مصرف البحرين المركزي

Central Bank of Bahrain

Financial Stability Directorate

Financial Stability Report

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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 seven chapters as follows: Chapter 1 reviews recent international and domestic macro-financial 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 assesses the financial condition and performance of the conventional insurance industry.

Chapter 5 reviews recent trends on the equity market while Chapter 6 examines stability issues relating to the payment and settlement systems. Chapter 7 is a **Special Feature** covering measures introduced by the CBB to assist the banking system to cope with emerging liquidity pressures and shield the financial sector from the spillover effects of the global crisis.

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

Executive Summary

Overall assessment

Bahrain's financial sector remains sound, with strong levels of capital and liquidity as well as solid profitability across most sectors. Although the sector remains well placed to absorb the impact of any downturn in economic activity, the global financial crisis has made the operating environment for financial institutions more challenging.

International and domestic macroeconomic trends

The financial sector problem that first emerged in the US real estate market during 2007 – the so-called "sub-prime" crisis – was transformed in the course of 2008 into an event of global proportions. By the middle of 2008 the sub-prime problem had become the "Credit Crunch" in which the losses suffered by U.S and European banks as a result of their exposure to sub-prime assets reduced their capital and hence their capacity to lend. This sharply reduced the availability of credit in Europe and the U.S, while at the same time both corporate and household borrowers began to "de-leverage" reducing substantially the amount of debt outstanding on their balance sheets. Until the final quarter of 2008, the consensus view was that these financial developments would translate into a global economic slowdown, but the worst effects would be concentrated in the developed markets. The emerging economies were expected to continue their recent strong growth.

The collapse of the U.S investment bank Lehman Brothers in mid-September 2008 moved the financial crisis into a new and much more unpredictable phase. The immediate effect was a scramble for liquidity in the main international financial centres, and by the large international banks. There was a massive rise in risk aversion in financial markets, which was reflected in a variety of indicators, including a rise in risk premiums, the rising cost of Credit Default Swaps (CDS), and steep falls in global stock markets. Activity in interbank markets virtually ceased.

In response, governments around the world took a variety of exceptional measures in an effort to support financial intermediation and to protect payments systems. Several countries, including the US and UK, provided public funds as capital support to large, systemically-important financial institutions; general guarantees of deposits and other bank liabilities were introduced; and central banks engaged in unprecedented qualitative and quantitative easing, significantly reducing their policy interest rates and accepting as collateral a much broader range of financial instruments than hitherto. In the short term these measures helped to stabilize banking systems, although more time will be needed for their effect to become fully apparent and for financial intermediation to begin to approach normalcy.

In the light of these developments, consensus forecasts for the global economy in 2009 have been revised downwards, with IMF projections indicating that world output will grow by only 2.2% in 2009, compared to the 5% growth recorded in 2007 and the 3.7% growth expected for 2008. One positive development has been the decline in inflation, largely due to declines in *food and energy prices,* which should provide some relief to consumers and businesses in both advanced and emerging markets. However, by the end of November 2008, the United States, the U.K., Germany, and Japan were all officially in recession. Most advanced economies are expected to contract in 2009 and although output will still expand in key emerging economies such as China and India, a notable slowdown in their growth rates is also forecast.

Following the events of September 2008, many emerging economies experienced a substantial outflow of capital as global financial institutions reduced their exposure to what had come to be perceived as higher risk assets. This affected the availability of credit in emerging markets and placed domestic financial institutions under additional liquidity pressures. In addition, falls in commodities prices began to have an impact on the economic outlook of commodity producing countries. This development had a notable impact in the countries of the GCC as the oil price declined from $147 per barrel in July 2008 to $40 per barrel at the end of the year.

Until September 2008 the consensus view was that the GCC countries would continue to enjoy their recent strong growth, albeit at a slightly slower rate than in previous years. However, in line with the downgrade in the global economic outlook, growth expectations in the GCC have also been revised downwards. In addition, the global financial crisis has already had an impact in the GCC, with several countries experiencing significant stock market corrections in line with global trends. Some GCC members have needed to provide support to their banking sectors, either in the form of recapitalization funds, or by providing blanket guarantees of deposits, or by a combination of both. There is anecdotal evidence that investment projects are being delayed or scaled back owing to much tighter credit conditions.

Within this overall picture, the impact of the crisis on Bahrain has been relatively modest to date. The Government and the Central Bank have not considered it necessary to resort to some of the exceptional measures adopted elsewhere in the world as Bahrain's financial institutions and markets continued to operate normally throughout the crisis. The Central Bank did, however, introduce a number of new measures designed to assist the financial system to cope with any liquidity pressures emanating from the global turmoil. These included the introduction of a swap facility which enabled commercial banks to swap US dollars for Bahraini Dinars and an expansion in the range of collateral it will accept in its repo facility. The Central Bank has also engaged in close monitoring of both individual institutions and the financial system throughout the period under review. Various measures taken by the Central Bank are detailed in Chapter 7 of this report (Special Feature).

The non-financial sector

There has been a noticeable slowdown in the pace of growth of borrowing by Bahraini *households*. The current debt service ratio appears manageable particularly given increases in employment levels, increases in wages, and falling consumer prices. However, financing conditions for personal loans remain tight.

Despite increasing debt levels in the *business sector* financing conditions remain favorable as average lending rates to businesses remain relatively low. Nonetheless, debt service levels require close monitoring, particular in the event that the second round effects of the financial crisis are more severe than currently projected.

The banking sector

Banking institutions in Bahrain remain financially robust. Capital and liquidity positions are healthy, despite recent declines in regulatory capital adequacy ratios and liquidity pressures arising from the global financial crisis. However, earnings performance has weakened, with conventional wholesale banks recording a net loss (as a group) for the first time in many years.

Changes to the credit ratings of some banks reflect issues that are specific to those individual banks rather than a changed perception of the banking sector as a whole. Enhanced risk management will need to form a vital part of the industry's response to the more challenging operating environment created by the global financial crisis.

The insurance industry

Solvency margins for the *insurance industry* are comfortable and there has been a marked decline in the level of receivables, which had been increasing over the past two years. However, reflecting the increasingly challenging environment for financial institutions, net income for the industry is down and cost ratios have increased, driven primarily by a sharp jump in net claims. On a positive note, market perceptions of the sector are still sound, with an increase in market capitalization year-on-year, despite the substantial declines in GCC markets in recent months.

Equity markets

The *Bahrain stock market*, like other GCC equity markets, experienced significant volatility in recent months. Between May and September 2008, the Bahrain All Share Index lost a total of 411 points (down 16.7%). However, the market was still able to post a 12% year-on-year increase in market capitalization.

The "Hotel and Tourism" sector was the principal driver of market growth, with capitalization 29.0% higher year-on-year, followed by the

“Investment” and “Commercial banks” segments with expansions of 19.0% and 13.2% respectively. In contrast, the "Industrial” and “Services” sectors declined by 4.8% and 8.5% respectively.

Payments and settlement system

The overhaul of the payments and settlement infrastructure has reduced significantly the risks associated with payments and settlement transactions. Credit, liquidity, legal, and operational risks are at a minimum and we consider the payments and settlement system to be robust and secure.

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

Key Points

The financial crisis becomes global

Global growth prospects deteriorate

Moderation in global inflation

GCC inflationary pressures should ease but slowdown in growth expected

Macroeconomic outlook for Bahrain mirrors GCC 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 contained in the IMF's *World Economic Outlook*, October 2008, *World Economic Outlook Update*, November 2008 and *Global Financial Stability Report*, October 2008.

The financial crisis becomes global

Since the last *Financial Stability Report* of June 2008, the financial crisis that began in the US sub-prime sector has become a truly global phenomenon. The collapse of the US investment bank Lehman Brothers in mid-September 2008 moved the crisis into a new and much more unpredictable phase. The immediate effect was a scramble for liquidity in the main international financial centres, and by the large international banks. There was a massive rise in risk aversion in financial markets, which was reflected in a variety of indicators, including a rise in risk premiums, the rising cost of Credit Default Swaps (CDS), and steep falls in global stock markets. Activity in interbank markets virtually ceased.

In response, governments around the world took a variety of exceptional measures in an effort to support financial intermediation and to protect payments systems. Several countries, including the US and UK, provided public funds as capital support to large systemically important financial institutions; general guarantees of deposits and other bank liabilities were introduced; and central banks engaged in unprecedented qualitative and quantitative easing, significantly reducing their policy interest rates and accepting as collateral a much broader range of financial instruments than hitherto. In the short term these measures have helped to stabilize banking systems, although more time will be needed for their effect to become fully apparent and for financial intermediation to begin to approach normalcy.

Global growth prospects deteriorate

During the second half of 2008 the global financial crisis began to feed through to activity in the real economy and by end-November 2008, the United States, the U.K., Germany, and Japan were officially in recession. In response, large fiscal stimulus plans have been assembled in several countries, including the US, UK, Germany and China.

