

Two roads home

Islamic finance does have a presence in North America, although not a prominent one. Blake Goud takes a look at its history, and examines the latest developments in the US and Canada

The growth of Islamic finance developed along a similar track in both the US and Canada. The industry initially centred on Murabaha-based Shari'ah-compliant mortgage products, but has since gradually shifted towards Ijarah and diminishing Musharaka-based products.

Islamic mortgages represent a large target market because each purchase is larger than almost any other retail financial transactions. The lack of Shari'ah-compliant mortgages also meant that Muslims in North America have lower home ownership rates than the general population. The large transaction size of home purchases also helps to mitigate additional costs associated with making the transaction Shari'ah-compliant.

Since the 1980s, a few non-bank financial institutions have begun offering Shari'ah-compliant mortgages in the US. The availability of these Islamic mortgages grew rapidly with agreements to resell the mortgages to government sponsored enterprises (GSEs) such as the Federal Home Loan Mortgage Company (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). However, the greater availability of Islamic mortgages also resulted in criticism surrounding the use of funds received from the GSEs, which are raised through conventional debt sales.

In 2005, the University Bank of Ann Arbor spun off its Islamic finance operations to form the University Islamic Financial Corp, becoming the first US bank to launch an Islamic banking subsidiary. According to

its most recent filing with the Securities and Exchange Commission (SEC), University Islamic has \$19 million in Islamic mortgages for the second quarter of 2008.

It also originates Islamic mortgages that it sells off to Freddie Mac that do not appear on its books. Between the mortgages on its books and those it resells to Freddie Mac, University Islamic originates around \$5 million per month in its best months. This is relatively small compared with some non-bank financial institutions such as Guidance Residential in Virginia, which reached the \$1 billion mark for total Islamic mortgages financed in the middle of 2007.

PROFITABLE

However, what separates University Islamic from its competitors is that it had developed the US' first Shari'ah-compliant, FDIC-insured deposit product. Depositors receive profits based on the returns of the company's Islamic mortgage portfolio, a return weakly correlated with US Treasury bills and notes of similar maturities. University Islamic is now expanding geographically; opening branches in New Jersey and Virginia, and expects to become profitable later this year.

In Canada, there are no Islamic banks such as University Islamic, few options for Islamic mortgages with non-bank financial institutions, and a few Islamic co-operatives. As there are no organisations such as Freddie Mac and Fannie Mae, demand for Islamic mortgages far outstrips the capital available to supply financing. One of the largest Islamic mortgage companies in



Canada is the non-bank financial institution UM Financial, based in Toronto.

UM Financial was established in 2004 as a non-bank financial institution that arranges home financing. Initially, it received \$4 million in Mudarabah financing from Credit Union Central of Ontario (Cuco), the trade association and central financial facility for 600 Canadian credit unions, now called Central 1 Credit Union following a merger with Vancouver-based Credit Union Central of British Columbia. The Mudarabah financing grew over the next few years to reach \$120 million at its peak.

One Cuco-member credit union, the McMaster Savings & Credit Union Ltd, began offering a Shari'ah-compliant deposit product, which invested in \$3.5 million of the mortgages arranged by UM Financial. According to Omar Kalair, the chief executive of UM Financial, the deposit products from McMaster, as well as other products developed by the Royal Bank of Canada, "have not had a huge response in the community". Currently,

UM Financial is not arranging any more Islamic mortgages through Central 1 Credit Union, but continues to service around 500 mortgages which remain outstanding.

UM Financial recently began a pilot project using their UM Real Estate Investment fund to finance Musharaka mortgages. The mortgages are currently limited to \$60,000 per client, primarily due to a shortage of available capital following the credit crisis. There is currently a waiting list of nearly 6,000 people wishing to purchase or refinance a house.

"We have not been able to finance new clients [using only] our community funds," said Kalair. "We are about to launch our [Musharaka mortgage] product with a major Canadian bank." This will provide them with access to more capital as well as a national network of branches through which they will be able to distribute their product.

