Financial Stability Directorate

Financial Stability Report

February 2015

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The Financial Stability Report (FSR) is a semi-annual report prepared by the Financial Stability Directorate. It is available in PDF format in the Publications and Data section at http://www.cbb.gov.bh.

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Preface

A key objective of the The Central Bank of Bahrain (CBB) is to ensure the continued soundness and stability of financial institutions and markets. As the single regulator for the Bahraini financial system CBB attaches utmost importance in 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 centre and ensuring that the sector continues to contribute significantly to growth, employment and development in Bahrain.

> *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.*

This objective is the primary responsibility of CBB's Financial Stability Directorate, which conducts regular surveillance of the financial system to identify areas of concern and undertakes research and analysis on issues relating to financial stability. 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.

The FSR is prepared regularly for the CBB management, reviewing recent trends and identifying areas of concern which require supervisory and policy attention. Financial Soundness Indicators (FSIs) are used to monitor the financial sector on a continuous basis.

This new edition of the FSR is organized into six chapters divided into two parts part as follows:

- Part I: looks at national and international developments:
  - Chapter 1 reviews recent international financial developments.
  - Chapter 2 examines the recent developments in Bahrain's financial sector and also households.
- Part II: looks at the developments in the banking sector:
  - Chapter 3 evaluates the financial condition and performance of conventinoal banks
  - Chapter 4 evaluates the financial condition and performance of Islamic banks.
- Part III: looks at the developments in equity market and payment and settlement systems.

- Chapter 5 reviews recent trends on the equity market.
- Chapter 6 focuses on stability issues relating to the payment and settlement systems.

Unless indicated otherwise, Chapter 3 and Chapter 4 of the report analyzes data covering the period between end-March 2014 and end-September 2014.

Executive Summary

Global Macro Financial Environment Overview

The global economic and financial conditions have weakened and potential growth rates are being revised downward by major international organizations, i.e. the IMF and OECD. This new trend has affected the global demand and makes the full recovery a challenging task for some advanced economies. The slowdown of economic activity and the persistence of uncertainty have raised downside risks.

Since our August 2014 report, global economic activity decelerated slightly but it remained subdued and growth remained uneven across countries and regions as well. Across major advanced economies, the recovery was strongest in the US, prompting the gradual removal of monetary policy stimulus. Similarly, the UK economy had shown courageous sign of recovery during the recent period.

Economic activity in the Euro area stalled since the second quarter with weaknesses in core economies such as France and Germany and increased geopolitical tensions. Concerns about the very low level of inflation and the medium-term growth outlook have led the ECB to step up its further unconventional monetary policy stimulus by injecting exceptional liquidity.

As for emerging economies, they have experienced a fairly broad-based slowdown in the first quarter of 2014. In the second quarter of 2014, the BRICS countries' (Brazil, Russia, India, China, and South Africa) growth was positive but it is far from its previous levels.

The Non-Financial Sector Overview

Bahrain has emerged as a major regional financial center. This has been essential to the development of its economy and the financial sector has come to play a significant role in economic activity and employment creation.

The insurance industry has progressed effectively during the past few years, which has grown into a regional hub. Insurance contribution increased remarkably from over the decade. The boom in Islamic banking and Islamic financial services make Bahrain a very attractive destination for Islamic finance. In this sense it is worth recalling that Bahrain worked efficiently since the seventies to achieve what the country has today.

The Bahraini financial and banking sector is still performing well and represented 15%of GDP in 2014. The assets of the retail banking sector rose from BD 18.6 billion in 2007 to BD 30.1 billion in the November of 2014. Wholesale banking assets stood at USD109.2 billion as of end November 2014.

Retail banking total assets continued growing since December 2012. This increase in retail banking assets was driven by domestic assets which contributed to 52% of total assets at November 2014, up from 46.2% at end-September 2013.

Outstanding personal loans, used as a proxy for household borrowing, for the period shows that the household debt burden raised with a gradual increase between the period March 2014 to September 2014.Personal loans as a percentage of GDP increase steadily while business loans and advances has seen a drop.

Conventional Banks

The financial soundness indicators show that conventional retail and wholesale banks did not experience any deterioration to their capital positions. Capital adequacy ratios for conventional retail banks increased compared to the previous quarter. Capital adequacy ratio for locally-incorporated wholesale banks was 20.8% Loan delinquencies have shown decreases for conventional retail and wholesale banks reaching 3.3% and 5.7% respectively. Loan concentration remains for conventional retail and wholesale banks despite some decrease in some sectors.

As at end-September 2014, return-on-assets (ROA) was 1.2% compared to 1.4% in September 2013 for conventional retail banks. Return-on-equity (ROE) for locally-incorporated retail banks was 11.3% in September 2014 compared to 15.0% in September 2013. ROA for the conventional wholesale banking sector was at 0.6% in September 2014, a decrease from the 1.0% in September 2013. ROE for local wholesale banks increased from 4.3% to 4.0%. For conventional retail banks and wholesale banks liquid assets as proportion of total assets increased to 37.4% and 21.8% respectively.

Islamic Banks

The financial soundness indicators show that capital positions decreased for Islamic retail banks and declined slightly for Islamic wholesale banks. The capital adequacy ratio of Islamic retail banks decreased to 15.4% in September 2014 and 24.3% for Islamic Wholesale banks.

Non-performing facilities (NPFs) for Islamic retail banks increased slightly to 12.6% in September 2014 from 12.3% in March 2014. For Islamic Wholesale banks, NPFs decreased from 5.1% to 5.0% over the same period. Facilities concentration has increased for retail Islamic banks and wholesale Islamic banks. The earnings picture looks better for Islamic retail banks in September 2014 with ROA increasing to 0.4% and an increase in ROE to 3.9% compared to results in September 2013. ROA and ROE for wholesale banks remained relatively unchanged. Moreover, Islamic retail liquidity position was relatively unchanged with the liquid asset ratio slightly decreasing to 13.5% from 13.7% and increasing for Islamic wholesale banks to reach 22.8%. The facilities to deposit ratio increased slightly for Islamic retail banks and decreased for Islamic wholesale banks.

Performance of Equity Markets

A look at *year-on-year* data shows that the Bahrain All Share Index increased by 177.7 points (14.2%) between December 2013 and December 2014. The index experienced steady increases from November 2013 to March 2014. However, the index experienced a slight dip in April 2014.

Market capitalization of the Bahrain Bourse stood at BD 8.3 billion (Table 5-1). This level of market capitalization is 2.6% higher than the level as at end-June 2014 and 19.6% higher *year-on-year*. As December 2014, the price-earnings ratio (P-E ratio) for the stock market stood at 10.41, an increase from the 10.07 attained last year in December 2013 and the 10.29 in June 2014.

The bulk of the value of shares traded in December 2014 was the Services sector whose traded shares (by value) represented 47.7% of total shares traded up from 6.5% in June 2014.

The GCC Markets performed very well in the first two quarters of 2014, supported by steady production over the GCC countries and high oil prices. Accommodative monetary policy in the GCC countries given its peg to the US dollar and expansionary fiscal policy that materialized through major investment projects (especially in the non-oil sector) reinforced investors' sentiments and business confidence.

Payments and Settlement System

The various components of Bahrain's payments and settlement framework continue to function efficiently. The payment system in Bahrain can be classified as retail and wholesale payments. Retail payments include cheques, credit transfers, and debit and credit card transactions. Wholesale payments refer to the real time gross settlement system to process inter-bank payments.

In the period between June 2014 and December 2014, the average daily volume of cheques processed through the Automated Cheque Clearing System (ACS) increased by 3.0% from 13,754 to 14,168 (year-on-year decrease of 0.9%) (The average daily value of cheques increased by 5.0% from BD 42.0 million in June 2014 to BD 44.1 million in December 2014 (year-on-year increase of 10.0%).

The number of withdrawal transactions processed through the ATM Clearing System increased by 9.8% from 786,425 to 863,244 (year-on-year growth was 24.5%)(Chart 6-2). Similarly, in value terms, total withdrawals processed increased by 5.5% from BD 82.4 million to BD 86.9 (year-on-year growth was 25.2%).

Between June 2014 and December 2014, the *average daily volume of transfers* increased by 27.7% from 2,294.8 to 2929.7 (27.8% year-on-year increase). In value terms, the *average daily value of transfers* witnessed an 8.1% decrease from BD 205.5 million in June 2014 to BD 188.9 million in December 2014 (19.9% year-on-year decrease).

Part I:

Developments in the International and Domestic Financial Markets

1. Developments in the International Financial Markets

Chapter 1

Key Points

- Since the August 2014 Financial Stability Report, global growth slowed and prospects declined.
- In October 2014, the International Monetary Fund (IMF) revised down its forecast for growth in 2014 and 2015 to 3.3% and 3.8% respectively.
- Financial markets are experiencing heightened volatility driven by concerns about slowing and uneven global economic growth.
- The future adjustment in monetary policies by major developed countries, particularly QE, remains an important risk factor for global growth and financial stability.

1.1 Overview

Since our August 2014 Financial Stability Report, the global economy has shown weaker-than-expected performance in the second and third quarter of 2014 and recovery remains a challenge. In October, the International Monetary Fund (IMF) revised down its forecast for growth in 2014 and 2015 to 3.3% and 3.8% respectively.

Continuous monetary policy accommodations in many advanced economies has led long-term interest rates to be around zero while some equity indices have reached a peak, higher than the pre-crisis levels. However, high accommodative monetary policy could rise uncertainty and hamper the sustainability of economic development.

During the previous six months, the global economic and financial condition was marked by some important events in advanced countries and emerging market economies as well. These events could be summarized as follow:

- In the US, after a mitigated growth during the first quarter of 2014 caused by harsh weather conditions the US economy rebounded strongly in the second quarter of 2014 and growth rate was 4.2 %. This performance is mainly due to the retail sector, which recorded a strong demand as consumer confidence, improved. Furthermore, the US real estate market has recently shown signs of recovery in both volume and price and the US economy have witnessed an upsurge in home sales and non-residential investments. Regarding the monetary policy, the Federal Reserve has already announced in its willingness to normalize the US monetary policy by reducing the pace of its asset purchase program. Hence, the Fed is currently preparing for a smooth exit from the unconventional monetary policies to conventional one.

- In Euro area, after a good sign of recovery in the first quarter of 2014 the economic conditions worsened in the third quarter. Unexpectedly, Germany' economy, largest European economy and most important Europe's growth engine, shrank for the first time in more than a year, In October 2014, the International Monetary Fund (IMF) revised down its forecast for growth in 2014 and 2015 to 0.8% and 1.3% respectively. Growth among EU countries remains disproportionately and the gaps in economic performance remain large. Facing the pressure, the ECB cut interest rates to a record low level in September and scheduled injecting more liquidity in the economy and it pledged implementing further structural reforms to support the Eurozone economy. In the fourth quarter of 2014, the risk of deflation persists and questions regarding the Greek exist rebounded again.

- Japan’s economy declined in the third quarter of 2014 as high public debt inherited from the past creates major macroeconomic and fiscal challenges. Growth nearly stalled and the recovery has been slowed by the crisis legacies. The slowdown of Japanese economic activities has pushed the exchange rate over ¥119/US$ in end-December 2014, its highest level since 2008.

- In emerging market economies, lower potential growth is the dominating factor. For these economies as a whole, potential growth was revised down in 2014 and 2015 by the IMF to 4.4% and 5.0% respectively mainly due to weaker exports, lower commodity prices and political uncertainty. China is sustaining high growth, but its growth is expected to slow in the coming period. India has recovered from its relative slump; thanks in part to

effective policies and a renewal of confidence, growth is expected once again to exceed 5.6% in 2014 and 6.4% in 2015. In contrast, uncertain investment prospects in Russia had already lowered growth before the Ukraine crisis, and the crisis has made growth prospects worse. Uncertain prospects and low investment are also weighing on growth in Brazil.

- The MENA region, as an important bloc of the world economy, has recorded a positive sign of recovery but growth rate was lower than expected. This is mainly due to the political and economic turmoil in MENA region, notably in Libya, Yemen, Iraq and Syria, that makes uncertain the stability of the MENA region.

- GCC countries are a central bloc of the MENA region; they have recorded strong economic performances boosted by large infrastructure projects. This performance has strengthened the positions of GCC banks which remain well capitalized and profitable. In Bahrain, banks remain quite profitable and well capitalized, and their reported non-performing loan ratios remain low. However, the recent sharp drop in the prices of oil and some other commodities, should it become persistent, will weigh on the overall GCC economy.

In the following section, we analyze recent trends in the global economy and we study the evolution of major financial and economic indicators during the previous six months.

1.2 Global Macro-financial Environment

After a short period of prosperity, the global economic and financial conditions have weakened and potential growth rates are being revised downward by major international organizations, i.e. the IMF and OECD. This new trend has affected the global demand and makes the full recovery a challenging task for some advanced economies. The slowdown of economic activity and the persistence of uncertainty have raised downside risks.

Financial market sentiment remained positive with high equity prices, and spreads on Credit Default Swaps have continued to decline and yields on 10 Year Sovereign Bonds remain low relative to historical norms. However, global risk appetite increased, but market volatility was generally moderate and under controls.

1.3 Recent Trends in the Global Economy

A. Economic Performance

Since our August 2014 report, global economic activity decelerated slightly but it remained subdued and growth remained uneven across countries and regions as well.

Across major advanced economies, the recovery was strongest in the US, prompting the gradual removal of monetary policy stimulus. Similarly, the UK economy had shown courageous sign of recovery during the recent period.

In contrast, the recovery in Europe remains fragile. Economic activity in the Euro area stalled since the second quarter with weaknesses in core economies such as France and Germany and increased geopolitical tensions. Concerns about the very low level of inflation and the medium-term growth outlook have led the ECB to step up its further unconventional monetary policy stimulus by injecting exceptional liquidity.

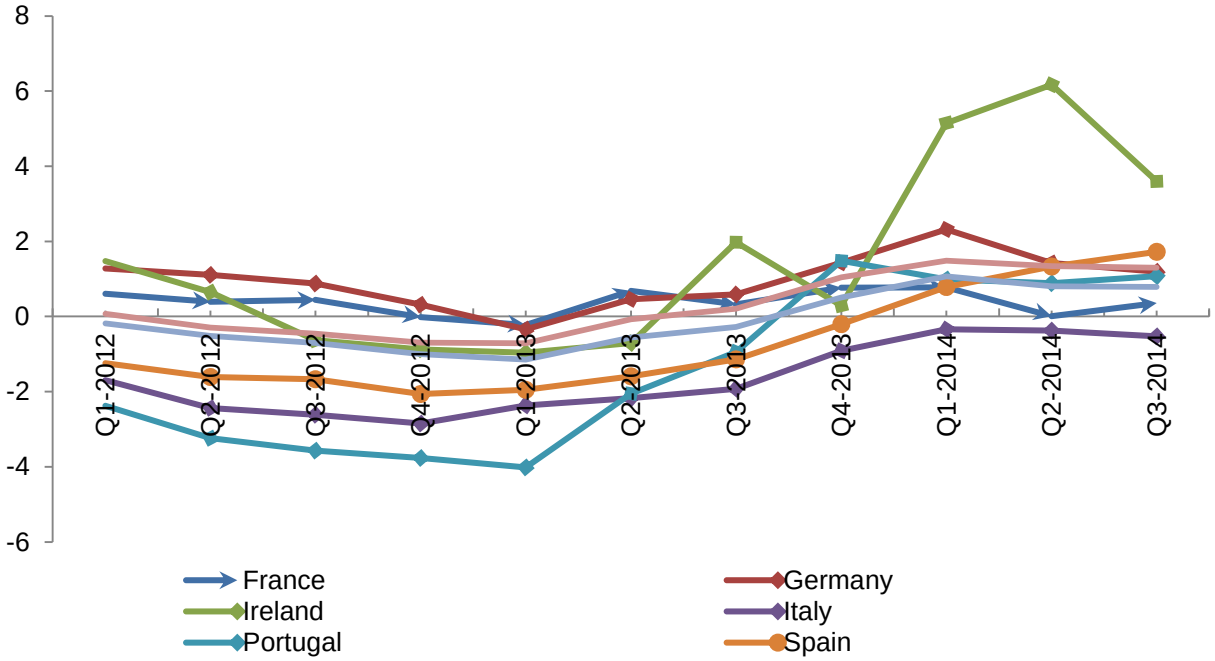
The recent OECD's data shows that since the fourth quarters of 2013, the Euro Area (18 countries) has been experiencing a positive growth. In the first quarter of 2014, Euro Area (18 countries) has achieved a growth by 1.1% but slowed down to reach 0.80% and 0.78% in the second and third quarter respectively. Similarly, the Eurozone (28 countries) had growth since the third quarter of 2013. In the first quarter of 2014, Euro Area (28 countries) real GDP growth was 1.40% and then the pace of growth has declined slightly to stay at 1.34% and 1.29% in the second and third quarter respectively. This disappointing level of growth is not enough yet to bolster investment activities and to create job in the Eurozone.

The risks surrounding the economic outlook for the Euro Area are evaluated to be on the downside as the risk of deflation weigh on the growth of the euro area. To boost further the Eurozone economic recovery, the European Central Bank announced in June 2014 a variety of new easing actions for the Euro area including: forward guidance that policy rates will remain at present or lower levels for an extended period of time; a negative deposit rate at the European central bank; operations to support bank lending to households (excluding residential mortgages) and non-financial corporations; and plans to explore purchases of asset-backed securities.

At a country level study, Ireland has achieved the highest best performance as GDP growth reached 6.16% in the second quarter of 2014 and 3.59% in the third quarter. Germany, the largest economy in the Eurozone occupied the second place with GDP growth stood at 1.43% and 1.20% in the second and third quarter respectively.

While Portugal and Spain have shown good signs of recovery and have renewed with positive growth rates since the beginning of the year, Italy remains in recession until the third quarter of 2014.

Chart 1-1: Real GDP Growth in some Europeans countries (Quaterly%) Seasonally adjusted*



** Growth rate compared to the same quarter of previous year, seasonally adjusted*
Source: OECD Quarterly National Accounts

Regarding non-European countries (Chart 1-2), the economic condition improved slightly, especially in Australia, which recorded a positive GDP growth of 2.7% in the second and third quarters of 2014 where economic activity has remained robust.

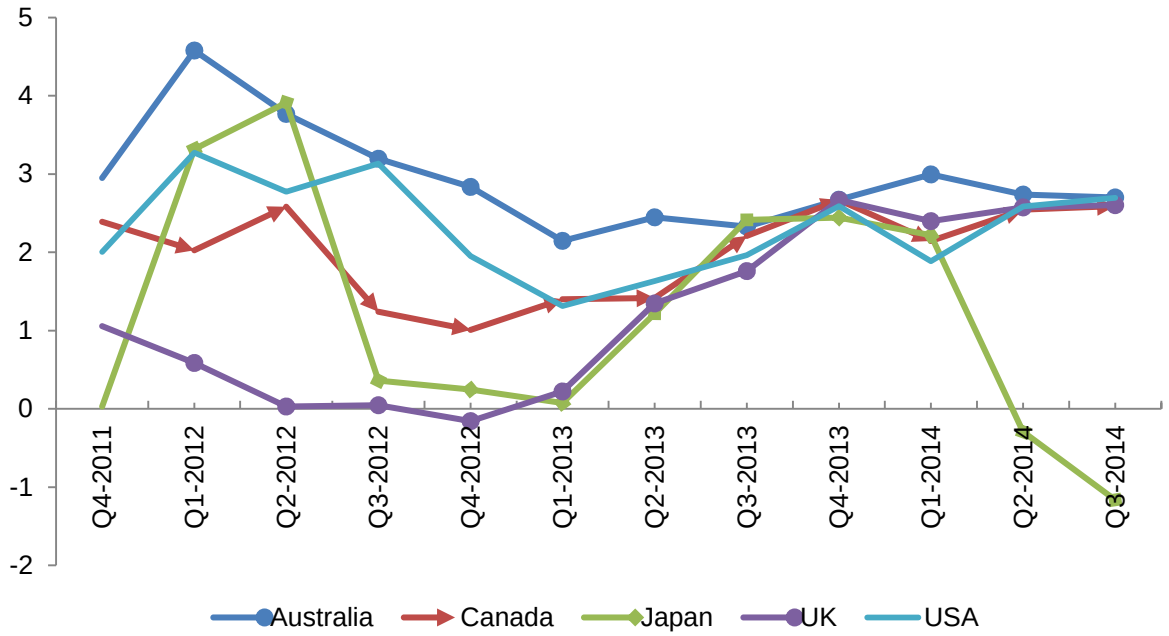
In the UK, GDP grew by 2.5% for the same period, supported by The Bank of England quantitative easing programs. Recently, the Monetary Policy Committee (MPC) indicated that as the economic conditions improved and that Bank Rate was likely to rise only progressively and to a level below its pre-crisis average.

For Japan, after an outstanding performance in end-2013 and a 2.2% of GDP growth realised in the first quarter of 2014, the country fell unexpectedly into recession in the third and fourth quarter of 2014.

In the United States, quarterly growth moved to 2.58% in the second quarter 2014 from 1.88% in the first quarter of 2014. This good performance was supported by strong private consumption and business investment along with a continued progress in the labour market and the housing sector. Monetary policy is expected to remain highly accommodative during 2015, while fiscal policy will be less restrictive than in the previous year. The external

conditions for the United States economy are expected to improve, but only slightly, as foreign demand from major trade partners is expected to remain relatively weak.

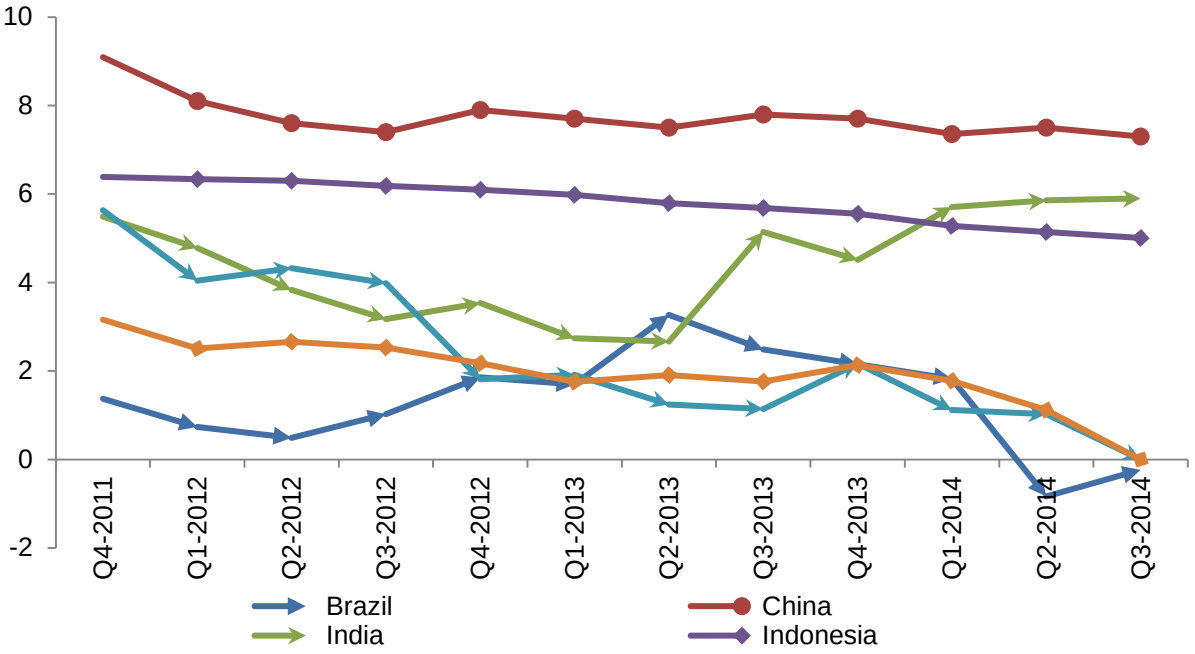
Chart 1-2: Real GDP Growth in Advanced Economies (Quaterly%)*



** Growth rate compared to the same quarter of previous year, seasonally adjusted*
Source: OECD Quarterly National Accounts

As for emerging economies (Chart 1-3), they have experienced a fairly broad-based slowdown in the first quarter of 2014. In the second quarter of 2014, the BRICS countries' (Brazil, Russia, India, China, and South Africa) growth was positive (3.84%) but it is far from its previous level (10.75% in 2007). In the second quarter of 2014, the growth rate fell down to 3.30% mainly due to the slowdown of the Russia economy and the political tension along with the drop of oil price that heavily weighs on its economy. While India economy continues to perform well, Brazil's economic performance slowed in the second and third quarters of 2014 as it fell into recession. In China, the interactions among the ongoing correction in real estate markets, the highly indebted local governments, and the financial sector continue to pose a significant downside risk.

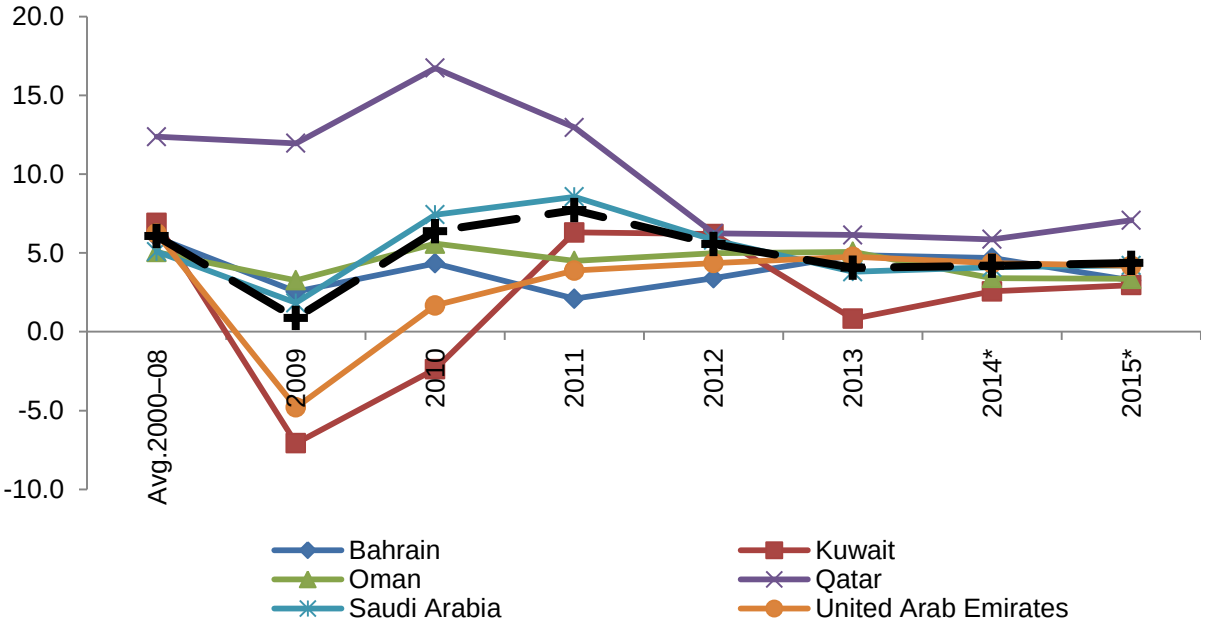
Chart 1-3: Quaterly Real GDP Growth in BRICS (Quaterly%)*



**Growth rate compared to the same quarter of previous year, seasonally adjusted*
Source: OECD Quarterly National Accounts

Regarding the Gulf Cooperation Council (GCC) region, solid economic growth was experienced (4.4%) in 2014, and the IMF forcasts that GCC economic performance will continue to improve further in 2015 and with a growth rate is expected to be 4.4% (Chart 1-4).

