

Secretary-General

11 March 2016

Mr. William Coen

Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Mr. Coen,

Feedback on the Second Consultative Document on Revisions to the Standardised Approach for Credit Risk

It was a pleasure for the IFSB to participate in the latest Basel Consultative Group Meeting that was held in Abu Dhabi in January 2016. Please find attached a Note containing comments that follow from the presentation made by Mr. Frank Pierschel at the BCG meeting on the second Consultative Paper on Revisions to Standardised Approach for Credit Risk. The IFSB Note focuses on risk weights applied to equity exposures, real estate and project finance exposures.

We note the reduction in the risk weight applied to equity exposures under the standardised approach. However, the concern about simplicity at the expense of risk-sensitivity still remains with respect to the flat risk-weight treatment proposed for all types of equity exposures, especially when considering the various equity-based contract types in Islamic finance that fall under this category. The proposed risk-weight treatment would not be able to account for some of the variations in underlying risk factors that may be present in the different equity-like contracts practiced by Islamic banks.

Noting that the type of equity position in the banking book that is envisioned in Basel II is equity holdings in companies that are customers of the bank which are also debtors of the bank for loan financing, we would like to further explicate the types and nature of equity exposures that are relevant to Islamic finance. Islamic banks have exposures to equity-like financing instruments (profit-sharing instruments) which are a type of equity exposure in the banking book as defined in Basel II, but which, in many cases are different in nature and purpose from those envisaged in Basel II. Naturally, this implies a need for greater flexibility in assigning risk weights to such types of financing. Particularly, there are different risk implications given the variations in operational structures of the equity-like contracts being practiced and in some cases, the combination of equity-like financing with debt- or lease-based subcontracts. These structural peculiarities and their associated risk-mitigating effects can produce lower risk exposures compared to a pure equity holding.

These considerations are particularly relevant in light of concerns that have been raised by practitioners and regulators regarding the high risk-weights proposed for equity-based exposures, as well as concern that regulators may not operationally recognise the different risks inherent in the various types of equity participation arrangements employed by Islamic banks for financing purposes.

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The IFSB has sought to provide some guidance on this matter in its capital adequacy standard (IFSB-15) that complements the Basel III capital framework. Accordingly, the treatment of credit risk exposures and capital impairment risk arising from the aforementioned forms of equity investments takes into consideration, a number of factors, including: (i) the structure and purpose of the enterprise; (ii) the types of the underlying assets in which the funds are invested; (iii) the credit risk rating of the counterparty; (iv) the credit risk mitigation techniques used; and (vi) the amount of specific provisions made for the overdue portion of accounts receivable, among others. The treatments prescribed in IFSB-15 provide greater scope to apply lower risk-weights when appropriate, than those required by the simple risk-weight method, subject to a robust supervisory review of various factors, including the infrastructure and capacity of the IIFS to monitor the performance and operations of the financed entity, the quality of the collateral used, the nature of business activities to be undertaken, the legal and regulatory environment, adequacy of financial control and reporting system of the customer and the bank, information sharing procedures, valuation methods and exit strategies.

In view of the above and highlighting the need to provide the appropriate degree of risk sensitivity in the treatment of the distinct equity exposures of Islamic banks, we would suggest the retention of a range of risk-weights, with some room for supervisory discretion in the treatment of the equity based exposures.

In addition to treatment of equity exposures, we have provided comments in two other areas where institutions offering Islamic financial services are more active: which are project finance and real estate exposures.

Based on the above and given the distinct types of risk exposures and mitigating factors in the various equity-type contracts used in Islamic finance, further consideration is needed to provide the appropriate risk sensitivity of the treatment for equity exposures. Therefore, we would suggest the retention of a range of RWs, with some room for supervisory discretion in the treatment of the equity based exposures, reflecting the appropriate degree of risk sensitivity.

With highest regards and best wishes.

