



# **RISK MANAGEMENT MODULE**



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<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-A:</b>	<b>Introduction</b>

## RM-A.1 Purpose

### *Executive Summary*

RM-A.1.1 This Module sets out principles of risk management for Islamic bank licensees. Apart from a general requirement in RM-1.1.1 below, all other principles are grouped into six categories of risks, and are to be used as the basis for Islamic bank licensees' risk management processes.

### *Introduction*

RM-A.1.2 This Module provides a set of guidelines of best practice for establishing and implementing effective risk management in Islamic bank licensees. This Module follows the Guiding Principles included in the Islamic Financial Services Board (IFSB) (Risk Management Standard issued in December 2005) and risk management principles issued by the Basel committee.

RM-A.1.3 This Module sets out fifteen principles of risk management that give practical effect to managing the risks underlying the business objectives that Islamic bank licensees may adopt. The Module provides some examples of current practices, recognising that these practices may change as markets change and as technology, financial engineering and improved coordination between regulatory authorities makes other strategies available. However, the Module does not detail every possible control procedure.

RM-A.1.4 The Module provides specific guidance and outlines a set of principles applicable to six categories of risk:

- (a) Credit risk;
- (b) Equity investment risk;
- (c) Market risk;
- (d) Liquidity risk;
- (e) Rate of return risk; and
- (f) Operational risk .

RM-A.1.5 The Central Bank of Bahrain ('the CBB') recognises that the specific risk management practices of each Islamic bank licensee will vary in scope and content depending on its activities. All Islamic bank licensees are expected to make meaningful risk assessments based on the principles described in this Module.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-A: Introduction</b>

## RM-A.1 Purpose (continued)

RM-A.1.6 It is crucial for Islamic bank licensees to recognise and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the risks noted in Paragraph RM-A.1.4. In addition, Islamic bank licensees may face consequential business risks relating to developments in the external marketplace. Adverse changes in Islamic bank licensees' markets, counterparties, or products as well as changes in the economic and political environments in which Islamic bank licensees operate and the effects of different Shari`a rulings are examples of business risk. These changes may affect Islamic bank licensees' business plans, supporting systems and their financial position. In this regard, Islamic bank licensees are expected to view the management of these risks from a holistic perspective.

RM-A.1.7 Islamic bank licensees are also exposed to reputational risk arising from failures in governance, business strategy and processes. Negative publicity about the concerned Islamic bank licensees' business practices, particularly relating to Shari`a non-compliance in products and services, could have an impact upon market position, profitability and liquidity.

### *Legal Basis*

RM-A.1.8

This Module contains the CBB's Directive (as amended from time to time) relating to risk management and is issued under the powers available to the CBB under Article 38 of the Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law'). The Directive in this Module is applicable to all Islamic bank licensees (including their approved persons).

RM-A.1.9 For an explanation of the CBB's rule-making powers and different regulatory instruments, see section UG-1.1.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-A: Introduction</b>

## RM-A.2 Module History

### *Evolution of the Module*

RM-A.2.1 This Module was first issued in January 2013. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made: Chapter UG-3 provides further details on Rulebook maintenance and version control.

RM-A.2.2 The most recent changes made to this Module are detailed in the table below:

### *Summary of Changes*

Module Ref.	Change Date	Description of Changes
RM-2.1.2, RM-2.1.13, RM-2.2.15, RM-3.3.4, and RM-7.2.4	04/2013	Minor corrections.

### *Superseded Requirements*

RM-A.2.3 This Module does not replace any regulations or circulars in force prior to January 2013.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-B:</b>	<b>Scope of Application</b>

## **RM-B.1 License Categories**

### **RM-B.1.1**

This Module applies in full to all locally incorporated banks. Branches of foreign banks which are licensed in Bahrain must ensure that their policies and procedures are consistent with these requirements.



MODULE	RM: Risk Management
CHAPTER	RM-1: General Requirements

## RM-1.1 Risk Management

### RM-1.1.1

Islamic bank licensees must have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight to identify, measure, monitor, report and control the categories of risk relevant to their business, and where appropriate, to hold adequate capital against these risks. The risk management function must have an appropriate standing and authority within the bank and must be actively involved at an early stage in elaborating the bank's risk strategy and in all material risk management decisions.

### RM-1.1.2

The above process should take into account appropriate steps to comply with Shari'a rules and principles, to ensure the adequacy of relevant risk reporting to the CBB.

### RM-1.1.3

The Board must approve the risk management objectives, strategies, policies and procedures that are consistent with the Islamic bank licensee's financial condition, risk profile and risk tolerance. The risk management objectives, strategies, policies and procedures must be stated in a set of formal risk management documents. The risk management documents must be communicated at all levels within the Islamic bank licensee involved in the implementation of risk management policies (see Sections HC-1.2, HC-9.2, CM-2.1 and CM-4.7 for more detailed rules and guidance).

### RM-1.1.4

Islamic bank licensees must implement sound processes of risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information system (MIS) for internal risk reporting and decision-making that are commensurate with the scope, complexity and nature of the Islamic bank licensee's activities.

### RM-1.1.5

Islamic bank licensees must implement an adequate control framework with effective checks and balances in compliance with CBB Rulebook requirements identified in this and other Modules and with the requirements of the CBB Law.

### RM-1.1.6

The Board must ensure that risk reporting to the CBB is made within the required deadlines and of high quality. In addition, to formal reporting requirements, the Board and senior management must be prepared to provide additional information to the CBB and stakeholders of the Islamic bank licensee to identify emerging problems, including those giving rise to systemic risk issues.



MODULE	RM:	Risk Management
CHAPTER	RM-1:	General Requirements

## RM-1.1 Risk Management (continued)

### RM-1.1.7

The Islamic bank licensee must make appropriate and timely disclosure of information to investment account holders (IAHs) to enable assessment of risks and rewards of investments, using AAOIFI auditing standards (see Paragraphs PD-1.3.32 – PD-1.3.35 for detailed disclosure requirements).





<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-2:</b>	<b>Credit Risk</b>

## RM-2.1 Definition and Profiles of Credit Risk

RM-2.1.1 Credit risk is generally defined as the potential that a counterparty fails to meet its obligations in accordance with agreed terms. This definition is applicable to Islamic bank licensees managing the financing exposures of receivables and leases (for example, Murabahah, Diminishing Musharakah and Ijarah) and working capital financing transactions/projects (for example, Salam, Istisna` or Mudarabah<sup>1</sup>). Islamic bank licensees manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration. Credit risk includes the risk arising in the settlement and clearing of transactions.