Chart 1-4: Real GDP Growth in GCC Countries (Annual percent change)



**Denotes forecast.*
Source: IMF MENAP Regional Economic Outlook, October2014.

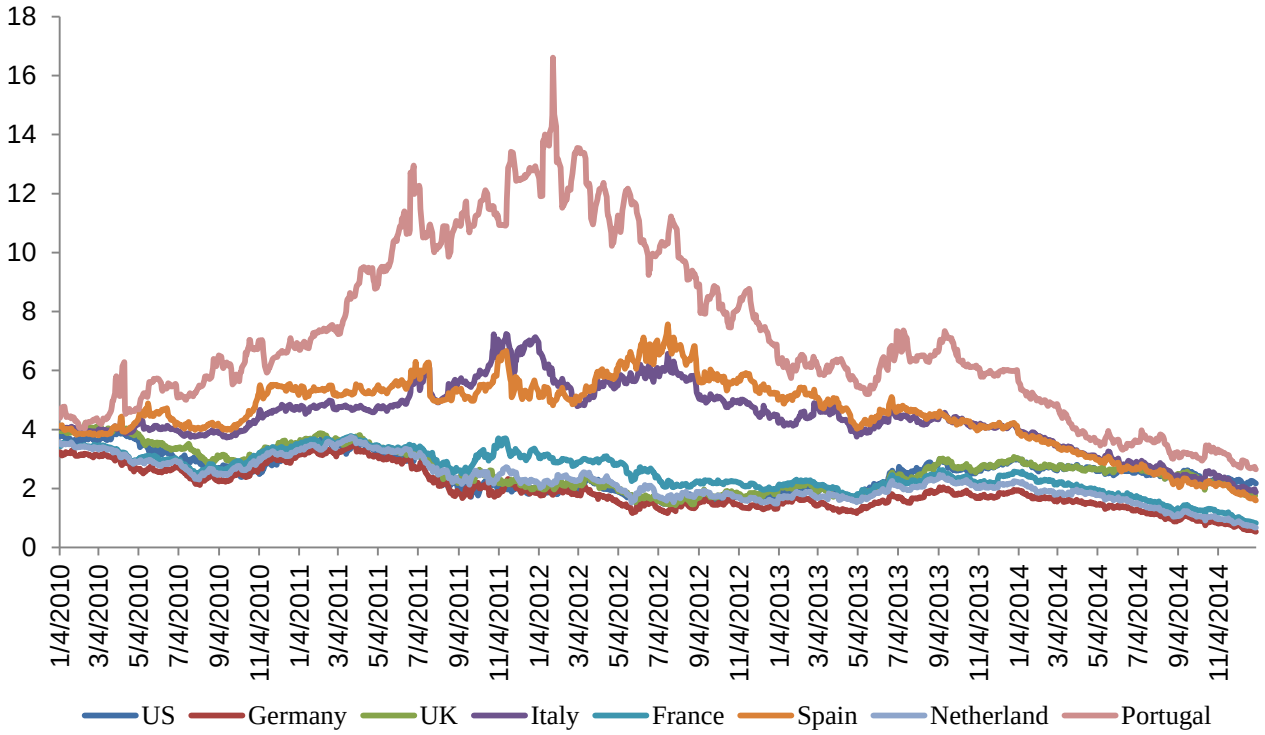
Despite the trouble in the MENA region and the drop in oil prices, the member states of the GCC have been on a stable growth path.

B. Financial Markets

Chart 1-5 highlights the change in Yields on ten-year sovereign bonds in some European countries and the US. The Graph clearly shows the reaction of the market following the decision of The Federal Open Market Committee to taper the pace of its asset purchases early summer 2013. Sovereign bond yields rose and this has triggered market volatility and caused depreciation of some currencies, notably those of emerging market economies.

Since the last Financial Stability Report, yields decreased to historical levels. As we can see in Chart 1-5, at a ten-year maturity, Spanish and Italian government bond yields have fallen to their lowest level in Euro area history, while yields on Portuguese bonds have fallen to pre-crisis levels. Spreads on yields of ten-year bonds over the Bund have fallen to four-year lows for Portugal, and three-year lows for Spain and Italy. The fall in Yield is the result of the highly accommodative monetary policy (quantitative easing program) by major central banks that have calmed the volatility of stock market and reduced the systemic risk. The recent actions by the central banks and policymakers have narrowed modestly the spreads on euro area periphery government bonds. Low Yield reflects a subdued inflation expectations and the outlook for modest economic growth in most economies.

Chart 1-5: Yields on 10 Year Sovereign Bonds



Source: Bloomberg

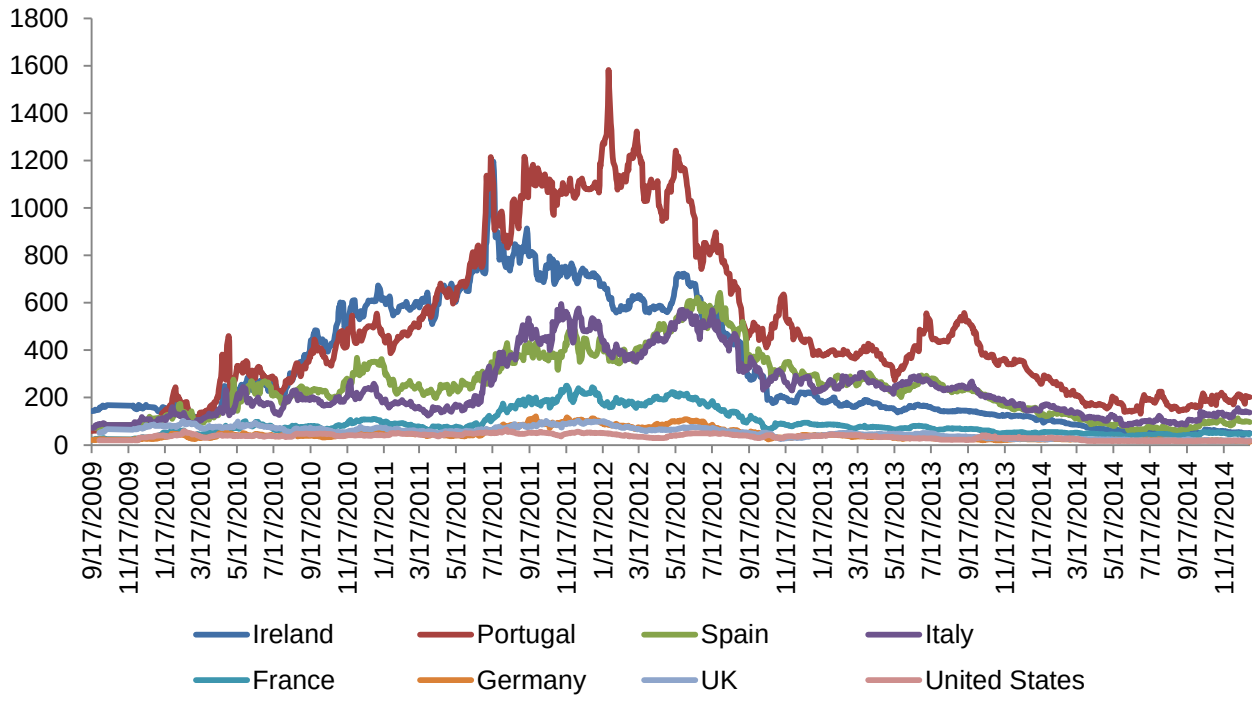
CDS spreads are a fundamental metric of default risk. Broadly, a higher spread on the CDS implies a greater risk of default for the reference entity. Chart 1-6 provides information as to how financial markets perceive the risk of default on corporate and sovereign debt. It illustrates spreads on five-year CDS in some European countries and the US since 2009.

Prior to the crisis, CDS spreads were low for all of the referenced countries, showing that investors placed low probabilities on these countries defaulting on their debt. The policy measures launched by the European Central Bank have declined the financing cost and increased liquidity and profitability of banks.

After a short increase during the third quarter of 2013, Spreads on Credit Default Swaps for peripheral euro area countries have continued to fall over the last few months following a rapid rise in US long-term interest rates. Their levels now are well below the peaks observed in 2011 and 2012 (see chart 1-6). Yet risk premia remain neighboring to the levels reached during the financial turmoil of 2008. This will recover financing conditions for many banks and deposit flows will stabilize.

Furthermore, the average five-years CDS spreads declined considerably (Chart 1-6) in most advanced economies. In the US, UK, Germany and France Spreads on Credit Default Swaps remained low since 2009 despite public debt levels that are comparable to or above those of southern Euro area member states.

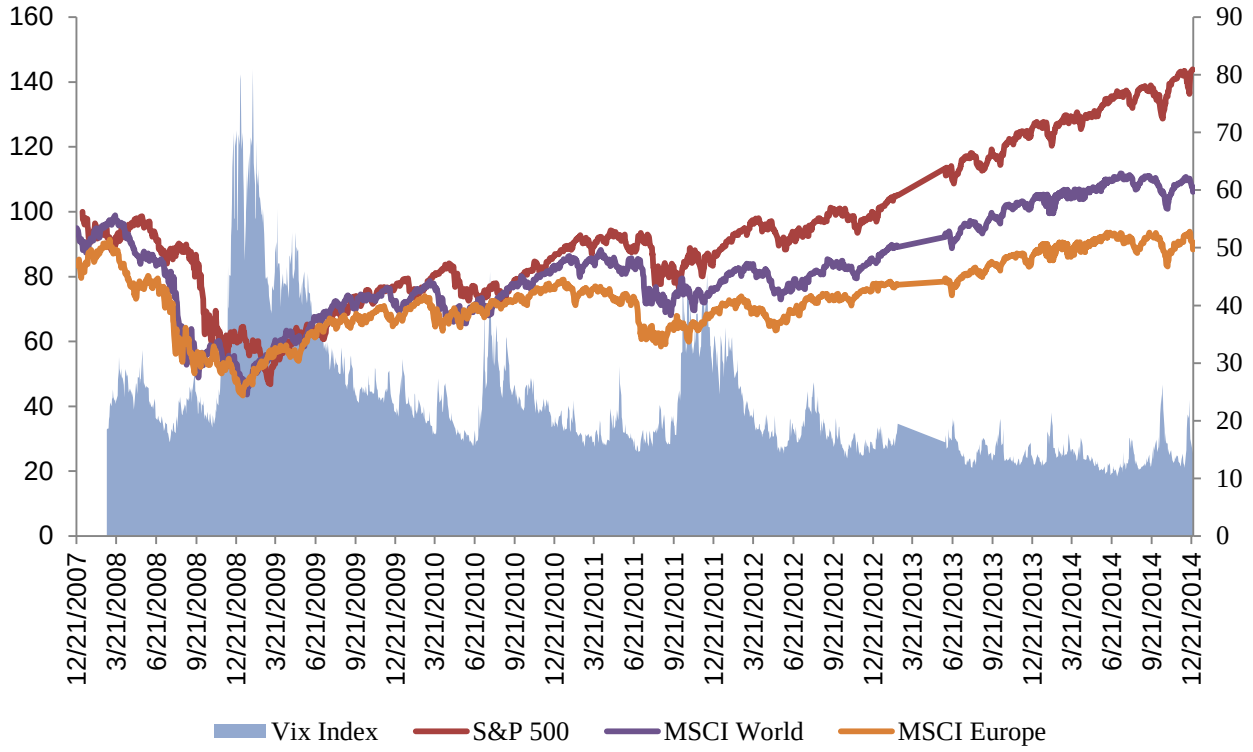
Chart 1-6: Five Year Spreads on Credit Default Swaps



Source: Bloomberg

Regarding global equity markets, chart 1-7 shows that following a period of uncertain sentiments during the summer 2013; optimism returned to global equity markets. This is due to exceptional policy measures and quantitative easing programs undertaken in some advanced economies that had an immediate impact on equity markets.

Chart 1-7: Global Equity Market Indices (Re-indexed to January 2008)



Source: Bloomberg

C. Volatility of the major currencies

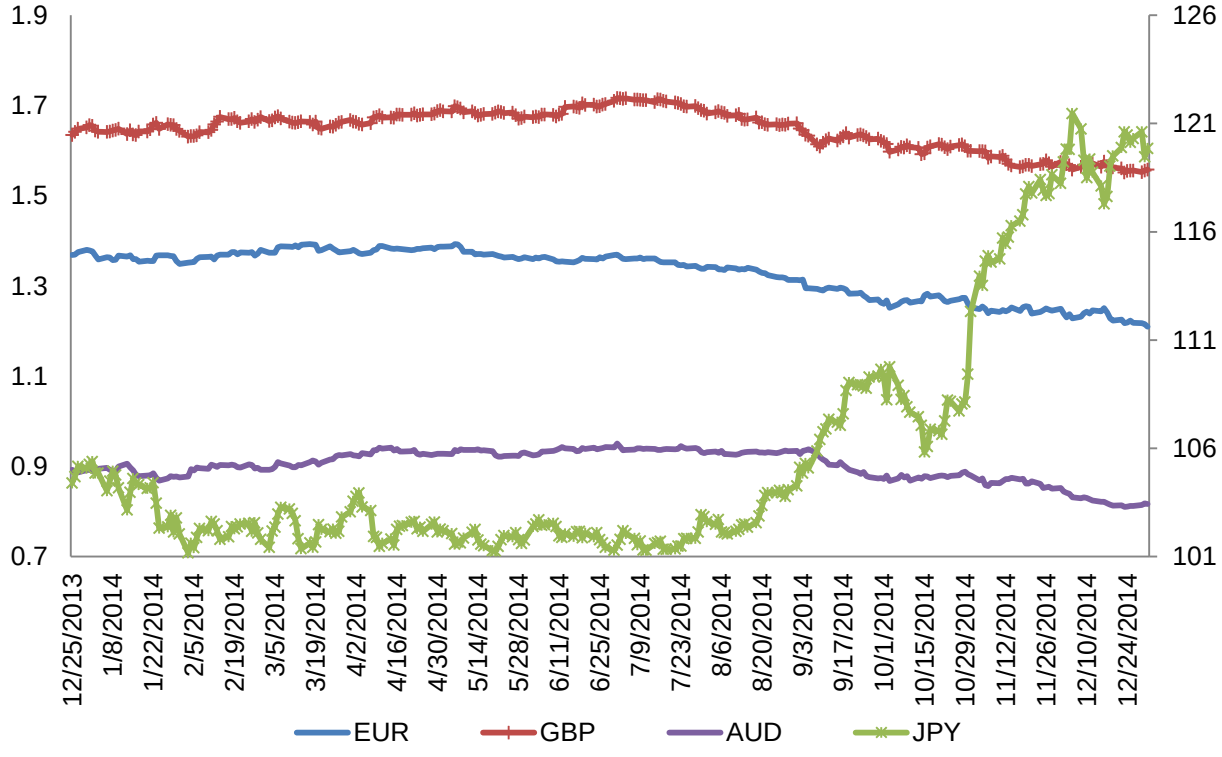
The modest economic performance of peripheral countries and persistence uncertainty on the future of Greek within the Euro area have added some pressure on the European single currency. Furthermore, the geo-political concerns in Russia-Ukraine have also weighed on the power of the Euro. As a result, all these factors have devaluated the value of the single currency against its most important competitor. It seems that the announcement of European Central Bank President Draghi to devaluate the Euro finally worked. In fact, from June to December 2014, the Euro lost 10% of its value against the US Dollar as it moved from 1.36$ to 1.21$ in this period (chart 1.8). The single European currency was influenced by the unfavorable growth and interest rate differentials as compared with the US outlook, but it should boost competitiveness and export activities.

Since our Jun's report, the British pound (GBP) depreciated slightly against the US dollar. In October 2014, UK inflation dropped to 1.2% which is the weakest in five years has added pressure on the Bank of England to keep interest rates at record lows level. As a result, lower UK interest rates make the British pound (GBP) less attractive to international investors seeking higher yield.

The introduction of new quantitative ease measures in Japan during 2013 has triggered a significant depreciation of the yen vis-à-vis all major currencies. In January 2014, Japanese yen (JPY) depreciated slightly against the US dollar and it was traded at 102$. This was the inevitable consequence of the easy monetary policy followed by the Bank of Japan since April 2013 which through its bond buying programme has been flooding the market with money to combat deflation. Since January2014, the Japanese exchange rate was very stable against the US dollar but this ended in end-August. The slowdown of Japanese economic activities has pushed the exchange rate over ¥119/US$ in end-December 2014, its highest level since 2008.

Finally, Australian dollar depreciated slightly during the past six months, it was traded at 0.89US$ in January 2014, and it is at 0.93US$ in June 2014. To conclude, the stronger U.S. dollar is the result of a mixture of factors including relative interest rates, balance of trade, and perceived safe-haven status.

Chart 1-8: Various Currencies Against US dollar



Source: Bloomberg

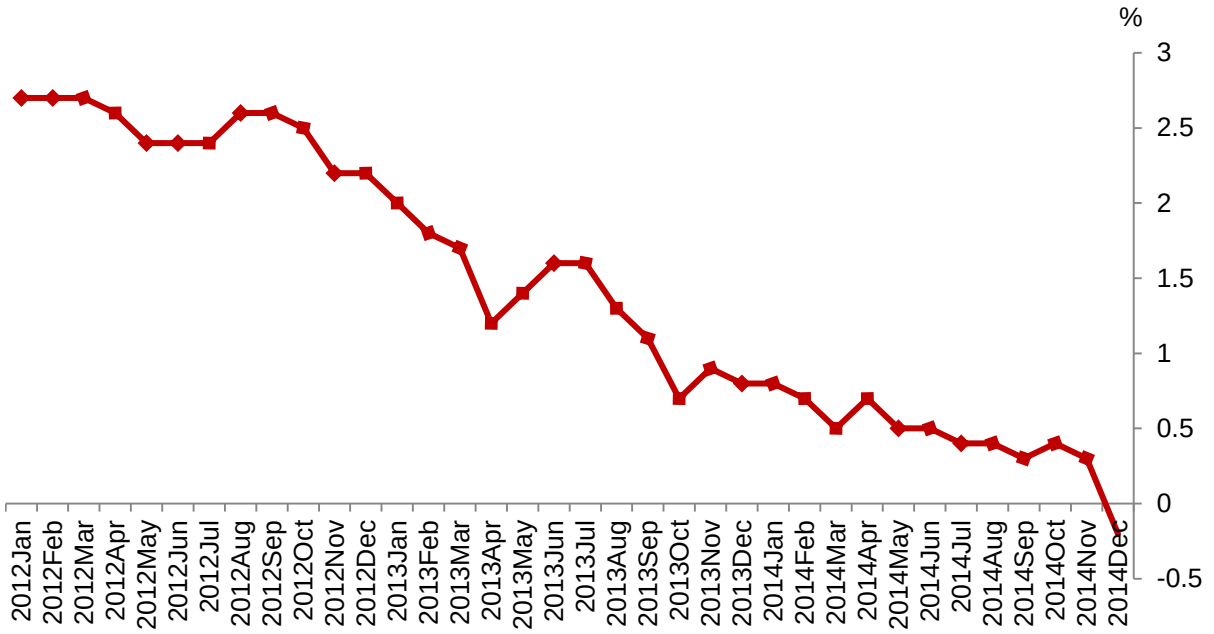
D. The Eurozone and the persistence of low inflation

Recent data reveals that the euro area financial markets have slightly improved during the past few months especially for peripheral countries. Data also reveal the strengthening of bank balance sheets in Europe. The recent Euro area economic and financial performance was supported by thoughtful efforts for boosting economic recovery, progress with structural reforms in fragile euro area economies and a fully assistance by the European Central Bank; the latest one was in September 2014.

According to the ECB, credit growth across Europe remains weak. In most central and eastern European countries credit is either stagnant or growing at low rates. In many countries of the euro area credit to the private sector is even in negative territory. The ECB reveals that low growth prospect is the most important reason of this lack of performance in the credit market.

Regarding inflation in the Eurozone, it stood at -0.2% (year on year) in December 2014 (see Chart 1-9). It has been persistently declining for almost a year, and constantly undershooting forecasts.

Chart 1-9. Overall inflation in the euro area (HICP)



Source: European Commission (Eurostat) and European Central Bank data

The Eurozone is now obviously diverging from many advanced economies notably the US and UK where inflation remains positive and closes to target. One of the reason explaining the low inflation environment in Europe is essentially, economic agents have a strong preference for holding money and government bonds rather than financial or real assets.

The persistence of very low inflation and weak economic growth have pushed the ECB to purchases Eurozone government bonds to minimize the risk of a slide into deflation. According to the October World Economic Outlook (IMF 2014b), the Eurozone inflation rate "is expected to remain substantially below the ECB's price stability objective through at least 2019.

To conclude, risks to the Euro area persist. Banking systems continue to face financial stress and the regional economy continues facing various challenges especially: high unemployment persists and price declines in some countries that could increase the real burden of debt service. All these problems associated with the global uncertainty may make European banks facing new challenges and new risks, which suggests that an improved situation does not mean the end of the crisis and uncertainty. Moreover, as we described previously, Europe's (17 and 27 countries) GDP growth remains low and high unemployment continue to weigh negatively on the global financial market. The weak economic performance in Europe, combined with potentially a period of low interest rates and continued weak market growth remain key concerns in European and international markets. Moreover, the fiscal imbalances in PIIGS countries (Portugal, Italy, Ireland, Greece, and Spain) remain unsustainably high, with the prospect of painful deleveraging persisting for a number of years. Ensuring sustainable economic growth is the only path to restore confidence of investors, but until now it remains the principal challenge for European policymakers.

2. Developments in Bahrain's Financial and non-Financial Sector

Chapter 2

Key Points

- Despite the global uncertainty and the trouble in MENA region retail banking total assets continued growing since December 2012.
- The Bahraini financial sector performed effectively with no major financial stability concerns and represented 15% of GDP in 2014 (Q3)
- The wholesale banking sector has witnessed a drop in its total assets from USD 196.3 billion in 2007 to USD109.2 million as of end November 2014.
- Household debt ratio increased.
- Business debt ratio stable.
- Construction permits increased and commercial licenses dropped

2.1 Overview

The aim of this chapter is to assess the recent development of the Bahraini financial sector during the past few months and to appraise whether the local banking and financial sector are remaining resilient or not since our last evaluation. 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.

2.2 Bahrain's Banking sector

Over the past decades, Bahrain has emerged as a major regional financial center. This has been essential to the development of its economy and the financial sector has come to play a significant role in economic activity and employment creation.

In Dec 2014, the banking sector in Bahrain was made up of 103 banks, categorized as follows:

- 28 retail banks (including 6 Islamic retail banks); 13 locally incorporated and 15 branches of foreign banks
- 76 wholesale banks (including 17 Islamic wholesale banks)

There are also 291 non-banking financial institutions operating in Bahrain, including investment business firms, insurance companies (including Takaful and Re-Takaful firms), and specialized licenses.

The insurance industry has progressed effectively during the past few years, which has grown into a regional hub. Insurance contribution increased from 1.9% to 2.5% of GDP over the decade. Particularly strong growth over the last five years has been in medical insurance (which now accounts for 15% of total premiums). Long-term insurance (life and savings products) has also grown rapidly. The insurance market in Bahrain now comprises 25 locally-incorporated firms and 11 overseas firms carrying out insurance, reinsurance, takaful and retakaful. These institutions offer all basic and modern insurance services such as medical and health insurance, long-term insurance (life and savings products). The expansion in the takaful sector (Sharia compliant insurance) has been particularly impressive, with gross contributions rising from $5 million in 2001 to more $110 million in 2013.

In Bahrain, the first Islamic commercial Bank, Bahrain Islamic Bank, was established in 1979 and since that, Bahrain has become the home to the Accounting and Auditing Organization for Islamic Financial Institutions, International Islamic Financial Market, Liquidity Management Centre and Islamic International Rating Agency, and the Bahrain Institute of Banking and Finance. In 2014, the Global Islamic Finance Report (GIFR) reveals that Bahrain was ranked fourth over 40 countries by Islamic Finance Country Index (IFCI).

2.2.1 The size of the banking sector

Bahrain's banking sector represented 13.5 times of GDP in 2007. Despite the global financial turmoil, the size remained large and amounted to 11.5 times of GDP from 2008 until 2010.

In 2013, the size of the banking sector (times GDP) fell by to become 5.9 times of GDP. According to the table below, the wholesale banking sector has witnessed the largest drop moving from 8.1 times of GDP in 2010 to 3.6 in the fourth quarter of 2013 and to 3.4 times of GDP in Q3/2014. The drop can be attributed to:

1- The global financial turmoil which has affected the economic activities and investments of banks

2- The 2011 events in the region feared the investors to invest in the MENA region as a whole. The region has witnessed slow movements of capital inflows and sometimes there were massive movements of capital outflows.

3- The European sovereign debt crisis. Some wholesale banks in the Kingdom are offshore European banks. Stricter regulatory requirements and the restructuration of Europeans banks' balance sheets have had direct implication on their balance sheets moving funds to the mother's country.

4- The increase in GDP from BD millions 8,624.8 in 2009 to BD millions 12328.2 in 2013.

Further, Table 2-1 shows that the size of the retail banking sector decreased slightly during the same period and it recorded an increase in the third quarter of 2014 to become 2.42 times the GDP.

Despite the contraction in the banking size, the Bahraini financial and banking sector are still performing well and represent 15% of GDP in 2014 (CIO Bulletin 2014/Q3). There are no major or minor effects of the drop of the overall size of the banking sector in the economy of Bahrain. This shows that the weight of wholesale banks in Bahrain is not significant compared to domestic banks. Therefore, we can conclude that retail banks in Bahrain are the main engine for the financial sector growth in the Kingdom.

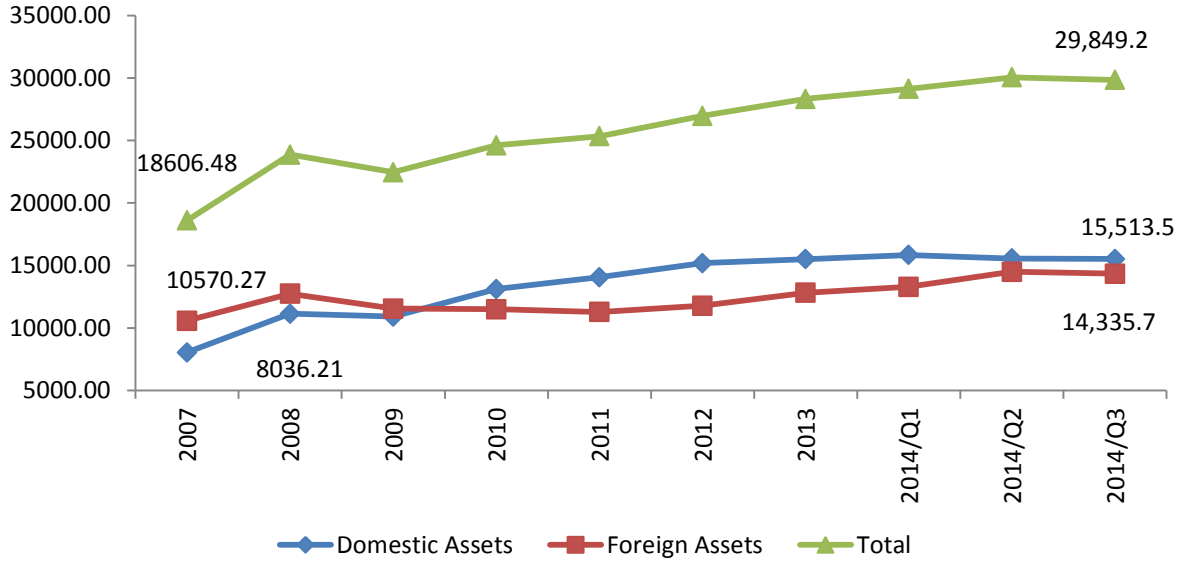
Table 2-1: Evolution of the size of the Banking sector in Bahrain since 2007

	2007	2008	2009	2010	2011	2012	2013/Q4	2014/Q3
Size of the Banking sector (times GDP)	13.4	11.5	11.5	11.5	6.8	6.9	5.9	5.8
Consolidated Balance Sheet of Retail Sector (USD billion)	49.5	63.5	59.8	65.4	67.3	71.7	75.3	79.4
As times of GDP	2.69	2.9	3.09	3.38	2.32	2.47	2.3	2.4
Consolidated Balance Sheet of Wholesale Sector (USD billion)	196.3	188.9	162.5	157.7	129.0	127	116.7	112.4
As times of GDP	10.7	8.6	8.4	8.1	4.5	4.4	3.6	3.4

Souce: CBB Statistical Bulletin

Bahrain's financial sector has faced a number of shocks over the past seven years from the sub-prime crisis to the recent political events. The banking sector managed to perform well despite these financial, social and economic shocks. In Bahrain, the retail banking sector has continued to expand. The assets of the retail banking sector rose from BD 18.6 billion in 2007 to BD 29.9 billion in the third quarter of 2014 (see Chart 2-1).

