Basel III: Impacts on the IIFS and the Role of the IFSB

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Abdullah Haron
Assistant Secretary General
About the IFSB

Introduction

• Based in Malaysia, officially inaugurated on 3 November 2002, and started its operation on 10 March 2003

• Serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and takaful

• To this end, the work of the IFSB complements BCBS, IOSCO and IAIS
About the IFSB cont’d

Objectives

• Develop standards & recommend its implementation
• Provide guidance on effective supervision and regulation & develop risk management & disclosure criteria
• Establish cooperation with standard international setting bodies & member countries
• Enhance & coordinate initiatives to develop instruments and procedures for efficient operation and risk management
• Encourage cooperation among member countries
• Facilitate capacity building and development of human capital
• Undertake research
• Establish database
• Miscellaneous objectives agreed by the General Assembly
About the IFSB cont’d

191 members from 43 jurisdictions

<table>
<thead>
<tr>
<th>By membership type</th>
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<tbody>
<tr>
<td>Full Member</td>
<td>29</td>
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<td>Associate Member</td>
<td>23</td>
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<tr>
<td>Observer Member</td>
<td>139</td>
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<tr>
<th>By organisational demarcation</th>
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<tbody>
<tr>
<td>Regulatory / supervisory authorities</td>
<td>54</td>
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<tr>
<td>Inter-governmental organisations</td>
<td>7</td>
</tr>
<tr>
<td>Financial institutions and professional firms</td>
<td>130</td>
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</tbody>
</table>

Membership as at March 2011
Agenda

• Background: Regulatory Framework
• Basel III Framework: An overview
• Nature of the regulated IIFS
• Impacts of Basel III to IIFS
• The Role of the IFSB
Background: Regulatory Framework
Background: Regulatory Framework

- **1988**: Capital 0-8% based on credit risk equivalents (also to cover other risks)
- **1996**: G30 recommendations 1994
  
  Basel risk management guidelines for derivatives
  
  Minimum requirements for trading activities
  
  Credit risk treatment

- **2006**: Capital based on credit risk
  
  - Standard method
  
  - Int. rating based method
  
  As well as op risk and Market risk charges

- **2010**: IFSB: capital based on the adaptation of Basel II standardized formula - excludes risks borne by the PSIA (standard and supervisory discretion)
  
  IFSB: special issues in capital adequacy on securitization and real estate

- AAOIFI: CAR - excludes risks borne by PSIA

Basel III
**Background: Regulatory Framework cont’d**

<table>
<thead>
<tr>
<th>Preconditions</th>
<th>Regulatory Requirements</th>
<th>Supervisory Action</th>
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<tr>
<td>Basic conditions for the effective functioning of The IIFS supervisory authority and The IIFS sector</td>
<td></td>
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<tr>
<td>Financial (Capital Adequacy)</td>
<td>Governance and Risk management</td>
<td>Disclosures</td>
</tr>
</tbody>
</table>

**Supervisory review process**

- The IIFS supervisory authority
- The IIFS sector
The IFSB standards

It is important to note the **notion of balance in the regulatory requirements of IIFS and the supervisory review programme** employed in this context.

The supervisory authorities will have to exercise judgement regarding the **appropriate weights and balance to be given in the application of qualitative and quantitative measures** in their policies on capital adequacy, risk management, corporate governance and disclosure requirements.
## Development of the IFSB standards

<table>
<thead>
<tr>
<th>Standard</th>
<th>Commencement of preparation</th>
<th>Issuance</th>
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</thead>
<tbody>
<tr>
<td>Risk management</td>
<td>2003</td>
<td>2005</td>
</tr>
<tr>
<td>Capital adequacy</td>
<td>2003</td>
<td>2005</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>2004</td>
<td>2006</td>
</tr>
<tr>
<td>Transparency &amp; market discipline</td>
<td>2005</td>
<td>2008</td>
</tr>
<tr>
<td>Supervisory review process</td>
<td>2005</td>
<td>2008</td>
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</table>

*Note:* * corresponds to the date of the 1st meeting of the Working Group
## Development of the IFSB standards *cont’d*

<table>
<thead>
<tr>
<th>Standard</th>
<th>Commencement of preparation</th>
<th>Issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special issues in capital adequacy</td>
<td>2006</td>
<td>2008</td>
</tr>
<tr>
<td>Governance of investment fund</td>
<td>2006</td>
<td>2008</td>
</tr>
<tr>
<td>Governance of Takaful operator</td>
<td>2006</td>
<td>2009</td>
</tr>
<tr>
<td><em>Sharī‘ah</em> governance</td>
<td>2007</td>
<td>2009</td>
</tr>
<tr>
<td>Conduct of Business</td>
<td>2007</td>
<td>2009</td>
</tr>
<tr>
<td>Solvency for Takaful</td>
<td>2008</td>
<td>2010</td>
</tr>
<tr>
<td><strong>Liquidity Risk</strong></td>
<td>2010</td>
<td>2011 (ED)</td>
</tr>
<tr>
<td><strong>Stress Testing</strong></td>
<td>2010</td>
<td>2011 (ED)</td>
</tr>
</tbody>
</table>

