

# FINANCIAL REGULATORS FORUM IN ISLAMIC FINANCE

## Session 3

**Business Operations and Risk Management**

**in Islamic Banking**

**By**

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**29 Mar 2007**

## Agenda

- Introduction - Overview of Islamic Banking Fundamentals
- Inherent Risks in Institutions Islamic Financial Services ('IIFS')
- Prudential and Robust Risk Management Framework
- Case Study – Inherent Risks in a business activity and risk mitigation

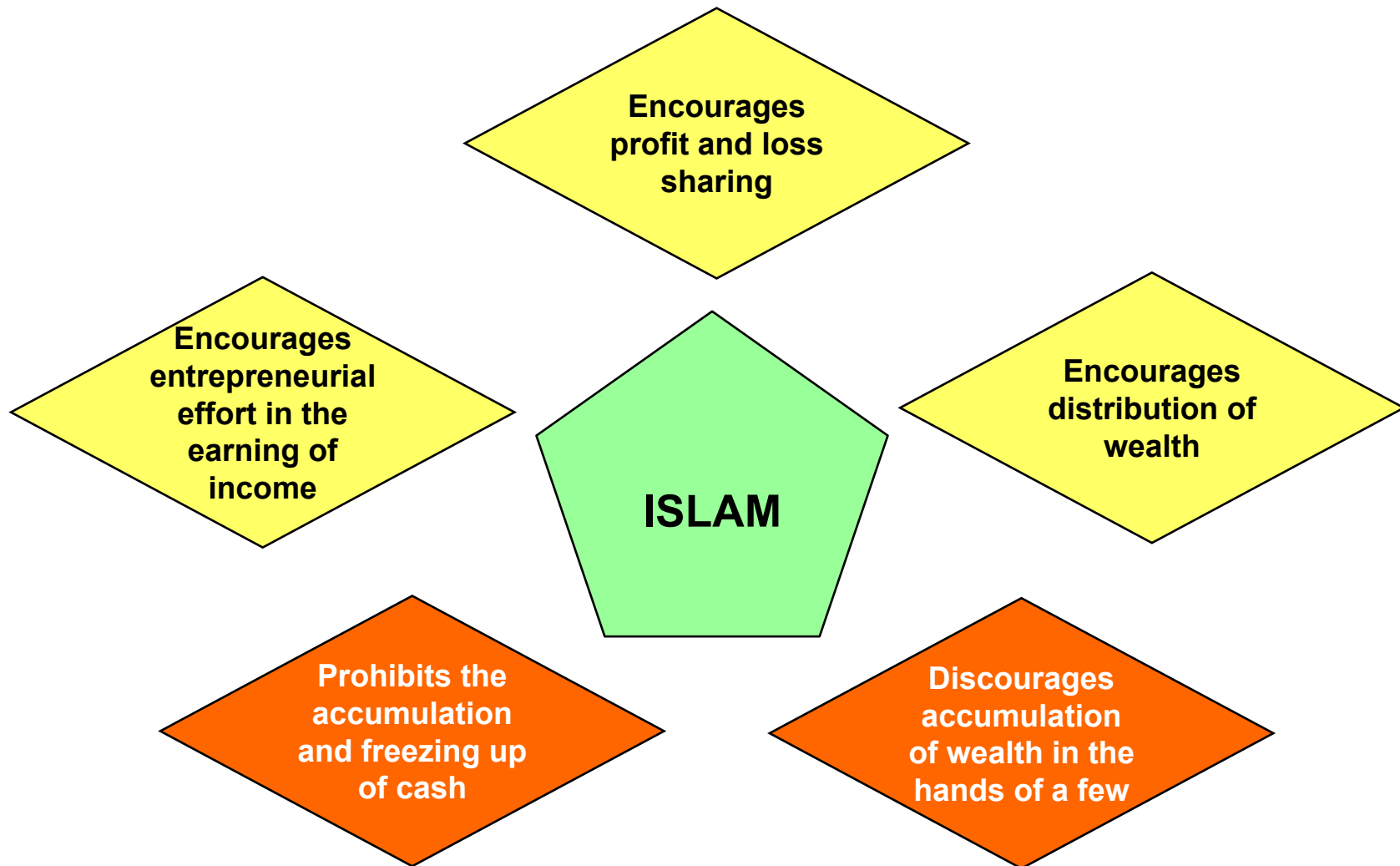
# INTRODUCTION - OVERVIEW OF ISLAMIC BANKING FUNDAMENTALS



### *As an background...*

- Freedom
- Transaction without interest
- Fairness
- Good Service
- Protecting the right of buyer and seller (Transparency in transaction)
- Sincere and Honest
- Hardworking and Dedicated

# THE ECONOMICS BEHIND THE PRINCIPLES OF ISLAMIC BANKING



## ISLAMIC FINANCE SHOULD BE FREE FROM PROHIBITED ELEMENTS SUCH AS...

- x Riba (usury)
- x Gharar (uncertainty / fraud)
- x Tanajusy (conspiracy to create artificial demand)
- x Tadlis al-aib (hiding the defects)
- x Khilabah (manipulation)
- x Khiyanah (fraudulent acts)

“Allah has permitted sale and forbidden riba”

(Al-Baqarah : 275)



## DOCTRINE OF USURY (“RIBA”)

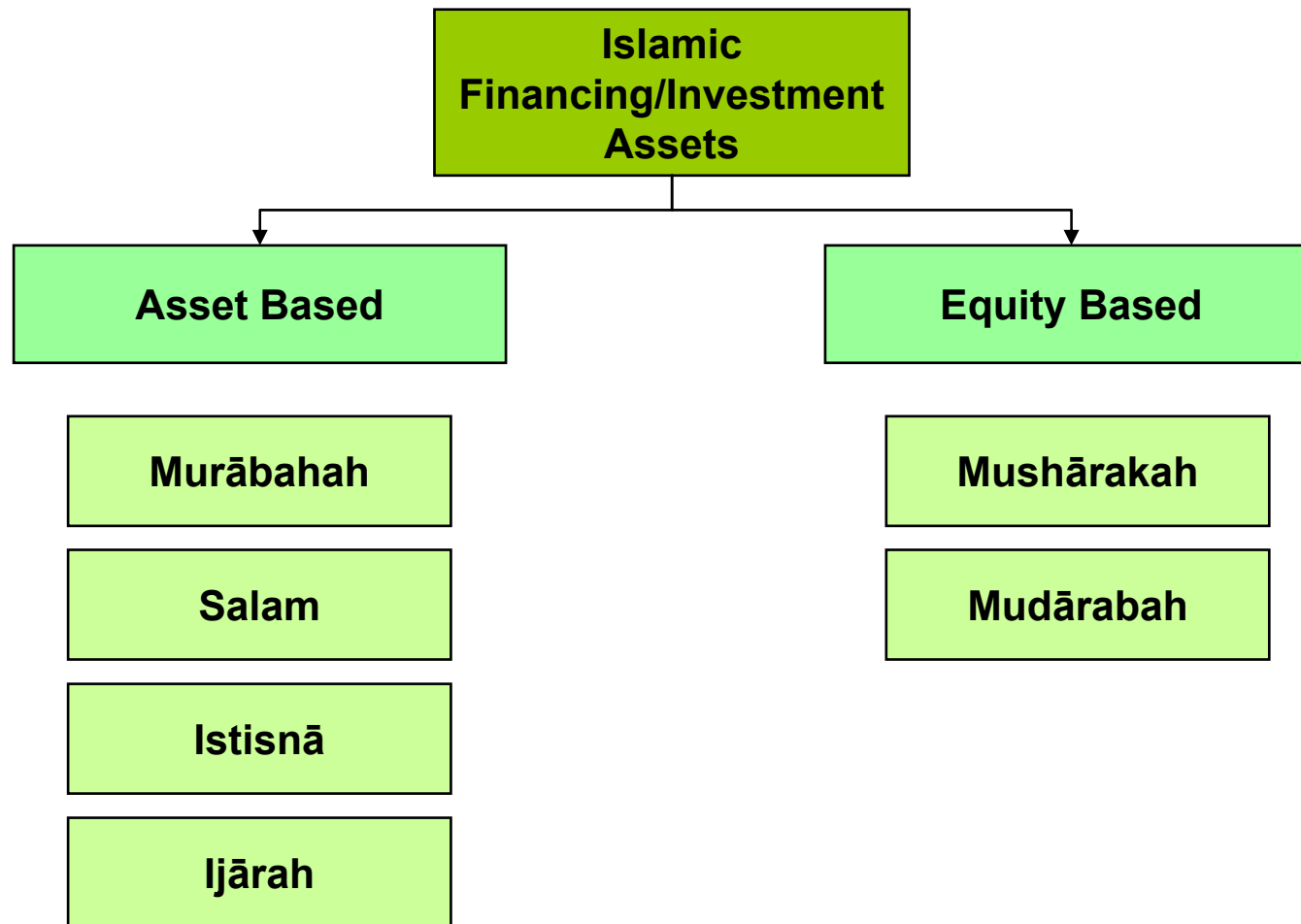
Fundamental principal of Islamic Banking rest on the doctrine of RIBA (usury) which literally means “an increase or excess”.

