

**Kingdom of Bahrain: Financial System Stability Assessment,  
including Reports on the Observance of Standards and Codes on the following topics,  
Banking Supervision, Insurance Supervision, Securities Regulation, and  
Anti-Money Laundering and Combating the Financing of Terrorism**

This Financial System Stability Assessment on the **Kingdom of Bahrain** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **January 12, 2006**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Kingdom of Bahrain or the Executive Board of the IMF.

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KINGDOM OF BAHRAIN

**Financial System Stability Assessment**

Prepared by the Monetary and Financial Systems and  
Middle East and Central Asia Departments

Approved by Charles Enoch and Mohsin Khan

January 12, 2006

This Financial System Stability Assessment is based primarily on work undertaken in the course of two missions to Bahrain in April and June 2005 as part of the Financial Sector Assessment Program (FSAP). The FSAP findings were discussed with the authorities during the Article IV consultation mission in November 2005.

The FSAP team comprised Daniel Hardy (mission chief), Ian Carrington, Jorge Chan-Lau, Marianne El-Khoury, Philip Schellekens, Tanya Smith, and Sibel Yelten from MFD; Nuri Erbas (MCD), Joy Smallwood (LEG); Antonio Garcia Garcialuna (World Bank); Mohamad Muhsin Mohd Anas (Bank Negara Malaysia, banking supervision expert); Nicholas Cook (UK Financial Services Agency, banking supervision expert); Erik Huitfeldt (consultant, insurance expert); Mark McGinness (Australian Securities and Investments Commission, securities market specialist); and Boudewijn Verhelst (Belgian Financial Information Unit, financial intelligence and criminal justice expert). The FSAP team is grateful for the excellent cooperation received from the authorities and market participants.

The main findings of the FSAP are:

- The financial system is enjoying strong performance under favorable circumstances, and is likely to remain a major contributor to overall growth. The main risk stems from potential overheating in the economies of the region, but the system should be resilient to likely shocks.
- Prudential regulations are modern and comprehensive, and supervision is generally effective, especially in the dominant banking sector. Supervisory capacity needs to be expanded in line with new regulations and to keep up with the growth and increasing sophistication of financial institutions.
- The further expansion of the Islamic sector, the development of housing finance, and the deepening of securities markets are important for the future growth of the financial system. The banking and insurance sectors will eventually undergo consolidation.

The main author of this report is Daniel Hardy, with contributions from the rest of the FSAP team.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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## Glossary

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AML	Anti-money laundering
AMLU	Anti-Money Laundering Unit
BCP	Basel Committee's Core Principles for Effective Banking Supervision
BD	Bahrain dinar
BMA	Bahrain Monetary Agency
Bps.	Basis points
CAR	Capital adequacy ratio
CBBL	Central Bank of Bahrain Law
CCL	Commercial Companies Law
CDD	Customer due diligence
CFT	Combating the financing of terrorism
CIS	Collective Investment Scheme
CSDR	Clearing, Settlement, Central Depository and Registry
DCR	Displaced commercial risk
DNFBP	Designated Nonfinancial Business or Profession
FATF	Financial Action Task Force
FCB	Full Commercial Bank
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSI	Financial soundness indicators
FT	Financing of terrorism
FTA	Free Trade Agreement
FTS	Fund Transfer System
GCC	Gulf Cooperation Council
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBL	Investment Banking License
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
LAR	Liquid asset ratio
ML	Money laundering
MOF	Ministry of Finance
MOIC	Ministry of Industry and Commerce
MOJ	Ministry of Justice
MOU	Memorandum of Understanding
MSA	Ministry of Social Affairs
NPL	Nonperforming loan
OBU	Off-shore Banking Unit
RIA	Restricted Investment Account
ROA	Return on assets
ROE	Return on equity
ROSC	Report on Observance of Standards and Codes
RTGS	Real time gross settlement systems
SCP	IOSCO's Core Principles of Securities Regulation
URIA	Unrestricted Investment Account

## EXECUTIVE SUMMARY

**Bahrain's financial sector is enjoying good results and growth in a favorable environment, and soundness indicators suggest that the system is robust.** The banking sector is well-capitalized. Asset quality has been improving and provisioning is high. Profitability surged in 2004–05, but historically, return on equity has been moderate for many institutions. The insurance sector is also well-capitalized. Available indicators for nonfinancial sectors show that household debt relative to disposable income is low but rising, and the corporate sector is on average not highly leveraged.

**Nonetheless, the authorities must be vigilant with respect to emerging risks.** Favorable liquidity conditions have caused regional equity and real estate markets to surge. Consumer lending has grown rapidly, although it slowed in 2005 following a tightening of loan to income limits. Possible regional geo-political disturbances constitute another risk factor, although Bahraini financial institutions have withstood such shocks in the past. Results from a comprehensive stress testing exercise, where due allowance was made for the risk-sharing features of Islamic institutions, suggests that banks as a whole could withstand even a severe shock. Nonetheless, individual banks may be vulnerable to a “boom and bust” in credit, or adverse movements in interest rates or equity prices. Hence, the authorities need to closely monitor rising exposures, and eventually a preemptive tightening of prudential requirements may be warranted.

**The Bahrain Monetary Agency (BMA), which has had supervisory authority over the entire financial system since 2002, has modernized prudential requirements and is enhancing its supervisory capacity.** The regulatory framework, which is designed to accommodate both conventional and Islamic institutions, is largely in conformity with the relevant regulatory standards. The payments and securities settlements systems are reliable and efficient, and are in the process of being upgraded. Prudential supervision and notably that of banks is generally effective, while that covering the smaller insurance sector is developing rapidly. A significant challenge is to ensure that the BMA has the staff and skills to keep up with expansion of the financial sector and innovations in its products.

**The positive reputation of the BMA has contributed to Bahrain's attractiveness as a financial center.** The BMA also strives to be transparent and consultative. Under current legislation, it is not formally fully independent, and some of its powers are not comprehensively specified in law. However, several of these and other shortcomings relative to international standards should be largely remedied once the proposed Central Bank of Bahrain Law (CBBL) is passed and the new licensing framework introduced.

**A number of issues deserve attention.** (Key recommendations including those from the detailed assessments of observance of standards are summarized in the table below):

- **Once the current round of issuing regulations is complete, continued efforts need to be made to enhance implementation by both the BMA and financial institutions.**

This will require the allocation of sufficient resources within the BMA; staff quality must be supported by competitive remuneration and on-going training to maintain effective supervision of a growing and increasingly sophisticated financial system. The authorities should build on existing efforts to assist licensees and others to implement regulatory requirements, for example, on the organization and functioning of the AML/CFT system. The effectiveness of supervision could be raised by better management, reconciliation, and analysis of available data, and the compilation of indicators for nonfinancial sectors.

- **Adequate provision of supervisory resources is especially important now, when a large number of applications are being received for bank licenses.** Entry is a sign of confidence in the system, but, as in other economic sectors, new ventures are likely to be riskier than established ones. Licenses should be granted mainly on the basis of a careful analysis of applicants' business plans, taking into account competition in the sector as a whole. Furthermore, it would be appropriate for applicants to cover the costs of processing license applications, and for all banks to cover at least some of the cost of on-going supervision.
- **Reserve requirements should be reformed, first by allowing banks to meet requirements on an average basis.** In due course, the BMA should aim to reduce the tax on intermediation in the national currency implicit in the reserve requirement. At the same time, the BMA should begin to require collateral for all lending to banks.
- **Some other specific regulations and in particular the liquid asset requirement need to be modernized.** The regulation of reinsurance risk could be refined. The BMA will have to develop supervisory capacity in such areas as the trading in derivatives as the system develops.
- **The BMA has broadly adequate powers of enforcement and bank resolution, which it has used effectively, but more contingency planning would be valuable.** When conditions eventually become less benign, the authorities may have to cope with a wave of mergers in the banking and insurance sectors, where many institutions are small.
- **Many financial institutions appear to face a shortage of appropriate local investment vehicles, which limits the development of the sector.** In part for this reason, the introduction of a market-based system of financing lower and middle-income housing would be highly desirable. Trading in securities markets remains thin, in large part because most investors follow a "buy and hold" strategy. Also, efforts could be pursued to make Bahrain a more attractive location for the issue of private tradable securities, and to invigorate the secondary market by introducing new players.
- **Legislation needs to be amended to make terrorist financing in itself an offense, and to support the payments and clearing systems.** In connection with the passage of the CBBL, provisions on the legal status of pledged assets and custody arrangements should be strengthened.



**Competing financial centers in the region and further afield are bound to catch up with Bahrain in terms of size and facilities.** However, the available evidence suggests that Bahrain will maintain its attractiveness as a platform for financial institutions. In this connection, the authorities have grounds to hope that Bahrain, with its sophisticated financial institutions, will benefit from the greater financial sector integration among Gulf Cooperation Council (GCC) members that is under discussion, provided that the integration is governed by market-friendly principles.

**The authorities have indicated that they broadly agree with this analysis, and have begun to take steps to implement the recommendations.** Already some regulations have been refined, and supervisory staff are being recruited. The BMA plans in 2006 to introduce its integrated licensing framework, rework certain regulations (e.g., on liquidity requirements), and to enhance its supervisory capacity through reorganization and improved data management.

### Summary of Key Recommendations

Short Term	
General	<ul style="list-style-type: none"><li>• Pass the CBBL, with provisions to strengthen central bank independence and powers, and refinements to provisions on payments and settlements.</li></ul>
Banking	<ul style="list-style-type: none"><li>• Introduce averaging in the fulfillment of reserve requirements.</li><li>• Modernize the liquid asset requirement.</li></ul>
Insurance	<ul style="list-style-type: none"><li>• Complete schedule of on-site supervision of all insurance companies.</li><li>• Continue to provide guidance to companies in complying with the new regulations.</li></ul>
Payments and Securities Settlement Systems	<ul style="list-style-type: none"><li>• Require that BMA credit in the payment system be fully collateralized.</li><li>• Strengthen the current legal framework, especially with respect to explicit provisions on assets pledged as collateral and the protection of custodian arrangements in event of bankruptcy.</li></ul>
AML/CFT	<ul style="list-style-type: none"><li>• Pass legislation criminalizing terrorist financing in itself.</li></ul>

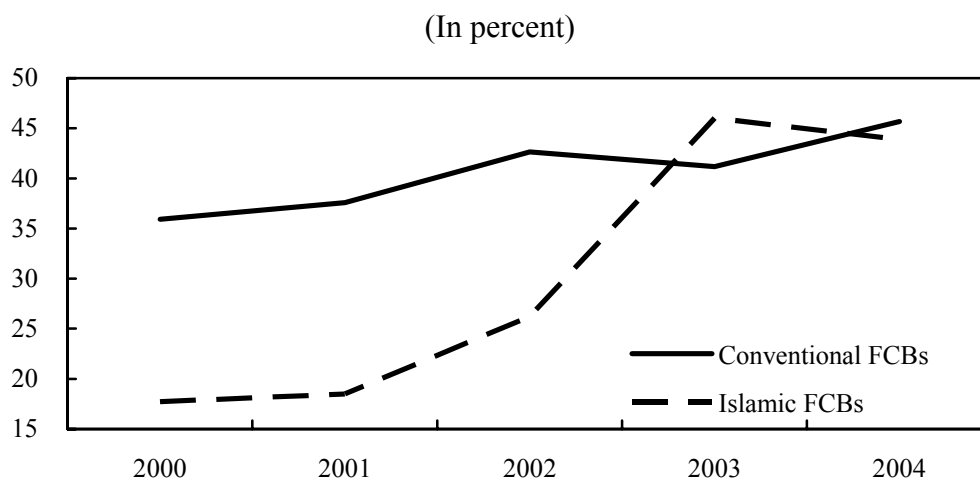
<b>Medium Term</b>	
General	<ul style="list-style-type: none"> <li>• Develop on-site supervision expertise in line with new market activities, risk management practices, and the complexity of new regulations.</li> <li>• Improve the management, reconciliation, and analysis of data to identify incipient system-wide concerns and to compile financial soundness indicators; begin tracking indicators for the nonfinancial sector; monitor more closely country and transfer risk.</li> </ul>
Banking	<ul style="list-style-type: none"> <li>• Prepare criteria and procedures for assessing mergers and possible exit by banks.</li> <li>• Define explicit criteria for assessing the extent to which acquisitions and investments may expose banks to undue risk or hinder effective supervision.</li> <li>• Establish limits and conditions for liquidity support in connection with the introduction of the integrated licensing framework.</li> <li>• Review scope for privatizing government stakes in commercial banks.</li> <li>• Develop greater capacity to supervise market risk management, and establish appropriate limits for market risk.</li> </ul>
Insurance	<ul style="list-style-type: none"> <li>• Prepare for possible consolidation and exit, for example, by elaborating procedures guides for evaluating applications for mergers.</li> </ul>
Payments and Securities Settlement Systems	<ul style="list-style-type: none"> <li>• Set pricing for use of the real-time gross settlement (RTGS) system to ensure that all large-value payments are channeled through the system.</li> <li>• Undertake a study of alternative risk management systems in the securities settlement system to strike a better balance between safety and efficiency.</li> </ul>
Securities Markets	<ul style="list-style-type: none"> <li>• Expand bilateral international Memoranda of Understanding (MOUs) with regulators and exchanges, particularly those with cross-trade links.</li> <li>• Consider privatizations via share issues on the Bahrain Stock Exchange (BSE) to increase trading volume and depth in the equity market, and the cross-listing of shares with other regional exchanges.</li> <li>• Streamline debt issuance procedures to shorten the documentation and placement process.</li> <li>• Increase liquidity in debt secondary markets by issuing larger amounts of government securities on a pre-announced scheduled, and encouraging qualified nonbanks to participate in the repo market.</li> </ul>
AML/CFT	<ul style="list-style-type: none"> <li>• Establish a regulatory framework for capital markets licensees comparable to that for other financial institutions</li> <li>• Intensify inspection program for AML/CFT for capital markets and insurance licensees.</li> <li>• Further develop the AML/CFT system for non-financial entities and non-profit organizations.</li> </ul>

## I. BACKGROUND

### A. Macroeconomic Setting

1. Bahrain has one of the most diversified economies in the region, in part because its financial sector has developed strongly, serving both the domestic economy and those of its neighbors, and contributes importantly to GDP and employment (Table 1).
2. Overall growth rates have been high in the past several years, largely due to the expansion throughout the region associated with the surge in oil prices, and are expected to be sustained in the medium term. Historically, fluctuations in the world price of oil and regional geopolitical shocks have led to wide fluctuations in growth; since the start of the 1990s, annual real non-oil GDP growth has fluctuated between 13 percent and about 1 percent.
3. The Bahraini dinar (BD) has been effectively pegged to the U.S. dollar since 1980 (at US\$2.659 for BD 1), and the Bahrain Monetary Agency (BMA) is formally required to hold foreign currency assets in excess of currency in circulation; this constraint is currently met by a wide margin. There are no exchange controls or restrictions on capital movements. In these circumstances, the scope for domestic monetary policy is very narrow, and interest rates follow U.S. rates closely.
4. These conditions, combined with the strong balance of payments, have contributed to rapid growth in credit, especially in loans to households (Figure 1). Stock market and real estate prices have also increased sharply, though less than elsewhere in the region, and construction—especially of commercial properties—has been booming.

Figure 1. Bahrain: Share of Credit Going to Households



Sources: BMA; and IMF staff estimates.

## **B. Financial Sector Structure**

5. The financial system includes a full variety of institutions (Appendix I and Table 2). It is dominated by banks, which are classified as full commercial banks (FCBs), which carry out retail and other banking business in BD and other currencies in the on-shore market; off-shore banking units (OBUs), which generally operate in foreign currencies with nonresidents; and banks with investment bank licenses (IBLs), which are oriented towards investment and merchant banking activities. Each category includes both conventional and Islamic banks. The total assets of OBUs are very large (in part because assets from across the region are booked in Bahrain), but the total assets of even the on-shore sub-sector exceed GDP. At end-2004, 113 banks were licensed, up from 101 at end-2000. Banks participate in a common interbank market in U.S. dollars; activity in the domestic BD interbank market is limited. The on-shore and off-shore insurance sectors are of significant size, as is the BSE.

6. Bahrain is a regional financial center. The OBUs, IBLs, and other financial institutions, which include important locally-owned institutions, base their regional operations in Bahrain because they are attracted by such factors as Bahrain's geographical location and the prevalence of a modern regulatory environment, rather than regulatory or tax arbitrage (no corporate taxes are levied in Bahrain, but that advantage obtains elsewhere in the region).

7. Bahrain is actively promoting Islamic finance through a Shari'a-compatible regulatory framework and the establishment of a variety of supporting national and international institutions.<sup>1</sup> Commercial financial institutions now offer a comprehensive set of services in compliance with Shari'a law, including banking services and insurance (known as takaful), and the market for government and corporate Islamic securities—known as sukuks—is developing.

8. Corporate accounting follows International Accounting Standards (IAS). Conventional financial institutions follow International Financial Reporting Standards (IFRS), and Islamic institutions are mandated to follow the analogous standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Well-trained accountants and auditors are available. Broadly satisfactory legislation and institutional arrangements are in place to handle bankruptcies and the liquidation of firms, although repossession of primary residences used as collateral is difficult. Systems to register movable and immovable property are operational.

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<sup>1</sup> For convenience, the terms "credit," "loans" and "deposits" will be understood to include the analogous items in Islamic finance where no confusion results. Correctly speaking, Islamic institutions offer a variety of financing instruments that avoid charging interest. They accept non-interest bearing deposits along with investment accounts that are remunerated on a risk-sharing basis.

Table 1. Selected Macroeconomic Indicators, 2000–2005

(end of period, except where indicated)

	2000	2001	2002	2003	2004	2005 1/
Total population (2004)	707,160					
GDP per capita (Bahraini dinars, 2004)	5,857					
<hr/>						
<b>Real Sector</b>						
Nominal GDP (BD millions, year end)	2,997	2,981	3,176	3,612	4,141	4,886
Real GDP (percent change)	5.3	4.6	5.2	6.8	5.4	6.9
Oil sector (percent change) 2/	11.2	0.8	1.3	1.1	-11.5	-7.5
Non-oil sectors (percent change)	4.1	5.5	6.0	7.9	8.6	9.0
Consumer price index (period average percent change)	-0.7	-1.2	-0.5	1.7	2.3	2.7
Private savings ratio (in percent of GDP)	7.3	3.6	10.9	13.4	15.0	17.1
(percent change)						
<b>Monetary and market data</b>						
Money (M1)	4.6	23.9	17.2	26.9	4.8	13.7
Broad money (M3)	10.2	9.2	10.3	6.3	4.2	13.7
Domestic credit	6.0	2.2	13.9	9.2	23.9	16.0
Foreign currency deposits/total deposits (percent)	32.8	31.3	28.6	25.4	25.2	25.8
Interest rate (money market rate, in percent)	6.9	3.9	2.0	1.2	2.8	4.0
Bahrain Stock Exchange (index, percent change, end of period)	-18.4	-2.5	3.4	28.8	30.2	23.8
(in percent of GDP)						
<b>Contribution to GDP</b>						
Total financial corporations	19.0	16.4	15.9	18.9	24.2	...
Domestic financial institutions	5.7	5.0	5.9	5.9	6.7	...
Offshore financial institutions	9.2	8.4	7.2	8.8	12.0	...
Insurance	4.2	3.0	2.8	4.2	5.4	...
Oil and gas	17.8	17.2	16.5	15.6	13.1	...
<b>Public finances</b>						
Overall fiscal balance	9.8	0.8	-3.9	-2.0	0.3	1.9
Government external debt	4.3	4.7	5.8	12.1	10.9	9.9
Government domestic debt	25.0	25.5	26.5	25.0	24.2	21.6
<b>External sector</b>						
Exchange rate (Bahraini dinars per US dollar)	0.376	0.376	0.376	0.376	0.376	0.376
Real effective exchange rate (percent change)	2.7	2.0	-0.5	-7.9	-6.2	-1.5
Current account balance (in millions of U.S. dollar)	846	239	-35	219	442	829
Capital and financial account balance (in millions of U.S. dollars)	13	-318	-1,130	543	-340	-710
Gross official reserves (in billions of U.S. dollars)	1.2	1.4	1.4	1.4	1.6	1.7
Reserve cover (months of imports) 3/	3.1	2.9	2.7	2.4	2.0	2.0

Sources: Bahrain authorities; and IMF staff estimates and projections.

1/ Projected or preliminary.

2/ Includes crude oil and gas.

3/ Imports of goods and services (excluding factor income).

Table 2. Financial System Structure, June 2005

	Number of Institutions 1/	Total assets	Asset share in group	Assets as percent of GDP 2/
		(in millions of U.S. dollars)	(in percent)	
<b>Banks</b>				
Full Commercial banks - FCBs	24	15,531	100.0	141.0
Domestically owned	11	12,025	77.4	109.2
Foreign owned	13	3,506	22.6	31.8
<i>Of which: Islamic</i>	6	2,217	14.3	20.1
Domestically owned	5	2,164	13.9	19.7
Foreign owned	1	53	0.3	0.5
Investment Banks - IBLs	36	6,464	100.0	58.7
Domestically owned	33	6,450	99.8	58.6
Foreign owned	3	14	0.2	0.1
<i>Of which: Islamic</i>	15	3,025	46.8	27.5
Domestically owned	15	3,025	46.8	27.5
Foreign owned	0	0	0.0	0.0
Offshore Banks - OBUs	52	100,137	100.0	909.3
Domestically owned	11	33,975	33.9	308.5
Foreign owned	41	66,162	66.1	600.8
<i>Of which: Islamic</i>	3	1,214	1.2	11.0
Domestically owned	1	671	0.7	6.1
Foreign owned	2	543	0.5	4.9
<b>Non-bank financials</b>				
Insurance companies 3/	20	2,052	100.0	18.7
Domestically owned	12	2,020	98.4	18.4
Foreign owned	8	32	1.6	0.3
<i>Of which: Islamic</i>	2	131	6.4	1.2
Domestically owned	2	131	6.4	1.2
Foreign owned	0	0	0.0	0.0
Investment advisory and other financial services	25	32	100.0	0.3
Domestically owned	22	31	99.1	0.3
Foreign owned	3	0	0.9	0.0
<i>Of which: Islamic</i>	2	9	28.1	0.1
Domestically owned	2	9	28.1	0.1
Foreign owned	2	2	9.4	0.0
Financing Companies 4/	4	115	100.0	1.0
Licensed money changers/brokers	22	129	100.0	1.2
<b>Memorandum items</b>				
Stock market valuation (in millions of U.S. dollar)		16,679		151.4

Sources: Bahrain Monetary Agency; and IMF staff estimates.

1/ Operating institutions.

2/ 2004 GDP. Onshore only.

3/ Financial data as of end-2004. On-shore only.

4/ Only one was operational at June 2005.

## II. INSTITUTIONAL AND REGULATORY FRAMEWORK

9. The authorities have established a sophisticated regulatory framework, and built up institutions for its implementation. The main challenge is to oversee a large and growing number of institutions while integrating supervision across the financial sector. The BMA is strained simultaneously to conduct thorough and regular on- and off-site supervision of banks and other financial institutions, undertake system-wide monitoring, and keep regulations up-to-date. Once the current round of issuing regulations is complete, attention needs to focus on enhancing implementation by both the BMA and financial institutions.

