Central Bank of Bahrain
Financial Stability Directorate

Financial Stability Report

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Preface

Financial stability can be defined as a situation where financial intermediaries and markets are able to provide financial services continuously and prudently, even in the face of 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. This emphasis on financial stability 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 purpose of this surveillance is to identify sources of risk and mitigate them before they crystallize into systemic financial turbulence.

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 aim is to assess the financial condition and performance of financial intermediaries and markets, identify potential risks to financial stability and propose remedial supervisory actions for any recognized vulnerabilities.

This edition of the FSR is organized into five chapters plus an Annex 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 financial condition and performance of the banking sector (conventional and Islamic), while Chapter 4 reviews recent trends on the equity market. Chapter 5 examines stability issues relating to the payment and settlement systems. Annex 1 presents a Special Feature on "Trends in Credit Card Receivables".

Unless indicated otherwise, this report analyzes data covering the period between end-September 2006 and end-March 2007.

Executive Summary

Overall assessment

The Bahraini financial system remains healthy and robust. Both the conventional and Islamic banking segments possess strong balance sheets, evidenced by high levels of capital, good asset quality, ample liquidity and impressive earnings. The equity market has been able to weather most of the market turbulence that occurred across the GCC during 2006 and the payments and settlement system is being strengthened to enhance its safety, soundness and security. In addition, the financial sector continues to be supported by favorable domestic, regional and global macroeconomic environments. Notwithstanding, there are some trends that require attention from a financial stability perspective.

International and domestic macroeconomic trends

Following the remarkable 5.4% expansion of 2006, *world output* is expected to continue growing in 2007, albeit at a slower pace of around 4.9% per annum. The current travails of the United States' economy imply that it will not be the engine of global output expansion and the impetus for global growth will come from countries of Developing Asia.

International financial markets are showing signs of stress, with reports of hedge fund losses in the sub-prime mortgage market in June 2007. These events have evoked fears that the currently benign credit cycle may be peaking and a turbulent "correction" might be imminent.

The possibility of a disorderly unwinding of *global trade imbalances* remain, especially given the shift in the financing of US current account deficits from low-risk assets to riskier debt instruments. *Oil prices* are forecast to average $60.75 per barrel during 2007, although risks of supply disruptions remain.

Bahrain's *macroeconomic environment* is strong and stable. Although oil is still a mainstay of the economy, the continued expansion of the non-oil sector is encouraging, helping to provide a solid, diversified base for the economy.

The non-financial sector

Available figures for 2006 indicate that the personal loans-to-GDP ratio declined during the year. This trend is welcome, given the fact that interest rates on personal loans have been moving upwards. In contrast, the level of indebtedness in *the business sector* rose further in 2006, with the ratio of business loans to non-financial GDP reaching 45.8%, up from 40.4% in 2005.

The strong performance of the non-oil sector is evidenced by the continued increases in commercial licenses issued as well as the growth of non-financial output. While this gives some comfort that business balance sheets are not being stretched, it is critical that lenders continuously monitor existing borrowers and ensure that new loans are extended on a sound and prudent basis.

The boom in *construction and real estate development* continues as evidenced by permits for construction as well as trends in land prices.

The banking sector

The performance of *domestic banking institutions* continues to be impressive, with solid profits and high levels of capitalization. Non-performing loans remain in single digits although NPLs in retail banks edged up somewhat, compared to September 2006 levels. As reported in the January 2007 *Financial Stability Report*, retail banks continue to show relatively high NPLs in some sectors (e.g. trade and construction). A special investigation of credit card receivables in retail banks also indicates uncomfortably-high levels of delinquency (see Annex 1).

Equity markets

The 2006 turbulence in GCC equity markets spilled over into 2007 in the form of selling pressures on the *Bahrain stock market.* However, investor sentiments appeared to have turned positive by mid-year, as the Bahrain All-Share Index gained some momentum, rising by over 200 points in May 2007.

Payments and settlement system

The *payments and settlement infrastructure* in Bahrain is currently in transition, with ongoing implementation of initiatives such as a new Real Time Gross Settlement (RTGS) System, an image-based Cheque Truncation System (CTS) and the new Scripless Settlement System (SSS) for government securities. Upon completion, these initiatives will help address most of the legal, credit and operational risks exhibited by the current payments and settlement system. 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 that the Bahraini financial system remains healthy and robust, the following areas warrant attention:

- Retail banks have a relatively high and growing level of credit card delinquencies.
- Available data show that conventional retail banks have relatively high non-performing loans in construction, although the trend has been downward.
- Retail banks' coverage ratios (provisions and interest in suspense as a proportion of non-performing loans) are also relatively low for construction; coverage ratios in construction are low for wholesale banks as well but their NPLs in this sector are much lower.
- Conventional retail bank lending is concentrated in "consumer and personal" loans (23.1%) while the lending of conventional wholesale banks is concentrated in the "financial" category (34.3%).
- The clearing and settlement system on the Bahrain Stock Exchange is exposed to *settlement agent risk.* Trades are settled through a single private agent, the Bank of Bahrain and Kuwait (BBK). This makes the system heavily dependent on the continued financial and operational health of BBK.

1. International and Domestic Macroeconomic Developments

Key Points

Global economic growth is set to continue, albeit at a slower pace

Developing Asia and Africa expected to provide the fillip for growth in 2007

Recent losses in the US sub-prime mortgage market have heightened fears of an abrupt reduction in risk appetites, wider spreads and higher volatility.

Macroeconomic performance in Bahrain continues to be robust, with the non-oil sector maintaining its growth

Strong performance also registered in other 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 variables 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 pre-dated financial crises.

1.1. International Macroeconomic Trends[1]

Global economic growth set to continue

Following the 5.4% expansion recorded during 2006, world output is expected to continue growing, although at a slower rate. Recent IMF projections show that world output will stabilize at around 4.9% for 2007 and 2008 (Table 1.1). With real GDP growth forecasts of 8.8% and 8.4% for 2007 and 2008 respectively,

[1] This section draws on various projections contained in the IMF's, *World Economic Outlook*, April 2007 and *Global Financial Stability Report*, April 2007.

Developing Asia will provide the impetus for global growth as the slowdown in the US housing market continues to impede its economic performance.

Table 1.1: Global Output Growth—2006-2008

	2005	*2006*	*2007**	*2008**
World	4.9	5.4	4.9	4.9
United States	3.2	3.3	2.2	2.8
Euro Area	1.4	2.6	2.3	2.3
Japan	1.9	2.2	2.3	1.9
Developing Asia	9.2	9.4	8.8	8.4
Middle East	5.4	5.7	5.5	5.5
Sub-Saharan Africa	6.0	5.7	6.8	6.1

**IMF projections.*
Source: IMF, World Economic Outlook, April 2007.

Urgent need for global trade imbalances to adjust

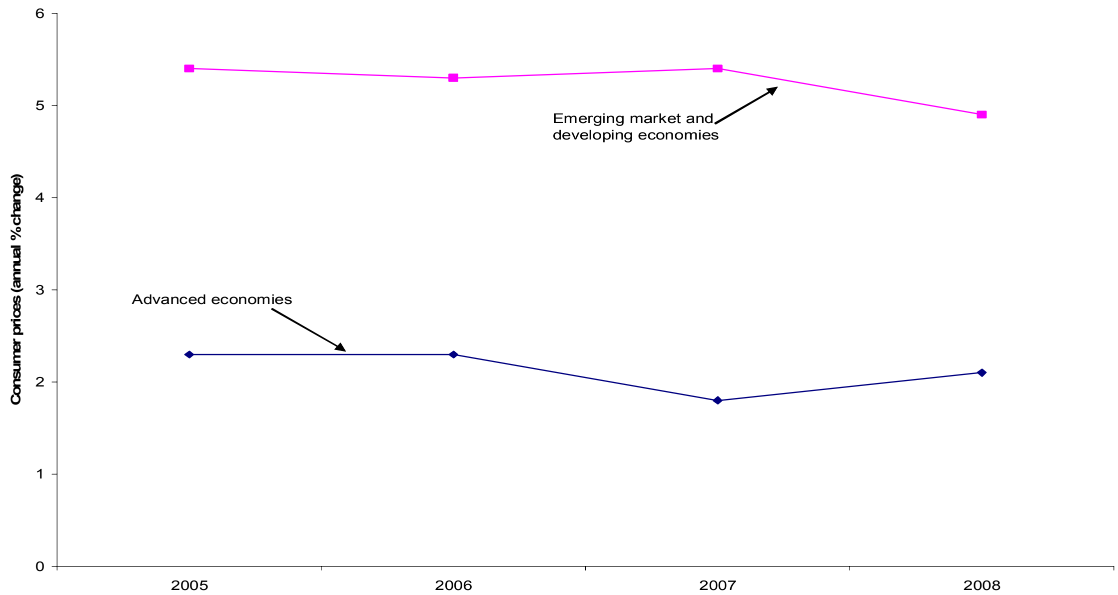
World trade is currently characterized by large imbalances, with a large US current account deficit corresponding to sizeable surpluses in China, Japan and the oil exporting Gulf countries. With US current account deficits standing at almost $900 billion, the weakening of the dollar seems to have helped trim imports and increase export volumes. US exports grew by 8.9% in 2006 and are forecast to further expand by 8.0% in 2007; growth of imports slowed down to 5.8% and is expected to slow down further to 2.9% in 2007.

Although foreign capital continues to flow into the US to finance its current account deficits, there are signs that the composition of capital inflows is changing from low-risk assets such as government bonds into riskier debt instruments, which are more sensitive to interest rate and exchange rate movements.

Global inflation rates remain under control

It is remarkable that global inflation has remained subdued in the face of strong world output growth. In 2007, consumer prices are expected to decline further to an average of 1.8% in advanced economies before rising slightly to 2.1% in 2008. In emerging market and developing economies, consumer prices are projected to rise to 5.4% in 2007 and then edge downwards to 5.1% in 2008 (Chart 1.1). Tighter monetary policy and the moderation of oil price increases in 2006 have contributed to keeping inflation under check.