*Note:* * corresponds to the date of the 1st meeting of the Working Group.
Basel III Framework: An Overview
Basel III Framework: An Overview

The Global Reform Agenda

Basel III: Capital and Leverage
- More restrictive definition of capital
- More demanding capital ratios, bigger capital buffers
- Higher capital charges for counterparty risk
- Formal leverage ratio

Basel III: Quantitative Liquidity Standard
- Liquidity Coverage Ratio: to survive 1-month stress
- Net Stable Funding Ratio: to require longer term funding sources

Systemic Risk
- SIFIs Too big too fail
- Surcharges
- Levy and resolution funds
- OTC derivatives and central clearing
- Non-bank financial institutions

Compensation, Cross Border Resolution, Countercyclical Provisioning, Accounting
**Basel III Framework: An Overview cont’d**

### Capital

1a. Increased quantity
- Rise in the overall capital ratios
- Forward looking provisions
- Additional requirements for systemically important institutions

1b. Capital buffer
- Capital conservation
- Procyclical adjustment

1c. 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

### Leverage Ratio

2. Enhanced risk coverage and new capital standards for counterparty credit risk
- Credit risk
- Market risk
- Higher capital requirements
  - Trading book exposures
  - Securitization exposures
  - Resecuritization
- 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 Ratio

4. Liquidity ratio
- 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
Basel III Framework: An Overview cont’d

Higher Minimum Capital Adequacy Requirements

<table>
<thead>
<tr>
<th>Year</th>
<th>Tier I Common Equity (%)</th>
<th>Other Capital (%)</th>
<th>Other Tier I Capital (%)</th>
<th>Capital Conservation Buffer (%)</th>
<th>Cycliclical Buffer (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>2%</td>
<td>4.5%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2012</td>
<td>3.5%</td>
<td>4%</td>
<td>3.5%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2013</td>
<td>4%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2014</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2015</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2016</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2017</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2018</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2019</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2020</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
</tr>
<tr>
<td>2021</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
<td>4%</td>
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<tr>
<td>2022</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4%</td>
<td>1.5%</td>
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## Basel III Framework: An Overview cont’d

### Timeline

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum common equity</strong>&lt;br&gt;capital ratio</td>
<td>3.50%</td>
<td>4.00%</td>
<td>4.50%</td>
<td>4.50%</td>
<td>4.50%</td>
<td>4.50%</td>
<td>4.50%</td>
<td>4.50%</td>
<td>4.50%</td>
</tr>
<tr>
<td><strong>Capital conservation buffer</strong></td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minimum common equity plus</strong>&lt;br&gt;capital conservation buffer</td>
<td>3.50%</td>
<td>4.00%</td>
<td>4.50%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.00%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phase in of deductions from CET1 (inc. amounts exceeding the limit for DTAs, MSRs and financials)</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td>100%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minimum Tier 1 capital</strong></td>
<td>4.50%</td>
<td>5.50%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minimum total capital</strong></td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td></td>
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</tr>
<tr>
<td><strong>Minimum total capital plus conservation buffer</strong></td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.50%</td>
<td></td>
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<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 or Tier 2 capital</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>Phased out over 10-year horizon beginning 2013</td>
</tr>
</tbody>
</table>

- Leverage ratio | Supervisory monitoring | Parallel run 1 January 2013 – 1 January 2017 | Disclosure starts 1 January 2015 | Migration to Pillar 1
- Liquidity coverage ratio | Observation period begins | Introduce minimum standard |      |      |
- Net stable funding ratio | Observation period begins | Introduce minimum standard |      |      |
Basel III Framework: An Overview cont’d

**Capital Impact**
- Equity capital to increase by 25%-40%* or more, banks will need to look at ways to optimize the use of capital
- Additional Tier 1 capital need is almost 60% of the current Tier 1 outstanding capital
- The deferred tax assets change and the new capital instruments will have significant tax implications
- Fall in ROE is 3.7% when not considering impact of NSFR and 4.3% when considering its impact
- Cost of capital may increase as debt is replaced by equity
- Restructuring of balance sheet to dispose phased out capital instruments and optimize usage of capital
Basel III Framework: An Overview *cont’d*

**Global Capital Framework**
- Increase quantity of capital
- Better quality of capital
- New leverage ratio

**Risk Coverage**
- Increasing capital charges
- Counterparty credit risk

**Global Requirements for Liquidity Buffers**
- Liquidity coverage ratio
- Net Stable funding ratio
- Monitoring liquidity risk

