

An Islamic Banking Model in Canada

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Abstract

The goal of this applied project is to explore the creation of a sharia-compliant banking institution in Canada. Features of the market will be assessed by employing various analysis techniques to identify whether or not the potential opportunity is substantive. This is especially important given the barriers to offering Islamic Banking products.

Islamic banking models are substantially different from Western models. One of the most significant differences is the prohibition of interest, or, *riba*. Many Muslims in the world see Islamic finance as a way to promote participation in society to meet economic objectives through economic and social justice. Waste is discouraged and charitable giving is mandated through a wealth tax known as *zakat*.

Individual products can be offered in ways that are *sharia*-compliant. Some of the compliance involves charging mark-ups and fees instead of interest and avoiding investing in industries that are *haram*, forbidden, such as pornography or alcohol. Ventures that involve too much uncertainty are also not permitted as this would constitute a risk akin to gambling which is also not permitted. A *sharia* board working for the financial institution ensures compliance.

In terms of market size, there could be as many as one million Muslims in Canada currently and this number is expected to increase substantially in the future. Most are middle class and are more educated than the average Canadian. Almost every major centre across the country has a Muslim community. A financial institution that could build relationships with these communities and provide education about Islamic finance products would have a distinct advantage. Technology could be effectively leveraged to not only expand geographical reach but also cultural reach by the offering of services in multiple languages.

The firm would also have to exist within the Canadian landscape. This would mean adhering to all Canadian regulations and laws such as anti-money laundering, privacy, and anti-terrorism legislation as well as The Bank Act and established human resources practice. Public perceptions about Islamic finance would also have to be controlled to the greatest degree possible.

Products would also have to be offered at a cost that puts them on par with conventional finance products. This is because of the overwhelming tendency of Muslims in Canada to utilize conventional banking. This is a challenging prospect given the niche nature of the products and the relatively small size of the market. Outsourced technology and services could help control costs. The establishment of basic personal banking products that are checked upon creation for *sharia* compliance as well as acting as a reseller for already established third-party products (for example, Islamic investments) could eliminate the expensive requirement for a sitting *sharia* board.

Current competition in the Islamic market is virtually non-existent. No one firm offers a suite of comprehensive banking products that most Canadians would require day to day. Entry into the market, however, is stymied by the lack of legislation applicable to Islamic finance. Existing banks would additionally have to seek an “Islamic window” to be able to comply with *sharia* law, and emergent banks are awaiting the approval of a charter in order to begin to compete in the market.

The winner of the market would be a firm that would be able to access expertise and experience with Islamic finance, compete on price, comply with established regulations and standards, leverage their brand to connect with various Muslim communities, and have enough capital to withstand competition from large firms. Firms that can work with regulators to help establish appropriate legislation (that in part would alleviate the double taxation issues) will also have a distinct advantage.

Islamic banking will become a reality in Canada as demographics shift. The likely entry point into the market for many will be the establishment of a regulatory framework. Given the maturity of the Canadian personal banking marketplace, this may be a future segment of the market worth fighting for. At a minimum, companies will no longer be able to ignore Muslims as a target market.

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Introduction

This applied project seeks to answer the following question: Should a financial institution in Canada be created to offer *sharia*-compliant Islamic banking products to Canadians?

This is a relevant question to ask as other Western countries with Muslim populations have seen financial institutions enter this market. If a significant opportunity exists, one Canadian institution could gain first mover strategic advantage by attempting to capture this emerging market.

However, it is not clear whether or not there is significant opportunity. Are there enough Muslim households in Canada to support a niche product offering? Of this population, would a significant proportion require *sharia*-compliant banking, or would most shop around for the highest value and lowest cost product regardless of how the loans, mortgages, bank accounts, investments, or bank accounts would be structured?

There are also potentially significant barriers to offering Islamic banking products. It is not clear if the barriers to offering a suite of products can be overcome and still result in profitability. For example, an Islamic loan or mortgage cannot be offered as merely one additional product using existing infrastructures by reselling from some other financial institution. Rather, an entity would have to be assembled that is completely separate from existing banks due to prohibitions dealing with those who charge interest. In fact, an Islamic mutual fund could not hold stock in the parent bank that has created the Islamic “window” for the separate Islamic entity to exist in the first place.

Through the literature review concentrating on Islamic banking rules and regulations, it will hopefully be possible to determine what structures would have to be in place to satisfy *sharia* requirements. The analysis part of the paper would then concentrate on determining how a Canadian financial institution could seek to establish a *sharia*-compliant Islamic financial institution to begin offering a suite of Islamic banking products. Other factors will be detailed in DEPEST and SWOT analyses.

Research Purpose and Research Questions

This conceptual study will examine Islamic banking both in terms of an external macroenvironmental fit (through a DEPEST and SWOT analysis) as well as an internal strategic alignment (through a Five Forces analysis).

The DEPEST analysis will seek to answer the following questions:
Demographic

Are there enough sufficiently observant Muslims in Canada to constitute a demand for Islamic banking products? How is this population expected to change over time?

Environmental

What are the environmental impacts of *sharia* banking models?

Political/Legal/Regulatory

What legal, political, and regulatory barriers does an Islamic banking model in Canada face? What are some of the tax implications of *sharia*-compliant banking? What challenges with jurisdictions could exist? What human resource issues might exist given that Muslims would almost certainly prefer to deal with other Muslims, and perhaps even male Muslims primarily or exclusively?

Economic

Can Islamic banking models be offered competitively and profitably? What suite of products would be most appealing to the Muslim population? What suite of products would be the most profitable?

Social-Cultural

What are the barriers Muslims would face in doing business with an institution with a likely very limited physical presence? How would non-Muslims in Canada react to Islamic banking models being offered by Canadian financial institutions? How would hiring practices be viewed by society at large?

Technological

What are the technological barriers to offering *sharia*-compliant banking? How could technology assist in reaching Muslims in multiple locales?

The Five Forces analysis (described in Grant, p. 73) will examine the following positions to gauge the attractiveness of the Islamic banking market: the threat posed by new competitors, the intensity of competition, available substitutes to Islamic banking, the bargaining power of customers, and the bargaining power of suppliers.

The SWOT analysis will examine the Strengths, Weaknesses, Opportunities and Threats faced by an Islamic banking model in the marketplace. This will include an analysis of any institutions already offering Islamic financial products in Canada as well as other major financial institutions operating in other countries that could reasonably commence operations in Canada.

Literature Review and Review of Related Theory

Even a cursory review of Islamic banking practices and beliefs results in a rapid realization that the philosophy of money and the acquisition of wealth is in stark contrast with the Western world.

Khan and Mirakhor describe several hallmarks of an Islamic economic system. While some economic principles (such as the prohibition of *riba* or interest) are codified in the Quran [“Those who devour *riba* will not stand except as stands one whom the Devil hath driven to madness by touch” (II:275)], others are specified in the *Sharia*, or “the codifications of injunctions given in the Quran and the traditions of the Prophet Mohammed” (Khan & Mirakhor, 1987, p. 2).

Khan and Mirakhor also contend that individual rights are only gained after the fulfillment of certain human obligations have been met. Individuals have the right to pursue “economic interest within the frameworks of the *Sharia*” (Khan & Mirakhor, 1987, p. 2).

One of the foundations of Islam is *Tawhid*, “a total commitment to the will of God” (Mills & Presley, 1999, p. 1) that requires submission to God’s revealed will. Mills and Presley add that “there is no part of life that can be placed in a secular compartment, devoid of religious and ethical considerations” (1999, p.1). Further, “the spiritual and moral takes precedence over the material and pragmatic, based on the assumption that human happiness is ultimately to be found in moral obedience rather than material ease” (Mills & Presley, 1999, p.2). Rewards and punishments in the afterlife are proportionate to moral obedience against the standards set out in the Quran.

Indeed the penalty for usury is nothing short of a place in Hell. In some assessments, it is a sin on par with adultery and more sinful than maternal incest (Mills & Presley, 1999, p. 8). Interest is seen as living off the work of others without working oneself (Mills & Presley, 1999, p.11).

In contrast to Western banking models, the objectives of an Islamic financial system is to “help society achieve its accepted economic objectives” through the pursuit of social and economic justice (Mills & Presley, 1999, p. 5). These include “full employment, an optimum rate of economic growth and a stable value of money” (Mills & Presley, 1999, p. 5).

The philosophy of work is that all those mentally and physically able should not be allowed to practice voluntary unemployment, especially when it places a burden on family members or the state. It is considered a “divine duty to work” (Mills & Presley, 1999, p. 3). Idleness is seen as a “manifestation of unbelief in the religion” according to Khan and Mirakhor (1987, p.3). The ideal is that “everyone can use all their abilities to work and gain just reward from that work effort” (Mills & Presley, 1999, p. 3). Justice, therefore, is equal opportunity; the

role of the state is to provide a basic level of physical and educational necessities.

Wealth is seen as a blessing and worth striving for, however the methods of “earning, possessing, and disposing of wealth are defined by the *Sharia*” (Mills & Presley, 1999). Rules regarding extravagance, waste, and sharing are codified there, including wealth sharing and charitable obligations.

Zakat, a form of wealth tax, is another important concept in Islam. According to Mills and Presley, *zakat* is also to prevent the inherent accumulation of funds into the hands of a concentrated few and guard against hoarding (Mills & Presley, 1999, p. 4). The annual rate of 2.5% applies to all cash holdings.

