The trillion-dollar pie

INTEREST IN NO-INTEREST ISLAMIC FINANCE IS GROWING

Is Canada missing an opportunity to tap this sizeable market?

By **Naheed Mustafa**

The Islamic financial sector is growing exponentially, and there's a growing sense that Canadians are well placed to have a piece of a nearly trillion-dollar global pie.

Centred in the Muslim world — Malaysia is the hub — the Islamic financial sector has major dollars pumped into it from oil-rich Gulf nations. According to a 2012 report from the Toronto Financial Services Alliance's Islamic Finance Working Group (IFWG), the assets of the top 500 Islamic banks expanded by 33 per cent in the last two years to $1.1 trillion. The report also points out that if Canada wants to take advantage of the opportunities — including Goldman Sachs's $2 billion Islamic bond program — Canada should make changes to its system to properly address taxation of Islamic financial products.

"I think this is a really, really exciting opportunity for Canada," says Jeffrey Graham, a Toronto-based lawyer with Borden Ladner Gervais. Graham is also co-chair of the IFWG, a public-private partnership hoping to position Toronto as North America's Islamic finance centre. The group is looking at possible amendments to federal and provincial tax regimes to "level the playing field." While Islamic finance is still in its infancy here, Graham says we have an open and innovative financial sector which could make the necessary accommodations without sacrificing strong regulation.

Several Western countries including France, the United Kingdom and Australia have adjusted their regulatory frameworks to accommodate participation in this sector. France is now home to two masters' programs in Islamic finance offered through the University of Paris, and CIMA (the Chartered Institute of Management Accountants) in Britain has launched an advanced diploma in Islamic finance. Toronto's Centennial College offers a CIMA-affiliated certificate in Islamic finance and investment while the University of Toronto's Rotman School of Management has a three-day Islamic finance program.

Addressing regulatory issues

So what is it about this emerging and growing sector that makes it different from conventional Western practices? Simply put, Islamic finance allows both individuals and companies to invest and carry out transactions in accordance with the Islamic faith. These transactions must follow a set of principles that are derived from the Islamic legal code (sharia) that, if followed, make an investment halal, or permissible.

But to tap into the market potential of Islamic finance, Graham says certain regulatory issues need addressing. He points out that, for example, certain transactions — such as a joint venture involving newly constructed residential property — would have "considerably more" GST issues to manage than conventional transactions would. The IFWG says possible amendments to the Financial Administration Act, the Public Lands Act and the Land Transfer Act would help level the playing field so Islamic financial transactions could remain competitive.

Allowing the Islamic finance model a spot in the Canadian marketplace could allow Canada to attract foreign — and domestic — investors who have billions of dollars, but who are only interested in sharia-compliant opportunities. Moreover, Islamic finance is open to all individuals regardless of faith, so the potential market is much larger than just the Canadian Muslim population. In fact, in the United States and United Kingdom, ethical investors make up a sizeable portion of the client base.

Islamic finance in Canada

It's difficult to find reliable numbers for the value of the Canadian Islamic finance sector mostly because transactions take place outside formal financial structures and are not tracked. While there are smaller players in the Islamic mortgage and insurance sectors, they represent a fraction of ongoing business.

In addition, none of the major banks currently offer Islamic banking products and Canada's current regulatory environment make providing such offers difficult. The Bank Act limits a bank's ability to be a partner, but in the Islamic model the bank is always a partner and shares in the profit and loss.

Nauman Farooqi, an associate professor in the commerce department at Mount Allison University in New Brunswick, has studied Islamic finance and looked at its various manifestations in Canada. He says the main difference between conventional Western finance and Islamic finance is that the Islamic model guarantees no return. To gain, one must risk.

"If a bank is going to give me a loan, it couldn't care less if my business survives. But if it was an injection of money, then [the bankers] would have to think about whether they were willing to take on the risk to get the return," he says. "They would make sure I'm a good investment."

Such investments would also eschew excessive risk which is also prohibited under sharia. If a business fails, all partners, including the bank, lose. If the business thrives, everyone benefits. Sharia-compliant transactions are appealing "because they present a win-win for all involved."

Farooqi says the average Muslim-Canadian user of Islamic finance is involved in simple transactions, such as purchasing a car or home. Case in point: a friend of Farooqi's wanted to buy a house but didn't want to pay interest. He entered into an agreement with the seller, who was not Muslim, to pay a markup on the total cost of the home. Payments were spread out over several years. "They hired a couple of lawyers who drew up the contract and they sorted it out," he says.

But there are other opportunities as well.

A good example of a sharia-compliant model that's already well known in the West is the venture in which investors inject capital but also own a portion of the venture. If the venture fails, the investor loses; if the venture succeeds, the investor profits.

"The venture capital industry is sharia-compliant because it's based on a risk-sharing model," says Farooqi. "We don't call it Islamic finance, but essentially it is."

