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Reinvent business model, Islamic banks told

Islamic banks are being cautioned against past business practices of high leverage and excessive maturity mismatching, if they are to survive in a fundamentally-changed, post-crisis global financial system.

Instead, Islamic financial institutions (IFIs) need to embrace a new business model which rests on more secure foundations of diversification of revenues and consolidation, said Mr. Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain (CBB).

He was speaking at the inaugural plenary session of the 17th annual World Islamic Banking Conference (WIBC), held in Bahrain from 22-24 November 2010.

“The aftermath of the financial crisis presents the Islamic financial industry with both an opportunity and a challenge,” said Mr. Al Maraj in his keynote speech.

“The opportunity is clear: according to reliable estimates, the industry now amounts to over US\$1 trillion, and some consultants estimate that it could double in size within a decade. However, as the warnings on investment products remind us, past performance is not necessarily a guide to the future. As the Islamic financial industry grows, it becomes more important than ever to ensure it rests on secure foundations.”

He noted that in the decade prior to the global financial crisis, the exceptional returns achieved by IFIs mirrored those of their conventional counterparts, with assets doubling almost every two years and net incomes doubling every year. As has now become clear, such extraordinary returns, by conventional banks and IFIs, could only be achieved by excessive risk-taking, encouraged by an environment of cheap and plentiful liquidity.

“If we examine carefully the trends in Islamic banking in the years prior to the

crisis, we can see that there are important similarities between the practices of IFIs and those of conventional banks,” said Mr. Al Maraj.

Like conventional institutions, IFIs increasingly funded long-term assets with short-term funding. Although the assets and liabilities were structured in a Shari’a-compliant manner, the degree of maturity mismatching was just as great as practiced by conventional institutions. In some cases, in fact, where the asset involved a long-term development project, the degree of maturity mismatching was significantly greater.

Although IFIs did not invest in ‘toxic’ assets, the assets they did invest in were just as illiquid as structured financial products, and in the past two years have been just as difficult for them to sell.

IFIs also greatly increased their leverage. They did so in a Shari’a-compliant manner, but balance sheets expanded on the back of static capital levels, just as they had done in conventional banks. And, despite the extraordinary returns earned, capital was not retained in the institution but was distributed to shareholders in the form of dividends and to staff in the form of bonuses.

“Although the parallels between conventional finance and Islamic finance in the years prior to the crisis are not total, there are enough to suggest that many of the lessons are the same,” said Mr. Al Maraj.

Just as conventional banks are being forced by market pressures and regulators to rethink their business models, the need for the reinvention of the business model of IFIs is just as great.

IFIs will need to build a more broadly-based franchise than in the past. It is very likely that there will be less scope in future for smaller niche players that provide only a limited range of services. Instead,

IFIs need to build diversified sources of revenue, relying not only on placement and performance fees, but also on the steady stream of income generated by such unglamorous but essential activities as advisory services, asset management, and providing financial services to retail clients.

“Diversification of the industry will need to go hand in hand with its consolidation. Larger, more broadly-based institutions will be key to the emergence of an industry with more sustainable business models,” said Mr. Al Maraj.

See also ‘Challenging Road’ – Page 2

INSIDE

Page 2

Challenging road ahead for Islamic banks

Page 3

Risk sharing in Islamic finance

Page 4

Islamic banks urged to diversify risk, consolidate

Page 5

AAOIFI stresses commitment to harmonisation

Page 6

Bahrain’s banking system ‘highly liquid’

Page 7

Corporate governance a top priority

Page 8

New obligations for bank boards

Page 9

IMF praises CBB for managing crisis

Page 10

Rulebook for specialised licensees

Page 11

Bahrain market yet to recover

Page 12

Financial Sector Fact sheet

Challenging road ahead for Islamic banks

This year has witnessed clear signs of a global economic revival with the GCC and key markets for Islamic finance outperforming the rest of the world, according to a key report unveiled at the World Islamic Banking Conference (WIBC) in Bahrain.

However, despite strong growth posted by the Islamic finance industry, amidst the economic recovery, profitability of Islamic financial institutions (IFIs) has declined and the road ahead is challenging.

These were among the main conclusions of the World Islamic Banking Competitiveness Report, prepared by leading global strategy advisory firm, McKinsey & Company. The annual report is developed in collaboration with the WIBC, held this year from 22-24 November.

The event was convened under the patronage of His Royal Highness Prime Minister Prince Khalifa bin Salman Al Khalifa, and held under the official support of the Central Bank of Bahrain (CBB).

More than 1,200 delegates from over 50 countries attended the event, which was held under the theme 'Building a new growth paradigm for the Islamic banking and finance industry in the new global financial landscape'.

The 2010-11 edition of the World Islamic Banking Competitiveness Report provides a comprehensive update on the competitive performance of leading Islamic banks and the development of new strategies for the new global financial landscape.

Titled 'In Search of New Opportunities', the report notes that the Islamic banking industry has continued to grow despite the turbulence in the global economy, with Islamic banks outperforming their conventional counterparts in terms of asset growth.

However, both market values and profitability of Islamic banks have come under pressure, narrowing the gap with conventional peers.

"In order to meet market expectations, Islamic banks will have to improve operational performance by learning from conventional banks and capture new pockets of growth," says the report.

The small and medium enterprise (SME) and mid-market segments offer significant opportunity for Islamic banks, particularly in emerging markets, given that SME and mid-market segments account for approximately

25-35% of loan volumes and are growing faster than the rest of the market.

The report points out that in addition to filling select gaps in product portfolio through investment in product development, Islamic banks must also aggressively bolster sales models and design tailored credit strategies for SME and mid-market segments in order to seize the opportunities it provides.

It says that Islamic retail banking will be one of the key drivers of banking revenue growth in the Middle East and capturing the affluent banking customer segment will be key.

It also notes that Islamic banks have the opportunity to grow beyond their core principles but are also increasingly facing stiff competition from conventional banks that offer Islamic products.

Providing an in-depth analysis on how Islamic banks need to change the way they measure performance in a liquidity and capital constrained world, the report points out that capital and liquidity pressures have not eased.

"Since the (global financial) crisis in 2008, capital and liquidity pressures have not eased and in order to manage capital and liquidity, Islamic banks need to ensure that they increase transparency and put in place greater management discipline and oversight," the report adds.

"Banks need to re-assess their internal asset and liability pricing for both liquidity and their cost of capital and include it in their business unit profit calculations."

Exploring the growth opportunities that takaful (Islamic insurance) offers in the GCC market, the report suggests that although the GCC insurance market has grown fast, it is still under-penetrated.

Takaful represents approximately 36% of the total premiums in key markets and continues to gain a larger share of the total insurance premiums. However, despite the faster growth, takaful operators' Return on Equity (RoE) is lower compared to conventional players.

Strong growth in population in the GCC region and a high and fast growing GDP per capita and private consumption are likely to propel the growth of takaful. With a mix of good demographics and positive steps in regulation, takaful operators are likely to enhance their future profits, the report concludes.