Chart 2-1: Retail Banks' Assets (BD million)

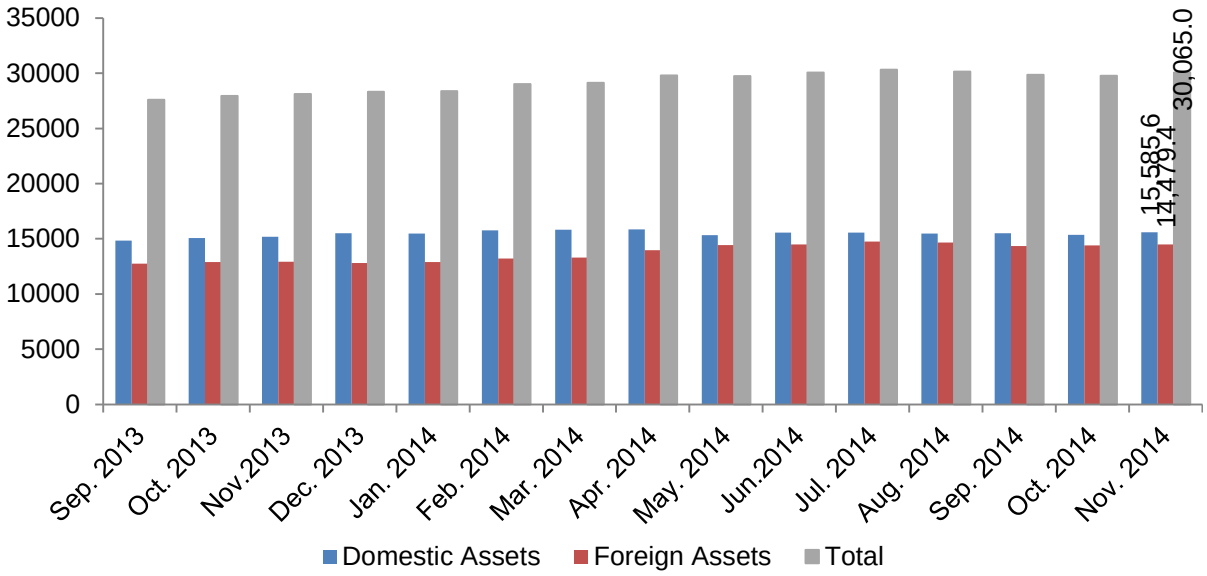


Source: Central Bank of Bahrain

It is worth mentioning that despite the global uncertainty and the troubles in MENA region, retail banking total assets continued growing since December 2012 moving from BD 26.9 billion to BD 27.5 billion as of end-September 2013 to reach BD 30.05 billion in November 2014 (see Chart 2-2). This increase in retail banking assets was driven by domestic assets

which contributed to 51.8% of total assets at November 2014, up from 46.2% at end-September 2013.

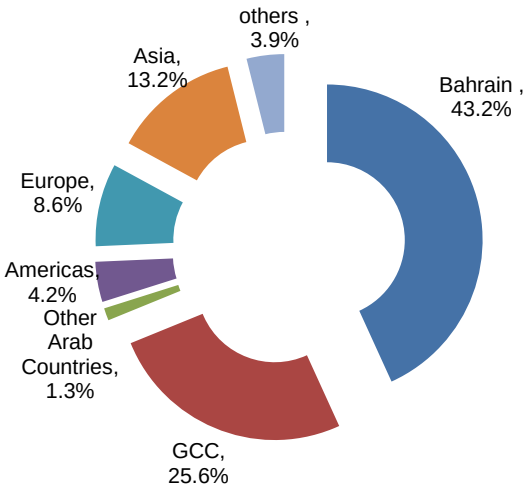
Chart 2-2: Categorization of Retail Banks' Assets (BD million)



Source: Central Bank of Bahrain

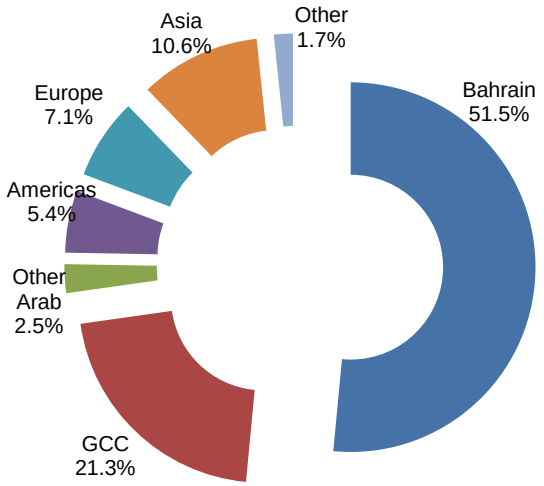
According to the charts below, it is crucial to notice that half of the 49.5% of foreign assets are GCC assets (22%). The level of Europe and American in retail banking remains almost stable during the past seven years (+11%) 2007. This shows that the retail-banking sector in Bahrain is lightly exposed to foreign risk from U.S and Europe.

Chart 2-3: Retail Banks' Assets (%) by Geographical Classification (2007)



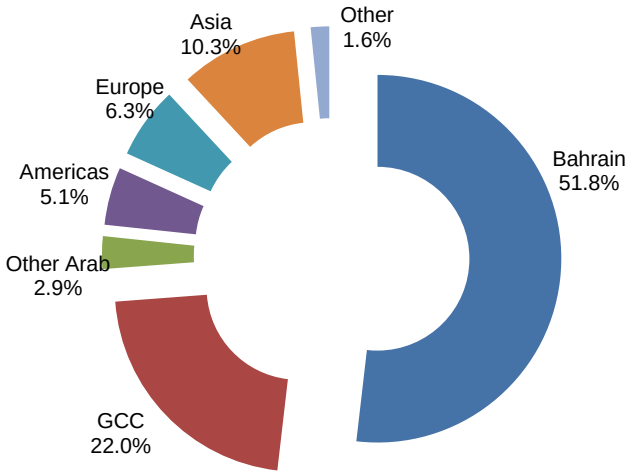
** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

Chart 2-4: Retail Banks' Assets (%) by Geographical Classification (2013)



** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

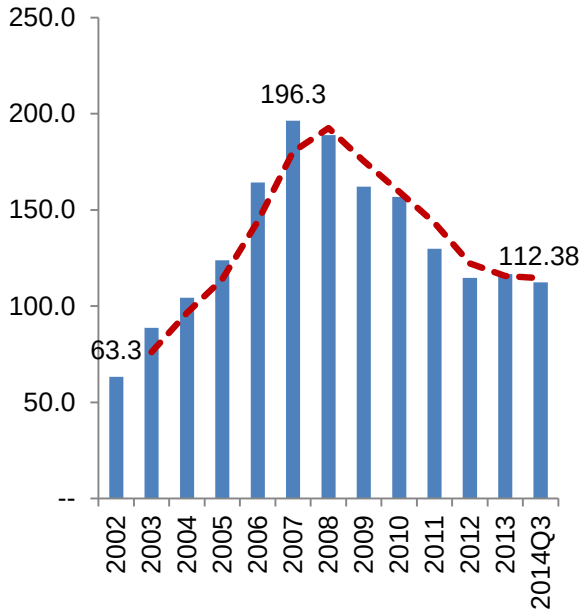
Chart 2-5: Retail Banks' Assets (%) by Geographical Classification (November 2014)



** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

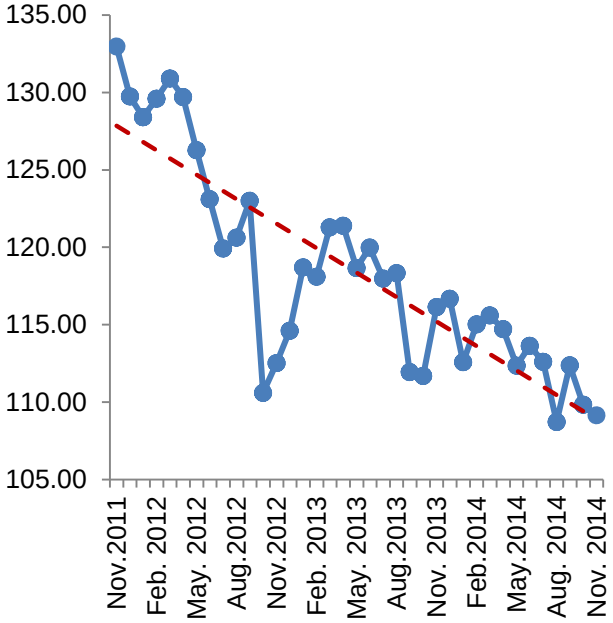
In contrast to the retail banking sector, the wholesale banking sector has witnessed a drop in its total assets from USD 196.3 billion in 2007 to USD 114.6 billion in 2012; hence a decrease of 41.6 %. Despite an improvement in the volume of total assets in the wholesale banking sector during the six months of 2014, reaching a peak of USD 115 million in May 2014, the volume became USD109.2 billion as of end November 2014 (See Charts 2-6 and 2-7).

Chart 2-6: Wholsale Banks' Assets (USD Billion)*



---. *Mouving average trendline*
** For conventional and Islamic wholesale banks*
Source: Central Bank of Bahrain

Chart 2-7: Wholsale Banks' Assets (USD Billion)*



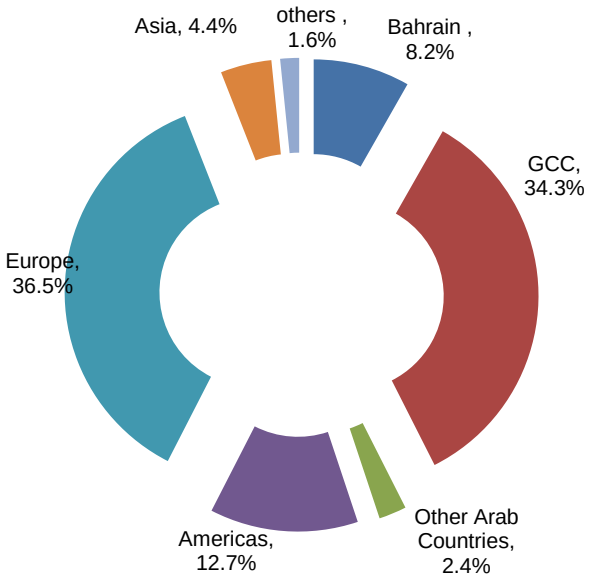
--- *Linear Trendline*
** For conventional and Islamic wholesale banks*
Source: Central Bank of Bahrain

Looking at wholesale banking assets by geographical classification, it is important to note that the most significant drop is recorded in the GCC area, which fell from 34% in 2007 to 31% at end-November 2014 (see Charts 2-8, 2-9 and 2-10).

According to the geographical classification of wholesale banks' assets, we can see the main evidences below:

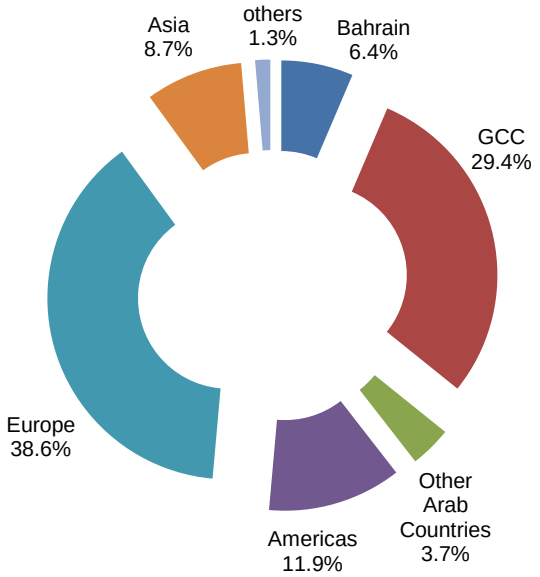
- The share of America's total assets decreased considerably since 2013 after a long period of stable level (2007-end-2013).
- The share of Europe's total assets is the most important share, and it remained stable and during the past seven years.
- There is a further increase of Asian assets which moved from 4.4% from 2007 till 2011 to 10.4% at end-November 2014.
- GCC total assets dropped significantly during the past few years, but the they represent almost the third of the wholesale banking sector

Chart 2-8: Wholesale Banks Assets by: Geographical Classification (2007) *



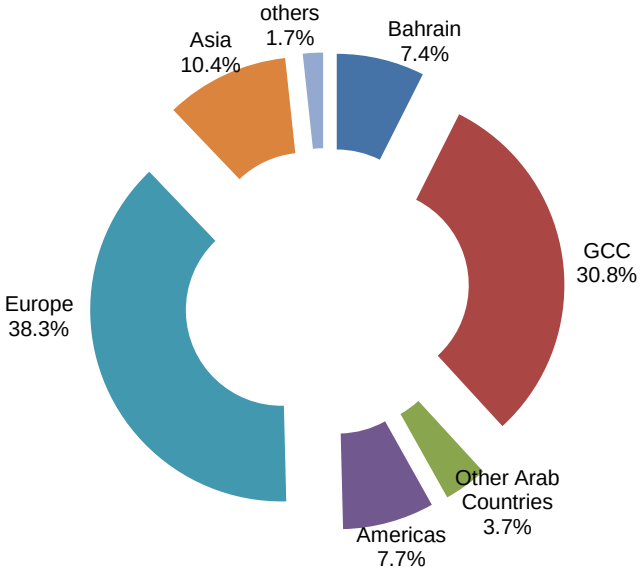
** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

Chart 2-9: Wholesale Banks Assets by: Geographical Classification (2013) *



** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

Chart 2-10: Wholesale Banks Assets by Geographical Classification (November 2014) *



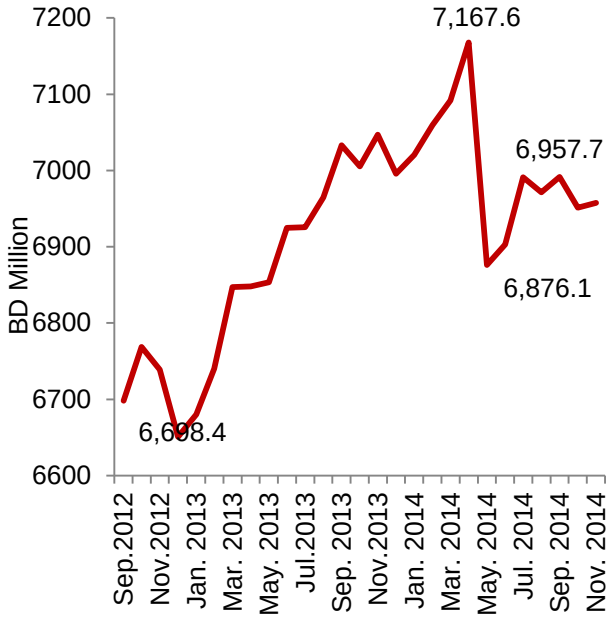
** For conventional and Islamic retail banks*
Source: Central Bank of Bahrain

2.2.2 Credit Developments

Since December 2012, the credit condition has also improved considerably. The credit to the private sector moved from BD 6,958 million in September 2012 to BD 7.167.6 million in April 2014. After a sudden drop in May 2014, the volume of credit regains momentum and reached BD 6.957.7 million in end-November 2014 (Chart 2-11). The high credit growth reveals the recovery of the economic activities and the restore of confidence in the kingdom of Bahrain.

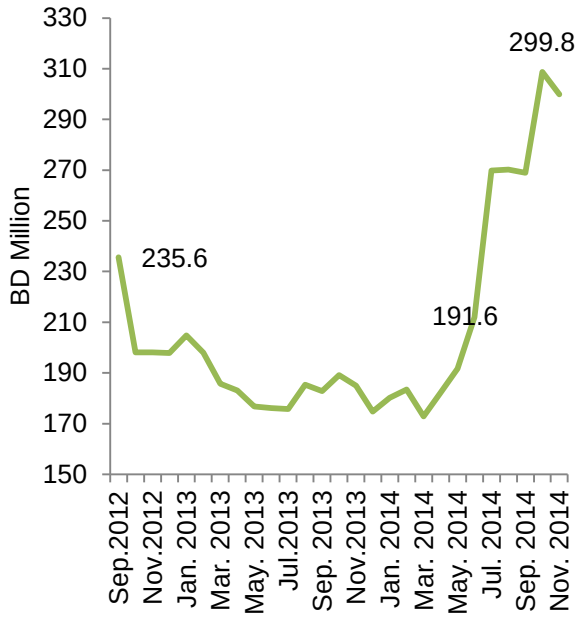
Regarding banks' lending to the government, it increased significantly during the past few months, moving from BD 235.6 million in September 2012 to BD 299.8 million at end-November 2014 (chart 2-12).

Chart 2-11: **Credit to Private Sector (BD Million)**



Source: Central Bank of Bahrain

Chart 2-12: **Loans to Government (BD Million)***



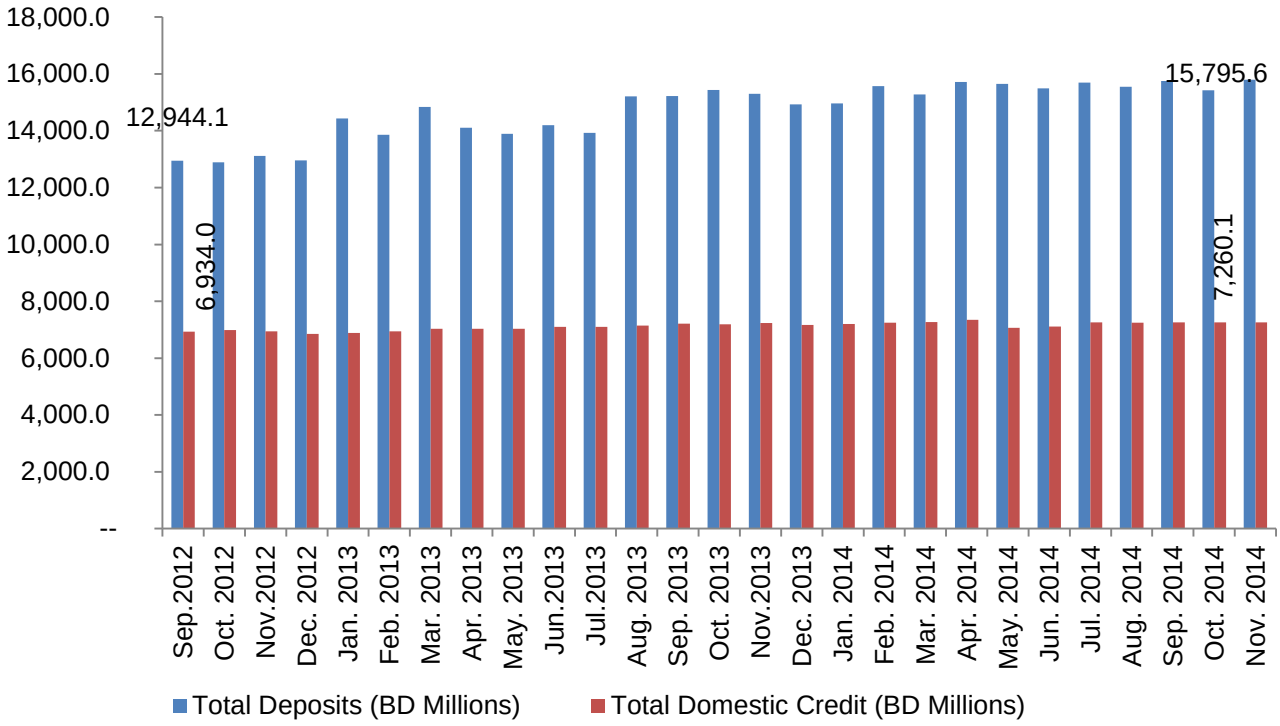
Source: Central Bank of Bahrain

*Excluding securities

Regarding total deposits, they reached BD15,795.6 billion in November 2014, where 68% of them are total local deposits. Interestingly, this was followed by an increase in total domestic credits which moved from around BD 7.0 billion in September 2012 to BD 7,260.1billion at end-November 2014 (chart 2-13).

Despite the high availability of liquidity (the total deposits represent 128.2% of GDP in November 2014) total domestic Credit remains moderate in Bahrain; it represents only 58.9 % of GDP as of the third quarter of 2014.

Chart 2-13: Total Deposits and total Domestic Credit (BD Million)



Source: Central Bank of Bahrain

Box 1: Measuring Concentration and Banking Competition in Bahrain

The Bahraini banking sector has experienced some important movements of consolidation, merger and acquisitions and restructuring. All these mergers and fusions have changed the degree of concentration of the banking sector and have boosted the level competition.

A. Concentration

The structure of the Bahraini banking sector has evolved substantially during the past decade. Before the 2007 financial crisis, the Bahraini banking sector was described by the dominating position of the large five banks. Since 2009, the growing number of banks and expansion of activities has created dynamic developments in the local banking sector and has had a major impact on market concentration.

Broadly, market concentration is one of the most important aspects of competition. Literature reveals various indices to measure the concentration of the banking sector. The most common measure used on market concentration has been a simple concentration ratio which combines assets or deposits or credit of three or four or five largest bank (noted, *b)* to to the whole market size. Generally, the ratio ranges from zero to unity and it is expressed as follows:

$$CTR_b = \sum_{k=1}^{n} \frac{X_i}{T} \qquad (1)$$

Where X is assets (or deposit or credit) of the largest bank and

T is the total assets (or deposit or credit).

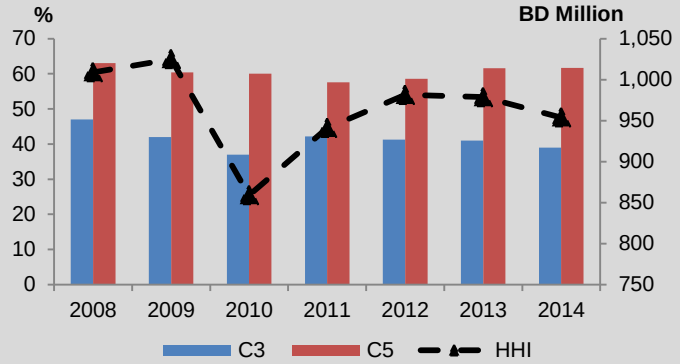
In banking industry the most used indicator of banking concentration is the CR-3 and *CR*5-Concentration ratios which measure the weight of 3 or 5 largest banks in the country to total assets of the whole banking system. There is also the *Herfindahl-Hirschman Index* ("HHI") which is calculated by squaring the market share of each bank competing in the market and then summing the resulting numbers. HHI is expressed as follows:

$$H = \sum_{i=1}^{N} s_i^2 \qquad (2)$$

Where s_i is the market share of bank *i* in the market and *N* is the number of banks. The US Department of Justice defines markets with an HHI below 1,500 points to be un-concentrated, an HHI between 1,500 and 2,500 points to be moderately concentrated, and an HHI above 2,500 points to be highly concentrated.

The results are displayed in Box Chart 1 show that in Bahrain, the share of the 5 largest banks in overall assets of banking system was 65 % by the end of 2008 to 42 percent in October 2014. During the last years, this indicator has shown a continuous dropping trend.

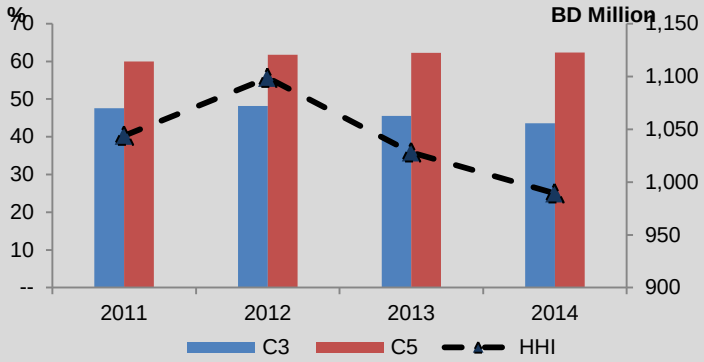
Box Chart 1: Concentration of the banking sector in Bahrain (On banking assets)



Source: Central Bank of Bahrain
Data for all retail banks including domestic and foreign assets.

Regarding the deposits side, Box Chart 2 exposes the recent trend in banking concentration in Bahrain; it indicated that the market is relatively un-concentrated.

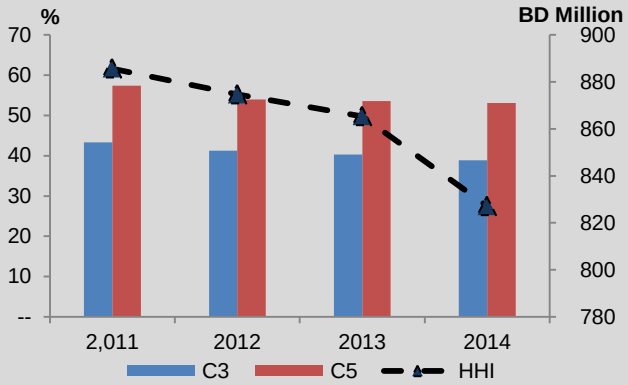
Box Chart 2: Concentration of the banking sector in Bahrain (On banking deposits)



Source: Central Bank of Bahrain
Data for all retail banks including domestic & foreign deposits.

Turning now to the level of concentration from a credits side, similar results have been found which confirm that the banking sector in Bahrain is not concentrated.

Box Chart 3: Concentration of the banking sector in Bahrain (On banking credits)



Source: Central Bank of Bahrain

B. Competition

An econometric model is used to measure the competition of the banking sector in Bahrain. The basic framework uses the famous Panzar–Rosse (*H*-statistic) approach to determine whether the banking system is competitive, monopolistically competitive or monopolistic markets (Panzar and Rosse, 1987). The model below will indicate that Bahraini's commercial bank system has an imperfect competition market structure

The Panzar and Rosse (PR) Approach

The model investigates the extent to which a change in factor input prices is reflected in equilibrium revenues earned by a specific bank. The PR model provides a measure called *"H-Statistics"* ranging between 0 and 1 which is a competition measure based on the estimated responsiveness of firm revenue to changes in factor input prices. The H-statistic is therefore expressed as follows:

$$H = \sum_{k=1}^{m} \left[\frac{\delta R_i^*}{\delta w_{ki}} \cdot \frac{w_{ki}}{R_i^*} \right] \qquad (1)$$

Where R_i is the equilibrium revenue for bank *i* and w_{ki} is the input price of factor k for bank *i.*
The PRH statistic is given by the sum of the elasticities of revenue with respect to input prices, ($\beta_1+\beta_2+\beta_3$). The sum of the factor price elasticities indicates how responsive revenue is to a percentage change in factor prices. Hence, the result of H-statistics corresponds to a certain situation of the market: monopoly market; monopolistic competition or perfect competition.

The economic interpretation of the H statistic is summarized as follows:

- If, *H*≤0; this result indicates a collusive oligopoly or a monopoly, in which an increase in costs causes output to fall and price to increase. Because the profit-maximizing firm must be operating on the price elastic portion of its demand function, total revenue will fall.
- If 0 < *H* < 1, in this case industry faces the intermediate case of monopolistic competition in which an increase in costs causes revenues to increase at a rate slower than the rate of increase in costs.
- Finally, if H=1; this means that the market is operating under a perfect competitive environment, in which an increase in costs causes some firms to exit, price to increase and the revenue of the competitors to increase at the same rate as the increase in costs.

The Model

Following the previous studies, we consider the following equation:

$$\ln(IR_{i,t}) = \alpha + \beta_1 \ln(W_{1,i,t}) + \beta_2 \ln(W_{2,i,t}) + \beta_3 \ln(W_{3,i,t}) + \delta_{i,t}^{'} M + \lambda D + \varepsilon_{i,t} \qquad (2)$$

$$H = \beta_1 + \beta_2 + \beta_3 \qquad (3)$$

In equation (2) *i* indexes banks and *t* indexes time. Dependent variable ln(I$R_{i,t}$) is the natural logarithm of total income that includes interest (proxy for output price of loans), for bank *i* in year *t*. We consider three inputs: labor, funds and physical capital. We consider $W_{1,it,}$ $W_{2,it}$ *and* $W_{3,it}$ the prices of the inputs with $W_{1,it,}$ is the ratio of interest expenses to total deposits and money market funding (proxy for input price of deposits), $W_{2,it}$ is the ratio of personnel expense to total assets (proxy for input price of labor) and $W_{3,it,}$ is the ratio of other operating and administrative expense to total assets (proxy for input price of equipment/fixed capital). *M* is the matrix of controls including the ratio of equity to total assets, the ratio of net loans to total assets, and the logarithm of assets as an indicator of the size of the bank. The error term $\varepsilon_{i,t}$ is a random disturbance term, it is assumed to be normally distributed. We take natural logarithms of all variables and equation (2) and then we will be estimated using both Ordinary Least Squares (OLS) and with fixed bank-specific effects (in the latter case $\alpha = \alpha_i$). Our model includes 12 commercial banks operating in Bahrain for the period 2002-2013.

