

Islamic Finance An Alternative Finance System

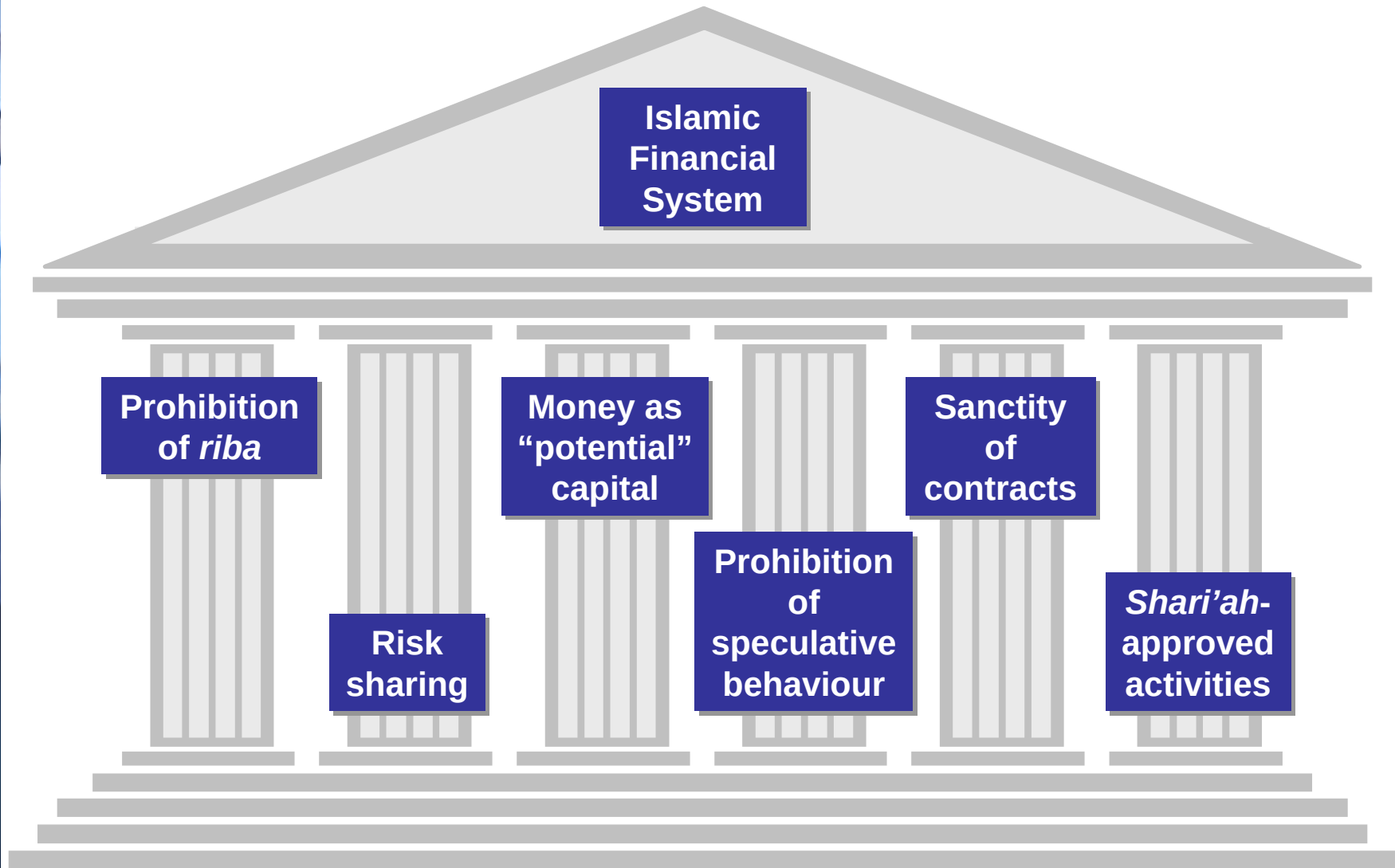
Dr John Lee, KPMG Kuala Lumpur
Dar-es-Salaam, Tanzania
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This presentation is confidential and solely intended for the participants off the KPMG Training in Dar es Salaam, Tanzania.



agenda

- Islamic Finance Development
- Risk and Corporate Governance
Differentials in Islamic Financial Institutions
- Islamic Financial Services Board
Standards
- Economic Capital Management Framework