### A. Legislation and Institutions

10. The authorities are working to implement integrated regulation and supervision of the financial sector at the BMA. The BMA has been responsible for banking regulation and supervision, and for payments system oversight since its founding in 1973. In 2002, supervisory responsibility for the insurance sector supervision was transferred from the Ministry of Industry and Commerce (MOIC), and securities markets oversight was transferred from the BSE. These two institutions still play some role, for example, in registering companies and in monitoring market conduct, respectively. The Ministry of Finance (MOF) has responsibilities, for example, in approving decisions to intervene in distressed banks. Cooperation among these institutions appears to be good. The BMA also works closely with regulators abroad, and has established channels for sharing information, for example, through Memorandums of Understanding (MOUs). Nonetheless, the expanding cooperation with supervisors from other jurisdictions will be an on-going priority as interlinkages develop.

11. The most important piece of legislation governing the financial sector is the BMA Law of 1973. This law has a number of shortcomings, as do other financial sector laws, in such areas as ensuring the formal independence of the supervisor. However, these shortcomings have had little impact in practice. In particular, de facto the BMA acts with considerable autonomy.

12. In recognition of the need to modernize legislation following the establishment of an integrated regulator, the authorities have drafted a new CBBL, which is currently before parliament. The current draft seems satisfactory in most regards, and would reinforce the BMA's independence and clarify its responsibilities, and powers.<sup>2</sup> Consideration should be given to upgrading accountability arrangements, such as by including a process for reporting to parliament. Early passage of this legislation is strongly recommended.

13. The BMA is preparing to introduce an integrated licensing framework for all financial institutions.<sup>3</sup> The framework would resolve issues that have arisen where specialized

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<sup>2</sup> Some refinements relating to payments systems issues are suggested below.

<sup>3</sup> The Fund provided technical assistance in developing the framework.

institutions have not easily fitted into existing license categories. The BMA has recently refined regulations on the governance of financial institutions, and is developing criteria for evaluating the prudential implications of major acquisitions and investments as part of its implementation of the Basel II capital accord.

14. The BMA makes considerable efforts to be transparent, especially with regard to its supervisory responsibilities, and consults widely on new regulations. The preparation of a comprehensive set of rulebooks compiling regulations for all financial institutions is an important contribution in this regard. Financial institutions in Bahrain expressed the opinion that the BMA is open to dialogue while remaining fair and consistent in the application of its regulations. Given that the exchange rate is fixed by legislation and the economy is very open, the transparency of monetary and exchange rate policy is assured.

15. Some further strengthening of accountability and transparency arrangements should be considered. For example, a quality assurance function could be developed to assess the effectiveness of on-site and off-site supervision. Also, in order to enhance public awareness of internal accountability standards, the BMA could make public its code of conduct.

## **B. Sectoral Regulation and Supervision**

16. The level of observance of financial policy standards is generally high (see the Reports on Observance of Standards and Codes in the Annex), especially in the areas of greatest relevance to the current activities of financial institutions in Bahrain. The BMA will have to develop supervisory capacity in such areas as derivatives operations as they gain in importance. Many of the remaining shortfalls will be resolved by passage of the CBBL, or are connected to the newness of the integrated regulatory framework and staffing constraints.

17. The assessments were based on the laws, regulations and supervisory practice then current. The BMA has a program of updating the rulebooks, and most of the recommendations included here are in its work program—some have been implemented since the time of the FSAP missions. Moreover, the BMA will be reorganized and additional staff with expertise are being hired to enhance on-going monitoring and analysis of the financial system.<sup>4</sup>

### **Banking sector**

18. The BMA's approach to banking supervision is largely risk-based, and regulations address the major risk factors. Regulations and supervision covering FCBs, IBLs, and OBU's are substantially the same except where necessitated by their different activities (such as conducting business in BD with residents). Prudential regulations for Islamic and conventional institutions are closely aligned to ensure as far as possible a "level playing field." The 12 percent consolidated capital adequacy requirement provides a substantial

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<sup>4</sup> The reorganization will be broadly along the lines suggested by a recent IMF technical assistance mission.



cushion against shocks. The BMA has recently tightened regulations governing personal loans by reducing the maximum permitted ratio of loan service costs to household income. The authorities plan to introduce provisions of the Basel II capital accord in stages over the next four years.

19. Regulations covering bank liquidity need to be modernized. Current regulations, based on a 25 percent liquid asset requirement (LAR), fail to take fully into account the degree of liquidity of all of a bank's assets and liabilities, and its scope for managing liquidity on a more active basis. Also, these regulations drain liquidity from the secondary market for government securities. The BMA is working to update the liquidity regulation.

20. The number of banking supervisory staff available (currently the banking supervision and regulation divisions together have about 40 professionals) is barely adequate given the number and complexity of institutions. Furthermore, turnover has been a problem, suggesting that remuneration is not fully competitive with the private sector. Continuous financial innovation, for example in structured products and Islamic instruments, necessitates on-going training.

21. The supervisory workload has been augmented recently by numerous applications for licenses (mainly for Islamic IBLs). Such entry is generally to be welcomed as a source of growth and a sign of confidence, yet one may question whether there will be room in the market for all entrants to succeed. The first-best response would be to grant licenses mainly on the basis of a careful analysis of business plans, taking into account the fact that entry itself crowds the market. Entrants could also be requested to cover the costs of this analysis. The wave of entry suggests that in due course the sector will consolidate; having in place procedures for dealing smoothly with mergers and exit is therefore essential. In this connection, the authorities will have to develop a policy on competition in the financial sector.

22. One area of focus should be the management, reconciliation, and analysis of data to identify incipient system-wide concerns. The planned construction of a comprehensive data management system should facilitate these efforts. In addition, currently available raw data and information from the new credit bureau could be used to compile financial indicators for the nonfinancial sector. The authorities could also begin tracking property prices.

### **Securities markets**

23. The standard of security market regulation and supervision is satisfactory given the size of the sector. Passage of the CBBL will correct some deficiencies, for example, by reinforcing the autonomy of the regulator. As in the supervision of other sectors, continued efforts will be needed to implement all regulations effectively as the market becomes more sophisticated, to which end qualified staff must be retained. The planned introduction of a formal corporate governance code for listed companies and rules on takeovers is welcome, and benefit both the corporate and the financial sectors. Expanding international MOUs with regulators and exchanges, particularly those with cross-trading links, is encouraged.

## **Insurance sector**

24. The recently-issued section of the rulebook on insurance establishes a comprehensive regulatory framework applicable to all insurance companies. Expanded reporting requirements are being implemented. The BMA realizes that attention now needs to be directed more at effective supervision through detailed on-site and off-site monitoring and analysis, including of off-shore institutions.

25. The treatment of reinsurance risk deserves special attention. Since the Bahraini market for some insurance products is non-diversified and many insurers are constrained by their low absolute capital base, heavy use of reinsurance in insuring large projects is appropriate and unavoidable. However, companies should have to assess, and take into account in provisioning, the reliability of their reinsurance providers; otherwise, some insurers might seek out low cost, less reliable reinsurance.

## **AML/CFT**

26. Bahrain has a new and relatively comprehensive anti-money laundering legal framework centered around Decree Law 4/2001. The offense of money laundering extends to any type of property and applies to persons who commit the predicate offense. There are currently four cases of money laundering before the courts, all of which have been generated from local investigations.

27. Financing of terrorism is not currently a criminal offense in Bahrain.<sup>5</sup> A draft law which would amend the relevant provisions to create this offense is before parliament. The draft law should be amended to ensure that the terrorist financing offence fully addresses the risks of terrorist financing in a way that would also be fully compliant with international standards.

28. The Anti-Money Laundering Unit (AMLU), Bahrain's Financial Intelligence Unit (FIU), undertakes typical FIU functions, but does not have a high profile with all reporting entities, and it is recommended that measures be taken to address this deficiency.

29. Capital market licensees have been subject to specific AML regulations from the BMA since 2004, but these are not comparable in scope to those that cover other BMA licensees. It is important that capital market licensees be subject to an equivalent supervisory regime, and that work on upgrading regulations for money changers and brokers is finalized, to avoid money laundering attempts being directed at the "weakest link."

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<sup>5</sup> The government believes nonetheless that it currently has sufficient powers to take action against terrorist financing (and has done so without challenge) based on an interpretation of what constitutes illegality under the general criminal law of Bahrain.

30. The MOIC is the primary regulator for designated nonfinancial businesses and professions (DNFBP), and has taken some actions. It has issued AML guidelines and has undertaken a number of visits to DNFBPs. However, the MOIC's general supervisory powers may not be fully effective for AML/CFT purposes. Bahrain has taken measures to strengthen the regulation of non-profit organizations, but challenges to its effective implementation remain.

## **Payments and securities settlement systems**

### ***Payments***

31. The main payments system is based on end-of-day netting of payments between the BD clearing accounts of the FCBs at the BMA. Systemic risk is managed through the liquidity requirement and credit extensions by the BMA, including uncollateralized clearing accounts overdrafts as a last resort measure. The planned implementation of a Real Time Gross Settlement (RTGS) system could strengthen the payment system and keep it up to date with systems operated in other financial centers. To achieve the full benefit of building an RTGS system, it is recommended that the authorities take steps to effect:

- A requirement that the extension of BMA credit should be fully collateralized to provide participants with incentives to manage credit and liquidity risk, and to limit the BMA's exposure to potential losses.
- A pricing policy and close coordination with system participants to ensure that all large-value payments are channeled through the RTGS.
- The closure of certain gaps in the current legal framework, such as the lack of comprehensive provisions related to bankruptcy, for example, regarding the status of assets pledged as collateral.

### ***Securities settlement systems***

32. The securities depository for non-government securities, the Clearing, Settlement, Depository, and Registry System (CSDR) limits settlement risks through a guarantee fund and settlement limits. The risk management system, however, involves blocking securities as soon as a trade is initiated, which may be unnecessarily costly given that the system also ensures delivery versus payment. It is therefore recommended that the authorities, in cooperation with market participants, study alternative mechanisms that might strike a better balance between safety and efficiency.

33. As in the case of the payment system, the primary legislation governing the securities settlement system lacks explicit guidance related to bankruptcy and insolvency. In addition, there is no explicit legal protection for custody arrangements for securities, although the quasi-public status of the CSDR and the fact that ownership of securities in the CSDR is established at the level of the individual investor are mitigating factors. Nonetheless, it is desirable that all custody arrangements be protected, in primary legislation, from third-party claims in case of insolvency or bankruptcy of the custodian.

## **C. Market Support**

### **Monetary instruments and liquidity management**

34. The BMA has available a range of powers and instruments to manage domestic liquidity, but, in the context of what amounts to a currency board regime, they are dormant. The most relevant issues in this area relate to the reserve requirement and the BMA's role as lender of last resort.

35. The current reserve requirement mandates banks to maintain on a continuous basis unremunerated reserves at the BMA equal to 5 percent of end-of-month BD deposits and analogous liabilities. This amounts to a tax on intermediation in the national currency, yet does not effectively serve a monetary policy or liquidity maintenance purpose. Allowing the fulfillment of the requirement on an average basis would facilitate liquidity management by banks. In addition, it would be preferable to measure the reserve base as an average of the positions over the period to secure a more representative figure.

36. The medium-term aim should be to reduce the required reserve ratio, and/or to remunerate required reserves. Such a move would promote use of the national currency and the competitive position of FCBs. However, the move should be gradual because a reduction in the reserve requirement ratio in current circumstances would probably result in banks placing the released liquidity in dollar assets. Also, an alternative source of income for the BMA (such as fees for banking supervision) would have to be found.

37. The authorities recognize that the quasi-currency board limits the scope for emergency liquidity support, while the open capital account implies that financial flows could be large and rapid. Should the need arise, limited operations could be envisaged for on-shore banks, since foreign reserves are currently well above currency in circulation. The authorities may wish to establish internal guidelines for emergency liquidity support. Accountability would be enhanced by publishing the amounts and conditions of any support after the situation has normalized. It is understood by market participants that the BMA is not responsible for liquidity support of the off-shore banks, most of which are subsidiaries of major institutions. However, when the integrated licensing framework is introduced and there are no "off-shore" banks as such, the BMA will have to introduce an explicit limit on its potential responsibilities in line with available resources, for example, by making clear that its support does not extend to all overseas activities.

### **Bank resolution**

38. The BMA has legal powers to discipline banks and to intervene. However, the current BMA Law contains many provisions on taking a bank into administration or liquidating it, but rather little on less drastic steps. The proposed CBBL includes provisions creating a more appropriate degree of flexibility.

39. Over the past several years, the BMA has exercised its powers to discipline banks, and has intervened in three small banks, without much impact on the system as a whole.

Going forward, the BMA may wish to identify principles of prompt corrective action, which could reduce the likelihood that a failing bank will engage in risky and potentially expensive gambles for redemption.

40. The authorities are planning to modify the existing deposit insurance scheme. The proposed new scheme would be funded by an ex ante levy on banks, and provide up to BD 7,500 compensation per depositor (roughly twice GDP per head). The new scheme seems well designed. Consideration could be given to differentiating charges on banks according to the riskiness of their operations. The conditions under which investment accounts at Islamic banks would be covered should be defined precisely while making allowance for the sharing of commercial risks between investment account holders and shareholders.

### **III. FINANCIAL SECTOR SOUNDNESS**

41. Both financial soundness indicators (FSIs) and the results of a stress testing exercise point to the robustness of the financial system. Regional geo-political events could be a source of disturbance, yet the Bahraini financial system has successfully weathered such events in the past. The greatest economic vulnerability is to a regional “boom and bust” cycle coinciding with a rise in world interest rates and a fall in equity prices, but the system as a whole could withstand even a large shock. Some individual banks may be more vulnerable to specific risk factors, and some smaller institutions are new and lack experience with stress situations

#### **A. Financial Soundness Indicators**

42. Banks incorporated in Bahrain are well-capitalized, and most have a risk-weighted capital adequacy ratio (CAR) well above the 12 percent minimum (Table 3). The CAR for IBLs has tended to decline in recent years as they have expanded their risk-weighted assets, while those of other banks have been approximately stable. In aggregate, loan portfolios are diversified by sector and geographically (Figure 2). However, a few banks seem to have devoted an increasing share of their resources to personal lending and commercial real estate lending.<sup>6</sup> Personal lending is of concern because it has been growing rapidly, and real estate lending exposes a bank to the possibility that the regional property boom might come to a sudden end.

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<sup>6</sup> Conventional FCBs tend to hold relatively more personal loans than do Islamic FCBs, which have relatively larger exposure to the real estate sector. Large real estate companies obtain much financing in the form of securities and equity participation.

Table 3. Banking Sector Financial Soundness Indicators, 2002-2005 1/  
(In percent, end of period, unless noted otherwise)

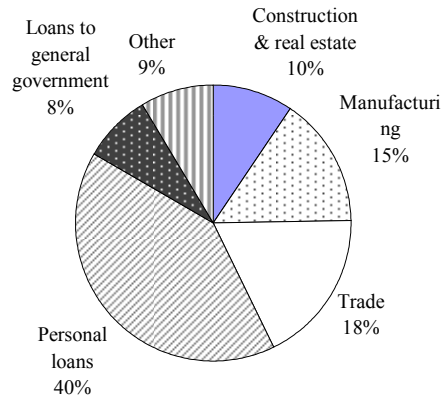
	Conventional						Islamic										
	FCBs			IBLS+OBUS			FCBs			IBLS+OBUS							
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004					
<b>Capital adequacy</b>																	
Regulatory capital to risk-weighted assets (level)	23.4	23.8	25.7	17.2	18.3	22.0	73.1	60.2	69.5	32.9	40.4	37.8	27.5	32.2	22.3	32.8	27.0
Regulatory tier I capital to risk-weighted assets	16.6	16.2	16.5	15.0	14.9	16.7	70.2	55.9	56.0	30.9	37.1	34.4	21.3	29.3	17.1	28.9	31.5
Capital to assets	12.8	12.9	13.6	9.9	9.2	12.5	21.2	17.6	22.5	24.2	...	...	13.6	27.1	11.9	19.1	31.0
<b>Asset quality</b>																	
Nonperforming loans to total gross loans 2/3/	8.1	10.3	7.6	7.2	6.3	6.4	17.5	9.2	6.8	9.9	...	11.4	7.4	10.4	2.6	3.4	12.3
Nonperforming loans net of provisions to capital 2/3/	6.2	13.7	10.4	8.7	5.7	1.7	...	10.8	5.0	14.9	7.8	5.3	12.8	0.3	-0.2	5.4	1.4
Coverage ratio 4/	80.6	67.7	68.0	69.0	77.6	89.3	...	33.7	51.0	...	34.3	38.1	54.6	81.6	102.5	48.4	23.6
Foreign currency loans to total loans 5/	37.6	36.5	34.2	n.a.	n.a.	n.a.	50.4	41.9	31.7	n.a.	n.a.	n.a.	54.7	n.a.	n.a.	29.2	n.a.
Large exposures to capital 6/	126.2	102.7	86.0	236.0	265.7	228.1	13.4	50.0	67.6	108.0	87.8	75.7	184.0	109.3	257.6	256.4	187.6
Large exposures to banks to capital	51.3	20.8	18.7	107.9	105.6	71.0	...	...	...	...	...	...	62.3	15.7	130.9	...	...
Large exposures to non-banks to capital	74.9	81.9	67.2	128.2	160.1	157.1	...	...	...	...	...	...	121.7	65.9	126.7	...	...
Exposures to affiliated and other "connected" counterparties to capital	37.2	28.6	12.4	16.2	17.9	28.8	...	...	...	...	...	...	11.9	27.7	25.5	...	...
<b>Earnings and profitability</b>																	
Return on average assets 7/	1.5	1.9	2.2	0.2	0.6	2.5	1.4	1.8	3.0	2.2	...	...	2.1	...	3.3	4.2	4.5
Return on average equity 7/	13.2	18.3	20.8	1.8	6.2	20.3	6.5	10.1	13.3	8.9	10.3	11.9	16.0	...	28.6	21.7	14.4
Interest margin to gross income	67.3	62.1	57.3	49.1	36.2	23.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	66.8	...	25.4	n.a.	n.a.
Noninterest expenses to gross income	59.2	50.2	45.1	89.2	59.6	37.0	52.7	53.6	43.3	62.4	54.9	50.7	43.4	...	21.5	...	47.2
Personnel expenses to noninterest expenses	45.5	50.9	55.5	35.1	31.9	20.2	57.4	50.6	44.7	34.6	35.7	39.2	57.9	...	68.2	...	42.4
Trading and fee income to gross income 8/	4.1	4.8	3.3	13.0	13.0	38.0	6.0	9.0	2.9	55.2	53.2	70.0	3.1	...	55.5	...	20.3
<b>Liquidity</b>																	
Liquid assets to total assets	25.6	23.6	31.3	26.1	29.7	37.2	46.8	38.7	44.3	19.2	...	...	32.9	40.6	36.2	10.6	23.7
Liquid assets to short-term liabilities	29.6	28.4	37.3	41.0	48.5	61.4	126.0	79.7	87.4	110.1	144.1	137.9	40.4	125.8	55.0	133.2	57.6
Foreign currency liabilities to total liabilities 5/	50.8	48.7	51.7	n.a.	n.a.	n.a.	20.6	31.3	38.1	n.a.	n.a.	n.a.	48.3	n.a.	n.a.	31.9	n.a.
<b>Sensitivity to market risk</b>																	
Net open position in foreign exchange to capital 5/	67.1	74.5	77.9	n.a.	n.a.	n.a.	...	16.4	19.4	n.a.	n.a.	n.a.	76.8	n.a.	n.a.	...	n.a.
Net open position in non-US\$ foreign exchange to capital 5/	1.2	1.1	1.3	n.a.	n.a.	n.a.	...	...	...	n.a.	n.a.	n.a.	5.7	n.a.	n.a.	...	n.a.
Net open position in equities to capital	6.1	4.4	4.2	8.8	13.4	17.1	...	7.3	21.7	...	7.3	5.9	...	12.7	9.6	17.7	18.7
<b>Number of reporting institutions</b>	4	4	4	4	16	16	3	4	5	15	17	19	4	11	6	5	16
Share in total sector's assets	10.9	...	...	...	82.9	...	1.4	...	...	4.7	...	...	12.9	10.2	65.9	3.2	7.8

Sources: Bahrain Monetary Agency, and IMF staff estimates.  
"n.a." = "not applicable" due to nature of banks' business or Islamic restrictions.

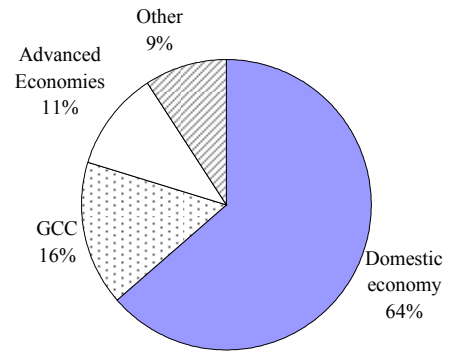
- 1/ Locally incorporated institutions.
- 2/ Includes nonperforming loans on which payments of interest or repayments of principal are 90 days or more past due and all loans on which specific provisions have been made.
- 3/ Excludes interest in suspense for conventional banks.
- 4/ Coverage ratio is defined as the level of provisions as a ratio of non performing loans.
- 5/ Onshore sector only (FCBs)
- 6/ Large exposure is defined as any exposure to counterparty or a group of closely related counterparties which is greater than, or equal to, 10 percent of (consolidated) capital base.
- 7/ Annualized for 2005Q2.
- 8/ Includes foreign exchange gains or losses.

Figure 2. Sectoral and Geographical Distribution of Bank Assets

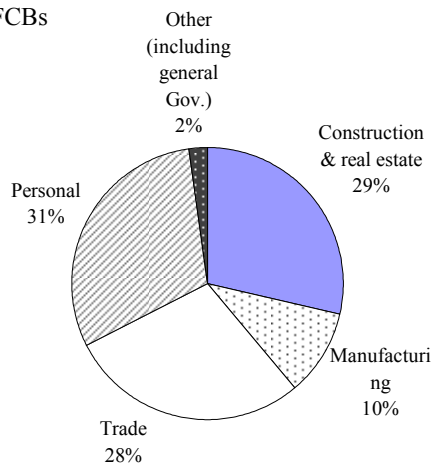
Conventional FCBs



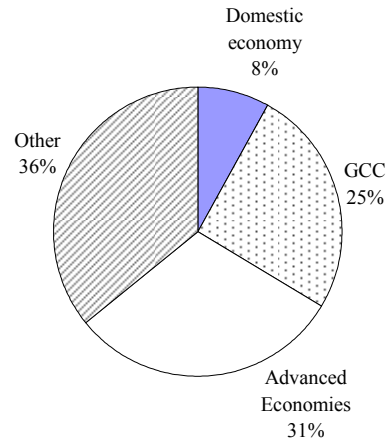
Onshore sector



Islamic FCBs



Offshore sector



43. The quality of loan portfolios has been improving, which is unsurprising in the current macroeconomic environment, and provisioning is high and rising.<sup>7 8</sup> It is noteworthy that, according to prudential returns data, Islamic banks do not place significant funds in what is termed their profit equalization and investment risk reserves, which are meant to act as buffers to smooth returns on the profit-sharing investment accounts. They should be encouraged to build up these reserves for a time when returns are less favorable.

44. With favorable business conditions and low marginal provisioning needs, bank profitability was strong in 2004 and the first half of 2005. Profitability is expected to slip slightly in the second half of 2005 due to rising interest rates. In recent years, conventional FCBs have recorded the highest return on equity (ROE); the ROE of Islamic banks tends to be depressed by their excess liquidity and very high capitalization.

45. Banks traditionally maintain high levels of liquidity, higher indeed than that required by the prudential liquidity requirements. A large proportion of both lending and deposits by FCBs are denominated in U.S. dollars, but this is viewed as unproblematic given the currency regime. Banks' net positions in securities and, for some categories, equity constitute more significant exposures to market risk.

