

ICiFIL2021

July 07 - 08, 2021
26 - 27 Zulkaedah 1442 H

INTERNATIONAL CONFERENCE ON ISLAMIC FINANCIAL LITERACY

"Enhancing the Wellbeing of Society, Sustaining the Economy"

IIUM INSTITUTE OF ISLAMIC BANKING AND FINANCE (IIiBF)



الجامعة الإسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بوتري برني، الفلارا، جنترا، ماليزيا

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Achieving Financial Stability Of Islamic Banks Through A Bespoke Enterprise Risk Management Framework (ERMF)

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Introduction

Definition:

Enterprise Risk Management (ERM) —various ways firms keep check on their risks to harness opportunities and attain institutional objectives.

ERM Framework (ERMF) —a document aim to set general guidelines for managing risk of events or actions that could result in adverse outcomes for the institution (COSO, 2004)

> **ERMF:** increases probability and quantum of success and reduces the probability and quantum of failure in the pursuit of organisational objectives.

> **ERMF:** aids IBs to achieve their objectives (risk-adjusted returns) within the risky real-world business environment

Key objectives of ERMF:

- To provide the IB with an awareness of key risks within its Islamic Banking business model
- To establish common risk culture amongst staff and management, facilitating communication and goal congruence in line with Shari'ah principles.
- To provide the IB with Shari'ah-compliant instruments
- To stipulate the risk governance structure in the IB with attendant roles and responsibilities of constituent organs.

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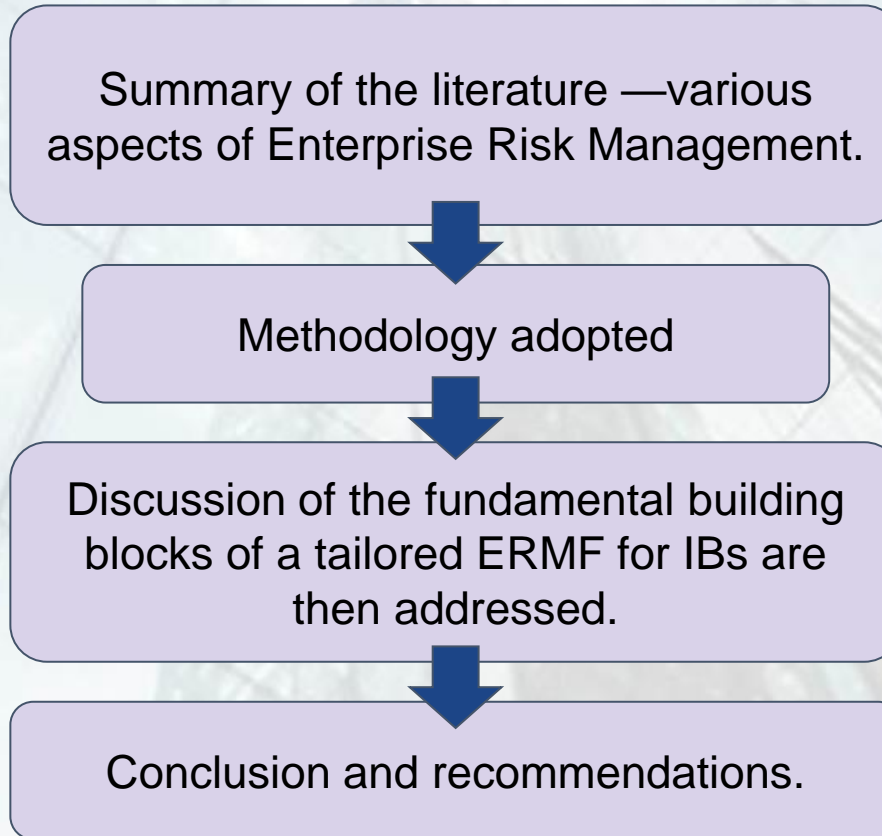




Flow of Paper

Purpose: to proffer the fundamental building blocks of developing a robust ERMF tailored to the uniqueness of IBs.

—In recognition of unique risks and risk management operations to promote overall financial system stability.



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Literature Review

Point of reference:

The Committee of Sponsoring Organization of the Treadway Commission (COSO)

- > **Definition of ERM Framework (ERMF) by COSO** —a document aim to set general guidelines for managing risk of events or actions that could result in adverse outcomes for the institution (COSO, 2004)
- > **ERMF** should permeate through the whole organisation based on an enterprise-wide view rather than in silos.

Strategic	High level goals that are aligned with and support the firm mission and vision
Operations	Resources are efficiently and effectively used
Reporting	Reliable reporting system and processes
Compliance	Compliance with the applicable industry standards, law and regulations.

- > **ERM** should impact the strategic level to support and facilitate the realisation of ultimate organisational objectives such as the maximisation of shareholders' wealth.

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Methodology

- The methodology used for the study is qualitative because it best addresses the research problem within the practical constraints and limited timeframe
- It is an in-depth content analysis of documented literature of relevant academic journal, policy documents, industry standards and reports to generate deep insights.
- Document analysis involves a systematic process of analysing and evaluating documents (Bowen, 2009).
- It generates empirical knowledge through examination and interpretation of the documented data (Corbin and Strauss, 2007).
- The insights have been synthesised toward achieving the research objective of proposing guidelines for the development of a bespoke ERMF for IBs in order to achieve financial system stability.

