Jurnal Middle East and Islamic Studies

Volume 8
Number 2 *Volume 2 Juli-Desember 2021*

Article 6

12-11-2021

Islamic Banking Risk Assessment Process: A Case Study from Indonesia

Ita Sitasari
Sekolah Tinggi Ekonomi dan Perbankan Islam Mr. Sjafruddin Prawiranegara, itasitasari@gmail.com

ISLAMIC BANKING RISK ASSESSMENT PROCESS A CASE STUDY FROM INDONESIA

Ita Sitasari
Sekolah Tinggi Ekonomi dan Perbankan Islam
Mr. Sjafruddin Prawiranegara, YAPI Al-Azhar Indonesia
Email: itasitasari@stebankislam.ac.id

Abstract

Indonesian Islamic banks are required have minimum capital in relation to bank's risk profile rating that comes from the comprehensive risk assessment process. This is a qualitative study to observe how Islamic banks in Indonesia respond to the regulation, with the focus observation on the material risk identification process, risk indicators and determination of risk level. Based on discussion with some risk officers of Islamic banks indicates that the banks do not have specific process to identify material risks. They make assessment on risk types that have been defined by regulator. They also do not develop additional Islamic risk indicators to describe the unique risks of Islamic transactions. They just follow the risk indicators that have been defined by regulator. To determine the rating of each material risk, they defined some scales and threshold derived from the bank's risk appetite and tolerance. From the observation of annual reports, it was found that not all banks disclose their risk profile rating. The number of respondents were limited compared to the number of all Islamic banks therefore the result of discussion might not represent the population. Future research is required to develop methodology for a comprehensive risk assessment for Islamic banks as a prerequisite for the implementation of ICAAP.

Keyword: Risk Profile, Risk Indicators, Risk Level, ICAAP

INTRODUCTION

Indonesian Islamic banking and finance has been developing rapidly for many years. Based on Islamic Finance Development Report 2020, Indonesia is the second position as The Most Developed Country in Islamic Finance and the fourth position in Global Islamic Indicator 2020-2021. However, despite having the world's largest Moslem population and forming a dynamic emerging economy, Indonesia still plays a minor role in the global Islamic banking industry. Currently, market share Islamic banking in Indonesia as of June 2021 is 6.59% from the total banking industry. It lags far behind the country's domestic conventional banking.

Apart from the recent growth

of Islamic banking in Indonesia, from the point of banking supervision, Indonesia as one of G-20 forum members and other international forums such as Basel Committee on Banking Supervision (BCBS), Islamic Financial Services Board (IFSB), and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has given its commitment to adopt the recommendations by the forums and taken part in the global financial system reform. One of the recommendations that has been implemented by Indonesian banking is the capital framework. Capitalization is one of the main focuses in Indonesia Banking supervision authority in implementing prudential principles

The Indonesian Financial Services Authority (OJK) through POJK No 21/POJK.03/2014 regarding the adequacy of minimum capital requirement requires all Indonesian banks to have minimum capital in relation to bank's risk profile rating and to include risk profile rating in the assessment of bank soundness rating. Risk profile rating is expected resulted from a comprehensive risk assessment process which is able to describe all major risks and the quality of risk management process of the bank. A comprehensive risk assessment process is a preliminary of internal capital adequacy assessment process (ICAAP) implementation.

The standard process of risk profile assessment has been defined by regulator. Based on the regulation, Islamic banks in Indonesia are required to assess at least 10 (ten) types of major risks both on the inherent risk and the quality of risk management application. Minimum risk indicators to be considered in assessing each type of risk have been defined by regulator. However, to have a comprehensive risk assessment for an Islamic bank, the

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

Bank must enhance the standard process of assessment to be able to represent the unique risks of Islamic bank transaction and activities. The inadequate of Islamic risk indicators may lead to the wrong interpretation of the risk profile.

The study aims to observe how Islamic banks in Indonesia respond to the regulation. The study is expected to answer the questions as follows:

1) How is the process to identify material risk?
2) What are the unique risk indicators for assessing inherent risk in Islamic Banks?
3) What are the unique risk indicators for assessing risk control in Islamic Banks?
4) How is to determine the risk level for each type of risk and for the aggregate risk profile?

The study is organized as follows. The following section review the regulatory standards and the unique risks of Islamic banks. Subsequently, the next section discusses the common practice of risk profile assessment by Islamic bank in Indonesia and the proposed recommendation, and lastly the conclusion.

METHODOLOGY

ICAAP

ICAAP or internal capital adequacy assessment process is an internal process to assess the overall adequacy of capital in relation to the bank's risk profile and strategy to maintain its capital levels. The objective of ICAAP is to ensure that a bank understands its risk profile and has systems in place to assess, quantify and monitor risk. The bank should be able to identify all material risks and measure those risks that can be reliably quantified to determine how such risks affect the Islamic banking institution's overall capital adequacy; and to develop a strategy for maintaining adequate capital levels consistent with the Islamic banking institution's risk profile, and taking into account its strategy focus and business plans as well as its control environment.