The latest projections from the International Monetary Fund (IMF) indicate that world output will grow by only 2.2% in 2009, compared to the 5% growth recorded in 2007 and the 3.7% growth expected for 2008 (Table 1.1). Further deterioration is expected for 2009 in the major advanced economies, with the United States' economy shrinking by 0.7%, the Euro Area by 0.5% and a 0.2% contraction in Japan. Although emerging economies such as China and India will still enjoy rapid growth in comparison, a significant slowdown in growth rates is projected, as recession in the US and Europe lead to a fall in the demand for their exports.

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

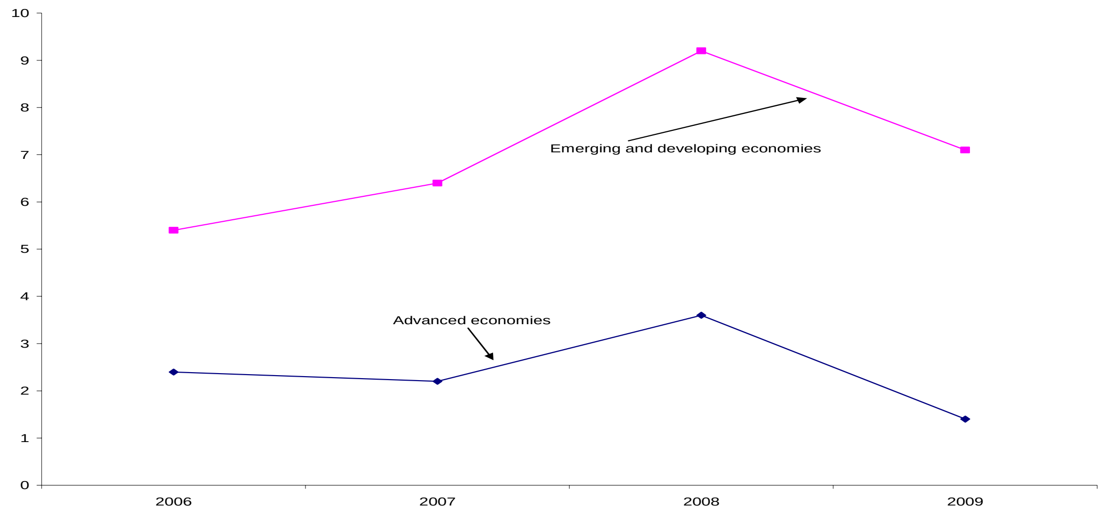
	2006	2007	2008*	2009*
World	5.1	5.0	3.7	2.2
United States	2.8	2.0	1.4	-0.7
Euro Area	2.8	2.6	1.2	-0.5
Japan	2.4	2.1	0.5	-0.2
Developing Asia	9.8	10.0	8.3	7.1
---China	*11.6*	*11.9*	*9.7*	*8.5*
---India	*9.8*	*9.3*	*7.8*	*6.3*
Middle East	5.7	6.0	6.1	5.3
Africa	6.1	6.1	5.2	4.7

**IMF projections*
Source: International Monetary Fund, World Economic Outlook Update, November, 2008

Inflationary pressures ease

For much of 2008 it had appeared that the world economy could be confronted by a period of "stagflation" in which stagnant or declining levels of output were combined with high and rising levels of inflation. A major source of inflationary pressures was the elevated levels of food and energy prices over the past year. However, with the deterioration in global economic conditions, inflationary pressures have rapidly eased. Inflation in advanced economies is expected to moderate to 1.4% in 2009 (compared to 3.6% in 2008), while inflation in emerging and developing economies should decline to 7.1% (compared to 9.2% in 2008) (Chart 1.1).

Chart 1.1: Global Consumer Prices, 2006-2009 (%)*



**2008 and 2009 IMF projections*
Source: International Monetary Fund, World Economic Outlook Update, November 2008

Spillover effects reach the GCC

Although the GCC continues to enjoy strong economic fundamentals, a slowdown in growth is expected in 2009. The weaker economic growth outlook for the GCC is due to a combination of factors, including tighter international credit conditions and a fall in the price of oil. The global contraction in the supply of credit has affected the timing of several large infrastructure and property developments around the GCC, while the viability of some marginal projects may need to be reviewed. Secondly, crude oil prices have fallen from a high of around $147/barrel in 2007 to $40/barrel in December 2008. This will undoubtedly have significant implications for all GCC economies which have expanded rapidly in recent years on the back of high oil receipts.

Hence, similar to trends in other emerging and developing economies, a slowdown in growth is expected in the GCC countries for 2009, due principally to cut-backs in bank lending and lower oil prices (see Table 1.2).

Table 1.2: GCC Growth Performance—2007-2009 (% changes)

	2007	2008*	2009*
Bahrain	8.1	5.3	4.7
Kuwait	4.8	4.5	2.4
Oman	6.9	6.9	5.5
Qatar	12.5	13.5	10.2
Saudi Arabia	3.4	4.1	2.3
UAE	6.1	5.8	3.1

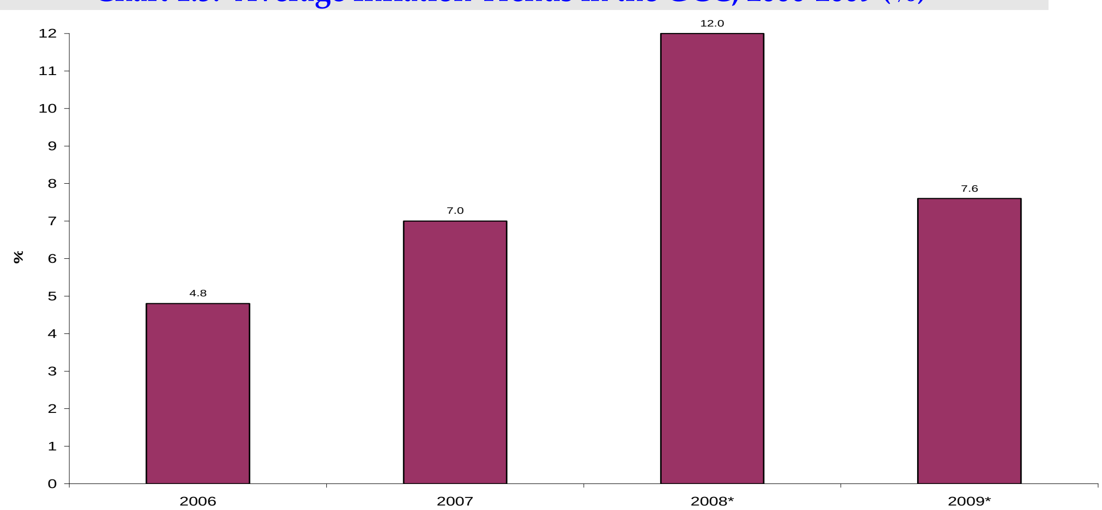
**IIF projections*

Sources: IIF and Statistical Publications from individual countries

In addition, the global financial crisis has already had an impact in the GCC, as some countries experienced significant stock market corrections in line with global trends, with the Dubai and Saudi markets worst hit (see Chapter 5). Some GCC members have also needed to provide support to their banking sectors, either in the form of recapitalization funds, or by providing blanket guarantees of deposits, or by a combination of both.

On a more positive note, average inflation is expected to decline across the GCC in 2009 as the region benefits from the global decline in food and energy prices (Chart 1.3).

Chart 1.3: Average Inflation Trends in the GCC, 2006-2009 (%)*



** *2008 and 2009 figures are projections*

Source: Institute of International Finance

Bahrain's economic outlook mirrors GCC trends

Bahrain is the least oil dependent nation in the GCC with growth driven largely by the non-oil sector. The financial services industry is especially strong and is the single largest contributor to national output (26.7%). Nonetheless, oil export receipts are the largest source of government revenue and the close linkages between Bahrain and other regional economies mean that a regional slowdown will affect Bahrain's economy.

Projections by the IIF indicate that Bahrain's GDP growth will slow to 5.3% in 2008, with a growth rate of 4.7% forecast for 2009 (Table 1.3). As oil prices decline, the current account surplus is expected to shrink considerably to 7.2% of GDP in 2009 while the fiscal balance is projected to return a deficit amounting to 6.7% of GDP.

