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Risk Management and Compliance

This CIBAFI briefing will review recent developments in bank risk management and compliance, taking into consideration global initiatives that affect Islamic banks as well as initiatives that have arisen from within the Islamic banking industry itself. It will also suggest some areas of focus for the Shariah-compliant industry as a whole and for individual Islamic banks as they look to develop their risk management and compliance functions in the years ahead.

The growth of risk management and compliance functions has been one of the most significant trends in global banking over the last few years. It has been driven in large part by new banking regulations and by enhanced banking supervision that followed the global financial crisis.

As participants in the global banking system, Islamic banks have been strengthening their risk management and compliance functions in parallel with their conventional peers; but the growth of risk management and compliance within Islamic banks has also been prompted by the continuing expansion of the Shari'ah compliant industry and the development of new financial instruments.

In January 2016, CIBAFI organised an international seminar on risk management and compliance in Islamic financial institutions. The seminar drew together regulators, bankers, and others who are involved in the development of risk management and compliance functions at Islamic banks.

The role of risk management and compliance within the management structure

Risk management has historically been seen as the second line of defence' within a bank's internal control system: the first line is the business units, who are responsible for identifying and managing the risks that they incur, and the third line is internal audit, which stands outside the management structure of a bank and provides an independent assessment of the effectiveness of a bank's internal controls.

The risk management department operates independently of the business lines, though it is part of the management structure of the bank. It provides advice to business units and senior management, and assesses the risks that the bank is facing, offering both a more specialised perspective and one that looks beyond individual business units to encompass the full range of a bank's activities.

This view of risk management's position within a bank's internal control structure has not changed significantly in recent years, despite the upheavals caused by the global financial crisis.

What has been changing is the relationship between the risk management function and the rest of the senior management team, and between the risk management function and the board of directors. In simple terms,

International standard setters now expect to see greater interaction between the Board of Directors and the risk management function, and correspondingly greater independence from senior management and in particular from the chief executive officer.

The compliance function sits alongside risk management within the second line of defence. In the last few years, compliance has grown rapidly to become a significant force within a bank's internal control structure. This growth has been driven by the huge increase in regulation in recent years and by the willingness of regulators to impose large penalties for non-compliance. In emerging markets, the compliance function is crucial in helping banks maintain correspondent banking relationships by demonstrating their implementation of international standards related to the fight against financial crime and their compliance with international sanctions.

Changing Risk Landscape

Credit, market and operational risks remain central to banks' thinking on risk management, not least because risks in these three areas drive regulatory capital requirements under Pillar 1 of the Basel Accords.

Changes to banks' credit and market risk management have primarily arisen in response to external initiatives, such as Basel II and III, which, inter alia, are transforming the way in which banks assess non-performing loans and make provisions against them; and the Basel Committee's Fundamental Review of the Trading Book, which sets higher capital standards against certain types of market risk[1].

Thinking on liquidity risk management is receiving much greater attention than before as a result of the new liquidity standards introduced in the Basel III Accord (the Liquidity Coverage Ratio and the Net Stable Funding Ratio), and the greater focus that supervisors are giving to liquidity as part of the Pillar Two supervisory review process. Banks in the European Union must now show supervisors their Internal Liquidity Adequacy Assessment Process (ILAAP), alongside the longer-standing Internal Capital Adequacy Assessment Process (ICAAP).

There is also a range of new risks that are receiving greater attention now than in the past. These include, for example, the risk that banks will fall victims to cybercrime; the risk that they will inadvertently breach economic sanctions on countries, companies and individuals; the risk that the way in which their employees behave will be deemed inappropriate or that their behaviour will breach internal codes of professional conduct; and reputational risks arising from a variety of other factors.

Some of the biggest risk-related losses reported by banks in recent years have arisen as a result of these new risks. For example, in June 2014, BNP Paribas paid US$8.9 billion in penalties to US enforcement agencies to settle claims that it had assisted clients to evade US sanctions on various countries; in November 2014, six banks paid a total of £2.7 billion to British, US and Swiss regulators to settle claims related to the manipulation of foreign exchange benchmarks; and over the last few years, British financial institutions have paid hundreds of millions of pounds in fines after they sold inappropriate products to retail investors and small businesses.

