WORLD BANK GROUP
Finance & Markets
Global Islamic Finance Development Center

Regulatory and Supervisory Challenges of Islamic Banking After Basel-III

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Road Map

I. World Bank Global Islamic Finance Development Center

II. What does Basel III call for?

III. The Implications of Basel III for Islamic Banks

- Capital Requirements
- Liquidity Standards
- Leverage
- Additional Charges for SIFIs

III. Overview of Post-Basel III Challenges for Islamic Banks

A knowledge Hub: World Bank Global Islamic Finance Development Center

The volume of *Shariah*-compliant instruments has been expanding at more than 10 percent annually

GIFDC can help mobilize a creative new source of finance for development

GIFDC can help World bank client countries take advantage of the rapid growth of financial assets that are compliant with Islamic law

Islamic finance has the potential to focus vast new resources on development

Shariah-compliant finance can channel investment toward underserved segments such as poor households, SMEs and agriculture

GIFDC can contribute to the WBG's goal of promoting financial inclusion and ensuring universal access to financial services

Core Activities of Global Islamic Finance Development Center

Financial Sector Development

- Strengthening Regulatory environment
- Facilitating Standardization
- Enhancing Governance and Transparency
- Financial Stability and Risk management

Research and Knowledge Hub

- Producing quality research on topics with development impact
- Knowledge dissemination through international seminars and workshops
- Capacity building for emerging markets

Markets Development

- Technical and Advisory services for new markets
- Collaborate with stakeholders in developing new products and new markets
- Standardization of market practices

II. What does Basel III call for?

The main objective of Basel III addresses the challenges resulting from the crisis at their origin.

Strengthening the Global Capital Framework

Introducing Global Liquidity Standards and Monitoring

A Non-risk Based Leverage Ratio

Additional Charges to SIFIs

An Enhanced Risk Coverage

An Overview of Basel III Framework

Capital framework

1(a) Increased quantity

- Rise in the overall capital ratios
- Forward looking provisions
- Additional requirements for SIFIs

1(b) Capital buffers

Capital conservation

Counter-cyclical

Domestic SIBs

1(c) Increased quality

Tier-1: Tighter eligibility standards

To be phased out

- Capital instruments other than common equity
- Intangibles
- Deferred tax assets
- Other items

Tier-2: Simplified

Tier-3: Abolished

2. Enhanced risk coverage and new capital standards for counterparty credit risk

Credit risk

Market risk

Higher capital requirements

- Trading book exposures
- Securitisation exposures
- Resecuritisation

Counterparty credit risk

- CVA risk
- Wrong way risk
- Move towards central counterparties

3. Leverage ratio

- Includes both on-balance sheet and adjusted off-balance sheet assets
- A minimum threshold of 3%

Liquidity standards

4. Liquidity ratios

Liquidity coverage ratio

- High quality liquid assets to cover a 30-day stress scenario

Net stable funding ratio

- Measure of structural liquidity
- Based on a long-term (1 year) funding requirement

Monitoring metrics

- Contractual maturity mismatch
- Concentration of funding
- Available unencumbered assets
- Market-related monitoring tools

Source: BCBS, IFSB, Islamic Financial Services Industry Stability Report 2013

Basel III implementation timelines, helping to smooth out the regulatory costs

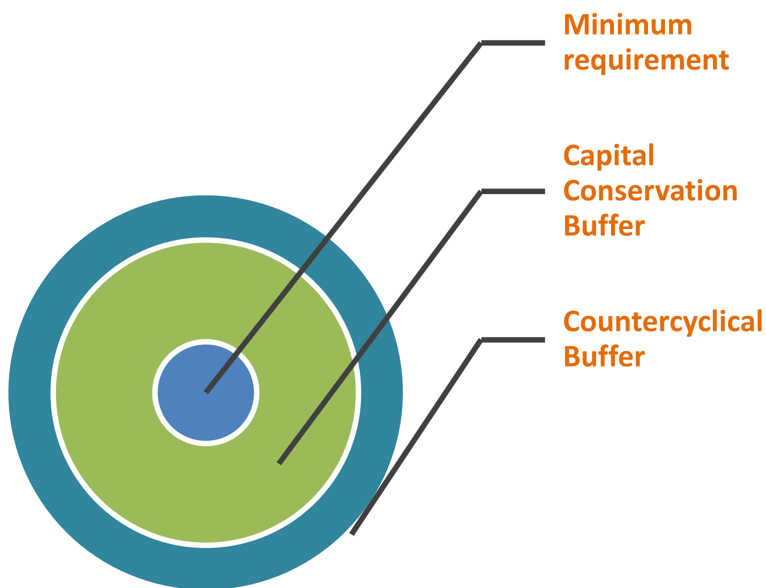
	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	

