



## Comparison of Islamic Finance Regulatory Conditions in Australia and Saudi Arabia

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### Abstract:

The origin of Islamic finance can be traced back to the seventh century. Despite the growth of Islamic finance in various countries, its regulation is marked with a number of apparently entrenched problems. This study came to compare the conditions of Islamic Finance Regulatory in Australia and Saudi Arabia. When compared with Saudi Arabia, the Australian financial sector has regulatory and legal frameworks that comprise of multiple bodies, while Saudi Arabia presently has no definite laws or regulatory conditions which govern Islamic finance. Both AU and the KSA are vitally situated, are thriftily strong, have high liquidness as well as strong overseas benefit pool which give them all the power they necessitate to progress into celebrated Islamic investment centers. Nonetheless, when compared to KSA, the Australian banking regulatory authorities are mandated to develop and institute regulatory instruments to govern Islamic finance.

**Keywords:** Islamic finance, regulations, Saudi Arabia, Australia.



## **Introduction**

The origin of Islamic finance can be traced back to the seventh century. This implies that it is not a new phenomenon. Nevertheless, the commercial implementation of Islamic finance is comparatively new and regardless of the novelty, there are prohibitions that prominently feature in the Islamic finance analysis. Particularly, Islamic finance is an all-embracing term which is used in describing various types of investments that adhere to the sharia principles. Business, economics, finance and law tend to form a solitary dimension within the sharia. Therefore, as the fastest growing industry, Islamic finance is based on some financial pillars. These include the asset backing principle, the loss and profit sharing principle, ban on certain financing economic sectors, ban on speculation, uncertainty and interests.

Despite the growth of Islamic finance in various countries, its regulation is marked with a number of apparently entrenched problems. Indeed, there are piecemeal approaches to the legal and regulatory architecture which largely remain untested and incomplete, and this has really dogged the Islamic finance industry. As a matter fact, the regulatory conditions of Islamic finance amid Saudi Arabia and Australia have attracted the attention of many scholars. These two well-known countries have different regulatory conditions as regards to Islamic finance. There are also areas of similarity with respect to the applicable products and service structures, and these constitute the basis of this essay.

## **The regulatory conditions of Islamic finance in Australia**

While other banks are bound to operate according to the Sharia precepts.

When compared with Saudi Arabia, the Australian financial sector has regulatory and legal frameworks that comprise of multiple bodies. According to the Australian Bankers' Association Fact Sheets (n.d.),

The bodies include the

Australian Securities and Investment Commission (ASIC),

The Australian Prudential Regulations Authority (APRA) and

The Reserve Bank of Australia (RBA).



The Council of Financial Regulators (CFR) is responsible for the coordination of the above named agencies.

The Council of Financial Regulators (n.d.) asserts that, CFR contributes to the efficacy and competence of the Australian financial regulation as it offers high level forums for collaboration and cooperation amongst the members.

In the 1959 Banking Act, under sub-section 9(3), the authorized individuals in Australia are mandated to perform any kind of banking business operation as was approved by APRA to the MCCU in 1997.

When traditional banks branches were closed, the new Australian community banks that emerged were operated and funded by the limited town groups.

Still, the Islamic cooperative financial institutions which are community based are issued with licenses after being registered so that they can continue with their cooperative dealings under the 1992 Cooperative Act (Ahmad & Kabir 2006, p.10).

Even though there is a difference between conventional banks and Islamic finance with respect to practice, objectives and missions,

**The operation of Australian Islamic financial institutions is still subjected to similar regulations and laws that are applicable to their conventional banking peers.** In fact, all the supervisory and regulatory frameworks are interest based.

**This is the point of similarity between the AU and KSA Islamic finance because both countries have not yet developed uniform legal and regulatory frameworks that are intended to support the Islamic financial system (Ahmad & Kabir 2006, p.10).**

### **The regulatory conditions of Islamic finance in Saudi Arabia**

Saudi Arabia is the current largest global Islamic finance player in terms of funds volumes. This kingdom has over ninety two billion US dollars in Sharia compliant financial assets (see appendix 1).



