Challenges for Islamic Banks in Complying with Basel III

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The rationale for Basel III

- Limitations of Basel II
- The global financial crisis of 2008
- Lender of the last resort burdens on government fiscal deficits
- Lack of anti-cyclical protection
- Reactive rather than pro-active regulation
- Absence of stress testing

Basel III capital adequacy requirements

- Banks to hold 4.5% of common equity to risk-weighted assets (RWA)
  - Basel II 2%
- Tier I capital 6% to RWA
  - Includes common equity, retained earnings and some reserves
  - Basel II 4%
- Additional capital buffers
  - Mandatory capital conservation buffer of 2.5%
  - Discretionary countercyclical buffer, which allows national regulators to require up to another 2.5% of capital during periods of high credit growth
- Minimum 3% leverage ratio
  - Equity to debt calculated (bank liabilities, not RWA)

Liquidity provision

- Liquidity Coverage Ratio
  - Banks to hold sufficient high-quality liquid assets to cover its total net cash outflows over a 30 day period
- Net Stable Funding Ratio
  - Available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress
  - Stress could result from a prolonged recession, a real estate crash or environmental catastrophe

Risk assessment framework

- Basel II
  - Recognition of different types of risk
  - Collateral reduces credit risk with lower risk weighting for residential mortgages
- Basel III
  - Focus on counterparty credit risk
  - Systemic risk recognised after 2008 crisis
  - Excessive exposure to a single counterparty increases vulnerability
  - Possibly insufficient attention to financing concentration

Application to Islamic banks

- Islamic banks and the 2008 crisis
  - Conventional banks, notably Lehman Brothers, caused the crisis
  - Unjust that Islamic banks should suffer the consequences
  - Credit default swaps not permissible under *Shari'ah*
- Islamic finance part of global economy
  - Regulated with conventional banks
  - Financing concentration an issue for Islamic banks
  - Islamic bank depositors entitled to protection
  - Islamic finance should not be a burden on government

IFSB Exposure Draft 15

- Revised capital adequacy standards
  - Issued 1st November 2012
  - Original standards in IFSB 2, December 2005
- Consultation
  - Public Hearing 1: 18 November 2012, Dubai
  - Public Hearing 2: 22 January 2013 in KL
  - Written submissions by 31st March 2013

IFSB suggestions on additional capital in the form of *sukuk*

- Equity based
  - Could count as 1.5% additional Tier 1 capital to RWA under Basel III
  - *Musharaka* or *mudaraba* structure
- Capable of absorbing losses
- Issued and paid-up
- Minimum maturity 5 years
  - Any amortisation of principal within 5 year period on a straight line basis
  - No call expectation
- Non distribution of profit
  - This would not constitute a default event
- *Sukuk* unsecured and not guaranteed

Case study:
ADIB Basel III compliant *sukuk*

- Issuance
  - Thursday 8 November 2012
  - Arrangers HSBC, NBAD & Standard Chartered
- Financials
  - Issuance target $1 billion, orders $15.5 billion
  - 330 investors, 38% Asia, 32% GCC, 26% Europe
  - Pricing 6.375% profit rate
- Structure
  - Perpetual *murabaha* note
  - Profit reset after every 6 years
- Tier 1 qualifying conditions
  - Deferral of profit payment mandatory if ADIB breaches minimum capital requirements of UAE Central Bank or has inadequate liquidity
  - Dividend stopper if breaches applied both to ordinary shares and the new *murabaha* note, but latter is senior

The status of investment *mudaraba* accounts

- Liabilities or equity
  - Profit and risk sharing characteristics
  - High proportion of Islamic bank deposits in *mudaraba* accounts
  - If equity could count towards Tier 1 capital
  - If classified as term liabilities increase capital adequacy requirements
  - IFSB 15 suggests *mudaraba* accounts should not count as Tier 1 capital
- Liquidity implications
  - Low velocity of circulation reduces liquidity coverage ratio
  - How should *mudaraba* deposits be treated in the calculation of the Net Stable Funding Ratio?

