive regulatory model...
suits the Islamic financial service providers’ need in both religious and financial terms and they have the autonomy to select the optimal combinations of the SSB or market mechanisms for the certification of their products and transactions. The timely evidence-based evaluation system ensures the feedback to be incorporated in the planning and reforms, hence increasing the responsibility and sustainability of the Islamic financial institutions. Thus the responsive regulatory option outweighs the alternatives.

The responsive regulatory framework can be operationalised as a ‘seven-stage model’ (Figure 4). The seven stages include
- Stage 1: Identifying the governance and regulation problem
- Stage 2: Identify the objectives of governance and regulation
- Stage 3: Establish the baseline of regulation as per the ‘public ordering’
- Stage 4: Develop the self-regulatory mechanisms
- Stage 5: Identifying the hybrid mechanisms
- Stage 6: Establish a code of conduct & transfer the good practice into policies & procedures
- Stage 7: Develop an evidence-based evaluation system to monitor the progress and provide feedback to Stage 1.

![Figure 4: A Seven-Stage Responsive Regulatory Model for Islamic Financial Institutions in Australia](image)

### 3. Application of the proposed model: corporate governance of the Shariah Supervisory Board (SSB)

This section applied the seven-stage model (Figure 4) on the corporate governance of the SSB.

**Stage 1: Identifying the governance and regulation problem**

The SSB is a binding requirement in the Shariah Law as the ‘public offering’ which has the coercion power. Hence, a SSB has to be presented in order to meet the religious
requirements. However, the SSB becomes a corporate governance issue due to that set rules are yet to be establishment on the selection, composition, assessment and dismissal of the SSB members.

While some international jurisdictions have established regulatory requirements for the appointment of Shariah advisory bodies, there is no standardised requirement across jurisdictions in respect of the eligibility and qualification of Shariah advisors (IOSC 2004). Should the SSB members be elected or appointed?

The stakeholders in this problem include the regulators from IFSB and AAOIFI, national and local level regulators, investors, directors of the SSB and the board of directors.

Stage 2: Identify the objectives of governance and regulation

The objectives of the introduction the SSB is to bind with the Shariah compliance as well as improving the Stakeholders’ interests.

The credibility of the Islamic finance sector is a paramount concern to the majority of stakeholders. The importance of trust in the Islamic capital market was repeatedly raised by stakeholders and reputation is seen to be an essential component of establishing Islamic businesses anywhere in the world.

Shariah is open to interpretation and scholars frequently hold varying views on key Shariah issues. Islamic jurisdiction is not bound by precedent, and opinions may deviate from previous decisions made by other Shariah scholars. This lack of standardisation may become a cause for concern. It may result in different transactions being interpreted differently, leading to consumer uncertainty regarding Islamic finance products.

National and state regulations often necessitate a compromise of Shariah compliance in Australia – for example, the requirement to declare the level of interest on a mortgage contract, which is not appropriate for Islamic mortgages. However, in instances like these where there is no legal alternative Shariah scholars allow a degree of flexibility in the application of Shariah law. This flexibility is also not uniformly applied.

The pool of Shariah scholars from whom to draw advice upon financial products is relatively small in Australia. Notably, many of the wholesale providers currently seek compliance endorsement overseas. Other jurisdictions that have a mature Islamic capital market, such as Malaysia and Dubai, regulate Shariah compliance.

The lack of industry standards or regulation of Shariah compliance gives rise to three possible problems:

- Allowing potential rogue operators to flourish and damage the reputation of the Islamic finance sector in Australia;
- The compromise of consumer confidence in cases where the interpretation of Shariah compliance does not meet with common interpretation, or where the Shariah ruling is not disclosed;
- The decline in international investment if Shariah compliance does not meet international standards.
Stage 3: Establish the baseline of regulation as per the ‘public ordering’
The establishment of the SSB requires that the directors to be elected have to possess sufficient Shariah knowledge and should exercise Shariah compliance checks as an internal auditing mechanism. Other requirements may be pertinent to the regulatory requirements for financial service companies in Australia.

