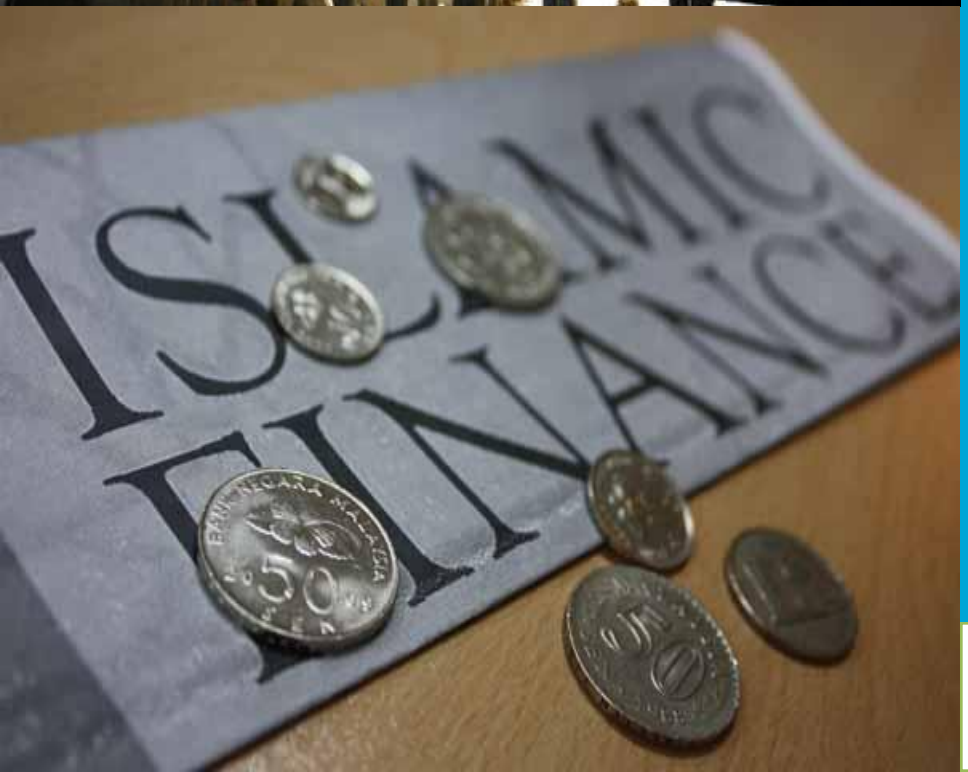

Risk Management in Islamic Finance

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International Shari'ah Research Academy for Islamic Finance

Agenda of Discussion

- Risk Management in Islamic Finance: Concepts & Types
- Shari'ah Non-Compliancec Risk
- Standards on Shari'ah Governance
- Recommendations

RISK MANAGEMENT: CONCEPTS AND TYPES

CONCEPT OF RISK MANAGEMENT IN ISLAM

Text in Al-Qur'an

وَقَالَ يَٰبَنِيَّ لَا تَدۡخُلُواْ مِنۢ بَابٖ وَٰحِدٖ وَٱدۡخُلُواْ مِنۡ أَبۡوَٰبٖ
مُّتَفَرِّقَةٖۖ وَمَآ أُغۡنِي عَنكُم مِّنَ ٱللَّهِ مِن شَيۡءٍۖ إِنِ ٱلۡحُكۡمُ
إِلَّا لِلَّهِۖ عَلَيۡهِ تَوَكَّلۡتُۖ وَعَلَيۡهِ فَلۡيَتَوَكَّلِ ٱلۡمُتَوَكِّلُونَ ٦٧

"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 wardd 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?

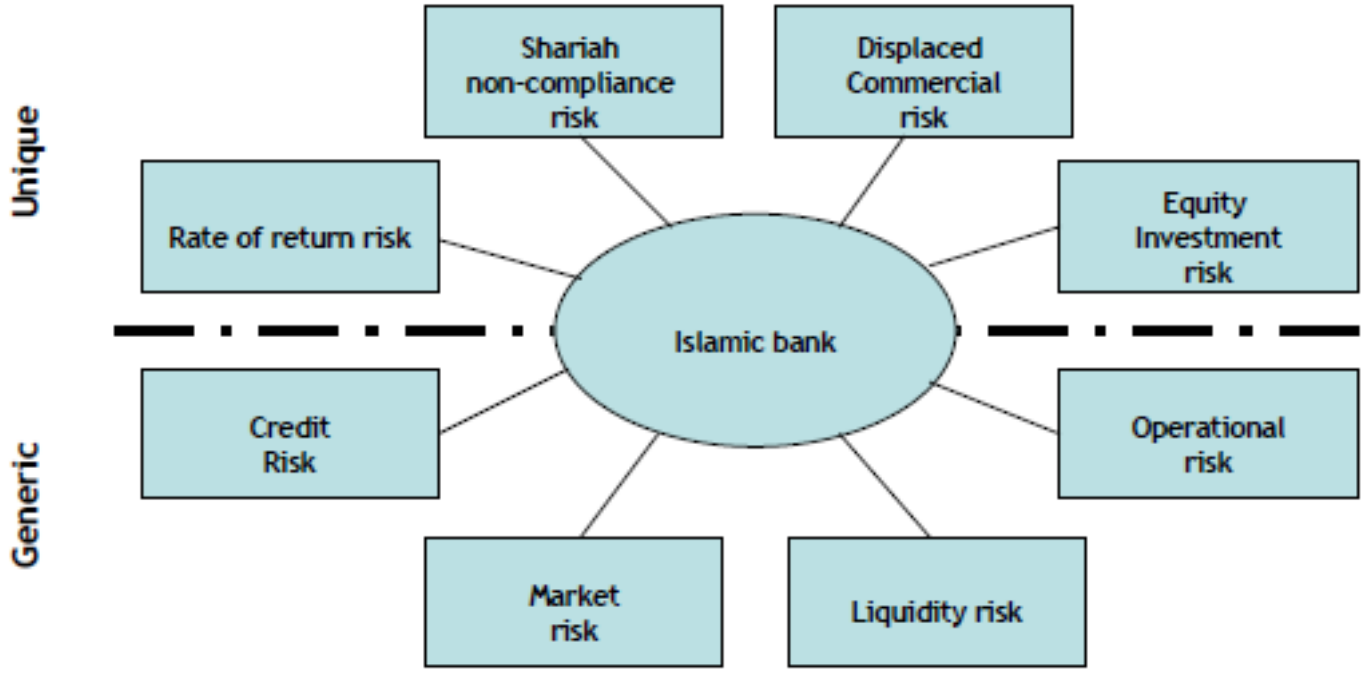
Risk management is the process by which various risk
exposures are
(1) identified,
(2) measured/assessed,
(3) mitigated and controlled,
(4) reported and monitored.

