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LEGAL ASPECT OF ISLAMIC BANKING: A CASE STUDY OF BAHRAIN

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Kingdom of Bahrain is considered one of the leading countries in the Middle East where Islamic banking is growing enormously adopting various legal changes necessary to provide a level playing field to the Islamic banking industry. In order to pave the road to smooth running of the industry, innovative and legislative arrangements are introduced from time to time. Notably, the government of Bahrain strives to set it as an international hub for Islamic banking. As such, the Bahrain may be considered as an ideal model for countries, which are involved in developing Islamic banking in their respective countries. Eventually, the study finds that Bahrain has introduced various legal changes as well as mandated the adherence to Shari'ah *Standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for smooth running of Islamic banking industry which can be adoptable by other jurisdictions.*

Key words: *Islamic Banking, Growth of Islamic Banking, Bahrain, Islamic Finance*

1. Introduction

Bahrain is an Island with historical connections to the Persian Empire. It is a former province of Iran, which is called as "Pearl of Persian

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Gulf" and is densely populated Arab country. Its area is only 260 square miles, which is one of the most crowded countries on earth. It is home for one million people approximately.[1] Bahrain has a long history as a hub of banking and it strives hard to retain that status.[2] Likewise, the Kingdom of Bahrain is considered to be the hub of Islamic banking according to the Central Bank of Bahrain, which is proud to play host to the largest concentration of Islamic financial institutions in the Middle East region. A country, indeed, with an area of only 665 square kilometers has become one of the leading Islamic financial centers in the region.[3] The objective of this paper is to examine Islamic banking in Bahrain focusing on legislative changes made to accommodate it and to learn from its experiences, which may guide countries that are interested to enhance and develop the Islamic banking.

2. Method and Materials

The study adopts a qualitative research method that considers primary and secondary data. As primary data, statues such as the Central Bank of Bahrain and Financial Institutional Law 2006, the Financial Services and Markets Act 2000 of the United Kingdom and the Commercial Companies Law 2001 of Bahrain were referred. Books, journal and a number of publications published by the Central Bank of Bahrain were considered under secondary data. The Financial Services and Markets Act 2000 of the United Kingdom has been discussed in the paper in order to show that Bahrain has adopted an innovative approach.

3. Discussion and Results

This paper has been divided into five parts. The first part includes introduction, objective and methodology. The part two discusses the development of Islamic banking in Bahrain in order to give a brief sketch on it. The regulatory framework such as licensing procedure and registration of banks are elaborated in part three. The part four discusses regulatory issues such as tax and stamp duty. As Islamic banking is overtaking the conventional banking, its future prospects are discussed briefly the part five and the paper concludes with suggestions.

3.1. Development of Islamic Banking in Bahrain

With the establishment of the Bahrain Islamic Bank in 1978, the first Islamic bank, the history of Islamic banking in the country began. The Gulf War broke out in 1990 and was one of the triggers, which prompted a rapid development of Islamic banking and finance in Bahrain. The increase of oil prices and huge revenues as a result of this it stimulated the Islamic banking market escalating the demand for Islamic tailored investments and services. Since then, Bahrain has seen the flourishing growth and swift development of Islamic banking institutions (IBIs). It is, therefore, obvious that the Islamic banking system in Bahrain is undoubtedly booming. Its total assets reached $20 billion in 2006. In the same year alone, three Islamic banks were granted banking licenses with another two a year earlier. There are more banks in the queue waiting for the Central Bank's approval.[4]

This is why the Global Financial Centers Index, published in the UK, has recognized Bahrain as one of the world's fastest-growing financial centers, ranking it 39th. Looking closer at the banks in Bahrain, especially the locally incorporated banks, it is observed that they achieved a record of net profits in 2006. The immense change, which took place in 2007, was the increasing role of the Islamic banking sector, which rose dramatically by 73.2% from $666.1miliion in 2006 to $1153.4 million in 2007. This huge increase in profits was replicated in both wholesale Islamic banking (66%) and retail Islamic banking (93%), and paved the way for the growing attraction and sophistication of Islamic finance throughout the region. The Islamic banks in 2008 accounted for 50% of the aggregate net profits of Bahrain's banks, considerably higher than the 33% they accounted for in 2006. The mounting demands for Islamic banking products indicate that the role of Islamic banks in the overall profits of Bahrain's banks may even be on rise in the days to come.[5]

