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Financial Regulators Forum on Islamic Finance

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Agenda

Introduction

Risk management in Islamic banking

Issues and challenges

Shariah compliance - How we are doing it.

Moving forwards – Key takeaways

Islamic retail banking...at a glance



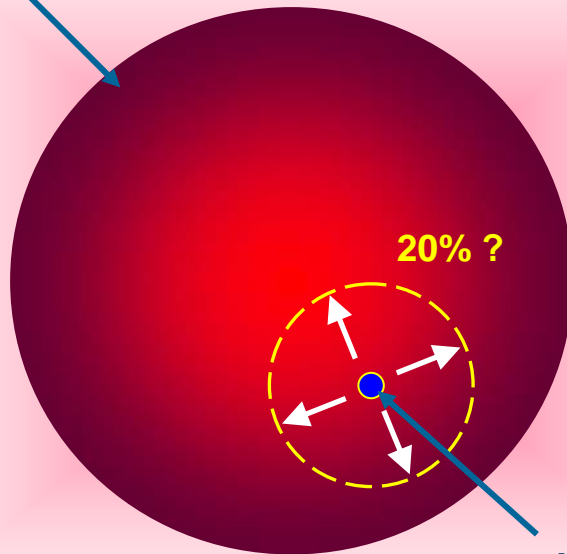
More than 300 Islamic financial institutions hold an estimated US\$250 – US\$300 billion in assets worldwide.

High concentration in the Middle East and Southeast Asia with Bahrain and Malaysia the biggest hubs respectively.

Retail deposits of Islamic Banks in the Middle East achieve high average annual growth rates: around 15 – 20% per annum.

Islamic banking's latent potential unexplored

Global banking assets



Islamic banking assets

1%

Drivers of Demand

Sound value proposition

Both on the demand and supply side. Islamic banking provides customers with sound financing and investment alternatives and provides banks with returns that are competitive with conventional operations.

Latent religious demand

20% of the world population is Muslim, and this figure is steadily growing.

Latent ethical demand

\$1 in \$8 invested in the US is invested responsibly.

Malaysia as regional Islamic financial hub



Aim

Malaysia as Regional Islamic Financial Hub

Malaysia as Islamic financial hub will facilitate greater liberalisation and penetration to new markets abroad

How to achieve?

Greater Liberalisation of Malaysian Markets

The most successful market is not necessarily the largest in size, but the most open and dynamic to change

Guided by

9th Malaysia Plan (9MP) 2006

Financial Sector Master Plan (FSMP) 2001

Capital Market Masterplan (CMP) 2001

Malaysia's positioning as regional and Global hub for Islamic finance will significantly contribute towards economic development

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Risk management in Islamic banking

Banks are exposed to a wide range of risk. Some of the risks are as follows:-

Financial Risk

Credit risk

The risk of counterparty failure to meet their obligations in a timely manner

Market risk

Risk common to entire class of assets and liabilities due to economic changes or external events

Liquidity risk

Risk that arises from the difficulty of trading on asset and difficulty in obtaining funding at a reasonable cost

Prepayment risk

The risk of financing being prepaid before maturity due to a drop in interest rate

Settlement risk

Risk that a counterparty does not deliver security or its value in cash as per agreement when the security is traded after other counterparty (ies) have delivered security or cash as per agreement

Risk management in Islamic banking...cont

Business Risk

Volatility risk

Fluctuations in the exchange rate of currencies

Country risk

Potential volatility of foreign assets due to political or financial events in a particular country

