



# Islamic Finance Credentials

FINANCIAL SERVICES

# Islamic finance today

Islamic banks are expected to account for 40 to 50 percent of total savings of the world's Muslim population within 8 to 10 years\*

The Islamic finance sector has developed into a global phenomenon which is highly dynamic and growing rapidly. There are now around 270 Islamic financial institutions worldwide with assets estimated at more than US\$265 billion, financial investments above US\$400 billion and a growth rate estimated to be around 15 percent p.a.\*

While the main centers of Islamic finance in the world today are traditionally acknowledged to be the Middle East, Malaysia and the U.K., the clientele of Islamic financial institutions are not confined to Muslim countries but are spread over Europe, the United States of America and the Far East. Nor are the providers confined to local institutions as global players are increasingly playing major roles in the industry today.

At KPMG we are very conscious of the growing importance of the Islamic finance industry and are pleased to be contributing to its continued advancement.

Brendan Nelson  
Global Chairman, Financial Services  
KPMG LLP (U.K.)

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\* Source: International Islamic Finance Forum, 2005

# Some of the issues



## **Financial reporting**

While the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has promulgated a range of accounting standards, many Islamic financial institutions are still required to report to the market in accordance with local GAAP or International Financial Reporting Standards (IFRS). Mismatches can arise between the treatment of Islamic products under local GAAP or IFRS and their treatment under Islamic principles. In addition, the specific nature of many Islamic products as well as the increasing complexities of reporting GAAPs and IFRS in particular, make financial reporting for many Islamic financial institutions very complicated. Similarly, it has become evident that the role of the external auditor to Islamic financial institutions requires a different skill set and experience to that possessed by some accounting organizations today.

## **Taxation**

The taxation implications of offering Islamic products in certain jurisdictions have until recently largely been disadvantageous, which has restricted their use and availability. In other jurisdictions, efforts have only just begun to investigate the tax treatment of such products. Although there have been significant advancements in the taxation of Islamic products, further work is required to help enable Islamic institutions to compete on a level playing field with non-Sharia'a compliant institutions.

## **Financial regulation and supervision**

While the establishment of the Islamic Financial Services Board (IFSB) has aided in filling the vacuum of regulatory guidance to Islamic financial institutions, some financial regulators and supervisors around the world still do not distinguish between the treatment of Islamic and conventional financial products. The result is that the same prudential rules are applied to both, which can pose difficulties to Islamic financial institutions. This means that they must have equivalent financial resources, governance structures and internal controls to conventional banks and will also need to interact with their customers in a similar manner, despite the fact they follow a different business model. Similarly, the impending risk management and measurement requirements of Basel II are another example of the increasingly complex regulatory challenge facing Islamic financial institutions.

## **Sharia'a compliance**

One of the key factors differentiating Islamic financial institutions is the need to demonstrate compliance with Sharia'a in all their activities (including non-financial activities). There is a lack of consensus in the industry as to whether certain transactions or activities are compliant, which can cause confusion among practitioners and customers as well as restricting the concept of Islamic finance from wider acceptance and recognition. The industry is also limited to a handful of respected scholars who often serve on a number of Sharia'a committees to different banks, which can also restrict product innovation. Finally, demonstrating compliance with Sharia'a can be difficult as different institutions have different governance models by which they set and test their compliance.

Similarly, it has become evident that the role of the external auditor to Islamic financial institutions requires a different skill set and experience to that possessed by some accounting organizations today

### **People**

Due to the recent emergence of Islamic finance as a significant force in the industry, there is a shortage of professional staff and managers with experience and knowledge of Islamic financial products and relevant Sharia'a knowledge. 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 attracting new customers.

### **IT and management information systems**

The Islamic financial business model and its products typically require different forms of management reporting. Conventional systems often cannot meet these requirements.

### **Liquidity management**

Unlike their conventional counterparts, many Islamic financial institutions currently lack access to Sharia'a compliant short term liquid investment markets and financial instruments with which to manage excess liquidity or liquidity shortages. While the industry has seen some recent initiatives (e.g. the establishment of the Liquidity Management Centre), this is still an area where many Islamic financial institutions face difficulties.

### **Risk management and mitigation**

Whereas financial risk management is widely practiced by conventional institutions, it is under-developed in Islamic financial institutions. This is typically due to many conventional risk management instruments being deemed to be unacceptable to Sharia'a requirements. This can either force Islamic financial institutions into having to accept riskier portfolios or to accept lower returns in exchange for a lower risk profile.

### **Corporate governance**

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 and they must look to find ways to allow these customers to play an active role in the governance process. This is coupled with increasingly complex corporate governance requirements (e.g. the Combined Code, Sarbanes-Oxley) applied to all institutions in many jurisdictions, few of which have been designed with the Islamic financial business model in mind.



# KPMG's Global Islamic Financial Services practice

## A global multi-disciplinary approach

KPMG was one of the first accountancy organizations to meet the needs of Islamic financial institutions across national boundaries and we continue to be one of the industry's top international advisors.

KPMG's Global Islamic Financial Services (GIFS) team comprises a global network of professionals with in-depth knowledge of Islamic finance providing practical, value added assistance to KPMG firms' clients across a range of specialisms and issues. Members of the team are based in KPMG's three operating regions: EMA (Europe, Middle East and Africa), Asia Pacific and the Americas with a center of excellence based in Bahrain.

