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THE COVID-19 PANDEMIC: SUPERVISORY IMPLICATIONS AND PRIORITIES FOR ISLAMIC BANKING

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THE COVID-19 PANDEMIC: SUPERVISORY IMPLICATIONS AND PRIORITIES FOR ISLAMIC BANKING

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THE COVID-19 PANDEMIC: SUPERVISORY IMPLICATIONS AND PRIORITIES FOR ISLAMIC BANKING

Introduction¹

The COVID-19 outbreak continues to wreak havoc on economies across the globe. It has plunged the world into recession and made economic recoveries a daunting and uphill task ahead for the financial industry. It has threatened the stability of the global financial system.²

Banking supervisors are faced with an unprecedented set of circumstances, and are pursuing unprecedented regulatory measures to mitigate the impact of the outbreak. The financial sector including Islamic finance is certainly going to be significantly affected because of the devastating effects of the COVID-19 outbreak.

In this respect, a number of questions³ have emerged for authorities supervising Islamic banking, for instance: Are there any specificities that require a different regulatory and supervisory approach to deal with the impact of COVID-19 on Islamic banks and to ensure robust navigation? How can supervisors ensure a level playing field while promoting economic growth and maintaining financial stability in dual banking systems?

In the above context, this is the fifth Toronto Centre Note addressing supervisory issues in the wake of the COVID-19 outbreak. The first four focused on *issues for supervisors during crises; business continuity planning by supervisory authorities; the impact of the COVID-19 outbreak on credit quality; and supervising corporate governance during crises*.⁴ This Note complements the existing TC Notes to address specificities of Islamic finance. It covers recent supervisory actions aimed at containing the impact of the outbreak and compares them across a sample of 13 jurisdictions, where Islamic finance is categorized as systemically important.

This Note discusses seven potential implications and priorities for supervisors regulating Islamic banks in response to the COVID-19 pandemic in dual banking systems:

1. ensuring supervisory transparency, clarity in regulatory interventions, and a level playing field for Islamic banks;
2. navigating a tricky trade-off between regulatory capital requirements and economic growth;
3. managing Islamic banks' asset quality and the treatment of moratoria and non-performing financing;
4. dealing with a liquidity crunch and providing *Shari'ah*-compliant liquidity support and lender-of-last-resort facilities;
5. providing supervisory support for issuing sovereign *Sukūk* for fiscal deficits;
6. evaluating stress testing and credit quality; and

¹ This Note was prepared by Dr. Jamshaid Anwar Chattha.

² International Monetary Fund (2020).

³ Chattha (2020a).

⁴ Toronto Centre (2020a, 2020b, 2020c and 2020d).

7. reviewing financial safety nets and insolvency regimes for Islamic banks.

Supervisory navigation of the COVID-19 pandemic: key implications and priorities for Islamic banking

The COVID-19 outbreak has brought a range of implications for all types of financial institutions. Islamic finance is no exception, being part of the global financial system. In any jurisdiction, the potential impact of these implications should be assessed in proportion to the size of Islamic banks, the complexity and nature of the dominant portfolios (e.g. real estate, financing-driven) on their balance sheets, and the economy in which they operate.

Within Islamic finance, the Islamic banking segment remains the most dominant with around 73% of Islamic financial assets. Islamic finance is now categorized as systemically important in 12 jurisdictions – Bahrain, Bangladesh, Brunei, Djibouti, Iran, Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, Sudan, and UAE – where the market shares of Islamic banking have reached 15% and above.⁵ If we include Pakistan and Oman, which are close to 15%, the list becomes 14 jurisdictions.⁶ 91% of Islamic banking assets are concentrated in jurisdictions where Islamic finance is of systemic importance, and the concentration specifies significant exposure to two regions: the GCC region (42.3%) and Asia (28.2%).

Since the outbreak of the COVID-19 pandemic, the authorities have taken various measures.⁷ These measures include: announcing a mandatory moratorium on repayments, restructuring and/or rescheduling of financing, providing government guarantees, using capital buffers and granting capital relief, providing liquidity facilities through various tools, and ensuring uninterrupted access to financial services for the general public.

Annex 1 summarizes how supervisors in jurisdictions with a significant presence of Islamic finance (e.g. Kuwait, Malaysia, Oman, Pakistan, Saudi, and UAE) have released prudential buffers such as the capital conservation buffer (CCB) and domestic systemic risk buffers, allowing banks to operate below the normal requirements. They have also issued supervisory instructions by temporarily adjusting supervisory priorities on certain regulatory requirements such as how the regulatory capital and liquidity buffers included in the Basel III framework should be used (e.g. Kuwait and Malaysia enabling banks to operate below normal capital and liquidity requirements). Some jurisdictions like UAE and Pakistan have indicated the *Shari'ah* compliance perspective on the implications of a payment moratorium and the restructuring/rescheduling of financing facilities for Islamic banks.

A1. Ensuring supervisory transparency, clarity in interventions, and a level playing field for Islamic banks

Supervisory authorities in dual banking systems should ensure supervisory transparency and clarity of their various regulatory and supervisory interventions in the market while safeguarding a level playing field for Islamic banks. Supervisors should coordinate with standard-setting bodies for Islamic finance.

Transparency is an important consideration in the supervisor's relationship with the financial institutions that it supervises. In any crisis it is likely that supervisory policy choices for the

⁵ Islamic Financial Services Board (2019).

⁶ This Note also refers to Turkey and Indonesia, as they are members of G20 and have importance for Islamic finance, though their respective market share is less than 10% in their jurisdictions.

⁷ International Monetary Fund (2020); Bank for International Settlements (2020); Chattha (2020a).

containment of the crisis will involve elements of supervisory discretion and trade-offs. Supervisors should carry out their obligations in a transparent⁸ manner by making important decisions publicly available (mainly through the supervisor's website).

Any micro- or macro-prudential measures, or specific regulatory measures with respect to expected credit losses (ECL), the treatment of both new and existing financing assets impacted by COVID-19, and the treatment of non-performing financing (NPF) and government guarantees, should be made clear and consistent for both conventional banks and Islamic banks. These measures and their implications are discussed in the following subsections.

If there is mixed messaging from the supervisors or a clear policy is not articulated quickly, the banking industry will react with extreme caution, which defeats the intention of providing support to the economy in the first place. Supervisors should bear in mind that supervisory clarity on the treatment of "moratorium" can create confusion in the market for the market participants. Hence, this clarity is not only important in order to avoid any reputational risk in relation to Islamic banks, but also to avoid confusion among the beneficiaries of the moratorium intended to help their financial predicaments amid COVID-19. This has happened in some jurisdictions, where the supervisory authority has clarified the expectations and the right treatment of the deferred payment relief plan, in particular for Islamic banks.

