

FAQs for IFSB-15

Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes]

Q 1. Will the IFSB capital adequacy standard be applicable to any institution offering Islamic financial services (IIFS), either on a consolidated basis within a group or subgroup, or on a solo basis?

Answer: The standard will be applicable to any IIFS that falls within the scope as stated herein, on a fully consolidated basis at the holding company level within a group or subgroup of IIFS, or on a solo basis, or on both fully consolidated and solo bases as determined by the respective supervisory authority. The standard is not intended to be applied at the consolidated level to a group or subgroup that consists of entities other than IIFS as defined in the standard. The application of this standard by supervisory authorities should be commensurate with the nature, size, complexity and type of products of the IIFS in the jurisdiction (paragraph 10).

Q 2. What are the minimum capital requirements for IIFS?

Answer: The eligible capital requirements for IIFS shall be not less than 8% of total risk-weighted assets (RWA) at all times. IIFS shall maintain Common Equity Tier 1 (CET1) capital of at least 4.5% of RWA at all times. Tier 1 Capital (CET1 plus Additional Tier 1, or AT1) must be at least 6.0% of RWA at all times. Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of RWA at all times (paragraph 22).

Q 3. Are the dividends declared and payable included in CET1?

Answer: The dividends declared and payable are not included in CET1, as such amounts are classified as liabilities in accordance with International Financial Reporting Standards (IFRS) and would normally be so classified by accounting standards applicable in the jurisdiction (paragraph 24(iv)).

Q 4. What type of claim is represented by common equity in the event of liquidation of the IIFS?

Answer: Common equity represents the most subordinated claim in the event of liquidation of the IIFS, having a claim on the residual assets after all senior claims have been repaid. In terms of sharing any losses as incurred, common equity serves as a first loss position and is able to absorb losses on a going concern basis (paragraph 25(a)).

Q 5. Specific criteria for common equity, as mentioned in paragraph 25(g), require that common equity is clearly stated and disclosed on the IIFS's balance sheet. Does "balance sheet" refer to that in the audited and published financial statements?

Answer: Yes, it refers to the balance sheet in the audited and published financial statements of the IIFS, as required by the respective legal and/or supervisory stipulations.

Q 6. What types of instruments are considered as AT1 capital?

Answer: AT1 capital consists only of instruments that have a high degree of loss absorbency (paragraph 26). As per IFSB-15, the only recommended capital-qualifying instrument under

AT1 is equity-based (*Musharakah*) *Sukūk*, which is a general-obligation *Sukūk*. This *Sukūk* has the most loss-absorbing structure from a Shari'ah perspective. The term "general obligation" is used to refer to the loss absorbency characteristic. It should be noted that this would not be the case with *Muḍārabah Sukūk*, since the *Rabb al-Māl* would not be liable for the general liabilities of the IIFS (and notably for the amount owed to current account holders). *Musharakah Sukūk* can also be treated *pari passu* with shareholders' funds. The *Musharakah Sukūk* is perpetual in nature and has no maturity date (paragraphs 26 and 27).

Q 7. What types of instruments are considered as Tier 2 (T2) capital?

Answer: Subject to Shari'ah compliance, an IIFS may issue T2 capital instruments in the form of *Mudarabah* or *Wakalah Sukūk*, the underlying assets of which would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. It is essential that the terms of conversion, notably the trigger point and the conversion ratio, are clearly specified in the *Sukūk* contract so as to avoid *gharar*. After conversion of the *Sukūk* in the event of the IIFS's non-viability or insolvency, T2 capital would rank *pari passu* with CET1, along with AT1 capital. The original minimum maturity shall be at least five years (paragraphs 28 and 29).

Q 8. Explain the current exposure method as a tool for computing credit equivalents.

Answer: The current exposure method in Appendix C (page 137) of IFSB-15 is applied to over-the-counter (OTC) Shari'ah-compliant hedging instruments to measure total exposure for the purposes of capital calculations within market risk. The method aims to calculate the cost of replacing such a position should the counterparty default by *marking to market* all positive positions (notional value) and then adding on a factor determined using the table for "future credit exposures". The longer the residual maturity date, the higher the add-on, as there is an increased chance of volatility and price movement.

