

Financial Stability Report 2015



Central Bank of Kuwait



CENTRAL BANK
OF
KUWAIT

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Financial Stability Report

for the calendar year 2015

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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FOR THE YEAR 2015



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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.

We are pleased to release our 4th FSR for the calendar year 2015, 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 the 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.

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 2015 (CY15) using December 31st, 2015 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 is based on the consolidated banking system data, including both conventional and Islamic banks within Kuwait and their subsidiaries and branches abroad. Due to some data limitations, we have not covered the performance of 12 foreign banks' branches in Kuwait (which account for about 4.4% 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.

***Data Sources:** Discussion in Chapter 1 to 3, first two sections of Chapter 4 (Money & FX Markets) and Chapter 5 is based on the data from the CBK. The sections on the Kuwait Stock Exchange (KSE) & Real Estate Market in Chapter 4 are based on the data from the KSE and the Ministry of Justice, respectively.*



Notwithstanding the challenging economic environment amid steep and sustained fall in oil prices since mid-2014, banking system in Kuwait remained sound and stable during the year under review (CY2015). Domestic credit posted a healthy growth, banks' non-performing loan ratio continued its steady decline to reach a historically low level, coverage ratio climbed to a new high, capital adequacy levels stayed robust and net income grew positively, albeit at a much slower pace than in 2014. These trends collectively highlight that banking sector, at least so far, has weathered the oil rout fairly well. While banks entered the low oil price environment from a position of strength, the positive outcome observed in CY15 can in part be attributed to higher public spending which helped contain the impact of falling oil prices on domestic economic environment. Banks' resilience would have come under pressure had there been a scaling back of public investments or a major correction in real estate prices. Backed by ample financial buffers, the government commendably ramped up infrastructure spending despite the sharp drop in oil revenues. Moreover, stable employment conditions for Kuwaiti nationals coupled with positive growth in wages supported consumer spending in general, except for the sale of durables which was influenced by a cautious outlook.

Positively, oil price (for Kuwaiti Export Crude-KEC) has more than doubled from around \$19 per barrel in January 2016 with global supply glut shrinking and demand firming up. Though the recent recovery in oil prices proffers some relief in the near term, only comprehensive fiscal and structural reforms will enable Kuwait wean itself off oil dependence. Thanks to its enormous financial savings and low public debt, Kuwait can afford the reforms to be gradual as long as the measures are sustained. Rationalizing expenditures, cutting wasteful and poorly targeted subsidies, increasing non-oil revenues, creating incentives for nationals to work in the private sector, and diversifying the economy in general are few of the areas which would continue to require unremitting attention. Without such reforms, economic outlook would remain weak, which in conjunction with protracted lower oil prices can, over time, erode buffers in the banking sector and reduce its resilience.

Financial Intermediation: After two years of double-digit growth, banking system posted a much slower expansion when viewed on a consolidated basis; assets grew by a muted 2.6% during 2015. However, growth in domestic assets was much healthier at 5.7% on the back of strong growth in domestic credit which was up by 8.5% compared to 6.3% in 2014. Lending to the households was particularly strong at 10.6%; household sector turned out to be the top recipient for bank credit in 2015,

Domestic credit off-take has been fairly healthy

surpassing the real estate sector. However, as the bulk of lending to households (83.8% in 2015) has been in terms of installment loans for repair and purchase of private homes, banks' combined exposure to real estate sector reached almost half of their total credit portfolio. Yet the risk profile of installment loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, notwithstanding the apparent lack of diversification, banks' credit portfolio itself has been fairly healthy with non-performing ratios at low levels (see Chapter 2). On the liability side, growth in banks' consolidated deposits slowed down to 3% compared to 7.8% in 2014. Domestic deposits grew only a tad better, posting 3.3% increase in 2015. However, the banking system continued to enjoy a stable funding base with 63% of the total deposits placed in the time deposit category.

Credit Risk: 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, on a consolidated basis, has dropped to a historically low level of 2.4% (1.9% on domestic, Kuwait-only basis) as of December 2015, well below 3.8% last observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the last few years is particularly visible if the existing NPLR (2.4%) is compared with the double-digit NPLR (11.5%) recorded in 2009. Moreover, the coverage ratio (available provisions to NPLs) have reached 205% (275 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. Such positive developments in both NPLR and coverage ratio collectively exhibit the success of the CBK and local banks' endeavors in improving asset quality of the banking system.

Both the level and ratio of NPLs have dropped to a new low of 2.4% ...

...with coverage ratio reaching a historically high level of 205%

While flow of non-performing loans (NPLs) under different classifications reveals some buildup of new NPLs, loans under 'loss' category have clearly diminished. Sectoral analysis of NPLs indicates that the decline in NPLR has been broad based with many of the key sectors experiencing a contraction in their respective NPLRs. One noticeable exception has been the household sector, posting a marginal increase in NPLs, though its non-performance ratio remains fairly contained (2.5% as of December 2015). Geographically, the share of NPLs originating from banks' operation in the GCC and Africa regions has somewhat increased. Industry breakdown reveals that conventional banks account for 57.8% of total NPLs, almost in sync with their share in gross loans (60%).

