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Central Bank of Bahrain

Financial Stability Directorate

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Table of Contents

Preface.....	4
Executive Summary	6
1. International and Domestic Macro-Financial Developments.....	10
2. The Non-Financial Sector.....	16
2.1. Households	16
2.2. Business Enterprises	19
2.3. Construction and Real Estate	21
3. Financial Condition and Performance of the Banking Sector	24
3.1. Conventional Retail Banks.....	25
3.2. Conventional Wholesale Banks	30
3.3. Islamic Retail Banks	35
3.4. Islamic Wholesale Banks.....	37
3.5. Overall Assessment of the Banking Sector.....	38
4. Financial Condition and Performance of the Insurance Industry	40
5. Performance of Equity Markets	43
6. Payment and Settlement Systems.....	47
6.1. Key Trends in Payment and Settlement Systems.....	47
6.2. Assessment of Payment and Settlement Systems	52

List of Tables

Table 1.1: Global Output Growth—2006-2008.....	11
Table 1.2: Bahrain—Selected Macroeconomic Indicators	14
Table 1.3: Aggregate Economic Indicators for the GCC Countries	15
Table 2.1: Average Monthly Wages (BD)	19
Table 2.2: Commercial Licenses Issued for Construction and Real Estate	21
Table 2.3: Selected Construction Permits by Type	21
Table 2.4: Trading in Land (BD Million).....	21
Table 2.5: Bahrain Land Prices—Selected Areas, 2005 vs. 2007**	22
Table 3.1: Distribution of Retail Bank Lending.....	26
Table 3.2: Distribution of Retail Bank Lending.....	27
Table 3.3: Retail Banks’ NPL Ratios by Sector	28

Table 3.4: Retail Banks' Coverage Ratios by Sector	28
Table 3.5: Ratings for Locally-Incorporated Retail Banks	29
Table 3.6: Wholesale Banks' NPL Ratios by Sector	31
Table 3.7: Wholesale Banks' Coverage Ratios by Sector	32
Table 3.8: Distribution of Wholesale Bank Lending	32
Table 3.9: Distribution of Wholesale Bank Lending	33
Table 3.10: Wholesale Banks--Local Currency Deposit Ratings.....	34
Table 3.11: Retail Islamic Banks-Local Currency Deposit Ratings	36
Table 3.12 : Wholesale Islamic Banks--Local Currency Deposit Ratings	38
Table 4.1 : Ratings for Bahraini Insurance Companies.....	42
Table 5.1: Market Capitalization on the Bahrain Stock Exchange	44
Table 5.2: Sectoral Indices of Bahrain All-Share Index.....	45
Table 5.3: BSE—Price-Earning Multiples.....	45
Table 5.4: BSE—Value of Shares Traded by Sector	46

List of Charts

Chart 1.1: Global Consumer Prices (%)*	12
Chart 2.1: Personal Loans and advances (% of GDP)	17
Chart 2.2: Growth Rate of Total Personal Loans and Advances (%).....	18
Chart 2.3: Business Loans and Advances (% of Non-Financial GDP).....	20
Chart 5.1: 2007 Performance of BSE All-Share Index (% changes)	44
Chart 6.1: RTGS System: Average Daily Volume and Value of Payments Processed	49
Chart 6.2: ACS System: Average Daily Volume and Value of Payments Processed	50
Chart 6.3: Number and Value of ATM Transactions	51

List of Boxes

Box 3.1: Exposure of Bahraini Banks to the Real Estate Sector.....	39
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Preface

Financial stability can be defined as a situation where the financial system is able to function prudently, efficiently and uninterrupted, even in the face of adverse shocks¹.

As the single regulator for the Bahraini financial system, the Central Bank of Bahrain (CBB) attaches utmost importance to fostering the soundness and stability of the financial system. This emphasis stems from CBB's recognition that financial stability is critical to maintaining Bahrain's position as a regional financial center and ensuring that the sector continues to contribute significantly to growth, employment and development in Bahrain.

In pursuit of its objective of promoting financial stability, the CBB conducts regular financial sector surveillance, keeping a close watch on developments in individual institutions as well as in the system as a whole.

The *Financial Stability Report* (FSR) is one of the key components of CBB's financial sector surveillance framework. Produced semi-annually by the Financial Stability Directorate (FSD), its principal purpose is macro-prudential surveillance, assessing the safety and soundness of the financial system as a whole (intermediaries, markets and payments/settlement systems). The ultimate objective of such macro-prudential analysis is to identify potential risks to financial stability and mitigate them before they crystallize into systemic financial turbulence.

This edition of the FSR is organized into six chapters as follows: Chapter 1 reviews recent international and domestic macroeconomic developments, assessing possible implications for financial stability in Bahrain. Chapter 2 examines the financial position of households and business enterprises as well as trends in the construction and real estate sector. Chapter 3 evaluates the

¹ This definition has been slightly modified in comparison to previous editions of the *Financial Stability Report*.

financial condition and performance of the banking sector (conventional and Islamic), while Chapter 4 assesses the financial condition and performance of the conventional insurance industry. Chapter 5 reviews recent trends on the equity market while Chapter 6 examines stability issues relating to the payment and settlement systems.

Unless indicated otherwise, this report analyzes data covering the period between end-March 2007 and end-September 2007.

Executive Summary

Overall assessment

The Bahraini financial system is in a robust shape. Operating within a sound domestic macroeconomic environment, financial intermediaries exhibit solid financial health and have not been affected adversely by the ongoing global financial turbulence.

Expanding bank balance sheets are adequately underpinned by high capital adequacy, low non-performing assets, plenty of liquidity, continued growth of earnings and stable ratings from accredited rating agencies. The equity market has regained momentum, after experiencing selling pressures in the early part of 2007. The safety and security of the payments and settlement system has been strengthened considerably, following the introduction of a Real Time Gross Settlement System (RTGS) and a Scripless Securities Settlement System (SSSS) for government securities. Additional comfort comes from the state of the non-financial sector as the debt burden of Bahraini households continues to fall and rapid growth of non-financial corporations provides support for the current debt burdens of the business sector. Nonetheless, this report identifies some issues that require attention from a financial stability perspective.

International and domestic macroeconomic trends

In the wake of the global financial turbulence, expectations of world output growth have been dampened with a 4.8% growth rate now forecast for 2008. The ongoing difficulties of the United States' economy suggest that the performance of the global economy will depend largely on economic performance in emerging markets, notably China and India.

International financial markets experienced a meltdown in the latter half of 2007 with a serious liquidity "dry-out", increased volatility, and a sharply-reduced investor appetite for risk. Several notable international banks suffered huge marked-to-market losses on mortgage-related assets. A classic bank run

occurred in England as *Northern Rock*, a mortgage lender, suffered mass withdrawal of deposits, following disclosure of its difficulties in obtaining liquidity. Fearful of the potential adverse impact on the real economy, the US Federal Reserve has been compelled to cut interest rates three times by a total of 100 basis points and the European Central Bank (ECB) has injected massive amounts of liquidity into the market. The Bank of England also cut its bank rate by 25 basis points in early December 2007.

The size of *global trade imbalances* continues to evoke concern, despite the beneficial effect of a weakening dollar on the US current account deficit. As *oil prices* hovered around \$100 per barrel in November 2007, the large surpluses of the oil exporting countries appear set to expand further in the coming months. Also, stronger demand and rising food prices are beginning to put upward pressure on *inflation* in emerging market and developing economies.

The *macroeconomic outlook* for Bahrain is satisfactory, providing a favourable environment for financial intermediaries and markets. The outlook for the GCC countries in general continues to be positive, although concerns are increasing about inflationary pressures, particularly in Qatar, Saudi Arabia and the UAE.

The non-financial sector

Household debt burdens have been further reduced in the second half of 2007, with the personal loans-to-GDP ratio falling to 19.6%. This trend is welcome, given the fact that interest rates on personal loans have stayed high, despite recent cuts in interest rates. In contrast, the level of indebtedness in *the business sector* rose, with the ratio of business loans to non-financial GDP reaching 49.1% in September 2007, compared to 45.8% in March 2007.

The robust performance of the non-oil sector continues and a 7.7% growth rate is forecast for 2007. The boom in *construction and real estate development* also persists as evidenced by soaring land prices. The main financial stability issue emanating from the non-financial sector is the emerging oversupply of properties (residential and commercial) in the real estate sector, in the face of growing bank exposures to the sector. In response, the Central Bank of Bahrain has now proposed limits on the real estate exposures of banks (see Box 3.1).

The banking sector

Against the background of recently-completed structural changes, *domestic banking institutions* (conventional and Islamic) show sound financial health, as rapidly expanding balance sheets are underpinned by high capital adequacy, low non-performing assets, plenty of liquidity, continued growth of earnings and stable ratings from accredited rating agencies. Negative points include evidence of sectoral concentration in bank portfolios as well as the aforementioned rapid growth in banks' exposure to the construction and real estate sector.

The insurance industry

The insurance sector is in good shape as evidenced by comfortable solvency margins, rising profitability and improved performance of insurance stocks. However, the relatively high levels of insurance receivables require attention as this could become a source of credit risk to insurance companies.

Equity markets

The *Bahrain stock market* has fully regained momentum, following selling pressures experienced in the early months of 2007. Year-on-year, market capitalization has risen by 22%, reaching BD9.7 billion in October 2007 (129% of nominal GDP). Between May and October 2007, the All-Share Index gained over 300 points. Valuations have consequently increased, with the price-earning (P-E) multiple standing at 12.52 in October 2007, compared to 10.86 in May.

Payments and settlement system

The *payments and settlement infrastructure* has been strengthened considerably, with the introduction of a new Real Time Gross Settlement (RTGS) System and the Scripless Securities Settlement System (SSSS). These initiatives have served to reduce credit and liquidity risks substantially. One outstanding concern relates to the settlement agent risk associated with the clearing and settlement of equity trades on the Bahrain Stock Exchange (BSE).

Financial Stability Alerts

Although the overall financial stability assessment indicates no serious concerns about the safety and soundness of the Bahraini financial system, the following areas warrant attention:

- Bahraini banks (conventional and Islamic) have high exposures to the construction and real estate sector. These exposures have also grown rapidly in recent months. CBB is responding to this situation by proposing limits on banks' real estate exposures (see Chapter 3, Box 3.1).
- Although non-performing loans in construction continue to diminish, coverage ratios (i.e. provisions and interest in suspense as a proportion of non-performing loans) are low in this sector for both retail and wholesale banks.
- Conventional retail bank lending is concentrated, with two sectors ("consumer and personal" and "financial") accounting for over 40% of the loan book of locally-incorporated banks. Overseas retail banks have over 30% of their loans in a single sector (manufacturing).
- Conventional wholesale banks also show concentrated portfolios. Both locally-incorporated and overseas wholesale banks have almost 70% of their loan portfolio in three sectors ("financial", "services" and "manufacturing").
- Insurance companies have relatively high levels of insurance receivables which could become a source of credit risk.
- As mentioned in the *July 2007 Financial Stability Report*, the clearing and settlement system on the Bahrain Stock Exchange is exposed to *settlement agent risk*.

