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Basel Accords and Islamic Banking: A critical evaluation¹

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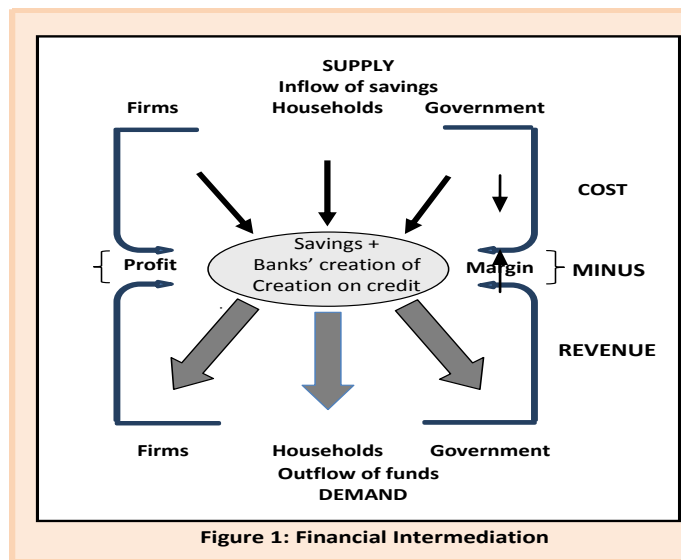
Abstract

The worldwide colossal failures of financial institutions in the wake of the 2007–2010 financial turmoil the yesteryear advocates of liberalization and privatization converted almost overnight into vocal supporters of raising the safety walls around the interests of various stakeholders, especially the depositors. Admittedly, it was the heightened lure of leverage gains that led the financial institutions to expand credit beyond what the volume and quality of their capital assets warranted without crossing the limits of safety. The devastation led to a paradigm shift, so to say, at the national and international level in finance focusing on liquidity coverage of obligations that financial institutions must maintain for their own safety as also in the wider social interest. Stringent and regular watch was needed; it was felt, to ensure the compliance. The Basel Committee on Banking Supervision (BCBS), an organ of the Bank for International Settlements (BIS) developed what are known as Accords i.e. agreements defining capital and its adequacy for banks to keep the risk they could take within limits of safety. It is interesting to find that Malaysia was in a sense predictive of events that unfolded to revamp and strengthen its own regulatory framework. Also, the IFSB was alert to announce some new standards. This paper attempts a critical appraisal of these developments with a view to assess how far Islamic banks really need Basel Accords and are likely to absorb them without being cumbersome.

Key words: Islamic finance; Capital Adequacy; Basel Accords; Shari'ah compliance; Bank Negara action.

1. Introduction: the ailment

In an economy, the entities that save money out of their current incomes are largely not the same as need money for a variety of uses, especially for business. Financial institutions, dominantly banks, operate as intermediaries between the savers and the users of money. They collect large and small amounts from the savers in the form of deposits and advance the same as loans to those



¹ The author alone is responsible for the views expressed in this paper. They need not in any way be associated with the institution where he works.

who need financing. The revenue banks earn from their lending operations minus what they pay to attract *cash* deposits constitutes the *bank margins*. From this gross income banks take out their operating expenses to arrive at the net profit for their owners². Collectively, these profits are the cost that society has to pay to the banking system for performing the mediation function so vital for wealth creation and distribution. Figure 1 above depicts how financial intermediation works. The banks use in their lending activities not only the cash deposited with them; they also create *credit-on-credit* which the conventional fractional reserve system so liberally facilitates. Credit deposits equal the cash holdings of a bank multiplied by the reciprocal of the reserve ratio minus the cash base of credit creation². This base is enhanced by the technique we call as maturity transformation³.

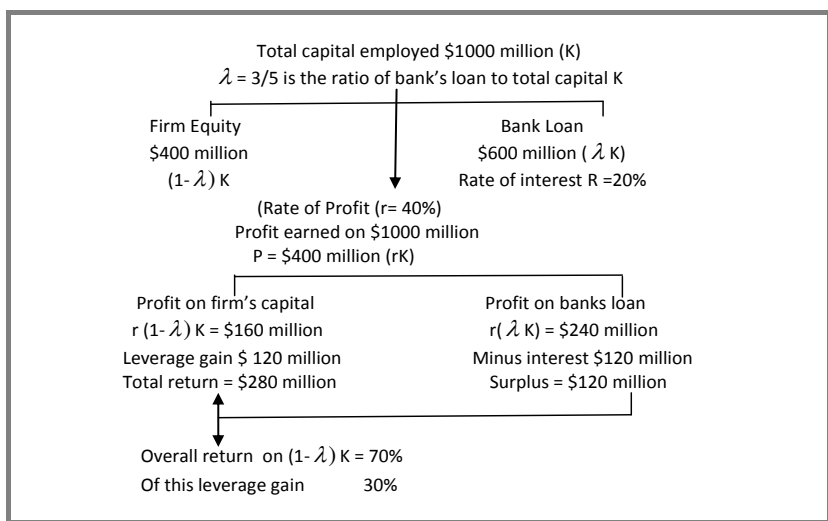


Figure 2: Leveraging magnifies returns on shareholders' equity

Not banks alone but their business clients too gain by multiple credit expansion. For, they enhance profits for their stakeholders through leveraging on equity as long as the schedule of expected profits runs above the schedule of interest rates (that is until the bubble bursts).