Islamic Law strictly prohibit any predetermined fixed increase or charge earned on use of one’s money by others.

Derivation of profit from use of capital in business venture is viewed as justified return, while interest arising from lending of money or capital is not.

Islam encourages profit & loss sharing. Reward is only justified when risk of a business is shared by both entrepreneur and the provider of capital

Some of the Islamic Financing/Investment Assets  
(non-exhaustive list)...



## THE MAIN DIFFERENCE BETWEEN ISLAMIC FINANCIAL INSTITUTIONS (IIFS) AND CONVENTIONAL FINANCIAL INSTITUTIONS

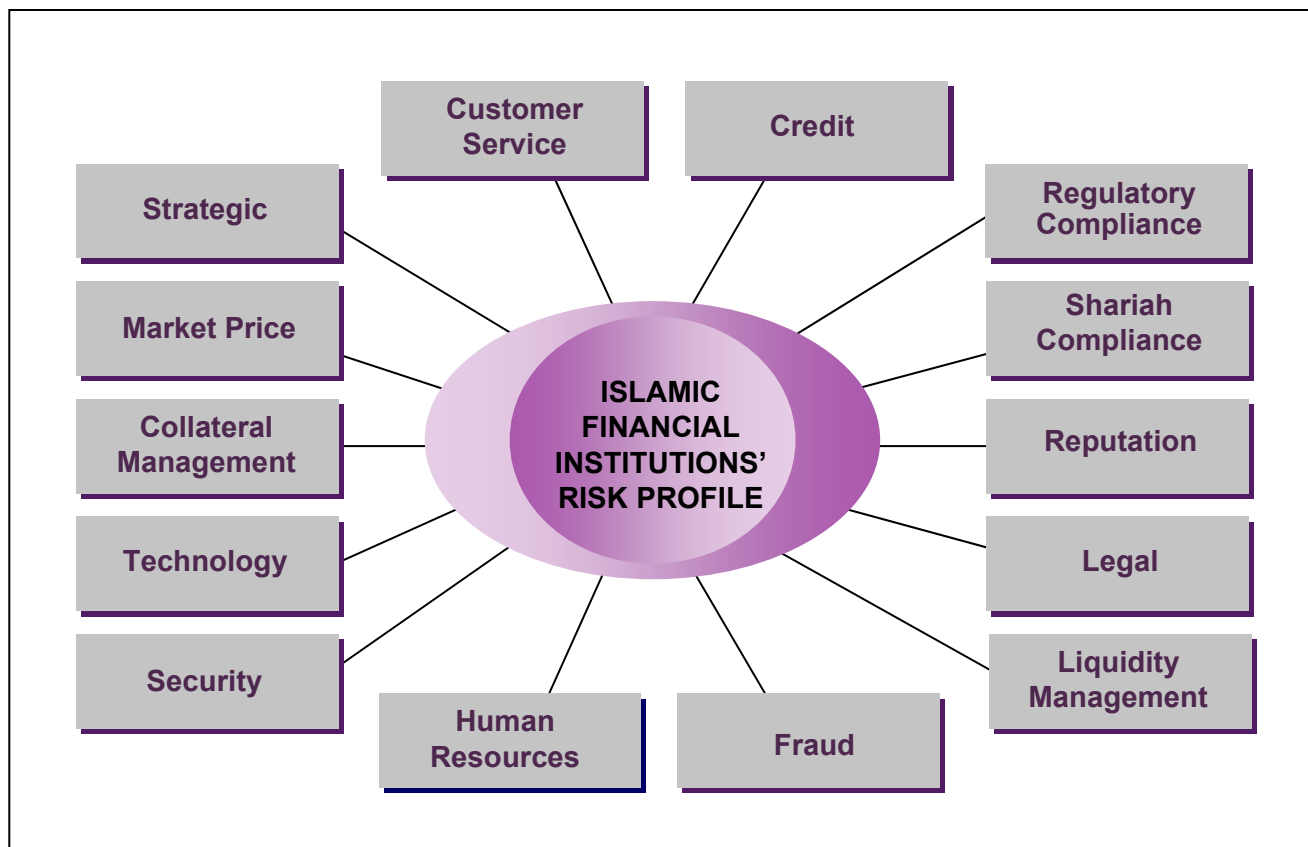
- Can be for same purpose i.e. financing
- Operates in accordance with the Syariah concept (Islamic rules of transaction)
- Uncontaminated by 'riba' (interest)
- Promoting the profit-sharing concept
- Financing based on the trading principle



## INHERENT RISKS IN IIFS



## AN IIFS MAY FACE A MULTITUDE OF DIFFERENT RISKS...



*...these and many others*

An IIFS have to understand its own risk profile which in effect, means identifying and assessing risks, identifying and evaluating controls effectiveness, grouping risks and prioritization of these risks

In identifying these risks, we will be guided by regulatory guidelines, Shariah Rules, Islamic Financial Services Board (IFSB), Islamic Framework on Auditing and Accounting (AAOIFI) and our relevant guidelines

## RISKS ARE INHERENT IN EACH BUSINESS LINE IN A FINANCIAL INSTITUTION AS DEFINED BY BASEL II...

Level 1	Level 2
Corporate Finance	Corporate Finance
	Municipal / Government Finance
	Merchant Banking
	Advisory Services
Trading & Sales	Sales
	Market Making
	Proprietary Positions
	Treasury
Retail Banking	Retail Banking
	Private Banking
	Card Services
Commercial Banking	Commercial Banking
Payment and Settlement	External Clients
Agency Services	Custody
	Corporate Agency
	Corporate Trust
Asset Management	Discretionary Fund Management
	Non-Discretionary Fund Management
Retail Brokerage	Retail Brokerage

## ...AND RISKS ARE INHERENT IN EACH SUPPORTING UNIT...

Supporting Units
Operations
Finance
Information Technology
Human Resources
Administration
Corporate and Strategic Planning
Legal and Compliance
Shariah
Treasury Back Office
etc



## ...THESE RISKS CAN GENERALLY BE GROUPED

Taken from IFSB's classification and short definitions

### Credit Risk

The potential that a counterparty fails to meet its obligations in accordance with agreed terms

### Equity Investment Risk

The risk arising from entering into a partnership for the purpose of undertaking or participation in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business

### Market Risk

The risk of losses in on-and-off balance sheet positions arising from movements in market prices

### Liquidity Risk

The potential loss to IFI arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses

### Rate of Return Risk

The risk is generally associated with overall balance sheet where mismatches arise between assets and balances from fund providers

### Operational Risk

The risk of loss arising from failures in internal controls involving processes, people and systems or from external events