Table 1.3: Bahrain's Economic Outlook*

	2007	**2008***	**2009***
Real GDP growth (%)	8.1	5.3	4.7
Inflation (CPI)	4.4	3.4	3.1
Current account balance (% of GDP)	16.1	20.8	7.2
Fiscal balance (% of GDP)	3.2	7.8	-6.7

**IIF forecasts.*

Source: Institute of International Finance

2. The Non-Financial Sector

Key Points

Household borrowings increase although financing conditions for personal loans remain tight

Business debt ratios also rising but their financing conditions ease

Leading indicators point to a slowdown in construction and real estate

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

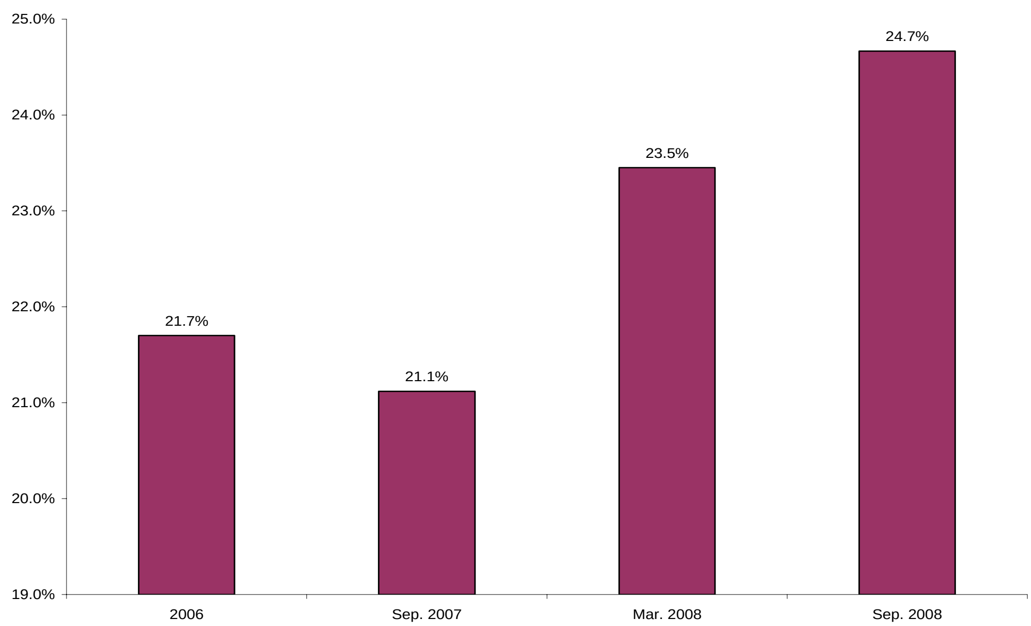
The construction and real estate sector receives special attention because this sector is usually highly sensitive to developments in macroeconomic conditions and financial institutions in Bahrain have direct and indirect exposures to the sector.

2.1. Households

Slightly higher debt ratio but slowdown in rate of growth

Using outstanding personal loans from all banks as a proxy for "household" borrowing, we observe that the household debt burden has increased slightly since the last *Financial Stability Report*. The ratio of personal loans to GDP increased from 23.5% of GDP as at end-March 2008 to 24.7% by end-September 2008 (Chart 2.1)[2]. There was however a substantial slowdown in the *rate of growth* of personal loans outstanding, which grew by 5.1%, compared to the 11% over the period covered by the *June 2008 Financial Stability Report* (Chart 2.2). Financing conditions for personal loans have remained tight, with average lending rates standing at 8.2% by end-2008:Q3, slightly lower than the 9.3% recorded at the same time last year. This is in spite of several cuts in the CBB policy rate over the past year.

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

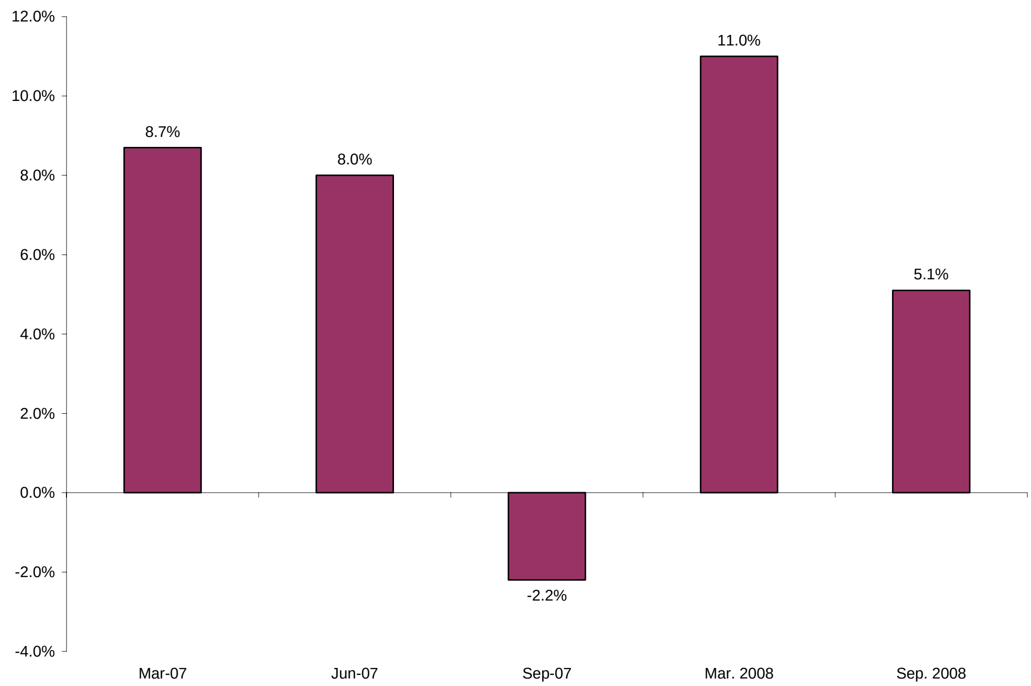


***The personal debt-GDP ratios for September 2007 and March 2008 have been revised using updated GDP numbers*

Source: Central Bank of Bahrain

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

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. Trends in employment could therefore be used to gauge the level of household income risks. As at end-2008:Q3, overall employment levels in Bahrain stood at 458,456 compared to 397,918 at the same point in 2007 (an addition of 60,538 jobs).

Rising wages have also contributed to the improving outlook for household income risks. In the absence of household income data for Bahrain, we look at average monthly wages in the private and public sectors, as proxies for trends in household income. As at end-September 2008, average private sector wages stood at BD248 per month, compared to BD231 per month as at 2007:Q3 (Table 2.1). Average monthly public sector wages also show an upward trend, standing at BD770 per month as at end-2008:Q3, compared to BD705 per month at the same time last year.

Table 2.1: Average Monthly Wages (BD)

	2006:Q3	2006:Q4	2007:Q1	2007:Q2	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3
Private Sector	213	210	224	228	231	232	246	248	248
Public Sector	677	700	695	706	705	774	772	782	770**

***Decrease is due to advance salary payments and staff leave*

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 expected moderation in inflation rates, especially the prices for food, which is a major component of consumption baskets in Bahrain. Declining inflation will increase the spending power of residents and improve their ability to service debt under the current tight financing conditions.

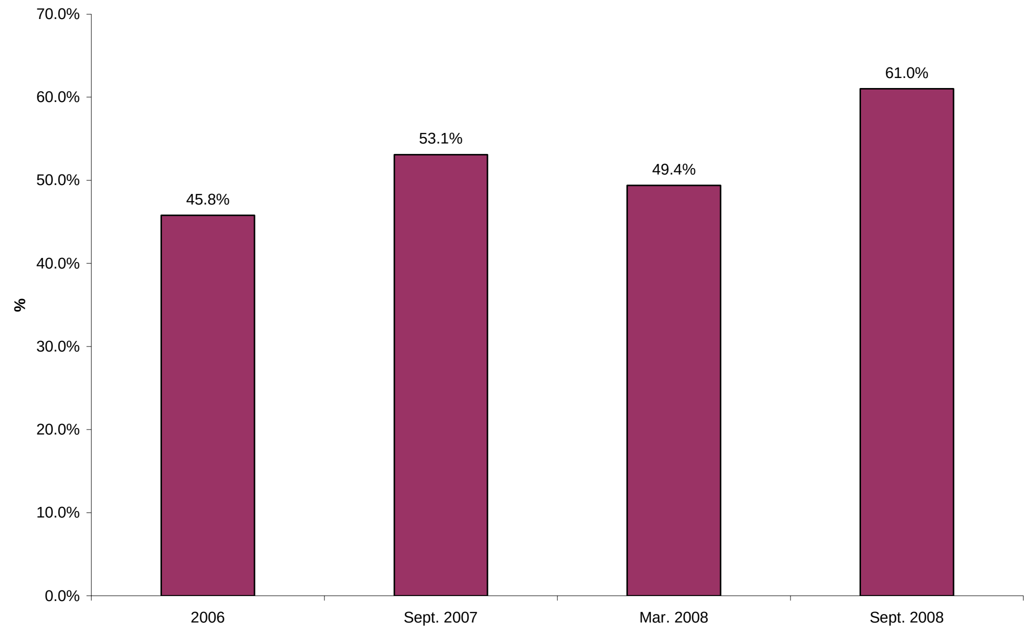
2.2. *Business Enterprises*

Increase in business debt ratio

Between March and September 2008, the ratio of business loans to GDP rose from 49.4% to 61% (Chart 2.3). While this increase is partly explained by the adjustments to GDP numbers, it also reflects increased borrowing by businesses concerned that loans and lines of credit will become unavailable if the global financial crisis is prolonged.

However, financing conditions for businesses are still somewhat favorable, with average borrowing rates standing at 6.8% in 2008:Q3, compared to 8.1% the previous year.

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



***The business debt-GDP ratios for September 2007 and March 2008 have been revised using updated GDP numbers*

Source: Central Bank of Bahrain

2.3. Construction and Real Estate

Slowdown in licensing and permits for construction and real estate

As the global financial crisis worsens, there is evidence of some cooling in the construction and real estate sector. In the third quarter of 2008, a total of 430 new commercial licenses were issued for construction, real estate and associated activities, compared to 501 licenses in the second quarter (Table 2.2).

