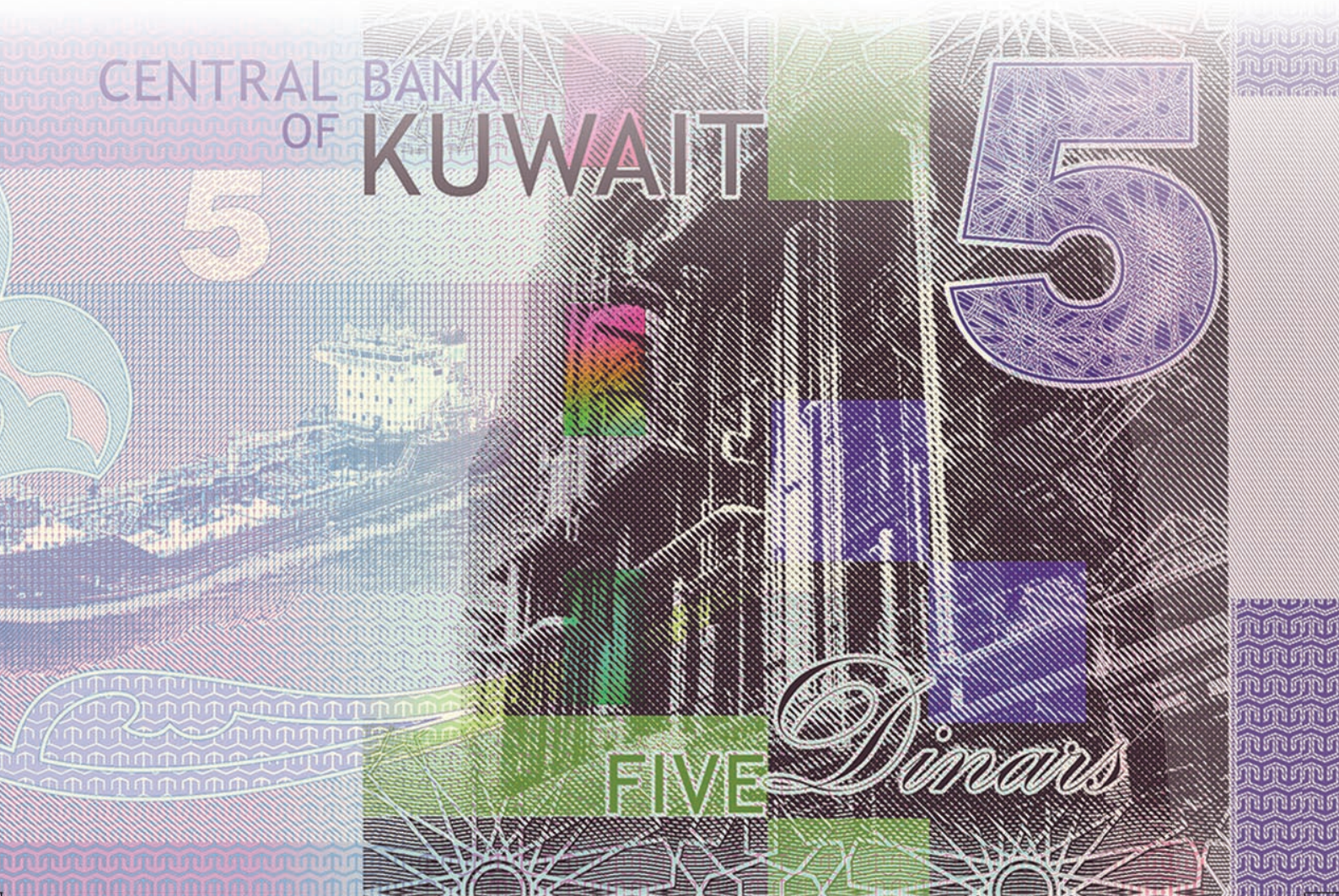




Central Bank of Kuwait



Financial Stability Report 2013



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Financial Stability Report

for the calendar year 2013

Financial Stability Office
Central Bank of Kuwait



**H. H. Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah
The Amir Of The State Of Kuwait**



**H. H. Sheikh Nawwaf Al-Ahmad Al-Jaber Al-Sabah
The Crown Prince Of The State Of Kuwait**



**H. H. Sheikh Jaber Al-Mubarak Al-Hamad Al-Sabah
The Prime Minister Of The State Of Kuwait**

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PREFACE

Financial stability refers to the resilience of the financial system to unanticipated adverse shocks. A financial system, consisting of institutions, markets and infrastructure, can be viewed as stable if it continues to ensure, even in times of stress, an efficient allocation of financial resources and fulfillment of its key macroeconomic objectives. Given the colossal social and economic costs of any financial crisis, maintaining financial stability is a key objective of central banks and regulatory authorities around the globe.

The Central Bank of Kuwait (CBK), being the lead regulator of Kuwait's bank-centric financial system, devotes considerable resources and attention to ensure a sound and stable financial system in the country. A separate Financial Stability Office (FSO) has been set up with the mandate to regularly examine the developments in the financial sector; the Financial Stability Report (FSR) is a flagship publication of the FSO, evaluating the performance of various components of the financial system and serving as a key surveillance tool for the CBK. The first FSR, published in 2013, was well received as it provided a comprehensive review of the developments in the financial system.

We are pleased to release our 2nd FSR, an annual publication composed of five chapters covering all three aspects of the financial system: institutions, markets and infrastructure. We dedicate the first three chapters to coverage of the banking sector, the most significant component of our financial system. Chapter 1 assesses the role and performance of banks, both conventional and Islamic, as financial intermediaries, by highlighting trends in both credit allocation and deposit mobilization. Chapter 2 evaluates the risks faced by the banking system, covering various dimensions of credit, market and liquidity risks. Chapter 3 examines the trends in profitability and solvency of the banking system and its resilience against a variety of major shocks, both endogenous and exogenous under different financial and economic stress scenarios. Chapter 4 explores the key developments in money, foreign exchange, equity and real estate markets, the four key components of our domestic financial market. Finally, chapter 5 examines the performance of retail and large-scale payment and settlement systems in the country. At the end of various chapters, we also analyze some topical issues of interest.

Through the publication of our FSR, we intend to promote transparency and encourage informed public discourse on various developments in the financial system. We hope that the analyses contained in our report will help all stakeholders form a better understanding of the key issues and facilitate appropriate policy initiatives to address the upcoming challenges.

We pray to Allah the Almighty to grant success to our efforts and endeavors and to enable us to achieve the welfare of our beloved country, under the patronage of His Highness the Amir, Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, His Highness the Crown Prince, Sheikh Nawwaf Al-Ahmad Al-Jaber Al-Sabah, and His Highness the Prime Minister, Sheikh Jaber Al-Mubarak Al-Hamad Al-Sabah, may Allah bestow on them good health and continued success.

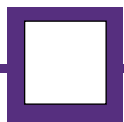
*Dr. Mohammad Y. Al-Hashel
Governor, Central Bank of Kuwait*



COVERAGE AND DATA CONVENTIONS

This Financial Stability Report (FSR) primarily examines the performance of the key components of the financial system for the calendar year 2013 (CY13) using December 31st, 2013 as the cut-off date. All amounts are in Kuwaiti Dinar (KD), unless specified otherwise.

Our analysis of the banking system in the first three chapters of this FSR is based on the consolidated banking system data, including both conventional and Islamic banks within Kuwait and their subsidiaries abroad. Due to some data limitations, we have not covered the performance of 11 foreign banks' branches in Kuwait (which account for about 5.12% of the consolidated banking system) but we intend to make it part of our analysis in the future. Therefore, readers are cautioned that our consolidated banking system data differs from the Kuwait only data that is available on CBK's website. The last two chapters of the report cover, respectively, performance of the domestic markets and payment & settlement systems within Kuwait only.



During the year under review (2013), the banking system experienced positive developments on almost all fronts, ranging from strong growth in assets & deposits to a visible drop in non-performing loans (NPLs). Banks' net income, however, posted a contraction of 10% due both to higher non-interest and provisions expenses. Specifically, during 2013, banking system assets, on a consolidated basis, posted double-digit growth for the first time in the last six years; growth in assets was fairly broad based as all key components made positive contributions. There were visible signs of improvement in credit off-take on the back of strong growth for household credit, followed by real estate sector. In general, credit to all key economic sectors posted positive growth, except for investment companies which contracted by 19.2% in 2013 on top of a 15.7% fall recorded a year earlier amid the ongoing deleveraging in the sector. Banks' deposits recorded an impressive growth of 11.2% on the back of strong contribution by both domestic and foreign operations of Kuwaiti banks. With 62.2% of banks' deposits in the time deposit category, the banking system continued to enjoy a stable funding base.

Banking assets and deposits posted double digit growth during 2013

The risk profile of the banking system reveals that given the traditional nature of banking, credit risk appears the most significant risk for Kuwaiti banks, accounting for 90% of their risk-weighted assets. Positively, asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). For instance, the gross NPLR has dropped to 3.6% as of December 2013, lower than the 3.8% observed in 2007 before the financial crisis struck. Segregation of non-performing loan (NPLs) by age also reveals a visible slowdown in the buildup of new NPLs as loans 'under monitoring', and 'substandard' categories have contracted in the last two years, with a particularly sharp drop in the former category. Sectoral analysis of NPLs indicates that the real estate sector has witnessed a perceptible decline in the NPLs during 2013. Sector wise, the household sector loans appear the healthiest in relative terms. On the other hand, loans extended to investment companies have much higher level of non-performance, though the scale of banks' exposure to investment companies stand significantly reduced. Geographically, the share of NPLs originating from banks' operation in the European region has inched up, though the magnitude of these NPLs is well-contained. Industry breakdown suggests that conventional banks account for 57.8% of total NPLs, compared to their 61.6% share in gross loans. Banks' exposure to the equity market remains considerable, notwithstanding the recent drop in various indicators; equity investments make up around 26.6% of banks' total investment, and use of firms' shares as collaterals account for 31% of banks' overall collaterals. Finally, banks'

Both the level and ratio of NPLs have visibly dropped

liquidity levels continue to remain strong and funding base quite stable, further supported by the presence of a formal law guaranteeing all deposits within Kuwait.

Banks enjoy ample liquidity and stable funding base

Data for banks' operating performance reveals that banks' net income posted a contraction of 10% during 2013, due both to higher non-interest and provisions expenses. Return on assets as well as equity also experienced a decline as growth in assets and equity outpaced the growth in net income. Islamic banks further gained their share in industry profits, making it almost commensurate with their share in total banking assets. Still, conventional banks account for 63.3% of the industry profits and 61% of the industry assets. The share of non-interest expense has been on a steadily rising trend, while interest expenses experienced a marginal drop in a low interest environment. Cost to income ratio has inched up for the banking sector, though conventional banks, on average, still remain significantly more cost efficient than their Islamic counterparts. Capital adequacy ratio (CAR) of the banking sector strengthened further, reaching a fairly high level of 18.8%. Group-wise, CAR of both conventional and Islamic banks has converged in 2013. Results of CBK's Quarterly Stress Testing Exercise reveal that banks, individually and collectively, have been able to withstand various shocks in credit, market and liquidity, simulated under a wide range of micro and macro-economic scenarios.

Banks' net income observed a contraction while the capital adequacy remained strong

A look at the performance of the domestic markets reveals that the banking system continued to be characterized by conditions of ample liquidity during 2013, reflected both by an increase in the volume of monetary operations conducted to absorb surplus liquidity and the low level of KD interbank interest rates. A decrease in the volume of government debt outstanding was accompanied by an increase in the issuance of CBK bonds, particularly of 3-months maturity. The volume of direct interventions, conducted through interbank deposits with conventional banks and Tawaruq arrangements with Islamic Banks, also witnessed a rise during the year. Operations aimed at lengthening the average tenor of KD Treasury Bonds outstanding were evidenced by the issuance of longer tenor bonds with maturities extending to 10-years which, in turn, established important benchmarks for the issuance of corporate debt throughout the KD yield curve. Relative to the exchange movements in other currencies, fluctuations in the value of KD remained modest; in particular, the USD/KD exchange rate changed only by 0.45% through the year.

The banking system remained liquid and FX market stable

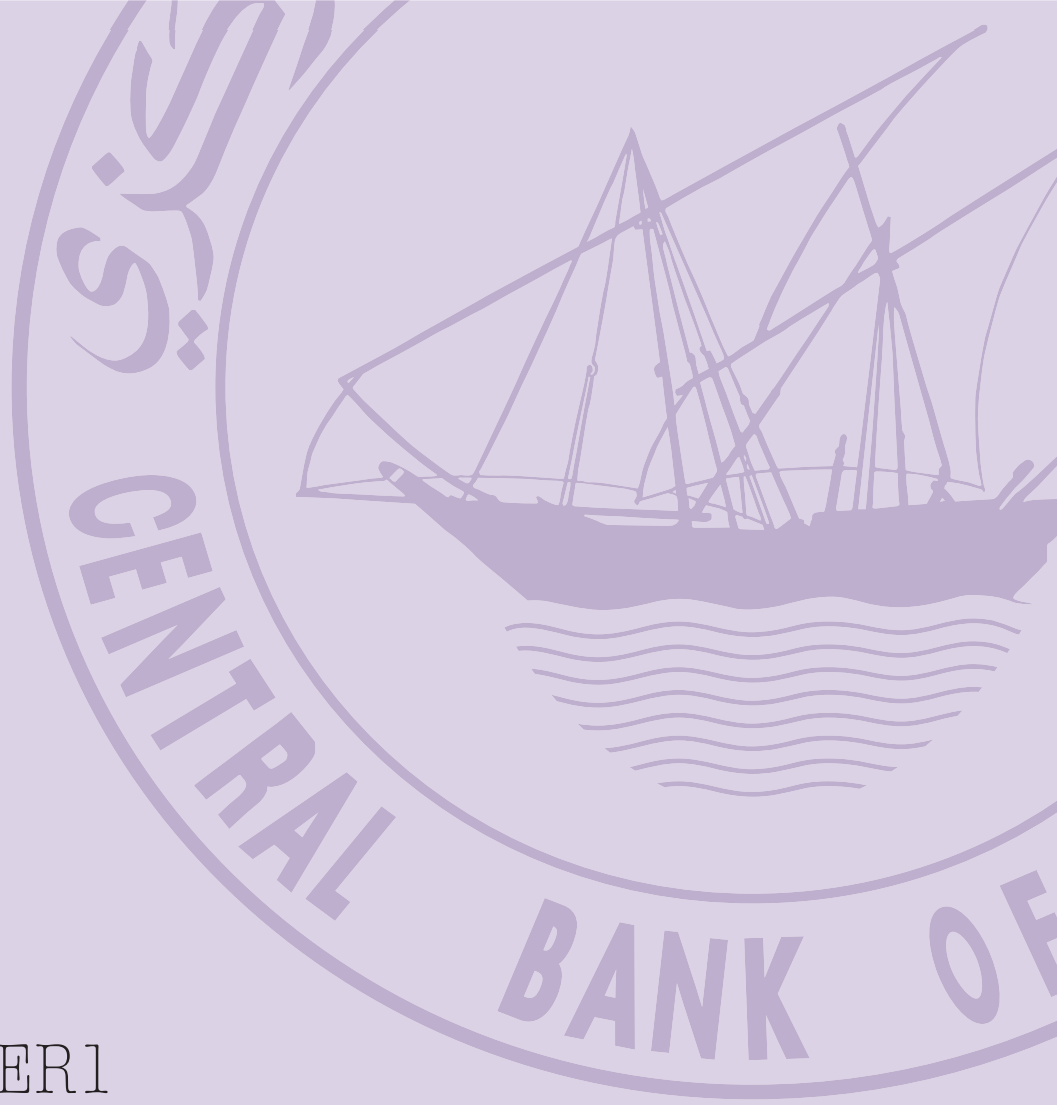
The Kuwait Stock Exchange (KSE) remained particularly buoyant during the first five months of 2013, though losing steam as the year came to a close. The rally, essentially observed in the small cap stocks, was driven in part by the positive sentiment about the domestic political climate. Yet the market remained shallow with a few sectors like financial services, real estate and banks accounting for most of the market activity, if viewed in terms of value or volumes.

KSE was particularly buoyant during early 2013; Real estate market observed positive growth in all segments

The real estate market maintained its double-digit growth, with all segments exhibiting a positive trend. However, the signs of increasing demand pressures amid supply constraints were visible in the residential sector.

Performance of the payment and settlement systems in Kuwait reveals that both the retail and large scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on daily basis. In case of retail payments, use of ATMs and point of sale (POS) related transactions have witnessed growth of 7.3% and 17% respectively during 2013, when viewed in terms of value of transactions. During the year under review, the share of ATM related transactions was higher (60%) in value while that of POS transactions was higher in terms of volume (57%). E-banking infrastructure has also been growing in Kuwait, as the number of ATMs and POSs machines witnessed a growth of 3.3% and 11.5%, respectively reaching 1,475 and 31,686 machines by December 2013. While electronic based transactions account for 97.3% of all transactions in terms of volume, paper based transaction (through cheques) still has a sizeable share (57%) in term of value. Large scale payment system (KASSIP) handled 1.09 million transactions worth KD 288 billion during 2013. Finally, banks' branches continued to rise, as 16 new branches during 2013 pushed the total branches in Kuwait to 400.

Both the use of electronic payments and related infrastructure have been growing steadily



CHAPTER 1

BANKS' FINANCIAL INTERMEDIATION

2013

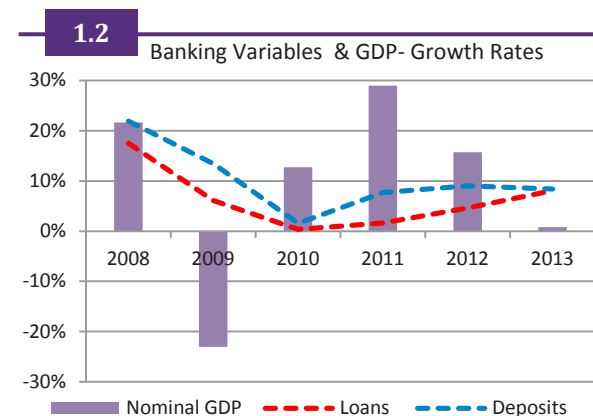
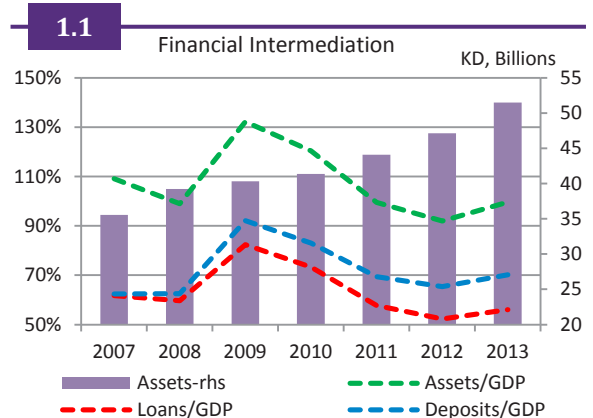
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BANKS' FINANCIAL INTERMEDIATION

The banking system, on a consolidated basis, posted a double-digit growth for the first time in the last six years; growth in assets was fairly broad based as all key components made positive contributions. There were visible signs of improvement in credit off-take on the back of strong growth for household credit, followed by real estate sector. In general, credit to all key economic sectors posted positive growth, except for investment companies which contracted by 19.2% in 2013 on top of a 15.7% fall recorded a year earlier amid the ongoing deleveraging in the sector. Finally, banks' deposits recorded an impressive growth of 11.2% on the back of strong contribution by both domestic and foreign operations of Kuwaiti banks. With 62.2% of banks' deposits in the time deposit category, the banking system enjoys a stable funding base.

Intermediation ratios improved amid strong growth in banking variables

Banks' performance as financial intermediaries improved during 2013, bucking the declining trend of the earlier three years¹. Accordingly, intermediation ratios, measured by the key banking variables with respect to nominal GDP, exhibited an upward movement (*Figure 1.1*). The improvement in intermediation ratios in 2013 was due to the combined effect of relatively stronger growth in key banking sector variables like assets, loans and deposits on the one hand and sluggish growth in nominal GDP on the other (*Figure 1.2*). For instance, while loans and deposits increased in 2013 by 8.1% and 8.4% respectively, nominal GDP recorded a marginal gain of 0.8%², helping intermediation ratios to record improvement. The trend in intermediation ratios for earlier years can be explained by a much higher fluctuations in the nominal GDP on account of volatile oil prices in international markets.



¹ The data used in Figure 1.1 and 1.2 is for the domestic banking sector only, unlike our discussion in the rest of the chapter which is based on consolidated data.

² GDP data for 2013 is based on IMF forecast.

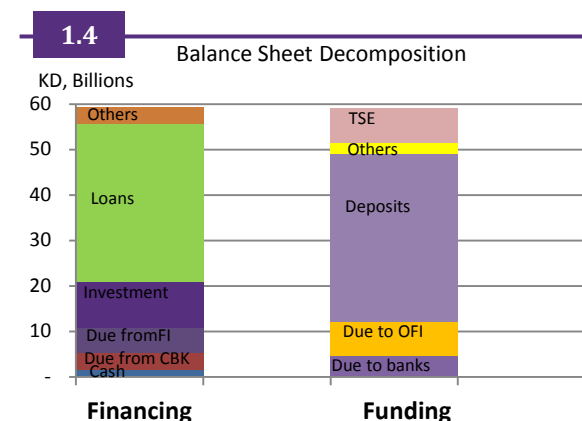
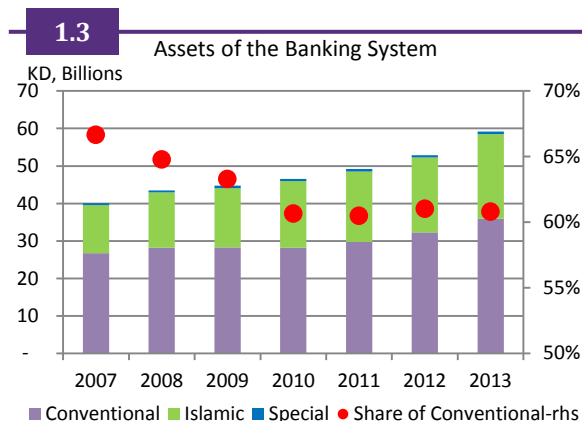
Financial system remains bank centric

Kuwait has a bank-centric financial system, with the banking sector accounting for around 84.1% of the domestic financial sector. Investment companies are the second major player in the domestic financial system with around 14.5% share as of December 2013. Exchange companies, insurance companies and funds constitute the rest. Domestic banking sector consists of five conventional, five Islamic and one specialized bank. Conventional banks, with 60.8% share as of December 2013 in the consolidated banking assets of KD 59.2 billion³, dominate the overall banking system; however, their share has broadly remained the same in the last four years (*Figure 1.3*).