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Literature on Value Proposition of ERM:

- **Karanja (2017)** : US companies ERM implementation aligned with industry best practice in aspects of strategy, operation and compliance instead of reporting.
- **Krause and Tse (2016)** : Benefits of effective ERM implementations:
 - increased firm value, decreased earnings, and stock price volatility
 - lower external capital costs, higher capital efficiency, better risk assessment and awareness, and better tactical & strategic decision-making processes (Bromiley et al., 2015).
- **Beasley et al. (2008)** : markets react positively to the adoption of an ERM program of large firms as well as those firms experiencing earnings volatility
- Contribution of ERM to enhancing shareholders' value
 - McShane et al. (2011)** : shareholders' value is positively impacted by ERM adoption
 - Grace et al. (2015)** : relationship between ERM adoption and firm value and found that cost and revenue efficiency are positively associated with ERM adoption
 - Quon, Zéghal, and Maingot (2012)** : inconclusive results about the relationship between ERM and firm performance

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Discussion: Guidelines for the Development of a bespoke ERMF for IBs

- **Risk Appetite** : Risk appetite is the type and amount of risk that an IB is willing to take in different positions in Islamic products in order to meet their strategic objectives.
—Expressing risk appetite includes setting a target credit rating of the IB and also setting limits for various portfolios.
- **Risk Awareness - Unique Risks of IBs** : Risk awareness is the promoting of staff understanding of the existing risks, potential for occurrence or impact and how to prevent or manage these risks in the IB
—Categorisation of Risks faced by IBs

Authors	Categorisation of risks
Naseem Al Rahahleh (2019)	Rate of return risk, Displaced commercial risk, Operational Risk, Reputational Risk, Shari'ah Risk, Credit, Market, Equity Risk, Liquidity & Solvency Risk and Hedging Risk
Iqbal, Zamir, and Mirakhor (2007)	Credit risk, market risk, and equity investment risk, rate of return risk, liquidity risk and hedging risk, legal risks, Shariah risks
Habib and Khan (2007)	Credit risk, market risk, mark-up risk, Commodity/asset price risk, Liquidity risk, Operational risk, Legal risk, Withdrawal risk, Fiduciary risk, Displaced commercial risk, Bundled risks
Hassan, A. (2009)	Foreign-exchange risk, Credit risk, Operating risk, Liquidity risk, Legal risk, Solvency risk, Interest rate risk, Contemporary risk, Price risk, Reputation risk, Strategic risk, Other risks
Abu Hussain and Al-Ajmi (2012).	Credit risk, Liquidity risk, Operating risk, Legal risk, Regulatory risk, Reputation risk, Strategic risk, Solvency risk, rate of return risk, Settlement risk, Concentration risk, Price (equity) risk, Foreign-exchange risk, Country (political) risk, Residual risk
IFSB (2005)	credit risk, market risk, and equity investment risk, rate of return risk, liquidity risk and operational risks

IFSB standard

— **Credit Risk**

Liquidity risk

— **Equity investment risk**

— **Market risk**

— **Rate of return risk**

— **Operational risk**

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Discussion: Guidelines for the Development of a bespoke ERMF for IBs

- **Risk Culture :** Employees of the IB are aware about Shariah rules and risks impacting business processes and products.
 - All staff adhere sound risk governance principles with bottom-up involvement from front-line risk-takers.
 - Islamic banking risk measures and methodologies are consistent and well-integrated across the bank.
 - Balance between quantitative and qualitative assessment of risk (understand limitations and assumptions).

- **Risk Governance Structure :**

- (i) Board of Directors (BoD) Organ**

The BoD acts on behalf of shareholders to set policy, strategy and objectives, and oversee the executive function. It sets the risk appetite, ensures that it is reflected in the bank's strategy and cascaded throughout the organisation

- (ii) The Shari'ah Board (SB) Organ**

The IB's Shariah Board is responsible for expressing an opinion on the bank's total compliance with Shariah in all its activities.

- (iii) The Senior Management Organ**

Senior or top Management mainly C-suit executives of the IB implement risk management systems, processes and controls for managing the risks to which the bank is exposed consistently with the direction given by the Board.

- (iv) The Internal Audit Organ**

The Internal Audit Organ reports independently to the audit committee of the supervisory Board (S.B.) in order to be and to be seen to be independent.

- (v) Shariah Internal Audit Organ**

Shariah Internal Audit Organ (SIAO) is separate and independent of the Internal Audit Organ (I.A.O.) as they both have a different focus.

- (vi) Risk Management Organ**

The risk management organ (RMO) of the IB is a separate organ which reports directly to the Chief Executive Officer of the bank because risk management is a management function.

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Discussion: Guidelines for the Development of a bespoke ERMF for IBs

- **Enterprise Risk Management Framework Review Mechanism**

IB must recognise the fact that its ERMF document is a living document which required the need to make provision for regular and independent reviews of the ERMF covering risk management policies and procedures

Conclusions & Recommendation

The study suggest five fundamental building blocks of developing a robust ERMF for IBs tailored in recognition of their unique risks and risk management operations

- risk appetite
- risk awareness
- risk culture
- risk governance structure and ERM framework review mechanism

>IBs are recommended to use the guide to develop tailored ERMFs in their organisations.

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