1. International and Domestic Macro-Financial Developments²

Key Points

Recent financial turbulence could threaten global growth

The size of global trade imbalances still worrisome

Oil prices reach record highs

Satisfactory macroeconomic outlook for Bahrain

Inflationary pressures in some GCC countries

From a financial stability perspective, a review of international macroeconomic trends is important because globalization has increased the potential for cross-border transmission of economic and financial shocks. This is particularly relevant to Bahrain, as a small, open economy with a fixed exchange rate and fully open capital account.

In addition, developments in the domestic macroeconomic environment have a strong influence on financial stability as adverse movements in key macroeconomic indicators can increase various types of risk facing financial institutions or lead to the emergence of serious vulnerabilities. Indeed, lessons of experience with episodes of financial crisis have shown that macroeconomic shocks have often preceded financial crises.

² This chapter draws on various projections contained in the IMF's, *World Economic Outlook*, October 2007 and *Global Financial Stability Report*, October 2007.

Recent financial turbulence could threaten global growth

The recent turbulence in global financial markets has dampened global growth expectations somewhat, with the IMF revising its 2008 growth projections downward by half a percentage point. At 4.8%, global growth is still estimated to remain strong in 2008 largely on the back of impressive output expansion in emerging economies, particularly China and India (Table 1.1). The growth performance of emerging economies is therefore anticipated to compensate for any slowdown in output from the United States as the probability of recession increases in the world's largest economy. Nonetheless, the restoration of financial stability is paramount as ongoing financial stress could still damage economic growth through its negative impact on domestic demand in key economies.

Table 1.1: Global Output Growth – 2006-2008

	2005	2006	2007*	2008*
World	4.8	5.4	5.2	4.8
United States	3.1	2.9	1.9	1.9
Euro Area	1.5	2.8	2.5	2.1
Japan	1.9	2.2	2.0	1.7
Developing Asia	9.2	9.8	9.8	8.8
---China	10.4	11.1	11.5	10.0
---India	9.0	9.7	8.9	8.4
Middle East	5.4	5.6	5.9	5.9
Africa	5.6	5.6	5.7	6.5

*IMF projections.

Source: IMF, *World Economic Outlook*, October 2007.

Global trade imbalances still worrisome

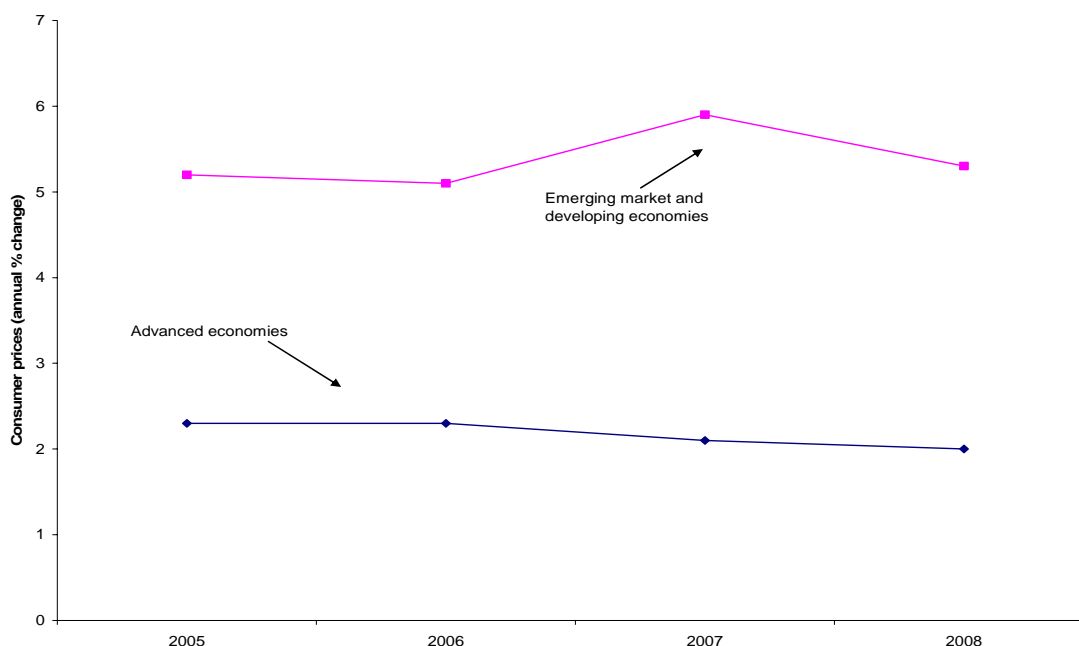
As mentioned in the January 2007 and July 2007 *Financial Stability Reports*, the current large imbalances in world trade continues to be a source of concern. Large US current account deficits currently amounting to 5.5% of GDP correspond to sizeable surpluses in China, Japan and the oil exporting Gulf countries. Although the recent depreciation of the US dollar should continue to

help reduce American imports and expand export volumes, concerns of a disorderly adjustment still remain. In particular, the recent financial turbulence has raised fears of disruptions to the flow of foreign capital to finance the US current account deficit.

Inflationary pressures appear in emerging markets

Due to a combination of stronger demand and rising food prices, inflation is beginning to rise in emerging market and developing economies with a 5.9% rate expected for 2007 (compared to 5.1% in 2006) before falling to 5.3% in 2008 (Chart 1.1). Inflation rates should remain modest in the advanced economies, with consumer prices increasing by an average of 2.1% in 2007 (versus 2.3% in 2006) and 2.0% in 2008.

Chart 1.1: Global Consumer Prices (%)*



*2007 and 2008 are IMF projections

Source: IMF, *World Economic Outlook*, October 2007

Turbulence in global financial markets

The unusually benign conditions in global financial markets finally ended in the summer of 2007 with a serious liquidity “dry-out”, increased volatility, and a sharply-reduced investor appetite for risk. The trigger was the accumulation of arrears on US sub-prime mortgage loans which translated into huge marked-to-market losses for several global financial institutions and a widespread hoarding of liquidity. The markets for sophisticated “structured products” such as Collateralized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs), and Credit Default Swaps (CDS) were particularly hard-hit by the market convulsions.

Further disruptions in the money market led to a near-collapse of the inter-bank market, compelling the US Federal Reserve to cut interest rates thrice by a total of 100 basis points in addition to massive injections of liquidity into the system by the European Central Bank (ECB). The Bank of England also cut its bank rate by 25 basis points in early December 2007. In the UK, *Northern Rock*, a mortgage lender heavily dependent on the money market for funding, suffered a classic bank run as news emerged that it had received emergency assistance from the Bank of England.

The initial impact of this crisis on emerging markets has been minimal, given the relative lack of structured products in these markets. However, some Gulf-based financial institutions reportedly suffered valuation losses on their limited holdings of these structured products. Nonetheless, the crisis has persisted with occasional convulsions in the wholesale credit markets and there is some nervousness that the turbulence might spread to the emerging markets. The widespread belief that much larger losses would be announced by international banks at year-end has further undermined confidence in financial markets.

Oil prices reach record highs

In November 2007, oil prices reached record highs of \$99 per barrel on the back of stronger-than-predicted global demand. The surge in prices also came from fears of supply disruptions, heightened by the continuing tension between Iran

and the United States and the decision of the Turkish parliament to allow military incursions into Northern Iraq in pursuit of Kurdish guerillas. In early December 2007, oil prices began to soften as expectations leaned towards an economic slowdown in the United States with the attendant reduction in the demand for oil. Prices have subsequently moderated to around \$86 per barrel.

Satisfactory macroeconomic outlook for Bahrain

Available projections indicate that Bahrain's *real GDP* will increase by 6.6% in 2007, slightly higher than the 6.5% growth recorded last year (Table 1.2). The non-oil sector will continue to grow, albeit at a slightly slower rate (7.7% vs. 8%). *Inflation*, as measured by the official Consumer Price Index (CPI) is estimated at 4.9% as at November 2007. However, this number is based on a new 2006 CPI basket and is not directly comparable to the inflation numbers reported in previous years. The *current account surplus* is projected to increase further to around 16% of GDP, influenced largely by high levels of oil and aluminum prices. The import coverage of international reserves is forecast to decrease to 3.2 months in 2007, compared to 3.8 months in 2006.

Table 1.2: Bahrain – Selected Macroeconomic Indicators

	2005	2006	2007*
Real GDP growth (%)	7.9	6.5	6.6
<i>Oil sector (%)</i>	-8.8	-1.0	0.3
<i>Non-oil sector (%)</i>	11.6	8.0	7.7
Inflation (CPI)	2.6	2.2	4.9**
Fiscal balance (% of GDP)	3.4	2.7	1.7
Domestic Government Debt (% of GDP)	19.6	15.7	11.2
M2 Growth (%)	22.0	15.0	34
Export growth (%)	33.3	15.3	21.5
Import growth (%)	22.5	12.6	19.0
Current account balance (% of GDP)	11.0	13.3	16.2
International reserves (months of imports)	3.1	3.8	3.2

*Estimates only

** Please note that CPI numbers from 2007 onwards are not directly comparable to previous years due to the construction of a new CPI basket in 2006. Number shown is as at end-November 2007

Source: Central Bank of Bahrain, Ministry of Finance and Central Informatics Organisation

Positive outlook for GCC economies, but inflationary pressures building

The outlook for GCC economies remains positive, given continued high oil prices (see Table 1.3. The oil windfall has allowed high levels of private and public sector investment, supporting strong GDP growth, particularly in the non-oil sector. The strong growth performance has however been accompanied by increasing inflationary pressures, notably in Qatar and the UAE. Given the fact that GCC currencies (except the Kuwaiti dinar) are pegged to the US dollar, there is an ongoing debate about the possible contribution of the weakening dollar to imported inflation. Regardless of source, containing inflation has now become a key objective of GCC governments in the short- to medium-term.

Table 1.3: Aggregate Economic Indicators for the GCC Countries

	2005	2006	2007*
Nominal GDP (USD billion)	612.3	717.9	799.7
% Change	26.8	17.2	11.4
GDP Per Capita (USD '000)	17.5	19.8	21.3
Real GDP (% Change)	6.8	6.1	5.2
<i>Hydrocarbon GDP</i>	3.2	2.7	1.4
<i>Non-Hydrocarbon GDP</i>	8.5	8.9	8.0
Inflation (%)	4.1	5.3	6.7
External Debt (% of GDP)	19.2	26.5	28.3
Fiscal Balance(% of GDP)	20.3	22.8	18.8
Central Gov. Debt (% of GDP)	27.9	22.3	16.9

**estimates*

Source: Institute of International Finance

2. The Non-Financial Sector

Key Points

Household debt burdens fall further

Business debt burden continues to increase

Soaring levels of activity in construction and real estate

The assessment of financial stability requires an evaluation of the financial condition and performance of non-financial entities: households, business enterprises, as well as the construction and real estate sector. Households and business enterprises are the major customers of financial institutions. Not only are they sources of deposits, they represent major sources of demand for financial sector products and services. The financial condition and performance of financial institutions therefore depend to a large extent on the financial condition of their customers (households and enterprises) and their vulnerabilities to changes in the economic environment.