Decomposition of the balance sheet of the banking system highlights the prevalence of traditional instruments one would expect in a bank-centric financial system. For instance, loans account for as much as 58.7% of the total assets as of December 2013 (*Figure 1.4*). Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 17% share in total assets. On the liabilities side, deposits account for 62.2% of total liabilities, indicating a healthy deposit base to help Kuwaiti banks befittingly perform their intermediation role.

Double-digit growth in banking assets was first since 2008

Growth in the banking assets turned double digit (11.9%), as the banking sector accumulated another KD 6.29 billion, pushing its asset base to a new high of KD 59.2 billion by December 2013. Both in absolute and growth terms, this was the most significant growth achieved in the last six years; it seems the banking sector, which experienced much slower growth in the wake of global financial crisis, is finally gaining momentum. A look at the asset



³ These numbers are based on consolidated data that also includes Kuwaiti banks' subsidiaries abroad. However, due to some limitations in the breakdown of data, these numbers exclude 11 foreign bank branches with combined assets of KD 3.2 billion.

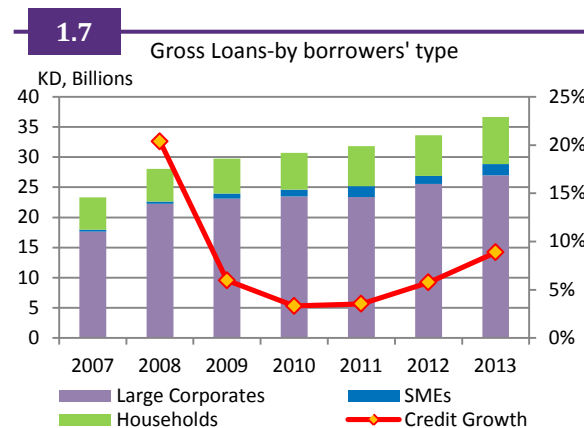
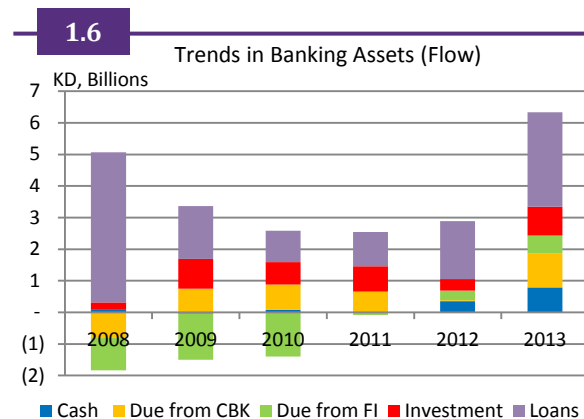
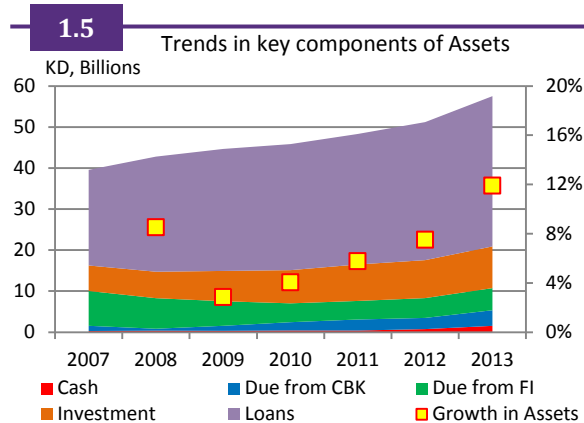
composition of banks reveals that both loans and investments have remained the two major components of the banks' balance sheet, collectively accounting for 79% of total assets as of December 2013 (Figure 1.5).

Flow data for the key components of banks' assets further exhibits that growth in assets was broad based, with positive contribution by all the key components in overall asset growth, in particular from loans which increased by KD 2.98 billion during 2013 (Figure 1.6). Contrary to the previous years, banks also closed the year 2013 with a sizeable increase in their cash holdings. 'Due from Financial Institutions' which includes both interbank lending and placements, made a positive contribution as well. There was also a sharp rise in 'due from CBK' category primarily because of the CBK's increased operations with Islamic banks to absorb surplus liquidity, as the Central Bank continued to fulfill its role in appropriately managing the liquidity flows within the entire banking system.

Credit growth has picked up, amid growing household lending

During 2013, banks expanded their loan portfolio by another 2.98 billion, posting a growth of 8.9% (Figure 1.7). This was the strongest growth recorded in the last five years, a clear indication of the pickup in credit off-take. In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 73.7% of total gross loans. A distant second was the households sector, with 21.3% share in overall credit and outstanding loans amounting to KD 7.81 billion as of December 2013. The share of SMEs in overall lending improved from 4% in 2012 to around 5% in 2013. With increasing focus of the government to promote SMEs in Kuwait with a view to generate additional employment and business growth, share of bank lending to these enterprises is likely to improve in future, though a major shift in credit allocation away from corporates and households is unlikely in the medium term.

Currency-wise break down of the gross loans indicates that more than two thirds of the overall



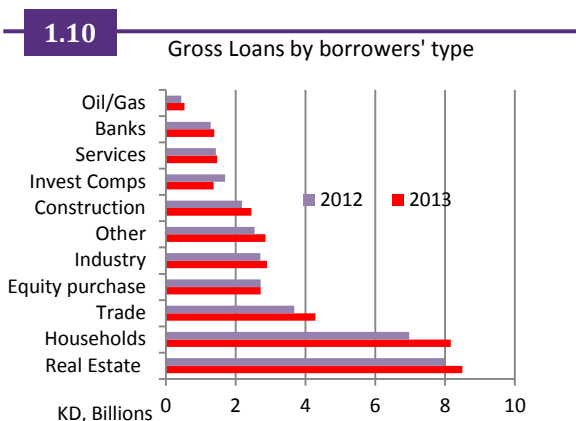
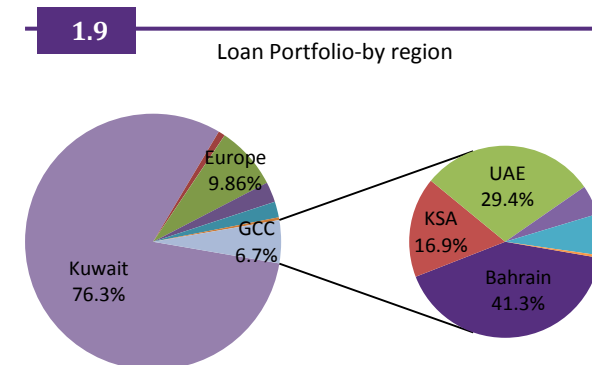
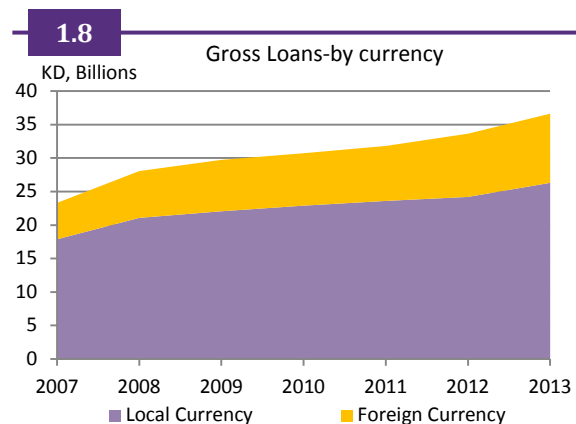
lending was in the domestic economy, with the share of foreign currency loans remaining almost the same (28.2%) in 2013 as observed a year earlier (*Figure 1.8*).

Loans' break up in terms of lending to the public and private sectors reveals that almost the entire lending was directed towards the private sector (98.5%), while the share of lending to the public sector further slipped to 1.5% during 2013 and was primarily for liquidity management purposes. With strong revenue profile of the public sector on the back of robust current account and budget surpluses over the last decade, the need for public sector to borrow from the banking system have remained minimal. The strong financial profile of the public sector has in turn helped Kuwait avoid the issue of private sector crowding out that some countries with frequent borrowing from the banking sector typically experience.

Geographical breakdown of the banks' lending portfolio reveals that out of banks' 36.6 billion of gross loans as of December 2013, 27.9 billion (76.3%) have been granted within Kuwait (*Figure 1.9*). The remaining 23% of the gross loans are distributed among various regions, with Europe and GCC accounting for around 9.86% and 6.7% respectively. Within GCC, banks' greatest credit exposure is confined to Bahrain, followed by UAE and KSA.

Except for investment companies, credit growth was positive for all sectors

Breakup of gross loans across various sectors indicates that lending to real estate and households sectors collectively accounted for around 45.5% of the total gross loans. As of December 2013, real estate and households had outstanding credit worth around KD 8.49 and KD 8.16 billion respectively (*Figure 1.10*). In general, all the key sectors observed a positive growth in credit utilization, except for the investment companies. In continuation of the trend in previous years, outstanding loans to investment companies contracted by another 19.2% in 2013 on the top of a 15.7% fall recorded a year earlier. With the continuous reduction of banks' exposure to investment companies, the share of gross loans to this



sector decreased to 3.7% of banks' overall portfolio in 2013, indicating the diminishing size of this type of lending amid investment companies' ongoing deleveraging.

The trend in loans over the years reveals that banks' collective exposure to key sectors remained fairly stable, with little indication of a sudden surge in any specific sector (Figure 1.11). While the loans are concentrated in few key sectors, a relatively stable trend in credit allocation suggests that banks have avoided the boom and bust cycles in their lending practices, underlining a conservative approach towards credit allocation.

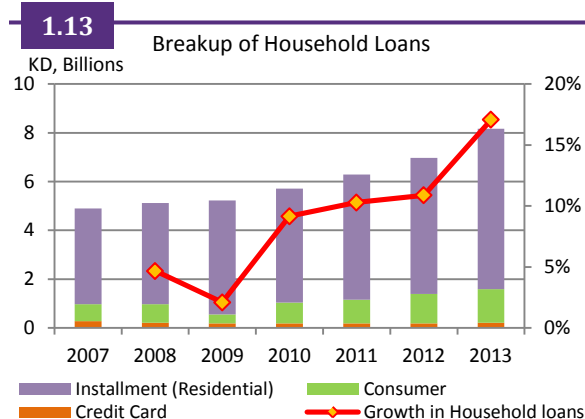
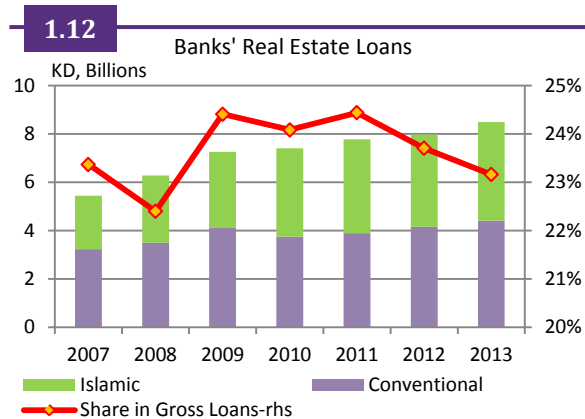
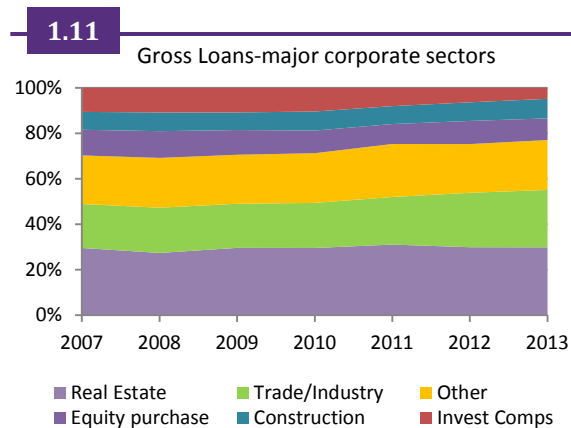
Almost a quarter of banks' lending is to the real estate sector

Banks' most significant exposure remained towards the real estate sector as these loans accounted for around 23.2% of banks' gross loan portfolio in 2013 (Figure 1.12). During the year under review, credit to real estate posted a growth of 6.5%, compared to a much slower growth of 2.6% in 2012. Lending to real estate segment has also remained almost equally divided among conventional and Islamic banks, though conventional banks had a slightly higher share (51.9%) as of December 2013.

Growth to households was the strongest among all sectors

Bank lending to households posted a strong growth of 17.1% in 2013, on the top of double-digit growth observed in 2011 and 2012 (10.3% and 10.9% respectively) (Figure 1.13). Pick up in credit off-take by households is a clear sign of improving consumer sentiments. The prevailing environment of low interest rates accompanied by the accommodative monetary policy has also encouraged household demand for banks credit.

With KD 8.17 billion of outstanding credit, the share of lending to household sector in banks gross loans further increased to 22.3% in 2013 compared to 20.7% a year earlier. Around 80.5% of the household loans have been *installment loans*, which are long term



personal loans for repair and purchase of private homes. These loans are repaid in monthly installments over a period not exceeding 15 years. Consumer loans, meant for purchase of consumer durables or to cover education/medical expenses, constituted the second major category of household loans with 17% share as of December 2013. Finally, credit card related loans made around 2.5% of overall household loans.

Growth in the investment portfolio was driven by banks' investments in other fixed income securities

On the back of a strong growth in banks' investments in other fixed income securities as well as in government securities, overall investments portfolio witnessed a growth of 9.88% during 2013, compared to a much slower growth rate of 4.07% a year earlier (Figure 1.14). A breakdown reveals that out of KD 10.17 billion of total investments, around KD 4.67 billion (46%) were placed in government securities as of December 2013. Banks' equity investments formed the second major category with 26.6% share in total investments. In the last few years, banks' exposure to other fixed income securities has particularly been on the rise; in 2013, it reached 18% of overall investments compared to 13.9% a year earlier.

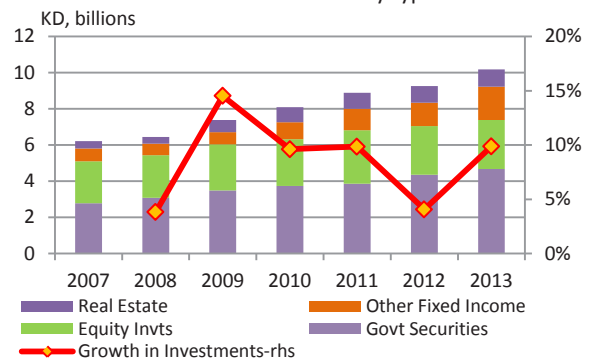
Geographical distribution of the investments indicates that banks' investments within Kuwait posted a visible drop, from 53.3% in 2012 to 47.6% in 2013. On the other hand, banks' exposure to some other regions went up, particularly in the countries within GCC and Asia (Figure 1.15).

Banks' deposit recorded another year of double-digit growth

Banking system deposits posted double digit growth in 2013, increasing by 11.2% compared to 11.6% a year earlier (Figure 1.16). Overall deposits reached KD 44.29⁴ billion as of December 2013, with domestic deposits accounting for 78% of total deposits of the banking system. Due to growing expansion of

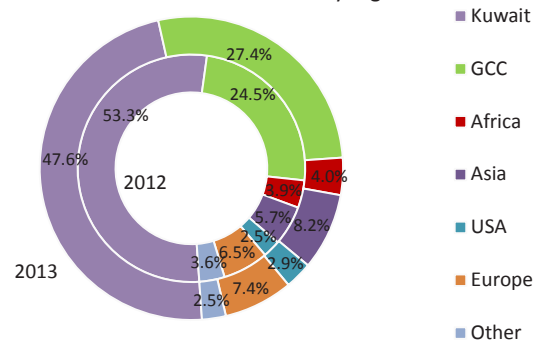
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Banks' Investments- by type



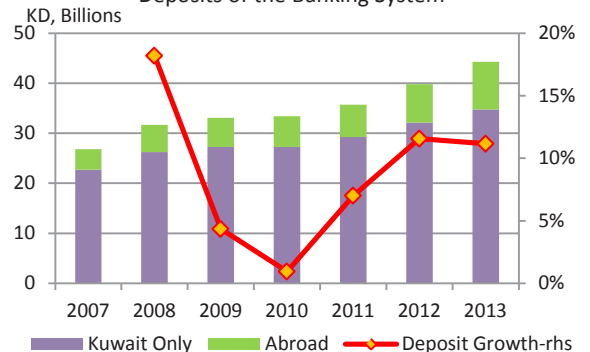
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Investment Portfolio-by region



1.16

Deposits of the Banking System

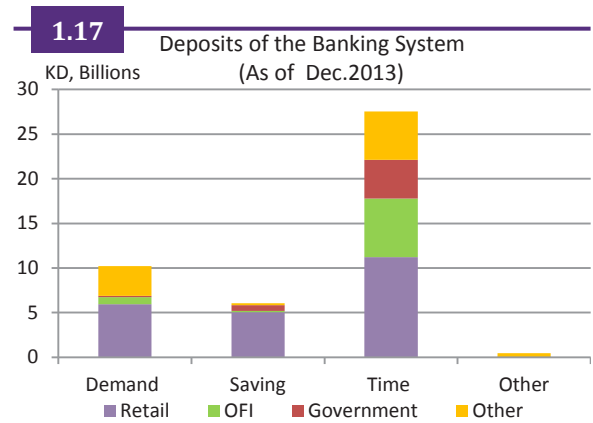


⁴ This includes government and private deposits as well as 'due from other financial institutions'.

Kuwaiti banks abroad, the deposits raised through branches and subsidiaries abroad registered robust growth of 23.3% in 2013 on top of 19% growth observed a year earlier. Accordingly, share of these deposits in banks' total deposits went up from 19.4% to 21.5% in 2013.

Around two-thirds of banks' deposits are time deposits

Breakdown of deposits reveals that time deposits account for around 62.2% of the total deposits, highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress. While most of Government deposits are in time deposit category, both retail and other financial institutions also maintain large amounts of time deposits (*Figure 1.17*). In terms of types of deposits, retail deposits are well diversified, in line with the consumers' transaction and precautionary demands for money. Finally, the deposits of other financial institutions (OFI) and government are overwhelmingly placed as time deposits.

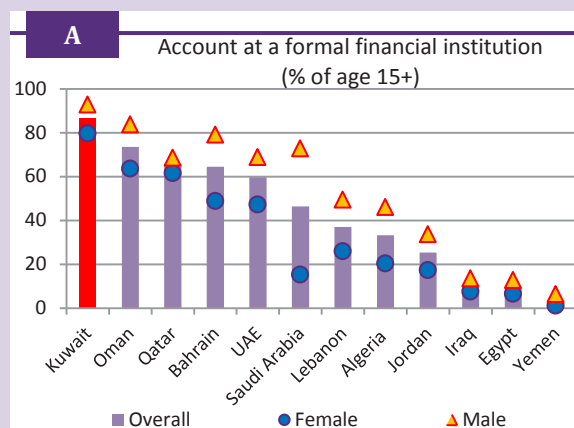


Financial Inclusion in Kuwait

Financial inclusion refers to the proportion of individuals and firms who use formal financial services. By some estimates, around 2.5 billion working-age adults in the world do not have an account at a formal financial institution, thus leaving them at the mercy of informal financial setups, if at all. It is pertinent to point out that ‘financial inclusion’ is not the same as ‘access to finance’; some firms or individuals may choose not to use certain financial services despite having access. For instance, an individual having an account with a bank may choose not to save any money there (thus maintaining a current account only) or may have no money to save. On the other hand, despite having strong demand, some segments of the society may have no access to finance either due to excessive costs (travel distance or documentation etc.) or simple unavailability of such services; policy makers are concerned about increasing access to these segments of society in particular.

There has been increasing recognition that financial inclusion can play a key role in reducing abject poverty and promoting broad based growth. Given the fact that around half of the world’s adult population is still ‘unbanked’, increasing access to formal finance is essential. The World Bank, with an aim to better understand the nature of financial inclusion and thus design appropriate remedial policies, compiled a comprehensive dataset in 2012. This dataset offers valuable insights about how adults in 148 countries save, borrow, make payments and manage risks. The data reveal that 50% of the adults worldwide have an account at a formal financial institution, 22% have saved at a formal financial institution in the past 12 months and 9% have obtained a new loan in the past year⁵. The unbanked population reports that high costs, physical distance and lack of proper documentation are some of the key barriers to inclusive finance. Understandably, there are significant differences among the advanced and less developed countries; in general, the account penetration is much higher in economies with higher GDP per capita.

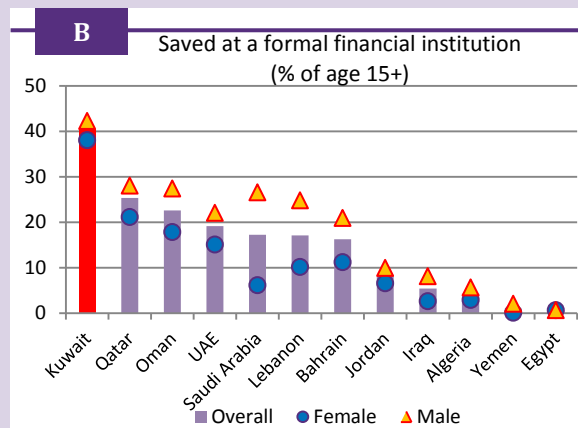
Against this backdrop, it is worth examining the status of financial inclusion in Kuwait. Using the World Bank’s dataset, we evaluate the performance of the financial sector in Kuwait in comparison to some other countries in the region. We specifically look at four distinct areas in financial inclusion, namely maintaining an account, saving at and taking loan from a formal financial institution and making payments. In Kuwait, 86.8% of the population above the age of 15 years has an account with a formal financial institution (*Figure A*). Gender wise breakdown reveals that 92.7% male and 72.8% females above the age of 15 years maintain an account. These numbers suggest that Kuwait has the highest level of financial penetration



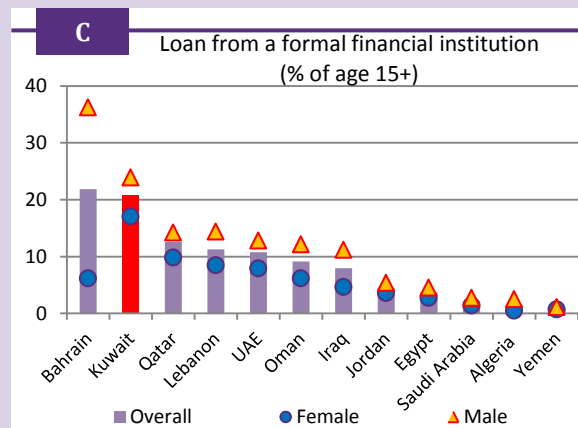
⁵The World Bank’s Global Findex (Financial Inclusion) Database, 2012.

compared to other countries in the region. Moreover, both male and female customers have fairly similar level of access to finance, when it comes to maintaining an account.

