A Risk-Based Supervisory Framework for Islamic Banks in Nigeria

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Abstract. The objective of this research is to propose a new bespoke risk-based supervisory framework (RBSF) for Islamic banks in Nigeria, that accommodates their specificities in terms of the “unique inherent risks” and “unique risk management control functions” of the Islamic banking business model. Current conventional banking based RBSFs fail to capture these specificities, which this new RBSF aims to bridge. The fast-growing systemic importance of the Islamic banking industry in various jurisdictions around the globe warrants effective supervision that recognises their specificities. The new RBSF gives a more accurate assessment of Islamic banks’ health (risk profile) which ensures more effective risk-based supervision of Islamic banks in a bid to improving their safety and soundness to promote overall financial system stability. The methodology adopted has been a qualitative approach through both content analysis of the current RBSF in Nigeria to identify gaps and a semi-structured interview (analysed with Atlas ti-8) to obtain expert recommendations on developing the new RBSF tailored for Islamic banks in Nigeria. The expected contribution of the Framework proposed by this study is that Islamic banks will be better supervised by regulators which will lead to safer Islamic banks and in turn promote the safety and soundness of the financial system at large. The study will also aid Islamic banks to better understand and manage the unique risks inherent in their line of business (Islamic banking). This paper also contributes to alleviating the current shortage of academic literature on the crucial regulatory subject of risk-based supervision in the Islamic finance industry.

Keywords: Risk based supervision · Framework · Islamic bank · Risk · Regulation

1 Introduction

The banking system is the backbone of the global economy; if it is sound, the economy is sound, if it is weak, the economy weak (Kabiret al. 2015; Muhammad-Al-Amine 2016). The importance of a sound banking system was most evident during the recent 2007–2008 global financial crisis that shook the world. The current on-going COVID-19 pandemic crisis has once again amplified the importance of resilient banking system
in withstanding shocks and ensuring the continuous flow of credit and palliatives for economic recovery.

Diverse analyses of the crisis by the Basel Committee on Banking Supervision (BASEL), the Financial Stability Board (FSB), the International Monetary Fund (IMF), and various national bank supervisory authorities, reveal a global consensus that the failure of regulators to implement proper risk-based supervision was the main reason for the onset and severity of the 2007–2008 global financial crises (Jean-Philippe 2018; Michael 2015; Zamorski and Minsoo Lee 2015). Effective supervision of banks is critical towards ensuring a safe and sound banking system (McDonough 2000).

There are two approaches to banking supervision: Compliance-based approach and Risk-based approach. The compliance-based approach was the traditional approach: it is rules-based. It involves box ticking of compliance with the rules. The modern approach to achieving effective banking supervision is through the use of Risk-Based Supervision (RBS). Risk-based supervision is principles-based. It is beyond mere compliance because it focuses on areas of highest risks in banks and the banking industry (Central Bank of Ireland 2018).

A Risk-Based Supervisory Framework (RBSF) is a document used by banking regulators to articulate their consistent approach to implementing RBS for the effective supervision of banks operating in their respective countries. The risk-based supervisory Framework operationalises RBS by assessing both the inherent risks (such as credit risk and market risk) in these banks and the quality of risk management control functions (such as internal audit function and risk management function) in the banks. The central idea that makes RBS effective is the focusing of finite regulatory time, effort and resources on the key risks within the banks and the banking industry to achieve the end goal of a safe and sound economy (BASEL 2012).

One segment of the global banking industry that has experienced rapid growth, is Islamic banking, which far outpaces conventional banking growth. Islamic banks have grown in two dimensions: number and size. However, growth comes with its risks. Some of these risks emanate because growth comes with the increased complexity of operations, which in turn escalates operational risks. The assets of the banks also grow, which means growth in credit risks emanating from matching credit portfolio asset growth. As such, the Islamic banking industry is no exception to the need for effective supervision to ensure overall economic stability (IFSB 2018).

However, the current pressing challenge is that the risk-based supervisory Framework (RBSF) utilised in Nigeria, was introduced in 2008 with only conventional banks at heart. In fact, it was developed three years before the Central Bank of Nigeria introduced the regulation permitting Islamic banking in Nigeria (in 2011) and the subsequent licensing of the first Islamic bank later the same year (CBN 2011). As such, the Framework does not accommodate the specificities of Islamic banks. Consequently, when the RBSF is used to supervise Islamic banks in Nigeria, it proves grossly inefficient because it fails to address the peculiar (unique) needs of Islamic banking risks (such as equity investment risk and Shari’ah non-compliance risk). The risk management control functions (such as Shari’ah Board and Internal Shari’ah Audit) unique to Islamic banks are also omitted and thus unassessed by the existing RBS framework. Therefore, this paper highlights
this problem and proposes an ideal risk-based supervisory framework for Islamic banks in Nigeria developed through interview of experts in the field.

According to the International Monetary Fund (2018); Islamic banks undertake distinct operations with risk profiles that differ in important respects from conventional banks, with associated financial stability implications. Thus, these distinctions underscore the need for the development of a tailored (bespoke) risk-based supervisory framework that addresses the specificities of Islamic banks to promote financial stability. This paper aims to address this need by proffering a bespoke risk-based supervisory framework for Islamic banks in Nigeria.