Table 2.2: Commercial Licenses Issued for Construction and Real Estate

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

Source: Ministry of Municipality Affairs and Agriculture

Similarly, the total number of construction permits issued by the Ministry of Municipalities Affairs and Agriculture declined from 1199 in the second quarter to 939 in the third (Table 2.3). The number of construction permits and commercial licenses issued are leading indicators of performance in this sector and both point to a possible slowdown in the months ahead.

Mirroring the third-quarter declines in commercial licenses and construction permits, the *value of traded land permits* fell from BD549.4 million in 2008:Q2 to BD366 million in 2008:Q3 (Table 2.4).

Table 2.3: Selected Construction Permits by Type

	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3
Demolition and New construction	158	53	36	48	28
New construction	1002	819	801	1136	905
Reclamation	10	3	3	15	6
Total	**1170**	**875**	**840**	**1199**	**939**

Sources: Ministry of Municipality Affairs and Agriculture

Table 2.4: Trading in Land (BD Million)

	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3
Total Value of Traded Land Permits	**330.4**	**443.6**	**537**	**549.4**	**366**
Value of Permits for Bahrainis	*308.4*	*416.5*	*500.2*	*486.7*	*317.6*
Value of Permits for Non-Bahrainis	*22*	*27.1*	*36.8*	*62.7*	*48.4*

Sources: Ministry of Municipality Affairs and Agriculture

Overall Assessment of the Non-Financial Sector

The outlook for households is satisfactory, against the background of recent increases in employment, rising wages and falling consumer prices. However, financing conditions for personal loans remain relatively tight.

Debt levels in the business sector are increasing but this is mitigated by relatively favorable financing conditions as average lending rates to businesses remain low.

For the construction and real estate sector, leading indicators point to a slowdown in the levels of activity in the sector. There are anecdotal reports of construction projects being cancelled or downsized. On a positive note, the fall in the prices of materials should provide some relief to the sector and a sharp correction is not expected because Bahrain's real estate sector is not overextended as is the case in other GCC countries.

3. Financial Condition and Performance of the Banking Sector

Key Points

Overall, the banking sector remains safe and sound, despite the ongoing global financial turmoil

However, there are some signs of a more challenging operating environment for banks, including a net loss for conventional wholesale banks during the review period

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.

In contrast to previous *Financial Stability Reports*, this edition reviews developments in the banking sector over a nine-month period (from December 2007 to September 2008)[3].

[3] As a result of the introduction of a new reporting framework for banks, the June 2008 Financial Stability Report used a cut-off date of December 2007 for the analysis of banking trends. We will revert to the usual six-month review period starting with the June 2009 report.

Unless specified otherwise, the analysis in this chapter is based on consolidated financial data (Bahraini and non-Bahraini operations), as at end-September 2008.

3.1. Conventional Retail Banks

Capital position of retail banks is sound but has fallen recently[4]

As at end-September 2008, the aggregate capital adequacy ratio for locally-incorporated retail banks stood at 15.5%, compared to the 24% level attained in December 2007. The core capital ratio (ratio of Tier 1 capital to risk-weighted assets) also fell to 10.9% (from 17% in December 2007).

Although retail banks expanded their capital base over the period, the increase was outpaced by the rise in total risk-weighted exposures which caused capital adequacy ratios to decline.

Rapid loan growth but asset quality remains satisfactory

Retail banks' total loans outstanding rose by over 200% over the nine-month period under consideration. However, asset quality remains satisfactory. As at end-September 2008, loans classified as non-performing (NPLs) amounted to only 3.7% of gross loans, slightly up from the 3% recorded at the end of December 2007. A breakdown by license category indicates that average NPLs in locally-incorporated retail banks were higher at 4.8% compared to 0.8% for overseas banks.

Under the new Central Bank of Bahrain reporting framework, local retail 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 small across sectors, with the highest rates posted in "consumer and personal" (2.2%), and "manufacturing" (2.2%). Provisioning for these loans also exceed 100%. It

[4] 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.

is however important that retail banks aggressively monitor loans that are "mildly impaired" (i.e. between 30 and 90 days past due) to guard against migration to more serious delinquency categories. In addition, the rapid loan growth means that banks should be doubly-vigilant in monitoring all new exposures.

Concentration of assets

Retail banks' lending portfolio shows a concentration of loans in a few sectors. In locally-incorporated retail banks, over 50% of all loans were in two sectors: "consumer and personal" and "construction/real estate" (Table 3.1). The emergence of the construction and real estate sector as the single largest recipient of retail bank lending is particularly notable, as it was fourth in the rankings just nine months ago.

Concentration levels are even higher for overseas retail banks, where "manufacturing" remains the single largest recipient of loans, accounting for 37% of loans outstanding (Table 3.2). As at end-September 2008, the top three sectors (manufacturing, services and financial) jointly accounted for 75% of total loans outstanding in overseas retail banks.

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

	Sept 2007	Dec. 2007	Sept. 2008
Consumer and Personal	21	21.6	25.2
Government	6.1	6.3	4.3
Construction/Real estate	12.7	13.4	28.9
Manufacturing	16.4	15.4	10.5
Mining & Quarrying	1.3	1.3	1.6
Agric, Fishing and Forestry	0.2	0.1	0.4
Financial	21.0	21.4	10.4
Trade	10.2	9.7	8.2
Services	11.2	10.7	10.5

Source: Central Bank of Bahrain

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

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

	Sept 2007	Dec. 2007	Sept. 2008
Consumer and Personal	13.2	13.4	5.1
Government	3.9	3.3	0.4
Construction	8.6	8.1	9.1
Manufacturing	30.6	30.4	37.2
Mining & Quarrying	0.3	0.3	0.4
Agric, Fishing and Forestry	0.6	0.4	0.3
Financial	15.3	9.8	12.7
Trade	12.3	8.9	9.8
Services	15.1	25.4	25.0

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

Decline in bank earnings

As at end-September 2008, return-on-assets (ROA) was 1.1% for local retail banks, down from 1.7% last December. For overseas banks, ROA was 1.2% (compared to 1.4% last December). Return-on-equity (ROE) amounted to 9% for local retail banks, down from 12% in December 2007.

A breakdown of data on earnings shows that local retail banks earned most of their income from interest receipts, with *net interest income* representing 55% of gross operating income. However, this represents a decline, when compared to the 64% share posted in December 2007. The most remarkable feature of bank earnings is the rapid growth of non-interest income, which grew by 170% over the nine-month period and now accounts for 46% of gross income (up from 36% in December 2007).

One interpretation of this trend is that local retail banks have become more successful in diversifying sources of income and may be less vulnerable to declines in interest rates or in loan demand. While this is a welcome development, it is important to ensure that banks have the risk management framework in place to support their involvement in new, fee-based activities.

For overseas retail banks, net interest income accounted for a larger share of gross income (68%) and recent earnings have also been driven by interest income. For this category of banks, non-interest income actually declined by 11% between December 2007 and September 2008.

Minimal liquidity risks

Between December 2007 and September 2008, retail bank deposits expanded by 140% confirming their continued ability to mobilize deposits, even in the current stressful environment. The overall loan-deposit ratio for the segment stood at 65%, indicating that the retail banks are more dependent on funding from comparatively more stable customer deposits. However, the ratio of non-bank deposits to total deposits dropped to 55% (from 68% in December 2007), due principally to a sharp increase in bank deposits for overseas retail banks (over 200%). Finally, the liquid asset ratio for retail banks remained unchanged at 30% by end-September 2008.

Market perceptions

In December 2008, Fitch Ratings reviewed the individual ratings for three retail banks in Bahrain. For the most part, the review took into consideration circumstances specific to these institutions against the background of the ongoing global financial turmoil. There were no rating changes for National Bank of Bahrain (NBB) and Ahli United Bank (AUB) although it was noted that AUB's ratings could come under pressure if the situation deteriorates significantly. However, following recent losses on structured products, the rating for Bank of Bahrain and Kuwait (BBK) was downgraded from "C" to "C/D".

3.2. Conventional Wholesale Banks

Capitalization is high but has declined[5]

As at end-September 2008, the regulatory capital adequacy ratio for locally-incorporated wholesale banks stood at 18% (down from 21% in December 2007). The core capital adequacy position (ratio of Tier 1 capital to risk-weighted assets) also fell from 17.3% to 16%. This suggests that while capital increases have not kept pace with increases in risk-weighted assets, wholesale banks have strived more to boost core capital levels, in contrast to the past couple of years when they have focused more on expanding Tier 2 capital.

Further improvement in asset quality

As at end-September 2008, loans classified as non-performing (NPLs) amounted to 1.1% of gross loans (down from 1.5% in December 2007). Locally-incorporated wholesale banks show an NPL ratio of only 0.5% compared to 1.4% for their overseas counterparts. Wholesale banks also experienced a 28% decline in loans outstanding, most likely due to cutbacks in lending as the global financial turmoil unfolded.

