Challenges and failure of Implementation of Basel Accord II and reasons to adopt Basel III both in Islamic and Conventional Banks

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ABSTRACT

This article is about the failure of Basel Accord II and reasons to adopt the Basel Accord III in both conventional as well as Islamic financial institutions. Our main objective is that why the Basel accord II fail? And why we need the Basel Accord III? For this purpose we use both the data collection sources (Primary and Secondary). For secondary data we pick up the balance sheet of Islamic as well as conventional banks and for the primary data we fill the questionnaire from the credit and operational mangers of the banks.

Key Words: Basel Accord, Financial Institution, Failure, Implementation, Basel Committee on banking supervision, Risk Weighted Assets, CAR, Credit Risk.

1. Introduction:

1.1 Basel Origin:

The Basel Committee on Banking Supervision was established as the Committee on Banking Regulations and Supervisory Practices by the central-bank Governors of the Group of ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets. The first meeting took place in February 1975 and meetings have been held regularly three or four times a year since. (Swaan, 2009)

The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. (Swaan, 2009)

The most important issue for the regulatory authorities is soundness of the banking system. Before 1990s almost all of the banks measure its soundness by the leverage ratio.

Leverage Ratio = Capital / Total assets

If the leverage ratio result is high it means banks are very strong against the risk and vice versa. But in this ratio we cannot make difference between assets and risk. With the passage of time the risk against assets will increase but our capital does not change and bank fails to make its soundness and became insolvent. (Hasan, 2002)

1.2 Basel Accord I:

The basic requirement of this Basel accord is that all the financial institution holds the capital at least 8% of its risk weighted assets. The capital of the banks consist of two parts, first part which include the share holder’s equity and retain earning is called Tier 1 Capital and second part of capital which consist upon all inter external resources are called Tier 2 Capital and the Basel Accord 1 required that Tier 1 capital must represent the half part of total capital or Tier 1 capital must 100% of Tier 2 capital. (Hasan, 2002)

According to Basel Accord 1, banks assign different types of risk weights to their assets according to the category of debtors like (0%, 20%, 50% and100%). It means that if the assets having 0% risk weight then the banks required no capital for this type of assets like government securities etc but if the assets having 20% risk weight then the banks must require capital 1.6% of the value of asset and the assets having 50% risk weight then the banks must require capital 4% of the value of this type of assets and if the assets having 100% risk weight then the banks must require capital 8% of this type of assets. So the Basel Accord 1 measures the risk by this equation:

Risk-Based Capital Ratio = Capital / Risk-Adjusted Assets

After ten years of Basel Accord implementation many changes of technology, finance and many other things are occur due to this there is a lot of weaknesses arise in Basel Accord 1 like 8% capital adequacy rate. The banks move their high risk assets off the balance sheet another weakness are that the Basel Accord 1 does not consider the operational risk as well. (Mohanty, 2008)

1.3 Basel Accord II:

After taking into considering all of the weaknesses of Basel Accord 1 the “Basel Committee on banking Supervision” (BCBS) decided that they change the existing Basel into more risk sensitive Basel and they introduced the **Basel Accord II**. (Akhtar, 2006)

The Basel accord II provide the more risk sensitive framework for the all financial institution especially for banks. According to Basel Accord II we measure the risk by the following equation:

Risk-Based Capital = Capital / Credit Risk + Market Risk + Operational Risk

The Basel Accord II deals with all kind of risk like credit risk market risk and operational risk so the one difference between Basel Accord I and Basel Accord II is that the Basel Accord II also deal with operational risk which does not deal the Basel Accord I. So the Basel accord I set the 8% capital requirement only for credit risk but the Basel accord II same 8% capital requirement not only for credit risk but also included the operational risk. (Ahmad, 2008).

After five years of Basel Accord II implementation there were lot of weaknesses arise in Basel Accord II which were the reasons of failure the Basel Accord II.

1.4 Failure of Basel Accord II:

Following were the causes of failure of Basel Accor II:

The first cause was "**pro-cyclical process**" due to this if there is economical boom in the country then banks require less capital for recovering the risk but in case of down of economy then banks require more capital for recovering the risk. (Udeshi, 2004)

The Basel Accord II has "pro-cyclical process" due to this if there is economical boom in the country then banks require less capital for recovering the risk but in case of down of economy then banks require more capital for recovering the risk. (Teply, 2010)

The second cause of failure was the lot of use the rating provided by external sources. In many organizations has no credit assessment department so they relays on credit rating provided institutions. So the external credit rating provided institutions became more important. This create the problems like the external institutions mispriced the risk due to this the conflicts were arises and that's way we need to revise the Basel Accord. (Teply, 2010)

The U.S. bank's supervisors most of the time claims that the two approaches like Advance Internal Rating Based (AIRB) and Advanced Measurement Approach (AMA) for credit and operational risk respectively are very complex so these are implemented by only large banks in U. S. So, the financial institution having $250 Billion consolidated assets are requiring that they implement the advance approaches. (Mohanty, 2008)

1.5 Basel Accord III:

The Basel Accord III improves the capital and liquidity requirement that the banks stand in the financial crises. In Basel accord III the common equity increase from 2% to 4.5% and the Tier 1 capital reserve is also increase from 4% to 6% to meet the liquidation problem of the banks. An additional and extra reserve is require to maintain by banks which is included in Basel Accord III which is not the part of Basel Accord II is **"Capital Conversation Buffers"** which 2.5%. This buffer can be use by the banks in stress situations. (Mehta, 2012)

Another additional reserve is require to maintain by the banks which becomes the part of Basel Accord III not included in Basel Accord II is "**Countercyclical Buffer"** which is not fixed it vary from 0% to 2.5%. It is requires to maintain by the banks in case if the credit is increase more than increase in GDP. An instrument is introduced by the Basel Accord III for the liquidity problem is called **"Liquidity Coverage Ratio"** (LCR). The basic purpose of this ratio that bank must have the assets of high quality that can easily converted in cash to meet the cash requirement of 30 days. This ratio must not less than 100%. (Mehta, 2012)

Research Aim:
Our basic aim of the research that to find the reasons of failure of Basel Accord II and why we need to update the Basel Accords for both Islamic and conventional banking system. Another aim of our study is that to find the impact of Basel especially on Islamic banking system.

Research Objectives:
To accomplish our aim we required both types of data primary as well as secondary. To get primary data we develop the questionnaire and fill it from both Islamic as well as conventional banks and for secondary data we take the balance of Islamic and conventional banks from their websites and apply the statistical techniques on the data and get the result to complete our aim.

Significance of the research:
After getting the result, we will able to find the main causes of failure of Basel Accord II and we will also in position that we have sold reasons that why we need to update the Basel accord II and we will also able to know what are the effects of Basel on Islamic financial Institutions and are changes is required to implement the Basel in Islamic banking system.

