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CIBAFI BRIEFING

Tier 1 and Tier 2 Capital Sukuk

This Briefing considers some of the important aspects of 'Capital Definitions' under the Capital Adequacy revised standards and describes some of the instruments that conform to these regulations. In addition, the Briefing presents an analysis of Sukuk that Islamic banks have issued to strengthen their capital ratios. The Briefing also highlights some issues that Islamic financial institutions may face and provides key messages for them as they seek to implement these new regulatory standards in their respective jurisdictions.

Following the unprecedented events that surrounded the 2007-08 financial crisis, the global banking industry took drastic measures to repair the global economy and to strengthen financial markets. A major part of this work has entailed the revision of the capital adequacy standards for banking institutions worldwide in the form of Basel III. The new capital standards address the deficiencies of the previous Basel II accord, for example by changing the definition of capital that could be used in the calculation of regulatory capital ratios. The Islamic finance industry standard setter, the Islamic Financial Services Board (IFSB), meanwhile, also issued a revised capital adequacy standard for institutions offering Islamic financial services. (The standard is known as the IFSB-15.)

This Briefing will consider some of the important aspects of 'Capital Definitions' under these revised standards and describes some of the instruments that conform to these regulations, and presents an analysis of Sukuk that Islamic banks have issued to strengthen their capital ratios. Lastly, the Briefing highlights some issues and key messages for Islamic financial institutions.

Background

The Basel III Accord, agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11, made important changes to the previous Basel II regime. Under Basel III, rules on the loss absorbency of capital are much stronger than they were under Basel II and the capital adequacy ratios for both Tier 1 and Tier 2 types of capital have been revised, and discretionary buffers introduced (with initial implementation in 2016).

Table 1: Basel III Implementation Timeline

	2015	2016	2017	2018	2019
Common Equity	Full compliance	-	-	-	-
Conservation Buffer	-	Phase-in introduction	-	-	Full compliance
LCR	Minimum standard	-	-	-	-
NSFR	-	-	-	Minimum standard	-
Leverage Ratio	Disclosure	-	-	Full compliance	-
Countercyclical Buffer	-	Discretionary introduction	-	-	-

Source: BIS, CIBAFI

Higher capital requirements under Basel III are leading banks to raise additional capital and to retain earnings as a way of building capital internally. During the years immediately after the crisis, Islamic banks were more resilient and their credit and asset growth was relatively higher compared to their conventional counterparts (Hasan, M. & Dridi, J. 2010). This supports the widely held belief that Islamic banks are comfortably able to meet Basel III requirements.

This cover will have advantages for Islamic banks in the Basel III era as it will push their conventional counterparts towards maintaining higher capital ratios than they have been maintaining in the past, especially those banks that have been highly leveraged. While Islamic financial institutions are currently not large enough to have global systemic importance, some of them have been designated as Domestic Systemically Important Banks (D-SIBs) and may be required to hold higher levels of capital, with appropriate framework for the assessment for further regulatory oversight. This may include setting up of higher loss absorbency requirements for these D-SIBs, among others. For this and other reasons, some Islamic banks have seen a need to strengthen their capital adequacy levels, and have started to issue Sukuk that qualify as Additional Tier 1 capital or Tier 2 capital instruments. It is these Sukuk that are the subject of this Briefing.

	Table 2 : Capital components Basel III	% of RWAs
1	Minimum common equity Tier 1 ratio	4.5
2	Capital conservation buffer (common equity)	2.5
3	Minimum common equity Tier 1 ratio + Capital conservation buffer (CCB) [(1)+(2)]	7
4	Additional Tier 1 Capital	1.5
5	Minimum Tier 1 Capital ratio [(1) +(4)]	6
6	Tier 2 Capital	2
7	Minimum total Capital (MTC) [(5)+(6)]	8
8	Total Capital requirement - MTC + CCB [(7)+(2)]	10.5

Source: BIS, CIBAFI[1]

Increasing the Quality of Capital

The Basel Committee's proposals to strengthen the definitions of regulatory capital were intended to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market.

