الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Kingdom of Bahrain

December, 2017

TRUST . TRANSPARENCY . INDEPENDENCE

ECONOMIC & BANKING SECTOR OVERVIEW[1] - BAHRAIN

Amidst a gradually improving but still low oil price scenario, GCC countries continue to face considerable financial challenges with adverse implications on the respective fiscal positions given heavy reliance on the hydrocarbon sector. Our outlook on Bahrain sovereign remains cautious given a tough fiscal environment and depressed GDP growth expectations[2] . Our overall assessment incorporates the country's strategic linkages with Kingdom of Saudi Arabia and potential capital flows from other GCC nations.

Bahrain – the smallest GCC economy is represented by 1.4 million population base and more than BD8,400[3] GDP per capita at 2016. With roughly BD12 million GDP in 2016, the country achieved 3% growth from 2015 primarily buoyed by infrastructure projects within the non-oil sector while oil output was curtailed. Similar growth trend continued during Q1'17 (2.9%). Construction sector activity remained healthy as planned projects under the GCC Development Fund ("GDF") came online. Economic performance over the medium term is expected to persist at similar level, being primarily led by infrastructure spending funded by the GDF. Under the Vision 2030, Bahrain has been implementing several measures for economic diversification based on which the composition of hydrocarbon sector in its overall GDP reduced to 19.3% in 2016 from 43.6% in 2000. Other significant non-hydrocarbon contributors to GDP include financial services, manufacturing (aluminum, food processing), tourism and government services.

Albeit declining, Bahrain continues to showcase considerable fiscal reliance on oil & gas related revenues, as these represent about three-fourth of the aggregate revenues at 2016 and H1'17. The global oil prices showcased uptick over the recent weeks however still remain range bound primarily benefiting from the OPEC agreement, with Brent Crude averaging around US$43.5/barrel[4] ("bbl") during 2016 (2015: US$52.3/bbl) and year to date[5] 2017 at ~US$51.8/bbl. As such, both current and fiscal account balances have remained under pressure for the country more so since 2015. However, in our view, pressure on Bahrain's current account deficit should subside, as oil & bauxite prices increase, even if slightly. With oil and gas revenues reducing by 50% during 2015-2016, caused the fiscal deficit of the country to exacerbate to 13.5% in 2016 (from 2014: 3.6% deficit) while the government spending has largely remained stable over recent years. Given the country's high fiscal break-even price (2016: US$132/bbl) among GCC economies, we expect Bahrain's fiscal deficit would continue to persist going forward, albeit it is expected to fall below a still considerable 10% of GDP in 2017. This has also resulted in increased reliance on debt issuance thereby leading to uptick in the government's debt to GDP ratio to 75.4% at H1'17 (2016: 74%; 2015: 61.8%).

[1] Sources include CBB statistical bulletins; CBB's Kingdom of Bahrain prospectus for bond issuance dated Sept. 2017; IMF – Middle East Regional Economic Outlook – statistical appendix dated Apr. 2017; EIA
[2] IMF forecast 2017: 2.5%
[3] CBB – statistical bulletin Apr.- Aug. 2017
[4] EIA; Europe Brent Spot Price FOB (US$ per barrel)
[5] Jan. - Sept. 2017 and as of Oct. 20, 2017 US$57.8/bbl

Table 1: Key Economic Indicators			
Amounts & ratios as stated	2014	2015	2016
Real GDP (US$'b)	29.9	30.8	31.7[6]
Real GDP Growth, %	4.5%	2.9%	3.0%
• Non-Hydrocarbon Sector	4.9%	3.6%	3.7%
• Hydrocarbon Sector	3.0%	-0.1%	-0.1%
Current Account Balance (% of GDP)	3.3%	-0.3%	-4.6%
Fiscal Balance (%of GDP)	-3.6%	-13.0%	-13.5%
Inflation	2.8%	1.8%	2.8%
Debt / GDP	44.4%	61.8%	74.0%
International Reserves (In US$'b)	6.06	3.39	2.45
Source: Bahrain EDB; CBB Prospectus dated Sept. 2017			

As such, the Government of Bahrain has initiated certain structural reform measures to be implemented over the course of medium- to- long term to address the fiscal deficit. Income side measures include increased taxes on certain items and imposition of new government service fees in addition to implementation of VAT from 2018. On the cost side, the government has removed subsidies for certain food products, increased petrol prices whilst also rolling out plans for phased reduction in subsidies on electricity, water, diesel and kerosene. The aforementioned measures are expected to push up inflation, some of which has already been noted. However, given a budgeted fiscal deficit of about ~US$3.6b in 2017 and ~US$3.5b in 2018, these measures will not be sufficient to wholly address the situation.

Bahrain has maintained its status as the financial hub in GCC despite it being a relatively small economy. This is in part due to its better regulatory framework, particularly in relation to Islamic banking. The domestic retail banking segment is a highly competitive landscape which has evolved over the years, comprising 23 conventional and 6 Islamic banks, altogether representing about 43%[8] of the overall banking sector assets; the remaining industry assets mostly comprise wholesale banking assets. Bahrain has the largest concentration of Islamic banks in the Middle East, accounting for about 29.3% of Bahrain's total retail banking assets as of end-2016[9].

