مصرف البحرين المركزي

Central Bank of Bahrain

Financial Stability Directorate

Financial Stability Report

June 2009

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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 shocks.

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. CBB recognizes 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 macro-financial developments. Chapter 2 examines the financial position of households and business enterprises as well as trends in the construction and real estate sector while Chapter 3 evaluates the financial condition and performance of the banking sector (conventional and Islamic).

Chapter 4 assesses the financial condition and performance of the conventional insurance industry and Chapter 5 reviews recent trends on the equity market. Chapter 6 focuses on stability issues relating to the payment and settlement systems.

Unless indicated otherwise, this report analyzes data covering the period between end-September 2008 and end-March 2009.

Executive Summary

Overall assessment

In spite of the far-reaching impact of the global financial crisis on financial centres around the world, the Bahraini financial sector has not experienced a *systemic* crisis. In the early days of the crisis, some banks suffered substantial losses, due to their exposure to toxic mortgage-related securities. In recent months, other stress points have appeared with some wholesale banks facing liquidity difficulties.

Fortunately, these stress points have not translated into generalized systemic problems and efforts are ongoing to address the specific difficulties of the banks currently under stress. But if the crisis impacts the real sector more strongly, other banks currently unscathed may suffer from second-round effects of the turmoil, possibly in the form of credit losses. There is therefore a need for continued vigilance in order to ensure that the impact of the crisis on the Bahraini financial sector remains contained.

International and domestic macroeconomic trends

In the first half of 2009, conditions in international financial markets improved somewhat, compared to the state of affairs in September 2008. Despite these improvements, the cleaning up of financial systems is still ongoing and major advanced countries are currently wrestling with the recessionary impact of the crisis. Key emerging and developing countries have also experienced a slowdown in economic activity.

On a positive note, global inflation remains subdued as food and commodity prices have plummeted. These global developments have impacted the Bahraini economy negatively, with a reduction in GDP growth, shrinkage of the current account surplus and deterioration in government finances.

The non-financial sector

Available data shows that the debt ratio for *households* has fallen further, although interest rates on personal loans have decreased. Also, food price inflation has subsided somewhat against the background of higher employment numbers and higher wages. Debt levels in the *business sector* are lower, a welcome development as interest rates on business loans increased slightly. For the *construction and real estate sector*, the cooling effects of the global financial crisis continues, but an increase in permits for "new construction" points to a desire by developers to take advantage of currently low prices of construction materials. <u>However, there is a need for continuous monitoring of the situation as the full impact of the crisis on businesses and households are yet to become evident</u>.

The banking sector

Not surprisingly, the Bahraini banking sector has not been immune from the global crisis. Since the collapse of Lehman Brothers in September 2008, the wholesale banking sector has faced a tightening of available liquidity from banks outside the Middle East and North Africa region and in May 2009, two wholesale banks, subsidiaries of Saudi financial/industrial conglomerates, defaulted on certain foreign exchange and trade finance obligations. These banks are currently in the process of working out their obligations with creditors, against the background of wider debt restructuring in their parent groups.

<u>However, it should be noted that these incidents resulted from circumstances specific to these banks and their parent companies and not indicative of a generalized problem in the Bahraini banking sector</u>. Despite the unusual levels of stress transmitted through the global financial crisis, the sector has not experienced *systemic* liquidity shortages.

Despite these pressures, conventional wholesale banks as a group show positive earnings for the period under review, compared to the net losses reported in the last *Financial Stability Report*. Also, capital adequacy ratios are comfortable across all banking segments and asset quality is still satisfactory. However, banks continue to show high levels of asset concentration risks, although progress is being made in reducing these risks.

Finally, we stress that it is important to maintain continued vigilance given the possible negative impact of the crisis on the real economy and the potential second-round effects on the balance sheets of banks, perhaps through losses on loans. The widely-reported difficulties of some business groups in the Gulf may be early indications that the crisis is beginning to have more significant effects on the private sector. An economic downturn will also have adverse affects on banks' income prospects, putting pressure on net earnings.

The insurance industry

There are no serious financial stability concerns in the insurance industry. Solvency margins remain substantial and companies are sharing risks more broadly with re-insurance companies. Costs have also been reduced significantly, translating into an increase in net income. One area of concern is the increase in insurance receivables in the period up to March 2009, reversing the previous success in lowering the level of receivables.

Equity markets

The global financial crisis has impacted the Bahraini Stock Exchange negatively, with declines in market capitalization and in the main price index. This trend is however not unique to Bahrain as other GCC markets were also affected. There are now signs of a recovery in the market as investor confidence begins to return, albeit tentatively. However, the recovery of the Bahrain exchange has been slower than that in other GCC markets. We envisage that levels of activity will be far below 2008 peaks for a few more months, until there are definite signs that the global financial crisis is nearer a final resolution.

Payments and settlement system

Bahrain's new payments and settlement infrastructure continues to function normally, with the RTGS now providing a quick and efficient framework for processing payments for banks' retail customers. The various safeguards incorporated into the new framework have also served to minimize credit, liquidity and operational risks. Hence, we do not see any financial stability concerns at this juncture.

1. International and Domestic Macro-Financial Developments[1]

Key Points

Global financial crisis not fully resolved

World output contracts

Economic recession brings low inflation

Adverse effects on Bahrain's economic outlook

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.

[1] This chapter draws on various projections and analysis contained in the IMF's *World Economic Outlook*, April 2009 and *Global Financial Stability Report*, April 2009.

Continued impact of the global financial crisis

Since September 2008, the devastating impact of the global financial crisis on economies around the world has become very clear. Economic activity has slowed substantially in the major advanced economies and key emerging markets, including China have suffered in tandem, experiencing sharp falls in exports, capital flight and slower growth in output. Risk aversion also remains strong with banks reluctant to lend to the other banks and to the real sector. Unemployment rates have climbed rapidly in the US, the Euro Area and in emerging economies, as a lack of access to finance has forced businesses to either scale back their activities or close down entirely.

As a consequence of the extraordinary measures taken by governments in advanced countries to fight the crisis, many international banks now have either majority or substantial government ownership. There is also a global agreement to coordinate policies under the aegis of the G-20 group of countries which met in April 2009 to discuss a coordinated response to the crisis. In the US, a program to purchase toxic assets in partnership with private entities was unveiled and the biggest banks were subjected to stress tests in order to determine their needs for extra capital.

Although conditions in international financial markets are far better than as at September 2008, several issues remain unresolved. Many banks still have so-called toxic assets on their balance sheets and in many cases, the exact value of these assets remains indeterminate. Many banks still need to raise capital in order to fill holes created by previous asset losses before they can resume lending to the private sector on a reasonable scale.

Severe contraction in the global economy

As mentioned earlier, the feed-through of the financial crisis into the real economy had serious consequences around the world. In the final quarter of 2008, the advanced economies suffered a record 7.5% decline in real GDP while emerging markets contracted by 4%. In 2009, global output is expected to decline by 1.3% as the economic recession continues in the US, UK, Germany and Japan.