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



Strategic	Legal	Fiduciary	Reputation	Transparency	Regulatory compliance

GENERIC RISKS FOR BANKS

Types of risks	Definition
Credit risk	The potential that a counterparty fails to meet its obligations in accordance with agreed terms and conditions of a credit-related contract
Market risk	The potential impact of adverse price movements such as benchmark rates, foreign exchange rates, equity prices on the economic value of an asset
Liquidity risk	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
Operational risk	The potential loss resulting from inadequate or failed internal processes, people and system or external events

UNIQUE RISKS FOR ISLAMIC BANKS

Types of risks	Definition
Shariah non-compliance Risk	Risk arises from the failure to comply with the Shariah rules and principles
Rate of return risk	The potential impact on the returns caused by unexpected change in the rate of returns
Displaced Commercial risk	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.
Equity Investment risk	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 *Mudharabah* and *Musharakah* contracts.

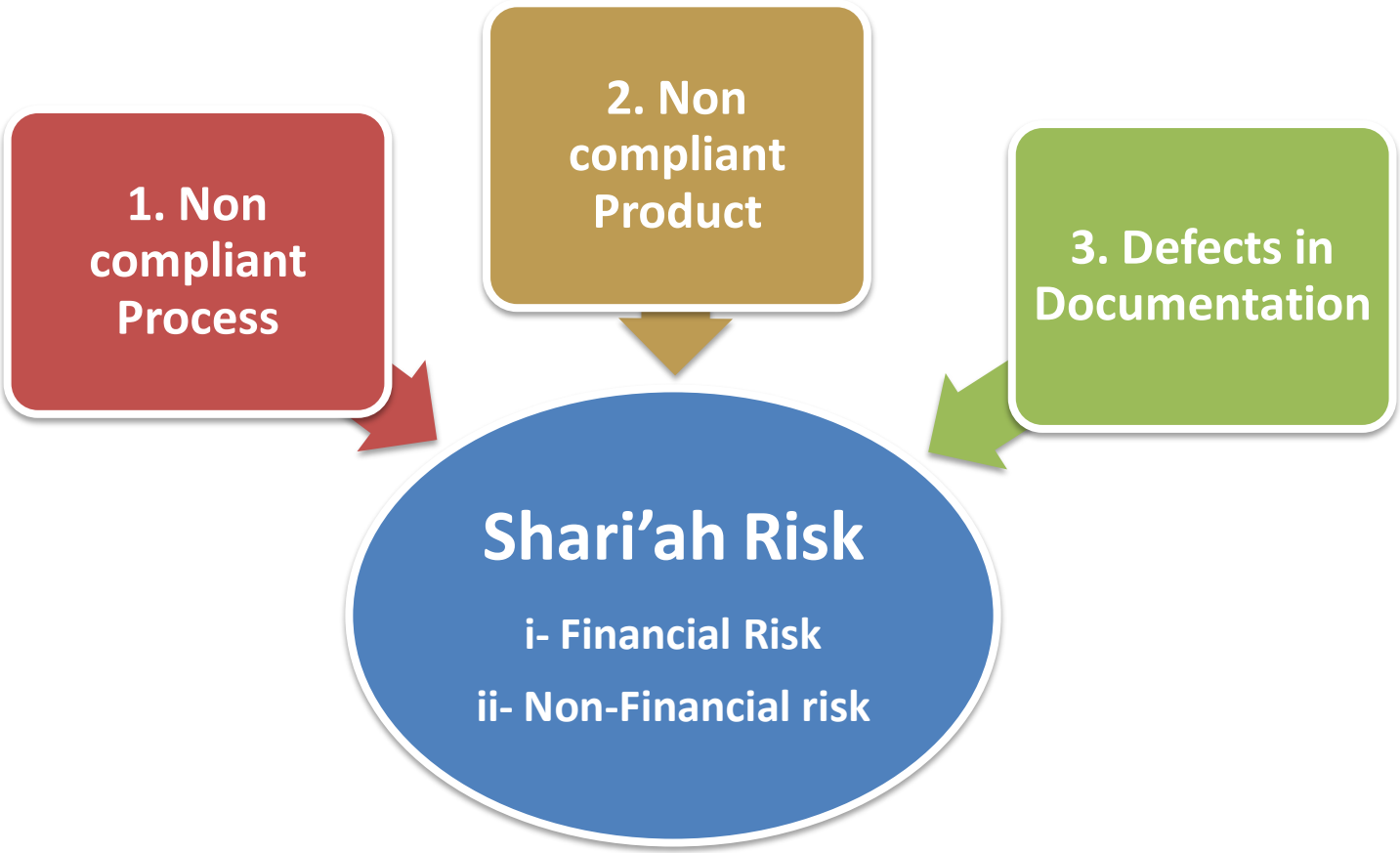
SHARI’AH NON COMPILANCE RISK

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…



IMPLICATIONS OF SHARIAH NON-COMPLIANCE

Non Financial Impacts	*Financial Impacts*
Against the Principle of Shari'ah (Impediment from God's blessing or *barakah)*.	Invalidation of contract (*'aqad*)
Contravention of the provision of Islamic Banking Act 1983 (Section 3(5)(a) & Section 4)	Non-halal income
Jeopardize the Bank's reputation as an Islamic bank	Legal dispute