Key meeting held on Islamic hedging

The Central Bank of Bahrain (CBB) hosted a meeting of the International Islamic Financial Market (IIFM) Shari'a Advisory Panel and invited IIFM member banks active in Islamic hedging/risk mitigation segment of the Islamic finance industry to attend.

The purpose of the meeting, held on 11 November 2010, was to conduct deliberations between Shari'a scholars and market practitioners on Islamic hedging products, which are essential for risk mitigation of real assets and real economic activity.

"The main aim of the meeting was to obtain guidance from eminent scholars on acceptable Islamic hedging products and the industry's standardization requirements for this important area of Islamic finance," said Mr. Ijlal Alvi, Chief Executive Officer of IIFM.

Mr. Khalid Hamad, Executive Director, Banking Supervision, at the CBB and Chairman of IIFM, said the Tahawwut (hedging) Master Agreement, launched by IIFM in March 2010, governs the most widely required Islamic hedging products and, at the same time, provides the basis for further standardization in the hedging segment, which is one of the most critical and essential areas for risk mitigation.

"We, at the CBB, are pleased to host such a prestigious dialogue and are gratified by the support of scholars, market practitioners and representatives of the Association of Islamic Banks in Malaysia for Islamic financial market unification efforts," he said.

The TMA has been developed based on documentation architecture which allows further standardization in the Islamic hedging segment. Since standardization is a very comprehensive process and has to be carried out in different stages as required by the industry, the TMA is the first step of a much larger block which sets the stage for standardization of product schedules, templates and annexes as well as legal provisioning of close-out netting in various Islamic jurisdictions.

Islamic Finance and Risk Sharing

The global financial crisis has provided a valuable opportunity for Islamic finance to demonstrate the usefulness of its chief characteristic – risk sharing – says Professor Abbas Mirakhor, Chair of Islamic Finance at the International Centre for Education in Islamic Finance (INCEIF). In this article, he details the origins of the concept of risk sharing in Islamic finance and calls on the modern day industry to be true to this critical precept.



Epistemologically, the foundation of the belief that Islamic finance facilitates real sector activities through risk sharing is rooted firmly in the Qur'an, specifically Verse 275 of Chapter 2. This verse ordains that all economic and financial transactions are conducted via exchange contracts (al-Bay') and not through interest-based debt contracts. Necessary condition (al-bay') and sufficient condition (no-riba) for Islamic finance are thus established. Lexicons of the Qur'an define contracts of exchange (al-Bay') as contracts involving exchange of property in which there are expectations of gains and probability of losses. By entering into contracts of exchange parties improve their welfare by exchanging the risks of production, transportation and sale of properties they have acquired.

Risk sharing serves one of the most important desiderata of Islam: the unity of mankind. It intensifies human interaction and this is one of the most powerful justifications for globalization. It is asserted that trade and financial integration increase interaction resulting in greater familiarity which facilitates risk-sharing. Feedback processes triggered by integration create a virtuous cycle leading ultimately to "a global village".

Risk Shifting

Empirical research, however, provides ample evidence of failure of financial integration to achieve the hoped for degree of risk sharing. The reason is not difficult to understand. The dizzying pace of financial innovations of the past several decades created the opportunities and instruments of "risk shifting" rather than risk sharing. The financial sector became increasingly "decoupled" from the real sector with the growth of the former outpacing that of the latter by double-digit multiples. Emergence of a crisis was inevitable and, ultimately, much wealth was destroyed. The slow progress of conventional finance to promote risk-sharing provides Islamic finance with a valuable opportunity to demonstrate its usefulness on a global scale.

Theoretically, the characteristic operational requirements of Islamic finance

are known. These include: (i) transparency, trust and faithfulness to terms and conditions of contracts (ii) close relationship between finance and real sector activities such that the rate of return to the latter determines that of the former (iii) asset/liability risk matching (iv) coordinated asset/liability maturity structure (v) asset/liability value matching such that the value of both sides of the balance sheet move simultaneously and in the same direction in response to changes in asset prices and (vi) limitations on credit expansion and leverage.

It has been demonstrated that such a system would be stable and capable of generating employment, income and growth. This implies that the litmus test of usefulness of Islamic finance would be its ability to reduce poverty and induce growth through its chief characteristic: risk sharing.

The full spectrum of instruments of such a financial system would be expected to run the gamut from short-term, liquid, and low risk financing of trade contracts to long-term financing of real sector investment. At the lower end, it would provide financing for sale and purchase of produced goods to allow greater production and at the other end provide financing for planned production in the future; all financing taking place through risk-sharing. Such a system would leave no room for pure financial transactions, i.e., financial activities that have no relation to real sector production. There would be non-interest debt contracts, such as *duyun* and *qard hassan*, but their main purpose would be to facilitate consumption smoothing for those experiencing liquidity shocks.

Reverse Engineering

The evolution of Islamic finance thus far points to its development as a new asset class intended to remedy a market failure in conventional finance to develop instruments demanded by Muslim investors. Rooted in conventional finance, the new asset class had to design instruments that resembled those of its host system without violating the "no-riba" condition. A number of instruments were reverse-engineered to meet the demand. Financial engineers were thus focused on the design of instruments that served the lower end of the spectrum: low-

risk, short-term and liquid instruments of generally large denomination and placed mostly in the wholesale market. They are not available in the secondary market to serve the risk hedging needs of ordinary households and firms. Very few are of high quality enough to meet the liquidity needs of the market.

Without concerted efforts to develop the high end of the spectrum, there is the possibility of emergence of a path-dependence process whereby the industry continues to churn out more—albeit in greater variety—of same types of instrument. After all, finance is well familiar with the "theory of spanning" (the idea that an infinite number of instruments can be "spanned" out of one basic instrument) which was the foundation of the development and expansion of the derivatives market. The mushrooming of *sukuk* instruments may well point to a similar process at work in the Islamic finance industry.

For Islamic finance to achieve its objectives, development of medium-to-long term risk-sharing instruments is an imperative. Given the track record of the industry thus far, it appears unlikely that the industry by itself will produce such instruments. This is a case of market failure justifying governments' affirmative action to motivate progress. A first-step solution could be design of medium-to-long term risk-sharing instruments to finance development expenditures. A typical emerging market or developing economy devotes 30-40% of its budget to development expenditures financed by taxes and/or domestic and external borrowing. There is no convincing reason why all or part of the development budget cannot be financed through risk-sharing instruments which could be made available to households and firms in the secondary market to enable them to hedge their risks. These instruments could also serve as much-needed, high quality liquidity and benchmarking instruments. Additionally, replacement of borrowing to finance the development budget with risk-sharing instruments would have obvious distributional implications.

Islamic banks urged to diversify risk, consolidate

Islamic financial institutions need to give more attention to limiting risk concentrations and diversifying away from the volatile asset class of real estate.

This was a main message from Mr. Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain (CBB), during recent appearances at two key seminars on Islamic finance, held in Bahrain and Washington DC.

