الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Kingdom of Bahrain

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ECONOMIC OUTLOOK BAHRAIN

Of the six-member Gulf Cooperation Council ("GCC")[1] states, the Kingdom of Bahrain ("Bahrain" or "the country") is the smallest economy with a nominal GDP of US$38.3bn in 2018. With a population base of 1.5mn and a GDP per capita of US$24,051 in 2018, the country is classified as 'high-income earning' by the World Bank.

Table 1:Bahrain- Key Economic Indicators			
%, unless otherwise stated	2016	2017	2018E
Population (thousand)	1,424	1,501	1,503
GDP per capita (USD)	22,619	23,715	24,051
Real GDP growth (%)	3.2%	3.8%	1.8%
Inflation (CPI Year End, %)	2.8%	1.4%	2.1%
Unemployment Rate (%)	1.3%	1.3%	0.96%
Current Account Balance as % of GDP	-4.6%	-3.8%	-5.9%
Fiscal Balance as % of GDP	-13.4%	-10.1%	-6.2%
Total Government Gross Debt as a % of GDP	81.3%	88.2%	93.4%
Source: CBB Statistical Bulletin, EDB Quarterly Report, World Bank; E: Estimate			

Akin to most other GCC states, Bahrain has been working towards economic diversification to reduce dependence on oil and gas sector, which accounted for 17.8% of its real GDP in 2018 (2017: 18.4%; 2000: 43.6%). Following improvement in real economic growth to3.8% in 2017, the country's momentum slowed in 2018 having posted growth of 1.8%, which is lower than the average GCC growth of 2% for the period. This deceleration was mostly led by decline in oil production, given OPEC and Russia led curtailments, and slowdown in retail, hospitality, and financial services sectors. Overall crude production in Bahrain was lower in 2018 by 1.6%, including 0.6% lower offshore production on account of maintenance. Nonetheless, contraction in hydrocarbon-based GDP of 1.2% in 2018 (2017: -0.7%) was partially offset by non-oil sector, which also posted slower growth of 2.5% vis-à-vis 4.9% in the previous year. The country's announcement of offshore shale reserves in 2018 has not substantially impacted economic sentiment given uncertainty of time line till production and financial benefits thereof. However, given that this marks the largest discovery for the country since 1932, with an estimated reserve deposit of 81.5 billion boe[2] and 13.7tcf[3] of light gas, it may be considered an important development for the economy over the long term.

Bahrain posted positive growth in all sectors of the economy, except mining and hospitality. Construction and real estate sectors surged by 5.6% and 3.6% during 2018 compared to 1.7% and 5.9%, respectively, in 2017.

Despite recovery in oil prices, the current account deficit widened in 2018 to 5.9% (2017: 3.8%). In 2018, average oil prices improved to about US$71/bbl[4] from US$ 54/bbl a year ago, with Brent crude spot prices having rallied to above US$85/bbl in October 2018. Natural gas prices also depicted improvement in 2018 to about US$3.2/MMBtu from US$2.9/ MMBtu in 2017. Despite growth in U.S. shale oil production, crude prices may continue to be supported by U.S. sanctions on Venezuela and heightened geo-political tensions. In the current year, crude prices may be expected to hover around US$70/bbl (average YTD June 2019: ~US$66/bbl) with significant potential of downside volatility. While some support on the fiscal front may yet be gained at this price level, this would still be well below Bahrain's fiscal break-even price .

With the implementation of VAT in 2018, the country's fiscal deficit depicted improvement to 6.2% during the year vis-à-vis 10.1% deficit in 2017. Further, the Government also launched a medium-term fiscal balance program last year, encompassing six major fiscal consolidation initiatives expected to result in an annual projected impact of Bahraini Dinar ("BHD") 800mn (~US$2.1bn) by 2022. Given the twin deficits, Bahrain's public debt has been piling up on a timeline, having increased to 93.4% of GDP as at end-2018, up from 88.2% as at prior year-end. The US$10bn financial support from other GCC states – Saudi Arabia, United Arab Emirates and Kuwait during Q4'18 deflated imminent concerns on debt repayments falling due during last year, and have also led to a decline in borrowing costs. Nonetheless, challenges persist and business operating risks remain elevated.

[1] Including With Saudi Arabia leading at US$683.8bn and leading Qatar at US$166.3bn at 2017 (Source: IMF – Regional Economic Outlook, May 2018)
[2] Barrels of oil equivalent
[3] trillion cubic feet
[4] bbl: barrel; Source: EIA – Brent spot price

ISLAMIC RETAIL BANKING SECTOR - BAHRAIN

Bahrain has rapidly become a global leader in Islamic finance despite being a relatively small economy in GCC; Bahrain is host to the largest concentration of Islamic Financial Institutions. There has been remarkable growth in Islamic banking when viewed over an extended timeline, the market share of Islamic banks increased from 1.8%[4] of total banking assets in 2000 to 14.5%[5] at end-2018. The domestic retail banking segment is a highly competitive landscape which has evolved over the years, comprising 24 conventional and 6 Islamic banks, and altogether representing about 45%[6] of the overall banking sector assets at end-2018; the remaining industry assets mostly comprise wholesale banking assets. Further, CBB's regulatory regime in Bahrain has set higher standards of transparency, governance and competence for all banks operating in the country, including Islamic banks.

