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**Professional paper**

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## **REGULATION OF THE OPERATIONAL RISK IN ISLAMIC BANKING**

### **Abstract**

The general overview of the global regulatory treatment and characteristics of the operational risk in Islamic banking and its similarities and differences with the operational risk in conventional banking is one of the aspects of Islamic banking which will be interesting theme for research in the next years.

The operational risk can not be avoided in the business activities of the Islamic banks and therefore the operational risk management is important function in Islamic bank. This is especially about issues related to compliance with Shari`ah rules and principles and the capital requirements for operational risks which arise from priority of use of the Shari`ah Law in Islamic banking operations and risk management.

The establishing of international organization for Islamic finance in the 90s of XX century was the first step to achieve higher level of standardization in use of Islamic banking products and services in compliance with Shari`ah and set up common prudential standard for risk management systems and controls. In this direction are also the rules and principles prescribed from the Islamic Financial Services Board in a role of a central body for regulation of operational risk management in Islamic banks.

**Key words:** operational risk, Shari`ah law, regulation, Islamic bank, Islamic finance.

**JEL classification:**G 21, G28, G29, Z12.

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## 1. The position of Islamic banking in the new financial architecture

Islamic banking is part of the broader concept of Islamic finance. The Islamic banks are financial intermediaries that operate in accordance with the Shari`ah principles, and there exists a ban (prohibition) for the banks to work with interest (*Riba*); the financial contracts should not contain provisions which introduce uncertainty (*Gharar*); prohibition to finance gambling (*Maysir*); the earnings should not derive from economic activities related to financing of pornography, alcohol, tobacco, weapon trafficking (*Haram*); each financial transaction should be measurable and there should be a possibility to identify the funds, and, the parties within the financial transactions must share the risk and the profit.<sup>1</sup>

Islamic banking is generally widespread in countries with predominantly Muslim population in Asia and Africa, where the big international banks as well are trying to take market share<sup>2</sup>. However, it is often seen in non-Muslim countries as well,<sup>3</sup> and, within the creation of conditions for attracting Islamic banks, Great Britain is the leading country, which pretends to grow up into a centre of Islamic finance and trade through the bank regulation changes that Great Britain makes, to provide place for the Islamic finance products at the market.<sup>4</sup>

Today, the Islamic banking is in continuous development no matter of the conventional banking system suffer from crisis. In the world, there are 325 Islamic banks, two of them are in Australia, six of them are on Bahamas, 38 in USA, there is one Islamic bank in Denmark, one in France and one in Ireland, in Germany and Switzerland operate five Islamic banks per country, and 23 Islamic banks are in Great Britain, there are four of them in Luxemburg, and according to the Islamic

<sup>1</sup> Hylmun Izhar, Identifying Operational Risk Exposures in Islamic Banking, (2010), Kyoto Bulletin of Islamic Area Studies 3-2 p.20

<sup>2</sup> Some of the leading banks has their own representative offices in Muslim countries where, through the Islamic windows, offer to their clients banking products acceptable for the Islamic banking: (e.g. USA: Citibank, JP Morgan/Chase, Goldman Satche i UBS Warburg; Great Britain: HSBC, Barclays Capital, ANZ Grindlays Bank; Netherlands: ABN Amro; France: BNP Paribas, Societe Generale; Germany: Commerzbank i Deutsche Bank; Japan: Nomura Securities; Switzerland: UBS).

<sup>3</sup>The Arabic banking corporation has offices in: Frankfurt, London, Milano, New York, Paris, Sao Paolo, Stockholm, Moscow. ABC (Arab Banking Corporation)

<http://www.arabanking.com/world/IslamicBank/En/Products/Pages/CommercialBanking.aspx>

<sup>4</sup> Uhomoi bhi Toni Aburime, Felix Alio, Islamic Banking: Theories, Practices and Insights For Nigeria, International Review of Business Research Papers Vol.5 No. 1 January 2009 Pp. 324.

financial principles, in South-east Europe, operates one Islamic bank in Bosnia and Herzegovina.<sup>5</sup> Some estimates show that more than 250 financial institutions in more than 45 countries, operate with Islamic finances, and the industry has growth of more than 15% per year in the last five years. The annual turnover of the market is estimated at \$ 350 billion, compared to the \$ 5 billion in 1985.<sup>6</sup>

Facts that show the seriousness of the Islamic finance and Islamic banking are the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI) in 1991,<sup>7</sup> than the establishment of Dow Jones Islamic Market<sup>8</sup> in 1999, to offer investment portfolios in accordance to the Shari`ah law, in 2003 starts working the Islamic Financial Services Board and in 2005 starts working The Islamic International Rating Agency (IIRA),<sup>9</sup> so, we can say that the Islamic banking grows up into key player in the international finance.