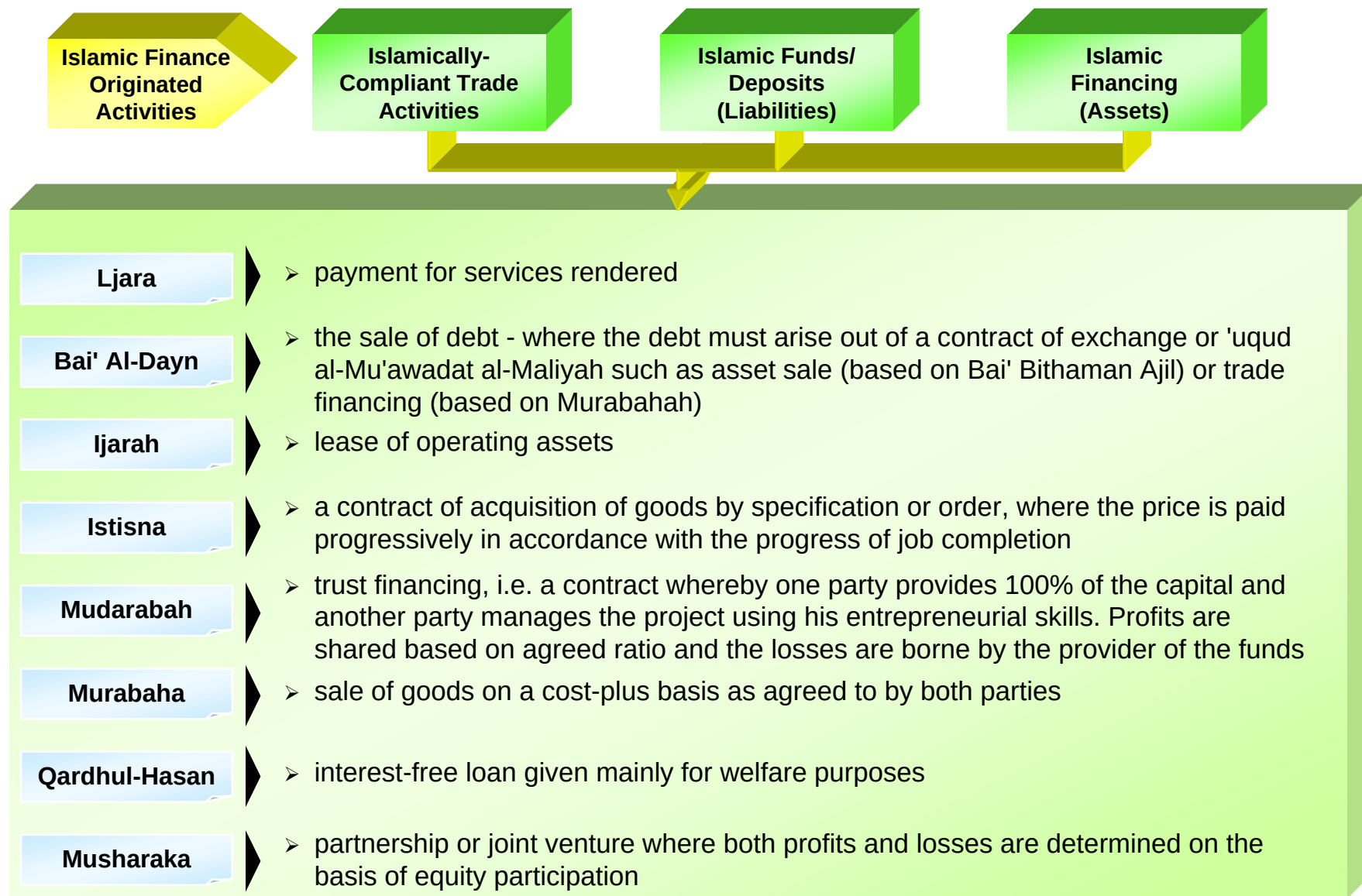


- The sale of usufruct is permissible, as evidenced by the following verses [28:26 27]

D: O father, hire him on wages, for truly the best to employ is a strong and trustworthy man!

F to the man: I intend to wed one of my daughters to you, on condition that you work for me for eight years, and if you complete ten full years, that will be a grace from you.

Key Islamic Finance Principles used to structure Financial Activities and Products



Global Presence of Islamic Financial Services

The World Bank estimates that there are more than 240 providers of Islamic financial services across Muslim & Non-Muslim Countries, with assets worth nearly US\$300 billion in 2005 (1998: US\$140 billion).



Development of Islamic Financial Services

Islamic Financial Services has evolved since the establishment of the first commercial Islamic banks in the 1970s

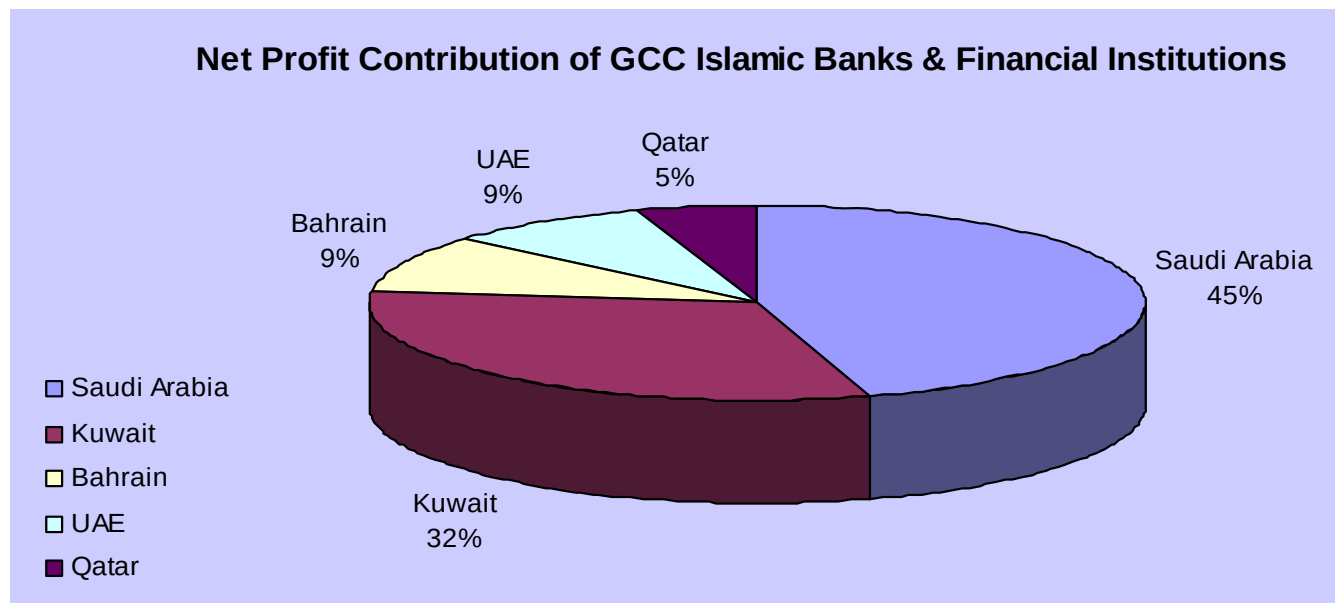
1970s	1980s	1990s	2000s
Institutions: ▪ Commercial Islamic banks Products: • Commercial Islamic banking products Area: • Gulf / Middle East	Institutions: ▪ Commercial Islamic banks ▪ Takaful ▪ Islamic investment companies Products: • Commercial Islamic banking products • Takaful Area: • Gulf / Middle East • Asia Pacific	Institutions: ▪ Commercial Islamic banks ▪ Takaful ▪ Islamic investment companies ▪ Asset management companies ▪ Brokers / Dealers Products: • Commercial Islamic banking products • Takaful • Mutual Funds / Unit trust • Islamic bonds • Shariah-compliant stocks • Islamic stock broking Area: • Gulf / Middle East • Asia Pacific	Institutions: ▪ Commercial Islamic banks ▪ Takaful ▪ Islamic investment companies ▪ Asset management companies ▪ E-commerce ▪ Brokers / Dealers Products: • Commercial Islamic banking products • Takaful • Mutual Funds / Unit trust • Islamic bonds • <i>Shariah</i>-compliant stocks • Islamic stock broking Area: • Gulf / Middle East • Asia Pacific • Europe / Americas • Global Offshore Market