Market & Liquidity Risks: Banks' exposure to the equity markets, though still significant, has been on a steadily declining trend; equity investments make up around 22.8% of banks' total investments, and use of firms' shares as collaterals

accounts for 22% of banks' overall collaterals. Banks' liquidity levels have remained healthy despite some tightening in the interbank market. Newly introduced liquidity coverage ratio also highlight that banks are comfortably above the minimum benchmark (70% for 2016) or even against the ultimate benchmark of 100% which would be effective in 2019.

Profitability: Banks' net income, on consolidated basis, grew by a modest 7% in 2015, at a much slower pace compared to 26.5% in 2014. Both return on assets as well as equity experienced a marginal improvement as growth in net income outpaced the growth in assets and equity. Though non-interest income recorded positive growth after experiencing contraction in 2014, growth in interest income in 2015 was barely half of what was observed a year earlier. By banking groups, conventional banks accounted for 64.5% of the industry profits and 60.7% of the industry assets. Cost to income ratio marginally came down with improvement in efficiency of Islamic banks. Still conventional banks, on average, remained significantly more cost efficient than their Islamic counterparts.

Banks' net income posted positive, albeit slower growth

Solvency: Capital adequacy ratio (CAR) of the banking sector further improved to reach 17.5%, well above the CBK's 12.5% requirement for 2015. Though the improvement in CAR was largely driven by conventional banks in 2015, Islamic banks continued to maintain capital adequacy ratios above their conventional counterparts, which in part also explains their lower efficiency ratios. Banks' overall leverage ratio was 9.7% in 2015, well above 3% benchmark proposed by the Basel Committee, indicating banks' capacity to extend credit without the risk of breaching the leverage ratio. Results of CBK's quarterly stress testing exercise reveal that banks, individually and collectively, have been able to broadly withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

Capital adequacy improved further to reach 17.5%

Money & FX Markets: CBK, in lockstep with the Federal Reserve, raised its discount rate by 25 bps in December 2015. Domestic inter-bank rates were on ascent few months in advance of CBK's move, largely in anticipation of an impending lift-off by the Federal Reserve. Both the scale of liquidity absorptions as well as interbank rates indicate that liquidity in the banking sector, while still healthy, has slightly tightened; accordingly, absorption both in terms of interventions and Tawaruq for shorter maturities visibly tapered by the close of 2015. CBK's mop up exercise relied, almost entirely, on the use of one-week instruments, further reducing the share of one-month arrangements. In the foreign exchange market, KD depreciated against USD by 3.6% in 2015 while appreciating against EURO and

Interbank rates have slightly climbed up with some tightening of liquidity

KD's peg to a basket of currencies helped reduce exchange rate volatility

GBP by 6.7% and 0.9% respectively; diverging growth trajectories and monetary policies across major economies influenced the exchange rates.

Stock Exchange & Real Estate Markets: Kuwait Stock Exchange, moving in lockstep with the protracted decline in oil prices, closed the year down in double digits (14.1%) as the absence of a domestic catalyst left the market more attuned to global developments; large cap stocks retreated by 15% (Kuwait-15 index) despite banks' healthy profits. Kuwait's real estate market also markedly slowed down both in terms of number and sales value of the deals, after enjoying positive growth for five consecutive years (with a particularly robust expansion in 2014). The retreat was broad based as all three segments (residential, investments and commercial) contracted significantly as steady fall in oil prices weighed on investors' sentiments. Yet the real estate prices seemingly held up well, averting any serious correction; this suggests the presence of genuine demand as well as investors' preference to stay put. However, materialization of an extreme tail event like a sharp correction in the real estate prices, though highly unlikely, could test the resilience of the banking sector, given banks' significant exposure to the real estate market, both in terms of loans and collaterals.

KSE closed the year 14.1% down; Real estate market contracted by 28.7% in terms of sales

Payment Systems: 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. During 2015, value of ATMs and point of sale (POS) based transactions posted growth of 5.2% and 13.2% respectively. These growth trends are similar to the ones observed in 2014 and underscore the resilience of household consumption in Kuwait despite a challenging economic environment. There are, however, signs of a slowing trend in the sales of consumer durables. To facilitate the increasing use of e-banking, necessary infrastructure in Kuwait has also been expanding; the number of ATMs and POS machines grew by 4.7% and 13.1%, respectively reaching 1,708 and 43,322 machines by December 2015. Moreover, branch network also continued to expand (particularly for Islamic banks), bringing total bank branches in Kuwait to 422.

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

Outlook: Going forward, growth in private sector credit is likely to remain healthy amid ongoing emphasis on capital spending. Moreover, oil market is heading towards a more balanced position with current oil price hovering around \$45 per barrel; however, prices are unlikely to improve much further this year as even current recovery was in part due to a bout of unplanned supply disruptions. Still, better oil prices would partially stem the sharp decline in revenues, enhance government's capacity to continue with an expansionary fiscal stance and would

Banking sector would continue to remain resilient

improve the domestic operating environment. Kuwaiti banking sector, which has remained unscathed so far, is likely to benefit further from this relatively improved outlook on domestic front, though risks emanating from their foreign operations can increase, particularly in countries with challenging security and/or economic conditions. Even domestically, a slight uptick in NPLR can't be ruled out, given the slim potential for its further decline and the lagged effect, if any, of lower oil prices. However, the banking sector in general is well placed to remain resilient in the near term, though the capacity to withstand various shocks does vary across banks.