The construction and real estate sector receives special attention because this sector is usually highly sensitive to developments in macroeconomic conditions and financial institutions in Bahrain have direct and indirect exposures to the sector.

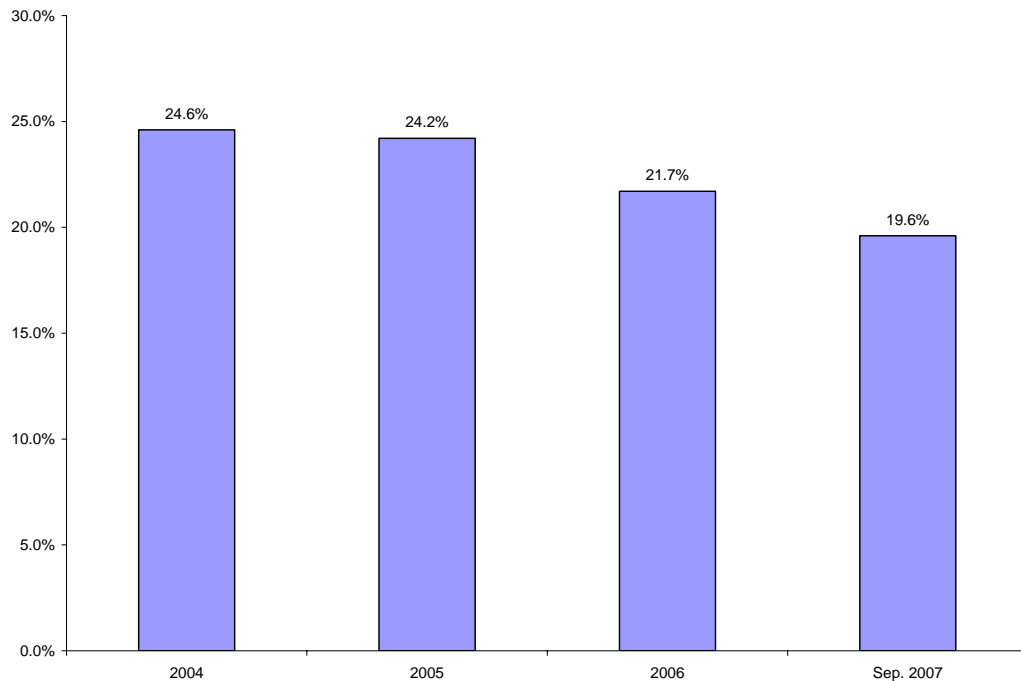
2.1. Households

Further shrinkage in household debt burden

Using outstanding personal loans from all banks as a proxy for “household” borrowing, we observe that the household debt burden has continued to diminish during 2007. The ratio of personal loans to GDP declined from 21.7% as at end-2006 to 19.6% by the end of September 2007

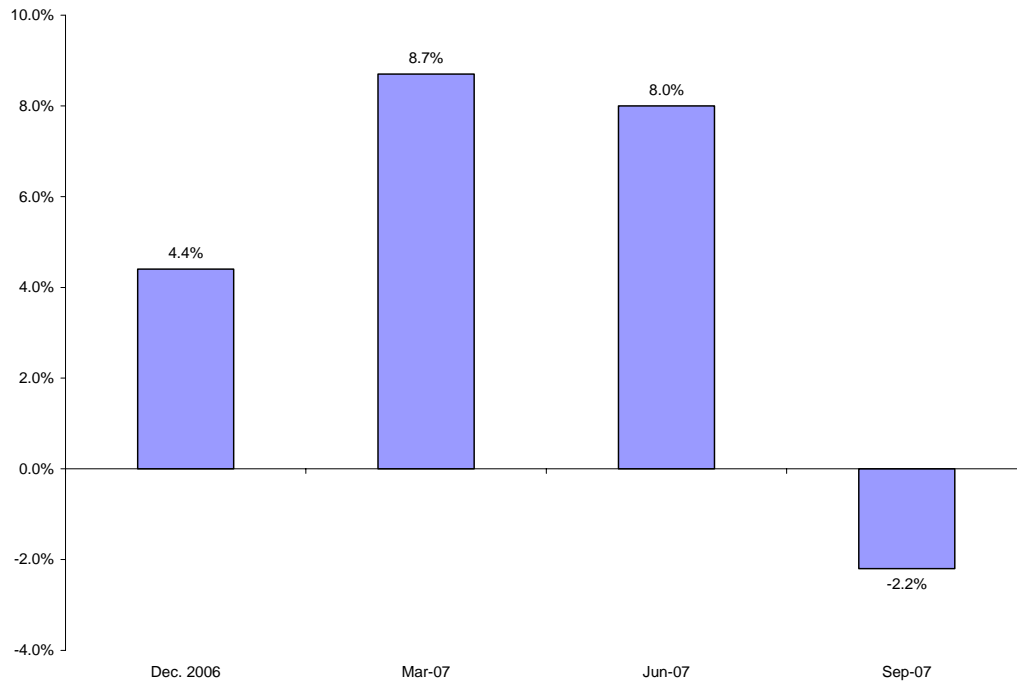
(Chart 2.1)³. Correspondingly, personal loans recorded negative growth during the third quarter of 2007, falling by 2.2% relative to 2007:Q2 (Chart 2.2). Financing conditions for personal loans have remained tight, with average lending rates standing at 9.3% during 2007:Q3, slightly up from the 9.2% prevailing at the same time last year.

Chart 2.1: Personal Loans and advances (% of GDP)



Source: Central Bank of Bahrain

³ We relate household borrowing to nominal GDP in the absence of reliable household income data. The denominator uses IMF projections for 2007 nominal GDP.

Chart 2.2: Growth Rate of Total Personal Loans and Advances (%)

Source: Central Bank of Bahrain

Improved outlook for household income risks

Household income is a principal source of funds to service and repay debt. The limited data available indicates that on average, household income risk may be falling, given the creation of new jobs and rising wages.

Overall employment levels in Bahrain increased from 381,126 at the end of 2007:Q1 to 397,918 by the end of the third quarter. In the absence of household income data for Bahrain, we look at average monthly wages in the private and public sectors, as a rough proxy for trends in household income. Average private sector wages continue on an upward path, reaching BD231 per month as at end-September 2007 (Table 2.1). Average public sector wages have been consistently higher than private sector wages and after falling during the first quarter of 2007, average public

sector wages subsequently began to move upwards, reaching BD705 per month by the end of the third quarter.

Table 2.1: Average Monthly Wages (BD)

	2004	2005	2006:Q1	2006:Q2	2006:Q3	2006:Q4	2007:Q1	2007:Q2	2007:Q3
Private Sector	214	207	212	211	213	210	224	228	231
Public Sector	597	664	674	684	677	700	695	706	705

Sources: General Organisation for Social Insurance and Civil Service Bureau

As the private sector continues to account for the lion's share of total *formal* employment (90.3% as at September 2007), a trend of improving average private sector wages suggests that households depending on private sector wages are experiencing an improving ability to service debt out of current income (on average). The overall impact will however depend on the proportion of total personal loans taken out by private sector employees, a breakdown which is not currently available. While the available data could be used to make tentative observations, solid conclusions are only possible when reliable household income data becomes available for Bahrain.

2.2. Business Enterprises

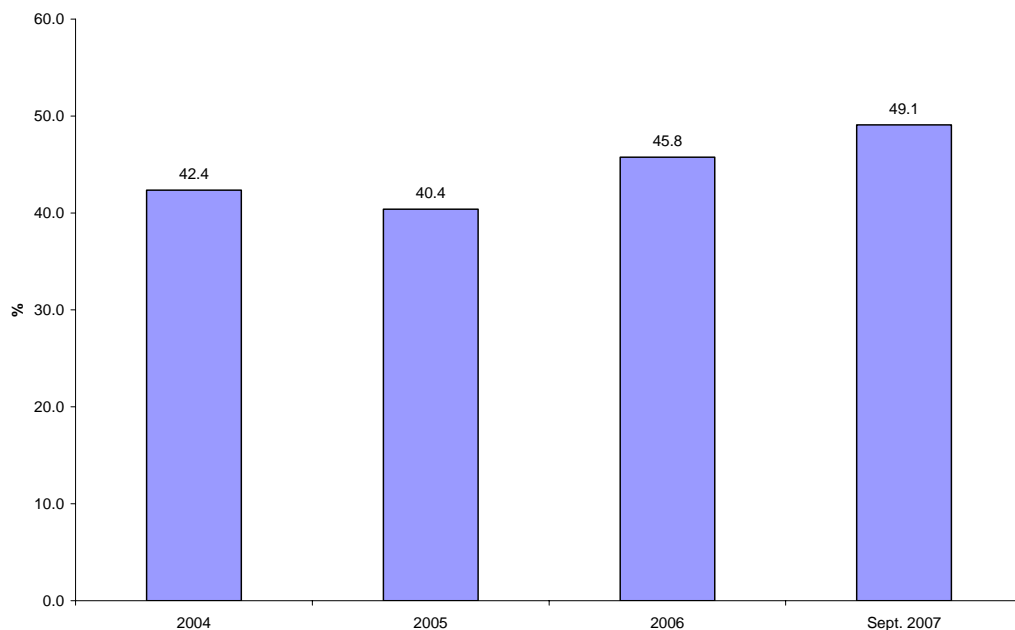
Non-financial sector growth remains strong

The sustained robust performance of the non-oil sector continues, with a 7.7% growth projected for 2007. This performance has continued to underpin a high level of activity in the private sector. Following the issuance of a record 8181 commercial licenses in 2006, a further 5964 new licenses have been issued in the first three quarters of 2007, indicating that the environment remains conducive to the establishment of new business enterprises.

Business debt burden increases

In 2007, the ratio of business loans to non-financial GDP increased further to 49.1% (end-September 2007), compared to the 45.8% recorded in 2006 (Chart 2.3). As mentioned in the July 2007 *Financial Stability Report*, we do not consider this level of indebtedness to be too burdensome for business enterprises given the currently positive macroeconomic and business conditions. Nonetheless, there is a need for lenders to continuously monitor existing business borrowers while ensuring that new loans are extended on a sound and prudent basis.

Chart 2.3: Business Loans and Advances (% of Non-Financial GDP)



Source: Central Bank of Bahrain

2.3. Construction and Real Estate

Slowdown in licensing and permits for construction and real estate

As at the end of 2007:Q3, the number of new commercial licenses issued for construction, real estate and associated activities totaled 1492, down 32% year-on-year (Table 2.2). Similarly, the number of construction permits issued by the Ministry of Municipalities Affairs and Agriculture reached 3313 by the end of 2007:Q3, compared to 3494 recorded at the same time last year (Table 2.3).

