CONTEXT

There has been a significant growth of interest in Islamic Finance (IF) in both the Muslim and non-Muslim world. IF is based on the fundamental religious doctrines of Islam and as such provides a unique and trust-based approach to financial management. This seminar provided an overview of IF from an international perspective, North American and Canadian perspective. A panel of internationally renowned specialists in academic and financial services industry circles had the opportunity to share their thoughts on the growth of IF, challenges and issues inherent to the model.

ISLAMIC FINANCE INTRODUCTION

IF has been in existence for over 1,400 years. It is currently a growing subsection of the global financial system with a number of countries, Muslim and non-Muslim, implementing IF systems. The principles of IF come from Islamic Law, or Shari’a, which originates in the Islamic Holy Scripture known as the Qur’an. Because of this religious connection, the economic model of IF is bound by certain rules: charging interest is not allowed, nor are high-risk ventures or any endeavors that would profit from exploitation, gambling, or alcohol. In the housing market, IF structures include ijara contracts based on capital lease, murabha re-selling with a mark-up, or musharaka ownership in conjunction with a bank. IF in North America has been growing to fill the demand for retail financial products from the Muslim population. It is growing in both Canada and the United States which has sparked interest from academic and financial institutions as well as from government organizations. In Canada, the Canada Mortgage and Housing Corporation (CMHC) produced a lengthy report about some of the most important issues surrounding IF in the Canadian market.

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CMHC REPORT

The CMHC commissioned Gowlings, a Canadian Law Firm for Business and Commerce, to produce a report in order to provide additional insight concerning the adaptability of IF in the Canadian retail financial market. This document included information specifying some of the principles of IF, including prohibition of interest, transparency, and decision making in accordance with Islamic law. In addition to noting some of the implications stemming from Shari’a, the report included case studies of IF applications in countries such as the United Kingdom and Australia.

According to CMHC, IF exists in the Canadian marketplace. While Shari’a Law does not necessarily contravene relevant Canadian laws, it does introduce new and additional legal considerations. For example, there are property standards, environmental impact assessments, and liability for the payment of taxes considerations. The CMHC report concludes that a significant amount of additional research in the area of IF is required in order to produce a more thorough picture of the feasibility of implementation in the Canadian financial system.

ALTERNATIVE INVESTMENTS: ISLAMIC FINANCE IN AN INTERNATIONAL, NORTH AMERICAN AND CANADIAN CONTEXT

On March 14, 2013, three prominent professionals with deep knowledge of a rapidly growing subsection of the global financial system presented their work on IF at the University of Ottawa.

Dr. Mahmoud Mohieldin provided a clear picture of the potential of IF and where it is today. Dr. Mohieldin is an executive at the World Bank Group having served as a Managing Director, and is currently the Special Envoy to the President for the Millennium Development Goals. Prior to joining the World Bank, Mr. Mohieldin held numerous positions in the Government of Egypt. He was a member of the Commission on Growth and Development. He served as Board Member of several universities, regional research centers and think tanks. As a Professor of Economics, he has authored numerous publications and articles in leading economic journals.
Two discussants supported Dr. Mohieldin’s presentation. Rehan Huda presented on IF in a North American context. Mr. Huda is currently a founder and Director of Amana Canada Holdings, a firm specializing in structuring IF products and services for the Canadian marketplace as well as for Middle East investors. Rehan has been a guest speaker on Islamic Economics and Finance at a variety of international conferences and universities and has been interviewed by leading media outlets in Canada and abroad. He also assisted in initiating and teaching the first MBA course in IF at a North American university, the Rotman School of Business at the University of Toronto.

Walid Hejazi, an Associate Professor of Business Economics, and Academic Director, at the Rotman School of Management, completed the seminar by explaining what IF looks like in the Canadian context. Dr. Hejazi teaches Canada’s current and future business leaders in the MBA, EMBA, and custom Executive programs. Mr. Hejazi has also developed a successful course in Islamic Finance, which is a for credit course in the MBA program at the University of Toronto. This represents the first such course in Canada. He has published extensively in many business journals and publications.
The World Bank Global Financial Development Report of 2013 evaluates the usefulness of the financial sector based on debt, access, efficiency and stability. The report found that weak supervision and regulation were endemic to the conventional global financial system and that the 2008 financial crisis emerged due to lack of regulation and less than efficient market conditions. The report found that the system performed poorly prior to the financial crisis and even more poorly post-financial crisis. It was mandatory to revise the regulatory framework and to evaluate the role of the state in the relation to the financial sector. One of the conclusions coming out of this report is the need to take a look at different ways of doing things. IF could complement or provide an alternative to the conventional financial system.
Dr. Mohieldin acknowledges that IF currently accounts for only 0.1 to 0.5 percent of the total financial assets in the global economy; however, he refers to the work for two prominent economists, Umer Chapra (2008) and Kenneth Rogoff, to explain that it is not the size of the industry that counts it is the quality. IF can provide a financial system that is based on something different than the conventional financial system. There may be lessons learned from something different. For example, the idea advanced by Robert Shiller from Yale University which would tie bond performance to the performance of the economy. These bonds would pay more when a country’s economy is growing and less when it is in recession. These points provide the transition from discussing the conventional financial system and the 2008 financial crisis toward IF.