Basel II has delineated five main features of ICAAP; a) Board and Senior Management Oversight; b) Comprehensive Risk Assessment; c) Sound Capital Assessment; d) Monitoring and Reporting; and e) Internal Control Review. An Islamic banking institution's ICAAP should identify all material risks faced by the bank, therefore the ICAAP should address [IFSB, 2013].

(i) Risk captured under Pillar 1 such as credit risk, market risk and operational risk;

(ii) Risk not fully captured under Pillar 1 such as risks relate to underestimation/uncertainty of risks calculated under Pillar 1 and may include model risk or securitization risk;

(iii) Risk types not covered by Pillar 1, covering risks which credit concentration risk, rate of return in the banking book and other types of are not specifically addressed under Pillar 1 including displaced commercial risk, liquidity risk, and risks that are more qualitative in nature and cannot be measured exactly such as legal risks, shariah non - compliance risk, reputational risk or strategic business risks.

(iv) Changes in external factors such as regulatory risks, economic or business environment that may affect their risk profile over time.

For each material risk identified, Islamic banking institutions should ensure that the risk assessments are supported by consistent and robust risk assessment approaches; quality data used for risk measurement; and sound techniques and methodologies that in line with the Islamic banking institution's size, nature of business and complexity of activities. All assessment of risk should incorporate both quantitative and qualitative elements. Quantitative approach should form the foundation of a risk measurement framework based on readable data

DOI: 10.7454/meis.v8i2.139

and methodologies while the qualitative approach should incorporate management experience, the adequacy of control environment, and judgment to supplement quantitative assessment of risks. Qualitative approaches are particularly important for risk types where common measurement techniques are absent such are Shariah non-compliance risk or liquidity risk.

Risks are assessed on an inherent and residual basis. Inherent risk is the risk derived from the environment without the mitigating effects of internal control while residual risk is the risk remains after the risk controls are designed. Risk assessment should first be applied to inherent risk. Once risk controls have been developed, the residual risk is then managed. It is impossible to eliminate all risks. Some degree of residual risk is inevitable. Residual risk cannot be ignored. The control of residual risk should be aligned with the organization's risk tolerance.

The categorization of each identified risk to the various materiality level such as Low, Medium, and High level is a challenging task as this is depending on the organization's risk tolerance and appetite. Most organizations define scales for rating risks in terms of impact, likelihood, vulnerability and other dimension. These scales comprise rating levels and definitions that foster consistent interpretation and application by different user. The more descriptive the scales, the more consistent their interpretation will be by users. The trick is to find the right balance between simplicity and comprehensiveness. Scales should allow meaningful differentiation for ranking and prioritization purposes. Five points scales yield better dispersion than three points scales. Every enterprise is different and the scales should be customized to fit the industry, size, complexity, and culture of the organization in question.

Risks in Islamic Banking

Islamic banks face two types of risks - risks they have in common with traditional banks as financial intermediaries, such as credit risk, market risk, liquidity risk and operational risk and risks that are unique to them due to their compliance with the shariah such as Shariah non-compliance risk, rate of return risk, displaced commercial risk, fiduciary risk, and equity investment risk [Ahmed and Khan, 2006]. Consequently, the process and techniques of risk identification and risk management system available to the Islamic banks could be of two types – standard techniques which are not in conflict with the Islamic principles of finance and techniques which are new or adapted keeping in view their special requirements. Due to their unique nature, the Islamic institutions need to develop more rigorous risk identification and management systems. Some of the key risks faced by Islamic banks are discussed below.

Credit Risk

Credit risk is generally defined as the potential that a counterparty fails to meet its obligation in accordance with agreed terms [IFSB, 2005]. Due to the unique characteristics of each financing instruments, credit risk shall be assessed separately. Credit risk would take the form of settlement/payment risk arising when one party to a deal pays money (e.g. in a Salam or Istisna contract) or delivers assets (e.g., in a Murabahah contract) before receiving its own assets or cash, thereby, exposing it to potential loss. In case of profit-sharing modes of financing (like Mudarabah and Musharakah contract) the credit risk will be non-payment of the share of the bank by

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

the entrepreneur when it is due. This problem may arise for banks in these cases due to the asymmetric information problem in which they do not have sufficient information on the actual profit of the firm. As Murabahah contracts are trading contracts, credit risk arises in the form of counterparty risk due to nonperformance of a trading partner. The nonperformance can be due to external systematic sources. According to research by Ahmed and Khan, credit risk appears to be the least in Murabahah, and the most in Musharakah, followed by Diminishing Musharakah and Mudarabah. It appears that profit sharing modes of financing are perceived by the bankers to have higher credit risk.

