

FAQs on IFSB-1:
Guiding Principles of Risk Management
for Institutions (Other than Insurance Institutions) Offering Only Islamic
Financial Services

- 1. How can Institutions offering Islamic Financial Services (IIFS) manage risks arising from the changes in the economic and political environments in which they operate?**

Answer: IIFS may face consequential business risks relating to developments in the financial landscape. Adverse changes in IIFSs' markets, counterparties, or products as well as changes in the economic and political environments in which IIFS operates are examples of business risk. Such change may affect IIFSs' business plans, supporting systems, and financial position. In response, IIFS is expected to adopt a holistic approach to managing these risks.

The Board of Directors (BOD) of IIFS assumes a pivotal role in this process. The BOD of IIFS 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. IIFS must maintain a heightened awareness of the economic and political environments in which they operate.

This proactive stance allows IIFS to anticipate and respond effectively to changes, ensuring that risk management is aligned with the institution's overall objectives. By being mindful of economic and political landscapes, IIFS can optimize risk diversification and asset allocation strategies, fostering resilience and stability in the face of evolving external conditions. This integrated approach underscores the commitment of IIFS to uphold principles of sound risk management while adhering to Islamic finance principles.

- 2. In the case where IIFS operates in multiple jurisdictions, how should they address the potential Shari'ah non-compliant risk arising from different Shari'ah rulings?**

Answer: According to Principle 7.1, IIFS shall ensure that they comply at all times with the Shari'ah rules and principles as determined by the relevant body in each of the jurisdictions in which they operate. It implies that for IIFS operating in multiple

jurisdictions, adherence to Shari'ah rulings is mandatory *across all* the jurisdictions in which they operate.

While most Shari'ah rulings across jurisdictions provide consistent substance and guidance, some variations between jurisdictions may arise due to differences in methodologies applied in promulgating such rulings. To manage potential Shari'ah non-compliant risks arising from such variations, IIFS along with its Shari'ah Board/Advisor should establish a robust framework for Shari'ah compliance that considers the unique aspects of each jurisdiction.

This may also involve continuous communication and collaboration with Shari'ah scholars and authorities in each jurisdiction to ensure a harmonized interpretation and application of Shari'ah principles. Furthermore, regular reviews and updates to internal policies and procedures should be conducted to accommodate any changes in Shari'ah rulings across jurisdictions.

This approach not only mitigates the risk of non-compliance but also reinforces the IIFS's commitment to upholding Shari'ah principles consistently across its operations in diverse geographical areas.

3. Referring to question no. 2 above, what aspects should RSA pay attention to when regulating or supervising such IIFS?

Answer: The supervisory authority shall satisfy itself that IIFS has adequate Shari'ah compliance mechanisms in place. These will include (a) a well-defined and adequately qualified and staffed organisational structure, (b) clear lines of authority and accountability; and (c) policies and procedures about the approval of products and activities that require adherence to Shari'ah rules and principles applied in every jurisdiction in which the IIFS operates. The supervisory authority may require IIFS to have an independent and regular review of Shari'ah compliance in this regard. IIFSs' compliance with Shari'ah rules and principles holds paramount importance to their sustainability.

4. Considering that different risk types may arise at different stages, what are the appropriate methodologies for measuring and reporting the credit risk exposures under each Islamic financing instrument?

Answer: According to Principle 2.3, IIFS shall develop and implement appropriate risk measurement and reporting methodologies relevant to each Islamic financing instrument concerning managing their counterparty risks, which may arise at different contract stages.

For example, in during the contract life, the risk inherent in a Murābahah contract is transformed from market risk to credit risk, thus the IIFS may employ an appropriate methodology that considers the price volatilities of the underlying assets. The selected methodology shall be appropriate given the nature, size, and complexity of the IIFS's credit-related activities. IIFS shall ensure that adequate systems and resources are available to implement this methodology.

5. How can we protect the delivery of imported goods from abroad that gives rise to other risks that may not be insured?

Answer: While being insured with takaful (Islamic insurance) is one of the common techniques to mitigate risks related to the delivery of imported goods, in line with paragraph 37, IIFS shall have policies to define adequately the action to be taken by IIFS, which includes identifying 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).

6. What key operational considerations should IIFS shall have in place for credit risk management?

Answer: IIFS shall have in place a framework for credit risk management that includes identification, measurement, monitoring, reporting, and control of credit risks. Adequate capital should be held against credit risks assumed. IIFS shall also comply with relevant rules, regulations, and prudential conditions applicable to their financing activities.

IIFS shall holistically assess credit risk and ensure that credit risk management forms a part of an integrated approach to the management of all financial risks. 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.

IIFS also shall have in place:

- an appropriate credit strategy, including pricing and tolerance for undertaking various credit risks;
- a risk management structure with effective oversight of credit risk management; credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- an appropriate measurement and careful analysis of exposures, including market and liquidity-sensitive exposures; and
- a system (a) to monitor the condition of ongoing individual credits to ensure the financings are made by the IIFSs' policies and procedures, (b) to manage problem credit situations according to an established remedial process; and c) to ensure adequate provisions are allocated.

7. What Shari'ah-compliant credit risk mitigating techniques are appropriate for equity investment instruments?

Answer: According to Paragraph 59, IIFS shall use Shari'ah compliant risk-mitigating techniques, which reduce the impact of possible capital impairment of equity investment instruments. An example of a risk-mitigating technique appropriate for equity investment instruments is the use of Shari'ah permissible security from the partner.

8. In conducting due diligence of conventional counterparties, i.e., when IIFS is involved in syndicated financing, what aspects should the IIFS give due consideration particularly concerning Shari'ah compliance?

