

**Diploma in Islamic Banking (DIB), Part-I**  
**Exam: Sep-Oct`21**  
**Code :101 (Alternative Financial System)**

**Session-IV**

**Risk management , Challenges faced by IFIs**

**Governance & supervision: Bank's internal and Central Bank**

**Presented by**

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**Islami Bank Bangladesh Limited**



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# Session overview

The following important topics will be covered as per chapter 8 (Risk management), chapter 9 (Regulation, Supervision and Governance of the Alternative Financial System) and chapter 10 (Opportunities, Issues and Challenges) of Paper-101 of DIB Part-I:

**Ch. 8 : What is Risk, Risks faced by financial institutions, Unique Risks faced by IFIs, Risks in Islamic contracts, Risk management & its Shari`ah basis, Risk management Process etc.**

**Ch. 9 : What is Corporate Governance (CG), Islamic CG, Importance of CG for IFIs,**

**Ch. 10 : Challenges faced by IFI**

**All Ch. : Short Notes**



**1.  
Risk  
Management**

# An Introduction to Risk

'Risk' is a well known term widely used especially in the business and financial arena.

The Risk arises when there is a possibility of more than a single result and the ultimate result is mostly unknown.

Though all businesses face uncertainty, financial institutions face some special kinds of risks given their nature of business.

The objective of financial institutions in general is to maximize profit and shareholders value-addition by providing different financial services which commonly involve managing risks.

# 1. What is Risk

Risk means uncertainty, danger, chance, jeopardy, peril etc.

Risk is essentially anything that threatens or limits the ability of an organization to achieve its objectives. It implies future uncertainty about deviation from expected earnings or expected outcome.



# 1.2 Risks faced by financial institutions

Financial institutions can face a number of different risks. **Financial risk** is the umbrella term used for multiple types of risks associated with financing and related transactions. It is the risk associated with how an institution finances its operations: Some major risks are:

**Credit risk:** This is the risk that arises due to debtor's non-performance. It is the potential that a counterparty will fail to meet its obligations in accordance with agreed terms

**Liquidity risk:** This is the potential of loss to a financial institution arising from their inability to either meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses

**Market risk:** This is the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leasable assets and in off-balance sheet individual portfolios.

# 1.2 Risks faced by financial institutions

## (Contd.)

**Operational risk:** This risk is defined as the risk of loss resulting from inadequate or failed processes, people, systems or from external events. One of the operational risks which is only relevant to IFIs is Shari'ah non-compliance risk.

**Systematic risk:** This risk is inherent in the entire market or an entire market segment. It is the risk that is carried by an entire class of assets and/or liabilities.

**Rate of return risk:** This risk is associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers. It gives rise to displaced commercial risk.

**Displaced commercial risk:** The risk that IFIs may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by investment account holders when the return on assets is under-performing as compared with competitors' rates.

# 1.3 Unique Risks faced by IFIs

Besides the above common risks, the IFIs may face the following unique risks:

- Shari`ah non compliance risk
- Inventory risk
- Equity Investment risk
- Displaced Commercial risk
- IT adaptation risk
- Efficiency risk
- Customer acceptance risk
- Differentiation of opinion (of SSC) risk
- Communication risk

# 1.4 .1 Areas of Shari`ah non compliance in IFIs

As an Islamic financial institution Shari`ah non compliance may occur in any form of the banking operations. Such as:

- i. Policy, statutes, rules, agreement and procedures of the bank.
- ii. Financial Statements
- iii. Product Approval Process
- iv. General Banking portfolios of the bank.
- v. Investment portfolios of the bank.
- vi. Foreign Exchange operations.
- vii. Treasury Service
- viii. Shari`ah Governance
- ix. Miscellaneous Services rendered by the bank.
- x. Other areas of Shari`ah non compliance

# 1.5 Risks in Islamic contracts

Risks in different Islamic contracts / products evolve and change from one to another dependent on the different stage of the transaction. For example, for products that involve financial assets, the financing risks may transform from credit risk to market risk and vice versa at different stages of the contract.



# 1.5.1 Risks Associated with Islamic Mode of Finance: Bai Modes

## 1 Agreement to purchase

- Shari'ah non-compliance risk
- Operational risk

## 2 Order / receipt of goods

- Shari'ah non-compliance risk
- Credit risk
- Market risk
- Operational risk

## 3 Contract

- Market risk
- Operational risk

## Default

- Shari'ah non-compliance risk
- Credit risk
- Market risk
- Operational risk

## 4 Delivery of goods

- Shari'ah non-compliance risk
- Operational risk<sub>1</sub>

# 1.5.2 Risks Associated with Islamic Mode of Finance: Iajara Modes

## 1 Promise to lease (binding)

- Shari'ah non-compliance risk
- Operational risk

## 2 Order / receipt of asset

- Shari'ah non-compliance risk
- Market risk
- Operational risk

## 3 Contract

- Shari'ah non-compliance risk
- Credit risk
- Market risk
- Operational risk

## Default

- Shari'ah non-compliance risk
- Credit risk
- Market risk
- Operational risk

## Rejected / defective asset

- Shari'ah non-compliance risk
- Market risk

## Delivery of defective asset

- Market risk
- Operational risk

## 4 Maturity

- Shari'ah non-compliance risk
- Market risk

# 1.6 Risk management

**Risk management** is a process of identifying potential risks before they occur, assessing the possible impact of the risks when they materialize and setting procedures and taking action to avoid the risk entirely or minimize its potential impact..



