

CANADA ISLAMIC FINANCE OUTLOOK 2016



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Contents

04	Foreword
06	Executive Summary
08	Chapter One Introduction to Islamic Finance
28	Chapter Two Islamic Investment Opportunities in Canada
60	Chapter Three Positioning Canada as an Islamic Finance Hub
68	Glossary of Terms
70	Endnotes
72	Contributors

EXCLUSIVE INTERVIEWS

24
ELEANOR DE ROSMORDUC
Senior Advisor — Market Intelligence,
Luxembourg for Finance

26
WAYNE EVANS
Senior Advisor International Strategy,
TheCityUK

38
SACHIN MAHAJAN
Managing Director Head of Middle
East, North Africa, South Asia
(MENASA), Canaccord Genuity
(Dubai) Ltd.

44
MOHAMMED AL-HADI
Regional Director — North America,
Alawwal Capital

66
PROFESSOR WALID HEJAZI
Academic Director of Islamic Finance
Programs & Associate Professor of
Business Economics, Rotman School
of Management & Munk School of
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Foreword



H.E. ARIF Z. LALANI

Canada's Special Envoy to the Organisation of Islamic Cooperation (OIC)

Islamic finance is growing rapidly, outpacing the growth of the conventional finance industry and even grabbing market share from it. This success has been driven in part by the internationalisation of Islamic finance as it reaches beyond its core markets of the Middle East, North Africa and Southeast Asia, and into new ones such as Europe and the Americas, including Canada, which is the focus of this report.

As the report notes, Islamic finance is part the fabric of our financial services industry. The Toronto Stock Exchange (TSX) launched a Shariah Index in 2009. Some Canadian banks, insurance companies, and our export credit agency have been providing Islamic finance products and services over the past few years.

The fact that Islamic finance is a niche industry in Canada may surprise some readers. Yet, Muslims currently make up about 2.8% of Canada's population and, given recent demographic trends, that ratio is projected to rise to approximately 6.6% by 2030.

In parallel with this growth, an ever bigger transformation has been taking shape, this time just outside Canada's borders: the global economy has done a pivot to the East. China has been at the center of this phenomenon, but several Muslim-majority countries should also deserve to be highlighted. Today, the 57 members of the

Organisation of Islamic Cooperation (OIC) have a combined GDP of some US\$6.7 trillion, making them the fourth largest economic bloc in the world after the U.S., China and the E.U. These Islamic economies are expanding at a growth rate of 5.4%, which is nearly twice the global average that the IMF estimated at 3.1% in 2015 in its latest forecast*.

The foregoing has resulted in the expansion of Islamic finance and of all the sectors of the Islamic economy around the world, which can be key to global prosperity and security. By addressing common challenges across OIC countries such as youth unemployment through greater financial inclusion, microfinance and SME lending, Islamic finance can be highly influential. Likewise, by fostering greater trade and investment ties between Western countries and the Muslim world, Islamic finance can serve as a bridge of understanding among businesses and consumers of different cultures and faiths. Notwithstanding the impor-

tance of these dividends, Islamic finance and more broadly, the Islamic economy, are markets whose consumers and needs should be addressed because doing so makes good business sense, more than anything else.

Canada's competitiveness, its ease of doing business, its strong macroeconomic fundamentals (Canada is one of only two countries in the G-7 to enjoy a triple-A credit rating**), and its strategic location, make it an ideal link to the U.S., Asia, Europe, Africa and the Middle East. Furthermore, Canada's natural resources wealth that ranges from mining to hydrocarbons, combined to its ambitious infrastructure development agenda, provide an environment rich in investment opportunities for Sharia-compliant investors given the asset based or asset backed requirements of Islamic finance. Noteworthy as well, Canada has been home to the soundest banking system in the world for eight consecutive years according to the World Economic Forum, and its financial

regulatory regime has been proven to be compatible with many Islamic finance activities.

The Toronto Financial Services Alliance (TFSA) has been leading the way in advocating for Canada to explore the opportunities that creating a hub for Islamic finance in Toronto might provide. Toronto has always been an innovator and has been at the vanguard of new and emerging trends in the world of finance. Last year, for example, Canada became the first country in the Western Hemisphere to establish a renminbi trading hub, opening new financial channels between Canada and China, the world's second largest economy. As Islamic finance continues to push into new geographies and increases its global reach, Toronto has a role to play. This Thomson Reuters study commissioned by the TFSA is therefore a valuable and timely addition to the growing interest in Islamic and in socially responsible finance across the globe.

Sincerely,

Arif Z. Lalani

Canada's Special Envoy to the Organisation of Islamic Cooperation (OIC)

* IMF World Economic Outlook, Oct. 2015

** By the big three credit agencies (Standards & Poors, Fitch, and Moody's)

Executive Summary



Canada's Islamic finance aspirations are strong in several areas: across asset management, in banking and as a source of foreign capital to benefit the country's companies and its governments which have large infrastructure investment needs.

OPPORTUNITIES

Banking

Canada's banking system — the safest in the world for many years — and AAA credit rating for the sovereign presents many opportunities for Islamic finance growth. The Canadian market also has a significant and growing Muslim population estimated at more than 1.3 million (3 percent of the population) which is expected to rise to 3 million (6.6 percent of the population) by 2030.

Muslim Canadians represent a significant market for their financial needs including investing for retirement, buying a home and protecting themselves, their families and their businesses with insurance. The banking market is a clear opportunity as a result of the large transaction sizes and there is demand sufficient to support over US\$2 billion in Shariah-compliant mortgages in the first year rising to US\$17.7 billion by 2020 which represents an immediately addressable market for a smaller Islamic bank.

Responsible finance

One of the leading areas for Canada's financial industry is the socially responsible finance sector which shares a lot with the values and some practices with the Islamic finance industry. In particular, Canada's asset managers have a wealth

of international experience, including working in responsible and Islamic investing that positions them well to capture a share of the estimated US\$23 billion in assets across the largest OIC markets that are projected by Thomson Reuters to be managed using a combination of both Islamic and ESG methodologies. This is in addition to the US\$558 million in potential domestic Muslim assets that could seek out an expanded asset class universe for Islamic funds offered in Canada including from UCITS funds. An Islamic fund universe in Canada that attracts non-Muslims could be even larger, at US\$2.04 billion according to our estimates.

Islamic insurance (takaful)

Another area where Canada is poised to expand its leadership — both at home and abroad — is in Islamic insurance (takaful). This reflects both the recent experience of companies like Manulife Financial and Sun Life Financial operating in Southeast Asia as well as the long history of Canadian mutual insurance. Within the insurance business, mutual insurers are the most similar to the way that takaful provides a more fair and transparent relationship between policyholders and their insurer.

International

Another opportunity for Canada is looking internationally. Canada has significant trade links with Muslim majority countries around the world and is recognized by its position at 41st in the State of the Global Islamic Economy Report 2015-16 rankings, ahead of Western peers like Germany (47th) and the U.S. (48th). A key export is food and Canada's regulatory system will require, starting in 2016, that all halal food produced in Canada show who has certified it. This will strengthen Canada's ability to export food to target the fast growing global Muslim markets.

economy and AAA credit rating, coupled with the need by Islamic financial institutions across the globe to increase their high quality liquid assets to meet new Basel III requirements, it would likely find significant demand.

Sukuk

Finally, Canada has the opportunity to look to foreign sources of capital including sukuk markets to make the needed infrastructure investments that totals C\$172 billion (US\$130 billion), 9 percent of Canada's GDP. In addition to this infrastructure funding need, Canada's corporations could benefit from diversifying their sources of funding through international sukuk. To catalyze this opportunity both in infrastructure and the corporate sector and to position Toronto as a North American Islamic finance hub, it would be useful for the federal or a provincial government to issue a debut sovereign sukuk. Given Canada's strong



Introduction to Islamic Finance

▲
Looking up at Harbour Centre
through glass domed roof,
Vancouver, BC, Canada.



CHAPTER 1

The modern Islamic finance industry is relatively young. It emerged only in the 1970s, in large part because of efforts by early 20th-century Muslim economists who envisioned alternatives to conventional Western economics whose interest-based transactions violate Islamic law. The impact of this young industry on the global financial system started only a few decades ago but Islamic finance is evolving rapidly and continues to expand to serve a growing population of Muslims as well as conventional, non-Muslim investors.

Introduction to Islamic Finance



The modern Islamic finance industry is relatively young. It emerged only in the 1970s, in large part because of efforts by early 20th-century Muslim economists who envisioned alternatives to conventional Western economics whose interest-based transactions violate Islamic law. The impact of this young industry on the global financial system started only a few decades ago but Islamic finance is evolving rapidly and continues to expand to serve a growing population of Muslims as well as conventional, non-Muslim investors.

The core concepts of Islamic finance date back to the birth of Islam in the 7th century. Muslims practised a version of Islamic finance for many centuries before the Islamic empire declined and European powers colonized Muslim nations. However, like in other areas, there has been significant influence from Islamic economists and merchants on the development of Western finance including ideas of the Limited Company which emerged from the Roman 'Commenda', which itself was based on the Islamic finance concept of *mudaraba*.

A row of Canadian flags outside Canada House in Trafalgar Square, London.

Core principles of Islamic finance



he prohibition of interest (*riba*) is the most well-known core principle of Islamic finance. There are two other core principles that also affect the financing process

and make Islamic finance distinct from conventional finance: *gharar* and *maysir*. *Gharar* refers to contracts where there is excessive contractual uncertainty. This would include conventional insurance contracts where payments are made in exchange for uncertain payout (and possibly no payout) with uncertain timing. *Maysir* describes the prohibition of transactions that are similar to gambling and includes transactions where one party's gain comes solely at the expense of the other (zero-sum transactions).

In addition to these unique aspects of Islamic finance, as a faith-based system it builds on principles which are held much more widely than Islam and bring in concerns for fairness, justice and equity which can be found throughout the Judeo-Christian traditions, too. Besides these broadly held beliefs, Islamic finance has several specific areas where there must be compliance for something to be considered compliant with the principles of Islamic law.

First, it must not be involved (in more than a *de minimis* way) in economic sectors which are prohibited (*haram*). The primary exclusions that are more or less universally shared as being prohibited for Islamic investment are:

- Conventional (interest-based) financial services
- Conventional insurance
- Production, distribution or sale of alcohol, tobacco and pork

- Gambling
- Pornography
- Weapons

Most of the above prohibitions (screens) will be familiar to investors based in Western countries accustomed to seeing them in the context of socially responsible investing (SRI). There is a long history behind the Western socially responsible finance sector that emerged from Quaker and other Christian beliefs as they developed during the 19th and 20th centuries. Since the underlying value systems are very similar between the Judeo-Christian and Islamic traditions, it is natural that some of the same screens are present in each.

However, not all of the exclusions are the same but some of the smaller ones (in terms of restricting investment opportunities) are only shared by some of the faith traditions: both Islamic and Jewish faiths prohibit pork. Furthermore, while Islam and Christianity have differing views on alcohol consumption (prohibited by one but not the other), there are similarities in terms of the social impact that makes each frequently unwilling to finance alcohol (it is a common SRI exclusion as well as being prohibited for Islamic investors).

Although there are both similarities and differences between SRI and Islamic finance, the two sectors have not been integrated. In markets like Canada where there is significant strength in socially responsible finance (including mutual insurance and credit unions) and the potential for investment inflows from Islamic investors, there exists a possibility for the two to become more closely aligned and advance the interests of both towards shared values.

Principles in practice: Islamic finance products

Financing products



he way the principles and prohibitions are implemented in Islamic finance transactions is that instead of loans, transactions are structured with reference or linked to an asset.

In the most commonly used transaction, called *murabaha*, a commodity or asset is purchased in the spot market by the financier to the customer who pays the cost plus a disclosed, fixed profit over time. The buyer can either use the commodity or asset they purchased, or sell it to use the cash for another purpose.

An alternative (and also commonly used product) is a sale-and-lease-back, or leasing transaction, called *ijara*. The financier buys an asset from the customer and leases it back to the customer for a fixed period of time, after which the customer

commits to a purchase undertaking to repurchase the asset to end the transaction.

In either type of transaction, a capital markets alternative is created by replacing the financier with a special purpose vehicle (SPV) which is funded by issuing certificates (*sukuk*) to investors for whose interests the SPV works as the counterparty to the originator. These contracts are used widely in Islamic finance including in banking.

Although there is an often-stated preference that Islamic banks use more partnership-like contracts that replace the debtor-creditor relationship, it is not commonplace. Even in the absence of partnership contracts (limited by the application of regulations like the Basel Accords which favor debt over equity through capital adequacy requirements), the relationship between the banks and their customers incorporates protections for the customers including avoiding profiting from delays in repayment caused by genuine customer hardship.

COMMON FINANCIAL RATIO SCREENS FOR ISLAMIC INVESTMENT

	% of Market Cap	% of Assets	% of Equity	% of Revenue
Debt	33%	33%		
Interest-based debt	33%	33%	82%	
Debt + Liquid Funds	50%			
Accounts Receivable	33% - 49%	33% - 45%		
Receivables + Cash		50%		
Liquid Assets		33%		
Cash + Interest-Bearing Securities	33%	33%		
Interest Income				5% - 10%

Source: Adapted from Table 2 (Shariah Quantitative Screens) in Ho, Catherine SF, Nurul Afiqah Abd Rahman, Noor Hafizha, Muhamad Yusuf and Zaminor Zamzamir. 2011. "Comparison of Quantitative Shari'ah Compliant Screening Methods," *ISRA International Journal of Islamic Finance*, Vol. 3, No. 2.

Fixed income products

An increasingly common structure used for *sukuk*, the Islamic equivalent of conventional bonds, is an agency (*wakala*) structure where a special purpose vehicle (SPV) issues *sukuk* and uses it to purchase a pool of tangible or intangible assets. Whereas the *murabaha* transaction is not tradeable, a *wakala sukuk* is tradeable provided that no more than 49 percent of its assets are made up of intangible assets including *murabaha* receivables.

Unlike a securitization, there remains recourse against the originator rather than solely against the assets sold to the SPV which provides investors with an asset-based, unsecured debt equivalent. This type of structure has been used by many issuers including the Islamic Development Bank, Hong Kong's sovereign *sukuk*, the World Bank's International Finance Corporation, and the International Islamic Liquidity Management Corporation (IILM).³

Investment products

Beyond the banking and fixed income investment areas, Islamic investing uses the sector screens as exclusionary screens in a way similar to the technique used by SRI investors. It excludes companies that generate more than a *de minimis* amount (usually 5 percent) of revenue from impermissible businesses, including interest income. Islamic investors further supplement these direct screens of interest and other impermissible income with indirect screens designed to exclude companies with interest-bearing debt by removing companies that have high levels of debt (usually more than one-third of their total assets or market capitalization), accounts receivable (usually those with higher than 45 percent of total assets or market capitalization) and cash (those with debt plus liquid assets higher than half of market capitalization or those with cash more than 33 percent of total assets or market capitalization).

Insurance products

Finally, in the insurance market, Islamic finance has an offering that is like a hybrid between mutual insurance and shareholder-owned insurance companies. Like the former, policyholders' contributions are owned by the policyholders and invested on their behalf. Like the latter, the shareholders own a fund which manages the investments of the policyholders' fund and receives a share of profits (*mudaraba*) or a fixed agency (*wakala*) fee, or a combination of the two. If there is a shortfall in the policyholders' fund, the shareholders will make an interest-free loan (*qard*).

This model of *takaful* operators (as the shareholder-owned company is referred to) have come under criticism because the *qard* loans from shareholders to policyholders have grown large and, in many cases, will not likely be repaid by the end of most *takaful* policies.⁴ This erodes the ownership of the policyholders' fund by the policyholders. In the absence of this ownership (and the right therefrom for policyholders to be paid a share of the investment and underwriting profits from their funds), the model becomes much more similar to a shareholder-owned insurance company.

ISLAMIC FINANCE SECTORS

Sector / Asset Class	Total Assets (US\$ Bn)
Islamic Banking	\$1,346
Islamic Funds	\$56
Other Islamic Financial Institutions	\$84
Sukuk	\$295
Takaful	\$33
Total	\$1,814

*data is as of 2014

Source: Thomson Reuters — The State of the Global Islamic Economy Report 2015-16

Shared values and potential areas of convergence



As described above, there are many areas of similarity between many of the exclusionary screens used in Islamic finance and conventional financial services. Furthermore, there are potential areas of convergence between the principles of Islamic finance and of SRI on the debt averse nature of

Islamic investment and finance. Pressure within Western countries that has come following the financial crisis for banks to become simpler, for individuals and companies to become less reliant on highly leveraged capital structures and for ethics to become more ingrained in the financial services industry are all values shared with Islamic finance.⁵



>
The city of
Vancouver, Canada.

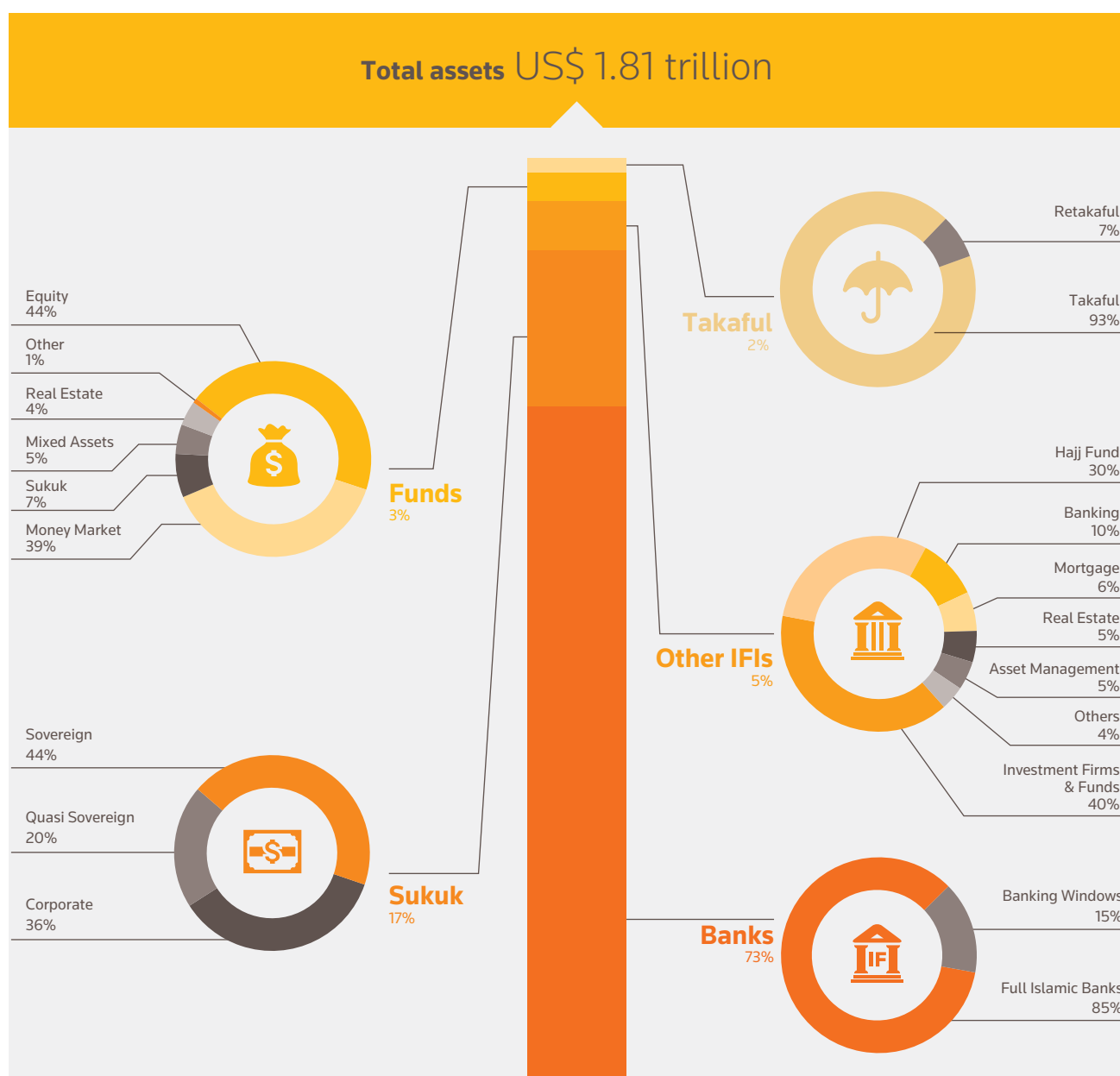
Global Islamic Finance Landscape



The *State of the Global Islamic Economy Report 2015/16* produced by Thomson Reuters estimated that Islamic finance assets globally reached US\$1.81 trillion in

2014, up from US\$1.66 billion a year earlier. Most of these Islamic finance assets (74 percent) are held by Islamic banks and most of the assets are located in Muslim-majority countries within the 57-member countries of the Organization of Islamic Cooperation (OIC).

