



FINANCIAL ADVISORY SERVICES

# Making the Transition From Niche to Mainstream

Islamic Banking and Finance: A Snapshot of the Industry and Its Challenges Today

ADVISORY

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# Foreword

In publishing this paper on challenges and opportunities in Islamic banking and finance our aim at KPMG's network of firms is to provide perspective on these issues and, hopefully, have it serve as a catalyst for a discussion on change, opportunity, and growth.

These are, indeed, exciting times in the global financial marketplace—financial innovation continues at breathtaking pace while the size and intricacy of transactions seem to reach new levels on an almost daily basis.

Islamic finance stands out on its own as an industry demonstrating remarkable development, expansion, and consumer up-take—all in a relatively short period of time. With much achievement behind it, the industry is now looking forward to a crucial and challenging stage in its development. The outcome will shape much of its path and progress over the coming years.

Indeed, as an industry predicated on originality and creativity, it must continue to measure itself against these benchmarks to reach the next level. At KPMG's network of firms, we are delighted to be able to play a part in helping the industry formulate the ideas and means to meet these challenges in a robust and creative manner.

Brendan Nelson  
Global Chairman, Financial Services  
KPMG in the United Kingdom



# Introduction

*Although the concept of Islamic finance was once regarded as an exotic niche of the financial world, these days it is growing rapidly.... Moreover, the sector used to be dominated by local banks in Malaysia or the Middle East but now a growing number of non-Muslim banks are also joining the fray.*

Source: "Islamic Banking Confounds Skeptics," *Financial Times*, June 2, 2006

As the modern Islamic financial services industry enhances its sophistication, an increasingly affluent Muslim-investor population continues to voice its desire for more investment products that adhere to Islamic principles. Coinciding with this surge in demand is the progressively more significant role that Islamic finance plays in the global financial community. Indeed, with respect to the breadth and range of products and services offered, the distinct line that once separated Islamic financial institutions from their conventional counterparts is blurring.

The Islamic finance sector has become a dynamic, fast-growing global phenomenon. Islamic industry estimates are that there are now about 300 Islamic financial institutions in 75 countries, holding assets estimated at more than US\$300 billion, and another US\$400 billion in financial investments. Moreover, for the past five years or more, these institutions have been growing at about 15 percent per year. Estimates are that the market should continue to grow considerably in the foreseeable future, given the amount of oil wealth in much of the Muslim world and a pent-up demand for investment products developed according to the tenets of Sharia'a—the legal and ethical code of Islam.

With an estimated 1.6 billion Muslims in the world,<sup>1</sup> and with Islam considered to be the fastest-growing religion in the world, increasingly financial institutions globally are creating Islamic investment alternatives.

While the main centers of Islamic finance are the Middle East, Malaysia, and the United Kingdom, customers are not confined to Muslim countries but are spread across Europe, the United States, and the Far East. It's therefore no surprise that many of the multinational financial institutions are involved in the sector.

The industry has embraced a wide range of institutions and products, including commercial Islamic banks, Islamic investment companies, Islamic investment banks, insurance companies, asset management companies, e-commerce, and brokers and dealers. Products include commercial Islamic banking products, insurance products, mutual funds and unit trusts, Islamic bonds, and Sharia'a-compliant stocks.

This phenomenal rate of growth will likely be affected by a number of challenges:

- Further product development and consistency of product structure
- Widespread acceptance of the products and operations by consumers across different regions
- Short-term investment opportunities
- Continued and wider education of individuals with the appropriate skills to take the industry forward
- Enhancement of corporate governance and risk management practices

<sup>1</sup> Islamicweb.com, 2006

- Adaptation of conventional tax regimes to meet the needs of Islamic products and create a level playing field with conventional products
- The need to satisfy local generally accepted accounting principles (GAAPs), IFRS, and financial and prudential regulations

To fulfill this potential, the pressure remains on Islamic financial institutions to strive toward additional and more sophisticated offerings for consumers who demand Sharia'a-compliant products. These consumers are making it increasingly clear that returns, service, and convenience of these offerings are just as critical as Sharia'a compliance.

Indeed, this is a clear measure of the progress the industry has made in a matter of years—no longer is there a perception that you should be prepared “to pay extra” for Sharia'a-compliant products.

Historically, Sharia'a compliance was the primary issue among investors. The debate now encompasses additional issues, including, quality of return, transparency of disclosure, and excellence of customer service among others.

We take a closer look at some of these challenges and issues in the following pages.



# Growth and Business Development

With the Muslim population accounting for nearly one quarter of the world’s population, and expected to grow at a faster rate than any other religion, and, with demand for Islamic products rising, the availability of Sharia’a-compliant banking, investment, and insurance products continues to grow.

**Sharia’a:** Islamic law as revealed in the Quran and through the example of the Prophet Muhammad (PBUH).

An Islamic financial institution usually has a Sharia’a committee comprised of scholars in Islamic law who provide advice on strategy and review new products and operations to determine whether they are Sharia’a compliant.

The Islamic financial services industry is not yet a single, thriving marketplace but rather a collection of markets, each of which is at a different level of development and sophistication in terms of product development, competition, and regulation.

The industry faces competition from a number of angles, not least from the conventional financial sector. Well-established, Western-based global financial players continue to open and expand operations in Muslim regions of the world and have built infrastructures to enter markets, particularly in the Islamic financial centers of Dubai, Bahrain, and Kuala Lumpur. They are using their considerable operational, marketing, and technology skills to produce and distribute Islamic financial products in direct competition with indigenous financial institutions.

At the World Islamic Funds Conference held in May, 2006, in Bahrain, Baljeet Kaur Grewal, Chief Economist and Head of Investment Banking Research at Maybank Investment Banking Group, provided the following diagram of the stages of evolution in Islamic finance worldwide.

