Developing a Framework of Islamic Bank Operational Risk Management:
‘People Risk’

(Membangunkan Rangkakerja Pengurusan Risiko Operasi bagi Perbankan Islam: ‘Risiko Pekerja’)

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ABSTRACT

The study of human resource has become a crucial topic in understanding the determinants of operational risk. Given the various sources of operational risk, losses resulting from staff performance seemed to be the major cause as employees are the key players who manage the processes and systems of undesired events. This study explored the influence of staff performance attributes toward operational risk management, with a focus on ‘people risk.’ The study was conducted using qualitative approach via face-to-face and telephone interviews with 14 respondents from 7 Islamic banks in Malaysia. Our preliminary finding showed that training, education, experience and compensation lead toward better management of ‘people risk’. Hence, a clear understanding of the factors affecting ‘people risk’ would help ensuring an effective and successful strategy in managing human resources especially in developing the operational risk management framework for the Islamic banking institutions.

Keywords: Islamic banking institutions; operational risk management; staff performance

INTRODUCTION

Operational risk (OR) is considered as a relatively new risk category being emphasized in the risk management framework of banking institutions in Basel Capital Accord (Basel II and Basel III). Although OR is already inbuilt in banking activities ever since bank was established, the danger of failure in managing it appeared in the 1990s. It emerged in the wake of a series of financial institutions’ failure in 1990s such as Daiwa Bank’s branch in New York, Barings Bank in London, and Ihlas Finance House in Turkey to name a few. In this context, financial distress resulted from weak corporate governance, contributed by ‘people risk’ (Abdullah, Shahimi & Ismail 2011a). While the bankruptcy of Barings bank and more than USD 1 billion loss in Daiwa Bank were clearly due to frauds by a single person (Nicholas William Leeson for Barings and Toshihide Iguchi for Daiwa), the loss in Ihlas Finance was associated to mismanagement by a group of unethical or greedy people. Similar to the case of Daiwa bank, the declining performance of the bank in the aftermath of 1997 Asian financial crisis was due to weak corporate governance in terms of the monitoring and controlling system of the risk management framework, particularly in overseeing liquidity and market risk. Specifically, these losses were mainly attributed to various causes: primary rogue and unethical traders (e.g. Nicholas William Leeson & Toshihide Iguchi); and the lack of monitoring mechanism for Barings and Daiwa bank. In addition, there were also weaknesses in internal control, poor management, regulatory failures, weaknesses of outside support institutions, and the attitude of the monetary authorities toward Ihlas Finance and bank failures during the 1997 financial crisis. Notwithstanding the mixture of various causes of financial distress, the common threat across those cases is the absence of risk-management policies. These policies are controlled by the principle employees, which may lead to ‘people risk’ (PR). Due to
the aforementioned series of bank losses and misconduct, the Bank of International Settlement (BIS), 2011 has required capital charged for OR be included as part of regulatory capital requirement under Basel II and Islamic Financial Services Board (IFSB) (Appendix 1).

In addition to the OR faced by conventional banks, the Islamic banks are also exposed to legal, fiduciary, and Shariah non-compliant risks (Akkizidis & Khandelwal 2008; El-Tiby 2011; Hassan, Kayed & Oseni 2013; Iskandar 2014). Those risks are unique, but may be harmful to the sustainability of Islamic banks. This is because Islamic bank products have specific contractual features that require extensive monitoring and special drafting of contract with non-standard legal jurisdictions. Competent and skilled workers are highly required during this stage as to ensure the monitoring and implementation of the contract comply with the Shariah Advisory Board’s requirements. Failure of having competent and ethical employees, who are well versed in shariah, economics, finance and structured banking products will increase the risks (whether in terms of legal environment and fiduciary) to the Islamic banks; which might result in tarnishing the bank’s performance and image. As such, employees with appropriate knowledge and skills are extremely important to the sustainability and reputation of Islamic banks. In addition, although the current OR exposure of the Islamic banks may not be significantly different from their conventional counterparts, as most of their financing products are still based on mark-up pricing (Bai Bithaman Ajil (BBA) and murabahah) contracts2 (Aggarwal & Yousef 2000), it is not impossible for the OR to become the riskiest element in the future. This is because an increasing number of Islamic banks (triggered by foreign banks) are willing to offer financing products based on partnership and profit sharing (mudarabah and musharakah) contracts.

In fact, OR has been empirically ranked (via survey and interviews) as the second riskiest after credit risk in the operation of Islamic banks in Malaysia; with shariah non-compliant risk classified as one of the independent risks (Ahmad, Abmalek & Mohamad Yazid 2009). Given that the IFSB included the shariah non-compliant risk as part of OR, this infers that the risk contributed by OR in their study is downward bias. In another study, a survey conducted by Khan and Ahmed (2001) showed that the managers of Islamic banks worldwide perceived OR as the most critical risk after mark-up risk. They found that OR is low in fixed income assets of murabahah and ijarah (mark-up pricing financing) and the highest in diminishing musharakah (equity/hybrid financing). With the underlying spirit of the Islamic banking system to move into equity financing, the risk management of OR would become pertinent and complicated.

Against this background, the objective of this research is to investigate four staff performance’s attributes that might influence the Malaysian Islamic banks’ OR exposure with respect to PR. It is hoped that the findings will help the policy makers as well as practitioners to improve the risk management framework of the Islamic banking institutions, especially in managing human resource. This study contributes to the existing literature by providing exploratory findings with the aim of presenting the underlying motivations of whether those four attributes are worth exploring for future empirical quantitative research. This is because each of the attribute has a wide scope that need to be dwelled into individually.

The remainder of this paper is organized as follows. Section 2 entails review of related literature, followed by the research framework and methodology in section 3. Section 4 discusses the findings and finally, section 5 concludes.

LITERATURE REVIEW

As to date, there is limited literature that directly investigates the relationship between staff performance and PR in the banking sector (Akkizidis & Khandelwal 2008; Izhar 2010). Thus, this section dwells into the meaning or definition of the Islamic banks’ OR, PR, as well as staff performance attributes with a specific focused on training, education, experience and compensation. This is because the understanding of the definition of each element is crucial in strategizing the management of human resources to enhance the risk management framework for OR with respect to PR.

OPERATIONAL RISK

Definition/Concept According to Basel II OR refers to the loss potential resulting from inadequate or failed internal processes, people, systems, or from external events. This definition includes legal risk1, but does not include reputational risk4 or the risk resulting from strategic decisions. In general, OR is the risk that arises from human and technical errors or accidents. It can be the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology. Specifically, ‘people risk’ may arise due to incompetence and fraud by the employees, while ‘technological risk’ may be the result of telecommunications system and program failure. On the other hand, ‘process risk’ may occur due to various reasons including errors in model specifications, inaccurate transaction execution and violation of operational control limits (Khan & Ahmed 2001). OR is not a well-defined concept and there is still no standard and clear definition of OR (Netter & Poulsen 2003; Akkizidis & Khandelwal 2008; Izhar 2010). Notwithstanding the uniformity of its definition, most authors more or less believe that OR is the risk of loss resulting from failed or inadequate internal processes, systems, and people, or from external events (Basel II).

Category of Operational Risk (Basel II) The Basel Committee on Bank Supervision (2001) has identified seven categories of operational risk associated with:

1. Category 1: Human Risk
2. Category 2: Technology Risk
3. Category 3: Internal Processes Risk
4. Category 4: External Events Risk
5. Category 5: Systems Risk
6. Category 6: People Risk
7. Category 7: Strategic Risk
1. **Internal fraud**: An act of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events which involve at least one internal party.

2. **External fraud**: An act of a type intended to defraud, misappropriate property or circumvent the law by a third party.

3. **Employment practices and workplace safety**: An act inconsistent with employment, health or safety laws or agreements from payment of personal injury claims or from diversity/discrimination events.

4. **Client, products and business practices**: An unintentional or negligent failure to meet a professional obligation to specific client (including fiduciary and suitability requirement) or from the nature or design of a product.

5. **Damage to physical assets**: The loss or damage to physical assets from natural disaster or other events.


7. **Execution, delivery and process management**: Failed transaction processing or process management from relations with trade counterparties and vendors.

**Definition/Concept According to The Islamic Financial Services Board (IFSB)** OR specifically addresses losses resulting from shariah non-compliance and the failure in fiduciary responsibilities.

**Definition/Concept According to Previous Research** The general conclusion from studies carried out by Archer & Haron (2007), Fiennes (2007), Sundarajan (2005) and Chapra and Khan (2000) suggested that it can be divided into four major categories, namely, general operational risk, shariah non-compliant risk, legal risk and fiduciary risk.

The general OR can arise from various banking activities, which are rather similar for all financial intermediaries, whether shariah compliant or not. However, the asset based nature of financing products in Islamic banking such as murabahah, salam, istisna’ and ijarah may give additional risk in contract drafting and execution that are specific to such product (Akkizidis & Khandelwal 2008; Izhar 2010). For instance, the cancellation risks in non-binding murabahah and istisna’ contracts could also trigger OR. Thus, a special clause (which requires human capital skill) is needed to explicitly explain the stand of parties (bank and client) in the contract drafting. Another significant issue in Islamic banking products is related to monitoring aspect. As the sale contract of the Islamic products often involves underlying assets (Rosly 2005; Bakar 2008; Hassan et al. 2013), the Islamic banks need to maintain and manage asset or commodity inventories that are often illiquid. The case is even worse for equity contracts. The musharakah and mudarabah contracts require extensive and regular monitoring, which involve employees’ competences and skills in the evaluation process.

In addition to general OR, Islamic banking system is also exposed to shariah non-compliant risk. Shariah non-compliant risk refers to: (a) risk relating to potential non-compliance with shariah rules and principles in the bank’s operations, and (b) the risk associated with the Islamic bank’s fiduciary responsibilities as a mudharib toward fund providers (rabb al-mal) under the mudharabah contract. In case of misconduct or negligence by the mudharib, the fund invested by the fund providers becomes a liability of the mudharib. Besides, Iqbal and Mirakhor (2007) mentioned that fiduciary risk may lead to the risk of legal recourse in a situation where the Islamic banks breach their fiduciary responsibility toward depositors and shareholders. As fiduciary agents, Islamic banks are expected to act in the best interest of their depositors/investors and shareholders. Therefore, deviation in the objectives of investors and shareholders may lead the banks to fiduciary risk. For example, in the case of partnership investment (mudarabah and musharakah) in the asset side, the banks are presumed to have performed adequate screening and monitoring of the project. Thus, any non-deliberate negligence in analysing and monitoring of the projects could result in the banks to face fiduciary risk. Also, the risk of non-compliance with shariah requirements may have an impact on the permissible income of the Islamic banks. To solve these shariah non-compliant issues, the Islamic banks need officers who are proficient in investment management, ethical and at the same time have adequate and comprehensive knowledge in shariah, finance and structured banking products. These skilful officers will reduce the banks’ exposure to PR.

For legal risk, Islamic banks face additional risk as compared to its conventional counterparts with regard to Islamic banking operations, especially the problems of legal uncertainty in interpreting and enforcing shariah contracts. Iqbal and Mirakhor (2007) pointed out that the different adoption of shariah rules may result in different financial reporting, auditing, and accounting treatments by Islamic banks. For example, some shariah scholars consider the terms of murabahah or istisna’ contract to be binding on the buyer, but the others argue that the buyer has the option to refuse even after placing the order and paying the commitment fee. Furthermore, Abdullah et al. (2011b) mentioned that one of the decided thirteen cases on Bai’ Bithaman Ajil (BBA) property financing in Malaysia did not produce a favourable outcome to Islamic banking institutions. The judgment stated that the Islamic bank may only claim on the principal sum, not the profit margin. This is due to the fact that the interpretation of Property Purchase Agreement (PPA) and Property Sale Agreement (PSA) independently is not acceptable under other schools (mazhab/madhab). Even though it is acceptable under the Shafi’i madhab, the PPA and PSA cannot be interpreted independently from the Islamic Financial Services Act.
Finally, the Islamic banks are also liable for losses arising from their negligence, fraud, misconduct or breach of their investment mandate. The risk of losses which arises from such events is characterized as a fiduciary risk. In other word, fiduciary risk is an indication of failure to perform the standards of agreement that are applicable to their fiduciary responsibilities. The Islamic banks’ fiduciary duty is about protecting the trust from all fund providers. Two important aspects that need serious consideration in safeguarding the trust are:

1. Shariah aspect: Islamic banks must ensure that the activities and the products are shariah compliant;
2. Performance aspect: Islamic banks are required to have sound financial performance, without which, fund providers might indicate that there is mismanagement or misconduct.

For example, mismanagement of current account holders’ funds can expose the bank to fiduciary risk. It might occur when Islamic banks are suffering heavy losses when utilising such funds which could result in the depositors losing confidence in the bank.

As those aforementioned operational risks are unique and may be harmful to the sustainability of Islamic banks, the future of Islamic financial institutions will depend to a large extent on how well the Islamic banks manage risks. To sustain their competitive advantage, the Islamic banks should have competent employees as to ensure that the products are shariah compliant as well as the banks are efficiently managed. Lack of skilled employees would lead to a higher exposure to PR. Notwithstanding the fact that OR is sourced from various factors, this study takes a closer look on PR as it is the major foundation of OR in Islamic banks as the employees are the ones who manage the process, technology, external events, etc (Akkizidis & Khandelwal 2008; Izhar 2010).

STAFF PERFORMANCE ATTRIBUTES

Human resource is a key element in improving firm performance as well as sustaining competitive advantage. To sustain competitiveness in an organization, employees are becoming valuable asset at increasing productivity. Training programs, educational background, compensation and experience are some popular factors that influence employee’s job satisfaction and performance, and eventually influence firm performance (Marimuthu, Arokiasamy & Ismail 2009). As research on staff performance attributes for the banking sector is very few, the literature from the firms’ perspectives is also included.

Training Training is the most important investment in human capital (Nogodalla & Abdelghani 2014); and the context of it comprises motivation to learn, declarative knowledge, skill acquisition, post-training self-efficacy, reactions, knowledge-transfer, and post-training job performance (Colquitt et al. 2000; FunHo & Yusuff 2009; NZIER 2004). In investigating the effects of human resource management practices on productivity, it was found that training practices raise a worker’s productivity and performance (Mercy & Omolo 2013). Looking into the training programme (on-job training, induction training, in-service training, off-job training), Akiyele (2007) discovered that employee can only perform better through the acquisition of skills, knowledge and ability from training program. Meanwhile Haberlina, Beauchamp, Agnew and O’Brien (2012) found that the methodological approach of training (pyramidal or consultant-led training) plays an important role to the effectiveness of training program.

In another study, specifically focusing on industrial training, NZIER (2004) concluded that trainees, after a training, are likely to be 5-20% more productive than before their trainings. Similarly, Abbas and Yaqoob (2009) who did a survey in banking sector, hotel industry, and telecommunication sector in Pakistan found that training has a positive synergetic effect to the overall employee performance. For the case of commercial banks in India, Khera (2010) found that training is the strongest human resource practice that significantly contributes to employee performance for foreign banks. Meanwhile, high motivating environment and employee’s benefit are the two strongest practices for local private and public banks. Finally, for the Islamic banking institutions, Zairani, Shaari and Ali (2008) highlighted that the Islamic banks’ employees should have sufficient training and knowledge of the products and services the banks offer so that the employees have the technological advancement in structuring the micro aspects of the banking businesses.

Education The educational background controls to some extent the position and work level of employees (Nogodalla & Abdelghani 2014). Prior studies provided mix evidences on the relationship between educational level and employee performance. Zadeh (2014) found a meaningful relationship between intellectual capital and performance of the employees; while Kahya (2007), who researched on employees’ tasks and contextual performance, found that education is negatively correlated with task performance but positively correlated with contextual performance. Also, he inferred that task performance may diminish with increasing education level, meaning that high education level may not guarantee high job performance. On the other hand, Soesilowati and Salim (2009) found that the level of education significantly contribute to the improvement of employees’ productivity and performance. They hypothesized that educated workers tend to be more responsive in receiving instruction, and adopt new technology and tasks easily; thus, increasing their abilities to innovate and improve organizational performance.

For the financial sector, Krueger and Lindahl (2000) strongly emphasized on the need to hire professional executives who are more customer-centric, technology-savvy, highly qualified, flexible and agile with
comprehensive skill set for banking industry to survive in this era of financial globalisation and liberalisation. Academic qualification alone is inadequate as it is just instructs of knowledge and basic skills.

**Experience** Employee experience can be defined as employees’ rational and emotional reactions toward their organizational and external environments to enable them to achieve goals and satisfy needs that are important to them (Capek 2007; Deveaua & McGilla 2014). It was also found that experience has significant and positive effect on employee productivity (Robbins, Odendaal & Roodt 2001; Flap & Volker 2004). Separating task and contextual performance, Kahya (2007) showed that experience has a significant direct or indirect impact on task performance, but not on contextual performance.

Equating long job tenure with highly experienced employees, Addison and Schnabel (2003) showed evidence that the larger the share of employees with longer tenures, the higher the employee and firm’s performances; conjecturing positive relationship between experience and performance. Similarly, Khan and Soverall (2007) found that both age and job tenure are positively related to employee performance. In another study, Blanpain (2005) who quantifies optimal job tenure for employee performance concluded that 14 years is the optimal tenure for the European countries’ productivity performance.

**Compensation** Compensation is one of the primary motivators for employees in staff performance attributes (Weldon 2012). For non-financial institutions, it is found that incentive pay contributes to improved employee performance (Ichniowski, Shaw & Prennushi 1997; Mohamad, Lo & La 2009). Identifying an overall effect size for incentive via several mediating variables (i.e. location of study, incentive type, incentive competition, program term, team and individual incentives, mental and physical work tasks, study type, and quantity/quality performance goals), Conly, Clark and Stolovitch (2003) found that regardless of the goal, i.e. to improve quantity or quality of employee performance, incentive has a positive effect on employee performance. Then, by differentiating the quantities of work performed (output) and the quality of the work (accuracy) for employee performance, Mason and Watts (2009) found that how the employees is paid has a larger impact on their output and accuracy as compared to the amount of pay.

For the banking industry, Nkiru (1997) who studied a similar issue but focusing on three different management levels (managerial level, senior officer and junior officer) concluded that monetary incentive increases employee performance at all levels. The employee performance would enhance overall bank performance, be it in terms of increasing efficiency or reducing risk exposures. Besides, studying the intellectual capital efficiency of the financial institutions, Nik Muhammad, Isa and Nik Ismail (2008) found that banking sectors owned the largest chunk of intellectual capital, followed by insurance company and brokerage firm. As human capital efficiency (determined by salaries, education, training) influences intellectual capital efficiency, this research will fill the gap in the banking literature by exploring the link between OR and Human Capital Attributes (HCA). The findings of this research will help us rationalise whether the banking industry requires more intellectual human capital than the others.

**METHODOLOGY**

The study was conducted using qualitative approach in order to explore the employee performance attributes toward operational risk management focusing on PR (people risk). In order to gain detailed information on the operations of local Islamic banking institutions in Malaysia, the exploration of this issue requires interview. Thus, this study conducted face-to-face and telephone interviews with 14 respondents from 7 Islamic banks in Malaysia i.e. Bank A, Bank B, Bank E, Bank H, Bank I, Bank K and Bank X. The respondents were Risk Management Officers and Credit Officers of the banks; and the interviews were conducted for 20 to 30 minutes with each respondent. Email was submitted to 20 potential respondents to explain the purpose of the study and to gain permission to conduct the interview. Due to confidentiality, the respondents had requested that their names and the institutions they represent in this study be disguised. 14 respondents replied the email agreeing to be the respondents for the study while others refused due to work commitment.

The interviews were done in English and mostly were conducted at the respondents’ offices in the headquarters of the respective Islamic banks located in Klang Valley. However, some of the respondents preferred to be interviewed via telephone. This telephone interview was conducted in a private setting by the researcher to ensure confidentiality. Respondents consisting eight males and six females were involved in this study. The interviews were then transcribed and analysed using content analysis. The data from the interview were analysed for similarities and only relevant data were categorized accordingly.

**FINDINGS AND DISCUSSIONS**

At the beginning of the interview, the researcher distributed a list of operational risks issues (Akkizidis & Khandelwal 2008; Izhar 2010) that captures categories of operational risk such as fiduciary risk, general risk, shariah non-compliant risk, legal risk and people risk. The respondents were required to give their opinions on which of the listed issues are significant to their banks. This is to ensure the importance of people risk (PR) in risk management framework of the banking sector. As for fiduciary risk, the issues are:

1. A low rate of return on deposits will lead to withdrawal of funds.
2. Depositors would hold the bank responsible for a lower rate of return on deposits.
3. The rate of return on deposits has to be similar to that offered by other banks.

Meanwhile for shariah non-compliant risk, the issues are:
1. Lack of short-term Islamic financial assets that can be sold in secondary markets.
2. Lack of Islamic money markets to borrow funds in case of need.
3. Inability to re-price fixed return assets (like Mudharabah) when the benchmark rate changes.
4. Inability to use derivatives for hedging.

For legal risk, the issues are:
1. Lack of legal system to deal with defaulters.
2. Lack of regulatory framework for Islamic Banks.

And finally, for PR, the issue is:
1. Lack of understanding of risks involved in Islamic modes of financing.

It was found that the issue on people risk is being highlighted by the respondents on the severity of PR. As according to Mr. H, Risk Officer of Bank A,

“i think, most of our staff in the other departments as well as the front desk officers do not really understand the risk involved in the Islamic banking products offered by our banks,” (Mr. H, Bank A)

Similarly, Miss R, Credit Officer of Bank X highlighted the same issue,

“people risk…for instance, sometimes when a customer came to the bank and requested for personal financing from the front desk officer, and asked the officer on the difference between the Islamic and conventional product, the officer just mentioned that they are more or less the same except that the Islamic product needs more documentation,” (Miss R, Bank X)

Thus, this reaffirms the aim of this research, which was to explore the influence of staff performance attributes on PR such as training program, experience, education and compensation. Prior studies on firm performance have shown that training, be it formally conducted outside the firm (off-the-job training) or informally introduced inside the firm (on-the-job training), is related to firm performance (Ying 2005; Fleiser & Kniessner 1988; Ismail 1996). Similarly, education (Black & Lynch 1996; Jaji & Ismail 2010), experience (Ismail 2008; Ismail & Zainal Abidin 2010) and compensation (Booth & Satchell 1994; Elias 1994) also influence firm performance.

TRAINING PROGRAM
From the face to face and telephone interviews, it was discovered that the respondents were involved in various trainings either within or outside the financial institutions which was conducted specifically for risk management officers. (i.e. courses, on job training, external training, seminar, conferences and awareness programmes). These different types of training indicate that the participants are well trained and equipped with the necessary skills to perform their tasks and improve their work performance. The modules included in their trainings are Loss Event Reporting & Key Risk Indicator, product and service offered by the bank, Banking Operation Guidelines and training on how to deal with customers and the rules which are related to the banking operation. The trainers are of external and internal trainers. The internal trainers are senior officers, managers and auditors from Human Resource, Risk Management, and Shariah Department, respectively.

The participants claimed that training helps them to increase their degree of efficiency and in a way, it improves the banks’ profitability. However, a respondent mentioned that there are not many occurrences of OR in his bank that would affect the bank’s profitability and the amount involved was also marginal. According to another respondent, non-performing financing is reduced and OR exposures are well within control after the bank conducted some training programs. Besides, some respondents highlighted that the participants gained beneficial knowledge such as exposure to fraud cases and operational risk. Moreover, some respondents mentioned that similar fraud and irregularities were not repeated after attending training programmes. Taken together, our findings imply that training may reduce Islamic banks’ PR exposure.

“I noticed that after the training, I no longer repeat the same mistake. Before this, I’m actually not sure on the proper sequencing of the sales and purchase contract. The training reinforces on this matter, then only I realized that it is important to make sure that the process is done accordingly, “ (Miss A, Bank B)

“I received much information on examples of frauds during the training. This is very beneficial. This will prevent me from doing the same…I also realized that not only me, but most of my colleagues are highly motivated after we attended the training,” (Mr C, Bank E)

“It helps to reduce non-performing financing, improves risk management and thus leads to increase in bank profitability. So I think it is good for us to attend trainings once in a while,” (Mr D, Bank A)

EDUCATION
With respect to education, most respondents agreed that educational level of the employee plays a major role in reducing PR in Islamic banks. Most of them stated that a degree level is the minimum requirement for a risk management officer position. However, one respondent believed that a degree or educational qualification does not matter.

“The important thing is the operational or technical know-how or knowledge in the task assigned, in which one gains from experience, and also attitude. I think education is just a plus point…maybe as a developmental process for all employees.
However I don’t think it is a major factor to reduce operational risk” (Miss G, Bank H)

With regard to the types of educational development offered by the banks, respondents mentioned that the employees are given the opportunities to take courses (whether internal or external courses) as well as to further studies, fully sponsored by the bank.

“...I've been working here for 6 years. In terms of accessing the right solution. The overall banking system works. Moreover, it is easier to look at things in entirety and would be able to relate how the problem as compared to less experienced employees. This is because experienced employees are able to diagnose and solve problems and adequately experience play a role in earlier detection of irregularities. It would be better if the top management can utilise existing employees’ knowledge in developing effective process of banking operation.

“...When I first joined this department, a mentor was assigned to assist me as to make sure that I’m on the right track. I also attended different types of training regarding the products offered by the bank,” (Miss W, Bank I)

Our findings showed that having a degree is the minimum qualification for the risk and credit officers although it is not explicitly stated in the job requirement. However, skills and hands-on competency are regarded as more important than paper qualification. Adding to that, in terms of educational development, the banks provide life-long learning programs for the staff to pursue their knowledge for personal as well as professional enhancement. As for knowledge development, some of the banks implement job rotation so that the staff can learn other job scope in order to get a big picture of the whole operational process. The employees are also given various trainings especially on new products and services offered by the banking industry. Therefore, educational elements such as academic qualification, educational development and knowledge development are important in operational risk management framework.

EXPERIENCE

With respect to experience, our findings showed that all respondents agreed that experience is an important factor in minimising OR in Islamic banks. This is consistent to Hoizer (1988), Robbins et al. (2001), Kahya (2007), Addison and Schnabel (2003) and Khan and Soverall (2007) who highlighted that experience is an important element in improving firm performance.7 Experienced employees are more capable at diagnosing and solving problem as compared to less experienced employees. This is because experienced employees are able to look at things in entirety and would be able to relate how the overall banking system works. Moreover, it is easier for them to identify root-caused problems and provide the right solution.

“I’ve been working here for 6 years. In terms of accessing financing application, I think experience plays a major role especially to identify fake or genuine business proposals. Some of the proposals are too good to be true! Unexperienced staff won’t be able to pinpoint this,” (Mr Z, Bank B)

In ensuring that the employees have adequate experience to efficiently and effectively handle OR, banks normally share new information with their employees through meetings, conferences and Lesson-Learn-Memo. Also, discussion and brainstorming sessions are good learning tools in providing working experience to the employees in addition to training programmes.

“When I was monitoring one of the commercial properties’ financing, I found that the client conducted a different business than what he earlier proposed and approved by the bank. To make things worse, the business turned to be non-shariah compliant! What I did was, I quickly shared my experience using Lesson-Learn-Memo so that my colleagues will be alert regarding this matter,” (Mr. V, Bank E)

Our findings showed that experience elements such as the ability to share and learn from each other’s experience, solve and foresee problems and adequate experience play a role in earlier detection of OR occurrence.

COMPENSATION

Our findings indicated that in terms of compensation, majority of the respondents agreed that incentives may decrease Islamic banks’ OR exposure. In terms of the basis of incentives, the rewards should be based on the employee’s performance (i.e. skill and hard work), qualification and experience. In terms of the types of incentives, the banks are currently awarding their employees through bonuses, promotions, salary adjustments based on merits and commissions for fee-based products. In terms of desired incentives, some respondents suggested their banks to introduce incentives on risk reductions and key performance index (KPI).

“I prefer if the bank provides incentive for zero fraud and irregularities. It would be better if the top management can provide risk-dividend- bonus. I think that will be an excellent motivational reward to encourage the staff!,” (Miss F, Bank K)

“I would love to have extra allowance for my commission whenever I sell products and services of the bank. I believe everyone would love to have money as a reward,” (Mrs S, Bank I)

“It will be great if we can further our studies without being bonded. That will give us higher chances for career development,” (Mr J, Bank H)

Our findings revealed that compensations provided by the bank such as bonus, promotion and commission are important in improving the operational risk management framework of the Islamic banking institutions in Malaysia.

THE PROPOSED MODEL

Based on our findings, we proposed the following model:
The model demonstrates that training, education, experience and compensation are the factors that influence PR. The model represents the OR management of the Islamic banking institutions in Malaysia. As for training, training programs, modules, trainers and application of learning are the important elements that influence the effectiveness of training. For the case of educational component, the critical factors are academic qualification, educational as well as knowledge development. With regard to compensation, bonuses, commissions and promotions are the incentives provided by the banks which are regarded as important elements in motivating the employees. As for experience, the ability to share and learn from previous experience as well as problem solving are the crucial elements which can influence people risk. The theoretical implication of this proposed model is on the influence of HCA toward PR. Hence, this extends the current literature on OR whereby the elements of staff performance which includes education, training, compensation and experience are added. As for the industrial implication, the proposed model gives insights to the Islamic banking institutions in considering the four elements in developing their OR framework. For instance, as for the training element, the Islamic bank might want to strategise their training programs (i.e. modules, facilitators, timing, participants, etc.) in order to minimise PR.

CONCLUSION

Our findings suggest that there are four factors (i.e. training, education, experience and compensation) affecting OR with respect to PR exposure of the Islamic banks in Malaysia. Our findings are parallel to the Malaysian New Economic Model (NEM) introduced in 2010, which put greater emphasis on the aspect of quality, innovation and creativity of the individuals as the key determinants to economic growth or productivity. With respect to Islamic banking institutions, as our exploratory results revealed the relationship between training, compensation, education and experience with people risk, further empirical studies are urgently needed to facilitate the policy makers in developing the OR management framework for the Islamic banking institutions with respect to PR. A clear understanding of the whole scenario related to PR would help to ensure effective and successful strategies in managing human resources for the Islamic banks.

ENDNOTES

1 Basel I (1995): operational risks = all that is not a credit risk or a market risk. Basel II (2004): includes operational risk as a specific type of risk in banking institutions. Basel III: framework on bank capital adequacy, stress testing and market liquidity risk. In Basel III, OR can also be affected via the effectiveness of the management of market liquidity risk. If the bank does not manage the market liquidity risk efficiently, it will affect the operational risk of the bank as a whole.
2 BBA and Murabahah contracts are somewhat similar to conventional financing in terms of their mark up pricing element. Both Islamic and conventional banks are exposed to general operational risks such as process, system, people, IT, etc.
3 Legal risk is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It includes the exposure to litigation from all aspects of an institution’s activities.
5 Task performance engages patterns of behaviours that are directly involved in producing goods or service or activities that provide indirect support to organizational core technical processes, while...
contextual performance is individual efforts that are not directly related to their main task function but are important because they shape the organizational, social, and psychological contexts that serve as the critical catalyst for task activities and processes.

6 Intellectual Capital Efficiency = Human Capital Efficiency [salaries, education, training] + Structural Capital Efficiency

7 In the banking sector, a good performance can be viewed either in terms of increasing efficiency or decreasing risk exposure.

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APPENDIX

APPENDIX 1. Regulatory Capital for Operational Risk

<table>
<thead>
<tr>
<th>BASEL II</th>
<th>IFSB</th>
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</thead>
<tbody>
<tr>
<td>Tier 1 + Tier 2</td>
<td>Tier 1 + Tier 2</td>
</tr>
<tr>
<td>Risk-Weighted Asset (Credit risk + Market risk + Operational risk)</td>
<td>RWA (Credit risk + Market risk)</td>
</tr>
<tr>
<td></td>
<td>Operational risk - RWA funded by PSIA (Credit risk + Market risk)</td>
</tr>
</tbody>
</table>

- IFSB capital adequacy framework serves to complement the Basel II in order to cater for the specificities of Islamic banking institutions.
- The major contribution of the IFSB is to acknowledge that the uses of funds (AAOFI – sources of fund) for Islamic banks, which are by nature shariah compliant, are also justified.
- In addition, the provisions for operational risk and the treatment of profit sharing investment account (PSIA) are also justified.

*Source:* Shahimi & Abdullah (2011a)