Zakat is due when a Muslim’s wealth exceeds the value of 85 grams of gold on the anniversary of when the value had been achieved. This ensures a continuous cash flow to *zakat* beneficiaries throughout the year (Soubra, 2009, p. 56)

Zakat must be paid with the intention of obedience to God, and without this intention is not considered *zakat*. Unpaid *zakat* is always due and is “considered as a debt” (Soubra, 2009, p. 56). Rates vary. For example, the *zakat* on natural resources is 20%, on agricultural products is 5 or 10% (due at cultivation, depending on the method of irrigation), and is 2.5% on livestock, trading activities, savings, and the profit from financial assets such as buildings or stocks.

The beneficiaries of *zakat* are also mandated in the Quran—those included are the poor (those who live below the subsistence level because they are unable to participate in economic activities), the needy (who participate but who do not earn enough to meet a subsistence level, stranded travelers, indebted individuals, and slaves requiring liberation), as well as *zakat* fund employees, and recent converts. Works can also be performed “in the sake of God” (Soubra, 2009, p. 63) which includes building mosques and printing books, but can also include the “act of military defense...and the proliferation of Islam” (Soubra, 2009, p. 63). Although the majority of *zakat* purposes are truly benevolent,” it is also clear that *zakat* in Canada would need to be directed carefully towards the large number of approved Islamic organizations acceptable to Canadian authorities that are non-military in nature.

Regarding property rights, it is acknowledged that “God is the ultimate owner of all property” but that “man has been given the right of possession as a trust” (Khan & Mirakhor, 1987, p. 2). Wealth and property are not to be treated as an end, and natural resources should be shared by all members of society. These stewardship rights are protected in *Sharia* law (Mills & Presley, 1999, p. 3).

Instead of interest, profit and loss sharing is seen as more equitable than *riba* (Mills & Presley, 1999, p.5). *Riba* is explicitly forbidden in the Quran: "Oh believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject the faith..." (3:130-1). Two forms of deposits, transaction deposits and investment deposits, can be used as capital to finance various ventures. Transaction deposits are similar to Western demand deposit accounts in the respect that the funds can be demanded at any time, although no interest is paid on transaction deposits. However, some view that these guaranteed deposits should require a 100% reserve (Mills & Presley, 1999, p.166). Investment deposits "more closely resemble shares in a firm" (Mills & Presley, 1999, p. 5) and the deposit amount is not guaranteed. Rather, a portion of the profits or losses are shared according to the proportion of the investment the depositor holds.

Musharakah mutanaqisah, or diminishing *musharakah*, is a common form of Islamic mortgage. With *musharakah mutanaqisah*, the client and the bank purchase a house (perhaps with the client investing 25% and the bank investing the rest). Both the client and the bank are allotted a certain number of units based on the initial investment. The bank then rents its stake (in units) to the client and the client purchases these bank units one at a time until the client owns all the units and therefore owns the entire asset (Samadani, 2007, p. 76).

Bay Mujjal is deferred payment sales with a mark-up included. Lease purchases are also permitted (Mills & Presley, 1999, p.6) and are the most common form of Islamic mortgage (Mills & Presley, 1999, p. 170). A deferred delivery purchase is *Bay Salam* where the "buyer pays the seller the full negotiated price of a product which the seller agrees to deliver at a specified future date" (Mills & Presley, 1999, p. 171). Service charges are permitted on transactions, but the fees must not be imposed "proportional to the size of the loan" (Mills & Presley, 1999, p.171) lest the fee resemble *riba*.

Two contracts are required for this, one being a lease, *ijarah*, and the other is the purchase of the bank owned units. Some feel that two contracts in one agreement automatically results in *gharar* (unacceptable risk akin to gambling) and therefore is *haram* (forbidden). However, because one contract (the leasing), is not dependent on the other (the purchasing of units), *musharakah mutanaqisah* is *halal* (permitted) (Samadani, 2007, p. 76).

Mudarabah loans provide funds "In return for a predetermined share of the profits earned" and are provided by one investor (Mills & Presley, 1999). A *musharakah* transaction, by contrast, involves numerous investors who share in the profits of a venture according to the capital each provided. Often a *musharakah* certificate is produced to make these transactions "transferable corporate instruments secured by the assets of the company" (Mills & Presley, 1999, p. 6).

Rather than investments being made based on creditworthiness, the emphasis in Islamic banking is on the “soundness of the project and the business acumen and managerial competence of the entrepreneur” (Ahmed, Iqbal & Fahim Khan, 1983, p. 28). However, Islamic banks are not seen as secular institutions. As a result, certain investments that conflict with Islamic moral values are forbidden. Examples include but are certainly not limited to casinos, alcohol production, pork production, and any other activities that are explicitly *haram* or viewed as harmful to society.

In addition, there is clearly a different view of profits in Islamic banking. In the West, the objective is profit maximization, while the objective in Islamic banking “is not to maximize profits because maximization is at the cost of other elements like employees, service quality products, and shareholders. Therefore it is professional to set the objective to achieve acceptable level of profit” (Soubra, 2009, p. 93). As well, Islamic banks are expected to finance some social activities without expectation of profit.

Islamic insurance is seen as particularly problematic. *Riba*, *qimar* (gambling), and *gharar* are all features of traditional Western insurance models.

Gharar, loosely translated as uncertainty, is also not permitted in Islamic finance. Six types can exist within a contract relating to “the existence of the thing sold, ...the possession of the thing sold, ...the thing sold itself, ...the price, ...the payment of price, ...and relating to both the thing sold and price” (Samadani, 2007, p. 15).

Gharar in insurance results from the fact that the value of the loss is completely uncertain (Mills & Presley, 1999, p. 5). As well, paying a small amount “as a premium in lieu of a big amount obtainable in the future is nothing but *riba*” (Samadani, 2007, p. 82). *Qimar* is a factor because the future potential event necessitating the insurance is indefinite (Samadani, 2007, p. 82).

Some Muslim scholars believe that the existence of an Islamic welfare state that would provide for all needed members of society would negate the need for insurance. Indeed, it has been narrated in the life of the Prophet that he observed a practice with the Ashari people collecting food communally and distributing it equally among community members. It has been pointed out, however, that this situation revolved around the necessities of life. As well, it is viewed as preferable that a large group of people accepting the loss together is “better than that it is faced by the afflicted person alone” (Samadani, 2007, p.85).

Islamic alternatives include assembling a fund created by donations to provide to the needy as required. In Western terms, this would not be considered insurance at all. However, a slightly more formalized version of this called a *Takaful* more closely resembles insurance over charity.

In *Takaful*, the company “acts as a trustee and manages the affairs of the company” (Samadani, 2007, p.88) but does not own the pool—the company merely manages it by collecting premiums and pays the policy holders in the case of loss. The policy owners are the actual owners of the pool of funds and therefore act as both the insurers and the insured.

One challenge identified by Khan and Porzio across all products and arrangements is that some Islamic scholars may see some practices or products as *Sharia* compliant while others may not. Common standards are being developed by organizations like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (Khan & Porzio, 2010, p. 171).

Challenges and barriers may also exist within the Muslim community. A small survey of 503 Muslims in the UK indicated that some had little knowledge of *Sharia* finance. Still others were aware of Islamic financing models, but were dissuaded from proceeding because of the higher costs. [Part of the increased cost is attributed to the small scale of the market (Khan & Porzio, 2010, p. 219).] The market for Islamic mortgages in the UK is further reduced due to the “low socio-economic position of the Muslim population in the UK” (Khan & Porzio, 2010, p.219) which may or may not be a factor in Canada. This, and other market limitations, will be examined in the analysis section of the final project.

Analysis

DEPEST Analysis

Demographic

The most recent Statistics Canada information regarding the Muslim population was collected in the 2001 census. Data show an increase in the Canadian Muslim population to 579,640 from 253,265 in 1991 (Statistics Canada, 2001). In 2001, it is estimated that 2% of the population were Muslim.

Statistics Canada also reports that the Muslim population is expected to increase substantially over time. Best estimates of the 2011 Muslim population are in the one million range (Statistics Canada, 2005b). Estimates suggest that by 2031, 14% of the population would be non-Christian. Further, “Within the population having a non-Christian religion, about one-half would be a Muslim by 2031, up from 35% in 2006.” (Statistics Canada, 2010).

The median age of the Muslim population was 28.1 in 2001 (Statistics Canada, 2005b) suggesting a very young population. As well, McDonough and Hoodfar as cited by Selby have identified that Muslims new to Canada are typically from middle or upper-middle class families (Selby, 2007).

Muslims in Canada are also typically more educated than the Canadian population at large (see Table One below), outperforming the Canadian average in each of the categories at the University level and above.