Source: BCBS

III. The Implications for Islamic Banks

Capital Requirements

Capital definition is getting more strict with some deductions from capital and buffer requirements are increasing.



Capital Requirements and Buffers			
	Common Equity Tier 1	Tier 1 Capital	Total Capital
Minimum	4.5%	6%	8%
Conservation Buffer	2.5%		
Minimum plus conservation buffer	7%	8.5%	10.5%
Countercyclical buffer range	0-2.5%		

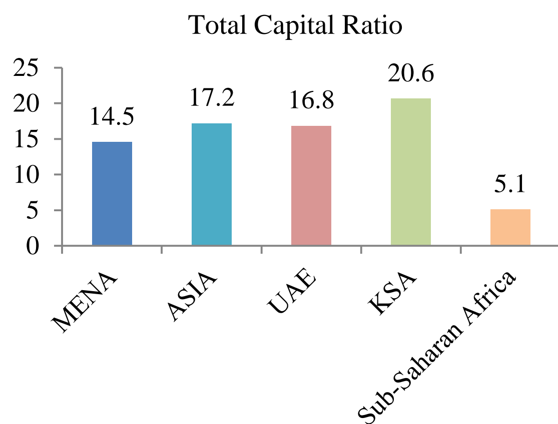
Source: BCBS

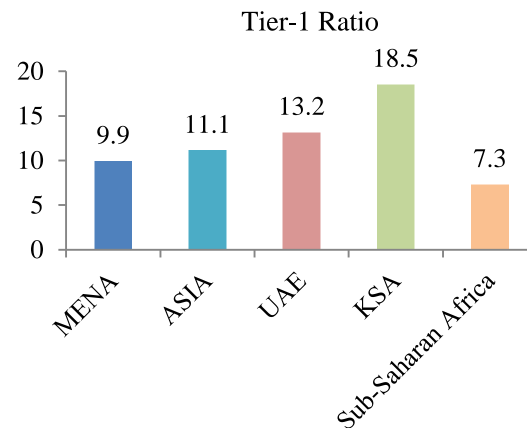
IFSB- Standards continue to be revised in light of Basel-III requirements

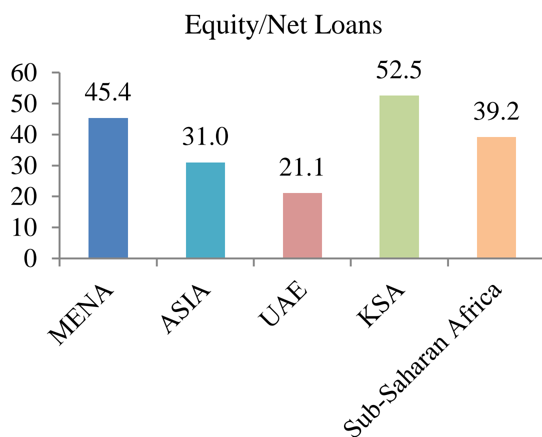
1. Revised Capital Adequacy Standard (IFSB-15)
2. Revised Guidance on Key Elements in the Supervisory Review Process (IFSB-16)
3. Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity *Murābahah* Transactions (GN-2)
4. Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of *Alpha* in the Capital Adequacy Ratio (GN-4)
5. Guidance Note On Quantitative Measures For Liquidity Risk Management In Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions And Islamic Collective Investment Schemes (GN-6)

