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Challenges in Implementation of Capital Adequacy Guidelines in Bahraini Islamic Banks

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Abstract: This paper aims to shed light on challenges and issues faced by Bahraini Islamic banks about the capital adequacy guidelines. In Muslim countries, ever-increasing Islamic financial activities, including participation, equity, and ownership, have played an important role in bringing Islamic banking and making financial instruments more attractive. In this study, the role and implementation of Capital Adequacy Ratio (CAR) were critically examined while viewing the gaps it has failed to fill to make Islamic banking more successful in Bahrain. In this study, the qualitative method was used. Both primary and secondary sources were used to collect data for this research. This research was theoretical exploratory, and explanatory in nature. The research concluded that the protection of depositors and safeguarding assets is the key role of any managerial financial body. For internationally active banks, capital adequacy recommendations are set by Basel II Accord's Pillar 1. Sources of funds of a conventional bank are disregarded by the proposed guidelines in the Islamic banking system of Bahrain, and it also evaluates the risks of its actions that arise from the funds' uses. The study contributes by shedding light on the challenges and issues that Bahraini Islamic banks face when it comes to capital adequacy guidelines.

Keywords: *Capital adequacy, Islamic bank, Bahrain, conventional banks, CAR*

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INTRODUCTION

In the Gulf region, the Kingdom of Bahrain is considered to be an important financial hub since the dual banking system exists in Bahrain. There are currently many interest-free Islamic banks and commercial banks operating in the banking sector in Bahrain. Recently, a footprint was shown by almost 20% annual growth of global Islamic finance in Bahrain. In three decades of the evolution of Islamic banking industry, many Islamic banks have been set up under heterogeneous economic and social environments (Economic Development Board Bahrain, 2017). A small banking system was set in a rural area of Bahrain which reached a level where both international and local banks started working in order to offer wide ranges of services and products in Islamic banking. Historically, the regulations of non-profit institutions and financial institutions are not the same as conventional banks since its implementation is not always delegated or given to the same regulatory bodies (Khokher & Alhabshi, 2019; Liang & Renneboog, 2017). However, there can also be seen the coexistence of conventional banks with Islamic banks. Therefore, the governments have pressure to apply the same rules and regulations on both banks (Al-Ajmi, Hussain, & Al-Saleh, 2009).

No completely different and separate regulatory laws have been formulated yet to govern the Islamic banks' operations as they make efforts to get support and benefits which can be provided by the conventional banks. Even in a country like Saudi Arabia, which is Sharia-compliant by nature, there is no separate regulatory framework for Islamic

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banks. Although both commercial and Islamic banks are bound to follow Sharia, a joint regulatory framework is used in order to achieve economic benefits. Bahrain is no exception. The joint regulatory framework is used by both types of banks while having no obligations with reference to such compliance. In this context, it can be argued that it is worth noting that Islamic banks function under those laws that are governed by commercial banks in Bahrain. And these laws don't support tailored or specific issues of Islamic banking in many instances. However, in a global world economy, many key challenges are being faced by Islamic banks to compete with conventional banks (Islamic Financial Services Board, 2005a). By January 2008, in OEDC countries, commercial banks were asked to implement the Basel Committee on Banking Supervision (1996) documents on the "Amendment to the Capital Accord to Incorporate Market Risks" and on the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework", hereby known as Basel II Accord that set standards for effective banking practices and capital adequacy. It says that all Islamic banks would be bound to follow up and abide by international standards. Moreover, capital adequacy has emerged to be the keystone to safety which has reflected supervision concerns. A functional approach has been proposed by Iqbal and Khan in order to regulate economic/financial institutions, where the functions and operations of Islamic banks were analyzed in order to modify rules and regulations in an appropriate way for providing them better safety and support (Hassan & Chowdhury, 2010; Muliadi & Feriyanto, 2018). Therefore, the present study aims to deal with Challenges and issues with regard to the Implementation of Capital Adequacy Guidelines to Islamic Banks in Bahrain.