Equity Investment Risk

Equity investment risk is the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. In particular, the relevant instruments are typically based on the Mudarabah and Musharakah contracts. The nature of equity investment requires enhanced monitoring to reduce informational asymmetries. The risk profiles of potential partners (Mudharib or Musharakah partner) are also crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfillment of bank's fiduciary responsibility as an investor of IAH (Investment Account Holder) funds on a profit sharing and loss bearing basis (Mudarabah) or a profit and loss sharing basis (Musharakah).

Market Risk

Market risk is the risk of losses in on and off -balance sheet positions arising from movements in market prices such as fluctuations in values in tradable, marketable or leasable assets (including Sukuk) and in off-balance sheet individual portfolio (for example restricted investment accounts). The risks relates to the volatility of market values such as commodity price of a Salam asset, the market value of a Sukuk, the market value of a Murabahah assets purchased to be delivered over a specific period, the fall in the residual value of the leased asset at the expiry of the lease term, and of foreign exchange rates. Financial institutions use a benchmark rate to price different financial instruments. Specifically, in a Murabahah contract the mark-up is determined by adding the risk premium to the benchmark rate. The nature of fixed income assets is such that the mark-up is fixed for the duration of the contract. As such if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result Islamic banks face risks arising from movements in market interest rate. Market risk is relatively high in most modes of finance. It is among the highest ranked in terms of severity for profit-sharing modes of financing with the highest for Musharakah followed by Mudarabah and Diminishing Musharakah. Murabahah and Istisna are considered to have the least market risk followed by Ijarah.

Liquidity Risk

Liquidity risk is the potential loss to Islamic banking that arises from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses. Liquidity risk of Islamic bank can be into two types; lack of liquidity in the market and lack of access to funding. In the first type, illiquid assets make it difficult for the bank to meet its liabilities and financial obligations. In the second, the institution is unable to borrow or raise funds at a reasonable cost, when needed. Limited availability of a Shariah-compatible money market and intra bank market is the leading

DOI: 10.7454/meis.v8i2.139

cause of liquidity risk. Liquidity risk of instruments will be smaller if the assets can be sold in the markets and/or have short-term maturity.

The bankers consider Mudarabah to have the least liquidity risk, followed by Murabahah. Note that both of these instruments are usually used for short-term financing. Other instruments are perceived as relatively more risky, with Diminishing Musharakah showing the highest liquidity risk and product-deferred instruments of Salam and Istisna. Ijarah is also perceived to have a relatively higher liquidity risk.

Rate of Return Risk

Islamic banks are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in Investment Account Holder's having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that the bank are concerned with result of their investment activities at the end of the investment-holding period which can not be pre-determined exactly.

A consequence of rate of return risk may be displaced commercial risk. This risk is the transfer of the risk associated with deposits to equity holders. This arises when under commercial pressure banks forgo a part of profit to pay the depositors to prevent withdrawals due to a lower return. Displaced commercial risk implies that the bank though may operate in full compliance with the shariah requirements, yet may not be able to pay competitive rates of return as compared to its peer group Islamic banks and other competitors. Depositors will again have the incentive to seek withdrawal. To prevent withdrawal, the banks will need to apportion part of their own share in profits to the investment depositors.

Operational Risk

Operational Risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including loss resulting from shariah non-compliance and the failure in the fiduciary responsibilities.

Shariah non-compliance risk is the risk that arises from the bank's failure to comply with the shariah rules and principles determined by the Shariah Board or the relevant body. Shariah compliance is critical to Islamic bank's operations, products and activities to fulfill the expectation of the fund providers in using shariah-compliant banking services. These risks expose Islamic bank to fund providers' withdrawals, loss of income or voiding contracts leading to a diminished reputation of the limitation of business opportunities.

Fiduciary risk is the risk that arises from the Islamic bank's failure to perform in accordance with the explicit and implicit standards applicable to their fiduciary responsibilities. A lower rate of return than the market rate also introduces fiduciary risk, when depositors/investors interpret a low rate of return as breaching of investment contract or mismanagement of funds by the bank (AAOIFI 1999). Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to fully comply with the shariah requirements of various contracts. While, the justification for the Islamic banks' business is compliance with the shariah, an inability to do so or not doing so willfully can cause a serious confidence problem and deposit withdrawal.

Legal Risk

Given the different nature of financial contracts, Islamic banks face risks related to their documentation and enforcement. As there is no standard form of contracts

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

for various financial instruments, Islamic banks prepare these according to their understanding of the shariah, the local laws, and their needs and concerns. Lack of standardized contracts along with the fact that there are no litigation systems to resolve problems associated with enforceability of contracts by the counterparty increases the legal risks associated with the Islamic contractual agreements. Lack of Islamic statues and courts that can enforce Islamic contracts increases the legal risks of using these contracts.