Table One: Education Level of the Canadian Population and of Muslims in Canada

Extrapolated from Statistics Canada: *Selected Educational Characteristics (29), Selected Religions (35A), Age Groups (5A) and Sex (3) for Population 15 Years and Over, for Canada, Provinces, Territories and Census Metropolitan Areas, 2001 Census - 20% Sample Data*

Educational Level	Canadian Population		Muslims in Canada	
	Total	Percent	Total	Percent
Total population 15 years and over by school attendance	23,901,360	100.0%	411,520	1.7%
Less than high school graduation certificate	7,476,900	31.3%	102,290	24.9%
High school graduation certificate only	3,367,895	14.1%	55,475	13.5%
Some postsecondary education	2,590,165	10.8%	51,450	12.5%
Trades certificate or diploma	2,598,925	10.9%	25,420	6.2%
College certificate or diploma	3,578,400	15.0%	43,800	10.6%
University certificate or diploma below bachelor's degree	601,425	2.5%	16,230	3.9%
University degree	3,687,650	15.4%	116,855	28.4%
Bachelor's degree	2,534,010	10.6%	74,445	18.1%
University certificate above bachelor's degree	382,955	1.6%	9,630	2.3%
Master's degree	642,055	2.7%	26,475	6.4%
Earned doctorate	128,625	0.5%	6,310	1.5%

Source for original data: Statistics Canada. (2010). Selected Educational Characteristics (29), Selected Religions (35A), Age Groups (5A) and Sex (3) for Population 15 Years and Over, for Canada, Provinces, Territories and Census Metropolitan Areas, 2001 Census - 20% Sample Data. Retrieved November 11, 2010 from

<http://www12.statcan.ca/english/census01/products/standard/themes/RetrieveProductTable.cfm?Temporal=2001&PID=67772&APATH=3&GID=517770&METH=1&PTYPE=55496&THEME=56&FOCUS=0&AID=0&PLACENAME=0&PROVINCE=0&SEARCH=0&GC=0&GK=0&VID=0&VNAMEE=&VNAMEF=&FL=0&RL=0&FREE=0>

Determining how religious Muslims are in Canada is not an easy task. One contributing factor is that Muslims in Canada are not a homogenous group. Each of the various waves of Muslim immigration has been unique. In the 1980s, Canada became a haven for those fleeing the Lebanese Civil War. Another major wave in the 1990s saw an increase of Somali nationals fleeing a civil war there. That same decade, Bosnian Muslims came to Canada escaping the breakup of the former Yugoslavia. There are also significant numbers of Muslims of Iranian decent, but given Canada's immigration policies, it would not be unreasonable to assume that Canada is also home to immigrants from virtually all predominately Muslim countries in the world.

It might also be tempting to assume that those coming to Canada are seeking a different life, one of economic and personal freedoms. Certainly, for some, this is the case. But still others come to enjoy religious freedom and wish to maintain the practices from their country of origin. It might not be unreasonable to assume that the majority of Muslims in Canada fall somewhere in between, but again, this is a difficult determination to make for such a disparate group that consists of Muslims of different sects from all over the world.

However, the examination of interreligious unions might be able to assist:

Table Two: Interreligious unions in Canada

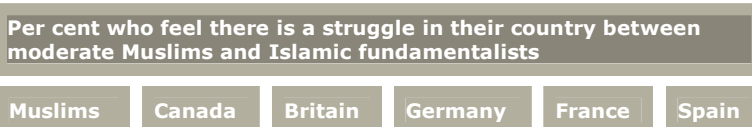
Religious Groups	1981	1991	2001		
			Both Sexes	Men	Women
	% of population in couples who are in interreligious unions				
Total	15	17	19	19	19
No Religion	38	27	25	32	17
Catholic	12	14	16	15	17
Protestant	14	17	21	19	23
Mainline Protestant¹	15	19	23	21	25
Conservative Protestant	9	11	13	11	15
Other Protestant	15	22	25	23	27
Orthodox Christian	23	25	26	27	24
Christian n.i.e.	19	18	18	15	20
Muslim	13	11	9	11	6
Jewish	9	12	17	19	16
Buddhist	19	16	19	16	22
Hindu	11	10	9	9	8
Sikh	4	4	3	4	3
Other Eastern religions	26	24	27	25	29
Other religions	41	41	46	40	50

Source: Statistics Canada. (n.d.) Retrieved November 12, 2010 from <http://www.statcan.gc.ca/pub/11-008-x/2006003/t/4169265-eng.htm>.

Table Two shows that interreligious marriages for Muslims in Canada appear to be on the decline, and were half the rate of the Canadian population at large. Generally speaking, interreligious marriages only occur between those with low levels of religiosity which may indicate that as a whole, Muslims are more religious than average Canadians.

A joint study between the Canadian Broadcasting Corporation (CBC) and Environics Research Group also points to Islamic moderation in Canada, especially compared to other countries. This is evident in the comparatively low scores of conflict between moderates and fundamentalists as well as the low percentage of Muslims that identify with the extremists' causes.

Table Three: Islamic Moderation Survey Questions



in					
Yes	40	58	49	56	21
No	50	35	40	43	65

Per cent who identify with moderates or extremists in this struggle

Muslims in	Canada	Britain	Germany	France
Moderates	80	66	75	89
Extremists	14	25	14	10

Source: Canadian Broadcast Corporation. (2007). *Canada's muslims, an international comparison*. Retrieved November 13, 2010 from <http://www.cbc.ca/news/background/islam/muslim-survey.html>.

As well, the majority of Muslims in Canada live in Ontario with Toronto hosting the largest Muslim population. There are also significant populations in Montreal, Ottawa, and Vancouver. There are few Muslims in the North, in PEI and Newfoundland (Statistics Canada, 2005a).

Environmental

Existing Canadian financial institutions have altered business practices to better serve social responsibility agendas. It is clear that many stakeholders within Canadian society are concerned about environmental impact and banks have responded accordingly.

Examples include:

- Royal Bank's prioritization of environmental issues including climate change, forestry, indigenous peoples, biodiversity, and water. RBC made the 2010 list of "Canada's Greenest Employers" and through the RBC Blue Water Project has made a "\$50 million philanthropic commitment over 10 years to combat the emerging global water crises (Royal Bank, 2010).
- TD created the "TD Friends of the Environment Foundation" that has donated \$53 million to local environmental projects and causes. A "Go Green" challenge offers college and university students a chance at cash prizes, internships and sustainability grants for winner's schools (TD FEF, n.d.).
- BMO's Environmental Action Plan includes five areas of focus with accompanying policies and programs surrounding energy reduction and efficiency, sustainable materials, transport, and waste management, and a program for sustainable procurement (BMO, 2008).

Most banks offer electronic statements in lieu of creating paper statement and attempt to lower energy costs within branches and other office buildings. This is often accomplished through the use of energy efficient equipment (such as computer servers) and advanced building techniques. However, these activities may be more of a response to cost reduction pressures as to corporate social responsibility pledges. Socially responsible investments and energy loans are also becoming mainstays in the Canadian banking landscape.

Obviously a smaller, niche financial institution could not hope to make “proactive” environmental contributions of the same magnitude and scope of large financial institutions. But there are guiding principles in Islam that relate to the environment that may be applicable.

According to Khalid (2002) there are three relevant ideas that *Sharia* scholars agree upon:

“1. The interest of the community takes precedence over the interests of the individual; 2. Relieving hardship takes precedence over promoting benefit; 3. A bigger loss cannot be prescribed to alleviate a smaller loss and a bigger benefit takes precedence over a smaller one. Conversely, a smaller harm can be prescribed to avoid a bigger harm and a smaller benefit can be dispensed with in preference to a bigger one.” (Khalid, 2002, p. 3)

There are also legislative principles that protect scarce resource utilization to protect the common welfare, and abuse of rights to land or resources is penalized. Another principle is one of benefit protection and detriment reduction (Khalid, 2002, p. 4)

Taken together, some of these ideas are at odds with environmental protection. Considering only the *Sharia* points above, it could be argued that resources could be mined to virtual extinction to promote collective benefit and relieve hardship. However, the belief that "God is the ultimate owner of all property" and that "man has been given the right of possession as a trust" (Khan & Mirakhor, 1987, p.2) suggests that defiling what God has given would be *haram* in some sense, even if man does have rights to use the environment for these predetermined objectives. Waste is also abhorred.

It appears, therefore, that an Islamic bank would be likely to follow the example of HSBC Amanah which is to offer online banking and socially responsible investing, but concentrate all charitable efforts on the mitigation of human suffering (HSBC Amanah, 2010).

Political/Legal/Regulatory

Political

It is unlikely that an Islamic bank in Canada would be considered a political entity in itself, providing that all of the Canadian rules and regulations are in place and

are actively followed. Where an Islamic bank may come under fire is in how business is done and with whom. For example, the Canadian public at large may not be accepting of a bank that primarily employs or deals with men without providing equal opportunity and rights to female employees or clients (additional analysis on this will be included subsequent sections). The bank would also have to be cautious with the relationships that it builds with the community at large.

Although Canada is a place that has codified freedom of religion in its constitution, and although Canada tolerates many faiths, Canadians appear to be uncomfortable with extremism. Often the laws and practices are inadequate to manage these situations, and one gets the sense that Canadians would prefer to wish the problems away rather than taking them head on.

This appears to be true with the Hutterites who recently lost a Supreme Court ruling regarding pictures on driver's licenses (one Hutterite community claimed that these "graven images" were against their religion) (CBC, 2009). This appears to also be so with the polygamist Mormon community (FLDS) in Bountiful, British Columbia where accusations of abuse and bigamy have caused investigations from the RCMP (CBC, 2006).

