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To: Members of the Executive Board

From: The Acting Secretary

Subject: **Bahrain—Banking Supervision—Report on Observance of
Basel Core Principles**

The attached report on the observance of Basel Core Principles for Bahrain relating to banking supervision has been prepared in the context of the 2000 Article IV consultation discussions with Bahrain (SM/00/108, 6/7/00), which is tentatively scheduled for discussion tomorrow, Wednesday, June 21, 2000.

Mr. Dicks-Mireaux (ext. 35699) and Mr. Menchikov (ext. 37558) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

BAHRAIN

**Banking Supervision—Report on Observance
of Basel Core Principles**

Prepared by the Monetary and Exchange Affairs and Middle Eastern Departments

Approved by Paul Chabrier and Stefan Ingves

June 19, 2000

- Prepared by a MAE led team of experts in the context of the 2000 Article IV consultation mission during the period of February 15-28, 2000, on the basis of information provided by the Bahraini authorities.
- The MAE expert team was led by Dmitri Menchikov (MAE) and included Keith Bell (formerly of the Office of the Superintendent of Financial Institutions, Canada) and Timothy Sullivan (formerly of the Office of the Comptroller of the Currency, United States).
- Bahrain is compliant with most of the Core Principles (CPs). The high degree of compliance with banking supervision standards has contributed to a well capitalized and resilient banking system. However, the Bahrain Monetary Agency (BMA) does not have the specific legal authority to require its prior review and approval of the proposed acquisition of controlling shareholder interests in established banks. Other areas that require further improvements include the BMA's independence, adequacy of the supervisory staff, banks' permissible activities, acquisitions and investments, and connected lending. In this context, the authorities agreed with the team on an early action plan to address identified areas in need for improvement.
- The principal author of this report is Mr. Menchikov.

Report on the Observance of Standards
and Codes

Banking Supervision—Report
on Observance of Basel Core
Principles

Bahrain

Prepared by a staff team led by the International Monetary Fund in
the context of an Article IV mission, on the basis of information
provided by the Bahraini authorities.

The International Monetary Fund
June 2000

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I. SUMMARY ASSESSMENT

A. General

1. The Bahrain Monetary Agency (BMA) requested an assessment by the International Monetary Fund (IMF) of its compliance with the Core Principles of Effective Banking Supervision developed by the Basel Committee on Banking Supervision. The assessment was conducted in the context of the 2000 Article IV consultation mission, closely following the "Core Principles Methodology" approved by the Basel Committee on Banking Supervision. Following is the summary of the detailed assessment report which was transmitted to the Bahraini authorities separately.

2. The BMA was empowered as the bank supervisory, regulatory, and licensing authority in Bahrain by Decree Law No. 23 of 1973, "The Law Establishing the Monetary Agency of Bahrain," as part of the establishment of the BMA. The assessment was based on this Law and prudential regulations issued by the BMA. Under the Law, the BMA is responsible for the supervision, regulation, and licensing of bank and non-bank financial institutions in Bahrain, including commercial banks, investment banks, specialized banks, offshore banking units, branches of foreign banks, representative offices of foreign banks, investment advisors and brokers, money changers, money brokers, and providers of ancillary services to the financial sector.¹

B. Background

3. Large movements in international oil prices have had a substantial impact on recent macroeconomic performance in Bahrain. Sharp declines in oil prices in 1998 contributed to a weakening of the fiscal position and external current account. The budget position shifted from balance to deficit. The absence of significant fiscal adjustment helped sustain domestic demand and economic growth; strong growth was recorded in the non-oil retail and wholesale trade, tourism, and utility sectors. Consumer prices fell slightly and the external current account deficit widened considerably. The partial recovery of oil prices in 1999, along with the stabilization of world aluminum prices, supported an improvement in economic performance and a narrowing of economic and financial imbalances. The fiscal budget deficit contracted, reflecting rising oil prices, the implementation of nontax revenue-raising measures and restrained expenditure policies. Economic activity in the non-oil sector continued to expand steadily, supported by increases in financial sector services, tourism, manufacturing, and construction. Consumer prices fell. IMF staff projections for 2000 indicate a favorable economic performance, reflecting higher world oil prices, a return to normal oil production levels, and restrained financial policies.