CHAPTER 1

BANKS' FINANCIAL INTERMEDIATION

2015

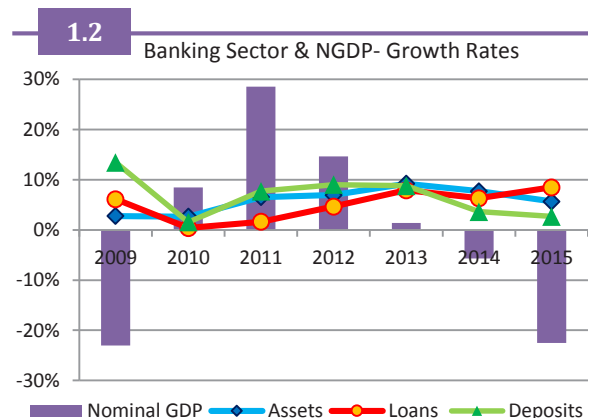
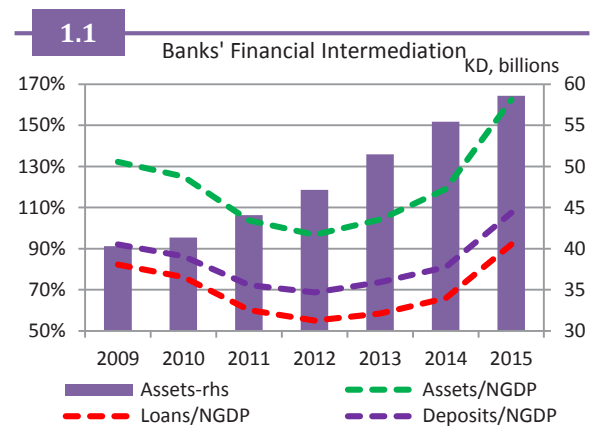
After two years of double-digit growth, banking system posted a much slower expansion when viewed on consolidated basis; assets grew by a muted 2.6% during 2015. However, growth in domestic assets was relatively healthier at 5.7% on the back of strong growth in domestic credit which was up by 8.5% compared to 6.3% in 2014. Lending to the households was particularly strong at 10.6%, which made the household sector the top recipient of bank credit in 2015, surpassing the real estate sector. However, as bulk of the lending to households (83.8% in 2015) has been in terms of installment loans for repair and purchase of private homes, banks combined exposure to real estate sector reached almost half of their total credit portfolio. Yet the risk profile of installment loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, notwithstanding the apparent lack of diversification, banks' credit portfolio itself has been fairly healthy with non-performing ratios at low levels (see Chapter 2). Finally, growth in banks' consolidated deposits slowed down to 3% compared to 7.8% in 2014. Domestic deposits grew a tad better, posting 3.3% increase in 2015. Yet the banking system continued to enjoy a stable funding base as 63% of the total deposits were placed in the time deposit category.

Banks' intermediation has ensured extensive financial inclusion

Financial intermediation by the banking sector continued to improve further in 2015, rather at a relatively sharp pace than what was observed in 2014. Accordingly, intermediation ratios, measured in terms of key banking variables relative to the nominal GDP, climbed up further (Figure 1.1)¹.

Steady rise in financial intermediation ratios during 2015 was both on account of a relatively decent growth in the key banking variables (i.e. assets, loans and deposits) and sharp contraction in the nominal GDP amid record low oil prices (Figure 1.2). Specifically, while assets, loans and deposits increased in 2015 by 5.7%, 8.5% and 3.2% respectively, nominal GDP shrank by 22.5%², resulting in a much stronger rise in intermediation ratios than would have been possible in the case of positive GDP growth.

In general, banks' role as financial intermediaries has



¹ The data used in Figure 1.1 & 1.2 is for the domestic banking sector only (including 12 foreign bank branches in Kuwait). However, unless otherwise specified, rest of the chapter is based on consolidated data, which includes operations of Kuwaiti banks' subsidiaries & branches abroad. Moreover, due to some data limitations, our discussion based on consolidated data excludes 12 foreign bank branches operating in Kuwait with combined assets of KD 3.16 billion.

² Nominal GDP for 2015 has been taken from the IMF's World Economic Outlook of April 2016.