**Stages of Evolution In Islamic Finance: Islamic Financial Services Industry**

	Institutions	Products	Area
<b>2000s</b>	<ul style="list-style-type: none"> <li>Commercial Islamic banks</li> <li>Takaful</li> <li>Islamic investment companies</li> <li>Islamic investment banks</li> <li>Asset management companies</li> <li>e-commerce</li> <li>Brokers/dealers</li> </ul>	<ul style="list-style-type: none"> <li>Commercial Islamic banking products</li> <li>Takaful</li> <li>Mutual funds/Unit trust</li> <li>Islamic bonds</li> <li>Sharia'a-compliant stocks</li> <li>Islamic stockbroking</li> </ul>	<ul style="list-style-type: none"> <li>Gulf/Middle East</li> <li>Asia Pacific</li> <li>Europe/Americas</li> <li>Global Offshore Market</li> </ul>
<b>1990s</b>	<ul style="list-style-type: none"> <li>Commercial Islamic banks</li> <li>Takaful</li> <li>Islamic investment companies</li> <li>Brokers/dealers</li> </ul>	<ul style="list-style-type: none"> <li>Commercial Islamic banking products</li> <li>Takaful</li> <li>Mutual funds/Unit trust</li> <li>Islamic bonds</li> <li>Sharia'a-compliant stocks</li> <li>Islamic stockbroking</li> </ul>	<ul style="list-style-type: none"> <li>Gulf/Middle East</li> <li>Asia Pacific</li> </ul>
<b>1980s</b>	<ul style="list-style-type: none"> <li>Commercial Islamic banks</li> <li>Takaful</li> <li>Islamic investment companies</li> </ul>	<ul style="list-style-type: none"> <li>Commercial Islamic banking products</li> <li>Takaful</li> </ul>	<ul style="list-style-type: none"> <li>Gulf/Middle East</li> <li>Asia Pacific</li> </ul>
<b>1970s</b>	<ul style="list-style-type: none"> <li>Commercial Islamic banks</li> </ul>	<ul style="list-style-type: none"> <li>Commercial Islamic banking products</li> </ul>	<ul style="list-style-type: none"> <li>Gulf/Middle East</li> </ul>

Source: Aseambankers, World Islamic Funds and Capital Markets Conference, May 2006, Bahrain

The markets themselves are expanding. The United Kingdom, in particular, has seen significant landmark activity recently with the creation of two stand-alone Islamic banks, the Islamic Bank of Britain Plc, and the European Islamic Investment Bank Plc, while major U.K. retail players such as HSBC and Lloyds TSB have been quick to focus on this retail market and broaden their product offering. Similarly, global investment banks such as Deutsche Bank and Credit Suisse have established their own Islamic finance desks, typically centered in London, to provide Islamic corporate and investment banking services to these markets. Indeed, at a recent conference on Islamic finance in London, the U.K. Chancellor announced the ambition of the British government to make Britain “the gateway to Islamic finance and trade.”<sup>2</sup>

In the United States growth has been slower, although Islamic mortgages have found a market. The Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae), national organizations that purchase home mortgages on the secondary market, have purchased Sharia’a-compliant mortgages, supplying much needed liquidity that has enabled the growth of the Islamic mortgage market in the United States.

Sheikh Hussein Hamid Hassan, who assisted in the creation of one of the first Islamic banks in 1975 and who sits on Sharia’a compliance boards at a number of financial institutions, was quoted as saying: “I am getting delegations from China, from Russia, from Japan, from all over the world wanting [my advice on how] to set up Islamic banks. We are very, very busy.”<sup>3</sup>

There are a number of identifiable, and related, factors that have contributed to, and should continue to contribute to, the growth in worldwide Islamic finance. For many Muslims, the development of a robust Islamic financial marketplace has allowed them to find appropriate instruments that promote justice, goodness, and equitability. This attitude has led to an expansion of the investor base, and may be acting as a foundation to permit cross-border cooperation in the growth of the industry.

However, others argue that, to some extent, the growth rates witnessed by the industry have been contrived and point to the phenomenon of “conversions” by conventional banks to Islamic banks where, for example, existing customers’ conventional accounts are transformed to Islamic accounts rather than growth rates being attributed to new customers being attracted to Islamic banking.

Aside from those issues, the following are a few of the significant factors that impact growth and business development in the marketplace.

Three fundamental prohibitions in Islamic finance:

**Riba:** Interest. Essentially riba covers any return of money on money.

**Gharar:** Similar to “uncertainty” in English. This is often used as the grounds for criticism of conventional financial practices such as short selling, speculation, and derivatives.

**Maysir:** Similar to “gambling.” Often used to argue against conventional insurance and derivatives.

<sup>2</sup> Chancellor of the Exchequer Gordon Brown, speech at the Islamic Finance and Trade Conference, London, June 13, 2006

<sup>3</sup> “Islamic Banking Confounds Skeptics,” *Financial Times*, June 2, 2006

Some of the key terms:

**Mudaraba:** An investment partnership, whereby the investor provides capital to an entrepreneur in order to undertake a business/investment activity.

While profits are shared on a pre-agreed ratio, loss of investment is borne by the investor only (unless negligence of the entrepreneur can be demonstrated).

**Murabaha:** Purchase and resale of a particular asset/commodity at a markup.

**Musharaka:** An investment partnership where profits are shared per an agreed ratio whereas losses are shared in proportion to the capital/investment of each partner.

**Ijara:** An Islamic lease agreement.

**Sukuk:** Similar characteristics to that of a conventional bond with the difference being that they are asset-backed. Sukuk represent proportionate beneficial ownership of the underlying asset.

**Takaful:** Islamic insurance. Structured as a charitable collective pool of funds based on the idea of mutual assistance. Takaful schemes are designed to avoid the elements of conventional insurance that are problematic for Muslims.