A variety of products such as *mudarabah, ijarah, murabahah, musharakah, salam and istisna* are provided by Islamic banks in Bahrain. Restricted and unrestricted investment account facilities are also available for customers. Similarly, almost all of the services provided by the conventional banks are provided by Islamic banks too after appropriate modification has been made to them to comply with principles of the *Shari'ah*. Consequently, the entire assets of the Islamic banks grew at the rate of 44.6% during the period of 2004-2007. This rate of growth is a clear indication of the successful over taking of the conventional banking system in the country.[6]

The demand for Islamic financial products has been tremendously increasing. This resulted in the emergence of a number of Islamic banks. Of the nine new banks licensed by the Central Bank of Bahrain (CBB) in 2007, six were Islamic banks. More importantly, Bahrain's Islamic banks are playing a competitive role both locally and globally. Recently, there was a study, which rated fifty Islamic banks globally growing fast by assets and net profits, of which twelve were Bahraini Islamic banks, which are displayed in the Table 1. This means that 24% of the total fast growing banks in the world exist in Bahrain. This upward trend is, indeed, expected to continue despite the surging competition from Dubai and Qatar.

Despite the strong competition from GCC countries, in general, and Dubai and Qatar, in particular, Bahrain remains a cornerstone in the banking sector. More importantly, it has spearheaded the Islamic banking activities in the region and has developed into the natural and well-located center for Islamic banking in the Middle East region with 29 Islamic banks with a total size of US$18.4 billion. Bahrain is at the forefront of the market for Islamic bonds (*sukuk)*. The CBB has played a leading role in the introduction of these innovative products. In 2001, the CBB became the first sovereign in the world to develop and issue *sukuk.* Since then, the CBB has an established schedule of *sukuk* issuance, which comprises short-term as well as medium to long-term *sukuk.* US$13.3 million *Sukuk al-ijarah* of six month tenure and a US$ 15.9 million issue of *sukuk al-salam* of three month tenure are each offered once a month. For the medium and long-term tenures, the CBB has offered a total of 14 issues of *ijarah sukuk* with a total value of US$2.05 billion. The most recent one, a five-year US$350 million international issue listed on the London Stock Exchange, was made in March 2008.[7]

Bahrain is pursuing a dual banking system. It is not focusing solely on Islamic banking but also encourages the presence of conventional banks. Both sectors are given equal opportunity and equal treatment. According to Al-Sayyed, there has been an increase in conventional banks in the country, but this increase has not been as significant as that of their Islamic counterparts. He further states that there is a lot of interaction going on between Islamic and conventional banks in Bahrain. A large number of specialists from the latter have moved to work at the Islamic banking institutions.[8]

Accordingly, the CBB is promoting both Islamic banking and conventional banking equally. The author is unable to agree with this stance. Bahrain is a Muslim country, which should promote only the Islamic banking system in order to fulfill the objective of the Islamic economic system that strives to abolish the *riba*-based transaction, which has been proved to be a failed system that has created huge economic turmoil globally. Bahrain may be a role model for a fully-fledged Islamic banking system that advocates good ethics, values, justice, benevolence and fairness. It is notable that three countries in the Muslim world, Iran, Pakistan and Sudan are becoming successful in the achievement of such an objective of converting their banking system into a fully *Shari'ah*-based one.