The event in Bahrain, held on 3 October 2010 by the Islamic Financial Services Board (IFSB), focused on 'Business Models in Islamic Finance', while the World Bank hosted a seminar on 'Risk-Sharing in Financial Systems: Islamic Finance Perspective'. The latter event was held on 12 October 2010 in Washington DC, on the sidelines of the annual IMF-World Bank meetings.

"We are all aware of the great potential that exists in the Islamic finance field. However, the industry will only realise the predicted growth trends if it can properly address some fundamental issues, central to which are the business models of Islamic financial institutions," Mr. Al Maraj said at the IFSB seminar.

The rapid growth in the industry in the last decade has meant that few Shari'a-compliant financial institutions have been able to achieve significant economies of scale. Many remain comparatively small and focused on niche markets. The result is that the industry comprises many small scale firms engaged in very similar activities and with comparatively high concentrations of risk.

"For the long-term health of the industry it is important to generate greater scale and diversity," said Mr. Al Maraj.

Diversification needs to occur over several different dimensions.

Diversification Benefits

In the first place, diversification is needed of the industry's exposure to particular economic and industry sectors, such as real estate. Many Islamic financial institutions (IFIs) have built up a comparatively high exposure to the real estate sector. In part, this is the consequence of the requirement for Shari'a-compliant institutions to have a real asset to back their financial assets. Nonetheless, these exposures also have a downside, as the experience of the past few years has shown.

Like conventional financial institutions,

some IFIs have suffered losses resulting from their exposure to real estate markets around the world. Moreover, because they are frequently the direct owners and developers of real estate projects, IFIs have been exposed to a wider range of risks than conventional ones.

"As the IFSB argued in a recent paper, the events of the past few years should have given the industry a clear signal that it must reduce its reliance on real estate as an asset class. The requirement for a real asset to back financial assets can be met in many other ways than by financing the construction of office buildings, shopping malls or luxury apartments. The industry should look instead at the scope for increasing the finance it provides for productive assets such as factories, ports, mines, and oil processing facilities. Financing these activities may appear less profitable in the short-term, but may be a better proposition on a risk-adjusted basis," said Mr. Al Maraj.

Diversification is also needed of product offerings that will allow IFIs to serve their customers better and to generate more stable revenues. Currently, IFIs have a comparatively narrow range of financial products to offer their clients. Developing a greater product range will not only benefit consumers it will also create new sources of revenue that tend to be more stable than those generated by cyclical industries, such as real estate, he said.

Financial Turbulence

At the World Bank seminar, Mr. Al Maraj was joined by other leading speakers in examining the characteristics of Islamic finance and whether this had helped IFIs avert the worst effects of the global financial crisis.

Sri Mulyani Indrawati, Managing Director, World Bank, said that against the backdrop of the harsh lessons on the use of leverage and derivative products, Islamic finance has received praise from several quarters for its relative resilience and stability.

She drew attention to the fact that "researchers argue that the principles of risk-sharing and strong linkages to the real sector have protected Islamic finance from becoming exposed to toxic assets that devastated conventional financial institutions."

Dr. Ahmad Mohamed Ali Al Madani, President of the Islamic Development Bank, said risk sharing is not only a fundamental

principle of Islamic finance but it is the very basis on which Islamic banking has been founded.

He urged the World Bank and the International Monetary Fund (IMF) to help further enhance the global understanding of Islamic finance as a strong and resilient financial system.

Mr. Al Maraj cautioned against over optimism regarding the relative successes of IFIs during the global financial crisis.

"IFIs, at the end of the day, work in the real economy. They are part of the international financial architecture and any turmoil in this environment affects them as well," he said.

There is a need to enhance the industry's ability to manage risks, particularly liquidity risk and limiting risk concentrations.

"Islamic financial institutions find it difficult to manage their liquidity risk given the relative absence of short-term money market instruments. This has been a problem for the industry for some time. However, the events of recent years should give a greater sense of urgency to resolving these problems," said Mr. Al Maraj.

The CBB has been at the forefront of innovation in assisting IFIs to manage their liquidity. In late 2008, the CBB launched the Islamic Sukuk Liquidity Instrument (ISLI), which provides access to short-term liquidity against Government of Bahrain Ijara (leasing) Sukuk. The CBB is also working on the design of other financial instruments which could assist Islamic financial institutions in managing their liquidity.

Several other speakers also acknowledged that the Islamic finance industry has not been fully shielded from the financial turbulence and that the impact of the crisis is still being felt. For example, some issuers of Islamic investment certificates, or sukuk, have defaulted as a result of the real sector effects of the global financial crisis. In addition, given that the industry is relatively young, it has yet to be fully tested in many areas, including in dealing with institutional failures.

There are also still pending policy issues and weaknesses regarding the overall corporate governance and risk management of institutions offering Islamic financial services.



AAOIFI stresses commitment to harmonisation

Standards formulated by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have become the core of the re-engineering process of Islamic finance, delegates at a Bahrain conference were told.

AAOIFI's standards are now being followed either as part of a regulatory requirement or as internal guidelines by all leading Islamic financial institutions across the world, including in the Middle East, Asia Pacific, South Asia, Central Asia, Europe and Africa, said Shaikh Ebrahim bin Khalifa Al Khalifa, Minister of Housing and Chairman of the AAOIFI Board of Trustees.

He was speaking at the AAOIFI-World Bank Conference on Islamic Banking and Finance, held on 1 and 2 December 2010, under the auspices of the Central Bank of Bahrain (CBB).

The event, held annually in Bahrain, is part of AAOIFI's consultative process with the international Islamic finance industry to facilitate its standards development and review program.

Discussions at this year's event covered such topics as corporate governance requirements for Shari'a Supervisory Boards (SSBs), conflicts between fatwas issued by different SSBs, insolvencies in Islamic financial institutions, challenges in the capital markets, non-compatibility of certain international standards with Islamic financial transactions as well as applying Wa'ad (promise) and Irboon (earnest money) in Islamic financial transactions.

More than 400 delegates, representing the international Islamic finance industry, including leading Shari'a scholars, regulators, academics, and Islamic finance practitioners from 30 countries, attended the event.

"The standards issued by AAOIFI provide the basis for innovation within the framework of Islamic teachings. Ultimately, this will enhance users' confidence in Islamic practices and encourage growth of demand," said Shaikh Ebrahim.

The adoption of AAOIFI standards in financial jurisdictions across many parts of the world, are a testament to the confidence and global applicability of the standards.

In turn, the wide application of AAOIFI's standards is progressively contributing to standardization and harmonization of international Islamic finance practices. It

has also facilitated product development by Islamic financial institutions in compliance with Shari'a principles, said Shaikh Ebrahim.

AAOIFI has so far issued 86 standards in the areas of accounting, auditing, ethics, governance and Shari'a matters.

In order to strengthen the adoption and technical application of the standards, AAOIFI has, in recent years, made significant progress regarding the implementation of the Certified Shari'a Adviser and Auditor (CSAA) development programme. Similar progress has also been made on the Certified Islamic Professional Accountant (CIPA) development programme.

"Both programmes have helped improve the level of professionalism in the industry and give further support to the future of the industry," said Shaikh Ebrahim.