Research methods:

We use both qualitative and quantitative methods of research in our study. For this purpose we use both the data collection sources (Primary and Secondary). For secondary data we pick up the balance sheet of Islamic as well as conventional banks and for the primary data we fill the questionnaire from the credit and operational mangers of the banks.

Research Questions:

Why Basel Accord II fails?
What are the reasons to adopt Basel III?
Why Basel is not suitable in IFI?

Research Implementation:
Our research problem is very hot issue in financial system of all the countries so the finding of our research is applicable in all the countries especially in banking system where the Basel Accord is the hot issue and necessary to adopt it.

Future scope of research:
In our research we discuss the Basel II failure and reasons to adopt the Basel III in future we discuss the problem arises in the implementation of Basel Accord III by both the financial institutions conventional as well as Islamic and possible solution of the problem arises on Basel Accord III.

2. Literature Review:

2.1 Basel Origin:

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The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. (Swaan, 2009)

2.2 Basel Accord I:

In 1988 the "Basel Committee on banking Supervision" (BCBS) introduced the **Basel Accord 1** for the help of financial institution to deal with risk associate with banks and this Basel Accord also eliminate the all the limitation of leverage ratio to measure the solvency of the banking system. (Akhtar, 2006)

The basic requirement of this Basel accord is that all the financial institution holds the capital at least 8% of its risk weighted assets. The capital of the banks consist of two parts, first part which include the share holder's equity and retain earning is called Tier 1 Capital and second part of capital which consist upon all inter external resources are called Tier 2 Capital and the Basel Accord 1 required that Tier 1 capital must represent the half part of total capital or Tier 1 capital must 100% of Tier 2 capital. (Hasan, 2002)

According to Basel Accord 1, banks assign different types of risk weights to their assets according to the category of debtors like (0%, 20%, 50% and100%). It means that if the assets having 0% risk weight then the banks required no capital for this type of assets like government securities etc but if the assets having 20% risk weight then the banks must require capital 1.6% of the value of asset and the assets having 50% risk weight then the banks must require capital 4% of the value of this type of assets and if the assets having 100% risk weight then the banks must require capital 8% of this type of assets. So the Basel Accord 1 measures the risk by this equation:

Risk-Based Capital Ratio = Capital / Risk-Adjusted Assets

After ten years of Basel Accord implementation many changes of technology, finance and many other things are occur due to this there is a lot of weaknesses arise in Basel Accord 1 like 8% capital adequacy rate. The banks move their high risk assets off the balance sheet another weakness are that the Basel Accord 1 does not consider the operational risk as well. (Mohanty, 2008)

2.3 Failure of Basel Accord I:

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Regulation of the banks in U.S. requires that the only large as well as complex banks only apply the advance approaches but the large banks not requires implementing the advance approaches. Due to lack of resources and expertise in the emerging Asia-Pacific countries they were not able to implement the Basel Accord II up till 2007. In Asia-Pacific countries market structure is not good cooperate governess is not good and there is high chances of failure the market so the

implementation of Basel accord II is a big task for Asia-Pacific banks supervisors as well as banks managers. (Mohanty, 2008)

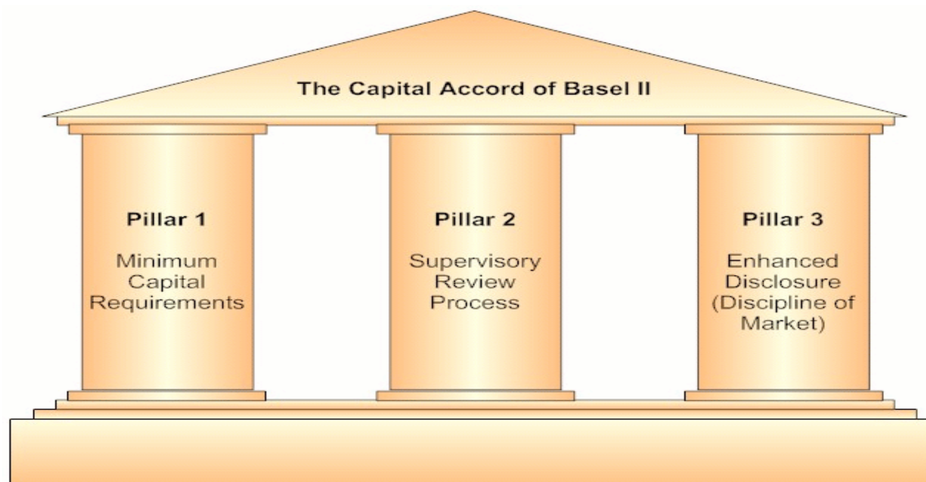
2.4 Basel Accord II:

After taking into considering all of the weaknesses of Basel Accord 1 the "Basel Committee on banking Supervision" (BCBS) decided that they change the existing Basel into more risk sensitive Basel and they introduced the **Basel Accord II**. (Akhtar, 2006).

The Basel accord II provide the more risk sensitive framework for the all financial institution especially for banks. According to Basel Accord II we measure the risk by the following equation:
Risk-Based Capital = Capital / Credit Risk + Market Risk + Operational Risk

The Basel Accord II deals with all kind of risk like credit risk market risk and operational risk so the one difference between Basel Accord I and Basel Accord II is that the Basel Accord II also deal with operational risk which does not deal the Basel Accord I. So the Basel accord I set the 8% capital requirement only for credit risk but the Basel accord II same 8% capital requirement not only for credit risk but also included the operational risk. (Ahmad, 2008).

So, the Basel Accord II consists upon three pillars:
1- "Minimum Capital Requirement"
2- "Supervisory Review Process"
3- "Market Discipline"



1-Minimum Capital Requirement:

The capital adequacy rate 8% is same in Basel Accord II but it does not include only risk weighted assets but also include the Market as well as operational risk. Tier I Capital is also 50% of the total capital or 100% of Tier II Capital. The changes are arise in Basel II against the Basel I is the inclusion of operational risk as well as the approaches of measures the risks. (Hasan, 2002)

2- Supervisory Review Process:

In Basel II the supervisory review process is the new pillar which is not included in Basel I. In Basel I the risk weights which are given to asset were fixed which were straightforward to apply but in case

of Basel II the bank must use the different types of approaches to measure the operational, market and credit risk. For the choosing of approach the supervisor must review that the bank are in position to meet the minimum requirement for the implementation of the approach. (Hasan, 2002)

3-Market Discipline:

The third pillar also new in Basel II who requires that the bank must disclose their soundness, risk and capital adequacy to the market that market understands the banks soundness, risk portfolio as well as adequacy of capital. (Hasan, 2002)

