



WORLD BANK GROUP

Finance & Markets

Global Islamic Finance Center

BASEL III and TIER 1 SUKUK

Developing Sukuk Markets Workshop

20 April 2015, Monday

10:00 AM-11:00 AM

M. Murat COBANOGLU

The World Bank Global Islamic Finance Development Center

Istanbul, Turkey

mcobanoglu@worldbank.org

Roadmap

- I. **OVERVIEW OF BASEL III CAPITAL ADEQUACY REQUIREMENTS**
- II. **MOTIVATIONS AND RECENT DEVELOPMENTS**
- III. **TIER-1 *SUKUK* DETAILS AND STRUCTURE**
- IV. **ISSUES, CONCERNS AND CONCLUSION**

I. Overview of Basel III Capital Adequacy Requirements

Basel III requires banks to strengthen their capital and liquidity positions

Against the backdrop of the global economic crisis, an opportunity has emerged to restructure risk and regulation approach in the financial sector fundamentally.

The Basel Committee on Banking Supervision (BCBS) has collectively reached an agreement on reforms to “strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector,” which is being referred to as “Basel III.”

According to the BCBS, the Basel III proposals have two main objectives:

- To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector
- To improve the banking sector’s ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spillover from the financial sector to the real economy

The proposals highlighting the key changes and implications:

- Increased quality of capital
- Increased quantity of capital
- Reduced leverage through introduction of backstop leverage ratio
- Increased short-term liquidity coverage
- Increased stable long-term balance sheet funding
- Strengthened risk capture, notably counterparty risk

To achieve these objectives, the Basel III proposals are broken down into three parts on the basis of the main areas they address:

- Capital reform (including quality and quantity of capital, complete risk coverage, leverage ratio and the introduction of capital conservation buffers, and a counter-cyclical capital buffer)
- Liquidity reform (short-term and long-term ratios)
- Other elements relating to general improvements to the stability of the financial system.

A Brief History

December 2009: BCBS issued consultative document

August 2010: Consultation on “gone concern” capital requirements

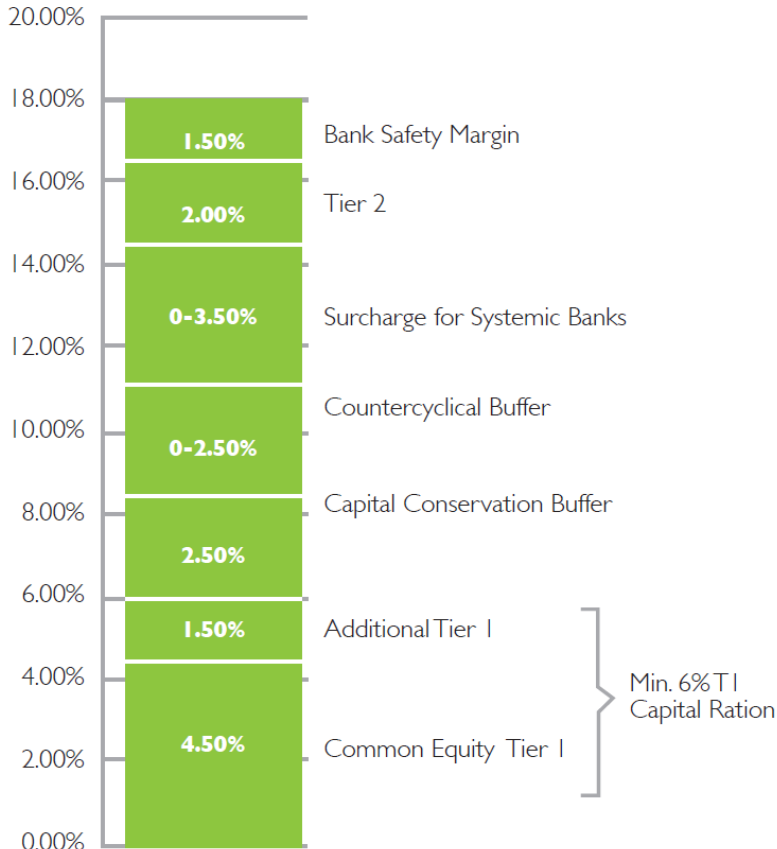
September 2010: BCBS agree calibration of capital standards

December 2010: Final Basel III rules published

June 2011: Basel III revised and republished

Basel III Capital Definitions

New Bank Capital Structure (exc. National Regulator additions)



All elements of the capital ratio are affected by the Basel III framework.

$$\text{Capital ratio} \uparrow = \frac{\text{Eligible capital} \downarrow}{\text{Risk-weighted assets} \uparrow}$$

Tier 1: must have the ability to absorb losses on a **going-concern basis** and comprise of common equity and AT1

Tier 2: can absorb losses on a **gone-concern basis** as determined by the regulator and comprise of qualifying subordinated bank debt.