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

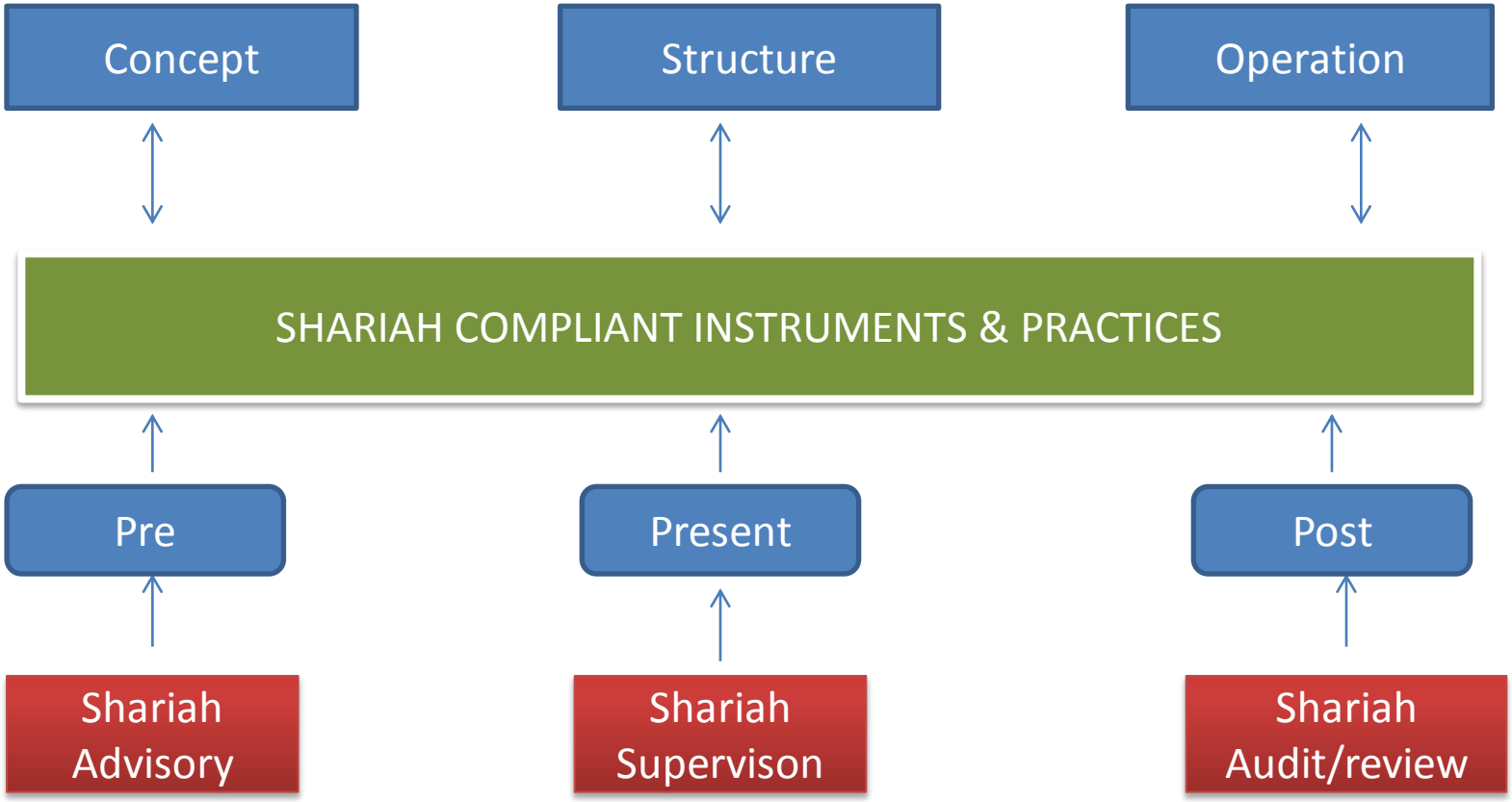
3. To perform Control and Supervision

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



Shari'ah Advisors and Product Development

Ex-Ante

Ex-Post

Ex-Ante product development

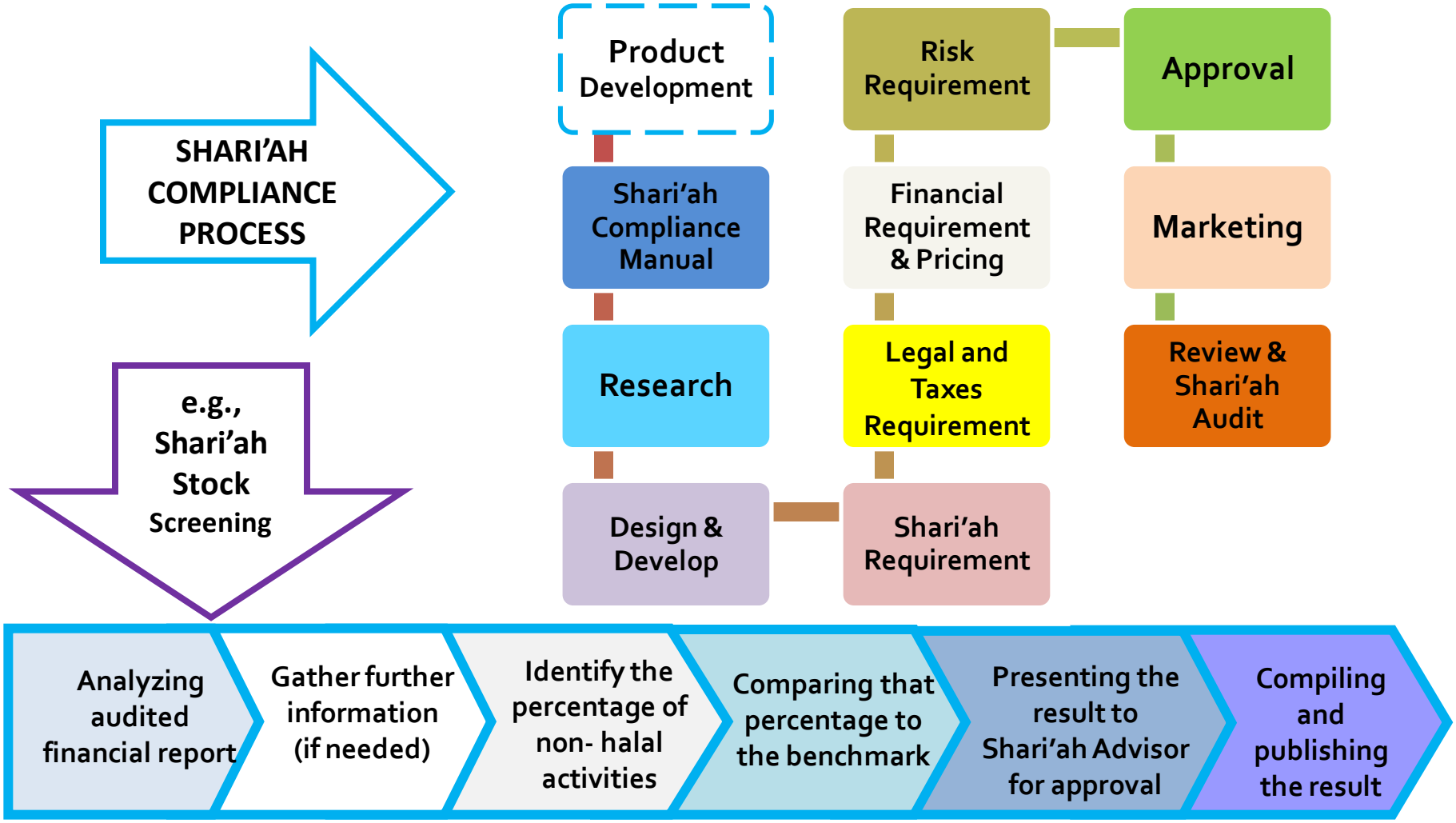
1. Identify the need
2. Identify the appropriate contract