China and India are also experiencing a substantial slowdown in growth. While global growth is expected to resume in 2010, current projections indicate it will be at a sluggish rate of 1.9%.

Table 1.1: Global Output Growth—2006-2009 (% changes)

	2007	**2008**	**2009***	**2010***
World	5.2	3.2	-1.3	1.9
United States	2.0	1.1	-2.8	0.0
Euro Area	2.7	0.9	-4.2	-0.4
Japan	2.4	-0.6	-6.2	0.5
Developing Asia	10.6	7.7	4.8	6.1
---China	*13.0*	*9.0*	*6.5*	*7.5*
---India	*9.3*	*7.3*	*4.5*	*5.6*
Middle East	6.3	5.9	2.5	3.5
Africa	6.2	5.2	2.0	3.9

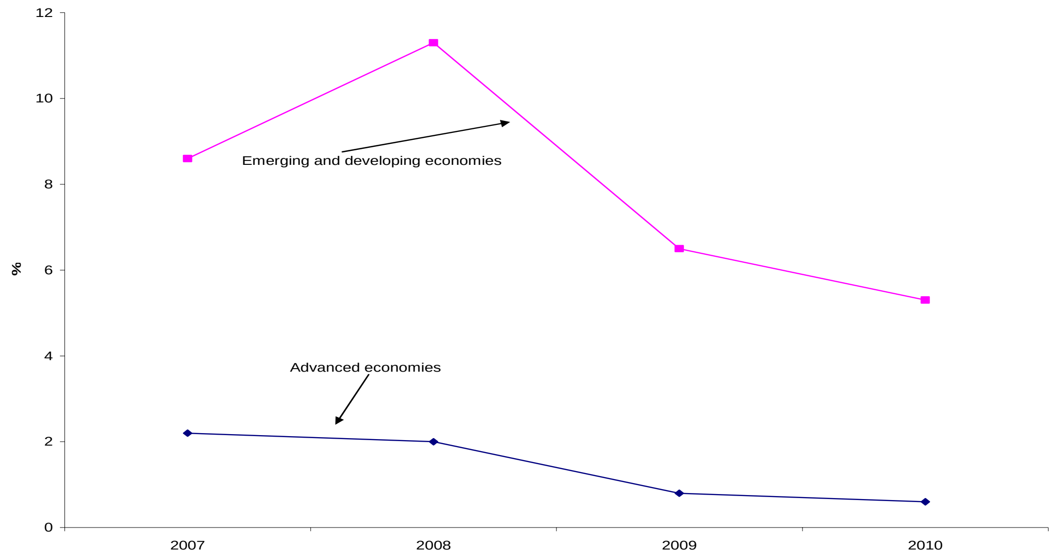
**IMF projections*

Source: International Monetary Fund, World Economic Outlook, April 2009.

Global recession brings low inflation

As the global economy deteriorated during 2008, inflationary pressures eased considerably. This trend has continued in the first half of 2009. Inflation in advanced economies averaged 2% during 2008 with a 0.8% rate projected for 2009 and 0.6% in 2010 (Chart 1.1). Although inflation in emerging markets rose from 6.4% in 2007 to 9.3% in 2008, moderation to 5.7% is anticipated in 2009, with a further fall to 4.7% in 2010.

Chart 1.1: Global Consumer Prices, 2007-2010 (%)*



**2009 and 2010 IMF projections*
Source: International Monetary Fund, World Economic Outlook, April 2009

Global financial crisis dampens Bahrain's economic outlook

The ongoing financial crisis and the sharp fall in commodity prices have also affected the Bahraini economy negatively. GDP growth was 6.3% in 2008, compared to 8.4% the previous year, largely due to a drop in non-oil output (mainly financial services). Pressures on external accounts resulted in a contraction of the current account surplus, from 14.6% of GDP in 2007 to 10.6% in 2008.

The fall in food and commodity prices has helped to keep inflation subdued at 3.5%, although lower oil prices have also led to a deterioration in government finances, with the IMF projecting a fiscal deficit amounting to 11% of GDP in 2009. However, in June 2009, the Bahrain government successfully raised $750 million dollars through an international *Sukuk* issuance, suggesting continued international confidence in the Kingdom's economic prospects.

2. The Non-Financial Sector

Key Points

Household borrowings fall despite a drop in interest rates on personal loans

Business debt ratios also decline but rates on business loans rise slightly

Activity remains subdued in the construction and real estate sector

A rise in the number of permits for new construction may signal the beginning of increased activity

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.

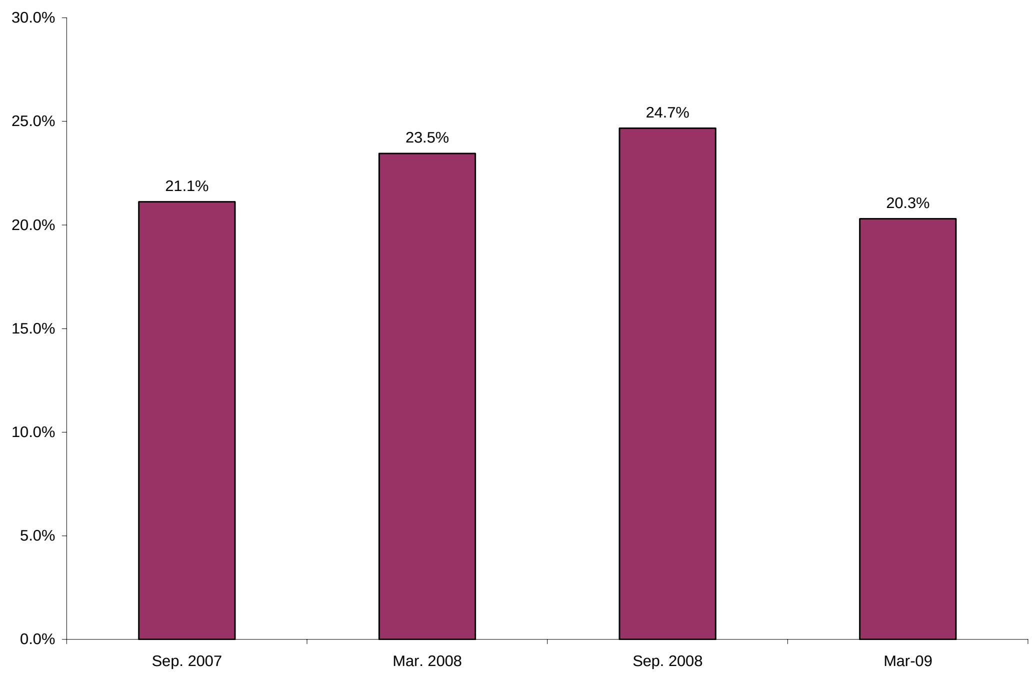
2.1. Households

Debt ratio falls

Using outstanding personal loans from all banks as a proxy for "household" borrowing, available data indicate that the household debt burden declined between September 2008 and March 2009. The ratio of personal loans to GDP fell from 24.7% as at end-September 2008 to 20.3% by the end of March 2009 (Chart 2.1). In the challenging environment created for banks by the global financial crisis, there was also a decline in personal lending, which fell by 2.4% between September 2008 and March 2009 (Chart 2.2).