Source: "Bank Capital Regulations and New Style Hybrids"
Twenty Four Asset Management, January 2014.

Basel III Capital Requirements and Timetable

Phases		2013	2014	2015	2016	2017	2018	2019	
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%	
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%	
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%	
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%	
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%	
	Minimum Total Capital			8.0%				8.0%	
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%	
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013					

Going Concern (AT1) vs Gone Concern (T2)

Additional Tier I instruments are "going-concern" capital - capital that can be depleted without placing the bank into insolvency, administration or liquidation.

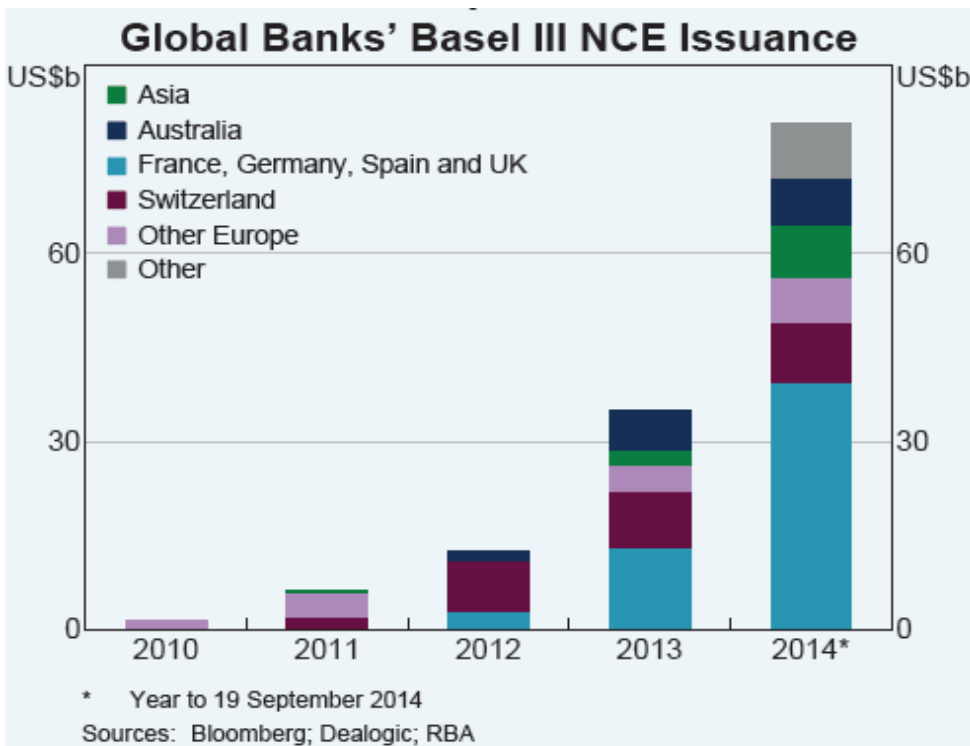
Tier II instruments are "gone-concern" capital - capital that is subordinated to depositors in the winding-up or insolvency of the bank.

Features	Additional Tier-1 capital instruments	Tier-2 capital instruments
Ranking	Subordinated	Subordinated
Maturity	Perpetual, no maturity date	Original maturity of at least 5 years
Call option	Callable at minimum of 5 years	Callable at minimum of 5 years
Discretionary coupon/profit/periodic distributions?	Yes, at the <u>full</u> discretion of the bank	None
Principal loss-absorption linked to a non-viability event?	Yes. Write-off/conversion upon a non-viability event	Yes. Write-off/conversion upon a non-viability event
Other principal loss-absorption terms?	Write-off/conversion when the CET-1 capital ratio \leq 5.125%	None

Source: "A Credit Rating Agency's Perspective On Basel III sukuk", IIFM Industry Seminar on Islamic Financial Market, RAM Ratings, 1 December 2014.