# 1.6.1 Shari`ah Basis of Risk management

Islam encourages manage/mitigate the risk resulting from uncertain events to avoid loss. Because, without risk management it is nothing but driving into darkness with the headlights turned off.

Allah SWT says in the Holy Quran:

"And he said, O my sons, do not enter from one gate but enter from different gates; and I cannot avail you against [the decree of] Allah at all. The decision is only for Allah ; upon Him I have relied, and upon Him let those who would rely [indeed] rely".

(Sura Yusuf: Verse 67)

We should not leave everything for Allah SWT to manage. We must try to manage things to our best. It is mentioned in the Holy Quran,

“That is because Allah would not change a favor which He had bestowed upon a people until they change what is within themselves. And indeed, Allah is Hearing and Knowing.” (Al Anfal: 53)

## 1.6.1 Shari`ah Basis of Risk management (Contd.)

*Prophet (pbuh) once asked a Bedouin (a nomadic Arab) who had left his camel untied, “Why do you not tie your camel?” The Bedouin answered, “I put my trust in Allah”. Prophet (pbuh) then said, “tie up your camel first then put your trust in Allah”.*

The history of the Prophet (pbuh) peace be upon him is also full of lessons, how Muslims should manage the risks. For instance, the Prophet (pbuh) initiated his sacred mission right from home and then moved to the people closely associated with him. This is to reduce the risk of rejection.

Furthermore the history of the Prophet (pbuh)'s migration to Madinah gives us other lessons on how did the Prophet (pbuh) manage the risk. The Prophet (pbuh) reduced the risk of getting killed by asking Ali (R) to sleep in his bed during the night of emigration. The assassins posted by Quraish around the Prophet (pbuh)'s house were waiting to kill him at the moment he left his house early in the morning, peeping now and then through a hole in the door to make sure that he was still lying in his bed.

He (pbuh) also reduced the risk of being attacked with enemies through setting out on foot for the southward Yaman leaving the busy northward path to Madina.

# 1.6.2 Risk management Process

Islamic financial Institution can protect the interest of depositors and investment accountholders through following proper Risk Management Processes:



# 1.6.3 Risk management Process in IFIs: IFSB Requirement

The general requirements prescribed by IFSB relating to the risk management process are as follows:

- IFIs shall have in place a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information systems for internal risk and reporting and decision making that are commensurate with the scope, complexity and nature of the IFIs' activities.
- IFIs shall ensure an adequate system of controls with appropriate checks and balances is in place. The controls shall:
  - ❖ Comply with Shari'ah rules and principles;
  - ❖ Comply with applicable regulatory and internal policies and procedures;
  - ❖ Take into account the integrity of risk management processes.

## 1.6.3 Risk management Process in IFIs: IFSB Requirement (contd.)

- IFIs shall ensure the quality and timeliness of risk reporting available to regulatory authorities. IFIs must be prepared to provide additional and voluntary information needed to identify emerging problems possibly giving rise to systematic risk issues. When appropriate, the information contained in the report shall remain confidential and shall not be used for public disclosure.
- IFIs shall make appropriate and timely disclosures of information to investment account holders so that the investors are able to assess the potential risks and rewards of their investments and to protect their own interests in their decision making process. Applicable international financial reporting and auditing standards shall be used for this purpose.



**2.**  
**Governance &  
supervision  
of IFIs**

# 2.1 What is Corporate Governance

## (CG)

Corporate Governance, in brief CG refers to the system of structuring, directing and controlling a corporate body with the objective of achieving long-term strategic goals which satisfy shareholders, creditors, employees, customers and other stakeholders.

The International Chamber of Commerce defines:

“Corporate governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations.”

Although the scope of CG in IFIs is larger than in conventional FIs, the overall concept of CG is the same.

## 2.2 Islamic Corporate Governance



### Components of Islamic CG

# 2.3 Importance of Corporate Governance for IFIs

AAOIFI has laid down various underlying reasons for pursuing effective CG in its Governance Standard No. 6 'Statement on Governance Principles for IFIs'. Such as,

## **i) Enhancing confidence**

The financial services industry (whether conventional or Islamic) is one in which 'trust' is vital. Sound governance practices serve to enhance public confidence.

The Board of Directors, Shari'ah Supervisory Board, management, employees and other parties dealing with or working for an IFI must strive to enhance confidence and trust which are vital to the survival and growth of its business.

## **ii) Shari'ah compliance**

Governance in the context of an IFI goes well beyond the boundaries of 'CG' in the conventional context since it also has religious connotations attached to it.