In a dual-banking system with a sizeable Islamic banking component, the supervisory role is more complicated as the supervisor is required to supervise two sets of banking institutions with different risk characteristics, while ensuring a consistent regime.⁹ As the COVID-19 outbreak unfolds, supervisors need to coordinate with standard-setting bodies for Islamic finance such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) given the recent developments at their respective counterparts: the Basel Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB). Guidance provided by these bodies would be helpful to the authorities supervising Islamic banks in their respective jurisdictions in ensuring a level playing field.

Supervisors should also provide guidance on the impact of the COVID-19 outbreak on the calculation of risk-weighted assets (RWAs) in the calculation of the capital adequacy ratio (CAR) for Islamic banks including, among others: (a) regulatory treatment as regards the number of days a financing is past due in the context of applying default triggers as set out by the IFSB;¹⁰ (b) financing subject to government guarantees should use the relevant sovereign risk weight (RW) rather than that associated with the borrower; (c) any reduction in standard supervisory haircuts under credit risk; and (d) extension or relaxation, if any, on *Shari'ah*-compliant eligible collaterals in the CAR calculation.

The BCBS has also introduced a set of measures including deferring Basel III implementation (including the recently revised market risk framework and Pillar 3 disclosure requirements) for one year to January 2023 to provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities resulting from the impact of COVID-19 on the global banking system.¹¹ In this context, there is a definite role to be played by the IFSB. As of writing this Note, the IFSB is yet to issue any guidance to supervisors on the deferment of the IFSB equivalent of Basel III. In particular, the IFSB

⁸ Bank for International Settlements (2020).

⁹ Chattha (2020b).

¹⁰ Under the IFSB-15 Framework higher capital requirements are applied to financing that are classified as past due (usually on the basis of a 90 day past due criterion) or defaulted.

¹¹ Basel Committee on Banking Supervision (2020).

should review the Basel III-equivalent standards implementation date to provide a level playing field for supervisors.

With respect to the accounting side, the IASB has also issued a key statement on ECL recognition and key steps to be taken by banks in the light of the current uncertainty resulting from COVID-19.¹² In addition, supervisors may relax the transitional measures applying to the alignment of accounting and prudential measures of capital adequacy. This relaxation will allow banks a longer period during which they do not have to take the full capital impact of ECL in the initial years of moving to the new accounting standard.¹³

Moreover, supervisors of Islamic banks – which are following AAOIFI FAS 30 (Impairment Credit Losses and Onerous Commitments), equivalent to IFRS 9 – should note that AAOIFI is yet to issue guidance on the recognition of ECL for Islamic banks to take account of COVID-19-related moratoria on repayments. In this respect, supervisory authorities have to play a central role to press the international standard setters to issue guidance or guidance specific to Islamic banks.

A2. Navigating a tricky trade-off between regulatory capital requirements and economic growth

Supervisory authorities should maintain a reasonable level of prudence between preserving the safety and soundness of Islamic banks, maintaining financial stability, and supporting economic activity. Supervisors and other relevant authorities may consider relaxing regulatory capital requirements and macro-prudential buffers to reduce the impact of the COVID-19 shock on the economy; but supervisors should continue monitoring market conditions and should undertake a review of such relaxations provided to the banks.

The global Islamic banking average capital adequacy ratio (CAR) stood at 18.2% in 2019 (IFSB 2019), which was a position of good strength ahead of the COVID-19 outbreak. In general, the total capital and Tier-1 capital adequacy ratios in most jurisdictions were both stable and above regulatory requirements. However, this strength may not be sustained in light of worsening economic conditions and increasing non-performing financing (NPFs) in many jurisdictions.

In the majority of emerging market economies, the most dominant form of financial intermediation is the banking system. Banks (including Islamic banks) may be reluctant to extend lending (financing) as they contend with the higher capital, liquidity, and reserve requirements imposed since the global financial crisis, while also facing the COVID-19-related downturn in economic activity, increasing NPFs and lower income.

In these conditions, the authorities have provided banks with temporary relief in the form of a relaxation of micro- and macro-prudential regulatory ratios and restrictions on dividends payments. This is intended to help banks navigate the impact of the COVID-19 economic downturn and allow the banking sector to remain engaged in the financing of households and businesses.

Supervisors should not reduce the level of ‘alpha’¹⁴ to increase the CAR for regulatory purposes. The reduction of the value of alpha would imply that the level of displaced

¹² International Accounting Standards Board (2020).

¹³ Basel Committee on Banking Supervision (2020a).

¹⁴ Alpha (α) refers to the proportion of assets funded by unrestricted profit-sharing investment account (PSIA), which is to be determined by the supervisory authorities. When the supervisory discretion version of the CAR formula is applied, a proportion – “alpha” – of the RWA financed by investment account holders (IAH) funds is included in the denominator of the CAR.

commercial risk (DCR) had been reduced, which would not be the case.¹⁵ On the contrary, increasing the level of alpha would make sense if DCR had increased in the current difficult and testing times, but that would not result in the Islamic bank's CAR improvement. Thus, it is preferable for supervisors to reduce the requirement for CAR with temporary restrictions on dividend distributions, which is quite transparent, whereas changing 'alpha' is not.

Macro-prudential authorities have reduced or removed the requirements for some capital buffers because: (a) there is no significant threat to financial stability from excessive credit growth or asset price bubbles; and (b) high capital requirements might constrain banks from continuing to lend during the economic downturn and thereby decrease the prospect of economic recovery. This is consistent with the basic principle of macro-prudential instruments designed to respond to financial cycles, namely that they should be applied counter-cyclically, being increased during the upswing of the financial cycle, but reduced during the downswing to prevent the supply of credit being constrained by prudential capital requirements.¹⁶

For example, the Central Bank of Kuwait (CBK), with an Islamic banking market share of approximately 40%, adjusted its regulatory capital requirements by a reduction of 2.5% in CAR from 13% to 10.5%. Furthermore, in an effort to target more support for SMEs, the credit risk weight for exposures to SMEs has been reduced from 75% to 25% in order to empower banks to provide more financing to this sector.

The CBK has also allowed its banks to release the capital conservation buffer (CCB) and has increased the maximum loan-to-value ratio for the financing of private housing and development. Similarly, the Central Bank of Oman (CBO) reduced the CCB by 50% from 2.5% to 1.25%, and the financing-to-deposit ratio was increased by 5% (from 87.5% to 92.5%) for the productive sector of the economy.

The State Bank of Pakistan (SBP) reduced the CCB from 2.5% to 1.5% and increased the maximum permitted Debt Burden Ratio (DBR) for consumer loans from 50% to 60%. Moreover, Bank Negara Malaysia (BNM) also allowed banking institutions to draw down on capital and liquidity buffers to support lending activities. In this respect, banking institutions may draw down on the CCB of 2.5%; however, the BNM indicated that it would expect banking institutions to restore their buffers within a reasonable period after 31 December 2020.

The Central Bank of UAE is allowing banks to tap into the CCB up to a maximum of 60%, and the D-SIBs buffer up to 100% without supervisory consequences, effective from 15 March 2020 for a period of 1 year, but only to support the extension of credit facilities within the UAE.