Source: Islamic Capital Market Fact Finding Report – Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions, July 2004

Islamic Financial Services, a rapidly-growing alternative financial system gaining global attention

Islamic Financial Services in the Gulf Cooperation Countries

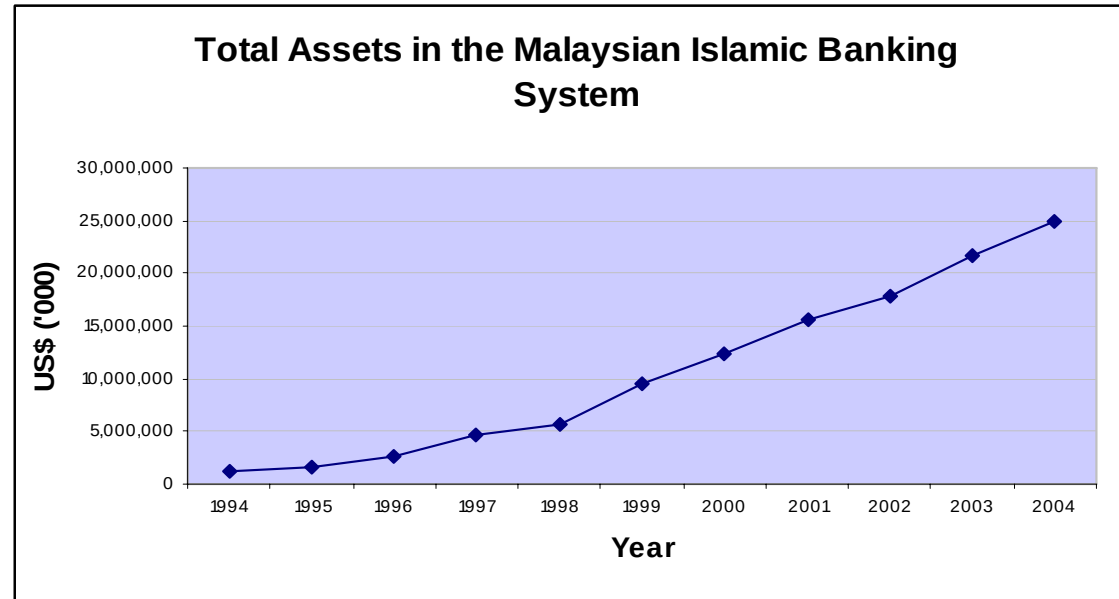
A World Bank report notes that assets of Islamic financial service providers is largely concentrated in the GCC



- Assets of Islamic banks and financial institutions in the GCC countries totaled US\$49.5 billion in 2003 compared with US\$22.5 billion in 1998.
- Net profit of Islamic banks and financial institutions in the GCC countries totaled US\$1.3 billion in 2003 as compared with net profits of US\$632 million in 1998.
- Of the US\$1.3 billion in net profit earned in the GCC region, Saudi Arabian banks lead the industry, contributing almost 50% to regional earnings. Growth of net profits in the region ranged between 35% and 65%.

Source: Article from the General Council for Islamic Banks and Financial Institutions, "Islamic Finance Shows Robust Growth", 12 December 2004.

Islamic financial services is also developing a strong presence in Asia. Industry developments in Malaysia is a case in point.



- Islamic financial service providers in Malaysia comprise of domestic and foreign Islamic banks, commercial banks, merchant banks and discount houses.
- As at end-2004, there was a total of 29 financial institutions providing Islamic financial services.
- Since 2000, assets in the Islamic banking industry has been growing at an average annual rate of 19%. Total assets in the Islamic banking sector in 2004, totaled approximately US\$24.9 billion (RM94.6 billion) and accounted for 10.5% of total assets in the banking system.
- The market share of Islamic deposits increased to 11.2% of total banking sector deposits in 2004, while Islamic financing comprised 11.3% of total financing in the sector over the same period.

- Drivers of growth in Islamic finance:
 - Current account surpluses of oil-exporting Islamic countries;
 - Desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity; and
 - Introduction of broad macroeconomic and structural reforms (in financial systems, the liberalisation of capital movements, privatization, and the global integration of financial markets).
- The establishment of the Islamic Financial Services Board (“IFSB”) will further spur the growth in Islamic finance. The IFSB aims to set prudential standards and other core principles for Islamic banking and finance globally.

Launch of Islamic Profit Rate Swap

- The Shariah equivalent of an Interest Rate Swap has been approved. Currently, at documentation stage done in cohort with the International Swap and Derivative Association (ISDA). The IPRS is expected to deepen the market as Islamic financial institutions would be able to manage their interest rate risk.

Commencement of Islamic Stock Broking Activities

- It is believed that Bursa Malaysia is working on a new Islamic Stock Broking Guideline to facilitate the provision of this service by existing securities firm. This is expected to create excitement and facilitate greater growth in the Islamic Index of Bursa Malaysia.

