

# **Risk Management Guidelines**

**for**

# **Islamic Banking Institutions**



**State Bank of Pakistan**  
Islamic Banking Department

**[www.sbp.org.pk](http://www.sbp.org.pk)**

## The Team

Name	Designation	Contact
Pervez Said	Director	(9221)921 2495 <a href="mailto:pervez.said@sbp.org.pk">pervez.said@sbp.org.pk</a>
Mahmood Shafqat	Senior Joint Director	(9221)921 2509 <a href="mailto:mahmood.shafqat@sbp.org.pk">mahmood.shafqat@sbp.org.pk</a>
Zahid ur Rehman	Junior Joint Director	(9221)245 3744

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## RISK MANAGEMENT GUIDELINES FOR ISLAMIC BANKING INSTITUTIONS

### **Preamble:**

i) With the intention of rolling out standards issued by Islamic Financial Services Board (IFSB) in Pakistan, Risk Management guidelines for Islamic Banking Institutions (IBIs) have been compiled by tailoring the *IFSB guiding principles on Risk Management* to our market. However, these guidelines should be considered in addition to the various Risk Management Guidelines issued by SBP from time to time and IBIs will be required to comply with both set of guidelines. These Guidelines for IBIs will further complement and enhance the current Risk Management regime of SBP by identifying and suggesting technique to manage various types of risks unique to IBIs.

ii) These Risk Management Guidelines provide a set of best practices for establishing and implementing effective risk management in IBIs. These Guidelines set out fifteen principles of risk management that give practical effect to managing the risks underlying the business objectives that IBIs may adopt. The principles contained in these Guidelines are designed to complement the current risk management principles issued by the 'Basel Committee on Banking Supervision' (BCBS) and other international standard-setting bodies.

iii) These Risk Management Guidelines for IBIs provide specific guidance for each category of risk, drawn from discussion on industry practices, outlining a set of principles applicable to the following six categories of risk:

- Credit risk
- Equity investment risk
- Market risk
- Liquidity risk
- Rate of return risk
- Operational risk

iv) All IBIs are expected to make meaningful risk assessments based on the principles described in these Guidelines. However, it is crucial for IBIs to recognize and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. In addition, IBIs may face consequential business risks relating to developments in the external marketplace. Adverse changes in IBIs' markets, counterparties, or products as well as changes in the economic and political environments in which IBI operate and the effects of different Shariah rulings are examples of business risk. These changes may affect IBI's business plans, supporting systems and financial position. In this regard, IBIs are expected to view the management of these risks from a holistic perspective.

v) IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBIs' business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

## 1. General Requirement:

**Principle 1.0:** IBIs shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

### Board of directors (BOD) and senior management oversight:

1. As with any financial institution, the risk management activities of IBIs require active oversight by the BOD and senior management. The BOD shall approve the risk management objectives, strategies, policies and procedures that are consistent with the IBIs' financial condition, risk profile and risk tolerance. Such approvals shall be communicated to all levels in the IBI involved in the implementation of risk management guidelines.
2. The BOD shall ensure the existence of an effective risk management structure for conducting IBI's activities, including adequate systems for measuring, monitoring, reporting and controlling risk exposures.
3. IBIs shall have in place a Shariah Advisor, in accordance with sound principles of corporate governance and SBP's Fit and Proper Criteria for Shariah Advisors, to oversee that IBIs' products and activities comply with Shariah rules and principles as advised by SBP and Shariah Advisor.
4. The BOD shall approve limits on aggregate financing and investment exposures to avoid concentration of risk and ensure that IBIs hold adequate capital against these exposures. The BOD shall review the effectiveness of the risk management activities periodically and make appropriate changes as and when necessary.
5. Senior management shall execute the strategic direction set by the BOD on an ongoing basis and set clear lines of authority and responsibility for managing, monitoring and reporting risks. The senior management shall ensure that the financing and investment activities are within the approved limits.
6. Senior management shall ensure that the risk management function should be separated from risk taking function and is reporting directly to the BOD or senior management. Depending on the scope, size and complexity of IBI's business activities, the risk management function is carried out by personnel from an independent risk management unit. These personnel shall define the policies, establishes procedures, monitor compliance with the established limits and report to top management on risk matters accordingly.