LITERATURE REVIEW

In Bahrain's economy, the leading sector was the extraction of petroleum in the early years of independence. The country could never attain the Saudi Arabia and Kuwait's production level despite the fact that Bahrain is the first country which produced the oil and a refinery. The country's economy got diversified when it lost competitiveness in the production of oil. Nowadays, the banking sector and retail sector are the country's leading sectors, along with the production of aluminium (Hassan, Aliyu, Huda, & Rashid, 2019). In the Middle East, Bahrain is the fastest growing country due to these policies. In its region, it is one of the freest countries, and it may be effective in this success. Financial and banking services, specifically Islamic banking as one the pioneer sectors of Bahrain, have taken advantage of the regional benefit related to the oil's demand. Highest revenue is brought by petroleum production export, and processing still banking industry has a massive share in the revenue of Bahrain. It may be useful to make comparisons between banking revenues of the 1990s and the 2000s to express the boom in banking services. In 1990, \$7.000 million could be generated by Islamic banks, but in 2008, this amount increased to \$37.000 million with a growing increase up to 98.22% (Chapra & Tariq Ullah, 2000). Under the three basic components, the progress of Islamic banking improvement can be analysed: banking regulations, operations, and improvement in alternative Islamic financial instruments. Different Islamic financial products and instruments have been pioneered by the CBB (Central Bank of Bahrain), the single regulator. These Islamic financial products include Murabaha, Sukuk (Islamic securities), and Musharaka contracts (Katzman, 2018; Razalli & Hasnan, 2017; Riedl & Smeets, 2017).

In Bahrain, takaful (Islamic insurance) is very popular. The country attempts to increase interest to retakaful, which is Islamic reinsurance and takaful. For Shari'a-compliant companies, a stock market has been introduced by the Bahrain house. Due to these improvements, conventional insurance became able to serve more competent and qualified products. To the greatest applications of Islamic Finance Institutions (IFI) of the Gulf region, Bahrain is a home in every area of Islamic finance, such as Sukuk issuance, asset management, and Shari'a-compliant reinsurance and insurance. As stated by Economic Development Board Bahrain (2017), in recent years, between 2009 and 2013, the Islamic finance industry grew fastly by seventeen per cent. In this fast growth, economies in Asia such as Malaysia and Gulf region countries such as UAE, Qatar and Bahrain contributed. Nowadays, inventors from all over the world are passionate and excited to have international investments and businesses. Inventors who aren't Muslim are searching for alternate options for profitable finance and also for ethical investment. Islamic finance has a strength which fascinates investments and is the ability to manage dependency and risk (Hassan, Aliyu, & Hussain, 2019; Neminno & Gempes, 2018; Verdelhan, 2018). By 2020, it seems that there will be demand projects for at least 150 new financial institutions (Economic Development Board Bahrain, 2017). In financial inclusions, Bahrain showed amazing and extraordinary performance among the sample countries. As compared to the other regional countries, Bahrain has thirty-two IFI while in Jordan, this number is 6, in Oman, it is 3, and in Lebanon, it is 4. In 2016, Islamic assets per adults were calculated as \$29.194. Kuwait is the closest country to this rate with \$28.102. Bahrain's great performance is related to being one of the pioneer countries which originated Islamic finance, but in implementation of capital adequacy guidelines to

Bahraini Islamic Banks, there have been many challenges (Sabah & Hassan, 2019). With these policies, the kingdom is one of the largest Islamic financial centres in the world, although the competition in its Gulf counterparts and current internal political instability has been increased (Hassan & Dicle, 2005).

METHODOLOGY

It has been argued by Katzman (2018) that research design can be viewed as a procedure through which a person narrows down his/her viewpoint for fulfilling the goals and objectives of a specific study. In this study, the qualitative method was used. Both primary and secondary sources were used to collect data for this research. This research was theoretical exploratory and explanatory in nature. Case studies and different books, journals, newspaper publications and scholarly articles were reviewed and thoroughly evaluated.

Capital Adequacy Framework

Banks are helped in absorbing their losses; in addition to this, they are also helped in avoiding failure in the long run through a cushion which is named as capital. CARs are a measure of capital's amount that a bank must hold, and it is expressed as a bank's total weighted assets' percentage. It is required from banks to hold at least eight per cent capital to assets ratio so that they can be categorized as "adequately classified" under Basel I and Basel II. Promotion of financial stability is the purpose of encouraging first and then requiring banks to hold a strong capital position (Katzman, 2018). In 1988, Basel I capital agreement was signed, and its purpose was to encourage leading banks around the world so that fair competition can be promoted and also to retain strong capital position by making reductions in inequalities in capital requirements among various countries. This accord's keystone is that at least 8% of CAR should be maintained by banks. By dividing total capital by total risk-weighted assets, CAR can be calculated. Assets are divided into five risk groups by Basel I agreement (0, 10, 20, 50 and 100%) on the basis of counterparty risks and credit. It was found later that there are many deficiencies in the 1988 Accord, which tempted for further review (Basel Committee on Banking Supervision, 1998).