Thus, credit expansion is extra attractive for both the parties – banks and the business clients. But for the same reason banking also becomes an extra risky venture. The profit lure has frequently led to over-expansion of credit coupled with reckless speculative borrowings; the process eventually culminating in financial crashes, big or small.

Certain developments the wave of liberalization initiated during the decades before the turn of the century persistently pushed the leveraging lure beyond the limits of sustainability. Caution in both credit expansion and borrowings gave way to adventurism that ended in the onset of the

² If R is the risk-free rate of interest and α the risk premium, the rate of interest charged on loans R_L will be determined as follows $R_L = (R + \alpha)$. Likewise, if risk discount rate β is the rate of interest R_D on deposits would be expressed as $R_D = (R - \beta)$. The formulations will yield gross bank margins as equal to $R_L - R_D = (R + \alpha) - (R - \beta) = (\alpha + \beta)$ where α need not be equal to β . $[(\alpha + \beta) / \text{total assets}]$ gives the margin coefficient for inter bank profitability comparisons. However, in the Islamic Profit and Loss Sharing system, why should R be discounted is tenuous.

³ Commercial banks normally grant short-term loans of three months duration. Business transforms them into long term through a renewal or roll over process which benefits banks as well.

2007–2010 financial crises the like of which the world had seldom experienced before. The turmoil continues unabated in a unique go-halt-go mode; today is highelation in the Wall Street,tomorrow a deepening gloom.

Colossal has been the failures of banks, insurance companies and investment house across the globe. Wild and wide have been the devastations; chaos and despair unparalleled⁴. Indeed, the experience has caused a distinct paradigm shift in financial economics. The yesteryears advocates of liberalization and privatization have turned almost overnight into vocal pleaders for raising the safety walls to protect the stakeholders, especially the depositors⁵.

The existing conventional regulations of financial institutions are being tightened at the local and international levels via what we have come to know as the Basel Accords. The measures they contain focus on strengthening the balance sheet structures of financial institutions. They specify capital adequacy requirements for these institutions, banks specially, and insist on their observance with a view to improving their resistance to future crises especially in times of the run on bank deposits. Interestingly, the Accords maintain silence on credit creation and control measures. Since this paper is meant to look at Basel Accords from the viewpoint of Islamic banks, a few preliminary observations may not be out of place.

To begin with, Islamic banking is a tiny fraction of the gigantic world financial system: Islamic banks held less than 1% of the global banking assets by the end of 2013. Their areas of operation, socio-economic environment, trading modes and instruments used are much different from the Basel Accords' underpinnings. Again, these Accords are structured to protect conventional banks in future against the possible damage of the sort the current turmoil has inflicted on them. It is widely claimed that the impact of the crisis on Islamic banks was negligible due to the in-built strength of the system, especially the firm linkage between the money and real values. . If this claim is true, to what extent would Islamic banks need to implement the Basel Accords? Finally, Islamic banks have to meet Shari'ah obligations restrictive of indulgence in over-risky transactions. Why then put additional burden on them?

To ponder on such questions and search for answers, a brief background to Basel Accords and what they seek to do maybe helpful.

2. Basel Accords

A chronic capital insufficiency to cover the mounting debt default risks has increasingly been cited as the primary source of agony the world frequently passes through because of recurrent financial crises. The predicament has led to focus on defining capital more precisely and fix the

⁴ (The) falling U.S. housing prices and rising delinquencies on the residential mortgage market could lead to losses of \$565 billion dollars. When combining these factors with losses from other categories of loans originated and securities issued in the United States related to commercial real estate, potential losses were put at about \$945 billion. The \$945 billion estimate of losses, represents approximately \$142 per person worldwide and 4 percent of the \$23.21-trillion credit market. Global banks were likely to carry about half of these losses. The loss figure \$945 billion is just an estimate; actual amount may even be higher. IMF Global Financial Stability Report released on April 8, 2008.

⁵ Under Basel Accords, in the event of a winding-up, depositors' funds rank in priority before capital, so depositors would only lose money if the bank makes a loss which exceeds the amount of capital it has.

levels of its adequacy the financial institution must candidly observe for their own safety as also in the wider societal interest. In a fast-changing world of finance, a regular watch over the systemic liquidity was needed to make the security concepts work effectively without impairing economic dynamism.

The Basel Committee on Banking Supervision (BCBS), an organ of the Bank for International Settlements (BIS), has long been made responsible for keeping the all important watch. The Committee is a group of eleven developed countries – G 10 + Spain⁶. The work of the Committee is to harmonize banking standards and regulations within and between countries, especially to see that no *foreign* banking institutions of the group could avoid or evade supervision. Thus, the Committee was an exclusivist organization in its very origin and so it continues to remain.

