مصرف البحرين المركزي

Central Bank of Bahrain

Annual Report

2008

Table of Contents

I. Monetary Policy Developments

During the year 2008, the Central Bank of Bahrain ("CBB") initiated a number of measures under its monetary policy framework to ensure the normal functioning of Bahraini money markets. These measures included new monetary policy instruments and several policy rate decisions.

These decisions were aimed to calm the tensions in the Bahraini dinar money market that occurred as a result of the concerns surrounding the global sub-prime crisis and the subsequent global financial market turmoil.

The following developments have been implemented:

Monetary Policy Instruments

In addition to its standard monetary policy instruments - standing facilities of overnight and one-week deposits as well as overnight repos and secured lending – the CBB opened a FX-swap facility and started to accept a broader range of collateral for its normal repurchase facilities during 2008. These new measures were aimed to ensure the smooth and effective functioning of the money markets in Bahrain.

The FX-swap facility allows eligible counterparties to obtain Bahraini dinar in return for US dollars. It is available at the request of retail banks on all business days with no pre-defined limit to the amount.

The CBB also launched a Sharia-compliant money market instrument "Islamic Sukuk Liquidity Instrument" ("ISLI"). The ISLI is aimed to assist Islamic banks' access to liquidity and it is technically based on three separate sales of government Ijara Sukuk (short & long-term) transactions, requiring three parties for a transaction; the bank, the market maker and the CBB. This new instrument means that as well as being able to lend overnight funds against its usual eligible collateral (Bahraini dinar deposits at the CBB and government of Bahrain T-bills), the CBB accepts government of Bahrain short and long term Ijara Sukuk as collateral without a haircut.

Reserve Requirements

The reserve requirement measure requires all retail banks to maintain a daily interest free balance with the CBB of certain percentage of their Bahraini dinar denominated non-bank deposits.

In the fourth quarter of 2007, the procedures for the CBB compulsory reserve requirement measure were reviewed in order to reflect monthly figures more quickly. Furthermore, in the first quarter of 2008, the CBB increased the reserve requirement rate from 5% to 7% in response to increasing inflationary measures and excess liquidity in the banking system.

Interbank Rates

The Bahrain Interbank Offered Rate ("BHIBOR") was developed in 2006 by the CBB in collaboration with a number of banks and Reuters. BHIBORs indicate the BD lending rates between banks from overnight to 12 month tenors.

At the end of 2008, the 3 month BHIBOR money market rate was at 2.84%, compared to 4.78% at end of 2007.

In an effort to further improve the BHIBOR process to quote best possible representative rates in an efficient and transparent manner, the CBB assigned the responsibility of facilitating and monitoring the process of the BHIBOR rates to the Bahrain Association of Banks ("BAB").

Monetary Policy Management

Monetary Policy Committee

The CBB Monetary Policy Committee ("MPC") continued to hold regular meetings during the course of 2008. The MPC monitors economic, financial and liquidity developments in the market and sets recommendations for monetary policy instruments as well as policy rates for the facilities provided by the CBB. The committee, through its weekly meetings and recommendations to H.E. the Governor, has played a key role in the CBB's response to dealing with effects of the global turmoil.

Money Market Forum

During 2008, the Bahrain Money Market Forum started to meet on a monthly rather than quarterly basis in order to discuss global, regional and local financial conditions and their impact on financial intuitions in Bahrain. This Forum has proved to be an efficient and useful communication channel between the market participants and the CBB on ongoing financial market developments and their interpretations.

The Bahrain Money Market Forum was established in 2007 and it includes representatives of a number of conventional and Islamic banks operating in the Kingdom as well as members of the CBB's Monetary Policy Committee.

Key Policy Interest Rate

In light of domestic and global economic and financial developments, the CBB took a number of monetary policy decisions to change its key policy rates. The CBB lowered deposit interest rates seven times during the year 2008. This led to a reduction in the one-week deposit facility interest rate from 4.0% to 0.75%.

The CBB also adjusted the rate on the overnight deposit facility to 0.25%, from 3.50% and cut the overnight repo rate (against T-bills) and the overnight BD secured rate (against BD deposit) to 2.75% from 5.25%.

Money Supply

Broad money measure M2 (defined as Currency in Circulation plus Private Sector Demand, Time and Saving Deposits) reached BD 6,728.4 million at the end of 2008, thus recording an increase of BD 1,045.8 million (18.4%) over end-2007. This was due to an increase in private sector time and savings deposits by BD 719.7 million (17.5%) and in demand deposits by BD 278.1 million (21.1%). M3 (defined as M2 plus government deposits) increased by BD 1,324.7 million (19.9%) to reach BD 7,981.8 million.

Domestic Interest Rates

The weighted average BD time deposit rate (3-12 months) decreased from 3.47% at end-2007 to 1.29% at end-2008. The weighted average saving rate decreased from 0.36% to 0.23%. The weighted average interest rate on business loans increased from 6.91% at end-2007 to 7.43% at end-2008, and the interest rate on personal loans decreased from 9.27% to 8.09%.

II. Banking Developments

The Consolidated Balance Sheet of the Banking System

The consolidated balance sheet for the banking system (retail and wholesale banks) increased to reach USD 252.4 billion by the end of 2008, compared to USD 245.8 billion at the end of 2007, an increase of USD 6.6 billion, or 2.7%. Wholesale banks represented 74.8% of the total balance sheet whilst retail banks represented 25.2%.

Assets

Domestic banking assets amounted to USD 48.5 billion at the end of 2008 compared to USD 37.6 billion at the end of 2007, registering an increase of USD 10.9 billion (29.0%).

Foreign assets amounted to USD 203.9 billion at the end of 2008 compared to USD 208.2 billion at the end of 2007, a decrease of USD 4.3 billion (2.1%).

Net foreign assets fell from USD 6.8 billion at the end of 2007 to USD 6.0 billion at the end of 2008, decreasing by USD 0.8 billion (11.8%).

Liabilities

Domestic liabilities rose to USD 54.5 billion at the end of 2008 compared to USD 44.4 billion at the end of 2007, an increase of USD 10.1 billion (22.7%).

Total foreign liabilities decreased at the end of 2008 by USD 3.5 billion (1.7%) to reach USD 197.9 billion against USD 201.4 billion at the end of 2007.

Retail Banks

The consolidated balance sheet for retail banks rose to BD 23.9 billion at the end of 2008 compared to BD 18.6 billion at the end of 2007 (28.5%).

Assets

Total domestic assets increased by BD 3.1 billion (38.6%) to reach BD 11.1 billion at the end of 2008. Claims on private non-banks increased by BD 1.9 billion (43.6%) and claims on banks by BD 1.1 billion (77.2%). Claims on general government (loans) increased by BD 0.02 billion (8.0%) compared with the end of 2007.

Foreign assets recorded an increase of BD 2.1 billion (19.8%) reaching a total of BD 12.7 billion at the end of 2008 compared to BD 10.6 billion at the end of 2007. Claims on the non-banks increased by BD 0.7 billion (12.3%), while claims on banks increased by BD 1.5 billion (30.6%).

Loans and Credit Facilities

The current balance of loans and credit facilities for the economic sector rose by BD 1.7 billion (40.5%) to reach BD 5.9 billion at the end of 2008 compared to BD 4.2 billion at the end of 2007.

The business sector constituted 65.7% of total loans and credit facilities, while individuals and the government sector contributed 29.5% and 4.8% respectively.

Liabilities

Total domestic liabilities increased by BD 2.2 billion (21.6%) from BD 10.2 billion at the end of 2007 to BD 12.4 billion the end of 2008. This was due to an increase in liabilities to private non-banks by BD 1.0 billion (18.5%) and to banks by BD 0.7 billion (32.3%). Liabilities to general government increased by BD 0.4 billion (39.7%) and to CBB by BD 0.1 billion (128.5 %).