Equity risk

Depreciation of investments due to stock market fluctuations

Operational risk

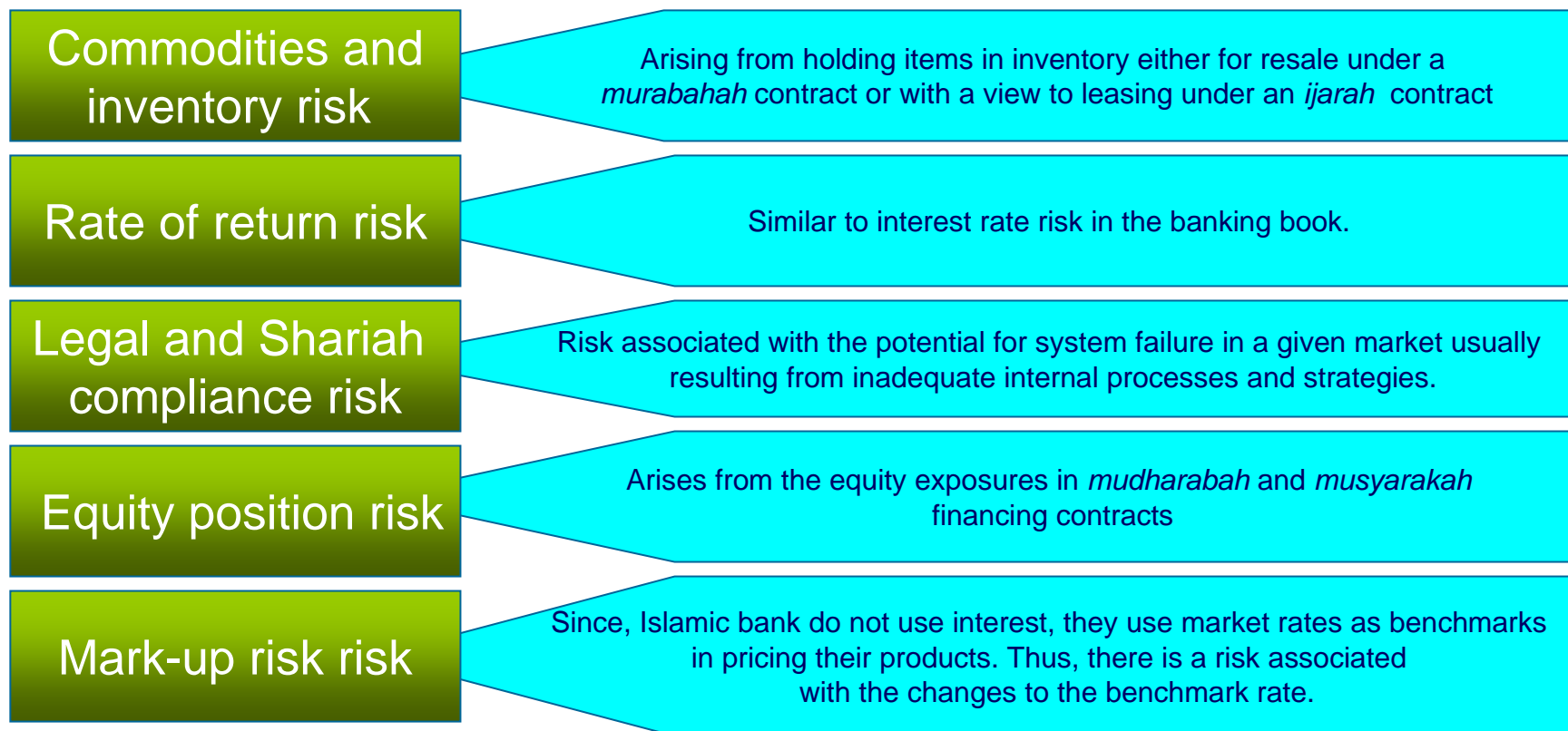
Risk associated with the potential for systems failure in a given market, usually resulting from inadequate internal processes and strategies, people, system or from external event

Event risk

Unpredictable risk due to unforeseen events such as banking crisis, contagion effects and such other exogenous factors

However, there are risks specific to Islamic banks

Risks specific to Islamic bank



The complexities of the respective risks in Islamic financial instruments need to be explored and quantified for effective assessment and management

Why we need risk management?



Emphasis on improved corporate governance goes hand in hand with the need for improvements in risk management standards especially during period of uncertainty.

Minimise adverse consequences

Robust internal controls to provide qualitative standards are also necessary to complement the quantitative analysis.

To provide a check and balance

The risk management infrastructure needs to be in place.