Q 9. Does retained earnings include the fair value changes of AT1 and T2 capital instruments?

Answer: Retained earnings and other reserves, as stated on the balance sheet, are positive components of CET1. To arrive at CET1, the positive components are adjusted by the relevant regulatory adjustments set out in paragraph 31 of the IFSB capital adequacy standard.

No regulatory adjustments are applied to fair value changes of AT1 or T2 capital instruments that are recognised on the balance sheet, except in respect of changes resulting from changes in the fair value of liabilities due to the IIFS's own credit risk variations, as set out in paragraph 31(b) of the IFSB standard.

Q 10. Where associates and joint ventures are accounted for under the equity method, are earnings of such entities eligible for inclusion in the CET1 capital of the group?

Answer: Yes. Where associates and joint ventures are accounted for under the equity method, earnings of such entities are eligible for inclusion in the CET1 of the IIFS to the extent that they are reflected in retained earnings and other reserves of the IIFS and are not excluded by any of the regulatory adjustments set out in paragraph 31.

Q 11. What is the treatment of pension funds and liabilities for the regulatory capital adjustment?

Answer: An IIFS may have its own pension fund, while some IIFS may establish a pension fund in order to meet a regulatory requirement in a jurisdiction in which they operate. Where

such pension funds are on the balance sheet or consolidated balance sheet of the IIFS, the net assets of the fund should be deducted from CET1 capital (paragraph 31(e)).

Q 12. What is the reason behind derecognising the cash-flow hedge reserve in the calculation of CET1?

Answer: If an IIFS has a cash-flow hedge reserve, the amount of this reserve that relates to the hedging (by means of Shari`ah-compliant hedging instruments which are reported at fair value in the IIFS's balance sheet) of items which are themselves not reported at fair values in the IIFS's balance sheet, including projected cash flows, should be derecognised in the calculation of CET1. This means that positive amounts should be deducted and negative amounts added back. The element of the cash-flow hedge reserve that gives rise to artificial volatility in common equity is thereby removed, since such an element reflects only the fair value of the hedging item but not that of the hedged item (paragraph 31(g)).

Q 13. Will any increase in equity capital resulting from a securitisation transaction be deducted from the calculation of CET1?

Answer: Any increase in equity capital resulting from a securitisation transaction shall be deducted from the calculation of CET1. Certain securitisation exposures arise from the provision of credit enhancement by the IIFS as originator by retaining a residual equity interest in a percentage of the securitised asset. In such cases, the capital treatment of the IIFS's residual equity share will be a risk weighting of 1,250%, though it will be subject to supervisory discretion (paragraph 31(h)).

Q 14. Why are *zakat* obligations deductible from capital?

Answer: *Zakat* obligations are liabilities; they are owed by the IIFS and are not permanent or loss absorbing; therefore, they must be deducted from capital. An IIFS shall have a framework and mechanism in place for the recognition and measurement of *zakat* obligations and shall disclose the amount of such obligations in its balance sheet. These requirements are, nevertheless, subject to the provisions of applicable national laws, regulatory requirements and applicable accounting standards (paragraph 31(k)).

Q 15. What are the additional capital requirements for IIFS in terms of the capital conservation buffer and countercyclical buffer (CCB)?

Answer: IIFS shall be required to maintain a capital conservation buffer and a CCB above the minimum capital requirements of 8% of RWA. The capital conservation buffer shall amount to 2.5% of RWAs above the regulatory minimum capital requirements and should comprise only common equity (paragraph 36). The CCB can be chosen in the range of 0–2.5% of RWA wholly of CET1, depending upon the discretion of the supervisory authority (paragraph 68). Guidance on these buffers is provided in detail in sections 2.2 and 2.3 of the standard.

Q 16. Can the level of CCB be set higher than 2.5%?

