

Islamic Finance in North America 2009

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Blake Goud

yasaar media

Journalism With Judgement

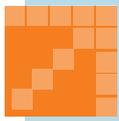
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Connecting *Wall Street* with the *Islamic Crescent.*

Two allied firms with five areas of focus

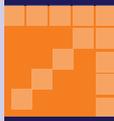
Codexa Capital and **Calyx Offshore** are specialized investment banking firms connecting clients with and within the Islamic Crescent. The distinction between the firms relates to their focus. Under the Calyx brand, we conduct our work for conventional-sector investment strategies, whereas the Codexa name focuses on Shariah-compliant business. We have crafted the distinction to provide clarity in our client relationships.

Codexa Capital management's experience at earlier employers—including Merrill Lynch, AIG, and Deutsche Bank—informs our approach across a spectrum of activities, from product development and capital introduction work, to asset advisory, corporate finance, and investment research in support of client initiatives. This same management team built, at our predecessor firm, a business that ranked among the

"Top 500 Islamic Financial Institutions" listed in London-based *The Banker* magazine. In the wake of the 2008 credit crisis, we transitioned from venture capital backing to management ownership, and articulated our two allied but distinct areas of focus.

We are headquartered in New York and operate through affiliations across the Islamic Crescent for timeliness, local knowledge, and regulatory responsiveness. Our strength lies in cross-border, transnational, and multilateral activity, responding to a contact base stretching from Casablanca to Jakarta. Our approach to both relationships and transactions emphasizes clarity, accountability, and process discipline. Client assignments further benefit from our commitment to communications excellence as a core element in marketing and sales success.

	Islamic	Conventional
Product Development: <i>Crafting</i>	✓	✓
Corporate Finance: <i>Solving</i>	✓	✓
Capital Introduction: <i>Finding</i>	✓	✓
Investment Research: <i>Analyzing</i>	✓	✓
Asset Adversory: <i>Structuring</i>	✓	✓



Ready For Take-Off

The USA and Canada have not featured very prominently in the development of Islamic finance on the global stage until relatively recently. The reasons for this may have more to do with marketing than substance since, as this report shows, there has been a lot of activity in these core markets for a number of years but perhaps not enough of it made the headlines outside of the North American press.

After 9/11 there was much press concerning the repatriation of funds from North America back to the Gulf from investors who were nervous that their funds would be frozen and unreachable and doubtless some of this money did indeed make its way back and found itself fuelling the inflation-fed property boom that the Gulf experienced until the wheels came off just recently. But this exodus of funds only affected a part of the home-grown Islamic finance market in North America and the rest of it ploughed on regardless, gaining traction and scale.

Islamic finance has developed in North America along two very different tracks. The first is the retail finance track that gains most of the headlines. This concerns Islamic home finance in the main, although it also concerns non-interest bearing bank accounts and community efforts to offer Shariah compliant solutions. Such efforts inevitably follow the geographic spread of the Muslim population of North America since this is where the demand is.

In this regard Canada has an easier time of it than the USA since the Canadians are legally allowed to ask the religion of their population and therefore can more easily identify where Shariah compliant solutions are most needed. The USA, in contrast, is constitutionally disallowed from asking the religion of its population and so finds itself in the odd position of having no idea whatsoever what the Muslim component of that population is. In the post-PC (politically correct) world in which we live this may seem like a debilitating anachronism, but it is not something that is likely to change anytime soon.

The other track along which Islamic finance has developed in North America is perhaps grander in scale but is less visible and concerns the investment of predominantly GCC-based Islamic funds in North American industries in a Shariah compliant manner. These include initiatives like Gulf Finance House's investment in Halcore, the US ambulance manufacturer, Arcapita's interest in the Elysian Development Group in Chicago and Church's Chickens, Unicorn Investment Bank's acquisition of Gardens Residential Care Centers in California and Ellington Leather Goods and many more.

None of this is particularly surprising. The USA is one of the largest and most mature financial markets in the world. Until relatively recently most investors also believed that it was one of the best regulated markets and in spite of the recent hiccoughs, it probably still is. In North America there is wealth, sophistication, and a high level of regulation. There is a huge and diverse infrastructure of small, medium, and large enterprises many of which will be looking for funding or investment from one source or another. Since many GCC-based Islamic investment banks were awash with cash it is hardly surprising that the cash would find a way to be deployed where there was a need.

An equally important element in this jigsaw is the educational background of many of the CEOs of the Gulf's Islamic investment banks. Often they hold first degrees, second degrees, or MBAs from educational establishments in North America. This means that this generation of Islamic financiers is happy working and doing deals on both sides of the Atlantic, which explains not simply their propensity to do deals but also the abundance of regional offices of Islamic investment banks in North America.



Introduction from Paul McNamara

But the report that follows is not simply a catalogue of who has done what in the sphere of Islamic finance in North America. It is the most comprehensive analysis so far undertaken of what has been achieved in each of these two main spheres as well as an insight into where the industry will develop from here.

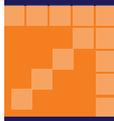
At the time of writing the globe at large is still talking up the prospects of economic recovery and both Goldman Sachs and Merrill Lynch look like they might be starting to replicate their stellar profits of yesteryear. And yet.

And yet. And yet it is no longer clear that the world wants to go back to the good old bad old days before the crisis. There is still a strong sense of ennui surrounding the way things used to be. Many are looking for a change and Islamic finance might be the change they are looking for, representing as it does a mode of financing that is inherently more risk-averse than its conventional counterpart.

Where better to find genuine green shoots of recovery than in the fastest growing segment of the financial world today, in the most complex and affluent countries of the world? Without doubt Islamic finance in North America is heading into its most fascinating phase yet and by the time we come to publish Islamic Finance in North America 2010 the landscape could look very different to the way that it does today.



Paul McNamara is the editorial director of Yasaar Media



Foreword from Douglas Clark Johnson

CEO and Chief Investment Officer, Codexa Capital



Not long ago, I was on a flight from Riyadh to Jeddah, reading a text about the Islamic faith. The man sitting next to me, who happened to be wearing Saudi national attire, said, “You don’t look Muslim.”

I lifted the Koran from my travel bag and replied, “I must have missed the section that describes what a Muslim looks like. Can you point out the reference?”

It is a story that I often tell because it reminds me that all humans, by their very nature, commonly make assumptions that at times are ungrounded in context. Business is no different. Certainly the conventional financial services sector makes rash assumptions about the Islamic sector, and vice versa.

A quick scan of US-based blogs on the topic would lead the uneducated reader to assume that Islamic banking was largely about terrorist financing. One site even goes so far to refer to one of my accomplished American colleagues as a “Shariah-sop.” I am not sure what that means, but it is probably not complimentary.

Likewise, I recall a heated moment in Cairo when an Islamic banking executive declared,

“You don’t really expect me to believe that an American firm can actually and legitimately be Shariah-compliant.” In a moment of pushback, I suggested that there were upwards of 7 million Muslims living in the United States who might argue differently.

My point is that perception often becomes reality, but that’s not necessarily the same as truth. And while I afford my own clients a great deal of leeway in their views and expressions, I tend to be less generous with persons in the public domain, on account of my classic East Coast education. I came of age in the intellectual equivalent of a Middle East souk.

My heartfelt desire to understand the grounding and nuances of Islamic finance globally - whether in North Africa, the Levant, the Gulf, South Asia, or Southeast Asia - helps fuel the all-hours effort it takes to stay connected to such a sphere from a New York headquarters. A multilateral approach informs our effort to make an impact on the Islamic Crescent. We can be most effective, in my view, not by taking on Gulf institutions on local deals in Bahrain or wrestling with Malaysian institutions on projects in their own backyard, but rather by focusing on the cross-border and trans-national elements of our work. In this context, Karachi and Dhaka command as much attention as Dubai. (If only those economies would do a better job at capital formation).



Foreword from Douglas Clark Johnson

CEO and Chief Investment Officer, Codexa Capital

We are fortunate in having opportunities to introduce issuers and investors to each other in ways that transcend mere commercial ties. A particularly satisfying example is an Islamic project finance effort on which we are now working, that uses American and Indian talent to structure a deal in the Ukraine to be syndicated primarily to Middle East and Southeast Asian names.

Back to Cairo. I journeyed to the heart of the country's religious establishment to visit with a well-known Shariah scholar at Dar al-Iftaa. This involved some advance notice because my limited Arabic speaking capability required engaging a translator. When I showed up at the appointed hour, the security supervisor at the front desk said to me in broken English, "You're the American businessman, right? We're expecting you, but what are you doing here? We never see people like you in our building."

Ultimately it is the passion of inter-cultural re-understanding that drives one to work the phone at 3:00 am from Wall Street. Sometimes the banker in Kuwait, or the institutional salesman in Kula Lumpur, or the finance officer in Sri Lanka asks, "What are you doing awake at this hour?" I tend to reply, "Can I help it if my home office is at the lag-end of world time zones?"

My colleagues and I welcome the opportunity to sponsor this publication. In a small way, our hope is that the report will help to connect issuers and investors, across the Islamic and conventional spaces, forthrightly and successfully.

It is a big world. There is much to do.





A rapidly growing global industry develops under the radar in the United States and Canada

The Islamic financial industry has grown rapidly across many parts of the world and has expanded outside Muslim majority countries like Malaysia and the countries of the Gulf Cooperation Council (GCC) into areas of the west like the United Kingdom, Germany, Japan and North America. However, the growth in North America, Canada and the United States, differs from its growth in other areas of the world in the primarily retail focus of the products receiving the most attention. In many cases, Islamic financial products were developed in response to the demands of Muslim communities within the two countries rather than from developments within the broader financial markets.

The relatively small size of the Muslim community in the US (2-8 million) and Canada (1 million) and the design of their regulatory systems have combined to leave the Islamic financial industry in North America relatively under-developed compared to other regions of the world. However, over the past 30 years, the industry has grown from primarily offering Shariah compliant alternatives to investing and buying a home into many different areas of financial service.

The types of products available to Muslim consumers within the core areas of development has also expanded and liquidity enhanced through the participation of Freddie Mac and Fannie Mae in the Islamic home finance areas. While the greatest attention has been given to the retail area of Islamic finance in North America, the wholesale finance market is of equal or greater size. However, because the products are often developed for foreign investors

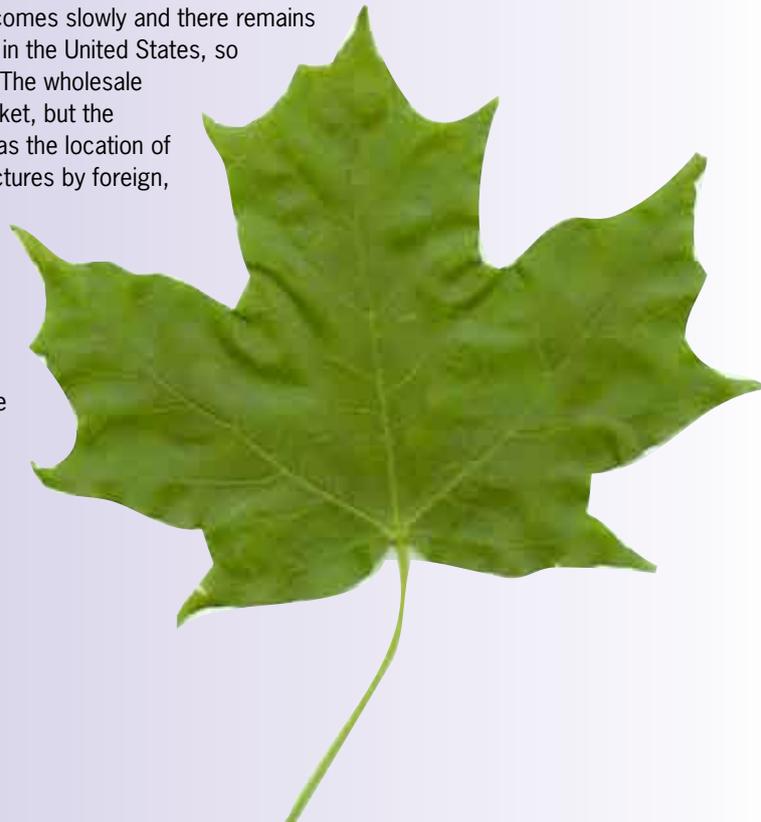


investing primarily in US assets, it has not received as much attention as the smaller domestic retail industry.

One common misunderstanding among many observers is that the United States holds an unfriendly view towards Islamic financial services, particularly since the 9/11 attacks. However, once one looks at how financial regulation interacts with Islamic finance in the United States, it paints a different picture. While government officials do not speak at Islamic finance conferences about their desire to attract Islamic finance to the United States as is the case for some other western countries, the regulatory system and the regulators who guide it are working behind closed doors with Islamic financial industry practitioners to aid the development of products that are compatible with US laws and regulations as well as the Shariah. In Canada, the government is still considering how it will regulate Islamic banks having completed but not released two studies on the industry and thus there remains uncertainty about the path the industry will take moving into the future. But again, the government is working to educate itself on Islamic finance to see what place the industry will play within the financial services market in the country.

In many respects, the retail Islamic financial industry in North America has remained focused on the local market and, unlike many large conventional financial institutions in the country, most Islamic financial institutions have not yet broadened their focus to tap into global financial markets. This too is changing, but change comes slowly and there remains a fairly limited number of financial institutions and products in the United States, so the domestic market still has room to expand and deepen. The wholesale market has always been far more global than the retail market, but the participation of the United States has been largely passive as the location of investments made through Shariah compliant financial structures by foreign, mainly Middle Eastern, investors.

Although the Islamic finance industry in the US has not attracted the same attention as other regions of the world and even other countries in the west, it has seen a large amount of growth and development particularly during the past 10 years and this should continue as new products are developed and new institutions open.



WELCOME TO TORONTO

North America's hub for Islamic Finance



Toronto is Canada's financial capital and the third-largest financial services centre in North America after New York and Chicago. It's home to Canada's five largest banks, 50 foreign bank subsidiaries and branches, along with 115 securities firms. In 2008, *Forbes* magazine listed Toronto as one of the top 10 most economically powerful cities in the world. The Toronto Stock Exchange has launched a Shariah index, where an Islamic ETF is to be launched in the near future. Corporate and sovereign sukuk are also in the works while the Toronto Financial Services Alliance has created a working group on Islamic Finance.

As Canada's premier Islamic financial institution, we're proud to call Toronto home. Want to know more? Ask us, we know. Call us at (416) 424-4100 x 114.

Facts about Toronto:

- > Population of 5.4 million, making it the fifth largest city in North America
- > Best educated workforce in the G7
- > Home of the TSX, the third largest stock exchange in North America & seventh largest in the world (\$1.5 trillion market capitalization)
- > 160 million customers & suppliers are within one-day's drive

Facts about Canada:

- > Population of over 33 million ~ more than Saudi Arabia and UAE combined
- > Second largest country in the world
- > World's second largest oil reserves
- > Canadian dollar is seventh most traded currency in the world
- > Ninth largest economy globally
- > Islam is fastest-growing religion with 1 million adherents
- > Diverse, multicultural population



Canada's Premier Islamic Financial Institution
Member IFSB and AAOIFI



Awarded **Best Business Leadership in North America**
by *World Finance Magazine* Islamic Finance Awards (2009)



A brief history of Islamic finance in North America





Leaders in Islamic Finance and Investment

- Excellence in Islamic Finance -- Contribution to Islamic Legal Practice (International Islamic Finance Forum - 2009)
- Islamic Finance Deal of the Year for Europe (*The Banker* - 2009)
- Islamic Finance Most Innovative Deal of the Year (Saudi Arabia - *Euromoney* - 2009)
- Islamic Finance Best Project Finance Deal of the Year (Qatar - *Euromoney* - 2009)
- Islamic Finance Deal of the Year for Qatar (*Islamic Finance News* - 2009)
- Best new Private Equity Fund (*Private Equity World* (MENA - 2009))
- *Chambers Global 2009* and *Chambers USA 2009* ranked King & Spalding as a Tier One firm.”

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A brief history of Islamic finance in North America

The North American retail Islamic finance industry developed primarily from within Muslim communities. As described below, Muslims make up a small fraction of the total population of the United States and Canada although they make up a larger than average share in a few cities. This geographical concentration has caused the development of Islamic financial institutions in those areas where Muslims live, primarily in Chicago, Detroit, Washington, DC, Minneapolis-St. Paul and Los Angeles. However, just as the presence of Islamic financial institutions in cities with large Muslim minorities is notable, it is equally notable that some cities with large Muslim minorities do not have any Islamic financial institutions.

size of the Muslim population vary widely. The common range of estimates used in the media is between 5 million and 8 million, although studies trying to estimate population by collecting and analysing data put the estimates lower, usually between 2 million and 4.5 million.

Regardless of which estimates of the Muslim population are used, the Muslim share of the US population is very low, probably under 2 per cent. However, the overall population numbers hide the geographical density of Muslims in a few large urban areas and this concentration has significantly shaped the development of the industry. The largest concentrations of Muslims are in Boston, New York City, Washington, DC, Atlanta, Chicago, Detroit, Minneapolis-St. Paul, Houston, Dallas, Los Angeles and San Francisco.

Muslim Population and Geographical Density

Table 1: Recent estimates of the Muslim population in the United States

Source	Estimate	Date	Methodology
Newsweek article	7- 8 million	2008	No source provided
Pew Research Center	2.35 million	2007	Telephone interview with 55,000 people to get a national sample of 1,050 Muslims
CIA World Factbook	1.7 - 2.0 million	2009	Estimate based on 0.6% population share
Nimer report	2.56 - 4.39 million	2002	Extrapolated from data on SAT test takers collected by the College Board
Congressional Research Service	5-7 million	2009	No source provided

Sources: Ali, Lorraine, "Islam and Obama," Newsweek, November 7, 2008. Pew Research Center. 2007. Muslim Americans: Middle Class and Mostly Mainstream. Washington, DC: Pew Research. Central Intelligence Agency. 2009. CIA World Factbook: United States. Accessed June 16, 2009. Available from: <https://www.cia.gov/library/publications/the-world-factbook/geos/US.html>. Ilias, Shayerah. 2009. "Islamic Finance: Overview and Policy Concerns," Congressional Research Service Report No. RS22931, February 9, 2009. Available from: <http://www.fas.org/sgp/crs/misc/RS22931.pdf>. Nimer, Mohamed. The North American Muslim Resource Guide: Muslim Community Life in the United States and Canada. New York: Routledge, 2002. A summary of the Nimer Report is available from: http://www.pluralism.org/resources/statistics/nimer_stats.php.

One of the most important factors determining the location of growth of Islamic finance in North America over the past few decades has been the size of the market for Islamic financial products, which is heavily influenced by the population size and density of the Muslim communities. In the United States, the Census Bureau is not allowed to ask about respondent's religion and consequently, statistics on the

Although Canada's population is nearly 1/10th of that of the United States and absolute numbers of Muslims are smaller, it has a larger Muslim population as a share of the population. Unlike its American counterpart, the national statistical agency Statistics Canada, does ask respondents to identify their religion. Data from the most recent Census in 2001 is in the table overleaf.

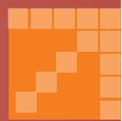


Table 2: Muslim population in Canada, 2001 and 2011 (est.)

Region	Muslim Population		Share of Population	Share of Canadian Muslim Population
	2001	2011 (est.)	2001	2001
Canada	579,640	1,103,300	2.0%	100.0%
Ontario	352,525	698,800	3.1%	60.8%
Quebec	108,620	194,800	1.5%	18.7%
British Columbia	56,215	102,600	1.5%	9.7%
Toronto, Ontario	254,110	505,700	5.5%	43.8%
Vancouver, B.C.	52,590	92,100	2.7%	9.1%
Calgary, Alberta	25,920	43,700	2.7%	4.5%
Montreal, Quebec	100,185	179,400	3.0%	17.3%
Ottawa	41,725	74,400	4.0%	7.2%

Source: Statistics Canada. 2001 Census, "Religions in Canada". Data available from: <http://www12.statcan.ca/english/census01/home/index.cfm>. Estimates for 2011 are from Belanger, A. and E. Caron Malefant. 2005. Population projections of visible minority groups, Canada, provinces and regions. Ottawa, Ontario: Statistics Canada, Table A2, page 53.

One stark difference between the United States and Canada is that the Muslim population is concentrated primarily in one region, Ontario and specifically in Toronto, with over 40 per cent of all Muslims in Canada living in Toronto and a further 20 per cent living in other areas of Ontario. As a result, Islamic financial institutions in Canada are also predominantly located in Ontario and thus benefit from avoiding differences between provincial regulatory environments that plague many Islamic financial institutions in the United States. As the Statistics Canada projections for 2011 illustrate, the Muslim population in Canada is growing rapidly and this population growth is likely to be accompanied by increasing demand for Islamic financial services.

Early developments, 1980s and 1990s

During the 1980s, two Islamic financial institutions began operating in the United States, the Amana Funds, a mutual fund company in Bellingham, Washington and American Finance House-LARIBA in Pasadena, California. These two companies offer what remains the core focus of the Islamic financial industry: small business/home finance and Shariah compliant

retail investment products. Both companies were started in the middle of the decade and both remained small until the early 2000s. Amana Funds, which is managed by Saturna Capital Corporation started in 1987 with one fund with assets of \$3.2 million and grew to exceed \$10 million in 1994, the year in which it offered its second fund. The two funds entered the 21st century with slightly less than \$50 million in total assets under management.