Globally, there is a rapid increase in the number of economies or jurisdictions permitting the introduction of Islamic banking operations via the establishment of new Islamic banks or Islamic banking windows in conventional banks or the conversion of existing conventional banks and other financial institutions into full-fledged Islamic banks. Furthermore, some jurisdictions now have Islamic banks that have grown huge in size, interconnectedness and complexity (Thomson Reuters 2018). Thus, these jurisdictions have been designated as systemically important because the Islamic banking assets exceed 15% of the market share in those jurisdictions (IMF 2017 and IFSB 2018). Consequently, this trend requires regulators to rise to the challenge of understanding and supervising these emerging unique risks and risk management control functions to ensure overall financial system stability. These Islamic banking risks are different from the conventional banking risks in terms of three additional unique risks: the rate of return risk, equity investment risk and Shari’ah non-compliance risk. Conventional banking risks are more familiar to regulators due to several centuries of existence (Hassan and Aliyu 2018 and Solé 2007). In contrast, Islamic banking is just over 40 years old (Organization of Islamic Cooperation 2015)! The Islamic banking, risk management control functions are also different from those of conventional banking in terms of the unique need to have in place a Shari’ah Board, Shari’ah Internal Audit function and Shari’ah Compliance function in addition to the regular control functions of a conventional bank (AAOIFI 2015).

Therefore, this research work aims to propose a bespoke risk-based supervisory framework to supervise Islamic banks in Nigeria with an adequate understanding of their unique risks and risk management control functions deduced from interviewing experts in the field. This is the gap this study aims to fill. The study seeks to answer the question of what would be an ideal risk-based supervisory framework for Islamic banks in Nigeria (Alam and Rizvi 2017).

This study will contribute particularly in assisting regulators or supervisors (Central banks and other regulators) in understanding and applying the proposed bespoke risk-based supervisory Framework for the effective supervision of Islamic banks towards attaining overall financial system stability. This proposed Framework will lead to a more accurate assessment of the financial soundness of these Islamic banks. The paper also assists Islamic banks to better understand and manage the risks inherent in their line of business (Islamic banking). The paper shall further contribute to lessening the current shortage of literature on risk-based supervision in the context of the Islamic finance industry as a foundation for future researchers. The rest of this paper is structured as follows: sections two and three discuss the literature review and methodology respectively,
section four gives an overview of the current RBSF in Nigeria, while sections five and six present the content analysis and interview results respectively.

2 Literature Review

Risk is an uncertain phenomenon that exposes investments to losses (Alam 2019). Banks, by nature, are in the business of risk management (Allen and Santomero 1997). Banking risks are understood to be the risks inherent in banking as a line of business. There are different types of risks a bank is exposed to which are broadly categorised into credit risk, operational risk, liquidity risk and market risk (BASEL 2012). Central Banks (regulators) around the world are focused on managing banking risks both at an individual bank’s level and at the banking system or industry level in a bid to ensuring financial system stability.

Banking supervision means oversight of regulated banks (operators) by the regulator (central bank) to ensure proper conduct. Banking supervision is usually conducted by Central Banks in various countries around the world. It is essential to clarify that though regulation and supervision are often used interchangeably, regulation is different from supervision because regulation refers to the written rules that define the permissible activities and behaviour of banks. However, supervision refers to ensuring adherence to the rules (Federal Reserve Bank 2019). Regulation has been explained by Ping (2014) as static rules made by the regulator, while supervision is an on-going process, where regulatory oversight ensures to guarantee that the regulated bank adheres with the static rules. The focus of this research is on supervision.

Risk-based supervision in simple terms means supervision by focusing on risks. The Basel Committee on Banking Supervision (BASEL 2012), the globally recognised international standard setter for promoting global financial stability (owned by 60 central banks); defines the concept of risk-based supervision (RBS) as; the approach in which supervisors (regulators) assess the risk profile of banks in terms of, the risks they carry (inherent risks), the effectiveness of their risk management and, the risks they pose to the banking and financial systems. Islamic Financial Services Board (IFSB), the international standard-setter for the Islamic financial services industry (similar to BASEL), defines the concept of risk-based supervision (RBS) as; the supervisor’s approach to a supervised bank based on the supervisor’s assessment of the risks to which the bank is exposed and of the bank’s capability to manage these risks (Islamic Financial Services Board 2014).

According to the analyses of the 2007–2008 Global Financial Crisis by the Basel Committee on Banking Supervision (BASEL), the Financial Stability Board (FSB), the International Monetary Fund (IMF), and various national bank supervisory authorities, there is global consensus that the failure of regulators to implement proper risk-based supervision was the main reason for the onset and severity of the global financial crises (Jean-Philippe 2018; Michael 2015; Zamorski and Minsoo Lee 2015). The critical role of risk-based supervision in ensuring financial system stability has been similarly echoed by Caprio et al. (2008), Al-Khoury and Arouri (2016), Dan (2010), Levine (2010), Barth et al. (2012), Tadesse (2006), Mohseni-Cheraghlouasli et al. (2012) and Ajibo (2015).

The world bank’s bank regulation and supervision survey dataset was studied by Mohseni-Cheraghlou et al. (2012), using a series of univariate tests. The study found
significant differences between crisis and non-crisis countries, which suggests that crisis countries had weaker regulatory and supervisory frameworks relative to the countries that avoided the direct impact of the crisis.