Non-common equity (NCE) issuances-Conventional Case

- AT1 type non-common equity issuances have increased strongly in recent years. The main reason for banks to issue is to raise their capital in order to meet the stricter Basel III capital requirements and to replace maturing instruments issued under the Basel II framework.



- Moreover, the low interest rate environment has supported investor demand; these securities offer higher yields than senior debt or term deposits, reflecting their higher risk.

INVESTOR TYPE OF AT1 ISSUANCES

Share of issuance, per cent		
Investor Type	2013	2014
Asset managers	63	59
Hedge funds	12	21
Insurance/pension funds	6	9
Banks/private banks	16	10
Other	3	1

(a) From a sample of 11 AT1 European contingent convertible instruments with data available on investor distribution
Sources: Dealogic; RBA

Source: Financial Stability Review, September 2014, Reserve Bank of Australia.

II. Recent Developments and Motivations

A Recap of Basel III implications on Islamic Financial Institutions (IFIs)

		Basel III proposals	Impacts on IFIs		
Capital requirements	Capital structure	Capital Quality	<ul style="list-style-type: none"> Shifted focus from Tier 1 and Tier 2 towards an improved quality capital that is Core Tier 1. A system based on equity and contingent capital instead of debt 	<ul style="list-style-type: none"> Basel III reduces the debt advantage that the conventional institutions have over IFIs in terms of capital cost. It will put the two systems on equal terms. IFIs still have to develop shari'ah compliant contingent capital structures 	
		Capital Deductions	<ul style="list-style-type: none"> Enhancement of Core Tier 1 capital, e.g., excluding hybrid forms of capital, deducting minority interests, deferred tax, unrealized losses and pension funds surplus. 		
		RWA	<ul style="list-style-type: none"> Increased RWA for OTC derivatives that are not centrally cleared. Capital charge for mark-to market losses. These caused a great damage during the crisis. 		<ul style="list-style-type: none"> No impact from OTC derivative RWA increases Potential for Capital charge for mark-to market losses to be applied for Sukuk
	Capital ratios	Tier1 Capital ratios	Tier 1 capital ratio: Basel II: minimum 4% Basel III: minimum 6%	CoreTier 1 capital ratio: Basel II: minimum 2% Basel III: minimum 4.5%	<ul style="list-style-type: none"> In the conventional side, the changes in ratios will lead to an increase in Loss-Bearing Capital. This is also due to the new definition of the Core Tier 1 capital. Islamic counterparts will be less affected as they are generally well capitalised .
		Buffer Capital Ratios	Capital Conservation Buffer: 2.5% buffer met with common equity to face stress periods	Counter cyclical Capital Buffer: 0%-2.5% of common equity to achieve broader protection.	
	Leverage ratio		<ul style="list-style-type: none"> The maximum permissible ratio was not mentioned. The calculation of the ratio depends on the accounting regime. 	<ul style="list-style-type: none"> The ratio will affect the conventional banks lending The leverage ability is already limited in IFIs for shari'ah compliance purposes. 	
Liquidity requirements	Liquidity Coverage Ratio (LCR)	$\frac{\text{Stock of highly liquid assets}}{\text{Net cash flow over a 30-day stress period}} > 100\%$	<ul style="list-style-type: none"> These requirements would urge IFIs to enhance their liquidity management. Currently, IFIs suffer a competitive disadvantage due to: <ul style="list-style-type: none"> ✓The lack of appropriate liquidity instruments: standardized, AAA graded, tradable and logically priced. ✓The confinement of liquidity within regional frontiers: the need of a global liquid interbank market. 		
	Net Stable Funding Ratio (NSFR)	$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$			

BASEL III and IFSB-15

- For clarifying the implementation of Basel III CAR, the Islamic Financial Services Board (IFSB) released IFSB-15 in December 2013 which introduces a framework for capital adequacy and liquidity requirements.
- IFSB-15 aims to introduce a framework for capital ratio and liquidity requirements that ensures effective risk management in the Islamic banking industry.
- IFSB-15 analyzes the risk exposure of Islamic financial products (like profit-sharing investment accounts and *sukuk*) and services, and proposes capital ratio requirements and other rules to match. IFSB-15 also prescribes rules on the capital preservation buffer and leverage ratios.