In addition, AAOIFI has introduced a contract certification program – to certify that financial contracts between Islamic financial institutions and their clients comply with AAOIFI standards and Shari'a rules and principles.

In this respect, AAOIFI has awarded its certification to electronic messages on interbank Murabaha transactions made by SWIFT, the international finance industry body that provides the communication and messaging platform. Similar certification has been awarded to financial contracts concluded by Bahrain Islamic Bank. This means that the bank's operations comply with AAOIFI standards and Shari'a rules and principles.

AAOIFI has also collaborated with the Bahrain Institute of Banking and Finance (BIBF) in the development and certification of its educational programmes, especially those relating to Islamic finance.

"We hope that these certification efforts will encourage greater harmonization of international Islamic finance practices and promote an increasing degree of standardization in the international Islamic finance industry," said Shaikh Ebrahim.

In order to achieve wider adoption of the standards, AAOIFI will also continue to coordinate with central banks, regulatory authorities and Islamic financial institutions to ensure that the standards are followed and that they can support the expansion of the industry.

World Bank move on Islamic finance

The World Bank is in the process of establishing a multi-donor trust fund dedicated to financing technical assistance and advisory projects which will strengthen Islamic finance globally.

The announcement was made by Mr. Abayomi Alawode, Lead Financial Sector Specialist, in the World Bank's East Asia and Pacific Region division, at the AAOIFI-World Bank Conference in Bahrain.

"One area of emphasis will be to further improve the legal and regulatory foundations of Islamic finance by encouraging convergence among the Islamic finance standards in different jurisdictions," said Mr. Alawode, who was formerly Advisor, Financial Stability, at the Central Bank of Bahrain (CBB).

"Other projects will focus on issues such as deepening and broadening Islamic financial markets, improving knowledge management to underpin policy formulation, expanding the reach of Islamic financial services to the 'un-banked' segments of society and enhancing the monitoring of financial stability and systemic risk within the industry."

He said discussions are already ongoing on the modalities for the fund and that the World Bank will be counting on the cooperation of many key players in the industry to make the fund a reality.

"Shari'a principles of risk-sharing and asset-backing for transactions, as well as the prohibition of speculation gave Islamic financial institutions some inherent strength which shielded them from the worst effects of the recent global financial crisis," said Mr. Alawode.

"While several conventional financial institutions imploded, undermined by their dependence on high leverage and use of complex derivatives to transfer risk, Shari'a-compliant financial institutions were not exposed to speculative sub-prime and toxic assets which devastated their conventional counterparts.

"We at the World Bank are keen to work with our partners in the Islamic finance industry to investigate further how these lessons could be distilled and deployed towards building stable and resilient financial systems."

However, this does not mean that everything is fine with the Islamic finance industry, said Mr. Alawode, stressing that any form of complacency would be dangerous.

Bahrain's banking system 'highly liquid'

Bahrain's banking system is once again highly liquid, with 2010 marked by a pattern of modest recovery, according to a top Central Bank of Bahrain (CBB) official.

While credit growth remains subdued, systemic liquidity pressures have abated. Although a swap facility, instituted by the CBB at the height of the crisis, remains available, no bank has accessed the facility since the early part of 2010.

Deposits with the CBB have grown to comparatively high levels and bidding in Government bond auctions remains very strong with coverage levels often in the 300-400% range, despite the downward trend in interest rates for much of the year.

"All of the above factors indicate that the financial system has succeeded in managing its way through the extreme liquidity pressures that were experienced when the global financial crisis spread to the emerging markets at the end of 2008," said Shaikh Salman bin Isa Al Khalifa, Executive Director, Banking Operations, at the CBB.

He was speaking at the first National Asset-Liability Management Middle East conference held in Bahrain on 10 and 11 November 2010, with the support of the CBB. Held under the theme 'Effective reserve and liability management in the current environment', leading speakers at the event addressed the issue of how the outlook of public institutions across the world has changed and the lessons learned in the aftermath of the global financial crisis.

In his keynote address, Shaikh Salman elucidated the impact of the global financial crisis in Bahrain and the implications it had for CBB's approach to reserves management. He said Bahrain's financial markets continued to function normally during the worst of the crisis in 2008 and the first half of 2009 and the Government of Bahrain did not consider it necessary to take some of the extraordinary measures, such as the recapitalization of banks and providing blanket guarantees, which were adopted in other parts of the world.

Although two wholesale banks were placed under administration during the course of 2009, there was no spill-over effect on the wider financial system. In fact, financial

markets seem to have taken comfort from the prompt and effective action taken by the CBB in dealing with the two problem banks.

Liquidity Crunch

"In Bahrain, as in the rest of the world, the impact of the financial crisis was felt first through a withdrawal of liquidity, a situation that was reinforced by our currency peg to the US dollar," said Shaikh Salman.

Owing to the market reaction to the Lehman Brothers failure in the final quarter of 2008, Bahrain's financial institutions began facing liquidity pressures.

To offset the liquidity outflow that took place after the Lehman bankruptcy, the CBB instituted a new swap facility that permitted banks to exchange US dollar for Bahraini Dinar without a penalty fee. This helped greatly to ease liquidity conditions in Bahrain's money markets and allowed the 2008 year-end to pass without any significant market disruptions.

As 2009 unfolded, liquidity pressures gave way to rising credit losses. However, losses reported by Bahrain's banks have been in line with those that would have been expected in a normal business cycle.

The domestic impact of the crisis has been limited in large part due to the fact that Bahrain's real estate market had not experienced high levels of speculative activity. However, since Bahraini banks are major providers of credit throughout the Middle East and North Africa region, they have been affected by credit defaults elsewhere.

"Nonetheless, the high levels of capital adequacy of our banks have allowed them to absorb these losses and the banking system remains on a solid footing," said Shaikh Salman.

The extraordinary nature of the crisis has invited extraordinary measures from central banks around the world, led by the US Federal Reserve. Policies that were once regarded as unthinkable, such as quantitative easing, have now become an established part of central banking practice.

"In Bahrain's case, we do not currently face this problem. The collapse in the oil price in early 2009 did have a significant spill-over effect on our domestic economy

and, therefore an accommodative monetary policy remains appropriate for our needs," said Shaikh Salman.

"Nonetheless, we will have to monitor the impact of any further monetary easing in the advanced economies very closely and we do have available to us a number of macro-prudential policy tools, such as reserve requirements, which would enable us to respond appropriately within the constraints imposed by our currency peg arrangement.

"The currency peg means that quantitative easing is not a policy that we could ever contemplate. Nonetheless, there are a number of lessons that we as a central bank can draw from the experience of the past few years."

Managing Risk

He stressed the importance of good liquidity risk management by commercial banks.

"Even in a crisis, the central bank should be the lender of last – and not first – resort. This means that commercial banks need to have considered their funding strategies under a variety of stress scenarios, as well as having contingency funding plans in place," said Shaikh Salman.

He said the CBB welcomes the new, greater emphasis given to liquidity risk management under the new Basel III proposals.

On its part, the CBB is in a process of drafting regulations on liquidity standards and has been in consultation with the industry.