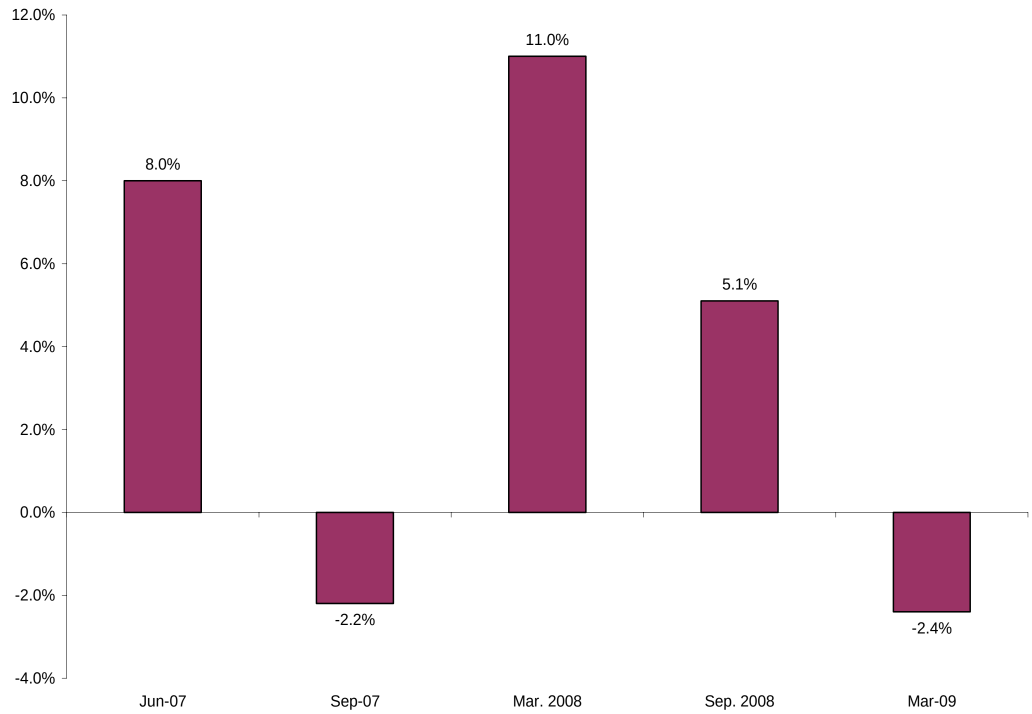
This downward trend has occurred despite a drop in average interest rates on personal loans from 8.2% in September 2008 to 7.9% by end-March 2009.

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



Source: Central Bank of Bahrain

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



Source: Central Bank of Bahrain

Positive trends for household income

Household income is a principal source of funds to service and repay debt. Trends in employment could therefore be used to gauge the level of household income risks. As at end-2009:Q1, the overall employment level in Bahrain stood at 483,777 compared to 410,162 at the same point in 2008 (an addition of 73,615 jobs). However, it should be noted that employment numbers only provide an indirect indication of potential household income, given the fact that a sizeable proportion of new jobs are for expatriate workers.

Trends in wages have also been positive. As at end-March 2009, average private sector wages stood at BD269 per month, compared to BD248 per month at the end of 2008:Q3 (Table 2.1). Over the same period, average monthly public sector wages also rose from BD770 per month to BD802 per month.

Table 2.1: Average Monthly Wages (BD)

	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q1
Private Sector	246	248	248	264	269
Public Sector	772	782	770	797	802

Sources: General Organisation for Social Insurance and Civil Service Bureau

With the private sector accounting for over 90% of total *formal* employment, a trend of increasing employment and improving average private sector wages connotes an improving ability of workers to service debt out of current income (on average).

Another positive note is the substantial fall in food prices over the past year as the global financial crisis resulted in economic slowdown around the world. Since imported food items feature heavily in the consumption baskets of households in Bahrain, the fall in food prices has the potential to increase the spending power of residents and improve their ability to service existing bank debt.

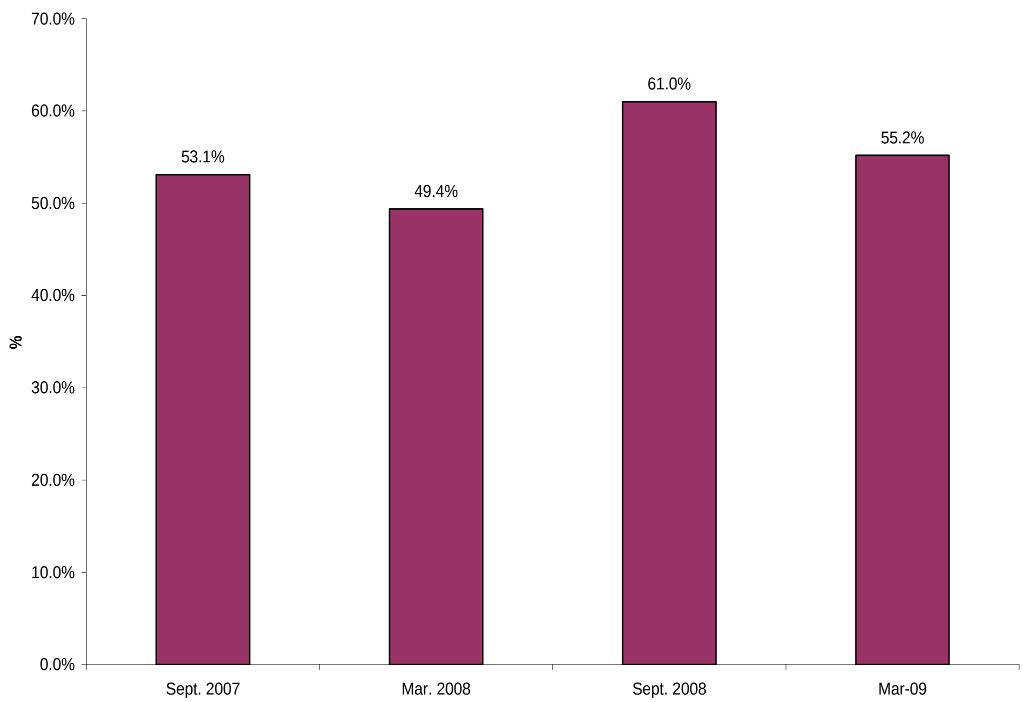
2.2. Business Enterprises

Business debt ratio declines

Between September 2008 and March 2009, the ratio of business loans to GDP fell from 61% to 55.2% (Chart 2.3). This trend no doubt reflects the impact of the global financial crisis which has created a high level of risk aversion among banks and compelled business enterprises around the world to de-leverage.

Over the period, average interest rates on business loans rose slightly from 6.8% in 2008:Q3 to 7% by end-March 2009.

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



Source: Central Bank of Bahrain

2.3. Construction and Real Estate

Continued slowdown in real estate licenses and construction permits

The global financial crisis continues to have cooling effects on the construction and real estate sector. In the first quarter of 2009, a total of 369 new commercial licenses were issued for construction, real estate and associated activities, compared to 415 licenses in 2008:Q4 and 430 in 2008:Q3 (Table 2.2).

