

Empowering Risk  
Intelligence in  
Islamic Finance  
Managing risk in  
uncertain times





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# Foreword

The global financial crisis continues to hit hard, with almost all markets of the world economy, and indeed almost all sectors, having been directly or indirectly impacted by this major economic turbulence. The financial services - including Islamic Finance - are facing a catalogue of regulatory and practice-related reforms. This new wave of regulatory reforms, aimed at upholding best practices, has renewed emphasis on prudential oversight and good governance. These changes resulted greater pressure on financial institutions offering Islamic financial services (IIFS) to galvanize their risk exposures and governance capabilities. Moreover, the complexity of Sharia'a-compliant debt and equity instruments has evolved, and types of risks, issues and investors, as well as market conditions, have emerged, all of which have made it imperative for IIFS to develop and adopt integrated risk management strategies, in order to protect their businesses and stakeholders.

In many jurisdictions there is now heightened awareness and scrutiny by national regulators and industry standard-setters to safeguard the interest of investors and customers. Key to this is the importance of public awareness and market education. Hence, Deloitte Islamic Finance Knowledge Center (IFKC) is committed to producing relevant and timely thought leadership in

Islamic Finance, which addresses and investigates important issues in practice and regulation. The prime objective of this approach is to produce timely relevant insights from the industry practice and to strive to promote the value of best practices amongst stakeholders. Lastly, this report focuses on the governance and structural aspects of an effective risk management framework in Islamic Finance. It presents an analysis of case studies developed, new insights in risk management practice to empower risk intelligence in Islamic Finance and suggests ways to manage risk in troubled times.

Regards,

**Hatim El Tahir, director, Islamic Finance Knowledge Center (IFKC), Deloitte in the Middle East**



# Executive summary

The Islamic Finance Risk Intelligence survey, published by IFKC at Deloitte Middle East, assesses the status quo of risk management practice in the Islamic Finance industry. The report is based on a survey and group of case studies developed during the second half of 2011 encompassing 20 Islamic Financial institutions from the Middle East and South East Asia, with aggregate assets of more than \$50 billion, and representing a range of Islamic Financial institutions. In addition, several interviews were conducted with industry leaders and risk management executives. The analysis included cross reference analysis of Deloitte's research and analysis in risk management and made use of Deloitte's Risk Intelligence Maturity Model in developing point of views on Islamic Finance risk intelligence. Needless to say, the overall questions and issues discussed with institutions and risk executives were structured around Deloitte's four enterprise risk management (ERM) capabilities, namely Governance, Process, People, and Technology. Finally the report similarly benefited from revelations and reflections of the 'Executive Roundtable on Risk Management', organized by the Islamic Financial Services Board (IFSB), hosted by the Central Bank of Bahrain and supported by Deloitte IFKC, in December, 2011.

In summary, the following key challenges warrant the attention of Islamic Finance industry leaders and stakeholders:

1. 63% of respondents believe that strong commitment from Boards, Sharia'a Supervisory Boards and Management is required to improve ERM in Islamic Finance.
2. 65% of the institutions offering Islamic Financial Services (IIFS) that participated in our study are considering the development of an ERM program.

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## 63% of respondents believe that strong commitment from Boards, Sharia'a Supervisory Boards and Management is required to improve ERM in Islamic Finance

3. Only 59% of the IIFS that participated have implemented the IFSB's Risk Management Standard; 63% reported that they have not received any external rating, and less than quarter of the respondents had considered or received external rating from an Islamic rating agency. This constitutes a real challenge posed to industry participants and standard-setters such as the IFSB, AAOIFI, IIFM and the IIRA, to enforce best practices.
4. Creating a risk-aware culture is considered the most (68%) important benefit of ERM. The IIFS lack skilled risk experts, and institutions are required to invest in building capabilities in key risk management pillars - People, Process, Technology and Governance.
5. 56% of the group studied have risk management software, and 44% of them lag behind in automation of risk information management.
6. Risk function executives and policy-makers are faced with new international regulatory and governance requirements and are required to fully adapt to international best practices.



## Introduction

As Islamic Finance continues to evolve, institutions offering Islamic financial services (IIFS) have continued to face many challenges on the operational and management fronts. Questions and issues relating to best practices in risk management and effective risk functions have surfaced as a result of this important dialogue. Many Islamic and traditional financial institutions are reviewing their risk management functions and models. Executive directors, Sharia'a Supervisory Board members, and boards of directors, are more actively engaged in the risk management decision-making process than ever before. The regulatory coordination and harmonization of standards and Sharia'a fatwas is inevitable and market and practice synergy is an aspiration of all stakeholders.

This report is structured around three sections. First, it introduces risk governance in Islamic Finance and underscores the key factors underpinning its practice. The report then moves to discuss the key results of the Deloitte IFKC Survey on risk intelligence conducted between March and July, 2011. The discussion and analysis encompasses industry and practice revelations in two key markets, the Middle East and South East Asia. It highlights new insights that have emerged from the case studies which were developed and tested against Deloitte's ERM maturity model. The case studies included a group of 20 institutions offering Islamic financial services (IIFS), operating globally from nine countries. The surveyed group had total assets of more than \$50 billion and included IIFS in commercial and investment banking and Takaful sectors. Half of the institutions have assets totaling less than \$1000 million; a quarter of them have assets totaling between \$1000 million and \$10,000 million. Finally, the report concludes with insightful complementary points of views from prominent industry thought leaders around the world to share their contextual perspective on risk management.

## Risk governance in Islamic Finance

The profile of risks affecting the IIFS today is vastly different than that of the risks impacting them a decade ago. Globalization and changes in technology, product offerings, process, and the nature of business transactions create new types of challenges and risk to the Boards and executives of these institutions. Risk drivers in Islamic Finance stem from common conventional known types of risks, as well as the unique Sharia'a compliance risk that shapes the operations of the IIFS business. The latter constitutes a fundamental prerequisite factor for developing any risk management strategy for the IIFS whether in sourcing of funds or use of funds. It is, however, the role of Boards and executives that ensures compliance to Sharia'a principles in all levels of IIFS operations and management of their assets. In discussing risk governance in Islamic Finance, two key factors warrant consideration – first the embodied element of the fiduciary relationship between the SSB, Board, management and other stakeholders of the institution and secondly the importance of transparency and disclosure in these unique operational and management relations.

## The essence of the fiduciary relationship

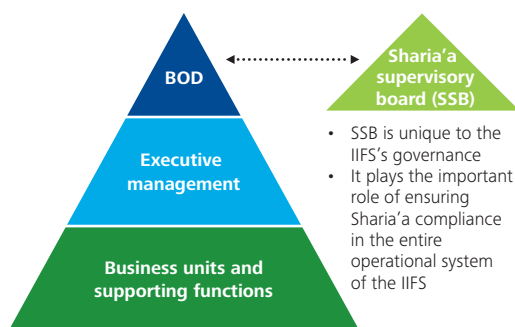
The fiduciary relationship between the shareholders, investors and other stakeholders is paramount in understanding the regulatory needs of risk management and its practice. The common theme in this unique relationship is good governance and an adequate financial and management reporting mechanism. Key to this is the role of Sharia'a Supervisory Boards (SSBs) in vetting business suitability to comply with Sharia'a principles, and its obligation to safeguard the interest of investors, management and clients. This important role is galvanized by support from interdependent business units and functions such as legal, human resources, tax/Zakat, information technology, and finance. These interdependent units harness the task of identifying,

measuring, managing, and monitoring risks, in four main ways:

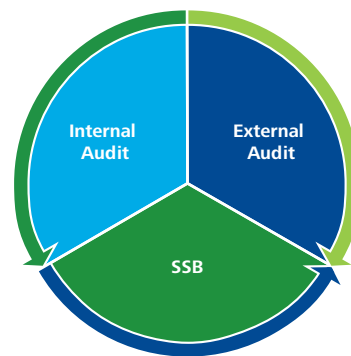
- Strategy: developing institution-wide policies and procedures and controls that help build risk governance
- Planning: providing required resources and information management
- Transparency: ensuring homogenous flow of information and standardized practice
- Education and training: identifying training needs and skills development within the institution.

