Understanding CAR in the context of Islamic banking

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BANK capital serves as a liquid bulwark to warrant the smooth operations of both Islamic and conventional banks, turning the banks into a better likelihood of endurance in the banking market. In general, a bank capital is viewed as the source of funds provided by the owners of the bank, which acts as a cushion to thwart a bank failure's occurrence.

This week I draw your attention pertinent to capital adequacy ratio (CAR) in the context of Islamic banking. For this purpose, three questions are answered using an analytical technique: Question #1 – What is meant by the term CAR? Question #2 – What makes CAR's components? Question #3 – Does an Islamic bank have a better CAR?

By definition, CAR is a measure of the amount of the capital owned by the bank that typically captures Tier 1 Capital and Tier 2 Capital and are divided by risk-weighted asset (RWA). CAR plainly acts as an enabler to protect depositors of CASAFA (i.e. current account, savings account & fixed account) in which their deposits are principally guaranteed for consumer protection. In addition, CASAFA is also subject to Malaysia Deposit Insurance Corporation's (MDIC) protection up to MYR 250,000 limit per account includes both the principal amount of a deposit and the interest/return, separately applied to Islamic and conventional deposits.

Further, CAR is overtly essential for two key reasons. The first reason is to maintain **public confidence**. Public confidence is the spirit and willingness to advocate Islamic banks in terms of consumers' continuous use of banking products. In turn, the consumers bring forward a positive words of mouth to influence others for use. Without adequate amount of capital, there is a great inclination for withdrawal behaviours by depositors. Thus, bank panic and bank failure tend to be more appealing. Bank panic is a financial crisis where there exist simultaneous cash withdrawals from the bank out of confidence and fear that the bank tends to be closed down. While bank failure is defined as the inability of the bank to meet a short term obligation of the requests from depositors and creditors out of insolvency. The second reason is of **competitive factor**. The bank that has an unwavering and adequate rate of capital tends to be operated glibly and is able to create more customers, adding to the existing customer base resulting in great performance of Islamic banking products, turning it to an exemplary example.

Maybank Islamic, for instance, has been awarded "The Islamic Bank of the Year 2017" for Asia-Pacific and Malaysia by London-based financial publication, The Banker on the 13rd June 2017. The reasons are of two, viz., a strong Tier 1 capital (12%) and total *Shariah*-compliant assets (16%), implying capital adequacy is crucial along with *Shariah* compliancy.

According to Bank Negara Malaysia (2015), however, based on Capital Adequacy Framework for Islamic Banks, CAR is determined by capital and risk weighted assets. The former is based on common equity Tier 1 capital (CET1), additional Tier 1 capital and Tier 2 Capital. CET1 includes ordinary shares, share premium, retained earnings, other disclosed reserves, qualifying minority interest and regulatory adjustments. While additional Tier 1 captures additional Tier 1 capital instruments issued by Islamic banks, share premium, qualifying CET1 that is held by third parties and regulatory adjustments. It is utilized to absorb losses without a bank being required to cease trading. Instead, Tier 2 Capital should include Tier 2 capital instruments that are not included in Tier 1 Capital, share premium, additional Tier 1 and 2 capital instruments issued by consolidated subsidiaries and held by third parties, financing loss provisions and regulatory adjustments applied in the calculation of Tier 2 Capital. It is used to absorb losses in the event of a winding-up that will benefit depositors at large

Total RWA is computed as the sum of credit RWA, market RWA, operational RWA and large exposure risk requirements as determined in accordance with the Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets). In addition, it should also be adjusted when investment accounts are in place. These accounts are recognized as a risk absorbent in line with the requirements as set out in the policy document on investment accounts.

To compute capital adequacy ratios, at least, three formulas are explained. The first one is CET1 Capital Ratio, which is obtainable as CET1 is divided by Total RWA. The second one is Tier 1 Capital Ratio, which is obtainable as Tier 1 Capital is divided by Total RWA. The last one is Total Capital Ratio, which is obtainable as Total Capital is divided by Total RWA. These formula will render different percentile. To meet minimum capital adequacy ratios, Islamic banks should earn 4.5 percent for CET1 Capital Ratio, 6.0 percent for Tier 1 Capital Ratio and 8.0 percent for Total Capital Ratio.

With respect to the third issue, I shall provide an example for educational purposes. I deliberate Maybank Islamic Berhad out of its outstanding performance and controlled Islamic banking market. The bank's CAR is computed in line with BNM's Capital Adequacy Framework for Islamic Banks (Capital Components) and Capital Adequacy Framework for Islamic Banks (Risk Weighted Assets) that are issued on 13rd October 2015. The bank's total risk weighted assets are computed based on

(i) credit risk under internal-rating based approach
(ii) market risk under standardized approach and
(iii) operational risk under basic indicator approach.

The bank CET1/Tier 1 Capital includes paid-up share capital, share premium, retained profits and other reserves while Tier 2 Capital includes Tier 2 capital instruments, collective allowance and surplus of eligible provision over expected loss. The bank RWA includes total risk-weighted assets for credit risk, total risk-weighted assets for market risk and total risk-weighted assets for operational risk. Given these components, the bank total capital ratio is 16.49% (total capital MYR 10,296,480,000/ total risk-weighted assets MYR 62,445, 248,000) and 18.553% (total capital MYR 11,503,021, 000/ total risk-weighted assets MYR 62,001, 885,000) for 2015 and 2016, respectively. The values are well above than the threshold value of 8.0 percent, inferring the bank has a sound capital level for competitive and stable banking operations.

All in all, capital adequacy is notable to vouch that an Islamic bank's risk exposure is backed by a high quality capital that imbibe losses on a going concern basis. Indeed, the bank CAR's elements, somewhat, are resemble to their conventional peers, however but, the nature of underlying business activities has made the CARs for both are relatively distinct. To be remain competitive, however, capital adequacy is explicitly of need to protect stakeholders from losses of their funds in which additional cushion of assets is allocated to meet claims in liquidation, which in turn to promote sound and stable performance of the bank in the industry, at least.

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