Introduction of Musyarakah Sukuk in the Debt Capital Market

- In Q3'06 Malaysia will have its first Musyarakah Sukuk in the market. Although Musyarakah is better known as an equity product the transaction would have fixed income features which would qualify it as a debt capital market product. This structure can be applied, amongst others, for Project Finance and Asset Backed Securitisation. Its introduction is expected to broaden the market.

Implementation of Islamic Exchangeable Sukuk

- The equivalent of a conventional exchangeable bond the Islamic version would be riba free and exchangeable into Shariah approved stocks. Expected end 2006.

Advent of Middle East style of Islamic Banking

- With the entry of Islamic banks backed by Middle Eastern players it is foreseen Islamic home financing and car financing in Malaysia would become more interesting. In the Middle East it is known that some banks are essentially in the business of buying houses and cars from developers and manufacturers before selling them to the bank's client on deferred basis. This will give greater choice to consumers.

Commencement of Commodity Murabaha Deposits

- It is expected that some banks will introduce Commodity Murabaha Investment Account to complement the current Mudharabah Investment Account. The new account would give certainty of return and assurance on getting back the full deposit. Nonetheless, some would still continue with Mudharabah as it provides an opportunity to enjoy greater return."

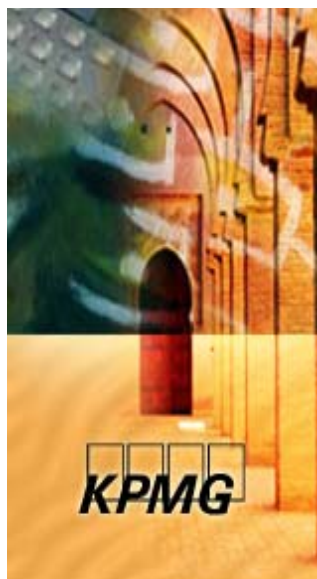


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Structural balance sheet of a Islamic financial institution is different to a conventional financial institution

Conceptual Balance Sheet of Islamic Financial Institutions

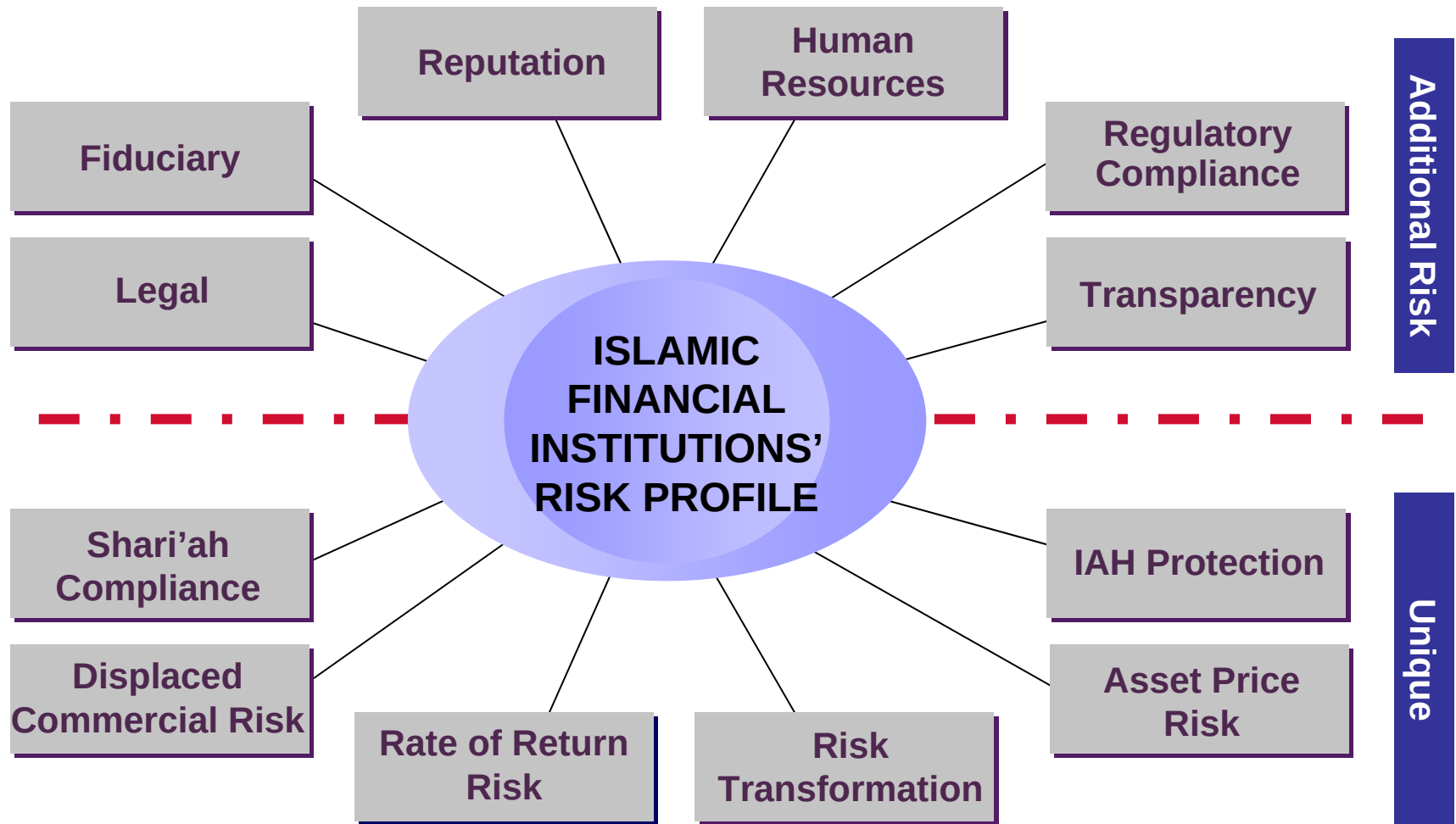


Assets	Liabilities
Asset-backed Transactions Murabahah / Ijarah / Istisna' / Salam	Demand Deposits Amana
Profit Sharing Transactions Mudharaba / Musharaka	Investment Accounts Mudharaba
Fee based Services Ju'uala Qardh Hasan	Special Investment Accounts Mudharaba / Musharaka
	Equity