Massive mind shift

Jim Fischer is an associate professor at the Bissett School of Business at Mount Royal University in Calgary. He spent several years in the United Arab Emirates teaching business and says Islamic finance models, while not hard to adapt to a Canadian environment, require a certain attitudinal shift.

"For conventional companies to adapt to Islamic practice, they'd have to wrap their minds around it. They'd be nervous," says Fischer.

But he says it's important to look past the initial discomfort because the underlying principles fit in very nicely with prevailing Western — liberal, free market, capitalist — ideas. "It treats the entrepreneur fairly instead of giving someone a guaranteed profit despite the outcome. If you look at classical liberal economic thinking, that's very consistent with those types of values."

Putting attitudes aside, Fischer says practice would not necessarily be an issue. For accounting, for example, there's no real difference between how conventional companies manage their books and

CANADA'S MOST COMMON SHARIA-COMPLIANT TRANSACTIONS

Ijarah means lease, rent or wage. Typically, one party makes available a service or an asset to another party for a fixed period and price, both of which are to be negotiated at the outset.

Mudarabah is a profit-sharing partnership, but only one partner invests the money while the other partner manages. Profits are shared according to a pre-negotiated ratio, but loss is only incurred by the investor.

Murabahah is like a rent-to-own agreement. The sale of an asset will include a profit margin

PRINCIPLES OF ISLAMIC FINANCE

- The charging or paying of interest is prohibited.
- There can be no guaranteed profit in a financial venture. Any profit or loss must be shared by all partners in the venture.
- Transactions must be backed by assets: money in and of itself has no value.
- Investments can be made only in products and practices that are not prohibited by Islamic teachings. Investing in pornography, gambling, alcohol, pork products or weapons is banned.
- Because excessive uncertainty and speculation are like gambling, they are prohibited.

how sharia-compliant businesses manage theirs.

"Bookkeeping is bookkeeping," Farooqi says. "As far as pure accounting systems are concerned, you wouldn't have any issues."

But one area that could prove challenging for Canadians is the complexity of technical rulings. The Islamic financial system is based on legal rulings by qualified scholars of sharia who are in the business of giving religious and legal sanction and determining whether a particular transaction is in keeping with religious dos and don'ts.

While the specifications for older products are fairly stable, there's always a process of scholarly rigour applied to innovations or new financial products. Canadians working in finance would ultimately have to wait on clerics to decide if a particular product — one that might be generating some excitement in the financial world — is permissible.

Islamic finance also might help with financial regulation in general. Governments around the world are already working on tightening up regulations. The Financial Stability Board, chaired by Mark Carney, the governor of the Bank of Canada, was created in 2009 just after the G20 London Summit. The risk-sharing, conservative principles in Islamic finance might be a welcome addition to the Canadian landscape.

Indeed, some of these principles, if enshrined in Western practices, might have helped stave off the global financial crisis, says Farooqi. "If you look at some of the literature over the last couple of years, there's been some discussion that if the banking system were closer to a sharia-compliant system, we wouldn't have seen the kind of financial ruin we've seen." ■

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MISSION POSSIBLE

3 PROBLEMS, 3 SOLUTIONS

How a group of volunteers led the way on Islamic investing in Canada

By **Pervez Nasim**, CMA, as told to **Naheed Mustafa**

We started in 1982 when Muslims — many of whom had come to Canada as students — were choosing to stay in Canada and establish themselves. We were faced with three important challenges: some of us had savings, but didn't know what to do with them because we didn't want to earn interest; we needed homes, but didn't want to use interest to purchase; and some of us had good incomes, but weren't taking advantage of RRSPs because they were interest-based investments.

In 1982, I got my CMA and wondered what I could do as an accountant to benefit the broader community. A few of us put our heads together and established an Islamic housing co-operative. This co-op provided Muslims with a place to put their savings and a way to purchase homes. To deal with the RRSP issue, we established the al-Amin RRSP in 1985. At the time, I was with the Ministry of Finance, and on weekends I looked after this commitment as a volunteer. Twenty-eight years later, I'm still volunteering.

When we started, the group was tiny. Seventeen people joined the co-op and each put in $1,000. We could only buy two or three houses a year. Now we have more than 4,000 members, including U.S. investors, and buy two or three houses per month across the country.

The idea is to work as a community and help others. Then others will help you.

that is agreed upon by both parties and must be stated at the outset. The total cost can then be broken down into chunks to be paid over time. The seller cannot charge extra (i.e., interest) in the event of a late payment, but can hold on to ownership of the asset until deferred payment is made.

Musharakah is a joint venture. Two or more partners provide funds, and profits are shared between the partners according to how much each invested. If there is a loss, then each partner loses according to how much he/she invested. Active partners get a greater share of profit than silent partners do.