Typically, a stakeholder associates himself with an IFI or conducts business with it or two reasons; its efficiency or competence, and its Shari'ah compliance. It is therefore important to have a governance mechanism in place to ensure the latter.

# 2.3 Importance of Corporate Governance for IFIs (Contd.)

## **iii) Business model and unique risks**

The business model of an IFI is characterized by contracts that are designed to be compliant with Shari'ah. The risks associated with such contracts are unique and unlike a typical conventional lending contract. It is important that both the IFI and its clients recognize the distinguishing features of the contracts they are signing.

As an example, the underlying structure of Mudaraba contract typically used to raise funds on the liability side of an IFI makes it quasi-equity rather than a liability.

## **iv) Social responsibility**

The principles of Shari'ah strike a balance between the interests of the individual and those of the society to which he or she belongs. Thus, the governance structure of an IFI should align, to the extent possible, the interests of the stakeholders, of those charged with governance and of the society. IFIs are established to assist in using wealth and financial resources in a manner beneficial to investors as well as to the community at large.

# 2.3 Importance of Corporate Governance for IFIs (Contd.)

## v) Stakeholders' interests

It is important for those charged with governance to understand who their key stakeholders are. This understanding allows for the establishment of a governance structure which is characterized by high levels of accountability. Those charged with governance are accountable towards the interests of all key stakeholders of an IFI.

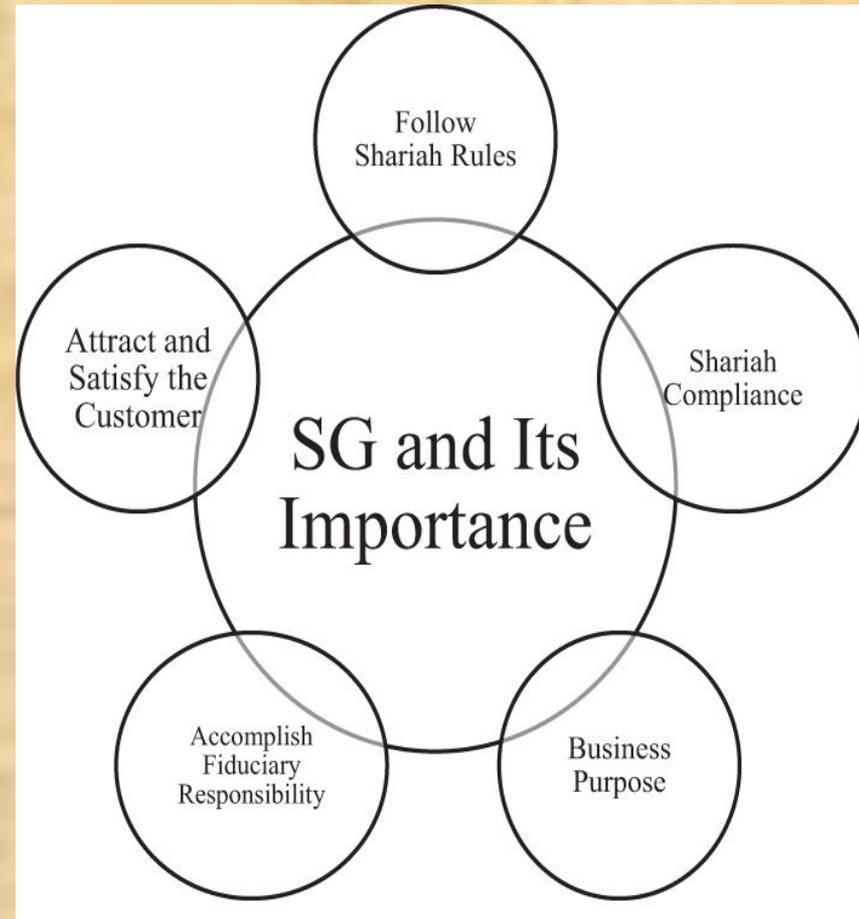
The interaction of an IFI with its stakeholders has much to do with timely and efficient distribution of financial and non-financial information regarding its operations and performance.

## vi) Business ethics and culture

An IFI's code of ethics comprises of values derived from Shari'ah. These values underpin the behavior of all persons employed by or associated with the IFI in carrying out their respective duties or obligations to the institution. The Board of Directors, management and the SSB are the major parties responsible to ensure that an ethical culture is established within an IFI.

## 2.4 Shari`ah governance

Shari`ah governance is indispensable for ensuring confidence in the Islamic banking in the eyes of the public. A proper Shari`ah governance framework would ensure strict Shari`ah compliance in all practices of the industry. This would give credibility to the industry and instill public confidence. It would also promote operational and financial stability, since it would ensure that the value propositions of Islamic finance are implemented in practice.





**3.  
Challenges  
faced by IFIs**

# 3.1 Challenges faced by IFI to implement Islamic banking

## □ So Many compliance Issues

As a Shari`ah based financial institution IFIs have to abide by so many compliance issues. It is the biggest challenge of IFIs for all times. Such

- Shari`ah compliance issues
- Compliance of Money Laundering and terrorist finance issues
- Compliance of Ethical Issues
- Compliance of Central Bank policies/circulars/guidelines.
- Compliance of govt. laws/policies/guidelines
- Combating cyber issues.