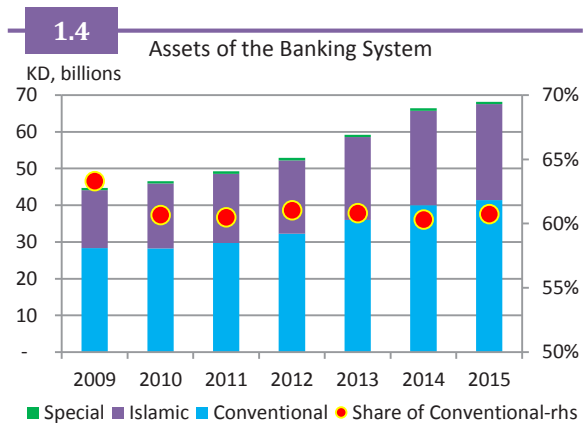
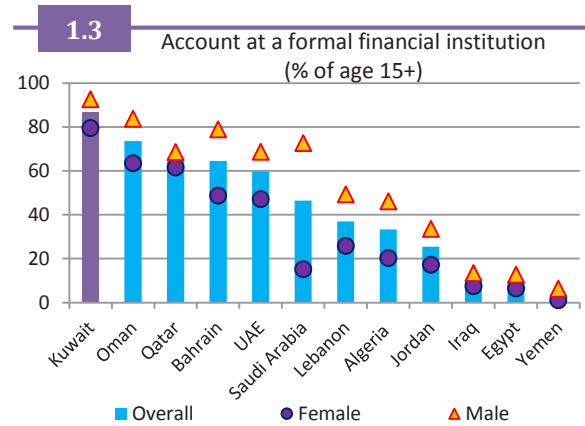
ensured a fairly high degree of financial inclusion in Kuwait. For instance, The World Bank’s database on financial inclusion³ reveals that 86.8% of the population above the age of 15 years in Kuwait has an account with a formal financial institution.

Moreover, gender wise breakdown indicates that 92.7% male and 79.6% females above the age of 15 years maintain an account. These numbers suggest that Kuwait has the highest level of financial penetration compared to other countries in the Middle East & North Africa (MENA) region (*Figure 1.3*). Additionally, both male and female customers have fairly similar level of access to finance, when it comes to maintaining an account. As discussed in detail in *Box 1.1* of our Financial Stability Report-2014, the level of financial inclusion in Kuwait is fairly high on other counts as well, putting Kuwait in the lead across the MENA region.

Financial system continues to remain bank-centric

Kuwait financial system continues to remain bank-centric, as the banking sector⁴ accounts for around 82% of the domestic financial sector. Investment companies are the second major player in the domestic financial system with around 14% share as of December 2015. Investment funds, insurance companies, and exchange companies constitute the rest. Domestic banking sector consists of five conventional, five Islamic and one specialized bank. Moreover, Kuwaiti banks have sizeable presence in numerous other countries, with total assets of their subsidiaries & branches abroad accounting for 18.1% of the consolidated banking system.

When viewed on a consolidated basis⁵, conventional banks dominate the overall banking system, with 60.7% share as of December 2015; however, their share has remained broadly the same since 2010 (*Figure 1.4*). Islamic banks, with 38.3% share in consolidated banking system, represent one of the



³ The most recent data available on financial inclusion is of 2014.

⁴ Domestic banking sector including foreign banks’ branches within Kuwait.

⁵ Consolidated data includes Kuwaiti banks’ subsidiaries & branches abroad (see footnote 1).

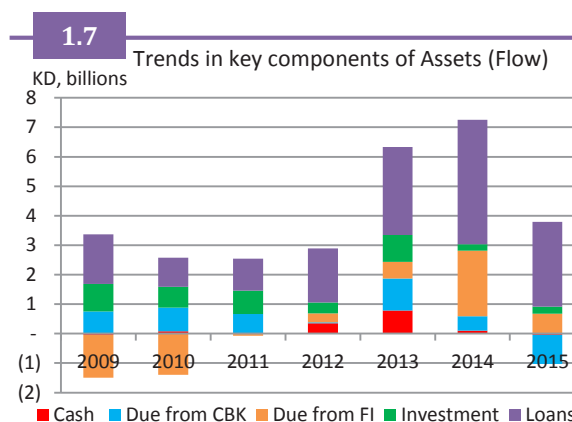
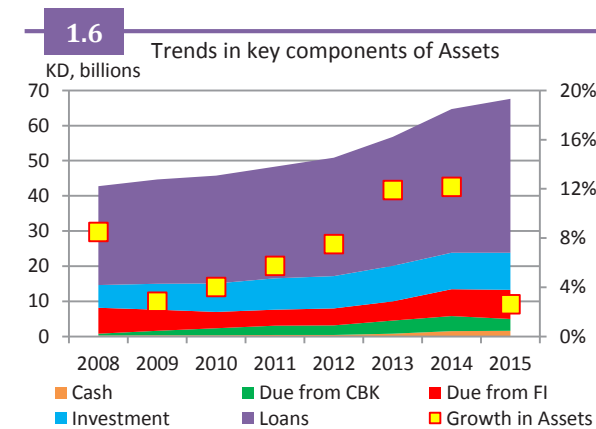
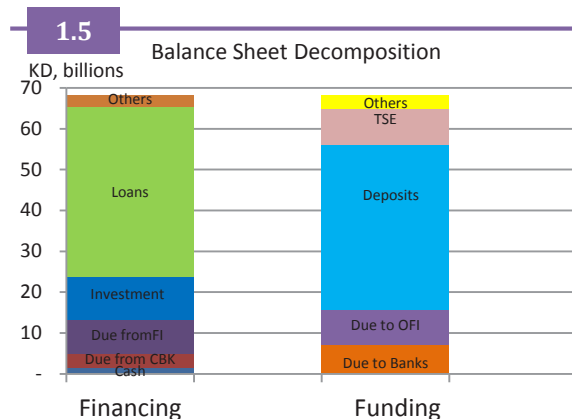
most significant presence of Islamic banks in any country across the globe with a dual banking system. Strong presence of Islamic and conventional banks underscores the effectiveness of CBK's endeavors in ensuring a level playing field for both types of banks and also provides customers a variety of choices to fulfill their banking needs.

