

RESEARCH REPORT



Islamic Housing Finance in Canada



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REPORT TO CANADA MORTGAGE AND HOUSING CORPORATION

ISLAMIC HOUSING FINANCE IN CANADA

Prepared by

Gowling Lafleur Henderson LLP

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The study entitled – Islamic Housing Finance in Canada commissioned under Canada Mortgage and Housing Corporation's (CMHC) research mandate is intended to provide the finance industry and the public with a better understanding of Shari'a mortgage lending.

It was undertaken by Gowling, Lafleur, Henderson LLP.

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REPORT TO CANADA MORTGAGE AND HOUSING CORPORATION

ISLAMIC HOUSING FINANCE IN CANADA

PART 1 EXECUTIVE SUMMARY

Islamic finance (IF) combines religion, risk and reward into a unique form of commerce that has existed for over 1,400 years, but only about 35 years in its current modern form. IF is present in many countries, including in Western democracies. The overarching principles of IF are that interest is forbidden, fairness and transparency govern financial relations, and that profit is earned from labour and enterprise rather than speculation.

IF is governed by an economic model that aims to comply with *Shari'a* law. *Shari'a* is the formally established sacred law found in the *Qur'an* and based upon Allah's (God's) commandments. IF is based on the principles enunciated in the *Qur'an*, *Sunnah* (the sayings and conducts of the Prophet Muhammad), *ijma* and *qiyas* (laws made by qualified Islamic scholars and jurists). Definitions for these and other Arabic terms used in IF can be found in the Glossary at the end of this report.

IF products, services and institutions therefore cannot engage in or contribute to any of the following (the first three of which are relevant to housing finance):

- charge or pay explicit interest, which is considered usury;
- be deemed a gambling contract or involve high risk;
- allow for profit from speculation, exploitation or uncertainty; or
- support endeavours involving gambling, alcohol, pork, armaments manufacture or pornography, among others.

Islamic Housing Finance

The application of *Shari'a* to the housing finance industry internationally differs in significant ways from that of other areas of IF investment and finance. It primarily serves individuals rather than institutions: it is more state-centric and less internationalized than

other forms of finance and investment; it does not necessarily develop alongside the development of other forms of investment and finance; and it is intimately linked with domestic policies and politics.

IF housing finance usually takes the form of one of three main *Shari'a*-compliant vehicles: *ijara* or capital lease contracts, *murabaha* (sale and resale with mark-up) and diminishing *musharaka* (joint ownership, with the bank's share diminishing over time).

Different jurisdictions have differing preferences with regard to which of the above IF structures are used in housing finance. In the UK, for example, *ijara* is prevalent. In the US, *ijara* and *murabaha* are both used extensively and many institutions offer both, and diminishing *musharaka* is becoming ever more popular. These variations are due to borrowers' preferences in terms of features and beliefs, as well as to how the regulatory framework in a particular jurisdiction treats different legal instruments.

This report analyses Islamic housing finance in a sampling of countries throughout the world representing: (1) Western secular countries with minority Muslim populations (UK, US, Australia, France); (2) secular countries with majority Muslim populations (Algeria, Turkey, Malaysia); and (3) Islamic states (GCC, Pakistan). Our sample was also organized to include both common law (UK, US, Malaysia, Pakistan) and civil law jurisdictions (France, Algeria, Turkey), in order to eventually draw parallels with the Canadian legal system. The report then examines the development of Islamic housing finance in Canada and the legal and regulatory obstacles that arise.

Islamic Housing Finance Internationally

The UK is the most developed IF market in the Western world. The UK has amended its consumer regulatory and tax frameworks to eliminate regulatory differences between *Shari'a*-compliant housing finance contracts and conventional mortgages. Islamic housing finance contracts are regulated by the Financial Services Authority of the UK (the FSA) in the same way as conventional mortgages. Nevertheless, volume in *Shari'a*-compliant housing finance is modest, estimated at only £500 million compared with mortgage lending as a whole at over £1.1 trillion. Thus, IF mortgages would represent only 0.045% (forty-five one hundredths of 1%) of the UK mortgage market.

The US has significant experience with IF housing finance. The pace of growth in Islamic “mortgages” began to increase around the year 2000. In this regard, the US has had a different development arc than the UK. IF products and services in the US tend to be ‘hybrid’ creations of certain *Shari’a* scholars, government regulation and the financial markets, but have been criticized by some as disguising, rather than fundamentally altering, the principles of conventional finance that are incompatible with the *Shari’a*.

Australia currently supports a Muslim population of approximately 340,390. This population is growing rapidly, having expanded by more than 80,000 (or 28%) from 1996 to 2006. While conventional Australian lenders have long been involved in *Shari’a*-compliant finance offshore, the domestic market appears to remain largely undeveloped.

France is home to the largest Muslim population in Europe, representing 7% to 8% of the French population. Despite this, until recently IF was practically nonexistent in France. Several reasons might explain this slow development. One of them is a possible reluctance from the French banking authorities to authorize what might be perceived as a violation of the principle of separation of church and state. Another explanation is low demand and obstacles to supply-led *Shari’a*-compliant instruments. The demand issue may possibly be explained by a fatwa issued in 1999 by the European Council for Research and Fatwa, authorizing conventional bank loans (bearing interest) for the purchase of houses used as a principal residence if no *Shari’a*-compliant credit is available.

Algeria (a secular republic with a mostly Muslim population) is demographically suitable for mortgage lending, with its population increasingly middle class and urban. It is the largest country in the Mediterranean region and the second largest country on the African continent. At present, Islamic housing finance is negligible, but Islamic vehicle finance has out-stripped conventional finance, largely because it is more price competitive.

Malaysia (a secular republic with a common law tradition) has an official strategy of developing and nurturing Islamic banking and finance. Its progressive industry

developments include a clear legislative mandate, a robust regulatory framework, resources that include the Institute of Islamic Banking and Finance Malaysia, the International Centre for Leadership in Finance, and the International Centre for Education in Islamic Finance, as well as a wide range of tax exemptions across the Islamic finance spectrum. It is estimated that one in ten banking transactions in Malaysia today is Islamic-based. The government has undertaken various initiatives to create a vibrant and comprehensive Islamic banking and finance system.

Shari'a-compliant mortgages in Malaysia are provided by Islamic banking institutions (IBIs). As of June 2006, there were 22 IBIs in Malaysia, including foreign banks, and *Shari'a*-compliant mortgage lending amounted to CAD\$4.31 billion (RM16.1 billion) or 21.6% of the IBIs' total financing, and 12.3% in terms of total housing loans outstanding in the banking system. Interestingly, these have experienced success among the non-Muslim population as well; about 70% of customers of Islamic banks in Malaysia are non-Muslims.

In Turkey, Islamic mortgage financing has developed informally to remedy the lack of access to capital available to its citizens in conventional and regulated financial markets. The official Turkish system is based upon 'housing credits' offered by banks, essentially short-term loans with borrowing costs built in. Housing credits are unaffordable to the majority of homebuyers, due to their relatively short terms (often 5 to 10 years) and high rates. Consequently, housing credits comprise only 3% of the housing finance market, with the remainder of homebuyers self-financing through private borrowing (often from family). However, some IF mortgage instruments are currently offered by housing finance corporations, which are banks or leasing companies that provide loans directly to the consumer.

The Gulf Co-Operation Council (GCC) is comprised of the kingdoms of Saudi Arabia and Bahrain, the sultanate of Oman, and the emirates of Kuwait, Qatar, and the United Arab Emirates. These officially Islamic states have some of the largest and longest-standing IF institutions in the world.

Interestingly, recent growth in the IF sector has been influenced by conventional financial institutions which are increasingly offering *Shari'a*-compliant products.

Where firms offer IF services, those that have been most successful have focused on the needs of customers and explained the nature of their *Shari'a*-compliant products.

In Pakistan (another officially Islamic republic, and one with a common law tradition), liberalization of the mortgage-lending industry has been ongoing in recent years, though the current contribution of housing finance is extremely limited. While mortgages have conventionally been interest-based, there has been recent growth in IF mortgage offerings. As with secular mortgages, IF lenders in Pakistan look to credit history, payment capacity and collateral from their customers.

More generally, IF in Pakistan has become a widely adopted source of finance. Islamic financial institutions address a core need in the under-served marketplace, by educating consumers on the availability and feasibility of financial products and services, and by providing financing solutions on a wide scale to the general population. A unique aspect of Pakistan's development of IF has been the involvement of the financial regulatory authorities in developing the legal forms of IF retail contracts.

Islamic Housing Finance in Canada

Canadian immigrants (Muslim's included) embrace a goal of homeownership, as is evidenced by the rising number of immigrant homeowners.

A few tentative steps have been made by small private sector entities to provide IF mortgage or mortgage-like products, such as *musharaka* (co-ownership) and *ijara* (lease) for home purchase, along with IF investment products. Other Islamic housing corporations offer *mudaraba*-type shared ownership.

These firms have continued to operate for several years without intervention or facilitation from regulatory authorities. This demonstrates that IF housing finance products can be offered in the Canadian marketplace under the existing legal, regulatory and administrative framework. Though it is difficult to accurately assess, most

Canadian firms offering Islamic housing finance state that demand currently exceeds supply.

Canadian Legal and Regulatory Considerations

The interface of *Shari'a* law with the Canadian legal system does not, in and of itself, create any particular issues. In a *Shari'a*-compliant housing finance transaction, however structured, the common law (civil law in Quebec) would apply to the transactional documents as they would to any other contract. Principles of Canadian real property law would continue to apply to the property that was the object of the transaction.

Conceptually, a *Shari'a*-compliant transaction is structured using Canadian legal instruments and contracts, but in a manner that does not contravene the *Qur'an* and the subsidiary teachings, rulings and interpretations that collectively make up *Shari'a* law.

Most of the designated legal contracts used in *Shari'a*-compliant finance have a counterpart in Roman law, which forms the basis of civil law and has also informed the common law in its development over the centuries. Thus, no difficulties arise in describing the *Shari'a*-compliant contracts in conventional legal terms, be it in a common or civil law legal system.

Islamic financial products should not present any particular difficulties under Canadian accounting standards, given the experience in the UK and the US. Like much of the rest of the world, Canada has opted to adopt International Financial Reporting Standards (IFRS) commencing in 2011. Given the growth of IF internationally, it can be expected that international harmonization of IF accounting and reporting with IFRS will occur in due course.

Legal Context for Islamic Housing Finance in Canada

While the various structures for IF can be created under Canadian law, all of them raise specific legal issues that must be addressed by lenders wishing to offer Islamic housing finance products.

The *musharaka*, *ijara*, *murabaha* and *mudaraba* structures all involve a period of ownership or shared ownership by the financier. Items of particular concern are liability for environmental contamination and non compliance with property standards under municipal by-laws and other regulations. This exposes the financier to a significantly greater risk in these IF structures compared to a lender holding a mortgage.

With holding title or ownership of real property comes direct liability for payment of taxes and various other charges such as condominium fees and special assessments that are imposed on owners of the property.

IF structures to finance residential property that are based on or include *ijara* or rent type payments for the property may be subject to residential tenancy legislation. Where residential tenancy legislation applies, the obligations of the financier and the procedures for dealing with default and servicing matters is significantly different from those for conventional mortgages.

There are also land transfer tax, GST and HST considerations. All these structures have a common requirement that the financial institution become owner of all or part of the property, either for an instant or for the term of the loan. For new and existing houses this raises issues of land transfer tax. For new homes, it also raises issues with respect to the federal Goods and Services Tax (GST) and harmonized provincial sales tax (HST).

Many of the taxes imposed on homebuyers and homeowners have some relief provisions. These generally would not be available if as part of the IF structure, the homebuyer does not take immediate title and ownership of the property.

Conclusion

While there are significant differences across jurisdictions, the take-up rates for IF retail products is invariably extremely low, even in jurisdictions such as Malaysia and Pakistan where government support has been strong.

In the literature canvassed for this report, there is a noted lack of input from the Muslim community at large as to their needs and preferences. It does not appear that there have been any systematic studies on Muslims' attitudes towards IF in particular countries or across different countries. Without this work, it is not possible to extract meaningful reasons for the country differences and trends. For example, having a large Muslim population is correlated with a low level of demand for life insurance (which is prohibited under the *Shari'a*), suggesting that religious factors may indeed have an impact. However, personal income, inflation and institutional development are also strong predictors. Nevertheless, it remains unclear whether market forces alter ideological preferences or vice versa.

PART I. INTRODUCTORY OVERVIEW OF ISLAMIC FINANCE

(1) INTRODUCTION.

Islamic finance (IF) combines religion, risk and reward into a unique form of commerce that has existed for over 1,400 years, with only the past 35 years in its current modern state. According to Vogel and Hayes, IF's modernization corresponded with a growing desire among devout Muslims to better align their everyday lives in the modern world with the traditional tenets of their faith.¹

IF has become a significant worldwide industry, including in Western democracies, and is estimated to be worth at least USD\$300bn per annum.² A recent study published by the Financial Services Authority (FSA) of the UK refers to "conservative" estimates of worldwide growth in IF at a rate of 10-15% for the foreseeable future.³ Considering that Muslims make up a quarter of the world's population, the Muslim population in Canada, at 780,000, is still relatively small.⁴ There is growing interest in Islamic financing techniques throughout most of the world and the publication of many learned texts, government studies and commercial and specialized journalism on this subject.

The International Monetary Fund (IMF) has credited this growth with several factors, including:

- increasing demand from the growing number of Muslims living in western countries;
- growing oil wealth in the Islamic OPEC countries; and
- the attractiveness of *Shari'a*-compliant financial products and services to non-Muslims seeking ethical investments or fair financial products.⁵

¹ Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance*, Brill Leiden, Boston, 1998, 2006, p.1 and p.5.

² *Users Guide to Islamic Finance Documents*, Loan Market Association, 20 February, 2007 at p. 2.

³ Michael Ainley, et al., *Islamic Finance in the UK: Regulation and Challenges*, Financial Services Authority, November, 2007 at p. 3.

⁴ Statistics Canada, online:

<<http://www12.statcan.ca/english/census01/Products/Analytic/companion/rel/canada.cfm>>.

⁵ M. El Qorchi, *Islamic Finance Gears Up*, *Finance & Development*, December 2005, Vol. 42, No. 4, International Monetary Fund.

IF is governed by an economic model that is compliant with *Shari'a* law. This model emphasises fairness above all else, and is based on principles where everyone involved in a transaction make informed decisions, wealth is acquired only through productive work, and only socially-useful enterprises are supported.⁶ One of the strictest prohibitions in *Shari'a* is against usury (*riba*), that interest payments in many conventional financial arrangements violate. Whether IF has achieved its “goal of an alternative system of commerce-based notions of fairness and social justice” has been questioned by some in the Muslim community.⁷ Nevertheless, there is no doubt that a sophisticated catalogue of IF products, services and institutions are developing to serve the financial needs of Muslims in Islamic and non-Islamic countries.

The key factor in expanding the market in both the US and the UK came with changes to the regulatory environment made specifically to enable IF. By publicly stating that the government had “no objection” to the establishment of IF products and services, and by reducing barriers such as the double-stamp tariff in the UK on Islamic housing finance contracts, or the creation by Freddie Mac of a securitization plan for Islamic mortgages in the US, an environment conducive to IF housing finance was created.

This report attempts to provide a factual introduction and examination of IF with a primary focus on housing finance. The report is intended to assist financial executives and their advisors, Government policy makers, and the general public in understanding Islamic housing finance.

The report is divided into three parts:

- Part I examines the basic principles of *Shari'a* law and their application to financing transactions, both generally and in housing finance. It also makes comparisons between *Shari'a* legal principles and their non-Islamic counterparts, many of which have originated from the same sources.

⁶ Ainley, note 3 at p. 4.

⁷ Haider Ala Hamoudi, “Jurisprudential Schizophrenia: On Form and Function in Islamic Finance”, (2007) 7 (2) *Chicago Journal of International Law Symposium: Islamic Business and Commercial Law* at 605.

- Part II examines Islamic housing finance models in a number of countries, selected to be representative of officially Islamic states, secular states with a Muslim majority, Western states with a Muslim minority, common law jurisdictions and civil law jurisdictions.
- Part III then examines the current state of Islamic housing finance in Canada and the applicable legal, regulatory and administrative context.

These three Parts are preceded by an Executive Summary and followed by a Conclusion and Glossary of Islamic finance terminology.

(2) PRINCIPLES OF ISLAMIC FINANCE.

1. Overview of *Shari'a* Lending.

This part provides an overview of the main concepts of IF applicable to retail financial products, how IF compares with conventional finance, and the main commercial techniques used in Islamic housing finance. Certain of the Arabic terms used in this report are only briefly described or partially described. More information on these terms can be found in the Glossary at the end of this report.

2. The Main Concepts of Islamic Finance.

Shari'a

*Shari'a*⁸ is the formally established sacred law found in the *Qur'an* and based upon Allah's (God's) commandments. IF is based on the principles enunciated in the *Qur'an*, *Sunnah* (the sayings and conducts of the Prophet Muhammad), *ijma* and *qiyas* (laws made by qualified Islamic scholars and jurists).⁹

Shari'a law governs many aspects of life in Muslim countries, from political and economic, to criminal and ethical matters. *Shari'a* is not a codified system of laws, and

⁸ Arabic words can have different spellings depending on the Romanization used: for example '*Shari'a*' is also Romanized as '*sharia*' or '*shari'ah*'; the *Qur'an* also appears as the '*Qu'ran*' and the 'Koran'. Here, we have attempted to use the most common form of Romanization for each Islamic term, as found in the major sources used for this report.

⁹ Hjh Siti Faridah Abd Jabbar, *The Shari's Supervisory Board: a potential problem in Islamic finance?*, Comp. Law, 2008, 29(1), 29-32.

interpretations of its principles vary between different schools of thought and between different scholars.¹⁰

Financial relations also follow *Shari'a* law. IF products, services and institutions therefore cannot engage or contribute to any of the following, the first three of which are relevant to housing finance:

- charge or pay explicit interest, which is considered usury;
- be deemed a gambling contract or involve high risk;
- allow for profit from speculation, exploitation or uncertainty; or
- support endeavours involving gambling, alcohol, pork, armaments manufacture or pornography, among others.