RM-2.1.2 The following premises relate to the sound processes of credit risk management in an Islamic bank licensee:

- (a) The role of banks can embrace those of financiers, suppliers, Mudarib and Musharakah partners. Islamic bank licensees should concern themselves with the risk of a counterparty's failure to meet his obligations in terms of receiving deferred payment and making or taking delivery of an asset. A failure could relate to a delay or default in payment, or in delivery of the subject matter of Salam or Parallel Istisna', entailing a potential loss of income and even capital for the Islamic bank licensee;
- (b) Due to the unique characteristics of each financing instrument, such as the non-binding nature of some contracts, the commencement stage involving credit risk varies. Therefore, credit risk should be assessed separately for each financing instrument to facilitate appropriate internal controls and risk management systems; and
- (c) Islamic bank licensees should consider other types of risks that give rise to credit risk. For example, during the contract life, the risk inherent in a Murabahah contract is transformed from market risk to credit risk. In another example, the invested capital in a Mudarabah or Musharakah contract will be transformed to debt in case of proven negligence or misconduct of the Mudarib or the Musharakah's managing partner.

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<sup>1</sup> In cases where Mudarabah is used in project finance, a licensee advances funds to a customer who acts as Mudarib in a construction contract for a third-party customer (ultimate customer). The ultimate customer, who has no direct or contractual relationship with the licensee, will make progress payments to the Mudarib who in turn makes payment to the licensee. The role of the licensee is to provide bridging finance on a profit-sharing basis to the Mudarib pending its receipt of the progress payments from the ultimate customer. The licensee is exposed to credit risk on the amounts advanced to the Mudarib.



MODULE	RM: Risk Management
CHAPTER	RM-2: Credit Risk

## RM-2.2 Credit Strategy

### RM-2.2.1

Islamic bank licensees must have in place a framework for credit risk management that includes identification, measurement, monitoring, reporting and control of credit risks. Adequate capital must be held against credit risks assumed. Islamic bank licensees must also comply with CBB rulebook requirements, regulations, resolutions and parts of the CBB Law applicable to their financing activities.

### RM-2.2.2

Islamic bank licensees must assess credit risk in a holistic manner and ensure that credit risk management forms a part of an integrated approach to the management of all financial risks.

### RM-2.2.3

Given the nature of Islamic financing instruments, the sources of credit risk may be the same as that of market or operational risks. For example, in a Salam contract, changes in market risk factors such as commodity prices, as well as the external environment (for example, bad weather) become key determinants affecting the likelihood of default.

### RM-2.2.4

Islamic bank licensees must have in place:

- (a) An appropriate credit strategy document which includes pricing and tolerance for undertaking various credit risks;
- (b) A risk management structure with effective oversight of credit risk management: This includes credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- (c) An appropriate measurement and careful analysis of exposures, including market- and liquidity-sensitive exposures; and
- (d) A system:
  - (i) To monitor the condition of ongoing individual credits to ensure the financings are made in accordance with the Islamic bank licensees' policies and procedures;
  - (ii) To manage problem credit situations according to an established remedial process; and
  - (iii) To ensure adequate provisions are allocated in accordance with CBB requirements.

### RM-2.2.5

Islamic bank licensees must implement a credit strategy using various instruments in compliance with Shari'a, whereby the credit strategy recognizes the potential credit exposures that may arise at different stages of the various financing agreements.



MODULE	RM:	Risk Management
CHAPTER	RM-2:	Credit Risk

## RM-2.2 Credit Strategy (continued)

### RM-2.2.6

The Board must define and set the bank's overall levels of risk appetite, risk diversification and asset allocation strategies applicable to each Islamic financing instrument, economic activity, geographical spread, season, currency and tenor in the credit strategy document. The Board must be mindful of and take into account the permissible types of financing instruments available in different locations wherever the Islamic bank licensee undertakes cross-border transactions. The Board must take into account seasonal aspects resulting from a shifting or termination of use of certain financing instruments, thus affecting the overall concentration exposures of the Islamic bank licensee's financing portfolio.

### RM-2.2.7

For example, the Islamic bank licensee may offer Salam contracts during a certain season where a product can most likely be delivered and sold at maturity.

### RM-2.2.8

An Islamic bank licensee's credit strategies must include a list of all types of applicable and approved transactions and financings that the bank is allowed to undertake. The approved list must include formal exclusions from any engagement by the Islamic bank licensee in certain prohibited industries, such as pork meat, alcohol, gambling, pornography etc. The approved list must be kept up to date and communicated to the relevant personnel within the Islamic bank licensee, and an internal compliance function must be organised and empowered to ensure that such rules are applied.

### RM-2.2.9

The Board should ensure that it is aware of the commencement of exposure to credit risk inherent in different financing instruments and in various jurisdictions when developing the strategy. The non-binding promise and legal enforcement aspects vary among market counterparties and customers or from one jurisdiction to another, which may give rise to operational risks and other risk management problems relating to Shari'a compliance.

### RM-2.2.10

When setting the level of risk appetite relating to counterparties, the Board must ensure that:

- (a) The expected rate of return on a transaction is commensurate with the risks incurred;
- (b) Measures have been put in place to prevent excessive credit risk (at both individual and portfolio levels) and risk concentration (for example financing instruments, economic activity, geographical and sectoral spread); and
- (c) It considers the CBB's exposure limits for counterparties.



MODULE	RM: Risk Management
CHAPTER	RM-2: Credit Risk

## RM-2.2 Credit Strategy (continued)

### RM-2.2.11

The risk management function must carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

### RM-2.2.12

Islamic bank licensees must establish policies and procedures defining eligible counterparties (retail/consumer, corporate or sovereign), the nature of approved financings and types of appropriate financing instruments. The risk management function must obtain sufficient information to permit a comprehensive assessment of the risk profile of the counterparty prior to the financing being granted.

### RM-2.2.13

Islamic bank licensees must have a policy for carrying out a due diligence process<sup>2</sup> in evaluating counterparties, in particular, for transactions involving:

- (a) New ventures with multiple financing modes: Islamic bank licensees must carry out due diligence processes on customers or sovereigns using multiple financing modes to meet specific financial objectives designed to address Shari'a, legal or tax issues of customers: and
- (b) Creditworthiness that may be influenced by external factors: Where significant investment risks are present in participatory instruments, especially in the case of Mudarabah financings, additional counterparty reviews and evaluations will focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash flows<sup>3</sup>. Risk mitigating structures must be put in place by Islamic bank licensees as far as possible.

### RM-2.2.14

Islamic bank licensees must receive their Shari'a Supervisory Board Fatwa on all new financing proposals that have not been proposed before or amendments to existing contracts. Islamic bank licensees may also engage appropriate technical expert (for example an engineer) to evaluate the feasibility of a proposed new project and to assess and approve progress billings to be made under the contract.

<sup>2</sup> The process may include Value at Risk, stress testing and sensitivity analysis, amongst others.

<sup>3</sup> Please refer to Chapter RM-3 on Equity Investment Risk.



MODULE	RM:	Risk Management
CHAPTER	RM-2:	Credit Risk

## RM-2.2 Credit Strategy (continued)

RM-2.2.15 In a financing involving several related agreements, Islamic bank licensees need to be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. To be Shari'a compliant, subject to the interpretation of its Shari'a scholars, an Islamic bank licensee should ensure that all components of the financial structure are contractually independent, although these may be executed in a parallel manner despite their interrelated nature.