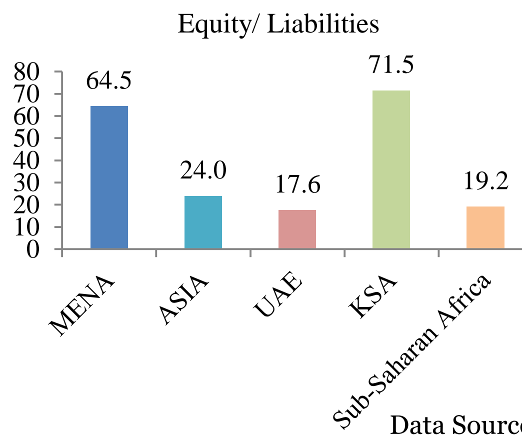
Implication for Islamic Banks- Comparative Capital Adequacy Ratios

- Middle Eastern banking system will be less effected compared to Islamic banks located in emerging markets.







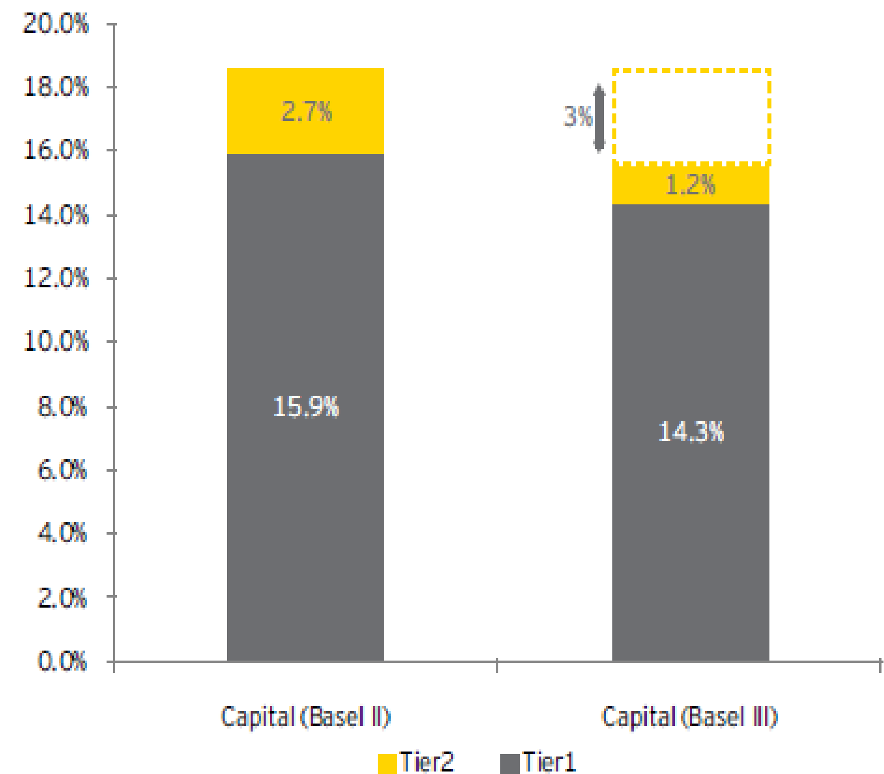


Data Source: Comcec Report, September 2014

A expected reduction of 3% in capital ratios of IBs in GCC - part of this can be addressed through efficient capital planning.

Key sources of change

- Limited recognition of minority interest, AT1* and T2** capital
- Stringent restrictions on AT1 and T2 eligibility
- Additional deductions from capital:
  - Increase in capital charge from CCR***and market risk (Basel 2.5



Source: World Islamic Banking Competitiveness Report 2013-2014, Ernst and Young

A new innovative Sukuk (Perpetual Sukuk) has started to be issued to abide by CARs

- Corporates, banks and governmental institutions have issued Perpetual *Sukuk* as Tier-1 capital.

