Risk Management in Islamic Finance

Assoc Prof. Dr. Mohamad Akram Laldin
Executive Director
Agenda of Discussion

- Risk Management in Islamic Finance: Concepts & Types
- Shari’ah Non-Compliance Risk
- Standards on Shari’ah Governance
- Recommendations
RISK MANAGEMENT: CONCEPTS AND TYPES
CONCEPT OF RISK MANAGEMENT IN ISLAM

Text in Al-Qur’an

“O my children, do not enter the capital of Egypt by one gate but go into it by different gates. However, knowl it well that I cannot warded off you Allah’s will for none other than He has nay authority whatsoever. In Him I have put my trust and all who want to rely upon anyone should put their trust in Him alone.” (Yusuf: 67)

Hadith from the Prophet s.a.w

• Prophet s.a.w once asked a Beduin who had left his camel untied, “Why do you not tie your camel?” The Beduin answered: “I put my trust in God.” The Prophet s.a.w then said, “tie up your camel first then put your trust in God.”
WHAT IS RISK?

Risks are *uncertain future events* that could influence the achievement of the financial institution’s (i.e., Bank’s) objectives, including strategic, operational, financial and compliance objectives.

*Uncertain future events* could be:
- Failure of a borrower to repay a financing
- Fluctuation of foreign exchange rates
- Fraud, incomplete security documentations, etc
- Non-compliance with shari’ah law and principles
- Other events that may result in a loss to the IFI’s or Islamic Bank
WHAT IS RISK?

A Bank’s business (whether Islamic or Conventional) is to take calculated risks. As such Risk Management is not the minimization of losses but the optimisation of the risk reward equation.

The competitive advantage of a Bank is dependent on how well it manages risk.
WHAT IS RISK MANAGEMENT?

Risk management is the process by which various risk exposures are
(1) identified,
(2) measured/assessed,
(3) mitigated and controlled,
(4) reported and monitored.
Risk Classifications

1. Financial risks include:
   - MARKET RISK, the risk originating in instruments and assets traded in well-defined markets
   - INTEREST RATE RISK, the exposure of a bank’s financial conditions to movements of interest rate.
   - CREDIT RISK, the risk that counterparty will fail to meet its obligations timely and fully in accordance with the agreed terms

2. Non-financial risks include:
   - OPERATIONAL RISK, the risk that arises due to insufficient liquidity for normal operating requirements reducing the ability of banks to meet its liabilities when it falls due.
   - REGULATORY RISK, the risk that arises from changes in regulatory framework of the country
   - LEGAL RISK, the risk relate to risks of unenforceability of financial contracts
RISK PROFILE OF ISLAMIC BANK

Diagram showing the risk profile of an Islamic bank with categories such as Shariah non-compliance risk, displaced commercial risk, equity investment risk, operational risk, market risk, and liquidity risk.
## GENERIC RISKS FOR BANKS

<table>
<thead>
<tr>
<th>Types of risks</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td>The potential that a counterparty fails to meet its obligations in accordance with agreed terms and conditions of a credit-related contract</td>
</tr>
<tr>
<td><strong>Market risk</strong></td>
<td>The potential impact of adverse price movements such as benchmark rates, foreign exchange rates, equity prices on the economic value of an asset</td>
</tr>
<tr>
<td><strong>Liquidity risk</strong></td>
<td>The potential loss arising from the Bank’s inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses</td>
</tr>
<tr>
<td><strong>Operational risk</strong></td>
<td>The potential loss resulting from inadequate or failed internal processes, people and system or external events</td>
</tr>
</tbody>
</table>
## UNIQUE RISKS FOR ISLAMIC BANKS

<table>
<thead>
<tr>
<th>Types of risks</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shariah non-compliance Risk</td>
<td>Risk arises from the failure to comply with the Shariah rules and principles</td>
</tr>
<tr>
<td>Rate of return risk</td>
<td>The potential impact on the returns caused by unexpected change in the rate of returns</td>
</tr>
<tr>
<td>Displaced Commercial risk</td>
<td>The risk that the bank may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The bank foregoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.</td>
</tr>
<tr>
<td>Equity Investment risk</td>
<td>The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under <em>Mudharabah</em> and <em>Musharakah</em> contracts.</td>
</tr>
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SHARI‘AH NON COMPILANCE RISK
SHARI’AH NON-COMPLIANT RISK

Shariah compliance is paramount!

✓ Original basis for having a banking system that meet the religious requirements of Muslims
✓ Factor that distinguishes Islamic banking from conventional banking.
✓ Ensures acceptance, validity and enforceability of contracts from Shariah point of view.
✓ Fulfils the objectives of Islamic finance i.e. to achieve justice and fairness in the distribution of resources.
Shari’ah Non-Compliance Risk can be found in three aspects...

