General Council for Islamic Banks And Financial Institutions

CIBAFI

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI Policy Note on Draft Recommendations of B-20 Turkey Financing Growth Taskforce

30 April 2014

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CIBAFI Policy Note on the 1st Draft Recommendations of B-20 Turkey Financing Growth Taskforce

Background

The B-20 group, a platform for business leaders from G-20 economies, has come up with the B-20 Turkey Financing Growth Taskforce in 2015, with several key aims to improve and strengthen the current global financial architecture; increase and diversify the access to equity for small-to-medium enterprises (SMEs); and improve the financing structure of the corporate world towards a better balance of debt and equity financing. The Taskforce recommendations have selected priorities in the area of improving global regulation of markets and facilitating SME financing.

CIBAFI, as the global umbrella of Islamic financial institutions, was requested by the Taskforce to propose a brief policy note specific to the Islamic finance industry, in response to the priorities of the Taskforce recommendations. This is in line with the G-20's annual agenda, with Turkey holding the group Presidency for the year 2015, in promoting Islamic finance in the form of equity financing and *Sukuk*. Therefore, the CIBAFI Secretariat's brief policy note presents several recommendations which are of importance to the global Islamic finance industry within the scope of the Taskforce priorities.

Global regulation of markets

The Taskforce has selected four key regulatory priorities that need to be addressed. These are: the review of the standardized approach and RWA; Total Loss Absorbing Capacity (TLAC); trade finance; and regulatory consistency.

The Secretariat believes that the current development in banking prudential regulation is of importance to the Islamic finance industry. The Basel Committee on Banking Supervision (BCBS) has issued a consultative document "Revisions to the Standardized Approach for credit risk" in December 2014. The Committee primarily aims to enhance the standardized approach for credit risk through e.g. reducing reliance on external credit ratings; increasing risk sensitivity; enhancing comparability of capital requirements across banks, etc. Meanwhile, the Financial Stability Board (FSB) has issued a consultative document "Adequacy of loss-absorbing capacity of global systemically important banks in resolution" which was developed at the request of G20 leaders in order to improve the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution.

The following sections are based on the Secretariat's recommendations with respect to the global regulation of markets in order to promote sustainable growth of the industry. Our perspective is that of practitioners who will have to implement standards and regulations, while finding a balance between the requirements of regulators, the market, their shareholders, their customers, and other stakeholders.

1. Enhancing regulatory consistency for Islamic financial institutions

Like its conventional counterpart, the Islamic finance industry has experienced a succession of regulatory changes, some of which continue. The industry deals with standards originating from not only the Basel Committee but also the Islamic Financial Services Board (IFSB), which adapts BCBS standards to cater for specificities of Islamic finance operations and business model. As with the BCBS standards, the IFSB standards then have to be translated into national regulation. The complexity in regulatory development for Islamic finance industry has resulted in two main consequences. First, the lengthy process has created a significant delay in adopting appropriate regulations for the Islamic finance industry. For example, while the final version of the BCBS Liquidity Coverage Ratio was issued two years ago, in January 2013, the IFSB's corresponding standard (Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions offering Islamic Financial Services (IIFS)) was adopted only in April this year. Second, the implementation of banking prudential regulations for IIFS has varied across different jurisdictions, leading to regulatory inconsistencies for Islamic finance operations.

In view of that, the Secretariat suggests that the Basel Committee should consider and incorporate Islamic finance on a systematic way from the beginning of their standard-setting process, in order to avoid significant delay and ensure regulatory clarity for IIFS. Regulators need to implement regulations catering for specificities of Islamic finance, to enhance regulatory consistency that ensures a level playing field for IIFS across different jurisdictions and mitigates the presence of regulatory arbitrage. We also believe that any regulatory changes need to be consistently implemented, and paced so as to give a chance for the IIFS to learn, reconsider and adjust their medium term business models. Introducing more complexity might potentially affect the growth of the industry, and hence the review process of the revised standardized approach and RWA needs to minimize unnecessary change and the risk of unintended consequences.

2. Incorporating risk drivers specific to Islamic financial transactions

The Secretariat applauds that the BCBS has moved towards the approach of using risk drivers in order to enhance risk sensitivity and granularity. However, the Secretariat questions whether the use of the proposed uniform risk drivers is sufficient to capture distinctive risks in Islamic finance transactions. In this area, the BCBS needs to recognize the efforts of the IFSB with respect to different treatments on risks according to various types of Islamic financial contracts. For the example of corporate exposures, IIFS may provide financing and hold investments in the banking book in the form of *Musharakah* or *Muḍarabah*, where these exposures under profit-sharing modes have different treatments on risk weight depending on investment types such as business venture, diminishing *Musharakah*, specific project, etc. This type of financing might result in an impairment of capital without any credit default being involved, and therefore additional risk parameters are required (beyond revenues and leverage). In addition, the risk drivers for retail portfolios and exposures secured by real estate, where Islamic transaction structures differ from conventional ones, need also to account for various stages of transactions depending on the type of Islamic contract used. The Secretariat would support any effort by the BCBS to conduct a more extensive risk driver analysis, followed by adequate calibration, which cater for specificities in Islamic financial transactions.