Answer: The CCB can be chosen in the range of 0–2.5%. However, a supervisory authority has discretion to implement any other macroprudential tools, such as the financing-to-value ratio, dynamic provisioning or the leverage ratio, which it deems fit for the jurisdiction. In addition, if the need arises, the level of the CCB can be set higher than 2.5% for all domestic banks and foreign banks with locally incorporated subsidiaries (paragraph 68).

Q 17. What additional capital requirements apply for IIFS which are designated as domestic systemically important banks (D-SIBs)?

Answer: IIFS which are identified as D-SIBs by the supervisor will be required to hold additional capital as a higher loss absorbency (HLA) requirement of between 0.5% and 3.5% of CET1 to total RWAs, depending upon the chosen assessment methodology and relevant buckets, if any, by the respective supervisory authority (paragraph 121). Detailed guidance on the D-SIBs is provided in section 2.6 of the standard.

Q 18. What is the Shariah-compliant alternative to repo/reverse repo and borrowing/lending of *Sukūk* and Islamic securities as mentioned in paragraph 170?

Answer: This is still an evolving area and practices differ widely between jurisdictions. Some structures, generally based on *Wa'd* or a unilateral promise by one party, are used in the marketplace. No globally uniform structure for a conventional repo is available, due to the issue of *riba* embedded in some structures. Some IIFS raise short-term liquidity in the Islamic market by commodity *Murabaha (tawarruq)* structures which involve the deferred payment purchase and spot sale of an asset/commodity. Approval to use these structures is usually sought from Shari'ah board members of the IIFS or from the national Shari'ah authority in the respective jurisdiction.

Q 19. Explain the terms “matched” and “offsetting” in respect to the capital charge for benchmark risk in trading positions in *Sukūk*, as mentioned in paragraph 225.

Answer: “Matched *Sukūk* positions” refers here to two *Sukūk* issuances that may be held which are identical in risk profile – that is, they have the same maturity and the same credit rating as the issuers, which are comparable entities. Such positions may be offset against each other to net off the total exposure and reduce the overall capital requirement. Offsetting is restricted only to matched positions in the identical issues. No offsetting will be permitted between different issues even if the issuer is the same, since differences in features of *Sukūk* with respect to profit rates, liquidity and call features, etc. would imply that prices may diverge in the short run (paragraph 225).

Q 20. Explain the measurement of the net open position of exposure in a single currency.

Answer: If an IIFS has payables/receivables which are in a different currency from its base currency, it will need to hold capital for foreign exchange risks. The net open position in each currency exposure is calculated by adding the following:

- a. net spot position (total assets less total liabilities including accrued profit in the currency in question);
- b. net position of a binding unilateral promise by the IIFS to buy and/or sell currencies on a specified future date (that are not included in the spot position);
- c. guarantees and similar off-balance sheet instruments that are likely to be called and irrecoverable; and
- d. any other items representing an exposure to risk in foreign currencies – for example, a specific provision is held in the currency in question but the underlying asset is held in a different currency (paragraph 231).

Q 21 What is “alpha’?”

Answer: “Alpha” refers to the proportion of (risk-weighted) assets funded by unrestricted profit-sharing investment accounts (UPSIA) and is required to be included in the denominator of the capital adequacy ratio (CAR). The permissible value of alpha is subject to supervisory discretion. A supervisory authority may decide to extend this treatment to restricted PSIA (RPSIA). Such risk-sharing between a PSIA and an IIFS gives rise to a supervisory discretion formula that is applicable in jurisdictions where the supervisory authority takes the view that, in order to mitigate withdrawal risk and the attendant systemic risk, IIFS in the jurisdiction are permitted (or in some jurisdictions required) to smooth income to the investment account holders (IAHs) (paragraph 284(b)).

Q 22. In the standard formula for calculation of the CAR, an IIFS is not required to hold regulatory capital in respect of commercial (i.e. credit and market) risks arising from assets funded by a PSIA. This implies that RWAs funded by such accounts are excluded in respect of commercial risks in calculating the denominator of the CAR, leaving only operational risk (paragraph 284(a)). The following table shows values of RWAs against different kinds of credit risk, market risk and operational risks.