He also stressed the importance of ensuring that reserves are highly liquid and are available at the time of need.

"As we saw during the financial crisis, there are only a few financial markets that continue to function during periods of the most extreme market stress. These markets are mainly those for Government debt in a handful of currencies that have reserve or quasi reserve status," said Shaikh Salman.

The CBB is obliged to hold the great part of its reserves in the form of dollar-denominated assets. The crisis has reinforced the importance of considering the depth and liquidity of the markets for the assets held by the CBB.

Central banks must also now pay greater attention to credit risk in their reserve management strategy. They need to think hard about the types of counterparties and clearers with which they are prepared to deal and to set out a clearly articulated profile for their acceptable range of counterparties.

"Even in a crisis, the central bank should be the lender of last – and not first – resort. This means that commercial banks need to have considered their funding strategies under a variety of stress scenarios, as well as having contingency funding plans in place," said Shaikh Salman.



Corporate governance is top priority

The issue of corporate governance has become front and centre of the agenda for both business leaders and regulators around the world, following the global financial crisis.

The crisis has provided many illustrations of the failure of corporate governance and, as a result, international regulators are hard at work to effect appropriate regulatory controls, said Mr. Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain (CBB).

He was speaking to delegates attending a workshop on contemporary issues and solutions relating to corporate governance and board effectiveness conducted by the GCC Board of Directors Institute (BDI). The high-level event, held in Bahrain from 1-3 November 2010, was attended by senior directors from leading corporate entities and institutions in the region. It was hosted by Investcorp, a leading asset management firm specializing in alternative investments, headquartered in Bahrain.

In a keynote address, Mr. Al Maraj stressed the importance of good corporate governance practices for all businesses and especially for banks, because of the special position of trust which banks hold.

Common Pattern

“There is a common pattern in the financial institutions that have failed since the summer of 2007. The Chief Executive was a dominant figure who made sure that he alone took all important decisions. There was no culture of open debate and discussion among senior management, with the result that other members of the board of directors did not feel able to challenge the Chief Executive’s decisions. Many bank boards lacked banking experts. Individuals were recruited to the board of banks for their connections rather than for their knowledge of the banking industry and their ability to ask the right questions,” said Mr. Al Maraj.

The Basel Committee on Banking Supervision has recently revised its detailed guidance on the corporate governance of banks in light of the crisis. In October, it issued a set of 14 Principles for Enhancing Corporate Governance in Banks that updates its earlier guidance on this subject. Many of the Principles set out by the Basel Committee are of general application to all firms, and not just banks.

With respect to board practices, the Basel Committee states that the board has overall responsibility for a bank, including its business and risk strategy and financial soundness in governance. Perhaps the most

important consequence is that the board must pay attention to the long-term interests of the institution and to those of all stakeholders, including depositors and creditors. In other words, good corporate governance means not focusing on short-term returns to shareholders, but concentrating on what is in the best long-term interests of the company. This will often involve taking into account not only the interests of the owners, but also the interests of creditors, employees, and other stakeholders.

The Basel Committee also recommends that there should be a clear distinction between the responsibilities of the board and those of senior management. While the board takes overall responsibility for the direction of the business, the senior management should ensure that a bank’s activities are consistent with the business strategy, risk appetite and policies approved by the board.

An especially important responsibility of senior management is to ensure that there are appropriate systems for managing risk, including a comprehensive and independent risk management function.

The importance of an independent risk management function is something clearly underlined by the financial crisis. Prior to the crisis, some banks did not give the risk management function the stature and authority that it needs. Rather than being treated as an integral part of the business, risk management and compliance were seen as overhead costs which were a distraction from profit generation. Risk managers lacked the direct access to the board which would have given them the ability to challenge the Chief Executive and other senior managers.

Accordingly, the Basel Committee recommends that banks should appoint a Chief Risk Officer who should be a senior executive with independence and authority who is in overall charge of a bank’s risk management functions.

Big Bonuses

“Another important issue concerns compensation practices. As I am sure you are aware, a major contributory factor to the financial crisis was that the staff of financial institutions were rewarded for short-term risk-taking,” said Mr. Al Maraj.

The incentive structures created by bonuses paid over a limited time horizon encouraged traders to focus on short-term profitability and financial engineers to design new financial instruments that could generate immediate profits, while the risks were pushed off to some indefinite future date.

The Basel Committee recommends that the board should review the design and operation of the compensation system and monitor it to ensure that it operates as intended.

Compensation should be effectively aligned with prudent risk-taking, including the time horizon over which risks materialize and should also be symmetric with risk outcomes. This means that compensation practices should avoid paying out large bonuses on the basis of short-term profits, when there is a possibility that the transaction could result in significant losses to the firm in two or three years’ time.

Bonuses should, therefore, reflect the overall financial impact of a transaction, the results of which may not be known for several years.

“All firms, and not just banks, need to avoid a situation in which their compensation practices reward employees for taking excessive short-term risks,” said Mr. Al Maraj.

“All firms, and not just banks, need to avoid a situation in which their compensation practices reward employees for taking excessive short-term risks,” said Mr. Al Maraj.

“This is not to say that bonus systems are undesirable. They clearly have a role to play in providing incentives to employees to perform well and reduce the fixed element in employee compensation, thus giving more flexibility in cost control. But remuneration systems need to balance risks and rewards.”

He stressed the importance of avoiding short-termism.

“The greatest risk to a business arises from an exclusive focus on the short-term, whether it is the next quarter’s results or an employee’s end-of-year bonus. Successful businesses are those that plan for the long-term, that understand the risks of their industries and sectors, and which invest and build for the future. High standards of corporate governance are an essential mechanism to ensure this long-term perspective,” said Mr. Al Maraj.



New obligations for bank boards from 2011

The Central Bank of Bahrain (CBB) has issued new requirements incorporating the Corporate Governance Code, which was issued earlier this year by the Ministry of Industry and Commerce.

The new CBB rules for banks, which come into effect from the beginning of 2011, include the new Corporate Governance Code requirements, the existing CBB requirements and new Board of Directors (BoD) attendance rules.

The new rules, which were first announced on 19 October 2010, incorporate the nine fundamental principles of corporate governance stipulated in the code for financial institutions, their boards and managements to follow. As Islamic finance is considered an increasingly important market segment, one of the principles of the code addresses Islamic institutions in relation to the implementation of Islamic Shari'a principles.

The CBB corporate governance rules focus on the Board's roles and responsibilities, the decision-making process and independence of judgment. The CBB rules clearly state that the Board's role and responsibilities should include:

- Monitoring the overall business performance and strategy for the bank;
- Causing financial statements to be prepared which accurately disclose the bank's financial position;
- Monitoring conflicts of interest and preventing abusive related party transactions; and
- Assuring equitable treatment of shareholders, including minority shareholders.

The review of the strategy process requires the Board to review the bank's business plans and the inherent level of risk in these plans as well as assess the adequacy of capital to support the business risks of the bank.

The CBB rules stipulate that independence of judgment necessitates stringent requirements on non-executive directors who must be fully independent and must constructively scrutinize and challenge senior management and executive directors.