These four areas of coordination are affecting the decisions made in all areas of operations, management, risk management and business strategy. Strategic risk dialogue begins with engaging management and business support units. Prudential oversight, good corporate governance and financial reporting and disclosure are key factors to ensure effective risk management in Islamic Finance. The three-party interdependent approach of disclosure and reporting in Islamic Finance consists of interaction and coordination between three main parties. The coordination between the SSB, internal audit and external audit is a similarly important process in risk management which ensures consistency, standardization and Sharia'a-compliance at all levels of the institution's operation.

#### The fiduciary relationship in Islamic Finance



#### Transparency, Disclosure and Reporting framework (TDR)



##### Internal Audit

- Standardized policies and procedures of reporting practices
- Identify and align standard business transparency practices
- Update of regulatory practices and accounting standards

##### External Audit

- Consistency in practices, concerning transparency and information disclosure
- Holds additional responsibility as 'Sharia'a Compliance Inspectors'

##### SSB

- Coordinate with external auditors to ensure Sharia'a compliance in areas concerning operations and accounting practices

Consequently, Islamic Finance risk executives are required to develop risk management strategies that address the full spectrum of risks, including industry-specific ones such as Sharia'a compliance, competition, community development, strategic, reporting, and operational. IIFS's boards and executive management should invest in risk management practices that are infused into the corporate culture, and design risk strategy and decision-making that evolve out of a risk-informed process rather than assuming risk considerations. Along with this expectation, four key categories of risk areas are identified:

1. Enhance risk governance strategy aligned with Board's support and oversight.
2. Enhance operational risk assessment and process standardization.

3. Integrate Sharia'a compliance in all operational risks and process strategies.
4. Standardize and enhance disclosure and reporting procedures.

**Risk categories in Islamic Finance: four key areas of risks**



**Strategic risk**

Enhance risk governance strategy supported by Board oversight

**Operational risk**

Enhance coordination between process, people, technology and Sharia'a compliance that impact overall performance of IIFS

**Financial risk**

Standardize disclosure procedures. Reporting, valuation, liquidity, market and credit risks

**Sharia'a compliance risk**

Integrate Sharia'a Compliance in process and operational risks

**The Islamic Finance Risk Management capability model**

The implementation of an integrated and holistic risk management approach in Islamic Finance is a compelling need to empower the risk function and operate an effective risk practice. The following key steps propose the building blocks of an effective enterprise-wide risk management system in Islamic Finance. Seven key areas of risk capabilities are identified as shown in the following diagram:

**The Islamic Finance Risk Management capability model**



The seven building blocks

Source: Deloitte ME IFKC



### Introduction to Deloitte IFKC's risk intelligence in Islamic Finance:

This section is based on the findings of a survey conducted in 2011. The questions and interviews with risk executives across the region were structured around Deloitte's four ERM capabilities:

- Governance
- Process
- People
- Technology

**Governance:** The governance capability focuses on the structure and organization of the risk management function (even if no risk manager position formally exists) in order to make risk-intelligent decisions and execute those decisions in a timely and effective manner. A company needs to define roles and responsibilities of the board and its committees, management, internal audit and risk management functions with respect to risk management. Risk management policies such as risk appetite, tolerance and delegation of authority need to be formally documented and communicated.

**Process:** The process capability focuses on the process in place to execute risk management. This includes core operational and infrastructure business processes necessary to run the risk management in an efficient manner to create and protect value.

**People:** The people capability focuses on having the right number of people with the appropriate training and awareness to execute the risk management process. This includes trained people at all levels and a company-wide risk awareness culture.

**Technology:** The technology capability focuses on IT systems used to analyze and communicate risk information throughout the organization as well as to enable risk-intelligent decision-making in a timely manner.

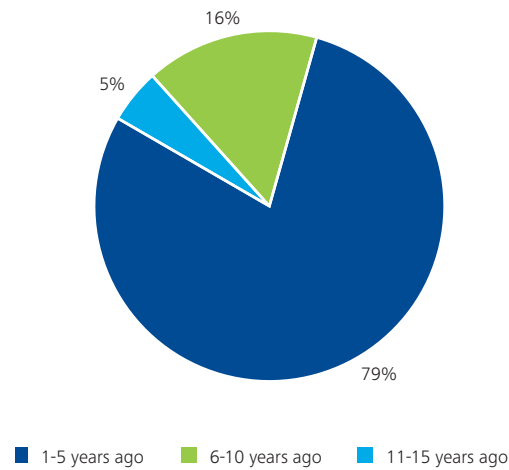
Deloitte ERM capability model <sup>TM</sup>



### Key challenges facing Islamic Financial institutions

Enterprise Risk Management (ERM) is relatively new in the Islamic Finance industry. 79% of the institutions that took part in the survey have a risk department established in the last five years. Only 5% of the IIFS' risk departments were set up more than 10 years ago.

#### When did you set up your risk department?



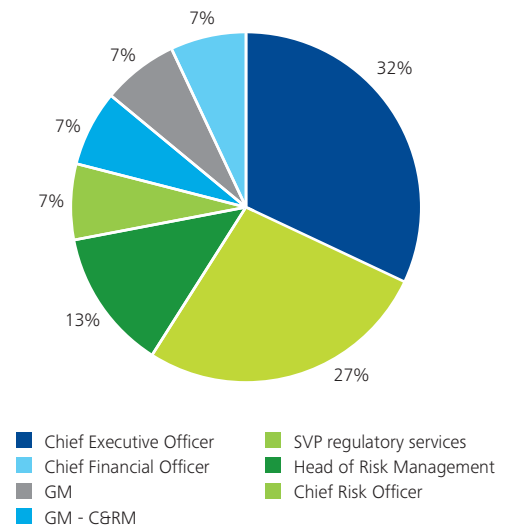
### Governance

#### Risk governance and oversight

The case studies and survey shared with IIFS in the Middle East and South East Asia have shown that many IIFS have strengthened or adopted risk governance frameworks and assigned Boards and senior executives to the role of risk management.

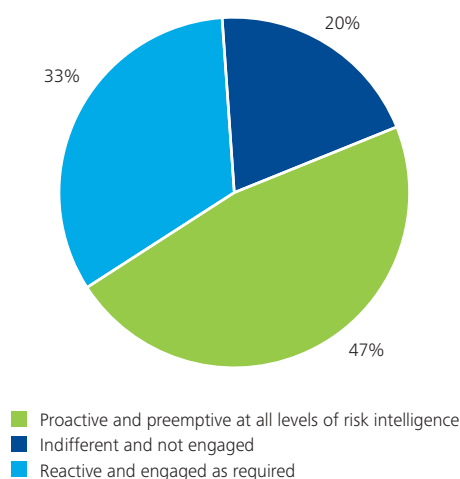
### Who, at executive level, has been assigned accountability for the ERM program?