RBS is based on the fundamental fact that supervisory resources (supervisory staff, supervisory time, supervisory funding and others) are finite and some banks are more important (pose more substantial risks) to the economy than others (Sergeant 2002; Arora and Agarwal 2009 and Central Bank of Ireland 2016). As such, since most countries have more banks than the regulator’s supervisory resources, the best way to ensure effective banking supervision is through the use of RBS.

Risk-based supervision in Islamic Banking has received very little attention from prior literature despite its significance towards ensuring the safety of Islamic banks and the financial system at large. There is an urgency to ensure RBS is applied effectively through the aid of a tailored RBS framework because of the rapid growth of the Islamic banking industry both in terms of number and size of players. In 1975, during the early inception of Islamic banking, there were only two Islamic banks; Dubai Islamic Bank and the Islamic Development Bank (Organization of Islamic Cooperation 2015). Today there are over 500 Islamic banks globally with a total asset base of US$1.72 trillion (Thomson Reuters 2018).

In fact, Islamic banks in over 12 countries around the world have been designated as systemically important because Islamic banking assets exceed 15% of the market share in those jurisdictions (IMF 2017 and IFSB 2018). The systemic importance of the Islamic banking industry in these countries underscores the severe potential threat to the economies in the event of any Islamic bank’s failure or distress. Consequently, the Islamic banks must be given close, timely and adequate supervision by the regulator to ensure risks to financial system stability are identified early enough for prompt intervention. The RBS framework is explicitly designed as a working tool for the regulator to facilitate the effective implementation of risk-based supervision towards achieving this early intervention (Jean-Philippe 2018). Al Rahahleh et al. (2019) in their study aimed to review recent developments on risk management in Islamic banking and finance literature, pointed out the presence of unique risks and risk management control functions in Islamic banks and attributed the uniqueness to the differences between an Islamic bank and a conventional bank. These differences have also been highlighted as the very reason Islamic banks need a tailored risk-based supervisory framework that accommodates their unique nature (Alam and Rizvi 2017 and Van Greuning and Iqbal 2007). The success of the utilisation of risk-based supervision has led regulators to apply it in the supervision of not only banks but also insurance and takaful (Islamic insurance) companies, pension funds and other financial institutions (Fung et al. 2017 and Bank Negara Malaysia (BNM) 2019).

Ismail (2015) in his conceptual study of risk-based supervision for Islamic banks posits that the whole process of risk-based supervision needs to be revisited, both at the Islamic bank (supervised institutions) level and at the supervisory authority bank (regulator) level. Ismail argues that supervision by risk approach provides the supervisor and the Islamic banking industry with a high level of consistency in effective supervision.

However, this study differs by focusing on proposing a bespoke risk-based supervisory framework as a practical working tool for regulators to facilitate the proper
implementation of RBS for Islamic Banks in Nigeria. The proposed Framework will adequately take cognisance of the unique risks of Islamic banking and the related risk management control functions to facilitate effective implementation of RBS towards promoting financial system stability in the context of the Nigerian economy.

Paresh Kumar Narayana and Dinh Hoang Bach Phanb (2019) in their literature review study of 112 past Islamic banking studies of top-ranked journals, identified the gap of inadequate Islamic banking studies linked with economic significance. This study links economic stability with the use of risk-based supervision to promote the stability of Islamic banks. Alam and Rizvi (2017) in their literature review study on “Empirical Research in Islamic Banking: Past, Present, and Future” identified the area of regulatory supervision to promote effective Islamic banking operation and bank stability as one of the areas in need of extensive research. It is hoped that this paper will contribute to filling the above-identified gaps and promoting safer financial systems and economies at large.

3 Methodology

Methodology is defined as the practices and techniques used to gather, process, manipulate and interpret information that can then be used to test ideas and theories about social life (Bryman 2008). This paper has adopted the qualitative method which is focused on gathering, analysing and interpreting data (textual or audio or visual) rather than numerical data (Creswell 2014). This paper has used the descriptive method by carrying out both a conceptual and relational content analysis of the current risk-based supervisory Framework in Nigeria to identify gaps. Furthermore, the study also used semi-structured interviews to gather expert opinions to develop the proposed Ideal RBSF for Islamic banks in Nigeria. The experts interviewed were selected using both Purposive and Snowball sampling methods. Atlas ti-8, a leading qualitative data analysis software, was used to analyse and interpret the interview results. Time horizon in relation to methodology refers to the number of times data is collected to answer the research question(s). According to (Sekaran and Bougie 2016), studies can be classified into two types based on the time horizon. These are cross-sectional studies and longitudinal studies. Cross-sectional (one-shot) studies refer to studies that gather data just once in order to answer the research question while longitudinal studies collect data at more than one point in time to answer the research question. Most studies conducted are cross-sectional in nature because it is resource (time, efforts and costs) intensive to obtain data multiple times. As such, the cross-sectional study is selected in this paper because of its cost-efficiency.