Chart 1.1: Global Consumer Prices (%)*

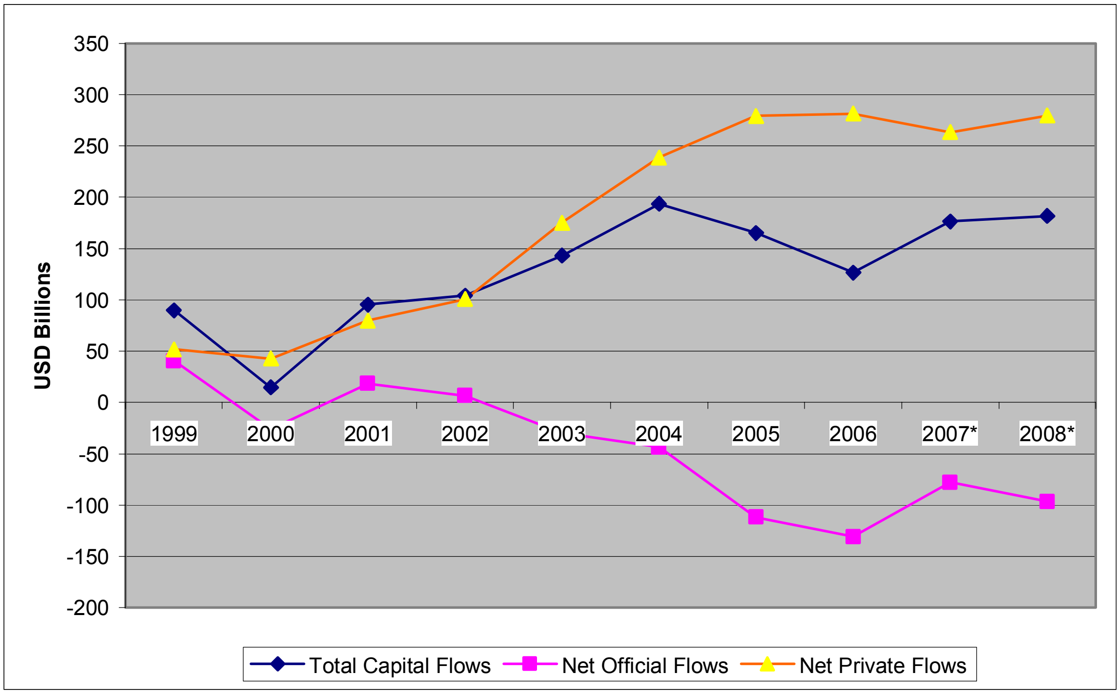


**2007 and 2008 are IMF projections*
Source: IMF, World Economic Outlook Database

Fears of a "correction" in financial markets

In an environment of ample liquidity, low volatility and relatively low real interest rates, investor appetite for risk has risen in tandem with the search for high yields. Leverage is at historically-high levels, with private equity funds making record-sized buy-outs, using large amounts of borrowed funds. The activities of hedge funds have also attracted attention. Further, sizeable amounts of capital have flowed into emerging markets, in continuation of the search for higher yields as well as in response to much-improved economic performance in these economies (Chart 1.2).

Chart 1.2: Emerging Market Capital Flows, 1999-2008*



**Comprises of net direct investment, net portfolio investment, and other long and short-term net investment flows, including official and private borrowing. Emerging markets consist of Africa, Central and Eastern Europe, the CIS, Developing Asia, Middle East and the Western Hemisphere. 2007 and 2008 Figures are estimates.*
Source: IMF, World Economic Outlook, April 2007.

However, international financial markets are beginning to show signs of stress, as evidenced by the February/March 2007 sell-off in emerging markets and reports of hedge fund losses in the sub-prime mortgage market in June 2007. These events have evoked fears that the currently benign credit cycle may be peaking and a turbulent "correction" might be imminent. As almost every market participant has acknowledged, the current easy conditions in financial markets are not going to last for ever. Concerns are mounting that a sudden change in market conditions such as a reduced investor appetite for risk may result in higher spreads and higher volatility. If a large scale "correction" were to occur, it could set off turbulence in both matured and emerging markets, with serious adverse consequences for the real sector.

Oil prices expected to remain robust

Oil prices are forecast to remain high, despite the anticipated increase in output from some African countries. The average price of oil is expected to be $60.75 per barrel during 2007, rising to $64.75 in 2008. Risks of supply disruptions however remain.

Positive outlook for GCC economies, but inflationary pressures building

The outlook for GCC economies remains positive, given continued high oil prices. The oil windfall has allowed high levels of private and public sector investment, supporting strong GDP growth and healthy current account surpluses. Although oil still remains the pivotal sector for these economies, the recent strong performance of the non-oil sector has been encouraging (see Table 1.2). The expansion in non-hydrocarbon activities is welcome because the long-term sustainability of growth and development in the region depends on the ability to diversify their economies and reduce vulnerabilities to the vagaries of the oil sector.

Although the economic performance of the region has been sound, some countries in the GCC (e.g. UAE and Qatar) have experienced strong inflationary pressures. Containing inflation has therefore become a key objective of GCC governments in the short- to medium-term.

Table 1.2: Summary Economic Indicators for GCC Region.

	2004	*2005*	*2006**	*2007**
Nominal GDP (USD billion)	482.5	608.9	722.8	790.9
% Change	19.0	26.2	18.7	9.4
GDP Per Capita (USD ‘000)	14.1	17.1	19.6	20.6
Real GDP (% Change)	6.8	7.1	6.7	7.0
Hydrocarbon GDP	*6.2*	*5.2*	*3.3*	*4.5*
Non-Hydrocarbon GDP	*7.3*	*8.0*	*8.0*	*7.9*
Inflation (%)	2.7	4.3	5.2	4.3
External Debt (% of GDP)	19.7	20.3	20.1	21.6
Fiscal Balance(% of GDP)	14.3	21.7	23.7	19.9
Central Gov. Debt (% of GDP)	41.5	27.2	21.4	17.7

Source: Institute of International Finance

1.2. Domestic Macroeconomic Environment

Solid output growth and moderation in official inflation

Final GDP data for the year 2006 is not yet available. However, provisional national accounts data indicate that *real GDP* grew by 6.4% in 2006, compared to the 7.8% growth of 2005 (Table 1.3). The non-oil sector continues to grow, registering a 7.3% expansion in 2006. Indeed, the oil sector contracted by 0.8% (in real terms) during the year. Inflation, as measured by the official Consumer Price Index (CPI) stood at 2.1% in 2006, a slight decrease from the 2.6% recorded in 2005.

Table 1.3: Bahrain—Selected Macroeconomic Indicators

	2004	2005	2006*
Real GDP growth (%)	5.6	7.8	6.4
Oil output growth (%)	-11.5	-8.4	-0.8
Non-oil output growth (%)	8.7	10.2	7.3
Inflation (CPI)	2.4	2.6	2.1
Fiscal balance (% of GDP)	1.4	5.1	n.a.
Domestic Govt. Debt Outstanding (BD million)**	585.5	627.2	679.1
Domestic Government Debt (% of GDP)**	13.9	12.5	11.5
Domestic credit growth (%)	24	17.6	15.6
M2 Growth (%)	4.1	22.0	15.0
Export growth (%)	13.4	33.3	15.3
Import growth (%)	14.6	22.5	12.6
Current account balance (% of GDP)	3.7	11.8	12.3
International reserves (months of imports)	3.1	3.1	3.8

**Provisional GDP data only*

***Public borrowing through securities only.*

Source: Central Bank of Bahrain and Central Informatics Organisation

Domestic interest rates edge upwards

In the first quarter of 2007, there were slight increases in personal loan rates and short term deposit rates (Table 1.4). Business loan rates averaged 7.6% during the same period, slightly down from the 7.8% highs in mid-2006. Also, personal loan rates averaged 9.1%, higher than the level reached during the last quarter of 2006. Deposit rates increased from an average 4.4% for 2006 to 5.2% in the first quarter of 2007.

Table 1.4: Average Interest Rates (%)

	2006:Q1	2006:Q2	2006:Q3	2006:Q4	2007:Q1
Personal loans**	9.0	8.6	9.2	8.9	9.1
Business loans**	7.3	7.8	7.8	7.6	7.6
Commercial bank deposit rate (3-12 mths)**	4.2	4.5	4.4	4.4	5.2

*** Weighted averages of rates during the last month of each quarter*
Source: Central Bank of Bahrain

Robust external sector performance

In 2006, the *current account surplus* expanded to BD721.3 million, an increase of 14% over 2005. The substantial increase in the *surplus on goods* was the major contributor to this increase, influenced by high levels of international oil and aluminum prices. Oil was also dominant on the import side, accounting for 57% of the total import bill, influenced by the import of crude oil from Saudi Arabia for processing at Bahrain's refinery.

Bahrain's official reserves have been accumulating at a rapid pace, reaching BD1080.4 million (roughly $2.8 billion) by the end of 2007:Q1. This was 35.5% higher than the level attained during the same period last year. The reserves position was sufficient to finance 3.4 months of imports.

Overall assessment

As pointed out in the *January 2007 Financial Stability Report*, the ongoing economic boom is beneficial to the financial sector. With IMF projections indicating that oil prices will remain high during 2007, the robust support for government revenue, domestic investment and growth in Bahrain will continue. If oil prices were to dip, the diversified nature of the Bahraini economy is expected to provide a sizeable amount of protection.

2. The Non-Financial Sector

Key Points

In 2006, the personal loans-GDP ratio declined

However, the pace of borrowing picked up in the last quarter of 2006

Overall business debt burdens increased

High 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 some financial institutions in Bahrain have direct and indirect exposures to the sector.