Decomposition of the balance sheet of the banking system highlights the prevalence of traditional instruments expected in a bank-centric financial system. For instance, loans account for as much as 61% of the total assets as of December 2015 (Figure 1.5). Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 15.6% share in total assets. On the liabilities side, deposits account for 59.2% of total liabilities, indicating a healthy deposit base to help Kuwaiti banks befittingly perform their intermediation role.

Growth in banking assets noticeably slowed down

After two years of double-digit growth, consolidated banking assets posted significantly slower growth of 2.6% in 2015 (Figure 1.6). Specifically, assets worth KD 1.7 billion were added to the banking system, putting total assets at KD 68.1 billion by December 2015. However, it was markedly slower expansion compared to the addition of KD 7.2 billion in 2014.

Flow data for the key components of banks' assets reveals that slower asset growth was largely due to reduction in banks' placements with both the central bank as well as other financial institutions (Figure 1.7). In particular, 'Due from CBK', which reflects banks' placements with CBK, posted a substantial decline of KD 987 million in 2015; it was the first contraction since 2008 and suggests tightening liquidity conditions with reduced excess liquidity in the banking sector. Accordingly, CBK's liquidity absorption (mopping up of the excess liquidity from commercial banks through interventions/tawarruq) noticeably tapered



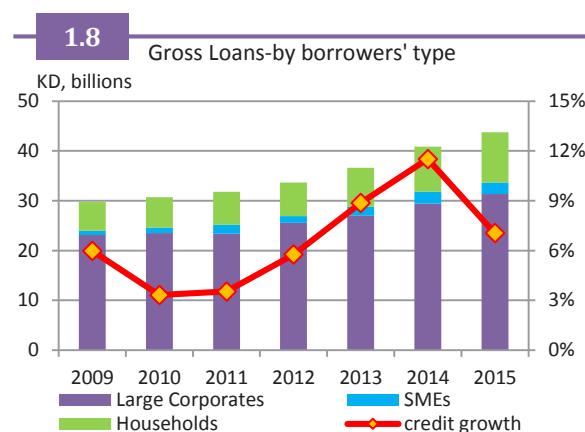
by the end of 2015 (see Chapter 4 for details). ‘*Due from Financial Institutions*’ which includes both interbank lending and placements, also posted much slower growth compared to 2014. Yet the growth in loans was healthy as non-oil sector was able to grow well amid strong growth in capital expenditures and healthy trends in household borrowings, notwithstanding the drop in oil-sector GDP.

.....yet domestic credit off-take remained strong

During 2015, banks’ consolidated loan portfolio expanded by another KD 2.9 billion, posting decent growth of 7.1% (Figure 1.8). While much lower compared to the growth recorded in 2014 (11.5%), credit off-take was still fairly healthy. More significantly, domestic credit grew by an impressive 8.5⁶% in 2015, compared to 6.3% a year earlier; it was encouragingly higher growth, particularly at a time when the Nominal GDP declined by 22% amid record-low oil prices.

In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 71.7% of the total gross loans. A distant second was the households sector, with 23% share in overall credit and outstanding loans amounting to slightly above KD 10 billion as of December 2015. Though still limited, there has been a shift from corporates to households in terms of credit allocation as the share of household sector has marginally improved in the last few years.

On the other hand, share of SMEs in overall lending slightly decreased to 5.3% in 2015. To increase lending to SMEs, CBK has incentivized banks by using a preferential risk weight of 75% for SME finance. Moreover, at the national level, the Kuwaiti parliament approved a new law in March 2013 to establish the ‘*Kuwait National Fund SMEs Development*’. The National Fund, in partnership with local banks will grant loans (under separate conventional and Sharia-compliant schemes) up to a maximum of KD



⁶ This ratio comes down to 8.2% if we exclude credit extended by 12 foreign bank branches in Kuwait.

500,000 to eligible SMEs by contributing 80% of the funding, while the remaining 20% will be provided by the partner bank(s).

