What impact of Basel Accord III on Islamic banks?

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Introduction

In 1988, the Basel Capital Accord, known as "Basel I", was established by a group of central banks and other national supervisory authorities, and approved by the G10, working under the governance of the Basel Committee on Banking Supervision (BCBS). It was meant to promote the soundness and the stability of the international banking system, basically by imposing a minimum capital ratio of 8% of capital to risk-weighted assets. During the last years, the international financial and banking system have been facing perturbations and changes (especially through different innovations and financial crisis), which prompted the BCBS to develop a new accord in 2004, namely Basel II, because Basel I was not efficient enough and showed its limit in preventing banks failure. The new regulatory framework was based on three pillars: minimum capital requirement, supervisory review and market discipline.

The huge impact of the 2007 international financial crisis, principally on the international banking system stability, pushed the BCBS to review the previous Basel Accords in order to adept them toward implementing a new regulation and supervision banking framework. Thus, by the end of 2009, Basel Accord III was proposed and reviewed by the G20 before its implementation. The new accord focuses mainly, on new capital and liquidity regulations to ensure the soundness of banks and high-quality capital, which ought to be high enough to absorb losses and to scope the financial markets risk.

Islamic banking system was not affected directly by the last international financial crisis, but the impact was witnessed and felt through the adoption of the Basel III, which have yet to take into account the specificities and features of the Islamic banking system, but based on Sharia-compliant instruments and activities. However, the Islamic Financial Services Board (IFSB), one of the major international Islamic supervisory and regulatory Boards, worked to establish Basel Accord sharia-compliant and which proved to have a positive impact in countries, such as Malaysia and Pakistan. Nevertheless, many Islamic banks still suffering because the Basel sharia-compliant is not mandatory, and hence is not adopted by financial authorities of several countries and Basel III is considered to be an obstacle and hindering the development of Islamic banks in a context dominated mainly by a conventional system.

This paper aims to analyze the following problematic: "***Can Islamic banks work in accordance to Basel Accord III?***", and thus, by studying the impact of Basel Accord III on Islamic banks and the role of the ISFB in the new international regulatory framework. Our research is based principally on the conceptual literature review and empirical studies related to this topic, which unfortunately remain rare. The lack of database, empirical studies, transparency and the difficulty of accessing to some specialized journals, reports and papers hinder the quality and relevance of the research being carried out this area.

Basel Accord III: an overview

The huge impact of the 2007 global financial crisis on the international financial and banking system stability drove researchers and policy makers, mainly the Basel Committee on banking and supervision, to establish a new framework for banks in order to be able to face up to various risks. Hence, they developed the Basel III Accord, based on the banking regulatory previous frameworks (a specially, Basel II).

Indeed, in December 17th, 2009, the Basel Committee released two consultation papers in which it proposed strengthening global capital and liquidity regulations with the goal of promoting a more resilient international banking sector. The proposal highlights the following[1]:

- Implements changes starting in January 2013 and doing through a transitional period that lasts until January 2019;
- Raises the quality, consistency, and transparency of the capital base through stricter rules on eligibility of instruments to be included in (core) Tier 1 capital;
- Enhances risk coverage by strengthening counterparty credit risk capital requirements arising from derivatives, repurchase transactions, and securities financing;
- Supplements risk-based capital requirements with the addition of non-risk-based leverage ratio as a backstop measure;
- Reduces pro-cyclicality and promotes countercyclical capital buffers through a combination of forward-looking provisioning and capital buffers;
- Introducers new global liquidity standards that include a stressed liquidity coverage ratio and a longer-term structural liquidity ratio; and
- Addresses systemic risk and interconnectedness, with more specific proposal developed in 2010.

Basel III has not yet come into effect, it is predicted that it will increase the capital charge for derivatives and securities transactions, increase risk charge for exposures, increase minimum capital levels allowed, change the definition of capital permitted to

[1] PwC's (Price waterhouse Coopers) Financial Services Institute (FSI); (October 2010); "*The new Basel III framework: Navigating changes in bank capital management*"; USA; p 13.

count towards meeting minimum level, increase the leverage ratio, and impact the liquidity coverage ratio (LCR) and net stable funding ration (NSFR)[1], as it is illustrated in table1.

Table 1: Basel III Accord Timeline

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Minimum common equity ratio			3.50%	4.00%	4.50%	4.50%	4.50%	4.50%	4.50%
Capital conservation buffer						0.625 %	1.25%	1.875 %	2.50%
Minimum common equity plus capital conservation buffer			3.50%	4.00%	4.50%	5.125 %	5.75%	6.375 %	7.00%
Phase in of deductions from CET1 (inc. amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital			4.50%	5.50%	6.00%	6.00%	6.00%	6.00	6.00%
Minimum total capital			8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Minimum total capital plus conservation buffer			8.00%	8.00%	8.00	8.00%	8.00%	8.00%	8.00%

[1] Hersh Emily Sarah; (Spring 2011) ; « *Islamic finance and international financial regulation*"; Journal of International Service; American University; Washington, DC; p55.

