Challenges in Islamic Bank Supervision

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2:00 PM – 3:00 PM

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Outline

• What is Islamic Finance
• Islamic Finance growth and geographic dispersion
• Islamic bank balance sheet structure
• Risks in Islamic banks
• Supervisory and Regulatory Frameworks for Islamic banks
• Policy Messages
WHAT IS ISLAMIC FINANCE?

Islamic finance (IF) refers to the provision of financial services in accordance with Islamic jurisprudence (Shari’ah).

**Principles**
- No interest
- Avoid excessive uncertainty
- Asset based
- Strong ethical basis

**Products**
- Sales with deferred payments
- Lease
- Fee-based services
- Profit-sharing financing

**Cross-Sectoral**
- Banking
- Leasing
- Securities (Sukuk) & equities
- Investment funds
- Insurance
- Micro-finance
ISLAMIC BANKING IS GROWING RAPIDLY...

Islamic Banking Assets Growth Trend (2008-14) ($US in billions)

- GCC
- MENA (excl. GCC)
- Asia
...TO BECOME SYSTEMIC IN A DOZEN OF COUNTRIES...

Islamic Finance Markets by Systemic Significance
... SUKUK ALSO GROWING WITH INCREASED INTERNATIONALIZATION

Global Sukuk Issuance
($US in billions)

Sukuk Issued (right scale)
...AND SOVEREIGN SUKUK ISSUANCE 2014-2015 YTD

LUXEM - BOURG: $253 mn

UK: $343 mn

THE GAMBIA: $16 mn

SENEGAL: $205 mn

TURKEY: $2.4 bn

PAKISTAN: $1.5 bn

HONG KONG SAR: $1 bn

Bahrain: $1.5 bn

Qatar: $3 bn

BANGLADESH: $2 mn

BRUNEI: $316 mn

INDONESIA: $617 mn

MALAYSIA: $6.4 bn

Source: Bloomberg, Gulf News, Rasameel Research.

(1) Total sovereign direct borrowing was ~$5.2 billion 2012, a portion of which was Sukuk.
... WHILE THEY ARE INCREASINGLY USED TO FUND INFRASTRUCTURE

Total Infrastructure Sukuk Issuance
($US in millions)
# Islamic v Conventional Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>More real asset inventory holdings</strong>&lt;br&gt;(real estate, automobiles, commodities)</td>
<td><strong>Demand Deposits</strong>&lt;br&gt;No return on deposits</td>
</tr>
<tr>
<td><strong>Investment Assets (Profit Sharing) &amp; Financing Assets</strong>&lt;br&gt;-investments in business ventures&lt;br&gt;-more leasing/rental&lt;br&gt;-more equity structures and instruments&lt;br&gt;-returns contingent on profits</td>
<td><strong>Profit Sharing Investment Accounts</strong>&lt;br&gt;-Compensated return earned from asset side&lt;br&gt;-Profit sharing reserves&lt;br&gt;-Principal not guaranteed</td>
</tr>
<tr>
<td><strong>Fee based Services</strong>&lt;br&gt;-Charges and fees are important</td>
<td><strong>Capital</strong>&lt;br&gt;-mostly equity far less debt instruments</td>
</tr>
</tbody>
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Example - [Auto Murabaha Example](#)
Risks

• Similar categories of risks between Islamic and conventional banks:
  – Credit Risk - Market Risk - Liquidity Risk.
  – Operational Risk - AML/CFT

• Risks unique to Islamic Banks (additional risks):
  – Displaced commercial risk - Rate of return risk
  – Equity investment risk - Shariah compliance risk

• Islamic banks need different treatment for:
  – Liquidity (HQLA limited -run-off, drawdown rates, haircuts)
  – Exposure limits (greater concentration risk)
  – Capital Charges (for new instruments, higher for greater concentration, market risks on commodities)
  – Risk weights (for new instruments, higher for Islamic, limited hedging)
  – AML/CFT – Layering makes funds harder to track – more attention required to KYC and AML/CFT.
Conventional Bank Losses