Total foreign liabilities increased to BD 11.5 billion at the end of 2008 compared to BD 8.4 billion at the end of 2007, an increase of BD 3.1 billion (36.9%). Non-bank liabilities increased by BD 1.3 billion (37.1%) and banks increased by BD 1.8 billion (36.7%).

Deposits

Total domestic deposits increased to BD 7.6 billion at the end of 2008 compared to BD 6.3 billion at the end of 2007, an increase of BD 1.3 billion (20.6%). This was due to higher private sector deposits which increased by BD 1.0 billion (18.9%) and general government deposits which increased by BD 0.4 billion (39.3%).

Domestic deposits in Bahraini dinar increased by BD 1.0 billion (26.2%) to reach BD 5.0 billion at the end of 2008. Domestic foreign currency deposits grew by 13.8% or BD 0.3 billion to reach BD 2.6 billion. Bahraini dinar deposits and foreign currency deposits constitute 53.2% and 46.8% of total deposits respectively.

Wholesale Banks

The consolidated balance sheet for wholesale banks fell by USD 7.4 billion or 3.8% to reach USD 188.9 billion at the end of 2008 compared with USD 196.3 billion at the end of 2007.

Assets

Total domestic assets rose to USD 18.9 billion at the end of 2008 compared with USD 16.2 billion at the end of 2007.

Foreign assets decreased by USD 10.2 billion (5.6%) to USD 170.0 billion at the end of 2008. This was due to decreases in claims on head offices and affiliates by USD 10.6 billion (19.7%), the value of securities held by banks decreased by USD 8.1 billion (19.2%) and claims on banks decreased by USD 4.7 billion (20.5%).

Liabilities

Total domestic liabilities increased by USD 4.2 billion (24.3%) to reach USD 21.5 billion at the end of 2008 compared with USD 17.3 billion at the end of 2007.

Foreign liabilities fell by USD 11.7 billion (6.5%) to reach USD 167.3 billion at the end of 2008, compared with USD 179.0 billion at the end of 2007. This decrease was mainly due to a decrease in liabilities to banks by USD 13.3 billion (21.0%) and to non-banks by USD 11.5 billion

(30.8%), while the value of securities decreased by USD 0.9 billion (18.2%).

Geographical Distribution of Assets / Liabilities and by Major Currencies

The share of total assets of the Gulf Cooperation Council (with the exception of the Kingdom of Bahrain) reached a total of 37.2%, 34.5% for Western Europe, 10.7% for American countries, and 4.1% for Asian countries, while their share of total liabilities were 28.6% and 40.8% 6.4% and 5.7% respectively.

As for currency, the share of GCC currencies (with the exception of Bahraini Dinar) of the total assets and liabilities were 13.4% and 10.1%, respectively, and the dollar was 65.4% of total assets and 70.5% of total liabilities. As for the euro, it comprised 11.4% of total assets and 11.0% of total liabilities.

Islamic Banks

The consolidated balance sheet for Islamic banks rose by USD 8.3 billion (50.6%) to reach USD 24.7 billion at the end of 2008 compared with USD 16.4 billion at the end of 2007.

Assets

Total domestic assets rose to USD 11.8 billion at the end of 2008 compared with USD 9.5 billion at the end of 2007.

Foreign assets increased by USD 5.9 billion (85.0%) to USD 12.8 billion at the end of 2008. This was due to increases in claims on head offices and affiliates by USD 2.8 billion (166.2%), the value of securities held by banks increased by USD 1.2 billion (106.9%), claims on investments with banks increased by USD1.2 billion (85.9%) and claims on investments with private non-banks by USD0.8 billion (33.0%).

Liabilities

Total domestic liabilities increased by USD 2.1 billion (20.0%) to reach USD 12.6 billion at the end of 2008 compared with USD 10.5 billion at the end of 2007.

Foreign liabilities rose by USD 6.0 billion (100.0%) to reach USD 12.0 billion at the end of 2008, compared with USD 6.0 billion at the end of 2007. This increase was mainly due to an increase in liabilities to banks by USD 2.2 billion (66.4%) and to non-banks by USD 0.5 billion (36.4%) and capital & reserves by USD3.3 billion (251.4%).

III. Regulatory and Supervisory Developments

Regulatory Developments

As part of CBB's continuing development of the regulatory structure, work was carried out during the year 2008 to strengthen regulatory policies and to develop fair and practical rules in order to maintain market integrity.

Below is a summary of the above mentioned development projects:

CBB Rulebook Volume 4 (Investment Business) Updates

Following the introduction of the Investment Business License in 2006, considerable demand has been noted not only from the local and regional industry, but also from international reputable asset managers. Since then, the CBB commenced on updating the Rulebook to include changes resulting from developments in the financial sector and international best practice.

During the same period, the "Quarterly Prudential Return" pertaining to Investment Business firms was reviewed and circulated to licensed institutions for consultation. After incorporating industry feedback, the same will be issued to Investment Business Licensees for implementation.

Furthermore, the "Training and Competency" Module ("TC") of CBB Rulebook Volume 4 was circulated to licensees for consultation during the 2nd quarter of 2008 and will be issued to Investment Business Licensees for implementation shortly.

As an objective, the CBB endeavours in developing the rules and regulations pertaining to its licensees. Accordingly, the CBB has been working closely with consultants to review and finalise the remaining modules within Volume 4, namely:

- Group Supervision ("GS")
- Dispute Procedures ("DP")
- Public Disclosure ("PD")
- Compensation ("CP")

Upon ensuring that the above modules contain all the rules and regulations required to regulate Investment Business Licensees, they will be issued to the industry for consultation, after which they will be amended as per the feedback and best practice to be issued in their final form.

CBB Rulebook Volume 5

The CBB is currently working on developing a new rulebook that contains new regulations and rules equivalent to internal standards to govern specialised activities that include Financing Companies (Conventional & Islamic), Leasing Companies (Conventional & Islamic), Money Changers, Representative Offices, Ancillary Service Providers, and Trust Service Providers.

A draft Request for Proposal ("RFP") has been prepared regarding this matter to invite consulting firms to provide their bids on developing this Rulebook.

Rules Governing Raising Disputes Before the Disputes Resolution Committee

After the CBB Law was issued in September 2006, the CBB set up two separate special committees tasked with expediting the resolution of disputes within the financial industry. Resolution number (6) was issued on the 17th January 2008 by the Ministry of Justice and Islamic Affairs on Rules governing raising disputes before the Disputes Resolution Committee of the CBB which includes 25 Articles that oblige licensees to comply with.

Financing Real Estate Investments

Due to the accelerated growth of the real estate sector, the CBB monitored bank exposure concentrations to the sector on a periodic basis, communicating to banks the need to exercise caution and care in their practices. To avoid overconcentration by licensees in real estate exposures, the CBB issued 3 consultation papers to licensees and the feedback has been studied and reflected where applicable. These papers were a preliminary step in order to introduce new limits and directives on the real estate financing and investments by banks and financing firms.

The proposed directive includes limits on credit concentrations and investment exposures of banks to the real estate sector, whereby a maximum credit concentration limit of 30% of the total loan portfolio was proposed for financing real estate and 40% of the capital base for investment exposures in the real estate sector.

To permit the CBB to obtain more comprehensive information on the potential risks presented by financial institutions' exposures to the real estate sector as well as to assist it in the design of new regulations on real estate exposures, the CBB conducted in November of 2008 a survey of bank's exposure to the real estate sector (an exercise by Banking Supervision, Licensing, and Financial Stability Directorate). This survey covers various forms of exposures, including among others, the direct financing to real estate, mortgages as well as exposures through Special Purpose Vehicles ("SPVs"). It also asks for data on anticipated real estate exposures.

Schedule of Fines

The CBB is currently studying the application of CBB Law provisions that allow for the setting of a schedule of fines for all banks, insurance companies, consulting firms and other institutions under its regulatory mandate in the event of non adherence to CBB reporting requirements.