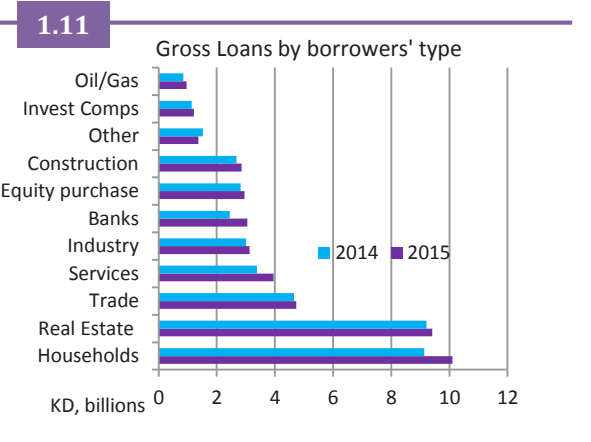
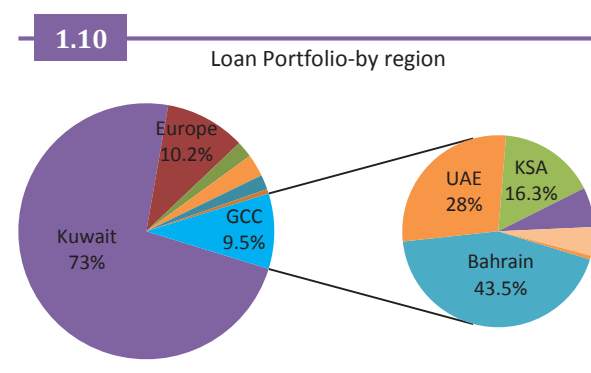
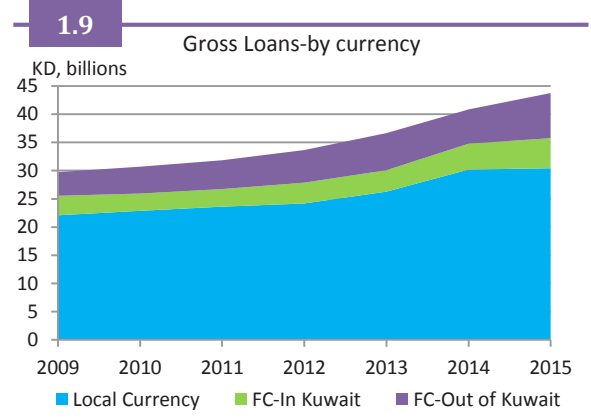
Loans' break up in terms of lending to the public and private sectors reveals that almost the entire lending was directed towards the private sector (99.2%), while the share of lending to the public sector further slipped to a paltry 0.8% during 2015. With huge accumulation of assets over the last decade, the need for public sector to borrow from the banking system have remained minimal. Strong financial profile of the public sector has also helped Kuwait avoid the issue of private sector crowding out that countries with frequent government borrowing from the banking sector typically experience.

Currency-wise breakdown of the gross loans indicates that almost 70% of the overall lending was in the domestic currency, though the share of foreign currency (FC) loans improved from 26% in 2014 to reach 30% by 2015 (Figure 1.9). Within FC loans, around 60% in 2015 were granted by Kuwaiti banks' subsidiaries & branches abroad (FC-out of Kuwait).

Geographical breakdown of banks' lending portfolio reveals that out of banks' 43.7 billion of gross loans as of December 2015, almost KD 32 billion (73%) have been granted within Kuwait (Figure 1.10). The remaining 27% of the gross loans have been distributed across various regions, with Europe and GCC accounting for around 10.2% and 9.5% respectively. Within GCC, banks' greatest credit exposure is confined to Bahrain, followed by UAE and Saudi Arabia.

Credit growth was positive for all key sectors

Breakup of gross loans across various sectors indicates that all key sectors experienced positive growth in terms of credit off-take (Figure 1.11). Noticeably, *households* became the major recipient of bank credit in 2015, surpassing the *real estate* segment that has traditionally been the top beneficiary of bank lending. The shift in banks' lending away from real estate and towards households, while muted at



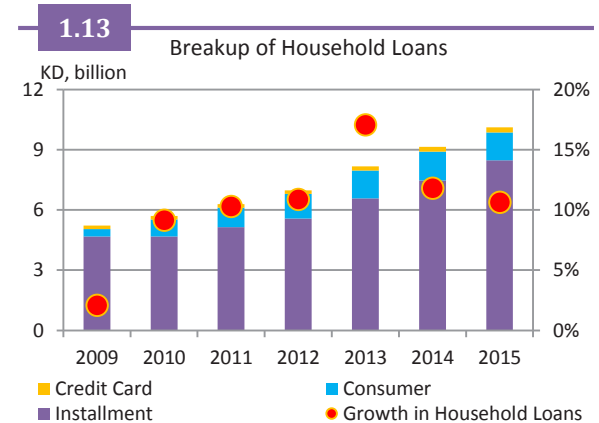
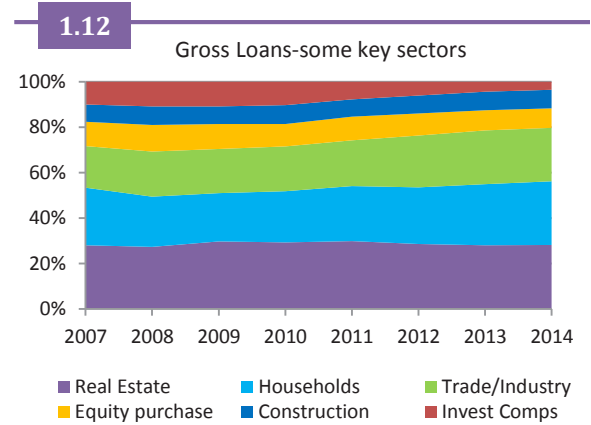
present, underscores banks' changing preference in favor of low-risk areas.

Banks' lending to investment companies also posted positive growth in 2015, thus bucking the trend of earlier years; however, its share in banks' overall loan portfolio remained stagnant around 2.8%. Still, this marginal increase in lending to investment companies seemingly marks the reversal in the trend of deleveraging that the sector has been experiencing since 2009.

Notwithstanding the above-mentioned shifts, the broader trend in loans over the years reveals that banks' collective exposure to key sectors have remained largely stable, with little indication of a sudden surge in any specific sector (Figure 1.12). 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. However, concentration remains high as four sectors (real estate, households and trade and services) account for almost 64.5% of the entire credit portfolio.