In comparison to enduring financing, temporary funding was considered as having lesser risk, and the weight which was received by it was 20% while risk-weight was at 100% of things with a maturity greater than a year. At the expense of longer term, encouragement of short-term lending has caused instability in finances by such risk weighting systems. On the basis of three reinforcing pillars, the Basel II Accord was developed: market discipline, supervisory review, and minimal capital requirement. Pillar 1, market discipline, talks about issues of public information disclosure for participants of the market to assess the bank's strong points. Pillar 2, key supervisory principles are to aid banks in maintaining adequate with the new accord, capital's definition has not been changed (Basel Committee on Banking Supervision, 1998). Under Pillar 3, CAR of 8% must be held by banks, but its method for calculation of ratio is entirely different from the Basel I's approach. It is risk-weighted assets' computation in which two further categories of risks are included for modification: operational risk and market risk. Market risk arises due to market price movements due to the risk of losses in on- and off-balance sheet positions. Under Basel II innovations, there are two categories of bank activities which are banking books and trading books from the objective and aim of calculation of CAR (Basel Committee on Banking Supervision, 1998). All banking activities are in the banking book, such as funds' transformation of depositors into instruments or loans provided to funds users, the trading book collects the activities of selling and buying securities. In the portfolio of securities, exposure of a bank to market risk is reflected, and it is estimated on the basis of the trading book. Risk of loss which results from insufficient internal procedures is referred to as operational risk (Tabash & Dhankar, 2012).

Basel II's Pillar 1 stipulates CAR for conventional banks as:

$$CAR = \frac{(\text{Tier1Capital}\ \ \text{Tier2Capital})}{(\text{Risk Weighted Assets})} \tag{1}$$

Calculation of risk-weighted assets has a methodology which is very important as riskier assets as they infer to stay sufficiently capitalised, there is a need to increase the capital base by a bank. For calculating risk-weighted assets, a detailed framework has been set by Basel II's Pillar 1 so that different levels of risks can be catered which are usually faced by conventional banks in routine life actions (Tabash & Dhankar, 2012). Basel II standards do not explain for the hazards which are associated with the activities' nature of banks (Islamic). Fairness is the primary principle of Islamic finance, and at a basic level, the structure of financial institutions is risk and profit-sharing, and it is also towards fee-based revenues. In terms of spirit, there is a close connection between Islamic finance institutes and asset management firms as compared to the banking institutes which are conventional, and on balance sheet, the influence of their operations is exceptional (Archer, Karim, & Sundararajan, 2010). While keeping in view Islamic banks' activities, many discrepancies can be found which are not just limited to financial intermediation only. Islamic banks are playing many roles, such as financial advisor, consultant, and trader. As a result, there are various Islamic financing modes that have their own individual risks which have great impact upon balance sheet's both sides. Islamic bank's unique features are emphasised by these particularities, and they also raise serious concerns and fears about Basel method's applicability to banks which are Islamic in nature (Balthazar, 2006).

Capital Adequacy Framework and Bahraini Islamic Banks

There is a variance between the conventional risk and that which arise from the operations of Bahraini Islamic banks and for Basel II, they aren't accounted. Accounting and Auditing Organization for Islamic Financial Institutions (1999) issued a statement in 1999 which was "Statement on the Purpose and Calculation of the CAR for Islamic Banks" towards development of a concrete framework. This was the very first initiative which appropriately talks about the hazards encountered by banks which are Islamic in nature located in Islamic countries, and Bahrain is not exclusive (Islamic Financial Services Board, 2005a). For Islamic banks, a method of CAR calculation is given by the document (Accounting and Auditing Organization for Islamic Financial Institutions, 1999). On standards of Basel II, much of the recommended methodology is based upon the main discrepancy related to accountabilities side of the balance sheet of Islamic banks. There is a discrepancy between sources of Islamic banks' funds and Bahrain's conventional banks. Many researchers assessed CAR of Islamic banks of Bahrain according to equation (1), and it was then argued that there are no subordinate debts and preferred shares, so there is no problem in the calculation of capital, which means that capital of Islamic banks in Bahrain is composed of Tier 1 share reserves and capital. Through three kinds of accounts, investing and financing activities are funded by Islamic banks in Bahrain, along with the equity of shareholders: unrestricted investment accounts, savings accounts, and current accounts (Islamic Financial Services Board, 2008). There is full guarantee of payment upon request of customers in saving and current accounts as it is similar in conventional banking. Lesser protection is required by investment account as their funds are held on the basis of PLS, and they also settle to tolerate the hazards which are related to these funds' investment (Islamic Financial Services Board, 2008).