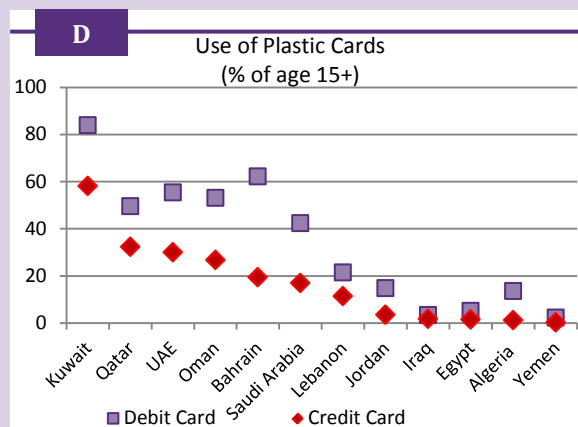
When it comes to saving at a formal financial institution, Kuwait again leads the region as 40.3% of its population above 15 years uses formal financial institutions to save (Figure B). Moreover, this percentage is significantly higher than other countries in the region. A quick comparison between Graph A and B also reveals that only around half of the people who maintain an account with a formal financial institution chose to save there. This could be either due to availability of better opportunities for savings (and investments) outside the banking system and/or due to limited ability of some income groups to save, particularly in less affluent countries of the region.



Statistics for the loans taken from a formal financial institution reveals that 20.8% of adults above 15 years in Kuwait have obtained a loan in the past 12 months⁶. This percentage is marginally lower than observed in Bahrain (Figure C). However, the difference between the loan taken by a male and a female customer is much lower in case of Kuwait, indicating a more gender-neutral access to loans.

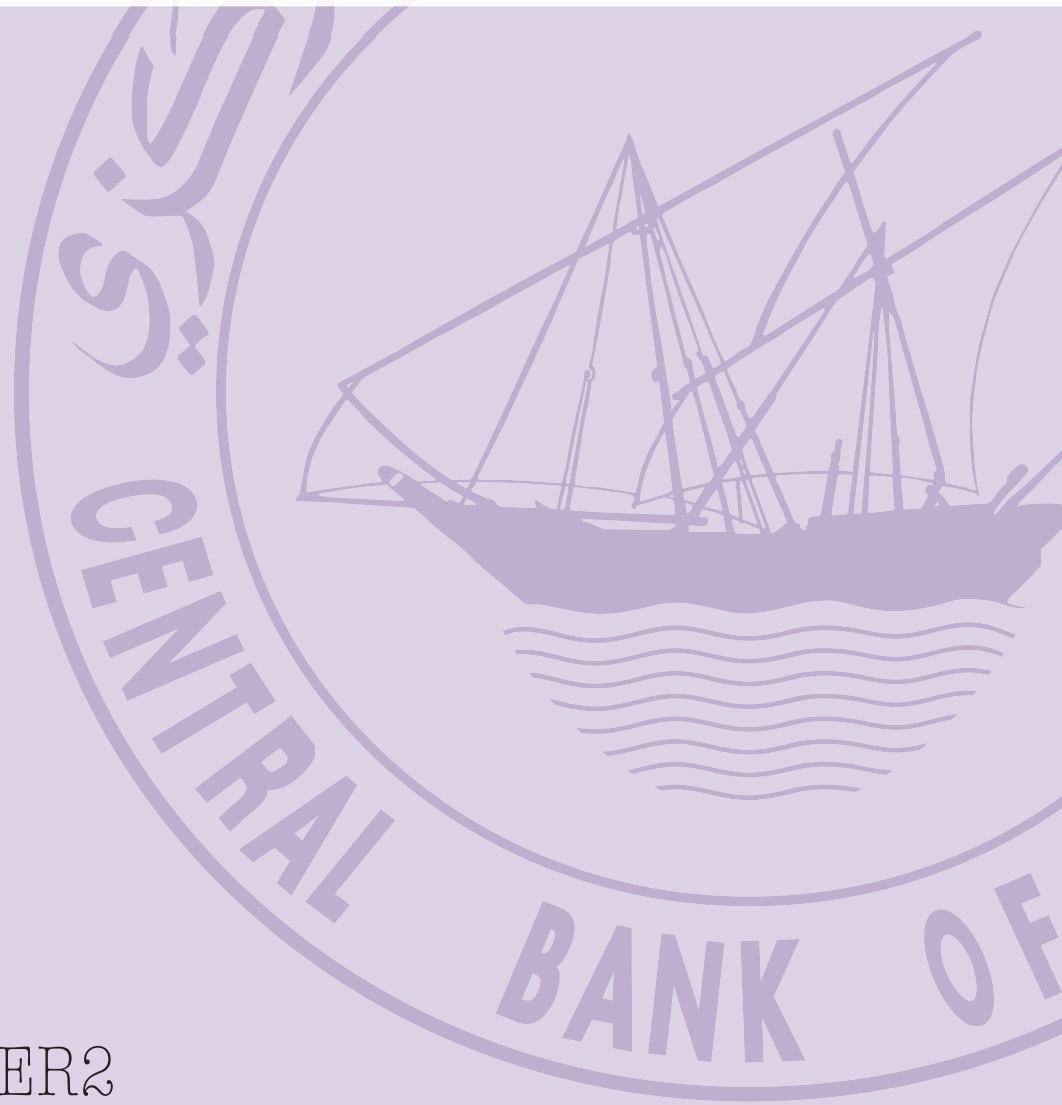


Finally, the data indicating the use of various means of payments reveals that 83.9% of adult population above the age of 15 years in Kuwait has debit cards while 58% also maintain a credit card (Figure D). Again, the percentage of population using electronic means of payment is significantly higher in Kuwait when compared with rest of the region.



The high level of financial penetration in Kuwait is the result of CBK and banks' continuous efforts to improve access to formal finance for all segments of the society by encouraging banks to expand their branch networks, to offer innovative saving products, facilitate credit and to promote the use of modern means of payments.

⁶This dataset was released by the World Bank in 2012.



CHAPTER 2

BANKS' RISKS ANALYSES

2013

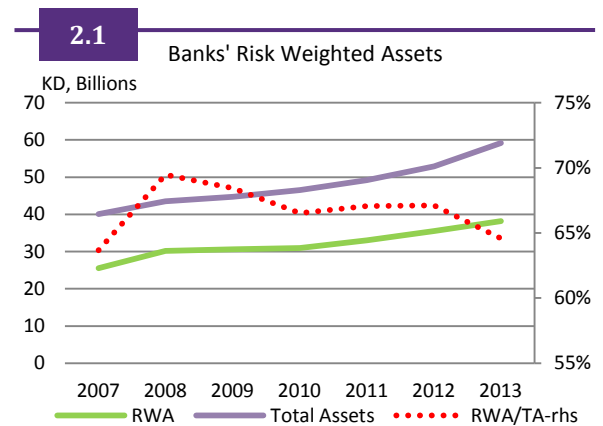
Asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR has dropped to 3.6% as of December 2013, lower than the 3.8% observed in 2007 before the financial crisis struck. Segregation of non-performing loan (NPLs) by age also reveals a visible slowdown in the buildup of new NPLs as loans 'under monitoring', and 'substandard' categories have contracted in the last two years, with a particularly sharp drop in the former category. Sectoral analysis of NPLs indicates that the real estate sector has witnessed a perceptible decline in the NPLs during 2013. Sector wise, the household sector loans appear the healthiest in relative terms. On the other hand, loans extended to investment companies have much higher level of non-performance, though the scale of banks' exposure to investment companies stand significantly reduced. Geographically, the share of NPLs originating from banks' operation in the European region has inched up, though the magnitude of these NPLs is well-contained. Industry breakdown suggests that conventional banks account for 57.8% of total NPLs, compared to their 61.6% share in gross loans. Banks' exposure to the equity market remains considerable, notwithstanding the recent drop in various indicators; equity investments make up around 26.6% of banks' total investments, and use of firms' shares as collaterals account for 31% of banks' overall collaterals. Finally, banks' liquidity levels continue to remain strong and funding base quite stable, further supported by the presence of a formal law to guarantee all deposits within Kuwait.

Share of risk-weighted assets in total assets has come down...

The share of risk-weighted assets (RWAs) in the total assets of the banking sector can potentially indicate the magnitude of risk in the asset base. As of December 2013, the share of banks' RWA in their total assets has come down to 64.6%, from 67.1% a year earlier (*Figure 2.1*). This is due to relatively higher growth in total assets compared to that of RWA, suggesting a shift towards safer assets in the banks' balance sheets. As we highlight below, other key indicators of credit risk also point towards an improved risk profile of the banking system.

.....with NPLs receding to the pre-crisis levels

Non-performing loans (NPLs) of the banking sector have dropped to their lowest level in the last six years, thanks to the strenuous efforts made by banks on CBK's instructions and active encouragement. The pool of NPLs have been steadily declining since 2009, suggesting that banks have been able to arrest the



growth in non-performing loans quite early on and thus without much damage. Net NPLs (Gross NPLs less specific provisions) also reveal a similar trend, climaxing in 2009 with a steady decline afterwards.

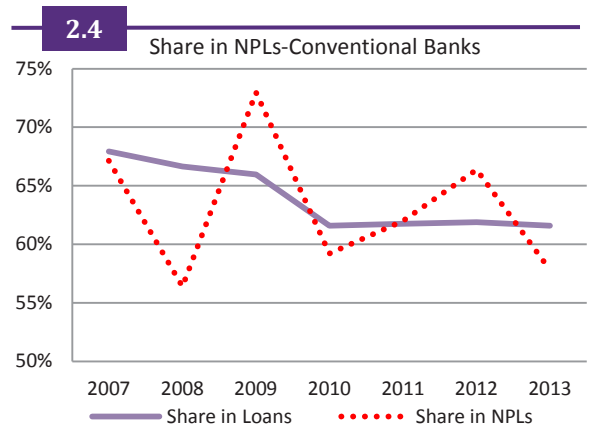
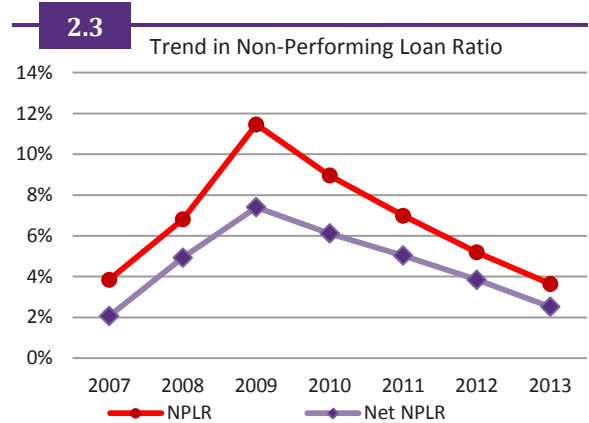
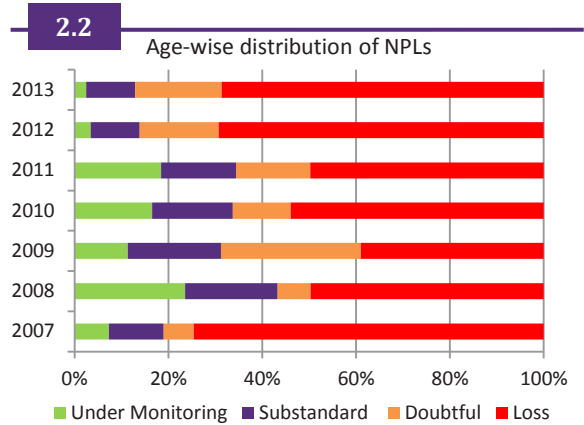
Additionally, NPLs break up by age also indicates that not only overall NPLs have come down but the built up of new NPLs has also significantly dropped, with the share of loans ‘under monitoring’ and ‘substandard’ categories, the first two categories in NPLs age-wise classification, visibly lower in the last two years (Figure 2.2).

With the steady decline in NPL, the NPL ratio (NPLR) has also come down to 3.6% by Dec-2013, even lower than the pre-crisis ratio of 3.8% observed in 2007 (Figure 2.3). Given that credit risk constitutes the bulk of banks’ RWA, declines in both the size and ratio of NPLs indicate significant improvement in the health of the banking system. Net NPLR have also been on a downward trend since 2009, as banks, on the instructions of the CBK, have continued to build sufficient levels of provisions.

A breakdown of NPLs by type of banks reveals that conventional banks’ share in the industry NPLs have dropped to 57.8% by December 2013 from 66.4% a year earlier (Figure 2.4). With their share in total loans (61.6%) remaining almost the same as in 2012, the quality of conventional banks’ loan portfolio has improved relative to Islamic banks. Given the fact that top four banks account for 72.4% of the total loan portfolio of the banking industry, a sharp change in the quality of credit portfolio in even one of the major banks can significantly influence the industry average.

Banks’ coverage ratio has continued its growth unabated

As required by the CBK, Kuwaiti banks have been building up additional provisions since the start of financial crises to withstand any potential deterioration in their credit portfolios. During 2013, total available provisions witnessed a growth of 8% compared to an insignificant rise of 0.5% during 2012.

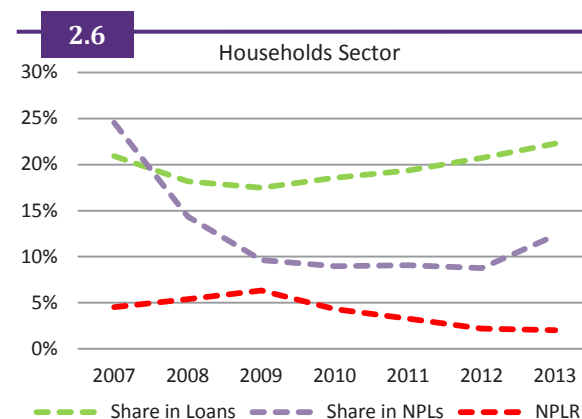
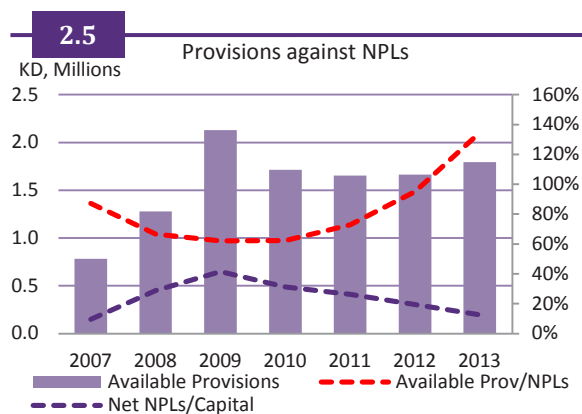


Accordingly, the *available provisions to NPL ratio* surged to 135%, an all-time high in the last seven years, and significantly greater than the pre-crisis ratio of 87% (*Figure 2.5*). Though the increasing level of provisions has some bearing on banks' profits, it has significantly enhanced the resilience of the banking system (as we discuss in Chapter 3).

A breakdown of available provisions reveals that precautionary provisions have been on rise in particular. CBK has continued to press upon banks for accumulating such provisions to help them better withstand any possible deterioration in the quality of their credit portfolios. These provisions are counter cyclical in nature, as the build-up of these provisions in relatively benign times would enable the banking sector to better cope with any potential downturns, without compromising their ability to extend credit. With the aforementioned trend in provisions, the *net NPLs to capital ratio* (indicating the fraction of banks' capital that could be hit by NPLs) has steadily declined in recent years.

Households sector boasts the lowest NPLR, thanks to CBK's stringent regulations

NPLs breakdown by sector reveals that the households sector accounts for 12.3% of the total NPLs while having a share of 22.3% in banks' loan portfolio (*Figure 2.6*). As of December 2013, the household sector posted the lowest NPLR of 2.0%, making it the safest portfolio in relative terms. A number of CBK regulations over the years have helped keep the non-performing loans in the households sector at the minimum. For instance, these loans are primarily extended to nationals, provided the payments are not above 40% of their salaries (net of all deductions). Moreover, the interest rate charged on these loans is capped at 3% above the prevailing discount rate set by the CBK. Furthermore, since these loans are typically smaller in magnitude and are granted to numerous individuals, the overall portfolio is well diversified with a much lower risk profile.



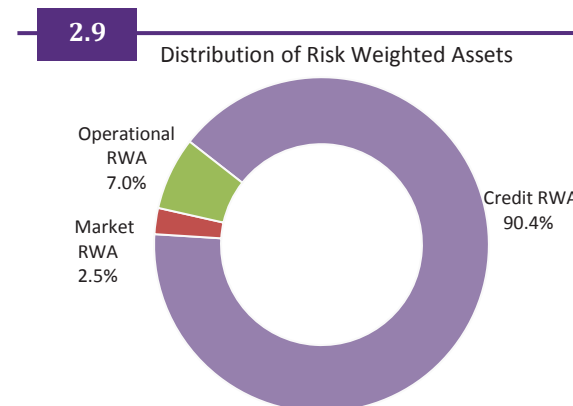
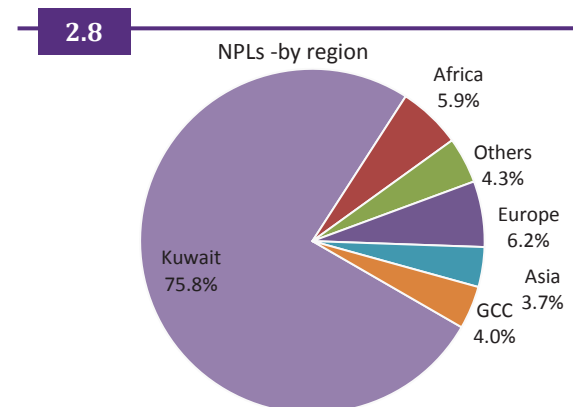
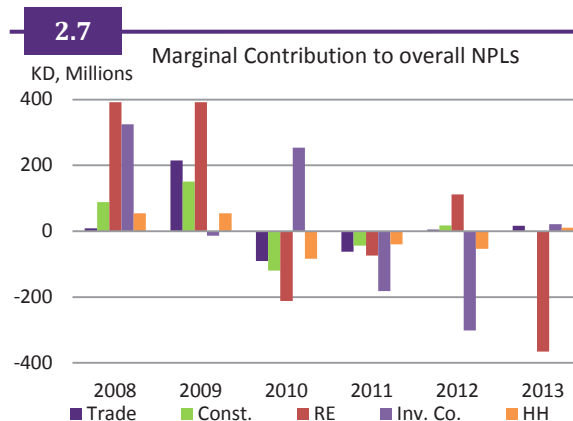
On the other hand, the real estate and construction sector accounts for around 40.7% of total NPLs while having a share of 29.9% in total loans. This disproportionately higher level of non-performing loans indicates the concentration of banks' credit risk in real estate and construction. On a positive note, marginal contribution of real estate in overall NPLs has become negative in 2013, given the continuous recovery in the real estate market⁷ (Figure 2.7).

In the case of investment companies, their significance as banks' key borrowers has continued to decline. While the NPLR for the investment companies is among the highest, their impact for the banking sector is limited as this portfolio have been effectively ring-fenced.

Geographical distribution of NPLs reveals that the share of domestic NPLs have visibly come down from 79.6% in 2012 to 75.8% in 2013, another indication that pace of domestic NPLs have slowed down more significantly than for the operations abroad (Figure 2.8). Outside Kuwait, the level of non-performing loans in the European region is still contained, though its share in total NPLs has increased from 3.5% in 2012 to around 6.2% in 2013. On the other hand, the share of NPLs originating from GCC has edged down from 5.7% to 4% during 2013.

Market risk remains the smallest component in overall RWAs

Given the traditional nature of Kuwaiti banks' operations, market risk remains a fairly small component of the overall RWAs, accounting for a meager 2.5% (Figure 2.9). The insignificant contribution by market risk in overall RWAs is on account of relatively smaller trading portfolios and also due to the fact that the risk weighted assets (RWA) are calculated under Pillar-1 of Basel II which excludes interest rate risk in the banking book. On the other hand, credit risk is understandably the most significant of all risks confronted by Kuwaiti banks,



⁷ See Chapter 4 for details.

given the traditional nature of banking operations primarily geared towards credit facilities.

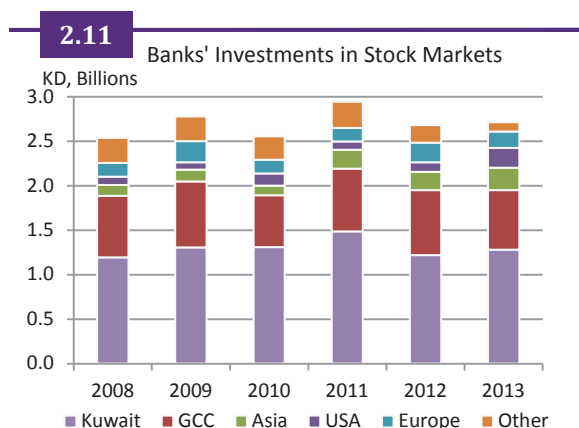
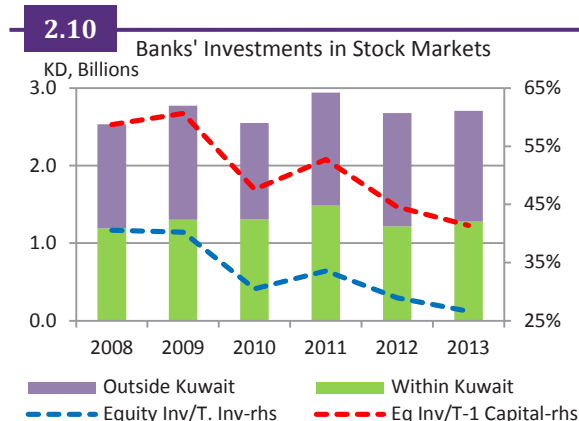
Despite the steady decline, bank' equity investments are significant

A key aspect of market risk faced by Kuwaiti banks is their exposure to the stock market, which can be viewed in three different dimensions; banks' direct investments, use of shares as collateral in lending and loans for purchase of shares. The first aspect covers banks' direct exposure to the equity market while the other two highlight the banks' indirect exposure, through their loan portfolios.