However, while these relaxations may help to finance economic growth, some supervisors are concerned about the risks of moral hazard, if compliance with new and tougher rules as set out by the Basel III and the IFSB on lending/financing standards is reduced, and the risk that some banks will not have sufficient capital and liquidity if they have to set aside large provisions due to NPFs and a deterioration in collateral values.

This represents a tricky trade-off to navigate and a classic case of conflicting expectations and priorities for banks and their regulators. Therefore, the regulatory and supervisory responses to deal with the impact of the COVID-19 pandemic need to maintain the balance between preserving financial stability, maintaining soundness of financial institutions, and supporting economic activity.

¹⁵ Chattha and Archer (2016).

¹⁶ Toronto Centre (2020c)

While Islamic banks should ensure prudent financing in the context of COVID-19, and apply sound risk management practices regarding the identification of defaults and assessing borrowers for other indicators of unlikeliness to pay, supervisors should be cautious in allowing banks to reduce their capital ratios at a time when NPFs and financing losses are on an increasing trend and could increase further. Supervisors should continue monitoring market conditions, and regularly review the relaxation of regulatory requirements and the use of macro-prudential tools.

A3. Managing Islamic banks' asset quality and the treatment of moratoria and non-performing financing (NPF)

Supervisory authorities and Islamic banks should look at banks' asset quality and the treatment of NPF from three perspectives for customers receiving relief under COVID-19: the accounting treatment covering provisioning, ECL and modification loss, staging and classification; the *Sharī'ah* perspective including restructuring and deferment of profit under existing and/or new financing contracts; and regulatory guidance. Supervisors should also ensure consistent and prudent assessment of ECLs and NPFs by Islamic banks.

The global Islamic banking average NPF ratio was reported to be 4.9% in 2019 (IFSB 2019). However, the longer the 'sudden stop' in economic activity continues due to the COVID-19 outbreak, the more inevitable is a significant rise in NPFs. This will have several implications for ECL, write-offs, and liquidity, causing a drag on profitability for Islamic banks, which will consequently affect the capital reserves provided by retained earnings (Annex 2). One of the key regulatory responses that supervisors have taken to contain the financial implications of the COVID-19 pandemic is by providing "moratorium". The asset quality and treatment of the NPF of Islamic banks should be managed and monitored from *three perspectives* (i.e. the accounting treatment and provisioning, *Sharī'ah* governance, and regulatory dimension) which are presented below.

Accounting treatment and ECL

Islamic banks should correctly recognize ECL in their provisions for doubtful receivables in line with international financial reporting standards such as IFRS or AAOIFI, where applicable, and recognize that this will have an impact on their capital adequacy.

IFRS 9 sets out a framework for determining the amount of ECL that should be recognized. It requires that lifetime ECLs be recognized when there is a significant increase in credit risk (SICR) on a financial instrument. Both the assessment of SICRs and the measurement of ECLs are required to be based on reasonable and supportable information that is available to an entity without undue cost or effort. In assessing forecast conditions, consideration should be given both to the effects of COVID-19 and the significant government support measures being undertaken.¹⁷

IFRS 9 does not address certain specificities of Islamic banks (e.g. different stages of contracts, and treatment of *Mushārah* and Diminishing *Mushārah* financing). There is much conventional guidance available from IFRS 9 and its equivalent, the AAOIFI FAS 30. However, application of AAOIFI FAS 30 would be possible for Islamic banks only if their respective authority has required the implementation of FAS 30 in the jurisdiction; otherwise, Islamic banks will have to follow the IFRS 9 treatment of exposures to customers receiving relief during the moratorium under the circumstances of COVID-19.

¹⁷ International Accounting Standards Board (2020).

The economic consequences of the COVID-19 outbreak will mean that the creditworthiness of some borrowers will deteriorate over the longer term, while some other borrowers will need support in the short-term but may not suffer a deterioration in their lifetime probability of default. This makes it particularly difficult for banks to account for the impact of the outbreak in terms of loan classification, ECL, provisioning, credit risk weightings, and the impact on their capital ratios. Moreover, payment holidays granted across all financing of a particular type should not be an automatic trigger to conclude that an SICR has occurred on all these financings, and therefore that all these financings should move from Stage 1 (a 12-month ECL) to Stage 2 (a lifetime ECL measurement).¹⁸

Sharī'ah perspective

The *Sharī'ah* perspective is an essential component of Islamic banks' operations. From an Islamic perspective, the notion of "moratorium" is mentioned in the Quran. Allah SWT, in the Holy Quran in *Surah Al-Baqra* (2: 280) instructs creditors to be patient with the debtors who are having a hard financial time, and grant them time until it is easy for them to repay: "*And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [from your right as] charity, then it is better for you, if you only knew.*"

In Islamic finance, if the transaction has been carried out on credit resulting in a receivable (e.g. using *Murābahah*¹⁹), Islamic banks cannot charge an extra amount for extending the date of payment (i.e. rescheduling). In the case of *Murābahah*, this means that they cannot charge extra for deferring *Murābahah* payments, as this would mean increasing the mark-up retrospectively. Thus, once the sale price (cost + profit) is fixed for *Murābahah* financing, an Islamic bank cannot claim more than the pre-fixed sale price, even if the payments were to be delayed with the asset becoming 'non-performing'.

In terms of rescheduling, refinancing, or reclassification, Islamic banks should therefore bear in mind that *Sharī'ah* rules and principles do not allow them to refinance debts on the basis of renegotiated higher markup rates; however, debt rescheduling or restructuring arrangements (without an increase in the amount of the debt) are allowed.

The *Sharī'ah* supervisory board (SSB), being a part of the overall governance framework of an Islamic bank, should therefore be involved by the Islamic banks seeking their opinions on potential *Sharī'ah* issues on a 'moratorium' for existing financing. The discussion with the SSB should include the *Sharī'ah* perspective on:

- deferment of profits under existing *Sharī'ah*-compliant financing contracts (e.g. *Murābahah*, *Salam*, *Istisna*, *Ijarah*, *Mushārahah*, and *Diminishing Mushārahah*);
- restructuring and rescheduling of existing *Sharī'ah*-compliant financing contracts;
- late penalty charges and rebate on financing;
- impact of different stages of the *Sharī'ah*-compliant financing contracts (e.g. inventory stage and financing receivable stage);
- mechanisms for adjusting or amending future profit-sharing ratios; and
- forgoing profits on financing to be a form of charity to help affected customers.

The second dimension of the 'moratorium' issue for Islamic banks is the impact on new financing. Islamic banks should not only think about giving a moratorium on the existing financing to customers to keep going, but they also need to think about how to proceed with new financing in such a difficult time, especially to basically-sound customers who are not currently in receipt of financing but need financing to deal with cash flow problems caused by the COVID-19 crisis. As such, Islamic banks can continue giving new financing to customers on the basis of *Murābahah*, but they may have to provide a moratorium on payments with a

¹⁸ Toronto Centre (2020c).