Being a single regulator for all listed and unlisted financial institutions, the CBB will issue similar requirements for insurance

companies, investment firms and companies listed on the Bahrain Stock Exchange in the near future.

Best Practice

"The purpose of these new rules is to establish best practice corporate governance principles in the Kingdom of Bahrain, and to provide protection for depositors, investors and other stakeholders through compliance with those principles," said Mr. Khalid Hamad, Executive Director, Banking Supervision, at the CBB.

"International experience and research have proven that good corporate governance attracts investment, protects investors and other stakeholders, and enhances a company's value."

The new rules include more detailed requirements on the role of the Board and their committees in establishing a clear and efficient management structure which aims at achieving optimum assurance of rigorous controls of critical functions such as financial audit, compliance and internal control.

The rules also cover detailed requirements for audit, remuneration and nominating committees, recognising the essential roles of these committees in ensuring that the bank maintains high standards of corporate governance. The composition of these committees is predominantly focused on independent directors, bringing into light the importance attached to independence of judgment for such important decision making aspects of running a bank.

Conflict of Interest

Rules on avoidance of conflict of interest have been strengthened, detailing the expectations of the CBB whereby directors and senior managers must not enter into competition with the bank; not demand or accept substantial gifts from the bank for themselves or their associates; not misuse the bank's assets nor use privileged information or take advantage of business opportunities to which the bank is entitled, for themselves or their associates.

Furthermore, directors and senior managers must absent themselves from any discussions or decision-making that involves a subject where they are incapable of providing objective advice, or which involves a subject or transaction where a conflict of interest exists.

One of the fundamental new requirements for the Board is its critical role in disclosing the bank's corporate governance to the public and to its shareholders. In line with international best practices and the code, the CBB rules dealing with disclosure on corporate governance have been enhanced.

In addition to the current disclosure requirements in place, public disclosure of corporate governance included in the annual report must now refer to detailed information in relation to individual share ownership by directors and senior managers of the bank, the approval process for related party transactions, the types of material transactions that require Board approval, the dates of all Board and committee meetings as well as attendance record of directors at these meetings.

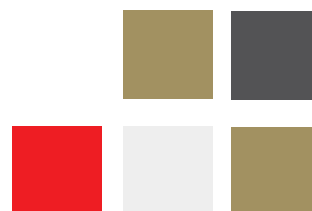
Disclosure to Shareholders

Additional disclosure requirements to shareholders have also been added to the CBB rules. The disclosure to shareholders include remuneration of individual board members as well as the remuneration policy; the remuneration paid to each person in the senior management divided in each case into salaries, perks, bonuses, gratuities, pensions and other components; the audit fees charged by the external auditor; the non-audit services provided by the external auditor and fees; the reasons for any switching of auditors and reappointing of auditors; and conflict of interest that have arisen and the steps taken by the board to ensure that directors exercise independent judgment in considering transactions and agreements in respect of which a director or executive officer has a material interest.

As part of the rules dealing with the Board's decision making process, individual Board members must attend at least 75% of all Board meetings in a given financial year. Voting and attendance proxies for Board meetings are now prohibited at all times.

The new rules become fully effective from 1 January 2011, in line with the implementation date of the Code. In the run-up to the rules coming into force, banks have been required to make a detailed assessment of their work in order to comply with the new Code.

"International experience and research have proven that good corporate governance attracts investment, protects investors and other stakeholders, and enhances a company's value," said Mr. Khalid Hamad, Executive Director, Banking Supervision, at the CBB.



Bahrain named 'Best Financial Centre'

Bahrain was named 'Best Financial Centre' by *Global Investor* magazine, a flagship publication of Euromoney Institutional Investor.

The award, announced on 10 November 2010 at the magazine's 'Future of the Capital Markets in the Middle East Summit', was conferred on Bahrain in recognition for its long standing status as a jurisdiction of excellence for financial services.

The citation also recognised the work of the Central Bank of Bahrain (CBB), which is widely acknowledged as an even-handed, transparent and innovative regulator of the Kingdom's financial services industry.

The award was received on behalf of the CBB by Shaikha Nayla Ali Al Khalifa, Head, External Communications, at the CBB.

"The CBB is delighted with this commendation for Bahrain as a sound and safe jurisdiction for financial services," said Mr. Rasheed Mohammed Al Maraj, Governor of the CBB, the only single regulator in the Middle East.

"The recognition of Bahrain's leadership in financial services is particularly timely, as it comes during a time of continued

weakness in the global economy, following an unprecedented financial crisis.

"In Bahrain, the CBB has worked closely with the industry to steer through these difficult times. Such cooperation, which is a cornerstone of the way the CBB regulates its licensees, has helped minimize the repercussions of the global crisis on Bahrain's banks and other financial firms."

Maintaining a regulatory environment that is, at once, business-friendly and adheres to international best practice is also a key element of Bahrain's success as an international financial centre.

It is no surprise then that over the past three decades, Bahrain has built up the Middle East region's largest concentration of financial services firms, with over 400 firms at present, representing a good mix of international, regional and local players offering a very wide variety of services.

The award from *Global Investor* is the latest for the Gulf's most well-established and mature financial centre which is also a global centre of excellence in Islamic finance. In July this year, the CBB was voted Best



Shaikha Nayla is seen at the ceremony with the Bahrain award.

Financial Centre at the International Takaful Summit; it was the third year in a row that the CBB had taken the top award.

IMF praises CBB for its response to the global crisis

Bahrain has won praise from the International Monetary Fund (IMF) for its handling of the global crisis and the Central Bank of Bahrain (CBB) has been commended for steering the Kingdom's financial services industry through these difficult times.

As a result, the near-term economic outlook for Bahrain is "favourable", the IMF has said, following its 2010 Article IV Consultations with Bahrain. The IMF holds the consultations annually with its members with the aim of assessing each country's economic health and forestall future financial problems.

In a statement, issued on 13 December 2010 at the conclusion of its Bahrain mission, the IMF said:

"The economy of Bahrain has managed the global crisis well. The global crisis produced a sharp fall in oil prices, a tightening of global capital markets, and declines in regional and local real estate markets. High initial levels of bank capital and sound prudential norms established by the CBB ensured the resilience of the financial system, without recourse to the extensive direct interventions seen in many countries. The wholesale banking system started a deleveraging process at the beginning of 2009 with balance sheets

continuing to be scaled back, reflective of a move to more conservative portfolios.

"The near-term outlook is favorable. Buoyed by the rebound in oil prices, the continuing recovery in the global economy and fiscal stimulus, growth is expected to accelerate from the 3% recorded in 2009 to 4% in 2010 and further to 5% in 2011. Inflation is anticipated to remain contained at around 2.5% next year.

"Managing the recovery and the exit from fiscal stimulus creates a number of policy challenges but also provides an opportunity to address underlying imbalances. Increased government borrowing in the last couple of years has increased debt levels and highlighted the need to rebalance the fiscal accounts in order to ensure the existence of sufficient fiscal space to respond to external shocks in the future.