Risk Specificities in Bahraini Islamic Banks

Activities of Islamic banks have a different risk profile as they have a difference in form and substance as compared to the operations of conventional banks. For conventional banks, three kinds of risk exposures are identified by Basel II: market risk, credit risk, and operational risk. For Islamic and conventional banks, a comparative risk profile has been drawn in Table 1.

Table 1 *RISK PROFILE*

Conventional Bank	Islamic Bank
1. Credit Risk	1. Credit Risk
2. Market Risk	2. Market Risk
Equity Risk	Equity Risk
Commodity Risk	Commodity Risk
Interest Rate Risk	Interest Rate Risk
Foreign Risk	Foreign Risk
3. Operational Risk	3. Operational Risk
	Price Risk
	Displaced Commercial Risk
	Fiduciary Risk

Default payment risk is the credit risk, and on the basis of counterparty risk, risk weights are assigned. Movement in market prices gives rise to market risk by losses in on- and off-balance sheet positions (World Bank Group and Islamic Development Bank, 2016). It is applicable to the financial instruments' portfolio which comprises of four elements and is held by the bank: commodity risk, interest rate risk (supplementary categorized into general and specific market risks), and foreign exchange risk. Risk of loss is due to insufficient internal processes representing operational risk. Four different categories of risks have been identified by initial efforts made by intellectuals to satisfy the features and specificities of Shariah-compliant services and products, and for Basel II, these risks are not accounted (Chapra & Tariq Ullah, 2000).

Risk implication on banking and trading book of Islamic books has been introduced in this section. For both conventional as well as Islamic banks, operational and credit risks can be accounted in a similar fashion, and market risk has got special attention. Islamic banks' operations are interest-free (Gurrea-Martínez & Remolina, 2019). As in pricing, London Inter-bank Offered Rate (LIBOR) is used usually as a standard, so interest rate risk exists to some extent. Rate of return gets affected due to change in reference rate. Rate of return is probably collected by the bank to pay its depositors and also for uses of funds. This is called a rate of return risk. Three more types of hazards are recognised for banks which are Islamic: displaced commercial, fiduciary, and price risks (Sundararajan & Luca, 2002).

Price risk occurs when there is a risk that the price of primary assets will change over the transaction period. Conventional bank gets exposed to market risk if it acquires commodity, and market risk is one of the forms of price risk. There is a Shariah rule that an individual cannot sell something which he/she owns and for being acquiescent with this rule, there is a need for Islamic banks that they have to own different assets in Bahrain so that they can trade it to their clients when in need of funding. The bulk of transactions of banks (Islamic) are disclosed to price risk. Price risk is due to the accomplishment of various assets, and it further presents a banking book with a new dimension (World Bank Group and Islamic Development Bank, 2016). Basel II endorses that banks retain records of their actions which are based on the trading book or banking book. In the same way, market risk exposure is calculated for Bahrain's conventional and Islamic banks on the trading book's basis (Basel Committee on Banking Supervision, 1998). Credit risk is calculated by banking book. In the Islamic bank's banking book, commodity price risk exposure has been caused by the attainment of multiple physical assets. A new specificity has been introduced by this which has not been talked about; on the basis of banking book with financial institute's trading book, there is need to calculate market risk exposure (Schoon, 2008).

As the management of investment accounts, Islamic banks in Bahrain and other countries face unique risks. In the implementation of the deposit contract, there is a likelihood that the bank will be remorseful of misconduct or negligence; then this is referred to as fiduciary risk. As a result, depositors may withdraw their deposits as they lose confidence (Sidlo, 2017). If there is a probability that the bank isn't capable of competing with other banks, either conventional or Islamic, then displaced commercial risk arises. Profit equalisation reserve account should be held by Islamic banks to counter such type of risk. For later distribution, a provision is subtracted from earnings of the investment account holder, and it is put aside. On these accounts, a competitive return can be paid by Islamic banks even if they produce a low rate as compared to rates of market interests. The question is that to which extent this practice is compliant with Shariah (Al Maraj, 2008). For establishment and implementation of effective risk management in institutes of Islamic finance, a set of best practice guidelines was published by (Islamic Financial Services Board, 2005b). An important milestone is represented in this document in standardising and harmonising the Islamic finance institutes' exposure by identifying six risk types: operational risk, market risk, rate of return risk, credit risk, equity investment risk and liquidity risk. For some of these risks, especially liquidity and operational risk, more exertion is greatly needed in order to provide various strategies (Sidlo, 2017).

