

# Islamic Finance from niche to mainstream?

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As a result of the financial crisis the financial sector is searching for alternatives to compensate lost business and to recover the damage to clients' confidence. In recent years responsible investment products have appeared as one of these alternatives.

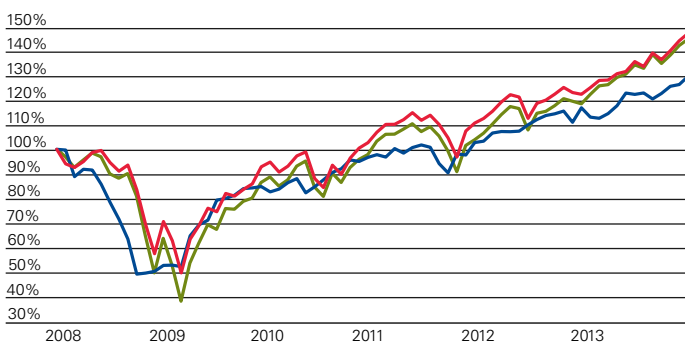
One pillar of responsible investments is ethical business products - such as Islamic Finance. Although Islamic Finance has been distributed beyond the borders of Muslim countries, there are still some key challenges for the niche to become a mainstream business – either because of gaps of investors' knowledge/understanding, a shortage of offered products or even image issues.



From an economic point of view, Islamic Finance offers the following advantages:

The graph shows the historical development of the Shariah compliant indices **S&P 500 Shariah** and **FTSE Bursa Malaysia Hijrah Shariah** in comparison to the **conventional S&P 500**. While the S&P 500 focuses lies on conventional financial values, the Shariah compliant indices leave financial values out and concentrate on commodities including e.g. Apple Inc., Exxon Mobil Corporation, Johnson & Johnson or Sime Darby Bhd (plantation), Petronas (oil & gas) and IOI (palm oil). As a result of the financial crisis the S&P 500 dropped 64%, while the decrease of the Islamic indices was lower than 53%.

The development since the beginning of the financial crisis shows a lower volatility and also a lower slump of the Shariah compliant indices. Nevertheless, isolated Islamic Finance products are not a protection against financial crisis, but can be used for portfolio diversification.



— S&P 500 Shariah  
— S&P 500  
— FTSE Hijrah Shariah

Fund	Return*	Volatility**
S&P 500	0.64%	18.01%
S&P 500 Shariah	0.67%	16.37%
FTSE Hijrah Shariah	0.42%	12.11%

\* Average monthly return since 2008 \*\* Volatility based on monthly value since 2008

**S&P 500**



**S&P 500 Shariah**



**FTSE Hijrah Shariah**



- Information Technology
- Consumer Staples
- Oil & Gas
- Financials
- Consumer Discretionary
- Real Estate
- Health Care
- Materials
- Automobiles
- Energy
- Utilities
- Industrials
- Telecommunication

Besides the economic aspects,  
Shariah compliant business also implies  
administrative alternatives and  
not forgetting moral approaches

### There is a certain vocabulary with Arabic terms to get used to when entering into Islamic Finance.

The names that you hear in connection with Islamic Finance, are the compliant types of contracts. **Shariah compliance is achieved by the terms of these contract types and by the underlying assets of the agreement.** Examples of such contracts are as follows:

**Ijarah:** Similar to a lease agreement. Ijarah is not originally a mode of financing but a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. Contrary to a conventional lease agreement, there is no interest charge attached to the contract but while fixing the rent of the asset, the lessor includes all the costs incurred while purchasing the asset. Ijarah contracts may be used in the context of mortgage loans.

**Istisna:** Long-term construction contract whereby a party undertakes to manufacture, build or construct assets, with an obligation from the manufacturer or producer to deliver them to the customer upon completion. A bank may be involved between the buyer and the constructor for the financing part; in this case the contract is a parallel-Istisna.

**Murabahah:** Simple sale agreement at cost plus. The seller discloses the actual cost he has incurred in acquiring the asset and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage. It is a firm sale.

**Mudarabah:** Equity based financing similar to conventional equity investments in nature. Losses cannot exceed the investor's investment and profits have to be shared according to contractually pre-agreed fixed rates.

**Musharakah:** Similar to joint ventures. Losses cannot exceed the investor's investment and profits have to be shared according to contract.

**Sukuk:** Similar to asset backed bonds. Contrary to conventional bonds, the remuneration is not based on a fixed interest rate but on the returns generated by the underlying asset. For instance, the Sukuk may be remunerated by the rental income of the building that it finances. This kind of Sukuk is called Sukuk al Ijarah because of the underlying lease agreement.