The Canadian public may see the Hutterites as an eccentric sect that is unwilling to meet the obligations of the Province of Alberta in order to drive. The perceptions of the Bountiful polygamists likely surround issues of child marriages, abuse, and the use of public monies to build schools and make social assistance payments to "single mothers" (who are actually additional wives in "spiritual marriages" with FLDS men). But Canadians likely hold a very special view of Islamic extremism which is laden with fear and suspicion especially after the 9/11 attacks, the Omar Khadr affair and the conviction of the jihadist Toronto 18. (This would not dissimilar to the view of Islamic fundamentalism in many places in the world, especially in westernized countries--see the table "Negative Traits Muslims and Non-Muslims See in One Another" in Pew, 2006.)

Although most Canadians believe that only some of their fellow citizens are hostile to Islam (75%), only 33% believe that Muslim values are a positive force in Canadian society (CBC, 2007).

It would be therefore critical that an Islamic bank in Canada would follow existing Anti-Money Laundering, Anti-Terrorism, and Privacy legislation to survive in the public sphere. Equally important, the bank could not appear to be funding or supporting extremism above and beyond compliance with legislation.

Legal

There are many legal considerations that intersect with banking. The Canada Deposit Insurance Corporation Act, the Bank Act, and taxation generally are likely main concerns for financial institutions.

The Canada Deposit Insurance Corporation Act concentrates mainly on deposits. This Act is not explicitly seen as a barrier to Islamic finance as no confirmation that conflicts exist has been established.

In order to gain the right to become a recognized financial institution, an applicant must be granted a charter by the Minister of Finance. Charters are granted to those applicants who have sufficient financial resources, have a solid business plan, have demonstrated business experience and personal integrity, as well as meet several other requirements. The proposed institution under consideration must also be in the interest of the Canadian financial industry overall.

There is little chance given the overall success of the well-envied Canadian regulatory environment that any requirements would be relaxed (TFSA, 2010, p. 9). There is even concern that a *Sharia* supervisory board would attempt to usurp some of the responsibilities traditionally assigned to a board of directors (TFSA, 2010, p. 9). There may be also concerns about Islamic banks holding real estate as part of *murabaha* mortgage arrangements due to statutory limits, issues surrounding foreign ownership or control, and difficulties with determining the cost of borrowing within an interest-free structure (TFSA, 2010, p. 10).

Regulatory

The Toronto Financial Services Alliance reports that “a joint task force that included representatives of the Financial Institutions Steering Committee – The Bank of Canada, Office of the Superintendent of Financial Institutions of Canada (OSFI), Canada Deposit Insurance Corporation (CDIC) and the Department of Finance – has considered the extent to which current federal banking and other financial services rules would need to be adapted to accommodate Islamic banks” (TFSA, 2010, p. 9). No guidelines have been created to date, and it is likely that existing financial institutions, especially larger ones, see this as a very real barrier. Having specific information from OSFI is desirable as institutions could enter the market in compliance with any guidelines rather than entering the market beforehand and having to adjust existing operations to conform with the established rules.

There are other regulatory requirements that any Islamic bank would have to meet. For example, the Personal Information Protection and Electronics Document Act is the prevailing legislation governing privacy in Canada. A potential area of conflict might be privacy issues between spouses as the legislation prevents one partner from learning about the financial affairs of another partner. This may be inconsistent with typical practices from some Muslim cultures in the world.

Anti-Money Laundering, Anti-Terrorism, international banking standards (such as BASIL II) as well as standard accounting practices would also have to be

followed. It is unlikely that any of these would be relaxed or adjusted in a substantive way to accommodate Islamic banking.

Economic

Profitability is as central to any discussion of a *sharia*-compliant financial institution in Canada as it is to any other type of business. While healthy reserves are required to receive a charter for a bank, profits are required to sustain the institution over time.

Typical products in banking include: deposit accounts, credit cards, loans, mortgages, investments, and occasionally insurance. These products are similar for both personal and business although not the same; business products become more complex as the ownership structures of the business also increase in complexity.

Not every product needs to be profitable, but any that aren't need to be compensated for by other more profitable products. It is also desirable to ensure that clients adopt as many products as possible to increase profitability per client and to ensure that clients have a high degree of "stickiness" with the financial institution.

Deposit Accounts

Western banks make money on deposit accounts in two ways. The first is by charging fees on the account either per transaction or as a flat rate to cover a number of transactions. The second is by using the deposits to fund loans. While the bank only has to keep a small fraction of the total outstanding deposits as a reserve, and while it pays a small rate of interest to the bank account owner, a higher interest rate can be charged to those taking out loans.

In Islamic banking, since *riba* is forbidden, different structures must be put in place for deposit accounts. The two principal arrangements are a trust (*Amanah*) or a deposit account (*Wadia*).

With *Amanah* accounts, the bank merely acts as a holder of the funds. The entire amount must be returnable at any time, and none of the funds can be co-mingled with bank funds. Administration fees are likely the only way to ensure that this arrangement can be profitable.

Money placed in *Wadia* accounts must also be segregated from other bank funds. However, in this case, a pool of funds is created and invested in various *sharia*-compliant assets and the bank itself is permitted to add funds to the pool. Each account holder is considered an investor and is either credited or debited monthly according to their share and the associated profit and loss. The bank makes money on its share in the same way as the other investors.

Credit Cards

Traditional banks make revenue in a number of ways in the credit card industry. Card holders pay fees and pay interest on outstanding balances, but banks also make a percentage on each transaction from the merchant. It is only in relatively rare cases where security is required to be able to use a credit card.

Sharia-compliant cards are entirely fee based. Controversy exists on these cards because the fees charged are seen as excessive as the total amount would be more than a Western bank would charge in interest. (Although this bodes well from a profitability standpoint, Muslim consumers may not be receptive to such an arrangement.) There are also restrictions on what can be purchased with the card; alcohol, gambling, pork products and other morally objectionable materials are forbidden. Often a deposit is required so that the card can take on a lease-like form rather than a loan-type form, an important distinction when it comes to the forbidden *riba*. Late fees are sometimes charged to encourage prompt payment, but when these fees are levied and paid, the funds are donated to charity.

It is unlikely that Islamic banks would be able to become successful acquirers in Canada. There would perhaps be a limited demand from Muslim business owners, but it would be unlikely that most business would be willing to comply with *sharia* restrictions on what could be charged to the card. There could also be conflicts with Visa Canada rules and practices about acceptance of the card and about how funds are transacted between individuals, merchants, and the bank.

Loans and Mortgages

Western loans and mortgages are profitable because the interest received by the institutions exceed defaults. In Islamic finance, there are methods to accomplish similar ends by acting as “deferred contracts of exchange [or] fixed income instruments” (TFSA, 2010, p.5): installment sale (*Murabaha*), lease (*Ijara*), or another form a partnership (*Musharaka*).

With *Murabaha*, the item or property is bought by the bank and immediately is sold to the client with a markup. The consumer pays over time in installments according to a predefined schedule. With *Ijara*, the bank maintains ownership of the property and the client buys the property at the end of a set term. In the case of real property, a leasing agreement is maintained, and part of the payment is applied towards the end purchase price. At the end of the term, ownership is transferred from the bank to the client. Diminishing *Musharaka* is similar except that the ownership is gradually transferred instead of at one point in time. The profit in these cases comes from a markup.

Investments

In Western banking, profits are made on investments through fees or (in the case of GICs for example) interest differentials.

Sukuk are the Islamic equivalent but are managed a little differently. There are also many different approved structures that *sukuk* can take and more are likely to emerge (TFSA, 2010, p.5). The basic structure is of an entity owned by investors that holds approved which is administered by a facilitator who is paid fees for setting up and maintaining the fund.

Insurance

Traditional insurance is based upon a pool of insured people paying different amounts based on their risk to an insurer who are reimbursed according to the rules of their policy when unforeseen events occur. Profit is made when the payouts are less than the revenue collected and the other costs to the insurance company.

Because the above situation involves an unknown outcome, it is considered speculation (both in the uncertainty, *gharar*, and gambling, *maisir*, sense) according to Islamic law and is therefore forbidden. Although a *sharia* compliant insurer may also make profits on underwriting and investments (through the establishment of a *takaful*), the policy holders are owners of the fund itself as well as the contributors. The *takaful* is administered by the company offering the service.

Other Considerations

Although each of the above products demonstrate an ability to be profitable, scale is important. The fixed costs involved to sell any of these products would have to be met and exceeded in the long term for any firm to survive. The cost to receive a charter, to navigate through the regulatory requirements, to set up offices, buy equipment and software, and pay employees could be considerable.

The size of the market itself might also be at issue, especially given that any Islamic financial institution could only hope to capture a fraction of it. With a population of a million Muslims (and perhaps 400,000 Muslim households or so as a result), the market seems huge. However, in 2005, Datamonitor (as cited by Tameme) estimated the value of the entire British Islamic mortgage at only 164 million British pounds. Demographic differences notwithstanding, the amount is not substantial considering that the Council of Mortgage lenders reports 137 billion British pounds worth of mortgages are expected to have been booked in 2010 alone in the UK, and during a recession at that (Council of Mortgage Lenders, 2010).

Taxation is another area of concern regarding profitability. In some Islamic mortgages, for example, because the financial institution is the owner of the mortgage until it is discharged, land transfer taxes must be paid twice. This is certainly substantial as in some jurisdictions this can add upwards of 1.5% to the purchase price. There is also for the potential for PST, GST (HST) and QST to be levied on some structures, and on the higher amount (that is, the price the

bank is charging for the asset which includes the markup) (TFSA, 2010). Clearly, this issue needs to be effectively managed to maintain competitiveness in the marketplace, possibly by selecting or attempting to establish structures where this problem does not exist.

