

Capital adequacy ratios

If supervisory authorities and central banks provide regulatory incentives to Islamic banks, they could provide true economic returns to investment account holders, argues **Syed Farook**. One such valuable incentive mechanism available is the capital adequacy ratio

WALK INTO SOME Islamic banks and you will see that they provide indicative rates of return based on historical performance, which, ironically, correlate with conventional banking deposit interest rates.

Is there a problem with this? Yes and no. Yes, the problem with this is that Islamic banks engage in a profit-sharing relationship with their investment account holders (the term given for the comparable of depositors). This means that investment account holders (IAHs) should enjoy true economic returns of the bank rather than distributions comparable to benchmark interest rates. There is no problem with this if the asset allocation strategy yields returns for the Islamic bank that are comparable to benchmark interest rates. However, studies have found that some (not all) Islamic banks do smooth distributions to IAHs.

The reasons for this are quite clear in the minds of some Islamic bankers. As an Islamic banker, I would tell you that if we do not provide rates similar to deposits, then our IAHs will move their funds to a bank (Islamic or otherwise) that does—in Islamic accounting circles called displaced commercial risk (DCR). This is a legitimate concern and it relates to the mentality of IAHs who may desire a stable low-risk return.

This “distributions smoothing”, while not generalised to all Islamic banks, could potentially cause the Islamic bank’s earnings to be volatile. Why? If pre-distribution revenues are poor in a particular year, Islamic bank shareholders have to sacrifice their profits for that year to subsidise IAHs’ appetite for returns.

This is further exacerbated by Islamic banks carrying a sizeable proportion of

fixed rate investments on their assets side without the associated benefit of being able to hedge fixed rate exposures until only recently. That means that when market-wide interest rates are increased, Islamic banks will be left with an underperforming portfolio of fixed rate instruments, while still having to increase their profit distribution rates for the benefit of their “sensitive” IAHs.

To mitigate and/or reduce the displaced commercial risk, some banks have



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resorted to the practice of smoothing distributions to IAHs, utilising unique smoothing reserves.

The practice of utilising reserves effectively shields the bank’s own capital from the effects of DCR. But what if these reserves are not enough? The practice of reserves is a new phenomenon, and banks, generally, do not have a significant build-up of reserves to protect against signifi-

cant systemic shocks; for instance, a hike in benchmark interest rates.

What this implies is Islamic banks that do practise distributions smoothing may just be subject to higher earnings volatility in the instances where they do not have a significant build-up of reserves or where they don’t have reserves at all.

Given the assumptions of finance theory, increased earnings volatility compared with conventional institutions might just imply that the shares of an Islamic bank are riskier than a conventional bank, assuming that a conventional bank has mechanisms to mitigate fixed rate exposures. This would make the Islamic bank a riskier asset to hold in the long term and, thereby, make the Islamic financial industry a riskier industry, particular without the benefit of hedging instruments and during times of economic contraction.

This theory—and it is just that—is quite contrary to the claims of Islamic economists. Islamic economists believe that Islamic banks are more resistant to economic shocks because they share profits and losses with IAHs.

Granted, if an Islamic bank truly provides “real economic” distributions to their IAHs, there is a good chance that the Islamic banks will be more resistant to economic shocks, since they are able to share the burden of the shock with IAHs. Indeed, this is one of the most compelling cases going for Islamic banks.

Yet, in reality, some Islamic banks may be more exposed to economic shocks and adjustments in market interest rates than conventional banks, because they practise smoothing, without having sufficient reserves or having no reserves at all.

The question, therefore, becomes: how can we really make the Islamic finance industry resistant to economic shocks

while still keeping our IAHs and shareholders content? The practice of reserves propagated by AAOIFI and the IFSB is one good solution. The substantial IFSB guidelines on risk management are even better, but these would not necessarily reduce the volatility associated with an economic shock being passed on solely to the shareholders.

The other solution is to incentivise Islamic banks to move towards providing IAHs with real economic returns based on underlying performance. Would IAHs agree to this? In some jurisdictions and for many banks they already do. In these jurisdictions, the value proposition of encouraging more Islamic banks to open shop is tremendous, since they will go a long way to avoid systemic risks to the financial system, particularly if they are doing a good job in managing their risks according to the IFSB guidelines.

But in others the common assumption would be that IAHs would not agree to receiving volatile distributions, since IAHs mistakenly believe that Islamic

banks should provide distributions just like conventional banks.

Professor Karim and Professor Archer suggest that this might be because of the inherent nature of bank depositors (whether Islamic or conventional), whose relatively low net worth means that they are naturally risk averse and prefer to earn stable low yield returns (compared with high net worth individuals who invest in shares, funds and all sorts of diversified risky investments).

But perhaps it may also have to do with market education of Islamic finance as an alternative financial system. Many people who are working within the industry still do not “believe” in the Islamic finance system and the benefit it offers.

In addition, customers and IAHs are still unclear about the benefits of this system at both the macro and micro economic level. Some customers would prefer stable returns rather than volatile returns based on performance, which may yield good returns for some customers and bad returns for others, depending on when

they invest with the Islamic bank.

Industry building infrastructure institutions such as AAOIFI and the IFSB are doing a lot to educate the market, particularly Islamic banks and practitioners, about the best practices in terms of relations with IAHs, profit distributions and disclosure.

The industry has come a long way in this regard and as a result of its painstaking contributions. But the reality is that the intended ripple effects to the rest of society, particularly IAHs, are taking much longer to flow through.