Pro-cyclicality in Islamic finance

- Basel III
  - Mandatory and discretionary capital buffers of 2.5% of risk weighted assets
- Limits to pro-cyclicality in Islamic finance
  - Finance linked to investment in real assets
  - Lower proportion of funding from non-loss absorbent demand deposits
  - Investment *mudaraba* accounts can be considered partially or wholly loss absorbent
- Types of Islamic investment that are pro-cyclical
  - Islamic bank equity investment including through *mudaraba* and *musharaka*
  - Investment in real estate as a *Shari'ah* compliant asset class

Leverage ratios in Islamic banks

- Definition
  - Leverage is the equity to debt ratio
- Islamic bank leverage ratio calculation
  - Paid-up equity to demand deposit liabilities
  - Paid-up equity to demand deposits plus unrestricted *mudaraba* deposits
- Assets included
  - Assets financed by unrestricted accounts counted in the exposure calculation
  - Assets financed by restricted *mudaraba* deposits not counted
  - Latter can be considered off-balance sheet
- Result
  - Leverage ratios lower for Islamic banks than for conventional counterparts
  - Islamic banks largely rely on retail deposits rather than inter-bank market funding which is less stable

Treatment of Islamic windows

- Prelevance
  - Islamic windows found in most jurisdictions
  - Prohibited in Qatar
- Capital requirements for Islamic windows
  - Calculation of separate capital adequacy ratios for Islamic subsidiaries
  - Result could be capital adequacy acceptable for Islamic window but unacceptable for parent bank
  - Alternatively where no separate accounts ratio subsumed in overall capital adequacy ratios
- Parent in another jurisdiction
  - Responsibility of home or host regulatory authorities for capital adequacy monitoring

Counterparty credit risk weights for Islamic banking assets, %

Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
Sovereigns & central banks	0	20	50	100	150
Multilateral development banks	20	50	50	100	150
Islamic & conventional banks	20	50	100	100	150

Ratings of selected OIC countries

Country	Moody's rating	Moody's outlook	S&P rating	S&P outlook
Bahrain	Baa1	Negative	BBB-	Stable
Egypt	B2	Negative	B	Negative
Indonesia	Baa3	Stable	BB+	Positive
Malaysia	A3	Stable	A-	Stable
Pakistan	Caa1	Negative	B-	Stable
Saudi Arabia	Aa3	Stable	AA-	Stable
Turkey	Ba1	Positive	BB	Stable
UAE	Aa2	Stable	AA	Stable

Exposure to profit sharing investments

- *Mudaraba* and *musharaka* financing
  - Exposes bank to capital impairment (market) risk as well as credit risk
- IFSB 15 recommendations
  - For listed companies 300% risk weighting
  - For private equity companies 400% risk weighting
  - Diminishing *musharaka* 100% risk weightings
- Supervisory slotting method
  - For project finance
  - Strong 90%
  - Good 110%
  - Satisfactory 135%
  - Weak 270%

Accepted collateral to mitigate risk

- *Hamish Jiddiyah*
  - Security deposits to purchase a lease which are binding
- *Arboun*
  - Deposits in an Islamic bank to purchase a commodity which are not refundable if purchaser backs out as with an option
- Profit sharing investment deposits
  - Interbank deposit by an Islamic bank
- *Sukuk*
  - Rated by an external agency
  - Unrated if listed on a recognised exchange and approved by the supervisory authority
- *Shari'ah* compliant equity
  - Includes units in an Islamic investment fund
- Guarantees by third parties
  - Sovereigns and central banks
  - International organisations
  - Islamic and conventional banks with a minimum A- rating

Qualifying assets for liquidity purposes

- Constraints facing Islamic banks
  - Cannot hold conventional treasury bills
  - Trade-off between assets having participatory risk characteristics and liquidity certainty
- Critique of existing liquid instruments
  - Commodity *murabaha* an unsatisfactory compromise
  - Eliminating credit and market risk from *sukuk* undermines their credibility under *Shari'ah*

Ownership and other non-traditional banking risks

- Unique Islamic bank exposure
  - Ownership risk with *murabaha* and *ijara*
  - Market risk with *mudaraba* and *musharaka*
  - Delivery risk with *salam* and *istisna*
- Risks shared with conventional lenders
  - Concentration risks a major issue
  - Reputational and *Shari'ah* risks
  - Systemic risks from conventional bank failures