

Islamic financial services: Overview and prospects for the Canadian marketplace

In the last thirty years, the Islamic financial services industry has undergone significant expansion in many parts of the world. A 2005 publication of the International Monetary Fund (IMF) estimated that there are over three hundred Islamic financial institutions worldwide, with an estimated \$250 billion in total assets and an annual growth rate of 15%.¹

The Islamic, or *Takaful*, insurance sector in particular has experienced a significant expansion since the first such insurer was established in 1979, with an estimated 250 *Takaful* insurers currently operating throughout the world.² From September 2005 to October 2006, eleven insurance companies announced their intention to enter the worldwide *Takaful* insurance market. In 2005, total *Takaful* premiums exceeded US\$2 billion and are expected to more than triple by 2015, to US\$7.4 billion.³

The IMF suggests that this continued growth is attributable to: (1) increasing demand from a large number of Muslims (including Muslim immigrants to Western countries) for financial services that are compliant with Islamic, or Sharia, law; (2) growing oil wealth in jurisdictions such as Dubai and other of the United Arab Emirates and the corresponding demand for Sharia-compliant investments; and (3) the attractiveness of Sharia-compliant financial services to non-Muslim investors seeking “ethical” investments.

Given the significant increase in the popularity of Islamic financial services worldwide, and growing Muslim populations in Canada’s major cities, the demand for Islamic financial services in Canada will no doubt grow over the next few years. The Office of the Superintendent of Financial Institutions (Canada) (OSFI) has already indicated that it is considering certain regulatory issues related to Islamic financial services in the Canadian marketplace. Developments in other countries, particularly the U.K., may be useful predictors of likely developments in Canada.

Sharia law and financial services

Sharia law refers to the body of formally established sacred law based primarily on Allah’s (God’s) commandments found in the Koran, which is the written word of Allah as revealed in Arabic to the Prophet Mohammed. Sharia law governs (to varying degrees) not only religious matters, but also political, economic, civil, criminal, ethical, social and domestic affairs in Muslim countries. While a thorough explanation of the various sources of Sharia law and its principles is beyond the scope of this Update, additional background is available on numerous internet websites.

The fundamental goal of Sharia-compliant financial services is to link the return earned on an investment to the productivity and quality of the investment, thereby ensuring a more equitable distribution of wealth. In practice, however, the business principles supported by Sharia law are sometimes incongruent with the fundamental concepts that underlie the

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secular financial services industry. For example, Sharia law prohibits both earning and paying interest (*riba*) – a cornerstone of the secular financial services industry. It also prohibits investment in certain businesses considered forbidden according to Islamic religious principles, including alcohol, gambling, pornography and pork-related products. Sharia law also rejects the concept of uncertainty or ambiguity (*gharar*), which is the basis for most insurance policies. These restrictions can limit the Muslim community's ability to participate in the secular financial services industry.

The U.K. experience

In the U.K., with its 1.8 million Muslims, financial regulators have long recognized the growing demand for Sharia-compliant financial services. In 1999, Howard Davies, former Chairman of the Financial Services Authority (FSA), hosted a meeting with representatives of the British Muslim community and detailed the regulator's likely approach to regulating Islamic banking in the U.K. In August 2004, the FSA authorized the first Sharia-compliant retail bank in the U.K., the Islamic Bank of Britain (IBB). In March 2006, the FSA authorized the European Islamic Investment Bank, a Sharia-compliant wholesale Islamic bank, and in October, 2006, the FSA took steps to require disclosure on Sharia-compliant mortgages and other Islamic products.⁴

In order to be considered truly Sharia-complaint, Islamic financial services and products must be both free from interest and managed in a manner that is consistent with Sharia law. This means that the managing financial institution (FI) cannot make any investments that earn interest or are otherwise prohibited in any way. Most Islamic FIs accomplish this by maintaining an internal Sharia Supervisory Committee. The IBB, for example, describes the role of its committee as follows:

The Sharia'a Supervisory Committee is comprised of experts in the interpretation of Islamic law and its application within modern day financial institutions. They are world leading scholars representing a wide spectrum of the Islamic faith and **they ensure that Sharia'a compliance is at the heart of everything we do and every product and service that we offer.**

The Committee meets on a regular basis **to review all contracts and agreements relating to our transactions** as well as **to advise us, guide us and sanction any new services that we introduce.** The Committee certifies every account and service we provide - without their approval, we cannot introduce a new product or service.⁵ [emphasis added]

Both the existence of such a committee and the disclosure of its members are required under the FSA regulatory regime.⁶ While the management board of the FI is not appointed by the committee and is under no formal obligation to follow the directives of the committee, in practice, instances where management fails to follow the committee's guidance are rare.⁷

One of the most important issues faced by the FSA in its regulation of financial services suitable for the Muslim population was the treatment of deposits. The FSA describes the issue and solution this way:

The U.K. legal definition of a deposit is: "a sum of money paid on terms under which **it will be repaid either on demand or in circumstances agreed by the parties.**" In other words, **money placed on deposit must be capital certain.** For a simple non-interest-bearing account there is no problem. The bank safeguards the customer's money and returns it when the terms of the account require it to do so. However **with a savings account there is a potential conflict between U.K. law**, which requires capital certainty, **and Sharia law**, which requires the customer to accept the risk of a loss in order to have the possibility of a return.