QUANTITATIVE DEVELOPMENT LANDSCAPE



Islamic banking

By asset size alone, the five largest markets for Islamic banking are Iran (US\$329 billion), Saudi Arabia (US\$300 billion), Malaysia (US\$174 billion), the United Arab Emirates (US\$127 billion) and Kuwait (US\$88 billion).

Islamic capital market

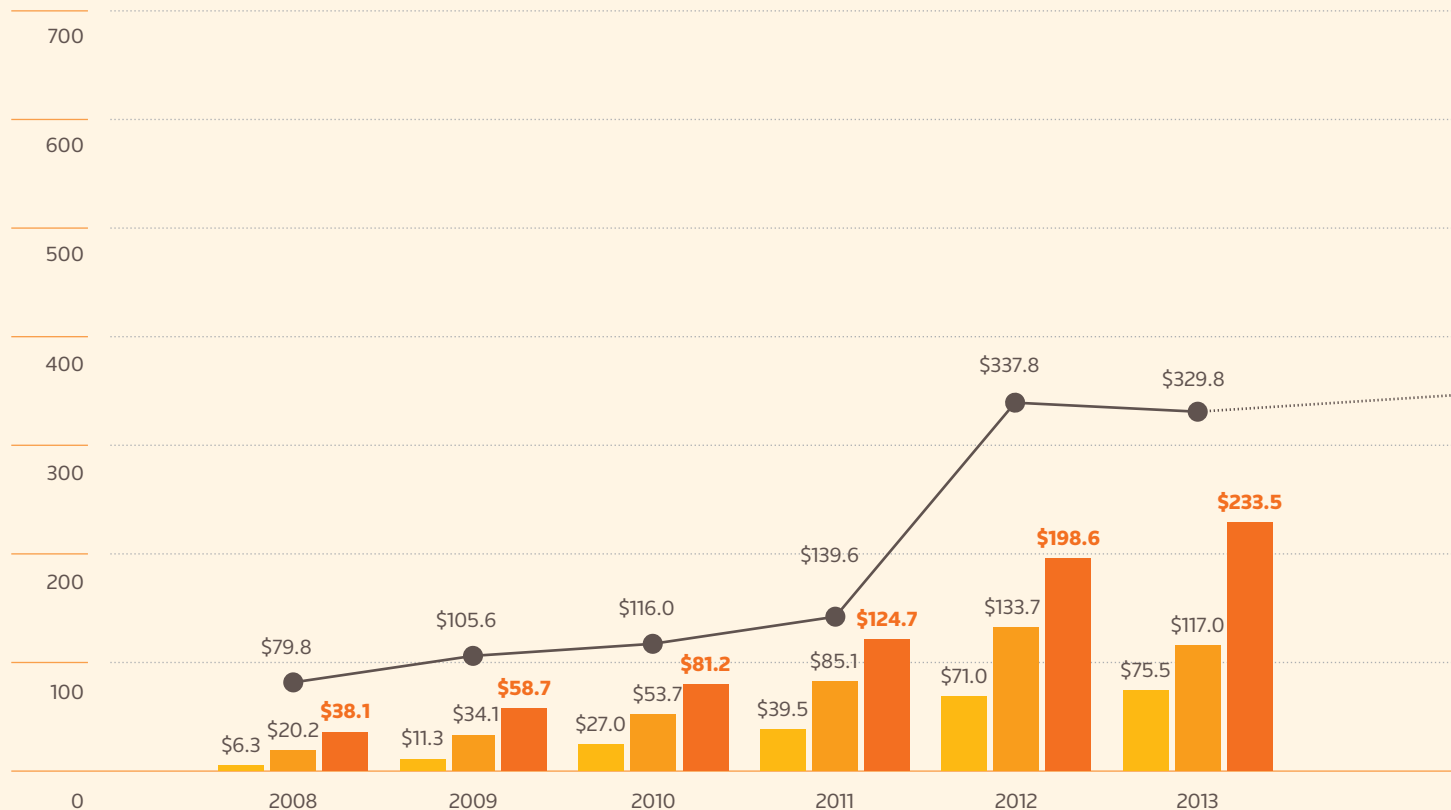
In the capital markets sector, which represents US\$295 billion in total assets (16 percent of total Islamic finance assets), *sukuk* issuance has fluctuated from US\$70.4 billion in 2011 to a record high level of US\$137 billion in 2012. Due to the slowdown in Emerging Markets and Malaysia's central bank curtailing its issuance, the

sukuk market may not reach the 2011 total before the year-end.⁶

However, despite the present headwinds as a result of a strong dollar and worries about Chinese growth prospects, the long-term picture for *sukuk* is bright with 2014 seeing sovereign issuances from key non-Muslim sovereigns (United Kingdom, Luxembourg, South Africa and Hong Kong). The issuance trends in 2015 have been more muted although Hong Kong returned with another *sukuk*, Luxembourg announced its intention to return in 2016 and Indonesia issued a US\$2 billion global *sukuk*. The debut sovereign *sukuk* issued by Luxembourg is a key part of their strategy to attract Islamic finance activity to the Grand Duchy (see our interview with Eleanor de Rosmorduc).

SUKUK DEMAND & SUPPLY LEVELS (2015 – 2020)

US\$ Bn



The Thomson Reuters *Sukuk Perceptions & Forecast Report 2015* updated the projections for the supply-demand gap in the *sukuk* market, and shows that the current gap as of 2015 is expected to be US\$227.1 billion and remain over US\$200 billion every year through 2019 before dropping to US\$195 billion in 2020. Issuance has slumped in 2015 and there may be a similar drop in demand as low oil prices remove some of the liquidity from markets with large Islamic banking hubs. The expected net impact is likely to be small and transitory because the underlying trends driving the demand is a growing Islamic banking sector still in the early phases of its growth.

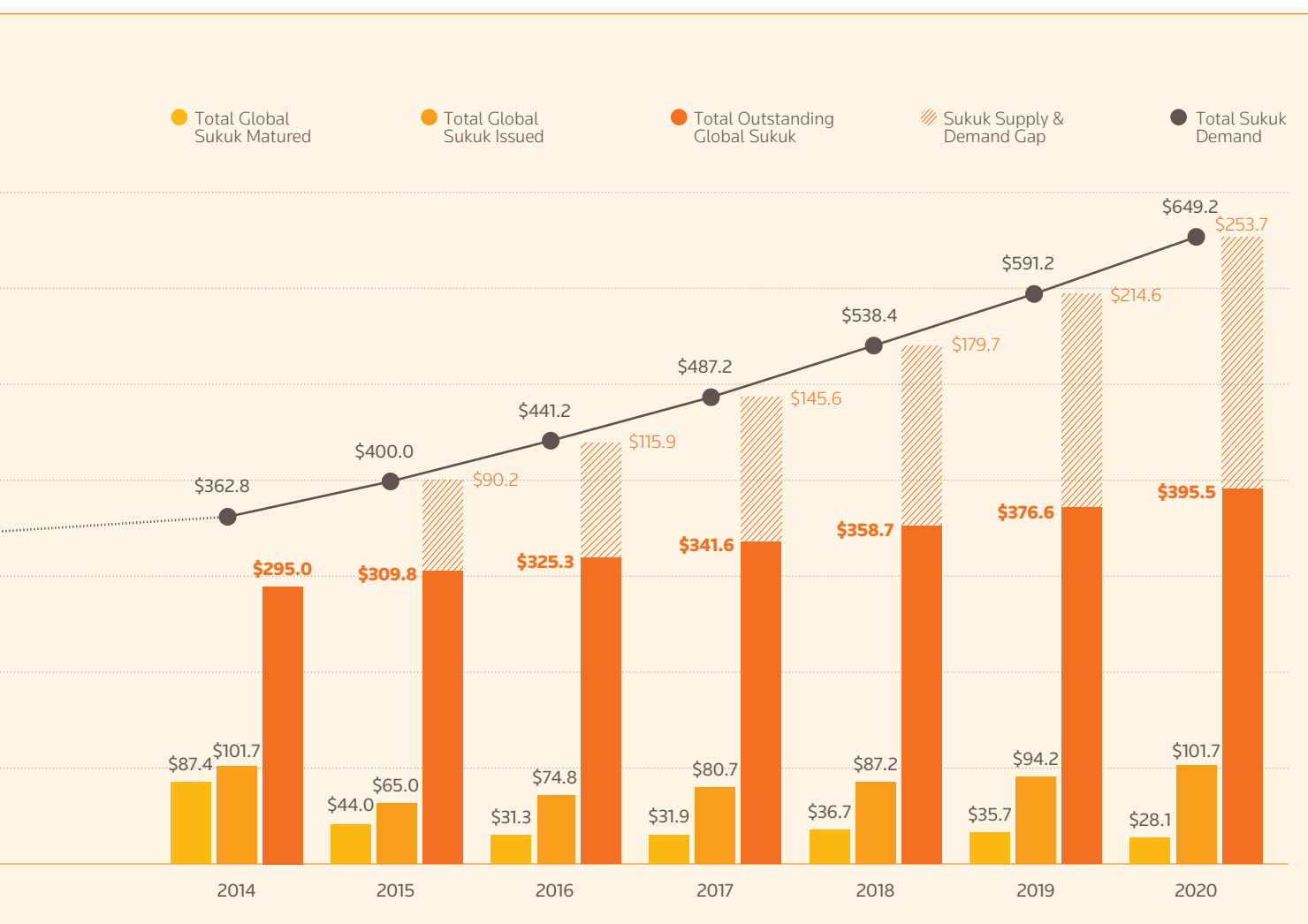
Canada has not seen a corporate *sukuk* issuance to date and its major banks have not been involved in Islamic finance domestically although

some have been active internationally and there is potential for this to be enhanced, as this report highlights.

The remaining areas of Islamic finance represent only a small share of the industry but they could be what Canada's strengths could support and, in some areas, where Canadian companies have already found significant opportunity internationally.

Mutual funds

One area is in the mutual fund sector which is estimated to have US\$60 billion in total assets today and which the Thomson Reuters' *Global Islamic Asset Management Report 2015* projects will reach US\$77 billion by 2019. As discussed





>
Totem Poles,
Stanley Park,
Vancouver, British
Columbia, Canada.

earlier, there are many overlaps between what Islamic asset managers do in their screening process with other socially responsible investment managers, such as Canadian investment managers, that use an exclusionary screening criteria.

Furthermore, there is a greater opportunity for Canadian asset managers who use Environmental, Social and Governance (ESG) factors to influence their investment decisions and incorporate values to add Islamic screens to expand

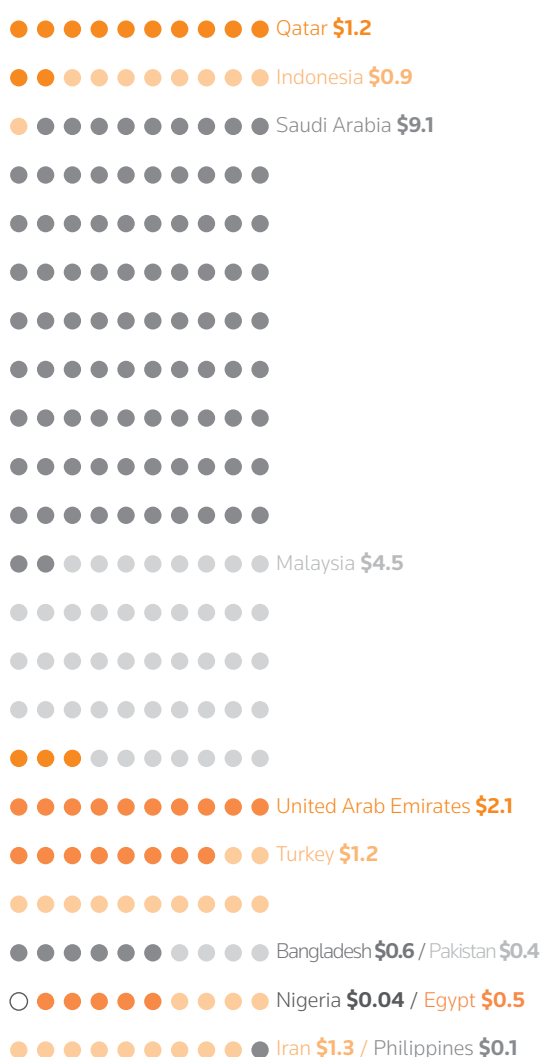
their business into growing Organization for Islamic Cooperation (OIC) markets where offering an ESG may work on its own but will have greater appeal to Muslim consumers if it can also demonstrate that it is Shariah-compliant. The opportunity just in the OIC countries for this type of product could reach US\$23 billion in assets in the 12 largest OIC markets by 2019, according to a recent report from Thomson Reuters.⁷

Takaful

On the insurance side, there are key similarities between the mutual insurance sector which has a long history in Canada and *takaful*, which is currently a small segment of the overall Islamic finance industry (US\$33 billion in assets) but whose future growth will receive support from favorable demographic trends among the Muslim population. Canada's mutual insurance dates back to the first half of the 19th century when farm mutual insurance companies were established to substitute for (uninterested) foreign insurers. Mutual insurance companies like these are policy-holder owned and controlled institutions that have deeper roots within their communities than shareholder-owned insurers where policyholders make payments and receive claims but are otherwise disconnected from their insurers.⁸

As described above, the *takaful* structure offers a middle ground between mutual insurance companies (many of which have sought demutualization to expand more rapidly) and some Canadian shareholder-owned insurers (including former mutual Sun Life Financial) that have become involved in *takaful*, particularly in South-east Asia. Canada-based Manulife Financial⁹ does not currently offer *takaful* but did acquire a fund management company in 2013 and offers several mutual funds in Malaysia.

PRUDENT ESG DEMAND IN THE OIC-12 (2019, US\$ BN)



Geographical Distribution of Islamic Finance Assets



Geographically, Islamic finance has developed the largest in Iran, across GCC and in Southeast Asia. These markets account for eight of the top 10 markets with Turkey and Bangladesh rounding out the list. While these markets account for the highest level of assets, they are not the only markets for Islamic finance globally and there has been growth outside of these regions that does not only cater to small Muslim-minority populations but positions these markets as 'hubs' to support the development of Islamic finance.

Western and non-Muslim markets

Further down the list of top Islamic finance markets are Switzerland (ranked 15th on the IFDI Quantitative Development Indicator), the United States (17th) and the United Kingdom (18th). This reflects asset growth in private banks, residential finance and mutual funds, and London as a global financial center, respectively. To these hubs, one could also add Luxembourg which has emerged as a key domicile for Shariah-compliant funds using the UCITS regulations to appeal to a global investor base and also for listing of *sukuk*. Behind Luxembourg, taking a similar approach is Ireland where they have attracted fund domiciles and *sukuk* listing as well. On the listing front, the Irish Stock Exchange has been very successful with 13 *sukuk* listed in 2014 representing US\$8.55 billion putting it second globally behind NASDAQ Dubai with US\$8.75 billion in listed *sukuk* that year.¹⁰

Similarly, the United Kingdom, where 4.6 percent of the population are Muslim, has taken a proactive approach to developing its Islamic finance proposition and unlike either Ireland or Luxembourg (which have Muslim populations of