The scarcity of funds available from credit unions and other investors in the wake of the recent credit crisis provides an interesting point of comparison between the US and Canada. In the US, the availability of financing from the GSEs provides a partial backstop for Islamic home finance companies.

MORTGAGES

Although the willingness of private investors, whether individual or institutional, to lend has dried up, there are still funds available from Freddie Mac and Fannie Mae, although their recent troubles has led them to dramatically tighten their lending criteria, said Stephen Lange Ranzini, University Islamic's chief executive. This reduces the amount of mortgages it can purchase from Islamic financial institutions,

The Canadian Mortgage & Housing Corporation (CMHC) was studying Islamic finance. According to Stephanie Rubec, media relations manager for CMHC, the study was to provide both the finance industry and the public with a better understanding of what Shari'ah mortgage lending is.

In February, there was controversy surrounding the \$65,000 study when the Muslim Canadian Congress asked the CMHC to scrap it. Despite the controversy, the CMHC plans to complete and release the study in late 2008. The CMHC made it clear that it has no plans to directly insure Shari'ah-compliant mortgages.

"The Shari'ah boards generally take the view that the source of funds is not relevant from a Shari'ah perspective, and they therefore only look at the structure of the transaction."

However, the lack of a secondary market for Shari'ah-compliant mortgages in Canada means that their availability is determined largely by the willingness of banks, credit unions and individuals to invest money. In both countries, a nascent market for Shari'ah-compliant deposit products has not yet provided enough capital to meet the demand for Islamic mortgages. As a result, companies offering these products have had to look elsewhere for capital. In the US, this has meant Freddie Mac and Fannie Mae, while in Canada, it has been credit unions and banks.

Both approaches have attracted some criticism regarding their Shari'ah-compliance because they rely on funds generated within the conventional financial market, even though both methods have been approved by Shari'ah scholars. The Shari'ah boards generally take the view that the source of funds is not relevant from a Shari'ah perspective, and they therefore only look at the structure of the transaction.

Unlike many other Islamic financial institutions, UM Financial receives their funds from conventional banks and credit unions through a Mudarabah agreement, where they receive a fraction, around 3 per cent in the agreement with Cuco, of the profits from the Islamic mortgages, while the credit union receives the remaining 97 per cent.

Another approach would be to start an Islamic bank that can take deposits and finance Islamic mortgages, similar to what University Islamic is currently doing in the US. Last year, Amana Canada Holdings submitted an application to be registered as the country's first Islamic bank. The company was not able

to give any comments on this issue as its application is still pending with the regulator. However, a decision on the application is expected to be reached by the end of the year.

The ultimate goal for Islamic finance in North America will be to find a source of financing outside of GSEs, or conventional banks and credit unions. There is, however, debate about whether this should be the overarching goal, or be set aside until Shari'ah-compliant home financing products are priced at par with conventional mortgage products.

UM Financial places its focus on working with domestic credit unions and banks using Mudarabah agreements where possible to offer Islamic mortgage at no extra cost vis-à-vis conventional mortgages, and serve the existing demand.

DEMAND

Kalair said, "In our discussion with the regulators, they encouraged our current business model." Rather than start a standalone Islamic bank, the regulators urged UM Financial to "work with [an] established Canadian institution to service the community demand" for Islamic financial products.

Islamic financial institutions in Canada have taken a different approach from their US counterparts to meet the demand for Shari'ah-compliant mortgages. This is partly due to the lack of GSEs that have provided the capital necessary to finance hundreds or thousands of Islamic mortgages.

Despite the challenges this approach creates, it also presents an opportunity to develop methods of financing that avoid a reliance on GSEs; the institutions either take deposits or start a real estate investment fund, or pen Mudarabah agreements with banks and credit unions. Although the goal of complete independence from conventional financial institutions is not currently possible, it may become a possibility in the future as Islamic finance becomes more common in North America.

Blake Goud is principal of sharingrisk.org