Consultation Paper on Private Placement Memorandums (PPM)

This regulation aims to set requirements for Private Placement Memorandums ("PPM") that are marketed by banks and financial institutions in Bahrain to potential investors. It includes requirements to disclose in detail the offering expenses or up-front discounts and placement commissions levied on the investor.

The CBB received feedback from banks and financial institutions with regards to the second consultation paper issued in May 2008. The CBB examined the comments received and issued the paper in its final form. Licensees will be obliged to apply those requirements after the necessary publication in the Official Gazette.

Regulation on Controllers of Banks

CBB issued a regulation on Controllers' of banks which specify the nature and limits of "control". This regulation is applicable in case of approving control over a licensee or listed companies. The regulation sets out procedures for approval of requests for controlling stakes in licensees or companies above defined levels. The regulation also sets out the procedures followed by the CBB to consider such requests.

For the purpose of the above stated regulation, "control" means (in relation to the acquisition, increase or reduction of control of a bank) the relationship between a person and the bank or other undertaking of which the person is a controller.

After consultations with the industry in 2007 as well as several discussions between the CBB and the Legal Affairs Directorate, the above stated regulation was published in the Official Gazette in June 2008.

Business and Market Conduct

The CBB, in its efforts to protect customers of banks and enhance transparency, increased the requirements of the conduct of business in Volumes 1 & 2 (for conventional & Islamic Banks respectively). These new requirements are consistent with those issued in Volumes 3 & 4 (for insurance firms & investment firms respectively) of the CBB Rulebook in June 2006 which includes requirements on providing investment activities in financial instruments.

This regulation aims to encourage high standards of business conduct, which are broadly applicable to all conventional bank licensees, all regulated banking services and all types of customers. The CBB, nevertheless, recognises that customers' level of sophistication and understanding of risks underlying financial instruments vary. Accordingly, the level of safeguards provided for in the business conduct requirements for retail customers, for instance, are different from those for accredited investors.

The CBB issued the final paper and included the requirements into Volumes 1 & 2 of the CBB Rulebook in April 2008 after studying the comments received from Conventional and Islamic banks on the consultation paper issued in 2007.

Licensing Regulation

The CBB has made changes to the current licensing process where the new licensing application is to be processed in one phase instead of two phases. This amendment was introduced in order to enhance the efficiency of the process, therefore, the CBB prepared a draft regulation that is under review and expected to be finalised in the first quarter of 2009.

Deposit Protection Scheme

The Kingdom currently has in place a post-funded scheme managed by a Deposit Protection Board. The CBB wishes to replace this scheme with a pre-funded arrangement along the lines negotiated between the Bankers' Society and the Bahrain Monetary Agency (as it was then) some years back.

The CBB has issued 2 consultation papers to its licensees during the year 2008 and currently in the process of analysing the feedback of the second consultation paper. The final regulation is expected to be issued during the first quarter of 2009.

The new proposed scheme will cover eligible deposits of natural persons (as defined) with amounts not exceeding BD 20,000.

Regulation on Identifying the Approved/Authorised Persons to Market Regulated Services

The CBB prepared a draft regulation to regulate the marketing of regulated services. The aim of the regulation is to prohibit non-licensees from providing or marketing regulated services in accordance with Article number 42 of the CBB Law. The draft is expected to be issued to the industry for comments in the second quarter of 2009.

Issuing Requirements on Supervising Micro Finance Institutions

The process of developing supervisory requirements on "Micro Finance" took much time and effort in order to allow the CBB to be prepared to supervise and regulate such activities. The CBB is currently studying issues related to providing licenses to two financial institutions to work in this field.

A team made a field trip to India to obtain knowledge and information on the experience of that country in this area. The team submitted reports and proposals in this regard with a view to developing certain regulatory standards. The trip increased the readiness of the Banking Supervision to supervise and regulate the work of those specialised institutions in providing microfinance.

Regulation on Identifying Rules and Procedures for the Work of Professional Societies in the Financial Field

The CBB in May 2008 issued Resolution number 27 which includes the rules and procedures that govern the work of Professional Societies in the financial field after receiving the comments of both the Bahrain Insurance Association and the Bahrain Association of Banks.

Corporate Governance

The CBB, in order to enhance and strengthen the requirements of corporate governance, incorporated few amendments into Rulebook

Volumes 1 & 2. The new rules require licensees to have an independent director on the board as a mandatory requirement. The CBB issued a consultation paper in this regard and studied the comments received from the industry then finalised the directives and updated the Rulebook.

Refund/Adjustment of Insurance Premium and Early Repayment Charges

The CBB incorporated new requirements regarding refunding borrowers' insurance premium at early repayment and putting a cap on the fees charged by banks for early repayment of the loans in Rulebook Volumes 1 & 2 in April 2008. The CBB has done so after conducting a number of studies to assess the effect of consumer finance requirements that was issued in January 2005 for retail banks and financing companies and after studying the results received on the consultation paper sent out to the retail banks regarding this matter.

Consultation Paper on Authorisation to Conduct Business as a Composite Insurance Firm

In April 2008, the CBB released the Consultation on Authorisation to Conduct Business as a Composite Insurance Firm.

As a result of the consultation undertaken on the authorisation to conduct business as a composite insurance firm, the CBB has opted not to pursue this proposed amendment and maintains its authorisation requirements that state that, with the exception of captive insurers and pure reinsurers, an insurance firm cannot undertake both general and long-term insurance business.

Consultation Paper on Solvency Margin Requirements for New Takaful Companies

In April 2008, the CBB issued a Consultation on Solvency Margin Requirements for newly established Takaful Companies. Comments received under the consultation document for transition rules for newly established takaful companies were supported by the industry and the Capital Adequacy Module of the CBB Volume 3 (Insurance) Rulebook was amended accordingly.

Large Exposure Limits for Shareholders With Significant Ownership of the Capital of Islamic Banks

In the second quarter of 2008, the CBB inserted and updated its requirements in Volume 2 of the Rulebook concerning the placement of a cap on financing facilities provided to significant shareholders owning 10% or more in Islamic banks. The changes were made after issuing a consultation paper on this matter and studying all the comments received from the Bahrain Association of Banks. These requirements serve to make Rulebook Volume 2 consistent with the existing Volume 1 requirements.

Anti-Money Laundering

The CBB's efforts have focused on raising levels of awareness amongst all licensees and ensuring the effective enforcement of the regulatory framework that has been developed in recent years specific to Anti-Money Laundering and Combating Terrorist Financing (AML/CFT). Efforts were focused in 2008 on upgrading the level of AML/CFT awareness for banks, moneychangers and insurance firms through examination visits.

The CBB carried out examinations on relevant licensees to ensure compliance with the CBB's regulations and to help improve their system of internal controls with respect to the prevention, detection, monitoring and reporting of suspicious transactions.

In striving to improve the AML/CFT framework in the Kingdom, the Policy Committee, which is responsible for formulating AML/CFT policies, procedures and coordinating with relevant internal and external bodies was re-established in 2008 to include an additional member, bringing the number to twelve members from relevant Ministries and government agencies. The Policy Committee also conducted regular quarterly meetings to ensure consistency and efficient coordination in its strategy and priority setting between relevant ministries. Policy Committee efforts in 2008 included the following:

- The enforcement of the disclosure system for customs through the passing of Ministerial Order No. 6 of 2008 by the Ministry of Finance, which brings the Kingdom in line with international standards specific to cash couriers.

- The issuance of an AML/CFT Ministerial Order specifically addressing Lawyers. In March 2008, the Ministry of Justice issued a Ministerial Order No. 2 of 2008 mandating onsite inspections of lawyers as well as the AML/CFT regulatory requirements.

