Implications of Basel II for Islamic financial products

Charles Ilako
Chairman, PricewaterhouseCoopers Global Regulatory Practice

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Charles Ilako
Chairman
PwC Global Regulatory Practice

Introductory remarks

I have been asked to speak about Basel II and its relevance in the context of Islamic banking. I am not going to focus that much of my attention on the individual products themselves but really look at an investment bank, looking at its balance sheets and its asset liabilities and how it would be treated in a Basel II world. In that context I will be referring to the Islamic Financial Services Board which has been playing a very key role in terms of setting regulatory capital standards for Islamic banks and has played a key role in advising regulators and Islamic banks on how best to implement Basel II.

Agenda

- What's different?
- Risks
- Pillar 1
- Pillar 2
- Pillar 3

Agenda

Three pillars

What I propose to do is talk about the differences, obviously between an Islamic bank and a conventional bank and look at the underlying risks in that context. Then I will look at the various pillars; Pillar I being the qualitative assessment of capital, Pillar II looking more at the governance, the risk management processes and the frameworks within an organisation and looking at what sort of impact that will have in determining the amount of capital a bank must hold and Pillar III deals with disclosure.

What's different ?

- Risks
- Basis for contracts
  - Profit sharing - Musharaka, Mudaraba
  - Sale \ Purchase - Murabaha, Istisna, Salam
  - Leases - Ijara
  - Sukuk - Asset based
- Regulatory capital implications

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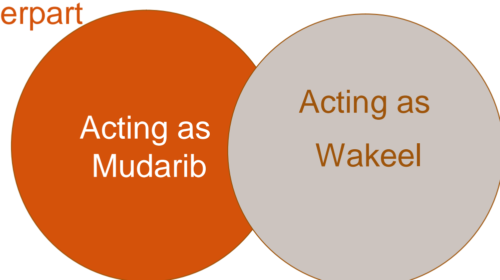
Risks

In terms of the risk, I think it is important to appreciate what sets Islamic banks apart, particularly with respect to the risk taken on by an intermediary, and the risk transferred to clients when a product is sold to them. From a market standpoint, while each Islamic financial product appears to be similar to one other conventional type product, the risk implications are very significant, and this clearly is a big issue from a regulatory capital standpoint. Take, for example, when a financial services customer places a deposit with a conventional bank. He or she is actually taking on counterparty risk with respect to that bank itself. If we are looking at an account holder who places a deposit, or more specifically, a Mudaraba deposit with an Islamic bank, in a sense what he or she is doing is taking on the risk of the underlying asset, not the bank itself. Therefore, again there is a fundamental difference in the way that the risks are assessed. Organisation standard setters, like the Islamic Financial Standards Board, are playing a key role in trying to analyse some of these differences and trying to assess what needs to be done from a regulatory capital standpoint.

Management of financial resources

- Operating models – banking/investment management/takaful
- The IFI acts as trustee/manager or as agent and not as counterpart



Management of financial resources

It is worth saying a word or two on the operating model, and it varies depending on whether we are looking at a bank, an asset manager of sorts, or a takaful operator. An Islamic bank can act as a trustee/manager or as an agent. Depending on those circumstances, again the regulatory capital treatment is quite different.

Funds mobilisation

		IFRS	AAOIFI
Equity	Equity	Share capital	Share capital
Mudaraba- **unrestricted**	Trust accounts/ Fund management	Off B/S	On B/S
Mudaraba **restricted**	Trust accounts/ Fund management	Off B/S	Off B/S
Musharaka	Joint venture	Off B/S	Off B/S
Sukuk	Bond type security	Off B/S	Off B/S
Wakala funds	Agency funds	Off B/S	Off B/S

