Guiding Principles of Risk Management

Accountable Executive & Custodian	Islamic Banking Division
Policy Owner	Head of Islamic Banking Division

Approved by DAB Governor:	Date	DAB Board Secretary ....

Contents

ISLAMIC REPUBLIC OF AFGHANISTAN

DA AFGHANISTAN BANK, GUIDING PRINCIPLES OF RISK MANAGEMENT FOR ISLAMIC BANKING AND FINANCIAL INSTITUTIONS

PART A: PREAMBLE

1. Background

1.1 This Guiding Principles of Risk Management (hereinafter referred to as "the Guideline") is issued by the Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be adopted and become the guiding principles for Islamic Financial Institutions, Financial Institutions operating with an Islamic Window and Financial Institutions operating with an Islamic Unit (collectively referred to as "the Bank") in the Islamic Republic of Afghanistan offering Islamic financial products.

1.2 This Guideline is intended to:

a) Ensure that the Banks have robust and dynamic risk management practices in place, as well as the Bank recognize that effective risk management would allow them to have greater control in achieving an appropriate balance between risks they wish to accept and risks they wish to mitigate.

b) Ensure that the Banks have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

1.3 The safety and soundness of banks rely on the effectiveness of risk oversight, control functions and risk management process. Over the last decade, risk management approaches and practices in the industry have evolved substantially, with increased attention to and advancements in risk management systems and practices observed among banks. Despite such progress, scope remains for further improving internal risk governance practices which underpin a sound risk management framework. This includes closer integration within banks of risk and corporate governance policies, processes and structures to support risk-related decision-making.

1.4 The guideline outline the need to assess and enhance the Bank's approach to managing risk by articulating high-level risk management principles that are comprehensive, proven in practice to be effective, and likely to stand the test of time.

1.5 The assessment and management of risks to ensure that risk-taking activities are aligned with a bank's capacity to absorb losses and its long-term viability are important and crucial to Banks. It is concerned in particular with the roles of the board, senior management, and risk management control functions as well as the processes by which risk information is collected, analysed and communicated to provide a sound basis for management decisions.

1.6 It is also concerned with the effects of incentives and organisational culture on risk-taking behaviours and perceptions of risk in the bank. With increasingly complex business operations and activities, the availability of comprehensive and integrated systems to support an enterprise-wide or consolidated view of risks, for both the individual bank and for the group, is particularly critical. Also important is the capacity of the Banks to respond swiftly to changes in the operating environment and developments in the bank's business strategies.

2. Purpose

2.1 The purpose of this guideline contained in this document is to provide a framework of principles on risk management approached, practices and processes to guide the Banks in performing its risk management function. Because banks operate differently, and there are various levels of sophistication at banks, and because the methodologies for managing risk continue to evolve, the guidelines are not meant to prescribe specific methodologies for managing risk.

2.2 The principles as provided in this Guideline shall constitute a general guideline for the guidance to Banks and all Banks are expected to develop methodologies for managing and controlling risk suited to its business needs and capabilities, as well as the needs and interests of its customers and other stakeholders. The guidelines do fundamentally address what the management of risk should accomplish. Each Bank should have maximum flexibility to design a program to meet its needs within these guidelines.

3. Scope of the Guideline

3.1 This Guideline is issued pursuant to Article 2.2 of the Afghanistan Bank Law gazetted on 12/17/2003 (corresponding to 30/10/1382) in relation to the powers of DAB to regulate and supervise Banks in the Islamic Republic of Afghanistan.

3.2 The overarching and guiding principles provided under this document are applicable to all Banks. Banks are expected to apply these principles taking into account the size, complexity, risk profile and nature of their activities.

3.3 The principles in this policy document are foundation for and complement other guidelines and sound practices papers issued by DAB on specific risks such as credit, market, operational, and liquidity risks. Collectively, they reflect DAB's supervisory expectations with regards to the Bank's risk management framework and practices, and form the basis for supervisory assessments of individual Bank performed by DAB.

PART B: OVERARCHING PRINCIPLES

4. Defining of Risk

4.1 Risk is defined as the potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organization's ability to meet its business objectives. Such constraints pose a risk by limiting a bank's ability to conduct its on-going business or to take advantage of opportunities to enhance its business.