However, the conventional banking system must also be allowed to operate to a certain extent considering the reciprocal rights and obligations towards non-Muslims. In support of this suggestion, the argument of Zialdin Ahmed is quoted and the author totally agrees with that view: "The guidance for all institutional developments in an Islamic society is to be derived from the principles of the *Shari'ah*. The form and content of Islamic banking practices have therefore to be deduced from the teachings of Islam. There was no prototype of modern banks in the early history of Islam. Even in the Western countries, banking in the form in which it exists today is of comparatively recent origin. The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental principles as enunciated in the Holy Qur'an and the *Sunnah* [9].[9] Meanwhile, a number of factors have contributed for

Bahrain to becoming a leader in Islamic banking. As al-Sayyed argues, one of the key reasons is the Central Bank's policy of encouraging innovation. Every Board consists of a minimum of three people. It is up to the Board to advise the bank on various aspects of Islamic banking and to decide, which products and services are *Shari'ah* compliant.

The Central Bank, for its part, also has a Supervisory *Shari'ah* Board, but this has a different role. It deals with the issue of *sukuk.* The Central Bank does not centralize the decision-making process concerning the *Shar'iah* compliance issues of individual banks, and does not interfere in these processes. However, the author disagrees with this policy because the direct supervision of the Central Bank concerning *Shari'ah* compliance is vital in order to ensure that an Islamic bank is operated based on Islamic banking principles. Such a practice is different in some other countries, for instance, Malaysia where the Central Bank of Malaysia has to approve any innovation in Islamic banking and finance before they are introduced to the market. In addition, the *Shari'ah* boards of all of the banks in the country are subject to review by the Central Bank. The author is of the opinion that this approach may be adopted by other countries such as Bahrain when operating Islamic banks and financial institutions. In addition, creating a favourable environment for the innovations has proved to be worthwhile. The product range of Islamic banking is expanding rapidly. The Bahraini banking market has witnessed the emergence of *Shari'ah* compliant credit cards and other Islamic products.[10]

More importantly, human resource is a prime factor for the development of Islamic banking or any other sector. Thus, Bahrain has individuals who are very experienced and who have extensive knowledge in Islamic banking. Due to the country's long tradition in finance, the Central Bank offers its expertise to specialists both within the country and outside it. The Bahrain Institute of Banking and Finance was set up under the auspices of the Central Bank in 1981 to provide training and education in various aspects of finance. The Central Bank has advised a number of countries, including the USA, UK, Sudan and Malaysia, on regulatory matters, which are considered to be compliant with the best international practice.[11]

3.2. Regulatory Framework of Islamic Banking in Bahrain

The financial system comprises several elements including depositors, banks, entrepreneurs and regulators. Financial institutions operating in any country must follow some regulations enforced by the Central Monetary Authority or the Central Bank of a country to better serve the public and the national interest. The major objectives of regulating the Islamic banks are to minimize the risk of failure and to accomplish some preferred objectives. Islamic bank regulations are designed to prevent Islamic bank based in the country has its own *Shari'ah* Board that is a mandatory authority, which Islamic bank regulations are designed to prevent Islamic commercial banks from becoming too risky and uphold public confidence in the country's financial system.[12] In line with this, the CBB is the single regulator of Islamic banks and other financial institutions operating in Bahrain. It has carried out a number of reforms in these sectors. It has introduced a new modernized licensing framework for financial institutions, which became effective in October 2006. There are five licensee categories that comprise the new framework. These are Islamic banking, conventional banking, insurance, investment business and specialized licensees.[13] The Table 1 displays this in a nutshell.

Previous banking law, the Bahrain Monitory Agency Law No 23 of 1973, has been replaced by the Central Bank of Bahrain and Financial Institutional Law 2006 (CBBFIL 2006), which consists of 188 Articles. The Bahrain Monitory Agency has also been replaced by the Central Bank of Bahrain since 2006(CBB). The new legislation has not many differences in substance, but it has effectively re-organized the provisions that were in force previously. Accordingly, the licensing and supervision of Islamic and conventional banks operating in and from Bahrain are being governed by the new legislation. The law provides for minimum capital and reserve requirements, and authorizes the CBB to decide the category of business, which banks may carry out. It entrusts the CBB with the power of inspection, which is inclusive of a comprehensive system of quarterly and monthly statistical returns from banks.[14]

