Presentation Flow

- Introduction of KFH Group
- Current credit crisis and its relevance to us
- Safety net built in Islamic Banking
- Things that can go wrong with Islamic Banking
- Lessons learnt for Risk Management
- Risk Management initiatives in KFH
- Conclusion and prognosis
Who We are – KFH Group

- KFH Kuwait Established in 1977
- 2nd largest Islamic Commercial and Investment Bank in GCC
- In past, awarded by The Banker and Euro-Money, “The best Islamic Financial Institution in the World” and “The Best Islamic Institution Worldwide” respectively
- Present in Bahrain, Malaysia, Turkey, Jordan and expanding aggressively in Saudi, Australia, Singapore, Qatar, UAE and others
- Major growth highlights
  - Asset growth @ 35% in 2006 and 39% in 2007.
  - Revenue growth @ 32% in 2006 and 43.5% in 2007.
  - Return on Equity @ 23% in 2006 and 23% in 2007.
  - Last quarter result Sept. 30, 2008
    - Total Profit till Sept. 30, 2008 at USD 1.74 Billion: @18% growth
    - Total asset at USD 39.59 Billion: @28% Growth
    - ROE 24%
- KFH Bahrain is wholly owned subsidiary of Kuwait Finance House, Kuwait
  - Established in 2002
  - Similar growth pattern as of KFH Kuwait

KFH Bahrain is wholly owned subsidiary of Kuwait Finance House, Kuwait
Causes of Credit Crisis

- Asset - Real Estate bubble
- Bad and Predatory lending (Sub Prime) practices, hence, low quality loan portfolio
- Leverage and miss understood dynamic nature of risk
- Over reliance on presumption of liquidity. Liquidity Crisis exacerbated by complex structure and asset price correction
- Debt and structures not backed by sufficient collateral
- Credit enhancement by complex structures and flawed rating model
- Complex structures and financial products allowing leveraged speculative bets
- Flawed incentive structure allowed excessive risk taking
- A mix of all the above
Safety net built in Islamic banking Model
- Money can’t earn you money, Interest ban
- No pain no gain, Profit sharing and loss bearing and equity or quasi equity oriented products
- Decoupling of Risk and Return is not allowed
- No contractual uncertainty and excessive risk taking
- Asset and equity based model, “banking in fundamentals”, hence, limited leverage
- Unique features of Asset and liability in Islamic banks strengthen linkages between financial and real sectors, and hence, enhance financial stability
- Simpler products backed by real economic needs and “real tangible” assets
- Complex Sharia “compliant” products seen with suspicion and less likely to be accepted
- Ethical nature of investing with undesirable sectors
Safety net can easily be compromised
- Quality of asset and portfolio is not guaranteed
- Reliance on short term financing and illiquid asset class
- Limited availability of balance sheet and portfolio hedging tools
- Asset Speculation
- The unique balance sheet features of Islamic banks which may provide stability, however, also give rise to significant unique risks
- Misselling of products
  - Can happen due to skewed incentive and bonus structures
- Sharia Arbitrage and opinion hunting
- Following letters of Sharia and not spirit, financial engineers can come up with products to suit any risk-return profile allowing speculative bets
  - Sharia Hedge Funds
- Islamic Banking industry is dominated by smaller banks with limited ability to
  - Invest on Risk Management Infrastructure
  - Manage liquidity efficiently
  - Diversify across various asset classes and geographies
Typical Risk Management Challenges in Islamic Banking

- Liquid asset class and liquidity management
  - Limited interbank instruments on funding side
  - Liquidity led market risk on asset side

- Asset based financing
- Islamic banking market is getting crowded
  - Puts speculative pressure on asset prices - Real Estate

- Fewer structures available to hedge risk especially balance sheet risk

- Lack of standardization. Islamic law is open to interpretation.

- Sharia compliance and innovation
  - Sukuk prices tanked and issuance halted after declaration that about 85% of Sukuk issued are not Sharia compliant due to repurchase agreement without the transfer of collateral/asset ownership. Sharia compliance risk transitions into Market Risk.