2.1. Households

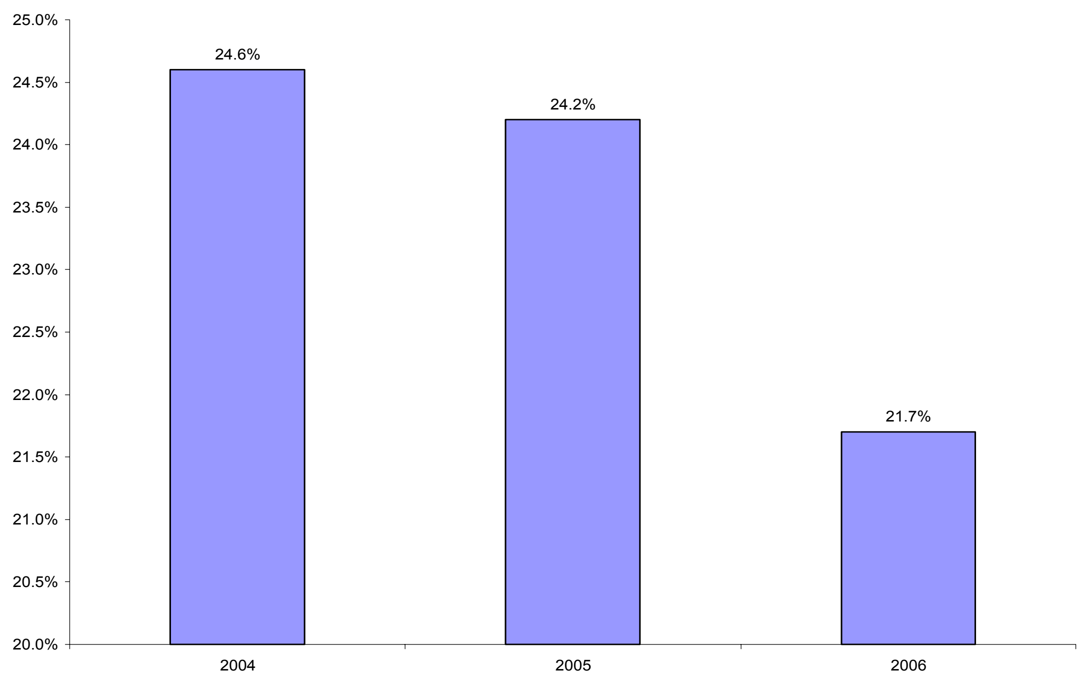
Household debt burden is falling

Using outstanding personal loans from all banks as a proxy for "household" borrowing, we observe that the household debt burden continues to shrink, falling from 24.2% of GDP in 2005 to 21.7% as at end 2006 (Chart 2.1)[2]. Although the growth of personal borrowings has picked up following the negative growth recorded between June and September 2006 (Chart 2.2), the 8.7% growth of personal loans is far below the 17% growth rate of nominal GDP in 2006. Overall, it seems we are continuing to see the dampening effects of the CBB-imposed

[2] We relate household borrowing to nominal GDP in the absence of reliable household income data.

limits on personal debt service-income ratios and maximum maturities for personal loans/consumer facilities. However, tightening financing terms may also have contributed, as evidenced by an increase in average personal lending rates from 8.2% in the third quarter of 2005 to 9.2% in the third quarter of 2006.

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

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 351,862 at the end of 2006 to 381,126 by the end of the first quarter in 2007. 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[3]. The numbers show that after falling progressively from BD221 per month in 2002 to BD207 per month in 2005, average private sector wages have picked up, standing at BD224 per month as at end March 2007 (Table 2.1). Average public sector wages

[3] Conclusions from this data should be considered tentative because: i) the data only covers those in formal employment; ii) the relevant numbers are *averages* only; iii) it abstracts from the fact that many individuals in formal employment also have supplementary sources of income (private business, freelancing, etc); and iv) private sector wages are influenced by the large number of low-paid unskilled workers.

have been consistently higher than private sector wages but fell slightly in the first quarter of 2007, relative to end-2006 figures.

Table 2.1: Average Monthly Wages (BD)

	2002	2003	2004	2005	2006:Q1	2006:Q2	2006:Q3	2006:Q4	2007:Q1
Private Sector	221	219	214	207	212	211	213	210	224
Public Sector	597	564	597	664	674	684	677	700	695

Sources: General Organisation for Social Insurance and Civil Service Bureau

Since the private sector accounts for the bulk of total *formal* employment (89%), a trend of improving average private sector wages suggests that households depending on private sector wages may experience 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

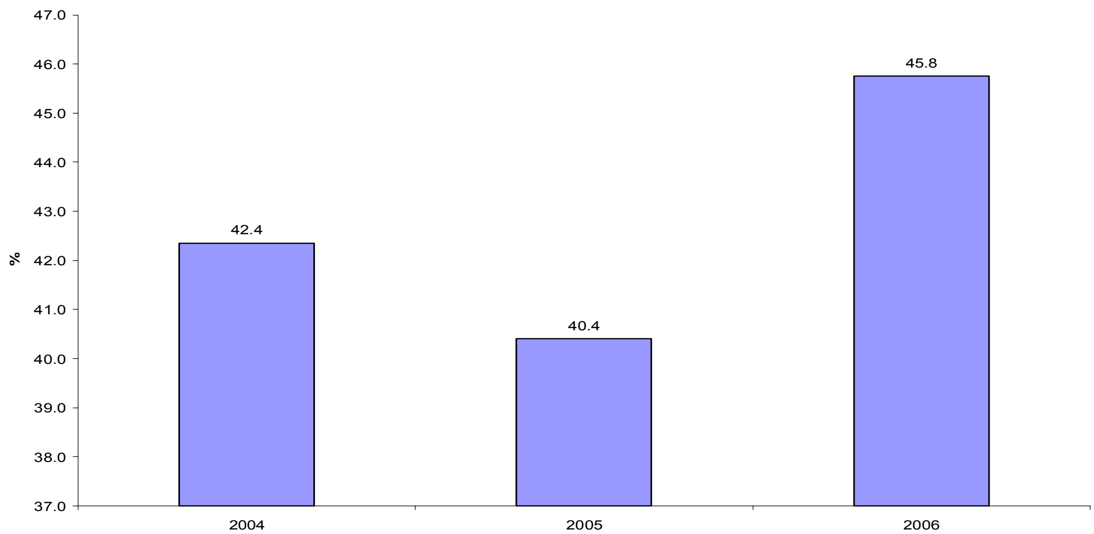
The performance of non-financial corporations in Bahrain continues to be impressive. Provisional 2006 GDP data show that output from this segment grew by 8.1%, slightly down from the 8.4% recorded in 2005. Final GDP data are likely to show a higher growth rate.

The desire to start new businesses remains strong, with a total of 8181 commercial licenses issued by the Ministry of Industry and Commerce in 2006, compared to 6706 in 2005. An additional 2135 licenses have been issued in the first quarter of 2007 alone, indicating that the environment remains conducive to the establishment of new enterprises.

Business debt burden increases

Available data suggests that the business debt burden is increasing. Following a slight decline in 2005, the *ratio of business loans to non-financial GDP* increased in 2006, to a high of 45.8% (Chart 2.3). This level of indebtedness should not be too burdensome for business enterprises given the currently positive macroeconomic and business conditions. However, good loans can quickly turn bad if macroeconomic conditions change abruptly, so lenders need 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

High levels of activity in construction and real estate

The level of activity in the construction and real estate sector remains high, with the number of new commercial licenses issued for construction, real estate and associated activities jumping from 2071 in 2005 to 2591 in 2006 (25% increase) (Table 2.2). In the first three quarters of 2007, an additional 561 new licenses have been issued for activities in this sector. Underlying these trends are the large amounts of liquidity available in the Gulf and the desire to deploy available funds into high-yielding real estate investments.

Providing further evidence of the strength of activity in this sector is the increase in the number of construction permits issued by the Ministry of Municipalities Affairs and Agriculture (Table 2.3). In 2006, a total of 4425 permits were issued for new construction, up from 3749 in 2005. In the first three quarters of 2007, a total of 969 permits were issued for new construction. There were a total of 36 permits issued for land reclamation in 2006, compared to 30 in 2005. 8 permits for reclamation were issued in the first three months of 2007.

Table 2.2: Commercial Licenses Issued for Construction and Real Estate

	2004	2005	2006	2007:Q1
Construction	222	1113	1494	261
Real Estate, Rentals and Associated Activities	688	958	1097	300
Total	**910**	**2071**	**2591**	**561**

Source: Ministry of Municipality Affairs and Agriculture

Table 2.3: Selected Construction Permits by Type

	2004	2005	2006	2007:Q1
Demolition and New construction	176	176	404	78
New construction	3936	3573	4021	891
Reclamation	49	30	36	8

Sources: Ministry of Municipality Affairs and Agriculture

Higher land prices

Although reliable real estate prices are not available, available evidence continues to point to increasing land prices. The *value of traded land permits* jumped from BD 517 million in 2005 to BD 876 million in 2006 (Table 2.4), a 69% increase. In the first three quarters of 2007, value of traded land permits totaled BD 245 million.

Table 2.4: Trading in Land (BD Million)

	2004	2005	2006	2007:Q1
Total Value of Traded Land Permits	431	517.1	876	245
Value of Permits for Bahrainis	395	462	810	204
Value of Permits for Non-Bahrainis	35.9	55.1	65.8	41

Sources: Ministry of Municipality Affairs and Agriculture

A breakdown of the data shows that BD810 million of traded land transactions in 2006 involved Bahrainis (92% of total transaction value), indicating that transactions involving either non-Bahraini buyers or sellers of land remains relatively small at this time.

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 household debt-output ratios, combined with rising wages and employment. However, financing terms remain tight, with interest rates on personal loans currently averaging 9.1%. This suggests that further reductions in household indebtedness would be beneficial. 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, there is limited hard data available on indicators such as vacancy/occupancy rates, real estate sales and prices, and rental rates. It is therefore difficult to determine the current state and prospects of this sector without more detailed information. The Financial Stability Directorate is making efforts to collect detailed data to facilitate a more robust analysis of this sector.

3. Financial Condition and Performance of the Banking Sector

Key Points

Structural changes are ongoing in the banking sector as the new licensing framework is implemented

The conventional banking sector shows high capital adequacy, good profitability and relatively low levels of non-performing loans

These same features are observable in the Islamic banking segment

However, coverage ratios are relatively low for nonperforming loans in some sectors such as construction

High levels of credit card delinquencies in retail banks

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 September 2006 to March 2007[4].

This edition of the *Financial Stability Report* was prepared against the background of structural changes in the retail banking sector, as the Central Bank of Bahrain implements its single-license policy. This has resulted in some banks switching licenses between the wholesale and retail categories.

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

3.1. Conventional Retail Banks

Deposit levels are high[5]

Given the favorable liquidity conditions in Bahrain, retail banks have found it relatively easy to raise deposits. As reported in the *January 2007 Financial Stability Report,* total retail bank deposits stood at BD4.9 billion by end-September 2006. Deposits continued to increase in the last months of 2006, reaching BD5.2 billion by the close of the year. However, we have witnessed a slight reversal of these trends in 2007. As at end-March 2007, total deposits had fallen back by 5.8% to end-September levels (BD4.9 billion).

A notable feature over the past six months was the increase in the importance of non-bank deposits, rising from 81% of total deposits in September 2006 to 89% by end-March 2007.

Slight decline in retail bank assets[6]

Overall retail banking assets grew from BD6.7 billion in September 2006 to BD7.1 billion in December 2006, but fell back slightly to BD6.4 billion by end-March 2007. This was due primarily to a fall in the level of loans and advances for all retail banks (overseas and locally-incorporated) to BD3.4 billion in March 2007, compared to the BD3.7 billion attained in September 2006.

While loans in locally-incorporated retail banks actually grew slightly by 9.5% between September 2006 and March 2007, this was offset by a 31% decline in loan volume in the overseas retail banking segment.