The CBB has also been preparing for the Kingdom's follow-up report to be conducted in May 2009 by the Middle East and North Africa Financial Action Task Force ("MENAFATF"), which will highlight Bahrain's AML/CFT developments during the period of 2006-2008, following the 2005 Financial Sector Assessment Program ("FSAP") evaluation conducted by the International Monetary Fund ("IMF"). Preparations for the upcoming MENAFATF Plenary, which will take place in the Kingdom of Bahrain, included the attendance of the MENAFATF Plenary, held in November 2008 in Fujairah, U.A.E., whereby the CBB presented its initial AML/CFT progress report following the 2005 FSAP evaluation.

Basel II

In late 2007, the CBB issued its regulatory requirements for the implementation of Pillars One and Three of Basel II, which came into force at the beginning of 2008. Pillar Two requirements for Capital Adequacy Assessment Plans were issued in early 2008. As such, all locally incorporated banks have started to calculate their CAR and submit their PIRs based on the Basel II methodology starting from the first quarter of 2008.

In addition, the CBB required each locally incorporated bank to appoint an independent consultant to conduct a risk profile review of the bank based on a set of detailed questionnaires that have been prepared by the CBB. The consultants are required to review the Bank's corporate governance and risk management framework to identify areas of non-compliance with the requirements of the Basel II framework and the

CBB rules in this regard. The qualitative findings of the risk profile report along with the quantitative supervisory information will be used by the CBB to set an individual Capital Adequacy Ratio for each of the locally incorporated banks in accordance with the risk profile and control environment of the bank; an approach that will be finalised during the next two years.

Supervisory Developments

As part of its policies and supervisory framework, the CBB continued to inspect and ensure compliance of financial institutions with its regulatory and supervisory requirements during 2008. The major banking supervision developments are as follows:

Inspection Directorate

The Inspection Directorate completed a pre-planned programme of on-site inspection visits to CBB licensees using the CMORTALE methodology. This methodology assesses capital, management, operational risks, risk management, transparency, asset quality, profitability and liquidity. In addition to this, the Directorate undertook a number of subject-specific visits to banks.

The Directorate increased both productivity and efficiency through increased utilisation of the upgraded TEAMMATE application, facilitating improved on-line review and monitoring of inspections.

Preparations for the implementation of Basel II were complete during the year, focusing on developments in the Basel II framework emanating from the Basel Committee on Banking Supervision.

The Directorate made significant advances with respect to the principle based and risk focused approaches to supervision. The Directorate improved its key strategic initiatives, which included a restructure of the management framework within the Directorate to facilitate greater focus on each of the specialist areas within the Directorates scope of responsibilities. The staffing compliment of the Directorate was increased, reflecting increased demand for focus towards regulatory supervision within the banking and financial sector.

In response to the greater focus towards the assessment of risk within the financial sector, the Directorate identified and implemented training and development programmes designed to provide inspection staff with the skills and experience necessary to assess the extent to which best practice risk management had been effectively embedded in the financial sector. These initiatives further enhance the risk focused approach championed by the CBB with respect to enhanced supervision activities.

The Directorate played an integral role in the CBB Security Measures Committee, which coordinates and liaises with the Bahrain Association of Bankers and the Ministry of Interior regarding proposals to continuously improve security systems at banks and ATMs. The Directorate also focused on ensuring that all licensed banks would comply with the EMV requirements defined by Europay International, MasterCard International and Visa International. The implementation of these standards will enhance the security of all card-based transactions, and enhance the customer-focussed security framework already in place within Bahrain. In addition, the Committee in co-ordination with other industry participants provided a platform for communicating and advising banks in relation to the benefits which can be derived from the implementation of the PCI Data Security Standard ("PCI-DSS").

Banking Supervision Directorates

The CBB, in promoting a prudent regulatory framework, continued its supervisory work through off-site supervision to ensure the application of sound regulatory practices pertinent to banking and financial institutions.

Among the key developments during the year 2008 were the following:

- The development and modernisation of the analysis of the periodic reports for all local banks after the implementation of the requirements of the Basel II Capital Adequacy Accord, which came into effect at the beginning of January 2008.

- The electronic transmission for the new periodic PIR reports from locally incorporated banks as well as overseas banks, which facilitates the CBB to automate and analyse the data given in such reports, is planned for implementation during 2009.

- After consultation with all audit firms, a new version of the Agreed Upon Procedures for the Review of the Prudential

Information Return was sent to the audit firms to submit their Reviews simultaneously to the concerned banks and to the CBB no later than 60 calendar days from the end of the subject quarter.

- The Banking Supervision Directorates also participated in the GCC Banking Supervision Committee meetings. A series of papers were prepared, including a new working paper which aims to unify and coordinate banking practices amongst the GCC countries and in conjunction with the forthcoming monetary union.

- The Banking Supervision Directorates actively participated in the meetings of the 'National Steering Committee on Corporate Governance', set up with the responsibility of developing practices on corporate governance for all institutions operating in the Kingdom of Bahrain.

- The CBB, in coordination with the Ministry of Justice and Islamic Affairs, established the Dispute Resolution Committee ("DRC") for settling disputes among its licensees.

A number of steps have been taken aimed at ensuring that interests of consumers and other users of the services of banks and financial institutions are adequately protected; including:

- The CBB closely monitored the cleaning-up of data in the BCRB system and set a deadline for the clean-up process and any licensees failing to meet the deadline are penalised for erroneous accounts.

- The CBB introduced new regulatory requirements concerning the refund of insurance on loan prepayments and top-ups and early repayment fees/charges.

- In a further step to minimise the risk of fraud cases occurring in customer debit and credit cards, licensees and affiliated merchants, the CBB accentuated its efforts by issuing directives to the concerned licensees issuing debit and credit cards in the Kingdom to become fully EMV compliant (as issuers and acquirers by the means of the issuance of EMV compliant credit and debit cards, ATMs be fully EMV compliant and all concerned merchants in the Kingdom be issued with EMV compliant POS terminals) by 30th June 2009.

Islamic Banking Supervision Directorate

The Directorate has continued its efforts to supervise the Islamic Financial Institutions, which include 19 Wholesale Banks, 6 Retail Banks, and 3 Financial Institutions.

Among the key developments during the year 2008 were the following:

- The Directorate continued receiving/collecting monthly, quarterly, and annual reports/returns; which are used as the basis for analytical reports, which in turn constitute the supervisory tools (used by the CBB) to diagnose the organisational and financial condition of the Banks and accordingly, the CBB conducts/holds regular supervisory meetings to discuss/resolve issues of concern raised by such reports.

- The Directorate closely followed up banks' progress in implementing Basel II requirements by reviewing monthly progress reports and conducting separate meetings with most of the banks to ensure their adherence to the CBB directives in this regard.

- The Directorate revised the Prudential Information Returns ("PIRI") to be in compliance with Basel II requirements. In addition, a new requirement for external auditors to review the Quarterly Prudential Information Returns was introduced (in the first half of the year).

- The Directorate designed and conducted several training courses in supervising/regulating Islamic Financial Institutions including a two-week course for representatives of the Ministry of Finance – Brunei, a two-week course for representatives of Central Bank of Lebanon, and a two-week course for representatives of the Central Bank of Syria.

- With regard to internal training, the Directorate conducted a number of workshops to improve/develop its in-house analytical skills.

Financial Institutions Supervision Directorate

Collective Investment Undertaking ("CIU")

In June 2007, the Central Bank of Bahrain revamped the mutual funds regulatory framework by issuing the CIU Module within CBB Rulebook Volume 6. The new framework classifies funds into:

- Retail funds targeting all types of investors,
- Expert funds targeting expert investors,
- Exempt funds targeting institutional investors, as well as high net worth individuals;

Following the new regulations, the Financial Institutions Supervision Directorate has commenced the exercise of classifying all of the existing locally incorporated funds into the above categories.