## 3.1 Challenges faced by IFI to implement Islamic banking

### □ Default Culture & Investment Reschedule

The top most challenge that has to face the Banking sector in Bangladesh is the willful Default Culture among most of the clients. In this case, Islamic banks have to bear more loss compared to the conventional bank. Because late payment charges, compensation and penalties are not treated as regular Income IFIs.



# Challenges faced by IFI to implement Islamic banking (Contd.)

## □ Limitation of Islamic Money Market & Capital Market Instruments

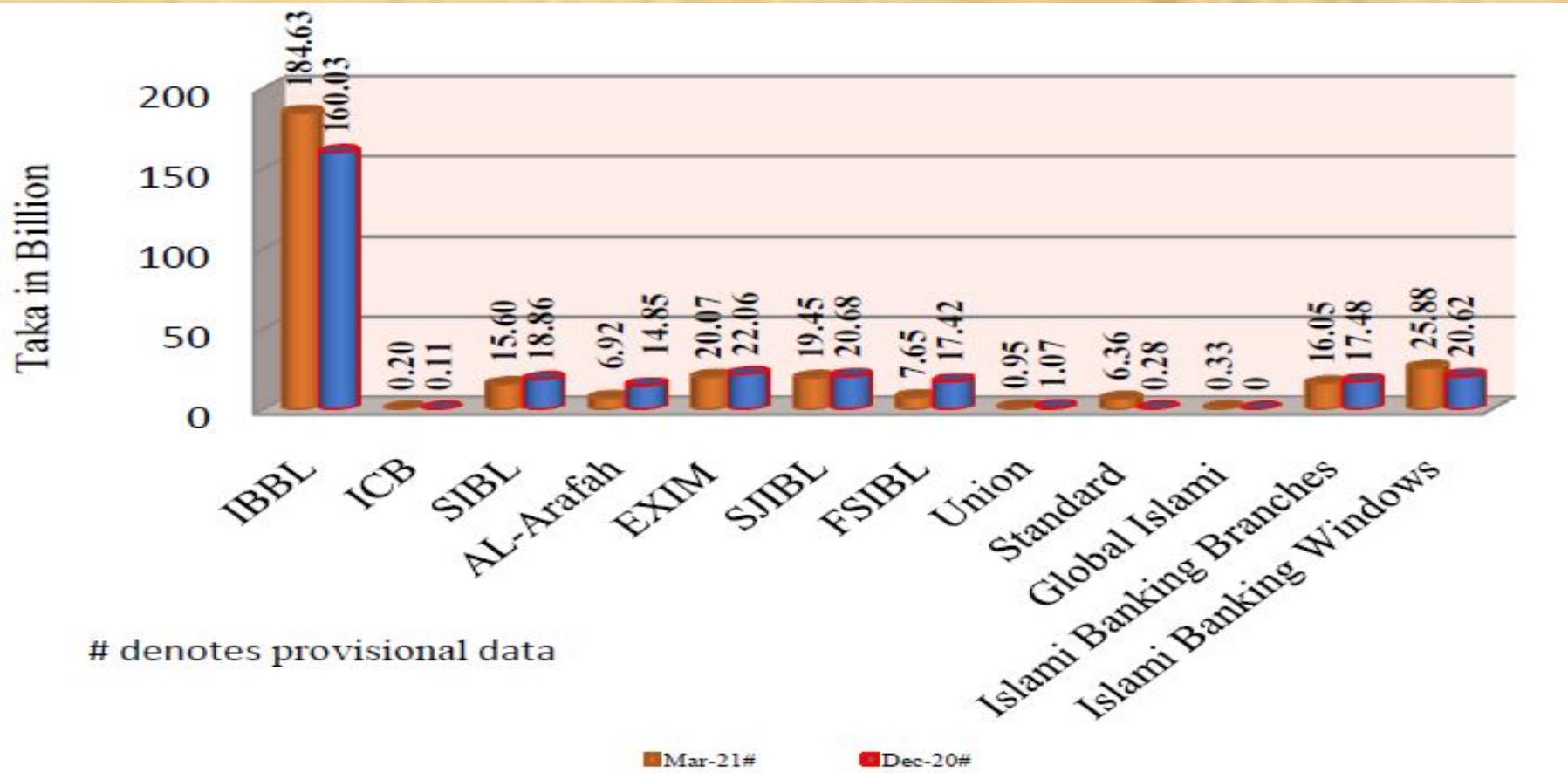
IFIs have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis.

In the Capital market of Bangladesh, there are limited tradable Financial Instruments. For that reason, the Islamic bank can't deploy their excess liquidity. That's why they are being deprived of the benefit from the income. Islamic banks can't invest in the traditional Instruments as those are interest based. Therefore:

- Bank's excess liquidity remains idle.
- CRR and SLR reserve can't be deployed due to unavailability of interest free instrument.



# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)



Excess liquidity of Islamic Banks stood 304.09 billion on March'21

# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## □ Leakage of income

Being interest free, Islamic bank can't take part in the field where there is a sing of interest. Bank can't include their income from reschedule investment as compensation charge to income account as this income is treated as 'Haram' in the eye of Shariah principles. As a result, depression of profit incurs here. Such as

- Income from Foreign currency clearing A/C is treated as interest.
- Income from 'Nostro Account' is treated as interest.
- Shariah non-compliant income derived from inspection by *Murakib* is treated as interest and is kept aside to 'Charity Fund'.Defalcated investment.

□ Incomes from defalcated investment as compensation/penalties are not included to banks profit.

## 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

### Shortage of trained and efficient manpower committed to Islamic Banking

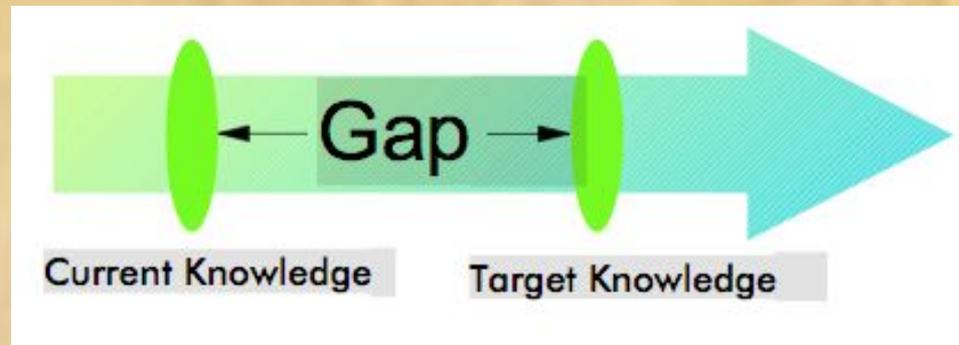
There is a shortage of Islamic Finance and Shariah knowledge based manpower to appraise, monitor, evaluate and audit the projects they are required to finance who can answer the query of the clients with full satisfaction.



# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## Knowledge gap among the mass people

Though Bangladesh is a Muslim majority country, but still is gap of knowledge regarding Islamic banking system among the people of different levels. They find hardly difference between two systems without name.



# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## Mismatching between business needs and existing investment products of IFIs

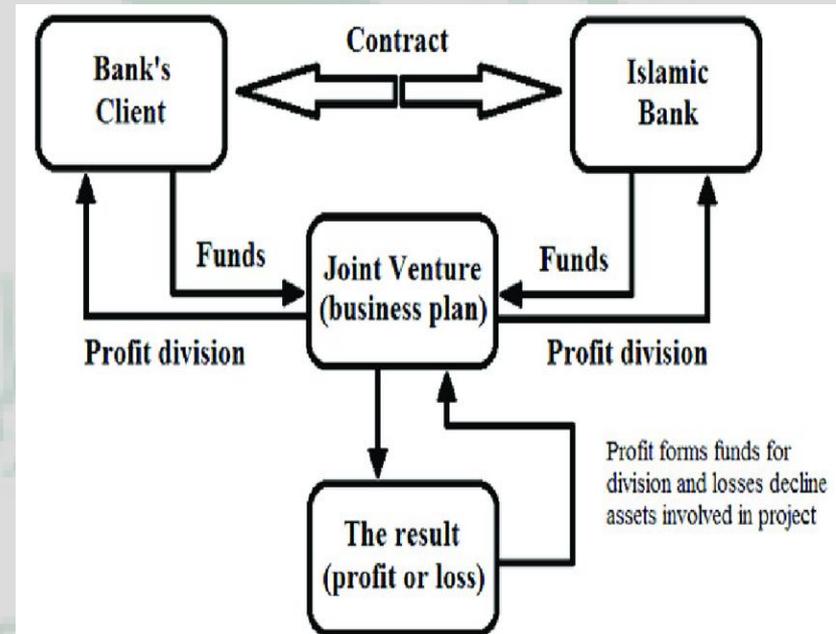
Most of the cases IFIs practice the products mimicking the conventional system after necessary modifications. Often the business needs of the clients can not be met by the existing product line of IFIs. Such as

- The cash requirement of the client can not be met in some cases.
- Forward Booking in case foreign exchange business
- Financing in case of Bidding the tender
- Financing service sectors
- Financing Mobile Financial Services (MFS) like Mcash, bKash etc.

# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## Challenge in Practicing profit-sharing Modes of Finance

The risk involved in profit-sharing mode of finance seems to be so high that most of the banks have resorted to those techniques of financing which bring them a fixed assured return. As a result, there is a lot of criticism that the IFIs have not abolished interest but have in fact only changed the nomenclature of their transactions. (Ref. <https://www.islamibankbd.com/>)



# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## Accounting system challenge



Islamic Banks have to apply the interest based Accounting system that is a challenge to follow the Shari'ah as there is no separate Islamic accounting system and new

some guidelines and standards for accounting and Shari'ah standard. In most of the cases title of accounts treatment of income differs among conventional, local and international standard.