### Risk Management Process:

7. IBIs shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management

information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of IBIs' activities.

8. IBIs shall ensure that an adequate system of controls with appropriate checks and balances is in place. The controls shall (a) comply with the Shariah rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

9. IBIs shall make appropriate and timely disclosure of information to depositors having deposits on Profit and Loss Sharing basis, minimum requirements of which are specified by SBP in its Guidelines for Shariah Compliance in IBIs", so that they are able to assess the potential risks and rewards of their deposits and to protect their own interests in their decision making process.

10. In addition to the above, following general requirements shall also be taken into account by the IBI.

- a) *Application of Emergency and Contingency Plan:* The senior management shall draw up an emergency and contingency plan, approved by the board of directors in order to be able to deal with risks and problems which may arise from unforeseen events.
- b) *Integration of Risk Management:* While assessing and managing risk, the management should have an overall view of risks the institutions is exposed to. This requires having a structure in place to look at risk interrelationships across the organization. Such a setup could be in the form of a separate department or bank's Risk Management Committee could perform such function. The structure should be such that ensures effective monitoring and control over risks being taken.
- c) *Risk Measurement:* For each category of risk, IBIs are encouraged to establish systems/models that quantify their risk profile. The results of these models should be assessed by independent risk review function.
- d) *Utilization:* The IBIs should develop a mechanism which should, to the possible extent, monitor that funds provided by them were utilized for the purpose these were advanced.
- e) *Role of Finance Administration Department:* It should be separated from finance origination department. It should be among the responsibilities of Finance Administration Department to monitor that the documents are obtained according to the requirement as specified in the product. For example, the dates play a very important role in Murabaha transactions and any transaction can be rendered invalid if the sequencing of obtaining documents is changed.
- f) *Management Information System:* The IBIs should specify control reports to be prepared by independent department that should be periodically submitted to board or senior management committee.
- g) *Human Resource:* IBI shall ensure that staff has been adequately trained regarding Shariah principles and procedures. There should be ongoing emphasis on staff training and development planning with clear objective for individual staff members. For this purpose, periodic workshops should be arranged by the IBI in coordination with Shariah Advisor.

## 2. Credit Risk:

11. These guidelines address the credit risk associated with specific features of Islamic financing contracts. The risk assessment and measurement processes undertaken by IBIs shall also be applicable to profit sharing assets (Mudarabah and Musharakah) which are classified under equity investments. Rigorous risk evaluation (including due diligence) and controls of these investments are necessary in view of their exposure to capital impairment.

12. The credit risk principles in this section are also applicable to credit risks associated with securitization and investment activities because, in the IBIs, an investment certificate or sukuk generally represents a direct pro-rata beneficial ownership of the holder in the assets of the underlying project.

### Definition and Profiles of Credit Risk:

13. 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 IBIs 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). IBIs need to 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 transactions.

14. The following premises relate to the sound processes of credit risk management in IBIs:

- The role of IBIs can embrace those of financiers, suppliers, Mudarib and Musharakah partners. IBIs concern themselves with the risk of a counterparty's failure to meet their 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 IBIs.
- 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 shall be assessed separately for each financing instrument to facilitate appropriate internal controls and risk management systems.
- IBIs will 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.
- IBIs are prohibited from using the amount of any penalty for their own benefit; they must donate any such amount to charity. This increases the cost of default.

**Principle 2.1: IBIs shall have in place a strategy for financing, using various instruments in compliance with *Shariah*, whereby they recognize the potential credit exposures that may arise at different stages of the various financing agreements.**

15. The BOD of IBIs shall define and set the institution'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. IBIs shall be mindful of and take into account the permissible types of financing instruments available in different locations wherever IBIs undertake cross-border transactions.

16. IBIs will 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 IBIs's financing portfolio. For example, the IBIs may offer Salam contracts during a certain season where a product can most likely be delivered and sold at maturity.

17. IBIs' financing strategies shall include a list of all types of applicable and approved transactions and financings. The approved list must include formal exclusions from any engagement by the IBIs in industries dealing in Haram or unlawful goods and services. The approved list will be kept up to date and communicated to the relevant personnel within the IBIs, and an internal compliance function will be organized and empowered to ensure that such rules are applied.