4.2 The assessment of risk exposures can range from a simple high-low matrix to a complex statistical analysis that quantitatively estimates the probability of a loss occurring and the probable amount of the loss. Regardless of the sophistication of the measure, banks often distinguish between expected and unexpected losses. Expected losses are those that the bank knows with reasonable certainty will occur (e.g., the expected non-performing rate of a mortgage portfolio) and are typically reserved for in some manner. Unexpected losses are those associated with unforeseen events (e.g., losses resulting from the subprime financial crisis); banks rely on capital as a cushion to absorb unexpected losses.

5 Risk Management

5.1 Banks are in the business of taking risk and getting compensated adequately via the return earned through the exposures undertaken. Risk management is the process by which a bank identifies, measures, monitors, report and controls its risk exposures to ensure that:

a) Risks are understood;
b) Risks are within tolerances established by the Board of Directors;
c) Risk-taking decisions are consistent with strategic business objectives;
d) Risk-taking decisions are explicit and clear;
e) The expected return compensates for the risk taken;
f) Capital allocation is consistent with risk exposures;
g) The bank's performance incentives are aligned with risk tolerances.

5.2 Risk management encompasses all of the activities of the bank that affect its risk profile. These include decisions and actions to avoid, mitigate, transfer, insure against, put limits on or explicitly take risk. Risk management occurs "on the line" where the risk is created, as well as in independent risk review and control functions, at the highest levels of management, and at the Board level.

5.3 The organizational structure through which risk management activities are conducted will depend on the culture of the organization, the size and complexity of the business operations in question, the type of risk being taken and the materiality of possible adverse outcomes. Thus, the application of risk management techniques differs from bank to bank.

5.4 Risk management generally does not have as an objective the elimination of risk. Many of the risks a bank assumes are inherent to the business of banking and an essential part of the intermediation function that banks perform, such as credit risk. For these, a bank wants to optimize the risk/return trade-off by either maximizing return for a given level of risk or minimizing the risk required for a desired level of return. Other risks are often a cost of doing business, such as compliance risks, and are typically risks that a bank wants or needs to reduce to some threshold level in an economical manner.

5.5 The goal of risk management is to enhance shareholder value while addressing the objectives of a bank's many stakeholders, including customers, management, employees, boards and shareholders, supervisors, rating agencies, investors, creditors and counterparties.

5.6 To be effective, concern for and tone for risk management must start at the top. It must become a part of the way the organization does business and not be viewed as an independent analysis. Proper risk assessment, analysis and management will not take place unless it is woven into strategic planning, budgeting process, operating plans, and business decisions.

6 Seven Overarching Principles

The following seven principles are central to the management of risk across a bank, within its business lines, and within specific risk categories. They include:

a) Board of Directors and Senior Management responsibility;
b) Framework for managing risk;
c) Integration of risk management;
d) Business line accountability;
e) Risk evaluation/measurement;
f) Independent review;
g) Contingency planning.

6.1 **Board of Directors and Senior Management responsibility**.

Overall risk management policies and tolerances should be set on a comprehensive, bank-wide basis by Senior Management; and reviewed with, and where appropriate approved by, the Board. Policies and tolerances addressing risk identification, measurement, monitoring, reporting and controlling should be clearly communicated to those areas affected throughout the bank.

This is to ensure that risk taking is consistent with shareholder expectations, the organization's strategic plan, and regulatory requirements, and that the firm's risk culture is understood throughout the organization

6.2 **Framework for managing risk**.

The Bank should have a framework for managing risk that is effective, comprehensive and consistent. Management should allocate sufficient funds to staff and support its chosen framework.

This is to ensure that all material risks are identified and managed in accordance with Senior Management's expectations, and to facilitate timely communication, coordination, escalation, and corrective action.

6.3 **Integration of risk management.**

To ensure that interactions among risks are identified, understood and managed as appropriate, risks should not be evaluated in isolation. The analysis required to aggregate and highlight risks across the entire organization must be done at a level high enough to encompass the whole firm.

This is to ensure that risk is managed consistently across the Bank, and that the interactions of various risks and the associated impact are understood and considered when strategic and tactical decisions are made.

6.4 **Business line accountability.**

Business lines should be accountable for managing the risks associated with their activities within established tolerances, as well as for the results, both positive and negative, of taking those risks. This accountability should exist notwithstanding the presence of one or more support functions dedicated to risk management activities.