First, in terms of banks' direct exposure, banks' equity investments represent 26.6% of their total investments by end of 2013 (Figure 2.10). While the share of their equity investments has dropped from around 40.2% back in 2009, it is still over a quarter of banks' total investments. When viewed in terms of banks' Tier-1 capital, banks' equity investments are around 41%, again a high percentage, though at the lowest level in the last five years. These numbers suggest that banks are vulnerable to sharp swings in equity prices. In case of some banks, higher equity investments are the result of debt for equity swaps made with their clients in the investment sector.

In terms of regional distribution, almost half of banks' equity investments are within Kuwait, which witnessed its share rising marginally from 45% to 47% during 2013 (Figure 2.11). On the other hand, banks' exposure to GCC and European equity markets has slightly come down from 27% to 25% and 8% to 7% respectively during the same period. With around 52% of banks' equity investments distributed across GCC, Asia and Europe etc., the diversification in banks' portfolio helps them withstand sharp swings. However, as historical experiences suggest, correlation across markets increase during times of stress, eroding the benefits of diversification that otherwise seems substantial in good times.

Second, in terms of banks' indirect exposure, equity collateral constitutes around 31% of the total



collaterals held by banks. The use of shares as collateral has been on decline, from a high of 40% of all collaterals in 2010 to 30.7% by 2013 (Figure 2.12). With equity collateral still accounting for around one third of the total collaterals, banks could be exposed to sharp swings in equity prices. However, the steady increase in the share of real estate collateral poses its own unique risks, not least because of the complications in liquidating such collaterals in the event of a default.

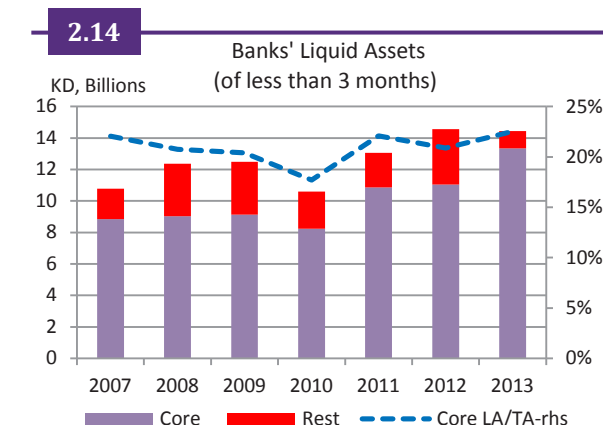
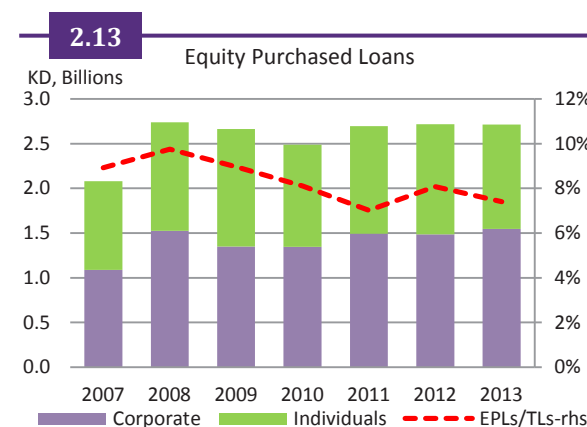
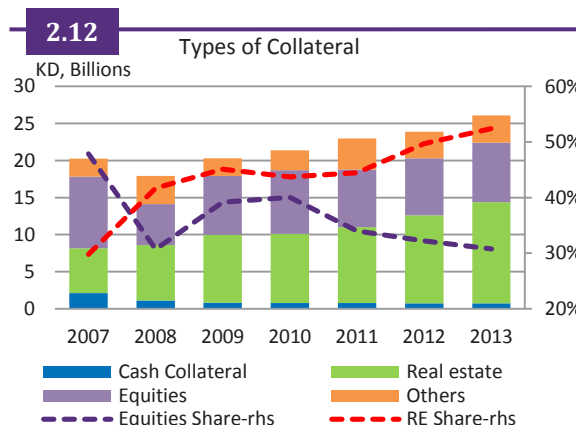
The third form of banks' indirect exposure has been in terms of loans granted to customers (both individuals and corporates) for trading in shares. These loans, termed as equity purchase loans (EPLs), make up around 7% of banks gross loan portfolio, thus within the limit of 10% set by CBK (Figure 2.13). A breakdown of these loans reveals that corporate sector has slightly higher share in these loans (57% in 2013) compared to individuals availing such facilities. With around 6.9% share in banks' non-performing portfolio, EPLs are a key component of banks' risk exposure, both from the point of credit and market risk.

Banks' have maintained strong liquidity levels

Banks liquid assets of less than three months have witnessed a rising trend since 2010, but with a slight drop during 2013 to reach at KD 14.4 billion (Figure 2.14). A breakdown between core and non-core liquid assets reveals that core liquid assets (including cash and cash equivalents, deposits with CBK, government securities, CBK bills, and deposits with banks etc.) represent 92.43% of the overall liquid assets in 2013, compared to 75.84% in 2012. Thus while the liquid assets have marginally come down in 2013, the share of core has significantly gone up. As a component of total assets, core liquid assets account for 22.5% as of December 2013

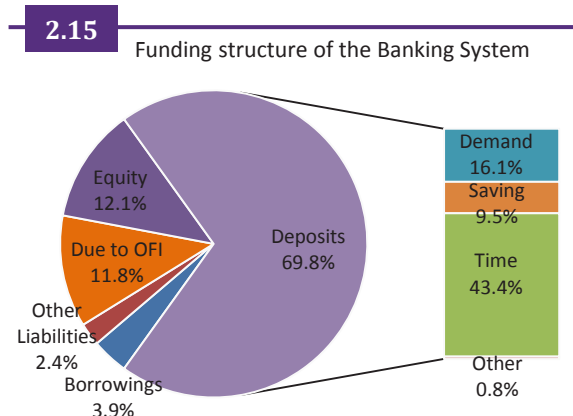
A stable deposit base is the key source of banks' funding structure

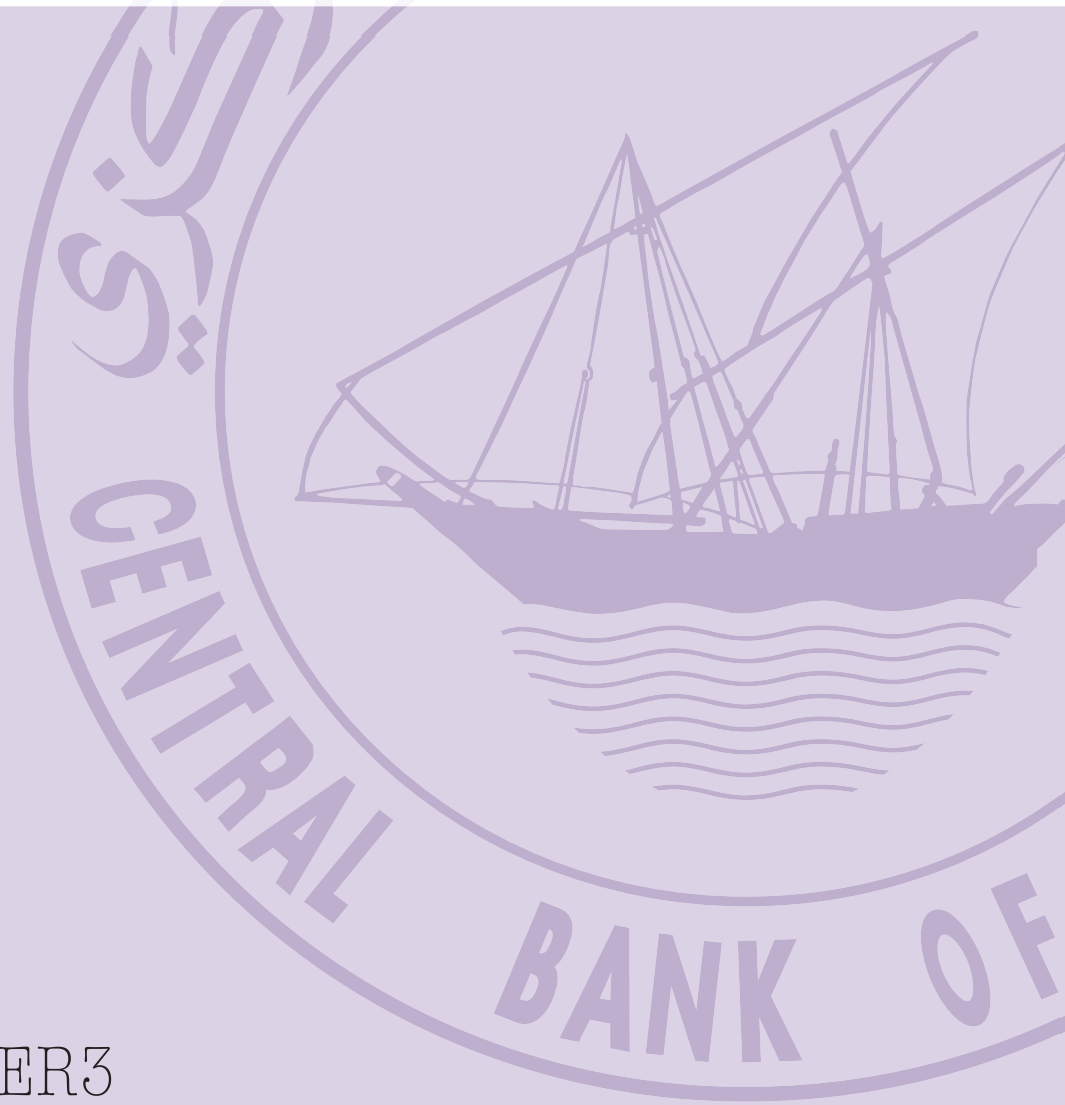
Customer deposits account for more than 2/3rds of the banks funding base as of December 2013 (Figure



2.15). Within deposits, time deposits constitute the bulk, accounting for 43.4% of the overall funding base and around 62.2% of total customer deposits. A sizeable share of time deposits provides Kuwaiti banks with a comfortably stable funding base to adequately perform their role as financial intermediaries. Moreover, since Kuwait formally enacted the Deposits Guarantee Law in 2008 to protect depositors, the risk of bank runs has also been effectively eliminated.

During 2013, share of demand deposits in overall funding marginally increased, from 14.7% to 16.1%. However, this gain did not come at the expense of time deposits (whose share went up by a much higher margin, a 3.8 percentage points). Rather it was the collective gain of deposits (of 3.6 percentage points) in overall funding, particularly due to stronger growth in time deposits, which has further strengthened the stability of the funding base.





CHAPTER 3

PROFITABILITY, SOLVENCY AND RESILIENCE

2013

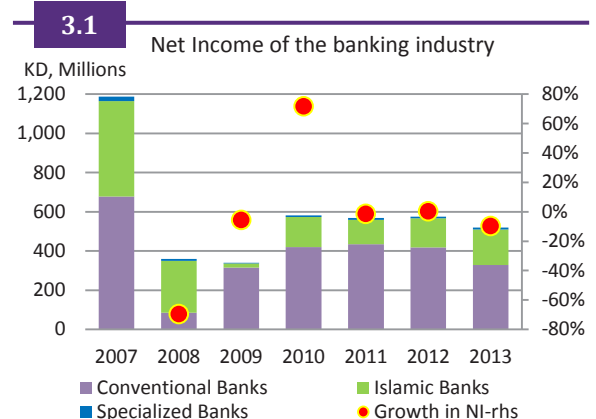
3

PROFITABILITY, SOLVENCY AND RESILIENCE

Banks' net income posted a contraction of 10% during the year under review (2013), due both to higher non-interest as well as provisions expenses. Return on assets as well as equity also experienced a decline as growth in assets and equity outpaced the growth in net income. Islamic banks further gained their share in industry profits, making it almost commensurate with their share in total banking assets. Still, conventional banks account for 63.3% of the industry profits and 61% of the industry assets. The share of non-interest expense has been on a steadily rising trend, while interest expenses experienced a marginal drop in low interest environment. Cost to income ratio has inched up for the banking sector, though conventional banks on average still remain significantly more cost efficient than their Islamic counterparts. Capital adequacy ratio (CAR) of the banking sector strengthened further, reaching a fairly high level of 18.8%. Group-wise, CAR of both conventional and Islamic banks have converged in 2013. Results of CBK's Quarterly Stress Testing Exercise reveal that banks, individually and collectively, have been able to withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

Net income, on a consolidated basis, declined by 10%

During the year under review, Kuwaiti banks experienced a noticeable drop in earnings; after tax net income, on a consolidated basis, went down by 10% to reach KD 519 million in 2013 (Figure 3.1). Stronger growth in non-interest and provisions expenses during 2013 was instrumental in bringing the industry profits down. While the steady growth in provisions has pushed the banks' coverage ratio to fairly high levels (see Chapter 2 for details), the robustness in coverage has come at a cost of lower industry profits. Another factor that helps partially explain the drop in net income in 2013 is the disappearance of the one-off impact of exceptional gains recorded by a major bank in 2012 on its shareholding of another domestic bank. Once we adjust for this unusual item that bolstered net income in 2012, the decline in earnings in 2013 appears muted. Breakdown of profits among domestic and foreign operations indicate that around 16.4% of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad, signifying the importance of banks' foreign operations.



...pulling down the overall return ratios as well

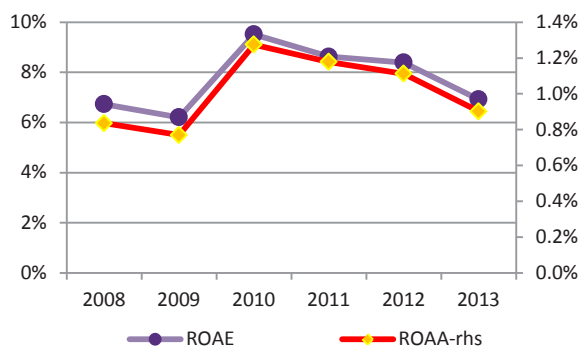
In line with the trend in net income, average return on equity and assets have edged further down in 2013, reaching 6.9% and 0.9% respectively (Figure 3.2). The last three years have witnessed a declining trend in both the return indicators due to a combined effect of much stronger growth in equity and assets of the banking system on the one hand and negative growth in net income on the other (except in 2012 when net income grew by a meager yet positive 0.2%).

Over the years, the gap between industry wide returns⁸ and those enjoyed by the Islamic banks have sharply narrowed (Figure 3.3). For instance, the ROE of Islamic banks was lower by 5.2 percentage points in 2009 when compared with all banks' ROAE; however, the gap now stands at a paltry 0.1% (as of December 2013). ROA has followed a similar pattern as well, suggesting that Islamic banks, on average, have been able to improve their earning profiles relative to the overall banking sector. Calendar year 2008 was an outlier in the sense that Islamic banks enjoyed a visibly positive differential in returns viz-a-viz the overall banking industry; however, this was primarily due to serious losses incurred by a conventional bank which turned the industry ratios in favor of Islamic banks.

With the improved earning profile of Islamic banks, conventional banks' share in industry profits has witnessed a concomitant decline (Figure 3.4). Yet, conventional banks still account for around 2/3rd of the industry profits, which is quite similar to their share in total assets as well. By 2013, the proportionate share of both conventional and Islamic banks in industry profits has converged to their respective share in overall banking assets. Admittedly, this is only true at the group level as differences in performance among individual banks still remain wide.

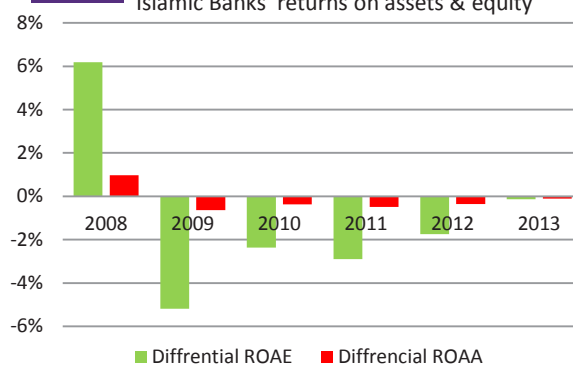
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Return on Equity & Assets



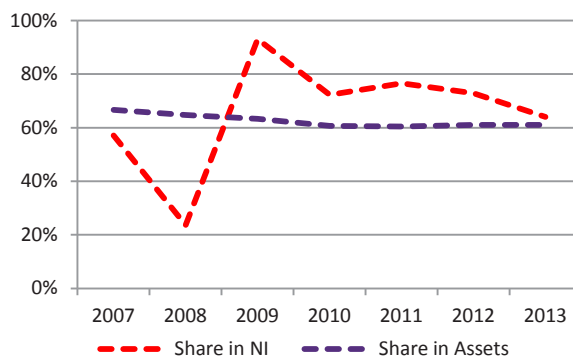
3.3

Islamic Banks' returns on assets & equity



3.4

Share of Conventional Banks



⁸ Differential ROAE= ROE of Islamic Banks – ROAE of the banking industry. A negative differential means Islamic banks lag behind the overall banking industry in terms of ROE. Differential ROAA can be interpreted likewise.

Lower interest expenses helped NII post a positive growth

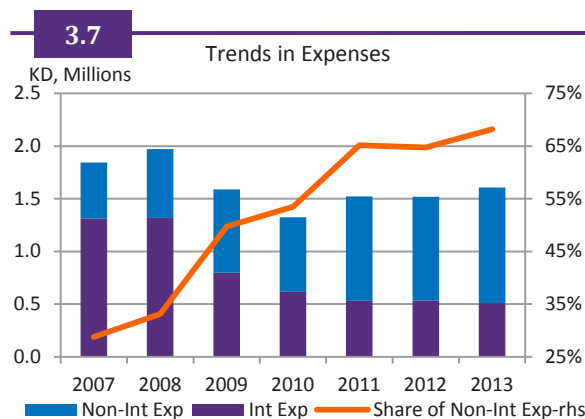
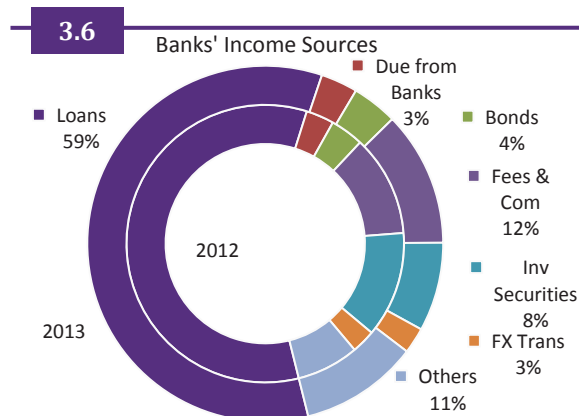
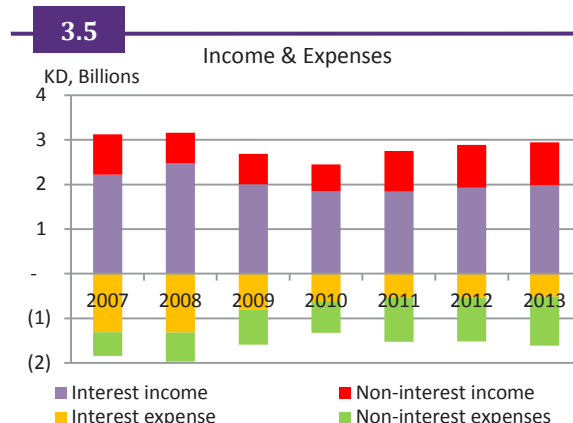
Both the interest and non-interest income recorded positive, albeit marginal growth during 2013, increasing by 2.9% and 0.2% respectively (Figure 3.5). Understandably, potential for higher interest income growth was after all limited, given the prevailing low interest rate environment. On the expense side, banks were able to cut down their interest expenses which posted a contraction of 4.5% during the year under review. This combined with a positive growth in interest income, helped banks in improving their net interest income (NII) by 5.7% during 2013.

In line with the historical trends, banks continued to generate bulk of their income from their loan portfolio (Figure 3.6). During 2013, income from loans accounted for 88% of banks' interest income and 59% of their total income. Moreover, the breakup of interest income from loans reveals that 52% came from credit facilities granted to retail clients while the remaining 48% from lending to corporates.

On the other hand, gains from investment securities registered a sharp decline of 33% in 2013 compared to a year earlier. This was mainly due to base effect as in 2012 a leading conventional bank recorded exceptional gains on its shareholding in another domestic bank.

Yet higher non-interest expenses & provisions dampened NII

The overall profitability of the banking sector was affected by a much stronger growth in non-interest expense as well as in provisions expense. Against the backdrop of a low interest rate environment, interest expenses have remained almost flat in the last three years, rather 2013 witnessing a drop of 4.5% (Figure 3.7). On the contrary, both the absolute size as well as relative share of the non-interest expenses have been on rise; in 2013, non-interest expenses were as high as 68.2% of interest and non-interest expenses combined, reflecting their growing importance in banks' overall cost of operations.



While the growth in loan loss provisions expense was more pronounced in 2012 (23.1%), the rising trend has continued in 2013 as well, as provisions expense were up by 16.7% to reach KD 677 million (Figure 3.8). CBK has required banks to continue building up precautionary provisions in line with a conservative approach. Accordingly, banks have made serious efforts in recent years to reduce unhealthy exposures and build-up strong provisions.