Mixed trends in sectoral lending

Between September 2006 and March 2007, available data reveals a mixed picture in sectoral lending. Double-digit growth in lending to construction (16% expansion) and financial sector (24%) were countered by the 37% fall in lending to agriculture, forestry and fishing, the 21% fall in lending to manufacturing and the 27% decline in lending to “other services”. There was also a 26% decline in personal lending over the period. Overall, personal loans continue to dominate retail bank lending, accounting for 24% of total retail bank loans, down from the 29.4% recorded in September 2006.

[5] The following trends reflect the aforementioned structural changes in the retail banking sector.
[6] The following trends reflect the aforementioned structural changes in the retail banking sector.

Average capital adequacy is still high but has declined[7]

When measured against both local requirements as well international norms, local retail banks exhibit high capital adequacy ratios. As at end-March 2007, the risk-weighted Capital Adequacy Ratio (CAR) for all locally-incorporated retail banks stood at 19.2%, down from 23% reached in September 2006. The core capital ratio (ratio of Tier 1 capital to risk-weighted assets) has similarly fallen from 16% in September 2006 to 14.8% by end-March 2007.

The fall in the capital levels has primarily been due to an increase in 100% credit risk-weighted assets which have increased by 21% on a year-to-year basis. Indeed, the CAR has been declining consistently over the past three calendar years as banks actively took advantage of expanding lending opportunities. Notwithstanding, banks need to ensure that further increases in risk assets continue to be underpinned by capital resources.

Retail banks are profitable

Net profits of the retail banking sector grew by 23% on a year-to-year basis, with interest income representing the bulk of bank earnings. As at end-March 2007, interest income constituted roughly 80% of total retail banking income, unchanged from a year earlier. A comparison of locally-incorporated with overseas retail banks indicates that 82% of their income comes from interest earnings, compared to 76% for overseas retail banks. In order to further improve their safety and soundness, it would be desirable for retail banks to diversify their income sources and reduce the dependence on interest income.

Slight increase in non-performing loans

As at end-March 2007, aggregate non-performing loans in retail banking stood at 5.1%. This was slightly higher than the 4.9% registered in September 2006. Compared to September 2006, NPL ratios went down for locally-incorporated banks (from 6.5% to 5.8%) while it increased slightly for overseas banks (from 3.6% to 4.6%). Overall coverage ratios are reasonable, standing at 76% for locally incorporated banks and 75% for overseas banks.

One area of concern relates to the high levels of credit card delinquencies observed in conventional retail banks. Details of this are provided in Annex 1, entitled “Trends in Credit Card Receivables”.

[7] The numbers here exclude overseas retail banks, which do not have prescribed capital levels or ratios.

NPLs relatively high in trade, construction and agriculture

Looking at available data for locally-incorporated retail banks (Table 3.1), we see that NPLs are highest in trade (16.5%), agriculture, fishing and forestry (11.3%) and construction (9.9%). The ratio for construction loans has however declined, compared to the 13.6% recorded in September 2006. The construction sector merits close attention, with its combination of relatively high NPL ratio (9.9%) and relatively low coverage of these NPLs by specific provisions and interest-in-suspense (24.4%)(Table 3.2)[8]. As highlighted in the January 2007 *Financial Stability Report*, substantially increasing the level of provisions for construction NPLs would be more reassuring.

Table 3.1: Retail Banks's NPL Ratios by Sector - Locally Incorporated Banks (%) **

	September 2006	March 2007
Consumer and Personal	4.1	4.4
Government	1.4	1.5
Construction	13.6	9.9
Manufacturing	6.3	5.7
Mining & Quarrying	2.8	0.3
Agric, Fishing and Forestry	12.3	11.3
Financial	1.4	0.8
Trade	17.5	16.5
Services	5.3	4.1

Source: Central Bank of Bahrain
***NPL numbers refer to proportion of outstanding loans that are non-performing*

Table 3.2: Retail Banks's Coverage Ratios by Sector - Locally Incorporated Banks (%) **

	Sept 2006	March 2007
Consumer and Personal	99.8	98.2
Government	100	100
Construction	29.3	24.4
Manufacturing	95.1	96.1
Mining & Quarrying	100	100.0
Agric, Fishing and Forestry	97.6	97.4
Financial	100	100
Trade	88.2	84.8
Services	56.2	80.1

Source: Central Bank of Bahrain
*** coverage ratios are defined as specific provisions and interest in suspense/non-performing loans.*

[8] It is important to note that the discussion of coverage ratios abstracts from the issue of collateral coverage, since the quality and value of non-cash collateral are difficult to evaluate on a macro-basis.

Retail lending is concentrated

Aggregate retail bank lending is concentrated, with the "consumer and personal" category attracting the bulk of retail bank lending (Tables 3.3 and 3.4). Locally incorporated banks have the bulk of their loans in two sectors (consumer/personal and financial sector), which together account for 44.3% of total loans. Overseas banks' loan portfolio is also dominated by two segments (consumer/personal and trade), together accounting for 56.6% of total loans and advances.

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

	Sept 2006	March 2007
Consumer and Personal	24.3	23.1
Government	7.5	6.6
Construction	10.3	11.6
Manufacturing	16.2	14.0
Mining & Quarrying	0.1	0.7
Agric, Fishing and Forestry	0.2	0.2
Financial	16	21.2
Trade	11.9	12.0
Services	13.4	10.6

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

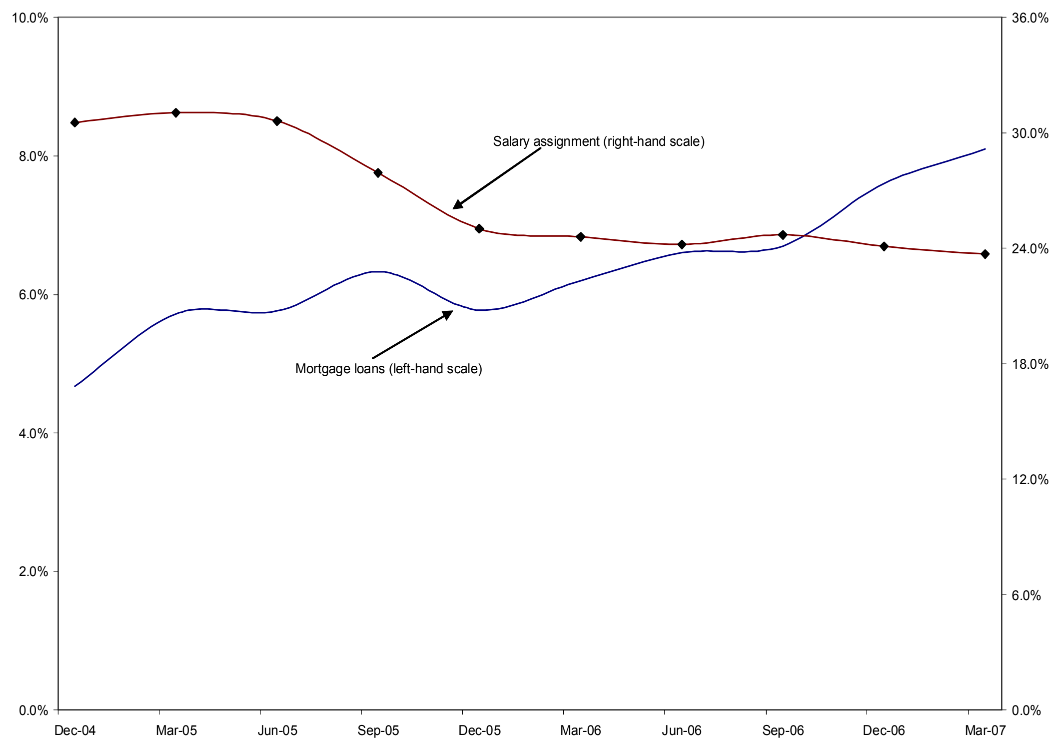
Table 3.4: Distribution of Retail Bank Lending (% shares; overseas banks)*

	Sept 2006	March 2007
Consumer and Personal	36.9	26.7
Government	7.0	8.7
Construction	7.5	11.3
Manufacturing	14.2	11.6
Mining & Quarrying	0.1	0.1
Agric, Fishing and Forestry	0.2	0.0
Financial	7.0	6.3
Trade	18.9	29.9
Services	8.2	5.4

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

One notable trend is the sharp fall in the proportion of consumer/personal loans in the portfolio of overseas banks alongside a sharp increase in the proportion of loans to "trade". A breakdown on consumer/personal loans also show a change in the composition of this segment, with "mortgage loans" standing at 8.1% of total retail loans compared to 5.7% two years ago (see Chart 3.1). Conversely, loans "with salary assignment" have declined from 31.1% in March 2005 to 23.7% in March 2007.

Chart 3.1: Mortgage and Salary Assignment Loans (% of total retail loans)



Source: Central Bank of Bahrain

Strong liquidity position

The liquidity position of retail banks continues to be strong, given the healthy growth in their deposit base over the past couple of years. As at March 2007, liquid assets represented 33.8% of total assets, (up from 27.4% in September 2006), indicating minimal liquidity risk and an ability to meet short-term obligations. Further, non-bank deposits accounted for 89% of total deposits, indicating a stable base for funding bank assets.

Upgrades push up 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 below shows credit ratings for selected locally-incorporated retail banks. Most of the ratings show "strong capacity" to service debt obligations with Moody's upgrading National Bank of Bahrain (NBB) and Bank of Bahrain and Kuwait (BBK) in new ratings released in April 2007[9].

Table 3.5: Local retail banks ratings

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

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

3.2. Conventional Wholesale Banks[10]

Slight decline in deposits and assets[11]

The deposit base of wholesale banks shrank slightly from $87.5 billion in September 2006 to $85 billion as at end-March 2007 (3% fall). This trend was largely influenced by the 4.6% drop in non-bank deposits (from $40.8 billion to $38.9 billion), with bank deposits also falling marginally from $46.6 billion to $46.3 billion (-0.6%). Bank deposits are however larger in size, currently accounting for 54.3% of total deposits.

Available data indicates that the fall in wholesale banks' deposits was driven primarily by a fall in the deposits of locally-incorporated wholesale banks, where total deposits declined by 21% between September 2006 and March 2007. This decline was experienced in both bank and non-bank deposit categories. In contrast, deposits in overseas wholesale banks increased by 25% over the same period. Reflecting the decline in deposits, wholesale bank assets only grew slightly from $161 billion in September 2006 to $162 billion in March 2007.

[9] 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.

[10] In contrast to the January 2007 *Financial Stability Report* and in full alignment with the licensing categories introduced in 2006, this section eliminates the distinction between off-shore banks (OBUs) and investment banks (IBLs).