All regulated services should be licensed and comply with the provisions of the said Act. Section 39 of the CBBFIL 2006 defines what is meant by "Regulated Services". It provides that "Regulated Services" shall mean the "financial services" provided by the financial institutions, including those governed by Islamic *Shariah* principles. One can observe that the same terminology has been used to mean the financial services in the section 2 of the Financial Services and Markets Act 2000, UK too. Similarly, "bank" means:

1) Any corporate body licensed under the terms of this law to accept deposit, advance loans, manage and invest funds with or without providing any other related services;
2) Any person licensed under this law to accept deposit, advance loans, manage and invest deposit and savings according to *Shari'ah* principles with or without providing other related services;
3) Any other licensee as approved by the Central Bank.

It is, therefore, clear that the term bank includes the Islamic banks and the same regulation will be applied to Islamic banks. The section 39(2) is relevant to Islamic banks. Meanwhile, there is no specific regulation for Islamic banking and financial institutions in Bahrain.[15] Although the Act is comprehensive similar to the FSMA, it does not provide a special treatment for Islamic banking concerning *Shari'ah* supervision and any other related issues that might surface.

However, these issues have been remedied by other instrument complying with Standards of Accounting and Auditing of Islamic Financial Institutions (AAOIFI), which have been made mandatory for IBIs operating in Bahrain.[16] This unique arrangement may be incorporated to other countries' legislation or the Central Bank may impose as a condition for issuance of license to the Islamic banks and windows. This move may standardize the quality of Islamic banking business. Similarly, this will help find IBIs that are willing to enter into mutual agreements for enhancement of the industry.

A strong regulatory framework is in place, which is a cornerstone of the Central Bank's policy. As Al-Sayyed argues, the regulations are of the highest standard of the best international practices and are flexible. The Central Bank is in constant ongoing consultation with the industry. It does not introduce any local or international regulations without consulting the financial services industry first. This is also a similar practice set out in the FSMA 2000 of the UK.[17] Ahmad Al-Bassam, director of licensing and policy of the CBB, states that, "The CBB offers the most comprehensive and robust regulatory framework and the most stable environment something, which has become crucial in the current financial climate".[18]

"As a Central Bank, it has made every effort to create a business environment that promotes a stable foundation for Islamic finance to flourish," said Hussain Sharaf, director of Islamic Financial Institutions Supervision of the CBB. Bahrain is recognized as a leader in Islamic banking. Investors from the Muslim world have long sought investment vehicles that offer returns in an Islamic acceptable manner. It is believed that it has created a regulatory climate in Bahrain that is conducive to fostering success within this industry. Both conventional and Islamic banks are subject to the same supervisory regulations. However, Islamic banking has the unique characteristic that makes it somewhat problematical to be compliant with exactly the same regulation.[19] In order to address this issue, IBIs in Bahrain are required to comply with the Standards of the AAOIFI. This is mandatory. The AAOIFI has issued a number of standards on accounting, auditing, ethics, governance and *Shari'ah* and it continues to revise them from time to time. This is a very useful move, which regulates IBIs in various aspects. The Bahrain regulators made an attempt to set a standard equivalent to the standard required to be adopted by conventional banks, which are based on the International Accounting Standards (IAS).[20]

Bahrain was one of the first countries to develop and implement regulations specific to Islamic banking to issue *sukuk*. In addition, the *waqf* fund was established in 2006 by the CBB to fund Islamic banking research, education and training. This is an evidence of the CBB's innovative approach and steering role towards the promotion of the industry. Another indication of Bahrain's role in the growth of Islamic banking is that it has been chosen as the host country for many international organizations whose goal is to give the right direction for the industry and set acceptable standards for Islamic banking. As such, the AAOIFI, the Liquidity Management Centre

(LMC), the International Islamic Financial Market (IIFM) and the Islamic International Rating Agency (IIRA) are housed in Bahrain and it is evident that Bahrain has much in terms of expertise, knowledge, and practical experience to offer the international Islamic banking and finance industry.[21] It has to be pointed out that these factors are crucial to regulate the Islamic banking industry effectively.