This is to ensure that the people who make business decisions understand the risks they are taking; incorporate that understanding into their decision making in order to achieve acceptable risk-adjusted returns; and are held accountable for the associated gains or losses. Those closest to the business in question are best positioned to identify the risks in the business, provided there is adequate independent review and control, and an incentive structure that encourages risk identification and management responses by the line.

6.5 **Risk evaluation/measurement**.

All risks should be qualitatively evaluated on a recurring basis and, wherever practical, the evaluation should include quantitative analysis. Risk assessments should consider the effects of both likely and unlikely events.

This is to allow management to understand the amount and nature of risk exposures using a common language, and to make informed decisions regarding allocation of resources for taking and managing risk.

6.6 **Independent review**.

Risk assessments should be validated by independent review functions with resources, authority and expertise sufficient to assess the risks, test the effectiveness of risk management activities, and make recommendations for remedial action.

This is to ensure that those who take or accept risk on the behalf of the institution are not the only ones who measure, monitor and evaluate the risks.

6.7 **Contingency planning**.

Risk management policies and processes to address potential crises and unusual circumstances should be in place and tested as appropriate.

This is to ensure that the organization is prepared to identify and deal with unusual situations in a timely and effective manner.

PART C: GUIDING PRINCIPLES OF RISK MANAGEMENT

7 Guiding Principles of Risk Management

7.1 This document sets out fifteen principles of risk management for the Bank. The essential feature of the Bank's activities is the requirement to comply with Shariah rules and principles especially the prohibitions of generating profits without bearing any risks. However, the Banks' fiduciary duty requires it to apply Shariah compliant risk mitigation techniques wherever appropriate. The Guiding Principles does not address risks specific to the insurance industry.

7.2 While the Basel Committee on Banking Supervision (BCBS) has published documents setting out sound practices and principles pertaining to credit, market, liquidity and operational risks of financial institutions, the present Guiding Principles serves to complement the BCBS's guidelines in order to cater for the specifications of the Bank.

7.3 The implementation of the Guiding Principles shall be undertaken in compliance with Shariah and within the legal framework of the jurisdictions in which The Banks operate and shall be commensurate with the size, complexity and nature of each The Banks. This Guiding Principles addresses the controls from the perspective of The Banks; however, each supervisory authority has a responsibility to establish an appropriate enabling environment for these controls to be effectively implemented.

7.4 Apart from a general requirement (Principle 1 below), all other principles are grouped into six categories of risks, and shall be used as the basis for The Banks' risk management process.

8 General Requirements

8.1 **Principle 1.0**

The Banks shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

9 Credit Risk

9.1. Principle 2.1

The Bank shall have in place a strategy for financing, using various instruments in compliance with Shariah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

9.2. Principle 2.2

The Banks shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

9.3. Principle 2.3

The Banks shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

9.4. Principle 2.4

The Banks shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

10 Equity Investment Risk

10.1. Principle 3.1

The Banks shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.

10.2. Principle 3.2

The Banks shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the Banks and the Mudarib and/or Musharakah partners.

10.3. Principle 3.3

The Banks shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of the institution's Shariah Board.

11 Market Risk

11.1. Principle 4.1

The Banks shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

12 Liquidity Risk

12.1. Principle 5.1

The Banks shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

12.2. Principle 5.2

The Banks shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.

13 Rate of Return Risk

13.1. Principle 6.1

The Banks shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

13.2. Principle 6.2

The Banks shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

14 Operational Risk

14.1. Principle 7.1

The Banks shall have in place adequate systems and controls, including Shariah Board/ Advisor, to ensure compliance with Shariah rules and principles.

14.2. Principle 7.2

The Banks shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with the Banks's own funds, the Banks shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the Banks's fiduciary responsibilities.

15 Board of Directors (BOD) and Senior Management Oversight

15.1 It is crucial for the Banks to recognise and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. In addition, The Banks may face consequential business risks relating to developments in the external marketplace. Adverse changes in the banks' markets, counterparties, or products as well as changes in the economic and political environments in which the Banks operate and the effects of different Shariah rulings are examples of business risk. These changes may affect the Banks' business plans, supporting systems and financial position. In this regard, The Banks are expected to view the management of these risks from a holistic perspective.

15.2 The Banks are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the 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. Reflecting the different nature of the business and the extent of risks faced by The Banks, supervisory authorities are urged to adopt a risk-based approach when assessing and evaluating the Banks' risk management activities.

