IMPLEMENTATION OF THE BASEL III AND ITS EFFECT ON BAHRAIN'S BANKING SECTOR

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Abstract

The financial crisis which occurred in 2007 and 2008 has had a major impact on the global banking industry. As a result, many banks went bankrupt or the governments had bailed them out. Thus, to protect banks against such a situation, the Basel Committee on Banking Supervision (BCBS) had scrutinized and altered the banking regulations, termed as the Basel III. The purpose of this study is to analyse the Basel III paradigm and its impact on the banks' financial health of Bahrain. This kind of study will enhance the understanding of Basel III and its impact on banking sector for researchers of GCC in general and Bahrain in particular.
The approach of the study is qualitative, whereas the theoretical framework has been used in the literature review. The empirical results were acquired from the interviews of various personnel from banks in Bahrain to gauge their perspective on Basel III paradigm. The overall perspectives of the banking personnel about Basel III were that it should have more stringent requirements. In this case, the capital requirements are considered to be too low and the risk weights are too unrealistic. However, majority of the banking personnel are still optimistic that Basel III does grant superior protection, but it doesn't provide complete protection against the chance of failure. According to the research findings, majority of respondents were optimistic and feel that it does help in protecting the banks, while others consider it completely useless and failed to prevent failures.

Keywords: Basel III, Risk Management, Banking Regulations, Financial Crisis, Basel Committee on Banking Supervision

1. BACKGROUND

Economic growth is largely dependent on banks and financial institutions since they act as a means for provision of financial services to businesses and individuals (Rabiul, 2010). Therefore, in order to bring stability to the banking system and to mitigate the risk factors associated to the failure to meet obligations, banks do not have a choice but to comply regulations at home and abroad set by the different regulators. Moreover, the trust of stakeholders can be retained with a healthy regulatory environment (Watanabe, 2011). The recent financial crisis revealed the existing systematic risk in the financial system which approached a complete collapse of the global financial system, due to linkages among banks and securities markets. Regulations such as the Solvency II and Capital Requirement Directives have been established in order to level with the risk factors in the banking system. However, in this research paper, the main focus will be on the "Basel III".

With the emergence of the global financial crisis, the flaws in the existing financial system came to light and called for efficient regulatory frameworks. Excessive off-balance-sheet leverage, inadequate capital, poor quality capital and insufficient risk management for liquidity were among the main flaws for the banks. These issues led to trading and credit losses. This conclusion was also confirmed by Stefan Water, the General Secretary of the BCBS as follows: *"The vulnerability of banking sector to the build-up of risk in the system was primarily due to excess leverage, too littl e capital of insufficient quality, and inadequate liquidity buffers".* The Bank for International Settlements (BIS) claims that in the absence of a holistic overview of the current capital position of banks, an efficient and effective estimation of relative risk factors could not be possible (BIS, 2010a). The lack of consistency in capital requirements and the management of risk weighted assets among various jurisdictions were expressed by the aggravating matters which in turn were leading to the failure of making a comparison between quality and sufficiency of capital for financial institutions in various countries. Therefore, in light of such events, a number of new initiatives in December 2010 were taken by BCBS such as

introduction of a new regulatory capital and liquidity regime, called the Basel III. It was believed that with the implementation of these regulatory reforms, the global capital standards will be strengthened more efficiently compared to Basel II.

According to the Basel III, the level of capital requirements and the proportion of reliable assets have been significantly increased. In addition to that, leverage and liquidity ratio have been introduced to ensure assets liquidity. The implementation of Basel III was slowly incorporated in the banking system since 2013. By the year end 2019, all the banks across the globe are expected to completely adopt the Basel III framework (BIS, 2011). However due to difference in regulatory, socio-cultural environment, the implementation of Basel III will be different in various jurisdictions. In order to comply with national regulations, small changes have been brought to the regulatory framework. However, in jurisdictions such as the EU, the Basel III is in accordance to the standards of Basel II and has therefore not demanded any adjustments.

According to the oppositions faced by the introduction of Basel III, there may be difficulty in raising capital, as it requires larger investments, more compliance, financial resources and efforts. In addition to that, the pressure on banks is increased with the squeezing of profit margins. According to a Quantitative Study Impact (QSI) conducted in December 2010, Group I banks require an additional capital of over €577 billion, and Group 2 banks require about €25 billion to meet the requirement of Basel III. However, this cost is exclusive of the skilled employees and new strategies etc. (BIS, 2010a). Following Kingdom of Saudi Arabia, Kingdom of Bahrain is the second Gulf State to accept the Basel III. In order to bring changes to the regulatory environment in Bahrain, the Central Bank of Bahrain (CBB) has released an efficient high level strategy for 2013-2019.

1.1. Research Aims

The primary aim of the research is to comprehend the potential effect of Basel III on banks in Bahrain. The goal is to scrutinize the implementation of the new regulation paradigm and its effect on Bahrain’s banking sector.

1.2. Research Objectives

The objectives of the current reseach will be to critically evaluate the perception of bank employees towards the implementation and future of Basel III in Banking Sector of Bahrain.

1.3. Structure of the Research Paper

The research paper is divided into five parts. First part deals with background of the study, research aim, and research objectives. The second and third part deals with literature review including research framework and research methodology respectively. Forth part deals with findings of the research. The last section deals with conclusion, recommendation, limitations and area of future researches.

