

IFSB Standards – Comparison to Basel II: Capital Adequacy

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Session Outline

- Common features of Basel II Pillar 1 and the IFSB Capital Adequacy Standard
 - Asset risk weights & credit risk mitigation
 - Market risk
 - Operational risk
 - Eligible capital
- Differences
 - Assets side:
 - particular risk characteristics of Islamic assets
 - credit risk mitigation
 - Funding side: Profit sharing investment accounts

Common Features: Asset Risk Weights & CRM

- IFSB CAS follows Standardised Approach
 - Lack of data for IRB approach
- Receivables under Murabaha, Salam & Istisna' contracts attract RWs of counterparties as under Basel II
- Approach to CRM is similar in principle, but there are some differences due to Shari'ah considerations

Common Features: Market Risk

- IFSB methods based on 1996 Amendment
 - Equity position risk in trading book & FX risk treatments essentially the same as Basel II
 - Method for bonds adapted for Sukuk
 - Maturity Ladder approach for commodities, but Simplified Approach is allowed
- Adaptations for Islamic bonds (Sukuk)
- Islamic *banking* assets may involve price risk exposures (see *differences*)

Common Features: Operational Risk

- IFSB CAS proposes Basic Indicator Approach as normal approach
- Standardised Approach may be used subject to supervisor's agreement re 'business lines'
- Definition of 'gross income' adapted to interest-free, profit-sharing environment

Common Features Eligible Capital

- Definition same as Basel II
 - No subordinated debt in Islamic banks
 - Profit sharing investment accounts are not part of eligible capital

Differences - Assets side

Risk characteristics of Islamic Assets (1)

- Islamic financing is either
 - Asset-based i.e. involves non-financial assets, or
 - Profit and loss sharing/profit sharing and loss bearing
- Most Islamic financing assets involve non-financial assets
 - Murabahah (credit sale of asset)
 - Salam (forward purchase of commodity)
 - Istisna' (construction contract financing)
 - Ijarah and Ijarah Muntahia Bittamleek (lease and lease-to-buy)

Differences - Assets side

Risk characteristics of Islamic Assets (2)

- There are also financings based on forms of partnership
 - profit and loss sharing (Musharakah)
 - profit sharing and loss bearing (Mudarabah)
- These result in a form of 'equity position risk in the banking book' but with a difference
- IFSB CAS applies Simplified Risk Weight Method or Supervisory Slotting Method

Differences – Credit Risk Mitigation

- Shari'ah restrictions & consequences
 - No provision of guarantees for valuable consideration
 - Limited availability of highly rated paper for use as collateral
 - Assets collateralised are often physical assets in Murabahah and IMB ('quasi-collateral') so don't normally reduce RW of exposure
 - But preferential RWs for RRE or CRE are applicable as under Basel II

Differences – Funding Side

- Profit-sharing investment accounts (PSIA)
 - Unrestricted PSIA replace conventional deposits
 - Restricted PSIA are off-balance sheet (normally) funds under management
- Operational risk charge required for both types
- In principle, no charge for credit or market risk for assets financed by Restricted PSIA
- More complicated for Unrestricted PSIA because of ‘displaced commercial risk’
 - see α (alpha) parameter on next slide

Differences – Unrestricted PSIA CAR formula

Eligible capital

[Total risk weighted assets (credit + market risks
+ operational risk)

Less

Risk weighted assets funded by Restricted PSIA (credit +
market risks)

Less

(1- α) (risk weighted assets funded by
Unrestricted PSIA (credit + market risks))

Less

α (risk weighted assets funded by PER & IRR of
Unrestricted PSIA (credit + market risks))]

If $\alpha = 0$, Unrestricted PSIA are treated the same as Restricted PSIA

If $\alpha = 1$, Unrestricted PSIA are treated the same as conventional
deposits (but with adjustment for PER/IRR)

Differences – Unrestricted PSIA

- PER and IRR are prudential reserves retained out of profits
 - PER = Profit Equalisation Reserve, retained out of profits before allocation between bank as fund manager & PSIA; used to smooth payouts to PSIA holders. Amount referred to is PSIA portion. Shareholders' portion is included in their reserves
 - IRR = Investment Risk Reserve, retained out of PSIA share of profits; used to cover losses attributable to PSIA.

Supplementary IFSB Capital Adequacy Standard

- ED about to be published
- Deals with issues not covered by existing standard
 - Shari'ah compliant securitisations (approach based on Pillar 1)
 - Investments in real estate
 - capital treatment based on Pillar 1
 - Includes prudential limits on real estate investment

Concluding Remarks

- Major problems in adapting Basel II methodology to Islamic banking
 - Profit sharing investment accounts:
Unrestricted PSIA somewhere between deposits and Collective Investment Schemes:
 - RWA to be included in CAR denominator
 - Financing on a profit & loss sharing basis (Musharakah) or profit sharing and loss bearing basis (Mudarabah):
 - Risk Weights