Comments of

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on

Basel II and Capital Requirements for Islamic Banks

by M. Kabir Hassan and Mehmet F. Dicle

Basel II: Implications for Islamic Banking

by Monzer Kahf

Cyclical Patterns in Profits, Provisioning and Lending of Islamic Banks and Procyclicality of the New Basel Capital Requirements

by Abd. Ghafar b. Ismail and Ahmad Azam b. Sulaiman

A major shortcoming of all three conference papers on Basle II and Islamic finance – for which the authors cannot be blamed – is that they do not take into consideration the recent documents of IFSB on a capital adequacy standard and on guiding principles of risk management for Islamic financial institutions, both issued in March 2005.[1] Some definitions and arguments in the conference papers might be modified and revised in the light of the IFSB documents, and the authors of the conference papers may wish to do so on their own. Since the authors of the conference papers could not refer to the IFSB documents, it is felt appropriate that the discussant will also ignore them for the time being (at least in the written version of the comments)

The papers of Hassan and Dicle and Kahf cover similar topics and shall be discussed together while the paper of Ghafar b. Ismail and Azam b. Sulaiman is of a completely different character and requires a separate treatment.

1. Papers of Hassan and Dicle and of Kahf

1.1. Qualitative Discourses

(1) The analysis of Hassan and Dicle is more extensive than Kahf's paper. The course of their arguments could be somewhat more stringent to avoid possible confusion: In part 2 the authors give a brief characterization of the most commonly

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[1] Both documents can be downloaded in an English and Arabic version from the website of IFSB: www.ifsb.org.

used Islamic financial instruments, and they add indications of typical risks of each instrument: for *murābaḥah* and *ijārah* a late payments risk and a mark-up (price) risk, for *salam* and *istiṣnāʿ* a delivery and default risk and a price risk (especially if parallel *salam* transactions are not permissible), for *muḍārabah* and *mushārakah* a liquidity risk, an income risk and (in varying degrees) a business risk, and for investment accounts a withdrawal risk. Part 3 takes the opposite direction and starts with an outline of types of risks faced by banks – namely a market risk, a credit risk, a liquidity risk, an operational risk and a legal risk. Then the Islamic financial instruments are related to these types of risks. This is partially redundant and partially confusing insofar as some types of risks mentioned in part 2 are either ignored or put under a different heading. Furthermore, in part 5 a risk classification of AAOIFI (commercial risk, fiduciary risk, displaced commercial risk) is introduced but not linked to the previous discussion.[2]

Kahf also deals with the Islamic modes of financing and their risk implications. His focus is a bit more towards accounting procedures, and he refers more frequently to AAOIFI standards (which he sometimes criticizes and comments on).

Part 4 of Hassan and Dicle deals with capital adequacy for Islamic banks. Kahf's paper is in parts more elaborate with respect to details of the credit risk assessment according to Basle II.[3] For most Islamic banks the standardized approach will be the relevant one. Specific risks make it mandatory to adapt and amend risk management methods and weighting schemes for Islamic banks.

This is particularly necessary and difficult with respect to Islamic types of partnership financing (*muḍārabah, mushārakah*) which have to be related to equity participations of conventional banks.

Another thorny issue is the treatment of Islamic substitutes (e.g. Parallel *salam*) for conventional derivative products.

It is pointed out that Islamic banks will face problems if they suffer from delayed payments which induce a risk weight of 150 percent. It will be difficult to get a compensation from the customers because Islamic banks are not allowed to charge an extra for delays.

Securitization can be a device for reducing a bank's risk exposure. "Considering the very nature of profit and loss accounts that participate to credit and market risks of assets directly, such accounts may be considered as securitization in terms of Basel II credit risk exposure." (Hassan and Dicle). Another remedy for risks (esp.

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[2] Kahf does not use the same terminology but he covers in substance most of the risks listed by Hassan and Dicle. For Kahf, "risks may relate to positions held as components of the bank's assets or liabilities, they may also relate to people, systems and processes with which a bank is involved; and risks may be caused by external or internal factors".