However, with regard to Islamic finance, Saudi Arabia has no devoted legal or regulatory frameworks notwithstanding the fact that Sharia compliant services and products account for nearly forty percent of the total banking assets.

**Basically, Saudi Arabia holds a total of 35% of the entire Sharia compliant financial assets that the collective GCC nations hold (\$262 billion).**

Yet, irrespective of this, Saudi Arabia lacks steadfast Islamic banking laws and the Kingdom is marred with occasionally lax and confusing regulations. These have restricted the development and advancement of the Islamic financial sector and have hindered Saudi Arabia from realizing its full aptitudes as a center for Islamic finance (Dubai International Financial Centre, 2010).

### **The constricted governing controls in KSA**

Basically, in the KSA, the finance division which is the key home funding cause relatively emerged unmarked from the economic crunch (see appendix 2). The reason could be because of the demanding regulatory provisions.

Even though in the recent years the finance industry has been liberalized, the KSA has upheld a wary approach anchored on its 1966 Banking Control Law. This gave wide-ranging supervisory powers to the SAMA to manage the regulation and licensing of all financial institutions, including the Islamic finance. The Saudi Arabia banking law supports the global banking model which allows Islamic banks to offer various financial services and products such as investment and retail activities (Dubai International Financial Centre, 2010). Nevertheless, the regulations controls are so tight that they require minimal exposure and high liquidity requirements.

### **The confusing Sharia regulations and principles:**

The common supervisory model functional in the bylaw of the KSA finance sector has a shortcoming. The model lacks separate and clear laws which govern the Sharia compliance finance, also known as the Islamic finance.



Whereas the KSA banking sector has been exposed to minimal risks, the Islamic finance growth has been hampered in this Kingdom by the approach called one-size fits all.

This is not only a current problem (Dubai International Financial Centre, 2010). In fact, in the past, the Saudi Arabian Sharia compliant finance seemed to have had a devastating history.

This is because between the fiscal years 1970s and 1988, the theoretically applied Islamic finance Sharia laws produced very dismal differences amid the Saudi conventional banks and the Islamic banks.

Regardless of the successive growth of the Saudi Arabian Islamic banking sector, the environment where most operations take place has continuously remained opaque.

The regulatory system is mainly flexible and exposed to the sturdy effect of the regime; there are no detached accrediting administrations and the system is flawed with disordered purebred.

Dubai International Financial Centre (2010) claim that, the incompatible Sharia authorization boards, deficiency of acknowledged procedures for safety as well as the ensuing suspicions in the authorized system have substantially produced obstructions to the external banks that contemplate to enter the KSA Arabian marketplaces.

This has moreover obstructed the prohibited innovation and development of the domestic Islamic finance sector.

**In conclusion therefore, it emanates that Saudi Arabia presently has no definite laws or regulatory conditions which govern Islamic finance.**

The **KSA financial institutions** which are nothing like the insurance organizations run devoid of prescribed Sharia submission compulsions. Furthermore, both the Islamic and conventional financial institutions are directed under similar supervisory frameworks.



In contrast, **the Australian Islamic finance or Islamic banking institutions** are subject to the Council of Financial Regulators which is bound to approve the novel Islamic banking services and products (Ahmad & Kabir 2006, p.10)

. In contrast, whereas the **Sharia regulatory board** in Saudi Arabia is compulsory for any Islamic financial institution, such a body has a practical sovereignty to decide the services and products that are deemed Sharia compliant. Irrespective of the fact that KSA has generally moved towards the unvarying universal Sharia submissive practices, the KSA is amongst the rare nations which have been unsuccessful to consent to the enforced forty one bookkeeping procedures and governance ethics that AAOIFI issues. This is contrary to the Australian case.

**Saudi Arabia is positively moving in the correct course** regardless of the frustrating regulatory conditions. For instance, the universal Islamic finance has been promoted by IDB (Islamic Development Bank) where the largest shareholder is Saudi Arabia (Rammal & Zurbruegg 2007, p.65). Not like the AU banks, this KSA financial institution proffers all Sharia submissive lending facilities and products which at present make up approximately 38% of the aggregate Saudi Arabian (KSA) finance sector monies.