3. Structuring the mechanism

Note:
Clarification of details process of how the *Sharī`ah* board reached its decisions is important!

Ex-Post Product Development

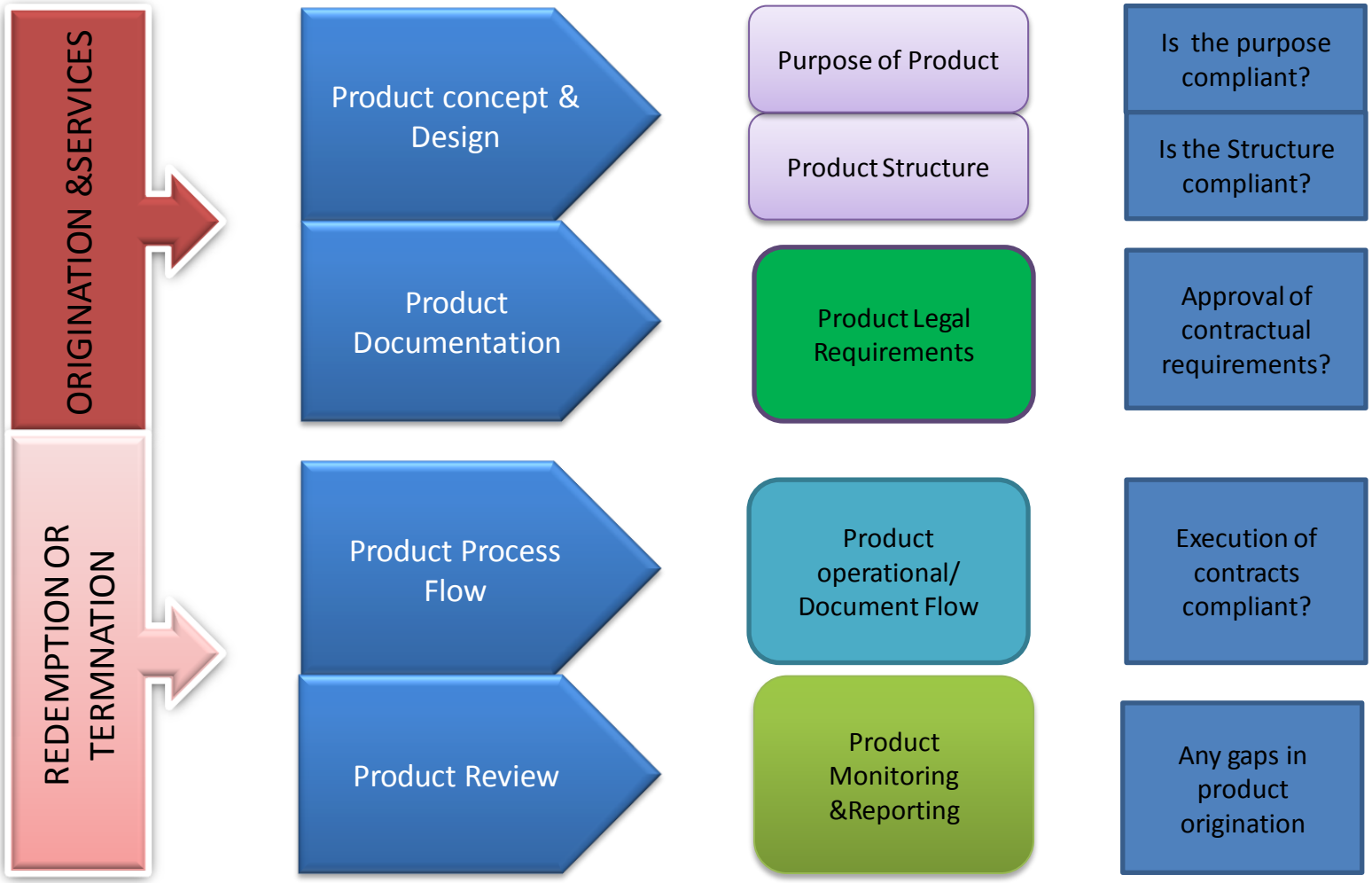
1. Supervising product applications in the market
2. Ensuring the bank follow the mechanism approved by shari'ah board
3. Ensuring *shari'ah* compliance
4. Preparing annual report

