



The catalysts for change
Strategic priorities in
governance and regulation
in Islamic Finance practice

Contents



Foreword from Deloitte	4
Foreword from IRTI-IDB Group	5
Executive summary	6
The regulatory environment	7
Corporate governance	8
Risk management and internal controls	9
Compliance	10
Sharia' compliance	11
Financial reporting and transparency	12
Business model optimization	13
Innovations in new asset classes	14
Talent development strategies	16
Navigating the route to change	17

Foreword from Deloitte

Dr. Hatim El Tahir
FCIB, FCISI
Director, Islamic
Finance Group
Leader, Deloitte Middle
East Islamic Finance
Knowledge Center
(IFKC)



Deloitte is pleased to present you with practical insights, providing a perspective on the ‘catalysts for change in Islamic Finance’ that broadly discusses the emerging regulatory, governance and operational practices. We invite you to consider the challenges facing the industry and how market participants are adapting their business models and governance frameworks in the new landscape.

Much has been written about Islamic Finance, its two-digit growth, the collective experience and evolving markets in many jurisdictions, but there has been little real insight on what strategies institutions offering Islamic Financial Services (IIFSs) might consider to capture new business opportunities and sustain growth in this ever-growing industry. While this pattern of growth continues for the most part of the industry and its subsectors, industry leaders are faced with a catalogue of internal and external challenges. Some of these challenges include regulatory, risk, governance, leadership and operational considerations. These cross-organizational issues rank high on the agendas of boards, CEOs, and executive management of IIFSs.

This whitepaper is based on Deloitte’s Islamic Finance thought leadership program, which has included a series of industry dialogues organized by Deloitte and IRTI-IDB Group. The industry executive platform initiative,

organized jointly with IRTI-IDB Group, presented a stimulating industry discussion with regulators, practitioners and industry professionals such as auditors, lawyers, academicians and Sharia’ scholars. Over 400 people participated in eight executive workshops held in key industry markets, including Bahrain, KSA, UAE, Oman, Sudan, UK and Turkey. Over 40 prominent industry thought leaders contributed to this initiative and presented their views on the new paradigm of a forward-looking industry. Their influence was paramount in making this paper. IIFSs now have a unique and limited opportunity to address the catalysts for change and take timely actions to execute their strategic priorities in governance, regulation, risk and leadership.

The purpose of this whitepaper is to shed light on the practice areas debated in our executive program and other related industry thought leadership programs. In particular, the emphasis is on the pain points of the industry. What progress has been made in developing good practices in areas such as governance, regulatory compliance, risk, sustainable business models, financial reporting, transparency and leadership?

We think you will find our insights timely and relevant, as they not only emphasize the importance of best practices but also how these leading practices will apply to all markets with different regulatory and Sharia’ frameworks and practices.

This paper is part of a series on Islamic Finance: Leading by Engaging produced by the Deloitte Middle East IFKC. Together, these reports provide industry leaders with insights to consider as they navigate the challenges that new customers and market conditions are creating, as well as allowing them to benefit from the lessons learned from other markets.

We hope that you enjoy reading this whitepaper and gain useful insights from it.

Foreword from IRTI-IDB Group

The Islamic financial system is capable of playing a stabilizing role in the world by removing the major weaknesses of the conventional system and, thereby, helping minimize the severity and frequency of financial crises. By requiring the financier to share in the risk, Islamic Finance introduces greater discipline into the system and links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully.

Islamic Finance is, however, still in its infancy and shares a very small proportion of international finance. The use of equity and Profit and Loss Sharing (PLS) is still relatively small while that of debt-creating modes is preponderant. This is due to a number of factors, including the lack of proper understanding of the ultimate objectives of Islamic Finance, the non-availability of trained personnel, and the absence of a number of shared or support institutions that are needed to minimize the risks associated with moral hazard, principal/agent conflict of interest, and late settlement of financial obligations. It is, however, expected that the system will gradually gain momentum and effectively play the role of complementing the efforts now being made internationally for promoting the health and stability of the global financial system.

Islamic Finance and its institutional infrastructure now consists of the following:

- Islamic financial institutions
- Islamic non-bank financial institutions
- Islamic insurance and re-insurance or Takaful and Re-Takaful, operators
- Islamic capital markets
- Islamic financial architecture and infrastructure including regulators and supervisors
- Governance infrastructure such as Sharia' governance institutions
- Standard setters for financial supervision and infrastructure
- Rating and external credit assessment institutions
- Financial statistics and information providers
- Knowledge management and human capital development institutions and programs

Islamic Research and Training Institute (IRTI), the intellectual arm of the Islamic Development Bank (IDB) Group, functions as the research and human capital development center for IDB member countries. It conducts and coordinates cutting-edge theoretical and applied research in Islamic economics, banking and finance. IRTI's vision is to be the global knowledge center of excellence on Islamic economics, banking and finance. IRTI's strategic plan is aligned with the IDB Group 10 Year Strategy, which considers Islamic Finance growth as one of the guiding principles.

One of the main strategies of IRTI is to collaborate with leading institutions in supporting the development of Islamic Finance. In this regard, and recognizing the importance of mutual collaboration and contribution to the Islamic Finance practice, IRTI and Deloitte have agreed to develop mutually strengthening and enriching knowledge-sharing collaboration in the landscape of Islamic Finance and Takaful. Our joint executive education program has not only identified gaps as practiced in different markets but has also addressed ways to enhance good practices in the industry.