	BASEL III	IFSB-15
Core Tier 1	Common Stock	Common Stock
Other Tier 1	Preferred Stock Hybrid Securities	Preferred Stock <i>Musharaka Sukuk</i>
Tier 2	Subordinated Bonds and Loans	<i>Mudaraba Sukuk</i> <i>Wakala Sukuk</i> (with an initial maturity of at least five years)

What is IFSB's Role?

The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and **enhances the soundness and stability** of the Islamic financial services industry by issuing global **prudential standards** and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

•Like Basel III, IFSB-15 also defines common equity as the Tier 1 core capital and preferred stock as the additional Tier 1 capital. However, it is important to note that preferred stock is only considered a Shariah-compliant instrument in some jurisdictions such as Malaysia.

Motivations for issuing Tier 1 Sukuk

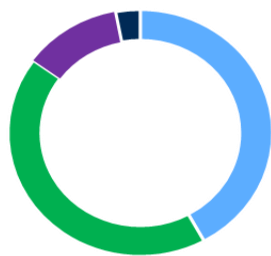
- ✓ Basel III compliant *sukuk*
 - ✓ can be an alternative funding source for institutions that face difficulties in raising capital through equity issuances as global financial instability depresses stock markets.
 - ✓ offer the potential for *sukuk* underwriters to expand market shares and further boost the supply of *sukuk* in global markets.
 - ✓ are eligible instruments for both conventional and Islamic institutions on the condition that funds are utilized for *Shari'ah-compliant* activities and assets.
 - ✓ have attractive features (equity-like, non-dilutive, no redemption)

Recent Developments

- ✓ An opportunity emerges for IFIs to boost their Tier 1 capital by issuing *sukuk* which comply with Basel III and IFSB-15 regulatory requirements.
- ✓ Financial engineering and product innovation tendency help to design the world's first Basel III compliant *sukuk* in November 2012 which was classified as Basel III AT1 compliant capital instrument.
- ✓ As the Basel III standards come into effect gradually, a total of 16 Basel III compliant capital adequacy *sukuk* have been issued to date raising USD 8.2bln in proceeds for 14 different issuing banks.

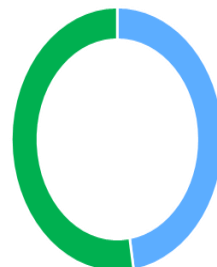
since November 2012

Issuance Volume (%)



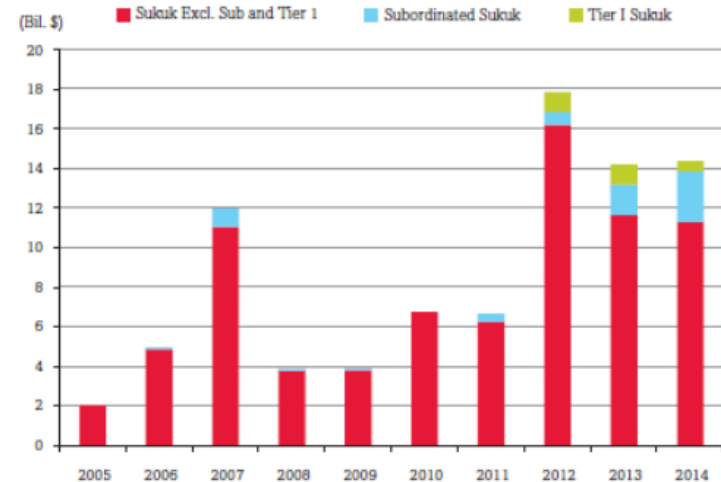
■ S.Arabia (42) ■ UAE (43) ■ Malaysia (12) ■ Turkey (3)

Issuance Type (%)



■ AT1 (43) ■ T2 (47)

TOTAL SUKUK ISSUED BY ISLAMIC FINANCIAL INSTITUTIONS



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Outstanding Basel III Compliant Sukuk