More generally, we also strongly support any efforts of deriving adequate risk drivers, and avoiding punitive risk weight, for equity and equity-like modes of financing by both BCBS and

IFSB, which is in line with the key objective of B-20 Turkey in improving the financing structure of the corporate world towards a better balance of debt and equity financing.

3. Aligning risk parameters to the nature of emerging economies and SMEs

The consultative document of the revised standardized approach for credit risk seems to assume a data-rich environment which is more likely to be found in developed economies. An in-depth analysis of the proposed revisions, including calibration, needs to account for emerging markets in which most IIFS are located. Moreover, several jurisdictions of IIFS have not yet implemented Basel III, and hence specific parameters should be defined in order not to penalize such Islamic banks (e.g. a punitive 300% risk weight to banks that are not under Basel III).

Finally, small-medium enterprises (SMEs) have served as a backbone of the many emerging economies, as well as value propositions of Islamic finance with respect to extending financial inclusion to the SME sector. The consultative document needs to have a distinct treatment for this sector in order to fully reflect its specific characteristics (e.g. the current revisions may put SME at disadvantages by not accounting for size adjustment commonly used in the IRB approach, lack of requirement to publish financial statements for SMEs, etc.). Adopting regulations which properly recognize the distinctive characteristics of SMEs will be in line with the key objective of the B-20 Turkey in diversifying the access to equity for small- to medium-size businesses.

4. Promoting external rating agencies catering for Islamic finance

The issue of overreliance on external ratings during the crisis was particularly attributable to securitization and sovereigns, and is in any event less relevant to the kinds of banks that will operate under the credit risk standardized approach than to larger and more complex institutions. Moreover, banks in emerging market economies operate in a less data-rich environment than those in developed economies, and so are less able to use the other proposed risk-drivers that the BCBS put forward. The Secretariat is of the opinion that the G-20 mandate is to reduce reliance on external ratings, rather than to remove their use altogether, and hence external ratings can be used as a yardstick complemented by other proposed risk drivers. An adjustment will be made if there is a conflict between the two in determining the risk weights.

In addition, the underlying rating approach needs to cater for the specificities of Islamic finance in order to avoid methodological errors in reflecting the nature of several types of Islamic financial contracts. While some progress has been made among the large international ratings agencies, there may still be a need for recognition of smaller and more specialized agencies in this area. The regulators and IIFS need to come up with a common acceptance of using Islamic ratings framework as a reference point among IIFS, which will not only provide a level playing field of Islamic finance but also ensure the long-term stability of the industry.

5. Reducing negative implication of regulatory treatment on Islamic trade finance

The Secretariat is of the opinion that the Basel III has assigned punitive credit conversion factors (CCF) in the area of trade finance and hence revision is encouraged to promote Islamic trade financing by IIFS, which are based predominantly in emerging markets. In emerging economies, firms can experience a significant increase in fees charged in order for financial institutions to reach a comparable cost of capital allocation, which might lead to a substantial increase in the cost of trade financing products to customers. This might have even larger adverse implications for IIFS since Islamic trade finance still deals with a wide range of issues, e.g. the competitive cost of Islamic trade financing, *Shariah*-compliant products available to meet the demand, the availability of *Shariah*-compliant hedging instruments, and the level of awareness with regard to Islamic finance in the countries' trading partners.

6. Revision on risk weight in short-term interbank claims to ease liquidity challenge of IIFS

Liquidity remains the most crucial issue within the top agenda of the Islamic finance industry, due to lack of available high quality liquid assets (HQLAs) and development of Islamic liquidity market. Even though the IFSB GN-6 acknowledges the common constraints and limitations in the availability of *Shariah*-compliant HQLAs for IIFS, IIFS still require more time to assess, evaluate and agree on appropriate HQLAs with local central banks, while requiring the IIFS to reconsider and adjust their business models and reclassify investments. There is also lack of clarification on treatment of various *Shariah* structures which determine the classification of quality of assets and assumed run-off rates of assets/liabilities (e.g. weight for contingent inflows such as profit sharing arrangements).