4 The Risk-Based Supervisory Framework (RBSF) in Nigeria

Risk-based supervision was officially introduced by the Central Bank of Nigeria (CBN) in Nigeria in July 2008, with the development of its risk-based supervisory (RBS) framework (CBN 2008). Prior to that, CBN had used compliance-based supervision (CBS) to supervise banks in Nigeria. CBS was mainly a rules-based, box-ticking and static process while RBS is a principles-based, risk-oriented and forward-looking process (Laura and
Weaknesses of the compliance-based supervision approach in Nigeria were exposed by the contagion effects of the 2007–2008 global financial crises during which the CBN had to use taxpayers money to bail out some troubled banks. The weaknesses paved the way for the adoption of the risk-based supervisory approach by the CBN in a bid to bolster financial system stability (Central Bank of Nigeria 2011). The current risk-based supervisory Framework in Nigeria is depicted in a summarised form with the risk matrix in Fig. 1 below:

| NAME OF BANK | RISK MATRIX AS AT DATE |
|-------------|-----------------------|
| Significant Activities | Materiality | Inherent Risks | Quality of Risk Management Control Functions | Net Risk | Direction of Risk |
| | Credit | Market | Operational | Liquidity | Legal | Strategic | Board | Senior Mgt. | Compliance | Internal Audit | Risk Mgt. | Financial Analysis |
| Significant Activity 1 | | | | | | | | | | | | |
| Significant Activity 2 | | | | | | | | | | | | |
| Significant Activity 3 | | | | | | | | | | | | |
| Overall Net Risk Rating | | | | | | | | | | | | |

Fig. 1. Risk matrix of the current Nigerian Risk Based Supervisory Framework (RBSF)

The RBSF Matrix in Fig. 1 as illustrated above has two primary components;

1. Inherent risks (credit risk, market risk, operational risk, liquidity risk, legal risk, and strategic risk) and
2. Risk management control functions (board, senior management, compliance, internal audit, risk management and financial analysis).

There are five other secondary components which support the primary components. These are; significant activities, materiality, residual or net risk, direction of risk and absorbers or additional support (capital and earnings). The current risk-based supervisory Framework does not accommodate the specificities of Islamic banks because, at the time of development back in 2008, Islamic banking was not in existence in Nigeria. Consequently, the 2008 RBSF is referred to as a conventional risk-based supervisory framework in this study. The focus of this research is to develop and propose a new risk-based supervisory framework for Islamic banks. This is to incorporate Islamic banking specificities on the two primary (major) components because these are the identified gaps in the current conventional RBS Framework. The two primary components of the Framework failed to accommodate the specificities of an Islamic bank in terms of the fundamental building blocks of RBS which are the “identification of inherent risks of an Islamic bank” and “assessing the quality of the Islamic bank’s risk management control functions”.

This study is not aimed at discussing the elements of similarities within the Framework which are both applicable to conventional and Islamic banks. These similarities are:
1. Similar Inherent risks (credit risk, operational risk, market risk, legal risk, liquidity risk, and strategic risk).
2. Similar Risk Management Control Functions (board, senior management, compliance, internal audit, risk management and financial analysis).
3. The other five secondary parts of the Framework which are both applicable to Islamic and Conventional Banks (significant activities, materiality, residual or net risk, the direction of risk and absorbers or additional support (capital and earnings)).

The unique inherent risks and unique risk management control functions specific to Islamic banks form the main scope of this study. This study argues that it is impossible to adequately apply the principles of RBS on an Islamic bank if the conventional RBS Framework used in identifying the inherent risks omits the unique inherent risks such as Shari’ah non-compliance Risk in an Islamic bank. This inadequacy is further compounded by the omission of equally important unique risk management control functions such as Shari’ah Board specific to an Islamic bank (IFSB 2005; IFSB 2009; AAOIFI 2015).

To highlight the importance of a new tailored risk-based supervisory framework (RBSF) for Islamic banks and also illustrate the consequences of an inadequate conventional banking focused RBS framework, this research work presents the RBSF Quadrant in Fig. 2 below:

![Fig. 2. Risk-based Supervisory Framework (RBSF) Quadrant](image)

The RBSF Quadrant above categorises RBS Frameworks into four categories (Fragile, Blind, Half-baked and Ideal) based on the extent to which the RBS Framework incorporates “some” or “all” of the major “inherent risks” specific to Islamic banks.
(shown on the y-axis) and also based on the extent to which the RBS Framework incorporates “some” or “all” of the major “risk management control functions (RMCF)” specific to Islamic banks (shown on the x-axis). Each of the categories in the quadrant is discussed below:

a. Fragile RBSF: This is an RBS Framework that is highly vulnerable and susceptible to inaccurately understanding and rating the risk profile of an Islamic bank because it only assesses some of the key inherent risks and some of the key risk management control functions and ignores other key inherent risks (such as Shari’ah non-compliance risks) and other key risk management control functions (such as Shari’ah Board). As such, because it is fragile and does not accommodate all key inherent risks and RMCF of Islamic banks, it cannot give an accurate rating of the financial health of the Islamic banks. When an Islamic bank is assessed using such a fragile framework, the resulting rating is misleading because it does not give the full picture.

b. Blind RBSF: The Blind RBSF is a Framework that has a blind-spot because it fails to have full visibility on all the key inherent risks in Islamic banks even though it may have incorporated all the key risk management control functions. The consequence is that when an Islamic bank is assessed with a blind RBSF, the Islamic bank is rated with a lower than normal risk rating because some key inherent risks have been missed out. Here the Islamic bank’s riskiness is understated.

c. Half-Baked RBSF: This a Framework that although it incorporates all the key inherent risks in Islamic banks, it fails to incorporate all the key risk management control functions. When an Islamic bank is assessed with a half-baked RBSF, the result is that the Islamic bank ends up with a higher than normal risk rating because some key risk management control functions (that could have mitigated the inherent risks) have been omitted. Here the Islamic bank’s riskiness is overstated.

d. Ideal RBSF: This is an RBS Framework that effectively recognises the specificities of Islamic banks in terms of all the key inherent risks and all the key risk management control functions of Islamic banks. As such, because it accommodates these specificities of Islamic banks, it gives an accurate reading of the financial health of the Islamic banks. When an Islamic bank is assessed using such an ideal RBS framework, the result accurate and in sync with the concept of risk-based supervision in which supervision is tailored to match the risk profile of the supervised institutions.