### Sharia'a Compliance

The key factor differentiating Islamic financial institutions is the need to demonstrate full compliance with Sharia'a in all activities (including non-financial activities), whether this is to internal stakeholders such as employees or external stakeholders such as customers and shareholders. *This compliance factor is the heart of the industry—its present, and its future—and it faces a number of challenges.*

### Scholars

At a micro level, there is the need to achieve consensus among these scholars regarding whether certain transactions or activities are Sharia'a compliant. This need to achieve consensus has, in the past, caused difficulties among practitioners and customers, and it has had the effect of restricting the concept of Islamic finance in many parts of the world market.

At a macro level, the industry has access to only a handful of acknowledged and accredited scholars who have the necessary combination of understanding of Sharia'a and knowledge of banking operations and products. This limited availability can restrict product innovation.

Such issues reflect wider structural deficiencies in the marketplace. To some industry observers and participants, the different potential applications of Sharia'a reinforces the need for the industry to act quickly to create an effective training program that would increase the number of scholars with the requisite religious and financial training.

On the ground meanwhile, bank executives must continue to work with Islamic scholars to develop more sophisticated products and sharpen their own understanding of Sharia'a.

### Debates around Standardization

There also is persistent debate within the industry around the need for a standardized legal, accounting, regulatory, and Sharia'a supervisory framework, which would provide an essential foundation for future growth, as well as a level playing field for Sharia'a-compliant products and conventional finance. Some industry participants say that only if the Islamic financial industry can meet these challenges head-on can it hope to really capitalize on the undoubted opportunities of a huge global market. They also argue that without this standardization, the industry is left exposed to "Sharia'a arbitrage" as institutions, bankers, and consumers seek to find the opinion that suits their objectives.

Other industry participants argue equally vociferously against this viewpoint, emphasizing that any such standardization could only be driven by cross-border, quasi-governmental organizations, with the inevitable impact on choice and speed of innovation and activity within the industry.

### Quality and Level of Sharia'a Compliance

Demonstrating compliance with Sharia'a can be difficult as different institutions have different governance models by which they set, measure, and monitor their compliance. These varying governance models have added a level of operational risk for any Islamic financial institution.

Going forward, this can present an opportunity where some institutions can look to differentiate themselves and achieve a competitive advantage over their peers.

Among the questions involving Sharia'a committees is whether there should be a separate specialized "Sharia'a audit" function—independent of the internal audit function—in order to support the basis of the Sharia'a committee opinion. If so, who or what body would provide the industry guidelines governing Sharia'a operations, scope, and standards?

Should external auditors be expected to provide an opinion on compliance with the Sharia'a guidelines and rulings issued by an Islamic bank's Sharia'a supervisory board? Arguably, only a handful of firms have the in-house knowledge and resources to provide such an opinion.

Despite the efforts made by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), no clear consensus has yet emerged on this front across the various markets and approaches still vary. What seems clear is that competition among institutions will drive some aspects of the response to these questions.

### Sharia'a Compliant versus Sharia'a Based

Finally, there is a view that some of the existing methods and tools in use reflect principles agreed upon decades ago. Often these were founded upon dispensations granted by scholars in the interests of establishing the first bases of this industry at a time when it lacked critical mass and when conventional financial institutions dominated the global financial markets.

Many now are hoping for an industry that seeks not so much to adopt replicas of conventional products and adapt them to be Sharia'a compliant, but one which revises its entire foundations and operation principles. Such an industry would be based, first and foremost, on the original principles of Sharia'a and Islamic economics and would develop its products from the ground up.

In fact part of this challenge hinges on the fact that many global economies today are often centered around wage/salary earning activities/occupations rather than actual proprietary trading activity, which is arguably closer to the heart of some classic Islamic economic models.

Whether ultimately this can or will be truly achieved is yet to be seen but this particular debate does also raise questions around the extent to which the Islamic financial economy can genuinely be separated from the relevant political economy.





### Liquidity

Liquidity is one of the current major challenges for the Islamic financial services industry. Many Islamic financial institutions have very large cash surpluses—generated principally by soaring energy prices. But unlike their conventional counterparts, Islamic financial institutions often have little or no access to a Sharia’a-compliant short-term liquid investment market of any depth. With a lack of products or assets in which to invest their money, institutions are finding it difficult to manage temporary and/or short-term excess liquidity or liquidity shortages.

An example of this broader issue of choice and availability is amply demonstrated when one takes a cursory glance at some of the Islamic equity indices that have been created. Islamic investment indices are equity benchmark indices designed to track the performance of leading publicly traded companies whose activities are consistent with Islamic Sharia’a law. Panels of scholars are comprised to screen equities for Sharia’a compliance before these indices are released. The indices are available for many of the major global exchanges and include the Dow Jones Islamic Market Indices and the FTSE Global Islamic Indices. By definition, these indices will always be a subset of the wider market, thus limiting the range of choice and associated risks and rewards to the Islamic investor.

The situation can be more challenging on the money markets side. While conventional banks often invest surplus short-term cash in overnight interest-bearing facilities or international treasury bills, similar assets of sufficient depth are typically not available to the Islamic financial institution.

Progress has been elusive, and there is a clear need for an integrated approach to developing comprehensive and in-depth Islamic money and securities markets. While the industry has seen some recent initiatives (e.g., the establishment of the Liquidity Management Centre and the International Islamic Financial Market), this is still an area where many Islamic financial institutions continue to face difficulties.