# ONE HAS TO ALSO UNDERSTAND RISKS INHERENT IN THE DIFFERENT ISLAMIC PRODUCTS AND UNDERLYING CONCEPTS

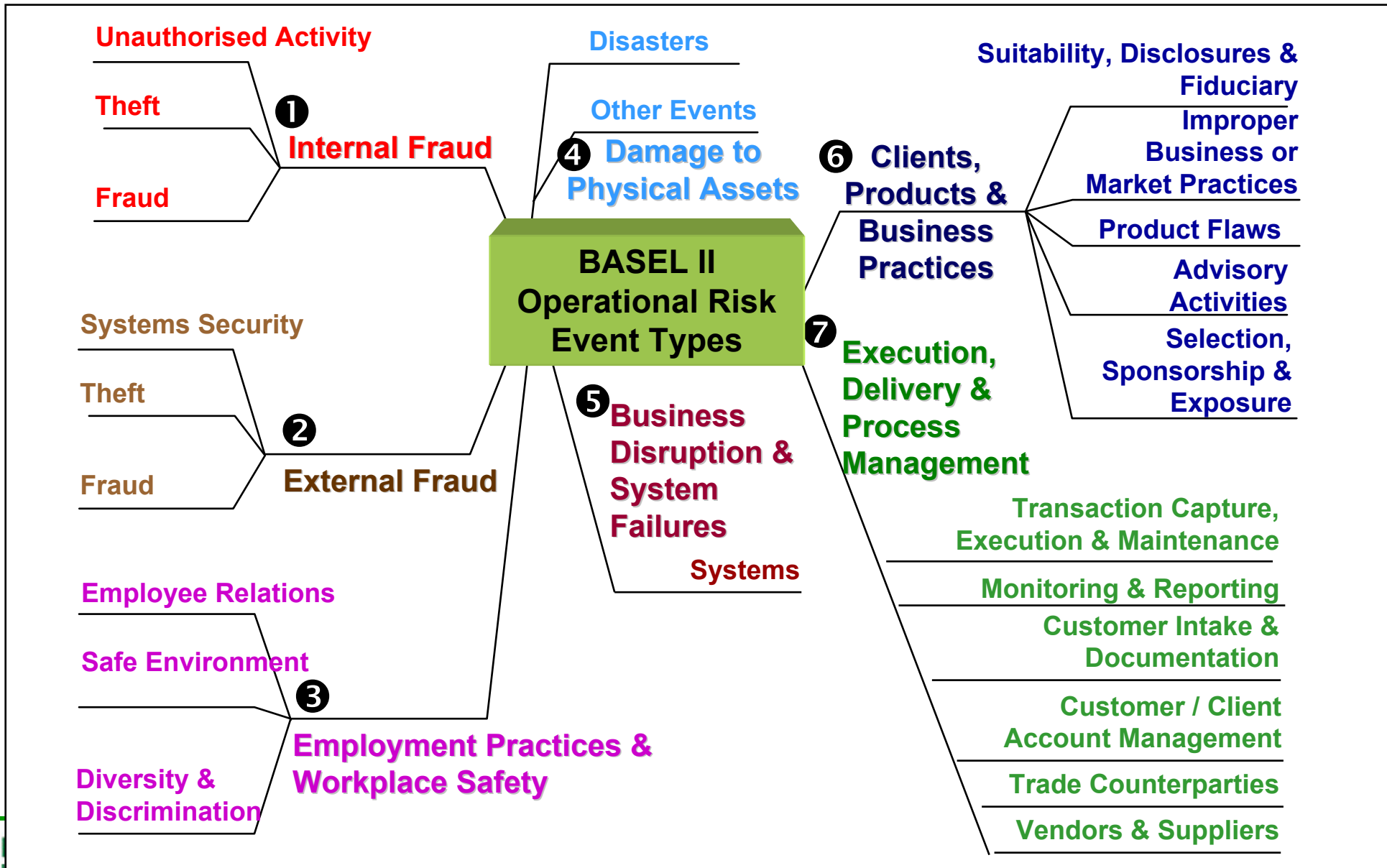
Business Line : Retail

Risk		Product		Home Fin - Completed			Home Fin - Construction			Home Fin - Refin			Car Financing			Equip Fin		Personal Fin	
				Murabahah	IMBT	ITB	Istisna (parallel Istisna)	Istisna and IMBT	Istisna and ITB	IMBT	ITB	Tawarruq	Murabahah	Ijarah (Op Lease)	IMBT (Fin Lease)	ITB (Fin Lease)	IMBT (Fin Lease)	ITB (Fin Lease)	Cash Fin - Tawarruq
<b>Credit Risk</b>	Default		X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	
	Recovery	Collateral																	
		Third Party Guarantees																	
		Documentation / Legal Risk																	
	Delivery																		
	Capital Impairment																		
	International	Country																	
<b>Portfolio Concentration Risk</b>	Economic Sector																		
	Single Name																		
<b>Market Risk</b>																			

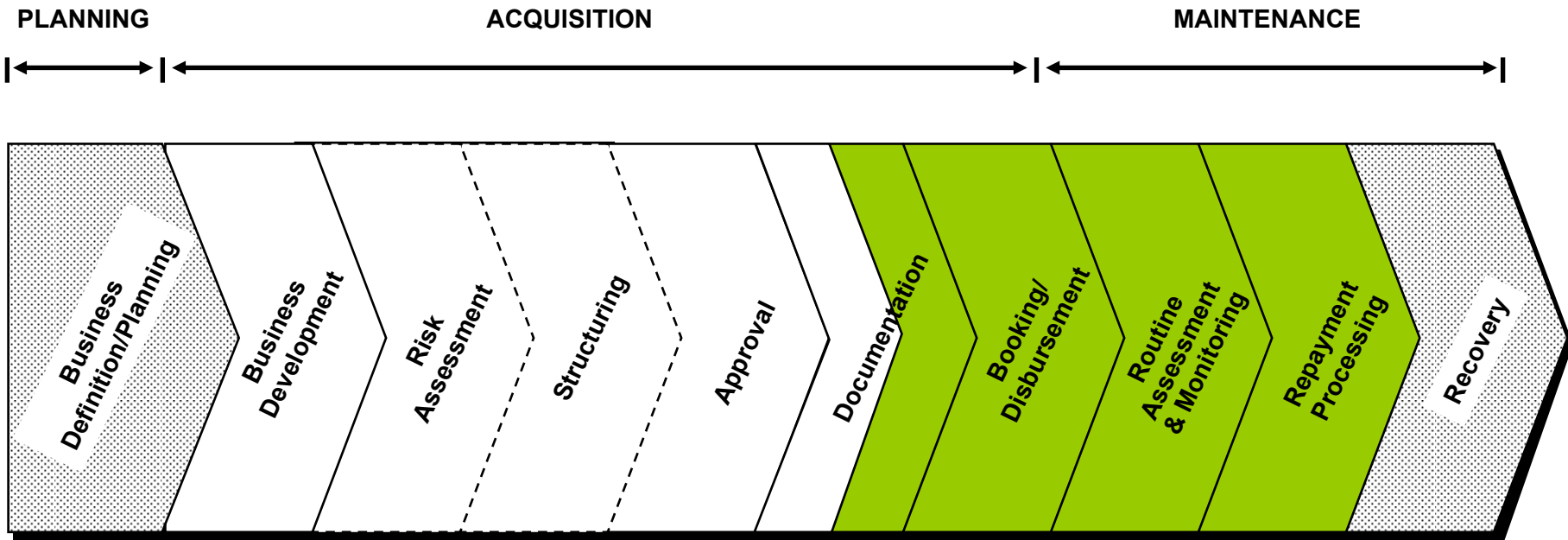
Each Product has its own inherent Credit, Operational and Market Risks and IIFS needs to fully understand the profile of each contract

Note : IMBT : Ijarah Muntahiyah Bi Tamlik    IBT : Ijarah Thumma Bai    QH : Qardh Hasan

# ...AND THE INHERENT OPERATIONAL RISKS IN THE PROCESSES/ACTIVITIES



# IN A TYPICAL CREDIT VALUE CHAIN ARE MANY OPERATIONAL RISKS



## Some of the key areas of concern leading to Operational Risks in the Credit Process

Staff lack of skills	Lack of Segregation	Unauthorised Approval	Documentation Error	Loss of Security Documentation
Poor Customer Services	Poor credit assessment templates	Internal Fraud	External Fraud	Poor credit training program

# PRUDENTIAL AND ROBUST RISK MANAGEMENT FRAMEWORK



# IFSB RECOGNISES THE DIFFERENT TYPES OF RISKS IN IIFS AND HAVE DEVELOPED PRUDENTIAL STANDARDS FOR IIFS



For prudential management of IIFS, IFSB is responsible for setting out and recommending standards and guidelines.

IFSB standards are meant to compliment Basel standards and are not to replace Basel standards.

Currently, the IFSB has issued three **Standards**:

- Risk management;
- Capital adequacy; and
- Corporate Governance

Two other standards are under discussion:

- Disclosure and Transparency; and
- Supervisory Review Process.

## SPECIFICALLY DEFINED IFSB STANDARDS FOR RISK MANAGEMENT

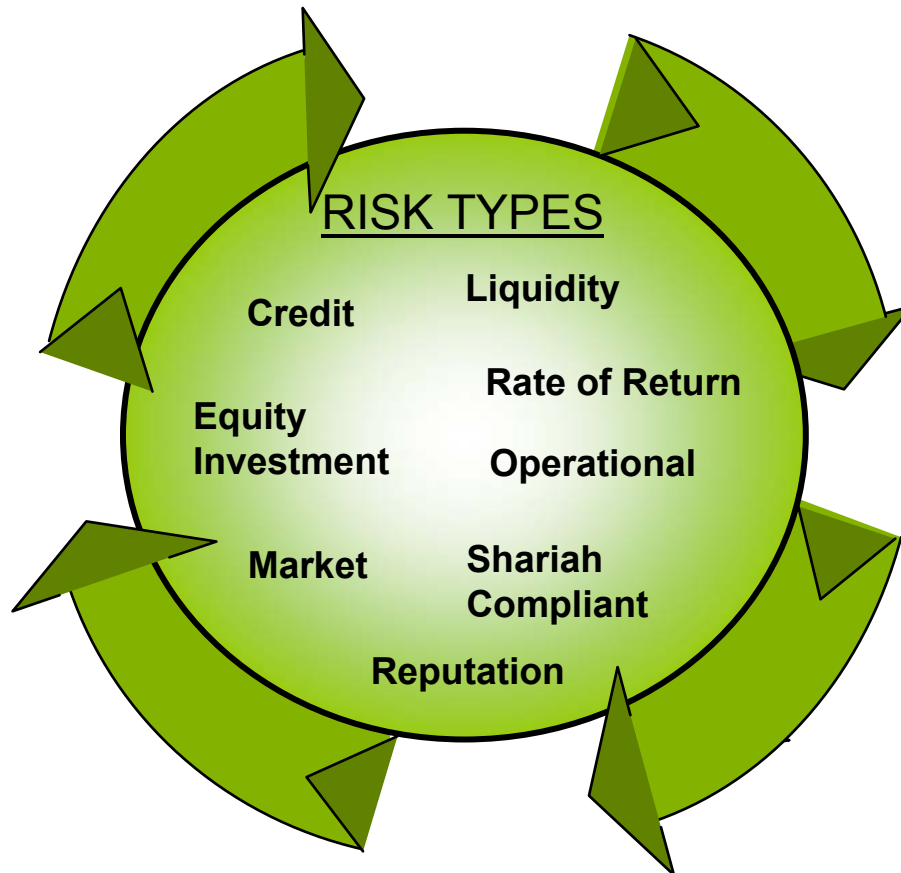
IIFS need to have in place a comprehensive risk management framework covering:

- Comprehensive risk management and reporting process
- Credit risk strategy, due diligence review, measuring and reporting, and mitigation
- Equity investment risk characteristics, valuation methodologies and exit strategies
- Market risk framework
- Liquidity risk
- Rate of return risk
- Operational risk

## TO MANAGE THE MULTITUDE OF RISKS IN AN IIFS, THERE IS A NEED TO HAVE A ROBUST RISK MANAGEMENT FRAMEWORK TO ...

- Assist management to minimise the likelihood of unexpected damage to:
  - earnings
  - reputation or
  - investors, business associates, customers and staff confidence
  
- Contribute to:
  - greater operational effectiveness and efficiency
  - better understanding of risks
  - better decision-making
  
- Promote a more risk-aware organisation culture which will add additional value to the business

# THE RISK MANAGEMENT FRAMEWORK NEEDS TO CAPTURE ALL RISK TYPES AND EVERY COMPONENT MUST BE INTEGRATE



Components of the Framework covering:

- Risk Strategy
- Risk Policies
- Risk Structure
- Risk Tools and Analytics
- Risk IT Infrastructure
- Risk Reporting

Development of a Risk Strategy includes...

- Documenting a statement of risk strategy aligned to the Business Strategy of the Bank
- Establishing the risk appetite and tolerance of the Bank
- Setting out the methodologies to calculate risk capital i.e. Economic Capital, Regulatory Capital
- Ensuring there is risk capital to support all the Business Activities
- Setting out the methodologies in measuring risks – credit, market, operational etc
- Identifying and evaluating all risks in the business activities
- Identifying the need for key risk policies and the key fundamentals in each policy

### The key Risk Policies relevant to IIFS:

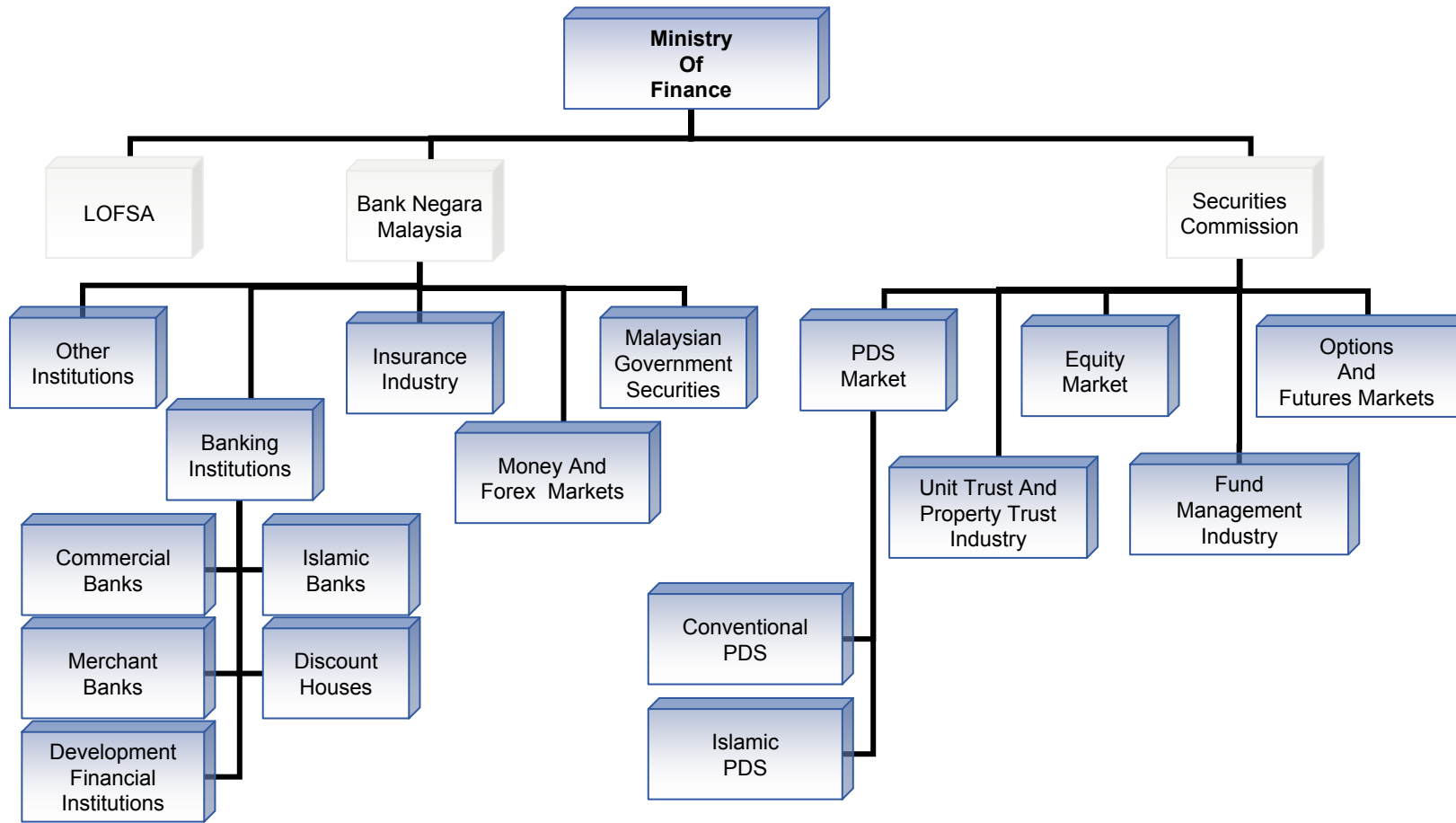
- Credit Risk Management Policies – Corporate, Commercial, SMEs, Retail, etc
- Market Risk Management Policy
- Operational Risk Management Policy
- Asset Liability Management Policy
- Treasury Investment Policy
- Treasury Trading Policy
- Trading Policy (for non Treasury i.e real estate)
- Investment Policy (for non Treasury i.e. real estate, funds)
- IT Risk Management Policy
- Code of Ethics and Conduct
- And many other Operational Policies

All Policies should take into account local prudential standards i.e. BNM and be structured to International practice standards i.e. BASEL II, IFSB

An example of a ***credit risk policy*** and the key components ...

- Governance (Define **Regulatory Authorities**, Shariah Compliance, Policy Responsibility etc)
- Accountability and Authority (Define roles and responsibilities of Board, Risk Management Committees etc)
- Types of Financing
- Target markets
- Risk Management and Control Principles
- Origination, Evaluation, Approval, Administration (Authority, Segregation of Duties, Limits, Risk Rating, Scoring etc)
- Customer and Portfolio Management
- Problem Management
- Financing Loss Provision

An IIFS must have a clear understanding of the regulatory framework



## ...and key Legislative Requirements

<p><b>Central Bank of Malaysia Act 1958 (Revised 1994)</b></p>	<ul style="list-style-type: none"> <li>▪ Provides for the administrative and objectives of BNM.</li> <li>▪ Enumerates the powers and the duties of BNM to issuance currency, maintenance of external reserve, authorised business of the bank, specific powers to deal with ailing institutions, etc.</li> </ul>
<p><b>Banking and Financial Institutions Act 1989</b></p>	<ul style="list-style-type: none"> <li>▪ Provides for the licensing and regulation of institutions (carrying on banking, finance company, etc.) and scheduled business (credit and charge card companies, leasing company, etc.)</li> </ul>
<p><b>Exchange Control Act 1953</b></p>	<ul style="list-style-type: none"> <li>▪ Restrict dealings in gold and foreign currencies, payments to and from residents, issuance of securities outside Malaysia, imports and exports and settlements.</li> <li>▪ Empowers the Controller for Foreign Exchange</li> </ul>
<p><b>Development Financial Institutions Act 2002 (Act 618)</b></p>	<ul style="list-style-type: none"> <li>▪ Focuses on development financial institutions (DFI) to ensure that the roles, objectives and activities are consistent with the Government policies and that the mandated roles are effectively and efficiently implemented.</li> <li>▪ Emphasizes on efficient management and effective corporate governance, provides a comprehensive supervision mechanism to strengthen the financial position of DFIs.</li> </ul>

