Capital Management in Islamic Finance:
Would Conventional Regulatory requirements be Appropriate for Islamic Finance?

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Outline

The role of capital: Islamic vs. conventional banks

The regulatory reform and enhancing regulatory capital: Convergence to Islamic Concepts?

Challenges in capital management in Islamic banks

How to address these challenges?

The role of capital: Conventional vs. Islamic

Conventional banks (CB):

- **The capital absorbs all type of losses from:**
  - **financial risks (credit, market, liquidity) and**
  - **non-financial risks (operational , reputational, etc)**

Islamic banks (IB):

- **The capital <u>does not bear the losses</u> that could result <u>from the risks of assets financed by PSIA</u> *(credit and market risks)* since under a Mudharabah contract losses are to be borne solely by the investment account holders.**

- **The IB could use Investment Risk Reserve (IRR) and Profit Equalisation Reserve (PER) to protect the PSIA investors from financial risks.**

The role of capital: Conventional vs. Islamic

- **Islamic bank capital bear losses for the following types of risks and events :**

  - **This risk arises from negligence or misconduct on the part of the IB in managing the PSIA (e.g. breach of terms and conditions of an investment mandate). This is <u>operational risk</u>.**

  - **Risks (not covered by IRR) in <u>assets funded by capital & other liabilities (excluding PSIA).</u>**

- **IB bank enjoys additional buffer through the loss-sharing nature of some liabilities.**

The Global Reform Agenda

Reform Agenda

Micro-prudential

Basel 3: Capital / Risk Capture / Leverage

- More restrictive definition of capital
- More demanding capital ratios; bigger capital buffers
- Higher capital charges for counterparty risk
- Formal leverage ratio constraint

Basel 3: New minimum quantitative liquidity standards

- Liquidity Coverage Ratio: to survive a 1 month stress
- Net Stable Funding Ratio: requires longer term funding sources

Macro-prudential

Systemic risk:

SIFIs "TBTF", Volker Rule; surcharges; Levy and resolution funds; OTC derivatives and central clearing; non-bank financial institutions

Compensation; cross-border resolution; countercyclical provisioning and capitalization; accounting.

The Regulatory Reform and Enhancing Regulatory Capital

Capital

Better quality, consistency and transparency of capital

- Predominance of Tier I capital
- Phasing out of Hydrides
- Phasing out of Tier III
- Harmonization of deductions

The case in IBs

Play limited role in IBs

Limit leverage

- Leverage ratio

Leverage is low in IBs

Forward looking and counter cyclical capital

- Capital conservation measures
- Forward looking provisioning
- Counter cyclical capital

IRR plays similar role

PER plays similar role

From Basel I to Basel III

Basel I

- Capital adequacy framework :
  - Credit risk
    - Fixed risk weights
  - Market risk