This approach aims to provide our member firms' clients with a well-established service in their markets. It gives them access to professional assistance which is characterized by entrepreneurial flair, commitment to national markets, and an understanding of the commercial and cultural differences between each country.

Islamic finance presents numerous critical challenges. KPMG's GIFS team have in-depth skills and experience in the following areas:

- Audit and accounting
- Taxation advice
- Regulatory authorization and compliance
- Agreed upon procedures to test Sharia'a compliance
- Conversion advisory services
- Issue and placement of Islamic products
- Forensics and anti-money laundering compliance
- Corporate governance advice
- Financial risk management
- Strategy development and implementation
- Market feasibility studies
- IT risk management and governance
- Executive search and selection
- Training

This service listing is a general overview of the services KPMG firms could undertake. Please note that regional and country legislation may prohibit the application of these services in certain jurisdictions.

# Why KPMG's Global Islamic Financial Services practice?



## **Major investor in Gulf Cooperation Council (GCC) – Feasibility and business plan for a new Islamic bank**

- A bank wanted a business plan to develop one of the largest Islamic banks in the world and also have a conventional window to compete globally with other International banks. The proposed capital of the bank was several billion U.S. dollars.
- KPMG member firms were required to develop the bank's strategy, a target operating model, organization design, and identify the initial market niche that would let the bank be profitable from the first year.
- The approach was a combination of three different entities under one broad corporate umbrella that could fill a niche in the market and allow significant returns to its stakeholders.
- The bank is currently under discussions over the launch date and the degree of public versus private ownership.

## **U.K. Islamic bank – Regulatory, taxation, accounting and transaction services**

- KPMG member firms on-going work with Western Europe's first stand-alone Islamic bank has helped to put our organization at the forefront of the development of Islamic finance in Europe.
- KPMG's Regulatory Compliance practice assisted the bank in its application for a full U.K. banking license.
- Representatives from KPMG's Tax Advisory practice worked closely with the bank on both corporation tax and VAT issues. Our professionals sit on HM Treasury and HM Revenue & Customs working parties developing U.K. tax legislation that can enable Islamic financial institutions to compete on a level playing field with non-Sharia'a compliant institutions. This culminated in new legislation that passed into U.K. law in the Finance Act 2005.
- KPMG's Audit and Accounting practice has worked on a range of issues with the bank including U.K. and IFRS accounting opinions on a wide range of Islamic products, statutory and other audits as well as transaction services in relation to the bank's initial public offering and listing on the Alternative Investments Market of the London Stock Exchange.

## **GCC bank – Conversion from a conventional to Islamic bank**

- A GCC based conventional bank, made a strategic decision to convert its operations to a full service Islamic bank. The bank approached KPMG member firms for assistance in identifying the requirements for the type of systems needed to offer Islamic products and services.
- The focus was to identify the requirements and evaluate potential new IT systems. To assist the bank in understanding the requirements, KPMG professionals led multiple training sessions for the client staff on many of the differences between conventional and Islamic products. KPMG member firms also highlighted the typical process flow differentiations between the two types of banks.

Our network of professionals also provided assistance with:

- Defining the core products and services to be offered immediately and in the short-term future.
- High-level definition of a Target Operating Model (i.e. processes and technology architecture) for launch.

At KPMG, we are very conscious of the growing importance of the Islamic finance market

Brendan Nelson  
Global Chairman, Financial Services

### **Malaysian Islamic bank – Risk management review**

- A major Malaysian Islamic bank appointed KPMG member firms to perform a bank-wide Risk Management engagement to conduct risk awareness training and a risk diagnostics review. The aim was to benchmark the bank's Islamic banking business processes and risk management practices against International Good Practice Standards in a number of key risk areas (credit, market, ALM and operational).

### **About KPMG's Financial Services practice**

No matter what your organization's position within the Financial Services market, KPMG member firms have the knowledge to help you. Our member firms serve around 20,000 financial institutions globally, from many of the world's largest banks, insurance companies and fund managers, to mid-sized national players and small-scale specialists.

KPMG has a network of highly experienced professionals dedicated to the financial sector. This network helps to ensure our firms can deliver projects locally or globally, according to client requirements.

### **Our focus**

KPMG's Financial Services practice focuses on providing Audit, Tax and Advisory Services to the Retail Banking, Investment Banking, Insurance, and Investment Management and Funds segments.

This industry focus gives our professionals an in-depth understanding of the issues facing financial institutions, helping them to provide practical services which are designed to be of real benefit to our member firms' clients.

### **Our aim**

The aim of our global network is to assist our member firms' clients build more profitable, focused and efficient businesses through:

#### **• Depth of experience**

Each client issue requires a tailored mix of skills and experience. From KPMG's range of resources, our global network can quickly create multi-disciplinary teams who work together efficiently and effectively to meet the needs of member firms' clients.

#### **• Commitment to client service**

Personal service is one of our top priorities, facilitating strong professional relationships with our member firms' clients based on open communication and the sharing of knowledge.

#### **• Advice built on understanding**

In the face of growing competition and ever more complex challenges, KPMG's Financial Services practice can help our member firms' clients face the future with confidence.

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