Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation (COMCEC)

Improving Banking Supervisory Mechanisms In the OIC Member Countries

COMCEC Coordination Office
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The analytical study titled *"Improving Banking Supervisory Mechanisms in the OIC Member Countries"* has been prepared specifically for the 4th Meeting of the COMCEC Financial Cooperation Working Group, to be held on March 18th, 2015 in Ankara, with a view to enriching the discussions during the aforementioned Meeting.

The study aims to identify recent developments in the banking supervisory mechanisms in the world as well as member countries and provide recommendations for improving banking supervisory mechanisms in the OIC Member Countries.

Banking Regulation after Basel III reform is going to be challenging in the near future. More intensive capital and liquidity levels will be required in the banking business across the globe. Thus, a better and more technical banking supervision is necessary to comply with the future global banking environment. In all but a few countries, bank capital is quite satisfactory. It seems that OIC member countries will experience a smooth transition to Basel III regulations. However, until the end of 2018, the Capital Adequacy Ratio in global banking will be 10.5%. A rigorous and coordinated Quantitative Impact Study (QIS) among member countries will be useful to see how countries would fare under Basel III future requirements.

By referring to the World Bank Regulation and Supervision Survey, which covers 180 countries, it has been found that OIC member countries need to improve their deposit insurance systems. Improving and coordinating the deposit insurance system is an important aspect of supervision for the member states. Basel III imposes extra liquidity provisions measured by the new liquidity coverage ratio (LCR), which requires banks to allocate additional liquidity by 2015. By looking at the standard liquidity measures in OIC countries, some member states might need to add more liquidity provisions in their banking systems. On average, liquidity side would constitute the most demanding side of regulations for OIC countries as discussed in the Islamic Financial Stability Board's most recent meeting. Member Countries should be ready for necessary balance sheet allocations to comply with these new changes. With exceptions such as Turkey and a few more countries, the average liquidity ratios may require some additional liquidity provisioning in the member states. The Turkish Banking Regulatory Authority was one of the first supervisory authorities, which required a liquidity provision before the credit crisis of 2008. This may also pose a problem for Islamic banking, since liquidity of the short-term funding market is very tight.

Supervisory mechanisms of OIC countries should also consider the coordination between home and host supervisory activities, since implementation of many of the future and present regulations requires different mechanisms for home and host countries. The Bank for International Settlement puts an important weight on minimizing the complications between home and host supervisory authorities. Moreover, even though every OIC country may have a different economic structure, financial stability is a common problem for all member states. Financial stability issues require correct diagnosis of potential instabilities and finding right financial and monetary tools to tackle them. Fast credit growth and vulnerability against sudden capital movements are the main financial stability problems faced by OIC countries. Various countries such as Kazakhstan and Nigeria have faced sharp volatility in their economies, causing abrupt changes in their banking systems. The Turkish Banking Supervisory authority together with the Turkish Central Bank have conducted some innovative and successful pre-emptive measures to deal with financial stability issues. This and other experiences conducted by other member states can be communicated effectively among members hence collaboration among member countries, is necessary to handle financial stability issues. However, rapid credit growth and potential credit risk may lead to future financial instability for OIC member states. As stated by the IFSB summit, developing a macroeconomic stress testing procedure for OIC member states would be very beneficial.

Recently, the role of monetary policy and banking supervision began to create some conflicting results. Some countries such as the UK chose to combine monetary policy and banking supervision under the Bank of England. Coordination of banking supervision and monetary policy is critical and OIC member states should discuss how monetary policy and banking supervision can be coordinated towards a more effective regulation and supervision scheme.

Islamic banking has been growing quite rapidly in recent years. Although it has some advantages over conventional banking, Islamic banking in OIC countries faces some challenges. The minimal use of complex derivatives is the major advantage of Islamic banking over conventional banking. However, relatively less liquid Islamic banking products may pose problems in complying with some of the criteria imposed by new financial regulations. In addition, since there are relatively few parties trading Islamic banking products, counterparty risk may cause some additional challenges for Islamic banking.

In this regard, the banking sector in the OIC member states has a strong growth potential in comparison with developed economies. However, potential financial stability issues and getting prepared for future capital and liquidity requirements are important challenges faced by member states. Member countries do have varying experience and expertise on banking supervision therefore, collaboration and cooperation on banking supervision activities among member states would be beneficial to improve banking practices. Since countries have similar risk factors, a common supervisory framework including a common stress testing methodology would be advantageous for member countries.

The new financial regulation requires various important changes for banking supervision. Firstly, Supervisors' knowledge and expertise on derivative and hedge accounting should be enhanced. The leverage ratio requires accurate derivative asset calculations in particular. Hence, banks' financial disclosure for derivatives is a critical step for banking supervision for the next period. Secondly, concentration of deposit and loan portfolios needs to be monitored more closely. Since many of the new regulations on liquidity (LCR) and credit risk calculations crucially depend on these concentration measures, extra supervisory effort needs to be exerted. Thirdly, Banks' internal risk measurement strategies need to be supervised more effectively under Basel III regulations. Fourthly, static bank capital assessments need to change with the philosophy of ICAAP. In the ICAAP, a bank defines and makes an assessment of the significant risks to which it is or could be exposed. Therefore, supervisors should investigate the macro and banking scenarios and corporate governance in the banks. Fifthly, Dividend policy for the banks will become a more important area after Basel III. Capital conservation buffers, especially, will be directly related to the retained earnings and dividend policies of banks. Therefore, supervisory activities should be directly focusing on banks' dividend policies. Last but not least, under Basel III, the form of capital plays a very important role. More supervisory effort should be devoted to deciding what can constitute Tier 1 capital.

As a conclusion, even though Basel III and other new regulations are very important developments for the future of banking, a successful implementation of these contemporary reforms should be supported with more technical supervision. OIC countries may have to enhance their technical supervision capacity parallel to these reforms. Since full implementation of Basel III will take time, countries have a relatively long period to set up their supervisory mechanisms to adopt the future changes in regulations.

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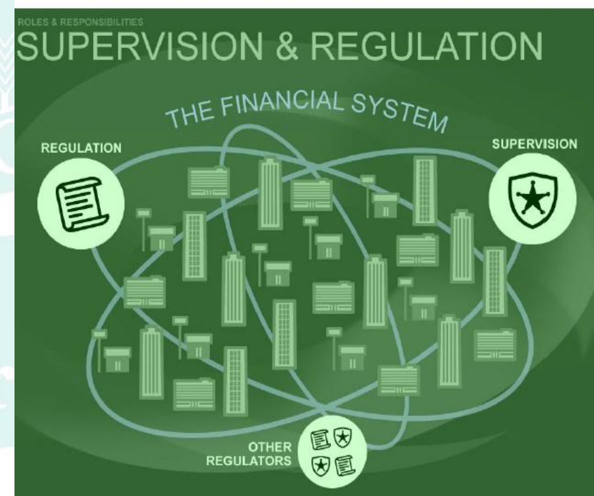

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