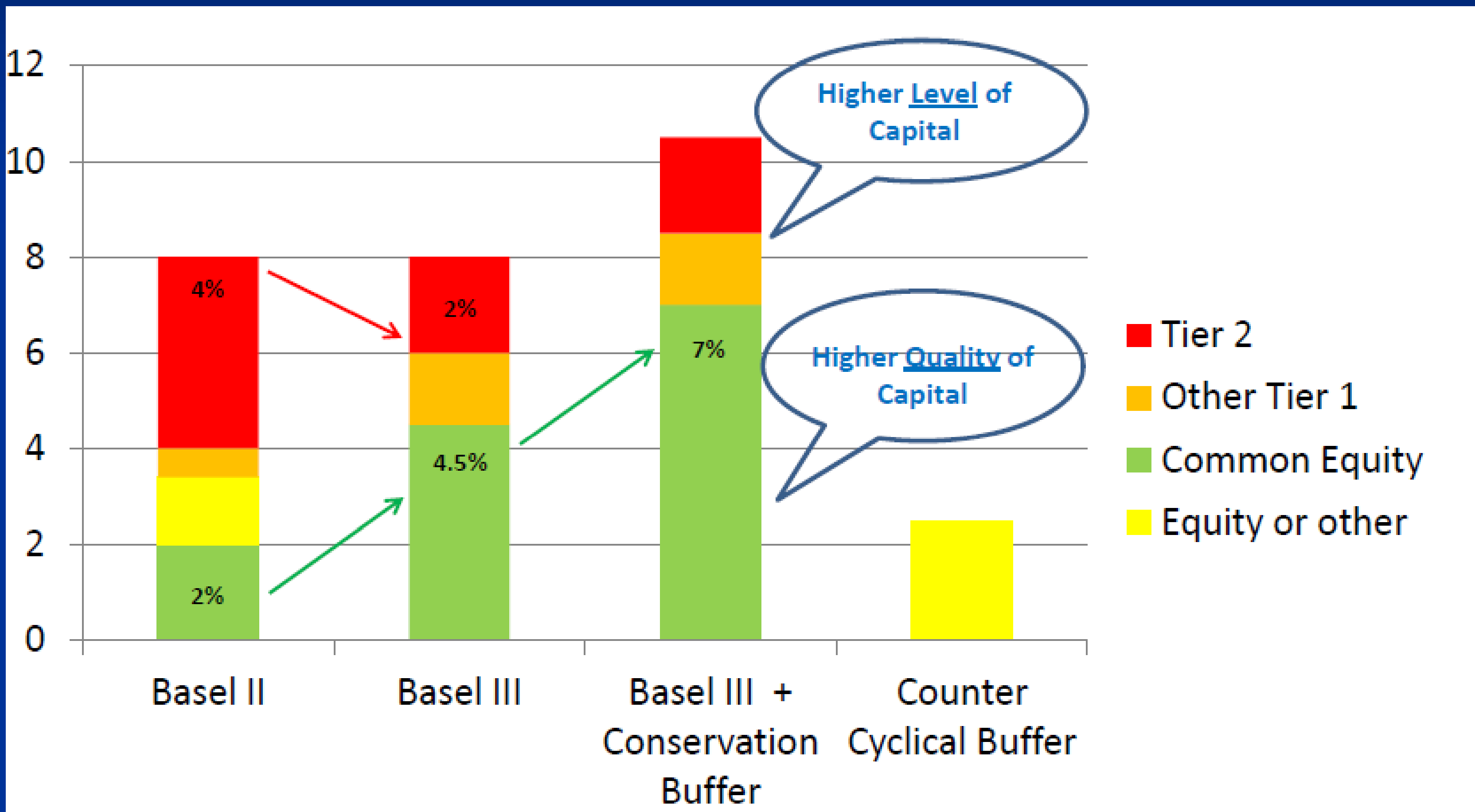
Basel II

- Capital adequacy framework:
  - Credit risk
  - Market risk
  - Operational risk
- Menu of more risk-sensitive approaches
- Supervisory review process
- Disclosure requirements