The cost of auditing also adds to the fixed costs of any *sharia*-compliant institution. Financial auditing is typically done annually to ensure that all transactions are being recorded correctly according to Islamic accounting rules. Procedural auditing, however is ongoing, and attempts to scan the operations of the bank to ensure that all *fatwas* are considered for all transactions (International School of Management, 2008).

Social-Cultural

Sharia-compliant banking has many potential socio-cultural impacts both internal to the Canadian Muslim community, but also given the large majority of non-Muslims.

Internal

Each Islamic bank becomes certified by a *Sharia* Supervisory Board. However, there is no recognized regulatory body that governs *sharia* banking. Each board, therefore, must act more or less independently.

There are few Islamic scholars who specialize in finance, and because these resources are scarce, these resources are typically expensive and the process is slow because scholars often serve on multiple boards. The International School of Management (ISM) refers to the approval process as “unpredictable” (International School of Management, 2008) and reports that many scholars lack the experience to manage competently and effectively. Preferred candidates are not only knowledgeable about Western-style finance, but also *sharia* law, especially regarding the portion of *sharia* law that pertains to financial transactions. Those coming to the Islamic financial industry from conventional financial institutions often lack the *sharia* component of knowledge, are seen as more apt to attempt to circumvent rules, and often try to replicate conventional models under a *sharia* banner. It is believed that the dearth of well-rounded scholars is acting as a serious constraint to growth of the Islamic financial industry (International School of Management, 2008).

The ISM also states that the practice of “*fatwa* shopping” also occurs on a regular basis. This occurs when a financial institution attempting to gain *sharia* compliance on a particular product or financial vehicle contacts the scholar who they believe is most likely to consider the product to be compliant and will grant the ruling, or *fatwa*. This is against the general *sharia* principle that states that the “litigation should be heard by the jurisdiction that has the most ties with the litigation (International School of Management, 2008).

This practice undermines the stability of the industry as a whole as there can be vast differences between what various financial institutions can offer and how they can perform financial duties. From a consumer's perspective, this could appear to be disorganized or confusing when trying to differentiate between offers in the marketplace. For consumers, investors, and for the financial institution itself, there is a potential for reversals or other changes to agreements already in place (International School of Management 2008). This can cause anxiety with Islamic banking and create risk in the industry above and beyond what is seen in western-style banking (where mortgages and loans have been made with little alteration for hundreds of years).

Operations also have to be audited under *sharia*-compliant structures. Again, no universal standards exist, however the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) has recommended that these audits take place annually. However, "as the subject is not fully developed the problem arises when trying to see what *sharia* auditing entails" (International School of Management, 2008). Although the AAOIFI has developed a certification, currently the classes are only available in Arabic. It would therefore be difficult for the majority of Canadian Muslims from non-Arabic backgrounds or from second or third generations to access these materials and seek certification as an auditor.

Also, *sharia* scholars come from different traditions, and not all *sharia* scholars are accepted by every sect or level of observance. It would be difficult to obtain a board of a variety of scholars that all Muslims would accept and support, let alone a board that would function effectively given the differences. Even though observant Muslims are required by *sharia* law itself to employ *sharia* finance when available, they may refuse to do business with an institution subscribing to a specific brand of *sharia* finance that is not their own.

Given that most Muslims in Canada are moderate, it is unlikely that clients of a *sharia*-compliant bank would object to dealing with female employees in a variety of roles. Traditional clients, however, may prefer male employees either primarily or exclusively. There also might be an insistence on traditional dress for women within this client type. With a minority of Muslim women in Canada wearing a *hijab* or other form of head covering, this may not be palatable to female employees. It would also be very hard to justify a denial of opportunity for various types of business or with certain types of clients (or the employment positions themselves) given Canada's employment equity legislation.

Given the lack of Islamic banking opportunities generally, it remains to be seen if, given that the purpose of the bank would be to serve Muslim constituents, there would be widespread support for large numbers of non-Muslim employees, especially in client-facing roles. However, Tameme's research (2009) suggests that in the UK, a majority of clients (76%) would prefer to deal in English and only 18% thought that it would be inappropriate for non-Muslims to act as

salespersons (24.8% were not sure, and 57.2% believed it was acceptable, Tameme, 2009, p. 226). This suggests the majority would be accommodating. A limited physical presence and a reliance on telephone and online contact may limit client issues associated with client preferences whether gender- or ethnicity-based.

The largest barrier to Islamic banking may be the lack of support from one of the two major Muslim associations in Canada. The vocal Muslim Canadian Congress (MCC), in fact, has been deeply critical of how Islamic finance is currently practiced in other jurisdictions. (By contrast, the larger and more conservative Canadian Islamic Congress has expressed support for Islamic banking in the past by holding a symposium on the subject.)

Quotes from the MCC (all from Muslim Canadian Congress, 2008) include:

- "...there should be no room in Canada for Saudi inspired Islamist political doctrines dressed up as innocuous religious requirements."
- "*Sharia* Banking is an obscene attempt to fleece an already marginalized Muslim community while promising them the exact opposite. On the one hand Imams are warning Muslims of hellfire if they deal with the existing banking systems, and on the other the same clerics are being paid by banks to herd Muslims towards a system that is based on lies and deception."
- "...there is no need to adapt it to the failed economies and medieval systems modeled on Saudi Arabia and Iran."
- "Religion has no place in the banking or mortgage industry..."
- "Muslim bankers and their hired clerics claim they indulge in interest-free banking, but in reality they hide this interest."
- The need to certify *sharia*-compliance of their Islamic products by "qualified *sharia* scholars" has created demand for the services of experts that more often than not are the indoctrinated products of radical *Wahhabi/Salafi sharia* faculties in Saudi Arabia and elsewhere, who generally hold views fundamentally inimical to the most basic values of Western civilization."
- "Even a cursory look at the names, affiliations and views of popular *shari'a* scholars...many of whom sit on the *shari'a* advisory boards of dozens of Islamic banks and get paid princely sums from each, would make it clear that most are hard line Islamists and, in at least some cases, open supporters of terrorism."

The MCC even requested that the Canadian Mortgage and Housing Corporation abandon their study on the subject entirely. Given the propensity for media coverage from a variety of Muslim voices, clearly any Islamic bank in Canada would have to attempt to effectively manage these perceptions.

External

A Muslim bank in Canada might find itself under immediate scrutiny by non-Muslims. Canadians in general appear to be supportive of some differences in society; the extension of marriage to same sex couples is one example. However, Canada's long struggle with the issue of "the two solitudes" may be equally indicative of a lack of a desire for interaction between disparate elements of society, in particular the Muslim community in Canada.

Canada's supposed tolerance to differences may be more of a myth than a reality when it comes to religion. This may be especially true when it comes to Islam. Principally, the issues that Canadians have with Islam surround three perceptions, real or imagined: the propensity or support towards extremism/terrorism, the unequal role of women in Islam, and "soft jihad" through the seeking of special privileges and the adjustment of Canadian society to fit with Muslim beliefs.

Findings from an Angus Reid poll, as reported by *McLean's* (McLean's, 2008), show that Canadians surveyed had the least favourable opinion of Islam when asked about major religions including Christianity, Buddhism, Judaism, Hinduism, Sikhism, and Islam. While 72% of respondents indicated a "generally favourable opinion of Christianity, Islam was scored as least favourable at 28% (this number was only 17% for Quebecers). When asked if various religions promoted violence, 45% believed Islam promoted violence while only 10% of people believed Christianity did. A vast majority of respondents would not support veiled voting (77%) and only 3% support *sharia* law. This is consistent with other Western views of Islam such as a British YouGov poll where respondents overwhelmingly associated Islam with extremism and repression of women (58% and 69% respectively, BBC, 2010).

Given these opinions that exist in Canadian society, it is probable that Islamic banks in Canada would fall under increased scrutiny. The Canadian public would be very sensitive to the any perceived dealings the bank had with extremists or with organizations that support extremist views. A great deal of political backlash and negative publicity would result if interactions such as these were to be discovered.

Canadians would also want to ensure that the Canadian banking system as a whole would not have to be altered to accommodate *sharia*-compliant transactions. The Canadian system's strength has recently become a model for the rest of the world as so many other countries saw their banking systems crumble during the recent global financial crisis. There is little appetite to see alterations made, and protections to ensure that each link in the chain is equally as strong and predictable is very desirable. An Islamic institution, therefore, would have to exist within the Canadian system without increasing risk to the system itself.

Lastly, Canadians would want to make sure that all of the protections afforded to women would apply to clients and employees of an Islamic bank. Ensuring women are free from discrimination and enjoy all of the privacy and financial entitlements that are prescribed by law would be a minimum standard that society at large would expect.

Once again, these perceptions would have to be managed by any Islamic bank wishing to do business in Canada.

Technological

Generally speaking, technology is clearly an enabler when it comes to banking. Over the past several decades, banking has evolved because of technological advancements. In the past, personal and small business banking was an activity that took place in a bank branch during limited hours of the day between a client and a teller. Today, transactions occur at point of sale and online 24 hours a day 7 days a week. It has become an expectation that banking be convenient and available when the client is.

