CHAPTER 5

Capital Regulatory Requirements for Islamic Banks in the UAE: A Comparative Analysis

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5.1 Introduction

A good quality capital is important to be addressed and considered as it is an essential component during times of financial crisis. International regulations and standards such as Basel and IFSB define regulatory capital for financial institutions. This study discusses the regulatory definition of bank capital in both the conventional and Islamic financial institution. However, capital adequacy ratio serves as an important purpose to promote stability and efficiency in the financial system as it tends to absorb a reasonable level of losses before the bank becomes insolvent. This gives the depositors and investors a level of confidence that their funds are being protected. Thus, the higher the level of capital adequacy ratio leads to a higher level of protection for the depositors.

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Due to the fact that the Islamic and conventional banks are somewhat different in terms of the nature of their operations, they are exposed to different types of risks. The Basel II has issued a detailed framework for the measurement of the risk-weighted assets. However, this framework is not compatible and does not address the risks relevant to the nature of the Islamic banks' operations and activities. Unlike the conventional banks, the Islamic bank may act as an investor, an agent, an adviser and a trader depending on the situations and the customer's demands which as a result every role the bank imposes has its own risk characteristic.

5.2 Regulatory Capital as Defined in Islamic Banks

Islamic banking adopts the *Shari'ah* rules and principles when conducting their operation and transaction activities and banking. The concept that the *Shari'ah* principles adopt for Islamic banks is that Islamic banks follow the profit and loss sharing concept and they are fees based. In terms of sourcing their funds, Islamic banks rely on equity and capital, deposits that do not bear any risk or yield any return and investment deposits that bear risks. Similar to the definition of capital in conventional bank, Islamic bank capital is defined as the amount of money that is involved in developing the banking business such as paid-up capital for the Islamic bank. While equity is commonly known as the retained earnings of the bank during their operational period.

In accordance with the Islamic Financial Service Board, IFSB-15, the Islamic financial institution components of capital consist of Tier-1 and Tier-2 capital. Tier-1 capital is divided into two categories which are: Common Equity Tier-1 (CET1) and Additional Tier-1 (AT1). IFSB has described the core capital as the "highest quality capital for institutions offering Islamic financial services (IIFS)". The CT1 capital includes retained earnings, common equity share and some reserves. While the AT1 capital includes *Shari'ah*-compliant instruments that carry a high degree of loss absorbency and some other reserves. The sum of the Tier-1 capital is considered as a going-concern capital that absorbs the losses faced by the Islamic financial institutions while it is still solvent. However, Tier-2 capital is considered as a gone-concern capital that absorbs additional losses than Tier-1 in the case that the financial institution is non-feasible. Tier-2 capital consists of *Shari'ah*-compliant instruments, general provision or reserves and any premium paid on the issuance of the instrument (IFSB 2013).

The IFSB-15 has stated in their guidelines some specific criteria for common equity which includes that it should be loss absorbent on a going-concern basis, its issuance should not mention that the instrument would be canceled, redeemed or bought back in their contract terms, it is perpetual in nature in terms of its principal amount and not paid back only in case of liquidation, it's paid amount should be described as equity capital and it is unsecured in nature. Furthermore, the IFSB standard mentions specific criteria related to AT1 capital. The criteria are that the *Sukuk Musharakah* issuance after the *Shari'ah* approval should be able to absorb losses, the instrument is issued and paid-up and neither the IIFS or related party exercises control or significant influence over the instruments in terms of purchasing or funding the purchase of the instrument directly or indirectly, the *Sukuk Musharakah* instrument is perpetual in nature with no maturity date and the amount paid is unsecured in nature nor guaranteed by IIFS or by a related party. Moreover, there are criteria set for Tier-2 capital (additional capital) described in the IFSB standard such as that for IIFS to issue Tier-2 capital instrument it should be in compliance with the *Shari'ah* and the instruments comes in the form of *Sukuk Mudarabah* or Wakalah of which would be convertible into share of common equity at the point of insolvency. Similarly, to Tier-1 and AT1 capital, the criteria of Tier-2 are that the instrument is issued and paid-up capital and the amount paid is unsecured in nature and not guaranteed by IIFS or any related party. Other criteria of Tier-2 capital are that the original minimum maturity shall be at least five years and that the distribution of profits is not linked to the credit rating of the IIFS whether in part or wholly. Table 5.1 summarizes the criteria of the regulatory capital components.