Year	Issuer	Structure	Amount (Million USD)	Type
June, 2012	Malaysian Airline (AIRA) Air Asia	Sukuk Al Musharakah	314	Domestic
November, 2012	Abu Dhabi Islamic Bank	Sukuk Al Mudharabah	1000	International
March, 2013	Dubai Islamic Bank	Sukuk Al Mudharabah	1000	International
September, 2013	Almarai Company	Hybrid-Mudarabah and Murabah	453	Domestic
November, 2013	GEMS Education	Sukuk Al Mudharabah	200	International
December, 2013	Malaysian Property Developer	Sukuk Al Musharakah	186	Domestic
June, 2014	Al Hilal Bank	Sukuk Al Mudharabah	500	International

- The asset-based or asset-backed nature of Islamic banks limits over-risky investments, thereby reducing RWAs of banks and helping achieve minimum capital requirements easily.

- In the case of using standardized approaches to calculate minimum required capital based on total exposures, the external credit assessments need to be more reliable and well-established in Islamic markets.

- In the calculation of CAR, the treatment of unrestricted PSIAs gains importance.

Liquidity Standards

Finding HQLA and insufficiency of secondary markets are thought to be challenging for Islamic banks

- On the asset side, due to the shallowness of Islamic securities market, Islamic banks suffer from a lack of Sharia-compliant short-term instruments. Covering short-term funding gaps within a 30-day period to abide by LCR is hard for Ibs.

- Maturity transformation is done by long-term debt issuance in conventional side, but what will be the source of stable funding for Islamic banks?

Liquidity Coverage Ratio (LCR)
$\frac{Stock\ of\ High\ Quality\ Liquid\ Assets}{Net\ Cash\ Outflows\ over\ a\ 30\ day\ period} \geq 100$
Ensures that the bank has sufficient high quality liquid assets to survive a severe 30 day stress

Net Stable Funding Ratio (NSFR)
$\frac{Available\ Amount\ of\ Stable\ Funding}{Required\ Amount\ of\ Stable\ Funding} \geq 100$
• **Promotes structural changes in the liquidity risk profiles of banks away from short-term funding mismatches toward more stable, longer term funding** • **Limits over-reliance on short-term wholesale funding during times of buoyant market liquidity**

Discretionary role of supervisory authorities gains importance in determination of run-off rates for deposits

- The treatment of the PSIAs under Basel III in relation to the LCR effects run-off rates.

- Main criteria for the treatment of PSIAs: PSIAs` possible loss-sharing characteristics and the impact this might have on their stability.
- The higher the run-off rate, the higher the liquidity needs and the lower the net stable funding eligibility of the PSIAs.

- Ultimately it is the regulator in each country that will decide what will be the treatment of PSIAs,

  - For example: *Malaysia's central bank provides a clear differentiation between what it calls a guaranteed deposit and an investment account.*

    i. General PSIAs, (unrestricted) broadly equivalent to conventional retail deposits, assigning a 100% run-off rate to these,

    ii. Specific or restricted PSIAs, deemed similar to managed investment accounts

- The lack of independent rating institutions, to determine the liquidity quality of borrowers is also a challenge

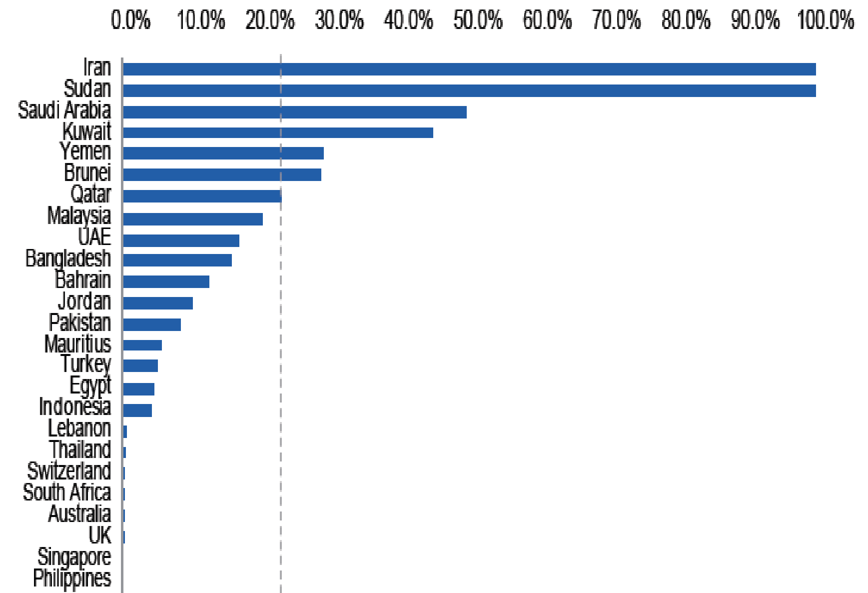
- An incentive to develop sharia-compliant insurance schemes, (that lowers run-off rates and deems deposits as stable) on a takaful basis.