Strategic Risk

Strategic risk can be defined as the risk of current or prospective impact on the Islamic bank's earnings, capital, reputation or standing arising from changes in the environment where the bank operates in and from adverse strategic decisions, improper implementation of decisions or lack of responsiveness to industry, economic or technological change.

Reputational Risk

Islamic banks are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the Islamic banks' business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity. The Islamic bank's failure to comply will affect not only them but also the industry as a whole. Furthermore, customers will be doubtful about how "Islamic" a product really is. Apart from earning a stable profit, reputation also plays a key role in keeping the company free from constant scrutiny by the public.

Local regulations

The minimum major risks and the risk indicators for Islamic bank's risk profile report assessment are defined in OJK's regulation

No.10/SEOJK.03/2014 regarding bank soundness rating. OJK requires Islamic bank to assess at least ten (10) type of risks namely Credit Risk, Market Risk, Liquidity Risk, Operational Risk, Legal Risk, Strategic Risk, Compliance Risk, Reputational Risk, Rate of Return Risk and Investment Risk. The latter 2 type of risks are the unique risk of Islamic bank, these types of risks are not assessed by conventional banks. The risk profile report covers the assessment of the inherent risk and the quality of risk management application. Inherent risk is the risk which is embedded on each banking activity/product that can be measured quantitatively or qualitatively without mitigating effects of internal control that may potentially impact to the bank financial condition. While the assessment of the quality of risk management reflects the assessment to the adequacy and effectiveness of risk control system of the bank.

The bank's inherent risk is influenced by internal and external factors such as business strategy, business characteristics, product's complexity, market industry and macro economy conditions. The minimum risk indicators of inherent risk are as the following table. The banks may add risk indicators to match with the bank's characteristic and complexity.

Table 1. Risk Indicators as Defined by Regulator

Risk Type and Risk Indicators	**Indicators**
Credit Risk: ▪ Composition of asset portfolio and concentration level	Financing Concentration by customer, industry, purpose and **syariah contract (debt based and profit sharing financing**)
▪ Asset quality and adequacy of provisions	Non Performing Financing (NPF), Impairment, Restructuring, Foreclosed Asset, Adequacy of financing provisioning

12

▪ Source and funding strategy	Funding process, asset growth, competitive rate, new product strategy
▪ External factor	Changing of external conditions that can impact on the customer's repayment capacity
Market Risk ▪ Volume & Portfolio Composition	Trading & Avalaible for Sale (AFS) Asset & Liability, Forward, Net Open Position (NOP), Equity, Temporary Equity Participation, Long Term Fixed Rate Liability
▪ Rate of Return Risk in the Banking Book (RORBB)	RORBB Exposure based on Re-pricing Gap, Unrealized loss of AFS Marketable Securities
▪ Business Policy and Strategy	Trading Characteristic, Complexity of Trading Product, Customer Behavior, Business Characteristic/Products feature which are sensitive to RORBB
Liquidity Risk ▪ Composition of Asset, Liability and Off Balance sheet transactions, Asset & Liability Concentration	Liquid Asset, Short Term Mismatch, Non-Core Funding, Asset & Liability Concentration, Significancy of Off Balance Sheet, Commitment & Contingency, Guaranteed Third Party Fund
▪ Vulnerability of Funding Needs	Vulnerability of funding needs based on gap analysis, cash flow projection and stress test.
▪ Access to Source of Funds	Reputation Bank to manage source of fund and Group support
Operational Risk ▪ Business Characteristic & Complexity	Business scale, organizational structure, complexity, variety of business process and products, corporate action and new business strategy, outsourcing
▪ Human resources	Human resources management, human errors operational loss
▪ Information technology & supporting infrastructure	Complexity, vulnerability, maturity and failure of IT system
▪ Fraud	Internal and External Fraud
▪ External event	Frequency and Impact of external event to the bank's activities
Legal Risk ▪ Litigation Factors	Amount of litigation charged to the Bank or potential loss because of litigation charge compare to the bank's capital

▪ Weaknesses of agreements	Weaknesses on the clauses of agreements
▪ Lack of legal rules/ changes of legal rules	Amount of bank's products that have not been supported by valid legal rules.
Strategic Risk ▪ The alignment of bank's strategy with the business environment	The alignment of bank strategy with; - Internal factors: vision, mission, business target, organization culture, human capability, infrastructure, bank's risk tolerance, information management system - External factors; macro economy conditions, IT development and business competition.
▪ High risk & low risk business strategy	The inherent risk is depend on the bank's strategy choice; high risk or low risk
▪ Bank's business position	Bank's position in the market, competitive advantage owned by bank compare to the peer group or banking industry as a whole
▪ Achievement of bank's business	Bank's performance compare to bank's business plans
Compliance Risk ▪ Type and materiality of regulatory breach	Type and materiality of regulatory breach and **shariah principles** found by Shariah Supervisory Board or regulator; amount of fines imposed by regulator
▪ Frequency regulatory breach or compliance track record	The amount of repeated regulatory breach found on the last 3 years
▪ Non-compliance of common	Breach on common business standards used by financial
business practice	institutions
Reputational risk ▪ The impact of negative reputation from the owner	The shareholder credibility or reputational event on the shareholder
▪ Non-compliance of business ethics including shariah ethics	Noncompliance on the: transparency of financial information, business cooperation with other stakeholders and **shariah principle implementation**

Source: (OJK, 2014)

The assessment of quality of risk management application comprises of four related aspects, namely (1) risk governance, (2) risk management framework, (3) risk management process, adequacy of human resources and information management system as well as (4) adequacy of internal control system. These are key factors to establish a risk control system. The minimum indicators are as the following table.

