

Issues and Challenges in the Implementation of Strengthened Supervisory Standards for Islamic Banks

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Outline

- Baseline supervision – Observance of Basel Core Principles in jurisdictions with sizable presence of IIFS
- Special issues in supervision of IIFS
- Implementation of Basel II & IFSB standards
- Treatment of PSIA – Supervisory Discretion on IIFS
Capital adequacy
- Risk mitigants in Islamic Finance-Investment Account management as a risk-mitigant.
- Cross border issues
- Design of Safety nets
- Way Forward

Observance of Basel Core Principles in Countries with IIFS

- **Compliance is weak in areas such as market risks, liquidity risks, operational risks & validation of supervisory information, consolidated supervision & disclosure regime**
- **Pre- conditions – legal infrastructure, systemic liquidity infrastructure – weak or not sufficiently transparent**
- **These are also critical areas for Basel II & IFSB standards**
- **Strengthening baseline supervision in core areas is key to IFSB/Basel II standards**

Some Unique Issues in the Supervision of IIFS

- **Transactions in real assets & commodities require strengthened supervisory norms on operational risks, and on separation of commerce from financial intermediation**
- **Liquidity risk management of IIFS is constrained due to limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure**
- **Shariah compliance review – relative roles of internal controls & audits, external auditor, and supervisory review – key to minimize operational & reputational risks of Shariah non-compliance**

Some Unique Issues in the Supervision of IIFS (cont'd)

- Risk characteristics are distinct for IIFS, and require adaptations in risk weights, capital adequacy, additional supervisory guidance, and in the disclosure framework, with guidance to complement existing accounting standards for IIFS & auditing environment.
- The role of investment account holders in sharing the credit and market risks is another unique feature that needs recognition in supervisory review, capital adequacy and disclosure, and raises cross sectoral issues for the approach to supervision.
- IT systems – Bank inspections to ensure adequacy of IT systems to support Shariah compliance, and minimize operational risks generally.

Implementation of IFSB and Basel II Standards

- **Most countries in Middle East, Asia, and Africa have announced their plans to implement Basel II for conventional banks during 2007-2015: almost all countries in the Middle east, 88% of countries in Asia, and 75% in Africa plan to adopt Basel II**
- **Standardized approach to credit risk is the most common, with a shift to FIRB approach eventually (100% (75%) in Middle East, 88% (88%) in Asia, and 75& (50%) in Africa)**

Implementation of IFSB and Basel II Standards (cont'd)

- **IFSB standards – that constitute the equivalent of Basel II for Islamic finance have been issued since December, 2005, and only a few countries have announced their intention to adopt these standards**
- **The need to adopt IFSB standards for IIFS in the same time line as for Basel II for conventional banks is important to ensure**
 - **Level playing field**
 - **Global integration of Islamic finance**
 - **Financial stability, as IFSB standards help recognize the unique risk characteristics of Islamic finance**

IFSB Standards

- **Capital Adequacy Standard (CAS) – issued in Dec 2005**
- **Guiding principles on Risk Management (RM) – issued in Dec 2005**
- **Guiding principles on Corporate Governance (CG) – issued in Nov 2006**
- **Exposure draft on guidance on key elements in the Supervisory Review Process (SRP) – approved for public consultation, Nov 2006, to be issued on November 2007**
- **Exposure draft on disclosures to promote Transparency & Market Discipline (TMD) – approved for public consultation, Nov 2006, to be issued in November 2007**

These standards together with additional guidelines on specific aspects of these standards constitute the Basel II equivalent for Islamic finance.