During the mid-1990s, the Islamic financial industry in the US made a significant step forward when United Bank of Kuwait requested interpretive letters on two of the most common products used in Islamic finance for home purchases. In 1997, its Ijarah wa iqtina (lease-to-own) product, based on a product developed by Samad Group/CIHF Partners based in Ypsilanti, Michigan, received a favourable interpretive letter from the Office of the Comptroller of the Currency (OCC).¹ In 1999, the OCC also issued an interpretive letter regarding UBK's Murabaha mortgage products that was also favourable.² Both products were viewed by the OCC as permissible products for banks to offer because the structure of the products was economically identical to

A brief history of Islamic finance in North America

conventional financial products. The important issue from the perspective of regulators was that banks should be solely involved with serving as intermediaries between depositors and borrowers and should not be making other investments with their capital, whether equity investments in businesses or holding ownership of real estate properties, with the exception of real estate held for sale following a foreclosure. This makes it extremely difficult for regulated banks to offer products besides those similar to *Ijarah wa iqtina* and *Murabaha* that produce the same economic outcome as conventional interest-bearing debt.

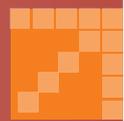
Although UBK left the US market, its geographical focus was primarily in California and Connecticut, the OCC interpretive letters serve as one of the most significant developments for the regulatory treatment of Islamic financial products for banks and the agency's rulings are mentioned by government officials in public speeches about Islamic finance. Thomas C. Baxter, Jr., the general council and executive vice president at the Federal Reserve Bank of New York described the OCC interpretive letters requested by UBK in the context of the regulatory approach to Islamic finance in a speech in 2005:

"The [OCC] approvals also demonstrate the type of creative thinking necessary to accommodate a religious practice not generally considered when the banking laws were first drawn up. [...] By looking to the economic substance of the transaction, the OCC was able to recognise that the risks incurred by the proponents of these products were not the same risks the statutes sought to curtail. As banking supervisors, we ought to be prepared to reach similar accommodations, while continuing to insist that financial institutions operate in a safe and sound manner."³

During the late 1990s, the Islamic finance industry in the US returned close to where it had been at the beginning of the decade on the retail side with the departure of both UBK and Al-Baraka USA which had also attempted to enter the US home finance market. The main development, the OCC interpretive letters, did not translate immediately into significant growth in Islamic finance, but enabled the significant growth in the latter half of this decade.

During the mid-to-late 1990s, one area did continue to grow largely independently of the retail banking and investment arena: wholesale Islamic finance. However, this growth was primarily focused on structuring Shariah compliant investments for Middle Eastern investors in the US real estate market; the investments were not designed for, nor made available to, Muslim investors within the United States. Although these products, largely property funds structured to be Shariah compliant that invested in the United States, began appearing as early as the late 1980s, the mid-1990s saw this growth expand. This period marked the beginning of the wholesale Islamic finance market in the





United States. It differed, however, from much of the retail Islamic finance which developed from within the American Muslim community in that it was focused on structuring investment activities for foreign investors looking to the deep US markets for investment opportunities.

A Catalyst for Growth – The Dow Jones Islamic Market Indexes

When the initial idea for a Shariah compliant investment product was considered by a group of Muslims in Indianapolis in 1984, they began by starting an investment pool among the group members. However, the demand for Shariah compliant investments grew beyond what could be accommodated within an investment pool and members approached a local fund manager, Nicholas Kaiser, who helped them start a mutual fund, the Amana Income Fund.⁴ At that time, however, the rules for screening investments for Shariah compliance were not standardised nor were there benchmark indices for Islamic mutual funds to compare performance, so the fund remained fairly small for its first decade. The launch of Failaka Advisors

This gap was filled in February 1999 when Dow Jones launched its first Islamic Market Indexes. The new indices provided a benchmark for Shariah compliant equity managers. Initially, the index series was composed of a Dow Jones Islamic Market World Index and eight sub-indices:

- DJIM-US
- DJIM-Canada
- DJIM-Asia/Pacific
- DJIM-Japan
- DJIM-Europe
- DJIM-U.K.
- DJIM-Extra Liquid (now DJIM-Titans 100)
- DJIM-Technology

Since the launch of these initial indices, the number of indices has expanded to more than 70 according to Dow Jones with 54 individual indices listed on the Dow Jones Islamic Market Indexes website as of July 2009. Out of the indices listed on the website, there are eight global indices, 10 sector indices, four Titans (Blue Chip) indices, four US indices, eight European indices, nine Asia/Pacific indices, eight other/country/regional indices and three specialty indices. Since the launch of the Dow Jones Indexes many other index providers have launched their own indices: Standard & Poor's, Morgan Stanley Capital International (MSCI), FTSE and most recently Russell Investments, each with slightly different methodologies being approved by their Shariah boards.⁵ In addition to the benchmarking function provided by the availability of an index, the launch of a series of indices screened according to Shariah compliance guidelines forced the creation of a clear and transparent methodology for screening equities to determine whether they qualify for inclusion in the index.

The criteria used to screen equities for the Dow Jones Islamic Market Indexes was approved by a board of the leading scholars in the industry with a diverse background of nationalities and is freely available online.⁶ This provides one of the first examples where Shariah standards were harmonised across multiple regions where in many cases there exists a difference of interpretation about Shariah compliance standards across these geographies. It also provides a clear, transparent guide to fund managers, investors and other Shariah scholars through the

based in Chicago, Illinois in 1996 provided the Islamic finance industry with some of the information useful for gauging relative performance of different funds around the world with its annual guide to Islamic funds. However, a gap remained in the industry because there was neither a set of broad market indices screened for Shariah compliance nor commonly accepted standards for determining which investments were Shariah compliant.

Table 3: Dow Jones Islamic Market Indexes Shariah Supervisory Board and Nationality

Sheikh Abdul Sattar Abu Ghuddah	Syria
Sheikh Justice Muhammad Taqi Usmani	Pakistan
Sheikh Nizam Yaquby	Bahrain
Sheikh Dr. Mohamed A. Elgari	Saudi Arabia
Sheikh Yusuf Talal DeLorenzo	United States
Sheikh Dr. Mohd Daud Baker	Malaysia

Source: Dow Jones Islamic Market Indexes FAQ.
Available from: <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicFAQ>

A brief history of Islamic finance in North America

publication of its Rulebook. In spite of the existence of several slightly different screening methodologies, the Dow Jones Index Shariah standards remain the most widely accepted having been adopted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its Standard 21 which covers stock and Sukuk investing.⁷

Following the launch of the Dow Jones Islamic Market Indexes, the Islamic mutual fund business saw new entrants drawn to the market

assets managed by Islamic equity funds in the US. On June 5, 2009, the Azzad Ethical Mid Cap Fund lowered its expense ratio from 1.9 per cent to 0.99 per cent effective July 1, 2009. Days later on June 11, 2009, the Azzad Funds announced that the Azzad Ethical Income Fund would be closed and all assets distributed by the end of July 2009.

The growth of mutual funds since the Dow Jones Islamic Market Indexes in Canada is even more muted than in the United States.

Table 4: Islamic Mutual Fund Performance

Fund Name	Ticker	Dividend Yield	1-year	3-year	5-year (annualised)	10-year
Amana Income Fund	AMANX	1.14%	-13.1%	2.1%	8.4%	4.2%
Amana Growth Fund	AMAGX	0.00%	-15.3%	1.5%	8.3%	5.3%
Azzad Ethical Income Fund	AEIFX	0.71%	-32.0%	-9.9%	-4.4%	n/a
Azzad Ethical Mid Cap Fund	ADJEX	0.00%	-22.2%	-4.7%	0.9%	n/a
Iman Fund	IMANX	0.00%	-28.9%	-3.8%	-0.3%	n/a
DJIM US Index	.IMUS	n/a	-21.5%	-2.4%	0.7%	-3.5%
Dow Jones Industrial Index	.DJI	n/a	-23.6%	-6.6%	-2.9%	-2.5%

Source: Fund performance data taken from Morningstar.com (As of 17 July 2009). Index performance is price performance only from GoogleFinance as of 17 July 2009.

by the opportunity to use a benchmark index and leverage the Shariah screening capabilities of the Dow Jones Islamic Market Indexes. The other funds, the Iman Fund, known as the Dow Jones Islamic Fund until 2008, and the Azzad Ethical Income and Ethical Mid Cap Funds were launched in mid-2000.

Despite the Dow Jones Islamic Market Indexes providing a benchmark for Islamic mutual funds, harmonised Shariah compliance criteria, as well as providing the option of licensing the index component lists, the Islamic mutual fund industry in the United States is largely dominated by the Amana funds which saw their assets under management grow from \$45.4 million as of May 31, 2000 prior to the Iman Fund and Azzad Fund launches to \$1.8 billion as of May 31, 2009 according to Morningstar, which represents 98 per cent of the total

The first two Shariah-compliant mutual funds were launched in Canada, the frontierAlt funds' Oasis Canada and Oasis World were launched in November 2006. These funds were followed by Oasis Global Income in September 2007. By the end of 2007, the funds had combined assets of \$4.4 million and, due to their small size, in July 2008, the Oasis World and Oasis Global Income were closed. As of December 2008, the remaining Oasis Canada fund had assets of \$2.9 million. Another fund manager, Global Prosperata recently launched a new Iman Fund with over \$2 million in assets as of June 30, 2009 and the fund manager expected the assets to double in the next 30-60 days. In June 2009, UM Financial and Jovian Capital Corporation announced they were planning an S&P/TSX 60 Index ETF which would be the first Shariah compliant ETF available in Canada.⁸ This

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follows the announcement that Javelin Investment Management JETS Dow Jones Islamic Markets International Index Fund began trading on the NYSE with \$4 million in assets on June 30, 2009.

Islamic finance during the real estate boom and crash of the 2000s

There were several significant developments for Islamic home finance in the 1990s in many areas including product development, increasing regulatory understanding of the financial products used in Islamic finance and the regulatory changes like the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 that removed many of the restrictions that prohibited banks from opening branches out of their home state.⁹ Despite all of these developments, the Islamic home finance industry looked remarkably similar in 2000 the way it did in 1990. However, one important difference was that in 2000, there were several financial professionals who developed experience with Islamic finance in the US with the United Bank of Kuwait before it was acquired by Al-Ahli Commercial Bank of Bahrain and left the US market in 2000¹⁰.

In 2001, the industry changed dramatically in the way Islamic finance companies funded their home financing with the approval for American Finance House-LARIBA to receive financing from the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). In conventional mortgages, brokers originate the mortgage with a home buyer and then sell the mortgage to Freddie Mac which then securitises them and sells them to investors. This removes them from the mortgage originator's balance sheet, freeing up additional liquidity to finance more home purchases.

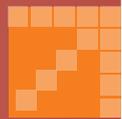
The way the American Finance House-LARIBA transaction works is that American Finance House-LARIBA and the home buyer agree to a maximum monthly payment based on the value of the house and the monthly amount for which it could be rented. The home buyer and American Finance House-LARIBA sign conventional mortgage documents. The purchase is funded by Freddie Mac which can then sell the mortgage as a securitised investment as it does with other mortgages.

American Finance House-LARIBA describes the process in their frequently asked questions on their website:

"Every single home is presented to Freddie Mac / Fannie Mae on line for approval or disapproval. If approved, LARIBA would forward the money from its own funds to purchase the house and is paid within a week or less by Freddie Mac / Fannie Mae. LARIBA does not charge Freddie Mac / Fannie Mae interest for using the money during that week's time."¹¹

American Finance House-LARIBA signs a separate agreement with the homebuyer recasting the transaction in terms of the maximum monthly rent agreed on between the two parties as a Musharaka agreement. Monthly payments pay the 'rent' as well as purchase a portion of the house 'conceptually' owned by American Finance House-LARIBA. In the American Finance House-LARIBA





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University Islamic Financial Corporation was the first and remains the only wholly Shariah compliant Islamic banking subsidiary in the United States.

model, the Musharaka agreement is separate from the standard mortgage documents used to receive financing from Freddie Mac. The financing model is similar in the relationship between American Finance House-LARIBA and Fannie Mae.

The entry of Freddie Mac, and to a lesser degree Fannie Mae, into the Islamic home finance market provide a huge source of liquidity into the market for Islamic home finance products. Within the first six months of the American Finance House-LARIBA agreement with Freddie Mac, \$1 million had been injected into the Islamic home finance market through LARIBA.¹² In August 2001, Freddie Mac also signed an agreement with Michigan-based Standard Federal Bank and United Mortgage of America to finance up to \$10 million in Ijarah home financings in that state. Standard Federal Bank, a subsidiary at the time of ABN Amro was renamed Lasalle Bank Midwest N.A. in 2005 and eventually sold to Bank of America in 2007. Despite the agreement with Freddie Mac, there were no completed financings due to issues raised by Freddie Mac that could not be resolved surrounding the due-on-sale clause that is in most mortgages. The due-on-sale clause gives the bank the right to foreclose on the house if the homebuyer transfers ownership to another owner. The structure of the Ijarah programme being developed by Standard Federal Bank ran into problems involving the due-on-sale clause that caused the lease-

to-own product to be incompatible with the agency's rules on leasing arrangements in excess of one year.

The role of Freddie Mac in the Islamic home finance market is hugely beneficial for increasing the availability of Islamic home financing but also raises a potential issue with Shariah compliance because Freddie Mac is financed using interest-bearing debt and mortgages are securitised along with interest-bearing mortgages in a securitised investment product. Freddie Mac typically purchases mortgages either for its own investment portfolio or for securitisation and resale to other investors. However, in fatwa from Shariah scholars, Freddie Mac's prevalence in the interest-based market and securitisation process was ruled as acceptable. In so far as the contract governing the home purchase meets both Shariah compliance standards and Freddie Mac underwriting standards, the source of the funds is not crucial to determining whether the transaction is Shariah compliant.

From the Shariah compliance perspective of the Islamic home finance provider, the only aspect that should merit attention would be the price paid by Freddie Mac in certain cases. Under most interpretations of Shariah, Ijarah and Musharaka mortgages can be resold at any mutually agreed price. However, Murabaha must be resold only at par. Neither restriction is an impediment for Freddie Mac's financing the Islamic home finance products because the financing comes directly from Freddie Mac after the loan is approved by the agency and what eventually happens with the mortgage is not an issue from the perspective of the individual product and institution's Shariah compliance. The source of funds is a common area of concern with conventional banks having Islamic 'windows'. As described by HSBC Amanah in the frequently asked questions section of their website, "The HSBC Amanah Shariah Supervisory Committee has approved the utilisation of conventional capital for the purposes of Shariah compliant financing while restricting the usage of funds in generating Islamic assets only".¹³ Moreover, when Freddie Mac was initially offering financing for Islamic mortgages, there was a possibility that many Islamic mortgages would be securitised and resold to Muslim investors.



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The entry of Freddie Mac into the Islamic home finance market provided a catalyst for the rapid growth in the market because it removed what had been a severe restraint: lack of capital. In addition, because Islamic home finance products were benchmarked with interest rates, which fell rapidly in the early 2000s, the products became more affordable to a greater number of potential home buyers. This alleviated the potential problem that Islamic finance was generally more expensive than equivalent conventional products because of the greater costs associated with structuring the products to be in compliance with both US law and the Shariah. In the United States, as elsewhere, this additional cost, often called COBM (cost of being Muslim), limited the appeal of Islamic financial products among those Muslims who would otherwise prefer an Islamic mortgage, but only if it could be had at a cost competitive with conventional products.

The first new entry into the Islamic finance market in the early 2000s was HSBC Amanah, the Shariah compliant division of the global bank HSBC. They began by offering Islamic home finance products using Murabaha in New York State in 2002. In their first year of operating, they financed home purchases worth \$20 million. However, they left the Islamic finance market in the US in 2006 citing insufficient demand for their products at the time.¹⁴

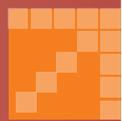
Also in 2002, newly-formed Guidance Financial (now called Guidance Residential) began offering Islamic home finance in Washington, DC and the Maryland and Virginia suburbs using a diminishing Musharaka model. It began following an agreement with Freddie Mac to finance \$200 million in home finance purchases, which eventually rose to more than \$1 billion by the middle of 2007.¹⁵ The following year, a small community bank in Chicago, Devon Bank, began offering Islamic mortgages following a demand from the local community the demographics of which had changed since the bank was founded in the 1940s. Devon Bank also began selling its Islamic mortgages to Freddie Mac, but not until 2005.

During 2003, University Bank of Ann Arbor in Michigan began offering Islamic home financing. The entry of University Bank was the first bank operating in Michigan to offer Islamic finance, significant because the largest population of Arab Americans is in Dearborn, Michigan, a suburb of Detroit 35 miles east of Ann Arbor. In 2005, University Bank launched a Shariah compliant banking subsidiary, University Islamic Financial Corporation, which was the first of its kind in the United States. All other Islamic financial institutions operate their Islamic financial activities within a bank alongside conventional financial activities or within a non-bank financial institution. University Islamic Financial Corporation was the first and remains the only wholly Shariah compliant Islamic banking subsidiary in the United States.

In addition to the home finance product available at other Islamic finance companies, University Islamic Financial Corporation also offers a deposit product that pays returns based on the return on the company's home finance products. The deposits are FDIC-insured and if the bank's home finance products are not profitable, depositors receive no return but would not lose any of the principal of their deposits. The FDIC insurance is not Shariah compliant, but in the absence of the bank failing, it would not have any impact on the operations of the bank or the source of the return on deposit accounts. One way for customers to avoid the problems posed by the FDIC insurance were the bank to fail would be to refuse to accept any payments from the FDIC fund. University Islamic Financial Corporation describes on its website that "Under current FDIC rules, all consumer deposits less than \$100,000 [temporarily increased to \$250,000 until the end of 2009] must be insured against capital loss".¹⁶

During the past decade, there have been a number of smaller Islamic home finance companies that operate in different areas and targeting different groups within the American Muslim community. One provider that has grown rapidly since its founding in 2003 is the African Development Center in Minneapolis-St. Paul, Minnesota. The African Development Center was started by a former banker, Hussain Samatar, to provide business and entrepreneurial training and Shariah compliant financing for American Muslim immigrants





from Africa, primarily Somalia, one of the largest immigrant groups in Minnesota. The African Development Center provided its first business loan in 2005 having started entrepreneurial training the year before. In 2008, the African Development Center also began providing Shariah compliant home financing through its nonprofit mortgage origination firm ADC Financial Services using a Murabaha product with financing from Freddie Mac and Fannie Mae. During 2009, it expanded this programme working with the Minnesota Housing Finance Agency.

The Islamic wholesale market

While there are a large number of Islamic financial institutions in the United States aimed at individuals wishing to use Shariah compliant methods for buying a house or car, financing their business or investing for their retirement, there are also Islamic financial institutions that focus on the wholesale market. These institutions are distinct from the retail market and emerged from property funds developed in the 1980s and 1990s to enable mostly Middle Eastern investors to invest in the US using Shariah compliant methods of finance. One of the largest companies is Arcapita, a Bahrain-headquartered private equity firm. Arcapita, formerly known as First Islamic Investment Bank, has been active in private equity, asset purchase and venture capital in the United States through its office in Atlanta, Georgia since 1998. The Atlanta operations were originally known as Crescent Capital Investments prior to the re-branding of the entire company as Arcapita in 2005. Since its founding, Arcapita has completed 71 transactions worth more than \$28 billion globally and within the US, these transactions include the purchase of Caribou Coffee, Church's Chicken (recently exited through a sale to San Francisco-based private equity firm Friedman Fleischer & Lowe), PODS and Yakima Products. At the end of the bank's most recently completed fiscal year ending June 30, 2008, the activities in the Atlanta office accounted for 30 per cent of the firm's portfolio. Arcapita is one of the largest of the wholesale Islamic financial institutions in the United States and represents one of the largest areas in the industry in terms of total assets. It is indicative of the

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types of wholesale Islamic finance industry that developed beginning in the mid-1990s where the United States is the destination for Shariah compliant investments, rather than the market for Islamic financial products.

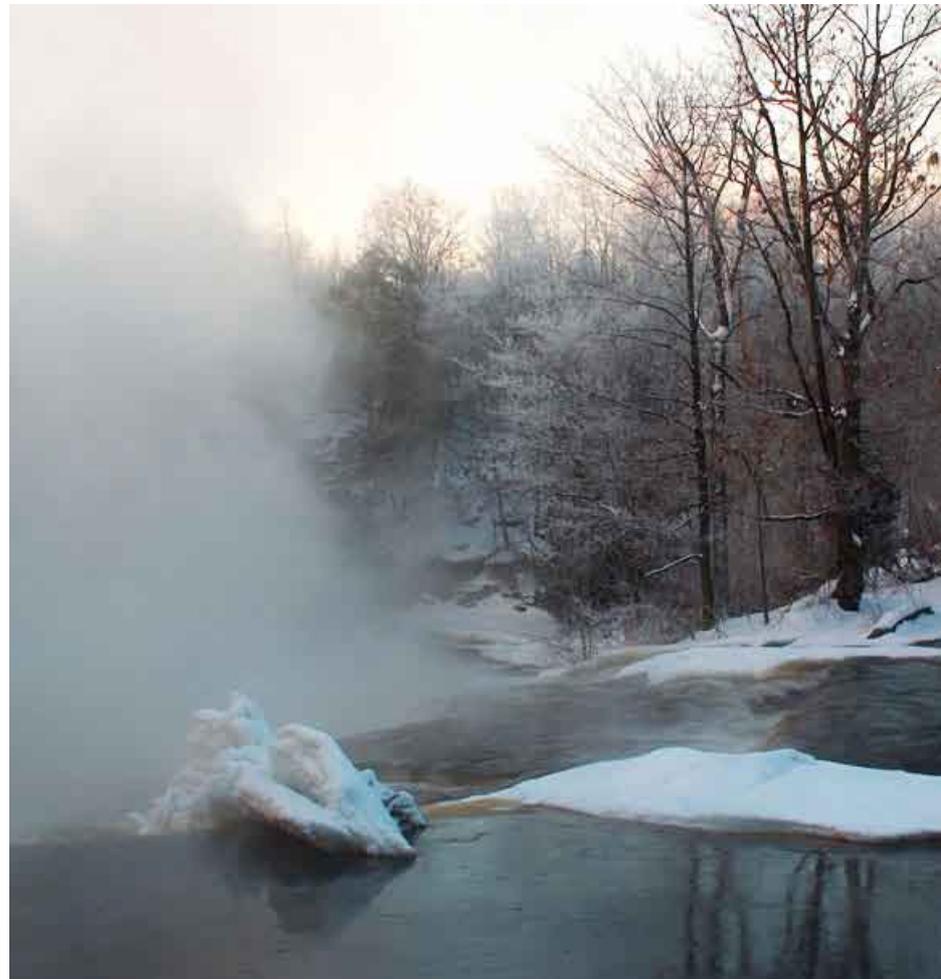
In the early 2000s, the wholesale financing area of Islamic finance saw the development of a few new entrants from the Middle East into the United States. The most established new firm was Gulf Investment House (GIH) which focused on property investments in the United States. In 2003, GIH purchased an industrial company, The Halcore Group, Inc., which manufactures ambulances, with an additional investment from Gulf Finance House (GFH). During the past five years, the two Gulf-based banks have collaborated in property funds as well as the purchase of another firm. In order to facilitate their investments in the United States and have a local presence in the two primarily areas of activity, private equity and real estate funds, they established two companies, Innovest Capital, based in Cleveland, Ohio, and TransOcean Capital, based in Boston, Massachusetts. In addition, other Islamic banks and investment houses have acquired investments, primarily in real estate, to diversify their investments.