### RM-2.2.16

Islamic bank licensees must have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

### RM-2.2.17

Islamic bank licensees must develop and implement appropriate risk measurement and reporting methodologies relevant to each Islamic financing instrument in respect of managing their counterparty risks, which may arise at different contract stages (including counterparty performance risk in Salam and Istisna' contracts). Depending on the Islamic financing instrument, the Islamic bank licensees must employ an appropriate methodology that takes into account the price volatilities of the underlying assets. The selected methodology must be appropriate given the nature, size and complexity of the Islamic bank licensee's credit related activities. Islamic bank licensees must ensure that adequate systems and resources are available to implement this methodology.

### RM-2.2.18

Islamic bank licensees must have in place Shari'a-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

### RM-2.2.19

Islamic bank licensees must clearly define their credit risk-mitigating techniques including, but not limited to, having in place:

- (a) A methodology for setting mark-up rates according to the risk rating of the counterparties, where expected risks should have been taken into account in the pricing decisions;
- (b) Permissible and enforceable collateral<sup>4</sup> and guarantees;
- (c) Clear documentation as to whether or not purchase orders are cancellable;<sup>5</sup> and
- (d) Clear procedures for taking account of governing laws for contracts relating to financing transactions.

<sup>4</sup> Islamic bank licensees are expected to include in their processes, an ongoing monitoring of quality and valuation of any collateral.

<sup>5</sup> In some jurisdictions, a purchase order backed by a promise to purchase would constitute a binding contract according to contract law and would be legally enforceable if adequately evidenced.



MODULE	RM: Risk Management
CHAPTER	RM-2: Credit Risk

## RM-2.2 Credit Strategy (continued)

### RM-2.2.20

Islamic bank licensees must establish limits on the degree of reliance and the enforceability of collateral and guarantees. They must protect themselves against legal impediments that may restrict the accessibility of collateral when they need to enforce their rights in respect of a debt. Islamic bank licensees must formally agree with the counterparty at the time of signing the contract on the usage, redemption and utilisation of collateral if the counterparty defaults in payment, and avoid over concentration on certain classes of collateral, such as real estate.

### RM-2.2.21

Islamic bank licensees must have policies to define adequately the action to be taken by the Islamic bank licensee when a customer cancels a non-binding purchase order. The policies must describe how the Islamic bank licensee:

- (a) Will monitor and control its exposures to suppliers, and especially during delivery between suppliers to the Islamic bank licensee where a customer is acting as an agent; and
- (b) Identify whether the risks associated with the assets will be borne by the supplier or the customer (which acts as agent and accepts the assets from the supplier)<sup>6</sup>.

RM-2.2.22 With respect to Subparagraph RM-2.2.21, the Islamic bank licensee may enter into a purchase contract with a supplier on a “sale or return” basis, with an option to return the purchased item within a specified period.

### RM-2.2.23

The risk management function must implement appropriate credit management systems and administrative procedures to undertake early remedial action in the case of financial distress of a counterparty or, in particular, for managing problem credits, potential and defaulting counterparties<sup>7</sup>. This system must be reviewed on a regular basis. Remedial actions must include both administrative and financial measures.

<sup>6</sup> Islamic bank licensees shall be mindful that the counterparty risk will not commence prior to execution of other contracts or before certain events take place. In the case of certain Murabahah transactions, the long period preceding the delivery of imported goods from abroad gives rise to other risks which may not all be covered by takaful or insurance.

<sup>7</sup> In certain jurisdictions, the Shari’a may differentiate between two kinds of defaulter; (a) the affluent or able (wilful defaulter or procrastinator); and (b) the insolvent defaulter who is unable to pay his debts due to reasons permitted by Shari’a, to determine whether a penalty can be imposed which should be disposed of.



MODULE	RM: Risk Management
CHAPTER	RM-2: Credit Risk

## RM-2.2 Credit Strategy (continued)

RM-2.2.24

Administrative measures may inter alia include:

- (a) Negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty;
- (b) Setting an allowable timeframe for payment or to offer debt-rescheduling or restructuring arrangements (without an increase in the amount of the debt);
- (c) Using a debt-collection agency;
- (d) Resorting to legal action, including the attachment of any credit balance belongs to defaulters according to the agreement between them; and
- (e) Making a claim under Shari'a-compliant insurance.

RM-2.2.25

Financial measures may include, among others:

- (a) Imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with Shari'a decided by the bank's Shari'a Supervisory Board; and
- (b) Establishing the enforceability of collateral or third party guarantees.

**RM-2.2.26**

**Islamic bank licensees must set appropriate measures for early settlements, which are permissible under Shari'a rules and principles for each Islamic financing instrument. These arrangements must be in line with CBB Rulebook requirements in Section CM-7.6.**

RM-2.2.27

With respect to early settlements referred to in Paragraph RM-2.2.26, Islamic bank licensees may grant discretionary rebate, to their customers by reducing the amount of receivables in subsequent transactions, if they so wish.

**RM-2.2.28**

**Islamic bank licensees must assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions.**

RM-2.2.29

For instance, in the case of an Istisna transaction, the Islamic bank licensee enters into an Istisna contract as seller to provide manufactured goods or a building to a customer. The Islamic bank licensee will then enter into another (parallel) Istisna contract as buyer with a supplier (manufacturer or builder), using the specifications drawn up for the original contract. If the supplier fails to deliver the manufactured goods or the building according to the agreed specifications, the Islamic bank licensee would equally be in default of its obligation. If necessary, a separate engineering department might be established or an outside expert should be engaged to evaluate, approve and monitor the technical aspects. Islamic bank licensees may also stipulate that the party to the first contract must inspect the manufactured goods or building from time to time during the production or construction process to satisfy themselves that the specifications are being met.



MODULE	RM:	Risk Management
CHAPTER	RM-2:	Credit Risk

## RM-2.2 Credit Strategy (continued)

### RM-2.2.30

Islamic bank licensees must establish appropriate policies and procedures that require them to honour their commitment to the parallel contract counterparty. In certain countries, where parallel contract is necessary to be transacted with the first Salam contract in order to mitigate market risk exposures, there must be no legal linkages between the two contracts.

### RM-2.2.31

Islamic bank licensees must implement a system to ascertain and fulfil their obligations in respect of leased assets, which are permanently impaired through no default of the lessee. In case of such impairment, Islamic bank licensees must provide the lessee with a replacement asset with similar specifications, if such specifications were agreed upon, or if the contract was renewed, or to refund the additional amounts (capital payments) included in the Ijarah Muntahia Bittamleek (IMB) lease rentals as compared with those in an operating Ijarah. Islamic bank licensees must establish appropriate risk management policies to mitigate losses arising from such damage during the term of the lease.

### RM-2.2.32

Islamic bank licensees must ensure, whenever possible, that there is sufficient Shari'a-compliant insurance coverage of the value of the assets, subject to availability. If necessary, Islamic bank licensees must engage an insurance advisor at an early stage to review the insurance coverage of the leased assets.