Off balance sheet

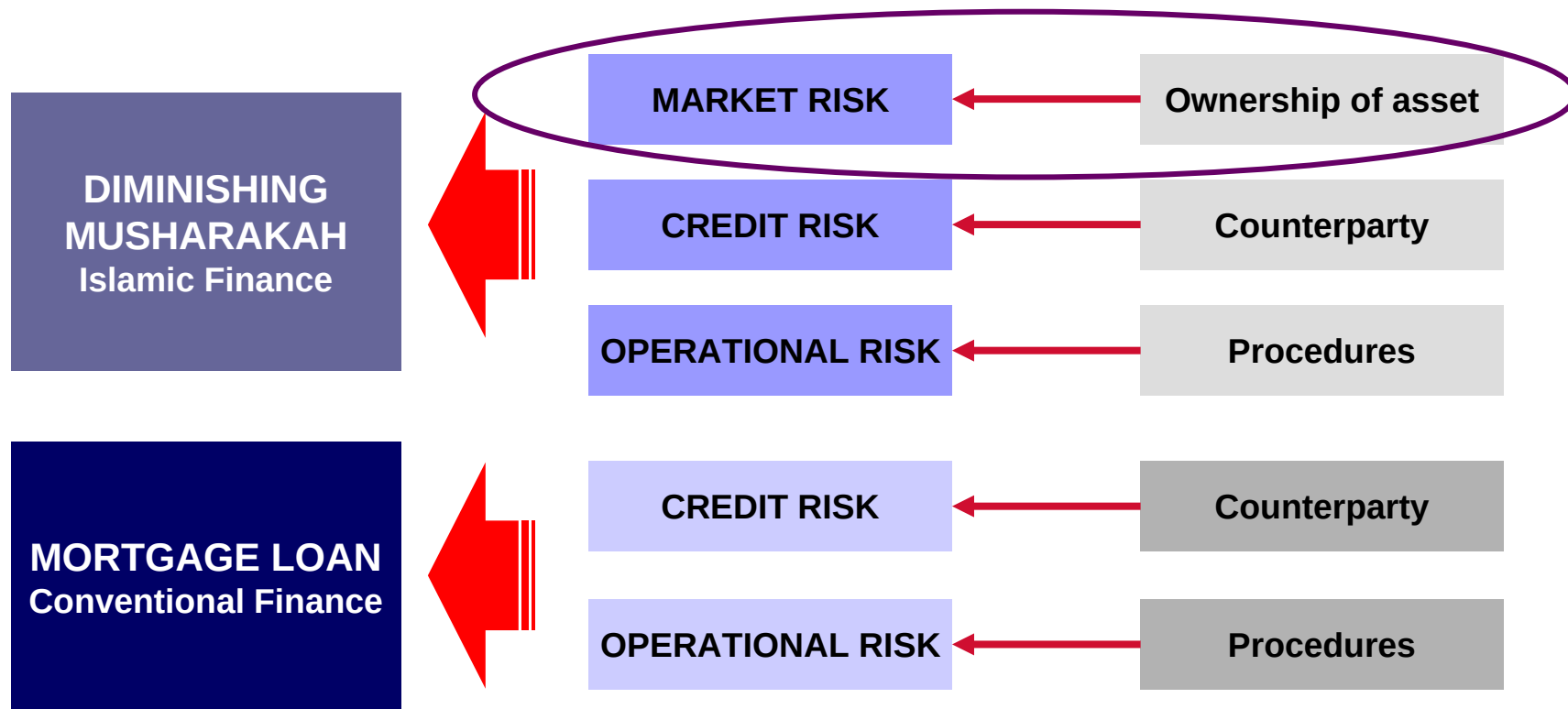
Restricted investments	Direct investors
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Islamic financial institutions' risk profile



Example of uniqueness of Islamic banking risk: Asset Price Risk

Home financing through Islamic and Conventional Financing Schemes

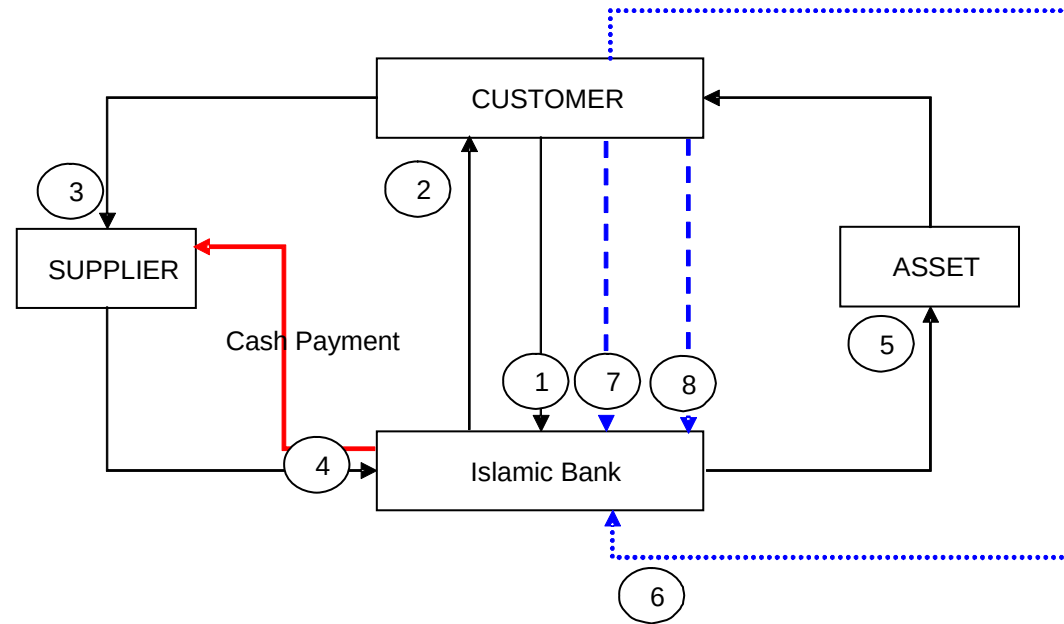


A number of other Islamic Products have similar risk exposures:

Murubaha	Ijarah	Salam	Istisna'
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Example of uniqueness of Islamic banking risk: Risk Transformation

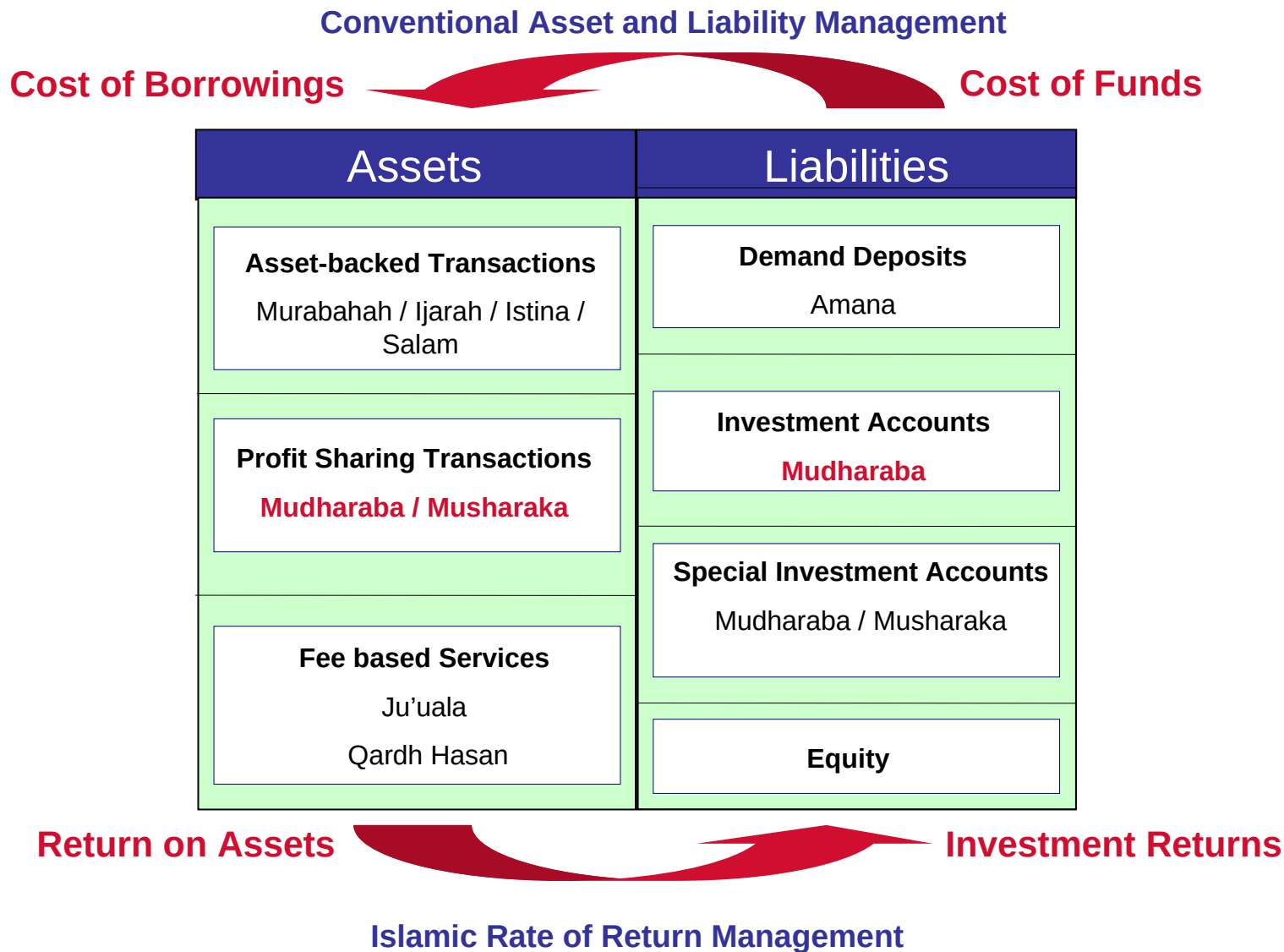
Ijarah Contract



PROCESS FLOW

- 1 Customer approaches and requests Islamic Bank to acquire the asset
- 2 Under the Principal/Agent relationship, Islamic Bank appoints the Customer as Agent
- 3 Agent will identify specific asset from a specific supplier
- 4 The Islamic Bank will purchase the asset from and pay to the supplier
- 5 Lease asset to customer under Ijarah contract
- 6 The Islamic Bank may request the customer certain guarantee
- 7 Payment of lease rental
- 8 For Ijarah Muntahia Bithamleek, at the end of the lease period, the customer can opt to purchase the asset for a cash consideration

Example of uniqueness of Islamic banking risk: Rate of Return Risk



Example of uniqueness of Islamic banking risk: Shari'ah Compliance

- **Existence of tangible assets** in each of the financing assets that involves the sale and purchase of assets (Murabaha and Ijarah) with the exception of Istisna;
- **Creation of additional obligations to Islamic financial institutions as the owner of goods** prior to the offer of sale to customers;
- **Disallowance of charging late payment**, penalty fee of price increase due to default, extension or rescheduling of payment;
- **Existence of financial guarantee from third party which is non-binding**;
- **Prohibition of debt trading element** in the financing structure.