The Shari'ah compliance process

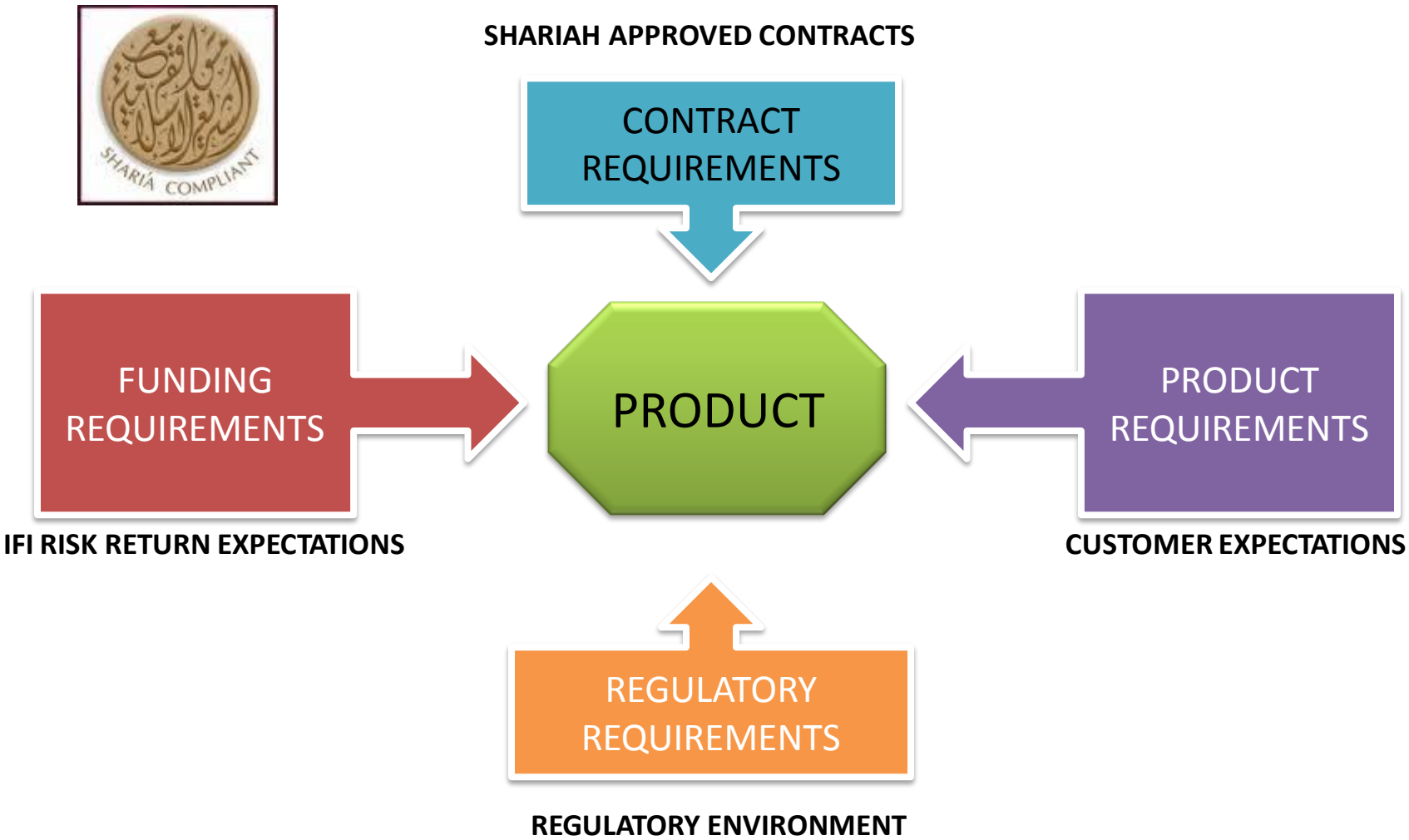


Governance for Product Development

The Shari'ah compliance output



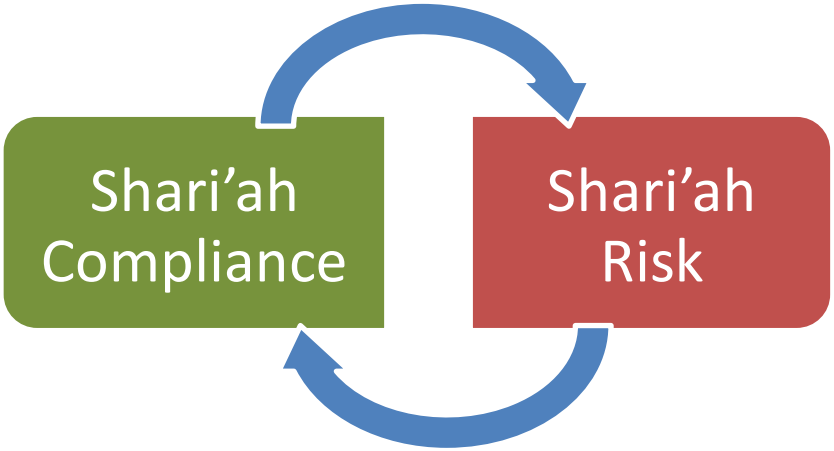
The Shari'ah compliance output



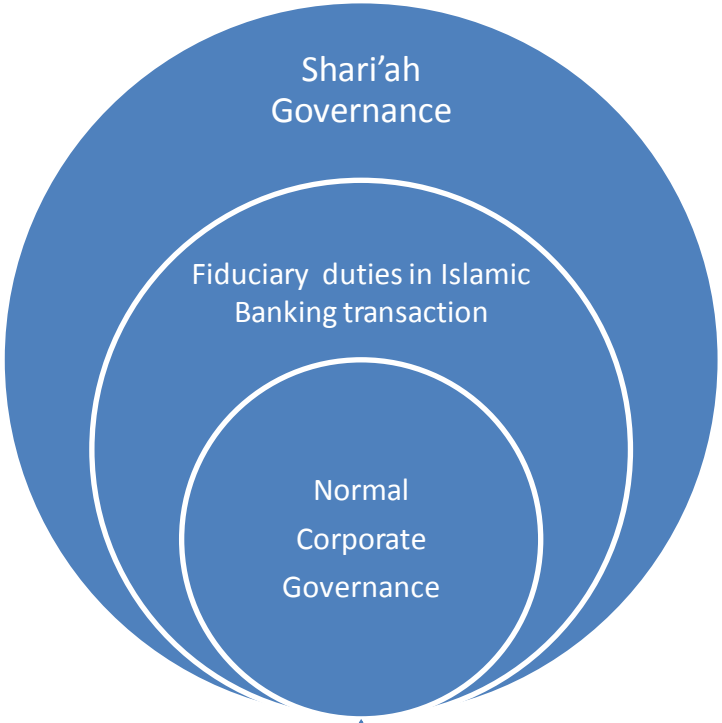
STANDARDS ON SHARI'AH GOVERNANCE

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:



Importance of Shari'ah Governance



Ensures compliance with Shariah rules & principles

Ensure strict Shari'ah-compliant

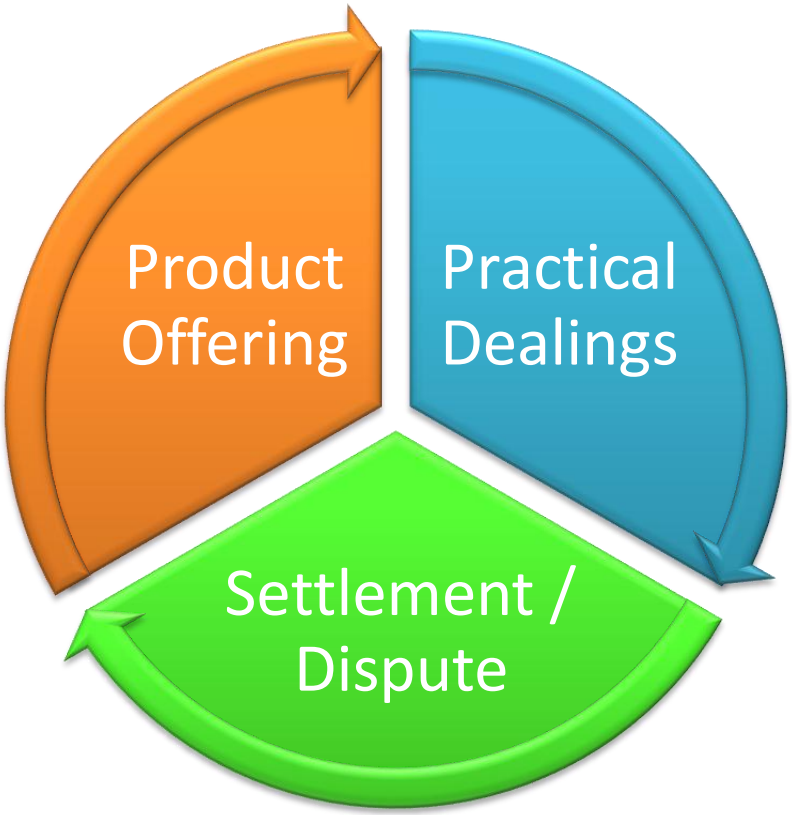
Instil public confidence

Promote operational/financial stability

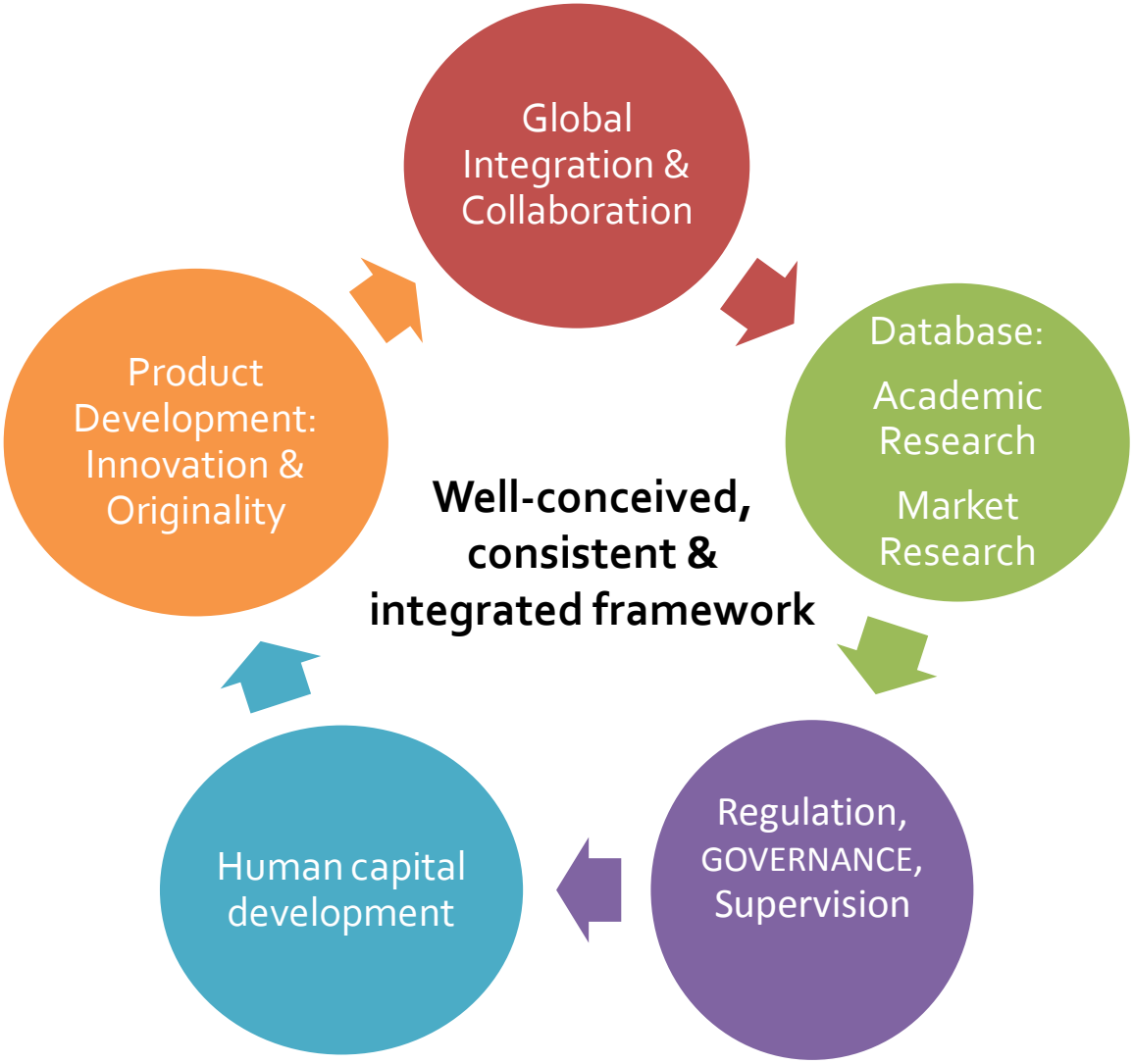
Principles of Islamic finance place great emphasis on strong corporate governance values & structure, transparency, disclosure of information & strict adherence to Shari'ah principles…

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



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: Appoinment, 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: Indepedence 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 toIFIs

IFSB Standard No. 10


ifsb

ISLAMIC FINANCIAL SERVICES BOARD

GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR INSTITUTIONS OFFERING ONLY ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (TAKAFUL) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS)

December 2006

- **IFSB 10 - GUIDING PRINCIPLES ON *SHARI`AH* GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES**
- **DATE OF COMMENCEMENT: DECEMBER 2009**

ifsb

ISLAMIC FINANCIAL SERVICES BOARD

IFSB Standard: Background and objectives

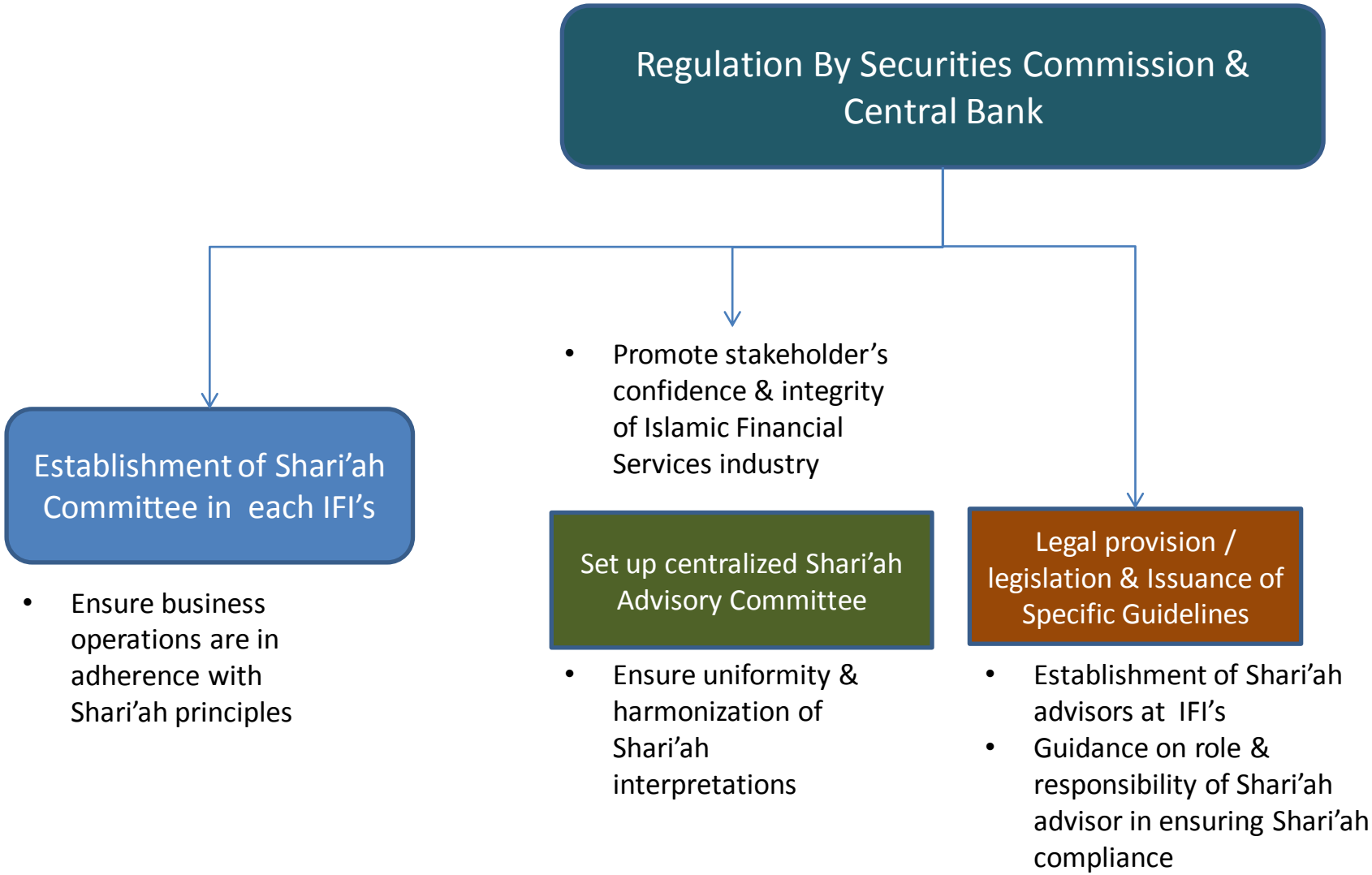
1. **Complement** other prudential standards issued by the IFSB
2. **Facilitate** better understanding of *Shari'ah* governance issues
3. Provide **an enhanced transparency** in terms of issuance, and audit/review process for compliance with *Shari'ah* rulings
4. Provide **greater harmonization** of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