In 32% of institutions the CEO is accountable for the ERM program while 27% have the Chief Risk Officer and 13% have the Head of Risk Management accountable. Thus, IIFS management and decision-makers should support the risk governance process with subject matter experts for in-depth analysis and adequate selection of risk solutions and strategies.



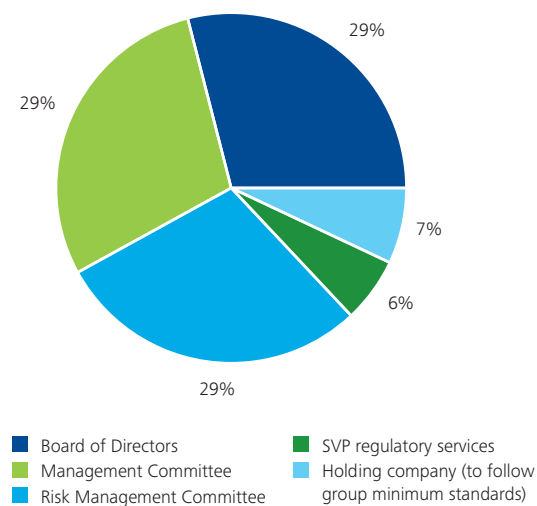
### Select the level of the Board of Directors' oversight and engagement in ERM at your institution.

47% of the surveyed group had proactive Boards at all levels of risk intelligence while 20% are indifferent and not engaged in the risk function. Boards and management are required to design a best practice risk oversight structure – with clearly-defined roles, responsibilities and accountability, as well as ways to continuously improve this process. They should also support the risk governance process with subject-matter experts for in-depth analysis and solutions.



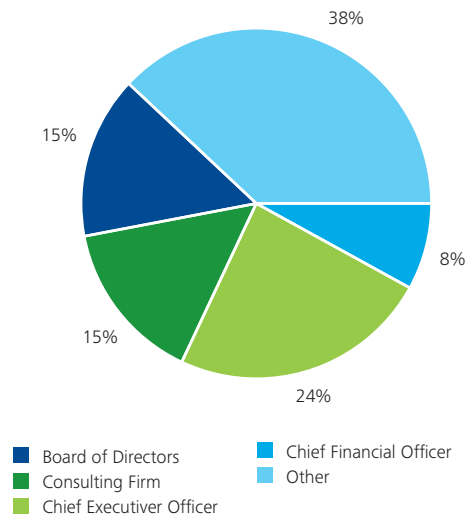
### Who is primarily driving the interest in ERM in your institution?

Boards and executive management appear to be the prime driver of interest in ERM, while the Management Committee and Risk Management Committee also have significant interest in ERM.



### If considering developing ERM in your institution, who would lead this initiative?

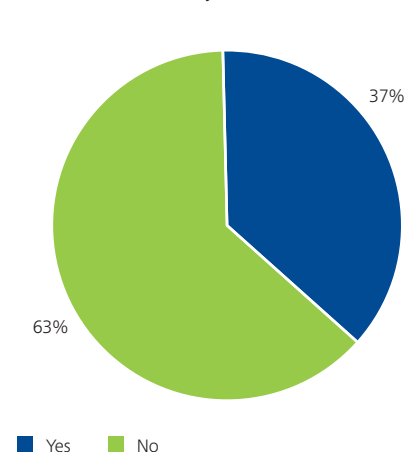
CEOs tend to lead ERM in IIFS (24%), followed by Boards (15%). However, more than a third of the surveyed group (38%) indicated that ERM was led by 'Other' which presumably includes professional service firms and consultants.



### Rating and credit assessment

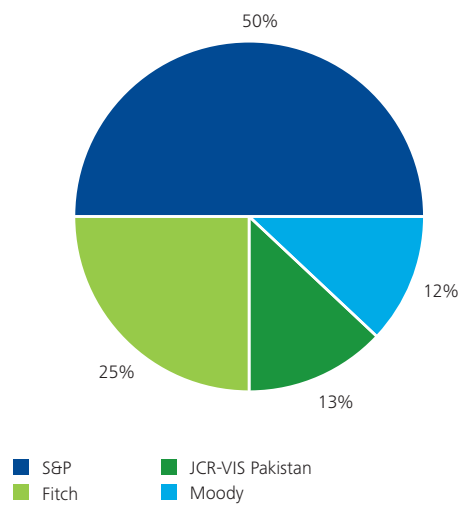
#### Has your institution received an external rating?

About two thirds (63%) of the surveyed group reported that they hadn't received any external rating. It is important to emphasize here the role of external credit analysis in light of Basel II requirements (for the standardized approach). IIFS are required to adopt this new set of requirements and update their internal reviews and control systems.



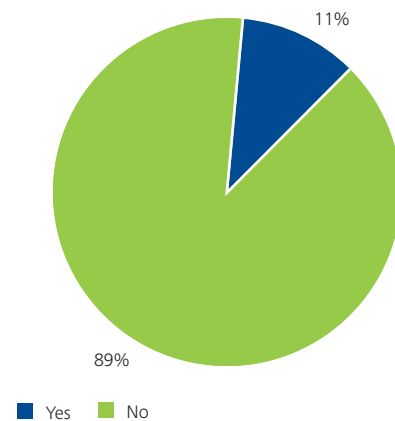
### Has your institution received an external rating?

Among those IIFS who received external ratings, 50% of them received a rating from S&P and 25% of them received a rating from Fitch.



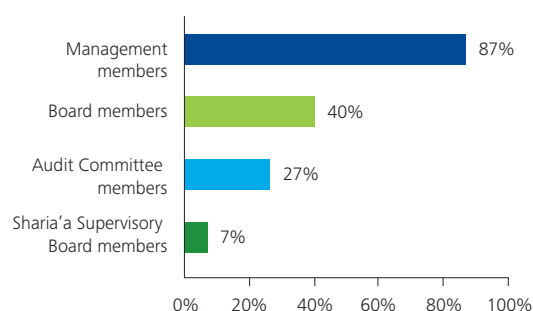
### Has your institution considered an external rating from an Islamic Rating Agency before?

The majority (89%) of the IIFS group surveyed have not considered an external rating from an Islamic Rating Agency. This finding clearly needs to be investigated further and it appears that there is a gap between Islamic rating agencies and the IIFS in understanding the importance and need for Islamic rating, its methodologies and approach. The majority (80%) of the institutions are not considering applying for a credit rating in the near future.



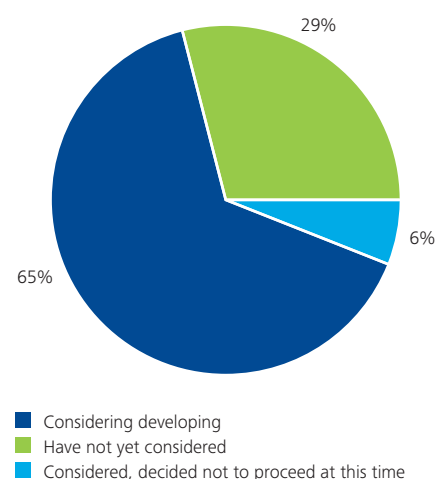
## Enterprise Risk Management (ERM) implementation

In the entire group surveyed, IIFS have a formal risk management function that manages the risk activities. In the majority of the institutions (83%), a risk committee oversees all risks. It is also observed that in 87% of the IIFS participants, 'management members' form the members of the risk committee.