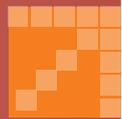
Another firm, Codexa Capital, which operates for offshore Shariah compliant investments along with its conventional partner firm Calyx Offshore, began in 2002 as one venture capital-backed company, Calyx Financial, focusing on hedge funds. Between 2002 and 2008, Calyx Financial refocused its activities on structuring offshore products to connect businesses needing financing with investors looking for Shariah compliant investment opportunities.

In 2004, the Islamic finance market saw the entrance of another subsidiary of a Gulf-based investment bank, Unicorn Investment Bank, with the launch of private equity firm UIB Capital, based in Chicago, Illinois. The company focuses on the acquisition of control in middle market companies with growth potential and typically invests between \$10 million and \$75 million in companies which usually have EBITDA of \$5 million or more.

Anchor Finance Group, based in New York, started in 2005 providing Shariah compliant financing to businesses. The firm focuses of financial and management financing and trade finance activities. Most of the financing activities are conducted through partner financial institutions including Deutsche Bank Trust Company, Merrill Lynch International and several other institutions based in the Gulf and Pakistan. The activities of Anchor Financial Group, in addition to business finance and product arranging, cross into the consumer realm: providing financing for investment properties owned by expatriate South Asians living in the United States in their home countries; in particular the Pakistani American community.

Most recently, Zayan Finance began offering commercial real estate financing in 2007. Based in New York, it has offices nationwide and





offers financing in all 50 states. The company provides capital using a Musharaka mutanaqisa (diminishing partnership) financial agreement where monthly payments cover Zayan's share of the rental income from the properties as well as a portion that buys out Zayan's share in the partnership. Unlike the residential financing market, Zayan focuses on larger investments, ranging from \$500,000 to \$2.5 million, compared with home financing companies that generally offer products that are sold on to Freddie Mac and Fannie Mae. The Freddie Mac and Fannie Mae financed purchases carry maximum loan amounts of \$417,000, although this was raised by the Housing and Economic Recovery Act of 2008 to \$625,000 and further raised for certain high-cost areas by the American Recovery and Reinvestment Act of 2009 to \$729,750.¹⁷

The Islamic finance industry has developed in the United States throughout the 2000s and has also grown north of the border in Canada although at a considerably slower pace. In 2007, there were two applications by groups wanting to open Islamic banks in Canada, but none has yet been approved. As of July 2009, there are reported to be up to six pending applications.¹⁸ In January 2008, the applications were placed on hold while two studies were completed by the Finance Ministry and the Canadian Mortgage and Housing Corporation (CMHC), the Canadian national housing agency which provides mortgage insurance and securitisation of mortgage-backed securities, in cooperation with regulatory agencies like the Office of the Supervisor of Financial Institutions, the Canadian Deposit Insurance Corporation and the Bank of Canada. The studies are designed to familiarise the financial regulators with Islamic finance and in particular with the legal, regulatory and taxation implications of Islamic financial products.

Although the applications for Islamic banks in Canada were held up by the desire of the government to complete the studies, these are reported to have now been completed, although not released. In the mean time, there are other sources available for home buyers looking to receive Shariah compliant financing. The largest is UM Financial Group, a company started in 2004 and financed \$120 million in home purchases using a Mudaraba financing from a local

credit union, the Credit Union Central of Ontario (CUCO). The company is currently expanding its financing source and anticipates an announcement of a partnership with one of Canada's major financial institutions. UM Financial Group has also set up a real estate investment fund to finance home purchases since the funds from this Mudaraba financing was used up, without any defaults and while returning significant profits for both UM Financial and CUCO.

In order to provide a larger source of liquidity to provide financing to the long waiting list of nearly 6,000 prospective home buyers or refines it is completing an agreement to be able to provide up to \$250 million in Islamic home financing per year using funds provided by one of Canada's major financial institutions. UM Financial Group expects to announce the signing of this agreement by the end of 2009 having seen it delayed due to the recent credit crisis. In addition to the financing from a larger bank, UM Financial Group is currently awaiting approval from the Canadian government to open a 'multi-cultural' bank, which would avoid the delay associated with the Islamic banking study as well as help to expand the appeal of non-interest-based products which meet not only the ethical requirements for Muslims, but also some sects within the Christian, Jewish and Mennonite faiths. Multi-cultural banking is a Canadian innovation and most of the major financial institutions have multi-cultural banking divisions that focus on attracting new immigrants into the banking sector by offering them retail banking services to integrate them into the financial side of living in Canada. For the banks, it provides a new area of deposits, which offer a cheaper source of financing for the bank than other sources especially with the dislocation in the credit markets.

In 2008, the Canadian market also saw the introduction of the first Takaful products offered by The Co-Operators Group. The group worked with Ansar Co-Operative Housing Corporation Ltd., an Islamic housing cooperative, over two years to develop home and auto Takaful.¹⁹ This is an area where the Islamic financial industry has developed slowly and in fits and starts both in Canada and the United States. The first Takaful company in North America, First Takaful USA, began in 1996,



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although it is no longer in operation. The most recent US-based Takaful provider was announced in December 2008 by a subsidiary of American International Group (AIG), Lexington Insurance Company and is sold through the Takaful division of Zayan Finance, Zayan Takaful.²⁰

Financing home purchases using the housing co-operative method

The standard practice for home finance in the United States, both conventional and Islamic, involves mortgage finance companies, banks and government sponsored entities like Fannie Mae and Freddie Mac, but one area where Islamic finance differs from this is the presence of housing co-operatives. In general, housing co-operatives are made up of members, akin to how a credit union functions, who contribute funds as an investment into an entity that safeguards the funds and invests them through the financing of other members' homes. In this way, the Islamic housing co-operative provides members with a halal source of income as well as the prospect of being able to buy a house once their turn comes.

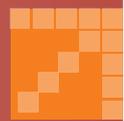
The financial model to which these co-operatives share the most in common is the rotating savings and credit associations (ROSCAs), which are common method of finance in many parts of the world in many different contexts. In a traditional ROSCA, a group of people all looking to finance something of similar value join together and each make weekly or monthly contributions so that the total contribution each period is enough to finance the purchase of one item. Each period, one member of the ROSCA is provided with financing to purchase the desired good and each period, one person is chosen to receive financing with all group members contributing an equal amount each period.

In the housing co-operative, members make an investment in the housing co-operative and once there is enough money collected to finance a house purchase, one member receives Islamic financing for their home purchase. Before a member is able to receive financing, the total investment by each member has to build up to an amount that serves as a down payment on the house.

When the house is purchased, it is done so by the co-operative, which holds the title to the house. Each month, the member pays the co-operative rent on the house which is adjusted, typically annually, to remain in line with prevailing rent. The rental amount is split between the co-operative to pay dividends to members and finance future purchases by the co-operative and the member's remaining principal balance. Once the member pays the co-operative the entire value of the house, including a portion of the appreciation in the home value, the title is transferred from the co-operative to the member.

The housing co-operative method has benefits as well as costs. The members are able to receive halal dividends as they build up their down payment from payments by members who have received financing. In this way, the co-operative operates like a real estate investment trust (REIT). However, the limitation on housing co-operatives is they are plagued by a shortage of capital to finance home purchases. All of the home purchases are financed entirely from the contributions of members and therefore there may be a significant length of time between when a member joins and when he can receive home financing. This has limited the number of co-operatives and some are no longer in existence like MSI Financial, a Houston, Texas-based housing co-operative started in the 1990s. Another issue that the co-operative method raises is that it may create a tax liability when the title is transferred from the co-operative to the member upon full payment of principal.

The model began in Canada with the Islamic Cooperative Housing Corporation, now the Ansar Cooperative Housing Corporation, based in Toronto, which began operating in 1981. The cooperative grew from 26 members in 1982 to nearly 2,900 in 2007, the last year for which data is available. Over the course of its operations, it has provided a dividend to members ranging between 6.0 per cent in its 1981-82 to 10.0 per cent in 1987. The most recent dividend was 6.4 per cent in 2007. The Ansar Housing Cooperative provided a model that has been replicated in several cities across the United States including in the San Francisco, California area by the Ameen Housing Co-operative.



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Canada's Premier Islamic Financial Institution

Member IFSB and AAOIFI

UM Financial is Canada's premier Islamic financial institution, serving Canada's growing 1 million-strong Muslim population. In 2004, UM Financial secured a Mudarabah funding facility from Central 1 Credit Union that has reached close to \$120m. This was used to finance residential home purchases on a Musharakah relationship. Recently, an award was presented to Central 1 Credit Union for its financing arrangement that has, over the last four years, provided over \$10m in profit for the institution. UM Financial currently offers Islamic financing, refinancing and line of credit for both residential and commercial clients.



UM has developed investment and deposit products with financial institutions for the Canadian marketplace. A \$100m subscription investment fund was established to finance residential and commercial real estate. A UM co-branded Islamic ETF is to be launched soon. The TSX, which has the S&P/TSX 60 Shariah index, gives investors access to Canadian equities with filters. Of the TSX 60, a total of 25 stocks have qualified. Firms such as Encana Corporation, Cameco, Imperial Oil and Barrick Gold are represented. Other sectors will be represented by Canadian icons like Research in Motion, Shoppers Drug Mart, Thomson Reuters, SNC-Lavalin, Biovail and MDS Inc.



A full service real estate brokerage is operated by UM which allows Canadians and foreigners direct access to commercial and residential real estate across Canada.



North America's first MasterCard® designed for the Muslim community is being led by Mint Technology Corp. for UM Financial. Working with UM, Mint Technology has also expanded its GCC operations, offering customized prepaid financial products and services for clients, such as payroll cards, using Canadian technology.



UM has advised many financial institutions and government organization on structure, marketing and Shariah compliance of Islamic financial transactions. We are currently engaged in a sovereign Canadian sukuk with various government agencies.

Achievements

UM has appeared as the only Canadian entry in the Banker magazine's Top 500 Islamic Financial Institutions and has been profiled on the front pages of the business sections of the three leading newspaper in Canada. UM is a member of two of the largest Islamic Finance associations: IFSB based in Malaysia and AAOIFI based in Bahrain. UM Financial was awarded Best Business Leadership in North America by World Finance Magazine Islamic Finance Awards in 2009. Omar Kalair, UM Financial's President and CEO, was among the top twenty pioneer Muslim Canadian business leaders presented awards by the Canadian Islamic Congress at the Canadian parliament in Ottawa. He was also awarded Entrepreneur of the Year 2009 by the Canadian Islamic Chamber of Commerce.

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The image features a sunset over a body of water. The sky is filled with soft, golden light and wispy clouds. The water in the foreground is dark, with a bright, shimmering path of light reflecting the sun's rays. A dark blue geometric shape, consisting of a horizontal bar and a trapezoidal section, is overlaid on the image. The title text is positioned within the white space of this overlay.

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The United States has significant regulation of financial services activities and does not distinguish between conventional banks and Islamic banks or Islamic 'windows' of conventional banks in its application of the laws and regulations that govern the financial services activities. The regulatory supervision of financial services activities is also highly fragmented between federal and state regulators as well as between different regulatory bodies at the federal level. One of the criticisms of regulatory bodies following the real-estate led crash of 2007-2009 was that this fragmentation allowed financial services companies, in particular, non-bank financial companies, in order to engage in regulatory arbitrage to reduce the regulatory oversight of their activities.

For the Islamic financial industry in the United States, this fragmented, overlapping regulatory authority has caused difficulty for broadening the availability of Islamic finance across the country because each state has a separate regulatory body governing banks while at a national level there are a number of regulatory bodies with overlapping jurisdictions across the activities of banks and non-bank financial institutions. In its 2008 Article IV review of the US financial system, the International Monetary Fund describes how "regulatory fragmentation and turf battles slow decision-making, blur lines of responsibility, and permit regulatory arbitrage".¹

This regulatory fragmentation is frustrating even for banks used to operating within the United States, but may be even more so for financial institutions entering the United States from foreign countries with centralised national banking regulators. It is possible that foreign-based Islamic banks exploring entry into the United States market could confuse the regulatory fragmentation with a general suspicion of Islamic banking and finance on the part of regulators, even where this is not present and this could deter foreign Islamic banks from entering the United States market.

Even outside banking, there are a number of regulatory bodies that regulate Islamic financial institutions; in the area of non-bank financial

institutions like mortgage brokers, it is typically the state financial regulatory agencies. For investment-related products, the primary regulator is the Securities and Exchange Commission. However, even within this area of financial services, there is some oversight by state financial regulators for all the states in which the product is offered.

In Canada, the regulatory environment is generally less fragmented with only a few national regulatory body whose regulatory scope includes the activities of banks and the primary banking regulator is the Office of the Superintendent of Financial Institutions (OSFI), Finance Canada, the Bank of Canada, Canadian Deposit Insurance Corporation (CDIC) and the Financial Consumer Agency of Canada (FCAC) which coordinate their activities through the Financial Institutions Supervisory Committee (FISC).

However, securities and insurance regulation, as well as province- or territorial-chartered financial institutions, are regulated at the province-level and not by the national regulators. However, these provincial and territorial regulators, 19 regulatory agencies across the 13 territories and provinces, cooperate on harmonising regulation through their participation in the Canadian Securities Administrators. There are also three self-regulatory bodies covering investment dealers, mutual fund dealers, and stock exchange regulation.

US Government Regulation of Financial Services Institutions

The United States financial services industry is regulated by a number of overlapping regulatory agencies with overlapping mandates. However, within each business area, there are generally two layers of regulatory supervision depending on the business size and geographic scope. To some degree, the design of the regulatory system is governed by the federalist structure of the United States. Government power is divided between the federal and state/local governments based on a fear on the part of the Founding Fathers of an over-powerful national government that usurps power from the states. The general idea that divides powers is that the states retain all of the powers that are

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not specifically given to the federal government. One of the powers specifically given to the federal government, the Interstate Commerce Clause, is to “regulate commerce with foreign nations and among the several states”.²

The primary effect of the Interstate Commerce Clause is that state-chartered financial institutions that operate only within one state are generally regulated by the state and those that have a national-charter and operate across many states are regulated by federal regulatory agencies. However, within this simple dichotomy, there are numerous exceptions in certain areas of bank and credit union activity. For example in most cases banks receive deposit insurance from the Federal Deposit Insurance Corporation (FDIC) while most credit unions receive deposit insurance from the National Credit Union Share Insurance Fund (NCUSIF). In other areas of operations, credit unions are subject to regulation by the Federal Reserve Board of Governors and regional Federal Reserve Banks.

The table above shows that the general pattern of bank regulation falls within the framework of federalism. The three different categories of non-foreign banks, foreign banks are regulated under a slightly different system described below, are state-chartered banks, national banks and bank holdings companies. State-chartered banks are those whose primary regulator is the Department of Financial Institutions of the state in which they are chartered. In general, most state banks are members of the Federal Reserve and are subject to additional regulation by the Federal Reserve. State banks that are not members of the Federal Reserve and which have FDIC insured deposits are regulated by the FDIC. There are very few state banks without FDIC insured deposits; the deposit insurance system works in part because nearly every bank carries FDIC insurance. Bank runs are prevented because the systemic risk of one bank failure is significantly limited by the nearly universal deposit insurance coverage. National banks are banks that are chartered by the Of-

Table 1: US Regulatory Oversight –Banks & Bank Holding Companies

	Bank Holding Companies	National Banks	State Member Banks
Chartering & Licensing	Federal Reserve & State Authority	OCC	State Authority
Branching			
Intrastate	Federal Reserve & State Authority	OCC	Federal Reserve & State Authority
Interstate	Federal Reserve & State Authority	OCC	Federal Reserve & State Authority
Mergers & Acquisitions			
Intrastate	Federal Reserve & State Authority	OCC	Federal Reserve & State Authority
Interstate	Federal Reserve & State Authority	OCC	Federal Reserve & State Authority
Reserve Requirements	N/A	Federal Reserve	Federal Reserve
Access to the Discount Window	N/A	Federal Reserve	Federal Reserve
Deposit Insurance	N/A	FDIC	FDIC
Supervision & Examination	Federal Reserve	OCC	Federal Reserve & State Authority
Prudential Limits, Safety & Soundness	Federal Reserve	OCC	Federal Reserve & State Authority
Consumer Protection	Federal Reserve & State Authority	Federal Reserve	Federal Reserve & State Authority
Enforcement	FTC	OCC	Federal Reserve & State Authority

Source: Federal Reserve Bank of New York. 2003. Banking Institutions and Their Regulators. New York: Federal Reserve Bank of New York. Available from: <http://www.newyorkfed.org/banking/regrept/BIATR.pdf>.

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office of the Comptroller of the Currency, a part of the United States Department of the Treasury. Despite the name, not all national banks operate in multiple states; the name refers to the source of the bank charter rather than the geographical scope of business.

Bank holding companies, in contrast, are holding companies that can own either state and/or national banks, as well as non-bank institutions. They are overseen by the Federal Reserve under Regulation Y, which provides the Federal Reserve Board of Governors with the power to enforce capital standards, approve mergers and acquisitions, and inspect the bank holding company. However, the banks owned by the bank holding company still remain under the oversight of its primary regulator. The advantage of the bank

States are owned by bank holding companies. Broken down by asset size, 96.7 per cent of the 478 banks with more than \$1 billion in assets are owned by bank holding companies while 83.0 per cent of all smaller banks, 6,683 banks, are owned by bank holding companies.³

Credit unions, institutions owned by an organised group of members who often share a common employer, pool their members' savings to offer loans to members, often at more competitive rates than banks because any dividends are paid to members instead of shareholders. Like banks, there are state- and federally-chartered credit unions with a slightly different structure of regulatory oversight than banks as shown in Table 2 below. The primary regulator of credit unions is either

Table 2: US Regulatory Oversight - Credit Unions

	Federal Credit Unions	State Credit Unions
Chartering & Licensing	NCUA	State Authority
Branching		
Intrastate	NCUA approval not required	State Authority
Interstate	NCUA approval not required	State Authority
Mergers & Acquisitions		
Intrastate	NCUA	NCUA & State Authority
Interstate	NCUA	NCUA & State Authority
Reserve Requirements	Federal Reserve	Federal Reserve
Access to the Discount Window	Central Liquidity Facility & Federal Reserve	Central Liquidity Facility & Federal Reserve
Deposit Insurance	Credit Union Share	Credit Union Share or State Insurance Fund
Supervision & Examination	NCUA	State Authority
Prudential Limits, Safety & Soundness	NCUA	State Authority
Consumer Protection	Federal Reserve & State Authority	Federal Reserve & State Authority
Enforcement	NCUA	State Authority & FTC

Source: Federal Reserve Bank of New York. 2003. *Banking Institutions and Their Regulators*. New York: Federal Reserve Bank of New York. Available from: <http://www.newyorkfed.org/banking/regrept/BIATR.pdf>.

holding company for the bank's owners is that it is easier and less costly to issue debt under the tax code as well as more flexibility in acquiring other banks and non-bank companies.

Because of the tax treatment of bank holding company debt, most banks even small ones are owned by bank holding companies. According to the Federal Reserve data as of the end of 2007, 83.9 per cent of all banks in the United

state financial regulator for state-chartered credit unions or the National Credit Union Administration (NCUA), a federal agency charged with chartering and regulating federal credit unions. One of the primary differences between banks and credit unions from a regulatory perspective is the source of deposit insurance. For banks, deposit insurance is provided by the FDIC while credit unions receive deposit insurance from the National Credit Union Share

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Insurance Fund (NCUSIF). The NCUSIF is an insurance fund run by the NCUA that, like the FDIC, is backed by the full faith and credit of the US government.

One of the starkest differences between banks and credit unions is that credit unions are not subject to nearly the same level of oversight by the Federal Reserve. The three areas where there is oversight, reserve requirements, access to the discount window, and consumer protection, represent more of an exchange of the benefit of access to the discount window to meet liquidity needs with the requirement that the credit unions maintain adequate reserves and operate under standard consumer protection regulations like disclosure of the Annual Percentage Rate (APR) on loan products they issue.