Since the PR-model is only valid if the market is in equilibrium, thus an equilibrium test should be performed by using an indicator of bank profitability indicator as the dependent variable, with the same econometric pattern (method and independent variables) as equation (2). Therefore; the model is expressed as follows:

$$\ln(1+ROA_{i,t}) = \alpha + \beta_1 \ln(W_{1,i,t}) + \beta_2 \ln(W_{2,i,t}) + \beta_3 \ln(W_{3,i,t}) + \delta'_{i,t} M + \lambda D + \varepsilon_{i,t} \qquad (4)$$

Where *ROA* is the Return on assets ratio while $W_{1\,it}$, $W_{2,it}$, $W_{3,it}$, *M*, and *D* are the same variables as defined above. As *ROA* can take on negative values, the reason by which we compute the dependent variable as *ln(1+ROA)*. We define the equilibrium E-statistic as *E= β1+β2+β3* from equation (4). The test of long-run equilibrium involves testing whether *E=0* by the use of *F-test.*

The Results for Bahrain

Box Table 1: Test for basic competition in Total Interest Revenue versus ROA

	OLS		GLS		OLS		GLS	
L(Total *Interest Revenue*)	Coef.	P>t	Coef.	P>t	Coef.	P>t	Coef.	P>z
L(*Input cost of deposits)*	0.193	0.000***	.22398	0.000***	-0.0029	0.092*	-0.0012	0.419
L(*Input cost of labor)*	0.263	0.000***	.06903	0.335	0.0123	0.000***	0.0048	0.221
L(*Input cost of capital)*	0.109	0.003***	.08603	0.025**	-0.011	0.000***	-0.0146	0.000***
L(*equity_ratio)*	0.072	0.118	.13470	0.008***	0.0026	0.338	0.0067	0.015**
L(*loans_ratio)*	0.24	0.000***	.240433	0.038**	0.015	0.000***	0.014	0.023**
L(Size)	-0.179	0.306	-.90654	0.061*	-0.012	0.226	-0.033	0.207
L(inflation)	0.021	0.269	.014328	0.406	-0.000	0.82	-0.00	0.436
Constant	0.123	0.781	1.25317	0.299	0.058	0.027**	0.083	0.212
H Statistics	0.565		0.379		-0.0022		-0.0107	
Nbr of Obs.	124		124		124		124	
F	36.32 (0.0000***)		21.37 (0.0000***)		7.97		10.56 (0.0000***)	
R-squared	0.7236		0.6156		0.348		0.7648	
Hausman	-		0.3491***		-		0.7983	
Breusch and Pagan LM	-		18.56 (0.0006***)		-		42.94 (0.000***)	
H=0/ E=0	F(1, 111) = 81.60 Prob>F = 0.0000***		chi2(1) = 20.15 Prob > chi2 = .0000***		F(1,111)=0.36 Prob>F =0.5497***		chi2(1)= 5.63 Prob>chi2= 0.0195**	
H=1/E=1	F(1, 111) = 47.95 Prob>F =0.0000***		chi2(1) = 54.08 Prob > chi2 = .0000***		F(1,111)=75102.22 Prob>F =0.5497***		chi2(1) = 47036.31 Prob>chi2 = 0.0000***	

Notes: Figures in parentheses are t-statistics.*significant at 10%,** significant at 5% ***significant at 1%.

The Wald-tests for the model indicate that H-statistic is significantly different from zero and significant chi-square statistic test results reject the null hypotheses of the existence of a monopoly (H ≤ 0) or perfect competition (H=1) bank system (Table 1-4). *The H-statistic value of 0.56 indicates that Bahraini's commercial bank system has an imperfect competition market structure*.

The estimations obtained from bank fixed effects and bank random effects General Least Square (GLS) models suggest the use of a bank fixed effects technique despite the Hausman test yielded 0.3491 which support the alternative method. However, the Likelihood Ratio (LR) test for the redundant cross-sectional fixed effects yielded 18.56 (p=0.0006***) preferring the fixed effects model. Consequently, we reported the results from the fixed effects model.

We run the original regression model in Equation (4) with return on assets being the new dependent variable to test for long-run equilibrium. Under this specification a value of E=0 would indicate an equilibrium in the banking markets under investigation. The results of the estimation of equation 3 are displayed in table 1-4 (right side of the table).

For the equilibrium condition, the sum of coefficients of ln ($W_{1,it}$), ln($W_{2,it}$) and ln($W_{3,it}$) (β1 + β2 + β3) in equation (4) should be equal to zero. The *E*-statistic of the OLS estimation is -0.0022 for the sample period. The Wald test of *E*-statistic cannot reject the null hypothesis that the *E*-statistic equals zero (*p*-value of 0.5497). Therefore, we conclude that the banking sector in Bahrain is in a long-run equilibrium and thus our earlier conclusions based on the *H*-statistic remain unchanged.

Results of GLS with fixed effects estimation confirm the findings of the OLS estimation and shows that E=-0.0107 which confirms the presence of long run equilibrium in the Bahraini banking sector (at the level of 1%). The Wald test of *E*-statistic confirms the reject of the null hypothesis of existence of monopoly or perfect competition.

Robustness checks

The dependent variable now includes non-interest revenues, which arguable makes it a more comprehensive measure of the overall degree of competition in banking services. The other, explanatory variables remain the same. Again, we estimate the model using OLS and GLS with fixed-bank effects:

$$\ln(\mathrm{TR}_{i,t}) = \alpha + \beta_1 \ln(W_{1,i,t}) + \beta_2 \ln(W_{2,i,t}) + \beta_3 \ln(W_{3,i,t}) + \delta_{i,t}^{'} M + \lambda D + \varepsilon_{i,t} \qquad (4)$$

Table 2 reports tests of conditions of competition in interest revenues. The Ordinary Least Square (OLS) method provides the estimates. The results presented in Table 1-5 exhibit statistically significant coefficients for the three bank input prices variable. *H* statistics is 0.572 and the Wald-tests for the model indicate that our H-statistic is significantly different from zero and significant chi-square statistic test results reject the null hypotheses of the existence of a monopoly (*H* ≤ 0) or perfect competition (*H*=1) bank system. The *H*-statistic value of 0.572 indicates that Bahraini's commercial bank system has an imperfect competition market structure.

The GLS estimation provides similar results to the OLS estimation and confirm the reject of reject the null hypotheses of the existence of a monopoly (*H* ≤ 0) or perfect competition (*H*=1) bank system.

Box Table 2: Tests of Conditions of Competition in Total Interest Revenue

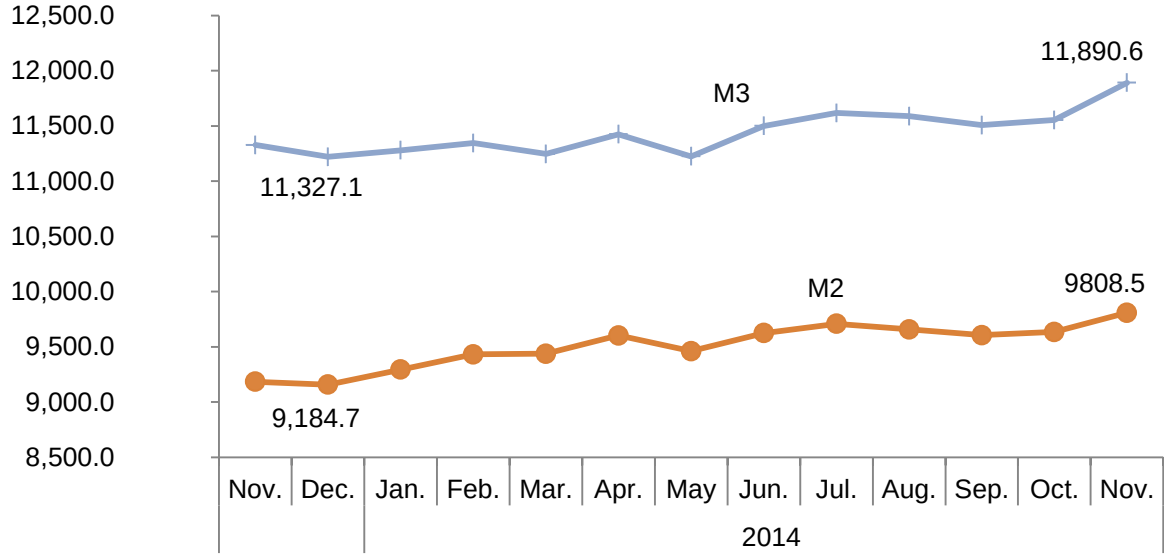
	OLS		GLS	
L(Interest Revenue)	Coef.	P>t	Coef.	P>t
L(*Input cost of deposits)*	.145	0.000***	.1792396	0.000***
L(*Input cost of labor)*	.303	0.000***	.1509072	0.076*
L(*Input cost of capital)*	.124	0.003***	.1053152	0.020**
L(*equity_ratio)*	.088	0.090*	.1711203	0.004***
L(*loans_ratio)*	.312	0.000***	.1881058	0.167
L(Size)	.196	0.319	-.3498491	0.538
L(inflation)	.021	0.343	.0185162	0.364
Con	-.454	0.368	.4454891	0.754
H Statistics	0.572		0.435	
Number of obs	124		124	
F	31.77 (0.0000***)		12.33 (0.0000***)	
R-squared	0.6960		0.6387	
Hausman			10.54	
Breusch and Pagan LM			(0.0006***)	
H=0/ E=0	F(1, 111) = 65.91 Prob > F = 0.0000***		chi2(1) = 19.03 Prob > chi2 = 0.0000***	
H=1/E=1	F(1, 111) = 36.46 Prob > F = 0.0000***		chi2(1) = 31.98 Prob > chi2 = 0.0000***	

Notes: Based on the results of the Hausman test and Breusch and Pagan LM tests of conditions of equilibrium are run with fixed effects. Figures in parentheses are t- statistics. *significant at 10%; ** significant at 5%; *** significant at 1%.

2.3 Monetary indictors

Money supply has continued to grow since the second quarter of 2013. M2 stood at BD 9,808.5 million in end-November 2014, 7% higher than its value of May 2013. M3 was BD 11,890.63 million in November 2014, 5% higher than in November 2013 (Chart 2-14).

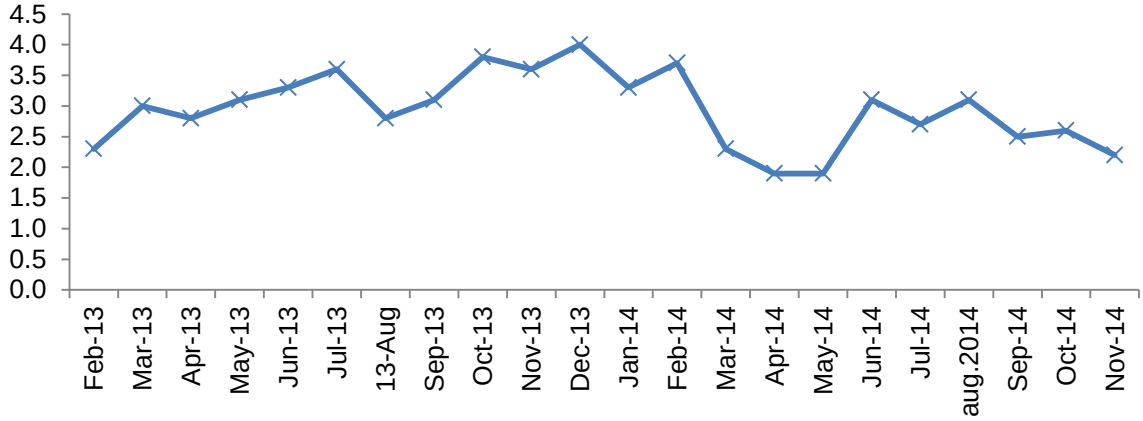
***Chart 2-14*: Money Supply (BD Billion) from May 2013 to May 2014**



Source: Central Bank of Bahrain

The inflation rate in consumer prices for the period January to November of 2013 was stable around 3.2%. In 2014, inflation in Bahrain was moderate. According to CIO (2014), inflation moved from 3.5% in January 2014 to 2.2% in November 2014. The most important decreases come from the "food and beverage", "transport", and "miscellaneous goods and services" which decreased by 1.3%, 1.2%, and 0.7% respectively.

Chart 2-15: Monthly Inflation in 2013-2014 (CPI%*)



**Growth rate compared to the same month of previous year, seasonally adjusted*
Source CIO Bahrain.

2.4 The Bahraini Households Sector

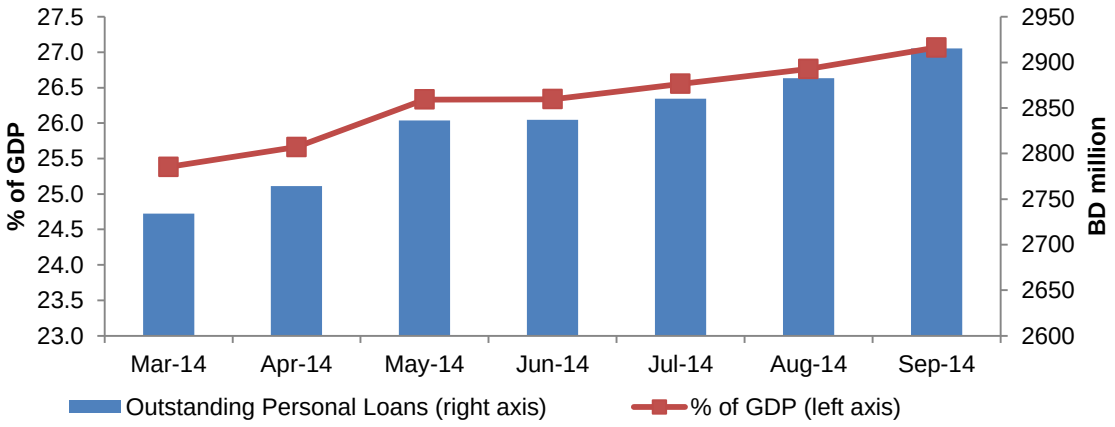
Households and business enterprises are the major customers of financial institutions. Not only are they sources of deposits, they represent major sources of demand for financial sector products and services. The financial condition and performance of financial institutions therefore depend to a large 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.

2.4.1 Household Debt Ratio

Outstanding personal loans, used as a proxy for household borrowing, for the period shows that the household debt burden rose with a gradual increase between the period March 2014 to September 2014 (Chart 2-16).

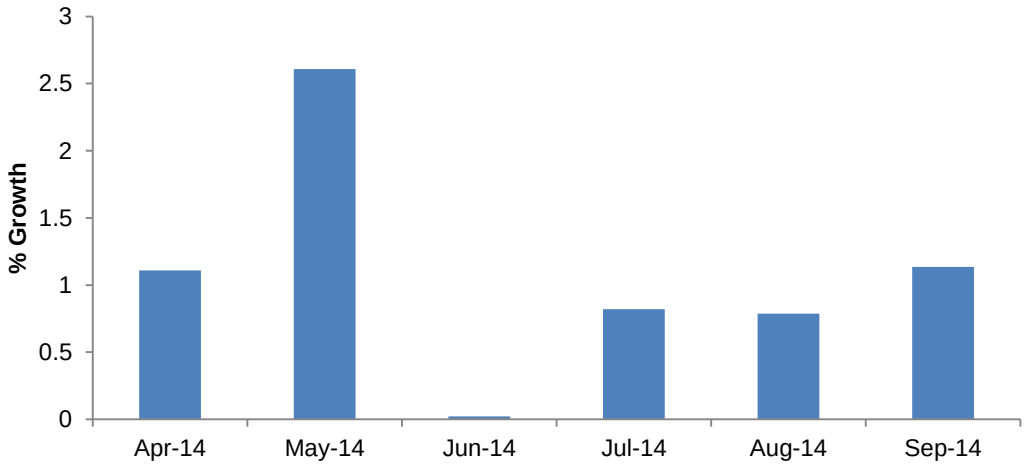
Chart 2-16: Personal Loans and Advances (Volume and % of GDP)



**Using 2012 GDP, provisional data*
Source: Central Bank of Bahrain

Personal loans as a percentage of GDP increase steadily from March 2014 to September 2014. Starting at 25.4% in March and capping at 27.1% in September. This is due to an increase in outstanding personal loans throughout the seven month period. Outstanding personal loans between March 2014 and September 2014 grew by 2.6%.

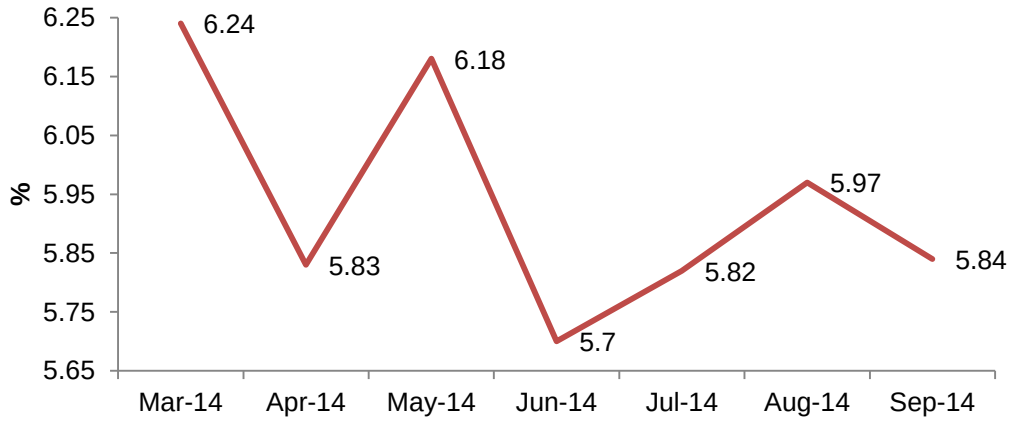
Chart 2-17: Growth Rate of Total Personal Loans and Advances (%)



Source: Central Bank of Bahrain

Interest rate on personal loans reached its peak at 6.24% in March 2014 (Chart 2-18) and fluctuated throughout the seven month period. Interest rates on secured and unsecured loans were constant throughout this period.

Chart 2-18: Retail Banks- Average Interest Rates on Personal Loans (%)

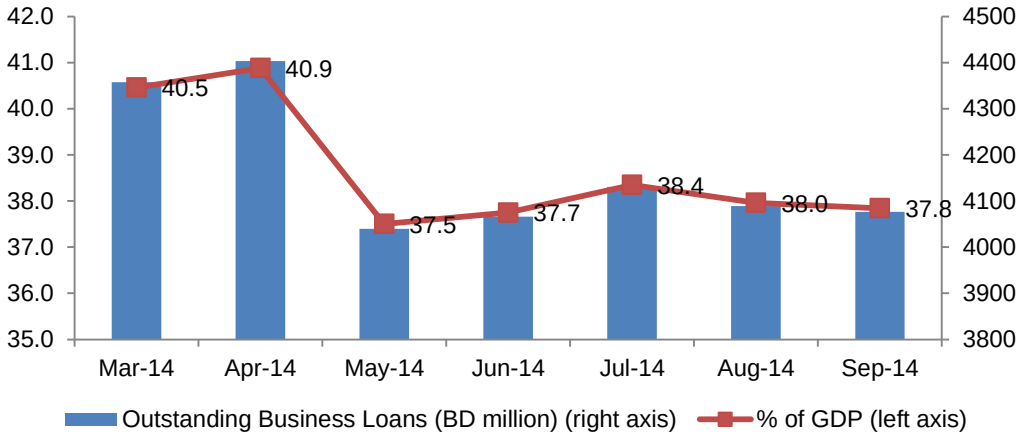


Source: Central Bank of Bahrain

2.4.2 The Bahraini Corporate Sector

Between March 2014 and September 2014, business loans and advances have seen a huge drop between April and May 2014 and then plateaued until September 2014 (Chart 2-19). Outstanding business loans averaged 38.7% of GDP decreasing from 40.5% in March 2014 to 37.8% in September 2014.

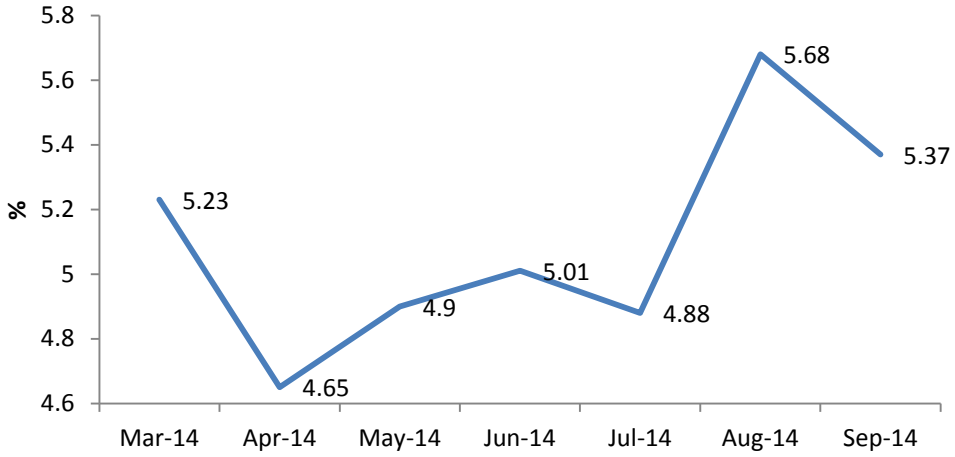
Chart 2-19: Business Loans and Advances (Volume and % of GDP)



Source: Central Bank of Bahrain

Average interest rates on business loans fluctuated throughout the seven months. It was at its lowest in April 2014 at 4.65% (Chart 2-20), and then reaching its highest rate in August 2014. Interest rates on non-bank financial loans on transportation & communication loans remained steady during this period at 3.1%.

Chart 2-20: Retail Banks- Average Interest Rates on Business Loans (%)



Source: Central Bank of Bahrain

2.4.3 Construction and Real Estate

Commercial licenses issued for construction increased from Q1 to Q2 but dropped in Q3 of 2014, while the real estate sector has seen a decrease in licenses throughout the year, with 308 licenses issued, down from 408 licenses in Q1.

Table 2-2: Commercial Licenses Issued for Construction and Real Estate

	2013:Q4	2014:Q1	2014:Q2	2014:Q3
Construction	219	200	282	258
Real Estate, Rentals and Associated Activities	406	408	388	308
Total	**625**	**608**	**670**	**566**

Source: Ministry of Industry and Commerce

The total number of construction permits issued by the Ministry of Municipalites Affairs and Agriculture has seen an increase from Q1 2014 to Q3 2014, with a total of 738 permits at the end of the third quarter.

Table 2-3: Selected Construction Permits by Type

	2013:Q4	2014:Q1	2014:Q2	201:Q3
Demolition and New Construction	8	8	16	14
New Construction	562	545	649	723
Reclamation	36	1	1	1
Total	**606**	**554**	**666**	**738**

Sources: Ministry of Municipality Affairs and Agriculture

2.5 Overall assessment of the Bahraini Financial sector and non-Financial Sector

Despite the global uncertainty and weak economic condition in emerging markets, all the indicators presented and analyzed above reveal that the Bahraini banking sector is performing efficiently all over the year 2014. Bank loans continue their recovery and credit growth is expected to grow further pace in the coming year. Overall funding conditions have improved and demand for loans has accelerated in Bahrain.

Banks operating in Bahrain are well capitalized, funding and liquidity buffers are well above minimum required standards, and non-performing loans continue to drop. Regulatory changes in recent years have helped to improve prudential standards for retail and wholesale banks (conventional and Islamic). All these changes have been beneficial for financial stability and will further strengthen the position of Bahrain as a financial center.

In the following chapters, the performance of the Bahraini banking sector (retail, wholesale, conventional and Islamic) will be analysed in, Bahrain Bourse, as well as the developments in e-payment activities during the previous semester.

Part II:

Performance of the Banking Sector

3. Conventional Banks

Chapter 3

Key Points

- An increase in capital positions of conventional retail and decrease in conventional wholesale banks.
- Non-performing loans (NPLs) for conventional retail banks remains unchanged while conventional wholesale banks decreases.
- Loan portfolios in conventional retail and wholesale banks remain concentrated despite the decrease in some sectors.
- Fall in earnings for conventional retail banks and conventional wholesale banks.
- Increase in liquidity for conventional retail banks and conventional wholesale banks.

3.1 Overview

This chapter analyses the banking sector under the following categories: conventional retail banks (section 3.2), conventional wholesale banks (section 3.3). Section 3.4 provides an overall assessment of the conventional banking industry. Unless specified otherwise, the analysis in this chapter is based on consolidated financial data (Bahraini and non-Bahraini operations), as at end-March 2013 and compared with end-September 2014.

This chapter offers macroprudential analysis of the conventional banking sector based on a set of selected Financial Soundness Indicators (FSIs).[1]

Annex 1 presents selected *Financial Soundness Indicators* (FSIs) for the different banking segments. Annex 2 presents selected graphs showing the development of selected indicators over time.

[1] This chapter does not contain a section on stress testing. Stress Testing exercises are performed separately in an internal report to obtain information on the potential quantitative impact of hypothetical scenarios on selected Bahraini Systemically-Important Banks (SIB's).

3.2 Conventional Retail Banks

Increase in capital adequacy [2]

Capital adequacy ratios for conventional retail banks slightly increased from 18.3% in March 2014 to 18.6% in September 2014. The core capital ratio (ratio of Tier 1 capital to risk-weighted assets) showed a slight decrease from 15.1% in March 2014 to 15.0% in September 2014. The leverage ratio (ratio of assets over capital) also showed a slight decrease of 0.3% from 8.6% in March 2014 to 8.3% in September 2014. The ratio of non-performing loans (NPLs) net remained unchanged at 8.9%.

Table 3-1 Capital Provisions Ratios for Local Conventional Retail Banks

Indicator	Mar. 2014	Sept. 2014
Capital Adequacy Ratio	18.3	18.6
Tier 1 Capital Adequacy Ratio	15.1	15.0
Leverage (assets/capital)(times)	8.6	8.3
NPLs net of provisions to capital	8.9	8.9

Source: Central Bank of Bahrain

No change in non-performing loans

Loan delinquencies have remained the same between the periods of March 2014 to September 2014 at 3.8%. The specific provisions as a proportion of NPLs showed a decrease to 53.9% in September 2014 from 55.2% in March 2014. The net NPLs of net loans increased from 1.7% in March 2014 to 1.8% in September 2014. For *local retail banks*, the NPLs remained unchanged at 4.7% in September 2014. For *overseas retail banks*, the NPLs increased to 1.8% in September 2014.

Table 3-2: NPL Figures for Conventional Retail Banks

Indicator	Mar. 2014	Sept. 2014
NPL's (% Gross)	3.8	3.8
NPL's Local Banks (% Gross)	4.7	4.7
NPL's Overseas Banks (% Gross)	1.7	1.8
Specific provisions (% of NPLs) *	55.2	53.9
Net NPL's (% of net loans)	1.7	1.8

Source: Central Bank of Bahrain

** Specific provisions as a percentage of NPL's are calculated as specific provisions divided by gross impaired loans minus interest in suspense.*

Available data on the sectoral breakdown of impaired loans [3] shows most sectors experiencing a decrease in impairment, while some experience an increase and others

[2] 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.

[3] Impaired loans include NPLs on which payments of interest or repayments of principal are 90 or more days past due and all loans and advances on which specific provisions have been made.