## **3.1 Challenges faced by IFI to implement Islamic banking (Contd.)**

### **Challenge for conventional Banks in their practice in Islamic banking through branches/windows**

- Inter-branch IBG A/C- Income mixed with the interest based banking service to the Islamic banking transactions.
- Islamic banking related knowledge gap among the members of Board of directors
- Transfer & Job rotation are done simultaneously between the Shariah Based & conventional banking units.
- Unskilled manpower is used to operate the Islamic banking activities.

# 3.1 Challenges faced by IFI to implement Islamic banking (Contd.)

## The COVID-19 Pandemic created New Challenges for IFIS

The COVID-19 pandemic is damaging economies across the world. For banks in particular, the pandemic generates multifaceted crises, mostly through increases in default rates. Bangladesh's banking sector already has a high level of non-performing loans (NPLs)

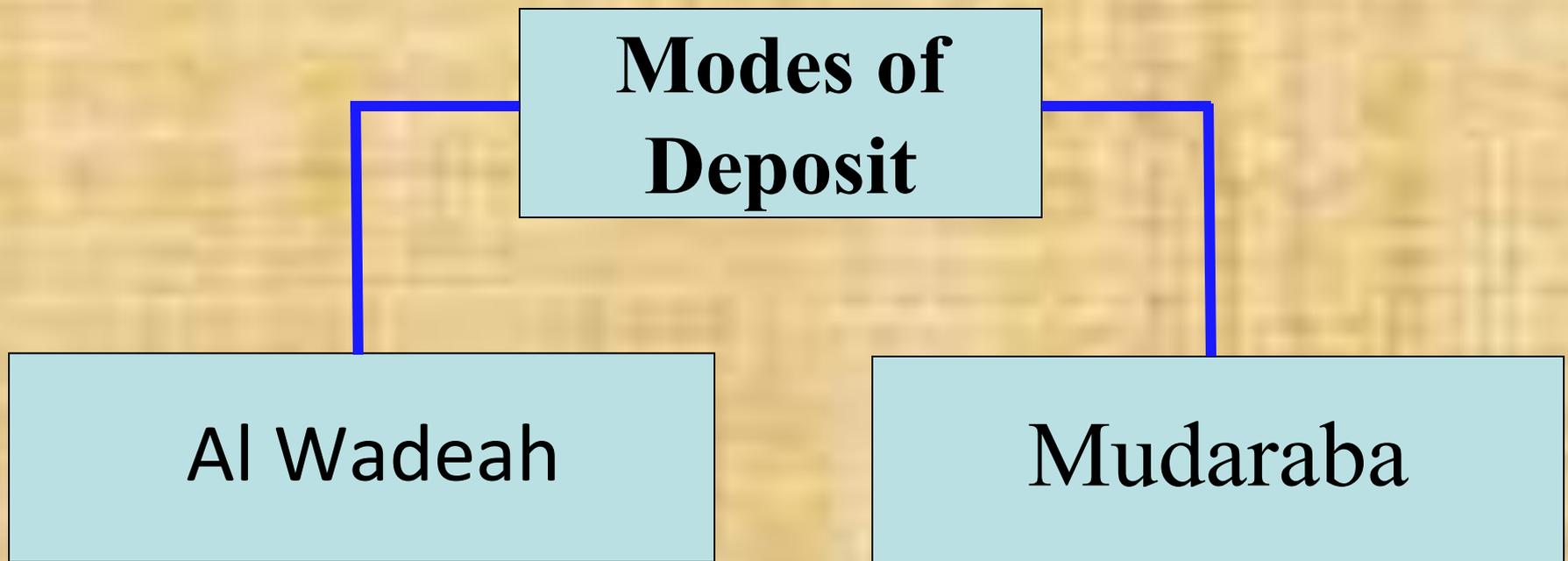
The pandemic is likely to worsen the situation having a profound impact on IFIs. Because regulatory authority continuously extended the borrowers' repayment time and it is known to all that the IFIs can not imposed any profit on the old liabilities of the clients.





**4.**  
**Short notes**

## 4. 1 Deposit Products of IFIs



# 4. 1 Deposit Products of IFIs (Contd.)

## **Al-Wadeah Accounts**

IFIs operates Al-wadeah Current Account on the principles of Al-wadeah. The Bank commits to refund money deposited in these Accounts on the demand of customers. On the other hand the Bank takes permission from customers that the Bank may utilize their money. Customers may operate these Accounts as their desires. No profit is disbursed in these Accounts and depositors do not bear any loss . The depositors have to pay government taxes and other charges, if any.