US branches of foreign banks operate under a similar regulatory system to their counterparts in domestic national and state banks. The primary difference between the regulatory oversight is that decisions on new national branches of foreign banks are overseen both by the OCC and the Federal Reserve where they are only under the oversight of the OCC for domestic national banks. A PricewaterhouseCoopers' guide on regulation in the United States for foreign banks describes it thus:

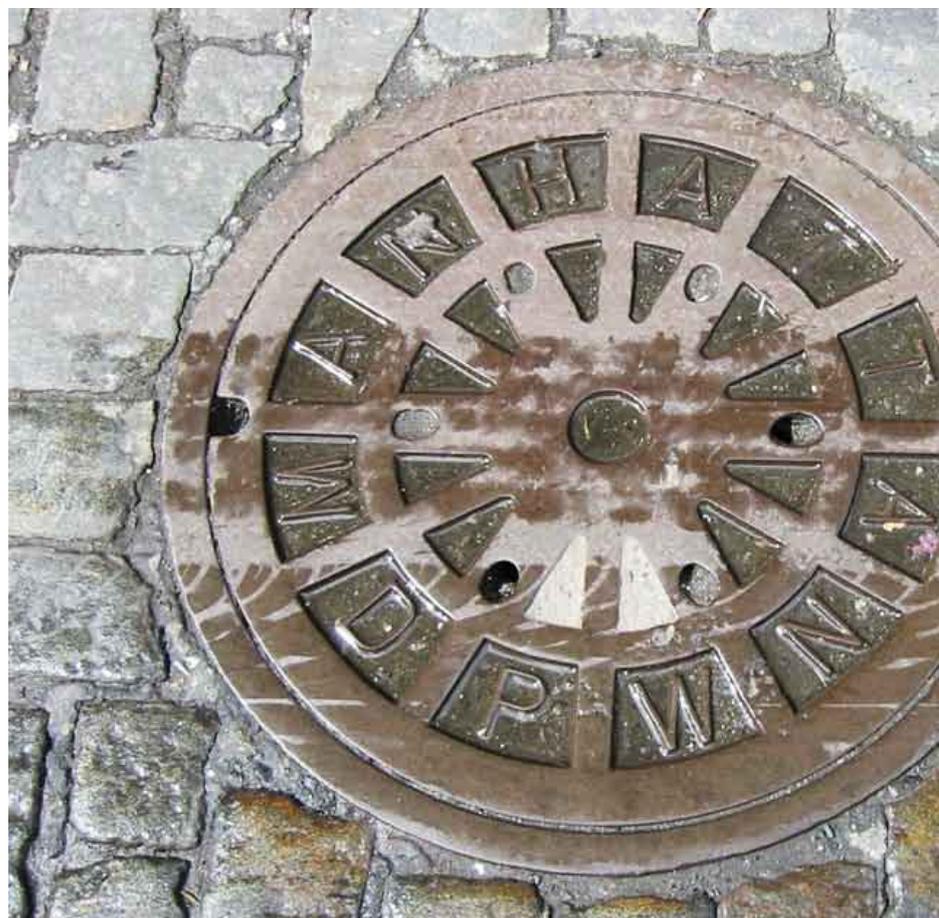
"A foreign bank that owns a US bank is, by definition, a bank holding company and subject to nonbanking restrictions on its US activities. Federal law also requires that a foreign bank with a branch or agency office or commercial lending company or Edge Act subsidiary in the United States be "treated" as a bank holding company, meaning its scope of US nonbank activities must also conform to the limits imposed on bank holding companies. Foreign banks principally engaged in a banking business outside the United States—called Qualifying Foreign Banking Organizations—may, however, hold investments in foreign nonfinancial companies that, subject to certain requirements and limitations, engage in nonfinancial activities in the United States..."⁴

From a regulatory perspective, a foreign bank either owns a US bank and is therefore a bank holding company or it has branches within the US and is overseen by the Federal Reserve under the Edge Act. In the former case, the

foreign bank owns 1) a subsidiary that qualifies as either a bank holding company itself; 2) a national bank; or, 3) a state bank.

The regulatory treatment described above is confined to the most heavily regulated institutions, deposit-taking institutions. Islamic financial institutions, however, are often organised as non-deposit-taking institutions either because it is not their core business (e.g. mutual funds) or because they are willing not to have a depositary base and are more focused on providing credit, whether for home financing, auto financing, or business. These institutions generally face a lighter regulatory burden than deposit-taking institutions. In the case of home, auto and business financing, these institutions are subject to the state regulations of the states in which they do business, primarily enforcement of consumer protection legislation.

The final area of regulation that was not covered is of mutual funds, investment banking and





publicly-traded bank holding companies which are regulated by the Securities & Exchange Commission (SEC) and state-level departments of finance. New securities issues are governed by the Securities Act of 1933, while secondary markets are governed by the Securities Exchange Act of 1934. Mutual funds are governed under the Investment Company Act of 1940. In general, companies registered with and regulated by the SEC will not be subjected to state regulation except for a notice filing of any securities registered with the SEC and any brokerage activities which operate in that state to comply with each state's Blue Sky Laws. Recent legislation has reduced the ability of states to review securities that are registered with the SEC although they are still able to initiate investigations involving potential fraud. In many cases when securities are limited to certain high net worth investors ('qualified' or 'accredited' as described in the Securities Act of 1933), there are additional exemptions from state registration requirements.

In the wake of the financial crisis of 2007-2009, the financial services regulations described above are likely to undergo some changes. These regulations are not finalised yet, but under the proposal made by the Obama Administration on June 18, 2009, the following changes would be made to the structure described above:

- The Federal Reserve would receive additional regulatory powers to monitor the overall financial stability of the US financial system. This would not affect most banks, but could lead to the Federal Reserve taking on regulatory powers currently in the hands of other regulators;
- The FDIC would be given the power to shut down any financial institution, not just those that it regulates like banks, that pose systemic risk;
- The Office of the Comptroller of the Currency, which regulates national banks, would be merged with the Office of Thrift Supervision, which regulates savings & loan associations, into one regulator, the National Bank Supervisor that regulates all federally-chartered financial institution;
- A new Consumer Financial Protection Agency would be charged with overseeing consumer protection rules; and,
- Hedge funds would be required to register with the SEC and would be subject to some oversight.

The new set of rules has not yet been enacted by Congress and it is very likely that the regulatory changes that do end up becoming enacted will look different to the Administration's proposed changes. Therefore, it is impossible to draw any firm conclusions on the regulatory impact on institutions within the regulatory picture.

US Government Regulatory Oversight of Islamic Financial Institutions

The US regulatory agencies charged with regulating the financial services industry do not have any power to regulate Islamic financial institutions any differently than they do any other similar conventional institution. In some cases, as with bank-initiated transactions involving the bank purchasing real estate, this has led to concern by regulators that banks offering Islamic financial products like Murabaha are violating rules prohibiting banks from owning real estate other than the bank's own buildings and any Other Real Estate Owned (OREO), which are foreclosed properties that the bank is required to sell within five years. This regulatory restriction, described in greater detail below, may explain why many Islamic financial institutions in the US have opted to avoid becoming deposit-taking institutions, generally banks and credit unions, in favour of becoming leasing companies or mortgage brokers. These institutional types are subject to far fewer restrictions than depository institutions, but also mean that there are few banking options for Muslims wishing to avoid depositing their money with interest-based banks.

One of the first accomplishments in the development of regulatory acceptance for Islamic banking products came with the entry of the United Bank of Kuwait into the US market in the late 1990s. The United Bank of Kuwait approached the Office of the Comptroller of the Currency requesting approval to offer Ijarah-based mortgages in the United States in 1997. UBK proposed the following structure for its Ijarah lease product:

"The Lessee will contract with the Seller to buy a single family residence and will tender a down payment. [...] Before funding the remainder of the purchase price, UBK and the Lessee will simultaneously enter into a Net Lease Agreement and a Purchase Agreement (collectively "the Agreements"). [...] UBK will supply the remainder of the funds to purchase the property from

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the Seller under the sales contract. UBK will have “legal title” to the property. UBK will record its interest in the property in the same manner as it would record a traditional mortgage.

UBK will not purchase or maintain an inventory of properties to sell to customers. Instead, the customer will be required to find the property that he or she wishes to purchase and negotiate the terms of the purchase with the Seller. The Branch also will not serve as a real estate broker or agent.

The Net Lease will convey to the Lessee occupancy rights in and to the property for a specified number of years. The Net Lease will require that the Lessee maintain the property, and pay charges, costs and expenses attributable to the property that an owner or purchaser would ordinarily otherwise pay. Monthly lease payments will be sufficient to cover principal and interest, and pay insurance and property taxes. The Lessee will amortise the entire principal by the end of the lease term.

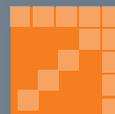
The Lessee will automatically become the legal owner of the property upon fulfilling the terms of the lease. Once the Lessee pays the final lease installment, the Lessee will not have to take any additional steps to acquire title to the property. The Purchase Agreement will also provide that the Lessee may acquire title to the property anytime before the expiration of the lease by prepaying the remainder of the purchase price.

In case of a material default under the lease, UBK will have remedies against the Lessee for nonpayment similar to those available to a lender on a “traditional” nonrecourse mortgage. UBK will provide notice of default to the Lessee and give the Lessee an opportunity to cure the default. If the Lessee cannot cure the default within a specified time, UBK will treat the property as if it had been acquired in foreclosure. UBK will not relet the property; instead, it will treat the property as Other Real Estate Owned (“OREO”) and sell the property in accordance with [the National Bank Act].

UBK represents that the Net Lease financing program satisfies the requirements of Generally Accepted Accounting Principles and the Net Lease will be treated as financing rather than leasing. The Branch’s General Ledger would have ac-



counts called Residential Loans and Islamic Home Finance Lease Receivables. The Branch will use the accrual methodology to account for both the conventional mortgage and the Net Lease home finance product. Although the two products will have different documentation, the monthly lease payments will be calculated in the same manner. UBK will add its margin to its cost of funds at the beginning of the lease. The London Interbank Offering Rate will be used to determine UBK’s cost of funds. UBK will then allocate lease payments to mirror the principal and interest breakdown of a conventional mortgage”.⁵



The key points of the lease transaction from the OCC's perspective concern 1) the ownership of the property by the bank, 2) the responsibility of the bank for the property's upkeep, 3) the role of the bank in the financing transaction, 4) the transfer of the title at the conclusion of the lease, 5) recourse by the bank in case of a default and the disposition of any properties it holds following default, and 6) the use of LIBOR to determine the cost of funds.

The OCC interpretive letter describes the restrictions on banking activities conducted by

federal branches of foreign banks which are regulated in a similar way to branches of domestic national banks. Items 1-3 are primarily focused on restrictions in the National Bank Act of 1863, which outlines the permitted activities by national banks. Guided by the laws and court decisions is that activities 'within the business of banking' must satisfy three criteria: "(1) is the activity functionally equivalent to or a logical outgrowth of a recognised banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks".⁶ Under the OCC analysis of relevant regulations and laws, a lease that is economically equivalent to a secured loan is allowed. Points 2-5 relating to transfer of title and the bank's ability to retake possession of the financed property, but only to sell it to recover its financing and not to re-lease the property, clarify that the lease does not produce any additional risk for the bank than a secured mortgage and the bank is not "embarking on hazardous real estate speculations".⁷ Point 6 regarding the use of LIBOR primarily shows that the bank is using an independent source for arriving at the cost of funds so it can demonstrate it prices loans to a benchmark plus a spread to account for the credit riskiness of the borrower.

Beyond the narrow question that the OCC addressed regarding the structure of the Ijarah home finance product, the OCC Interpretive Letter also provides additional guidance on how the regulatory authorities view Islamic financial products when judging their permissibility under US law. This returns to the arguments used by the OCC in determining whether the Ijarah product in particular, although not exclusively, is within the 'business of banking'. The first criteria applied are whether the product is functionally equivalent to another product that is permissible for banks to undertake. The OCC is quite clear in the method it uses to assess this using a Ninth Circuit Court ruling as guidance:

"The court reasoned that because secured lending and personal property leasing are functionally interchangeable, personal property leasing was within the business of banking and was therefore permissible. [...] According to the court, a lease that has the economic attributes

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of a loan is simply a new way of conducting an activity that is within the business of banking”.⁸ In contrast to Islamic fiqh which focuses primarily on the structure of a transaction over its form, the US courts and regulators who are guided by these courts focus primarily on the economic outcome from a transaction and therefore are able to accommodate structures that use impermissible forms under a literal interpretation of the banking laws so long as they create the economic outcome of permissible types of financing. This broad ability to interpret non-traditional financing methods makes US regulations quite flexible in accommodating Islamic financial products, but only in so far as they are “functionally interchangeable” with permissible products.

UBK asked whether it was permissible for the bank to securitise the Ijarah home financing products and sell it to investors. The OCC received this proposal favourably as well commenting:

“Because national banks may sell their mortgage assets under the express authority of [the National Bank Act], that rationale should extend to UBK’s Net Lease proposal since the Branch’s proposed activity is functionally equivalent to secured lending or mortgage lending. Moreover, a portfolio of prudently-arranged leases would not impose greater risks on the Branch than a portfolio of equally prudently-arranged loans”.⁹

Following the first OCC interpretive letter regarding Ijarah, UBK went back to request an interpretive letter regarding Murabaha home, inventory, equipment and construction finance in 1999. The OCC replied with a similar favourable reply that these too were permissible activities for national banks to undertake.¹⁰ While these relied on similar grounds as the Ijarah letter, one area mentioned in the Ijarah letter was a primary focus: the status of the bank as a ‘riskless principal’. The OCC used the analogy of a bank acting as a securities broker to effect the sale of securities where there was already a buyer and seller for the securities and the bank would not be subject to the risk of holding securities that could fluctuate in value while held on its own books. In the Murabaha contract, the bank would either finance a specific good from the outset or establish a Master Murabaha Agreement providing the client with a specified maximum amount under the agreement. The cli-





ent would find the items it needed, insure them and the bank would execute two agreements, one to buy and one to resell at a profit, which would be signed at the same time. In some cases, the bank would appoint the client as the agent of the bank but the bank would only provide the financing once the client provided the down payment to the bank.

Since these two interpretive letters were released in 1997 and 1999, respectively, there has been very little regulatory announcement regarding Islamic finance. However, that does not mean that regulators were not working with Islamic financial institutions as the latter were designing new products that could fit within US law. The US government has continued to keep abreast of new developments in the industry as it relates to the United States. In 2002, following a trip to Bahrain where he met with officials at the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), then-Secretary of the Treasury Paul O'Neill requested that his deputy secretary for international affairs John B. Taylor reach out to the Islamic financial industry in the US. As a result, the Treasury Department held an 'Islamic Finance 101' seminar on April 26, 2002.¹¹ Two years after that seminar at the Treasury Department, Mr. Taylor addressed the Harvard University Forum on Islamic Finance to announce the creation of a 'scholar-in-residence' programme at the Treasury. The position was filled by Dr. Mahmoud A. El-Gamal, the Chair of Islamic Economics, Finance and Management at Rice University and lasted from June to December 2004.

The Treasury's appointment of Dr. El-Gamal to the post of scholar-in-residence led to the publication of an Occasional Paper describing the industry's structure and growth that gave greater clarity to the areas where Islamic finance may be constrained by US laws.¹² In early 2005, Thomas C. Baxter, Jr. and William Rutledge, the general council and executive vice president, Bank Supervision, respectively, spoke about the regulation of Islamic financial services in the United States. In his speech, Mr. Baxter outlined the Constitutional grounds of the separation of church and state and its impact on the regulation of Islamic financial services:

"As Chief Justice Warren Burger observed some 20 years ago, the Constitution 'affirmatively mandates accommodation, not merely toler-

ance, of all religions, and forbids hostility toward any.' In other words, a corollary of the principle of religious freedom enshrined in our Constitution is that the secular law should adapt, as much as possible, to accommodate differing religious practices"¹³ (emphasis added)

Mr. Baxter outlined the ways in which a secular, common law system like the United States enjoys the flexibility to accommodate different types of products while acknowledging that it developed out of a "different cultural environment" that may preclude certain Islamic financial products but not "because of some latent bias".¹⁴ He discussed a few examples that demonstrate both the flexibility shown with regards to Islamic home finance as interpreted by the OCC as well as the FDIC approval of a modified version of profit-sharing deposit accounts created by SHAPE Financial, which are used by the University Islamic Financial Corporation in Michigan. In the latter case, the FDIC was open to the idea of profit-sharing deposit accounts, but could not approve a product where the principal was at risk. In the end, a compromise was reached where the accounts retained their value regardless of the performance of the underlying home finance assets, but the profits paid to depositors could fluctuate with this performance and in some circumstances depositors could receive zero return. Mr. Baxter's colleague Mr. Rutledge summarised the difficulty in a speech to the Arab Bankers Association of North America a few weeks earlier noting that "offering a profit-and-loss sharing deposit is a particularly difficult proposition under a western framework, which takes the certainty of deposit principal as a given".¹⁵

Mr. Baxter also highlighted one area that will pose significant problems for Islamic banking: "Under existing US banking law, profit-and-loss-sharing (PLS) arrangements such as Musharaka and Mudaraba may be difficult to implement since commercial banks in the United States are generally restricted from entering partnerships or taking equity stakes." In this case, products that are generally thought to be most in compliance with the Shariah, but as he noted, a small part of most Islamic banks' balance sheets, will be difficult to implement for depository institutions without changes to the laws. However, Islamic finance in the United States is primarily focused on a small part of the popula-

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tion and the small target market means that most Islamic financial institutions place greater emphasis on providing alternatives to the largest areas of need: home finance, auto finance, business financing of inventory and equipment, insurance and investments. One of these alternative structures is being used by Guidance Residential, an Islamic mortgage broker based in Virginia, in order to offer a diminishing Musharaka home finance product.

Canadian Government Regulation of Financial Services Institutions

The Canadian regulatory environment for financial institutions is in many ways more coherent than in the United States. There are fewer competing agencies and each agency has fewer overlapping responsibilities than comparable regulatory bodies in the US. The regulation of nationally-chartered banks, insurance companies, trust and loan companies, cooperative credit associations and fraternal benefit societies is conducted on the federal level and other institutions are regulated by the financial regulators on the province level in the provinces in which they operate.

The federal regulatory bodies all operate within the laws and policies governing financial institutions created by the Ministry of Finance Canada. Each agency has a specific area of regulatory oversight. The Office of the Supervisor of Financial Institutions (OSFI) regulates and supervises financial institutions for safety and soundness at the institution and systemic level. The CDIC is exclusively responsible for insuring depositors and works with the OSFI to accomplish this goal. The Bank of Canada, the country's central bank, manages the clearing, payment and settlement system, is responsible for monetary policy and regulating credit and currency. It is also the lender of last resort and provides emergency liquidity to eligible financial institutions. Finally, the Financial Consumer Agency of Canada (FCAC) is responsible for enforcing consumer-related aspects of the laws governing financial institutions. It also oversees the self-regulatory organisations.

Provincial bodies govern some insurance companies, although a vast majority is regulated by OSFI. However, even federally regulated insurers have their 'business conduct' regulated by the

provinces.¹⁶ The primary regulatory purview of the provincial financial regulators is over securities and credit unions/caisses populaires, which are not federally regulated. In the latter group, most securities dealers are part of nationally regulated financial institutions. Within the securities industry, there are two self-regulatory organisations: the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association (MFDA). The IIROC oversees securities dealers and the major exchanges. The MFDA regulates the sale of mutual funds in Canada.

One of the distinguishing factors of the Canadian and American systems of regulation relates to the cooperation between regulatory bodies in the former, which is in stark contrast





with the frequent turf-battles of the latter. One of the areas on which the Obama Administration is focusing reform efforts is on limiting the potential for regulatory arbitrage by financial firms. Despite the segregation of duties between the federal regulatory agencies in Canada, there is still potential for regulatory arbitrage because of the silo structure of financial regulation. Pan (2009) describes this weakness as: “[l]ying in the fact that parts of Canada’s regulatory system are still segmented by type of financial activity and regulation is split between the provinces and the national government”.¹⁷

Some efforts have been made to coordinate regulatory cooperation between the federal and provincial regulators. At the national level, the major regulatory bodies coordinate their actions through the Financial Institutions Supervisory Committee, which meets quarterly, and the Senior Advisory Committee, which meets on a more as needed basis. Each group is comprised of representatives of the Superintendent of the OFSI, Governor of the Bank of Canada, Chair of the CDIC, Commissioner of the FCAC and Deputy Minister of Finance. The provincial securities regulators work together to coordinate actions and move towards harmonisation of regulation through the Canadian Securities

Administrators, which is comprised of the chairs of the 13 provincial securities regulators.

Following the submission to OSFI of two applications in September 2007 to open Islamic banks in Canada, the department sent the applications to the Minister of Finance, which commissioned a study on Islamic finance. Another study was commissioned by the Canadian Mortgage & Housing Corporation, which reports to the Minister of Housing and was not specifically related to the applications by groups wanting to receive charters for Islamic banks. The Minister of Finance study has been completed but not yet released and none of the banking applications has yet been approved. The applications are currently being reviewed for the compatibility of their business models and products with the Canadian regulatory framework according to a Ministry of Finance official. The CMHC study was expected by the end of 2008 but has not yet been released. It attracted criticism from a secular Muslim group which views the industry as a ‘con job’.¹⁸ Until the two studies are released, there is little clarity on how the Canadian regulatory authorities will approach Islamic finance. However, in non-banking contexts, Islamic financial institutions are regulated identically to their conventional brethren.

The regulatory environment for Islamic financial institutions in North America is thus far identical to conventional financial institutions, pending the results of the CMHC study. However, each country has areas of the financial regulatory system that hamper growth of Islamic finance. In the United States, a fragmented regulatory environment divided between competing agencies at the federal level and 50 state regulators add costs for Islamic financial institutions wishing to offer services nation-wide. In Canada, a more centralised regulatory environment has created a bottleneck for Islamic banks with the delayed release of a study that will help the national regulatory bodies decide how to regulate Islamic banks. Despite these roadblocks, each country has characteristics that should prove to be beneficial: Canada suffers from much less regulatory overlap, particularly since many of the country’s Muslims are concentrated in Ontario, while the United States regulators have openly expressed their willingness to work with Islamic financial institutions to accommodate the unique aspects of Islamic finance as much as possible within US law.