"Reorienting spending away from untargeted subsidies – accompanied by compensatory transfers to needy households – would provide room for an increase in public investment as well as providing fiscal savings. Nonoil revenues are currently low, and broadening the revenue base would not only raise revenues but also provide insurance against fluctuations in oil prices.

"Given the exchange rate peg and the

monetary easing in the US, interest rates are expected to remain low. The CBB's existing macroprudential tools have worked well in preventing excesses from building up in the domestic financial system and will continue to play a key role in insulating the economy from fluctuations in global capital markets. With private sector credit growth gradually recovering, this will provide additional support for growth.

"The current high level of excess liquidity within the banking system provides an opportunity to foster the growth of the domestic debt market and push out the yield curve. A further strengthening of debt management capacity would be beneficial. While Islamic products have been an important growth area, there remain areas of uncertainty in the legal and regulatory framework that should be remedied.

"The large number of new entrants to the labor market anticipated over the next decade places a premium on ensuring the creation of new employment opportunities, especially with growth anticipated to be below historical averages. Regional GCC markets are likely to play an important role in fostering growth. Accelerating integration initiatives could provide important impetus to investment."

CBB regulatory approach is open, consistent

The hallmarks of the Central Bank of Bahrain's (CBB) regulatory approach are consistency, predictability and equal treatment for both foreign and domestic firms.

That was the message from Mr. Rasheed Mohammed Al Maraj, Governor of the CBB, at a meeting with the Bahrain British Business Forum (BBBF).

"Our aim is to adopt a regulatory approach that is open, transparent, and involves close consultation with the industry," he said at the meeting on 21 November 2010.

"We take the view that anything is permitted unless it is explicitly prohibited. As a public institution, the CBB is also proud of the fact that we are bound by the rule of law and we ensure that there is a clear legal basis for all of our decisions and directives.

"These policies have served Bahrain well and have been a major contribution to the growth of our financial sector. Since the 1970s, financial services have been one of the great success stories of our economy, along with tourism and manufacturing that have also made strong contributions to economic growth. Bahrain's economy has become the most diversified of any in the GCC, with the financial sector accounting for over one-quarter of our national output, a larger share than oil production and processing."

At present, more than 400 licensed

financial institutions operate in Bahrain, including 133 banks and 167 insurance companies, Mr. Al Maraj pointed out. Many are branches or offices of major financial institutions. As of August 2010, banking assets stood at US\$210.4 billion, while the fund management industry had almost US\$10 billion under management.

"Although our domestic market is small, many of the banks, insurers and asset management firms located in Bahrain use their presence as a hub from which to tap into the enormous opportunities that exist in both the GCC and the wider Middle East," said Mr. Al Maraj.

"As well as being attracted to Bahrain by our comprehensive and transparent regulatory framework, these firms also tell us that they are drawn here by the maturity and efficiency of our financial markets.

"Looking to the future, the financial services industry will continue to play a very prominent role in our economy. We realise that there are important lessons to be learned from the global financial crisis and we will certainly take notice of them.

"Nonetheless, we believe that Bahrain will continue to play a major role as the financial centre of choice for the Middle East and North Africa region. We will continue to encourage a diversified financial sector in which fund management and insurance will play an increasingly prominent role."

S&P affirms A rating for Bahrain

The Central Bank of Bahrain welcomed the rating assigned by Standard & Poor's (S&P) which reaffirmed the Kingdom of Bahrain's A credit rating, with stable economic outlook, the same rating received by the Kingdom last year.

In reaffirming its rating S&P recognized the Kingdom's prudent economic management and strong net external asset position. The rating agency also acknowledged the role played by the regulatory norms and supervision of the CBB in contributing to financial stability.

Welcoming the announcement, Mr. Rasheed Mohammed Al Maraj, Governor of the CBB, said: "The reaffirmation of the S&P rating is not only a recognition of Bahrain's sound economic management and financial stability but also a vote of confidence in the Kingdom's economic reform programme.

"As set out in the Kingdom's Economic Vision 2030, our ambition is to create a dynamic, competitive, well-diversified economy for the post-oil era. To that end we will further liberalize an economy that is already ranked the most free in the Arab world. Encouraging the growth and diversification of the financial sector is a major plank in that strategy."

Rulebook for specialised licensees launched

The Central Bank of Bahrain (CBB) has launched its Rulebook for Specialised Licensees. This latest volume of the CBB Rulebook, Volume 5, is part of the overall CBB Rulebook framework and contains the regulations and directives issued in accordance with the CBB Law, dealing with specialised licensees.

Specialised licensees refer to money changers, representative offices, financing companies, fund administrators, trust service providers and micro-finance institutions.

In keeping with CBB's established practice, Volume 5 of the CBB Rulebook reflects comments received from the

industry and other interested parties during the course of the consultation that took place earlier this year for licensed money changers. Taking into account the specialised nature of licensees governed by Volume 5, the CBB has opted to structure this particular Volume with a series of common Modules as well as specific Modules. The Money changers Chapter of Volume 5 includes specific modules related to authorisation, high level controls, general requirements, capital adequacy, business conduct and risk management.

Additional specific Modules will be issued in the coming months, with a Module for representative offices expected in January 2011.

CBB signs MoU with Irish central bank

The Central Bank of Bahrain (CBB) and the Central Bank of Ireland (CBI) have signed a memorandum of understanding (MoU) to enhance mutual cooperation in the financial services arena.

The pact was signed during a visit this month to Bahrain by a high level delegation representing the Irish financial services industry.

The Irish delegation was led by Mr. John Bruton, Chairman of the International Financial Services Centre (IFSC) of Ireland.

During their visit, the delegation hosted a seminar entitled 'Ireland – The financial services gateway to Europe',

which was attended by Mr. Rasheed Mohammed Al Maraj, Governor of the CBB. The event was aimed at identifying investment opportunities in the Republic of Ireland, and to learn from Bahrain's experience and knowledge in the fields of Islamic finance and financial services in general in order to enhance the economic relations between the two countries.

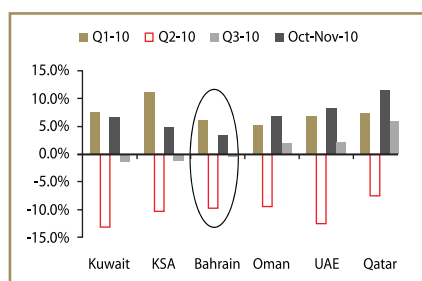
A highlight of the visit was the signing of the MoU between the CBB and the Central Bank of Ireland (CBI), which represents cooperation on the basis of mutual trust and understanding in the fields of supervision of financial institutions, investment and insurance businesses and collective investment schemes.

Bahrain stock market yet to recover

Mr. Jithesh Gopi, Head of Research at Bahrain-based Securities & Investment Company (SICO), reviews the performance of GCC capital markets during the past quarter and provides insights into the developments that affected the listed companies as well as an outlook on the overall markets.



