Islamic Banking & Risk Management in Oman

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The Development of Islamic Banking in Oman

- 15 June 2011 Islamic banking was licensed to be conducted side by side with conventional banking in Oman marking the start of a new era for banking in the Sultanate.
- 6 Dec 2012 the Banking Law was amended to accommodate Islamic Banking.
- 21 Dec 2012 the release of the Islamic Banking Regulatory Framework (IBRF) by the Central Bank of Oman (CBO).
- 11 Jan 2013 ...the opening of Bank Nizwa, Oman's first full-fledged Shari’a compliant bank.
- 18th. Of Dec 2013 the establishment of the High Shari’a Supervisory Authority
Passing successfully the initial stage

- Drawing from the experiences of other pioneering countries, the Islamic banking industry in Oman has passed successfully its initial stage.
- Now it is on its way to become a second viable, competitive and integrated part of the banking system in the country.
- According to the Thomson Reuters Islamic Finance Development Indicator (IFDI) report, which was released recently in the year 2014, The Sultanate has been declared as the world’s third most developed Islamic finance market.
Rapid Growth

- Islamic Banking in Oman emerged rapidly as one of the fastest growing segments.
- What have been achieved in three years is remarkable compared to other jurisdictions.
- Oman started with 8 Islamic banking players (2 full-fledged banks and 6 Islamic widows of Conventional banks) while many other countries started with 1 full-fledged bank only.
- In terms of Shari’a governance a High Shari’a Supervisory Authority was established in the CBO while such superior authority was initialed in few countries like Malaysia, Sudan and Pakistan.
• The first government Sukuk is expected to be lunched soon.
• Muscat Securities Market Shariah Index was lunched comprising presently 32 publicly-listed companies placed to capture market share.
Risk Management under the IBRF

- Through implementing the IBRF, Oman has adopted the best International regulatory RM standards including Basel Committee’s principles and IFSB and AAOIFI guidelines.
- The IBRF address all the risks not captured/or not captured fully in BIS RM framework like:
  - The Rate of Return Risk, Liquidity Risk, Country Transfer Risk, Business Strategic Risk, Settlement Risk, Credit Concentration Risk, Reputational Risk & other Residual Risks.
The RM system in Islamic banks & Windows under the IBRF

According to the IBRF Banks should have in place comprehensive RM processes which include:

- Board & Senior Management Oversight (RM Committee)
- Clear and effective RM Policy that conveys Risk Appetite/ Tolerance, Procedures & limits
- Identification, Measurement, Mitigation, Controlling & Reporting of Risks
- Effective MIS
- Effective Internal Controls, Stress Testing & ICAAP
- Aggregation & Diversification
Islamic Financing Instruments

Assets Based (Based on Sale/Purchase of an asset)       Profit Sharing (Based on risk sharing)

Murabaha Salam Istisna
Mudarabah

Exposed to:

Market Risk (Price Risk, FX Risk)       Credit Risk (Default of Counterparty)
Islamic Financing Instruments & Their nature of Risks

Murabaha (Binding & non-Binding)

Murabaha for the purchase Order

Displaced Commercial Risk (DCR)

Rate of Return (RR) Smoothing

PER

IRR
Credit Risk Management (CRM)

CRM (the Standardized Approach)

On B/S  Off B/S

Address the special features of Islamic Finance to ensure that there is:

Risk Rating
(Bank Credit & Statistical Bureau)
Assessment of Credit Quality

Risk Mitigation, Collateral (pledge of asset), The expected RR is commensurate with risk incurred, effective excessive CR management

KYC
The Operational Risk

- The Operational Risk

  - Failure of

  Procedures
  Systems

  People
Legal Risk & *Shari’a Non-Compliance Risk*

Legal Risk

- Fine
- Penalties

*Shari’a Non-Compliance Risk*

Non-recognition of Income
RM Governance

Shari’a Governance

SSB

ISR Committees

Internal Shari’a Compliance Unit

Shari’a Reviewer

SCU

Corporate Governance

BoDs

SAU

Board

GM/CEO

Compliance Function
What are the current issues confronting Islamic banking

- The correct understanding of the Islamic finance formulas and instruments by the customers
- The removal of confusion among bank staff in the application of the basic principles of “AlGrum Balgunum” & “Alkharag Baldaman”.
- Most customers feel that there is no real difference
- The rate of return is not competitive so far compared to the rate of interest (DCR)
- The customers are compensated at the expense of the shareholders
• The rigidity of some financing formulas (like the Murabaha) to be as a good substitute for the overdraft facility in financing working capital requirements.
• The risk of fund comingling between the window and the principal
• The transfer of risk between current and investment accounts.
The challenges

- How to:
  - Employ the innovation in Islamic financing instruments in serving the real economy without speculation and exposing to high risk?
  - Overcome the difficulties associated with managing risk in some formulas?
  - Assess Islamic finance products risks and capital requirements in the newly invented products?
  - Include them in the supervisory directives as the case with the Basel II and III requirements?
• Manage liquidity risk in the absence of alternative monetary instruments
• Modernize and to amend the laws and regulations to suit Islamic finance with respect to RM?
• Prepare the suitable regulatory framework and the necessary guideline for RM?
• Explore the principle of Profit & Loss Sharing (PLS) by concentrating on the Risk-Sharing formulas of financing rather than the none-Risk-Sharing instruments?
Measures need to be taken to improve RM

- To protect the market from the risk of unethical behavior like garar (hazardous sale, where the details concerning the transaction are unknown or uncertain), Ihtikar (monopolizing), bay’al mudhtarr (exploitation of acute need), najash (false bids) and jahala (lack of knowledge).
- To put in place comprehensive RM processes (including appropriate board and senior management oversight) to identify, measure, monitor and control all material sources of risks.
- To upgrade RM policies, practices, procedures and MIS.
• To improve the training in order to enable bank staff to analyse the unique nature of risks inherited in the credit, market, operational, rate of return, equity investment and the liquidity risk.
The issues need further study and investigation:

- Are Basel principles and standards for RM valid for Islamic banks?
- Do models like value at risk (VAR) and related concepts and analyses applicable to Islamic banks?
- Do the rating systems and metrics, of Basel applicable to Islamic banks?
- How to assess credit risk associated with individual exposures?
- How to deal with aspects of single-exposure risk using the structural, scoring, rating, and hazard rate approaches?
- How to manage Currency crises & FX intervention?
The Way Forward

- The way forward for the development of RM practices by:
- Creating the suitable regulatory environment.
- Applying the risk-sharing models
- Mitigating risk in equity investment & financing
- Improving the risk-based supervision
- Accommodating Islamic RM models.
- Designing a new credit rating system for Islamic banks.