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Islamic financial institutions in North America



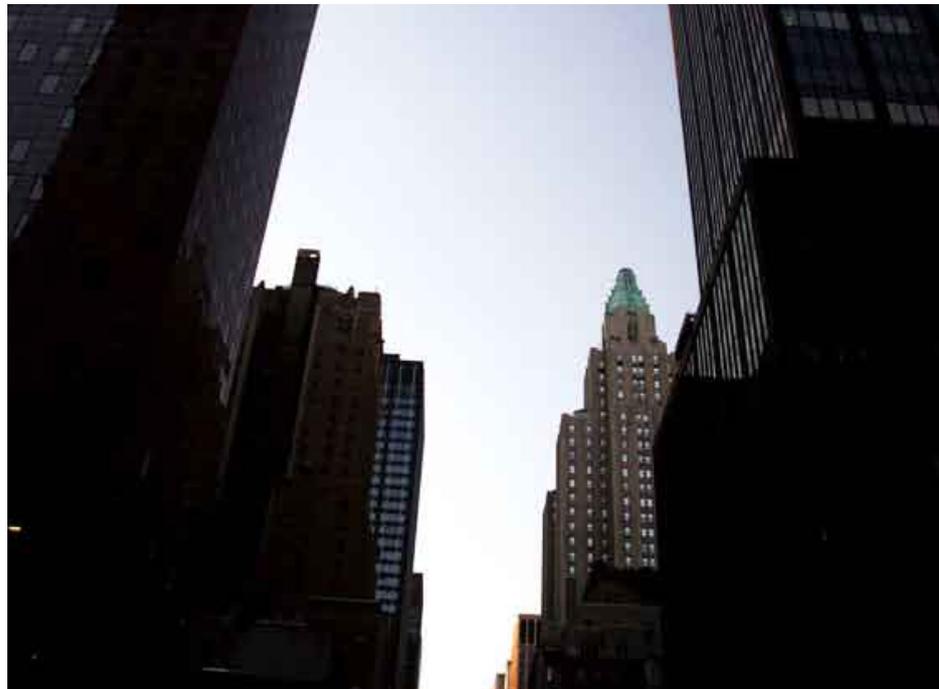


Islamic financial institutions in North America

The Islamic financial landscape in North America is currently not organised around strictly banking institutions as it is in other countries. The regulatory regime covering banks is stricter than in many other countries and the near universal requirement for banks to carry federal deposit insurance in both the United States and Canada provides a test for how receptive Muslims will be to financial services that are required to carry non-Shariah compliant deposit insurance.

So far, the market for Islamic financial products has been largely centred around non-bank financial institutions because the largest source of demand came from Muslims wishing to purchase homes without relying on interest-based mortgages. There is still healthy demand for this, particularly in Canada where there are fewer options and financial institutions report a large backlog of home buyers wishing to purchase or refinance. However, as demand grows, it will support the growth of more Islamic banks offering a greater array of services than non-bank financial institutions are able to provide. This may come from the launch of one or more Islamic banks or by other banks operating on Shariah principles that are not strictly 'Islamic' and are therefore more familiar to regulators. One area where growth is being seen is in business finance and commercial real estate financing. However, with the shrinking of the financial sector overall in the US, there is a risk that the credit crisis could begin to affect this area as well. In particular, the Islamic commercial real estate market could wither before it becomes firmly established if prices for commercial real estate begin falling rapidly as they already have for residential real estate.

Outside of banking activities like taking deposits and providing financing, the market is still developing slowly. The market for investments is particularly underserved. Currently, there are three fund management companies in the US and two in Canada that offer Shariah compliant mutual funds and two ETFs that have either recently launched or will launch shortly. There are no dedicated asset management firms that can provide individual advice to Muslims who want to do more than invest through mutual funds and ETFs.



The Islamic insurance, Takaful, market in the United States is currently nearly non-existent. The Takaful industry has been several years behind the Islamic financial industry globally, but this lag has been particularly severe in the United States. Following the departure of First Takaful USA in the early part of this decade, there was virtually no Takaful available until 2008.

Other areas of the Islamic financial industry such as legal and Shariah advisory services have grown fairly rapidly compared to some areas of the industry. There are many sources for Shariah advisory in both Canada and the US for Islamic financial institutions to use in addition to the globally recognised Shariah scholars used across the world. In contrast, many of the legal firms that advise on Islamic finance and have offices in the United States and Canada focus most of their attention on the global Islamic finance industry and less on the domestic markets because there is more activity outside North America. These firms also concentrate their work in the wholesale Islamic finance market which is primarily focused on finding investments that can be structured to be Shariah compliant within the US for funds coming from the GCC in particular. The US has a large conventional financial industry and many of the law firms



with Islamic finance practices have developed these in response to the market opportunities in other markets. For law firms that work on structuring Sukuk, the market in North America is particularly barren: one Sukuk has been issued by a US-based company and one is expected to be issued in August 2009 from a Canadian-based company. There is also talk of Canada issuing a sovereign Sukuk but no formal announcement has yet been made.

Banks Offering Islamic Finance

Currently, there are only two banks, Devon Bank in Chicago, Illinois and University Bank in Ann Arbor, Michigan, which offer Islamic financial products in the United States on a regular basis. Other small banks have taken more of an 'as requested' approach and have provided Shariah compliant financing but do not specifically market themselves as providing Shariah compliant financing.¹ Devon Bank and University Bank are also the two banks that offer Islamic financial products outside of their home states. In the case of both banks, the primary methods of home finance used are Murabaha and Ijarah which were both ruled permissible in the Interpretive Letters issued by the Office of the Comptroller of the Currency in the late 1990s.

In the case of Devon Bank, it offers primarily its residential Murabaha product outside of its home state of Illinois. It also offers Ijarah home financing as well as additional business financing outside of Illinois, as well as some institutional products. One of its out-of-state deals was an Ijarah wa iqtina financing of the San Diego, California Muslim Community Center. Other than the residential Murabaha and Ijarah, Devon Bank provides the residential products for home finance along with business financing and some construction financing in selected states around the United States depending on regulatory approval. However, because they are limited to using products like Ijarah and Murabaha, the construction financing is largely limited to financing construction materials and not to finance the labour costs that make up the bulk of many construction projects.² Devon Bank provides financing for home purchases and then resells them to Freddie Mac. Although the structure is different in order to receive

approval from Shariah scholars, the economic outcome is identical to conventional mortgages which allowed it to enter into an agreement with Freddie Mac that provides the bank with additional liquidity to offer additional new financing.

In addition to its banking activities, Devon Bank is working on expanding its product offering beyond what is possible within a banking area through its independent Devon Islamic Ventures – Offshore (DIVO) unit, which will be domiciled in Ireland to finance home finance using Musharaka finance, a home finance product currently unavailable for banks in the US to finance in addition to other, mostly real estate-based financing. The DIVO unit would raise capital from Islamic investors outside of the United States to provide Musharaka home finance products, as well as a number of additional products within the US.

The other bank that offers Islamic finance is the University Bank of Ann Arbor. It also offers financing products using Ijarah and Murabaha products. However, in contrast to Devon Bank, University Bank launched an Islamic finance subsidiary with money from Virtue Investors, LLC, a group of local Grand Rapids investors. Since the bank began offering Islamic financial services it had financed over \$20 million of home purchases.³ In addition to Islamic home financing, the bank is also the only one in the United States to offer a Shariah compliant deposit product that was developed by SHAPE Financial. The deposit product has attracted \$20 million in deposits and pays depositors a return that depends on the underlying portfolio of Islamic home financings provided by the bank.

Other banks that provide Shariah compliant financial services include Broadway Bank of Chicago, Lincoln State Bank, Cole Taylor Bank and newly formed bank RomAsia Bank. All of these banks do not market themselves as providing Shariah compliant finance and with the exception of RomAsia Bank, based in New Jersey, limit their activities within the state of Illinois.⁴

The main development within the Islamic banking industry in North America is due to



Islamic financial institutions in North America

come once the Ministry of Finance Canada and CMHC release their studies on Islamic banks and Islamic finance respectively. There could be decisions announced on applications to open an Islamic bank in the country, some of which have been awaiting approval since 2007. Although the number of applications and the identities of some of the groups are unknown, there are two groups known to have submitted applications: Amana Canada Holdings Ltd., which will operate as Eman Bank and Albassam House which is awaiting approval to open Al Salam Bank Canada which is currently being called the First Islamic Finance House of Canada, Inc. according to the company's website.⁵

Finally, the African Chamber of Commerce Minnesota is working on the first Muslim credit union in the United States.⁶ There have been other attempts in the past that have not reached fruition, but this one looks more likely to make it to the market. According to Martin Mohammed, the president of the United States African Chamber of Commerce, the credit union has received the necessary approvals and was scheduled for launch in 2009. However, following the financial and economic crisis in the United States, the launch was delayed until 2010. The credit union will focus on serving the Minneapolis-St. Paul area and the United States African Chamber of Commerce hopes it will provide a model for the launch of other Shariah compliant credit unions around the US

Non-Bank Financial Services Companies

As the Islamic finance industry develops in North America, the most common company structure, particularly for offering home financing, is non-banking financial institutions. Because they do not accept deposits, the regulation surrounding these companies is far lighter than for deposit-taking institutions like banks and credit unions. There are three larger companies in the United States and one in Canada that are non-bank financial institutions set up to provide business and home financing along with a number of smaller cooperatives, non-profits and less well known companies. In the US, the largest home financing company is Guidance Residential, based in a Virginia suburb of Wash-

ington, DC. The company has provided more than \$1 billion in home financing. In contrast to the banks providing Islamic finance, Guidance Residential can provide a diminishing Musharaka option because it is not restricted in the same way as banks from entering into equity investments and partnerships. The other company focusing on home financing, but which offers business financing as well is American Finance House-LARIBA. There have been several fatwas issued by Shariah advisory boards about the LARIBA product for its use of standard loan agreements with a separate agreement that reclassifies principal and interest payments as principal and profit-sharing payments in a Musharaka agreement.

One of the largest providers of Shariah compliant business financing in the US is Zayan Finance, based in New York City. It provides financing of multi-family residences as well as commercial real estate using a diminishing Musharaka structure. In contrast to many of the home financing companies, Zayan Finance provides financing for considerably larger projects, in some circumstances it will provide up to \$50 million in financing. Another New York-based non-bank financial institution is Anchor Finance Group, which provides financial and management consulting in addition to financial guarantees, letters of credit, and factor financing.

In addition to the major players, there are smaller, regionally focused or still-emerging non-bank financial institutions that offer services in the US Two of these are the non-profits African Development Center and Neighborhood Development Center which offer their business and home financing to people in the Minneapolis-St. Paul, Minnesota area, many of whom are Somali refugees. In other areas, housing cooperatives offer home financing to members in areas where there are or were limited alternatives such as the San Francisco Bay Area through the Ameen Housing Cooperative and the Toronto area through the Ansar Cooperative Housing Corporation, which began operating in 1981, well before any other Islamic financing was available. Other companies like Ijarah Loans provide Islamic finance nationwide in the US as well as Canada but do are relative newcomers and are not yet widely enough known to receive greater attention.





In Canada, the market is nearly entirely served by UM Financial Group which includes a non-bank financial institution, UM Financial, a real estate brokerage firm, UM Realty, and a real estate investment company, UM Investment. UM Financial provides home financing, although this is currently limited while the company finalises a financing agreement with one of Canada's major financial institutions that will allow it to offer up to \$250 million in new home financing and refinancing per year. Currently, UM Financial offers home financing using funds invested in UM Real Estate Investment Fund Inc., which currently limits the number of new financings but provides Muslims with an investment option that is Shariah compliant. UM Financial continues to service the \$120 million in home financing that it offered through a Mudaraba financing agreement with Credit Union Central of Ontario (CUCO). UM Financial has currently experienced no cases of default or foreclosure in their real estate financing portfolio with CUCO.

The other areas of UM Financial are growing, but much of the growth is within the UM Investment business. It has launched the UM Real Estate Investment Fund, which it expects to reach \$100 million and also offers Registered Retirement Savings Plans (RRSP) and Registered Education Savings Plans (RESP) and is working with Jovian Capital Corporation to launch an ETF based on the S&P/TSX 60 Shariah Index that will offer a Shariah compliant investment option with lower fees than mutual funds. UM Financial Group is launching a pre-paid card with Mint Technology Corp in August that will provide holders with a pre-paid MasterCard that functions like a credit card but without interest charges since the balance is pre-paid.⁷ UM Financial Group is also working with the government to explore the possibility of a Canadian sovereign Sukuk.

Finally, UM Financial is applying to receive a bank charter for a 'multi-cultural' bank that will provide Shariah compliant financing options and focus on providing services to Muslims as well as members of other religious groups who eschew interest-based financing. By taking the 'multi-cultural bank' rather than an Islamic bank approach, it hopes to avoid the regulatory delay associated with the Islamic banking applications awaiting approval



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because regulators are more familiar with 'multi-cultural' banks which are often represented as a separate division within many of Canada's largest banks already.

Mutual Funds/Investments

There are several different options for Muslim investors looking for Shariah compliant investment options in North America, but the investment options are far less comprehensive than those available to other investors because the market is smaller. In the United States, there are three companies that offer Shariah compliant mutual funds and one company that offers a Shariah compliant ETF.

The largest mutual fund company in North America is the Amana Funds, a part of brokerage firm Saturna Capital Corporation based in Bellingham, Washington. The Amana Funds net assets represent 98 per cent of all assets invested in Shariah compliant mutual funds in the United States. As of the most recent date for which data are available from Morningstar, May 31, 2009, the two Amana Funds, Income and Growth, had combined total assets of \$1.8 billion. The Growth Fund (AMAGX) focuses on companies with higher than average growth prospects while the Income Fund (AMANX) invests with the goal of capital preservation and current income. Although the Amana Funds have been by far the most successful Islamic mutual funds in terms of asset growth and performance, both receive a 5-star fund rating from Morningstar, the dominance within the market means that there are fewer investment opportunities available because of the difficulty of competing with the Amana Funds.

In fact, one of the competitors of the Amana Funds, the Azzad Funds, announced it would slash its expenses from 1.90 per cent to 0.99 per cent and eliminate one of its two funds, the Azzad Ethical Income Fund (AEIFX), both in early June 2009. As of June 30, 2009, the two funds had combined total assets of \$10 million. The remaining fund, the Azzad Ethical Mid-Cap Fund (ADJEX) is focused on long-term capital appreciation. In addition, Azzad Asset Management, which operates the Azzad Funds, has set up another mutual fund that is not yet operational, the Wise Capital Fund (WISEX). This fund aims to provide capital preservation and income with



The corporate investments focus on the consumer, healthcare, energy, technology and manufacturing industries in a variety of countries including the United States.

returns comparable fixed income securities by investing primarily in Sukuk according to the prospectus filed with the Securities & Exchange Commission in October 2008.

The other mutual fund company in the US is Allied Asset Advisors, which is owned by the North American Investment Trust (NAIT) operates the Iman Fund, formerly known as the Dow Jones Islamic Fund. This fund, which has \$25 million in total assets as of June 30, 2009 according to Morningstar, is focused on companies with above average earnings growth. The other significant area of investment products is that of exchange traded funds (ETFs) and until recently, there were no funds offered that had been screened for Shariah compliance. However, this changed in July 2009 with the launch of the first ETF in the Javelin Exchange Traded Shares (JETS) Dow Jones Islamic Market International Index Fund. The JETS Islamic International Fund is a passively managed ETF that tracks the Dow Jones Islamic Market International Titans 100 Index, an index composed of 100 of the largest Shariah compliant international (non-US) companies. As of July 2, 2009, the ETF held assets of \$4 million.

If the investment offerings in the mutual fund and ETF space are scarce in the United States, they are even more so in Canada, where the much smaller number of Muslims translates into lower demand for products that provide Shariah compliant investment alternatives. Currently there are two mutual funds and an ETF that is not yet launched.

The two funds, the frontierAlt Oasis Canada Fund and the Global Prosperata Iman Fund,





are both small mutual funds. The former has total assets of \$2.9 million and invests in publicly traded securities of Canadian companies while the latter, which recently launched, has \$200,000 in assets and selects investments from those in the Dow Jones Islamic Market Indexes. There is also an ETF being developed jointly by UM Financial Group and Jovian Capital Corporation that will track the S&P/TSX 60 Shariah Index, which Standard & Poor's launched earlier this year. UM Financial Group plans on launching the ETF by the end of 2009.

Private Equity, Venture Capital and Investment Banking

The area of Islamic financial services in North America that has perhaps the most interaction with the global Islamic financial services industry is in the private equity and venture capital area. The largest companies operating in the United States, UIB Capital and Arcapita, are both subsidiaries of GCC-based Islamic financial companies. Ittihad Capital operates primarily as an investment banking and venture capital firm based in Canada and, in contrast with Arcapita and UIB Capital, is an independent company that focuses entirely in Canada. The development of these areas of the Islamic financial industry, the wholesale segment of

Islamic finance, began in the mid-1990s with investments primarily from Middle Eastern investors in property and real estate located within the United States that were structured in a Shariah compliant way. As such, the wholesale market developed independently from the domestic Islamic financial industry that grew in response to needs from within the Muslim community. To this day there is a near total lack of any formal interaction between the retail and wholesale markets in North America, particularly in the United States.

Arcapita finances considerably larger companies and projects than either of its North American competitors with average deal size typically greater than \$200 million except in venture capital. The focus of its business is on corporate investment, real estate investment, asset-based investment and venture capital. The corporate investments focus on the consumer, healthcare, energy, technology and manufacturing industries in a variety of countries including the United States. The real estate business is focused on warehouses, self-storage, assisted living, residential, retail and healthcare including properties located in the United States. The asset-based business has a slightly different focus in terms of industries concentrating on industries that have large asset requirements like oil and gas, electricity and transportation. Finally, the venture capital area is nearly entirely focused on the United States and generally searches for healthcare, IT and industrial technology. As mentioned above, the venture capital investments are usually much smaller than the investments made in other businesses and usually do not exceed \$20 million over the life of the investment.

UIB Capital, in contrast to Arcapita, which is involved in a broad variety of industries and investment focuses, focuses on one area of investment, private equity transactions where it receives a controlling interest in mid-market companies. The industries that UIB Capital focuses on are in healthcare, technology, manufacturing, business and consumer services, consumer products and oil & gas. The investments also tend to be smaller reflecting its focus on smaller, growth-oriented companies. Each transaction it completes typically involves an equity investment of between \$10 and \$75 million.





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Alongside Arcapita and UIB Capital, two other firms were established in the United States to connect Gulf-based capital and US-based investment opportunities, also structured as subsidiaries of Middle East-based parent companies. The two firms are joint ventures between Gulf Investment House and Gulf Finance House. Innovest Capital, based in Cleveland, Ohio, is primarily focused on real estate acquisitions and development. Trans-Ocean Group Lt focuses primarily on private equity and currently has two portfolio companies and is considering additional acquisitions.

The other company in this segment of the industry is Ittihad Capital, a Toronto-based Islamic investment banking company. Currently, the company is working on developing a Sukuk investment product to address one of the most underserved investment areas in North America. Fixed income-like alternatives to money markets and bonds are simply unavailable to most investors. One of the main differences between Ittihad Capital and many other Islamic financial institutions is that it broadens the screening criteria beyond the traditional restrictions governing Shariah compliance to include other socially responsible investment criteria. In doing so, it broadens the scope of people it is targeting to include Muslims as well as non-Muslims who are not necessarily motivated by religious concerns. In some respects, this is a natural rebranding for an Islamic financial company operating in a specialised space with a limited market; Canada's population is one-tenth that of the US and Ittihad Capital, unlike Arcapita and UIB Capital, is not the subsidiary of a global company based in a market like the GCC where the Muslim population is significantly larger.

Islamic Financial Structuring and Advisory

In addition to the bevy of financial services firms offering Shariah compliant financing in North America, there are several different companies that offer advisory services, particularly relating to the development of new products and the structuring of financial transaction. These groups operate in many different areas of the financial services industry and some operate with a focus on Islamic finance outside of North America.



Codexa Capital has a focus on connecting asset management firms with funds usually located in Muslim-majority countries. It also connects firms needing capital with Shariah compliant sources of financing either through arranging financial transactions or by providing capital introduction. Many of the companies that receive funding arranged by Codexa Capital are located outside of the United States and in particular, there is a focus on the Indian Subcontinent and Southeast Asia. The firm also provides asset advisory and investment research services relating, in part, to mitigating the implications on diversification and asset allocation of excluding financial services companies and the geographical concentration of Sukuk as an asset class within the GCC and Southeast Asian regions.



Shariah Capital is another Shariah advisory firm that operates primarily outside of North America. The primary focus is on creating an Islamic hedge fund platform that allows other asset managers to run Islamic hedge funds using Shariah Capital's proprietary system that provides Shariah screening of investments as well a Shariah compliant way for the asset managers to establish short position. In addition, Shariah Capital launched the first Shariah compliant gold ETF which is available on the Dubai stock exchange, NASDAQ Dubai.

In addition to Islamic financial advisory firms operating outside of North America, there are also some that have a focus specifically on North America. SHAPE Financial Corporation, based in Virginia as well as Kuwait, was founded by Abdulkader Thomas who gained experience working with United Bank of Kuwait and was involved in requesting and receiving the interpretive letters from the Office of the Comptroller of the Currency regarding banks offering Ijarah and Murabaha which have enabled significant growth in the US Islamic financial industry. One of the main focuses for SHAPE was recently working with the FDIC on the deposit product now offered by University Islamic Financial Corporation.