18. IBIs shall be 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 may give rise to operational risks and other risk management problems relating to Shariah compliance.

19. When setting the level of risk appetite relating to counterparties, IBIs shall ensure that (a) the expected rate of return on a transaction is commensurate with the risks incurred; and (b) excessive credit risk (at both individual and portfolio levels) and risk concentration (for example financing instruments, economic activity, geographical spread) are being managed effectively.

**Principle 2.2: IBIs shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.**

20. IBIs shall establish policies and procedures defining eligible counterparties (retail/consumer, corporate or sovereign), the nature of approved Shariah Compliant financings and types of appropriate financing instruments. IBIs shall obtain sufficient information to permit a comprehensive assessment of the risk profile of the counterparty prior to the financing being granted.

21. IBIs shall have a policy for carrying out a due diligence process<sup>1</sup> in evaluating counterparties, in particular, for transactions involving:

- New ventures with multiple financing modes: IBIs shall carry out due diligence processes on customers or sovereigns using multiple financing modes to meet specific financial objectives designed to address Shariah, legal or tax issues of customers.

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<sup>1</sup> The process may include Value at Risk, stress testing and sensitivity analysis, amongst others.



- 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. Risk mitigating structures should be put in place by IBIs as far as possible.

22. IBIs, in their policy for approval, shall engage appropriate experts, including a Shariah advisor to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are Shariah-compliant at all times. IBIs may also engage an 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.

23. In a financing involving several related agreements, IBIs need to be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. To be Shariah compliant, subject to the interpretation of its Shariah scholars, IBIs shall ensure that all components of the financial structure are contractually independent, although these may be executed in a parallel manner despite their interrelated nature.

**Principle 2.3: IBIs shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.**

24. IBIs shall 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 IBIs may employ an appropriate methodology that takes into account the price volatilities of the underlying assets. The selected methodology shall be appropriate given the nature, size and complexity of the IBIs's credit related activities. IBIs shall ensure that adequate systems and resources are available to implement this methodology.

**Principle 2.4: IBIs shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.**

25. IBIs shall clearly define their credit risk-mitigating techniques including, but not limited to, having in place:

- 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;
- permissible and enforceable collateral<sup>2</sup> and guarantees;
- clear documentation as to whether or not purchase orders are cancelable; and
- Clear procedures for taking account of governing laws for contracts relating to financing transactions.

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<sup>2</sup> IBIs are expected to include in its process, an ongoing monitoring of quality and valuation of any collateral.

26. IBIs shall establish limits on the degree of reliance and the enforceability of collateral and guarantees. They shall protect themselves against legal impediments that may restrict the accessibility of collateral when they need to enforce their rights in respect of a debt. IBIs shall formally agree with the counterparty at the time of signing the contract on the usage, redemption and utilization of collateral if the counterparty defaults in payment.

27. IBIs shall have policies to define adequately the action to be taken by the IBIs when a customer cancels a non-binding purchase order. The policies will describe how the IBIs (a) monitor and control their exposures to suppliers, and especially during delivery between suppliers to the IBIs 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). For example, the IBIs 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.

28. IBIs shall have appropriate credit management systems and administrative procedures in place 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. This system will be reviewed on a regular basis. Remedial actions will include both administrative and financial measures.

29. Administrative measures may, inter-alia, include:

- negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty;
- setting an allowable timeframe for payment or to offer debt-rescheduling or restructuring arrangements (without an increase in the amount of the debt);
- using a debt-collection agency;
- resorting to legal action, including the attachment of any credit balance belongs to defaulters according to the agreement between them;

And financial measures may include, among others:

- imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with Shariah as decided by the IBIs Shariah Advisor; and
- Establishing the enforceability of collateral or third party guarantees.

30. IBIs shall set appropriate measures for early settlements, which are permissible under their Shariah rules and principles for each Islamic financing instrument.

31. IBIs shall assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions. For instance, in the case of an Istisna transaction, the IBIs enter into an Istisna contract as sellers to provide manufactured goods or a building to a customer. The IBIs will then enter into another (parallel) Istisna contract as buyers 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, IBIs would equally be in default of their obligation. If necessary, an outside expert may be engaged to evaluate, approve and monitor the technical aspects. IBIs 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.