5.2.1 Dubai Islamic Bank: A Case Study of Regulatory Capital

Dubai Islamic bank is considered to be the first Islamic bank that was established in 1975 to incorporate the rules and principles of *Shari'ah* in it practices and in its dealings. In addition, it is considered to be the largest Islamic bank in UAE. Thus, in accordance with Dubai Islamic Bank Annual Report (Table 5.2), it illustrates their source of funds in the equity section of the balance sheet report. Table 5.2 shows that the Islamic bank capital does consist of Tier-1 and Tier-2 capital. The Tier-1 capital includes retained earnings, share capital, statutory reserves and general reserves. While, Tier-2 capital includes exchange translation

Table 5.1 The criteria of the regulatory capital components

Common equity	*Additional Tier-1 (AT1)*	*Tier-2 capital*
Losses are absorbed on the basic of ongoing concern	Issue of *Sukuk Musharakah* with the ability to absorb losses	Issue of *Sukuk Muḍarabah* or *Wakalah* with the ability to absorb losses
Issued and paid-in	Issued and paid-up	Issued and paid-up
An expectation or a statement should not be created by IIFS that the instrument will be redeemed, canceled or bought back under any circumstance in the contractual terms	Neither the IIFS nor a related party over which the IIFS exercises control or significant influence can purchase the instrument, or fund its purchase, either directly or indirectly	Neither the IIFS nor a related party over which the IIFS exercises control or significant influence can purchase the instrument, or fund its purchase, either directly or indirectly
Most subordinated claim in case of liquidation of the IIFS	Perpetual in nature and has no maturity date	Original minimum maturity shall be at least five years and if the instrument is callable then issuer is allowed to exercise a call option only after five years
The principal amount is perpetual in nature and is never paid back unless in the case of liquidation	Neither secured nor guaranteed by the IIFS or any related entity	Neither secured nor guaranteed by the IIFS or any related entity
No conditions make distribution of profits (or payment of dividends) is obligatory	Distribution of profits must not be linked to the credit rating of the IIFS, either wholly or in part	Distribution of profits must not be linked to the credit rating of the IIFS, either wholly or in part
The paid amount is classified as equity capital in the IIFS balance sheet		
The paid amount in at issuance is neither secured nor guaranteed by the IIFS or its related entity		

Source Author

reserves, investment fair value reverse and hedging reserves. It is commonly stated and considered that share capital (common equity) will represent the most subordinated claim in the event of liquidation while the Tier-2 known as the additional capital will be ranked as the next highest quality capital that can absorb losses after common equity. One of the main differences in Tier-2 is that it includes *Shari'ah*-compliant

Table 5.2 Extract of Dubai Islamic Bank balance sheet

Equity	
Share capital	29
Statutory reserve	30
Donated land reserve	30
General reserve	30
Exchange translation reserve	30
Investment fair value reserve	30
Hedging reserve	31
Retained earnings	33
Equity attributable to equity holders of the Parent	
Non-controlling interests	35
Total equity	

Source Dubai Islamic Bank

instruments. In addition, a conflict arises between ranking of instruments such as common equity and equity-based *sukuk*.