### Funds

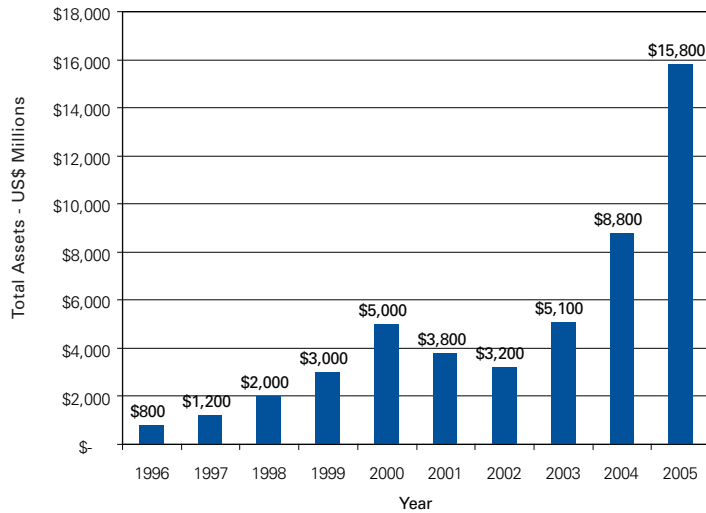
On the theme of liquidity, the Islamic financial market has expanded significantly in the past decade in particular, as evidenced by the growing number and value of Islamic equity funds. In 1994, there were nine funds with a collective value of US\$800 million, and by 2006 the numbers had jumped to 126 and US\$16 billion.<sup>4</sup> Two thirds of these funds are from the Middle East.<sup>5</sup> The largest Islamic fund holds assets of US\$1.2 billion, and while that figure pales in comparison to the largest funds in the world—some of which hold assets in excess of US\$100 billion<sup>6</sup>—that gap can also be viewed as a tremendous opportunity for growth. Islamic equity funds have been particularly popular among investors as the chart on the following page demonstrates.

<sup>4</sup> Unicorn Investment Bank, World Islamic Funds and Capital Markets Conference, May 2006, Bahrain

<sup>5</sup> United Arab Emirates Ministry of Finance; International Monetary Fund, 2006

<sup>6</sup> World Islamic Funds and Capital Markets Conference, May 2006, Bahrain

**Growth in Islamic Equity Fund Assets 1996 – 2005**

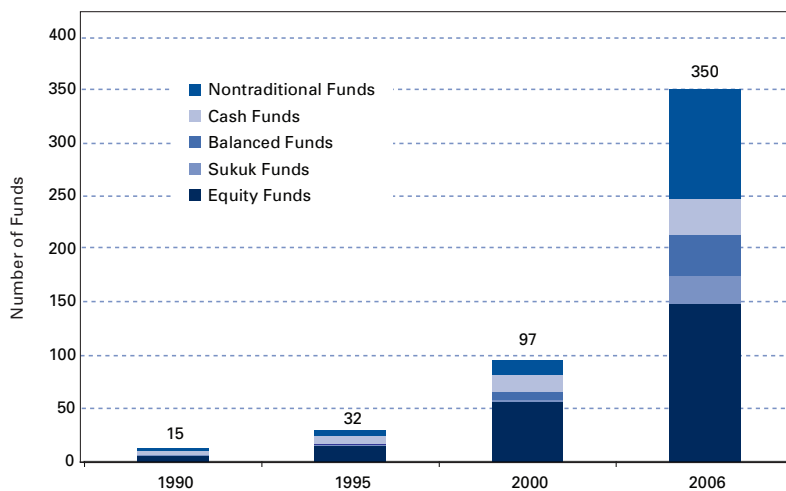


Source: The World Islamic Funds & Capital Markets Conference, May 2006, Bahrain

Innovative structures have also expanded the number of available vehicles while the range of Sharia’a-compliant funds now includes equities, murabaha trades, leases, sukuk, private equity, real estate, and even hedge funds. The total value of these funds is around US\$9.5 billion,<sup>7</sup> although there is still a weighting towards cash products among these.

**Islamic Fund Census: Nontraditional Funds Have Grown Especially Quickly**

Number of Sharia’a-Compliant Funds



Data as of April 30, 2006. This census includes programs that have been announced but not yet launched. Cash funds include murabaha and trade finance. Nontraditional funds include private equity, real estate, leasing, hedge funds, funds of funds, managed accounts and portfolios, and structured products.

Source: Failaka, Calyx Financial, World Islamic Funds & Capital Markets Conference, May 2006, Bahrain

<sup>7</sup> International Finance Corporation, World Islamic Funds & Capital Markets Conference, May 2006, Bahrain

*Islamic notes, known as sukuk, have been a significant driver behind the growth of the Islamic finance market.*

Despite this progress, there remains a significant imbalance in the industry, with demand for new products and investment avenues greatly exceeding supply. The choice is limited for investors and there are further restrictions as the funds can obviously only invest in asset classes acceptable under Sharia'a and not in areas such as, for example, armaments, gambling, and alcohol.

Overall, more funds are needed to absorb the extraordinarily high levels of liquidity currently prevailing in the industry today. There are also calls within the industry for existing funds to improve their levels of disclosure and transparency, and the overall infrastructure within which these funds operate continues to develop.

#### **Sukuk**

Islamic notes, known as sukuk, have been a significant driver behind the growth of the Islamic finance market. These instruments have been particularly important in addressing one of the most pressing issues in the industry—the ability to invest surplus funds held by Islamic banks in quality, shorter-term financial instruments that meet Sharia'a principles.

Sukuk have similar characteristics to conventional bonds, the difference being that they are asset-backed and represent proportionate beneficial ownership of the underlying assets. The returns on the sukuk are based on the yield generated by these assets. Multinational corporations, sovereign bodies, state corporations, and financial institutions have all used international sukuk issuance as an alternative to conventional syndicated financing.

The Bahrain-based Liquidity Management Centre estimates that in the first quarter of 2006, the size of the sukuk market reached US\$18 billion, of which US\$12 billion was issued by corporate entities, and US\$6 billion by sovereign entities.

There are an increasing number of mutual funds, pension managers, financial institutions and central banks holding sukuk paper as part of their diversification strategy, with a variety of splits between conventional and Islamic investors, depending upon the market involved.