Even mortgage and loan applications can be completed online, often with the paperwork arriving by mail or to a branch to be finalized. Assistance can be provided by email, FAQs, cobrowsing, and by phone.

Commercial banking has traditionally been more relationship focused as the needs of large companies are specific and varied. Frequent personal contact between the client and an agent of the financial institution is the model on which most commercial banking is built.

Technology could greatly aid a small Islamic financial institution both in working across multiple geographies as well as being able to appeal to a number of subgroups. Because Canadian Muslims are not a homogenous group, marketing and online materials could be offered in a number of languages such as Somali, Arabic, Urdu, Farsi, and others as the need arises. Online applications could also be offered in any language as long as the script appears in the Roman alphabet so that credit checks and regulatory requirements can be met by the financial institution. Even these credit checks and regulatory requirements can be partially or fully automated using technology.

Telephone assistance can also be offered in languages other than English and French. It is a simple matter to promote different toll-free numbers to various populations and route the calls appropriately. While a niche offering may not be able to offer around the clock personal service, the expectation may be different when dealing with a niche player. The trade off for availability may be that service is more personalized than at a large financial institution.

Credit cards, ATM cards, bank accounts, mortgages and loans heavily rely on technology to initiate, maintain, and report on activity. Legacy systems for many banks today, even large ones, included separate applications for each of these.

Virtually all applications can be and sometimes are outsourced by major financial institutions, including the online component of the business. (TSYS, for example, is a major supplier of credit card applications and is also acts as a transactions processor.) Certainly there are systems that can be assembled to manage the online presence, bank accounts, ATM cards and Visa cards as the Islamic forms of these products are not substantively different than what is already in the Canadian marketplace at large today.

Islamic mortgages and loans, however, are structured very differently. It would be difficult to imagine that there is an out-of-the-box application that both meets *Sharia* guidelines as well as Canadian regulatory requirements. Therefore, there is a significant possibility that that a highly customized application would be required.

Five Forces Analysis

Threat Posed by New Competitors

Although there are currently “no large bank currently offering Islamic finance products in any meaningful way” (KPMG, 2009, p.6), there is a threat that competition could quickly emerge from both existing financial institutions as well as financial institutions new to Canada.

Certainly larger financial institutions are better positioned from a capital perspective to enter the market, establish a presence in Islamic finance, and begin to compete. Potentially huge capital reserves from other areas of the business can be leveraged to hedge against start-up costs.

Some institutions will have easier access to the market, however. Those banks already operating in Canada could, in theory, already access the market now. The requirement for this segment of new competitor would be the establishment of an “Islamic window”. Islamic windows are separate legal entities created to conform to *sharia* requirements that are wholly owned subsidiaries of the parent financial institution. These vehicles allow the larger bank, who charges *riba* and acts in other ways contrary to established Islamic financial principles, to be able to offer *sharia*-compliant products in a way that is acceptable to scholars.

From an economies of scale perspective, it is uncertain whether or not existing banks in Canada could access any substantive savings given the mandatory establishment of the Islamic windows, primarily due to the forced separation of business activities between the parent organization and the Islamic subsidiary. However, banks that already offer *sharia*-compliant banking products, such as HSBC Amanah, may very well be able to tap into an economies of scale as

existing personnel, technology, systems, Islamic scholars, marketing materials, marketing strategies, product offerings, and brand presence, can be tapped and adapted to meet the requirements of the Canadian marketplace. HSBC Amanah already has a presence in Indonesia, Malaysia (which has the most mature Islamic finance market in the world), Saudi Arabia, the United Kingdom, and the United Arab Emirates. While HSBC Amanah offers a limited product offering in some countries (on the personal side, only bank accounts and mortgages are offered in the UK, for example), the company offers a wide range of products in others such as Malaysia where clients can access investments, mortgages, credit cards, and a wider suite of products.(HSBC, 2010). Because of the depth of knowledge and experience, HSBC Amanah should be considered a serious potential threat.

Retaliation of the existing small competitors against institutions that are massive by comparison (and that also may include RBC, BMO, and Scotiabank, who are all members of the TFSA Islamic Finance Working Group) can be seen as futile. None of these small players have the capital reserves or competitive advantage necessary to compete on the scale with players that can afford to exist in the market even in a losing position for an extended period of time.

In terms of access to distribution channels, all large competitors would face similar challenges in reaching the market at large. (Some smaller existing players are community-based cooperatives which operate on a niche basis. This may be a different market than the mass Islamic finance market.) It is also unlikely that any player could have any significant product differentiation as theoretically all products would have to conform to existing *sharia* requirements. What may be a differentiator is the nature of the institution itself—the brand, the school of *sharia* law that is adhered to, positive associations the bank has in the Muslim community and in the marketplace, and the types of charitable works and other corporate social responsibility agenda items that an institution takes on.

The largest barrier for new entrants aside from the capital requirements is the governmental and regulatory barriers. KPMG theorizes that several applications have been put forth to OSFI to create new Canadian banks that have an Islamic component, and that “the applications are on hold pending a policy decision” (KPMG, 2010, p. 6). It also seems that the larger institutions in Canada are awaiting a regulatory structure before entering the market. However, once this barrier comes down, charters are likely to be granted, Islamic windows will be created, and the competition will begin in a meaningful way.

Intensity of the Competition

Currently there are a few companies offering piecemeal services in Islamic finance in Canada. Some organizations act merely as consultants and intermediaries for a variety of transactions without offering any of the underlying services themselves. Certainly there is no one organization that offers the basic

financial services that average Canadians rely upon such as bank accounts, debit cards, credit cards, loans, mortgages, investments, and insurance.

Most major financial institutions will provide a non-interest bearing bank account including a debit card upon request. However, this involves dealing with institutions that charge *riba* which, in itself, is not *halal* even if the product itself may technically be permissible. In this realm, there may literally be no competition, at least formally from chartered financial institutions that have yet to seek an Islamic window.

UM Financial offers a reloadable MasterCard as a *Sharia*-compliant credit card product (UM Financial, 2010). This is different from fee-based cards offered in other more developed markets (such as Malaysia) where clients receive a monthly bill. No other card offerings have been announced in the Canadian Islamic finance market.

There is more competition around loans and mortgages. These players typically operate on a cooperative basis, and Ansar Cooperative Housing Corporation Ltd. is no exception. Clients buy shares in the cooperative as an investment until their turn to occupy arrives. Clients must have enough shares to occupy the home they have selected based on a formula: 20% of the first \$100,000 plus 25% of value of the home up to \$200,000 plus 30% of the value of the home up to \$300,000, and 100% of the difference thereafter, but not to exceed the amount of \$225,000 total. During occupation, rent is paid according to how much is owned by the cooperative and as the proportion of shares increases month by month, rent decreases. When the home is sold, gains or losses are also assessed. If the member has shares reflecting more than half of the value of the home, 90% of the gains or losses are paid to the homeowners and 10% to the cooperative. If less than half of the home's value are held in shares, the profits or losses are assessed at 80% to the homeowner and 20% to the cooperative. Provisions are made in the contract for numerous other aspects of the relationship such as improvements to the property and the requirements for the formal transfer of ownership from the cooperative to the individual (Ansar, 2008). Ansar Housing is also one of the affiliates (along with Qurtuba) referencing special rates for *Takaful* insurance. (The insurance itself is offered by COSECO which is a member of the Cooperators Group.) This may be the only *Takaful* offering in Canada to date.

Other companies have offerings, some much more defined than others:

- An-Nur (Ontario) Cooperative Ltd. offers two common mortgage arrangements, *musharaka* (partnership with the home paid for over time) and *murabaha* (cost plus profit paid in installments). Application forms for these mortgages are readily available and An-Nur has plans for a housing development project. Only a contact number is provided to manage

- inquiries for investments and loans (An-Nur, 2007). Salam Financial (2006) and Ijaraloans.com (2009) are much the same
- Qurtuba Housing Coop is similar to the above, with the exception that return rates are posted and detailed information is available on the share structure and rent payments. Qurtuba even has a physical office open Sundays. However, the last updates to the site were in 2009 (Qurtuba Housing Coop, 2009)
 - As previously mentioned, UM offers a credit card. Their site also references real estate services, an investment consultant, and “Islamic Finance” solutions which are so broadly defined that products, such as loans, are not mentioned (UM Financial, 2010)
 - Lariba Financial purports to offer personal and business loans as well as investment and RRSP options, however, no concrete details on any of these offerings are available on the Lariba website—only contact information appears (Lariba, 2007)

When investments are also offered, it is often on a reseller basis for funds that have been set up in other countries. Funds based on the S&P Sharia stock index are good examples. The one exception from the past was an offering from RBC Capital markets called the RBC Sharia-Compliant Equity-Linked Note (AMEinfo.com, 2004). Announced in 2004, it quickly faded into obscurity due to a lack of public interest.

In addition, the reference dates for some of the above websites have not been updated for more than five years suggesting that some companies are much more active in the market than others. By contrast, in the conventional finance market, literally hundreds of products have been launched over the last five years. Regular updates to marketing materials, especially a website, would be a minimum expectation. This suggests that overall there are a few players that are active and perhaps several that are either inactive or have a low level of activity in the Islamic finance market in Canada.