## **2. Treatment of operational risk in Islamic banking**

Consideration of the operational risk in Islamic banking and its regulatory treatment, is without intention to go into a detailed contemplation and explanation of the operational risk within the individual financial instruments and contracts, but there will be made some attempts to create general overview of the global regulatory treatment and characteristics of the operational risk in Islamic banking and its similarities and differences with the operational risk in conventional banking.

In that direction, as we can see in the above mentioned researches, the operational risk can not be avoid in the business activities of the Islamic banks. Moreover, some researchers argue that the Islamic banks are on impact of many operational risks which are different of those from which suffer the conventional banks. These statements are based on the arguments that the Islamic banks operations are not fully

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<sup>5</sup> Bosna Bank International, Sarajevo, Bosnia and Herzegovina. <http://bbibanka.com.ba>

<sup>6</sup> Mohamed Helmy, Risk management in Islamic banks, (2012), ESLSCA Business School, MPRA Paper No. 38706, p.7. <http://mpra.ub.uni-muenchen.de/38706>

<sup>7</sup> Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI), <http://www.aaofi.com/aaofi/Home/tabid/36/language/en-US/Default.aspx>

<sup>8</sup> Dow Jones Islamic Market™ Index <http://www.djindexes.com/Islamicmarket/>

<sup>9</sup> The Islamic International Rating Agency (IIRA), <http://www.iirating.com/Default.aspx>

standardized and there is a possibility, different banks to execute them in different ways. Another argument is the complexity and variety of Islamic bank products and services, as well as the fact that they are relatively new at the financial market. All above mentioned, together with the fiduciary responsibility of the Islamic bank show that the operational risk is the most important for the Islamic bank.<sup>10</sup> There is one thing more which can contribute to brighter exposure of the Islamic banks on operational risk, which is the necessity of compliance of the regulation for Islamic financial products with the regulation for conventional financial markets. That is undoubtedly big and complex work.

Therefore, the operational risk on which are exposed the Islamic banks in accordance with some authors can be divided into three categories<sup>11</sup> as the following:

- operational risks which are result of different types of bank activities, and can be sometimes similar with the activities of all financial intermediors, no matter whether they are in compliance with the Shari`ah principles or not.
- risk of compliance with the Shari`ah principles which is related to the potential incompliance with the Shari`ah rules and principles within the banking operations, as well as the risks related to the fiduciary responsibility of the Islamic bank as entrepreneur in the case of failure or negligence while investing, which are responsibility of bank and become its obligation.
- legal risk which derives from Islamic bank operations or problems related to the legal uncertainty in interpretation and execution of the contracts that are in compliance with the Shari`ah principles.

From here we can see that it is considered that the Islamic banks are exposed to regular operational risks as any other conventional bank, but they are also exposed to two additional groups of risks which can be classified as operational risks, which arise from the Shari`ah rules and principles.

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<sup>10</sup> Farhad Reyazat, *Risk Management Framework in Islamic Banking: Basel II and III, Challenges and Implications in Islamic Banking*, (2012), Money and Economy, Vol. 6, No. 2, Monetary and Banking Research Institute, Islamic Republic of Iran. p.78.

<sup>11</sup> Abdullah Marliana, Shahimi Shahida, Ismail Abdul Ghafar, *Operational in Islamic Banks: Issues and Management*, (2011), Persidangan Kebangsaan Ekonomi Malaysia ke VI (PERKEM VI), PROSIDING PERKEM VI, JILID 1 ISSN: 2231-962X, p.255

In the world of Islamic banking and Islamic finances, the regulatory role has the Islamic Financial Services Board<sup>12</sup> with its publications in which are set standards and principles for the operational risk and the Islamic banks.