## Are you planning the implementation of an ERM program, or any risk management activities in the near future?

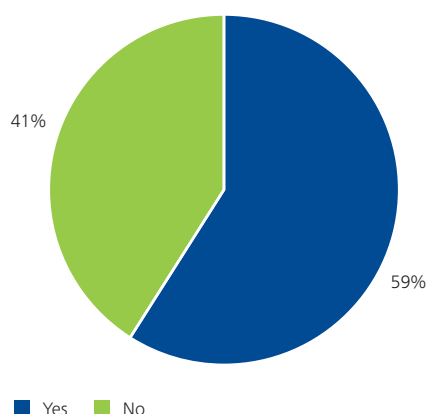
65% of IIFS surveyed are considering the development of an ERM program. 29% of them have not yet considered it, while 6% of them have decided to implement an ERM program. This finding is important and clearly indicates that the IIFS are lagging behind in the implementation of ERM. Therefore, boards and executives are advised to develop an intelligence risk strategy and develop appropriate action plans.



## Risk scope and best practices

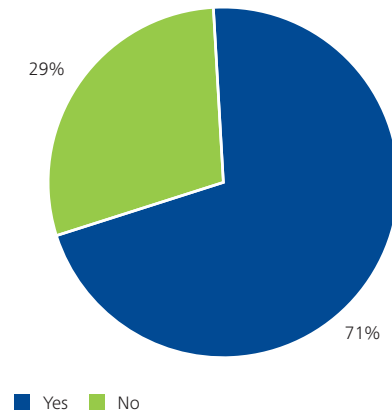
### Does your institution implement the IFSB's Guiding Principles of Risk Management?

Our group's case studies and survey show that only 59% of the IIFS have implemented the IFSB's Risk Management Standard. This finding highlights the challenge faced by standard-setters such as the IFSB, AAOIFI and the IIFM to ensure that standards and best practices are followed and implemented. It is probably true to say that national regulators such as central banks and capital market authorities, in markets where Islamic Finance has evolved, should play a more effective role to ensure this.



### Does your institution implement the IFSB's Guiding Principles on Sharia'a Governance?

In contrast, 71% of the group surveyed have implemented the IFSB's Guiding Principles on Sharia'a Governance. Key causes of Sharia'a compliance risks include non-standardized practices, diverse Sharia'a interpretations, and the lack of enforcement of Sharia'a laws in many jurisdictions.



### Please rank the following drivers for undertaking risk management activities.

	Composite score	Rank
Regulatory compliance (for example, market regulators)	87	1
Strategic reasons (for example, development of competitive advantage)	78	2
Business continuity (protection against hazards such as economic downturn, environmental crises, Sharia'a compliance, etc.)	70	3
Operational performance (efficiency and effectiveness of business processes)	69	4
Standard-setter compliance (for IFSB, AAOIFI, and IIFM)	44	5
Public image	29	6

Regulatory compliance (87%) is the prime reason for undertaking risk management activities followed by 'Strategic reasons', 'Business continuity', 'Operational performance', 'Standard-setter compliance' and 'Public image'.



### What are the primary goals regarding ERM that you would like to realize in the future?

'Align risk appetite and strategy' is the primary goal (75%) regarding ERM followed by 'Link growth, value, risk and return', 'Provide integrated responses to multiple risks', 'Minimize operational surprises and losses', and 'Seize opportunities'.

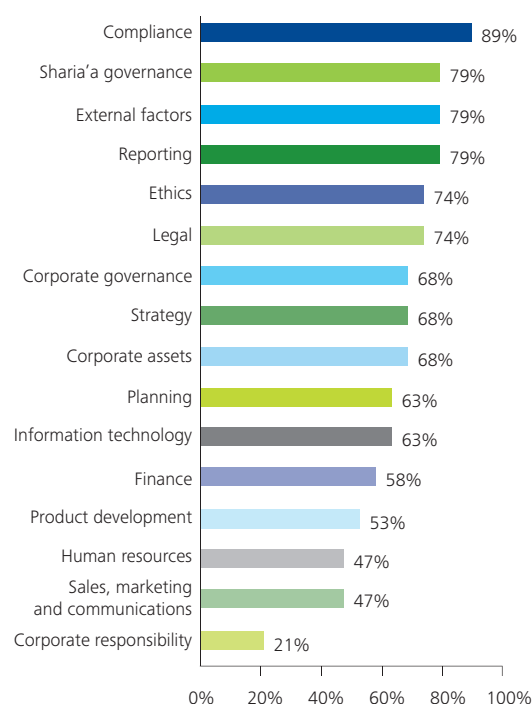
	Composite score	Rank
Align risk appetite and strategy	75	1
Link growth, value, risk and return	72	2
Provide integrated responses to multiple risks	49	3
Minimize operational surprises and losses	46	4
Seize opportunities	28	5

### Please rank the following realized benefits of ERM

'Creating a risk-aware culture' is considered the most (68%) important benefit of ERM followed by 'Reducing vulnerability to adverse events'. Surprisingly, 'Focusing integrated management reporting on the risks that matter most', was ranked least important.

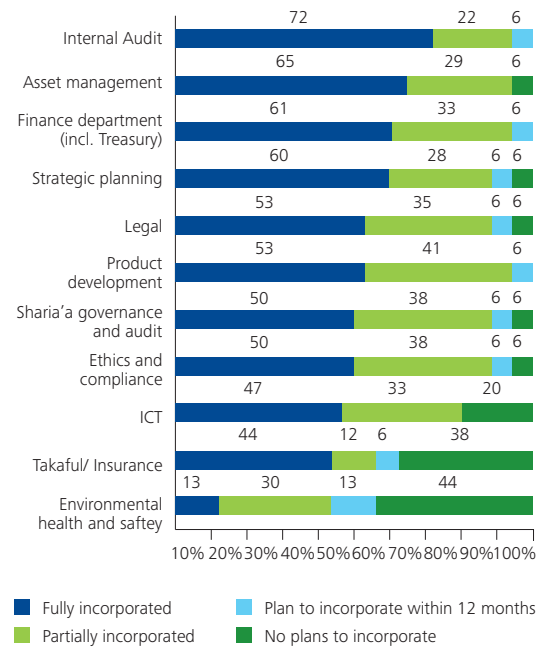
	Composite score	Rank
Creating a risk-aware culture	68	1
Reducing vulnerability to adverse events	56	2
Enhancing risk response decisions and mitigation plans	55	3
Identifying and managing cross-enterprise or interdependent risks	49	4
Focusing integrated management reporting on the risks that matter most	42	5

### What is the scope of your risk management? (Please select all the risks covered by your institution.)



A key risk area covered by many IIFS is compliance. The survey reveals that 89% of the IIFS consider compliance as an important risk to cover, followed by external factors and ethics. Corporate responsibility is the area least covered by risk management.