Some Additional IFSB standards and Guidance -Work in progress

- Capital adequacy requirements for Sukuk securitizations
- Capital adequacy Treatment of Real Estate Investment
- Shariah governance
- Recognition ratings by ECAI on Shariah compliant financial instruments
- Supervisory discretion on “Displaced Commercial Risk”

Practical Issues in Implementation of IFSB Standards

- **Strengthening risk management systems in IIFS, taking into account their unique risk characteristics – improving availability of data for risk measurement, particularly displaced commercial risk (DCR)**
- **Developing procedures for effective measurement & disclosure of DCR, and for the exercise of supervisory discretion on the size of this risk for the purpose of computing IIFS capital adequacy – A fundamental issue in Islamic Finance.**

Practical Issues in Implementation of IFSB Standards (cont'd)

- **Guidelines on rate of return calculations for PSIA, and on the use of PER/IRR**
- **Recognition criteria for ECAs suitable for rating Islamic finance institutions, and instruments**
- **Guidelines on the measurement of “non-performing financing” & “definition of default” for different types of Islamic finance contracts**
- **Develop good practices in designing credit registries and credit information systems that include Islamic finance contracts – to facilitate risk measurements**

Treatment of PSIA – Supervisory Discretion Formula

- **IFSB CAS allows for supervisory discretion on “ALPHA” – the proportion of Risk Weighted Assets (RWA) financed by unrestricted IAH funds (PSIA) that needs to be included in the denominator of the CAR**
- **If $\alpha=0$, PSIA is in effect a pure investment carrying the full risk of loss, and $DCR=0$**
- **If $\alpha=1$, PSIA is considered akin to deposits with both principal & return implicitly guaranteed, and hence DCR is at its maximum level**
- **If $0<\alpha<1$, IIFS is managing the PSIA to avoid being in either extreme, and $DCR>0$**

Investment Account Management and Control and Estimation of DCR (or ALPHA)

- A key issue for Islamic banks is to manage the risk sharing properties of PSIA – restricted & unrestricted – in order to mitigate partly the risks to shareholders that would arise in the case of IIFS protecting IAH against return volatility and thereby assuming some DCR

Investment Account Management and Control and Estimation of DCR (or ALPHA) (cont'd)

- **Tools of managing DCR:**
 - **Use PER, and IRR; for example, if PER & IRR are sufficient – built up in good times & drawn on in bad states of mature – and there is no need to transfer any income from shareholders to IAH to protect the latter from return volatility – then $DCR=0$, $APLHA=0$; If insufficient, $DCR>0$**
 - **Manage IAH expectations of risk-return mix (through disclosure & transparency) and ensure asset composition that is consistent with the disclosed risk-return mix**
 - **Some combination of the above to manage “ALPHA”**

