FAQs on IFSB-13:

Guiding Principles on Stress Testing for Institutions Offering Islamic Financial Services

Q1: How does IFSB-13 differ from TN-2 (Technical Note on Stress Testing for Institutions Offering Islamic Financial Services)?

Answer: IFSB-13: Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services is intended to complement the existing international stress-testing frameworks (which were developed with conventional banking in mind), by taking into consideration the specificities of IIFS, and to contribute to the soundness and stability of the IFSI and the financial sector as a whole. IFSB-13 follows a principles-based approach and includes guidance on the basic elements that a stress-test framework in IIFS and RSA should incorporate. However, IFSB-13 does not provide technical guidance on how to conduct the stress tests in practice. During the development of and public consultation on IFSB-13, the need for detailed guidelines on the operationalisation of IFSB-13 was emphasised. It was agreed to address the technical details of stress testing in due course in a separate IFSB Technical Note.

Q2: What are the main lessons learnt from the financial crisis that should be taken into consideration when designing stress testing framework for IIFS?

Answer: Although it has emerged that IIFS were resistant to the financial crisis to a certain extent, especially with respect to "first-round effects", when the financial crisis turned into an economic crisis, IIFS were exposed to "second-round effects", being affected by the general downturn and the fall in the value of assets. With regard to the specificities of IIFS, the question remains of how well IIFS will be able to absorb stresses and shocks that are more specific to the Islamic financial market with regard to, for instance, credit, market and operational risks, rate of return risk and displaced commercial risk, and (perhaps particularly) liquidity risks? This implies an approach to stress testing (including various specific scenarios) that differs in some respects from that applicable to conventional institutions, which IFSB-13 aims to set out and to explain.

Q3: Why PSIA [profit-sharing investment accounts], and especially unrestricted IAH, must be accounted in stress testing programme under specific scenarios?

Answer: Many IIFS get a significant part of their funding from unrestricted PSIA. Stress tests need to encompass the assets financed by unrestricted PSIA which are commingled with those financed by the own funds of the IIFS, along with other accounts like current accounts, etc. While, in principle, unrestricted IAHs bear the credit and market risks arising from the assets financed by their funds, shocks to these assets cannot be ignored as they are likely to have repercussions for the IIFS, such as Displaced Commercial Risk (DCR). In contrast, restricted PSIA are separate managed funds which are not commingled with other funds of the IIFS. Shocks to the assets of these funds will generally not have the same repercussions as shocks to those of unrestricted PSIA. This indicates a need for specific stress testing scenarios to be included in the stress testing methodologies to account for the various perspectives of PSIA and their treatment by IIFS in practice.

Q4: What are the main differences between scenario analysis and sensitivity tests within the stress testing framework? Can IIFS choose any of them?

Answer:

1- Differences between scenario analysis and sensitivity

In particular, it is important to distinguish between sensitivity analysis and scenario analysis. The latter is more powerful if used properly, since it can reflect the effects of several adverse conditions occurring simultaneously (e.g. a property price fall plus a credit freeze). In addition, scenario tests are characterised by a more complicated structure and include a simulation of several variables at the same time. Such an analysis is more valuable than a univariate one (like sensitivity tests), because it takes into account the possible inverse correlation between the impacts of individual risks. For example, an increase in the volume of financing originated by an IIFS increases its profitability, but it will also tend to increase credit risk and (through maturity mismatches) liquidity risk.

Can IIFS choose any of them?

Further, it is noted that there are circumstances where IIFS uses the combination of both approaches depending on their risk profile and strategic decisions. A less sophisticated IIFS may use sensitivity analysis to form a first approximation of the impact. Often a combination of both approaches may result in more resilience and diversification of the scope of analysis, by considering different severities and perspectives. In any case, IIFS should ensure that they undertake the sensitivity analyses and scenario analyses by using appropriate models (i.e. deterministic or stochastic, etc.), data and parameters (i.e. historical or hypothetical), and

forecasting periods (i.e. long-term or short-term). In addition to sensitivity analyses and scenario analyses, the main requirement should include the review and update of changing dependencies and correlations assumed between assumption and parameters.

Q5: What is exactly the role of Sharia Supervisory Board (SSB) in stress testing framework?

Answer: The role of the SSB in the stress testing framework should be clearly defined and documented by an IIFS in the policy development. Hence, in preparing written policies and executing action plans (i.e. remedial actions) as a result of the stress testing exercise, the SSB should be consulted to ensure that all aspects of Shariah-compliance are appropriately addressed so as to avoid any doubt with regard to the Shariah aspect.

Q6: What is the rationale behind including off-balance sheet items in the stress test scenario?

Answer: In addition to stressing on-balance sheet assets, an IIFS should also capture off-balance sheet exposures in its stress tests to determine the effects on its credit, liquidity and market risk profiles of off-balance sheet items such as commitments, guarantees and liabilities of unconsolidated special purpose entities (SPEs) in order to deliver a complete picture of IIFS-wide exposures.

Q7: Does IFSB offer/recommend any template for stress testing?

Answer: The use of appropriate and comprehensive methodologies in stress testing programmes is crucial in realising the purpose of the stress testing. However, given the varying risk management cultures among IIFS, the models and methodology developed and employed by IIFS may differ among IIFS. These Guiding Principles do not intend to prescribe any particular methodologies; instead, they are designed to enhance IIFS' practices in stress testing – in particular, by identifying the types of methodologies that should be considered by IIFS in designing stress testing programmes proportionate to their size and complexity.

Q8: How does capital planning-related stress testing differ from ICAAP (internal capital adequacy assessment process?

Answer: To be effective for capital planning purposes, a range of scenarios should be considered including, at least, an adverse economic scenario that is severe but plausible, such as a severe

economic downturn and/or a system-wide shock to liquidity. The stress should be IIFS-wide and cover all relevant risk areas and material entities within the IIFS, and scenarios used for the capital planning stress test should take account of all relevant material risks to which the IIFS is exposed. In this perspective, the objective of the capital planning-related stress testing should be to indicate how an IIFS can meet its capital requirements (whether regulatory minimum capital requirements or economic capital (i.e. ICAAP) requirements) at all times throughout a reasonably severe economic recession. Stress tests under ICAAP should be consistent with an IIFS's risk appetite and strategy, and contain credible mitigating management actions. In this context, IIFS is expected to exhibit a clear link between their risk appetite, business strategy, capital planning and stress testing programmes.

Q9: Since both stress testing and reverse stress testing are risk management tools, which of them is supposed to be conducted first? And why?

Answer: Reverse stress testing starts from a known stress test outcome (such as breaching regulatory capital ratios, or a liquidity crisis) and then asking what events could lead to such an outcome for the IIFS. As such, reverse stress testing complements, in an important way, the existing stress testing framework. It requires an IIFS to assess scenarios and circumstances that would put its survival in jeopardy, thereby identifying potential IIFS-wide business vulnerabilities.

Q10: What are the model and parameter risks posed by using models for stress testing? How can they be detected?

Answer: Where models are used, an IIFS should bear in mind that it cannot exactly replicate the real world; hence the use of the model itself poses modelling and parameter risks. While conducting stress testing, if the results show that a certain model is unstable or does not work as originally intended with extreme inputs, then management should consider rethinking the model, modifying certain parameters, or at least putting less weight on the accuracy of model output. In this respect, an expert opinion (which can provide an IIFS with adequate feedback and input on the effectiveness of models used in its stress testing) should be considered by the IIFS for model validation purposes. Any proposed amendments to the methodology of stress testing and its procedures should be approved by senior management of the IIFS.