The year to date (YTD) performance of the Bahrain Stock Exchange (BSE) continues to remain weak, declining by 2.3% compared to the S&P GCC index's 10.2% return during the same period. Although the Bahrain market lost less than its peers - Kuwait and Dubai - it underperformed other GCC bourses, despite an improvement in the overall economic growth of the Kingdom.



Bahrain's 3Q10 nominal GDP grew by 14% year on year (YoY) to US\$5.7 billion, led by the core oil and gas sectors (+13%) and manufacturing (+35%); with real GDP growing at a healthy rate of 4.4% YoY.

The improvement in the broader economy was not evident in the index's performance due to under-representation of core sectors among BSE listed companies, and continuing concerns about the health of segments of the Bahrain financial services industry, and more specifically the investment banking sector.

At a consolidated level, BSE listed companies' reported 3Q10 profits were overshadowed by Gulf Finance House's (GFH) losses. Excluding GFH's losses, 3Q10 profits grew by a healthy 9% YoY, while inclusion of GFH's losses leads to a contrasting YoY decline of 30%.

The poor performance of investment banks (which are mostly reliant on investment activities) and uncertainty over a revival in their fortunes, have led to their significant underperformance and to an overall negative sentiment in the broader market.

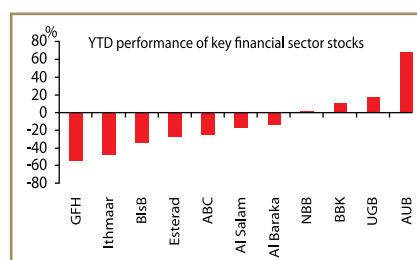
GFH was the top loser among blue chip stocks and is down more than 50% YTD. The bank has continued reporting significant losses during the nine months ended

September 2010, after reporting sizeable losses in 2009. In an effort to improve the bank's capital structure and to raise funds to pursue its revised growth strategy, GFH is planning to raise up to US\$500 million through a convertible murabaha.

AUB was the top performer amongst heavy weight stocks, as the stock rallied nearly 68% YTD on expectations of a possible stake sale by one of its major shareholders, Tamdeen Investment Company, and strong profit growth in 9M10. However, the deal failed to materialise as, according to media reports, Tamdeen rejected a request from the unnamed buyer to extend the offer period by six months.

Historical Lows

The BSE's trading activity continued to remain anaemic following regional trends. Although the average and overall activity saw some improvement in November 2010, this was mainly due to a few large transactions. The drop in liquidity and continuing concerns about some previously active stocks is a worry for investors, further aggravating the situation.



Mumtalakat successfully completed the IPO of Aluminium Bahrain (Alba), one of its flagship companies in Bahrain, in November 2010. The selling shareholder

offered 142 million shares in Bahrain and internationally, representing 10% of the total issued and paid up capital. On completion of the IPO, ordinary shares were listed on the BSE at BD 0.900 (US\$2.39) per share, and Global Depository Receipts (GDRs) representing 5 ordinary shares each, were listed on the London Stock Exchange at US\$11.97 per GDR.

Following the listing of Alba on BSE, the number of listed companies reached 49, including five non-Bahraini cross-listed companies. Alba, the world's fourth-largest individual producer of aluminium by capacity, is contributing to the much-needed diversification of the BSE, which has a heavy concentration of financial sector stocks.

The performance of the Bahraini stock market will continue to be driven by the financial sector's performance, and news flows related to key banking institutions, despite the addition of Alba.

Financial sector concerns have so far overshadowed the consistent performance of non-financial stocks, making these stocks undervalued and attractive for potential investors.

However, any sustainable rally in the market is linked to a recovery in regional markets, improvement in operating conditions of investment banks, and liquidity on the exchange. The BSE is one of the less expensive markets in the GCC, based on expected 2010 profits, and trades at a forward PER of 11.9x compared with the broader GCC average of 14.2x.

Bahrain listed companies' 3Q10 profit performance					
USD mn	3Q10	3Q09	2Q10	YoY	QoQ
Banks	182.9	141.6	196.8	29%	-7%
Communication	51.2	67.0	59.3	-24%	-14%
Consumer	20.5	22.4	31.9	-8%	-36%
Industrials	(5.7)	10.3	6.9	NM	NM
Others (utilities and energy)	0.9	14.3	0.1	-94%	NM
Other Fin. (real est., invest co's, ins.)	(94.5)	(36.6)	(46.7)	NM	NM
Total	155.3	219.0	248.3	-29%	-37%
Total Ex. GFH	270.4	248.3	288.5	9%	-6%

Financial Sector Fact Sheet

Regulator:	Central Bank of Bahrain
Financial Institutions:	412 (December 2010)
Financial Sector Workforce:	14,137 (2009)
	Bahraini nationals 9,313 (65.9%)
	Foreign nationals 4,824 (34.1%)
Key Economic Indicators:	
	GDP (Current) US\$19.3 billion (2009)
	Growth -12.8%
	GDP (Constant) US\$13 billion (2009)
	Growth 3.2%
	Financial Sector contribution to GDP 25%
	Sovereign rating A (S&P 2008) with stable outlook
	A (Fitch 2008) with stable outlook
	Population 1,106,509 (2008)
Banking Sector:	
	Assets US\$215.9 billion (November 2010)
	No. of institutions 133
	Retail banks 30
	<i>Locally incorporated 15</i>
	<i>Branches of foreign banks 15</i>
	Wholesale banks 76
	Representative Offices 27
	Islamic Banks (included in above):
	No. of banks 27 (December 2010)
	Assets US\$24.9 billion
Insurance Sector:	
	Total No. of Insurance Companies & Organisations
	Authorised in Bahrain 171 (December 2010)
	Domestic market
	Gross premiums US\$532 million (December 2009)
	No. of insurance firms 38
	Locally incorporated insurance firms 27
	Overseas insurance firms 11
	Takaful & Retakaful Firms (included above) 9
	Captives (locally incorporated – included above) 2
	Insurance Brokers 33
	Insurance Consultants 5
	Insurance Managers 3
	Representative offices 5
	Loss adjusters 11
	Actuaries 25
	Insurance Ancillary Services 2
	Insurance Pools & Syndicates 2
	Insurance Society 1
	Insurance Appointed Representative 5
	Corporate 4
	Individual 1
	Insurance licensees restricted 41
	Insurance Firms restricted 35
	Insurance Brokers restricted 4
	Insurance Consultants restricted 2
Investment Business Firms:	No. of firms 46 (December 2010)
Capital Market:	Market Capitalisation US\$20.06 billion (December 2010)
	Brokers 11
	Listings
	Companies 49
	Mutual Funds 35
	Bonds 11
Specialised Licensees:	No. of firms 21 (December 2010) [comprising: Trust Services
	Providers 3; Reg. Admin 5; Ancilliary Services 13]
	Money Changers 18
	Financing Companies 9
Funds Industry:	Authorised Funds 2,767 (December 2010)
	NAV US\$9.63 billion (September 2010)
	Local Funds 129
	NAV US\$5.58 billion (September 2010)
	Conventional-Local 74
	Islamic-Local 55
	Foreign Funds-Offshore 2,638 (December 2010)