

Risk & Compliance Management in Islamic Banking

Conventional and Islamic Banking from the Risk Perspective

Unlike conventional banks, Islamic banks share business risks with investors and borrowers. The fundamental difference between conventional and Islamic banking, from a risk perspective, is in the nature of risk sharing.

The profit sharing model in Islamic banking differentiates the nature of risk that the institution faces. This facilitates equitable distribution of profits and losses between depositors and banks or partners. With returns on the depositor's investment offered on a profit sharing basis, they have an equal share in the business risks of the institution. Similarly, financing based on Islamic tenets changes the nature of risks faced by Islamic institutions. While the conventional bank assures fixed rates on deposits, regardless of whether it makes profits or losses, the Islamic bank offers no such guarantees. If the bank earns profits during the financial year, it offers depositors the agreed rates; conversely, if the year has brought in losses, depositors share the burden together with the bank. One of the most important risks unique to an Islamic bank is the risk of non-compliance with Shariah principles.

Finally, to quote from Al-Hawari, 1996, Islamic banks attach varying degrees of importance to the elements of capital, capacity, collateral, character and condition from that of conventional banks. The conventional bank may accord priority to the collateral, whereas the Islamic bank gives priority to the character of the customer. The conventional bank is perhaps more interested in the capital and capacity, but the Islamic bank is focused on capacity rather than the capital. On the other hand, there may be some similarity between the conventional bank and the Islamic bank on the issue of priority attached to the security and soundness of a project submitted to the bank for financing.

Islamic Banking – Risks Overview

In general, all risks faced by conventional banks are also relevant to Islamic banking organizations, and to a large extent the measurement of these risks and the mitigation techniques deployed are common.

Risks common to conventional and Islamic banks include:

- ▶ Liquidity risk
- ▶ Credit risk
- ▶ Market risk _ both, exchange and volatility
- ▶ Legal risk
- ▶ Operational risk

Risks unique to Islamic banks include:

- ▶ Pricing risk under mark-up financing
- ▶ Commodity risk
- ▶ Ownership risk (assets owned as part of financing)
- ▶ Reputation risk (for non-compliance with Shariah principles)
- ▶ Counterparty risk in the case of:
 - ▶ Murabaha (declining to honor the 'promise to buy' agreement)
 - ▶ Istisna (declining to honor the 'promise to accept the delivery' agreement)
 - ▶ Salam (Declining to honor the 'supply on time' and quality, quantity agreement)

Risk Compliance - Current and Emerging Requirements for Islamic Banks

The discussion herein excludes regular suspects such as compliance with Basel II, SOX, IAS 39, IFRS, FAS 133, USA PATRIOT, KYC and AML; centering around environmental risk, information risk, and settlement risks.

ISO 14000

To manage voluntary compliance standards for environmental practices, several organizations, including financial institutions, have adopted ISO 14000 standards. Adhering to these standards implies outlining clear environmental goals and generating regular performance reports, though this is no guarantee of clean and efficient practices on the ground. The standards are about management systems and not about environmental pollution prevention.

Banks, including Islamic banks, must de-risk themselves by insisting that a corporate borrower is ISO 14000 compliant. ISO 14000 requires an organization to establish an Environmental Management System (EMS) to accomplish the following:

- ▶ Improve and monitor regulatory compliance
- ▶ Enhance internal management system efficiency
- ▶ Reduce waste
- ▶ Prevent pollution
- ▶ Improve environmental performance

ISO 14000 has legal implications that are not addressed in ISO 9000. It considers a broader array of interested parties, which includes banks, competitors, investors, ecosystems, lawyers, regulators, and suppliers.

Islamic banks, like other businesses, are potentially liable for environmental damage that their operations cause. However, because banking operations are not pollution-intensive, pollution from their own operations is not the primary environmental concern, but their focus is on derived environmental liability through debt and equity transactions. Poor environmental practices by banks' customers may reduce the value of collateralized property and/or increase the likelihood of fines or legal liability that reduces a debtor's ability to make payments to the bank.

Instances where banks have been held responsible and liable for contamination, where the banks held stakes in the form of secured interest, are not uncommon. (Mellon bank, Maryland Bank and Trust, and US Vs Fleet Factors corporation case). In the US, several organizations have provided guidelines to banking and financial institutions, to protect themselves from lender liability. These guidelines address the core of the bank's environmental risk management practices.

Settlement Risk Management

Emerging standards and guidance issued to mitigate settlement risks are applicable to Islamic banks. Some examples include:

Analysis of CLS (Continuous Linked Settlement)

CLS eliminates the risk of paying one currency and failing to receive the other. With CLS, both sides of the trade are settled simultaneously on a Payment

Versus Payment (PVP) basis. So, in effect, it is almost as final and certain as a domestic payment system. CLS has far-reaching effects – not only because it eliminates settlement risk, but also because participants can significantly improve their liquidity management and reduce costs. CLS eliminates settlement risk, increases trading opportunities and reduces costly reconciliation. Islamic banks can use CLS as a significant mitigation for settlement risk.