Islamic banks resolve this problem by **offering full repayment of the investment but informing the customer how much should be repayable to comply with the risk-sharing formulation.** This allows customers to choose not to accept full repayment if their religious convictions dictate otherwise.⁸ [emphasis added]

This sort of creative thinking is illustrated repeatedly in other types of Sharia-compliant financial services. While the words and phrases used to describe the various Islamic products and principles may, upon initial consideration, seem somewhat unusual to the secular financial services industry, the relationships they describe are not altogether unfamiliar.

Sharia-compliant products

■ ISLAMIC BANKING PRODUCTS

The IBB describes several Sharia-compliant banking products:

Ijara is a form of leasing. It involves a binding agreement in which the FI buys the goods and then rents them to its customer in return for a specified rental payment over the lease term. The duration of the lease and the rental payment are agreed upon by the FI and its customer. The FI retains ownership of the goods throughout the lease term and then assumes possession of the goods at the end of the lease term. This is similar to most lease agreements currently in use in the secular financial services industry.

Ijara-wa-iktana is a form of leasing similar to *Ijara*, except that included in the lease agreement is an obligation on the customer to buy the goods from the FI at the end of the lease term at a pre-determined price. Rental payments made during the lease period contribute towards the purchase price of the goods. Often, as a result, the final sale price at the end of the lease period will be for a minimal sum. This practice is similar to the fixed buyback option available at the end of most auto leases currently in use in the secular financial services industry.

Musharaka means “partnership.” It involves the customer placing capital with an FI and both parties sharing the risk and reward. The difference between *Musharaka* arrangements and traditional banking is that either party can set a profit-sharing ratio, but losses must be proportionate to the amount invested. This is the basis for most deposit accounts in Islamic FIs.

Ijara with diminishing Musharaka can be used for home-buying services instead of a traditional secular mortgage. “Diminishing *Musharaka*” means that the FI initially purchases the asset (typically a home) and retains legal title to the asset during the life of the lease/rental agreement it enters into with the customer. The FI then reduces its equity in the asset with any additional capital payment the customer makes over and above the rental payments agreed upon for the property. The customer’s ownership in the asset increases and the FI’s decreases by a corresponding amount each time the customer makes an additional capital payment. Ultimately, the FI’s ownership of the asset is transferred entirely to the customer. While this is fundamentally different from the secular mortgage financing model, it is not entirely unfamiliar and may be compared to rent-to-own programs offered by some housing developers.

Mudaraba refers to an investment made on the customer’s behalf by a more skilled person (*Mudarib*). It takes the form of a contract between the customer, who provides the funds, and the *Mudarib* (similar to a fund or investment manager, which could be an FI) which provides the investing expertise, where the parties agree in advance to the division of any profits. The *Mudarib* would make Sharia-compliant investments and share the profits with the customer, in essence charging for its time and effort in managing the investment. If no profit is made, the loss is borne by the customer and the *Mudarib* would not collect its fee. This is contrasted against the secular investing arrangement where the FI or fund manager charges a fee based on the number of transactions or the size of the overall portfolio, with no link to the performance of the investment.

Murabaha is a contract for purchase and resale that allows the customer to make purchases without having to take out a loan and pay interest. The FI purchases the goods for the customer, and re-sells them to the customer on a deferred basis, adding an agreed profit margin. The customer then pays the sale price for the goods over instalments, effectively obtaining credit without paying interest. Again, this is similar to many rent-to-own arrangements made in the secular financial services industry.

A ***Qard*** is a loan free of profit. FIs tend to use this arrangement for accounts. The customer’s account is treated as a loan to the FI, which is used by the FI for investment and other purposes. The loan must be repaid to the customer in full upon demand.

■ ISLAMIC (TAKAFUL) INSURANCE

Life (Family) and non-life (General) Sharia-compliant insurance products have been offered by Islamic insurers since 1979.⁹ In December of 1985, the influential Grand Counsel [*sic*] of Islamic Scholars (the “Grand Counsel”) approved *Takaful* (meaning “guaranteeing each other”) insurance as a permissible (*halal*) alternative form of insurance written in compliance with Sharia law¹⁰. The Grand Counsel approved *Takaful* insurance as a system of co-operation and mutual help, but left its operation and development to Islamic scholars and insurance practitioners. Since then, three models of *Takaful* insurance have developed along the Family and General lines

of business. In order to support the growth of the *Takaful* insurance market, re-*Takaful* insurance (or the Sharia-compliant reinsurance of *Takaful* companies) has also begun to emerge in recent years.