Risk associated with Islamic financing operations involving financial contracts and instruments which may give rise to other risk besides credit risk

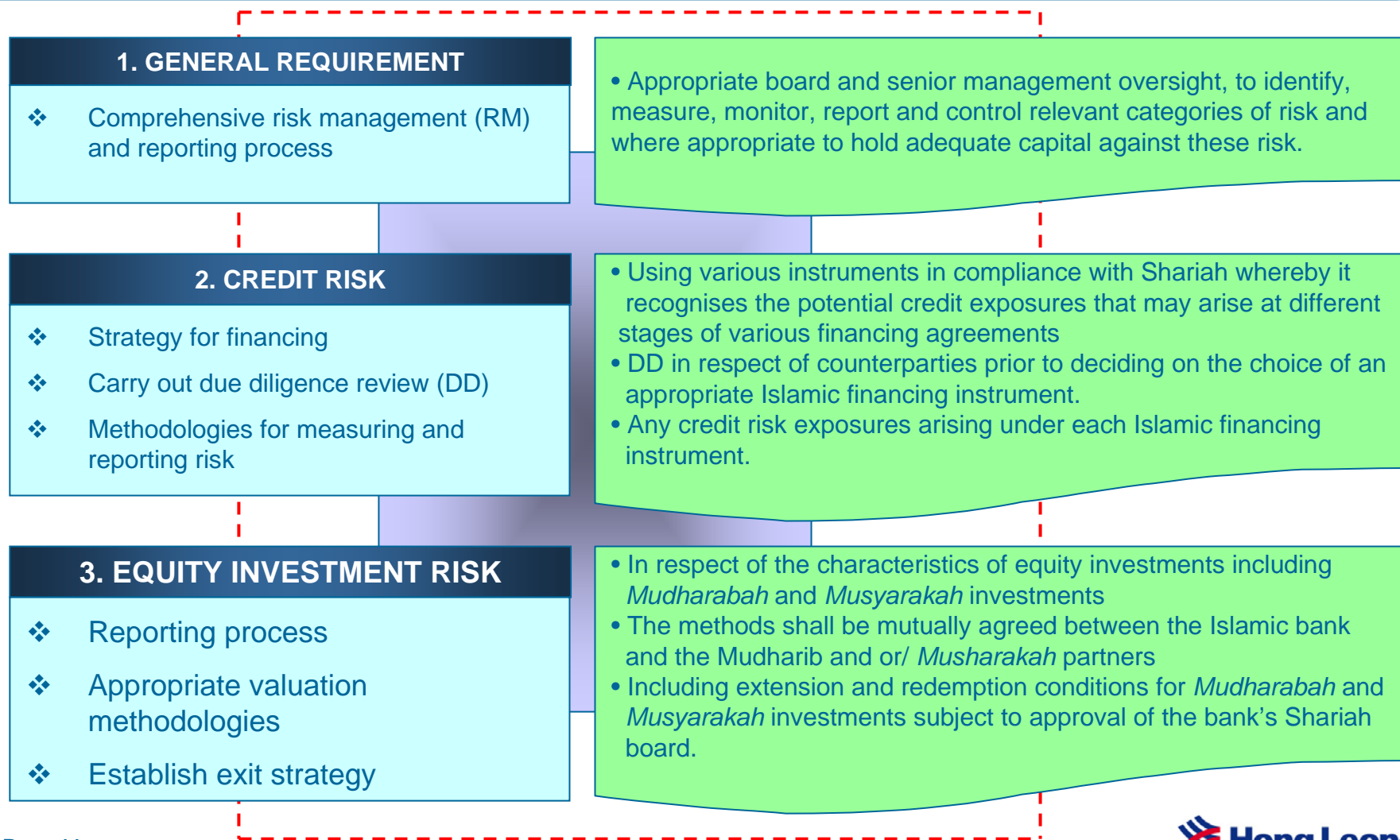
Address the unique characteristics

Identification, measurement, monitoring and control

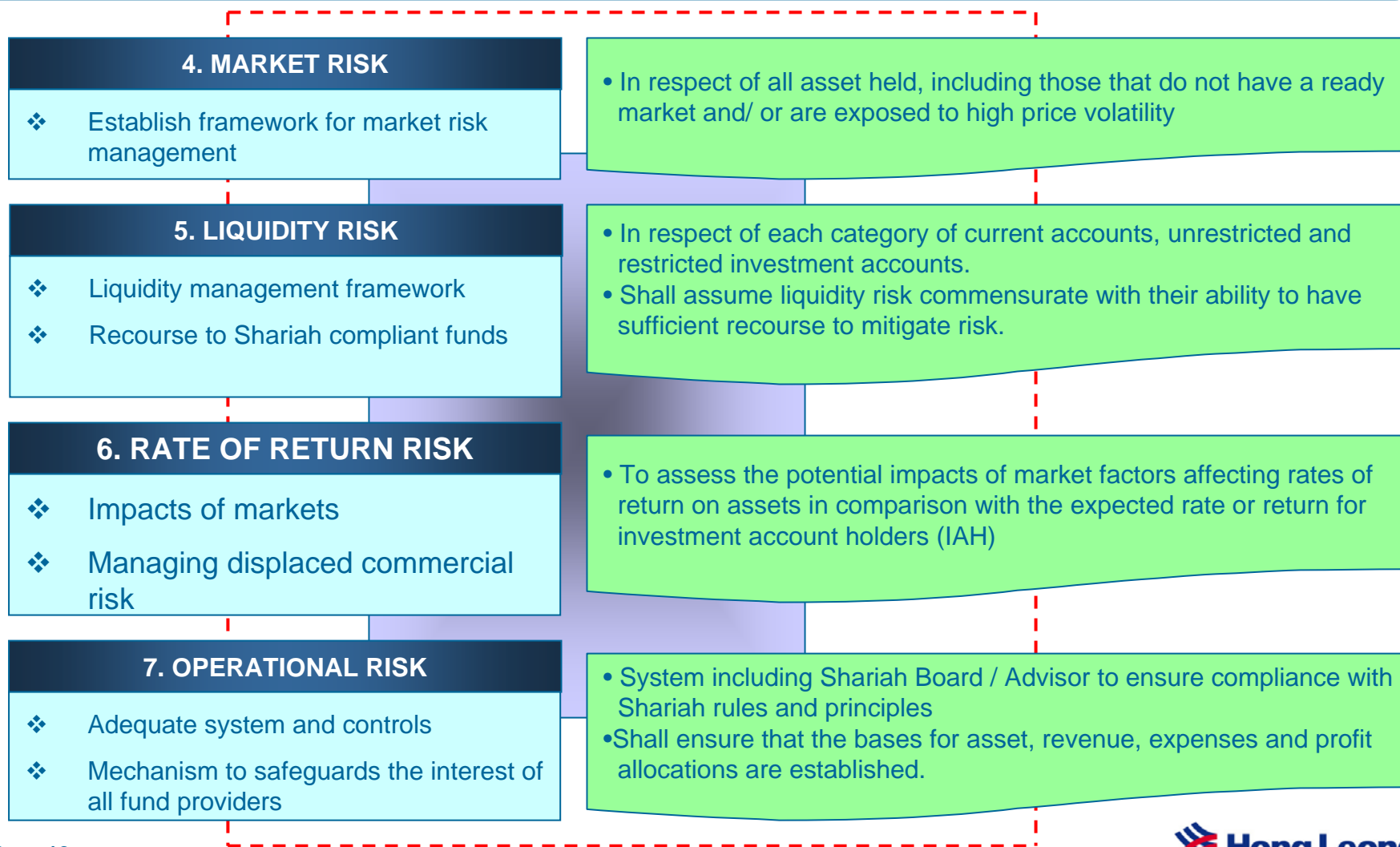
New hedging products which are scarce in the market need to be developed in the quest to seek compatible risk mitigating products.

The requirement to manage the risks becomes more important because of the uniqueness of the contracts.

IFSB Guiding Principles of risk management



IFSB Guiding Principles of risk management



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Some of the issues and challenges (Business operation)

✓ IFIs have a very unique risk characteristics and special requirement for **compliance to Shariah** principles

✓ As the returns in Islamic banking are uncertain (ex-post basis), **well developed IT systems** would be necessary to reduce the degree of uncertainty



✓ There is a need for Islamic banking industry to **develop a derivatives** market to mitigate and manage these emerging new risks

✓ The intricacy in profiling the risk in Islamic banking is further increase as the **risks may transform** from one type of risk to another at the various stages of the contract.