3.2.1. Registration of Islamic Banks under the Company Law 2001

Islamic banks are required to be registered under the CBBFIL 2006(The Central Bank and Financial Institutions Law, 2006: Article 40(b) and the Commercial Companies Law 2001(CCL) (The Company Law 2001 of Bahrain: Article: 6) The Article (2) of the CCL provides that a commercial company incorporated in the State of Bahrain shall take one of the following, otherwise, it shall be null and void:

1) General Partnership Company;
2) Limited Partnership Company;
3) Association in Participation;
4) Joint Stock Company;
5) Limited Partnership by Shares;
6) Limited Liability Company;
7) Single Person Company; and
8) Holding Company.

It is noteworthy to point out that an Islamic bank can be operated by a single person under the Single Person Company incorporated under the said Act subject to Art. (1) and 40(b) of the CBBFIL 2006, which provides that the bank means "Any person licensed under this law to accept, manage and invest deposits and savings according to the Islamic *Shari'ah* principles with or without providing other related services. In addition, Art. (1) Illustrates that "any person" will include natural and corporate persons.

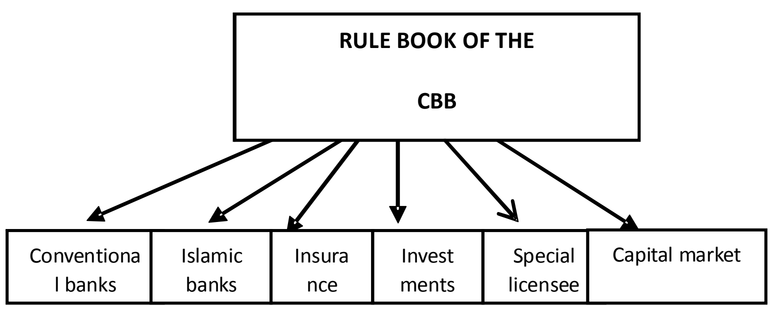
Further, it is mandatory that the Company's Memorandum of Association and amendments thereto shall be drawn up in Arabic and attested by a Notary Public; otherwise, it would be rendered null and void. Nevertheless, Association in Participation is exempted from this requirement.[22]

3.2.2. Licensing Procedure

Article 40 of the CBBFIL 2006 prescribes that no person may undertake a regulated service in the Kingdom of Bahrain unless licensed by the CBB. The CBB Rulebook provides comprehensive guidelines on the licensing process and associated matters of Islamic banks and other regulated services. Additionally, Islamic banks seeking a license must be registered under the Commercial Companies Law 2001. By virtue of Article (40) of the CBBFIL 2006, without due regard to the provisions of the CCL 2001, no financial institutions shall be established in the Kingdom of Bahrain with the exception of the approval from the Central Bank.[23]

The CBB Rulebook classifies the licensing category into six volumes. Volumes one and two cover conventional and Islamic banks respectively. Volumes 3, 4, 5 and 6 have been allocated to cover insurance, investment business, special licensees and capital market licensees, respectively. See the Table 1 that is displayed below.

Table 1
Classification of financial institutions for Licensing in Bahrain



Moreover, the Rulebook of the CBB contains the procedures to be followed by an applicant to provide regulated services. Thus, applicants are strongly instructed to communicate with the CBB in advance in order to get guidance on the CBB's license categories and other related essential requirements. Prior to submitting the application for a license officially there would be a meeting, which is called the "pre-application meeting" between the director in charge of the issuance of licenses and the applicant. There would be more than one meeting if the circumstances require so determining suitability to provide such a license. Applicants are expected to submit a proposal, which contains a short summary of their proposed business, mention of identified issues or questions and other related matters.