Sukuk	Structure	Country	Issue date	Tenure	Size	Rating (Moody's/ Fitch)	Type of capital
ADIB Capital Invest 1 Ltd	<i>Mudarabah</i>	United Arab Emirates	19th Nov 12	Perpetual (Callable 5-Yrs)	USD1bln	A2/A+	AT1
DIB Tier 1 Sukuk Ltd	<i>Mudarabah</i>	United Arab Emirates	20th Mar 13	Perpetual (Callable 6-Yrs)	USD1bln	Baa1/A	AT1
Al Hilal bank	<i>Mudarabah</i>	United Arab Emirates	30th June 14	Perpetual (Callable 5-Yrs)	USD500mln	A1/A+	AT1
DIB Tier 1 Sukuk Ltd	<i>Mudarabah</i>	United Arab Emirates	15th Jan 15	Perpetual (Callable 5-Yrs)	USD1bln	Baa1/A	AT1
Asya Sukuk Comp. Ltd	<i>Ijarah-Murabahah</i>	Turkey	28 th Mar 13	10 Yrs	USD250mln	Ba3/-	T2
SHB Tier 2 Sukuk	<i>Combination</i>	Saudi Arabia	15th Dec 13	10 Yrs (Callable 5-Yrs)	SAR2.5bln	-/-	T2
SABB Tier 2 Sukuk	<i>Mudarabah-Murabahah</i>	Saudi Arabia	17th Dec 13	7 Yrs (Callable 5-Yrs)	SAR1.5bln	A/-	T2
NCB Tier 2 Sukuk	<i>Mudarabah</i>	Saudi Arabia	20th Feb 14	10 Yrs (Callable 5-Yrs)	SAR5bln	-/-	T2
Am Islamic	<i>Murabahah</i>	Malaysia	28th Feb 14	10 Yrs (Callable 5-Yrs)	MYR200mln	AA3*	T2
Am Islamic	<i>Murabahah</i>	Malaysia	25th Mar 14	10 Yrs (Callable 5-Yrs)	MYR150mln	-/-	T2
Maybank Islamic	<i>Murabahah</i>	Malaysia	7th Apr 14	10 Yrs (Callable 5-Yrs)	MYR1.5bln	-/-	T2
RHB Islamic	<i>Murabahah</i>	Malaysia	15th May 14	10 Yrs (Callable 5-Yrs)	MYR500mln	AA3*	T2
Saudi Inv. Bank	Hybrid	Saudi Arabia	5th June 14	10 Yrs (Callable 5-Yrs)	SAR2bln	-/-	T2
Public Islamic	<i>Murabahah</i>	Malaysia	9th June 14	10 Yrs (Callable 5-Yrs)	MYR500mln	AA1*	T2
Hong Leong Islamic	<i>Ijarah</i>	Malaysia	17th June 14	10 Yrs (Callable 5-Yrs)	MYR400mln	AA2*	T2
Banque Saudi Fransi	Hybrid	Saudi Arabia	18th June 14	10 Yrs (Callable 5-Yrs)	SAR2bln	Aa3/A/A	T2

* RAM Ratings

- All AT1 type issuances were made by UAE based Islamic Banks in *Mudaraba* format.
- Malaysia based banks preferred to issue T2 type of *sukuk* because of national regulatory constraints.
- T2 type *sukuk* were issued in *murabaha* (for Malaysia based issuances) and hybrid models (for Saudi Arabia based issuances)