### RM-2.2.33

If a loss arises from negligence by the lessee, Islamic bank licensees are permitted to claim compensation from the lessee. The Islamic bank licensee (as lessor) bears the risks associated with the leased assets and cannot use a lessee's guarantees to recover the amount of the losses on the leased assets (unless these are due to misconduct, negligence or breach of contract on the part of the lessee).

### RM-2.2.34

Islamic bank licensees must implement an appropriate policy for determining and allocating provisions for non-performing credit facilities including counterparty exposures (See CM-3 for more details).





<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-3:</b>	<b>Equity Investment Risk</b>

## RM-3.1 Background

RM-3.1.1 This Chapter sets out the principles and rules pertaining to the management of risks inherent in the holding of equity instruments for investment purposes. In particular, for Islamic bank licensees, the relevant instruments are typically those based on the Mudarabah and Musharakah contracts. This Chapter focuses on such instruments. The risks entailed by holding equity instruments for trading or liquidity purposes are dealt with under market risk in Chapter RM-4. While investments made via Mudarabah and Musharakah instruments may contribute substantially to Islamic bank licensees' earnings, they entail significant market, liquidity, credit<sup>8</sup> and other risks, potentially giving rise to volatility in earnings and capital.

RM-3.1.2 The capital invested through Mudarabah and Musharakah may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, Islamic bank licensees may invest at different investment stages.

RM-3.1.3 One distinct difference between Mudarabah and Musharakah financings is in terms of Islamic bank licensee's involvement in the investments during the contract period. In Mudarabah, the Islamic bank licensee invests its money as a silent partner and, the management is the exclusive responsibility of the other party, namely the Mudarib. In contrast, in Musharakah financing the Islamic bank licensee invests funds with partners, and the Islamic bank licensee may be a silent partner, or may participate in management. Regardless of the authority under which the profit sharing instruments are used, both Musharakah and Mudarabah are profit-sharing financings, under which the capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to impairment in the event of losses (capital impairment risk).

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<sup>8</sup> One example of credit risk exposure arises from the Mudarib's obligation to pay the agreed share of profit to the Islamic bank licensee as Rabb al-mal when such payment falls due. Failure to meet this obligation constitutes a case of misconduct and negligence in the part of the Mudarib.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-3: Equity Investment Risk</b>

## RM-3.2 Definition and Profiles of Equity Investment Risk

- RM-3.2.1 The type of equity investment risk dealt with in this Chapter may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.
- RM-3.2.2 The characteristics of such equity investments include considerations as to the quality of the partner, underlying business activities and ongoing operational matters. By nature, this type of equity investment is exposed to a confluence of risks associated with Mudarib or Musharakah partner, business activity and operations.
- RM-3.2.3 In evaluating the risk of an investment using the profit sharing instruments of Mudarabah or Musharakah, the risk profiles of potential partners (Mudarib or Musharakah partner) are crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfilment of an Islamic bank licensee's fiduciary responsibilities as an investor of IAH funds on a profit-sharing and loss-bearing basis (Mudarabah) or a profit and loss sharing basis (Musharakah). These risk profiles include the past record of the management team and quality of the business plan of, and human resources involved in, the proposed Mudarabah or Musharakah activity.
- RM-3.2.4 Factors relating to the legal and regulatory environment affect equity investment performance, and need to be considered in the risk evaluation. These factors include policies pertaining to tariffs, quotas, taxation or subsidies and any sudden policy changes affecting the quality and viability of an investment.
- RM-3.2.5 Islamic bank licensees are exposed to the risks attaching to a lack of reliable information on which to base their investment appraisals, such as an inadequate financial control system. The mitigation of these risks may require the investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures.
- RM-3.2.6 Although timely allocation of profit can be agreed upfront, Islamic bank licensees should be prepared for delays and variations in cash flow patterns and possible difficulties in executing a successful exit strategy.
- RM-3.2.7 The risks arising from the use of profit sharing instruments for financing purposes do not include credit risk in the conventional sense, but share a crucial characteristic of credit risk because of the risk of capital impairment.



MODULE	RM: Risk Management
CHAPTER	RM-3: Equity Investment Risk

### RM-3.3 Operational Considerations

**RM-3.3.1** Islamic bank licensees must implement appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.

**RM-3.3.2** Islamic bank licensees must define and set the objectives of, and criteria for, investments using profit sharing instruments, including the types of investment, tolerance for risk, expected returns and desired holding periods. Islamic bank licensees must define their investments exit strategy (see paragraphs RM-3.3.14-16 for more details).

RM-3.3.3 For purposes of Paragraph RM-3.3.2, a Musharakah structure may contain an option for redemption whereby the Islamic bank licensee as financier has a contractual right to require its partner periodically to purchase, under a separate contract, a proportion of the Islamic bank licensee's share in the investment at net asset value or, if the contract so specifies on some agreed basis (Diminishing Musharakah).

**RM-3.3.4** Islamic bank licensees must implement and keep under review, policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from profit sharing investments. Islamic bank licensees must ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which an Islamic bank licensee invests as partner. These must include evaluation of Shari'a compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

**RM-3.3.5** Islamic bank licensees must identify and monitor the transformation of risks at various stages of investment lifecycles, for example, where the investee's business involves innovative or new products and services in the marketplace. Islamic bank licensees that employ different financing instruments (where one of which include Musharakah) at different contract stages must have appropriate procedures and controls in place, as different stages may give rise to different risks.

**RM-3.3.6** Islamic bank licensees must analyse and determine possible factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.



MODULE	RM: Risk Management
CHAPTER	RM-3: Equity Investment Risk

### RM-3.3 Operational Considerations (continued)

RM-3.3.7 Islamic bank licensees should use, if applicable, Shari'a compliant risk-mitigating techniques, both financial and non-financial in nature, to reduce the impact of possible capital impairment of an investment.

**RM-3.3.8** Islamic bank licensees must ensure that their valuation methodologies are appropriate and consistent, and assess the potential impacts of their methods on profit calculations and allocations. The methods must be mutually agreed between the Islamic bank licensees and the Mudarib and/or Musharakah partners.

**RM-3.3.9** Islamic bank licensees must agree with the Mudarib and/or Musharakah partners before entering into any agreement, on the appropriate valuation methods and periods for which the profit is to be calculated and allocated taking into account market practices and liquidity features.

RM-3.3.10 Valuation and accounting play an important role in measuring the quality of an equity investment, especially in a privately held entity, for which independent price quotations are not always available nor sufficient in volume to provide a basis for meaningful liquidity or market valuation. An appropriate and agreed method to be applied to determine the profit of the investment can be in the form of a certain percentage of either gross or net profit earned by the Mudarabah or Musharakah business, or any other mutually agreed terms.

**RM-3.3.11** In the case of a change of the partnership's shares in a Musharakah (for example in a Diminishing Musharakah), the shares changing hands must be valued at fair value.