Subsequently, the Central Bank will issue license or refuse to do so if requirements are not met. Furthermore, the application for a license under Articles 44 to 47 of the CBBFIL 2006 will be processed within 60 calendar days and the CBB is required to make a decision within that period. In addition, an applicant for a license is expected to submit all the documents as required by the CBB such as "a completed Form 1" together with all supporting documentation as specified in the form, under cover of a letter signed by an authorized signatory of the applicant.[24]

3.2.3. Vigilant Supervision

As Mashar M. Islam states, prudential information on returns is required from all banks operating in Bahrain. This includes quarterly prudential information returns, besides monthly and half yearly statistical returns, and yearly returns concerning management personnel and foreign exchange dealers. In addition, the auditor's management letter together with the response from the bank's management is required by the CBB. In order to avoid potential risk, Islamic banks are instructed to comply with five International Islamic Financial Accounting Standard (IFAS) and also to publish this information as supplement to their audited financial statements. This was made effective in 1997. Eventually, the audited accounts must be submitted to the CBB within 3 months of the end of the calendar year. External auditors are appointed annually and must be acceptable to the CBB. It has direct access to auditors in order to protect the financial integrity of a bank. Direct access to auditors by the CBB is allowed at the discretion of the auditors. Inspection is carried out on a regular basis that can cover any aspects of a bank's operations. Regular meetings are held with the senior management of banks to discuss past performance and future strategies. The CBB maintains a close coordination with auditors in accordance with the Bank for International Settlements (BIS) directives. Meetings are held with all locally incorporated banks in order to discuss issues such as capital adequacy, asset quality, internal control, profitability and liquidity. Inspections are carried out related to management, control systems, accounting and other book keeping records. Moneychangers provide the CBB with monthly turnover returns and quarterly Profit & Loss and balance sheet statements.[25]

3.2.4. Capital Adequacy

The minimum legal paid-in capital requirement is set according to each category of bank. Islamic banks are required to have initial capital of at least US$10 million. However, this rule may be relaxed in order to determine appropriate levels to be agreed with the CBB on a case-by- case basis. Furthermore, at all times an adequate level of capital funds must be maintained, measured on a risk-weighted basis in accordance with the Basel arrangements. In January 1998, the minimum risk-asset ratio was increased to 12% from the Basel recommended and internationally accepted minimum of 8%.[26]

3.2.5. Deposit Protection

In 1993, a deposit protection scheme was introduced under which deposits with the Bahrain offices of all commercial banks are protected in the event of a bank failure. This scheme provides up to the lesser of three quarters of the total amount or US$40,000. Government banks including the CBB and related parties are not entitled to this protection. Payments under the scheme will be met by contributions from all other commercial banks.[27]

In addition, the CBBFIL 2006 provides the Council may issue regulations to protect deposits and other rights of the customers of the licensee. Such regulations shall provide for compensating such customers in cases where the licensee is unable, or appears likely to be unable to meet claims made against him. The regulation may provide for the formation of one or more funds. Such funds shall constitute a separate corporate body and have an independent balance sheet and special regulations to be approved by a resolution issued by the Central Bank.[28]

3.2.6. Controls on Liquidity

It is the responsibility of the management to maintain adequate liquidity. A liquidity policy shall be agreed with the CBB concerning the high quality liquid assets and ability to meet obligations in due time.[29]

3.2.7. Dispute Resolution

Legal provisions are in place to resolve the disputes arising among IBIs. The CBBFIL 2006 provides that a Dispute Resolution Committee (DRC) shall be established in the Central Bank and shall have exclusive authority for settling disputes between the licensees. The committee shall be formed by a resolution to be made by the Council every three years as follows.[30]

1) Three judges of the High Court of Appeals to be delegated by the High Judiciary Council. The Committee shall be chaired by the most senior judge among the three;
2) Two of the senior officials of the Central Bank or two qualified personnel of high standing in finance services to be nominated by the Governor.