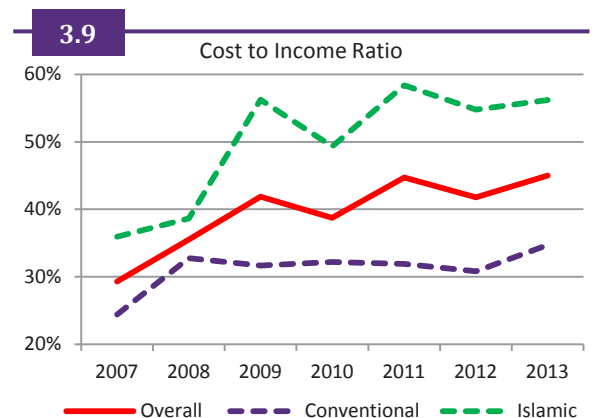
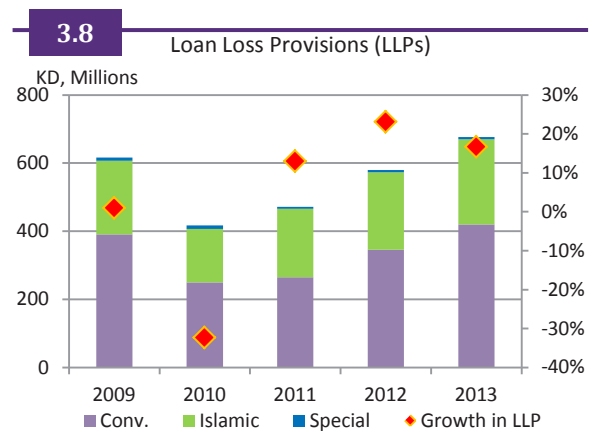
Conventional banks continue to exhibit better efficiency

Banks' operational efficiency has marginally deteriorated during 2013, as reflected by an increase in the cost to income ratio from 42% to 45% (Figure 3.9). This has been primarily on account of higher expenses related to 'salaries and other employee benefits' as well as relatively greater other non-interest expenses in 2013.

On average, conventional banks appear significantly more efficient than Islamic banks, at least when viewed in terms of cost to income ratio. Higher cost to income ratio for Islamic banks has a variety of reasons. First, operating environment for Islamic banks is somewhat more challenging, given Shariah restrictions on certain products/services otherwise available to conventional banks, making even normal operations like liquidity management more challenging. Second, transaction costs for Islamic banks are generally higher, both on account of higher legal and Shariah requirements to execute the same transactions. Third, high level of operating expenses for Islamic banks also stem from their non-banking subsidiaries which inherently are associated with higher operating expenditures.

Banks' CAR, already at high level, have further inched up

Kuwaiti banks have consistently maintained high capital levels, given CBK's strong focus on ensuring a stable financial system where robust capital adequacy plays an important role. During the year under review, banks' capital adequacy ratio (CAR) on consolidated



basis improved to 18.8%, compared to 18.5% in 2012 (Figure 3.10). Such high level of CAR underscores the strength of banks in Kuwait and is a key indicator of a stable banking system capable of withstanding any major shocks. To ensure those Kuwaiti banks' capital adequacy remains in line with global norms, CBK has already phased in the implementation of Basel III capital standards from January 2014.

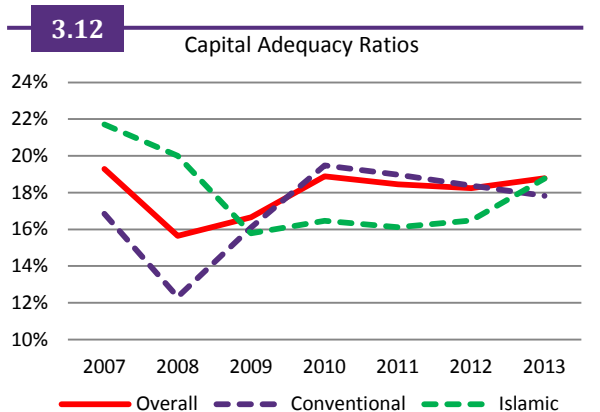
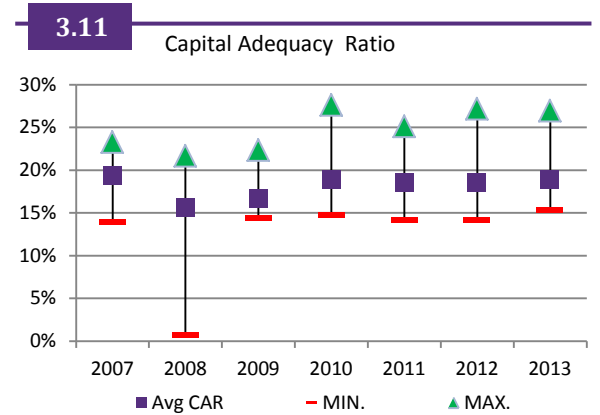
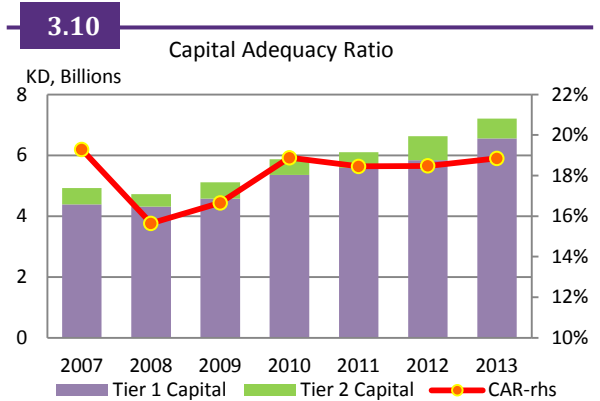
Improvement in CAR was essentially due to an increase in banks' Tier 1 (Core) Capital that witnessed 12.2% growth during 2013. Specifically, all the key components of banks' capital (e.g. paid-up capital, premium and retained earnings) made a positive contribution towards a higher CAR. Strength of the Kuwaiti banks' capital can be further observed from the fact that Tier 1 capital accounted for around 90.9% of banks' total capital in 2013, in comparison to 88.5% in 2012.

...with all banks having minimum CAR above 15%

A closer look at the CAR of individual banks indicates that even the lowest CAR maintained by a single bank was above 15% during 2013 (Figure 3.11). This level is significantly higher than the minimum required ratio of 12% set by the CBK. In fact, the minimum CAR maintained by any single bank was never lower than 14% during the last seven years, except in 2008 when one of the conventional banks experienced significant losses due to its exposure to some derivatives products. In that particular case, capital injection in the said bank was swift enough to avoid any serious repercussions for the banking system in general, with minimum CAR for the next year (2009) restored to 14.4%.

Capital adequacy of Islamic banks have observed stronger gains

Group wise, CAR of the Islamic banks have significantly improved during the last year, from 16.5% to 18.8% while that of conventional banks have registered a decline of 0.6% (Figure 3.12).



Other indicators of capital adequacy also reveal similar trends as Islamic banks seem to have experienced a much stronger improvement in their capital adequacy profiles (*Table 3.1*). However, given the fact that a few banks can significantly influence group averages, these trends are not necessarily an indication of broad based changes in group-wise capital adequacy ratios.

Banks' loss absorption capacity has strengthened further

Thanks to strong capital adequacy levels and higher provisions, banks' net NPLs to capital ratio, an indicator of the fraction of banks' equity that can be wiped out due to loan losses, has dropped further, reaching 12.6% by December 2013 (*Figure 3.13*). While the Net NPLs to Capital ratio was somewhat higher for the conventional banks in the last two years, it has converged to the level of Islamic banks. This suggests that on average, the final impact of increase in capital and in provisions have been somewhat similar for both the conventional and Islamic banks.

Leverage ratio of the banking industry was 8.7% as of December 2013, not only well above the global minimum of 3% but also higher than the more stringent 6% proposed by US regulators for their systemically important banks. The gap between Kuwaiti banks' leverage ratio and global minimum proposed by the Basel Committee on Banking Supervision has increased since 2008 and now stands at 5.7 percentage points (*Figure 3.14*). This gap reflects the range of cushion that Kuwaiti banks can use to expand their credit portfolio without breaching the global norms on leverage ratio.

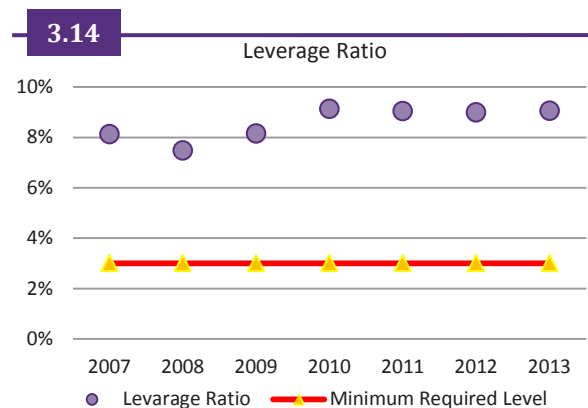
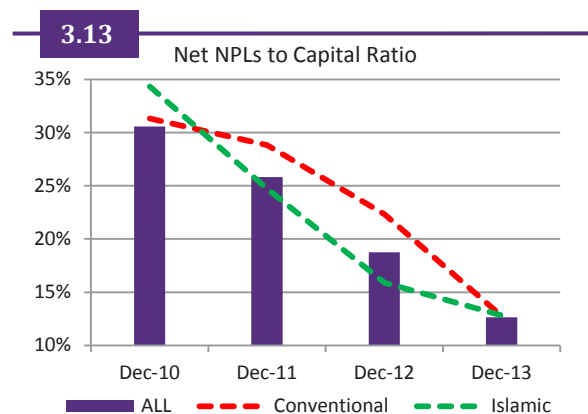
Banking sector appears resilient against major shocks

CBK conducts in-house stress testing exercises on a quarterly basis to determine the level of resilience of individual banks as well as of the entire banking sector (for details, see *Box 3.2* in the FSR of 2012). In line with past practice, quarterly stress tests were

Table 3.1

Bank's Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	2012	2013	2012	2013	2012	2013
Conv. Banks	18.4%	17.8%	16.0%	15.7%	12.3%	11.8%
Islamic Banks	16.5%	18.8%	16.3%	19.2%	12.0%	12.6%
All Banks	18.2%	18.8%	16.4%	17.4%	12.6%	12.5%



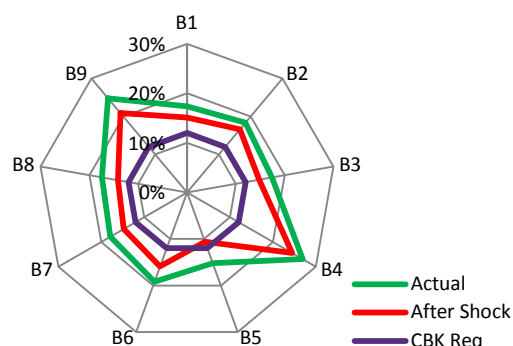
conducted using the data as of December 2013, applying various macro and micro level scenarios of different severities.

Our results show that banks⁹ in general were able to maintain high capital adequacy even after the impact of severe shock to the system calibrated under various scenarios (Figure 3.15). While the impact of shock was understandably different on individual banks, the lowest after-shock CAR of an individual bank was recorded at 11%, still sufficiently higher than the global norms.

Given the much larger share of credit portfolios in overall asset base, banks appeared more vulnerable to the deterioration in the quality of their loan/financing portfolio, particularly in specific sectors such as real estate and to a less extent towards investment companies. However, comparison of our stress test results over the years reveal that banks have strengthened their ability to withstand shocks even in these sectors by putting up additional capital and building more provisions.

In case of market risk shocks, banks had relatively greater exposure to a drop in asset prices through direct exposures to equity and real estate investments as well as indirectly through collateral coverage. On the other hand, banks' vulnerability to interest rate and foreign exchange risks remained limited. Finally, shocks related to liquidity crunch showed that banks remained liquid even under conditions of severe liquidity stress, highlighting banks' existing strong levels of liquidity.

3.15



⁹ One of the banks, due to its very high CAR, has been dropped from the Figure 3.15 to avoid distortion of the graph.

Islamic Finance- The challenges ahead¹⁰

Assalam-o-Alaikum! *Sabahal-khair* and a very good morning. It is a great pleasure for me to be here in Bahrain today to speak in this august forum. I am particularly thankful to H.E. Rasheed Mohammed Al-Maraj, Governor of the Central Bank of Bahrain for his kind invitation. The choice of venue for holding this World Islamic Banking Conference (WIBC) is appropriate indeed, given Bahrain's pioneering role in promoting Islamic finance. The country not only has a vibrant Islamic banking system but also houses a number of institutions that helped shape the development of Islamic finance. I would also like to congratulate WIBC for organizing this conference of great significance on the eve of their 20th anniversary celebrations.

As an industry, Islamic finance is no longer a novelty neither it is restricted to Muslim countries only. Over the last decade, the industry has transformed itself from being a niche market for devout Muslims to a viable alternative for the consumers of conventional finance, irrespective of their religious beliefs. The basic tenets of Islamic finance, like the idea of sharing profits and losses, investments only in ethically permissible areas, and the inseparable link of finance with real and productive economic activities, are understandably appealing to all. Estimates suggest that global market for Islamic financial services, as measured by Shariah compliant assets, has reached above USD1.7 trillion by now, a quantum leap from a paltry USD 150 billion in mid 1990s. Currently, there are more than 716 Islamic financial institutions operating in 61 countries. At its current pace, the growth in Islamic finance stands sharply ahead of conventional finance which experienced significant deleveraging and slowdown in the wake of global financial crisis. Moreover, *sukuk* or Islamic bond market has also leapt forward, with *sukuk* worth USD140 billion issued during 2012 alone.

While these developments are indeed encouraging, there is no reason for complacency. The reality is, we have just passed the first phase by showing that Islamic finance is a truly viable business proposition. While the credentials of Islamic finance stand undoubtedly established, its presence yet needs to expand. After all, Islamic finance is still merely one percent of the global financial system. So it is not the end. Rather, as Churchill once said, albeit in a different context, "It is not even the beginning of the end. But it is, perhaps, the end of the beginning".

The same could be said about the current state of Islamic finance. While we have every reason to celebrate the progress that has been made so far, we also need to recognize that we have a long journey ahead.

The next phase requires strenuous efforts to improve the capacity of all the key institutions involved in the development of Islamic finance. This applies not only to the academic, legal and regulatory bodies which have to continue to provide support and an enabling environment, but also to the Islamic Financial Institutions (IFIs) themselves. Without necessarily following a particular order, I would like to share my thoughts on each of these key institutions, assessing their progress so far and reflecting on the way ahead.

First, let me begin with the role of academic institutions as they are at the heart of our source of knowledge and wisdom. Conventional finance and economics has produced an enviable amount

¹⁰ Keynote speech delivered by H.E. Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait in the opening session of World Islamic Banking Conference, Bahrain, December 4, 2013.

of literature for decades, comprehensively covering theoretical foundations and empirical evidence. In contrast, rigorous analytical work in the field of Islamic finance is still generally lacking. This state of affairs is partially a reflection of the subdued importance that has been ascribed to quality research, irrespective of the subject matter. No wonder that in ‘The Times World University Ranking of 2013’, not a single university from any Muslim country features among the top 200. This is truly unfortunate, given that our ancestors were pioneers in various academic disciplines ranging from alchemy to astronomy and mathematic to medicine.

Unsurprisingly, we have failed to identify and build upon even those areas of research which are inherently at the heart of Islamic finance. For instance, conventional finance theory did not formalize the importance of risk until the work of Irving Fisher in the early twentieth century. The entire foundation of Islamic finance, on the other hand, is primarily based on the premise of ‘risk sharing’. If we had a vibrant culture of research at our universities, our academics would have developed these ideas much earlier than in conventional finance.

Let me acknowledge, however, that in the last two decades, considerable effort has been made to develop the theoretical foundations of Islamic finance. Still, most of this output is the result of personal dedication by a handful of scholars and not much by way of institutional efforts. But research is essentially a collaborative effort which requires the presence of appropriate incentives and adequate support. For instance, research led by Ricardo Hausmann at Harvard suggests that growth in a country is a function of knowledge---that of the society and not of individuals. So the implication is that unless we develop the institutional capacity for academic research, we would be unable to provide adequately trained human resource direly needed for further growth of Islamic finance. Barring a few notable exceptions, hardly any major university offers rigorous training in the subject, particularly at an advanced level. Similarly, we have not developed professional certification in the field that could be considered an equivalent of CFA, FRM or the likes in conventional finance. In the absence of cutting edge research in Islamic finance, we will continue to replicate the models of conventional finance.

Moreover, even in its current form, our research has generally failed to link *Fiqh with Finance*. While we have many notable scholars with profound knowledge of Islamic jurisprudence, many of them have limited exposure in modern finance. Likewise, our experts on conventional finance, in general, are poorly equipped to understand the implications of various Shariah injunctions. This dichotomy again highlights what I have mentioned earlier; a lack of capacity building at the institutional level which has led to individuals’ efforts being divergent and uncoordinated. The result is a yawning gap of knowledge between two groups of experts, leaving us with only a handful of scholars who are well versed in both modern finance and *Islamic Fiqh*. It is, therefore, no wonder that our banks struggle to find candidates for their Shariah boards who can suitably guide them in offering innovative products.

Secondly, I would like to talk about the legal institutions, which provide an enabling environment where Islamic finance can flourish. Let me first briefly explain why we should care about these institutions which essentially help protect property rights and enforce contracts.

Today we lament the fact that our Islamic banks appear quite similar to their conventional counterparts, saddled with bulk of debt-based financing while the share of equity and other partnership based instruments like *Musharakah* and *Mudarabah* remains negligible in their balance sheets. Although there are many reasons for this phenomenon, one potential explanation is the lack of an appropriate mechanism to enforce the contracts that ensure mutual trust. Indeed, an important puzzle in economic history is why risk-sharing methods of finance, despite their dominance for almost eight centuries, eventually lost their supremacy to debt-based financing.

Some have argued that it was the deterioration in mutual trust over time which led to plummeting preference for risk-sharing finance. The significance of mutual trust, a key component of social capital, has been strongly established by research produced in the last two decades. This literature also highlights the role of appropriate institutions that help reinforce mutual trust in societies, with a particular emphasis on the institutions that help protect property rights and enforce contracts.

Given these findings, let us objectively examine where we stand at present. In the World Bank's latest ranking of 'enforcing contracts' as part of their 'Doing Business Report' of 2013, no Muslim country ranks among the top 25 in terms of contract enforcement. While global rankings have their own limitations, these findings underscore the need for strengthening our legal environment. Hernando de Soto, a Peruvian economist emphatically wrote about the countries with poor legal infrastructure arguing that: "...majority of entrepreneurs are stuck in poverty, where their assets—adding up to more than US\$ 10 trillion worldwide—languish as dead capital in the shadows of the law". He contends that in the absence of effective legal institutions, inhabitants of such countries are just custodian of 'dead capital'---'dead' because while they may own plenty of resources, either they can't prove legal ownership or can't efficiently use them in various transactions, given the poor legal framework.

The upshot is that unless we create a legal environment that helps promote risk-sharing finance by reinforcing mutual trust, the practice of Islamic finance is unlikely to converge towards its theoretical foundations.

Thirdly, I would like to discuss the institutions that provide an enabling regulatory environment. Effective regulation of Islamic finance is a daunting task, particularly in the dual banking model where both Islamic and conventional institutions co-exist. Additionally, the peculiar nature of Islamic finance poses its own challenges in terms of designing a robust regulatory regime.

Positively, the coordination among regulators of Islamic finance has helped establish key institutions of Islamic financial architecture like the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the International Islamic Liquidity Management Corporation (IILM).

The AAOIFI has endeavored in the last two decades to set accounting standards for IFIs that are in line with global norms like the IFRS. Additionally, the IFSB has, for the last 11 years, aimed to provide prudential norms for the industry by suitably tailoring international best practices for IFIs. And the IILM, in August this year, debuted its first issuance of sukuk worth \$490 million which were fully subscribed. Admittedly, this is just the start of providing highly liquid, investment-grade financial instruments that Islamic banks urgently need to more effectively manage their liquidity flows.

However, as industry expands and Islamic banks converge to their theoretical foundations, the unique requirements of Islamic finance would necessitate a more robust regulatory response than a mere tweaking of existing regulations. Furthermore, as Islamic banks continue to expand beyond domestic borders, collaboration between supervisors across the countries would assume greater significance. So the capacity of regulators in effectively supervising the increasingly complex and larger IFIs would be tested as the industry prepares itself for the next phase of growth. Performance of the industry since the global financial crisis suggests that regulators have been generally successful in insulating IFIs from the shocks of financial meltdown, though second-round effects of the crisis have exposed higher concentration of risk among IFIs in certain countries.

Lastly, let me turn to the Islamic Financial Institutions, which are at the heart of this entire discussion. It is truly commendable that Islamic banks have successfully served millions of customers across Middle East, South-East Asia and beyond, offering variety of Shariah compliant products. Yet significant challenges remain.

Let us reconsider the growth numbers which I mentioned earlier. As we all know, part of the growth story is simple math--starting from very low base, growth is bound to be somewhat higher. But, in absolute terms, the share of Islamic finance in global financial assets is still small, barely around 1%. Moreover, Islamic banking market remains fragmented; the total assets of top ten Islamic banks were only 1 % of the asset of top ten conventional banks by end of 2010. After all, in terms of scale, we have not seen any Islamic Citibank or JP Morgan Chase, so to speak. Similarly, the size of the *sukuk* market with USD 237 billion outstanding is quite marginal, compared to a market of USD 78 trillion for conventional debt securities. Takaful, or Islamic insurance industry, is even smaller, representing a minor percentage of the global insurance industry.

Let us also examine the choices that our consumers are making. Industry statistics show that wherever Islamic banks co-exist with their conventional counterparts, it is still not a choice of majority in any Muslim country. To put it simply, no Muslim country with dual banking system has the share of its Islamic banks above 50%. One potential answer is perhaps that Islamic banks, in a race to mimic conventional model, have become so similar that consumers hardly notice the difference and are thus disinclined to switch over.

Moreover, it seems that Islamic banks are being content with serving the 'high-end' customers while a vast majority, particularly at the lower rung of the income ladder, remains grossly underserved-- if not completely ignored. The World Bank's data on financial inclusion for 2012 reveals that only 24% of the adult population has a bank account in South Asia, home to more than 700 million Muslims. Another survey, conducted in 2007 by Consultative Group to Assist the Poor (CGAP), an independent research center, revealed that in 19 Muslim countries, Islamic microfinance has a total estimated global outreach of only 380,000 customers, accounting for merely 0.5% of total microfinance outreach. These numbers collectively highlight that despite impressive growth, Islamic banks yet to reach out to millions. A banking model inspired by the philosophy of social justice can ill-afford to ignore its responsibility in serving the millions which are otherwise possibly at the mercy of exploitive informal money lenders.

