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CONFERENCE PROCEEDING

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2. ISLAMIC BANKING AND CAPITAL MARKET
3. MONEY PAYMENT SYSTEM & FINANCIAL INNOVATION
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ISLAMIC BANKING AND CAPITAL MARKET

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10	6th AICIF: 163-154	The Performance of Stocks Portfolio Based on Ethical Investment in Indonesia (Study On Islamic Index and Socially Responsible Index)	Lilis Renfiana, Syafiq M. Hanafi, Darmawan	UIN Sunan Kalijaga, Indonesia
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Operational Risks Disclosure of Islamic Banks: Selected Cases from Indonesia

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Abstract

The purpose of this paper is to discuss the operational risk disclosure practices of selected Islamic Banks in Indonesia. The methodology utilized in this study is analytical descriptive. The approach of the study is to evaluate the informational content of the operational risk disclosure in the bank's annual report using an index used by Neifar & Jarboui (2017). The index measures the presence of operational risk disclosure. The result is then analyzed for its effectiveness.
Three Indonesian Islamic Banks were chosen to reflect different backgrounds of Islamic banks where each bank has its own uniqueness. Bank x is chosen since it is of the pure full-fledged Islamic Bank in Indonesia. The Bank y is selected because it is a state owned company. While Bank z was previously a conventional bank, which is then converted into Islamic bank and is owned by one of Indonesian largest non-Islamic Bank.
The result shows that for Bank x and Bank y provide information as requested in the checklist. While for Bank z some information is missing and need further improvement.

Keywords: *Operational Risk, Disclosure, Basel Accord, Islamic Banks*

1. Introduction

In carrying out their activities, companies face various risks from low to high which could affect their going concern. It is important for stakeholders to obtain information related to risks so that they can make the right decisions. However, these parties have the potential to not getting the risk information they need because of the information asymmetry. Studies conducted in the UK by Linsley& Shrives (2006) find a gap in information regarding risk disclosure which in turn will make it difficult for stakeholders to assess the company's risk profile.
The importance of disclosing information which relates to risks in banking industry has been emphasized by The Basel Committee on Banking Supervision (BCBS). The third pillar of Basel II Accord, the market discipline, has set the disclosure requirements to enable market participants to assess relevant information with regard to scope of risk, capital, risk exposure, process of risk measurement and banks' capital adequacy (BCBS, 2011)
Operational risk management as one of the aspects of the risk management to be disclosed by each bank, plays significant role in ensuring the stability and sustainability of banking sector. Moreover, after the financial crisis in 2008, there is a demand for higher level of transparency in how banks manage their operational risk to enhance confidence in the banking system (Nobanee & Ellili, 2017).
Islamic banking industry which has shown considerable growth around the globe has a unique feature of operational risk because of its different contractual arrangement and general legal environment (Abdullah et al, 2011). Hence, Islamic banks face both operational risk encountered by every kinds of bank (conventional and islamic) and the ones specific to islamic banks.
Despite its importance, only limited attention has been given to disclosure of operational risk information in islamic banking literature, especially if compared to risk disclosure in general. Research in general risk

disclosure in banking including Linsley & Shrives (2006), Rashid et al (2012), Dignah et al (2012), AlMaghzhoum et al (2016), Ellili & Nobanee (2017). On the other hand, the extent of operational risk disclosure has been analysed by Nobanee & Ellili (2017) in Uni Arab Emirat, Barakat & Hussainey (2013) in Europe, Neifar and Jarboui (2017) in Asia.

This study attempt to investigate the extent of operational risk disclosure among islamic banks in Indonesia. None of the studies mentioned above were conducted in Indonesia. The approach taken is by evaluating the informational content of the OR disclosure in the bank's annual report using index used by Neifar&Jarboui (2017).

Three islamic banks were chosen to represent unique backgrounds of islamic banks. Just like in another countries, in Indonesia some Islamic banks are pure full-fledged Islamic bank from their inceptions while some others are newly converted subsidiaries. Some islamic banks are owned by islamic institution(s) parent company and some others are not.

2. Literature Review

2.1 Risk Management in Bank

The key role of banking is as financial intermediary in the economy. In carrying out this function various risks are faced by banks. Among them are financial risk, operational risk, business risk and event risk (Iqbal & Greuning, 2008). For this reason, banks need to implement effective risk management.