Available Substitutes

The availability of substitutes may depend on the level of religiosity of the individual. For religious individuals who adhere strictly to Muslim doctrine and will not under any circumstances be associated with *riba* or those who charge it, alternatives in Canada are limited. These individuals might be unbanked altogether and may be forced to use cash almost exclusively. The religious would not ever use loans, mortgages, or credit cards from mainstream Canadian banks meaning that any lending would have to take place privately, perhaps through other members of the Muslim community. [The inconvenience, regulations, and costs against using foreign banks (most of whom would not agree to deal with an out-of-country client in Canada in the first place) would likely be prohibitive to the point of infeasibility.]

Moderate Muslims, on the other hand, presumably already use conventional banking products. This group who is the clear majority could take advantage of the high level of competition in the industry generally. This group could select from literally hundreds of product choices across dozens of suppliers. The choices in the Canadian market for bank accounts, credit cards, loans, mortgages, and insurance is staggering. Products can be differentiated by structure, price, service, rewards, affiliation, proximity/accessibility of the institution, bundling discounts, and other metrics.

To illustrate the options for just one typical financial product, there are seventy-six credit card choices listed under “Standard Credit Cards – Regular Rate” alone on the Financial Consumer Agency of Canada’s comparison site (FCAC, 2010). This is only one category however—there are products listed under a variety of other categories such as Standard Credit Cards – Low Rate, Gold Credit Cards (Regular and Low Rate), Platinum Credit Cards (Regular and Low Rate), US Dollar Credit Cards, Student Credit Cards (Regular and Low rate), Secured Credit Cards, Retail Credit Cards, and Charge Cards.

Similar intensive levels of competition exist for loans, mortgages, bank accounts, and insurance in the very mature Canadian banking marketplace. Substitutes, therefore, for moderate Muslims are vast in number and easily accessible.

Bargaining Power of Customers

Once again, it can be stated that there are two types of customers, the religious and the liberal. Both of these groups have different bargaining positions in the Islamic finance marketplace as a result.

The religious must by the tenets of their faith only use *sharia* compliant financial products. With the limited options currently available, there may be only enough price sensitivity to the product to determine whether or not the product will be used at all. For example, if the overall cost of a mortgage were prohibitive, it would be likely that this segment would continue to rent. However, if more options were available a number of factors may come into play. One certainly would be price, but another factor may be the *sharia* law tradition that is employed by the financial institution. Affiliation, the individual or the institution being represented by the individual, and personal relationships, might be factors that could have greater importance in various Muslim communities.

The bargaining position of the moderate Muslims is much different. This segment can elect to utilize *sharia*-compliant banking products or any of the hundreds of comparable products in the conventional finance marketplace. Given the general lack of Islamic bank accounts, loans, credit cards and other financial products in Canada, it is very likely that at present a high proportion of Muslim Canadians are doing this very thing. Although this segment could conceivably switch to a *sharia*-compliant financial institution, switching costs (in the case of mortgages—the cost to move other products is negligible in most

cases) or simple inertia may make changing financial institutions an unattractive proposition.

Tameme (2009) demonstrated that there also seems to be a range of price sensitivities regarding mortgages (data on mortgages may be particularly telling as this expense is typically the biggest cost to consumers for financial products), likely at least partially stratified by degree of religiosity. Tameme found that 39.64% of respondents agreed that they were willing to take on an Islamic mortgage only if the cost were similar or lower than the cost of a conventional mortgage. Only 8.4% said that they would take an Islamic mortgage no matter what the extra cost, and 18% said they would take an Islamic mortgage if leading Islamic scholars have approved it. 3.6% would not take an Islamic mortgage under any circumstances, 5.2% said that Islamic mortgages were not possible, and 25.2% were not sure (Tameme, 2009, p. 165). However, the numbers change slightly when the question is asked somewhat differently. When respondents were asked not about personal willingness, but rather what *others* should do through the statement “An Islamic mortgage should be taken even if it is more expensive than a conventional mortgage”, 36.2% responded favourably, 38.6% didn’t know, and 25.3% were unfavourable towards the statement (Tameme, 2009, p.189). This suggests that although most Muslims have social values that promote the tenets of their faith, that personally they feel that they either cannot afford or should not be expected to afford to carry additional costs associated with Islamic mortgages.

But with both the moderates and religious, Tameme’s research shows that there may be a serious information gap when it comes to Islamic finance. In the results of the two survey questions above, 25.2% and 38.6% of respondents “didn’t know” or were “not sure” about the topic of taking out Islamic mortgages. Further, when asked to comment on whether Islamic mortgages were similar to conventional mortgages but the interest is “dressed up as rent” (Tameme, 2009, p. 190), once again, 44.6% were uncertain. Although most Muslims claim to know about Islamic Finance principles (72%), only about half (50.4%) knew the differences between an Islamic and a conventional mortgage with about equal numbers claiming not to know (23.2%) or not being sure (26.4%) about the differences.

Product awareness seems to be much higher. 64% in Tameme’s study were aware that Islamic mortgages existed in the UK (Tameme, 2009, p. 218). Most were made aware by family and friends (39.9%), but other sources such as bank publications (19.7%), the mosque (15.3%), the internet (8.9%) and newspapers (6.4%) also play a role. Combined with the information above, this data suggests that Muslims are aware of Islamic finance options, but may not be sure exactly what these products entail or how they are structured.

An Islamic financial institution in Canada would find that the religious would have a relatively low bargaining position because they are mandated to use *sharia-*

compliant banking products and would do so even if the price were higher than conventional products. Moderates, because of their propensity to substitute, are in a greater position of power providing the buyers are informed about how the products work. Without this knowledge, buyers may not even consider themselves to be within this market at all.

Bargaining Power of Suppliers

A large number of suppliers for financial institutions provide commodities such as office space, office supplies, computers, servers, and furniture. These materials are in wide distribution and any of a number of suppliers could be contracted to provide them. The two areas where suppliers could exhibit more influence are labour and technology.

As mentioned previously, there are few qualified and experienced Islamic scholars. As a result, candidates with sufficient qualifications could command large salaries on an ongoing basis. Attracting employees at other levels in the organization might also be challenging because of the need to be sensitive to and familiar with several Muslim cultures as well as Islamic banking as a concept. Although these employees may or may not demand higher salaries, recruitment might be more challenging.

Several technology firms can offer the systems for bank accounts, credit cards, loans, mortgages, investments, and even insurance. These are already specialized software solutions that are industry specific, so although there is competition, suppliers are limited. However, all of these solutions are geared towards offering products that effectively exist already in the Western world. A technology supplier that could integrate Canadian regulatory requirements as well as the checks and balances that would enforce *sharia* requirements could wield considerable power.

SWOT Analysis

Strengths

An Islamic financial institution operating in Canada could expect to be able to leverage a number of strengths. The first is that the various Muslim communities are underserved (and perhaps in some cases unserved altogether). An institution offering the basic services of a bank account, credit card, loan, investments, insurance and a mortgage under one brand could capture a significant proportion of this niche market. As well, there is effectively no serious competition at present to interfere with the attempts to capture this market as existing players offer portions of the banking relationship on a small and often local scale. The addition of a respected banking brand into the mix could make the proposition even more compelling for consumers, and the bank in question could gain the respect and loyalty of the Muslim community by simply offering Muslims the opportunity to more closely follow their beliefs. The Islamic finance market can also be expanded through client education. Making Muslims more

aware of what the products entail, and how the products relate to *sharia* law and Islam would make the products more relevant to this population.

The community is also young and educated meaning that the Muslim population in Canada is more likely than other Canadians to require mortgages and credit cards, products that are typically the most profitable in banking. As well, the use of technology could allow the financial institution to operate seamlessly across jurisdictions, geography, time zones, cultures, and languages.

Weaknesses

The weaknesses involved in attempting to start and operate an Islamic financial institution are formidable. Currently no charters have been granted for new financial institutions with an Islamic finance structure pending the construction and communication of a regulatory framework from OSFI. This stymies both existing banks who would seek an Islamic window if the regulatory requirements were known as well as potentially new banks with an exclusively Islamic focus who are awaiting approval from the Minister of Finance.

Other weaknesses associated with regulatory issues are apparent. For example, it is unlikely that there is an appetite to change any existing regulatory requirements in Canada to accommodate Islamic financing. This is due to Canada's relative success during the world economic crisis that is almost wholly attributed to the regulations in place prior to the crisis. If conflicts exist and serious regulatory exemptions are required for Islamic finance vehicles (limits in the holding of real estate for example) that could be perceived to undermine existing successful regulations, the situation may not be resolvable and Islamic finance in Canada could stay in its current state for the foreseeable future.

The Muslim population in Canada is also very small and therefore so is the potential profit potential for an Islamic financial institution. The capital commitment required to either create a financial institution or an Islamic window is substantial. Deep pockets would be required for any institution especially at the beginning of operations. As well, if large financial institutions begin to compete in the Islamic banking sphere, it might be difficult for a small player to survive at all. A small player may not be able to compete on price, and would not be able to sustain competing from a losing position over a long period of time. A large financial institution could hold out much longer.

A *sharia*-compliant financial institution would not only have to compete against other similar institutions, but in the case of seeking the business of the moderate Muslims, against existing large financial institutions who benefit from massive economies of scale. This is problematic as the nature of Islamic mortgages can lead to many extra forms of taxation. Islamic financial institutions are also audited an extra time for *sharia* compliance which also adds to the cost. Unless workarounds can be found, these costs may make competing on price unrealistic.