## **Mudaraba Accounts**

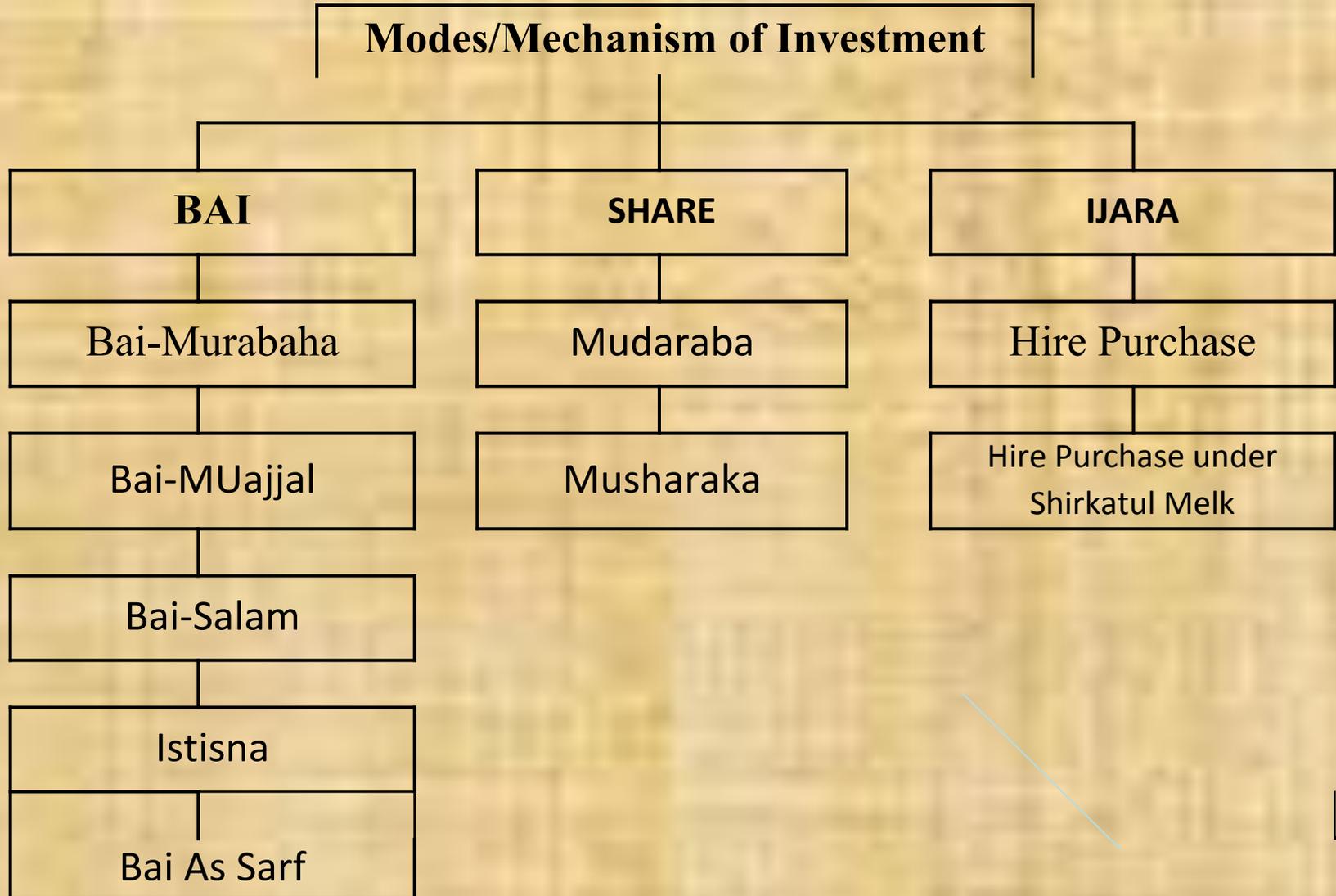
Mudaraba is a partnership of labour and capital, where one partner provides full capital and the other one manages the business. The capital provider is called Sahib-Al-Maal and the user of the capital is called Mudarib. As per Shariah principles, the Mudarib will conduct the business independently following Shariah principles. The Sahib-Al-Maal may provide advices, if he deems fit but he can not impose any decision over the Mudarib. Profit, if any, is divisible between the Sahib-Al-Maal and the Mudarib at a predetermined ratio, while loss, if any, is borne by the Sahib-Al-Maal. Mudarib can not avail of any salary or remuneration against his labour as a manager or conductor of the enterprise/business. The deposits, received by Islamic banks under this principle are called Mudaraba Deposits. Here, the depositors are called Sahib-Al-Maal and the bank is called Mudarib.

## 4.2 Al Wadeeah and Amanah

Deposits in current accounts with Islamic banks are regarded as Al Wadeeah and Amanah. If the bank obtains authority to use the funds in the current accounts to invest in its business, *Amanah* transforms into a loan from the depositor to the bank and the bank is liable to repay the full amount in the current account, irrespective of profit or loss made by the bank.

<b>Base for Difference</b>	<b>Al Wadeeah</b>	<b>Amanah</b>
<b>Meaning</b>	<b>Custody, safekeeping</b>	<b>Trust, reliability, trustworthiness, loyalty, honesty</b>
<b>Definition</b>	<b>safe-keeping of a sum of money with permission to use and refund on demand</b>	<b>refers to deposits in trust. Holding property in trust for another,</b>
<b>Liability</b>	<b>keeper and trustee of funds becomes wholly responsible and liable for its safekeeping.</b>	<b>entails the absence of any liability for loss, except for breach of duty.</b>
<b>Reward</b>	<b>The bank may offer reward the customer with a payment in the form of Hibah as appreciation for keeping the funds with the bank</b>	<b>No relevancy with this</b>

# 4. 3 Investment Products of IFIs



# 4.5 Risk management

**Risk management** is a process of identifying potential risks before they occur, assessing the possible impact of the risks when they materialize and setting procedures and taking action to avoid the risk entirely or minimize its potential impact.