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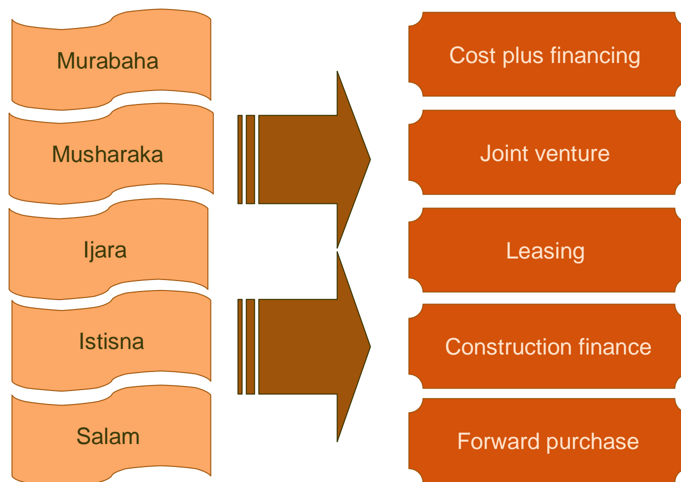
Funds mobilisation

If we look at the two sides of an Islamic bank's balance sheet, in terms of fund mobilisation, you have heard about all the different sorts of instrument that are used to mobilise funds and from an accounting perspective – if we are looking at international accounting standards or at the fine work of AAOIFI – there are some differences in the way these instruments are accounted for. There are some significant differences, and the regulators are having to grapple with which one of the two regimes is the appropriate way to view the risk assets.

Funds deployed



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Funds deployed
If one looks at how the funds are deployed: again different types of instrument, about which you have heard quite a bit already, have different accounting and financial implications.

Regulatory Capital

- What capital is available to cushion against the risks?
  - Owner's equity – share capital
  - Investment account holders' equity
- IFSB's Standard has additional cushions built in:
  - "α" in supervisory formula
  - Supervisory discretion

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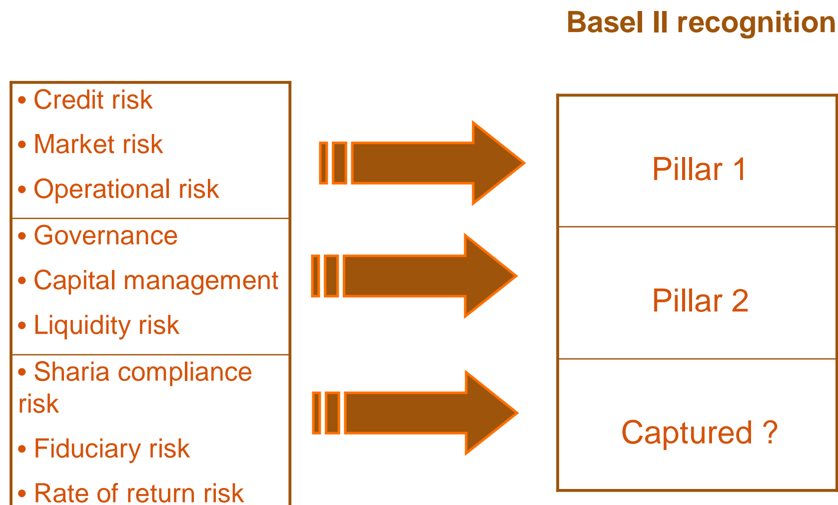
Regulatory capital
Therefore, from a regulatory capital standpoint, both sides of the balance sheet need to be looked at. Specifically, the key issue is that regulatory capital is there to support or cushion against unexpected losses. In the case of an Islamic bank, what is owner's equity? And how do we deal with investment accounts? From a pure Basel II perspective, it is literally silent on this issue, but the Islamic Financial Standards Board has raised some very useful guidance that is entirely relevant. I think the key issue here is that if one is looking at an unrestricted investment account, the question is, should it be taken into account, especially if the underlying risks ultimately lie with account holder.

From the point of view of standard setters, regulatory capital must be set aside for those sorts of exposure, for two principal reasons: one, the funds in an investment account are not permanent in nature unlike equity capital, and secondly, it is typically the case that an Islamic bank will make a contribution towards making good any losses that an account holder has suffered.

Again, there is a moral obligation in a sense **–** or competitive aspect **–** to ensure that investors are not overly punished as the result of unexpected losses etc. The way that this is done is through the introduction of a supervisory alpha which is basically a way of risk-weighting the underlying assets which relate to the account holder, and on that basis determining what is an appropriate level of capital that should be set aside for those exposures.