This was based on the observation that during the most recent financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also the

1. *Actual capital ratio may be greater than 10.5 because national regulators may impose discretionary countercyclical buffer, ranging between 0-2.5, and also due to surcharge on institutions which are on Global list of Systemically Important Banks (G-SIB) and Domestically Important Banks (D-SIBs) and any additional requirements imposed on the banks on a case-by-case basis under Pillar 2.*

investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support.

In order for instruments to be treated as regulatory capital, the Basel Committee considered that such instruments must be capable of bearing a loss. Tier 1 capital should be capable of bearing a loss while the bank remains viable ("going concern"), while Tier 2 capital should bear losses at the point of non-viability, but ahead of depositors and certain other creditors ("gone concern").

The Basel III regime therefore adopts new definitions of capital. Tier 1 Capital is divided into Common Equity Tier 1 (CET1) which, as the name suggests, is effectively the firm's common equity subject to certain adjustments, and Additional Tier 1 (AT1), which must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Tier 2 Capital must be subordinated to depositors and ordinary creditors of the bank, and have a maturity of at least 5 years with no incentive to redeem. The Basel Committee set out detailed criteria for eligibility in all three categories.

Conventional banks have managed to use these categories through various forms of capital instrument, including subordinated debt and so-called contingent convertible bonds (CoCos).These instruments, however, are fundamentally based on debt and interest (riba), and hence would not be permitted to Islamic banks.

Tier 1 and Tier 2 Capital Instruments

Structure of Additional Tier 1 Capital and Tier 2 Capital:

Instruments issued as debt that are designed to convert into equity to fulfil regulatory requirements are Tier 1 capital instruments. Under Basel III capital adequacy standards, the minimum Tier 1 capital requirement is 6% of risk-weighted assets (RWAs). This 6% is comprised of 4.5% of Common Equity Tier1 (CET1), and a maximum of 1.5% of Additional Tier 1 (AT1). The AT1 that Basel III compliant banks maintain, may include instruments that are subordinate, have fully discretionary non-cumulative dividends or coupons and have neither maturity date nor an incentive to redeem.

As already noted, AT1 capital is intended to absorb losses in a "going concern" situation, and the Basel criterion related to this is worth quoting in full:

"Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

- *Reduce the claim of the instrument in liquidation;*
- *Reduce the amount re-paid when a call is exercised; and*
- *Partially or fully reduce coupon/dividend payments on the instrument."*

Additionally, banks can maintain a maximum of 2% of their risk weighted assets (RWA) as supplementary capital called the Tier 2 (T2) capital. This may include revaluation reserves, undisclosed reserves, hybrid instruments and subordinated term debt. Tier 2 capital on the other hand, has to meet certain criteria, such as having a minimum original maturity of at least five years without an incentive to redeem, and being callable by the issuer after a minimum of five years with prior supervisory approval. This capital must have no credit-sensitive dividend features, and will be subordinated to depositors and unsubordinated creditors upon liquidation.

If banks hold more than the minimum 4.5% of CET1 then their holding of AT1 may be proportionally greater; and in turn, holding of Tier 2 may be proportionally greater.

IFSB Definition of Tier 1 and Tier 2 Capital

In December 2013, the Islamic Financial Services Board (IFSB), the prudential standard setter for the industry, responded to the Basel III standards by issuing IFSB-15: Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services.

The Sukuk instruments described in IFSB-15 may constitute Tier 1 capital only if they are Musharaka Sukuk. For Tier 2 capital, the standard permits Mudaraba and Wakala Sukuk. Issues around these limitations are discussed later.

For AT1 Musharaka Sukuk, the underlying assets should be the whole business of the bank. Loss absorbency is achieved because in these Musharaka Sukuk, the Sukuk holders are partners with the common shareholders in the equity capital of the bank, as per the terms of the Musharaka agreement, and thus fully share the risks and rewards of the bank's operations.

