الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Kingdom of Bahrain

May, 2017

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ECONOMIC OUTLOOK - BAHRAIN

The Kingdom of Bahrain ('Bahrain' or 'the country) is the smallest GCC economy, having a population of 1.4m and GDP per capita of more than USD 22,500. The country is categorized as a constitutional monarchy headed by H.H. Shaikh Hamad bin Isa Al Khalifa. Although Bahrain has, over the years, experienced stints of social unrest, these have broadly subsided in recent years. Bahrain was one of the first few countries in the GCC to realize the need for diversification and accordingly the composition of non-hydrocarbon sector in the country's GDP increased from less than 60% in 2000 to about 80% presently. Regarded as the most open economy within the GCC, featuring relatively lower cost of doing business, Bahrain has remained a popular attraction for foreign investment, as evident from the country's inward foreign direct investment stock, which comprised 88.9% of the GDP as of 2015 which was the highest amongst all GCC economies. The country also serves as an important financial centre for the MENA region, with the financial services industry being the largest non-hydrocarbon contributor to GDP at ~16%. Other significant non-hydrocarbon contributors to GDP include manufacturing, aluminum production and tourism.

Despite the output diversification initiatives implemented over the years, Bahrain continues to showcase considerable fiscal reliance on oil & gas related revenues, as these represent more than 80% of the aggregate fiscal revenues. As the global oil prices remain depressed, with Brent Crude averaging around USD 45.1 p/b during 2016 vis-à-vis USD 53.6 p/b during 2015, and despite the slight recovery in 2017 year to date (53.9 p/b), Bahrain's fiscal and current account balances have come under pressure. Oil related revenues in the period 2013-2015 reduced by 39% causing the fiscal deficit of the country to exacerbate, and reaching a high of 18% in 2016, whilst the current account balance has also posted deficits in 2015 and 2016. The fiscal deficit is expected to persist going forward, as the country has the highest fiscal break-even price, of USD 132 p/b, among GCC economies, although it is expected to fall below a still considerable 10% of GDP in 2017. On the contrary, the current account deficit should subside, as oil & bauxite prices increase, even if slightly.

Table 1: Key Economic Indicators

	2013	2014	2015	2016 (e)
Real GDP (USD' Billions)	28.6	29.9	30.8	31.8
Real GDP Growth, %	5.3%	4.5%	2.9%	3.4%
• **Non-Hydrocarbon Sector**	3.0%	4.9%	3.9%	3.7%
• **Hydrocarbon Sector**	15.3%	3.0%	-0.9%	1.9%
Current Account Balance (% of GDP)	7.8%	3.3%	-2.4%	-4.6%
Fiscal Balance (%of GDP)	-3.3%	-3.6%	-12.5%	-12.6%[1]
Inflation	3.3%	2.8%	1.8%	2.9%
Debt to GDP	41.3%	42.0%	60.3%	65.3%[2]
International Reserves (In USD Billions)	5.35	6.06	3.39	2.78[3]

The increased reliance on debt issuance, has led to an uptick in the country's debt to GDP ratio. However over the medium to long term, the government plans to address the fiscal deficit through a series of fiscal consolidation measures which include increased 'sin' taxes and imposition of new government service fees. On the cost side the government has removed subsidies for certain food products, increased petrol prices by 60% whilst also rolling out plans for phased reduction in subsidies on electricity, water, diesel and kerosene. In addition the government also plans to implement value added taxation system by 2018. The aforementioned measures are expected to push up inflation, some of which has

[1] *Government estimate; in contrast IMF estimate is considerably higher at 18%.*
[2] *As of Sep'16*
[3] *As of Jun'16*

already been noted. However, given a budgeted fiscal deficit of about USD 4b, these measures will not be sufficient to wholly address the budgetary deficit.

The Government of Bahrain has estimated the country's economic growth at 3.4% for 2016, although independent approximations lag government projections by about 50 bpts. The economic growth in 2016 was largely supported by the healthy construction sector activity 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.

Our overall outlook on Bahrain sovereign remains neutral, despite the tough fiscal environment and depressed GDP growth expectations. Our outlook incorporates Bahrain's strategic importance among GCC nations, considerable economic linkages with Kingdom of Saudi Arabia and capital flows from other GCC nations such as the State of Kuwait, Qatar & United Arab Emirates.

……Islamic Retail Banking Sector

Bahrain has maintained its status as the financial hub in GCC despite it being a relatively small economy. This is also 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 22 conventional and 6 Islamic banks, altogether representing 43%[4] 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 27% of Bahrain's total retail banking assets as of 2015[5].