Some of the issues and challenges (Business operation)

✓ The challenge is to enforce a framework that takes into account the unique characteristics of Islamic banking business without being a **regulatory burden** and **restricting its growth potential**

✓ Avoid **arbitrage** opportunities between the conventional and Islamic financial systems



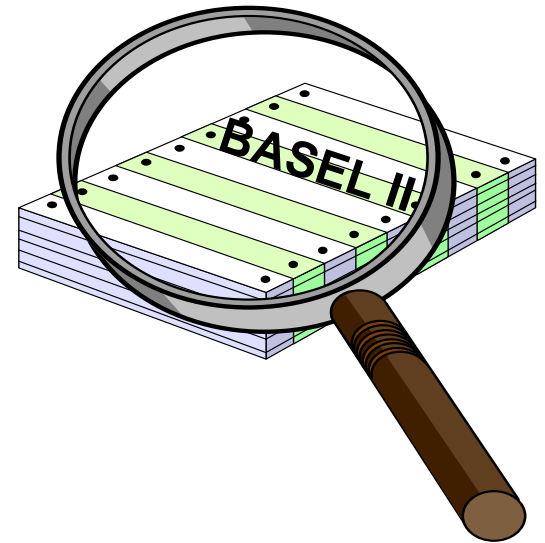
✓ To ensure each component that supports the **risk mitigation** are in place i.e legal, regulatory, supervisory as well as the Shariah infrastructures

✓ **New hedging products** which are scarce in the market need to be developed in the quest to seek for compatible risk mitigating products

Issues and challenges...continues (Business operation)

✓ **Basel II initiatives** have to be complemented with other dimension of risks that are inherent in Islamic financial transaction.

✓ Further refinement will have to be done by the Islamic financial specialist to assess the **appropriateness of the capital definition** in particular as outlined by the Basel committee



✓ If the Islamic banking were to be more engaged in the **profit-sharing arrangement** in its balance sheet, it will require Islamic bank to have a more rigorous risk management assessment and monitoring mechanism.

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Risk management in Islamic banking

