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comment
**Darrell Duffie**

## In banking, a bit of complexity can be a good thing

Regulators rightly want to remedy a serious flaw in the financial system: the complexity of bank capital requirements has made them vulnerable to manipulation.

In the rush to embrace simplicity, however, policymakers could inadvertently make safe investments unattractive for banks.

At issue is the risk-weighted capital ratio, a measure regulators have long used to assess banks' soundness. Instead of simply dividing equity by total assets, it assigns each asset a weight that is supposed to correspond to its risk. The idea is that US$10 in capital might be too little to absorb potential losses on $200 in subprime mortgage loans, but more than enough for the same amount in US government bonds. The safer a bank's assets are judged to be, the higher its ratio.

The approach hasn't worked well, because the risks of some assets have been badly underestimated. That's not surprising, given that regulators have often relied on banks to do the measurement using their own internal models. Bank executives typically prefer lower capital levels than regulators would judge sufficient, and thus are motivated to understate risks.

Regulators have incentive problems, too. It is politically incorrect to announce that the sovereign debts of some nations, especially their own, are riskier than others. Hence, regulators assign relatively undifferentiated and unrealistically low risk weights to government debt. This is a particular issue in the euro area, where banks have been encouraged by capital rules to load up on bonds issued by riskier countries such as Greece, Italy and Spain.

To mitigate the shortfalls of risk weighting, regulators are working on new leverage rules that would set a floor on capital as a percentage of assets, regardless of their riskiness. A proposed rule in the United States would set the minimum at 5 per cent for large banking holding companies. Global regulators, under the auspices of the Basel Committee on Banking Supervision, are also considering a new international minimum.

The US leverage rule would require some banks to raise more capital – meaning that the new rule would replace the risk-weighted ratio as the binding constraint. Raising bank capital levels is a good idea, but doing it this way could have an unintended effect: banks would be able to take on more risk for the same amount of capital merely by shifting to riskier assets.

It is strange for a bank to be told by regulators, "It doesn't matter if you move out of US Treasury bills into sketchy real estate loans, we will require you to have the same amount of equity to buffer your risk of loss". This distorts incentives for investment and lending, and could lead to excessive risk-taking. This, in turn, could prompt regulators to react with further tightening of the leverage requirement, which would serve only to exacerbate the problem.

How, then, can capital requirements be reformed, in light of their complexity and past abuses? Should regulators throw up their hands and say they cannot distinguish risky assets from safe ones? Surely not. Instead, the risk-weighting process should be made more conservative.

An improved approach would recognise that, other things being equal, banks are likely to invest more heavily in assets with lower risk weights. This "piling on" can cause even a safe asset class to endanger a bank. Research I did with the mathematicians Amir Dembo and Jean-Dominique Deuschel shows that it is relatively difficult for an adequately capitalised bank to fail from many small, high-risk loans unless they have a tendency to go bad at the same time. Given a failure, the culprit is relatively likely to be losses on very large loans to borrowers that had been judged safe. During the subprime crisis and the euro zone's sovereign-debt crisis, large loans with very low risk weights quickly became life-threatening.

The lowest risk weights should not be as low as they are today. Also, as a bank's investments become more concentrated in a given asset class, the risk weights for that asset class should go up.

The same principle applies to the system as a whole. As investments by banks, in aggregate, become more concentrated in a given asset class, risk weights for that asset class should rise.

Assets whose risks are difficult to judge should be assigned higher risk weights. If a bank is relying on mathematical models to assess a potential loss, and if it does not know which model gives the right answer, it should apply the one that is most relevant in extreme scenarios instead of averaging across them all. This is complicated and requires more effort on the part of regulators, but it can be done. When in doubt, regulators should err on the side of caution, and allow banks less leeway in the designs of their models.

Tossing out risk-weighted capital ratios in an effort to make regulation simpler would be a big mistake. It is possible to lift capital in the banking system to safer levels without depending on rules that are blind to the types of risk that banks take.

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✶ Bloomberg News


**Can Dubai's airport be a hub for the emirate's quest to become the next global centre for Islamic finance?** Kamran Jebreili / AP Photo

# Islamic finance can take off in aviation

**Some of the most powerful** industries in Dubai are connected to logistics and aviation, and the emirate can use them to pioneer lending models. **Nasser Saidi and Eugenio Berenga report**

Sheikh Mohammed bin Rashid, Vice President of the UAE and Ruler of Dubai, recently launched an initiative for Dubai to become the centre of the Islamic economy, with a view to have Dubai host the 10th World Islamic Economic Forum this year.