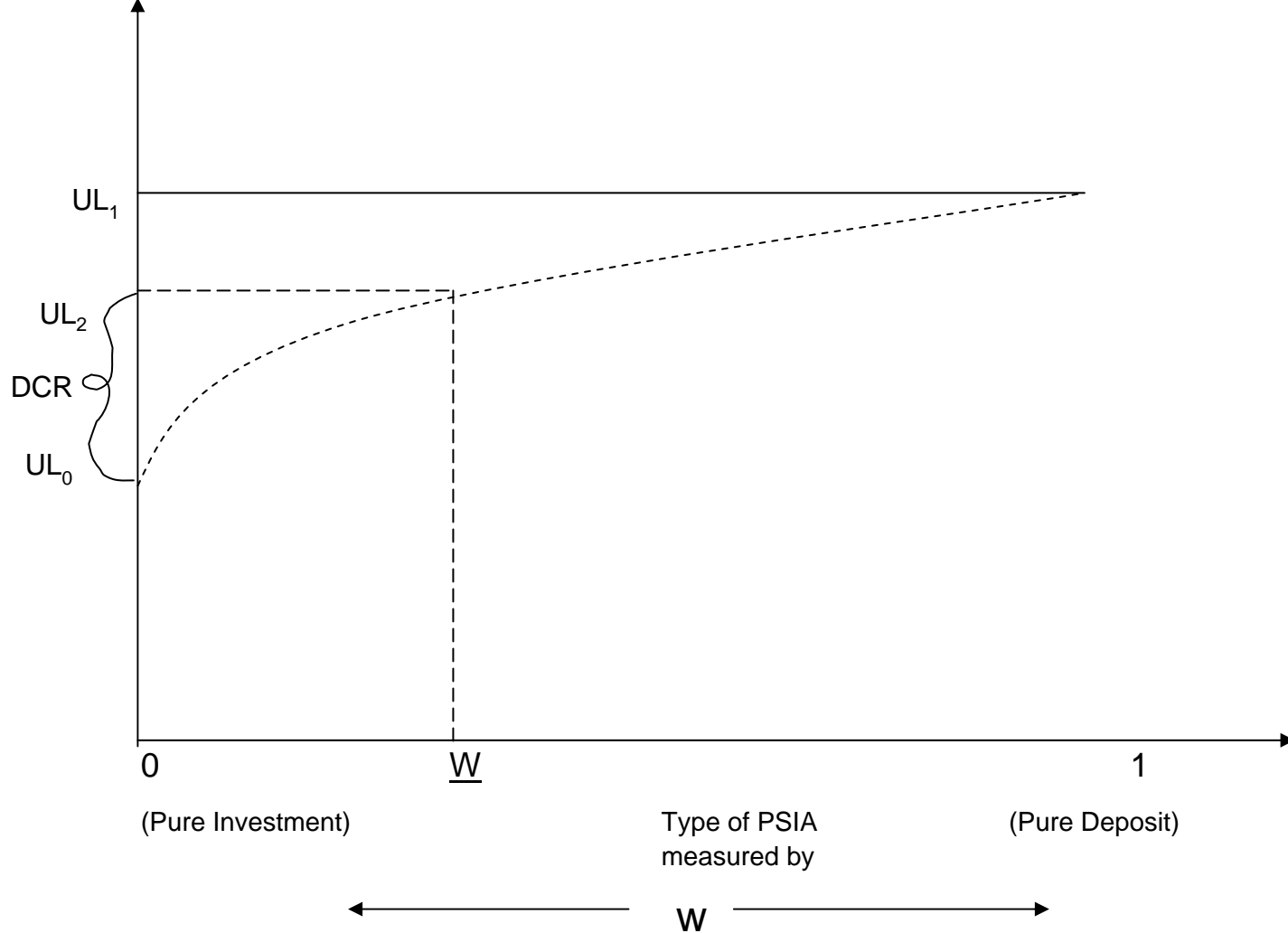
Estimation Of “Alpha”

Capital Adequacy Ratio for IIFS is highly sensitive to changes in the value of “alpha”. This sensitivity implies that if the CAR of an IIFS is calculated without the use of a reasonably realistic value of alpha, the CAR will not provide an adequately accurate measure of the IIFS’s capital adequacy.

The value of “alpha” depends upon the policies of IIFS toward the returns paid out to PSIA in relation to unsmoothed returns earned on assets invested with PSIA funds, and the market benchmark rates and the resulting DCR. ‘w’ represents the average weight attached to asset return , with “1-w “ representing the weight for the market benchmark

The estimation of “alpha ‘requires historical data on these returns and the related usage of reserves, and profit transfers from IIFS, so as to compute their variability and correlations, and the average “w”, and using these to estimate unexpected losses to shareholders under various Scenarios.

“Alpha “ is the ratio of estimated value of actual DCR to its maximum value.



Note: As w moves from zero to 1, the character of PSIA changes from being pure investment like product to pure deposit like product, requiring increasing amounts of shareholder capital. Additional capital requirements – i.e. the increase in unexpected losses as α shifts from 0 (pure mudarabah outcome) to its actual level “ $\underline{\alpha}$ ” given by $UL_2 - UL_0$ — is the measure of Displaced Commercial Risk (DCR). The maximum possible value of DCR is given by $UL_1 - UL_0$. The value of “ α ” in the Capital adequacy formula is given by the ratio of actual size of DCR to its maximum value, as shown in equation 13 in the text.

Modeling Investment Account Management: Targeted return to IAH

- For simplicity, assume that RI is determined as a weighted average of a market rate of return benchmark (R_m) and the actual investment return ($R_A - S_P$)
- $R_I = w R_m + (1-w) (R_A - S_P)$
- The weight “w” is a management decision, that could vary over time, and the task is to assess the average value of “w” over a period, as a basis for judging how the IIFS balances the interests of shareholders and its IAH.

