Islamic Risk Management – Afghan Style

Dr. Natalie Schoon is an internationally renowned risk management, Islamic banking and finance expert, based in London. Following the most recent Islamic fund development project in Afghanistan, GRU asked her to contribute an article on risk management in that country.

Similar to any other jurisdiction, Afghanistan has implemented the appropriate regulations to comply with Basel II and the Financial Action Task Force (FATF). Anyone could be forgiven for thinking that theoretical and practical implementation of these regulations is the same. Practice has a tendency to be different from theory and risk management in Afghanistan is no exception.

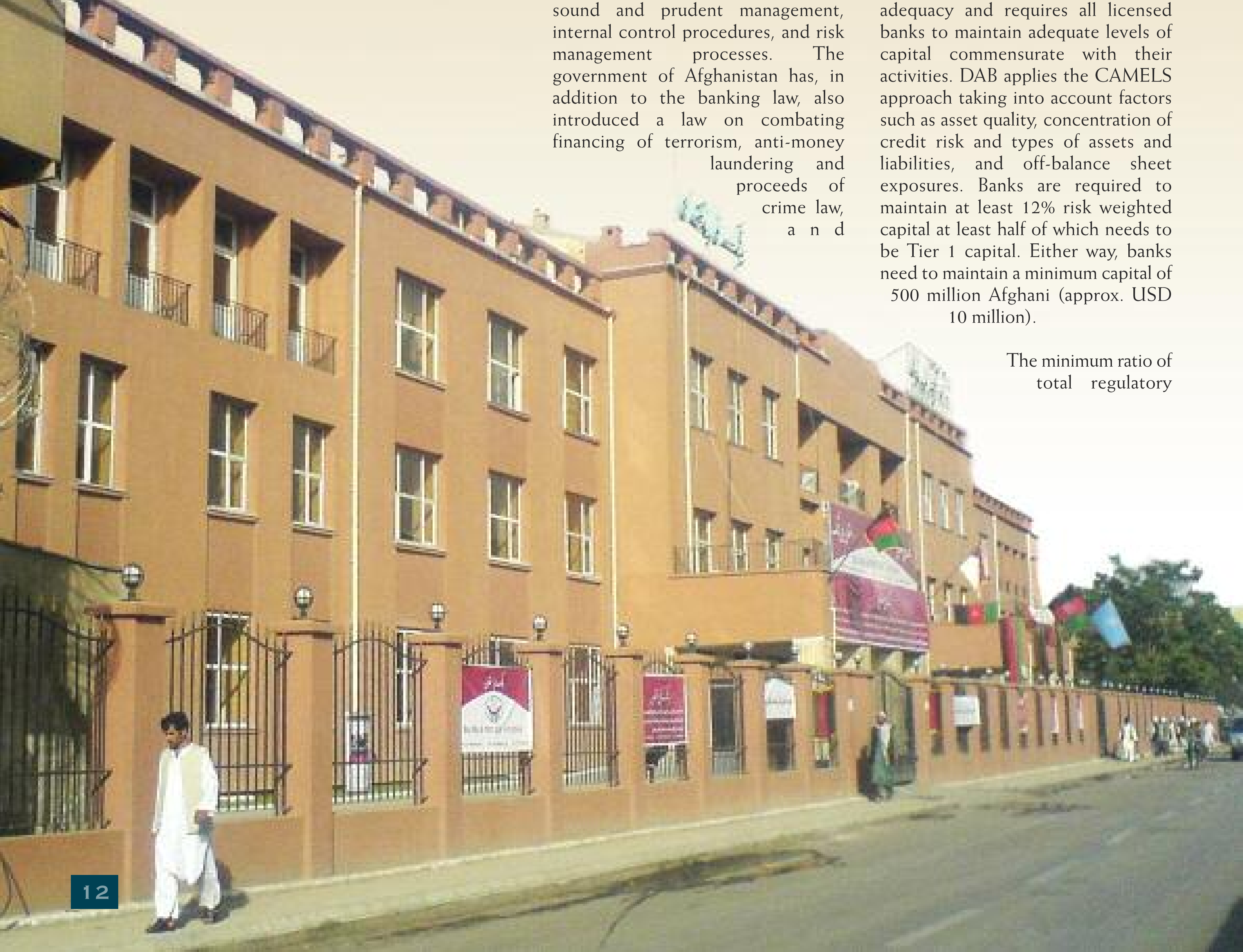
The Regulations

Banks established in Afghanistan are subject to the Banking Law of the Islamic Republic of Afghanistan and the regulations of Da Afghanistan Bank (DAB). The regulations that are issued and maintained by DAB are similar to those found in other jurisdictions and include procedures for licensing, cooperation with foreign regulators, and the requirement for sound and prudent management, internal control procedures, and risk management processes. The government of Afghanistan has, in addition to the banking law, also introduced a law on combating financing of terrorism, anti-money laundering and proceeds of crime law, and laws regarding secure transactions related to moveable and immoveable properties.