32. IBIs shall establish appropriate policies and procedures that require them to honour their commitment to the parallel contract counterparty. However, there must be no legal linkages between the two contracts.

33. IBIs shall have in place a system to ascertain and fulfill their obligations in respect of leased assets, which are permanently impaired through no default of the lessee. In case of such impairment, IBIs are required to 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 lease rentals as compared with those in an operating Ijarah. IBIs shall establish appropriate risk management policies to mitigate losses arising from such damage during the term of the lease.

34. IBIs shall ensure, whenever possible, that there is sufficient Shariah-compliant insurance (takaful) coverage of the value of the assets, subject to availability. If necessary, IBIs shall engage an insurance advisor at an early stage to review the insurance coverage of the leased assets.

35. If a loss arises from negligence by the lessee, IBIs are permitted to claim compensation from the lessee. The IBIs (as lessors) bear the risks associated with the leased assets and cannot use lessees' 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 lessees).

36. IBIs shall have in place an appropriate policy for determining and allocating provisions for (a) doubtful debts including counterparty exposures; and (b) estimated impairment in value of leased assets.

### **3. Equity Investment Risk:**

37. This section sets out the principles pertaining to the management of risks inherent in the holding of equity instruments for investment purposes. In particular, for IBIs, the relevant instruments are typically those based on the Mudarabah and Musharakah contracts. This section focuses on such instruments. The risks entailed by holding equity instruments for trading or liquidity purposes are dealt with under market risk in Section 4 below. While investments made via Mudarabah and Musharakah instruments may contribute substantially to IBIs' earnings, they entail significant market, liquidity, credit<sup>3</sup> and other risks, potentially giving rise to volatility in earnings and capital.

38. 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

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<sup>3</sup> One example of credit risk exposure arises from the *Mudarib's* obligation to pay the agreed share of profit to the IBIs 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*.

through a pooled investment vehicle. In the case of a specific project, IBIs may invest at different investment stages.

39. One distinct difference between Mudarabah and Musharakah financings is in terms of IBIs' involvement in the investments during the contract period. In Mudarabah, the IBIs invest their money as silent partners and, the management is the exclusive responsibility of the other party, namely the Mudarib. In contrast, in Musharakah financing the IBIs (and its partner or partners) invest their funds together, and the IBIs may be silent partners, 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).

40. The type of equity investment risk dealt with in this section 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.

41. 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.

42. 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 fulfillment of IBIs' fiduciary responsibilities as an investor of deposits 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.

43. 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.

44. Moreover, risks of change in technology and risk of substitution by new innovations being introduced in the marketplace can also affect the investment performance in a particular business.

45. IBIs 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.

46. Although timely allocation of profit can be agreed upfront, IBIs should be prepared for delays and variations in cash flow patterns and possible difficulties in executing a successful exit strategy.

47. 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.

**Principle 3.1: IBIs shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.**

48. IBIs shall 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. For example, a Musharakah structure may contain an option for redemption whereby the IBIs as financiers have a contractual right to require their partner periodically to purchase, under a separate contract, a proportion of the IBIs's share in the investment at net asset value or, if the contract so specifies on some agreed basis (Diminishing Musharakah).

49. IBIs shall have, 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. IBIs shall ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IBIs invest as partners. These should include evaluation of Shariah compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

50. IBIs shall 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. IBIs that employ different financing instruments (where one of which include Musharakah) at different contract stages shall have appropriate procedures and controls in place, as different stages may give rise to different risks.

51. IBIs shall analyze and determine possible factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.

52. IBIs shall use Shariah compliant risk-mitigating techniques, which reduce the impact of possible capital impairment of an investment. This may include the use of Shariah permissible security<sup>4</sup> from the partner.

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<sup>4</sup> Any collateral/security obtained by IBIs for Musharaka and Mudaraba shall not be applied or utilized to cover losses of the IBI except where Shariah permits application or usage of such collateral/security.

**Principle 3.2: IBIs shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IBIs and the Mudarib and/or Musharakah partners.**

53. IBIs shall 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.

54. 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 neither 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. In the case of a change of the partnership's shares in a Musharakah (for example in a Diminishing Musharakah), the shares changing hands shall be valued at fair value or on some other mutually agreed basis.