IB Risks v Basel II

If we now try and map Islamic banking risks to the Basel accord, under Pillar 1, typically under Basel II, we are looking at credit risk, market risk, and operational risk. In respect to Pillar 2, which is more the quantitative assessment, which then drives the decision whether any additional capital is required: issues such as governance risk, capital management risk and liquidity risk are picked up in that second level. The question is how should other Islamic banking risks, such as Shariah compliance risk, fiduciary risk, and the rate of return risk, be dealt with in an overall Basel II framework.

Market risk

First of all let us look at market risk: how does market risk arise in the context of the various types of products? In the case of the very first one we are looking at, murabaha, market risk arises before the sale. Therefore, depending on what type of instrument you are looking at clearly one or more forms of market risk arises.

Credit risk

• Murabaha	• Upon sale
• Salam	• Rentals
• Istisna	• Contract billing
• Ijara	• Purchase price
• Musharaka	• Upon termination etc
• Mudarabah	• Upon termination etc
• Sukuk	• Redemption

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Credit risk
Similarly, if you look at credit risk, again I am just listing the different types of Islamic banking product and when credit risk arises in those particular types of contracts. Again, if those contracts are held by an Islamic bank it will have to set aside a certain amount of capital which I will come to in a moment.

Operational risks – Perhaps critical

- Islamic Banks face major challenges
- Contractual and legal risks are onerous

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Operational risk

The third component to Pillar 1 relates to operational risks. An operational risk is one of those risks has been very difficult for financial institutions (and again I am talking about conventional banks) to try and put a number to. It is not so easy: just because a bank may have a lot of historical risk data does not necessarily mean that it is able to project that and apply that data to come up with some sort of quantitative assessment of what its operational risk is. Therefore, there are quite a lot of operational risks there. For Islamic banks, this is uncharted territory to a large extent. Clearly we are looking at documentation risk and we are looking at process risk. However, as the community starts to adopt a Basel II framework, I think it is going to be one of the key challenges for both standard setters, as well Islamic banks themselves, to determine what is an appropriate level of capital to support an Islamic bank's operational risks.

IFSB risk categories

Regulatory treatment

• Credit risk	RWA
• Equity position risk	RWA
• Market risk	RWA
• Liquidity risk	-
• Rate of return risk	"α"
• Operational risk	RWA

In terms of the risks I have just been talking about – credit risk, equity position risk, market risk, liquidity risk, rate of return risk, and operational risk – the general approach is basically to identify and measure the assets that an organisation has exposure to and then effectively risk-rate them on the basis of how risky those particular instruments are. That is the broad framework, which we obviously do not have time to go into, though it is a mathematical equation that comes into play.

Pillar 1 under Basel II

Credit
- Standardised approach
- Internal ratings based approach

Market
- Standardised approach
- Internal models approach

Operational
- Basic indicator
- Standardised
- Advanced measurement

Under Basel II – and this is again for a conventional bank, although we are flex it for an Islamic bank – basically for credit risk there are two broad approaches that can be adopted. First is a standardised risk approach, where the assets of the bank that are risk rated, or externally risk rated – the framework that uses external risk rating such as Moody's, Standard and Poor's, etc., to risk-weight the assets on the balance sheet with respect to credit risk and that is the very basic approach, but those organisations that have well-developed models that have been approved by regulators can use one of two internal ratings-based approach – the incentive in going for the more advanced approach is that there is a capital incentive: the way that the numbers will crunch out will produce a slightly lower level of capital requirement.

For market risk, again there is a standardised approach and then there is a value-at-risk-based approach for those organisations which meet the various qualifying criteria. With regard to operational risk, the basic measure is to look at gross income, by business division, and basically apply a percentage – typically 10-15% – to estimate what the operational risk capital charge is. For those organisations that do have historical data on operational risk and have good controls around that data, they are allowed to use the more advanced approach for operational risk, though again I do not have time to go into it in more detail.

Pillar 1 application by IFSB

How relevant are these approaches?