[11] The following trends reflect the aforementioned structural changes in the wholesale banking sector.

High wholesale bank capitalization[12]

As at end-March 2007, the risk-weighted Capital Asset Ratio (CAR) for locally-incorporated wholesale banks stood at 19.2%, up from the 17.4% registered in September 2006. This level of capital adequacy is more than double the international standard of 8% and significantly higher than the CBB requirement of 12%. Moreover, the core capital ratio (ratio of Tier 1 capital to risk-weighted assets) rose to 16.5% in March 2007, from 13.9% in September 2006.

Low NPLs but concentrated portfolios

As at end-March 2007, aggregate non-performing loans in wholesale banks stood at 1% of total gross loans, down from the 1.2% registered in September 2006. This level of non-performing loans is very low by any standard. An examination of non-performing loans by sector (March 2007) shows that NPLs are generally in single-digits (Table 3.6). However, there may be a need for additional provisions for NPLs in certain sectors where the coverage ratios are relatively low (e.g. mining and quarrying, construction and personal) (Table 3.7)[13].

However, aggregate wholesale bank lending is concentrated, with the "financial" category accounting for the lion's share of total lending in both locally-incorporated and overseas wholesale banks (Tables 3.8 and 3.9).

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

	September 2006	March 2007
Personal	1.4	3.5
Government	5.6	4.5
Construction	1.7	0.3
Manufacturing	2.3	2.4
Mining & Quarrying	0.1	0.1
Agric, Fishing and Forestry	1.0	4.2
Financial	2.8	2.9
Trade	2.8	2.6
Services	2.3	1.8

Source: Central Bank of Bahrain

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

[12] 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.

[13] It is important to note that the discussion of coverage ratios abstracts from the issue of collateral coverage, since the quality and value of non-cash collateral are difficult to evaluate on a macro-basis.

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

	September 2006	March 2007
Personal	81	63.5
Government	249.5	249.5
Construction	41.3	56.5
Manufacturing	64.6	74.2
Mining & Quarrying	14.4	11.8
Agric, Fishing and Forestry	92.8	13.3
Financial	110.6	109.5
Trade	81.4	86.9
Services	74.0	105.7

Source: Central Bank of Bahrain

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

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

	Sept 2006	March 2007
Consumer and Personal	12.6	3.1
Government	2.0	3.2
Construction	9.4	7.4
Manufacturing	20.3	20.9
Mining & Quarrying	2.4	2.7
Agric, Fishing and Forestry	0.6	0.6
Financial	23.0	28.0
Trade	12.0	14.0
Services	17.6	20.7

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)*

	Sept 2006	March 2007
Consumer and Personal	0.8	0.6
Government	10.5	8.7
Construction	7.3	5.9
Manufacturing	14.1	13.8
Mining & Quarrying	5.7	5.3
Agric, Fishing and Forestry	2.3	1.3
Financial	22.2	32.9
Trade	10.2	7.6
Services	26.3	22.9

Source: Central Bank of Bahrain

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

Wholesale banks are profitable and liquid

Globally, strong macro economic conditions have boosted bank earnings. Not surprisingly, the earnings momentum of wholesale banks has kept pace with net profits for all banks growing at 40% in the 12 month period up to March 2007. The principal source of income for wholesale banks is from non-interest sources, which constituted roughly 67% of total income.

As discussed earlier, wholesale bank deposits shrank slightly between September 2006 and March 2007. However, they have consistently maintained more than a third of their assets in liquid assets over the last five quarters up to March 2007, indicating a continuing ability to meet short-term obligations.

Local banks have stable ratings with median rating of "adequate capacity"

Examining the credit rating of selected wholesale banks, we see a picture of stable ratings from two major rating agencies, S&P and Moodys (Table 3.10).

If both rating agencies were to be considered, the median rating for local wholesale banks is "Baa2" on the Moodys scale or "BBB+" on the S&P scale. This rating indicates that wholesale banks have "adequate capacity" to pay interest and principal on their borrowings.

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	Upgraded
ABC	S&P	Jun-06	BBB+	Adequate Capacity	
	Moodys	Apr-07	A3	Strong Capacity	
Investcorp	S&P		Not rated		
	Moodys	Apr-07	Baa2	Adequate Capacity	Changed
UGB	Moodys	Apr-07	Baa3	Adequate Capacity	Reaffirmed
TIBC	S&P	Sep-06	BBB-	Adequate Capacity	

Sources: Moodys and S&P websites

3.3. Islamic Retail Banks

Deposit base is robust

Islamic retail banks have been experiencing a healthy expansion in their funding base. Between September 2006 and March 2007, Unrestricted Investment Accounts (URIA) grew by 53% from $1.5 billion to $2.3 billion. Restricted Investment Accounts (RIA) also expanded from $171.5 million in September 2006 to $949 million in March 2007, a growth rate of over 400%. These trends have helped to underpin the rapid expansion of Islamic banking assets (see below).

Increase in assets

Overall on-balance sheet assets for Islamic retail banks grew from $3.1 billion in September 2006 to $4.8 billion by end-March 2007. The growth in assets was driven primarily by the 66% growth in investments over the period, although total financing facilities also expanded by 55%. Financing facilities remain the single largest category of assets, accounting for 44% of total on-balance sheet assets in March 2007. It is however notable that the share of investments has edged up over the period, from 23.6% to 25.4%. A remarkable development is the over 400% expansion in assets financed by restricted investment accounts, corresponding to a similar rate of growth in the level of restricted investment accounts.

Robust capital adequacy and increased profitability

Islamic retail banks continue to exhibit high levels of capitalization relative to their risk-weighted exposures. As at end-March 2007, their capital adequacy ratio was 28.7%, slightly up from the 27.5% of September 2006. The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) has similarly increased from 21% in September 2006 to 23.7% by end-March 2007. These are high capital levels by any standards and have been achieved by actual increases in capital levels, since total risk-weighted exposures increased by 9% over the 6-month period.

At the end of March 2007, net profits of Islamic banks were 168% higher than at a similar point last year. Correspondingly, Return on Assets (ROA) increased from 0.82% to 1.26% year-on-year, while Return on Equity (ROE) increased from 5.2% to 7.7%.

Good asset quality but mixed picture on liquidity

As at end-March 2007, aggregate non-performing financing facilities (NPF) in Islamic retail banks stood at 4.1%, slightly up from the 3.4% recorded in September 2006. Although these ratios are still relatively low, it is important to keep a close watch on trends in the coming months in case this is a signal of deteriorating asset quality.

Islamic retail banks show strong liquidity positions, given the substantial growth in deposits described earlier. In addition, liquid assets amounted to 30% of total liabilities in March 2007, compared to 19% as at end-September 2006. However, deposits are quite concentrated, with the Top 10 depositors accounting for over 30% of total deposits. This situation makes them potentially vulnerable to shifts in depositor sentiments.

3.4. Islamic Wholesale Banks

Asset growth anchored on solid funding base

On-balance sheet assets of Islamic wholesale banks expanded from $9.7 billion in September 2006 to $16.1 billion in March 2007 (66% growth). The increase in assets was driven primarily by the 73% growth in total financing facilities over the period, although "investments" also expanded by 31%, while assets financed by restricted investment accounts diminished by 25%.

Financing facilities still represented the single largest category of assets for Islamic wholesale banks, accounting for 48% of total on-balance sheet assets in March 2007. The share of investments in total on-balance sheet assets shrank over the period, from 33% to 26%.

The growth in Islamic wholesale assets is anchored upon a solid funding base. Between September 2006 and March 2007, Unrestricted Investment Accounts (URIA) grew by over 200% from $1.7 billion to $5.6 billion. Restricted Investment Accounts (RIA) however declined from $1.6 billion to $1.2 billion.

Robust capital adequacy and increased profitability

Capital adequacy in Islamic wholesale banks is very high, standing at 43% in March 2007, down from the 53% registered in September 2006. The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) has similarly increased from 47% in September 2006 to 40.2% by end-March 2007 as Islamic wholesale banks find opportunities to make use of their abundant capital.

At the end of March 2007, net profits of Islamic wholesale banks were 32% higher than at a similar point last year. However, Return on Assets (ROA) fell from 1.52% to 0.9% year-on-year, while Return on Equity (ROE) also declined from 4.6% to 3.4%. The high capital ratios of Islamic wholesale banks suggest that there is abundant room for them to expand risk assets and improve earnings.

Good asset quality and ample liquidity

As at end-March 2007, aggregate non-performing financing facilities (NPF) in Islamic wholesale banks stood at 0.4% (down from the 1.9% registered in September 2006).

They also show strong liquidity positions, with liquid assets representing 38% of total liabilities in March 2007, compared to 30% as at end-September 2006. Deposits are also well-diversified, with the Top 10 depositors accounting for only 8% of total deposits.

3.5. Overall Assessment of the Banking Sector

Both the conventional and Islamic banking segments exhibit healthy balance sheets and show no signs of stress. Aggregate capital adequacy is comfortably above prescribed international and domestic norms, asset quality is broadly satisfactory, liquidity is ample and earnings are impressive. Notwithstanding, two issues require attention going forward: i) relatively high NPLs in construction and associated low coverage ratios for conventional retail banks; and ii) high levels of credit card delinquencies in retail banks (see Annex 1).

4. Performance of Equity Markets

Key Points

Growth of stock market size continues, evidenced by higher market capitalization

2006 selling pressures spill over into 2007, but investor sentiments has turned positive

In the face of low liquidity, market volatility still a challenge

Further expansion in market size

There are currently 50 companies listed on the market, in addition to 19 bonds (including 10 Sukuks) and 35 mutual funds. As at end-May 2007, market capitalization of the Bahrain Stock Exchange (BSE) stood at BD8.23 billion, equivalent to 140% of nominal GDP (2006 estimate). Current market capitalization is 29% higher than comparative figures for May 2006 and 3.4% higher than the position as at end-December 2006.

The growth in market size since December 2006 has been driven by the "Commercial banks" segment, with capitalization 8.2% higher than end-2006 (Table 4.1). The "Hotel and tourism" segment was another big gainer (increase of 7.2%). "Investment" recorded a marginal decline of 0.2%, a significant development because this segment has historically been a prime mover of growth in market capitalization.