Table 2.2: Commercial Licenses Issued for Construction and Real Estate

	2005	2006	2007 (end. Sept)
Construction	1113	1494	678
Real Estate, Rentals and Associated Activities	958	1097	814
Total	2071	2591	1492

Source: Ministry of Municipality Affairs and Agriculture

Table 2.3: Selected Construction Permits by Type

	2005	2006	2007 (end-Sept.)
Demolition and New construction	176	404	360
New construction	3573	4021	2929
Reclamation	30	36	24
Total	3779	4461	3313

Sources: Ministry of Municipality Affairs and Agriculture

However, land prices continue to soar

After reaching BD876 million in 2006, the *value of traded land permits* accelerated in 2007. In the first three quarters of the year, the total value of permits issued stood at BD921 million, higher than the total for the entire year of 2006 (Table 2.4).

Table 2.4: Trading in Land (BD Million)

	2005	2006	2007 (end-Sept.)
Total Value of Traded Land Permits	517.1	876	921.1
<i>Value of Permits for Bahrainis</i>	462	810	848.6
<i>Value of Permits for Non-Bahrainis</i>	55.1	65.8	72.5

Sources: Ministry of Municipality Affairs and Agriculture

Table 2.5: Bahrain Land Prices—Selected Areas, 2005 vs. 2007**

Area	RESIDENTIAL		COMMERCIAL	
	BD/sqft (2005)	BD/sqft (2007)	BD/sqft (2005)	BD/sqft (2007)
Adliya	12-15	20	25-35	40-65
Adhari	7-10	14	18-20	20-28
Al Diraz	8-9	8-11	9-10	20-26
Al Seef	10-15	30-50	35-50	120-200
Zinj	8-12	17-23	18-23	30-40
Barbar	6-10	8-11	15	12-15
Budaiya	6-9	10-15	9-12	14-30
Busaytin	10-12	15-22	16-20	25-35
Diplomatic Area	N/A	N/A	35-45	70-120
Exhibition Ave.	N/A	N/A	40-45	50-80
Hamad Town	6-8	8-12	9	15-20
Hoora	11	20-30	24-30	40-50
Isa Town	7-9	12-16	11-15	17-25
Juffair	10-15	25-45	20-25	60-100
Saar	8-10	12-20	10-14	23-25
Tubli	6-9	12-15	10-13	25-35
Um Al Hassam	10-12	14-20	19-24	40-50
West Riffa	6-8	9-13	10	15-20

Sources: Global Investment House (citing Cluttons Sales Review) and Arabian Homes (citing Remax)

**Prices averaged from recent sales; 2007 figures are October averages.

Table 2.5 above presents a more direct evidence of increasing land prices. It compares land rates between 2005 and 2007 (in BD per square foot) for different areas in Bahrain, covering both residential and commercial land. It is immediately evident that over the last two years, land rates have increased substantially in both market segments.

In 2005, *residential land prices* increased by 200% in Al Seef, 112% in Zinj and 150% in Juffair⁴. *Commercial land prices* have also recorded significant appreciation in prices, especially in high-demand areas such as A'ali, Adliya, Al Seef, Zinj, Diplomatic Area, Exhibition Avenue, Hoor, Juffair and Um Al Hassam.

A recent CBB study revealed a general consensus among key market players that in the *residential sector*, there is an emerging oversupply of properties in the high-end, luxury segment (villas and apartments), with a rich pipeline of properties still to come onto the market. In the area of *commercial property*, there is a similar consensus that luxury, high-end *office space* is becoming abundant compared to moderately-priced space. Taking into consideration projects in the pipeline and the potential demand for offices, some market players estimate that by 2010, Bahrain is likely to end up with excess office space to the tune of 200,000 sqm.

Overall assessment

From a financial stability perspective, it is encouraging that the financial “balance sheet” of households appears to be improving (on average), given the downward trend in the ratio of household debt to GDP, combined with rising wages and employment. However, financing terms remain tight, with interest rates on personal loans currently averaging 9.3%. Debt burdens in the business sector appear bearable, but if interest rates continue to rise, or if growth in the non-oil sector slows, stresses may begin to appear in the balance sheets of business enterprises.

For the construction and real estate sector, the major threat to financial stability is likely to come from an oversupply of both residential and commercial properties which may put downward pressure on property valuations and rental rates.

⁴ Price increases are calculated using the minimum land rates for the area.

3. Financial Condition and Performance of the Banking Sector

Key Points

Banking trends influenced by recently-completed structural changes

Both the conventional and Islamic banking segments continue to show satisfactory financial strength

However, increasing exposures to construction and real estate is a source of concern

This chapter analyzes the banking sector under the following categories: conventional retail banks (section 3.1), conventional wholesale banks (section 3.2), Islamic retail banks (section 3.3), and Islamic wholesale banks (section 3.4). Section 3.5 provides an overall assessment of the banking industry.

Unless specified otherwise, the analysis in this chapter is based on consolidated financial data (Bahraini and non-Bahraini operations), covering primarily developments from March 2007 to September 2007⁵.

As reported in the July edition of this Report, the conventional banking sector has been undergoing structural changes due to the implementation of CBB's single license policy. Notably, three wholesale banks have elected to become retail banks, thereby expanding the aggregate balance sheets of the retail banking sector substantially.

⁵ Please note that the consolidated figures in this chapter are not directly comparable to some of the banking data contained in the Central Bank of Bahrain's *Statistical Bulletins* which cover Bahraini operations only.

Consequently, the discussion in the following paragraphs should be viewed in the context of these structural changes. Where applicable, the analysis draws attention to cases where the reclassification of banks has resulted in significant “structural breaks” in the reported data.

3.1. Conventional Retail Banks

Expansion in retail deposits

As at end-September 2007, total retail bank deposits stood at BD 13 billion, up from BD4.9 billion in March 2007. This was however due primarily to the structural changes mentioned above. Without the reclassifications, retail deposits increased from BD4.9 billion to BD 6.6 billion. Nonetheless, Bahraini retail banks continue to have relatively easy access to retail deposits, given the high levels of liquidity currently available in the country (and in the Gulf region as a whole).

Assets grow in tandem

Aggregate retail banking assets grew from BD6.4 billion in March 2007 to BD18 billion by end-September 2007. Again, this was largely due to the structural changes. If these changes are ignored, retail banking assets only grew from BD6.4 billion to BD9.7 billion, which is still substantial but less remarkable.

Average capital adequacy improves⁶

Historically, locally-incorporated retail banks have exhibited high capital adequacy ratios. As at end-September 2007, the aggregate capital adequacy ratio stood at 16.7%, down from the 19.2% attained in March 2007. Similarly, the core capital ratio (ratio of Tier 1 capital to risk-weighted assets) declined from 14.8% in March 2007 to 9.6% in September 2007. Again, these changes have been due largely to the recently completed reclassification. If we exclude the new retail banks, aggregate capital positions actually improved from 19% to 21%.

⁶ The capital adequacy ratio relates total capital to risk-weighted assets. The numbers exclude overseas retail banks, which do not have prescribed capital levels or ratios.

Sound profitability of retail banks

Year-on-year, retail banks experienced a 78% growth in net profits. As at September 2007, the net interest margin for locally incorporated retail banks was 2%, compared to 1.9% in September 2006. Return on average assets (ROAA) also increased from 1.6% to 1.9% over the period. The improvement in the return on adjusted equity is more pronounced, jumping from 13.2% in September 2006 to 20.8% in September 2007.

Concentration risks in retail lending

Similar to the situation in the past couple of years, as at end-September 2007, locally-incorporated retail banks had over 40% of their loan book in two sectors: “consumer and personal” and “financial” (Table 3.1). In contrast, the lending behaviour of overseas retail banks seem to have changed, with the “manufacturing” sector now claiming the lion’s share of their total loans (31%)(Table 3.2). Indeed, the top three sectors (manufacturing, financial and services) jointly accounted for over 60% of overseas banks’ total lending. These changes are most likely due to the aforementioned reclassification of three wholesale banks.

**Table 3.1: Distribution of Retail Bank Lending
(% shares; locally incorporated banks only)***

	March 2007	Sept 2007
Consumer and Personal	23.1	21
Government	6.6	6.1
Construction	11.6	12.7
Manufacturing	14.0	16.4
Mining & Quarrying	0.7	1.3
Agric, Fishing and Forestry	0.2	0.2
Financial	21.2	21.0
Trade	12.0	10.2
Services	10.6	11.2

Source: Central Bank of Bahrain

*Figures may not add to a hundred due to rounding

**Table 3.2: Distribution of Retail Bank Lending
(% shares; overseas banks)***

	March 2007	Sept 2007
Consumer and Personal	26.7	13.2
Government	8.7	3.9
Construction	11.3	8.6
Manufacturing	11.6	30.6
Mining & Quarrying	0.1	0.3
Agric, Fishing and Forestry	0.0	0.6
Financial	6.3	15.3
Trade	29.9	12.3
Services	5.4	15.1

Source: Central Bank of Bahrain

*Figures may not add to a hundred due to rounding

Non-performing loans decrease

Overall asset quality of retail banks improved noticeably during the review period. As at end-September 2007, aggregate non-performing loans (NPLs) in all retail banks stood at 2.5%, down from 5.1% as at end-March 2007. Over the period, NPL ratios for locally-incorporated banks declined from 5.8% to 4.3% while overseas retail banks experienced a decline in NPLs from 4.6% to 1.7%.

Overall coverage ratios have also improved, standing at 85% for locally-incorporated banks (up from 76% in March 2007) and 86.6% for overseas retail banks (up from 75% in March).

Mixed Trends in Sectoral NPLs

Unlike the aggregate trends, sectoral NPLs display a somewhat mixed picture (Table 3.3). While NPLs declined in construction (from 9.9% to 7.3%) and manufacturing (from 5.7% to 4.6%), they rose in agriculture, fishing and forestry (from 11.3% to 13.4%) and consumer and personal (8.6% to 8.9%).

Coverage ratios are broadly satisfactory across sectors, except for the construction sector where a coverage ratio of 30.1% is relatively low (Table 3.4). As has been highlighted in previous editions of the *Financial Stability*

Report, a higher coverage ratio is desirable for the construction sector, given its vulnerability to “boom and bust” cycles. There may be a need to consider introducing more stringent guidelines for provisioning against expected losses in this sector.