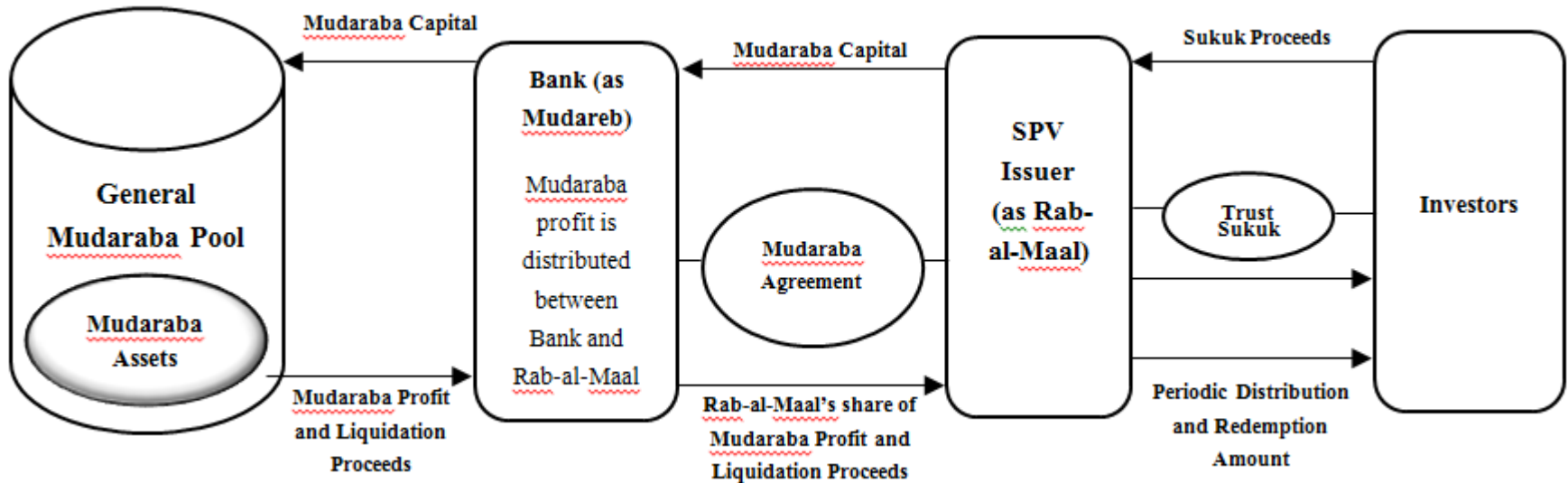
III. Tier-1 *Sukuk* Details and Structure

Tier-1 Sukuk Details

SUKUK NAME	ADIB TIER 1	DIB TIER 1	AHB TIER 1	DIB TIER 1
Issue Amount	1,000,000,000 USD	1,000,000,000 USD	500,000,000 USD	1,000,000,000 USD
Issue Date	19 November 2012	20 March 2013	30 June 2014	20 January 2015
Issue Price	100	100	100	100
Profit Rate	6.375%	6.250%	5.500%	6.750%
Benchmark Rate	6Yr MS-96 bps	6 Yr Ms-129 bps	5Yr MS-177 bps	
Status	Subordinated	Subordinated	Subordinated	Subordinated
Structure	Mudaraba	Mudaraba	Mudaraba	Mudaraba
Regulation	Reg S	Reg S	Reg S	Reg S
Listing	London SE	Irish SE	Irish SE	Irish SE
Over-subscription	15.5x	14x	9.5x	2.5x
Allocation Breakdown	38% Asia, 32% Middle East, 26% Europe, 4% US Offshore Investors	38% Middle East, 29% Asia, 29% Europe, 4% US Offshore Investors	40% Middle East, 31% Asia, 29% Europe	N/A
Embedded Options	Callable after 6 yrs	Callable after 5 yrs	Callable after 5 yrs	Callable after 6 yrs
Going Concern Loss Absorption Trigger	No principal loss absorption	No principal loss absorption	No principal loss absorption	No principal loss absorption
Non-viability Loss Absorption	Risk factor on potential statutory regime, but no contractual PONV clause	Risk factor on potential statutory regime, but no contractual PONV clause	Covered through permitted amendment via full and permanent write-down	Covered through permitted amendment via full and permanent write-down
Coupon Discretion	<ul style="list-style-type: none"> • Non-cumulative discretionary distributions • Non-payment upon <ol style="list-style-type: none"> (i) Bank having insufficient Distributable Profits, (ii) breach by Bank of Applicable Regulatory Capital Requirements, (iii) the request of the regulator, (iv) Solvency Condition not being met or (v) Bank electing not to pay 			