46. The FSIs for the insurance sector have been mostly stable or improving over the past several years (Table 4). Capital to asset and capital to reserves ratios are high in international comparison, but nonetheless non-life insurance business (the largest sub-sector) has achieved a good ROE. The ROE for other sub-sectors is less satisfactory; in the case of takaful companies. This may in part be explained by the newness of the companies, who must bear start-up costs and cannot yet exploit all economies of scale.<sup>9</sup>

47. Relatively few FSIs are currently available for the nonfinancial sector. At least the larger corporations for which data are collected by the MOIC have quite low leverage, although some individual companies deviate significantly from this generalization. Household indebtedness to banks has been increasing relative to disposable income, from a low base. No information is available on household wealth, the market value of which has probably been increasing rapidly as real estate and equity prices rise.

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<sup>7</sup> Banks appear rarely to write-off loans entirely (reportedly to facilitate the pursuit of claims through the courts), so that much of the current non-performing loan (NPL) ratio is attributable to loans that became impaired some time ago. NPL ratios in this report may differ from those published by the BMA because of differences in the treatment of interest in suspense.

<sup>8</sup> In 2005, certain OBUs moved some old nonperforming sovereign debt off-balance sheet, resulting in a large drop in NPLs.

<sup>9</sup> One major company started operations only in late-2004, which resulted in "jumps" in some of the series.



Table 4. Selected Non-Bank Financial Soundness Indicators, 2000-2004

(In percent, year end, unless noted otherwise)

	2000	2001	2002	2003	2004
<b>Insurance Sector 1/</b>					
<b>Capitalization</b>					
Net premium to capital					
Life and mixed insurance	7.0	25.8	32.3	36.9	48.8
Non-life insurance	78.6	73.2	74.9	85.5	42.7
Islamic insurance	27.3	30.2	43.9	37.1	6.1
Reinsurance	26.8	7.5	48.3	69.8	60.5
Capital to total assets					
Life and mixed insurance	49.9	42.5	37.7	33.4	28.3
Non-life insurance	27.8	33.5	31.2	28.5	43.0
Islamic insurance	58.8	64.1	58.5	55.8	86.8
Reinsurance	52.6	57.7	27.1	27.3	29.6
Capital/technical reserves					
Life and mixed insurance	141.4	139.3	100.8	86.8	75.9
Non-life insurance	85.8	103.4	90.6	81.2	167.2
Islamic insurance	558.7	368.7	261.8	172.1	1290.4
Reinsurance	75.9	92.2	45.0	43.8	60.0
Risk retention ratio (net premium to gross premium)					
Life and mixed insurance	27.3	33.2	36.2	35.4	38.8
Non-life insurance	52.1	51.6	43.3	44.8	45.8
Islamic insurance	63.6	63.7	48.3	45.0	47.6
Reinsurance	62.1	23.2	64.5	90.5	90.6
<b>Earning and profitability</b>					
Loss ratio (net claims to net premium)					
Life and mixed insurance	28.7	28.5	65.5	37.7	36.9
Non-life insurance	60.0	59.2	56.6	56.5	55.3
Islamic insurance	88.5	96.2	54.8	57.6	44.3
Reinsurance	111.8	367.4	104.9	68.8	60.4
ROE (return on equity)					
Life and mixed insurance	1.1	13.2	6.8	10.8	7.8
Non-life insurance	12.2	10.2	11.3	12.8	7.7
Islamic insurance	1.9	-17.0	1.6	8.4	1.9
Reinsurance	-47.5	-60.5	-19.9	3.1	11.9
<b>Corporate Sector 2/</b>					
Capital to assets	...	...	67.6	70.4	...
Return on equity	...	...	7.1	8.3	...
Return on assets	...	...	4.8	5.9	...
<b>Household Sector</b>					
Household debt to GDP 3/ 4/	16.7	17.8	21.4	22.2	24.5
Household debt to disposable income 3/	19.7	22.3	27.3	27.7	...
<b>Securities Market</b>					
Average turnover ratio	3.7	2.9	2.7	2.7	3.4
Market capitalisation to GDP	83.3	83.3	88.9	99.5	123.2

Sources: BMA, MOF and MOIC; and IMF staff estimates.

1/ Sample includes national (i.e. onshore Bahraini) insurance companies, excluding foreign branches.

2/ Sample includes 49 corporations.

3/ Personal credit from domestic banks only.

4/ Estimated values for 2004.

## **B. Stress Tests**

48. The examination of FSIs was complemented with the conduct of a comprehensive stress testing exercise (Appendix II). The shocks were calibrated with reference to historical events (such as recessions associated with falls in the oil price or regional disturbances) that have affected the banking system of Bahrain. The methodology takes into account differences between conventional and Islamic institutions in the treatment of deposits and investment accounts, and also in the structuring of their financing and investment transactions. Islamic banks, for example, are not directly affected by interest rate risk.

49. Because almost all banks start out highly capitalized and liquid, only in isolated instances would a bank's capital fall below the required minimum level even after a very large shock. The largest and most widespread impact is obtained when a deterioration in credit quality is combined with negative market shocks, as might occur in the event of a global and regional return to stagflation. As is to be expected, conventional FCBs have greatest exposure to credit risk, which would increase if lending were to expand rapidly before quality deteriorates. Interest rate risk is important for IBLs and, to some extent, OBUs, because of possible revaluation of their fixed-income securities. Some Islamic banks have quite large exposure to equity price risk. Across bank types, the largest impact is often found in the smaller, newer banks, but their initial capitalization is typically very high.

50. Stress testing cannot capture the possible effects of very large shocks, such as a major political disruption in the region. The peg to the U.S. dollar could conceivably be abandoned, perhaps in coordination with action by other GCC members. In this—very remote—eventuality, the banking system might have to deal with a liquidity drain and a deterioration in borrowers' creditworthiness, but, as mentioned, current indicators of liquidity and capitalization are strong.

## **IV. STRUCTURAL ISSUES AND FINANCIAL SECTOR EFFICIENCY**

51. Current favorable circumstances provide a good opportunity to take measures that maintain Bahrain's position as a leading financial center for the region, and enhance the financial sector's contribution to performance of the domestic economy.

### **A. Bahrain's Status as a Regional Financial Center**

52. Bahrain remains an attractive location for financial institutions, as evidenced by the continued growth in the number of institutions operating in the jurisdiction and the expansion of incumbents. Bahrain's advantages include, inter alia, its geographical location; its reputation for being well-regulated; the innovations that it has undertaken in developing all forms of Islamic finance and establishing institutions to promote the deepening of Islamic financial markets; the availability of a well-qualified workforce of nationals and expatriates; and reasonable operating costs. Nonetheless, other financial centers have tried to catch up. Such a process is inevitable. It need not be a threat, provided that Bahrain continues to offer

an environment attractive to institutions that have an interest in operating and being seen to operate in a well-regulated and supervised jurisdiction.

53. In this connection, it should be noted that Bahrain is a member of the GCC, which is planning to institute a monetary union from 2010, in the run-up to which remaining barriers between the financial sectors of the member countries are gradually being removed.<sup>10</sup> The monetary union in itself is not expected to have a major impact because the currencies of GCC members are already more or less tightly tied to the U.S. dollar. However, true financial integration involving regulatory convergence and the reduction in market barriers could lead to structural shifts. Bahrain, with its sophisticated financial institutions, would probably benefit if the integration was governed by market-friendly principles and temptations towards heavy state intervention and subsidization are resisted.

54. Under the integrated licensing framework, off-shore banks are expected to be allowed to undertake more on-shore business. The move is to be welcomed, but a phased approach is needed to dampen potential short-term competitive pressures on local banks. Furthermore, insofar as individual banks wish to expand the range of their activities, they will need time to build up relevant risk management capacity, and for the BMA to establish effective supervision.

## **B. Islamic Finance**

55. The variety and popularity of Islamic instruments has surged in recent years, driven mainly by the supply of funds from savers who wish to invest in Islamic vehicles, and to a lesser extent by entrepreneurs seeking financing using Islamic instruments. The growth is likely to remain rapid over the near term.

56. Perhaps the main challenge faced by Islamic financial institutions is the glut of savings. These are often placed in the interbank market using “commodity murabaha,” but procedures are somewhat cumbersome and returns low.<sup>11</sup> Investment opportunities are limited, especially for institutions that are too small to participate in the financing of major projects. Available investments are also often of much longer term than the financing received from savers. Takaful insurance companies and especially so-called “family takaful” companies (effectively life companies) lack investments that match the risk profile of potential claims. They also have to use conventional reinsurance due to the scarcity of Islamic reinsurance.

57. Another concern for Islamic banks is “Shari’a risk.” Compliance with Shari’a is judged by the board of Shari’a scholars established by each Islamic institution. Hence, for

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<sup>10</sup> For example, cross-country bank branching has recently been liberalized.

<sup>11</sup> Effectively the Islamic bank finances the purchase of a commodity. Typically, the commodity leg of a transaction is conducted via brokers in an international commodities exchange.

example, the value of an instrument purchased by one institution might suddenly be reduced if the Shari'a board of another institution deems it noncompliant. However, conflicting judgments will probably become less common as experience is gained.

### **C. The Banking Sector**

#### **The domestic banking sector**

58. Benign macroeconomic conditions have encouraged the on-shore banking system to expand rapidly in recent years. This expansion has not yet produced marked strains. Much of the increase probably represents a permanent structural shift, yet the recent acceleration suggests that "overheating" may become a problem if it does not soon moderate. The risk is primarily of misallocation of resources and social costs rather than systemic disturbance, although reputational risk must be considered. The recent lowering of the maximum ratio of household lending to disposable income has been effective in moderating growth in credit to this sector.

59. Domestic housing finance is one area offering considerable potential for expansion. Currently, lower-end residential property is provided mostly through government housing projects or financed by loans from the government-owned Housing Bank at subsidized interest rates. Housing Bank loans have frequently been forgiven by government edict. In these circumstances, it is not surprising that subsidized housing is severely rationed, while saving for house purchase and mortgage financing are weak. It is widely acknowledged that there is a substantial shortage of lower-priced housing.

60. The authorities are planning to move to a more market-based system whereby the Housing Bank would guarantee mortgages provided by commercial banks. The reform would have several advantages: the supply of lower-priced housing should expand, and the financial system (and in particular Islamic institutions) would benefit from the availability of longer-term savings and investment instruments. Consideration could be given to further development, such as securitization of mortgages, to make the market more liquid.

61. The specialized Housing Bank and the Bahrain Development Bank are subject to limited BMA supervision. Insofar as they begin undertaking commercial activities, and in particular intermediating funds from the public, they should be subject to tighter supervision.

#### **Management of structural change**

62. More widely, the authorities are aware that further structural shifts, and in particular consolidation, may be forthcoming. Competition in the Bahraini banking market is vigorous. Banks can be adequately profitable when conditions are very favorable, but if market conditions become more difficult or returns on alternative investments rise, banks will be under more pressure to reward shareholders. Therefore, banks may reduce their capitalization levels through share buybacks or mergers, which may also offer opportunities to realize economies of scale. Many Islamic institutions are currently rather small, and consolidation

should be expected as the sector matures. One may also see cross-sectoral mergers to create financial conglomerates.

63. The authorities need to be prepared for this eventuality. Procedures need to be in place to evaluate applications for mergers and acquisitions in a timely fashion, including those involving partners from abroad. In order to facilitate consolidation, the authorities may also consider divesting, in the current favorable environment, some of their equity stakes in commercial financial institutions—an action that is already under consideration. This would facilitate banks to team up among themselves or with larger partners, and thus benefit from economies of scale and transfer of expertise.<sup>12</sup>

#### **D. Insurance**

64. Gross domestic insurance premiums, at under 3 percent of GDP, are somewhat low for a country at Bahrain's stage of development, but higher than in most GCC countries. The industry and the authorities are making efforts to promote understanding of the value of insurance, and indeed premium income has been growing relatively fast. The Islamic insurance (takaful) sector has been especially vigorous. Some of the measures suggested above to expand the stock of Islamic financial instruments would also benefit takaful companies.

65. The on-shore insurance sector is fragmented. As in the banking sector, the BMA must be prepared for consolidation and possibly exit, for example, by preparing in advance a procedures guide on how to evaluate in a timely manner a request for approval of a merger. The BMA may also undertake contingency planning in the event that an insurance company requires rapid intervention. For both mergers and exit, a prime objective would be to implement the smooth transfer of policies-in-force and outstanding claims, for which the regulatory framework is in place.

#### **E. Development of Securities Markets**

66. Upgrading the legal, regulatory, and market infrastructure framework for debt issuance could accelerate the growth of the off-shore debt markets. For example, Bahrain could seek to attract Arab issuers of Eurobonds, which are traditionally listed on either the Luxembourg or London Stock Exchanges, by streamlining issuing procedures. The documentation and placement process takes four months in Bahrain, but in the Eurobond market the issuance process usually takes eight weeks for a new issuer, and for frequent issuers, the process can be shortened to a few days.

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<sup>12</sup> There is no evidence that non-specialized banks with Bahraini government shareholdings are currently less efficient or financially sound than other banks, and their management claim to act on a purely commercial basis. Therefore, there seems little public policy need to retain these shareholdings.

67. Development of the domestic debt market may be promoted by increasing the liquidity of both short-term and long-term instruments. Larger issues of BB-denominated government securities would help towards this end by increasing the “free float;” currently, government securities tend to be hoarded by banks and others, in part to meet the liquid asset requirement. Also, auctioning medium-term government securities according to a pre-announced calendar could help stimulate trading in the secondary market because investors might rebalance their holdings of on-the-run and off-the-run issues. Encouraging competent nonbank financial institutions to originate, distribute, and act as market makers of money market instruments could increase the supply of liquid investment assets. The range of repo market participants should be extended to qualified nonbank financial institutions (especially those which are significant holders of securities) so as to increase the volume of securities available for repo operations, and enable these institutions to invest their temporary surplus funds more flexibly and favorably.

68. Also the market for equity could be developed further. Trading volume and market depth could benefit from channeling eventual privatizations through the BSE, which would increase the number of investable securities,<sup>13</sup> and the cross-listing of shares in other regional exchanges, which would widen and diversify the investor base. The latter measure would require that regulatory standards in the other stock exchanges involved match those in Bahrain.

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<sup>13</sup> Market promotion is only one of many factors to be considered in selecting a privatization method.

## STRUCTURE OF THE BAHRAINI FINANCIAL SYSTEM

69. Despite the small size of Bahrain's economy, the financial sector is well diversified and well developed. Bahrain plays host to over 360 financial institutions, including the key players, such as commercial and Islamic banks, off-shore banking units, and insurance companies, as well as a large group of pension funds, financial advisory groups, and money brokers. There are currently 28 Islamic financial institutions licensed and active in Bahrain, including 6 full commercial banks, 15 investment banks, and 3 off-shore banking units. The financial sector is open to foreign investors and there are no restrictions regarding foreign ownership of financial institutions. Most of the financial institutions are privately owned. Cross-sectoral activities remain limited, with no financial conglomerates operating in Bahrain.

### **The BMA**

70. The BMA is the central bank, with responsibilities for monetary and exchange rate policy, management of international reserves, fiscal agency for the government, and supervision of the entire financial system and the payments system. The BMA Law grants it wide discretionary powers in the use of monetary instruments, issuing regulations, and taking enforcement actions. The law also stipulates the fixed exchange rate of the BD against the U.S. dollar, and a requirement that international reserves exceed currency in circulation.<sup>14</sup> Thus, the BMA stands ready to buy or sell BD liquidity on demand at the official buy and sell rates BD 0.375 and BD 0.377 per U.S. dollar, respectively, which it has maintained since 1980.

71. Under the quasi-currency board arrangements, the demand for BD liquidity is fully accommodated by foreign reserves variations and the consequent variations in base money. The BMA has available a range of monetary policy instruments, including primary issuances of conventional and Islamic government securities, repo facilities, an overdraft facility, and secured loan facilities against BD bank deposits. Banks are required to maintain 5 percent of end-of-month BD deposits (including unrestricted investment accounts in Islamic banks) in unremunerated reserves at the BMA; reserve balances must be maintained continuously throughout the subsequent month.

### **Banking**

72. The financial system consists primarily of three types of banks: full commercial banks (FCBs), off-shore banking units (OBUs), and banks with investment bank licensees (IBLs). Each category includes both conventional and Islamic banks. The key differences

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<sup>14</sup> Reserves can be allowed to fall to three quarters of currency in circulation in exceptional circumstances and with the permission of the Council of Ministers.

between the three banking categories lie in their ability to offer services for residents of Bahrain in BD:

- FCBs carry out all retail and other commercial banking activities in BD and any other currencies with residents and nonresidents of Bahrain, subject to such conditions as may be agreed upon with the BMA. Both Bahraini-owned and foreign banks operate as FCBs.
- OBUs may undertake all banking activities with nonresidents. Unless agreed upon with the BMA, all activities must be in foreign currency, except for its normal business operations' requirement. OBUs may not deal in any way with residents of Bahrain other than the Government of Bahrain and its agencies, and with licensed banks. With the specific approval of the BMA, a bank may participate in domestic development projects.
- IBLs may deal in foreign currency with nonresidents and with other banks in Bahrain. These institutions may also deal in traditional investment and merchant banking activities, particularly those directed toward securities' business (such as mergers and acquisitions, bond issues, underwriting, and financial advice), subject to such conditions as may be agreed upon with the BMA. Loans and advances, but no overdraft may be made to nonresidents. IBLs may take deposits only from nonresidents and only in foreign currency, or from BMA-licensed banks. In certain cases, with the permission of the BMA, dealing may be undertaken with nonbank residents of Bahrain.

73. Assets are concentrated among a few players. For example, the top five OBUs and two IBLs account for more than 75 percent of the total assets in the respective sub-sectors. However, the number of institutions has been growing, so that many small players are also active. The Islamic sector has been growing especially rapidly: consolidated assets of Islamic banks grew from US\$3.2 billion at end-2000 to US\$6.1 billion at end-2004. Some banking groups, including some Bahraini groups, hold several different licenses, so that, for example, the OBU is the parent company of an IBL and an FCB. Some (foreign) OBUs have Islamic subsidiaries or windows.

74. There are two state-owned specialized banks, the Housing Bank and the Bahrain Development Bank, which were established by legislation. The public sector, comprising government, public corporations and the government-run pension schemes holds majority ownership of one of the two large conventional FCBs (with about a 30 percent share of the on-shore market). The government also owns, either directly or indirectly, minority stakes in several banks. There is no recent evidence of government intervention in commercial decisions among non-specialized banks. In addition, some foreign government owns shares in certain institutions.

## **Insurance**

75. The on-shore insurance industry collects on average slightly under 3 percent of GDP in gross premiums annually. General insurance accounts for some three-quarters of total



domestic insurance underwritten. The single most important business line, based on gross premiums, was motor insurance, which accounted for 38 percent of the total in 2004. Life products for on-shore companies accounted for 32 percent of total gross premiums and demand for life and life-related products (including life, pensions, and medical insurance products) is increasing rapidly. Some companies offer reinsurance domestically, on a comparatively small scale, but important use is made of reinsurance from abroad. Total assets of domestic insurance companies reached US\$1.9 billion at end-2004, and investments reached US\$1.2 billion (10.9 percent of GDP).

76. Demand for Islamic insurance has been growing especially strongly. Two on-shore companies operate under Islamic principles (known as takaful). Islamic insurance was first established in Bahrain in 1989. Takaful insurers offer general and family takaful and follow the Al Wakala model (imposing a set fee to cover the management) in their underwriting operations and the Al Mudharaba model (profit sharing) for the investment activities of the takaful fund.

77. The off-shore insurance sector at end-April 2005 comprised 73 companies, including 57 insurance firms, 14 insurance brokers, and 2 insurance consultants. The off-shore companies are mainly engaged in offering insurance products in Saudi Arabia, but the Bahraini authorities require them to have functioning offices in Bahrain. Off-shore insurance companies, however, may relocate to Saudi Arabia following the recent promulgation of an insurance law in that country; this process has already begun, and in this connection the BMA withdrew several licenses in 2005. The outcome of this process will not be known until regulatory changes in Saudi Arabia are completed.

### **Securities Markets**

78. The current form of the Bahraini equity market, the BSE started operating in 1989. The market valuation of the BSE grew by some 40 percent, exceeding US\$13.5 billion, or 130 percent of GDP in 2004. Daily turnover, however, is low with an average of 70 to 100 daily trades worth about US\$1.8 million. Shares listed in the exchange comprise 46 Bahraini and non-Bahraini companies, 25 mutual funds, and 20 Bahraini government corporate bond issues (including Islamic securities, known as sukuks). Trading is undertaken through the 13 exchange member brokers, with a combined capital of US\$207 million, using an automated quote system and a modern settlement system, which ensures delivery versus payment on a T+2 basis.

79. Empirical evidence shows that the local stock market index is highly correlated with other stock market indices in the region. Econometric evidence suggests also that the market is informationally efficient relative to others in the region. However, the core of the investor base is composed of large institutional investors, including pension funds, which usually follow buy-and-hold strategies. These investment strategies reduce the free float in the market, partly explaining the low trading volume.

### **Payment and securities settlements systems**

80. The Fund Transfer System (FTS), operated directly by the BMA, is the main payment system in Bahrain. The system is based on the clearing accounts at the BMA of on-shore FCBs, the only direct participants in the system. The system, which operates only in BD, is fully automated, uses SWIFT communication standards, and settles transactions on a multilateral net basis at the end of the day. Large-value checks, worth over BD 10,000, are also settled directly on a gross basis through the FTS rather than through the checking clearinghouse. As a result, total settlement in the FTS is ten-fold that of the checking clearinghouse.

81. The main securities depository, the CSDR, functions as an internal department of the BSE. Corporate shares must be deposited at the CSDR in order to be traded at the BSE.<sup>15</sup> Although transactions must be performed through brokers, there are individual accounts for each investor at the CSDR. There is no principal risk since securities transactions are settled on a delivery versus payment basis. Delivery of the securities is guaranteed as ownership of the securities in the CSDR is verified whenever a sell instruction is entered into the trading system and the relevant securities are blocked until final settlement takes place on T+2. Liquidity risk remains though, since the cash leg settles on a multilateral net basis on T+2, opening the door for potential defaults in the event of a liquidity shortage. Liquidity risk is minimized through (i) a guarantee fund for settlement purposes financed with contributions from the broker-dealers; and (ii) limits on the settlement obligation any broker may accrue in one day, which is currently set at BD 1,000,000. If a broker exceeds the limit, it must deposit 30 percent of the excess by 9:30 a.m. on T+1.

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<sup>15</sup> Domestic government securities including sukuks are registered at the BMA.

## **STRESS TESTING PROCEDURES, ASSUMPTIONS AND OUTCOMES**

82. This appendix describes the methodology and results of the stress tests that were carried out as part of the Bahrain FSAP. The assessment is based on an estimation of the vulnerability of individual banks as well as the system as a whole to various exceptional but plausible shocks. However, stress testing is necessarily a partial equilibrium exercise, which ignores such phenomena as institutions' reactions to shocks, and which cannot be applied to hypothetical situations very different from the actual one.

83. The stress tests were conducted in collaboration with the BMA. The BMA provided coded individual bank data and suggested calibrations for shocks and scenarios.

### **I. COVERAGE—INSTITUTIONS AND RISKS**

#### **A. Institutions**

84. One particular feature of the banking system in Bahrain is the rich variety of banks operating on the island. First, Bahrain features a dual banking system, where conventional banks operate alongside banks based on Islamic principles. Given the recent rapid growth of Islamic banking, it is important to assess whether this growth is occurring on a prudentially sound basis. Second, Bahrain also has important on-shore and off-shore markets. While there are fundamental differences in the nature of activities of on-shore and off-shore institutions, the off-shore market is of critical importance to the financial hub status of Bahrain. Third, the landscape of banks is marked by many different business models, but there are also important overlaps.