55. IBIs shall assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements 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 recognized and agreed by all the investing parties, the IBIs will incorporate their potential impact in the IBIs's overall earnings.

56. IBIs 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.

**Principle 3.3: IBIs shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of the institution's Shariah Advisor.**

57. IBIs shall establish the criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments. The criteria may include alternative exit routes and the timing of exit. In case of losses where improved business prospects exist, IBIs may indicate an investment extension period. IBIs' 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 time, recover and yield profits.

58. IBIs shall recognize that, as a going concern, an investee may not always have the liquidity necessary to enable making profit distributions. Hence, IBIs shall agree with the investment partner the methods for the treatment of retained profits by the investee.

#### 4. Market Risk

**Principle 4.1:** IBIs shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

##### **Definition and Profiles of Market Risk**

59. 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. 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 Murabahah assets purchased to be delivered over a specific period) and of foreign exchange rates.

60. In operating Ijarah, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In Ijarah Muntahia Bittamleek, 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.

61. In Salam, IBIs 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 IBIs 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.

62. When IBIs are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyze 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 realizable at prices quoted in other more active markets.

63. IBIs 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 Shariah compliant methods.

64. In addition to the above, there should be middle office to perform market risk management function and to independently monitor, measure and analyze risks inherent in treasury operations of Islamic Banks. Besides the unit should also prepare control reports indicating deviations for the information of senior management.

#### 5. Liquidity Risk:

65. Liquidity risk is the potential loss to IBIs 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:**

66. There are two major types of fund providers: (a) current account holders; and (b) PLS deposit holders. These account holders require a degree of liquidity to be maintained by the IBIs to meet their requirements for withdrawals.

67. As current account holders do not participate in the profits of the IBIs' business activities, a sound repayment capacity is required to meet fully cash withdrawal requests as and when they arise. IBIs may rely heavily on funds provided by current account holders. Repayment by the IBIs 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 IBIs.

68. PLS deposit holders are those depositors who participate in the uncertainties of IBIs' 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 PLS deposit holders may be the result of (a) lower than expected or acceptable rates of return; (b) concerns about the financial condition of the IBIs; and (c) non-compliance by the IBIs with Shariah rules and principles in various contracts and activities.

69. Where the principle of Mudarabah is employed to source the funds, from an asset-liability management perspective, IBIs may be viewed as being hedged to the extent that the PLS deposit holders bear the risks of the assets in which their funds are invested. This statement is true only if the Mudarib (IBI) has acted in accordance with its fiduciary duties under the Mudarabah contracts and without misconduct or negligence.

70. PLS deposit holders do not share in the risks on assets financed by current accounts, which are borne by shareholders alone.

71. As fiduciary agents, the IBIs are concerned with matching their investment policies with risk appetites of PLS deposit holders and shareholders. If these investment policies are not consistent with the expectations and risk appetites of PLS deposit holders, the latter may withdraw their funds leading to a liquidity crisis for the IBIs. This applies particularly to PLS deposit holders.

**Principle 5.1: IBIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts and PLS deposits.**

72. IBIs need to identify any future shortfalls in liquidity by constructing maturity ladders based on appropriate time bands. The IBIs may have their own criteria for classifying cashflows, including behavioural methods, and may consider differentiating the types of cashflows as indicated below:

- Known cash flows – the maturities and the amounts are known in advance. This category includes receivables from Murabahah, Ijarah, Ijarah Muntahia Bittamleek receivables and Diminishing Musharakah.



- Conditional but predictable cashflows (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.
- 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.

73. When calculating net funding requirements (NFR), a substantial influence on the liquidity situation of IBIs relates to the management of their PLS deposit holders' 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 PLS deposit holders will maintain their funds at the IBIs until maturity. Therefore, an internal assessment of their expectations and incentives will be part of an NFR calculation.

74. Due to IBIs' dual role in meeting their obligations to current account holders and managing the expectations of their PLS deposit holders, the IBIs should make periodical cash-flow analyses under various market scenarios and conditions. 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 circumstances (for example non-linear events and chaotic conditions). For example:

- The analysis shall include assumptions about the repayment of invested capital to the PLS deposit holders.
- The scenarios shall be based on relevant assumptions based on factors affecting the IBIs' 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.
- In analyses based on behavioural assumptions and scenarios, IBIs will assess and apply the liquidity measures that reflect the specificities of each portfolio.