[3] In addition, he outlines the fundamentals of the second pillar (supervisory review process) and the third pillar (market discipline) of Basle II.

Liquidity risks) and an instrument for risk diversification has been mentioned earlier in the paper, namely *ṣukūks* – provided the *ṣukūk* market develops further and becomes more liquid.

Kahf's analysis leads him to the conclusion that "[t]rading book risks, in their literal sense, rarely exist in Islamic banks but quasi-trading book risks are much higher in IBs islamic banks] than in the conventional banks."

Both papers touch the problems of transparency and disclosure (which are related to pillars 2 and 3). Based on empirical data Hassan and Dicle conclude that "non-listed Islamic banks that consist of the majority of Islamic banks (60.94%) are the least transparent".

Part 5 on capital adequacy of Islamic banks in the paper of Hassan and Dicle is focussed on the capital side, i.e. What shall constitute the core capital of Islamic banks. Here the authors summarize opinions found in the literature (without taking a distinct position themselves). The main issue is the treatment of investment accounts based on profit and loss sharing.

Section 3 of Kahf's paper also discusses investment deposits and their treatment in the calculation of capital adequacy ratios. For him, "equity must be interpreted to include the equity of shareholders and the equity of the owners of unrestricted deposits because the latter carry their share of the risk of losses by virtue of the *muḍārabah* contract."

Although Hassan and Dicle do not explicitly express an own opinion, they quote several views presented in the literature which imply a conclusion somewhat different from Kahf's. Because PLS deposits share risks they look at first glance like a form of equity, but a closer look – which is traced back to Karim (1976) – reveals a basic difference: While equity capital is permanent, PLS deposits are temporary, i.e. They can be withdrawn. "In theory, PLS accounts participate to the investments directly and cannot withdraw their funds until the investments are liquidated and profits and losses are realized. … However, Islamic banks usually maintain some sort of profit leveling strategy which allows Islamic banks to honour withdrawals. Any lack of payment may have consequences to the Islamic banks in terms of withdrawal runs, incomparable liquidity service for customers versus conventional banks and hardship in collecting funds to PLS accounts. Therefore, in practise such funds enjoy liquidity and withdrawal rights before maturities." [4] (Hassan and Dicle).[5] With respect to capital adequacy ratios the suggestion (of Hassan

[4] In the following sentence, it should read "the third method", and in the third and forth line below this phrase it seems that a footnote attached to "PLS accounts" is missing.

[5] Kahf uses a more cautions terminology but nevertheless confirms that Islamic banks shield PLS deposits against losses: The "past experience of the Islamic banks over three decades indicates that there were events in which the share holders and the senior management felt certain moral responsibility, or at least moral desire, to voluntarily relieve owners of unrestricted deposits from certain losses including losses resulting from debtors'

and Dicle or/and of Karim?) is "that PLS accounts should be treated as a tier two capital", but (because of the limits in the Basle Accord) only up to the amount of the tier 1 capital.

The factual liquidity of PLS deposits can expose Islamic banks to a substantial liquidity risk. If losses passed on to PLS accounts would cause a withdrawal run, Islamic banks would suffer because of "the inexistence of marketable securities within the asset portfolio. Such risk should be included with the minimum required capital which liquidity position will be drawn upon."

(2) The last aspect is not elaborated any further by Hassan and Dicle, but it certainly deserves more attention. The 'withdrawal run risk' is unique for Islamic banks. Competition within the Islamic segment and with conventional banks will press individual Islamic banks to offer competitive returns for PLS deposits – the market interest rate being the benchmark. Islamic banks have to build up 'PLS return smoothening reserves' in order to be able to maintain the benchmark returns in periods of relatively low income (profits) or even losses from the actual financing business. This common practise of Islamic banks creates expectations of depositors: They will consider their PLS accounts factually risk free and highly liquid. A sudden disappointment of these expectations – i.e. The denial of withdrawals before maturity or the passing on of losses to the depositors – can induce a run on the bank. This may not only threaten the existence of the individual bank, but – through contagion effects – could endanger the whole Islamic finance segment. Given the illiquidity of securities markets and the lack of an Islamic interbank market, only equity capital can serve as a buffer for (moderate) losses. As a consequence, PLS deposits should not be considered tier 2 capital because a recourse to this capital may not facilitate but threaten the survival of a bank; it could turn out to be a suicidal medication.

