

Capital Management in Islamic Finance

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Contents

- Distinct Capital Requirement for IIFS
- Capital requirement for IIFS- current scenario
- Capital requirement for IIFS – Pakistan case
- Issues and challenges
- Way forward

Distinct Capital Requirement for IIFS

- Peculiar nature of IIFS deposits
- Distinct risk profile of IIFS financing and investment portfolio
- Assets price risk
- Higher Operational Risk
 - Shariah non-compliance risk
 - Fiduciary risk

Capital requirement for IIFS- current scenario

- Islamic banks co-exist in conventional banking system
- Common legal and regulatory framework for both conventional and Islamic banks in most jurisdictions
- Basel – II does not cover the peculiar nature of risks associated with Islamic finance
- AAOIFI and IFSB initiatives to prescribe mechanism for determining capital requirements for IIFS
- IFSB capital adequacy standards not yet fully adopted in most of the jurisdictions
- Other proposals
 - Treating Islamic banks as Mutual Funds
 - Segregating deposits streams with different Alpha values as per risk appetite of IAH

Capital requirements framework - Pakistan case

- Three types of Islamic banking institutions (IBIs)
 - Full fledged Islamic bank
 - Islamic banking subsidiary of a conventional bank
 - Islamic banking branches in conventional banks (IBBs)
- Common legal and regulatory framework for both conventional and Islamic banks
- Comprehensive Shariah compliance framework
- Similar MCR for conventional and Islamic banks including Islamic subsidiaries
- Lower MCR/IBF for IBBs
- Similar CAR for conventional and IBIs

Capital requirements framework - Pakistan case

Cont...

- Study to assess impact on CAR of IIFS if IFSB CAS adopted
 - IFSB CAR (Standard Formula; Alpha = 0) = 43.1%
 - IFSB CAR (Alpha = 1) = 20.9%
 - Basel – II = 20.5%
 - CAR based on Basel II and IFSB CAS almost same with Alpha = 1
 - Significant reduction in capital requirement with low Alpha value
 - Low Alpha value however not advisable in the present scenario
 - IAHS expectations on principal protection as well as rate of return are at par with conventional banks' depositors
 - IBIs also don't pass through the losses to depositors/IAHS

Issues and Challenges

- Globally regulatory capital is being enhanced/strengthened
- With the implementation of IFSB CAS, effective capital requirements may be much lower as shown in Pakistan study
- IAHS' expectations vis-à-vis conventional depositors
- Systemic risk implications
- Under developed PER and IRR policies
- Fiduciary and Shariah non-compliance risks to be quantified

Way forward

- Adoption of IFSB standard with necessary customization
- Mechanism for quantification of Shariah non-compliance and fiduciary risks
- Development and application of rate of return and profit smoothing framework
- Accelerating the development of framework for determining Alpha
- Parallel implementation in early stages
- IAH education and awareness
- Empirical study to estimate IAH risk perception and return expectations

Thanks