General Council for Islamic Banks and Financial Institutions

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI

ISSUE 9 • September 2018

CIBAFI BRIEFING

Real Estate Exposure in Islamic Finance: Regulatory Treatment

CIBAFI is pleased to present its ninth "CIBAFI Briefing" which considers the market's needs and more specifically our members' need to address the issue of real estate exposure as one of the important areas that requires awareness of the industry, regulators, and all other stakeholders. This Briefing presents an accurate snapshot of regulatory treatments of real estate, in both investment and financing exposures. Moreover, it explores key issues related to real estate, such as evaluation, categorisation and concentration, in addition to some Shariah issues.

1. Overview

Islamic finance and real estate tend to have a near perfect relationship, especially with the tangibility that is provided by such properties. The lack of investment choices in the Islamic finance industry gives real estate an advantage compared to other investment areas. Real estate also benefits from a number of other advantages including stability of income return, diversification of the assets portfolio, and hedging against inflation. However, although real estate looks attractive from many perspectives, it still has many drawbacks, including illiquidity, volatility and the cyclical nature of real estate.

The involvement of Islamic banks in real estate activities may take several forms including direct investing and financing through holding physical real estate, and/or indirect involvement through investment in the real estate industry such as (i) holding shares, (ii) portfolio, (iii) unit trust, and (iv) Islamic real estate investment trust.

Islamic banks may directly hold physical real estate for the following main reasons:

i. Financing: Real estate financing is an activity carried out through different contracts such as: Murabaha, Ijarah Muntahia Beltamlik, Diminishing Musharaka etc. These contracts lead Islamic banks to hold real estate either for short or long periods of financing. The ownership and existence of physical real estate is inevitable due to the nature of contracts and transactions in Islamic banks.

In a conventional mortgage, the buyer will hold title to the property and it will be pledged to the bank as a collateral for the loan. However, unlike a conventional mortgage, Islamic Banks will hold the title of the property (briefly or throughout the financing period based on the contract). Thus, Islamic banks may be exposed to a variety of risks if there are no effective risk management practices in place. There is also a risk of inappropriate regulatory treatment in jurisdictions which attempt to restrict banks' real estate holdings.

ii. Investing: Islamic banks may invest in real estate to obtain periodical income, capital appreciation, or both. For these purposes, an Islamic bank may use its financial resources (Shareholders) or Unrestricted Profit Sharing Investment Account (UPSIA) clients' money.

Operating Ijarah is included among investing activities because the bank will bear all the market risks related to the leased asset, which remains with the bank at the end of the Ijarah contract. Islamic banks sometimes enjoy more latitude from regulators in their ability to invest in real estate, partly in recognition of the limited types of Shariah-compliant investments available to them.

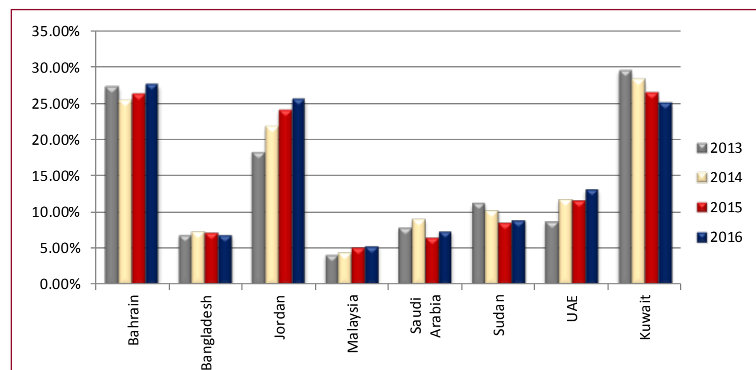
iii. Investment class for Restricted Profit Sharing Investment Accounts (RPSIAs): These investments are normally off-balance sheet and the risks associated with them are borne by investors not Islamic banks. These are, however, subject to volatility and illiquidity, and Islamic banks might have to provide liquidity support to their RPSIAs at difficult times.