At its core, IF provides a better control over business cycle fluctuation by tying financial transactions to the real economy. It also reduces the private and net public debt and eliminates bank runs. These are achieved by requiring 100% reserves banking. As can be seen by the graph below, Islamic Banks performed much better during the financial crisis than did conventional banks. One of the main reasons for this is the following defining characteristics of IF. One, it prevents *riba*, defined as any kind of acceptance of predetermined interest rates on debt. It takes away debt securities from the financial system. Two, it takes away *gharar*, uncertainty from contracts. There can be no ambiguity in the agreement. As Dr. Mohieldin eloquently stated, “only sell what you have, and cannot try to sell what you don’t”. The final requirements are not linked to performance, IF does not permit investment into industries which are considered *haram*, forbidden by Islamic Law, including firms which sell arms, tobacco, alcohol, pornography and pork.

![Graph showing performance of Islamic and conventional banks during crisis and recovery.]

*Sources: Beck, DemirgucKunt and Merrouche 2012*
If IF has an equivalent in the conventional financial system, it would be equity finance where both parties share in the profits; however, they would also share in losses. Dr. Mohieldin explained that there is no finance for the sake of finance. All transactions are linked to the real economy. There is a need for either an agricultural, industrial, or commercial activity behind the transaction. Of note, there are some discrepancies between theory and practice. IF includes the principles of property rights, Corporate Social Responsibility and human rights when dealing within the IF system. There is also an advocacy of risk and rewards to be distributed equally among the parties.

What does IF look like today? *Shari’a* compliant assets have more than doubled since 2006 and the industry continues to grow. It is a 1.1 trillion dollar industry comprising banking assets, *sukuk* (Islamic bonds) and assets under management. The majority of these assets are in Malaysia (63%), United Arab Emirates (16%) and Saudi Arabia (8%). Emphasis is placed on economic growth accompanies by social justice ensuring that lower class individuals have access to microfinance deposits and loans. Additionally, importance is given to redistribution of wealth. There has been an increase in the quantity and quality of IF services especially in the Gulf aided by the commodity boom leading to these countries having surplus capacity and liquidity. They have offered IF windows not only to Muslim clients, but also to non-Muslims clients seeking safe and quality investments. However, the picture is not all without challenges.

Dr. Mohieldin explains that there are five major challenges. One, the regulatory framework may not be conducive to easily integrate the IF system. The system at times needs to comply with two sets of regulation making it more expensive and inefficient. Some counties have decided to move forward with a dual-regulatory approach having one set of rules for the conventional banking system, and another for the IF system. Two, there is a need to look at the tax regime within countries. Some IF windows undergo double taxation because of the nature of the product or services. Some countries have started to address this problem. Three, there are issues surrounding insolvency. There is a need to work on insolvency rules with special adaptation for the IF system. Four, being a new industry, there are issues surrounding standardization with a number of countries trying to establish their institutions as the producer of the international standards for the industry. Finally, there is a need to establishing sound liquidity and risk-management practices. This means ensuring that compliance with Basel III rules and liquidity risk management are addressed.

Dr. Mohieldin completed his presentation by highlighting the role of The World Bank and their work with IF. There is knowledge sharing with the Islamic Development Bank, Islamic Financial Service Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). They also collaborate with the following research centers: INCIEF, Oxford Center for Islamic Studies, and Harvard Islamic Finance Project.
REHAN HUDA, DIRECTOR OF AMANA CANADA HOLDINGS

Mr. Rehan Huda provided additional information on IF and set the context of the industry in North America by providing the audience with a historical snapshot of its introduction and development. IF was brought to the American market during the 1970s as firms especially energy-related ones, formed stronger relationships with firms in the Middle East. He continued by stating that while IF is today adapted to a modern context, its origins in Islamic tradition and theology have important connections with modern North American economic principles. In North America and Europe, there have been small-scale experiments with IF with mixed results. Mr. Huda pointed out that there are three Islamic funds in the United States including one in Michigan, another in Chicago, and a third in California. IF mortgage contracts have received approval from US regulators, which led to a new Islamic mortgage market that was picked up by Fannie May and Freddie Mac in the early 2000s. During the sub-prime mortgage crisis which followed, IF mortgages proved to be significantly more secure because of the IF principal of transparency prevented the approval of high-risk mortgages. He concluded by stating that performance of IF was equally strong during the entirety of 2008 Financial Crisis, which showed the resilience behind an economic model that places significant value on transparency and the effective management of risk.