2. LITERAUTRE REVIEW

2.1. Fiscal Regulations

Microprudential and macroprudential regulation are the two approaches to run any fiscal body (Goodhart et al, 2013). Basel Accord was founded on the principles of microprudential approach, however, later on in Basel III, macroprudential regulation approach have been incorporated. To put it in a nutshell, microprudential regulation system strives to benefit the individual financial institutions at the basic level, whereas macroprudential regulation system addresses and minimizes the risks and threats at the financial system level (BIS, 2010b).

2.2. Global Financial Crisis

The financial crisis of 2007 highlighted some of the flaws prevalent in the Basel II system; Internal Rating based (IRB) approach was being one of the examples. So, it was essential for the Basel Committee to address these shortcomings. Thus, the efforts by the committee led to the inception of a new framework altogether, Basel III (BIS, 2010a). Chang (2010) is of the opinion that the overvaluation of the housing market in US in 2006 that initiated the crisis. Loans were granted easily to the buyers, such as mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) as the housing market prices were generally believed to be increasing. Such tools helped avert the risks associated with loans towards the investors; thus, making the lenders more willing to grant loans. Hence, the expansion of the market of these financial tools or securities attracted the interest of the investors from all around the globe in the housing markets of the US. However, in 2006, the interest rates rose to an all-time high, while the housing market started to decline. This led to the collapse of the market and had wider implications than the US itself. MBSs and CDOs were considered to be these innovative tools until the financial crisis; as they were a means of bypassing regulation, although they were successful in increasing the credit flow (Chang, 2010). The decline in the house prices and subsequent collapse of the housing market led to the realization that these financial innovations were hard to price (Acharya et al, 2009). Moreover, it was observed that they had a larger risk associated with them than expected and the complexity of these tools compelled the banking regulators to leave the decision of risk pricing up to the banks themselves (Chang, 2010).

2.3. Basel III Accord

Went (2010) stated that the Basel III has combined the risk-based capital and liquidity standards to minimize the damaging ramifications of the banking crisis. Blundell-Wignall & Atkinson (2010) further argued that the impact of Basel III are not yet that apparent and depend upon a number of related factors. Went (2010) has also stated that in order to increase the liquidity, banks need to be in possession of low-yielding liquid assets. This implies that the amount of high-yielding assets would naturally decrease and would result in lesser returns for the banks and the banking industry as a whole. Thus, to accomplish the capital requirements, the

bank would have to raise new capital and issue new types financial securities. In this way, the value of the capital as well as the returns can be increased. Moreover, capital can be raised in a number of different ways, such as reducing the dividend pay outs. This strategy would lead to reduced capital costs, funding expenses and equity risk premiums for the banks (King, 2011).

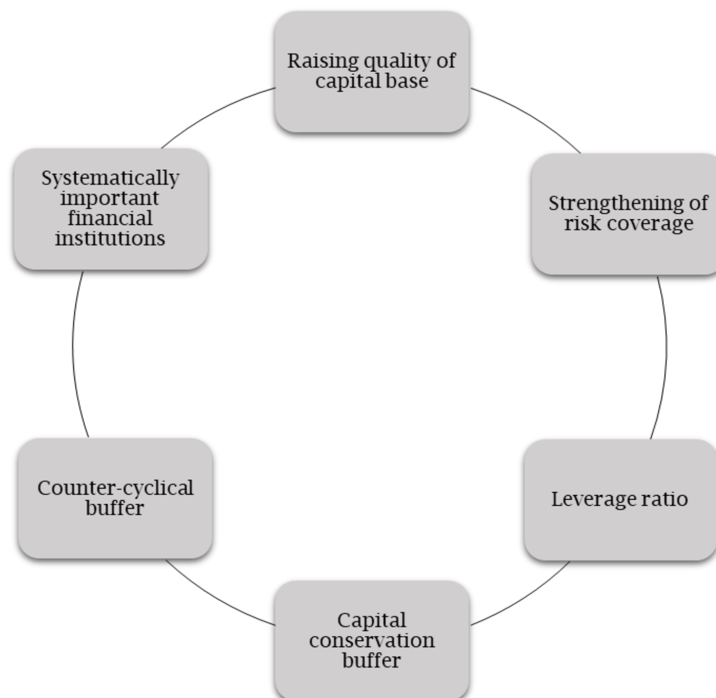
Effective mediation of the banking industry will subsequently decrease with the decrease in its exposure to high-risk weights, so that the higher capital demands can be achieved, according to Went (2010). This counter-cyclical buffer has been perceived as a positive as it facilitates in the reduction of excess credit creation and was viewed as a positive long term prospect. The higher capital costs arising because of the implementation of new regulations would be significantly reduced with this practice (King, 2011). This means that the credit costs, that had to be increased by the banks previously, would be reduced. Went (2010) further highlights another positive aspect of the Basel III, which is that it makes the banking industry self-reliant and totally independent i.e. not requiring government aid for the progression of the industry. Thus, it would help in minimizing risk premium related to the risks of the industry as a whole.