Table 2. Indicators for Risk Control System

Indicators
Risk Governance: • Adequacy of active supervision by Board of Commissioners, Board of Directors and Shariah Supervisory Board including the implementation of roles and responsibility • The awareness and knowledge of Board of Management on the risk management. • Risk Culture within the bank
Risk Management Framework: • Alignment of risk management strategy with the risk appetite and risk tolerance • Adequacy of organization structure to support the implementation of risk management including the clarity of roles, responsibility and delegation of authority • Adequacy of policy, procedure and risk limit
Risk Management Process, Adequacy of Human Capital and Management Information System: ▪ Identification process, measurement, monitoring and controlling ▪ Adequacy of Management Information System ▪ Adequacy of quantity and quality human resources for supporting effective risk management
Adequacy of Internal Control ▪ Adequacy of internal control system ▪ Adequacy of independent review by Internal Audit ▪ Adequacy of audit result and follow up

Source: (OJK, 2014)

Based on the above indicators, bank has to assess the level of severity of its inherent risk and the adequacy of its control system, which is identified in the following table.

Table 3. Inherent Risk Level & The Adequacy of Risk Control

Inherent Risk Level		The Adequacy of Risk Control	
Low (1)	Considering the bank's business activity, the probability of loss is very low in a certain period in the future	Strong (1)	The risk control system is strongly acceptable. Although has minor weaknesses, the weaknesses are not significant and can be excempted
Low to Moderate (2)	Considering the bank's business activity, the probability of loss is low	Satisfactory (2)	The risk control system is acceptable. Although has minor weaknesses, the

	in a certain period in the future		weaknesses can be settled in a business as usual activities
Moderate (3)	Considering the bank's business activity, the probability of loss is moderately high in a certain period in the future	Fair (3)	The risk control system is acceptable. Although the minimum requirement has been fullfilled, there are weaknesses that need management's attention
Moderate to High (4)	Considering the bank's business activity, the probability of loss is high in a certain period in the future	Marginal (4)	The risk control system is slightly acceptable. There are significant weaknesses that must be follow up soon
High (5)	Considering the bank's business activity, the probability of loss is very high in a certain period in the future	Unsatisfactory (5)	The risk control system is not acceptable. There are significant weaknesses that can not be settled by management.

Source: (OJK, 2014)

The assessment of inherent risk and risk control system will lead to the Net Risk for each type of risk and finally to the composite risk level. The composite risk level for each type of risk is summarized by using the following matrix:

Table 4. Composite Risk Level Matrix

Inherent Risk	Quality of Risk Management Application (Risk Control)				
	Strong	Satisfactory	Fair	Marginal	Unsatisfactory
Low	1	1	2	3	3
Low to Moderate	1	2	2	3	4
Moderate	2	2	3	4	4
Moderate to High	2	3	4	4	5
High	3	3	4	5	5
Composite Risk Profile	On bank's approach				

Source: OJK, 2014

The composite risk profile is determined at bank's own approach. The Bank may consider the materiality or significancy of each risk and set up a different risk weight for each type of risk. The composite risk profile categorized into 5 (five) clasifications. The smaller level indicates the less riskier of the Bank. The level of risk profile will determine the Bank's minimum capital as follows:

Net Risk Rating	Minimum CAR
1	8%
2	9% - <10%
3	10% - <11%
4	11% - <14%
5	11% - <14%

The regulatory minimum capital adequacy above is only covering credit risk, market risk and operational risk. For ICAAP purposes, if there is any material risk that needs additional capital allocation, it is the Bank discretion to set up additional capital. Regulator may require Banks to set up more capital if it is deemed necessary to cover potential loss.

METHODS

This study was based on qualitative data. Primary and secondary data was used throughout this study. The primary data used was based on a set of questions forwarded to several risk officers via e-mail and or by phone. The secondary data used were Islamic banks' annual reports. The interview via e-mail and or by phone was chosen because of time constraint. A benefit of using this method was that it made the interview effective by concentrating only on the required information. The questions were focused on the: i) risk identification process, 2) risk assessment indicators and 3) risk level determination process.