2.5 Implementation of Basel Accord II:

In the implementation of Basel accord II the European regulation authorities, supervisors and management faces the issue of accountability as well as financial stability. (Lannoo, 2005)

For the implementation of Basel II the banks management requires the high expertise which is a big challenge for any bank in implementation of Basel Accord II. The design of Base Accor II is also very complex. This complexity is not only as whole of regulation but also its components is very complex which disturb the bank's effectiveness and cost as well. (Philipp Härle, 2010)

The data of high is required for the implementation of Basel Accord II. For this purpose Banks paid high cost which is another challenge for banks to implement the Basel II. The banks face lot difficulties to identify the relevant risk and data. The Basel Accord implementation cost in European banks was between €45 million to €70 million. (Philipp Härle, 2010)

The success of implementation of Basel accord II depends upon the ability of bank's supervisors who plays a vital role for the implementation of Basel accord II. So, most experienced and expert supervisors are required for the implementation of Basel II which is a big challenge for the banks. (Caruana, 2006).

2.6 Failure of Basel II:

The challenges face by the supervisors is that they must require the high quality data as well as the supervisors need to upgrade their skills and expertise time to time. Another challenge for the supervisors is that the implementation of Basel accord should be transparent, consistent and fair throughout jurisdiction. (Parreñas, 2002)

Another challenge for the banks that they need the high quality data for IRB approach but the banks have not the time series data for this purpose, which creates big problem for accessing the risk. Another problem of banks they should meet the entire financial and accounting standard for full fill the third pillar of Basel Accord II which is called as market disclosure. (Parreñas, 2002)

The major and prime problem face by the regulation is that use of modern and complex models (due to lack of reliable and sufficient data bases in the banks) for accessing the risk in Basel Accord II like AIRB and AMA Model etc. (Griffith-Jones, 2006)

Most of the financial institutions like Life Insurance Companies (LIC's) must need to implement the Basel because they has link with foreign banks and they apply advanced approaches in Basel. They collaborate with these bank's supervisors to implement the Basel and face lot of difficulties if the country in which LIC operate not adopt the Basel. (Griffith-Jones, 2006)

The basic problem of Basel Accord II has pro-cyclical process due to this if there is economical boom in the country then banks require less capital for recovering the risk but in case of down of economy then banks require more capital for recovering the risk. (Teply, 2010)

Another problem of Basel Accord II is that the banks relay on external credit institution provided credit rating in this case banks totally depend upon the external credit rating provided institution. If any wrong or error occur in the information provided by the external credit providers then bank survive from risk. (Teply, 2010)

The main problem of the banking system is to get and transform the data in such a way that we are able to apply the relevant approach on the data which is a big challenge for the supervisors of the banking system. (Jovic, 2004)

The Basel Accord II is the very complex to understand as well as implement not only for regulatory authorities as well as regulated community. For the implementation of Basel Accord II the strong financial system of the organization as well as country is essential. (Seema Siddiqua Hai, 2007) Another problem of implementation of Basel Accord II is no availability of high quality data which is necessary for the implementation of Basel Accord. Another challenge face by the banks is that the operational cost of Basel Accord II. There is high cost bear by the banks in implementation of Basel accord II. (Seema Siddiqua Hai, 2007)

The basic problem of Basel Accord II has pro-cyclical process due to this if there is economical boom in the country then banks require less capital for recovering the risk but in case of down of economy then banks require more capital for recovering the risk. (Udeshi, 2004)

The one of the problems of Base Accord II that the verification of measurement of capital adequacy which is calculated under IRB as well as the IRB treatment qualification. (Milne, 2003) The one of the objective of Basel Accord II is that the Basel improves the competitive equality between the banks but it fails to do so. Many of the banks were winners and many of the banks were losers in Basel Accord II. The large institutions who were adopt the A-IBR receiving the significant gains then the small institutions. (Lall, 2010)

2.7 Basel Accord III:

The Basel Accord III improves the capital and liquidity requirement that the banks stand in the financial crises. In Basel accord III the common equity increase from 2% to 4.5% and the Tier 1 capital reserve is also increase from 4% to 6% to meet the liquidation problem of the banks. (Mehta, 2012)

An additional and extra reserve is require to maintain by banks which is included in Basel Accord III which is not the part of Basel Accord II is **"Capital Conversation Buffers"** which 2.5%. This buffer can be use by the banks in stress situations. (Mehta, 2012)

Another additional reserve is require to maintain by the banks which becomes the part of Basel Accord III not included in Basel Accord II is "**Countercyclical Buffer"** which is not fixed it vary from 0% to 2.5%. It is requires to maintain by the banks in case if the credit is increase more than increase in GDP. (Mehta, 2012)

An instrument is introduced by the Basel Accord III for the liquidity problem is called **"Liquidity Coverage Ratio"** (LCR). The basic purpose of this ratio that bank must have the assets of high quality

that can easily converted in cash to meet the cash requirement of 30 days. This ratio must not less than 100%. (Mehta, 2012)

With the application of Basel Accord III banks know able to holds the four times capital than the previous capital requirement. It means banks soundness is very high in this case as compare to previous. (Hannoun, 2010)

The Basel Accord III decreases the systematic risk but the Basel cannot eliminate the systematic risk at all. (Walden, 2010)

The crises are arises due to the Basel Accord fails to capture the both on and off balance sheet risks. The Basel Accord III provided the more tolls to accessing the different types of off and on balance sheet risks. The Basel Accord III provides the **"Capital Conversation Buffers",** "**Countercyclical Buffer" and "Liquidity Coverage Ratio"** (LCR) which are the measures against risks. (Atkinson, 2010)

In Basel Accord III long term reserves or provisions are established to avoid or cover the counter-cyclical effect for this purpose banks maintain more capital to absorb the uneven shocks. The Basel also provides the standards to measure the liquidity risk. (COSMA, 2010)

The Basel Accord III framework provides the more comprehensive and effective treatment of risk associated with the banks then Basel accord II. (GRIGORE, 2011)

The one of the reason of summer 2007 crises was that the lack of management of liquidity risk in almost all the financial institutions. Due to this the "Basel Committee of Banking Supervision" (BCBS) updates the Basel accord II and add the principle of management of liquidity risk in the Basel in 2008. (Lamoot, 2011)

For this purpose the "Basel Committee of Banking Supervision" (BCBS) provides the "Liquidity Coverage Ratio" (LCR) which ensures that the banks have quality assets that easily convert into cash to meet the one month cash requirement of the banks. (Lamoot, 2011)

Basel III has more regulation then previous Basel to survive in financial crises it has basic and fundamental effect on the profitability of the financial institution. (NUCU, 2011)