In view of that, the BCBS proposal, which leads to significant increases in risk-weights for short-term interbank claims, might have severe implications for the Islamic finance industry. Combined with the proposed 300% risk weight, this can result in significant increases in risk weights for bank exposures during economic downturn, where banks would be more reluctant to lend to each other. Hence, the Secretariat suggests the Committee should revise the proposed risk weight, along with preferential risk weights applicable for rolled-over short-term interbank claims.

7. Appropriate treatment on specialized lending risk weight to promote *Sukuk* infrastructure financing

Sukuk has been instrumental in promoting infrastructure financing. This is in line with the G-20's initiative to include Islamic bonds or *Sukuk* as an infrastructure financing tool in its annual agenda, which could promote the use of project-based *Sukuk*, structured using special purpose entity (SPE). However, the Committee proposal for specialized lending might have an adverse implication to infrastructure financing mostly in emerging economies. To use the specialized lending risk weight or the maximum of the corporate risk weight can be irrelevant for financing to a low quality SPE with high quality of the pledged asset. Since SPE is designed for bankruptcy-remote purposes, its treatment as a corporate appears inappropriate and may potentially lead to a 300% risk weight.

In view of that, the Secretariat is of the opinion that more risk sensitivity is required in lieu of a simple treatment of specialized lending. This can be achieved by considering the slotting approach under the IRB for credit risk SA, instead of a uniform risk weight, through developing adequate regulatory guidance in order to harmonize assessments. Assigning risk weights according to the risk of each phase of specialized lending (e.g. pre-operational and operational phases) will fit to the characteristics of Islamic financial transactions, as the risk-return profile varies driven by stages in Islamic financial contracts.

8. Treatment of profit-sharing investment account (PSIA) as potentially loss absorbent

The Secretariat supports the effort of the Financial Stability Board (FSB) in enhancing the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution. We recognize that a number of IIFS in some jurisdictions have systemic significance considered as Domestic Systemically Important Banks (D-SIBs). Hence, we suggest that the market-impact analysis should also consider the market impact of D-SIBs, in order to anticipate of complying with the same rules in the future.

Specific to Islamic finance, we suggest that profit-sharing investment account (PSIA) can be treated as loss absorbent where the account holders will bear risk to both return and principal, and hence this needs to be reflected within the TLAC calculations. Whether PSIAs can be considered fully loss-absorbing will depend on circumstances, including the representations made to account holders. (This variability is recognized through the concept of displaced commercial risk and the parameter α in the IFSB's capital standards.) However, the recent Islamic Financial Services Act (IFSA) in Malaysia is an important step towards loss-absorbency of such investment accounts (arguably making them more like collective investment schemes). There should thus be at least the possibility of PSIAs being regarded as fully or partially loss-absorbent.

In summary, therefore, we suggest that in this part of its report the B-20 should:

- Note that, while the ethos of Islamic finance is highly conducive to financing growth through real economic activities, it labours under a number of regulatory handicaps. Some of these stem from the fact that its specificities are not taken into account at the early stages of standard-setting; others are shared with other parts of the industry whose business is concentrated in emerging markets.

- Encourage the BCBS and other bodies to do more work on equity and equity-like forms of finance, which are particularly important in Islamic finance.

- Encourage the BCBS not to be too dogmatic in moving away from credit ratings, which remain a valid tool for assessing risk, especially in less data-rich environments. Specific to Islamic finance, the underlying rating approach catering specificities of *Shariah*-compliant financial transactions should be recognized as a reference point within the Islamic finance industry.

- Draw the attention of the FSB to the need to consider whether PSIAs can be treated as providing, if not fully, at least partially loss-absorbing capital within the TLAC calculation.

Facilitating SME financing

The Taskforce has selected priorities to tackle supply side obstacles or financing providers with respect to facilitating SME financing. This is in line with the interest of the Islamic finance industry in promoting SME financing in line with value propositions of Islamic finance, and the Secretariat believes that the proposed best practice solutions are very important to sustain the growth of the sector. The following sections are based on the Secretariat's recommendations with respect to promoting SME financing through Islamic finance.

1. Adjusting SME scoring according to risk parameters of equity-based financing

The Secretariat strongly supports the effort towards establishing SME scoring agencies in order to facilitate information transparency between SMEs and lenders. Nonetheless, we notice that the scoring is mostly based on a credit type of financing which emphasizes the probability of default. On the other hand, IIFS might become involved in profit-sharing investment on a *Musharakah* or *Mudarabah* basis, with the aim of holding for an indefinite period or with a view to eventual sale. This mode of financing can result in an impairment of capital without any credit default being involved. Since the Taskforce promotes establishing capital markets for SMEs as exit options (e.g. setting IPO taskforces), we believe that the SME scoring agencies as the entrance options need to incorporate risk parameters of equity-like modes of financing in order to promote and support the further roles of private equity and venture capital in this sector. Regulators can also take an initiative in setting up a junior equity market for SMEs in order to offer access to an additional source of finance and to reduce dependence on bank finance, much of it conventional.[1]