New Standards on Risk Management and Compliance

Recent changes to global standards on risk management and compliance can be seen in two areas:

1. *The introduction of the new accounting standard IFRS 9 has also been forcing banks to think carefully about likely loan losses. IFRS 9 is due for implementation in January 2018.*

- *Strengthening of governance standards related to the oversight and management of risk and compliance*
- *Strengthening of prudential standards related to the identification, measurement and mitigation of risks.*

For example, in the area of capital adequacy, Basel III updates Basel II by:

- ***Using a stricter definition of capital and increasing minimum amounts of capital that banks should hold***
- ***Expanding the range of risks against which capital must be held***
- ***Increasing the weighting of certain types of risks***

The effect of these changes has been to reduce the numerator (eligible capital) of the risk-weighted capital ratio and increase the denominator (risk weighted assets).

As part of the reconsideration of capital levels, the Basel Committee conducted a review of market risk capital. (This is sometimes known as the Fundamental Review of the Trading Book.) The Revised Minimum Capital Requirements for Market Risk were published in January 2016. The Basel Committee estimated that the new market risk standards would result in a median increase of 22% in banks' market risk capital requirements.

Basel III also introduced liquidity standards: Basel II had addressed only capital levels. The Liquidity Coverage Ratio (LCR) estimates a bank's ability to withstand market disruption during 30 days and the Net Stable Funding Ratio (NFSR) measures the extent to which a bank is reliant on short term liabilities to fund long term assets over a one year time horizon.

Alongside the new capital and liquidity standards, the Basel Committee introduced new standards related to large credit exposures. It also introduced additional capital requirements for Global Systemically Important Banks (G-SIB).

The strengthening of prudential standards on risk management and compliance has also been seen in changes to Pillar 2 of the Basel Accords. Under its Enhancements to the Basel II Framework, published in 2009 (and not updated under Basel III), supervisors are expected to give greater focus during the supervisory review process to assessing banks' risk management oversight. The Enhancements also identify seven specific risk management topics that supervisors should be sure to address:

1. ***Risk concentration***
2. ***Off-balance sheet exposures and securitisation risk***
3. ***Reputational risk and implicit support***
4. ***Valuation practices***
5. ***Liquidity risk management and supervision***
6. ***Sound stress testing practices***
7. ***Sound compensation practices***

Standards on compliance risk management have not been updated since the Basel Committee published, "Compliance and the compliance function in banks" in 2005. However, governance standards related to compliance have been updated: the 2015 update of Corporate Governance Principles for Banks includes a specific principle on compliance (Principle 9).

Risk Management Standards for Islamic Financial Institutions

In 2005, the Kuala Lumpur-based Islamic Financial Services Board (IFSB) published Guiding Principles on Risk Management for Islamic banks. (The document is sometimes referred to as IFSB-1). IFSB-1 identified six areas of risk that Islamic financial institutions should manage, in addition to a general requirement to oversee all risks in an appropriate manner. The six specific areas were:

Rate of return risk is similar to conventional banks' interest rate risk in the banking book – the risk that assets and liabilities will re-price at different times and by different amounts, leading to a reduction in the bank's earnings.

Equity investment risk is an area of risk where Islamic financial institutions are more vulnerable than their conventional peers in view of the greater role that equity finance plays within Islamic finance. IFSB-1 singles out Mudaraba and Musharaka structures as particularly important.

IFSB-1 has not been updated since it was published, but the IFSB has published a series of other Guiding Principles and Guidance Notes on subjects related the management of risks by Islamic financial institutions. For example, it has published Guiding Principles on Liquidity Risk Management (IFSB-12, March 2012) and a Guidance Note on Quantitative Measures for Liquidity Risk Management (GN-6, April 2015). It has published a Standard on Risk Management for Takaful Undertakings (IFSB-14, December 2013) and principles on stress testing (IFSB-13 December 2013) and on the supervisory review process (IFSB-16, March 2014).

The Bahrain-based International Islamic Finance Market (IIFM) has also been working to define standards related to risk management in Islamic finance. The IIFM develops model structures for Shari'ah-compliant financial instruments that, inter alia, enable Islamic financial institutions to hedge or manage risk exposures. For example, IIFM Standard-5 provides standard documentation for an unrestricted master investment wakalah agreement (economically similar to a conventional bank's interbank deposit), and IIFM Standard-4 provides standard documentation for Mubadalat al-arbaah (Profit Rate Swap), (economically similar to a conventional bank's interest rate swap).

IIFM's standards are all Shari'ah-compliant, and therefore Islamic financial institutions know that they can use them without fear of contravening Islamic principles; and because the documentation is designed to be widely applicable, it is hoped that a large number of Islamic financial institutions will be able to take advantage of them.

Risk Management Priorities in CIBAFI's Global Islamic Bankers' Survey

In November 2015, CIBAFI published its first Global Islamic Bankers' Survey. One of the areas surveyed was Islamic bankers' perception of the key risks that they were facing. Macro-economic and political risk topped the list, followed by technology and information technology (IT) security. After that came a series of financial risks such as 'default risk', 'liquidity risk' and 'currency risk'.