15.3 As with any financial institution, the risk management activities of the Banks require active oversight by the BOD and senior management. The BOD shall approve the risk management objectives, strategies, policies and procedures that are consistent with the Banks' financial condition, risk profile and risk tolerance. Such approvals shall be communicated to all levels in the Banks involved in the implementation of risk management policies.

15.4 The BOD shall ensure the existence of an effective risk management structure for conducting the Banks' activities, including adequate systems for measuring, monitoring, reporting and controlling risk exposures.

15.5 The Banks shall have in place an appropriate body, in accordance with sound principles of corporate governance, to oversee that the Banks' products and activities comply with Shariah rules and principles as approved in each jurisdiction.

15.6 The BOD shall approve limits on aggregate financing and investment exposures to avoid concentration of risk and, where required, ensure that the Banks hold adequate capital against these exposures. The BOD shall review the effectiveness of the risk management activities periodically and make appropriate changes as and when necessary.

15.7 Senior management shall execute the strategic direction set by the BOD on an on-going basis and set clear lines of authority and responsibility for managing, monitoring and reporting risks. The senior management shall ensure that the financing and investment activities are within the approved limits and must obtain approval from the BOD.

15.8 Senior management shall ensure that the risk management function is independent from the risk-taking activities and is reporting directly to the BOD or senior management outside the risk-taking unit. Depending on the scope, size and complexity of The Banks' business activities, the risk management function is carried out by personnel from an independent risk management unit or from a part of the Banks' general operations or compliance unit. The Banks without a separate risk management function shall develop other checks and balances to make use of limited staff.

This personnel shall define the policies, establishes procedures, monitors compliance with the established limits and reports to top management on risk matters accordingly.

16 Risk Management Process

16.1 The Banks shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of The Banks' activities.

16.2 The Banks shall ensure an adequate system of controls with appropriate checks and balances are in place. The controls shall (a) comply with the Shariah rules and principles, (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

16.3 The Banks shall ensure the quality and timeliness of risk reporting available to regulatory authorities. In addition to a formal standardised reporting system, The Banks shall be prepared to provide additional and voluntary information needed to identify emerging problems possibly giving rise to systemic risk issues. Where appropriate, the information contained in the report shall remain confidential and shall not be used for public disclosure.

17 Custodian of the Guiding Principles of Risk Management Guideline

17.1 This Guideline shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Guideline shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Guideline shall be made available to all stakeholders and SSB members for reference and implementation.

17.2 Banks may further refine the Guideline to suit their particular structure and policies. Such amendments shall be approved by the Bank's Risk Management Committee at the Board level. The Bank's Risk Management Division will have custody over the Bank's Guiding Principles of Risk Management Guideline.

18 Effective Date of the Document

The Effective date of this Guideline is the ______ day of _____________ 20___

APPENDIX 1

1.0 ISLAMIC HEDGING PRODUCTS

1.1 The main risk faced by an investor of Islamic money market instruments is the fluctuation in return which may fall below the investor's expectation and investment requirement. The exposure to the potential risks and returns need to be managed actively to achieve the risk-reward trade-off that is reasonable to the investor.

1.2 To address this risk, the investor may utilise several Islamic swap products available in the market, namely Islamic Currency Hedging and Islamic Profit Rate Swap (IPRS).

2.0 SHARIAH-COMPLIANT CURRENCY HEDGING

Due to the need to hedge currency risk, the contracts of *Wa'd*, amongst others, have been used to assist Islamic finance customers to hedge their real exposure to currency risk. This contracts of *Wa'd* is embedded in the agreement hence, they are contractual mechanisms which are put in place to contractually hedge this risk. These "contractual terms" arising from these two contracts can be controlled compared to market movement affecting the exchange rate of FOREX in the future.

2.1 Currency Hedging via the Unilateral Wa'd (Promise) Structure

2.1.1 *Wa'd* is a unilateral promise made by one party to another, binding on the party that makes the promise. In financing transactions, *Wa'd* provides assurance that the transaction will be executed as specified in the letter of undertaking or *Wa'd* document.