A look at the breakdown of *seriously impaired loans* for local wholesale banks (i.e. loans 90 or more days past due) shows an unusually high rate of impairment in the "personal/consumer" category (5% of outstanding loans to the segment), compared to other sectors where impairment ratios do not exceed 1%. This situation is however of no particular concern as personal/consumer loans constitute only 0.3% of total loans outstanding for wholesale banks.

[5] 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.

Loan portfolios are concentrated

Akin to the situation in retail banks, lending patterns for wholesale banks are concentrated. In *locally-incorporated wholesale banks*, the top three recipients of loans ("financial", "services" and "manufacturing") jointly accounted for 64% of total loans outstanding as at end-September 2008 (Table 3.4). This is virtually unchanged when compared to end-December 2007 data. *Overseas wholesale banks* however show increased concentration risks, with the same three sectors jointly accounting for 75% of lending, up from 68% in December 2007 (Table 3.5)

Table 3.4: Distribution of Wholesale Bank Lending
(% shares; locally incorporated banks only)*

	Sept 2007	**Dec. 2007**	**Sept. 2008**
Consumer and Personal	2.0	7.0	3.3
Government	5.6	2.7	2.2
Construction/Real estate	7.7	9.5	12.3
Manufacturing	21.0	20.2	25.0
Mining & Quarrying	2.7	2.8	1.6
Agric, Fishing and Forestry	0.7	0.6	0.8
Financial	25.0	21.3	20.6
Trade	15.0	14.1	15.7
Services	20.0	21.8	18.5

Source: Central Bank of Bahrain

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

Table 3.5: Distribution of Wholesale Bank Lending
(% shares; overseas banks)*

	Sept 2007	**Dec. 2007**	**Sept. 2008**
Consumer and Personal	0.5	0.3	0.3
Government	9.5	7.7	6.5
Construction/Real estate	10.3	11.4	9.4
Manufacturing	15.7	17.7	22.1
Mining & Quarrying	5.3	3.3	2.6
Agric, Fishing and Forestry	1.2	1.3	0.4
Financial	23.8	24.1	21.4
Trade	7.6	7.9	6.1
Services	26.1	26.3	31.1

Source: Central Bank of Bahrain

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

Net loss for wholesale banks

Income statement data show a net loss for wholesale banks (as a group) in the period up to September 2008. Return-on-assets (ROA) was -0.1%, compared to ROA of 0.6% in the period up to December 2007. The net loss position was entirely due to losses in local wholesale banks, for which ROA amounted to -0.8% and return-on-equity was -5.4%. Overseas wholesale banks showed a small net profit position, with an ROA of 0.4%.

Lower liquidity levels

Between December 2007 and September 2008, wholesale bank deposits declined marginally by 1.5%. The overall loan-deposit ratio for the segment stood at 88%, significantly higher than the 68% recorded as at end-December 2007. Unlike overseas wholesale banks which are fully loaned-up (loan-deposit ratio of 106%), the loan-deposit ratio for local wholesale banks was 67% indicating available room to expand lending from the deposit base.

Liquid assets are relatively low at 16% of total assets, a sharp drop from the 31% of December 2007. Further, 60% of wholesale bank deposits come from other banks and financial institutions, up from 56% in December 2007.

Market perceptions

In December 2008, Fitch Ratings reviewed the individual ratings for four wholesale banks in Bahrain. The review focused mostly on the particular circumstances facing individual institutions within the context of the current global financial crisis. Individual ratings for both Arab Banking Corporation (ABC) and Gulf International Bank (GIB) were downgraded to "D'. TAIB Bank's rating was affirmed at "C/D" while BMB was affirmed at "D/E".

3.3. Islamic Retail Banks

Healthy capital positions and improved profitability

Although slightly down, the capital buffers of Islamic retail banks is robust. As at end-September 2008, the regulatory capital adequacy ratio for Islamic retail banks was 28%, lower than the 34% recorded for end-December 2007. The core capital ratio was 24.4%, compared to 29% in December 2007.

Islamic retail banks enjoyed higher profits during the period under review, with their return on assets (ROA) reaching 5%, compared to 3.8% as at end-December 2007.

Good asset quality but high concentration

Asset quality for Islamic retail banks remains healthy. As at end-September 2008, aggregate non-performing financing facilities (NPF) were 3.8% of total facilities, only slightly higher than the 3.5% recorded at the end of December 2007. Available data indicates that NPFs are highest in the "trade" sector (10.4% of total facilities to the sector), followed by services (8.9%) and "manufacturing" (5.4%).

Similar to the situation in conventional retail banks, the level of asset concentration is high in Islamic retail banks. The top three recipients of financing, (construction/real estate, financial and personal/consumer) jointly accounted for 74.4% of total financing facilities at the end of September 2008.

Reduced liquidity

The volume of liquid assets available to Islamic retail banks has fallen from 25% of total assets in December 2007 to 18% by end-September 2008. Also, deposits from banks and other financial institutions currently constitute 46% of non-capital funding liabilities, a potential source of volatility in the deposit base. In addition, the 25 largest sources of funds represent 82% of non-capital funding liabilities.

3.4. Islamic Wholesale Banks

Decline in capital positions and lower profitability

Capital adequacy levels have declined substantially but still provide adequate cushion for unexpected losses. As at end-September 2008, capital the regulatory capital adequacy ratio (CAR) stood at 24.6%, compared to 40% in December 2007. This is a result of a more aggressive deployment of surplus capital, with risk-weighted assets increasing significantly. The core capital ratio (ratio of Tier 1 capital to risk-weighted exposures) was also lower at 22%, versus 37% in December 2007.

The picture on earnings is also less favorable, with return on assets falling from 4.2% in December 2007 to 1.5% by the end of September 2008.

Lower asset quality and smaller liquidity positions

As at end-September 2008, aggregate non-performing financing facilities (NPF) in Islamic wholesale banks stood at 7%, up from the 4.2% recorded in December 2007.

These banks also exhibit high levels of asset concentration, with the top three recipients of financing, (manufacturing, trade and financial) jointly accounting for 67% of total financing facilities at the end of September 2008.

Further, liquid assets now represent 19% of total assets, down from 25% last December. Some mitigation comes from the diversification of the funding base, with the 25 largest sources of funds accounting for only 6% of non-capital funding liabilities.

3.5. Overall Assessment of the Banking Sector

In general, Bahrain's banking institutions remain safe and sound, despite the ongoing global financial crisis. Nonetheless, declining capital positions and less robust earnings (including a net loss by conventional wholesale banks), point to a more challenging operating environment for banks. High levels of asset concentration remain a concern across both conventional and Islamic banks. In the months ahead, banks will need to maintain careful and effective risk management practices in the uncertain environment created by the global financial crisis.

Box 3.1: GCC Response to Spillover of Global Financial Turmoil

In the third quarter of 2008, banks in the GCC countries began to experience more serious pressures stemming from the global financial crisis. Before then, some banks had already reported losses from direct exposures to mortgage-related securities or to failing institutions in the United States.

In October, liquidity pressures intensified as many countries experienced large outflows of funds from their banking systems. A large part of these funds had entered in 2007 in anticipation of a currency revaluation. The Central Bank of the UAE responded by providing banks with a credit facility of DHS50 billion, followed by substantial government deposits. Government guarantees were also issued to cover bank deposits (including interbank and foreign branch deposits). Concerns about the real estate sector led to the takeover by the UAE government of Amlak Finance PJSC and Tamweel PJSC, Dubai's largest mortgage lenders, as the previously booming real estate market came under intense pressure.

In Kuwait, the largest bank, Gulf Bank suffered large losses on foreign exchange derivatives and had to cease trading on the stock exchange. In response to depositor worries, the Kuwaiti government moved to guarantee deposits and injected over $2 billion into the banking system. The Kuwait Investment Authority (KIA) also invested $1 billion to help support the falling stock market.

The Qatari and Omani authorities have issued assurances of liquidity support if needed by banks and Oman cut its repo rate to ease liquidity conditions. The Qatar Investment Authority (QIA) has also bought shares in the banking sector to help maintain prices.

In Saudi Arabia, the Saudi Monetary Authority (SAMA) has cut reserve requirements, lowered its repo rate and made available up to $36 billion to banks as a credit facility.

In Bahrain, the pressures have been less intense but the Central Bank of Bahrain has responded to emerging liquidity pressures by enhancing its lending facilities to banks, including the introduction of new currency swap arrangements (see Chapter 7 for details).

4. Financial Condition and Performance of the Insurance Industry[6]

Key Points

Capital positions are healthy with ample solvency margins

There has been a sharp reduction in the level of insurance receivables

Net income has declined as a result of higher cost ratios

Year-on-year stock market performance is still positive, despite declines experienced across GCC stock markets

Healthy capital and solvency positions

The insurance sector in Bahrain is adequately capitalized. For both general and life business lines, the available capital continues to exceed the required margin of solvency, with the actual solvency margin representing 42% of net premiums and 45% of total capital resources. As at end-September 2008, insurers' Tier 1 capital represented 19.6% of total assets, a marginal reduction over the March 2008 level (22%).