If this analysis holds true, Islamic banks are exposed to another latent risk, namely a 'credibility (or ideological) risk': In situations as outlined above, there is an obvious discrepancy between the legal status of PLS deposits and their factual treatment. It is constitutive for the concept of PLS deposits that losses are passed on to the account holders, but the negative fallout factually prevents the adherence to the principles of Islamic law. If this becomes the general practise, and if it is tolerated and sanctioned by Sharīʿah boards, the credibility and ideological distinctiveness of Islamic banking will suffer from a creeping erosion. A whole bunch of transparency and governance issues pops up, and it may become difficult to convince sceptical bank regulators and supervisory authorities in Western countries that the specific legal characteristics of Islamic financing transactions are sufficient to justify any special and different treatment.

Furthermore, the 'legal risk' (which was mentioned above) could get an additional dimension: If crucial Sharīʿah principles are not consistently implemented,

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default".

the adoption and application of Islamic law becomes blurred. This can give rise to various legal disputes between Islamic banks and customers, Islamic banks and public authorities, Islamic banks and conventional competitors, etc.

1.2. Quantitative Findings

Hassan and Dicle illustrate and underscore some of their arguments with precise figures. Since empirical studies on Islamic banks are rare, quantitative data will attract the reader's attention. However, figures for Islamic finance must never be consumed uncritically. Kahf made a small survey of the financial statements of 7 Islamic banks and found that "although Islamic banks do not have a unified standard for presenting their financial statements, most of them do not deviate much from the theoretical standard No. 2 of the AAOIFI and they have mostly disclosed sufficient information". These findings can be rephrased in a less conciliatory way: Islamic banks neither have a unified standard for presenting their financial statements, nor is it ensured that they all disclose sufficient information. As a consequence, the reliability and coverage of data sources should be thoroughly examined. Unfortunately, Hassan and Dicle do not say a single word on this. Instead, they leave the reader with a number of puzzles such as the following: In table 2-1 all shares of Islamic banks had a (surprisingly high) peak in 2000 and a sharp drop afterwards. Is there any 'real world' explanation for this phenomenon or does it express just a flaw in the data base?

In order to get at least a rough feeling for the data quality, the figures quoted by Hassan and Dicle for one country – Bahrain – were contrasted with official statistics. The Annual Report 2002 of the Bahrain Monetary Agency (BMA)[6] gives the following number of banks for the end of 2002: 23 commercial banks (including 4 Islamic), 51 offshore banking units (including 3 Islamic) and 36 investment banks (including 16 Islamic), i.e. A total of 39 conventional and 20 Islamic commercial and investment banks plus 48 conventional and 3 Islamic offshore banking units. The tables of Hassan and Dicle refer to only 14 conventional and 7 Islamic banks. The reason is that they use the Bankscope database which does not cover all but only approx. 3,000 "major banks" outside of Europe (5,900 banks), North America (12,000 banks) and Japan (900 banks).[7] Obviously their coverage is incomplete. Unfortunately, it is neither clear how "major banks" are defined in Bankscope nor how representative they are for the banking industry of a country in general and for the Islamic finance sector in particular.

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[6] http://www.bma.gov.bh/cmsrule/media/pdf/annualreport/anuual_2002eng.pdf

[7] Figures for March 2005 in a brochure of Bureau van Dijk and Fitch Ratings on Bankscope, http://www.bvdep.com/brochurePDFs/20421 BvD Fact Brochure Rev.pdf. The coverage in 2004 may have been even less.