- Valuation of Private Equity Portfolio and illiquidity on asset side

- Dichotomy of Deposits in Islamic Banking
  - Profit Equalization Reserve
  - Careful allocation of Profit Sharing Investment Accounts, PSIA funds to various asset class
  - Sharing of the risk on asset side with the owner of PSIA

- Available software and analytical solutions don’t cater to Islamic Products work flow
  - Dynamic nature of risk in a life cycle of single product
  - Bundling of Liquidity, Market, Credit and Operational Risk at various stages of the product and across time
At fundamental level, No

- Depends how far one goes to break the Islamic product into its granular financial engineering components
- Categories of Risk not very different
  - Credit risk, Equity investment risk, Market risk, Liquidity risk, Rate of return risk, Operational risk, Shariah Non Compliance Risk/Legal Risk, Fiduciary risk
  - Reputation Risk, Business Risk, Failure in Governance

- What is unique is
  - How risk factors interact with each other in a single product and also across time
  - That in conventional banks, predominance of market risk in the trading book and where in Islamic bank, it rests mostly in Banking Book
  - Limited Liquidity management and hedging tools and Shariah constraints
  - Market risk arises from owning the underlying physical assets until maturity of a contract or until the ownership is transferred
Basel II

- A major correction or one big loss in a concentrated portfolio can wipe out bank's capital in a moderately capitalized bank.
  - It is not hard to see this happening in this troubled time

- Is Basel dead?
  - Pillar 2 and Pillar 3 are corner stones of Basel
  - Funding long term assets with wholesale short term money
  - Risk Culture and empowerment of risk management framework are more critical
  - It is hard to imagine that a properly framed stress test wouldn't have highlighted what world is seeing today
  - Interaction of Liquidity with Market and Credit are now well understood
  - Identifying quantifying and reporting of the risk are not enough. Fundamental question always remains what are we going to do about it

- Basel still provides impetus to build Risk Management Culture in the bank. Have they succeeded?

- Basel II induced instability and accentuation of economic cycles
  - More losses -> more capital needs -> selling of assets/less lending
  - More price correction -> more losses. Results into deepening of recession
Establishment of Risk Management Framework is relatively new initiative

Enterprise wide Risk Management Framework at individual banks and at the Group level

Group Risk Management Committee
  - KFH – Kuwait, Bahrain, Malaysia and Turkey

Mandate of Group Risk Management Committee to
  - Meet quarterly
  - Decide on Risk Management System selection and implementation
  - Share Risk Management initiatives and knowledge
  - Decide on common reporting framework
  - Evaluate Risk Management issues to recommend action
Risk Management Framework in KFH Bahrain

- Risk Charter
- Capital Management Policy
- Various approved policies with Limit Structure
  - Credit Risk Policy and Methodology
  - Operational Risk Policy and Methodology
  - Market Risk Policy and Methodology
  - Asset Liability Policy and Methodology
  - Investment Risk Policy and Methodology
  - Business Continuity Plan including Liquidity Contingency Plan
- Integration of Risk Management Framework with the Policy and Procedure Manual of different departments in the bank
- Risk Procedure. Limit Numbers and Reporting standards
  - Trading procedures, limit number and reporting framework
  - Credit Risk, Investment Risk and Asset Liability limit numbers
- Risk System Infrastructure
  - Risk Databases and Data cleansing process
  - ALM System
  - Credit Risk Management System – Score card, Standardized and Advanced
  - Loss Event Database and RCSA framework
  - Matlab and Excel based Statistical and Mathematical Package
Integrated Risk and Capital Management

Risk strategy

Risk management framework

Infrastructure
- People → Mandates, roles & responsibilities
- Organisation structure
- IT → Databases, systems

Processes
- Identification & assessment
- Measurement (inc. models)
- Monitoring & reporting
- Mitigation & control
- Optimisation

Policies
- Implementation of desktop procedures for all business units & product types