Capital instruments that no longer qualify as non-core Tier 1 or Tier 2 capital				Phased out over 10-year horizon beginning 2013					
Leverage ratio	Supervisory monitoring		Parallel run 1 Juanuary 2013-1 January 2017 Disclosure starts 1 January 2015					Migration to Pillar 1	
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begings						Introduce minimum standard	

Source: Haron Abdullah; (23-24 October 2011); "*Basel III: Impacts on the IIFS and the role of the ISFB*"; AAOIFI-World Bank annual conference on Islamic banking and finance; Bahrain; p16.

The Basel Committee has proposed, in the context of Basel Accord III, the adoption of two proportions in meeting the liquidity requirements[1]:

Firstly, the "*Liquidity Coverage Ratio (LCR)*": designed in order to insure that a necessary assets to cover short-term obligations over a 30-day period. The LCR started to be regulated in 2011, but the 100% minimum has been enforced in 1st January 2015.

Secondly, the "*Net Stable Funding Ratio (NSFR)*": designed in order to insure that a necessary assets to cover over a one year and it is defined as the amount of available stable funding. The NSFR started to be regulated in 2012, but the 100% minimum should be enforced on January 1st, 2018.

[1] Ait Akash. S and Ben Nasser Mohamed ; (23-24 March, 2015) ; « *Islamic banks and the implication of Basel Committee standards- Basel 3-*";Tenth International Conference on Islamic Economics and Finance; Qatar Faculty of Islamic studies; P 17-19.

New standard has added namely the "*Leverage Ratio (LR)*". It is designed in order to contribute to the proper consideration of a wide range of leverage sources, both on-and-off balance sheet. This measure, not based on risk, should limit the accumulation of excessive leverage in the banking sector, and the minimum leverage ratio is currently set at 3%. The Committee proposed to test this standard during the period of 2013-2017, and banks were required to disclose on January 1st, ،2015. In the first half of 2017, the last final adjustments would be carried out in order to migrate to a Pillar 1 treatment January 1st, 2018.

The implications of Basel accord III on Islamic banks

The Basel III framework, based on the balance-sheet of conventional system banking, does not take into account the particularities of Islamic banks, which are based on Sharia-compliant instruments and activities (prohibition of interest, application of the profit-loss sharing principles…); because it is considered that Islamic finance, in general, had not been affected by the 2007 international financial crisis. However, the Islamic banks are obliged to adopt the new norms of Basel Committee due to their participation in the international banking system.

- Impact of the new capital requirement on Islamic banks

In terms of regulation, Kara (2011) finds that Islamic banks are in a advantageous position vis-à-vis of Basel III. Indeed, according to Habib and Khan (2007), the Islamic bank is essentially compounded of Tier 1 assets (compounded of common equity), and having some Tier 2 is very rare, as in general it is capital or hybrid capital linked to the payment of interest, what would allow Islamic banks to comply with Basel III requirements?. On this point, Harzi (2009) considered that Basel III has a positive impact in terms of competitiveness of Islamic banks[1].

Though, Islamic banks are required to maintain the following minimum capital adequacy ratios: *(i)* 4.5% as CET1 Capital Ratio, *(ii)* 6.0% as Tier 1 Capital Ratio, and *(iii)* 8.0% as Total Capital Ratio. This minimum capital adequacy requirement has taken effect the 1st of January 2015[2].

The Capital Ratio (CAR) is calculated by dividing the Eligible Capital (EC) by the total Risk Weighted Assets (RWAs) (i.e. credit risk, counterparty credit risk, market risk and operational risk), and concerning Islamic banks, a dilemma lies with the denominator of the formula because not all deposits are protected by shareholders capital. This

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[1] Harzi Adel ; (2009) ; "*The impact of Basel III on Islamic banks: A theoretical study and comparison with conventional banks*"; presented at the research chair "Ethics and financial norms" of University Paris 1 La Sorbonne and the King Abdul University (Jeddah); p 4-5.

[2] Bank Nagara Malaysia; (November 28th, 2012); "*Capital adequacy framework for Islamic banks (capital components)*"; Malaysia; p 5.

might be explained by the fact that in Islamic banks investment deposit fall under the profit sharing investment account (PSIA)[1].

Depending on the jurisdiction, the computation of CAR varies in dual banks, but when there is separation of capital, Islamic windows and conventional party determine separately their CAR and consolidate everything at the parent level by adding corresponding tiers and aggregating the RWA. On the other hand, everything is combined and fall under Basel III capital requirement, when capital separation is not required, which would mean that risks that are specific to Islamic banks have been not taken into account[2].