**RM-3.3.12** Islamic bank licensees must assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatement of partnership earnings. Reported earnings can be either gross or net. If for some reason the practices of smoothing profits over accounting periods and the establishment of escrow accounts to hold certain profit portions during the life of an equity investment are recognised and agreed by all the investing parties, the Islamic bank licensee must incorporate their potential impact in the Islamic bank licensee's overall earnings.



MODULE	RM: Risk Management
CHAPTER	RM-3: Equity Investment Risk

### RM-3.3 Operational Considerations (continued)

RM-3.3.13 Islamic bank licensees may agree with the Mudarib and/or Musharakah partners to engage independent parties where necessary to carry out audits and valuations of the investments. Provided these are properly executed and completed, these measures will help to ensure transparency and objectivity in valuation and in the distribution of profits and the determination of amounts to be redeemed.

**RM-3.3.14** Islamic bank licensees must define and establish the exit strategies in respect of their equity investment activities prior to commitment, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of the Islamic bank licensee's Shari'a Board.

**RM-3.3.15** Islamic bank licensees must establish the criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments.

**RM-3.3.16** The criteria may include alternative exit routes and the timing of exit. In case of losses where improved business prospects exist, Islamic bank licensees may indicate an investment extension period. Islamic bank licensees' expectations should be based on their assessment that there are plausible grounds for believing that there will be a business turnaround during the period resulting in the view that the investment will, in a defined time period, recover and yield profits.

**RM-3.3.17** Islamic bank licensees must recognise that, as a going concern, an investee may not always have the liquidity necessary to enable making profit distributions. Hence, Islamic bank licensees must agree with the investment partner the methods for the treatment of retained profits by the investee.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-4:</b>	<b>Market Risk</b>

## **RM-4.1 Market Risk**

RM-4.1.1 This Chapter sets out principles in respect of market risk, which refer to the potential impact of adverse price movements such as benchmark rates, foreign exchange (FX) rates, equity prices and commodity prices, on the economic value of an asset. Market risk exposures may occur at certain times or throughout the contract.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-4:</b>	<b>Market Risk</b>

## RM-4.2 Definition and Profiles of Market Risk

- RM-4.2.1 For the purpose of this Module, market risk is defined as 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 leaseable assets (including sukuk) and in off-balance sheet individual portfolios (for example Collective Investment Undertakings). The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a sukuk, the market value of Murabaha assets purchased to be delivered over a specific period) and of foreign exchange rates. Market risk capital requirements are outlined in paragraph CA-1.1.4.
- RM-4.2.2 In operating Ijarah, a lessor is exposed to market risk on the residual value of the leased asset at the maturity of the lease or if the lessee defaults or exercises early termination rights during the contract. In IMB, a lessor is exposed to market risk on the carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.
- RM-4.2.3 In Salam, Islamic bank licensees are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk that a failure of delivery of the subject matter would leave the Islamic bank licensee exposed to commodity price risk as a result of the need to purchase a similar asset in the spot market in order to honour the parallel Salam contract.
- RM-4.2.4 When Islamic bank licensees are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets.
- RM-4.2.5 Islamic bank licensees are also exposed to foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables. These exposures may be hedged using Shari'a compliant methods.



MODULE	RM: Risk Management
CHAPTER	RM-4: Market Risk

### RM-4.3 Operational Considerations

#### RM-4.3.1

Islamic bank licensees must implement an appropriate framework for market risk management (including reporting) in respect of all related assets held, including those that do not have a ready market and/or are exposed to high price volatility.

#### RM-4.3.2

The Board must develop a market risk strategy including the level of acceptable market risk appetite taking into account contractual agreements with fund providers, types of risk-taking activities and target markets in order to maximise returns while keeping exposures at or below the pre-determined levels. The strategy must be reviewed periodically by the Board, communicated to relevant staff and disclosed to fund providers.

#### RM-4.3.3

Islamic bank licensees must establish an appropriate sound and comprehensive market risk management process and information system, which (among others) comprise:

- (a) A conceptual framework to assist in identifying underlying market risks;
- (b) Guidelines governing risk taking activities in different portfolios of assets financed by investments accounts and portfolios of Collective Investment Undertakings and their market risk limits;
- (c) Appropriate frameworks for pricing, valuation and income recognition; and
- (d) A strong MIS for controlling, monitoring and reporting market risk exposure and performance to appropriate levels of senior management.

Given that all the required measures are in place (e.g. pricing, valuation and income recognition frameworks, strong MIS for managing exposures, etc.), the applicability of any market risk management framework that has been developed must be assessed taking into account consequential business and reputation risks.

#### RM-4.3.4

Islamic bank licensees must be able to quantify market risk exposures and assess exposure to the probability of future losses in their net open asset positions.





MODULE	RM: Risk Management
CHAPTER	RM-4: Market Risk

### RM-4.3 Operational Considerations (continued)

#### RM-4.3.5

The risk exposures in investment securities are similar to the risks faced by conventional financial intermediaries, namely market price, liquidity, foreign exchange rates and credit risk. In this regard, Islamic bank licensees must ensure that their strategy includes the definition of their risk appetite for these tradable assets and that this risk appetite is adequately supported by capital held for that purpose.

#### RM-4.3.6

In the valuation of assets where no direct market prices are available, Islamic bank licensees must incorporate in their own product programme a detailed approach to valuing their market risk positions.

#### RM-4.3.7

Islamic bank licensees may employ appropriate forecasting techniques agreed with their external auditor to assess the potential value of these assets.

#### RM-4.3.8

Where available valuation methodologies are deficient, Islamic bank licensees must assess the need to:

- (a) Allocate funds to cover risks resulting from illiquidity, new assets and uncertainty in assumptions underlying valuation and realisation; and
- (b) Establish a contractual agreement with the counterparty specifying the methods to be used in valuing the assets.<sup>9</sup>

#### *Collective Investment Undertakings (CIUs)*

#### RM-4.3.9

Islamic bank licensees have a fiduciary duty to apply the same risk management policies and procedures to assets held on behalf of investors in CIUs as they do for assets held on behalf of shareholders and unrestricted IAH.

#### RM-4.3.10

Where Islamic bank licensees play the role of market maker to CIUs, this gives rise to liquidity risk, which should be managed according to appropriate procedures as set out in Chapter RM-5

<sup>9</sup> It should be noted that similar arrangements are suggested to mitigate contract cancellation, which is explained under RM-2 Credit Risk.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-5: Liquidity Risk</b>

## **RM-5.1 Liquidity Risk**

RM-5.1.1 This Chapter sets out guidance pertaining to liquidity risks, which highlights the key elements for effective liquidity management within the scope of Islamic bank licensees' exposures. Islamic bank licensees solicit and attract various sources of funds to channel to their financing and investment activities. Islamic bank licensees may have various kinds of obligations, such as requirements to repay current account holders on demand, to provide committed funds in Musharakah transactions, and to make available cash flows for expenses or profit payments.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-5:</b>	<b>Liquidity Risk</b>

## RM-5.2 Definition and Profiles of Liquidity Risk

RM-5.2.1 Liquidity risk is the potential loss to Islamic bank licensees 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.

