BAHRAIN ISLAMIC FINANCE REPORT 2018

A Pioneer's Journey

مصرف البحرين المركزي
Central Bank of Bahrain

THE WAQF FUND
Promoting ethics in finance through Shari'a

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Executive Insights

Foreword

H.E. Rasheed M. Al-Maraj
Governor
Central Bank of Bahrain

It gives me great pleasure to introduce the Bahrain Islamic Finance Country Report. The Kingdom of Bahrain is among the early adopters of Islamic finance. Its first Islamic bank was established in the late 1970s when Islamic finance was a brand-new phenomenon anywhere in the world. With clarity of vision and unanimity of thought the various organs of the Bahrain government have each played a key role in establishing the country as a hub for Islamic finance. Bahrain is also home to global Islamic finance standard setting bodies such as the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM), and other entities with global mandates such as the General Council for Islamic Banks and Financial Institutions (CIBAFI) and the Islamic International Rating Agency (IIRA).

The Central Bank of Bahrain (CBB) has been at the forefront of development, first devising Islamic banking rules and regulations and then supervising Islamic banks. It has achieved a number of firsts—the first regulator in the world to create a separate rulebook for Islamic banks, first to regulate the Takaful industry and the first to issue Sukuk. The CBB is among the most active central banks when it comes to regular issuance of Sukuk in order to manage the liquidity of Islamic banks in the system. The CBB was also the first to create an endowment fund, the Waqf Fund, in order to build the capacity of the Islamic finance industry through education, training and research. The CBB and the Waqf Fund provide valuable financial and other support to standard setting bodies for the overall benefit of the industry.

The CBB has been a role model for other jurisdictions when it comes to Islamic finance. We facilitate visits on a regular basis from other countries in the Middle East, the Far East, Africa and Central Asia that come to Bahrain to benefit from the experience of the CBB. We believe that sharing experience is fundamental to continuously improving our systems, regulations and policies. We hope that the publication of this report will also contribute to this purpose.

I would like to thank both the Waqf Fund and Thomson Reuters for putting together this report and documenting Bahrain's success as an Islamic finance hub.

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Executive Summary

Since embarking on its Islamic finance journey in 1979, Bahrain has made great strides in the industry's development both domestically and globally. Bahrain has positioned itself as a leading hub for Islamic finance since the turn of the century. It has been ranked second in Islamic finance development by the Islamic Finance Development Indicator (IFDI) report for five years running.

Bahrain has a well-qualified and well-trained workforce in the Islamic finance industry. The Waqf Fund's capacity building initiatives targeted at specific segments of the industry have played a key role in achieving this. Also important is the contribution by the Bahrain Institute of Banking & Finance (BIBF), whose Center of Excellence in Islamic Finance dates back to 1997. Professional skills are the foundation of a strong Islamic financial ecosystem that places Bahrain at the forefront of Islamic finance jurisdictions.

As an industry hub, Bahrain is also home to some leading international Islamic finance bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM).

Stable growth in Islamic finance assets, dominated by banking and Sukuk

Bahrain boasts a high concentration of Islamic financial institutions, with 47 Islamic financial institutions operating in the country. Islamic finance assets reached a total of US$43.6 billion in 2017, up from US$38.1 billion in 2013.

The 27 retail and wholesale Islamic banking operations in Bahrain accounted for 70% of Islamic finance assets in 2017, amounting to US$30.6 billion. Nearly 80% of these assets are concentrated in six retail Islamic banks and five Islamic banking windows, while wholesale Islamic banks and banking windows operate on a much smaller scale. This has led to calls encouraging the consolidation of the sector.

Bahrain's Islamic finance industry also comprises Takaful, other Islamic financial institutions (OIFIs) represented by Islamic investment and financing companies, Sukuk and Islamic funds. Sukuk is the second largest Islamic finance sector, which accounted for 14.5% of total assets. It is also the fastest growing sector in the industry, with a five-year CAGR of 12%.

Pioneering development through regulatory efforts

The IFDI 2018 report ranks Bahrain first globally in Islamic finance regulation, Bahrain's strongest attribute as a leading Islamic finance hub. The Central Bank of Bahrain (CBB) issued the world's first Islamic banking and Takaful regulatory frameworks in 2001 and 2005, respectively. It was also the first regulator to enforce mandatory compliance with AAOIFI accounting, auditing and Shari'ah standards in 2007. In recent years, the central bank has been emphasizing enhancing the Shari'ah governance framework through standardization. In 2017, the CBB developed and issued after extensive industry consultation a comprehensive module for Shari'ah governance. Through this module the CBB hopes to significantly improve standards in the industry.

The next frontier: Islamic Fintech

Since 2017, Islamic banks in Bahrain have been increasingly adopting Fintech as a strategy for their future expansion and efficient work. Building on the newly introduced regulatory sandbox and Fintech related regulatory initiatives, there are bright prospects of Bahrain leading the region in Islamic Fintech as well.

Pioneering Development

Bahrain was the first country to:

- Issue dedicated Islamic banking regulations
- Issue Takaful regulations
- Enforce mandatory AAOIFI standards
- Launch islamic liquidity management program
- Issue sovereign Sukuk
- Establish Islamic finance qualification provider

Global Leader

IFDI Rankings

2nd In overall Islamic finance development

1st In Islamic finance regulation

US$ 44Bn Total Islamic finance assets

47 Islamic financial institutions

Home to leading industry bodies AAOIFI, IIFM, CIBAFI, IIRA

Global Leader in Islamic finance training and education

Legacy Continues

Leading Regulation

Driving standardization and innovation in **Shari'ah governance**

Islamic Fintech Hub

Public and private initiatives supporting development and innovation in **Islamic Fintech**

Bahrain Islamic Finance Landscape

Islamic finance at a glance

Bahrain's Islamic finance industry comprises five sectors: Islamic banking, Takaful, other Islamic financial institutions (OIFIs), Sukuk and Islamic funds. OIFIs in this report refer to financial institutions offering Islamic non-bank financing and Islamic investments. By the end of 2017, total disclosed Islamic finance assets in Bahrain were valued at US$43.6 billion, registering a CAGR of 3.4% since 2013. There were 46 financial institutions offering Islamic financial products and services in the country.

Although Islamic banking remains the largest Islamic finance sector with a 70% share, this share declined from 75% in the previous year, OIFI assets grew by 22% and outstanding Sukuk grew by 21%.

Bahrain has positioned itself as a hub for Islamic finance and has consistently been ranked second globally in the development of Islamic finance by the Islamic Finance Development Indicator (IFDI) report. This ranking has been mainly driven by Bahrain's robust Islamic finance regulatory framework, supported by a high concentration of Islamic financial institutions and the presence of key Islamic finance bodies.

Bahrain's Unique Proposition as an Islamic Finance Hub

Ranked 2nd in overall Islamic Finance Development

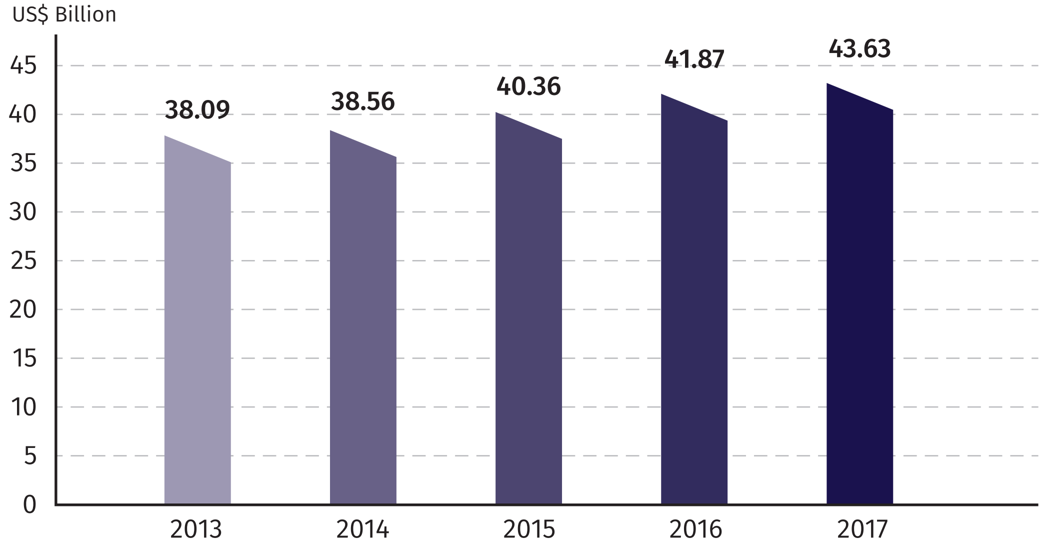
High concentration of Islamic financial institutions
- Ranked 5th in quantitative development by IFDI
- Home to 47 Islamic financial institutions

Robust regulatory framework
- Ranked 1st in Islamic finance regulation by IFDI
- Comprehensive regulatory frameworks governing all Islamic finance sectors
- CBB drive for Shari'ah governance standardization

Islamic Fintech development
- Fintech regulatory sandbox providing conducive environment for Islamic Fintech startups
- World's first Islamic Fintech consortium (ALGO) supporting Fintech research and development

Hub for Islamic finance bodies
- Host to key industry infrastructure bodies including AAOIFI, IIFM, CIBAFI and IIRA

Bahrain Islamic Finance Assets 2013–2017



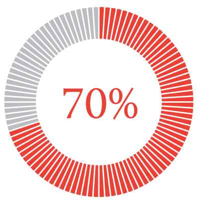
US$43.6 BILLION

Total Islamic Finance Assets 2017

3.4%

CAGR during 2013–2017

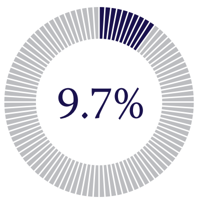
Breakdown of Islamic Finance Assets 2017



Islamic Banking

Total assets: **US$30.6 Billion**

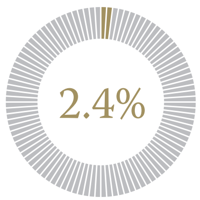
6 retail Islamic banks
14 wholesale Islamic banks
7 Islamic windows at conventional banks



OIFIS

Total assets: **US$4.2 Billion**

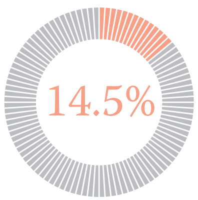
2 Islamic financing companies
10 Islamic investment companies



Takaful

Total assets: **US$1.1 Billion**

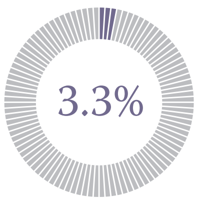
6 Takaful operators
2 reTakaful companies



Sukuk

Total assets: **US$6.3 Billion**

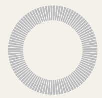
17 government issuances outstanding
2 corporate issuances outstanding



Islamic Funds

Total assets: **US$1.4 Billion**

29 locally incorporated Collective Investment Undertakings
4 locally incorporated Private Investment Undertakings



Share of total Islamic finance assets

Central Bank of Bahrain

Khalid Hamad

Executive Director — Banking Supervision
Central Bank of Bahrain (CBB)

1. According to the Islamic Finance Development Indicator (IFDI) report, Bahrain ranks first worldwide in terms of Islamic financial regulation. In your opinion, what are the factors contributing to Bahrain's success in this area?

I think the first and the foremost factor is political will at the highest levels of the government. The government of Bahrain has been quite clear and focused about developing and regulating Islamic finance since the 1970s when the first Islamic bank was established. All branches of the government have been in unison about the importance of Islamic finance and of Bahrain's position as a regional hub for the industry. The extensive knowledge and great experience gained early on have also given us a competitive edge in Islamic finance. All other factors are really a by-product of this experience—such as regulatory clarity, the establishment of Islamic global standard setting bodies, attracting global talent, the creation of the Waqf Fund for building the industry's capacity, etc.

2. A global leader in Islamic finance regulation, the CBB has made great strides in its efforts to tighten regulation and enforce standardization in the industry. What are the CBB's next strategic initiatives in developing Islamic banking regulations and supervision?

The CBB has recently issued a comprehensive Shari'ah Governance (SG) module, which is a serious attempt to take the Islamic finance industry to the next level of good governance. A number of new measures have been introduced for Islamic banks including the separation of Shari'ah Coordination and Implementation (SCI) and Internal Shari'ah Audit (ISA) functions, introduction of Independent External Shari'ah Compliance Audit (IESCA), a more robust framework for Shari'ah Supervisory Boards, etc. We are currently developing implementation guidelines for these functions, including the necessary credentials for professionals carrying out IESCA and the skills, experience and competencies required for ISA and SCI.

Currently, Islamic windows are outside the ambit of the SG module. In the future, we would like to cover them as well. We are also studying Islamic retail banks' practices in pool management and profit distribution to investment account holders (IAHs). We would like to develop regulations that ensure fair treatment to IAHs as they are very important stakeholders for an Islamic bank. We are also exploring, in cooperation with the Waqf Fund, the possibility of coming up with a better performance benchmark rate instead of the current practice of using the interbank rate for Shari'ah-compliant financings.