Yours sincerely,



Jaseem Ahmed



**Feedback on the Basel Committee on Banking
Supervision's Second Consultative Document on
Revisions to the Standardised Approach for Credit Risk**

11 March 2016

Reference of Consultative Document” Section 1.3, page 9 - para 5, bullet-point 1 & Annexure 1, page 33, para 43

EQUITY EXPOSURES

1. We would like to comment on the proposal to apply a flat risk weight of 250% to all types of equity exposures.
2. The application of a flat risk weight (RW) across all types of equity exposures may be overly simplistic when considering equity based contracts in Islamic finance, as it does not fully capture the varying levels of risk for the different types of equity exposures in Islamic banks. We also agree to the feedback on the 2014 consultative document that a flat risk-weight treatment would not reflect the credit quality of the issuer and the actual risk ranking of such exposures. Similarly, we endorse the view that applying the most conservative risk weights of the IRB approach for significant equity exposures (300% and 400%) to all equity exposures under the revised Standardised Approach (SA) would increase the gap between capital requirements calculated under the SA and IRB approach. Though the RWs have been reduced to 250% in the second consultative document, the problem of using the simplistic version and the lack of risk sensitivity remain. The type of equity position in the banking book that is envisioned in the relevant paragraphs of Basel II is equity holdings in companies that are customers of the bank which are also debtors of the bank for loan financing. Such equity exposures (shares) may or may not be listed on a recognised stock exchange.
3. Islamic banks have exposures to equity-like financing instruments (profit-sharing instruments) which are a type of equity exposures in the banking book as defined in Basel II, but which in many cases are different in nature and purpose from those envisaged in Basel II as described above. This implies a need for greater flexibility in assigning risk weights to such types of financing. A number of cases where different treatment of such equity exposures is warranted are discussed in the following paragraphs.
4. Equity-like contracts used by Islamic banks generally take the form of profit-and-loss-sharing financing with two main modalities. One is profit-sharing and loss-bearing (*Muḍārabah* financing) whereby the financier (bank) provides capital and the recipient undertakes the financed operation. The profits are shared whereas all losses are borne by the financier (bank). The second modality is pure profit-and-loss-sharing partnership

(*Mushārah*) where the two parties have equity-like financing of a project, and share the profits and losses. A variant of the latter is a form of *Mushārah* in which one partner (the customer being financed) progressively buys out the share of the other partner (the bank) over the life of the contract.

5. In fact, Islamic banks apply a number of variations of the aforementioned contracts, in which equity financing may be combined with other debt-like sub-contracts (such as lease or sale-based sub-contracts) or with other structural peculiarities that mitigate risk exposures, thereby lowering the level of risk compared to a pure equity holding.
6. Recognising the need to account for differences in the various types of equity exposures of Islamic banks, the IFSB differentiates between them and has provided guidance in IFSB-15 (IFSB Revised Capital Adequacy Standard, December 2013) on applying RWs to an Islamic bank's credit exposures to profit sharing modes under five categories. The nature the equity financing in the aforementioned categories, are briefly outlined below.
 - (a) **Financing of a commercial enterprise to undertake trading activities or a business venture:** In this form of equity investment, an Islamic bank invests in a commercial enterprise with the intention of holding the investment for an indefinite period or with a view to eventual sale (in the case of venture capital or private equity investments). As an equity investor, the banks' rights and entitlements are subordinated to the claims of secured and unsecured creditors.
 - (b) **Financing extended via diminishing *Mushārah*** in which the share of the Islamic bank is gradually reduced during the tenure of the contract until the asset is fully sold to the partner(s): In this type of financing, the bank enters into a partnership with the objective of transferring ownership to the customer, where the bank initially acts as joint-owner of the asset. The customer as a partner gives a binding promise to buy out the bank's share by making payments on specified future dates in accordance with a separate contract of sale entered at the same time. A diminishing partnership contract for working capital finance is similar to an equity exposure held in the banking book, but the RWs in this case may also be subject to a consideration of third party guarantees. This type of contract may also be associated with either a specific fixed asset/real estate leased to the customer under a lease contract or to the general working capital of the customers' business venture. In this case, the former would have a lower risk exposure compared to the latter. In particular, this type of contractual arrangement is used for home purchase finance, where the financier retains the title to the proportion of the asset(s) being financed for which the customer has not yet paid.