¹⁹ Globally 70% of the financing given by the Islamic banks is under *Murābahah* contract (IFSB 2019).

resultant impact on profitability. In this respect, one possible approach for Islamic banks is providing financing in the form of a simple *Qard*²⁰ to help sound customers weather the crisis.

One possible problem with this, however, is that the carrying value of the *Qard* would be less than its face value by the amount of the foregone return, i.e. the amount of mark-up that would have been applied to a *Murābahah* for an equivalent amount and maturity. This difference would need to be recognized in profit and loss (P&L). It would in effect be a kind of charitable donation. But the same would be true of the reduction in carrying value of a *Murābahah* or *Ijarah* on which payments were allowed to be delayed. However, the SSB would need to approve the classification of this as an expense of socially-responsible banking – *Maqasid-al-Sharī'ah*, or maybe Zakat for the shareholders.

Therefore, practically *Qard* could resolve the modification loss issue under IFRS 9, but in this case, Islamic banks would lose a significant amount of profit or markup on financing, which would affect their income, and there would also be a risk of default by the customers in question.

In their respective jurisdictions, supervisors should also ensure consistent and uniform treatment of *Sharī'ah* opinions on the issues pertaining to the moratorium, as any inconsistency – in *Sharī'ah* rulings and treatment on deferment of profits under existing and/or new *Sharī'ah*-compliant financing contracts and restructuring of such financings – can raise *Sharī'ah* non-compliance risk, leading to reputational risk in the Islamic banking industry. Moreover, in jurisdictions where there is a centralized *Sharī'ah* board, apart from the SSBs at individual Islamic banks, the opinions should be harmonized by the supervisory authorities to ensure consistency across the jurisdiction.

Regulatory perspective

The regulatory guidance to Islamic banks on a moratorium is important as it raises a number of serious implications for their financial statements and for the prudential and accounting treatment of a moratorium. Supervisory authorities should foster consistency in supervisory reporting and monitoring of the asset quality of Islamic banks by ensuring the consistent and prudent assessment by banks of ECLs and significant increases in credit risk. This should include issuing guidance to Islamic banks on how they should assess SICRs, measure ECLs, take account of deteriorations in the value of collateral, make provisions, and calculate regulatory capital ratios (with adjusted risk weights, if instructed) in the COVID-19 outbreak economic environment.

The deferment package is meant to ease cash flows for customers who are affected by the COVID-19 pandemic. Therefore, supervisors should ensure that banks remain responsible for their credit decisions and retain sound and robust credit standards during and after the deferment period. They should encourage Islamic banks to negotiate, in a prudent manner, temporary adjustments to financing terms for customers struggling to service their debts without compromising the *Sharī'ah* rules and principles. This should include:

- establishing a formal, internal COVID-19 committee, with a cross-disciplinary approach, to ensure that a risk management plan (including business continuity management, customer due diligence, coordination with SSB for *Sharī'ah* matters, and risk management functions) is developed and implemented in a timely manner;
- obtaining and documenting relevant evidence of the manner in which the customer is directly or indirectly affected, to qualify for the moratorium;

²⁰ *Qard* is a loan given by an Islamic bank, where the borrower is contractually obliged to repay only the principal amount borrowed.

- updating banks' existing policies and procedures and strengthening internal governance and controls as well as improving the overall monitoring mechanism;
- communicating updated policies and procedures including key parameters for a moratorium (i.e. terms of the deferment such as eligibility of customer, types of financing, tenor of financing, rescheduling or restructuring mechanism, charges for deferment) to all business lines;
- ensuring full transparency and disclosures to affected customers; and
- informing relevant departments of the regulatory treatment in implementing the specific financing arrangements and prudential treatment of problem assets (e.g. *days past due*²¹) and accounting for ECL during and after the deferment period, and its effect on provisioning.

The important questions that arise on the moratorium are: what if the financing and deferred profit is not recovered by the Islamic banks, which will increase the NPFs significantly? Can the central bank, with the covering of the Ministry of Finance (MOF), provide credit guarantees or specific financing write-offs to Islamic banks to mitigate the impact of COVID-19? In some countries, central banks have provided guarantees (of 70-100%) of financing offered by banks to help sound customers survive.

It is worth noting that if the government – directly or through the central bank – does not help by providing credit guarantees to such financing, Islamic banks will be limited in what they can do to help struggling businesses. They will be clement to existing debtors, but may not provide any new financing to help struggling but sound businesses, even small ones. Therefore, the government's role is crucial in such cases. With government guarantees and tax incentives along with other regulatory relief, Islamic banks will be able to respond positively; a domino effect of liquidity crisis in the banking industry can be avoided; and depositors including investment account holders' (IAHs) confidence in Islamic banking would be intact, knowing that their funds have been prudently managed.

Lastly, supervisors should also bear in mind that there is a need to have supervisory clarity for credit bureaux for ensuring that credit history for customers receiving relief under deferment and restructuring/rescheduling for Islamic financing instruments is captured without affecting the customer's credit standing.

A4. Dealing with a liquidity crunch and providing *Sharī'ah*-compliant liquidity support and LOLR facilities

Supervisory authorities should assess a broad range of liquidity risk factors of Islamic banks to mitigate the COVID-19 impact. Supervisors should consider reducing the liquidity requirements under various liquidity tools such as the LCR, NSFR, liquidity ratio, and statutory reserve ratio, and should continue to monitor the banks' liquidity situation. Central banks should provide *Sharī'ah*-compliant liquidity support and LOLR facilities to Islamic banks.

In some jurisdictions, liquidity risk might play a critical role prior to solvency risk given that liquidity conditions have tightened domestically and globally. Hence, supervisors should bear in mind that the impact of short-term liquidity risk might be immediate and solvency risk may appear at a later stage.

²¹ IFSB-15 (2013) states that for risk-weighting purposes, a defaulted exposure is defined as an exposure that is past due for more than 90 days or is a financing exposure to a defaulted counterparty.

The moratorium period for customers raises various threats regarding liquidity risk, including the effect on banks' cash inflows of the delays in receipts due to restructuring or a moratorium on payments. This underlines the need for supervisors to ensure that Islamic banks review the resultant disruption in cash flows and related liquidity problems. It is worth recalling the market turmoil of the global financial crisis, which highlighted the crucial importance of the linkages between credit risk (including counterparty credit risk), funding liquidity risk and market risk. Any Islamic bank should be able to integrate effectively and meaningfully this risk transmission.

Central banks have intervened via various tools (such as open market operations, FX swaps, reverse repos and the standing facility or discount window) to allow the financial system to continue to function effectively, and to stimulate the economy. For their part, supervisors should consider relaxing minimum liquidity requirements – the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) – and extending the timeline for the full implementation of LCR and NSFR (in line with the BCBS) in order to empower the banks' ability to perform their vital role in providing financing to productive economic sectors, and offering liquidity to help businesses continue operations.

