RISK MANAGEMENT IN ISLAMIC BANKS: THE CBK’S REGULATORY APPROACH FOR ISLAMIC HEDGING, LIQUIDITY MANAGEMENT AND SUKŪK

Session 1: Risk Management and Regulations in Islamic Banks

JW Marriot, Kuwait City

Dr. Jamshaid Anwar Chattha, CPIF
Chief Banking Researcher and Islamic Finance Expert
Central Bank of Kuwait

October 10, 2018
PRESENTATION SCOPE

- Islamic Finance – Relevance and Number Game and Kuwait Islamic Finance at Glance
- Risk Management at Islamic banks and their Prudential Regulation and Supervision
- The CBK’s Approach for Liquidity, Sukuk, and Islamic Hedging
Islamic Finance: Growth and Number Game

The global IFSI – covering Islamic banking, Islamic capital markets and Takāful – has surpassed the USD 2 trillion milestone in 2017 with an 8.3% growth in assets. 

Global Islamic Banking Assets and Market Share

- Kuwait’s financial system - bank centric - 84% of the domestic financial sector.
- Total 11 Kuwaiti Banks (5-conventional; 5-Islamic; 1-Industrial Bank) + 12 Foreign Banks incl. one Islamic
- Islamic banks share represent one of the most significant presence of Islamic banks in any country across the globe with a dual banking system.

Source: IFSB FSR 2018
Kuwait Islamic Finance At a Glance

Source: Central Bank of Kuwait (2018) - Islamic Finance in Kuwait: Broadening Horizons
Key Risks from an Islamic Bank’s business Model and Risk Management ……..

2 Dimensions of Risk Management

Islamic Bank level
Profitability
(Making Profits with risk)

Supervisor Level
Financial Stability

Banking Book

Trading Book

Various Risks:
Credit, market, liquidity, Operational, equity invest., Rate of return risk

Risk Management Tools:
Stress Testing
Value-at-risk
Hedging Instruments

Regulation + Supervision

Dual Banking

Risk Management Tools:
• BOD Collective oversight and risk governance ("Tone at the top")
• Risk culture, risk appetite framework and RAS - CRO
• Three lines of defense

Source: Chattha (2018)
The CBK’s Approach - Regulation and Supervisory Review Process

Central Bank Law No. 32 of the Year 1968

Supported by Legal, Accounting, and financial Infrastructure

Regulation

Capital Adequacy - sound capital assessment

Risk Management – comprehensive assessment of risks

Liquidity Management

Macro-prudential Policy Measures

Governance

• Board and senior management oversight
• Corporate Governance
• Shariah Governance

Capital Adequacy - sound capital assessment

• Quality and capacity of Islamic banks capital to absorb losses
• Going concern (Tier 1)
• Gone concern (Tier 2)

Risk Management – comprehensive assessment of risks

• ICAAP and ERM
• Types of risks captured under Pillar 1
• Types of risks not fully captured under Pillar 1

Liquidity Management

• Five Pillars of Liquidity Management
  - LCR + NSFR
  - 20% Liquid Assets

Supervisory approach - forward-looking assessment of the risk profile of individual banks and banking groups

Supervisory techniques and tools

Mix of On-site and Off-site activities surveillance

Intra-agency and inter-agency cooperation, coordination and information-sharing

Consolidated supervision and Home-Host cooperation

CAMELS-BCOM Model, OSS, ICAAP, Stress Testing, Macroprudential toolkit

Note: The above does not represent the exhausted list of CBK’s regulations and supervision tools.

Articles 86 -100 (Islamic Banks)

Source: Chattha (2017)
Risk Management and Stress Testing: Measuring the impact of ROR Risk ….
Need for Islamic Hedging Techniques – Islamic Profit Rate Swaps

- Voluntary practice based on international guidelines
- Supervisory requirement

Islamic Bank
- Product level
- Bank-wide intergerated stress testing

Supervisory (central bank)
- Portfolio level
- Group-wide (Parent level)

IMF
- Conduct stress testing mostly at system level to ensure safety and soundness of the financial system

Stress Testing

- Recession
- Stagnation
- Bank-run
- Market crash
- Natural disaster
- Contagion

Risk Management with Stress Testing and Supervision of Stress Testing…..