In addition to having different reasons and purposes for holding real estate (whether for investment or financing), Islamic banks also have different sources of funding for these holdings, notably UPSIAs and shareholder investments. The choice of funding source needs to be made with proper regard for the interests of PSIA clients, which may not coincide with those of shareholders, and to take account of the risk management issues concerned with that particular source, for example risk appetite and maturity mismatches.

Islamic banks have a high exposure to real estate and mortgages. CIBAFI Global Islamic Banker's Survey indicated that real estate is one of the top three sectors that have a high exposure in Islamic banks.

The Survey revealed that 53.45% of large Islamic banks and 65.22% of small Islamic banks have a high to very high exposure to real estate and mortgages. Islamic banks recorded a high percentage exposure to real estate in some jurisdictions including Bahrain, Jordan and Kuwait (See Figure 1).

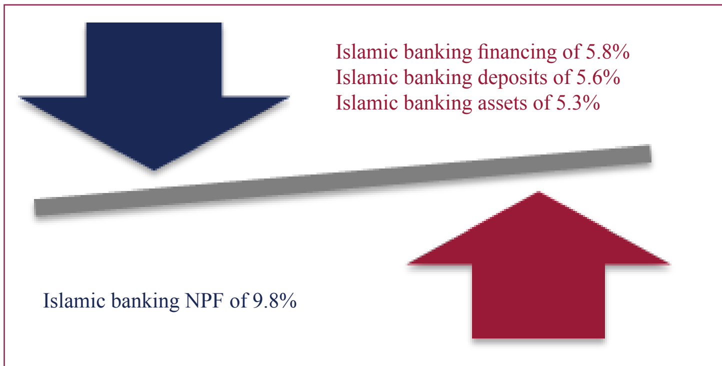
Figure 1. The percentage of real estate activities in Islamic banks (2013-2016)



Source: CIBAFI, Islamic Financial Services Board (IFSB)

The real estate exposure might be much higher than the figure above especially with different categorisations of real estate activities and with the existence of real estate investment options, which may have many implications on Islamic banks (IFSB, 2017). The IFSB report (2017) attempts to identify the effects of macroeconomic stress on the Islamic banking system and concludes that a change in real estate prices may have a critical effect on Islamic banks. The 10% decrease in real estate prices lead to an increase of Non-Performing Financing (NPF) by 9.8% and a decrease of financing deposits and assets by 5.8%, 5.6%, and 5.3% respectively (See Figure 2).

Figure 2. The effect of a 10% decrease in real estate prices on Islamic banking



Source: CIBAFI, IFSB

2. Risk Exposure of Real Estate and Regulatory Treatment

Real estate investment is especially risky at the development stage, with income-producing real estate rather less so. Real estate financing is generally less risky, and residential real estate is considered less risky than commercial due to the fact that people's homes are very important to them, and they are reluctant to default on a personal mortgage. International bodies such as Basel Committee for Banking Supervision (BCBS) and IFSB have developed some treatments for real estate within their standards. Brief analyses of these treatments and their impact on the industry are as follows:

2.1. BCBS Approaches: Brief Analyses and Impact on IFIs

BCBS provided major revisions to the Basel III treatment of real estate in the standard "Basel III: Finalising post-crisis reforms[1]" published in December 2017[2]. Brief analyses of the Revisions and their impact on IFIs are as follows:

a. The key objective of the Revisions is to reduce excessive variability of risk-weighted assets (RWA) by enhancing the robustness and risk sensitivity of the standardised approaches for credit/operational risk, constraining using of internally modelled approaches, complementing the RW capital ratio with a finalised leverage ratio and a revised and robust capital floor. The new regime in the Revisions aims to improve the risk sensitivity of real estate financing through securing loans over real property such as domestic or commercial mortgages.

b. The risk weights are set out in Table 1, but national supervisors may require banks in their jurisdictions to increase these risk weights if the supervisors consider them too low for national conditions. They are subject to some requirements for the loan such as i. finished property; ii. legal enforceability; iii. claims over the property etc.; iv. ability of the borrower to repay; v. prudent value of property; and vi. required documentation.

c. It will be seen that the Revisions base the risk weights (Table 1) heavily on the Loan to Value (LTV) ratio of the mortgage, which is an Islamic as well as a conventional ratio that is currently widely used to curb financing/ loan growth as well as Non-Performing Loan/Non-Performing Financing. This LTV approach, as a relatively new instrument, prevails over a fixed RW based on the creditworthiness of the counterparty; the latter is only applied if certain conditions are not met. As a result LTV becomes more important when providing financing and this may discourage banks from offering high LTV ratios. Hence, it may have an impact on real estate markets in different jurisdictions.