Households & Real estate are leading recipients of bank credit

Banks' credit to the households grew by 10.6% in 2015 to reach KD 10.1 billion, making household sector the top recipient of bank credit in Kuwait followed by the real estate sector (KD 9.4 billion). While growth in household credit was lower compared to 2014 (11.8%), it was still in double digits for the fifth consecutive year (Figure 1.13). Breakup of household loans reveals that around 83.8% 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 13.8% share as of December 2015. Finally,



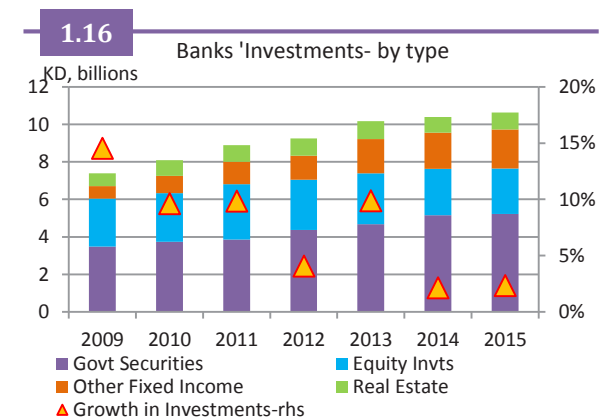
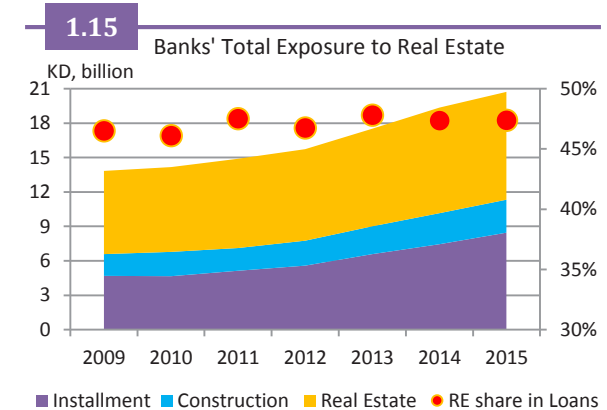
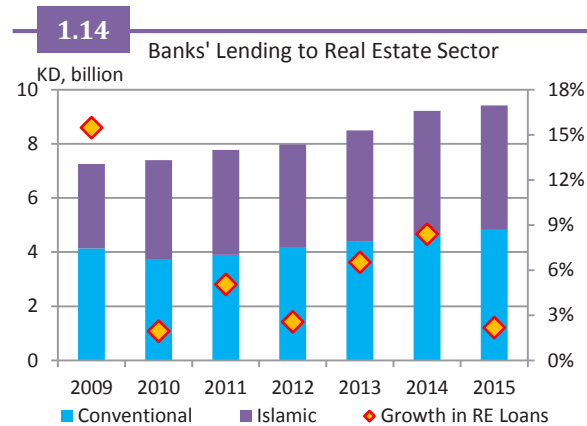
credit card related loans made around 2.4% of overall household loans.

Banks' lending to the real estate sector visibly slowed down in 2015 (2.2%) compared to much stronger growth in 2014 (8.4%) (Figure 1.14). As a result, share of the real estate loans in banks' overall credit portfolio marginally declined from 22.5% to 21.5% during 2015. Both conventional and Islamic banks had somewhat similar size of exposure to the real estate, with conventional banks' accounting for a slightly higher share (51.2%) in 2015.

Given the fact that bulk of the household loans are being used for repair and purchase of private homes, banks' overall exposure to the real estate is significantly greater than what appears from their direct lending of KD 9.4 billion. Banks' combined exposure to the real estate can be viewed in terms of their lending to (i) real estate sector (ii) construction sector and, (iii) installment loans to the households. Adding up the lending under these three categories, banks' exposure to real estate accounts for almost half of their entire lending portfolio (Figure 1.15). Yet the risk profile of installment loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, notwithstanding the apparent lack of diversification, non-performing loan ratio in the household and real estate & construction sectors has been at low levels (2.5% and 2.4% respectively in 2015), indicating limited degree of infection (see Chapter 2). Additionally, as highlighted in Chapter 4, no major correction in real estate prices has been observed though sales values have significantly come down. This suggests the presence of genuine demand amid supply bottlenecks particularly in the residential segment.

Banks' equity investments retreated amid falling stock prices

Banks' investment portfolio posted a modest growth of 2.3% in 2015 compared to 2.1% in 2014. While investments in associates recorded a major contraction (down 11.5%) in 2015, investments in real estate and other fixed income went up by 8.5% and 8.2% respectively (Figure 1.16). Investments' breakdown reveals that out



of KD 10.6 billion of total investments, around KD 5.2 billion (49.2%) were placed in government securities as of December 2015. Banks' equity investments formed the second major category with 22.8% share in total investments. In the last few years, banks' exposure to other fixed income securities has been on the rise in particular; during 2015, it reached 19.6% of overall investments compared to 13.9% in 2012.