The list of questions is as follows:

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

Table 5. List of Questions

	INTRODUCTORY QUESTIONS
1.	Are you involved directly in the risk profile assessment?
2	Are you using the SE OJK No 10/SEOJK.03/2014 regarding the Soundness Rating for Islamic Bank and Islamic Business Unit as a reference to prepare risk profile report?
	RISK IDENTIFICATION
1.	Related to the ICAAP implementation, bank is required to identify all risk faced by the bank. Is there a specific risk identification process in your bank? If yes, can you explain the process?
2.	Is there other material risk identified by the Bank other than the10 type of risk defined by regulator?
	RISK INDICATORS
1.	Is there any additional Islamic risk indicator developed by the bank other than what have been defined by regulator? If yes, can you share? (Islamic risk indicators are risk indicators which are unique for Islamic bank)
2.	Do you think the risk indicator defined by regulator has sufficient to represent the risk?
	RISK LEVEL DETERMINATION
1.	How do you determine risk level to each type of risk?
2.	Are you applying risk weight in the composite risk profile rating?
	OTHERS
1.	Was your bank's risk profile rating described in your bank's annual report?
2.	Is there any difficulty and challenges in preparing the risk profile assessment report?

Table 6: Risk Profile report on Bank's Annual Reports

No.	Islamic Banks	Inherent Risk Rating	Quality of Risk Management Application	Composite Risk Profile as per December 2020	Type of risks reported
1.	Bank Mandiri Syariah	Low to Moderate	Satisfactory	Low to Moderate	10 risks as defined by regulator
2.	BRI Syariah	Low to Moderate	Satisfactory	Low to Moderate	10 risks as defined by regulator
3.	BNI Syariah	Low To Moderate	Satisfactory	Low to Moderate	10 risks as defined by

					regulator
4.	BMI	-	-	-	
5.	BCA Syariah	Low	Satisfactory	Low	10 risks as defined by regulator
6.	BJB Syariah	-	-	-	
7.	Bank NTB Syariah	Low to Moderate	Fair	Low to Moderate	10 risks as defined by regulator
8.	Bank Bukopin Syariah	Moderate	Satisfactory	Moderate	10 risks as defined by regulator
9.	Bank Mega Syariah	Low to Moderate	Satisfactory	Low to Moderate	10 risks as defined by regulator
10.	Bank Victoria Syariah	Low to Moderate	Satisfactory	Low to Moderate	10 risks as defined by regulator
11.	Bank Aceh Syariah	-	-	Low to Moderate	10 risks as defined by regulator

Source: Annual Reports

RESULT & DISCUSSION

The results refer to the outcome of the interview conducted through e-mail and/or by phone. As already stated above there are three sections in the list of questions;1) the risk identification process, 2) the risk assessment indicators; and 3) the risk level determination process. The result of discussion is expected to be able to describe the common practice of risk profile assessment by Islamic banks in Indonesia. To support the interview result, the secondary source of data is used as references, such as bank's annual report. The results are followed by discussion and recommendation in the risk profile assessment process.

Material Risk Assessment Process

From the observance of the annual reports, all banks assessed or reported only 10 types of risk as defined by regulator, no additional material risk. Based on the discussion with some risk officers involved in the risk profile report, they explained that they focused assessing only to the 10 types of risk or less – equity investment risk - if the Bank does not have exposure in the profit sharing financings. They also mentioned that they did not apply a specific material risk assessment process to find out the possibility of other risk type. They considered that the 10 types of risk have represented all material risks faced by Islamic bank.

Inherent Risk Assessment Indicator

To assess the inherent risk, the risk officers must at minimum use the risk indicators defined in the regulation unless the banks do not have exposure on the said indicators. The risk officers may add or elaborate the indicators if required to be in line with the specific Islamic product or bank's activities. However, the risk officers conclude that the risk indicators defined has been sufficient to represent all type of risks because the guideline has covered some Islamic indicators. As practitioner, they also agreed that Islamic banks facing the same risk as conventional banks, so the same risk indicators can be used by both Islamic and conventional bank. They also realized that risk management technique is developed under the corridor of conventional banking. The specific tools for measuring risks in Islamic banking are not developed yet. As a benchmark, we can use the technique to measure the risk of Islamic banking using the same technique of conventional banking. Consequently, the result of risk assessment may not fully represent the unique risk of Islamic banking. As practitioner, it is quite challenging to develop the specific risk indicator or methodology since they have limited understanding of the risk of Islamic products.

The type of risks that usually be enhanced for the purpose of meeting Islamic product characteristics are; credit risk, Shariah non-compliance risk , rate of return risk and equity investment risk. Shariah non-compliance risk is theoretically under operational risk, but for the purpose of regulatory report, it is part of compliance risk. Some suggestions to be considered in developing the unique risk indicators are the followings.