	Approaches	Relevance
Credit	• Standardised approach • Internal ratings based approach	Yes Discretion
Market	• Standardised approach • Internal models approach	Yes Yes
Operational	• Basic indicator • Standardised • Advanced measurement	Yes Discretion Discretion

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Pillar 1 application by IFSB: how relevant are these approaches?
In the context of an Islamic bank, what the Islamic Financial Standards Board has done is to have taken the Basel II approach and adopted a standardised-based approach for both credit risk and market risk, not too dissimilar to a conventional bank's approach. However, what it has then said is that in those jurisdictions where a national regulator feels comfortable – it can actually evaluate an internal ratings-based approach and if the institutions that local regulator supervises do have the appropriate systems and governance practices in place – they can actually use the internal-based approach. That approach applies equally to market risk and operational risk. Therefore, we are moving towards a regime whereby Islamic banks potentially will be able to reap the capital benefits that conventional banks have had, or have recently had, since Basel II came into play.

Pillar 2

- How are Islamic bank regulators risk profiling their banks?
- IFSB's approach – how different?

Pillar II

I would just like to say a word or two about Pillar II, which is really important. If you look at Basel I then look at Basel II, the movement in regulatory capital has not been that significant as we have moved from the old Basel I regime to the new Basel II regime.

The real difference comes in the context of Pillar II where the capital requirements potentially increase by a factor of about 25% as a result of regulators going into an organisation and assessing the processes and controls around their regulatory reporting measurement and reporting systems and assessing that they are not as good as they ought to be, particularly in respect of the risk management processes and the overall corporate governance within a bank. It is really in the context of Pillar II that regulators have been slapping on an additional capital charge on top organisations.

Going forward I think the big challenge will be for regulators to assess some of the qualitative concerns that have been raised in this context. For Islamic banks that is going to be a very big challenge, certainly an even bigger challenge than the operational risk one that I mentioned earlier on. Again, however, I think the key issue in relation to Pillar II is looking at issues such as the board and senior management setting the right sort of tone within an organisation, ensuring that the sort of culture, which is embedded within an organisation, is very much a Shariah-compliant and a corporate governance-compliant environment.

Pillar 3

- Basel II Pillar 3 disclosures are very relevant – however application must take account of the specificities
- Standard on Transparency and Market discipline is being developed

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Pillar III
Let me finally say a few words about Pillar III. Pillar III is all about disclosure: it is all about ensuring that an organisation is disclosing appropriate information about the risks it runs, appropriate information about its regulatory capital position.

In the context of an Islamic bank, Pillar III is quite important because an Islamic bank, like every financial institution, is all about trust, but I think it is particularly true in the context of Islamic banking. Market disclosure and market discipline is one way of reinforcing the degree of trust that an organisation is able to attract with respect to the marketplace.

Again, we are not quite there with Pillar III yet but, quite clearly, if we look at the experience of conventional banks, Pillar III has been a serious challenge for them. I do know that the Islamic Financial Standards Board is in the process of issuing some guidelines in the context of transparency and market discipline, specifically with regard to Basel II, and I think that some sort of guidance is due out some time this year and think that is something we should be looking forward to.

How are you and your regulator coping with these complexities?

charles.ilako@uk.pwccom

........Thank you

Concluding remarks

I think the key point I would make is that we are moving rapidly towards a regulatory capital regime for Islamic banks that will be very similar to the sort of regime we currently have for Basel II. I think though that there is going to be a huge challenge to Islamic banks, particularly given the sort of environment we are in today, because it will be very difficult for a regulator to incentivise an organisation, by way of a capital reduction in today's market.

By that what I am basically getting at is that under Basel II, the underlying point is that for those organisations that invest significantly in risk management processes and systems, they will be allowed to use the more advanced process, obviously which require a greater degree of investment. However, the benefit of that is that their capital requirements will go down.

Where we are today, quite clearly, is that the regulatory focus is very much on ensuring that the regulatory capital levels do not fall considerably, and I think this is one of the challenges which Islamic banks are going to face going forward. To that extent, I think it is quite clear that the vast majority of them will probably adopt the most basic approaches, which will require the least amount of financial investment, at least over the next couple of years. However, I certainly do see organisations eventually migrating to some of the more advanced approached under the Islamic banking Basel II regime going forward.