In the conclusion of his evaluation, Went (2010) emphasized upon some of the major characteristics of Basel III; pro-cyclicality, shadow banking system, implementation, SIFIs and centralized counter-parties. In regards to pro-cyclicality, Went (2010) & King and Tarbert (2011) believed that although steps are being taken in the right direction, a major point is missing in those efforts. The shadow banking system is not specifically encompassed in the regulations of Basel III; however, they have the potential to become a source of credit (Lyngen, 2012). As such, pro-cyclical effects may be the result of the system or the banking industry itself. It is up to the choice of the countries in how they wish to incorporate Basel III into their respective systems. In fact, Basel III is still in its infancy in regards to being universally adopted, as many of the countries are still following the Basel II accord (Aathira and Shanthi, 2012). Thus, the effects of Basel III cannot be accurately gauged. There exists a threat of banks shifting their businesses to localities where the regulations are not imposed as strictly. The purpose of SIFIs is to hold larger capital buffer and the market for OTC derivatives is shifted to central counter-parties (King and Tarbert, 2011). According to Went (2010), it would bring about significant attention towards SIFIs as well as systematically promoting the central counter-parties. He further elaborated that this effect could potentially prove to be seriously damaging in case of a SIFI going wrong, as previously observed during the crisis. Lyngen (2012) strongly suggests that the events of the crisis should be carefully understood so that we could learn from them and the ultimate success of Basel III solely depends upon how the rules and regulations would be implemented in the future.

2.4. Basel III Framework

The main objective of the evolution of Basel II into Basel III was to refine the structure of the banking industry (Cardone et al, 2011); as well as to address the failures that were prevalent in the financial distress. The three pillars of Basel II are further expanded to establish Basel III, which emphasizes upon increasing the quantity and the quality of the capital and to develop a stronger base of risk coverage (West, 2010; King and Tarbert, 2011 & Cardone et al, 2011). The new features introduced in the Basel III are as follows:

Figure 1. Basel III framework



2.4.1. Raising Quality of Capital Base

The crisis served to demonstrate that the capital had not been adequately defined, which lead to the difficulty in the assessment of the capital; thus, highlighting the need for a high quality capital base. The hybrid capital, which is the combination of debt and equity, introduced in Basel II, reaching up to 15 % of Tier 1, would be phased out (Erel et al, 2011). Hybrid capital serves as equity for depositors and on the other hand serves as debt for tax reasons (King and Tarbert, 2011). High quality capital, such as equity and retained earnings, has been included in the new definition of Tier 1 capital (BCBS, 2011a).

2.4.2. Strengthening of Risk Coverage

The crisis highlighted that the risks, related to the derivatives and other on and off balance sheets, had been under estimated. These flaws had already been addressed by the BCBS by refining the framework of Basel II in 2009. This led to the increase in capital requirements for trading books and other securitization exposures as 2011 came to an end. The features of Basel III will be implemented by undertaking measures that would serve to make the capital requirements for counter-party credit exposure stronger (Ackermann, 2010). The main aim would be to increase the capital buffers backing these exposures and to decrease the pro-cyclicality in the overall industry, accompanied by other measure, to limit the systematic risk. The other measures comprise of minimizing the counter-party credit risk or giving incentives to have over-the-counter (OTC) derivatives shifted to the central counter parties, as stated by BCBS (2011a).

2.4.3. Leverage Ratio

High leverage had been observed one of the primary causes of the financial crisis of 2007. The banks were forced to reduce their high leverage because of the crisis that led to the increase in the downward trends in the economic market. Thus, the leverage ratio requirement was featured in the first pillar of the newly introduced Basel III to prevent the damage. The leverage ratio would serve to identify the risks in the risk weights for capital requirement measures; thus, serving as a constraining factor (BCBS, 2011a). BCBS would examine a leverage ratio of 3 % under a period of supervision of banks' leverage ratios. The calculations for the leverage ratio should account for the balance sheets of the banks as well as the off-balance sheet items that can possibly be the cause of producing large leverage. Hence, they should be taken under consideration with 100 % value.

2.4.4. Capital Conservation Buffer

The factors that have magnified and increased pro-cyclicality has prompted the BCBS to pay attention to this matter. As a result of it, Basel III has included the capital conservation buffer among the steps taken to address the problem. The buffer would be established by the banks in the time when the industry would not be experiencing any downtime and it would then be used when the banks incur losses (Ackermann, 2010). This buffer is constituted other than the minimum capital requirement for the banks. BCBS (2011a) has stated that the banks need to establish this buffer in financially sound periods by reducing dividend and bonus payouts. This has been further explained that the capital conservation buffer is required to be at least to 2.5 % of the CET1 and is sought to be completely administered by 1st January 2019.

2.4.5. Counter-Cyclical Buffer

This is another type of buffer that serves the ultimate purpose of decreasing the pro-cyclicality. This buffer facilitates the banks in times when the credit is increasing. This protection is necessary because it leads to significant losses if the period of excess growth in credit is followed by a period of economic downturn (Mehran & Thakor, 2009). Such growth periods fall under the supervision of the national authorities, which would identify such periods and notify the banks of their need for counter-cyclical buffer. The counter-cyclical buffer also serves to enlarge the capital conservation buffer would lie between the ranges of zero to 2.5 %. This percentage is dependent upon the factors, relating to the geographic locality of the banks, which cast their influence upon the banks through their portfolio of credit exposure (BCBS, 2011a).

2.4.6. Systematically Important Financial Institutions

Those banks that are a part of the systematically important financial institutions (SIFIs), i.e. they are considered as systematically important, have to fulfill a special requirement (King, 2013). This is because large institutions are normally inter-linked with each other have the potential to impart the shocks to one another. Hence, they are required to possess a certain loss absorbing capacity that is more than the minimum standards set for other, smaller scale institutions. The capacity is generally required to range from 1 to 2.5 % based on the importance of the banks in the systematic framework (BCBS, 2011a).