5.3 Regulatory Capital as Defined in Commercial Banks

The current banking system requires having capital regulation because it is considered to be an important and popular instrument due to its involvement of minimum capital requirement. The main reason for capital regulation to be adapted in the banking systems is to limit the probability of default as they require the banks to maintain a certain amount of capital by measuring it to the percentage of the total assets. Having adequate amount of capital acts as a buffer and a guarantee ensuring the bank maintains enough capital and funds available, giving the bank the capability to pay back to their creditors and depositors if a financial crisis occurs as well as to reduce the chance of insolvent risk occurring. Regulators bind the measurement of risk-weighted average of assets in determining the minimum capital requirement. Commonly, banks fund their capital through deposits and investments. However, nowadays the banks are engaging in international activities and are competing with banks from various jurisdictions to fund their capital. Thus, a regulation was developed by the Basel committee known as Basel Capital Accord of 1988 which required some banks locally and internationally to hold an eight percent minimum capital ratio in relation to the risk-weighted

assets. Furthermore, in 1993 the Capital Accord was implemented in the EU that all banks whether international or national must adapt the Basel capital requirements. The 1988 Basel Capital Accord was criticized for its shortcomings as it exhibits that the capital requirements do not link to the economic risk resulting from the opportunity of the opening of capital regulatory arbitrage. In June 2004, the Basel Committee on Banking Supervision developed a revised version of Basel Accord 1988 known as Basel II that consists of three pillars (Stolz 2007).

Financial institutions particularly banks whether Islamic or conventional that holds adequate amount of capital will be able to respond against unexpected losses. Creating an incentive for banks to manage their capital in order to reduce the risk of their owner's equity in the event of a loss occurring. Bank capital is not considered as an asset in which the bank set aside but rather it is a source of fund to absorb losses, liquidity risks and unexpected failures in the operation or business. In terms of sourcing their funds, conventional banks will include a large amount of debt whether in form of retail deposits or wholesale funds as well as risky loan which is referred to as liabilities and combine it with the bank's capital. In short, capital is defined as the bank's own funds or money, for example, retained earnings and share capital in which the money is not being borrowed or obliged to be repaid back by the bank to a lender. One of the characteristics of capital that differs from liabilities is that capital is perpetual which means that as long as the bank's business is continuing, the bank will not be obligated to pay to its capital investors. In addition, another characteristic of capital is that the dividends are distributed to the shareholders depending on the bank's profitability (Farag et al. 2013).

The bank capital in conventional banks is usually defined and divided into categories or tiers in which it includes the retained earnings, shareholder equity, hybrid capital instruments, reserves and subordinated loans or debts. However, the main factor of the bank's capital resource is their equity. Capital ratios are calculated as a percentage of the bank's capital to the risk-weighted average assets or the bank assets.

The structure of the bank's capital consists of Tier-1, which is referred to as the core capital or CET1, additional capital and Tier-2 which is referred to as the supplementary capital. Usually, the Tier-1 capital is

considered to be "a going concern capital" which will absorb the losses while the bank remains to operate and is insolvent. However, Tier-2 defines the "gone-concern capital" that will absorb the losses when Tier-1 capital has been used up and the bank no longer operates and in insolvent. In short, the main aspect of Tier-1 is that it tends to absorb the banks losses before any of the other tier capital and Tier-2 acts as a buffer in order to protect the depositors against the bank's decision to discontinue their operations and liquidate their assets. Tier-1 capital includes the paid-up capital, share premium, capital and special reserves and any other reserves. Furthermore, the Tier-2 capital includes the hybrid capital instrument, subordinated debt, revaluation reserves, provision on standard assets and special and investment reserve (Basel II Disclosures). Another component was introduced to be included in the bank capital which is Tier-3 which consists of subordinated loan capital with maturity of at least two years also known as short-term subordinated loan.

5.3.1 Commercial Bank of Dubai: A Case Study of Regulatory Capital

In contrast to Islamic banking, Commercial Bank of Dubai is one of the largest conventional banks in the United Arab Emirates. Thus, based on their annual report of year 2013 (Table 5.3), a study was conducted to illustrate the components of the bank capital that is summed up in total equity. Table 5.3 shows that the bank capital total regulatory capital does consist of Tier-1 capital or CET 1 which is the core capital, and the Tier-2 capital. The Tier-1 capital in Commercial Bank of Dubai is share capital, legal reserve, capital reserve and general reserve. The supplementary capital in Commercial Bank of Dubai is cumulative changes in fair values of AFS investments. Furthermore, the annual report reflects the order on how the respective capital components will be deducted in case of losses starting from the going-concern capital components (Tier-1 and AT1 capital) to the gone-concern capital components (Tier-2). Thus, when the bank faces losses while it continues its operation and is solvent, their common shareholders tend to be the first to bear and tolerate the losses after the usage of all the bank's profit and reserves.