This research has used the RBSF quadrant to buttress the importance of an ideal tailored RBS Framework for Islamic banks. The quadrant highlights the problem of how Islamic banks are disadvantaged compared to their conventional peers when their risk profile is misassessed because of an inadequate conventional RBS framework. Based on the RBSF quadrant the current conventional RBS framework in Nigeria falls into a fragile RBS framework category because it fails to assess all the key inherent risks and key risk management control functions specific to Islamic banks in Nigeria.

Consequently, this research work aims to propose a bespoke risk-based supervisory framework for the effective supervision of Islamic banks in Nigeria. A framework which incorporates the unique nature of risks of Islamic banks and the risk management control functions within these Islamic banks (which are different from conventional banks).
Failure to put in place an adequate framework threatens the safety and soundness of the Islamic banks and thus endangers financial system stability.

5 Content Analysis of the Current RBSF in Nigeria

This section discusses the content analysis performed on the current Central Bank of Nigeria (CBN) risk-based supervisory (RBS) framework. The content analysis of the current Central bank of Nigeria (CBN) risk-based supervisory (RBS) framework has been performed using both conceptual and relational content analysis. Conceptual content analysis involves performing content analysis by focusing on key concepts and themes while relational content goes an extra step of analysing relationships between the concepts or themes identified (Klaus 2004 and Columbia University 2020). This study aims to develop a new RBS framework for IBs in Nigeria. Towards this end, content analysis has been adopted to identify and understand the gaps within the current conventional RBS framework to ensure that the new Framework addresses these gaps and simultaneously maintains other aspects that are still relevant to both conventional banks (CBs) and Islamic banks (IBs) based on the local context of the Nigerian banking industry. The content analysis of the different sections of the conventional Framework are discussed below:

5.1 Section 1 – Introduction

This first section in the conventional RBS framework is an introduction which highlights the objective of the conventional RBS framework. The objective of the conventional RBS framework is to provide an effective process to assess the safety and soundness of banks and other financial institutions. This is in response to the changing financial landscape which necessitated the adoption of a risk-based approach to supervision, that focuses on the identification of risk and an assessment of the management of that risk by regulated entities.

Analysis of this section reveals that based on the objective, it is clear that the Framework is meant to assess the health of IBs by recognising their risk profile and quality of risk management. However, the Framework does not capture IBs risk profile effectively because it ignores the unique risks of IBs such as Shari’ah non-compliance risk. Also, in terms of risk management too, it ignores specificities of IBs such as Shari’ah Internal Audit. Consequently, the Framework cannot achieve its objective of assessing the health of Islamic banks until these critical gaps are addressed.

5.2 Section 2 – Risk Assessment

The second section of the conventional Framework discusses risk assessment. Risk assessment starts with the identification of “significant activities”. The assessed net risk (or residual risk) in these significant activities is derived as the summation of all inherent risks offset by the aggregate quality of the risk management control functions. This is represented by the equation below:

"Inherent Risks" mitigated by "Quality of Risk Management Control Functions" = "Net Risk"
Analysis of this section reveals that the equation representing the risk assessment process is equally relevant and applicable to IBs just like conventional banks, as such shall be maintained.

5.3 Section 3 – Significant Activities

Significant activities are any dominant line of business, unit (including a subsidiary) or process. Significant activities are identified from various sources, including the bank’s organisation charts, strategic business plan, capital allocations, and internal and external financial reporting.

The Framework emphasises two fundamental precepts in order to identify the bank’s significant activities. First is that supervisors must “know the bank”, i.e. understand its business model. This knowledge will allow supervisors to identify those activities that are key (significant) to the achievement of the bank’s business objectives or strategies. Second is that sound professional judgement of the supervisor is required in determining the significance or materiality of any activity in which a bank engages. It is important to note that significant activities are bank-specific as what is considered significant in one bank, maybe insignificant in another and vice versa.

Analysis of this section reveals that supervisors of IBs must know specificities of IBs, to understand how they are operationally different from CBs such as in terms of their Mudarabah profit sharing and loss bearing deposits (Investment Account Holders - IAH) which is a common significant activity of IBs. Furthermore, in order for supervisors of IBs to exercise sound professional judgement of IBs significant activities, they need to comprehend and take cognisance of the specificities of IBs. This is in line with the basic principle of supervision is that; “you cannot supervise what you do not understand”.

5.4 Section 4 – Inherent Risks

Inherent risks discussed in section four. These are the key risks intrinsic to any business entity. Every venture has its attached risk. Conventional banking has its key inherent risks which the conventional Framework identified as six main categories which are credit, market, liquidity, operational, legal (& regulatory) and strategic risks. The assessment of inherent risk is made at this stage without considering the bank’s quality of risk management control functions in implementing risk mitigation processes.