### *Profiles of Fund Providers*

RM-5.2.2 There are two major types of fund providers:  
(a) Current account holders; and  
(b) Unrestricted IAH.

These account holders require a degree of liquidity to be maintained by the Islamic bank licensees to meet their requirements for withdrawals. Subject to contractual conditions, investors in CIUs (while not on-balance sheet fund providers) may also give rise to liquidity management considerations, in so far as Islamic bank licensees may need to replace funds withdrawn by an investor pending realisation of the related assets.

RM-5.2.3 As current account holders do not participate in the profits of the Islamic bank licensees' business activities, a sound repayment capacity is required to meet fully cash withdrawal requests as and when they arise.

RM-5.2.4 Some Islamic bank licensees may rely heavily on funds provided by current account holders. Repayment by the Islamic bank licensees of the principal amounts deposited by current account holders is guaranteed without any rights to share in profits, as the current account holders do not share in the risks of the Islamic bank licensees.

RM-5.2.5 Unrestricted IAH are investors who participate in the uncertainties of an Islamic bank licensee's business; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by IAH may be the result of:  
(a) Lower than expected or acceptable rates of return;  
(b) Concerns about the financial condition of the Islamic bank licensees; and  
(c) Non-compliance by the Islamic bank licensees with Shari'a rules and principles in various contracts and activities.

RM-5.2.6 Where the principle of Mudarabah is employed to source the funds, from an asset-liability management perspective, Islamic bank licensees may be viewed as being hedged to the extent that the IAH bears the risks of the assets in which its funds are invested. This statement is true only if the Mudarib has acted in accordance with its fiduciary duties under the Mudarabah contracts and without misconduct or negligence.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-5:</b>	<b>Liquidity Risk</b>

## RM-5.2 Definition and Profiles of Liquidity Risk (continued)

RM-5.2.7 IAH do not share in the risks on assets financed by current accounts, which are borne by shareholders alone.

RM-5.2.8 As fiduciary agents, Islamic bank licensees are concerned with matching their investment policies with IAH and shareholders' risk appetites. If these investment policies are not consistent with the expectations and risk appetites of IAH, the latter may withdraw their funds leading to a liquidity crisis for the Islamic bank licensees.



MODULE	RM: Risk Management
CHAPTER	RM-5: Liquidity Risk

### RM-5.3 Operational Considerations

#### RM-5.3.1

Islamic bank licensees must implement a liquidity management framework (including reporting) taking into account both separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

#### *Liquidity Management Policy*

#### RM-5.3.2

Islamic bank licensees must maintain adequate liquidity to meet their obligations at all times. In this regard and taking into consideration the nature of the Islamic bank licensees, its business activities and its capital market environment, the Islamic bank licensees must have in place liquidity management policies, which must be reviewed periodically by the Board, covering:

- (a) Strategy for managing liquidity involving effective board of directors (BOD) and senior management oversight;
- (b) A framework for developing and implementing sound processes for measuring and monitoring liquidity;
- (c) Adequate systems in place for monitoring and reporting liquidity exposures on a periodic basis;
- (d) Adequate funding capacity, with particular reference to the board's assessment of the willingness, ability and likely support of shareholders to provide additional capital when necessary;
- (e) Access to liquidity through fixed asset realizations and arrangements such as sale and lease-back; and
- (f) Liquidity crisis management.

#### RM-5.3.3

The policies should incorporate both quantitative and qualitative factors. Quantitative factors include the extent of diversity and sources of funds, mismatches of liabilities and assets concentration of the funding base, reliance on marketable assets, or availability of standby lines of external funding. Qualitative factors include assessing the general ability of the management, the particular skills in treasury management and public relations, the quality of MIS, Islamic bank licensees' reputation in the market, the willingness and ability of shareholders to provide additional capital and, in the case of a branch or subsidiary the willingness and ability of the head office or parent to provide liquidity.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-5: Liquidity Risk</b>

### RM-5.3 Operational Considerations (continued)

RM-5.3.4 Since liquidity infrastructures vary from country to country, the Islamic bank licensees operating across jurisdictions are expected to adhere to local requirements for liquidity management. In this regard, Islamic bank licensees which are part of a group should normally be expected to be able to stand alone, and thus, to monitor and manage their own liquidity separately. However, with the agreement of the CBB, branches of foreign banks operating in Bahrain may take into account the assurance of liquidity provision by head office to the Bahrain branch.

#### *Measuring and Monitoring Liquidity*

##### RM-5.3.5

Islamic bank licensees must identify any future shortfalls in liquidity by constructing maturity ladders based on appropriate time bands, including those specified by the CBB in Module LM. The Islamic bank licensees may have their own criteria for classifying cash flows, including behavioral methods, and may consider differentiating the types of cash flows as indicated below:

- (a) Known cash flows – the maturities and the amounts are known in advance. This category includes contractual receivables from Murabaha, Ijara, IMB receivables and Diminishing Musharakah;
- (b) Conditional but predictable cash flows (Salam and Istisna') – conditionality is defined in terms of the type of contract or performance of work based on the agreed terms and conditions over an agreed period; or
- (c) Conditional and unpredictable cash flows – in some cases, an investment in a Musharakah is for an open-ended period and an exit strategy may be assessed periodically. The redemption of invested capital and possible levels of return on investment is conditional upon the performance of the activities.

RM-5.3.6 When calculating net funding requirements (NFR), a substantial influence on the liquidity situation of an Islamic bank licensee relates to the management of IAHS' expectations. While the basis of an NFR calculation is to assume that the funds are repaid at the contractual maturity date, it may not be realistic to assume that all IAHS will maintain their funds at the Islamic bank licensee until maturity. Therefore, an internal assessment of their expectations and incentives will be part of an NFR calculation.



<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-5: Liquidity Risk</b>

### RM-5.3 Operational Considerations (continued)

#### RM-5.3.7

Due to Islamic bank licensees' dual role in meeting their obligations to current account holders and managing the expectations of their IAHs, Islamic bank licensees must make periodical cash flow analyses under various market scenarios and conditions.

#### RM-5.3.8

The scenarios may vary, depending on local market conditions, and may be based on:

- (a) A "normal" operating environment (for example a steady state condition); and
- (b) Scenarios of adverse (stressed) circumstances (for example non-linear events and chaotic conditions). For example:
  - (i) The analysis should include assumptions about the repayment of invested capital to the IAH. In the event of investment losses, the extent to which the losses will be mitigated by the use of the IRR needs to be considered;
  - (ii) The scenarios should be based on relevant assumptions based on factors affecting the Islamic bank licensee's on- and off-balance sheet exposures. Liquidity levels and early withdrawal profiles computed under these scenarios will be back-tested periodically to validate the underlying assumptions of the measurement process; and
  - (iii) In analyses based on behavioral assumptions and scenarios, Islamic bank licensees should assess and apply the liquidity measures that reflect the specificities of each portfolio. In the case of certain market practices, Islamic bank licensees may have different types of portfolios (i.e. CIUs that are treated as off-balance sheet items). The size and characteristics of the assets, which Islamic bank licensees hold in relation to the investment portfolios financing CIUs, will determine their specific liquidity profiles.