The international regulatory treatment of the operational risk for Islamic financial institutions and Islamic banks, starts in 2005, with the publishing of Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services<sup>13</sup>, and this was the first step to formal introducing the severity of operational risk in Islamic banking.

Within the principle number seven dedicated to the operational risk, are given the basics for establishing appropriate systems and controls for operational risk in Islamic banks as well as the definition of operational risk and fiduciary responsibility of the Islamic banks.

The definition of operational risk in Islamic banking is in compliance with the basics on which the Islamic economy has been established/introduced. Although, at the first side, the definition about the operational risk seems identical with the definition given in Basel 2, dedicated to the conventional banking, there is also an essential difference.

Namely, the definition about the operational risk<sup>14</sup> in Islamic banking, says that it is a risk related to inappropriate or bad internal processes, people or systems or external events, but together with two additional elements which the potential losses connect to the incompliance with Shari`ah and failures in the fiduciary responsibility. Therefrom, we can remark that within the definition about the operational risk there are concluded the legal risk, and the reputational risk as well.

Paying attention to the elements which are specific for the operational risk in Islamic banking, the focus will be the incompliance with the Shari`ah rules and principles, and the fiduciary risk, legal risk, people risk and technology risk as well.

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<sup>12</sup> The Islamic Financial Services Board (IFSB)), which starts operating in 2003, is international organization for establishing standards that promote and enhance the soundness and stability of the Islamic financial institutions, through issuing prudential standards and principles for Islamic banking, capital markets and insurance. IFSB conduct surveys and coordinate initiative related to financial islamic industry and organizes seminars, conferences for the authority and the industry.  
<http://www.ifsb.org/>

<sup>13</sup> Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services, Islamic Financial Services Board,2005.

<sup>14</sup>Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services, Islamic Financial Services Board, december 2005, p.26.

In Islamic banking, the compliance risk with Shari`ah principles is considered as the greatest priority no matter what other operational risks are identified. This risk appears when the Islamic bank will not compliance its activities, products and services with the Shari`ah rules and principles defined from the Shari`ah Board or the Authority. When the Islamic bank operates on a territory where does not exist central body as Shari`ah Board, the Islamic bank establishes its own Shari`ah Board or engages a person that is familiar with Shari`ah, and in accordance with that person's opinions, the bank compliance its activities, products and services i.e. this Shari`ah Board additionally assess/evaluates the activities, products and services of the Islamic bank and gives consent for its use.<sup>15</sup> The establishment of this type of body within the Islamic bank and its operation are subject to evaluation in accordance with predetermined rules.<sup>16</sup> If the Islamic bank does not proceed this compliance, the transactions might be canceled, and the income would be considered as illegitimate.

The greatest importance of the compliance with Shari`ah principles and rules is due to the fact that the majority of clients that use Islamic bank services, does that because of principles related to the Islam and their perception about the compliance of the bank operation with the Shari`ah rules. If this perception is unsettled, this will make negative impact to the reputation of the bank in public and to the deduction of the bank income due to the reduction of the number of clients and their calling out funds of the bank accounts.

Second important element which is specific within the definition about the operational risk in Islamic banking, is the fiduciary risk which arises as a result of the Islamic bank failures to work in accordance with the standards which are applied for its fiduciary responsibility. In this case, using the funds of the investment and other accounts through which the bank executes its investment function and project financing, the Islamic bank will not realize profit or due to insufficient concern in the process of managing the funds, the bank will suffer losses which will disturb its liquidity and solvency. Due to avoid this type of situations or to decrease the probability of its arise, the Islamic bank should introduce

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<sup>15</sup> Declaration adopted by Shari`ah Supervisory Board of the Abu Dhabi Commercial Bank for its bank product which is available on: [http://www.adcb.com/Images/AmbitionEducation\\_tcm20-31925.pdf](http://www.adcb.com/Images/AmbitionEducation_tcm20-31925.pdf)

<sup>16</sup> Guiding Principles in *Shari`Ah* Governance Systems for Institutions offering Islamic Financial Service, Islamic Financial Services Board, December 2009.

clear and formal policies for undertaking those different and potentially conflict roles while managing different types of investment accounts.