The risk management term is broad and has many definition. However, it is important to note that it comprises the identification, measurement, exposure evaluation of risk. It also contain the mitigation, reporting and transfer of risk (Muhammad, 2016).

Banking is one of the most regulated industries. The purpose of these regulations is to protect depositors and maintain financial system stability. One of the most important regulations is related to capital adequacy requirements based on international standards such as the Basel II accord which was issued by BCBS in 2004 and revised in 2006. The accord consists of three pillars: minimum capital requirements, supervisory review process, market discipline through transparency and disclosure.

Due to the severe financial crisis that began in 2007, BCBS has introduced fundamental reforms to the regulatory international framework known as Basel III. Based on the three pillars of Basel II, the reform is said to strengthen microprudential regulatory and supervision, and adds a macroprudential overlay that includes capital buffers (BCBS, 2011, 2017)

2.2 Risk Management in Islamic Bank

Both Islamic banks and conventional banks face common risks such as credit risk, market risk, liquidity risk, and operational risk. However, the magnitude for Islamic banks are different due to their unique business model and the requirement to comply with Islamic commercial law (Eid, 2012).

Various studies have mentioned the uniqueness of Islamic banking characteristics that underlie differences in risk exposure faced by Islamic banking (Khan & Ahmed, 2001; Abedifar, 2012; Ariffin, 2005). Unlike their conventional counterparts, Islamic banks are structured upon risk sharing arrangement, both in mobilisation (source) and allocation (use) of funds. Consequently, credit risk and liquidity risk which are applicable to all banks, are higher in Islamic Banks. Islamic Banks also faces another types of risk not applicable to conventional ones. They are fiduciary risk and displaced commercial risk (Ariffin, 2005).

2.2 Risk Disclosure in Islamic Bank

Management literature provides many theories to explain corporate disclosure. Some of them are agency theory, signaling theory, legitimacy, and stakeholder theory. Based on the agency theory, corporate disclosure is needed to prove the alignment of interest between shareholders as the principal and management as the agent. In signaling theory, corporate disclosure is seen as a means to communicate specific signal from a company to its current and potential investors. For opponents of legitimacy theory, disclosure is part of demonstration of fulfillment of an implicit contract between a company and society. It is needed in order to be legitimate, that the company complies with the social values and norms of the society. Stakeholder theory attempt to explain that the company disclose many information to keep its relationship with its stakeholders sustain.

One of the information shall be disclosed by banking industries is risk disclosure. Risk disclosure is *all the information that firms provide in their risk exposure reviews, and they describe the firm's performance and its risks and how it copes with the risks in the annual report* (Aryani, 2010, p. 75).

The third pillar of Basel capital accord concerns with the market discipline. It requires banks to disclose their information to market with regards to risk assessment procedure and capital adequacy. In Indonesia, The Financial Services Authority (OJK) has issued regulations to suppport the implementation of the accord. For instance regulation number 32/POJK.03/2016 concerning transparency and publication of bank reports; regulation number 18/POJK.03/2016 concerning risk management for application of risk management for conventional banking; regulation number 65/POJK.03/2016 concerning application of risk management for sharia banking.

2.3 Operation Risk Management and Disclosure in Islamic Bank

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events (BCBS, 2001 p.2). It is also considered as residual risk since any risk other than market risk and credit risk categorised as operational risk. In Islamic banks, it includes legal and sharia compliance risk but excludes reputational risk and the risk resulting from strategic decision (Abdullah, Shuhaimi, Ismail 2011).

BCBS in its document has categorised operational risk as follows (BCBS, 2001):

1. Internal fraud
2. External fraud
3. Employement practices and workplace safety
4. Clients, products, and business practice
5. Damage to physical assets
6. Business disruptions and system failures
7. Execution, delivery and process management

The disclosure of information on banks' operational risk management has been the focus of study by several researchers.

Barakat & Hussainey (2013) investigates operating risk disclosures in finding the determinants of risk reporting practices in European banks. Using self-constructed index, their study reveal that total operational risk disclosure quality provided by banks in Europe is still moderate, while for voluntary disclosure the quality is relatively low.

Nobanee & Ellili (2017) measure the extent of operational risk disclosure of banks listed in Abu Dhabi Stock Exchange and Dubai Financial Market. Both conventional and Islamic banks in the study show low degree of operational risk disclosure in annual reports. The study using Linsley and Shrives (2006) index to measure the score of operational disclosure for all banks.

Neifar and Jarboui (2017) analyse the operational risk disclosure in annual reports of banks in several Islamic countries (Saudi Arabia, Bahrain, Jordan, Kuwait, Qatar, Emirates-Arabes-United, Malaysia, Iran) . The study use presence, quantity, and quality index. They conclude that generally those banks has improved their level of disclosure especially that of quality.

3. Methods

This study aims to explore the extent of operational risk disclosure in annual reports of Islamic banks in Indonesia. Three cases of Islamic bank is selected to reflect different background of those companies. Bank x is selected since it is one of the pure full-fledge Islamic bank in Indonesia. Bank y is selected because of its status as subsidiary of state owned conventional bank in Indonesia. Bank y was spinned off from its conventional parent. While Bank z is chosen to represent a converted conventional bank which is owned by one of the biggest private bank in Indonesia.

The degree of operational risk disclosure is measured using presence index used by Neifar & Jarboui (2017). Content analysis is applied in annual reports of the three banks for the year 2017.

4. Analysis

The result of content analysis based on the index used in this study, to the best of author's knowledge, is as follows:

No	OR DISCLOSURE PRESENCE INDEX	x	y	z
1	Amount of regulatory capital for operational risk (pillar 1 of the capital)	1	1	1
2	Measurement approach of regulatory capital for operational risk	1	1	0
3	Strategies and processes of operational risk management	1	1	1
4	Structure and organization of the operational risk management function	1	1	1
5	Scope and nature of the operational risk reporting system	0	0	0
6	Operational risk transfer/mitigation/hedging techniques	1	1	1
7	Operational value-at-risk (VaR/economic capital/Pillar 2 capital)	1	1	0
8	Internal audit function/internal control system	1	1	1
9	Key risk indicators (KRIs)/early warning systems (EWSs)	1	1	0
10	Self-assessment techniques	1	1	1
11	Scorecard models/scenario analyses/stress tests	1	1	1
12	Operational risk event databases (internal/external) .	1	1	0
13	SSB (Shariah Supervisory Board) .	1	1	1
14	Shariah compliance risk	1	1	1
15	Legal risks	1	0	1
16	Additional information on operational risk exposure and management	0	0	0

4.1 Bank x

For bank x, which is one of the oldest Islamic bank in Indonesia, the operational risk disclosure covers almost all aspect of the disclosure checklist. Only two things it doesn't describe that are scope and nature of operational risk reporting system and the additional information regarding the operational risk exposure. Bank x is quite detail in explaining operational risk management and techniques. Risk management is discussed in dedicated 42 pages of annual report.

For the regulatory capital for operational risk calculation it uses Basic Indicator Approach (BIA) for Sharia Commercial Bank. To identify and measure the operational risk, some tools are utilized such as the Risk and Control Self Assessment (RCSA), the Key Risk Indicator (KRI) and the Loss Event Database (LED).

4.2 Bank y

Bank y is a subsidiary of a state owned parent bank. It covers almost all feature of the list except in two details. The first is information with regard to legal risk. The second is additional information about the operational risk exposure. Bank y is quite detail in explaining operational risk management and techniques. Risk management is discussed in dedicated 32 pages of annual report.

The method to measure operational risk weighted asset is the Basic Indicator Approach (BIA). The tools used for the identification and measurement of operational risk are said to be updated but are not explained further.

4.3 Bank z

Bank z was previously conventional. Later on, it was bought and converted into Islamic bank by its conventional parent bank. Despite the big name of its parent, the bank fail to disclose important information such as the approach to measure regulatory capital for operational risk and the scope and nature of operational risk reporting system. It also doesn't say anything about Value at Risk, Key Risk Indicators (KRIs), and operational risk event. Risk management is discussed only in dedicated 4 pages of annual report.

With regard to quantitative information, all banks provide the information. However in terms of quality, using Neifar & Jarboui index, none of the banks give graphical illustration/forward looking information on risk management.

5. Conclusion

Two out of three banks in this study have put information on operational risk management regarded as "good practice". However, one of the bank doesn't put enough of it. Much can still be added and developed to the current practice of operational risk reporting.

This study has seeral limitations. It only investigates three banks out of 13 Islamic Banks in Indonesia. It only use one of the index utilized by Neifar and Jarboui (2017). Future research can use all the index: presence, quantity and quality of operating disclosure. Future study can also investigate the determinants of operational disclosure and the economic consequences of it.

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