(c) **An equity investment in a company or an Islamic collective investment scheme not held for short-term re-sale or trading purposes:** This type of holding is similar to an equity position held in the banking book and is not considered a trading book exposure.

(d) **A specified project:** A form of project financing where the bank as the supplier of financing advances bridging funds to an entity (the contractor) for undertaking a project for a third party (the final customer). In this structure the bank is entitled to a share of the contractor's profit on the project, but must bear 100% of any loss. While the bank does not have any direct or contractual relationship with the final customer, the bank stipulates that payments by the final customer to the contractor be made to an account (a 'repayment account') with the bank. Thus the risk exposure of the bank from the amounts advanced to the entity undertaking the project is mitigated by the amounts received from the final customer into the repayment account which are effectively collateralised. Hence, while the financing advanced to the contractor undertaking the project would normally be treated as an equity position in the banking book, the use of a structure involving the repayment account has the effect of substituting the credit risk of the ultimate customer for that of the financed entity, to the extent of the collateralised balance of the repayment account.

(e) **Joint ownership of real assets or movable assets on a (partnership) *Mushārah* basis for onward lease or sale basis:** In this form of contract, the bank can establish joint ownership of tangible fixed assets with a customer on a partnership basis with the assets being sold or leased to the customer. If the additional contract is a lease sub-contract, the ownership of the assets can produce rental income from the partnership. In this case, the risk of the partnership investment is that of the underlying lease contract, where the credit risk is mitigated by the underlying asset which acts as 'quasi-collateral' (i.e. the asset can be repossessed in the event of default by the lessee). In the case of a sale-based sub-contract, the Islamic bank is entitled to its share of income (mark-up profit) generated from selling the assets to third parties.

7. As is evident in the above delineations of various profit-sharing financing contracts extended by Islamic banks, these forms of equity-like financing call for differences in application and determination of risk weights for equity holdings, to reflect the risk implications of the differences in the instruments and operational structures.
8. The credit risk exposures and the capital impairment risk arising from such equity investments included on the asset side can be appropriately risk-weighted with due consideration to a number of factors, including: **(i) the structure and purpose of the**

enterprise; (ii) the types of the underlying assets in which the funds are invested; (iii) the credit risk rating of the counterparty; (iv) the credit risk mitigation techniques used; and (vi) the amount of specific provisions made for the overdue portion of accounts receivable, among others. For instance, a pertinent distinction in the application of RWs between *Muḍārabah* and *Mushārah* contracts is whether the Islamic bank acts as a silent partner or is involved in the management of the investment. From a risk management perspective, a distinction needs to be made between these two forms of contract in terms of the discretion to apply a lower RW where the Islamic bank is involved in management of the investment. The use of *Sharī'ah*-compliant risk mitigation techniques to reduce credit exposure is also quite pertinent as is the risk of possible capital impairment. The use of such risk mitigation and the subsequent reduction in credit exposures need to be taken into account when applying appropriate RWs.