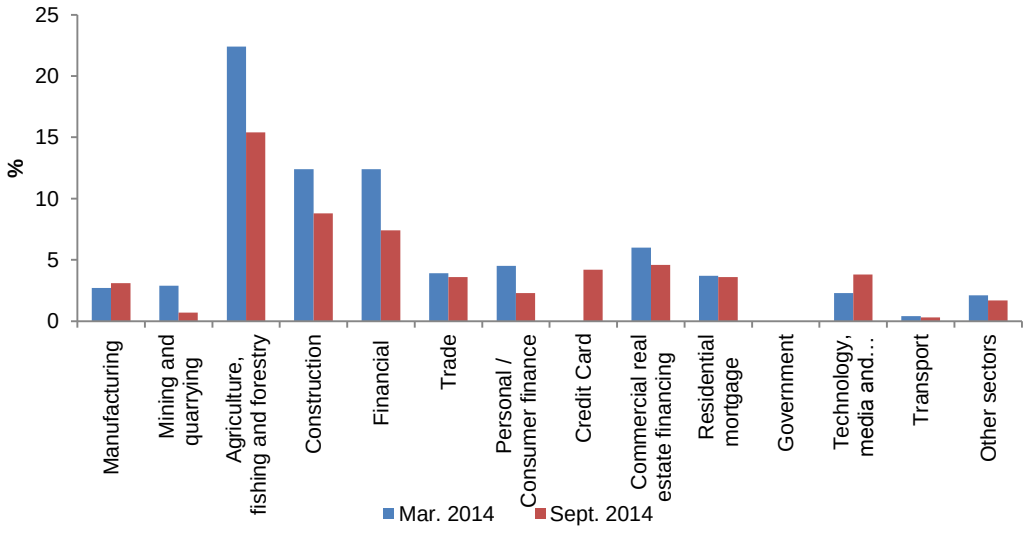
remaining unchanged (Table 3-3 and Chart 3-1). The highest decrease was in "Agriculture, Fishing and Forestry" by 7.0% followed by "Financial" by 5.0%.

Table 3-3: Conventional Retail Banks' Impaired Loan Ratios by Sector (% of gross loans per sector)

	Mar. 2014	Sept. 2014	Change
Manufacturing	2.7	3.1	0.4
Mining and quarrying	2.9	0.7	(2.2)
Agriculture, fishing and forestry	22.4	15.4	(7.0)
Construction	12.4	8.8	(3.6)
Financial	12.4	7.4	(5.0)
Trade	3.9	3.6	(0.2)
Personal / Consumer finance	4.5	2.3	(2.2)
Credit Card	-	4.2	4.2
Commercial real estate financing	6.0	4.6	(1.4)
Residential mortgage	3.7	3.6	(0.1)
Government	0.0	0.0	0.0
Technology, media and telecommunications	2.3	3.8	1.5
Transport	0.4	0.3	(0.1)
Other sectors	2.1	1.7	(0.4)

Source: Central Bank of Bahrain

Chart 3-1: Conventinoal Retail Banks' Impaired Loans by Sector (% of gross loans per sector)



Source: Central Bank of Bahrain

Loan portfolios remain concentrated

The loan portfolio of *locally incorporated retail banks* remains concentrated with the top recipient of loans being the "commercial real estate financing" sector accounting for 19.2% of total loans in September 2014, an increase from the 17.4% in March 2014. The "manufacturing" sector represented 12.3% of total loans down from 11.9% followed by the "personal/consumer finance" sector at 11.9%, a decrease from 12.6% over the same period.

The top two recipient sectors "commercial real estate financing" and "others"[4] jointly represented 33.1% of loans in September 2014, an increase from the 32.1% in March 2014. Exposure to real estate/ construction was 35.8% of total lending in September 2014, an increase from the 35.0% registered in March 2014.

Table 3-4: Distribution of Local Conventional Retail Banks' Lending (% total loans)*

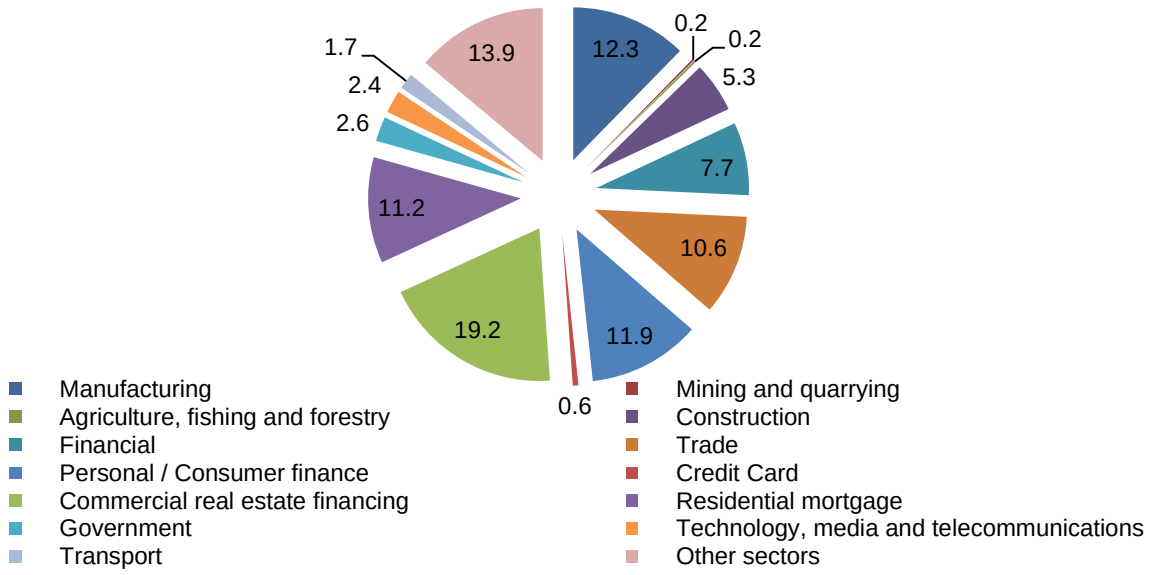
	Mar. 2014	Sept. 2014	Change
Manufacturing	11.9	12.3	0.40
Mining and quarrying	0.3	0.2	(0.10)
Agriculture, fishing and forestry	0.4	0.2	(0.20)
Construction	5.4	5.3	(0.10)
Financial	7.2	7.7	0.50
Trade	10.2	10.6	0.40
Personal / Consumer finance	12.6	11.9	(0.70)
Credit Card	0.5	0.6	0.10
Commercial real estate financing	17.4	19.2	1.80
Residential mortgage	12.2	11.2	(1.00)
Government	2.5	2.6	0.10
Technology, media and telecommunications	2.7	2.4	(0.30)
Transport	2.0	1.7	(0.30)
Other sectors	14.7	13.9	(0.80)
Top two recipient sectors	**32.1**	**33.2**	**1.10**
Real Estate/ Construction Exposure**	**35.0**	**35.8**	**0.80**

Source: Central Bank of Bahrain

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

*** Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

Chart 3-2: Distribution of Conventional Local Retail Banks' Lending (% of total loans)



Source: Central Bank of Bahrain

[4] The "others sectors" category includes sectors such as "private banking", "services", "tourism", and "utilities".

The numbers as of end-September 2014 continue to show high concentration of risk for *overseas retail banks* (Table 3-5 and Chart 3-3). The top recipient of loans was the "Manufacturing" sector with 19.2% of total loans in September 2014, an increase from the 19.0% in March 2014.

Table 3-5: Distribution of Overseas Conventional Retail Banks' Lending (% total loans)*

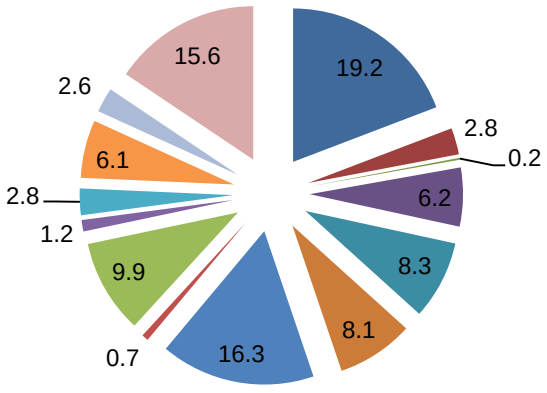
	Mar. 2014	Sept. 2014	Change
Manufacturing	19.0	19.2	0.20
Mining and quarrying	2.0	2.8	0.80
Agriculture, fishing and forestry	0.4	0.2	(0.20)
Construction	7.1	6.2	(0.90)
Financial	8.4	8.3	(0.10)
Trade	9.3	8.1	(1.20)
Personal / Consumer finance	16.4	16.3	(0.10)
Credit Card	0.7	0.7	(0.0)
Commercial real estate financing	6.8	9.9	3.10
Residential mortgage	1.2	1.2	0.00
Government	2.9	2.8	(0.10)
Technology, media and telecommunications	6.3	6.1	(0.2)
Transport	3.0	2.6	(0.4)
Other sectors	16.4	15.6	0.80
Top two recipient sectors	**35.4**	**35.3**	(0.10)
Real Estate/ Construction Exposure**	**15.1**	**17.3**	2.2

Source: Central Bank of Bahrain

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

*** Real Estate/ Construction exposure is the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

Chart 3-3: Distribution of Conventional Overseas Retail Bank's Lending (% of toal loans)



Manufacturing
Mining and quarrying
Agriculture, fishing and forestry
Construction
Financial
Trade
Personal / Consumer finance
Credit Card
Commercial real estate financing
Residential mortgage
Government
Technology, media and telecommunications
Transport
Other sectors

Source: Central Bank of Bahrain

The top two recipients of loans ("manufacturing" and "personnel/Consumer finance") jointly accounted for 35.3% of total loans. Exposure to real estate/ construction was 17.3% of total lending in September 2014, an increase from the 14.2% in March 2014.

Decrease in retail bank profitability

As at end-September 2014, return-on-assets (ROA) decreased to 1.2% from 1.4% in September 2013.ROA for *locally-incorporated banks* decreased from 1.4% in September 2013 to 1.1% in September 2014. For *overseas banks*, ROA increased from 1.3% in 2013 to 1.4% in September 2014. Return-on-equity (ROE)[5] for *locally-incorporated banks* decreased from 15.0 % in September 2013 to 11.3% in September 2014.

Net interest income (as a % of gross income) increased from 64.5% in September 2013 to 71.4% in September 2014. On the other hand, operating expenses as a proportion of gross income increased from 42.3% in September 2013 to 43.1% in September 2014.

Table 3-6: Profitability of Retail Banks (%)

	Sept. 2013	Sept. 2014
ROA *	1.4	1.2
ROA Locally Incorporated Banks	1.4	1.1
ROA Overseas Banks	1.3	1.4
ROE**	15.0	11.3
Net interest income (% total income)	64.5	71.4
Operating expenses (% total income)	42.3	43.1

Source: Central Bank of Bahrain
**ROA = ratio of net income to assets*
***ROE = ratio of net income to tier 1 capital (for locally incorporated banks only*

Liquidity position increased

Between March 2014 and September 2014, bank deposits increased while non-bank deposits decreased for retail banks. Bank deposits remained unchanged at 26.1% in September 2014. Non-bank deposits also remained unchanged at 73.9% over the same period. The overall loan-deposit ratio for the segment increased from 64.2% in March 2014 to 65.0% in September 2014. Liquid assets as a proportion of total assets showed an increase over the period of March 2014 to September 2014 from 24.4% to 26.8%, respectively. Similarly, liquid assets as a proportion of the short-term liabilities presented an increase from 33.6% to 37.4% over this period.

Table 3-7: Retail Banks' Liquidity Profile (%)

	March 2014	Sept. 2014
Loan-Deposit Ratio	64.2	65.0
Liquid Asset Ratio	24.4	26.8
Non-Bank Deposits as a % of total deposits	73.9	73.9

Source: Central Bank of Bahrain.

[5] We define equity in ROE as net profit over Tier 1 Capital.

Box 2: Macroprudential Policy and Tools in Bahrain

The Financial Crisis of 2008 highlighted the need for a pro-active approach to financial regulation and supervision. Macroprudential policy seeks to ensure financial stability over time through the use of various policy tools and instruments. Its main objective is to limit the risks and costs of systemic crises.

Box Table 1: Macroprudential Policy

	Macroprudential policy
Proximate objective	Limit financial system-wide distress
Ultimate Objective	Avoid macroeconomic costs linked to financial instability
Characterization of Risk	"Endogenous" (dependent on collective behaviour)
Calibration of prudential controls	In terms of system-wide risk; top-down

Source: Borio (2003).

A. Macroprudential policy tools and instruments

Macroprudential policy tools are defined as prudential tools set up with a macro (system wide or systemic) perspective that can support financial stability (Borio, 2009). Table-2 demonstrates select categories of macroprudential instruments with examples.

The use of macro-prudential policies aimed at reducing vulnerabilities in banking systems. Recent events have highlighted the high costs of financial crises. More generally, the potential economic costs arising from the way financial systems operate – whether from excessive financial cycles or spill overs through interconnectedness – are increasingly recognized.

Box Table 2: Select Macroprudential Instruments

Select Macroprudential Instruments	Examples
Risk measurement methodologies by Supervisors	Develop measures of systemic vulnerability as basis for calibration of prudential tools; Communication of official assessments of systemic vulnerability and outcomes of macro stress tests.
Regulatory Capital	Systemic capital surcharge; Reduce sensitivity of regulatory capital requirements to current point in the cycle and with respect to movements in measured risk; Increased regulatory capital requirements for particular exposure types.
Funding liquidity standards	Cyclically-dependent funding liquidity requirements; Concentration limits; FX lending restrictions; FX reserve requirements; currency mismatch limits; open FX position limits.
Collateral arrangements	Time-varying Loan-to-value (LTV) ratios; Conservative maximum loan-to-value ratios and valuation methodologies for collateral; Limit extension of credit based on increases in asset values; Through-the-cycle margining.
Risk concentration limits	Quantitative limits to growth of individual types of exposures; (Time-varying) interest rate surcharges to particular types of loans.
Profit distribution restrictions	Limit dividend payments in good times to help build up capital buffers in bad times.

Source: BIS (2008).

B. Macroprudential policy in Bahrain

The Central Bank of Bahrain is the single regulator of the financial system according to the central bank law. The Central Bank has a formal mandate to implement macroprudential policy.

The CBB has been using a number of macroprudential instruments over the years preceding the financial crisis of 2008. For example, reserve requirements on deposits and liquidity requirements have been commonly used. The CBB also has long imposed ceilings on personal loans in the form of a 50% cap on monthly repayments as a share of monthly salary of the borrower, among others. After the financial crisis, the CBB added a number of macroprudential instruments in order to actively ensure the stability of the financial sector. Table 3 demonstrates the current macro prudential toolkit at the Central Bank of Bahrain.

Box Table 3: Macroprudential Measures by CBB

Macroprudential Measures	Type
General Provisions	Minimum of 1% of net loans.
Reserve Requirements on Bank Deposits	5% of Bahraini Dinars non-bank deposits, due at first week of every month.
Leverage Ratios (Capital to Assets)	3% as per Basel III requirements will be implemented in 2017. In the meantime a 5% gearing ratio continues to apply.
Limits on Loan-to-Deposit Ratios	In the range of 60% to 65% on an individual bank basis.
Liquidity Requirements/Buffers	As per Basel III requirements, the CBB intends to introduce the LCR and the NSRF requirements. Currently banks must meet stock liquidity requirements of 25% liquid assets ratio.
Domestic Systematically Important Banks Capital Buffer	SIBs are subject to more frequent reporting and inspection. The CBB is evaluating the possibility of requiring such banks to hold more capital.
Limits on Maturity Mismatch	May not exceed 15% for the "at sight" band or 20% for the "one month" band.
Limits on Exposure Concentration	A bank may not incur an exposure to an individual counterparty or group of closely related counterparties which exceeds 15% of the reporting bank's consolidated capital base without the prior written approval of the CBB. Equivalent limits are in place for parties connected to the bank.

Source: CBB.

Box 3: Basel III Implementation in Bahrain

Basel III is an international regulatory framework for banks. It was introduced in 2013 after the Sub Prime Crisis that occurred in 2008. It was developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector. The phase-in of Basel III is taking place in stages and is expected to be implemented completely in 2019. The objectives of Basel III are for better quality of capital to enhance the banking sector's ability to absorb shocks from financial and economic stress; improve risk management and governance; and strengthen bank's transparency and governance.

The changes to be introduced by Basel III are:

- The quality, consistency, and transparency of the capital base will be raised.
- The risk coverage of the capital framework will be strengthened.
- A leverage ratio will be introduced. By 2019 Banks must have capital equivalent to at least

3% of their total assets.

- A series of measures will be introduced to promote the build-up of capital buffers.
- Introduction of a minimum liquidity standard for internationally active banks.

The Central Bank of Bahrain set a requirement for all locally incorporated banks to report pro forma Basel III ratios on leverage, capital adequacy and liquidity from March 2013. Consultation papers have been sent out to conventional bank licensees and a similar one to Islamic banks with amendments to the rulebook and new definitions that are up to date with Basel III terminologies.
The required Basel III ratios to be reported quarterly are as follows:

Box Table 4: Basel III Ratios

	Consolidated	Banks Only
Common Equity Capital Ratio	✓	✓
Total Capital Ratio	✓	✓
Liquidity Coverage Ratio	X	✓
Net Stable Funding Ratio	X	✓
Leverage Ratio	✓	✓

The CBB has issued a second consultation paper after taking a look at the industry's suggestions. The final version of the amended Capital Adequacy (CA) Module will come into effect in January 2015. These changes are related to Pillar One (capital adequacy) of the IFSB15 and Basel III. Further changes to the rulebook will be made later on.

Box Table 5: Macroprudential Measures by CBB
Scheduled CBB Phase-in arrangements for Basel III
(Shading indicates transition periods – all dates are as of 1 January)

	2013-2014	2015	2016	2017	2018	2019	As of Jan 2020
Leverage Ratio	Basel III Reporting			Disclosure starts	Migration to Pillar 1		
Minimum Common Equity Capital Ratio	Basel III Reporting	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	Basel III Reporting	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Phase-in of deductions from CET1(including amounts exceeding the limit for DTAs, MSRs and financials)*		20%	40%	60%	80%	100%	100%
Minimum Total Capital plus conservation	Basel III Reporting	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2015					
Liquidity coverage ratio (phase-in)	Basel III Reporting	Introduce minimum 60% ratio	Introduce minimum 70% ratio	Introduce minimum 80% ratio	Introduce minimum 90% ratio	100% LCR	
Net stable funding ratio	Basel III Reporting					Introduce minimum standard	

Countercyclical and SIBs Buffers are not mentioned in this chart
*Deferred Tax Assets, Mortgage Servicing Rights and investments in financial institutions.

3.3 Conventional Wholesale Banks

Decrease in capital adequacy[6]

As at end-September 2014, the regulatory capital adequacy ratio for locally-incorporated wholesale banks was 21.3%, a decrease from the 21.6% registered in March 2014. The core capital ratio (ratio of Tier 1 capital to risk-weighted assets) decreased to 18.4% in September 2014 from the 18.7% registered in March 2014. On the other hand, the leverage ratio (ratio of assets over capital) showed an increase of 0.2% from the 6.0% registered in March 2014 to 6.2% in September 2014. The ratio of non-performing loans (NPLs) net of provisions to capital decreased from 2.3% in March 2014 to 1.8% over the same period which is attributed to the decrease in non-performing loans.

Table 3-8: Capital Provisions Ratios for Local Conventional Wholesale Banks

Indicator	Mar. 2014	Sept. 2014
Capital Adequacy Ratio	21.6	21.3
Tier 1 Capital Adequacy Ratio	18.7	18.4
Leverage (Assets/capital)(times)	6.0	6.2
NPL's net of prov. to capital	2.3	1.8

Source: Central Bank of Bahrain

Decrease in non-performing loans of wholesale banks

As at end-September 2014, loans classified as non-performing dropped to 5.8%. The NPLs of *Locally-incorporated wholesale banks* remained the same at 3.8%. In contrast, *overseas wholesale* banks witnessed a decrease in NPLs from 9.0% to 7.5% over the same period. Specific provisions as a proportion of NPLs witnessed an increase from 66.1% in March 2014 to 72.6% in September 2014. The net NPLs decreased from 2.5% in March 2014 to 1.7% in September 2014.

Table 3-9: NPL Figures for Conventional Wholesale Banks

Indicator	Mar. 2014	Sept. 2014
NPL's (% Gross)	6.8	5.8
NPL's Local Banks	3.8	3.8
NPL's Overseas Banks	9.0	7.5
Specific provisions (% of NPLs) *	66.1	72.6
Net NPLs (% of net loans)	2.5	1.7

Source: Central Bank of Bahrain

** Specific provisions as a percentage of NPL's are calculated as specific provisions divided by gross impaired loans minus interest in suspense.*

[6] 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.

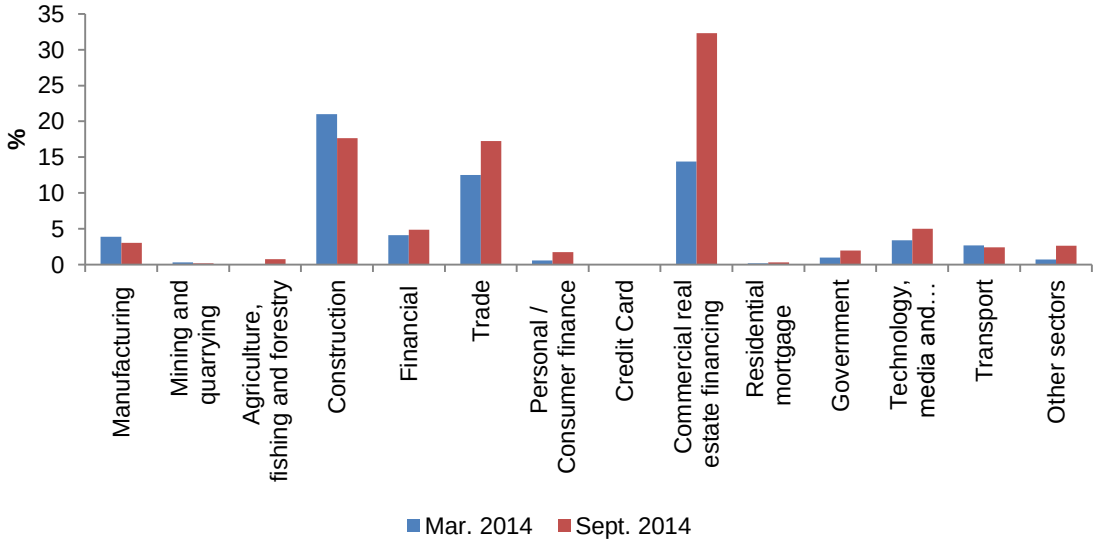
Available data on the sectoral breakdown of impaired loans shows that impairment in the "commercial real estate financing" was the highest between all sectors at 24.3% followed by the "Construction" sector with an impairment of 17.6%. The biggest increases were in the "Commercial real estate financing" sector which increased by 9.9% followed by "Trade" which increased by 3.8%. The largest decrease in impairment were found in the "Construction" sector which decreased by 3.4%.

Table 3-10: Conventional Wholesale Banks' Impaired Loan Ratios by Sector (% of gross loans to sector)

	Mar. 2014	Sept. 2014	Change %
Manufacturing	3.9	3.1	-0.8
Mining and quarrying	0.3	0.3	0
Agriculture, fishing and forestry	0.0	0.8	0.8
Construction	21.0	17.6	-3.4
Financial	4.1	4.5	0.4
Trade	12.5	16.3	3.8
Personal / Consumer finance	0.6	1.8	1.2
Credit Card	0.0	0.0	0
Commercial real estate financing	14.4	24.3	9.9
Residential mortgage	0.2	0.3	0.1
Government	1.0	2.0	1
Technology, media and telecommunications	3.4	4.1	0.7
Transport	2.7	2.4	-0.3
Other sectors	0.7	3.0	2.3

Source: Central Bank of Bahrain

Chart 3-4: Conventional Wholesale Banks' Impaired Loans by Sector (% of gross loans to sector)



Source: Central Bank of Bahrain

Loan portfolios remains concentrated despite decreases in some sectors

An examination of lending patterns as at end-September 2014 shows that for *locally-incorporated wholesale banks,* the top recipient of loans remained the "Manufacturing"

sector, which accounted for 28.4% of total loans in September 2014 representing an decrease from the 29.1% in March 2014 (Table 3-10 and Chart 3-5).

Table 3-11: Distribution of Conventional Local Wholesale Banks' Lending (% total Loans)*

	Mar. 2014	Sept. 2014	Change
Manufacturing	29.1	28.4	-0.7
Mining and quarrying	2.9	3.2	0.3
Agriculture, fishing and forestry	2.5	2.3	-0.2
Construction	7.3	8.2	0.9
Financial	21.4	22.6	1.2
Trade	10.2	10.9	0.7
Personal / Consumer finance	3.5	2.0	-1.5
Credit Card	0.0	0.0	0
Commercial real estate financing	1.7	1.5	-0.2
Residential mortgage	0.7	0.8	0.1
Government	1.4	0.9	-0.5
Technology, media and telecommunications	2.3	2.1	-0.2
Transport	6.6	7.0	0.4
Other sectors	10.4	10.1	-0.3
			0
Top two recipient sectors	**50.4**	**51.0**	0.6
Real Estate/ Construction Exposure**	**9.7**	**10.5**	0.8

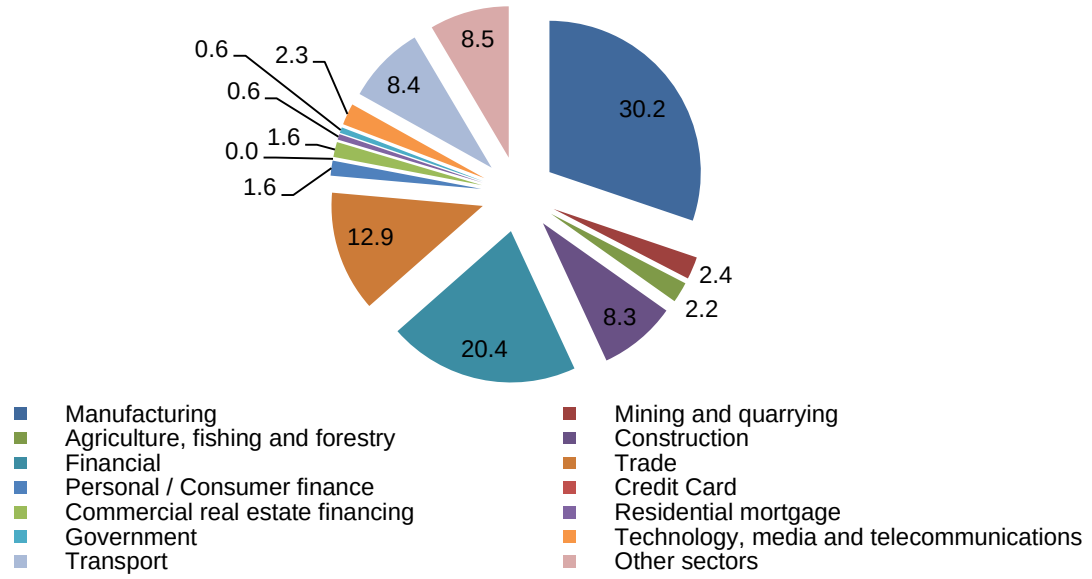
Source: Central Bank of Bahrain

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

*** Real Estate/ Construction exposure is the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

Also, the top two sectors ("manufacturing" and "financial") accounted for 51.0% of total lending in September 2014 while real estate/ construction exposure increased to 10.5% from 9.7%.

Chart 3-5: Distribution of Conventional Local Wholesale Banks' Lending (% of total loans)



Source: Central Bank of Bahrain

In *overseas wholesale banks*, the top recipient of loans in September 2014 was the "financial" sector, with 38.8% of total loans up from the 37.5% in March 2014 (Table 3-11 and Chart 3-6). The top 2 sectors (financial and other) jointly represented 57.8% in September 2014. Real estate/construction exposure increased from 8.0% in March 2014 to 8.9% in September 2014.