2.5. Liquidity Standards

The liquidity requirements are the possibly the major change made with the introduction of Basel III (West, 2010). The losses that would be potentially incurred by the bank should be able to be waived off by the bank's capital. Capital would be able to account for these losses if it is liquid or can be liquidated easily (MAG, 2010). Previously, Basel I and II focused upon the capital of the banks only; however, the introduction of Basel III accompanied with it an added emphasis upon the liquidity on the outside of capital requirements (BIS, 2011). The capital could not be adequately liquidated and such a capital does not have enough capacity to bear the losses incurred. The standards of liquidity imply a minimum requirement of liquidity to be followed for short-term as well as long-term prospects separately (BCBS, 2011a). These standards are usually based upon the funding structure of a particular bank. Short-term funding helps in acquiring money in a short amount of time and is usually required to be

paid back within the span of a year. On the other hand, long-term funding serves to develop a capital structure of the bank and has a maturity of over one year. Long-term funding is the more preferred of the two as it grants more security to the bank, as per Casu et al. (2006).

2.6. Liquidity Coverage Ratio

Liquidity coverage ratio (LCR) refers to the short-term liquidity standard and serves to guarantee adequate liquidity for the banks for a period of 30 days. It implies that the banks should be confident that the liquid assets they possess would be enough to cater for any stressful circumstances (Mishkin and Eakins, 2008). These circumstances may include credit rating, partial loss of deposits, loss of unsecured wholesale funding, abrupt increase in secured funding haircuts and increases in derivative calls on OBS exposures. King (2013) further elaborate that the liquid assets of the banks should be able to steer them through distressing circumstances for 30 days.

2.7. Net Stable Funding Ratio

Net stable funding ratio (NSFR) is the long-term liquidity standard and should be able to guarantee adequate liquidity for a period of more than one year (Kings, 2013). This ratio provides the banks with a minimum amount of stable funds for a period of one year. A minimum amount of assets is required to account for and fund the long-term liquidity assets. This minimum amount is based upon and derived from long-term assets liquidity risk (BIS, 2011a).

2.8. Basel III and Bahrain Banking sector

Bahrain is a small island state in the Middle East. Apart from the oil and gas sector, Bahrain's GDP majorly comprises of contributions from the financial services sector. As per 2015 yearly report of the CBB, the country's GDP consists of 17.2 % contribution from the financial sector. Till September 2016, there were 404 financial institutions, with 13,887 people workforce in Bahrain. The largest section of Bahrain's financial structure is its banking structure. More than 85% of the accumulated financial assets are represented by the banking sector, consist of Islamic and conventional, and is the main reason for the growth of Bahrain's economy (EL-Quqa et al, 2009). The International Association of Insurance Supervisors, Basel Committee and the International Organization of Securities Commissions has introduced international principles for organizations to follow and majority of them are adopted and followed by CBB. In addition, the licenses issued by the CBB have to undergo a combination of evaluation and tests. CBB's own examiners and specialists, along with offsite overseers take these assessments themselves. The examiners' main concentration is to investigate its financial report and supervisory revenues. They hold meetings with the licensees to monitor their strategy and to review their performance and resources acceptability (CBB, 2015). A requirement, to apply, at least, 12 % capital competence ratio, was a must for all the banks in Bahrain before 2013, and was assessed using the regulations of Basel II. But now, the rules have been reviewed to come across the necessities of Basel III. Apart from Saudi Arabia, which sketched Basel III and is an associate of the Basel commission, Bahrain has been the first to implement the Basel III in the Arabian Gulf. (Reuters, 2015). CBB asked the local banks, in 2010-11, to participate in two different measureable impact calculations in order to provide them with knowledge of how the Basel III has affected them in terms of capital acceptability and balance sheet. The official application of the Basel III procedure began on 27th November, 2012, with the CBB circulars, for which proper writing was required of their liquidity ratios and capital acceptability. In 2013-14, the reports were handed over, along with the Basel II PIR for the purpose of broadcasting. This was done only until December, 2014.

3. RESEARCH METHODOLOGY

The main objective of this study is to discover and assess the overall effect of the Basel III on the banking sector in the Kingdom of Bahrain. Ethridge (2004) points out that there are two main approaches to the research methodology; the qualitative research method and quantitative research method. In this research, we are using qualitative approach only.

3.1. Research Philosophies

According to Bryman & Bell (2007) and Yin (2014) different research philosophies such as the concepts of interpretivism and positivism should be clearly made distinctive. As for this research, an interpretivism approach was followed by the researchers as there were multiple situations and events which were to be explained as per specified scenario in its individual context.

3.2. Research Approach

As the Basel III framework has not been put in to practice completely in the Kingdom of Bahrain, thus the qualitative method technique is applied as no data exists that can be compared. For this study, an inductive approach is used by the researcher as this study does not contain a theory or a hypothesis that has to be tested. This study makes use of the deductive approach which allows the researcher to draw unlimited information from the available resources and come up with a newer or refined theory.

3.3. Secondary Data

The secondary data such as refereed academic journals and various websites were used. The more the data is gathered from different sources, the better the quality of the literature reviews would be. The data for this research was collected from different financial journals, banking regulation journals and management journals which helped the researcher to make sure that the information used was reliable and sufficient to provide answer to the research question and meet the aims of the research.

3.4. Primary Data

For this study, the interview sessions were conducted which were semi-structured in nature. Even though the use of semi-structured interview does not ensure the reliability or validity of the data when compared to structured interview, however, it is considered a more convenient way to extract the data as required by the researchers.