According to BMA statistics,[8] the total assets (consolidated balance sheets) stood at 4.0 billion BD = 10.7 billion US$ for the full commercial banks, at 58.8 billion US$ for the offshore banking units and at 4.5 billion US$ for the investment banks. This gives a total of 74.0 billion US$ for the conventional banks. The total assets of the conventional banks covered by Bankscope are 59.7 billion US$, i.e. 81 percent of the actual figure. For Islamic banks the figures are 2.9 (BMA statistics) and 2.4 billion US$ (Bankscope). However, the BMA statistics report that the off balance sheet assets of Islamic banks sum up to 3.1 billion US$ while this is not mentioned in the tables of Hassan and Dicle. The omission of these assets in the Islamic finance sector could be the explanation for some curious results in the tables of Hassan and Dicle. For example, the average total assets of 7 Islamic banks in the high income country Bahrain are smaller than the average total assets of 3 Islamic banks in the least developed country Bangladesh (471 vs. 549 million US$).

This may serve as a warning not to rush to conclusions without a more detailed and thorough examination of the coverage and quality of the Bankscope data. Depending on the definition of "major banks", it may well be that the Islamic finance sector is the more misrepresented the smaller a country is and the larger the numbers of conventional and Islamic banks are.

2. Paper of Ghafar b. Ismail and Azam b. Sulaiman

The authors pick up a relevant question, namely the danger of procyclical effects of the Basle II Capital Accord. If there was already procyclical behaviour under the rules of the Capital Accord of 1988, this will most probably be enhanced under the rules of Basle II.[9] This empirical question is addressed for a sample of 16 Islamic banks and Islamic banking windows in Malaysia for the period 1994 to 2004.

For a commentator who is not an expert in econometrics, some doubts arise whether the approach of the authors is suitable to identify procyclical effects. There are two groups of questions which are related to the macro design of the model and the micro quality of the data.

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[8] http://www.bma.gov.bh/cmsrule/media/pdf/statistics/bulletin/QSB_July_2005.pdf, table 12.

[9] "In contrast to the current Accord where, for a given quantum of lending to a particular set of borrowers, the capital requirement is invariant over time, under the new Accord the capital requirements will depend on the current risk assessments of those borrowers. If borrowers are downgraded in a recession, then the capital requirements faced by the bank will rise. This would be in addition to the possible reduction in the bank's capital because of write-offs and specific provisions".

2.1. Macro Design of the Model

The paper does not give any information about the number, length and amplitude of business cycles in Malaysia during the period under study. In the past, the average length of cycles was approx. 4 to 5 years in OECD countries (with considerable variances). Since the 1990s the cycles became by far less pronounced compared to previous decades, and sometimes it was even hard to identify a cycle at all. For readers who are not too familiar with Malaysia, a short characterization of the business cycles of that country would be useful.

If the average length of a Malaysian cycle were 5 years, then the data for 1994 to 2004 would cover only two full cycles or just one full cycle in the middle and half a cycle at the beginning and the end of the period. But it may be that there was no cycle in the traditional sense at all: The late 1990 were dominated by the unusually sharp Asian crisis which must not be seen as an extraordinarily sharp cyclical downturn but as a singular event with non-cyclical causes. The recovery was quite rapid, but it was accompanied by massive adjustment and restructuring policies which were non-cyclical in nature. In total, the years in the middle of the observation period were years of extraordinary business constellations, and it is very doubtful what conclusions can be drawn for periods of 'ordinary business'.

One of the big topics of business cycle research was the identification of the lag structure between relevant variables. There could be a consensus that GDP, unemployment and money supply have an impact on bank profits (equation 3), but there can be considerable disputes whether, for example, today's profits are impacted by the actual or next year's expected GDP, by the actual or last year's unemployment rate and by the (growth rate of) M3 two, three or four years ago. In the basic equations 3 and 5, all variables have the same time index t, and this seems to indicate that the model does not have any explicit lag structure. If this is not felt necessary, of if there is an implied lag structure, an explication should be given.

2.2. Micro Quality of Data

There are some queries regarding the time series for the 16 Islamic banks and Islamic windows (which are not reproduced in the paper).

To start with, the composition of the sample of 16 banks is not given, but it is by no means trivial. As can be seen from the table below, the number of financial institutions offering Islamic banking services has changed considerably over time. Further, the institutions participating in the Islamic Banking Scheme are of very different nature. Therefore it is important to know the composition of the sample.