The two members of the Committee, other than the judges, shall take an oath before the chairman of the Committee to the effect that they will carry out their mission sincerely and with conscience, and participate in the discussions of the Committee without having the right of voting with respect to the decisions issued by the Committee. The decisions of the Committee shall be explained and reached by a majority vote, however, in case of a tied vote; the chairman's side shall have the casting vote. Such decisions, after drafting of the same by the clerks of the said court, shall have the force of a resolution issued by the High Court of Appeals. The execution judge shall undertake the implementation of the decisions taken by the Committee pursuant to the provisions of the Civil and Trade Procedure Law. The Committee may decide to hear the witnesses and to assign experts to investigate all documents relevant to the dispute and take all measures necessary to the settling thereof. The Minister of Justice, in agreement with the Council, may issue a resolution to specify the procedures to be followed in presenting a dispute before the Committee and the manner of delivering the Committee's decisions to the relevant parties, and the remuneration of the members of the Committee.[31]This provision is unique and this may be incorporated to banking laws of other jurisdictions, which lacks in this regard.

3.2.8. Provisions for Bad and Doubtful Assets

Provisions are in place to monitor Islamic banks on a quarterly basis. Inspections and prudential meetings make policy and its compliance. If this arrangement is considered to be inadequate, measures are taken to motivate the banks to re-examine their policy and take the necessary action. The CBB applies the Bank of England's matrix formula for deciding upon the level of provisions required against problematic loans to sovereign borrowers.[32]

4. Regulatory Issues in Islamic Banking in Bahrain

The law of Bahrain represents a mixture of the *Shari'ah*, tribal law, and other civil codes and regulations. The new constitution promises an independent judiciary. The Higher Judicial Council supervises the courts. Courts have been granted the power of judicial review.[33] According to Article 2 of the Bahrain Constitution, the religion of the State is Islam. The *Shari'ah* is a principal source for legislation. The official language is Arabic.[34] However, *Shari'ah* has only a little role to play. It governs only family matters such as marriage and divorce. Commercial matters are governed by the English common law and the High Court has the jurisdiction to hear commercial case. Cases, therefore, concerning Islamic banking are also tried in the same court. However, a large part of the laws of Bahrain are based on published statutes, which derive from the *Shari'ah*. The Contract

Law and Civil Wrongs Ordinance 1970 are based on the principles of English common law, which were originally adopted during the British protectorate period. Much recent legislation is based upon and follows a civil-law format, much in the style of Egypt and France.[35] Nevertheless, one might expect that when Islamic banking cases are disposed, the *Shari'ah* would play a big role, as judges are familiar with the *Shari'ah.* This presumption is proved based on the Article 3 of Judicial Law of Bahrain: "Where a judge does not find a statutory provision that is applicable he shall derive the basis of his judgment from the principles of Islamic *Shari'ah* law. In the absence of *Shari'ah* provisions, rules of custom shall be applied. Special custom will apply over general custom. Where there is no custom, principles of natural law, justice and good conscience shall be applicable.[36]

As far as taxation is concerned, the single corporate income tax in Bahrain is levied only on oil, gas and petroleum companies at a rate of 46 percent. This tax is applicable to any oil company conducting its business activity in Bahrain of any kind, including oil exploration, production, or refining, regardless of the company's place of incorporation. However, 1% is levied on salaries, which go to an employment and training fund.[37] In addition, Bahrain has no value added tax, property tax or production tax.[38] It is, therefore, clear that no income tax is charged on other businesses, including Islamic banks. It is notable that there is no individual income tax either in Bahrain. However, employers who employ more than ten employees, irrespective of their nationality, must pay 10 percent of the employee's gross income to social welfare taxes. The employer's contribution is 7 percent of gross wages for insurance against old age, disability and death. This arrangement is applicable only to Bahraini employees. In the meantime, 3 percent of gross wages for insurance against employment injuries is applicable to all employees. The employee's contribution is five percent of gross wages for insurance against old age, disability and death, which is applicable to Bahraini employees only.[39] In line with this, an Islamic bank consisting of more than ten employees must comply with the above legislation.