Return to shareholders under alternative scenarios

Case1; $\alpha = 0, w = 0, R_I = R_A - S_P$ IRR/PER=0

$$R_{E0} = R_A - S_P,$$

Case2: $\alpha = 1, w = 1, R_I = R_m$, PER/IRR = 0

$$R_{E1} = (R_A - S_P) + DI/K \cdot (R_A - S_P - R_m)$$

Case3: actual outcome, $0 < w < 1$, PER/IRR non zero

$$R_{E2} = \{1 + (DI/K) \cdot w\} (R_A - S_P) - \beta (A/K) R_P - (DI/K) \cdot w \cdot R_m - DI/K \cdot R_{IR}$$

Unexpected Losses under alternative scenarios, and the formal definition of DCR and “alpha

- $ULO = PAR$ of R_{E0}
- $UL1 = PAR$ of R_{E1}
- $UL2 = PAR$ of R_{E2}
- $DCR = UL2 - UL0$
- “alpha” = $(UL2 - UL0) / (UL1 - UL0)$

“Alpha” is the ratio of actual DCR over its maximum value for any bank or Jurisdiction (see slide 6 for the rationale for the expression for “alpha”)

A Numerical illustration

- Based on panel data for about 12 banks over three years, $ULO=10$; $UL1= 205$; and $UL2$ (with $w=0.52$)= 110.
- Thus, for $w=0.5$, “alpha” = 0.48
- If $UL2$ (with $w = 0.3$)= 65, “alpha”=0.28

Risk Mitigants in Islamic Finance

- **Development of product innovations & risk management procedures to mitigate risks in Islamic finance has been fairly limited in scope so far**
- **Investment Account management ,and control of “alpha” is a powerful risk mitigant in Islamic finance.**
- **Off-balance sheet. derivatives (e.g. profit rate, SWAP, etc) are mostly proprietary products issued by IIFS in some jurisdictions, with still limited regulatory/market acceptance**
- **On-balance sheet risk management through Islamic asset securitization is more promising, but faces legal & regulatory hurdles**
- **Both product innovations supervisory review of risk mitigation approaches require further study & development**

Cross Border Issues Specific to Islamic Finance

- Shariah compatibility of Islamic instruments across borders
- Consolidated supervision of operations that combine Shariah compliant (in one jurisdiction) and non-Shariah compliant (in another jurisdiction) elements
- Need to develop guidance on home-host relationships in the international operations of IIFS

Design of Safety Nets for Islamic Finance

- Design of deposit insurance, insolvency regimes, and emergency lending, should ideally take into account the role of PSIA in risk sharing and other Shariah considerations that affect the probability of default and loss given default**
- What is the seniority & rights of PSIA relative to other stakeholders**
- What is the appropriate coverage of PSIA under a deposit Insurance scheme**
- Do distribution of losses among the counterparties to a transaction vary according to the features of Islamic finance contracts?**
- The answer would affect the ratings and risk weights of specific Islamic finance product**

Cross Sectoral Issues in Islamic Finance

- **Ambiguity of PSIA – is it deposit or investment?**
- **Highlights the need for supervisory cooperation synthesis in designing the supervisory/regulatory regime for IIFS**
- **Role of asset securitization in risk management of IIFS highlights the linkages between IIFS risk management, and the quality & depth of Islamic capital markets**
- **Islamic money and capital market development – with emphasis on asset securitization – is therefore key to overall financial soundness**

Way Forward on Implementation of IFSB Standards

- **Conduct reviews of baseline supervision & legal & institutional infrastructure for Islamic finance, & strengthen observance of BCP & strengthen legal/accounting infrastructures**
- **Conduct training/awareness programs in IFSB standards, its relationship to Basel II**
- **Design and Implement a work program to implement IFSB standards**
- **IFSB to further develop detailed guidelines & standards on specific supervisory and risk management issues in IIFS to support implementation.**

Way Forward on Implementation of IFSB Standards (cont'd)

- Guidance on estimation & supervisory review of “ALPHA” & “DCR”; on disclosure of risk-return mix to IAH, including the extent of DCR, are high priority issues**
- Implement a comprehensive program to develop Islamic money markets & systemic liquidity infrastructure, including a supervisory assessment of the risks & constraints that IIFS face, including in their participation in payment systems**
- Review legal & institutional implications of cross sectoral aspects of Islamic finance**