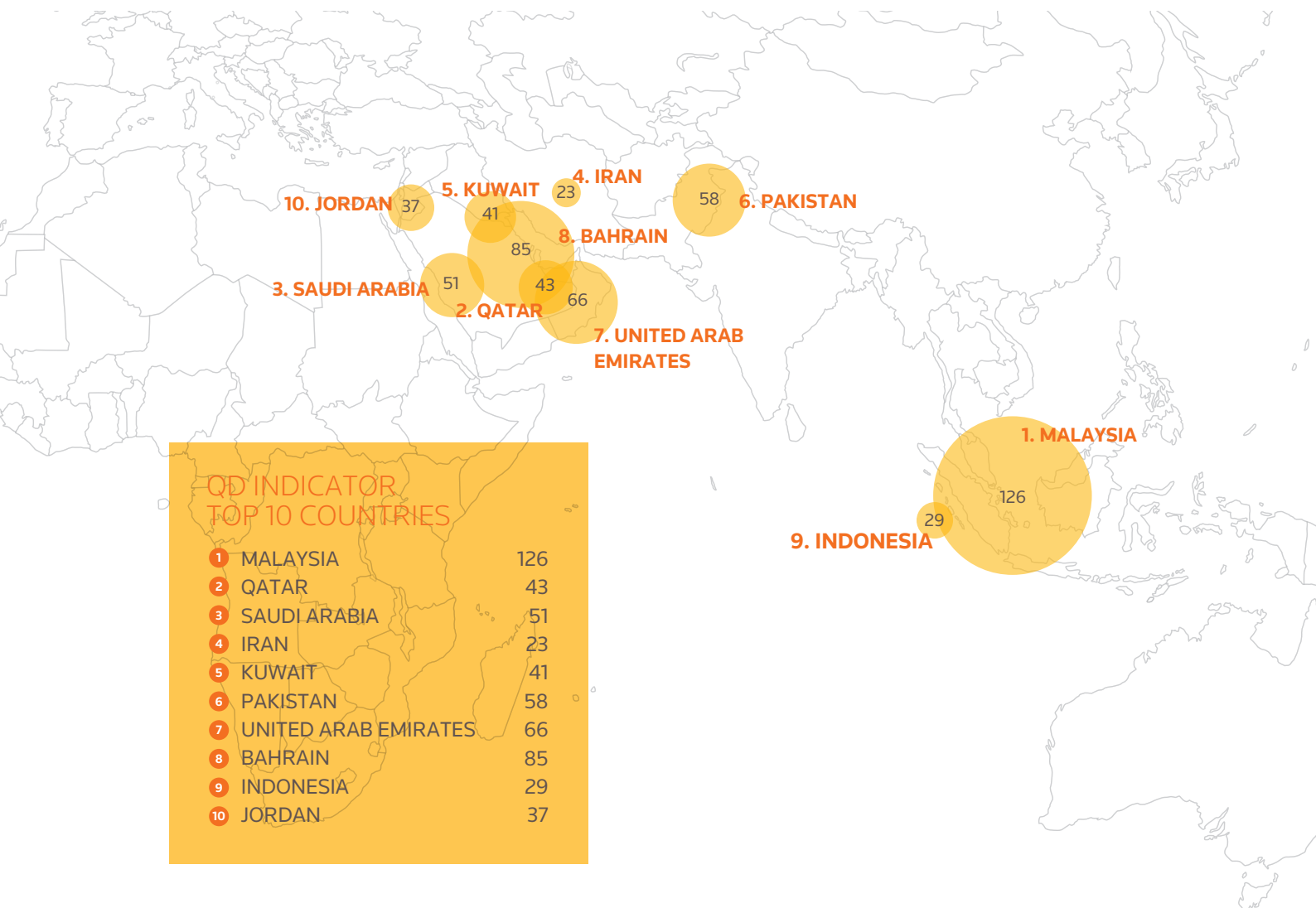
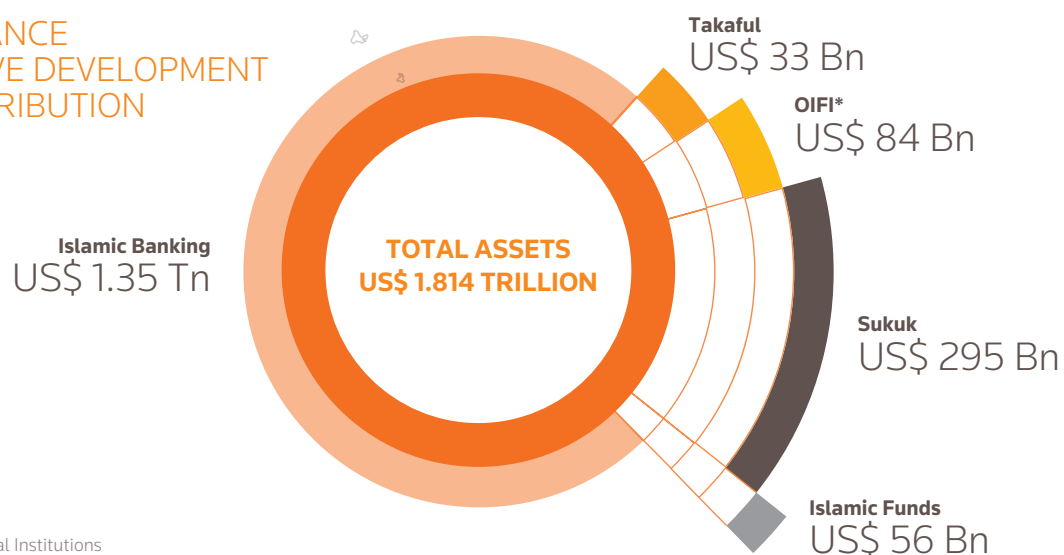
just 0.9 percent and 2.3 percent, respectively), the UK has made efforts on both a wholesale as well as a retail level. In both spheres, government involvement and active support has been invaluable from the leveling of the playing field between conventional and Islamic financial institutions which the Financial Services Authority (now the Prudential Regulatory Authority) set into place, where there are 'no obstacles, but no special favours' (see our interview with TheCityUK's Wayne Evans).¹¹

The UK has for many years used its position as a global financial center to attract Islamic finance and one of the areas where it had long maintained the intent but had not followed through was by issuing a sovereign *sukuk*. It completed this in 2014, a year when many non-Muslim sovereigns issued *sukuk* including Luxembourg, Hong Kong and South Africa. The UK sovereign *sukuk* was a small issuance at £200 million but attracted £2.3 billion in orders and it priced flat with conventional gilts, showing that *sukuk* need not be priced at a premium, a frequent criticism of Islamic finance.¹²

At the time when the *sukuk* was issued, there was concern that its small size and sterling-denomination would deter potential investors, a fear that did not materialize. Even a small *sukuk* issued in a currency not commonly used in Islamic finance (the U.S. dollar is widely used for global *sukuk* because most GCC countries link their currencies to it) can find demand. Speaking to Reuters at the time of the issuance, Khalid Howladar, Moody's global head of Islamic finance explained that "demand for high credit quality *sukuk* in the triple-A and double-A space far exceeds supply [...] to address forthcoming Basel III liquidity requirements."

Since 2014, only Hong Kong has returned, while the UK Export Finance guaranteed a *sukuk* issued by Emirates Airlines and Luxembourg suggested

QUANTITATIVE DEVELOPMENT LANDSCAPE

ISLAMIC FINANCE
QUANTITATIVE DEVELOPMENT
ASSETS DISTRIBUTION

*Other Islamic Financial Institutions

it would return in 2016.¹³ Yet, the strong demand for high credit quality *sukuk* will continue to support an untapped reservoir of funds searching for high-quality sovereign issuance.

The United States, which has a similar Muslim population (2.6 million) to the UK (2.9 million), is ranked relatively high compared to other non-Muslim markets where the governments have not promoted Islamic finance as actively. Unlike the UK where the government has taken an active role in promoting London's position in the Islamic finance industry and facilitating the necessary regulatory and tax changes that support its growth, the U.S. moves on an opposite path.

Despite a lack of explicit actions to support Islamic finance, the U.S. market is home to the two largest Islamic equity mutual funds, the Amana Income Fund and Amana Growth Fund (with net assets of US\$1.05 billion and US\$1.53 billion, respectively, as of the end of September 2015) and Guidance Residential, the largest Islamic home

finance company, which had provided US\$3.3 billion in Shariah-compliant home finance through the end of 2014.¹⁴ It is also an inbound destination for many investors from markets (including those in the GCC) where Islamic finance assets are much larger.

There are, from looking at examples from other parts of the world, ways that a non-Muslim majority nation can become involved in Islamic finance to develop its place in global capital markets, support its companies and infrastructure development and allow its Muslim minority citizens and others who see value in the Islamic finance products to have the option to use these products.

For Canada, as we describe below, the geographic concentration of the domestic Muslim population and less complex regulatory environment make it a more attractive market than the United States for home finance. For securities, the small size may limit the uptake of products but easier linkage with global fund markets and



FOR CANADA, AS WE DESCRIBE BELOW,
THE GEOGRAPHIC CONCENTRATION
OF THE DOMESTIC MUSLIM POPULATION
AND LESS COMPLEX REGULATORY
ENVIRONMENT MAKE IT A MORE ATTRACTIVE
MARKET THAN THE UNITED STATES
FOR HOME FINANCE.

large responsible investment markets could increase the effective market beyond what is available by only serving Canada's Muslim population. Furthermore, the asset class breakdown of funds available today hides some of the potential growth, particularly for equity funds.

Canada's companies export significant volumes to OIC countries with Muslim-majority populations, with the bulk of these exports going to markets where Islamic finance has a presence. These companies could look along these trade links for financing, whether that is trade finance (Export Development Canada has experience in this regard), for foreign investment through *sukuk* into their businesses and investment in natural resources like agricultural land, timber resources and real estate..

The challenge in both these areas is that the list of countries looking for capital is long but the success in demonstrating commitment to Islamic finance from their management and the leaders of their home countries does not always match. However, with the Government of Canada and the provincial governments of major provinces such as Ontario, Quebec, Alberta and British Columbia having both high credit ratings (Canada is one of the few countries to retain a sovereign AAA rating), and experience attracting foreign investors (including for public-private partnerships), the process of taking credible steps to demonstrate long-term interest should be easier with buy-in from people in a few key roles. One area which is challenging for Islamic financial institutions is currency risks due to underdeveloped hedging markets although some of Canada's sovereign and provincial debt is issued in USD which is preferred by many Islamic investors.

Leadership from government can go a long way towards helping companies benefit from Islamic finance and is now, following sovereign issuance by Hong Kong, UK and Luxembourg, almost expected from countries trying to become 'hubs' in their respective regions.



ELEANOR DE ROSMORDUC

Senior Advisor — Market Intelligence, Luxembourg for Finance

As an issuer with a currency that is not widely used in *sukuk* markets, what obstacle did the forex risk play in selling *sukuk* to global issuers, many of whom prefer USD-denominated assets?

We made a decision early on to issue the *sukuk* in Euro and to try and be the first sovereign issuer in this currency.

Our assumption was that a deal of just 200 million euros would easily find buyers. In addition to traditional institutional investors there was potential interest from Shariah-compliant investment funds (Luxembourg is a major domicile for Islamic funds) and the private banking community.

Do global investors avoid *sukuk* with AAA ratings because of their low yields? Could this change as Basel III rules come into force which value highly rated sovereign fixed income in liquidity rules?

There is a natural demand for AAA sovereign issues because there are very few countries in the world with such a rating.

That said, if an investor seeks a higher return there are lots of *sukuk* issues with higher yields.

Has a small sovereign *sukuk* of 200 million euros attracted much in secondary market liquidity?

Most Islamic debt issues are “buy and hold” securities. There will not be any secondary market. Reasons for this include scarcity, short maturities (the Luxembourg sovereign issue has a typical five year profile) and religious considerations that ban speculative trading.

Besides clarifying the tax side and harmonizing treatment of Islamic finance transaction, what was the most important regulatory change to facilitate Islamic finance development in Luxembourg?

It is true that the taxation administration has provided guidance on the tax treatment of *sukuk*. Otherwise, there was no regulatory change. It is worth mentioning that prospectuses for *sukuk* issues are drafted in accordance with standard international practice for such instruments.

How much of a role has the sovereign *sukuk* had in positioning Luxembourg to be a global player in Islamic finance versus being a culmination of efforts in other areas?

The 2014 sovereign *sukuk* underlines Luxembourg's commitment to Islamic finance and has confirmed the position of the Grand Duchy as an all-round Islamic finance center. This was reflected by several

important listings during the same year: Pakistan listed a sovereign *sukuk*, and both South Africa and Goldman Sachs chose Luxembourg for their maiden *sukuk* issues.

The Luxembourg sovereign *sukuk* was also a useful exercise from a technical point of view, requiring the coordinated efforts of the Ministry of Finance, Parliament and financial center professionals.



THE 2014 SOVEREIGN SUKUK
UNDERLINES LUXEMBOURG'S
COMMITMENT TO ISLAMIC FINANCE
AND HAS CONFIRMED
THE POSITION OF THE GRAND
DUCHY AS AN ALL-ROUND
ISLAMIC FINANCE CENTER.



WAYNE EVANS

Senior Advisor International Strategy, TheCityUK

WAYNE EVANS advises TheCityUK mostly on Islamic Finance but also on Middle East and North African issues. TheCityUK is a membership body representing the UK-based financial and related professional services industry. In 2013 he was one of six industry representatives on the UK Government's Islamic Finance Task Force.

Besides clarifying the tax side and harmonizing treatment of Islamic finance transaction, what is the most important regulatory change to facilitate Islamic finance development?

UK government policy towards Islamic finance since 2001 has been to create 'a level playing field' — amendments to legislation have been made to enable Islamic financial institutions to compete on equal terms with conventional counterparts. Tax changes have probably been the greatest enabler. Other important changes have been:

1. 2003: HM Treasury & Customs Tax Technical Group established

Finance Act — Legislative provision for Stamp Duty Land Tax ("SDLT") on Islamic Mortgages included

2. 2005: The SDLT provisions were extended to equity sharing arrangements

Government legislated for *murabaha* instruments as a purchase and resale arrangement

3. 2006: Government legislated for diminishing shared ownership for property or asset financing arrangements

SDLT relief extended to corporate entities

The Bank of England is currently working on a facility for Islamic banks to help with liquidity issues.

How much of a role has the sovereign *sukuk* had in positioning London to be a global player in Islamic finance versus being a culmination of efforts in other areas?

I would argue that London's position as the leading western hub for Islamic finance was secured before the issuance of the UK's sovereign *sukuk* — given the depth and breadth of the market and the expertise here. What the *sukuk* has done is to confirm the UK's position and to cement Government policy that the UK is a global player.

Does the absence of multiple successful domestic (standalone) Islamic finance institutions focused on retail consumers suggest a

larger minimum scale for Islamic banks to thrive beyond a couple million Muslims or does it reflect the participation of so many conventional banks?

This is quite a big question. Given the size of the UK's Muslim population the potential for Islamic banking and other Shariah-compliant products

(insurance etc.) is there; but it is fair to say that the retail side has not really taken off. It may be that the conventional banks with Islamic windows have impacted upon the market but I doubt this is the case. I suspect it is more to do with education, availability/accessibility, competition and cost.



AMENDMENTS TO LEGISLATION
HAVE BEEN MADE TO ENABLE
ISLAMIC FINANCIAL INSTITUTIONS
TO COMPETE ON EQUAL TERMS
WITH CONVENTIONAL COUNTERPARTS.

A low-angle, upward-looking photograph of several modern office buildings in Toronto. The buildings feature glass facades that reflect the sky and surrounding structures. The perspective creates a sense of height and architectural scale. The sky is a pale, overcast blue. In the foreground, some bare tree branches are visible, adding a touch of nature to the urban scene.

Islamic Investment Opportunities in Canada



CHAPTER 2

As discussed in the previous chapter, after the sector exclusionary screens are factored in, the primary focus of Islamic finance is to have financial transactions revolve around and be connected to tangible assets. Although that sometimes means the financing is specifically backed by tangible assets, more commonly the role of the asset is more indirect where it provides a link to real economic activity but where investors primarily take credit risk, rather than asset risk. These different structures provide much greater flexibility and can be used for asset-backed financing, asset-based financing and project-based financing.



As discussed in the previous chapter, after the sector exclusionary screens are factored in, the primary focus of Islamic finance is to have financial transactions revolve around and be connected to tangible assets. Although that sometimes means the financing is specifically backed by tangible assets, more commonly the role of the asset is more indirect where it provides a link to real economic activity but where investors primarily take credit risk, rather than asset risk. These different structures provide much greater flexibility and can be used for asset-backed financing, asset-based financing and project-based financing.

As in most countries, the long-term nature of infrastructure has led to a systematic under-investment in the assets needed to support continuing economic growth. A comprehensive report based on surveying 123 municipalities, the *Canadian Infrastructure Report Card*, estimated that based on studying drinking water, wastewater, storm water system as well as roads, about 30 percent of all infrastructure was rated between 'fair' and 'very poor'.¹⁵ The replacement cost for all of this infrastructure is estimated to be C\$171.8 billion, or 9 percent of GDP based on its level at the end of 2015.

 Nathan Phillips Square in Toronto, Canada.

The greatest need for infrastructure financing in Canada studied by the report card was municipal roads, where over 50 percent were found to be between 'fair' and 'very poor' condition. There is significant experience globally in structuring infrastructure financing for road projects where tolls can support the repayment of financing. However, there is a challenge using solely toll-based revenue sources for road projects in an Islamic finance context because most investors will prefer to generate fixed income-like returns which may not be fully supported by toll revenues. The same could be described for other projects like those for wastewater where there is a divergence between the social return and financial return able to be generated.

Many infrastructure projects will not generate specific cash flows representative of the true value added and their direct monetary value creation may not provide an attractive enough return for investors. In many conventional infrastructure projects, the lower financial returns are enhanced using significantly higher leverage than is used in other types of projects. While that can boost returns up to the levels required by investors to lock up their capital for a long period of time, it also carries risks which are more inconsistent with Islamic investors' expectations.

An empirical analysis using a database of project-level private infrastructure deals from 2012 found a significantly higher (equity) return for

infrastructure deals than for non-infrastructure deals and also found that these returns had a negative relationship with short-term interest rates.¹⁶ This provides empirical evidence that "infrastructure investments [likely] have higher leverage ratios than non-infrastructure investments".¹⁷ The authors of the previously cited study refer to other studies showing debt levels ranging from 50 percent for road projects to 83 percent in the water and energy sector to 90 percent for social infrastructure projects.

In addition, the long tenors of project finance do not match up with most Islamic investors' preferences. For example, respondents to the *Thomson Reuters Sukuk Perceptions & Forecast 2015* report overwhelmingly preferred *sukuk* with tenors of five years and below (63 percent of full-fledged Shariah-compliant institutions, 58 percent of Shariah-compliant windows and 67 percent of non-Shariah-compliant institutions that invest in *sukuk*).¹⁸ Between 5 percent and 7 percent prefer *sukuk* with tenors of more than 20 years which would be more appropriate for an infrastructure investment.

One alternative that may be interesting to open up additional sources of financing would be for shorter-tenor sovereign or provincial *sukuk* to raise funds to finance some infrastructure needs. These could be specifically important for projects without the direct cash flow to support *sukuk*, or for projects that require longer tenors than *sukuk*

TOP-LEVEL ESTIMATES FROM CANADA'S INFRASTRUCTURE REPORT CARD

Infrastructure	Rating	Replacement value of assets in poor/very poor condition (in C\$ Bn)	Replacement value of assets in fair condition (in C\$ Bn)
Municipal roads	Fair	35.7	55.4
Drinking water	Good	3.4	22.5
Wastewater	Good	7.7	31.3
Storm water	Very good	3.9	11.9
Total		50.7	121.1

Source: Figure 7 in Félio, Guy. 2012. Canadian Infrastructure Report Card. The Canadian Infrastructure Report Card: Ottawa, Canada.