The emirate is one of the architects of the ecosystem of Islamic finance (IF) in the Middle East, but it faces challenges from Malaysia, Singapore, Hong Kong and even London, all of which are vying to become the next global IF centre.

Can Dubai defy these established centres? The answer is yes, and it lies in the nexus of infrastructure, air transport and logistics and Dubai's growing strength as a regional financial centre.

Aviation, logistics and the sectors linked to them are the dominant contributors to Dubai's economy, representing more than 25 per cent of its GDP. Dubai is becoming an aerotropolis, a city built around its airports. Dubai International is rapidly encroaching on Heathrow's title as the world's leading airport by passenger numbers (about 7 million passengers short of the 65m passenger visitors).

More importantly, the composition of these passengers is from emerging markets – the fastest-growing travel segment – and long-haul passengers travelling on the latest A380 or 777X. Despite global economic uncertainties, 2012 passenger traffic rose 5.3 per cent from 2011 levels and estimates are for 5.5 per cent growth last year. This trend is expected to continue over the next 20 years, with world passenger traffic growing 5 per cent annually. Emerging-market traffic will have a 5.7 per cent compound annual growth rate in Asia Pacific, 6.3 per cent in the Middle East and 4.5 per cent in Latin America, given positive demographics and rising per capita incomes. Long-term demand forecast is for 35,280 units of the newest aircraft and is valued at US$4.8 trillion. $550 billion of this is expected to come from the Middle East, and $1.1tn from Asia-Pacific Islamic markets.

There will also be massive complementary investment in infrastructure for airports and logistics.

There is one question lurking in the back of the minds of aviation watchers – how will all these airline orders be paid for?

These massive investments require different pools of growth capital to enable their funding, particularly with the reduced tenure appetite of western commercial debt lenders and the increasingly sensitive export credit agencies. With more than $100bn in commercial jets poised for delivery globally this year and western banks increasingly focused on complying with the Third Basel Accord, liquidity requirements and managing their balance sheet risks, there is an obvious requirement for capital-hungry airlines to secure their funding. Turning to IF and capital markets is an important part of the answer.

Funding innovation is happening already, with airlines turning to capital markets to fund planes. The financing of aircraft and other capital expenditures by global airlines can be conducted efficiently and cheaply using IF. Aviation, transport and logistics are particularly suited to IF practices and instruments, including Ijara, Murabaha, Mudaraba, Bai Salam and Istisna. The rapidly growing sukuk market could be a potential major source of funds to meet those long-term funding requirements.

British Airways and Emirates have launched asset-backed bonds and sukuk to address funding diversification needs. The precedent established by Emirates is capable of broader regional application using Dubai as the platform for all the Arabian Gulf carriers. UAE and Qatar airlines accounted for 63 per cent and 51 per cent respectively of all the A380 and 777X orders at last month's Dubai Airshow.

The region's banking liquidity, coupled with the soft skills presented by the international banking franchises existing in the UAE, will help structure and sell the transactions to a wider international audience of savers – Islamic or otherwise. The fact that the familiarity with Islamic structures has increased in recent years bodes well for investor receptiveness.

Dubai has developed infrastructure and an airline business model that mitigate the risks in lending to this sector. Overlay that with the massive aircraft orders placed at the airshow, the GCC's regional liquidity and the Sharia-compliant regulatory structures available in the UAE, and the emirate has a powerful business case to negotiate with those who can help deliver this mantle.

The banks and financial institutions in the UAE have the know-how, experience, financial instruments and access to the liquidity to make Dubai the global hub of aviation finance based on IF principles.

Given Dubai's improving credit and successful Expo 2020 bid, it is best-placed internationally to introduce Islamic aviation financing, especially with these embryonic structures typically undermined by their risk-averseness, short-term nature and a tendency to be liquidity oriented.

This offering complements the established DIFC regulatory framework and will serve as a catalyst to soak up regional banking liquidity for local lenders, who with time will also lend in this asset class to diversify their portfolios.