3. What is the CBB's view on the recent trend of bank mergers and acquisitions in the region, particularly those seeking to form larger Islamic banks?

Islamic banks have progressed a great deal in the last four decades, but their small size is still an issue in all markets. Small banks cannot achieve economies of scale and are thus at a competitive disadvantage vis-a-vis their conventional counterparts. M&A is therefore a welcome trend, which will hopefully create stronger, financially more stable, and resilient institutions in the medium-to-long term. We have been encouraging financial institutions in Bahrain to consolidate since 2009. A number of Islamic wholesale banks have merged in the last three to four years.

However, M&A in itself is not sufficient to turn things around. A healthy dose of reform is also needed—including a change in mindset, improvement in business and market conduct, cost adjustment, and responsiveness to change and innovation. It is important to keep in mind that, according to research, a vast majority of M&A transactions end up failing to achieve their stated objectives. It takes a lot of courage, humility and constant hard work to make a merger or acquisition work.

> *The CBB has recently issued a comprehensive Shari'ah Governance (SG) module, which is a serious attempt to take the Islamic finance industry to the next level of good governance.*

4. The Waqf Fund was established by the CBB in 2006 to facilitate the advancement of Islamic finance in Bahrain through training, education and research. What role has the Fund played in the development of the wider Islamic finance ecosystem in Bahrain? Do you think other countries can follow this example as well?

The Waqf Fund has been a silent but highly effective player on the horizon of Bahrain's Islamic finance industry in the past 12 years. The concept was developed by the industry itself with the active encouragement and participation from the CBB (which is also the largest contributor to the Fund). It has a lean working structure with a Board of Trustees comprising the sponsors to the Fund and three independent members. It conceives various projects based on feedback from the industry through their representatives on the Waqf Fund board, and selects a suitable delivery partner from the market.

The Fund has trained hundreds of Bahrainis and non-Bahrainis in various programs. It has introduced customized training programs and development projects such as the Leadership Grooming Program, Advanced Diplomas in Islamic Finance and Islamic Jurisprudence, Advanced Shariah Reviewer Development Program, Business Ethics Program, the four-year academic degree on Islamic Banking & Finance from the University of Bahrain and CFO Grooming Program, etc. It also sponsored the development of AAOIFI's Certified Islamic Professional Accountant (CIPA) qualification and Certified Shariah Advisor & Auditor (CSAA) qualification, among others.

We believe the example of the Waqf Fund can be easily replicated by other countries so long as the regulator is the driving force behind the idea.

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EXECUTIVE INSIGHTS

Bahrain Economic Development Board

H.E. Khalid Al Rumaihi

Chief Executive Officer
Bahrain Economic Development Board
(EDB)

1. Bahrain has been ranked second globally and first regionally for five consecutive years in the Islamic Finance Development Indicator (IFDI) report. What has driven Bahrain to achieve and maintain this position?

Historically a pioneering force in the region, Bahrain has a longstanding reputation as a respected Islamic finance hub. The Kingdom has been driving innovation in the industry since its inception in the 1980s, and it continues to promote that same visionary culture to this day.

Bahrain's position as a leader in Islamic finance was cemented in 1990 when a number of regional Islamic financial institutions chose Manama as the home of the standard-setting body, AAOIFI. Bahrain is also home to the Islamic International Rating Agency (IIRA), which has positioned itself as an Islamic finance alternative to the "Big Three" credit rating agencies.

Crucially, we sit at the heart of the US$1.5 trillion GCC market—an economy undergoing a rapid economic transformation that is generating opportunities for private capital in areas with previously untapped potential. Islamic finance will be an important means of channeling that private capital into new investments.

Our reputation has been central to helping us develop a critical mass of institutions and individuals with deep expertise in Islamic finance, ranging from researchers and scholars to regulators and practitioners with decades of experience in the industry. A unique advantage in such a young industry, the strength of Bahrain's human capital is a testament to its historical significance and contemporary prominence in the sector.

2. How is EDB leveraging Bahrain's status as a leading hub for Islamic finance, both regionally and globally, to position the country as a destination for Islamic investments? How can this help achieve Bahrain's economic development goals?

Bahrain is home to many of the world's largest Islamic finance bodies. They help us position ourselves at the forefront of development in the industry as we establish our role as a global financial powerhouse.

A testament to the Kingdom's pioneering legacy is that in 2017 Bahrain became the first country in the region to adopt a nationwide regulatory sandbox, a best practice of only a few of the world's most progressive financial jurisdictions. The sandbox is open to both local and international firms, allowing them to develop and test experimental ideas in the financial sector. This initiative symbolizes our desire to encourage entrepreneurs with vision and inventiveness to further open Bahrain up to the global financial and tech community.

Today, the financial sector accounts for about 17% of the Kingdom's GDP, and we believe Islamic finance will play a growing role in the industry in the coming decades. Islamic banking assets have grown faster than conventional assets since 2008 and now account for around 16.3% of total banking assets in Bahrain. There is a large pool of capital ready to be deployed in Shari'ah-compliant investments, and a number of Islamic countries in the GCC and beyond have strong growth fundamentals that may offer investors attractive returns. The sector has demonstrated immense potential, and we certainly see Islamic finance and investment as integral to achieving Bahrain's economic development goals.

3. Earlier this year Bahrain achieved a significant milestone, the launch of Bahrain Fintech Bay — MENA's largest dedicated Fintech hub. How will this strategic initiative contribute to the development of Islamic Fintech in Bahrain? Is there a vision for Bahrain to also become a hub for Islamic Fintech?

Given Bahrain's strength in the financial sector and the opportunities in Islamic Fintech more broadly, we believe there is great potential for Islamic Fintech firms from around the world to grow and thrive here in Bahrain. Last year, ALGO Bahrain, the world's first Fintech consortium of three banks, was announced. It aims to accelerate the launch of Shari'ah-compliant Fintech solutions. Bahrain FinTech Bay, meanwhile, brings innovative businesses together, cultivating a productive ecosystem where Islamic Fintech firms are able to work alongside experts in other fields and benefit from a diversity of insights and perspectives.

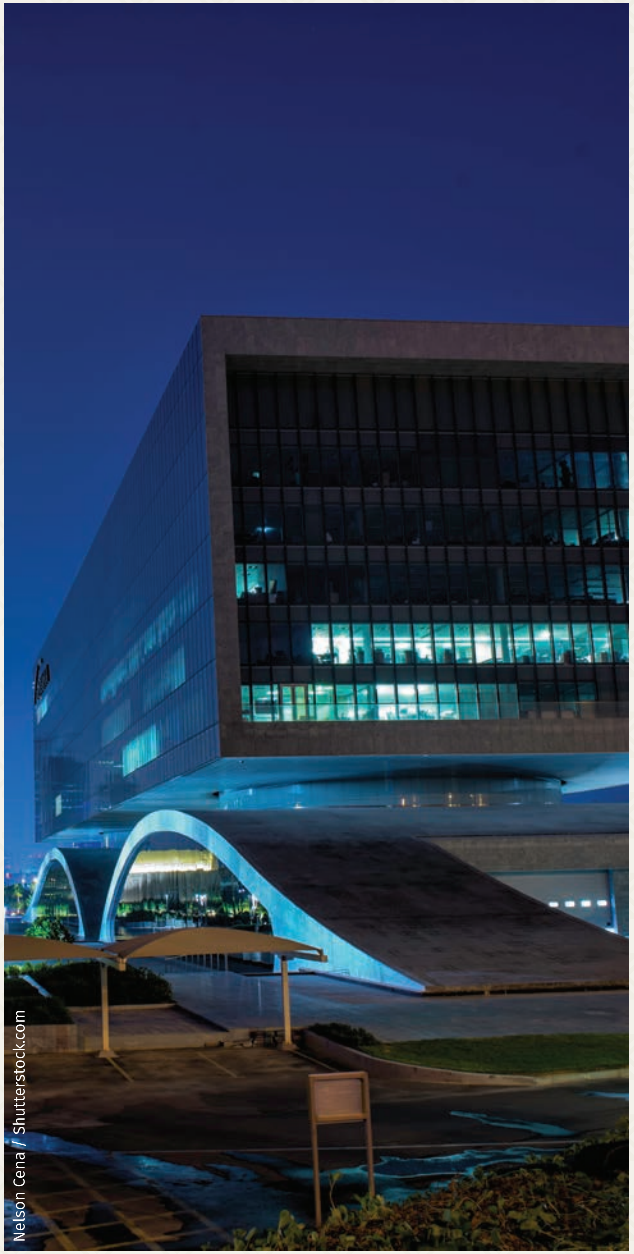
Islamic finance has grown rapidly in recent years, but to realize its full potential, it needs to be able to embrace the disruptions and opportunities created by Islamic Fintech. We are confident that Bahrain's unique strengths in the sector and its agile governance will effectively enable further growth.

4. BDB has recently launched a venture capital fund to boost the start-up ecosystem in Bahrain. What are the initiatives that EDB is pursuing to develop Islamic venture capital and private equity activity in Bahrain?

Arguably, the biggest challenge startups face is access to capital. The EDB aims to enable startup growth by promoting an environment in which companies have access to a wide range of funding options.

Islamic venture capital and private equity play important roles in supporting this ecosystem and are showing great promise in funding Islamic Fintech companies. They can also play a role in addressing another significant challenge we face in supporting the startup ecosystem—encouraging local and regional investors, who have traditionally invested in asset classes such as real estate, to consider investments in new areas such as venture capital and private equity. Islamic finance has the potential to support this process, particularly where individuals require or prefer Shari'ah-compliant investment opportunities.

We have recently launched several initiatives that complement the Al Waha Fund and support Shari'ah-compliant funding for startups. Last year, the CBB introduced regulations allowing for onshore Shari'ah-compliant crowdfunding, making Bahrain the first country in the region to do so. We have also introduced streamlined procedures for trust registration, enhancing the competitiveness of trust law and ensuring it is on par with global standards. This will support the development of venture capital and private equity funds more broadly.



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Hub for industry bodies

Bahrain is home to a number of important Islamic finance infrastructure bodies. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), General Council of Islamic Banks and Financial Institutions (CIBAFI) and Islamic International Rating agency (IIRA).

These institutions have enhanced the Islamic finance ecosystem in Bahrain, helping it maintain its position as an influential center in the global Islamic finance industry. Close collaboration between these bodies and the CBB allows them to test new industry standards in the domestic market. On the other hand, it also helps Bahrain adopt global best practices in Islamic finance. For example, the CBB has worked closely with IIFM to develop standardized documentation and contracts for its Wakala liquidity management tool.

> *The presence of these international bodies is the result of the foresight of the CBB, which has placed Bahrain at the cutting edge of Islamic financial services development.*
>
> *– Ijlal Ahmed Alvi, IIFM*

AAOIFI

Established in 1991, AAOIFI is perhaps the most influential Islamic finance standard-setting body that has issued over 100 standards covering Shari'ah, accounting, auditing, ethics and governance for international Islamic finance. It is considered an important reference for Islamic finance regulators across the world.

IIFM

IIFM was established in 2002 as a standard-setting body for Islamic capital and money markets, with a focus on streamlining Islamic financial contracts and product templates.

CIBAFI

An affiliate of the Organization of Islamic Cooperation (OIC), CIBAFI was established in 2001 to represent Islamic finance industry stakeholders, mainly Islamic financial institutions, to governments and national regulators. With over 120 member institutions from more than 32 jurisdictions, CIBAFI aims to advocate regulatory, financial and economic policies in the interest of its members, promote the role of the Islamic finance industry and consolidate collaborative efforts among its institutions.

IIRA

IIRA was established with the support of the Islamic Development Bank (IDB), commencing operations in 2005. It is mandated with providing independent assessments on the Shari'ah compliance of Sukuk issuers and issuances. Its main focus is local Islamic capital markets in OIC countries. IIRA also provides ratings assessing the financial strength of Islamic banks and Takaful institutions. It is the only rating agency with its own fiduciary rating methodology specially developed for Islamic financial institutions.