Nor are these instruments necessarily vanilla; revealing its sophistication level, a recent sukuk offering in the shipping sector named Venus Glory describes its structure as combining “an Islamic mezzanine tranche...with conventional senior debt and conventional equity.”<sup>8</sup>

As further evidence that this is truly becoming a global phenomenon, the German state of Saxony-Anhalt became the first non-Muslim issuer to tap the global Islamic debt market in 2004, raising some 100 million euros via a sukuk issue. In the United States, the East Cameron Gas Company, a Texas exploration company, became the first U.S. entity to make a sukuk issue in order to attract demand from investors in the Arab world.<sup>9</sup> The company sold US\$165 million of sukuk backed by royalties from the company's hydrocarbon reserves off the coast of the Gulf of Mexico.

<sup>8</sup> *Futures Magazine*, July 2006, “Want to Buy a Sukuk?”

<sup>9</sup> BSEC Beno Securitisation SAL, June 19, 2006, company announcement

It's not all good news, though. Despite the potential that sukuk offers to the challenges faced by the industry, there are barriers. While the sukuk market is developing rapidly, holders can often be obliged for Sharia'a reasons to hold these sukuk until maturity with the result that there is limited secondary market trading in these products.

Similarly, many sukuk issuances are often not rated, which inevitably impacts liquidity. There is also perhaps a need for further education among institutional investors on the mechanics of sukuk to achieve greater and wider uptake of these instruments.

Finally, many sukuk issuances can be highly intricate and complex and revolve around numerous special purpose vehicles (SPVs) in multiple locations. Further infrastructural development, particularly in areas such as the Gulf Co-operation Council (GCC), is needed from governments and central banks in the form of trust laws and regulations to allow these structures to continue to develop.

### **Retail and Consumer Banking**

Despite the massive growth and development in Islamic retail and consumer banking to date, it remains the area with one of the largest potentials for continued growth. While this segment is well-established in many Islamic markets, the retail consumer continues to demand high-quality service. Looking forward, Islamic banks need to continue to enhance service levels, network convenience, and staff knowledge, while encouraging their front-end staff to look beyond transactional interactions and build long-lasting relationships with their customers.

And with service and delivery heavily dependent on the quality of operations, Islamic banks will need to make sure they are geared up for any increases in volume by supporting the sales efforts of the front-end staff with appropriate systems and training.

Even with the funds available, the industry needs to work on Islamic market penetration. In Malaysia, which is home to 15 million Muslims and nine Islamic financial institutions, only 10 percent of total banking assets are held in Sharia'a-compliant accounts.<sup>10</sup>

### **Human Capital**

Due to the recent emergence of Islamic finance as a significant force as well as its exceptionally high growth rate within the global financial services industry, there is a shortage of professional staff and managers with experience and knowledge of Islamic financial products and relevant Sharia'a knowledge. This relative paucity of human capital is in addition to the aforementioned need for more scholars. Similarly, until recently there has been a shortage of easily accessible practical, professional, and academic training or research in this field. These factors have hindered the advancement of Islamic financial institutions' competitiveness, new product development, and ability to attract new customers.

*In Malaysia, which is home to 15 million Muslims and nine Islamic financial institutions, only 10 percent of total banking assets are held in Sharia'a-compliant accounts.*

<sup>10</sup> "Players Vie for a Prime Slice of a Promising Market," *Global Finance Magazine*, September 2005

*Apart from conventional taxation, Islamic financial institutions must also consider the need to accrue and provide for Islamic tax—Zakat.*

### **Taxation**

Due to their varied structures, Islamic financial products can be at a disadvantage in the marketplace when it comes to taxation in certain jurisdictions, suffering a relatively greater burden when compared to conventional finance. This disadvantage may be due to a lack of sufficient and appropriate understanding of these products by the relevant tax authorities.

Classic examples of such instances include the tendency to treat some Islamic products as equity products rather than confer upon them the taxation benefits of being debt products.

Although there have been significant advancements in the taxation treatment of Islamic products, in many countries (the United Kingdom in particular has made a number of changes to existing legislation to accommodate some of these products via the Finance Act 2005) these investigations are at an early stage and further work is required to help enable Islamic institutions to compete on a level playing field with their non-Sharia'a-compliant peers.

Apart from conventional taxation, Islamic financial institutions must also consider the need to accrue and provide for Islamic tax—Zakat. There are disparities in the industry around this issue, with some industry participants arguing that the Zakat should be provided by the institution and others arguing it should be provided for by the investor/depositor.



# Regulation, Reporting, and Corporate Governance

As much as the industry has grown, the restraints on it are considerable. Within the Muslim world there are fundamental issues that need to be addressed, including a lack of information among the general population about the Islamic financial marketplace, its products, and the opportunities Islamic finance presents. Outside the Muslim world, many investors have little understanding of Islamic finance.

A recent report published by the International Monetary Fund (IMF) suggested the industry must focus on industry rules if it expects to play a larger role in the global financial arena. “Islamic banking remains quite limited in most countries and is tiny compared with the global financial system. For it to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles—notably on the regulatory front.”<sup>11</sup>

## Regulation and Prudential Supervision

Although the establishment of the Islamic Financial Services Board (IFSB) has helped to fill the vacuum of regulatory guidance available to Islamic financial institutions, many financial regulators and supervisors around the world still do not distinguish between the treatment of Islamic and conventional financial products. Consequently the same rules are applied to both, which can cause difficulties for Islamic financial institutions. They are therefore expected to have the same financial resources, governance structures, and internal controls as conventional banks, and they are expected to interact with their customers in a similar manner, despite the fact that they follow a different business model than their conventional financial industry colleagues.