- Expected losses from Pillar 1 Credit, market, & Operational risks
- Unexpected losses from Pillar 1 Credit, market, & Operational risks
- Pillar 2 and Low probability High Impact losses
- Tail risk

Loss mitigants:
- Income Provisions
- Minimum Capital
- Capital buffers
- Insurance
- Risk transfer
- Derivatives
Islamic bank Losses

Unexpected losses from
Credit, market,
Operational risks

Low probability
High Impact losses
Tail risk

Losses from unique Islamic risk
Including PSIA losses

Expected Losses

Frequency of losses

Size of losses

Loss mitigants

Income
Provisions

Capital
Profit sharing investment account
Profit-sharing reserves

Capital buffers
Takaful
Loss sharing

Quasi-deposits that act as loss-absorbing instruments
ISLAMIC FINANCE OFFERS THE PROMISE OF SUPPORT TO GROWTH & STABILITY...

Inclusive growth

- Financial inclusion
- SME access
- Infrastructure investment

Financial stability

- Less leverage
- Greater incentive for risk management
- Loss-absorbency

Financial stability
ISLAMIC FINANCE STANDARD SETTERS ESTABLISHED

Adaptation

IF Implications

ISLAMIC

IFSB
IsDB
CIBAFI
AAOIFI
IILM
IIFM

CONVENTIONAL

FSB
IAIS
IOSCO
BCBS
IASB
IADI
Regulatory Framework

• Need legal framework that recognizes Islamic banking
• Potentially higher capital charges and risk weights to account for complex-layered risks
• Determination of HQLA and set: run-off, drawdown rates and haircuts for assets
• Decide on NPA definitions for Islamic banks
• Need regulation regarding treatment of loss-absorbent liabilities
• What is appropriate scope of depositor insurance: only demand deposits or PSIA as well?

Capital Adequacy Ratio Example - [Capital Adequacy Ratio Example](#)
Complexities & distinctiveness of Islamic banks call for:

- Careful licensing of Islamic bank and products as this poses:
  - greater governance challenges, and
  - determination of shariah compliance by qualified body
- Enhanced disclosure requirements
- Additional early warning systems
- More granular on-site visits to deal with complex layered risks
- Need for Training as supervisory capacity & knowledge is weak
Policy Challenges (safety and soundness)

• Changes to legal, accounting, LOLR frameworks needed as precondition

• Understanding the underlying nature of Islamic Banking:
  - Does it involve additional risk-taking incentives (given risk sharing)?
  - In what areas does it warrant different regulatory approach?

• Understanding banking system vulnerabilities – need for greater disclosure:
  - No consistent set of FSIs that are able to account for Islamic bank specificities
  - Which indicators should be followed for surveillance purposes?
Auto Murabaha Example

1. **Bank buys goods without availability of prospective buyer**

2. **Murabaha Contract and Purchase order Mark-up agreed**

3. **Goods To buyer**

4. **Murabaha Settled by Installments Over Time**

**buyer**

**seller**

**Islamic Bank**
Commodity-Sale Home Example

Commodity Seller → Spot Cash Payment → Bank

Commodity Buyer → Metal → 3rd party seller

Property Seller → Property Purchase Contract → Mutawariq

3rd party seller and 3rd party buyer are often affiliates

Deferred payments Spot Cash amount + Profit amount

Islamic vs Conventional Balance Sheet
Capital Adequacy Ratio Example

IFSB formula for capital adequacy ratios (different from Basel)

• Standard formula:

\[
\text{Eligible Capital} = \frac{[\text{Total RWA (credit + market risks) + Operational risk} - \text{RWA funded by PSIA (credit + market risks)}]}{}
\]

• Supervisory Discretion Formula (alpha usually 30 percent):

\[
\text{Eligible Capital} = \frac{[\text{Total RWA (credit + market risk) + Operational risk} - \text{RWA funded by RPSIA (credit + market risk)} - (1-\alpha) \text{RWA funded UPSIA (credit + market risk)} - \alpha \text{RWA funded by PER & IRR of UPSIA (credit + market risk)}]}{}
\]