Consequently, even with Islamic bank penetration rates rising and the dizzying growth rates, IAHs are hazy about the nature of their relationship with Islamic banks. Islamic banks (with the exception of a few), on the other hand, are doing little to increase the levels of disclosure to IAHs, considering the fundamentally different relationship between the bank as a manager (agent) and IAHs as an investor (principal).

This may be because it is difficult to

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change the mindset of the bank-depositor relationship, which has been grounded in stone over the centuries. Add to that the majority of the individuals who are employed in Islamic banks are largely scouted from conventional banks. Perhaps in time and with further education trickling through to the banking community this may be eventually be achieved.

However, assuming that some Islamic banks have no incentives to move in this direction themselves and provide true economic returns to IAHs, perhaps the only way to ensure this happens as quick as the pace of growth of the Islamic finance industry is if supervisory authorities and central banks provide regulatory incentives to Islamic banks.

One such valuable incentive mechanism available to central banks is the capital adequacy ratio (CAR). CAR sets the required level of shareholders' capital (usually 8% in most jurisdictions) against the total risk-weighted assets of an Islamic bank. Hence a CAR for a conventional bank would usually look like this:

$$\frac{\text{REGULATORY CAPITAL}}{\text{TOTAL RISK WEIGHTED ASSETS}}$$

However, the interesting aspect of this CAR formulation is the modification made by the IFSB to reflect differences in the underlying operations of an Islamic bank. The IFSB stipulates that Islamic banks need to maintain only a partial percentage of their risk-weighted assets funded by IAHs, at the discretion of the central bank or supervisory authority, the rationale behind this being that the depositors are supposed to be profit sharing and loss bearing.

Consequently, the Islamic bank should not have to maintain additional capital for funds invested on behalf of IAHs, considering that IAHs have to bear that risk themselves. The IFSB has left the percentage of risk-weighted assets funded by depositors (otherwise known as the *a* factor) up to the individual regulators to decide in their own jurisdictions. For example, the Bahrain Central Bank has ruled it to be 30% for the kingdom. This indirectly places Islamic banks at a competitive advantage, since they include only 30% of IAHs (which usually comprise a significant proportion of Islamic bank assets, around the 30-70% range).

Presumably, the rationale for this supervisory discretion formula is to allow

central banks and supervisors to decide on the profit sharing/loss bearing risk (displaced commercial risk or DCR) that Islamic banks are exposed to under their jurisdiction, in the event that the central bank has to rescue an Islamic bank.

However, what if an individual Islamic bank is more resistant to shocks in the local economy because it already undertakes pure performance-based profit/loss sharing with IAHs (that is, displaced commercial risk for its set of IAHs is lower)?

Regulators and supervisors can resolve this 'one size fits all' issue by imposing a variable *a* factor on Islamic banks



This supervisory discretion formula, if applied on a jurisdictional basis, assumes that all Islamic banks in that particular jurisdiction fit into the "one-size fits all" category. In a country like Bahrain, with 30% of IAHs risk-weighted assets included in the CAR denominator, this implies that IAHs will bear up to 70% of their losses, while the other 30% will be borne by the shareholders or the central bank. That individual bank, which has little or no displaced commercial risk, still has to bear the burden of IAHs.

Most central banks have applied this regulation in such a manner. There is nothing particularly wrong with this, in the absence of a better indicator of individual DCR exposure.

One way for regulators and supervisors to resolve this "one-size fits all" issue and indirectly incentivise Islamic banks to engage in providing true economic returns to IAHs is imposing a variable *a* factor on banks. The IFSB already provides this flexibility to each regulator to do this.

However, to provide for a variable *a* factor, the supervisory authorities would require accounting technology that would calculate the individual bank level exposure to DCR. This is quite achievable. Banks already provide quarterly returns to their supervisory authorities. The central bank or supervisory authority can design

a formula to calculate DCR exposure by which banks will report their individual exposure to DCR. Based on this exposure, the central bank can impose a variable *a* factor that will determine the capital a bank must hold against its risk-weighted assets funded by IAHs. In addition, banks can be given further *a* factor relief based on the extent of disclosures provided, with more disclosures allowing more haircuts on the extent of risk weighted assets funded by IAHs to be included in the denominator of the CAR.

If the measure is variable and banks have the opportunity to reduce the IAHs-based DCR capital charge, they will do whatever is in their capacity to reduce it. For one, this may include ensuring a more efficient asset allocation strategy, reducing dependence on fixed rate instruments such as *murabaha* and increasing variable (*ijarah*-based) and long term assets (*sukuk*).

It could also encourage Islamic banks to start moving towards greater disclosures directed towards IAHs, educating them about the nature of their relationship with the bank and the rationale behind the profit share distributed to IAHs, even if it happens to be lower than market-based deposit rates.

Besides increasing incentives to further engage with IAHs through disclosure, the potential benefits of this incentive approach to the *a* factor in the CAR calculation will have positive ripple effects on the broader Islamic financial system.

The financial system will be more resistant to economic shocks and systemic risk as the bank will actually share the effects of the shock with the depositors, while the depositors get to bear the fruit from expansionary cycles.

The banks will be more open to variable returns on their assets side, allowing the institutional appetite for variable returns-based *sukuk* such as *musharaka* or *mudaraba* to increase.

Supervisory authorities and Islamic bankers (who will have to follow suit) have a golden opportunity to achieve the goals of Islamic economics: to create a stable Islamic financial system, resistant to economic shocks that truly operates on the basis of profit and loss sharing. It is now up to them to take it there. ■

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