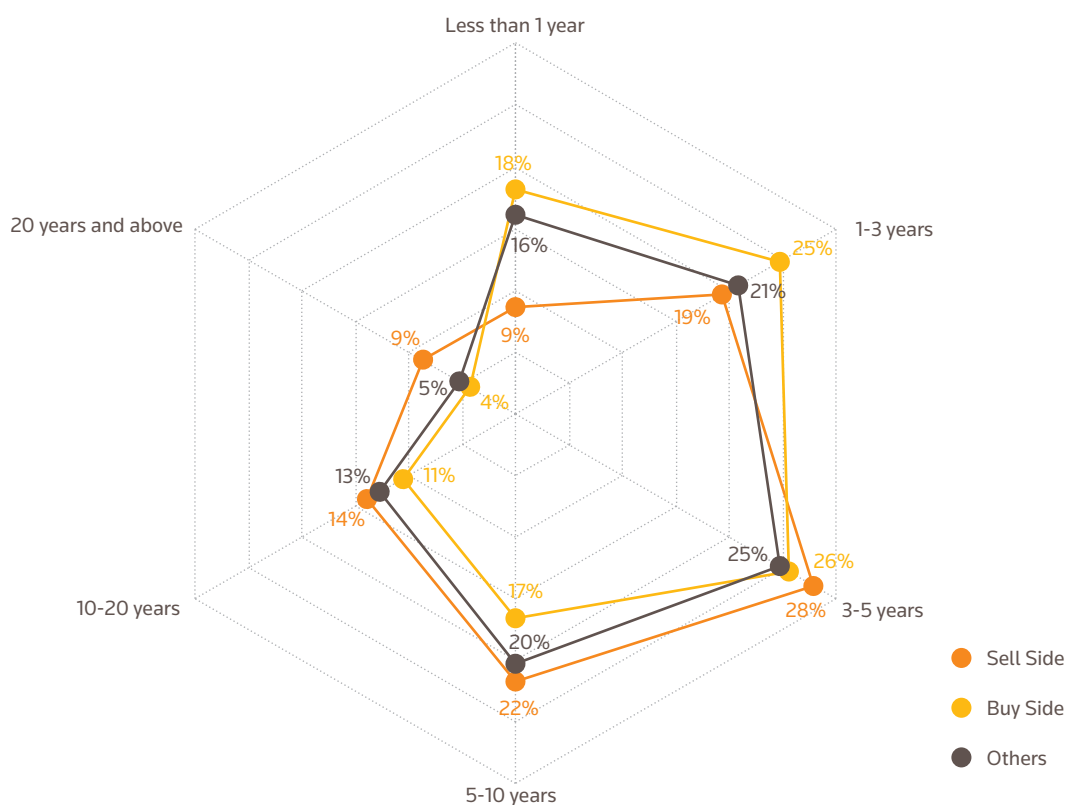
investors would prefer. Many conventional banks are concerned that Basel III rules could limit their participation in long duration infrastructure projects because they would face higher capital requirements.¹⁹ Islamic banks would face similar constraints that could be extenuated by their structures.

For example, many Islamic banks have balance sheets with a higher level of short-term deposits and fewer long-term sources of capital. This is changing with capital-boosting Basel III-compliant perpetual *sukuk* but Islamic banks' balance sheets remain tilted towards short-term liabilities to finance their assets. Because many of these short-term liabilities are in the form of profit-sharing investment accounts, they may not be treated as stable funding under the Basel III standards.²⁰ Therefore Islamic banks may be further hindered in their direct infrastructure financing activity where it is done with long tenors that many infrastructure projects require.

One method that could be used to mitigate the impact of Basel III rules to attract banks (which are the largest sources of syndicated financing for Shariah-compliant project finance and which would also be the largest buyers of *sukuk*) would be to finance more infrastructure using asset-based *sukuk* issued by the provincial or national Canadian government. These *sukuk* would likely carry a higher credit rating than a project-based *sukuk* and could be combined with longer-tenor *sukuk* for less-leveraged project financing transactions.

For example, in theory, a provincial government could raise funds through a *sukuk* to finance its budgetary needs to receive matching federal funds from the New Building Canada Fund (an infrastructure support fund administered by the Government of Canada based on province population levels).

TENOR PREFERENCES FROM MOST RECENT SUKUK REPORT



Source: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016.

Projects financed using federal resources must have at least 50 percent contribution from other sources. Currently all the Canadian provinces have at least a single A rating from Standard & Poor's or a Aa2 rating from Moody's which puts them in the 0 percent risk-weighting based on the standardized approach for Moody's ratings or 20 percent risk-weighting for the lower-rated provinces by S&P (Newfoundland & Labrador, Nova Scotia, Prince Edward Island, New Brunswick, Quebec and Ontario). For example, Ontario has a Aa2 rating from Moody's and an A+ rating from S&P and is given a 0 percent risk-weighting by most countries' supervisors with the exception of Switzerland and Malaysia which give it a 20 percent risk-weighting.²¹

With a change in government in Ottawa towards one which has a stated goal of increasing investment in infrastructure, it may also be possible for the funding to be raised by a national infrastruc-

ture bank that leverages sovereign, provincial, local and private capital.²² This would remove the project-specific risks of project-based *sukuk* and would allow more flexibility on tenors to be able to include *sukuk* as one source of financing for infrastructure projects that are larger than *sukuk* alone could finance.

The high ratings, even on provincial governments, give these provinces the ability to appeal specifically to Islamic banks because, as mentioned

CANADA'S NATIONAL AND PROVINCIAL RATINGS

	Moody's	S&P
Canada	AAA	AAA
Newfoundland and Labrador	Aa2	A+
Nova Scotia	Aa2	A+
Prince Edward Island	Aa2	A
New Brunswick	Aa2	A+
Quebec	Aa2	A+
Ontario	Aa2	A+
Manitoba	Aa2	AA
Saskatchewan	Aaa	AAA
Alberta	Aaa	AAA
British Columbia	Aaa	AAA

Source: Moodys & Standard & Poor's

SUPERVISORY RISK WEIGHTING OF ONTARIO SUB-SOVEREIGN BONDS BY COUNTRY

Country	Risk Weighting
Canada	0%
United States	0%
France	0%
Luxembourg	0%
Belgium	0%
Netherlands	0%
Australia	0%
Italy	0%
Ireland	0%
Germany	0%
United Kingdom	0%
Switzerland	20%
Finland	0%
Norway	0%
Denmark	0%
Singapore	0%
Malaysia	20%

Source: Ontario Financing Authority, "Risk Weightings" http://www.ofina.on.ca/ir/risk_weighting.htm (Accessed October 14, 2015)

above, they find high-quality *sukuk* to be in short supply. Without access to repo markets (there is no agreed upon Shariah-compliant structure for a repo alternative), many national supervisors have allowed longer-tenor *sukuk* to count towards their high quality liquid asset (HQLA) requirements.²³ One example is the Islamic Development Bank *sukuk* which receives a 0 percent risk-weighting by virtue of the IDB's status as a multilateral institution but presumably a sovereign (and particularly a USD) denominated *sukuk* from a double- or triple-A rated Canadian province could receive similar treatment.

Sovereign *sukuk* from non-Muslim majority countries and from non-Islamic multilateral institutions that carry regulatory benefits have received good pricing which has driven premiums down to the single-digit basis point level. In the case of the UK sovereign *sukuk*, despite be-

ing sterling-denominated and issued in a small £200 million size, it was priced flat with the conventional gilt curve. Using government-issued rather than project-based *sukuk* would bring benefits in terms of pricing (because of the more favorable regulatory treatment) and would also limit any misleading politically-driven argument that national infrastructure assets are being sold to foreign investors that could come from project-based *sukuk* that rely on sale-and-leaseback of the assets.

In addition to the infrastructure bank, project-based *sukuk* or sovereign and provincial issuance, there is potential for Canada's corporates to tap domestic Muslim liquidity as well as a diverse base of *sukuk* investors globally with *sukuk* issuance. This is discussed in more detail later in this chapter.

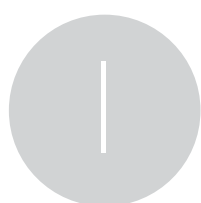
ESTIMATED PREMIUM / (DISCOUNT) (BPS) ON SOVEREIGN SUKUK VERSUS CONVENTIONAL BONDS

Sukuk	Tenor (Yrs)	Issue Date	Size (US\$ Mn)	Coupon	Premium / (Discount)
Indonesia Global Sukuk	10	05/21/15	2,000	4.325%	26
Indonesia Global Sukuk	10	09/2/14	1,500	4.350%	23
Hong Kong Sovereign Sukuk	5	09/10/14	1,000	2.010%	(48)
Pakistan International Sukuk	5	11/26/14	1,000	6.750%	79
Hong Kong Sovereign Sukuk	5	05/27/15	1,000	1.894%	(32)
Turkey Sovereign Sukuk	10	11/17/14	1,000	4.490%	18
RAK Capital	10	03/31/15	1,000	3.090%	(1)
Malaysia Global Sukuk	10	04/22/15	1,000	3.040%	(9)
Dubai DOF	15	04/23/14	750	5.000%	(16)
DIFC Investments Sukuk	10	11/5/14	700	4.330%	(19)
South Africa Sovereign Sukuk	5.75	09/18/14	500	3.900%	17
Malaysia Global Sukuk	30	04/22/15	500	4.240%	(11)
UK Sovereign Sukuk	5	06/25/15	343	2.040%	3
Luxembourg Sovereign Sukuk	5	09/30/14	253	0.440%	(4)

Source: Thomson Reuters EIKON, Zawya Islamic Sukuk Monitor & Thomson Reuters IFG calculations

Note: With the exception of UK (GBP) and Luxembourg (EUR), all the above *sukuk* are USD denominated. Premium/(Discount) was calculated by subtracting the coupon on the *sukuk* from the bid yield on a similar sovereign conventional bond with similar maturity issued in the same currency. No adjustment was made to reflect different remaining maturities on the comparison bonds.

Asset management and the growing Responsible Investment market



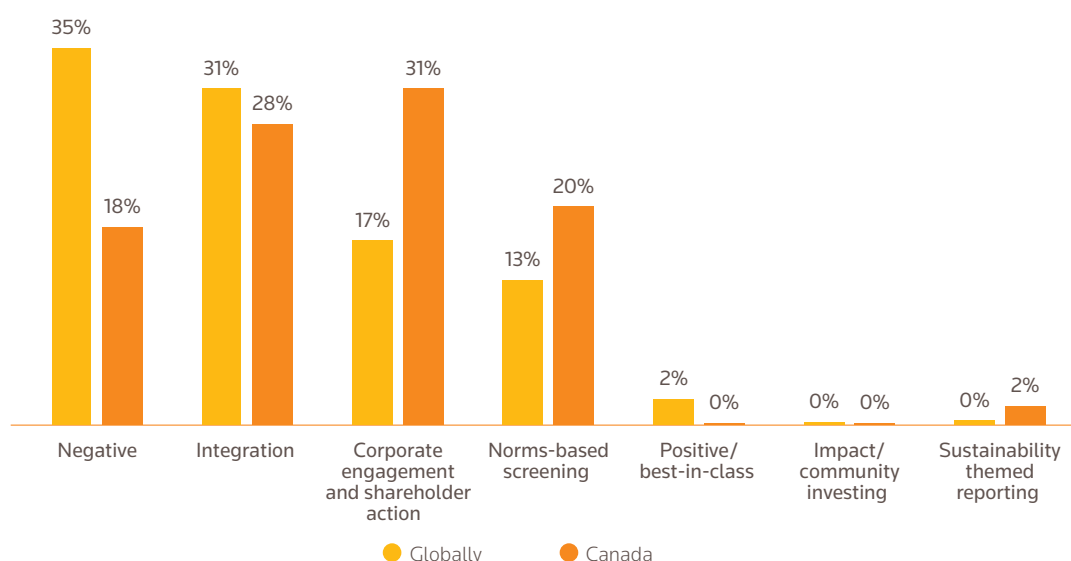
Infrastructure *sukuk*, or sovereign and sub-sovereign *sukuk* to finance infrastructure (either entirely constructed by the government or in cooperation with the private sector in public-private partnerships) offers the governmental side of the investment sector and the private sector analogue in the asset management business. Like other developed markets, Canada has seen rapid growth in its share of Responsible Investment in, with a particular shift by institutional investors who represent nearly 95 percent of the total assets under management that incorporate some form of Responsible Investment criteria.

For those not familiar with Responsible Investment, it includes both the Socially Responsible Investment (SRI) sector but has found significant growth by attracting investors who integrate an

analysis of the non-financial Environmental, Social or Governance (ESG) considerations within their financial analysis. This broadens the asset base that is included in Responsible Investing because in most countries, the consideration of non-financial ESG factors is considered as being consistent with asset managers' fiduciary duties.

In addition to being open to a wider base of asset managers than SRI, it is more widely seen to have performance and risk management benefits by providing a framework for detecting management quality and emerging risks in potential investments that a financial analysis alone would not find. That being said, it is also viewed as a way to incorporate values into financial investment behavior but to do so in a more systematic and nuanced way than traditional exclusionary screening which relies on a binary 'in' or 'out' decision-making process.

RESPONSIBLE INVESTMENT STRATEGIES (PERCENT OF ALL RI STRATEGIES)



*Data is as of 2014

Source: Responsible Investment Association, 2015 Canadian Responsible Investment Trends Report

Globally the Responsible Investment universe covers US\$21.4 trillion in assets under management as of 2014, up from US\$13.3 trillion (+27 percent annualized) and accounts for 30.2 percent of global managed assets. Canada represents a small portion of this market, just 4.4 percent, but has been punching above its weight in several types of Responsible Finance. Out of the total level of assets managed using norms-based screening, corporate engagement/shareholder action, and sustainability-themed approaches, Canada's assets represent 9.6 percent, 11.6 percent and 27.7 percent of global assets. In contrast, it holds a middling share of the exclusionary-screened assets and positive/best-in-class screened assets and is slightly above its overall share in ESG integration.

That might seem like a disadvantage for Canada's asset management industry since the exclusionary and ESG integration segments of Responsible Investing are the two largest (by a lot) but it provides Canada's asset managers with a relative advantage in areas of Responsible Investment that are growing. In the evolution of SRI, there was a progression from exclusionary (first-generation) to positive (second-generation), best-in-class (third-generation) and more recently towards ESG integration, active ownership/engagement, norms-based and impact-focused investing.²³ Gaining market share in the more recent growth areas will bode well for the future, particularly if they can be complemented with other growth areas like Islamic finance which currently uses only the first-generation-type exclusionary screens and which has a significant presence in several key emerging markets.

Starting with sustainability-themed investment screens, this is the smallest of the three areas in which Canada's asset management industry has global leadership (representing over one-quarter of all assets globally invested this way although this represents US\$49.4 billion in total assets). One of the gaps in Islamic asset management has been an inclusion of positive screens and it is particularly challenging on the side of environmentally beneficial investments. This is not because there is a gap in Islamic principles supporting investment in environmentally-beneficial investment but more in practice where most Is-

lamic asset managers are focused principally on their own domestic markets where significant shares of the potential investments (and economic activity) revolve around hydrocarbons.

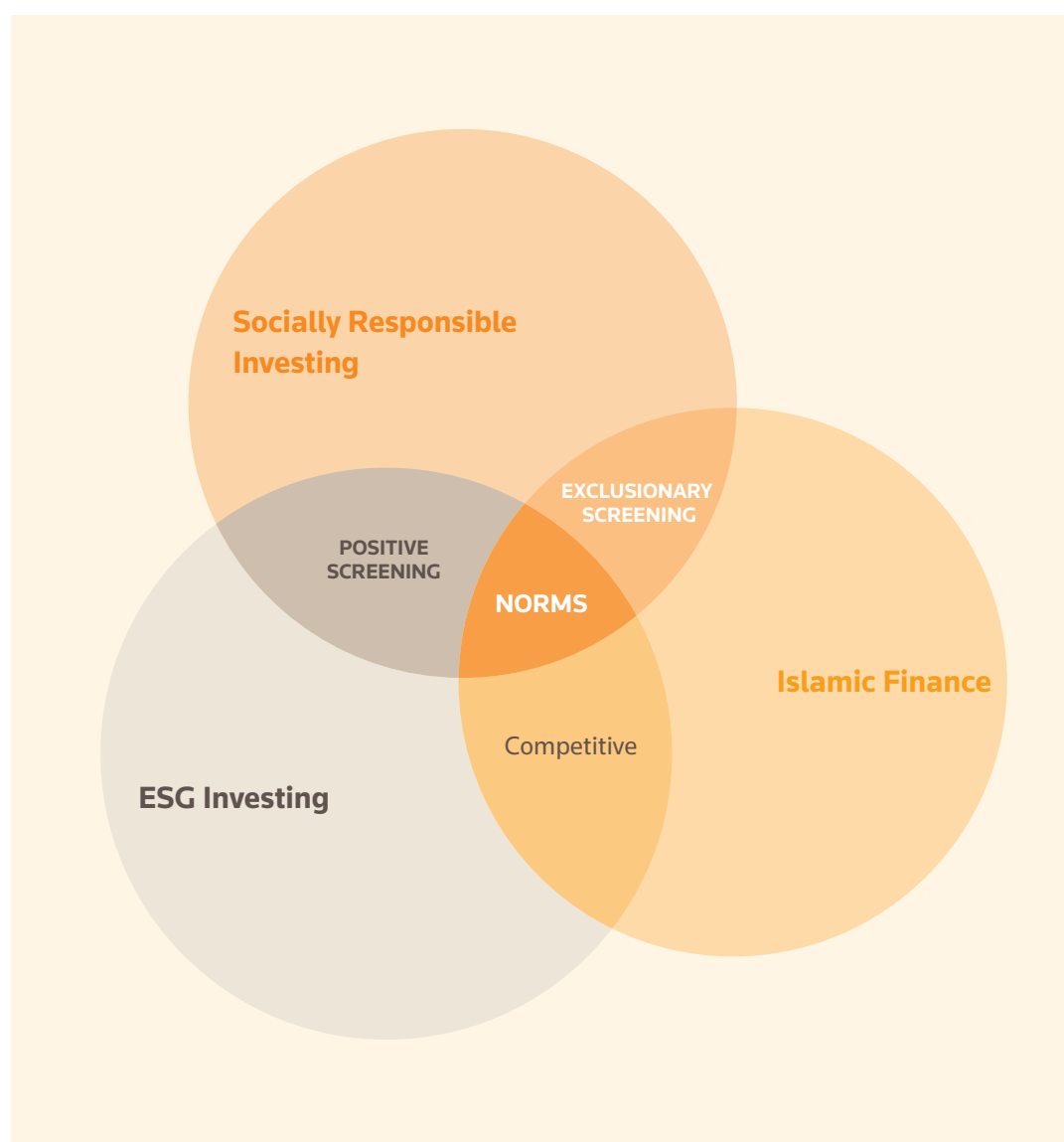
Thus implementing broad universe screens on environmental lines would exclude a significant portion of the investable universe. It would also make more restrictive investment strategies like fossil fuel-free investing nearly impossible because such a large proportion of the investment universe is connected to areas related to fossil fuel extraction. The experience of asset managers operating in Canada where nearly one-third of the S&P/TSX Composite Index market capitalization is in the resource extraction sector (energy and materials) poses a similar challenge. Focusing on sustainability-themed investments (which don't have to start from the broad market index) is a way to avoid the issues there being a large share of the universe excluded or limited for investment by its participation in resource sectors.

The other areas within Responsible Investment where Canada's assets represent a significantly larger share—corporate engagement and norms-based screening—also put Canadian asset managers in a position to capture a rising share of the Islamic fund market if there is a move towards greater incorporation of Responsible Investment principles. In each of these areas it is readily possible to incorporate responsible investment ideas with the existing exclusionary investment screens used by Islamic asset managers.