Table 3-12: Distribution of Conventional Overseas Wholesale Banks' Lending (% total Loans)*

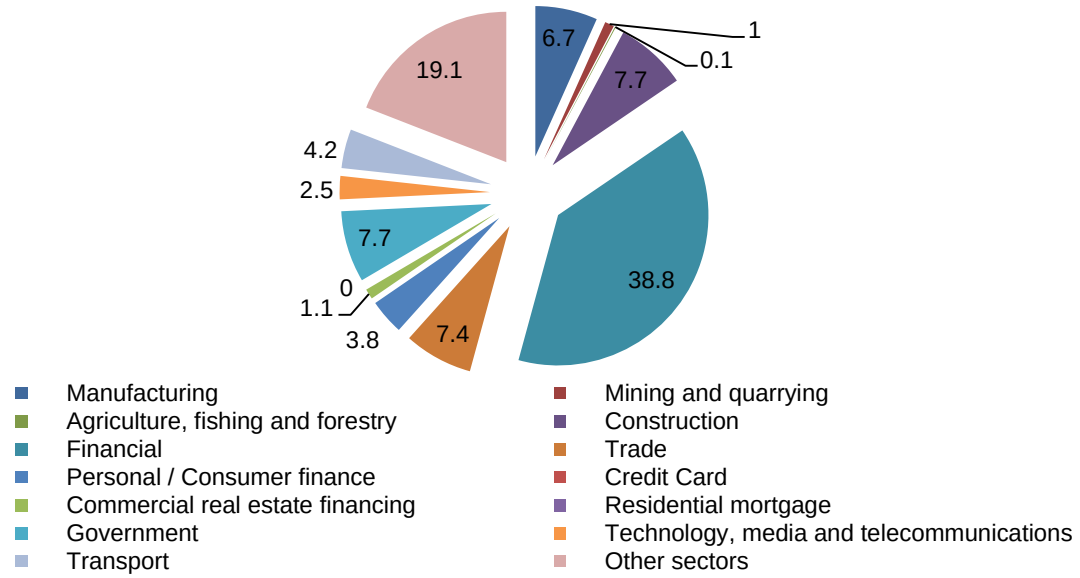
	Mar. 2014	Sept. 2014	Change
Manufacturing	8.0	6.7	(1.30)
Mining and quarrying	1.2	1.0	(0.20)
Agriculture, fishing and forestry	0.1	0.1	0.00
Construction	7.0	7.7	0.70
Financial	37.5	38.8	1.30
Trade	6.5	7.4	0.90
Personal / Consumer finance	3.7	3.8	0.10
Credit Card			0.00
Commercial real estate financing	0.0	1.1	1.10
Residential mortgage	1.1	0.0	(1.10)
Government	0.0	7.7	7.70
Technology, media and telecommunications	8.4	2.5	(5.90)
Transport	2.8	4.2	1.40
Other sectors	4.6	19.1	14.50
Top two recipient sectors	**56.6**	**57.8**	1.20
Real Estate/ Construction Exposure**	**8.0**	**8.9**	0.90

Source: Central Bank of Bahrain

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

*** Real Estate/ Construction exposure is the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

Chart 3-6: Distribution of Overseas Wholesale Banks' Lending (%)



Source: Central Bank of Bahrain

Decreased earnings for wholesale banks

ROA for the conventional wholesale banking sector was at 0.7% in September 2014, a decrease from the 1.0 in September 2013. The ROA for *local wholesale banks* decreased from 0.7% to 0.6% over the same period. ROA for overseas wholesale banks decreased from 1.2% to 0.8% over the same period.

ROE for *local wholesale banks* increased from 4.3% to 4.4%. Net interest income as a proportion of gross income increased from 49.1% to 52.3% in September 2014. Operating expenses as a proportion of gross income showed an increase from 39.9% in September 2013 to 59.3% in September 2014.

Table 3-13: Profitability of Wholesale Banks (%)

	Sept. 2013	Sept. 2014
ROA *	1.0	0.7
ROA Locally Incorporated Banks	0.7	0.6
ROA Overseas Banks	1.2	0.8
ROE**	4.3	4.4
Net interest income (% total income)	49.1	52.3
Operating expenses (% total income)	39.9	59.3

Source: Central Bank of Bahrain
**ROA = ratio of net income to assets*
***ROE = ratio of net income to tier 1 capital (for locally incorporated banks only*

Liquidity position improves

As at end-September 2014, the overall loan-deposit ratio for conventional wholesale banks stood at 70.2%, an increase from the 63.7% in March 2014. The loan deposit ratio for *local wholesale banks* increased to 69.0% in September 2014 from the 63.6% in March 2014. Over the same period, the loan deposit ratio for *overseas wholesale* bank increased from 66.4% to 71.2%.

Liquid assets for wholesale banks as a proportion of total assets increased to 19.9% in September 2014 from 19.4% in March 2014. *Locally incorporated wholesale banks* had a liquid asset ratio of 32.5% in September 2014 a increase from the 30.9% in March 2014. Overseas wholesale banks had a ratio of 7.6%, lower than the 9.8% registered in March 2014. Liquid assets as a proportion of short-term liabilities increased to 31.5% in September 2014 from 29.7% in March 2014. Lastly, the deposits from non-bank sources as a proportion of total deposits increased to 47.2% from 45.0% while bank deposits decreased from 55.0% to 47.1% over the same period.

Table 3-14: Wholesale Banks' Liquidity Profile (%)

	March 2014	Sept. 2014
Liquid Asset Ratio	19.4	19.9
Loan-Deposit Ratio	63.7	70.2
Non-Bank Deposits as a % of total deposits	45.0	47.2

Source: Central Bank of Bahrain.

3.4 Overall Assessment of the Conventional Banking Sector

The financial soundness indicators show that conventional retail banks witnessed an increase in capital adequacy ratio while conventional wholesale sectors witnessed a decline in capital positions. Capital adequacy ratios for conventional retail banks slightly increased to 18.6% in September 2014. Capital adequacy ratio for conventional wholesale banks was 20.8%. Non-performing loans have shown an improvement between periods of March 2014 to September 2014 from 3.8% to 3.3%, for conventional retail banks. As for conventional wholesale banks, loans classified as non-performing were at 5.7% in September 2014 compared to 6.8% in March 2014. Loan concentration remains high for conventional retail and wholesale banks despite some decreases in some sectors.

As at end-March 2014, return-on-assets (ROA) decreased for conventional retail banks and conventional wholesale banks to stand at 1.2% and 0.6% respectively. Return-on-equity (ROE) for conventional *locally-incorporated banks* decreased from 15.0 % in September 2013 to 11.3% in September 2014. ROE for *local wholesale banks* decreased from 4.3% to 4.0 over the same period.

For conventional retail banks, liquid assets as a proportion of total assets showed an increase over the period of March 2014 to September 2014 from 24.4% to 37.4%, respectively. Liquid assets for wholesale banks as a proportion of total assets also increased to 21.8% in September 2014 from 19.4% in March 2014.

4. Islamic Banks

Chapter 4

Key Points

- Capital positions are stable for Islamic banks with increase for Islamic retail banks and slight decrease for Islamic Wholesale banks.
- Increase in non-performing facilities (NPFs) for Islamic retail banks and small decrease for Islamic wholesale.
- Concentration of facilities for both Islamic retail banks and Islamic Wholesale Banks remains.
- Improved earnings for Islamic retail banks, with a decrease yet positive earnings for Islamic Wholesale banks.
- No major change in liquidity positions for Islamic retail and Islamic Wholesale banks.

4.1 Overview

This chapter analyzes the banking sector under the following categories: Islamic retail banks (section 4-2) and Islamic wholesale banks (section 4-3). Section 4.4 provides an overall assessment of the Islamic banking industry. Unless specified otherwise, the analysis in this chapter is based on consolidated financial data (Bahraini and non-Bahraini operations), as at end-September 2014 and compared with end-March 2014.

This chapter offers macroprudential analysis of the Islamic banking sector based on a set of selected Financial Soundess Indicators (FSIs).[7]

Annex 1 presents selected *Financial Soundness Indicators* (FSIs) for the different banking segments. Annex 2 presents selected graphs showing the development of selected indicators over time.

[7] This chapter does not contain a section on stress testing. Stress Testing exercises are performed separately in an internal report to obtain information on the potential quantitative impact of hypothetical scenarios on selected Bahraini Systemically-Important Banks (SIB's).

4.2 Islamic Retail Banks

decreases in Capital Positions

The capital adequacy ratio of Islamic retail banks decreased from 17.7% in March 2014 to 15.4% in September 2014. Tier 1 capital also decreased from 15.0% in March 2014 to 13.7% in September 2014.

Table 4-1 Capital Provisions Ratios for Islamic Retail Banks

Indicator	Mar. 2014	Sep. 2014
Capital Adequacy Ratio	17.7%	15.4%
Tier 1 Capital Adequacy Ratio	15.0%	13.7%
NPFs net of provisions to capital	26.6%	36.4%

Source: Central Bank of Bahrain

The ratio of non-performing facilities (NPFs) net of provisions to capital increased from 29.6% to 36.4% for the same period.

Slight increases in non-performing facilities

Non-performing facilities (NPFs) increased slightly to 12.6% in September 2014, compared to 12.3% in March 2014. Specific Provisoining decreased from 42.7% in March 2014 to 38.3% in September 2014.

Table 4-2: NPF Figures for Islamic Retail Banks

Indicator	Mar. 2014	Sep. 2014
NPFs (% Gross)	12.3	12.6
Specific Provisions (% of NPFs)	42.7	38.3

Source: Central Bank of Bahrain

A look at the non-performing facilities by sector indicates that the "construction" sector remains the sector with the highest impairment with 28.7% in September 2014 followed by "trade" and "manufacturing" with 23.8% and 19.2% respectively.

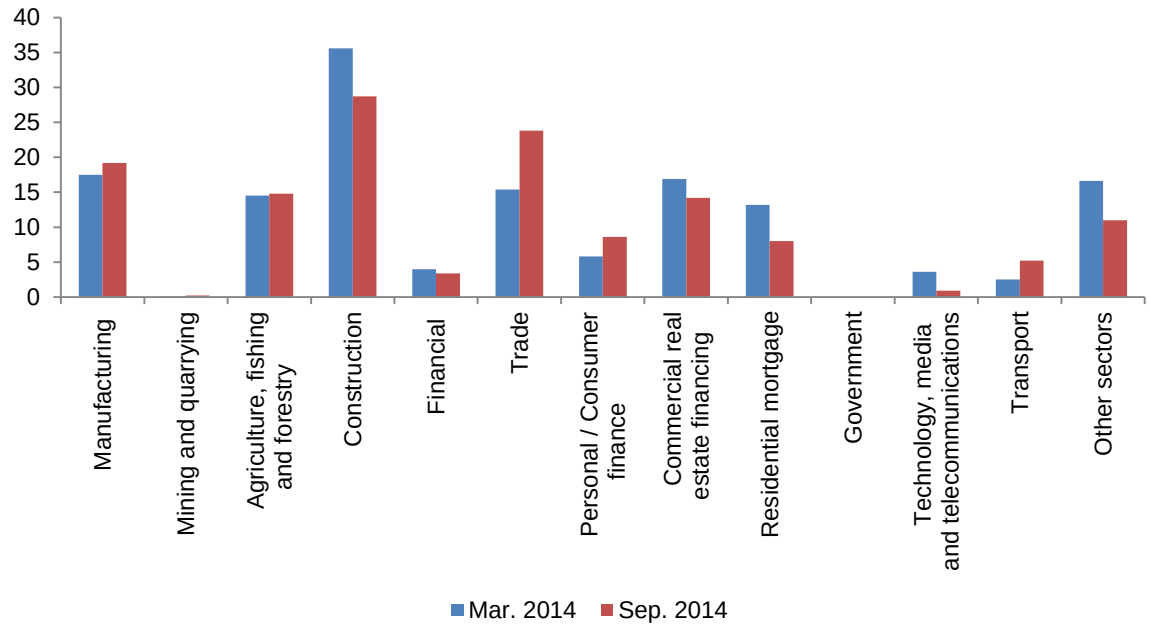
The biggest declines in NPF's by sector was in the "construction" Sector with a 6.9% decrease in NPFs from March 2014 to September 2014. The biggest increase in NPF's was the "trade" sector with an increase of 8.4%.

Table 4-3: Islamic Retail Banks' NPF Ratios by Sector (% of gross facilities per sector)

	Mar. 2014	Sep. 2014	Change
Manufacturing	17.5	19.2	1.7
Mining and quarrying	0.1	0.2	0.1
Agriculture, fishing and forestry	14.5	14.8	0.3
Construction	35.6	28.7	(6.9)
Financial	4.0	3.4	(0.6)
Trade	15.4	23.8	8.4
Personal / Consumer finance	5.8	8.6	2.8
Commercial real estate financing	16.9	14.2	(2.7)
Residential mortgage	13.2	8.0	(5.2)
Government	0.0	0.0	0.0
Technology, media and telecommunications	3.6	0.9	(2.7)
Transport	2.5	5.2	2.7
Other sectors	16.6	11.0	(5.6)

Source: Central Bank of Bahrain

Chart 4-1: Islamic Retail Bank's NPF's by Sector (% of gross facilities per sector)



Source: Central Bank of Bahrain

No significant change in asset concentration (loan portfolio)

Asset concentration has improved slightly over the past six months as Islamic retail banks have begun to slowly diversify their asset concentration. At the end of September 2014, the top recipient of financing was "personal / consumer finance", surpassing "commercial real estate financing" at 17.4% up from 15.1% in March 2014. The top two recipients of financing ("personal / consumer finance" and "commercial real estate financing") accounted for 34.3% of total facilities extended compared to 33.5% for the top two sectors in March 2014.

Moreover, the share of "Manufacturing" declined from 16.8% in March 2014 to 14.6% in September 2014.

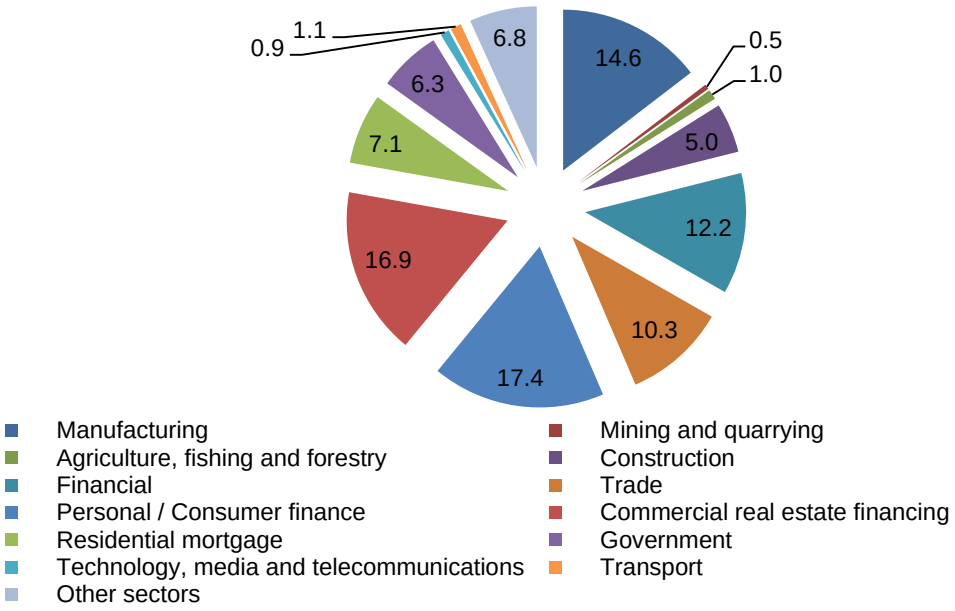
Table 4-4: Distribution of Islamic Retail Banks' Lending by Economic Activity (% of total facilities)*

	Mar. 2014	Sep. 2014	Change
Manufacturing	16.8	14.6	(2.20)
Mining and quarrying	0.6	0.5	(0.10)
Agriculture, fishing and forestry	0.9	1.0	0.10
Construction	4.8	5.0	0.20
Financial	11.1	12.2	1.10
Trade	11.0	10.3	(0.70)
Personal / Consumer finance	15.1	17.4	2.30
Commercial real estate financing	16.7	16.9	0.20
Residential mortgage	7.0	7.1	0.10
Government	7.0	6.3	(0.70)
Technology, media and telecommunications	0.5	0.9	0.40
Transport	1.0	1.1	0.10
Other sectors	7.4	6.8	(0.60)
Top two recipient sectors	**33.5**	**34.3**	**0.80**
Real Estate/ Construction Exposure**	**28.5**	**29.0**	**0.50**

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*
*** Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

On the other hand, "Real Estate/ Construction Exposure" exposure increased slightly from 28.5 % in March 2014 to 29.0% in September 2014.

Chart 4-2: Distribution of Islamic Retail Bank's Lending by Economic Activity (% of total facilities)



Source: Central Bank of Bahrain

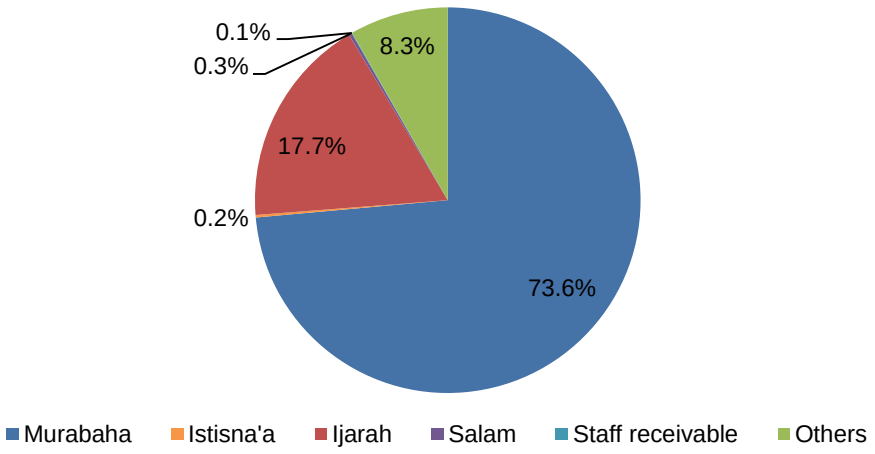
Lending distribution by Islamic instrument remained mostly stable over the past quarter. At the end of September 2014, the top recipient of finance was "Murabaha" at 73.6% in September 2014 up from 72.7% in March 2014. This was followed by "Ijarah" at 17.7% up from 17.6% in March 2014. Moreover, the share of "Salam" declined from 0.7% in March 2014 to 0.3% in September 2014.

Table 4-5: Distribution of Islamic Retail Banks' Lending by Islamic Instrument (% of total facilities)*

	Mar. 2014	Sep. 2014	Change
Murabaha	72.7	73.6	0.90
Istisna'a	0.2	0.2	0.00
Ijarah	17.6	17.7	0.10
Salam	0.7	0.3	(0.40)
Staff receivable	0.1	0.1	0.00
Others	8.8	8.3	(0.50)

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

Chart 4-3: Distribution of Islamic Retail Bank's Lending by Islamic Instrument (% of total facilities)



Source: Central Bank of Bahrain

Growing earnings

The return on assets (ROA) for Islamic retail banks increased from 0.1% in September 2013 to 0.4% in September 2014. Return on equity (ROE) increased from 1.1% in September 2013 to 3.9% in September 2014.

Table 4-6: Profitability of Islamic Retail Banks (%)

	Sept. 2013	Sep. 2014
ROA*	0.1	0.4
ROE**	1.1	3.9
Operating expenses (% gross income)	87.1	78.7

Source: Central Bank of Bahrain
* ROA = ratio of net income to assets
**ROE = ratio of net income to tier 1 capital

Slight decrease in liquidity

The volume of liquid assets available to Islamic retail banks decreased from 14.1% of total assets in March 2014 to 13.5% in September 2014. The ratio of total facilities to deposits increased from 79.2% in March 2014 to 81.3% in September 2014.

Table 4-7: Liquidity Measures for Islamic Retail Banks

Indicator	Mar. 2014	Sep. 2014
Liquid Assets (% of total assets)	14.1	13.5
Facilities – deposits ratio (%)	79.2	81.3

Source: Central Bank of Bahrain

4.3 Islamic Wholesale Banks

Slight decline in capital positions

As at end-March 2014, the CAR for Islamic wholesale banks slightly declined from 24.7% in March 2014 to 24.3% in September 2014. Tier1 capital similarly decreased from 23.7% to 22.8% over the same period. The ratio of NPFs net of provisions to capital had a minor decline to reach 3.5%.

Table 4-8 Capital Provisions Ratios for Islamic Wholesale Banks

Indicator	Mar. 2014	Sept 2014
Capital Adequacy Ratio	24.7	24.3
Tier 1 Capital Adequacy Ratio	23.7	22.8
NPFs net of provisions to capital	3.6	3.5

Source: Central Bank of Bahrain

Decrease in non-performing facilities (NPFs)

As at end-March 2014, NPFs for Islamic wholesale banks decreased to 5.0% in September 2014 from 5.1% in March 2014. Provisioning for NPF's decreased from 75.5% to 75.3% over the same period.

Table 4-9: NPF Figures for Islamic Wholesale Banks

Indicator	Mar. 2014	*Sept 2014*
NPFs (% Gross)	5.1	5.0
Specific Provisioning (% of NPFs)	75.5	75.3

Source: Central Bank of Bahrain

The sector with the highest impairment was the "Technology, media and telecommunications" sector with 52.0% in September 2014, up from the 48.6% in March 2014. This was followed by the "Agriculture, fishing and forestry" and "Construction" sectors.

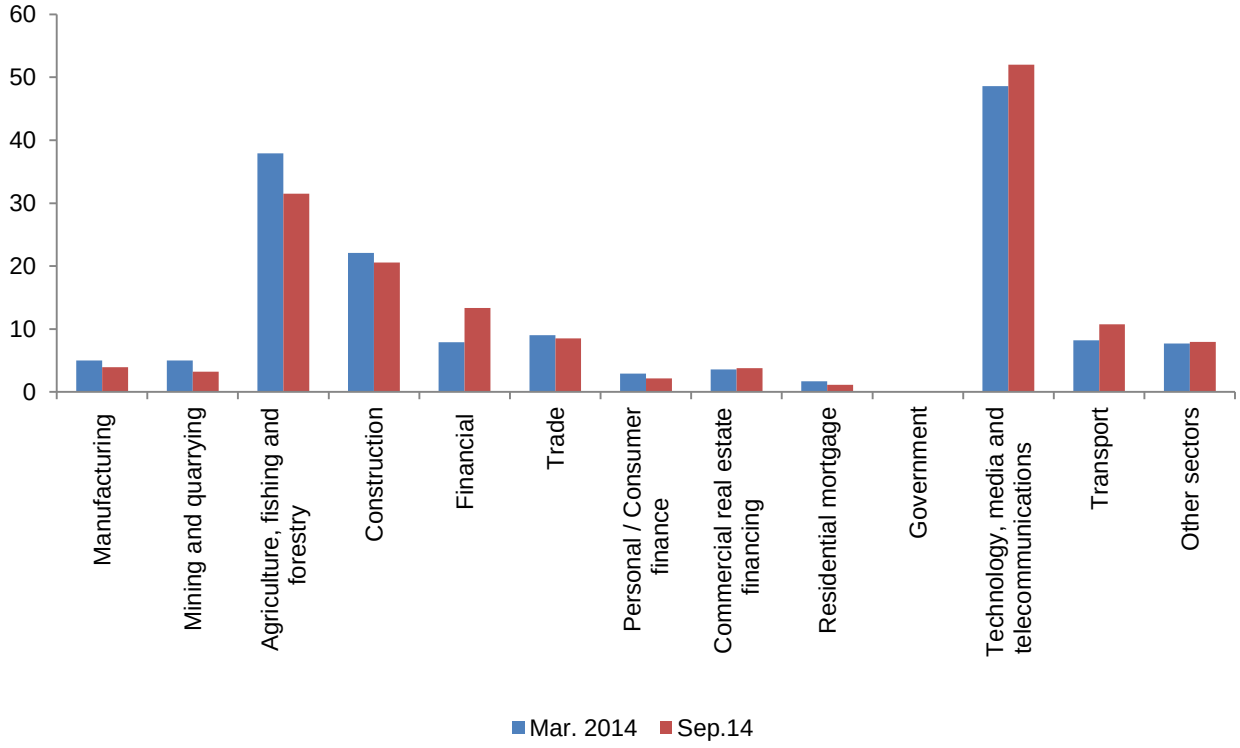
Available data on the sectoral breakdown of non-performing facilities shows that the biggest drop was in the Agriculture, fishing and forestry sector with a decrease of 6.4% from 37.9% in March 2014 to 31.5.1% in September 2014. The biggest increase was in the "financial" sector with an increase of 5.4%.

Table 4-10: Islamic Wholesale Banks' NPF Ratios by Sector (% of gross facilities per sector)

	Mar. 2014	Sept 2014	Change
Manufacturing	5.0	3.9	(1.1)
Mining and quarrying	5.0	3.2	(1.8)
Agriculture, fishing and forestry	37.9	31.5	(6.4)
Construction	22.1	20.6	(1.5)
Financial	7.9	13.3	5.4
Trade	9.0	8.5	(0.5)
Personal / Consumer finance	2.9	2.2	(0.7)
Commercial real estate financing	3.6	3.8	0.2
Residential mortgage	1.7	1.2	(0.5)
Government	0.0	0.0	0.0
Technology, media and telecommunications	48.6	52.0	3.4
Transport	8.2	10.7	2.5
Other sectors	7.7	7.9	0.2

Source: Central Bank of Bahrain

Chart 4-4: Islamic Wholesale Bank's NPF's by Sector (% of gross facilities per sector)



Source: Central Bank of Bahrain

Asset concentration remains high in some sectors

At end-September 2014, the "manufacturing" sector remained the top recipient of financing from Islamic wholesale banks, at 24.7%, surpassing "construction" at 16.3%. A noticeable

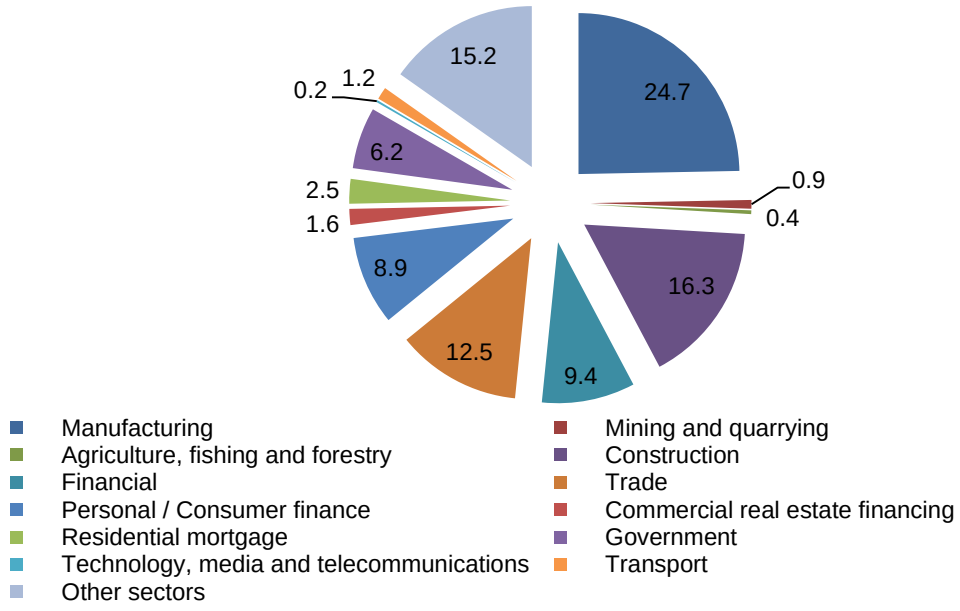
decrease in financing was in the financial Sector which decreased from 16.6% in March 2014 to 9.4% in September 2014.

Table 4-11: Distribution of Islamic Wholesale Banks' Lending by Economic Activity (% total facilities)*

	Mar. 2014	Sept. 2014	Change
Manufacturing	19.3	24.7	5.40
Mining and quarrying	0.6	0.9	0.30
Agriculture, fishing and forestry	0.4	0.4	0.00
Construction	15.3	16.3	1.00
Financial	16.6	9.4	(7.20)
Trade	12.9	12.5	(0.40)
Personal / Consumer finance	8.3	8.9	0.60
Commercial real estate financing	1.7	1.6	(0.10)
Residential mortgage	2.2	2.5	0.30
Government	7.3	6.2	(1.10)
Technology, media and telecommunications	0.2	0.2	0.00
Transport	1.7	1.2	(0.50)
Other sectors	13.5	15.2	1.70
Top two recipient sectors	**35.9**	**41.0**	**5.10**
Real Estate/ Construction Exposure**	**19.2**	**20.4**	**1.20**

Source: Central Bank of Bahrain
**Figures may not add to a hundred due to rounding*
*** Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*

Chart 4-5: Distribution of Islamic Wholesale Banks's Lending (% of total facilities)



Source: Central Bank of Bahrain

The top two recipient sectors in September 2014 ("manufacturing" and "construction") jointly represented 41.0% of total financing, up from 35.9% in March 2014. Real estate/ construction exposure increased from 19.2% in March 2014 to 20.4% in September 2014.