As part of its role in regulating financial institutions in line with international best practice, the Financial Institutions Supervision Directorate continued to review the CIU Module in light of developments in other major financial centres, industry feedback and best practice. As a result, the CIU Module is being updated on an ongoing basis.

Development of Trust Services

The Trust Law issued in July 2006 was translated from Arabic to English for use by financial institutions in the Kingdom and to attract new financial institutions from outside the Kingdom. Copies of the Trust Law were sent to all Retail and Wholesale Banks, Audit Firms, Local and Overseas Law Firms to create a dialogue for discussing the new law and benefiting from it by issuing investment instruments based on financial trusts.

Occupational Saving Schemes

The CBB has always been vigilant of the demands of the industry for innovative financial products in line with existing rules and regulations, and is therefore continuously developing its regulations or improvising new regulations to meet those demands.

During the first quarter of 2008, the CBB began establishing the primary standard conditions for registering Occupational Saving Schemes (OSS) for institutions licensed under Volumes 1 (Conventional Banks), 2 (Islamic Banks) and 4 (Category 1 and 2 Investment Business firms) of CBB Rulebook. The CBB circulated the standard conditions relating to OSS to all licensed banks and investment business firms, in addition to law firms and auditors operating in the industry, for review and consultation.

Based on the feedback received from banks and investment business firms, the revision of the primary standard conditions for registering OSS was finalised during the second quarter of 2008.

The schemes aim at segregating employees' savings from funds belonging to employers through facilitating the establishment of occupational saving schemes as trusts under the Financial Trust Law (Law No. 23 of 2006). The schemes also address the registration conditions, reporting requirements and restriction of investments. The CBB intends to issue the standard conditions shortly.

Financial Stability Directorate

During 2008, the Financial Stability Directorate ("FSD") continued to publish a range of analytical reports and successfully developed additional publications. In June 2008, the Directorate introduced the first Economic Report for the year 2007. This report presents international, regional and domestic economic developments over the course of the year 2007. It also covers monetary, financial and capital market developments and presents the public finances and the balance of payments for Bahrain. The report will continue to be published on an annual basis.

The FSD also continued to publish the semi-annual Financial Stability Reports along with other reports such as the Monetary and Financial Trends Report and Balance of Payments Report.

Among other key developments during the year 2008 were the following:

- Conducting the credit card survey semi-annually. Letters were sent out end of 2007 to financial institutions indicating that the credit card survey will conducted be semi-annually with submissions required in June and December of each year.

- Changes made on the Monthly Statistical Returns Forms with more data requirements reflecting a wider scope of data collected from financial intuitions.

- The Monthly Statistical Bulletin underwent some changes to reflect the new data gathered from the changed Monthly Statistical Returns.

- Conducting the National Accounts Survey on a quarterly basis starting 2009 where summary forms will be submitted by banks on a quarterly basis. The higher frequency data helps Bahrain reach and comply by the IMF Special Data Dissemination Standards ("SDDS").

- Performing sensitivity analysis on Balance of Payments data.

- Producing an internal Executive Summary of the Monthly Statistical Bulletin on a monthly basis.

Insurance Sector Supervision

The Insurance Supervision Directorate released an updated Insurance Market Review in September 2008. The review provides a very detailed information of the condition of the insurance industry in Bahrain. This was resulting from the implementation of new statutory reporting forms, which allows for more uniform financial reporting of insurance firms, providing the reader with greater insight in the insurance market.

Also, the insurance regulatory framework at the CBB has been updated to be in line with international best practice. These include:

- A draft of the Implementation Rules for the registration of Insurance Experts, Insurance Brokers and Representatives of Insurance Companies is prepared in line with the provisions of Article 74 of the CBB Law.

- Updating information on regulation and supervision rules of insurance licenses - Insurance Rulebook- Volume 3 on a quarterly basis and implementing these rules during the implementation stages. Capital requirements have been updated for branches of foreign companies, new system of licenses fees on CBB licensees as well as the requirements for actuarial appointments.

- An external actuary has been appointed to review the actuarial reports of selected life insurance companies for the financial year of 2007, to ensure that these life companies maintain adequate reserves to meet their obligations towards the policyholders. Furthermore, the external actuary will also evaluate life insurance policies and the marketing of these policies.

- Conducted Prudential Meetings with all Bahraini Insurance Firms and Overseas Insurance Firms (Foreign Branches).

The CBB closely monitored the impact of the financial crisis on insurance firms. Due to the uncertain investment climate, the CBB examined the impact of the investments downturn on the capital adequacy and solvency margins of the Bahrain insurers. The results showed that the impact was minimal. All insurance firms operating in Bahrain are in line with solvency requirements and are well-capitalised.

The CBB has also supported the pursuit of improved corporate governance practices in the insurance industry. Besides partnering with the industry to strengthen these practices, CBB is also an active member of the Corporate Governance and Compliance sub-committee of the International Association of Insurance Supervisors ("IAIS"). The CBB, in cooperation with the Bahrain Insurance Association, encouraged all insurance companies to take part in a joint survey of the International Association of Insurance Supervisors (IAIS) and the Organisation for

Economic Cooperation and Development (OECD) in order to study the corporate governance practices currently implemented by insurance companies in the region.

Having firmly placed Bahrain on the takaful map, the CBB is addressing takaful and retakaful rules and regulations already in place. As a member of the Solvency Capital Requirements for takaful operations committee of the Islamic Financial Services Board (IFSB), the CBB is working to respond to the current initiatives, in particular, the solvency requirements for takaful and retakaful operators.

IV. CBB Projects and Activities

CBB Actions to Protect the Bahraini Financial System from the Global Financial Crisis

As the global financial crisis worsened in the second half of 2008, it became apparent that many emerging markets will not be immune from the adverse spillover effects. To date, the impact of the crisis on the Bahraini financial system has been modest and the Government and the CBB have not considered it necessary to resort to some of the exceptional measures adopted elsewhere in the world as Bahrain's financial system and markets continued to operate normally throughout the crisis.

Nonetheless, the CBB did introduce a number of new measures designed to assist the financial system to cope with emerging liquidity pressures and shield the financial sector from the spillover effects of the global crisis. The following paragraphs provide details of various measures taken by the CBB in responding to the turmoil in global financial markets

Measures Taken to Improve Market Liquidity

1. **Interest rate changes:** On October 30, 2008, the US Federal Reserve cut its Fed Funds rate by 50 basis points to 1.00%. In response, CBB reduced its Policy Rate by 25 basis points to 1.50%. The smaller rate cut (relative to the US) was done with a view to encouraging capital inflows and stabilizing the markets. In conjunction with the reduction in the policy rate, the overnight repo and lending rates were also cut by 125 basis points to 3.50%. These adjustments helped to ensure that short-term financial assistance was available to banks at favourable rates. Furthermore, the Fed has also cut its Fed Funds rate by 75 to 100 basis points; keeping them at .25% to 0% in mid December. The CBB, in response, reduced its Key Policy Rate and its overnight lending rate by 75 basis points to .75% and 2.75% respectively.

2. **New FX Swap Facility:** Further, CBB introduced a new daily foreign exchange (FX) swap facility that allows banks to obtain Bahraini Dinar in return for US dollars at their initiative. This helps banks to obtain local currency when they have excess US dollars.

3. **Expanded Range of Collateral and New Islamic Liquidity Instrument:** In order to further ease access to its Standing Facilities for banks, CBB expanded the range of collateral it will accept from banks to secure borrowing from such facilities. Notably, Government of Bahrain short and long term *Ijara sukuk* are now acceptable as collateral for CBB lending to banks. With particular attention to liquidity management in Islamic banks, a new Islamic Liquidity Instrument was introduced, giving Islamic banks an opportunity to get overnight funding from the CBB.

4. **Regular Meetings with Bank Treasurers:** Since October 2008, CBB has been hosting regular meetings the Bahrain Money Market Forum, where the CBB meets with Treasury managers of the largest retail banks to discuss trends in the money market and examine possible policy responses. These meetings have undoubtedly contributed to the relative calmness of the Bahraini markets.