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The emphasis of Basel Accord II is on the risk effects upon the capital adequacy not on the risk management because the basic problem is that to manage the risk. (Kahf, 2005)

2.8 Basel implementation in Islamic Financial institutions:

Most of the Islamic Banking transactions creating the debts like Ijarah. This type of claims does not categories other then the Islamic financial modes like mention in Basel Accord II and Islamic banking fallow the AAOIFI accounting standards which does not require to categories these types of claim mention in Basel Accord II. (Kahf, 2005)

AAOIFI accounting standard number 5 discuses that the bank must disclose the ratio of profit distributed among the Islamic bank and the investor. Bank must disclose the rule of distribution of profit among the investor and bank which are the necessary part which are not mention in Basel Accord II. (Kahf, 2005)

One of the assumptions of Basel Accord II is that the counterparty of the entire asset in the balance sheet should be liability and capital only but this assumption does not meet in the case of Islamic banks. (Kahf, 2005)

The Basel accord II provides the opportunity to the Islamic Financial Institutions that they improve the risk management process as well as infrastructure for the financial stability of the institutions. (Tariqullah Khan, 2003)

According to the definition of AAOIFI the assets of Islamic Financial Institutions are different from the conventional banking system. These are in the form of Musharakah, Mudarabah, Istisna and Salam etc which are in cash and cash equivalent form, so risk associated with these assets are different from conventional banking system so difficult to apply Basel Accords on Islamic financial institutions than conventional banking systems. (OBAIDULLAH, 1998)

2.9 Challenges Face by Basel in IFI:

According to the Basel Accord II norms the two investments Musharakah and Mudarabah should assign the 100% weight and all the investment in fixed assets should assign the 100% weight so we misplaced the credit risk in these cases.

The Islamic banks also does not deals with derivative contracts they treated as un-Islamic contracts so credit and market both the risk are involve with these derivative contracts but Islamic banks are free from these types of risk and not require the capital in these regards (OBAIDULLAH, 1998)

The transactions of Islamic banks are different from the conventional banks so their risks are also different from the conventional banking system which is the big cause of failure of Basel Accord implementation in Islamic banking systems. (Ahmad, 2008)

In case of conventional banking system, the Basel Accord safe the depositor from risk that bank must have the sufficient capital to pay the principal amount and interest but in case of Islamic banks contract is based on profit and loss sharing bases not the return on fixed interest so the Islamic banks are not required the Basel accord to safe depositor interest. (Ahmad, 2008)

Another challenge to apply the Basel Accords that the restricted Mudarabah transactions are treated off-balance sheet item and unrestricted Mudarabah transactions are treated as on balance sheet item in Islamic banking system this unique process also a hurdle to implement the Basel Accords. (Ahmad, 2008)

Another problem to implement the Basel Accord it ignore the asset side of Islamic banking system these assets are backed by the commodity or real estate which have more risk than conventional banking system. (Ahmad, 2008)

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3. Methodology:

Primary data

In our study we use both primary as well as secondary sources of data collection. For getting the primary data we develop the questionnaire which have several questions about the Basel Accord and fill up almost 100 questionnaires from different branch and credit managers who have enough knowledge about the Basel Accord of both Islamic as well as conventional banks. We fill up the roundabout 40 Questionnaires from Islamic banks and remaining 60questionnaires from conventional banks.

Frequency Table:

Bank Type

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Islamic	40	39.6	40.0	40.0
	Conventional	60	59.4	60.0	100.0
	Total	100	99.0	100.0	
Missing	System	1	1.0		
Total		101	100.0		

As the result show by frequency table that the 40% questionnaire fill from the Islamic banks and 60% questionnaires fill from the conventional banks and total 100 questionnaire fill from the banks.

3.1 Secondary Data

For the secondary data collection we take the balance sheet of both four Islamic and four conventional banks. We take the time series data from the balance sheet of both the banks for four years 2008-11 in our analysis.

Conventional banks include the Allied Bank, Muslim Commercial banks, Habib Bank and Fayasal Bank.

Islamic Banks include the Dawood Islamic Bank, Bank Islami, Albarka Bank and Dubai Islamic Bank.

3.2 Variables

For the analysis of failure of Basel II we take failure of Basel II as a dependent variable and Quality Data problem, Pro-cyclical effects, liquidity problem and Relay on external institutions for credit rating taking as the independent variables.

Failure of Basel Accord II = Quality data problem + Pro-cyclical effects + liquidity problem + Relay on external institutions for credit rating.

For the analysis of Basel accord III we take the reasons to adopt Basel III as dependent variable and Remove Pro-Cyclical Effect, Satisfy with CAR, Solve Liquidity problem and more risk assessing technique taking as independent variables

Reasons to adopt Basel III = Remove Pro-Cyclical Effect + Satisfy with CAR + Solve Liquidity problem + more risk assessing technique

For the analysis of Basel Accord failure in IFI we take IFI not adopt Basel Accord as dependent variable and More risk in IFI, Basel safeguard the interest of depositor, Basel II CAR is not Sufficient and IFI different from conventional Banking as independent variables.

IFI not adopt Basel Accord = More risk in IFI + Basel safeguard the interest of depositor + Basel II CAR is not Sufficient + IFI different from conventional Banking

4. Data Analysis and Interpretation:

To analysis the secondary data we take four Islamic and four conventional banks. Conventional banks include the Allied Bank, Muslim Commercial banks, Habib Bank and Fayasal Bank. Islamic Banks include the Dawood Islamic Bank, Bank Islami, Albarka Bank and Dubai Islamic Bank.

We calculate the capital adequacy ratio (CAR) to check the implementation of Basel Accord. We calculated it capital required divided by risk weighted assets (RWA). So the CAR=Capital / RWA. For further analysis we use the primary data collection techniques. For this purpose we fill round about 100 questionnaires from the credit or branch managers who have enough knowledge about our topic.

5. Conclusion:

At the end we concluded that the there is several reasons of failure of Basel accord II like the pro-cyclical effects it means that we need less Capital Adequacy Requirement (CAR) in the situation of boom in the economy but in the case of down fall in economy we need more Capital Adequacy requirement which is a reason of failure of Basel Accord II.

Another cause of failure of Basel accord II that we were see in our study that Basel does not meet the liquidity requirement of Banks which is the big reason of recent financial crises. Data collection is

another reason of failure of Basel Accord, we need high quality data which is very costly and not easy to handle.

The banks are also much relay on the credit rating provided by the external financial institutions which is another reason of failure.

In the case of Islamic Financial Institution CAR is very low because the Islamic Financial Institution contains more risk than conventional banking system. There assets are different from the conventional banking system as well as risk is also different from the conventional banking system.