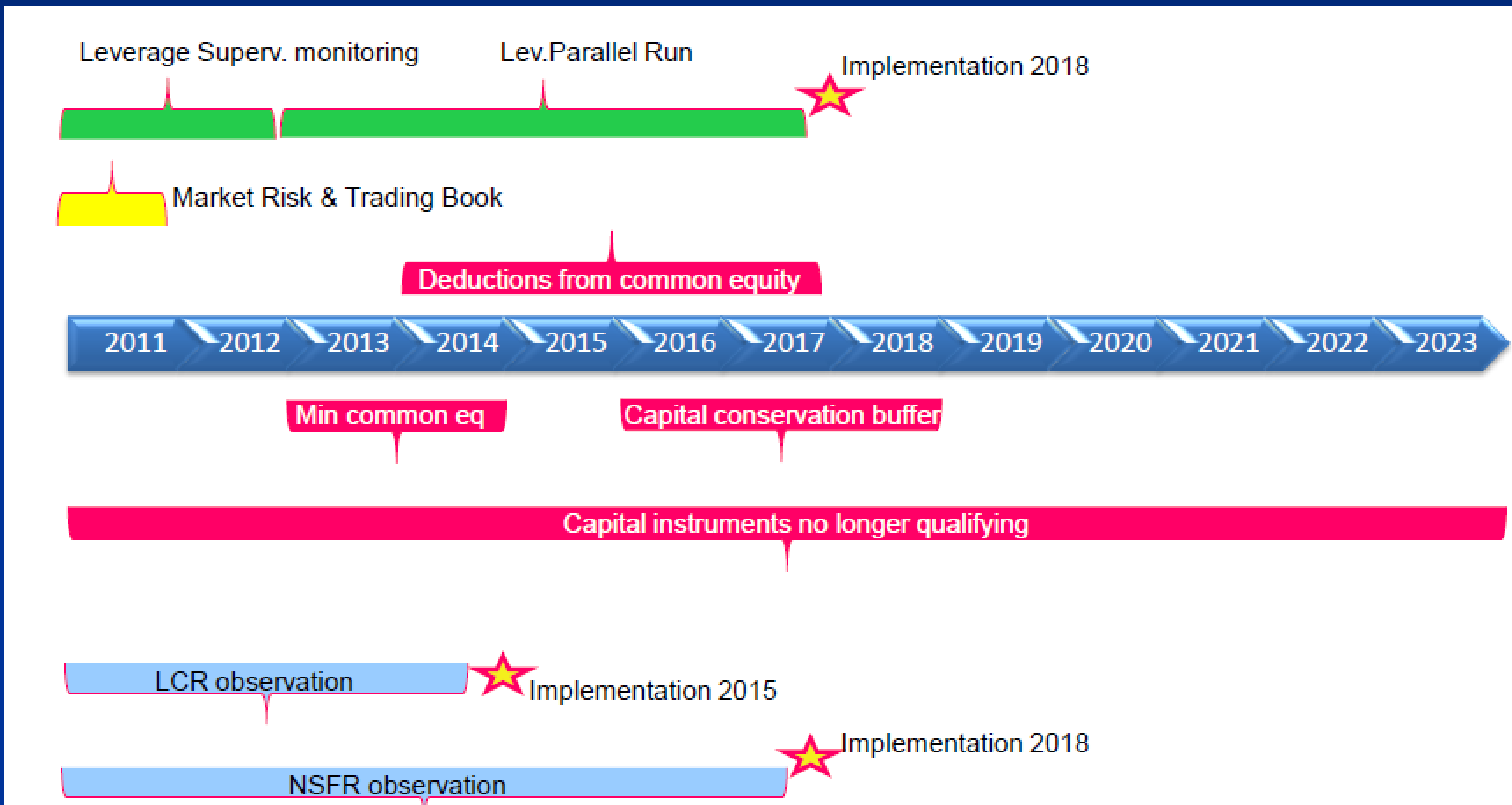
Basel III

- Capital adequacy framework:
  - Better capital base
  - Better risk coverage
  - Leverage ratio
  - Procyclicality
  - SIFIs
- Liquidity framework:
  - Short term LCR
  - Longer-term NSFR