It is not surprising that macro-economic and political risks should occupy such a prominent place in Islamic bankers' risk hierarchies. Many Islamic banks operate in countries that have been experiencing political troubles (for example, in the Middle East and North Africa) and many operate in countries that have been experiencing economic difficulties even in the absence of political troubles (for example, the oil exporting countries of the GCC, and Algeria and Indonesia). Yet these are risks over which banks have little control.

Some banks that responded to the CIBAFI Survey noted that they had tightened their risk assessment criteria in response to deteriorating political and economic conditions but apart from restricting new business in this way, there is little that Islamic banks (or conventional banks) can do to avoid such risks.

In contrast, risks related to technology and IT security are subject to management by individual banks. The technology that underpins banking operations is becoming more complex and cyber criminals are becoming better organised and more sophisticated , but banks can respond – and are responding – by giving greater focus to upgrading and maintaining their IT infrastructure and by anticipating the actions of financial criminals.

The other key risks identified by Islamic banks relate to financial performance and comprise areas where banks are able to reduce their risk profile and potential losses through sound policies and strong management. For example, default risk can be mitigated through strong credit analysis of potential clients and their proposed transactions, and currency risk can be mitigated by not allowing significant currency mismatches to arise on a bank's balance sheet. These are also the areas where the IIFM has been working to develop Shari'ah-compliant products that enable Islamic financial institutions to reduce risks through hedging exposures that the bank already has.

The new world of compliance

Despite the lack of new regulatory standards, the growth of banks' compliance functions has been remarkable in recent years. This is true for both conventional banks and Islamic banks.

Factors driving this growth have included:

- *The large number of new banking regulations with which banks need to comply and the higher penalties being imposed by regulators for non-compliance*
- *Increasing amounts of economic sanctions imposed on countries. These have included sanctions imposed by banks' home regulators, usually as part of international initiatives; and those imposed by third parties, usually the United States, but which constrain the way in which banks in other parts of the world may act*
- *Increasing sophistication of cyber criminals and the corresponding need for banks to update their procedures to defend themselves against attacks*
- *The global trend for large international banks to reduce their correspondent banking relationships with emerging market banks as part of a broader 'de-risking' policy, and the resulting pressure on emerging market banks to demonstrate that they are adhering to international standards on a wide range of issues.*

These factors apply to both Islamic and conventional banks, so Islamic banks have been under the same pressure as conventional banks to upgrade their compliance functions.

Islamic banks additionally face the need to ensure that their operations comply with the Shari'ah. This is not new – Islamic banks have always had this compliance obligation. Shari'ah compliance is often discussed under the term 'Shari'ah Governance.'

In 2009, the IFSB published a standard entitled, Guiding Principles on Shari'ah Governance Systems (IFSB-10). The Standard focussed on the work of the Shari'ah board and considered four principal themes:

Competence
Independence
Confidentiality
Consistency

The Standard also provided terms of reference for the Shari'ah board and made recommendations about professional standards and qualifications that Shari'ah board members should have.

However, just as a conventional compliance routine can only be effective if it permeates a bank's entire structure and becomes part of the bank's culture, so Shari'ah compliance also needs to go beyond the Shari'ah board.

There is a range of sources that Islamic banks can use to inform and measure the extent of their Shari'ah compliance. These sources include regulations published by national regulators that apply to banks in their jurisdiction and which can also be used as guidance by Islamic banks elsewhere.

The Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has published a series of Shari'ah standards designed to guide Islamic banks on the structure and operation of various Shari'ah-compliance contracts (for example, "Murabaha", "Ijara" "Musharaka") and how to approach various situations in a Shari'ah-compliant manner (for example [how to deal with a] "Procrastinating Debtor" and "Hiring of Persons").

In addition, the Islamic International Rating Agency (IIRA) produces Shari'ah ratings on banks and companies, assessing the extent of institutions' compliance to the stipulations of their own Shari'ah-committees.

In a significant new initiative, the IFSB and Kuala Lumpur-based International Shari'ah Research Academy (ISRA) have tried to link Shari'ah-compliance risk to operational risk capital requirements. A working paper entitled, Shari'ah non-Compliance Risk in the Banking Sector: Impact on Capital Adequacy Framework of Islamic Banks was published in March 2016. Based on data from 51 Islamic banks, the authors of the paper concluded that it would not be useful to require Islamic banks to hold additional operational risk capital against Shari'ah non-compliance risks (SNCR), and that such risks could more effectively be addressed through the Pillar II supervisory review process.