Similarly, the impending risk management and measurement requirements of Basel II are a further example of the increasingly complex regulatory challenges facing Islamic financial institutions. Given the complexities of the capital markets and the wide range of Islamic products and services being offered, some argue that Islamic organizations need guidance from an international Islamic authoritative body on how to meet these challenges. It is worth noting here that, in an effort to address some of these challenges, the IFSB recently issued two standards on risk management and capital adequacy for institutions (other than insurance institutions) offering only Islamic financial services. Going forward, there may be potential for these standards to be adopted by some regulators around the world as mandatory for stand-alone Islamic financial institutions within their jurisdiction.

It is indeed a complicated time for corporate governance and reporting in this rapidly evolving industry. Collectively, institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the IFSB, the International Islamic Financial Market (IIFM) and the International Islamic Rating Agency (IIRA), are attempting to create an industry-wide infrastructure around reporting, capital adequacy, and risk management standards. But much work remains, with plenty of debate and different views prevailing.



<sup>11</sup> “Islamic Finance Gears Up,” International Monetary Fund, December, 2005, Volume 42, Number 4

Still, the industry has been fortunate, in that relevant supporting institutions are being created rapidly, it has achieved recognition and respect in the global financial community, and cross-border standards are being instituted. While it is understood that there is some element of overlap in terms of the scope and mission of some of these institutions, generally, they are working toward convergence of international standards in an industry that encompasses about 75 countries.

In fact, a theme emerging is that one of the factors crucial to the success of promoting an Islamic financial services sector in a particular region or country is the vigorous support of the local government or financial regulator. This has certainly been the case in areas such as Bahrain, Malaysia, and even the United Kingdom.

### **Financial Reporting**

While AAOIFI has introduced a range of accounting standards, many Islamic financial institutions are required to report to the market in accordance with local GAAP or International Financial Reporting Standards (IFRS). The treatment of Islamic products under local GAAP or IFRS may well differ from their treatment under Islamic principles.

Financial reporting for many Islamic financial institutions can be complicated due to the specific nature of many Islamic products as well as the increasing complexities of GAAP and IFRS reporting. It is clear that the role of the external auditor to Islamic financial institutions requires skill sets and experience that some accounting organizations may not possess.

In particular, the importance of the accounting treatment for different Islamic products in different jurisdictions should not be underestimated in terms of the impact this can have on business plans, earnings projections, overall operating results, and business viability.

Undeniably, financial reporting is, in fact, a factor underpinning competition between the different global hubs. Different regions are trying to improve levels of disclosure and quality of financial reporting to make international investment therein more attractive. This endeavor is in contrast to efforts being made in the broader international arena to globalize reporting standards and agree on and adopt one single set of international standards.

### **Corporate Governance**

The corporate governance of an Islamic financial institution differs in several respects to that of its conventional counterparts, most notably in the need to ensure an institution's compliance with Islamic Sharia'a. This can be exacerbated by the fact that several Islamic financial products place the Islamic financial institution in a fiduciary role to its customers, meaning that the institutions must find ways to allow customers to play an active role in the governance process. This is coupled with increasingly complex corporate governance requirements, such as the Combined Code and Sarbanes-Oxley, that apply to all institutions in many countries, few of which have been designed with the Islamic financial business model in mind.

Although there is general agreement within the industry on the need to focus on reporting and corporate governance standards, there is little consensus not only on how to create those standards, but also on when the standards would be created and put in place. To begin with, there is no common approach on regulatory frameworks, and there is varying interpretation of Sharia'a-compliant products. The resulting lack of transparency in operations, and the varying levels of governance, raises questions about how effectively Islamic financial organizations are managing their internal controls. This therefore effects the industry as a whole.

The IFSB is also seeking to meet some of these challenges and has issued an exposure draft on corporate governance for stand-alone Islamic financial institutions (other than insurance institutions).

However, difficulties also reflect the fact that corporate governance is at a different stage of development in the Middle and Far East as compared to the United States and Europe.

Indeed, the issues around corporate governance are brought into particularly sharp focus when one considers the absolute need for institutions operating Islamic windows and other similar arrangements to achieve and demonstrate clear segregation between conventional and Islamic operations in terms of their governance and reporting procedures.



# Risk and Capital Management



Islamic financial institutions are based on a different foundation than conventional financial institutions.

The rationale of the former is conformance to the principles of Sharia'a law, as opposed to the profit maximizing objectives of the latter; these dissimilar roots give rise to contrasting risk profiles.

Islamic financial institutions abide by the following principles, among others:

- The promotion of fairness in transactions and the prevention of exploitative relationships
- The sharing of risk and reward between principals in a transaction
- Transactions should carry elements of materiality leading to a tangible economic purpose
- Upholding of the sanctity of contracts
- The prohibition of financing of activities that are haram (forbidden)

Financial institutions organized along these lines bear resemblance to asset-management companies—these institutions are co-investors and partners rather than providers or depositors of funds. Consequently, Islamic modes of financing, like the asset-based Murabaha or the profit-sharing Musharaka, display distinct risk characteristics that must be accounted for in capital adequacy requirements and risk management frameworks for Islamic financial institutions.

Risk management is relatively less advanced in Islamic financial institutions than it is in more traditional financial institutions, and the rapid growth of the Islamic financial industry in recent years has led to much debate over the regulatory issues the industry faces. Corporate scandals around the world have highlighted the importance of sound corporate governance and risk management procedures, and the Islamic finance world is not beyond scrutiny. To ensure effective risk management, conventional banks strive to abide by various practices such as the Basel frameworks, which have been in existence since the late 1980s. However, these frameworks are inadequate to guide the management of risks in Islamic financial institutions, whose workings and risk profiles differ from conventional financial institutions. Many conventional risk management instruments do not meet Sharia'a requirements, and this shortcoming can either force Islamic financial institutions into having to accept riskier portfolios or alternatively to accept lower returns in exchange for a lower risk profile.

