Basel II Enhances Islamic Banks

By implementing Basel II, Islamic banks will see capital savings and improvements in risk management practices — but they face a higher capital charge, DALILA ABU BAKAR reports.

The implementation of a new capital adequacy framework by Islamic banks will enhance their credibility and sustain their growth globally. Most Islamic banks worldwide implemented the new framework at the start of the year.

In Malaysia, Islamic banks implemented the Capital Adequacy Framework for Islamic Banks (CAFIB), which is equivalent to the standardized approach under Basel II for conventional banks, beginning January 2008. The framework was developed based on the Capital Adequacy Standard (CAS) issued by the Islamic Financial Services Board (IFSB) in 2006.

Bank Negara Malaysia (BNM) said that most Islamic banks had been observed to experience modest improvements in the capital adequacy ratio following the implementation of CAFIB, with increases in capital requirements due to the introduction of a new capital charge for operational risk being mitigated through capital savings enjoyed from lower risk weights for residential mortgages and retail exposures under the new framework.

Following the implementation of the new framework, the central bank expects to see capital savings and improved risk management practices in the industry through the supervisory expectations embedded within the framework, such as for the recognition of credit risk mitigants for purposes of capital savings. This would also be supported by an enhanced risk management system infrastructure.

During the development of CAFIB, BNM adopted a more collaborative and consultative effort in engaging industry players and stakeholders for the purpose of ensuring greater clarity in terms of the appropriate level of capital charges as well as the supervisory expectations in promoting a smooth transition from the traditional Basel I to the more risk-sensitive framework. Basel I was transformed to Basel II to make it more comprehensive.

More scrutiny with Basel II

While Basel I addressed only credit risk, Basel II looks at credit, market and operational risks. Basel II also provides for an assessment of a bank's capital adequacy, which is more risk sensitive; for example, through greater recognition of risk mitigants such as collateral and guarantees, which were less prevalent under Basel I.

To date, of the 12 Islamic banks in Malaysia, 10 have adopted CAFIB. The remaining two have been allowed to migrate directly to the internal ratings-based (IRB) approach in 2010.

According to BNM, CAFIB and the standardized approach under Basel II for conventional banks are generally similar, save for the following:

- Capital treatment is dependent on the type of Shariah contracts underlying the transaction;

- Profit sharing investment accounts (PSIAs) are recognized as risk mitigants;

- Physical collateral is recognized as a risk mitigant for credit risk;

- Availability of supervisory slotting criteria method and more granular risk weights for the specialized lending type of Islamic financing transactions; and

- The capital requirement for inventory risk arising from risks associated with the holding of physical assets has been introduced.

Mohammad Faiz Azmi, partner and global Islamic finance leader at PricewaterhouseCoopers (PwC), said the different capital requirements by conventional and Islamic banks had resulted in a higher capital charge for the latter.

"Islamic banks have non-financial assets in their balance sheet such as copper, cars and houses whereas conventional banks have loans. So, for capital purposes under Basel II, it is a big problem as conventional banks would have some

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capital set aside for these loans, but for Islamic banks, that capital is very high because Basel II was never designed to cover the non-financial assets. Hence, Islamic banks need more capital," Mohammad Faiz said.


Mohammad Faiz Azmi

Picture source: PwC Malaysia

He added that Islamic banks in the Middle East that offer Mudarabah or Musharakah and conduct equity-type or commodity-based transactions are experiencing higher risk and, hence, need more capital charge for these non-financial assets.


Dr John Lee

Picture source: KPMG

Dr John Lee, executive director of KPMG Global Lead Islamic Finance, said: "While the risk profiles of Islamic financial institutions on the surface are generally similar to those of conventional finan-cial institutions, Islamic financial institutions face some unique and distinct risks. In particular, the assets and liabilities (highlighted in red in Diagram 1) are unique to IFIs, given their profit and risk sharing structures."

According to Lee, an example of the distinct risk characteristic display by a profit-sharing transaction on the assets side is the home financing product. Often, an Islamic home financing facility is structured as a Diminishing Musharakah (see Diagram 2), which results in the Islamic financial institution having co-ownership in the house purchased, as opposed to a conventional mortgage product, in which the house is just collateral to the financial institution.