¹ The BMA is not responsible for the activities of insurance institutions and the Bahrain Stock Exchange, which are under the purview of the Ministry of Finance and National Economy.

4. The financial sector in Bahrain is diversified and expanding, notwithstanding the relatively small size of the economy. The financial sector's overall contribution to the economy—equivalent to 20–25 percent of GDP—is now slightly larger than the contribution of the oil sector. Over 180 financial organizations, including both traditional and Islamic institutions, are currently operating in Bahrain's domestic and offshore financial markets. The sector's growth and diversification draws substantially on Bahrain's long-established role as an offshore banking center, which is held in high regard worldwide. This strong reputation owes in large part to the BMA's high standards for licensing and prudential supervision and regulation. The BMA has made a substantial effort to introduce, maintain, and enforce bank supervision standards and procedures, as well as those for accounting and auditing in banks, at the level of international best practices. Its recent efforts to develop a comprehensive regulatory and operational framework for Islamic banking supports the role of Bahrain as a leading Islamic financial center. Banks are generally profitable and adequately capitalized and maintain satisfactory asset quality. Through conservative management and sound BMA supervisory and regulatory policies, banks have suffered little damage to their financial condition from the recent volatility in world financial and energy markets caused and there were no bank closures or bail-outs.

C. Findings

5. **Overall, the assessment shows that the BMA has achieved compliance with most of the Core Principles (CPs) which cover virtually all of the supervisory factors that broadly encompass the fundamentals of a sound supervisory system (Table 1).** However, the BMA does not have the specific legal authority to require its prior review and approval of the proposed acquisition of controlling shareholder interests in established banks. This is a major impediment to the BMA's prudential oversight and to its ability to supervise the banks. In addition, the BMA is not fully compliant with the CPs concerning the BMA's independence and resources for on-site and off-site supervision and those related to banks' permissible activities, acquisitions and investments, connected lending.

6. Traditionally, CPs are grouped into seven major categories: (i) preconditions for effective banking supervision; (ii) licensing and structure; (iii) prudential regulations and requirements; (iv) methods of ongoing supervision; (v) information requirements; (vi) remedial measures and exit; and, (vii) cross-border banking. The results are summarized according to these groups.

7. **Preconditions for effective banking supervision, CP 1.** The general legal, business, and accounting framework in which banks operate and banking supervision takes place is sound and well-established. Market discipline is effective. The supervisory authority has extensive powers to control the risks assumed by the banks. The BMA has extensive authority to license, supervise, and inspect all institutions. It also has the power to establish and enforce prudential safety and soundness standards and regulations. Information is appropriately shared among supervisors. The independence of the supervisory authority is, in practice, largely unfettered, although the required involvement of the Ministry of Finance and National Economy (MOFNE) could compromise the BMA's judgments in certain situations.

The potential for the direct involvement of the MOFNE in the BMA's decisions on licensing, closure, and certain administrative enforcement matters, as well as its presence on the BMA's Board of Directors, could compromise the independence of the BMA in implementing its supervisory functions.

8. **Licensing and structure, CPs 2-5.** While the criteria for establishing banks and approving the scope of their operations are thorough and include appropriate considerations, the BMA Law does not define either permissible activities for banks or the term "bank" itself. It does, however, prohibit the use of the term "bank" and its derivatives by institutions other than those regulated by the BMA as banks. Within the Law there remains some sharing of certain limited aspects of supervision and licensing with the MOFNE, but in practice bank supervisory activities are always undertaken by the BMA. Mergers of banks are subject to the prior approval of the BMA. The BMA also has the authority to review and give prior approval to proposed significant corporate acquisitions by banks and to consider the risks involved for the banks and its own supervisory interests. However, the BMA does not have specific legal authority to request its prior review and approval, and does not use specific standards and criteria against which proposed acquisitions/investments can be measured. The development of a standard assessment process should be considered.