## **Shari`ah Basis of Risk management**

Islam encourages manage/mitigate the risk resulting from uncertain events to avoid loss. Because, without risk management it is nothing but driving into darkness with the headlights turned off.

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# 4.6 CRR & SLR

## Cash reserve requirement (CRR)

CRR or cash reserve ratio is the minimum proportion / percentage of a bank's deposits to be held in the form of cash. Banks have kept these as cash with Central Bank.

All banks (conventional & Islamic) have to keep CRR of 4.00% of their deposits as per regulations.

When a bank's deposits increase by tk.100 crore, and considering the present cash reserve ratio of 4%, bank will have to hold additional tk 4 crore with central Bank and will be able to use only tk. 96 crore for investments and lending. Therefore, higher the CRR, lower the amount that banks can lend. Thus Central Bank can control the Liquidity by changing the CRR i.e. increase CRR to reduce the lendable amount and vice-versa.

## 4.6 CRR & SLR (Contd.)

### **Statutory. Liquidity Ratio (SLR)**

SLR is the reserve requirement that banks are required to maintain in the form of cash, gold reserves and central bank-approved securities before disbursing loans to the customers.

Islamic banks have to keep SLR of 5.5 per cent of their deposits, whereas for conventional banks it is at least 13 per cent as per regulations.



## 4. 7 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

AAOIFI, the international standard setting body for IFIs was registered in **1991** in the Kingdom of **Bahrain** as an international autonomous non-profit making corporate body.

Existing **Chairman** of Board of Trustees of AAOIFI, H.E. Shaikh Ebrahim bin Khalifa Al Khalifa and Mr. Omar Mustafa Ansari is hoding the position of **Secretary** General.



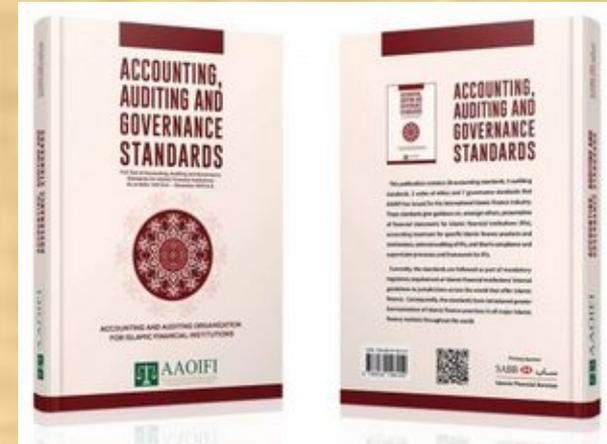
The **objectives** of AAOIFI include:

- Develop the **accounting and auditing concepts** relevant to IFIs;
- Disseminate the accounting and auditing concepts relevant to IFIs and their application through **trainings, seminars, publications, research** and other means;
- Prepare, promulgate and interpret accounting and auditing **standards** for IFIs; and

# 4. 7 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

It is supported by a number of institutional members, including central banks and regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, from over **45 countries**.

It has issued a total of **100 standards** in the areas of Shari'ah (**57**), accounting (**26**), auditing (**5**), ethics (**5**) and governance (**7**) for international Islamic finance.



Professional qualification programs (notably **CIPA**, the Shari'a Adviser and Auditor **CSAA**, and the corporate compliance program) are presented now by AAOIFI in its efforts to enhance the industry's human resources base and governance structures.

## 4. 8 International Islamic Financial Market (IIFM)



IIFM is a standard-setting body of the Islamic Financial Services Industry (IFSI) focusing on **standardization of Islamic financial contracts and product templates** relating to the capital and money market, corporate finance and trade finance segments of the IFSI.

IIFM which is based in Manama and hosted by the Central Bank of **Bahrain** (CBB), was established in **2002**.

its mission is to create a robust, transparent and efficient Islamic financial market, IIFM promotes at the global level **unification, best practices** and Shari'ah harmonization through introducing and developing Shari'ah compliant standard financial contracts. IIFM published total **14 standards** on different products of Islamic finance.

## 4. 9 Islamic Financial Service Board (IFSB)

The IFSB is an international standard-setting organisation, which started operations in **2003**. is an international standard-setting body that promotes and enhances the **soundness and stability** of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.



the work of the IFSB complements that of the **Basel Committee** on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

Since its inception, the IFSB has issued **36 Standards, Guiding Principles and Technical Notes** for the Islamic financial services industry.

**Malaysia**, the host country of the IFSB. **Dr. Bello Lawal Danbatta** is its existing **Secretary-General**.

**THE END**