Tier-1 Sukuk Structure

Mudaraba Structure

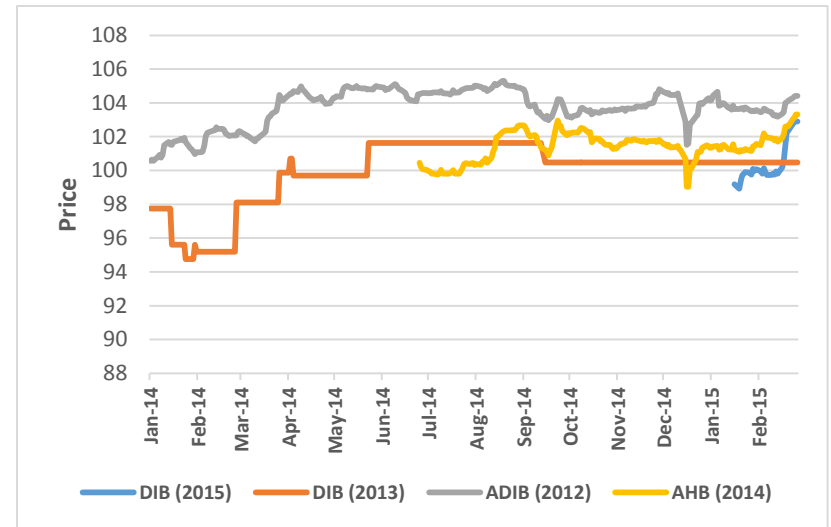
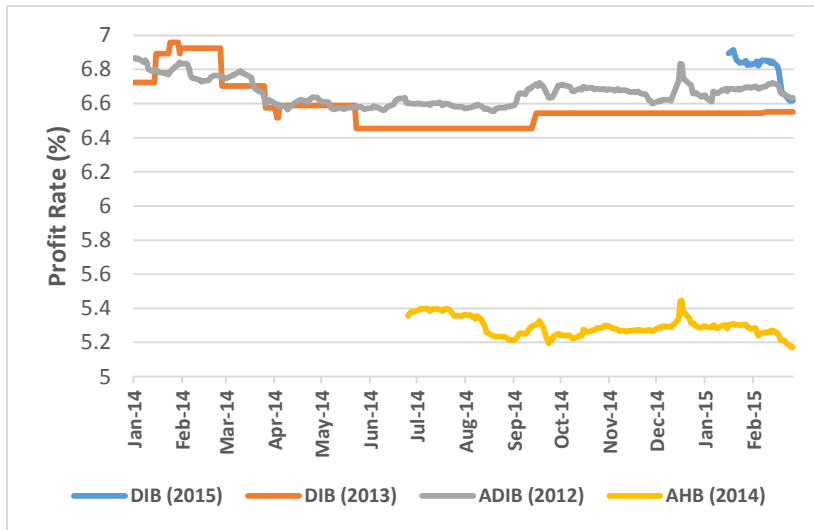


1. The Issuer issues *Sukuk* (which shall be perpetual and accordingly shall not have a fixed redemption) to the investors and collect the proceeds therefrom.
2. Pursuant to a *Mudaraba* Agreement between Bank (as *Mudareb*) and the Issuer (as *Raab-al-Maal*), a *Mudaraba* is constituted and the proceeds from issuance are contributed by the Issuer as the initial *Mudaraba* Capital.
3. Bank (as *Mudareb*) will invest the *Mudaraba* Capital in the general business of Bank in accordance with an agreed Investment Plan. The *Mudaraba* Capital as so invested will be converted into undivided assets in the General Pool as the *Mudaraba* Assets. Bank shall be entitled to co-mingle its own assets with the *Mudaraba* Assets.
4. Pursuant to the terms of the *Mudaraba* Agreement, Bank will pay (after deducting its share of the profit in respect of its co-mingled assets and in accordance with an agreed profit sharing ratio) *Mudaraba* Profit to the Issuer and the Issuer will utilize *Mudaraba* Profit to pay the Periodic Distribution Amounts to investors.
5. Payments of the *Raab-al-Maal* *Mudaraba* Profit by Bank (as *Mudareb*) are at the sole discretion of Bank (as *Mudareb*) and may only be made in circumstances where Bank will not be in breach of certain solvency and minimum capital conditions, before or as a result of making such payment.
6. Subject to certain conditions, at the discretion of Bank (as *Mudareb*), Bank (as *Mudareb*) may liquidate (on the basis of a constructive liquidation) the *Mudaraba* in whole, either: **i**) on the First Call Date or any *Mudaraba* Profit Distribution Date after the First Call Date; or **ii**) On any date on or after the date of the *Mudaraba* Agreement upon the occurrence of **(i)** a Tax Event or **(ii)** Capital Event.
7. The *Mudaraba* shall be automatically liquidated upon a winding-up, bankruptcy, dissolution or liquidation or other analogous event) of the *Mudareb* and/or if a Dissolution Event occurs.