In Islamic Financial Institution restricted and unrestricted Mudarabah are the unique transaction which are not maintain by the conventional banking system and having different risk so required different risk weights.

Basel Accord also works for the interest of customer which necessary in the case of conventional banking system where the contract are made on the basis of fixed interest but in the case of Islamic banking system, contracts is to be made on the basis of profit and loss sharing ratio where we did not required to save the depositor which is another cause of failure of Basel Accords.

As for as Basel Accord III is concern we concluded that the Basel Accord III remove the deficiency of Basel Accord II like the Basel Accord III remove the problem of pro-cyclical effects by providing the "**Countercyclical Buffer" .**

The Basel Accord III also removes the problem of liquidity by providing the increase in the ratio of capital Adequacy and **"Liquidity Coverage Ratio"** (LCR). In case of Islamic banking system Basel Accord III provides more capital for their high risk assets are cover it.

6. Recommendations:

At the end we recommended that the regulatory authorities must provide the training to the employees who deal with the Basel Accord. The employees who deal the Basel Accord have not enough knowledge about the Basel accord and the banks face lot of difficulties to hire and train the employees and bear high cost on it. So the regulatory authorities must provide the sources to all the banks to train their employees for the implementation of Basel Accord.

We also recommend that the regulatory authorities must take measures and implement the Basel accord on Islamic Financial Institutions. They must provide the different risk weights for the assets of Islamic financial institutions because their assets contain more risk than the conventional banking system.

The regulatory authorities also facilitate the bank to containing the high quality data which are necessary for the implementation of Basel Accords. Banks face lot of difficulties in obtaining the high quality data.

The regulatory authorities also facilitate the banks that they use the internal sources for credit rating rather than rely on external credit rating providers.

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The capital RWA assets of all the banks for four years are as follow:

5.1- Quantitative Research Methods:

Secondary Data Analysis

Figure I

	2008		**2009**		**2010**		**2011**	
	Risk Weighted Assets (Credit+ Market+ Operational Risk)	Capital Required	Risk Weighted Assets (Credit+ Market+ Operational Risk)	Capital Required	Risk Weighted Assets (Credit+ Market+ Operational Risk)	Capital Required	Risk Weighted Assets (Credit+ Market+ Operational Risk)	Capital Required
ABL	211,690,898	23,067,465	238,436,572	32,115,656	270,151,763	37,398,334	303,082,586	40,710,370
MCB	329,536,813	52,678,068	337,417,070	64,356,557	330,135,367	72,856,360	376,442	82,014
HBL	596,244,314	68,018,191	586,894,116	76,680,848	608,474,200	83,506,380	586,894,116	68,018,191
Faysal Bank	121,070,271	11,389,184	103,927,820	12,396,762	179,918,604	17,902,907	103,927,820	11,389,184
Dawood Islamic Bank	9,030,730	4,077,694	9,460,176	4,822,559	11,052,485	4,248,965	9,460,176	5,080,559
Bank Islami	23,155,542	4,436,283	21,987,275	4,436,283	23,155,542	4,516,407	---------------	------------
Albarka Bank	6,838,093	1,558,708	13,530,355	3,453,160	33,539,209	5,324,743	36,107,279	5,521,842
Dubai Islamic Bank	22,546,372	4,667,910	27,748,157	5,564,474	26,966,856	5,627,784	--------------	---------------

Capital Adequacy Ratio (CAR) = Capital Required / RWA

Figure II : Capital Adequacy Ratio

	2008	**2009**	**2010**	**2011**
ABL	10.90%	13.47%	13.84%	13.53%
MCB	16.28%	19.07%	22.07%	21.79%
HBL	11.41%	13.25%	14.61%	15.45%
Faysal Bank	9.41%	11.93	9.95	10.54%
Dawood Islamic Bank	45.15%	50.98%	38.44%	46.45%
Bank Islami	39.83%	20.18%	19.50%	----------
Albarka Bank	22.79%	25.53%	15.88%	15.29%
Dubai Islamic Bank	20.70%	20.05%	20.87%	-----------

According to the above figure 2 the capital adequacy ratio of all the banks is more than 8% which is mention in pillar 1 of Basel Accord II and it is calculated by the methodology provided by the Basel Accord II so we said that the almost all the banks fallow the Basel Accord. But the ratio of Islamic

banks is very large than the conventional banks it shows that the Islamic banks face more risk than the conventional banking system because the Islamic banks have different assets having different risk but more risk than conventional banks.

They are also use the same techniques which are mention in pillar II of Basel Accord II for assigning the credit, market and operational risk to their assets. So it is evidence that the banks adopt the Basel Accord II for risk accessing.

For further analysis of Basel accord II we calculate the Leverage Ratio of all above banks and result are show in figure III.

Figure III Leverage Ratio

	2008	**2009**	**2010**	**2011**
ABL	15.40	12.97	11.51	10.89
MCB	6.59	6.32	6.54	9.59
HBL	9.08	9.38	8.91	9.76
Faysal Bank	11.83	14.15	15.18	15.28
Dawood Islamic Bank	1.33	1.69	3.08	1.78
Bank Islami	2.67	6.25	8.44	7.94
Albarka Bank	4.54	4.66	8.93	8.97
Dubai Islamic Bank	4.87	4.86	5.59	5.61

From the above figure III we find that the Leverage Ratio of all the conventional banks is very high. It indicates that the liquidity problem face by all the conventional banks by the implementation of Basel Accord II.

But in the case of Islamic banks they did not adopt the risk weights techniques provided by Basel Accord II because the Islamic banks have different types of assets and risk and more capital adequacy ratio show in figure II. So their Leverage ratio is better than the conventional banking system. This is the reason that when 2006-07 financial crises arise, the conventional banking system survives but there is miner effect on Islamic banking system.

5.2- Qualitative Research Methods:

For further analysis we use the primary data collection techniques. For this purpose we fill round about 100 questionnaires from the credit or branch managers who have enough knowledge about our topic. After getting response we apply the statistical techniques on the data and find the following results.