Table 1. Regulatory treatment of real estate - BCBS approach

RISK WEIGHTS FOR RESIDENTIAL REAL ESTATE (RRE) EXPOSURES						
Repayment is not dependent on cash flows generated by property	LTV≤ 50%	50%<LTV ≤ 60%	60%<LTV ≤ 80%	80%<LTV ≤ 90%	90%<LTV ≤ 100%	LTV>100%
	RW 20%	RW 25%	RW 30%	RW 40%	RW 50%	RW 70%
Repayment is dependent on cash flows generated by property	LTV≤ 50%	50%<LTV≤ 60%	60%<LTV ≤ 80%	80%<LTV≤ 90%	90%<LTV ≤ 100%	LTV> 100%
	RW 30%	RW 35%	RW 45%	RW 60%	RW 75%	RW 105%

RISK WEIGHTS FOR COMMERCIAL REAL ESTATE EXPOSURES		
Repayment is not dependent on cash flows generated by property	LTV ≤ 60%	LTV > 60%
	Min (60%, RW of counterparty)	RW of counterparty

Repayment is dependent on cash flows generated by property	LTV ≤ 60%	60%<LTV≤ 80%	LTV > 80%
	RW 70%	RW 90%	RW 110%

Source: CIBAFI, Basel III: Finalising post-crisis reforms (2017)

1. The changes made in this standard will be referred in this document as "the Revisions".
2. The original version of Basel III did not amend the Basel II treatment of real estate, which is primarily concerned with mortgages (generally described as loans secured on property).

d. In regards to the financing of land acquisition, development and construction (ADC), which exhibits higher loss rate volatility, exposures will be risk-weighted at 150% unless they meet some determined criteria. If they meet the criteria[3], there is a possibility of some exposures being risk-weighted at 100%.

e. The Revisions deal also with defaulted real estate exposures where repayments do not significantly depend on cash flows generated by the property. These are to be risk-weighted at 100%, net of specific provisions and partial write-offs. Guarantees or financial collateral may be taken into account to reduce the exposure figure.

f. IFIs are mainly subject to the standardised approach rather than the internal ratings based (IRB) approach. However, the Revisions tighten the conditions under which the IRB can be used, and introduce a set of parameter floors which effectively limit the advantages a bank can gain from using the IRB as opposed to the standardised approach.

g. There is also some material on real estate as eligible collateral under the IRB approach.

It is a fact that the Revisions will not only be the operative standards for the conventional financial industry (and for the Islamic finance industry, in those jurisdictions that do not operate a separate regime for it); they will also influence the international Islamic financial bodies' work.

In particular, the IFSB should revise its capital adequacy standard to take account of the new BCBS standard.

The Revisions are important for IFIs from different perspectives. i. Some expected technical challenges in applying this treatment to Islamic banks; ii. identification of these issues and discussions with IFIs' supervisory authorities; iii. impacts of this treatment for Islamic banks; iv. the response of the international Islamic standard-setting bodies. Even if the technical application is done suitably, there will be significant impacts on IFIs in terms of capital adequacy and changing of their financing and investment strategies etc.

There are some issues specific to IFIs that are not covered in the Revisions such as i. the treatment of investment in real estate, and ii. real estate financing based on different Islamic financial contracts and financial products etc.

2.2 IFSB Approaches: Brief Analyses and Its Impact on IFIs

IFSB-7 (based on Basel II) drew a clear distinction between real estate investment and real estate financing exposures, and set out proposed risk weights. This was carried over and expanded in IFSB-15 (based on Basel III). The real estate financing of IFIs may take different forms such as Ijarah, Murabaha, and Ijarah Muntahia Beltamlik etc. Except for operating Ijarah, use of other contracts to provide real estate finance to customers will commonly fall in the category of financing. For example if the real estate is financed by a Murabaha contract, the Risk Weighting (RW) and treatments will depend on the provision and guidance provided for the Murabaha contract. The IFSB differentiated three categories of real estate investments: i. Real estate held at any stage of the development process, or even completed properties, where such a holding is not part of a financing transaction for a third party, ii. Real estate in the case of non-binding promises of financing activities, if the holding period has exceeded a short period such as six months, iii. Real estate for operating Ijarah.