For example, the Central Bank of Kuwait (CBK) has reduced its liquidity requirements such as the LCR, the NSFR, and the regulatory liquidity ratio. In addition, the CBK also increased the maximum limits for the negative cumulative mismatch and the maximum lending limits to providing financing.

Bank Negara Malaysia (BNM) has also issued guidance to the banking system to the effect that the implementation of the NSFR will proceed as scheduled on 1 July 2020, but the minimum NSFR will be lowered to 80% and banking institutions will be required to comply with the requirement of 100% from 30 September 2021. The BNM also took pre-emptive measures to boost liquidity through a reduction in the statutory reserve requirement ratio by 100 basis points.

From a funding liquidity risk perspective, two main sources of fund generation used by conventional banks are not available to Islamic banks: (a) they cannot take out interest-based financing from the interbank market or other sources; and (b) in most jurisdictions, for reasons of *Shari'ah* compliance, it is not permitted for Islamic banks to transfer their receivables, other than at face value. Banks, therefore, need to assess a broad range of liquidity risk factors arising from funding and assets/market liquidity exposure so that they can meet their financial obligations, and to identify sources of potential liquidity strain.

As part of liquidity risk stress testing, an Islamic bank should aim to take account of *inter alia*: a simultaneous drying up of market liquidity in several markets; linkages between reductions in market liquidity and resultant constraints on funding liquidity; severe constraints in accessing secured and unsecured *Shari'ah*-compliant funding; the ability to transfer liquidity across entities, sectors, and borders taking into account legal, regulatory, operational, and time zone restrictions and constraints; and liquidity support and LOLR facilities available from the central bank.²²

Due to the specificities of Islamic banks' liquidity cash flows, they should make periodical cash flow analyses of various types under COVID-19 conditions covering behavioural assumptions and contractual maturities. The analyses should be based on relevant assumptions, including the moratorium period and factors affecting the banks' on- and off-balance sheet exposures: (a) known cashflows, where the maturities and the amounts are known in advance (e.g. receivables from *Murabahah*, *Ijārah*, *IMB* and Diminishing

²² Islamic Financial Services Board (2012).

Mushārah); (b) conditional but predictable cashflows (*Salam* and *Istisnā'*); and (c) conditional and unpredictable cashflows (e.g. *Mushārah* and *Mudārah*).

In this context, there is concern about supervisors relaxing liquidity requirements.²³ Liquidity risk tends to be a weak point in Islamic banks, and it continues to be a concern in several jurisdictions with Islamic banking assets, due mainly to a lack of *Sharī'ah*-compliant avenues for liquidity management. In some other jurisdictions, there is an issue of liquidity shortages due to macroeconomic pressures, runaway inflation rates, and negative economic outlooks triggering increased deposit withdrawals.²⁴ Central banks, therefore, need to be prepared to offer *Sharī'ah*-compliant liquidity support and LOLR facilities to Islamic banks.

With respect to LOLR facilities, Islamic banks cannot obtain funds from conventional LOLR facilities or discount windows, as these involve the payment of interest. Contingency arrangements to obtain funds using *Sharī'ah*-compliant financial instruments are therefore essential, and are feasible as is evident from their existence in several jurisdictions. The global financial crisis, and the associated drying up of liquidity in financial markets across jurisdictions, tested central banks' ability to manage situations of stress, and highlighted the need for effective *Sharī'ah*-compliant LOLR facilities to support Islamic banks in situations of serious stress.

The experiences have also indicated the need for central banks (and banking supervisors where applicable) to provide greater clarity on their roles as providers of *Sharī'ah*-compliant liquidity support and LOLR facilities in both normal and stressed times.²⁵ For this, central banks may need to expand the range of eligible collateral beyond what they accept during normal times, while also expanding the range of counterparties with whom they deal.

Considering the present market conditions and supervisors' measures in relaxing minimum regulatory requirements along with a reduction in RWs for a few sectors, and temporary relief in capital buffers, it is essential for supervisors to monitor Islamic banks' liquidity positions and liquidity risk management to ensure that they continue to provide liquidity to the productive sectors of the economy in the jurisdiction.

A5. Providing supervisory support for issuing sovereign *Sukūk* for financing the fiscal deficits

Supervisory authorities should provide support for issuing sovereign *Sukūk* as part of a government strategy of diversification of financial instruments for financing fiscal deficits, thereby providing a basis for a liquid, deep, and active market in these instruments, suitable in some cases for meeting the requirements for the *Sharī'ah*-compliant high-quality liquid assets (HQLA) and expanding the list of *Sharī'ah*-compliant eligible collateral.

The COVID-19 outbreak presents a window of opportunity for the Islamic capital market (ICM) sector, particularly regarding the issuance of sovereign *Sukūk* as part of a government strategy to diversify its funding.

This issuance of sovereign *Sukūk* would help Islamic banks to improve their return on investment, to benefit from lower-asset RWs for CAR, and to expand their list of *Sharī'ah*-compliant eligible collaterals for liquidity purposes. Ideally, at least some of these *Sukūk* should qualify for increasing the banks' pools of *Sharī'ah*-compliant high-quality liquid assets

²³ Relaxing prudential liquidity requirements may be dangerous for Islamic banks in a crisis, especially if they are exercising clemency to their debtors (moratorium, restructuring) which will delay cash inflows and aggravate any liquidity mismatches.

²⁴ Islamic Financial Services Board (2019).

²⁵ Chattha and Halim (2014).

(HQLA). Thus, the *Sukūk* issuances should not only help the jurisdictions to finance their deficits, but also it is important to have a regular issuance program by governments or relevant authorities of a sufficient volume of *Sukūk* that qualify as *Sharī'ah*-compliant HQLA to build a liquid, deep, and active market.

Supervisory authorities should therefore work closely with the Ministry of Finance (MOF) and Debt Management Office (DMO) by providing liquidity forecasting assessments of the banking system in order to consider issuing *Sukūk*. Under a macro-prudential (or financial stability) mandate, there should be discussion within the Financial Stability Oversight Council (FSOC) representing all regulators (banking, insurance, capital market) and stakeholders (MOF, DMO) in the jurisdiction to ensure that *Sukūk* are considered by the government as part of the broader deepening of the financial markets.

Annex 3 demonstrates key considerations for potential sovereign *Sukūk* issuance for 13 jurisdictions, where Islamic finance is considered as systemically important, with respect to their fiscal deficits. These 13 jurisdictions, which include three G20 members, present a case where Kuwait, Malaysia, Qatar, Saudi Arabia, and UAE are rated between AA to A- (as investment grade) indicating relatively low to moderate credit risk; whereas Bahrain, Bangladesh, Indonesia, Jordan, Oman, Pakistan, and Turkey are rated between BBB- to B- (non-investment grade) signalling a higher level of credit risk.