The Canadian Muslim population is also not homogenous from a religiosity, culture, country of origin, mother tongue, or *sharia* law tradition preference. Marketing to a small disparate population such as this that is spread across several major centres throughout Canada would be a challenging effort.

Public perceptions would also have to be actively managed. Association or even perceived association with fundamentalism or terrorism could cause serious public relations issues up to and possibly including investigations by financial and legal authorities. The impact of these investigations would obviously be catastrophic even if no wrongdoing could be confirmed. The organization would have to be beyond reproach in other areas as well such as regulatory requirements (such as anti-money laundering and anti-terrorism requirements), legal requirements, and privacy requirements. Human resources practices would also have to be carefully managed to ensure that women and non-Muslims would be treated according to the relevant anti-discrimination legal protections. Even charitable causes supported by the organization would have to have very clean hands.

Opportunities

The Muslim population is set to increase substantially over time. For firms with a long term view, cementing the future market position by capturing a substantial portion of the Islamic finance market today could prove to be a solid strategy.

There are still opportunities in today's market however. This is especially true since no existing player has unique or superior access to Islamic Finance clients. One supporting strategy would be the effective use of technology to reach the disparate and dispersed Canadian Muslim population. Services could be offered in English and French as well as languages commonly spoken by Muslim immigrants such as Somali, Farsi, Arabic, and others to attempt to capture various cultural markets. Online and telephone interactions also may serve to negate any issues regarding gender or dress, and a company that can appeal to a younger and more moderate Islamic demographic would have a clear advantage.

There is also an educational component. The market can be grown by successfully communicating how various products (such as bank accounts, credit cards, loans, investments, and insurance) are structured and what makes each *sharia*-compliant. The firm doing the educating may be able to translate this effort into sales, especially if the interactions are personal and the brand is trusted.

Cost containment is key as most Muslims will only be willing to use Islamic financial products that are priced on par with those of the market at large. (There may be some opportunity to reach the non-Muslim population if mortgages in particular can be offered at an effective rate that is substantially below other

products in the market. However, this may be too challenging a prospect given the niche nature of the market.) Existing Canadian institutions could potentially leverage economies of scale to reduce cost. Institutions new to the Canadian market but with experience in Islamic finance could also benefit from some economies of scale especially regarding the use of existing systems and processes.

Threats

Existing financial institutions wishing to enter the market would be required to seek an Islamic window. The lack of operating regulations makes doing so unappealing as the unknown nature of the potential regulations contributes to the level of risk. New entrants are also being held back from gaining charter status even if these entities would be willing and able to assume these regulatory risks.

Both existing financial institutions and new entrants could potentially be competing with one new entrant in particular that is both experienced in the Islamic finance market and also associated with a large financial institution. HSBC Amanah has the ability to dominate given previous experience in multiple markets (including the UK, Saudi Arabia, and Malaysia which is the most mature market in Islamic finance), existing transferable systems and processes, as well as a well-financed parent company. This makes HSBC Amanah a serious competitive threat to any other incumbent.

The potential for Islamic banking products to be more expensive than conventional banking products could severely limit competitiveness and therefore market potential and profitability. This is especially true for mortgages.

In real terms, the market size for Islamic mortgages (again, this is the product with the largest cost, and is often an anchor product that increases client loyalty and opens clients up to other products as well) is quite small in comparison to the Canadian mortgage market as a whole. Even assuming that there are one million Muslims in Canada today (3.33%), only a fraction would be considering a new mortgage (or the renewal of an existing mortgage) at any given time. Of that small number, only a few would insist upon an Islamic mortgage—if Tememe is correct, only around 8% of Muslims which translates into a quarter of a percent of the Canadian population—although substantially more might consider Islamic finance options especially if the price is comparable.

The demand for other Islamic financial products is certainly larger than for mortgages as virtually all Canadians have at least a bank account and most adults have at least one credit card. The demand for *sharia*-compliant loans, investments, and insurance would be somewhere in the middle. These broader appeal products might be profitable although the total potential profit would be smaller in real terms than with mortgages. But still, in an overall sense, the market is an extremely small percentage of the Canadian market across all product types.

The Muslim Canadian Congress is likely to oppose any form of *sharia*-compliant banking. This, as well as other negative media coverage, may prevent an institution from gaining enough market share to be self-sustaining. At a minimum, this type of negative media coverage would likely prevent many non-Muslims from considering the alternative finance models offered by an Islamic financial institution.

Recommendations

The following recommendations should be considered for any firm wishing to succeed in the Islamic finance market in Canada.

- It is critical that the firm is competitive with the conventional market on price. This is because moderate Muslims make up the majority of the Islamic population in Canada and have a large propensity to substitute.
- In order to compete on price, cost containment is critical. This is exacerbated by the small size of the Islamic finance market. Part of reducing costs may be to set up simple, routine products (and the associated internal support processes) once under the supervision of a *sharia* board to ensure that ongoing costs are reduced. Acting as a reseller for investments and insurance so that another party effectively pays for the cost of those boards would also be prudent.
- A workaround for the additional property transfers and taxation should be actively sought and supported by the entire Canadian Islamic finance industry. OSFI should be pressured by all market participants to alleviate this extra burden.
- Existing banks wishing to enter the Islamic finance market may wish to begin the process of seeking an Islamic window. This may include assembling a stand-by team for when OSFI legislation is made public.
- A large existing player could attempt to compete at any point today in order to capitalize on a relatively young, wealthy, and rapidly expanding Muslim population. This strategy is not without risk, however. The demographic trend to make such an effort worthwhile is decades in the making which is certainly longer than the planning cycles for most financial institutions. Also, the sunk cost of retrenchment or serious alteration of the business by operating without established regulations for Islamic finance could be substantive. A better alternative may be to announce this strategy to OSFI thereby forcing the issue. In an ideal situation, the institution would work with OSFI and other players to help negotiate and craft the regulations.
- Rely on technology to reach a population that is multilingual and spread throughout the country. Use a scalable model that keeps costs down initially but that is ready for growth. This may be achieved through a licensing model or through the use of an outsourced provider.
- In the case of a small player, extra efforts are required to combat larger firms attempting to compete on price alone. Offer personalized service in

several languages to build trust and increase the number of word-of-mouth referrals critical to this business. Also offer comprehensive education and information about various Islamic finance products by accessing Muslim communities on a local and personal level.

- Show your products and your rates on a public website that is updated regularly. The website should also act as an information source and resource on the firm's products and how the products relate to Islamic finance.
- Ensure that your branding sends the message that your firm will allow Muslims to act in a manner that is consistent with their faith and beliefs by using Islamic financial vehicles.
- Carefully manage public perceptions. Be vocal in the public sphere about following all Canadian regulatory and legal requirements. Distance the firm from extremists and extremism. Attempt to gain support from the CIC at a minimum and MCC if possible. In the Corporate Social Responsibility sphere, find a charitable cause that both Canadian Muslims and Canadians at large would support and highlight this relationship appropriately.
- Continuously scan what other firms throughout the globe are offering and use the results as a starting point for a product offering. Put special emphasis on firms in mature markets such as Malaysia.
- Offer a comprehensive product suite in order to be a one-stop shop. Bundle the products and services to ensure to the greatest degree possible that each client is profitable and loyal.

Conclusion

This conceptual study examined the prospect of Islamic banking in Canada through macro- and micro-environmental analyses. The DEPEST analysis examined the Demographic, Environmental, Political/Regulatory/Legal, Economic, Sociological and Technological factors that relate to the market. The Five Forces analysis described the factors that influence the attractiveness of the market such as the threat posed by new competitors, the existing competition, substitutes, the bargaining power of customers and the bargaining power of suppliers. These analyses were used to compile a comprehensive list of strengths, weaknesses, opportunities, and threats (SWOT) and a series of recommendations that a firm seeking to enter the Islamic finance market in Canada could leverage.

It is likely that Islamic finance in Canada will become a reality, although it is difficult to say when this might occur. Certainly the lack of a regulatory framework is a major stumbling block to the beginning of competition on any serious scale. Demographic trends suggest that the market will only increase over time. It will up to individual firms to decide when a "tipping point" has been reached that balances the cost of entry into the market against the size and profit potential of the market. Given that charters for Islamic banks are currently on

hold, it is likely that many will consider the existence of a regulatory framework as the signal to enter the market.

There are also some unanswered questions about this market, namely, to what extent Muslims in Canada might be entrenched in their relationships with conventional banks. The potential to switch away from these institutions and towards a *sharia*-compliant institution remains to be seen. An Islamic bank that cannot gain new clients by successfully attracting them away from conventional banks could not expect to survive for long.

It is also unknown if Muslims of different traditions will accept an institution that models only one type of *sharia* law, let alone an institution with an Islamic focus but not a certifying *sharia* board. (It is possible, however, that this could even be considered a selling point given the feelings that some Muslims have about the perceived extremist and exploitive *Wahhabi* influence on Islamic finance.)

Whether the market will be eventually seized primarily by conventional banks who leverage their economies of scale to offer vast servicing, channel and product offerings, or by niche players who are able to offer personalized service consistent with Islamic values through Islamic finance, the competition will be aggressive. With the size of this segment increasing, there are few new frontiers in the mature Canadian personal banking market. If the demographic predictions are accurate, it is certain that in the not too distant future that financial institutions of all configurations will no longer be able to ignore this underserved market.

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