Further, on the liabilities side, the "deposit taking" activities, which are referred to as investment account holders ("IAHs"), are not like conventional deposits, but share the profit and loss of the Islamic financial institution. In other words, IAHs are like mutual fund holders or private equity fund holders.

Types of risk

With the availability of such product structures, Islamic financial institutions face unique and distinct risks such as:

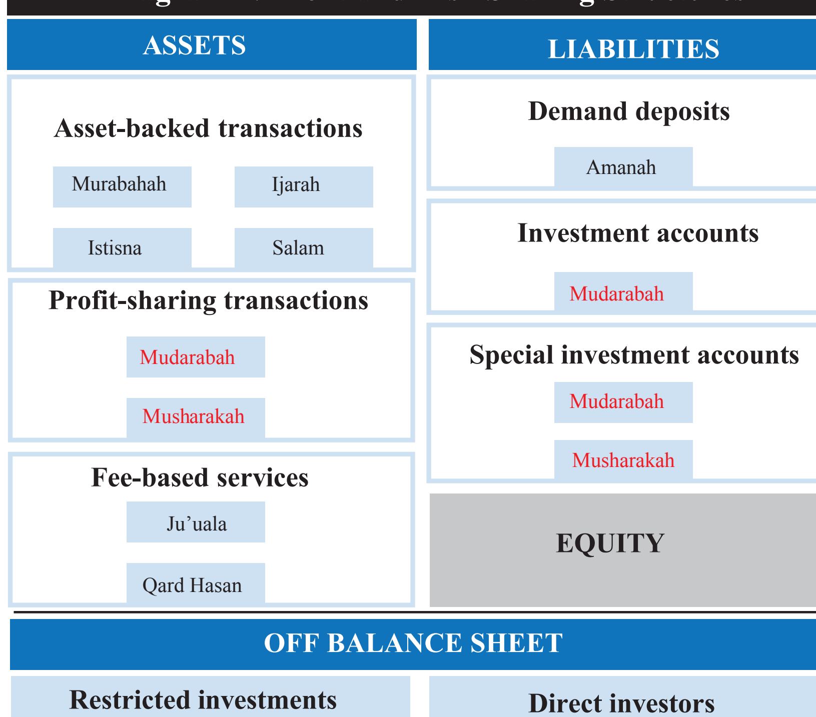
Displaced commercial risk: This arises when Islamic financial institutions are under pressure to pay a return that exceeds the rate earned on assets financed by their IAHs, when the return on assets is underperforming as compared with competitors' rates. In such a scenario, the Islamic financial institution may waive its rights to the profits or a part thereof in order to retain its fund providers and dissuade them from withdrawing their funds;

Rate of return risk: This is associated with overall balance sheet exposures where mismatches arise between the assets and liabilities of Islamic financial institutions. Revenue and expenses are generally accounted for on an accrual basis when deriving the exposure and the Islamic financial institutions are exposed to the expectation of IAHs when allocating their profits;