One issue for Islamic banks would be the risk weighting of a holding of sovereign *Sukūk* in both “investment grade” and “non-investment grade” as the former would attract a risk weighting of 20% or less for capital adequacy ratio purposes, whereas the latter would attract a risk weighting of 100%. For instance, the credit rating of Pakistan is currently B-, which is classed as ‘highly speculative’. The risk weighting of a holding of sovereign *Sukūk* issued by such a sovereign would therefore be 100%, but supervisory authorities should bear in mind that there would be the discretion in the Basel Committee standards to apply a lower RW (even zero) to sovereign *Sukūk* issues in domestic currency held by banks in the country.

Sukūk issuances also require, among other things, having in place robust insolvency law, an investor protection regime, and sufficient liquid secondary market for such *Sukūk*. Besides the local considerations for the issuance, *Sukūk* can be issued using foreign jurisdictions where suitable legislation is in force (e.g. Dubai Financial Market). One important thing for jurisdictions would be for the *Sukūk* to obtain a reasonably high credit rating, and this would require suitable asset backing (e.g. sovereign assets such as airports, highways). In this regard, international institutions such as the Islamic Development Bank (IsDB) might be prepared to provide credit enhancement to these *Sukūk*. A more liquid secondary market might then be possible through the use of international banks as market-makers. International Islamic Liquidity Management Corporation (IILM) HQLA-qualifying short-term *Sukūk* could be another option.

A6. Evaluating stress testing and credit quality

Supervisory authorities should evaluate the extent to which stress testing by Islamic banks has incorporated the potential impacts of COVID-19 on their earnings and capital, and specific risk characteristics such as credit quality and ECLs; assess the resilience of individual Islamic banks to adverse economic conditions and whether a bank is able to maintain sufficient capital and liquidity; and examine stress testing results to identify ‘tipping points’.

The COVID-19 pandemic has put significant emphasis on the role of stress testing within risk management. Stress testing should form an integral part of the overall governance of an Islamic bank. Solvency and liquidity stress testing should not only cover severe but plausible scenarios, but also *reverse* stress testing (the stresses that would cause a bank to fail). The

scenarios should capture not only a significant drop in macroeconomic variables such as GDP but also the spillover impact of this on specific sectors and industries. Pursuing a more thorough analysis of risk transmission and contagion mechanisms (i.e. '*ripple and reinforcing effects*') and better reflecting risk correlations that may vary in stressed conditions are fundamental for Islamic banks to include in their stress testing.²⁶

Supervisory review and assessment of the effectiveness of an Islamic bank's stress testing exercise is crucial in responding to an extreme economic condition. This review is essential from a number of perspectives: on a *solo basis* (but with both a micro and macro focus); on a *consolidated basis* (in the sense of supervising the bank as a unit together with the other entities within the 'banking group'), and on a *group-wide basis* (taking into account the potential risks to the bank posed by other group entities outside of the banking group).

Supervisory authorities should ensure that Islamic banks include the following key factors in their stress testing exercise:

- significant decline in domestic economic activity and deterioration of asset and commodity prices and specific sectors;
- impact of rating migrations on risk-weighted assets;
- adverse shifts in the distribution of default probabilities and recovery rates;
- foreign exchange fluctuations and volatility arising from general foreign exchange spot rate changes in cross-border transactions;
- withdrawal risk of unrestricted investment account holders' (IAHs) funds and the impacts of unrestricted IAHs' funding on Islamic banks' liquidity and solvency; and the mitigating effect of profit equalization reserve (PER) and investment risk reserve (IRR) on displaced commercial risk (DCR) and withdrawal risk;
- severe constraints in accessing secured and unsecured *Shari`ah*-compliant funding;
- liquidity reserves and regulatory-required ratios (such as LCR and NSFR); and
- the ability to transfer liquidity across entities, sectors, and borders taking into account legal, regulatory, operational, and time zone restrictions and constraints.²⁷

Supervisory authorities should ensure that stress testing conducted by Islamic banks has considered specific characteristics especially those related to risk characteristics, *Shari`ah* non-compliance risk, capital adequacy under deteriorating asset quality and NPFs, and the position of IAHs (along with PER and IRR reserves) as a capital buffer being considered by the Islamic banks. Banks should also be aware of the emergence of new risks, tipping points, and uncovered hidden concentrations that may arise from the emergent interaction of multiple interdependent risk factors (e.g. reputational risk precipitating a liquidity crisis).

Supervisory authorities should expect banks to be stress testing their credit exposures against various severe but plausible scenarios, including "U-" and "L-shaped" economic recoveries, not simply assuming that there will be a rapid "V-shaped" recovery.²⁸ These scenarios should be supported by feedback and second-round effects as a result of the initial shock. Banks should report the results of these stress tests to their supervisors, together with the actions they would take if these more adverse scenarios began to emerge.

Supervisors should also focus on banks' stress testing methodologies, for example how they are undertaking their analysis of credit quality and ECLs, including a review of details provided by banks of the calculation of various elements of financing non-performance (PDs, provisions, financing losses, utilization of PER and IRR, etc.) and the creditworthiness of

²⁶ Chattha (2020a).

²⁷ Islamic Financial Services Board (2012).

²⁸ Toronto Centre (2020c).

individual borrowers, and exercising judgement and applying flexibility in financing classification (staging and backward transitioning under IFRS 9 and FAS 30).

Since ultimate responsibility for stress testing lies with the board of directors (BOD) and senior management (SM), supervisors should consider whether SM has been sufficiently involved in the stress testing program and the BOD sufficiently informed. Stress tests should be used to support a range of decisions. Banks should identify credible management actions that address the outputs of stress tests and are aimed at ensuring their ongoing solvency. The BOD and SM have responsibility for taking appropriate management actions.

Supervisory authorities should also verify that the roles of a Governance Committee (or an equivalent committee) and *Shari`ah* supervisory board (SSB) are performed effectively so that they are involved in the stress testing program, or at least are informed of the stress testing results and/or of the *Shari`ah* compliance of the remedial actions based on the stress testing outputs.²⁹ Any significant failures in *Shari`ah* compliance could severely damage the reputation of an Islamic bank as well as potentially having more immediate adverse financial consequences (e.g. forfeiting of non-compliant income).

In conducting supervisory assessment of an Islamic bank's capital adequacy, supervisors should consider the following aspects in the assessment: future capital resources and capital needs of an Islamic bank under adverse scenarios; quality of assets and possible declining asset values; potential unanticipated losses and estimated resources to absorb those losses under adverse cases; and the Islamic bank's ability to raise additional capital through common stock and other forms of capital in the market. Supervisors should ensure that Islamic banks' shareholders should be ready and well prepared for the remedial actions of the above stress testing, including strengthening capital buffers.

To complement banks' stress tests, supervisory authorities should also undertake stress tests under a "top-down" approach to assess the possible impact of an anchor scenario (e.g. significant drop in oil prices, profitability, GDP) on both individual banks including Islamic banks and on the resilience of the banking system as a whole. The supervisory review should be continuous as developments unfold in the COVID-19 crisis.