**Liquidity Impact**
- Additional 40% requirement for liquidity over the liquidity buffer held currently
- Require an additional increase of 10 – 15% of stable funding over the currently available stable funding
- Liquidity risk, stress testing and reporting pose challenges for many banks
- Impact on income as bank invests in more liquid investments and curtailed loans maturity to match available stable funding
- Increased cost of liquid funds as demand increases and high interest costs of holding stable funds
### Basel III Framework: An Overview cont’d

<table>
<thead>
<tr>
<th>Global Capital Framework</th>
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<tbody>
<tr>
<td>Increase quantity of capital</td>
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<tr>
<td>Better quality of capital</td>
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<td>New leverage ratio</td>
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<td>Increasing capital charges</td>
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<td>Counterparty credit risk</td>
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<tr>
<th>Global Requirements for Liquidity Buffers</th>
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<tr>
<td>Liquidity coverage ratio</td>
</tr>
<tr>
<td>Net Stable funding ratio</td>
</tr>
<tr>
<td>Monitoring liquidity risk</td>
</tr>
</tbody>
</table>

#### Implementation issues and Operational costs
- Additional costs of implementation of systems for Basel III compliance is estimated to be between 30% and 50% of outlays for Basel II implementation
- Interdependence and complexity in designing systems to capture granular data for modeling and stress testing
- Drafting and incorporating new risk management policies and processes
- Increased operational costs of monitoring, reporting and being compliant by 2012

#### Strategic implications
- Restructuring or disposals of some business units to optimize usage of capital
- Inability to provide full-fledged services or products (trading, securitization) due to increasing capital charges and restrictions which can be up to a factor of 10 for securitization
- Pressure to increase lending spreads leading to possible loss of valuable customers
- Risk of falling below shareholder ROE expectation
- Growth can take a backseat with increased capital, liquidity and leverage requirement
Nature of the regulated IIIFS
## Stylised Balance Sheet of an IIFS

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; cash equivalents</td>
<td>Current accounts</td>
</tr>
<tr>
<td>Sales receivables</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>Investment in securities</td>
<td>Equity of Profit Sharing Investment Accounts (PSIA)</td>
</tr>
<tr>
<td>Investment in leased assets</td>
<td></td>
</tr>
<tr>
<td>Investment in real estate</td>
<td></td>
</tr>
<tr>
<td>Equity investment in joint ventures</td>
<td></td>
</tr>
<tr>
<td>Equity investment in capital ventures</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td></td>
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</tbody>
</table>
Risks: IIFS vis-à-vis conventional banks

• Unlike the predominantly borrowing and lending operations performed by conventional banks, the stylized balance sheet of an IIFS suggests that its business activities resemble a “one-stop shopping” model.

• The nature of risks to which an IIFS is exposed is not necessarily the same as those of a conventional bank.

• IIFS do not have the option to sell at a discount or to repackage and sell off their financial assets (e.g. receivables) as securities, which represent a high percentage of total assets, in order to take the risk off their balance sheet.
## Type of Risks

<table>
<thead>
<tr>
<th>Type of Risks</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Investment Risk</td>
<td>The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under <em>Muḍārabah</em> and <em>Mushārakah</em> contracts.</td>
</tr>
<tr>
<td>Rate of Return Risk</td>
<td>The potential impact on the IIFS’ returns caused by unexpected change in the rate of returns.</td>
</tr>
<tr>
<td>Displaced Commercial Risk</td>
<td>The risk that the IIFS may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The IIFS forgoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.</td>
</tr>
<tr>
<td><em>Sharī`ah</em> Noncompliance Risk</td>
<td>Risk arises from the IIFS’ failure to comply with the shariah rules and principles.</td>
</tr>
</tbody>
</table>
Overall, IIFS have been well capitalised since they started their operations. Tier 1 and total capital requirements currently stand at 8% and 12% respectively.

- IIFS have non-financial assets in their balance sheets
  - Capital charges with respect to inventory risk

- Majority of Islamic banks assess their credit risks by applying the standardised approach
  - Lack of data and smaller sample size
Risks: IIFS vis-à-vis conventional banks cont’d

• IIFS enjoy additional buffer through loss sharing nature of Muḍārabah contract – the risks of assets funded by the PSIA under the Muḍārabah contract are excluded from the calculation of CAR.

• The IIFS could use Investment Risk Reserve (IRR) and Profit Equalisation Reserve (PER) to protect the PSIA investors from financial risks.

• The IIFS will bear losses for the risks arising from negligence or misconduct on its part in managing the PSIA – operational risk.
Impact of Basel III on IIFS
Impacts of Basel III to IIFS

Current Scenario
- Basel III approaches to enhance the quality of capital. The enhancement changes the demographic of debt based capital to one of equity. IIFS already have a higher proportion of equity as capital.
- Basel III covers buffer capital ratios introduced via the Capital Conservation Buffer and Counter Cyclical Capital Buffer. The IIFS have introduced Investment Risk Reserve and Profit Equalisation Reserve.