The Framework stipulates that the assessment of the level of inherent risks in each significant activity is a function of the probability of occurrence and the impact of the inherent risk on the bank. This is represented by the equation below:

"Inherent Risk assessment" = "Probability of the inherent risk" X "Impact of the inherent risk"

The Framework rates the level of inherent risks into four buckets, i.e. High, Above Average, Moderate and Low. The Framework recommends four buckets (an even number of buckets not odd) for the rating to avoid supervisors from sticking to the middle by merely assigning average ratings.
High – H – The inherent risk is probable to occur before the next supervisory/examination exercise (usually one year) with a significant adverse impact on the bank

Above Average – AA - The inherent risk is likely to occur with a possibly impactful consequence to the bank

Moderate – M – The inherent risk though less likely, poses an issue of concern which may impact the bank adversely

Low – L – The inherent risk is unlikely to occur (remote), and crystallisation impact is negligible

Analysis of this section reveals that the current six inherent risks of the conventional RBS framework fail to accommodate the dominant inherent risks intrinsic to the business of IBs, such as equity investment risks. As such, the new Framework of IBs needs to recognise these unique inherent risks. The inherent risk assessment equation and the four rating buckets are equally applicable and relevant to IBs.

5.5 Section 5 – Quality of Risk Management

This section concerns the assessment of the quality of risk management control functions (RMCF) which helps to mitigate the level of Inherent risks affecting each significant activity. Conventional banking has its RMCF, which the conventional Framework identified as six main categories which are the Board of Directors, Senior Management, Compliance, Risk Management, Internal Audit, and Financial Analysis. The Framework further stipulates that the presence and nature of these functions vary based on the size and complexity of a bank.

The Framework stipulates that the assessment of the quality of risk management control functions (RMCF) related to each significant activity is based on the characteristics of the RMCF and performance of the RMCF. This is represented by the equation below:

“Effectiveness/Quality of RMCF” = “Characteristics” plus “Performance”

The Framework rates the quality of risk management control functions (RMCF) into four buckets i.e. strong, acceptable, needs improvement or weak. The Framework also recommends four buckets (an even number of buckets not odd) for the rating to avoid supervisors from sticking to the middle by merely assigning average ratings.

Strong – S – Exceeds minimum industry/regulatory standards and internal policies

Acceptable – A – Meets industry/regulatory standards and internal policies

Needs Improvement – NI – Though meets some industry/regulatory standards and internal policies, there are significant lapses

Weak – W – Chronic, worrying and pervasive level of deficiencies

Analysis of this section reveals that the current six RMCF of the conventional Framework fail to accommodate the Key RMCF specific to the business of IBs such as
Shari’ah Board. As such, the new RBS framework for IBs needs to accommodate these unique RMCFs. The RMCF assessment equation and the four rating buckets are equally applicable and relevant to IBs.

5.6 Section 6 – Net Risk

Net risk is discussed in Sect. 6. The assessed net risk (or residual risk) in each significant activities is derived as the aggregate level of all inherent risks offset by the aggregate level of quality of all the risk management control functions. This is represented by the equation below:

"Inherent Risks" mitigated by "Quality of Risk Management Control Functions" = "Net Risk"

The Framework rates the level of Net risk into four buckets, i.e. High, Above Average, Moderate and Low. Using the guiding chart below, for example, if the aggregate level of all the inherent risks for a significant activity is rated as “High” and the aggregate level of quality of all the risk management control functions is rated as “Strong” then the Net risk will be rated “Moderate” taking account of the mitigating impact of the strong quality of risk management which reduces the high level of inherent risk.

| Aggregate Level of Risk Management for Significant Activity | Aggregate Level of Inherent Risk for Significant Activity |
|-----------------------------------------------------------|--------------------------------------------------------|
| Strong Low                                                   Moderate Low Above Average Moderate |
| Acceptable Low                                              Moderate Low Above Average Above Average |
| Needs Improvement Moderate Above Average High High |
| Weak Above Average High High High |

Analysis of this section reveals that the equation representing the net risk assessment process is equally relevant and applicable to IBs just like CBs.

5.7 Section 7 – Direction of Risk

The Net risk assessments include a determination of the current direction of Net Risk over an appropriate time horizon for the bank. The time horizon considered is stipulated in each case. The direction of risk is usually the twelve months projected outlook indicating whether the risks are assessed/rated into three buckets as decreasing (D), remain stable (S) or increasing (I). The direction of risk could be less than twelve months (usually guided by when next the significant activity is scheduled to be supervised/examined); however, it is best practice not to exceed twelve because the further into the future one projects the more the uncertainties. This could make such projections less meaningful.

Analysis of this section reveals that the direction of risk assessment process is equally relevant and applicable to Islamic banks just like conventional banks.
5.8 Section 8 – Overall Net Risk

Section eight addresses overall net risk. In determining the Overall Net Risk, the relative significance or materiality of each activity is considered. This assessment ensures that an activity with low materiality but high Net Risk does not skew the rating of the Overall Net Risk. The Framework will focus supervisory efforts on materially high-risk activities, however, not to the total exclusion of other activities.