To promote its objectives, the Committee has developed the concept of capital adequacy (requirement) for banks⁷. It defines capital adequacy norms for *individual* institutions. Each bank has to fulfil the requirements that the Committee defines specifically for it. *Individualization* of institutions sharpens not only the exclusivity of the Committee but may also put its transparency in treating different banks under the scanner. If the scope of the Committee operations is to be seen as truly internationalised, the possibility of discriminatory treatment has to be eliminated. Globalization demands inclusion of additional countries in the Committee for ensuring air deal. Present Accords do grant ample discretionary latitude to non-members but the range and content of its recommendations may not uniformly be conducive to all. There is room for oligarchic decision structures to eventually become a *fait accompli* applicable without distinction in course of time. Indeed some writings seem to imply that the process is already on (Hawser 2014,1)

The BCBS has issued three Accords on capital adequacy since 1988. They contain standards that individual banks have to implement across the globe. The centre of attention in developing these standards has understandably been the eagerness to impart stability to the financial system to banish the recurrence of financial crises that confront the world so often. The Accords are too elaborate and technical in details for the ordinary bank employees and their clients. We shall focus on their generic thrust and policy direction in the text; the reader may find technical details with illustrations in Appendix 1. We may begin with an explanation of *capital adequacy* - the common thread that runs through these Accords.

Capital Adequacy: the risk-weighted approach

As explained above the primary objective of Basel Accords is to ensure adequate liquidity available in each bank to face abnormal withdrawals at critical times. This needs expeditious

⁶The group includes France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK, the US and Luxembourg (G-10) in addition to Spain.

⁷ Capital inadequacy refers to the possibility of a financial institution being hurt by an unexpected loss. To ward off such an eventuality, Basel I categorizes the assets of these institutions with reference to such a risk into five categories (0%, 10%, 20%, 50%, 100%). Banks that operate internationally are required to have capital adequacy – a minimum of capital - that would keep the weight of such risk at 8% or less Basel II modified the categorization..

asset management. Assets are classified according to the difference in the degree of risk (loss in value) they carry; that degree determines the comparative quality status of each class. This degree varies with the ease and speed with which an asset can be converted into another, particularly in cash. The assets that carry low degree of risk in this sense are of high quality and those which carry high risk are of low quality. Holding cash carries zero risk and so is almost the case with government securities; thus both are regarded high quality assets. In contrast, assets like residential mortgages carry higher risk; their asset quality is low. Similarly, assets, such as debentures (corporate bonds for long-term financing), are assigned a higher weight and are included in lower class assets. It comes about that risk-weight varies inversely with asset quality. We take the risk-weighted aggregate of all bank assets as a measure of a bank's overall risk exposure. We check if a bank has capital (liquidity) at least equal to this aggregate. For this purpose, Basel Accords define four *capital* categories called the 'tiers. Presently we identify two of the categories called as Tier 1 and Tier 2. A capital adequacy ratio (CAR) is calculated for each bank as follows.

$$CAR = \frac{\textit{Tier 1 capital} + \textit{Tier 2 capital}}{\textit{Aggregate risk weighted assets}} \qquad \textit{CAR must be} \geq 1$$

Tier 1 capital is that which is permanently and freely available to absorb losses without making the bank cease operating. For example, it includes ordinary share capital (equity) of the bank excluding revaluation reserves. Tier 1 capital is important because it protects both the survival of the bank and the stability of the financial system.

Tier 2 capital has items which generally absorb losses only in the event of bank liquidation; it thus provides a low level of protection for depositors and other creditors. It is available only when the bank has lost Tier 1 capital. Tier 2 capital generally includes items like revaluation reserves and other provisions. Tier 2 capital is bifurcated into upper and lower components; the former having no fixed maturity while the latter has limited life span making it less effective as buffer against losses. Also, there are some restrictions on Tier 2 capital; its upper part cannot be more than 100% and the lower part more than 50% of Tier 1 capital.

Basel Accords also provide for a Tier 3 capital that consists of short-term low priority (subordinated) debt. It can be used to cover market risk losses which Tiers 1 and 2 are insufficient to meet. Here we shall restrict the discussion to Tiers 1 and 2 capitals only

It is prescribed that the CAR should not be less than 4% for tier 1 capital and not less than 8% for both Tier 1 and Tier 2 combined. It may be noted that capital adequacy ratios even if higher than the minimum prescribed do not necessarily make the bank safe. They primarily deal only with *credit risks* to the exclusion of others. For example, risks of loss due to moral hazard, or Shari'ah non-compliance remain uncovered in the CAR calculation. Even so, the ratio approach is commendable for the following reasons:

- (a) It provides an easier way of comparing banks across different jurisdictions.

(b) Off -balance-sheet exposures can be easily included in capital adequacy estimates⁸

(c) Banks are free to carry low-risk liquid assets in their accounts books.

While one need not find difficulty with the efficacy of the weighting system, the CAR calculation side tracks a crucial fact in focusing on the appropriate adjustment of the numerator – the capital requirement to maintain the ratio paying little attention to the denominator, the *ipso facto* root of trouble. The leverage lure leads to mounting credit-on-credit expansion and all receivables appear on the asset side of the balance sheet magnifying the denominator. Banks cannot keep increasing the capital (numerator) to match the credit expansion to hold the ratio intact. Instead the pressure may lead to ‘watering’ the stocks or reduce the assets volume through undervaluation or excessive depreciation to use the accounting terms.