75. IBIs shall establish the maximum amounts of cumulative liquidity mismatches which they consider acceptable (within the regulatory requirements) and manageable for different time bands, as a percentage of total assets available. The effects of liquidity shortages may vary according to the fund providers' liquidity preferences; hence, separate limits on liquidity mismatches should be set up accordingly. These limits shall be regularly reviewed, taking into account the IBIs' liquidity situation, economic climate and market conditions.

**Principle 5.2: IBIs shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.**

76. IBIs shall assess the necessity and extent of their access to available funding sources. In managing their liquidity, IBIs have the following possible funding sources – natural cash flows arising from their usual banking activities, the realisation of tradable invested assets, asset securitisation, and their capacity to access shareholders' and/or head office funds.

77. IBIs' liquidity management policies shall include some form of contractually agreed orderly liquidation procedures ensuring maximum possible yield, to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the PLS deposit holders' capital and damage to the IBIs' reputation and viability.

78. IBIs must have a liquidity contingency plan addressing various stages of a liquidity crisis. IBIs should define the classification of these stages but may consider differentiating the stages as follows:

- 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 IBIs may suffer an institutional rating downgrade;
- A need to liquidate assets or investments in an orderly manner to meet such a liquidity gap or situation; and
- Emergency measures to be taken in the event that the previous steps fail to meet the liquidity gap adequately.

79. Where appropriate, IBIs shall include in their contingency plans the following factors and define appropriate action points at each stage:

- 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 realise full book value;
- Profile of other assets and the degree of liquidity of these assets;
- Assessment of Shariah-compliant and available funding products in the market including possible cooperation agreements with either other IBIs or conventional institutions on an interest-free basis for accessing temporary funding, or sale and leaseback arrangements for longer term funding;
- Possible liquidity arrangements with the central bank (on an interest-free basis);
- Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and
- Notification procedures for communication with IBIs' head office and/or supervisory authorities.

80. However, to the extent that IBIs intend to rely on the types of cooperation agreements mentioned above, they need to ensure that willing counterparties will exist for such arrangements.

## **6 Rate of Return Risk:**

81. This section 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.

82. Since IBIs' responsibility is to manage their PLS deposit holders' expectations and their liabilities to current account holders, the rate of return risk is a strategic risk issue forming part of IBIs' balance sheet risk management.

### **Definition and Profiles of Rate of Return Risk**

83. IBIs are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in PLS deposit holders' having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IBIs are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

84. A consequence of rate of return risk may be displaced commercial risk. IBIs may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by PLS deposit holders when the return on assets is under-performing as compared with competitors' rates. IBIs 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 IBIs to attract and retain investors (fund providers). The decision of IBIs to waive their rights to part or all of their Mudarib share in profits in favour of PLS deposit holders is a commercial decision, the basis for which needs to be subject to clear and well defined policies and procedures approved by the IBIs's BOD.

### **Operational Considerations:**

**Principle 6.1: IBIs shall 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 PLS deposit holders.**

85. IBIs shall 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, IBIs shall have in place competent staff to undertake the analysis of risk exposures arising from their consolidated balance sheet activities.

86. IBIs shall be aware of the factors that give rise to rate of return risk. The primary form of rate of return risk to which the IBIs 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.

87. IBIs shall 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 IBIs.

### **Rate of Return Risk Management**

88. IBIs shall have in place appropriate systems for identifying and measuring the factors which give rise to rate of return risk.

89. When calculating a rate of return, IBIs shall employ a gapping method for allocating positions into time bands with remaining maturities or repricing dates, whichever is earlier.

90. Fixed and floating rate assets of IBIs will be classified according to their receivable dates because the returns on these receivables represent the fund providers' direct and beneficial ownership of the assets. 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, IBIs 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 PLS deposit holders.

91. The measurement of rate of return risk highlights the importance of cash flow forecasting for instruments and contracts where IBIs are required to simulate and assess their behavioural 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 shall be considered in determining the type and extent of forecasted behaviour for IBIs.

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

93. In assessing exposure to rate of return risks, IBIs shall take into account the non-contractual behavioural maturity of the transactions in the context of the environment in which they operate and changing market conditions.