Identifying Risk Management Priorities for Islamic Banks

Islamic banks have been able to implement the more stringent global prudential banking standards that have been published in recent years. They generally hold far greater risk adjusted capital than the 8% minimum ratio, even after taking into account the adjustments made by Basel III to the way in which the ratio is calculated. Islamic banks are also expected to cope well with the new liquidity standards, despite the global lack of high quality liquid assets that are Shari'ah compliant.

The governance structure of Islamic banks that, unlike the structure of conventional banks, includes an important role for the Shari'ah Compliance Committee, does not impede the implementation of new standards that require directors to be more heavily involved in overseeing banks' risk management, and that require greater stature and independence for the risk management department.

Many of the risk management and compliance challenges that Islamic banks will face in the years ahead are likely to arise from risks and compliance issues that are specific to Islamic banks and the way in which the Shari'ah-compliant industry is evolving.

Examples of such risks include:

- *Equity Investment Risk*
- *Fiduciary Risk*
- *Rate of Return Risk*
- *Displaced Commercial Risk*

CIBAFI's Global Islamic Bankers' Survey (GIBS 2015) identified equity investment risk as one of the industry's major concerns. Islamic bankers know that offering equity investment/risk sharing products are central to the mission of Islamic finance, yet, according to the GIBS 2015, they have difficulty in structuring and pricing products that customers find attractive, while supervisors are often ill-equipped to assess the risks that the banks are taking. The risks that banks face in equity financing include:

- *The difficulty of valuing equity investments, since they are usually unquoted and illiquid*
- *The possibility of large variations in value over the life of the transactions – greater variation than would typically be seen in credit-like or trade related instruments*
- *The difficulty of effectively pricing products, in view of the lack of standardisation and clients' lack of familiarity with equity based products*
- *Uncertain and unfavourable regulatory treatment of* equity holdings

Islamic banks face greater fiduciary risk than conventional banks as a result of their use of Profit Sharing Investment Accounts (PSIA). Unlike conventional deposit accounts, where customers expect a defined return that is agreed in advance, investment account holders receive a return that depends on the performance of the underlying assets funded by their investment. As a result, investment account holders rely on the skill and judgement of the bank, acting as the investment manager. The bank has an obligation to deploy investment account funds in ways that are in the best interests of the account holders and to keep investment account holders informed of the decisions that it is taking. If the bank does not do these things, then it may breach its fiduciary responsibilities and have to make good any losses that investors suffer, and it may also have to pay damages.

All banks face "rate of return risk" – the risk that the difference in the rate of return earned on assets and the rate of return paid to depositors/investment account holders will move in a way that is unfavourable to the bank. (To be precise, in the case of Islamic banks, the danger is that the bank's share of the rate of return earned on assets will decline.)

Rate of return risk is particularly acute in the case of murabaha financing because banks are not permitted to adjust the rate of return (although they are able to adjust the rate of return, subject to the agreement of their customers, when using other contracts).

If returns on assets do fall, then Islamic banks may protect its investment account holders by reducing its own profit share or by drawing on its Profit Equalisation Reserve (PEP), if one exists. The risk that an Islamic bank may need to forgo part or all of its share in the profits to satisfy the expectations of investment account holders is termed, "displaced commercial risk."

1. *The first three of these risks, along with Shari'ah (non) compliance risk, were highlighted by Dr. Ronald Rulindo from the Indonesian Deposit Insurance Corporation in his presentation to CIBAFI's Risk and Compliance Seminar in Muscat. Displaced Commercial Risk refers to the risk that the returns that an Islamic bank is able to pay to profit and loss sharing account holders is lower than the returns offered by a conventional bank, with the result that the bank may lose market share.*

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Conclusions

Islamic banks are coping well with more stringent risk management requirements that have been introduced by global standard setters in recent years.

Islamic banks, like conventional banks, are facing a range of new risks, such as those from cyber criminals and those arising from the ways in which their employees behave, and they are strengthening their risk management departments in these areas.

Islamic banks need to do more to understand risks that are specific to their Shari'ah-compliant business models, such as equity investment risk, fiduciary risk and rate of return risk.

Standards related to Islamic banks' risk management should be updated to reflect the new regulatory environment and standards that have emerged since the global financial crisis.

Islamic banks have been upgrading their compliance functions to reflect the greater volume of bank regulation and the greater cost of non-compliance. However, more work needs to be done to define standards for Shari'ah compliance throughout a bank's operations in addition to the existing standards that relate to the work of the Shari'ah Compliance Committee

About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 120 members from over 30 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

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