How does it work?
Supervisory Perspective

Guiding Principles?
Templates?

Fat-tails

Top-Down vs. Bottom-Up

Source: Chattha and Archer (2016); Chattha (June, 2016)
Measuring the impact of ROR Risk …
Need for Islamic Hedging Techniques – Islamic Profit Rate Swaps

Figure 1: ICBs and CCBs - EVE Risk as % of Capital

The CBK’s Approach: Liquidity Risk and Shariah compliant lender-of-last resort (SLOLR)

First Line of Defense

- **Five Pillars of Liquidity – Banks Perspective**
  - Liquidity Coverage Ratio (LCR)
  - Net Stable Funding Ratio (NSFR)
  - 18% Liquid Assets
  - Maximum Financing/Lending Limit
  - Maturity Ladder Approach

- **CBK’s monetary operations - Liquidity absorption by CBK through intervention**
  - Robust Liquidity Infrastructure such as Inter-bank liquidity placements and RTGSS called as Kuwait’s Automated Settlement System for Inter-participant Payments (KASSIP).

<table>
<thead>
<tr>
<th>Time Band</th>
<th>Max. limit of Cum. Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 Days and under</td>
<td>10 %</td>
</tr>
<tr>
<td>1 month and under</td>
<td>20 %</td>
</tr>
<tr>
<td>3 months and under</td>
<td>30 %</td>
</tr>
<tr>
<td>6 months and under</td>
<td>40 %</td>
</tr>
</tbody>
</table>

Second Line of Defense – Provision in Banking Law to provide liquidity on Shariah-compliant basis…
The CBK’s Regulatory Treatment of Sukūk

**Asset De-recognition Criteria** - all credit risks (& price risk where applicable) have been transferred, no effective control over transferred assets, true sale & bankruptcy remoteness, and no claim against the originator.

Sukūk rated by **ECAIs are assigned risk-weights** based on the assigned ratings according to the standardised approach; Unrated Sukūk - nature of the entity and nature of the contract upon which the Sukūk are based

**Trigger point and the conversion ratio**, are to be clearly specified in the Sukūk contract so as to avoid *gharar*. Prior supervisory approval, If the instrument is callable.

**Profit Rate risk in trading positions in Sukūk**: specific risk and general market risk; measurement through three methods: simplified (time-bands and weights), maturity (Zones, time-bands and weights), or duration (time-bands and assumed changes in yield).
The CBK’s Regulatory Treatment for Shariah-Compliant Hedging Techniques

- The CBK’s Capital Adequacy Framework presents:
  - Exposures to CCPs arising from OTC Sharī`ah-compliant hedging contracts.
  - Islamic banks are not permitted to undertake derivative transactions for speculative purposes and should only use these to hedge their exposures.
  - All positions by Islamic banks should also be compliant with Sharī`ah principles and approved by the respective SSB. The CBK have discretion to impose additional capital charges on such positions on a case-by-case basis.
  - An example which illustrates the CCR treatment for Sharī`ah-compliant Hedging Contract and CVA Capital Charge, and replacement cost, bilateral netting agreements, and add-on factors based on residual maturity for Sharī`ah-compliant hedging contracts (e.g. FX and profit rate).
  - Islamic banks may use the applicable market accepted standard agreements such as the ISDA/IIFM Tahawwut master agreement (TMA).
Concluding Remarks

The growth, and increasing systemic importance of Islamic banks necessitates effective risk management, regulation and supervision. Regulation and supervision to recognize unique characteristics and instruments.

IFSB Standards, complemented by IIFM and AAOIFI standards, are paradigm for prudential regulation of Islamic Banks.

In line with the changing international regulatory frameworks, supervisors will continue refining and improving supervisory frameworks for Islamic banks.
Thank You!

Dr. Jamshaid Anwar Chattha, CPIF
Chief Banking Researcher and Islamic Finance Expert
Off-Site Supervision Department
Central Bank of Kuwait
janwar@cbk.gov.kw
Key References and Recommended Readings