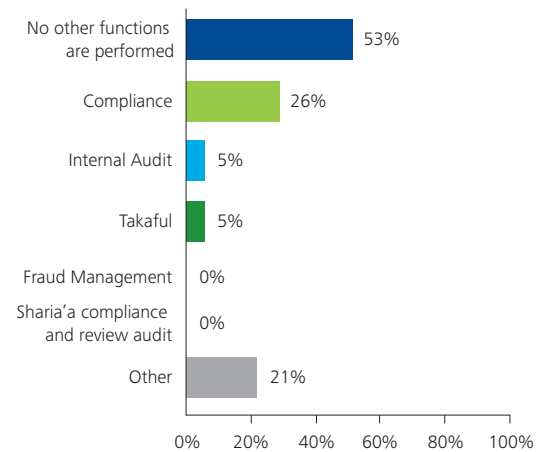
**What is the extent of risk management integration in your decision-making process? (Please indicate the degree to which risk management is integrated into your decision-making process in each of the departments below.)**



Most of the survey respondents either fully or partially incorporated risk management in all the processes listed above. However, 'Takaful / Insurance' and 'Environmental health and safety' are the two areas where the institutions need to incorporate the risk management process more efficiently.

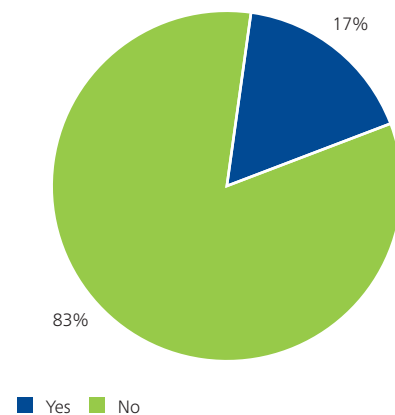
**Does your risk manager (or person responsible for ERM activities), perform other functions besides ERM?**

In 53% of institutions the risk manager does not perform any other functions besides ERM, while in other organizations he performs functions such as compliance and a few other tasks.



**Are there any risk management activities outsourced to an external party?**

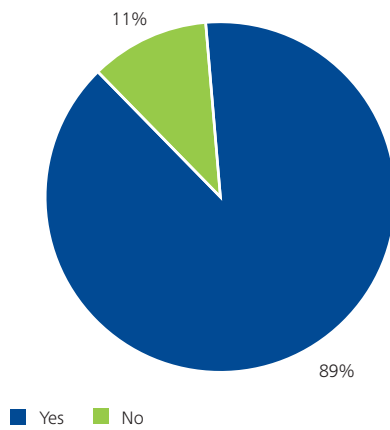
83% of the IIFS in the surveyed group do not outsource any risk management activities.



## Process

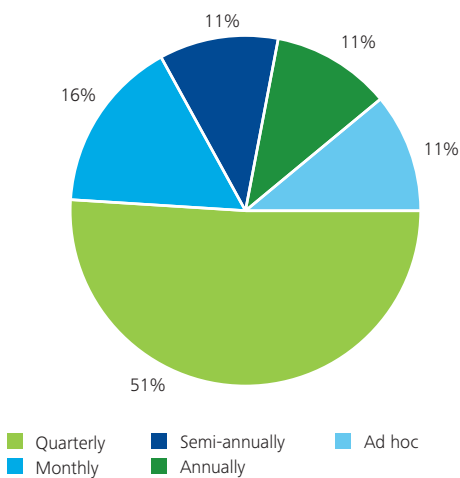
### Do you have a clearly defined and documented risk management process to execute risk management activities?

89% of the IIFS participants have a clearly defined and documented risk management process to execute risk management activities.



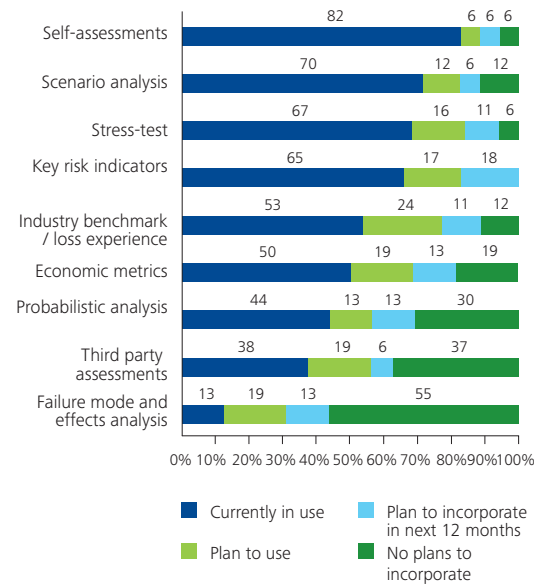
### How frequently are risk assessments conducted? within your institution?

67% of the IIFS conduct risk assessment at least once every quarter.



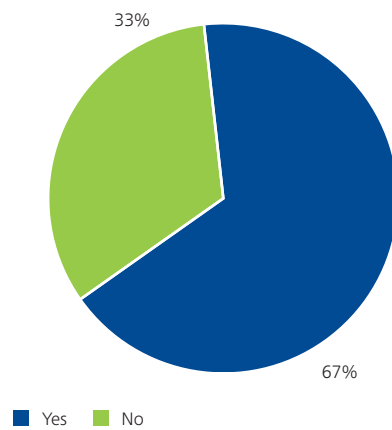
### What kind of risk assessment methods and methodologies do you use for risk analysis?

'Self-assessment' is the most popular methodology (used by 83% of the institutions) while 'Failure mode and effects analysis' is the least preferred (56% of the institutions have no plans to incorporate this).



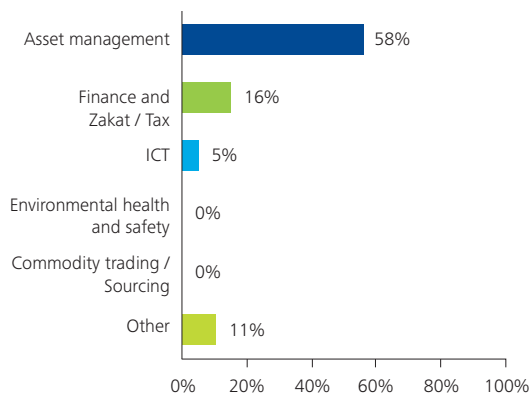
### Do you use quantitative risk analysis methods in your institution?

Two thirds of the IIFS participants use quantitative risk analysis methods.



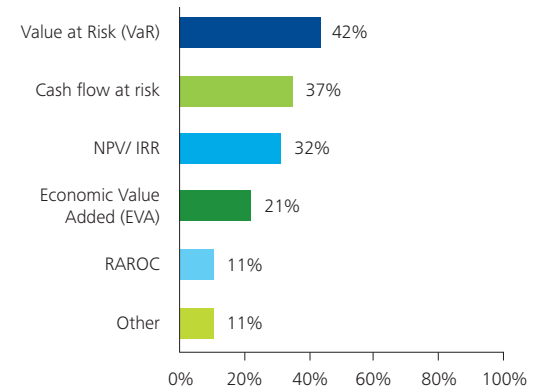
### In which functions/areas do you apply quantitative risk analysis?

58% of the IIFS that responded to our survey report that they use quantitative risk analysis in the 'Asset management' area while 16% of them said they use it in Finance and Zakat/Tax.



### What kind of risk measures do you use?

42% of survey respondents use Value at Risk (VaR) followed by 37% that use Cash flow at risk, 32% using NPV/IRR and 21% using Economic Value Added (EVA).