Takaful is based on the concept of “risk sharing,” not completely unlike secular insurance. One of the fundamental differences between *Takaful* insurance and secular insurance is that in *Takaful* insurance plans, the insurance premiums are considered “contributions” to a joint fund created to distribute the risk of an unfortunate event happening to a particular member to the group. The foremost purpose of a *Takaful* insurance plan is thus not to generate profits, but rather to promote mutual responsibility. The second distinct feature of *Takaful* insurance is the involvement and role of the Sharia Supervisory Committee as discussed above.¹¹

In a 2006 report on the *Takaful* insurance industry, Moody's identified three common models of *Takaful* insurers:

The *al-Wakala* model is prevalent in the Middle East and distinguishes between an operating company and the *Takaful* fund (which is comprised of contributions/premiums). The operating company is paid a fee deducted from the *Takaful* fund, rather than sharing in the underwriting result. The surplus of the fund belongs to the members; the operating company has entitlement to it.

The *al-Mudharaba* model is frequently employed in Malaysia and is structured as a profit-sharing arrangement between the operating company and the *Takaful* fund, usually based on the fund's underwriting result. The surplus of the fund belongs solely to plan members.

Waqf, unlike *al-Wakala* and *al-Mudharaba*, operates as a public foundation, with the fund not belonging to anyone in particular, and no distributions of surplus funds to members being possible.

Canadian prospects

The number of Muslim Canadians doubled from 253,300 in 1991 to 579,600 in 2001, the largest population increase among religious groups in Canada during that ten-year period. As of 2001, Muslims comprised 2% of Canada's total population,¹² and while the 2006 Census does not provide more recent information regarding religion and ethnicity, current trends suggest that this number continues to rise. In light of such population growth, and the rise of Islamic financial services worldwide, no doubt the demand for Islamic banking and *Takaful* insurance will also increase in Canada.

Based on the success of the introduction of Islamic financial services to other economies, it would appear likely that a similar financial service industry will in time also develop in Canada. Furthermore, Islamic products may be attractive to individuals of other non-Islamic traditions who are interested in making “ethical” investments. Finally, as noted above, many Sharia-compliant products are analogous to common secular financial products and the principles upon which Sharia-compliant FIs operate are somewhat akin to those upon which Canadian credit unions and mutual insurance companies operate. OSFI has already indicated that it is considering certain regulatory issues related to Islamic financial services in Canada. Some of these issues presumably include: corporate governance; capital adequacy; the various prohibitions in the *Bank Act* (Canada), including the leasing prohibitions; comfort of the Canadian regulator with both the concepts that underlie Sharia-compliant products and also the home jurisdictions of some foreign companies that may wish to enter the Canadian market. The FSA experience would presumably provide a framework for considering how best to address those issues in the Canadian context. Ideally, OSFI, as is its custom, would engage in a broad consultative process in order to elicit the views of all relevant stakeholders, including the rapidly growing Islamic community in Canada.

For further information, please contact your Stikeman Elliott representative or either author, Nevinne Hassan (nhassan@stikeman.com) or Stuart Carruthers (scarruthers@stikeman.com).

¹ M. El Qorchi, *Islamic Finance Gears Up*, Finance & Development, December 2005, Volume 42, Number 4, International Monetary Fund.

² “*Takaful: A Market with Great Potential*”, Moody's Investor Services Special Comment, August 2006.

³ See footnote 2.

⁴ See Policy Statement 06/12 issued by the FSA in October of 2006 at page 33, available at www.fsa.gov.uk/pubs/policy/ps06_12.pdf.

⁵ Available from the IBB website at: <http://www.islamic-bank.com>.

⁶ See Policy Statement 06/12 issued by the FSA in October of 2006 at page 33 & 34, available at www.fsa.gov.uk/pubs/policy/ps06_12.pdf.

⁷ See “*Takaful: A Market with Great Potential*”, AM Best Special Comment, August 2006.

⁸ See FSA Briefing Note BNO16/06 released March 9, 2006, available at www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml.

⁹ See footnote 2.

¹⁰ See “*Takaful Industry: Global Profile and Trends, 2001*”, from The Institute of Islamic Banking and Insurance at www.islamic-banking.com.

¹¹ See footnote 2.

¹² See “2001 Census: Analysis Series Religions in Canada” available from Statistics Canada at <http://www12.statcan.ca/english/census01/Products/Analytic/companion/rel/pdf/96F0030XIE2001015.pdf>