85. The institutions covered in the sample are included on a worldwide consolidated basis (thus, including all domestic and overseas subsidiaries of the locally incorporated parent). To assess the possible benefits from diversification between the on-shore and off-shore business or between conventional and Islamic finance, separate data was obtained in cases where on-shore banks are subsidiaries of off-shore banks, or Islamic banks are subsidiaries of conventional banks.

86. The conventional segment of the sample consists of eleven locally incorporated separate legal entities, namely, four FCBs, three OBUs, and three IBLs. The sample of conventional banks represent approximately 40 percent of the assets of all conventional banks, including the large foreign OBUs.

87. The Islamic segment consists of ten locally incorporated separate legal entities, among which two FCBs, one OBU and seven IBLs. The sample of Islamic banks represent over 85 percent of the assets of all Islamic banks.

88. The data collected for these institutions is as of end-2004. The stress tests thus provide an assessment of the vulnerability of the system as of that date. All results presented in this section are in millions of U.S. dollar.

### **B. Risks**

89. The following risk factors are considered: credit risk, market risk, and liquidity risk. The significance of interbank contagion is also examined. The shocks are calibrated with reference to historical events that have affected the banking system of Bahrain. Of particular importance is the past behavior of NPLs and provisioning. To this end, the BMA provided time series on the historical evolution of relevant variables before and after several recent risk events, including: the first Gulf War, the drop in oil prices during the 1990s, September 11, 2001, and the second Gulf War.

## **II. METHODOLOGY, SHOCKS, AND SCENARIOS**

### **A. Methodology**

90. The same shocks are applied to all banks alike. Thus, Islamic and conventional banks, as well as off-shore banks, investments banks, and full commercial banks are all treated alike. This facilitates the identification of relative vulnerabilities in an even-handed way.

91. The treatment of Islamic banks poses several specific methodological challenges. Particular attention is paid to the distribution of losses across bank shareholders and holders of unrestricted investment accounts (URIA) and restricted investment accounts (RIA). The liability of bank shareholders to URIA and RIA holders is limited to cases of misconduct or negligence of the bank in its role as fiduciary (mudarib). Islamic banks may, however, choose to smooth out the rate of return, and principal for that matter, of the investment account holders by reducing its own share of profits, depleting any reserves previously built up (called profit equalization and investment risk reserves) or financing any losses out of the bank's own equity base. The latter is termed displaced commercial risk (DCR).

92. To account for the possibility of fiduciary risk and DCR, the stress tests considers, for each shock and scenario, two extreme cases. The first is the case where investment account holders bear all the losses on the assets that they have financed. Bank shareholder equity is thus fully shielded from the risk embedded in these assets. The second is the other extreme where the bank as a mudarib is treated as a guarantor rather than custodian, and is thus held liable for any losses on investment accounts to the fullest extent. While neither extreme is likely to be realized in practice, they provide useful benchmarks against which to assess the potential range of risks.

93. The impact of the shocks is measured in terms of the effect on the regulatory CAR as well as the LAR. In terms of the effect on regulatory capital, the exercise assumes that losses resulting from shocks translate immediately into equity capital and, as the case may be, risk-

weighted assets. The conservative assumption is made that banks have no profitability buffers to cushion the detrimental effects of shocks.

94. As far as Islamic banks are concerned, the impact on capital is measured following AAOIFI guidelines regarding the calculation of the regulatory capital ratio. Specifically, a 50-percent credit conversion factor applies against assets financed by unrestricted and restricted investment accounts holders. This is in recognition of the fact that such assets may have some impact on banks' shareholder capital through fiduciary and DCR.

95. Due to a lack of data, the stress tests do not quantify the significance of implicit interest rate risk for Islamic banks. The pricing of various financing instruments of Islamic banks appears to be tightly connected to the prevailing conditions in the conventional market. Similarly, on the liability side, banks are reported to offer rates of return prospects to their customers that are competitively priced relative to conventional deposits. In the absence of a stress test for implicit interest rate risk, the scenarios place a higher burden on conventional banks than Islamic banks, as conventional banks are subjected to several types of interest rate shocks while Islamic banks are not. This also applies to the liquidity risk stress tests, where Islamic banks' liquid asset base is assumed not to be eroded by a hike in interest rates.

## **B. Shocks**

96. As noted earlier, the magnitude of the shocks is calibrated on the basis of comparison with several historical risk events. The following shocks were agreed with the BMA to be of plausible magnitude for the purpose of the stress testing exercise.

### **Credit risks**

- Credit shock 1: A five percentage-points increase in the loan-to-assets ratio. The increase could be interpreted as credit growth driven either by growth in assets or a change in the composition of balance sheets. All additional lending is categorized as 'standard'.
- Credit shock 2: An asset quality deterioration according to the transition matrix shown below. The figure in each cell represents the share of the category of the column that would migrate to the category of the row. For example, 90 percent of loans classified as standard remain standard; 4 percent move to substandard, 4 percent to doubtful and 2 percent to loss. The transition matrix would produce an approximate increase in the NPL-to-total-assets ratio of the FCBs in the amount of 5 percentage points. The stress tests assume that provisions are charged at the following rates: 0 percent for standard, 20 percent for substandard, 50 percent for doubtful, and 100 percent for loss. Credit shock 2 is applied to the loan portfolio after taking into account the increase in the standard loan category following Credit shock 1.

	<b>Standard</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Loss</b>
Standard	90			
Substandard	4	90		
Doubtful	4	7	90	
Loss	2	3	10	100

**Market risks**

- Interest rate shock 1: The impact of a parallel upward shift in the yield curve of 200 basis points (bps.) on net interest income at the three-month horizon. Nonparallel yield curve shifts were not considered due to the high level of data aggregation.
- Interest rate shock 2: The impact of a parallel upward shift in the yield curve of 200 bps. on net interest income at the one-year horizon.
- Interest rate shock 3: The impact of a parallel upward shift in the yield curve of 200 bps. on the entire debt securities portfolio (trading, available for sale, hold to maturity), assuming an average duration of 2.5 years.
- Interest rate shock 4: The impact of a parallel upward shift in the yield curve of 200 bps. on the hold-to-maturity portfolio of fixed-rate debt securities, using detailed residual maturity buckets and average coupon rates per maturity bucket. The maturity buckets used include 1-3 years, 3-5 years, ..., 13-15 years, and over 15 years. This stress test is only applied to the conventional banks for which this data was available.
- Equity price shock: A 30-percent decline in worldwide equity prices, applied to both listed and unlisted equities.
- Foreign exchange rate shock: A 20-percent appreciation and depreciation of the bilateral rates between the US dollar and the euro, and between the US dollar and the British pound. The focus is on cross-rates, given the high stability in the bilateral BD-US\$ exchange rate.<sup>16</sup>

**C. Scenarios**

**Basic scenarios**

97. The scenarios have been calibrated to roughly correspond to historical episodes. The first scenario illustrates a boom and bust cycle, where rapid credit growth in the domestic

<sup>16</sup> The BD-U.S.\$ rate would change only in circumstances that differ radically from current conditions. Stress testing for such a nonmarginal transformation would not be informative.

market is followed by a collapse in bank lending and a drastic deterioration in credit quality. This scenario is calibrated by applying Credit shock 1 and Credit shock 2 simultaneously.

98. The second scenario is the case of a world recession affecting the region. Credit shock 2, Interest rate shock 2, Interest rate shock 3 (for those banks that were not included in Interest rate shock 4), Interest rate shock 4 (thus, including the banks for which data was available), and the Equity price shock are applied simultaneously.

### **Interbank contagion**

99. With respect to the second scenario, the potential for spillover effects through default on interbank obligations are examined:

- Interbank contagion 1: For each bank individually, a default on its largest single exposure to an interbank borrower who is also part of the sample. It is assumed that the default results in the classification of the interbank exposure as loss, thus requiring a full 100 percent provisioning charge. The purpose here is to examine maximum possible ripple effect as a result of the default of any single borrower.
- Interbank contagion 2: For each bank, the default on its outstanding exposures to interbank borrowers in the sample, where default follows endogenously from the determination of whether the shocks of the stress tests cause the capital adequacy ratio of the relevant bank to fall below zero.

100. The contagion channel considered here is that operating directly through the interbank market among banks that are in the sample. The tests therefore do not capture the significant part of interbank transactions conducted with other entities.

### **Liquidity risk**

101. Compounding the deterioration resulting from the second scenario, liquidity shocks are imposed, applied individually as well as in interaction with equity price risk and interest rate risk:

- Liquidity shock 1: For all banks, a structural liquidity outflow of 10 percent of all qualifying liabilities, except for interbank liabilities, which suffer a 50 percent outflow.
- Liquidity shock 2: For all banks, the cumulative effect of a shock on liabilities as described above (Liquidity shock 1) and a price decline for listed equity securities of 30 percent.
- Liquidity shock 3: For conventional banks only, the cumulative effect of shocks on liabilities and equity prices (Liquidity shock 2) and a decline in the mark-to-market value of all listed debt securities (in the trading, available-for-sale and hold-to-maturity accounts).

102. Due to a range of data issues, the stress tests focus only on the stock of cash and balances with the central bank, marketable securities, and short-term placements as a means to satisfy liquidity needs, and thus may under-represent somewhat the initial liquidity position of banks.<sup>17</sup> The results may be most informative in terms of the changes in liquidity levels, as absolute liquidity levels need to be interpreted with caution.

### **III. RESULTS**

#### **A. Sensitivity Analysis**

##### **Conventional banks**

103. The conventional banks in the sample are all strongly capitalized, even though there is some degree of variety across banks (Table 5a).

##### ***Credit risks***

104. The impact of credit shocks is pronounced in absolute terms but small relative to the initially high capital bases. FCBs, as a category, are most affected by this shock, which is unsurprising given their proportionately large involvement in lending activities. More pronounced, however, are the effects of Credit shock 2, where FCBs again see the largest reduction in their capital ratios. Nevertheless, relative to their initial capital base, banks are able to withstand these single-factor shocks well.

##### ***Market risks***

105. The effect of a 200-basis points interest rate hike through net interest income is small for all banks. Roughly, half of them experience a positive effect over the three-month horizon, due to the fact that assets can be re-priced faster than liabilities (Interest rate shock 1). Similarly, about half of all banks show an increase in profits after one year (Interest rate shock 2). In other cases, the losses are small relative to capital. The valuation effect of an identical hike is, however, more significant. The system as a whole could loose up to 2 percent of its equity base (Interest rate shock 3). A more refined approximation, although unavailable for all banks and applicable to a different base of assets, suggests similar results (Interest rate shock 4). The results thus indicate that some of the OBUs may have relatively large exposures to interest rate risk, which would gain in importance if other shocks were to force these banks to liquidate their securities and realize losses. It should be noted that the stress tests have not taken into account the risk mitigating effects of banks' derivative activities.

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<sup>17</sup> This definition differs somewhat from that used for prudential purposes. In addition, as far as Islamic banks are concerned the liquid asset ratios include in the definition of total assets all on- and off-balance sheet assets, thus including also the assets financed by restricted investment accounts.



Table 5a. Stress Testing Results—Conventional Banks  
(CAR in percent)

	Average impact				Largest impact		
	FCBs	IBLs	OBUs	Total	FCBs	IBLs	OBUs
Initial CAR	23.9	25.1	19.1	20.7	...	...	...
Reduction in CAR due to (ppts):							
<i>Sensitivity shocks</i>							
(1) Credit shock 1 1/	-2.0	-1.3	-1.4	-1.5	-3.6	-3.2	-2.2
(2) Credit shock 2 2/	-5.2	-0.2	-2.9	-2.6	-6.2	-0.5	-3.7
(3) Interest rate shock 1 3/	-0.1	-0.2	0.6	0.4	-0.2	-0.4	-0.6
(4) Interest rate shock 2 3/	0.1	-0.2	0.9	0.6	-0.4	-0.5	-0.4
(5) Interest rate shock 3 3/	-1.2	-0.7	-2.2	-1.9	-1.6	-1.0	-3.1
(6) Interest rate shock 4 3/	-0.2	0.0	...	0.0	-0.6	0.0	...
(7) Equity price shock 4/	-1.2	-14.5	-1.2	-3.2	-1.9	-19.2	-2.1
(8) Foreign exchange rate shock 5/	0.0	0.1	0.1	0.1	0.0	0.0	0.0
<i>Scenarios</i>							
(9) Boom and bust 6/	-9.4	-1.8	-5.0	-5.0	-32.4	-5.0	-7.0
(10) World recession 7/	-10.0	-16.2	-6.3	-8.2	-31.4	-20.9	-7.6
<i>Interbank contagion</i>							
(11) Interbank contagion 1 8/	-3.7	0.0	-0.5	-0.7	-7.7	0.0	-2.1
(12) Interbank contagion 2 9/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Resulting CAR					Minimum level		
After (10) and (11)	10.3	8.9	12.4	11.9	6.0	5.9	5.6
After (10) and (12)	13.9	8.9	12.9	12.5	8.1	5.9	5.6

Sources: BMA; and IMF staff estimates.

1/ A 5 percentage points increase in the loan-to-assets ratio.

2/ An asset quality deterioration according to transition matrix (c.f. text).

3/ Interest rate shock 1: parallel shift in yield curve (+200 bps), 3-month horizon, flow effects on net interest income.

Interest rate shock 2: parallel shift in yield curve (+200 bps), 12-month horizon, flow effects on net interest income.

Interest rate shock 3: parallel shift in yield curve (+200 bps), valuation effects on securities portfolio, duration of 2.5 years.

Interest rate shock 4: parallel shift in yield curve (+200 bps), valuation effects on HTM portfolio of fixed-rate debt securities.

Due to data limitations, a subsample of 2 FCBs and 2 IBLs was used for the last shock.

4/ A 30 percent decline in equity prices.

5/ A 20 percent depreciation of bilateral rates.

6/ Scenario 1 = (1) + (2).

7/ Scenario 2 = (2) + (4) + (6) + (7). Used shock (5) if no underlying data for shock (6) is available.

8/ Given default on largest single interbank exposure, excluding credit to group entities.

9/ Given actual default by all banks that fail, excluding credit to group entities.

106. Equity price risk is important for many banks, particularly among the OBUs and IBLs. On average, the direct exposures of FCBs seem to be rather small. A mitigating factor is that a negative equity price shock need not affect these banks in the same way, since their respective investments may be in different markets. Foreign exchange risk with respect to cross-currency rates is negligible.

### **Islamic banks**

107. Islamic banks are strongly capitalized in part because assets financed by URIA and RIA attract lower risk weights than similar assets of conventional banks (Table 5b). In what follows, the results of the shocks are presented under the two extreme assumptions of no DCR and full DCR.

#### ***Credit risks***

108. The impact of the two credit shocks is small relative to the capital base. The FCBs seem to be affected most compared to the two other groups. In the case of full DCR, the impact becomes large, especially for certain banks, but even then, banks' capital buffers are able to absorb the individual shocks.

#### ***Market risks***

109. The impact of the equity price shock is more pronounced, particularly for Islamic IBLs. In the case of no DCR, one investment bank in particular seems to incur large losses. On the whole, banks are able to withstand the shock. In the case of full displacement risk, the potential losses are substantial for most Islamic banks, which suggests that, compared to their conventional counterparts, Islamic banks take on significantly more exposure to equity price risk on behalf of the investment account holders. The impact of foreign exchange movements in the cross-rates is again limited, with the exception of one bank that had a relatively large open position in euro on the measurement day.

## **B. Scenarios**

### **Conventional banks**

110. A boom and bust scenario (Scenario 1) would sharply reduce the capital base of many of the conventional banks, yet only a few would no longer meet regulatory requirements. The impact of rapid credit growth followed by rapid asset quality deterioration is particularly costly for the FCBs, who are most exposed to lending.

111. A world economic recession (Scenario 2) has the potential to decapitalize a wider group of banks more severely. Some of the OBUs and IBLs would come under pressure, especially due to the decline in equity prices. Several banks no longer meet the capital requirements, although they remain far from economic insolvency. The current high capital levels thus again seem to provide Bahraini banks with a comfortable cushion in the event of a synchronized global recession.

Table 5b. Stress Testing Results—Islamic Banks

(CAR in percent)

	Average Impact						Largest Impact	
	No DCR			Full DCR			No DCR	Full DCR
	FCBs	IBLs and OBUs	Total	FCBs	IBLs and OBUs	Total	IBLs and OBUs only	
Initial CAR	39.1	25.9	27.9	39.1	25.9	27.9	...	...
Reduction in CAR due to (ppts):								
<i>Sensitivity shocks</i>								
(1) Credit shock 1 1/	-2.5	-1.3	-1.4	-2.5	-1.3	-1.4	-2.6	-2.6
(2) Credit shock 2 2/	-1.3	-0.8	-0.9	-3.8	-2.9	-3.1	-1.9	-10.1
(3) Equity price shock 3/	-2.2	-3.4	-3.2	-6.8	-11.2	-10.4	-9.2	-30.3
(4) Foreign exchange rate shock 4/	0.3	1.8	1.6	0.3	1.8	1.6	0.0	0.0
<i>Scenarios</i>								
(5) Boom and bust 5/	-3.8	-2.1	-2.4	-6.1	-4.1	-4.4	-3.0	-11.0
(6) World recession 6/	-3.7	-4.4	-4.3	-11.1	-14.7	-14.1	-11.6	-41.2
<i>Interbank contagion</i>								
(7) Interbank contagion 1 7/	-7.0	-1.5	-1.9	-7.8	-1.7	-2.1	-28.9	-48.6
(8) Interbank contagion 2 8/	0.0	0.0	0.0	-8.8	0.0	-1.4	0.0	0.0
Resulting CAR							Minimum level	
After (6) and (7)	28.3	19.9	21.7	20.1	9.5	11.6	5.4	-59.2
After (6) and (8)	35.3	21.4	23.5	19.1	11.2	12.4	13.9	-10.6

Sources: BMA; and IMF staff estimates.

1/ A 5 percentage points increase in the receivables-to-assets ratio.

2/ An asset quality deterioration according to transition matrix (c.f. text).

3/ A 30 percent decline in equity prices.

4/ A 20 percent depreciation of bilateral rates.

5/ Scenario 1 = (1) + (2).

6/ Scenario 2 = (2) + (3).

7/ Given default on largest single interbank exposure, excluding credit to group entities.

8/ Given actual default by all banks that fail, excluding credit to group entities.

## Islamic banks

112. Islamic banks seem to be well-protected against the boom and bust scenario (Scenario 1). This follows from their high capitalization levels, and also from their limited involvement in risky lending activities. Even if there were to be full displacement of losses, banks would withstand the combined shock with relative comfort. No bank breaches prudential capital requirements.

113. If the losses of a world economic recession can be distributed to investment account holders, Islamic banks appear well-protected (Scenario 2). To the extent that the owners would voluntarily deplete their equity base to smooth out returns or be required to do so as a result of operational risk, two isolated cases would face capital problems. This is however, almost

entirely driven by an equity price shock, which reduces the economic value of both listed and unlisted equities and may, as far as unlisted equity is concerned, only become apparent if the banks are forced to sell the assets.

### **C. Interbank Contagion**

#### **Conventional banks**

114. Excluding intra-group exposures, the loss given default on the largest interbank exposure of a bank could in principle be significant (Interbank contagion 1). This is especially so for the FCBs who are the most active in terms of placing interbank funds with other banks included in the sample. However, correcting for the likelihood that such losses materialize as a result of the macroeconomic shocks applied in these stress tests, the effects are reduced (Interbank contagion 2). As the stress tests have not produced any actual bank failures, the chances of default on interbank loans are considered minimal.

#### **Islamic banks**

115. Losses given default on largest interbank exposures are a source of vulnerability for Islamic banks (Interbank contagion 1). In the recent environment of excess liquidity, Islamic banks have been active players in placing interbank funds with conventional banks on a commodity murabaha basis. In the case of full displacement, a few banks would become insolvent. If failure were to occur (under conditions of full displacement) and there were to be a default on the bank's interbank obligations, the spill-over effects would be such that especially the FCBs would lose a significant amount of their capital base (Interbank contagion 2).

### **D. Liquidity Risk**

#### **Conventional banks**

116. The three liquidity shocks applied cause a progressive deterioration in the liquidity position of banks (Table 5c, Liquidity shocks 1-3). It is clear from the table that initially comfortable liquidity positions can be eroded quite quickly. The largest changes seem to occur with the OBUs who are dependent on possibly volatile wholesale funding.

#### **Islamic banks**

117. The impact of the liquidity shocks is more heterogeneous for Islamic banks. The largest reduction in liquidity occurs among the OBU and IBLs in the event of outflows from demand deposits and investment account and a reduction in the marketable value of listed equity securities.

Table 5c. Stress Testing Results—Liquidity Impact

(LAR in percent, unless noted otherwise)

	Average				Largest change		
	FCBs	IBLs	OBUs	Total	FCBs	IBLs	OBUs
Conventional banks							
Initial LAR	25.5	44.9	47.3	44.1			
Reduction in LAR due to (ppts):							
(1) Liquidity shock 1 1/	-14.8	-8.5	-20.0	-17.9	-17.3	-19.2	-24.7
(2) Liquidity shock 2 2/	-15.6	-16.5	-20.3	-19.2	-17.7	-21.9	-25.0
(3) Liquidity shock 3 3/	-16.1	-16.5	-21.7	-20.3	-18.0	-22.0	-26.1
Total shortage of liquidity after (3) (in thousands of U.S. dollars)	0	0	4,575	4,575	0.0	0	4,575
Islamic banks							
	Average			Largest change			
	FCBs	IBLs and OBUs	Total	FCBs	IBLs and OBUs		
Initial LAR	16.6	27.8	26.0				
Reduction in LAR due to (ppts):							
(1) Liquidity shock 1 1/	-4.8	-15.7	-13.9	-8.0	-33.2		
(2) Liquidity shock 2 2/	-8.1	-18.9	-17.1	-8.1	-44.4		
Total shortage of liquidity after (2) (in thousands of U.S. dollars)	0	70,120	70,120	0	70,107		

Sources: BMA; and IMF staff estimates.

1/ 10 percent liquidity outflow for all qualifying liabilities, except for bank liabilities that suffer a 50 percent outflow.

2/ Cumulative effect of (1) and a 30 percent decline in listed equity securities.

3/ Cumulative effect of (2) and a decline in the mark-to-market value of all listed debt securities, due to a 200 bps parallel increase in the yield curve.

4/ Assuming no DCR.

## SUMMARY ASSESSMENT OF THE OBSERVANCE OF FINANCIAL SECTOR STANDARDS

This appendix contains summary assessments of Bahrain's observance of four international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory framework in Bahrain is adequate to address the potential risks in the financial system, as well as the strength of the underlying regulatory governance practices and market foundations, and the functioning of market infrastructure. The assessments have provided the basis for making recommendations for further strengthening the institutional, legislative, and regulatory aspects of the Bahraini financial stability framework.

The assessments were undertaken as part of the FSAP mission during April-May 2005 by a IMF team led by Mr. Daniel Hardy. The FSAP assessors are as follows: Mr. Mohamad Muhsin Mohd Anas (Bank Negara Malaysia) and Mr. Nicholas Cook (UK Financial Services Agency) for the Basel Core Principles for Effective Banking Supervision; Mr. Erik Huitfeldt for the IAIS Insurance Core Principles and Methodology; Mr. Mark McGinness (Australian Securities and Investments Commission) for the IOSCO Objectives and Principles of Securities Regulation; and Mr. Ian Carrington, Ms. Tanya Smith, Ms. Joy Smallwood (all IMF) and Mr. Boudewijn Verhelst (Belgian Financial Information Unit, financial intelligence and criminal justice expert) for FATF's Principles for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).