3.5. Interviews

In order to gather the primary data, interview sessions were planned as the researcher opted for using the qualitative approach. There are two types of interview as explained by Saunders et al (2009), standardized interview and non-standardized interview where the former comprises of questions which are readily available for the participants to answer and the latter is made up with questionnaires which are not standardized and can be changed according to the responses of the participants. For this research, non-standardized interview questions were used as the Basel III is comparatively new regulation to Bahrain and thus would have had low responses if the standardized version of questionnaires was used. The researcher prepared the interview questions after reviewing numerous academic material and journals on the research topic. The pilot study was conducted on five banks employees. It ensured that there were no biases remaining which might have made the respondents feel uncomfortable.

3.6. Participants Selection

The participants of the interview sessions were working in the banks in the senior managerial positions and knowledgeable in their fields. The researcher reached out to the only regulator in the country for managing the financial system, the CBB. One of the hardest things for the interviewer was to find the right people. The website of the bank only provided contact details of a small number of the sample population thus the researcher emailed different heads of departments to forward the request of participation to the relevant personnel in their respective departments. Total 12 participants took part in this research.

3.7. Validity and Reliability

It is highly imperative for an effective research to validate and verify the gathered data to ensure its reliability. According to Jackson (2014), there is no huge difference between the concepts of reliability and validity thus they are often mistaken for the same meaning. However, for any qualitative research, there is a difference between the two concepts, where the reliability is the precision and accuracy of the research findings and validity, according to Collis and Hussey (2013) is the degree to which a researcher measures the tests of the research till the desired results are achieved. Silverman (2013) & Yin (2014) are of the view that the research process should be applied accurately to ensure the validity of the research such as utilizing the correct techniques for analysis of the gathered data through interview. The researcher, for this study, conducted the interview sessions and summarized the answers which allowed the correction of any wrongly stated or misunderstood opinion so as to ensure the validity of the information gathered. Further to this, only the validated literature was made part of the research, for instance, internationally approved bank papers on the subject of international settlement.

3.8. Thematic Analysis

This method comprises of various distinct stages; the five stages include familiarization, thematic framework identification, indexing, mapping/chartin g, and lastly interpretation. In the last fragment, the main ideology of the analysis is explained. A case study approach was taken on as the researchers had limited prior knowledge of the subject matter at hand in addition to the time constraints which didn't allow for the interviewee's story to be completely empathized (Bryman and Bell, 2007). Despite the limitations, the researcher carried out the interviews themself and then went over them; which in turn benefited them as they then had a better understanding of the matter and associated concepts. This process assisted in achieving the goals of first step of the analysis i.e. familiarization. Moreover, the core of the conceptual framework formed the foundations of the questionnaires and interviews; even though the data was still in the raw form and had not yet been processed, the subject matter was recognizable and this facilitated in comprehending the 'identification' step. The themes that were recognized during the process are given in common themes section. Additional literature was studied and secondary information sources were consulted in order to compliment the evaluation and comprehension of the matter at hand.

3.9. Common Themes

Five common analysis themes with two questions per theme were organized to evaluate the research agenda in a systematic way. The themes and questions included in each theme are listed in Table 1.

3.10. Data Analysis Technique

The research is divided into multiple distinct yet interlinked stages in thematic analysis and then each step is evaluated one by one. In addition to being an efficient yet easily controlled approach, this technique also helps in the recognition, investigation, classification, and clarification of the problems, which are the attributes of a sound qualitative study.

Table 1. Common themes of research analysis

Theme	Questions
Perception regarding Basel III in Bahrain	Is the Basel III platform suitable to mitigate financial risk in banks of Bahrain? What are the probable advantages and disadvantages of implementing Basel III in Bahrain?
Implementation of Basel III in Bahrain	How are Bahraini banks implementing requirements of Basel III? Are there any hurdles or barriers in the way of executing the Plan's requirements?
Possible substitutes or upgrades for Basel III	Would you like to see any additions or deletions in the Plan? Do you believe some other substitute plan or strategy exists to cope with the challenges of global financial risk? How do you propose Basel IV should be strategized to further improve the present Basel III Plan?
Basel III and Global Financial Crises	Is Basel III alone capable of addressing the inherent risk associated with banking sector risks? Do you believe that Basel III will put down the risk of future global crises and will work, especially to safeguard Bahrain's banks?
Future of Global Banking	Do you see the nature of financial crises changing in future, especially in Bahrain? In future, what kind of improvements and obstacles do you see in the global banking sector?

4. FINDINGS AND ANALYSIS

A group of twelve research participants were involved in a focus group analysis. The participants involved representatives of the banking industry in Bahrain and included financial analysts, banking sector employees and auditors. Representatives from both Islamic and conventional banks were included in the discussion however as the Islamic banking sector occupies significant proportion of Bahrain's financial market, its representation was also kept in greater ratio (seven out of twelve participants belonged to this sector). Opinion of all respondents was recorded and verified against secondary sources. The findings from the exercise and analysis based on these findings are presented below.

4.1. Perception Regarding Basel III in Bahrain

Seven of the eight focus group participants agreed that Basel III is in fact helping Bahraini banking system head in the right direction and become at par with some of the best banking regulations practiced in the world. They believed that if Bahrain was to encourage investors both local and foreign as well as take measures to boost market confidence, it had to take steps towards mitigating financial risk within banking sector. Basel III can then provide a platform to secure the Bahraini banks against factors such as the ones experienced in the 2007-08 financial crisis. Furthermore, implementing the Basel III would allow Bahrain to be seen as a proactive risk preventer on global platform.

