Capital Management in Islamic Finance : Would conventional regulatory capital requirements be appropriate for Islamic Finance?

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Global Islamic Finance Forum| Islamic Finance: Opportunities for tomorrow| *Kuala Lumpur, October 26, 2010*

Outline

I Capital Management: Difference between Conventional and Islamic Finance

II Global move toward enhancing regulatory capital : Is there an impact for Islamic regulatory capital requirement?

III Overcoming challenges in Capital Management in Islamic Finance: Key Improvements

I.1- Different Types of Risks between Conventional and Islamic Financial Institutions

Conventional Banking	Islamic Banking
Credit Risk	Credit Risk
Market Risk	Market Risk
Liquidity Risk	Liquidity Risk
Operational Risk	Operational Risk
_	Displaced Commercial Risk
_	Legal and Shari’ah Risk

I.2- Implications of Profit –Sharing Investment Accounts on Capital Adequacy

Products	Characteristics and Supervisory Considerations	Risks	Implications on Capital Adequacy
Unrestricted Profit Sharing Investment Accounts	Deposit-Like Product (Implicit Fix Return and Capital guarantee)	*Risks borne by shareholders*	1
			α
	Investment Product (Variable Return, Non-Capital Guaranteed)	*Risks borne by Investment Account Holders except in the case of negligence and/or misconduct*	0

<u>Source:</u> Supervisory, regulatory, and capital adequacy implications of profit – sharing investment accounts in Islamic Finance, (Archer , Abdel Karim and Sundararajan 2010)

I.3- IFSB Standard Measure of Capital Adequacy (α=o)

$$\frac{\text{Eligible Capital}}{\begin{array}{c}\{\text{Total Risk-weighted Assets (Credit+ Market Risks) Plus Operational Risks} \\ \text{Less} \\ \text{Risk-weighted Assets funded by PSIA (Credit + Market Risks)}\}\end{array}}$$

<u>Assumptions</u>

- PSIA holders bear 100% of credit and market risk of assets funded by them therefore RWA for Credit and Market Risks are deducted.

- Islamic banks bear 100% of operational risk of managing all assets held or managed by bank

<u>Source:</u> Capital Adequacy Standard for institutions (other than insurance institutions) offering only Islamic Financial Services, IFSB 2

I.4 - IFSB Supervisory Discretion Measure of Capital Adequacy (α≠0)

$$\frac{\text{Eligible Capital}}{\begin{array}{c}\text{\{Total Risk-weighted Assets (Credit + Market Risks) Plus Operational Risks} \\ \text{Less} \\ \text{Risk-weighted Assets funded by Restricted PSIA (Credit + Market Risks)} \\ \text{Less} \\ (1-\alpha)\ \text{[Risk-weighted Assets funded by Unrestricted PSIA(Credit + Market Risks)]} \\ \text{Less} \\ \alpha\ \text{[Risk-weighted Assets funded by PER and IRR of Unrestricted PSIA (Credit+ Market Risks)]\}}\end{array}}$$

__Assumptions:__

- IIFS bear a proportion of credit and market risks of assets funded by PSIA and α (alpha) is the corresponding proportion of assets funded by PSIA, as determined by national supervisors. Therefore (1- α) is deducted. Moreover, an adjustment of the impact of PER/IRR on the absorption of the losses and hence on the α is accounted for.
- IIFS bears 100% of operational risk of managing assets

I.5 - Implications of the supervisory determination of the α factor

Capital Adequacy Ratios are highly sensitive to α factor

α

0 → **1**

If supervisory act as though α is equal to 0 when it should be close to 1

Islamic banks are significantly undercapitalized

If supervisory act as though α is close to 1 when it should be close to 0

Islamic banks carry excess amounts of capital which will affect their competitiveness

<u>Source:</u> Supervisory, regulatory, and capital adequacy implications of profit – sharing investment accounts in Islamic Finance, Archer – Abdel Karim and Sundararajan (2010)

II. Global move toward enhancing regulatory capital : Is there an impact for Islamic regulatory capital requirement?

BASEL III New Capital Requirement	Impact on Islamic Prudential Regulation
A. Increase in bank's capital quality, consistency and transparency • Greater focus on Common Equity • Innovative Hybrid capital instruments with an incentive to redeem will be phased out • Tier 2 simplified (no upper & lower) ; Tier 3 will be phased out • Stricter Definition through stringent deductions • Greater transparency of the capital base through disclosure of all elements of capital along with a detailed reconciliation to the reported accounts.	The new requirements would not affect IBs as the hybrid and Tier III capital instruments have played a limited role so far in their capital structure.