The norms-based screening approach was identified in the Thomson Reuters-RFI *Responsible Finance Report* as the most representative of the overlap between the forms of Responsible Investing (including Islamic finance). The chart on the next page shows a stylized view of the processes used by the various forms of responsible investing. As mentioned above, Islamic finance uses an exclusionary screening process which excludes particular sectors (largely overlapping with the most common exclusions from SRI like alcohol, tobacco and weapons) and adds its own screening process to exclude heavily indebted companies.

Islamic finance (both investing as well as banking) also focuses on being competitive with conventional finance; one criticism leveled about Islamic finance is that, despite its avoidance of interest-based transactions, it benchmarks its pricing and returns to interest-based benchmarks in order to remain price competitive with conventional finance. In a similar way, investments analysis that incorporates environmental, social and governance (ESG) non-financial information within the financial analysis performed on investments is widely promoted as being not only price competitive with conventional finance but offering superior returns.

In addition to what was described above relating to exclusionary screening and focusing on offering price competitive products, there is little overlap today in areas of positive screening between either SRI or ESG and Islamic finance but a high degree of potential overlap around the areas of norms-based screening. Unlike the sustainability-themed investment area where the overall size (of which Canada represented a large share) was small, there is a much bigger market with norms-based screening. Globally the Responsible Investment market screened using norms-based screens accounts for US\$5.5 trillion in total assets and US\$569 billion in Canada alone.





SACHIN MAHAJAN

**Managing Director Head of Middle East, North Africa, South Asia (MENASA),
Canaccord Genuity (Dubai) Ltd.**

MR. MAHAJAN has been involved on numerous transactions across various sectors since 2001 including consumer and industrial products, technology, media and telecommunications and real estate. Mr. Mahajan has advised on cross border transactions, hostile public take-over transactions, private acquisitions, going private transactions and restructuring transactions. Mr. Mahajan also spearheaded the cross border M&A activity between Canada and the Indian Sub-Continent and Middle East. Mr. Mahajan has recently relocated to UAE to establish Canaccord's MENASA (Middle East, North Africa and South Asia) office with focus on the Indian sub-continent and Middle East. Prior to joining Genuity Capital Markets in 2005 (now Canaccord Genuity), Mr. Mahajan worked for BMO Nesbitt Burns as a member of their Mergers & Acquisitions Group. Mr. Mahajan obtained his Chartered Accountant designation from Institute of Chartered Accountants of India and received a Masters in Business Administration from Richard Ivey School of Business, University of Western Ontario.

Canada's Muslim population is smaller than the U.S. where several large mutual funds have grown up over the years. Do you think the domestic Muslim population has a large enough size to be viable for Islamic funds?

While Canaccord is starting by building its Islamic finance proposition with a global mandate there is also a big market within Canada that makes it a perfect test market. There are over 1 million Muslims in Canada who provide a market but you have to offer a product that has a religious dimension while also offering one that works better economically to get Muslims to adopt it over competing conventional products.

There are also discussions with local GCC banks to supplement Canaccord's retail footprint with the bigger product offering that other banks' brokers offer. This will allow Canaccord to bring products from the GCC to Canada with a Shariah-compliant structure for Canada. Of the assets in Canada that investors might be interested in, real estate is appealing because it is the most stable asset class in Canada and also when compared to real estate in other markets GCC Islamic investors

might look to including London, Dubai or Malaysia.

There is a lot of capital in the Islamic finance space with not many places to put it and one method could be mortgage finance through Shariah-compliant vehicles to facilitate investment in the Canadian market. The mortgage market has to be on the institutional side where several Shariah-compliant mortgages are sold through a vehicle to get buy-in from investors as an example. It's something Canaccord is working on validating the economics because it is a very powerful structure for attracting Shariah-compliant investors to Canada.

Can Canadian corporates look to the sukuk market to supplement their financing needs or has the drop in oil prices limited the appeal with a slowing Canadian economy and more limited liquidity in areas where Islamic finance assets tend to be located (GCC/Malaysia)?

In addition to real estate, there is an opportunity to build a leasing portfolio for assets like trains and airplanes which are manufactured in Canada. These issuers could also diversify their funding base where now they go to the market for US\$1 billion every year, it would benefit

them to raise a few hundred million of that through *sukuk*, particularly those companies that do business with Muslim majority countries.

Does experience abroad dealing with Islamic financial products translate at all to being able to offer products to the Canadian market or are there key differences that might make a Canadian financial institution successful in a Muslim majority market but unsuccessful offering a similar product at home?

At the end of the day what matters to consumers are the prices or returns. For example, if a Muslim had the choice between a conventional mortgage where they are paying 3% versus an Islamic mortgage where they are paying 5%, chances are high that they will go with the conventional product. However, if the pricing is comparable at 3% for conventional and 3.25% for Islamic, they will more likely pick the Islamic product.

If the pricing on the Islamic product can be offered at a better rate than the conventional product, then they'll be able to get the market. If they price themselves out of the market, they will have a more challenging proposition

and especially with a new product, they'll have to be more aggressive with the product. It will be an evolving process that requires the firms offering financing to do their homework because pricing will dictate their success.

What areas of the market do you / Canaccord see as the biggest opportunities for within the domestic Canadian market and internationally to either attract capital to Canada or create new markets for Canadian financial institutions?

Within Canada, the biggest opportunity is to attract new capital from sources outside of Canada to begin with. There has to be a dedicated effort by someone who sees the opportunity working alongside a Canadian partner. It has to build from this base as people get used to it which could be a 36 month process, and has to incentivize other institutions to come in. The first step will likely have to be taken by a GCC based bank working with a partner in Canada. If they can figure out how to deploy institutional capital from the region into Canada, there will be a market for it because there are a shortage of Shariah-compliant assets.



AT THE END OF
THE DAY WHAT
MATTERS TO
CONSUMERS ARE
THE PRICES
OR RETURNS.

The experience for Canada's asset managers both within their home market and globally



any Canadian asset managers and insurers including BMO Asset Management, Manulife Financial and Sun Life Financial operate both in Canada and globally in the developed markets where Responsible Investment has a significant presence and, in the case of Sun Life and Manulife, also in Muslim-majority Emerging Markets. This experience in incorporating norms-based screening criteria into asset management can be useful for expanding into Muslim-majority markets where there already exists some adoption of norms-based standards by companies but where an Islamic investment offering will be required to unlock some of the demand. Within the top five of the largest 12 OIC markets identified by the *Responsible Finance Report* as having the greatest potential for an integrated Responsible Investment approach that included Islamic finance screens (referred to as 'prudent ESG' in that report), there are 450 companies which are signatories for the UN Global Compact which sets the global norms that are the basis for norms-based screening. These five countries (Malaysia, Qatar, Saudi Arabia, Turkey, and the United Arab Emirates) represent a large proportion of the Islamic finance market globally.

Yet, the presence of companies that are signatories to global agreements like the UN Global Compact are not the start and end of Responsible Investing — investors need to monitor the companies' compliance with their obligations under the UNGC and other agreements. In order to do so, engagement with companies has been a common practice in many markets with developed Responsible Investment industries. However, there is very little experience by Islamic investors or investors in general in markets where Islamic finance assets are concentrated which provides an opportunity for investment managers with experience in corporate engagements.

Since Canada's Responsible Investment market is well represented in this area (representing nearly 10 percent of global assets managed with an engagement/active ownership methodology), Canadian asset managers expanding into Emerging Markets (including those EMs with large presence of Islamic finance assets) represents a key area where the experience in engagement can help gain market share and lead to improvements in corporate governance and shareholder engagement more broadly.

Asset Management in Canada



A recent report from Pew Research Center called *The Future of The Global Muslim Population* estimates that, by 2030, there will be about 2.7 million Muslims living in Canada, and they will make up approximately 6.6 percent of the population (which is currently the level of Muslims in a number of European countries like France and The Netherlands). Currently, Muslims make up about 2.8 percent of the country's population. The study shows that relative to the total population, the number of Muslim consumers is growing faster in Canada than in the United States.

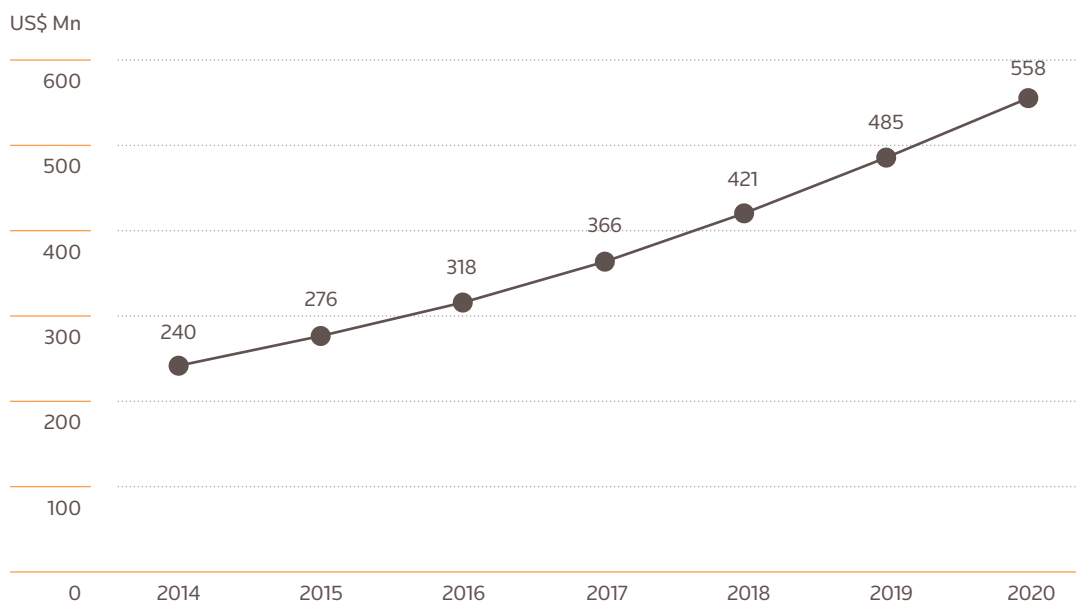
The primary opportunity for Islamic asset management is global and many of Canada's asset managers have looked abroad for opportunities in Islamic asset management but there does exist a domestic demand. Canada's Muslim population (at 1.3 million) is smaller by absolute numbers than its southern neighbor but represents 2.8 percent of the total population and is projected to grow to over 6.6 percent of the

Canadian population by 2030, the fastest growing component of the Canadian population.²⁵

As of the end of 2014, the total Islamic fund assets under management in Canada was US\$240 million and represented US\$18 million in equity funds and the remainder in bullion (commodity) funds, according to Thomson Reuters Lipper, and fund reports.

This is significantly different from the United States where the majority of Islamic finance assets are in equity funds. In fact, in the U.S., of the US\$3,632 million total assets in Islamic mutual funds, only 2.2 percent are in non-equity funds. The size of the U.S. equity funds does not represent the potential size of the Canadian market because the overall fund market is significantly larger by virtue of the 318 million population in the United States (versus 35 million in Canada). One of the U.S. fund managers, Saturna Capital, which manages the Amana Funds, estimated that between 60 percent and 70 percent of the funds they manage come from non-Muslim investors driven primarily by the fund's performance.²⁶

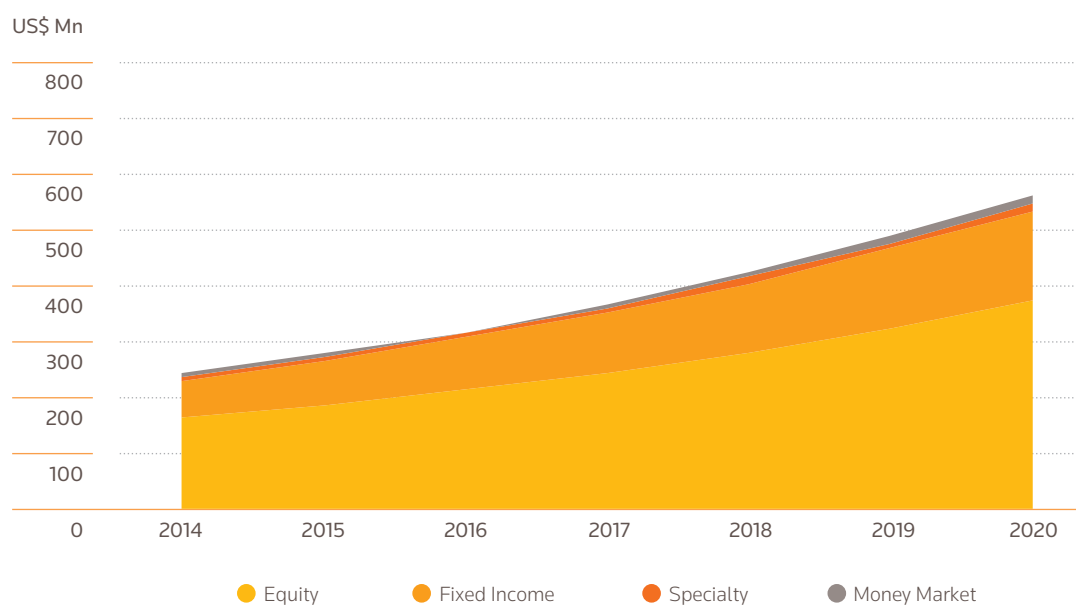
PROJECTIONS FOR CANADA'S ISLAMIC MUTUAL FUND MARKET BY 2020 (BASE CASE)



Source: Thomson Reuters IFG forecast.

Note: Actual data for 2014 is presented from Thomson Reuters Lipper and fund managers websites.

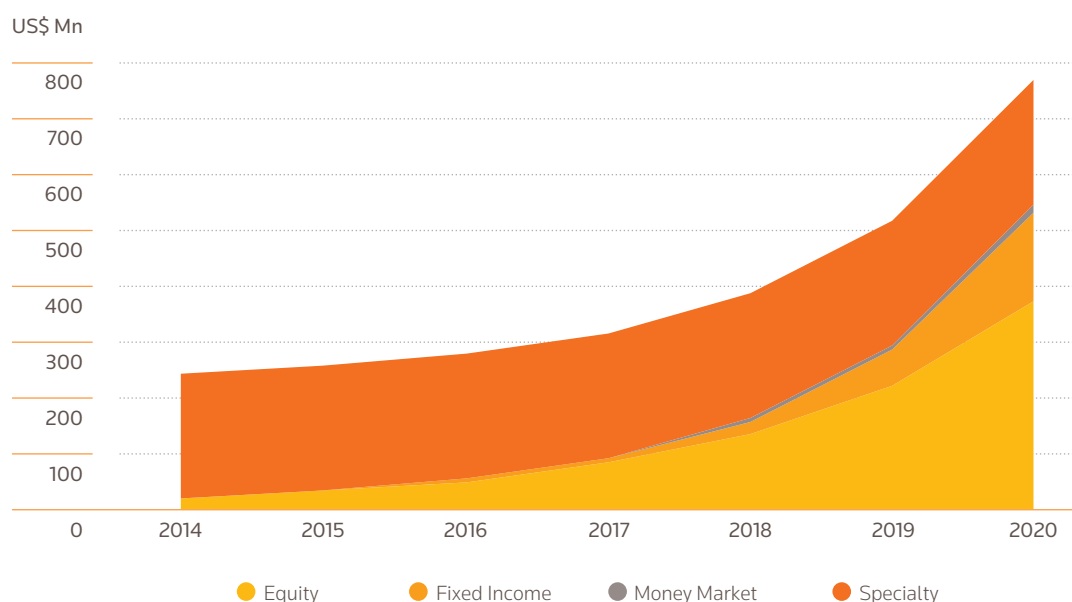
PROJECTIONS FOR CANADA'S ISLAMIC MUTUAL FUND MARKET BY 2020 BY ASSET CLASS



Source: Thomson Reuters IFG forecast.

Note: The projection for asset class split for 2014 is a proforma estimate based on the asset class breakdown of all Canadian mutual funds.

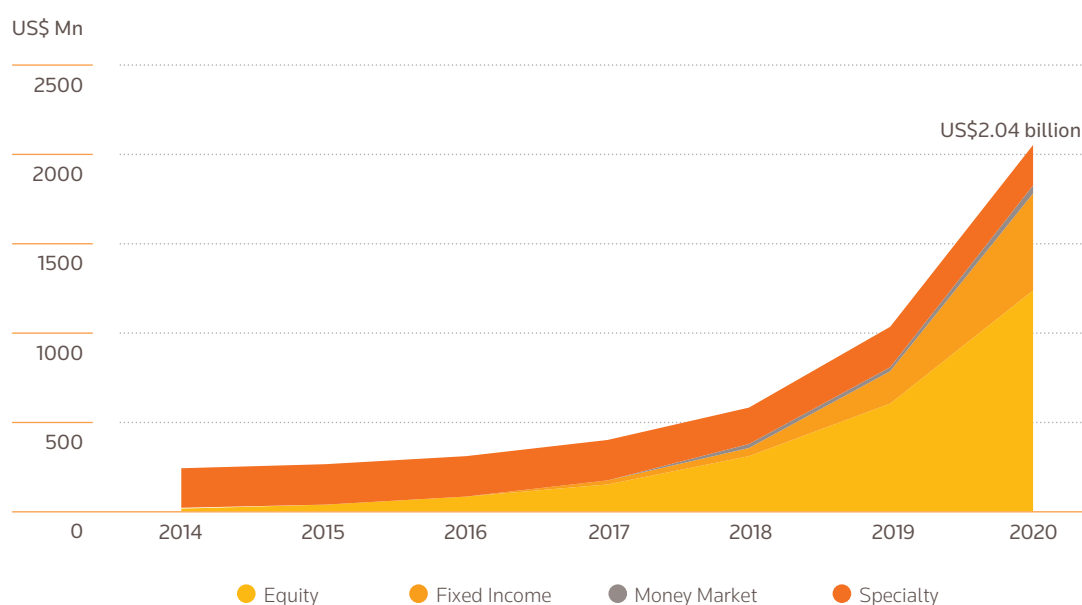
ASSET CLASS GROWTH COMPARED WITH TODAY'S SPLIT



Source: Thomson Reuters IFG forecast.

Note: The 2014 data are based on the actual asset class split which is assumed to converge to the overall universe of Canadian mutual funds by 2020, excluding the specialty fund category which is assumed to remain constant at the actual 2014 AUM of existing bullion funds.

PROJECTIONS FOR CANADA'S ISLAMIC MUTUAL FUND MARKET BY 2020 (WITH NON-MUSLIM TAKE-UP)



Source: Thomson Reuters IFG forecast.

Note: The 2014 data are based on the actual asset class split which is assumed to converge to the overall universe of Canadian mutual funds by 2020, excluding the specialty fund category which is assumed to remain constant at the actual 2014 AUM of existing bullion funds.