Table 1: Key Financial Indicators - Islamic Retail Banking Sector

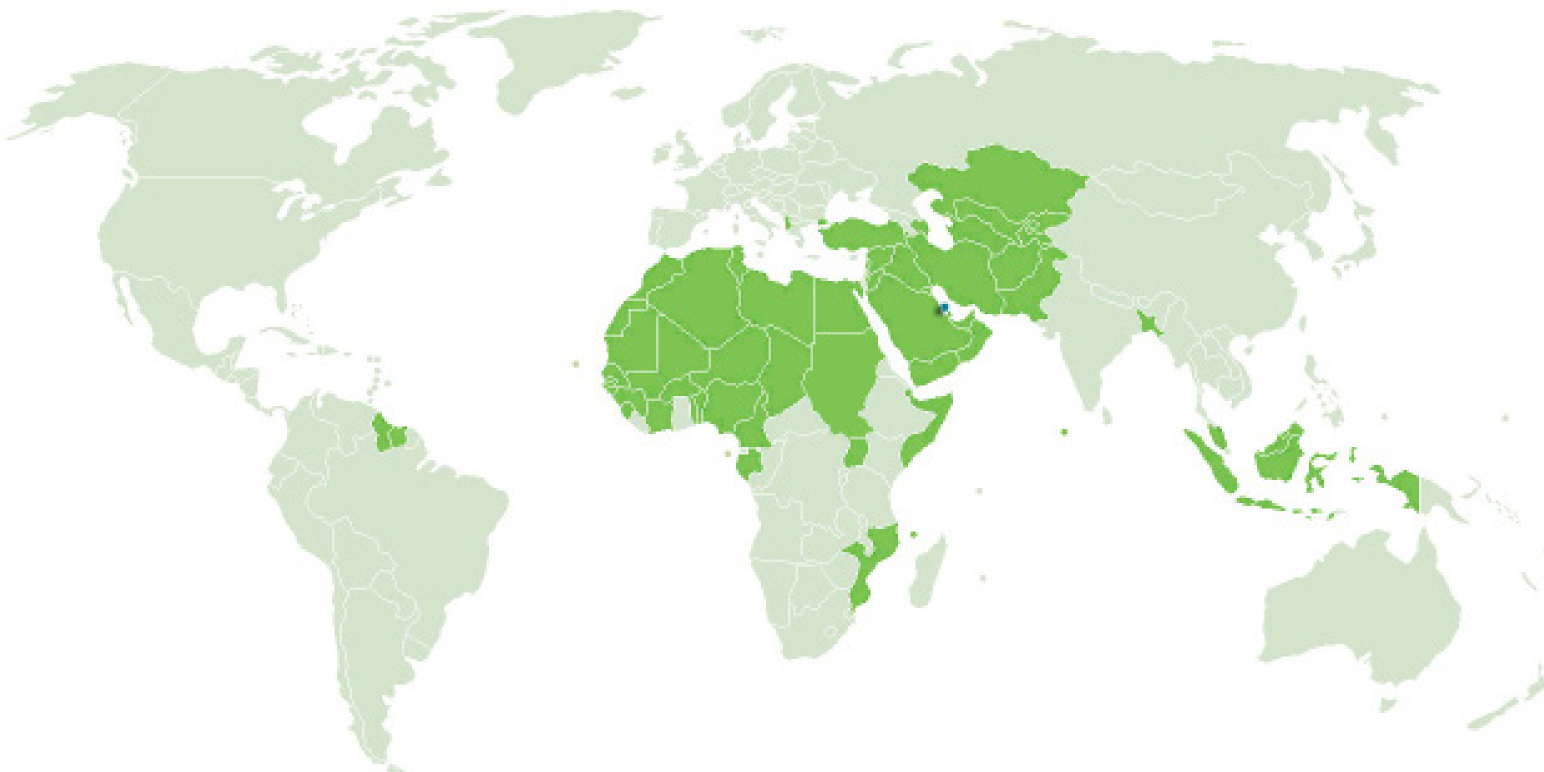
All figures are percentages	Q4'17	H1'18	Q4'18
CAR	18.6	18.1	17.6
Tier I CAR	15.5	15.1	14.6
Net NPFs to Equity	33.6	32.5	34.8
Gross Impairment	10.0	10.4	9.5
Provisions Coverage	35.9	43.5	38.6
Real Estate + Construction Exposure	27.0	28.7	28.0
RoA	0.6	0.3	0.6
RoE	6.1	2.5	6.8
Efficiency	78.2	77.5	78.5
Liquid Assets to Total Assets	12.0	14.5	14.1
Financings to Deposits	89.8	92.1	94.8

Source: CBB Financial Stability Report – Mar. 2019

Following slight contraction in 2017, the IRB industry assets[7] and deposits grew 2.3% and 4.8%, respectively, in 2018. Overall industry capitalization is adequate, and both CAR and tier-1 CAR are comfortable, although net impairments were high as a percent of capital indicating increasing credit risk. General asset quality remains an industry-wide concern particularly with higher financing disbursement to relatively vulnerable sectors, like real estate and construction. However, sector-wise diversification is also noted in comparison to historical trends, with rising allocation to trade shifting from personal consumer finance sector. Alongside, industry trends have generally evidenced increasing investment in capital light assets, such as sovereign issuances by Bahrain and other GCC nations. On the profitability front, industry spreads have narrowed as a result of a general uptick in cost of funding, whilst pricing on facilities has remained sticky, given the competition in the banking industry.

Our future outlook on the banking sector remains less than optimistic. Islamic banks' profitability may be impacted by strained spreads and expected credit losses, as weak macroeconomic conditions persist. Banks' exposure to sub-contractors and SMEs is most vulnerable to potential credit losses.

[4] *Oxford Business Group – Bahrain report*
[5] *CBB – Statistical Bulletin*
[6] *CBB Financial Stability Report March 2019*
[7] *Both adjusted for effect of consolidation*



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