Table 5.3 Extract of Dubai Islamic Bank balance sheet 2013

Equity		
Share capital	17	2,038,352
Legal reserve	17	1,379,813
Capital reserve	17	38,638
General reserve	17	1,100,000
Cumulative changes in fair values of AFS investments	17	54,712
Reserve for proposed bonus issue	17	203,835
Proposed cash dividend	17	611,506
Proposed directors' remuneration	17	11,000
Retained earnings		1,778,533
Equity attributable to equity holders of the Parent		7,216,389
Non-controlling interests		–
Total equity		7,216,389

Source Dubai Islamic Bank

5.4 Difference Between Islamic and Commercial Banks Capital Structure

In contrast to commercial banks whose cost of capital is represented by the cost of debt and equity, Islamic banks represent their cost of capital through profit and loss sharing by equity and depositors. Commercial banks finance their investment with the use of both debt and equity, while Islamic banks use the customer deposits, accounts and their equity financing to finance their investments.

Unlike conventional banks, the capital structure of Islamic financial institution includes the shareholders' equity as well as deposits that are divided into three categories which are current, restricted investment and unrestricted investment. According to Basel committee regulation, the capital structure is divided into three categories in which one of the categories is capital adequacy ratio in which the committee requires from bank to hold a minimum of 8% of capital in relation to the bank's total risk-weighted assets. This capital requirement was mainly set for the conventional financial institutions and services due to the fact that the conventional banks are well capitalized in order to hold a minimum total capital of at least 8% of the risk-weighted assets. Thus, for Islamic financial institution and services the Tier-1 capital is almost the same as for

Table 5.4 Difference between conventional and Islamic banks capital structure

	Conventional financial institution	*Islamic financial institution*
Cost of capital	Cost of debt and equity	Profit and loss sharing by equity and depositors' holders
Finance of investment	Both debt and equity	Customer deposits accounts and their equity
Capital structure	Shareholder equity, deposits and loans for a fixed reward (interest)	Shareholders equity as well as deposits that are divided into three categories which are current, restricted investment and unrestricted investment
Components of regulatory capital	Tier-1, Additional Tier-1 capital and Tier-2 capital	Core Capital (Tier-1) and additional capital (Tier-2)
Financial transactions	Debt-based transactions	Asset-backed transaction

Source Author

the conventional financial institution and services because it consists of the paid-up capital, retained earnings and reserves. However, the main difference between the conventional and Islamic banks regarding the capital structure is in Tier-2 capital of conventional banks it includes hybrid capital instruments and subordinated debts in which it contradicts to Islamic banks *Shari'ah* rules and principles. Therefore, Tier-2 capital in Islamic banks is *Shari'ah* capital instruments. Moreover, another difference is reflected by (IFSB 2012) in terms of categorizing the components of capital as they are defined as Core Capital and Additional Capital instead of distinguishing them between Tier-1, AT1 and Tier-2. The following table summarizes the differences of regulatory capital between the conventional and Islamic financial institutions (Table 5.4).

5.5 Comparing Regulatory Capital: Basel II, Basel III and IFSB

Table 5.5 illustrates and explains the comparison between the Basel II capital adequacy framework that is implemented in UAE as per Central Bank of UAE guidelines, IFSB capital adequacy framework (IFSB 2005) and Basel III the latest Accord guidelines issued by Basel committee.