2. Comprehensive package through a mixture of SME financing, cash *waqf* and micro*takaful*

While SME financing has played a larger portion in promoting the SME sector, Islamic finance can also benefit from its unique strength of *waqf* funds. A *waqf* is a voluntary charitable contribution, broadly similar to a trust fund, and meant for creation of a common wealth for the benefit of the people; its role moves beyond the need of fulfillment of the poor and the deprived through providing the means for long time empowerment and enrichment. *Waqf* funding, in the form of cash *waqf*, can be channeled into the support of SMEs in various ways, for example by providing supportive infrastructures for SMEs' business operations to further enhance their marginal returns. An interesting recent practice from some IIFS is to take a portion of clients' money into a cash *waqf*-based account, where depositors are given a list of the beneficiaries they prefer for allocation. This can be seen as a variant on crowd-funding.

Where very small enterprises are concerned, it may also be efficient to add micro*takaful* – the Islamic version of small-scale mutual insurance – to a package involving commercial SME financing and cash *waqf*, as a comprehensive package for the sustainable growth of small enterprises.

3. *Shariah*-compliant guarantee schemes for SME financing

The Taskforce proposes offering SME loan guarantees to share the exposure of banks to SME lending risks and reduce the risk weights attached to SME loans. The Secretariat believes that there is also a need for the Islamic finance industry to structure *Shariah*-compliant guarantee schemes for SME financing, along with a proper arrangement amongst counterparties involved, in order to provide a level playing field for Islamic SME financing. This can be achieved through a third-

[1] The stock market for SMEs with trading platforms have been established in some of non-Muslim countries such as China, India, South Korea, etc.

party guarantee scheme which might involve a role for government-linked institutions, while taking into account of the lack of collateralized assets in the transaction.

4. Entrepreneurs' skills enhancement and monitoring strategies

One of the most effective means to reduce default risk of SME financing is through enhancing the ability-to-pay of the entrepreneurs. This can be achieved by providing new entrepreneurs with enhancement skills to improve both soft skills (e.g. persistence, networking, self-confidence) and hard skills (basic start- up knowledge, business planning, financial literacy, managerial skills). Therefore, regulators can come up with entrepreneurship education policies, as well as establish specialized institutions which focus on developing entrepreneurial competencies and skills required before entrepreneurs receive financing. In that case, IIFS can potentially support and contribute by channeling cash-*waqf* funds and micro*takaful* to this program, which are synchronized with their SME financing activities in the subsequent phases. Enhancing the ability-to-pay can be combined with the improvement in the willingness-to-pay through various types of monitoring and incentive strategies (e.g. repeated financing, progressive financing, joint liability, etc.) in order to generate sustainable returns. This will fit better to equity-like modes of financing, with their payoffs highly exposed to business skills and moral hazard.

In this area, therefore, the Secretariat's views are closely aligned with those of the draft. We should, however, like the Taskforce to note in its report the strong moral alignment of Islamic finance towards the support of SMEs, and the availability of tools such as *waqf* to support this. However, in this area too there is a need for structures such as scoring and guarantee schemes to be better aligned to equity-based finance.

Appendix – Arabic Terminology

No.	Arabic Terminology	Definition
		D
1	**Diminishing Musharakah**	Diminishing Mushārakah or Mushārakah Mutanaqisah is a form of partnership in which one of the partners (customer) promises to buy the equity share of the other partner (financier) gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, followed by the financier leasing his equity share to the customer throughout the tenure of the lease, the customer will gradually buy the other financier's share at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" contract is independent from the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to give only a promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
		M
2	**Mudarabah**	A Muḍarabah is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the Muḍārib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Muḍārabah agreement whilst losses are to borne solely by the capital provider unless the losses are due to the Muḍārib's misconduct, negligence or breach of contracted terms.
2	**Musharakah**	A Musharakah is a contract between the institution offering Islamic financial services and a customer to contribute capital to an enterprise, whether existing or new, or to own a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Mushārakah agreement whilst losses are shared in proportion to each partner's share of capital.

	S	
3	**Shariah**	Divine Islamic law that encompasses all aspects of human life as revealed in the Qur'an and the Sunnah.
4	**Sukuk**	Sukūk (certificates) each of which represents the holder’s proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.
	T	
5	**Takaful**	Takaful is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In a Takāful arrangement, the participants contribute a sum of money as tabarru’ (donation) into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
	W	
6	**Waqf**	Waqf refers to a religious endowment i.e. a voluntary and irrevocable dedication of one's wealth or a portion of it - in cash or kind, and its disbursement for *Shariah*-compliant projects.