To meet the criticism, one can possibly argue that the pressure for maintaining the ratio-imposed capital adequacy, banks would have to restrict credit expansion. But such restriction carries the potential of hitting the economy adversely on growth and employment fronts. Unwittingly, it might trigger the same sort of crises it was intended to stop. Basel Accords neglect this side of the story. The solution of the problem lies in curbing leverage lure directly. This demands a review of the traditional instruments the Central Banks use for credit control to limit leverage gains⁹. The review must focus on the fast growing adverse impact of public policy on monetary practice. The collapse of mighty banks and the spread of state bankruptcies in the wake of recent turmoil are not accidental; the public policy dimension is quite visible; autonomy of the Central Banks is being corroded.

With the foregoing background developments, we may proceed to examine the basic provisions of various Basel Accords, to understand their content thrust and implications in the context of Islamic banks operating in a dual financial system.

Basel I (1988)

Soon after the formation of the Basel Committee, its members began to discuss the contours of a formal standard regarding the appropriate capitalization of internationally active banks. They noted that some such banks took advantage of jurisdictional differences to escape the regulators,

⁸The assets (and liabilities) of banks and other financial institutions are recorded in their balance sheets. However, the distinction between what are called off-balance sheet assets and on balance sheet assets is not exclusive. At times, on-balance sheet assets may become off-balance-sheet assets and vice versa; it all depends on managerial decisions. How, then, do we explain the term ‘off-balance-sheet assets’ and how are such assets different from ‘on-balance-sheet assets’?

The essential difference is that on-balance-sheet assets form part of the asset side total of the balance sheet, whereas off-balance sheet assets remain outside this total. However, this need not convey that off-balance-sheet assets are not shown on the balance sheet; they are recorded there. Let us illustrate. Broadly, the following situations give rise to off -balance-sheet assets: a) Debts that the bank advances to clients are included in its on-balance-sheet assets, but if the same debts are securitized and sold to third parties, they cease to be the assets of the bank. However, the bank may still manage the securities thus created for its customers. They become off -balance-sheet assets for the bank but are recorded in the form of a note in the balance sheet. Similar situations may arise in case of some liabilities also

It may be mentioned here that as Islam does not allow the securitization of debts, they remain off the balance sheet except in Malaysia, where *bay’al-dayn* (sale of debt) is allowed.

⁹Hasan (2014, 44 – 53) reviews current measures used for credit control and proposes a technique for limiting the leverage gains in a dual banking framework.

they even moved their activities to locations where the rules were not so stringent. The petrodollar boom had virtually ended and the financial sector was in the grip of the resultant crises of the 1980s. The circumstances pushed the issue of banks' capitalization to the top of Committee's program priorities. Long negotiations among the members led to the announcement of the first Basel Accord in 1988.

This Accord was simple and straightforward as it was essentially an agreement between the Basel Committee members and was initially applicable only to those of their banks that were operating at the international level outside the parent country. The Accord received prompt acceptance not only from the Basel country banks, but also from other global institutions. Basel I divided the capital of banks into two tiers on the basis of differences in the quality of their underlying assets, as already discussed above. Each of the two tiers was assigned a 4% risk weight that considered only credit risk, leaving out others, thus making the overall CAR equal to 8%. As this ratio was intended to define the minimum, not the optimal capital requirement for a bank, it was assumed that the well-capitalized banks would go in for higher ratios in order to cover the market and operational risks or currency exchange risks that the Accord had left out. It also did not cover the banks that were not operating outside the member countries. One often-mentioned aspect of Basel I is the *four pillars* on which it stands. The first pillar is the *constituents of capital* – Tier 1 and Tier 2 - that we have already explained.

The second pillar is the *Risk-weighting* system which constitutes a comprehensive process of assigning weights to various bank assets. It mentions five risk categories that cover all assets on the balance sheet of a bank over a 0-5 points range. The specification for an asset depends on the discretion of a country's central bank. It seeks to take advantage of closer proximity between banks' capital and the risk exposure of its assets.

The third pillar is a *Target Standard Ratio*. It ties together the first and the second pillars of the Accord. It sets a universal standard stipulating that 8% of a bank's risk weighted assets must be covered by Tier 1 and Tier 2 capital reserves. Additionally, Tier 1 capital must cover 4% of a bank's risk weighted assets. This ratio is taken as specifying the minimum safety limit for a bank.

Finally, the fourth pillar - *Transitional and Implementing Agreements*—sets the stage for putting Basel Accords into operation. It requires the Central Bank of each country to ensure that Basel Accords are implemented. The Central Banks across countries are requested to erect a strong surveillance and enforcement system to ensure that Basel Accords were observed and that the transitional weights are provided to the Committee so that it could adopt the same over a four year period in place of the Accord standards.