Table 5.5 Regulatory Capital: Basel and IFSB

	BASEL II	*IFSB*
Pillars	Pillar1: Minimum Capital Requirements Pillar2: Supervisory Review Process Pillar3: Market Discipline	Pillar1: Minimum Capital Requirements The standard is divided into seven sections where it covers for both credit and market risks are set out for each of the *Shari'ah*-compliant financing and investment instruments: *Murabahah* and *Murabahah*, *Salam* and Parallel *Salam*, *Istisna*' and Parallel *Istisna*', *Ijarah*, *Musharakah* and Diminishing *Musharakah*, *Muḍarabah*; and *Sukuk* held as investment – Treatment of Profit Sharing Investment Account (PSIA) is set
Risk-sensitive capital	Market risk, Operational risk and Credit risk	Credit risk, Equity position risk, Market risk Liquidity risk, Rate of return risk and Operational risk
Approaches	Credit risk: – Standardized approach and internal rating based Market risk: – Standardized and internal mode Basic indicator case to case bases Operational risk: – Standardized, Basic indicator and advanced measurement	Credit risk: – Standardized approach Market risk: – Mark to-market and mark-to-model valuation for trading in *Sukuk* General market risk: – "Maturity" or the "duration" method Operational risk: – (a) Basic indicator approach (BIA), standardized approach (TSA); or (ii) the alternative Standardized approach (ASA)
Capital adequacy ratio	Minimum ratio will 12%. Tier-2 capital will only be considered to a maximum of 67% of Tier-1 capital	Minimum ratio should be 8%. IIFS shall maintain CET1 capital of at least 4.5% of RWA at all times. Tier-1 capital (CET1 plus 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

(continued)

Table 5.5 (continued)

	BASEL II	*IFSB*
Components of regulatory capital	**Tier-1 capital** • Paid-up share capital, • Published reserves (including post-tax retained earnings), • Share premium, • Legal reserves, • General reserves, • Hybrid Tier-1 Instruments (approval from central bank UAE) • Minority interests in the equity of subsidiaries less than wholly-owned **Tier-2 capital** • General provisions • Un-disclosed reserves • Asset revaluation reserves/ Cumulative changes in fair value • Hybrid (debt/equity) capital instruments • Subordinated term loan **Tier-3 capital** • Short-term subordinated debt but requires prior approval from CBUAE for banks to employ Tier-3	**Tier-1 capital** • Common shares issued by the IIFS • Stock surplus • Retained earnings • Other disclosed reserves and comprehensive income, including interim profit or loss • Common shares issued by consolidated subsidiaries of IIFS • Regulatory adjustments/deductions applicable to CET1. **Additional Tier-1** • Instruments issued by IIFS that meet the • Premium received on the issue of instruments included in AT1 capital, and which is not included in CET1 • Instruments or qualifying capital issued by consolidated subsidiaries of the IIFS to third-party investors **Tier-2 capital** • Instruments issued by IIFS investors that meet the criteria of T2 capital • General provisions or reserves held against future • Premium paid on issue of T2 capital instruments • Instruments or qualifying capital issued by consolidated subsidiaries of an IIFS to third-party

Source Author

5.6 Analysis Between the Capital Adequacy Ratio of Islamic and Commercial Banks in the UAE

The banks in the United Arab Emirates whether Islamic or conventional under the guidelines of central banks are implementing the regulation developed by the Basel committee effective from the date of circulars which are the Notice 3735/2006 "Basel II Implementation in the UAE" dated August 27, 2006 and Notice 4004/2009 "Capital Adequacy". The circulars focus on the specific issues relevant for the UAE banking community with the complete guidelines of Basel II which includes the following documents "International Convergence of Capital Measurement and Capital Standards", June 2006 and "Enhancements to the Basel II Framework", July 2009, Bank for International Settlements (collectively referred to as "the Accord").