Additional Charges on SIFIs

- According to the Basel III rule, the larger complex banks would be subject to a capital surcharge ranging from 1% to 2.5% to be met with common equity not with complex and hybrid financial instruments.

- Since very few Islamic banks are considered big in size and they don`t use and offer highly hybrid products, additional charges for SIFIs could be of lesser issue for regulators for the time being.

- However, the Islamic banking share in total banking assets in some countries such as Iran, Sudan, Saudi Arabia, Kuwait and Qatar seems to have systemic importance with a higher than 20% Islamic banking share.



Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR

Source: IFSB Financial Stability Report 2014

IV. Overview of Post-Basel III Challenges for Islamic Banks

A Recap of Basel III implications on IFIs

Requirement	Group	Item	Basel III proposals	Impacts on IFIs
Capital requirements	Capital structure	Capital Quality	•Shifted focus from Tier 1 and Tier 2 towards an improved quality capital that is Core Tier 1. •A system based on equity and contingent capital instead of debt	• Basel III reduces the debt advantage that the conventional institutions have over IFIS in terms of capital cost. •It will put the two systems on equal terms. • IFIS still have to develop shari'ah compliant contingent capital structures
		- Capital Deductions	•Enhancement of Core Tier 1 capital, e.g., excluding hybrid forms of capital, deducting minority interests, deferred tax, unrealized losses and pension funds surplus.	
		÷ RWA	•Increased RWA for OTC derivatives that are not centrally cleared. •Capital charge for mark-to market losses. These caused a great damage during the crisis.	•No impact from OTC derivative RWA increases •Potential for Capital charge for mark-to market losses to be applied for Sukuk
	Capital ratios	= Tier1 Capital ratios	Tier 1 capital ratio: **Basel II:** minimum 4% **Basel III:** minimum 6% CoreTier 1 capital ratio: **Basel II:** minimum 2% **Basel III:** minimum 4.5%	•In the conventional side, the changes in ratios will lead to an increase in Loss-Bearing Capital. • This is also due to the new definition of the Core Tier 1 capital. •Islamic counterparts will be less affected as they are generally well capitalised .
		Buffer Capital Ratios	Capital Conservation Buffer: 2.5% buffer met with common equity to face stress periods Counter cyclical Capital Buffer: 0%-2.5% of common equity to achieve broader protection.	
Leverage ratio			•The maximum permissible ratio was not mentioned. •The calculation of the ratio depends on the accounting regime.	•The ratio will affect the conventional banks lending • The leverage ability is already limited in IFIs for shari'ah compliance purposes.
Liquidity requirements		Liquidity Coverage Ratio (LCR)	$\frac{\text{Stock of highly liquid assets}}{\text{Net cash flow over a 30-day stress period}} > 100\%$	•These requirements would urge IFIs to enhance their liquidity management. •Currently, IFIs suffer a competitive disadvantage due to: ✓The lack of appropriate liquidity instruments: standardized, AAA graded, tradable and logically priced. ✓The confinement of liquidity within regional frontiers: the need of a global liquid interbank market.
		Net Stable Funding Ratio (NSFR)	$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$	

Source: IDB (2011)

Key Messages for IBs

- The supervisory authorities` discretionary role is getting importance in the implementation of Basel III rules.