9. In the case of equity-like financing that is associated with a subcontract that is debt-based, IFSB-15 recommends a 'look through' principle, whereby the RW applied is that of the underlying contract (for example, if it is associated with a lease-subcontract, the risk of the partnership is that of the underlying lease contract). If the same financing structure is associated with a sale-based subcontract, the bank as the capital contributor is exposed to credit risk in respect of receivables from the buyer/counterparty. Thus, the RW for this form of partnership-based investment can be based on the credit standing of the counterparty/buyer, where external assessments of credit ratings are available. Moreover, in cases where the partnership-based contract is related to a specific tangible asset (chattels or real estate), further provision can be made in applying RWs, based on the fair value of the asset to which the bank has title.
10. These considerations are particularly relevant in the context of the concerns that have previously been raised by practitioners and regulators regarding the high RWs proposed for equity based exposures, as well as concerns that regulators may not operationally recognise the different risks inherent in the various types of equity participation arrangements employed by Islamic banks for financing purposes. The IFSB sought to provide appropriate guidance on these matters in IFSB-15.
11. The treatments proposed in IFSB-15 provide greater scope to apply lower RWs when appropriate than those required by the simple risk-weight method, subject to a robust supervisory review of various factors, including the infrastructure and capacity of the IIFS to monitor the performance and operations of the financed entity, the quality of the collateral used, the nature of business activities to be undertaken, the legal and regulatory

environment, adequacy of financial control and reporting system of the customer and the bank, information sharing procedures, valuation methods and exit strategies. Similarly, the use of the supervisory slotting method could also be considered, which treats the investment as a type of specialised financing, and requires banks to map their internal risk grades into four supervisory categories for specialised financing with associated risk weights ranging from 90%-270%.

- 12. Given the distinct types of risk exposures and mitigating factors in the various equity-like contract types used in Islamic finance, further consideration is therefore needed to provide the appropriate risk sensitivity of the treatment for such equity exposures**, particularly since a flat risk-weight treatment across all equity holdings would not properly reflect the actual risk ranking of the various types of equity exposures involved in profit sharing contracts in Islamic finance. **Therefore, we would suggest the retention of a range of RWs, with some room for supervisory discretion in the treatment of the equity based exposures, reflecting the appropriate degree of risk sensitivity.**

Page 8, Section 1.2 and Annexure 1, Page 32, para 41

PROJECT FINANCE

- 13.** While the IFSB does not differ on the proposed simpler approach for risk-weighting Project Finance exposures (at 150% during the pre-operational phase and 100% during the operational phase), with respect to the particularities of Islamic finance, greater granularity may be needed in the risk-weighting approach in two specific cases to increase risk sensitivity. The first case is where the bank provides financing in the form of stage payments to an enterprise (the contractor or sub-contractor) which is under contract to produce a constructed or manufactured asset to a third party (the customer or off-taker) who in turn makes payments to the bank on a contractually agreed basis (called *Istisnā* / Parallel *Istisnā* contracts). The bank's profit consisting of the spread between its receipts from the ultimate customer and its payments to the contractor. The second case is where a sale based contract (called *Muḍārabah*) is used to provide project financing with a 'repayment account' structure as described in paragraph 6(d) above. In these two cases, the treatment set out in IFSB-15 may be more appropriate in terms of providing a greater discretion in applying a relevant RW in line with the level of risk exposure, since this treatment has been developed to account for the specificities of the aforesaid contracts. In this context, IFSB-15 proposes an application of either the Simple RW method or the supervisory slotting criteria approach for specialised financing with RWs ranging from

70%-250% for *Istisnā* financing, or 90-270% in the case *Muḍārabah* financing, with 0% RW for the amount held with the Bank in the “repayment account”.

Page 14, section 1.5.1, Annex 1, Section 9.1, 9.2

REAL ESTATE EXPOSURES

14. The revised proposal on the risk-weighting of Real Estate exposures remains appropriate from the perspective of conventional exposures (lending) and could also be applicable to real estate financing provided under sale-based contracts in Islamic finance (such as *Murābahah*) or other similar contracts where financing is provided by the bank through the sale of an asset (in this case, real estate) at a mark-up/profit for deferred payment on an instalment basis. However, real-estate exposures from lease-based contracts (such as *Ijārah* and *Ijārah Muntahia Bittamlīk*) may call for application of the distinct treatment that has been proposed in IFSB-15 rather than the RW treatment that has been designed for loan finance-type transactions which may not be suitable for the specific risk characteristics of lease-based contracts.