Table 2.2: Commercial Licenses Issued for Construction and Real Estate

	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q1
Construction	161	179	149	221	162	171	166
Real Estate, Rentals and Associated Activities	227	229	294	280	268	244	203
Total	**388**	**408**	**443**	**501**	**430**	**415**	**369**

Source: Ministry of Municipality Affairs and Agriculture

However, the total number of construction permits issued by the Ministry of Municipalities Affairs and Agriculture rose from 842 in 2008:Q4 to 923 in 2009:Q1 (Table 2.3). Most of the increase occurred in the "new construction" category. One possible explanation is that many developers are seeking to take advantage of the substantial fall in the prices for steel, cement and other construction materials.

Table 2.3: Selected Construction Permits by Type

	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q1
Demolition and New construction	158	53	36	48	28	17	26
New construction	1002	812	816	1146	903	818	896
Reclamation	10	3	7	16	6	7	1
Total	**1170**	**868**	**859**	**1210**	**937**	**842**	**923**

Sources: Ministry of Municipality Affairs and Agriculture

Overall Assessment of the Non-Financial Sector

Available data shows that the debt ratio for *households* has fallen further, although interest rates on personal loans have decreased. Also, food price inflation has subsided somewhat against the background of higher employment numbers and higher wages. Debt levels in the *business sector* are lower, a welcome development as interest rates on business loans increased slightly.

For the *construction and real estate sector*, the cooling effects of the global financial crisis continues, but an increase in permits for "new construction" points to a desire by developers to take advantage of currently low prices of construction materials. <u>However, there is a need for continuous monitoring of the situation as the full impact of the crisis on businesses and households are yet to become evident</u>.

3. Financial Condition and Performance of the Banking Sector

Key Points

Some wholesale banks have experienced liquidity stress due to the global crisis.

Notably, in May 2009, two Bahrain-based wholesale banks defaulted on some market obligations, following financial distress in their parent groups.

However, pressure points have been specific to individual banks and are not indicative of a generalized systemic crisis.

On a positive note, capital adequacy ratios are comfortable across all segments and asset quality is generally satisfactory.

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), as at end-March 2009.

3.1. Conventional Retail Banks

Slight increase in retail banks' capital adequacy ratios[3]

As at end-March 2009, the aggregate capital adequacy ratio for locally-incorporated retail banks stood at 16.2%, slightly higher than the 15.5% registered as at end-September 2008. The core capital ratio (ratio of Tier 1 capital to risk-weighted assets) also rose to 12.6% (from 10.9% in

[3] The capital adequacy ratio relates total capital to risk-weighted assets. The discussion excludes overseas retail banks, which do not have prescribed capital levels or ratios.

September 2008). The higher capital adequacy positions were attained largely through cuts in banks' risk-weighted assets as lending was reduced in the uncertain environment created by the global financial crisis.

Increase in non-performing loans

As at end-March 2009, reported non-performing loans (NPLs) were 5.3% of gross loans, compared to 3.7% in September 2008. A breakdown by license category indicates that even though average NPLs were higher for locally-incorporated banks, overseas banks have experienced a faster deterioration in asset quality. Between September 2008 and March 2009, average NPLs in overseas banks jumped from 0.8% to 3% while NPLs for locally-incorporated retail banks increased from 4.8% to 6%.

Under the new Central Bank of Bahrain reporting framework, banks are required to provide a sectoral breakdown of *seriously impaired loans* (i.e. loans 90 or more days past due). A look at this data shows that the level of seriously impaired loans was generally low across sectors, except in "agriculture, fishing and forestry" with NPLs of 39.6%. This is however not worrisome, since this segment accounts for a mere 0.3% of total loans and advances.

High but declining asset concentration ratios

As in previous years, the lending portfolio of retail banks exhibits a concentration of loans in a few sectors. However, there is evidence that concentration levels are declining. As at end-March 2009, the top recipient of loans in *locally-incorporated retail banks* ("construction/real estate") accounted for 23.9% of total lending, compared to 28.9% in September 2008 (Table 3.1). Also, the top two sectors accounted for 43.8% of loans in March 2009, down from 54% in September 2008. These developments are welcome as they indicate that local retail banks are taking steps to address asset concentration risks.

One notable fact is the sharp drop in the share of the "financial" sector in total lending, from 21.4% in 2007 to 11.2% by March 2009. This is an indication of the general risk aversion among banks as the global financial crisis intensified.

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

	Dec. 2007	Sept. 2008	Mar. 2009
Consumer and Personal	21.6	25.2	19.9
Government	6.3	4.3	2.7
Construction/Real estate	13.4	28.9	23.9
Manufacturing	15.4	10.5	17.2
Mining & Quarrying	1.3	1.6	1.6
Agric, Fishing and Forestry	0.1	0.4	0.3
Financial	21.4	10.4	11.2
Trade	9.7	8.2	9.9
Services	10.7	10.5	13.3

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*

Similar trends are noticeable in *overseas retail banks*. As at end-March 2009, the top recipient of loans ("manufacturing"), accounted for 27.8% of loans, down from 37.2% in September 2008 (Table 3.2). Also, the top two sectors received 51.3% of loans as at March 2009, compared to 62% in September 2008.

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

	Dec. 2007	Sept. 2008	Mar. 2009
Consumer and Personal	13.4	5.1	9.3
Government	3.3	0.4	2.2
Construction/real estate	8.1	9.1	11.8
Manufacturing	30.4	37.2	27.8
Mining & Quarrying	0.3	0.4	1.3
Agric, Fishing and Forestry	0.4	0.3	0.3
Financial	9.8	12.7	11.6
Trade	8.9	9.8	12.2
Services	25.4	25.0	23.5

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*

Banks still profitable but earnings are lower substantially

Although retail banks are still profitable, they experienced a sharp fall in earnings between September 2008 and March 2009, no doubt as a result of the challenging environment created by the global financial crisis. Over the period, net profit for local retail banks fell by 56.5% while overseas retail banks suffered a 66% drop in net profits.

As at end-March 2009, return-on-assets (ROA) was 0.4% for locally-incorporated retail banks, down from 1.1% in September 2008. For overseas banks, ROA was 0.6%, compared to 1.2% in September. Return-on-equity (ROE) amounted to 5.7% for local retail banks, down from 9% in September 2008.

A breakdown of data on earnings shows that local retail banks earned most of their income from interest receipts, with *net interest income* representing 58.2% of gross operating income (compared to 55% in September). The story is the same for overseas retail banks, where net interest income account for 58.7% of gross operating income. Further reflecting the effects of the global financial crisis, net interest income in local retail banks fell by 60% while non-interest income declined by 65%. For overseas retail banks, net interest income dropped by 64.8% while non-interest income fell by 48.2%.