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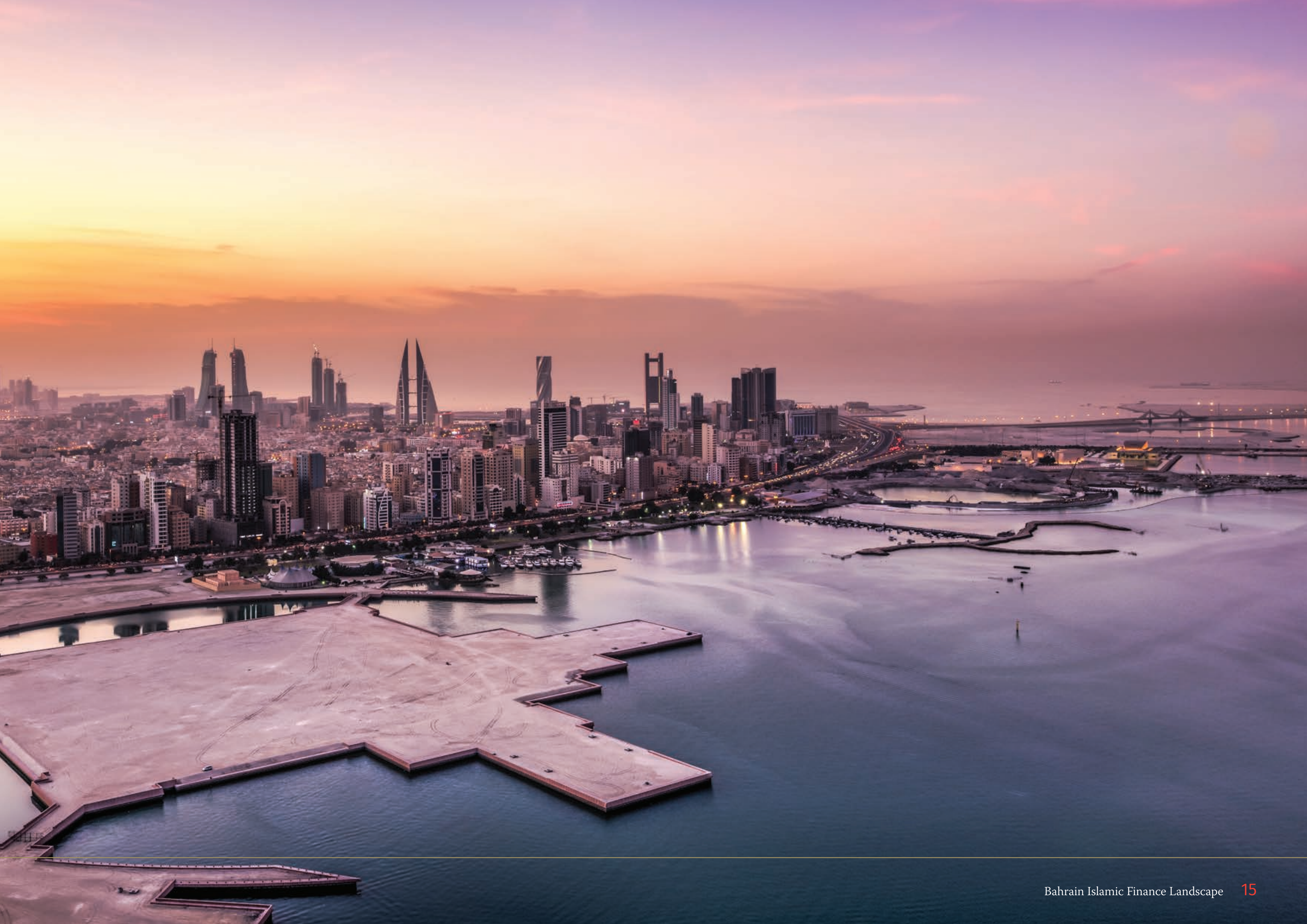


Accounting and Auditing Organization for Islamic Financial Institutions

H.E. Sh. Ebrahim bin Khalifa Al Khalifa

Chairman
Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI)

1. Bahrain is one of the few Islamic finance jurisdictions that enforce compliance with both AAOIFI Shari'ah and accounting standards. How has this step improved the regulation of the Islamic finance industry in Bahrain?

Standardization is a crucial area in the Islamic finance industry. Since its establishment in 1991, AAOIFI's main contribution has been to serve the specific technical needs of the Islamic finance industry stakeholders.

Bahrain ranked second globally and first in the MENA region in the fifth edition of the Islamic Finance Development Indicator (IFDI) report. This is the fifth consecutive year that Bahrain has retained this ranking, following Malaysia in first position.

Standards contribute to the qualitative development of the industry, enhancing credibility and cost reduction with increasing efficiency. AAOIFI is keen to address the unique requirements of Islamic finance industry stakeholders and to encourage harmonization. The step taken by Bahrain's regulator to fully adopt AAOIFI's standards has definitely had a positive impact, helping the Islamic finance sector in Bahrain grow to 27 Islamic banks and banking windows holding assets valued at over US$30 billion.

The industry will be further elevated at the international level, professionally and institutionally, through the development of more professional standards that will govern and regulate all its activities and areas of interest.

2. What are AAOIFI's strategic areas of focus in terms of the new standards you are issuing? Will Islamic Fintech become a new area of focus for AAOIFI in the next couple of years?

Globally, Fintech investment has grown remarkably in recent years. According to PWC's Global Fintech Report 2017, funding of Fintech startups has increased at a CAGR of 41% over the last four years, with over US$40 billion in cumulative investment.

Conventional financial institutions are rapidly embracing the disruptive nature of Fintech. They are forging partnerships to improve operational efficiency and to respond to customer needs for more innovative services. Islamic financial institutions are following the same trend. However, some Fintech transactions currently raise Shari'ah concerns in areas regarding ownership, possession and possibly Gharar (extreme uncertainty or lack of transparency).

AAOIFI's standard-setting strategy responds to market needs. With the impressive growth of the Fintech sector, it is definitely an area for AAOIFI to consider further. In fact, our October 2018 conference *The Role of Standardization for the Future of Islamic Finance* featured two sessions on Fintech, one on cryptocurrencies and the other on the rise of digital banking.

> *AAOIFI's Shari'ah standards are continuously guiding efforts to spread harmonization practices, and as a result, these are getting adopted in numerous jurisdictions.*

3. Recent events in the Sukuk market have raised concerns over Shari'ah non-compliance risk due to inconsistencies in Shari'ah standards and practices. How are AAOIFI's Shari'ah standards being developed for Sukuk supposed to address such concerns in the future?

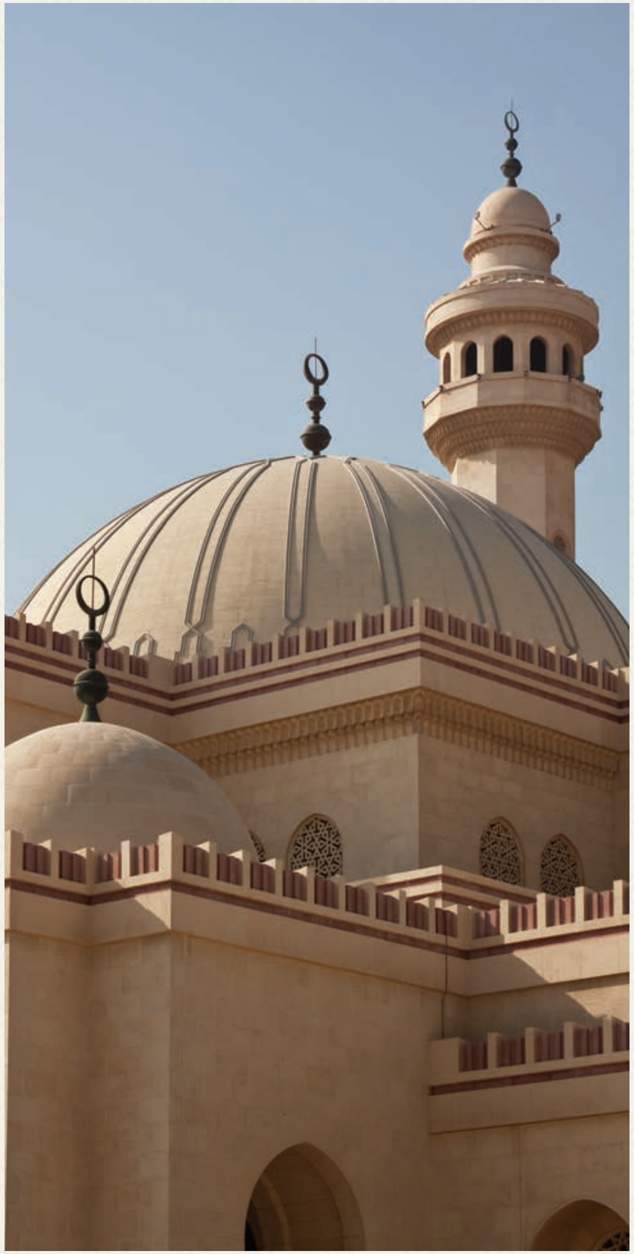
Sukuk are among the Islamic finance tools that have achieved the most significant growth and wide application—to the point that they are even considered a distinct sector. The evolution of the Sukuk sector, with a diverse array of structures and types, has made AAOIFI reconsider its existing standards on Sukuk. The revision is also necessary to reflect changes in the areas of accounting, law and regulations, etc. which relate to Sukuk.

AAOIFI initiated a comprehensive project on the revision of Shari'ah, accounting and governance standards on Sukuk in line with the developments in the field over the last two decades. In addition to the Shari'ah standard on Sukuk, there are three Financial Accounting Standards (FASs) covering Sukuk, namely Sukuk Issuances, Sukuk in the Books of Issuer, and the revised FAS 25 "Investment in Shares, Sukuk and Instruments". We are also working on the governance standard on Sukuk. All will be finalized shortly.

4. Can you tell us more about AAOIFI's efforts to achieve convergence in global Shari'ah standards and practices? Are there plans to collaborate with other standard-setting bodies in the industry to achieve this convergence?

AAOIFI's Shari'ah standards are continuously guiding efforts to spread harmonization practices, and as a result, these are getting adopted in numerous jurisdictions.

We have been keen to collaborate with other infrastructure bodies. We are pleased to announce that we have official signed MOUs with Islamic Financial Services Board (IFSB) and International Islamic Financial Market (IIFM) to work together on projects of interest. All infrastructure bodies in the Islamic finance industry share the same vision—to support the development of the industry. The aim of such collaboration is to provide guidance to the industry as well as to coordinate efforts for strengthening the development of the Islamic financial services industry in different areas and at different levels.



Islamic banking overview

Islamic banking shows resilience amid economic slowdown

At the end of 2017 Islamic banking assets in Bahrain reached US$30.6 billion, registering a 5-year CAGR of 1.7%. Islamic banking assets accounted for 16.3% of total banking assets in Bahrain. The sector has remained resilient despite a prolonged period of low oil prices and subdued economic growth. The year-on-year asset growth leveled during this period, with a marginal decline of 0.8% in 2017.

Islamic banking penetration stood at 88% of GDP in 2017, one of the highest in the GCC, largely owing to a high concentration of banks operating in the region's smallest economy.

Islamic banking assets concentrated with retail banks

At present, Bahrain's Islamic banking sector comprises 27 banking institutions split between 7 Islamic retail banks, 14 Islamic wholesale banks and 7 Islamic banking windows at conventional banks. 78% of Islamic banking assets are concentrated with retail Islamic banks and windows at conventional banks. In 2017, Ithmaar Bank controlled the largest share (31.1%) of Bahrain's retail Islamic banking assets.

Most of the smaller wholesale Islamic banks and windows individually account for less than 2% of total sector assets. Maintaining such operations would be unsustainable in the long run, indicating a strong need for consolidation in Bahrain's Islamic banking sector to improve its operational efficiency and sustain growth.

Innovating Islamic liquidity management

A unique feature of Bahrain's Islamic banking sector is its liquidity management framework. The CBB has developed an innovative model for Islamic liquidity management that uses three different Islamic financial structures appropriate for different tenors: Sukuk Al-Salam, Sukuk Ijarah and Wakala.

Similar to treasury bill issuances, the CBB runs consistently oversubscribed monthly programs, issuing short-term Sukuk Al-Salam (3-month) and Sukuk Ijarah (6-month) to absorb excess liquidity from Islamic banks and to offer the wider Islamic finance industry a liquid pool of Shari'ah-compliant investments. Bahrain's first short-term Sukuk Al-Salam was issued in 2007, and Sukuk Ijarah was introduced as a liquidity management tool in 2008.

In 2015, the CBB introduced a one-week Wakala liquidity management tool based on an IIFM standard contract, specifically developed for the central bank. The CBB acts as the agent for these banks, investing Wakala deposits in a Sukuk portfolio on the banks' behalf.

Bahrain's Islamic banks embrace consolidation

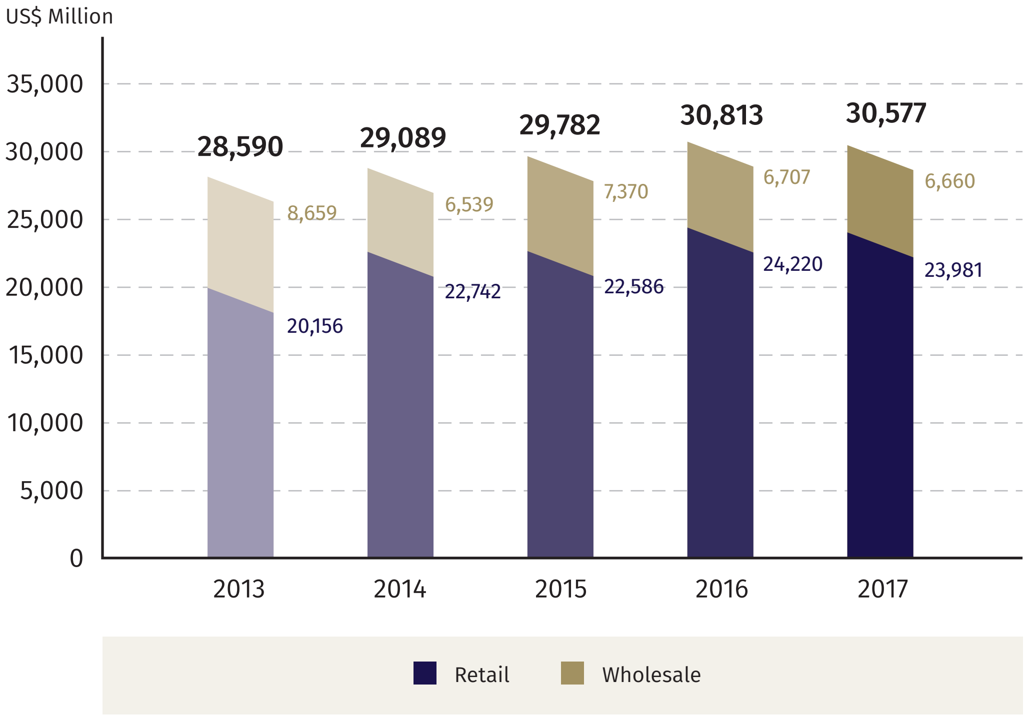
The CBB has called for the consolidation of Bahrain's banking sector since 2009, as a considerable proportion of banks in Bahrain, conventional and Islamic, remain small in size.