94. IBIs are encouraged to employ balance sheet techniques to minimize their exposures using the following strategies, among others:

- Determining and varying future profit ratios according to expectations of market conditions;
- Developing new Shariah-compliant instruments; and
- Issuing securitization tranches of Shariah permissible assets.

#### Displaced Commercial Risk Management

**Principle 6.2: IBIs shall have in place an appropriate framework for managing displaced commercial risk, where applicable.**

95. IBIs shall have in place a policy and framework for managing the expectations of their shareholders and PLS deposit holders. Where market rates of returns of competitors' PLS deposit holders are higher than those of IBIs' PLS deposit holders, the IBIs will evaluate the nature and extent of the expectations of their PLS deposit holders and assess the amount of the gap between competitors' rates and their own PLS deposit holders' expected rates.

## 7. Operational Risk:

96. IBIs are exposed to risks arising from failures in their internal controls involving processes, people and systems. The controls should provide reasonable assurance of the soundness of operations and reliability of reporting.

97. IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBI's business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

98. IBIs shall 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. IBIs shall also incorporate possible causes of loss resulting from Shariah non-compliance and the failure in their fiduciary responsibilities.

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

100. A reliable IT system is a must for profit sharing mechanism, failure of which may lead to Sharia non-compliance risk. The bank should identify key risk indicators and should place key control activities like Code of Conduct, Delegation of authority, segregation of duties, succession planning, mandatory leave, staff compensation, recruitment and training, dealing with customers, complaint handling, record keeping, MIS, physical controls etc.

**Principle 7.1: IBIs shall have in place adequate systems and controls, including Shariah Advisor, to ensure compliance with Shariah rules and principles.**

### **Shariah Non-Compliance Risk:**

101. Shariah non-compliance risk is the risk that arises from IBIs' failure to comply with the Shariah rules and principles prescribed by State Bank of Pakistan and Shariah Advisor of the IBIs. Shariah compliance is critical to IBIs' operations and such compliance requirements must permeate throughout the organisation and their products and activities. As a majority of the fund providers use Shariah-compliant banking services as a matter of principle, their perception regarding IBIs' compliance with Shariah rules and principles is of great importance to sustainability of IBIs. In this regard, Shariah compliance is considered as falling within a higher priority category in relation to other identified risks.

102. IBIs shall ensure that they comply at all times with the Shariah rules and principles as advised by the Shariah Advisor as well as SBP, with respect to their products and activities. This means that Shariah compliance considerations are taken into account whenever the IBIs accept deposits and investment funds, provide finance and carry out investment services for their customers.

103. IBIs shall ensure that their contract documentation complies with Shariah rules and principles – with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations.

104. IBIs shall undertake a Shariah compliance review at least annually, performed either by a separate Shariah audit department or as part of the existing internal audit function by persons having the required knowledge and expertise for the purpose. The objective is to ensure that (a) the nature of the IBIs's financing and equity investment and (b) their operations are executed in adherence to the applicable Shariah rules and principles as per the fatwa, policies and procedures approved by the IBIs's Shariah Advisor.

105. IBIs shall keep track of income not recognized arising out of Shariah non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of Shariah non-compliance, the IBIs may assess potential profits that cannot be recognized as eligible IBIs' profits.

**Principle 7.2:** IBIs shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where PLS deposit holders' funds are commingled with the IBIs' own funds, the IBIs shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IBIs' fiduciary responsibilities.

**Fiduciary risk:**

106. Fiduciary risk is the risk that arises from IBIs' failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, IBIs 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 PLS deposit holders. IBIs may fail to act with due care when managing investments resulting in the risk of possible forgone profits to PLS deposit holders.

107. IBIs shall establish and implement a clear and formal policy for undertaking their different and potentially conflicting roles in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their PLS deposit holders may include the following:

- Identification of investing activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the IBIs's fiduciary and agency duties and to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements;
- Allocation of assets and profits between the IBIs and their PLS deposit holders will be managed and applied appropriately to PLS deposit holders having funds invested over different investment periods; and
- Limiting the risk transmission between current and investment accounts.

108. IBIs shall adequately disclose information on a timely basis to their PLS deposit holders and the markets in order to provide a reliable basis for assessing their risk profiles and investment performance, as prescribed by SBP from time to time.

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