Regulatory and Supervisory Measures

1. **Controlling level of real estate exposures:** In addition to measures designed to address short-term liquidity pressures, CBB has also been focused on ensuring that the asset portfolio of Bahraini banks remain sound. To this effect, consultations have been conducted with the banking community on new regulatory measures designed to limit banks' real estate exposures. Also at end 2007, the CBB increased the regulatory risk weighting of real estate exposures to 200% to act as a regulatory constraint on excessive real estate expansion.

2. **Reviews of Risk Management Systems and Practices:** Also,

given the role of risk management failures in the global financial crisis, CBB has directed all locally incorporated banks to carry out internal risk management assessments in order to identify shortcomings that require attention. The outcome of these reviews will be discussed on a bank-by bank basis, with a view to agreeing on appropriate remedial measures to enhance risk management systems and practices.

3. **Review of Compliance with Risk Concentration Limits:** To supplement this comprehensive assessment of risk management, in the summer of 2008, CBB conducted a review of banks' policies and risk limits (compared with CBB regulatory requirements and best practice). All banks with observed deficiencies have been notified and directed to address the gaps by end-2008.

4. **Enhancing Liquidity Monitoring and Management:** The global crisis again underscored the importance of maintaining adequate levels of liquidity. Hence, since early September 2008, the CBB has enhanced its monitoring of bank liquidity, requiring all locally incorporated banks to report their liquidity positions on a daily basis and to report their risk exposures on a weekly basis. Work is also underway on new liquidity requirements for banks to be issued for consultation in 2009. These new requirements will take into account the new requirements issued by the Basel Committee in October 2008.

5. **Strengthening Deposit Protection:** The CBB is in the process of finalising new regulations to reform the existing deposit protection arrangements. The purpose of the reform is to bring deposit protection more closely into line with international best practices on deposit protection, and in particular to establish a pre-funded scheme (i.e. one in which a fund is accumulated in advance of any payouts to depositors, based on regular contributions by the member banks).

6. **Enhanced Monitoring of foreign bank branches based in Bahrain:** On 14th October 2008, the CBB wrote to all the branches of foreign banks operating in Bahrain to ask them to notify the CBB of any developments or events (negative or positive) that

may have a material effect upon the financial position of the parent bank in order that we may continue to monitor the effect of any home–country developments on the liquidity position of the Bahrain branch.

7. **Monitoring the use of special Purpose Vehicles by locally incorporated banks:** Many central banks and governments have noted the role played in the crisis by illiquidity in the so-called "shadow banking sector" on the regulated banking institutions and have called for the regulation and proper supervision of unregulated "special purpose vehicles" and other off-balance sheet funding arrangements. Noting these concerns, the CBB conducted a survey of the use of such vehicles by Bahraini banks. The CBB may issue guidance or regulations on the use of such vehicles in accordance with any new international standards.

8. **Tighter measures on dividend payments:** On 23rd November 2008, the CBB issued a Circular to all banks requiring them to seek the CBB's prior approval before announcing dividend payments. This measure was taken so that the CBB can ensure that banks maintain adequate levels of capital and reserves.

9. **Enhanced Inspection Regime:** The CBB is currently conducting additional on-site inspections of identified higher-risk banks and their higher-risk assets to assess their strengths and weaknesses.

10. **Stress Testing:** The CBB has conducted a stress testing exercise to assess the hypothetical impact of higher levels of investment portfolio losses and higher levels of non-performing loans on the financial soundness of banks. The purpose of this exercise was to identify thresholds of losses at which banks will fall below the minimum regulatory capital requirements.

Other Measures

1. **Contingency Planning:** The CBB has conducted a review of its internal policies and procedures for managing episodes of financial instability and is in the process of bringing them together in a single Contingency Plan. This will further

strengthen the capacity of the CBB to respond to cases of financial stress.

2. **Public Dissemination of Information:** As the effects of the crisis began to be felt within the GCC, CBB's External Communications Unit ("ECU") has been available to handle all external enquiries, with a designated spokesperson readily accessible to answer questions from members of the public. In addition to announcements of cuts to interest rates, regular press releases were also issued to reassure the public that our financial system remained robust and sound, despite the turbulence experienced in global and some GCC markets. The public was also assured that CBB was closely monitoring developments in different parts of the financial sector and will take quick and appropriate action if it notices any untoward developments.

Contingency Planning Task Force

In an effort to improve the CBB's ability to manage episodes of financial distress, on June 23rd 2008 a contingency planning task force was formed according to the administrative resolution number 41 for 2008. The task force was assigned with the responsibility of creating the CBB's Banking Sector Contingency Manual.

The Banking Sector Contingency Manual is intended to provide a framework for the practical implementation of a Contingency Plan for the prevention, management, and containment of individual or systemic financial disturbances. Contingency Planning has become part of the standard toolkit of central banks around the world in recognition of the importance of being prepared for a wide range of contingencies, no matter how remote.

The manual, which was submitted to H.E the Governor by end of January 2009, was the product of six months' work by a team of staff and advisers from various CBB Directorates. The Manual contains a set of policies, procedures, and actions that the CBB can use to respond to financial distress affecting either an individual bank or a more general problem affecting a large number of banks.

Payment Systems Developments

As part of the framework to develop the financial sector in the Kingdom of Bahrain, the RTGS is a system introduced by the CBB to settle interbank transactions in "real-time" rather than on an end of day basis replacing the deferred net settlement system and implemented in accordance with the Bank for International Settlements ("BIS") standards.

The system uses the global communication network SWIFT between the CBB and retail banks, allowing transactions to be executed in real time. In addition, retail banks can realize their positions with the CBB in real-time, online at throughout the system operating times.

The RTGS System went live on 14th June, 2007. For the year 2008, the average daily number of transactions was 1,171 with an average daily value of BD 306.9 million. The highest number of transactions occurred on 25th September, 2008 where the number of transactions peaked at 2,625 with a value of BD 303.6 million.

From June, 2008, the CBB has started charging RTGS participants for the use of the RTGS System. The annual membership fee of BD 3,500 for each RTGS member and an annual membership fee of BD 3,500 for each SSS member. This is in addition to daily charges of 400 fils per transaction processed in the RTGS System.

The transaction charges are taken on a daily basis while the membership fees are taken on the first working day of each year.

Automated Cheque Clearing

In 2007, the CBB upgraded its cheque clearing technology. A new cheque clearing sorter was introduced which has a speed of 300dpm (300 documents per minute) and image capability. The introduction of this sorter led to a significant reduction in timing for clearing cheques.

In 2008, another similar sorter was acquired to complement the current new sorter. This greatly reduced the time taken for clearing cheques in addition to better efficiency.

Previously, the cheque clearing data files were given to the bank representatives on floppy disk. Now, banks can access their cheque clearing data files through the CBB extranet in coordination with the IT Directorate. This caused a further reduction in time taken for the cheque clearing process as bank representatives don't have to wait for their respective floppy disk.

In 2008, just over 3 million cheques were processed with a value of BD 4.9 billion. On average, 12,316 cheques were processed daily, with an average value of BD 19.8 million per day.

New Licenses

During the period 2007-2008 the CBB issued a total of 83 new licenses for financial institutions (38 in 2007 and 45 in 2008). These licenses included 10 banking institutions (2 retail banks and 8 wholesale banks) and 8 representative offices of foreign banks and asset management companies, 25 insurance institutions, 40 investment companies.