Capital Adequacy

DAB's capital adequacy regulations were issued in 2006 and span a whopping 13 pages which makes them shorter than many summary papers on the subject. DAB applies a risk based approach for the calculation of capital adequacy and requires all licensed banks to maintain adequate levels of capital commensurate with their activities. DAB applies the CAMELS approach taking into account factors such as asset quality, concentration of credit risk and types of assets and liabilities, and off-balance sheet exposures. Banks are required to maintain at least 12% risk weighted capital at least half of which needs to be Tier 1 capital. Either way, banks need to maintain a minimum capital of 500 million Afghani (approx. USD 10 million).

The minimum ratio of total regulatory



capital to risk weighted assets is calculated as Total Capital minus prescribed deductions divided by Risk Weighted Assets.

DAB applies slotting criteria for risk weighting with four risk categories attracting 0%, 20%, 50%, and 100% risk weighting.

DAB Risk Weighting Categories

1. **Category 1 – 0%.** Including cash in Afghani and readily convertible currencies, balances with and claims on selected central banks, and loans fully collateralised by precious metals and precious stones, current accounts with DAB, or cash.

2. **Category 2 – 20%.** Including loans fully guaranteed or collateralised by selected central banks or central governments, cash in the process of collection, and banks operating in selected jurisdictions.

3. **Category 3 – 50%.** Including first lien residential mortgages, and loans to finance pre-sold or pre-leased real estate construction.

4. **Category 4 – 100%.** Including loans to private individuals, and any assets not captured in any of the other categories.

The recent changes in capital adequacy regulations resulting from the financial crisis appear to have largely passed by DAB, at least for the moment.

Assessing Credit Risk

Afghanistan is largely a cash based society particularly in relation to private financial transactions. Businesses, however, do turn to banks or suppliers for their financing needs. Besides the rather briefly defined capital requirements and regulatory reporting requirements including large exposure reporting, DAB does not provide the banks with any further requirements in their risk management operations. Generally speaking, banks in Afghanistan follow very similar principles to other banks in applying "know your customer" principles, and assessing the credit worthiness of clients.

There are, however, some interesting issues that apply to determining the credit risk of business counterparties. As a result of the economic and political circumstances in Afghanistan, many businesses have only relatively recently been (re)established, many of them with the use of funds made available by foreign donors. The vast majority of these funds have been provided free of charge as part of the on-going development effort. One of the unintended side effects of this situation is that businesses do not seem to have a notion of the obligations associated with taking out a loan such as the fact that it has a cost associated with it in the form of interest and the requirement of timely repayments. As a result, the efforts associated with recovering funds can be significantly higher than in some other jurisdictions.

Whether it has been due to the availability of free money, the economic climate, or both, many businesses have rapidly grown in a short period of time without necessarily evolving beyond the paternalistic stage of management. Although businesses have to be registered with the Ministry of Commerce, they are generally still run by the owner and his closest family, and are hardly seen as a separate entity. Accounting information is sketchy at most, and accounting systems are typically not in use. The absence of accounting information including profit and loss accounts, income statements and cash flow projections make forecasting difficult which is further hindered by a lack of financial analysis skills and other required resources.

In order to guarantee a loan, banks typically request collateral well in excess of the loan amount. This is not different from financial services in other countries. The ability to seize the collateral, however, is by far more difficult than it would be in western countries. Although a form of title deed exists, not every type is recognised by the current government causing further challenges for credit risk management.

In order to overcome the challenges that exist with repayment habits and the enforceability of collateral, many financial institutions have implemented the practice of requesting character witnesses to assess the willingness and ability of an applicant to repay a loan or to request guarantees instead of, or in addition to, any collateral. The enforcement of guarantees can, however, have completely different side effects. Having followed due process, and finally calling on a guarantor may result in the bank being repaid. Even so the original borrower may not live too long thereafter as guarantors generally do not take kindly on being called on and literally take the law in their own hands.

> The rules and regulations in Afghanistan are easy enough to abide by, and from what can be observed, easy enough to bend if needed.

Conclusions

The rules and regulations in Afghanistan are easy enough to abide by, and from what can be observed, easy enough to bend if needed. Practical solutions are found to overcome challenges with managing credit risk. In a country generally still considered a war zone with different cultural norms, where repayment of a loan is generally deemed to be optional, collateral cannot really be enforced, and calling on a guarantor may result in the death of the original borrower, managing credit risk may sound like a completely different kettle of fish, but the principles largely remain the same. After all, in the end it is all about maximising the chance to be repaid.

Natalie Schoon can be contacted at NS@riskrewardlimited.com