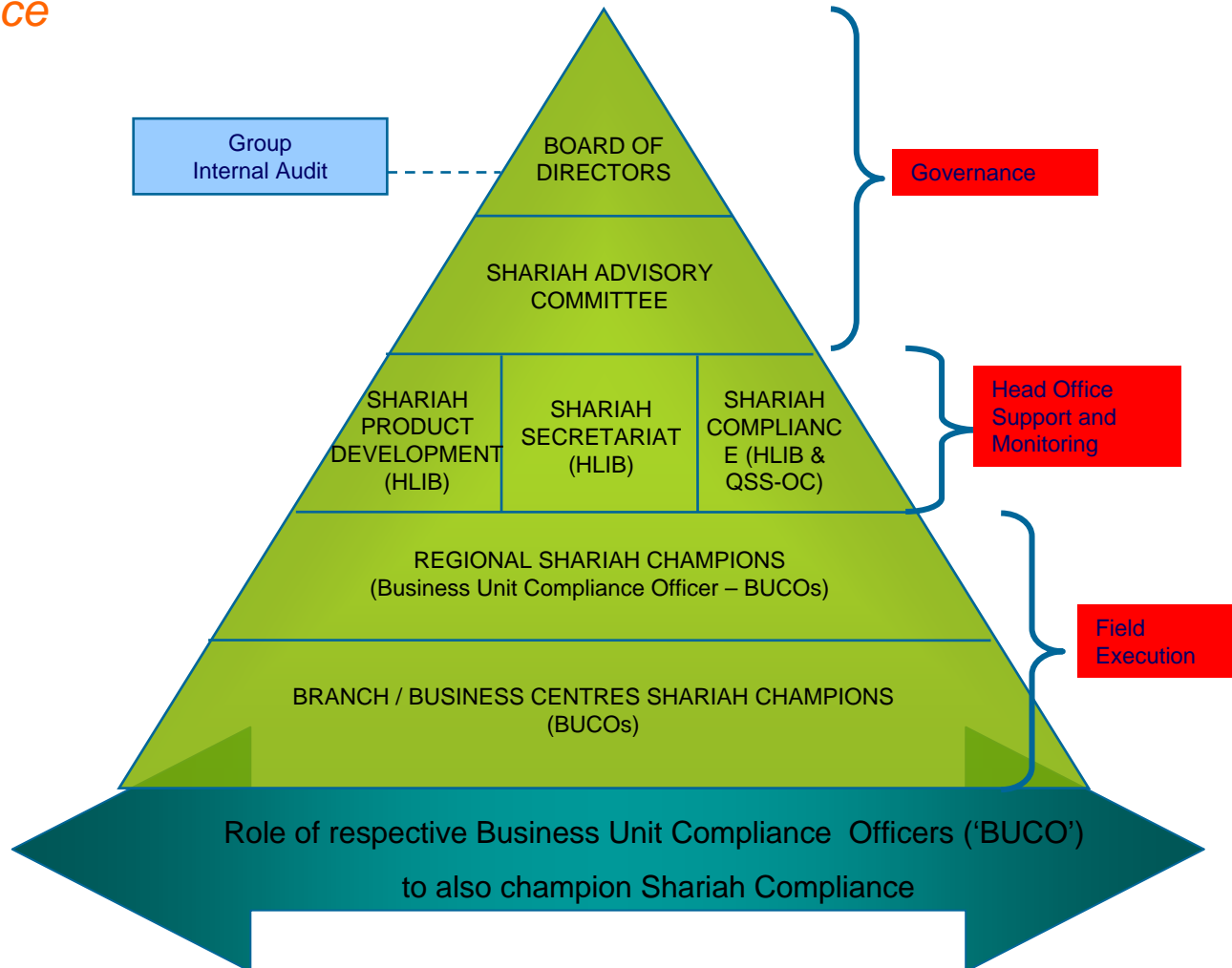
Issues and challenges

Shariah compliance - How we are doing it.

Moving forwards – Key takeaways

The main thrust for Islamic banking is Shariah compliance

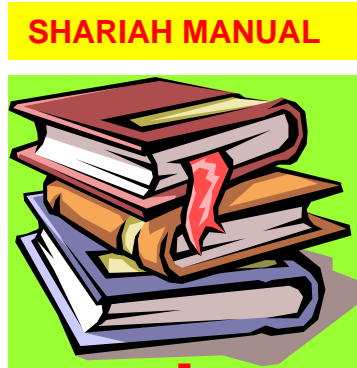
A key challenge in managing operational risk in Islamic banking is ensuring Shariah compliance