Minimal liquidity risks

Between September 2008 and March 2009, retail bank deposits expanded by 12.7%, despite the stressful financial and economic environment. The overall loan-deposit ratio for the segment stood at 68.4%, slightly higher than the 65% recorded for September 2008. This indicates that the retail banks can still depend on a relatively stable base of funding from customers. However, the ratio of non-bank deposits to total deposits dropped further to 40% (vs. 55% in September 2008) due mainly to an increase in bank deposits for overseas retail banks.

3.2. Conventional Wholesale Banks

Increase in capital ratios[4]

Wholesale banks have increased their capital cushions in the face of the global crisis. As at end-March 2009, the regulatory capital adequacy ratio for locally-incorporated wholesale banks stood at 20.4%, up from 18% in September 2008. The core capital adequacy position (ratio of Tier 1 capital to risk-weighted assets) also rose from 16% to 17.8%.

Marginal increase in non-performing loans

As at end-March 2009, loans classified as non-performing (NPLs) amounted to 1.6% of gross loans (slightly up from 1.1% in September). Locally-incorporated wholesale banks show an NPL ratio of 3.5%, a sharp rise from the 0.5% in September 2008. Overseas wholesale banks had an NPL ratio of 0.7% down from 1.4% in September.

A look at the breakdown of *seriously impaired loans* for local wholesale banks (i.e. loans 90 or more days past due) shows a relatively high 13% impairment rate in the "personal/consumer" category (up from 5% in September 2008). This is however not considered worrisome as loans in this category represent only 2% of total loans. Impairment rates in other sectors have also increased but are all in single digits (the highest was in "agriculture, fishing and forestry" with 5%).

Loan portfolios remain concentrated

An examination of lending patterns shows that for *locally-incorporated wholesale banks*, the top recipient of loans ("manufacturing") accounted for 27.2% of total lending in March 2009, compared to 25% in September 2008 (Table 3.3). Also, the top two sectors (manufacturing and financial) accounted for 47.5% of loans in March 2009, up from 45.6% in September 2008. In *overseas wholesale banks*, the top recipient of loans was the "services" sector, which accounted for 31.7% of total loans, only

[4] The capital adequacy ratio relates total capital to risk-weighted assets. The discussion excludes overseas wholesale banks, which do not have prescribed capital levels or ratios.

marginally higher than the 31.1% of September 2008 (Table 3.4). The top 2 sectors (services and financial) jointly represented 53.6% of total loans.

Table 3.3: Distribution of Wholesale Bank Lending
(% shares; locally incorporated banks only)*

	Dec. 2007	Sept. 2008	Mar. 2009
Consumer and Personal	7.0	3.3	3.3
Government	2.7	2.2	2.5
Construction/Real estate	9.5	12.3	13.0
Manufacturing	20.2	25.0	27.2
Mining & Quarrying	2.8	1.6	1.1
Agric, Fishing and Forestry	0.6	0.8	0.6
Financial	21.3	20.6	20.3
Trade	14.1	15.7	14.1
Services	21.8	18.5	17.8

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*

Table 3.4: Distribution of Wholesale Bank Lending
(% shares; overseas banks)*

	Dec. 2007	Sept. 2008	Mar. 2009
Consumer and Personal	0.3	0.3	0.3
Government	7.7	6.5	7.0
Construction/Real estate	11.4	9.4	8.5
Manufacturing	17.7	22.1	21.1
Mining & Quarrying	3.3	2.6	3.2
Agric, Fishing and Forestry	1.3	0.4	0.3
Financial	24.1	21.4	21.9
Trade	7.9	6.1	5.9
Services	26.3	31.1	31.7

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*

Positive earnings for wholesale banks

Following net losses in the period up to September 2008, available data indicates positive earnings for wholesale banks in the period up to March 2009. Return-on-assets (ROA) for the segment was a *positive* 0.2% (vs. *negative* 0.1% in September 2008). This swing was mainly the result of improved performance for local wholesale banks, which had been responsible for the September 2008 net loss position for wholesale banks as a group. ROA for local wholesale banks was 0.5% in March 2009, higher than the 0.3% for overseas wholesale banks.

Mixed picture on liquidity

There were improvements in banks' liquidity positions during the review period. As at March 2009, the overall loan-deposit ratio for conventional wholesale banks stood at 79%, down from 88% in September. Notably, the loan deposit ratio for *overseas wholesale banks* experienced a significant drop from 106% in September 2008 to 87% by the end of March 2009. The loan-deposit ratio for local wholesale banks declined to 64% (from 67% in September), indicating an improvement in their liquidity position.

In contrast to the foregoing improvements, liquid assets for wholesale banks represented 14% of total assets in March 2009, down from 16% in September 2008. Further, 72% of wholesale bank deposits come from other banks and financial institutions, up from 60% in September 2008.

Although the liquidity picture for the segment is not alarming, some individual banks are finding it difficult to cope. In May 2009, two wholesale banks, subsidiaries of Saudi financial/industrial conglomerates, defaulted on certain foreign exchange and trade finance obligations, following financial distress in their parent groups.

3.3. Islamic Retail Banks

Healthy capital positions and improved profitability

The capital position of Islamic retail banks declined from 28% in September 2008 to 22.4% in March 2009. Although this is still well above the regulatory capital requirements, it continues the trend of falling capital levels in Islamic retail banks (the capital adequacy ratio was 34% in December 2007). The Tier 1 capital ratio stood at 21.8% in March 2009, compared to 24.4% in September 2008.

Profits increased marginally over the period, with return on assets (ROA) standing at 5.1% in March, from 5% in September 2008.

Non-performing facilities are low but assets are concentrated

As at end-March 2009, aggregate non-performing financing facilities (NPF) were 3.5% of total facilities, down from 3.8% in September 2008. A look at the sectoral breakdown of non-performing facilities indicates that the “manufacturing” sector now shows the highest level of NPF (9.5%) taking over from the “trade” sector which now has an NPF ratio of 6.5% (10.4% in September). “Personal and consumer finance” is third with an NPF ratio of 6.3%.

Similar to the situation in conventional retail banks, the level of asset concentration is high in Islamic retail banks. The top recipient of financing (construction/real estate) accounted for 37% of total financing as at end-March 2009. The top-two recipients (construction/real estate and trade) jointly accounted for 48% of total financing facilities at the end of March 2009.

Mixed picture on liquidity

The volume of liquid assets available to Islamic retail banks rose to 21% in March 2009, from 18% in September 2008. However, deposits from banks and other financial institutions currently constitute 54% of non-capital funding liabilities (up from 46% in September 2008). As highlighted previously in this report, this situation constitutes a potential source of volatility in the funding base of Islamic retail banks.

3.4. Islamic Wholesale Banks

Slight improvement in capital positions but net losses

As at end-March 2009, the regulatory capital adequacy ratio (CAR) for Islamic wholesale banks stood at 25.2%, slightly higher than the 24.6% recorded for September 2008. There was a sharp slowdown in the pace of increase of risk-weighted assets as banks cut back on their deployment of surplus capital. The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) was also higher at 25.2% (compared to 22% in September 2008).

The earnings performance of Islamic wholesale banks was poor, as they registered net losses as a group over the period. Return on assets fell from 1.5% in September to -0.2% in March 2009.