Consolidation is gradually emerging as a key trend in Islamic banking due to slow economic growth, which places liquidity pressures on financial institutions. One example is the merger of Al Salam Bank and BMI Bank in Bahrain, which commenced in 2014 and concluded only recently.

In 2018, Kuwait Finance House (KFH) and Ahli United Bank (AUB) resumed merger talks from 2017. If the merger proceeds, it will form a new Islamic bank worth over US$90 billion in assets, making it the sixth-largest bank in the GCC. KFH initiated the move, aiming to build scale and expand its network both regionally and internationally.

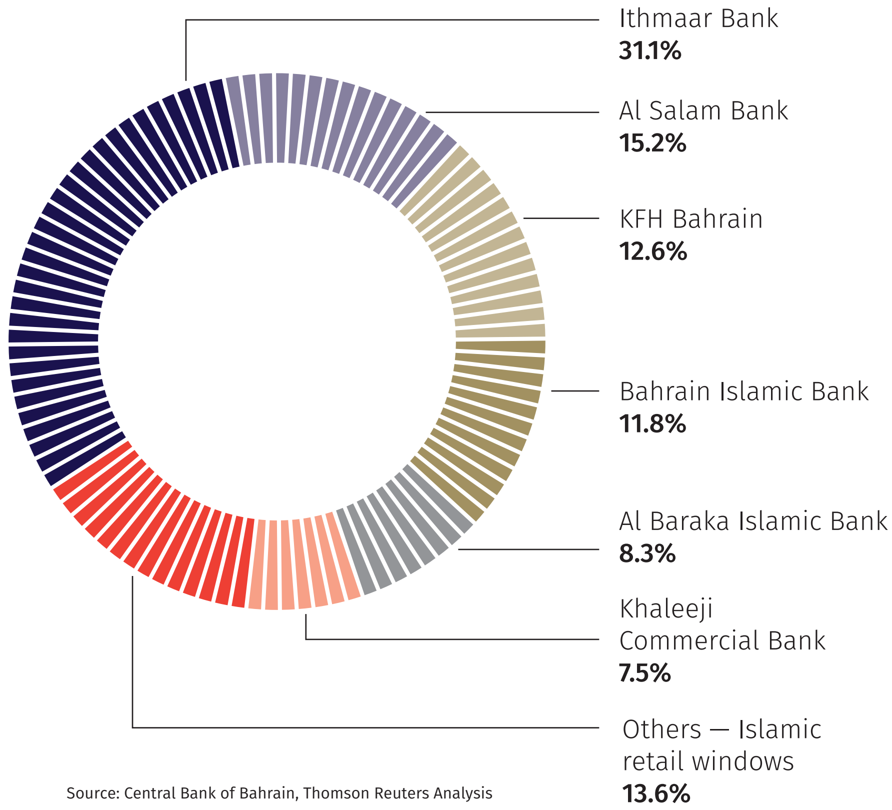
In a market such as Bahrain, with a large number of banks and high banking penetration levels (over 500% overall), consolidation is a cost-effective way to restructure the banking system. The trend will help improve the industry's financial stability by eliminating inefficient institutions, such as those with poor liquidity and capitalization. However, it is worth noting that consolidation on its own is only a partial solution to operational and cost inefficiency. In order to be more efficient and financially stable, banks will need to proactively revamp their operations and adopt innovation and technology as strategic priorities.

Bahrain Islamic Banking Assets 2013–2017



Source: Central Bank of Bahrain, Thomson Reuters Analysis

Bahrain Islamic Retail Banking Market Share 2017



Source: Central Bank of Bahrain, Thomson Reuters Analysis

1.7%
CAGR during 2013–2017

88%
Islamic banking penetration in 2017

78.4%
of total Islamic banking assets held in retail operations in 2017

EXECUTIVE INSIGHTS

Kuwait Finance House - Bahrain

Abdulhakeem Al-Khayyat

Managing Director & CEO
Kuwait Finance House (KFH) – Bahrain

1. KFH is one of the pioneers of Islamic banking in the region with over 40 years in the industry. What have been KFH's milestones in Bahrain since it was established in 2002?

After the Bank's success in Kuwait, it was obvious that opening a subsidiary in Bahrain, the financial heart of the GCC, would ensure the continued development of the brand and provide the platform needed to build a regional Shari'ah-compliant bank. In 2002, a small team opened an office and one branch on Government Avenue with a capital injection of almost US$100 million. Since then, the workforce has reached 300 staff members, servicing a portfolio of almost 100,000 customers across 10 branches with assets exceeding a peak of BHD1.5 billion.

The Bank was one of the first to recognize the importance of extending the Ijara financing concept to credit cards and developed its own proprietary infrastructure to achieve this. We introduced the award-winning Investment Savings account 'Libshara' which has been extraordinarily successful. This year, KFH became one of the first fully Shari'ah compliant banks in Bahrain to develop a comprehensive digital onboarding platform ("Jazeel") which was completed within five months. Not only will this make it even easier for our customers to seamlessly interact with the Bank 24/7 but it is the start of a very ambitious program which will see the Bank continuously introducing innovative and industry leading digital solutions.

2. According to the Islamic Finance Development Indicator (IFDI) report, Bahrain ranks first worldwide in terms of Islamic banking development. In your opinion, what are the key factors contributing to Bahrain's leading position?

There are a number of factors that have undoubtedly led to this pre-eminence. Firstly, in terms of regulation and governmental support, Bahrain is and has been consistently at the forefront of providing the right environment not just for banking but financial services as a whole. This has been especially the case for Islamic banking where there is a separate supervision directorate within the CBB and a dedicated regulatory rulebook covering Islamic banking.

Secondly, Bahrain has been a recognized financial center for many years with a highly developed infrastructure, favorable trade agreements and excellent links to the rest of the GCC. This allowed it to offer an attractive environment for new Islamic banks willing to enter the market.

Thirdly, Bahrain's workforce provides tremendous opportunities for employers to operate on an international platform and with world-class standards. Backed by institutions such as the Bahrain Institute of Banking & Finance (BIBF) and the Bahrain Economic Development Board the industry is able to draw on an increasing pool of talent that is able to provide a distinct competitive edge in the region.

Finally, there is healthy co-operation among the key industry players including the six Islamic banks to collectively improve the quality of products and services and governance thereof. KFH Bahrain played a key role in establishing an 'Islamic Bankers Action Committee' in 2017, which has served to bring together industry experts to share information and identify issues relevant to all parties. We have been extremely fortunate that the CBB has been in attendance and provided their support and guidance throughout. Key milestones include the establishment of a Fintech development platform (ALGO), the identification and analysis of relevant legal and technical issues and updates provided by strategic partners on their key projects (such as BENEFIT and the BIBF) on efficiency and educational opportunities.

3. KFH-Bahrain has been an active partner of Bahrain's government through public-private partnerships (PPPs) in projects like Durrat Al Bahrain and Diyaar Al Muharraq. How do such projects fit within the bank's vision? Do you see PPPs with Islamic banks extending to key infrastructure projects in the future?

Islamic finance at its core is asset backed, which provides a higher degree of certainty and security for both parties entering a transaction. We contribute to the real estate supply not only as a source of potential revenue for consumer finance but also to benefit our deposit base by sharing with them the profits of these endeavors.

This is the principal reason that KFH promoted and supported mega-developments like Durrat Al Bahrain and Diyaar Al Muharraq. We have provided solutions for social housing as well as high-end properties, catering to the needs of both ends of the spectrum.

In terms of future collaboration between Islamic banks and the government on infrastructure projects, we can only see this going from strength to strength. Such projects are an excellent source of project finance revenue and there is a clear demand in the region to boost economic activity. Islamic banks are developing the expertise needed to handle large ticket deals, building a great track record in the region which will continue to grow.

4. How do you see the recent trend of bank consolidation in the GCC? Will it impact the Islamic banking landscape in Bahrain? Is the creation of larger Islamic banks through bank consolidation the way forward for the industry?

As financial stability is the cornerstone of secure Shari'ah-compliant banking, we welcome all opportunities for consolidation in the industry where it builds larger and more efficient balance sheets. Whilst consolidation is a key feature of every maturing market, it has the added benefit of creating the space for new smaller players to compete in niche areas and broaden the choice for customers. We expect that further consolidation will also help to lower the cost of finance which in turn will not only make Shari'ah-compliant finance more competitive but also provide it with the opportunity to reach new markets requiring deep pockets to initially establish business footprints.

5. KFH-Bahrain recently announced its partnership to form the Islamic Fintech consortium, ALGO. How do you see fintech shaping the future of Islamic finance and banking, particularly in Bahrain? What action needs to be taken by Islamic financial institutions and regulators alike to ensure this potential is achieved?

Without doubt, Fintech is important to the future of Islamic finance. Most of the banks in Bahrain have either launched a digital platform or are in the process of developing one. KFH Bahrain's digital platform, Jazeel, is amongst the first and is making great strides to capture market share and leverage its capabilities.

However, the market is moving very fast in this area and the dilemma that all the banks are facing is what products should be launched through these platforms, what is the right architecture to be adopted and who are the right service providers to deliver these for us. There is simply no time to work through all the possible combinations and permutations, therefore we are left with having to take a risk and be prepared for trial and error.

Hence, the initiative that the CBB has rolled out in support of this, the regulatory sandbox, is extremely important. We have found the CBB sandbox to be both flexible and well supported. Coupled with this, the Bahrain government's digitization and electronic data processing initiatives will support Fintech innovation.

Al Baraka Banking Group

Adnan Ahmed Yousif

President & Chief Executive
Al Baraka Banking Group B.S.C. (ABG)

1. With over 30 years in the industry, Al Baraka Bank is one of Bahrain's longstanding Islamic banks. How do you view the development of the industry in Bahrain? What is the unique proposition that Bahrain presents as a leading hub for Islamic finance?

Bahrain launched its first Islamic bank almost four decades ago, making it a pioneer in the Islamic banking and finance sector regionally and globally. The CBB has developed a comprehensive prudential and reporting framework that is tailor-made for all the concepts and requirements of Islamic banking. Moreover, Bahrain has pioneered many popular financial instruments and products such as Sukuk, which are available through regular short-term issuances.

Bahrain is also home to the region's largest concentration of Islamic finance institutions in almost every area of Islamic finance, from asset management and Sukuk issuance to Takaful. Bahrain is also headquarters to professional bodies and associations that set worldwide standards for the industry, such as AAOIFI and the IIFM, as well as CIBAFI (the industry's global trade association) and IIRA, and many Shari'ah-compliance consultancies and audit firms.

The CBB has also established a special fund to finance research, education and training in Islamic finance—the Waqf Fund. It is actively working with the stakeholders and prominent and qualified members from the Islamic banking industry, especially BIBF, towards elevating and developing industry standards. In order to help the industry keep pace with the latest developments, the CBB has recently encouraged its foray into digitization and Fintech activities by establishing a regulatory sandbox.

2. How do you see growth trends in Islamic banking in Bahrain evolving over the next five years? In which business segments and markets do you see growth opportunities for Islamic banking in Bahrain in this time?

Overall, Bahrain's Islamic finance industry will continue to expand over the coming five years. However, a number of factors will impact this growth. On the downside, these factors will include subdued economic performance primarily due to moderate, yet stabilizing, oil prices and geopolitical concerns. On the positive side, Islamic finance has much to offer the local and regional economy, thanks to a strong regulatory environment led by the CBB. We see a natural connection between Islamic finance principles and responsible finance, Sustainable Development Goals (SDGs) and impact investing. These all aim to create a more equitable financial system that has a positive tangible impact on the local economy and population.

So, what will help the industry achieve its full potential? In our view, standardization of Shari'ah interpretation, legal documentation and market education are the keys to success. The moves toward central Shari'ah boards and external Shari'ah audits are steps in the right direction. Streamlining legal documentation and creating greater clarity for investors about risks is also important in expanding the industry. Finally, digitization and more broadly adopting the Musharaka model of financing should better help the industry contribute to financial inclusion and social development.