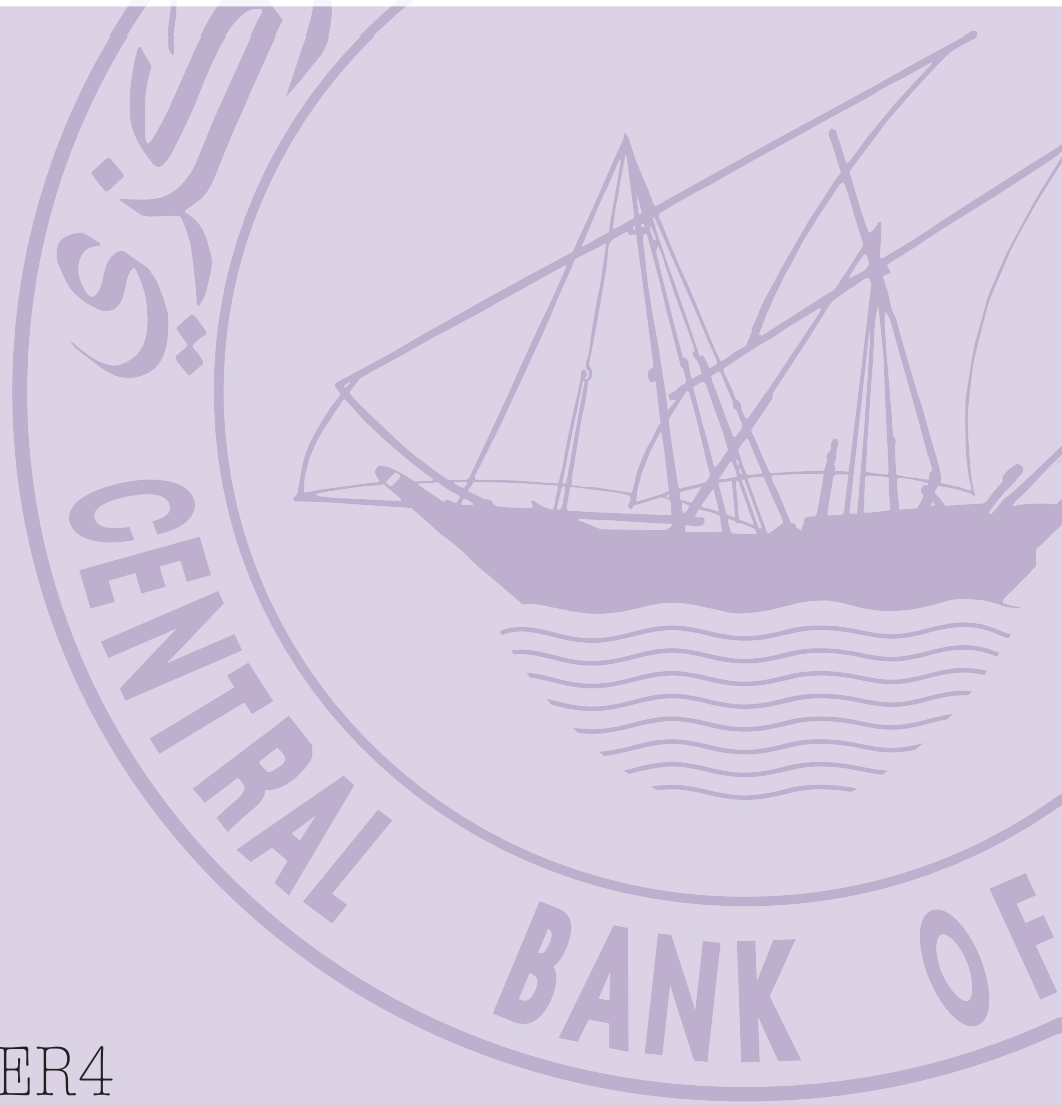
Connected to above discussion is the need for promoting genuine innovation at IFIs. This can only be achieved if IFIs earmark considerable resources for rigorous research, working in liaison with the academic world. Leadership in business will remain a distant dream until IFIs establish their thought leadership first, which inevitably requires a vibrant culture for research and innovation.

To conclude, Islamic finance has made significant progress by successfully completing the first phase of its operations. But to grow further, while remaining true to the essence of Shariah, concerted efforts are required on part of all key institutions, ranging from academia to regulatory bodies and the IFIs themselves.

Developments in the last few years have brought to light the inherent instability of conventional finance. Additionally, the unfolding of events like rigging of the LIBOR and miss selling of mortgages has intensified the debate about the role of incentive structures and ethics. In these testing times, the expansion of Islamic finance has the potential to offer an alternative model—a

model that is ethically right, socially just, and economically productive.

I hope that the deliberations among industry experts and Shariah scholars during various sessions of this conference will offer valuable insights in addressing the issues I briefly highlighted today. Thank you very much.



CHAPTER 4

DOMESTIC MARKETS

2013

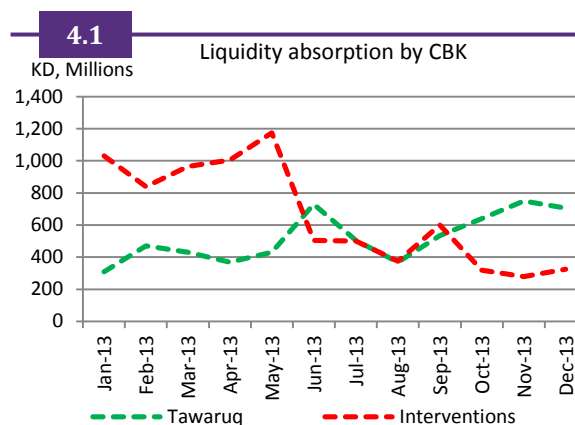
4 DOMESTIC MARKETS

The banking system continued to be characterized by conditions of ample liquidity during 2013, reflected both by an increase in the volume of monetary operations conducted to absorb surplus liquidity and the low level of KD interbank interest rates. A decrease in the volume of government debt outstanding was accompanied by an increase in the issuance of CBK bonds, particularly of 3-months maturity. The volume of direct interventions, conducted through interbank deposits with conventional banks and Tawaruq arrangements with Islamic Banks, also witnessed a rise during the year. Operations aimed at lengthening the average tenor of KD Treasury Bonds outstanding were evidenced by the issuance of longer tenor bonds with maturities extending to 10-years which, in turn, established important benchmarks for the issuance of corporate debt throughout the KD yield curve. Relative to the exchange movements in other currencies, fluctuations in the value of KD remained modest; in particular, the USD/KD exchange rate changed only by 0.45% through the year. The Kuwait Stock Exchange (KSE) remained particularly buoyant during the first five months of 2013, though losing steam as the year came to a close. The rally, essentially observed in the small cap stocks, was driven in part by the positive sentiments about the domestic political climate. Yet the market remained shallow with a few sectors like financial services, real estate and banks accounting for most of the market activity, if viewed in terms of value or volumes. The real estate market maintained its double-digit growth, with all segments exhibiting positive trend. However, the signs of increasing demand pressures amid supply constraints were visible in the residential sector.

Money & FX Markets:

Higher absorptions during 2013 reflect conditions of surplus liquidity

CBK's monetary operations continued to be aimed at maintaining appropriate conditions of system liquidity while smoothing out fluctuations caused by periodic variations in the volume of funds introduced or withdrawn from the banking system. During the earlier months of 2013, most of the liquidity absorption was from the commercial banks (interventions) while that from Islamic banks (Tawaruq¹¹) remained at a fairly lower level (Figure 4.1). However, the trends merged during the 3rd quarter as CBK mopped up almost the same amounts both from commercial and Islamic banks. During the



¹¹It is an important tool for liquidity management, where banks can place excess liquidity with the central bank both on short and long term basis, using a mechanism similar to commodity *murabaha*.

last quarter, absorption from Islamic banks took the lead while that from commercial banks continued to decline.

In general, the scale of liquidity absorption was greater in 2013, compared to the earlier few years, suggesting an increasing level of excess liquidity in the banking sector (Figure 4.2). Moreover, the share of interventions and Tawaruq with one-week maturity was significantly higher than for the one-month maturities. During the last quarter of 2013 in particular, the liquidity absorption was predominantly in the one-week maturity period.

CBK bonds of 3-months posted a strong recovery

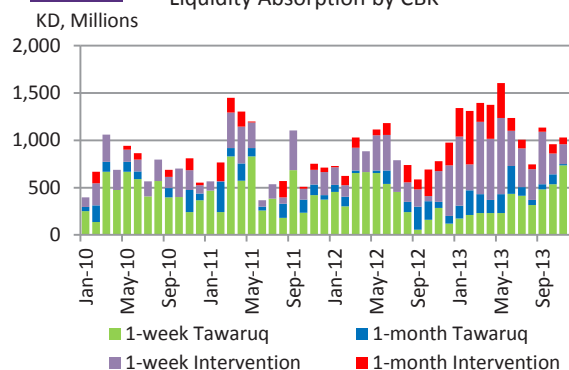
During 2013, issuance of CBK bonds was up by 12%, with total issuance worth KD 6,092 million compared to KD 5,443 million in 2012. The break up in terms of tenors reveals that bonds of 3-months maturity experienced a sharp rise during the year, in sharp contrast to its negative growth of 7% in 2012 (Figure 4.3). Specifically, 3-months bonds observed a strong annual growth of 39%, as their issuance surged from KD 3,237 million in 2012 to KD 4,514 million in 2013. On the other hand, 6-months bonds experienced a contraction of 28%, as bonds worth KD 1,578 million were issued in 2013 compared to KD 2,206 million in 2012. As a result, share of 6 month bonds in total issuance of CBK bonds have dropped from 41% in 2012 to 26% in 2013.

Issuance of public debt instruments have steadily declined

In line with the trend observed last year, the volume of public debt issued continued to decline (Figure 4.4). For instance, since July 2012, no treasury bills of 3-months maturity have been issued. In case of treasury bills of 6-months maturity, the last issue was around four years back, in 2009. As a result, the outstanding value of public debt instruments came down from above KD 2 billion to around 1.52 billion by 2013.

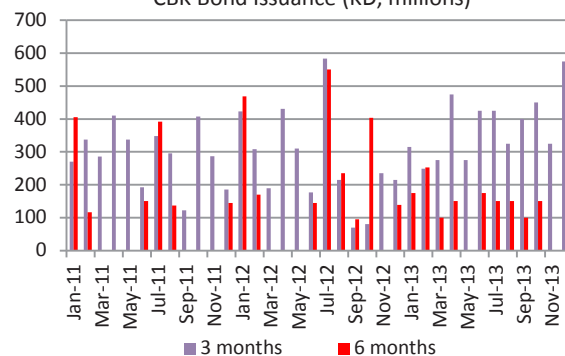
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Liquidity Absorption by CBK



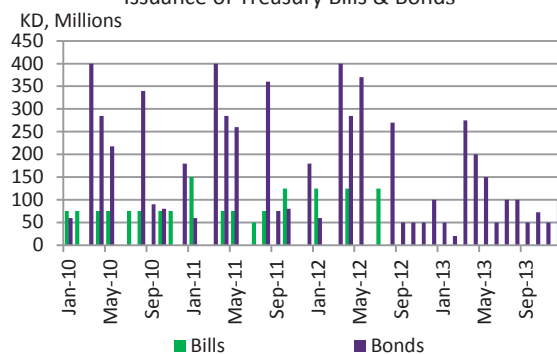
4.3

CBK Bond Issuance (KD, millions)



4.4

Issuance of Treasury Bills & Bonds



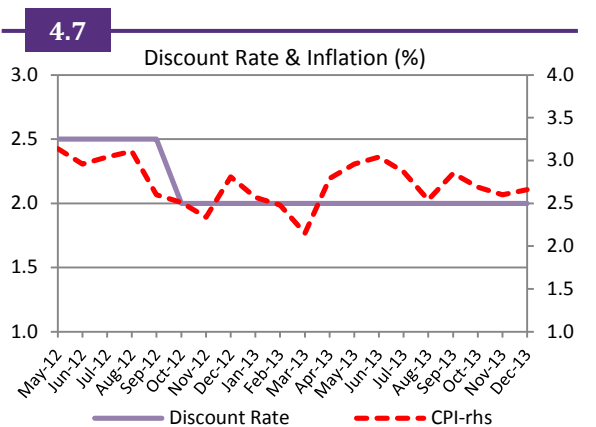
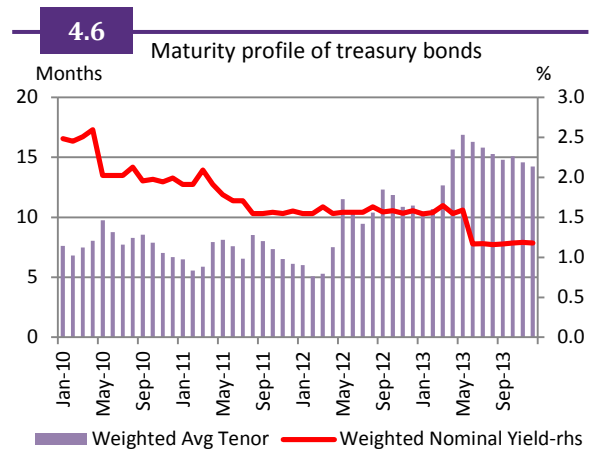
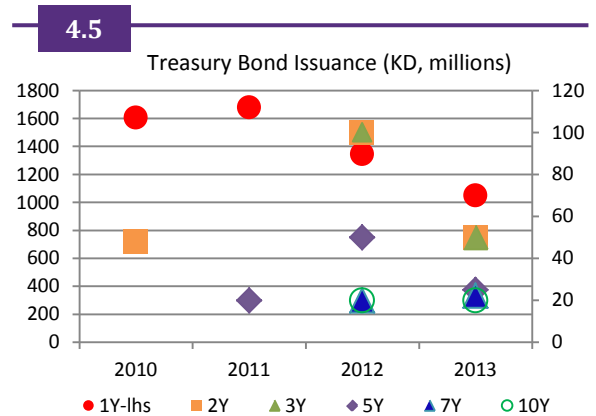
Breakdown of treasury bonds of various maturities over the last few years reveal a visible shift towards the issuance of longer tenor treasury bonds. For instance, in 2012, bonds with maturity of 3, 7 and 10 years were issued for the first time in recent years, followed by another issue of various maturities in 2013 (Figure 4.5). However, despite the growing issuance of bonds with higher maturities, bonds of one year maturity, with issuance worth KD 1,050 million in 2013, still account for bulk of the overall issuance. Attempts by the CBK to introduce a longer term KD benchmark yield curve by issuing bonds of longer tenor have, at occasions, been frustrated by banks' under subscription of these issues.

By increasing the issuance of relatively longer term bonds, CBK has aimed to extend the sovereign yield curve to longer horizon and help establish a meaningful benchmark for the pricing of corporate debt. An obvious outcome of this strategy is the improvement in the weighted average tenor of the treasury bonds, on average, from 9.3 months in 2012 to 14.3 months in 2013 (Figure 4.6). At the same time, weighted nominal yield has come down, which in part explains the banks' limited appetite for longer tenors. Banks are seemingly reluctant to lock into higher maturity bonds amid historically low interest rates.

CBK has kept the discount rate unchanged at 2%

During 2013, CBK maintained its discount rate, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in Kuwaiti Dinar¹² (Figure 4.7). The discount rate was last slashed by 50 basis points on 3rd October, 2012 to bring it down to 2%. With the inflation rate in desirable range, prevailing prices did not warrant a change in discount rate. By keeping interest rate at 2%, CBK also aimed to help increase the private sector credit off-take, given its important contribution towards non-oil economic sector. The existing interest rate environment also remained

¹² For instance, banks can charge up to 3% above discount rate on consumer and housing loans, up to 2.5% above discount rate on commercial loans of less than one year and up to 4% above discount rate on commercial loans of above one year maturity.



conducive in ensuring the continuous attractiveness of the local currency deposits, particularly in comparison to the historically low levels of interest rates prevailing in many advanced countries.

While the discount rate remained unchanged, the gap between lending rate on KD-based credits and weighted average rate on KD deposits narrowed further (*Figure 4.8*). Consequently, the spread reached around 3.11 percentage points on average during 2013, compared to 3.46 percentage points during 2012. The marginal drop in spread was more due to a decline in lending rate on KD-based credits, which eased to 4.647% in 2013 compared to 5.066% in 2012.

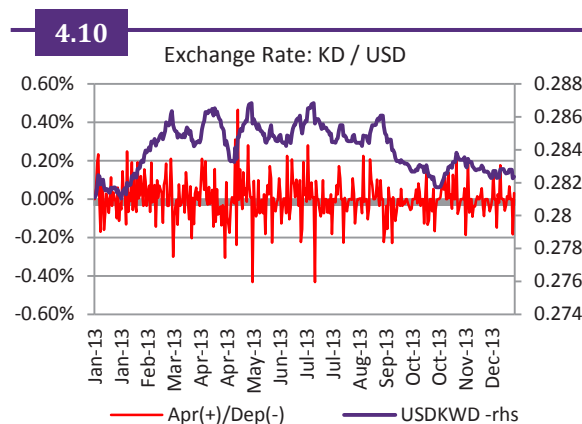
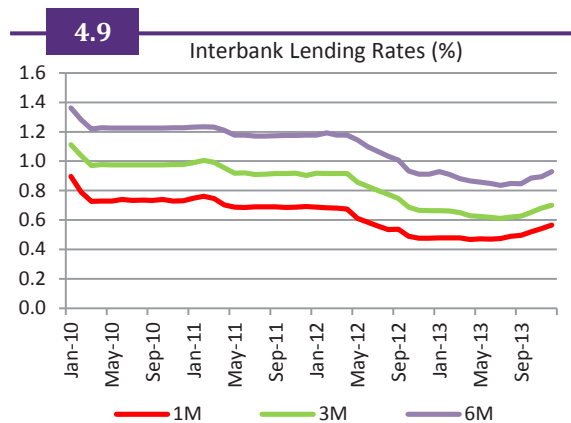
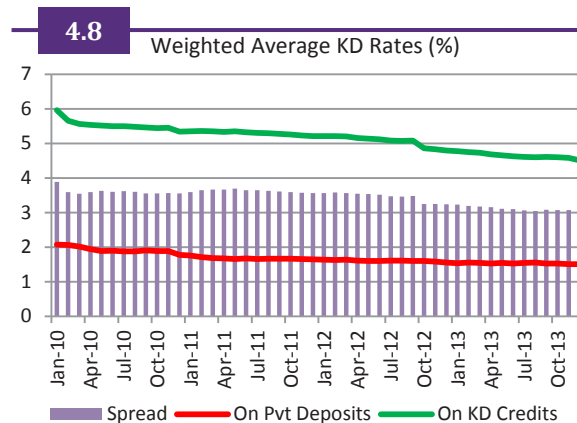
KD interbank interest rates remained close to historic lows during most of the year (*Figure 4.9*). An uptick in the rates observed towards the end of the year was due to seasonal factors and domestic developments.

Exchange rate between KD and USD has remained stable

The USD/KD exchange rate continued to demonstrate a high level of stability, moving only 0.45% over the year as a whole (*Figure 4.10*). The pace of monthly changes in the USD/KD exchange rate was slower in the final quarter of 2013 than during the first nine months of the year.

Notwithstanding the fluctuations in exchange rate, the parity between KD and USD has remained fairly stable, with almost all the fluctuations around a narrow range of $\pm 0.47\%$.

As a matter of policy, Central Bank of Kuwait has pegged the KD, since 20th May 2007, to an undisclosed special weighted basket of currencies of countries that share significant financial and trade relations with the State of Kuwait. Earlier, between 2003 to 2007, CBK followed a USD peg at KD 0.29963:USD 1 with a $\pm 3.5\%$ band.



KD slightly depreciated against GBP and EUR in line with USD's depreciation against these currencies

Exchange rate between KD viz-a-viz other key currencies reveal that KD depreciated against both Euro and GB Pound by 4.36% and 2.25% respectively (Figure 4.11). This depreciation in KD was in sync with the depreciation of USD against the afore-mentioned two currencies. On the other hand, KD posted strong appreciation of 17% against Japanese Yen during 2013, essentially as the ultra-loose monetary policy of the Bank of Japan coupled with a revised inflation target continued to weaken the Yen. When viewed in terms of USD exchange rate, KD has far less fluctuations compared to other key currencies (Figure 4.12). As evident, JPY has recorded sharp depreciation against USD while GBP and Euro have posted moderate appreciation.

Kuwait Stock Exchange (KSE):

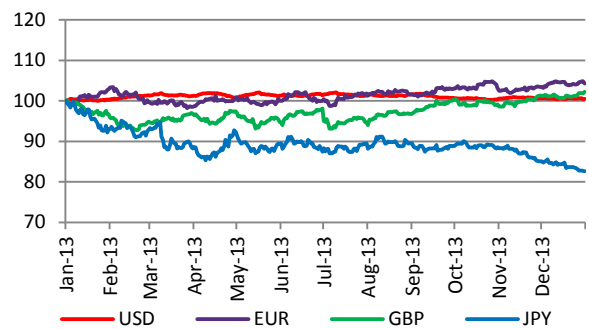
Kuwait's bourse posted strong gains during early 2013

During 2013, the Kuwait Stock Exchange Price Index (PI) recorded an impressive return of 27.2%, compared to a modest gain of 2.1% in 2012 (Figure 4.13). The Weighted Index (WI), another key indicator better representing Kuwait's large-cap companies, witnessed a relatively smaller but still noticeable return of 8.4% year-on-year (YoY). Finally, the Kuwait-15 Index, first launched in May 2012 and covering 15 highest ranked companies in terms of liquidity and capitalization, posted a moderate gain of 5.4% YoY.