The overarching principles in *Shari'a* are that all forms of interest are forbidden, that fairness and transparency govern all financial relations, and that profit is earned from labour and enterprise rather than speculation.¹¹

Interest/Usury

In *Shari'a*, money is viewed as having no intrinsic value and, instead is considered merely a means of exchange. The payment or receipt of interest is therefore viewed as profiting without effort or labour.¹² While scholars debate whether interest, in its various forms, actually contravenes these *Shari'a* laws barring usury, it is generally accepted within the Muslim community that interest is prohibited.

It is important to note that profit from a risk taken in a commercial enterprise is acceptable, and this can provide a return on investment for financiers or investors.

¹⁰ The four main schools are *Shafi* (followed predominantly in the Far East, e.g. Malaysia), *Hanbali* (predominantly in the Middle East, e.g. Saudi Arabia), *Hanafi* (followed predominantly in South East Asia, e.g. Pakistan) and *Maliki* (followed predominantly in Africa). *Users Guide*, note 2 at p. 3.

¹¹ Islam teaches that money must be used in a meaningful way. Money can be earned through labour, effort or trading, but not from any form of idleness – literally 'money from money'. In the time of the Prophet Mohammad, exorbitant lending rates were prevalent and the thus the payment of interest was forbidden because it led to injustice. Similar prohibitions also exist in the Old and New Testaments.

¹² *Users Guide* at p. 3.

Return on investment in IF is therefore best conceptualized as a shared risk of both profit and loss – the potential for profit based upon investment as well as that for capital loss.¹³ In housing finance, this often means that the financier participates to a certain extent in both an increase or a decrease in the value of the house.

Uncertainty/Unjust Enrichment

Under *Shari'a*, a contract will be considered void if any fundamental term contains uncertainty (*gharrar*). The uncertainty principle is linked to the concept that one should not profit from endeavours that deceive or rely on a power imbalance. Profit is expected to be earned from effort and labour only, such as by trading or manufacturing.

The uncertainty principle is wide and uncertainty as to the subject matter, price, time of delivery or parties will automatically void a contract. Further, uncertainty can arise due to the nature of the agreement itself. This is a major complication in Islamic housing finance because, in addition to a *Shari'a*-compliant mortgage, an Islamic form of insurance, called *takaful*, is required as well.

In addition, contracts where one party is viewed as having gained unjustly at the expense of another are prohibited. This principle includes situations where one party is enriched while exercising duress or undue influence on the other party. It is not possible, for example, for a defaulting debtor to be charged a default fee by a creditor, as the obligation to pay the fee would be considered undue pressure to discharge a contractual obligation. The implications of this prohibition for housing finance are discussed in greater detail in Part III.

Speculation

Commercial risk that can be considered akin to gambling is strictly prohibited under *Shari'a*. Contracts that involve such speculation (*maisar*) are therefore considered void. This principle may taint certain conventional insurance arrangements because the uncertainty as to whether the insured event will ever occur may cause such arrangements to be considered to be speculative. The test is whether something has

¹³ Tim Plews, *Establishing Islamic banks in the West: The case of the Islamic Bank of Britain*, Islamic Retail Banking and Finance: Global Challenges and Opportunities (Euromoney Books:London, 2006) at p. 37.

been gained by chance rather than productive effort, and therefore inherent risk in an otherwise valid commercial venture will not void a transaction. Investments that rely even in part on speculation are not permitted. This excludes conventional derivatives, futures, hedges and many other products that have become familiar to conventional investors. However, speculation is generally not an issue with Islamic housing finance, or most other retail financial products.

Unethical Investments

IF investments must conform to ethical prohibitions against investing in industries that are not considered moral. These include industries involving gambling, alcohol, pork, armaments and pornography, among others. This is generally not an issue in housing finance. However, it does arise with retail investment products. Determining whether a particular company or investment product conforms to *Shari'a* can be difficult without expert guidance. Many investors, for example, would not be able to accurately gauge the full scope of business of a large multi-national corporation. Consequently, major investment institutions in most states surveyed have created verified IF-compliant investment products.

3. How IF Compares to Conventional Lending.

While *Shari'a*-compliant financiers are not allowed to receive a guaranteed return, such as interest, they can invest in profit-sharing ventures that involve business risk, or lease transactions without interest.¹⁴ In addition to a narrower scope of permitted lending and borrowing, IF involves several other considerations. These include: certifying *Shari'a* compliance through the use of boards of scholars, additional investment risks (that in turn lead to higher transaction and/or funding costs), the involvement of third parties in order to facilitate transactions, and the effects of certainty and transparency on both payment schedules and profit margins.

Shari'a Boards or Committees

Financial or business ventures offering products and services must have some mechanism to confirm that their offerings are compliant. Most IF products are therefore

¹⁴ Zamin Iqbal, *Islamic Financial Systems*, Finance & Development, June 1997, Volume 34, No.2.

vetted by a board or committee of religious scholars that scrutinizes any proposal for compliance with the Islamic precepts mentioned above.¹⁵ Individual transactions are also vetted by Islamic scholars. Scholars are religious experts who have been trained through both university and religious institution-based courses of study in religion, law and finance.

Boards generally meet at regular intervals to review products or transactions and to issue an opinion (*fatwa*) to validate each one. Although different *Shari'a* committees may have differing views in respect to a specific issue, this is mitigated by the fact that scholars may sit on the *Shari'a* boards of more than one institution. The divergence of views on a particular issue is primarily geographically determined.¹⁶

Since IF standards and interpretation differ by nation and geographic region, the resulting *Shari'a* 'arbitrage' means that products and services that are considered valid in one market may not be so viewed in another,¹⁷ or within a market some products or transactions may be generally accepted whereas others may be subject to debate among scholars. A related issue is that of compliance throughout a product or service lifecycle. Though *Shari'a* approval is generally only sought at the beginning of a transaction, compliance is in reality an ongoing obligation. In the UK, for example, the Financial Services Authority has advocated an 'internal *Shari'a* audit' process.¹⁸

While global players such as Citibank, UBS, HSBC or Deutsche Bank are able to retain *Shari'a* boards, there is a worldwide shortage of scholars to sit on such boards or to vet individual transactions.¹⁹ Further, the shortage of recognized scholars is expected to worsen over time given the twin factors of explosive growth in the sector and the lengthy process for training new scholars.²⁰

¹⁵ *Users Guide* at p. 4.

¹⁶ Iqudeer Latif, *Introduction to Islamic Finance*, Legal & Commercial Publishing Limited, 2008, at p. 4.

¹⁷ Ainley at p. 16.

¹⁸ Ainley at p. 17.

¹⁹ Mohammed Abbas, *As Islamic banks boom, scholars are hard to find*, Reuters, January 21, 2008.

²⁰ Abbas, note 19.

Increased Risks, Higher Costs

The introduction of IF instruments or services into a conventional market initially carries increased risks for both consumers and lenders, with commensurately higher transaction costs. First, with little experience in offering IF products, financial institutions are less able to evaluate the risk of default and other costs of borrowing for these accounts. A lack of familiarity can lead to higher transaction and monitoring costs.

This increased uncertainty is a risk that must then be accounted for in the cost of borrowing, making IF products potentially less attractive, on a strictly monetary basis, than their conventional counterparts.

For example, an IF-compliant mortgage using an *ijara* (lease) or *murabaha* (purchase and resale) transaction, presents an increased risk for lenders, who are required to take on an ownership role jointly with a customer in the purchase of a home. This is contrasted with a conventional mortgage where the customer retains sole title and the lender has only a lien on the property. Lenders who undertake this interim ownership role may face exposure to liability for losses, taxes, labour, or environmental concerns as owners. In addition, there may be further risks of liability to the customer if a dispute as to title arises. Finally, there is a difficulty in acquiring insurance to offset these risks given *Shari'a's* restrictions in that field.²¹ A lender must therefore charge additional fees or a higher rate to offset these risks and expenses. These costs are highest when an IF industry is underdeveloped. More efficient markets such as the UK and US have relatively modest increases in costs for IF customers.

In the case of mortgage products, there is a very real concern in that compliance rules could change during the life of an agreement based on a particular product, throwing into question its enforceability. This has the effect of discouraging firms from bringing IF products and services to market, and also increases risks for those who do.

Parties

In IF transactions, additional parties than those found in a conventional transaction may be required to facilitate the steps required to complete the transaction. Lenders, for

example, often act as the purchaser of an asset and may have interim title, with its commensurate responsibilities and liabilities. IF-compliant investment schemes, such as *murabaha*, often require an investment agent. While conceptually similar to a fund manager, agents in IF transactions can have other responsibilities, such as signing authority for both purchasers and customers.

In some transactions, a party may take on several roles in succession, each of which must be clearly documented. For example, a purchaser can be appointed as an agent (*wakeel*) for an investment agent in order to purchase an asset. The purchaser can then be directed to purchase the asset from the investment agent, with a management agreement of the asset assigned back to the investment agent.²² As above, the additional roles required of parties to an IF transaction or the involvement of third parties can raise transaction costs, and increase risks or give rise to conflicts of interest. An apt comparison in conventional finance would be mutual fund structures, where potential conflicts of interest are highly-regulated by way of complex rules, regulations and governance requirements.

Prepayment

While prepayment is common in conventional finance, and can often result in a reduction in financing charges, prepayments in IF are different. Under *Shari'a*, prepayments must be for an amount that is certain and unchanging, with the total profit fixed. As profit may change over the life of the agreement, a buffer or reduction in discount is necessary to offset the risk for the financier. While an IF agreement can contain a clause that allows for a rebate to be paid to offset changes in market conditions over the life of an agreement, these rebates cannot be mandatory.²³

Determination of Profit/Treating Customers Fairly

Profits must be determined in advance to meet the requirement of certainty. Nevertheless, profits can be calculated in part by reliance upon published benchmarks.

²¹ Though mutual-type *takaful* instruments, discussed below, may be used as a substitute for true insurance.

²² *Users Guide* at pp. 12-13.

²³ *Users Guide* at p. 19.

Transparency of the profit element in a transaction is part of the larger principle of treating all parties to a transaction fairly. In a lending relationship such as a mortgage transaction, this translates to a requirement of a financier to “pay due regard to the interests of its customers and treat them fairly.”²⁴ This additional level of disclosure requires the lender to state faults, disclose profits and avoid misrepresentations.²⁵

4. Financial Instruments.

IF financial instruments can be grouped according to their secular counterparts – insurance, mortgages, debt and secured financing, leasing and so on. IF has developed a catalogue of sophisticated solutions to the investment and financial needs of Muslims. In many instances, these are compatible and viable within a Western financial environment.

Debt Financing

Ijara, that is akin to leasing, is the most common structure used as an alternative to secured debt financing in order to finance an asset for a purchaser. As will be discussed below, *ijara* is most often used in the purchase of a home; however, it may be used for the purchase of whole businesses, equipment or other depreciable assets as well, including consumer goods. In an *ijara* arrangement, the lender agrees to purchase the asset chosen by the borrower, who in turn pays rents or lease payments. These payments are calculated to be paid over a schedule, and to add up to a pre-determined total price. Upon the completion of the payment schedule, title to the asset is signed over to the borrower. Conceptually, *ijara* is comparable to rent-to-own or lease-to-buy arrangements in conventional consumer and commercial asset-based financing.

Commercial Lending

Conventional commercial lending is difficult to replicate in IF due to *Shari'a's* requirement that any financing be backed by tangible assets. The most common vehicle for acquiring cash is through the use of *sukuk*, a form of bond that monetizes the present value of an asset's future cash flow – a concept extensively used in

²⁴ Ainley at p. 22.

²⁵ For a general discussion of the requirement for commercial ethics, See Vogel, note 1 at p. 65.

conventional structured finance as well. *Sukuk*'s are essentially corporate bonds that are structured similarly to asset-backed securities (ABS). However, contrary to conventional ABS that are usually backed by financial assets, *sukuk* must be backed by tangible assets or a right of use or services.²⁶ *Sukuk* is generally combined with other IF vehicles, such as *ijara* or *murabaha*, depending on the structure of the particular arrangement. While *sukuk* borrowing is viable for corporations, governments and projects as a way of obtaining funds, its application in housing finance is limited to the secondary market.

Insurance

While insurance can serve as an investment vehicle, it is primarily used as a shield against risk both in IF and conventional finance. However, conventional insurance arrangements are not considered permissible under *Shari'a* law because of the uncertainty principle. Since the insured risks may not come to pass, conventional contracts of insurance are considered speculative. Therefore, insurance models compliant with *Shari'a* law have had to develop. IF insurance products (*takaful*) operate by mutual risk sharing, that taken literally means "guaranteeing each other" (*kafalah*). *Takaful* products differ from conventional (non-mutual) insurance products by eliminating uncertainty, as well as any element of gambling or interest. In a *takaful* fund, payments akin to premiums are made into a central fund, managed by a *takaful* operator. Payments to cover an individual's losses are viewed as helping another person in need. Uncertainty is eliminated as payments and compensation are fixed.

Investment

IF investments must be in industries, products or companies that derive profits from trading or manufacturing, rather than speculation or interest. Further, they must comply with the ethical prohibitions noted above, in addition to other *Shari'a* requirements. This can rule out a wide range of companies, such as hotel chains with gaming operations or supermarkets that sell pork and alcoholic beverages.²⁷ All conventional banks and

²⁶ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Statement on Sukuk, 2008.

²⁷ Rodney Wilson, *Islamic Finance in Europe*, RSCAS Policy Papers, European University Institute – Robert Schuman Centre for Advanced Studies, PP 2007/02, at p. 15.

financial institutions are ruled out due to the prohibition against interest. Nevertheless, there are several funds, both worldwide and in Canada that manage to invest outside of these prohibited areas. The Dow Jones Islamic Index, for example, is comprised solely of companies that meet these requirements and that have less than one-third of their market capitalization in borrowed funds.²⁸ It is also of note that *Shari'a*-compliant funds tend to outperform the market when bank shares are faring badly, and to under-perform when bank profits are healthy.²⁹

Cash investments akin to savings accounts can also be achieved under IF. The Islamic Bank of Britain, for example, offers treasury accounts with fixed terms for investors. Returns are greatest for the longest investment periods. The deposits are structured on a *murabaha* basis, which means that the funds are used to buy and sell commodities on the London Metal Exchange. Purchase and resale is hedged, thus avoiding movements in spot rates. While this exposes depositors to increased risks and reduced liquidity, it allows an investment vehicle for cash on relatively short-term deposits.³⁰ Any investment involving futures or derivatives is strictly prohibited.

5. Mortgage Lending.

According to Thomas, current demand exceeds the supply of IF capital for housing finance, and this requires both financing and capital market funding solutions.³¹ In Canada, *Shari'a*-compliant mortgages currently cost between 100 and 300 basis points more than comparable conventional mortgages due to their scarcity and firms' relative inexperience with these products and lack of access to funding.³² In contrast, IF mortgages have a spread of only 40 to 100 points over their conventional counterparts in the US. This is due in part to the maturity of IF lending there. Both Fannie Mae and Freddie Mac, the two US housing finance authorities for example, are participating in

²⁸ Wilson, note 27 at p. 15.

²⁹ Wilson at p. 15.

³⁰ Wilson at p. 8.

³¹ Abdulkader Thomas, "Structuring Islamic mortgage and home finance products", *Islamic Retail Banking and Finance: Global Challenges and Opportunities*, (London: Euromoney Books, 2006) at p. 75. Thomas notes that this trend is true across jurisdictions, whether in Western countries with an affluent Muslim minority (e.g. the United States), developing nations with a growing middle class (e.g. Malaysia), or in poor Muslim countries (e.g. Pakistan).

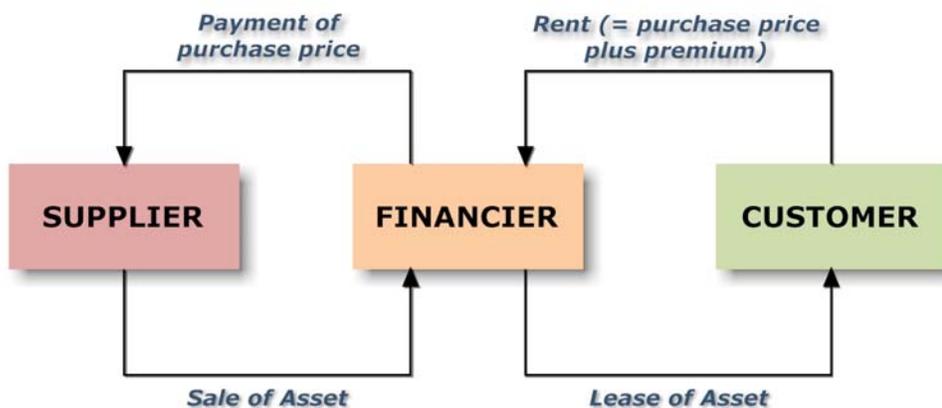
³² Carrie Talt, *Faith-based mortgages court Muslims*, Financial Post, May 23, 2007.

the US secondary market.³³ Currently, IF-compliant mortgages are offered in Canada only by a few small enterprises and there is no real secondary market to speak of.

There are several viable arrangements for offering IF-compliant mortgages, but three main *Shari'a*-compliant vehicles are typically used in other countries: *ijara* or lease contracts, *murabaha* (sale and resale with mark-up) and *musharaka* (joint ownership).

In an *ijara*-based mortgage, the financial institution partners with the customer to purchase the home. A valuation is undertaken and the costs of borrowing over the amortization period in conventional transactions are referenced to set a lease rate that pays off the house over the amortization period. Strictly speaking an *ijara* could be understood as just a lease. As a financing model, however, an *ijara* is really a deferred asset sale akin to a lease with a bargain purchase option at the end of the term. The bank retains title to the home, and the customer pays monthly “rental” payments. Upon the conclusion of the rental period, the bank signs the title of the home to the customer, concluding the transaction.