Islamic Banks and Banks Participating in the Islamic Banking Scheme	end of 1999	end of 2000	end of 2001	end of 2002	end of 2003	end of 2004
Islamic Banks	2	2	2	2	2	2
Institutions with Islamic Windows/Facilities	22	21	14	14	13	12
- Commercial Banks	16	14	10	9	7	3
- Finance Companies	5	5	5	3	4	4
- Merchant Banks	7	7	7	7	7	7
- Discount Houses				4	4	5
- Development Financial Institutions						
Total	*52*	*49*	*38*	*39*	*37*	*33*

The problem of mergers is addressed in the paper: In order to calculate averages and growth rates, a 'virtual merger' was calculated for the year before the actual merger.[10] But it is not clear how many artificial data have entered the analysis, and it is unknown which type of banks were affected (most probably commercial banks).

When the number of observation units (Islamic banks and Islamic windows) is relatively small, mergers change the denominator for averages markedly. With a change in the denominator, the relative weight of the individual observation unit changes. This could be ignored if it can safely be assumed that all units perform and behave in a (rather) identical way – in the extreme, it does not matter whether the data reflect the actions of 16 or 2 institutions. Factually, however, the institutions are of very different nature, and there are clear differences in performance indicators between Islamic banks and Islamic windows. A calculation of the return on equity for the two Islamic banks and the Islamic windows of 10 commercial banks for the year 2002 shows a striking difference:[11] While the return on equity

[10] "Mergers pose an obstacle to calculating averages and, particularly, growth rates. To overcome this drawback so that the least number of observations possible is lost, it has been decided to artificially recreate the merger a period in advance. That is to say, if two Islamic windows merge at t, for the purposes solely of calculating averages and growth rates, the resulting institution is considered to have already existed at t-1, reconstructing it on the basis of the data from the individual institutions involved in the merger. A similar problem arises for institutions that, having belonged at t-1 to a consolidated group, leave such group at t. To calculate both the averages of certain variables and their growth rates, the figure at t-1 is obtained from their individually reported financial statements".

[11] The figures are taken from the Ph.D. thesis of Alexander von Pock, Strategic Management in Islamic Finance, to be submitted to the faculty of economics and business administration of the University of Bochum (Germany), supervised by the author of these comments.

for the Islamic banks was 5 and 6 percent, it was in the range between 15 and 36 percent for the Islamic windows. This is most probably not due to more profitable financings and investments of the Islamic windows[12] but due to a weaker capitalisation of the Islamic windows. If conventional banks with Islamic windows strive for the maximization of the total (conventional plus Islamic) profits, there will be various reasons (from taxation to reputation) and instruments for the management to influence the composition of profits, deposits, investments, etc. between the conventional and the Islamic section. Cyclical effects could affect the whole business of a conventional bank with an Islamic window, but they may not be visible in the Islamic section because they are displaced by the consequences of management decisions.

In the model, deposits are one explanatory variable for profits. It should be noted that the volume of deposits in the Malaysian Islamic sector is not determined by market forces alone. By the end of 2004, 20 percent of the investment deposits and 29 percent of the demand deposits of the Islamic Banking Scheme originated from the government.[13] It is possible that the government uses its deposits in the Islamic system for macroeconomic stabilization purposes and thus counteracts market trends.

All these arguments do not mean that the question of potentially procyclical effects of Basle II regulations is irrelevant and should not be addressed with reference to empirical data. However, the unique situation of Malaysia requires a more elaborate discussion of the specification of the model, the macroeconomic and industry-specific environment, and the quality and flaws of the statistics used.

[12] The return on assets is in the range of 0 to 2 percent for all Islamic banks and windows (with one exception of 3 percent for an Islamic window).

[13] Calculated from table II.18 "Islamic Banking Scheme – Deposits by Type and Holder: Banking System" of the Monthly Statistical Bulletin July 2005 of Bank Negara Malaysia, http://www.bnm.gov.my/files/publication/msb/2005/7/pdf/ii_18.pdf. Additional 21 percent of the investment deposits and 7 percent of the demand deposits originated from financial institutions.

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