### **Differences between who to apply the structure**

**Murabaha Mudarabah, Salam, Istisna, Ijarah and Musharakah** are all forms of **financial contracts that are applied by the Islamic banks.**

**These financial contracts are controlled by the Islamic principles based on the Shariah.**

**They form the core financial transactions that are undertaken by the Islamic banking and other financial institutions.** In highly Muslim controlled countries such as Saudi Arabia, these principles are applicable to all the stakeholders of the bank including the governments (Zaher & Hassan 2001, p.157).

**However, in countries like Australia where the Muslims are the minority, these Islamic banking contractual principles are applied to Muslims only.**



The Islamic banks are controlled by the Shariah principles.

In fact, one of the principles is the sanctity of the contracts. **This principle states that before any execution of Islamic banking transactions, the parties involved must be satisfied that the transaction is valid according to the Shariah laws (Lewis & Latifa 2001, p.116).** In other words, the transactions should not be voidable.

**This principle also forms the basis in which conventional banking and Islamic banking in KSA and AU differs.**

Whereas **no transactional agreement** is required in the conventional banking, it is a **must that the agreement be executed during the exchange of goods and services as well as during the fund disbursement under Murabaha, Salam and Istisna contracts within the Islamic banking (Lewis & Latifa 2001, p.116).**

The other important principle drawn from Shariah is the profit and risk sharing nature. According to this principle, no profit should be earned from capital invested or assets unless the earner of that profit has taken the ownership risks (Bliss 2001, p. 29).

Therefore, in both KSA and AU Islamic banking, the risks and gains are shared by the deposit holder, the bank or the financial institutions and the depositor (Lewis & Latifa 2001, p.111). Similarly, in case the borrower suffers losses, the losses will be shared with the lending bank according to the financial mode used, either Mudarabah or Musharakah.

In an Islamic country like Saudi Arabia where Islamic banking is prominent, the two modes of financing namely Mudarabah and Musharakah are applied by Islamic banks as forms of participatory modes of financing in addition to non-participatory mode of finance (Zaher & Hassan 2001, p.151). In Saudi Arabia, Mudarabah is used as a form of partnership in which one party provides the funds whereas the other party provides the expertise. In most cases, the public provide funds through deposits while the administrative works and management responsibilities are exclusively left to the banks (Ismail 2010, p. 220).



The profit and loss sharing ratios are determined before entering into agreement. According to Lewis and Latifa (2001, p.112), Mudarabah can either be restricted or unrestricted depending on terms of agreement.

Before entering into contract, it is essential for the parties to agree on a particular formula in which the actual profits would be shared. The profit sharing formula has been left open by the Shariah to the mutual consent of the parties (Archer & Rifaat 2007, p.177). In a non-Muslim country such as Australia, such contractual agreements are bounded by the larger banking regulations rather than by Shariah even though the Shariah principles are applied (Zaher & Hassan 2001, p.161).

**Musharakah is the contractual agreement between the parties that establishes the process of sharing profits and losses in partnership or joint businesses** (Archer & Rifaat 2007, p.177). Under this agreement, the Islamic banks provide funds which are added to the funds provided by other individuals or institutions which are then put in the investments. Under the treaty, while not certainly a necessity, all the funds suppliers are eligible to join the administration (Ismail 2010, p. 221). Although earnings are collectively distributed amongst the associates based on the pre-agreed fractions, the losses are spread to the allies exactly on the basis of the principal supply fraction.

**Murabaha is the most commonly used financial mode by the Islamic banks. It is where the seller has the obligation of disclosing the cost of the commodity and the amount of profits that is being charged** (Archer & Rifaat 2007, p.177). Though Murabaha may look like a loan given out with interest, it is rather a sale of commodity at profit. Under the Murabaha mechanism, the Islamic bank purchases the commodity as the requirement of the customer and sells it on his behalf on a cost plus profit basis (Lewis & Latifa 2001, p.117). The bank is compulsive to divulge fee and turnover boundaries to the clientele under this prearrangement. In fact, the KSA bank, instead of progressing currency to the mortgagor purchases the merchandises from the third -party and retails the merchandises to the buyer on proceeds. Murabaha is majorly used to facilitate short-term financing requirements to the customer in both KSA and AU (Lewis & Latifa 2001, p.117).