Decline in the level of insurance receivables

Previous editions of the *Financial Stability Report* raised concerns about the high levels of insurance receivables. Following new rules introduced by CBB, insurance companies have been more aggressive in pursuing overdue receivables, leading to a substantial reduction in their levels[7]. As at end-September 2008, receivables represented 61% of gross premiums, compared to over 100% in March 2008. This trend has reduced

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

[7] CBB has introduced a rule that all debts due for more than six months be valued at zero for capital valuation purposes.

significantly, the credit risk facing insurance companies from this source but we expect further reductions in the months ahead as the new rule is fully implemented.

Increase in re-insurance ceded

The risk retention ratio (net premiums/gross premiums) declined to roughly 80% (compared to 95% in March 2008) as uncertainties in the operating environment encouraged Bahraini insurers to pass along more underwriting risks to re-insurers. Although the healthy balance sheets of insurers support their ability to bear risk, it is a prudent move to share risks more broadly in the current atmosphere of global economic and financial stress.

Decline in net income but positive market perception

Insurance companies experienced a 38% decline in net income in the period up to September 2008 as cost ratios increased across the industry. The *claims ratio* (ratio of claims incurred to premiums earned) has risen sharply to 71%, compared to 29% in March 2008. Similarly, the *expense ratio* (ratio of expenses to earned premiums) increased to 28%. The *combined ratio* (claims ratio plus expense ratio) of 99% is substantially higher than the ratio of 47% recorded for March 2008.

In spite of the ongoing financial turmoil and the large declines in stock market capitalization across GCC markets, market capitalization of the insurance sector increased on a year-to-year basis from BD200.2 million in September 2007 to BD209 million by end-September 2008.

Overall assessment

The financial condition of the insurance sector is satisfactory going by available data on capital positions and solvency margins. A decline in earnings is a negative development, but that is not surprising in these challenging times. There has been remarkable success in reducing the level of insurance receivables, and a further decline is expected in the coming months.

5. Performance of Equity Markets

Key Points

Despite the recent turmoil, market capitalization increased year-on-year

Downward trend in the Bahrain All Share Index

Although some segments have experienced increased activity, aggregate trading is still relatively low

Significant increase in market capitalization

As at end-September 2008, market capitalization of the Bahrain Stock Exchange (BSE) stood at BD10.3 billion, equivalent to 148% of GDP (Table 5.1). This level was 12.2% higher than the level for the same period of 2007, indicating the continued growth in the size of the stock market.

The "Hotel and Tourism" sector was the principal driver of market growth, with capitalization 29.0% higher year-on-year, followed by the "Investment" and "Commercial banks" segments with expansions of 19.0% and 13.2% respectively. In contrast, the "Industrial" and "Services" sectors declined by 4.8% and 8.5% respectively.

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

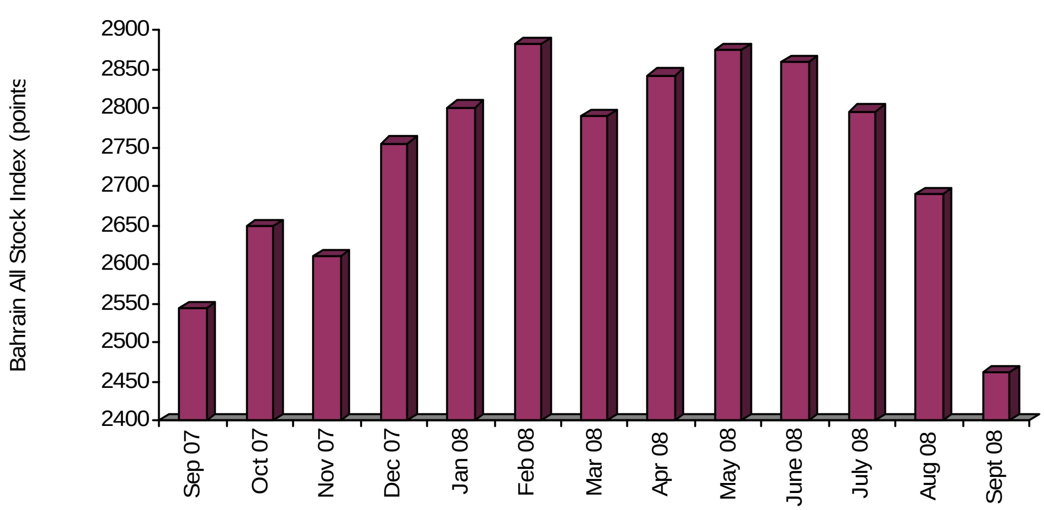
	Sept 2007	Sept 2008	Sept 2007-Sept 2008 change (%)
Commercial banks	3122.6	3535.2	13.2
Investment	4178.2	4971.7	19.0
Insurance	200.2	209.0	4.4
Services	1519.7	1390.3	-8.5
Industrial	16.8	16.0	-4.8
Hotel and Tourism	119.5	154.1	29.0
TOTAL	**9157.0**	**10276.2**	**12.2**

Source: Bahrain Stock Exchange

Downward trend in market index

Between May 2008 and September 2008, the Bahrain All Share Index lost a total of 411 points (down 16.7%) (Chart 5.1). The largest decrease was witnessed in September 2008 where the index fell more than 227 points from the previous month. This was a reflection of the ongoing global financial crisis and the associated loss of investor confidence in both matured and emerging markets.

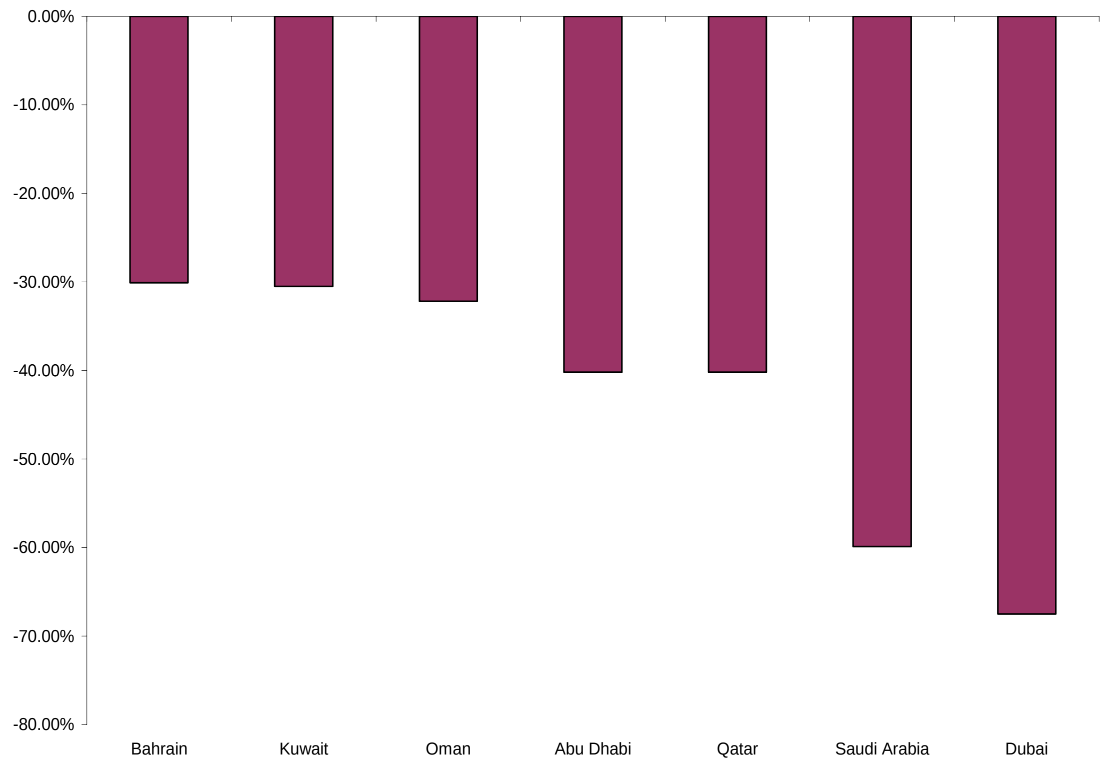
Chart 5.1: Recent Trends in the BSE All-Share Index, Sept. 2007-Sept. 2008



Source: Bahrain Stock Exchange

Although the impact of the crisis has been felt across GCC equity markets, the Bahraini market was one of the least affected as the Dubai and Saudi markets have been the worst hit (Chart 5.2).

Chart 5.2: GCC Equity Markets—Changes in Market Capitalization (Dec. 07 to Nov. 08)



Sources: Institute of International Finance

Stock prices look reasonable

As at September 2008, the price-earning ratio (P-E ratio) for the stock market stood at 11.24, down from the 11.81 attained in September 2007 (Table 5.2).

Table 5.2: BSE—Price-Earning Multiples

	Sept 2007	May 2008	Sept 2008
Commercial banks	17.28	17.70	14.99
Investment	9.51	9.72	10.34
Insurance	8.03	8.93	9.32
Services	12.63	10.28	8.73
Industrial	9.17	8.71	8.73
Hotel and Tourism	10.35	8.85	9.84
Total Market	**11.81**	**11.81**	**11.24**

Source: Bahrain Stock Exchange

Investor optimism about the "commercial banks" sectors is evidenced by its P-E multiple of 14.99, which is higher than the market average, even though it is a decline from the 17.28 recorded in September 2007. Multiples for other sectors are below the market average.