Answer: In the context of syndicated financing where an IIFS engages with conventional counterparties, due diligence is crucial to ensure adherence to Shari'ah principles. While IFSB-1 standards primarily prescribe due diligence for counterparties as recipients of financing (addressing credit risk, as per Principle 2.2), it is prudent for IIFS to extend this practice to conventional counterparties involved in syndicated or joint financing arrangements.

Given that conventional counterparties may not inherently comply with Shari'ah principles, the IIFS should take proactive steps to reinforce Shari'ah compliance. This involves verifying the commitment of conventional counterparts to ensure that every decision and process in the syndicated financing aligns with Shari'ah principles. This consideration goes beyond credit risk and extends to mitigating operational risks associated with non-compliance to Shari'ah principles.

By incorporating Shari'ah-compliant safeguards within the syndicated financing framework, IIFS can enhance the overall ethical and operational integrity of the collaborative financial arrangement. This approach serves to align the activities of conventional counterparts with the Shari'ah principles, fostering a harmonized and compliant financial ecosystem.

9. What are the risks when IIFS holds assets that are not actively traded with the intention of selling them? What considerations should the IIFS take into account in managing these risks?

Answer: According to Principle 4.1, when IIFS 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.

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

In the valuation of assets where no direct market prices are available, IIFS shall incorporate in their product programme a detailed approach to valuing their market risk positions. IIFS may employ appropriate forecasting techniques to assess the potential value of these assets. Where available valuation methodologies are deficient, IIFS shall assess the need (a) to allocate funds to cover risks resulting from illiquidity, new assets, and uncertainty in assumptions underlying valuation and realisation; and (b) to establish a contractual agreement with the counterparty specifying the methods to be used in valuing the assets.

10. Can you please give examples what Shari'ah-compliant hedging instruments that may be used to manage market risks related to fluctuation in foreign exchange rates?

Answer: IIFS are 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 Sharī'ah compliant methods.

IIFSB issued a Technical Note Sharī'ah Compliant Risk Management Tools (TN-5) in August 2023. TN-5 has recommended the use of Wa'd Forward Foreign Currency Exchange, which is a unilateral promise to sell/purchase by agreement to sell/purchase foreign currencies at a future date.

11. Assuming an IIFS offers an Investment Account (IA) product where there is a possibility IA Holders (IAH) will bear the capital loss, what measures should RSA take to ensure IIFS has the mechanisms in place to manage the rate of return risk?

Answer: IIFS are exposed to the 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. The rate of return risk differs from interest rate risk in that IIFS is concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

A consequence of the rate of return risk may be displaced commercial risk. IIFS may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is underperforming as compared with competitors' rates. IIFS may decide to waive their rights to part or their entire Muḍārib share of profits to satisfy and retain their fund providers and dissuade them from withdrawing their funds.

RSAs may recommend the IIFS for the use of profit smoothing techniques, such as the establishment of profit equalisation reserve (PER) and investment risk reserve (IRR). A PER is the amount appropriated by IIFS out of their gross income, before allocating the Muḍārib share, to maintain a certain level of return on investment for IAH and increase

owners' equity. The basis for computing the amounts to be so appropriated should be pre-defined and applied by the contractual conditions accepted by the IAH and after formal review and approval by the IIFSs' BOD. In certain jurisdictions, the supervisory authority lays down requirements relating to the maintenance of the PER. An IRR is the amount appropriated by IIFS out of the income of IAH, after allocating the Muḍārib share, to cushion the effects of the risk of future investment losses on IAH. The terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the BOD.

The supervisory authority shall assess the capacity of IIFS to manage the rate of return risk. The supervisory authority needs to obtain sufficient information to assess the IAHs' behavioural and maturity profiles and satisfy itself as to the adequacy and quality of IIFSs' policies and procedures regarding the rate of return risk management.

12. How can we regularly review and address operational deficiencies in IIFS?

Answer: According to Principle 7, IIFS 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. IIFS shall also incorporate possible causes of loss resulting from Sharī'ah non-compliance and the failure in their fiduciary responsibilities. The supervisory authority shall satisfy itself that IIFS has in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities.

IIFS shall have in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities. This framework shall be consistently implemented throughout IIFSs' organisation and understood by all relevant staff. IIFS shall conduct periodic reviews to detect and address operational deficiencies. The reviews and evaluation of internal controls shall include independent audit coverage and assessment by internal and/or external auditors.

13. What key measures are recommended to control and mitigate reputational risk management by an IIFS?

Answer: IIFS are exposed to reputational risk arising from failures in governance, business strategy, and process. Negative publicity about the IIFSs' business practices, particularly relating to Sharī'ah non-compliance in their products and services, could have an impact on their market position, profitability, and liquidity. Supervisory authorities should expect an IIFS to identify potential sources of reputational risk to which it is exposed and appropriate policies to manage such risk.

Once an IIFS identifies potential exposures arising from reputational concerns, it should measure losses it might experience under adverse market conditions. In addition to the direct financial impacts, reputational risk can induce losses for an IIFS in the following ways: (a) loss of current or future customer base – resulting in a reduction in expected future revenues; (b) loss of employees within the organisation – increasing by hiring costs; and (c) increased costs of (i) financial funding via credit or equity markets; (ii) supervisory restrictions, fines or other penalties; (iii) court proceedings; and (iv) compensation or damages paid to customers.

An IIFS should develop methodologies to measure the effect of reputational risk in terms of other risk types (e.g. credit, liquidity, market, or operational risk) to which it may be exposed. This could be done by including reputational risk scenarios in regular stress tests – for instance, including non-contractual off-balance sheet exposures in the stress tests to determine the effect on an IIFS's credit, market, and liquidity risk profile.