The treatment of real estate exposures based on IFSB standards completes the Basel II and Basel III standards by taking into consideration the specific nature of Islamic banks' engagement in real estate (See Table 2). However, the recent revision of BCBS is not reflected in the IFSB standards. Technical issues in the applications to IFIs and related discussions with IFIs supervisory authorities may provide an agenda for the IFSB when it comes to revising its capital standard to deal with the Islamic finance specificities. In addition to this, IFSB may facilitate the implementation of the standards through technical assistance to IFIs' supervisory authorities and banks.

Table 2. Regulatory treatment of real estate - IFSB approach

Real estate financing	Risk Weights (RW)
Murabaha, Ijarah Muntahia Beltamlik, Diminshing Musharaka[4]	Market risk: 187.5% RW[5] (Assets in balance sheet of the bank)
	Credit risk: Based on customer's rating or 100% RW for unrated customer
Real estate Investment	**Risk Weights (RW)**
Holding real estate for investment	187.5 % RW[6]
Non-binding stage of financing	187.5 % RW
Operating Ijarah	Credit risk: Based on customer's rating or 100% RW for unrated customer.
	Market risk: 187.5% RW

Source: CIBAFI, IFSB-15

3. The criteria are: i. the prudential underwriting standards meeting with the requested requirements, ii. pre-sale or pre-lease legally binding written contracts amount to a significant portion of total contracts or substantial equity at risk (par 75).

4. Istisna' is not included in this table due to the existence of many stages of the transaction. The treatment of Istisna' is provided in section 4.4 (IFSB-15).

5. If collateral is available, financing activities may have preferential RW. The RW will be 35% if a Murabaha contract is secured by residential real estate, and 100% if secured by commercial real estate or 50% subject to eligibility criteria (IFSB-15).

6. The RW of 187.5% is equivalent to a capital charge of 15% if the minimum capital requirement is 8%.

3. Key Issues and Challenges

3.1. Evaluation of Real Estate

A proper evaluation of real estate value plays a vital role in assessing the Islamic banks' exposure to real estate. In the future it will also be critical to determining risk weights, since in financing transactions these will be based on the LTV ratio. An independent evaluation by a third party that has experience in the real estate market and different types of real estate will enhance the reliability of the evaluation. The recent revisions of Basel III point out that the valuation must be appraised independently by using prudently conservative valuation criteria.

AAOIFI FAS-26 indicates that IFIs shall disclose to which extent the value of real estate investments is based on the evaluation by an independent valuer who holds recognised and relevant professional qualifications, and has recent experience in the location and category of the investment of real estate being valued. IFSB-15 indicated that for real estate investments this evaluation might be conducted by in-house function that may also undertake property research, provide technical advice and execute marketing strategies for real estate activities.

In either cases, third party or in-house, the evaluation of real estate shall be reliable and appropriate because it is the base of risk weight and capital adequacy's calculations, in addition to the role of this evaluation in monitoring the limit of real estate exposure, if any.

3.2. Concentration Limit

The IFSB-7 proposed a concentration limit for aggregate real estate investment exposures of 60% of regulatory capital, with a 15% limit on single real estate investment exposures. However, this was not carried forward into IFSB-15. Instead it was covered in the supervisory review standard IFSB-16, where it was argued that the Board of Directors, as part of its risk management, should set its own limits for real estate concentration, but also that supervisory authorities should set over-arching limits. In this case, however, no figures were proposed.