The Framework rates the level of Overall Net Risk into four buckets i.e. High, Above Average, Moderate and Low. Once the Overall Net Risk has been obtained the objective of the new RBS framework for Islamic banks is achieved which is to provide an effective process to assess the safety and soundness of Islamic banks based on an adequate assessment of their risk profile and quality of risk management. Other secondary issues of Capital and Earnings are not the focus of this research because as stipulated in the current conventional RBS framework in Nigeria, they are only absorbers of losses and are not considered a substitute for sound risk management. Our focus is on the risk profile and effective risk management to curtail risk crystallisation which triggers the losses and are secondarily absorbed by capital and earnings. This study advances that the aim is to proactively safeguard against losses which reflects sound risk management and best protects the safety and soundness of the IBs.

In essence, this content analysis has aided to identify the key gaps within the current conventional RBS framework that needs to be addressed by the new RBS framework for Islamic banks in Nigeria. The content analysis has also bolstered a clearer understanding of the assessment process of the RBS framework and how it is used for rating the health of banks.

6 Interview Results Analysis and Interpretation

This section discusses the responses of the respondents interviewed using the semi-structured interview questions. The analysis was performed using Atlas ti-8 (a leading qualitative data analysis software) (Table 1).

6.1 Profile Analysis of Respondents

Four respondents were selected and interviewed. Purposive and Snowball sampling methods were adopted for the selection process. Three respondents (R1, R3 and R4) were selected using purposive sampling as a starting point to get a rich diversity of experiences from the industry (Central Bank of Nigeria and Islamic Financial Services Board) and also from academics (Ummul Qura University). R1 was requested to recommend another expert based on snowball sampling method to which he recommended R2, who was also interviewed.
There were three fundamental characteristics defining the expert profiles selected to be interviewed. Firstly is that they needed to have a minimum of 5 years grounded in both banking supervision from a regulatory perspective and secondly also Islamic banking. Thirdly, the expert must be knowledgeable about the Nigerian market in other to capture the local context in the proposed RBS Framework as such all the respondents were Nigerians who had worked in Nigeria and understood the local market. However one of the respondents R3 the academic did not have banking supervision experience but was selected because of his academic background to provide an academic perspective and because of the difficulty of finding a suitable academic that also had banking supervision experience within the limited timeframe of the pilot study.

The total number of four expert respondents used for the study is deemed as appropriate for the qualitative nature of this study by Creswell and Creswell (2017). This is based on the grounded theory approach to sample size, which focuses on saturation. According to Charmaz (2006), data collection should stop even with two participants if the categories (or themes) are saturated. Hence, the sample size of four respondents used for this study sufficiently produced reliable grounded theory on the subject of the study proposing an RBS framework.

| S/N | Respondent  | Assigned code | Experience | Years of experience | Organisation                      |
|-----|-------------|---------------|------------|---------------------|-----------------------------------|
| 1   | Respondent 1 | R1            | Banking Supervision, Islamic Banking and Nigerian Market | Over 10 years industry experience | Central Bank of Nigeria           |
| 2   | Respondent 2 | R2            | Banking Supervision, Islamic Banking and Nigerian Market | Over 10 years industry experience | Central Bank of Nigeria           |
| 3   | Respondent 3 | R3            | Islamic Banking and Nigerian Market | 5–10 years academic experience | Ummul Qura University, Makkah, Saudi Arabia |
| 4   | Respondent 4 | R4            | Banking Supervision, Islamic Banking and Nigerian Market | Over 10 years industry experience | Islamic Financial Services Board (IFSB), Malaysia |
6.2 Analysis and Interpretation

Subsequent to conducting the interviews, that data from the respondents’ responses were coded, mapped, analysed and interpreted using Atlas ti-8 (a leading qualitative data analysis software). The results are presented and discussed below:

Question 1a: In your opinion, how would you advise the CBN to incorporate Shari’ah Non-compliance risk (SNRC) into the RBS Framework? Should it be a standalone risk or as a subset of an existing risk category or other suggested way?

Question 1b: Can you walk us through the reasoning behind your choice recommended in the above question?
Based on the coding and mapping diagram of questions 1a and 1b above, three respondents (R1, R3 and R4) had a consensus that SNCR should be a sub-set of operational risk while R2 contradicted the three of them. R2 provides his rationale in Question 2 by pointing to the fact that SNCR is the primary risk in Islamic banks as such, deserves a standalone focus. R1, R3 and R4 justify their position by indicating the difficulty of assessing SNCR based on its qualitative nature and the dearth of professionals that understand both Shari’ah and banking. Therefore, the conclusion is that 75% of the respondents propose that the new RBS framework should assess SNCR as a sub-set of operational risk which triangulates with IFSB’s international standard which classifies SNRC as a sub-set of operational risk (IFSB 2005).

Question 1c. In your opinion how do you advise CBN incorporates Equity investment Risk into the RBS Framework, as a standalone risk or as subset of an existing risk category or another suggested way?

