

Comments of

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on

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 Azman b. Sulaiman

Basel II: Implications for Islamic Banking

by

Monzer Kahf

Basel II and Capital Requirements for Islamic Banks

by

M. Kabir Hassan and Mehmet F. Dicle

General Comments

The papers, taken together, cover some of the key issues and implications of the New Basel Capital Requirements for Islamic Banks. The papers by Mr. Monzer and Messrs. Hassan and Dicle consider the specific risk characteristics of Islamic finance products, the applicability of Basel II in light of these characteristics, and discuss the scope of reduction in capital requirements due to risk sharing by Profit Sharing Investment Accounts (PSIA). Many of the issues and questions raised by these authors are addressed in the draft standards for capital adequacy and risk management of Islamic banks, issued for public comments by Islamic Financial Services Board (IFSB). The IFSB standards provide fairly detailed guidance on adaptations of Basel II to the specific risk characteristics of Islamic banks. In particular, the IFSB draft proposes an adaptation of standardized approach to risk measurement – based on externally provided rating categories – and within this

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framework allows supervisory discretion to recognize the extent of risks assumed by the PSIA's in computing capital adequacy for Islamic banks.

In contrast, paper by Ismail and Sulaiman, does not explicitly recognize the role of PSIA as a factor influencing – or even mitigating – the procyclicality of profits, provisioning, and lending in Islamic Banks. I will say more on this later.

Specific Comments

Procyclicality of Basel II

The greater risk sensitivity of New Basel Capital Accord can raise provisions and capital requirement and lower profits and lending in an economic downturn, thereby accentuating the recession. Is this proposition of procyclical impact of New Capital Accord valid for an Islamic bank, whose lending is asset based, and whose risks are shared with PSIA? If increased risks in a recession are cushioned by PSIA, the procyclical impact on Islamic Banks should be much reduced compared to conventional banks. A testing of this proposition, would require a somewhat modified modelling of profits, and an examination of whether the share of PSIA in total assets has any discernible effect on profits (assigned to share holders) and lending over the business cycle. Moreover, procyclical effects can be dampened by supervisory approaches of requiring forward looking provisions, and by increased transparency on the evolution of risks over time in order to dampen market reactions and smoothen provisions.

The paper by Ismail and Sulaiman does not address the question whether Islamic banks are better insulated from procyclical effects owing to risk sharing by PSIA. While the reported empirical work is interesting, there is a need to modify the estimated model (of profits and lending) to reflect the specificities of Islamic banks, and thereby address the above question more explicitly.

Applicability of Basel II

It is by now well recognized that the language of risks and methodology of risk and capital measurement of Basel II are ideally suited to the needs of Islamic banks. Key issue is what are the challenges of implementation? Monzer Kahf's paper seems to imply that for each category of risk – say operational risk, or credit risk – the corresponding capital requirement should be lower than implied in Basel II for conventional banks, on account of risk sharing by unrestricted IAH. This separate treatment of each type of risk may not be reliable in practise, because unrestricted IAH share in the bank's aggregate risk, and the aggregate risk is typically lower than the sum of individual components of risk, owing to correlations among risk factors. In addition, the extent to which PSIA share in the aggregate risks will vary across banks and overtime. The empirical challenge is to measure the aggregate risks, and its distribution between shareholders and IAH, before assessing Islamic bank's capital adequacy. The new IFSB capital adequacy standard moves partly in this direction, although not fully.

Capital adequacy of Islamic banks

Hassan and Dicle provide a useful survey of Islamic finance instruments and their risk characteristics and provide some valuable insights:

- PSIA create additional liquidity risks that need to be managed and taken into account in capital adequacy calculations.
- PSIA tied to *muḍārabah* or *mushāarakah*, or *ṣukūks* issued based on Islamic bank's asset portfolio, can help reduce liquidity risks and maturity mismatches.
- Given the relatively large exposure of Islamic banks to SME's, IRB approaches may be more suited to altering risk weights for SME borrowers.
- While several proposals exist on how to incorporate PSIA in bank capital adequacy formula, the amount and types of risks shared by the PSIA's can be calculated using bank specific experience under the New Basel Capital Accord. This however would require an internal modelling of bank risks.
- The fact that PLS accounts are not permanent (can be withdrawn) and pose additional liquidity risks means that they cannot be considered capital, but needs to be factored into the" capital adequacy ratio equation, but with a limited weight"

In all these issues, the draft IFSB standard proposes some initial solutions as described below.

a) While there is no explicit discussion of capital requirements for liquidity risk in the IFSB draft, (same is true of Basel II), the importance of sound liquidity risk management by banks and the importance of taking this into account in supervisory review are well recognized in the IFSB draft "Guiding Principles of Risk Management for IIFS".

b)The IFSB draft on capital adequacy proposes lower risk weight of 75% for retail exposures (including SME's) through *murābahah*, *ijārah*, and *istiṣnā'* Contracts. This is same as in Basel II, and is designed to capture diversification benefits of retail portfolios.

c) Development of innovative PSIA products linked to the issuance of *ṣukūks*, or PSIA's linked to specific asset classes can enhance the risk sharing characteristics of PSIA and make PSIA a key risk mitigate in Islamic finance. Thus the weight to be attached to PSIA in capital adequacy equation can be bank specific. IFSB draft allows for a specified fraction $(1-\alpha)$ of risk weighted assets (RWA) funded by PSIA, (and a fraction α of the assets funded by the reserves held for future distribution to PSIA's) to be deducted from total RWA for capital adequacy purposes. The fraction " α " is subject to supervisory discretion, based on

the extent of risk sharing with PSIA (i.e. Extent of displaced commercial risk borne by shareholders)

d) A key challenge is to develop a model based (or other indicator based) approach to estimating α . An estimation of α based on value-at-risk approach is discussed in my paper for this conference. This approach will, however require a strengthened supervisory review process to validate the model, and exercise discretion in approving the applicable weight for PSIA in the capital adequacy equation.