Islamic banking and Basel II: challenges ahead

'No obstacles – no special favours' describes the UK regulator's attitude towards Islamic banks when applying banking regulations – which includes the regulations surrounding the Basel II capital adequacy directive. But is the directive itself quite as accommodating? Don Brownlow, NewHorizon's contributing editor, talks to Dr Natalie Schoon, head of product development at the Bank of London and The Middle East plc.

Dr Natalie Schoon,
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The term 'Basel II' is now commonplace around the banking world. Most people have at least some idea of what it means, but some of the nuances of its application to Islamic banks may not be quite so well understood.

The intention of Basel II, quite simply, is that the regulators want to ensure that banks are prudent in maintaining sufficient reserves to protect themselves and their depositors against untoward events in their loans, their operations or, within reason, the market itself. The idea is that a bank needs to set aside capital, which is essentially the bank's own money, for each of a set of defined categories of risk. The more risky the bank or its business, then the more capital it needs to put to one side to provide a cushion against things going wrong.

As Dr Schoon points out, 'the initiative was really aimed at the large banks of the G10 developed countries. What was originally intended for a Citibank or a JPMorgan now equally applies to a small savings & loan [institution] in the United States'.

It also, of course, applies to Islamic institutions. Depending on the uptake of Basel II in a particular country, it will apply to some Islamic banks sooner than others. Nevertheless, it may eventually apply to almost every Islamic financial institution. In many countries the regulations are already in place – for others it is on its way. In the main, Islamic banks tend to be relatively small and are often located in countries where Basel II is not the regulator's top priority, according to Dr Schoon. So the impact on Islamic banking has not been felt as much as it has been on some small conventional banks that happen to be situated in nations that have already adopted the directive. Nevertheless, Dr Schoon believes that Islamic banks will largely be affected in 'the same way as any of the smaller conventional banks' around the world.

Even though Basel II applies equally across all banks, its impact is felt differently in the smaller banks than in the bigger banks. The differences are not in the legislation itself but in the availability of associated models and historical data that a bank requires to complete its capital adequacy calculations. 'The larger banks are able to progress major development projects,' Dr Schoon says, 'even when the actual capital relief was yet unknown'. These development projects relate to banks creating customised ratings models based on available historical data in the bank rather than using the 'standardised' approaches that are generally adopted by the smaller banks. Those standardised approaches offer reduced costs of implementation and maintenance compared to the custom internally-built models used by the largest banks.

'Smaller banks, including the Islamic banks, are likely to suffer from a lack of data and

How capital adequacy is calculated

The amount of regulatory capital is calculated based on the aggregate of all of the bank's risk weighted assets multiplied by eight per cent. The eight per cent multiplier originated in the Basel I agreement and has not been changed in Basel II. See below:

Example Asset Classes	Risk Weight
Central governments, central banks, OECD governments	0%
Multilateral development banks, banks incorporated in the OECD	20%
Mortgages	50%
Private sector, commercial companies owned by the public sector, all other assets	100%

For example: A loan to a 'bank incorporated in OECD' attracts a 20 per cent weighting. The calculation is: for each £100 lent the lending bank must maintain £100 x 20% x 8% or £1.60 in regulatory capital. For the 400 per cent weighting given to lending with an equity position *(see body of article)*, the calculation would be £100 x 400% x 8% or equal to £32 in regulatory capital.

a smaller sample size,' according to Dr Schoon, which restricts them when attempting to build their own models, whereas the largest banks, including those that offer Islamic windows, are able to develop customised risk models using their own historical experience.

When specifically looking at historical loan losses, there are loss databases available to the conventional banks such as the Pan European Credit Data Consortium (PECDC) or the North American Loan Loss Database (NALLD). These databases are however not necessarily suitable for Islamic banks since they are associated with conventional finance. In addition, the risk appetite of Islamic banks may be different. There is an opportunity in the Islamic banking community to create a specialised database that is specific to Islamic institutions and their loan loss history. In fairness, many Islamic banks are so new that they have not as yet seen the full economic cycle, so even if the industry's loan loss history were available then it might not yet provide a significant sample size.

The main components of Basel II – credit risk and operational risk – are shown in *Box 1*. There are other risks but, for the most part, conversation is often restricted to these two main items. 'Credit risk' generally means the quality and risk level of the bank's loan book; 'operational risk' generally refers to the quality of the bank's internal processes, people and systems.

When comparing Islamic banks to smaller conventional banks there is not likely to be too much difference in the levels of operational risk encountered by either group. It is in the assessment of credit risk where the Islamic and conventional approaches to financing can result in different capital adequacy treatments.