More recently, Zeus Capital Advisors started providing structuring advice on Shariah compliant real estate and investment services both for domestic and foreign investors. Unlike many other advisory firms, Zeus Capital advises on domestic investments and the banking application process. It is currently raising funds, primarily from investors in the Chicago, Illinois area, for a newly chartered Islamic community bank. It hopes that a community bank in Chicago, which is currently awaiting its charter from the Office of the Comptroller of the Currency, will provide the model for a national network of community banks offering a consistent suite of Shariah compliant financial products.⁸ In some ways, the dual focus on connecting US investment opportunities with Middle Eastern capital, as well as the domestic efforts to create Islamic community banks with local capital and community involvement, provide one area where the retail and wholesale markets can connect. In addition to the advisory firms listed above,

there are several smaller firms with more specialised focus. Albassam House, Inc., based in Calgary, Alberta, is involved with one of the Islamic banking applications submitted to the Minister of Finance Canada. In addition, it is working on a joint venture project in Saudi Arabia, where its founders have significant business experience and ties.

Shariah Advisory and Oversight

Because the Islamic finance industry is a much smaller part of the financial industry in the United States and Canada with a more retail-focused product mix and a broad diversity of Muslims from different parts of the world, the Shariah review is done within many financial institutions by local or national Shariah boards. These boards provide fatwas on a wide variety of subjects including finance unlike the boards that oversee most Islamic financial institutions made up of scholars whose focus is primarily on providing Shariah review of financial products. In addition to the diversity of Muslims in North America, the way products are reviewed is in part determined by the small size of the industry in which most participants do not have the scale required simultaneously to receive Shariah review by the globally-recognised scholars and offer competitively priced products. However, there may be also be greater demand for products that are approved by scholars who are linked with local Muslim communities rather than global figures without the same connections within the American and Canadian Muslim communities.

Within the United States, there are three groups that provide Shariah review of financial products: the Fiqh Council of North America, the Shariah Supervisory Board of America and the Assembly of Muslim Jurists of America. On the institutional side, in contrast to the retail side, there is one group, the Straight Way Ethical Advisory, which is composed of North American-born but globally trained and located Shariah scholars. Straight Way Ethical Advisory focuses solely on the Islamic finance industry and provides a relatively new type of Shariah review. Instead of financial institutions hiring their own Shariah board of individual scholars, this type of firm allows Islamic finance companies to hire the firm to provide

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the review. In light of the potential conflict of interest of scholars being directly employed by the firms whose products they review, they are instead employed by an independent firm, much like lawyers and accountants and therefore should be more insulated from perceived, if not actual, conflicts of interest. It provides a middle ground between the system used in much of the world of financial institutions hiring scholars individually and the Malaysian system where there is one national Shariah board.

The Fiqh Council of North America was founded in the 1960s as the Religious Affairs Committee of the Muslim Students Association and later evolved into its present form as an independent nonprofit affiliate of the Islamic Society of North America following the latter organisation's founding in 1980. In addition to Islamic financial products, the Fiqh Council issues fatwas and research about other issues that affect the lives of Muslims in the United States, as well as holding conferences on a variety of subjects. Its stated goal is to provide "essential information to the general public in North America on Islamic matters by issuing clear and concise legal statements from within a mainstream Islamic legal paradigm".⁹

The Shariah Supervisory Board of America is a similar organisation to the Fiqh Council of North America but is primarily focused on a local community in the Chicago, Illinois area. The group received some criticism following the disappearance of Salman Ibrahim, its former vice president and CEO of Sunrise Equities following news reports that investors in Sunrise Equities were the victims of an alleged fraud by Salman Ibrahim's company. However, the Shariah Supervisory Board of America is not alleged to have any role in Sunrise Equities.

The Straight Way Ethical Advisory, based in the United States with Shariah advisors in both the United States and Canada, was founded by Taha Abdul-Basser and Faraz Rabbini, provides many of the same services as the Islamic Finance Advisory Board including Shariah review and audit as well as research and education.

Takaful

The Takaful industry in North America is nearly non-existent. The lack of Takaful providers does mean that there is probably an untapped

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There are many sources for Shariah advisory in both Canada and the US for Islamic financial institutions to use in addition to the globally recognised Shariah scholars used across the world.





market because most homeowners are required to carry insurance on their homes and most states also require automobile insurance. Currently, the requirement that insurance be carried coupled with the lack of availability of Takaful has compelled many Muslims to purchase conventional insurance, something that is generally accepted by scholars because of its necessity and because there are no Shariah compliant alternatives. In Canada, the Co-Operators Group launched an auto Takaful product in 2008 after working on it for several years with the Ansar Co-operative Housing Corporation.

In December 2008, American International Group announced it would begin offering Takaful through its Lexington Insurance Company subsidiary under the 'Lexington Takaful Solutions' brand. The first product provides Shariah compliant insurance for homeowners and other areas of Shariah compliant insurance are planned. Currently, Zayan Finance, through its Zayan Takaful subsidiary offers the AIG Takaful product.

Law Firms with Islamic Finance Practices

In addition to the growing Islamic financial industry in the United States and Canada, there are several law firms which have started Islamic finance practices that have lawyers located and working in North America, both on domestic transactions as well as investment transactions undertaken by foreign investors wishing to purchase assets in North America, particularly in the United States.

The majority of the firms that work in Islamic finance in the US are focused primarily on Islamic finance in the Middle East and their work within the United States is confined to occasional transactions on investments structured to be Shariah compliant. The law firms with a limited Islamic practice include Patton Boggs, Gibson Dunn & Crutcher, Dechert, Sonnenschein Nash & Rosenthal, and Shearman & Sterling primarily operate in this way, even though they have lawyers working on Islamic finance based in the United

States. Fulbright & Jaworski has a similar global focus for its Islamic finance practice, although it has been involved in several Islamic finance products in the US, Canada and Europe. Gersten Savage is a New York-based law firm that became involved with Islamic finance through its hedge fund practice which has worked with Shariah Capital on that firms' Islamic hedge fund platform.

One of the larger firms with an Islamic finance practice that focuses on inward investments into the United States structured to be Shariah compliant is King & Spalding. Lawyers in the New York and Atlanta offices work with their colleagues in the Middle East and London on Shariah compliant wholesale market transactions from investors primarily in the Middle East. Unlike many other law firms, King & Spalding has an entire practice area that it established in 1995 with 20 lawyers focused primarily on the Islamic finance industry with many focused on the United States.

Another firm, Murtha Cullina, based in the northeastern United States, takes a different approach from the global law firms, some of which are based in the United States, and all of its offices are located within the United States. Its Islamic finance practice therefore is more focused on Islamic financial transactions in the United States while involving a roughly even mix of domestic and foreign investors looking for primarily US-based investments.

In Canada, however, the legal firms operating in Islamic finance are primarily Canadian firms operating with domestic Islamic financial institutions on products and investments within Canada, although there is some work that involves non-Canadian financial institutions, issuers and investors. The firms most actively engaged in the legal aspects pertaining to Islamic finance are Stikeman Elliot, Gowlings Lafleur Henderson, Ogilvy Renault, Cassels Brock & Blackwell and Blake, Cassels & Graydon.

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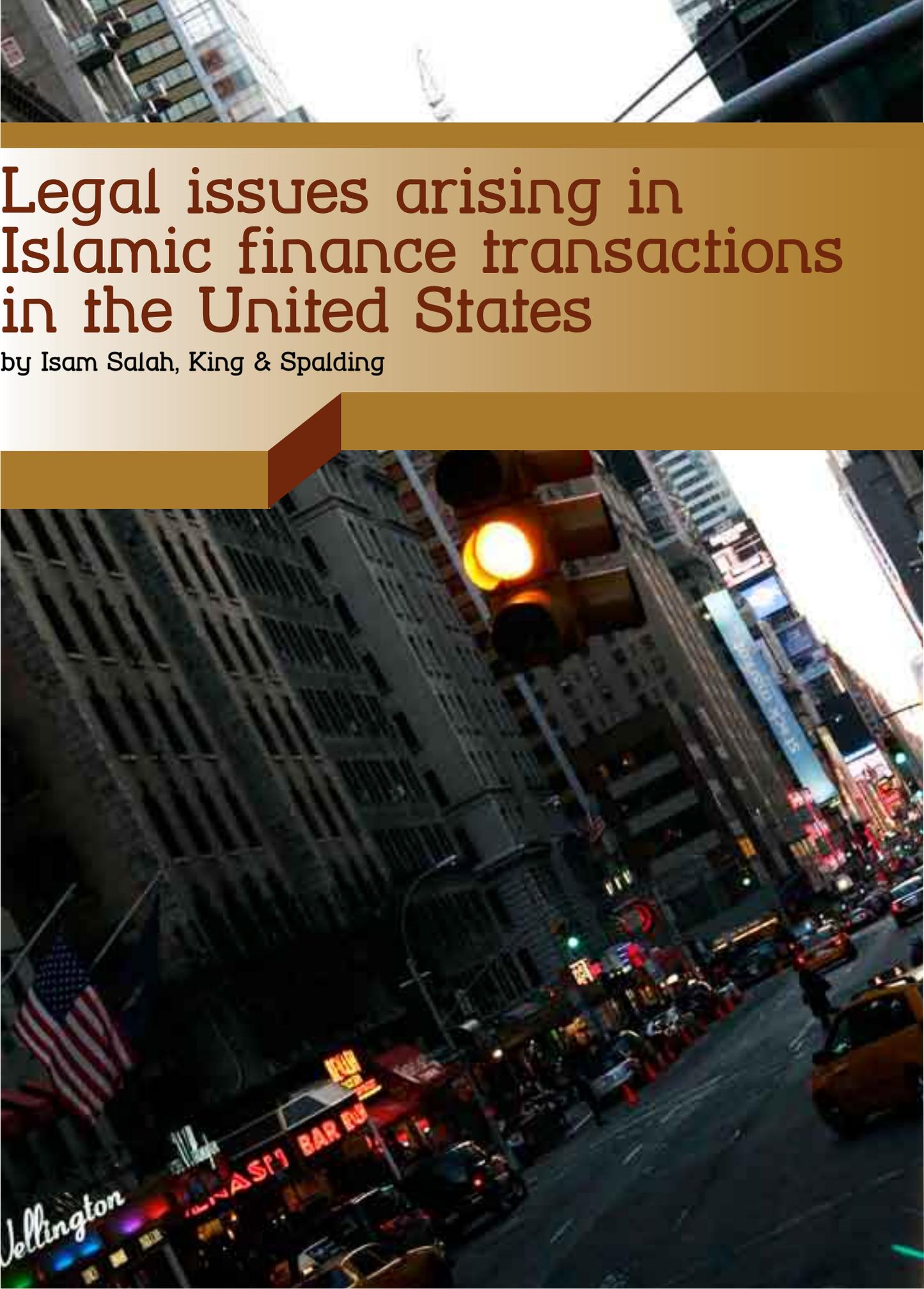
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Legal issues arising in Islamic finance transactions in the United States

by Isam Salah, King & Spalding

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Introduction

Islamic finance in the United States has developed along two distinct paths during the past 15 years. The first is the development of retail Islamic finance and investment products by conventional US financial institutions and several Shariah compliant non-bank financiers, and the marketing of those products to consumers and small businesses. The second is equity investment by non-US Islamic institutions (and their clients) in US assets, in particular property, companies and leased equipment. While there is some overlap on certain issues, in general the legal issues that have impacted these two lines of activity are quite different.

The development and marketing of Islamic financial products to consumers in the US

has required the sponsors of those products to obtain approvals from US or state banking regulators, as well as tax rulings from local tax authorities. The regulatory approval process has focused on the legal and economic substance of those products and how they do or do not fit into a regulatory framework that is based on interest-based products or conventional financing structures. In addition, sponsors have had to consider the application to their products of the various federal and state laws that are intended to protect consumers in their financial and investment dealings.

In contrast, the making of equity investments in US assets and, in particular, the financing of those investments by US financial institutions raise a number of legal issues of a non-regulatory nature that are typically

addressed by the parties in the structuring of the proposed transaction or in the transaction documentation.

This section will provide an overview of some of the key legal issues associated with the offering of Shariah compliant financing and investment products to US consumers, and the financing of wholesale equity investments in the United States. Although several Islamic structures are used for these financing arrangements, the principal Islamic structures in use are Murabaha, Ijarah and Ijarah Wa'iqtinah, and our discussion will be limited to those structures.

Retail financing products

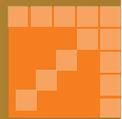
Regulatory considerations. The groundwork for the approval of Shariah compliant retail financing products in the United States was established with the approval by the Board of Governors of the Federal Reserve (Federal Reserve) of the offering of such products by the foreign subsidiaries and branches of US banks. During the 1985 to 1997 period, the Federal Reserve authorised some of the leading US financial institutions to offer Murabaha and Ijarah products in countries, such as Pakistan and the Sudan that had mandated that all financing activities in those countries be provided on an Islamic basis. During this same period, the Federal Reserve also approved the offering of such products by the foreign subsidiaries and branches of certain US banks in countries in which the offering of such products was not legally mandated, but in which there existed strong and increasing demand.

Implicit in the granting of these approvals was a determination by the Federal Reserve that the risks associated with offering the specified Murabaha and Ijarah products were substantively no different than the risks associated with comparable conventional financial instruments. In a Murabaha transaction, the financial institution will first purchase the goods that have been specified by its customer and then, once ownership has been transferred to the financial institution, resell those goods to the customer on a cost plus profit basis, usually with payment to be made at an agreed future date. As a result of this arrangement, the financial institution will take title to the goods for a short period of time before

reselling the goods to its customer. In an Ijarah or Ijarah Wa'iqtinah structure, the financial institution will hold title to the leased assets until the end of the lease term. Taking title to goods and then reselling those goods is not a typical activity for a US financial institution. Nevertheless, in its approvals the Federal Reserve chose to look to the substance of the transactions rather than the form and in doing so reached the conclusion that the risks posed to the US financial institutions were essentially credit risks of the type regularly managed by those institutions in their traditional banking operations.

This focus on the substance of the proposed financing transaction rather than its form was essential to the regulatory approvals that were next granted by the Office of the Comptroller of the Currency (OCC) in the 1997 to 2001 period. During that period, the OCC approved on a case-by-case basis the offering of Murabaha and Ijarah Wa'iqtinah arrangements to finance home purchases. Not only did the OCC conclude that the transactions were essentially credit transactions, and that the applicant US financial institutions had the expertise to identify and manage those credit risks, but the OCC also addressed the restrictions placed on ownership of real estate by US financial institutions. US banks are not permitted to own real estate, other than to house the operations of the bank, or real estate acquired as a result of a foreclosure. The purpose of these restrictions is to prevent banks from engaging in speculative real estate investment activities. In its approvals, the OCC again took a substantive view of the transactions in question and determined that the risks associated with the ownership of real estate in these situations were credit risks rather than the types of risks intended to be prevented by the regulatory restrictions. Its approvals were granted that basis. The New York State Banking Department also approved similar home mortgage financing products during the same period.

Tax considerations. Although regulatory approval of Murabaha and Ijarah financing products is a precondition for such products to be offered by regulated US banks, those approvals do not address all of the legal issues faced by US banks in offering such



products to consumers seeking to finance home purchases on a Shariah compliant basis. As with many Islamic financing products, their viability may depend on the tax treatment of the financing product. For example, state property transfer taxes need to be taken into consideration in any home finance product that is based on a Murabaha or Ijarah Wa'iqtinah structure. Most states have property transfer taxes that will impose a tax on each transfer of real estate or each recording of a deed. If a Murabaha or Ijarah Wa'iqtinah structure is used, the initial purchase of the home by the bank will be subject to a transfer tax, the payment of which will typically shifted to the consumer or built into the resale price or the lease rental payments. When the Murabaha or lease payments have been fully made and the property is to be transferred to the consumer, a second real estate tax is likely to be payable, thus imposing an additional tax burden on an Islamic financing transac-

tion that is not applicable in a conventional mortgage financing. The tax authorities in New York have recognised the inequity of imposing a second tax payment on a Shariah compliant structure when the substance of the transaction is the equivalent of a conventional financing, and rulings have been issued on a case-by-case basis to eliminate this double tax burden.

Ownership risks. Regardless of whether a Murabaha or an Ijarah Wa'iqtinah structure is used to finance the purchase of real property, a financial institution will have become part of the "chain of title" of the property even if, in a Murabaha structure, only for a moment. US law imposes various responsibilities and liabilities on the current and prior owners of real property, and a bank participating in financing structured in a Shariah compliant manner will need to recognise and mitigate those risks. If, for example, a property is found to have environmental issues, the current and prior owners may be legally obligated to pay the cost of any



Legal issues arising in Islamic finance transactions in the United States

required clean-up of the property. These are risks that are generally not applicable to banks providing conventional mortgage finance. These risks can be mitigated by having environmental experts conduct thorough diligence prior to undertaking the transaction. Indemnities from the bank's customer may also be sought, but such indemnities may be insufficient. Structurally, the bank's other assets can be protected from these risks by using a separate subsidiary for each financing transaction, but the creation and maintenance of a new entity for each transaction will drive up the cost of the transaction and may put the financing product at a competitive disadvantage in comparison with a conventional mortgage financing product.

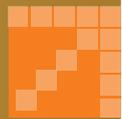
The ownership of property also carries with it the risk of liability for injuries occurring on the property. A financial institution financing the acquisition of property through an Ijarah Wa'iqtinah structure needs to be mindful of those risks and should obtain an indemnification undertaking from its customer, which is the party that occupying the property, or insurance protecting it against the risks associated with its ownership of the property. Other risks. Murabaha and Ijarah Wa'iqtinah structures can be used by US financial institutions to finance the purchase of goods or equipment in addition to real estate. When these structures are used to finance the purchase of goods or equipment, the financial institution will seek to address some of the risks unique to those transactions.

A customer in a Murabaha transaction will want to have the benefit of the supplier's express and implied warranties relating to the goods or equipment, and the financial institution will want to be sure that its customer is looking to the supplier, rather than to the financial institution, should the customer seek to make claims under those warranties. It is generally possible to transfer contractually the benefit of the supplier's warranties from the financial institution to the customer, and this issue should be addressed during the customer's preliminary dealings with the supplier, and in the purchase contract that is eventually signed between the financial institution and the supplier, otherwise the warranties will end up benefitting only the financial institution.

Similarly, the financial institution will seek to eliminate any warranty claims that might be made against it by its customer. Although it is generally possible to disclaim warranties, such disclaimers, especially in a consumer context, are generally not favoured and would probably be strictly construed against the financial institution. In most states, any disclaimer of warranties must be conspicuous and the language used must clearly call the customer's attention to the exclusion. In addition, the disclaimer of certain implied warranties, such as merchantability and fitness for a particular purpose requires specific language to be enforceable. Warranty disclaimers that fail to meet those requirements may be held to be invalid.

The nature of a Murabaha transaction is such that the purchase price to be paid by the customer does not change if the customer is required to make early payment, for example in a default situation, or if the customer seeks to pre-pay the purchase price voluntarily. This feature of a Murabaha transaction can create problems under US laws that aim to protect consumers by limiting the interest or finance charges that





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The consensus among Shariah scholars is that the property owner should retain the obligation to make major or structural repairs to the property and to maintain casualty insurance on the property.

may be imposed in a consumer transaction, that impose a limit on penalties resulting from mandatory or voluntary prepayments or that require full disclosure of all interest and finance charges applicable in a consumer transaction. Under US laws, the profit element of a Murabaha purchase price would be treated as interest. The general practice of Islamic financial institutions in voluntary prepayment situations is to provide the customer with a compensatory payment that is intended to offset the financial institution's receipt of the portion of the profit embedded in the Murabaha price that is “unearned” as a result of the early payment. This approach is not documented, and the Islamic financial institution has no legally enforceable obligation to make such compensatory payment to its customer. Nevertheless, making such compensatory payments is generally expected by participants in Murabaha transactions.

Such an approach, however, does not work in the regulated field of consumer finance in the United States. What we have seen in this situation in which US legal requirements and Shariah requirements come into conflict is that the Shariah scholars, recognising the utility of providing Shariah compliant financing products to the Muslim community, have permitted the financial institutions providing such financial products to rebate the “unearned” profit back to the customer so that the financial institution may avoid violating US laws concerning the receipt of usurious interest charges or what might be considered to be impermissible prepayment penalties.



Retail investment products

The offering of retail investment products to US consumers is still a work in progress. Investment accounts of the type offered by Islamic institutions in the Middle East are not yet available in the United States. Those investment accounts are based on a sharing in the profits and losses of the depository bank, an arrangement that puts the invested amount at risk. The notion that an amount placed on deposit by a consumer with a US bank could be at risk is inconsistent with the US regulatory framework, which does not permit the invested amount to be at risk, and backs that arrangement with federal deposit insurance up to specified limits.

The United Kingdom, which has a regulatory approach that is similar to the approach taken by the United States, has responded to that difference by continuing the guaranty of the investment amount but permitting the bank's customer to waive the benefit of the guaranty if the depository institution suffers a loss that would otherwise have been shared by the customer. US regulators have not yet been asked to approve such an arrangement. The depository arrangements currently targeted to the Muslim community in the US permit the customer to share in the profits of the depository bank, but not in any of the bank's losses. This arrangement, while financially beneficial to the customer, is not in full compliance with Shariah principles because the customer is not required to share in the bank's loss. It remains to be seen whether a US financial institution will seek regulatory approval of a deposit product that would pass on the financial institution's losses to the depositor under a UK-style waiver approach or some other arrangement that has the same substantive effect. In considering a solution to this problem, one approach that has been suggested would be to treat a profit and loss sharing deposit as an investment product regulated by the Securities and Exchange Commission, rather than a banking product regulated by the federal and state banking regulators.