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B. Increase in the required level of capital • Increase of the minimum common equity requirement **from 2%** (equivalent to 1% according to the new def) **to 4.5%;** • Increase of the Tier 1 minimum capital requirement **from 4%** (equivalent to 2% according to the new def) **to 6%;** • Additional Capital conservation buffer of **2.5%** of common equity to withstand future periods of stress ➢ The required total common equity will be brought to 7%, Tier 1 capital 8.5% and **Total Capital 10.5%.**	The increase in the required capital could be considered in the case of IBs especially the Capital Conservation Buffer.

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C. Introducing a non-risk-based leverage ratio Simple leverage Ratio, as a backstop to the Risk based capital measure Tier1/Assets > 3%	The requirements for addressing the leverage risk in the case of IBs is, in principle, not relevant as the leverage ratio should be low since IBs do not use deposit type investment accounts except the current accounts. However, in view of the growing practice of raising term deposits and making term loans based on reverse murabaha or tawaruq transactions, a gearing for this specific type could be applicable.

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BASEL III New Capital Requirement

D. Macroprudential Overlay for the Reduction of Systemic Risk

- Reduce procyclicality : Introducing the **countercyclical capital buffer** calibrated in a range of **0 - 2,5%** that would require institutions to build up defensive buffers in good times that could be drawn down in bad times.

Implications on Islamic Prudential Regulation

•Increased pro-cyclicality of IBs due to:

o The growing practice of raising term deposits and making term loans based on reverse murabaha or tawaruq transactions reduced the profit and loss sharing financing forms

o The effects of fair value accounting on the trading books that are similar to those for conventional banks.

o The relying on External Credit Assessment Institutions (ECAI) rating.

➢ Since the exposure to the cyclicality is a resultant of the IIFs management of the DCR, it would be preferable to require from Islamic Banks to maintain counter-cyclical buffer under Pillar II

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E. Macroprudential Overlay for the Reduction of Systemic Risk	
• Account for the interlinkages and common exposures : Additional loss-absorbing capacity for Systemically Important Financial Institutions (systemic capital surcharge?)	Islamic banks are exposed to : (1) interlinkages through commodity murabaha arrangements and intra group exposures e.g. between Takaful and banks ; and (2) common exposures such as real estate exposures. ➢ A systemic Capital surcharge could be also applicable.
F. Sufficient time for a smooth transition	• Sufficient time for smooth transition too.

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BASEL III new global minimum liquidity standards	Impact on Islamic Prudential Regulation
• Committee's liquidity coverage ratio (hold a buffer of high-quality liquid assets to deal with cash outflows in an acute short term stress scenario) • Net stable funding ratio : address funding mismatches and provide incentives to banks to use stable sources to fund their activities	Islamic Banks lacks funding liquidity standards.

III- Overcoming Challenges in Capital Management

- DCR Estimation should be based on Supervisory rules and not just on discretion basis. Clearer methodology and data requirement should be made available.

- Investigation on the extent to which Islamic Banks are being pro-cyclical in order to assess the effectiveness and level of a countercyclical capital buffer.

- Set-up of a prudential standard on the minimum liquidity requirement for IBs.

- Ensure the enforcement by the national supervisory agencies of the capital adequacy prudential standards issued by the IFSB.

CONCLUSION

“Building a fail-safe financial system is impossible.

If the reform process can identify and mitigate these systemic risks, the overall system will be more resilient.”

<u>Source:</u> “Towards a failsafe financial system", BIS Annual Report 2008/09