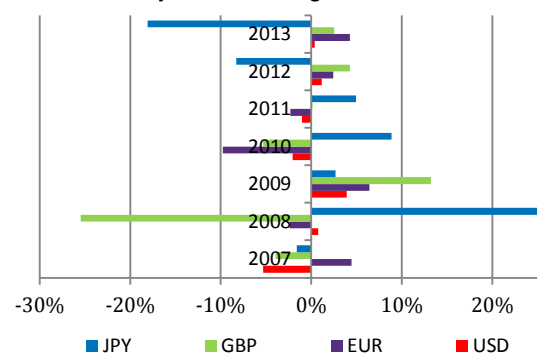
.....with PI witnessing a sharp rally in the first five months of 2013

From January 2013, the KSE got off to a good start, recording 5.2% gain in PI during the first month. The rally, essentially driven by small-cap stocks, continued up till May 2013. The PI posted an impressive return of 42% by May 28, 2013, reaching 8,430.73 points, the highest level since December 2008. While the value-weighted index trailed behind the PI, it still recorded a decent 13.8% gain during

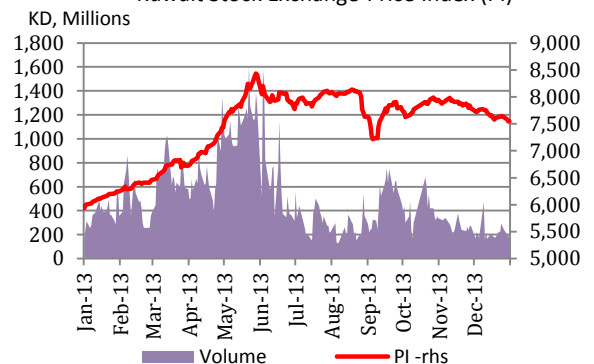
4.11 Key Exchange Rates in KD (rebased)



4.12 Major currencies against KD



4.13 Kuwait Stock Exchange-Price Index (PI)



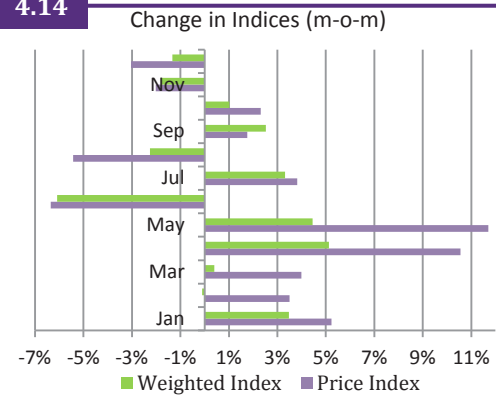
the same period. These impressive returns, accompanied with high liquidity in the market, were influenced by the positive sentiments regarding domestic political situation and improving prospects for the implementation of government's development plan. Even globally, market sentiments were positive during these months, as reflected by strong rallies across key markets.

...followed by a broad correction and dissipating momentum

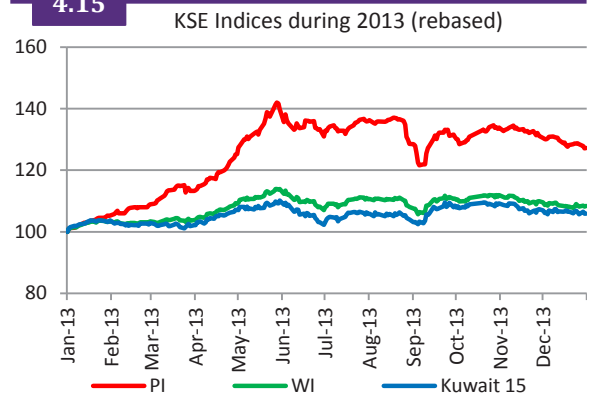
Market recorded a broad correction in June 2013 as all key indices posted a decline; PI and WI were respectively down 6.4% and 6.1% month-on-month basis (*Figure 4.14*). However, the slowdown was expected, in part due to the start of the summer vacations. The market posted a visible recovery in July, notwithstanding the shorter trading hours due to Ramadan, as both PI and WI were up by 4% and 3%, respectively. During the later months, the index moved sideways, gaining in one month and losing momentum in the other. The PI was down by 5% in August partly because of negative sentiments amid escalating regional tensions with possible US led strike on Syria. Market however recovered during September as the diplomatic solution to Syrian crisis somewhat pacified investors' concerns. Gains were particularly higher in WI, as large-cap stocks posted a relatively stronger rally, unlike during the other months of 2013 where PI was in the lead. Market activity also improved, in part due to listing of Warba Bank and the end of summer vacations. Positive activity prevailed in October as well, though liquidity was lower amid week long Eid-al-Adha holidays. The last two months of 2013 recorded a decline in all the indices, though the retreat in PI was somewhat stronger.

A comparison between KSE's three indices across the year reveals a visible divergence between PI viz-a-viz the WI and Kuwait-15, essentially driven by a stronger rally in small cap stocks (*Figure 4.15*). On the other hand, Kuwait-15 posted the smallest gains. The relatively subdued performance of both WI and Kuwait-15 suggests that robust gains in PI were

4.14



4.15



primarily driven by positive sentiments than market fundamentals. The equity prices also failed to truly reflect the improvements, albeit modest, in the corporate earnings observed during 2013.

To put the foregoing discussion on market rally in perspective, the PI, notwithstanding its impressive gains during 2013, still traded at much lower level compared to the pre-crisis peaks observed during 2007-08 (*Figure 4.16*). On the contrary, global equity indices like S&P and Dow Jones even surpassed the levels last seen in the pre-crisis period of 2007, thanks to unconventional monetary policies of the major central banks.

Trading activities significantly improved during 2013

A look at the KSE's key indicators reveals that trading activity considerably increased during 2013. The total volume posted a strong rise of 54% YoY, reaching 127.8 billion shares, compared to 83.1 billion shares in 2012 (*Table 4.1*). Similarly, the total value traded increased significantly, reaching KD 11.1 billion, compared to KD 7.3 billion in 2012 (up by 52%). The number of deals almost doubled to 2,136 compared to 2012. Moreover, market capitalization stood at KD 31 billion during 2013, adding KD 2 billion since the beginning of the year, compared to a slight decrease during 2012. Finally, the number of listed companies went down by three in 2013.

Financial services & oil and gas indices enjoyed the most gains

The Financial Services Sector was the best performer in 2013, recording a return of 26% YoY, followed by Oil & Gas, which posted a return of 23% (*Figure 4.17*). As the rally in the PI was largely influenced by small cap stocks, both Financial Services and Oil & Gas indices closely trailed the PI. On the other hand, Telecom sector, representing the large-cap stocks, appeared least performing since the rally was primarily in the small cap stocks.

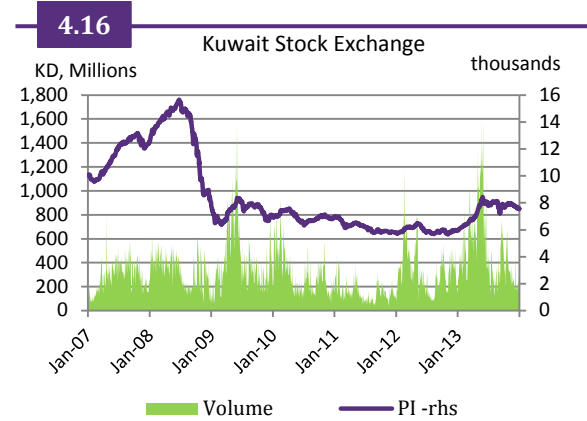
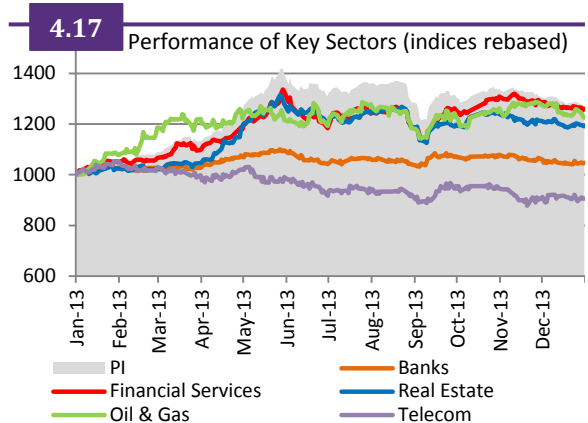


Table 4.1:

Key Indicators of Kuwait Stock Exchange

	2010	2011	2012	2013
KSE Price Index	6955.5	5814.2	5934.3	7549.5
Highest	7575.0	6999.4	6492.4	8430.7
Lowest	6319.7	5764.3	5650.0	5934.3
Market Capitalization (KD bil)	36.3	29.3	28.9	31.0
Total Value (KD bil)	12.5	6.1	7.3	11.1
Total Volume (bil)	74.7	38.3	83.1	127.8
No. of Deals (,000)	1,254	617	1,196	2,136
Companies Listed	217	214	199	196



Two sectors account for around 3/4th of the market volume

Financial Services Sector and Real Estate Sector, collectively accounted for as much as 73.8% of the average monthly market volume, compared to their combine share of 60% during 2012 (Figure 4.18). The growing level of concentration in terms of market volume suggests that the depth of stock market, already at a fairly low level, is further declining. Given that Financial Services Sector alone accounts for around 39.5% of the total market volume, its index understandably trails PI quite closely (Figure 4.17). Banks and Industrial sectors also have around 6% to 12.5% share each in the total market volume. Collectively, these four aforementioned sectors cover almost the entire market.

...though market is relatively less concentrated in terms of value

When viewed in terms of average monthly value, four sectors (Financial Services, Real Estate, Banks and Industrial) account for 88% of the total market value traded (Figure 4.19). Unlike in case of market volume, here *Banks* also appears to be a key player. Their share in average market value has been around 18% in 2013, much higher than their share in market volume. Relatively higher prices for most of the banks' shares explain the greater contribution of this sector in overall market value.

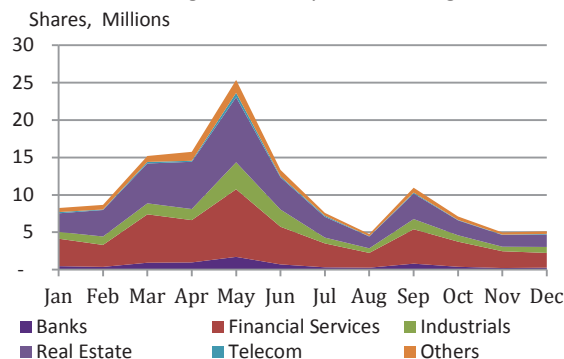
Real Estate Market:

Drop in residential sector's share indicates supply constraints

The three key components of the real estate market in Kuwait include *Residential, Investments* and *Commercial* real estate properties. During 2013, residential real estate, also labeled as private housing, accounted for around half of the market (49%) in terms of total value of the deals made, followed by investments (38%) and commercial (11%) sectors (Figure 4.20). While still representing around half of the real estate deals, share of residential sector has slipped from 55%

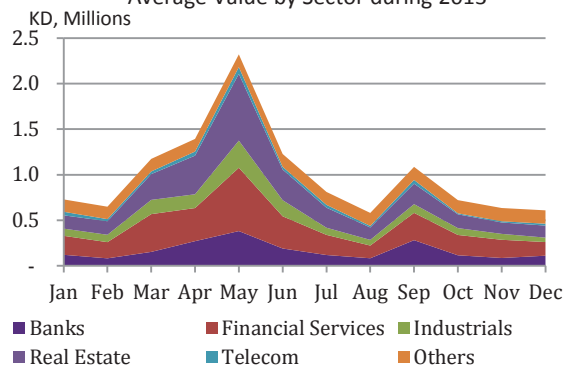
4.18

Average Volume by Sector during 2013



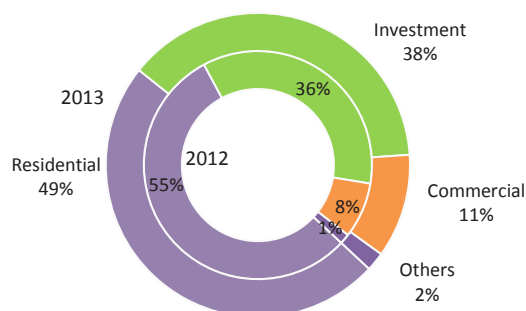
4.19

Average Value by Sector during 2013



4.20

Real Estate: Segment wise Share (based on value of deals)



in 2012, suggesting an increasing level of supply constraints in the sector.

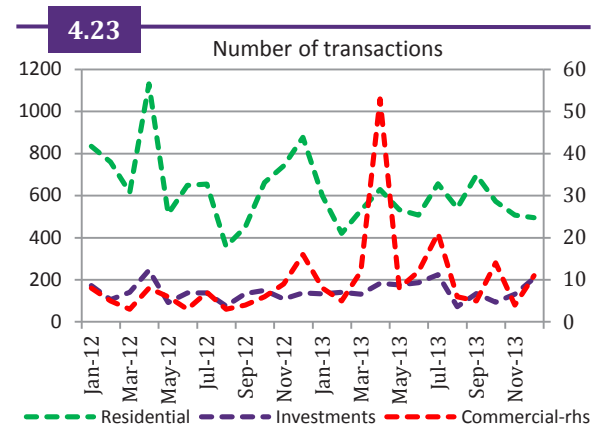
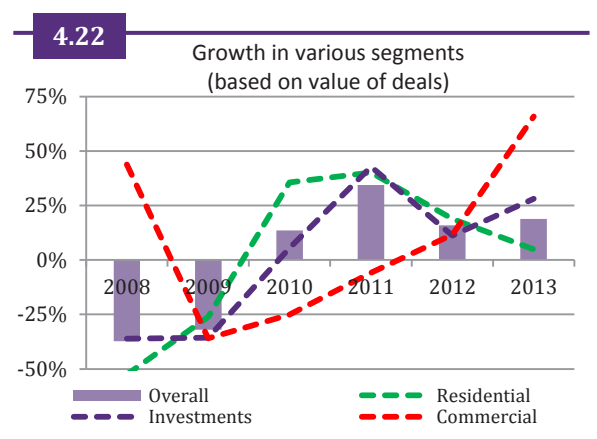
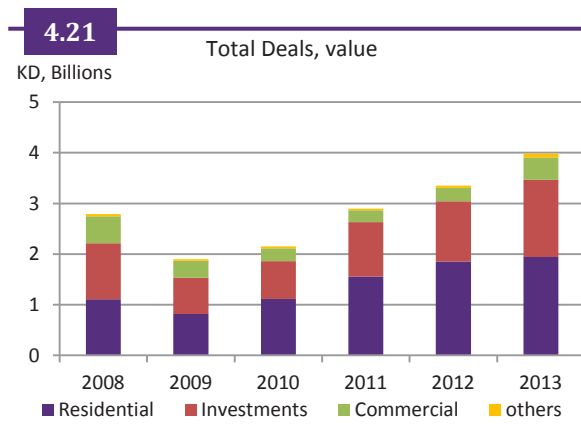
Double-digit growth in the value of deals is a sign of continuous recovery

Real estate market continued to recover, a trend that started in 2010 (Figure 4.21). During 2013, total deals worth KD 3.98 billion were recorded, compared to KD 3.35 billion during 2012, registering a rise of around 18.8%. This growth was on top of double-digit growth rates recorded in the earlier three years since 2010.

There are obvious differences in growth trajectories for value of deals across various real estate sectors. For instance, growth in the residential sector has slowdown since 2011, an indication of supply shortages amid high demand for private housing among nationals (Figure 4.22). On the other hand, commercial sector posted a sharp growth of 66% during 2013, which might further increase the existing level of over-supply in the market and the possibility of a price correction in the future. In general, sharp swings in this sector are common given the small number of high value transactions that can strongly influence overall growth trends.

Numbers of deals were down by 12.7% to reach 8,735 deals in 2013 compared with 10,003 deals in 2012. In particular, the residential sector recorded 6,687 deals in 2013 compared to 8,247 deals in 2012 (18.9% drop), a possible indication of supply constraints in the private housing sector amid strong demand (Figure 4.23). Another reason for the slow down in residential sector deals, particularly in the last quarter of 2013, could be the instructions issued by the CBK imposing certain controls on the funding granted to high-worth customers for their purchase/ development of real estate.

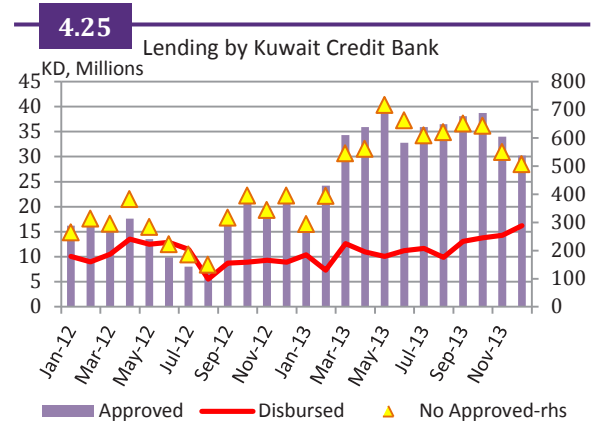
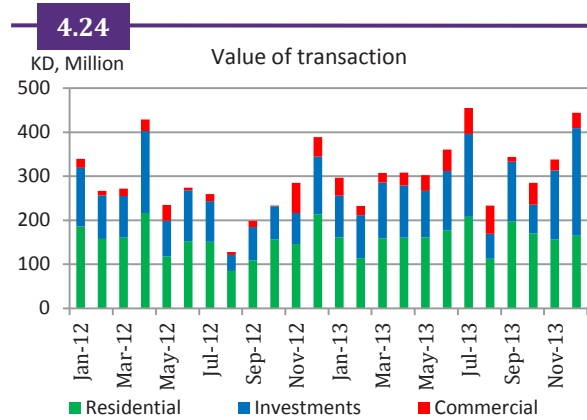
Analysis of the monthly transactions during 2013 reveals the seasonal pattern which is typical of the real estate market in Kuwait (Figure 4.24). Market was least active during the months of February and August,



respectively due to national and Eid-al-Fitr holidays. While August recorded a strong improvement of 87% year-on-year, transactions were still at the lowest level, also due to much stronger activity observed during July, which in fact represented five weeks of data.

KCB's approved loans post a sharp rise, indicating strong demand pressures in private housing

Kuwait Credit Bank (KCB), an independent banking institution owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing loans to Kuwaiti nationals for purchase, construction or renovation. During 2013, loans worth KD 394.4 million were approved, registering an impressive rise of 111.8% compared to 2012 (Figure 4.25). Number of loans approved also posted a sharp rise during 2013, as 6,745 loans were approved compared to 3,539 loans in 2012. The swift increase in approved loans (both in terms of amount and number) was a clear sign of demand pressure for private housing, though in part it could be ascribed to the release of land by the government in Jaber al-Ahmad city, Naseem and Sabah al-Ahmad area. Loan disbursements trailed behind approvals, and the growth was far less pronounced compared to loans approved, suggesting that KCB maintained a certain level of disbursements irrespective of the approvals made. Slower rate in disbursement is also partly due to the fact that loan approved are availed in tranches, depending upon the pace of construction/renovation work.



Regulating exposure to the Real Estate Market

The real estate sector is a significant component of any country's economy, for a variety of reasons. First, housing is a major investment for individuals, representing a significant portion of their personal wealth. And in terms of their liabilities, payments for housing loans represent a considerable share of their monthly outlays. Second, and a corollary to the first point, banks in general have significant exposures to housing markets, both in terms of direct lending as well as through the use of real estate as collateral. Financial systems with sizable presence of Islamic financial institutions have even higher exposures to real estate markets, given the focus of Islamic banks on tangible assets for credit facilities. Third, the boom and bust cycles in the housing market are common and have a significant bearing on the overall growth in economic activity. Research by the IMF for OECD countries shows that the recessions during 1960-2007, when accompanied by property busts, were persistent with cumulative output losses two to three times higher. For these reasons, the real estate sector is a key focus of the macro prudential policy which aims to contain systemic risks to financial stability by, inter alia, preventing excessive credit growth. To stem the sharp rise in mortgage lending and housing prices, macro prudential measures are useful for central banks which otherwise have to use interest rates, a rather blunt tool, to check the growth in credit.

Globally, a number of macro prudential measures have been used to reduce the vulnerabilities in the real estate sector; in particular, the use of loan to value (LTV) and debt to income (DTI) ratios is quite common in many countries, supported by empirical evidence. For instance, Igan and Kang¹³ (2011) demonstrate that the restrictions imposed on LTV and DTI ratios in Korea helped contain the rise in prices and transaction volumes. Wong et al.¹⁴ (2011) argue that the introduction of an LTV ratio cap effectively reduced the systemic risk caused by house price cycles in Hong Kong. Lim et al.¹⁵ (2011) show that measures such as caps on LTV and DTI ratios, dynamic provisions and compulsory reserves help reduce procyclicality in bank lending. Claessens et al.¹⁶ (2013) underscore the effectiveness of LTV and DTI ratios in restraining the growth in financial sector during boom periods.

Recent measures by the CBK: In Kuwait, the real estate market has posted a double-digit growth during the last four years in a row, which is in stark contrast to a negative growth observed both in 2008 and 2009 (*for details, see the section on Real Estate Market preceding this box*). Given the existing trends in the domestic real estate market, CBK has proactively issued a new set of measures to protect the individuals as well as the banking system from the potential over exposure to the housing market. These new measures, issued on November 12, 2013 address the financing provided by banks, investment and financing companies for purchasing and/or developing real estate located in residential areas. These measures are meant to shield the financial system from excessive exposure to real estate and to contain the potential for an asset price bubble.

¹³Igan (D.) and kang (H.) (2011) "Do LTV and DTI limits work? Evidence from Korea", IMF, *Working Paper*, No. 297.

¹⁴Wong (T.), Fond (T.), Li (k.) and Choi (H.) (2011) "Loan-to-value ratio as a macroprudential tool: Hong Kong's experience and cross-country evidence", BIS, *Papers*, No. 57.

¹⁵Lim (C. H.), Columba (F.), Costa (a.), kongsamut (P.), otani (a.), Saiyid (M.), Wezel (T.) and Wu (X.) (2011) "Macroprudential policy: what instruments and how to use them? Lessons from country experiences", IMF, *Working Paper*, No. 11/238.

¹⁶Claessens (S.) Ghosh (S.) and Mihet (r.) (2013), "Macroprudential policies to mitigate financial system vulnerabilities", *Journal of International Money and Finance*, No. 39, pp. 153-185.

These measures specifically require that the financing should be based on LTV ratio, with varying level of caps depending upon the purpose of financing facility.

Purpose of Loan	LTV Ceiling
Purchase of undeveloped land	50%
Purchase of existing real estate	60%
For construction only	70%

Moreover, the CBK instructions require that the value of the real estate used must be based on the purchase price or the real estate valuation amount, whichever is lower. Evaluation of the property must be conducted by two independent evaluators registered with the Ministry of Commerce & Industry and who are not related to any of the parties involved in the transaction. As for the construction costs, these should be estimated by specialized and approved offices in the field.