High asset concentration but lower NPFs

As at end-March 2009, aggregate non-performing financing facilities (NPF) in Islamic wholesale banks stood at 5.3%, down from 7% in September 2008.

These banks however still exhibit high levels of asset concentration. The top recipient of financing, (financial), accounted for 30% of total financing facilities at the end of March 2009. As at the same date, the top two recipient sectors (financial and services) jointly represented 51% of total financing facilities.

Improvement in liquidity positions

As at end-March 2009, liquid assets represented 24.6% of total assets, compared to the 19% registered in September 2008. Also, deposits from banks and other financial institutions currently constitute a reasonable 24% of non-capital funding liabilities (up from 20% in September 2008).

3.5. Overall Assessment of the Banking Sector

Bahrain's wholesale banking segment has faced liquidity pressures over the past few months and in May 2009, two wholesale banks, subsidiaries of Saudi financial/industrial conglomerates, defaulted on certain foreign exchange and trade finance obligations. These banks are currently in the process of working out their commitments, against the background of wider debt restructuring in their parent groups.

However, it should be noted that these incidents are a result of circumstances specific to these banks and their parent companies and not indicative of a generalized problem in the Bahraini banking sector. Despite the unusual levels of stress transmitted through the global financial crisis, the sector has not experienced a *systemic* crisis.

On a positive note, conventional wholesale banks as a group show positive earnings for the period under review, compared to the net losses reported in the last *Financial Stability Report*. Capital adequacy ratios are comfortable across all banking segments and asset quality is still satisfactory. However, banks continue to show high levels of asset concentration risks, although progress is being made in reducing these risks.

If the crisis impacts the real sector more strongly, other banks currently unaffected may suffer from second-round effects of the turmoil, possibly in the form of credit losses. An economic downturn will also have adverse affects on banks' income prospects, putting pressure on net earnings. There is therefore a need for continued vigilance in order to ensure that the impact of the crisis on the Bahraini financial sector remains contained.

4. Financial Condition and Performance of the Insurance Industry[5]

Key Points

Solvency margins exceed business requirements substantially

Increase in the level of insurance receivables

Growth in net income as companies reduce costs

Healthy capital and solvency positions

In spite of the global financial crisis, the Bahraini insurance sector continues to exhibit adequate capital levels. As at end-March 2009, insurers' Tier 1 capital represented 21.9% of total assets, up from 19.6% in September 2008. For both general and life business lines, the available capital exceeds required margins of solvency by substantial amounts.

Increase in the level of insurance receivables

As a result of new CBB rules that all debts due for more than six months be valued at zero for capital valuation purposes, there was a substantial decline in the level of insurance receivables from over 100% in March 2008 to 61% by September 2008. However, available figures for end-March 2009 indicate that the level of receivables have increased again to 72% of gross premiums, probably due to the effects of the global crisis on the prompt payment of premiums.

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

Increase in re-insurance ceded

The risk retention ratio (net premiums/gross premiums) declined further to 74.8% in March 2009, from 80% in September 2008. As pointed out in the December 2008 *Financial Stability Report*, this trend is attributable to uncertainties in the operating environment which has encouraged Bahraini insurers to pass along more underwriting risks to re-insurers, thus sharing risks more broadly in the current challenging environment.

Net income increases

In the period up to March 2009, insurance companies experienced a 14% increase in net income, principally due to successful cost-cutting measures. The *claims ratio* (ratio of claims incurred to premiums earned) fell sharply from 71% in September 2008 to 52.5% by March 2009. Also, the *expense ratio* (ratio of expenses to earned premiums) fell from 28% in September 2008 to 26% in March 2009. As a result of these trends, the *combined ratio* (claims ratio plus expense ratio) of 78.5% in March 2009 is significantly lower than the 99% ratio recorded for September 2008.

Overall assessment

There are no serious financial stability concerns in the insurance industry. Solvency margins remain substantial and companies are sharing risks more broadly with re-insurance companies. Costs have also been reduced significantly, translating into an increase in net income. One area of concern is the increase in insurance receivables in the period up to March 2009, reversing previous success in lowering the level of receivables.

5. Performance of Equity Markets

Key Points

Significant decline in market capitalization as the global financial crisis impacts Gulf stock markets

Market price indices also down substantially

There are initial signs of a turnaround but level of activity is still far below 2008 peak levels

Significant decrease in market capitalization

As at end-May 2009, market capitalization of the Bahrain Stock Exchange (BSE) stood at BD6.6 billion, equivalent to 80.7% of nominal GDP (Table 5.1). This level of market capitalization is about 36% lower than the level as at end of September 2008 (and 41% lower than the level in May 2008). This no doubt reflects the negative impact of the global financial crisis on market valuation across the Gulf.

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

	Sept. 2008	May 2009	% change
Commercial banks	3535.2	2,321.0	-34.3
Investment	4971.7	2,820.1	-43.3
Insurance	209.0	196.5	-6.0
Services	1390.3	1,142.6	-17.8
Industrial	16.0	13.9	-13.1
Hotel and Tourism	154.1	154.2	0.1
TOTAL	**10276.2**	**6,648.3**	**-35.3**

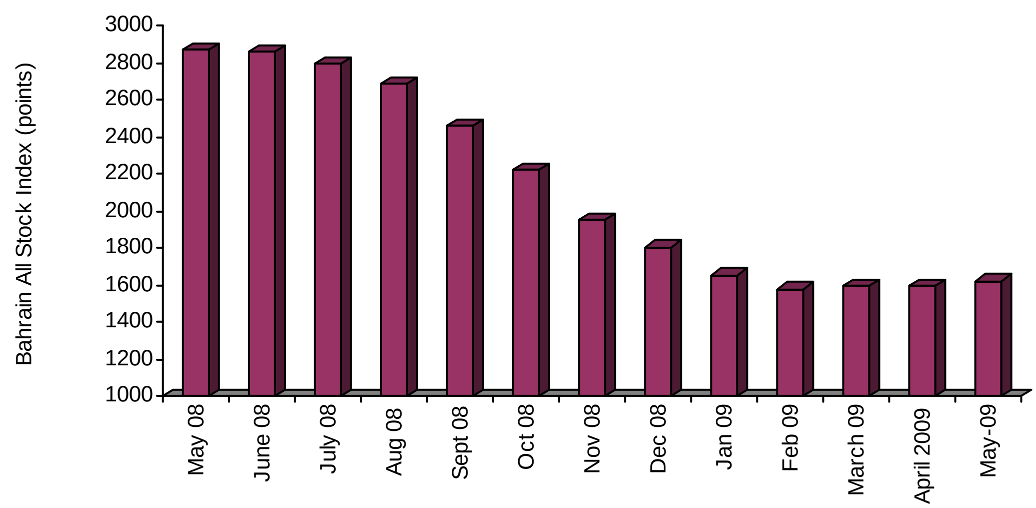
Source: Bahrain Stock Exchange

Over the period, virtually all sectors experienced a decline in market capitalization. The only exception was the "hotel and tourism" sector, which saw a marginal 0.1% gain. The largest decline occurred in the "investment" sector, where market valuation fell by 43.3%.