Moreover, they apply the same standards of Basel II and take into consideration the measurement of capital adequacy ratio which is the ratio of the capital base over the risk-weighted assets. In addition, both banks take into account the market, operational and credit risk exposure when calculating the capital adequacy. Both foreigners' banks and banks in the United Arab Emirates have the same purpose for implementing the Basel II standards which are to improve the risk management incentives, to introduce a new capital charge which is operational risk and to increase the risk-weighted sensitivity for credit. Similarly, both banks have the defined the regulatory capital according to criteria for capital components under Basel standards and are comprised into three levels of tiers of capital. The criteria under Basel for the capital components are the capability of banks to absorb their losses based on an ongoing basis, the subordination to depositors and other creditors and permanence. Similarly, to foreigner banks, banks in the United Arab Emirates include in their Tier-1 capital components disclosed reserves, paid-up equity and non-cumulative perpetual preferred stocks. Moreover, both include the same capital components for Tier-2 capital such as undisclosed reserves, subordinated debt and hybrid debt equity capital instruments. Furthermore, both are permitted to include Tier-3 capital in their capital charge if it needed to take into consideration the proportion of the capital requirement of market risk. In addition, both banks use standardized approach as their method to calculate the risk charges for credit, market and operational risk. In terms of the standardized approach method for credit risk, both banks apply a fixed risk weighting to asset on the basis of

type of entity such as bank, corporates, retails and other as well as based on a credit rating such as AA and BBB.

There are few differences between the Central Bank of UAE guidelines and the international banks guidelines when implementing the capital adequacy ratio. First, for foreigner's banks under the Basel II Accord of capital, it stated that the total capital ratio must be at least eight percent and that the Tier-2 capital is limited to 100% of Tier-1 capital. However, in accordance with the Central Bank of UAE, the minimum capital adequacy ratio should be at least 12% and that the Tier-2 capital is limited to 67% of Tier-1 capital. Unlike the foreigner banks in terms of the Tier-3 capital to be included in the capital base, the banks in the United Arab Emirates need to take approval from the central bank prior to their decisions. In contrast to the foreigner banks, central bank has issued guidelines related to the methods of calculating the risk charges only for standardized approaches and internal rating-based approach. While in foreign banks, there are other guidelines provided for other methods such as the value at risk approach for calculating the risk charge for market risk.

5.7 Conclusion

Central Bank of UAE should instruct and direct all Islamic financial institutions, particularly Islamic banks in the UAE to implement IFSB standards and guidelines for capital adequacy requirements.

- Capital adequacy ratio serves as an important purpose to promote stability and efficiency in the financial system. It tends to absorb a reasonable level of losses before the bank becomes insolvent. This gives the depositors and investors a level of confidence that their funds are being protected. Thus, the higher the level of capital adequacy ratio leads to a higher level of protection for the depositors. Due to the fact that the Islamic and conventional banks are somewhat different in terms of the nature of their operations, they are exposed to different types of risks. The Basel II has issued a detailed framework for the measurement of the risk-weighted assets. However, this framework is not compatible and does not address the risks relevant to the nature of the Islamic banks' operation and activities.
- Unlike the conventional banks, the Islamic bank may act as an investor, an agent, an adviser and a trader depending on the situations and the customer's demands which as a result every role the bank imposes has its own risk characteristic.

- CBUAE should require Islamic banks in the UAE to implement capital adequacy framework for Islamic banking proposed by Islamic Financial Services Board (IFSB) in the "Capital adequacy standard for Institutions (other than insurance institutions) offering only Islamic financial services" issued in December 2005 and revised in 2012.
- The activities of Islamic banking differ from those of the conventional banks as shown in the balance sheet of Islamic banks. The liabilities side includes a mixture of contract with investment deposits that are quasi-equity in nature and in which these deposits are in accordance with the profit and loss sharing principles.
- Thus, in order for Islamic banks to determine a proper CAR it needs to measure these risks as well in which IFSB standard provides a guideline for measurement of risks.
- The Basel II Accord framework does not consider the risk of those Islamic financial institutions when measuring the risk-weighted asset while in IFSB standards it provides guidance to Islamic banks on the methods of measuring those risks in order to compute a proper capital charge. In addition, IFSB standards have adjusted the factors of credit risk mitigation which includes *Urbu*n and *Hamish Jiddiyyah* and are different from the conventional banks credit risk mitigation reflected in Basel standards.

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