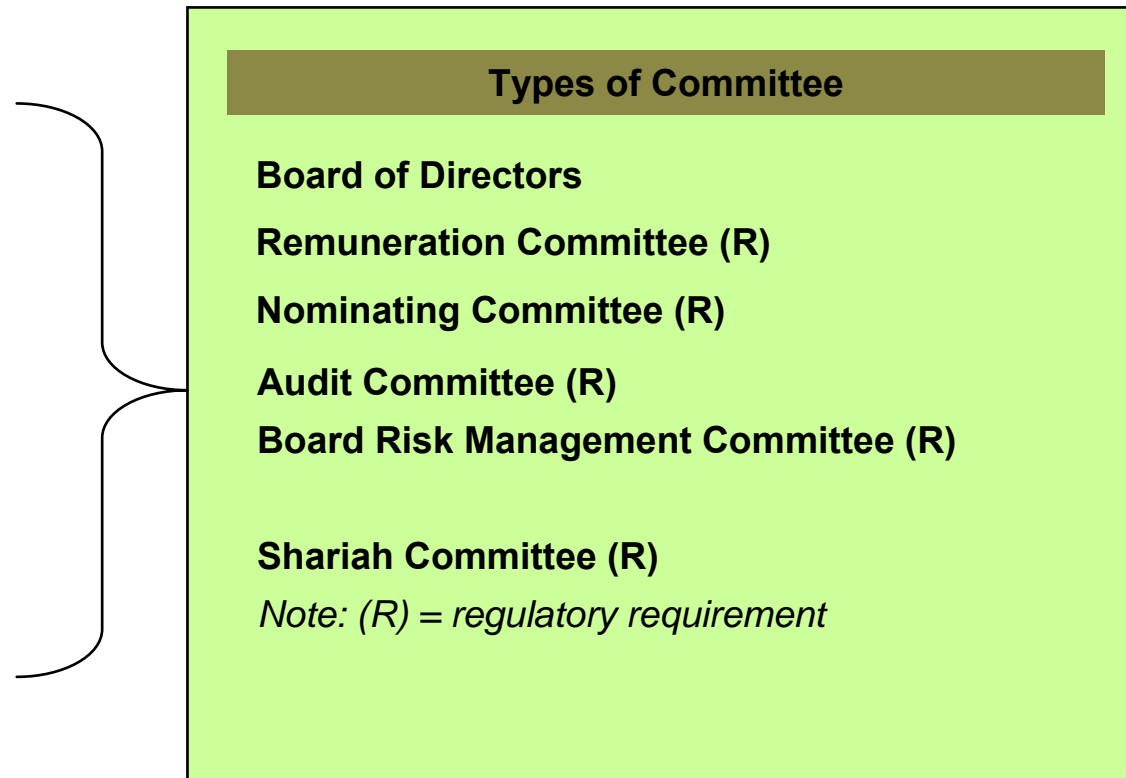
<p><b>Anti-Money Laundering Act 2001 (Act 613)</b></p>	<ul style="list-style-type: none"> <li>▪ Criminalises money laundering of proceeds from the predicate offences and provides for suspicious transaction reporting, record-keeping and the functions of a financial intelligence unit.</li> <li>▪ Provides for investigation into money laundering activities, law enforcement agencies to freeze, seize and forfeit proceeds from predicate offences as well as prosecution of money launderers</li> </ul>
<p><b>Payment System Act 2003 (Act 627)</b></p>	<ul style="list-style-type: none"> <li>▪ Make provisions for the regulation and supervision of payment systems and payment instruments and for matters connected therewith.</li> </ul>
<p><b>Companies Act 1965</b></p>	<ul style="list-style-type: none"> <li>▪ Make provisions to banking institutions that are incorporated as public companies.</li> </ul>
<p><b>Hire Purchase Act 1967</b></p>	<ul style="list-style-type: none"> <li>▪ Regulates the form and contents of hire purchase agreements and the rights and duties of parties to such agreements.</li> </ul>

## Cont'd ...key Legislative Requirements

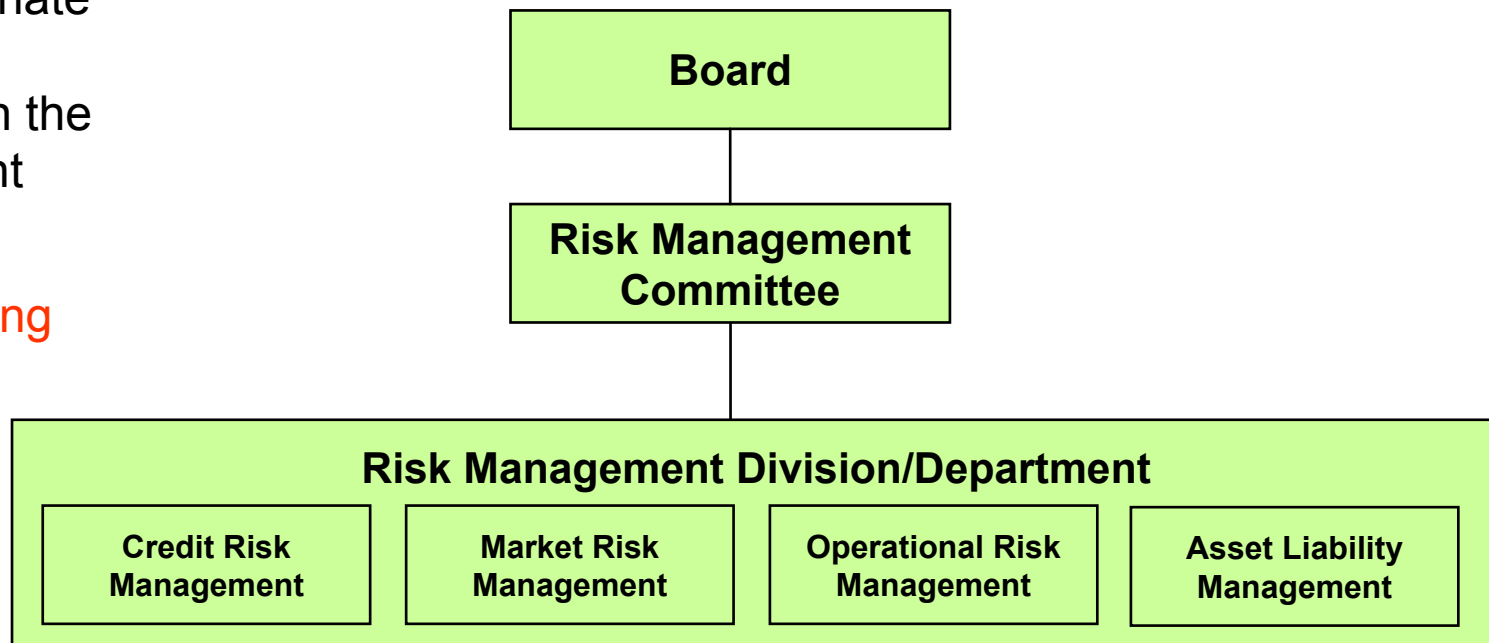
<p><b>BNM Garis Panduan, circulars and letters</b></p>	<p>GP 1 – Guidelines on Directorship in the Banking Institutions</p> <p>GP 2 – Guidelines on Submission of Annual Accounts</p> <p>GP 3 – Guidelines on the Suspension of Interest on NPLs &amp; Provisions for Bad &amp; Doubtful Debts</p> <p>GP 4 – Guidelines on Staff Training Fund</p> <p>GP 5 – Guidelines on the Credit Limit to a Single Customer</p> <p>GP 6 – Prohibition of Loans to Directors, Staff and their Interested Corporations</p> <p>GP 7 – Code of Ethics: Code of Conduct for Directors, Officers and Employees in the Banking Industry</p> <p>GP 8 – Guidelines on the Specimen Financial Statements for the Banking Industry</p> <p>GP 9 – Money Laundering &amp; “Know Your Customer Policy”</p> <p>GP 10 – Guidelines on Minimum Audit Standards for Internal Auditors of Financial Institutions</p>	<p><b>Islamic Banking Act 1983</b></p>	<ul style="list-style-type: none"> <li>▪ Provides BNM with powers to supervise and regulate Islamic banks.</li> <li>▪ Provides for the licensing and regulation of Islamic banking business.</li> </ul>
		<p><b>BNM GPs-i</b></p>	<ul style="list-style-type: none"> <li>▪ Equivalent to the BNM Garis Panduan but specific to Islamic Banking Institutions.</li> </ul>
		<p><b>MASB1-i</b></p>	<ul style="list-style-type: none"> <li>▪ Provides guidelines on presentation and disclosure of financial statements.</li> <li>▪ To recommend the application of accrual accounting to Islamic banks as the Benchmark method and cash accounting as the alternative method.</li> </ul>