Downward trend in market index

A look at year-on-year data shows that the Bahrain All Share Index lost a total of 1,251.87 points (a 43.6% decrease) between May 2008 and May 2009 (Chart 5.1). November 2008 was a particularly bad month, during which the Index lost a total of 271 points. Although a turnaround seemed to have begun in March 2009, the Index is still far below the peaks attained in 2008. By the end of May 2009, the Index stood at 1,622.15.

Chart 5.1: Recent Trends in the BSE All-Share Index, May. 2008-May 2009



Source of Data: Bahrain Stock Exchange

As mentioned above, the negative trends on the market reflects the impact of the global financial crisis, which has been felt across GCC equity markets, with all markets in the region experiencing year-on-year declines in relevant price indices (Table 5.2, next page). However, a look at trends since November 2008 indicates that other stock markets in the GCC are faring much better than the BSE.

Between November 2008 and May 2009, the BSE All Share Index was down by 16.8%, compared to declines of 8.2% in Kuwait, 4.4% in Dubai and 3.5% in Abu Dhabi. Indeed, three GCC markets recorded large gains over the period, with the Saudi market up by 24.4%, Doha by 15% and Muscat by 18%.

Table 5.2: Stock Market Indices in GCC counties

	May 2008	Nov 2008	May 2009	May 2008 - May 2009 change (%)	Nov 2008-May 2009 (%)
Bahrain All Share Index	2,874.02	1,949.20	1,622.15	-43.6	-16.8
Tadawul All Share Index	9,529.34	4,738.14	5,893.34	-38.2	24.4
Kuwait Market Index	15,014.5	8,875.2	8,150.0	-45.7	-8.2
Doha Stock Market 20 Index	11,884.77	6,071.39	6,980.76	-41.3	15
Dubai Financial Market Index	5678.59	1964.66	1878.09	-66.9	-4.4
Abu Dhabi Index	5,037.85	2,775.85	2,679.41	-46.8	-3.5
Muscat Securities Market Index 30	11,554.69	6263.86	5138.95	-55.5	18

Sources: Bahrain Stock Exchange, Saudi Stock Exchange, Kuwait Stock Exchange, Dubai Financial Market, Abu Dhabi Securities Exchange, and Muscat Securities Market

Drop in price-earning ratios

As at May 2009, the price-earning ratio (P-E ratio) for the stock market stood at 7.81, down from the 11.24 attained in September (Table 5.3). Notable was the jump in P-E ratio for the "insurance" sector from 9.32 in September 2008 to 19.42 in May 2009.

Table 5.3: BSE—Price-Earning Multiples

	May 2008	Sept. 2008	May 2009
Commercial banks	17.70	14.99	9.80
Investment	9.72	10.34	6.44
Insurance	8.93	9.32	19.42
Services	10.28	8.73	7.25
Industrial	8.71	8.73	7.35
Hotel and Tourism	8.85	9.84	7.77
Total Market	**11.81**	**11.24**	**7.81**

Source: Bahrain Stock Exchange

Aggregate trading levels remain low

Trading is relatively thin on the BSE, with the turnover ratio (value of trading as a share of market capitalization) at around 0.3%, up from the 0.1% registered in September 2008. As in previous periods, the "investment" sector accounted for the bulk of trading on the market, with 50% of total trades (Table 5.4). This however represented a fall in its share when compared to the 64.3% recorded for September 2008. One notable trend is the surge in trading in the "services" sector, with its share of trading jumping from only 8.8% in September 2008 to 20.5% in May 2009. This sharp swing was mainly due to a substantial fall in trading levels for other sectors.

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

	May 2008	Sept. 2008	May 2009
Commercial banks	60.7	24.8	29.4
Investment	28.3	64.3	50.0
Insurance	0.8	1.1	0.0
Services	8.5	8.8	20.5
Industrial	0.6	0.0	0.0
Hotel and Tourism	1.1	1.1	0.1

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

Source: Bahrain Stock Exchange

Overall assessment

The global financial crisis has impacted the Bahraini Stock Exchange negatively, with declines in market capitalization and in the main price index. This trend is however not unique to Bahrain as other GCC markets were also affected. There are now signs of a recovery in the market as investor confidence begins to return, albeit tentatively. We envisage that levels of activity will be far below 2008 peaks for a few more months, until there are definite signs that the global financial crisis is closer to a final resolution.

6. Payment and Settlement Systems

Key Points

The use of the RTGS for retail payments and settlement continues to grow

The new payments and settlement system is operating smoothly

Credit, liquidity, legal and operational risks remain low

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

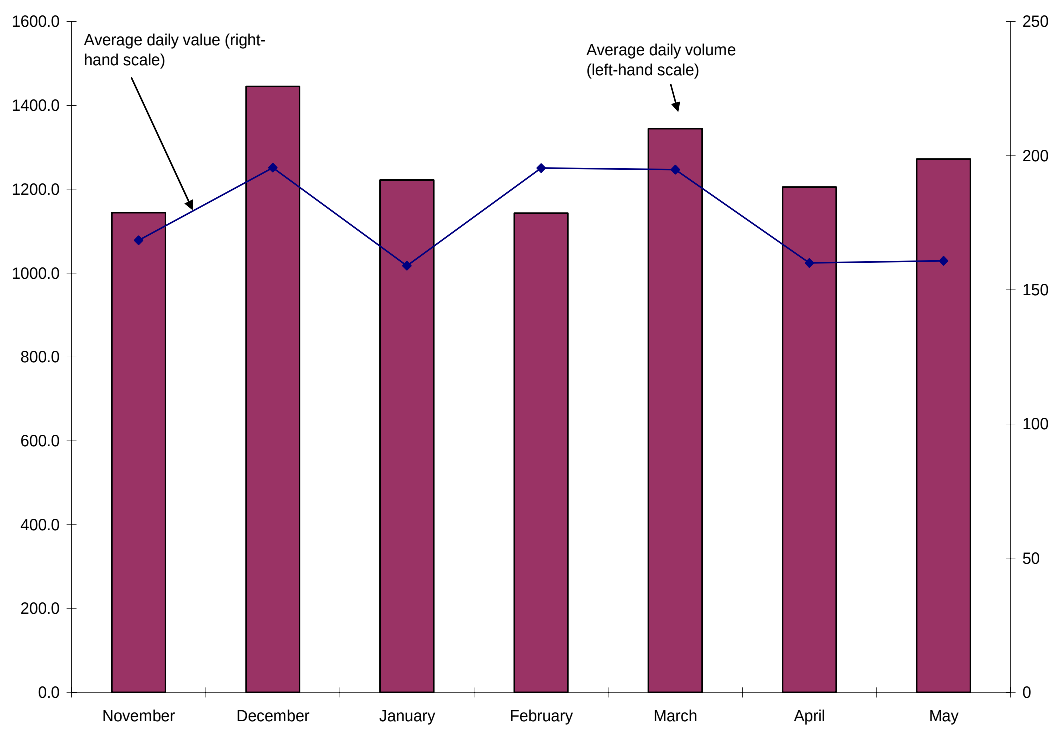
The current payments and settlement infrastructure in Bahrain comprises of five main components: i) the Real Time Gross Settlement System (RTGS); ii) the Automated Cheque Clearing System (ACS); iii) the ATM clearing system; iv) the Scripless Securities Settlement System (SSSS); and v) the clearing, settlement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

Real Time Gross Settlement System (RTGS)

The RTGS is Bahrain's primary system for processing large-value, inter-bank payments. However, the RTGS is also used to process small-value retail payments for bank customers.

