INNOVATION FOR GROWTH
BASEL III CREATES A GOLDEN OPPORTUNITY

While the growth of global sukuk has already achieved double digits over previous years, there are still relatively unexploited openings to accelerate growth, such as with new, innovative structures that help to capitalise banks in a Shariah-compliant way.

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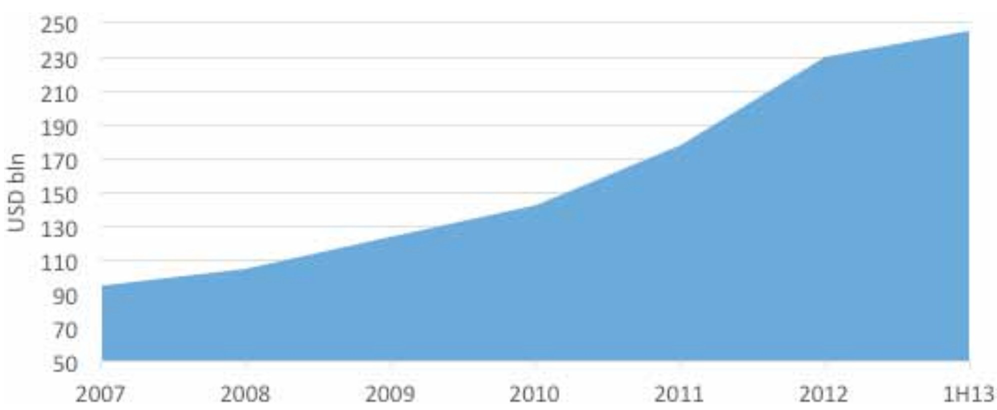
The Islamic finance industry now has an opportunity to innovate a new breed of Basel III compliant sukuk that could address the capital adequacy needs of Islamic banks as stipulated by the Basel III accords.

Tier-1 capital is regarded to be the 'going concern' capital which absorbs losses while the bank is still solvent. It consists mainly of Common Equity Tier 1 (CET1) instruments such as ordinary shares and reserves. Basel III does, however, allow 1.5% of the minimum Tier 1 capital ratio to be in the form of additional tier 1 (AT1) capital. AT1 capital is a layer of additional going-concern capital which is perpetual in nature. Together, the CET1 and the AT1 constitutes subordinated paid-in capital capable of absorbing losses.

When referring to AT1 capital, the Basel III accords are signalling towards instruments that are potentially hybrid in nature (of equity and debt), offering fixed rates of return while able to absorbs losses as per equity instruments via returns which can be deferred and non-cumulative.

To satisfy the Basel III requirements, there is ample opportunity to innovate a new breed of 'Basel III compliant' sukuk that can address the capital adequacy needs of Islamic banks. Such an innovation offers the potential for sukuk underwriters to expand market shares and further boost the supply of sukuk in global markets. The global sukuk market continues to show strong growth momentum in 2013 after a bumper year in 2012 that saw issuances rise 54.2% y-o-y[1] . Likewise, the compound annual growth rate for total sukuk outstanding between 2007 and 2012 reached 19.4%[2]. An additional market-segment of Basel III compliant sukuk that satisfy regulatory requirements can expand the horizons and usability of sukuk as financial instruments.

Global Sukuk Outstanding Trend



Source: Bloomberg, IFIS, Zawya, KFHR

The first sukuk to have claimed to be in compliance with Basel III requirements was issued in November 2012 by Abu Dhabi Islamic Bank (ADIB). The issuance was worth USD1bln and classified as AT1 capital requirements. This issuance generated an overwhelming response with an order book of USD15.5bln (more than 30 times over-subscribed on the initial benchmark size), and carries a profit rate of 6.375%, the lowest ever coupon for an instrument of this type. These statistics reinforce the proposition that sukuk issuers have an opportunity to tap into the Basel III-compliant sukuk market.

[1]*KFH Research*
[2]*ibid*

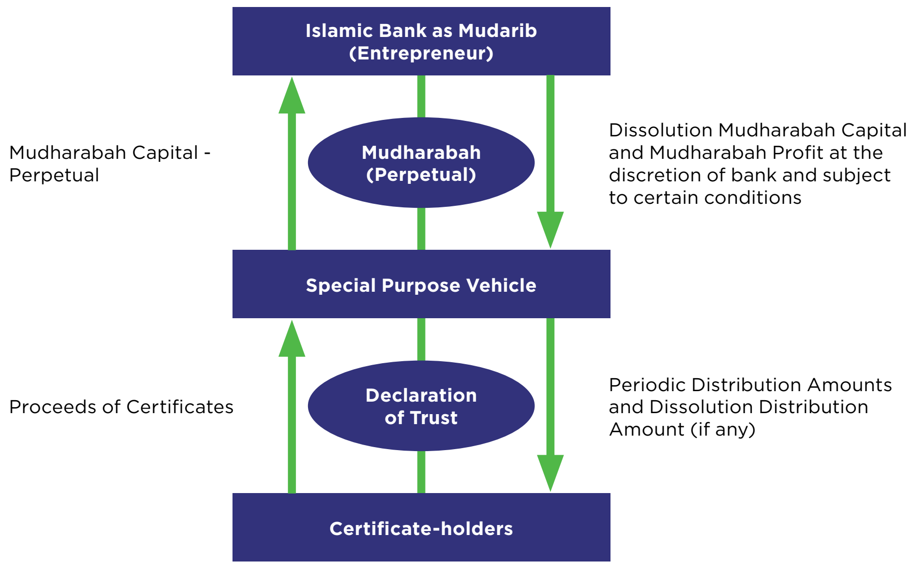
Similarly, Basel III compliant sukuk can be an alternative funding source for institutions that face difficulties in raising capital through equity issuances as global financial instability depresses stock markets. Basel III compliant sukuk are an eligible instrument for both conventional and Islamic institutions on the condition that funds are utilised for Shariah-compliant activities. Hence, market expectations are that the ADIB issuance will steer interest among other banks, particularly in the Middle East where regulators generally require higher levels of capital, to explore issuances of such sukuk. The momentum is expected to pick up pace as Basel III accords are phased-in through the coming years.

