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The Progress of Islamic Banking and Finance in Bahrain

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ABSTRACT

The progress of Islamic banking and finance in Bahrain is discussed under three broad but interrelated headings: regulation, operation, and education. Islamic institutions have long recognized the need to establish a regulatory regime that is industry-specific but constructed to a standard that compares favorably with international best practices in the regulation of conventional financial institutions. The Islamic financial industry well understands the urgent need to design financial instruments acceptable to the *shari^{c}a* in order to enable institutions to better handle liquidity and investment priorities and to provide markets wherein those instruments may be traded. The Islamic financial community needs to show the world that it is an able competitor to conventional finance and has promise for success and expansion. In this regard, Islamic finance may have to accept its primary responsibility for human resource development and public education, and to invest accordingly.

I. INTRODUCTION

In reviewing the progress of Islamic banking and finance in Bahrain, it is important to consider three broad but interrelated aspects: regulation, operations, and education. All three of these aspects are good indicators of the growth and maturity of Bahrain's Islamic finance sector.

II. REGULATION

The Bahrain Monetary Agency, the central bank of the Kingdom of Bahrain, has the statutory regulatory responsibility for the banking industry, and thus regulates Islamic institutions that conduct banking and financial activities in the Kingdom. While rigorous regulation is always the prime objective of the authorities, it is also an important concern of all the institutions licensed by the agency, including the Islamic institutions themselves. This mutual interest underpins the excellence of Bahrain's regulatory reputation on the world stage. The voluntary acceptance of both the conceptual and the practical implementation of a stringent regulatory regime is a clear indication of the maturity of these institutions. Islamic institutions have long acknowledged that the need to construct a regulatory regime that is industry-specific, transparent, and maintained to a standard that is comparable to the best of international practices. Indeed, since the establishment of the first Islamic bank in 1975, intensive efforts were made to develop such a framework.

These efforts culminated over a decade ago in the creation of the Accounting and Auditing Organization for Islamic Financial Institutions. The organization was registered in Bahrain in 1991, and to date has issued eighteen financial accounting statements: four auditing standards, four government standards, nine *shari^{c}a* standards, and a code of ethics. At the practical level, the organization is a member of the standard advisory council of an international accounting standards board, and maintains close links with the IMF, the Basel Committee, and the United Kingdom Financial Authority. The standards set by the Accounting and Auditing Organization for Islamic Financial Institutions are at least comparable to, and in some cases more stringent than, those applied to the conventional sector. The Kingdom of Bahrain, which is home to two-thirds of the Islamic institutions operating in the Gulf, now requires licensed institutions to adopt IFE standards. The Saudi authorities require all banks offering Islamic products to be guided by IFE standards, and Malaysia has been committed to this conversion as well. In addition, Qatar has issued standards based upon IFE standards. These developments are clear evidence of the acceptance of standards by the international regulatory community. In this context, the agency in consultation with the industry has developed a framework known as the Prudential Information and Regulation for Islamic Banks (PIRI) which takes the standards developed by the Accounting and Auditing Organization for Islamic Financial Institutions into consideration.

The Basel Committee guidelines and PIRI framework covers five important aspects:

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- Capital adequacy, for both credit and market risk
- Asset quality including monetary large exposures and related party exposures
- Regulatory treatment of investment accounts both restricted and unrestricted and both on and off balance sheet
- Prudential requirements concerning liquidity management on balance sheets
- Separated funds related to restricted investment accounts analysis of earnings quality.

It is therefore self-evident that Islamic financial institutions based in Bahrain, at least, are now subject to a regulatory standard that is comparable to that expected by international regulatory authorities of the conventional sector.

III. Operation

The agency has long been aware that the framework of liquidity management is less efficient for Islamic institutions than for conventional operations. The ability of conventional banks to use short-term instruments to absorb liquidity surpluses or relieve shortages is a long-established mechanism that enables the efficient working of capital markets. It has given these institutions the benefit of a central bank and lender of last-resort operations: a delicate, yet flexible, mechanism that can be engaged for the mutual benefits of all parties. These instruments are not used by Islamic institutions, being structured on the basis of deferred financial compensation for consumption.