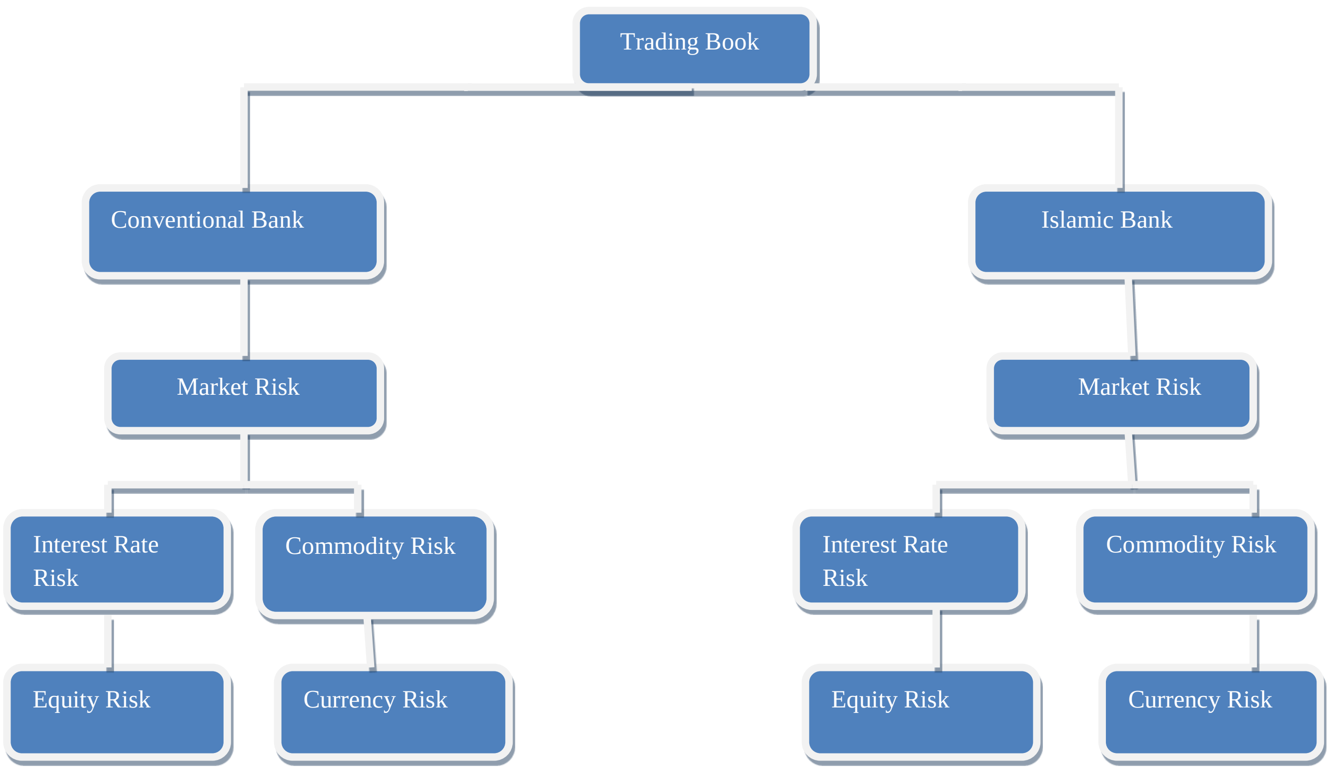

Figure 1 *Conventional Bank vs Islamic Bank*

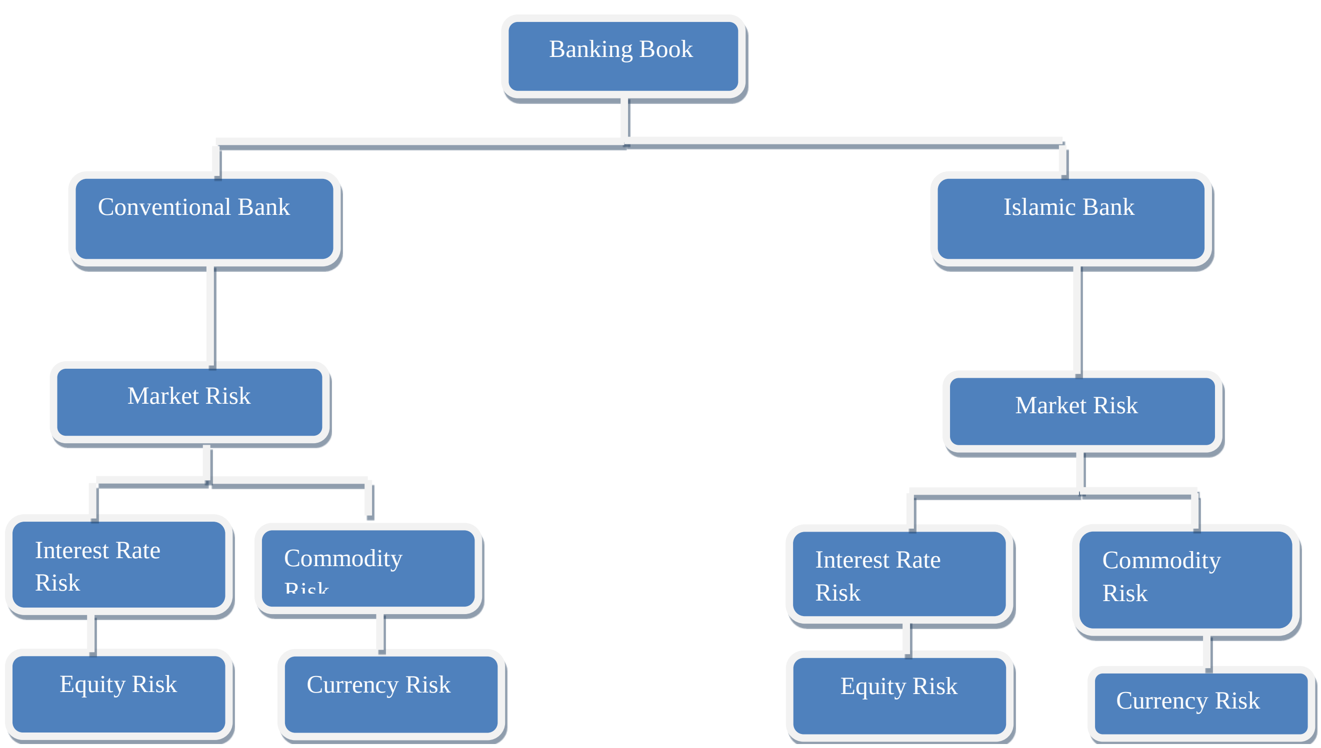

Figure 2 *Conventional Bank vs Islamic Bank*

CONCLUSION

Protection of depositor and safeguard of deposits is a factor which needs to be ensured, and this is the objective. Deposits are at the bank's disposition, and that should be assured of the complete payment. When funds of depositors into yielding assets are invested in Bahrain by a conventional bank, then it must tolerate all risks which are related to such actions. Under restricted investment accounts and Islamic banking, depositors are not impartial providers of funds. Such depositors take part in activities of bank investment via risk-sharing schemes and supply investment accounts. As compared to conventional depositors, Islamic bank depositors need lesser protection. In the calculation of CAR, there is the inclusion of fifty per cent of assets (risk-weighted) instead of 100 per cent by investment accounts. This solution is provided by AAOIFI. A major drawback of AAOIFI proposal is lack of reflection on the Islamic bank's balance sheet's asset side. As compared to conventional banks, various risks Islamic banks are exposed to arise from funds' uses. Real assets play their role in banking Islamic finance activities, which reveals them to extensive commodity price risk. Investing and financing activities are shown to new market risk dimension, which applies to banking book and also to the trading book, which also leads towards market risk exposure. As a result, there is a probability that risk-weighted assets of Islamic banks will be greater as compared to their peers. However, the Islamic banking system in Bahrain is still facing lots of issues and challenges that need to be addressed, since they are exposed to various risks which include liquidity risk that is not being focused by the current proposals in Bahrain. Therefore, it can be contended that the Islamic banking system is still at development's infant stage, and there only one money-making instrument which is relied by Islamic banks on Murabaha. There is a need to work more to prevent and reduce risks and challenges which are being faced by Bahraini Islamic banks.

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