**Table 3.3: Retail Banks’ NPL Ratios by Sector
- Locally Incorporated Banks (%) ****

	March 2007	Sept 2007
Consumer and Personal	8.6	8.9
Government	1.5	1.5
Construction	9.9	7.3
Manufacturing	5.7	4.6
Mining & Quarrying	0.3	0.1
Agric, Fishing and Forestry	11.3	13.4
Financial	0.8	0.8
Trade	16.5	16.5
Services	4.1	3.2

Source: Central Bank of Bahrain

**NPL numbers refer to proportion of outstanding loans that are non-performing

**Table 3.4: Retail Banks’ Coverage Ratios by Sector
- Locally Incorporated Banks (%) ****

	March 2007	Sept 2007
Consumer and Personal	98.2	105
Government	100	100
Construction	24.4	30.1
Manufacturing	96.1	93.2
Mining & Quarrying	100.0	100
Agric, Fishing and Forestry	97.4	100
Financial	100	100
Trade	84.8	86
Services	80.1	85

Source: Central Bank of Bahrain

** Coverage ratios are defined as specific provisions and interest in suspense/non-performing loans.

Minimal liquidity risks

The overall liquidity position of retail banks remains strong, given the continued expansion of total deposits. The ratio of non-bank deposits to total deposits is at a high of 64%, indicating a relatively stable base for funding bank assets. However, we have witnessed a weakening of the liquid asset ratio, which fell from 34% in March 2007 to 28% in September 2007. Notwithstanding this decline, we consider the overall liquidity positions to be satisfactory and do not perceive any significant liquidity risks at this time.

Stable median ratings of local retail banks

In addition to the accounting data analyzed in the preceding paragraphs, we take a look at the credit rating of retail banks as a market-based indicator of financial health. Table 3.5 has been updated from the *July 2007 Financial Stability Report* to include any changes or new ratings for locally-incorporated retail banks. One significant change is the inclusion of ratings assigned by *Capital Intelligence*, which is one of the rating agencies accredited by the Central Bank of Bahrain for Basel II purposes⁷.

Table 3.5: Ratings for Locally-Incorporated Retail Banks

Bank	Agency	Last Update	Deposit Rating	Meaning	Remarks
NBB	Fitch		A-	Strong Capacity	
	Moodys	Apr-07	A1	Strong Capacity	Upgraded
	CI		BBB+	Adequate Capacity	
BBK	Moodys	Apr-07	A2	Strong Capacity	Upgraded
BMI	S&P		BBB-	Adequate Capacity	
	Moodys		Baa2	Adequate Capacity	
	CI		BBB	Adequate Capacity	
AUB	Fitch		A-	Strong Capacity	
	CI		A-	Strong Capacity	

Sources: Moody's, S&P and Fitch websites

⁷ The Central Bank of Bahrain has recognized S&P, Moodys, Fitch and Capital Intelligence for assigning risk weights under the standardized approach under Basel II.

As we can see in Table 3.5 above, most of the ratings show “strong capacity” to service debt obligations, following Moody’s upgrading of NBB and BBK in April 2007⁸.

3.2. Conventional Wholesale Banks⁹

Growth in deposits and assets

The deposit base of wholesale banks increased from \$85.4 billion in March 2007 to \$89.1 billion as at end-September 2007 (4% increase). This is mainly attributed to an increase in bank deposits from \$46.6 billion to \$49.2 billion (5.6% growth). Non-bank deposits increased marginally from \$38.9 billion to \$39.9 billion (2.6%). Overall, the bulk of wholesale banks’ deposits still come from other banks and financial institutions (55% of total deposits).

A breakdown of the deposit data indicates that the increase in wholesale banks’ deposits was driven primarily by an increase in the deposits of locally-incorporated wholesale banks, where total deposits increased by 14.5% between March 2007 and September 2007 (from \$37.1 billion to \$42.5 billion). In contrast, deposits in overseas wholesale banks decreased from \$43.7 billion in March 2007 to \$41.3 billion in September 2007.

Reflecting the increase in deposits, wholesale bank assets grew from \$162 billion in March 2007 to \$174 billion in September 2007 (7.4% increase). In general, it is conceivable that the growth of deposits and assets in wholesale banks could have been larger, if not for the structural changes discussed earlier.

⁸ The upgrades resulted from the implementation of Moody’s Joint Default Analysis (JDA) for Bahraini banks, which factored in the possibility of sovereign support for banks in times of distress.

⁹ Please note that wholesale bank balance sheets are denominated in US dollars.

High wholesale bank capitalization¹⁰

As at end-September 2007, the capital adequacy ratio for locally-incorporated wholesale banks stood at 19.5%, up marginally from the 19.2% registered in March 2007. Given that the Core capital ratio (ratio of Tier 1 capital to risk-weighted assets) declined from 16.5% to 16.1% over the period, wholesale banks appear to have been acquiring additional Tier 2 capital. Indeed, the Tier 2 capital ratio increased from 2.6% in March 2007 to 3.4% by the end of September 2007.

Low NPLs but concentrated portfolios

Asset quality of wholesale banks is very strong, with very low non-performing loans. As at end-September 2007, aggregate non-performing loans in wholesale banks stood at 0.8% of total gross loans, down from the 1.1% registered in March 2007. A breakdown of NPLs by sector shows no cause for concern as NPL ratios are generally in single-digits (Table 3.6), although coverage ratios are relatively low in some sectors (e.g. “personal”, “agriculture, fishing and forestry”, and “mining and quarrying”)(Table 3.7).

**Table 3.6: Wholesale Banks’ NPL Ratios by Sector
- Locally Incorporated Banks (%) ****

	March 2007	Sept 2007
Personal	3.5	3.9
Government	4.5	2.1
Construction	0.3	0.3
Manufacturing	2.4	1.7
Mining & Quarrying	0.1	0.2
Agric, Fishing and Forestry	4.2	0.8
Financial	2.9	2.6
Trade	2.6	2.0
Services	1.8	1.7

Source: Central Bank of Bahrain

***NPL numbers refer to proportion of outstanding loans that are non-performing

¹⁰ The capital adequacy ratio relates total capital to risk-weighted assets. The numbers exclude overseas wholesale banks, which do not have prescribed capital levels or ratios.

**Table 3.7: Wholesale Banks' Coverage Ratios by Sector
- Locally Incorporated Banks (%) ****

	March 2007	Sept 2007
Personal	63.5	38.9
Government	249.5	234.5
Construction	56.5	52.2
Manufacturing	74.2	81.0
Mining & Quarrying	11.8	16.1
Agric, Fishing and Forestry	13.3	36.8
Financial	109.5	104.0
Trade	86.9	88.8
Services	105.7	109.9

Source: Central Bank of Bahrain

In terms of concentration risks, the scenario remains relatively unchanged from recent months. In locally-incorporated wholesale banks, the “financial”, “services” and “manufacturing” sectors jointly account for 66% of total lending (Table 3.8). For overseas wholesale banks, these same three sectors also account for roughly 66% of total lending (Table 3.9).

**Table 3.8: Distribution of Wholesale Bank Lending
(% shares; locally incorporated banks only)***

	March 2007	Sept 2007
Consumer and Personal	3.1	2.0
Government	3.2	5.6
Construction	7.4	7.7
Manufacturing	20.9	21.0
Mining & Quarrying	2.7	2.7
Agric, Fishing and Forestry	0.6	0.7
Financial	28.0	25.0
Trade	14.0	15.0
Services	20.7	20.0

Source: Central Bank of Bahrain

*Figures may not add to a hundred due to rounding

**Table 3.9: Distribution of Wholesale Bank Lending
(% shares; overseas banks)***

	March 2007	Sept 2007
Consumer and Personal	0.6	0.5
Government	8.7	9.5
Construction	5.9	10.3
Manufacturing	13.8	15.7
Mining & Quarrying	5.3	5.3
Agric, Fishing and Forestry	1.3	1.2
Financial	32.9	23.8
Trade	7.6	7.6
Services	22.9	26.1

Source: Central Bank of Bahrain

*Figures may not add to a hundred due to rounding

Relatively stable wholesale bank profitability

Between September 2006 and September 2007, net interest margin (NIM) for wholesale banks declined slightly from 1.7% to 1.6%. The return on average assets (ROAA) has however remained steady at about 0.7% over the same period. Non-interest income continues to dominate wholesale banks' revenue streams, accounting for 56% of total income in September 2007.

Current liquidity levels are ample

As measured by the proportion of liquid assets to total assets, local wholesale banks are very liquid, as this ratio has been consistently above 30% for the past fifteen months. In addition, their ability to mobilize deposits remains strong. Regardless, the dependence of these banks on deposits from other banks and other financial institutions imply some element of risk that these sources could prove unavailable at critical times. It is therefore advisable for wholesale banks to have in place contingency plans for replenishing liquidity especially in times of market stress.

Local wholesale banks have stable ratings

Table 3.10 is updated from the *July 2007 Financial Stability Report*. One change is the inclusion of ratings assigned by *Capital Intelligence*. During the period under review, Moody's changed the rating outlook on GIB's deposit rating from "stable" to "negative" due to the bank's exposure to US residential mortgage-backed securities. The outlook for the other banks remained unchanged.

Table 3.10: Wholesale Banks--Local Currency Deposit Ratings

Bank	Agency	Last Update	Deposit Rating	Meaning	Remarks
GIB	S&P		A-	Strong Capacity	
	Moodys	May 07	A2	Strong Capacity	Outlook changed from "stable" to "negative"
	CI		A	Strong Capacity	
ABC	S&P	Jun-06	BBB+	Adequate Capacity	
	Moodys	Apr -07	A3	Strong Capacity	
	CI		BBB+	Adequate Capacity	
Investcorp	S&P		Not rated		
	Moodys	Apr -07	Baa2	Adequate Capacity	Changed
	CI		A-		
UGB	Moodys	Apr -07	Baa3	Adequate Capacity	Reaffirmed
TIBC	S&P	Sep-06	BBB-	Adequate Capacity	
TAIB	CI		BBB-	Adequate Capacity	

Sources: Moodys, S&P and CI websites

3.3. Islamic Retail Banks

Slower growth of deposit base

Over the past few months, Islamic retail banks experienced a slowdown in the pace of growth of their deposit base. Between March 2007 and September 2007, unrestricted Investment Accounts (URIA) grew by only 2% (from \$2.33 billion to \$2.37 billion), compared to the 53% growth registered between September 2006 and March 2007. Restricted Investment Accounts (RIA) expanded by 18% from \$949 million in March 2007 to \$1.12 billion in September 2007, a growth rate of 18%. Again, this is far below the 400% growth in RIA recorded between September 2006 and March 2007.

Increase in assets

Overall, on-balance sheet assets for Islamic retail banks grew from \$5.45 billion in March 2007 to \$6.99 billion by end-September 2007 (28.2% growth). "Investments" was the primary driver of asset growth, expanding by 45% over the period. Total financing facilities also increased by 36% from \$2.4 billion to \$3.3 billion (an increase of 37%). Financing facilities remain the single largest category of assets, accounting for 48% of total on-balance sheet assets in September 2007. It is however notable that the share of total investments in on-balance sheet assets has edged up over the period, from 24.4% to 27.8%.

Fall in capital adequacy but increased profitability

Islamic retail banks have shown a decline in the levels of capitalization relative to their risk-weighted exposures. As at end-September 2007, their capital adequacy ratio (CAR) was 35.7%, down from the 40.1% attained in March 2007. However, this level is still higher than the 28.8% registered in September 2006.