There has, therefore, been a need to design instruments capable of performing similar liquidity functions for Islamic financial institutions. Clearly, the prime property of such instruments is universal acceptability within the Islamic banking community; any new instrument must straddle the gap between secular finance and religious belief. The Bahrain Monetary Agency has, over the last two years, developed and successfully issued two types of instruments within these parameters: *sala-sukuk*, short-term securities, and *ijara* leasing certificates, with three to five years of maturity. Both issues have been listed on the Bahrain Stock Exchange.

A. *≠ukuk*

The short-term *sala-sukuk* instrument closely resembles a forward contract. It is essentially a transaction where two parties commit to a sale, the purchase of an underlying asset. The price is determined and fully paid at the time the contract is agreed. The seller agrees to provide the asset in the agreed quantity, and of the agreed quality to the purchaser, at an agreed future date. Since this transaction requires a full prepayment, it is clearly beneficial to the seller. As such, the contract price is pitched lower than the prevailing spot price of the underlying commodity. The difference between the lower sale price and the spot price is the compensation by the seller for the privilege of receiving an advance payment.

B. Establishment of Markets

Linked to the development of Islamic instruments has been an urgent need to establish markets where such instruments can be traded on a day-to-day basis, to satisfy both the liquidity and investment preferences of individual institutions. An agreement signed by the Agency, the Islamic Development Bank, and a number of other central banks, has created a framework for the establishment of an international Islamic financial market. Similarly, various Islamic financing institutions have committed resources to provide a liquidity management center to help institutions manage their liquidity flows.

IV. Education

There are two aspects to the question of education: first, the enhancement of skills and encouragement of professional competence among those engaged in the industry, and second, the education of the general public.

A. Educating the Industry

It is widely understood within Bahrain and the greater Gulf region that someone must accept primary responsibility for the training and development needs of Islamic financial institutions. A meaningful investment in human resources is the foundation upon which any company or industry flourishes. The Islamic financial community must realize this if truly seeks to be a significant and competitive financial services alternative in a global economy, and invest accordingly.

The Bahrain Institute of Banking and Finance was established in 1981 in order to provide contemporary training and education in management, leadership skills, banking, insurance, accounting, finance, and information technology. In the years since its establishment, the Institute has become the premium provider of training and learning services to all sectors of the economy for the Gulf region, and is the undisputed regional center for banking and financial training. The Institute has now developed a dedicated Islamic training department which serves as a resource for both Islamic and conventional banks. It continues to enhance its professional reputation through strategic alliances with professional international bodies and academic institutions, in order to integrate strategic partnership resources into its training solutions, and make sure that benchmark practices around the globe are central to its approach to performance improvement.

B. Educating the World

One must acknowledge that the image of Islamic finance has suffered a blow, particularly after the tragic events of 11 September 2001. It is now widely seen as having a presence only on the very periphery of the international financial world, and its theoretical and practical concepts are little understood outside the Muslim world. It is believed to be an easy target for money-laundering, criminal, and terrorist operations. These negative views are untrue and unfair. This prejudice must be countered, and there is thus a pressing need for the industry to explain and promote Islamic finance to the rest of the world. Such responsibility, which needs to be assumed by practitioners and regulators alike, must demonstrate that, like its conventional counterpart, Islamic finance is engaged in genuine economic activity motivated by similar concepts of wealth creation; that its business is conducted in an open and transparent manner, while working within the tenets of Islamic laws; and that it is regulated to standards comparable to international best practice adopted by the conventional financial sector.

V. Conclusion

Bahrain is required by its role as a center of the Islamic finance industry to take active interest in the process of furthering its development. The Bahrain Monetary Agency, and other institutions in the Kingdom, have thus been leaders in the innovations described above: in regulation, operational development, and in the oft-neglected sphere of education. Such steps are essential in order for the industry to flourish in a changing global environment.