1. Non compliant Process
2. Non compliant Product
3. Defects in Documentation

Shari’ah Risk
i- Financial Risk
ii- Non-Financial risk
## IMPLICATIONS OF SHARIAH NON-COMPLIANCE

<table>
<thead>
<tr>
<th>Non Financial Impacts</th>
<th>Financial Impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Against the Principle of Shari’ah (Impediment from God’s blessing or <em>barakah</em>).</td>
<td>Invalidation of contract (<em>aqad</em>)</td>
</tr>
<tr>
<td>Contravention of the provision of Islamic Banking Act 1983 (Section 3(5)(a) &amp; Section 4)</td>
<td>Non-halal income</td>
</tr>
<tr>
<td>Jeopardize the Bank’s reputation as an Islamic bank</td>
<td>Legal dispute</td>
</tr>
</tbody>
</table>
The importance of SHARI’AH REVIEW & SHARIAH AUDIT...

- **SHARI’AH REVIEW** = Self Assurance
  - Perform by management i.e. Shari’ah department
  - Support the work of the Shari’ah Committee & basic requirements of the IFIs
  - Non-independence ex-ante and ex-post assurance process
  - Shari’ah reviewer is not an auditor

- **SHARI’AH AUDIT** = Independent Assurance
  - Perform by internal Shari’ah auditor or/and external Shari’ah auditor
  - Enhance integrity & credibility of the IFIs Independence in appearance & ex-post audit
  - Reporting directly to the Audit Committee & the Board
The Role of Shari’ah Board Committee . . .

1. To be Shari’ah Authority/Reference in Islamic Finance

2. To Ensure Shari’ah Compliance in Product Development and Operation

3. To perform Control and Supervision
1. To be Shari’ah Authority/Reference in Islamic Finance

- To ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it
- To advise the financial institutions on any Shari’ah issue relating to Islamic financial businesses, activities or transactions
- To provide advice to any Islamic financial institution or any other person as may be provided under any written Law

- The Shari’ah committee will be referred to by the court or arbitrator in disputes involving Shari’ah issues in Islamic banking & finance and takaful
- In the case of the arbitrator, in Malaysia, the SAC’s resolution “shall be binding” on the arbitrator (obligatory)
- In the case of the court, in Malaysia, the SAC’s resolution “shall be taken into consideration” on the court (advisory)
2. To Ensure IFI’s Shari’ah compliance in Products and Practices

SHARIAH COMPLIANT INSTRUMENTS & PRACTICES

- Concept
- Structure
- Operation
- Pre
  - Shariah Advisory
- Present
  - Shariah Supervision
- Post
  - Shariah Audit/review
Shari‘ah Advisors and Product Development

Ex-Ante

Ex-Post

20
Ex-Ante product development

1. Identify the need
2. Identify the appropriate contract
3. Structuring the mechanism

Note:
Clarification of details process of how the Shari`ah board reached its decisions is important!
Ex-Post Product Development

1. Supervising product applications in the market
2. Ensuring the bank follow the mechanism approved by shari’ah board
3. Ensuring shari’ah compliance
4. Preparing annual report
The Shari’ah compliance process

SHARI’AH COMPLIANCE PROCESS

- Presenting the result to Shari’ah Advisor for approval
- Analyzing audited financial report
- Gather further information (if needed)
- Identifying the percentage of non-halal activities
- Comparing that percentage to the benchmark
- Compiling and publishing the result

SHARI’AH COMPLIANCE PROCESS

- Product Development
  - Shari’ah Compliance Manual
  - Research
  - Design & Develop

- Risk Requirement
  - Financial Requirement & Pricing
  - Legal and Taxes Requirement

- Approval
  - Marketing
  - Review & Shari’ah Audit

- e.g., Shari’ah Stock Screening

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Governance for Product Development
The Shari’ah compliance output

**Product concept & Design**
- Purpose of Product
- Product Structure
- Product Legal Requirements

**Product Documentation**
- Approval of contractual requirements?

**Product Process Flow**
- Product operational/Document Flow
- Product Monitoring & Reporting

**Product Review**
- Execution of contracts compliant?
- Any gaps in product origination

**Origination & Services**
- Redemption or Termination
The Shari’ah compliance output

- **IFI RISK RETURN EXPECTATIONS**
- **CUSTOMER EXPECTATIONS**
- **REGULATORY REQUIREMENTS**
- **PRODUCT FUNDING REQUIREMENTS**
- **PRODUCT REQUIREMENTS**

**SHARIAH APPROVED CONTRACTS**

**PRODUCT**
STANDARDS ON SHARI’AH GOVERNANCE
SHARI’AH GOVERNANCE

• Shari’ah risks can be managed via proper Shari’ah governance framework, installed in all jurisdictions and adoption of mutual respect approach.
• Refers to structures and process adopted by Islamic financial institutions to ensure compliance with Shari’ah rules and principles.
• It deals with:

  SHARI’AH COMPLIANCE
  SHARI’AH RISK
Importance of Shari’ah Governance

- Ensures compliance with Shariah rules & principles
- Fiduciary duties in Islamic Banking transaction
- Normal Corporate Governance

Ensure strict Shari’ah-compliant

Instil public confidence

Promote operational/financial stability

*Principles of Islamic finance place great emphasis on strong corporate governance values & structure, transparency, disclosure of information & strict adherence to Shari’ah principles...*
SHARI’AH GOVERNANCE

• The Shari’ah governance enters into all aspects of IFI’s operation.
• The shari’ah compliance is not only in operational processes, but now its chain continues even when disputes are brought to court.
• Shari’ah governance is not only under Shari’ah board responsibility, but the whole stakeholders in IFI’s industry.
A Robust Islamic Financial System requires a Sound Shari’ah Governance Framework

Well-conceived, consistent & integrated framework
Global Standards on Shari’ah Governance

- Governance practices therefore **play a vital role** in ensuring that business are run in a prudent and sound manner ...