Based on the understanding of the Regulatory Framework, Legislative Requirements and the IIFS's Business Model, an IIFS will need to develop a robust risk organisation structure for oversight

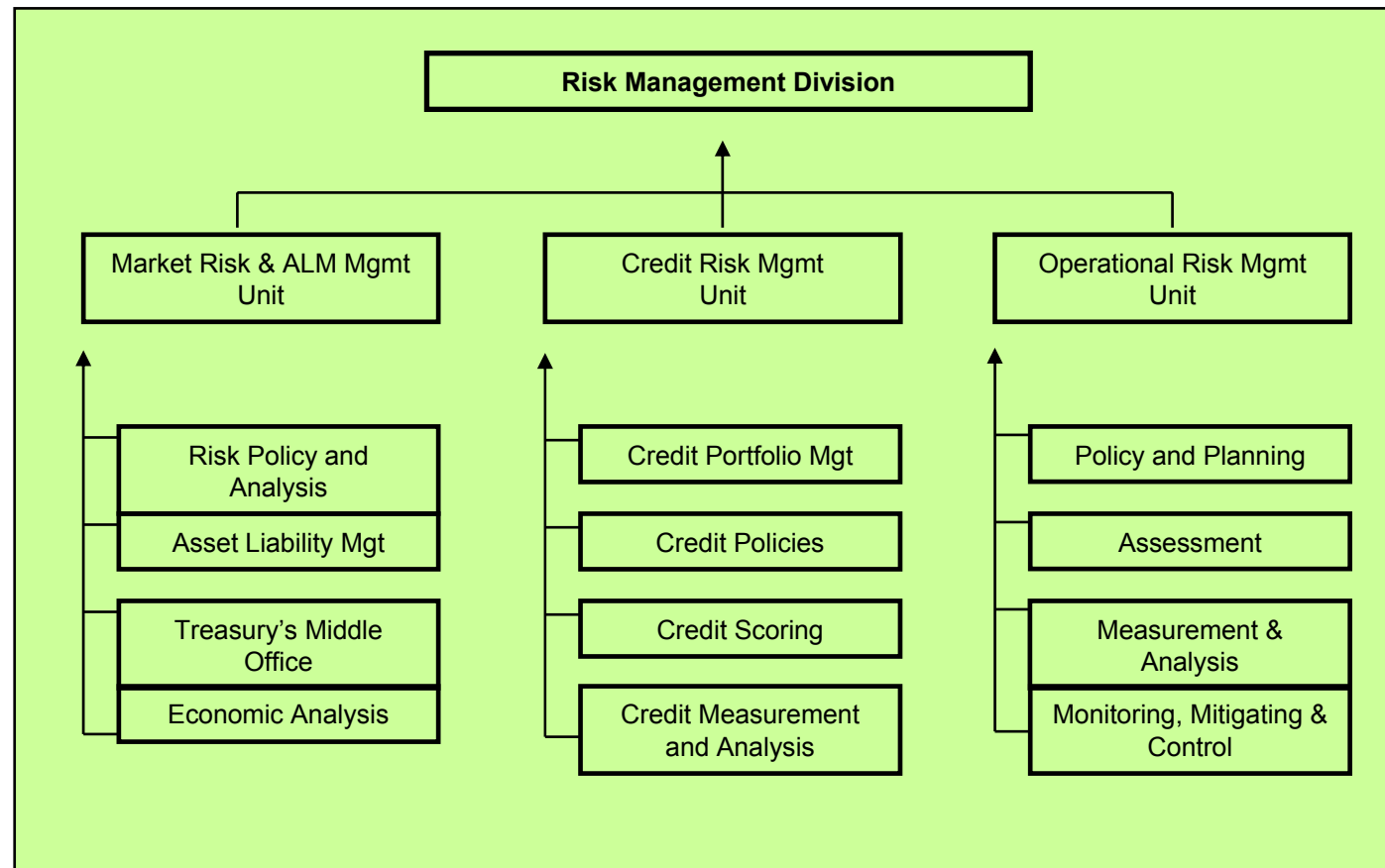
- Set up the appropriate **Governance Structure** to assist in the risk oversight
- Set up and clearly define the **Mandates** of the Committees



- Set up the appropriate risk organisation structure to assist in the overall risk oversight
- Set up **clear independent reporting lines**

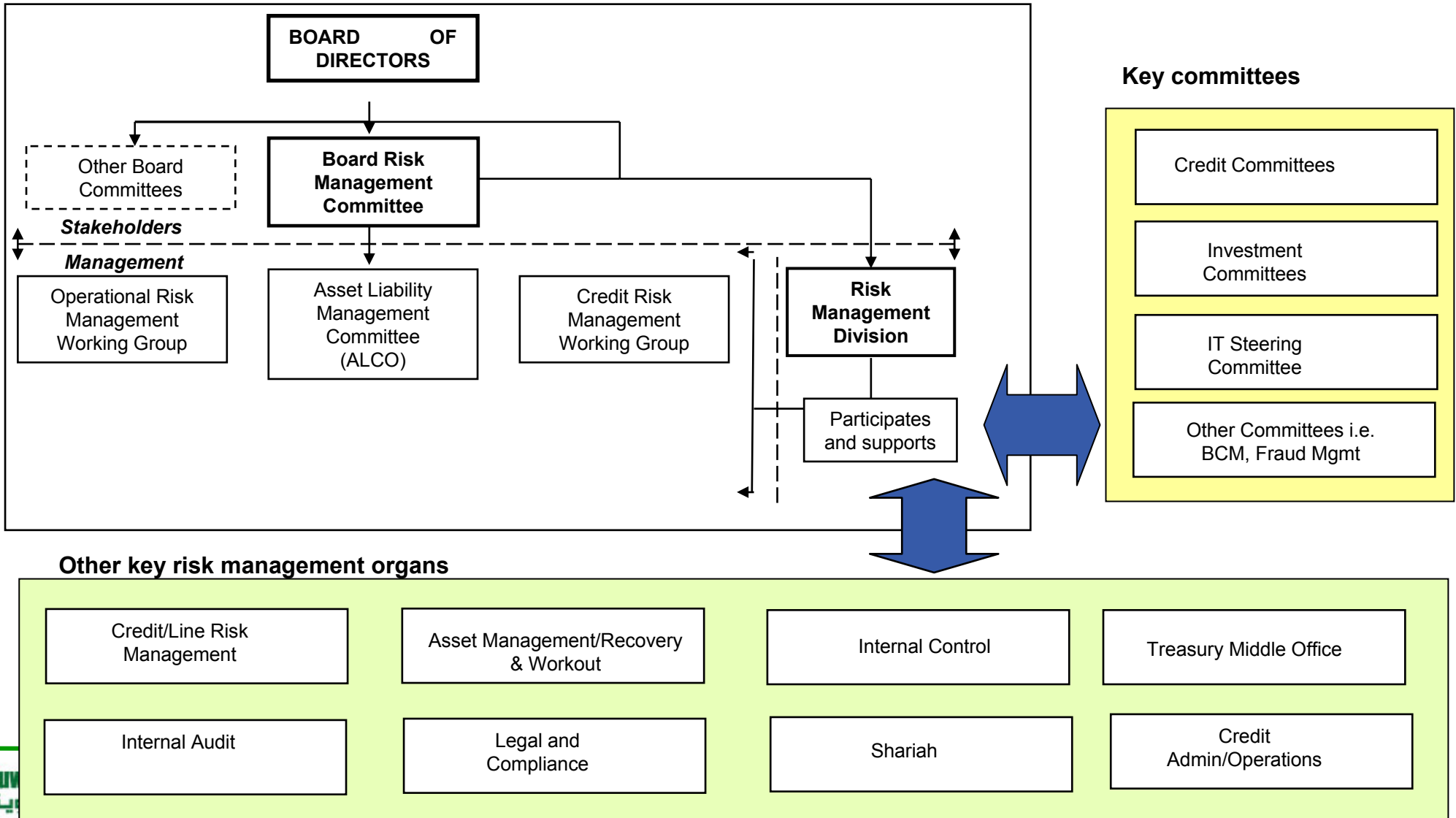


- Define the **role of Risk Management**
- Set up the roles and responsibilities of each **risk management function**




Define the Risk Structure to include  
**critical links with all risk related  
 Functions and Committees**