Before constructing our variables we check the reliability of our data in each case it is greater than 0.70 which means that our data is reliable one example is as fallow:

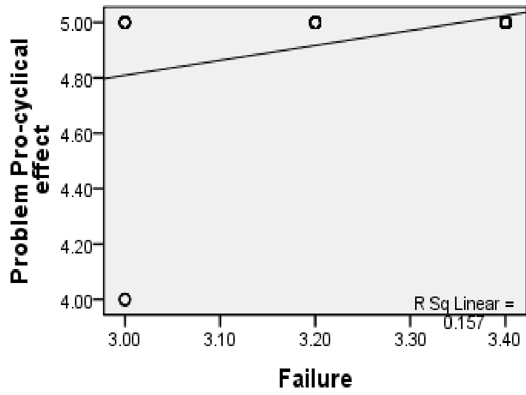
Figure IV

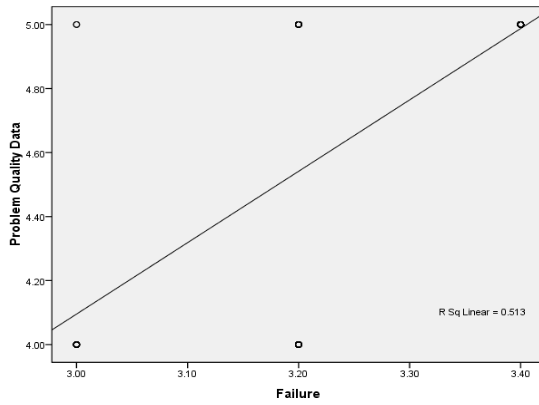
Reliability Statistics

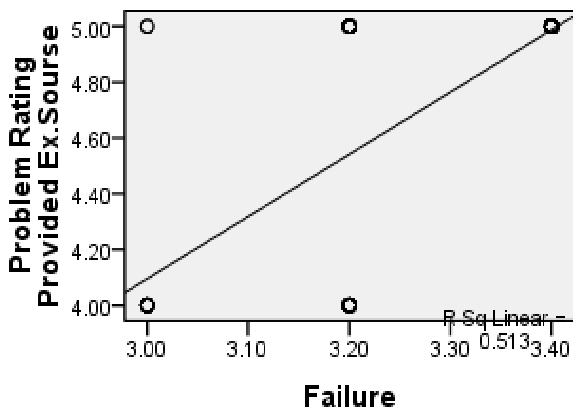
Cronbach's Alpha	N of Items
.767	4

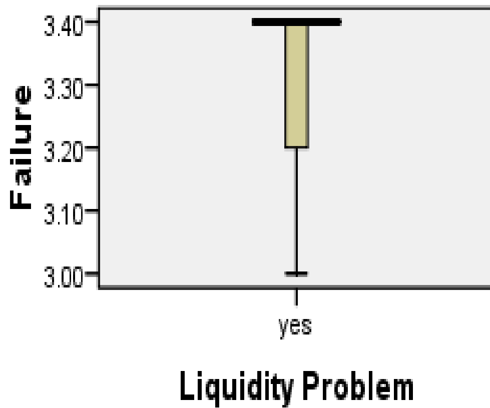
5.3- Reasons of failure of Basel II:

First we take the scatter plots to check the relationship between the variables.









In all above case you see that there is positive relationship between the variables it means that all above four variables (Quality Data, Pro-cyclical effects, liquidity problem and Relay on external institutions for credit rating) are the major reasons of failure in the implementation of Basel accord II.

Regression:

For further analysis we apply regression on above variables to see the effects the results are as follows:

Table # 1

Model	R Square
1	1.000

Table # 2

Model	Beta	Sig.
(Constant)		.000
Problem Quality Data	.623	.000
Problem Pro-cyclical effect	.272	.000
Problem Rating Provided External sources	.623	.000

a. Dependent Variable: Failure of Basel Accord II

The value of R square = 1.0 indicates that 100% changes in dependent variables are coming from independent variables and 0% changes due to other variables. The value of significance of all the independent variables = 0.0000 which is less than 0.05 it means that all the independent variables has significant relationship with dependent variable.

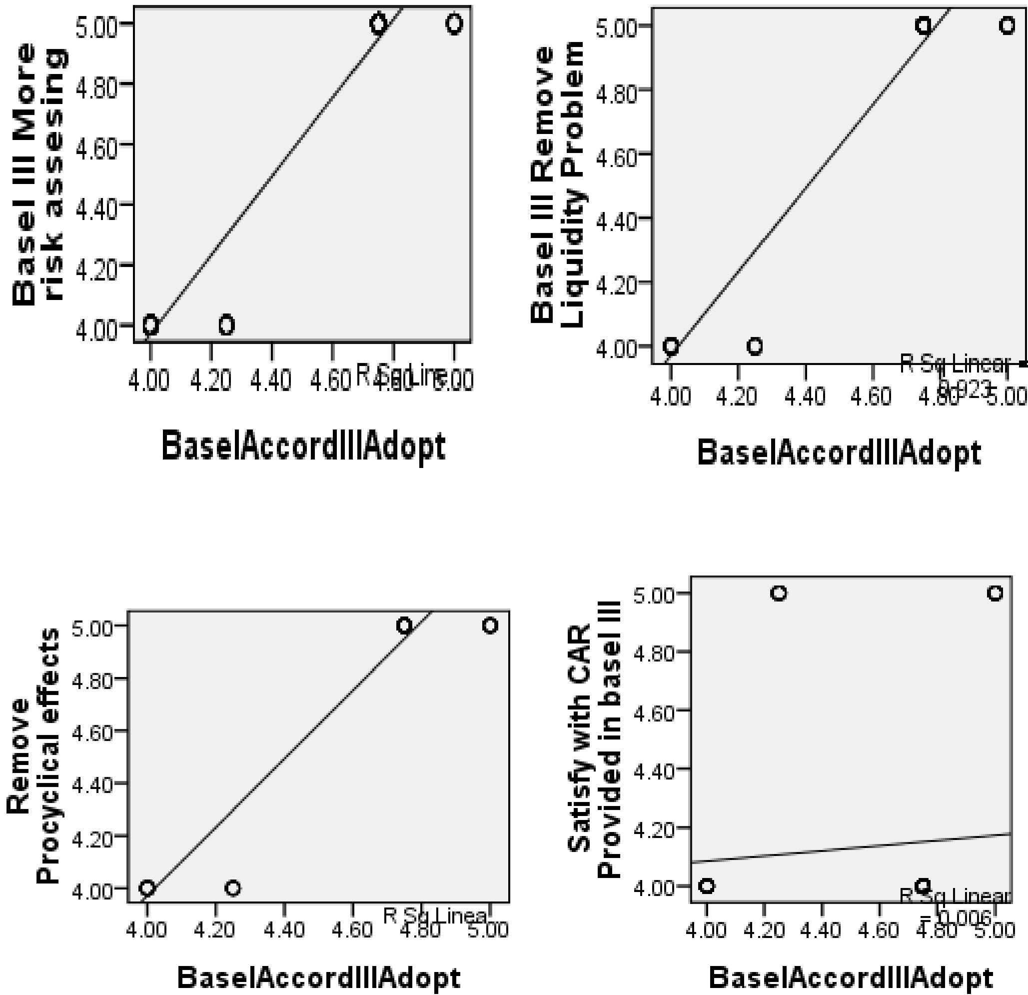
The value of beta of Problem Quality Data = 0.623 it means that if there is one unit increase in problem of quality data the dependent variable (Failure of Basel Accord II) will increase by 0. 623 units and vice versa.