A large number of new institutions were licensed during 2008 such as:

1- BNP Paribas 3U
2- Allianz Global Investors Europe GmbH
3- Lazard Asset Management Limited
4- BSI SA
5- BNP Paribas Asset Management BSC (c)
6- Sarasin (Bahrain) B.S.C. (c)
7- Credit Suisse
8- GIC Funds Services Company Bahrain
9- Apex Fund Services Ltd.
10- Ogier Fiduciary Services Bahrain
11- Legal & General Gulf B.S.C. (c)
12- ACR Retakaful MEA B.S.C. (c)
13- First Energy Bank B.S.C. (c)

This reflects the growing confidence in Bahrain as a financial centre and its ability to attract foreign investment, which will enhance Bahrain's reputation and competitive position in banking and financial sector in the region.

Currency Issue

On 17th March 2008, the CBB issued new banknotes in denominations of BD 20, 10, 5, 1 and 0.5 labelled with "Central Bank of Bahrain" instead of "Bahrain Monetary Agency". The new banknotes, coming with new security features and innovatively distinct designs, were in circulation along with those notes and coins issued in 1993.

The Currency Issue Directorate, in its efforts to familiarise and aware the public of the new security features embedded in the new notes, held myriad introductory meetings with other Directorates and government agencies and institutions, predominately in daily dealing with notes and coins such as the Electricity and Water, Customs and Ports, Post Office, Ministry of Labour, and General Directorate of Traffic. A number of workshops were convened, as well, in the Bahrain Chamber of Commerce and Industry and the Saudi Bahraini Institute for the Blind.

In May 2008, the Currency Issue directed a circular to all retail banks and money changers operating in Bahrain requiring them to acquire special forgery-detecting machines. These devices should employ all security features integrated into the new notes.

The Directorate has put into use a new money sorter and counter which principally performs counting, sorting and forgery detecting functions. It also started destroying worn-out, impaired and ineligible banknotes.

Participation in Conferences, Seminars, Meetings and Workshops

During 2008, the CBB hosted many conferences, seminars and workshops; operating as both provider of facilities and organiser of events which raise the profile of the Kingdom's banking and financial sector. The CBB encouraged financial institutions to participate in those events to make them more fruitful.

Bahrain organised a large number of events in the region. The CBB continued to organise annual conferences such as the World Islamic Banking Conference in Bahrain, which has been held continuously for the last fifteen years. The CBB contributed to the 27th General Arab Insurance Federation ("GAIF") Conference held in the Kingdom of Bahrain on 26th to 28th February 2008, with the theme of "Towards A More Integrated Arab Insurance Market". More than 1,000 delegates representing most of the Arab and International insurance and reinsurance companies and insurance supervisors attended the conference.

The CBB also contributed to Annual Shari'a Conference, and other conferences held by the Bankers' Society of Bahrain, the General Council for Islamic Banks and Financial Institutions ("GCIBFI") which is headquartered in Bahrain, the Accounting and Auditing Organisation of Islamic Financial Institutions ("AAOIFI"), and other institutions that support the banking and financial sector in the Kingdom of Bahrain.

The CBB hosted a Takaful Workshop during the period of 24th to 25th February 2008 organised by the International Association of Insurance Supervisors ("IAIS") and Islamic Financial Services Board ("IFSB"). The CBB participated in regular meetings of the IAIS as a member of the Corporate Governance Task Force on 20th to 21st November 2008. Moreover, the CBB participated in the regular meeting of the IFSB Council as a member of the Takaful Capital Adequacy and Solvency committee on 28th November 2008.

To give those conferences greater international importance, the CBB has involved major international institutions in organising different conferences and events, including the International Monetary Fund ("IMF"), The Financial Stability Institute ("FSI"), the Islamic Development Bank ("IDB") and other international financial institutions.

In addition to these conferences, the CBB initiated, in conjunction with the Bahrain Institute for Banking and Finance ("BIBF"), many specialised seminars in the areas of banking and finance. It also organised workshops designed to expand technical knowledge on the latest international developments in specific banking and financial domains.

At the international level, in order to demonstrate the expansion and development of the financial sector in the Kingdom of Bahrain, the CBB participated in a number of workshops and held many meetings with officials in financial sectors of Western and East Asian countries during 2007-2008. The aim was for the CBB to share Bahrain's experiences and evolution as a financial centre in the Middle East and to give foreign officials the opportunity to recognise the various advantages and benefits Bahrain has reaped in its leading role in the development of the financial sector, particularly Islamic banking, an area that many Western countries wish to participate in now and in the future.

The total number of conferences and events in which the CBB participated in during 2007-2008 inside and outside the Kingdom was 58.

V. CENTRAL BANK OF BAHRAIN
Balance Sheet and Profit and Loss Account and Appropriation
31 DECEMBER 2008

AUDITORS' REPORT TO THE CHAIRMAN OF THE BOARD OF DIRECTORS OF THE CENTRAL BANK OF BAHRAIN

We have audited the accompanying balance sheet of the Central Bank of Bahrain (the "Central Bank") as of 31 December 2008, and the related profit and loss account and appropriation for the year then ended.

Management Responsibility for the Balance Sheet and the Related Profit and Loss Account and Appropriation

The management is responsible for the preparation and fair presentation of the balance sheet and the related profit and loss account and appropriation in accordance with Royal Decree No. 64 of 2006. This responsibility includes: designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of the balance sheet, profit and loss account and appropriation that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on the balance sheet and the related profit and loss account and appropriation based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the balance sheet and the related profit and loss account and appropriation are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the balance sheet and the related profit and loss account and appropriation. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the balance sheet and the related profit and loss account and appropriation, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the balance sheet and the related profit and loss account and appropriation in order to design audit procedures that are appropriate for the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the management, as well as evaluating the overall presentation of the balance sheet and the related profit and loss account and appropriation.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the balance sheet, related profit and loss account and appropriation present fairly, in all material respects, the financial position of the Central Bank as of 31 December 2008 and the results of its operations for the year then ended in accordance with the accounting policies set out in Note 2 of the balance sheet and the related profit and loss account and appropriation and in compliance with the Royal Decree No. 64 of 2006.

18 March 2009
Manama, Kingdom of Bahrain

CENTRAL BANK OF BAHRAIN
BALANCE SHEET
At 31 December 2008

	Notes	*2008* *BD '000*	2007 BD '000
ASSETS			
Gold	4	***2,500***	2,500
Foreign reserves	3 & 4	***1,926,435***	1,957,843
Cash, due from Bahraini banks and treasury bills	5	***36,978***	3,977
Due from international organisations		***211***	211
Equipment		***2,512***	2,352
Other assets	6	***7,087***	11,613
		1,975,723	1,978,496
LIABILITIES AND CAPITAL FUNDS			
LIABILITIES			
Notes and coins in circulation	4	***370,772***	307,604
Bahraini dinar deposits		***963,924***	1,066,271
Due to Ministry of Finance		***62,661***	56,553
Due to other central banks		***410***	372
Payable to Kingdom of Bahrain	9	***10,500***	10,505
Other deposits		***94,812***	85,481
Provision for currency withdrawn		***6,298***	6,315
Other payables	7	***2,029***	5,491
		-	
		1,511,406	1,538,592
CAPITAL FUNDS			
Capital	8	***200,000***	200,000
General reserve	9	***174,216***	163,716
Contingency reserve	10	***71,400***	58,000
Revaluation reserve	11	***18,701***	18,188
		464,317	439,904
		1,975,723	1,978,496

Chairman

Governor

CENTRAL BANK OF BAHRAIN
PROFIT AND LOSS ACCOUNT AND APPROPRIATION
For the year ended 31 December 2008