Three respondents however saw Basel III as a move to overburden Bahraini banks and noted that it may cause a slowing down of economic progress by lowering GDP figures at least temporarily. For struggling small and medium sized banks, the capital regulations may prove difficult to implement. Increasing capital will have a direct impact on institutional investment in Bahrain which will see a downward trend in coming years. One respondent said that most Bahraini banks may not really be ready for Basel III as yet and considerable financial strengthening of the economy was a pre-requisite to implementing the Plan.

According the 2011 Report on Bahrain by Oxford Business Group, Central Bank of Bahrain (CBB) has initiated a number of reforms including mandatory application of Basel III Plan by Bahraini Banks. KPMG Report notes that Bahraini banks are significantly capable of implementing the capital requirements and leverage rates (KPMG, 2011). However, the OECD's economic department believes that Basel III implementation, especially in developing economies may decrease GDP growth (OECD, 2010). This shows that Bahrain would have to move carefully and implement the Basel III gradually to avoid a harsh impact on economy.

Participants were then asked to identify the possible advantages and disadvantages of implementing Basel III in Bahrain. Most participants agreed that in the longer run, the agreement will benefit the Bahraini banks however authorities and international monetary organizations may have to help the smaller and medium-sized banks to make full use of the Basel III accord.

Among its advantages, one participant said that Basel III offers a much more reliable and sharp definition of capital compared to its predecessors: Basel I and II. He also noted the increase in capital requirements as a positive measure to improve banks' resilience. Two other participants saw the new introduction of the 'liquidity ratio' concept as a strong point of the accord and said that it will boost investor confidence to know that banks have measures in place to withstand stress for a defined period when crisis hits. Most participants saw the Basel III accord as an urgently needed plan to address future financial crises before they have serious consequences for local and international banks. The 2007-2008 crisis opened the eyes of regulators and taught banks to put in place mitigation measures for such risks in future.

Participants also pointed out the bleaker side of the accord. In response to the improve credit definition argument, a local Bank Operational Manager noted that emerging bank market such as that of Bahrain, usually consisted of equity and reserves. One bank manager noted that classification of sovereign debts as 'zero risk' debts was questionable as all debts have an element of risk. For most Bahraini banks, according to one other participant, requirements to increase capital are difficult to implement. Interestingly, a participant also added that Basel III provides flexibility to some extent regarding financial activities, which will give cover to certain entities to misuse the leverage provided under the accord.

Analysis shows that Bahrain performed better than most Middle Eastern economies during the 2007-8 and has since then taken overreaching steps in curbing the risks of such future crises on its economy. Basel III comes as a significant development in this endeavour and has potential to raise Bahraini banking sector to international standards. The potential drawbacks of the accord can be overcome by adequate external auditing and monitoring by relevant financial authorities.

4.2. Implementation of Basel III in Bahrain

Five respondents said that Bahraini banks were still in the process of inculcating the regulations of Basel III accord in their operational models and the task is likely to be achieved by the end of 2016. The new stricter banking rules, they added contained elements of loss absorption mechanism. Loss absorption may be converted into equity, if issuer expects insolvency. Two bank managers, however, added that guidelines from the CBB although received, needed certain revisions before they could be put in effect by big and small banks. Bahraini banks, for instance, could not issue subordinate debts as of now because of lack of regulations in this respect. A representative of an Islamic Bank in Bahrain said that Islamic banks should look into their strategic business and services decisions to be able to cope up with changing global market dynamics.

The CBB has drafted regulations for both Conventional and Islamic banks to bring the Basel III guidelines in effect by early 2015. Under the accord, Bahrain would require tier 1 losses to be absorbed by converting them into common shares or through a stage-wise approach, which does not overburden the holders of the instruments with heavy loss. According to the AAOIFI, which includes 200 members from 40 countries representing conventional banks, Islamic finance institutions and other monetary organizations, the Islamic banking sector, while performing satisfactorily, could further accelerate growth through the Basel III implementation, in Shari'ah-compliant ways (Vinnicombe, 2012).

The major hurdle identified by four participants was that small and medium sized banks were unable to realize the capital requirements and liquidity rates. Under the accord, overnight deposits by banks would have to be lowered and corporate treasuries would have to get used to that. Deposits are a major way for banks to earn and make money. In return, banks are likely to push some of the liquidity risk on corporate treasury customers. Another limitation identified by some respondents was the Plan's inability to address the Islamic Banking sector adequately and that alternate measures for liquidity and risk management needed to be introduced in this sector, which formed a significant part of Bahraini banking sector as well as international financial system.

According to Abu Hussain and Alajami (2012), the Islamic banking sector showed greater resilience to the 2007-08 GFC compared to conventional banks. However owing the Shari'ah requirements of interest-free transactions, Islamic banks are unable to hold liquidity management instruments such as government bonds. As these banks cannot obtain funds from the private market to cover their liquidity ratios, they are dependent on interest-free funding by the public sector. Most Islamic countries have adopted the Sukuk bonds as a means to provide liquidity management for Islamic financial institutions. These banks may then face problems in meeting the Basel III LCR and NSFR requirements and should be aided by emergency funds by the government in the form of LOLR (Abu Hussain and Alajami, 2012).