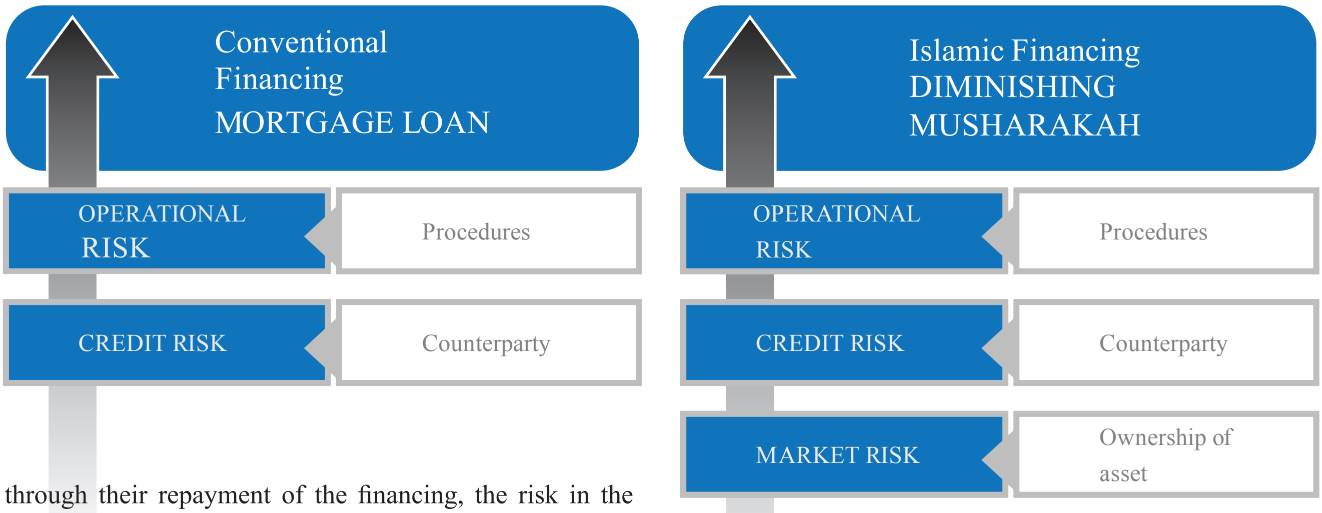
Asset price risk: This is associated with exposures to price volatility of the underlying "real" assets inherent in some financing modes, which are in the form of trading and real investments. The risk arises because Islamic financial institutions carry out many asset-based transactions in which they take ownership of physical assets as co-investors.

Asset transformation risk: This arises because the risk associated with a financing structure transforms itself during the term of the financing. For example, in a Diminishing Musharakah home financing structure, the risk may initially be an asset price risk, given that the Islamic financial institutions are co-owners of the asset. However, as the home owners build up their equity ownership further

Diagram 1: Profit and Risk Sharing Structures



Digram 2: Comparison of Risk Characteristics



through their repayment of the financing, the risk in the financing structure transforms to more credit risk.

Fiduciary risk: This arises from a breach of the investment contract for management of IAHs' funds.

Shariah compliance risk: This arises from non-compliance with Shariah principles in conducting the Islamic financial institutions' business.

IFSB's prudential standards

Lee said IFSB has issued several prudential standards to complement the Basel standards to address the specificity of Islamic products. These standards include capital adequacy, risk management and corporate governance.

At the onset of the implementation of CAFIB, the Islamic banks were expected to incur some costs to enhance the infrastructure and engage resources, either internally or from external resources, to facilitate enhancement of their risk management capabilities.

The level of investments would depend on the state of readiness of the institution and its business strategy, moving forward. However, over the medium to longer term, BNM expects the benefits of the investment to outweigh the cost derived from the ability of the banks to manage their risk and capital more effectively, thus leading to more profitable business income.

"Of course, from my perspective as an auditor, Basel II in a way rewards 'good' banks and punishes 'bad' ones. It helps you differentiate between well-run banks and those that are not so well run," said Mohammad Faiz of PwC.

The implementation challenges faced by the banks are common across both Islamic and conventional banks. Most banks have to enhance their capabilities in terms of processes, policies and infrastructure in order to be eligible for some of the capital savings embedded within the framework such as for residential mortgage, retail portfolios as well as for credit risk mitigation. As a result, from the outset, some banks would not be able to enjoy the full benefits of the capital framework in terms of capital savings.

Most banks have the necessary information to undertake the capital computation residing in various systems that are not integrated. This would require investments to enhance the systems as well as to address the insufficient supply of human talents.

"The cost of investment in Basel is high as the banks need to change the system to run calculations and the front-end system, they also need consultants and the experts in Basel are in Europe," Mohammad Faiz explained.

However, he pointed out that Islamic banks are willing to invest in Basel II to avoid higher charges in borrowing.

"A bank in Malaysia that does not implement Basel II will be charged more if it wants to borrow from a bank overseas that is Basel II compliant. So, if you don't implement, it will become a business rather than a regulatory issue," he said.

Mohammad Faiz feels that Islamic banks have to be more capitalized because of the nature of their business.

"Hopefully, we will have bigger and not more Islamic banks. I think Basel II can force them to do that because if they have to put so much money aside, they will have become bigger banks. Bigger banks can take bigger jobs and give out bigger loans," he concluded.