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 0.14%, down from the 0.74% registered in May 2008. There has bee a notable surge in trading of shares in the "Investment" segment, with its share of total trading increasing to 64.3% by the end of September 2008 up from 28.3% in May 2008 (Table 5.3).

Table 5.3: BSE—Value of Shares Traded by Sector (% shares)*

	Sept 2007	May 2008	Sept 2008
Commercial banks	60.6	60.7	24.8
Investment	25.0	28.3	64.3
Insurance	3.0	0.8	1.1
Services	10.5	8.5	8.8
Industrial	0.0	0.0	0.0
Hotel and Tourism	0.7	1.2	1.1

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

Source: Bahrain Stock Exchange

In contrast, the share of trading in the "Commercial banks" segment dropped significantly from 60.7% in May 2008 to 24.8% in September. These two sectors still account for the bulk of trading on the exchange, representing 89.6% of total trading by value, a marginal increase from the 89.0% in May 2008.

Overall assessment

As described above, the level of activity on the Bahrain Stock Exchange is relatively low. Also, an examination of price-earning multiples suggests that stock prices are not overvalued. The recent downward trend in the market index mirrors the sell-off experienced across the GCC and the Bahrain market has turned out to be one of the least affected.

6. Payment and Settlement Systems

Key Points

The recent improvements in infrastructure for payments and settlement have reduced credit, liquidity and operational risks substantially

Legal risks are also mitigated by the detailed policies, rules and procedures governing the operation of the system

Nonetheless, there is room to further reduce legal risks through the introduction of a Payments Systems Act

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

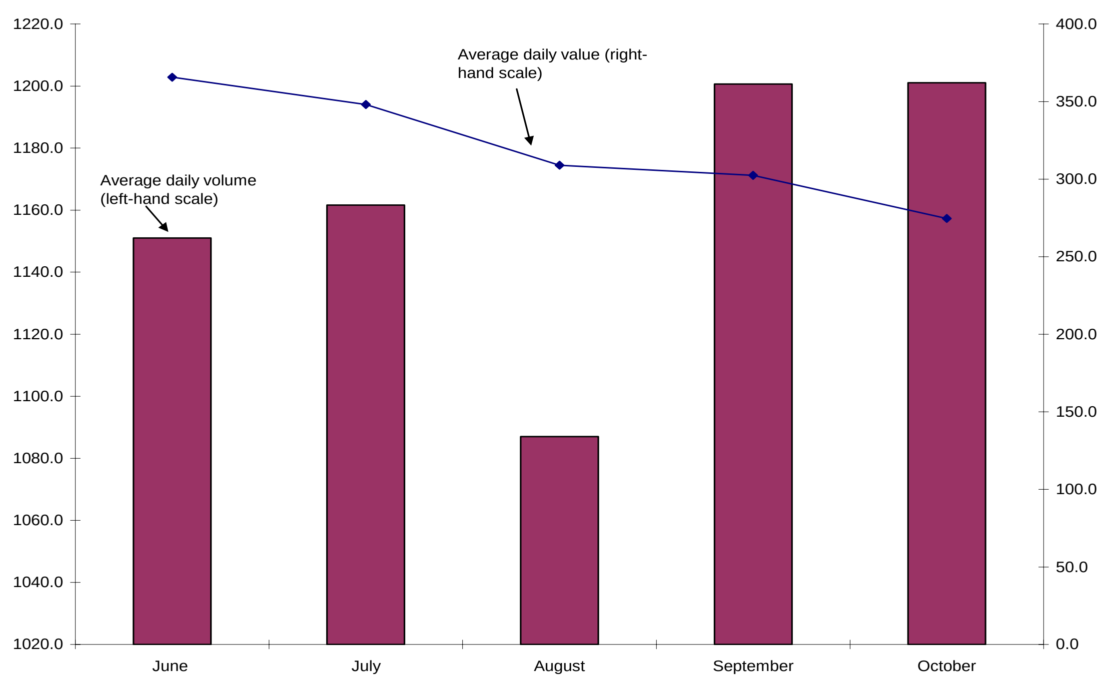
The current payments and settlement infrastructure in Bahrain comprises of five main components: i) the Real Time Gross Settlement System (RTGS); ii) the Automated Cheque Clearing System (ACS); iii) the ATM clearing system; iv) the Scripless Securities Settlement System (SSSS); and v) the clearing, settlement 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 June 2008 through October 2008. Over this period, the *average daily volume of transfers* increased moderately from 1151 in June to 1201 in October, an increase of about 4%. In value terms, transfers decreased steadily from a daily average of BD365.7 million in June 2008 to BD274.6 million in October, suggesting that the RTGS is being used more and more to process small-value retail payments for bank customers.

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



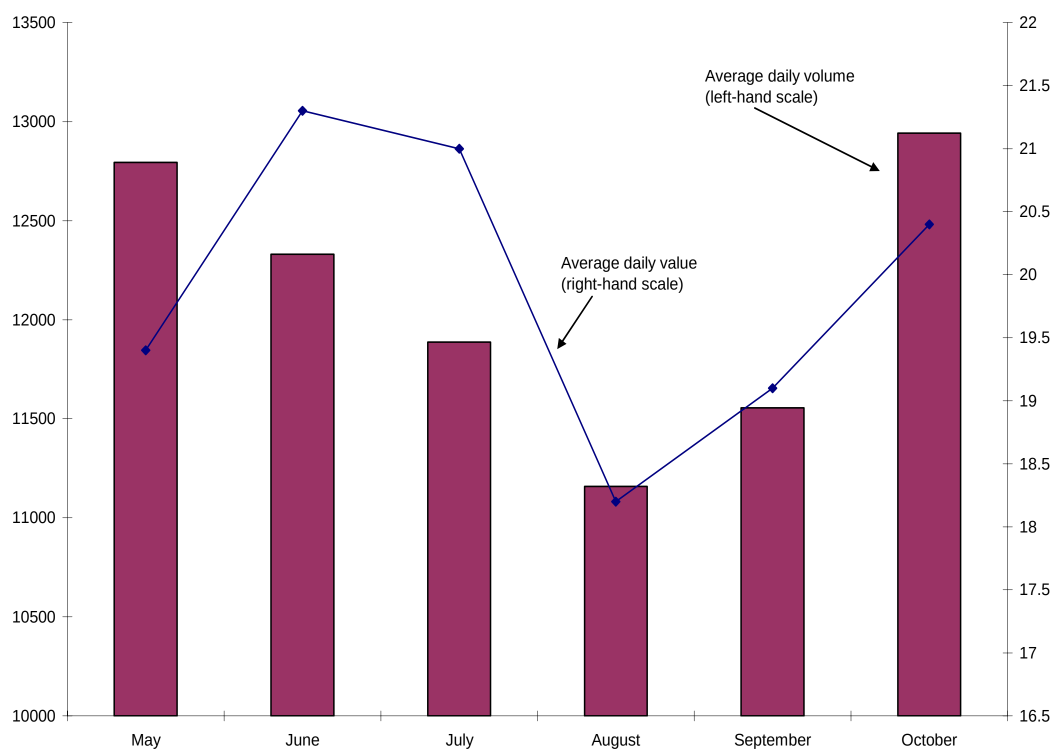
Source: Central Bank of Bahrain

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 May 2008 through October 2008. Over this period, the average daily volume of cheques processed increased from 12,794 in May to 12,942 by October. The increase in the *average daily value of cheques* was more modest, rising from BD19.4 million in May to BD20.4 million by October.

For both volume and value indicators, a notable fall was experienced in August 2008, typically a slow month in Bahrain for bank transactions