The assessments were preceded by self-assessments undertaken by the Bahraini authorities. The evaluations during the FSAP involved a close analysis of all relevant laws and regulations, a review of actual practices, and discussion with Bahraini authorities, market participants, and industry associations.

The degree of Bahrain's observance of international financial sector standards and codes is high, though in each area certain aspects were identified where further improvements would be desirable. The Bahraini authorities note in their responses that they are aware of the areas that need further reforms and efforts, such as in the collection and analysis of information, and are in the process of addressing them; some action has been taken since the time of the assessment.

## **V. COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

### **General**

118. The assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was conducted as part of the Financial Sector Assessment Program (FSAP) for Bahrain. The Bahrain Monetary Agency (BMA) cooperated fully with the assessment and provided all the necessary clarifications and documents.

### **Information and methodology used for assessment**

119. The BMA provided the assessment team with a self-assessment of compliance with standards and principles and responses to a questionnaire on Bahrain's financial sector, macro prudential indicators and the legal and regulatory framework in advance of the mission. During the mission, the responses to the questionnaire and self assessments of compliance with the standards and principles were clarified and checked through detailed discussion and interviews with the BMA, bankers, the Bankers' Society of Bahrain, the Ministry of Justice, the Ministry of Industry and Commerce, the Ministry of Finance (MOF), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and accounting firms.

120. The assessments were carried out from 24 April to 7 May 2005. All the assessments were based on the laws (namely the BMA Law 1973 and the Commercial Companies Law 2001), regulations (BMA Rulebook volumes on conventional and Islamic banks) and policies and practices in place at the time the assessments were made. References were also made to the draft Central Bank of Bahrain Law (CBBL), and Consultative Papers.

### **Institutional and macroprudential setting, market structure overview**

121. Bahrain has a small but comparatively well diversified economy, although oil market conditions have strong direct and indirect influence on performance. Bahrain maintains a tight peg to the U.S. dollar; since there are no exchange controls or restrictions on capital movements, inflation and interest rates follow U.S. rates closely.

122. Bahrain has emerged as a major regional financial center. At end-2004, over 300 financial institutions were in operation, and the number of institutions has been growing. The system is dominated by banks, which include, besides domestically-incorporated institutions, a range of foreign institutions from the region, industrialized countries, and other emerging markets. The system currently consists of three categories of banks: Full Commercial Banks (FCBs), which operate in the domestic retail market; institutions with Investment Banking Licenses (IBLs), whose business is largely limited to foreign-currency denominated investment and merchant banking activities with non-residents; and numerous Off-Shore Banking Units (OBU) which are allowed to carry out all retail and commercial banking activities but as a general rule only with non-residents (and only in foreign currency). The

Islamic sector has been growing in importance and a number of banks in all categories operate according to Shari'a principles, and Islamic securities (known as sukuks) have been issued by government and corporations. Capitalization is generally strong and the sector is profitable. A deposit insurance scheme is in operation.

123. The BMA, the single financial sector regulator since 2002, has responsibility for regulating and supervising the banking sector. Thus, financial sector supervision is in a period of transition, although the adjustment for the banking sector is less than that for other sectors. The BMA recently issued the volumes of its Rulebook that collect all regulations on conventional and Islamic banks. Passage is awaited of the CBBL, which will provide a unified legal framework for the BMA's role as integrated financial sector regulator and enhance its authorities in various regards. The BMA is currently reviewing the licensing system with a view to achieving greater cross-sector consistency; the intention is to move to the new system in 2006.

### **General preconditions for effective banking supervision**

124. Given the volume of intermediation, the "credit culture" seems to be well entrenched. Broadly satisfactory legislation and institutional arrangements are in place to handle bankruptcies and the liquidation of firms. The legal system, including the availability of legal services and the functioning of the courts, is adequate, although there is a recognized need among judges for more expertise in financial matters and the establishment of specialized courts that could render more timely judgments. Legislation has been in force and implemented for some time, covering such areas as company registration and governance, contracts, and the registration of movable and immovable property. An initiative is currently under way to enhance corporate governance. Corporate accounting follows International Accounting Standards, and the accounting and auditing professions include representatives of all major international firms. Conventional financial institutions follow International Financial Reporting Standards (IFRS), and Islamic institutions follow the analogous standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Direct government interference in commercial decision-making is rare. The clearing, payments, and settlement system is efficient and reliable.

### **Main findings**

125. Banking supervision in Bahrain meets high standards. Compliance with the BCP is strong, especially in areas that are of greatest relevance to the current activities of banks in Bahrain. The system still needs to be refined in several respects, and efforts are needed to keep regulations and supervision up to date with the more sophisticated operations that banks may wish to introduce. The authorities recognize that, given Bahrain's role as a regional financial center, they have an extra incentive to ensure that the supervisory framework promotes the sound and efficient development of the sector.



***Objectives, autonomy, powers and resources (CP 1)***

126. The BMA Law provides adequate powers for the BMA. However, the 1973 Law has a number of weaknesses: it does not define the BMA's objectives with regard to banking regulation and supervision in any detail; the BMA's independence is limited by requiring it to obtain the approval of the MOF in certain key areas including the granting and cancellation of banking licenses and certain budgetary aspects; and the BMA's powers of sanction, other than suspension or cancellation of banking licenses, are not spelt out in any detail. Nonetheless, the mission team observed no significant problems arising from these formal weaknesses, which are expected to be addressed in the CBBL.

127. The BMA has been striving to increase the number and quality of its supervisory staff. While these efforts have been relatively successful, significant supervisory challenges lie ahead which will demand a continued strengthening of resources. These challenges include the integration of the BMA into a single regulatory body, the implementation of Basel II, and the general growth in innovative and increasingly complex banking products. It is important that the number and particularly the quality of supervisors with relevant banking experience keeps pace with these challenges, to which end BMA remuneration must be kept competitive with that available in the private sector.

***Licensing structure (CPs 2-5)***

128. Under the 1973 BMA Law, banking and the scope of regulated banking activities are not clearly defined. This has created difficulties in fitting certain institutions into the current licensing framework. BMA proposals for a new integrated framework which clearly distinguishes between traditional bank deposit-taking activities, investment services, insurance and other specialist financial activities are currently nearing completion, with a target for implementation by the end of the year. Timely adoption of these proposals would bring licensing arrangements up to date and ensure they are adapted to the BMA's new status as the single financial sector regulator.

129. The licensing process would benefit from clearer procedures for the processing of applications and analysis of related information. In particular, the text setting out international best practice in corporate governance is included in the banking volumes of the rulebook currently has only consultation status. It is important that the BMA continues to stress the importance of these issues with regard to licensing as well as on-going supervision.

130. The BMA has also recently published proposals regarding major acquisitions and investments by banks. These proposals would improve the capital treatment of such acquisitions and clarify "close links" provisions.

***Prudential regulations and supervision (CPs 6-15)***

131. The rules and regulations on capital adequacy generally conform to the Basel standards, and include a capital charge for market risk. For Islamic banks, the BMA requires

the adoption of AAOIFI recommendations on the computation of capital adequacy, which recognizes the risk undertaken by the investment holders. The BMA's minimum capital adequacy requirements are monitored on both a solo and consolidated basis and are above the Basel minimum. A framework to stress test the capital adequacy of banks would provide additional supervisory comfort on the adequacy of the bank's level of capital.

132. In managing credit risk, the BMA has prescribed various rules and regulations, including the requirement of the board to set policies on large exposures and connected lending, although loans to connected parties from conventional banks are not strictly required to be on non-preferential terms. Banks are required to adopt IFRS for loan impairment and provisioning; the external auditors are largely responsible for ensuring adequacy of loan loss provisions through the annual audit process. The external auditors are required to review and report on the bank's risk management system and exposures in market risk, credit risk (including country risk) and operational risk. Liquidity risk is controlled through a 25 percent liquid asset requirement.

133. The BMA monitors compliance with the prudential requirements through on-site examination and quarterly submissions of the prudential information report, which must be verified by the external auditors. In view of the bank's diversity of exposures to other countries, the supervision could extend its prudential analysis to the banks' individual country risk exposures.

134. In view of the different nature and risk of Islamic banking, the BMA has established an off-site supervision unit to oversee the Islamic banks. Although the supervisors understand the risk associated with Islamic banks, there is a need to continuously enhance the risk measurement framework for Islamic banks, where innovation is on-going.

135. In its efforts to strengthen the corporate governance in banking, the BMA intends to issue "High Level Controls Environment" (currently under consultation) to set the minimum standards and best practice on minimum high level controls to be adopted by the locally incorporated banks. Some of the main elements prescribed are the establishment/composition/role of pertinent board committees (nomination, remuneration, board risk management, and audit committees) and definition of independent committees.

136. The BMA has been active in ensuring that banks have adequate policies and procedures on "know your customer." The BMA had implemented AML/CFT requirements, and in April 2005 further updated requirements in line with the June 2003 revisions to the FATF 40+ 9 Recommendations were introduced. The Compliance Unit in the BMA monitors banks' compliance with the AML regulations, receives copies Suspicious Transaction Reports, and conducts follow-up to re-assess the adequacy of the relevant bank's AML compliance system.

***Methods of on-going supervision (CPs 16-20)***

137. The BMA undertakes off-site and on-site supervision, supplemented by “reporting accountants” arrangements, which address the need for more detailed information on specific issues affecting an institution. The BMA's risk assessment is based on a risk profiling system to prioritize on-site inspections. The arrangements for consolidated supervision are satisfactory, although closer attention might be given to the overseas operations of Bahraini banks outside major markets. Generally, there is a comprehensive and high quality approach to on-going supervision. However, the monitoring and analysis of overall trends in the banking system could be enhanced, and the growing number of licensed banks puts strain on supervisory capacity.

***Information requirements (CP 21)***

138. Locally incorporated banks are required to publish annual audited accounts. There is no specimen bank model prescribed by the BMA for the publication of the annual audited statements but banks are required to prepare audited accounts in accordance with the IFRS. The requirement for disclosure are the same for all locally-incorporated banks, whether FCBs, IBLs, or OBUs. However, the minimum disclosure requirements prescribed by the BMA for Islamic banks are not as extensive as for conventional banks. The BMA requires external auditors to review and report on the bank’s risk management and risk exposures. The external auditors must be approved by the BMA and are drawn from the big international audit firms. Approval by the BMA is required for declaration of dividend distributions and BMA officers are required by law to keep confidential certain types of information. The external auditors have access to the BMA by law, and in practice do frequently report to the BMA on issues that require BMA’s attention.

***Remedial Measures (CP 22)***

139. The BMA’s authority to take appropriate remedial actions are prescribed in the BMA Law and its approach to addressing failures of banks to comply with its regulatory requirements are set out in the Enforcement Module of the Rulebook. The future CBBL will give the BMA a wider range of explicit enforcements powers, particularly to give directions and impose penalties.

***Cross-border banking (CPs 23-25)***

140. The BMA has the authority to share information needed by the home country for carrying out consolidated supervision. The branches of foreign banks are subject to similar regulations as locally incorporated banks (with variations in capital, large exposures and disclosure requirements). The BMA has the authority to supervise the foreign branches/subsidiaries of locally incorporated banks. The BMA does not conduct on-site examination of overseas units and relies on discussion with head office in prudential meetings, external auditor's reports, submissions of returns, and visits to the host supervisors.

141. The BMA actively pursues information sharing with regulators from the GCC and one other foreign regulator. However, in light of Bahrain’s position as a financial center, there is room for more extensive information sharing arrangements with other regulatory authorities.

**Recommended action plan and authorities’ response to the assessment**

**Recommended action plan**

Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
1 Objectives, Autonomy, Powers and Resources	<ul style="list-style-type: none"> <li>• Adoption of the draft CBBL would enhance the autonomy of the BMA and clarify its legal powers.</li> </ul>
1.1 Objectives	<ul style="list-style-type: none"> <li>• More formal arrangements for assessing the BMA’s performance against its objectives are recommended.</li> <li>• Public disclosure of such an assessment and other information about the BMA’s activities would enhance transparency and accountability.</li> </ul>
1.2 Independence and resources	<ul style="list-style-type: none"> <li>• Removal of the current requirement for prior approval of the Ministry of Finance in certain areas such as licensing and budget is recommended. Adoption of the draft CBBL would achieve this end.</li> <li>• A minimum term of office for the Governor should be specified in law.</li> <li>• Legislation should specify possible grounds for the removal from office of the Governor and a requirement to publish grounds in that event.</li> <li>• The BMA should maintain its effort to further increase the number and quality of its supervisory staff. Increased flexibility over salary scales is needed in order to be able to recruit staff with appropriate banking experience and skills.</li> </ul>
1.4 Powers to enforce compliance	<ul style="list-style-type: none"> <li>• Legal powers which specify a more clearly elaborated range of sanctions is recommended. Adoption of the draft CBBL would help achieve this end.</li> </ul>

Reference Principle	Recommended Action
1.5 Legal Protection	<ul style="list-style-type: none"> <li>• While legal protection is currently provided generally for government employees via the Civil Code, specific protection for BMA staff exercising their duties in good faith is recommended. Adoption of the draft CBBL would achieve this end.</li> <li>• In addition it is recommended that assurances should be given regarding protection of BMA staff against the cost of defending their actions while discharging their duties, perhaps in the form of internal documentation.</li> </ul>
1.6 Information sharing	<ul style="list-style-type: none"> <li>• It is recommended that procedures manuals on information sharing and confidentiality are finalized and implemented.</li> </ul>
2 Permissible	<ul style="list-style-type: none"> <li>• It is recommended that the new licensing framework proposed by the BMA should be adopted as soon as possible in order to clarify the definition of regulated activities. Action in this area would complement the provisions in the draft CBBL.</li> </ul>
3 Licensing criteria	<ul style="list-style-type: none"> <li>• It is recommended that the BMA continues to give priority to its initiatives regarding corporate governance with a view to establishing best practice with respect to the responsibilities, qualifications and independence of directors in the banking sector. In addition, detailed internal policies and procedures for processing license applications are recommended.</li> </ul>
4 Ownership	<ul style="list-style-type: none"> <li>• Criteria should be developed for judging whether to approve proposed changes in significant ownership.</li> </ul>
5 Major acquisitions and investments	<ul style="list-style-type: none"> <li>• It is recommended that explicit criteria for the assessment and treatment of major acquisitions and investments by Bahraini banks are established, and especially for the pre-approval of major investments in nonbank enterprises.</li> </ul>
9, 11, 12, 13 Large exposure, country risk, market risk, other risk	<ul style="list-style-type: none"> <li>• BMA should continue its efforts to build up adequate skill and resources for on-site supervision, as these would greatly enhance the assessment of the adequacy of banks' information systems and risk management.</li> <li>• The framework for interest rate (rate of return) risk in the banking book and liquidity risk management (for the conventional banks) should be further developed.</li> </ul>
10 Connected lending	<ul style="list-style-type: none"> <li>• The requirement that loans to connected parties be at arm's length and on non-preferential terms (except to a limited extent as part of staff compensation) should be extended to conventional banks.</li> <li>• The requirement that Board approval should be a precondition for the granting of a loan to a connected party should be made mandatory rather than a matter of guidance.</li> </ul>

Reference Principle	Recommended Action
14 Internal control and audit	<ul style="list-style-type: none"> <li>The establishment of a high level control environment would facilitate and promote effective performance of board oversight (such as establishment of board committees and definition of independent directors), taking into account the nature and scale of the business operations.</li> </ul>
15 Money laundering	<ul style="list-style-type: none"> <li>Legislation needs to contain provisions ensuring that the BMA can share all relevant information, even when such information is not directly related to the BMA's responsibilities.</li> <li>The BMA needs to make efforts to implement effectively all new provisions in this area.</li> </ul>
16 On-site and off-site supervision	<ul style="list-style-type: none"> <li>The BMA should maintain its efforts to further enhance the number and quality of its on-site and off-site supervisory staff.</li> </ul>
17 Bank management contact	<ul style="list-style-type: none"> <li>The BMA should extend its contact with banks' management to regular contact with members of banks' boards.</li> </ul>
20 Consolidated Supervision	<ul style="list-style-type: none"> <li>All overseas operations of subsidiaries and branches of Bahraini banks should be given due attention in the context of consolidated supervision.</li> </ul>
22 Remedial measures	<ul style="list-style-type: none"> <li>A wider range of explicit enforcement powers is recommended. Adoption of the draft CBBL would provide for this.</li> </ul>
23, 24, 25 Global consolidated supervision, host country supervision and supervision over foreign banks establishments	<ul style="list-style-type: none"> <li>Greater attention should be given to global consolidated supervision of large locally incorporated banks, including of their nonbank activities and information sharing with host supervisors.</li> <li>For foreign bank establishments, the BMA should conduct periodic assessments of the home country supervisor's practices in consolidated supervision.</li> </ul>

### Authorities' response to the assessment

142. The BMA welcomes the assessment that banking supervision in Bahrain meets high standards, and that compliance with the Basel Core Principles is strong, particularly in the areas of greatest relevance to the current activities of banks operating in Bahrain. The BMA also endorses the findings of the report, most of which cover areas already identified as requiring further strengthening, as noted at various points in the assessment. The BMA will continue with its various on-going efforts aimed at further developing its banking supervision capabilities, and believes that these will substantially address the points raised in the assessment over the next 12-18 months.

143. Several of the findings (Core Principles 1, 15, and 22) relate to the BMA Law. Its replacement, the draft CBBL, which has been under preparation for some time and is now currently before parliament, would address most of these. Neither the BMA nor the Government of Bahrain can prejudge when the new law will be adopted, since this lies in the

hands of the parliament; but it is hoped that the legislative process will be completed by mid-2006 at the latest.

144. The BMA's plans to introduce a new integrated license framework (Core Principles 2 and 3) are at an advanced stage: draft regulations are currently being finalized, after several rounds of industry consultations, and are now expected to be introduced in early 2006, after a final round of discussion with the industry (offered at their request).

145. Existing rules on major acquisitions and investments are being reviewed as part of the Basel II project. Proposals will be finalized over the course of 2006. The BMA will be revisiting its liquidity requirements as part of its 2006 work plan as well. Other, more minor suggested improvements to individual rules will also be addressed during 2006, as part of the routine quarterly updates to the BMA Rulebook.

146. Finally, senior management is fully conscious of the need to ensure adequate resourcing of the BMA's supervisory functions. Indeed, some improvements have already been achieved, through the hiring of staff with industry experience, and an overall increase in numbers. These efforts will continue; and they will be further supported by on-going plans to develop a more capable IT infrastructure, over the next 2 years, which will eventually see full data warehousing capabilities and more automation of data retrieval and assessment.

## **VI. SUMMARY ASSESSMENT OF OBSERVANCE OF THE INSURANCE CORE PRINCIPLES**

### **General**

147. The regulation and supervision of the insurance sector was assessed relative to the Insurance Core Principles and Methodology issued by the International Association of Insurance Supervisors (IAIS) in October 2003. The assessment was performed as part of the FSAP assessment for Bahrain.

148. The assessment is based on reviews of (i) relevant laws and regulations; (ii) a self assessment prepared by the Insurance Directorate at the Bahrain Monetary Agency (the BMA) and numerous relevant documents provided by them; (iii) a series of interviews and discussions with officials from the Insurance Directorate and other officers of the BMA; (iii) meetings with the insurance association, private insurance companies, intermediaries, auditors, and other financial institutions; and (iv) review of marketing documents and insurance contracts used in the Bahrain market.

### **Institutional and macroprudential setting—overview**

149. Bahrain is a middle-income country with an economy closely integrated with those of its neighbors in the Gulf Cooperative Council (GCC). Growth rates in recent years have been high. The exchange rate is tightly pegged to the U.S. dollar.

150. Bahrain has emerged as a major regional financial center, with over 300 financial institutions providing a wide range of financial services in areas including banking, insurance, capital markets, and investment advice, and the number of institutions has been growing. At end-April 2005, the on-shore insurance sector comprised 22 licensed insurance companies (of which 12 were locally incorporated; not all licensees were yet operational), 30 insurance brokers, and 7 insurance consultants. Two on-shore companies operate under Islamic principles (known as takaful). The on-shore insurance industry collects on average slightly under 3 percent of GDP in gross premiums annually. General insurance accounts for some three-quarters of total domestic gross premiums. Motor insurance accounts for about half of all non-life business; insurance of major public sector installation constitutes another major business line. Life products for on-shore companies accounted for a fifth of total gross premiums. Demand for Islamic insurance has been growing especially strong. Some companies offer reinsurance domestically on a comparatively small scale, but important use is made of reinsurance from abroad. Total assets of domestic insurance companies reached US\$2 billion at end-2004, and investments reached US\$1.2 billion (10.9 percent of GDP).

151. The off-shore insurance sector at end-April 2005 comprised 73 companies, including 57 insurance firms, 13 insurance brokers, and 3 insurance consultants. The total amount of gross premiums for the off-shore sector was in excess of US\$1 billion in 2003. The off-shore insurance companies are allowed to conduct business only outside Bahrain, but are required to have functioning offices in Bahrain, and they are subject to all the legislation and regulation governing on-shore insurance companies. They are mainly engaged in offering insurance products in Saudi Arabia. Some off-shore insurance companies, however, may relocate to Saudi Arabia following the recent promulgation of an insurance law in that country. This process had already begun at the time of the assessment, and in this connection the BMA withdrew the licenses of 10 off-shore companies in March and April 2005, and more licenses have been withdrawn subsequently.

152. Insurance companies are mostly well-capitalized. They have generally been profitable, although the return on equity has been moderate, mainly because capitalization is high and some companies (especially takaful companies) may currently suffer from a shortage of suitable and remunerative investment vehicles.

153. The BMA is the insurance supervisor, and its Insurance Directorate is responsible for the majority of the supervisory tasks. Licensing of insurance companies is conducted by the Licensing and Policy Department at BMA, while on-site inspections are performed by the Inspection Department. The Compliance Unit deals with regulation and supervision of AML/CFT measures.



154. The legal framework governing the insurance sector consists of: the Amiri Decree No. 3 of 1987 regarding compulsory auto insurance; Amiri Decree No. 17 of 1987 (the Insurance Law), an insurance law regulating life insurance, general insurance, and insurance intermediation; The Law Establishing the Monetary Agency of Bahrain of 1973 (the BMA Law); and the Amendment to the Insurance Law, 2002, unifying supervisory responsibilities; previously, the insurance sector had been regulated by the Ministry of Industry and Commerce (MOIC). In early May 2005 the BMA issued a collection of regulations (the Rulebook) containing a comprehensive set of insurance regulations, which are in all regards substantially more rigorous than previous regulations.

155. This assessment was undertaken during a period of transition, with both significant changes to the regulatory framework and introduction of new Islamic insurance products. The BMA and the private sector have now to implement and control compliance with the Rulebook. Moreover, following the creation in 2002 of a unified financial sector regulator in the BMA, proposals for an integrated licensing framework, applicable to all institutions including insurance companies, is currently circulating for comments. In addition, it is anticipated that the Central Bank of Bahrain Law (CBBL) will be passed in the foreseeable future. The CBBL is meant to provide the legal framework for the BMA's role as integrated financial sector regulator, and to enhance its authority and autonomy in various ways.

### **General preconditions for effective insurance supervision**

156. The preconditions for effective insurance regulation generally obtain in Bahrain. Economic stability has been maintained, and supporting infrastructure is adequately developed. The legal system, including the availability of legal services and the functioning of the courts, is adequate, although there is a recognized need among judges for more expertise in financial matters and the establishment of dedicated commercial courts that could render more timely judgments. Broadly satisfactory legislation and institutional arrangements are in place to handle bankruptcies and the liquidation of firms. Company registration and governance law, contracts law, and the registration of movable and immovable property legislation has been in force and implemented for some time. Corporate accounting follows International Accounting Standards (IAS), and the accounting and auditing professions include representatives of all major international firms. Conventional financial institutions follow International Financial Reporting Standards (IFRS), and Islamic institutions follow the analogous standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Direct government interference in commercial decision-making is rare. The clearing, payments and settlement system is efficient and reliable.