MOHAMMED AL-HADI

Regional Director — North America, Alawwal Capital

MOHAMMED has over 15 years of hands-on experience in corporate finance and funds management in addition to proven track record of business development achievements. He is a board member on several equity and real estate funds. His expertise is in developing business strategy, fund raising, product development, business evaluation and resource management. Mohammed holds a Bachelor's degree in Industrial Management from King Fahd University of Petroleum and Minerals, Dhahran, Saudi Arabia.

What is Canada's greatest advantage relative to other countries (UK, Luxembourg, U.S.) seeking foreign investment and developing an Islamic finance proposition?

There are several advantages here, most important being:

- The size of the Muslim community in Canada is among the largest in the world. Also, the economic condition of Muslim households in Canada is in a better position when compared with peers in other Western countries although it is still underserved when it comes to Shariah-compliant financing tools and/or investment products.
- The overall economy, especially the banking sector in Canada, is more consistent compared to other developed countries.
- The cost of doing business in Canada is still within acceptable ranges.

Do you think Canada can thrive as both a market where domestic retail and institutional investors support a domestic fund management business or is it primarily a market that gets the most benefit from receiving

Shariah-compliant investment from places like Saudi Arabia that have bigger pools of investable wealth?

Well, this is a complex question. When attracting retail and some HNWI's, it is very essential to have a domestic operation. It is a regulatory requirement, but it also gives more confidence to investors, especially retail, and facilitate for better customer services as well. This is true either if it is for Shariah or conventional, in Canada and/or elsewhere. Hence, with an estimated size of immediate investable wealth for Shariah-compliant investments of more than US\$7.5 billion (according to our recent market study) we believe that servicing the local Canadian market by providing Shariah-compliant investment tools to domestic retail, HNWI's and institutional investors through a domestic fund management operation should be the first priority.

On the other hand, Canada can still thrive as a market that receives foreign investments. Canada is a developed country that is full of natural and human resources. Thus, with such a young and diverse demography, a lot of venture opportunities always come to the surface. Therefore, for Saudi

investors looking for geographic diversification of their portfolios in a relatively less correlated territory, Canada could be on the top of the list, especially in sectors like real estate, healthcare services, and technology. Hence, we, at Alawwal Capital, look to have an affiliated operation unit in Canada as a competitive edge that allows us to be in direct contact with the growing investment opportunities in the Canadian market and to be able to make them available to our network of Saudi and GCC investors.

What are the target markets for inbound investment into Canada? Is it real estate? Oil & gas and other familiar industries to Saudi investors? Others?

Well, in general, sectors of primary interest are real estate, Shariah-compliant financial services, healthcare, bio-tech and pharmacy. However, opportunities in other sectors will also be considered on an opportunistic basis.

Does the beginning of a recession in Canada scare off investors or do investors see the weakness of the Canadian dollar as an opportunity to get exposure to a market with generally solid fundamentals?

As you said, the Canadian economy basically stands on solid fundamentals and that's what really counts. Thus, with the current recession it could be a good time to find good bargains. However, the current currency rate is not a major attraction for investment, though it looks attractive today. But, a further reduction would be rather a threat to returns at the exit time of the investment. Overall, in addition to economic fundamentals, an opportunity showing a high potential for capital gain would be of more interest to Saudi investors. However, a serious consideration for Saudi investors would be the tax environment. Thus, having in place a proper tax-efficient structure when offering to Saudi investors is the real challenge.

With yields on Canada's 10-year bonds around 1.5 percent, are there promising investments with a high enough return potential to be appealing to Gulf investors?

Investments in real estate development, venture capital and private equity could return around 15 percent per year and even more. So, yes, there are promising investments that could potentially look attractive to Saudi and Gulf investors.

Any other thoughts you would like to share that aren't covered under the questions above?

Both Canada and GCC haven't had the opportunity to develop and enjoy mutual investment relations at the level of what these countries represent in the world economy. A reason here could be the lack of adequate inter-banking and financial services that would create opportunities on both sides. Hence, we, at Alawwal Capital, hope to succeed in bridging this gap.

The U.S. and Canadian markets are relatively similar to one another although there are regulatory hurdles that prevent funds available in the U.S. from being invested in by Canadians. However, the future growth could replicate the American market if there were fund managers with sufficient resources and interest to actively offer funds nationwide wherever Canadian Muslims reside. This has been a key strategy to open the markets that received a boost from good performance which attracted many non-Muslim investors.

If such a marketing push were designed, it could support growth in Canadian Islamic mutual fund assets of at least US\$557 million by 2020, which would represent a 132 percent increase from today's level. The basis for this growth is the wide differential between the average Islamic mutual fund asset per Muslim consumer in Canada and the United States. Despite GDP per capita levels that are nearly equal between the U.S. and Canada and financial markets that are relatively similar, the average Muslim in the U.S. holds US\$352 in assets compared with US\$207 in Canada.

The figure for the U.S. does not represent the entire assets held in Islamic mutual funds because a significant value of these assets are from non-Muslim investors drawn by the performance of the funds which is not necessarily replicable. To adjust for a realistic level, we assume that 70 percent of the U.S. mutual fund assets are held by non-Muslims solely attracted by the track record that was bolstered by recent performance during the financial crisis. Some of this performance is structural — that is, determined by the fundamental characteristic of Islamic mutual funds — and our estimates therefore should be conservative.

From the current per capita level, we assume that this level will increase each year towards reaching the level in the U.S. today by 2020. To estimate the Muslim population in Canada for 2014 and 2020, we take the Pew Research Center's estimates for 2010 and 2030 and assume a smooth rise which equates to an annual growth rate of the Muslim population by 5.3 percent each year and resulting in a Muslim population of 1.6 million by 2020. Combining these two es-

timates, we project the level of Islamic mutual fund assets in 2020 at US\$557 million, an annual growth of 15 percent.

There are three reasons why this estimate could significantly underestimate the potential for Islamic mutual funds in Canada.

Non-Muslim investors and Responsible Islamic Investment

The estimated per capita asset level in Islamic mutual funds in the United States is used at US\$352 per Muslim American. This is significantly lower than the raw asset value divided by the Muslim population because it incorporates the 70 percent of the Islamic mutual fund assets which are estimated to be held by non-Muslim Americans. If an Islamic mutual fund were available in Canada that also incorporated some of the responsible investment methodology used by 31 percent of Canada's mutual fund managers, it would open the market much wider than it currently is where many investors view it as a niche only available to Muslims. An Islamic fund universe in Canada that attracts non-Muslims could be even larger, at US\$2.04 billion according to our estimates.

The wider UCITS market

Until recently, it was difficult to sell UCITS (Undertakings for Collective Investment in Transferable Securities) mutual funds within Canada which limits the market to just small fund managers or those with close ties with Canada's Muslim population. However, changes made in 2014 eased the regulatory process for funds to offer UCITS to Canadian institutional investors and high net worth individuals which facilitates offering products that have a global investor base in Canada.

While this will make some of the market more competitive for domestically focused fund managers it is probably necessary to allow Canada's institutions to offer cost-effective Islamic options which requires more scale than can be accomplished with domestic investors alone. If an



THE RESULT IS A RISE IN THE
GROWTH POTENTIAL FOR
ISLAMIC EQUITY MUTUAL FUNDS
OF US\$371 MILLION BY 2020.

institutional investor, like a pension fund, were to offer an Islamic alternative to their standard conventional investment option, they will need to be able to offer exposure to the full spectrum of asset classes, including fixed income, to meet their fiduciary duty and create a diversified portfolio. Because of the scale and international presence required to access *sukuk* markets to offer this fixed income alternative, the ability to access global (*sukuk*) funds will enhance the opportunity for Islamic funds to develop domestically within Canada.

Different Asset Classes

The current asset value of Canada's Islamic mutual funds is not necessarily reflective of the asset class allocation that will be desired by Canada's Muslims. The market is dominated currently by two bullion funds which have an international investor base; Canada's equity mutual fund universe is much more limited with one fund with assets of US\$18 million at the end of 2014 representing the universe. According to the Investment Funds Institute of Canada, there were US\$1.1 trillion in mutual fund assets. If the balanced funds were evenly split between equity and fixed income assets, it would imply that 60 percent of the mutual fund assets in Canada were invested in equities, 36 percent in fixed income, 2 percent in specialty funds and 2 percent in short-term investments (cash equivalents like money market mutual funds).

This asset allocation corresponds very closely to Canada's demographics and the 'Rule of 100' which says that an investor should take his age and subtract it from 100 to get the appropriate allocation to equities (the median age in Canada is 40.1 years). Canada's 'visible minority' population which includes most Canadian Muslims has a lower median age at 33.4 years and would benefit from a slightly different allocation with about two-thirds equity and one-thirds fixed income, specialty and cash. Based on this allocation, we broke down the projected Islamic mutual fund asset growth by the asset classes represented.

The result is a rise in the growth potential for Islamic equity mutual funds of US\$371 million by 2020. As described above, there is a lower opportunity for scale in Shariah-compliant fixed income funds, with an estimated US\$162 million by 2020. Money market and specialty funds have limited potential demand and if low interest rates remain around current levels, the loss to investors from investing in cash versus money markets will be small. We estimate that by 2020, investors would prefer to allocate US\$12.4 million in specialty funds and US\$11.3 million to money market funds. By taking into account what consumers will demand based on their investment needs, it results in a total of US\$515 million in new demand (US\$353 million for equity funds and US\$162 million in fixed income funds).

Appealing to a wider audience



To make the difference clearer between what the potential market is for just Muslim investors versus the potential market if non-Muslims were attracted to Islamic funds (for example by their inclusion of ESG analysis alongside the Shariah screening), we start with the baseline estimate of US\$557 million by 2020 which, again, is based on the level of assets rising from US\$207 per Muslim Canadian to US\$352 per Muslim Canadian by 2020. If, however, the non-Muslim take-up of Canadian Islamic mutual

funds matched half of what we estimate (which has the effect of returning Islamic mutual funds back five years, to 2009), it would result in an additional US\$235 million in total assets.

Using the asset class approach described above to determine more precisely the potential demand separated by asset class (and account for the large total asset base represented by specialty bullion funds today), the total increase in demand from current levels would be US\$889 million, split into US\$619 million in equity funds and US\$270 million in fixed income funds.



Islamic Banking in Canada



The experience to date with Islamic banking in Canada has been limited although the Canada Mortgage and Housing Corporation (CMHC), the country's national housing agency, commissioned a study in 2010 which found no legal obstacles for Islamic mortgage products. The Canadian home finance market is primarily dominated by federally regulated banks that account for 60 percent of the mortgage market and are consulted by two-thirds of all mortgage seekers in Canada. However, the CMHC report notes that "none of [the banks] have actually offered Shari'a compliant housing finance [...] even on a pilot-project basis."²⁷

Instead, the home finance market has been primarily conducted on the basis of regulated housing cooperatives that have formed in several provinces. These cooperatives allow prospective home buyers to get home finance but first they must become members of the cooperative and buy shares in the cooperative which are used to finance members who joined before them. The waiting period and down payment equivalent for these cooperatives varies but they usually require at least a 20 percent down payment (in some cases up to 50 percent) and entailed a waiting period of six months at a minimum.

The housing cooperatives, the oldest of which have been in operation for over 30 years (e.g., Ansar Co-operative Housing Corporation) provide a valuable but inadequate source of Shariah-compliant home financing in Canada. They rely on member's contributions to finance home purchases and often limit the value they will finance regardless of the down payment. They do not provide a solution that scales well to provide for the community's need for finance. With over 1.3 million Canadian Muslims today, rising to close to 1.6 million by 2020 according to the rate of growth implied by the Pew Research Center's estimates, the housing cooperatives are unlikely

to be able to scale fast enough to meet all of the demand.²⁸

Other institutions have cropped up to meet the demand in a more sustainable way including the Assiniboine Credit Union in Manitoba which has offered a diminishing *musharaka* product since 2010. Assiniboine had US\$3.8 billion in assets at the end of 2014 but does not break out its Islamic mortgage business separately.

A challenge for non-bank financial institutions offering Islamic mortgages, like the problem faced by the cooperatives, is the access to financing. However, an Islamic bank regulated by the Office of the Superintendent of Financial Institutions will have access to customer investments/deposits that will provide a stable source of funding. Most mortgages in Canada are originated and retained by institutions whose goal is to maintain a long-term, broad relationship with their customers, unlike the United States, which has contributed to Canada's position as the world's safest banking system according to the World Economic Forum.²⁹

A future Islamic bank in Canada would rely primarily on deposits to finance its portfolio of home loans. A new Islamic bank in Canada would not be issuing loans with loan-to-value in excess of 80 percent which would be exempt from requirements to have mortgage insurance (CMHC or private insurance) avoiding potential Shariah questions that would arise.

Another question that will inevitably arise with banking is whether there is sufficient demand for Islamic mortgage products. But, with the population rising and, in general, much more concentrated in one geographical area (nearly half of Canada's Muslims live in the Greater Toronto Area) than the United States, there is a market for Shariah-compliant home finance and one that can be estimated using reasonably conservative estimates to be large enough to offset any up-front costs.

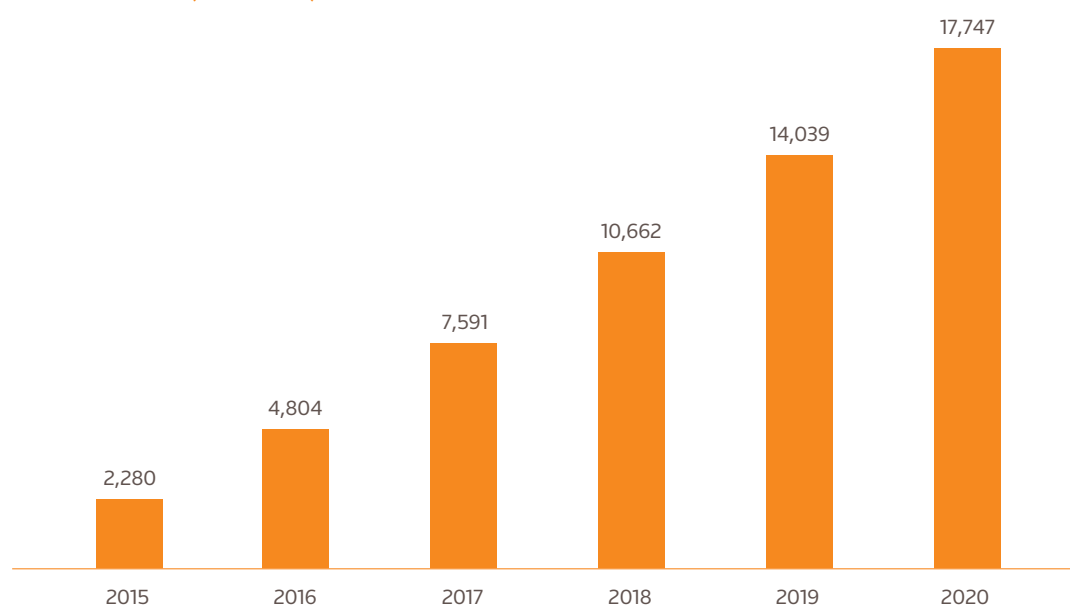
To estimate the potential size of the Islamic home finance market (which would make up the bulk of the Islamic banking market), we use the estimated Muslim population calculated by extrapolating annual estimates for 2015 through 2025 population numbers from the Pew Research Center's 2010 and 2030 projections. To turn the population into the home buying population unit, we assume that the household size of the Muslim population is equal to the population as a whole. Based on this assumption that works out to about 376,277 Muslim households in 2011.

The average sales price in March 2015 (during the peak Spring season when volumes are likely to be highest) was C\$439,144.³⁰ We use this value for the estimates because it is likely to understate the average sales price for the Muslim population nationwide since such a high proportion reside in the GTA where home prices are higher. This conservative approach should also make the estimates resilient should home prices decline modestly as Canada's housing market cools down after years of asset price growth.

Not all Canadian Muslims will buy a home, of course. Nor will all go for Islamic home finance products. To reach a reasonably conservative estimate, we assume that all home purchases will be made with a 20 percent down payment (meaning the asset created on the bank balance sheet will be 80 percent of the sales price). We also assume that Muslims will not reach a higher level of homeownership than the population as a whole. According to 2011 census data, this level is 69 percent of the 13.3 million households in Canada.

The hardest part of this exercise is estimating the Muslim population share that will only use Islamic finance versus those who will consider it and those who specifically will not use an Islamic finance product. A rule of thumb that is used in the industry is that about one-third of the Muslim population will use Islamic finance if it is available and this population is not very price sensitive. Another 50-60 percent of Muslims will consider Islamic finance if it is cost competitive.³¹ The remainder (one-fifteenth to one-sixth) will never use Islamic finance products. To be conservative, we estimate that it will reach 25

PROJECTED POTENTIAL ISLAMIC HOME FINANCE ASSETS IN CANADA (US\$ Mn)



Source: Thomson Reuters IFG forecast.



WE ESTIMATE THAT THE FIRST YEAR
WOULD SEE US\$2.3 BILLION IN
ISLAMIC MORTGAGE ORIGINATIONS
WITH OUTSTANDING FINANCING
RISING TO REACH US\$17.7 BILLION
BY 2020.

percent of Canadian Muslims by 2025 with an even increase from zero to this level over the intervening 10 years.

The outcome of this exercise is a modest market opportunity for Canada's large banks. Without making allowances for the initial boost that the launch of an Islamic finance product from a major Canadian bank would produce, we estimate that the first year would see US\$2.3 billion in Islamic mortgage originations with outstanding financing rising to reach US\$17.7 billion by 2020. However, there are many smaller banks, trust companies and credit unions that could thrive with a sound portfolio of US\$2.3 billion in Islamic mortgages. Over time, a new institution would develop with underwriting and risk

management capabilities to develop commercial lending and leasing businesses that have the potential to significantly improve returns on investment for investors in a new Canadian domestic Islamic bank.

Islamic banking in Western markets has been primarily driven in two areas: deposit products (a safe and Shariah-compliant place for consumers to bank) and home finance (a large purchase which most people are not able to do without financing). There is absolutely no reason to doubt that a well-regulated Islamic banking institution can find a home in Canada providing core banking services to Muslims and other Canadians attracted to the principles underlying Islamic finance.

Corporate Funding / Private Equity



In addition to the two prior sections which have focused on the domestic market for investment products and for home finance, there is a potentially much larger and more easily accessible market to use Islamic finance as a mechanism to attract funding to Canada. One way that would be the most rapid would be to encourage investment in Canada through the Canadian equity markets. However, the Islamic fund market is small, and mostly domestically focused in the countries where funds are domiciled (principally Malaysia and the MENA region). Together these two regions account for 39.4 percent and 45.6 percent of assets in Islamic funds; only 5.8 percent of Islamic funds have global mandates.³²

This leaves three principal channels for investment in Canada: **private investment by HNWI and family offices, Islamic trade finance** and **corporate debt issuance**.

The first area is likely to already be occurring but flows are difficult to measure (separating investments from regions where Muslim HNWI

represent a large share of foreign investment and where these investments are likely to be structured in a Shariah-compliant method). In most cases, these investments are directed into real estate which does not provide a regular source of funding to Canada's corporates.