3. In your opinion, how can innovation help shape the future of Islamic finance and banking? How is ABG leveraging innovation to achieve its potential as an Islamic bank both locally and globally?

Today, the tech-savvy digital consumer is ever ready to adopt anything that provides greater convenience. Internet usage is improving exponentially, thanks to the spread of new networked devices and gadgets. This is an opportune time to tap these technological advances and to fulfil the ever-increasing needs of the current digital generation. Furthermore, Islamic banks must compete with conventional counterparts in all these critical areas of banking technology and innovation.

ABG considers innovation a strategic tool in achieving its vision and mission. It is making great strides towards applying information and digital technologies in its banking operations throughout its network of 675 branches located across 16 countries. The Group has recently announced the launch of the world's first Islamic Fintech consortium, ALGO, along with two other banks. A number of Fintech initiatives are in the works at Al Baraka Bank in Turkey, such as the establishment of Al Baraka Garage, which acts as an accelerator for technology and Fintech startups. Moreover, the group has organized Al Baraka Fintech Hackathon, and launched its first digital bank in Germany.

4. ABG has one of the largest Islamic banking networks worldwide, reaching markets such as Pakistan, Turkey and South Africa. How does ABG select new markets in which to expand its operations? In which area of ABG's business do overseas operations focus: retail or corporate?

Several factors contribute to our choice of potential locations for expansion. Some of the markets where we have expanded are considered an extension of our current markets geographically, culturally and economically. Examples of these are Morocco and Libya, and we have planned future expansion in other African countries. Our decision to enter some markets such as Indonesia was based on its position as a major Islamic nation with a flourishing potential for Islamic banking. Our aspiration to expand into some European markets has been based on the global spread of Islamic banking and the recognition of the sector as an industry that supports sustainable development around the world. This strategy has been made feasible as developed countries have adjusted their laws and regulations to allow Islamic banks to operate or arrange the issuance of Sukuk in these jurisdictions.

All of our banking units offer products and services to both retail and wholesale customers with a major focus on their local markets. They also participate in the financing of major infrastructure projects launched by local governments. Our units have many innovative product initiatives to offer their markets. In all of their activities and transactions, these units are committed to providing products and services that offer added value to the client, the economy and society at large.

Other Islamic finance sectors

Small Takaful sector in need of consolidation

Bahrain is home to a robust insurance sector, supported by friendly regulations and a comprehensive offering of ancillary insurance services. The ecosystem also benefits Islamic insurance, or Takaful, which has experienced steady growth in the past five years. Coming from a low base Takaful represents the smallest Islamic financial sector in Bahrain, making up a mere 2.4% of total industry assets. In 2016 Takaful assets were valued at US$1.1 billion, up from US$989 million in 2013 — a CAGR of 1.9%.

Aggregate gross Takaful contributions reached US$170 million at the end of 2016, contributing 22% of total premiums and contributions in Bahrain. As with the wider insurance sector, general Takaful accounts for an 85% share of gross contributions. Owing to slow growth in contributions Takaful penetration in Bahrain remained flat at 0.5% between 2013 and 2016, but still among the highest in the GCC.

Six full-fledged Takaful institutions were operating in Bahrain in 2016, providing both general and family Takaful (except Al Hilal Takaful which provides only family Takaful). Three firms, Takaful International, Solidarity Bahrain and T'azur, held a combined 80% share of Bahrain's Takaful market. Takaful International accounted for the largest share of 33%. The sector also includes two reTakaful firms: ACR ReTakaful and Hannover ReTakaful, which account for 16% of the country's total reinsurance/reTakaful premiums.

As with the banking sector, the CBB has been encouraging initiatives to consolidate the insurance sector through mergers and acquisitions. Recent M&A activity in Bahrain's insurance sector indicates that the consolidation wave is no longer exclusive to banks. The most notable of these transactions was the merger between Solidarity General Takaful and Al Ahlia Insurance Company in 2017, forming Solidarity Bahrain.

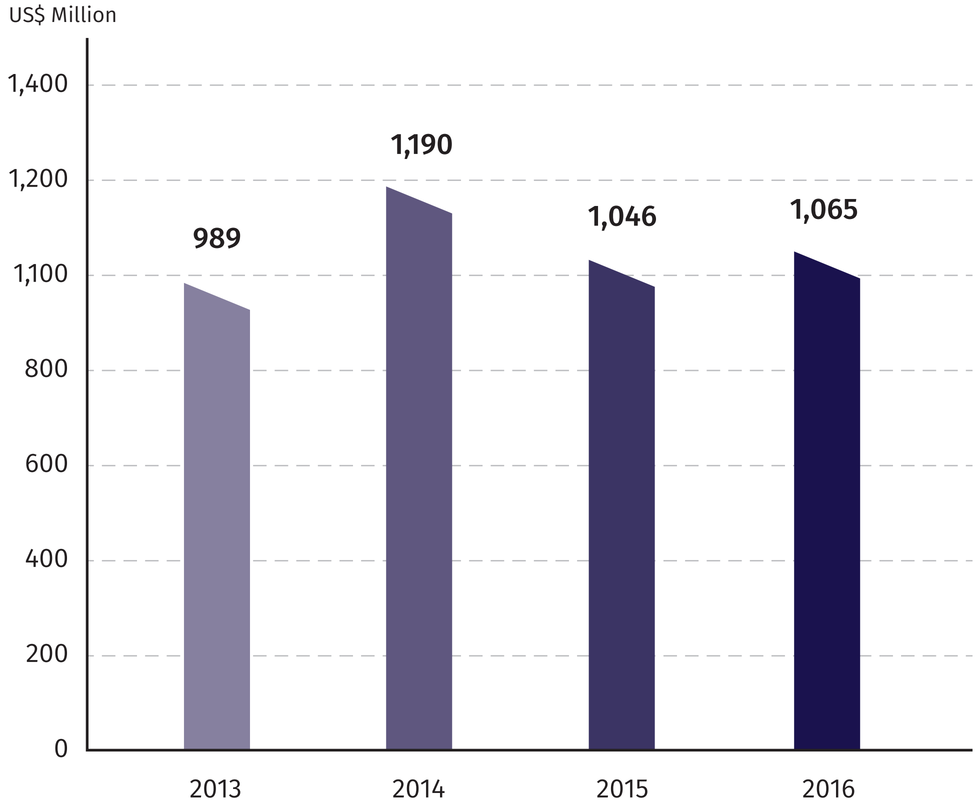
Thriving OIFI sector

OIFIs including Islamic financing and investment companies hold 9.7% of total Islamic finance assets in Bahrain. This sector comprises ten Shari'ah-compliant investment firms and two companies providing Islamic financing for real estate and SMEs. The total assets for the sector amounted to US$4.2 billion by the end of 2017, growing at a CAGR of 8.2% since 2013.

Islamic investment firms and financing companies are governed by a CBB regulatory framework that stipulates specific rules for Shari'ah-compliant institutions.

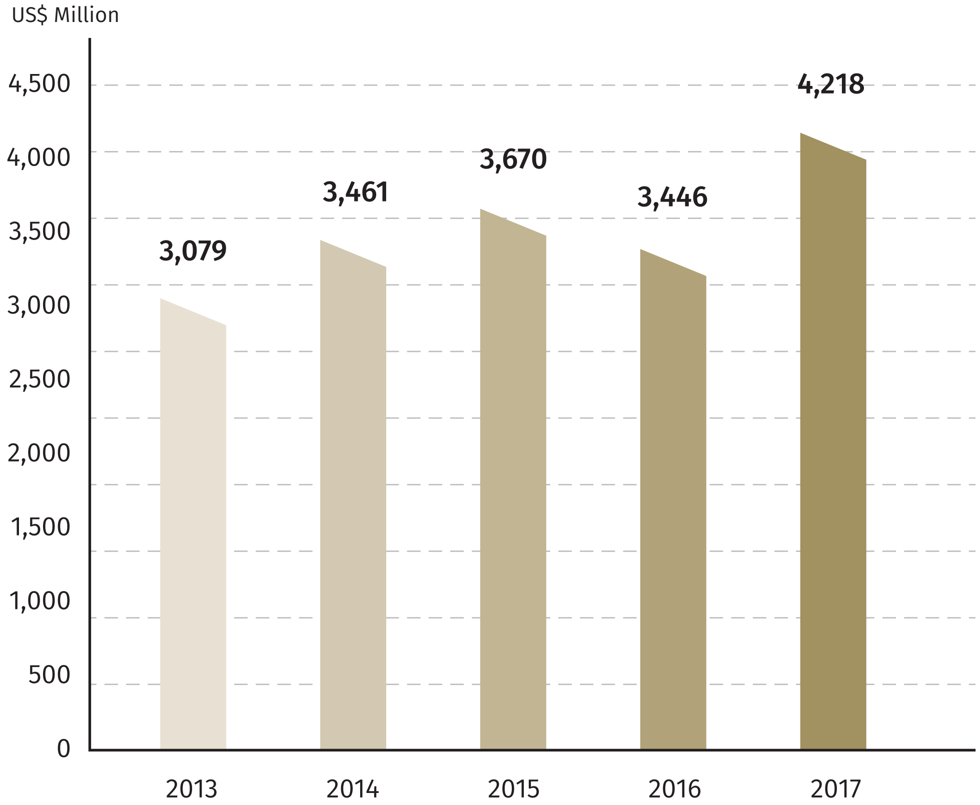
> *improving corporate governance and standardization [...] remain key areas for improvement of Takaful regulations.*

Bahrain Takaful Assets 2013–2016



Source: Central Bank of Bahrain, IFDI Reports 2014-2018

Bahrain OIFI Assets 2013–2017



Source: Central Bank of Bahrain, IFDI Reports 2014-2018

1.9%

CAGR during 2013–2016

8.2%

CAGR during 2013–2017

Regular CBB issuances driving Sukuk growth

Sukuk make up the second largest segment of Bahrain's Islamic finance industry. By the end of 2017, the total value of outstanding Sukuk was US$6.3 billion from 19 issuances. Bahrain's Sukuk market enjoyed the strongest growth among Islamic finance sectors with a CAGR of 12.2% since 2013.

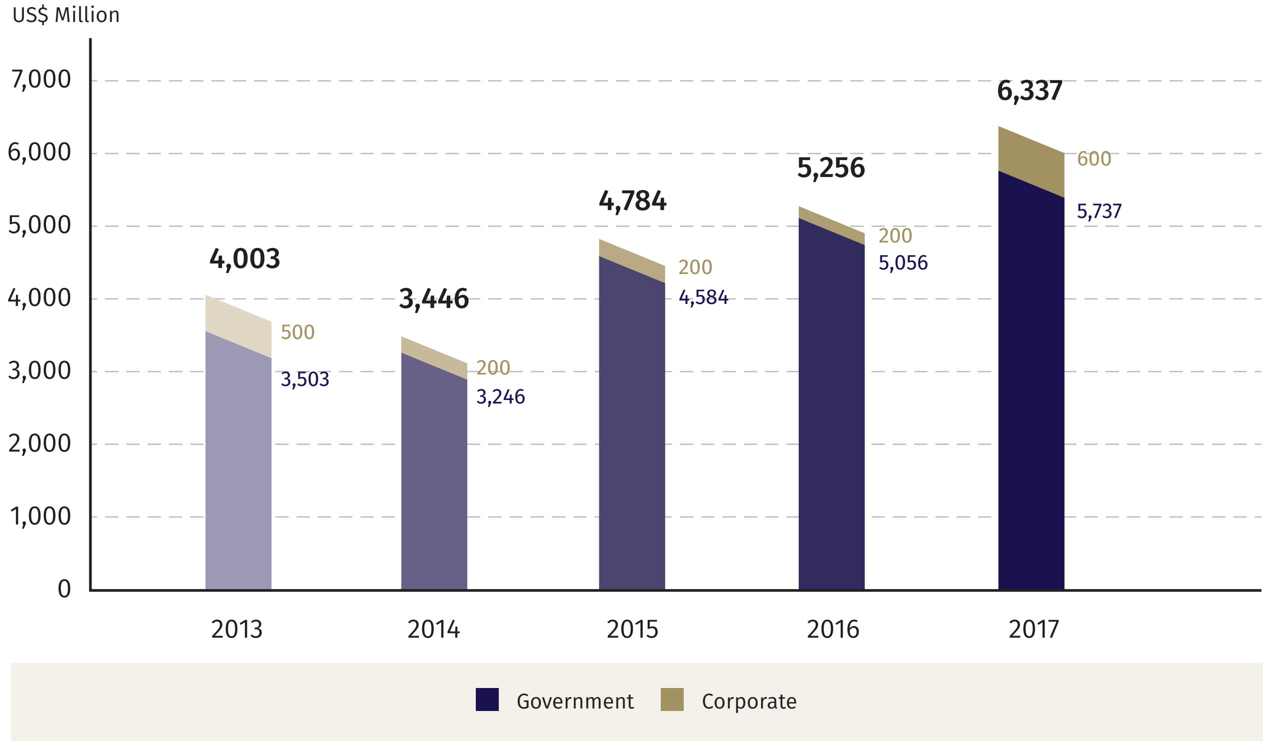
Bahrain was the fifth largest issuer of Sukuk globally in 2017, raising US$3.8 billion from 27 issuances. Sukuk issuances in Bahrain are driven by government issuances. The central bank is the most regular issuer of Sukuk in Bahrain through its short-term Sukuk Al-Salam and Ijarah programs.