A7. Reviewing financial safety nets and insolvency regimes for Islamic banks

Supervisory authorities should review and ensure the financial safety nets such as the provision of *Shari`ah*-compliant deposit insurance (SCDIS) and a *Shari`ah*-compliant lender-of-last-resort (SLOLR) scheme, as well as an insolvency regime for Islamic banks, sharing information under home-host coordination with other authorities, and the crisis preparedness of the supervisory authority more generally.

The strengthening of financial safety nets comprises the establishment of a SLOLR and SCDIS for Islamic banks. These facilities are considered important components of financial safety nets in the banking sector and can play a critical role in a crisis. The COVID-19 crisis presents an opportunity to supervisory authorities to review these safety nets for Islamic banks.

While a SLOLR was discussed earlier (see section A4 above), a key element of the framework for systemic protection is a SCDIS designed to apply to unrestricted profit-sharing investment accounts (PSIA), which can contribute to public confidence in the system and thus limit contagion from Islamic banks in distress. A conventional deposit insurance system has been established in many jurisdictions, but the business model of Islamic banks calls for

²⁹ Islamic Financial Services Board (2012).

certain adjustments in the way such a scheme should be structured for fund providers, mainly IAH. This requires careful consideration of *Shari'ah* issues by supervisory authorities.

Insolvency regimes also play a key role in the financial sector. An efficient crisis management framework, recovery and resolution regime, and a robust bankruptcy and/or insolvency procedure are essential in order to minimize potential disruptions to financial stability arising from bank failures.³⁰ A sound institutional framework for crisis management and resolution requires a clear mandate and an effective legal underpinning for each relevant authority (such as banking supervisors, national resolution authorities, finance ministries, and central banks).

The insolvency regime should address and cover the specificities of Islamic financial institutions – among them priorities of claims among creditors of a failed institution, asset sale and transfers, correct contractual treatment of assets funded by PSIA and the rights of IAHs, ownership of the assets jointly funded by PSIA and the institution, treatment of reserves such as PER and IRR, *Sukūk* issued by an Islamic bank as capital instruments (mostly equity-based) and the rights of their holders, legal governance, and the enforceability of *Shari'ah* contracts in the resolution regime. The principles that will be applied on these issues for Islamic banks need to be established well in advance of any failure or potential failure.³¹

Some Islamic banks may end up being non-viable as a result of the COVID-19 outbreak. Supervisory authorities need to plan in advance for this possibility. This will involve planning to put Islamic banks into liquidation, using a range of resolution tools, or possibly for some form of government support. This would also be a good time for supervisory authorities to be focusing on banks' internal NPF management capabilities, in particular their ability to reduce NPFs.³²

In the preparedness for the possibility of a system-wide crisis, an important consideration is ensuring greater cooperation on cross-border and consolidated supervision.³³ Supervisory authorities should give due consideration to the possible impacts of cross-border effects (whether it is “*direct impact*”, such as through cross-border balance sheet linkage that might occur as a result of an Islamic bank's risk concentration, or “*contagion impact*”, such as through spillover resulting from exogenous global shocks) and related cross-border implications.

There should be clear understanding of the individual and joint responsibilities for crisis management and resolution, and how these responsibilities will be discharged in a coordinated manner. This requires the supervisory authorities to enter into arrangements with other supervisory authorities to coordinate financial stability measures – in particular, in the areas of surveillance and supervision – to facilitate the timely implementation of pre-emptive responses to systemic risk.

Conclusion

In the context of Islamic banking, supervisors should be paying particular attention to the following as the COVID-19 pandemic unfolds:

1. Ensuring supervisory transparency and clarity of various regulatory and supervisory interventions in the market, while safeguarding a level playing field for Islamic banks in dual banking systems.

³⁰ Islamic Financial Services Board (2015).

³¹ Chattha (2020b).

³² Toronto Centre (2020c).

³³ Islamic Financial Services Board (2015).

2. Maintaining a reasonable level of prudence in striking a balance between: (a) preserving the safety and soundness of the Islamic banks and financial stability, and (b) supporting and stimulating economic activity. Supervisors should continue monitoring market conditions, and regularly review the relaxation of regulatory requirements and the use of macro-prudential tools.
3. Ensuring consistent and prudent assessment by Islamic banks of problem assets and the treatment of moratoria, ECLs, and NPFs from three perspectives: the accounting treatment, *Sharī'ah* perspective, and regulatory guidance. Islamic banks should establish a formal, internal COVID-19 committee, with a cross-disciplinary approach, to ensure that a risk management plan (including business continuity management, customer due diligence amid moratorium, coordination with SSB for *Sharī'ah* matters, and risk management functions) is developed and implemented in a timely manner.
4. Assessing a broad range of liquidity risk factors of Islamic banks to mitigate the COVID-19 impact. Supervisors should consider relaxing minimum liquidity requirements and extending the timeline for the full implementation of LCR and NSFR. Central banks should provide *Sharī'ah*-compliant liquidity support and LOLR facilities to Islamic banks.
5. Providing supervisory support for issuing sovereign *Sukūk* as part of a government strategy to diversify its funding. The supervisory authorities should work closely with the Ministry of Finance and Debt Management Office by providing liquidity forecasting assessments of the banking system in order to consider issuing *Sukūk*. This should help jurisdictions in local ICM development and assist the Islamic banks by making these *Sukūk* available as investments with low-asset RWs as well as expanding their list of *Sharī'ah*-compliant collaterals for liquidity purposes.
6. Evaluating the extent to which stress testing by Islamic banks has incorporated the potential impacts of COVID-19 on their earnings and capital, and specific risk characteristics such as credit quality and ECLs. The supervisory review should be continuous as developments unfold in the COVID-19 crisis.
7. Ensuring the establishment and availability of financial safety nets such as the provision of *Sharī'ah*-compliant deposit insurance and a *Sharī'ah*-compliant LOLR scheme, as well as an insolvency regime for Islamic banks. The safety nets and the insolvency regime should address and cover the specificities of Islamic banking.

Annex 1: Supervisory and prudential measures from systemically important Islamic finance jurisdictions

Central bank/supervisory authority	Market share Islamic banking*	Moratorium, financing restructuring and rescheduling	Liquidity and capital adequacy	Macro-prudential policy tools	Expected credit losses (ECL) provisioning	Central liquidity operations
Monetary Authority of Brunei Darussalam	63.30%	6 months	-	-	Guidance provided for financing and ECL	-
Central Bank of Kuwait	40.60%	6 months	Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and Capital Adequacy Ratio (CAR) reduced; RWs for SME reduced	Loan-to-Value (LTV) increased; release CCB within the capital base	Yes	Yes. <i>Sharī'ah</i> -compliant facilities under <i>Tawarruq</i> for Islamic banks
Bank Negara Malaysia	26.70%	6 months	Operate below the minimum LCR of 100% and minimum NSFR lowered to 80%	Drawdown on the Capital Conservation Buffer (CCB)	FAQ is issued on accounting treatment and modification loss	Yes
Central Bank of Oman	12.40%	6 months	-	CCB reduced 50%; Financing to Deposit Ratio (FDR) increased	Yes	Yes
State Bank of Pakistan	12.90%	12 months deferment of principal amount; Islamic banks to develop solutions in consultation with, and approval of, their respective <i>Sharī'ah</i>	-	CCB reduced by 1% from 2.5% to 1.5%; Debt Service-to-income (DSTI) or Debt-to-Burden Ratio (DBR) relaxed	FAQ issued. Regulatory modalities provided to Islamic banks for treatment of deferment of profit under <i>Murābahah</i> , <i>Salam</i> , <i>Istisna</i> , <i>Ijarah</i> , <i>Mushārahah</i> , and <i>Diminishing Mushārahah</i>	Yes