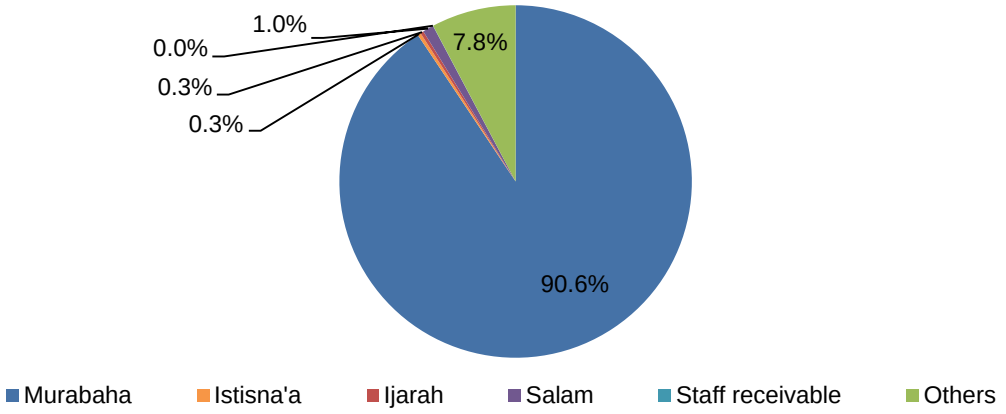
Lending distribution by Islamic instrument shows that at the end of September 2014, the top recipient of finance was "murabaha" at 90.6% up from 89.9% in March 2014.

Table 4-12: Distribution of Islamic Wholesale Banks' Lending by Islamic Instrument (% of total facilities)*

	Mar. 2014	Sep. 2014	Change
Murabaha	89.9	90.6	0.70
Istisna'a	0.3	0.3	0.00
Ijarah	0.4	0.3	(0.10)
Salam	1.1	1.0	(0.10)
Staff receivable	0.0	0.0	0.00
Others	8.3	7.8	(0.50)

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

Chart 4-6: Distribution of Islamic Wholesale Bank's Lending by Islamic Instrument (% of total facilities)



Source: Central Bank of Bahrain

Decrease in earnings

The earnings performance of Islamic wholesale banks declined over the period from September 2013 to September 2014. Return on assets (ROA) decreased from 0.6 % in Sept 2013 to 0.5 in September 2014s. Similarly, return on equity (ROE) dropped from 3.6% to 3.5% over the same period.

It should be noted however that operating expenses (as % of gross income) increased from 56.7% in September 2013 to 59.6 in September 2014.

Table 4-13: Profitability of Islamic Wholesale Banks (%)

	June 2013	June 2014
ROA*	0.6	0.5
ROE**	3.6	3.5
Operating expenses (% gross income)	56.7	59.6

Source: Central Bank of Bahrain
* ROA = ratio of net income to assets
**ROE = ratio of net income to tier 1 capital

Liquidity position improves slightly

As at end- September 2014, liquid assets of Islamic wholesale banks represented 22.8% of total assets, 0.2% higher than the 22.6% registered in March 2014. On the on the other hand, the facilities deposit ratio decreased from 67.2% to 64.7% September 2014.

Table 4-14: Liquidity Measures for Islamic Wholesale Banks

Indicator	Mar. 2014	Sept. 2013
Liquid assets (% of total)	22.6%	22.8
Facilities-deposit ratio	67.2%	64.7

Source: Central Bank of Bahrain

4.4 Overall Assessment of the Islamic Banking Sector

The financial soundness indicators show that Islamic retail banks and wholesale banks' capital positions decreased during the period between March 2014 and September 2014 reaching 15.4% and 24.3% respectively.

Non-performing facilities increased for Islamic retail to reach to reach 12.6% while it decreased slightly for Islamic wholesale banks to reach 5.0% Facilities concentration has decreased in some sectors in retail Islamic banks and wholesale Islamic banks.

The earnings picture looks better for Islamic retail banks with an increase in ROA and ROE, but a minor decrease for Islamic Wholesale banks.

Islamic retail banks experienced a minor change in its liquidity position as the liquid asset ratio decreased slightly while the facilities to deposit ratio had a small increase. Islamic wholesale's liquidity positions showed a minor increase in liquid assets increased while facilities to deposit ratio decreased.

Part III:

Developments in the Equity Market and Payment Systems

5. Performance of Equity Market

Chapter 5

Key Points

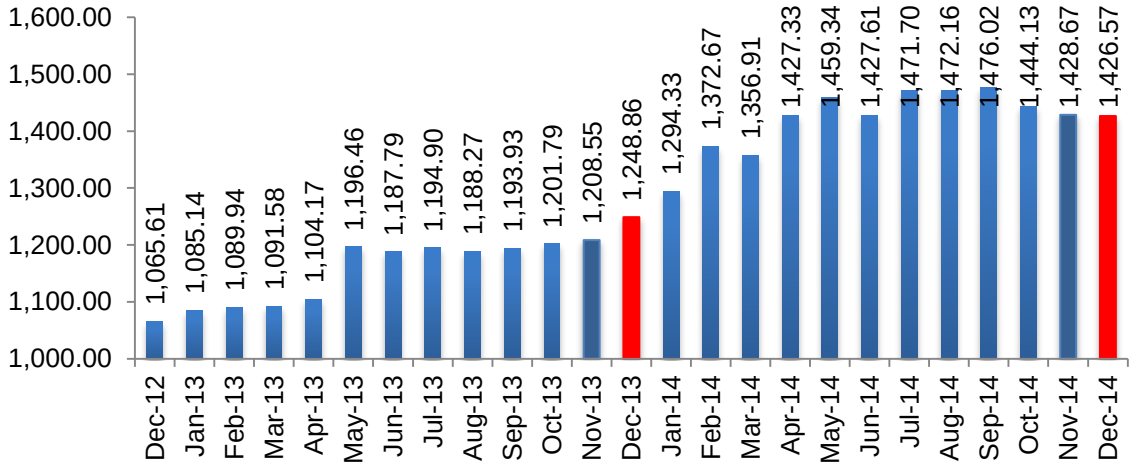
- Increase in the Bahrain All Share index
- Year-on-year growth in market capitalization
- Year-on-year growth in price-earnings ratio
- GCC indices decline amid decreasing oil price

5.1 Bahrain Market Trends

Increase in market index

A look at *year-on-year* data shows that the Bahrain All Share Index increased by 177.71 points (14.2%) between December 2013 and December 2014 (Chart 5-1). The index experienced steady increases from November 2013 to February 2014. However, the index experienced a slight dip in May 2014. The Bahrain all share index stabilized in the lower bounds of around 1400 points by December 2014 after reaching its peak in September 2014 at 1476.02 points. With growing business and investors' optimism and planned government project expenditure, the index is likely to grow positively over the upcoming period.

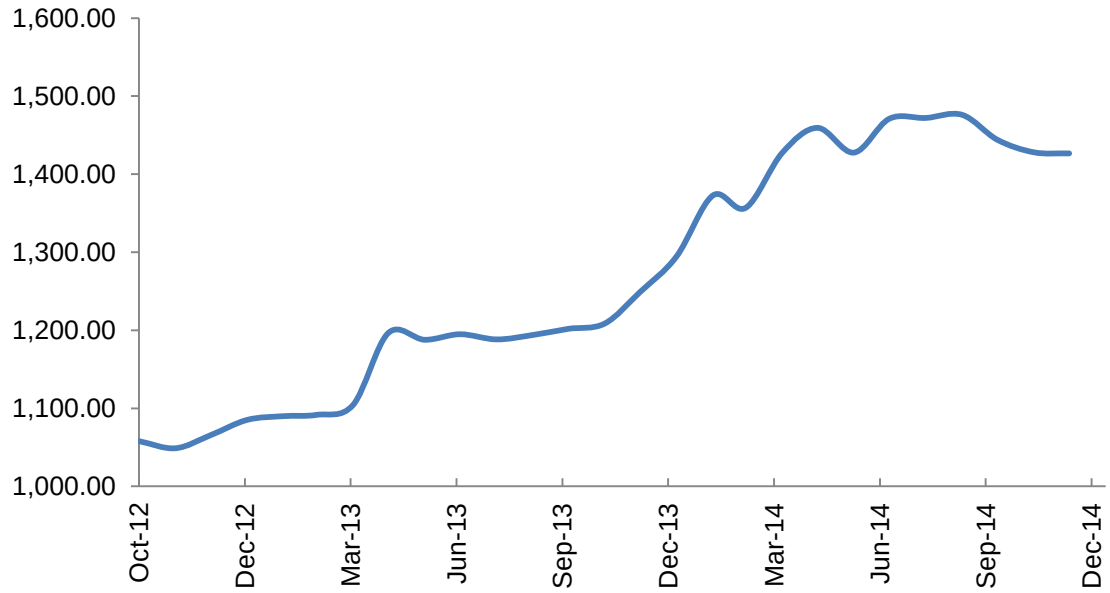
Chart 5-1: Recent Trends in the Bahrain All-Share Index, Dec 2012-Dec2014



Source of Data: Bahrain Bourse

Looking at the overall performance of the Bahrain All Share index since December 2012 (Chart 5-2), the index has performed positively in the last two years. Markedly, the Bahrain All Share Index has experienced a stable increase in the period between December 2013 and December 2014, reflecting growing confidence in the Bahraini stock market.

Chart 5-2: Bahrain All-Share Index, December 2012-December 2014



Source of Data: Bahrain Bourse

Increase in market capitalization

As at end-December 2014, market capitalization of the Bahrain Bourse stood at BD 8.3 billion (Table 5-1). This level of market capitalization is 2.6% higher than the level as at end-June 2014 and 19.6% higher *year-on-year*.

Table 5-1: Market Capitalization on the Bahrain Bourse

(BD)

Sector	Dec. 2013	June 2014	Dec. 2014	June 2014-Dec. 2014 (% Change)	Dec 2013-Dec. 2014 (% Change)
Commercial banks	3,252,843,599	3,825,790,134	3,793,805,442	(0.8)	16.6
Investment	1,690,109,301	2,159,672,680	2,295,082,815	6.3	35.8
Insurance	166,687,991	174,549,943	163,878,591	(6.1)	(1.7)
Services	915,966,276	1,099,045,952	1,125,569,854	2.4	22.9
Industrial	761,544,011	647,368,316	751,120,639	16.0	(1.4)
Hotel and Tourism	175,800,031	207,494,503	197,610,963	(4.8)	12.4
Total	6,962,951,209	8,113,921,529	8,327,068,303	2.6	19.6

Source: Bahrain Bourse

A breakdown of market capitalization by sector indicates that "investment" recorded the highest *year-on-year* increase in market capitalization (35.8%) followed by "services" (22.9%) and "commercial banks" (16.6%). The "insurance" and "industrial" sectors were the only sector that witnessed a year on year decrease in market capitalization.

Increase in price-earnings ratios

As December 2014, the price-earnings ratio (P-E ratio) for the stock market stood at 10.41, an increase from the 10.07 attained last year in December 2013 and the 10.29 in June 2014. The "services" sector witnessed the highest increase in the P-E ratio between December 2013 and December 2014 followed by the "industrial" sector. The "commercial banks" and "insurance" sectors witnessed decreases in the Price-Earnings ratio over the same period.

Table 5-2: Price-Earnings Multiples

Sector	Dec. 2013	June 2014	Dec. 2014
Commercial banks	12.56	10.79	10.63
Investment	8.19	9.15	9.47
Insurance	12.55	10.13	9.50
Services	9.49	13	12.87
Industrial	7.69	7.95	9.22
Hotel and Tourism	11.92	12.88	12.26
Total Market	10.07	10.29	10.41

Source: Bahrain Bourse

The bulk of the value of shares traded in December 2014 was the "services" sector whose traded shares (by value) represented 47.7% of total shares traded up from 6.5% in June 2014. The "commercial banks" sector represented 42.0% of the total value of shares traded in December 2014 down from 76.2% in June 2014 (Table 5-3).

Table 5-3: Value of Shares Traded by Sector (% shares of total value traded)*

Sector	Dec. 2013	June 2014	Dec. 2014
Commercial banks	68.5	76.2	42.0
Investment	19.4	10.2	0.0
Insurance	0.0	0.3	0.0
Services	9.3	6.5	47.7
Industrial	2.6	1.7	6.0
Hotel and Tourism	0.2	4.9	2.4

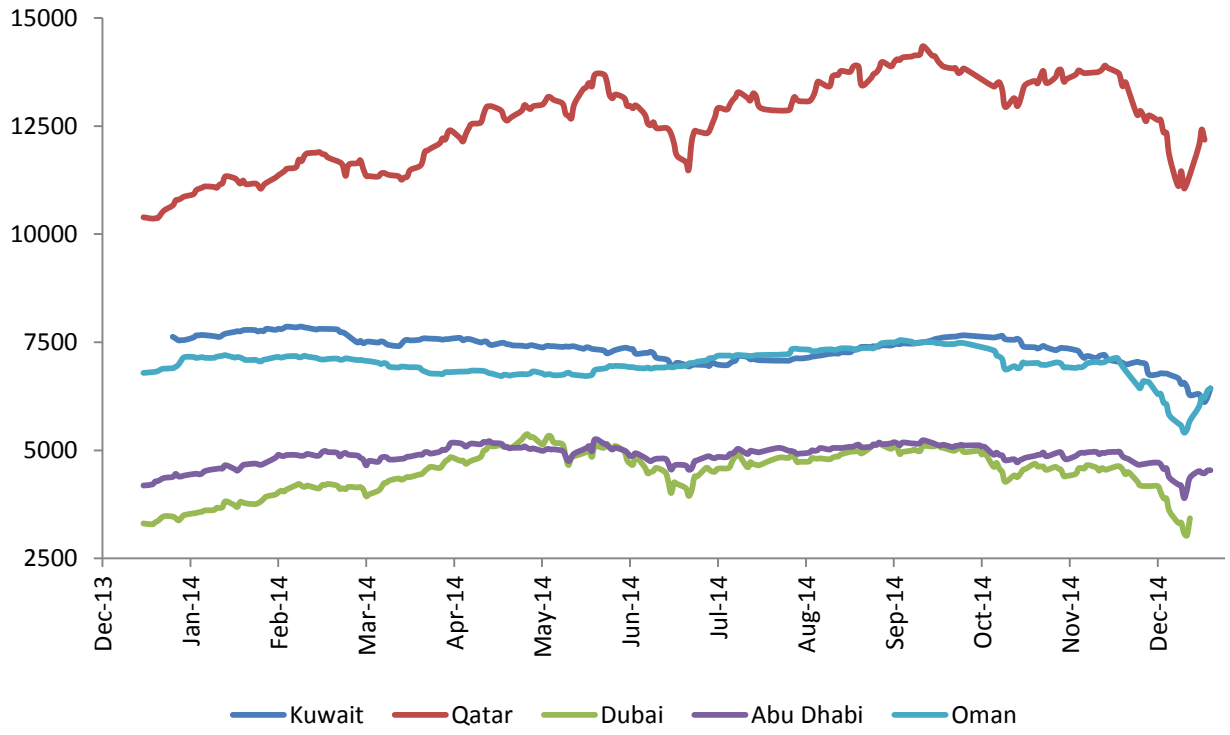
**Figures may not add to a hundred due to rounding*
Source: Bahrain Bourse

5.2 GCC Market Trends

The GCC Markets performed very well in the first two quarters of 2014, supported by steady production over the GCC countries and high oil prices. Accommodative monetary policy in

the GCC countries given its peg to the US dollar and expansionary fiscal policy that materialized through major investment projects (especially in the non-oil sector) reinforced investors' sentiments and business confidence. The Dubai stock market soared after UAE's success of winning the right to host the World Expo in 2020. Local firms are expected to initiate major projects in anticipation to host the World Expo of 2020. The real estate market and the tourism sector as well continued to contribute positively to the UAE markets.

Chart 5-3: GCC Indices Dec 2013 – Dec 2014



Sources: Bloomberg

However, as the price of oil starting to decline (reaching a five-year low in December 2014) in the second half of 2014, GCC markets and indices, given their exposure to oil prices, started to tumble. Dubai Stock market index dropped by 23% over the last six months, while Kuwaiti and Saudi Arabia stock markets fell by 14.7% and 10.4% and stock markets of Qatar and Bahrain declined by 9% and 1.7% respectively (Table 5-5). Nonetheless, most economists believe that the GCC countries have built up strong reserves over the years to support fiscal spending and keep the economies strong, in spite of declining oil prices.

Table 5-4: Stock Market Indices in GCC counties

Index	Dec-13	Jun-14	Dec-2014*	June 2014- Dec. 2014 (%)	Dec. 2013-Dec. 2014 (%)
Bahrain All Share Index	1,248.8	1,427.6	1,403.2	(1.70)	12.40
Tadawul All Share Index	8,301.1	9,864.6	8,410.9	(14.70)	1.30
Kuwait Market Index	7,741.6	7,321.1	6,562.7	(10.40)	(15.20)
Qatar Exchange Index	10,396.3	13,696.9	12,339.8	(9.90)	18.70
Dubai Financial Market Index	2,987.1	5,056.3	3,882.9	(23.20)	30.00
Abu Dhabi Index	3,986.1	5,157.6	4,582.9	(11.10)	15.00
Muscat Securities Market Index 30	6,767.6	6,890.7	6,059.1	(12.10)	(10.50)

Sources: Bahrain Bourse, Saudi Stock Exchange (Tadawul), Kuwait Stock Exchange, Qatar Exchange, Dubai Financial Market, Abu Dhabi Securities Exchange, and Muscat Securities Market.

5.3 Overall assessment of the equity market

The performance of the Bahrain All Share Index has been upwardly trending with a 14.2% year-on-year growth in the Index and a 9.5% year-on-year increase in market capitalization. Bahrain market capitalization increased by 1.9% compared to June 2014. With few exceptions, most sectors of the economy exhibited a year on year increase in the price-earnings ratio reflecting strong corporate earnings and improved conditions.

In the GCC equity markets, however, the indices have been temporarily decreasing given the declining oil price. Markets in the GCC are very sensitive to oil price fluctuations. The oil price has reached a five-year low in December 2014, hovering around $65 per barrel. The overall market conditions should improve over the medium term, however, propped up by government spending on various infrastructure projects.

6. Payments and Settlements Systems

Chapter 6

Key Points

- The various components of Bahrain's payments and settlement framework continue to function efficiently.
- Retail payments include cheques, credit transfers, and debit and credit card transactions.
- Year-on-year decrease in the volume and increase in value of cheques processed through the ACS.
- Year-on-year rise in value and the number of ATM withdrawals.
- The availability of cash has increased over the past decade due to growing number of ATMs.
- Year-on-year increase in volume and decrease in value of transfers through the RTGS.

6.1 Overview

Payments 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.

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 Scriptless Securities Settlement System (SSSS); and v) the clearing, settlement and depository system for the Bahrain Bourse. Bahrain's payments and settlement framework continue to function efficiently. The RTGS in particular remains a robust framework for processing retail and wholesale payments in Bahrain. The launch of the ACS was a milestone to the Bahraini financial sector which raised efficiency and customer services. This section describes recent trends in the retail and wholesale payments system.

6.2 Retail Payments

In the Kingdom of Bahrain, households can carry out their cash and non-cash transactions with a wide range of instruments of payment. Cash payment instruments are basically based on paper money and coins. It is the most popular instrument in Bahrain and it is based on face-to-face or hand-on-hand operation. Non-cash payment instruments include: cheques, credit transfer, debit transfer and debit and credit cards. In this section we show the evolution of retail payment transactions based on paper money and e-payment channels.

6.2.1 Cheques and paper based instruments

Cheques are seen as the most popular instrument in use among non-banks in all types of payments. With the increasing usage of electronic means of payments, in particular debit cards and credit cards, the use of cheques in the Kingdom of Bahrain decreased drastically. Cheques are still used for retail and large-value payments in virtually all the national payments systems in the Kingdom and remain the principal instrument for large-value payments.

In 2013, the CBB has decided to improve the use of cheques in order to reduce their related risks. Therefore, it launched a new cheque clearing system based on the electronic transmission of images and payment information. The new procedure replaced the common paper-based procedure on May 2012. The Bahrain Cheque Truncation System (BCTS) was commenced in cooperation with the BENEFIT Company (BENEFIT) which also operates Bahrain's ATM service and point-of-sale systems. The Automated cheque clearing system (ACS) replaced the old paper based cheque clearing system in Bahrain. The main feature of the ACS is that it speeds up the clearing process and customers could process cheques on the same day.

Year on year decrease in average daily volume and increase in value of cheques through ACS

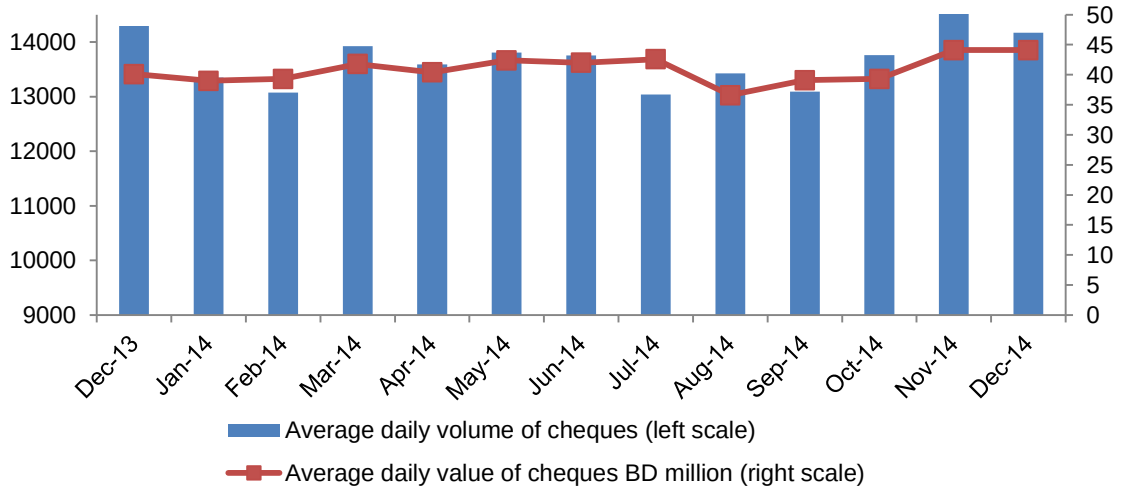
In the period between June 2014 and December 2014, the average daily volume of cheques processed through the Automated Cheque Clearing System (ACS) increased by 3.0% from 13,754 to 14,168 (year-on-year decrease of 0.9%) (Chart 6-1). The average daily value of cheques increased by 5.0% from BD 42.0 million in June 2014 to BD 44.1 million in December 2014 (year-on-year increase of 10.0%).

The average daily volume kept fluctuating from July 2014 until December 2014; however the biggest increase was by 7.4% in November 2014. The average daily volume reached its peak in November 2014 at 14,775 average daily transactions. The average daily volume had a drop in July 2014 by 5.2%.

The average daily value of cheques was mostly growing between July 2014 and December 2014. The highest value of cheques cleared was seen in November and December 2014 both by BD 44.1 million whereas the lowest value of cleared cheques occurred in August 2014 by BD 36.6million. It has to be noted that cheques are now cleared in the Bahrain Cheque

Truncation System (BCTS), which went live on 13th May, 2012 and there is no cap on the value of cheques cleared in the BCTS.

Chart 6-1: ACS System- Average Daily Volume and Value of Payments Processed, Dec 2013-2014



Source: Central Bank of Bahrain

6.2.2 E-Payment systems

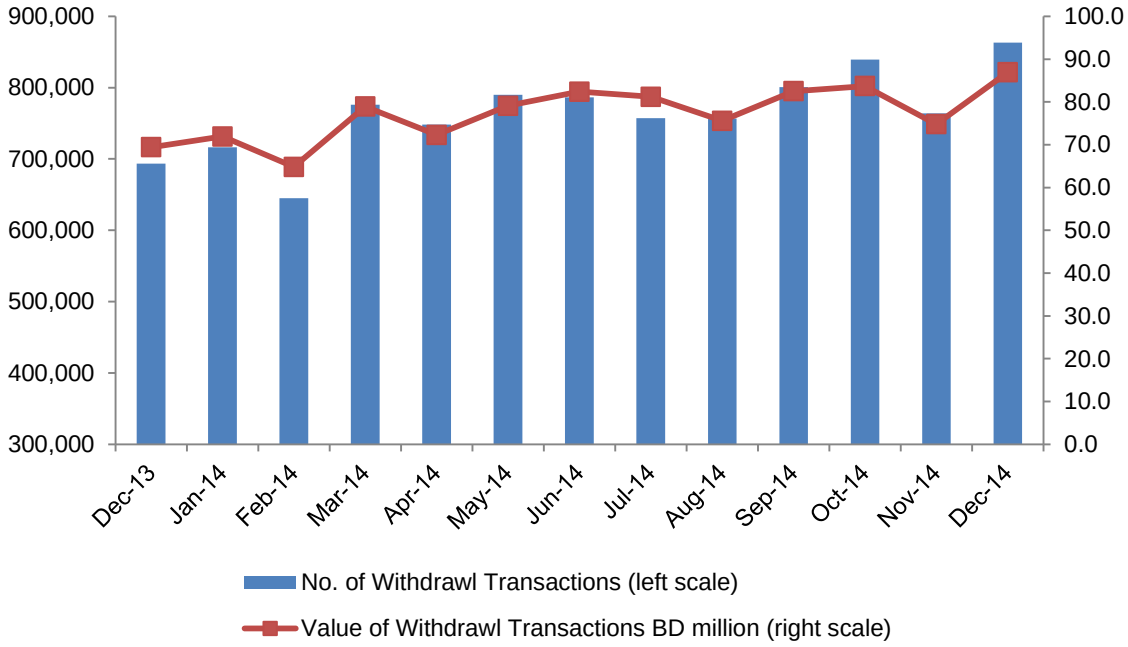
ATM clearing is based on a Deferred Net Settlement (DNS) system. The Benefit Company in Bahrain receives and processes all the ATM transactions. The GCC net, a leased line network across the GCC countries, provides for the communication backbone for the transmission of all the ATM transactions and settlement related electronic messages (source: Benefit website).

Year on year growth in number and value of ATM withdrawals

Between June 2014 and December 2014, the number of withdrawal transactions processed through the ATM Clearing System increased by 9.8% from 786,425 to 863,244 (year-on-year growth was 24.5%)(Chart 6-2). Similarly, in value terms, total withdrawals processed increased by 5.5% from BD 82.4 million to BD 86.9 (year-on-year growth was 25.2%).

There have been fluctuations in both the value and volume of transactions between June 2014 and December 2014. December 2014 witnessed the highest number of ATM withdrawals with an increase of 13.0% whereas the biggest decrease in the number of withdrawals took place in the month of July 2014 by almost 3.7%. The highest value of withdrawals was witnessed in December 2014 by BD 86.9 million and the lowest value of withdrawals in November 2014 by BD 74.8 million.

Chart 6-2: Number and Value of ATM Transactions, Dec 2013- Dec 2014



Source: The Benefit Company

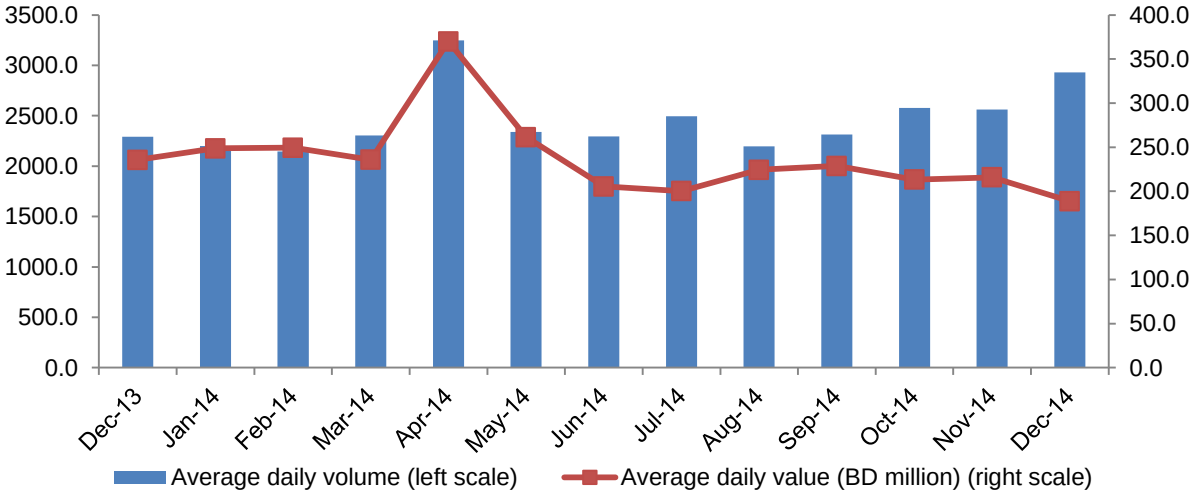
With the widespread use of internet and mobile services in Bahrain, another payment solution was introduced by banks. Nowadays, Bahraini household started paying their bill online (e-bill) with both internet and mobile bill. Moreover, the government of Bahrain encouraged the use of internet ICT tools in all the government services. It launched the e-government portal which includes the most important services. In addition to the development of e-banking and internet banking, a number of banks in Bahrain offer mobile banking services to their customers. The purpose is to receive regular information on their balances accounts and their current transactions.