	Notes	*2008 BD '000*	2007 BD '000
INCOME			
Interest income		*73,976*	93,104
Interest expense		*29,199*	45,393
Net interest income		*44,777*	47,711
Registration and licensing fees		*5,252*	4,619
Exchange gain on sale of US dollars		*5,489*	5,280
Net realised investment gain (loss)		*4,937*	(1,201)
Other		*336*	339
		60,791	56,748
EXPENDITURE			
Staff costs		*8,392*	6,814
General and administration expenses		*6,610*	5,678
Managed funds and advisory fees		*914*	998
Notes issue expenses		*3,900*	2,248
		19,816	15,738
Profit for the year before provision		*40,975*	41,010
Provision for impairment	3	*(6,575)*	-
NET PROFIT FOR THE YEAR		*34,400*	41,010
Transfer to contingency reserve	10	*(13,400)*	(20,000)
Transfer to general reserve	9	*(10,500)*	(10,505)
BALANCE PAYABLE TO KINGDOM OF BAHRAIN		*10,500*	10,505

NOTES TO THE BALANCE SHEET AND PROFIT AND LOSS ACCOUNT AND APPROPRIATION
At 31 December 2008

1 ACTIVITIES

The Central Bank of Bahrain ("the Central Bank") is the Central Bank of the Kingdom of Bahrain and operates under the Royal Decree No. (64) of 2006 issued by His Majesty the King Hamad bin Isa Al Khalifa King of the Kingdom of Bahrain (the "Royal Decree"). The Central Bank is responsible for organising the issue and circulation of the currency of the Kingdom of Bahrain as well as its foreign exchange, managing the value of the currency of Kingdom of Bahrain, endeavoring to ensure monetary stability, supervising and regulating the banking, insurance and capital market sectors so as to realise the objectives of the economic policy of the Kingdom of Bahrain, and participating in the creation of a developed money and financial market. The Central Bank acts as the fiscal agent on behalf of the Government of the Kingdom of Bahrain and is the supervisory authority for the financial sector in the Kingdom of Bahrain. The Central Bank has no branches or operations abroad.

2 SIGNIFICANT ACCOUNTING POLICIES

The balance sheet and related profit and loss account and appropriation are prepared in compliance with the Royal Decree.

Accounting convention

The balance sheet and related profit and loss account and appropriation are prepared under the historical cost convention.

Foreign reserves

Foreign reserves comprises deposits placed and investments denominated in foreign currencies. All investments and deposits are carried at cost less provision for impairment.

For the Central Bank's investments portfolio, premiums or discounts on purchase are amortised on a straight-line basis over the remaining life of the investment and included under interest income in the profit and loss account and appropriation.

Purchases or sales of financial assets are recognised on the settlement date, i.e. the date by which the executed asset trade is settled.

Depreciation

The cost of the building and any addition thereto is expensed in the year in which the cost is incurred. The cost of other equipment is depreciated by equal annual installments over the estimated useful lives of the assets.

Foreign currencies

Foreign currency transactions are recorded at rates of exchange ruling at the date of the transactions.

Monetary assets and liabilities in foreign currencies at the balance sheet date are retranslated on the basis of the official par value of the Bahraini dinar in relation to the United States dollar and the closing market rates of exchange for the other currencies.

In accordance with Article 22 (a) of the Royal Decree, all profits resulting from the revaluation of the Central Bank's assets or liabilities in gold or foreign currencies as a result of any change in the parity-rate of the Bahraini dinar or the rate of exchange of the Central Bank's assets of such currencies, are required to be recorded in a special account to be entitled "Revaluation Reserve Account".

In accordance with the requirements of the Royal Decree, the gain or loss on the foreign exchange contracts is recognised in Revaluation Reserve account. Upon disposal of the assets the related gain or loss on the forward contracts is recognised in the profit and loss account and appropriation.

Provision for impairment

The Central Bank assesses at each balance sheet date whether there is objective evidence that an investment is impaired. This include a significant or prolonged decline in the fair market value of the investment below its cost.

Gold

Gold is carried at cost.

Notes and coins in circulation

Notes and coins in circulation are stated net of the Bahraini dinar notes and coins held in banking stock.

Revenue recognition

Interest income is recognised on a time apportioned basis, taking into account the principal outstanding and the rate applicable. Registration and licensing fees are accounted for based on the calendar year to what they relate to. Investment gains are recognised when realised.

Note issue expenses

These are recognised when incurred.

3 FOREIGN RESERVES

	2008 ***BD '000***	*2007* *BD '000*
This comprises the following:		
Bond portfolios	**546,294**	596,619
Bank deposits	**1,386,716**	1,361,224
	1,933,010	1,957,843
Less: provision for impairment	**(6,575)**	-
	1,926,435	1,957,843

All bonds are quoted in active markets with 96% being of investment grade BBB or higher (2007: 97%). All deposits and 89% of bonds are in US dollars (2007: 92%). For other foreign currencies, mainly Euros and Sterling, these are 98% hedged into US dollars. The bond portfolios include BD 5,330 thousand net unrealised gains on non-US denominated bonds and related forward foreign exchange contracts used to hedge such bonds (2007: gain of BD 4,817 thousand).

The market value of the bond portfolios at 31 December 2008 was BD 514,229 thousand (2007: BD 591,847 thousand).

During the year, the Central Bank has recognised an impairment provision of BD 6,575 thousand.

4 EXCESS OF AUTHORISED BACKING FOR CURRENCY IN CIRCULATION

	2008 BD '000	*2007 BD '000*
Authorised backing:		
Gold	**2,500**	2,500
Foreign reserves - note 3	**1,926,435**	1,957,843
	1,928,935	1,960,343
Currency in circulation:		
Notes and coins	**(370,772)**	(307,604)
Excess of authorised backing over currency in circulation	**1,558,163**	1,652,739

The fair value of gold as at 31 December 2008 was BD 49,019 thousand (2007: BD 47,237 thousand).

5 CASH, DUE FROM BAHRAINI BANKS AND TREASURY BILLS

	2008 BD '000	2007 BD '000
Cash	9,478	217
Due from Bahraini banks	2,699	3,760
Treasury bills issued by the Government of Bahrain	24,801	-
	36,978	3,977

6 OTHER ASSETS

	2008 BD '000	2007 BD '000
Interest receivable	1,907	6,475
Staff loans	3,462	3,370
Others	1,718	1,768
	7,087	11,613

7 OTHER PAYABLES

	2008 BD '000	2007 BD '000
Interest payable	193	2,722
Accrued expenses	296	1,066
Payables	1,540	1,703
	2,029	5,491

8 CAPITAL

	2008 ***BD '000***	*2007* *BD '000*
Authorised	**500,000**	500,000
Issued and fully paid up	**200,000**	200,000

9 GENERAL RESERVE

	2008 ***BD '000***	*2007* *BD '000*
Balance at beginning of the year	**163,716**	153,211
Transfer from profit and loss account and appropriation	**10,500**	10,505
Balance at end of the year	**174,216**	163,716

In accordance with Article 12 of the Royal Decree, the Central Bank maintains general reserve which is credited with the following percentages of its net profit:

- 100% of the Bank's net profit until the amount of the general reserve reaches 25% of the authorized capital of the Central Bank;
- 50% of the net profit until the amount of the general reserve is equal to the authorized capital of the Central Bank;
- 25% of the net profit until the amount of the general reserve is double the amount of the authorised capital of the Central Bank.

Any net profit after such allocation is to be transferred to the Kingdom of Bahrain general account within three months of the date of the approval of the Central Bank's accounts.

10 CONTINGENCY RESERVE

	2008 **BD '000**	*2007* *BD '000*
Balance at beginning of the year	**58,000**	38,000
Transfer during the year	**13,400**	20,000
Balance at end of the year	**71,400**	58,000

The Board has approved a transfer of BD 13,400 thousand of the current year's net profit to the contingency reserve. This includes BD 8,400 thousand that has been specifically allocated to fund the purchase of a new headquarters for the Central Bank.

11 REVALUATION RESERVE

	2008 **BD '000**	*2007* *BD '000*
Balance at beginning of the year	**18,188**	16,367
Movement during the year	**513**	1,821
Balance at end of the year	**18,701**	18,188

The revaluation reserve relates to exchange gains and losses recognised in accordance with the Royal Decree.