4.3. Possible Substitutes or Upgrades for Basel III

Having identified the possible pros and cons of the Basel III implementation in Bahrain, this theme endeavoured to obtain stakeholders' insight into the nature of plan and suggestions regarding amendments in the plan. While most members were satisfied that Basel III is the first step towards a thorough international risk mitigation strategy, some participants desired improvements. Two participants proposed an alternative strategy to cope with banking risks in Bahrain.

Four of the twelve group members explained their stance regarding the impacts of Basel III for developing economies of the ME. In their opinion, the accord was a blatant favor for developed economies and large international banking corporations as even large corporations in developing economies could not easily manage credit ratings. The sophisticated new 'stress testing' measures required under the liquidity management principle would offer serious technical challenges to local banks. Basel III was then seeking to homogenize the developed and emerging financial markets, which was not a workable solution. Aspirations of Basel III, according to respondents, could only be realized by a mutualistic cooperation between mature financial markets and struggling ones.

The World Pensions Council cites one limitation of Basel III as its intensive dependence on standardized assessment of 'credit risks', which results in strengthening anti-competitive policies (Ahmed, 2014). While respondents proposed no substitute solution, their views showed a desire to allow a stage-wise implementation with assistance from the government and donor agencies. According to the International Monetary Fund (IMF), the organization will assist those financial institutions seeking to implement Basel III principles in their operations (IMF, 2011).

Although the implementation deadline for Basel III is 2019, respondents were inquired about strategic reforms they believe should form a core part of the next accord. The failure of Basel I and II to stop the GFC of 2007 is an eye-opener for policy-makers to pay close attention to overcoming the deficits of the present accord. While not tested in crises situation yet, based on respondents' perspective, the current Basel III has certain strategic loopholes that must be addressed to enable emerging economies such as Bahrain benefit from its implementation.

Seven respondents believed that if Basel IV has to learn from the experiences of the present accord, the first would be to understand that the one-size-fits-all model does not suit the global financial risk assessment and measurement process. This point is also seconded in the OECD report which cites the criticism that this generalization underpins the credibility of modeling process under the accord (OECD, 2010). Basel IV, according to two respondents, should endeavour to form a homogenous strategy for treating promises that make up any financial system. Then there is the question of the shadow banking system and an adequate mechanism to address this sector.

According to KPMG, under Basel IV, the capital requirements will be made more stringent and banks

would have to increase the credit reserves (KPMG, 2011). This means that if emerging financial markets are not brought at par with the global market standards, there is a likelihood that these banks would fail to implement the standards. Basel III should therefore be homogenously implemented in all financial sectors: conventional and Islamic, to enable the next phase of financial reforms.

4.4. Basel III and Global Financial Crises

As per financial analysts and the CBB officials, Bahrain was surprisingly not as strongly affected by the recession as others (CBB, 2015). Most participants gave positive opinions about the Basel III and noted that they expected considerable improvement in global risk management. Two bank managers said that Basel III was rightly equipped to aid banks test their stress bearing capability and take measure to prevent liquidation. The leverage ratio would help banks prevent build-up of excess leverage that may lead to a 'credit crunch' during crisis. The OECD views this as a 'backstop' measure to prevent deleveraging crunch in banking system (OECD, 2014).

Two participants, however, gave the other side of the picture and viewed definition of high-quality capital as a positive move but disagreed with arbitrary risk-weights that encouraged pro-cyclicality of the banking industry. Another possible loophole of the accord may be the opacity of derivative regulation mechanism by not paying attention to measuring correlation of internal risk in banks (Ahmed, 2014). Keeping this debate in mind, Basel III is in no way a perfect financial risk containment policy, however, it is a large leap towards sustainable financial market compared to its predecessors. Banks should see Basel plans' implementation as a step-wise approach where one set of strategies is followed by the next (Basel IV) to achieve the ultimate objective – financial sustainability of the banking sector.

Considering the question about suitability of Basel III accord in preventing a future financial crisis in Bahrain and the ME economies in general, participants had mixed opinion. Some experts cited that the nature of Bahraini banks, in fact most ME banks were different from conventional financial market. Sharia's regulations and nature of market made these banks structurally different whereas Basel III measures were designed to suit conventional interest-based banks.

However, Reuters note that geographical areas where most Islamic banks operate (ME and Southeast Asia) have relatively stronger economies and can bear stress testing and credit regulations (Reuters, 2015). As most of these banks are free from derivatives in their balance sheets and risky assets, they performed better than their counterparts during crises. But Islamic financial must look for alternative credit bases such as Sukuk bonds and public credit in order to expand their credit reserves. This can help Bahraini banks better implement the Basel III accord within its market.

4.5. Future of Global Banking

Interestingly, eight of the twelve participants believed that a financial crisis was not preventable and was deemed to occur. What accords such as Basel III may do is to mitigate its impact and prevent a complete failure of global banking. According to the economist Alan Taylor, leverage measures show that today's financial sector is heavily dependent on private sector funding (Perugini et al, 2015). Therefore future recessions are likely to be much more painful and intense if and when it happens. According to a recent study conducted by IMF, Islamic banks showed higher resilience to the GFC than conventional banking sector however serious policy and regulatory loopholes surfaced (IMF, 2011). The largest Islamic banks are located in GCC including Bahrain and the sector is now too big to ignore. Islamic banking is not immune to the effects of the GFC and regulatory framework of these banks will not be able to impede an oncoming Recession in future (Helleiner, 2010). This means that ME economies should gear up and implement proactive measures to curb the effects of future crises.