**Generally, contracts used by Islamic banks have to include transparency and honesty. The bank must provide details on the prices, delivery details, the product quality as well as quantity of goods. The information should be availed to all parties involved and the contract results should always be free from ambiguity.**

In AU, full disclosure of the contracts decreases or eliminates the unnecessary complexity and financial complications. Full disclosure will entail the disclosure of the risks that are involved through the provision of full information to the investors and buyers (Ismail 2010, p. 221). Comparing their usability within countries, they are applicable to all citizens in Islamic countries such as Saudi Arabia while they are selectively applied to only Muslims in non-Islamic countries such as Australia.

### **Comparing the banking performances**

Islamic banks such as Saudi Arabian Bank Al-Rajhi have indicated greater performance in the last ten years. The Bank Al-Rajhi has recorded an increasing growth in profitability and returns in terms of dividends to the shareholders. Moreover, the bank has also been growing in terms of its assets portfolios which are attributed to the diversification in the growing Islamic financial sector within the region (Al-Rajhi Bank 2011, p.8). As indicated in appendix 2, the Bank Al-Rajhi has averagely achieved 3.6% growth on assets returns whereas the growth in the return on shareholders' equity has averaged 24.3% in that decade (Al-Rajhi Bank 2011, p.9). The return on the profit per share has reached SR4.92. According to the bank, this growth in returns has hugely been attributed to the strict application of the national accountability standards provided by the Saudi Arabian Monetary Agency (Al-Rajhi Bank 2011, p.6).

**On the contrary, ATB have experienced a decreasing growth on profitability, returns on assets as well as returns on the shareholders equity.** Though the bank has recorded the largest trading volume compared to the Islamic banks in Saudi Arabia, the growth in returns is wanting. The major setback is the vulnerability to the external financial shocks and lack of financial standardization on investments. However, prior to the financial crisis, ATB experienced growth but at a slow pace.



**The other advantage that Islamic banks such as Bank Al-Rajhi have is that they are not vulnerable to the external financial shock such as the financial crisis experienced in the recent years. This is because of the banking policies that are imbued within the Islamic principles that emphasize standardization and ethical values in banking.** Moreover, Bank Al-Rajhi has some inherent qualities that have been contributing to its resilience. These inherent qualities, according to the bank management, have been supported by prudent risk management and regulatory framework which is effective, sound governance and strategic leadership (Al-Rajhi Bank 2011, p.10).

**Bank Al-Rajhi still remains to be the best bank due to its risk management and investment resilience. Besides, the bank is operating in a fast growing banking industry sector. Apart from the promising growth, the bank sound management, effective regulatory framework and strategic leadership increases its advantages for investments. Furthermore, these attributes contribute to the increased financial capabilities which would in turn be beneficial to the investors.**

## Conclusion

**When compared to Australia, Saudi Arabia is evidently a growing market which offers excellent abilities to support Islamic finance. The kingdom has however not attained the position of being considered the regional hub**

**. Both AU and the KSA are vitally situated, are thriftily strong, have high liquidity as well as strong overseas benefit pool which give them all the power they necessitate to progress into celebrated Islamic investment centers.**

It is only on the basis the regulatory conditions that the Islamic finance in AU and KSA are perceived to be different. Despite the disparities, Australia and Saudi Arabia have no legal and regulatory frameworks to govern and supervise the operation of Islamic finance.