Chart 6.1 shows the volume and value of payments passing through the RTGS system from November 2008 through May 2009. Over this period, the *average daily volume of transfers* increased from 1144 in November 2008 to 1272 in May 2009, an increase of 11%. In value terms, transfers decreased from a daily average of BD168.5 million in November 2008 to BD160.8 million in May 2009. The combination of increased average daily volume and lower average value suggests a significant rise in the use of the RTGS to process small-value retail payments for bank customers.

Chart 6.1: RTGS System: Average Daily Volume and Value of Payments Processed, Nov. 08-May 09



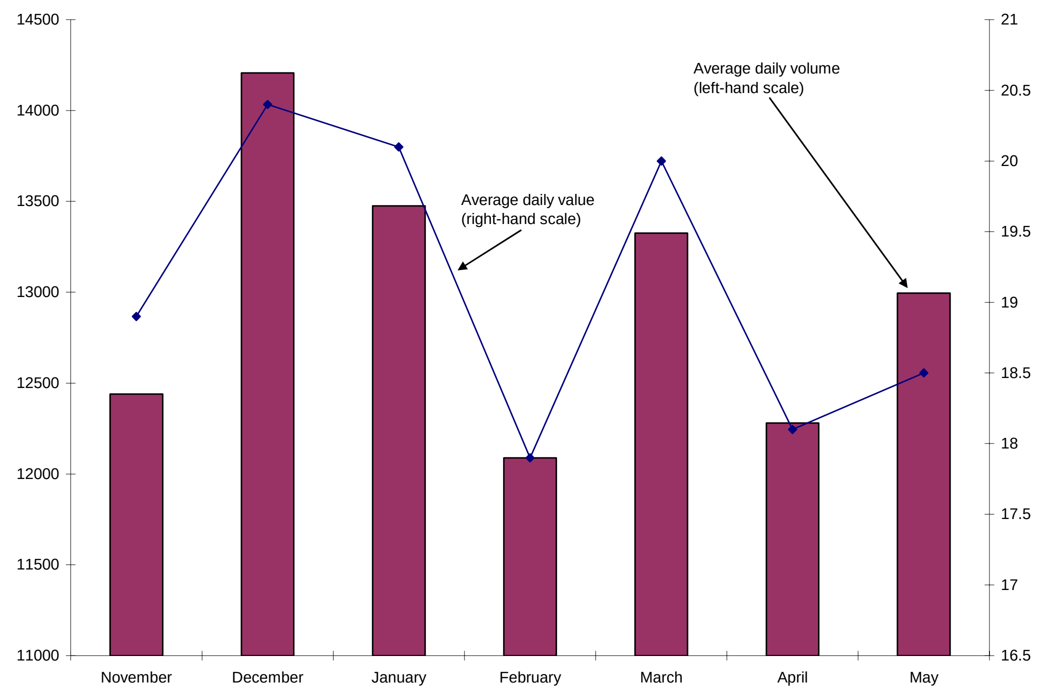
Source: Central Bank of Bahrain

The Automated Cheque Clearing System (ACS)

Chart 6.2 below shows the volume and value of cheques processed through the Automated Cheque Clearing System (ACS) from November 2008 through May 2009.

Over this period, the *average daily volume* of cheques processed increased from 12,440 to 12,995. In contrast, there was a slight decline in the *average daily value of cheques* from BD18.9 million in November 2008 to BD18.5 million in May 2009.

Chart 6.2: ACS System: Average Daily Volume and Value of Payments Processed, Nov. 08-May 09

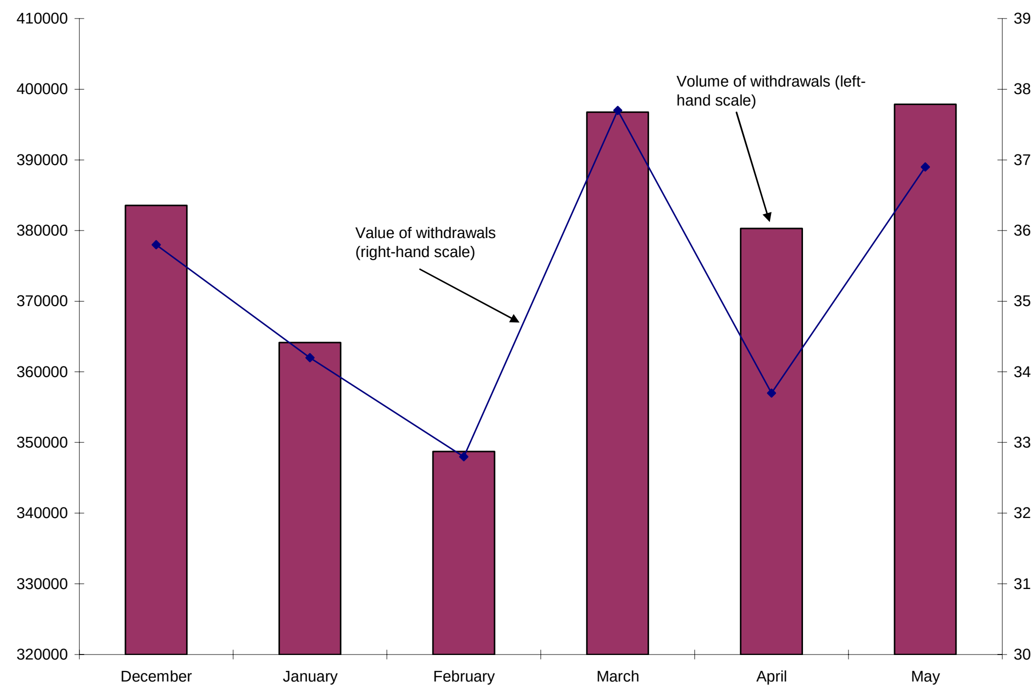


Source: Central Bank of Bahrain

ATM Clearing System

Between December 2008 and May 2009, the *number of withdrawal transactions* processed through the ATM Clearing System increased from 383,574 to 397,861 (3.7% growth) (Chart 6.3). In *value terms*, total withdrawals processed increased from BD38.3 million in December to BD39.7 million in May.

Chart 6.3: Number and Value of ATM Transactions, Dec. 08-May 09



Source: The Benefit Company

6.2. Assessment of Payment and Settlement Systems

Bahrain's new payments and settlement infrastructure continues to function normally, with the RTGS now providing a quick and efficient framework for processing both retail and wholesale payments. The various safeguards incorporated into the new framework have also served to minimize credit, liquidity and operational risks. Hence, we do not see any financial stability issues at this juncture.

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