The few corporate Sukuk issued to date have been based mostly on other structures, such as Murabaha, Mudaraba and Musharaka. In 2017, Al Baraka Banking Group issued a perpetual Mudaraba Sukuk raising US$400 million. Previously Gulf International Bank issued Murabaha Sukuk worth US$300 million in 2011.

In 2001 the Bahrain government issued the country's debut Sukuk, and the world's first sovereign Sukuk, aiming to diversify its funding base. The issuance raised US$100 million from a 5-year Sukuk Ijarah.

Facing budget deficits in recent years after more than a decade of surpluses, GCC countries have turned to Sukuk as an alternative source of funding. Sukuk made up 19.8% of public debt issued by the Bahraini government in 2017.

Bahrain Sukuk Outstanding 2013 – 2017



Source: Thomson Reuters

12.2%

CAGR during 2013 – 2017

90.5%

government share of total sukuk outstanding in 2017

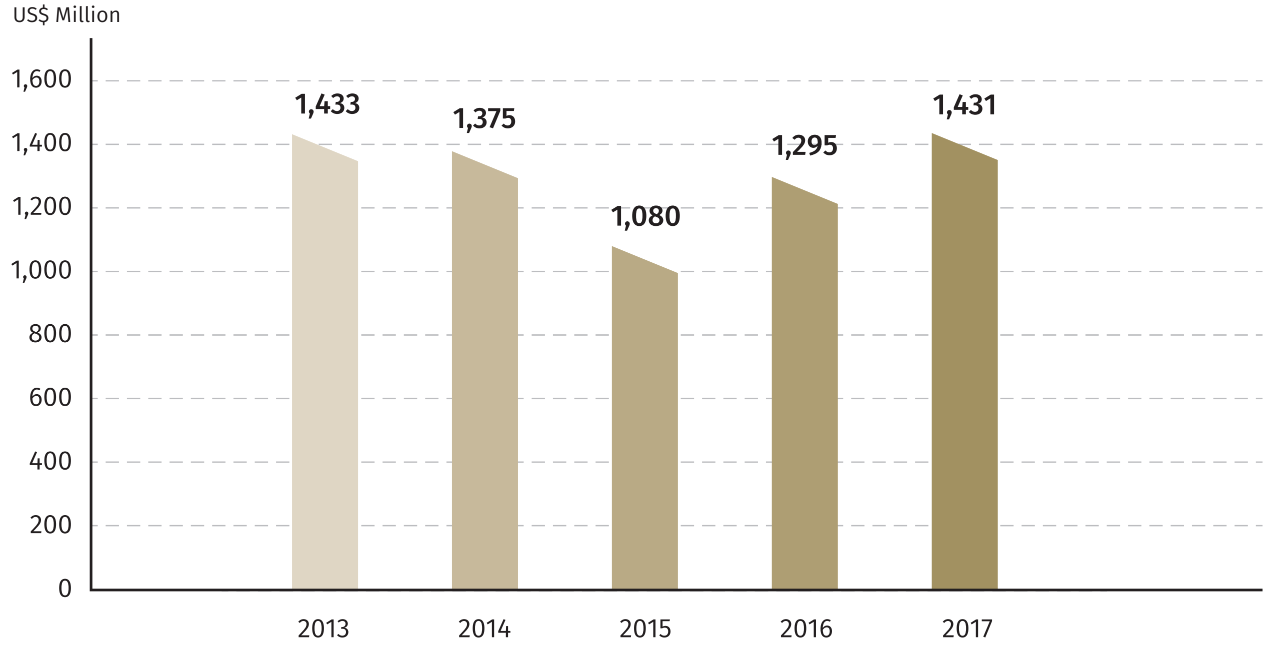
Islamic funds' performance buoyed by regulatory support

Shari'ah-compliant funds in Bahrain are centered around Islamic mutual funds structured as Collective Investment Undertakings (CIUs), and hold 3.3% share of Islamic finance assets. At the end of 2017, there were 90 Islamic mutual funds in Bahrain, including 29 locally incorporated CIUs, four locally incorporated Private Investment Undertakings (PIUs), and 57 registered foreign offshore funds.

Although the recent economic slowdown brought on by lower oil prices has led to fluctuations in asset prices, the value of Islamic funds in Bahrain has remained relatively stable over the last five years. Growing by 14% in 2017 alone, the total net asset value (NAV) of locally incorporated Islamic funds reached US$1.4 billion, or 19% of the total NAV of Bahrain's mutual funds. This is attributable to the regulatory developments in Bahrain's funds industry.

> *Although the recent economic slowdown brought on by lower oil prices has led to fluctuations in asset prices, the value of Islamic funds in Bahrain has remained relatively stable over the last five years.*

Bahrain Islamic Mutual Funds NAV 2013 – 2017



Source: Central Bank of Bahrain

19.3%

Islamic funds share of total mutual funds' NAV in 2017

EXECUTIVE INSIGHTS

International Islamic Financial Market

Ijlal Ahmed Alvi

Chief Executive Officer
International Islamic Financial Market
(IIFM)

1. Bahrain has maintained a leading position in the global Islamic finance industry. From a regulatory standpoint how integral have the CBB's standardization initiatives been to the development of Islamic finance in Bahrain?

Bahrain has been at the heart of developments in the global Islamic finance industry for the last four decades. It is universally acknowledged as the intellectual capital of Islamic finance and a center of professional expertise.

The Kingdom was among the first countries to encourage Islamic banking and to nurture the concepts, rules and common standards of Shari'ah compliance. The CBB was the first regulator in the region to develop and implement regulations specific to Islamic banking, a decision that established its reputation for operating one of the most progressive regulatory frameworks in the GCC.

Bahrain is also home to three of the four leading international infrastructure development institutions for Islamic finance — namely, AAOIFI, IIFM and CIBAFI.

The presence of these international bodies is the result of the foresight of the CBB, which has placed Bahrain at the cutting edge of Islamic financial services development.

2. What has been IIFM's role in supporting the CBB's drive to enforce standardization across the Islamic finance industry in Bahrain?

As one of the founding members of IIFM, the CBB's support has been central in shaping IIFM's strategy of introducing globally standardized Shari'ah-compliant financial contracts and product templates.

The IIFM standards serve as international benchmarks. They have considerably reduced costs and negotiation time for Islamic financial institutions globally, while at the same time facilitating industry unification and Shari'ah harmonization.

The CBB encourages financial institutions to use IIFM standards, which are voluntary in nature, to benefit from the operational transparency, legal robustness and widely recognized Shari'ah-compliance in its Islamic financial documentation and product confirmations.

3. In 2017, IIFM announced a three-year strategic plan to expand the scope of its standardization initiatives. What are IIFM's new initiatives under this plan and which areas of Islamic finance are you looking to expand into? How will these initiatives contribute to further development of the industry in Bahrain?

To deepen its efforts to develop the Islamic finance industry, IIFM's three-year strategic plan for 2017-2020 will expand the scope of IIFM standardization and other initiatives to new segments beyond the existing Islamic capital and money market segments.

The Islamic business segments in which IIFM intends to publish new standards include corporate and trade finance, syndication and gold-related documentation and product standards. It also plans to develop additional Islamic foreign exchange, commodity hedging and investment standards. In the future, IIFM may also seek to develop standards for other Islamic business segments, such as Takaful.

IIFM has made a conscious effort to make its standards available widely to all industry segments to increase transparency, liquidity and depth in the Islamic financial system. Standardization also encourages innovation in the industry. Similarly, it helps open up captive business to all players and allows easier access to new entrants, expanding the overall market base.

Industry-wide standards increase confidence in the financial system and aid regulators in monitoring and providing tools to the local market participants.

4. The standardization of Islamic financial contracts across jurisdictions has emerged as a critical issue facing Islamic finance. In your opinion how can financial regulators and industry standard-setting bodies, like IIFM, work towards addressing this issue?

The role of standard-setting bodies is to develop standards based on market requirements for both transnational as well as domestic players. The active involvement of all stakeholders in the development of standards is essential to achieving the overall objective of creating a unified global industry.

The support and participation of financial regulators in standardization initiatives is critical in maximizing the potential of standard-setting organizations. When new standards are published, the support of national regulators ensures their implementation across jurisdictions, either as a mandatory requirement or through regulators' direct recommendations.

Industry-wide standards increase confidence in the financial system and aid regulators in monitoring and providing tools to the local market participants.

Bahrain's Islamic Finance Journey

Islamic finance milestones

The history of Islamic finance in Bahrain spans nearly four decades. Today, the country is acknowledged worldwide as an industry pioneer, remaining at the forefront of Islamic finance development and innovation both regionally and globally.

1979-2000:
Laying the foundations
Bahrain's journey began in 1979 when Bahrain Islamic Bank was established as the first full-fledged Islamic commercial bank. The country's first Takaful operator, Takaful International, opened for business a decade later. Until the mid-1990s, Islamic finance grew slowly in the country, with only a handful of Islamic financial institutions in operation. However, excess liquidity in the aftermath of the Gulf War spurred renewed interest in Islamic financial products in Bahrain.

In the 1990s, government and private initiatives embarked upon the development of a wider Islamic finance ecosystem. AAOIFI, the oldest Islamic finance standard setting body, was established in Bahrain in 1991 with support from the Islamic Development Bank (IDB). The presence of AAOIFI and other Islamic finance infrastructure bodies has enhanced Bahrain's attractiveness to Islamic financial institutions and investors. In 1997, the Bahrain Institute of Banking and Finance (BIBF) established its Centre for Islamic Finance (CFIF), regarded among the first Islamic finance qualification providers globally. BIBF has become a global leader in Islamic finance professional education and training.

2001-2005:
Introduction of Islamic capital markets
The turn of the century witnessed several milestones for the Islamic finance industry in Bahrain. In 2001, the Bahrain Monetary Agency (BMA), which was renamed the Central Bank of Bahrain, became the world's first central bank to issue Sukuk. This was also Bahrain's first-ever Sukuk. It paved the way for the frequent issuance of Sukuk for Islamic liquidity management. Bahrain's first corporate Sukuk was issued in 2005 by the Durrat Sukuk Company, raising US$152.5 million.

Bahrain also became the first country to issue dedicated Islamic banking regulations in 2001 and Takaful regulations in 2005, staking out a lead position in Islamic finance regulation. During this period, three more infrastructure bodies were established in Bahrain, including CIBAFI in 2001, IIFM in 2002 and IIRA in 2005.

2006-2014:
Augmenting the regulatory framework
As the CBB assumed the role of financial regulator from the BMA in 2006, it sought to fill whatever gaps remained in its Islamic finance framework and augment its regulations. The central bank enhanced Shari'ah governance in 2007 by making the AAOIFI standards compulsory for Islamic banks. The CBB initiated its Islamic liquidity management Sukuk program in 2008. Regulations were issued between 2006 and 2013 covering both conventional and Shari'ah-compliant investment and financing companies, Islamic mutual funds and Sukuk.

2015-present:
Drive for innovation and stronger Shari'ah governance
2015 saw the introduction of a new Wakala based Islamic liquidity management tool developed by the CBB.

In recent years, the CBB has sought to develop the Fintech sector with its Fintech Regulatory Sandbox and crowdfunding regulations, including Islamic crowdfunding, both introduced in 2017.

The CBB also issued a comprehensive Shari'ah governance module in 2017, which introduced external Shari'ah compliance audit for the first time. It also tightened the regulations for the Shari'ah Supervisory Board, Shari'ah compliance function and Internal Shari'ah audit.

Bahrain's Islamic Finance Milestones

2012
CBB issued regulations for conventional and Islamic CIUs

2013
CBB launched a new Wakalah liquidity management instrument for Islamic retail banks

CBB issued regulations on issuing and offering Sukuk

2015
Bahrain Bourse introduced trading and direct subscription to government bond and Sukuk issuances for the first time in the region

2016
Payment Service Provider (PSP) and card processing companies became new regulated activities

2017
CBB introduced landmark Fintech Regulatory Sandbox and regulations for conventional and Islamic crowdfunding

CBB issued landmark "Shari'ah Governance Module"

2010
CBB issued regulations for specialized licensees, including Islamic financing companies

2008
Bahrain became the first country to issue short-term Islamic liquidity management instruments

2007
CBB imposed requirement to establish independent Shari'ah Supervision Committees at all Islamic banks

CBB became first regulator to make compliance with all AAOIFI standards mandatory at all Islamic banks and windows

2006
CBB issued regulations for conventional and Islamic investment firms

CBB established, taking over as Bahrain's financial regulator

Waqf Fund established by CBB

2001
Bahrain became the first country to implement dedicated Islamic banking regulations

CIBAFI established in Bahrain

2002
IIFM established in Bahrain

BMA established the Liquidity Management Center (LMC) to facilitate Islamic liquidity management

2004
Bahrain issued its first US$250 million five-year Sukuk Ijarah to fund airport expansion

2005
Bahrain became the first country to introduce a Takaful/re-Takaful regulatory framework

IIRA established in Bahrain

2001
CBB became the first central bank to issue sovereign Sukuk

1997
BIBF established its Centre for Islamic Finance (CFIF)

1991
AAOIFI established in Bahrain by IDB

Bahrain hosts the first annual World Islamic Banking Conference (WIBC)

1989
First takaful operator in Bahrain established—Bahrain Islamic Insurance Company (Takaful International)

1979
First Islamic bank in Bahrain established—Bahrain Islamic Bank (BISB)

1973
Bahrain Monetary Agency (BMA) established to regulate the banking sector

Pioneering Islamic finance regulation

Bahrain has long been at the forefront of Islamic finance regulation, and the CBB's forward-looking approach has created regulatory models for global emulation. The country's financial regulatory framework has been formulated through consultation with industry players and codified in standards of best practice. Over 30 countries have turned to the CBB for assistance in developing their own Islamic finance sectors in the past decades. The central bank is also known for the continuous development and upgrading of its regulatory framework to meet international best practices and achieve standardization.