## RISK STRUCTURE



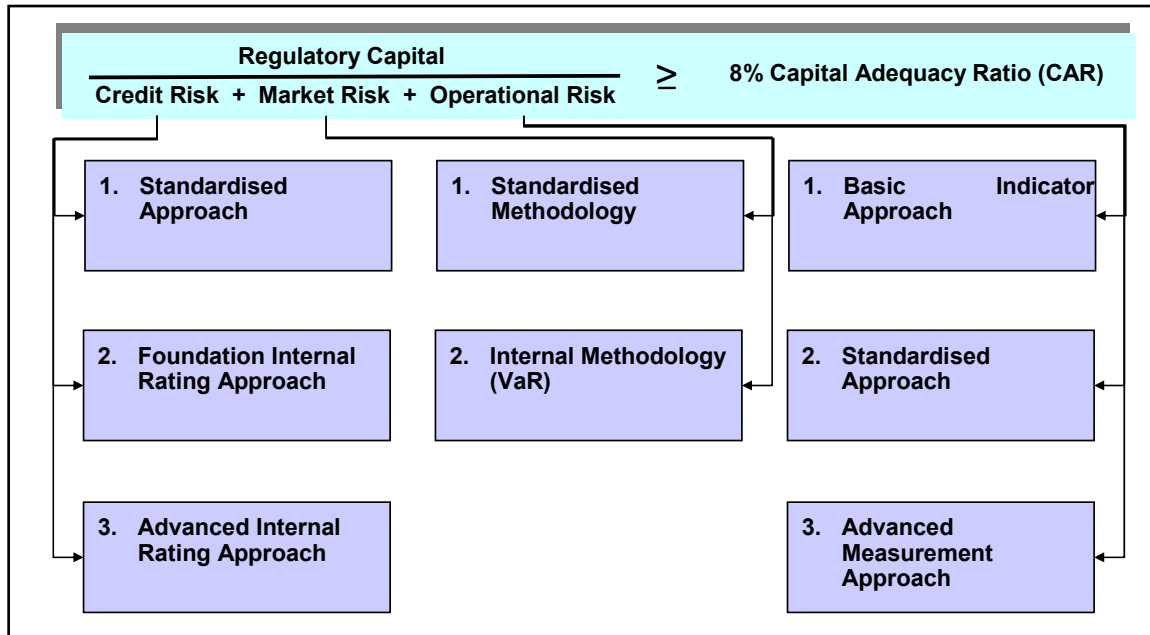
## Risk Tools and Analytics are:

- *Selecting the appropriate risk quantification approaches*
- *Setting risk limits* 
- *Utilising risk models, such as risk rating and credit scoring models or VaR*
- *Understanding assumptions and limitations*

Limits should include the following ...

Single/Group Exposure Limit  
Substantial Exposure Limit  
Industry Exposure Limit  
Regional Exposure Limit  
Credit Grade-wise Exposure Limit  
Tenor-wise Exposure Limit  
Product-wise Exposure Limit  
Unsecured Exposure Limit  
Off Balance Sheet Exposure Limit Bank  
Exposure Limit  
Domestic Banks  
International Banks  
Country Exposure Limit

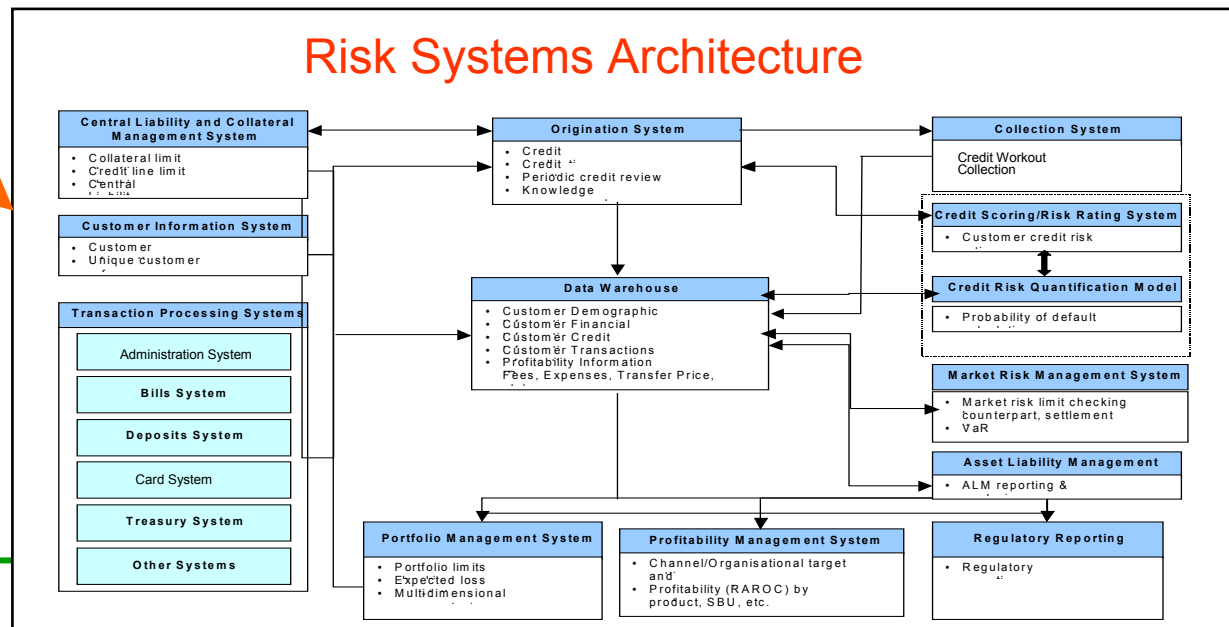
# Risk Capital Calculation



# RISK IT INFRASTRUCTURE

Based on the selected approaches and risk management intention, IIFS to set up appropriate IT infrastructure to support the risk management initiative

# Risk Systems Architecture

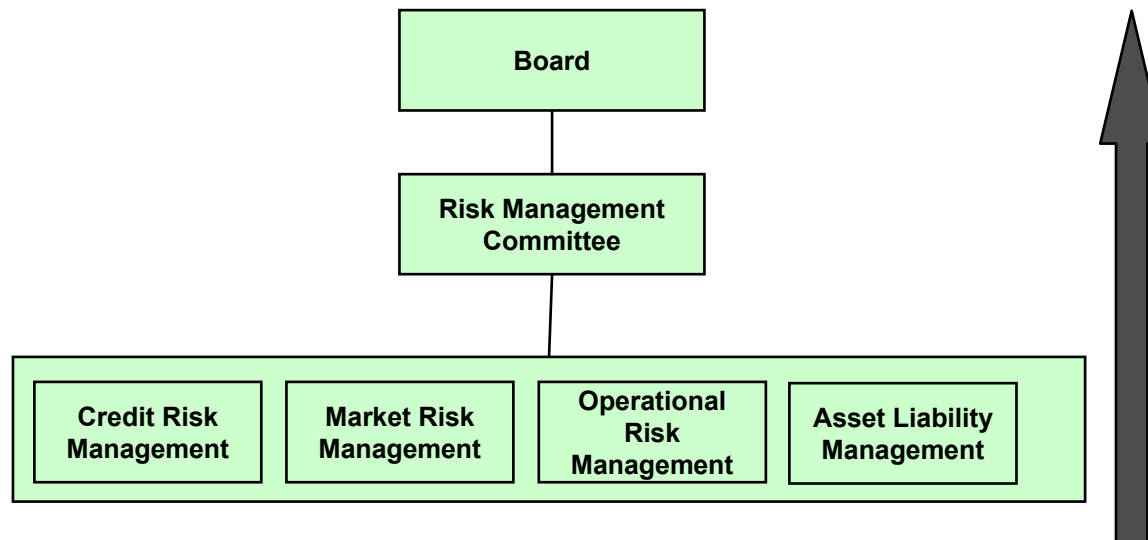


# RISK REPORTING

Providing accurate and timely risk reports to top management and Board in order for them to make inform decisions

Report should include at a minimum...