6.3 Wholesale Payments

Year on Year Increase in volume and decrease in value of payments through RTGS

In Bahrain, wholesale transaction are made though the Real Time Gross Settlement (RTGS), which hinges on (real-time) which settles fund transfers, on solo basis when an order arises (without netting). The major difference is that it takes orders on spot rather than later. The RTGS is Bahrain's dedicated system for processing large-value, inter-bank payments. However, the RTGS also processes small-value retail payments for bank customers. The volume and value of payments passing through the RTGS system between December 2013 and December 2014 is seen in Chart 6-4 below.

Chart 6-3: RTGS System- Average Daily Volume and Value of Payments Processed, Dec 2013 – Dec 2014



Source: Central Bank of Bahrain

Between June 2014 and December 2014, the *average daily volume of transfers* increased by 27.7% from 2,294.8 to 2929.7 (27.8% year-on-year increase). In value terms, the *average daily value of transfers* witnessed an 8.1% decrease from BD 205.5 million in June 2014 to BD 188.9 million in December 2014 (19.9% year-on-year decrease).

Annex:

Financial Soundness Indicators
Selected Graphs

Annex 1: Financial Soundness Indicators

Annex1 Table 1:
Selected Financial Soundness Indicators—Conventional Retail Banks

(End of period)

	Sep-13	Mar-14	Sep-14
Capital Adequacy			
Total capital adequacy ratio (%) *	18.5	18.3	18.6
Tier 1 capital adequacy ratio (%) *	14.3	15.7	15.0
Leverage (assets/capital)(times)*	8.3	8.6	8.3
Non-performing loans net provisions to capital ratio (%)*	9.2	8.9	8.9
Asset Quality			
Non-performing loans (% of gross loans)	4.2	3.8	3.8
Specific provisions (% of NPLs)	53.2	55.2	53.9
Net non-performing loans (% of net loans)	2.0	1.7	1.8
Loan concentration (share of top-2 sectors) (%)	30.7	29.4	30.8
Real Estate/ Construction exposure (%) **	28.4	28.6	29.9
Earnings			
ROA retail banks (%)	1.4	0.4	1.2
ROA Local Retail banks (%)	1.4	0.4	1.1
ROA Overseas Retail banks (%)	1.3	0.6	1.4
ROE Local Retail banks (%)***	15.0	4.0	11.3
Net interest income (% of gross income)	64.5	68.1	71.4
Net fees & commissions (% of gross income)	14.5	15.3	15.7
Operating expenses (% of gross income)	42.3	41.2	43.1
Liquidity			
Liquid assets (% of total assets)	26.5	24.3	16.8
Liquid assets (% of short-term liabilities)	37.7	33.5	37.4
Loan-deposit ratio (%)	62.8	64.2	65.0
Deposits from non-bank sources (% of total deposits)	78.1	73.9	73.9

** Locally-incorporated banks only*
*** Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*
**** ROE is defined as net profit over Tier 1 Capital.*
Source: Central Bank of Bahrain.

Annex1 Table 2:
Selected Financial Soundness Indicators—Conventional Wholesale Banks

(End of period)

	Sep-13	Mar-14	Sep-14
Capital Adequacy			
Total capital adequacy ratio (%) *	22.4	21.6	21.3
Tier 1 capital adequacy ratio (%) *	19.1	18.7	18.4
Leverage (assets/capital)(times)*	5.5	6.0	6.2
Non-performing loans net provisions to capital ratio (%)*	5.3	2.3	1.8
Asset Quality			
Non-performing loans (% of gross loans)	8.4	6.8	5.8
Specific provisions (% of NPLs)	62.8	66.1	72.6
Net non-performing loans (% of net loans)	3.4	2.4	1.7
Loan concentration (share of top-2 sectors) (%)	51.7	47.7	47.9
Real Estate/ Construction exposure (%) **	9.6	8.8	9.6
Earnings			
ROA retail banks (%)	1.0	0.5	0.7
ROA Local Wholesale banks (%)	0.7	0.4	0.6
ROA Overseas Wholesale banks (%)	1.2	0.6	0.8
ROE Local Wholesale banks (%)***	4.3	2.5	4.4
Net interest income (% of gross income)	49.1	35.2	58.3
Net fees & commissions (% of gross income)	22.1	37.3	26.0
Operating expenses (% of gross income)	39.9	39.3	49.5
Liquidity			
Liquid assets (% of total assets)	16.9	19.4	19.9
Liquid assets (% of short-term liabilities)	28.9	29.7	31.5
Loan-deposit ratio (%)	60.1	63.7	70.2
Deposits from non-bank sources (% of total deposits)	42.2	45.0	47.2

** Locally-incorporated banks only*
***Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total lending.*
**** ROE is defined as net profit over Tier 1 Capital.*
Source: Central Bank of Bahrain.

Annex1 Table 3:
Selected Financial Soundness Indicators—Islamic Retail Banks

(End of period)

	Sep-13	Mar-14	Sep-14
Capital Adequacy			
Total capital adequacy ratio (%) *	17.5	17.6	15.4
Tier 1 capital adequacy ratio (%) *	14.9	15.0	13.7
Leverage (assets/capital)(times)*	7.8	8.1	9.7
Non-performing facilities net provisions to capital ratio (%)*	30.8	28.6	36.4
Asset Quality			
Non-performing facilities(% of gross facilities)	13.1	12.3	12.6
Specific provisions (% of NPFs)	39.1	42.7	38.3
Net non-performing facilities (% of net facilities)	8.0	7.0	7.4
Facilities concentration (share of top-2 sectors) (%)	36.1	33.7	34.3
Real Estate/ Construction exposure (%) **	27.6	28.5	29.0
Earnings			
ROA (%)	0.1	0.1	0.4
ROE (%)***	1.1	1.2	3.9
Net income from own funds, current accounts and other banking activities (% of operating income)	63.2	75.5	73.0
Net income from jointly financed accounts and Mudarib fees (% of operating income)	27.4	16.9	18.6
Operating expenses (% of gross income)	87.1	77.2	78.7
Liquidity			
Liquid assets (% of total assets)	13.7	14.1	13.5
Facilities-deposit ratio (%)	78.2	79.2	81.3
Current accounts from non-banks (% of non-capital liabilities, excl. URIA)	22.6	24.5	24.8

** Locally-incorporated banks only*
***Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total financing.*
**** ROE is defined as net profit over Tier 1 Capital.*
Source: Central Bank of Bahrain.

Annex1 Table 4:
Selected Financial Soundness Indicators—Islamic Wholesale Banks

(End of period)

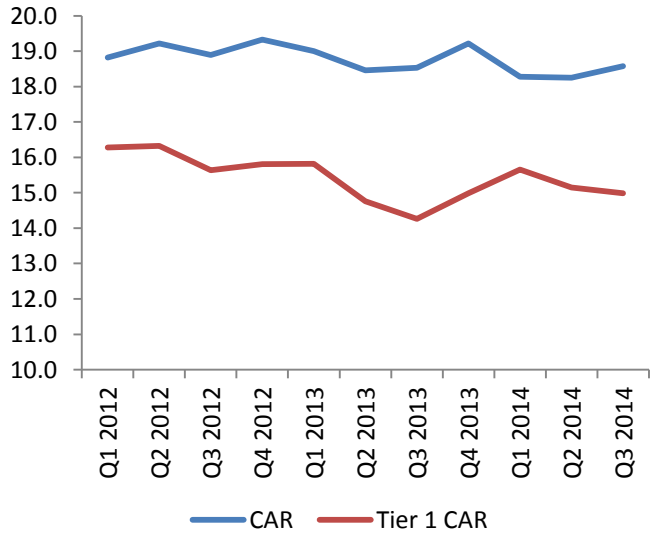
	Sep-13	Mar-14	Sep-14
Capital Adequacy			
Total capital adequacy ratio (%) *	25.0	24.7	24.3
Tier 1 capital adequacy ratio (%) *	23.6	23.7	22.8
Leverage (assets/capital)(times)*	5.8	6.2	6.2
Non-performing facilities net provisions to capital ratio (%)*	4.3	3.6	3.5
Asset Quality			
Non-performing facilities(% of gross facilities)	5.4	5.1	5.0
Specific provisions (% of NPFs)	72.8	75.4	75.3
Net non-performing facilities (% of net facilities)	1.5	1.3	1.2
Facilities concentration (share of top-2 sectors) (%)	40.0	35.8	41.0
Real Estate/ Construction exposure (%) **	16.9	19.3	20.4
Earnings			
ROA (%)	0.6	0.2	0.5
ROE (%)***	3.6	1.3	3.5
Net income from own funds, current accounts and other banking activities (% of operating income)	65.6	66.4	63.6
Net income from jointly financed accounts and Mudarib fees (% of operating income)	32.9	32.2	34.8
Operating expenses (% of gross income)	56.7	59.8	59.6
Liquidity			
Liquid assets (% of total assets)	21.1	22.4	22.8
Facilities-deposit ratio (%)	71.2	67.2	64.7
Current accounts from non-banks (% of non-capital liabilities, excl. URIA)	43.1	42.1	43.2

** Locally-incorporated banks only*
***Real Estate/ Construction exposure is calculated as the share of the Construction, Commercial real estate financing and Residential Mortgages sectors of total financing.*
**** ROE is defined as net profit over Tier 1 Capital.*
Source: Central Bank of Bahrain.

Annex 2: Selected Graphs

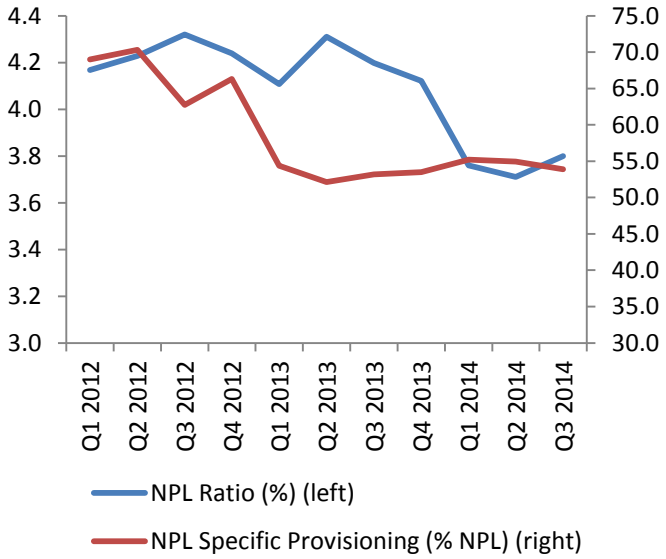
A. Conventional Retail

Annex 2 Graph 1: CAR



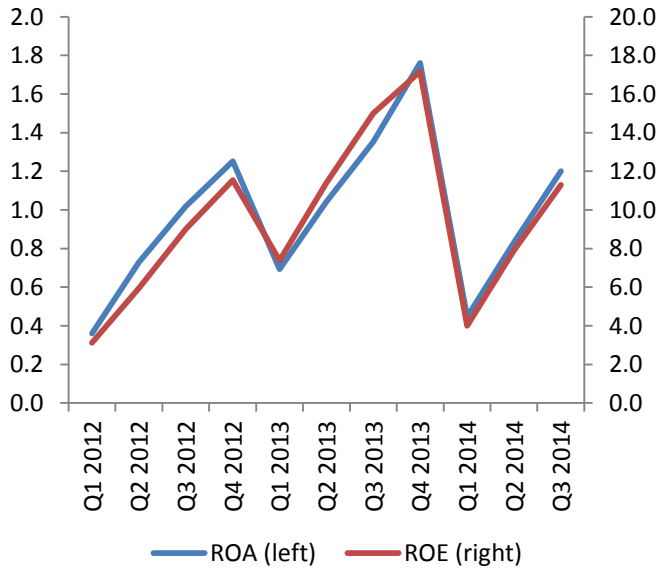
Source: Central Bank of Bahrain

Annex 2 Graph 2: NPL and Provisioning



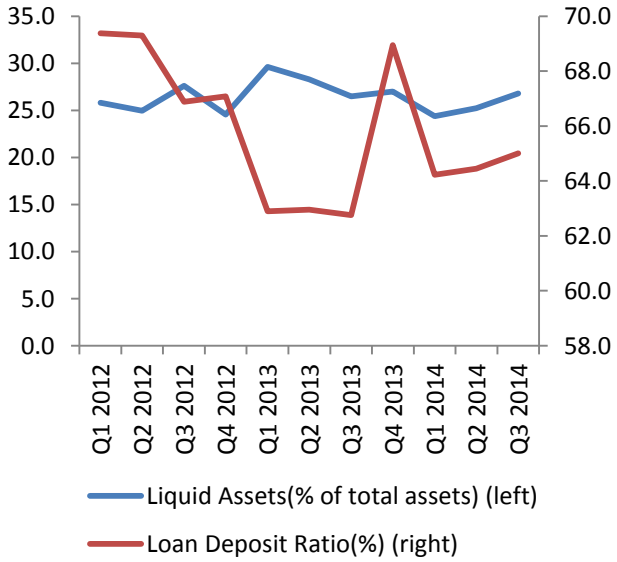
Source: Central Bank of Bahrain

Annex 2 Graph 3: Profitability



Source: Central Bank of Bahrain

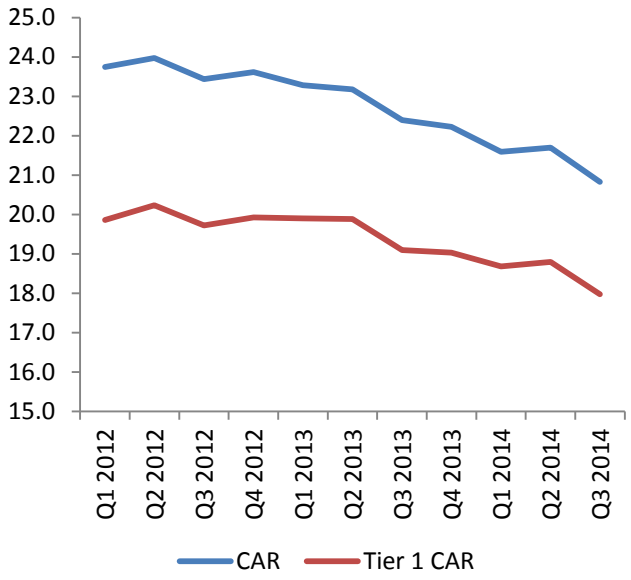
Annex 2 Graph 4: Liquidity



Source: Central Bank of Bahrain

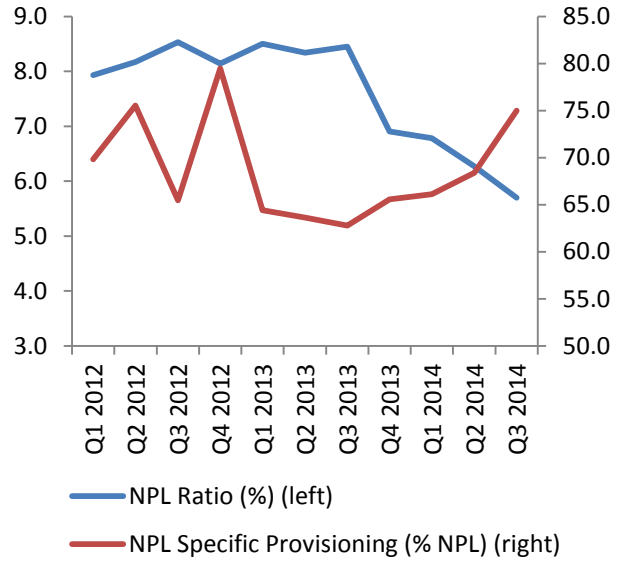
B. Conventional Wholesale

Annex 2 Graph 5: CAR



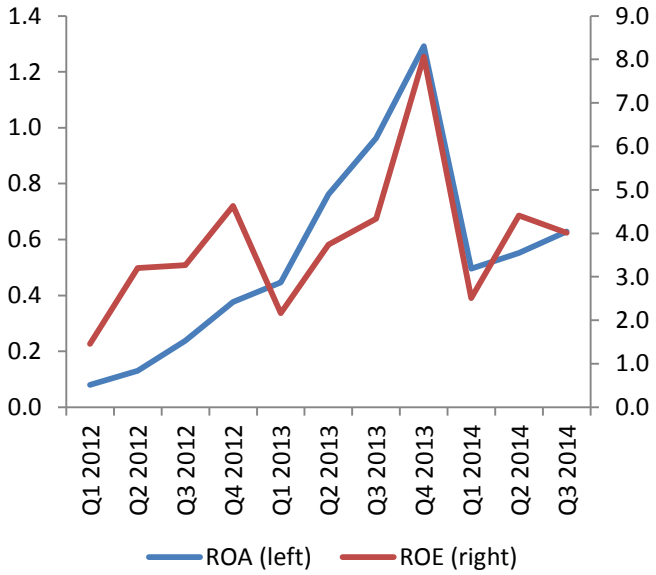
Source: Central Bank of Bahrain

Annex 2 Graph 6: NPL and Provisioning



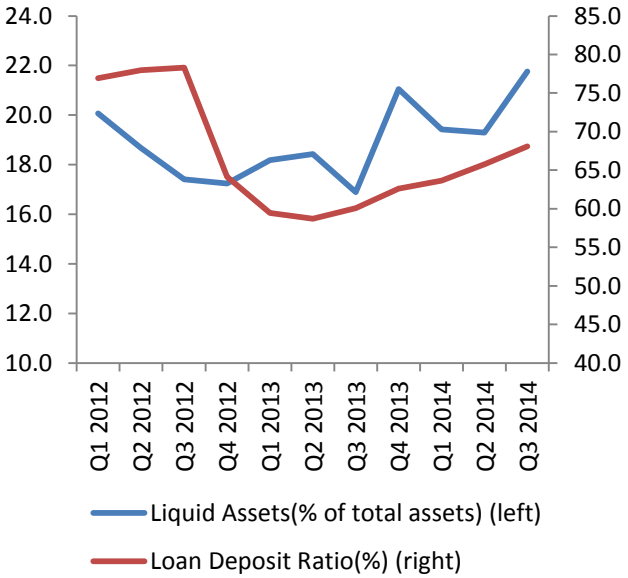
Source: Central Bank of Bahrain

Annex 2 Graph 7: Profitability



Source: Central Bank of Bahrain

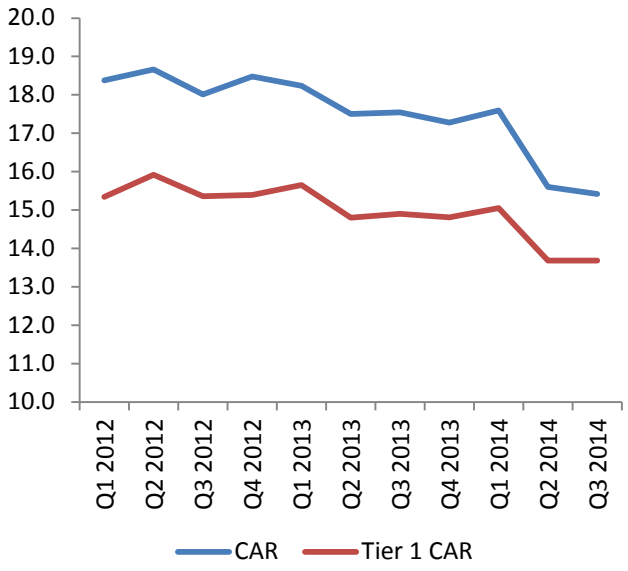
Annex 2 Graph 8: Liquidity



Source: Central Bank of Bahrain

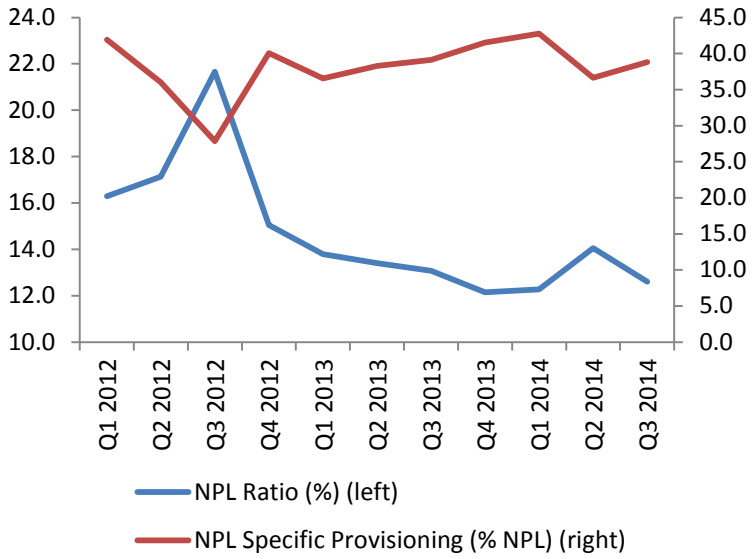
C. Islamic Retail

Annex 2 Graph 9: CAR



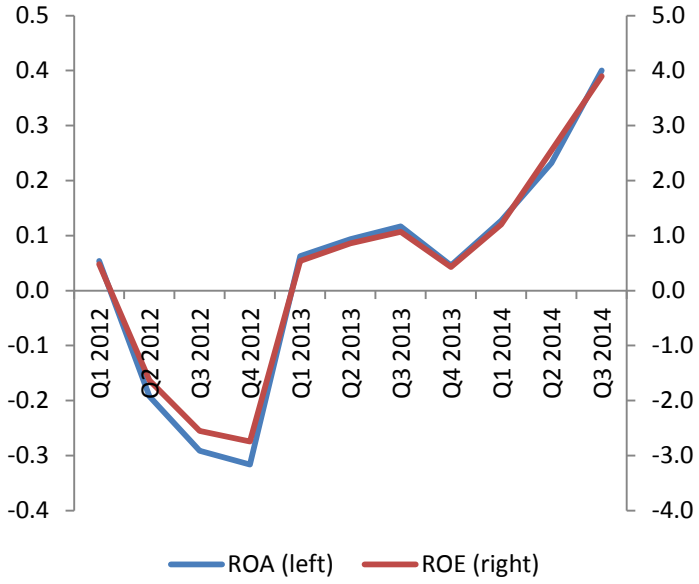
Source: Central Bank of Bahrain

Annex 2 Graph 10: NPL and Provisioning



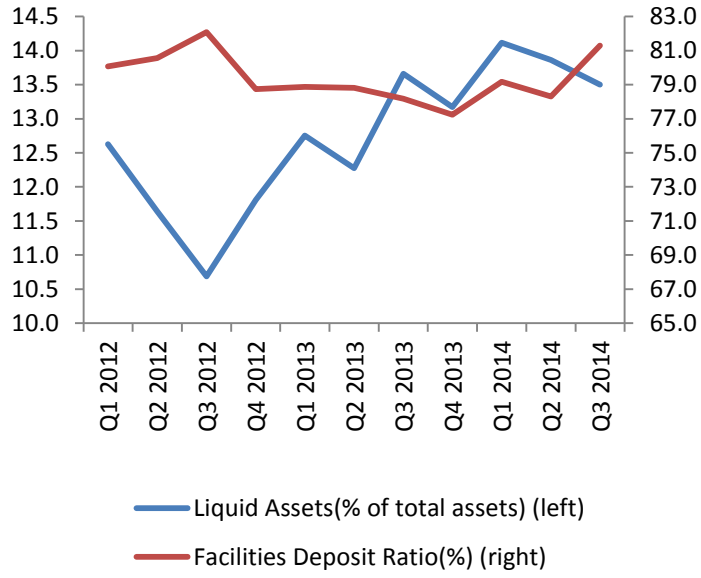
Source: Central Bank of Bahrain

Annex 2 Graph 11: Profitability



Source: Central Bank of Bahrain

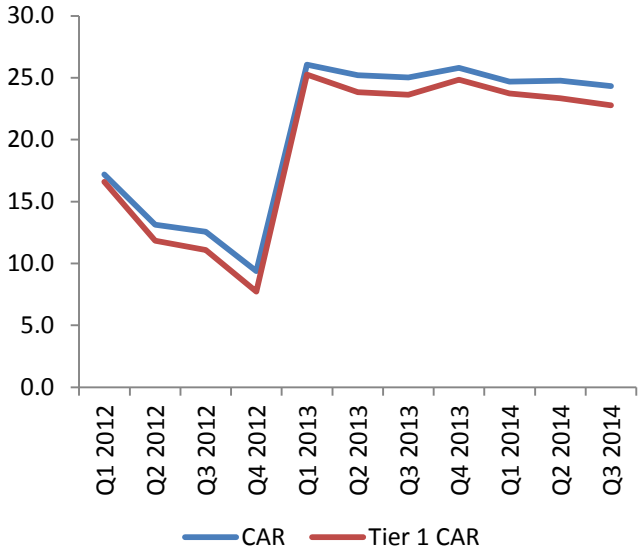
Annex 2 Graph 12: Liquidity



Source: Central Bank of Bahrain

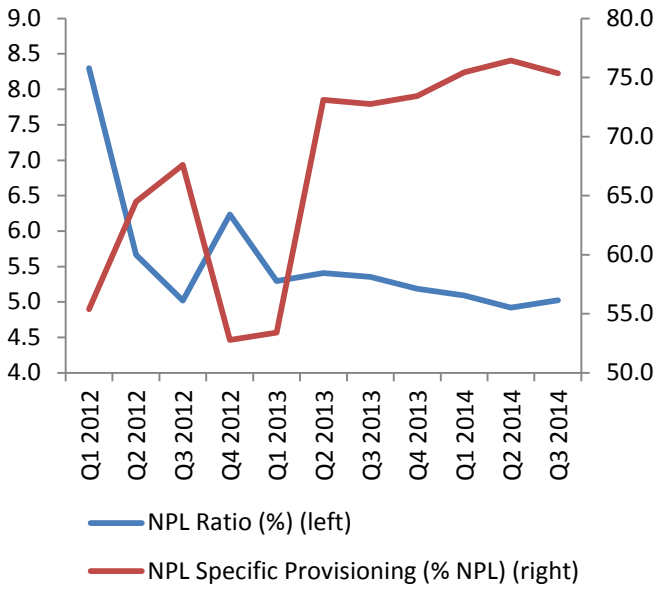
D. Islamic Wholesale

Annex 2 Graph 13: CAR



Source: Central Bank of Bahrain

Annex 2 Graph 14: NPL and Provisioning

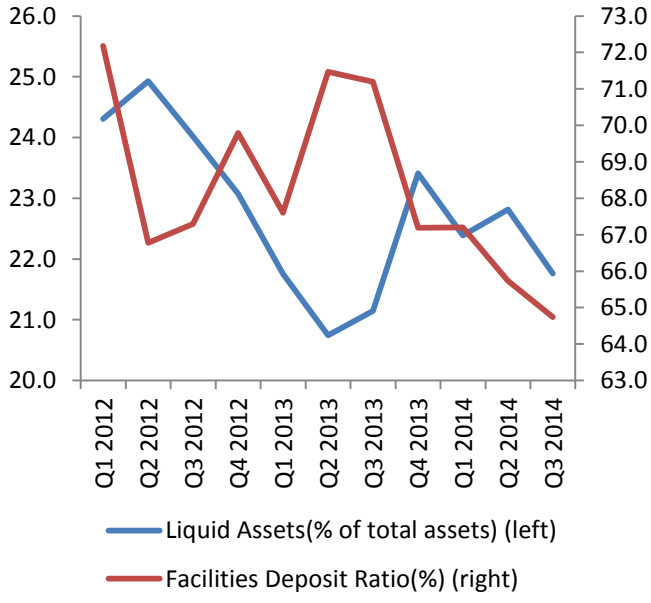


Source: Central Bank of Bahrain

Annex 2 Graph 15: Profitability

Source: Central Bank of Bahrain

Annex 2 Graph 16: Liquidity



Source: Central Bank of Bahrain