Secondary Market Performance

All AT1 Sukuk are eligible for secondary market trading.

Secondary market activity is limited.



Source: Bloomberg, as of 15 April, 2015.

V. Issues, Concerns and Conclusions

Issues and Concerns

1. 'Loss Absorption' Feature of AT1 Capital

The implementation of Basel III accords is up to national regulatory authorities. **In UAE, local version of Basel III does not include a loss absorption feature allowing regulators to convert debt into equity if an issuer faces insolvency.** Because of their large state budget surpluses and lack of broad-based income taxes, Gulf governments do not see that much of a need to protect taxpayers from bank crises with loss-absorption clauses. Thus four AT1 issuances in UAE do not include loss absorption feature.

This is an important concern because some other countries' supervisory bodies require loss absorption mechanism in order to qualify an issue as high quality capital (AT1). As an example, **Malaysian regulator Bank Negara requires loss absorption mechanisms, which could raise costs for the issuer of a subordinated *sukuk*, in all Basel III-compliant instruments both *sukuk* and bonds.** Because of this reason there is no AT1 type issuance in Malaysia up to now.

2. The 'Shortfall' Case

A *mudarib* has the option to indemnify the *sukuk* holders if the liquidated *mudaraba* assets are lower than the original *mudaraba* capital, and pay the shortfall under certain circumstances.

When the shortfall is not covered by the *mudarib*, it refers a slightly riskier position versus its conventional counterpart.

What remains to be seen is **what the *mudarib* actually does if and when such a shortfall occurs**, and more importantly **what affect this has on other similar outstanding paper.**

Issues and Concerns

3. The Cost of Capital

AT1 securities are perpetual, subordinated and equity-like instruments that include loss absorption feature. These imply higher cost of issuing AT1 *sukuk* since **the pricing would bear a slight premium in comparison with conventional bonds.**

Issuances so far did not reflect the idiosyncratic risks of these instruments because of staggering demand which caused to squeeze spread over benchmark rates.

It is not clear **whether banks outside the supportive environment of UAE could price their hybrid *sukuk* so cheaply.**

4. Shariah Governance

- All AT1 issuances, the *Mudareb* is expressly authorised to co-mingle the *Mudaraba* Capital in its general business activities carried out through the General Pool.
- **According to Sairally et al (2013) :** “...since the proceeds of issuances were co-mingled with issuers’ assets and used for the general obligation of it, the structure became *musharaka*.”
- If these contracts are treated as *musharaka*, the question has to be answered is **whether the *shari’ah* law allows subordination among ordinary shareholders and *musharaka* *sukuk* holders.**
- **The main Shari’ah principle regarding *musharaka* is:** “Profit is based on the agreement of the parties, but loss is always subject to the capital contribution [of investment]” (Al-San'ani, 1403H, 8: 248).
- Sairally et al (2013) give plenty of references stating that **“subordination of ordinary shareholders vis-à-vis *musharakah* *sukuk* is not possible.** Moreover, they should be ranked pari passu and be treated equally in terms of loss absorption.”

Source: Sairally, S. B., M. Muhammad and M. Munjid Mustafa (2013), “*Instruments for Meeting Capital Adequacy Requirements of Additional Tier 1 And Tier 2 Under Basel III: A Shari’ah Perspective*”, Paper Proceeding of the 5th Islamic Economics System Conference (iECONS 2013), "Sustainable Development Through The Islamic Economics System", Organized By Faculty Economics And Muamalat, Universiti Sains Islam Malaysia, Berjaya Times Square Hotel, Kuala Lumpur, 4-5th September 2013.

CONCLUSION

- The trend of issuing Basel III compliant *sukuk* supports the global *sukuk* market.
- Up to now, there are four issuances in type of AT1 capital and twelve issuances in type of T2 capital.
- All AT1 issuances were made by UAE-based banks.
- Future projection:
 - T2 type issuances may continue all around the world.
 - There are some concerns regarding Tier 1 type *sukuk* issuances
 - Loss Absorption Feature
 - Shortfall Case
 - The Cost of Capital
 - Subordination Issue

THANK YOU...