- Key Risk Indicators
- ALCO reports covering Repricing and Liquidity Risk Profiles
- Industry and Sectoral Tracking
- Assets Quality Profile and Trends
- Impaired A/Cs tracking
- Total Financing and Investment Portfolio
- Key Operational Risks tracking
- Risk Capital Calculations



## CASE STUDY – INHERENT RISKS IN A BUSINESS ACTIVITY AND RISK MITIGATION



We will take an example of Mushārah contract in Commercial Banking

Mushārah

Level 1	Level 2
Commercial Banking	Commercial Banking
Payment and Settlement	External Clients
Agency Services	Custody
	Corporate Agency
	Corporate Trust
Asset Management	Discretionary Fund Management
	Non-Discretionary Fund Management
Retail Brokerage	Retail Brokerage

### Shariah Principle: *Mushārahkah* (Sharing)

#### Definition of concept:

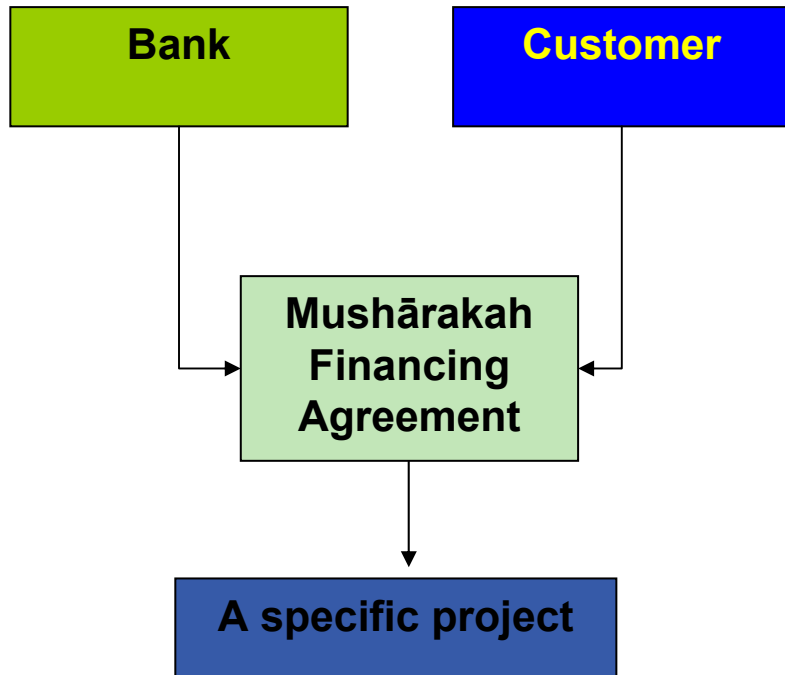
- (1) Financing for a business venture provided by IIFS to its select customer based on a **partnership** agreement.
- (2) **Both parties** will contribute capital.
- (3) **Both parties** will share profit and loss at a pre-determined ratio.

#### Types of Mushārahkah:

- (1) **Joint-venture or partnership** basis which is based on Joint-account and without formation of any separate entity; or
- (2) **Equity participation** which involves the incorporation of a joint-venture limited company under the Companies Act.

## SOME KEY FEATURES OF MUSHARAKAH

### Product Modus Operandi – Joint-Venture (JV) Arrangement

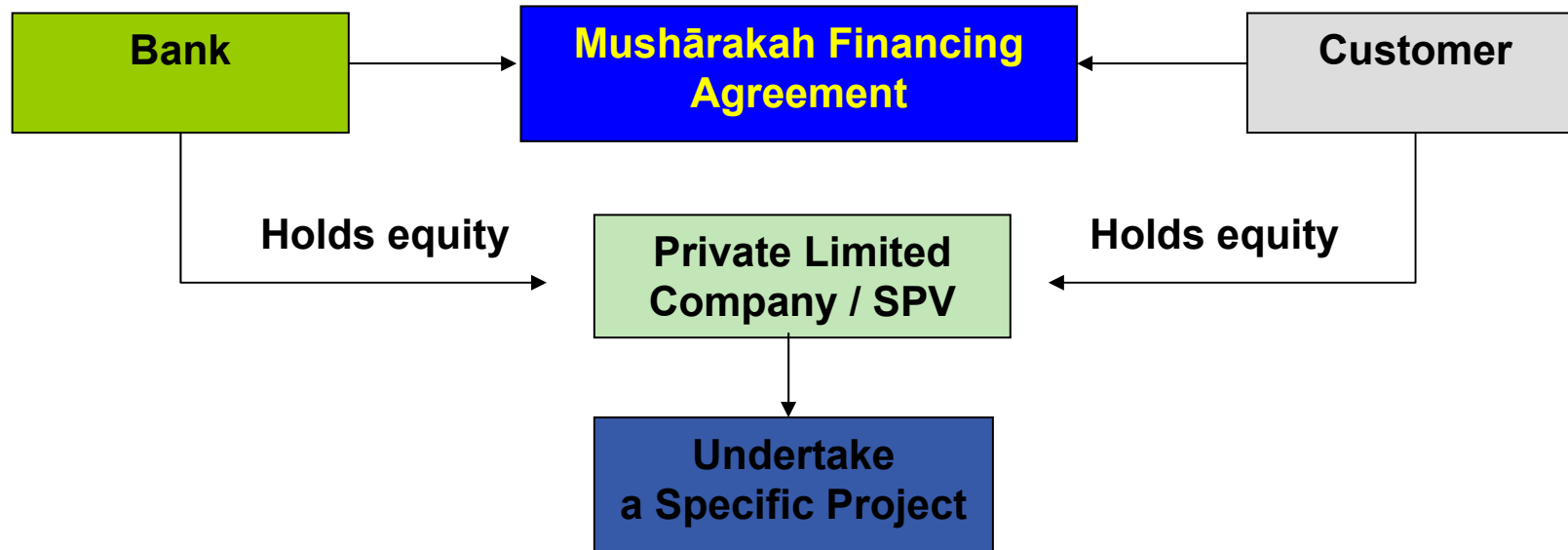


- Formation of the Musyarakah for a particular project is via a **Mushārahah Financing Agreement**.
- Financing to be disbursed either in one lump sum or progressively, directly into a Project Account.
- Project Account will be **under the name of the customer**, the **operations of the account** will be jointly authorized by the Bank and the customer.

- Less costly, less formality and statutory requirements, and shorter time to form this arrangement.
- It is suitable for a **short-term** or **small project**.
- The Financial Institution can have **maximum** and **direct control** of the project.

## SOME KEY FEATURES OF MUSHARAKAH

### Product Modus Operandi – Equity Participation Arrangement



IIFS and customer will **form a corporate vehicle** which will undertake a specific project.

The **management** of the corporate vehicle will be appointed by the **two parties** to represent their respective interests and to ensure the success of the undertaken project.

## POTENTIAL KEY RISKS AND RISK MITIGANTS

Apart from the normal credit counterparty risks, these are some specific risks to Mushārahah Financing to consider:

### Risks

#### Capital Impairment Risk

As an equity investor there is a risk of losing its capital

### Mitigants

Can structure to 2 parts – Small Equity portion and Financing

The invested capital can be small in relation to the Mushārahah Financing. The invested capital is redeemable either by liquidation of the Mushārahah assets at the end of the contract or as mutually agreed or upon divestment of partnership

#### Entrepreneurial Risk as an active partner

1. Losses are to be borne by the Bank and its partners according to the loss sharing ratio
2. No fixed rate of return

Losses are limited to the capital since this is a limited company

Internal Rate of Return are computed based on projected cash-flow. Profits may be recognised based on cash-flow and adjusted on a periodic basis i.e. annually or semi annually

## POTENTIAL KEY RISKS AND RISK MITIGANTS

### Risks

#### Ranking

As an equity investor, serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

### Mitigants

#### Ranking - Equity

Need to have stringent customer selection and IIFS should only deal with very reputable real estate development companies with good track record. Customer fits this category. Equity portion is small in relation to overall.

#### Ranking - Financing

The Financing Portion can be a much larger portion to the fund raising exercise, and is ranked similar to conventional unsecured creditors/loans

## POTENTIAL KEY RISKS AND RISK MITIGANTS

### Risks

#### Unlimited Liability

The liability of the partner in joint-venture agreement is unlimited but covers all debt of the project which exceeds the contributed capital of the project

### Mitigants

#### Unlimited Liability

The SPV should be a limited company, in essence this would remove any element of the unlimited liability.

#### Misused financing

The financing may be misused by the customer as it is not being used for the intended purpose

#### Misused financing

Negative covenants and other restrictions will be set to ensure that the financing be used only for specific purposes. Otherwise, the financing will be recalled. Indemnity Letter will be executed where if there is fraud or breach of contract, the customer will indemnify IIFS.

IIFS's participation in the Board gives us control over the flow of funds

## POTENTIAL KEY RISKS AND RISK MITIGANTS

### Risks

#### Reputation

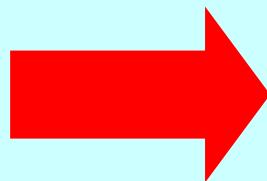
The failure of the joint-venture may bring/create adverse publicity for the Bank

### Mitigants

#### Reputation

This risk can have great impact on the Franchise name and that is the reason why this type of JV is limited only to very reputable and established companies

#### **Additional Mitigant**



#### Board Representation

In the case of JV Limited Company, IIFS will be represented on the Board of Directors in all its strategic decision making, except for financing. This is a good risk mitigant as IIFS is fully aware of the condition of the project.

THANK YOU