Capital Impact
- Require IIFS to hold much more of the best form of capital while some of the existing capital will cease to count.
- Deductions from capital will increasingly be made from core tier 1.
- Dividends and bonuses will be constrained to boost core tier 1.
- IIFS will have to hold purer liquidity in larger amount and match closely between their lending and deposit base.
- A large part of the IIFS' profits over the next decade will go into the new standing funds.

Leverage Ratio
- PSIA cannot be included in additional Tier1 capital because they do not meet the criteria set out by the Basel III.
- Assets financed by the PSIAs are excluded from the exposure measure because the PSIAs are not included in the Tier 1 capital.
- Generally, IIFS are not highly leveraged due to the strict prohibition of 33% debt to equity ratio.
- In summary, no noticeable impact on IIFS positions.
Impacts of Basel III to IIFS *cont’d*

Global Capital Framework
- Increase quantity of capital
- Better quality of capital
- New leverage ratio

Risk Coverage
- Increasing capital charges
- Counterparty credit risk

Global Requirements for Liquidity Buffers
- Liquidity coverage ratio
- Net Stable funding ratio
- Monitoring liquidity risk

**Current Scenario**
- Liquidity has been a major issue in Islamic finance due to the nature of Islamic financial instruments and contracts which tend to be short to medium term given the lack of depth in the long-term liquidity market.
- Challenges also include: a) lack of appropriate standardised liquidity instruments, b) limited capability to transfer fund across borders, and c) reliance on retail funding which locks the IIFS to domestic markets.

**Liquidity Requirement Impact**
- Highly rated Sukuk are considered to meet the stock liquidity requirements.
- The need to maintain a stock of assets that can be turned into cash requires the industry stakeholders to collaborate with one another.
- Treatment of PSIA and other sources of funds with respect to the run-off in the calculation of liquidity ratio.
- The role of rating agencies will play a role in determining sukuk rating.
Impacts of Basel III to IIFS cont’d

- Global Capital Framework
  - Increase quantity of capital
  - Better quality of capital
  - New leverage ratio

- Risk Coverage
  - Increasing capital charges
  - Counterparty credit risk

- Global Requirements for Liquidity Buffers
  - Liquidity coverage ratio
  - Net Stable funding ratio
  - Monitoring liquidity risk

Tier 1 is already the case of IIFS

Tier 3 is limited in IIFS

Leverage is already low in IIFSSs

PER and IRR play similar role in forward looking provision and counter cyclical capital

Shari`ah compliant Instruments

Establishment of the IILM
Role of the IFSB
Against the backdrop of the global financial crisis and economic downturn, regulatory authorities have focused on securing financial stability and rebuilding the trust of various stakeholders in the industry.

Basel Committee addresses the weaknesses through both micro and macro prudential measures in its current work.

**Micro**

- Task 1: Raise the quality of capital
- Task 2: Improve the coverage of risk
- Task 3: Require much higher levels of capital to absorb the types of losses associated with the crisis
- Task 4: Introduce a global liquidity standard to supplement the capital regulation
- Task 5: Introduce stronger supervision, risk management and disclosure standards

**Macro**

- Task 1: Introduce a leverage ratio
- Task 2: Introduce measures to raise capital in good times so that they can be drawn down in periods of stress to reduce procyclicality
- Task 3: Require globally systemic banks to have additional loss absorbancy
The IFSB has formed a working group early this year, aiming to revise the existing IFSB standards on capital adequacy including securitisation and real estates

- Not to put IIFS at a disadvantageous position;
- Provide guidance on capital adequacy treatment of major Shari’ah compliant products;
- Offer enough flexibility;
- Address the peculiarities of IIFS with respect to various components of eligible capital, while taking into account the prevailing experiments by some IIFS to raise capital through innovative Shari’ah compliant structures; and
- Promote robust risk management.
Role of the IFSB *cont’d*

The IFSB issues two new Exposure Drafts (EDs) for a three-month Public Consultation. The EDs are drafts of guiding principles on: 1) Liquidity Risk Management and 2) Stress Testing for institutions offering Islamic financial services (IIFS).

- The liquidity risk management endeavors to delineate a set of guiding principles for the robust management of liquidity risk by IIFS and its vigorous supervision and monitoring by supervisory authorities, taking into consideration the specificities of IIFS and complementing relevant existing and emerging international standards and best practices.

- The stress testing aims to provide a set of guiding principles intended to complement the existing international stress testing framework.
Thank you for your attention

abdullah@ifsb.org

References

*Special thanks to my brother Muhammad Adli Musa for his critical review on this presentation.*