For instance, in their empirical study on Islamic banks of Pakistan, Azeem, Marsap & Ozari (March 2015) found that there was a significant positive relationship between total investments to asset ratio and capital to asset ratio from the period 2010-2013, and that under Basel III they were still growing their financial volume and their capital adequacy ratio was stabilized. The study showed that investments of Islamic banks of Pakistan since implemented Basel III grew from Rs.338 billion to Rs.709 billion from 2010-2013, and they concluded that banks were investing their assets in less riskier categories and stabilizing their CAR[3].

- Impact of Liquidity Ratio on Islamic banks

The new liquidity ratios, outcomes of Basel Accord III, namely: Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) will have a sizeable effect on Islamic banks for two reasons: *(i)* the lack of a developed Islamic money market, and *(ii)* the lack liquid Islamic investment instrument with short term maturities. LCR and NSFR do not take into account the specificity of the Islamic finance: for the LCR, it misses to Islamic banks the abundance of Sharia-compliant short term instruments; and for the NSFR, there is no profusion of longer term liabilities that can be withdraw at short term[4].

In fact, Islamic banks are lacking High Qualified Liquidity Assets (HQLA) to meet the definition of level 1 and level 2 assets under the LCR numerator despite the fact that the Basel Committee granted derogation for Islamic banks to use sukuk as HQLA. For the denominator which is the total net cash outflow, the inflow from sharing is unknown and difficult to estimate and for outflow the treatment of PSIA as stable deposit is questionable. Regarding the NSFR, the issue is less problematic for Islamic banks than for the LCR, because the PSIA and other deposits can be considered as

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[1] http://www.riskdynamics.eu/blog/bid/325781/Islamic-Banking-and-Capital-Requirements-Part-2 (accessed on 28/07/2015)

[2] http://www.riskdynamics.eu (op.cit)

[3] Azeem.M.M, Marsap.A & Ozari.C; (August 2015); "*Impact of Basel Accord on banking system (Evidence from Islamic banks of Pakistan)*"; Applied Finance and Accounting; Vol. 1, No. 2; p 4.

[4] Harzi Adel; (2009); Op.cit; p 14.

Available Stable Fund (ASF) on the numerator and the Sukuk and other modes of Islamic financing (such as leasing, markup sale, …) might fall under the Required Stable Funding (RSF) in the denominator depending on the counterparty and the applicable RSF factor[1].

For dual banks, in practice, the liquidity is mixed and managed at the parent level. Exceptionally, the Islamic window's liquidity is separated and handled at the window level. There is also the issue of funds transfer which is problematic, due to sharia restrictions, when the parent is transferring some amounts to the windows[2].

For jurisdiction where an LCR rule does not exist and cross-border activities are minimal, the objective should be to gradually move to the LCR framework to give banks time to improve capacity. During this transition, consideration should be given as to whether the LCR parameters are sufficiently stringent or need to be tightened as appropriate to the local context. Also, it would be important to assess the treatment of PSIA from liquidity perspective[3].

For example, to response to the problematic of the LCR on Islamic banks, due to the absence of highly rated short-term liquid and tradable financial instruments Sharia-compliant, a group of central banks hailing from three different continents along with the Islamic Development bank (IDB) worked together to set up the International Islamic Liquidity Management Corporation (IILM), a multilateral entity which regularly issues highly rated short-term sukuk instruments to enhance cross-border liquidity flows, international linkages and financial stability of the institutions that offer Islamic financial services. Since its inaugural (August 2013) until 2014, the ILLM has currently issued a total of seven series of sukuk which include issuances and re-issuances, with a total of $4,54 billion with an outstanding sukuk amounting to $ 1,35 billion[4].

The role of the Islamic Financial Services Board (IFSB)

At the end of 2013, the ISFB published ISFB-15, a proposal for comprehensive regulatory reform aimed at strengthening capital and liquidity requirements for Islamic banks, based on Basel regulations[5], and it is a revised and an enhanced version of two previous IFSB standards on capital adequacy, namely IFSB-2: Capital adequacy

[1] http://www.riskdynamics.eu/blog/bid/326835/Islamic-Banking-and-Liquidity-Risk-Part-3 (accessed on 1/07/2015)

[2] Idem

[3] Mejia. A.L; (December 2014); "*Regulation and supervision of Islamic banks*"; International Monetary Fund working paper/14/2019; USA; p 16.

[4] World's Islamic Finance Market Place; (August 14th, 2014); "*Basel III sukuk innovated*"; Malaysia; p 6.

[5] Lackmann Bedi Gunter; (Summer 2014); "*Basel III creates new opportunities for sukuk (Islamic bond) issuance*"; Nomura Journal of Capital Markets; Vol.6, No.1; p 3.

standard for IIFS (2005) and IFSB-7: Capital adequacy requirements for Sukuk securitizations and real estate investments (2009)[1].