Regarding future of the banking system, six respondents claimed that macroeconomic stability for the banking system would become difficult to achieve, increasing the probability of a future crisis or a local crisis exposed from global dimensions. Standard external auditing and monitoring tools will become necessary to prevent future crises. These tools are likely to be strategized in the upcoming Basel IV (OECD, 2010). Transparency of credit sources and publicity of bank reserves will serve to boost private sector confidence. Emerging economies such as those of the Gulf would have to devise appropriate measures to incorporate global risk mitigation policies such as the Basel accords to prevent another GFC.

5. CONCLUSION

Over the years, the Gulf economies have emerged as major world players in the financial market. Bahrain is one of the most significant developing economies of the Gulf with the second-highest valued currency unit in the world. Since the 20th century, Bahrain has heavily invested in the banking sector. Like most of the Gulf economies, Sharia's laws dominate the financial market and Islamic banking is an important part of the system. Research has shown that this particular banking niche was somewhat better able to absorb the shocks of the 2007 recession compared to conventional banking and Bahraini economy did not suffer a major blow during the period. However, Bahrain was among one of the first few Gulf countries to begin the process of implementation of the Basel III accord to strengthen its banks against a future crisis and to bring its financial market risk management standards at par with the international markets of the developed world.

The CBB outlined a strategy for implementation of the plan within larger and medium sized banks, both Islamic and conventional, in the country. Analysts believe that Bahraini banks are well suited and fully capable of implementing the Plan's capital requirements and leverage rates as they have powerful economies. Under the plan, Bahraini banks are required to absorb tier 1 losses by converting them common shares so as not to overburden the holders of the instruments with heavy losses.

However, criticisms regarding the accord and

its implementation patterns in Bahrain and other emerging economies still prevail. Some believe that the accord is a blatant favouritism approach towards large international financial corporations and smaller banks would suffer. Most banks, even larger ones in emerging economies such as Bahrain would not possess the kind of capital required under the accord. Furthermore, the credit definition, liquidity ratio principle and leverage rates do not apply to Islamic banks, as they are not based on private funding. The labelling of sovereign debts as zero-risk debts was also seen as a loophole in policy by many. Most importantly however, some believed that implementing the plan may result in lower GDP growth in the country over the coming years as institutional investment and government spending may see a downward trend.

The failure of Basel III's predecessors in impeding the oncoming GFC of 2007-08 has made some analysts and economists wary of Basel III and its potential to stop the same. The global Islamic banking sector cannot now be ignored as it forms a substantial part of the international financial market and is housed in some of the major emerging economies of Southeast Asia and ME. The unique nature of this banking niche subjects it to unconventional types of threats and an alternative strategy may be needed to address these issues. The AAOIFI recognizes this and has called for Islamic banks in Bahrain and elsewhere to evaluate and measure the extrinsic and intrinsic risks and devise appropriate strategies to address these. The Shari'ah law forbids Islamic banks from being involved in interest-based transactions and therefore they are only liable to accept public sector credit. Most Islamic countries have now launched the Sukuk bond schemes as an alternative backstop measure to prevent liquidity in these banks.

5.1. Recommendations

It is recommended that the Basel IV accord should pay attention to the Islamic banking sector and devise appropriate strategic measures to stress-test and ensure liquidity. Bahraini financial market stakeholders believed that while the Basel III accord is considerably better than its predecessors in terms of capability to address potential crisis, its one-size-fits-all approach may harm some regional financial markets and new crisis may emerge from these neglected segments in future.

Another recommendation to improve the accord's risk management capability would be to include regulations addressing the shadow banking system. Some analysts believe that the flexibility provided under the accord through credit regulations, would allow some banks to take advantage of shadow financial markets and harm the overall financial market in the longer run. The calculation of risk-weights too, should be improved to include internal banking risks as well. Presently, the SIFIs in many developing markets, are findings it difficult to implement Basel III requirements in terms of increasing credit under the capital requirement. Monetary institutions and financial authorities such as the government, IMF or others may aid these through controlled investment.

Some scholars also believe that the NSFR and LCR are encouraging more risk taking by financial institutions. Under the liquidity measures, banks are required to hold more 'liquid' assets, which may lower returns and incentivize banks to take risks. Considering these aspects and drawbacks highlighted in the research, if Basel III has to be made a foolproof tool to check any future crises, revisions must be made regarding definition of credit, increased capital requirements, liquidity and leverage ratios especially for Islamic banks and sovereign bonds risks. Lack of efficient regulation and supervision will allow derivatives to be passed out to less regulated industries. It is recommended that steps be taken towards establishing a global supervisory coordinator to ensure that promises are not shifted and transparent credit flows are in place.

Bahrain is on the right track towards adopting proactive approaches to financial risks, however, assessment of internal banking risks and the plight of SIFIs must be addressed, if the baking sector has to develop sustainably. Implementation of Basel III will prove to make the Bahraini financial sector stronger than ever and prevent future crises in the market. To extract maximum benefit out of the accord, the government and financial regulators may implement the recommendations listed in this research to customize risk management strategy to suit the Bahraini economic model.

5.2. Limitations and Area of Future Research

The research is based on interview and thematic analysis which can be based on perceptions and experience of interviewers. In future researchers can use capital base changes and its impact on risk exposures in the context of risk mitigation. Researchers can use the complete banking sector of Gulf Cooperation Council countries. The cultural value impact on banking operations in the context of coming Basel IV can be another study to be considered. The similar study can be done at global level.

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