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Jaime Caruana
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel
Switzerland

Dear Mr. Caruana,

**CIBAFI response to the Basel Committee's Consultative Document on Standardised
Measurement Approach for Operational Risk**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) compliments the Basel Committee on Banking Supervision (BCBS) and takes this opportunity to express its appreciation of the work that the BCBS is doing on proposed revisions to the operational risk capital framework.

CIBAFI is an international body representing Islamic financial institutions, who offer services and products complying with Islamic rules and principles (Shari'ah). CIBAFI acts as the voice of the Islamic finance industry, and has a membership of over 120 banks and non-bank financial institutions, both large and small, from 30 countries and jurisdictions.

We welcome this opportunity to offer our comments and recommendations on the BCBS's Consultative Document (BCBS CD) on Standardised Measurement Approach for Operational Risk. The comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. CIBAFI's perspective on

the BCBS CD reflects our mission and the identity of our members. It is that of practitioners in Islamic financial institutions who will have to implement standards and regulations, while finding a balance between the requirements of the regulators, the market, their shareholders, customers, and other stakeholders. In particular, although we recognise that the BCBS's standards are intended for internationally active banks, we are aware that many jurisdictions implement them more broadly, often for understandable reasons of consistency. We have therefore tried to consider how they might impact on a broader class of banks than those at which they are formally directed.

1. Withdrawal of internal modelling

We acknowledge the inherent complexity of the Advanced Measurement Approach (AMA) and the lack of comparability arising from a wide range of internal modelling practices. Based on our observation, the AMA is used by only a relatively small proportion of Islamic banks, generally among the largest. We therefore expect its withdrawal to have a very limited impact on CIBAFI members, and most of our members are content to see it withdrawn. However, some members do have some concerns on the withdrawal of internal modelling, as well as comments on the proposed new approach.

The comments that address the withdrawal of the AMA are as follows:

- Operational risk is dominated by unexpected loss events in the tail of the distribution rather than 'average' ones. Hence, risk capital needs to be allocated to cover those extremes rather than an average based on expected losses. An approach based on past quantified losses also does not have a forward looking feature since it assumes the future will follow the past.
- Operational risk is also heavily impacted by the unique operational risk environments of particular banks, and by their control environments. The new approach may diminish a consideration of these due to abandoning the scenario analysis. The RCSA, KRI, and correlation & dependencies elements are used in

such an analysis as tools of operational risk measurement system to ensure that key drivers of operational risk are captured and that a bank's operational risk capital estimates are sensitive to its changing operational risk profile and forward looking.

As regards the proposed new framework:

- There is no solid theoretical basis for using income as a proxy for operational risk. In addition, there are no theoretical nor empirical justifications that were given for the bucketing and coefficients used in the framework.
- At a more technical level, the service component includes “other operating expenses” which, for some banks at least, will include operational risk losses and related provisions. But these are also an element in the calculation of the internal loss multiplier (for those banks to which it applies). There is thus an element of double-counting within the calculation.
- One member argued that the calculation of the Business Indicators for each bucket, and the coefficients attached to them, should be subject to supervisory discretion in each jurisdiction, to reflect differences in accounting practices and business environments. It is, however, fair to point out that other members attached substantial weight to consistency of regulation generally.
- The document needs to clarify how the proposed new Pillar 1 approach interfaces with Pillar 2. Banks that can demonstrate good internal modeling and strong operational risk systems and controls should gain through Pillar 2 a partial offset to higher Pillar 1 requirements. Otherwise there will be no incentives to improve operational risk management practices for banks below the €1 billion threshold.
- While most of our members mentioned that they will not be impacted by the requirement to collect bank-specific data on operational risk losses, some of the less sophisticated Islamic banks have a concern pertaining to whether they have

historical operational loss data (good-quality loss data) for the past 5-10 years to calculate the loss component. They thus believe that the data requirements for calculating internal loss experience and the proposed disclosure requirements will impose an additional burden. However, others saw it as beneficial that the new module will encourage banks to collect data on operational losses effectively, efficiently, and on timely manner through preferential treatment.