### Please rank in order the following challenges with respect to quantitative risk analysis.

	Composite score	Rank
Identifying and applying effective quantitative risk measuring techniques	55	1
Implementing supporting tools for quantitative risk measuring techniques	45	2
Identifying the required data for your quantitative risk analysis	37	3
Effectiveness of data capturing	35	4
Finding qualified quantities modeling experts	31	5

'Identifying and applying effective quantitative risk measuring techniques' is the top challenge (56%), followed by 'Implementing supporting tools for quantitative risk measuring techniques', 'Identifying the required data for your quantitative risk analysis', 'Effectiveness of data capturing', and 'Finding qualified quantities modeling experts'.

**Which of the following ERM best practices require improvement/attention? (Select all that apply)**

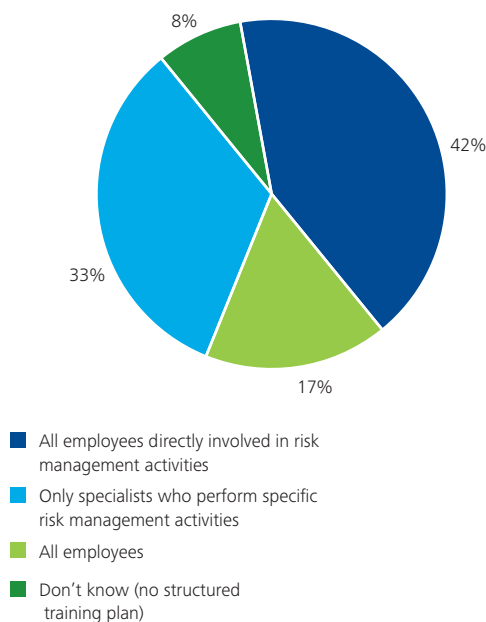


63% of respondents believe that strong commitment from board and management is required to improve ERM followed by improving the risk governance system, developing the right talent and risk education program and understanding the risk culture. The boards and executive management of IIFS are advised to work with an experienced ERM advisor to accelerate buy-in and ensure knowledge transfer throughout the process.

**People**

**Who is involved in your ERM training program? (Please select only one answer that is most applicable to your institution.)**

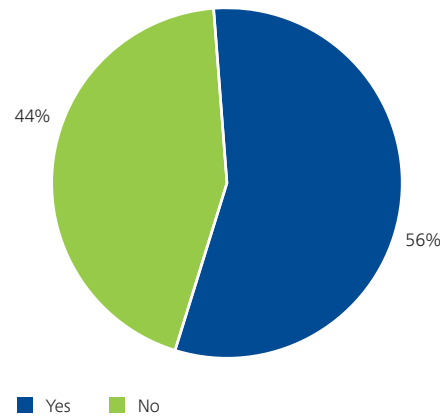
Roughly half of the institutions provide ERM training programs. In 42% of institutions all employees directly involved in risk management activities are involved in an ERM training program, while in 33% of institutions only specialists perform this activity.



## Technology

### Do you have risk management software or tool(s)?

56% of institutions have risk management software while the remainder don't. In addition, 62% of the institutions built their risk management tool in-house.

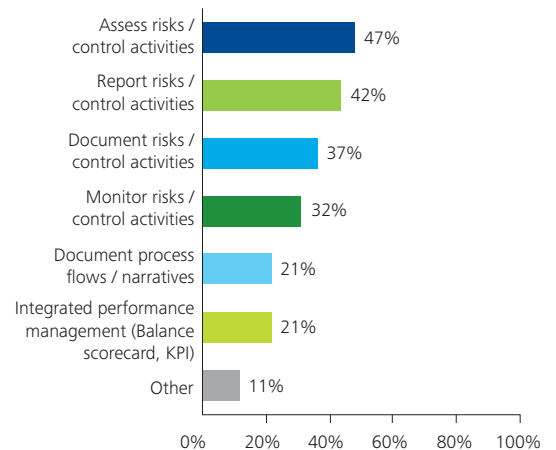


## Risk exposures

### Which of the following activities are performed at your institution using the risk management tool?

Our analysis shows that the top three activities performed are 'Assess risks/control activities', 'Report risks/control activities' and 'Document risks/control activities' respectively. In addition, 'Asset performance risk' is the top risk that the institutions are facing, followed by 'Credit, liquidity and market risks'. 'Ethics risk' ranked last among respondents.

'Ineffective risk oversight and governance' are the most likely hindrance to Islamic Finance Institutions' risk management effectiveness followed by 'Absence of a clear ERM strategy', 'Lack of Sharia'a-compliant risk mitigating instruments', 'Poor execution of ERM strategy', 'Lack of skilled risk management personnel' and 'Irrelevance of IT systems and processes'.





### Empowering the Risk Intelligence Enterprise

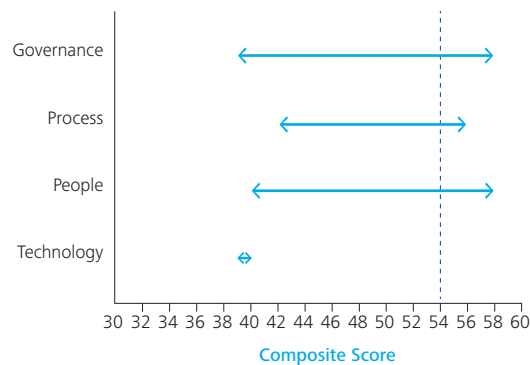
Overall Assessment of the 'ERM Capabilities', the Deloitte Maturity Model:

\*For illustrative purposes we have drawn a line at 54 to represent the midpoint of the maturity model.

\*Note that the composite score range is from 18 to 90.

Our overall assessment of the risk maturity to the group studied exhibits least maturity on 'Technology'. It should also be noted that the risk maturity on the other three pillars is also lacking. For example, 'Governance', in the 20-IIFS group, tends to range in the midpoint. Similarly in the 'Process' and 'People' capabilities, the analysis reveals that the IIFS didn't go beyond the range of the midpoint. This allows for room improvement in the ERM capabilities discussed. Thus the IIFS are required to build their risk capabilities and competencies to ensure an effective risk management function that addresses their unique risks and operational models.

Overall Assessment of the 'ERM Capabilities', the Deloitte Maturity Model



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## Recent events, whether affecting conventional or Islamic Finance, have revealed that there are still deficiencies in the management of risk

### Thought leaders' perspective on Risk Management

To sum up our report, Deloitte IFKC organized 'intellectual knowledge dialogue' with Islamic Finance thought leaders from the two key markets of MENA and SEA. The debate revolved around the four key areas of importance in risk intelligence: governance, process, people, and technology. By doing this, we aimed to engage industry regulators, practitioners, academics and professionals in an exchange of benchmarks, views, and insights with the aim of hopefully bridging gaps in industry practices and regulation. Moreover, Deloitte IFKC supported an executive roundtable on 'Risk Management in Islamic Finance', held in Manama in December, 2011, organized by the IFSB and hosted by the Central Bank of Bahrain. The following comments are extracts from our 'Intellectual knowledge dialogue' with Islamic Finance thought leaders.

### Governance

"Regulators need to promote good governance principles (e.g corporate governance codes and IFSB risk management principles." **Richard Ellis**, Advisor, Banking Supervision, Central Bank of Bahrain.