	Risk-weighted assets (RWA)	Amount in USD
a.	Total RWA for credit risk (CR)	224,872
b.	Total RWA for market risk (MR)	48,425
c.	<u>Subtotal RWA (CR+MR)</u>	273,297
d.	Total RWA for operational risk (OR)	23,965
e.	Total RWA (CR+MR+OR)	297,262
f.	RWA (CR & MR) funded by profit-sharing investment account holders @41%	112,052
g.	<i>RWA (CR & MR) funded by restricted investment account holders @4%</i>	10,932
h.	<i>RWA (CR & MR) funded by unrestricted investment account holders @37%</i>	101,120
i.	<i>RWA (CR & MR) funded by PER and IRR @1%</i>	2,733
j.	Total CAR denominator	?

What would be the total amount of the CAR denominator in the “standard-formula” calculation? Please show the calculation.

Answer: The total CAR denominator using the “standard formula” is calculated as follows:

$$\begin{aligned}
 \text{Total CAR denominator} &= \text{Total RWA (credit + market risks) + Operational risk} \\
 &\quad \text{Less} \\
 &\quad \text{RWA funded by PSIA (credit + market risks)} \\
 &= (c) + (d) - (f) \\
 &= 273,297 + 23,965 - 112,052 \\
 &= 185,210
 \end{aligned}$$

Q 23. With reference to the previous question, we now consider the situation where the IIFS uses the “supervisory discretion formula” to calculate the CAR denominator. In this approach, the commercial risks of assets financed by UPSIA (i.e. the volatility of the returns excluding overall losses) are considered to be borne proportionately by

both the unrestricted investment account holders and the IIFS. Hence, a proportion of the RWA funded by UPSIA, denoted by the Greek letter “alpha”, is required to be included in the denominator of the CAR, the permissible value of alpha being subject to supervisory discretion (paragraph 284(b)). Let us assume that the value of “alpha (a)” is 30%. What would be the total amount of the CAR denominator using the “supervisory discretion formula” for the calculation? Please show the calculation.

Answer: The total CAR denominator using the “supervisor discretion formula” is calculated as follows:

$$\begin{aligned}
 \text{Total CAR denominator} &= \text{Total RWA (credit + market risks) + Operational risk} \\
 &\text{Less} \\
 &\text{RWA funded by RPSIA (credit + market risks)} \\
 &\text{Less} \\
 &(1 - \alpha) [\text{RWA funded by UPSIA (credit + market risks)}] \\
 &\text{Less} \\
 &\alpha [\text{RWA funded by PER \& IRR of UPSIA (credit + market} \\
 &\text{risks)}] \\
 &= (e) - (g) - (1 - 0.30) \times (h) - (0.30) \times (i) \\
 &= 296,262 - 10,932 - (0.70) \times (101,120) - (0.30) \times (2,733) \\
 &= 214,726
 \end{aligned}$$

Q 24. Regarding *ijarah* contracts, as mentioned in paragraph 400, what do “residual value” and “recovery value” refer to?

Answer: “Residual value” refers to the price of the asset at the end of the lease period. Residual values of assets are determined by banks based on past models and future predictions.

“Recovery value” refers to the estimated value of the asset that can be recovered in the event of default. This will depend on the market value of the asset at the point of default.

Under *ijarah* contracts, the total estimated value of lease receivables for the whole duration of a leasing contract shall be risk-weighted according to the lessee’s rating: 100% RW for an unrated lessee less recovery value of the leased asset (paragraph 400).

Q 25. What does “non-competition” mean in terms of bankruptcy declaration?

Answer: The word “non-competition” appears to suggest that the investors and the issuer will not compete against each other in filing for bankruptcy; that is, prior to filing bankruptcy, the parties are to meet and negotiate with each other. Here, the originator, investors, credit enhancers and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer (paragraph 483(c)).