The IFSB has started to fill the regulatory gaps with its recent publication of a set of standards for capital adequacy and guidelines for risk management—tailored specifically to the products offered by Islamic financial institutions. These new standards—based on the original Basel frameworks—illustrate that the broad principles of risk management can be maintained across both Islamic and conventional banking sectors.

Given the current state of the Islamic finance marketplace, it is appropriate to examine where the risks in the industry arise, and—perhaps more importantly—how the capital adequacy and risk-management standards established by the IFSB can address these risks. Ultimately the capital markets are not likely to look kindly on the industry if it fails to upgrade its risk management activities.

This is a human capital challenge as much as any other—finding the people who understand conventional leading practice risk management techniques and who are able to apply these to an Islamic financial operating model.

## Hedging, Risk Management Tools, and Financial Innovation

Hedging can be one of the most contentious issues in Islamic finance. Conventional futures and short positions, which are often vital ingredients in hedge funds, can be difficult to achieve under Sharia'a principles. Some options have however begun to be featured in Islamic fund management, and capital-protected products are also experiencing some growth, with Sharia'a scholars in a few regions of the world approving several hedge funds. This has made advocates of this approach far more optimistic that hedging strategies will take off in the Islamic finance marketplace.

There can be a common misperception that risk prevention is frowned upon by the Sharia'a. In fact, the Sharia'a actually views risk prevention as desirable as long as appropriate methods are used to achieve it. In practice, the challenge often centers on achieving accurate management of an individual identified risk and avoiding entering into speculative scenarios or transactions.

Typically though, the use of derivatives, such as options, swaps, and forwards in their traditional form, is not widely accepted because these are interest-based instruments. Additionally, some scholars have been concerned by the recent scandals that have been associated with some of these particular instruments (e.g., options and swaps). Despite these problems, hedging is an area where a creative approach to new-product development could reap real benefits; an Islamic class of hedging and risk management tools would provide the investor with potentially huge applications and benefits in the shape of portfolio protection and more effective risk management.

Indeed, since early 2000 there has been considerable progress in finding ways to apply derivatives to reduce certain risks such as currency and commodity risks (e.g., in Malaysia, some Sharia'a-compliant hedging instruments, such as profit rate swaps, have been introduced. However, much of this progress remains localized with limited scope for cross-border application and further work is still needed.

### **Legal Risk**

And what of legal complications? While all institutions must seek to achieve robust and transparent compliance with Islamic Sharia'a, the fact remains that a large proportion of Islamic banking transactions are conducted within the bounds of international (typically English) law. Islamic financial institutions must address this legal reality and work to ensure that they are able to deal with this hurdle.

### **Ratings**

While Islamic financial institutions are typically rated by the major conventional providers such as Moody's, Standard & Poor's, and Fitch-IBCA, there are those who advocate the need for a specific Islamic rating agency.

Such an agency would not only consider the creditworthiness of obligors, their overall risk management abilities, and governance structures, but also such an agency would take into account the systems, processes, and methodologies the institution has in place to measure, monitor, and demonstrate compliance with Sharia'a.

Accordingly, in June 2005, the Islamic International Rating Agency became operational. A public joint stock company owned by a number of different Islamic banks and other interested parties, it aims (as per its own Web site) to "provide maximum insight and clarity into credit rating, corporate governance, and Sharia'a compliance, in an effort to support the capital market and improve its functioning."

There is evidence, however, that the global ratings agencies understand and acknowledge the Sharia'a factor and they have developed specialized teams to review Islamic financial institutions.

Going forward, such ratings could prove to be a key differentiator between institutions, although, ultimately, such ratings might be a factor that consumers, rather than lenders to Islamic financial institutions, would focus on.

# Conclusion

The double-digit annual growth of the Islamic finance industry is evidence of the exciting opportunities in this sector, with a vast untapped market of over a billion people around the world with unprecedented widespread high levels of liquidity.

This is an industry that has made astounding progress in a matter of years. Competition continues to heat up, as the traditional large global financial players take on the local institutions. Such competition, by itself, is evidence of the worldwide interest this industry has generated.

Going forward, there may be some consolidation within the industry while the creation of the Islamic “mega-bank” looks more and more inevitable. Indeed, given the liquidity generated by the energy wealth in the Middle East, it is not impossible in the future that an Islamic financial institution may seek to acquire a major global player in the financial markets to generate critical mass and acquire market share.

To truly reach its potential, the industry needs to meet the challenges head on. In particular, it needs to continue to innovate in broadening the range of products available, working hand-in-hand with scholars to create new offerings that remain compliant with Sharia’a law.

And by agreeing on and harmonizing issues on governance, regulation, reporting and taxation, the industry can only improve its profitability and gain a greater standing in the eyes of the world’s capital markets as well as the individual consumer.

A unique industry, Islamic finance is now facing up to unique challenges. However, these are not the challenges of independent operation. Instead, they are the challenges of global recognition.



## Appendix: Interview with Tariq Al-Rifai, Regional Director of Unicorn Investment Bank

During the World Islamic Funds & Capital Markets Conference in Manama, Bahrain, Tariq Al-Rifai, Regional Director of Unicorn Investment Bank, gave a presentation on Islamic equity funds and their development since 1994. Mr. Al-Rifai said he believes much progress has been made, but much remains to be made if the sector is to grow and become more influential in the world financial community. Afterwards, Mr. Al-Rifai agreed to answer some specific questions for KPMG professionals about some key themes and issues raised during the conference. An edited version of that question-and-answer session follows.

Questions to Mr. Al-Rifai were posed by Samer Hijazi, senior manager in the Financial Services practice based in London and a member of KPMG's Global Islamic Financial Services team, and by Timothy R. Dougherty, a director at KPMG's Audit and Advisory Research Institute, based in New Jersey.