Wholesale equity investment

Acquisition and financing structure. Regulatory issues are generally not relevant to Shariah compliant equity investment in properties,

Legal issues arising in Islamic finance transactions in the United States

companies and leased equipment in the United States. Such investments, undertaken on a wholesale basis by Islamic financial institutions typically for syndication to their clients, have their own legal issues, but those issues are addressed in the transaction documentation and generally do not involve regulatory authorities. The structure that appears to be most frequently used for the acquisition and financing of US assets on a Shariah compliant basis is an Ijarah Wa'iqtinah, or a lease-purchase arrangement. We will use that structure in the context of an investment in a portfolio of stabilised commercial and residential properties to illustrate some of the key legal issues.

In an Ijarah Wa'iqtinah, the property is held by a special purpose entity (SPE) that is usually owned by a corporate services company. The property being acquired from the third party seller is transferred directly to the SPE. At the time of acquisition, the SPE will enter into an Ijarah Wa'iqtinah lease of the property with an entity (InvestorCo) established for that purpose by the Islamic financial institution sponsoring the investment. The Ijarah Wa'iqtinah documentation will require InvestorCo to make an initial payment to SPE, which payment may be treated as an initial rent payment, but in substance it represents the equity investment made by InvestorCo in the property. SPE will enter into a conventional financing arrangement with a US bank or other lender (Lender), and the proceeds of that financing together with the initial payment made by InvestorCo will be used by SPE to pay the purchase price of the property. InvestorCo, as master lessee of the property from SPE, will become the landlord in relation to the tenants physically occupying the property. InvestorCo will secure its obligations under the Ijarah Wa'iqtinah documentation by assigning to SPE its rights under the tenant leases as collateral and by granting a security interest in any other assets of InvestorCo. The SPE will, in turn, secure its obligations under the mortgage loan from Lender with an assignment of its rights under the Ijarah Wa'iqtinah documentation with InvestorCo, and with a collateral assignment of the collateral received from InvestorCo. Rent payments by InvestorCo under the Ijarah Wa'iqtinah are substantially equivalent to the debt service obligations of SPE under the mortgage loan documentation

with Lender. As a result, any payment default by InvestorCo is likely to result in a payment default under SPE's mortgage loan documentation with Lender. Moreover, the mortgage loan documentation is likely to have an explicit cross default to defaults by InvestorCo under the Ijarah Wa'iqtinah documentation (a corresponding cross default in the Ijarah Wa'iqtinah documentation to a default under the mortgage loan documentation is typically not agreed because of Shariah considerations). In conjunction with the Ijarah Wa'iqtinah documentation, SPE would typically grant to InvestorCo a "call" right to purchase the property at any time or at certain specified times for an acquisition cost specified in the Ijarah Wa'iqtinah documentation. InvestorCo would, in turn, typically grant to SPE a "put" right to require InvestorCo to purchase the property upon an event of default for an amount equal to the acquisition cost. The Ijarah Wa'iqtinah documentation will require that certain tasks associated with ownership of the property be handled by SPE. SPE will typically seek to retain InvestorCo (or an affiliate of InvestorCo) under a separate supplemental agreement to handle the performance of those responsibilities on behalf of SPE. The amount required to be paid by SPE to InvestorCo under this supplemental agreement would be factored into the rent payment obligations of InvestorCo under the Ijarah Wa'iqtinah documentation. The last document comprising the Ijarah Wa'iqtinah documentation would typically be a tax matters agreement in which



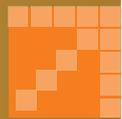
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InvestorCo and SPE would agree on the US tax treatment of the overall transaction. This type of structure can also be used in connection with a corporate acquisition or an acquisition of leased assets, and the key legal issues that arise in such arrangements tend to be the same.

Structural legal issues. Two key legal issues are presented in the above-described acquisition and financing structure. InvestorCo (and the investors who have capitalised InvestorCo) will seek to be treated as the owners of the property to obtain the US federal tax benefits of property ownership. To

achieve that tax treatment, all of the benefits and burdens of ownership of the property must rest with InvestorCo, notwithstanding that InvestorCo is the lessee of the property and not the title holder. Achieving that tax treatment while respecting Shariah principles can be challenging but it is achievable. The other key legal issue relates to Lender's recognition that, while its mortgage loan is to SPE, which is the title owner of the property, its true "borrower" is InvestorCo, which is leasing the property from SPE. Lender will want to be certain that this structure – in which an SPE is interposed between it and its true borrower – will not negatively impact Lender's rights or the enforcement of its remedies. These broader issues end up being addressed in the mortgage loan documentation between Lender and SPE and in the Ijarah Wa'iqtinah documentation between SPE and InvestorCo.

Tax ownership of the property. To pass Shariah scrutiny, a lease must provide that certain responsibilities that are generally thought of as being attributable to property ownership be retained by the property lessor. The consensus among Shariah scholars is that the property owner should retain the obligation to make major or structural repairs to the property and to maintain casualty insurance on the property. As a consequence, the Ijarah agreement that forms a part of the Ijarah Wa'iqtinah documentation in our example must provide that such responsibilities are the obligation of SPE. That allocation of responsibilities, however, is inconsistent with the tax perspective, which takes the view that these burdens allocated to SPE should instead be the responsibility of InvestorCo if InvestorCo seeks to be treated as tax owner of the property. This conflict is resolved through the supplemental agreement by which SPE retains InvestorCo to undertake on behalf of SPE the responsibilities for major repairs and property insurance allocated to SPE under the lease document.

Another point of conflict pertains to the consequences of a casualty resulting in a total loss. Under Shariah principles, one cannot lease an asset that no longer exists, so if a total loss of the property occurs as a result of a casualty, the lease must terminate. As

the lease essentially represents the extension of the financing provided by Lender to SPE and from SPE on to InvestorCo, one can see how such a result would not be acceptable to Lender, plus the result would be inconsistent with the tax position that all risks and rewards of property ownership must fall on InvestorCo if it is seeking to be treated as the owner of the property for federal tax purposes. This conflict is also typically resolved in the supplemental agreement, which may provide that InvestorCo (as the contractor under the supplemental agreement) is responsible for maintaining insurance that upon a casualty resulting in a total loss of the property will pay out insurance proceeds equal to the outstanding obligations under the Ijarah Wa'iqtinah documentation (those obligations being substantively identical to the obligations of SPE under the mortgage loan). The consequence of this arrangement is to reallocate back to InvestorCo the risks associated with a total loss arising from casualty.

Bankruptcy. If the property investment performs poorly and defaults occur, Lender will want to be certain that the Ijarah Wa'iqtinah structure and the holding of title to the property by SPE will not put it in a worse position than if it had provided financing directly to the substantive owner. This structural issue could be mitigated by InvestorCo entering into a direct agreement with Lender under which it acknowledges that its lease is subordinate to Lender's mortgage on the property, and that such lease may be terminated upon a foreclosure of the mortgage by Lender. Most Shariah compliant investors, however, are not prepared to have direct contractual dealings with Lender, and the resulting solution has been to place the requested subordination provisions directly in the Ijarah agreement between SPE and InvestorCo. These self-executing provisions provide for an acknowledgement by InvestorCo that the Ijarah agreement is subordinate to the mortgage of Lender and may be terminated by Lender upon a foreclosure of the mortgage. While the mortgage foreclosure procedure may be a little more complicated because of the loan-to-lease arrangement, the foreclosure process should not be materially more complicated than foreclosing on a conventional mortgage financing structure.



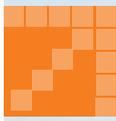
Governing law. Although the Ijarah Wa'iqtinah documentation is intended to comply with Shariah principles, the agreements are generally stated to be governed by New York law (except for the mortgage and related security documentation, which are typically governed by the law in which the property is located). The occasional suggestion that the documentation should be governed by Shariah principles (in addition to the local secular law) has been generally resisted on the basis that such provisions conflict with the selection of the local law as being the governing law of the transaction and are likely to create confusion in an enforcement scenario. Instead, the goal should be to have the legal effects of the documents be consistent with Shariah principles, while looking to the local secular law to achieve such effects in a predictable manner.

In summary, a number of the regulatory and legal issues associated with the introduction of Islamic financing and investment products in the United States, and the making of wholesale equity investments in the United States, have been identified and addressed, but there remain a number of issues, especially on the regulatory front, that will no doubt be explored and resolved in the coming years as Islamic finance makes inroads into the United States.

Isam Salah heads up the Middle East & Islamic Finance practice at King & Spalding, and is based in the firm's New York City and Dubai offices.

Sukuk in North America - issuers and investors





Sukuk in North America - issuers and investors



The one area where Islamic finance in North America has noticeably lagged behind that of other non-Muslim other countries like the UK, Germany and Japan is in Sukuk, an area that has seen the most growth in recent years. The growth in the Sukuk market globally has risen from almost nothing in 2002 to its peak in 2007 but United States companies and markets have not been active in this market. The sole Sukuk, described below, from a US issuer was the East Cameron Gas Sukuk. It was issued in 2006 and the company fell into bankruptcy in 2008. Following the East Cameron Sukuk, Siraj Capital announced that it was in “final negotiations” to arrange a \$250 million Sukuk for “an oil and gas company operating in South America and listed on the New York stock exchange” to finance the company’s exploration activities.¹ The Sukuk for the unnamed company has not yet been issued following the steep global decline in Sukuk issuance during 2008 and 2009. However, in July 2009, a Canadian company, Bear Mountain Resort, announced it was planning to issue a Sukuk by October.

With deep and liquid capital markets, the United States is the target for many different types of investments so it is somewhat puzzling that the country has not attracted activity in the Sukuk market. In contrast to the US, London has made it a priority to attract Islamic finance and Sukuk in particular. It has several Islamic investment banks and there are many Sukuk listed on the London Stock Exchange. One main difference that has helped London attract Islamic finance is that there has been a major effort to attract the industry to London, whereas in the US stricter financial monitoring related to money laundering following the 9/11 attacks has deterred Gulf investors afraid of being inadvertently targeted. One organisation in the U.K., the International Financial Services, London (IFSL), which promotes London’s financial services industry begins its report on Islamic finance with a clear goal: “London is establishing itself as the key western centre of choice for Islamic finance”.² There is no similar group supporting the Islamic finance industry in New York.

One of the problems cited for Sukuk offering in the United States is that the regulatory environment is unfriendly to Islamic finance. While

this may be true for many areas like banking, unintentionally in most cases, it is unlikely to drive issuers to London just to avoid the regulation. In many cases, Sukuk are offered only to institutional buyers and often have minimum investment amounts high enough that they could be restricted to ‘accredited’ or ‘qualified’ (high net worth) purchasers and take advantage of exemptions from securities registration requirements. For example, one potential source of investment capital in the United States is hedge funds searching for a ‘new’ asset class. A Reuters article about an unnamed prospective Sukuk included an indirect quote from Ibrahim Mardam-Bey, the CEO of Siraj Capital, saying that “a majority” of investors in the East Cameron Gas Sukuk were hedge funds looking for capital market portfolio diversification.³



There has been no further announcement about the Sukuk, but Siraj Capital lists the transaction on its website and indicates that it still has a mandate for the project.

The sole Sukuk to date from a US-based company came from the East Cameron Partners, a small oil and gas wildcatter firm with oil and gas properties off the coast of Louisiana. The Sukuk was structured as a Musharaka between East Cameron and an SPV, Louisiana Offshore Holdings (LOH) that received the proceeds of the Sukuk issue from an offshore SPV in the Cayman Islands. The Musharaka contributions from investors was \$166 million in cash for East Cameron to use to buy out the equity stake held by a previous financier as well as to fund working capital and exploration and production in the two offshore fields. East Cameron contributed an overriding royalty interest (ORRI) that provides LOH with the right to a certain volume of production until maturity. There were also Shariah compliant price hedges included to offset large swings in prices of gas and oil during the first few years



of production. The Sukuk was structured using reserve accounts to provide the same cash flow as a bond would but the sale of an ORRI to LOH that gave investors rights to a certain volume of production changed the transaction from one resembling debt into a more equity-like financial product.

However, due to insufficient production caused, in part, by hurricane damage, East Cameron Partners filed for bankruptcy in October 2008. The bankruptcy of this issuer has the potential to provide greater certainty for investors and issuers in the United States because it will provide some experience to how Sukuk are treated in cases of default/bankruptcy in US courts. In the absence of any experience of resolving this situation, investors as well as issuers are left guessing how Sukuk default or the bankruptcy of the issuer will be handled based on previous rulings on similar conventional debt instruments. The primary issue for the bankruptcy court to determine in the East Cameron case is whether the sale of the ORRI to LOH was in fact a 'true sale' as a legal opinion stated when the transaction was completed. The issuer is arguing that the sale of the ORRI to LOH was not in fact a 'true sale' but was a disguised secured finance transaction which would give the company's other creditors' claims on the ORRI.

In a ruling earlier this year Judge Robert Summerhays rejected the contention that the 'true sale' was not valid noting that "[Sukuk] holders invested in the Sukuk certificates in reliance of the characterisation of the transfer of the royalty interest as a true sale".⁴ The ruling in favour of the Sukuk holders would appear to give them rights to the ORRI that is protected from claims by other creditors of East Cameron Partners. Part of the transaction involved specifying a 'back-up operator' and 'back-up off-taker', which could allow Sukuk holders to continue receiving delivery of production up to the amount specified in the ORRI agreement and would provide Sukuk holders with some recovery of their principal following the bankruptcy of the primary operator, East Cameron Partners.⁵

The bankruptcy case is still proceeding, but the ruling by Judge Summerhays should provide greater certainty if there are other

companies in the US considering using Sukuk to finance their activities. Having some legal precedent could make investors more likely to invest in Sukuk knowing that US courts have respected the structure of the East Cameron Sukuk and investors will probably be able to enforce their rights to the assets sold to a SPV that was designed to be 'bankruptcy-remote', that is, to be insulated from claims by the issuer's other creditors in the case of a bankruptcy or default. Issuers could benefit from this decision because investors may demand a lower risk-premium for the Sukuk structure compared to a conventional debt financing.

The East Cameron Sukuk was followed shortly by an announcement that Siraj Capital, whose CEO Ibrahim Mardam-Bey worked on the East Cameron Sukuk with Lebanese firm BSEC, was in final negotiations to work on a \$250 million Sukuk for an unspecified "oil and gas company operating in South America and listed on the New York stock exchange" according to Mardam-Bey.⁶ There has been no further announcement about the Sukuk, but Siraj Capital lists the transaction on its website and indicates that it still has a mandate for the project.⁷ Perhaps in part due to the credit crisis which has overwhelmed the US financial markets over the past two years, the Sukuk market has not developed further.

In July 2009, the market saw the announcement of the first new planned Sukuk, again involving Siraj Capital, announced at the London Sukuk Summit. The Sukuk announced is a planned \$380 million Sukuk that is expected to be closed in October 2009 for Bear Mountain Resorts. Bear Mountain Resorts, owned by former National Hockey League player and co-owner of the Tampa Bay Lightning hockey team Len Barrie, is developing a \$2.5 billion resort community near Victoria, British Columbia that will be built over the next decade and will have 3,500 residences as well as a 36-hole golf course.⁸ The Sukuk proceeds will be used to continue construction by repaying bank debt, pay out investors and for working capital over the next five years. This Sukuk is the latest to be announced in North America and would be the first by a Canadian issuer, but Siraj Capital CEO Ibrahim Mardam-Bey says that "we have a pipeline of potential opportunity in the US and Canada".⁹



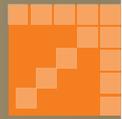
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Controversy





There has been controversy within the broader community in North America about Islamic finance and much of it has been undeserved. Although there have been instances of fraud, most of the controversy has been contrived by groups who operate within a generally Islamophobic mindset, particularly following 9/11. In the wake of the 9/11 attacks, the United States became fearful of many external threats and anything 'Islamic' attracted special attention. Since then, there have been four events that have attracted the most attention: AIG Takaful, Sunrise Equities, the CMHC Islamic finance study and the Holy Land Foundation trial. Each has been used to attract negative attention to the Islamic finance industry, but none has significant factual support and none has had a significant impact on the industry. Of the four events that have occurred, perhaps the one with the greatest likelihood of impacting how Islamic financial institutions in North America are viewed by their clients is the alleged Sunrise Equities fraud.

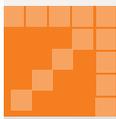
Sunrise Equities was formed in 2001 billing itself as a Shariah compliant real estate investment company. The company organised new construction projects, primarily condominiums and mixed-use buildings and attracted investors mostly from the local Muslim population within Chicago. Then Sunrise Equities, as the manager of the LLC formed for each project, would approach banks to finance the construction of the buildings using Shariah compliant financing. The construction would proceed and the units in each building would be sold and investors would receive their investment along with their share of any profits generated. The company completed several properties and was paying investors dividends until 2008. According to press reports and the law firm representing investors who lost money, many investors took additional Shariah compliant home equity financing from Guidance Residential, the only firm in the US that provides the service, to increase their investments.¹ The first sign that something was amiss was a comment on a consumer complaint website suggesting that an investor had not received any payments from Sunrise Equities.² In August 2008, other investors became concerned when dividend cheques failed to arrive from the company. Shortly thereafter, the management of the firm disappeared with the founder

and CEO Salman Ibrahim presumed to have returned to his native Pakistan. Salman Ibrahim was a respected figure within the community prior to his disappearance and served on the board of the Shariah Supervisory Board of America (SSBA), which provides fatwas to individual Muslims and had also worked with the nearby Devon Bank when the latter was creating its home finance product.

The concentration of investments in condo and mixed-use real estate, sectors which were devastated in the financial crisis that began in 2007, may have created problems for the financing of the properties. An Associated Press article describes a meeting in which "[Salman] Ibrahim told about 50 investors [...] that banks were demanding \$1 million more from him." Shortly thereafter, he disappeared and the investors have filed an involuntary petition to put Sunrise Equity into bankruptcy to try to recover lost investments.

While no other Islamic financial institutions are alleged to have been involved in the alleged Sunrise Equities fraud, there is potential reputational risk for other Islamic financial institutions in North America. The risk from the alleged Sunrise Equities fraud is predominantly from within the Muslim community which relies on Islamic financial institutions to provide honest Shariah compliant financial products. The alleged Sunrise Equities fraud, however, could lead to a greater degree of suspicion from Muslim clients. In contrast, the other areas of controversy are primarily focused on the attitudes of the non-Muslim population towards the industry.

The second area of contention related to AIG's launch in December 2008 of Takaful through its Risk Specialists Companies, Inc. under the brand Lexington Takaful Solutions.³ The new product was announced after the September 2008 bailout of AIG, which resulted in the US government owning 80 per cent of the company. Later in December, a conservative non-profit law firm that "promotes conservative Christian values," the Thomas More Law Center filed suit against the US government and then-Treasury Secretary Hank Paulson and then-New York Federal Reserve President Timothy Geithner claiming that the launch of the Takaful products violated the US Constitutional separation of church and state enshrined in the



Controversy

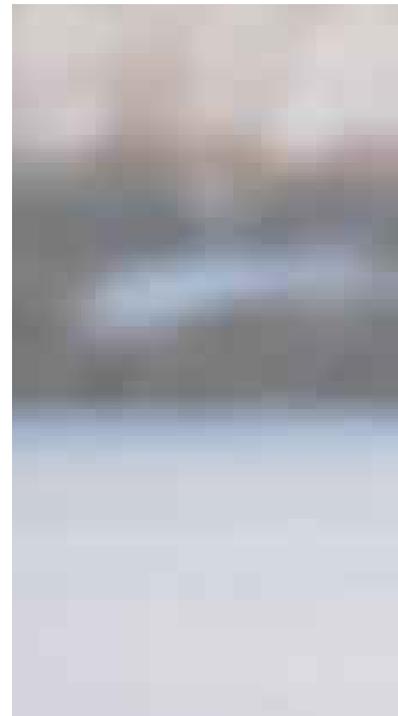
First Amendment.⁴ The government moved to have the case dismissed shortly after it was filed. However, on May 26, 2009, the District Judge hearing the case ruled against the government's motion to dismiss.⁵ The judge's decision hinged upon the consolidation of AIG subsidiaries' activities into the parent company and the lack of US government specificity about what the bailout funds were to be used for. Furthermore, he cited the fact that the launch occurred after the government took its nearly 80 per cent ownership of the company and the Treasury Department's second 'Islamic Finance 101' seminar that occurred after the US government acquired its ownership of AIG.

Despite the judge's ruling to deny a motion to dismiss the case, most constitutional scholars think the case is unlikely to succeed. Robert Tuttle, a professor at George Washington University who specialises in religion, law and the establishment clause was quoted following the filing of the lawsuit, "The plaintiff is going to have a very hard time in showing they have standing under the establishment clause [...] The question is whether the government has funded religion, not whether the religion is good or bad that the government has funded. Then the next question is whether the government is responsible for what AIG has done".⁶ Following the judge's ruling, Robert Tuttle indicated he was surprised the plaintiff's standing was recognised and that decision seems inconsistent with the approach taken by other federal courts.⁷ One of the primary contentions over the public reaction to the AIG launch of Takaful products in the US concerns the charitable donations that critics suggest could be misappropriated. However, in the case of AIG, any charitable donations from surplus funds in the Takaful Protection Pool are donated to UNICEF, the Red Cross and the Red Crescent; well regarded global charities where misappropriation is unlikely and specific donations from the AIG Takaful programme would have no greater risk of misappropriation than any other funds donated to these charitable organisations.