These two types of risks, the risk of compliance with Shari`ah principles and the fiduciary risk are considered as serious treat for the Islamic bank because this can lead to decreasing the number of clients what will result in: decreasing the profitability, withdrawel of funds, loss of other incomes, unfulfillment of the financial obligations, damage to the reputation of the bank, and limitation of the Islamic bank business possibilities.

The legal risk arises of various reasons related to unstandardized practices for execute and interpretation of different contracts in different states, the insufficient number of legal experts in this area, the legal ground of the Islamic financial instruments in some countries, as well as incompliance with the changes of the laws and other regulation.

Additionally, the lack of Central regulation body with sufficient authority to define and control the Shari`ah principles, is one of the reasons which lead to different use of the rules for financial statements, revision and accounting in Islamic banks. There should not be put aside the oppinions that some of the operational aspects of the Islamic bank activities are insufficiently covered with legal regulation which leads to higher legal risk exposure in Islamic banking. Therefore, it is considered that the impact of the legal risk over the Islamic banking is important and cannot be ignored.<sup>17</sup>

Risk of people has braighter context in Islamic banking rather than in conventional banking. The reasons for this are particularly in the characteristics of the Islamic financial intruments and the operation principles related to the Shari`ah, but also in the environment where the Islamic banks operate. In Islamic banking, the staff must recognize and understand the financial products and services in Islamic banking as well as the financial products and services of the conventional banking. This requirement limits the number of quality staff that can be in short term employed in the Islamic bank, and this also increases the possibility of mistakes, frauds, incompliance with the Shari`ah principles and other types of failures, intentional or unintentional, and increases the exposure on operational risk.

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<sup>17</sup> Hylmun Izhar, Identifying Operational Risk Exposures in Islamic Banking, (2010),Kyoto Bulletin of Islamic Area Studies 3-2, p.28

From aspect of the environment, there is a necessity in Islamic bank industry to be developed through innovators, risk managers, regulators and supervisors that have knowledge in modern finances and understand the principles of Shari`ah i.e. the Islamic law on financial transactions. The lack of trained people has been already recognized as a problem and there are founded institutions which offer training programmes in Islamic banking and Islamic finances. In Europe, precisely in London, Great Britain, operates Institute of Islamic Banking and Insurance<sup>18</sup> which offers training programmes, conferences and seminars, lecturers and publications for Islamic finance and Islamic banking. This Institute also promotes the document entitled: 'Moral Code of Conduct in Islamic Finance'<sup>19</sup>, for every person that wants to work in Islamic banking. They make reference to the Dutch banking code, where each member of the Board of directors of the Dutch bank NIBC, has signed moral and ethic declaration.<sup>20</sup> With this approach, they hope to educate staff capable of creating financial innovations in accordance with the requests of the clients, and at the same time they will not include interest and are going to be in compliance with the other Shari`ah rules.

If the Islamic banks want to be competitive with the conventional banks at the international markets, their future operations will more depend on the technology, so, the technological risk will become more important for the Islamic banks risk management. If the Islamic bank does not want or is not capable of following the technological development in the banking operations, the Islam bank will be far behind its competitors. Hence, the use of technology within the bank operations arise the possibility or likely hood of supervening events related to the operational risks and risks from the information technology. Therefore, each Islamic bank should upgrade and test the soundness and stability of its system, to be able of offering new products and services to the clients, in accordance with Shari`ah principles, to follow the market trends and to comply with the regulatory changes as well as to provide the necessity of more information and knowledge in the Islamic bank management.

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<sup>18</sup> Institute of Islamic Banking and Insurance (IIBI), <http://www.Islamic-banking.com/>

<sup>19</sup> Recommendation for a 'Moral Code of Conduct in Islamic Finance', 4th International Annual Thematic Workshop – 'Legal Compliance versus Moral Responsibility in Islamic Finance', 2012  
[http://www.Islamic-banking.com/resources/2/Moral%20Code%20of%20Conduct%20-%20IIBI\\_ISR%20-%20draft%20\\_10%2009%202012\\_.pdf](http://www.Islamic-banking.com/resources/2/Moral%20Code%20of%20Conduct%20-%20IIBI_ISR%20-%20draft%20_10%2009%202012_.pdf)

<sup>20</sup> NIBC Bank - Nederland, <http://www.nibc.com/en/about-nibc/corporate-governance/moral-and-ethical-conduct-declaration.html>

### 3. Management of operational risk in Islamic banking

The operational risk management in Islamic banking has the same or similar characteristics as the operational risk management in conventional banking. In Islamic banking exist two level of operational risk management as well:

- micro level where the Islamic bank as financial institution manages itself its operational risk events and operational risk profile, and
- macro level where the competent authority or bank supervisory authority prescribes general rules for establishing systems and controls for the operational risk management within the Islamic banks, and in the Islamic banking system as whole.