Table 2: Bahrain - Islamic Retail Banking Sector		
% unless otherwise mentioned	Sep'15	Sep'16
CAR	15.6	17.1
Tier I CAR	13.6	14.9
Net NPFs to Equity	23.8	28.3
Gross Impairment Ratio	11.7	12.1
Provisions Coverage[7]	36.8	34.1
Real Estate / Construction Exposure	28.4	29.4
RoAA	0.4	0.2
RoAE	3.2	1.6
Efficiency	74.6	82.6
Liquid Assets / Total Assets	11.2	12.3
Financings / Deposits	75.4	82.9
Source: Financial Stability Report - CBB		

Within the country's Islamic retail banks, Bahrain operations exclusively showcased a deposits[10] growth of 8% in 2016. On the other hand, the related industry assets grew by 7% albeit on a consolidated basis driven by healthy growth in credit off take. While overall industry capitalization has improved with both CAR and tier 1 CAR being comfortably high, general asset quality remains an industry-wide concern, despite having posted gradual recovery since the 2008 global financial crisis. With investment spending in the country largely being dominated by the real estate sector, the industry depicts considerable concentration in the sector. Cognizant of these concerns, the industry has generally been showcasing increasing interest 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, albeit pricing on facilities has remained sticky given the high competitiveness in the banking industry. As such, our outlook on the banking sector also remains less than optimistic in line with the macroeconomic situation, wherein fiscal tightening may weigh in on the repayment ability of corporate and SME borrowers, and also translate into possibly weaker credit off-take. Profitability levels could also remain under pressure on account of the possible increase in provisioning burden, and the likely persistent strain on banking spreads.

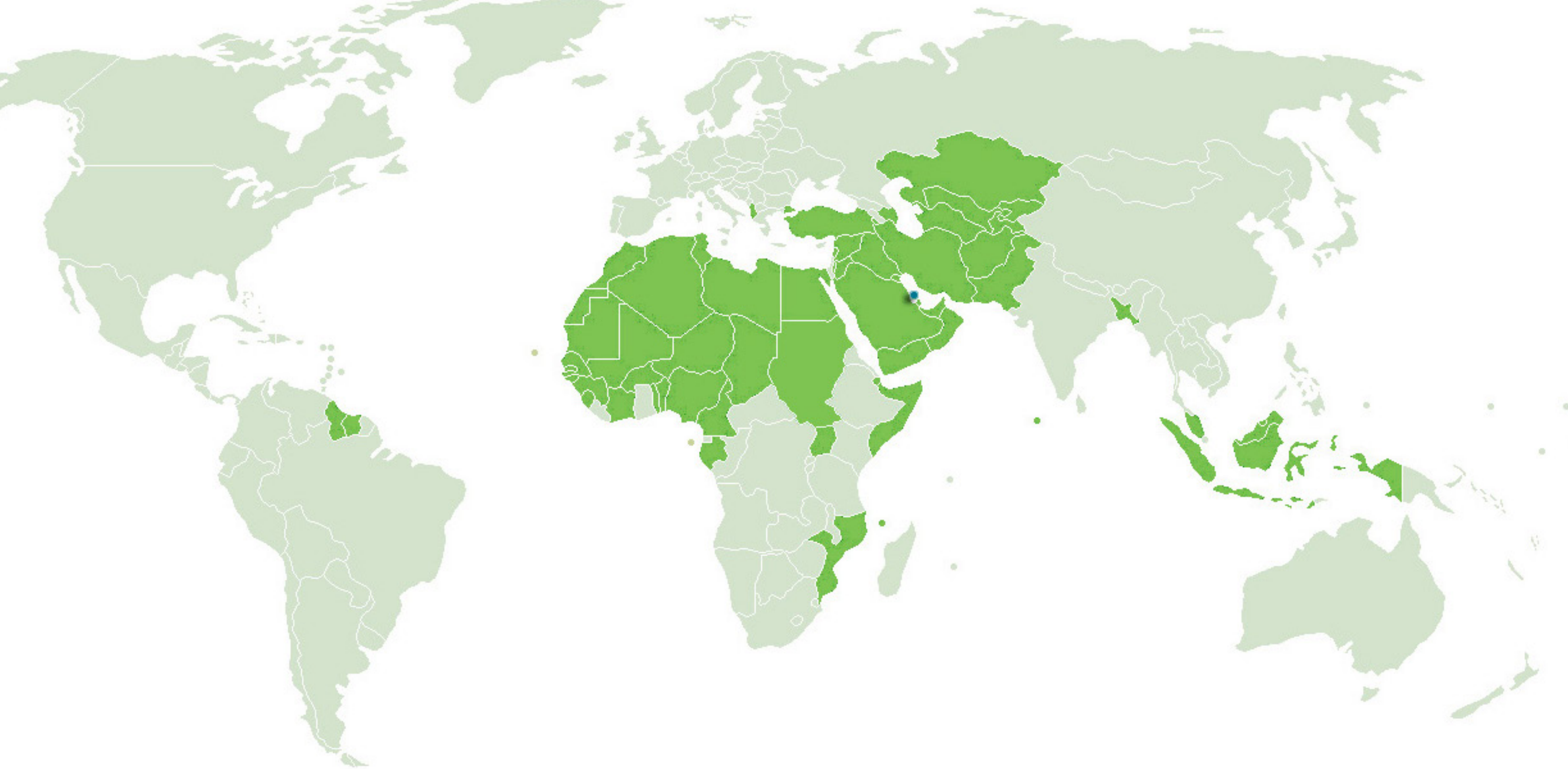
[6] *CBB*

[7] *Specific provisions*

[8] *CBB Financial Stability Report, Feb 2017.*

[9] *Individual Islamic bank consolidated assets compared with the overall retail banking asset base*

[10] *Adjusted for effect of consolidation*



الوكالة الإسلامية الدولية للتصنيف

Islamic International Rating Agency

P.O. Box 20582, Kingdom of Bahrain
Tel: +973 17211606, Fax: +973 17211605
Website: www.iirating.com | Email: iira@iirating.com