**Professor Mohamed
Azmi Omar**
Director General
Islamic Research and
Training Institute
Islamic Development
Bank Group

Executive summary

Looking back

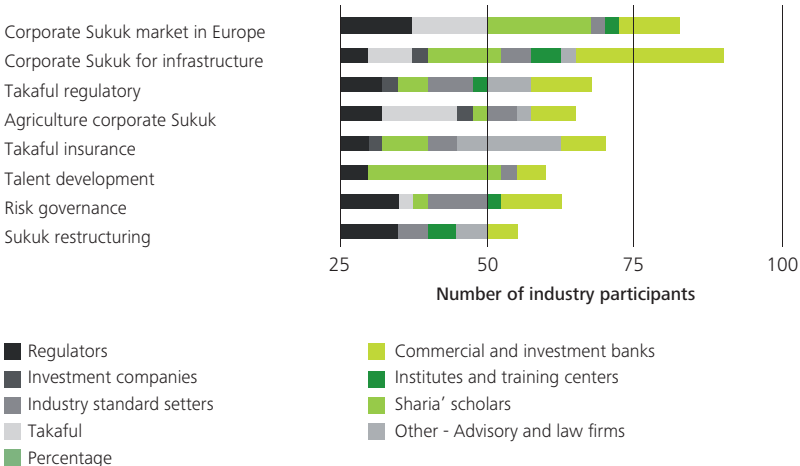
Our industry research confirms that the Islamic financial services industry continues to experience profound regulatory and practice challenges, and there is continued pressure on industry stakeholders to revisit their governance and business models.

In recent years, there has been much discussion of Islamic Finance moving into mainstream global finance. While it has not yet made the desired impact on a global level, Islamic Finance’s integration to mainstream global finance is largely complete and likely irreversible. Despite continuing to grow, some uncertainty over regulatory acceptability in some jurisdictions still remains unsolved.

Returns on Islamic funds and investment products often outpace their conventional counterparts. The Sukuk market is growing in several parts of the world and has attracted sovereign and institutional investors worldwide. Takaful insurance is growing by two-digit figures and the potential for further growth is evident in several markets in Asia, Africa and the Middle East.

However, Islamic Finance still faces the aforementioned challenges and perhaps a few new emerging ones, but the industry generally continues to grow and the overall outlook for growth is strong due to both long-standing and new trends globally.

Profile of participants



Source: Deloitte research and analysis

Looking forward

Reactions to some of the issues emerging from the current long economic, social and financial uncertainties around the world have all contributed to the big question of change in the perception and practice of our industry practitioners. For the purpose of our paper and analysis we have defined change as a strategy implemented by the board, executive management, and other personnel of the IIFS, designed to provide an overhaul plan to implement leading industry practices in the following strategic priority areas:

- Strengthening the governance and compliance environment
- Improving risk management practices and internal controls
- Financial and accounting frameworks
- Improving Sharia’ compliance process and audit
- Sustainable business models and operational excellence
- Attracting and retaining talent
- Leadership and talent development
- Industry collaborative initiatives

Every practice of these involves major decisions and significant change. One new approach that we are advocating is to think about engaging the industry in collaborative dialogue platforms to address the catalysts for change in regulation, governance, risk and reporting transparency. This approach is driven partly by current industry needs to stand up to competition and challenges, and partly by the increasingly strategic role that change is expected to play in business today. For many IIFSs, we believe a change may be the right plan for the industry’s boards and executive management to revitalize and energize policies and plans, and boldly develop the services and capabilities needed to support IIFSs’ future growth objectives.

The scope and reach of our executive workshop program cited above shows a broad range of participants and practices.

The regulatory environment

An un-level playing field

There has been much debate around the issue of the exact impact that regulatory inconsistency has on business and competition in the Islamic financial market. This regulatory inconsistency has existed not by choice but largely due to different regulatory regimes, and in some markets different products structure offerings, where the industry has operated and evolved. Several IIFs maintain multi-country operations and face challenges to deal with different regulatory settings and financial reporting standards, such as IFRS versus AAOIFI, as well as modes of financing and capital requirements, to name a few. Evidently, this regulatory inconsistency has created an unnecessary un-level playing field upon which the industry grows and also potentially acts as delivering a competitive disadvantage to the Islamic financial service industry.

Regulatory and standards development

Regulatory and standards updates

National regulatory authorities				
	Banking	Capital market	Wealth management	Takaful insurance
	<ul style="list-style-type: none"> Ownership transfer Land registry laws Double tax issues B-III implementations 	<ul style="list-style-type: none"> Industry screening Industry indices SPVs and trust laws Funds and FoFs 	<ul style="list-style-type: none"> Tax incentives Collective investment rules Professional investors 	<ul style="list-style-type: none"> Business models Capital adequacy Solvency II-III Distribution channels
Industry business support	CBS solutions <ul style="list-style-type: none"> Path solutions Temenos Misys 	Capacity building <ul style="list-style-type: none"> IRTI - IDB Group CIBAFI CISI - UK CIMA - UK BIBF EIBF 	Applied research <ul style="list-style-type: none"> Deloitte IFKC IRTI - IDB Group IFP - Harvard University University of Durham Thomson Reuters ISRA 	Executive education <ul style="list-style-type: none"> IFSB, AAOIFI, IIFM Deloitte IFKC IRTI-IDB Group CIBAFI INCEIF
Industry standard setters	IFSB <ul style="list-style-type: none"> ED TN-2: Technical Note-2 on Stress Testing for Institutions Offering Islamic Financial Services (IIFS) IFSB-18: Guiding Principles for Retakaful (Islamic Reinsurance) (2016) IFSB-17: Core Principles for Islamic Finance Regulation (Banking Segment) (2015) GN-6: Guidance on Quantitative Measures for Liquidity Risk Management Revised (2015) IFSB-16: Revised Guidance on Key Elements in the Supervisory Review Process of IIFS (2014) IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (2013) 	AAOIFI <ul style="list-style-type: none"> Collaboration Initiative with IASB Project for Sharia' Standard on Gold Discussed the revision of Sukuk standards with leading international Islamic Finance shareholders On-going revision and development project for Sharia' Standard No. (17) Sukuk Arabic version publications 	IIFM <ul style="list-style-type: none"> Master collateralized Murabaha agreement Guidelines for Islamic hedging and liquidity management Global Sukuk reports 	IILM <ul style="list-style-type: none"> Successful rounds of Sukuk issuances to stimulate liquidity Emphasis on HQLAs