IJARA



Graphic from Islamic Finance: Overview, Legal & Commercial Publishing Limited

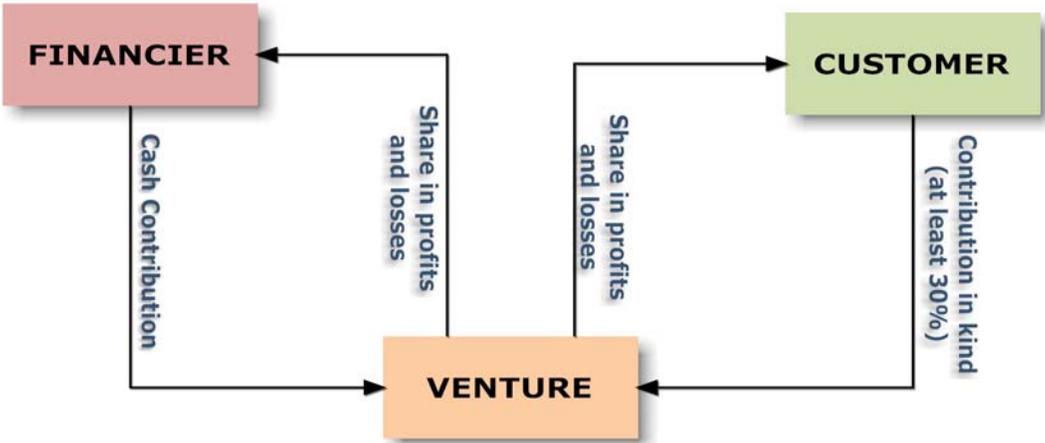
Rents can be fixed, reset at agreed periodic intervals based on agreed benchmarks, or variable based on an agreed index. Similarly, *ijara wa iqtina*, or lease and acquisition,

³³ Talt, note 32.

has been widely accepted by both Muslim scholars and consumers in many Western countries.³⁴ In this arrangement, the lender purchases the property chosen by the customer, and the two parties enter into a leasing arrangement in favour of the customer. In some transactions, the lender agrees to assign its ownership to the customer at a fixed point in time. Lenders prefer these methods of home financing as they allow changes to reflect altered credit risk, market conditions or payment history, and are more easily securitized than other methods.³⁵

Long-term housing finance can also be facilitated through the use of co-ownership arrangements (*musharaka*) or purchase and re-sale at a mark-up (*murabaha*). In *musharaka*, the joint interests of the home buyer and financial institution are recorded on title, with the customer buying down the financial institution over time.

MUSHARAKA



Graphic from Islamic Finance: Overview, Commercial Publishing Limited

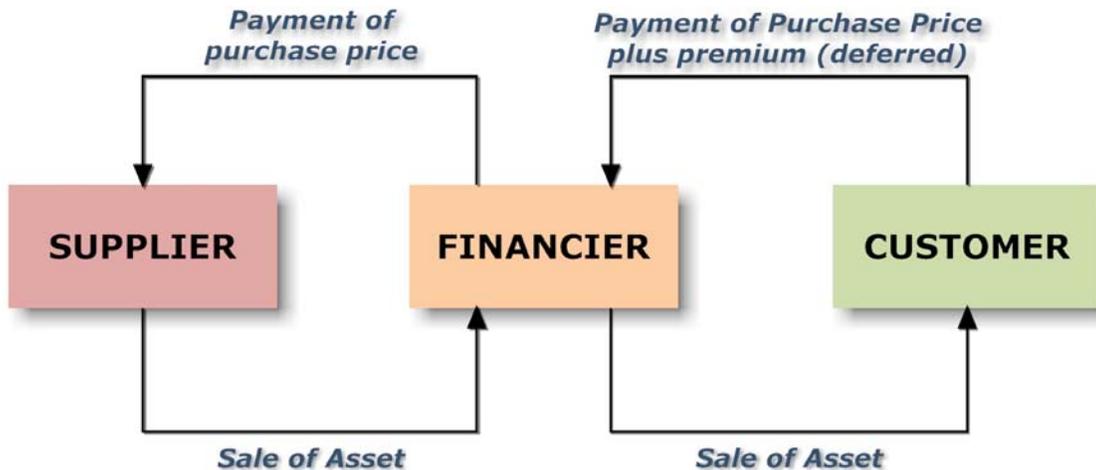
In *murabaha*, the financier purchases the property and immediately sells it to the customer for the original price plus an agreed-upon profit margin. The customer pays

³⁴ Thomas, note 31 at p. 81.

³⁵ Thomas at p. 81.

this higher price in deferred payments according to a fixed payment schedule.³⁶ In *murabaha*, the property is immediately re-sold to the home buyer.

MURABAHA



Graphic from Islamic Finance: Overview, legal & Commercial Publishing Limited.

Finally, some institutions have offered integrated *ijara* and *murabaha* mortgages, with the lender and customer entering into a partnership agreement. In these arrangements, the lender pays up to 90 per cent of the capital with the customer paying the remaining 10 per cent.³⁷ Payments are then scheduled as rents for amortization periods up to 25 years. An advantage to this kind of mortgage agreement structure is that rents can be variable. As an incentive to customers, lenders can make initial payments smaller than later payments to coincide with a customer's expected rise in income over the life of the agreement.³⁸ This arrangement can also serve to offset or delay the additional costs associated with an IF mortgage, making it more attractive for customers.

³⁶ Ainley at p. 20.

³⁷ Wilson at p. 10.

³⁸ Wilson at p. 11.

All IF mortgage vehicles face an additional issue: as the lender or financier is the party who initially acquires title, and the customer subsequently acquires title upon the completion of the rental or leasing period, taxes and land transfer fees are potentially charged twice during the life of the transaction.³⁹ The most direct way to address this issue is by way of regulatory change. In the UK, for example, the Government eliminated double “stamp duties” (a tax on legal documents) for IF mortgages, making *Shari’a*-based mortgages more competitive. However, administrative changes by tax authorities and/or creative transaction structuring can be employed as interim measures.⁴⁰

Istisnaa

While *ijara* or murabaha-based mortgage products are generally used to finance purchases of an existing home, *istisnaa* agreements are used where the asset has yet to come into being, such as an unbuilt house.⁴¹ In housing finance, *istisnaa* involves the sale of a house under construction - at cost plus profit. Generally, it is used for construction of larger buildings; however, it can also be used to finance the construction of a single dwelling. In this arrangement, the lender agrees to develop the proposed property for the customer, with the latter taking delivery upon completion. Payment may be in phases, upon completion, or according to a rental schedule over a longer period. In order to protect the customer, *istisnaa* agreements often include a liquidated damages clause whereby the lender is liable to bear a daily charge beyond the agreed upon delivery date. The total penalty is then deducted from the original price.⁴²

Differences Across Markets

It is worth noting that jurisdictions appear to have differing preferences with regard to which of the above IF structures are used in housing finance. In the UK, for example, *ijara* is prevalent. In the US, by contrast, *ijara* and *murabaha* are both used extensively and many institutions offer both, and diminishing *musharaka* is becoming more popular.

³⁹ This is discussed in detail in Part III.

⁴⁰ See Part III, “Legal Issues”.

⁴¹ Sohail Zubairi, *Home finance schemes in the UAE: A case study*, Islamic Retail Banking and Finance: Global Challenges and Opportunities (Euromoney Books: London, 2006) at p. 96.

⁴² Zubairi, note 41 at p. 96.

These variations may be explained, in part, due to borrowers' preferences in terms of features and beliefs, as well as the regulatory obstacles that have to be over-come and how best this can be achieved in a particular jurisdiction.

6. Funding.

In contrast to conventional banking that is funded by capital, interest-bearing deposits and inter-bank deposits, Islamic banking operates on a strictly profit-sharing basis.

There are three major sources of funds for an Islamic bank: (1) the bank's own capital and equity; (2) transaction deposits; and (3) investment deposits. Transaction deposits are guaranteed their nominal value and the bank pays no return on the deposit. Funds used through this type of deposit cannot be used for profitable investment. In the circumstances, banks will likely levy a service charge on deposit holders.⁴³

Investment deposits are the principal source of funds for Islamic banks. They resemble shares in a firm rather than a conventional bank deposit. In such a deposit there is no guarantee of return, but rather a contract between the bank and the depositor whereby the depositor is entitled to a share of the profit or loss of the bank. The profit/loss ratio will be agreed to by the parties in advance.⁴⁴

This severely constrains the ability of an Islamic bank to raise the funding required for a sizeable housing finance portfolio, thereby making pure Islamic housing finance difficult in the absence of a secondary market. This is discussed more extensively in Part III.

⁴³ Abdel Karim Halabi & Abdul Malik Mirza, *Islamic Banking and the Housing Industry*, www.housingfinance.org.

⁴⁴ Karim Halabi & Malik Mirza, note 43. The closest comparator in conventional financial institutions would be credit union member shares.

PART II. APPLICATION OF *SHARI'A* TO MORTGAGE LENDING INTERNATIONALLY

(1) INTRODUCTION.

The application of *Shari'a* to the mortgage industry⁴⁵ internationally differs in significant ways from that of other areas of IF investment and finance. It primarily serves individuals rather than institutions: it is more state-centric and less internationalized than other forms of finance and investment; it does not necessarily develop alongside the development of other forms of investment and finance; and, it is intimately linked with domestic policies and politics. As discussed in Part III, *Shari'a*-compliant housing finance must develop within a fairly complex framework of mortgage, land title, insurance and consumer protection legislation.

In recent years several small companies have begun offering limited *Shari'a*-compliant home financing options in Canada, although with higher financing charges, and higher transaction costs than conventional products. The situation in Canada is not unique, and the experiences of other countries with applying *Shari'a* principles to mortgage lending are illustrative of how the product develops.

This Part examines the development of IF housing finance in several countries. In most cases, the development of these markets has occurred with a mix of public and private investment, government regulatory adaptation, and a gradual increase in competition in the marketplace. In certain instances (e.g. UK, New Zealand), jurisdictions have adopted specific laws to facilitate IF housing finance, while in others (e.g. US, Australia, France) these financing instruments are being offered without significant legislative changes.

Second, secular states with large Muslim populations (e.g. Turkey, Algeria, Malaysia) provide a useful portrait of markets where *Shari'a*-compliant mortgage products could

⁴⁵ Bill Maurer, *Pious Property: Islamic Mortgages in the United States*, (New York: Russel Sage Foundation, 2006) at p. 4. *Shari'a* mortgage lending is, in itself, a misnomer. *Shari'a*-based mortgages are generally not mortgages at all but rather one or more of several *Shari'a*-compliant products that serve to effect a similar outcome for IF consumers: the purchase and eventual ownership of real property. Companies offering these products often market them as 'Islamic mortgage alternatives' or 'Islamic mortgage replacement products'. With this caveat in mind, these terms will be used interchangeably here, and are implicit wherever the term 'IF mortgage' is used.

become prominent. In fact, IF mortgage lending in these markets currently face many of the same obstacles as in predominantly non-Muslim states.

Third, wholly Islamic states (e.g. Saudi Arabia, Pakistan, the Gulf-Co-operation Council (GCC) states), offer a view as to how the development of *Shari'a* mortgage lending nevertheless can be slow. In some states (e.g. Pakistan, Malaysia), *Shari'a* is melded with an English common law tradition similar to that of Canada (excluding Quebec).

Finally, there are no significant differences among states with English common law-based legal systems (e.g. UK, US, Pakistan, Malaysia, New Zealand, Australia) and states with civil law (e.g. France, Algeria, Turkey, Lebanon). Research indicates that the legal instruments used for IF mortgage lending are recognized and function much in the same way in both the common law and civil law systems.

For each category of jurisdiction, the report attempts to:

- determine what kinds of *Shari'a*-compliant instruments are being used in mortgage lending;
- estimate the market size and geographic breakdown of both conventional and *Shari'a* mortgage lending; and
- explain the legal and regulatory environment in each state, including whether IF financing is regulated or not.

In many instances reliable information does not exist on some of the above-mentioned points. The report nevertheless attempts to provide a comprehensive review sufficient to inform policy-makers and financial executives in Canada as to how *Shari'a*-based mortgage lending works.

(2) WESTERN SECULAR DEMOCRACIES.

1. The United Kingdom.

The UK is the most developed IF market in the Western world. As such, it is worthy of a detailed examination regarding the development of *Shari'a* mortgage lending.

The Development of a *Shari'a*-compliant financial market in the UK

As IF has grown globally, the UK has sought, with considerable success, to position itself as an emerging global “hub” of IF.⁴⁶ Although *Shari'a*-compliant financial transactions were taking place in the London financial markets as early as the 1980s, these were aimed exclusively at wholesale and high net-worth investors and based on the *murabaha*-type of transaction.⁴⁷

Retail Islamic products took another decade to appear and, even then, only to a limited degree. The market began to grow considerably in the new millennium as rising oil prices began to create excess liquidity in the Middle East. Major lending institutions such as Citi, Deutsche and HSBC began to establish a greater presence in the Middle East and South/South East Asia. These firms established business lines known as “Islamic windows”, that contributed significantly to the development of IF retail products as they increased access to greater resources and increased the global experience in product development.⁴⁸

Insofar as the *Shari'a*-compliant retail financial market is concerned, volume is modest in the UK and is estimated at only £500 million compared with mortgage lending as a whole in the UK at over £1.1 trillion.⁴⁹ Thus, assuming the accuracy of these estimates, IF mortgages would represent only 0.045% (forty-five one hundredths of 1%) of the UK mortgage market.

Research suggests that there are a number of reasons for this modest growth in the UK retail market for *Shari'a*-compliant financial products. These include:

⁴⁶ Juan Sole, “Islamic Banking Makes Headway”, online: <<http://www.imf.org/external/pubs/ft/survey/so/2007/RES0919A.htm>>.

⁴⁷ Ainley, note 3 at p. 6.

⁴⁸ Ainley at p. 7.

⁴⁹ “Speech by the Economic Secretary to the Treasury, Ed Balls MP, to the Euromoney Conference on Islamic Finance”, online: <www.hmtreasury.gov.uk/newsroom_and_speeches/speeches/econsecspeeches/speech_est_300107.cfm>.

- A lack of information and knowledge about Islamic financial services within the Muslim community;⁵⁰
- Scepticism of *Shari'a* permissibility even of those financial products that have received the approval of recognized *Shari'a* scholars;⁵¹
- Education, occupation and income levels;⁵² and
- Cost, as compared with conventional mortgage finance.

These factors appear to have constrained the demand for *Shari'a*-compliant mortgages in the UK. It is estimated that there is a potential Islamic mortgage market of roughly 45,000 households in the UK, giving rise to a potential market valued at somewhere between £3 billion and £4.5 billion (in 2006).⁵³

Surprisingly, the experience of the UK may suggest that high urban density has a negative relationship with demand for IF products. Demand for *Shari'a*-compliant mortgages appears to be highest in the north of the country and lowest in London and its suburbs where the majority of British Muslims live.⁵⁴

Humayon Dar⁵⁵ suggests that the market for Islamic financial services in the UK is supply-led and that those entering the market will have to create demand for their products.

While these observations may suggest that the market for *Shari'a*-compliant financial services may not be as large as some thought originally, recent events indicate that the IF market may be more resilient than conventional mortgage lending. Some have suggested that the 2007-08 credit crunch did not hit the Islamic mortgage market with the ferocity it did in other markets. This may be due in part to the relatively small size of

⁵⁰ Humayon A. Dar, "Demand for Islamic Financial Services in the UK: Chasing a Mirage?", *Loughborough University Institutional Repository*, at p. 1.

⁵¹ Dar, note 50 at p. 14.

⁵² Dar at p. 17.

⁵³ Dar at p. 16.

⁵⁴ Dar at p. 17.

⁵⁵ Lecturer, Department of Economics, Loughborough University, Leicester, UK.

the market, the fact that much of the money behind Islamic lenders appears to be “oil-backed”, and that there is less room for leveraging in a *Shari’a*-compliant mortgage model.⁵⁶ However, it may simply be that loans were made more prudently to higher income households. Also, with mainly real estate assets, Islamic banks are naturally illiquid and are required to hold more cash than conventional peers in order to pare illiquidity risks.

Islamic Mortgage Instruments in the United Kingdom

In the UK mortgages have been generally structured under two different *Shari’a*-compliant contracts; the *murabaha* and the *ijara*.⁵⁷ The *murabaha* is defined as a “regulated mortgage contract” by the Financial Services Authority of the UK (the FSA) and is regulated in the same way as a conventional mortgage.⁵⁸

Ijara-based contracts can be divided into two types: the *ijara* and the diminishing *musharaka*. An *ijara* applied to housing finance operates functionally as a capital lease.

A variation on this model is the diminishing *musharaka*. In this model the transfer of ownership from the financier to the customer is gradual: as payments are made, over time the customer gradually buys the financier’s equity in the property.

The Regulatory and Legislative Framework in the United Kingdom

Regulation by the FSA

Originally, although *murabaha*-type mortgages were regulated by the FSA because they fell under the definition of a “regulated mortgage contract”,⁵⁹ *ijara*-based contracts were unregulated. This was seen as a considerable weakness as it meant that *ijara* customers were potentially vulnerable to mis-selling and unfair treatment without proper redress or the same level of protection as customers taking out conventional

⁵⁶ “Islamic Mortgage Range to Expand”, online: <[http://www.islamicmortgages.co.uk/index.php?id=184&tx_mininews_pi1\[showUid\]=57&cHash=b8dc87963e](http://www.islamicmortgages.co.uk/index.php?id=184&tx_mininews_pi1[showUid]=57&cHash=b8dc87963e)>.

⁵⁷ Ainley at p. 20.

⁵⁸ Ainley at p. 20.

⁵⁹ Article 61(3), *Regulated Activities Order*.

mortgages.⁶⁰ This weakness was addressed in the *Finance Act, 2007* when *ijara*-based contracts and diminishing *musharaka* arrangements were brought into the FSA regulatory framework as “home purchase plans”.

A “home purchase plan” is defined as an arrangement under which, at the time it is entered into:

- A person (the home purchase provider) buys a qualifying interest, or an undivided share of a qualifying interest, in land (other than time share accommodation) in the UK;
- An individual or trustee whose beneficiary is an individual (the home purchaser) is obliged to buy that interest over the course of or at the end of a specified period; and
- The individual or a related person is entitled to use at least 40% of the land as a dwelling during that fixed period and intends to do so.⁶¹

What this means is that an arrangement will not qualify as a home purchase plan (and thus will not be regulated by the FSA) if:

- The home purchaser is not an individual or a trustee;
- The land is used for the purpose of renting it as a dwelling to someone other than a related person of the individual who is obliged to buy it; or
- The land is used primarily for business purposes.⁶²

Regulatory Changes for Tax Treatment

Not only has it been necessary to amend the consumer regulatory framework to ensure that customers purchasing *Shari'a*-compliant products have a “level playing field”, but the tax treatment of these products also had to be addressed.