"Recent events, whether affecting conventional or Islamic Finance, have revealed that there are still deficiencies in the management of risk. The technical issues of the identification, measurement and reporting of risk are the subject of detailed scrutiny by the various Risk Professionals' Institutes and research in firms and universities worldwide. More worrying is the ongoing challenges faced by several institutions to fully

adapt to the new governance requirements and technology implications of the crisis." Professor **John Board**, Dean, Henley Business School, University of Reading, UK

"Unified laws for close-out netting, insolvency and ownership rights are required not only for existing transactions but will also greatly facilitate the required innovation in Islamic hedging and liquidity management segment of the industry." **Ijlal Alvi**, CEO, IIFM.

"One of the beauties of Sharia'a is that it allows interpretation as situations demand. It is open for ijtihad. However, a Takaful operator domiciled under one jurisdiction and wanting to grow and write business under another is highly likely to face different interpretations of the governing Sharia'a regime regulations. Perhaps practitioners should plead with regulators to try and consider a form of consensus."

**Mahomed Akoob**, Managing Director, Hannover ReTakaful.

"In Islamic Finance the development of governance framework is still relatively slow and in need of serious attention. The regulators should obtain inputs from industry, Sharia'a scholars and academicians in developing a robust framework." **Daud Vicary**, President and CEO, INCEIF, Malaysia.

"The regulator should play an important role in developing a robust governance framework with input from the industry, Sharia'a scholars and academicians. A robust Sharia'a governance framework is needed in order to ensure a due process is observed in ensuring the integrity of Sharia'a is preserved. In this regard, lessons can be learnt from the jurisdictions which have developed a strong Sharia'a governance framework such the Sharia'a Governance Framework (SGF) developed by The Central Bank of Malaysia."

**Dr. Mohamad Akram Laldin**, Executive Director, ISRA, Malaysia.

"Full disclosure of corporate governance practice should be published in annual reports of IFIs." **Sohail Jaffer**, Partner, International Business Development, FWU AG International, Luxembourg.

"The central theme of corporate governance for an IIFS is its basic framework which nests around the SSB and the internal controls which support it." **Moineddin Malim**, CEO, Mashreq Al Islamic Finance Co.

"The business model of most Islamic commercial banks is based on mobilizing funds in profit sharing investment accounts (PSIA), which are governed by the Mudaraba contract. This poses many governance challenges to which Islamic banks should pay attention. Whilst PSIA holders are exposed to the risk of loss of their equity, absent misconduct and negligence, they enjoy weak governance structure. PSIA holders have no say in the appointment/dismissal of the bank's management, external auditors or members of the Sharia'a board. It is important to create awareness of this issue." **Professor Datuk Rifaat Abdel Karim**, INCEIF, Malaysia Visiting Professor, ICMA Centre, Henley Business School, University of Reading, UK, Adjunct Research Professor.

"Until the beginning of the financial crisis hardly anyone was arguing that financial reporting standards should be written with the objective of financial stability in mind." **Prof. Dr. Necdet ŞENSOY**, Central Bank of the Republic of Turkey.

## Process

"There are differences between the conventional financial system as compared to the Islamic financial system in terms of core operational and business processes; for example, in conventional derivative products the risk is detached from the balance sheet items and is traded separately while in the case of Islamic hedging, the requirement is directly linked to economic activity or balance sheet items and there is no trading of risk." **Ijlal Alvi**.

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## The business model of most Islamic commercial banks is based on mobilizing funds in profit sharing investment accounts (PSIA), which are governed by the Mudaraba contract

"Core operational and business process differences need to be addressed by the market practitioner in conjunction with the regulator." **Daud Vicary**.

"The necessity of disciplined underwriting and risk-commensurate pricing in the face of severe competition among Takaful operators themselves and with conventional insurers is a tightrope that Takaful and retakaful operators alike are walking." **Mahomed Akoob**.

"In the realm of Islamic banking, the fiduciary responsibility of the staff becomes paramount when compared to their peers in conventional banking in view of their role as Mudaribs [trustees] of the depositors and investors." **Faiz Afzaluddin**, Head of Operational Risk, Dubai Islamic Bank.

For an effective process in risk management, **Shaji Chandrasena**, Director, Financial Risk Supervision, Monetary Authority of Singapore, believes that IIFS should "carry out consistent independent and rigorous valuation practices across the firm".

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## Training of the Islamic Finance workforce in the market would be necessary for the practitioners to understand how Islamic Finance products work and in turn communicate to the public

### People

"The industry already has a shortage of human capital and the complexity of Islamic Finance (and associated financial statements) requires more oversight and attention." **Khalid Howladar**, Senior Credit Officer, Islamic Finance, Moody.

"IIFS need to implement a policy to develop, mentor and retain talent. A consistent approach is needed to develop first-class talent in the relevant disciplines and a meritocracy created to promote and reward such professionals." **Sohail Jafar**.

"The industry lacks practitioners who are Sharia'a savvy and Sharia'a experts who are market savvy. This process can only be carried out by educational institutions like INCEIF where specific course modules and programs that combine the two areas are taught. Simultaneous training of the current workforce in the market in such modules would be necessary for the practitioners to understand how IF products work and in turn communicate to the public." **Daud Vicary**.

"Training of the Islamic Finance workforce in the market would be necessary for the practitioners to understand how Islamic Finance products work and in turn communicate to the public." **Daud Vicary**.

"Any employer looks for two aspects in recruitment: high caliber and retention thereof. With the relative scarcity of qualified Islamic Finance professionals and the sheer competition over this limited talent pool, operational risk needs careful monitoring."

**Mahomed Akoob**.

### Technology

"The hedging tools to mitigate certain risk such as currency and rate of return mismatches as well as enabling law reforms are the most crucial and challenging areas in the Islamic financial services industry." **Ijlal Alvi**.

"Customized risk management technology is necessary to be in place. Genuine efforts are needed to develop such platforms and need to come through a combination of market practitioner, academic and Sharia'a scholar." **Daud Vicary**.

"Specific technological ability is important for IF as much of the existing technology is the result of 'tweaking' of conventional technology. Genuine effort is needed with the combination of effort from Sharia'a scholars, market practitioners and academics to ensure a genuine technological product." **Dr. Mohamad Akram Laldin**.

"In Takaful, as in conventional insurance, you need to know exactly where you stand at all times. Investing in real-time exposure and accumulation monitoring systems is no longer a luxury or a value added. It is not even a necessity. It is a condition for survival."

**Mahomed Akoob**.

"A Management Information System should be based on 'group exposure' for all allied industries and the correlation impact be computed in risk modeling and risk capital estimation." **Ahmed Adil**, Global Head of Risk Management, Arcapita Bank, Bahrain.

## Conclusion

This report examines three closely-linked issues: risk governance, regulatory pressures and accountability, and the challenges faced by IIFS to develop effective risk intelligence. The report shows that risk management in Islamic Finance and conventional finance probably have more in common than is sometimes suggested. The cash-rich industry of Islamic Finance may have much to offer to the troubled conventional finance industry. However, careful consideration and risk assessment and analysis should be observed in areas where Islamic Finance differs in operations and practice.

The analysis in this report highlights several challenges faced by IIFS and Islamic financial regulators alike. Global and regional jurisdictional regulatory reforms are continuing. How this regulation will affect the Islamic Finance industry and the role of IIFS in the economy is yet to be seen. One thing is certain – the traditional operations and management of Islamic Finance will need to change. IIFS around the globe will not only need to deal with risk management but will also need operational effectiveness and a skilled workforce to empower risk intelligence in Islamic Finance and deal with managing business and financial risks at all times.