The specifics of the operational risk management in Islamic banking determine the scope, the content and the requirements about written policies, procedures and processes for identification, measurement, monitoring and control of the operational risk. However, the final objective is identical as it is in the conventional banking and it should help in the processes of decision making for accepting, avoiding or reducing the operational risk which the Islamic banks are faced.

One of the most important requirements for the Islamic banks related to the operational risk management is a compliance of its activities, products and services with the Shari`ah principles. If the Islamic bank fails to achieve this compliance, it would be potential danger for the bank income and the reputation. For those reasons, the Islamic Financial Services Board recommends to the Islamic banks, in its stress testing programmes, to put in different aspects of risk of incompliance with the Shari`ah rules and principles.<sup>21</sup>

This approach assumes that the Islamic bank should be capable of quantifying in its own stress testing programmes, according defined scenarios, the potential losses from failures of compliance of the specific products or activities, and to evaluate whether the business continuity plans are in function of effective risk management raised from Shari`ah incompliance.

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<sup>21</sup> Principle 3.15, Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services [excluding Islamic Insurance (*takaful*) Institutions and Islamic collective Investment schemes], IFSB-13, Islamic Financial Services Board, 2012, p.37.

Additionally, the Islamic bank, as part of the stress testing, should evaluate the financial implications from any impact to the bank reputation as result of significant failures in compliance with the Shari`ah principles. The recommended stress test programmes should be adequate with the scope, the complexity and the nature of the bank operations. In this direction, it is recommended the smaller Islamic banks to have more simple stress testing programmes with lower level of technical approach which is more focused to qualitative aspects, although, the bank management board has the opinion that they are very well familiar with the risk profile of the bank.

In the case of Islamic banks with complex structure and scope of activities, it is recommended to execute stress testing with more complex scenarios with qualitative and quantitative aspects which will include more business lines and geographic regions where the bank has its own operations.

#### **4. Conclusion**

The approach to treatment of operational risk in Islamic banking is not that different than conventional banking. In Islamic banks there exist systems and controls, and written policies, procedures and processes for operational risk management.

Islamic banks are also profitable financial organizations although their operational environment is determined with religious principles from Shari`ah Law. This situation in some cases is advantage but in the world where conventional banks dominate, it's not easy to achieve sufficient strength for competitive run.

Islamic banks are subjects of same or similar risk as other financial institutions and risk management is one of the most important functions of any Islamic bank. Due to their specifics related to Shari`ah principles and rules, they are more vulnerable to operational risk and operational risk management in Islamic banks is still a challenging task.

Main reasons for that is a lack of standardization of banking products and services and fiduciary responsibility and lack of central competent authority for interpretation of Shari`ah rules and principles in the context of use of this products and services. This is significant potential operational risk because, in any moment, it allows some individual bank Shari`ah Board to declare them as illegitimate. In this

context is also the legal risk through interpretation of Islamic financial contracts as well as use of informational technology in banking operations as technology risk and people risk through limited possibilities for training the employees in Islamic banks.

In the last decade, the regulation and capital requirements for operational risk are subject of documents issued from Islamic Financial Services Board which are in accordance with the documents issued from Basel Committee of Banking Supervision but complied with Shari`ah. These documents represent improvement in operational risk management because it is a step forward to achieve standardization in implementation of prudential standards as preconditions to avoid or reduce operational risk events. The acceptance of this recommendations from Islamic bank, will get over the weaknesses in the treatment of operational risk event in different Islamic banks in different jurisdictions.

The process of consolidation on international Islamic financial institutions with authority to regulate some issues in banking will contribute to the better understanding of complexity and nature of operational risk in Islamic banking, and the constant growth of Islamic banking will impose obligation for most efficient operational risk management.

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