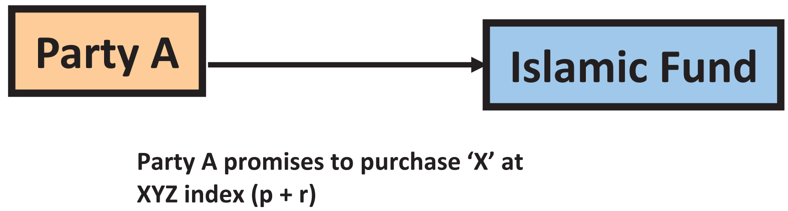
2.1.2 Under wa'd structure, only one party (obligor/promisor) promises to buy/sell as the case may be, where he is bound by that promise (which is binding). The other party / promisee / obligee is not bound to proceed with the promise that was undertaken by the promisor.

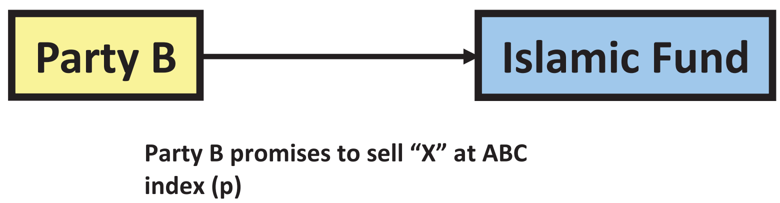
2.1.3 Binding promise from only one party is not deemed valid under Islamic law as a contract. Therefore, this can facilitate FOREX.

2.1.4 The fixed exchange rate under wa'd structure hedges the currency risk in the future.

2.1.5 Without this hedging technique, one party (Party A) may suffer a loss that was due to the fluctuation of the exchange rate of FOREX involving different currencies. Under normal circumstances, the risk would be hedged using forward FOREX, which is not compliant with Shariah principles.

2.1.6 The transaction flow for a Currency Hedge via the unilateral *Wa'd* Structure is as illustrated in the following diagram:





2.1.7 There is no issue for spot currency trading, as contemporary Shariah jurists regarded such settlement at T+2 as spot, based on `*urf tijari* (customary business practice).

2.1.8 However, this permissibility is only applicable for currency hedging purposes. Such a transaction may be arranged between the Islamic financial institution and its clients, or between the Islamic financial institutions and conventional financial institutions.

3.0 Islamic Profit Rate Swap

3.1.1 Islamic Profit Rate Swap (IPRS) in its structure and net effect is very similar to interest rate swap (IRS), which is a plain vanilla derivative generally used globally.

3.1.2 The IPRS aims to:

- Match funding rates with return rates (from investment)
- Achieve lower cost of funding
- Restructure existing debt profile without raising new finance or altering the balance sheet
- Manage exposure to interest rate* movement
- Protect financial institutions from fluctuations in borrowing rates and to provide a risk control mechanism

**(Note: an increase in benchmark rate may result in higher expectation of rate of return of any investment for Islamic banks)*

3.1.3 A typical IPRS would involve two stages:

Stage 1:

(i) The Islamic bank sells an asset to a counterparty for a notional amount.
(ii) Then the counterparty subsequently sells the asset to the Islamic bank at notional principal plus a fixed mark-up profit rate.
(iii) The net result of this stage is that the notional amounts cancel out, leaving the Islamic bank as the fixed profit payer.
(iv) The fixed rate is payable according to the reset period, for instance, every quarter or six-monthly.

Stage 2:

(i) The Islamic bank sells an asset to the counterparty for a notional amount plus a floating rate.
(ii) The counterparty subsequently sells the asset to the Islamic bank for the notional amount.
(iii) The net result of this second stage is that the counterparty becomes the floating rate payer.

Therefore, upon completion of both stages, the Islamic bank is the fixed profit rate payer and floating rate receiver while the counterparty is in the opposite position.

3.1.4 Hence, through the IPRS, institutions can restructure the nature (fixed vs. floating) of their existing rates of return. The IPRS is based on the combination of two commodity *Murabahah* contracts:

- The floating-rate leg involves the periodic *Murabahah* sale of a commodity by the protection seller in exchange for future instalments at the fair value (market) price plus a floating-rate profit portion ("cost-plus") that varies according to changes in some pre-agreed benchmark (e.g. some interbank funding rate such as the London Interbank Offered Rate (LIBOR) or KLIBOR).

- The fixed-rate leg stipulates the one-off sale of a commodity by the protection buyer in exchange for a stream of future predetermined payments.

3.1.5 The transaction flow for an IPRS is as illustrated in the following diagram: