SUPERVISION OF ISLAMIC BANKING INSTITUTIONS

BNM-MTCP-JICA: PROGRAMME FOR OFFICIALS OF PALESTINE MONETARY AUTHORITY (PMA)
Malaysian Approach to Supervision of Islamic banks

Overview of Islamic banking supervision structure of Bank Negara Malaysia

Objective & KPI:
- No unanticipated amber financial institutions
- Effective intervention and resolution of problematic financial institutions
- Administration of legislation and regulatory requirements

Governor
Bank Negara Malaysia

Deputy Governor
(Supervision Sector)

Assistant Governor
(Supervision Sector)

Banking Supervision
Department

Deputy Governor
(Regulation Sector)

Assistant Governor
(Regulation Sector)

Islamic Banking &
Takaful Department

Other supervision
divisions

Islamic Banking
Supervision Division

- Relationship Managers
- Regulatory Approvals

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Malaysian Approach to Supervision of Islamic banks - Supervisory Cycle

**Composite Risk Rating**
- LOW
- MODERATE
- ABOVE AVERAGE
- HIGH

**Supervisory Intervention Stage (SIG)**
- Routine Supervisory Activities
- Enhanced Monitoring
- Early Intervention
- Advanced Intervention
- Restructuring
- Resolution

**Communication to the Banking Institutions**
- Gaps
- Sup Concern
- Risk Mitigation Program
- Sup Expectations
- CRR Communication with Board and CEO
- Supervisory letter sent to institution

**Follow-up and Monitoring**
- Follow-up on management actions
- CRR progress reporting

**Bilateral / multilateral discussion**
- Discussion with banks, EA and other relevant parties on issues/supervisory concerns identified through continuous surveillance

**Risk Assessments**
- Significant Activities
- Inherent Risks
- Quality of Risk Management
- Capital strength & Earnings sustainability assessment

**Rating Panel**
- Platform which provides independent challenge to supervisor’s risk assessment
- Consists of Director and independent Deputy Director
- CRR upgrade/downtrade requires Assistant Governor’s concurrence

**Engagement with Relevant Parties**
- Assessment
- Continuous Surveillance and Analysis
- Offsite Analysis
- Onsite Review
- Supervisory Strategy & Planning
- Supervisory Plan

**Reporting & Intervention**
- Composite Risk Rating
- Supervisory Intervention Stage (SIG)
- Communication to the Banking Institutions
- Follow-up and Monitoring

**Engagement with Relevant Parties**
- Bilateral / multilateral discussion with the banks, EA and other relevant parties on issues/supervisory concerns identified identified through continuous surveillance

**Continuous Surveillance and Analysis**
- Offsite Analysis
- Analysis on qualitative/quantitative information (periodic submission by FIs) to assess changes to institution’s risk profile/results of previous review
- Monitor external and internal developments

**Onsite Review**
- Review of operational processes, internal control and risk management practices
- Review of credit files
- Engagements with Board and management team

**Supervisory Strategy & Planning**
- Supervisory Plan
## BNM Risk-based Supervisory Framework (SuRF)

### Objectives
To provide a systematic and effective process to assess the safety and soundness of licensed financial institutions.

### Methodology
Evaluating an institution’s risk profile by assessing the net risk, which is the aggregate level of inherent risks offset by aggregate quality of risk management.

### Key Principles

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
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<tbody>
<tr>
<td>Supervision is conducted on consolidated basis</td>
<td>Risk identification and evaluation is central to the effectiveness of the framework</td>
</tr>
<tr>
<td>Risk identification and evaluation is driven by significant activities</td>
<td>Supervisory assessment is driven by significant activities</td>
</tr>
<tr>
<td>Leverage on the work of the institution, depending on the reliability and their competency</td>
<td>Level and frequency of supervisory scrutiny depends on the risk assessment results</td>
</tr>
<tr>
<td>Supervisory intervention shall be timely and the degree of intervention commensurate with risk profile</td>
<td>Reliance on external auditors, appointed actuaries and other regulators to minimise duplication</td>
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Supervisory Risk Framework Overview

Significant activities
- Project Financing
- Personal Financing
- Ar-Rahnu
- Treasury
- ALM

Assessment on inherent risk of significant activities which covers:
- Product features, institution specific risk factors/business risk profile & economic environment

Effectiveness of Risk Management & Control Functions (RMCF) in managing inherent risk

Overall Net Risk
- Sustainability of Earnings
- Strength of Capital

Composite Risk Rating & Direction of Risk

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SuRF - Quality of Risk Management (QRM)

Quality of Risk Management (QRM)

1. Operational Management (OM)
   - Directly involved in the day to day operations of the activity

2. Risk Management Control Functions (RMCF)
   - Provides a level of review independent from day-to-day operations

Strong, Acceptable, Marginal or Weak.

- Board Oversight
- Senior Management
- Risk Management

- Internal Audit
- Compliance
- Information & Communication
Quality of Risk Management = OM + RMCF

**Operational Management (OM) – day-to-day operations:**

- Appropriateness of organizational and operational structure
- Adequacy of policies, procedures and limit structure
- Effective Implementation of business operations
- Adequacy of internal controls
- Adequate system infrastructure and support
- Analysis and reporting

**Info & Communication**

1. Board Oversight
   - Board composition & competency
   - Approve and monitor business progress
   - Appointment & assessment of management team
   - Set & review risk appetite

2. RMCF
   - Control function independent from day-to-day operations

3. Risk Management
   - Comprehensiveness and robustness of risk management methodologies (identification; measurement; monitoring; control)
   - Adequacy of risk framework and policies
   - Technical competencies and continuous development of skills and knowledge

4. Internal Audit
   - Staff competency
   - Audit scope and planning
   - Adequacy of sampling coverage
   - Effectiveness of audit (issues raised and rectification measures)
   - Reporting and documentation

5. Compliance
   - Staff competency
   - Scope of compliance review function
   - Effectiveness of compliance function (issues raised; sample selection)
   - Reporting & documentation

6. Senior Management Oversight
   - Establish effective internal controls over risk management process
   - Ensure effective implementation of OVERALL operations
   - Adherence to responsibilities established by Board for measuring, managing and reporting of risk.

- Adequacy of policies, procedures and limit structure
- Effective Implementation of business operations
- Adequacy of internal controls
- Analysis and reporting

**Board Oversight**

- Board composition & competency
- Approve and monitor business progress
- Appointment & assessment of management team
- Set & review risk appetite

**RMCF**

- Control function independent from day-to-day operations

**Risk Management**

- Comprehensiveness and robustness of risk management methodologies (identification; measurement; monitoring; control)
- Adequacy of risk framework and policies
- Technical competencies and continuous development of skills and knowledge
Specificities of Islamic Banking within SuRF

Awareness on Shariah governance & compliance, and the presence of appropriate resources and infrastructure catering for the uniqueness of Islamic banking operations

1. Operational Management
   - Appropriate policies & procedures to cater for the uniqueness
   - Understanding of the concept and unique products by the front liners

2. Board Oversight
   - The presence of effective and independent Shariah committee
   - Board composition to be well equipped with knowledge of Islamic banking

3. Risk Management
   - Need to have pool of expertise to understand the uniqueness of Islamic banking in order to identify, measure, control and monitor the unique risks effectively.
   - Measurement methodology must be tailor-made to fit Islamic banking operations

4. Internal Audit & Compliance Function
   - Robust day-to-day compliance framework to ensure compliance to Shariah requirement
   - Competency of staff for compliance and internal audit in understanding the uniqueness of Islamic banking

Unique elements in QRM of Islamic banks

Unique elements of inherent risks of Islamic banks

- Operational and Legal risks arise due to Shariah non compliance risk
- Fiduciary risk arises due to PSIA
- Equity Investment risk arises out of Musharakah financing
- Higher liquidity risk due to limited Islamic instruments
Composite Risk Ratings (CRR)

Composite Risk Rating (CRR) is an assessment of the overall risk profile of a FI, after considering the earnings outlook and strength of capital.

Rating Categories
- Low
- Moderate
- Above Average
- High

CRR would serve as one of the basis for the supervisory actions and interventions.
Philosophy and Guiding Principles for Supervisory Intervention

- Normal regulatory oversight
- Enhanced & more intense monitoring

Intensity of monitoring dependent upon stage of intervention

Ongoing monitoring and assessment
Supervision of Islamic banks presents its own challenges to the regulators

- **Fiduciary Risk**
  - Triggered by the equity participation concept. Failure to fulfill the fiduciary duties can cause confidence problem and deposit withdrawals.
  - Enhanced disclosure requirement is crucial to protect the IAH interests.

- **Strong Governance Structure**
  - Roles of Board and Shariah Comm. to ensure IAH interests are protected and compliance with Shariah.

- **Cross Border Supervision**
  - Product Acceptance
    - Accommodating different Shariah rulings between jurisdiction
  - Information Sharing
    - Sharing of the supervisory concerns
    - Shariah rulings from the parent as well as home jurisdictions
  - Resolution
    - Resolution and disposal of assets
    - Keeping home supervisors informed of the overseas subsidiary’s development

- **Transparency & Disclosure**
  - Quantitative and qualitative disclosure is required (e.g. on the applicable policies, the investment made and the profit calculation method)

- **Legal Disputes**
  - Civil v Shariah court – need for clear jurisdiction to preside power over Islamic Banking disputes
  - Malaysian Experience – Civil court have jurisdiction over Islamic Banking Legal Disputes

- **Product Acceptance**
  - Accommodating different Shariah rulings between jurisdiction

- **Information Sharing**
  - Sharing of the supervisory concerns
  - Shariah rulings from the parent as well as home jurisdictions

- **Resolution**
  - Resolution and disposal of assets
  - Keeping home supervisors informed of the overseas subsidiary’s development

- **Transparency & Disclosure**
  - Need for clear jurisdiction to preside power over Islamic Banking disputes
  - Civil court have jurisdiction over Islamic Banking Legal Disputes

- **However, Central Bank Act 2009 give recognition to BNM SAC as the reference point for civil court ruling on Islamic Banking Legal Disputes**
In view of specificities of Islamic banks, we need to be mindful of challenges in supervising Islamic FIs...

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<tr>
<th>AREA OF CONCERN</th>
<th>CHALLENGES</th>
<th>MALAYSIA’S EXPERIENCE</th>
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<tbody>
<tr>
<td>Legal Framework</td>
<td>• Full legal back-up required for effective supervision</td>
<td>• Strong support from authority ~ in Malaysia, regulation &amp; supervision is governed under Islamic Financial Services Act 2013</td>
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</table>
| Supervisory Resources      | • Level of understanding among supervisors on the uniqueness of Islamic banking  
                              | • Need to catch-up with innovation in the market                                    | • Training needs are addressed by various training providers e.g. INCEIF, IBFIM and other ad-hoc training providers. |
| Supervisory Infrastructure  | • Do we need specific supervisory framework?                              | • In view of similar banking & risk management principles, the existing supervisory framework is applicable but with modification  
                              | • MIS need to be adjusted to meet the specificities of Islamic finance            | • Bank Negara is continuously enhancing the MIS capability to address the specificities of Islamic banking supervision. |
| Cross-Boundary Supervision | • Universal concept of Islamic banking – may cross regulatory boundary (e.g. capital market, foreign jurisdiction) | • Close and continuous collaboration with other supervisors (e.g. SC, PIDM and home-host supervisors)  
                              |                                                                                   | • Ingredients for effective cross border supervision:                             |
|                            |                                                                          | • Understanding of supervisory philosophy and objective                            |                                                                                   | • Common understanding among the supervisors especially on the specific risks |
|                            |                                                                          | • Clarity of responsibilities of home and host supervisory authorities             |                                                                                   | • Easy access to relevant information |

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<table>
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<th>Challenges in Supervising Islamic Banking windows</th>
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<tr>
<td>Lack of capacity building initiatives</td>
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<tr>
<td>Fully leverage on conventional infrastructure and resources would hamper development of capacity building in the long run</td>
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<tr>
<td>Lack of autonomy (less priority given to Islamic Banking Business)</td>
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<tr>
<td>Hamper effective decision making on Islamic banking business in terms of staff recruitment, IT system enhancement (acquisition), business proposition</td>
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<tr>
<td>Lack of autonomy (less priority given to Islamic Banking Business)</td>
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<tr>
<td>Restrict product innovation</td>
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<td>Lack of autonomy (less priority given to Islamic Banking Business)</td>
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<tr>
<td>Needs to strengthen shariah compliance measures may not in the priority</td>
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<tr>
<td>Potential co-mingling of funds</td>
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<tr>
<td>use of shariah-compliant funds towards funding of conventional assets</td>
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<tr>
<td>Constraint in IT system</td>
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<tr>
<td>Limited ability to cater for Islamic banking products as the IT system is based on conventional product parameters</td>
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<tr>
<td>Diversity of Board composition</td>
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<tr>
<td>Board may not have adequate knowledge on Islamic finance</td>
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<tr>
<td>Difficulties in analysing Cost efficiency issues</td>
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<tr>
<td>Difficulties in evaluating cost efficiency and effectiveness on Islamic banking business</td>
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<tr>
<td>Potential excessive risk taking activities</td>
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<tr>
<td>Risk exposures are not limited to allocated capital since Islamic windows are leveraging on the bank-wide capital</td>
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</table>
Dealing with Problem Islamic Banks

Options for Crisis Management of Islamic banking Institutions

**Bad bank / assets carved-out**
Sales of receivables and financing which amounts to trading of debt

**Lender of Last Resort**
Shariah acceptance on underlying contracts for LOLR
Limited spectrum of liquid assets available

**Deposit Insurance**
Third party guarantee over customers deposit in return for premium/fee paid annually

**Applicability Hinges on Respective Jurisdictions Shariah Requirements and Acceptance**

**BNM SAC resolution** - trading of debt (Bai al-Dayn) is acceptable

**Backed by Islamic Repo Facility based on:**
- Sell and Buy-back Agreement (SBBA)
- Collateralised Murabahah

**BNM SAC resolution** – deposit guarantee scheme based on Kafalah bil Ujr
*July 2013* – coverage to exclude profit sharing investment accounts (PSIA)

**Sharing of Experience (Malaysia)**
Thank You