⁶⁰ “New Legislation Increases Fairness for Islamic Homebuyers”, online: <www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_58_05.cfm>.

⁶¹ Article 63F(3), *Regulated Activities Order*.

⁶² Perimeter Guidance Manual 14.4, *Financial Services Authority Handbook*.

Stamp Duty Land Tax

Under normal UK tax law principles each transfer of ownership of land is subject to the payment of Stamp Duty Land Tax (SDLT). It was perceived that the application of normal tax principles to *Shari'a*-compliant mortgage models gave rise to inequality and created a barrier to social justice.⁶³ This arose because these models of finance involve two sales or transfers of title: one to the bank/financier and one (at a later date) to the customer, thus giving rise to a double liability for SDLT.

This was addressed in April 2003 when double liability for SDLT was abolished. In respect of the *ijara*-based model, section 71A of the *Finance Act, 2003* provides relief from double SDLT where arrangements are entered into between a customer and a financial institution under which the financial institution:

- Buys a freehold or leasehold interest in land (or an undivided share that is held in trust for the institution and the customer as beneficial tenants in common);
- Grants a lease (if the freehold is purchased) or sub-lease (if a leasehold is purchased) to the customer; and
- Agrees with the customer that the customer has a right to call for the interest purchased by the financial institution.⁶⁴

In respect of the *murabaha*-based model, section 73 of the *Finance Act, 2003* provides relief where arrangements are entered into between a customer and a financial institution under which the financial institution:

- Buys a freehold or leasehold interest in land;
- Sells that interest to the customer; and
- Is granted a legal mortgage over the interest by the customer.⁶⁵

⁶³ Speech of the Rt. Honourable Gordon Brown, MP, Chancellor of the Exchequer, March 23, 2005.

⁶⁴ Section 71A, *Finance Act, 2003*.

⁶⁵ Section 73, *Finance Act, 2003*.

While intending to put *Shari'a*-compliant mortgages on a more level playing field with conventional mortgages, these SDLT relief provisions created an inadvertent tax avoidance loop-hole whereby SDLT could be avoided by placing ownership of a property in a subsidiary of the financial institution and subsequently selling shares in the subsidiary company rather than the property.⁶⁶

It is estimated that the use of this loophole allowed commercial property investors to avoid paying SDLT on more than £1 billion (\$1,985,237,101.81 CAD) worth of transfers that would otherwise have been subject to SDLT at 4 per cent.⁶⁷

When this unintended consequence was discovered, a new anti-avoidance provision was added via the Stamp Duty Land Tax (Variation of the *Finance Act* 2003) Regulations 2006.⁶⁸ Further changes to the anti-avoidance provisions were announced on March 12, 2008 with the stated purpose of preventing abuse where financial institutions assist parties to avoid payment of SDLT.⁶⁹

Prudential Requirements: Basel and the EU

Under Basel I, *murabaha*-based home finance products were considered to have the same risk as conventional mortgages, risk weighted at 50%. *Ijara*-based products were risk weighted at 100%, presumably because they were carried as property rather than financial assets by the lender. This made them more expensive than conventional mortgages. In the European implementation of Basel II, the EU Capital Requirements Directive, the risk weights of all three products are the same in the UK and elsewhere in Europe, set at 35%.⁷⁰

⁶⁶ “Shari’a SDLT Loophole Closes”, online: <[http://www.taxation.co.uk/Articles/2008/03/12/52921/Shari’a+SDLT+loophole+closes.htm](http://www.taxation.co.uk/Articles/2008/03/12/52921/Shari'a+SDLT+loophole+closes.htm)>.

⁶⁷ James Rossiter “Chancellor to Close Loophole”, *The Times* (March 5, 2008).

⁶⁸ Section 75A, *Finance Act*, 2003.

⁶⁹ HM Revenue & Customs Budget Note 60, 2008.

⁷⁰ Ainley at pp. 19 and 21.

2. The United States.

Overview of the Market

The US has significant experience with IF products and services and the Muslim community is said to have attained the critical mass needed to sustain a viable market.⁷¹ IF products and services in the US tend to be ‘hybrid’ creations of certain *Shari’a* scholars, government regulation and the financial markets.⁷² The pace of economic growth prior to the financial crisis appears to have fuelled the market, but it has also been observed that once a point of critical mass occurs in the market, growth of the IF mortgage industry will accelerate.⁷³ In this regard, the US has had a different development arc than the UK. Several factors have contributed to this growth in the industry, although it is not clear which factor or factors have been determinative.

IF Mortgage Instruments in the United States

The American Finance House underwrote the first IF mortgage in 1987 for the purchase of a home in Madison, Wisconsin.⁷⁴ The contract was based upon a *murabaha*, or cost-plus model, where the financier purchased the property and the client paid the cost at a preset rate over a period of time. Since then, IF mortgage lending in the US has grown in fits and starts, with the Saudi firm Dallah al-Baraka opening an office in California in 1988.⁷⁵ In 1998, the United Bank of Kuwait (UBK) followed suit, only to withdraw from the US market for failure to achieve acceptable penetration into its target communities after providing over 60,000 IF mortgages over two years.⁷⁶

⁷¹ Estimates put the Muslim population in the US between 0.5% and 3% of the US population. Source: Maurer, note 45 at pp. 8 and 20. These statistics are compounded by difficulties in demographic assessment and reporting in the US. For example, do Malaysian-Americans identify as ‘Asian’ or ‘Muslim’ in surveys? The US census does not ask religious affiliation and, consequently, there exists no clear data for determining the US Muslim population. At the 1.75% mid-point of these estimates, the Muslim population in the US would be similar in percentage terms to that of Canada.

⁷² Thomas at p. 75.

⁷³ Thomas, note 31 at p. 75.

⁷⁴ Maurer at p. 33.

⁷⁵ Maurer at p. 33.

⁷⁶ Maurer at p. 33. Similar experiences were had by The Ameen Housing Cooperative in California and MSI (an outgrowth of the Islamic Circle of North America) in Houston, Texas, among others.

The real growth in IF mortgages in the US did not arise until 2001, when Freddie Mac invested \$1 billion in existing American Finance House mortgages.⁷⁷ It has since invested approximately \$45 billion in IF mortgages and has purchased leases from other companies. In 2005, Fannie Mae similarly agreed to purchase \$10 billion in Islamic financing contracts.⁷⁸ Private sector firms also provide their own products. In 2002, for example, General Financial partnered with Freddie Mac with an initial commitment of \$200 million. HSBC, Deutsche, Citi and others have similarly entered the market. Thus the IF mortgage market leapt from virtually nothing in 2000 to over \$300 billion US a year in 2005 and growing.⁷⁹

One of the results of this market development has been a dramatic drop in the waiting period to obtain an IF mortgage. Prior to the entrance of Freddie Mac and Fannie Mae, potential clients waited as long as six years to get an Islamic mortgage due chiefly to limited capital.⁸⁰

These products have not been without criticism, however. Freddie Mac, for instance, continues to use standard mortgage paperwork with an addendum that simply changes the word “interest” with “rent” or “profit”. Some Muslims feel that these “Islamic” mortgages merely substitute a word but do not substantially affect the reality.⁸¹ For many Muslims, these types of practices represent less-than-subtle methods of circumventing *Shari’a* rather than innovation in providing financial services. It is also not clear whether these mortgages would fall under any of the categories explored above as they so closely resemble their conventional counterparts.

In 1999 the Office of the Comptroller of the Currency approved instalment sales with the bank taking title to property as a banking instrument, and in 2000 granted an interpretive ruling to Key Corporation for a form of *istisnaa*.⁸² The result has been that any real

⁷⁷ Maurer at p. 34.

⁷⁸ Maurer at p. 34.

⁷⁹ Thomas at p. 78.

⁸⁰ Maurer at p. 35.

⁸¹ Maurer at p. 41.

⁸² Thomas at p. 76.

estate vendor is now able to bring an IF mortgage product to market and can have confidence as to its regulatory treatment.

The growth in the IF mortgage sector in the US has led to a “convergence of expertise in Islamic mortgage financing and *Shari’a* supervision and scholarship.”⁸³ Prominent *Shari’a* scholars now sit on the supervisory boards of companies offering IF mortgages. This merging of *Shari’a* and secular lending has led to new developments too, such as the use of mortgage application forms printed on letterhead, with fine print and space for a *fatwa*.

3. Australia.

Overview of the Market

Australia currently supports a Muslim population of approximately 340,390.⁸⁴ This population is a rapidly growing one, having expanded by more than 80,000 (or 28%) from 1996 to 2006.⁸⁵

While conventional Australian lenders have long been involved in *Shari’a*-compliant finance offshore, the domestic market is presently dominated by community-based Islamic cooperative financial institutions. MCCA,⁸⁶ purportedly the largest of these financial cooperatives, counts 6,900 member-customers on its roster and originates \$120 million⁸⁷ in *Shari’a*-compliant home mortgages per annum. While MCCA has recently been joined in the market by smaller lenders such as Islamic Cooperative Finance Australia (ICFA), the market appears to remain largely undeveloped, suggesting that *Shari’a*-compliant financial institutions in Australia face many of the same challenges as those operating in the UK – namely, a supply-led market in which participants must create demand for their products and services.

⁸³ Maurer at p. 95.

⁸⁴ ABS Census 2006, 20680 – Religious Affiliation by Sex – Australia, online: <<http://www.censusdata.abs.gov.au/>>.

⁸⁵ The most current Australian census data is for 2006.

⁸⁶ Muslim Community Cooperative (Australia).

⁸⁷ MCCA Corporate Profile, online: <http://www.mcca.com.au/Corp_Profile/CorporateProfile2006.pdf>.

Islamic Mortgage Instruments in Australia

Mortgage arrangements in Australia have been structured under three primary *Shari'a*-compliant contracts: the *murabaha*, the *ijara*, and the *musharaka*.

The *murabaha*, also known in the Australian market as a “Cost Plus” arrangement, operates in the same fashion as in other jurisdictions. As with *ijara* arrangements in the UK, one complication with this *Shari'a*-compliant model in Australia is that it gives rise to a double incidence of stamp duty under Australian state law (once for the original purchase, and again for the re-sale). In the State of Victoria, that has the largest Muslim population in Australia,⁸⁸ the state Parliament amended the governing *Duties Act* in 2004 so that sales/re-sales taking the form of “Cost Plus” arrangements would be treated as unitary transactions.⁸⁹ Other jurisdictions have not yet followed suit, and so *murabaha* mortgage transactions continue to incur “double duties” in the other states⁹⁰ giving rise to an uneven playing field within Australia.

The *ijara* arrangement, otherwise known in Australia as the “Usufruct Sale and Lease”, involves an initial purchase of the property by the financial institution, after that the financial institution and the intending property owner enter into a “lease-to-buy” arrangement at an agreed rent. As with conventional Australian operating leases, the lessee acquires ownership of the asset at the end of the lease. The only stipulation with the *ijara* is that the final price must be set at the time of entering into the sale and purchase contract, so as to comply with transparency requirements under *Shari'a*.⁹¹ Thus the rate of return to the financial institution is fixed for the duration of the term.

Like the *murabaha*, the *ijara* also raises issues of “double duty” under Australian state revenue laws. While Victorian state law has been amended to provide relief against double taxation for *ijara* mortgage arrangements, other states continue to levy “stamp duties” at each stage of the *ijara* transaction.⁹² Another potential pitfall relating to the

⁸⁸ B. Birrell and V. Rapson, “Two Australias: Migrant Settlement at the end of the 20th Century” (2002) 10 (1) *People and Place* 12.

⁸⁹ Via insertion by the *State Taxations Acts (Amendment) Act* 2004.

⁹⁰ John Barry, “Islamic Property Financing”, (2007) 15 (66) *Australian Property Law Journal* 4.

⁹¹ Barry, note 102 at p. 5.

⁹² Barry at p. 6.

ijara is that the arrangement gives to the intending property owner no interest in the freehold title under Australian law during the life of the parallel sale and lease. While the intending property holder will hold a leasehold interest over the property, under the prevailing Torrens land title system (whereby a register of land holdings maintained by the state guarantees indefeasible title to those listed in the register), he or she will have no registered interest in the freehold until the final payment is made and ownership is formally transferred.⁹³

It is also possible for financial institutions and intending purchasers to enter into shared equity arrangements known simply as *musharaka* in Australia. These arrangements are substantially similar to the diminishing *musharaka* in the UK examined above.

The *musharaka*, while theoretically *Shari'a*-compliant, is seen to be particularly problematic under Australian law. While there are no complications relating to the registration of the financial institution and the intending owner as tenants in common under the Torrens system of land registration, the decreasing ownership of the financial institution and the increasing ownership of the intending owner cannot readily be reflected in the Torrens register. One commentator is of the view that “any attempt to do so would lead to an impossible level of ongoing effort and expense to keep the Torrens register synchronized with the growing proprietorship of an intending land owner”.⁹⁴

To overcome this complication, and to ensure that the intending owner’s increasing equity is acknowledged and protected, the financial institution can declare itself trustee of the Register for the intending owner’s expanding share. This solution itself raises another set of complications as the parties will have to ensure that the declaration of trust reflects the underlying growth in the interest of the intending owner. Therefore *musharaka* may not presently be a viable *Shari'a*-compliant mortgage instrument in Australia given the constraints of Australia’s current land law and registration system.

⁹³ Barry at p. 6.

⁹⁴ Barry at p. 8.

4. New Zealand.

Overview of the Market

The *Shari'a*-compliant lending market is relatively undeveloped in New Zealand, a fact largely attributable to the nation's small Muslim population, estimated at roughly 36,000.⁹⁵ Nevertheless, Foundation Capital Markets (FCM), a conventional New Zealand lender, has been offering a product called "Manzil" since 2006. While technically not *Shari'a*-compliant (FCM and its affiliates do not maintain a *Shari'a* supervisory board), Manzil is *Shari'a*-compliant on its face and was crafted in consultation with the Federation of Islamic Associations of New Zealand and several other Islamic authorities.⁹⁶ The Manzil seems to be a variation on the typical *murabaha* arrangement prevalent in Australia and the UK.

In addition to the Manzil offered by Foundation Capital Markets, two IF companies, Crescent Financing and Al-Haramain Islamic Finance, have also been launched in New Zealand with the express intention of eventually offering traditional Islamic mortgage instruments such as the *murabaha* and the *ijara*.⁹⁷

5. France.

Overview of the Market

France is home to the largest Muslim population in Europe, representing 7% to 8% of the French population. Although exact numbers are not available (French laws do not allow the census to canvass ethnic origin and religion), the estimates speak of French Muslims representing about one third of the total in Europe.

Despite a large Muslim population, until recently IF was practically nonexistent in France. In fact, France is considered late in the development of IF compared to other Western countries. Several reasons might explain the slow development of IF in France. One of them is a possible reluctance from the French banking authorities to authorize

⁹⁵ New Zealand Census 2006 – religious affiliation, online: <<http://www.stats.govt.nz/NR/rdonlyres/0D04FC7F-B1C5-4ACD-B1D0-34A6A7500A33/0/31religiousaffiliation.xls>>.

⁹⁶ Online: <<http://www.manzil.co.nz/>> .

⁹⁷ Mustafa M. Farouk, "Islamic finance in New Zealand", online: <<http://www.islamicfinancenews.com/newsletter/2007/v4117/article3.php>>.

what might be perceived by the French population as a violation of the principle of separation of church and state. Banks offering products developed in accordance with religious beliefs could be seen as infringing on this important French principle, enacted back in 1905.⁹⁸ French banks may be concerned that offering IF products could have a negative impact on their reputation.⁹⁹ A more plausible explanation may be that French housing finance is based primarily on personal loans, rather than mortgage loans, whereas Islamic housing finance is based on recourse to the property.

The lack of IF product offerings in France can also be explained by relatively low demand and obstacles to supply-led *Shari'a*-compliant instruments. The demand issue may possibly be explained by a *fatwa* issued in 1999 by the European Council for Research and Fatwa, authorizing conventional bank loans (bearing interest) for the purchase of houses if the house is to be used as a principal residence and if no other type of credit is available.¹⁰⁰ Being formally authorized to use conventional banking instruments, French Muslims appear less active in requesting *Shari'a*-compliant instruments. Moreover, a large percentage of the Muslim population in France is constituted of Muslims of Maghreb and West African backgrounds, where IF is not as developed as in some Muslim countries of the Middle East. Moroccan, Algerian and Tunisian banks, for example, offer very few Islamic products.¹⁰¹ Consequently, since the

⁹⁸ Jessica Barre, *La finance islamique : Sujet tabou en France?*, 23 avril 2008, online: <www.saphirnews.com>.

⁹⁹ Saddy notes that:

...there is a political stigma associated with the perceptions described above. Some French banks that were contacted expressed reservation regarding their association with an institution directed mainly to serve Muslims clients. Almost all of them expressed the general view that an explicitly designated Islamic bank, as much as an explicitly designated Christian or Jewish bank, would be clearly in conflict with the concept of laïcité...

One bank that has been actively marketing its own Islamic financial products to French Muslims was blunt in saying that it has a certain image in the market and it would not want to be seen as catering to the needs of Muslims. Hypocrisy aside, it seems that conserving the purity of its Brahman image outweighs any financial benefits that might be obtained from serving a community of some sort of "untouchables".

Fehmy Saddy, *Islamic Community Banking in France: the Tayssir Bank Experiment*, online: <www.ribh.wordpress.com/2007/10/02/vers-la-creation-de-la-premiere-banque-islamique-en-France>.

¹⁰⁰ Conseil Européen de la fatwa et des recherches; Fatwa 26, online: <www.crcm-cha.org>.