Nonetheless, **when compared to KSA, the Australian banking regulatory authorities are mandated to develop and institute regulatory instruments to govern Islamic finance.**

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### Appendixes:

#### Islamic and Conventional Banks in the Gulf Region, 2008

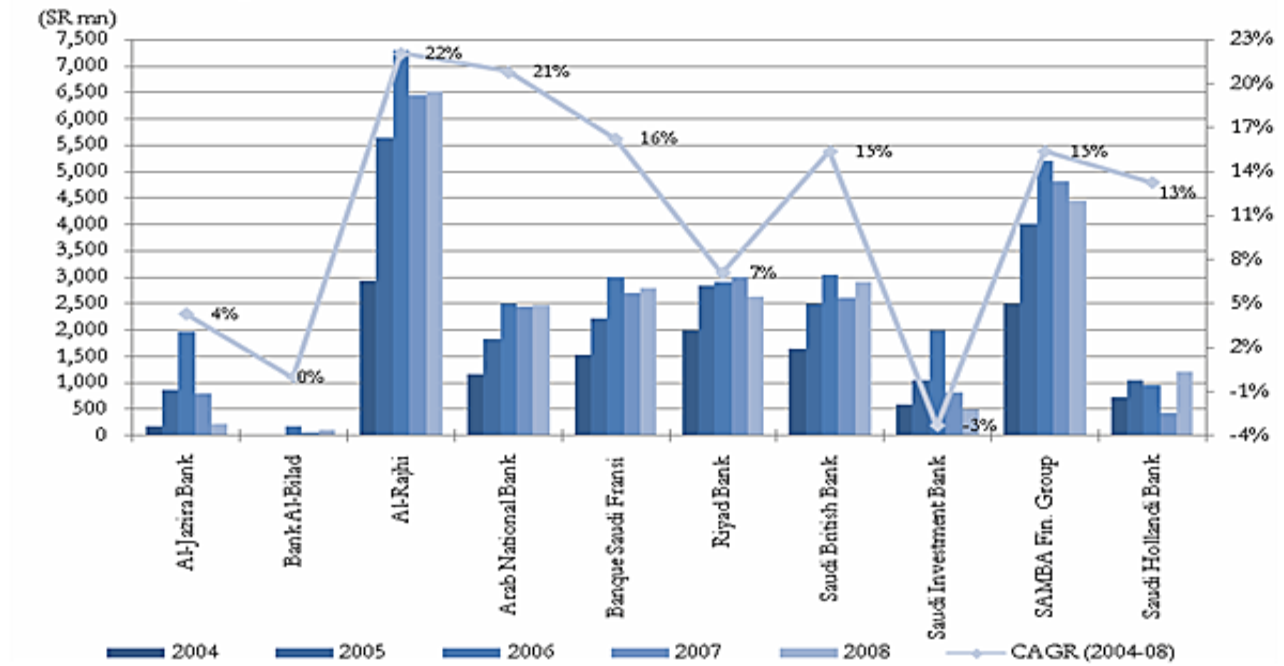
Particulars	Conventional banks	Islamic banks
Assets (USD Billions)	1,135,669	232,189
Assets growth 2007-08	16.3%	38.2%
Profits (USD Billions)	22,008	7,666
Profits growth 2007-08	-6.1%	20.1%
Profits/Assets	1.9%	3.3%

#### Financial Highlight at Al-Rajhi Bank RJHI (2005-2009)

Financial highlights	2005	2006	2007	2008	2009	5-Yr growth %
Total assets	95038	105,209	124,886	164,930	170730	80
Growth %		10.7	18.7	32.1	3.5	
Loans & advances	79,915	89,133	103,285	140,837	145,819	82
Growth %		12	16	36	4	
investments	220	430	1,590	3,167	2,888	1213
Growth %		95	270	99	9	
Customer deposit	70,112	73,398	89,725	116,611	120,553	72
Growth %		5	22	30	3	
Shareholders' equity	13,469	20,179	23,606	27,032	28740	113
Growth %		50	17	15	6	
Net income	5,633	7,302	6,450	6,525	6,767	20
Growth		30	-12	1	4	
ROE %	47.6	43.4	29.5	25.8	23.6	
ROA	5.93	6.94	5.16	3.99	3.96	



### Saudi Banking Sector Profitability



Source: Tableau & Company Reports