Table 2: Key Financial Indicators - Islamic Retail Banking Sector

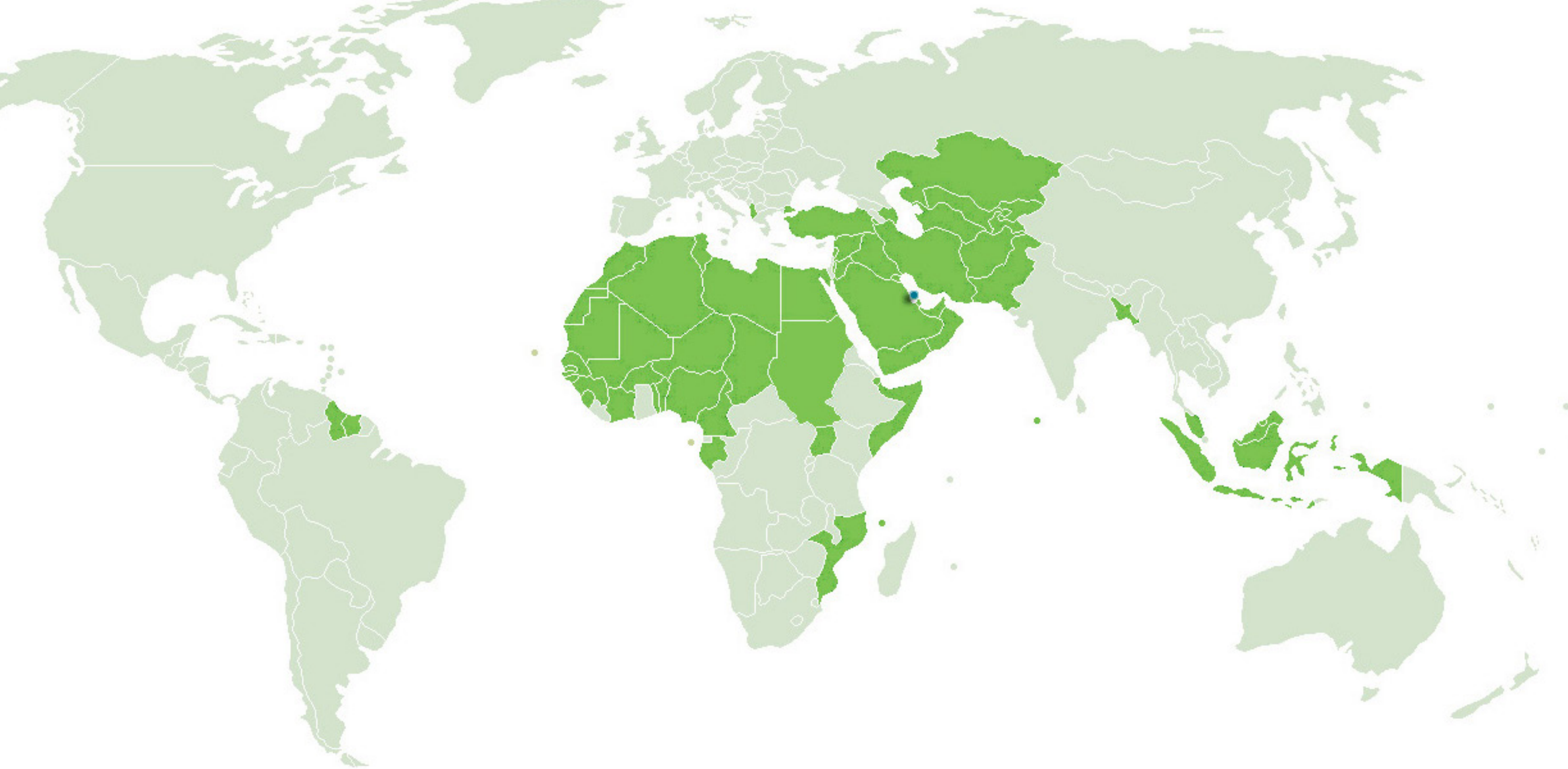
CAR	15.6	17.1
Tier I CAR	13.6	14.9
Net NPFs to Equity	23.8	28.3
Gross Impairment	11.7	12.1
Provisions Coverage	36.8	34.1
Real Estate / Construction Exposure	28.4	29.4
RoAA	0.4	0.2
RoAE	3.2	1.6
Efficiency	74.6	82.6
Liquid Assets to Total Assets	11.2	12.3
Financings to Deposits	75.4	82.9

The Islamic Retail Banks (IRBs) industry assets[6] grew by 11% whilst deposits showcased a growth of 8% in 2016. Healthy growth was observed in credit off take. Overall industry capitalization has improved, and both CAR and Tier-I CAR are comfortably high.

Nonetheless general asset quality remains an industry concern, although the industry has posted gradual recovery since the 2008 global financial crises. 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, 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, on account of 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 are expected to remain under pressure, on account of the provisioning burden, and the likely persistent strain on banking spreads.

[4] *CBB Financial Stability Report, Feb 2017.*
[5] *Individual Islamic bank consolidated assets compared with the overall retail banking asset base*
[6] *Adjusted for effect of consolidation*



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