### Standardization

#### Q.

There is a commonly voiced concern regarding the lack of standardization around Sharia'a-compliant quality investments. What is your view on whether there should or should not be standardization?

#### A.

One of the scholars at the conference said he felt that standardization would block development in the industry. I strongly disagree with that idea. I think fund managers are looking for standardization. For example, if you have a mutual fund in the United States, you know what the SEC regulations are, you know what you can and cannot do. Something similar should be available for the Islamic industry, and that is not available today.

#### Q.

Among other fund managers and asset managers, do you think you are in the majority or in the minority in your disagreement?

#### A.

I think I am in the majority of those of us on the financial side. On the Shari'a side, I think, the common view is

that standardization is not good. This disagreement could continue for some time but in the future there will have to be some standardization. However, right now, from the Sharia'a point of view, it is still a relatively new field and they [the scholars] do not want to set anything in stone until they have time to see how the markets move or fully understand some of the new instruments.

#### Q.

On that same issue, do you believe that this will be a regional issue where the Middle East will differ from, say, Malaysia, or North America?

#### A.

I definitely think that is correct. There are a few [scholars] in the United States who tend to have a more financial view on this which is shared by some of the Asian or Malaysian scholars, and some work is already under way to standardize procedures outside the Middle East. Within the Middle East, it always has been a little bit more conservative, but then again, there always has been more debate here.

**Q.**

There are some who would argue that the lack of standardization actually creates a larger and more liquid market because people have a wider variety of choice. Do you think standardization could take away some of that choice and liquidity?

**A.**

No. For example having standardized procedures in the United States does not limit investment opportunities and having standardization gives you a clearer vision of what financial tools are available.

**Performance Benchmarking****Q.**

Moving on to performance benchmarking tools available to the Islamic asset manager, it seems that the conventional asset manager has a wide variety of indices and other benchmarks against which to track performance. How do you think that situation is mirrored in the Islamic finance world?

**A.**

There are two separate aspects of benchmarking. The first is on the capital-markets side where we have a number of indices, such as the Dow Jones Islamic Index, the FTSE Islamic indices, the indices in the Gulf region, etc. I think, from that point of view, Islamic indices are well covered.

But, when it comes to benchmarking against other products, I don't think there is much out there right now. Some of the more conservative people in the industry don't agree with comparing Sharia'a-compliant funds to con-

ventional benchmarks. Others think that the differences are minor, the structuring is very similar; you are competing with a conventional debt instrument, therefore you should be able to benchmark to the same.

**Q.**

Do you think there is a need for developing a purely Islamic benchmark?

**A.**

I see the need for, and I see the appeal of, having a unique index for Islamic debt instruments, although I don't think that it will be developed any time soon.

**Product Development****Q.**

Let's discuss the availability of liquidity and risk management tools to the Islamic asset manager. This goes back to the debate about introducing hedging tools, such as derivatives, into the Islamic finance world. Some have been introduced, but there appears to be some skepticism and conservatism towards the use of these products. What is your view on the development and use of Islamic derivatives and/or hedging tools?

**A.**

They are needed, but the problem with the Islamic finance industry is that there is a lot of copying going on and not a lot of innovation. Instead of determining what the Islamic investor base is looking for and then developing that product, you have a lot of Islamic funds that have just tried to copy conventional products.



**Q.**

Would you say that this inability to develop more products is one of the key obstacles facing the industry today?

**A.**

Yes, but I don't wish to sound too negative. The industry needs to be creative, and this aspect of it hasn't been too creative so far. While global financial institutions view research and development activities as a necessary investment, some Islamic companies can view R&D as a long-term expense with no clear outcome.

**Q.**

If you could snap your fingers and speed something up in financial innovation, what would it be?

**A.**

I'd say it is a shift in attitude; it is a change in culture that Islamic banks really need to consider. Innovation is important to the growth and sustainability of a bank and future earnings.

**Appealing to a Broader Market****Q.**

What are your views on the appeal of Islamic asset management products to non-Muslim investors?

**A.**

If you look at who is investing in the Sharia'a-compliant funds in Malaysia, roughly half of the investors are Chinese. If you look at the Gulf, I don't think you'll find too many non-Muslims investing in Islamic funds. The same holds true in the West.

**Q.**

To what do you attribute the difference in Asia, where so many non-Muslims are involved in Islamic products, and in the United States, Europe and the Gulf, where there are so few non-Muslims involved?

**A.**

It comes down to awareness. Many investors aren't aware that some of these products exist. Then again, some investors who are aware may think, "That is a religious choice" and probably stay away. I think it is an education issue for the market.

**Quality of Return vs. Quality of Compliance****Q.**

Looking at the Muslim consumers, to what extent do you think they have moved along from desiring an investment that is purely Sharia'a compliant to desiring an investment that is also competitive to a conventional equivalent?

**A.**

Early on, when Islamic investments started to appear in the market, the only people who bought into them were conservative and only looking for Sharia'a-compliant investments. However, investors are now increasingly demanding returns on a par with conventional products.

**Q.**

There has been significant growth in the amount of money heading into Islamic funds. The number of Islamic funds, for example, is now more than 125, whereas there were fewer than 50 less than a decade ago. Do you think the growth can continue, bearing in mind the challenges you have noted?

**A.**

I think growth will continue because of the liquidity in the market and demand from investors for a wider range of innovative products. However, the industry will not realize its true potential unless some of these challenges are addressed.

*Mr. Al-Rifai has been involved in Islamic finance since 1996 when he established Failaka International Inc., a Chicago-based Islamic financial research and consulting firm. Unicorn Investment Bank is licensed as a Sharia'a-compliant investment bank and is regulated and supervised by the Bahrain Monetary Agency (BMA). It has offices in the United Arab Emirates, the United States, and Malaysia.*



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