#### RM-5.3.9

Islamic bank licensees must establish the maximum amounts of cumulative liquidity mismatches which they consider acceptable (subject to the requirements of Module LM) and manageable for different time bands, as a percentage of total funds available. Assets must be clearly segregated according to sources of funds, and Islamic bank licensees must monitor their liquidity exposures separately according to the nature and mix of their fund providers – current account holder and unrestricted IAH, which can be expected to vary substantially. The effects of liquidity shortages may vary according to the fund providers' liquidity preferences; hence, separate limits on liquidity mismatches must be set up accordingly. These limits must be regularly reviewed, taking into account the Islamic bank licensee's liquidity situation, economic climate and market conditions.



MODULE	RM: Risk Management
CHAPTER	RM-5: Liquidity Risk

### RM-5.3 Operational Considerations (continued)

#### *Liquidity Risk Mitigation*

RM-5.3.10 Islamic bank licensees may only assume liquidity risk commensurate with their ability to have sufficient recourse to Shari'a-compliant funds to mitigate such risk.

#### RM-5.3.11

Islamic bank licensees must assess the necessity and extent of their access to available funding sources. In managing their liquidity, Islamic bank licensees have the following possible funding sources – natural cash flows arising from their usual banking activities, the realization of tradable invested assets, asset securitization, and their capacity to access shareholders' and/or head office funds.

#### RM-5.3.12

Islamic bank licensees' liquidity management policies must include some form of orderly liquidation procedures, to avoid having to liquidate assets at unfavorable prices, resulting in the erosion of the IAH capital and damage to the Islamic bank licensees' reputation and viability.

#### RM-5.3.13

Islamic bank licensees must have a liquidity contingency plan addressing various stages of a liquidity crisis. Islamic bank licensees must define the classification of the various stages of a liquidity crisis.

RM-5.3.14 For purposes of Paragraph RM-5.3.13, Islamic bank licensees may consider differentiating the stages of a liquidity crisis as follows:

- (a) Identification of a liquidity gap or a situation which acts as a triggering event where withdrawals do not follow predictable patterns when, for example, the Islamic bank licensees suffers an institutional rating downgrade;
- (b) A need to liquidate assets or investments in an orderly manner to meet such a liquidity gap or situation; and
- (c) Emergency measures to be taken in the event that the previous steps fail to meet the liquidity gap adequately.

RM-5.3.15 Where appropriate, Islamic bank licensees should include in their contingency plans the following factors and define appropriate action points at each stage:

- (a) Holdings of tradable high quality liquid assets, which may be readily disposed of in sizeable amounts in deep markets taking into account the likelihood that it will not be possible to realize full book value;
- (b) Profile of other assets and the degree of liquidity of these assets;
- (c) Assessment of Shari'a-compliant and available funding products in the market including possible cooperation agreements with either other Islamic bank licensees or conventional institutions on an interest-free basis for accessing temporary funding, or sale and leaseback arrangements for longer term funding;





<b>MODULE</b>	<b>RM: Risk Management</b>
<b>CHAPTER</b>	<b>RM-5: Liquidity Risk</b>

### RM-5.3 Operational Considerations (continued)

- (d) Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and
- (e) Notification procedures for communication with Islamic bank licensees' head office and/or supervisory authorities.

RM-5.3.16 However, to the extent that Islamic bank licensees intend to rely on the types of cooperation agreements mentioned above, they need to ensure that willing and committed counterparties will exist for such arrangements.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-6:</b>	<b>Rate of Return Risk</b>

## RM-6.1 Rate of Return Risk

RM-6.1.1 This Chapter sets out principles in respect of rate of return risks. The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers.

RM-6.1.2 Since Islamic bank licensees' responsibility is to manage their IAHs' expectations and their liabilities to current account holders, the rate of return risk is a strategic risk issue forming part of Islamic bank licensees' balance sheet risk management.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-6:</b>	<b>Rate of Return Risk</b>

## RM-6.2 Definition and Profiles of Rate of Return Risk

- RM-6.2.1 Islamic bank licensees are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs' having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that Islamic bank licensees managing Shari'a-compliant products are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.
- RM-6.2.2 A consequence of rate of return risk may be displaced commercial risk. Islamic bank licensees may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAHs when the return on assets is underperforming as compared with competitors' rates. Islamic bank licensees may decide to waive their rights to part or their entire Mudarib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on Islamic bank licensees to attract and retain investors (fund providers). The decision of Islamic bank licensees to waive their rights to part or all of their Mudarib share in profits in favour of IAHs is a commercial decision, the basis for which needs to be subject to clear and well defined policies and procedures approved by the Islamic bank licensee's BOD.
- RM-6.2.3 A Profit Equalisation Reserve (PER) is the amount appropriated by Islamic bank licensees out of their gross income, before allocating the Mudarib share, in order to maintain a certain level of return on investment for IAHs and increase owners' equity. The basis for computing the amounts to be so appropriated should be pre-defined and applied in accordance with the contractual conditions accepted by the IAH and after formal review and approval by the Islamic bank licensees' BOD.
- RM-6.2.4 An Investment Risk Reserve (IRR) is the amount appropriated by Islamic bank licensees out of income of IAHs, after allocating the Mudarib share, in order to cushion the effects of the risk of future investment losses on IAHs. The terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the BOD.
- RM -6.2.5 The CBB does not set any required minimum levels of appropriation or balances of PER and IRR relative to IAHs funds. It recommends that Islamic bank licensees pay due regard to relevant IFSB Guidance Notes and Standards in relation to PER and IRR with particular reference to the IFSB Guidance Note GN-3 dated December 2010 (Practice of Income Smoothing the Profits Payout to Investment Account Holders).



MODULE	RM: Risk Management
CHAPTER	RM-6: Rate of Return Risk

## RM-6.3 Operational Considerations

**RM-6.3.1** Islamic bank licensees must establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for IAHS.

**RM-6.3.2** Islamic bank licensees must take necessary steps to ensure that the management processes relating to the identification, measurement, monitoring, reporting and control of the rate of return risk (including appropriate structure) are in place. Since the rate of return risks are emanating from various balance sheet positions, Islamic bank licensees must recruit competent staff to undertake the analysis of risk exposures arising from their consolidated balance sheet activities.

**RM-6.3.3** Islamic bank licensees must be aware of the factors that give rise to rate of return risk. The primary form of rate of return risk to which the Islamic bank licensees are exposed comprises increasing long-term fixed rates in the market. In general, profit rates earned on assets reflect the benchmark of the previous period and do not correspond immediately to changes in increased benchmark rates.