Table 7. Additional Islamic Risk Indicator for Inherent Risk

Example of Additional Islamic Risk Indicators
Credit Risk ▪ Financing concentration as per shariah contract ▪ The treshold limit should consider the risk level of the shariah contract (buy and sell, profit sharing or ijarah akad) ▪ The composition of asset quality as per shariah contract
Market Risk ▪ The exposure Trading & AFS as per shariah contract ▪ The methodology to assess rate of return risk on the banking book for Islamic banking product
Operational Risk Shariah non-compliance incident because of human errors, internal procedure, weaknesses in IT
Legal Risk ▪ Shariah non-compliance incident because of weaknesses in legal aspect ▪ Amount of litigation charged because of Shariah non-compliance incident
Compliance Risk Type and materiality of Shariah non-compliance incident
Reputational Risk Reputational risk incident because of shariah non-compliance incident
Rate of Return Risk Comparison profit produced by debt financing and profit sharing financing
Equity Investment Risk • The asset quality of profit sharing scheme

Risk Control Assessment Indicator

The risk control assessment is the assessment for the adequacy of risk management application as a whole. The risk officers agree that the regulatory risk control indicators defined have been sufficient to represent the major aspect of risk management system. The indicators are common to both conventional and Islamic banks. However, since the nature of Islamic contracts and instruments introduces some risks that are unique to Islamic banks, a

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

risk management system in an Islamic bank should have the necessary framework to address these risks. The various items that can be included to add the regulatory risk indicators for risk control system:

Table 7. Additional Islamic Indicator for Risk Control System

Example of Additional Islamic Indicators
Risk Governance: • Are the members of the board and management able to assess the true risks of inherent in Islamic banks? • Is the appointment of Shariah Supervisory Board (SSB) in line with OJK regulation and internal governance? • Is the current SSB role adequate to provide an effective oversight that commensurate with the size, complexity and nature of the bank's business? • Is the ethic of conduct for employees is adequate to represent the Islamic culture of the Bank?
Risk Management Framework: • Is the risk appetite statement adequate for representing the Shariah non-compliance risk appetite? • Is there a specific unit responsible for Shariah management and Compliance? • Are there established policies and procedures for the Shariah management?
Risk Management Process, Adequacy of Human Capital and Management Information System: ▪ Is there a governance process established to oversee the end to end process for Islamic product both pre and post development including shariah requirement? ▪ Is there a systematic record for shariah- non compliance incidences? ▪ Does current competency of human resources on shariah principles meet the Islamic bank's products and activities? ▪ Are there sufficient awareness programmes provided to ensure that all its operations and business activities are in accordance with shariah acroos the Bank?
Adequacy of Internal Control ▪ Is there shariah audit? ▪ Is the competency of internal audit department adequate for performing shariah audit?

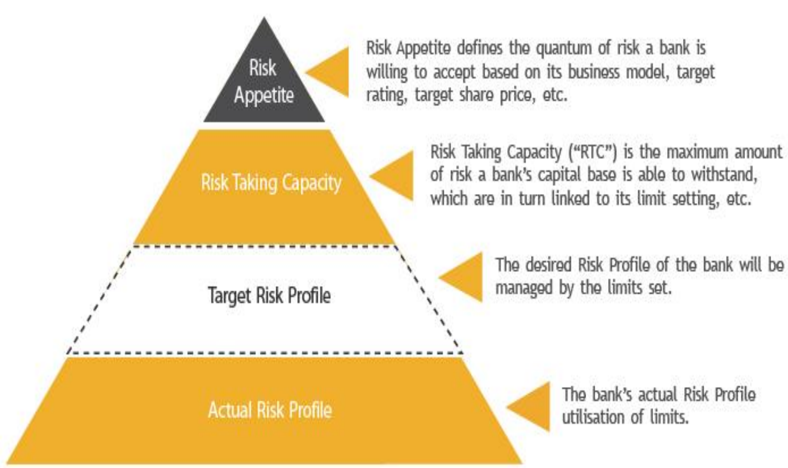
The above examples can be elaborated in accordance with the size of bank's business activity and the related regulatory requirement. To develop risk indicators for adequacy of risk control is easier than developing risk indicators for inherent risk assessment. Research by Ahmed and Khan said that Islamic banks have been able to establish better risk management policies and procedures than measuring, mitigating and monitoring risks.

The Determination of Risk Level

The third topic of discussion is the determination a risk level for a certain risk. The risk officers construct a certain threshold and scales which is derived from the bank's risk appetite. Some of them assigned weight to risk drivers or key risk indicators to arrive at the final assessment.

Risk appetite is the amount and type of risk an organization is willing to accept in pursuit of its business objective. It defines the self-imposed constraints, quantitatively or qualitatively, and drivers which we have chosen to limit or influence the amount of risk undertaken. The first element defined is "risk taking capacity" which is the amount of capital available to buffer all relevant risks, given its capital base, liquidity, borrowing capacity and regulatory constraints and the second element is the target or desired risk profile. Risk limits and targets are specific quantifiable thresholds for key risk metrics across risk dimensions and risk classifications. The following diagram provides the key elements within the risk appetite statement.