### **Main findings**

157. The legal, regulatory and supervisory framework largely observes the essential criteria of the IAIS Insurance Core Principles and Methodology. The degree of observance will be higher, once all aspects of the Insurance Rulebook are implemented, and the CBBL is

passed. The most immediate outstanding challenge is the full and effective implementation of the existing regulations, given the resources available to the BMA.

### *The supervisory system*

158. The BMA has responsibility for the regulation and supervision of the entire financial system, and its objectives are clearly stated. It is not formally fully independent, although in practice it operates with considerable autonomy. The BMA has extensive powers established by law, on which basis it has promulgated comprehensive, detailed regulations. The BMA consults frequently with the insurance industry and other interested parties in developing and implementing these regulations, and makes considerable efforts to be transparent. The BMA has powers to license all relevant institutions, verify compliance with the regulations through on-site and off-site supervision, and to impose sanctions.

### *Ongoing supervision*

159. The Rulebook sets out how the BMA will conduct its functions, and it describes a clear, transparent and consistent regulatory process. The BMA conducts on-site and off-site supervision, and market analysis. However, at the time of the assessment, the BMA had conducted few on-site supervisory visits, and had limited staff resources available for off-site insurance supervision and market analysis. The data management challenges created by the more extensive reporting requirements will themselves take some time to be sorted out. It is therefore critical that the promulgation of the Rulebook is followed up with training and strengthening of staff.

160. The BMA has in place or is about to finalize several bilateral exchange of information agreements with supervisors in other countries. Given Bahrain's role as a financial center, it is important that the BMA continue to strengthen cooperation with supervisors from the home countries of the insurers that are operating branches in Bahrain. The BMA law provides satisfactory exemption from the confidentiality requirements to allow closer cooperation with foreign supervisors, but the rules on the BMA's right to cooperate and assist other foreign supervisors need to be stronger and clearer.

161. There have reportedly been instances where a domestic insurer "fronts" for foreign insurers; the foreign insurers is effectively selling insurance and the local insurer is effectively a broker. The Rulebook recognizes the concern, and warns companies that the BMA will scrutinize closely the management by firms of the risks associated with possible fronting.

162. Primary legislation (the Insurance Law and the BMA Law) does not set out preventive or corrective powers in much detail, but BMA's general power to regulate and to withdraw the license is accepted as satisfactory authority to impose specific actions, and the BMA has a record of disciplining insurance companies as needed, and of dealing with problem banks. The Rulebook lays out a broad range of enforcement measures available, including issuing directions and putting the insurance licensee under administration. The BMA has the legal power to withdraw the license from an insurer should certain conditions

obtain, but the protection of the rights and entitlements of policyholders and other policy beneficiaries in case of insolvency are not given priority in primary legislation. Passage of the CBBL will further strengthen the legal basis for enforcement action.

### ***Prudential requirements***

163. With the promulgation of the Rulebook, the BMA has provided the insurance industry with satisfactory regulations in most areas. The content of these rules are more advanced than the rules in the previous framework and it will require substantial efforts by the BMA to control the industry's compliance with these new rules. The most demanding rules include: corporate governance for insurers; insurer's regular reporting requirements to BMA; the risk management measures that must be implemented by insurers; the new prudential requirements involving calculation of the insurer's liabilities; investment standards; and the capital adequacy rules. The BMA expects that supervision in these areas will intensify following the promulgation of the Rulebook.

164. The legal framework does not contain substantial regulation regarding use of derivatives because the insurance industry did not now use financial derivative instruments. It is anticipated that use of financial derivatives could begin in the future, so regulations on the use, accounting, and transparency of derivatives should now be developed.

165. Although currently no true financial conglomerate operates in Bahrain, and the structure of groups of insurance companies is relatively straightforward, the BMA needs to further develop procedures and requirements for consolidated and group supervision, when insurance conglomerates and more complex groups start operating in Bahrain, and ensure that sufficient resources are available to implement these.

### ***Markets and consumers***

166. The Rulebook requires insurers to have in place strategic underwriting, re-insurance and pricing policies approved and reviewed by its Board of Directors. The BMA must continue to strengthen the supervision in these areas, ensuring that each insurer has a clear strategy to mitigate and diversify risks (including re-insurance risk), and a methodology to set premiums on reasonable assumptions to enable the insurer to meet its commitments

167. Bahraini insurance firms are required to publish comprehensive audited, annual reports. The Rulebook provides rules for valuation of liabilities based on sound accounting and actuarial principles, which the BMA has power to review and amend. The sufficiency of technical provisions is yet not systematically reviewed by the BMA itself, which so far has relied entirely on the reports of companies' external auditors.

168. The Rulebook requires that insurers and intermediaries act with due skill, care and diligence in dealing with consumers. Insurers and intermediaries are required to have policies on how to treat consumers fairly and provide training to ensure compliance with those policies.

169. The Rulebook requires insurers and intermediaries to ensure high standards of integrity of their business. The Rulebook addresses insurer fraud, and claims fraud is a punishable offense under the criminal law. The BMA has the authority to cooperate with enforcement authorities, as well as with foreign supervisors, to deter, detect, record, report and remedy fraud in insurance.

170. Insurance intermediaries are required by law to be licensed by the BMA. Insurance intermediaries must have adequate commercial and professional knowledge, and comply with the fit and proper requirement. The BMA has power to take corrective action, apply sanctions, and revoke the intermediary’s license if needed.

***AML/CFT***

171. The Rulebook incorporates most of the AML/CFT recommendations promulgated by FATF, but implementation of the rules is pending. The lack of Suspicious Transaction Reports from insurers and other evidence suggest that insurers have only limited working knowledge of the AML/CFT provisions of the Rulebook. The BMA should begin AML/CFT training and on-site inspections of the insurers. The AML/CFT rules also need to be amended to specify procedures for verifying customer identity where no face-to-face contact takes place.

**Recommended action plan**

172. The following are some specific suggestions on how to continue to pursue the authorities’ objective of maintaining a regulatory and supervisory framework for the insurance sector that promotes its efficiency and sound development. Several of these suggestions go beyond what is strictly required for observance of IAIS principles.

Recommended Action Plan to Improve Compliance with the IAIS Core Principles

Reference Principle	Recommended Action
3. Supervisory authority	<ul style="list-style-type: none"> <li>• The BMA should consider making adjustments to its pay scale so it can compete effectively with the private sector in hiring and maintaining the best qualified staff.</li> <li>• The forthcoming CBBL should include a provision, requiring that reason be given for the eventual dismissal of the BMA Governor.</li> </ul>
5. Supervisory cooperation and information sharing	<ul style="list-style-type: none"> <li>• BMA should continue to strengthen its cooperation with supervisors in other jurisdictions.</li> </ul>

Reference Principle	Recommended Action
6. Licensing	<ul style="list-style-type: none"> <li>• The BMA should determine whether foreign re-insurers under fronting arrangements with domestic insurers in reality are insurers that need to be licensed.</li> <li>• The BMA should include in its on-site inspection procedures the identification of “fronting,” evaluating attendant risks, and giving appropriate guidance to the companies concerned (including possibly advice on how to end the practice).</li> <li>• The guidance in the Rulebook could be redrafted to make clear that the BMA does not condone “fronting.”</li> </ul>
7. Suitability of persons	<ul style="list-style-type: none"> <li>• The Rulebook should be amended to explicitly disallow directors and senior managers from fulfilling multiple functions (notably oversight functions) that pose a conflict of interest, and to require that appropriate segregation of responsibilities be maintained.</li> </ul>
9. Corporate governance	<ul style="list-style-type: none"> <li>• Regulations in this area should be fully enforced through verification now that the Rulebook has been issued.</li> </ul>
11. Market analysis	<ul style="list-style-type: none"> <li>• Analysis activities should be increased, to which end resources will have to be made available.</li> </ul>
12. Reporting to supervisor and off-site monitoring	<ul style="list-style-type: none"> <li>• The BMA will have to develop its analytical capacity and a framework to effect on-going monitoring. To this end, additional staff resources and staff training may be necessary.</li> </ul>
13. On-site inspection	<ul style="list-style-type: none"> <li>• On-site inspection must be undertaken on a more regular basis for all insurance companies. To this end, additional staff resources and staff training may be necessary.</li> </ul>
16. Winding-up and exit from the market	<ul style="list-style-type: none"> <li>• The authorities should consider how to give priority to claims of policyholders and beneficiaries when liquidating an insurer.</li> </ul>
17. Group-wide supervision	<ul style="list-style-type: none"> <li>• Reporting requirements and supervisory practice covering groups and conglomerates will need to be developed further as their organizational forms become more widespread.</li> </ul>
18. Risk assessment and management	<ul style="list-style-type: none"> <li>• The BMA intends to intensify monitoring of companies’ risk management systems following the recent promulgation of the Rulebook.</li> </ul>

Reference Principle	Recommended Action
19. Insurance activity	<ul style="list-style-type: none"> <li>• The BMA must strengthen the supervision of insurance activity following the Rulebook coming into force, ensuring that each insurer has a clear strategy to mitigate and diversify risks by defining the limits on the amount of risk retained and taking out appropriate reinsurance cover, or using transfer arrangements consistent with its capital position.</li> <li>• BMA must also review carefully an insurer’s methodology used to set premiums to determine that they are established on reasonable assumptions to enable the insurer to meet its commitments. It must review reinsurance arrangements to check that they are adequate, that the claims held by insurers on their re-insurers are recoverable, and that the insurer accounts for reinsurance risks on a true and fair basis.</li> </ul>
20. Liabilities	<ul style="list-style-type: none"> <li>• The BMA should develop more capacity to evaluate the work of external auditors in assessing the adequacy of provisions, including through on-site supervision.</li> </ul>
21. Investments	<ul style="list-style-type: none"> <li>• Implementation of the requirements to investments should now start following the promulgation of the Rulebook.</li> <li>• The investment rules for takaful insurance companies need to be kept under review as the Islamic sector develops.</li> </ul>
22. Derivatives and similar commitments	<ul style="list-style-type: none"> <li>• The BMA should develop rules regarding derivatives in anticipation of the likely future use of these instruments, for example, to hedge currency exposure.</li> <li>• Any regulations on foreign exchange exposure should take into account a company’s overall net exposure.</li> </ul>
23. Capital adequacy and solvency	<ul style="list-style-type: none"> <li>• The Rulebook’s capital adequacy and solvency regulation should now be implemented following the promulgation of the Rulebook.</li> </ul>
28. Anti-money laundering, combating the financing of terrorism	<ul style="list-style-type: none"> <li>• Implementation needs to be enhanced following the promulgation of the Rulebook. The BMA must address the adequacy of AML/CFT measures as part of its supervision of insurers, and promote awareness of AML/CFT in the industry.</li> <li>• The Rulebook may have to be amended in some regards to promote best practices in all aspects of AML/CFT, as per the AML/CFT assessment.</li> </ul>

### **Authorities' response**

173. As noted in the Executive Summary of the FSSA, “the BMA ... has modernized prudential requirements and is enhancing its supervisory capacity.” The recently issued Insurance Rulebook provides a solid base for the BMA’s insurance regulatory framework.

174. The BMA has taken note of the recommendations focusing on additional staff resources and training. To this end, the BMA has continued its recruitment efforts and has added one new staff member in the Insurance Supervision Directorate and continues its ongoing search for qualified candidates. In addition, the BMA supports its staff through numerous training activities. In the past six months alone, staff from the Insurance Supervision Directorate have taken part in several insurance specific courses, aimed at obtaining their ACCI designation. Also, two staff members attended a three-day session offered by Off-shore Group of Insurance Supervisors (OGIS) and a two-week onsite training session with the Insurance and Pensions Authority of the Isle of Man. Two other staff members are in the process of writing their CPA exams.

175. The BMA is also taking an active role in promoting insurance supervision training in the region. Through its contacts with the IAIS, it has received approval to host a regional seminar on IAIS core principles risk assessment, financial analysis, and remedial action that will take place in March 2006. This follows a similar training event that took place in February 2005 in Bahrain. Such activities reinforce the BMA’s commitment to staff training and is also an excellent opportunity to strengthen cooperation with insurance supervisors from other jurisdictions.

176. The BMA continues its efforts to closely monitor and take necessary supervisory actions with respect to the off-shore insurance sector. In this regard, in addition to the withdrawal of 10 insurance licenses in April 2005, the BMA has recently withdrawn licenses from a further 8 companies.

177. The BMA is undertaking an active consultation with the insurance industry towards the finalization of new reporting forms. These new forms will form the basis for an improved management information system as well as provide input for a comprehensive approach to analyzing factors that may have an impact on insurers and insurance markets.

178. To improve its ability to assess the adequacy of technical provisions, the BMA has retained the services of a consulting actuary. The consulting actuary has the necessary expertise to evaluate the valuation reports provided to the BMA and ensure that insurance firms are maintaining an appropriate level of technical and mathematical reserves in relation to their book of business.

179. In its October 2005 update to the Insurance Rulebook, the BMA has amended its Module FC (Financial Crime), taking into account the recommendations following the FSAP. In particular, Modules FC for all three published volumes of the Rulebook (Conventional

banks, Islamic banks and Insurance) have been realigned to ensure greater consistency across all three volumes. In doing so, Module FC for the Insurance Rulebook now specifically deals with attempted suspicious transactions (FC-4.2.4), non face-to-face business (FC-1.4) and several chapters deal with enhanced customer due diligence.

180. The BMA continues its work towards the full implementation of the Rulebook and has held several insurance industry information sessions, to make insurance licensees aware of the expectations of the BMA on meeting the requirements of the Rulebook. The ongoing implementation will continue as the new formal reporting is put in place and as both offsite and onsite supervision gain additional experience in using the updated and relevant information obtained from insurance licensees.

## **VII. SUMMARY ASSESSMENT OF IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION AND TRANSPARENCY OF SECURITIES REGULATION**

### **General**

181. The assessment of the securities regulatory system in Bahrain was performed as part of the Financial Sector Assessment Program for Bahrain. The assessment covers the legislative and regulatory frameworks, the self-regulatory activities of the Bahrain Stock Exchange (BSE), and the responsibilities and functioning of the Bahrain Monetary Agency (BMA) as the regulator of the securities market. The main purpose was to assess the observance of IOSCO objectives and principles of securities regulation and market supervision, and to suggest areas where further improvement and development may be appropriate.

### **Information and methodology used for assessment**

182. The assessment follows the methodology developed by IOSCO.<sup>18</sup> The assessment is primarily concerned with whether the objective of the principle is sufficiently met from: (i) a legal perspective, by identifying the powers and authorities conferred on the regulator, the relevant provisions of applicable laws, rules and regulations, and the procedures intended to implement these; and (ii) the perspective of the exercise of those powers and authorities in practice, and whether enforcement of the framework is efficient. The assessment is not meant to assess the application of this infrastructure to particular cases.

183. This assessment is based upon a review of laws, rules and regulations, documentation and reports on the market and its operations; interviews with BMA and other government officials, the BSE management and staff, legal experts, and representative market participants

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<sup>18</sup> Revised in April 2003.



and intermediary members of the securities industries; and a self-assessment report prepared by the BMA. The BMA and all other interlocutors cooperated fully, and were ready to provide additional information and explanation as needed.

184. The main documents reviewed include relevant laws (namely the BMA Law 1973, the Bahrain Stock Exchange Law 1987, and the Commercial Companies Law 1975), regulations (the BSE Internal Regulations), and policies and practices in place at the time the assessments were made. References were also made to the draft Central Bank of Bahrain Law (CBBL), the draft Securities and Exchange Regulations, circulars, directives, guidelines, and Consultative Papers.

### **Structure and Role of the Securities Industry**

185. Bahrain is a middle-income country with an economy closely integrated with those of its neighbors in the GCC. Growth rates in recent years have been high. The exchange rate is tightly pegged to the U.S. dollar; since there are no exchange controls or restrictions on capital movements, inflation and interest rates follow U.S. rates closely. Gross government debt is moderate.

186. Bahrain has emerged as a major regional financial center. At end-2004, over 300 financial institutions were in operation, providing a wide range of financial services in areas including banking, insurance, capital markets, and investment advice, and the number of institutions has been growing. The system is dominated by banks, which include, besides domestically-incorporated institutions, a range of foreign institutions from the region, industrialized countries, and other emerging markets.

187. With respect to securities markets, the market valuation of the BSE exceeded US\$13.5 billion, or 130 percent of GDP in 2004. Empirical evidence shows that movements in the local stock market index is highly correlated with other stock market indices in the region. Turnover, however, is low with an average of 70 to 100 daily trades worth about \$1.8 million. Shares listed in the exchange comprise 46 Bahraini and non-Bahraini companies; 25 mutual funds, and 20 Bahraini government and corporate bond issues. For the past several years the government has concentrated on issuing Islamic securities, termed sukuk, which take the form of either medium-term leasing-based (ijara) instruments, or shorter term instruments associated with forward (salam) contracts on commodities such as aluminum. The BMA acts as the government's fiscal agent in the issue and management of securities.

188. Stock exchange trading is undertaken through the 13 exchange member brokers, which include several relatively large institutions (sometimes affiliated with banks) and some individual brokers. Securities are de-materialized with the exception of certain government instruments. The quote system is automated, and the modern settlement system ensures delivery versus payment on a T+2 basis. In particular, all securities that are traded in the BSE must be cleared and settled at the Clearing, Settlement, Central Depository and Registry (CSDR) and the clearing bank agreed by brokers-dealers. The cash leg of securities transactions is settled on a multilateral net basis by 9:30 a.m. in T+2. For potential defaults

due to a liquidity shortage, the BSE has established a guarantee. There is also a limit on the net settlement obligation any broker may accrue in one day; in case brokers exceed this limit, they must deposit 30 percent of the excess by 9:30 a.m. of T+1.

189. Approximately 1400 mutual funds and similar collective investment schemes (CIS) are offered in Bahrain. These are mostly offered by banks or their subsidiaries, and marketed towards wealthy individuals from the region.

### **Regulatory structure and practices**

190. The BMA has overall responsibility for licensing, regulation and supervision of the securities markets, and oversight over the BSE. It is well respected by the industry and internationally, and has available human and financial resources to fulfill its responsibilities. It enjoys a high degree of autonomy.

191. The BMA was made the single regulator and supervisor for the entire financial sector in 2002, when it took over primary responsibility for securities market regulation from the Bahrain Stock Exchange (BSE), and that for the insurance sector from the Ministry of Industry and Commerce (MOIC). The latter two institutions, however, still play supervisory and regulatory roles. In particular, the BSE is a self-regulatory organization (SRO) responsible for the regulatory and operational day-to-day business in the capital market. The MOIC has some responsibilities in regards to commercial companies and the company registry function, and the listing of collective investment schemes (CIS).

192. In some regards the BMA is still working to integrate the regulatory framework and practices applied to different parts of the financial system. A series of comprehensive Rulebooks are being prepared; those for conventional banks, Islamic banks and insurance had been issued at the time of the assessment, and the volumes applicable to securities markets are in an advance state of preparation. Proposals for an integrated licensing framework, applicable to all institutions including securities firms, is currently circulating for comments. Parliament is considering the Central Bank of Bahrain Law (CBBL), which will clarify and streamline various aspects of the applicable legal framework, and in particular the BMA's independence and powers.

### **General preconditions for effective securities regulation**

193. The preconditions for effective securities regulation generally obtain in Bahrain. Broadly satisfactory legislation and institutional arrangements are in place to handle bankruptcies and the liquidation of firms. Legislation has been in force and implemented for some times covering such areas as company registration and governance, contracts, and the registration of movable and immovable property.<sup>19</sup> The legal system, including the

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<sup>19</sup> An initiative is currently under way to enhance corporate governance.

availability of legal services and the functioning of the courts, is adequate, although there is a recognized need among judges for more expertise in financial matters and the establishment of dedicated commercial courts that could render more timely judgments.

194. Corporate accounting follows International Accounting Standards, and the accounting and auditing professions include representatives of all major international firms. Conventional financial institutions follow International Financial Reporting Standards (IFRS), and Islamic institutions follow the analogous standards set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Direct government interference in commercial decision-making is rare. The clearing, payments, and settlement system is efficient and reliable.

### **Main findings**

195. The standard of security market regulation and supervision is generally high. Certain refinements are currently needed, many of which the BMA and BSE are addressing. Further development will be needed when the market starts to use more complex instruments.

196. **Principles relating to the regulator (1-5).** The legal and regulatory framework supports the regulator's work by providing clear and objective responsibilities, and resources and capacity to perform regulatory functions and exercise its power. The independence of the regulator is somewhat compromised by the role of the Prime Minister and the Finance Minister as Chairman and Deputy Chairman of the BMA respectively. The proposed CBBL seeks to address this issue by establishing a seven-member Administrative Council. There are some weaknesses regarding the structure and enforceability of market misconduct provisions, which may constrain the effective use of enforcement powers (see below). The regulatory process is clear and consistent, and considerable efforts are made to be consultative and transparent. Cooperation between the three authorities does not appear to be a formal specific requirement in law, but the need to do so is acknowledged, as confirmed by the signing of a MOU in March 2005 between the BMA and the BSE. A similar arrangement between the BMA and MOIC is in draft. The staff of the regulator observes the highest professional standards. The BMA has had difficulty offering a sufficiently attractive remuneration package to attract and retain staff with specialized relevant skills.

197. **Principles relating to self-regulation (6-7).** The BSE is the only self-regulatory financial organization in Bahrain. The BMA supervises the BSE on an ongoing basis, ensuring compliance with the BSE Law, rules and regulations of the BMA, and that rules, procedures, and regulations treat all members of the BSE in a fair and consistent manner. Day-to-day operation and management of the BSE is retained with the BSE, which can impose enforceable fines or other penalties whenever there are breaches of the law and/or regulations. The MOU clarifies that the BMA is charged with laying down the regulation for licensing without affecting the rights and powers of the BSE and the CSDR in relation to membership in the BSE.

198. **Principles relating to enforcement (8-10).** Provisions providing the regulator with the powers to conduct surveillance, undertake investigations, and obtain information to ensure compliance with the relevant securities laws. The provisions are spread across a number of laws, regulations, decrees and orders, but taken together they grant the regulator wide powers to inspect the business operations of a regulated entity, without prior notice if needed. The proposed CBBL and the Securities and Exchange Regulations (SER) are expected to consolidate those provisions. While the regulator has the power to obtain a broad range of information and documents from regulated entities, this power does not extend to requiring material from individuals who are not licensees. The proposed CBBL has been drafted to correct this gap. The BMA, the MOIC, and the BSE can seek orders, refer matters for civil proceedings, impose administrative sanctions, initiate or refer matters for criminal prosecution, or order the suspension of trading. In the past the authorities have made use of these powers.

199. The BMA has established a separate Inspections Directorate and provided guidelines for the inspection of brokers. A systematic, well-prepared on-site inspection program for brokers has begun in the last year and all but 3 of the 13 brokers registered in the BSE have been already inspected. The supervision of brokers is aided by the BSE, which monitors trading activity in the stock exchange to assess risks for the whole market and each individual broker. The BSE is also responsible for making inquiries into complaints of market irregularities or allegations of misconduct

200. **Principles relating to cooperation (11-13).** The BMA and the BSE cooperate actively with foreign securities regulators and exchanges. There is no specific provision in the Law vesting authority in the BMA (or MOIC or BSE) to share nonpublic information with their domestic and foreign counterparts, and the BMA is subject to confidentiality provisions that prevent it from divulging information unless it is necessary for the exercise of its functions. However the BMA contends that no specific domestic law impedes or prohibits international cooperation and established practice (so far unchallenged) supports this. The legal restriction on BMA or BSE access to information held by individuals other than licensees or regulated entities potentially impedes international cooperation in certain circumstances. Shortcomings in this area are addressed in the proposed CBBL. It is anticipated that BMA will become a signatory of the IOSCO Multilateral MOU once the CBBL is passed.