The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) has similarly decreased from 35.5% in March 2007 to 29.5% by end-

September 2007. This decrease can be attributed to the substantial 63% increase in total risk-weighted exposures.

At the end of September 2007, aggregate net profits of Islamic retail banks were 199% higher than at a similar point last year. Correspondingly, Return on Assets (ROA) increased from 2.42% to 2.97% year-on-year.

Good asset quality but evidence of liquidity risks

As at end-September 2007, aggregate non-performing financing facilities (NPF) in Islamic retail banks stood at 3.8%, slightly down from the 4.1% recorded in March 2007. Liquid assets amounted to 25 % of total liabilities in September 2007, a drop compared to 29% at end-March 2007. The Top 10 depositors account for over 75% of total deposits, a huge increase from 29% in March 2007. This situation of highly concentrated deposits makes Islamic retail banks potentially vulnerable to liquidity risks arising from shifts in depositor sentiments.

Stable ratings for Islamic retail banks

This edition includes credit ratings for Islamic Retail banks from Capital Intelligence and the International Islamic Rating Agency (IIRA), a credit rating agency specializing in the Islamic financial services industry. Table 3.11 shows ratings for three Islamic banks (Al Baraka, Bahrain Islamic Bank and Shamil Bank). The ratings indicate “adequate capacity” to service debt obligations, with stable or positive outlooks. In September 2007, Shamil Bank received an upgrade from Capital Intelligence.

Table 3.11: Retail Islamic Banks-Local Currency Deposit Ratings

Bank	Agency	Last Update	Deposit Rating	Outlook	Remarks
Al Baraka	CI		BB+	Stable	
BISB	CI		BB-	Stable	
	IIRA	Apr 07	BBB-	Positive	
Shamil	CI	Sept 07	BBB	Stable	Upgraded
	S&P	Nov 07	BBB-	Stable	

Source: Al Baraka, BISB, and Shamil websites.

3.4. Islamic Wholesale Banks

Growth in assets and funding base

On-balance sheet assets of Islamic wholesale banks expanded from \$16.1 billion in March 2007 to \$20.1 billion in September 2007 (25% growth). The increase in assets was driven primarily by the 41% growth in total financing facilities, which more than offset the 11% decline in investments. Assets financed by restricted investment accounts diminished by 20% over the period.

Financing facilities still represented the single largest category of assets for Islamic wholesale banks, accounting for 55% of total on-balance sheet assets in September 2007. The share of investments in total on-balance sheet assets shrank over the period, from 26% to 19%.

Between March 2007 and September 2007, Unrestricted Investment Accounts (URIA) grew by 11% from \$5.6 billion to \$6.2 billion while Restricted Investment Accounts (RIA) declined by 23% from \$1.3 billion to \$1.0 billion.

High capital adequacy accompanies strong profitability

Capital adequacy in Islamic wholesale banks is very high, standing at 42% in September 2007, the same level as in March 2007. The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) has however decreased from 40% in March 2007 to 38% by end-September 2007. This indicates that Tier 2 capital has been increased to offset the decrease in Tier 1 capital (or to compensate for an increase in risk-weighted exposures).

At the end of September 2007, net profits of Islamic wholesale banks were 15% higher than at a similar point last year. Consequently, the return on assets for Islamic wholesale banks rose from 0.9% to 1.2%.

Good asset quality and ample liquidity

As at end-September 2007, aggregate non-performing financing facilities (NPF) in Islamic wholesale banks stood at 0.8% of total financing facilities (up from the 0.4% registered in March 2007).

Liquidity positions are also satisfactory, with liquid assets representing 35% of total liabilities in September 2007, slightly down from the 38% registered in March 2007. Further, deposits appear to be well-diversified, as the Top 10 depositors in Islamic wholesale banks account for only 5% of total deposits.

Wholesale Islamic Banks have stable ratings of “adequate capacity”

Table 3.12 shows credit ratings for two Islamic Wholesale banks. They indicate adequate capacity to meet their debt obligations and in October 2007, Gulf Finance House received an upgrade from Capital Intelligence.

Table 3.12 : Wholesale Islamic Banks--Local Currency Deposit Ratings

Bank	Agency	Last Update	Deposit Rating	Outlook	Remarks
Al Amin	CI		BB+	Stable	
GFH	CI	Oct 07	BB+	Stable	Upgraded

**Source: Al Amin and GFH websites.*

3.5. Overall Assessment of the Banking Sector

In general, the financial condition and performance of the Bahraini banking system is satisfactory, with both conventional and Islamic banks showing solid financial health. This is evidenced by high capital adequacy ratios, good asset quality, good earnings performance and high levels of liquidity. However, the rapid growth in banks' exposure to the construction and real estate sector raises some concern, particularly in view of the emerging oversupply of property in both the residential and commercial real estate segments. In response, CBB has decided to impose direct limits on banks' real estate exposures in order to contain them within prudent limits (see Box 3.1).

Box 3.1: Exposure of Bahraini Banks to the Real Estate Sector

As in other GCC countries, Bahrain is currently experiencing a boom in its construction and real estate sector. Tens of projects are underway in residential, offices and retail segments, in addition to ongoing infrastructure projects. Bahraini banks are providing financing to this sector in many ways, including: i) direct financing of investment in real estate; ii) mortgage loans; iii) loans to construction companies; and iv) equity holdings in real estate companies (including developers). We have also witnessed an increase in the overall amount of loans secured by real estate.

In November 2007, the Central Bank of Bahrain conducted a special study of banks' exposure to this sector, drawing relevant implications for financial stability. It was revealed that between December 2006 and June 2007, retail banks (conventional and Islamic) experienced a 54% growth in overall exposures to the sector, with faster growth rates seen in some categories of exposure. For instance, retail loans to construction companies grew by 132% during the period while banks' direct financing of investments in real estate increased by 71%. Loans secured by real estate also expanded by 51% during this period.

More importantly, exposures currently constitute an uncomfortably large proportion of retail banks' capital base, amounting to 67% of capital as at end-June 2007 (compared to 49% in December 2006).

For wholesale banks (conventional and Islamic), real estate exposures expanded by 32% between December 2006 and January 2007. The biggest increase (in percentage terms) occurred in "real estate acquired through settlement" (139%), followed by the financing of investments in real estate (96% growth), and loans to construction companies (77%). Total wholesale banks' exposure to the sector represented 25% of capital base in June 2007 (vs. 19% in December 2006).

In response to these trends and as part of its efforts to protect the stability of the financial system, CBB has issued a consultation paper, outlining direct limits on banks' real estate exposures. The main provisions include: i) real estate financing not to exceed 25% of a bank's gross loan portfolio; ii) a 70% loan-to-value limit on all real estate financing; iii) collateral values of 150% whenever real estate is used to secure other forms of borrowing; iv) investment concentration limit of 30% of capital base for investments for a bank's own account¹¹. Islamic banks have an additional provision that they may not utilize funds raised from unrestricted investment accounts in real estate development projects.

¹¹ See Central Bank of Bahrain, *Real Estate Limits and Directives*, Consultation Paper 1, December 2007.

4. Financial Condition and Performance of the Insurance Industry¹²

Key Points

Capital levels and solvency margins are satisfactory

The level of insurance receivables is relatively high

Rising profitability underpinned by increases in investment income

Improving market perception of insurance companies

Insurance penetration and assets

As at end-September 2007, the ratio of gross premiums to GDP stood at 2.9%, with general insurance accounting for roughly 80% of gross premiums. This indicates that life insurance is still relatively underdeveloped in Bahrain.

Between June and September 2007, total assets of insurance companies (conventional only) expanded by 27.6%, with investments constituting the largest single portion of assets (35% of total assets).

¹² Please note that this chapter focuses only on conventional insurance companies and excludes companies licensed to do business in Saudi Arabia.

Capital adequacy is satisfactory

In general, the aggregate capital position of the insurance industry is satisfactory and there is confidence in the ability of the industry to meet its liabilities. Insurers' Tier 1 capital currently accounts for 23% of total assets and the absolute amounts of capital allocated to both general and life business lines exceed the required margin of solvency. As at end-September 2007, the actual solvency margin represented 73% of net premiums and over 100% of net claims.

Relatively high insurance receivables

As at end-September 2007, insurance receivables (mostly premiums) accounted for 54% of gross premiums, suggesting that insurance companies face some difficulties in collecting on receivables. However, this represents an improvement when compared with end-June 2007 when receivables accounted for 72% of gross premiums. Nonetheless, it is important to note that a high level of receivables could become a major source of credit risk for insurance companies. Although large amounts of receivables also tend to overstate assets (thereby inflating solvency margins), the Central Bank of Bahrain guards against this by stipulating that any receivables due for more than six months receive zero value for solvency purposes.

Reasonable risk-retention ratios

The risk retention ratio (net premiums/gross premiums) stood at 63% in September 2007, slightly down from the 65% recorded in June. It indicates that the industry is on average balancing its risk bearing capacity with the prudence of passing along some underwriting risks to re-insurers.

Increasing profitability of insurance companies

Bahraini insurance companies show respectable profitability, with the average industry Return on Equity (ROE) standing at a healthy 12% as at end-September 2007 (slightly up from 11% in June 2007). Over the same period, reported net income of insurers rose by 30%, driven primarily by a

38% expansion in investment income. Indeed, at the end of 2007:Q3, *net investment income* accounted for roughly 70% of insurers' total net income.

The *claims ratio* (ratio of claims incurred to premiums earned) stood at 56% in September 2007, down from the 63% registered in June 2007. The *expense ratio* (ratio of expenses to earned premiums) was 32% (compared to 35% in June).

Therefore, the *combined ratio* (claims ratio plus expense ratio) stood at 88% in September 2007, down significantly from the 98% recorded in March. These trends indicate that insurers are beginning to increase the size of their underwriting profits, even though they currently rely substantially on investment income to underpin profitability.

Improving market perception of insurance companies

Stock market data relating to the insurance industry suggest that market perceptions of the performance and future viability of the industry is improving. Market capitalization for the insurance sector stood at BD210.7 million in October 2007, compared to BD173.8 million a year earlier (21% expansion in size). Also, the All-Share Index for Insurance in October 2007 was at 2379.43, compared to 1955.19 a year earlier. Available information on credit ratings for Bahraini insurers also presents a favorable picture (Table 4.1).

Table 4.1: Ratings for Bahraini Insurance Companies

INSURANCE COMPANY	AGENCY	LAST UPDATE	RATING	OUTLOOK
Arab Insurance Group (B.S.C.)	S&P	Dec 2004	BBB	Stable
Hannover Re Takaful	S&P	Dec 2007	A	Stable
Bahrain Kuwait Insurance Co.	S&P	June 2005	BBB	Stable
Bahrain National Insurance Co. B.S.C (c)	S&P		BBB+	Stable

*Sources: ARIG, BKIC, BNI and Global Reinsurance websites.