Criticism

By the year 1999 all countries including China, Russia and India had adopted the Accord provisions. Even so, Basel 1 Accord has attracted much criticism. Put briefly. The main points raised are as follows. First, Basel I focused its attention only on credit risk to the exclusion of others no less important and restricted the application of its recommendations to G-10 countries. Also, it covered not all the local banks but only those which were also operating outside their

country. Second, due to haste the Committee showed in the implementation of its recommendations, banks were not always able to translate them into language easily understood by the wide ranging clientele; this hindered the popularization of the recommendations. Third, even as the G-10 countries had already in place for long-term growth most of basics that Basel I required, the regulators there saw in the overdoing of its recommendations a discrimination against their mega private banks; they began to demand extension of the Accord across the globe to all including emerging markets. Finally, the Accord provided leeway for banks to apparently maintain a low risk profile, while they could indulge in taking much higher risks. To illustrate, the gap between the short-term and long-term debt weighting was in the 1:5 ratio and the banks could easily convert short term debt into the long-term through the technique of maturity transformation. The weighting system in implementation also contained an incentive for banks to shuffle the geographical locations for their operations. We shall see that subsequent Basel Accords did take notice of such criticisms and changes were made to plug the loopholes.

Basel II (2004)

The limitations of the Basel I Accord surfaced over the years and the criticism of its recommendations led the Basel Committee to revise the standards of capital adequacy for internationally active banks. The Basel II Accord was published in June 2004 and was titled as the *international Convergence of Capital Measurement and Capital Standards: a Revised Framework*. The framework was further amended in July 2005. Basel II greatly expands the range, depth and technical aspects of the original Accord. This is done essentially by revising and revamping its pillars.

1. Taking note of the Basel I criticism for the **first pillar** Basel II makes the measurement of a bank's risk-weighted assets more sensitive and candid closing the loophole the earlier Accord contained. A bank now cannot conceal risk-taking through a transfer of assets to subsidiaries or combing branch assets into a composite whole for the bank. Changes have also been made in the weighting scheme incorporating the Rating Agencies' evaluation of assets into the picture. For example, A+ to BB+ debt is weighted at 50% while all debt rated below B- is risk-weighted at 150%. Pillar 1 now covers not only the credit risk but others also. The Accord now provides risk-weightings for all other market based assets. Its strategy covers stocks, commodities, currencies, and mixed instruments where weight assignment is based on a separate set of methodologies

A special feature of the Pillar relates to the provision of protection against operational risks; it requires the creation of a Reserve Pool out of profits. Of the three methods proposed for the purpose, the *Standardized Approach* looks simpler and operational. The method identifies business lines of a bank and the percentage each line's profit should contribute to the reserve in cash form.

2. Pillar 1 seeks to quantify the reserve banks would need to cover market risk arising due to the fluctuations in asset prices. For this it makes a distinction between fixed income assets like bonds and other sources such as equity, commodities and currencies where income is

could be fluctuating. Implicitly, it separates the two components of the overall market risk: interest rate risk and volatility risk.

For fixed income assets, the risk evaluation is the “value at risk” estimation (VAR). It is a complicated technique. Therefore, for banks that cannot do not want to implement the VAR, Pillar 1 recommends the creation of a reserve tied to the asset maturities for protecting their fixed income assets against interest rate variations. Box 3

3. Compared to pillar I of Basel II Accord, its **Pillars 2 and 3** are much less complicated. Pillar 2 essentially deals with the Regulator-bank relations. Regulators have the right supervise the bank; they can even liquidate a bank if needed. They have the power to oversee the internal risk evaluation procedures implementing the provisions the pillar 1 specifies. They also have the discretion to change or amend these provisions in the light of local requirements, especially if they find that a bank cannot manage its credit, market and operational risks.

Pillar 2 indeed enhances the powers of the regulators considerably. Regulators are now allowed to create a “buffer” capital facility in addition to the minimum capital requirement if banks are found attempting to avoid pillar I provisions. The regulators are allowed to take appropriate action to pre-empt the oncoming crises in countries like China and Korea in case capital reserves tend to fall below the minimum.

4. **Pillar 3** seeks to improve market discipline *within* a country’s banking sector. In this regard the Accord makes a rather revolutionary proposal – to make available for public gaze some of the information regarding the banking structure and performance until now available only to the regulators.

Basel III (2010–11)

Building on and carrying forward the Basel II framework, the BCBS made public its third Accord, popularly known as Basel III, in 2010–11. The Accord was planned for introducing it over the period from 1 April 2013 until 31 March 2018. The Basel III Report is a comprehensive document focusing on the consistency of risk weightings for banking assets generated. The salient features of the Accord are briefly as follows:

- **Capital requirements:** In addition to raising the capital requirement ratios for both the tiers, Basel III introduces two more capital buffers:
 - i. A 2.5% capital conservation obligatory buffer, and
 - ii. A counter-cyclical buffer, which would allow national regulators to require up to another 2.5% of capital during periods of high credit growth. The adoption of this proposal is not compulsory.
- **Leverage ratio:** Basel III introduces a minimum *leverage ratio* which is calculated by dividing Tier 1 capital by the bank’s average total assets. The banks are expected to maintain a leverage ratio in excess of 3%. In July 2013, the US Federal Reserve Bank announced that the minimum leverage ratio would be 6% for eight system important financial institutions and 5% for their bank holding companies. A system important financial institution (SIFI) could be a

bank an insurance company or some other financial institution which if fails may trigger a financial crisis.