5. Future Prospects of Islamic Banking in Bahrain

Bahrain might be small in size but to the Islamic banking industry it is being recognized as bigger and a veritable giant. It has become an international hub for Islamic banking by hosting the biggest concentration of Islamic financial institutions in the Gulf. It also plays host to a number of global organizations conducive to the evolution of Islamic banking, notably the AAOIFI, the International Islamic Financial Market, the Liquidity Management Centre, the Islamic International Rating Agency etc. It is anticipated that the presence of those institutions will help the Islamic banking industry grow faster than ever and there is no doubt that it would remain an international hub for Islamic banking in the days to come.

The Government of Bahrain has set out to make the country into the Singapore or Hong Kong of the Gulf, and, hopefully, of the whole Middle East and South Asia. Although at present wholly or partially government-owned enterprises dominate the economy, laws and regulations have been overhauled in recent years, particularly since 1990, in an attempt to make the business climate as welcoming as possible for free enterprise and in order to attract foreign companies.[40] Exemption from income tax, property tax, value added tax (VAT) or production tax (Excise Duty), indeed, provides incentives to the Islamic banking industry, which will grow much faster as there are no notable hurdles unlike other jurisdictions. This will attract offshore Islamic banks as well to locate their business in Bahrain.

The growth rate of Islamic banking is relatively higher than the conventional banking in Bahrain. Conventional banks face hard competition from Islamic banking. Some banks want to convert themselves into Islamic banks in order to survive. This trend suggests that a fully Islamic banking system would soon dominate the country joining the countries that already have a fully Islamic banking system such as Pakistan, Sudan and Iran.

The *Waqf* Fund was established in 2006 by the CBB, with contributions from the Central Bank and eight leading Islamic banks in Bahrain. Its members now include 18 leading Islamic financial institutions, in addition to the CBB, with the aim of advancing

Islamic finance training, education and research. Its capital contributions, which stand at approximately US$7 million, allow the fund to pursue these goals through a broad range of initiatives. Apart from its work in training and research, the fund also acts as an industry incubator by hosting roundtable discussions on development issues where leading figures focus on key issues and recommend the best way forward for the industry.[41] The constant research and training would find solutions to various problems the industry may face.

6. Conclusion

Bahrain is a leader in Islamic banking in the Middle East. It is a Muslim country where the influence of Islamic law is in force to a great extent despite it is not being fully under *Shari'ah* jurisdiction. However, the industry is growing tremendously in the country. However, it has different problems and challenges in promoting the industry. Most of the problems can be resolved thorough discussions and the exchange of ideas. Staff and staff development are common problems for all Islamic banks in Bahrain, which requires an operating staff knowledgeable both in the conventional as well as Islamic principles governing Islamic banking. Staffs with such qualities are hard to meet.

Meanwhile, Bahrain is also becoming a regional and international hub for Islamic banking industry. It has also made a considerable contribution to the industry. It remains a host country for a large number of Islamic banking and finance organisations in the world, e.g. AAOIFI. Additionally, it has the capability to play a major role in promoting and shaping the industry both within the region and globally. As Bahrain is a country with a number of *Shari'ah* scholars, it may concentrate more on resolving issues in relation to the *Shari'ah.* The Islamic banking industry in Bahrain is regulated by one regulator, the CBB. With the benefit of its experience, it may become actively involved in an effort to provide a balanced system of regulation to the world. The CBB borrowed a number of good things from the UK regulatory system and additionally it has made AAOIFI's *Shar'ah* Standard compulsory for Islamic banks to comply with them. Due to this, it has a comprehensive system of Islamic banking legislation, perhaps one suitable for the whole world.

In addition, in Bahrain, there are no specific issues like double or dual taxation, double stamp duty or any other legal issues, which might surface in a non-Muslim jurisdiction. Therefore, Bahrain will continue to be an international hub for Islamic banking due to the liberal policy it always seems to adopt in relation to Islamic banking. It is noteworthy to point out that, there is no income tax, value added tax, property tax or any other taxes in Bahrain. Instead, it gives a number of incentives for business including Islamic banking. For example, only 5% custom levy is imposed for normal goods imported. The foreign companies are given the right to full ownership. Eventually, Bahrain could be an ideal example for a country that makes efforts to promote Islamic banking.

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