Robust Islamic finance regulatory model

In 2001, Bahrain implemented the Prudential Information and Regulation for Islamic Banks (PIRI) system, the first dedicated Islamic banking supervisory framework. PIRI, which corresponds to Volume 2 of the CBB rulebook, sets industry requirements in capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management.

Bahrain took another pioneering step in 2005, when it introduced the world's first comprehensive regulatory framework for Takaful and reTakaful meeting IAIS standards, under the insurance rulebook (Volume 3). In 2014, after a two-year consultative process, the CBB introduced a revised and improved operational and solvency framework for Takaful and reTakaful firms, bringing the industry in line with global requirements.

Volume 4 of the CBB rulebook was issued in 2006, covering both conventional and Islamic investment firms. The regulatory framework specifies operational and Shari'ah-compliance rules for Islamic investment firms, requiring the use of AAOIFI accounting and auditing standards and a Shari'ah

Supervisory Board. Islamic investment firms are not permitted to offer Islamic financing, accept deposits or offer profit-sharing investment accounts. In 2010, the CBB issued similar regulations for Islamic financing companies under Volume 5 of its rulebook covering specialized licensees.

Islamic asset management was next on the CBB's list, receiving a regulatory boost in 2012. The central bank issued Volume 7 of its rulebook which provides a comprehensive regulatory framework for conventional and Islamic CIUs domiciled or offered for sale in Bahrain. The majority of Islamic mutual funds in Bahrain take the form of CIU schemes, and these regulations set strict guidelines for corporate governance and the roles and responsibilities of all parties involved. The framework also allowed for new types of funds to be established in the country, including Real Estate Investment Trusts (REITs) and PIUs. In 2014 the CBB issued regulations for Shari'ah advisory services providers in Volume 5 of its rulebook, enabling Islamic investment firms and collective investment schemes to outsource the Shari'ah review process and optimize their operational and cost efficiency.

The CBB issued a new regulatory module in 2013, the Regulatory and Supervisory Module on Issuing and Offering of Securities and Shari'ah-compliant Sukuk (OFS Module). The module, which is a significant part of Volume 6 of the CBB's capital market rulebook, opens up Bahrain's Sukuk market to GCC issuers. This framework regulates the issuance, offering, floating and subscription of fixed income securities, including Sukuk, issued in Bahrain or by a Bahrain-licensed institution. The regulations were developed according to international standards and best practices provided by International Organization of Securities Commissions (IOSCO).

Comprehensive Shari'ah governance module

2017 saw a significant development for the Islamic finance sector in Bahrain with the issuance of the Shari'ah governance module. The CBB described the new module as a "major attempt to establish industry-leading Shari'ah governance principles and practices in Bahrain." Applicable to retail and wholesale Islamic banks starting in the second half of 2018, the module establishes a clearly-defined Shari'ah governance structure comprising four elements: the Shari'ah Supervisory Board (SSB), a Shari'ah coordination and implementation function (headed by a Shari'ah Officer), an internal Shari'ah audit function, and an external independent Shari'ah-compliance audit.

The introduction of a mandatory internal Shari'ah audit function reporting separately to the SSB, and the new requirement for independent external Shari'ah compliance audit make this structure unique, effectively moving away from the self-regulation model previously followed by Islamic banks in Bahrain. This model strikes a balance between a centralized Shari'ah governance model using an apex Shari'ah supervisory authority and a decentralized model of self-regulation. In the new system, individual SSBs will still make rulings on the products and services of their banks without the direct supervision of a higher Shari'ah authority. However, they are now required to make these rulings and their jurisprudential evidence available to the public to ensure transparency. The CBB's Centralized Shari'ah Supervisory Board (CSSB) is available to resolve any dispute about a product between individual banks' SSBs. The new framework is aimed to achieve a more consistent and robust Shari'ah compliance system for Islamic products in the Kingdom.

Driving harmonization and standardization in Shari'ah standards

Islamic financial institutions in many jurisdictions around the world typically follow multiple reporting systems without standardization, a key challenge to the global Islamic finance industry. The CBB has a long-ranging goal to implement standardization in Shari'ah governance across the industry.

In its 2007 amendment of Islamic banking regulations, the CBB made it mandatory for all Islamic banks and banking windows in Bahrain to adhere to AAOIFI accounting, auditing and Shari'ah standards. The purpose of this decision was to achieve greater consistency in Islamic banks' reporting and Shari'ah compliance, thus considerably reducing their exposure to Shari'ah non-compliance risk.

The CBB has been working closely with standard-setting bodies such as IIFM to further standardize Islamic banking products. The standardization will lead to reduced documentation and structuring costs.

During 2018, the CBB has issued a new risk management module for Islamic banks with requirements to measure and report exposure to financial risks. The module will provide a detailed framework to improve and standardize risk management practices, covering aspects such as the management of credit risk, market risk, operational risk, and profit rate risk. The CBB has also issued specific risk management rules on reputational risk, ICAAP, stress testing, Domestic Systemically Important Banks (DSIBs) and liquidity risk.

Sheikh Esam Ishaq

Sheikh Esam Ishaq

Shari'ah Scholar

1. According to the Islamic Finance Development Indicator (IFDI) report, Bahrain has by far the most developed Shari'ah governance system for Islamic finance worldwide. What are the key success factors that have produced such a robust Shari'ah governance structure?

There are a number of factors that have contributed to this success. First and foremost is the presence of a central regulator — the CBB — that is directly and actively involved with Islamic financial institutions in ensuring that at least a minimum level of governance is maintained. Second is Bahrain's remarkable history as a center for Islamic finance standard setting. Bahrain is now approaching the end of its third decade in this field, hosting AAOIFI, which is globally recognized for setting accounting, auditing and Shari'ah standards. Another important factor is the commitment we are seeing from the leaders in Bahrain's Islamic finance industry to increase the level of compliance and fulfillment of Shari'ah governance requirements. The higher echelons of Islamic financial institutions in Bahrain are relatively young compared to other jurisdictions, and thus more idealistic and committed to upholding governance standards.

2. Recent events in Islamic capital markets have brought to surface concerns over Shari'ah compliance risk, which has stemmed from a lack of standardization in Shari'ah guidelines and standards. In your opinion, have Shari'ah governance practices in Bahrain been able to address these concerns successfully?

It is apparent that recent events, such as the Dana Gas Sukuk debacle, have raised red flags. In this particular case, there was a gap between regulation and Shari'ah governance requirements. The Dana Gas claims came from a Shari'ah basis; however, the lack of robust governance framework governing the issuance of Dana Gas Sukuk is what allowed them to make this claim. This has opened the eyes of many investors who were unaware of the risks of such a situation occurring, or would have even been caught off guard bearing these risks. Sukuk, in particular, is an area where governance remains lacking, which has led AAOIFI to develop a new standard on Sukuk governance. The standard has been drafted and will be shared soon with industry practitioners and regulators for consultation.

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3. In your opinion, what will be the main challenge facing the industry in terms of Shari'ah governance in the near future?

A key challenge will be the adoption of new governance and Shari'ah standards. We have to see how long it will take for current draft governance and Shari'ah standards to come into practice, and how long it will take to actually make them mandatory requirements. The central banks of Bahrain and the UAE have made AAOIFI Shari'ah standards mandatory for Islamic banks and some other Islamic financial institutions, which has boosted the level of authority for these standards and has encouraged AAOIFI to continue its efforts to develop standards. This move will push other regulators and Islamic financial institutions in the region to get on board and adopt AAOIFI standards for better governance.

Unique Islamic Finance Initiatives in Bahrain

Fintech — the next frontier

A long-established financial center, Bahrain has naturally made developing a domestic Fintech industry a priority, seeking to establish a competitive lead as the region's Fintech hub.

Bahrain repositioning as regional Fintech hub

Leading the drive for Fintech development is Bahrain's Economic Development Board (EDB), which established the Bahrain Fintech Bay (BFB) in February 2018. BFB is a public-private partnership with Singapore's Fintech Consortium and the first Fintech hub and incubator in the region. In October 2018, BFB launched the Global Islamic & Sustainable Fintech Center (GISFC). The center is concerned with driving Fintech adoption and development, boosting Islamic finance growth in Bahrain.

Islamic banks in Bahrain are embracing Fintech, and many have announced their fintech and digital strategies. In December 2017, Bahrain Development Bank, KFH and Al Baraka Banking Group together launched the world's first Islamic Fintech consortium — ALGO. The consortium will organize and fund research and development in Islamic Fintech. It has plans for 15 unique Fintech platforms by 2022, covering areas including Islamic financing, Takaful and investment advisory. Other examples include the US$10 million Fintech Innovation Lab at Bahrain Islamic Bank, and "Meem", the region's first digital Islamic bank launched by the Gulf International Bank.

CBB shaping fintech regulation

The CBB is a key player in Bahrain's Fintech future, developing an innovation-friendly regulatory framework at its dedicated Fintech and Innovation unit, the first of its kind in the region. This unit is mandated with setting regulatory frameworks that encourage and support innovation in the financial services industry, at both financial institutions and Fintech startups.

The CBB's Fintech regulatory framework includes the region's sole onshore regulatory sandbox. Created in June 2017, the sandbox currently hosts 16 approved entities. It allows Fintech startups and established financial institutions to test their solutions in a temporary regulatory environment with lighter regulations and access to regional markets.

In 2017, the CBB also issued regulations for Islamic and conventional crowdfunding (equity-based and financing-based). These regulations aim to promote financial inclusion and facilitate easier access to finance for SMEs.

In line with Bahrain's national Cloud First policy, the CBB has amended some of its regulations to enable licensed financial institutions to migrate and store information and data on the cloud, subject to certain encryption requirements.

A key initiative in the CBB's pipeline is the development of open banking regulations, which are planned to be released in early 2019. These regulations can potentially become a catalyst for change in the financial industry. Open banking will be facilitated and supported by an open API technology that will enable customers to access their financial data and initiate payments with various financial institutions through a single unified platform.

In a joint initiative with the Information and e-Government Authority (IGA) and the Benefit Company (local switch), the CBB is currently developing a national electronic Know Your Customer (eKYC) utility. This initiative aims to streamline customer information and improve the efficiency of the customer onboarding process. Effectively, it will lead to significantly reducing the time taken by a customer to open a new account.

In 2018, the CBB collaborated with the UK's Financial Conduct Authority (FCA) along with 11 other regulators to create the Global Financial Innovation Network (GFIN). Building on an FCA proposal to establish a 'global sandbox', GFIN aims to offer a more efficient process for innovative firms to interact with regulators. It also aims to develop a framework for regulatory collaboration on innovation-related topics.

Islamic Fintech — the way forward

With these recent developments in Fintech, Bahrain enjoys a robust infrastructure and conducive operating environment that position it to become a hub for Islamic Fintech. Through collaboration with the international standard-setting bodies in the country, Bahrain could further enhance its Islamic Fintech regulatory framework by creating standards of Shari'ah governance and documentation for Islamic Fintech platforms. BIBF is helping expand Islamic Fintech expertise in Bahrain with Fintech workshops targeting Islamic banks and its new Fintech Executive Program in partnership with the IFSB.

Bahrain Institute of Banking and Finance

Dr. Ahmed Al Shaikh

Director
Bahrain Institute of Banking and Finance (BIBF)

1. BIBF is a recognized brand in training within the financial sector. Where does Bahrain stand in terms of the development of its Islamic finance talent? What role has BIBF played in the development of the breadth and quality of the Islamic finance talent pool in Bahrain?

The BIBF was established in 1981 as the training arm of the CBB. It is a non-profit organization with a focus on educational quality. BIBF is organized around seven learning centers including Banking, Accounting and Finance, Leadership and Management, IT and Project Management, Insurance, Academic Studies and of course Islamic Finance. Since our inception, we have trained over 340,000 individuals from 63 countries. Within Bahrain, the BIBF continues to be the backbone of the financial sector. Most employees of financial institutions have been trained at the BIBF, whether at entry level, technical or professional training, executive development or board-level training.