- **Liquidity requirements:** Basel III introduced two obligatory liquidity ratios. One is the *liquidity coverage ratio* that requires a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days.

The other is the *net stable funding ratio* that requires the available amount of stable funding to exceed the amount needed to cover a one-year period of extended stress, i.e. the exposure of bank capital levels to turbulent economic and financial scenarios. Thus, Basel III tightens the leverage ratio framework and disclosure requirements for the banks and other financial institutions to enforce discipline in the wavering financial markets.

4. Basel Accords and Islamic finance

Islamic finance operates as an integral part of the global financial system. As such, Islamic banks have to fall in line with international regulations as and when enforced. This adds to a unidirectional convergence of the systems (Hasan 2011). The Basel Committee Accords on capital adequacy measures have forced the pace of such convergence. Basel I was narrowly focused on the banks of the Committee member countries and was of little consequence for Islamic banks. Basel III recommendations are in the process of being implemented over a time span. Thus, it is Basel II standards that demand consideration in the present context. These standards have blanket reach, covering banks across the globe. Islamic bankers and jurists found some of the prescriptions of the Accord in compatible with the nature of Islamic banks' portfolios. For instance, the equity estimation for Islamic banks must include not only the bank owners' stake but also the investment deposits involved in participatory contracts.

Since the aim of these Accords is to have an adequate level of capital available in a bank for risk management, the following discussion is contextual to the risk-weighting of assets. It is also important to mention that in the calculation of risk-weights, banks have the choice of adopting the Basel II framework for the calculation of capital adequacy or the internally set standards, with its approval.

The choice has allowed the central banks of countries to modify standards to accommodate their domestic requirements. For example, in 2007 the Reserve Bank of New Zealand simplified its explanation and examples of capital adequacy ratios and calculated the same for local banks. Various sorts of standards for the Islamic financial institutions are set by the two autonomous international institutions – the AAOIFI and the IFSB. The AAOIFI sets the *Shari'ah compliance* standards for entering the Islamic financial markets. The objective is to build the confidence of the populace in Islamic finance by ensuring, in addition, the transparency of the transaction and protection of the depositors' interests.

Malaysian response: Malaysia was in particular quick to see Basel Accords coming and initiate measures as though in prior their compliance thanks to the foresight of the BNM. The regulatory framework and supervisory structure for financial management had already evolved over time at a rather brisk pace characteristically remaining focused on pre-emptive and preventive action

aiming at stability and growth of the sector. Arrangements were made to enforce responsible business conduct, curb financial waywardness, ensure *Shari'ah* compliance of contracts, keep financial markets orderly and payment systems sound in addition to having tools ready to deal with crises when needed. BOX 4 from the *Shari'ah Governance (SG) Framework* provides the constituents of the paraphernalia. There is neither the need nor the space here to discuss the provisions or the implications of the listed laws for Islamic banking. Suffice to say they harmonize well with the

BOX 4

**Malaysia's legal system for regulating
Islamic financial industry**

CBA Central Bank of Malaysia Act 2009

IFSA Islamic Financial Services Act 2013

FSA Financial Services Act 2013

DFIA Development Financial Institutions Act 2002

Anti-Money Laundering and Anti-Terrorism Financing Act 2001

intention and thrust of the Basel Accords. Their existence verifies that the BNM is not merely the central bank but is the bank of Malaysia. It has acted with expedience and faster than most of Central Banks in developing countries have done in testing situations. The BNM has been able to harmonize national interests with global demands, especially in the tumultuous years since the turn of the century. It has kept the *Shari'ah* scholars, academicians and industry players continually engaged in meaningful deliberations on various issues relating to the industry. Consensual decisions emerged to become the basis of several reforms culminating in the recent introduction of the SG Framework. As a result for example the on-going imitation of conventional products resulting in the erosion of their *Shari'ah* compatibility, is now frowned at and a December 2012 ruling intends at phasing out buy-back of *'inah*' sale and replace it by commodity *murabahah* and *tawarruq*. Most important is the rationalization the SG has executed in the organization and role of *Shari'ah* committees: the number of their members has been raised from 3 to 5, the frequency of their meetings has been increased, the scope of their participation in management is enhanced and they are given greater operational independence. It is suggested that the voting and non-voting distinction among the members may also be abolished.

The supervisory role of the *Shari'ah* Advisory Council of BNM (SACoBNM) is expanded to become the apex authority for the ascertainment of applied *Shari'ah* in IBF. The Central Bank has already demonstrated the value of the 2009 Central Bank of Malaysia Act. This has been followed by the introduction of the Islamic Financial Services Act 2013 which probably is the most comprehensive legislation the industry has ever seen worldwide. Supervision, audit, and research have all been revamped. The SG introduced not only the two tiers for capital adequacy also initiated measures that aimed at ensuring a 'robust risk management control process and internal research capacity'. In this context, a liquidity management corporation has recently

been established. In the same vein the IFSB has recently announced two more standards for Islamic financial institutions to strengthen regulation of Islamic banks at the global level.