Protecting the interest of Investment Account Holders (“IAH”)

- IAH are exposed to potential conflict of interest with the management of an Islamic Financial Institutions, which may look after the interest of shareholders at the expense of IAH.
- This requires more emphasis on fiduciary responsibility or establishment of detailed regulations designed to monitor potential conflicts of interest.
- Furthermore, adequate disclosure of relevant information about the Islamic Financial Institutions' investment objectives and policies, operational guidelines that govern the relationship between the Islamic Financial Institutions and IAH, etc. should be made available.
- Albeit IAH may have no representation in the organs of governance such as the Board of Directors or Shariah Supervisory Board, they have every right to expect accountability and transparency on investment made on their behalf.

Keeping the Shari'ah Supervisory Board ("SSB") informed:

- SSB is a specific organ of governance. It should be concerned with monitoring Shari'ah compliance and not just issuing fatwas.
- Since SSB members may lack monitoring skills, auditors and audit committee should act in concert to assist SSB.

Ensuring greater transparency in financial reporting

- The current financial reporting practices of Islamic Financial Institutions do not provide adequate information to their IAH regarding the revenues and expenses accruing to their particular investment fund
- IAH is rightfully entitled to transparency, e.g., calculation of Mudarib share and profit allocation



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IFSB is developing prudential standards for Islamic financial institutions



For prudential management of Islamic financial institutions, IFSB is responsible for setting out and recommending standards and guidelines.

IFSB standards are meant to compliment Basel standards and are not to replace Basel standards.

Currently, the IFSB has issued two **Standards**:

- Risk management; and
- Capital adequacy.

Two other standards are being developed:

- Corporate Governance; and
- Disclosure and Transparency.

IFSB Standards for capital adequacy (1/3)

Risk	Capital Adequacy Requirements
1. Credit	▪ Similar to Basel II, but bearing in mind the specificities of Islamic products, e.g., Mudarabah and Musharakah should be treated as equity exposures and hence use Basel II equity portfolio type approach for capital adequacy. ▪ Credit risk mitigation for Islamic financing is less prevalent and likely to be more complicated.
2. Market	▪ For equity and foreign exchange risk, similar to Basel II. ▪ Treat asset price risk like commodity under Basel II. Use maturity ladder or simplified approach for the time being. In future, internal model for each commodity may be developed.

Risk	Capital Adequacy Requirements
3. Operational	▪ Similar to Basel II, i.e., Basic Indicator, Standardised or Advanced Measurement Approach. ▪ In future may consider higher alpha or beta factor for Shari'ah non compliance risk. ▪ If using Advanced Measurement Approach, Shari'ah non compliance risk loss data should be collected and modelled separately.
4. Displaced Commercial	▪ Additional capital charge will be imposed on Islamic financial institutions that practice income smoothing as opposed to institutions that pass on the losses completely to the IAHS. Under the latter, the assets financed directly by IAHS are allowed to be deducted from the denominator of the CAR ratio. For the former, a certain percentage of assets financed by IAHS will be added “back” to the denominator of the CAR ratio.

The CAR formula for Islamic financial institutions sharing losses completely with the IAHs

$$\frac{\text{Regulatory Capital}}{\text{Total RWA (Credit Risk + Market Risk) + Operational Risk} - \text{RWA funded by the IAHs}} \geq 8\% \text{ Capital Adequacy Ratio (CAR)}$$

The CAR formula for Islamic financial institutions that practices income smoothing

$$\frac{\text{Regulatory Capital}}{\text{Total RWA (Credit Risk + Market Risk) + Operational Risk} - (1 - \alpha) \text{ (RWA funded by the IAHs)} - \alpha \text{ (RWA funded by Profit Equalisation Reserve and Investment Risk Reserve)}} \geq 8\% \text{ Capital Adequacy Ratio (CAR)}$$

Islamic financial institutions need to have in place a comprehensive risk management framework covering:

- Risk strategy
- Risk profiles of products
- Risk measurements for credit risk, equity investment risk, liquidity risk, rate of return risk and displaced commercial risk
- Risk reporting
- Risk system

Key principles in designing this framework that financial institutions should adhere to:

**Compliance with
Shari'ah laws**

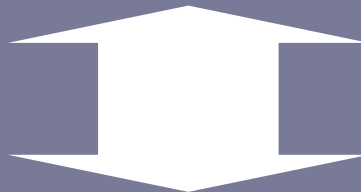
**Safeguard the
interest of IAHs**

**Compliance with
Basel
Requirements
generally**

Proposed IFSB Standards on Corporate Governance aim to cover...

Information environment and transparency:

- Specifying and enforcing appropriate disclosure requirements
- Fostering auditors independence and enforcing the relevant and applicable auditing standards, e.g., AAOIFI and IFRS
- Focusing on **protection of the IAH's interests**



Organs of governance:

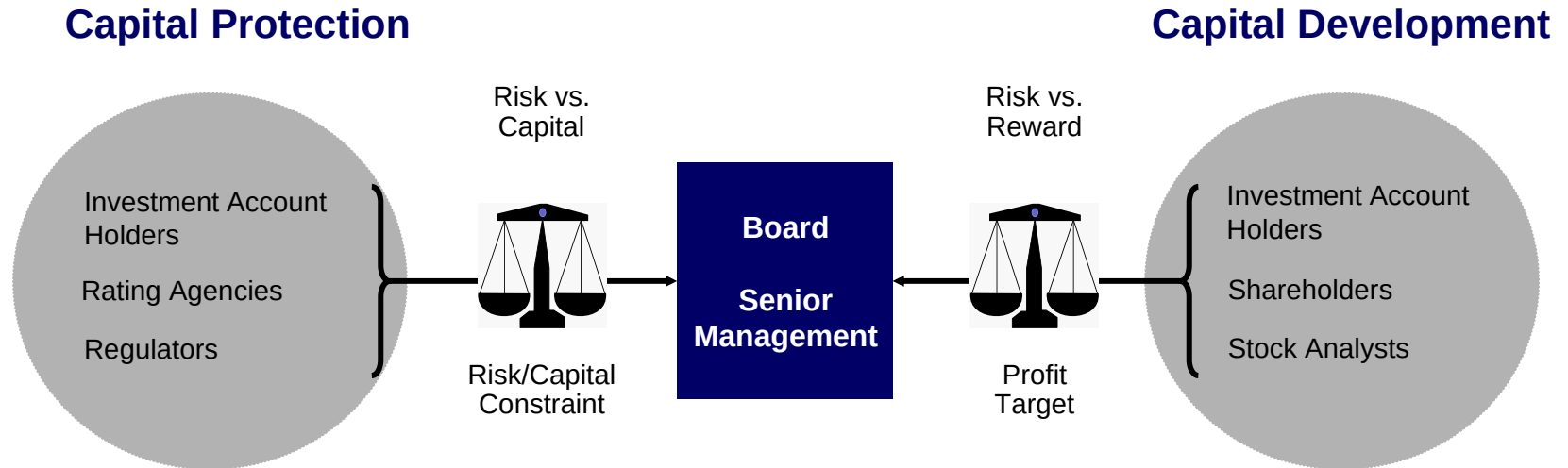
- Specifying clearly the responsibilities of the Board & senior management, especially in regard to the fiduciary responsibility.
- Addressing issues of insiders, 'grey directors' & related party transactions
- Making arrangements for safeguarding interests of IAH
- Providing for monitoring Shari'ah compliance



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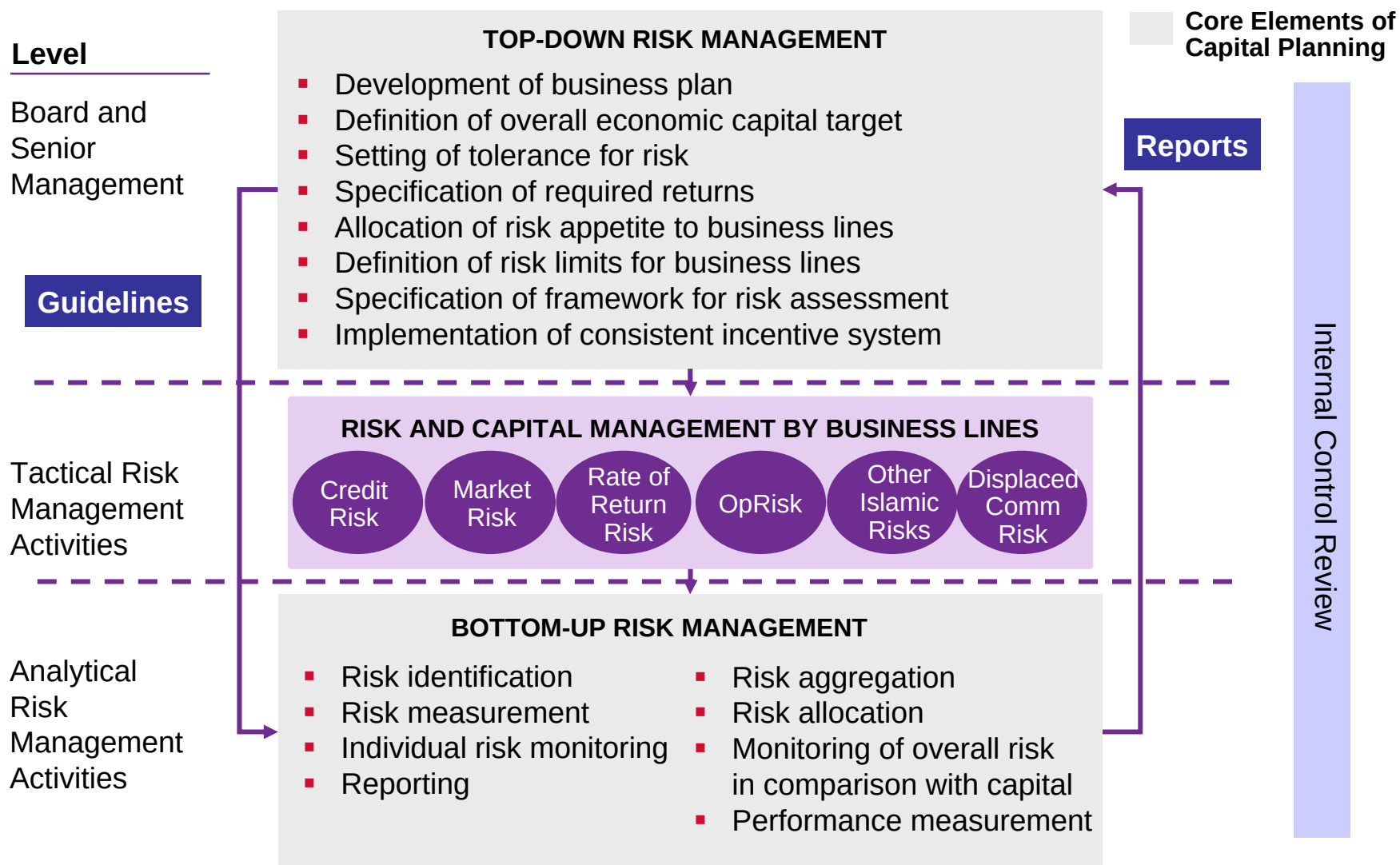
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Islamic financial institutions have a more unique agency problem



... and Islamic financial institutions could balance this competing objectives through a more strategic risk management approach.

An Economic Capital Management Framework helps to meet these objectives



In your groups take 40 minutes to share views and ideas on the following topics:

- 1) What are the main challenges in terms of risk management
 - a) From a bank perspective, if your bank is/were to launch Islamic Bank Services,
 - b) from a regulatory/supervisory perspectives.
- 2) Do you see any potential in developing Islamic Banking products/services?
 - a) If yes, what actions would you recommend,
 - b) If not, motivate your opinion.

Present the result of your discussion in front of the group.