An area that has recently received increased attention in Islamic finance is trade finance — a new CEO was recently appointed to the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) and Sheikh Hamdan bin Mohammed, Crown Prince of Dubai, suggested that the Emirate would study establishing an Islamic export-import bank.³³ Yet, this is an area where Canada already has some experience through Export Development Canada which, in 2014, provided a credit guarantee for a US\$78 million lease by Ethiopian Airlines for four Bombardier airplanes which were being leased by Bahrain-based Ibdaar Bank.³⁴ Following the transaction by EDC, UK Export Finance, the export credit agency for the United Kingdom, provided a guarantee for a US\$917 million *sukuk* issued by Emirates Airlines used to finance the purchase of Airbus planes.

SIZE AND GROWTH POTENTIAL OF THE ISLAMIC ECONOMY (EX-ISLAMIC FINANCE)

US\$ Bn	2013	2019	CAGR
Halal food	1,128	1,585	12%
Travel	142	233	9%
Media & Recreation	179	247	8%
Fashion	230	327	10%
Pharma & Cosmetics	129	186	6%

Source: TR State of the Global Islamic Economy report 2014-15.

Besides export credit agencies, there is also an opportunity for banks, both in Canada and internationally to finance trade between Canadian exporters and importers in OIC countries. These markets are fast growing and trade finance could be an area that helps Canada's economy and benefits from the weakening of the Canadian dollar. In 2014, the value of exports from Canada to the OIC markets reached US\$11 billion, almost 90 percent of which goes to the top 15 markets.

As described elsewhere in this report, a significant component of these exports are agricultural goods which offers a way to use Canada's Islamic finance growth to support its position within the Islamic economy. For example, trade finance developed for agricultural producers could also be used to fill the trade finance needs for a company like Viva Canada which manufactures halal

generic drugs to Muslim markets in Asia from a base in Brunei. Canada ranked 41st overall in the Thomson Reuters *State of the Global Islamic Economy 2015-16* rankings so adding trade finance to build its position in halal food would help it expand further in other Islamic economy sectors, including where it is high in the rankings like media & recreation where it ranks 10th. Its position in the overall Islamic economy rankings puts it ahead of Western peers like Germany (47th) and the U.S. (48th).

The final channel by which investments could be directed to finance Canadian companies is either private equity transactions or through *sukuk* issuance by Canada's corporates. The latter channel is likely to be the most significant because they are likely to be made by Islamic banks, which hold approximately three-quarters of total Islamic finance assets, and are largely restricted from equity investments by capital rules. And while the issuance volumes have fallen in 2015, there is a long-term source of demand for these instru-

VALUE OF IMPORTS FROM 15 LARGEST OIC-MEMBER IMPORTERS OF CANADIAN PRODUCTS, 2014

Country	Value (US\$ Mn)
Indonesia	1,834
United Arab Emirates	1,587
Saudi Arabia	1,126
Turkey	965
Malaysia	718
Bangladesh	640
Nigeria	481
Egypt	420
Algeria	420
Morocco	360
Pakistan	351
Iraq	254
Sudan (North + South)	211
Qatar	172
Kuwait	129

Source: ITC Trade Map.

BOND ISSUANCE BY SECTOR – TOP 50 CANADIAN CORPORATE ISSUERS

	Top 50 % of total issuance	% of Top 50 issuers
Banking	36%	47%
Non-bank financial institutions	7%	10%
Telecom	7%	9%
Gas Distribution	6%	7%
Electric Utility	5%	6%
Transportation	4%	6%
Life/Health Insurance	4%	5%
Real Estate	2%	2%
Media	2%	2%
Food & Drug	1%	1%
Retail	1%	1%
Auto	1%	1%
Services	1%	1%
Beverage (Alcoholic)	0%	1%

Source: Thomson Reuters IFG analysis of Figure 23 in Patel, Tarun and Kevin Yang. 2015. The Canadian Fixed Income Market 2014. Ontario Securities



THE DIVERSIFICATION WOULD PROVIDE
A BENEFIT FOR ISSUERS, PARTICULARLY
THOSE MULTINATIONALS WITH OPERATIONS
IN MUSLIM-MAJORITY COUNTRIES
WHO WOULD GAIN VISIBILITY FROM
ISSUING SUKUK.

ments from the growing Islamic finance industry, and particularly for high-credit quality issuers.

Canada's corporate issuance within the country accounts for US\$468 billion in 2014, or 22 percent of the total domestic issuance volumes. Issuance by Canadian corporates outside of Canada is US\$493 billion, a similar amount but 76 percent of total issuance outside of Canada.³⁵ The sovereign or sub-sovereign issuance by Canada's national or provincial governments are much more focused on the domestic market although US\$151 billion is issued outside of Canada.³⁶ *Sukuk* markets are smaller; total outstanding *sukuk* as of year-end 2013 was US\$280 billion.³⁷

Not all of the market would be suitable for *sukuk* issuance. While some conventional banks like Goldman Sachs have issued *sukuk*, it is uncommon; there would be limited demand for issuers whose underlying business is not Shariah-compliant. Based on the top 50 bond issuers in the Canadian market from 2013, which account for 77 percent of the total bond market index, only about one-third (36 percent) of bonds come from issuers who are Shariah-compliant in their primary business activities. The most significant exclusions are for banks (47 percent), non-bank

financial institutions (10 percent) and insurance companies (5 percent).³⁸

Excluding companies which do not have significant tangible assets to be used in structuring *sukuk* would still leave an approximate US\$175 billion in outstanding issuance which could be refinanced using *sukuk*. The diversification would provide a benefit for issuers, particularly those multinationals with operations in Muslim-majority countries who would gain visibility from issuing *sukuk*. Issuance by Canadian issuers might find more competition for their offering than in the conventional markets because Canadian *sukuk* are likely to be judged as good credit risks and there is a significant scarcity for this type of paper (the UK sovereign *sukuk* for £200 million attracted more than £2 billion in bids and priced flat with conventional gilts).

The most common structure used by new non-financial issuers in recent years has been the *sukuk al-ijara*, which is similar to a sale-lease-back transaction with an SPV used to act as trustee on behalf of investors. The difficulty this has created in many jurisdictions is that it often creates additional tax liability which could make it uneconomical compared to a conventional

bond. The tax liability arises because there are two transfers of an asset in the transaction (once to the SPV when the *sukuk* is issued and again when the asset is purchased to fund redemption of *sukuk* certificates).³⁹

Another tax issue that could arise is whether the investment by foreign investors would be subject to withholding, which they would be if they received rental income in Canada but not if they received interest income from a conventional bond. This withholding would be at a 25 percent rate on any periodic distributions (equivalent to interest payments) which would severely affect *sukuk* which are already likely to carry relatively low yields.⁴⁰ Many countries including the UK and Luxembourg have changed their tax laws to put the two transactions on equal footing from a tax position to make the market more appealing to issuers considering *sukuk* versus conventional bonds.

In the short term, until there is a strong enough flow of transactional activity, issuers and investors can reasonably expect to rely upon advance rulings from Revenue Canada, a well-established practice where new structures and products first enter the Canadian market. There is every reason to believe that if there is evidence of significant new activity for which rulings would be required, that the tax policy officials within the Government of Canada would be prepared to work with issuers, financial institutions, lawyers, accountants and other professional advisers to clarify

regulatory requirements to achieve the transparent level playing field that has been achieved in jurisdictions such as the UK.

In the last several months a number of new players have entered the Canadian market in different ways. Canaccord Genuity Group Inc., Canada's largest independent investment dealer, opened an office in the Dubai International Financial Center, with objectives that include helping Canadian issuers access the global Islamic capital markets (see our interview with the Managing Director of that office on page 38), and a new Canadian financial advisory firm, Avicenna Capital Limited, was formed in Toronto for the purpose of developing new Islamic financial products for Canadian corporate investors.

In addition, Al Awwal Capital from Jeddah, Saudi Arabia, is currently exploring establishment options in Canada to provide investment advice and products for Saudi investors and the local Muslim community in areas such as Canadian real estate, private equity, and health care projects (see the interview on page 44). These private initiatives are complemented by a number of recent developments. First, the Governments of Canada and the UAE have been involved in the creation of a Canada-UAE Business Council that will include a focus on the Islamic economy. Earlier this year a Canada-Saudi Business Council was incorporated that has plans to contribute to the growth of trade and investment flows between the two countries.

Islamic Economy Sectors



beyond the Islamic finance sector, there is a wider market for products that are structurally impacted by Islamic principles and values — the Islamic economy.

The size of this market is estimated to grow to US\$3.75 trillion globally by 2020, according to the latest State of the Global Islamic Economy Report 2015/16.⁴¹ Although the Muslim popula-

tion in Canada is relatively small, that does not mean the Islamic economy cannot be significant for Canadian business.

Large chunks of the spending that drive today's Islamic economy in some areas (fashion, cosmetics) are driven by developed markets, and companies that can address this market today will be in a good position to serve the rising demand in the OIC markets where the bulk of the



> The Saint Joseph Oratory in Montreal, Canada is a National Historic Site of Canada.

demand will come from in the future. For example, Muslims in Western Europe and North America spent US\$22 billion on clothing and fashion, making them the second largest Muslim market after Turkey.⁴² In just Canada, Muslims spent US\$0.6 billion on cosmetics and US\$2.9 billion on media and recreation.⁴³

In addition, as mentioned above in regards to trade finance, the growth in OIC markets can have a supportive impact on companies that export to these markets. One factor that makes these markets accessible are the standards regarding halal certification. Some of the biggest success comes from markets where the government takes a proactive approach towards the labeling of halal products.⁴⁴

Canada is the world's fifth-largest exporter, accounting for 3.5 percent of the total value of world agriculture and agri-food exports.⁴⁵ Canadian agri-food exports to key halal markets exceeded US\$3.2 billion in 2010.⁴⁶ More recent estimates are not available but the grain exports which make up a significant share of the food exports to key halal markets rose 50 percent between 2010 and 2014.

Muslim food expenditure globally represented US\$1.12 trillion as of 2014 and not all of that spending occurs in Muslim-majority countries; Muslims in the U.S. which is Canada's largest food export market, as well as Muslims in other Western countries would further boost the potential market for halal food exports.

Canada recently amended the Food & Drug Regulations (effective in April 2016) to introduce rules on labelling, packaging and advertising halal food to require that they state the certification body or individual who certified the food. This will support Canada's exports to other markets because all producers will show who has certified their products. This transparency could help grow agricultural/food exports from Canada globally to be accepted within the Muslim world where Canada is already represented by Maple

Lodge Farms which exports halal food to more than 50 countries.⁴⁷

Most of the areas of the Islamic economy outside of food (fashion, cosmetics & pharmaceuticals, travel and media & recreation) are in the early stages of their development and many of the companies (particularly in fashion, cosmetics and media) are (or began as) home-based businesses. Even the ones which have grown larger have done so as micro- or small-businesses with few employees who have relied on using the power of social media to gain exposure. A lot of the "business" of the Islamic economy is not being addressed currently either in Muslim-majority markets or in Western markets.

The combination of large addressable markets coupled with relatively early-stage businesses calls for the support of early-stage and growth capital from angel, venture capital and private equity investors. These investors would have the chance to provide the mentorship, business skills and connections that will help to propel these businesses from their current level into leadership roles in the global Islamic economy. The seeds have been planted with the existing businesses beginning to define and demonstrate that there is a market for Islamic fashion, cosmetics, and media. In other areas, there is a well-defined market — many Muslim travelers are looking for travel accommodation that meets their needs — but the sources of capital to create a family (halal) hotel brand has not been not established.⁴⁸

Both the capital constrained (and intensive) businesses like hotels, as well as the SMEs serving other areas of the Islamic economy, are growth areas that could become huge opportunities for investors with the ability to see the market potential and find the businesses that will serve the market. It is an area that requires, for most businesses, a smaller level of capital than the other areas discussed in this report like home finance or *sukuk*, but offers even greater global potential.



GLOBAL ISLAMIC ECONOMY

\$1.8 trillion of food & lifestyle sector expenditure (2014) projected to reach \$2.6 trillion (2020)

\$1.35 trillion in Islamic banking assets (2014) projected to reach \$2.6 trillion (2020)



Halal Food



Islamic Finance



Travel



Fashion



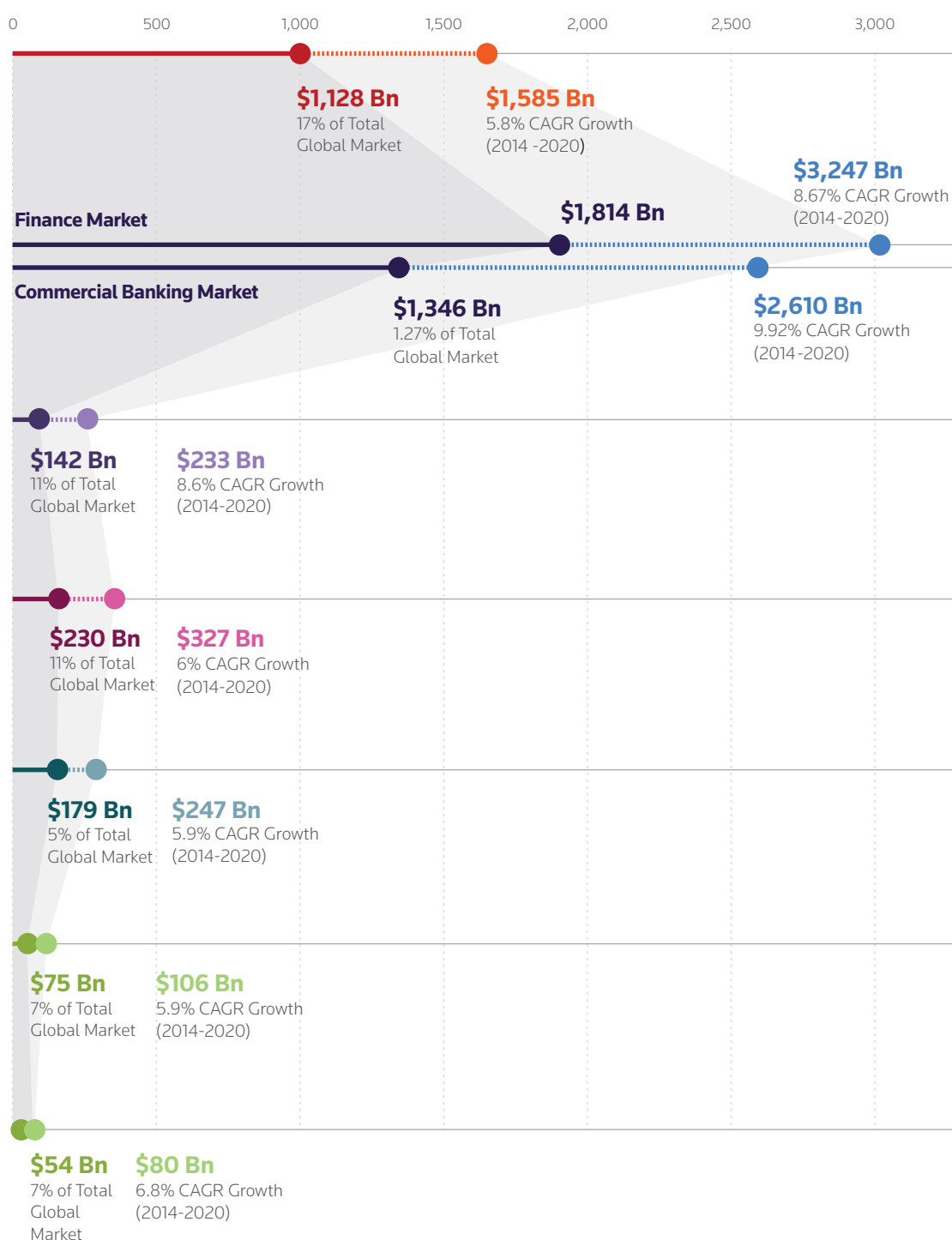
Media & Recreation



Pharmaceuticals



Cosmetics



References:



Existing Muslim Market* (2014, USD)



Potential Market Size (2020, USD)

TOP 10 Countries

Global Islamic Economy Indicator



Malaysia

- | | | |
|------------------------|------------|--------------|
| 2 United Arab Emirates | 5 Pakistan | 8 Qatar |
| 3 Bahrain | 6 Oman | 9 Jordan |
| 4 Saudi Arabia | 7 Kuwait | 10 Indonesia |



Total Global Market
(2014, USD)
\$6,755 Bn

TOP 5 Countries for the Halal Food Indicator

- | | | | | |
|------------|------------|------------------------|-------------|--------|
| 1 Malaysia | 2 Pakistan | 3 United Arab Emirates | 4 Australia | 5 Oman |
|------------|------------|------------------------|-------------|--------|



Global Banking Asset
(2014, USD)
\$105.7 Tn

TOP 5 Countries for the Islamic Finance Indicator

- | | | | | |
|------------|-----------|------------------------|----------------|--------|
| 1 Malaysia | 2 Bahrain | 3 United Arab Emirates | 4 Saudi Arabia | 5 Oman |
|------------|-----------|------------------------|----------------|--------|



Total Global Market
(2014, USD)
\$1,304 Bn

TOP 5 Countries for the Halal Travel Indicator

- | | | | | |
|------------|------------------------|-------------|------------|----------|
| 1 Malaysia | 2 United Arab Emirates | 3 Singapore | 4 Thailand | 5 Jordan |
|------------|------------------------|-------------|------------|----------|



Total Global Market
(2014, USD)
\$2,119 Bn

TOP 5 Countries for the Modest Fashion Indicator

- | | | | | |
|---------|------------------------|---------|----------------|-------------|
| 1 China | 2 United Arab Emirates | 3 Italy | 4 Burkina Faso | 5 Sri Lanka |
|---------|------------------------|---------|----------------|-------------|



Total Global Market
(2014, USD)
\$3,543 Bn

TOP 5 Countries for the Halal Media & Recreation Indicator

- | | | | | |
|-------------|------------------------|-----------|------------------|----------|
| 1 Singapore | 2 United Arab Emirates | 3 Lebanon | 4 United Kingdom | 5 France |
|-------------|------------------------|-----------|------------------|----------|



Total Global Market
(2014, USD)
\$1,111 Bn

TOP 5 Countries for the Halal Pharma & Cosmetics Indicator

- | | | | | |
|-------------|---------|------------|------------|----------|
| 1 Singapore | 2 Egypt | 3 Malaysia | 4 Pakistan | 5 Jordan |
|-------------|---------|------------|------------|----------|



Total Global Market
(2014, USD)
\$742 Bn

TOP 5 Countries for the Halal Pharma & Cosmetics Indicator

- | | | | | |
|-------------|---------|------------|------------|----------|
| 1 Singapore | 2 Egypt | 3 Malaysia | 4 Pakistan | 5 Jordan |
|-------------|---------|------------|------------|----------|

All estimates by DinarStandard Research & Advisory as follows (Islamic Finance current estimates ThomsonReuters 2014 Data). The GIE Indicator model at: <http://www.zawya.com/GIEI/>. Projections were determined by regressing historical annual growth of the relevant industry metrics on GDP growth for each country, showing high correlation. The regression determined a line of best fit that, using IMF GDP forecasts, projected industry growth. IMF Outlook Oct 2014 Database for baseline projections. DinarStandard Muslim market estimates & analysis.