IFSB-15: Standard has revised Capital Adequacy for Institutions offering Islamic Financial Services excluding the *Takāful* Institutions and Islamic Collective Investment Schemes (IIFS). The revision has enhanced the version of two previous standards namely IFSB-2 of 2005 and IFSB-7 of 2007 dealing with requirements for *Sukūk*, Securitizations and Real Estate Investments (2009). It is worth noting that IFSB-15 also adopts Basel III proposals on capital components and macro prudential tool for the IIFS. The Standard would help implement a capital adequacy framework that will ensure effective coverage of risk exposures of the IIFS and allocation of appropriate capital to cover these risks.

For this purpose, IFSB-15 provides guidance on the features and criteria for high-quality regulatory capital components, including Additional Tier I and Tier 2, to comply with *Shari'ah* rules and principles. Similarly, the standard also provides new guidance on macro policy tools, such as capital buffers, leverage ratio and important local banks, which will facilitate supervisory authorities in achieving the goal of protecting the banking system and the real economy from system-wide shocks. Supervisory authorities among the IFSB member countries are expected to start the implementation of IFSB-15 in their respective jurisdictions by January 2015.

Basel III is designed for staggered implementation over time. The span gave it flexibility and space for adjusting with changing needs and circumstances. Another welcome feature is that countries can adjust capital adequacy requirements to suit local conditions.

Unfortunately Basel III came on the scene when costs are rising and returns on capital are falling. Critics were quick to argue that the step would hinder the growth rates ignoring that bumpy rides may also cause slower rates. In Europe, regulators ignoring such apprehensions are insistent on implementing the Basel Accords. Smaller banks are likely to gain. Indeed, part of the criticism emanates from ideological commitment to free markets.

5. Concluding remarks

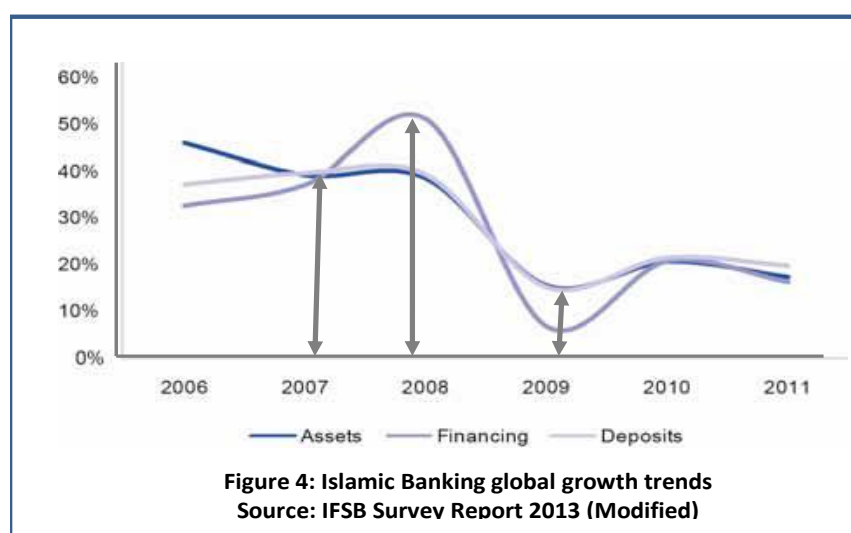
The main objective of this paper was to improve the understanding of Basel Accords, their thrust and implications which objectives have presumably been met. On a more important side, we find that the Basel accords need not create any special difficulty for adoption in the Islamic section of global finance because they largely aim at achieving risk mitigation and stability: objectives that *Shari'ah* also supports. Furthermore, the Accords contain flexibility to meet local and Islamic norms. Also, the greater role to regulators the Accords grant must be taken as a boon for the financial industry including its Islamic segment.

However, Basel Accords are lopsided to the extent that they exclusively focus on the numerator – the capital and its tiers – in calculating the capital adequacy ratios. But the denominator that includes receivables resulting from the creation of *credit-on-credit* seems to be the main culprit in the crisis generation. Based on the fractional reserve principle, the credit creation power of the banking system as a whole is indeed vast. It is the major source that fuels speculation and fans the leveraging lure. The impact is devastating. Insistence on capital adequacy is welcome but it may not deliver unless credit control measures are revamped and

expanded to curb effectively the leverage gains as explained in Table 1. Islamic banking has an in-built safeguard against the danger as maintaining linkage with the real economy in all its transactions is obligatory.

The increasing dominance of the waywardness fiscal compulsions over the monetary expedience cannot also be ignored.

The Malaysian SG Framework is work-in-progress and what we have seen so far are positive developments introduced mainly in response to informed opinion and demand at the national and international levels¹⁰. The 2013 Survey Report the IFSB is also a well-placed consolidation of its position on standards. Interestingly, the Survey negates the much cherished thought that Islamic finance was not much affected by the current crisis. The following Figure 4 is self-explanatory.



Shrinkage of GDP and trade is the conduit not so much the financial markets.

The recent developments in Islamic finance operations seem progressively dissolving into the mainstream currents. Not a few perceive that its Islamic character is being eroded. Most of Basel recommendations are so far welcome but the situation may not remain so in future. The composition of the BCBS is exclusive in terms of its membership– G10+Spain. The membership of the organization must be expanded to include members from the developing countries including Muslim where Islamic finance is concentrated and is going to be dominant in course of time. The call for expansion is logical and democratic; it will enhance confidence and transparency.