Stage 4: Develop the self-regulatory mechanisms
Financial institutions have their own in-house independent Shariah advisory bodies that screen and endorse their Islamic products. The Shariah certification process is generally undertaken by private sector in-house Shariah advisory bodies, driven by private sector-led initiatives, and is not mandated by any specific regulatory or policy requirement. The SSB may have to work with the Shariah advisory bodies in order to exercise a final check.

An industry-led ‘Shariah compliance board’ was proposed as a means by which to regulate Shariah compliance and secure the market nationally. It may be the case that the current Islamic market in Australia is too small to warrant introducing additional regulation at this time. Alternatively, the industry could develop its own set of voluntary standards. There is benefit to developing an industry voluntary code of conduct for Shariah boards as an industry development exercise. A voluntary code would provide additional certainty for investors as to the Shariah compliant nature of a product (i.e. brand integrity) and maintain industry standards at an international level. This approach would have the greatest benefits if adopted nationally.

Industry codes of practice have been developed by a number of industry associations in the financial services sector. They range in content from general statements of principle about how the financial services industry operates, to listing specific industry practices which are guaranteed by the code.

Stage 5: Identifying the hybrid mechanisms
Appropriate Shariah certification is issued for all Islamic capital market products and services e.g. in Malaysia, Indonesia, Sudan and Pakistan. The Shariah certification process is undertaken at the regulator’s level, under the guidance of their own Shariah advisory bodies to formally advise on issues of Islamic capital market products and services. Shariah compliance issues are taken into consideration in the regulator’s functions such as product approval, eligibility criteria for intermediaries, reporting requirements of regulated entities, and enforcement of regulatory requirements.

Stage 6: Establish a code of conduct and transfer the good practice into policies and procedures
Existing codes either contain minimum standards or standards which are aimed at best practice, some examples include the Finance Brokers Association of Australia’s Code of Practice & Disputes Resolution; and Financial Services Council’s Code of Conduct and Code of Ethics.

In recognition of the strong stakeholder support the national and local level regulators should facilitate stakeholder development of a voluntary code of conduct for Shariah boards in order to promote industry development.
The code of conduct, as well as the procedure of SSB director selection, evaluation, compensation and removal and other good practices as well as lessons learned can be codified into policies and procedures to govern the operation of the Islamic financial institutions.

Stage 7: Develop an evidence-based evaluation system to monitor the progress and provide feedback to Stage 1.
Evidence-based system can be introduced to evaluate the performance of the proposed responsive regulatory system. Any feedbacks can be incorporated into Stage 1 for another round of reform.

As mentioned at the beginning of the case, Abdul and David had been challenged by the perplex but yet to be developed regulatory framework for Islamic finance companies in Australia. The abovementioned seven-stage model offers a guidebook for them to analyse any governance and/or regulation problems at any stage of the development of their Islamic financing businesses.

4. Conclusion, limitations and future work

After investigating the potential development opportunities of Islamic finance in Australia, it was found that their regulatory requirements have been largely ignored. As such, the shadow existence of Islamic finance has been further impeded by the unintended consequences of ‘one size fits all’ regulatory model. A responsive regulatory model was developed (Figure 3), followed by its seven-stage operational model (Figure 4) to guide application of the proposed responsive regulatory model.

Furthermore, the responsive regulatory model has been applied to the corporate governance of the Shariah Supervisory board. The model, comparing to the extant ‘one size fits all’ model, it has shown advancement in efficiency, suitability, accountability and sustainability.

Admittedly, this study is subjected to the limitation that it only focused on the Islamic finance in Australia from the macro-level. Hence, future endeavours may be devoted to micro-level analysis, which analyses the regulatory compliance behaviour of each individual Islamic financial service provider in Australia.
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