201. **Principles relating to issuers (14-16).** Requirements for timely and comprehensive disclosure apply to public offerings, annual and quarterly reports, shareholder voting decisions, and other events and relevant information. The BMA assures the accuracy and timeliness of disclosures. Derogations from full disclosure requirements are tightly circumscribed. The regulatory and legal framework in Bahrain ensured that the rights of shareholders are protected and that shareholders within a class shall rank *pari passu*. In practice the Organization for Economic Cooperation and Development principles in regard of right and equal treatment of shareholders of public shareholding companies listed in the BSE are applied. Financial information, which is available on a timely basis to the public, is

prepared following high quality, internationally acceptable accounting and auditing standards.

202. **Principles relating to collective investment schemes (17-20).** Regulations require that CIS operators must have minimum financial resources, sufficient experience, and professional qualifications to carry out their duties in relation to a particular scheme. There are rules ensuring the segregation and protection of client assets. Custodial and investment functions cannot be performed by the same entity. Conflicts of interest affecting a person involved in the operation of a scheme is meant to be prevented by regulations that prohibit that person from owning shares in the scheme above a threshold set as percentage of the total nominal amount of the securities. Regulations require that investors in CIS receive adequate information to make an informed judgment on the merits of the scheme, and that CIS documents should disclose the legal status of the scheme. The regulatory framework guarantees that valuation of CIS assets is up to date.

203. **Principles relating to market intermediaries (21-24).** Market intermediaries have to be licensed by the BSE. The licensing conditions, which are deemed fair and equitable, guarantee minimum entry standards since they require that brokers need to satisfy requisite educational qualifications and expertise in financial markets, to have a track record of good conduct, and participate in a Guarantee Contribution Fund. Capital requirements are adequate for the state of development of the BSE. The framework for sound risk management and internal controls in Bahrain is broadly appropriate given the state of development of the market. In particular, an external auditor has to evaluate the quality of internal control and risk management systems, including the implementation mechanisms. The CDSR Rules contain detailed procedures for dealing with the failure of a market intermediary.

204. **Principles relating to secondary markets (25-29).** The BSE Law, and the Trading Rules, and the CSDR Rules of the BSE comply with prudential and other requirements designed to reduce the risk of noncompletion of transactions. The BSE monitors day-to-day trading activities through market surveillance system and the market control, collects and analyses the trading information, and monitors the conduct of market participants. The BMA also monitors the overall day-to-day trading activity and risk on the BSE. Pre-trade information (bids and offer prices) and post-trade information (including price and volume) is disseminated to market participants on a real-time basis by the BSE's trading system.

205. Use of insider information is prohibited by the regulatory framework. However, the offence of insider trading is not defined in primary legislation, but only in BMA guidelines and standards. Nonetheless, the BSE has been able to act on clients misconduct on the basis of the concept of "suspicious trading," which is defined in its Internal Regulations. The offence of insider trading is defined in the proposed CBBL.

206. The regulations, procedures, and mechanisms in place are adequate to ensure that proper handling of large exposures, default risk, and market risk in the BSE. Trading capital limits based on the amount of collateral posted in the transaction, the capital of the market participant, the number of settlement days, and a statutory maximum risk limit. An

automated system monitors the trading capital limits on a real-time basis. There are clear procedures on how to deal with a case of default. Information on large exposures is shared with foreign authorities through a number of bilateral MOUs.

207. **Principle relating to securities settlement (30).** The BSE operates the securities settlement system, and is in turn supervised by the BMA in fulfillment of this function. Provisions and mechanisms are in place to manage and contain all manner of risks. The system has operated consistently smoothly. Nonetheless, there is still a need to strengthen further the payment and securities settlement systems oversight function, focusing on monitoring settlement systems and infrastructure rather than the activities of the various participants in isolation. On operational reliability, the BSE is already taking some measures; additional measures could include relocating the back-up server(s) to a different location, the development of formal business continuity plan with detailed procedures for crisis management and information dissemination, and regular testing and training of both the back-up facilities and personnel.

208. Settlement finality for securities trade and the transfer of ownership of securities occurring by means of book-entries is only recognized at the level of Resolutions, not of primary law. There is no explicit protection at the level of the law for custody arrangements for securities. Similarly, provisions at the law level regarding the concepts of acceptance, irrevocability or settlement finality of a payment order, and their possible implications in different circumstances are incomplete. There is no protection for the payments system against bankruptcy procedures, in particular for the assets pledged in the form of collateral by system participants. However, there are some mitigating factors, namely, that the CSDR being a quasi-public institution and that ownership of securities in the CSDR is established at the level of the individual investor.

### **Recommended actions**

209. The following are some suggestions on how to continue to pursue the authorities' objective of maintaining a regulatory and supervisory framework for securities markets that promotes their efficiency and sound development.

Recommended Plan of Actions to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
<b>Principle 1</b>	<ul style="list-style-type: none"> <li>To clarify the shared roles of the BMA and the MOIC, a Memorandum of Understanding has been drafted and needs to be signed. This document will complement a recent MOU between the BMA and the BSE.</li> </ul>
<b>Principle 2</b>	<ul style="list-style-type: none"> <li>The independence of the BMA is supervisory matters, which is currently limited by the role of the Prime Minister and the Finance Minister as Chairman and Deputy Chairman of the BMA, needs to be enhanced. The proposed CBBL seeks to address this structural aspect by establishing a seven member Administrative Council, all “expert[s] in financial services.”</li> </ul>
<b>Principle 3</b>	<ul style="list-style-type: none"> <li>The BMA may need to revise its level of remuneration to attract more staff with capital markets experience as the market develops.</li> </ul>
<b>Principle 5</b>	<ul style="list-style-type: none"> <li>The BMA must continue to ensure that systems are effectively used to monitor compliance with staff rules of conduct.</li> </ul>
<b>Principle 7</b>	<ul style="list-style-type: none"> <li>The BMA should plan and in due course implement further on-site inspection at the BSE.</li> </ul>
<b>Principle 8</b>	<ul style="list-style-type: none"> <li>Given the intrusive nature of powers to obtain information and enforce regulations, it is important that they be comprehensive and explicit. The proposed CBBL should achieve this.</li> </ul>
<b>Principle 9</b>	<ul style="list-style-type: none"> <li>The regulator (be it the BMA, MOIC or BSE) should have express powers to require information from any persons involved in relevant conduct or who may have information relevant to a regulatory or enforcement inquiry/investigation. The proposed CBBL (Article 123) has been drafted to meet this principle and should be passed.</li> </ul>
<b>Principle 10</b>	<ul style="list-style-type: none"> <li>The BMA and the BSE must require that a company subject to penalties then take remedial action, and that they monitor to the company to ensure that systems are in place to prevent the reoccurrence of the problem.</li> </ul>
<b>Principle 11</b>	<ul style="list-style-type: none"> <li>There should be a specific provision in law vesting authority in the BMA (or MOIC or BSE) to share nonpublic information with their domestic and foreign counterparts. The proposed CBBL, which provides for this authority, should be supported.</li> </ul>

<p><b>Principle 12</b></p>	<ul style="list-style-type: none"> <li>• Once the CBBL is passed, the BMA should become a signatory to the IOSCO Multilateral MOU.</li> <li>• The BSE and BMA need to maintain bilateral international MOUs with regulators and exchanges, particularly those with cross-trading links.</li> </ul>
<p><b>Principle 13</b></p>	<ul style="list-style-type: none"> <li>• The BMA and BSE need express authority to obtain and share with their international counterparts relevant information that is not held by licensees or regulated entities and needs to be sought from individuals or entities that are not regulated by them.</li> </ul>
<p><b>Principle 20</b></p>	<ul style="list-style-type: none"> <li>• The regulation could be strengthened further by requiring mandatory external auditors and that the auditor's report should be provided to the BMA regardless of whether the audit finds fault or not with the information reported by the scheme.</li> <li>• Given the relatively low liquidity of the securities market, the BMA and the BSE should research how to refine methods and recommendations on valuation of CIS when the underlying securities are rarely traded.</li> </ul>
<p><b>Principle 23</b></p>	<ul style="list-style-type: none"> <li>• The exemption for brokers from completing CDD or identifying the source of a customer's funds, if that customer is purchasing a share in a collective investment venture, should be eliminated.</li> <li>• A consultation paper on the Draft Rules for Establishment and Maintenance of Risk Management and Internal Controls for Licensed Securities Business Institutions (issued to the industry on January 26, 2005) should be finalized and implemented.</li> <li>• The BMA and the BSE will have to develop further their own evaluation of internal control and risk management systems.</li> </ul>
<p><b>Principle 28</b></p>	<ul style="list-style-type: none"> <li>• The offence of insider trading should be clearly defined in primary legislation. The passage of the CBBL, as currently drafted, would clarify the issue.</li> </ul>



<b>Principle 30</b>	<ul style="list-style-type: none"><li>• There is a need to further develop the payment and securities settlement systems oversight function, focusing on monitoring settlement systems and infrastructure.</li><li>• The planned measures to improve the operational reliability of the CSDR should be implemented as soon as possible. Some additional measures include relocating the back-up server(s) to a different location, the development of formal business continuity plan with detailed procedures for crisis management and information dissemination, and regular testing and training of both the back-up facilities and personnel.</li><li>• Settlement finality for securities trade, the transfer of ownership of securities occurring by means of book-entries, and custody arrangements for securities should be embedded in primary legislation rather than resolutions. Similarly, provisions at the law level regarding the concepts of acceptance, irrevocability, settlement finality of a payment order to be processed by the system and their possible implications in different circumstances need clarification. Weaknesses in these areas might be corrected through amendment to the draft CBBL.</li></ul>
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**Authorities’ response**

210. The BMA welcomes the assessment that the standard of securities market regulation and supervision is generally high and is compliant with most of the IOSCO Principles of securities regulation. The BMA is pleased to note the findings of the report confirm that the legal and regulatory framework supports the regulator’s work by providing clear and objective responsibilities and powers, and that the BMA and BSE cooperate actively with foreign securities regulators and exchanges.

211. The report observes that all requirements for timely and comprehensive disclosure applies to public offerings, annual and quarterly reports, and shareholder voting decisions; that the regulatory framework ensures the protection of shareholders’ rights; and that in practice the OECD Principles with regards to the rights and equal treatment of shareholders are applied. All financial statements and information are prepared following internationally accepted accounting and auditing standards.

212. The report further shows that the framework for sound risk management and internal controls is appropriate, given the state of the development of the market and the transition period of adopting a single regulatory model for the whole financial sector, and that the BSE Law, Trading and Clearing and Settlement Rules comply with prudential and other requirements designed to reduce the risk of non-completion of transactions.

213. The proposed Central Bank of Bahrain Law (CBBL), Securities and Exchange Regulation (SER) and other proposed rules and regulations will strengthen provisions relating to market misconduct, such as market manipulation, price manipulation, insider

trading, etc., by providing the BMA and BSE with more explicit powers regarding effective implementation and enforcement.

214. In respect of the finding that provisions relating to the capital markets are spread across a number of laws, rules and regulations, the proposed CBBL, the SER and the new draft of the CCL, which is currently under discussion, will consolidate all the laws, rules and regulations relating to the capital market and minimize the overlaps and shared responsibilities among authorities.

215. The findings that “BMA and BSE cooperate actively with foreign securities regulators and exchanges” will be further strengthened in the new CBBL and SER, and the BMA has already taken further steps by forwarding its application to IOSCO to become a signatory of the IOSCO Multilateral MOU, which is currently being screened by the designated committee of IOSCO.

216. With regards to the findings on lack of enforcement powers to obtain information and materials from entities who are not licensees, specific provisions for sharing of non-public information with foreign and domestic counterparts and criminalizing insider trading explicitly (IOSCO Principles 9, 13, and 28), the proposed CBBL and SER will consolidate the current legislation and will address the gaps as pointed out in the assessment.

217. The BMA plans to introduce a corporate governance code for listed companies and lay down rules on mergers and takeovers, which will further enhance the rights of the shareholders. Although the current rules and regulations in respect of settlement finality, irrevocability of transfer of securities, custody arrangements and protection from bankruptcy proceedings are governed by the BSE’s regulatory framework, these rules and regulations will be further strengthened by the proposed CBB Law and SER. The BMA does recognize the need to put in place a solid disaster recovery and contingency plan at the BSE: this issue is already under discussion at the BSE Board.

218. The findings that “... there is still a need to strengthen the payment and securities settlement system oversight function, focusing on monitoring settlement systems and infrastructures rather than activities of various participants in isolation”, will be addressed, in part through the BMA’s RTGS payment system project, currently being implemented.

219. Finally, the BMA recognizes the need to ensure adequate resourcing of its capital markets supervisory function, particularly by recruiting additional professional staff and enhancing its capital markets database.

## **VIII. REPORT ON OBSERVANCE OF STANDARDS AND CODES—FATF RECOMMENDATIONS FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM (AML/CFT)**

### **General**

220. This report on the Observance of Standards and Codes for the FATF 40 Recommendations for Anti-Money Laundering and 9 Special Recommendations Combating the Financing of Terrorism provides a summary of the level of observance with the FATF 40+9 Recommendations, and provides recommendations to strengthen observance. In preparing the detailed assessment, a review was undertaken of the relevant AML/CFT laws and regulations; supervisory and regulatory systems in place to deter money laundering (ML) and the financing of terrorism (FT) among prudentially regulated financial institutions, designated nonfinancial businesses and professions (DNFBPs) and nonprofit organizations (NPOs); and the capacity and implementation of criminal law enforcement systems. The assessment is based on the information available at the time it was completed on May 2, 2005.

### **General Situation of Money Laundering and Financing of Terrorism**

221. The authorities believe that Bahrain has a relatively low level of domestically generated criminal proceeds and therefore believe that the greatest risk of money laundering is related to foreign proceeds that might transit through Bahrain. Bahrain's well-developed banking system, along with its geographical location in the Middle East as a transit point along the Gulf and into South Asia make it a potential target for money laundering and terrorist financing activities.

222. Currently there are four money-laundering prosecutions under way. The predicate offenses are fraud, corruption, illegal gambling and pandering. All these cases originated from suspicious transaction reports (STRs) filed by banks; with the alleged launderers trying to place their illegal proceeds into the banking system.

### **Legal systems and related institutional measures**

#### ***Criminalization of ML and FT***

223. ML is criminalized by Article 2.1 of Decree Law 4/2001 with Respect to the Prevention and Prohibition of the Laundering of Money (DL 4/2001). The offence of money laundering extends to any type of property and applies to persons who commit the predicate offence, so self laundering is an offence. However, it is not necessary that a person be convicted of a predicate offence in order to be convicted of a money laundering offence. The intentional element of the money laundering crime may be inferred from objective factual circumstances. Money laundering may also be ascribed to corporate bodies. Corporate bodies may be fined up to BD 1 million (US\$2.65 million). Corporate criminal liability for offences

does not limit civil or administrative liability. Financial institutions may also be separately sanctioned by the Bahrain Monetary Agency (BMA) and the Ministry of Industry and Commerce (MOIC). Natural persons may face a term of imprisonment up to 7 years as well as a BD 1 million fine.

The financing of terrorism is not currently a criminal offense in Bahrain. A draft law amending the provisions of DL 4/2001 is now in parliamentary committee. If passed, the amendments would create an offence of terrorist financing in Article 3.1 of the amended DL 4/2001. As the amendments currently read, the terrorist financing offence would not be fully compliant with international standards as it does not criminalize providing funds to a terrorist or terrorist organization and only criminalizes terrorist financing when the terrorist act, for which funds were provided, actually takes place. While DL 4/2001 clearly creates a criminal offence drafted in the common law style, the proposed FT offence is drafted in a civil law style but does not, on its face, create an offence and this may be open to legal challenge. The assessment made recommendations to address the above deficiencies and also recommended that the offence be drafted in the common law style in order to mirror the drafting of the money laundering offence in the same law.

### ***Confiscation, freezing, and seizing of proceeds of crime***

224. Under the provisions of DL 4/2001 it is possible to confiscate all property directly or indirectly derived from any criminal activity, as well as substitute assets and income yields. Alternatively all other property belonging to the convicted person, his spouse, or minor children is subject to confiscation up to the value equivalent to the laundered assets. Bona fide third parties can claim their rights before, during, and after the court proceedings. Ex parte seizure is provided for in DL 4/2001 and in the 2002 Code of Criminal Procedure (CPC) during the judicial procedure under the Public Prosecutor.

225. In the absence of a specific terrorist financing offence, both as a stand alone offence or as a predicate to money laundering, confiscation on these grounds is not possible, except indirectly in some cases on the basis of aiding and abetting offences that occur in a terrorist context.

### ***The Financial Intelligence Unit and its functions***

226. The Anti-Money Laundering Unit (AMLU) performs the typical Financial Intelligence Unit (FIU) functions of receiving and processing the disclosures of suspected money laundering and related crimes forwarded by the entities subject to the reporting obligations of the DL 4/2001. It also de facto receives and processes suspected terrorist related disclosures even though the financing of terrorism is not yet an offence in Bahrain. As a police-type FIU, the AMLU carries out its own investigations, has access to the appropriate information to perform its functions, and executes money laundering related court orders. It can query additional information directly from the disclosing entity, but has to address the court to obtain information and documents from other persons or entities. It can seize suspect assets upon receipt of a court order, but in urgent cases it can do so on its own authority for a

maximum period of three days (see above). The FIU received 330 STRs since the inception of the reporting system. 24 STRs constituting 18 cases were forwarded to the Public Prosecutor, of which only 4 cases related to money laundering.

227. The AMLU does not have a high profile with all reporting entities, especially DNFBPs. This might be related to the fact that reporting entities are also required to submit STRs to their primary regulator, with whom they inevitably have a closer working relationship. The mission recommended that the AMLU take steps to raise awareness about its role and functions and to issue further guidance on the filing of STRs.

### ***Law enforcement, prosecution, and other competent authorities***

228. The Public Prosecutor's Office is headed by a Prosecutor General, assisted by a Senior Advocate General, and is in charge of the (judicial) investigation and prosecution of offences and as such it receives, investigates, and prosecutes cases forwarded by the AMLU. Furthermore, the Public Prosecutor's Office supports the AMLU investigation whenever coercive measures are required, supplies legal advice to the police, and supervises telephone tapping. The office also plays an important role in mutual legal assistance and extradition.

### **Preventive measures—financial institutions**

229. The BMA assumed responsibility for all financial institution licensees in 2002. This includes banks, insurance licensees, capital market licensees, and money changers. The Agency's Compliance Unit is responsible for implementing its AML supervisory program for all banks, insurance and money changer licensees. The BMA's Capital Markets Division is responsible for the regulation of licensees in the security sector.

230. The BMA issued AML regulations in 2001 to its existing licensees (i.e. mainly banks and money changers). Following the expansion of its responsibilities in 2002, capital market licensees were subject to AML regulations in 2004 and insurance licensees became subject to such regulations in May 2005. Since 2001, the BMA has updated its regulations leading up to the issuance of revised Financial Crimes Modules of its Rulebook volumes for banks, which became effective on April 5, 2005.

231. The Rulebook provides broad coverage of AML supervisory issues and establishes a comprehensive framework for the application of the 40 + 9 Recommendations. Nevertheless, the mission has provided recommendations for the enhancement of the Rulebook and other aspects of the supervisory framework in general. The BMA must also address the process of Executive Directors issuing regulatory instruments. While regulations have been issued by the Executive Director, the authorities were unable to document that the Board of Directors had agreed to a delegation of this authority. It will be important to ensure that the legal requirements identified in the CBBL are fully addressed with respect to the circulars, rulebooks, and other documents taking the form of "special regulations."

232. The mission emphasized the particular importance of capital market licensees, but also money changers and money brokers, being subject to a supervisory regime comparable

to that applicable to banks and insurance companies. The mission recommended that measures be taken to strengthen supervision of capital markets licensees in a number of areas including, customer due diligence (CDD) measures, politically exposed persons (PEPs), and the monitoring and reporting of suspicious transactions.

233. The broad challenge that lies ahead for the BMA is that of integrating the provisions of the rulebook and achieving consistency in the AML/CFT supervision for banks, insurance, capital market, and money changer licensees. This is a particular concern in respect of capital market licensees as they will be regulated by the Capital Markets Division, which does not currently have plans to issue regulations on AML/CFT equivalent to the rulebooks for banks and insurance companies. In responding to these challenges, the BMA will need to increase its AML supervisory resources, in particular bringing insurance and capital markets expertise into the Compliance Unit.

#### **Preventive measures—designated non-financial businesses and professions**

The schedule to DL 4/2001 lists real property transactions, bullion dealing, legal practice and advocacy, audit and accountancy as activities covered by the legislation. The law does not cover casinos, company and trust service providers, and dealers in precious metals and stones. However casinos are not permitted in Bahrain and the authorities report there are no company and trust service providers. The authorities also report that there are no notaries in Bahrain and that such services are provided by the Ministry of Justice (MOJ). The MOIC (the supervisor for DNFBPs), has determined that approximately 1,700 registrants fall into this category. At the time of the mission MOIC had undertaken 158 visits to DNFBPs for 2005.

234. The mission expressed concern about the Ministry's ability to effectively regulate DNFBPs as its general supervisory powers appear to be specifically related to Commercial Companies law and may not provide effective AML/CFT supervisory powers. Concern was also expressed about the Ministry's failure to properly consult with the MOJ in relation its plans to supervise lawyers as DNFBPs.

#### **Legal persons and arrangements and nonprofit organizations**

235. The MOIC is responsible for the registration of all business in Bahrain. In undertaking its due diligence, the MOIC requires applicants to produce personal identification documents and evidence of beneficial ownership. Due diligence is undertaken on directors, shareholders, and partners of applicants.

236. There are measures in place to prevent the unlawful use of legal persons by money launderers, but these measures cover banking, insurance, money changers, and money brokers. Capital markets licensees are not currently covered.

237. The Rulebooks for banks and insurance licensees have differing requirements, with more stringent requirements applied to banks. The bank Rulebooks indicate that a "bank

must obtain a signed statement from all new customers confirming whether or not the customer is acting on their own behalf or not.” The Rulebook requirements are further enhanced with the requirement that “where a customer is acting on behalf of third parties, the bank must obtain a signed statement from the beneficial owner(s) that he/they is/are the ultimate beneficiary or beneficial owner of the account/facility, and giving authority to the customer to act on his/their behalf.”

238. The insurance Rulebook more closely mirrors the requirements of the 2001 Regulation, with one exception. There is no requirement to make enquiries as to the structure of the company so as to sufficiently determine the provider of funds, the principal owner(s) of the shares and those who have control over the funds; and for corporate customers to update them on significant changes to ownership and/or legal structure. However, the Rulebook does require insurance companies to obtain a list of and verify the identity of the main shareholders of a legal entity holding 20 percent or more of the issued capital. In addition, CDD requirements are applied to beneficiaries of life insurance policies, with the added requirement that the insurance licensee must establish the relationship between the insured party and the beneficiary or beneficiaries.

239. Capital markets licensees are currently subject to Ministerial Order (MO) 7/2001 and Resolution 1/2004. The MO only covers the general topic of client verification and does not address specific issues such as CDD for legal persons or determination of beneficial owners. Resolution 1/2004 provides slightly more detail and requires that information on the “particulars of the company’s owners and its main shareholders” be obtained prior to account opening. It is not clear what action would be taken if the companies owners and main shareholders are themselves companies, trusts, or other legal arrangements.