ISO 20022

Prepared originally by the technical committee ISO/TC68 (as ISO 15022) dealing with banking, securities and related financial services, ISO20022 replaces the earlier standards - ISO 7775 and ISO 11521 and ISO 15022. Deemed mandatory by SWIFT, the new standard helps achieve straight through processing in financial transactions between organizations. Apart from the traditional store and forward mechanism, the new standard aims at achieving straight through processing by online real-time interaction with back-end systems, and with batch downloads and uploads. Complex messages and business transactions can be handled with the new standard. The standard is significantly more business oriented than the earlier message-oriented approach. To improve liquidity, ensure faster and secure payments, Islamic banks must comply with ISO 20022 and address settlement risk effectively.

Information Risk Management

Emerging standards to mitigate information risk include:

CoBIT

Control Objectives for Information and Related Technologies, is an open standard aimed at managing risks associated with Information Technology. Issued by ISACA, CoBIT is the de facto standard practiced, followed and referenced worldwide across industry verticals including banking. Board of Governors of Federal Reserve-US has referenced CoBIT as the implementation tool kit in their Circular on Uniform Rating System for Information Technologies (URSIT). CoBIT can be effectively used to manage risks arising out of Information Technology. Coupled with management guidelines, CoBIT provides the business orientation to control the security aspects of Information Technology.

Islamic banks can effectively use the CoBIT framework to manage information risk and streamline IT governance.

ISO/IEC 27002:2005

ISO 27002 is an information security standard designed for implementation in the commercial sector. It comprises a comprehensive set of controls considered to be best practices in information security including policies, practices, procedures, organizational structures and software functions. ISO 27002, as a security standard, is contextually relevant for Islamic financial institutions.

SAS70

Statement on Auditing Standards (SAS) 70, Service Organizations, is an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA). SAS 70 is the authoritative guidance that allows service organizations to disclose their control activities and processes to customers and customers' auditors in a uniform reporting format. A SAS 70 examination signifies that a service organization has had its control objectives and control activities examined by an independent accounting and auditing firm.

SAS 70 is generally applicable when an auditor ('user auditor') audits the financial statements of an entity ('user organization') that obtains services from another organization ('service organization') Service organizations that provide such services could be application service providers, bank trust departments, claims processing centers, Internet data centers or other data processing service bureaus.

Ubiquity of the informed and demanding customer today clearly heightens the relevance of SAS 70 compliance for Islamic banks.

Role of Technology in Risk Assessment and Management

Islamic banks can successfully manage and minimize risk across the business ecosystem by leveraging a robust IT environment to implement a holistic ERM strategy. Some key areas the technology can impact positively include:

KYC

Every customer is analyzed for background, nature of business, credit rating, previous financial records, financial history, and relationship with existing customers at the bank. The technology platform tracking this data raises alarms to alert stakeholders at the bank at appropriate junctures, to ensure KYC compliance. Comprehensive support is offered for customer identification, black listing of customers, tracking defaulting customers and managing introductions. Customer account activities are also monitored for abnormalities.

FATF

Technology plays a pivotal role in addressing the requirements of 'anti-money laundering' and 'preventing terrorist financing' as suggested by FATF. Solutions can be deployed to continuously analyze and report all suspect transactions supporting money laundering and terrorist activity, enabling the bank to take prompt corrective actions. Exceptions at the transaction level can be tracked, account activities can be monitored for abnormality and all remittances can be tracked. The system can also track cheque utilization, limit utilization, and end use of funds borrowed.

Credit risk and default risk

Systems can be deployed at the bank to monitor and track borrowing accounts. Support can be offered for online and real-time monitoring of funds utilization, limit utilization and liability tracking. Real-time valuation of collateral, validation against current liability, and reporting of overdues can be effectively managed.

Information risk management

Sophisticated applications can be used to manage information risk. Proper definition of access controls, information sharing on only need-to-know basis, effective user management, robust information processing capability, good business continuity planning, and well prepared disaster recovery plans are some of the clear benefits of deploying these systems, to control information.

Asset liability management

Though manual tracking of inflows and outflows at the bank is a possibility, size adds to the complexity, creating the need for automation to manage liquidity risks and credit risks. Technology has proved an effective answer. Today ALM systems not only handle the required cash flows, but also analyze trends in such flows, provide alerts on mismatch, provide triggers on stressed buckets, analyze cost-to-close mismatches, tolerance, spread and so much more.

Straight through processing and CLS

Technology facilitates STP, Continuous Linked Settlement and automation in the entire settlement business, dramatically reducing the float, risk and uncertainty. End-to-end automated payment and settlement systems can help Islamic banks address settlement risk effectively.

Counterparty risk

Technology can be deployed to assist the bank in proper identification, assessment and analysis of previous transactions of counterparties. It can also empower banks to send out triggers on delays, monitor delivery, and proactively identify potential for non-payment of contractual amounts on due dates.

In Conclusion

- ▶ While compliance does mean a greater cost outlay towards technology investments as well as streamlining business processes, such regulations play an important role in helping the Islamic bank build trust and manage risk effectively.
- ▶ Technology can also ensure that time-to-compliance is addressed as effectively as time-to-market for progressive Islamic banks.

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