Basel III: More and Better Quality Capital

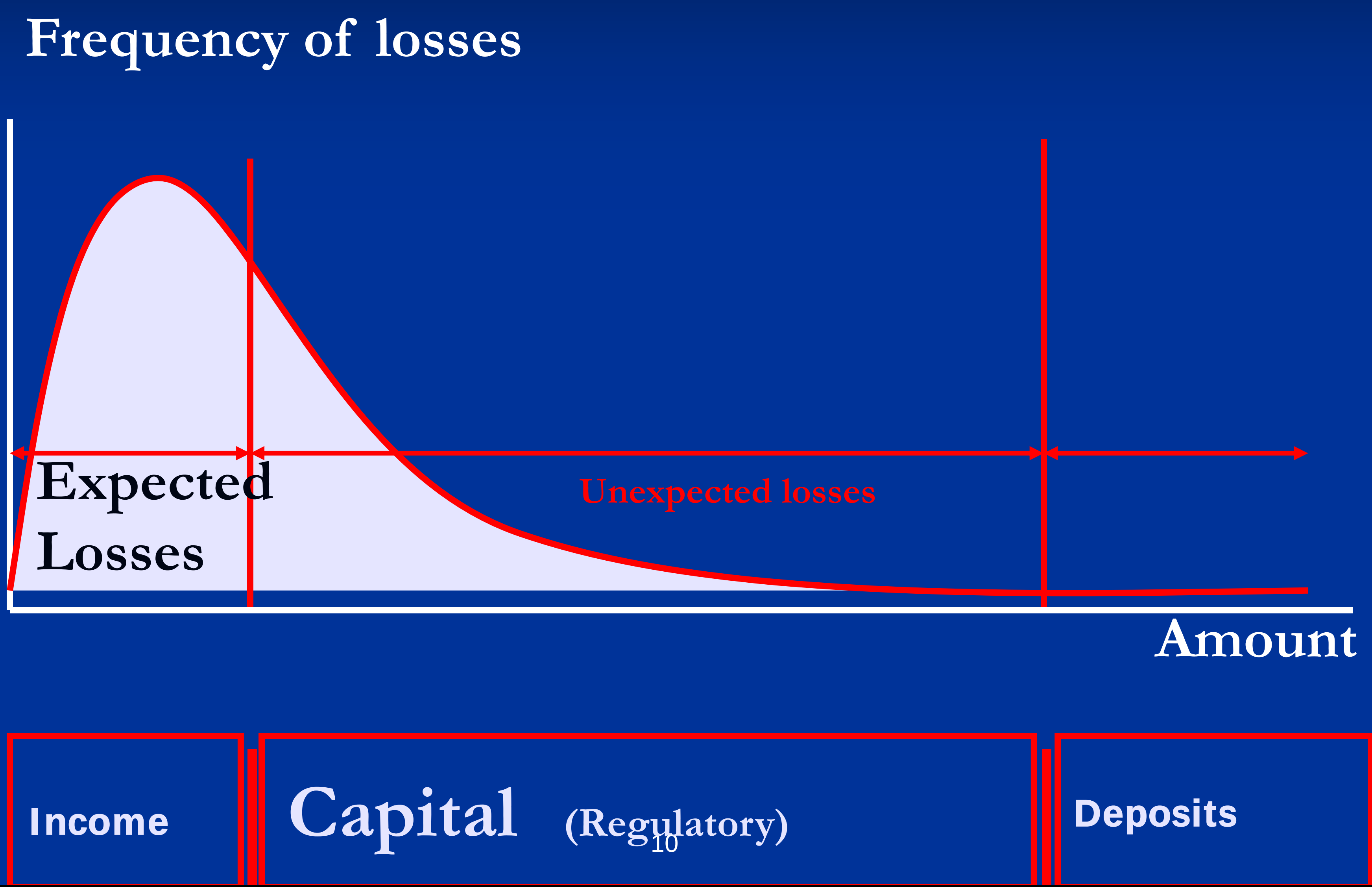


Phase in Arrangements



Challenges in Capital Management in IBs

The Role of Capital in Conventional Banks



Challenges in Capital Management in IBs

The role of capital (regulatory capital) in Islamic banks

CAR conventional bank

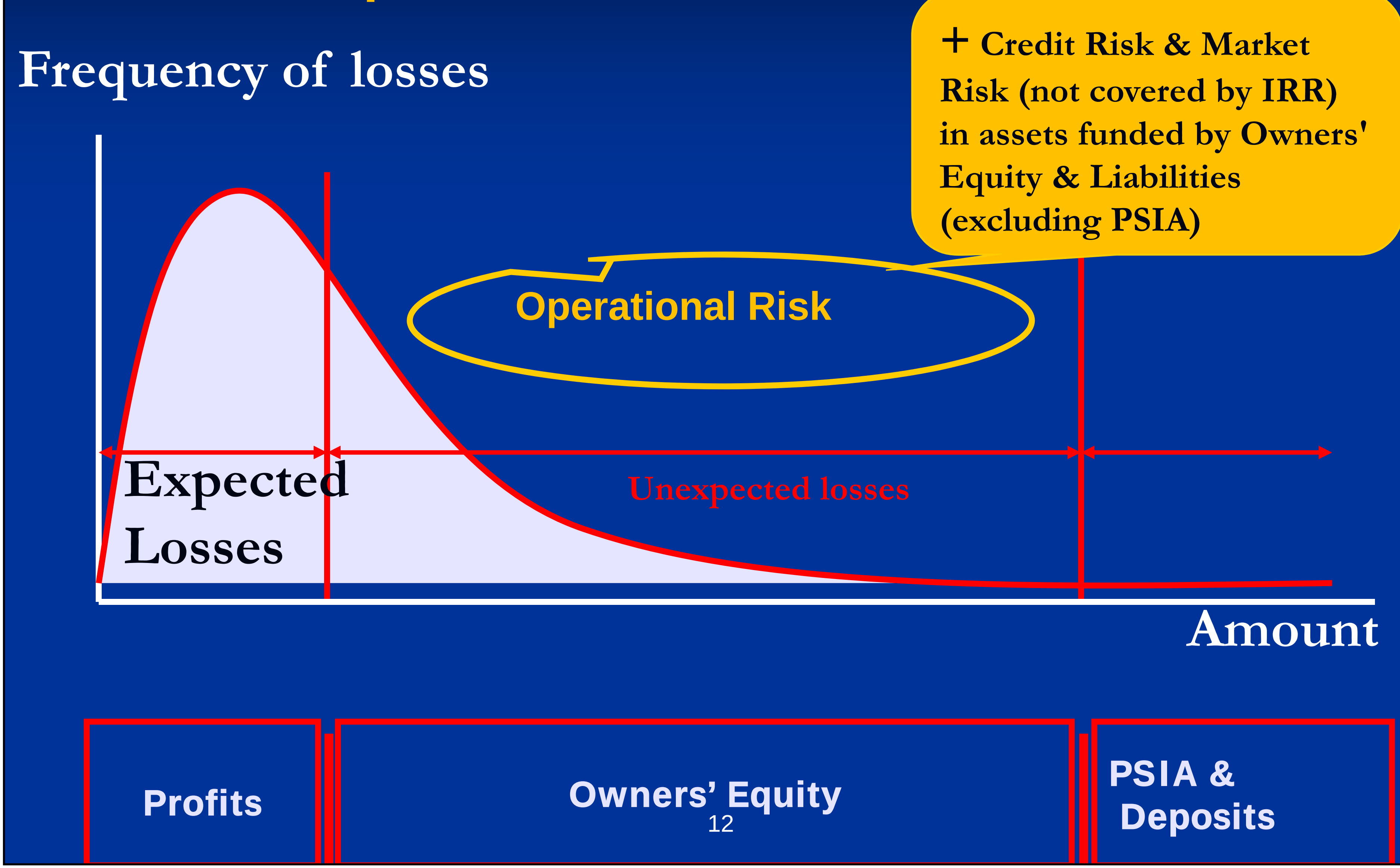
$$Risk - Based\ \ Capital\ \ Ratio = \frac{Capital}{Credit\ \ Risk + Market\ \ Risk + Operational\ \ Risk}$$

CAR for Islamic bank ?

$$Risk - Based\ \ Capital\ \ Ratio = \frac{\mathrm{Re}\,serves\ \ (IRR + PER) + Owners'\ \ Equity}{Market\ \ Risk + Credit\ \ Risk + Operational\ \ Risk}$$

Challenges in Capital Management in IBs

The Role of Capital in Islamic Banks



Challenges in Capital Management in IBs

The Role of Capital in Islamic Banks

Profits	Profit Equalization Reserve (PER) + Investment Risk Reserve (IRR)	PSIA

How to address the challenge of limited loss-absorbency of capital?

By allowing the use of capital to protect the principle/return of PSIA holders based on (i) discretionary power of shareholders and (ii) approval by supervisors

Thank you