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Banking opportunity

Products target growing pools of cash

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A growing pool of would-be investors and borrowers, many sitting on piles of surplus cash, others simply in need of mortgages, remains untapped by Canada's biggest banks.

The demand for Islamic financial instruments certainly exists. But beyond holding basic accounts, observant Muslims in Canada find themselves disconnected from retail banking.

Despite signs a few years ago that shariah-compliant products were ready to enter the Canadian market, the niche segment has not advanced beyond infancy.

"We have immigrants who come to us and sit in our offices and tell us they have a million dollars sitting in one of the Big Five banks, in cash," says Omar Kalair, president of UM Financial, one of the few providers of Muslim mortgages in Canada.

"We have people who have been renting for the last 30 years, even if they have $100,000 salaries, because they can't buy a house," he says.

Interest -- an essential component of Western finance -- prevents many of Canada's one million Muslims from properly managing their assets. Shariah, or Islamic canonical law, forbids the payment or collection of interest. While property ownership and profits are permissible, making money from money alone is not.

Investments and loans in compliance with shariah are instead backed by assets. In one kind of Islamic mortgage transaction, the bank buys the property and sells it back to the new homeowner, who is required to make a down payment. The mortgagee then agrees to an instalment payment plan, which includes a profit for the bank. The transaction, called a murabaha, resembles a rent-to-own agreement.

The payment schedule may be identical to a conventional mortgage, but there is a difference in the fundamentals, says Stephen Ranzini, president of University Bank in Ann Arbor, Mich., which operates the first wholly Islamic banking subsidiary in the United States.

Mr. Ranzini likened the distinction to halal meat versus regular meat. "They look the same, they taste the same, but they're made in a very different way. It's the process," he said, speaking at the inaugural conference of the Usury-Free Association of North America held in Toronto this past week.

But creating financial instruments that comply with ancient rules is an inexact undertaking that requires the expertise of religious scholars.

At least in the West, that means more time and effort involved in creating and selling such financial instruments, and higher costs than conventional bank offerings. That price difference is called the "shariah premium."

Economies of scale have been slow to appear, Mr. Ranzini says.

He founded his bank's specialty subsidiary in 2002 to cater to the United States' largest concentration of Arab Americans, and only recently reached profitability. "It takes tremendous capital, patience and perseverance," he says.

That's one key reason why Canada's major banks haven't waded in.

Over time, however, Mr. Ranzini's University Bank eliminated the premium and now offers shariah-compliant home financing comparable to conventional mortgages.

That's positive news for Canadian bankers, and the opportunities presented by the Muslim market should also grab their attention.

The potential market is huge, with the Canadian Muslim population expected to reach 1.5 million by 2017. And a recent poll indicated that around half of Muslims would prefer shariah-compliant retail banking options.

Guidance Residential LLC, the biggest player in the United States, has provided more than US$1-billion in Islamic mortgages. There is currently US$2.75-billion invested in mutual funds that comply with shariah. And globally, Thomson Reuters recently pegged the value of the Islamic finance industry at US$1-trillion.

In addition, Islamic investments offer a certain enhanced level of security, Mr. Ranzini says. "If you are financing a physical thing, which is always required in Islamic finance, that's inherently a lot safer activity than if you're financing a leveraged buyout of a company."

That aversion to excessive risk, also a guiding Islamic principle, applies to capital markets as well, says Hooman Sabeti, senior counsel at Allen & Overy LLP in Singapore.

With fewer triggers for default, Islamic financing tends to be more lenient, less risky and generally more friendly to borrowers, Mr. Sabeti says.

On the other side of the coin, transaction costs may be higher due to the individualized nature of each deal and the intricacies of getting shariah approval.

The absence of Canada's big banks from alternative financing deals reflects an institutional inertia, Mr. Sabeti says.

"Conventional finance has been around for several millennia. Everyone knows what it is. Islamic finance, which is just a couple of decades old, is trying to compete or offer another option to people, but it has to do it against a backdrop of a wholly worked-out system of finance," he says.

"Where there are deals, there are bankers. And right now, it's not clear to bankers that there are deals."

However, it is becoming increasingly clear to many.

Last year, General Electric Capital Corp. became the first Western multinational to issue an Islamic bond, completing a US$500-million sukuk issuance. It was a strategic move designed to diversify the company's investor base, Mr. Sabeti says.

"For them, it was important politically to show there is a commitment to that region. It's an important market for them as a multinational."

Brian Koscak, a partner at Cassels Brock & Blackwell LLP, expects to see a Canadian corporation make a sukuk issuance in the next year or so.

"We're at the crossroads. We're beyond that this is new, an idle curiosity."

Sukuk bonds have the potential to be a new asset class in Canada, Mr. Koscak says, adding that the instrument is not as mysterious as it might seem.

"I would suggest that an income-trust structure is far more complicated than an Islamic-bond structure," he says.

Canadian credit unions have showed some initiative, filling the gap created by the absence of the large banks.

Central 1 Credit Union provided UM Financial with a funding line to offer shariahapproved home financing to customers in Toronto.

"The credit union system is unique, we've always been interested in niche players," says Linda Jeffery, directory of treasury services at Central 1.

Since 2005, UM Financial has provided 500 homebuyers in Canada with $120-million in murabaha financing.

And the company recently partnered with MasterCard to introduce the first "credit" card in North America aimed at Muslim consumers. Cardholders must first load up their cards with cash, spending only money they actually own and avoiding interest payments or credit-card debt.

Mr. Kalair says it is now only a matter of time before UM teams up with a major bank to expand and extend its line of products.

"Even though there are limited products and the pricing is high ... in the Muslim community, if they were provided an opportunity, they would be ready to switch over."

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THE BASICS OF ISLAMIC FINANCE

Islamic finance, in its present form, emerged in the 1970s to offer alternative financing and investment options in compliance with shariah, which denounces riba, the collection or payment of interest, and gharar, which is excessive risk or uncertainty. Islamic principles, however, do not preclude profits or property ownership, but transactions need to be structured in a different way. Several types of shariah-compliant instruments are now available.

MURABAHA

Also know as a sale on profit or a cost-plus sale, murabaha involves using an intermediary to acquire an asset, usually property. Rather than obtaining a mortgage to make the purchase, a bank, for example, will buy the property outright and resell it to the homebuyer at an agreed profit. That markup is factored into a predetermined schedule of payments.

EQUITIES

Equity investing is allowed, and many Islamic mutual funds are on the market, as long as the company or fund does not involve any practices or products prohibited by the Koran. Those include: riba, gharar, may-sir (gambling), alcohol, pork, non-halal meat, tobacco, weapons and defence, hotels, casinos, gambling, cinema, music or pornography.

MUSHARAKA

Similar to joint-venture financing, participants in a musharaka agreement will all contribute capital to acquire an asset, with each sharing the profits and bearing the losses proportionally. When an Islamic bank lends money under this arrangement, it charges a floating rate that is pegged to the borrower's rate of return, making the bank's profit on a loan proportionate to the company's profits.

MUDARABA

This form of trust financing is very similar to musharaka, but one party provides the capital financing and the other manages the project or investment.

IJARA

The Islamic version of a lease is often followed by an acquisition. A bank will purchase an asset and lease it to the borrower for a specific time and cost. Payments include a debt-repayment component and a rent component, which includes the bank's predetermined profit.

DEPOSITS

Islamic banks offer non-interest-bearing deposit accounts, which compensate depositors with hibah, or gifts of cash, at a specified rate.

SUKUK

Islamic bonds are structured as instruments backed by assets that are leased back to the issuer, who pays rent.