¹⁰¹ Pascal Grangerau and Mehdi Haroun, *Financements de projet et financements islamiques*, Banque & Droit no 97 – sept.-oct. 2004.

population is not familiar with IF, they may not be as demanding for these types of products as Muslims from other jurisdictions.¹⁰²

IF Mortgage Instruments in France

IF in France is limited to some real estate structured finance transactions whereby French banks help Middle-East Islamic funds to acquire real properties in France. These transactions are normally executed using the *murabaha* Islamic structure. Only four banks are reportedly active in that area: the Société Générale Corporate & Investment Banking, HSBC, Citi and Eurohypo AG.¹⁰³ No official numbers are available concerning the exact number of *Shari'a*-compliant real estate transactions entered into by these financial institutions in France; however, it is definitely a very low number. It is important to note that some French banks have been active for a number of years in various Middle Eastern countries, so the capacity to offer IF in France would seem to exist.¹⁰⁴

There is no specific legislation governing *Shari'a* lending in France. However, most authors are of the opinion that the traditional *Shari'a*-compliant instruments do fit within the French legal system without the need to change legislation.¹⁰⁵ Although the French legal system does not constitute an impediment to IF, neither is it perfectly adapted to Islamic financing instruments. The main obstacle is the double taxation that results from the use of traditional Islamic instruments such as the *ijara* and the *murabaha*, that involve two separate transactions. Nevertheless, some alternative types of financing put forward in France to facilitate homeownership, such as *ijara*, have been considered by the Muslim community as *Sharia*-compliant alternatives to conventional banking finance.¹⁰⁶

¹⁰² Nadia Hathroubi-Safsaf, *Zoubair Ben Terdeyet, fondateur du premier cabinet de finance islamique en France*, February 27, 2008, online: <www.ribh.wordpress.com/2008/02/27/zoubair-ben-terdeyet>.

¹⁰³ A. Fulconis-Tielens; «La finance islamique a-t-elle un avenir prometteur en France?», *Revue Banque No 696* Novembre 2007.

¹⁰⁴ This is the case, for example, of Crédit Agricole, BNP Paribas and Société Générale.

¹⁰⁵ Chucris-Joseph Serhal, *La finance islamique : une intégration possible dans le système bancaire français*, *Banque & Droit*, no 106 – mars-avril 2006.

¹⁰⁶ *Recherche de solutions sans frais d'intérêts bancaires*, online : <www.wmaker.net/AIDIMM>.

A formal demand was made in 2006 from FS International Partners SA to get authorization from the French banking authorities to open the first Islamic bank in France, named Tayssir Bank. Although there was some willingness to consider the application, the French banking authorities have imposed two conditions. The first is that the bank be open to all customers irrespective of religion; and second, that the applicants find a French or European financial institution to sponsor the Islamic bank and participate in at least one third of its equity. This second condition has not yet been met but the project is apparently still active.¹⁰⁷

(3) SECULAR REPUBLICS WITH MUSLIM MAJORITIES AND SECULAR LAW.

1. The People's Democratic Republic of Algeria.

Overview of the Market

Unlike many other African countries, Algeria is demographically suitable for mortgage lending, with its population increasingly middle class and urban. It is the largest country in the Mediterranean region and the second largest country on the African continent, preceded by Sudan. The population was estimated by the National Office of Statistics (NOS) at 33 million inhabitants as of January 1, 2008.¹⁰⁸ The majority of the population lives in urban centers (58.3%), with 30 towns having more than 100,000 inhabitants.¹⁰⁹ Algeria's GDP was \$141 billion in 2007 (compared to \$1.4 trillion for Canada), with a per capita GDP of \$4,110 (compared to \$46,736 for Canada).¹¹⁰ This makes Algeria the second richest African country after South Africa.¹¹¹

Islam is enshrined in the Algerian constitution, though the legal system remains secular. The preamble to the constitution states, for example, the three fundamental

¹⁰⁷ Saddy, note 111.

¹⁰⁸ National Office of Statistics (NOS) of Algeria, a public organism under the supervision of the minister of State of Algeria reporting to the Chief government in charge of planning, online: <<http://www.ons.dz/>>.

¹⁰⁹ « Rapport national sur les objectifs du Millénaire pour le développement – Algérie », Algerian Government, July 2005 at p.10.

¹¹⁰ Information compiled from Statistics Canada and Industry Canada by Foreign Affairs and International Trade Canada. Online: <<http://geo.international.gc.ca/cip-pic/geo/algeria-fs-fr.aspx>>.

¹¹¹ These numbers are equivalent to those published by the NOS in Algerian dinar.

components of Algeria: Islam, “Arabité” and “Amazighité” (a reference to the Berber civilization). It further states:

Art.2 – L’Islam est la religion de l’État. [Islam is the state religion.]

Art.3 – L’Arabe est la langue nationale et officielle. [Arabic is the national and official language.]

Art.29 – Les citoyens sont égaux devant la loi, sans que puisse prévaloir aucune discrimination pour cause de naissance, de race, de sexe, d’opinion ou de toute autre condition ou circonstance personnelle ou sociale. [Citizens are equal before the law, without discrimination on account of birth, race, sex, opinion or any other personal or social condition or circumstance.]

Despite lobbying efforts on the Algerian government by concerned actors in the industry, edict no. 03-11 of August 26, 2003, relating to currency and credit is still enforced against all financial institutions licensed by the central bank, whether they offer conventional financing products, IF products or both. In January 2007, the minister of Finance declared, in response to questions from the National People’s Assembly, that he was categorically opposed to any preferential measures in favour of Islamic banks.¹¹²

Islamic financing at the retail level is concentrated in the automotive and real estate sectors. Some major Algerian banks offer IF mortgage finance through both *ijara* and *murabaha* structures; however, their financial statements do not provide a separate breakdown of housing-related assets. The market leader in the financing of motor vehicle purchases is a Saudi-Algerian joint venture, with close to 50,000 vehicles financed through *murabaha* contracts since 2001 (17,500 in 2007). Under these contracts, a loan can represent up to 70% of the purchase price of the vehicle and be reimbursed in up to 48 months. The profit margin between the purchase price of the vehicle for the bank and the sale price to the customer is usually fixed between 8% and 8.5%. The success of this product is attributable to its competitiveness, with financing costs roughly 10% less than competitors’ conventional financing products.¹¹³ This bank

¹¹² Source : « Espace des banquiers Algériens : Blog », online: <www.banquiersalgeriens.spaces.live.com/blog/cns!BF17D62C45884FB0!207.entry>.

¹¹³ Le Maghreb, note 127.

also has the effective marketing approach of placing kiosks in dealerships in order to gain direct contact with potential customers.

Another player in Algeria is a Bahrain-based bank with Algerian loans and advances in the aggregate amount of US \$177 million in 2007. It offers various IF products such as *murabaha*, *ijara*, *ijara muntahia nittamleek*, *ijarah mawsoufa bil dhima*, *salam*, *istisna'a* and *sukuk*.¹¹⁴

Other Algerian commercial banks increasingly have offered *Shari'a*-compliant financing products in recent years;¹¹⁵ in fact, it would appear that any financial institution wanting to enter into the Algerian financing industry has no other choice but to offer *Shari'a*-compliant automotive leasing products, in order to be competitive with major banks that offer such products.

Finally, foreign firms, such as European and American banks, offer IF services in Algeria. All of the Islamic financing products offered by these firms are *Shari'a*-compliant. As was noted by one commentator, “the experts agree that the future of Islamic finance in the Maghreb lies more in its competitiveness than in its compliance with the Qur'an.”¹¹⁶

2. Malaysia.

Overview of the Market

It is estimated that one in ten banking transactions in Malaysia today is Islamic-based.¹¹⁷ IF in Malaysia had its beginnings with the establishment of a pilgrimage fund in 1963.¹¹⁸ The fund was used as a savings mechanism for Malaysian Muslims to set

¹¹⁴ See, online: <www.arabbanking.com/index/index.asp>.

¹¹⁵ Based on the « Espace des banquiers Algériens : Blog », *Ijara ia ikita* contracts are also offered by the Algeria Gulf Bank, online: <www.banquiersalgeriens.spaces.live.com/?_c11_BlogPart_BlogPart=blogview&_c=BlogPart&partqs=amonth%3d8%26ayear%3d2007>.

¹¹⁶ “*Au Maghreb, une prudente progression*”, Journal Le Monde, Paris, Florence Beaugé, December 18, 2007 “[e]n fin de compte, tous les experts le disent: l’avenir de la finance islamique au Maghreb réside davantage dans sa compétitivité que dans sa conformité au Coran”.

¹¹⁷ “*Regulatory Review of Islamic Finance in Malaysia*”, MIF Monthly- Malaysia: The International Islamic Financial Center. Available online at: <www.Mifmonthly.com/article10.php>.

¹¹⁸ “*Recent Developments in Islamic Finance in Malaysia*”, Keynote address by Dr. Zety Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysian Islamic Finance Issuers and Investors Forum August 14, 2006. Online: <<http://www.bis.org/review/r060824a.pdf>>.

aside money for the cost of performing the Islamic pilgrimage to Mecca. From these early beginnings it became apparent that there was a viable market for *Shari'a*-compliant financial services, and in 1993 the Malaysian government allowed conventional banks to offer Islamic banking products to the retail market.¹¹⁹

Since then, the government has undertaken various initiatives to create a comprehensive Islamic banking and finance system as reflected by a recent report by Bank Negara Malaysia (BNM). The report found that:

- (a) Assets of the Islamic banking system (including Islamic banking windows operated by conventional banks) had been increasing at an average rate of 18.9% since 2000. By the end of 2006, Malaysia's Islamic banking and finance assets accounted for 12% of assets in the industry as a whole.
- (b) *Takaful* (Islamic insurance) assets and combined *takaful* contributions accounted for 6.1% of total assets.¹²⁰
- (c) Malaysia's *sukuk* (Islamic bonds) represent 67% of total global *sukuk* outstanding as at the 23rd of January, 2007.¹²¹

The international financial community has taken note of Malaysia's strategic direction in developing and nurturing Islamic banking and finance. Its progressive industry developments include a clear legislative mandate, a robust regulatory framework, resources that include the Institute of Islamic Banking and Finance Malaysia, the International Centre for Leadership in Finance, and the International Centre for Education in Islamic Finance, as well as a wide range of tax exemptions across the Islamic finance spectrum.¹²²

¹¹⁹ "Building an Effective Legal and Regulatory Framework for Islamic Banking (IB)", Financial Regulators Forum, March 29, 2007. PowerPoint Presentation by Bank Negara Malaysia. Online: <http://www.bnm.gov.my/microsites/giff2007/pdf/frf/06_01.pdf>.

¹²⁰ Financial Regulators Forum, note 134.

¹²¹ Financial Regulators Forum.

¹²² "Malaysia: Leading Islamic Finance", Price Waterhouse Coopers Malaysia, Online: <www.pwc.com/extweb/indissue.nsf/docid/1D681D874F24FDA7CA25720A00158BFD>.

Regulatory Framework

Malaysia has a unique institutionalized legal infrastructure that enables the development of Islamic finance initiatives. These include a dedicated High Court, a regional center for Arbitration in Kuala Lumpur, a financial mediation bureau as an alternative dispute resolution mechanism and a Law Review Committee to enhance existing legislation and smooth execution of Islamic financial contracts.¹²³

Tax Incentives

In addition to the government's regulatory initiatives to spur the growth of Islamic finance, tax neutrality and incentives have also been established. *Shari'a*-compliant financial transactions have been provided with tax neutrality, meaning that *Shari'a*-compliant financial products incur no greater tax liability than conventional financial products.¹²⁴ Such initiatives include legislation to provide tax deductibility for profits on

Islamic financial products similar to the treatment of interest in conventional products. In addition, various tax exemptions and withholding tax exemptions available for conventional products also apply to *Shari'a*-compliant financial products.¹²⁵

Islamic Mortgages in Malaysia

In 1993, conventional banking institutions were permitted to offer *Shari'a*-compliant banking products and services through Islamic windows, subject to specific guidelines issued by BNM.¹²⁶ In 1994, the secondary mortgage market for *Shari'a*-compliant mortgage products was created by Cagamas, the national mortgage corporation, when it purchased *Shari'a*-compliant mortgages from Islamic banking institutions (IBIs).¹²⁷ As of June 2006, there were 22 IBIs in Malaysia, including foreign banks, and *Shari'a*-compliant mortgage lending amounted to CAD\$4.31 billion (RM16.1 billion) or 21.6% of IBIs' total financing, and 12.3% in terms of total housing loans outstanding in the

¹²³ Price Waterhouse Coopers Malaysia, note 137.

¹²⁴ MIF Monthly- Malaysia, note 132.

¹²⁵ MIF Monthly- Malaysia.

¹²⁶ Financial Regulators Forum.

¹²⁷ "*Islamic Mortgages in Malaysia*" by Noor Ashikin Ismailm, Malaysian Islamic Finance Issuers and Investors Forum 2006. Online: <<http://www.malaysianislamicfinance.com/monthly/mifsupplement/article4.html>>.

banking system.¹²⁸ Interestingly, these have experienced success among the non-Muslim population as well; about 70% of customers of Islamic banks in Malaysia are non-Muslims.¹²⁹

Shari'a-compliant mortgages in Malaysia were first based on *murabaha* and that remains the dominant model;¹³⁰ However, *Shari'a*-compliant mortgage lending markets in Malaysia continue to evolve. In March 2006, Kuwait Finance House (Malaysia), Malaysia's first foreign Islamic bank, received approval from BNM to introduce a home financing product based on the *musharaka* model.¹³¹ Nonetheless, the most popular models for *Shari'a*-compliant mortgage lending in Malaysia remain the traditional *murabaha* and *ijara* models.¹³²

3. Republic of Turkey.

Overview of the Market

Islamic mortgage financing in Turkey developed to remedy the lack of access to capital available to its citizens. The current Turkish system is based upon 'housing credits' offered by banks, essentially short-term loans with borrowing costs built in. Housing credits are unaffordable to the majority of homebuyers, due to their relatively short terms (often 5 to 10 years) and high rates. These factors combine to make monthly payments unrealistically high for most potential buyers. Consequently, housing credits comprise only 3% of the housing finance market, with the remainder of homebuyers self-financing through private borrowing (often from family).¹³³

This situation has led to two significant and related problems in the housing markets. First, large urban areas in Turkey have a high volume of unofficial and unauthorized

¹²⁸ Ismailm, note 142.

¹²⁹ Nathif Adam, *Converting a conventional retail bank to Islamic banking, Islamic Retail Banking and Finance: Global Challenges and Opportunities*, (London: Euromoney Books, 2006) at p. 41.

¹³⁰ KFH Home Financing-i, Online: <www.kfh.com.my/retail_banking/financing/home_financing.php?>.

¹³¹ Kuwait Finance House, "KFH's Musyarakah Mutanaqisah Home Financing". Online: <http://www.kfh.com.my/retail_banking/financing/musyarakah_mutanaqisah_home_financing.php?intPrefLangID=1&#>.

¹³² Ismailm, note 142.

¹³³ Ismailm at p. 4.

housing, up to 40% by some estimates.¹³⁴ Second, the ineffective and almost non-existent housing finance system keeps this unofficial market afloat and hinders the development of an open market.¹³⁵

IF Mortgage Instruments

IF mortgage instruments are currently offered by housing finance corporations, that are banks or leasing companies that provide loans directly to the consumer.¹³⁶ All housing finance firms must be licensed by the Banking Regulation and Supervision Agency (BRSA) in order to offer such products. Under the new legal reforms, all homes that are to be the subject of a mortgage must be appraised by independent appraisers authorized by the Capital Markets Board (CMB).

(4) ISLAMIC REPUBLICS WITH *SHARI'A* LEGAL SYSTEMS WHOLLY OR PARALLEL TO SECULAR LAW.

1. Gulf Co-Operation Council Countries.

Overview of the Market

The Gulf Co-Operation Council (GCC) is comprised of the kingdoms of Saudi Arabia and Bahrain, the sultanate of Oman, and the emirates of Kuwait, Qatar, and the United Arab Emirates. GCC countries have some of the largest and longest-standing IF institutions in the world, and are said to be the “natural home” of Islamic finance.¹³⁷ Deposits in IF banks in the Gulf states are in the range of 15-25% (compared with approximately 10% in Malaysia and 0.1% in the UK).¹³⁸ Interestingly, recent growth in the IF sector has been influenced by conventional financial institutions that are increasingly offering *Shari'a*-compliant products. Much of the growth of the IF mortgage lending industry in the GCC states is fuelled by demographics.¹³⁹

¹³⁴ Pekin, et al., *Turkey: Memorandum On The Law Amending The Laws Related To The Housing Finance System*, Supplement – The 2007 Global Report, International Financial Law Review, at p. 1. Online: <www.iflr.com/?Page=17&ISS23918&SID=696652>.

¹³⁵ Pekin, note 149 at p. 1.

¹³⁶ Pekin at p. 2.

¹³⁷ Adam, note 144 at p. 40.

¹³⁸ Wilson, note 27 at p. 27.

¹³⁹ Abdi at p. 50.

Where firms offer IF services, those that have been most successful have focused on the needs of customers and explained the nature of their *Shari'a*-compliant products. The investment culture is different among the Gulf states, with retail banking and services for individuals well-represented in Dubai, for example, whereas in poorer Muslim states there are generally only custom services for institutional clients and the wealthy.¹⁴⁰

Mortgages and the treatment of real property in the GCC is more state-specific than banking and finance in general. Real estate is an inherently jurisdiction-specific investment intimately linked to a state's treatment of real property. This can vary considerably from state to state and from the same state's treatment of other investments.

The relationship between civil and religious laws, and the regulation of the finance industry, also varies across states. Some states have forced *Shari'a* upon their banking systems (as non-GCC Iran did in 1983 with its Usury Free Banking Law). These types of radical reforms have been criticized as stifling innovation and competition, as well as limiting customer choice.¹⁴¹ Such forceful measures are also problematic in an increasingly interconnected worldwide financial system. Not all Middle Eastern states support IF, even among those with Muslim populations. Oman, for instance, has expressly forbidden the provision of IF and banks there cannot take advantage of this growing market.¹⁴²

IF Mortgage Markets in the GCC

Despite the Gulf's role as the home of IF, it appears that relatively limited work has been done to serve Muslim consumers in the retail mortgage markets in most GCC countries. Nevertheless, there have been some noteworthy developments as part of, or due to, the maturation of the IF market in general, that have in turn affected the type and range of IF mortgage products available. These include:

¹⁴⁰ Wilson at p. 27.

¹⁴¹ Wilson at p. 18.

¹⁴² Abdi at p. 54.