Finally, no policy whatever be the standard is worth more than what it is in implementation. Money does not create any problems; its mismanagement does. And management to succeed demands a minimal of honesty, transparency and equity to make policies achieve their

¹⁰See the opener of Chapter 12, 'Islamic Banking and Finance – An integrative approach by Zubair Hasan, Oxford University Press January, 2014.

objectives. That minimal is unfortunately missing everywhere. The claim the Islam can do the trick is valid but can present day Muslims do it carries a big question mark unless demonstrated.

Appendix 1

Basel Accords: calculation of the capital adequacy ratio for banks

Capital Adequacy ratio expresses the amount of a bank's capital as a percentage of its risk-weighted credit exposures. The Accords define two types of capital for the purpose and a separate adequacy ratio is calculated for each before they are added up to obtain the overall ratio. The two capital types are called Tier 1 capital and Tier 2 capital. The calculation of each Tier requires making of some adjustment to its amount shown on the balance sheet of the bank.

In general **Tier 1 capital** includes:

- Ordinary share capital of the bank or equity
- +
- Revenue reserves such as audited retained earnings
-
- Current year's losses
- Future tax benefits and
- Intangible assets such as goodwill.

Tier 2 capital has two components – upper and lower

Upper component

This generally includes

- Unaudited retained earnings
- Revaluation Reserves
- General provision for bad debts
- Irredeemable cumulative preference shares
- Perpetual subordinate debt (It has no maturity date and ranks last among the creditors for payment)

Lower component

Generally, this component includes:

- Subordinated debt with at least a five year term
- Redeemable preference shares that remained unpaid for not less than 5 years.

Total Capital is the sum of Tier I and tier 2 capital minus the following items

- Equity investments in the subsidiaries
- Shareholdings in other banks beyond 10% of that bank's capital.
- Unrealized revaluation losses on securities holdings.

Table 1 Calculation of capital illustrated (Figures in billion USD imaginary)

Tier 1		Tier 2	
Ordinary share capital (Equity)	7	Upper	
Audited retained earnings	8	General bad debt provision	2
Less: Goodwill	-3	Revaluation reserve	4
		Lower	
		Subordinated debt	2

		Redeemable preference shares	3
		Shareholding in other banks	-3
Total tier 1 capital	12	Total tier 2 capital	8
TOTAL CAPITAL		12 + 8	20

Having explained and illustrated the calculation of capital needed for the numerator of the CAR, let us see how the denominator is set. In other words how the credit exposures are estimated. The important feature of the calculation here is that it takes note not only of entries on the balance sheet of a bank but of off balance sheet deals as well. Table 2 summarizes the risk weight assignments used for the purpose.

On balance sheet exposures	Risk weight %	Off balance sheet exposures	Risk weight %
Cash	0	Direct credit substitutes ^a	100
Short term claims on government	0	Asset sale with recourse	100
Log-term claims on government (> 1 yr.)	10	Commitment with certain drawdown ^b	100
Claims on banks	20	Transaction related contracts ^c	50
Claims on public sector entities	20	Underwriting / sub-underwriting facilities	50
Residential mortgages	50	Other commitments with an original	50
All other credit exposures	100	Short-term trade related contingencies	20
		Other commitments original maturity >1 yr.	0

Note 1

- a. Guarantees, Bills of exchange and letters of credit are examples of direct substitutes.
- b. For example include such items as forward purchases and partly paid shares.
- c. For example performance bonds, bid bonds fall in this category.

Note 2

The last category of the off-balance sheet – other commitments – covers current exposures including interest rate contracts and foreign exchange contracts are assigned separate risk-weights.

Table 3: Calculation of risk-weighted exposures

On-balance sheet				Off-balance sheet			
Exposure type	Amount	Risk-weighting %	Risk-weighted exposure	Exposure type	Amount	Risk-weighting %	Risk-weighted exposure
A	B	C	D = B x C	E	F	G	H = F x G
Cash	15	0	0	Guarantee	10	100	10
5-yr. Gov. stock	20	10	2	Asset sale (Recourse)	18	100	18
Lending to banks	30	20	6	Forward purchase	23	100	23
Home loans	52	50	26	Performance bond	8	100	8
Commercial loans	65	100	65	Underwriting facility	28	100	28
Fixed assets	31	100	31	Trade contingency	31	100	31
				Forward FX contract	5	20	1
				Interest rate swap	5	20	1
Total			130				120
TOTAL RISK WEIGHTED CAPITAL: 130 + 120 = 250							

Calculation of Capital Adequacy Ratios:

Tier 1 capital to total risk-weighted exposures = 12 divided by 250
= 4.32 %

Total capital to total risk-weighted exposures = 20 divided by 250
= 8 %

Acknowledgement: This Appendix 1 is based on Reserve Bank of Canada document (2007): *Capital adequacy ratios for banks – simplified explanation and example of calculation*, downloaded 1-9 from: <http://www.rbnz.gov.nz/finstab/banking/regulation/0091769.html> Accessed on May 15, 2014

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