The purpose of this standard is to assist the implementation of capital adequacy framework that should ensure effective coverage of risk exposure of the IIFS and allocation of appropriate capital to cover risks. In order to achieve these objectives, IFSB-15 provides guidance on the features and criteria for high-quality regulatory capital components, including additional Tier 1 and Tier 2 Sharia-compliant. Also, it provides new guidance on macro-prudential tools, like capital buffers, leverage ratio and domestic systemically important banks. The IFSB-15 has implemented in the IFSB member countries since January 2015, however, not as an obligation, but according to country's regulatory and supervision decisions[2].

The IFSB-15 is structured as follows[3]:

Section 1: provides the background and objectives, as well as the scope and coverage, of the standards. Further, it specifies the proposed date of starting implementation of the standard. It also includes a brief overview on the specificities of Islamic financial instruments and the structure of the standard.

Section 2: outlines basic features and criteria for various components of capital to be applicable to IIFs, as well as regulatory adjustments and deductions attached to these components. This section also illustrates the application of the capital conservation buffer, countercyclical buffer and leverage ratio for IIFS keeping in view their balance sheet structure and specificities in the application of these requirements.

Section 3: further expands the guidance provided in the earlier IFSB SAG related to calculation of credit risk, market risk and operational risk. In order to incorporate recent enhancement in the global capital standards and cover some areas not previously included. Inter alia, the sub-section on credit risk mitigation has been restricted to cover new credit risk mitigation techniques. Sub-sections on market risk and operational risk have also been update. Lastly, the sub-section on profit-sharing investment accounts (PSIAs) has been enhanced to provide a more comprehensive guideline on the treatment of PSIAs and adjustments in the CAR.

Section 4: sets out the minimum capital adequacy requirements for both credit and market risks for each of the Sharia-compliant financing and investment instruments: murabahah and murabahah for the purchase order, commodity murabahah

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[1] http://www.ifsb.org/preess_full.php?id=242&submit=more (accessed on 29/07/2015)

[2] Idem

[3] Islamic Financial Services Board; (December 2013); "*ISFB-15: Revised capital adequacy standard for institutions offering Islamic financial services (excluding Islamic insurance (takaful) institutions and Islamic collective investment schemes)*"; Malaysia; p 4-5.

transactions, salam and parallel salam, istisna, ijarah and irahah muntahia bitamlik, musharakah including diminishing musharakah, mudarabah, qard, and wakalah.

Section 6: combine guidance on capital adequacy treatment of sukuk and securitization an exposure of IIFS included in IFSB-2 and IFSB-7, and incorporates global regulatory developments related to originating, issuing and holding sukuk in various stages of the securitization process.

Section 7: specifies capital requirements for exposures of IIFS to real estate financing and investment activities, when and IIFS utilizes its own (shareholders') funds or those generated from PSIA and other fund provides. This section, which was originally part of IFSB-7, has been further updated to cover best practices of supervisory authorities to improve supervision of IIFS' real estate exposures.

Conclusion

The instability in the international banking system, following the 2007 international financial crisis, enhanced the necessity for the development of a new international regulatory framework based, essentially, on the Basel Accord III, which consist to promoting the global capital and liquidity requirements through the raising of the soundness capital base and enhancing risk coverage in order to face shocks arising from financial stress. Nevertheless, the establishment of Basel III was based on the conventional banking system without taking into account the characteristics of Islamic banks, despite the fact that they are an integral part of the international financial system.

On one hand, this might be explained by the fact that Islamic banks were not really affected by the 2007 international financial crisis. In addition, supervisory and regulatory group members were mostly from countries where the banking system is based on the conventional one. However, many Islamic banks were, and still, affected negatively by the Basel III (viewed mainly on the liquidity ratio, in comparison with the capital ratio) because they are treated as their conventional counterpart; but in some countries, as in Malaysia and Pakistan, positive impacts were observed, and that due to the application of the Basel III sharia-compliant by Malaysian and Pakistani central banks.

Indeed, to respond to the requirements and to respect the specificities of Islamic banks, the ISFB (with the collaboration of other groups) reviewed the Basel accords and developed what is known as the IFSB-15, which consist of a number of sharia-compliant agreements and rules, and hence allowed Islamic banks to work in accordance to international regulatory accords together with Islamic principles. The IFSB-15 is limited to few countries (where Islamic regulation rules are adopted). Thus, Islamic supervision and regulatory organisms are called to establish guidelines better suited to the Islamic banking and finance system specific needs and requirements,

rather than relying on the conventional system, and the success of this latter will be through more innovation, creativity and effort (*ijtihad*) from Islamic scholars.

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