Shariah E-manual...towards a better compliance

Shariah principles serve as a self-regulating mechanism that protects IFIs from unproductive, speculative and unethical activities

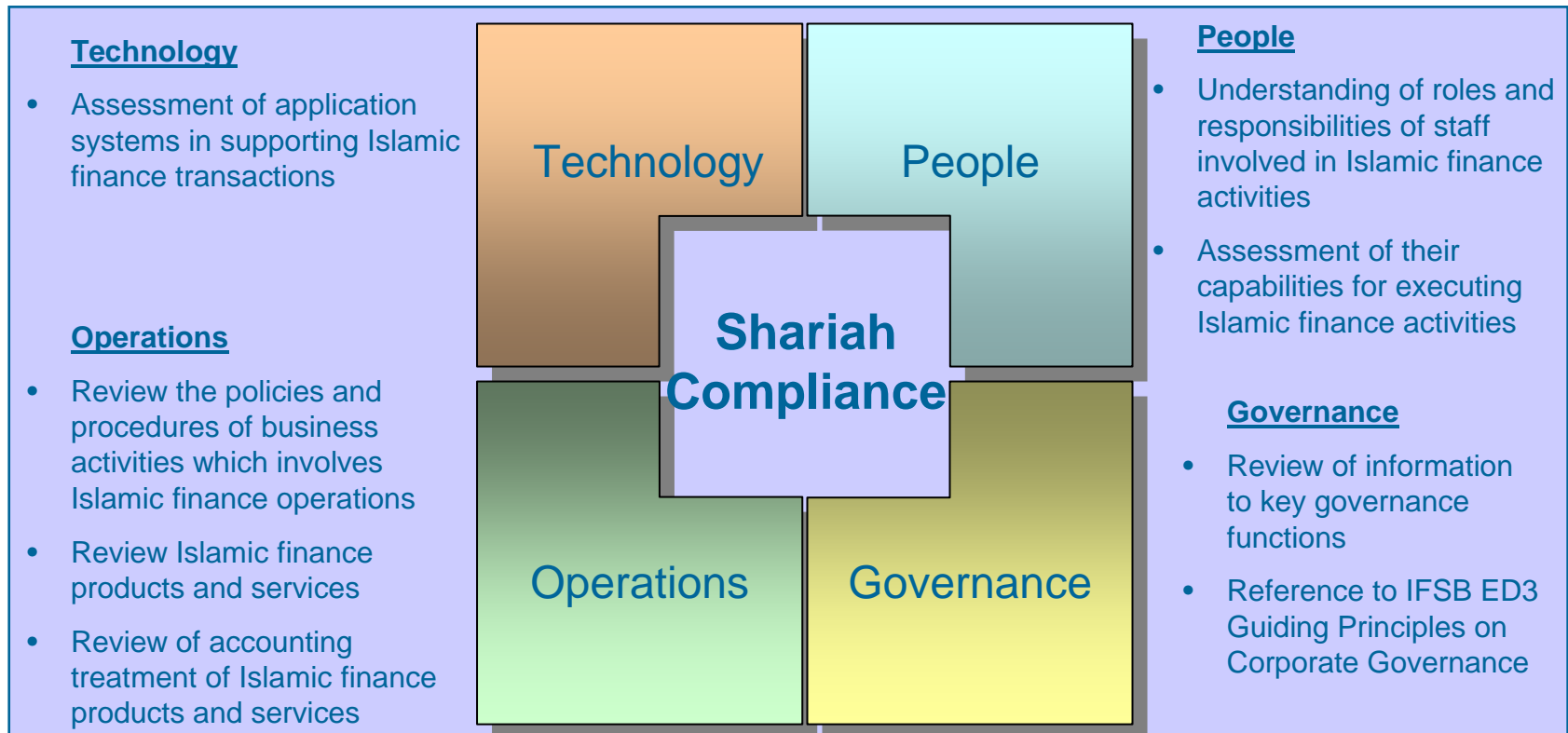
Product Manuals make reference to Shariah Manual on general/ centralised Shariah principles, hence reducing redundancy and improve ease of maintenance