- International non-governmental agencies attempting to fill the regulatory void by issuing guidelines for IF;
- The recent conversion of secular banks and financial institutions to *Shari'a*;
- The offering of *Shari'a*-compliant products by secular banks and financial institutions; and
- Liberalization of the housing market in some jurisdictions, such as Dubai in the UAE.

The oldest Islamic bank in the GCC is the Dubai Islamic Bank, established in 1979.¹⁴³ More recently, several banks and financial institutions in the GCC have undergone conversion to *Shari'a*-compliant models, including Sharjah Islamic Bank in 2002. In Kuwait, the Kuwait Real Estate Bank converted to *Shari'a* in 2004. The regulatory bodies in the UAE have sought to encourage consolidation among IF firms in an effort to avoid the potential levelling out in market development noted above.¹⁴⁴

IF and conventional finance options are also available more broadly to consumers in more developed states such as the UAE. Currently, three Islamic financial institutions there – Dubai Islamic Bank, Tamweel LLC and Amlak Finance – offer IF mortgages in *ijarah*, *murabaha* and *istisnaa* vehicles.¹⁴⁵ Research has shown that the strongest factor for customers choosing an IF product is the assurance of *Shari'a* compliance, especially if the *Shari'a* board members are known locally.¹⁴⁶

Some GCC states have witnessed the liberalization of their housing markets, opening the door to IF mortgage lending. This has been due in part to oil wealth fuelling the budding emergence of a middle class in many GCC states. Dubai provides the clearest example. Beginning in the 1990's the housing industry there experienced increasing

¹⁴³ Wilson at p. 18.

¹⁴⁴ Abdi at p. 60.

¹⁴⁵ Zubairi, note 41 at p. 91.

¹⁴⁶ Wilson at p. 22.

liberalization as part of UAE's drive to modernize and diversify.¹⁴⁷ A large influx of well-paid foreign workers increased demands for foreign ownership of property to be permitted. While approximately 80% of Dubai's population is foreign, nearly all local and foreign residents are Muslim.¹⁴⁸ While many foreign nationals hold accounts with multinational banks such as HSBC, those wishing to become part of the local business community often willingly engage the services of a local IF provider, in part to establish their credentials as Muslims.¹⁴⁹ This unique set of factors has created a large demand for IF mortgage products in Dubai.

Despite slow legal reforms, two successful schemes have resulted in a thriving real estate market allowing foreign nationals to own property.¹⁵⁰ First, in an only-in-Dubai scenario, a massive reclaimed land project has commenced that will soon allow foreigners to circumvent strict ownership regulations by purchasing property that is not on the mainland.¹⁵¹ Second, the Dubai government has also backed plans by at least one major developer to issue 'sub-title' to its properties through its Islamic finance subsidiary.¹⁵² Under the subtitle system, a purchaser gains all the rights of ownership, including the right to resell the property, but the developer retains technical title and processes changes in sub-title holdings in order to remain in regulatory compliance.¹⁵³

Saudi Arabia has similarly witnessed conversions from conventional to Islamic banking. In 1988, the Al Rajhi Company for Currency Exchange (Al Rajhi) was approved to convert itself into a formal Islamic bank by the Saudi Arabian Monetary Agency (SAMA). Since that time, Al Rajhi has grown to become the largest Islamic bank in the world.¹⁵⁴ This has led to other banks following suit, and to some extending *Shari'a* compliance to every aspect of their operations. Bank Al Jazira, for example, runs each of its retail

¹⁴⁷ Zubairi at p. 88.

¹⁴⁸ Wilson at p. 22.

¹⁴⁹ Wilson at p. 22.

¹⁵⁰ Wilson at p. 22.

¹⁵¹ Zubairi at pp. 89-90.

¹⁵² See, for example, online: <<http://www.amlakfinance.com/>>

¹⁵³ Zubairi at p. 90.

¹⁵⁴ Adam at p. 42.

branch operations according to the provisions of *Shari'a*.¹⁵⁵ Official government policy towards IF in Saudi Arabia has been called “indecisive”.¹⁵⁶ In fact, there is a noticeable lack of a formal regulatory and legal framework for Islamic finance in the country.

2. The Islamic Republic of Pakistan.

IF Mortgage Instruments in Pakistan

Liberalization of the mortgage-lending industry has been ongoing in recent years, though the current contribution of housing finance is extremely limited.¹⁵⁷ In 2001, the government launched a National Housing Policy to encourage homeownership through mortgage incentives, tax rebates and legal and documentary standardization. While mortgages have conventionally been interest-based, there has been recent growth in IF mortgage offerings. The first of these was introduced in 2003 in the form of a diminishing *musharaka* product. There are now at least 15 firms offering such mortgages. As with secular mortgages, IF lenders in Pakistan look to credit history, payment capacity and collateral from their customers.¹⁵⁸

The retail IF sector generally has had excellent recent performance, with record net profit earnings.¹⁵⁹ Islamic financial institutions address a core need in the marketplace by educating consumers on the availability and feasibility of IF products and services, and by providing financing solutions on a wide scale to the general population.¹⁶⁰ Since such product offerings must be strictly *Shari'a*-compliant, firms are forced to compete on other metrics, unlike jurisdictions where conventional and *Shari'a* products compete directly.

In terms of housing finance, *musharaka* and *mudaraba* are essentially the only forms available. This has the effect of making borrowers partners in the bank when they seek

¹⁵⁵ Adam at p. 42. Other banks are at various stages of conversion, or development of *Shari'a* services. National Commercial Bank of Saudi Arabia (NCB) has 161 of its 248 branches dedicated exclusively to IF services.

¹⁵⁶ Adam at p. 42.

¹⁵⁷ Ali Khan at p. 67. Ali Khan notes that the rate was only 2% of GDP in 2006.

¹⁵⁸ Ali Khan at p. 68.

¹⁵⁹ Ali Khan at p. 63.

¹⁶⁰ Ali Khan at p. 65.

to finance something. Profit or loss on the investment is therefore shared by both the bank and the borrower, as in other jurisdictions where IF is offered.

Musharaka is currently the process of choice for Islamic housing finance in Pakistan.¹⁶¹ There are two main categories of this model, *shirkatul aqd* and *shirkatul milk*. In the former, a partnership is effected between the lender and the borrower in a joint commercial enterprise. The latter is similar, with the parties being partners in the acquisition of an asset and having a co-ownership interest divided into units.¹⁶² As with *musharaka* in most other jurisdictions, the customer purchases a predetermined share of the property through an equity contribution, that may be drawn out over time. This model provides flexibility to the customer to “prepay” or “pay down” by buying units ahead of schedule, thus lowering monthly instalments. Financial regulatory authorities have been involved in developing the legal form of these IF mortgage contracts in Pakistan.

¹⁶¹ Ali Khan at p. 68.

¹⁶² Ali Khan at p. 68.

PART III. LEGAL, REGULATORY AND ADMINISTRATIVE CONSIDERATIONS.

(1) INTRODUCTION.

This part addresses the legal, regulatory and administrative considerations associated with the provision of Islamic housing finance products in Canada.

(2) OVERVIEW OF THE CANADIAN ISLAMIC HOUSING FINANCE MARKET.

Canadian immigrants (Muslim's included) embrace a goal of home ownership, as is evidenced by the rising number of immigrant homeowners and housing market data showing immigrants being attracted to areas with more affordable house prices.¹⁶³

The Muslim Population; General Population Statistics

In 2006, the Muslim population was estimated to be between 783,700 and 930,600 (an average of 857,100), representing roughly 2.5 per cent of the total Canadian population, up from 2 per cent at the time of the 2001 census.¹⁶⁴ The most conservative population projection scenario estimates that by 2011 the Muslim population in Canada will be 983,400, while the most liberal scenario predicts growth to 1,299,300, or approximately 3.8 per cent of the total Canadian population.¹⁶⁵

Longer term predictions anticipate a sustained level of growth in the Canadian Muslim community. The most conservative projections for 2017 would place the Muslim population in Canada at about 1,225,900¹⁶⁶, while the most liberal scenario predicts a Muslim population of approximately 1,784,300¹⁶⁷ – about 4.8 per cent of the total Canadian population.

¹⁶³ Maurer at p. 10; Statistics Canada, *2006 Census: Changing Patterns in Canadian Homeownership and Shelter Costs*, p. 26.

¹⁶⁴ Statistics Canada, *Population projections of visible minority groups, Canada, provinces and regions, 2001-2017*, pp. 49, 61.

¹⁶⁵ *Population projections*, note 185 at pp. 50, 62.

¹⁶⁶ Silvana M. D'Alimonte and Lauren Temple, *Shari'a-compliant Financing*, February 25, 2008 in *Commercial Mortgage Transactions: Complex Issues in Documentation and Due Diligence*, Continuing Legal Education, The Law Society of Upper Canada at p. 51.

¹⁶⁷ D'Alimonte and Temple, note 187 at p. 63.

Regional Breakdown

Between 2001 and 2017 it is expected that the regional distribution of Muslims throughout Canada will remain fairly constant.

In 2001 roughly 61 per cent of the Muslim population resided in Ontario with approximately 44 per cent of the total population residing in the Toronto area, with a significant population in Ottawa as well.¹⁶⁸ After Toronto, the next largest concentration of Muslims is in the Montreal region, where roughly 16.5 per cent of the total Muslim population resides.¹⁶⁹ Outside Ontario and Quebec, the provinces with the next largest concentration of Muslims are British Columbia (9 per cent) and Alberta (8 per cent).¹⁷⁰ Muslims residing in British Columbia live mostly in the Vancouver area, while most Alberta Muslims live in Calgary.¹⁷¹

The lowest concentrations of Muslims in Canada are in Prince Edward Island and the Territories where less than 1 per cent of the Muslim population resides.¹⁷²

Portion of the population that might be interested in *Shari'a*-compliant finance

Little empirical evidence based on a sound methodology assumptions exist to accurately project what portion of the Canadian population would be interested in utilizing *Shari'a*-compliant financing.

Based on the development of Islamic housing finance internationally, it appears that in most countries the market develops on a supply-based model. Therefore, it would be wrong to extrapolate a take-up rate for Islamic finance products as a percentage of the Muslim population. For purposes of the technical considerations that follow, this report assumes that the market in Canada would be supply-driven, and that the population is large enough for financial institutions to be interested in developing *Shari'a*-compliant housing finance products that would target the Muslim population. It is impossible to

¹⁶⁸ *Population projections* at p. 48.

¹⁶⁹ *Population projections* at p. 48.

¹⁷⁰ *Population projections* at p. 48.

¹⁷¹ *Population projections* at p. 48.

¹⁷² *Population projections* at p. 48.

speculate whether, all other things being equal, the Muslim community in Canada would embrace these products. Several commentators have observed that pricing is the main determinant of mortgage and other retail finance product selection.

(3) CURRENT STATE OF ISLAMIC HOUSING FINANCE IN CANADA.

A few tentative steps have been made by a few small financing entities to provide IF mortgage or mortgage-like products, such as *musharaka* (co-ownership) and *ijara* (lease) for home purchase, along with IF investment products. Certain Islamic housing corporations offer *mudaraba*-type shared ownership.¹⁷³

Most of these firms have continued to operate for several years without intervention or facilitation from regulatory authorities. At a minimum, this demonstrates that it is possible for IF housing finance products to be successfully offered in the Canadian marketplace under the existing legal, regulatory and administrative framework. Though it is difficult to accurately assess, most of the firms involved in the market state that demand currently exceeds supply.

None of the large conventional mortgage lenders are currently in the market. One of the obstacles that has been identified by some lenders is the incompatibility of their back office mortgage servicing systems and operations with the specific financial instruments and techniques required to provide traditional *Shari'a*-compliant housing loans. Another stated factor is a lack of confidence in the market potential. The third factor is regulatory uncertainty as to how IF housing finance loans should be treated.

Islamic Housing Cooperatives

The cooperative model was one of the first whereby *Shari'a*-compliant mortgages were offered in Canada. Prospective borrowers become members of the cooperative by buying common or preferred shares in the cooperative, that is the means by which the co-op raises its capital to a level sufficient to fund the housing loan portfolio. Financing is in turn offered to members on a non-profit basis.

¹⁷³ As these instruments have been discussed in detail above, they will not be elaborated on here.

A member of the cooperative obtaining a *Shari'a*-compliant mortgage will provide a down-payment with the balance being funded by the cooperative. Members then, over the term of the mortgage, purchase shares in the cooperative equal to the financed cost of the property.

Although this model provides funding on a non-profit basis, a down-payment is required that is typically greater than the down-payment required in a conventional mortgage (in some cases as high as 50 per cent). Moreover, as the equity capital for these non-profit organizations needed to leverage debt comes from the purchase of shares by the members, the amount of funds available is necessarily limited. A further common characteristic of this type of model is a requirement that individuals be members of the cooperative for a period of time (in some cases six months) before being eligible for funding.

In one such co-op, to qualify for a *Shari'a*-compliant mortgage members must have shares that equal 20 per cent of the first \$100,000 of the purchase price of the property, 25 per cent of the difference between the first \$100,000 and the cost of the property up to \$200,000, 30 per cent of the difference between \$200,000 and the actual cost of the property up to \$300,000, and 100 per cent of the difference over \$300,000. The maximum contribution by a cooperative is capped at \$225,000.¹⁷⁴

Cooperative corporations use a diminishing *musharaka* model of lending whereby title to the property is held by the cooperative and the purchaser pays a monthly "occupancy charge" or rent in proportion to the cooperative's ownership in the property. As further shares in the cooperative are purchased the monthly occupancy charge is proportionately reduced.

When members have purchased shares in the cooperative equivalent to the purchase cost of the property (plus one preferred share), title to the property is transferred from the cooperative to the member and any gain or loss realized will be divided 90 per cent to the member and 10 per cent to the cooperative if at that time the member had shares equal to more than 50 per cent of the purchase price of the property. If at that time the

¹⁷⁴ See, online: <<http://www.isnacanada.com/achc.htm>>.

member had shares worth 50 per cent of the purchase price or less, the loss or gain is divided 80 per cent to the member and 20 per cent to the cooperative.¹⁷⁵

The cost of the one preferred share that the member must purchase prior to the transfer of title from the cooperative to the member is determined by the Board of Directors of the cooperative and is 10 per cent or 20 per cent of the difference between the present fair market value of the property less the purchase price, the cost of authorized major improvements and fees.¹⁷⁶

Quebec

As in the rest of Canada, IF housing finance is not very developed in the province of Quebec. In 2001, the Muslim community represented 1.5 per cent of the Quebec population with 108,620 Muslims, most of them living in the Montréal region.¹⁷⁷

However, interest-free home mortgages have been available to Quebec Muslims since 1991 through a cooperative, the objective of which is to allow Muslim families to become homeowners using a *musharaka* type of arrangement. Under this arrangement, the cooperative buys the house in partnership with the member then rents its interest in the house to the occupant. The monthly payment is comprised of two components, one corresponding to the rent payable by the occupant and the other to a reimbursement of principal that reduces the cooperative's share in the property over time. It normally takes about fifteen years for the occupant to buy out the cooperative's entire share. The occupant and the cooperative share the loss or gain in value of the house.¹⁷⁸

The occupant must provide a down payment of at least 20 per cent of the purchase price of the house. This consequently limits the number of people able to benefit from these arrangements. A major problem also arises regarding the sources of financing of the cooperative itself. The cooperative does not have any conventional banking

¹⁷⁵ See, online: <<http://isnacanada.com/achc.htm#info%20for%20home%20buyers>>.

¹⁷⁶ See, online: <<http://isnacanada.com/achc.htm#info%20for%20home%20buyers>>.

¹⁷⁷ Statistics Canada, 2001 Census.

¹⁷⁸ See, online: <www.qurtuba.ca>.

arrangements for funding its operations and relies exclusively on the investments of its members.¹⁷⁹

Specialized Islamic Mortgage Lenders

A more flexible model than cooperatives for *Shari'a*-compliant lending involves a specialized *Shari'a* lender obtaining funding from third parties such as conventional mainstream financial institutions and on-lending those funds by way of Islamic mortgages.

One popular lending model used by Islamic housing finance entities in Canada is based on the *musharaka*, whereby the purchaser and the entity enter into a joint venture or partnership pursuant to which the purchaser contributes the down payment for the purchase of the property and the lender contributes the balance of the purchase price.¹⁸⁰ In turn, the purchaser agrees to pay to the lender over the term of the agreement a sum equal to the amount advanced by the lender plus a “profit amount”. Until payment of the amount advanced by the lender and the “profit amount”, the lender has security over the property in the form of a non-interest bearing mortgage covering the principal plus the profit amount, with the right to assign that mortgage to any third party.¹⁸¹

In addition to the *musharaka* between the lender and the purchaser, there are separate arrangements between the lender and third party funding institutions whereby the lender is provided with a line of credit to fund the *musharaka* from conventional lending institutions. In return, the institution receives “charge amounts” as monetary compensation for the amount advanced to the lender and takes as security an assignment of the mortgages from the lender.¹⁸² Under this model, both the housing finance and the funding of the portfolio are arranged on a *Shari'a*-compliant basis.

¹⁷⁹ *Prêteur sans intérêts Finance Islamique*, Le Journal étudiant de l'UQAM, numéro 16, 23 avril 2008.

¹⁸⁰ Omar Kalair, CEO, UM Financial, July 29, 2008.

¹⁸¹ Draft Musharakha (Partnership) Home Financing Agreement of Purchase.

¹⁸² Omar Kalair, CEO, UM Financial, July 29, 2008.

Advantages and Disadvantages

One of the potential advantages of this model over that of the cooperative structure is that down payments can be more in line with conventional lending models and can potentially be as low as 5 per cent; however, finding sources of capital for funding these *Shari'a*-compliant mortgages continues to be a challenge.

While one of the advantages of such a model is that there is potentially a larger pool from which to obtain capital to finance *Shari'a*-compliant mortgages, anecdotal evidence from Muslim lenders suggests that the demand for *Shari'a*-compliant mortgages still outweighs the supply of funds.