9. **Prudential regulations and requirements, CPs 6-15.** With the recent addition of market risk-related computations, capital charges, and reporting requirements to their long-standing risk-weighted capital adequacy requirements, the BMA has brought its capital adequacy requirements broadly into compliance with the Basel Capital Accord. Currently all banks exceed the minimum capital adequacy ratio of 12 percent. The BMA has issued rules and regulations that provide comprehensive instructions and requirements for lending and investment policies and procedures for banks, as well as the related internal control systems. Other, more specific, credit-related directives, which establish policies and procedural requirements for asset quality classification and provisioning, credit concentration, connected lending, and country risk have also been issued and provide substantive guidance to banks' operations. However, the BMA does not require that transactions with connected parties exceeding specified amounts or otherwise posing special risks be subject to approval by a bank's board nor does it require that procedures be in place to prevent persons benefiting from a loan participating in the preparation of the loan assessment or of the decision itself. Therefore, it is recommended that the rules on connected lending be modified to address these issues.

10. The BMA has introduced guidelines, in line with the international standards of the Financial Action Task Force (FATF), to enforce the control of money laundering. Compliance with the circular on money laundering is evaluated in the on-site inspections and the banks are required to report to the BMA relevant suspicious transactions. Proposed anti-money laundering legislation is currently pending with the Government of Bahrain.

11. **Methods of ongoing supervision, CPs 16-20.** The BMA practices direct and indirect supervision, including on-site inspection, off-site surveillance, and prudential reporting, and imposes its prudential standards on a consolidated basis for all of the locally-incorporated

financial institutions within its jurisdiction, including their subsidiaries and foreign operations. On-site inspections are planned in consultation with the off-site supervision directorates and conducted using standardized, written procedures. The BMA directorates that are responsible for on-site inspections and off-site surveillance perform their functions, which are based on appropriate procedures, effectively. However, the BMA's human resources that are allocated to supervision are inadequate to continue to undertake timely, comprehensive supervision of a growing, diverse group of financial institutions.

12. Regular contact between the BMA and the management and external auditors of banks is an integral part of the coordinated on and off-site supervisory processes. The BMA has full authority to request any information needed in the exercise of its supervision. The various required prudential reports are submitted by the banks electronically and are reviewed, analyzed, and followed up by the off-site supervision directorates.

13. **Information requirements, CP 21.** Bahrain is in full compliance with this Principle. Both traditional and Islamic financial institutions are required to prepare prudential and other financial information, and other reports, in accordance with appropriate international accounting standards. Extensive public disclosure requirements are in place. The BMA ensures that information provided from bank records is verified periodically through on-site inspections and by the banks' external auditors.

14. **Remedial measures and exit, CP 22.** The BMA Law authorizes the BMA Board of Directors to pursue a series of graduated remedial measures in the event that the supervision of a bank reveals problems or a bank fails to comply with prudential rules. The BMA has been generally successful in obtaining prudential compliance and the correction of matters requiring attention through its ongoing supervisory communications with the banks, without needing to use sanctions and penalties. The latter, in some cases, require approval by the MOFNE.

15. **Cross-border banking, CPs 23-25.** Bahrain fully complies with these Principles. These Principles are all related to cross-border banking issues, such as cooperation between home and host country supervisors and exchange of information, consolidated supervision on a global basis, and equal supervisory treatment of domestic and foreign banks. The BMA has the authority to supervise the overseas operations of locally-incorporated banks. As an essential supervisory measure, the BMA has conducted periodic on-site examinations of the overseas establishments of these banks and includes these activities in its ongoing supervisory process. Supervisory information is exchanged, as appropriate, with foreign home and host country supervisory authorities through ongoing informal contacts, as necessary. The BMA enforces the same supervisory policies and standards, as appropriate, on the operations of foreign banks in Bahrain, including both offshore banking units and branches, as are required for locally-incorporated institutions.