DR. HEJAZI, ASSOCIATE PROFESSOR AT THE ROTMAN SCHOOL OF MANAGEMENT, UNIVERSITY OF TORONTO

Dr. Walid Hejazi was intent on changing people’s perception of the Middle East. He provided insight by transmitting that given the changing nature of the global economy, it is important to consider the growth of Chinese and Middle Eastern financial markets. He continued by stating that Canada is pursuing increased foreign investment (FDI). He was adamant that Canada needed FDI period, and that the countries in the Cooperation Council of Arab States of the Gulf (GCC) would make complementary partners considering they have over a trillion dollars in excess liquidity. He stated that during the 2008 Financial Crisis, Shari’a compliant institutions performed better than their non-Shari’a counterparts. The strength of IF following the crisis sparked new interest in this economic model, and Canada’s strong reputation in the Gulf solidifies its place as an ideal trading partner. In order to capitalize on this foreign investment, there is a need for Canadians to become better aware of IF. Misconceptions surrounding democracy in the Middle East may hinder opportunities to do business; however, statistics indicate that many Gulf firms have corporate governance structures which perform at par with Western ones. He referred to a number of graphs to prove his point.
CONCLUSION

As was demonstrated by Dr. Mohieldin, Dr. Hejazi and Mr. Huda, there are differences between IF and the so-called “conventional” financial system. They also painted a picture where both systems can be reconciled. With 165 academics, financial services professionals, public servants and students in attendance for the seminar, there is interest in exploring the possibilities of this industry in Canada. As highlighted by the speakers, the process of integrating an IF system into a Western capitalist system poses some challenges. The United Kingdom and the United States implemented an IF system by changing their regulatory and taxation systems. This will be no different for Canadians if they chose to follow suit. It will also be important to differentiate between a need among the Canadian Muslim community for Shari’a compliant financial services and a request by few for a separate legal system based on Shari’a law. The later has been contentious as seen by Canadian media coverage of the issue. There was also a question posed during the seminar which confused social issues with economic ones. The video of the seminar will provide a much better context for the questions and answers than can be described in this paragraph.


While conducting research to develop the seminar on IF, it was discovered that there is a nascent network of Canadians working towards implementing an IF system in Canada. The CMHC report was written to understand the potential of Shari’a compliant mortgages for the Canadian real-estate market, and there are some students working at the master’s level investigating different aspects of IF. The seminar brought the organizers into contact with professionals at the Canadian Department of Foreign Affairs and International Trade and the Toronto Financial Service Alliance (TFSA), a public private partnership dedicated to promoting Toronto as a global financial services centre. The professionals at the TFSA explained that an IF working group was formed to do policy work and to identify issues and options when it comes to IF. Additionally, Dr. Mohieldin was invited to repeat his presentation for the leadership of the major Canadian financial institutions through the TFSA. Interest in IF among Canadians is growing and the system could take root and develop. Only time will tell.

Seminar summary written by:
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The Governance Innovation Lecture Series is an initiative from the University of Ottawa’s Centre on Governance, Faculty of Social Sciences. The main objective of the series is to create a space for thinking about innovative solutions to address contemporary problems and challenges faced by governments. Senior Fellows, visiting researchers and faculty associated with the Centre on Governance will be the first asked to contribute to the series. The series focus on applied, concrete and targeted innovations and will aim at fostering dialogue between the academic, the government and the non-governmental sectors. The selected governance innovations should focus on public governance, public management, and public policy along with relationships between the government, the private sector and civil society in public policy design and public service delivery. The target audience is the academic community, civil servants, public and non-profit actors and the general public.

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The Cycle de conférence Innovations en gouvernance est une initiative du Centre d’Études en gouvernance de la Faculté des sciences sociales de l’Université d’Ottawa. Elle a pour but de créer un espace de réflexion sur les solutions novatrices, originales et même parfois avant-gardistes pour faire face aux grands défis et problèmes contemporains auxquels les gouvernements sont confrontés. Les professionnels en résidence, les chercheurs invités, les universitaires associés au Centre d’Études en gouvernance sont les premiers sollicités. Le caractère appliqué, concret et ciblé de la série vise à favoriser le dialogue entre le milieu universitaire et celui des intervenants gouvernementaux et non-gouvernementaux. Les innovations proposées portent sur la gouvernance publique, la gestion publique, les politiques publiques, les rapports entre les acteurs gouvernementaux et non-gouvernementaux (secteur privé et société civile) dans le développement de politiques ou la production de services publics. Le public cible se compose de la communauté universitaire, des intervenants du secteur public et communautaire et du grand public.

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