The Islamic Financial Services Board (IFSB) released draft guidelines on capital adequacy for Islamic banks in November 2012 which clarifies the use of sukuk as additional capital. As per the IFSB Exposure Draft 15, sukuk issued against assets owned by an Islamic bank may be used by that bank as additional capital to meet regulatory minimum requirements. The minimum maturity of the sukuk is five years and it should not have step-up features, such as periodic increases in the rate of return, giving an incentive for the issuer to redeem it.

The ADIB USD1bln sukuk was based on the contract of Mudharabah and is classified as equity, which therefore does not include principal loss absorption or equity conversion features. Periodic distributions are fully discretionary and non-cumulative. The sukuk is unrated, but will be included in Fitch-eligible capital with a 50% equity credit. It has no maturity date while ADIB can choose to repay the sukuk on certain dates from 2018 if it wishes.

Below is an illustrated example of a Basel III compliant sukuk Mudharabah structure. The notable difference is that unlike some of the previous sukuk issuances, payments of Mudharabah profit by Islamic banks (as Mudarib) is at the sole discretion of the bank and may only be made if it meets certain conditions. The certificates are perpetual securities in respect of which there is no fixed redemption date and accordingly, the Mudharabah is a perpetual arrangement with no fixed end date. Subject to certain conditions set out in the Mudharabah agreement, the Islamic bank may at its option liquidate the Mudharabah in whole, but not in part, on the basis of an actual liquidation of the Mudharabah. For example, in the ADIB sukuk, it was agreed ADIB will only liquidate the Mudharabah to the extent that, on a dissolution, the Mudharabah capital would be equal to the nominal amount of the sukuk to be repaid. To the extent that ADIB (as Mudarib) breaches this obligation, it is required to indemnify the issuer (SPV) in respect of this shortfall.

ADIB Basel III Compliant Perpetual Sukuk Mudharabah Structure



In conclusion, Basel III has now introduced new considerations for managing tier 1 capital adequacy ratios of Islamic banks. Nonetheless, Basel III has created a market gap for the supply of Basel III compliant sukuk which can be filled by issuers. Such issuances would help in boosting the growth rates of the sukuk industry while further reinforcing the role of Islamic finance in the global financial industry.

Brief Overview of Basel III Capital Adequacy Standards

The implementation of the Basel III accords have begun from 1 January 2013 and banking institutions now have to meet the following minimum capital requirements expressed in risk-weighted assets: 3.5% CET1 capital, 4.5% tier-1 capital and 8% total capital. During the transitional period from 2013 up to and including 2019, these ratios will gradually be stepped up to 4.5% CET1, 6% tier-1 capital and 8% total capital. In addition, a conservation buffer is required to be built up to a percentage of 2.5% starting from 1st January 2016 and through to 1st January 2019. Ultimately, banks are required to hold 10.5% of their total capital expressed in risk-weighted assets.

In order to qualify as AT1 capital, an instrument must be subordinated to depositors, general creditors and subordinated debt, have no maturity date and may only be callable at the option of the issuer after a minimum of five years. The issuer must also have full discretion to cancel payments and the cancellation of such payments must not impose any restrictions on the issuer except in relation to distributions to the issuer's shareholders. In addition, subsequent to the initial release of Basel III, the Basel Committee on Banking Supervision indicated that AT1 capital instruments must also incorporate either: (i) a write-down of the principal of the instrument; or (ii) a mandatory conversion of the instrument into common equity, if the financial institution's CET1 falls below a certain threshold.

Basel III Timeline

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Common Equity				Initial Compliance					Full Compliance	
Conservation Buffer							Initial Compliance			Full Compliance
LCR		Regulatory Reporting				Full Compliance				
NSFR			Regulatory Reporting						Full Compliance	
Leverage Ratio				Regulatory Reporting		Public Reporting			Full Compliance	
Countercyclical Capital Buffer							Anticipated Application			
Other	G20 Ratification – Nov Basel Ratification – Dec	CDR III adoption	CDR III Compliance (anticipated) Translation of rules into local laws							

Source: BCBS, KFHR