It also appears that transaction costs for *Shari'a*-compliant mortgages can be higher than a conventional mortgage due to the role of third parties in these transactions. This additional cost can be reflected in an increase in the base cost of a *Shari'a*-compliant mortgage of between 100 and 300 basis points over a conventional mortgage.¹⁸³

A question often put to Canadian Islamic housing finance entities is why they have not tapped the Gulf states for investors and/or to create a secondary market for their product. In discussions with investors in GCC states, the subject of political and regulatory risk invariably comes up as a damper on Middle East investment in highly-regulated consumer sectors, such as housing finance. Another constraint is that Middle East investors typically have a much shorter term investment horizon (3-5 years) than that required by *Shari'a*-compliant housing finance structures (15-25 years). Finally, until recently an additional factor was the much higher rates of return that could be earned by investments in the developing world, as opposed to North America.

Canadian Banks and other Mainstream Financial Institutions.

Federally-regulated banks occupy approximately 60 per cent of the mortgage market in Canada and are consulted by approximately 66 per cent of mortgage seekers.¹⁸⁴ Banks provide both institution-branded products and third-party brand products. However, to

¹⁸³ See, online: <http://www.lawtimesnews.com/index.php?option=com_content&task=view&id=2078>.

¹⁸⁴ Canadian Association of Accredited Mortgage Professionals, Annual State of the Residential Mortgage Market in Canada, November, 2007.

date none of them have actually offered *Shari'a*-compliant housing finance, not even on a pilot-project basis.

(4) LEGAL ISSUES.

Shari'a Interface with the Canadian Legal System

The interface of *Shari'a* law with the Canadian legal system does not, in and of itself, create any particular issues. In a *Shari'a*-compliant housing finance transaction, however structured, the common law (civil law in Quebec) would apply to the transactional documents as they would to any other contract. Principles of Canadian real property law would continue to apply to the property that was the object of the transaction.

Conceptually, a *Shari'a*-compliant transaction is structured using Canadian legal instruments and contracts, but in a manner that does not contravene the *Qur'an* and the subsidiary teachings, rulings and interpretations that collectively make up *Shari'a* law. In this sense, Islamic finance resembles structured finance, in that it typically uses a series of contracts to create a “structured” relationship rather than relying on a background of conventional law.

To avoid misunderstanding, it should be noted that there is a fundamental difference between using Canadian contracts in a *Shari'a*-compliant manner, as occurs in IF, as opposed to importing *Shari'a* law to displace the Canadian law governing legal and social relationships, such as family law. IF uses and applies strictly Canadian contracts and instruments in a way that avoids offending *Shari'a* religious principles.

Most of the designated legal contracts used in *Shari'a*-compliant finance have a counterpart in Roman law, that forms the basis of civil law and has also informed the common law in its development over the centuries. Thus, no difficulties arise in describing the *Shari'a*-compliant contracts in conventional legal terms, be it in a common or civil law legal system. There are no contracts or requirements that cannot be met using conventionally drafted legal instruments that are fully enforceable under the laws governing the contract, be it the laws of a Canadian province, the laws of a US

state, the laws of England or the laws of any other developed civil or common law jurisdiction.

Shari'a Interface with Generally Accepted Accounting Principles

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an international non-profit body based in Bahrain that was created to establish various standards, including accounting and audit standards and *Shari'a* standards for Islamic financial institutions. A limited number of countries in the Middle East have adopted those standards for their Islamic financial institutions. To date, however, the majority of Islamic financial institutions have developed primarily along national lines and follow the accounting standards applicable in their governing jurisdiction. The AAOIFI is particularly useful in helping to harmonize approaches and standards in Islamic jurisdictions that have not developed their own standards, and from one Islamic jurisdiction to another.

For purposes of institutions that apply Canadian accounting standards to their financial reporting (i.e. Canadian Generally Accepted Accounting Principles or "GAAP"), Islamic financial products should not present any particular difficulties, particularly given the experience in the US and UK. Financial innovation occurs all the time and requires that institutions and auditors continually consider the accounting treatment of new structures, products or unique transactions.

It is beyond the scope of this paper to comment on the specific accounting treatment of particular IF structures; however, because IF housing finance is largely based on the lender assuming an ownership interest in the property there is a possibility that the accounting treatment of IF housing loans could differ from that of conventional mortgage financing. Although an Islamic housing lender usually holds title to the property, in both the US and the UK, Islamic "mortgages" are treated as financial instruments rather than interests in real property. If inconsistencies were to arise, the notes to the financial statements of an institution with a materially significant portfolio of IF assets (or liabilities) could fully explain the substance and accounting treatment of these assets and liabilities, much in the same way as notes to Financial statements would deal with a significant but unique transaction entered into by a particular entity.

A final point to consider regarding accounting is that any concerns about presentation of Islamic finance assets, liabilities and transactions under Canadian GAAP will soon disappear. Like much of the rest of the world, Canada has opted to adopt International Financial Reporting Standards (IFRS) commencing in 2011. Given the rapid and widespread growth of IF internationally, it can be expected that international harmonization of IF accounting and reporting with IFRS will occur in due course. The Chartered Institute of Management Accountants has recently announced that it will be offering a certificate in Islamic finance globally. Other professional accountancy organizations are likely to follow.

Real Property Law Considerations

While the various structures for IF can be created under Canadian law, there are structuring considerations to their use that must be addressed by lenders in Canada.

Property Owner Liability

The *musharaka*, *ijara*, *murabaha* and *mudaraba* structures all involve a period of ownership or shared ownership by the financier. Items of particular concern are liability for environmental contamination and non compliance with property standards under municipal by-laws and other regulation. Generally speaking, in most provinces liability for environmental contamination and remediation and for property standards compliance falls on title holders and owners. This exposes the financier to a significantly greater risk in these IF structures compared to a lender holding a mortgage. A mortgagee attracts no liability for these matters unless it is in possession and control of the property. For those few cases, a mortgagee can manage the risk through due diligence investigations and federal and provincial legal protections for lenders in possession.¹⁸⁵ The liability of the financier who holds title or ownership for the clean-up of a secured property and any adjoining lands to which the contamination may have migrated has the potential to significantly exceed the amount of the financing on the property.

¹⁸⁵ *Bankruptcy & Insolvency Act*, RSC 1985 c. B-3 as amended S. 14.06.

With holding title or ownership of real property comes direct liability for payment of taxes¹⁸⁶ and various other charges such as condominium fees and special assessments¹⁸⁷ that are imposed on owners of the property. In the mortgage structure, these claims are limited to priority over the mortgage so the lender can choose to pay them or let them be recovered out of the property. In an ownership structure, the municipality or the condominium corporation could take the easier course of pursuing the financier directly for the payment of the outstanding taxes, fees and assessments instead of taking tax sale or other enforcement procedures. With two owners, both would be responsible for these liabilities and assessments.

Rental Property Considerations

IF structures to finance residential property that are based on or include *ijara* or rent type payments for the property may be subject to the *Residential Tenancies Act, 2006* (Ontario) (RTA) and similar legislation in most provinces. The RTA applies to any agreement that includes payment of rent or monies for the occupation of property for residential purposes for a period of time.¹⁸⁸ While some distinction can be made between a residential tenant and a purchaser in possession making payments on account of the purchase price, in view of the broad scope of the application of the RTA, a lender can have no certainty the RTA will not apply to an IF agreement that includes rent type payments.

Where the RTA applies, the obligations of the financier and the procedures in dealing with default and servicing matters is significantly different from those for conventional mortgages, including the following:

- (a) the financier would have a duty to maintain the property in a good state of repair and in compliance with all applicable safety and maintenance standards.¹⁸⁹ The RTA does not permit a landlord to contract out of this obligation and pass it to the

¹⁸⁶ *Municipal Act, 2001*, S.O. 2001, c. 25, s. 307(1).

¹⁸⁷ *Condominium Act, 1996* SO 1996.

¹⁸⁸ S.O. 2006 c. 17 as amended s.1, .s.2.

¹⁸⁹ S.O. 2006 c. 17 as amended at ss.1, 20.

IF customer.¹⁹⁰ The cost of repairs and management fees could not be added to the amount financed and any provision in the IF agreement making the failure to repair or the cost of repair a default would be void;

- (b) the *ijara* or rent type payment does not have to be fixed and the IF contract can provide for a periodic adjustment of rent by reference to an index or by re-pricing similar to renewal terms for mortgages. A problem arises in that rental rate increases would be subject to rent control restrictions in the RTA¹⁹¹ including the 120 day prior notice period for any increase, the limit of one increase per year (making variable rate arrangements impractical) and the cap on the annual maximum permitted increase that is set by regulation based on the CPI for the province plus recovery of certain increased costs;
- (c) the usual “due on sale” and assumption provisions of a mortgage would in an *ijara* contract be dealt with by the rules regarding assignment and subletting of leases in the RTA.¹⁹² The financier could not arbitrarily or unreasonably refuse consent to a purchaser who wants to purchase the property by assuming the existing financing by taking an assignment and assuming the existing *ijara* contract. If the financier refused consent to an assignment, the IF customer as tenant would have the right to terminate the contract. On an assignment with consent and on a termination for refusal to consent, the IF customer would be released from further obligation on the IF contract;
- (d) in the event of default under an *ijara* contract, recovery of arrears, recovery of possession and other enforcement would be by proceedings before the Landlord and Tenant Board.¹⁹³ The private power of sale (in Ontario) and the judicial remedies for mortgage default could not be used. The specific procedures and time periods for the process of eviction would generally be no longer than for a mortgage action, but the time limits and formalities for certain steps give less

¹⁹⁰ S.O. 2006 c. 17 as amended at ss.1, 4.

¹⁹¹ S.O. 2006 c. 17 as amended at Pt. VII.

¹⁹² S.O. 2006 c. 17 as amended at Pt. VI.

¹⁹³ S.O. 2006 c. 17 as amended at Pt. XI.

flexibility for the financier and create greater risks for having to start the process all over again for any misstep. Judgments for payment would also be much more cumbersome. A judgment for the outstanding amount on the IF contract, similar to a judgment for the debt outstanding on a mortgage, is not possible because of the prohibition in the RTA on acceleration clauses. Only after realization and a detailed proof of loss and proof of having taken all steps to mitigate loss, could an arrears judgment be obtained;¹⁹⁴

- (e) there are other residential tenancy-specific rules in the RTA that will impact how the financier can deal with its security (e.g. on maturity, if the required final payment is not made and the financier could not recover vacant possession from the IF customer as under a mortgage). Instead, the *ijara* contract will continue as a month-to-month tenancy unless a notice of termination stating the contract would not be extended had been delivered at least sixty days before the maturity date.¹⁹⁵ If the financier did not want to extend or renew, the IF customer could continue in possession making the same monthly payment, and the only way the financier could terminate that tenancy would be by making a sale to a purchaser who wanted to occupy the premises on behalf of the homebuyer's family. Under the *Mortgages Act* (Ontario), there is a recognized procedure with specific obligations on the occupants to provide access and cooperation in order to help market the property to facilitate its sale; it is more difficult to do so under the RTA.

Home financing by way of *ijara* or integrated *ijara* and *murabaha* contracts are possible but potential maintenance and repair and other obligations imposed on the financier, and the different servicing and enforcement procedures, would require existing mortgage lenders to establish significantly different pricing, funding and staffing.

¹⁹⁴ S.O. 2006 c. 17 as amended at ss. 88, 89.

¹⁹⁵ S.O. 2006 c. 17 as amended at ss. 38, 49.

Default and Enforcement

In a situation where the IF contract includes *ijara* or rent type payments and can be construed as a residential tenancy agreement under provincial law, the special residential tenancy enforcement process and issues as noted above apply.

Where the IF structure is in substance a long-term agreement of purchase and sale, or a co-ownership with purchase obligations, the only remedy would be recourse to the courts for enforcement of the specific terms of the IF contract. Generally, courts should recognize actions to enforce these kinds of IF contracts as an action akin to foreclosure and should give the IF customer rights similar to a mortgagor, including relief from forfeiture and the right to reinstate the contract or redeem the property.

However, where the IF financing is a *musharaka* contract structured as a true partnership with full sharing of profits and losses, the financier's claim for payment has the risk of being subordinated to other claims. On the bankruptcy of the IF customer in a partnership contract, the trustee in bankruptcy becomes a tenant in common of the property with the financier, each for their respective interest in the property at that time, and the financier will not be paid its claim for the amount owing to it by the bankrupt until all other creditors are fully satisfied.¹⁹⁶

Recovery of late charges is an issue in these IF structures because they resemble interest on amounts in arrears. Under *Shari'a*, interest on overdue payments is not permitted. In a *mudaraba* contract with a marked-up price, the profit is fixed and is not supposed to be subject to change because of default or other changed circumstances. Certain fees or penalties (often to be paid to a charity rather than a lender) are permitted by *Shari'a* but would be prohibited as default charges under federal and most provincial cost of credit legislation.

Insurance

The interests of both the buyer and financier in IF are preferably insured through *takaful*, a *Shari'a* compliant form of risk sharing that would have no or limited availability. A

¹⁹⁶ *Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 142.*

customary policy of fire and extended peril insurance that names the financier as the insured or an additional insured for the period of its ownership or co-ownership would be required. As the financier is a named insured rather than a mortgagee, the IBC standard mortgage endorsement that protects a lender from misrepresentations and acts of the owner that otherwise void or limit coverage would not apply. An endorsement that similarly protects the financier from such misrepresentations or acts of the IF customer would have to be developed for effective coverage of the financier's interest.

New Home Construction

The *ijara*, *musharaka* and *mudaraba* finance structures are only available for properties that are in existence. A building mortgage would be an *istisnaa* contract by which the financier would undertake to complete and deliver a new home. A financier offering assistance would have to subcontract completion of construction. Such contracts would be outside the powers of regulated financial institutions; however, they do lend themselves well to builder-provided financing, with the financial institution becoming involved with the buyer under another IF arrangement once completion and delivery have occurred.

Dealing with Property Subject to IF

The IF structures are for financing the IF customer for a fixed profit or series of payments so are generally structured to be amortized over the term of the IF contract, rather than by a series of terms shorter than the amortization as is common for mortgages in Canada. Closing out the IF contract early is therefore not generally provided for.

There is no legal impediment to a sale of a property subject to an existing IF contract that is assumed by a purchaser, subject to the financier's approval. In the case of an *ijara* contract, this is by way of assignment of the lease and purchase right. In practice, an IF customer would, in most cases, prefer a new financing for its purchase.

Assumption, prepayment in full or other early close-out provisions in the IF contract are matters for consideration of *Shari'a* compliance and are not legal impediments.

Partial prepayment privileges are similarly matters that for *Shari'a* compliance may not appear in the IF contract but there are no legal impediments to doing so.

Variations and Hybrid Structures

To deal with some of these legal impediments and issues and for marketability of property and IF finance, finance structures that follow some but not all *Shari'a* have been and are likely to continue to be developed. These include use of back-to-back agreements of purchase and sale rather than titled ownership transfers as described above, terms shorter than the amortization of the financing with concepts of renewal, prepayment with appropriate rebate or prepayment charges and profit margins in place of interest as noted in respect of some of the US forms in Part II.

Interest and Cost of Credit Disclosure

Neither the *Interest Act (Canada)* nor the cost of credit legislation requires an annual interest rate as part of the contract or disclosure.

A principle of *Shari'a* is the duty to treat each customer fairly including full disclosure of cost. A substantial part of this obligation is reflected in the existing cost of credit disclosure obligations imposed on credit grantors under federal and provincial laws. IF contracts involving *ijara* or rent type payments with a purchase right, or pure partnership or co-ownership, are outside the cost of credit disclosure requirements. The legislated requirements do not extend to real property lease obligations or partnerships.

Other IF structures that involve a marked up purchase price or other fixed profit amount have attributes that bring it within the definition of an extension of credit and require disclosure in accordance with the regulations. Compliant disclosure is possible as essentially they require a statement of the amount of value given by the lender compared to the value to be received by the lender expressed both as a dollar and cents amount and as an annual percentage rate (APR)

Tax Treatment of Islamic Housing Finance Structures

As noted above, Islamic housing finance is typically structured as:

- *Ijira* (lease) with a bargain purchase option once the value of the property and lease profit have been paid;
- *Murabaha* that involves purchase by the financial institution and immediate re-sale to the home buyer with a mark-up payable over time; or
- Diminishing *musharaka* (or *mudaraba*) that involves co-ownership, with the purchaser buying out the financial institution's interest over time and culminating with a formal conveyance by the financial institution of its remaining interest to the home buyer once that interest has been fully bought out.

All these structures have a common requirement that the financial institution become owner of all or part of the property, either for an instant or for the term of the loan. For new and existing houses this raises issues of land transfer tax. For new homes, it also raises issues with respect to the federal Goods and Services Tax (GST) and harmonized provincial sales tax (HST).

As regards land transfer tax, it would be beyond the scope of this paper to examine each of Canada's 13 jurisdictions. Therefore Ontario has been selected to illustrate the types of issues that arise. However, the result is likely to be the same in other provinces that impose land transfer taxes.

Land Transfer Taxes – Double Taxation

Land transfer taxes are imposed on each transfer of an interest in real property except as security.¹⁹⁷ Tax rates in Ontario are 0.5 per cent of the purchase price on the first \$55,000.00, 1 per cent on the additional purchase price up to \$250,000.00, 1.5 per cent on the additional purchase price up to \$400,000.00 and 2 per cent on any balance of the purchase price.¹⁹⁸

In an *ijara*, *musharaka* and other IF contracts, land transfer tax would be payable again on completion of the financing. The taxes would be charged on the gross sale price including all amounts in whatever way paid to acquire the interest in the property. So for

¹⁹⁷ *Land Transfer Tax Act*, RSO 1990 c.L.6 as amended.

¹⁹⁸ *Land Transfer Tax Act*, RSO 1990 c.L.6 as amended at s. 2.

an *ijara* house financing, land transfer tax would not be payable on the lease payments as they are made, but the lease payments made would comprise part of the gross price on which tax is payable at the time of the transfer by the financier to the buyer.¹⁹⁹ This compares to no tax payment on the completion of a mortgage financing. Therefore, without legislative relief or administrative adaptation, these IF house finance structures would result in double land transfer taxes.

In the case of a co-ownership type IF structure such as *musharaka*, the land transfer tax would be payable by the co-owners (buyer and financier) on acquisition of the property, and then again on completion of the financing on registration of transfer of the financier's interest in the property to the co-owner. If structured as a diminishing *musharaka* with the buyer acquiring an additional interest in the property with each payment, the broad reach of the anti-avoidance provisions of the Ontario *Land Transfer Tax Act*²⁰⁰ could be construed to require payment of tax within thirty days of each such unregistered transfer of the beneficial interest in the property.