The value of beta of Problem Pro-cyclical effect = 0.272 it means that if there is one unit increase Problem Pro-cyclical effect the dependent variable (Failure of Basel Accord II) will increase by 0. 272 units and vice versa.

The value of beta of Problem credit rating provided by external sources = 0.623 it means that if there is one unit increase in Problem credit rating provided by external sources the dependent variable (Failure of Basel Accord II) will increase by 0.623 units and vice versa.

5.4- Reasons to adopt Basel III:

For the analysis of reasons to adopt the Basel III accord we take the following results and find the reasons:



According to the all above scatter plots we said that the dependent variable (reasons to adopt Basel III) has positive relationship with all independent variables (Remove Pro-Cyclical Effect, Satisfy with CAR, Solve Liquidity problem and more risk assessing technique)

For further analysis we develop the regression equation on our data. The results of regression equation are as follows:

Regression:

For further analysis we draw the regression equation whose results are as follow:

Table # 1

Model	R Square
1	1.000

Table # 2

Model	Beta	Sig.
(Constant)		.000
Basel III More risk assessing	.405	.000
Basel III Remove Liquidity Problem	.608	.000
Remove Pro-cyclical effects	.741	.000
Satisfy with CAR Provided in Basel III	.284	.000

a. Dependent Variable: Basel Accord III Adopt

The value of R square = 1.0 indicates that 100% changes in dependent variables are coming from independent variables and 0% changes due to other variables and dependent variable (Basel Accord III adopt) has a significant relationships with all independent variables (Remove Pro-Cyclical Effect, Satisfy with CAR, Solve Liquidity problem and more risk assessing technique) because the value of significant = 0.000 in all the cases.

The value of beta of more risk assessing technique = 0.405 it means that if there is one unit increase in more risk assessing technique the dependent variable (Basel Accord III adopt) will increase by 0. 405 units and vice versa.

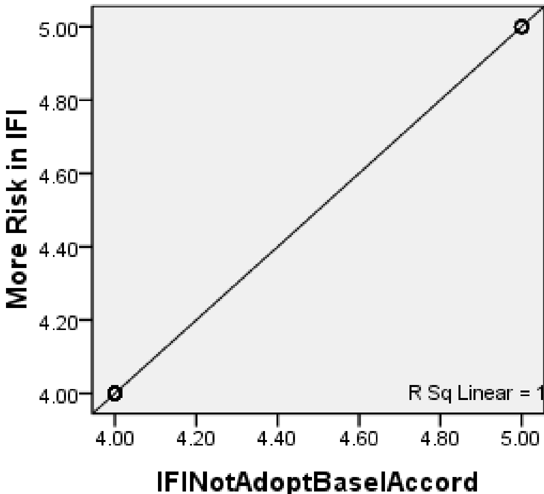
The value of beta of Solve Liquidity problem = 0.608 it means that if there is one unit increase Solve Liquidity problem the dependent variable (Basel Accord III adopt) will increase by 0. 608 units and vice versa.

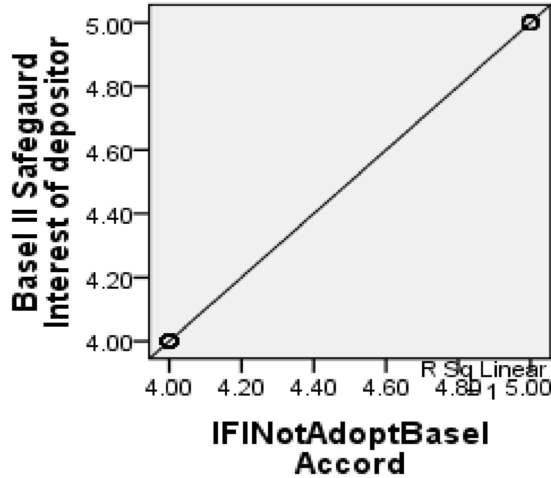
The value of beta of Remove Pro-Cyclical Effect = 0.741 it means that if there is one unit increase in Remove Pro-Cyclical Effect the dependent variable (Basel Accord III adopt) will increase by 0.741 units and vice versa.

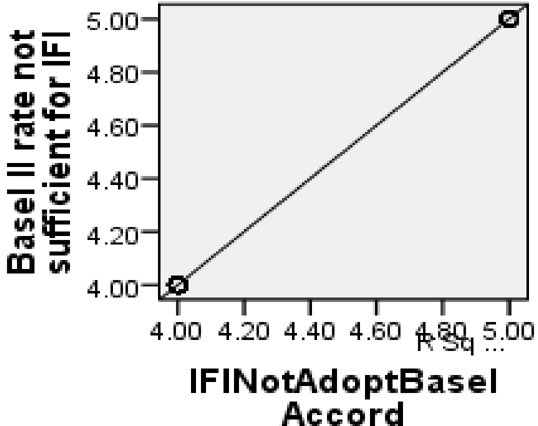
The value of beta of Satisfy with CAR = 0.284 it means that if there is one unit increase in Satisfy with CAR the dependent variable (Basel Accord III adopt) will increase by 0.284 units and vice versa.

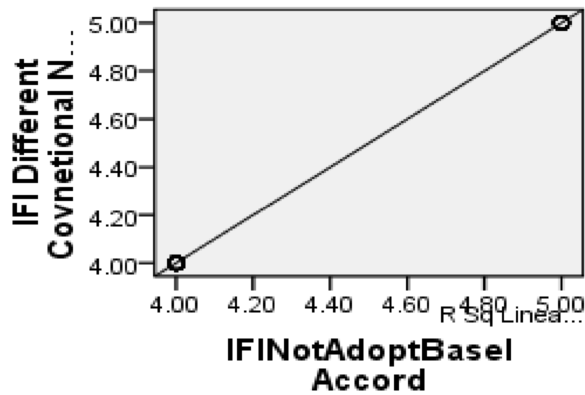
5.5- Basel Accord and Islamic Financial Institutions:

For the analysis of Basel Accords on Islamic Financial Institutions we plot the scatter plots:


5.00
4.80
4.60
4.40
4.20
4.00
More Risk in IFI
R Sq Linear = 1
4.00
4.20
4.40
4.60
4.80
5.00
IFINotAdoptBaselAccord


5.00
4.80
4.60
4.40
4.20
4.00
Basel II Safegaurd
Interest of depositor
R Sq Linear
= 1
4.00
4.20
4.40
4.60
4.80
5.00
IFINotAdoptBasel
Accord


5.00
4.80
4.60
4.40
4.20
4.00
Basel II rate not
sufficient for IFI
R Sq ...
4.00
4.20
4.40
4.60
4.80
5.00
IFINotAdoptBasel
Accord



According to the all above scatter plots we said that the dependent variable (IFI not adopt Basel Accord) has positive relationship with all independent variables (More risk in IFI, Basel safeguard the interest of depositor, Basel II CAR is not Sufficient and IFI different from conventional Banking).