For T2 Sukuk, the underlying assets would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. The terms of conversion, notably the trigger point and the conversion ratio, must be clearly specified in the Sukuk contract. After conversion of the Sukuk, T2 capital would rank pari passu with CET1 capital.

Almost contemporaneously with this standard, the International Shariah Research Academy for Islamic Finance (ISRA) published a research paper on the Shariah issues around Basel III capital instruments. It is understood that the emerging conclusions of this work influenced those of the IFSB. It certainly argues that only the types of Sukuk admitted in IFSB-15 have the appropriate Shari'ah characteristics for admissibility as AT1 and T2 capital respectively. It does, however, note that there are issues of nomenclature, and that certain instruments described as Mudaraba or Wakala also have Musharaka characteristics which would make them admissible as AT1.

Capital Instruments Issued by Conventional Banks

Banks globally have issued instruments to strengthen their capital ratios, including both for AT1 and T2 capital. Examples of AT1 instruments issued by conventional banks

include contingent convertible capital instruments (CoCo bonds) and Contingent Capital Certificates (CCC). These instruments are used as hybrid capital instruments that absorb losses when the capital of the issuing bank falls below a certain level. High-trigger CoCos can be issued as part of Additional Tier 1 capital and low-trigger CoCos as Tier 2 capital securities. According to Fitch, CoCos are the riskiest debt issued by banks, with only a quarter of the Eurozone market judged investment-grade in 2015. This may be mainly due to their loss absorption and conversion to equity abilities.

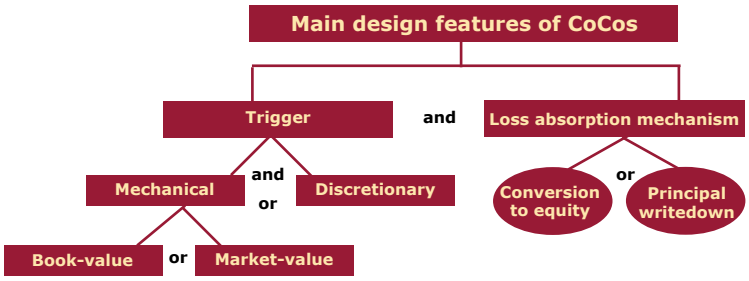

Chart 1: Source: BIS Quarterly Review 2013

Having said that, the features of AT1/T2 instruments may have an impact on banks' shareholders and the management. For example, banks may restrict their lending activities to satisfy regulatory requirements and to escape market backlash if it triggers the breach. As AT1 instruments (with write-down features) have the ability to absorb some losses ahead of the equity holders (over the portion of losses covered by the write-down), the incentives of the existing shareholders might be affected. In this situation the priority of the creditor is reversed and the existing shareholders may have lower incentives to inject additional capital to safeguard the trigger, and instead, will prefer to wait until a trigger is breached forcing AT1 instrument holders to bear the losses.

The AT1/T2 capital may increase the bank's value since it is not only tax efficient, but can also reduce bankruptcy costs and lessen investment distortions. The firm's value under the CoCo-equity financing is generally higher than that under the normal bond-equity financing when debt is protected. Also, a bank may issue these instruments to insulate it from financial instability due to stock market volatility.

Conversely, it is also argued that AT1/T2 capital of these kinds may improve market discipline by subjecting banks to increased scrutiny by investors who would stand to lose if certain trigger points are reached.

IFSB-compliant and Basel III-compliant Instruments issued by Islamic banks

Basel III-compliant capital instruments are now seen as an alternative source of finance for Islamic banks that want to raise additional capital in order to enhance their capital ratios. Since Islamic banks cannot issue interest-paying debt, Sukuk have, to some extent, filled up the untapped market for boosting the regulatory capital of the Islamic banks.

Many Islamic banks have issued Sukuk with the aim of satisfying their regulatory obligations. Malaysian Islamic banks have shown a proactive approach while complying with both Basel III and IFSB standards. For example, Maybank Islamic and Bank Rakyat Malaysia Bhd, have issued Sukuk to fulfil their regulatory capital requirements. Several other Islamic banks have issued these instruments, including some in Kuwait, Turkey, Pakistan, Saudi Arabia and the United Arab Emirates.