240. Non-profit organizations are regulated by the Ministry of Social Affairs (MSA). The legal framework for the supervision of NPOs is established by a number of laws which have the objective of establishing an environment of sound corporate governance for these organizations. In recent years the MSA has undertaken a review of the legal and regulatory framework for NPOs and implemented a number of changes to more directly address the vulnerability of NPOs to abuse for the financing of terrorism.

241. At the time of the mission there were 386 registered societies including 80 charities. The Directorate of Development and Local Societies (DDLs) has a staff of 4 persons to undertake its work. These resources are inadequate to allow the department to undertake reviews of the financial information submitted by societies or to undertake inspections of these organizations. As a result, the legislative changes that were made cannot be effectively implemented.

### **National and international cooperation**

242. Coordination and cooperation between supervisory agencies could be improved. Regarding coordination, there are numerous ministerial orders, regulations, circulars, and rulebooks underpinning the AML/CFT program in Bahrain. The high-level governmental

AML Policy Committee should take a central role in reviewing these instruments in order to ensure that there is a consistency of approach and a coordinated message.

243. Cooperative efforts between the FIU and the supervisory agencies are based on custom and practical considerations, not on specific legal provisions. The AMLU and the BMA, for example, are legally bound to a high degree of confidentiality, and there is no legal framework regulating or coordinating any cooperative relationship between these natural allies. Recognizing that confidentiality remains an important consideration, they should be able to exchange information on non-compliance with the DL 4/2001 requirements by the reporting entities. Operational cooperation between law enforcement agencies, such as customs and police, is systematic and frequent.

244. Mutual legal assistance between judicial authorities is generally governed by Article 426–428 of the 2002 CPC (“Letters rogatory”). In money laundering related matters, Article 8 of DL 4/2001 gives the AMLU a specific responsibility in the execution of foreign assistance requests, that goes beyond the cooperation at FIU level. Under both regimes the assistance is broad and virtually unrestricted, not only in money laundering cases but also in FT cases. Dual criminality is not required (also for coercive measures), only that the execution does not violate the public order of Bahrain (Article 427 CPC). The absence of a formal FT offence does not affect the mutual legal assistance capacity as it is not subject to the dual criminality principle.

245. Extradition is possible even without a treaty although Bahrain does not extradite its own nationals. Extradition is subject to the dual criminality principle and reciprocity. As terrorist financing has not yet been criminalized, no extradition is possible on this ground. Extradition can be granted however when the facts can be qualified as aiding and abetting, or other complicity to, extraditable crimes that have happened in a terrorist context.

Recommended Action Plan to Improve Compliance with FATF Recommendations

FATF 40+9 Recommendations	Recommended Action (listed in order of priority)
<b>1. General</b>	
<b>2. Legal System and Related Institutional Measures</b>	
Criminalization of Money Laundering (R.1 & 2)	<ul style="list-style-type: none"> <li>• Criminalize the financing of terrorism so that it becomes a predicate offence for money laundering.</li> <li>• Extend corporate criminal liability to infringements of the AML requirements penalized by Articles 2.6 and 3.5 of DL 4/2001.</li> <li>• Criminalize other predicate crimes, such as market manipulation, insider trading, product piracy, and piracy (on the seas).</li> <li>• Specifically add legal documents or instruments, in electronic or digital form, evidencing title to the definition of property, particularly as Bahrain is a financial center.</li> <li>• Specifically add use or conversion of property to the definition of activity of money laundering.</li> </ul>



<p>Criminalization of Terrorist Financing (SR.II)</p>	<ul style="list-style-type: none"> <li>• Enact proposed legislative amendments on criminalizing terrorist financing, particularly for the case of financing terrorist organizations or terrorists who have not committed a specific terrorist act.</li> <li>• Form a drafting sub committee of the AML Policy Committee who can coordinate drafting of all relevant AML/CFT laws with the Legal Affairs Directorate of the Cabinet Office before the bills are submitted to the parliamentary process.</li> </ul>
<p>Confiscation, freezing and seizing of proceeds of crime (R.3)</p>	<ul style="list-style-type: none"> <li>• Criminalize corporate liability in the Penal Code and clearly state to which bodies corporate criminal liability applies.</li> <li>• Beside the lacuna created by the absence of an autonomous or predicate FT offence, the seizure and confiscation regime is quite comprehensive but would benefit from certain improvements</li> <li>• Amend Article 64, par.2 Penal Code in respect of the condition of the property (not) belonging to the accused.</li> </ul>
<p>Freezing of funds used for terrorist financing (SR.III)</p>	<ul style="list-style-type: none"> <li>• Criminalize the financing of terrorism.</li> <li>• Designate a committee or agency to be the 1373 designation agency who can make a prompt and binding determination regarding terrorist targets designated by other countries.</li> <li>• Have systems in place whereby notification of such a designation can be disseminated to all parties who may be holding terrorist funds or assets so that such funds or assets can be frozen without delay.</li> </ul>
<p>The Financial Intelligence Unit and its functions (R.26, 30 &amp; 32)</p>	<ul style="list-style-type: none"> <li>• The FIU should periodically review the effectiveness of its systems to combat ML and FT.</li> <li>• The FIU should issue guidance on filing STRs to raise awareness and to ensure consistent understanding of its role in the AML/CFT framework.</li> </ul>
<p>Law enforcement, prosecution and other competent authorities (R.27, 28, 30 &amp; 32)</p>	<ul style="list-style-type: none"> <li>• Introduce an autonomous and predicate FT offence.</li> <li>• Formally regulate the conditions and modalities for postponing or waiving seizure.</li> <li>• Create jurisprudence that will give direction to law enforcement regarding achieving efficiency in terms of convictions and asset recovery.</li> <li>• Reinforce the human resources of the Public Prosecutor's Office in the expectation of increased demands related to AML/CFT and the specialization of the prosecution.</li> <li>• Keep statistics on the amount of criminal proceeds seized and confiscated.</li> <li>• Review the effectiveness of the evidence gathering process regarding anti-money laundering.</li> <li>• More cases have to be submitted to the courts, not limited to local events but particularly those with an international connotation where the assets appear in Bahrain but the predicate activity occurred outside the national territory. The ensuing jurisprudence will show if prosecution of ML as an autonomous offence, separated from its predicate criminality, stands a real chance for positive results.</li> </ul>

<p>Cash couriers (SR IX)</p>	<ul style="list-style-type: none"> <li>• Develop a disclosure or declaration system for the Bahrain borders. This is being envisaged in Article 5bis of the draft amended AML law.</li> <li>• Address the legal basis of the Customs interception of large cash amounts, which is open to challenge.</li> <li>• Consider adding a legal provision to the amendments planned for DL 4/2001 regarding false declarations/disclosures and lack of declarations/disclosures under the proposed disclosure system.</li> </ul>
<p><b>3. Preventive Measures— Financial Institutions</b></p>	
<p>Risk of money laundering or terrorist financing</p>	
<p>Customer due diligence, including enhanced or reduced measures (R.5 to 8)</p>	<ul style="list-style-type: none"> <li>• Banks and insurance companies must implement the regulatory requirements introduced in the new rulebooks.</li> <li>• The BMA must verify implementation efforts related to the new rulebooks through continued (in the case of banks) and new (insurance) on-site inspection programs.</li> <li>• PEP requirements should be included in regulations for capital markets licensees, as well as money changers and money brokers.</li> <li>• Regulations for capital markets must be enhanced to meet the CDD requirements of FATF, as well as meeting the same comprehensiveness standards as applied to other financial sector licensees by the BMA.</li> <li>• Language should be added in the regulations to ensure that financial institutions pay attention to ML/FT risks arising from new technologies.</li> <li>• CDD requirements for non-face-to-face account opening should be established for capital markets licensees, unless this type of account opening is specifically prohibited.</li> <li>• FC 2 should be reviewed and updated to address TF concerns, particularly paragraphs 2.2.1(d), 2.2.1(g), 2.2.2(a), and 2.2.3.</li> </ul>
<p>Third parties and introduced business (R.9)</p>	<ul style="list-style-type: none"> <li>• Clarification is required as to the exact circumstances under which a capital markets licensee, such as a broker, could rely on an introducer.</li> <li>• The regulations should specify that consideration will be given to the country where the introducer is based and whether that country abides by the FATF recommendations.</li> </ul>
<p>Financial institution secrecy or confidentiality (R.4)</p>	<ul style="list-style-type: none"> <li>• Conduct on-site inspections of insurance and capital markets licensees to confirm that there is no bank secrecy in place in practice with regard to accessing information from financial institutions pursuant to their responsibility under the requirements of DL 4/2001.</li> </ul>
<p>Record keeping and wire transfer rules (R.10 &amp; SR.VII)</p>	<ul style="list-style-type: none"> <li>• Implementation of the recordkeeping requirement should be verified for capital markets and insurance licensees through on-site inspection.</li> </ul>

<p>Monitoring of transactions and relationships (R.11 &amp; 21)</p>	<ul style="list-style-type: none"> <li>• Requirements should be established for money changers, and money brokers to ensure that due attention is given to unusual, large or complex transactions.</li> <li>• Capital markets, money changes, and money broker licensees should also be required to ensure that the background of large, complex or unusual transactions, including those coming from other countries are reviewed and that the findings of those reviews are put in writing and for money changers and money brokers maintained in the financial institution’s records for five years.</li> <li>• Counter-measures should be established for those situations involving transactions with jurisdictions that do not adequately apply the FATF Recommendations.</li> <li>• Capital markets licensees should be subject to stronger requirements when dealing with clients or transactions from jurisdictions that do not sufficiently apply the FATF recommendations. The BMA must also develop a mechanism to inform the capital markets licensees of the jurisdictions where greater caution should be considered.</li> </ul>
<p>Suspicious transaction reports and other reporting (R.13-14, 19, 25 &amp; SR.IV)</p>	<ul style="list-style-type: none"> <li>• STR reporting should be clarified for capital markets licensees in two important ways: it should be made clear that all reports go to both the AMLU and the BMA; and reporting should be for both ML and FT suspicions.</li> <li>• The requirements for money changers and money brokers should be brought up-to-date to make clear when a report must be filed (i.e., not based on a list of examples provided by the BMA).</li> <li>• The BMA should assess the level of awareness and understanding of STR requirements within the capital markets and insurance licensees, given that these two groups have never filed an STR.</li> <li>• The AMLU should also work to raise awareness within the capital markets and insurance licensees regarding STR reporting, and consider applying sanctions for willful non-compliance.</li> <li>• The rate of forwarded cases to the Public Prosecutor should increase, irrespective of the predicate criminality being identified or not, if only to create the jurisprudence necessary to give direction to the investigations and clarify the evidentiary requirements.</li> <li>• The introduction of a formal predicate or autonomous FT offence is required to create the necessary legal context for related STRs.</li> <li>• The definition of suspicious transaction must be made a uniform one.</li> <li>• The immunity clause for reporting to the appropriate authorities should carry the condition of good faith.</li> <li>• There must be a formal and express obligation to report attempted transactions for financial institutions (excluding</li> </ul>

	<p>banks, which are already covered).</p> <ul style="list-style-type: none"> <li>• STRs should, whenever reasonably possible, be submitted to the FIU before the transaction is executed, to enable immediate law enforcement intervention.</li> </ul>
Internal controls, compliance, audit and foreign branches (R.15 & 22)	<ul style="list-style-type: none"> <li>• Money Laundering Reporting Officers (MLRO) for capital markets licensees should be required to monitor transactions, unless that responsibility is specifically assigned to another individual.</li> <li>• The BMA should ensure that audit, training, and internal controls for capital markets licensees, money changers, and money brokers encompass FT, as well as ML.</li> <li>• Capital markets licensees with foreign branches or subsidiaries should be required to inform the BMA when local requirements abroad prohibit them from implementing the BMA regulatory requirements. Implementation of this requirement for insurance companies should be verified through on-site inspection.</li> </ul>
The supervisory and oversight system—competent authorities and SROs (R. 17, 23, 29 & 30).	<ul style="list-style-type: none"> <li>• Extend corporate criminal liability to infringements of the AML requirements penalized by Articles 2.6 and 3.5 of DL 4/2001.</li> <li>• Inspections must be undertaken on the capital markets and insurance licensees.</li> <li>• Existing BMA resources, particularly human resources, need to be enhanced to meet its responsibilities as a consolidated supervisor. In particular, expertise in insurance and capital markets should be added to the Compliance Unit for the on-site inspection program.</li> <li>• Clarify or redraft Article 8.2 of MO 7/2001 to specify that the prohibition relates to information concerning the disclosure and the intervention of the FIU.</li> <li>• Establish clear rules and appropriate coordination regarding the criteria to either apply administrative sanctions or criminal penalties.</li> </ul>
AML/CFT Guidelines (R.25)	<ul style="list-style-type: none"> <li>• The BMA should address the regulatory weaknesses identified in the assessment, particularly those related to capital markets licensees, since there are no current plans to enhance the existing regulatory framework for AML/CFT for those licensees.</li> </ul>
Ongoing supervision and monitoring (R.23, 29 & 32)	<ul style="list-style-type: none"> <li>• The BMA should move forward rapidly with its plans to inspect insurance and capital markets licensees for AML/CFT.</li> </ul>
<b>4. Preventive Measures— Nonfinancial Businesses and Professions</b>	
Customer due diligence and record-keeping (R.12)	<ul style="list-style-type: none"> <li>• The exemptions from customer identification requirements in Article 4 of MO 23/2002 and Article 7 of MO 7/2001 should be reviewed to make them consistent with the FATF recommendations, particularly Recommendation 9.</li> <li>• The requirements in respect of beneficial ownership, PEPs, understanding the nature of a customer’s business, non-face to face customers, introduced business and companies that have</li> </ul>

	<p>nominee shareholders or shares in bearer form should be addressed in law regulation or other enforceable means.</p> <ul style="list-style-type: none"> <li>• The guidelines on measures to be employed for PEPs should be strengthened to require that registered persons establish systems to identify customers as PEPs and that the activity of such persons be subject to enhanced monitoring.</li> <li>• Provision should be made for persons to undertake CDD measures when there is a suspicion of ML or FT or where there are doubts about the veracity of CDD information previously obtained.</li> <li>• Persons should be required to adopt measures to prevent the misuse of technological developments in ML or FT schemes.</li> <li>• Persons should be required to consider filing an STR in circumstances where they are unable to complete CDD measures in respect of a customer.</li> <li>• Provision should be made for persons to undertake on-going scrutiny of transactions during the course of a relationship to ensure that transactions are consistent with the institutions knowledge of the customer.</li> <li>• MOIC should reinforce with all DNFBPS that the requirements for the retention of customer identification records are those found in MO 4/2001 and not MO 23/2002.</li> <li>• MOIC should intensify its planned program of inspections to verify compliance with AML requirements.</li> <li>• Lawyers should be trained on the application of the DL 4/2001 to their practice of law.</li> <li>• Lawyers should keep client identification records on all their clients pursuant to the DL 4/2001 requirements.</li> <li>• MOIC or MOJ should issue MO for lawyers regarding CDD and record keeping.</li> </ul>
<p>Monitoring of transactions and relationships (R.12 &amp; 16)</p>	<ul style="list-style-type: none"> <li>• MOIC needs to intensify its efforts to familiarize DNFBPs with the notion of suspicious transactions and the requirements for monitoring customer activity.</li> <li>• Registered persons should be required to report attempted transactions that are considered to be suspicious.</li> <li>• Registered persons should be required to give special attention to business relationships and transaction with persons from or in countries that do not or insufficiently apply the FATF Recommendations.</li> <li>• Where transactions from countries that do not or insufficiently apply the FATF Recommendations have no apparent economic of visible lawful purpose, the background and purpose of such transactions should be examined and written findings should be available to assist competent authorities.</li> <li>• There should be a requirement that records of suspicious transaction activity be maintained for a period of five years.</li> <li>• MOIC and MOJ should develop systems to advise registered persons of countries with weak AML/CFT systems.</li> </ul>

	<ul style="list-style-type: none"> <li>• MOIC or MOJ should issue MO to lawyers on above recommendations.</li> </ul>
<p>Suspicious transaction reporting (R.16)</p>	<ul style="list-style-type: none"> <li>• MOIC needs to intensify its efforts to familiarize DNFBPs with the requirements for the reporting of suspicious transactions and in particular reinforcing that STRs should be sent to the AMLU.</li> <li>• MOJ should issue regulations and guidance regarding the clarification of requirements to file STRs and how this requirement can be complied with in the face of legal privilege.</li> <li>• Urgent training for lawyers is required regarding the filing of STRs for suspicious transactions or attempted transactions by their clients.</li> <li>• MO should be issued to lawyers by either the MOJ or the MOIC regarding STRs; clarification needed on legal privilege and filing STRs.</li> <li>• MOJ and MOIC should coordinate and decide which Ministry to conduct on-site inspections of lawyers.</li> </ul>
<p>Internal controls, compliance &amp; audit (R.16)</p>	<ul style="list-style-type: none"> <li>• DNFBPs should be required to undertake audits to assess the effectiveness of their AML systems.</li> <li>• There should be a requirement for compliance officers to have timely access to customer identification information data and other CDD information, transaction records and other relevant information.</li> <li>• There should be a requirement for registered persons to have screening procedures to ensure high standards when hiring employees.</li> <li>• Either the MOJ or the MOIC should issue a MO mandating on-site inspections of lawyers</li> <li>• Coordination between the MOJ and Ministry of Industry and Commerce to determine who is best suited to conduct the on site inspections is critical.</li> <li>• On site inspections should be carried out on lawyers to ensure compliance with the requirements of the DL 4/2001.</li> <li>• MO should be issued to lawyers regarding the application of DL 4/2001 to their practices.</li> </ul>
<p>Regulation, supervision and monitoring (R.17, 24-25)</p>	<ul style="list-style-type: none"> <li>• For the avoidance of doubt, MOIC should have its supervisory powers in relation to MO 23/2002 provided more explicitly in law. It should also ensure that all AML requirements in respect of DNFBPs are addressed through law, regulation or other enforceable means.</li> <li>• MOIC should develop a wider range of sanctions to make the sanction regime more effective.</li> <li>• MOIC and MOJ should agree on a single supervisory arrangement for lawyers as DNFBPs.</li> <li>• MOIC needs to generally intensify its efforts to promote awareness of AML/CFT legislative and regulatory requirements among DNFBPs.</li> <li>• MOIC should consider requesting DNFBPs to return their self-assessment circulars as it could be a useful input as the Ministry</li> </ul>

	<p>tries to establish a risk-based framework for its supervisory responsibility for DNFBPs.</p> <ul style="list-style-type: none"> <li>• MOIC should amend the certificate signed by compliance officers to include reference to MO 7/2001.</li> <li>• Appropriate civil and administrative sanctions should be created for failure to comply with the DL 4/2001 and any consequent Ministerial Order.</li> </ul>
Other designated non-financial businesses and professions (R.20)	<ul style="list-style-type: none"> <li>• Registered persons should be required to pay attention to the threats posed by new technologies.</li> </ul>
<b>5. Legal Persons and Arrangements &amp; Nonprofit Organizations</b>	
Legal Persons–Access to beneficial ownership and control information (R.33)	<ul style="list-style-type: none"> <li>• The capital markets regulations should be enhanced with respect to their approach to beneficial ownership. The regulations should mirror the approach taken in the bank rulebooks, which establishes a more robust requirement for licensees to know the beneficial owners of legal persons.</li> </ul>
Nonprofit organizations (SR.VIII)	<ul style="list-style-type: none"> <li>• In terms of its program to address the potential for the abuse of charities for the financing of terrorism, DDLS should develop a more risk-based approach that focuses on potential vulnerability to this risk.</li> <li>• The BMA should consider revising FC 1.5 of the Financial Crimes module of the rulebook for banks to reflect the provision of Article 85 of RD 21/89 (i.e., that charities are required to obtain the approval of MSA before making a foreign transfer of funds in excess of BD 3,000.</li> </ul>
<b>6. National and International Cooperation</b>	
National cooperation and coordination (R.31)	<ul style="list-style-type: none"> <li>• Clear gateways should be created regulating communication between FIU and supervisory authorities, especially in cases of non-compliance.</li> <li>• Policy Committee to take a policy lead on revisions of DL 4/2001 and the Terrorism Law.</li> <li>• Policy Committee to take a lead in coordination and cooperation matters between ministries.</li> <li>• Appropriate Ministries should coordinate on the issue of inspecting lawyers for AML compliance.</li> </ul>
The Conventions and UN Special Resolutions (R.35 & SR.I)	<ul style="list-style-type: none"> <li>• Fully implement the 1999 International Convention on the Suppression of Financing of Terrorism.</li> <li>• Provide legal mechanisms to allow law enforcement to share information regarding AML/CFT and terrorism issues.</li> </ul>
Mutual Legal Assistance (R.32, 36-38, SR.V)	<ul style="list-style-type: none"> <li>• Devise arrangements for coordinating seizure and confiscation.</li> <li>• Consideration should be given to the utility of creating an asset forfeiture fund.</li> <li>• Statistics should be kept on the MLA requests (investigation, seizure and confiscation) pertaining to ML and predicate offences in order to periodically review the efficiency of the</li> </ul>

	system.
Extradition (R.32, 37 & 39, & SR.V)	<ul style="list-style-type: none"> <li>• Introduce the offence of financing terrorist activities, terrorist organizations and/or terrorists in criminal law to enable extradition on these specific grounds.</li> <li>• Statistics should detail the extradition grounds and the length of time to complete the MLA process.</li> </ul>
Other Forms of Cooperation (R.32 & 40, & SR.V)	<ul style="list-style-type: none"> <li>• The FIU statistics should also include spontaneous referrals.</li> </ul>

### Authorities response

246. The government of Bahrain welcomes the acknowledgement in the detailed assessment that AML/CFT issues are taken very seriously in the Kingdom and that authorities have worked hard over the past few years to implement an extensive AML framework. The detailed assessment noted that virtually all the major concerns expressed in the last evaluation, conducted in 2000, have since been addressed. Similarly, the Government of Bahrain will address the areas identified for further improvement in this assessment, as part of its efforts to ensure an AML/CFT regime that is compliant with evolving international standards.

247. Amongst other things, with respect to the *legal system and related institutional measures*, the Government of Bahrain will review the proposed changes to the draft anti-terrorist financing law, which is currently before parliament. In the meantime, CFT efforts will continue, based on existing legal powers. The government is also in the process of strengthening the role and membership of its national policy committee, in order to enhance coordination between relevant ministries and other agencies involved in AML/CFT efforts. This is likely also to include formally tasking the committee as the UNSCR 1373 designation agency. The range of relevant statistics collected will be developed, and on-going efforts to implement a declaration system in line with Special Recommendation IX will be finalized.

248. As regards *preventive measures for financial institutions*, work to update regulations in line with the revised FATF 40 Recommendations will be completed by the end of 2005, with remaining licensees brought up to the same standards as those applied to banking and insurance licensees. Capital market licensees (i.e., stock exchange brokers) will be brought into the BMA Rulebook structure, and their existing AML requirements upgraded in line with the recommendations. Since the assessment was undertaken, focused AML/CFT on-site examinations of capital market licensees have started, and will be extended to insurers from September 2005 onwards.



249. With regards to *preventive measures for non-financial businesses and professions*, the MOIC will address all the issues raised in the report, including amending legislation to make its powers to enforce AML/CFT measures explicit – even though the MOIC is of the opinion that its existing enforcement powers are sufficient in this respect. As regards *non-profit organizations*, the MSA has already increased budgeting to recruit additional staff, and will be working to implement effective on-site examination of NPOs. Lastly, as regards *national and international cooperation*, clearer legal gateways for the exchange of information at the domestic level, between supervisory and law enforcement agencies, will be developed.