Regression:
For further analysis we draw the regression equation whose results are as follow:

Table # 1

Model	R Square
1	1.000

The value of R square = 1.0 indicates that 100% changes in dependent variables are coming from independent variables and 0% changes due to other variables and dependent variable

Table # 2

Model	Beta	Sig.
(Constant)		.000
Basel II Safeguard Interest of depositor	.241	.000
More Risk in IFI	.236	.000
Basel II rate not sufficient for IFI	.248	.000
IFI Different Conventional Not adopt Basel	.916	.000

a. Dependent Variable: IFI Not Adopt Basel Accord

Dependent variable (IFI Not Adopt Basel Accord) has significant relationships with all independent variables (Basel II Safeguard Interest of depositor, More Risk in IFI, Basel II rate not sufficient for IFI and IFI Different Conventional Not adopt Basel) because the value of significant = 0.000 in all the cases.

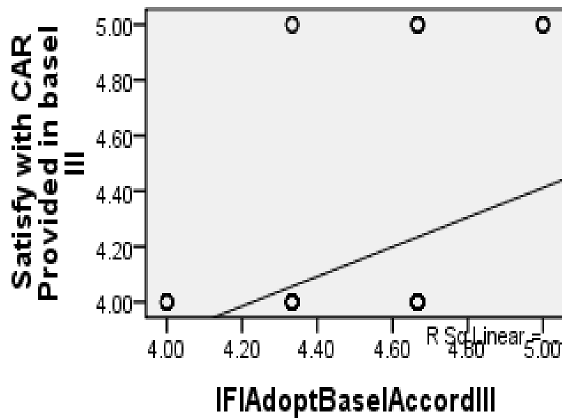
The value of beta of Basel II Safeguard Interest of depositor = 0.241 it means that if there is one unit increase in Basel II Safeguard Interest of depositor the dependent variable (Basel IFI Not Adopt Basel Accord) will increase by 0. 241 units and vice versa.

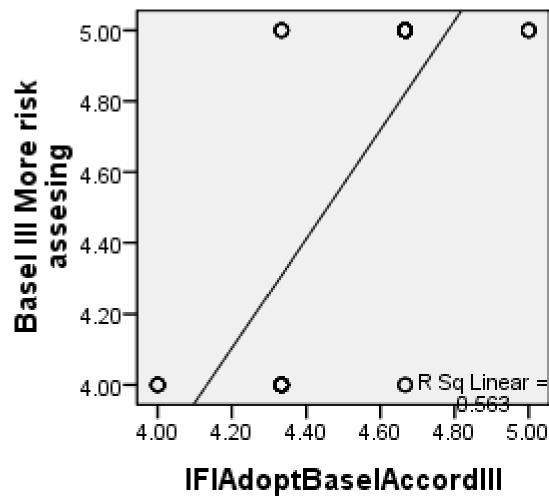
The value of beta More Risk in IFI = 0.236 it means that if there is one unit increase More Risk in IFI the dependent variable (IFI Not Adopt Basel Accord) will increase by 0. 236 units and vice versa.

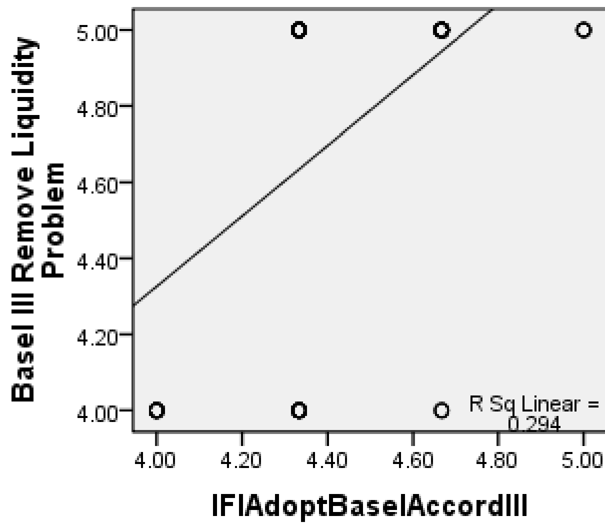
The value of beta of Basel II rate not sufficient for IFI = 0.248 it means that if there is one unit increase in Basel II rate not sufficient for IFI the dependent variable (IFI Not Adopt Basel Accord) will increase by 0.248 units and vice versa.

The value of beta of IFI Different Conventional Not adopt Basel = 0.916 it means that if there is one unit increase in IFI Different Conventional Not adopt Basel the dependent variable (IFI Not Adopt Basel Accord) will increase by 0.916 units and vice versa.

For further analysis we need more scatter plots to check the relationships between the variables.







According to the all above scatter plots we said that the dependent variable (IFI should adopt Basel Accord III) has positive relationship with all independent variables (More risk assessment, Solve liquidity problem and More CAR Ratio).

Regression:
For further analysis we draw the regression equation whose results are as follow:

Table # 1

Model	R Square
1	1.000

The value of R square = 1.0 indicates that 100% changes in dependent variables are coming from independent variables and 0% changes due to other variables and dependent variable

Table # 2

Model	Beta	Sig.
(Constant)		.000
Basel III More risk assessing	.684	.000
Basel III Remove Liquidity Problem	.569	.000
Satisfy with CAR Provided in Basel III	.477	.000

a. Dependent Variable: IFI Adopt Basel Accord III

Dependent variable (IFI Adopt Basel Accord) has significant relationships with all independent variables (Basel III More risk assessing, Basel III Remove Liquidity Problem and Satisfy with CAR Provided in Basel III) because the value of significant = 0.000 in all the cases.

The value of beta of Basel III More risk assessing = 0.684 it means that if there is one unit increase in Basel III More risk assessing the dependent variable (Basel IFI Adopt Basel Accord) will increase by 0. 684 units and vice versa.

The value of beta Basel III Remove Liquidity Problem = 0.569 it means that if there is one unit increase Basel III Remove Liquidity Problem the dependent variable (IFI Adopt Basel Accord) will increase by 0. 569 units and vice versa.

The value of beta of Satisfy with CAR Provided in Basel III = 0.477 it means that if there is one unit increase in Satisfy with CAR Provided in Basel III the dependent variable (IFI Not Adopt Basel Accord) will increase by 0.477 units and vice versa.