In a *mudaraba* house financing, where the property is purchased by the financier and resold to the home buyer with a marked-up purchase price, the land transfer tax would be payable on the initial acquisition on the IF customer's purchase price and again on the higher resale price. Double taxation has been alleviated by structuring the *mudaraba* by way of back-to-back agreements of purchase and sale where the buyer makes an agreement for purchase of the property it wants to buy with the seller and assigns that agreement to the financier who then makes an agreement to resell the property back to the buyer at the marked-up price. Only one title registration is made as the financier directs the initial seller to convey the property to the IF customer at closing of the purchase and the IF customer then gives a mortgage to secure the marked-up price less the amount of the deposit and down payment.

¹⁹⁹ *Land Transfer Tax Act*, RSO 1990 c.L.6 as amended at s. 1(1) "value of the consideration".

²⁰⁰ *Land Transfer Tax Act*, RSO 1990 c.L.6 as amended at s. 3.

The Ontario Ministry of Finance has confirmed in at least one non-published administrative ruling that only one land transfer is payable with such back-to-back agreements of purchase and sale and that the tax is charged on the higher marked-up purchase price. Under this ruling, the IF customer is therefore in effect paying tax on the cost of the financing which, if it was interest on a mortgage, would be tax free. Therefore, without further legislative relief or administrative adaptation, this modified *mudaraba* structure would still result in some measure of double taxation.

GST/HST and Capital Gains Tax

Tax issues also arise with regard to GST treatment of new homes and capital gains tax.

Typically in a conventional new home purchase the builder charges GST to the buyer. First time home buyers are entitled to a partial GST rebate of up to (approximately) 1.8 per cent on the first \$250,000 of the purchase price and diminishing as the purchase price increases up to \$450,000, at which point the rebate ends and GST is payable at the full rate.

If the bank purchases the house for holding under an *ijira* (capital lease), the bank will most likely be required to pay GST on the purchase. No GST will be payable by the buyer when the bank finally conveys its interest to the buyer at the end of the *ijira* because the home will not be a new home. As the lease is a capital lease whereby the bank takes no (or little) residual value risk, there should be no capital gain to the bank on the transaction, so long as the payments under the lease are characterized as lease income.

In a diminishing *musharaka*, where the bank retains a certain measure of residual value risk (see co-op structures above where co-op retains 10 per cent of the gain or loss), it is not clear whether this would be treated by the Canada Revenue Agency (CRA) as income or capital.

In new home *murabaha*, where back-to-back sales are involved, the GST/HST treatment is quite complex and will depend on how the CRA ultimately views the roles and relationships among the parties. Financial institutions are typically not entitled to GST input credits on financial transactions and do not charge GST on financial services.

However, they are entitled to input tax credits on lines of business that are not GST exempt, provided the goods and services purchased by the bank are not commingled with the exempt business services they provide. Double GST taxation would arise if the bank did not have an input tax credit and was nevertheless required to charge GST to the buyer.

Home Buyer/Home Owner Tax Benefits

Many of the taxes imposed on homebuyers and homeowners have some relief provisions. These generally would not be available if as part of the IF structure, the homebuyer does not take immediate title and ownership of the property. Tax benefits that would be adversely affected include:

- (a) Land transfer tax: in Ontario first time buyers of a home in the price range of \$150,000.00 to \$200,000.00 can claim a rebate starting at 90 per cent of the first \$5,000.00 to 10 per cent of the last \$5,000.00 of tax paid in that range of the purchase price;²⁰¹
- (b) GST: first time homebuyers are entitled to a partial rebate of GST paid on a new home of up to approximately 1.8 per cent of the first \$250,000.00 of purchase price and diminishing as the purchase price increases up to \$450,000.00.²⁰² GST is not charged on resale of any residential property.

Where the transaction is structured by way of back-to-back agreements of purchase and sale (as described above with regard to land transfer tax), the GST rebate would not be available unless the first of the back-to-back transactions were disregarded for tax purposes.

- (c) Capital gains: under the *Income Tax Act*, the gain on a home owner's principal residence is generally not subject to capital gains tax.²⁰³ A material gain in the value of the property during the time that title to the property is held by the financier in an IF structure would not be available to the home owner. In co-

²⁰¹ *Land Transfer Tax Act*, RSO 1990 c.L.6 as amended at s. 9.

²⁰² *Excise Tax Act*, RSC 1985 as amended s. 254.

²⁰³ *Excise Tax Act*, RSC 1985 as amended s. 40.

ownership structures such as diminishing *musharaka*, the allocation of gains in a way non-proportionate to ownership interest would be difficult.

(5) CANADIAN REGULATORY ENVIRONMENT.

Regulatory Approaches

In some jurisdictions, regulators have determined that certain IF products are compliant with secular laws, leaving *Shari'a* elements to form part of marketing or customer service. In other jurisdictions, *Shari'a* law itself informs the products and services that may be offered. In the US, these issues have been resolved collaboratively, with one author describing Islamic mortgages as “a hybrid creation of certain *Shari'a* scholars, the financial sector, and the US government.”²⁰⁴

In the absence of specific regulations, IF solutions tend to be *ad hoc*.²⁰⁵ Indeed, it has been noted that before the regulatory bodies in the US began to issue interpretations, efforts to supply IF home finance were “situation-specific and capital-constrained.”²⁰⁶

In remarks at an OSFI seminar in October of 2006, a senior OSFI representative stated that OSFI and other government departments were discussing the implications of Islamic finance and Islamic banking in Canada.²⁰⁷ Some of the considerations and challenges identified by OSFI were stated to be:

- Whether the products fit within the *Bank Act*;
- Whether they can be recorded in accordance with generally-accepted accounting principles and in particular, how “profit” or “mark-up” would be accounted for versus interest;
- What the capital implications would be and how the products would be risk-weighted as opposed to their conventional counterparts;

²⁰⁴ Maurer at p. 3.

²⁰⁵ Thomas , note 31 at p. 75.

²⁰⁶ Thomas at p. 75.

²⁰⁷ Remarks by Geraldine Low, Director of Approvals and Precedents, presented at the annual OSFI Legislation and Approvals seminar, Toronto, Ontario, October 31, 2006.

- Financial presentation;
- True understanding of the risks on the balance sheet associated with the products; and
- Consumer disclosure and customer awareness and protection issues.

The following year, Julie Dickson, then Acting Superintendent of Financial Institutions and now Superintendent, had this to say regarding the new entrants into the Canadian financial market, or innovation in product offerings, both generally and with respect to Islamic Finance in particular:

First we need to understand whether such services fit within our policy framework by assessing the extent to which Islamic finance and banking accomplish economic functions that are equivalent to existing products, together with an assessment of whether these functions fit under existing legal, accounting and fiscal regimes.²⁰⁸

Ms. Dickson went on to describe the analysis through which OSFI would examine innovations in financial services including Islamic Finance:

- (a) Do these products fit within the broad policy framework?
- (b) Do they fit within the financial institutions statutes?
- (c) How are these products accounted for?
- (d) How is the risk weighting performed?
- (e) What about customer disclosure requirements?
- (f) Are there liquidity management issues?
- (g) How will corporate governance requirements be met?
- (h) Is the potential market of sufficient size to be able to support these products?

²⁰⁸ Remarks by Julie Dickson, Acting Superintendent, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Joint Meeting of the Credit Union Stabilization Funds of Canada, Ottawa, Ontario, June 15, 2007.

The Ability of Banks to provide Islamic Housing Finance

Most product offerings in the realm of housing finance would not be prohibited within the existing regulatory framework for banks and other federally-regulated financial institutions (FRFI's).

All three of the typical IF housing finance structures require the bank to take an ownership interest in the property, either for an instant as in the case of *murabaha*, or for an extended period in the case of *ijarah* and diminishing *musharaka*.

These techniques raise the following questions under the *Bank Act*:

- (a) Does the acquisition of an ownership interest in the property contravene a prohibition in section 410 of the *Bank Act* against dealing in "goods, wares and merchandise"?

The most obvious answer is that real property is not included within the concept of goods, wares and merchandise. However, a broader interpretation from a regulatory standpoint, and one that would be relevant in the financing of personal property, is that the purchase and resale of goods in order to provide an Islamic finance product is a *financial service* rather than a commercial or trading transaction.

- (b) Would *ijarah* contravene any restrictions on leasing contained in the *Bank Act*?

The *Bank Act* prevents banks from providing operating leases of personal property, and from providing financing leases of automobiles and household goods. *Ijarah* in the context of home finance would be classified as a financing lease of real property and therefore would not be restricted by the leasing prohibitions contained in the *Bank Act*.

- (c) Does the *Bank Act* prohibit a bank from having on-going ownership interests in real property, such as to impede its ability to provide financing by way of *ijarah* or diminishing *murabaha*?

There are no outright prohibitions in the *Bank Act* against the ownership of real property by a bank. However, the Act does limit the book value of real property that small and medium sized banks may hold as a percentage of their regulatory capital. The current

limit is 70 per cent, which means that the book value of the real property held by the bank cannot exceed 70 per cent of its regulatory capital. The provision does not apply to widely-held banks with regulatory capital in excess of one billion dollars.

(d) What is the impact of the prohibition against high-ratio mortgage lending?

Section 418 of the *Bank Act* generally prohibits banks from making mortgage loans with a loan to value ratio (LTV) in excess of 80 per cent, unless the loan is insured by CMHC under the *National Housing Act*, or under an approved private insurance program.

Section 464 of the *Bank Act* contains a definition of “loan” that would encompass IF arrangements, but that definition does not apply to section 418.

High ratio mortgages raise the problem of insurance, that is not *Shari'a*-compliant because it is viewed contrary to the prohibitions against uncertainty (*gharar*) and speculation and gambling (*maisir*). *Takaful*, a type of mutual insurance, is permitted and would be required for both high ratio “mortgages” and insured conventional arrangements.

(e) Impact of the restriction on partnerships?

Section 421 of the *Bank Act* prohibits a bank from being a partner in a partnership, other than a limited partner of a limited partnership. Diminishing *musharaka*, with its joint ownership and risk/reward sharing, might be considered to be a type of partnership as would *mudaraba*, unless the latter were characterized as a limited partnership. The prudential intent of the prohibition is to prevent a bank from assuming unlimited liability for the acts of the partnership, that is a defining feature of partnership.

(f) Risk-weighting of Islamic mortgages.

As was mentioned in Part I in the discussion of Islamic mortgages in the UK, under Basel I, *murabaha* and diminishing *musharaka* were risk-weighted as mortgages at 50 per cent, whereas *ijira* was risk-weighted at 100 per cent. This is presumably because it was considered to be a property interest rather than a mortgage. Upon the implementation of the European Basel II standardized approach (section II.A.8, “Claims secured by residential property”), the *ijira* is given the same risk-weight as the other

mortgage products. The European regulator has therefore concluded that *ijira* lending is “fully secured by mortgages on residential property”. The Canadian Capital Adequacy Requirements (CAR) implementing Basel II refers to “mortgages” on residential property as qualifying for the new 35 per cent risk-weighting. However, it is unknown whether *ijira* based products would be considered “mortgages” or leased property, that in the latter case would further widen the spread between *ijira* and the other structures to 65 per cent rather than 50 per cent under Basel I.

PART IV. CONCLUSIONS.

It is important to note that while there is demand for Islamic housing finance, Muslims are not necessarily without all recourse where IF mortgage products are lacking. In Europe, for example, one ruling of the European Council for Fatwa and Research stated that Muslims could purchase homes using conventional mortgages where no alternatives existed on the *Shari'a* principle of *daruarah*, or necessity.²⁰⁹

One prominent US-based scholar estimates that, broadly speaking, approximately 30-40% of Muslim consumers will choose *Shari'a*-compliant products if given the choice;²¹⁰ however, the research conducted for this report does not support this assertion. While there are significant differences across jurisdictions, the take-up rates for IF retail products is invariably extremely low, even in jurisdictions such as Malaysia and Pakistan where government support has been strong.

In the literature canvassed for this report, there is a noted lack of input from the Muslim community at large as to their needs and preferences. It does not appear that there have been any systematic studies on Muslims' attitudes towards IF in particular countries or across different countries.²¹¹ Without this work, it is not possible to extract meaningful reasons for the country differences and trends. For example, having a large Muslim population is correlated with a low level of demand for life insurance, (which is prohibited under the *Shari'a*) suggesting that religious factors may indeed have an impact. However, personal income, inflation and institutional development are also strong predictors. Nevertheless, it remains unclear whether market forces alter ideological preferences or *vice versa*. That is, it is impossible to say how the Muslim population in any country would respond to an increasing array of IF products and services were they introduced.

In the end, it may be asked what the difference is between IF mortgages and secular mortgages, given the similarities in payment schedules and the end results. In fact, it

²⁰⁹ Maurer at p. 40.

²¹⁰ Yusuf Talal DeLorenzo, "The Shari'a scholar's view of Islamic consumer finance and retail products" in *Islamic Retail Banking and Finance: Global Challenges and Opportunities* (2006: Euromoney Books, London) at p. 5.

²¹¹ Maurer at p. 9.

may be that this debate matters most to Muslim homeowners, rather than the actual products.²¹² The question for housing finance lenders and regulators in the West may be whether IF can 'fit' within an existing regulatory framework, or whether such a framework can be minimally modified.

Further, this approach may be the most inherently workable given that most IF products are based upon achieving conventional financing ends (e.g. investment, home finance) by unconventional means (i.e. no interest). The counter is a risk of over-regulation or misinformed regulation, especially considering that the modern IF tradition is very recent, that scholars' views are still being debated and will evolve, and that IF must be competitive with conventional finance.

²¹² Maurer at p. 35.

PART V. GLOSSARY OF COMMON ARABIC TERMS AND EXPRESSIONS USED IN ISLAMIC FINANCE.

Bai' bithaman ajil (deferred payment sale) – a purchase with sale at a mark-up that is undisclosed.

Bai dayn (debt financing) – trading in debt instruments.

Bai Salam (forward financing) – financiers purchase an asset with payment in advance and delivery by the customer at a later date. Financiers receive a lower purchase price in exchange for advance payment, and can sell the asset upon delivery at mark-up, representing profit.

Daruarah (necessity where no alternative) – under this principle, some scholars have argued that Muslims may use conventional mortgages or financial products where no viable alternative exists.

Fatwa (religious ruling) – a *fatwa*, in the context of IF, represents the opinion of a board of Islamic scholars who have evaluated a product, service or transaction for compliance with *Shari'a*.

Halal (Islamically acceptable) – literally means lawful or licit

Haram (Islamically unacceptable) – literally means unlawful or illicit

Ijara (operational leasing contract) – a customer approaches a financier about a leased asset, the financier agrees to acquire a lease and to charge a mark-up to the customer by way of rents. These rents also must include charges for increased risk to the financier, the costs to insure, if any, and tax liabilities. As with *murabaha*, rental payments include an agreed profit element to avoid prohibitions against interest and uncertainty.

Ijara Wa Iqtina (lease purchase financing) – an *Ijara* is an agreement with a purchase and sale condition at the conclusion of a rental period. Functions as a lease-to-own agreement with risks borne by the financier in exchange for rents.

Istisnaa (construction financing) – similar to *ijara wa iqtina*, used to purchase large equipment or construction assets, with deferred payment schedules. It is typically a contract under which a manufacturer or contractor agrees to build something at a future date.

Murabaha (mark-up financing) – a financier buys an asset from a supplier and immediately sells it to a buyer at an agreed mark-up price. Title is held by the financier for a short time, and the profit is therefore deemed to be derived from a sale of goods rather than interest. The mark-up price may be payable immediately or at a future date. The margin may be based upon LIBOR or another verifiable rate. *Murabaha* transactions require additional covenants to protect the financier against liability while holding title.

Mudaraba (trust finance) – purchase and sale with disclosed mark-up, between a group of investors and a manager of the investment. Investors or a financier puts up capital, which the manager then invests. Investments must be in *Shari'a*-compliant areas of investment. Savings accounts or mutual fund-type investment arrangements can be comprised using *mudaraba*.

Mudareb (manager) – in *murabaha* or *mudaraba* investments, the customer acts as manager or caretaker of investment.

Musharaka (equity financing) – financier and customer provide financing for a project or transaction in an agreed upon ratio. Profits are based on a similarly agreed-upon ratio; however, losses are pro-rated to the original investment. The customer acts as the manager or caretaker of the investment, with responsibility to earn a return for the financing 'partners'.

When used in a mortgage transaction, the investment participation of financier diminishes over time as its ownership interest is passed to the customer. Rents are paid by the customer for an agreed-upon length of time.

Qard Hassan (interest free loan) – this can include a deposit to a bank.

Rabb al Maal (group of investors) – the partners or investors who contribute capital to a venture, usually as passive investors

Riba (usury or interest) – usury as interpreted by the *Qur'an*, including interest.

Salam (purchase of commodity with future delivery) – a commodity is purchased with a future delivery date set. The price is agreed upon and paid in full in advance. The commodity is often sold prior to delivery for a higher price, with the margin representing the profit.

Shariah (Islamic law) – Islamic law as revealed by the Holy *Qur'an* and the *hadith*, and the sayings of the Prophet Mohammad.

Sukuk (Islamic securities) – a negotiable instrument that can be bought and sold on a secondary market. Used in conjunction with *musharaka* or *ijara*, wherein the holder of the note replaces the seller in holding title to the asset. Though similar to a bond or debt instrument, *Sukuk* differs as it is backed by an asset, whereas a bond or security gives no right to title of the underlying asset.

Takaful (joint guarantee) – a form of group or mutual risk-sharing that functions in a manner similar to insurance.

Tawarruq (sale of commodity with future delivery spot for cash) – conceptually similar to “reverse” *murabaha*, wherein a financier buys an asset from a supplier, immediately sells to a buyer, who in turn immediately sells to a third party. The customer receives cash with a deferred obligation to the financier. The financier will charge a larger mark-up than in a conventional transaction to account for increased risk on the third party. Care must be taken to separately document each transaction to avoid characterization as being a disguised loan.

Wakeel (agent) – a purchaser who assumes an agency role in acquiring an asset.

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