Table 4.1: Market Capitalization on the Bahrain Stock Exchange (BD Million)

	May 2006	Dec. 2006	May 2007	Dec.-May Change (%)
Commercial banks	2162.6	2591.7	2804.7	8.2%
Investment	2638.3	3680.4	3672.6	-0.2%
Insurance	174.1	167.5	171.6	2.4%
Services	1266.6	1398.4	1451.6	3.8%
Industrial	17.2	16.8	16.7	-0.5%
Hotel and Tourism	112.1	108.1	115.9	7.2%
TOTAL	**6371.2**	**7962.9**	**8233.3**	**3.4%**

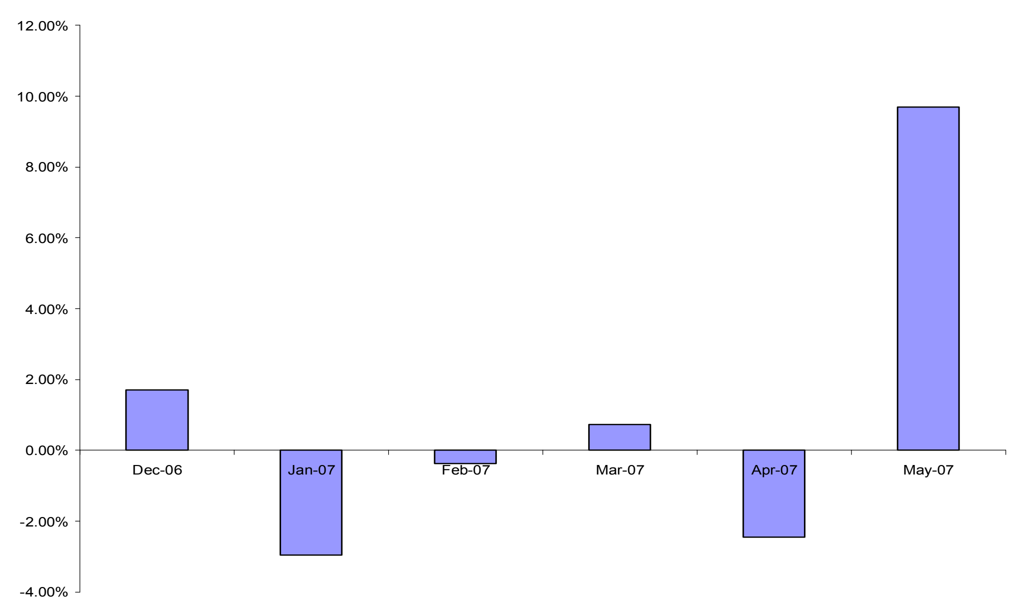
Source: Bahrain Stock Exchange

Market slowly gains momentum

The negative sentiment observed on the market during 2006 persisted into the first few months of 2007, as the BSE All-Share Index recorded declines in January (-3%) and February (-0.36%)(Chart 4.1). A slight gain in March (0.73%) was followed by another decline in April (-2.46%). However, May 2007 proved to be different substantially, with the index gaining over 200 points for a total increase of 9.7% for the month.

Overall, the index at the end of May 2007 stood 93 points higher than at the end of December 2006 (4.2% increase). Trading in May was dominated by the "commercial banks" and "hotel and tourism" sectors (Table 4.2). The results for May 2007 indicate that investors are beginning to regain confidence in the market and the momentum gained may indicate that the market may finally be recovering from the after-effects of the Gulf-wide correction in stock markets during 2006.

Chart 4.1: 2007 Performance of BSE All-Share Index (% changes)



Source of Data: Bahrain Stock Exchange

Table 4.2: Sectoral Indices of Bahrain All-Share Index

	May 2006	Dec. 2006	May 2007	Dec.-May Change (%)
Commercial banks	2403.36	2925.77	3167.31	8.3%
Investment	1826.15	1848.22	1889.44	2.2%
Insurance	1959.82	1883.96	1930.95	2.5%
Services	1778.7	1957.76	2032.3	3.8%
Industrial	1493.06	1456.41	1450.16	-0.4%
Hotel and Tourism	2091.68	2017.75	2163.64	7.2%
OVERALL INDEX	**2025.90**	**2217.58**	**2310.81**	**4.2%**

Source: Bahrain Stock Exchange

Stock prices look reasonable

A look at the price-earnings (P-E) ratio suggests that Bahraini stocks are not overvalued, given the ongoing economic boom. The P-E multiple for the entire market currently stands at 10.86, lower than for the same period last year (Table 4.3)[14]. Bahrain's P-E multiple is also lower than multiples for other GCC countries.

Historically, the "commercial banks" sector has exhibited a P-E multiple higher than the market average, indicating strong investor optimism about the prospects of this segment. Generally, multiples for other sectors have either been below or at par with the market average, although the "services" sector rose above the market average in May 2007.

Table 4.3: BSE—Price-Earning Multiples

	May 2006	Dec. 2006	May 2007
Commercial banks	15.14	18.45	15.52
Investment	11.19	12.27	8.61
Insurance	6.21	9.96	6.77
Services	10.82	11.95	12.61
Industrial	11.67	11.39	9.17
Hotel and Tourism	10.82	10.46	9.99
Total Market	**11.84**	**13.59**	**10.86**

Source: Bahrain Stock Exchange

[14] A P-E ratio of 10.86 implies that investors are willing to pay BD10.860 for every BD1 of earnings.

Low market liquidity persists

The turnover ratio (value of trading as a share of market capitalization) is around 0.4%, which is low by any standards. As observed for the past few years, trading remains concentrated, with the "commercial banks" and "investment" sectors accounting for the bulk of trading on the BSE (Table 4.4).

Table 4.4: BSE—Value of Shares Traded by Sector (% shares)*

	2006:Q4	2007:Q1	May 2007
Commercial banks	46.4	36.7	40.5
Investment	48.6	47.8	40.0
Insurance	0.2	1.3	0.5
Services	4.6	7.9	9.5
Industrial	0.0	0.1	0.2
Hotel and Tourism	0.2	0.6	0.4

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

Source: Bahrain Stock Exchange

Overall assessment

The BSE has been able to weather the regional turbulence of 2006 and the recovery witnessed in 2007. The market however remains underdeveloped with low levels of activity. Although volatility is observable on the market, there are no significant issues from a financial stability perspective.

5. Payment and Settlement Systems

Key Points

Growth in volume and value of payment and settlement transactions

The current payments framework exhibits some legal, credit and operational risks

In recognition of this fact, CBB is currently implementing several initiatives aimed at strengthening the payment system and mitigating these risks

These initiatives include: a Real Time Gross Settlement (RTGS) System, an image-based Cheque Truncation System (CTS) and a new Scripless Settlement System (SSS) for government securities

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.

5.1. Key Trends in Payment and Settlement Systems

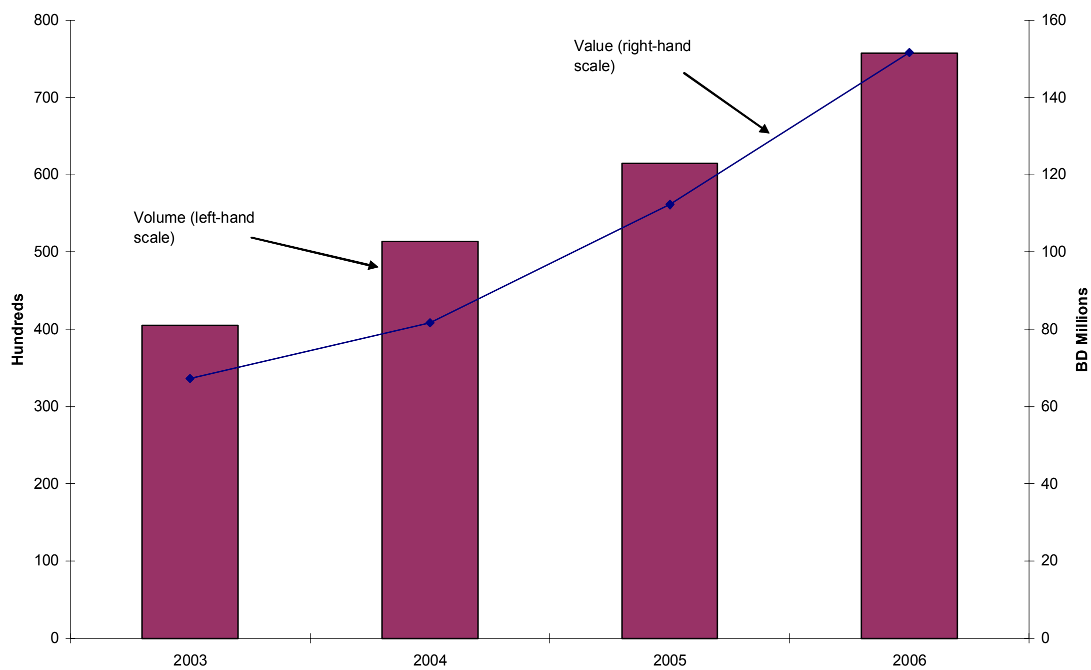
The payments and settlement infrastructure in Bahrain comprises of five main components: i) the inter-bank payments and settlement system; ii) the Automated Cheque Clearing System (ACS); iii) the ATM clearing system; iv) the depository and settlement system for government securities; and v) the clearing, settlement and depository system for the Bahrain Stock Exchange (BSE).

Inter-bank payments and settlement system

This is the system for processing large-value payments in Bahrain. Inter-bank payments are currently settled and accounted for on a bilateral basis, using the banks' clearing accounts with the Central Bank of Bahrain (CBB). CBB therefore acts as the settlement agent and finality of payments is assured by using risk-free "central bank money". The transmission of payment instructions is done through the global SWIFT messaging system[15]. In 2006, payments passing through the inter-bank payment system totaled BD37 billion, seven times the size of Bahrain's annual GDP. The volume of transfers averaged 757 per day, compared to a daily average of 615 transfers in 2005 (23% increase) (Chart 5.1). In value terms, transfers during 2006 averaged BD151 million per day, compared to an average daily value of BD112 million in 2005 (35% increase).

Given the large values that settle through this medium, the inter-bank system holds a critical place in the financial system and the economy as a whole. It could therefore be designated as one of the systemically-important payment systems (SIPS) in Bahrain[16]. As from June 2007, the CBB is gradually replacing the inter-bank payment system with a Real-Time Gross Settlement (RTGS) System, which will become the medium for large value transfers (see Section 6.3). The transition to the RTGS will be completed by September 2007. The RTGS will retain the status of a systemically-important system.