2. A distinctive type of risk in Islamic banks: Shari'ah Non-Compliance Risk (SNCR)

Shari'ah Non-Compliance Risk (SNCR) is one of the key distinctive risks which distinguishes Islamic banks from their conventional peers. By definition, SNCR represents failure to satisfy the essential requirements and conditions of the Shari'ah contracts as stipulated in the applicable standards in the relevant jurisdiction or other widely accepted international standards. For Islamic banks, therefore, the scope of operational risk also includes the losses resulting from Shari'ah non-compliance and failure to meet their fiduciary responsibilities. There has been a recent study of SNCR, available at [http://www.ifsb.org/docs/2016-03-30%20SNCR%20Paper%20\(WP-05\)%20\(Final\).pdf](http://www.ifsb.org/docs/2016-03-30%20SNCR%20Paper%20(WP-05)%20(Final).pdf), which attempts to assess this risk and its impact on a capital adequacy framework using the Shari'ah non-compliant income (SNCI) of Islamic banks as a proxy for the SNCR. As this type of risk is not addressed in the BCBS Consultative Document, CIBAFI would like to take opportunity, through commenting to the BCBS on how SNCR should be handled the options being either Pillar 1 or Pillar 2. Most of our members suggested that SNCR should be treated under Pillar 2, for the following reasons.

Firstly, although the evidence, using SNCI as a proxy, suggests that SNCR is typically small, it is too sparse to provide a reliable quantification. In addition, it is not clear how far SNCI is a reliable proxy, since SNCR may manifest itself in product flaws, suitability or fiduciary issues which will not necessarily be recorded under this heading.

Secondly, some have argued that a major incident of Shari'ah non-compliance could pose an existential threat to a bank or indeed a wider systemic threat. This belongs to reputational risk which in any event remains a Pillar 2 item. It might best be addressed through scenario analysis, through observing the SNCR interaction with other types of risk in stressed scenarios. Our members therefore suggested that SNCR should be covered in ICAAP program of Islamic banks and that an SNCR-specific framework for this needs to be developed under Pillar 2, with well-defined qualitative and quantitative risk factors for identification, and appropriate scenario analyses.

The third point is whether Shari'ah non-compliance losses should be included in bank level operational risk loss data. Most of our members considered that they should, since internal loss data is the pivotal element for risk identification and assessment, as well as enhancing risk transparency and supporting risk reduction measures. Hence, Islamic banks will comply with regulatory qualification requirements and industry standards while capturing one of the pivotal risks in Islamic finance industry. This may also lay the foundations for a better quantitative treatment of SNCR in the future.

3. Distinctive banking account of Islamic banks: Treatment of Profit Sharing Investment Accounts (PSIAs)

The Profit Sharing Investment Account (PSIA) is a key distinctive banking account that distinguishes Islamic banks from their conventional banks. Unlike conventional deposit accounts, where customers expect a defined return that is agreed in advance, investment account holders (IAH) receive a return that in principle depends on the performance of the assets they have funded. In other words, IAH have an ownership claim on assets (and any resulting profits) that have been funded by their investments and they (not the bank) are exposed to losses on those assets. In practice, smoothing mechanisms are often used to mitigate the risks to IAH, and there is a variety of regulatory treatments of these accounts, some regulators treating them like deposits, others as pure risk-bearing investments, and others somewhere between.

To apply the proposed SMA to PSIAs, it will be necessary to map the bank's income from them to the Business Indicator definitions mentioned in the Annex 1 of the BCBS CD. Without guidance on how this should be done, we see a risk that different regulators will specify different treatments, based on their treatment for other purposes, and that this will lead to unjustified inconsistency in the operational risk capital requirements.

We acknowledge that as there are different views among regulators, so there are different views among our members as to what the correct classification of PSIA within the Business Indicator framework should be. One group of our members suggested that the income associated with PSIA can be treated under "Interest, operating lease and dividend", which would treat them as analogous to deposits. On the other hand, the other group of our members stated that because a PSIA is an investment account and has a risk-absorbing attribute; it should be mapped to "Services", which considers it as asset management activities generating fee and commission income.

It may be that the treatment of PSIAs can be subject to supervisors' discretion, taking into account different practices on PSIAs across jurisdictions. However, it would be helpful if the practical impact of different treatments could be assessed as part of the QIS, so that it is possible to judge whether these do in fact lead to material differences in capital requirements.

We remain at your disposal should you need any further clarifications on the above.

Yours sincerely,



Abdelilah Belatik
Secretary General