CAPITAL MANAGEMENT IN ISLAMIC FINANCE - WOULD CONVENTIONAL CAPITAL REQUIREMENTS BE APPROPRIATE FOR ISLAMIC FINANCE ?

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Introduction:

- The traditional role of capital (buffer against unexpected losses); purpose of capital adequacy regulation – limiting probability of adverse outcomes beyond bank's capacity to bear losses
- Same norms applicable to Islamic financial institutions and conventional banking.
- A uniform application of the norms may result in discrimination against Islamic banks due to differences in the nature of intermediation.
- Basel capital adequacy norms and Islamic banks .

Capital Management - Differences Between Conventional & Islamic Finance

Key Differences

- Sharia'h rules and governance.
- Risk sharing Investment Account deposits.
- Investment Account Holders a unique class of quasi-liability holders – neither depositors nor shareholders. They absorb all losses on investments made with their funds. Need for alternative formulation of capital adequacy to include investment accounts as capital
- Differences in nature of intermediation and liabilities.

Capital Management - Differences Between Conventional & Islamic Finance (cont'd)

Capital adequacy considerations for Islamic Banks:

- **Asset- backed financing**
- **Displaced Commercial Risk and Income Smoothing**
- **Calculation of risk weights and treatment of PER in capital adequacy computation**

Global Move Towards Enhancing Regulatory Capital and the Islamic Capital Concept

- The global financial crisis (GFC) and financial system reforms
- Capital and financial stability
- Basel II and III
- Islamic finance concept and lessons of the GFC

Advanced Measurement Approaches Practiced by Conventional Banks - An Imperative for Islamic Banks

- Need to adopt Basle II and integrate suggested systems to Islamic banks' operations
- Existing risk weighting/measurement approaches:
  - standardized approach
  - internal ratings based (IRB) approach
- The choice of the IRB approach depends on supervisors' approval and the existence of the required capabilities
- The IFSB's Capital Adequacy Standard covers only the standardized approach to credit risk measurement

Advanced Measurement Approaches Practiced by Conventional Banks - An Imperative for Islamic Banks

- Need for Advanced Approaches for Islamic banks
  - Banks will be allowed to assess their own capital requirement subject to supervisory review process and verification.
  - The quality (probability of default) of each asset is determined individually which makes the risk weighting less complex
  - The IRB approach allows each bank to develop its own risk management system and culture
  - Lack of ratings or external source of credit assessment for the clients of most Islamic banks
  - International recognition

Overcoming Challenges in Capital Management in Islamic Finance: Key Improvements for Impactful Results

Key Challenges:

- **The Sharia'h debate in respect of financial innovations in Islamic finance**
- **Islamic banks currently operate in a global environment that in most cases caters for conventional financial practices.**
- **Limited set of short-term traditional liquidity management instruments.**
- **Islamic banks tend to have a concentrated base of deposits or concentrate on a few select sectors or assets which makes them vulnerable to cyclical shocks or exposes them to risk.**
- **prohibited use of wide range of derivative instruments for hedging purposes or transfer of risks.**

Overcoming Challenges in Capital Management in Islamic Finance: Key Improvements for Impactful Results (cont'd)

Suggested Improvements for more impactful results:

- Financial engineering- to introduce new Shariah-compatible products that enhance liquidity, risk management and portfolio diversification.
- Need for uniformity and harmonization of Shariah and standards and practices across markets and borders
- Separate capital adequacy for demand and investment deposits
- Internal and External Rating- to promote transparency and enhance competitive advantage of IFIs.

Effective Capital Management in Islamic Finance - Going Back to the Basics

- Islamic finance is asset-backed form of financing
  - Prohibits lending and borrowing on the basis of interest.
  - Minimizes the likelihood of creating inverted pyramids of debts.
  - Implies greater emphasis on transparency and disclosure.
- This contributes to effective capital measurement and promotes the safety and soundness of individual institutions
- Contribute towards financial stability as evidenced by the recent global financial crisis.

Conclusion

- Conventional capital adequacy requirements cannot be appropriate for Islamic financial institutions due to the specificities of Islamic finance.
- A uniform application of the Basle capital adequacy norms to both conventional and Islamic financial institutions may be discriminatory and defeat the "level playing field" objective
- AAOIFI and IFSB capital adequacy standards address the specificities of Islamic finance.
- Both standards are based on Basle I and II with some modifications and thus provide alternative ways to compute capital adequacy measures for Islamic financial institutions.