**RM-6.3.4** Islamic bank licensees must assess the effect of the level of their dependency on current account holders' funds. Although no returns are expected by current account holders, the sudden withdrawal of these funds would have an adverse impact on the overall potential rate of return for Islamic bank licensees.

### *Rate of Return Risk Management*

**RM-6.3.5** Islamic bank licensees must implement appropriate systems for identifying and measuring the factors which give rise to rate of return risk.



MODULE	RM: Risk Management
CHAPTER	RM-6: Rate of Return Risk

### RM-6.3 Operational Considerations (continued)

#### RM-6.3.6

When calculating a rate of return, Islamic bank licensees must employ a gapping method for allocating positions into time bands with remaining maturities or re-pricing dates, whichever is earlier. Fixed and floating rate assets of Islamic bank licensees must be classified according to their receivable dates because the returns on these receivables represent the fund providers' direct and beneficial ownership of the assets.

#### RM-6.3.7

Actual cash flows may indicate a gap for a given time band, affecting the rate of return for that period. Depending on the complexity and the nature of their business operations, Islamic bank licensees may employ techniques ranging from simple gap to advance simulation or dynamic approaches to assess future cash flow variability and net income. The estimates derived from selected approaches may provide acceptable approximations of periodic future earnings' variability; hence, the outcomes will yield different levels of expected returns to IAHS.

#### RM-6.3.8

The measurement of rate of return risk highlights the importance of cash flow forecasting for instruments and contracts where Islamic bank licensees are required to simulate and assess their behavioral maturity, underlying assumptions and parameters, which must be reviewed periodically for reliability. The materiality of potential threats to future earnings and the usefulness of the resulting information must be considered in determining the type and extent of forecasted behavior for Islamic bank licensees.

#### RM-6.3.9

In assessing whether a potential threat is likely to have a material, likely and imminent impact on a balance sheet position, Islamic bank licensees must ensure that they understand the different characteristics of their balance sheet positions in the different currencies and jurisdictions within which they operate.

#### RM-6.3.10

In assessing exposure to rate of return risks, Islamic bank licensees must take into account the non-contractual behavioral maturity of the transactions in the context of the environment in which they operate and changing market conditions.

#### RM-6.3.11

With reference to Paragraph RM-6.3.10, in case of early repayment made by the customer (in Murabaha or Ijara transactions), Islamic bank licensees may accept full settlement but give rebates on subsequent transactions, while in other cases, the Islamic bank licensees may give rebates immediately at their discretion without any reference to this in the contract.



MODULE	RM: Risk Management
CHAPTER	RM-6: Rate of Return Risk

### RM-6.3 Operational Considerations (continued)

- RM-6.3.12 Islamic bank licensees are encouraged to employ balance sheet techniques to minimize their exposures using the following strategies, among others:
- (a) Determining and varying future profit ratios according to expectations of market conditions;
  - (b) Developing new Shari'a-compliant instruments; and
  - (c) Issuing securitisation tranches of Shari'a permissible assets.

#### *Displaced Commercial Risk Management*

**RM-6.3.13** Islamic bank licensees must have in place an appropriate framework for managing displaced commercial risk, where applicable.

**RM-6.3.14** Islamic bank licensees must have in place a policy and framework for managing the expectations of their shareholders and IAHs. Where market rates of returns of competitors' IAHs are higher than those of Islamic bank licensees' IAHs, the Islamic bank licensees must evaluate the nature and extent of the expectations of its IAHs and assess the amount of the gap between competitors' rates and their own IAHs' expected rates.

**RM-6.3.15** Islamic bank licensees must develop and maintain an informed judgment about an appropriate level of the balances of PER, bearing in mind that its essential function is to provide mitigation of displaced commercial risk. Some Islamic bank licensees must maintain the proportion relating to IAHs in this reserve within the IAHs equity, with the purpose of smoothing returns to IAHs, and in particular, to enhance their returns if these are below those of competitors. This implies that there will be years in which the balance of this reserve will be increased, and others in which it will be depleted.



<b>MODULE</b>	<b>RM:</b>	<b>Risk Management</b>
<b>CHAPTER</b>	<b>RM-7:</b>	<b>Operational Risk</b>

## RM-7.1 Operational Risk

RM-7.1.1 This Chapter sets out principles pertaining to appropriate systems and controls to address Islamic bank licensees' operational risks. Islamic bank licensees are exposed to operational risk through failures in their internal controls involving processes, people and systems. The internal controls should provide reasonable assurance of the soundness of operations and reliability of reporting.



MODULE	RM: Risk Management
CHAPTER	RM-7: Operational Risk

## RM-7.2 Types of Operational Risk relevant to Islamic Banks

### RM-7.2.1

Islamic bank licensees must consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Islamic bank licensees must also incorporate possible causes of loss resulting from Shari'a non-compliance and the failure in their fiduciary responsibilities.

### RM-7.2.2

Islamic bank licensees are exposed to risks relating to Shari'a non-compliance and risks associated with the IIFs' fiduciary responsibilities towards different fund providers. These risks expose Islamic bank licensees to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities.

### RM-7.2.3

**Shari'a non-compliance risk is the risk that arises from Islamic bank licensees' failure to comply with the Shari'a rules and principles determined by the Shari'a Board of the Islamic bank licensees and the CBB.**

### RM-7.2.4

Shari'a compliance is critical to Islamic bank licensees' operations and such compliance requirements should permeate throughout the organisation and their products and activities. As a majority of the fund providers use Shari'a-compliant banking services as a matter of principle, their perception regarding Islamic bank licensees' compliance with Shari'a rules and principles is of great importance to their sustainability. In this regard, Shari'a compliance is considered as falling within a higher priority category in relation to other identified risks.

### RM-7.2.5

**The bank's Shari'a Supervisory Board is responsible for establishing policies to deal with any Shari'a non-compliant transaction, taking into account its reputational risk and it must also follow existing AAOIFI disclosure requirements.**

### RM-7.2.6

Fiduciary risk is the risk that arises from Islamic bank licensees' failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, Islamic bank licensees may become insolvent and therefore unable to:

- (a) Meet the demands of current account holders for repayment of their funds; and
- (b) Safeguard the interests of their IAHS. Islamic bank licensees may fail to act with due care when managing investments resulting in the risk of possible forgone profits to IAHS.





MODULE	RM:	Risk Management
CHAPTER	RM-7:	Operational Risk

## RM-7.3 Operational Considerations

### RM-7.3.1

Islamic bank licensees must implement a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities.

RM-7.3.2 The framework referred to in Paragraph RM-7.3.1 should be consistently implemented throughout an Islamic bank licensee's organisation and understood by all relevant staff.

RM-7.3.3 Islamic bank licensees should conduct periodic reviews to detect and address operational deficiencies. The reviews and evaluation of internal controls should include independent audit coverage and assessment by internal and/or external auditors.