Diagram 1. Key Elements of Risk Appetite



Source: IIF

https://scholarhub.ui.ac.id/meis/vol8/iss2/6
DOI: 10.7454/meis.v8i2.139

After each risk is valued, the composite risk level must be assigned. Considering the significance and materiality of each risk, the weightages can be applied. The composite risk level is the final assessment that usually contains management's justification.

Risk profile assessment is not just a report, but it is one of key factors for Enterprise Risk Management. It is the way in which enterprises get a handle on how significant each risk is to the achievement of their overall goals. To accomplish this, enterprises require a risk assessment process that is practical, sustainable, and easy to understand. The process must proceed in a structured and disciplined fashion. It must be correctly sized to the enterprise's size and complexity.

Although each risk is assessed individually, the risks do not exist in isolation. Management should manage the risk interactions and give the holistic view of risks to be able to identify the potential events that may affect the achievement of the organization's objectives.

CONCLUSION

Risk profile assessment is one of the tools for assessing bank's risk. Based on OJK's approach, bank's risk profile is assessed on the inherent risks and the quality of risk management application. Although OJK has set minimum type of risks with their risk indicators, for the first step of assessment, the bank should perform a certain process to identify material risks of the bank

The second step is to develop a set of assessment criteria or risk indicator that may reflect the nature of the bank. Developing risk indicators requires skill and expertise on the bank's risk, risk management system as well as the bank's objective, strategy and risk appetite. To develop Islamic risk indicators is quite challenging. The risk officer should have deep understanding on the nature of risk on Islamic contracts and appropriate risk management system to address those risks. The nature of risk faced by Islamic banks is complex and difficult to mitigate since there is no specific Islamic risk tool for the assessment. The risk methodology is usually developed under conventional banking practices. Islamic banks have been able to establish better risk management policies and procedures than measuring, mitigating and monitoring risks.

The banking practitioners need more support from local Shariah experts and the regulator. The role of Shariah Supervisory Board should be enhanced in terms of the capability in understanding banking risk transactions and in interpreting Shariah fatwa into risk management practices.

Risk assessment is all about measuring and prioritizing risks so that risk levels are managed within defined tolerance thresholds without being overcontrolled or forgoing desirable opportunities. The study is limited to the risk profile assessment performed by Islamic banks in Indonesia to respond to the regulatory guideline. Future research is required to add other risk factors and methodology for a comprehensive risk assessment for Islamic banks and to ensure whether the risk assessment is adequate for the implementation of ICAAP.

REFERENCES

Ahmed, Habib and Tariqullah Khan (2006). "*Risk Management in Islamic Banking*", in M.Kabir Hassan and Mervyn K.Lewis (Editors),. Handbook of Islamic Banking, Edward Elgar Publishers.

Ahmed, Habib., *Risk Management Assessment Systems: An Application to Islamic Banks*. Islamic Economic Studies, Vol 19 No.1

IFSB (Islamic Financial Services Board) (2005)., *Guiding Principles of Risk k*

Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services., Islamic Financial Services Board., Kuala Lumpur

IFSB (Islamic Financial Services Board) (2013). *Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions & Islamic Collective Investment Schemes*. Islamic Financial Services Board.

IIF (Institute of International Finance) (2011). *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*. Institute of International Finance. World Economic Forum (2015). Insight Report: Global Risks 2015 10th edition.

OJK (Otoritas Jasa Keuangan) (2014). *OJK Circular Letter No.10/SEOJK.3/2014 regarding Soundness Rating of Shari'ah Commercial Bank and Shari'ah Business Unit*. Otoritas Jasa Keuangan.

OJK (Otoritas Jasa Keuangan) (2014). *OJK Regulation No. 21/POJK.03/2014 regarding Minimum Capital Adequacy Ratio in accordance to Risk Profile of Shari'ah Bank*. Otoritas Jasa Keuangan

Bank Negara Indonesia Syariah (BNI Syariah) (2020). Annual Report 2020.

Bank Syariah Mandiri (BNI Syariah) (2020). Annual Report 2020

Bank Rakyat Indonesia Syariah (BRI Syariah) (2020). Annual Report 2020

Bank Muammalat Indonesia (BMI) (2020). Annual Report 2020

Bank Panin Dubai Syariah (BPDS) (2020). Annual Report 2020

Bank Bukopin Syariah (BBS) (2020). Annual Report 2020

Bank Victoria Syariah (2020). Annual Report 2020

Bank Nusa Tenggara Barat Syariah (Bank NTB Syariah) (2020). Annual Report 2020

Bank Jabar Banten Syariah (BJBS) (2020). Annual Report 2020

BPD Aceh Syariah (2020). Annual Report 2020

Bank BCA Syariah (BCA Syariah) (2020). Annual Report 2020