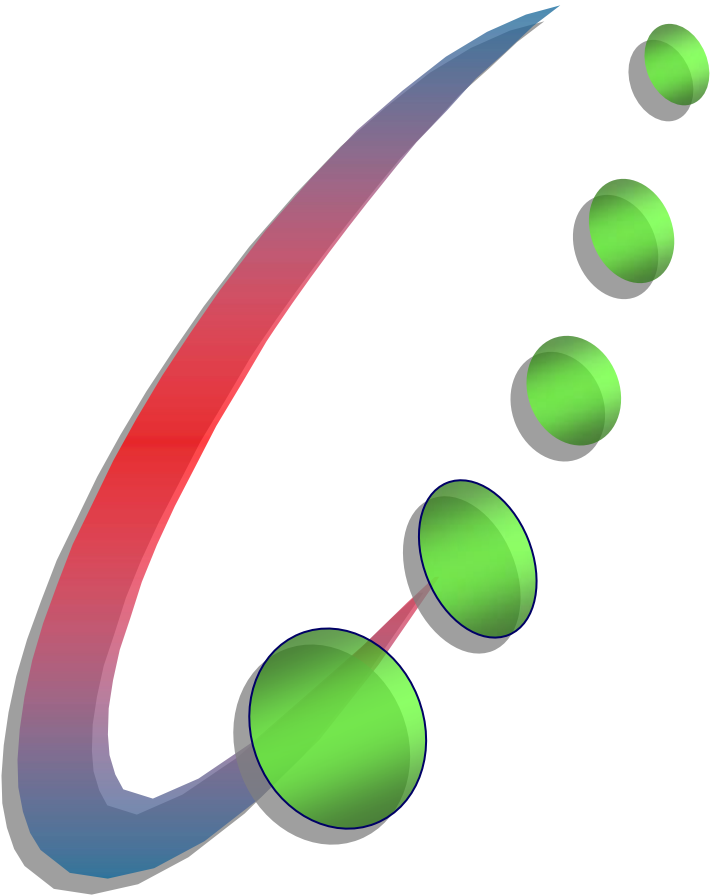
E-manual will provide greater access to staff on bank-wide basis, enabling better referencing for compliance

Develop Shariah Compliance Methodology and Audit Programs

*The regulatory framework in which Islamic banking operates is thus able to draw on the strengths of the **Shariah injunctions**, to reinforce financial soundness and stability of the **Islamic banking system**.*



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Moving forward: key takeaways

The risk management infrastructure in IFIs needs to identify, unbundle, measure, control and monitor all the specific risk

Sound risk management practices will minimise adverse consequences faced by FIs during period of uncertainty

The main thrust for Islamic banking is Shariah compliance

Well developed IT systems would be necessary to reduce the degree of uncertainty

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Thank You

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