3.3. Role of Supervisory Authorities

Both BCBS and IFSB have placed a great responsibility on the supervisory authorities related to real estate exposures. Basel II and III, in addition to the Revisions, indicated that the national supervisory authorities should evaluate the assigned risk weights and require banks to increase them if necessary. IFSB-15 indicated that the supervisory authority shall ensure that IFIs have in place adequate valuation rules and proper valuation methodologies to evaluate its real estate activities. This implies that supervisory authorities need to have practical knowledge of the real estate markets in their jurisdictions, as well as default rates on financing, in order to be able to judge whether any changes to risk weights are appropriate and whether banks are managing real estate risk properly and prudently.

Supervisory authorities are also likely to have the primary responsibility for implementing the Basel III revisions, or an Islamic counterpart.

In this area, as well as some policy issues, they will have some technical ones to deal with. For example, they will need to ensure that the dividing line between real estate financing and real estate investment is properly drawn for Islamic banks (and does not depend solely on who holds title to the asset). They will also need to ensure that the LTV ratio is properly calculated when Islamic contracts are used in the financing.

3.4. Shariah Issues on Real Estate (Zakah)

As mentioned before, real estate financing might use different contracts. Shariah rules and principles must be fulfilled based on each contract. The important Shariah issue in respect to investment in real estate is Zakah. There is consensus among scholars that the real estate that is owned for investment shall be subject to Zakah, and Zakah shall be assessed based on the value of real estate at the prescribed date to pay Zakah. This also includes real estate under construction, when Zakah shall be based on the valuation of the real estate under construction. However, operating Ijarah does not impose any Zakah requirement on the real estate itself; Zakah shall be paid on the rental amount at the prescribed date of Zakah. Islamic banks shall calculate Zakah on real estate investments through evaluating their real estate properly at the prescribed time to pay Zakah.

Conclusion

The Revisions of Basel III, introduced in December 2017, aim to provide a prudent, credible, and more risk sensitive calculation of RWAs. Most of the Islamic regulatory treatment of real estate is still based on Basel II, which is concerned mainly with mortgages, and Basel III (pre-reform) which provided no amendments to Basel II treatment. In relation to the Islamic finance industry, IFSB drew a clear distinction in its standards between investments and financing exposures; the treatment of real estate and proposed risk weights still depend on Basel II. Both BCBS and IFSB have placed large responsibilities on the supervisory authorities to insure a proper treatment of real estate in their respective jurisdictions.

Islamic banks are more exposed to real estate due to its involvement in both investment and financing real estate activities, in addition to the cyclical nature, volatility and illiquidity of those properties. As a result, Islamic banks may be hit particularly hard by any downturn in the real estate sector. Therefore, this issue imposes concerted efforts from supervisory and standard bodies, board of directors and managements, and all related parties to evaluate and assess properly all risks related to such investments.

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Policy Recommendations and Key Findings

- The source of funding for real estate (whether for investment or financing purposes) shall be taken into consideration by IFIs. Some issues such as risk appetite and maturity mismatches shall be considered separately based on the funding source.
- The Revisions of Basel III shows a shift from a static to a more risk sensitive approach of calculating RWAs. Standard setters in Islamic finance should take this shift into consideration in any upcoming reforms and revisions, and also deal with the expected application issues.
- The IFSB should revise their capital adequacy standards after determining the main technical issues and application complexities of the Basel III Revisions in light of the main specificities of IFIs.
- Islamic banks may use tools such as financing-to-value and financing-to-income ratio limits. This may help in containing borrowers' repayment risk and banks' exposures to real estate. They could also help limit the risk of asset bubbles/ credit booms.
- A standardised categorisation of real estate activities may enhance the ability of Islamic banks to assess risk weights in a better way; it will also enhance the ability of the supervisory authorities to exercise its monitoring role effectively.
- Even where real estate is correctly evaluated and reported in a standardised category, Islamic banks need to be aware of indirect exposure of real estate; banks had provided finance (other than direct finance for real estate) to individuals and firms which were themselves exposed to the real estate sector and whose ability to repay was therefore dependent on that sector.
- Shariah supervisory bodies in Islamic banks and on a national level shall play a more effective role on the Zakah issue in real estate.
- A proper treatment of real estate requires combined efforts of regulatory and supervisory authorities, management and board of directors, Shariah bodies and all other related parties.

About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 125 members from more than 33 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

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