### What is the purpose of Islamic Finance?

**Ethical business** - based on the intention of the Shariah to protect human life, intellect and properties. Shariah compliant business is structured considering the common interests. Therefore most Islamic business products are structured in the form of a partnership. A central characteristic of Shariah compliant products is the avoidance of "Gharar" – uncertainty. The **avoidance of uncertainty** shall ensure that **no contracting party is disadvantaged**. Risk and rewards shall be shared between the business partners. Consequently, the use of speculation, uncovered short sales as well as the majority of derivatives is considered as **gambling** ("Maysir") and **is prohibited**. In addition, money is considered as a tool of exchange and not as an asset; therefore making money with money by granting interest bearing loans for instance is prohibited. The underlying of each Islamic Finance product must be a real asset.

### Who decides what is Shariah compliant and what is not?

Non-profit organizations **AAOIFI** and **IFSB** define standards and guiding principles of Shariah compliant business. The abidance of these standards has to be controlled by a

**Shariah board** and a **Shariah scholar**. The basic rules and standards defined by AAOIFI and IFSB are generally applicable, but several interpretations of the Quran (depending on the related country) influences the controls and implementation!

### What is a Shariah Board and a Shariah Scholar?

The Shariah Board and the Shariah Scholar are in charge of verifying the **compliance** of the products or transactions with the Shariah rules. Scholars are independent. The Shariah Board reports to the Scholar. A Scholar is a well educated person in Shariah and Quran, as well as in business economics, who **certifies that a business fulfils the standards** of Islamic Finance.

### What makes Luxembourg an attractive place for the set up of Islamic Banks and Islamic Funds?

Luxembourg is being promoted by the government as a **European hub** for Islamic funds and Sukuk. It is possible to set up Shariah compliant products using either non-regulated structures or regulated structures such as UCITS or AIFs. Compliance with Shariah rules must be considered in addition to compliance with the specific laws and regulations applicable in Luxembourg for the kind of vehicle chosen. Luxembourg is the **second largest fund domicile** in the world and is already the **third largest domicile for Islamic funds worldwide**, behind Malaysia and Saudi Arabia. These three countries cover more than **70%** of the Islamic fund market. The number of regulated and unregulated Islamic funds in Luxembourg has increased to **111 funds** in 2013. The **assets under management amount to EUR 5bn**. In addition 16 Sukuk are listed on the Luxembourg stock exchange as at 2013. Finally, the government





of Luxembourg is considering the issue of the **first sovereign Sukuk in Luxembourg**, several banks already offer Shariah compliant **asset management, Islamic banks** from Qatar and Indonesia plan to open branches in Luxembourg in 2014 and **Family Offices** from the Middle East see attractive investment opportunities in Luxembourg and the EU.

Source: Luxembourg for Finance, Luxembourg Stock Exchange, zawaya.com, Thomson Reuters Global Islamic Asset Management Report 2014

## But Luxembourg is not a Muslim country, are Islamic Finance products also available for non-Muslims?

Products of Islamic Finance are **not restricted to Muslims** only. Islamic Finance principles are driven by Ethics rather than religion. Sharia compliant products may be defined as a separate asset class. In that case "Islamic" is just a name, covering characteristics of e.g. transparency and lower volatility. **Even the Vatican recommends Islamic Finance as an example of ethical business.**

Source: L'Osservatore Romano

## How KPMG may help you

### PRE SET-UP STAGE

- Market Research
- Market Entry Studies
- Regulatory Assessment
- Market Positioning
- Taxation Advice
- Conversion Advisory

### SET-UP STAGE

- Business Strategy
- Business / Financial Plan
- Governance Structure
- Risk Management
- Business Processes
- Defining and Implementation
- Islamic Finance Learning
- Executive Search and Selection

### OPERATIONAL STAGE

- Audit and Accounting
- Feasibility Studies
- Economic Management
- Performance Management
- Regulatory Advice
- Assessment of Shariah Compliance
- IT Risk Management
- Risk Management Review
- Training on Islamic Finance

### TRANSFORMATION STAGE

- Business Transformation
- Forensics
- Business Model Review
- Governance and Risk Management Review

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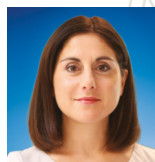
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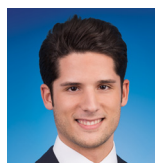
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## KPMG Global – Network

KPMG Luxembourg and our Islamic Finance specialists are part of KPMG's global network of Islamic Finance professionals. In this network we share our expertise and experience to allocate the best solutions and experts to your needs.



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