Most Islamic banking jurisdictions require all AT1 and T2 capital instruments to include a contractual principal loss absorption mechanism that is activated by the "trigger event". For example, the Saudi Arabian Monetary Agency (SAMA) (via its circular #BCS 5611) requires its banks to comply with these requirements when planning to issue any additional Tier 1 or Tier 2 capital instruments.

As at end of August 2016, about US$10.2 billion worth of Basel III-compliant Sukuk had been issued globally, with Saudi Arabia and Malaysia being among the largest issuers. Malaysian banks issued Sukuk that complied with the IFSB standards as early as 2011. Banks in GCC countries, such as Saudi Arabia, United Arab Emirates and Qatar, have also issued Sukuk to strengthen their capital adequacy ratios, as have banks in Turkey, and a subsidiary of Al Baraka Banking group in Pakistan. The majority of Sukuk that have been issued were either classified as either Murabaha or Hybrid Sukuk followed by Mudaraba. Tier 2 Sukuk account for 67.43% of the total issued.

BASEL III Sukuk Issuance Timeline for Selected Banks

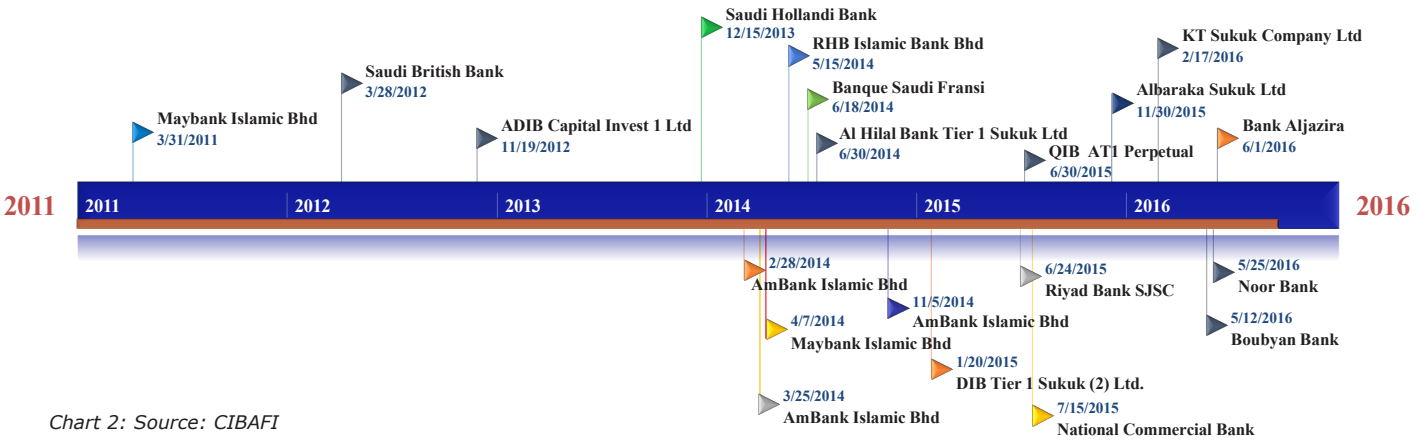

Chart 2: Source: CIBAFI

The following table shows in more detail the types of instrument that have been used to raise Tier 2 capital, including the country of incorporation of the issuing bank.