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**The report shows that risk management in Islamic Finance and conventional finance probably have more in common than is sometimes suggested**

Responding to these new realities may require effective risk governance. IIFS Boards, Sharia'a Supervisory Boards and executives have an important role to play in providing proactive oversight of risk management and risk strategy. The executive risk officers equally play an important role in coordinating risk management implementation and activities between boards and SSBs and other business supporting units in the institution.



# Deloitte in the Middle East

## ME Representative Office

### Regional office

Gefinor Center, Block D  
Clemenceau Street  
P.O.Box 113-5144  
Beirut, Lebanon  
Phone +961 (0) 1 748 444  
Fax +961 (0) 1 748 999

## ME Consulting

### Regional office

Arabia House  
131 Phoenicia Street  
P.O. Box 11-0961  
Riad El-Solh, Beirut  
1107 2060 Lebanon  
Phone +961 (0) 1 366 844  
Fax +961 (0) 1 367 738

## ME Enterprise Risk Services

### Regional office

Emaar Business Park  
Building 1, Sheikh Zayed Road  
P.O. Box 282056  
Dubai, UAE  
Phone +971 (0) 4 369 8999  
Fax +971 (0) 4 369 8998

## ME Financial Advisory Services

### Regional office

DIFC, Currency House  
Building 1 - Level 5  
PO Box 282056  
Dubai, UAE  
Phone +971 (0) 4 506 4700  
Fax +971 (0) 4 327 3637

## ME Tax Services

### Regional office

Currency House  
Building 1 - Level 5  
P.O. Box 282056  
Dubai, UAE  
Phone +971 (0) 4 506 4700  
Fax +971 (0) 4 327 3637

## The Deloitte ME Islamic Finance Knowledge Center (IFKC)

Al Zamil Tower. Government Avenue,  
Manama, Kingdom of Bahrain  
Phone +973 17214490 Ext 2018  
Fax +973 17214550

## Bahrain

### Manama

Al Zamil Tower  
Government Avenue  
P.O. Box 421  
Manama, Kingdom of Bahrain  
Phone +973 (0) 17 214 490  
Fax +973 (0) 17 214 550

## Egypt

### Cairo

95 C, Merghany Street,  
Heliopolis 11341, Cairo, Egypt  
Phone +20 (0) 2 2290 3278  
Fax +20 (0) 2 2290 3276

## Alexandria

Madinet El Sayadla  
Building No 10,  
Smouha, Alexandria  
Phone +20 (0) 3 426 4975  
Fax +20 (0) 3 426 4975

## Iraq

### Deloitte & Touche

### Management Consulting W.L.L.

6 Royal City  
Erbil, Iraq  
Phone +964 (0) 770 694 6554

## Jordan

### Amman

Jabal Amman, 190, Zahran  
Street, Amman, Jordan  
P.O. Box 248  
Amman 11118, Jordan  
Phone +962 (0) 6 5502200  
Fax +962 (0) 6 5502210

## Kuwait

### Kuwait City

Fahad Al-Salem Street  
Salhia Complex  
Kuwait City, Kuwait  
P.O. Box 23049  
Safat 13091, Kuwait  
Phone +965 (0) 2243 8060  
Fax +965 (0) 2245 2080

Ahmed Al-Jaber Street,  
Dar Al-Awadi Complex,  
7th Floor  
P.O. Box 20174, Safat 13062  
Sharq, Kuwait  
Tel +965 22408844  
Fax +965 22408855

## Lebanon

### Beirut

Arabia House,  
131 Phoenicia Street  
P.O. Box 11-961 Beirut  
Riad El-Solh, Beirut  
1107 2060 Lebanon  
Phone +961 (0) 1 364 700  
Fax +961 (0) 1 367 087

## Oman

### Muscat

MBD Area  
Muscat International Center  
Muscat, Sultanate of Oman  
P.O. Box 258, Ruwi  
Postal Code 112  
Sultanate of Oman  
Phone +968 (0) 2481 7775  
Fax +968 (0) 2481 5581

## Palestinian Territories

### Ramallah

Al Mashreq, Insurance Building  
P.O. Box 447  
Ramallah, Palestinian  
Controlled Territories  
Phone +970 (0) 2 295 4714  
Fax +970 (0) 2 298 4703

## Qatar

### Doha

Al Ahli Bank Building  
Sheikh Suhaim Bin Hamad Street  
P.O. Box 431, Doha, Qatar  
Phone +974 (0) 4434 1112  
Fax +974 (0) 4442 2131

## Saudi Arabia

### Deloitte & Touche

### BakrAbulkhair & Co.

### Riyadh

Al-Salam Building,  
Prince Turki Bin Abdullah  
Al-Saud Street  
Sulaimania Area  
P.O. Box 213, Riyadh 11411  
Phone +966 1 2828400  
Fax +966 1 2828428

## Al Khobar

ABT Building, Al Khobar  
Saudi Arabia  
P.O. Box 182  
Dammam 31411, Saudi Arabia  
Phone +966 (0) 3 887 3937  
Fax +966 (0) 3 887 3931

## Jeddah

Saudi Business Center  
Madinah Road  
P.O. Box 442  
Jeddah, 21411, Saudi Arabia  
Phone +966 (0) 2 657 2725  
Fax +966 (0) 2 657 2722

## Syria

### Damascus

9 Fardos Street  
P.O. Box 12487  
Damascus, Syria  
Phone +963 (0) 11 221 5990  
Fax +963 (0) 11 222 1878

## Rawda

38 Rawda Street  
P.O. Box 12487  
Damascus, Syria  
Phone +963 (0) 11 331 1212  
Fax +963 (0) 11 332 2304

## United Arab Emirates

### Abu Dhabi

11th Floor  
Al Sila Tower  
Sowwah Square  
P.O. Box 990 Abu Dhabi,  
United Arab Emirates  
Phone +971 2 4082424  
Fax +971 2 4082525

## Dubai

1001 City Tower 2  
Sheikh Zayed Road  
P.O. Box 4254  
Dubai, UAE  
Phone +971 (0) 4 331 3211  
Fax +971 (0) 4 331 4178

## Fujairah

Al-Fujairah  
Insurance Co. Building  
P.O. Box 462  
Fujairah, UAE  
Phone +971 (0) 9 222 2320  
Fax +971 (0) 9 222 5202

## Ras Al-Khaimah

Ras Al-Khaimah, Insurance  
Building, Al-Nakheel,  
Ras Al-Khaimah UAE  
P.O. Box 435  
Ras Al-Khaimah, UAE  
Phone +971 (0) 7 227 8892  
Fax +971 (0) 6 574 1053

## Sharjah

Corniche Plaza 2,  
Al Buhairah Corniche  
P.O. Box 5470  
Sharjah, UAE  
Phone +971 (0) 6 574 1052  
Fax +971 (0) 6 574 1053

## Yemen

### Sana'a

Sana'a Trade Center Eastern  
Tower, Algeria Street  
P.O. Box 15655  
Sana'a, Yemen  
Phone +967 (0) 1 448 374  
Fax +967 (0) 1 448 378

For Libya and Mauritania  
inquiries, please contact the  
ME Representative Office.





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