Following are some other salient features¹⁷ of the new measures announced on November 12, 2013 :-

- Credit decision must be based on an integrated credit study that addresses the requirements stipulated under CBK instructions concerning Rationalization of Credit Policy (i.e determining customer's credit worthiness and repayment capacity; examining customer's credit history using Ci-Net data and Risks Center System; evaluating customer's cash flows and studying the impact of various stress scenarios on his/her ability to repay in a timely manner etc).
- The customer needs to have sufficient sources of net cash flows, other than his/her monthly salary and the income from properties to be financed, of not less than 50% of his/her obligations resulting from this finance.
- The bank/company also needs to verify that the loan is being used for the intended purpose; in case of credit for real estate development, financing should be released in proportion to the progress in the executed work.
- The principle amount and interest thereon should be repaid in quarterly installments at the very least, over a period commensurate with the purpose of finance, with a maximum period of 10 years. In the case of credit granted for real estate development, the bank/company is allowed to grant a grace period of 2 years, given that the loan remains 'performing'.
- The bank/company needs to inform the customer about the total cost of financing, funding burdens calculated under different interest rate scenarios of increasing rates, mechanism for determining the interest (profit) rate and reference prices used, present and future charges and commissions etc and to maintain evidence of the same.
- The bank/company is required to retain a copy of all documents related to the real estate (including documents of real estate purchase and payment of the real estate value and fees related to any other party in the matter), and proof of disclosure to the client on all the points mentioned above.
- A financing policy, approved by the board of directors, is required to be prepared by the bank/company. This financing policy has to cover all potential risks, including the controls required to measure and mitigate these risks, while taking into account all the instructions

Similar to the measures taken by CBK, many countries have adopted various policies over the years to stabilize their respective housing markets. The following paragraphs briefly illustrate the experiences of some of these countries in containing the boom in housing markets:-

- In **South Korea**, the supervisory authorities introduced LTV regulations in 2002, putting

¹⁷ For details, see <http://www.cbk.gov.kw/PDF/HousingRegAR.pdf>

limits on the ratio of mortgage loans to the related housing value as collateral. Different LTV ratio caps were introduced based on loan maturity, housing prices and location of the property. Later, in 2005, DTI caps were imposed to complement the existing regulations on LTV ratios. Korean experience with both LTV and DTI suggests that these measures were effective in containing the surge in housing loans as well as property prices during periods of boom. Bank of Korea reckons that outstanding amount of mortgage loans and housing prices would have been 137% and 75% higher in the absence of these measures.

- In **Hong Kong**, authorities have historically used various LTV ratios depending upon the trends in housing prices. For instance, the LTV threshold was first reduced from 90% to 70% in 1991. As the residential property prices continued to climb, authorities further reduced the maximum LTV ratio to 60% in 1996. However, as the East Asian financial crisis struck in 1997, market conditions in Hong Kong changed, prompting the authorities to restore the LTV to 70% in 2001. Yet as the housing prices experienced another period of sharp increase since 2009 amid lower interest rates and strong capital inflows, the LTV was again reduced to 60% in 2009. During 2013, Hong Kong Monetary Authority introduced the 50% LTV ratio for residential properties with a value of HKD 10 million or more, 60% for the properties valued between HKD 7-10 million and 70% for the properties valued lower than HKD 7 million. For commercial and industrial properties, the maximum LTV ratio has been set at 40%. Empirical studies evaluating the success of these policy measures suggest that tightening the LTV caps reduces household leverage which in turn plays a major role in lowering the mortgage default risk.
- In **Indonesia**, the residential Property Price Index PPI (for 14 major cities) increased by 7.4% during Q1 2013, the highest since Bank Indonesia started publishing property prices in 2008. During the last quarter of 2013, residential property sales increased by 26.7% year on year, with total outstanding housing loans up by 21.74%. These developments prompted the Bank Indonesia to issue a new mortgage law in late 2013, specifically targeting the multiple home buyers with an aim to limit speculative activity in the Indonesian property market. Under the new law, LTV ratio for the purchase of a second property was reduced to 60% for land properties and apartments measuring more than 70 sqm, and to 50% for purchases beyond the second property. These new LTV ratios have also been applied to Sharia financing.
- In the **UK**, the housing market has witnessed a swift recovery in recent times, with prices increasing by around 10 percent during 2013. In particular, property prices in London were up by 18% in the past year, boosted by the government's 'Help to Buy Scheme' which provides taxpayer-backed guarantees for home buyers. However, the scheme has been criticized for fueling demand without addressing the problem of insufficient supply. The Bank of England (BOE), in May 2014, termed the housing market as the most serious threat to financial stability as well as to the country's fragile recovery. While the BOE expressed its inability to address the chronic undersupply of housing in the UK, the central bank appeared determined to ensure a robust banking system capable to withstand any potential shock from the housing markets. BOE suggested that it may cap the amount individuals can borrow as a multiple of their income or may introduce a new *affordability test* that would assess the ability of borrowers to cope with much higher mortgage payments when interest rates eventually rise.



CHAPTER 5

PAYMENT AND SETTLEMENT SYSTEMS

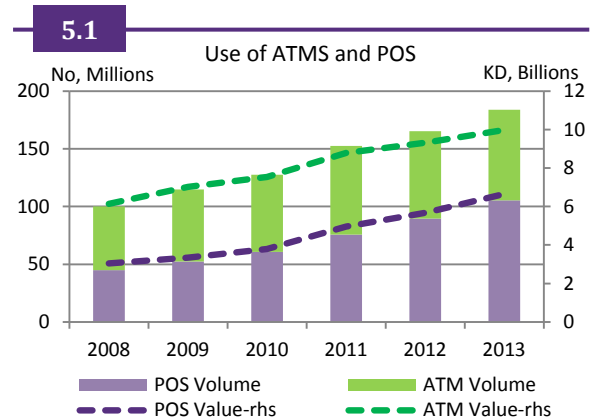
2013

Both retail and large scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. In the case of retail payments, use of ATMs and point of sale (POS) related transactions have witnessed growth of 7.3% and 17% respectively during 2013, when viewed in terms of value of transactions. During the year under review, the share of ATM related transactions was higher (60%) in value while that of POS transactions was higher in terms of volume (57%). E-banking infrastructure has also been growing in Kuwait, as the number of ATMs and POS machines witnessed a growth of 3.3% and 11.5%, respectively reaching 1,475 and 31,686 machines by December 2013. While electronic based transactions account for 97.3% of all transactions in terms of volume, paper based transaction (through cheques) still has a sizeable share (57%) in term of value. Large scale payment system (KASSIP) handled 1.09 million transactions worth KD 288 billion during 2013. Banks' branches continued to rise, as 16 new branches during 2013 pushed the total branches in Kuwait to 400.

The use and infrastructure of E-banking has been steadily rising

Retail Payment Systems are designed and used for a large volume of relatively low value transactions. With the growing use of information technology and increasingly secured systems, transactions through the E-banking have been on rise in Kuwait. Accordingly, ATM and point of sale (POS) transactions that are operated by the K-net have exhibited a steady increase in the past six years (*Figure 5.1*).

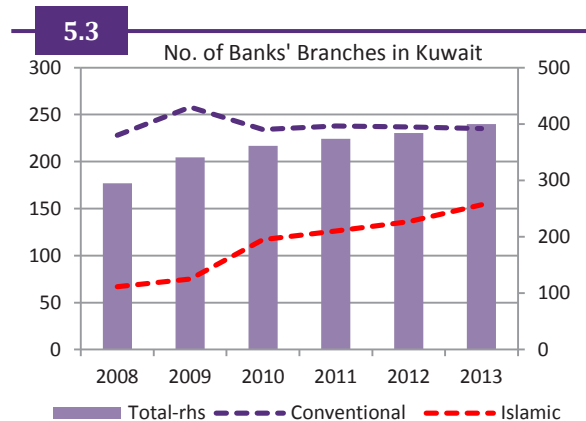
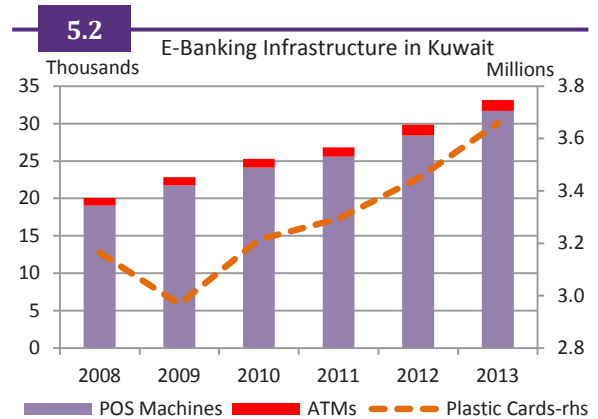
The declining trend in the share of ATM based transactions (out of total ATM & POS based transactions) continued in 2013 as well, with a drop in share from 62% to 60% in terms of value and from 46% to 43% in terms of volume (number of transactions). In terms of growth trends, the value of ATM transactions increased by 7.3% to reach KD 9.9 billion compared to KD 9.3 billion in 2012. The number of ATM transactions also registered a positive growth rate of 3.6% in 2013 compared to a contraction of 1.4% in 2012.



In case of POS, value of transactions conducted through the POS machines reached KD 6.64 billion in 2013, registering a growth of 17% compared to 2012 when value of these transactions was recorded around KD 5.68 billion. In terms of number of transactions through POS, growth of 17.7% was observed in 2013 as transactions reached 105.32 million compared to 89.48 million transactions in 2012. The growing use of electronic banking is understandable, given the convenience of cashless transactions. Further, retailers offering discounts on online purchases have also promoted the use of e-banking. On the banks' part, this trend helps in maintaining lower operation cost by reducing the number of visitors for cash related transactions.

Growth in electronic banking has been adequately supported by the growing retail payment infrastructure in Kuwait. During 2013, the number of POS machines and ATMs witnessed a growth of 11.5% and 3.3%, respectively reaching 31,686 and 1,475 machines by December 2013 (Figure 5.2). The growth in ATM machines, albeit positive, slowed down significantly, indicating the relatively limited scope of additional ATM machines given their existing penetration. The issuance of new plastic cards (debit and credit cards) also registered a 6.1% growth in 2013, with total plastic cards reaching 3.66 million, around 84% of which are debit cards.

Despite the growing use of e-banking, number of banks' branches have continued to increase, albeit at a moderate pace, given the already high penetration of banks' branches in the country (Figure 5.3). As of December 2013, the total number of banks' branches (including Islamic, conventional and foreign banks) reached the 400 mark, as 16 new branches were added during the year. The pace of growth in banks' branches is visibly higher for Islamic banks while that of conventional banks has levelled off. The decline in conventional banks' branches in 2010 with an associated rise in Islamic banks' branches was due to the conversion of a conventional bank into an Islamic bank.



Paper based transactions remain significant in terms of value

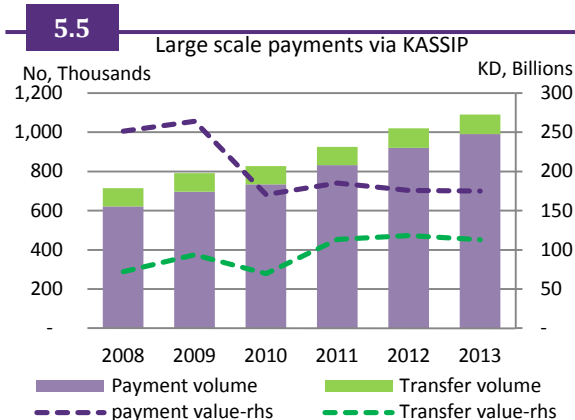
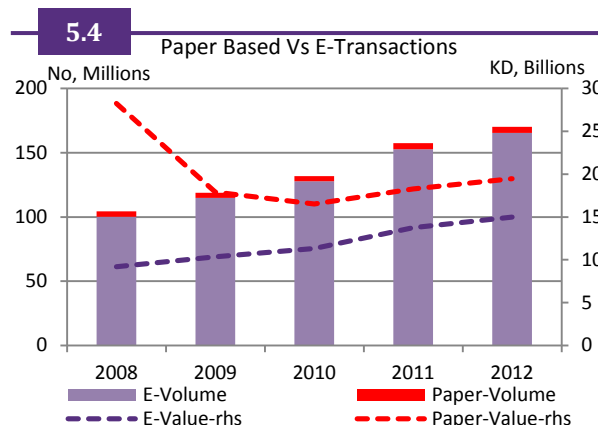
With growing use of e-banking, the share of paper based transactions, when viewed in terms of number of transactions (volumes), have remained insignificant (Figure 5.4). For instance, during 2012, only 2.7% of around 189 million transactions were conducted through the use of cheques. However, as we would expect, the share of paper-based transactions in terms of value still remains significant around 57.5% during 2013. Though even there, e-banking is catching up, as its share in terms of value (amount) has gone up from 25% in 2008 to 43% in 2013. Accordingly, e-banking is also becoming a key part of the payment system even in terms of value, with transactions worth KD 16.6 billion conducted through e-banking during 2013, compared to KD 22.5 billion through cheques.

During 2013, total presented cheques (clearing cheques plus cash cheques) reached 5.09 million cheques with a total value of KD 22.5 billion. Cash cheques worth KD 9.5 billion accounted for 54.2% of the total number of cheques presented during the year.

Majority of the transactions handled through KASSIP are payment related

A real time gross settlement system (RTGS) has been in place in Kuwait since August 2004, known as the Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP). The main purpose of this system is to process large value payments as well as being able to handle a large number of low value transactions.

Typically, transactions settled through KASSIP consist of *payments* and *transfers*, with the former involving a third party (customers) and later between banks. The bulk of the transactions handled through KASSIP are related to payments (Figure 5.5). During 2013 alone, as many as 1.09 million transactions were managed through KASSIP, registering a growth of 6.9% compared to 2012. In terms of value of



transactions, 2013 witnessed a slight drop of 2.1%, as total transactions worth KD 288 billion were handled compared to KD 294 billion in 2012. On a daily basis, KASSIP handles an average of 4,365 transactions worth KD 1.15 billion, playing a critical role in overall payment system of Kuwait.

For each KASSIP participant, different liquidity support overdraft limits are set by the CBK during the day (based on the collateral provided by the bank). These limits are available to participants between start of day and interim cut-off only, whereas the amount of the limit at interim cut-off is re-established automatically at start of day of the next business day.

It is worth mentioning here that CBK maintains a 'fall back' KASSIP system, capable of taking over operations in the unlikely event of a potential system breakdown. This fall back system can receive copies of all transactions posted on the main KASSIP system (in real time), ensuring the smooth takeover of operations if required by circumstances. Participants of KASSIP are also required to maintain disaster recovery and business continuity arrangements approved by the CBK.

The 6th issue of the Kuwaiti Currency

Issuance of currency notes is one of the key mandates of the Central Bank of Kuwait (CBK). Over the years, CBK has been issuing Kuwaiti currency of different denominations to fulfill the public need for domestic currency. In continuation of its earlier efforts to keep the Kuwaiti currency in line with the best global standards of security and elegance, the CBK, on May 19, 2014, unveiled the 6th Issue of the Kuwaiti Currency which will be in circulation from June 29, 2014 (for details of the first five issues, see Table at the end of this box).

The 6th issue of the Kuwaiti Dinar banknotes includes the most advanced security features available in the banknote printing industry such as color-changing ink and geometric shapes that become visible upon tilting the banknote. The design and security features of new banknotes reflect the significant efforts made by the CBK to keep pace with developments in modern banknote design and printing, as well as enhancing the image, security and quality of the currency in general. The new banknotes also incorporate raised print to help the visually impaired in distinguishing various banknotes.

Key Security Features of the new Currency Notes:



TOUCH

Feel the raised value print on both sides of the banknote that act as symbols for the visually impaired.



LIFT

Hold the banknote up to the light to see the falcon watermark with the brighter value on each banknote.



Hold the banknote up to the light to see the irregular shapes printed on the front and back that combine to form the banknote's value.





TILT

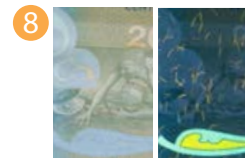
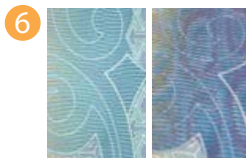
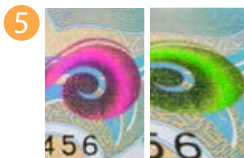
Tilt the banknote up and down to see the wave shapes change colour.

An area of solid print appears as circles when tilting the banknote.

On the back, a security thread changes colour upon lifting. When directed to the light, the artwork and the banknote's value appear.

CHECK

Under a UV lamp, fluorescent elements become visible on both sides of each banknote.



Moreover, the 6th issue of the Kuwaiti Dinar banknotes employs a clear and elegant structure throughout the entire series, using visual representations of nationally significant elements and economic accomplishments grounded on one unified background---the Kuwaiti flag. Using lively hues and interactive features, the banknotes feature important and culturally significant buildings on the front while illustrating Kuwait's accomplishments and economic milestones on the backside. Following paragraphs provide the details about key design features of the new currency notes:-

Denomination: 20 Kuwaiti Dinar Note

Key Theme: Ruling & the Sea

On the front of the banknote appears the illustrious Seif Palace, a symbol of sovereignty and ruling power to all of Kuwait's rulers where the country's affairs are administered. The Boom, the largest and most popular traditional Kuwaiti dhow, is featured on the front and rear of the banknote, an element that alludes to Kuwait's modernization as well as its rich economic and commercial history that is linked to the deep blue seas. Another element included on the back is a pearl diver, one of the earliest professions that enabled Kuwaitis to earn a living before the discovery of oil.



Denomination: 10 Kuwaiti Dinar Note
Key Theme: Democracy & the Desert

The glorious Kuwait National Assembly Building, a symbolic pillar of Kuwait's democratic constitution, is beautifully illustrated on the front of the banknote. Kuwait's diverse desert life takes over on the banknote's rear; a captivating illustration of a falcon oversees a seated camel dressed regally in a traditional sadu saddle.



Denomination: Five Kuwaiti Dinar Note
Key Theme: Economy, Finance & the Oil Industry

With its powerful pyramid steel structure, the Central Bank of Kuwait's newly constructed building portrayed on the banknote's front represents the Bank's objectives of ensuring monetary and financial stability. The back of the banknote shows one of Kuwait's oil refineries and a tanker as a testament to Kuwait's precious source of prosperity.



Denomination: One Kuwaiti Dinar Note
Key Theme: Kuwait's History & Islam

A superb illustration of the Grand Mosque, the largest mosque in the country as well as a symbol of Kuwait's Islamic identity, is portrayed on the banknote's front. The rear of the banknote displays a real-life illustration of an iconic column, one of the many influences of ancient Greece's civilization that swept across and settled in Kuwait's island of Failaka.



Denomination: Half Kuwaiti Dinar Note
Key Theme: Kuwait's Icons & its Environment

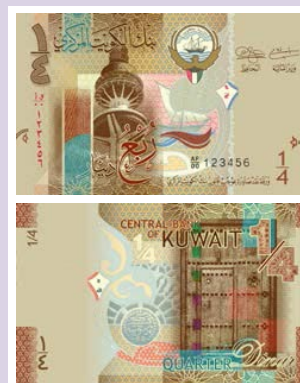
Arguably the most familiar and important Kuwaiti landmark, the Kuwait Towers are illustrated on the banknote's front as they soar mightily into the sky. The banknote's rear alludes to Kuwait's marine life and the significance of preserving it such as the endangered hawksbill sea turtle and the silver pomfret (Al Zubaidi), Kuwait's most popular fish.



Denomination: Quarter Kuwaiti Dinar Note

Key Theme: Kuwait's Liberation & Heritage

The striking Liberation Tower, a massive 372-meter structure that is one of the main landmarks in Kuwait City as well as one of the tallest buildings in the world, appears on the front of the banknote as a symbol of Kuwait's independence since its construction in 1996. The banknote's rear portrays a traditional wooden Kuwaiti door, a plaster carving and the first Kuwaiti coin used locally.



A brief history of the first five issues:-

Issue	In Circulation on	Description
1 st	April 1, 1961	The first issue was the result of the promulgation of the Kuwaiti Currency Law in accordance with the Amiri Decree No. (41) of 1960. This Law stipulated that the Kuwaiti Dinar shall be the national monetary unit and established the Kuwaiti Currency Board under the chair of then Minister of Finance and Economy, Sheikh Jaber Al-Ahmad Al-Jaber Al-Sabah. Accordingly, on the first day of April 1961, the first issue was put into circulation, replacing the then circulating 'Indian rupee'. The first issue was withdrawn from circulation effective February 1, 1982 and ceased to be a legal tender on May 31, 1982.
2 nd	November 17, 1970 for 10, 1/2, and 1/4 dinar notes; April 20, 1971 for 1 and 5 dinar notes	The Second issue followed the establishment of the CBK in replacement of the Kuwaiti Currency Board, with the CBK taking over the function of issuing currency notes and coin in addition to other tasks. The second issue was withdrawn from circulation effective February 1, 1982, and ceased to be a legal tender on May 31, 1982.
3 rd	February 20, 1980, for KD 10, 5, 1, 1/2 and 1/4 notes; February 9, 1986 for KD 20 note	Following the accession of H. H. Sheikh Jaber Al-Ahmad Al-Jaber Al-Sabah, the third issue of Kuwaiti Dinar was released in 1980. Due to the exceptional circumstances ensuing from the Iraqi invasion of Kuwait in 1990, this third issue was withdrawn from circulation effective March 24, 1991, and ceased to be a legal tender after 45 days from that date. The right of exchanging these notes at the CBK expired on Saturday, September 30, 1991.
4 th	March 24, 1991	Soon after the liberation of Kuwait, the fourth issue was put into circulation in March, 1991 to allow for a speedy exchange of the withdrawn third issue and to ensure the country's swift economic recovery. The fourth issue was withdrawn from circulation on August 17, 1994 and ceased to be a legal tender effective February 16, 1995. The right of exchanging these notes at the CBK expired on Monday, August 16, 2004.

5th

April 3, 1994

The Fifth Issue of the Kuwaiti Currency was released in 1994. It is the current circulating currency of the State of Kuwait which incorporates various technical features and security developments used by the banknote printing industry.