Question 1d. Can you walk us through the reasoning behind your choice recommended in the above question?
Based on the coding and mapping diagram of questions 1c and 1d above, the respondents are 50%:50% divided over whether EIR should be treated as a standalone category of risk or should be treated as a sub-category of another risk category. R4 and R1 opine that it should be a standalone category because it is in line with IFSB classification and poses a risk beyond conventional banking risk types. Thus this accommodates the specificities of Islamic banks to capture their risk profile. While R3 and R4 contradict R4 and R1 based on the rationale that the equity instruments of musharakah and mudarabah that give rise to EIR are not material to the Islamic banks’ (NIFIs – Non-interest financial institutions) operations compared to sale-based instruments such as Murabaha and RBS is based on focusing on what is material as such EIR should be a sub-category under either credit or market risk. Consequently, for the purpose of the new RBS Framework, the earlier opinion of having EIR as a standalone category will be adopted because it triangulates with IFSB standards (IFSB 2009).
Question 1e. In your opinion how do you advise CBN incorporates Rate of Return Risk (RoRR) into the RBS Framework, as a standalone risk or as subset of an existing risk category or another suggested way?

Question 1f. Can you walk us through the reasoning behind your choice recommended in the above question?
Based on the coding and mapping diagram of questions 1e and 1f above, one of the respondents (R4) suggests that RoRR should be a separate risk category because its importance usually warrants Islamic banks to hold reserves (profit equalisation and investment risk reserves). However majority of the respondents recommend that RoRR should be a sub-category of market risk because RoRR is a function of market rate movements. Thus for the purpose of the new RBS framework, RoRR will be treated as a sub-set of market risk.

Question 2a. Based on CBN’s current RBS Framework, certain risk management control functions of Islamic banks are omitted. These are the Shari’ah Board, Shari’ah risk management department or unit or function, Shari’ah internal audit function, Shari’ah compliance or review function, Shari’ah research function, Shari’ah advisory function, Shari’ah secretariat function and Shari’ah control function amongst others.

In your opinion, should CBN incorporate some or all of these functions, what would be the best way to reflect this within the RBS Framework?

Question 2b. Can you walk us through the reasoning behind your choice recommended in the above question?
Based on the coding and mapping diagram of questions 2a and 2b above, all respondents agree on one point which is that all these Shari’ah related risk management control functions are important and should be accommodated in the new RBS framework. However, two respondents (R1 and R2) proposed two closely linked recommendations of how these should be implemented in the Framework, which formed the consensus to be incorporated in the new Framework. The recommendation is that these three control functions: Shari’ah Board, Internal Shari’ah Audit Unit/Department and Shari’ah Compliance Unit/Department should be incorporated as these can sufficiently cover all the shari’ah related functions.

R2 further highlighted that the absences of these three control functions as standalone categories in the current conventional RBS framework was a major bane for banking supervisors at the central banks which made implementing of RBS for Islamic banks skewed and thus deficient. This point buttresses our research problem, which this study aims to address with the introduction of the new RBS framework.

Question 3a. Based on your experience dealing with Islamic banks in Nigeria over the years; Can you kindly tell us some of the challenges faced in using the current RBS Framework to assess Islamic banks?
Based on the coding and mapping diagram of question 3a above, only R2 answered the questions in which he highlighted the inadequacy of the current conventional RBS framework in addressing the specificities of Islamic banks in Nigeria. This further strengthens our research objective to solve this problem with the new RBS framework.

Question 4a. In light of the research topic and sequel to the above questions, is there anything you will like to add or comment on in general before we end?

Based on the coding and mapping diagram of questions 4a, R2 responded highlighting that the outcome of this research will be useful for policy adoption at the Central Bank of Nigeria which depicts the significance of the study.

Question 4b. Can you kindly recommend another expert like yourself who is well-grounded in terms of banking supervision and Islamic banking (cognizant of the Nigerian market as we
Question 4b was aimed at facilitating the snowball sampling method in which the initial expert respondents recommended other experts. In fact, R2 was selected based on the recommendation of R1, which proved the effectiveness of the snowball sampling.

6.3 The New RBS Framework for Islamic Banks in Nigeria

Based on the analysis and interpretation of the interview results which took account of both the specificities of Islamic banks and the local context of the Nigerian market, the outcome is a new RBS framework tailored for Islamic Banks in Nigeria which is depicted using the Risk Matrix in Fig. 3 below:

![Risk Matrix](image)

**NAME OF ISLAMIC BANK**

**RISK MATRIX AS AT DATE**

| Significant Activities | Materiality | Inherent Risks | Quality of Risk Management Control Functions | Net Risk | Directin of Risk |
|------------------------|-------------|----------------|-------------------------------------------|---------|-----------------|
|                        |             |                |                                           |         |                 |

*RoRR - Rate of Return Risk and **SNCR - Shari'ah Non-compliance Risk

![Fig. 3](image)

**Fig. 3.** The new Risk-Based Supervisory Framework (RBSF) for Islamic Banks in Nigeria

7 Conclusion

This research paper has examined the subject of risk-based supervision of Islamic banks which is critical for ensuring the safety and soundness of Islamic banks and the financial system at large. It has proposed an ideal risk-based supervisory framework for Islamic banks in Nigeria by incorporating the unique inherent risks and risk management control functions of an Islamic bank to ensure proper supervision. The methodology adopted has been a qualitative approach using both an in-depth content analysis of the current RBSF in Nigeria and semi-structured interviews of experts that informed the new RBSF for Islamic banks. The main objective of the paper is to propose an ideal risk-based
supervisory framework for Islamic banks in Nigeria such that Islamic banks will be better supervised which will lead to safer Islamic banks and in turn promote the safety and soundness of the financial system at large. It is recommended that the Framework be used by regulators to better assess the financial soundness of Islamic banks.