- We currently see a **positive development in the industry** by having global standards on Shari’ah governance ...
AAOIFI – GSIFI
(GOVERNANCE STANDARD FOR ISLAMIC FINANCIAL INSTITUTIONS)

1. GSIFI 1: Shari’a Supervisory Board: Appointment, Composition and report
2. GSIFI 2: Shari’ah Review
3. GSIFI 3: Internal Shari’ah Review
4. GSIFI 4: Audit & Governance Committee for IFI
5. GSIFI 5: Independence of Shari’ah Supervisory Board
6. GSIFI 6: Statement on Governance Principles for Islamic Financial Institutions
7. GSIFI 7: CSR Conduct & Disclosure for Islamic Financial Institutions
AAOIFI GSIFI Objectives

- To lay down the key principles and concepts relevant to governance in IFIs
- To assist IFIs as well as their stakeholders to appreciate the respective roles of those charged with governance
- To establish the foundation upon which the development of future governance or compliance standards will take place
- To provide the necessary inter-linkages between the various current and future standards applicable to IFIs
IFSB Standard No. 10

- IFSB 10 - GUIDING PRINCIPLES ON SHARI`AH GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES
- DATE OF COMMENCEMENT: DECEMBER 2009
IFSBI Standard: Background and objectives

1. Complement other prudential standards issued by the IFSB
2. Facilitate better understanding of Shari’ah governance issues
3. Provide an enhanced transparency in terms of issuance, and audit/review process for compliance with Shari’ah rulings
4. Provide greater harmonization of Shari’ah governance structures and procedures across jurisdictions

END GOAL:
Stakeholders should satisfy themselves that an appropriate and effective Shari’ah governance system is in place

FRAMEWORK
- Highlighting the components of a sound Shari’ah governance system
- Focus on competence, independence, confidentiality, and consistency of Shari’ah boards
Malaysian Initiative in Shari’ah Governance Framework

Regulation By Securities Commission & Central Bank

- Promote stakeholder’s confidence & integrity of Islamic Financial Services industry

Establishment of Shari’ah Committee in each IFI’s
- Ensure business operations are in adherence with Shari’ah principles

Set up centralized Shari’ah Advisory Committee
- Ensure uniformity & harmonization of Shari’ah interpretations

Legal provision / legislation & Issuance of Specific Guidelines
- Establishment of Shari’ah advisors at IFI’s
- Guidance on role & responsibility of Shari’ah advisor in ensuring Shari’ah compliance
Shari’ah Governance Framework for IFI’s in Malaysia

Shari’ah Governance refers to structures and process adopted by Islamic financial institutions to ensure compliance with Shari’ah rules and principles.

Shari’ah Governance must be observed by all stakeholders in the industry.
SOME RECOMMENDATIONS
Recommendations

A. Prudential control framework
   • IIFS shall have in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities.

B. Shari’ah Compliance Mechanism
   • IIFS shall have adequate Shari'ah compliance mechanisms in place:
     • a well-defined and adequately qualified and staffed organisational structure,
     • clear lines of authority and accountability;
     • policies and procedures pertaining to the approval of products and activities that require adherence to Shari'ah rules and principles.

C. Impact Review And Analysis
   • Impact review and analysis of Shariah compliance in terms of frequency and prevalence of such compliance based on the internal Shariah control systems would be facilitate the appropriate Shariah audit rating.
   • In terms of management and control this analysis provide feedback to post audit or compliance review as well as follow up with corrective actions prior to issuance of Shariah compliance review and audit reports.
Moving forward...

Enhancing Shari’ah Compliant Measurement
- Concerted effort by all – the regulator, Shari’ah advisors, shareholders, auditors and the public
- Basis of measurement – theory and practice
- Standard of measurement – towards a global shari’ah standard

Method of Measuring Shari’ah Compliance
- Criteria and framework of a good Shari’ah compliance measurement
- Internal and external shari’ah supervision, review and audit

Shari’ah Framework vs Legal Set up
- Legislations – amendments or exemptions
- A re-look at Court interpretations and decisions
- Good and effective legal documentations

Human Capital
- Enhancement of Shari’ah training (researchers, practitioners, industry players, managements, regulators)
- Enhancement of Shari’ah experts’ exposure to current commercial realities and knowledge
ワシディッラヒ علي سيدنا محمد وأله وسلم
والحمد لله رب العالمين