Overall assessment

The insurance sector is in good shape as evidenced by comfortable solvency margins, rising profitability and improved performance of insurance stocks. However, the relatively high levels of insurance receivables require attention as this could become a source of credit risk to insurance companies.

5. Performance of Equity Markets

Key Points

Further expansion of market capitalization

Market fully regains momentum, following selling pressures in early 2007

Despite increased buying activity, stock prices still look reasonable

The “buy-and-hold” attitude of most investors causes persistent low liquidity

Further expansion in market size

With the listing of Seef Properties in late July 2007, there are now 51 companies listed on the market, in addition to 18 bonds (including 10 Sukuks) and 33 mutual funds. As at end-October 2007, market capitalization of the Bahrain Stock Exchange (BSE) stood at BD9.7 billion, representing 129% of nominal GDP (2007 projection). Current market capitalization is 22% higher than comparative figures for October 2006.

The growth in market size has been driven by the “Commercial banks” segment, with capitalization 29% higher year-on-year (Table 5.1). The “Investment” and “Insurance” segments also recorded double digit growth rates of 23% and 21% respectively. More modest gains were witnessed in the “Services” and “Hotel and Tourism” segments while the “Industrial” sector experienced a 3% decline in capitalization year-on-year.

**Table 5.1: Market Capitalization on the Bahrain Stock Exchange
(BD Million)**

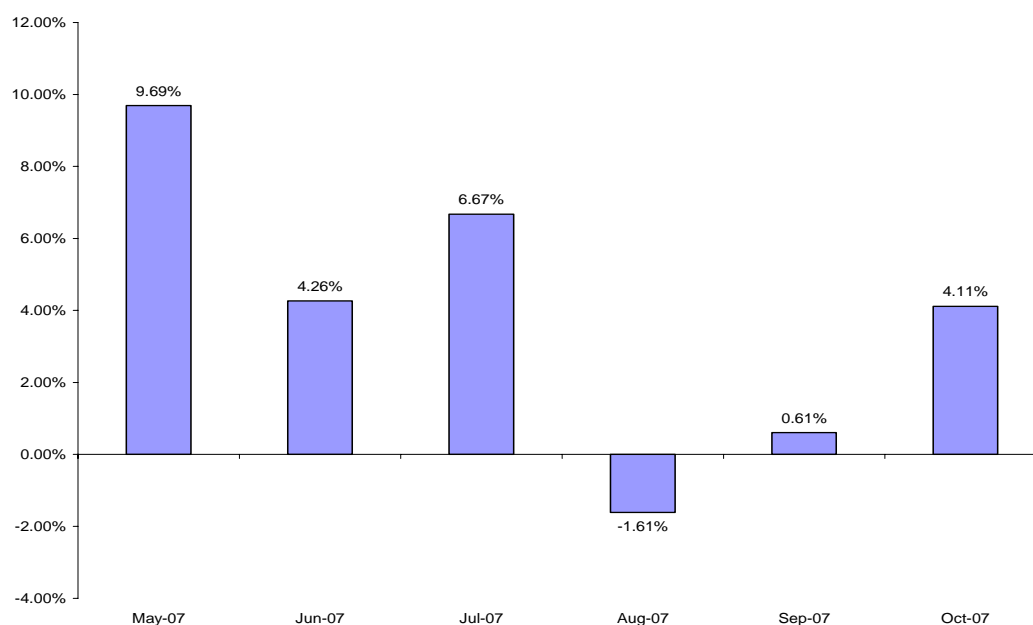
	October 2006	May 2007	October 2007	May 2007- Oct. 2007 change (%)	Oct. 2006 to Oct. 2007 change (%)
Commercial banks	2493.2	2804.7	3208.9	14%	29%
Investment	3729.1	3672.6	4577.6	25%	23%
Insurance	173.8	171.6	210.7	23%	21%
Services	1467.5	1451.6	1582.4	9%	8%
Industrial	17.4	16.7	16.9	1%	-3%
Hotel and Tourism	113.1	115.9	122.7	6%	8%
TOTAL	7994.2	8233.3	9719.5	18%	22%

Source: Bahrain Stock Exchange

Market slowly gains momentum

Since May 2007, the performance of the BSE All-Share Index has been uneven. Market gains in June and July were followed by a 1.6% fall in August. The index turned positive again in September and October 2007, increasing by 0.6% and 4.1% respectively (Chart 5.1). Overall, the index at the end of October 2007 stood 337 points higher than at the end of May 2007 (15% increase) (Table 5.2).

Chart 5.1: 2007 Performance of BSE All-Share Index (% changes)



Source of Data: Bahrain Stock Exchange

Table 5.2: Sectoral Indices of Bahrain All-Share Index

	Oct. 2006	May 2007	Oct. 2007	May-Oct. Change (%)
Commercial banks	2814.57	3167.31	3437.92	9%
Investment	1886.01	1889.44	2339.56	24%
Insurance	1955.19	1930.95	2379.43	23%
Services	2054.51	2032.30	2100.23	3%
Industrial	1507.52	1450.16	1463.01	1%
Hotel and Tourism	2110.78	2163.64	2291.35	6%
OVERALL INDEX	2230.56	2310.81	2648.50	15%

Source: Bahrain Stock Exchange

Stock prices still look reasonable

A look at the price-earnings (P-E) ratio reveals that valuations are beginning to increase, reflecting a full recovery from the correction of 2006 and responding to the ongoing economic boom. The P-E multiple for the entire market stood at 12.52 in October 2007, compared to 10.86 at the end of May (Table 5.3). Despite this trend, Bahrain's P-E multiple is still lower than multiples for other GCC countries.

Strong investor optimism about the "commercial banks" and "Services" sectors is evidenced by their P-E multiples which are higher than the market average. Multiples for other sectors are below the market average.

Table 5.3: BSE—Price-Earning Multiples

	May 2007	Oct. 2007
Commercial banks	15.52	17.76
Investment	8.61	10.44
Insurance	6.77	8.49
Services	12.61	13.03
Industrial	9.17	9.25
Hotel and Tourism	9.99	10.63
Total Market	10.86	12.52

Source: Bahrain Stock Exchange

Low market liquidity persists

Trading is relatively thin on the BSE, with the turnover ratio (value of trading as a share of market capitalization) at around 0.2%, down from the 0.4% of May 2007. There have however been some changes in trading patterns over the past few months, including a significant drop in the share of “commercial banks” in total trading (from 40.5% to 21.5%) as well as the substantial improvement in the share of the “services” segment (from 9.5% to 24.2%)(Table 5.4). Nonetheless, trading is still concentrated with the top two sectors accounting for 72% of total trading (by value).

**Table 5.4: BSE— Value of Shares Traded by Sector
(% shares)***

	May 2007	Oct. 2007
Commercial banks	40.5	21.5
Investment	40.0	48.3
Insurance	0.5	4.8
Services	9.5	24.2
Industrial	0.2	0.1
Hotel and Tourism	0.4	0.9

**Figures may not add to a hundred due to rounding*

Source: Bahrain Stock Exchange

Overall assessment

There are no financial stability issues emanating from activities on the Bahrain Stock Exchange. Although market capitalization continues to increase, liquidity levels remain very low.

6. Payment and Settlement Systems

Key Points

New Real Time Gross Settlement (RTGS) System and Scripless Securities Settlement System (SSSS) introduced

These initiatives have reduced credit and liquidity risks substantially

Some legal risks however remain due to the absence of an over-arching Payment Systems Act

The Bahrain Stock Exchange's clearing and settlement system is still vulnerable to settlement agent risk

Payment and settlement systems are central to the smooth operation of the financial sector and the efficient functioning of the economy at large. Not only do they facilitate trade in goods and services, they are also critical for transactions in financial assets. Hence, disruptions to payment systems have the capacity to transmit shocks and trigger widespread financial and economic disturbances. Therefore, an assessment of the safety and soundness of payment and settlement systems is important for the evaluation of risks to financial stability.

6.1. Key Trends in Payment and Settlement Systems

The current payments and settlement infrastructure in Bahrain comprises of five main components: i) the Real Time Gross Settlement System (RTGS); ii) the Automated Cheque Clearing System (ACS); iii) the ATM clearing system; iv) the Scripless Securities Settlement System (SSSS); and v) the clearing, settlement and depository system for the Bahrain Stock Exchange (BSE).

Real Time Gross Settlement System (RTGS)

The RTGS was introduced in June 2007 as Bahrain's new system for processing large-value, inter-bank payments. The RTGS processes and settles all inter-bank payments in real time, on-line mode, using the global SWIFT messaging system to transmit payment instructions¹³. To enhance its overall usefulness, the RTGS also provides settlement services for retail payments. The move to an RTGS system completed Bahrain's move away from the previous Deferred Net Settlement System (DNS) which was inherently exposed to credit and liquidity risks, since settlement was done only at the end of the day, on a net basis. Given the large values that settle through the RTGS, it is designated as a Systemically Important Payment System (SIPS)¹⁴.

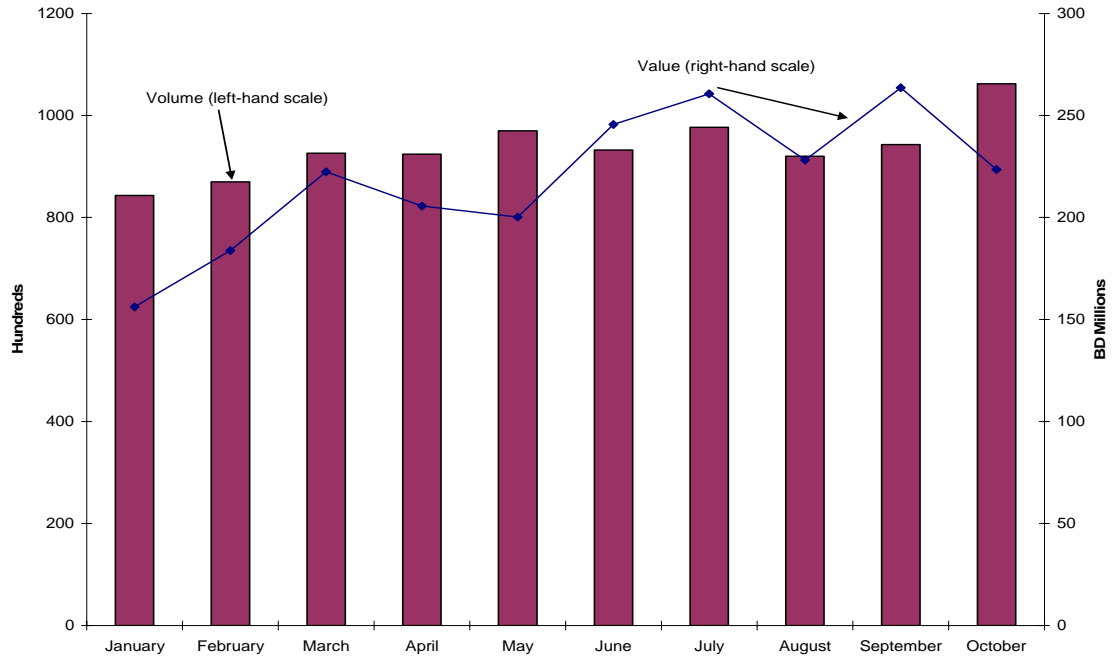
Chart 6.1 shows the volume and value of payments passing through the inter-bank payment system from January to October 2007¹⁵. The volume of transfers increased steadily from an average of 843 transfers per day in January 2007 to an average of 970 per day in May 2007. There was a slight dip in transfer volume during June (coinciding with the partial introduction of the RTGS), but this trend turned upward again in July and by end-October 2007, the daily average of transfers through the RTGS reached a high of 1062. In value terms, transfers increased from a daily average of BD156.2 million in January 2007 to BD223.5 million by end-October.