Whatever the eventual outcome of the AIG lawsuit, the biggest area of controversy with the least relation to the Islamic finance industry in the United States, is the US v. Holy Land Foundation for Relief and Development. The Holy Land Foundation trial focused on whether a US charity,

the Holy Land Foundation for Relief and Development, which conducted its charitable operations in the Palestinian Territories and neighbouring countries where there are large numbers of Palestinian refugees, was providing assistance to Hamas. Hamas has been on the US list of terrorist organisations since 1995 and so providing any assistance to the group is illegal. The Holy Land Foundation was shut down by the US government shortly after the attacks of 9/11. However, the case was focused on whether \$12 million provided to ostensibly charitable activities ended up being used by Hamas-affiliated groups either for charitable activities through local Zakat Committees or for terrorist activities by the group. Either way, the US government contended that this amounted to material support for a terrorist organisation.

Where the case made an impact on the Islamic finance industry was in the perception of the industry's connections to several 'un-indicted co-conspirators' named: the Council on American-Islamic Relations (CAIR), the Islamic Society of North America (ISNA) and the North American Islamic Trust (NAIT).⁸ No organisation was alleged to have any part in criminal activities, but the 'un-indicted co-conspirator' label is used to denigrate the groups and any organisation that can be linked with these groups. In fact,





the Justice Department in its own guidance to Federal prosecutors discourages the use of naming any 'unindicted co-conspirators'. Specifically, it states that "in the absence of some significant justification, federal prosecutors generally should not identify unindicted co-conspirators in conspiracy indictments".⁹ The American Civil Liberties Union, in a June 2009 report, criticised the government's shut down of the Holy Land Foundation and three others saying the moves "chilled American Muslims' charitable giving in accordance with their faith, seriously undermining American values of due process and commitment to First Amendment freedoms".¹⁰

The group named in the lawsuit with the most connections to the Islamic finance industry in the US is NAIT which runs the Iman Fund, a mutual fund which provides investment advice to the fund through Allied Asset Advisors. Critics of the Islamic financial industry often try to use the label of 'un-indicted co-conspirator' to draw connections between the groups and the Holy Land Foundation trial even though NAIT as well as the other un-indicted co-conspirators named in the lawsuit were never charged with any crime. The use by anti-Islamic groups of the lawsuit may be one of the fundamental reasons the Justice Department advises federal prosecutors to avoid naming un-indicted

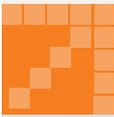
co-conspirators in the first place. As described above, US regulators, particularly on the Federal level, are very accommodative of Islamic finance, and this cooperation continued during the lengthy Holy Land Foundation trial.

The final major area of controversy around the Islamic finance industry in North America began in early 2008. In the previous autumn, two groups submitted applications to the Minister of Finance requesting approval to open Islamic banks in Canada. The Minister of Finance of Canada and the Canadian Mortgage & Housing Corporation, the national housing agency each commissioned studies on Islamic finance. The Minister of Finance study was specifically focused on the Islamic banking applications while the CMHC study was designed to help the agency "better understand Shariah banking [because] it is part of our mandate to understand all aspects of the Canadian housing system" according to Douglas Stewart, the CMHC's vice president of policy and planning.¹¹ The major source of controversy was the contention by the Muslim Canadian Congress, a secular Muslim group in Canada, that Islamic finance is a 'con job' that the group accuses of "taking advantage of the most disadvantaged people".¹²

The criticism of Islamic finance in general for creating products that in essence replicate conventional interest-based financial products is not new nor is it unique to North America. In response to the Muslim Canadian Congress complaints, UM Financial (now part of UM Financial Group) founder and CEO Omar Kalair wrote a letter to Karen Kinsley, CMHC's CEO, which said, "Islamic mortgages are equity partnership with payments coming in the form of profits (rental). Islamic finance is structured trade products devoid of usury, similar to ethical products which have filters".¹³ In the UM press release about the study, Mr. Kalair points out that similar products are offered for other faith groups like Mennonites through the Manitoba Credit Union and that "Islamic mortgages are only for those who wish to avail the product [and] it is an individual decision and we should leave the individual to make that decision".¹⁴

The major controversies surrounding Islamic finance in North America affect the industry to varying degrees. In some cases, they reflect controversy within the Muslim community. In others, they reflect a genuine concern about Islamic



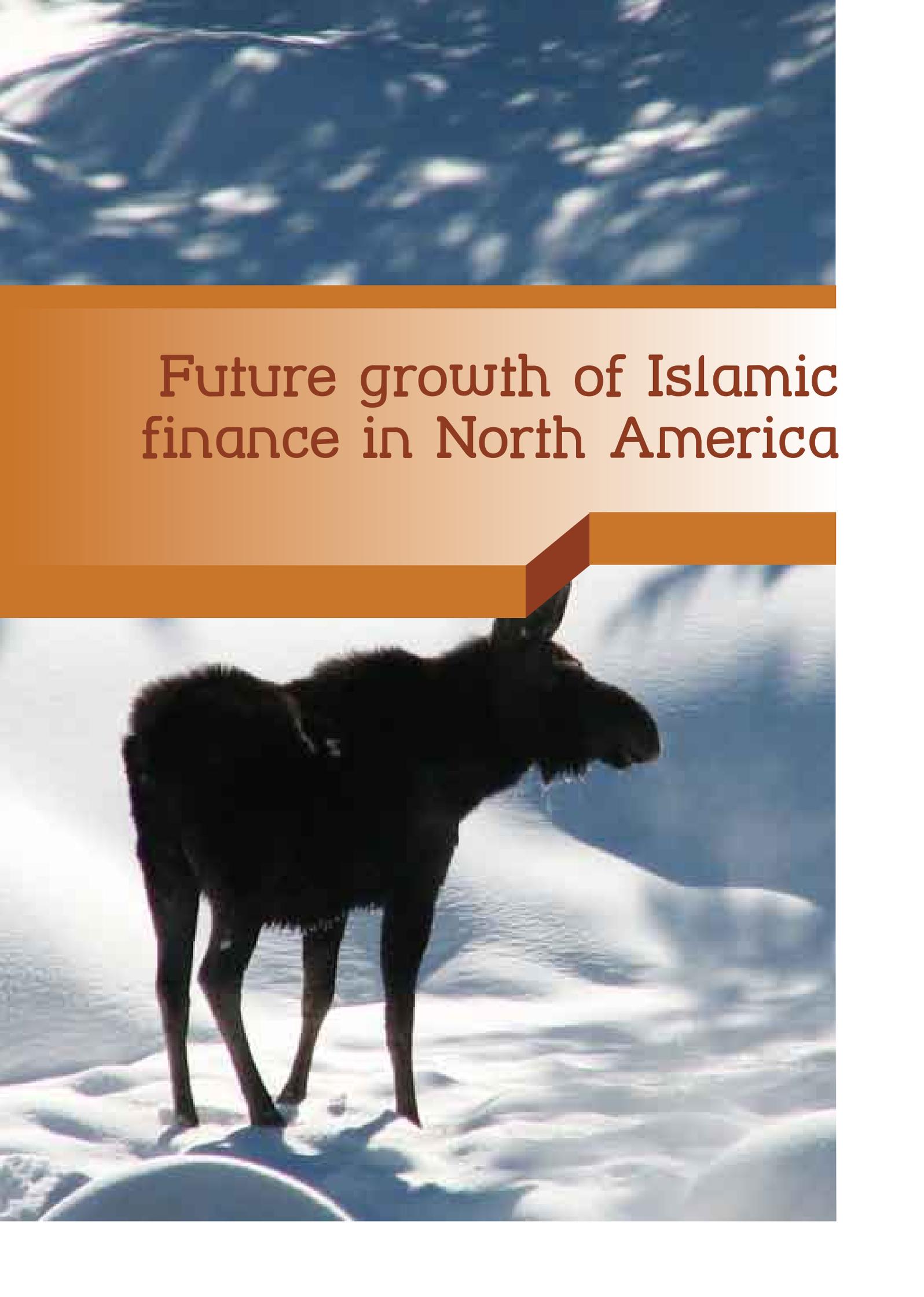


financial institutions' reputation as the alleged Sunrise Equities fraud illustrates. In other cases, the controversy is generated by people whose motivations are generally Islamophobic and who view the industry within their own conceived idea of a 'clash of civilisations'. The reaction from the Islamic financial community has ranged from challenging questionable claims to ignoring what

would be a futile argument with ideologically-driven opponents. While some of the controversy has led to angst within the Islamic financial industry, it is in general no more controversial than other areas of finance in North America and, within the limits of US and Canadian law, has considerable promise that overshadows these small areas of controversy.

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14. *Ibid*.

The image features a dark silhouette of a moose standing on a snowy mountain peak. The background is a bright, hazy sky with soft, white clouds. The moose is positioned in the lower half of the frame, facing right. The overall scene is serene and naturalistic.

Future growth of Islamic finance in North America

Future growth of Islamic finance in North America

The Islamic finance industry has grown rapidly over the past 10 years as new institutions opened and Freddie Mac and Fannie Mae provided increased liquidity into the home finance market. That being said, the industry is still even more nascent in North America than it is in other parts of the world and there are several areas where Islamic finance has room to grow within the continent.

The Islamic finance industry in the US and Canada emerged with a focus on providing the most basic financial services to Muslims living in the two countries: home finance and investments. Despite a great increase in these two areas, the industry is still very limited to a few banks providing Murabaha and Ijarah as well as non-bank financial companies adding a Musharaka option which banks are currently prohibited from offering. In addition, as much as the developments within the industry has reduced the so-called cost of being Muslim, the additional cost for using Shariah compliant products, a growth in the number of new institutions that are expected to enter the market in the coming years should place more competitive pressure on existing firms as well as increase the profile of Islamic financial institutions in the US which should provide more voices to spur additional regulatory clarity on new products that are currently unavailable.

In the investment area, there are two large mutual funds and a few other smaller funds which have grown at a far slower rate. While broad market ETFs are either being launched or are in the development process, there still exists a quandary for many Muslims about how to manage their investments without being able to invest in bonds or other fixed income products. The lack of access to one of the most fundamental asset classes is severely detrimental to Muslims especially in times like the recent financial market crash when equity prices fell sharply and home values fell as well. In response to this problem, there are Sukuk products and funds being developed but none has been launched. Even when these funds launch, they may be constrained by their ability to find enough liquid investments with fixed-income-like characteristics. However, this problem is not unique to North America. Islamic banks across the world have com-

plained of the lack of liquid Shariah compliant investments that behave similar to conventional bonds.

In other areas like venture capital and private equity, the growth within North America is often less to do with the domestic environment since there are plenty of investment opportunities across the industry spectrum that meet Shariah compliance criteria. In this segment of the industry, growth is more dependent upon the global than the North American economies. Because many firms working in the US are subsidiaries of foreign institutions, particularly from the GCC, the liquidity behind private equity and venture capital in the US and Canada is tied to the economies of the GCC and in many cases, also the price of oil and natural gas, which remains a large source of liquidity in that region. The wholesale market has remained largely independent from the domestically-oriented retail market and in some areas this has led to a missed opportunity for the retail market to capitalise on a source of financing besides Freddie Mac and Fannie Mae.

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There is likely to be further growth and development of what is and likely will remain a niche segment in the large North American financial industry.

The global growth of Sukuk was nearly meteoric during 2002-2007 and despite the financial crisis, Sukuk continued to represent a significant part of the Islamic finance industry, but the growth largely missed the United States and Canada. There has still only been one issue, by East Cameron Partners, that is now in bankruptcy, and there are potentially two issues being developed now that, even were they issued, would only bring the total issuance to around \$900 million. However, the US markets in conventional fixed income securities is one of the deepest and most liquid in the world. Perhaps no other area of Islamic finance in North America has the potential to grow more. This



growth would be compounded if the financial markets in the United States took greater steps to attract Sukuk listings. However, given that the financial industry continues to struggle after the credit crisis and the drive other exchanges in the UK, the GCC, and Southeast Asia have shown for attracting Islamic finance, the US is likely to lag until it decides to court the Islamic finance industry more thoroughly. However, there are encouraging signs. The recent Indonesian sovereign Sukuk was structured to include disclosures required for US onshore investors

to invest in under rule 144A and although just the third such Sukuk to meet these standards, it could signal the beginning of a trend to attract North American capital.¹

Overall, the Islamic finance industry has a promising future in North America and while it is unlikely to compete with the industry in the GCC and Malaysia or even the UK, there is likely to be further growth and development of what is and likely will remain a niche segment in the large North American financial industry.



Footnote

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Launching an Islamic Investment Fund

By Douglas Clark Johnson, Codexa Capital

The current environment provides a timely opportunity for asset managers to explore the opportunities available in the Islamic investment sector. While by no means isolated from the impact of global financial upheaval, the Shariah-compliant market nevertheless retains significant liquidity, as well as appetite for employing it productively.

We recognize that many conventional-industry managers may be curious about this terrain, but not yet confident about its relevance to their own business. We offer answers to questions that conventional-investment practitioners may have about Shariah-compliant asset management.

“Is the Islamic investment business truly meaningful?”

The “cultural demonstration” across the Islamic world now ensures a captive audience for Shariah-compliant products and services in ways that would have been unfathomable ten years ago. McKinsey & Co, in a recent study, called Islamic banking the “trillion dollar opportunity.” We believe that investment firms willing to commit to launching an Islamic strategy into global markets will reap meaningful long-term benefits from a diversified shareholder base.

As a relatively new portion of the global financial services industry, Islamic banking and finance do not yet follow the rigid segmentation seen in the conventional business. The major Islamic banks in Southeast Asia and the Gulf are just beginning to define wealth management, corporate finance, retail banking, and asset management. Further industry growth will continue to clarify these distinctions.

No one knows the exact number of Islamic funds in the marketplace, given the absence of a definitive census and the extension of these funds across multiple geographies and asset classes. One Singapore-based data provider suggests there may now be more than 700 Islamic funds, which represents as much as a four-fold increase over the past five years. Estimates of total assets under management in Islamic funds vary widely. Islamic investment in general tends to concentrate on public equity, private equity, and real estate, although this concentration does not necessarily translate directly into fund inventories.

The Shariah-compliant business may be a refuge for relative buoyancy at this time. Islamic banks, in particular, have not collided with the credit crisis to the degree of their conventional peers. Not only do Shariah principles forbid the charging or accepting of interest, but Islamic banks have further been shielded by Shariah restrictions on engagement with corporations whose balance sheets are heavily debt-laden. Admittedly, the sector has been confronted by a global recession that has effectively disproved the theoretical decoupling of emerging and major markets. Nevertheless, pools of liquidity in the Middle East prevail even in the face of lower oil prices, and pockets of resiliency in Asia retain near-term as well as longer term economic promise.

“Who invests in Islamic funds?”

Investors in Islamic funds do not have to be Muslim. Indeed, over the recent cycle, conventional investors in many Shariah-compliant equity funds would have done relatively well, given the lack of financials exposure because of the Shariah prohibition on interest income. Most buyers of Islamic funds, however, are in the major Muslim geographies of Southeast Asia and the Middle East. There is also an established Islamic banking and finance industry in London, given regulatory incentives offered by the UK government.

Indicative Asset Sources, by Region				
	Gulf	Subcontinent	Southeast Asia	Europe
Regional Banks (Treasury)	Yes	No	Yes	Yes
Asset Managers	Yes	No	Yes	Yes
Retail Distribution	Yes	No	Yes	No
Government-Related Institutions	Yes	No	Yes	No
Wealth Management Firms	Yes	No	Yes	Yes
High Net Worth/ Family Offices	Yes	Yes	Yes	Yes
Islamic Insurance (Takaful)	Yes	No	Yes	No

Investors in Islamic funds are not just retail; many institutions have Shariah-compliant mandates or Shariah-sensitive charters. One of the largest institutional investors in Malaysia, for instance, is the multi-billion-dollar Lembaga Tabung Haji savings fund, which can invest only in Shariah-compliant instruments. In Saudi Arabia, many private investment firms will only consider Islamic opportunities. We are further seeing the development of an Islamic wealth management business based on traditional asset allocation concepts in jurisdictions like Switzerland and Singapore.

“How can we benefit from launching an Islamic fund?”

Certainly the major benefit is the ability to reach a broader universe of potential investors, stretching across Europe, North Africa, Gulf markets, the Subcontinent, and Southeast Asia. At one end of the “Islamic Crescent,” the Europeans have readily acknowledged the potential of the industry and encouraged its development in money centers like London and now Paris. At the other end of the Islamic Crescent, the Malaysians have rebuilt their financial infrastructure along Shariah-compliant dimensions, in the wake of the Asian currency crisis. The Indonesians are now moving in the same direction. Singapore is also looking to build its franchise, as is Hong Kong.

Another, if less obvious, benefit for the asset manager is progress in developing a truly global brand. This, in turn, creates a virtuous circle of business development between Islamic and conventional sectors. In the absence of a mature, internationally focused asset-management business in many money centers, such as Bahrain and Kuala Lumpur, conventional managers may be able to reap separate account opportunities once they are recognized for their expertise in the Islamic fund-management business.

Finally, the impetus to launch a fund at the bottom of a cycle is particularly strong. A fresh start at asset-gathering provides managers with the potential for performance-fee revenue, even as existing vehicles undertake a prolonged climb back to high-water marks.

“What investment requirements do we have to meet?”

Islamic investment guidelines are based on Shariah guidelines, narrowly understood by some as Islamic law. In reality, Shariah is a code of behavior that governs all dimensions of a Muslim's dealings in life. We find it more helpful to think in terms of a discipline, rather than a religious credential, when contending with Shariah-compliant investment guidelines.

Translating Shariah compliance into the investment space includes avoidance of making money from money (interest) and speculation (stock-shorting and derivatives), as well as investing in companies that do. Also prohibited is investment in industries that engage in activities involving alcohol, tobacco, and weaponry, among selected others. Scholars have further codified guidelines on company debt ratios for qualification as targets of Shariah-compliant investment.

There is no definitive global standard for applying Shariah guidelines. Indeed, the Islamic finance industry encompasses ongoing debate in scholarly circles about the integrity of certain structures, especially in the realm of Islamic parallels to bonds and hedge funds. Recognized scholars - and the advisory firms with whom they are associated - provide assistance to asset managers in monitoring the structure and content of their investment products and scope of their profit-related activities.

“How can your firm determine the opportunity for our strategy?”

We appreciate a manager's desire to “put a toe in the water” before jumping into the pool. While our comprehensive fund development process includes more than 40 deliverables packaged for client benefit, we offer a limited Stage One project aimed at defining the opportunity in the Shariah-compliant space for a particular investment strategy.

Our project vets a specific fund concept with a selection of investors across the Muslim world. In practice, the majority of these names will be in the Gulf, given our franchise in the region. But we are also mindful of the intelligence offered by sounding out key names in Southeast Asia and Europe. At the end of this process, we will not only have a sense of the viability of the fund offering, but ideally may have soft commitments for investment upon completion of the structuring and regulatory approval process.

Codexa Capital aims to bring proven investment strategies to the Shariah-compliant marketplace worldwide. In particular, we seek to provide innovative, even unique, concepts to a fund inventory that has grown rapidly in the past decade, but still has many gaps.

Note on Codexa Capital

Douglas Clark Johnson is chief executive officer of Codexa Capital, a specialized investment banking firm concentrating on Islamic finance. The firm helps clients raise capital for funds and companies, through Shariah-compliant vehicles its designs, develops, and brings to market. Codexa also serve banking and wealth-management organizations by creating Islamic investment products for their clientele. Codexa is headquartered in New York and operates through affiliations across the Islamic Crescent for timeliness, local knowledge, and regulatory responsiveness. For further information, visit www.codexacapital.com

Yasaar Media is a specialist media house that focuses exclusively on the Islamic finance domain. The founders of Yasaar Media recognise that there is a serious need for an information provider in the Islamic finance space: a provider that produces in-depth reports and studies on specific market niches, asset classes and countries. These reports are designed to be market-defining works that will become the benchmark in their field. As the Islamic finance industry grows and expands so too does the need for high quality analysis and comment that is produced in a timely fashion.

The founders of Yasaar Media have, between them, decades of experience in talking to and writing about the Islamic finance industry. By bringing these decades of experience together Yasaar Media offers a level of insight and knowledge that few could match. The Yasaar Media team has first hand experience of publishing newsletters, magazines and books focused specifically on the Islamic finance sphere. The products produced by Yasaar Media are aimed at filling a void in the Islamic finance data set that is often overlooked by others. While magazines and newsletters can provide news and views they often struggle to supply a comprehensive overview of a subject. That is because there is no single data provider with the insight, the resources, the experience and the market clout to deliver such an overview.

About the author



Blake Goud is the founder and principal of Sharing Risk dot Org, a think-tank working to provide information and analysis on the Islamic finance industry. Mr. Goud is also the co-owner and chief compliance officer of Marqum Capital, a Portland, Oregon, USA-based Registered Investment Advisor. Mr. Goud has written extensively about the Islamic finance industry and writes the monthly 'Expert Opinion' column for Dubai, UAE-based Business Islamica magazine. He also has been the US Correspondent for Dubai, UAE-based Islamic Business & Finance magazine since 2007. His articles have appeared in several publications including Islamic Finance News and Clear Profit.

In April 2008, Mr. Goud presented a paper, "The Development and Implementation of Shari'ah-based Microfinance Using the Grameen Group Financing Methodology" at a workshop at the 8th Harvard University Forum on Islamic finance. He has been profiled in Oregon Business Magazine's Power Book 2008, The Oregonian, UU World (the magazine of the Unitarian Universalist Association).

Mr. Goud served as executive director of two non-profits, the Institute of Halal Investing and One Ummah Foundation, from 2006 to 2008. The former is a think-tank working to demystify Islamic finance among both Muslims and non-Muslims while the latter is focused on funding education in several Asian countries. Prior to founding Marquam Capital, Mr. Goud was chief compliance officer for another Oregon-based Registered Investment Advisor.



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