As an example of such a difference, Dr Schoon points out that 'one of the areas of concern to regulators is when banks lend to institutions for which they also own equity'. In the conventional banking world

Box 1

Basel II: Available approaches for Credit Risk

Credit risk is defined as the risk that a counterparty will default on one or more payments. Three approaches can be used to determine the required capital:

Standardised Approach

Roughly the same as the current Basel II approach. In addition to the standard risk weights currently available, clients need to be graded by an External Credit Assessment Institution (ECAI). The rating of the counterparty will be incorporated into the overall risk weighting.

Foundation Internal Ratings-Based Approach (FIRB)

Banks do not rely on ECAIs for their ratings, but determine the probability of default (PD) of their borrowers using an internally built model. Loss-given default (LGD) and exposure-at-default (EAD) are determined based on supervisory rules defined in Basel II.

Advanced Internal Ratings Based (AIRB)

Not only the PD, but also LGD and EAD are determined based on internally built models.

Basel II: Available approaches for Operational Risk

resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputational risk. Similar to the calculation of the minimum capital requirements for credit risk, three methodologies are available for the calculation of operational risk capital charges:

Basic Indicator Approach

The capital charge is calculated as a fixed percentage (15%) of average gross income over the previous three years. The percentage is determined by the local regulator.

Standardised Approach

The banks' activities are divided intro eight business lines, and the capital charge is calculated per business line as a percentage of gross income. The percentages differ according to the business line and are set by the local regulator.

Advanced Measurement Approach (AMA)

Banks apply their own internally developed model, which incorporates quantitative and qualitative criteria such as internal loss data, key risk indicators, scenario analysis and self-assessment.

this could signal a risky situation. But, of course, taking an equity position in a company can often be an integral part of a transaction when an Islamic bank lends using Shari'ah-compliant instruments.

Generally, regulators are of the view that banks should not hold significant equity positions in companies to which they also lend. This is based on the belief that a bank's risk increases when the ownership position and the provision of lending are in the same hands. The view is that lending money to a company you own (or have a significant stake in) results in 'non-arm's length dealing' which generally attracts a significantly higher risk. Any equity position held by a bank is therefore penalised under Basel II by assigning a higher risk weighting for capital adequacy purposes. This can have a direct impact on an Islamic bank when it lends to an institution under an equity participation financing arrangement, such as a musharakah or a mudarabah structure for example. In these structures the bank's financing takes the form of an equity position in accordance with Islamic principles.

It is in an attempt to rectify possible inequities that the regulators not only look at the type of instrument being used but also the purpose for which it is used. Dr Schoon points out that, for example, 'a musharakah that is used for a mortgage would attract the same treatment as a conventional mortgage; if it is used for specialised finance then the regulator could apply "supervisory slotting criteria"; however, if it is used for other purposes then it would attract the same treatment as would an equity holding' i.e. a three or four hundred per cent risk weighting depending on whether it is public or private equity. This adds to the capital costs of mudarabah and musharakah agreements making them more expensive. This higher cost of capital should be taken into account when advising a client and it may be that alternate structures would meet the client's needs at a lower cost.

The Islamic Financial Services Board (IFSB) has published a standard for capital adequacy – The Application of Capital Adequacy Standards – that follows the Basel II directive. Because this standard is aimed purely at Islamic institutions its breadth is not as broad as the main Basel II directive. It contains, for example, only the 'standardised model'. Similarly to Basel II, the recommended IFSB standards are not implemented globally in the same way. For example, the Financial Services Authority (FSA – the UK's financial services regulator) through its local implementation of Basel II does not apply the IFSB guidelines in the UK, but treats Islamic transactions under the same guidelines as conventional transactions. There is, however, still no relief from the four hundred per cent weighting for equity positions held in counterparty institutions. The Islamic banking community is small but it is pressing for its voice to be heard by regulators regarding this equity issue. There are no known plans at this time for the weightings to be changed.

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The origins of Basel II

Basel II is an update to the original Basel agreement (often referred to as Basel I) that was reached by the Basel Committee for Banking Supervision in the Swiss town of the same name. The Basel I capital adequacy rules came into effect in 1988.

Basel II was intended to improve some of the weaknesses in the original agreement. Most notably, Basel I did not take into account the quality or credit-worthiness of a bank's counterparty (borrower). A large and well managed organisation with no defaults in its history was rated at the same level as a much more risky institution.

This was corrected by the introduction of weighting that varied according to the counterparty's credit risk history. In addition, weightings for operational risk were also introduced.

Having reached an accord in Basel each regulator was then to arrange for appropriate legislation in its own country to turn the agreement into locally applicable law.

The initiative was really aimed at the large banks of the G10 developed countries. But various international accounting scandals and the atmosphere of corporate regulation that created such reactions as the Sarbanes-Oxley regulations in the US provided a fertile regulatory environment for the emerging Basel II standard to be adopted worldwide and for every type of bank.

Publication: NewHorizon
This article has been extracted from NewHorizon – Global perspective on Islamic banking and insurance.
Issue 167 – January–March 2008
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