Chart 5.1: Inter-Bank Payment and Settlement System: Average Daily Volume and Value of Payments Processed



Source: Central Bank of Bahrain

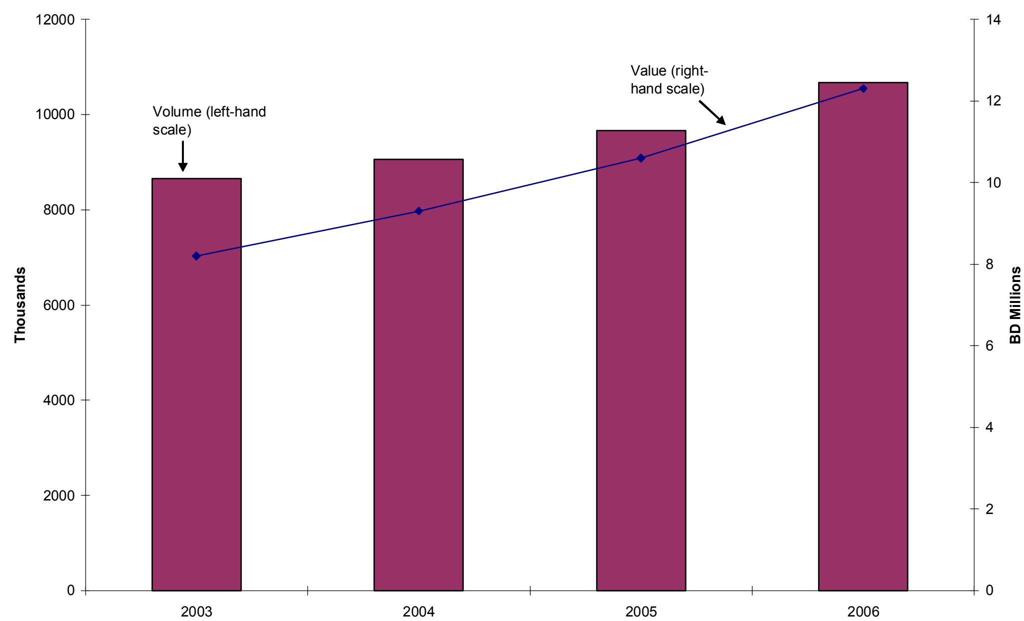
[15] SWIFT-- Society for Worldwide Interbank Financial Telecommunication--provides secure messaging services to financial institutions and market infrastructures in over 200 countries. It is headquartered in Belgium.

[16] 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.

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 (see Box 5.1). In 2006, the ACS system processed an average of 11,000 cheques per day, compared to the average daily volume of 10,000 cheques processed in 2005 (Chart 5.2). In value terms, cheques cleared through the ACS had a daily average value of BD14.6 million, relative to an average daily value of BD12.3 million in 2005.

Chart 5.2: Inter-Bank Payment and Settlement System: Average Daily Volume and Value of Payments Processed



Source: Central Bank of Bahrain

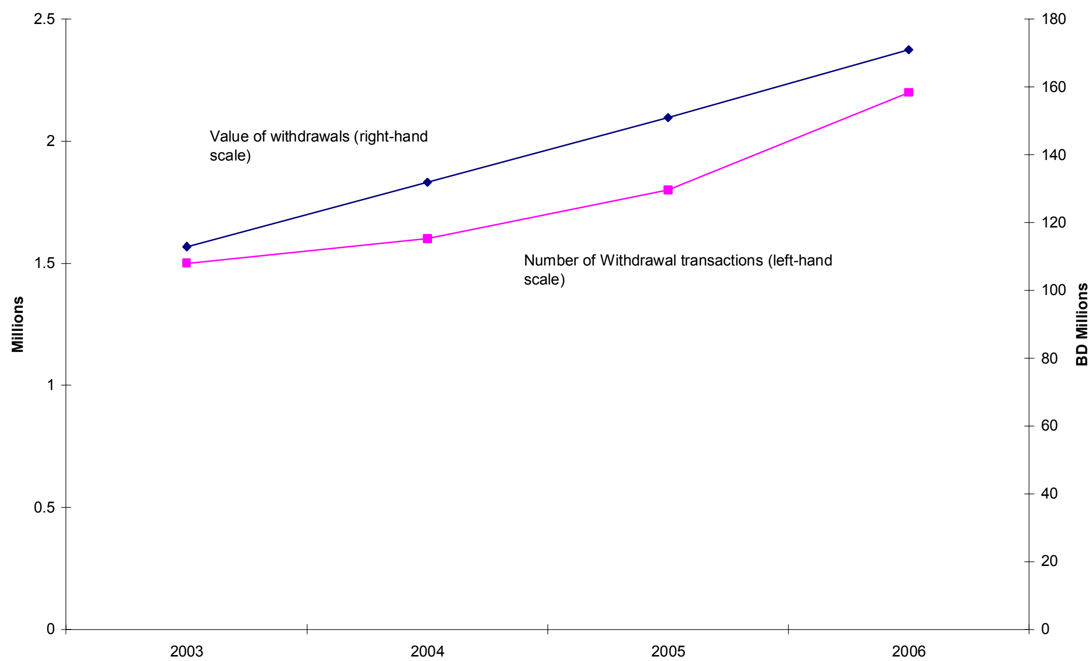
ATM Clearing System

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)[17]. Transmission of ATM transactions and settlement related messages are channeled through GCC Net, a leased line network across the GCC countries. In 2006, over

[17] Benefit only handles transactions where one bank's ATM card is used to withdraw cash from another bank's ATM.

2.2 million withdrawal transactions were processed through the system, compared to 1.8 million transactions in 2005 (Chart 5.3). In value terms, total withdrawals processed in 2006 amounted to BD171 million, versus BD151 million processed in 2005.

Chart 5.3: Number and Value of ATM Transactions



Source: The Benefit Company

Depository and Settlement System for Government Securities

Currently, the CBB offers depository and settlement services to banks and other financial institutions with respect to their holdings or transactions in government securities. A new Scripless Securities Settlement System (SSSS) is currently being developed and will be implemented along with the RTGS system (see Section 5.3).

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), thereby creating a fast and efficient trading, clearing and settlement framework, 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.

Box 5.1: Types of Fund Transfer Systems

(a) Settlement Characteristics

Net Settlement Systems: The settlement of payments occurs on a net basis. A bank's net position is determined as the total payments received less total payments sent. The *net settlement position* could then be either a net credit position (receipts exceed payments) or net debit position (payments exceed receipts). This could be calculated either on a bilateral basis (settling of net positions between pairs of banks) or multilateral basis (each bank settles its overall net position against all the other participating banks).

Gross Settlement Systems: The settlement of payments is done transaction-by-transaction, without netting debits against credits.

(b) Timing and Frequency of Settlement

Deferred Settlement Systems: Final settlement of payments takes place at one or more designated times during the processing day, with a lag between the receipt of payment instructions and final settlement. If final settlement takes place at the end of the processing day, this is referred to as an *end-of-day net settlement system*. It is also possible to settle at a designated time during the processing day, without netting debits against credits. Such systems are called *end-of-day gross settlement systems*.

Real time settlement systems: The settlement of payments is done on a continuous basis throughout the processing day. Payment instructions are settled as soon as they are submitted.

5.2. Assessment of Payment and Settlement Systems

This section provides a risk assessment of Bahrain's payment and settlement systems. There are different types of risk associated with the design and operation of payments and settlement systems. A conceptual description of the main risks is provided in Box 5.2.

It is important to note that Bahrain's payment and settlement infrastructure is in transition, with far-reaching changes being implemented in a number of areas (see section 6.3 below). Hence, the assessment of the current payment and settlement framework should be viewed in that light, as many of the issues identified below are already being addressed by various initiatives currently under implementation.

Box 5.2: Risks in Payment Systems

Credit risk: The risk that a party within the system will be unable to fully meet its financial obligations within the system either when due or at any time thereafter.

Liquidity risk: The risk that a party within the system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future. The intended recipients may also be unable to meet their obligations on time.

Legal risk: The risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks.

Operational risk: The risk that operational factors such as computer failures/malfunctions, human error and any other operational mistakes will cause or exacerbate credit or liquidity risks.

Systemic risk: The risk that the inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other system participants or of financial institutions in other parts of the financial system to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the system or of financial markets.

Settlement agent risk: This only applies in cases where a settlement agent is privately owned. It is the danger that failure or operational problems in a settlement agent will impede the successful completion of payment and settlement transactions.

Credit and liquidity risk

Over the years, Bahrain's main payment systems have proven to be robust. Nonetheless, a few areas of weakness have been identified. Most importantly, the Deferred Net Settlement (DNS) System employed by both the inter-bank and cheque clearing components of the payment system is inherently prone to credit and liqudity risks, since settlement is done on a net basis at the end of the day.

If a particular bank in a debit position is unable to meet its obligations at the end of the day, the entire DNS frameworks may break down and payments cannot settle. In this case, all transactions have to be unwound and re-calculated. However, there is currently no provision for 'unwinding' at the CBB and in order to mitigate credit risk, CBB allows banks with shortfalls to overdraw their clearing accounts, albeit with a penal 20% annual interest charge. Overdrawn clearing accounts in turn expose CBB to credit risks posed by banks experiencing shortfalls. The practice of overdrawing clearing accounts will however cease with the introduction of the RTGS system.

Legal risk

Bahrain's payment and settlement systems lack a statutory legal foundation as there is no Payment Systems Act. However, laws in areas such as contracts and insolvency would have applicability to the operation of payment systems. In the absence of a statutory legal framework for the payment system, the move to an RTGS system has entailed the development of detailed rules, regulations, standards and procedures for participants in the system. This should go a long way toward strengthening the legal basis for transactions through the RTGS system. However, there is a need to consider the pros and cons of developing a more overarching Payment Systems Act to cover issues such as the finality of payments, recognition of electronic payments, legal basis for check truncation as well as the oversight powers of the 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 evaluates the effectiveness of the contingency arrangements. Again, these issues are receiving attention as part of the move to an RTGS system.

Settlement agent risk

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.

5.3. Improvements to the Payment and Settlement Systems

In recognition of the shortcomings of the current payment and settlement system in Bahrain and as part of its oversight responsibilities, the Central Bank of Bahrain is taking several steps to strengthen the framework for payments and settlements substantially and reduce credit, liquidity, operational and legal risks.

First, the CBB is in the process of introducing a Real Time Gross Settlement (RTGS) System, where all large-value payments will be processed and settled in real time, on-line mode. SWIFT will remain as the messaging system when the RTGS System goes live. Although the RTGS will be used primarily for large-value, inter-bank payments, it is expected that it will also provide settlement services for retail payments. The first phase of the RTGS was implemented in early June 2007, involving seven banks and The Benefit Company. In the third week of July, twelve other banks are expected to join. Full roll-out is envisaged by late August 2007.

