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Measurement of the displaced commercial risk in Islamic Banks

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Highlights
\begin{itemize}
  \item We identify the displaced commercial risk DCR exposure of Islamic banks.
  \item We identify the scenarios of displaced commercial risk exposure to compute the DCR Profits and Losses to Islamic banks shareholders.
  \item Scenarios of risk depend on the actual rate of return on investment accounts, the benchmark rate of return and level of existing reserves to mitigate the DCR.
  \item We assess the capital charge needed to cover the displaced commercial risk using the Value-at-risk measure of risk, DCR-VaR.
  \item We assess the coefficient alpha $\alpha_{\text{CAR-VaR}}$ for the capital adequacy ratio for Islamic banks.
  \item We consider three methods, the Historical non-parametric VaR, the parametric-VaR and the Extreme Value Theory-VaR.
\end{itemize}

Abstract

The objective of the research is to quantify the displaced commercial risk (DCR) based on quantitative finance techniques. We develop an internal model based on the Value-at-risk (VaR) measure of risk to assess the DCR-VaR and the alpha coefficient $\alpha_{\text{CAR}}$ in the capital adequacy ratio of Islamic banks. We identify first the scenarios of exposure of Islamic banks to DCR that depend on the actual return on unrestricted profit sharing investment accounts (PSIA\textsuperscript{U}), the benchmark return as well as the level of the existing profit equalization reserve (PER) and investment risk reserve (IRR). Second, we quantify the DCR-VaR and the alpha coefficient $\alpha_{\text{CAR-VaR}}$ for a given holding period and for given confidence level. We illustrate the DCR-VaR model on selected Islamic banks from Bahrain. Our model helps to better assess the needed equity to cover the DCR and an accurate capital adequacy ratio for Islamic banks. The model has also policy implications for regulators and the IFSB to develop better guidance on good practices in managing this risk.
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