Positioning Canada as an Islamic Finance Hub



CHAPTER 3

As this report has covered, the primary competition within North America for Islamic finance comes from the United States. Although it is a much larger market overall, proportionately it has a smaller Muslim population compared to Canada. Furthermore, while Canada's Muslims live coast-to-coast from Vancouver and Victoria to Nova Scotia and Newfoundland, a large share — nearly 50 percent — live in the Greater Toronto area which is also where a significant share of Canada's financial system is based.



As this report has covered, the primary competition within North America for Islamic finance comes from the United States. Although it is a much larger market overall, proportionately it has a smaller Muslim population compared to Canada. Furthermore, while Canada's Muslims live coast-to-coast from Vancouver and Victoria to Nova Scotia and Newfoundland, a large share — nearly 50 percent — live in the Greater Toronto area which is also where a significant share of Canada's financial system is based.

These advantages are coupled with an outward looking orientation that is more favorable to Islamic finance than in the United States, both in terms of regulatory aspects like the ability of UCITS to reach both the Canadian and global market and even seemingly small things like official counts to accurately measure Canada's Muslim population (which is not done by the U.S. Census following a 1976 law that barred the agency from asking about religion).⁴⁹

In other areas, there has been pushback against U.S. insurer AIG, over its tiny *takaful* business. After AIG received a huge bailout during the financial crisis, a lawsuit was filed by a plaintiff represented by David Yerushalmi, arguing that the bailout promoted religious doctrine as a result of AIG's *takaful* business. The lawsuit was found lacking evidence but despite the win, there remains a perception that Islamic finance is not welcomed by the United States.⁵⁰

With the gap that exists in North America, Toronto has the potential to become the financial center for Islamic finance in North America just as it has established itself as the North American trading hub for the Chinese currency, the Renminbi (RMB). Although the economy and financial markets are smaller than its southern neighbor, the regulatory system is more facilitative with more regulation occurring at the national level, rather than being covered by many provincial laws. The U.S. regulations feature a patchwork of overlapping bodies that regulate banking, insurance and securities

^
Flying Canadian geese over Bow river valley with the golf courses against Rocky Mountains. Banff National Park, Alberta, Canada.

that involve both Federal and State regulators in many cases.

In contrast, Canada's regulations are more centralized with the Bank of Canada, the Office of the Superintendent of Financial Institutions (OSFI) and the Canadian Deposit Insurance Corporation (CDIC) regulating all banks while provincial agencies regulate credit unions and caisses populaires and securities firms.⁵¹ For securities activities, by market capitalization, the Toronto Stock Exchange (TSX) is 8th largest in the world (US\$2.2 trillion). TSX is first in the world in listed mining, oil and gas and clean tech companies, and largest in North America and second largest in the world in terms of companies listed (including 347 International listings). In 2009, Standard & Poor's launched the S&P/TSX 60 Shariah Index which include Shariah compliant equities representing 73% of Canada's equity market capitalization.⁵²

The centralization of the regulation of banks is good in terms of doing business (lowering the costs of complying with many different regulators).

Further, the Canadian government has indicated interest in promoting the entry of small banks and is streamlining the process so that applications can start without the promoters incurring the same costs as they would for a full application. Jeffrey Graham, a Partner at Borden Ladner Gervais LLP, and head of the firm's financial services regulatory and Islamic finance practices, notes that this opens an opportunity for an Islamic bank in Canada.⁵³ If an Islamic bank were to be established successfully through this process, it would allow the new Islamic bank to serve the large populations that exist in Ontario, British Columbia and Quebec without having separate, possibly contradictory, regulation from provincial regulators the way it might occur for an interstate bank in the U.S.

Facilitating Islamic Finance in Canada — Regulatory Requirements

The biggest challenge to domestic development of Islamic banking is the difficulty of new insti-

tutions getting through the application process to receive a banking license. However, notwithstanding the recent weakness in Canada's economy (due in large part to lower commodity prices), the banking system is notable for its stability throughout the financial crisis.

The Islamic banking sector has succeeded with relatively few banks holding more than US\$10 billion in assets and as a result, a relatively small Canadian Islamic bank has good prospects for success, given the lack of interest in Islamic banking at this time among the major Canadian banks. A new entity should be able to outsource significant systems related requirements and tap into the services provided to smaller institutions. The ready availability of internet and remote access banking platforms could be a considerable advantage to a new Islamic banking institution which would establish a limited branch network in the relatively few urban areas with high concentrations of Muslim Canadians.

Encouraging a conventional bank (or more credit unions) to offer Islamic finance products could be a faster way to jumpstart Islamic banking in Canada, however while the market is adequate to support a smaller financial institution it is not likely to justify the investment in systems, products, training and compliance for one of Canada's larger conventional banks.

There may be some taxation related issues that will need to be addressed for a significant Canadian Islamic banking sector to develop and flourish, as would be true in any Western jurisdiction where interest payments are the most common form of payment being made to financial institutions or by financial institutions to clients.

A Discussion Paper from KPMG which followed the release of a paper released by the TFSA Islamic Finance Working Group outlined the taxation issues and categorized them into two groups: GST/HST and income tax and withholding.⁵⁴ While the issues raised require further consideration, it should be noted that Islamic home financing activities have been undertaken in Canada for more than 30 years successfully with full knowledge and cooperation from Ca-

nadian governmental authorities. Thus, there is no reason to believe that a more substantial Islamic banking presence would have any greater difficulty working cooperatively with regulatory authorities than is currently the case to ensure a level playing field for financial products and services structured in either a conventional form or in a form that complies with the requirements of Islamic commercial law.

Facilitating Islamic Finance in Canada — Ecosystem and Awareness Building

Canada's Muslims are in general aware of Islamic finance and its role in financial inclusion for many Muslims who could access the financial system but for their belief that conventional finance violates Islamic principles. This presumption has received challenge in Canada from some groups who believe that the existing structure of Islamic finance is a more costly form of conventional finance designed to use its Islamic label to attract consumers who would be better served, according to the proponents of this view.

Most Muslims, however, are not naïve about the challenges facing Islamic finance or the areas where its practice falls short of the aspirational vision it has for facilitating economic development through risk-sharing rather than risk-shifting, and refocusing a bloated financial system back to its role as a facilitator of the 'real' (i.e. non-financial) economy. Education plays a key role in building awareness of Islamic finance as well as improving its practice. The University of Toronto's Rotman School (see our interview with Walid Hejazi) has been a leader although it is not the only university in Canada offering Islamic finance programs which will help greatly to build the domestic ecosystem.

Recognizing these shortfalls and the fact that only a fraction (usually estimated to be around 30 percent) of Muslims will only use Islamic finance products do not invalidate efforts to develop Islamic finance. Instead, it increases the importance of developing the human capital base to support Islamic finance in its current form and to develop the visionaries who can

find ways to move it closer to its principles. This means training lawyers, accountants and Shariah scholars to operate Islamic financial institutions, and reinforcing their knowledge of the activities occurring around the world to improve upon Islamic finance and have frank discussions among themselves, with other participants in the global Islamic finance sector and with regulators to improve the way that Islamic finance operates.

For example, before 2013, the idea that profit sharing investment accounts (PSIAs) should be designed to deliver a different risk-reward profile was a good theoretical argument for making Islamic banks more resilient by truly making depositors bear the additional risk that was required to generate potentially higher returns. However, starting on July 1, 2015, under the new Islamic Financial Services Act passed in 2013, Malaysian Islamic banks were required to separate their deposits between those that are principal guaranteed (and insured with the deposit insurance fund PIDM) and investment accounts which are able to earn higher returns but which are not insured deposits.^{55,56}

With the experience just beginning in Malaysia to see how willing consumers will be to risk the principal of their deposits in order to gain potentially higher returns, there is an opportunity for others to stay informed with developments. Other countries like Canada can position themselves as leaders in industry development if they bring together their own financial services professionals and regulators together to discuss the opportunities and risks that such a shift presents. For Canada, in particular, the opportunity is bolstered by the strength and resilience of the banking system during the financial crisis which puts its financial institutions and regulators ahead of others who are still cleaning up the effects of the last crisis. It is a comfort to both Canadian and international investors that Canada has the safest and soundest banking system in the world.⁵⁷

Taking a leadership role in Islamic finance, however, is not just about organizing seminars to train financial professionals and regulators and develop thought leadership about the direction of the Islamic finance industry globally.

It also requires concrete actions to demonstrate an interest in Islamic finance from top leaders. One potential action would be a sovereign *sukuk*, which would provide both financial assets needed by the Islamic finance industry and increase Canada's prominence in global Islamic finance markets. In 2014, four non-Muslim sovereigns (Hong Kong, Luxembourg, South Africa and the United Kingdom) issued *sukuk* and received competitive pricing, with the UK's *sukuk* attracting the biggest oversubscription (11.5 times oversubscribed).

Most of these countries tapped the *sukuk* market not because they needed to diversify their funding sources, but because they view Islamic finance as a significant force for growth in the global financial system. The UK Finance Minister George Osborne used the *sukuk* offering not to mention the possible role that *sukuk* could play in infrastructure funding or in diversifying the UK's funding source but by stating:

"Today's issuance of Britain's first sovereign *sukuk* delivers on the government's commitment to become the Western hub of Islamic finance and is part of our plan to make Britain the undisputed center of the global financial system".⁵⁸

The bar has been raised in Islamic finance so that aspirants to 'hub' status cannot just announce plans for a *sukuk* (as the UK had done for many years, most recently at the World Islamic Economic Forum held in London in 2013), but have to do something tangible like issue a *sukuk* and follow it with other activities that support the development of Islamic finance in their nations and across the globe.

Canada has a real opportunity to develop a sustainable and prosperous Islamic finance industry. It has a strong and increasingly global financial sector with aspirations for growth into Emerging Markets, many of which have already embraced the principles of Islamic finance. Canadian governments, federal and provincial, are looking to attract new foreign direct investment and for them, the Islamic capital markets have been largely untouched. Similarly Canadian corporations with aspirations



RESPONDING TO THE
INCREASED DEMAND FOR
KNOWLEDGE AND SKILLS
IN THIS AREA, A COURSE
IN ISLAMIC FINANCE WAS
CREATED AT THE ROTMAN
SCHOOL IN 2011, THE FIRST OF
ITS KIND IN CANADA.

to become more prominent in parts of the world where Islamic sources of capital are available are increasingly interested in opportunities to access that capital. Of equal importance and opportunity is the growing, respected and prosperous Muslim population in Canada and its desire for additional financial products and services offered in a manner compliant with the principles of Islamic commercial law. Finally, Toronto has a highly effective public-private sector organization, TFSA, which has a track record of being a catalyst for coordinated actions by the private sector and governments in Canada. The interest of the TFSA in making Toronto a more important global financial center and the growing importance of Islamic finance to the future of the global financial sector justify TFSA taking further steps to facilitate the growth of an Islamic finance sector based in Toronto. If progress continues to be made, it is reasonable to expect that Toronto will emerge as the North American center for Islamic finance.



PROFESSOR WALID HEJAZI

Academic Director of Islamic Finance Programs & Associate Professor of Business Economics, Rotman School of Management & Munk School of Global Affairs University of Toronto

WALID HEJAZI, PHD has been a professor at the University of Toronto for over 20 years. His research expertise is in the areas of Global Competitiveness, Foreign Investment and Islamic Finance. He has consulted governments internationally and has appeared five times before Canadian parliamentary committees on these issues. He created the course in Islamic Finance at the Rotman School of Management, the first course of its kind in Canada. He has published over 40 articles in academic peer reviewed journals and has published extensively in mainstream magazines. He is the recipient of several teaching and research awards, most recently for a paper that highlights the importance of the English language in doing business internationally. Hejazi has taught courses in over 30 countries and is currently working to enhance Rotman's presence in the Middle East. He has also led international study tours for MBA students to Egypt, Jordan, Qatar, Turkey, and the UAE.

Over the past many years, the Rotman School has created a portfolio of Islamic finance activities. The School holds numerous sessions annually for executives from Toronto's financial district and for government officials, and regularly holds roundtable discussions on issues related to Islamic Finance.

There continues to be significant demand from Toronto's financial district and from MBA students to learn more about Islamic finance. Perhaps the largest source of this demand is driven by the potential of Islamic finance within Canada.

As the global market for Islamic finance continues to grow at exceptionally high rates, many within Canada's financial district have become intrigued. Also, with a growing Muslim population within Toronto and within Canada, financial institutions are increasingly paying attention to the possibility of enhancing the offerings of Shariah structures.

There is also a surge in startups in the Islamic finance space, often involving people from our programs. Perhaps most importantly, however, is the potential of Islamic finance on the commercial side and the increased opportunities becoming

available to the Canadian market. As the capital bridge deepens between pools of capital internationally seeking investments in stable markets and Canada, as well as the increasing use of Shariah structures for capital raised within Canada, there is a significant increase in the demand to better understand these structures, particularly how they compare to conventional structures and how they fit within the Canadian regulatory environment.

The questions posed most often in our interactions with both business and government officials are as follows:

- 1. What is the potential for Islamic finance within Canada?**
- 2. Is this potential more on the commercial or the retail side?**
- 3. How are Shariah structures different and how are they similar to their conventional counterparts?**
- 4. To what extent do Shariah structures fit within the Canadian regulatory and tax regime?**

Responding to the increased demand for knowledge and skills in this area, a course in Islamic finance was created at the Rotman School in 2011, the first of its kind in Canada. The course is offered to MBA students and covers basic and advanced Islamic finance concepts. Now in its fifth offering, the course has among the highest student evaluation results across the School, and is systematically oversubscribed — the demand for the course is overwhelming. The course attracts a wide variety of students, with a small minority being Muslim — only about 20 percent. The majority of the students come from other backgrounds. There is also a remarkable demand from people outside the School to sit in on the course.

Students develop a thorough understanding of the fundamental building blocks of Islamic finance and are required to apply this understanding in two course related projects. Each year students, working in groups, are tasked with developing a business case for a particular Shariah-compliant product within the Canadian market and present to a panel of practitioners from Canada and abroad.

A second project requires students to structure a set of contracts that are Shariah-compliant and would mitigate moral hazard considerations for private equity transactions. This subject is incredibly important given the growth in capital flowing into Canada that is being invested into Shariah-compliant structures. Students are able to apply their understanding and knowledge in finance which they gain from their other conventional finance courses to demonstrate how conventional structures would need to be revised in order to be Shariah-compliant. This allows them to benchmark Shariah structures off of their understanding of conventional structures, and allows them to truly understand where there are differences between the two approaches.

Each year, the students are asked what motivated them to take the course. The major reason is their desire to learn more about Islamic finance. As students embark on their post-MBA careers, they recognize the potential of Islamic finance globally and within Canada. As such, they appreciate how a deep understanding of these structures can enhance their attractiveness to financial institutions, as well as any

other company that may come into contact with Shariah structures.

In addition students are intrigued by the ethical underpinnings of Islamic finance. One area of growth as reflected in student projects is the focus on Shariah finance being used for renewable energy projects or other initiatives related to sustainability.

There are also many graduates from the course that are deeply engaged in further developing the Islamic finance market in Canada, from creating Shariah funds, to arranging Shariah financing for commercial investments, providing retail investors with Shariah-compliant alternatives to consider, as well as attempts to provide basic financial services that are Shariah-compliant.

It is also important to highlight the increasing number of students at the doctoral level doing research related to Islamic finance. Topics of research include developing a better understanding of the risks faced by Shariah-compliant financial institutions, the need for more liquid Shariah-compliant instruments, and Shariah governance.

Glossary of Terms

Phonetic Spelling	Term	Definition
I	Ijarah	Lease, rent or wage Ijarah is an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred
	Istisna	Manufacturing Contract Istisna is a contract used to order for the manufacture of goods for purchase. The contract allows cash payment in advance and future delivery or future payment and future delivery. Istisna contracts are used for providing a facility for financing for manufacturing or construction of projects
M	Mudarabah	Investment management partnership A form of partnership where one party provides the funds while the other provides expertise and management. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital. Synonym: qirad.
	Murabahah	Full disclosure trust sale also, Markup/ Cost plus sale Originally a term describing a sale in which the seller sells his merchandise for more than the price at which he acquired it. The term is used in contemporary Islamic finance to describe a financing scheme in which a financial institution, usually a bank, agrees to purchase merchandise for a client provided that the client promises to purchase it from the financial institution at an agreed mark-up.
	Musharakah	Investment Partnership standard Islamic transaction in which two or more parties enter into any one of several related types of partnerships see mudaraba, musaqa, muzara'a). In a typical musharaka agreement, two or more parties agree to provide capital (ra's mal) towards the financing of a commercial venture, share profits according to a stipulated ratio and share losses on the basis of equity participation.
Q	Qard Hasan	Interest-free loan An interest-free loan given for either welfare purposes or for fulfilling short-term funding requirements. The borrower is only obligated to repay back the principal amount of the loan.
R	Riba	Interest Riba means Interest. Riba is forbidden in Islamic economic jurisprudence (fiqh) and considered as a major sin. Simply, unjust gains in trade or business, generally through exploitation
S	Salam	Sale A sale in which delivery is deferred until some stated date in the future. It is used for agricultural products and other fungibles. In order to comply with the Shariah, a salam contract must specify the quality of the good to be delivered, and payment must be made at the time the contract is entered
	Shariah-compliant	In accordance with Islamic Law An investment fund which meets all of the requirements of Shariah law and the principles articulated for "Islamic finance."
	Sukuk	Islamic Bond A term used in contemporary Islamic finance to describe financial certificate equivalents to conventional debt issuances such as bonds. However, unlike debt issuances, Sukuk holders are the legal and/or beneficial owners of the underlying assets, and as such, receive the equivalent of a coupon from the share stipulation, condition.

Phonetic Spelling	Term	Definition
T	Takaful	Islamic Insurance Takaful is a type of Islamic insurance, where members contribute money into a pooling system in order to guarantee each other against loss or damage.
	Wakalah	Agency A standard Islamic practice, often used in financial transactions, wherein one party acts as an agent (wakeel) for another party.
W	Waqf	Charitable trust Endowment. Also can be referred to as 'Awqaf.' Acts as an agent (wakeel) for another party.
	Zakah/Zakat	Compulsory alms-giving In the Quranic view, Zakat is a way to redistribute the wealth, thus defining a charity-based economy with a particular interest in the poor and the dispossessed Muslims. It is calculated at 2.5% of each person's assets to be paid each year in charity.
Z		

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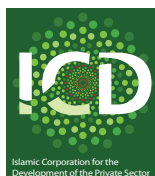
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