FRAMEWORK

- Highlighting the components of a sound *Sharî'ah* governance system
- Focus on competence, independence, confidentiality, and consistency of *Sharî'ah* boards

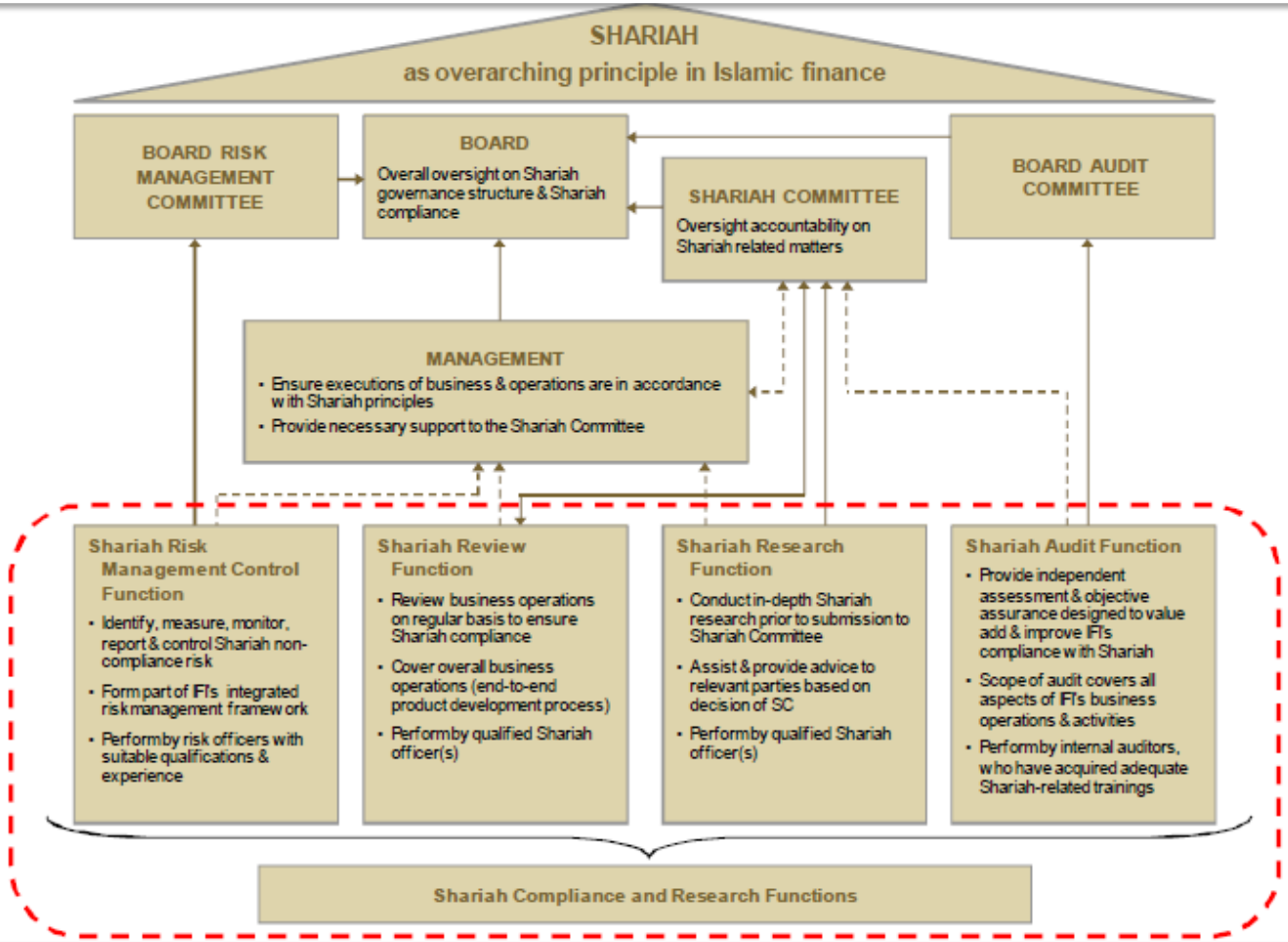
END GOAL:
Stakeholders should satisfy themselves that an appropriate and effective *Sharî'ah* governance system is in place

Malaysian Initiative in Shari'ah Governance Framework



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 *Sharī`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 *Sharī`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

وصلى الله على سيدنا محمد وآله وسلم

والحمد لله رب العالمين