Our Centre for Islamic Finance (CFIF) was established in 1997. It has the unique distinction of being the oldest Islamic finance professional qualification provider in the world. We strive to facilitate not only the local but also the global Islamic finance industry by providing holistic solutions such as consultancy and product development, in addition to training.

We have recently launched our flagship Advanced Diploma in Islamic Finance (ADIF) as a distance-learning program using virtual classroom software to deliver courses outside Bahrain. Within Bahrain, we have more than 1,000 graduates who serve the Islamic finance industry from seasoned professionals in senior positions to new recruits.

We also offer the Advanced Diploma in Islamic Commercial Jurisprudence (ADICJ), which focuses on *fiqh* (Islamic jurisprudence). This is a unique program offered exclusively by the BIBF, covering a comprehensive range of topics through which we have helped elevate the knowledge and understanding of Shari'ah resources. We also conduct targeted workshops on specific topics of interest to the industry. In 2018 our focus was on regulation, compliance, IFRS9, Fintech and VAT.

2. In which areas of Islamic finance education has there been more demand in Bahrain? Does BIBF focus solely on Islamic banking, or does it extend to other areas such as regulation, Shari'ah governance and Fintech?

Over the past three years, we have seen increased demand for our ADIF program, reflecting strong interest in a full understanding of the entire Islamic finance spectrum, rather than one specific area. This program has six modules that cover all aspects of Islamic banking and finance, and is recommended by the Central Bank of Bahrain for professionals in positions of authority at Islamic banks.

It is the only Islamic finance professional qualification in the world with a progression route into a UK MBA program. ADIF graduates spend one month of intensive study at the University of Bolton and complete a thesis to earn an Executive MBA from the University of Bolton. In this way, finance professionals opting for ADIF can earn a professional qualification in Islamic finance as well as an Executive MBA from the UK in a year and a half.

Moreover, we recently launched a course on CBB regulations and compliance for Islamic banks, and have held a variety of specialized workshops on topics including risk management, Takaful, investments and Sukuk structuring. Fintech is an area of interest for the BIBF—we have partnered with European tech firms and MasterCard to conduct a Fintech workshop specifically targeted at Islamic banks. In October 2018 we launched a Fintech Executive Program with IFSB.

3. A key challenge for Islamic finance globally is the skills gap in the existing workforce, where many graduates, although qualified, still lack working knowledge of the industry. What is the key impediment to effective Islamic finance education? Where does it need to improve?

If we look at the state of education globally, there is a big mismatch between theory and actual practice. The BIBF tries to counter this divergence by providing training with faculty who are not only active market practitioners but also possess the passion and talent to educate.

The BIBF focuses on hands-on practical learning with case studies and real-life market scenarios rather than just a theoretical understanding. When it comes to the CFIF, our strategy for the past three years has been to effectively leverage technology to facilitate education for the Islamic finance industry worldwide. In line with this vision, the BIBF was the first in the Middle East to launch a Simulated Dealing Room, followed by the first Islamic banking simulation in the world.

> *Over the past three years, we have seen increased demand for our ADIF program, reflecting strong interest in a full understanding of the entire Islamic finance spectrum, rather than one specific area.*

From a global perspective, our regional and international impact has been quite significant. The Center is leveraging technology with its e-learning strategy. We have provided training in GCC countries as well as in Russia, Kazakhstan, Seychelles, the UK and elsewhere. The CFIF works with Central Banks as well as financial institutions. We also work with universities in the UK to develop their Islamic finance modules and have developed the IFQ Level 2 qualification for the Chartered Institute of Securities and Investments (CISI).

4. What are BIBF's future strategic initiatives to develop Islamic finance professionals in Bahrain and globally?

When it comes to training in Islamic finance, BIBF is a global leader. We have worked on several training initiatives for international institutions such as the World Bank and Islamic Development Bank. We act as the effective Islamic finance training arm of several Central Banks such as the Central Bank of Kazakhstan, and in several countries in Africa. The University of Bangor also outsources their Master of Islamic Finance degree to BIBF.

BIBF is the only entity in the world exclusively working with AAOIFI and IFSB on e-learning. This initiative will develop a holistic Islamic finance portal, which includes e-learning training modules for AAOIFI standards, IFSB standards, IIFM contracts and BIBF's own training content, including training for front-facing staff of Islamic banks. We believe the future of training is in a hybrid model of classroom and e-learning, and BIBF is concentrating to further develop both these areas.

Developing world-class professionals

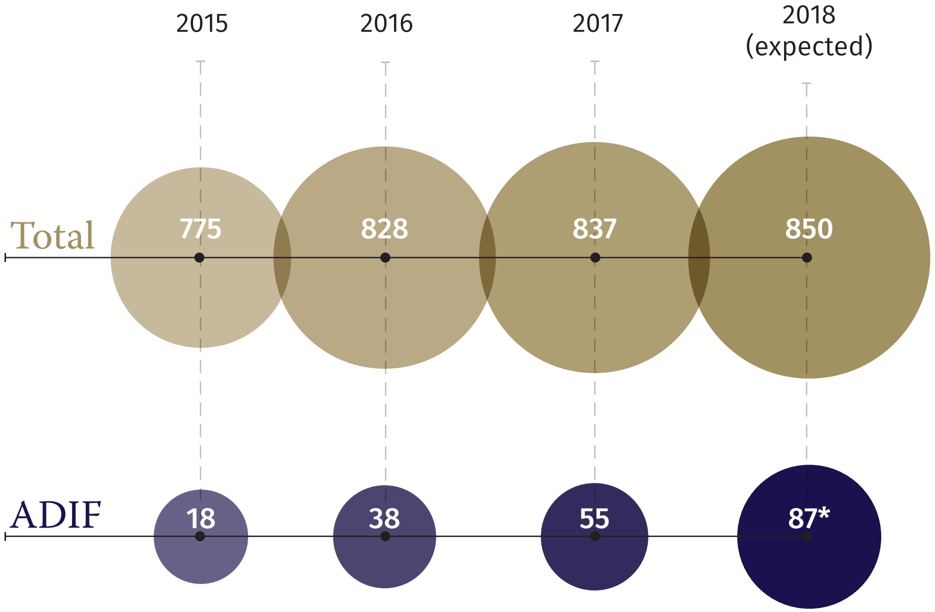
Bahrain has long invested in educating and training its financial services workforce, including its Islamic finance professionals. The country boasts one of the region's most qualified bodies of finance sector specialists. Indeed, this makes it stand out from regional peers as a hub for both conventional and Islamic finance. BIBF and the Waqf Fund have been critical to developing Bahrain's highly-skilled Islamic finance professionals.

BIBF preparing world-class Islamic finance workforce
BIBF, the education and training arm of the CBB, is the backbone of Islamic finance education in Bahrain. One of the key programs it offers is the Advanced Diploma in Islamic Finance (ADIF), among the oldest professional qualifications in the Islamic finance industry. To date, ADIF has trained about 1,000 graduates, who presently work at conventional and Islamic banks around the world.

> *Over the past three years, we have seen increased demand for our ADIF program, reflecting strong interest in a full understanding of the entire Islamic finance spectrum, rather than one specific area.*
>
> *— Dr. Ahmed Al Shaikh, BIBF*

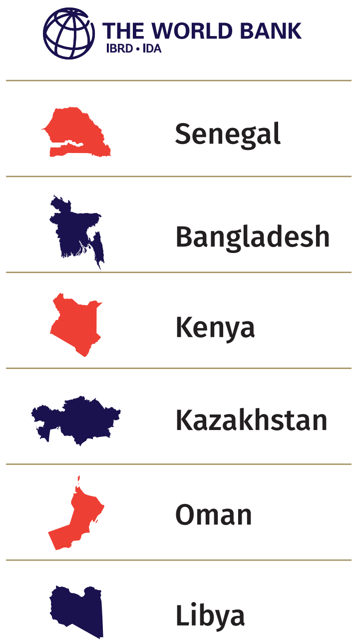
BIBF Centre for Islamic Finance Highlights

Total and ADIF enrollment 2015–2018



*1includes 14 students for distance learning

Outreach outside Bahrain includes:



OVER 1,000
ADIF graduates in Bahrain

300%
Increase in ADIF trainees since 2014

Source: BIBF

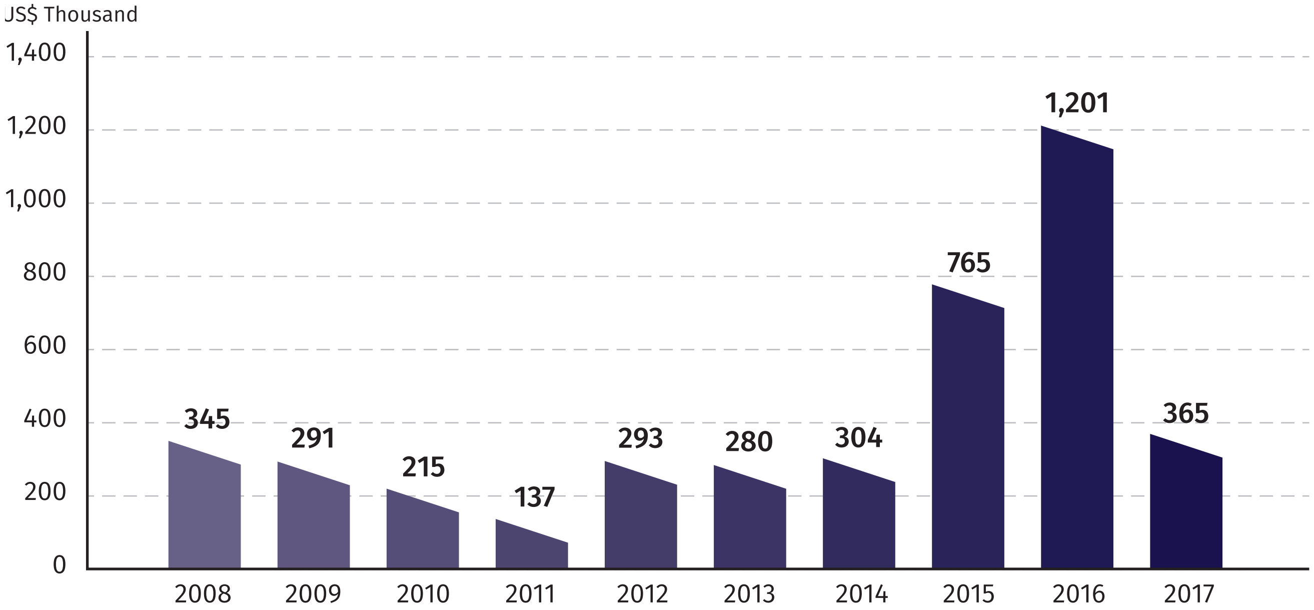
Waqf Fund sponsoring key Islamic finance training programs

The Waqf Fund was established in November 2006 by the CBB in partnership with Islamic finance industry stakeholders. Essentially, the Waqf Fund is an endowment, which is invested in Islamic money market instruments in Bahrain, and the returns are used to sponsor projects in Islamic finance education, training and research. The Fund's 13-member Board of Trustees comprises senior professionals from the Islamic banking industry and three independent members. As the Board members come from the industry, they are able to direct the Fund's programs to solving practical issues facing Islamic finance industry both in Bahrain and globally.

Most of the Fund's initiatives take the form of customized training programs directed at the capacity building of specific segments of the Islamic finance industry. These initiatives are executed through partner organizations such as BIBF. Over the last 12 years the Fund has fully funded and participated in the development of a number of programs, some of which include:

- Advance Diploma in Islamic Finance
- Advance Diploma in Islamic Commercial Jurisprudence
- Advance Shari'ah Reviewer Development Program
- Roundtable Discussions
- Development of a course on Business Ethics for Islamic Bankers

Waqf Fund Spending 2008–2017



US$7 MILLION
Size of Waqf Fund in 2018

US$4.2 MILLION
Total Waqf Fund spending since establishment

4.6%
Current annual return on endowment investments

Source: Waqf Fund

- Assistance and sponsorship for University of Bahrain in developing and launching a 4-year B.Sc. in Islamic Banking & Finance program
- Shari'ah Scholar sessions
- Annual Corporate Governance workshops
- Revamping AAOIFI's CIPA and CSAA qualifications
- Leadership Grooming Program
- CFO Grooming Program
- Sponsorship for Islamic economics textbook project
- Sponsorship for Islamic finance training program for Bahraini lawyers, judges and prosecutors

The Waqf Fund offers a replicable model, for Islamic finance jurisdictions worldwide, for selective intervention and capacity building for the development of the Islamic finance industry and its ecosystem. Given the small size of individual market players, many of the previously mentioned initiatives would not be commercially viable and thus abandoned in the absence of the Waqf Fund. The Waqf Fund has thus been a silent but extremely effective player in the success of Bahrain as an Islamic finance hub.

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BAHRAIN ISLAMIC FINANCE REPORT 2018

A Pioneer's Journey

مصرف البحرين المركزي
Central Bank of Bahrain

THE WAQF FUND
Promoting ethics in finance through Shari'a

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