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

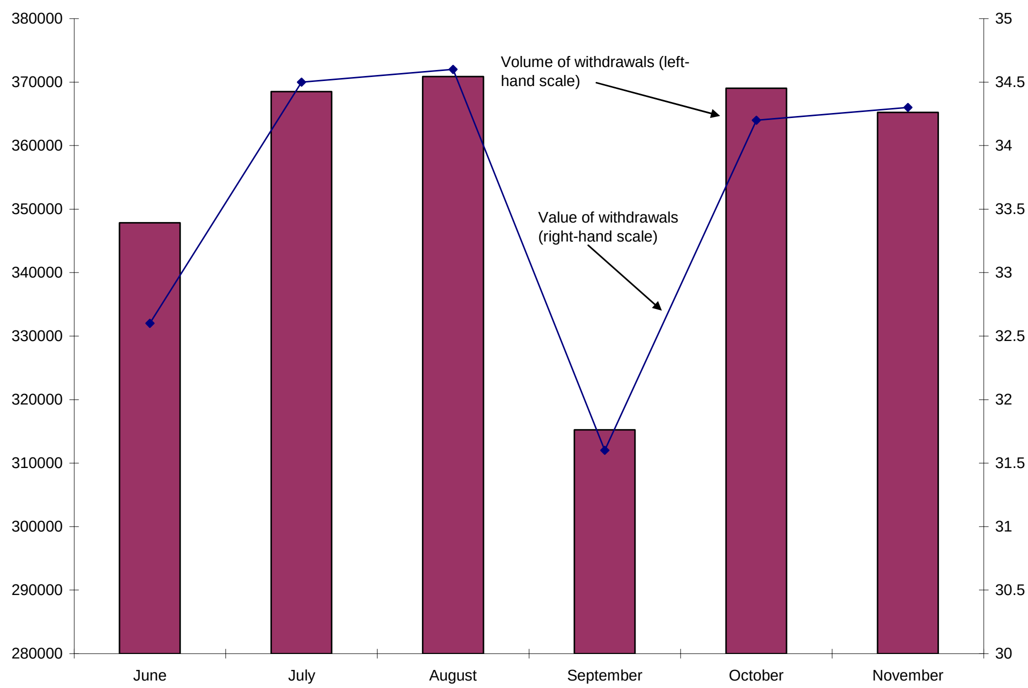


Source: Central Bank of Bahrain

ATM Clearing System

Between June and November 2008, ATM transactions showed a somewhat volatile pattern. Over the period, the *number of withdrawal transactions* processed increased from 347,836 in June to 370,875 in August before falling to 315, 247 in September (Chart 6.3). By end-November, the volume of withdrawals stood at 365,225. *In value terms*, total withdrawals processed increased from BD32.6 million in June to BD34.6 million in August, before falling to BD31.6 million in September. This indicator stood at BD34.3 million at the end of November.

Chart 6.3: Number and Value of ATM Transactions



Source: The Benefit Company

6.2. Assessment of Payment and Settlement Systems

The overhaul of the payments and settlement infrastructure has minimized risks associated with payments and settlement transactions. In particular, processing and settlement of payments in real time through the RTGS has reduced *credit and liquidity risks* substantially and we do not see any credit or liquidity risk issues at this juncture.

The use of detailed rules, regulations, standards and procedures for participants in the RTGS is substituting for a statutory code, thereby keeping *legal risks* under control. However, as recommended in previous editions of this report, consideration should still be given to the enactment of an overarching <u>Payment Systems Act.</u>

Similarly, *operational risks* are minimal as Bahrain's payment systems continue to prove robust in terms of security and operational reliability. The use of a sole settlement agent for stock market transactions is still a concern but this "settlement agent risk" is receiving due attention. Overall, we consider the payments and settlement system to be robust and secure.

7. Special Feature: Protecting the Bahraini Financial System from the Global Financial Crisis

7.1. Introduction

As the global financial crisis worsened in the second half of 2008, it became apparent that many emerging markets will not be immune from the adverse spillover effects. To date, the impact of the crisis on the Bahraini financial system has been modest. The Government of Bahrain and the Central Bank of Bahrain (CBB) have not considered it necessary to resort to some of the exceptional measures adopted elsewhere in the world as Bahrain's financial institutions and markets continued to operate normally throughout the crisis.

Nonetheless, the CBB did introduce a number of new measures designed to shield the financial sector from the spillover effects of the global crisis. The following paragraphs provide details of various measures taken by the CBB in response to the turmoil in global financial markets.

7.2. Measures to Improve Market Liquidity

(a) Interest rate changes: On October 30, 2008, the US Federal Reserve cut its Fed Funds rate by 50 basis points to 1.00%. In response, CBB reduced its Policy Rate by 25 basis points to 1.50%. The smaller rate cut (relative to the US) was done with a view to encouraging capital inflows and stabilizing the markets. In conjunction with the reduction in the policy rate, the overnight repo and lending rates were also cut by 125 basis points to 3.50%**.** This made the overnight rates more symmetrical around the policy rate of 1.50%, with the overnight lending rate now 200 basis points above and the overnight deposit rate 100 basis points below the one-week policy rate. These adjustments helped to ensure that short-term financial assistance was available to banks at favourable rates.

(b) New FX Swap Facility: Further, CBB introduced a new daily foreign exchange (FX) swap facility that allows banks to obtain Bahraini Dinar in return for US dollars at their initiative. This helps banks to obtain local currency when they have excess US dollars.

(c) Expanded Range of Collateral and New Islamic Liquidity Instrument: In order to further ease access to its Standing Facilities for banks, CBB expanded the range of collateral it will accept from banks to secure borrowing from such facilities. Notably, Government of Bahrain short and long term *Ijara sukuk* are now acceptable as collateral for CBB lending to banks. With particular attention to liquidity management in Islamic banks, a new Islamic Liquidity Instrument was introduced, giving Islamic banks an opportunity to get overnight funding from the CBB.

(d) Regular Meetings with Bank Treasurers: Since October 2008, CBB has been hosting regular meetings of the Bahrain Money Market Forum, where the CBB meets with Treasury managers of the largest retail banks to discuss trends in the money market and examine possible policy responses. These meetings have undoubtedly contributed to the relative calmness of the Bahraini markets.

7.3. Regulatory and Supervisory Measures

(a) Controlling level of real estate exposures: In addition to measures designed to address short-term liquidity pressures, CBB has also been focused on ensuring that the asset portfolio of Bahraini banks remain sound. To this effect, consultations have been conducted with the banking community on new regulatory measures designed to limit banks' real estate exposures. Also at end 2007, the CBB increased the regulatory risk weighting of real estate exposures to 200% to act as a regulatory constraint on excessive real estate expansion.

(b) Reviews of Risk Management Systems and Practices: Given the role of risk management failures in the global financial crisis, CBB has directed all locally incorporated banks to carry out internal risk management assessments in order to identify shortcomings that require attention. The outcome of these reviews will be discussed on a bank-by-bank basis, with a view to agreeing on appropriate remedial measures to enhance risk management systems and practices.

(c) Review of Compliance with Risk Concentration Limits: To supplement this comprehensive assessment of risk management, in the summer of 2008, CBB conducted a review of banks' policies and risk limits (compared with CBB regulatory requirements and best practice). All banks with observed deficiencies were notified and directed to address the gaps by end-2008.

(d) Enhancing Liquidity Monitoring and Management: The global crisis again underscored the importance of maintaining adequate levels of liquidity. Hence, since early September 2008, the CBB has enhanced its monitoring of bank liquidity, requiring all locally incorporated banks to report their liquidity positions on a daily basis and to report their risk exposures on a weekly basis. Work is also underway on new liquidity requirements for banks to be issued for consultation in 2009. These new requirements will take into account the new requirements issued by the Basel Committee in October 2008.

(e) Strengthening Deposit Protection: The CBB is in the process of finalising new regulations to reform the existing deposit protection arrangements. The purpose of the reform is to bring deposit protection more closely into line with international best practices on deposit protection, and in particular to establish a pre-funded scheme (i.e. one in which a fund is accumulated in advance of any payouts to depositors, based on regular contributions by the member banks).

(f) Enhanced Monitoring of foreign bank branches based in Bahrain: On 14th October 2008, the CBB wrote to all the branches of foreign banks operating in Bahrain, asking them to notify the CBB of any developments or events (negative or positive) that may have a material effect upon the financial position of the parent bank in order that we may continue to monitor the effect of any home–country developments on the liquidity position of the Bahrain branch.

(g) Monitoring the use of special Purpose Vehicles by locally incorporated banks: Many central banks and governments have noted the role played in the crisis by illiquidity in the so-called "shadow banking sector" on the regulated banking institutions and have called for the regulation and proper supervision of unregulated "special purpose vehicles" and other off-balance sheet funding arrangements. Noting these concerns, the CBB conducted a survey of the use of such vehicles by Bahraini banks. The CBB may issue guidance or regulations on the use of such vehicles in accordance with any new international standards.

(h) Tighter measures on dividend payments: On 23rd November 2008, the CBB issued a Circular to all banks requiring them to seek the CBB's prior approval before announcing dividend payments. This measure was taken so that the CBB can ensure that banks maintain adequate levels of capital and reserves.

(i) Enhanced Inspection Regime: The CBB is currently conducting additional on-site inspections of identified higher-risk banks and their higher-risk assets to assess their strengths and weaknesses.

(j) Stress Testing: The CBB has conducted a stress testing exercise to assess the hypothetical impact of higher levels of investment portfolio losses and higher levels of non-performing loans on the financial soundness of banks. The purpose of this exercise was to identify thresholds of losses at which banks will fall below the minimum regulatory capital requirements.

7.4. Other Measures

(a) Contingency Planning: The CBB has conducted a review of its internal policies and procedures for managing episodes of financial instability and is in the process of bringing them together in a single Contingency Plan. This will further strengthen the capacity of the CBB to respond to cases of financial stress.

(b) Public Dissemination of Information: As the effects of the crisis began to be felt within the GCC, CBB's External Communications Unit (ECU) has been available to handle all external enquiries, with a designated spokesperson readily accessible to answer questions from members of the public. In addition to announcements of cuts to interest rates, regular press releases were also issued to reassure the public that our financial system remained robust and sound, despite the turbulence experienced in global and some GCC markets. The public was also assured that CBB was closely monitoring developments in different parts of the financial sector and will take quick and appropriate action if it notices any untoward developments.

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