Challenges and Opportunities

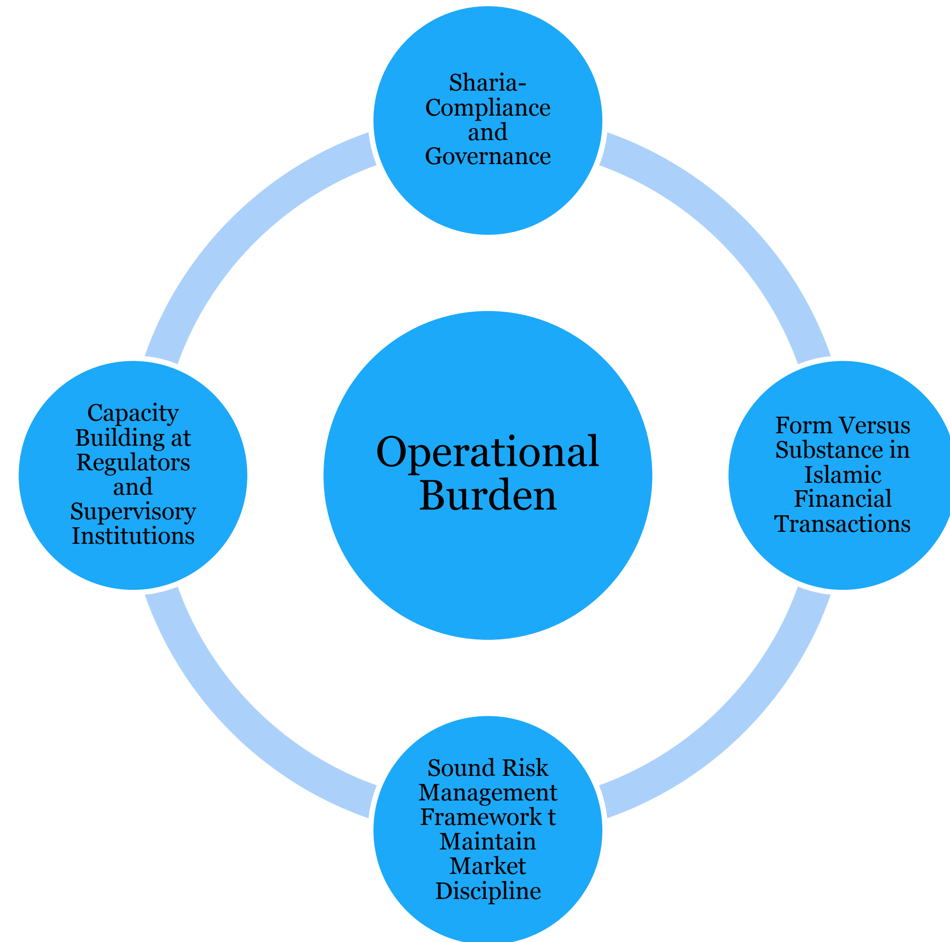
- Impact of run-off rate for PSIA on liquidity requirement.
- Incentive to develop HQLAs to overcome liquidity issues.
- Impose of a discipline on utilization and maintenance of capital. (*Capital optimization through the review o their internal processes and through the optimal capital structure)*
- A potential slow-down in growth of the sector because of increased capital, liquidity and leverage requirements.
- The importance of discretionary role of national regulators in the implementation of Basel III rules, that recognizes industry limitations.
- An incentive to develop sharia-compliant insurance schemes, (that lowers run-off rates and deems deposits as stable) on a takaful basis.

Operational Risks and Costs

- Increased exposure to operational risks arising from compliance to Basel III.
- Increased need for state-of-the art risk systems, quantitative analysis, IT systems, and internal control systems and reliable credit rating systems.
- Increased operational costs of monitoring and reporting
- Robust framework for stress testing.

Regulatory and Supervisory Challenges

- A hybrid approach of firms having their own supervisory boards and that of having a national board. An establishment of Shariah body-at CBs and Securities Commission that could act as the final arbiter of Shari`ah matters
- Greater burdens on Boards of Directors, in an era of the sound governance and control of banking institutions has taken center stage.
- Complying with Shari`ah principle in substance while harmonizing and standardizing contracts and operating procedures without jeopardizing innovation needed for the industry
- With the lack of knowledge and expertise on the supervisory authority side, requisite training and capacity development becomes essential.
- A sound risk management framework is needed to maintain the market discipline for all stakeholders, to mitigate systemic risk.



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