Day to day risk management
- Risk analysis • Limits • Pricing
- Capital management • RAPM & optimisation • Learning & development
Risk Governance Structure at KFH

Level 1
- Board of Directors
- Shariah Board

Level 2
- Board committees
  - Executive Committee
  - Audit Committee
  - Risk and Governance Committee
  - Nomination and Remuneration Committee

Level 3
- Senior management committees
  - Asset and Liability Committee
  - Credit Committee
  - Investment Committee

Level 4
- Risk Management Group
  - Credit risk
  - Market risk
  - Operational risk

Level 5
- Business lines
  - Desktop level procedures, systems and controls in day-to-day Business

Internal Audit
Risk Management Organizational Structure

- Market Risk Unit and Analytical Modeling Unit
- Asset Liability Unit and Investment Risk Unit
- Credit Review and Credit Risk Management Units
- Operational Risk, AML, Compliance, Quality Units
Establish relevant policies and procedures outlining responsibilities of each department. Many business processes were re-written and updated to reflect the following:

- How the Risk Charter and Risk appetite get implemented
- Establish the external relationship of Business Department with the other stake holders such as Audit, Risk, Sharia Advisors and various Management and Board level Committees
- Policies and Procedures for the Business Department to manage their responsibilities

Risk Management reviewed and included comments in the policies and procedures of business departments:

- To reinforce risk processes and establish business unit responsibility to bank’s Risk Charter and Capital Management Policies
- Further to inculcate a sense of risk awareness and accountability in the business units
Take Away Lessons from KFH Experience in establishing Risk Management setup

- Risk Culture is the most difficult aspect to set up
  - Management Buy In
  - Establishing the Role of Risk Management Department
  - Earning Respect and Support from Business Units
    - Function of political set up, history and reward structure

- Basel is considered Risk Management Project
  - Basel is a bank wide project

- Consistent Framework for Market, Credit, Operational Risk, Liquidity
  - Risk is Risk and loss is loss, does it matter which one?
  - Common Analytical Framework
  - Consolidating Market, Credit and Operational Risk
    - How do you consolidate?
    - How do you control risk in one framework?

- Drastic Revamp of IT System to support Risk Management Framework
  - Don’t underestimate data requirement
    - Gathering data will approx 50% of your effort
    - Cleansing the data will take another 25% of your effort
  - Don’t underestimate the role of other Business and IT Departments in the above process
  - Ensure that data reference is common among Finance, Risk and other units
  - If not done right, you are most likely to become data manager than risk manager
Sure. It can, despite the inbuilt safety features
- It may not be as extreme as we have seen in this current time

Asset prices can correct big time
- Demand sufficient collateral, equity from borrower in excess of 40% could have mitigated so many defaults
- Diversify across business lines and region

Asset Price correction coupled with liquidity issues could be disastrous for banks
- With heavy concentrated position
- Without diversified funding base
- Who lack sophistication in Risk Management and Internal Control standards
- Stress test need to include liquidity as one of the parameters to see the impact on valuation

Islamic Model of Banking doesn’t necessarily guarantee good financing and investment decisions
- Good Credit decisions need discipline. Remember the four Cs.
- Competition for business could relegate best risk management practices at the back. Tendency to Profit first, manage risk later!

Deteriorating economic fundamentals coupled with lax risk management framework is a recipe for disaster
- Islamic Bank tend to small with limited ability to invest on Risk Management Infrastructure
- Limited access to liquidity
Due to very nature of Islamic Banking, Risk Management should be an integral part of decision making

- Risk Management would be a driver for growth in future

Increasing competition among Islamic Banks with deteriorating economic fundamentals will bring consolidation. Only strong banks will exist which

- Develops well diversified portfolio and funding base
- Tightly integrates risk management framework with business

Implementing Risk Management infrastructure and culture in not that easy. Time to implement them is now

- Need to invest on people, Risk Management System and dissemination of Risk Management culture in the bank

We at KFH have invested heavily in People, Process, Systems and Risk Governance Structure

Question is whether you will do enough?
THANK YOU