An IF aviation hub lending and investing in airlines is a greenfield business compatible with Dubai's ambitions. Dubai has the potential to leverage its existing stakeholders to spearhead an aviation financing hub serving its aspirations and globally by making IF a pillar of aviation finance.

Dubai can capitalise on its access to the capital of the region and to plentiful IF liquidity with limited investment opportunities – it can develop the market potential of the IF industry itself. As an aviation financing hub, Dubai could also act as a catalyst for future airports and logistics infrastructure using sukuk to address airport capacity constraints in emerging markets.

Dubai-based Islamic financing of the aviation and logistics sector can become the core of Sheikh Mohammed's Islamic Economy initiative.

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## Good riddance to the Federal Reserve's money-printing programme

world view
**Sujata Rao**

If the medicine tastes bad, it is probably doing you good. Emerging economies might console themselves with that thought when they're suffering market cramps and haemorrhaging capital as the United States ends its monetary stimulus.

The Federal Reserve will begin winding down its US$85 billion-a-month money-printing programme this month, and emerging markets are seeing foreign investment pull back as a result. Last year, about $30bn fled emerging equity and bond funds tracked by EPFR Global, provisional data shows.

That is a blow, particularly for deficit countries such as India or Turkey, which rely on foreign inflows to plug balance-of-payment gaps. The hope is the volatility induced by tapering will prod governments into reforms that reduce their sensitivity to shifts in global capital.

"Policymakers are under pressure to implement reforms that were put on the back burner. Tapering is at least getting that narrative going," said Manik Narain, a strategist at the Swiss financial firm UBS. "It's too early to position for it, but if we do get reform it could be the start of the rebirth of emerging markets."

The Fed's $3.7 trillion expansion of its balance sheet was a mixed blessing for developing countries. Economic growth was pumped up by record-low borrowing costs and hundreds of billions of dollars in stock and bond-market investments.

But with so much easy money coming in, most governments got away with very little labour reform, privatisation, productivity gains or improvements to power and transport infrastructure. Progress in those areas will be key to attracting longer-term investment in manufacturing or services.

Past emerging-market crises – India in 1991, Mexico in 1994, Russia in 1998 and Turkey in 2001 – led to reforms that transformed those economies.

Mexico and India are ahead of the game this time. India has begun to shrink budget deficits, cut some subsidies and raise energy tariffs. Expectations of reform after the Indian elections due in May have helped the rupee rise 11 per cent from record lows in the middle of last year.

Energy-sector reform kept the Mexican peso's loss against the dollar last year to 1.6 per cent, compared with falls of 10 per cent or more elsewhere in Latin America.

But analysts said elections in a range of countries this year would discourage unpopular reforms for now. Any proposed changes in Russia or South Africa could be hampered by healthy prices for their oil and metals exports.

"[The volatility] has spurred reform in some countries, but it's not EM-wide, that's for sure," said Christian Keller, the head of Eastern Europe, Middle East and Africa (EEMEA) research at Barclays in London.

Capital Economics told clients that policymakers had an opportunity to undertake supply-side reform, but it feared that "incumbent governments may try to boost re-election prospects by pushing ahead with populist spending plans, causing current-account deficits to widen further."

Considering all that possibility and taking a longer-term view, a quick end to money printing is probably not a bad thing

The Brazilian central bank's governor, Alexandre Tombini, may have spoken for many emerging-market policymakers when he recently called US policy "normalisation" a "net-positive". The sooner the Fed withdrew its stimulus the better, he said.

That is unsurprising. The Fed's money printing gave central bankers headaches by fuelling explosive spending and debt, property bubbles, price and currency inflation.

As domestic interest rates were cut to levels well below what was justified by fundamentals, current-account gaps blew out. Brazil's deficit, for instance, is running at 3.5 per cent of annual economic output, up from 1 per cent in September 2009.

"Policymakers are focusing on short-term volatility, which means they are too busy to focus on longer-term issues. The later the tapering the bigger the imbalances," said David Hauner, head of the EEMEA fixed-income strategy and economics at Bank of America Merrill Lynch.

As tapering progresses, markets will be able to better reward reformers and punish the laggards by focusing more on country-specific factors, Mr Hauner said.

"The best for emerging markets will be: 'let's get this done, have the US. Treasury yields repriced to 3.50 per cent or so and let's move on'."

✶ Reuters