Source: Deloitte research and analysis

Key insights and messages

1. Risk-based approach to regulation

Given the differentiating factor of Sharia' compliance, IIFs are encouraged to adopt the risk-based approach guidelines set by industry standards such as the revised RB- approach guiding notes – IFSB-13, 14, 15 and 6.

2. Need for a better cross-border cooperation

A large majority of our consultations with industry practitioners and thought leaders believe that there is a need for better cross-border cooperation and coordination between different regulatory authorities in key markets. This is an absolute priority to improve regulatory consistency toward market synergies.

3. Culture of regulatory compliance

In addition, industry personnel should observe ongoing efforts to respond to regulatory changes and requests for information.

4. Implementation of industry best practices

Standard-setting bodies (SSBs) such as the IFSB, AAOIFI and IIFM often look to the leading IIFs in the industry, based on which they develop standards and guidance for new regulations in risk, capital and solvency. In these instances, they develop industry best practices and assist IIFs to implement them. However, the industry should be given more incentives to implement these standards. National regulatory authorities equally need to help create the required awareness among market players and other stakeholders to adapt a culture of good practices.

Corporate governance

Improving governance frameworks

Executives and industry leaders are placing increased emphasis on their sustainable growth, focusing on providing client-centric Sharia'-compliant solutions and highly transparent services. In parallel, defining how to expand geographically and balancing these core values with desired business expansions is of paramount importance to have good governance in place.

Industry best practices have been developed to help IIFs manage this growth while maintaining the need to provide Sharia'-compliant services effectively and more competitively. Significant efforts have been made to improve practices in governance and Sharia' governance alike. Some of the key standards and guiding notes developed include:

- The IFSB Guiding Principles on Sharia' Governance Systems for Institutions Offering Islamic Financial Services, 2009
- The IFSB Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions And Islamic Mutual Funds), 2006

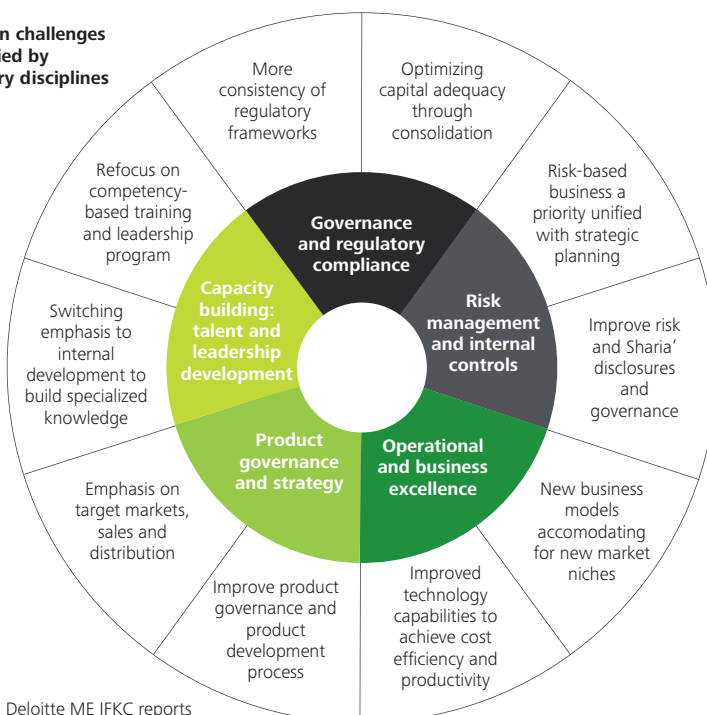
- The IFSB Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), 2007
- The AAOIFI Accounting, Auditing & Governance Standards (for Islamic Financial Institutions, 2007

Governance in the Takaful industry

Strengthening the regulatory frameworks of the Takaful industry requires a focused effort and the support of all industry stakeholders. National regulators as well as industry standard-setting bodies (SSBs) need to work together to take bold actions and initiatives to improve Takaful practices and policy-making processes.

Market conduct regulation around the world is becoming increasingly intrusive and judgment-based, with regulators demonstrating readiness to intervene at all stages of the business cycle. This seems less of a regulatory concern in the Takaful industry, and operators are left without adequate scrutiny in product governance and offerings. This is particularly true in the case of complex investment-linked products.

The ten challenges classified by industry disciplines



Source: Deloitte ME IFKC reports

Key insights and messages

1. Emphasis on good governance

IIFs deal with more complicated financial transactions and must comply with Sharia' rules, and improving governance activities that impact the core value proposition is among the industry's top strategic priorities. This pattern is supported by national regulatory authorities and industry standard setters such as the IFSB, AAOIFI and the IIFM.

2. Improving relationships

Boards, executive management and other unit managers of IIFs will need to adapt their expertise and embrace a culture of best practices in governance and transform competencies in good Sharia' governance. Business models should evolve and take account of Sharia' processes, compliance and risk mitigations.

3. Boards' oversight committees

Boards are increasingly forming oversight committees, in risk governance and audit, defining roles and responsibilities and aligning the work of these committees to the overall business strategies and day-to-day work of the institution.

Risk management and internal controls

Refocus to adapt to the change

Risk management in Islamic Finance has undergone a refocusing in the last decade or so in an attempt to make its techniques and processes more adaptable to the increasingly complex products and structures offered. Evidently this pattern is also viewed as a responsive action to the demands of regulators and industry stakeholders.

Risk management is one of the major concerns faced by all industry practitioners, as the numerous types of risks faced by Islamic banks – Sharia' compliance, liquidity, credit, operational and regulatory risks – all have a significant impact on any business's sustainability and going concern. As such, the board's risk oversight role is critical in providing clarity in the direction of strong risk-mitigating controls.

Risk oversight practices in the industry are one of the most important sources for maintaining Sharia' compliance and credibility in Islamic Finance. Building capabilities in risk is not uncompromisable and Deloitte suggests 'seven' building blocks to strengthen the risk practices.

Risk oversight practices in the industry are one of the most important sources for maintaining Sharia' compliance and credibility in Islamic Finance

The seven building blocks of risk capabilities



Source: Empowering Risk Intelligence in Islamic Finance, Deloitte Report, 2011

Key insights and messages

1. Governance capabilities

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 the 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.

2. The risk function and oversight

Our observations and studies suggest that many forward-looking industry executives and boards are generally intensifying their risk oversight efforts, emphasizing the necessity of aligning the risk function with other key corporate functions. In this context, four key risk practice areas need be identified:

- The risk governance strategy should be enhanced to be aligned with the board's support and oversight.
- The operational risk assessment and process standardization should be enhanced.
- Sharia' compliance should be integrated in all operational risks and business processes and policies.
- Disclosure and reporting procedures should be standardized and enhanced.

3. Reinforcing the need for Sharia' compliance

Reputation and Sharia' compliance in the industry are becoming more important than in the past, reinforcing the dire need for Sharia'-compliant processes. Arguably this can be attributed to the increased competition in business.

As the industry evolves and clients' demand for Sharia'-compliant products and services increases, it is essential for IIFs to recognize the importance of improving Sharia' compliance processes to offer a wide spectrum of products and services globally.

Compliance

The need to integrate compliance controls into business

The increased cost of regulatory compliance and the challenges of developing effective total compliance management (TCM), together with rising product complexities in the industry, have triggered the need to develop a holistic approach to Sharia’ compliance processes which align all functional and operational departments under a central compliance function.

Deloitte’s key elements of TCM have been developed to help boards and executive management in the Islamic financial service industry assess the effectiveness of an organization’s governance programs. The chart on the right shows the key elements of TCM and highlights the importance of board oversight and governance as a top-level support to implement an effective compliance function.

The key point to make in this approach is the effectiveness of the Sharia’ compliance function in coordinating processes and compliance activities at different levels of the operations of any IIFS.

The key elements of TCM

Board oversight and governance		
Culture and business environment		
Sharia’ governance		
Communication and training	Single compliance function	Internal and external reporting
	Risk assessment	
	Policies and procedures	
	IT Systems and information management	
Controls, monitoring and assurance		

Source: Deloitte research and analysis

One certainty is that IIFSs have to deal with heterogeneous legislative and regulatory requirements in different markets and sectors, and possibly slightly different Sharia’-compliant products in some jurisdictions. Naturally, this has created more pressure on the standardization of compliance functions and frameworks across the industry, and necessitates more investment in tailoring the practice in organizations that operate across borders.

Nonetheless, there is a broad consensus among industry practitioners that compliance functions have become more integrated and aligned to the overall strategy and business planning of IIFSs.

Our research shows that organizations that apply a routine “ticking the box” approach are missing the point entirely and, even worse, are losing out on an opportunity to gain from the business value that can be derived from successfully embedding the latest regulatory practices. Hence, compliance officers in Islamic Finance are advised to be wary of this kind of exercise and are encouraged to invest more in training, systems and processes that will help them achieve best practices, such as the TCM approach.

Key insights and messages

1. Build competencies in key areas

Based on our discussion and analysis, there are four broad key areas that require more focus to build capabilities. These are governance, process, people and technology, which are addressed in different aspects in this paper.

2. A need to integrate compliance controls into business

3. Capital management compliance — Increased scrutiny of capital adequacy, requiring improved measurement capability, stress testing, and scenario analysis

IIFSs have an opportunity to mitigate the rising costs of compliance by approaching compliance comprehensively. Boards and executive management need to foster a total compliance management culture and invest more in training and technology to make better use of people and data.

The following points are worth noting and require more attention by IIFSs:

- Improve business policies and procedures and adopt best practices developed by industry standard setters
- Invest in technology and knowledge-management strategies
- Adopt a holistic approach to compliance e.g. total compliance management (TCM) and leverage alignment of common regulations and achieve effective compliance management

Sharia' compliance

An issue of reputation

Our analysis shows that Sharia' compliance in the industry is a reputation-related issue and, if not well managed, can have significant implications for the IIFS and its operations and consequent profitability.

Sharia' compliance risk should be embedded in all phases of operations and management.

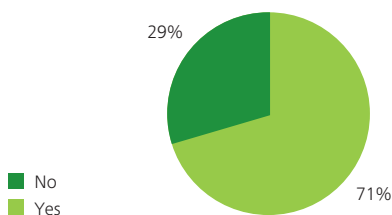
Industry practitioners in many countries have welcomed the recent trend of regulators to mandate independent Sharia' audit assurance. In the Gulf, the Central Bank of Oman introduced this new regulation. The Central Bank of Bahrain is believed to be introducing the same measures in the near future.

However, one of the key challenges in Sharia' compliance management is the way in which the functions measure performance and carry out the compliance tasks. Many IIFSs conduct compliance-related activities in silos. This creates gaps, redundancy, overlap, and challenges with resource allocation. Potentially this can make the IIFS fail to comply with critical regulatory and Sharia' requirements.

It is clear from our analysis that some aspects of Sharia' compliance-related activities remain largely exercised in the following ways:

- Organizing meetings with regulatory authority officers
- Feedback from peers and other units within the organization or the IIFS
- Customer surveys

Implementation of the IFSB's guiding principles on Sharia' governance



Source: Empowering Risk Intelligence in Islamic finance, Deloitte Report, 2011

Industry practitioners in many countries have welcomed the recent trend of regulators to mandate independent Sharia' audit assurance. In the Gulf, the Central Bank of Oman introduced this new regulation.

Key insights and messages

1. Core business competency

Sharia' compliance is a core business competency in the industry and hence essential for a better performance over the long-term. The downside risk of non-compliance cannot be underestimated. Boards and executive management of IIFSs are recommended to provide the necessary support and oversight to this important reputational function.

2. Strategy alignment

It is now common practice to coordinate compliance strategy with those of the firm's strategy and business objectives. Therefore, IIFSs are recommended to introduce international best practices in financial services and adapt to new techniques and measures that improve compliance practices. More precisely, executive management are required to align their Sharia' compliance strategy and all important aspects of its practice with the organization's overall business objectives.

3. Sharia' compliance process improvement

- Generally, IIFSs have adopted different approaches to the governance of compliance guided by AAOIFI and IFSB standards.
- Internal Sharia' auditors most often seem to have the sole responsibility for Sharia' compliance strategy, coordinating with the organization's Sharia' Supervisory Board. Executive management are equally thought to be engaged in this process and provide the support and direction to ensure effective Sharia' compliance functions.
- However, our analysis indicates that there is a need for better and effective systems that align business processes, financial reporting and IT and core banking systems. These are certainly some gaps that exist within the industry Sharia' compliance process. IIFSs are recommended to seek advice from professional firms to assist them in improving their Sharia' compliance functions and identifying gaps between existing processes and industry leading practices.

Financial reporting and transparency

Quality and transparency

The need for increased efficiencies in financial reporting and transparency in Islamic Finance continues to challenge finance executives across the industry. Evidently, the persistent challenge relating to adopting IFRS versus AAOIFI is yet to be resolved.

Designing and implementing changes to the finance organization, processes and core banking systems has never been more important.

Based on practice observations, discussions with numerous industry practitioners, and knowledge gained from Deloitte thought leadership programs, we have developed a set of practical insights to help guide industry executives as shown in the chart below.

The most pressing challenges in Islamic financial and management reporting is the lack of recognition of the AAOIFI accounting standards by many key markets. Some of the options currently discussed by industry

leaders are the possible harmonization between IFRS and AAOIFI, a trend that has been recently revitalized by the new leadership of the AAOIFI organization.

Key insights and messages

1. Finance transformation

Finance transformation is a change strategy that can assist Islamic Finance executives in improving their finance functions to enhance accounting processes and systems and improve the overall value of the finance function.

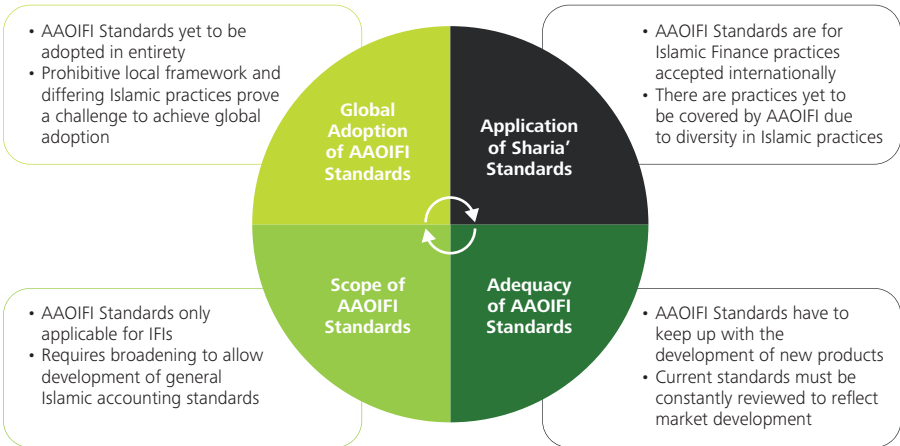
2. Improve accounting and financial reporting processes

IIFSs have to work towards standardizing their processes across borders. Finance personnel need to develop financial reporting policies and manuals to work towards consistent application of policies and accounting judgments across business units and jurisdictions.

3. Benefits of standardization

Standardization can reduce Sharia' compliance risks and improve liquidity across borders. It could also reduce the cost of compliance with statutory financial reporting requirements and improve related internal controls audit.

Key issues in Islamic accounting implementation



Source: Deloitte research and analysis

Business model optimization

The need for sustainable business models

The alignment of IIFs' business and operating models and governance framework enhances the opportunity for value creation. This does not come without challenges, though. Each stakeholder in the IIFS must adapt to satisfy the demands of the other. In this context, the development of sustainable business models begins with business model optimization. Arguably, this is a process which balances and integrates the operating business models and good corporate governance planning.

The equity- and asset-based business models, featured in Islamic Finance, can be powerful tools to resolve some of the world's current challenges in financing social and infrastructure development in many countries. Many factors come into play when deciding on effective business models to tap into the industry. Whether in asset management, Takaful insurance or capital markets, Islamic Finance has evidently built resilient business and operational models that suit current socioeconomic environments in many parts of the world.

IIFs seek to remain competitive through technological innovation and product creation. More precisely, the need to select the right business model and market entry strategy is often driven by external factors that go far beyond regulatory and Sharia' requirements. Institutions that expect to develop sustainable growth strategies will fundamentally opt for enhancing operational capabilities - particularly in strategic areas, such as leadership and management, innovative product and marketing approaches, and building effective governance practices. The same is true for IIFs facing aggressive growth and synergy targets, or significant increases in competition from conventional counterparts.

Key insights and messages

1. Operational and business excellence

The industry in general is fast becoming a technology business, and IIFs long ago embraced technology in all functional and operational fronts. IIFs can achieve cost efficiency and improve productivity through the building of technological capabilities and make better use of Information Technology System (ITS) to attain business excellence and good financial performance.

In many ways, technology has been a great help in optimizing business model effectiveness and business expansion and growth.

2. Business processes

Generally, IIFs, like all other financial institutions, are overwhelmed with increasing regulatory pressures. Thus, there is a dire need for the industry to stay apace of these developments. IIFs should adopt clear policies to improve operational processes and product development processes.

3. Cost management and shared services

Managing costs in a low growth and economic downturn environment has prompted increased movement toward centralization and shared service models in the Islamic finance practice. IIFs' management have responded timely and introduced measures to reduce cost and improve efficiency and controls.

Managing costs in a low growth and economic downturn environment has prompted increased movement toward centralization and shared service models in the Islamic Finance practice

Innovations in new asset classes

Rise in capital market instruments

Increased insights and the development of 'alternative financing' asset classes are of timely importance for both governments and the private sector. Interestingly, the rise of global Sukuk issuance in recent years has heightened the debate around innovation in capital market instruments and new assets to suit the new economic order.

Recent developments in Islamic capital market instruments are opening up new possibilities for alternative ethical finance. For instance, corporate Sukuk has the capability to finance social and economic infrastructure projects and is able to integrate more efficiently into global capital markets. The rising capital scarcity and increasing demand for social and infrastructure investments in emerging economies as well as maturing economies mean that corporate and project financiers are in search of alternative and cost effective financing to meet these needs.

Corporate Sukuk has the capability to finance social and economic infrastructure projects and is able to integrate more efficiently into global capital markets

In November 2015, Deloitte and IRTI-IDB Group held an executive workshop to discuss Deloitte's study findings and potential use of Sukuk to finance infrastructure projects in Europe and elsewhere in developing countries. Consensus rapidly emerged that corporate Sukuk will be crucial to complement corporate bonds and provide an alternative financing option to issuers and investors. However, this would be predicated on an enabling environment of supportive policymaking and improved empirical research on the practical efficiency and competitiveness of Sukuk. Some of the challenges and key insights are discussed below.

Key Sukuk financing structures and sectors

Renewable Energy/ Pharmaceutical/Manufacturing	Murabaha	Cost plus financing arrangement: financing the purchase of commodities used in the production of renewable energy, pharmaceutical medical drugs and textiles.	Expansion of operations in International markets Expansion of operations in local markets Investing in new business streams
	Salam	Sale where goods are purchased in advance for delivery on an agreed future date: financing the purchase of commodities used in the production of renewable energy, pharmaceutical medical drugs and textiles.	
	Istisna'	Construction project to be delivered on a future date for a fixed, agreed-upon price and with specific product specifications: financing the construction of production plants/facilities in overseas territories and locally.	
	Ijarah	Leasing arrangement: finance or operating lease of equipment used in the production of renewable energy, pharmaceutical medical drugs and textiles.	
Real Estate	Murabaha	Construction project to be delivered on a future date for a fixed, agreed-upon price and with specific product specifications: financing the development of real estate properties.	Using Sukuk to diversify capital sources
	Istisna'	Construction project to be delivered on a future date for a fixed, agreed-upon price and with specific product specifications: financing the construction of production plants/facilities in overseas territories and locally.	
	Ijarah	Leasing arrangement: finance or operating lease of equipment used in the production of renewable energy, pharmaceutical medical drugs and textiles.	

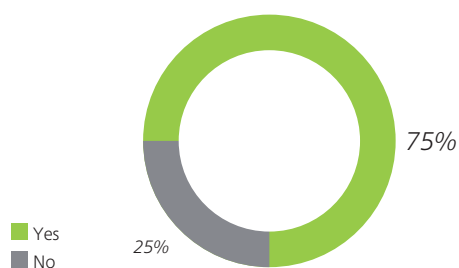
Source: Deloitte report, Corporate Sukuk in Europe, 2015.

Corporate Sukuk to bridge the gap of investment capital

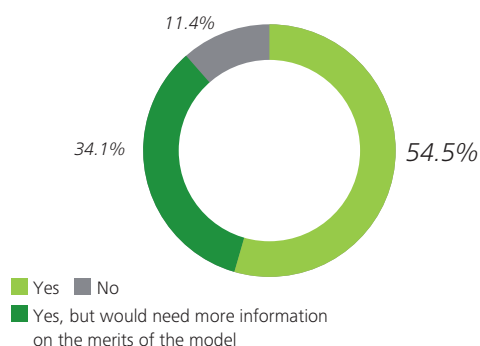
Countries	Key challenges for Sukuk issuance
France	The key challenge that remains in France is the current political climate, which has discouraged both medium-size enterprises and even large corporations from public issuance of Sukuk, despite having the platforms and resources to generate a demand and supply for corporate Sukuk.
Turkey	The key challenge in Turkey is the macroeconomic instability in the country, which has threatened to reverse the growth in Turkey's economy. Improving regulations to allow for more effective and efficient issues of additional Sukuk before redemption of the first Sukuk in circulation, or creating an effective mechanism to handle creditors' rights and bankruptcy proceedings could encourage Non-Banking Financial Institutions (NBFIs) to turn to the Sukuk markets to raise capital or invest in Sukuk. However, the political climate might be challenging for this initiative to be implemented.
Germany	The key challenge that remains for Germany is largely due to taxes. While there are no withholding taxes on interest or payments under a loan, there is a 26% withholding tax placed on bonds/Sukuk, resulting in high costs involved for Sukuk issuance.
UK	The key challenge for the UK is to introduce measures to make Sukuk issuances more attractive than the other conventional and Islamic financing options currently available on the market.

Source: Deloitte Report, Corporate Sukuk in Europe, 2015.

Will you still consider investing in Sukuk if it provides the same/lower yield as bonds with the same characteristics?



Would you consider alternative financing e.g. (Islamic Finance), in an attempt to diversify your investment portfolio and reduce risk?



Source: Deloitte Report, Corporate Sukuk in Europe, 2015.

Key insights and messages

1. Bridging the gap in classic lending

Our study shows that corporate Sukuk offers a practical new asset class that will be able to bridge the gap in classic capital investment. Over 90% of our online survey respondents have considered the new asset class as an ethical investment. Strikingly, 75% of respondents would still consider investing in Sukuk even with lower/similar yields than other bonds.

2. Flexibility in structure and uses

Our research presented different practical scenario cases of possible uses of Sukuk to finance different sectors. The Sukuk has the salient feature of flexibility to structure equity and debt notes for medium- and long-term financing requirements in different sectors of the economy. See list of possible structures in the chart of Key Sukuk financing structures and sectors.

3. Different risk and return profiles

In many ways, Sukuk offers a different risk and return profile for investors and issuers alike. Corporate Sukuk offers access to reputable international issuers, connecting them with a pool of investors in the wealthy regions of the Middle East and Asia.

4. Bankruptcy laws

Bankruptcy law is crucial for facilitating these new structures in Europe. In particular, the introduction of sale contract transactions in which investors are protected by asset-backed Sukuk.

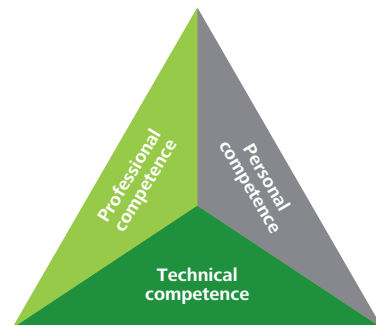
Corporate Sukuk offers access to reputable international issuers, connecting them with a pool of investors in the wealthy regions of the Middle East and Asia

Talent development strategies

Holding on to your most effective people

Islamic Finance is experiencing challenges on multiple fronts. In an industry of changing practice and regulation, the development and retention of talent is impacting on innovation and growth sustainability. Retention incentives are an important part of any organization. Industry institutions need to retain their employees because they need their intellectual capital to allow the organization to continue to operate effectively.

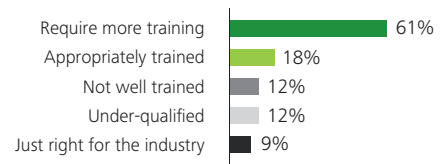
As shown on the chart below, three competencies are sought in employees. The balance of all three competencies is important to provide the quality services aspired to by the faith-cautious customers.



Intellectual capital is a key asset

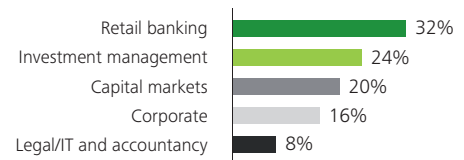
Recent Deloitte research revealed interesting insights about the skills scarcity in the industry in the Middle East region and the dire need for training and capacity building. For instance, 61% of Islamic Finance professionals and practitioners require more training and skills development. Generally, the study findings endorse the need for more investment in people and human capital, and the development of competency-based training and leadership development programs.

Current skill level of Islamic Finance professionals and practitioners % of companies interviewed



As this is a multiple select question, percentages may not add up to 100%.

Areas of operations requiring immediate attention in training % of companies interviewed



Source: The Deloitte Islamic finance leaders survey in Middle East, benchmarking practices

Key insights and messages

1. Developing a talent strategy

An effective talent retention strategy can help IIFs hold on to people and knowledge, while freeing executive managers to focus on the most pressing need of delivering business objectives. A bespoke talent development strategy can help enhance business continuity and lay the groundwork for sustainable growth.

Strategies should also be comprehensive and holistic in meeting the requirements for all levels of the organization.

2. Harnessing Islamic Finance education

Islamic Finance education should enhance the professional and technical competencies of employees. The qualifications developed need to be bespoke and relevant to the business models of the industry and not merely use generic ones available in markets.

3. Collaborative industry research

Our analysis suggests that industry stakeholders should work more closely and coordinate efforts to promote a culture of best practices and professional excellence. The industry lacks skilled resources and funding to conduct applied research. In this context, Deloitte Middle East has led several strategic collaborative initiatives working with a number of institutions around the world to develop international industry research, and build practical business insights through case studies. These worldwide initiatives led by the firm have created a dynamic industry knowledge management (KM) platform in which over 40 international prominent thought leaders contributed.

Navigating the route to change

Key takeaways

A change strategy to re-invent the value propositions of the Islamic financial service industry is high on the agenda of many industry leaders. This necessity was fueled lately by the global economic downturn coupled with geopolitical risks, which created more pressure on industry strategists and policy-makers.

Evidently, they need to make significant investments in planning and executing a change strategy. Embracing the issues and challenges discussed in this whitepaper will arguably help IIFs sustain business continuity. However, too often the same rigor and commitment are not dedicated to preparing the functional leadership team to navigate this change.

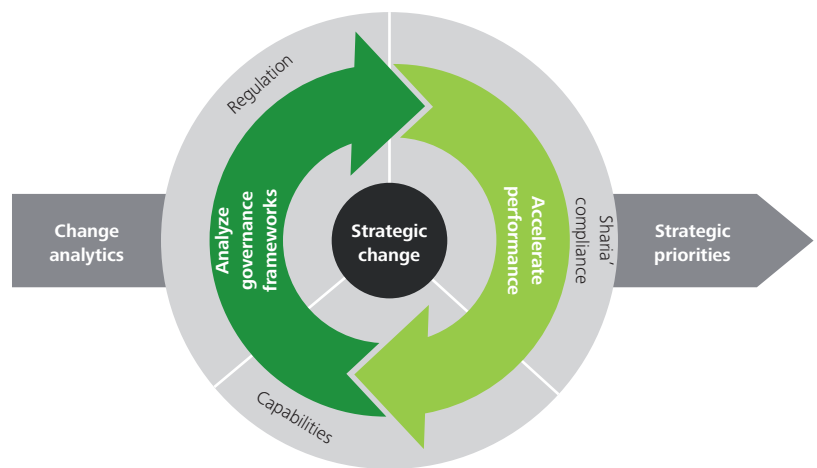
As an industry executive, your leadership team will need to invest in building a committed and aligned team to address your organization's needs and address gaps in practices and expertise.

However, at the same time there are undoubtedly business benefits from enhanced change analytics, particularly in view of the much more sophisticated governance, regulation and compliance that are key to the strategy. The chart below sheds light on the process of change requirements and assessment. By analyzing governance frameworks using sophisticated change analytics, Islamic Finance professionals can develop the pressing strategy solutions that enable their institutions to improve governance and accelerate performance. In parallel, industry executives can bring more value to their IIFs using this approach by addressing questions such as:

- Are the business and financial goals of the IIFS viable?
- What products and markets deliver the greatest promise for revenue or growth in a particular jurisdiction and set of regulations?
- How should the IIFS revamp its business and financial model to generate a competitive advantage?
- How often should governance frameworks be updated to reflect on the business environment and the institution's business objectives?

There are undoubtedly business benefits from enhanced change analytics, particularly in view of the much more sophisticated governance, regulation and compliance that are key to the strategy

- What resources and capabilities enable management to effectively execute and deliver the change strategy without impacting on the fundamentals of Sharia' compliance?



The answers to the above questions and acting upon them should help deliver the strategic change aspired and create value to shareholders and stakeholders. Leadership and management executives can tailor this approach and choose effective ways to implement a change strategy that is able to enhance governance, performance and stakeholder satisfaction.

Key contacts



Joe El Fadl

Partner

Regional Financial Services

Industry Leader

Tel +961 1 364 700

jelfadl@deloitte.com



Dr. Hatim El Tahir

Director, Islamic

Finance Group

Leader, Deloitte Middle East

Islamic Finance Knowledge

Center (IFKC)

Tel +973 17 214490

heltahir@deloitte.com



Aejaz Ahmed

Partner

Enterprise Risk Services

Tel +966 1 282 8400

aeahmed@deloitte.com



Nauman Ahmed

Partner

Middle East Tax Leader

Tel +966 1 3 887 3739

nahmed@deloitte.com



Aly El Azhary

Partner

Audit

Tel +966 2 657 2725

alelazhary@deloitte.com



James Babb

Partner

Clients and Industries Leader

Tel +971 4 376 8888

jbabb@deloitte.com



Khaled Hilmi

Partner

Financial Services Industry

Consulting Leader

Tel +971 4 376 8888

khilmi@deloitte.com



This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte network") is, by means of this communication, rendering professional advice or services. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's more than 220,000 professionals are committed to making an impact that matters.

About Deloitte & Touche (M.E.)

Deloitte & Touche (M.E.) is a member firm of Deloitte Touche Tohmatsu Limited (DTTL) and is a leading professional services firm established in the Middle East region with uninterrupted presence since 1926.

Deloitte provides audit, tax, consulting, and financial advisory services through 26 offices in 15 countries with more than 3,300 partners, directors and staff. It is a Tier 1 Tax advisor in the GCC region since 2010 (according to the International Tax Review World Tax Rankings). It has also received numerous awards in the last few years which include best employer in the Middle East, best consulting firm, the Middle East Training & Development Excellence Award by the Institute of Chartered Accountants in England and Wales (ICAEW), as well as the best CSR integrated organization.