Table 3: Tier 2 Capital Sukuk (Basel III)

Issuer Name	Sukuk Structure Type	Coupon	Maturity	Country of Incorporation	Amount Issued (in Principal Currency)	Principal Currency
Saudi British Bank SJSC	Hybrid Sukuk	3.4273	2017/3/28	Saudi Arabia	1,500,000,000	Saudi Riyal
AmBank Islamic Bhd	Murabaha	4.4	5/11/2019	Malaysia	100,000,000	Malaysian Ringgit
Maybank Islamic Bhd	Musharaka	4.22	31/3/2021	Malaysia	1,000,000,000	Malaysian Ringgit
AmBank Islamic Bhd	Murabaha	5.07	28/2/2024	Malaysia	200,000,000	Malaysian Ringgit
AmBank Islamic Bhd	Murabaha	5.05	25/3/2024	Malaysia	150,000,000	Malaysian Ringgit
Maybank Islamic Bhd	Murabaha	4.75	5/4/2024	Malaysia	1,500,000,000	Malaysian Ringgit
RHB Islamic Bank Bhd	Murabaha	4.95	15/5/2024	Malaysia	500,000,000	Malaysian Ringgit
Albaraka Sukuk Ltd	Other Sukuk	10.5	30/11/2025	Turkey	250,000,000	US Dollar
KT Sukuk Company Ltd	Ijara	7.9	17/2/2026	Turkey	350,000,000	US Dollar
Saudi Hollandi Bank SJSC	Hybrid Sukuk	2.8688	12/12/2023	Saudi Arabia	2,500,000,000	Saudi Riyal
National Commercial Bank SJSC	Murabaha	3.451	19/2/2024	Saudi Arabia	5,000,000,000	Saudi Riyal
Banque Saudi Fransi SJSC	Mudaraba	2.3525	18/6/2024	Saudi Arabia	2,000,000,000	Saudi Riyal
Saudi British Bank SJSC	Hybrid Sukuk	3.5109	28/5/2025	Saudi Arabia	1,500,000,000	Saudi Riyal
Riyad Bank SJSC	Istithmar	3.4727	24/6/2025	Saudi Arabia	4,000,000,000	Saudi Riyal
Arab National Bank	Hybrid Sukuk	3.2689	7/10/2025	Saudi Arabia	2,000,000,000	Saudi Riyal
Bank Aljazira JSC	Hybrid Sukuk	4.1273	2/6/2026	Saudi Arabia	2,000,000,000	Saudi Riyal

Source: Thomson Reuters, CIBAFI [6]

Key issues in Tier 1 and Tier 2 Capital Sukuk

Atypical balance sheet structure: While Islamic banks have issued Sukuk for regulatory compliance, their balance sheet structure can pose certain challenges. Islamic banks' deposits mainly comprise restricted and unrestricted profit sharing investment account holders' funds (PSIA), which might have relatively shorter maturities and relatively shorter track record to be evaluated in historical stress situations.

Higher cost of instruments: In jurisdictions where the capital markets are relatively shallow and the cost of securities remains relatively high, the issuance of instruments for the purpose of Tier 1 and Tier 2 capital may not be very attractive and banks may continue to rely on CET1 and internal growth to build their capital. For example, during the last three years, the average capital adequacy ratio of Turkish banks has been 14–16%, and their capital is predominantly (85–90%) composed of CET1.

Asset size squeeze: In the run-up to the Basel III compliance, Sukuk issuance for regulatory capital requirements may become less attractive to some Islamic banks, especially for financing long-term assets such as infrastructure project financing, etc. Moreover, the banks may have to secure more capital, which may include disposing of some of their financing portfolios to meet the regulators' demands.

Shariah issues: Table 3 above shows that many institutions have issued Sukuk with structures different from the structures required by the IFSB standards (For example, Murabahah or Ijarah structures do not meet the requirements of IFSB Sukuk). For AT1 issues, this may be in some instances a matter of nomenclature, it is clear that supervisors have accepted as having the necessary loss absorbency structures which the ISRA researchers and the IFSB do not believe can have this property while remaining consistent with Shariah. It is unclear whether the differences here are in the understanding of Shariah or in the analysis of loss absorbency. However, it is clear that there is a need for further debate among both Shariah scholars and supervisors to reach an understanding which can be applied consistently by different Shariah boards and in different jurisdictions.