Since payments are settled on a continuous basis under RTGS, its introduction will reduce credit risks substantially, especially for large-value payments. The RTGS will be managed and operated by the CBB, which will also house the technical infrastructure on its premises.

Further, in an effort to make the cheque clearing process faster and more efficient, the CBB has developed a plan to implement an image-based Cheque Truncation System (CTS) which will submit cheque images and the associated MICR information to receiving banks (through the CBB), replacing the transmission of physical cheques through the system. The cheque images will be used for debiting the drawer’s accounts. The CTS will be implemented upon completion of the RTGS roll-out. In the meantime, the existing cheque-clearing system has been upgraded with the addition of more sophisticated sorter machines.

In addition, a new Scripless Securities Settlement System (SSSS) is currently being developed and will be implemented along with the RTGS system. The SSSS will immobilize or dematerialize government securities and will provide for auction, issue, and allotment of all government securities, including Sukuks. It will also provide for securities transactions such as sale, purchase, repos and reverse repos. It will be multi-currency capable and based on Straight Through Processing (STP).

Finally, CBB is in the initial stages of setting out a holistic and comprehensive road map for the future enhancement of the payment and settlement system. The road-map will be anchored on an overall vision for the development of financial sector infrastructure, given the continuing rapid growth in the financial sector and the need to meet the needs of financial institutions and their customers.

Overall assessment

The payments and settlement system is in transition with several projects underway to strengthen the framework. These initiatives should go a long way towards enhancing the safety, security, efficiency and robustness of Bahrain's payment systems thereby reducing payment system risks and fostering financial stability.

Annex 1: Special Feature: Trends in Credit Card Receivables

Introduction

A key business segment for retail banks is the provision of personal finance for households and individuals in Bahrain. Personal financing is available in different forms, including loans secured by various kinds of assets (property mortgage, vehicles or deposits), loans with salary assignment as well as financing through credit cards (basically personal lines of credit)[18].

This Special Feature analyzes available data from the 2006 Credit Card Receivables Survey, conducted by the Financial Stability Directorate (FSD). This survey is mounted annually by FSD to monitor trends in total credit card amounts outstanding and levels of delinquencies. The overall level and changes in credit card delinquency are often good leading indicators of impending deterioration in the personal/consumer finance segment. Given the fact that consumer finance accounts for more than a fourth of all total loans of retail banks, this has implications from a financial stability perspective.

Description of Sample

The annual credit card receivables survey is based on a sample of three locally incorporated and seven overseas retail banks (see Annex Table 1). This sample covers three out of the five locally incorporated retail banks and six operationally active overseas retail banks (out of twelve). BBK, with significant onshore card operations is represented by its subsidiary, *Credimax*.

[18] "Personal finance" excludes mortgages and business loans to individuals.

Annex Table 1: Coverage of Credit Card Survey

Bank Type	Name
Locally Incorporated*	BBK , NBB, BSB
Overseas**	AUB, Citi, HSBC, SCHB
Other	Shamil Bank, Amex and Diners

**BMI is excluded from the survey as its credit card operations are insignificant; Future Bank does not have credit card operations.*
*** Arab Bank is excluded as its card is a debit card; BNP, Habib, HBTF, Mashreq, NBK, Rafdain and United Bank do not have credit card operations*

Source: Credit Card Receivables Survey

The analysis contained in this Special Feature focuses on the conventional retail banks and classifies AUB as an overseas retail bank to facilitate comparison with data for previous years. American Express and Diners' Club with relatively small operations have been included for completeness.

Key Findings

Increasing credit card penetration

As Annex Table 2 below shows, the number of credit card accounts jumped by 35% between 2004 and 2005 but slowed down considerably in 2006 (0.3% growth). When compared to the total population of Bahrain, we see a remarkable level of penetration, with the number of accounts representing 18% of the total population. Even if we control for cardholders with multiple accounts, this is a high level of penetration for a country of Bahrain's size. This could be due to a combination of factors, including: i) the well-developed financial sector; ii) an increase in the number of salaried workers; iii) presence of expatriates from countries with a strong credit card culture; iv) growing culture of consumerism among Bahrainis; and v) more aggressive marketing by banks.

Annex Table 2: Key Ratios- All Banks

	2004	2005	2006
Total number of accounts	98, 705	133, 498	133, 918
Number of accounts/total populations	14%	18%	18%
Total Limits (BD million)	168	182	184
Total Outstanding (BD million)	67.0	88.8	90.4
Utilization Ratio	40%	49%	50%
Interest rates on credit cards (Q4)	18.64%	20.28%	20.46%
Interest rates on personal loans (Q4)	7.73%	8.31%	8.89%

Source: Credit Card Receivables Survey & MSB

Annex Box 1: Credit Card Terminologies

A credit card account could have primary and secondary card-holders. Since both primary and secondary holders have a single overall limit, we focus only on primary cardholders. Thus, the **number of credit card accounts** is defined with reference to the primary cardholders of a bank. If a particular individual has multiple cards from different banks, these are treated as separate accounts.

Market share is defined in terms of a bank's share of the aggregate number of credit card accounts of all banks surveyed.

The **utilization ratio** is defined as the ratio of total outstanding amounts to total limits and indicates the extent to which the line of credit available has been utilized by account holders.

Rollover is the amount in respect of which the cardholder has not fully repaid the statement balance but has at least made the minimum payment required by the bank. Although the cardholder is free to pay back the entire amount outstanding in any billing cycle, most cardholders prefer to pay only a fixed (minimum) amount and spread repayment over a period of time.

An account is treated as **overdue** when the minimum amount of payment is not made on the due date after the grace period.

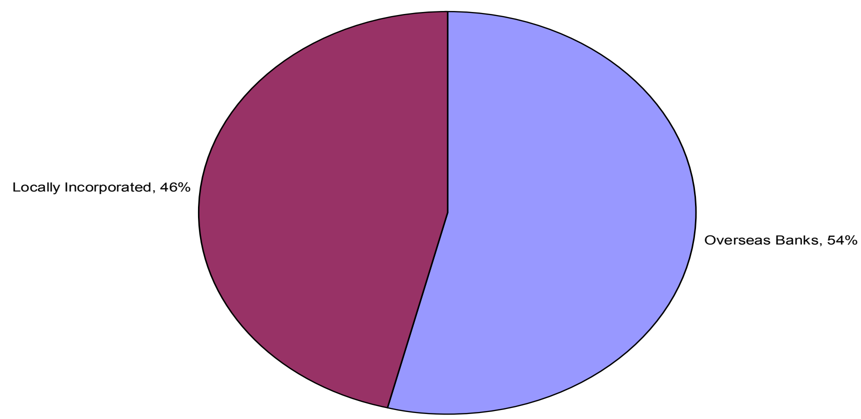
Delinquency is measured by the total amount of credit card receivables overdue for more than 90 days. The delinquency ratio is defined as the ratio of overdue outstanding for more than 90 days and remaining unpaid at the last day of the reporting month to the total credit card outstanding.

Write-off amount refers to the total amount of credit card receivables written off by a bank. Although write-off policies vary from bank to bank, typically, an account will be written off when the receivable has been overdue for more than 180 days or when the ultimate repayment of the receivable is unlikely (e.g. the cardholder is bankrupt or cannot be located).

Market is dominated by overseas retail banks

In terms of market shares, overseas retail banks currently dominate the market, accounting for 54% of the total number of accounts (Annex Chart 1). However, *Credimax* (BBK's wholly owned subsidiary) is the overall market leader in credit cards, accounting for 37% of all accounts in 2006. Other locally-incorporated retail banks have relatively small amounts of business in credit cards.

Annex Chart 1: Market Shares of Banks -2006 (by Accounts)



Source: Credit Card Receivables Survey

If market shares are measured by outstanding amounts, the gap between overseas and locally incorporated banks widens slightly, with the share of overseas retail banks increasing to 56%, compared to 44% for locally-incorporate retail banks. This probably implies that credit cards issued by overseas banks have higher limits or are used more actively by the relevant cardholders.

Relatively high levels of financing through credit cards

Credit cards not only provide convenience at the point of purchase, but also allow consumers to defer payment over a period of time. Deferred payments are called "rollovers", as the consumer pays only the minimum balance and rolls over the balance to the next billing cycle.

Available data from the survey indicates that over 80% of credit card holders had outstanding balances by end-2006, compared to 68% in 2005. This suggests that more and more cardholders are taking full advantage of the line-of-credit facility provided by credit cards.

Worrisome levels of "overdues" and "delinquencies"

An issue of immediate concern is the relatively high levels of delinquency on credit card accounts. As shown in Annex Table 3 below, over 20% of credit card accounts were overdue at the end of 2006, with delinquencies (overdue by more than 90 days) representing 18% of total amounts outstanding.

Annex Table 3: Performance of Credit Card Accounts

	2004	*2005*	*2006*
Number of overdue accounts/Total number of accounts	18%	15%	20%
Delinquent amounts/Total outstanding amounts	11%	12%	18%
Write-offs/Total Outstanding amounts	7%	6%	2%

These findings suggest that cardholders are finding it difficult to pay the card balances, perhaps due to rising interest rates on credit cards. Although interest rates have increased across the board, the rise has been faster for credit cards, reaching over 20% by the fourth quarter of 2006 (see Annex Table 2)[19]. Further analysis shows that while overall delinquency ratios have been rising, overseas retail banks currently have a higher delinquency ratio (25%) than locally-incorporated banks (9%).

In the absence of information on consumer spending across income and age groups, it is difficult to pin-point reasons for this increase in delinquencies. One view is that an unsecured exposure like an outstanding credit card balance could have the lowest priority for a borrower. In case the cash flow of the borrower is strained, credit card payments may receive the lowest priority of repayment, with home and auto loans as well as other personal loans getting higher priority. As mentioned earlier, the high interest rates on outstanding balances could also be putting a strain on the cash flow of cardholders.

Conclusions

Against this backdrop, it is important that retail banks implement stronger credit risk management practices in this area, including stricter standards for approving

[19] Interest rates on credit card receivables shown in Annex Table 3 are based on a monthly survey conducted by CBB's Financial Stability Directorate which does not differentiate rates higher than 21%. (for example some banks charge as high as 29%).

credit card applications. Closer monitoring of credit card receivables is also warranted.

In addition, there is an urgent need for extensive consumer education in this area, since the general feeling is that many cardholders are not fully aware of the costs of having large outstanding balances on their accounts or the methods of capitalizing interest payments. In the recent past, CBB had raised awareness levels with customers on the methods of calculating effective interest rates, and the annualized percentage rates (APR) for various kinds of loans. A similar approach could prove to be beneficial here.

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