		Supervisory Boards (SSBs)				
Qatar Central Bank	25.50%	6 months	-	-	Yes	Yes
Saudi Arabian Monetary Authority	51.50%	6 months	Guarantees on SMEs	Yes	The guidance and procedures for classifications of facilities under IFRS 9 for three stages provided	Yes
Central Bank of Republic of Turkey** Banking Regulation and Supervision Authority (BRSA)	5.30%	Yes	-	Yes	Regulatory clarity on treatment of default period (90 days to 180 days), restructuring of loans, and ECL	Yes
Central Bank of UAE	20.60%	6 months Higher Sharia Authority (HSA) for financial and banking activities issued Sharia parameters related to the postponement of instalments for Islamic banks	-	Tap into the CCB up to a maximum of 60% without supervisory consequences for 1 year; D-SIBs are allowed to use 100% of their D-SIB buffer	Guidance provided on IFRS 9 staging and classification of customers receiving relief	Yes

*Market shares are taken from latest IFSB FSR 2019, which had included Q2 2018 data for comparison and consistency; hence the actual share of these countries for Q4 2019 is different and has improved significantly as per the latest data from respective national central banks' websites.

Note: The information in this table is based on the facts available at the time of publication, and may be subject to change. The table shows policy measures for 9 economies with systemically important Islamic finance. The table does not include details on all of the central bank measures that have been introduced.

Source: Author and National Central Banks' websites.

Annex 2: Implications from the treatment of moratoria and non-performing financing (NPF)

Stylized Balance Sheet of an Islamic Bank	
Assets	Liabilities and Capital
Cash and cash equivalents	Current account/Demand Deposits (Non-Mudārabah (<i>Wadī'ah</i> or <i>Qarḍ</i>))
Central bank placements	Savings account (<i>Mudārabah</i> or Non-Mudārabah (<i>Wadī'ah</i> or <i>Qarḍ</i>))
Interbank placements	Commodity <i>Murābahah</i> account (<i>Tawarruq/Murābahah</i>)
Financing/Sales receivables	Interbank deposits (<i>Murābahah/Mudārabah</i>)
• Asset-based financing “based on <i>Murābahah</i> , <i>Bay' Muajjal</i> , <i>Salam</i> or <i>Istisnā'</i> contracts”	Unrestricted PSIA (<i>Mudārabah</i>)
• Equity financing or investments “based on <i>Mudārabah</i> and <i>Mushārahah</i> contracts”	Profit equalization reserve (PER)
• Lease financing assets based on “ <i>Ijārah</i> and <i>Ijārah Muntahia Bittamlīk</i> (IMB) contracts”	Investment risk reserve (IRR)
Investment in securities	Other deposits
Investment in leased assets	<i>Salam/ Istisnā'</i> payable for financing
Investment in real estate	Tier -2 <i>Sukūk</i> /Instrument
Equity investment in joint ventures	Other liabilities
Equity investment in capital ventures	Capital and Reserves
Inventories	
Other assets	
Fixed assets	
Off-Balance Sheet - Restricted Investment Account	

Existing Financing affected by Moratorium + NPF + deferment of profit

+

Forgoing profits on New Financing during Moratorium

→

Negative Impact on Net Income

Note: With respect to COVID-19 and respective various regulatory measures by the regulatory authorities, the table presents the implications for Islamic banks from *Shari'ah*, accounting and regulatory perspective, in particular reference to financing being the most dominant segment of an Islamic bank balance sheet. The respective *Shari'ah* Supervisory Board (SSB) should provide parameters not only for the postponement of instalments for Islamic banks, but also the ways (if any) whereby financing could be restructured without loss of profit under a moratorium period in the context of Covid-19.

Source: Chattha, Alhabshi, and Meera (2020) and Author.

Annex 3: Supervisory considerations for issuing sovereign *Sukūk* for financing fiscal deficits

#	Jurisdiction	Central bank	Sovereign rating	Policy rate cut (bps)	Market share Islamic banking (%)	Fiscal deficit (% of GDP)	COVID-19 measures
1	Bahrain	Central Bank of Bahrain	BB-	75	14.30	-10.6	Yes
2	Bangladesh*	Bangladesh Bank	BB-	75	20.70	-5.2	Yes
3	Brunei**	Monetary Authority of Brunei Darussalam	-	50	63.30	-10.5	Yes
4	Indonesia***	Bank Indonesia	BBB-	50	5.70	-2.2	Yes
5	Jordan	Central Bank of Jordan	BB-	150	15.60	-6.1	Yes
6	Kuwait	Central Bank of Kuwait	AA	125	40.60	4.8	Yes
7	Malaysia	Bank Negara Malaysia	A-	50	26.70	-3.2	Yes
8	Oman	Central Bank of Oman	BB	75	12.40	-7.0	Yes
9	Pakistan	State Bank of Pakistan	B-	425	12.90	-8.8	Yes
10	Qatar	Qatar Central Bank	AA-	175	25.50	4.1	Yes
11	Saudi Arabia	Saudi Arabian Monetary Authority	A	75	51.50	-4.5	Yes
12	Turkey***	Central Bank of Republic of Turkey	BB-	325	5.30	-5.3	Yes
13	UAE	Central Bank of UAE	AA-	75	20.60	-0.8	Yes

*The Bank Bangladesh Bank repo interest rate was reduced from 6% to 5.75%, and then to 5.25% effective from 12 April.

** Monetary Authority of Brunei Darussalam's overnight standing facilities rate.

***In Indonesia, Bank Indonesia is not the banking supervision authority, which is the Indonesian Financial Services Authority (OJK). Likewise, the Banking Regulation and Supervision Authority (BRSA) is responsible for the oversight and regulation of the Turkish banking sector, whereas the Central Bank's primary objective is to achieve and maintain price stability.

Note: The information in this table is based on the facts available at the time of publication; Policy rate cut represents total accumulated cut in bps from January 2020 until end of April 2020. The sovereign rating is sourced from Fitch Long-Term Foreign-Currency Issuer Default Rating, and reflects the latest available rating. The Fitch rating of Brunei is not available. Market shares are taken from latest IFSB FSR 2019. Fiscal balance is as of year 2019.

Source: Author's computation based on data from National Central Banks' websites, Fitch Ratings, IMF, World Bank, Bloomberg, and IFSB (2019).

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