Supervisory approvals: It is notable that all the T2 issues that have been approved are for banks in just 3 jurisdictions. A similarly small number of jurisdictions (though not the same ones) account for the AT1 issues. Some jurisdictions prominent in Islamic banking have no regulatory capital issues at all. While there is, of course, no publicly available information on the discussions that Islamic banks in those jurisdictions have had with their supervisors, it would be a little surprising if the absence of issues were simply due to lack of interest by banks. It therefore appears that some supervisors are reluctant to approve even Sukuk based on the limited set of structures accepted by the IFSB. This puts their banks at a competitive disadvantage.

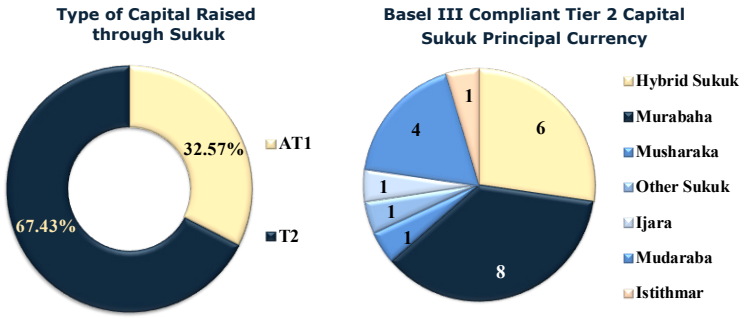

Chart 3 -4 Source: Thomson Reuters, CIBAFI [2]

2. Thomson Reuters Eikon & CIBAFI (figures calculated based on publicly available information and may vary)

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Conclusions

With the final deadline for full implementation of Basel III capital standards fast approaching – all elements will be phased in by 1st January 2019 – Islamic Banks need to ensure that they have sufficient capital to meet the expectations of their regulators and that they comply with capital standards of Basel III (and the IFSB). AT1/ T2 Sukuk add to a bank's risk-bearing capacity in stress situations, without burdening them with tax-inefficient equity financing in good times. This will help reduce the probability of bank's failure, protect shareholders' interests by allowing lower cost of capital and lending at relatively lower rates, while at the same time fulfilling the regulatory requirements.

AT1 and T2 capital instruments may also reduce the incentive for banks to move their safer portfolios off balance sheet. Regulators of Islamic finance markets would want to encourage Islamic banks to issue these instruments to better manage respective banks' CET1 and T2 capital ratios and reduce the amount of equity they hold.

As Islamic banks can quickly be recapitalised via the debt-equity conversion mechanism of these Sukuk, the banks' liabilities will also reduce, and as a result its probability of default (PD) and loss given default (LGD) will also fall after its recapitalisation. These mechanisms can safeguard Islamic banks (to some extent) against market volatility and possible future credit crunches.

There is a need for Islamic financial standard setter bodies such as the IFSB and AAOIFI to develop standards for Sukuk that encompass larger regulatory compliance through more types of Sukuk (in addition to Mudaraba, Musharaka and Wakala).

Islamic finance stakeholders may wish to consider the following points:

- *To what extent will the regulators of Islamic banks encourage and facilitate issuances of these Sukuk which will safeguard Islamic banks against possible financial downturns in the Basel III era?*
- *Regardless of the available tools and instruments to meet Basel III capital requirements, Islamic banks should keep up their concerns to enhance CET1 capital as this is considered the best capital component to absorb unexpected losses.*
- *How can we find ways to achieve greater consistency in the understandings of what Sukuk structures can fulfil the requirements of Tier 1 and Tier 2 capital?*
- *How should these Sukuk issuances be aligned with the interest of the shareholders, management and other stakeholders of the banks?*
- *How feasible will the new AT1 and T2 instrument issuances be from a Shariah and PSIA account holders' perspectives?*

About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 120 members from over 30 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

Contact Information:

General Council for Islamic Banks and Financial Institutions (CIBAFI)
Jeera 3 Tower, Office 51, Building No. 657, Road No. 2811, Block No. 428
Manama, Kingdom of Bahrain. P.O. Box No. 24456

Email: cibafi@cibafi.org
Telephone No.: +973 1735 7300
Fax No.: +973 1732 4902
www.cibafi.org

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