¹³ SWIFT-- Society for Worldwide Interbank Financial Telecommunication--provides secure messaging services to financial institutions and market infrastructures in over 200 countries. It is headquartered in Belgium.

¹⁴ SIPS are those that, because of the size or the type of the payments they process, could trigger or transmit serious shocks across domestic or international financial systems or markets if they are not protected from risks.

¹⁵ From July 2007, the data refers to inter-bank transactions through the RTGS system.

Chart 6.1: RTGS System: Average Daily Volume and Value of Payments Processed

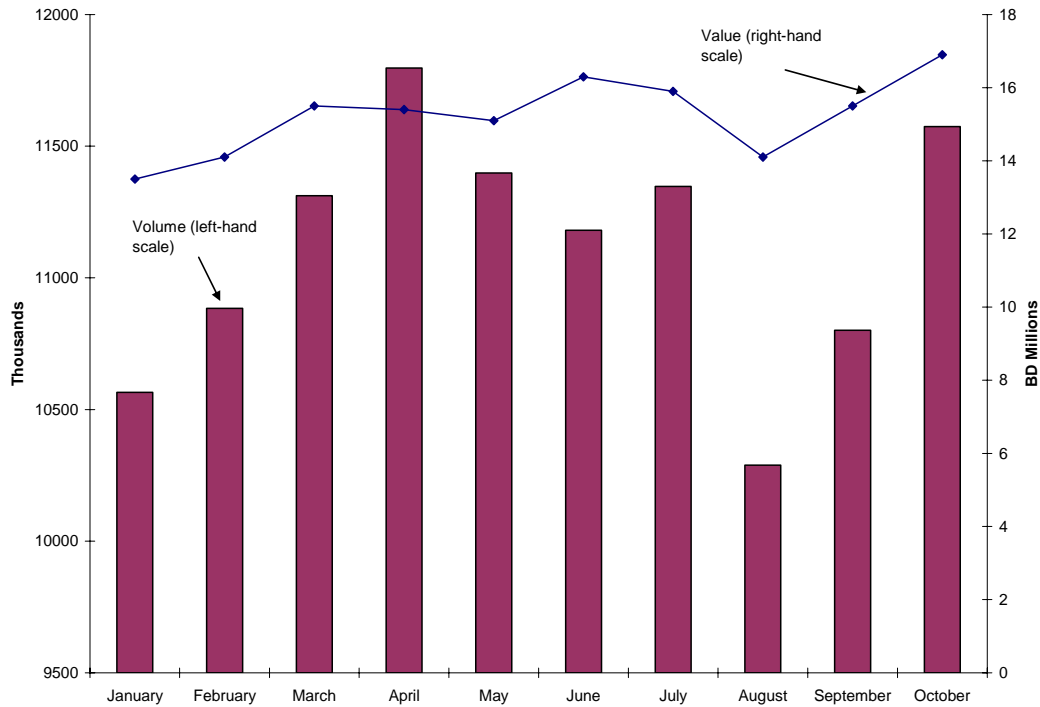


Source: Central Bank of Bahrain

The Automated Cheque Clearing System (ACS)

The ACS uses the Magnetic Ink Character Recognition (MICR) coding scheme to process inter-bank cheques through pre-programmed cheque sorting machines. Settlement is done on a Deferred Net Settlement (DNS) basis. Chart 6.2 below shows the volume and value of cheques processed through the system from January to October 2007. The average daily value of cheques has increased from BD13.5 million in January 2007 to BD16.9 million in October 2007. Similarly, the volume of cheques processed increased from an average daily amount of 10,565 in January to 11,574 in October.

Chart 6.2: ACS System: Average Daily Volume and Value of Payments Processed



Source: Central Bank of Bahrain

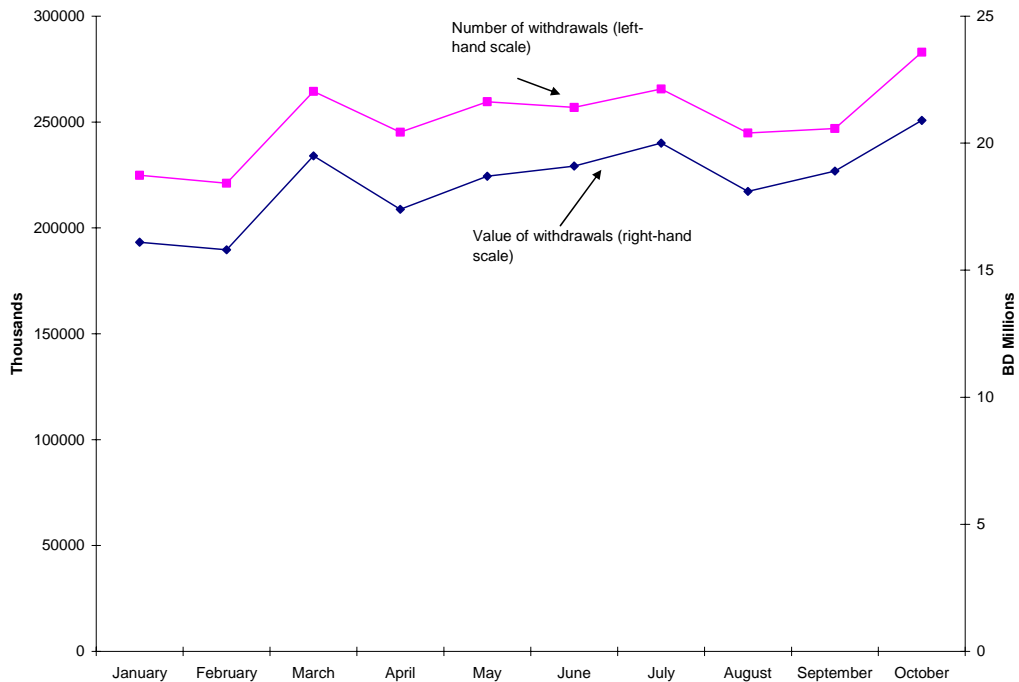
ATM Clearing System

The CBB is the designated settlement bank for ATM transactions across the GCC. The clearing process is also based on a Deferred Net Settlement (DNS) System. *The Benefit Company*, a firm owned by a consortium of Bahraini banks, receives and processes all the ATM transactions (in addition to debit card transactions)¹⁶. Transmission of ATM transactions and settlement related messages are channeled through GCC Net, a leased line network across the GCC countries. During 2007, the number of withdrawal transactions processed through the system increased from 225, 000 in January 2007 to 282,000 in October 2007 (Chart 6.3). In value

¹⁶ *The Benefit Company* only handles transactions where one bank's ATM card is used to withdraw cash from another bank's ATM.

terms, total withdrawals processed increased from BD16.1 million in January 2007 to BD20.9 million by end-October 2007.

Chart 6.3: Number and Value of ATM Transactions



Source: The Benefit Company

Depository and Settlement System for Government Securities

The CBB offers depository and settlement services to banks and other financial institutions with respect to their holdings or transactions in government securities through a new Scripless Securities Settlement System (SSSS). This new system is fully integrated with the RTGS and the fund legs of all securities transactions are settled through the RTGS system. The SSSS immobilizes or dematerializes government securities and provides for auction, issue, and allotment of all government securities, including *Sukuks*. It also provides for securities transactions such as sale, purchase, repos and reverse repos. The SSSS is multi-currency capable and based on Straight-Through Processing (STP).

Depository and Settlement of Equities and Bonds

Day-to-day trading on the Bahrain Stock Exchange (BSE) takes place through the Automated Trading System (ATS). All trades executed through the ATS are subsequently routed to an automated Clearing, Settlement and Central Depository System (CDS), creating a fast and efficient trading, clearing and settlement framework and ensuring delivery versus payment (DVP) on a T+2 basis. Full dematerialization of *current trading* has been achieved and securities are transferred in electronic book-entry form between the seller and the buyer via the CDS. However, on an overall basis, about 70% of securities still exist in physical form, with full dematerialization of *outstanding securities* not yet attained.

6.2. Assessment of Payment and Settlement Systems

Credit and liquidity risk

The introduction of the RTGS system has made Bahrain's large value payments system more robust. Since payments are processed and settled in real time, credit and liquidity risks have been reduced substantially.

Legal risk

Without a Payment Systems Act, Bahrain's payment and settlement systems lack a statutory legal foundation. However, the move to an RTGS system has entailed the development of detailed rules, regulations, standards and procedures for participants in the RTGS. This has somewhat compensated for the lack of a statutory legal framework. Nonetheless, there is a need to seriously consider introducing a broader Payment Systems Act, perhaps as part of the comprehensive road map currently being developed for the payments and settlement system¹⁷.

¹⁷ Such an Act will cover issues such as the finality of payments, recognition of electronic payments, legal basis for check truncation as well as the oversight powers of CBB.

Operational risk

In general, Bahrain's payment systems are robust in terms of security and operational reliability. The use of the secure global SWIFT system for transmitting payment messages provides comfort. In addition, the payment infrastructure is covered under CBB's Business Continuity Planning, with emergency back-up processing capacity (off-site) and contingency planning developed. However, there is a need for more regular testing of these arrangements, perhaps in the form of "fire-drills" which simulate actual crises and evaluate the effectiveness of the contingency arrangements. Again, these issues are receiving attention as part of the move to an RTGS system.

Settlement agent risk

As pointed out in the *July 2007 Financial Stability Report*, the current design of the Bahrain Stock Exchange's securities clearing and settlement exhibits settlement agent risk. Bank of Bahrain and Kuwait (BBK) is the sole settlement agent for stock market transactions, indicating that the settlement of market transactions is heavily dependent on the continued financial and operational health of BBK. Consideration should therefore be given to reforming the clearing and settlement framework, possibly by establishing an independent, non-bank settlement agent owned by the BSE or the brokers, with settlement carried out through the RTGS system.

Overall assessment

The payments and settlement system has been strengthened substantially with the introduction of the RTGS system and the SSSS. These initiatives have gone a long way in enhancing the safety, security, efficiency and robustness of Bahrain's payment systems thereby reducing payment system risks and fostering financial stability.

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