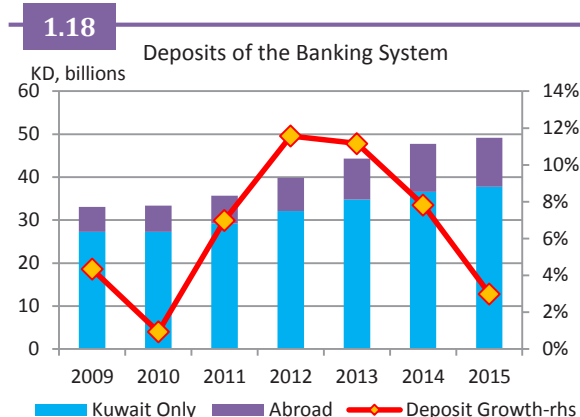
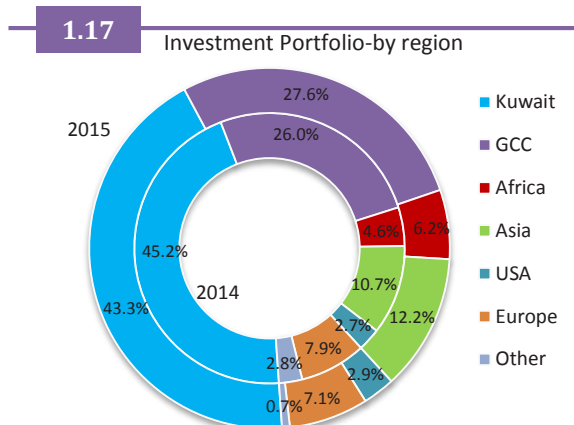
Geographical distribution indicates that banks' investments within Kuwait marginally declined from 45.2% in 2014 to 43.3% in 2015. Moreover, a slight decrease in banks' investments in Europe was also observed. On the other hand, banks' exposure to all other regions went up, particularly in the countries within GCC, Africa, Asia etc (Figure 1.17). These trends collectively underscore the improving diversification of banks' investment portfolios.

Growth in deposits markedly declined

During 2015, banking system deposits posted slower growth of 3%, compared to much stronger increase recorded during the earlier three years (Figure 1.18). Deposits raised through subsidiaries and branches abroad grew at an even slower pace (2.1%) compared to the growth in domestic deposits (3.3%), though the growth in both categories was significantly lower than in 2014. Overall, deposits reached KD 49.2⁷ billion as of December 2015, with domestic deposits accounting for 76.8% of total deposits of the consolidated banking system. Over the years, the share of deposits from abroad has been slowly increasing due to the growing expansion of Kuwaiti banks abroad. Specifically, this share has gone up from 15% in 2007 to 23.2% in 2015 (though marginally lower than 23.4% recorded in 2014).

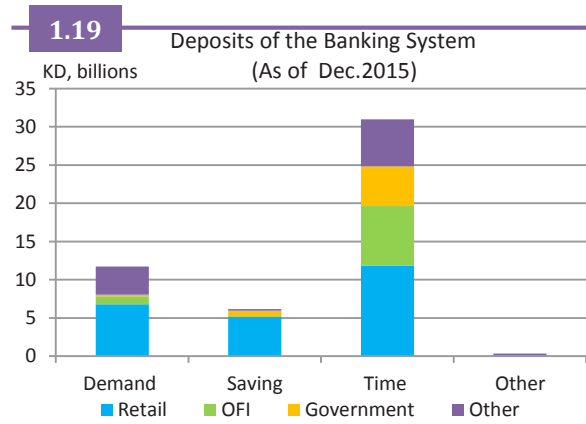
Around two-thirds of banks' deposits are time deposits

Breakdown of deposits reveals that time deposits account for around 63% of the total deposits,



⁷ This includes government and private deposits as well as 'due to other financial institutions'.

highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress (*Figure 1.19*). Retail deposits are well diversified into three different categories (demand, saving and time), 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. Given the strong fiscal profile of the government, presence of its deposits in the time deposit category further adds to the stability of banks' funding base.



Islamic Finance: Past, Present and the Future⁸

Your Excellencies, Distinguished guests, Ladies and Gentlemen,

A very good morning - it is a great pleasure for me to welcome you all.

I am deeply indebted to all the honorable ministers and governors of central banks and other distinguished guests for joining us today on this auspicious occasion. In particular, I would like to warmly welcome and thank Madame Christine Lagarde, Managing Director of the International Monetary Fund (IMF) for graciously supporting this endeavor and personally attending this conference.

I would also like to sincerely thank the staff of the IMF, the staff of the Middle East Center for Economics and Finance in Kuwait and my dedicated colleagues at the Central Bank of Kuwait (CBK) for their efforts in making this conference a success.

It is the first time that the IMF is co-hosting a conference on Islamic Finance such as this, and the Central Bank of Kuwait is privileged to be a partner in organizing this historical event.

Taking this opportunity, I would like to share a few thoughts on the progress of Islamic finance in a historical context. My speech is set against three different times, covering the past, the present and the future. I will start with a very brief history of Islamic finance, particularly in the context of Kuwait, then turn to cover the present, and finally reflect upon its future. This broad sweep through history will hopefully help us see where we started from, how far we have reached and where we are heading next.

1-Islamic finance of the past; a humble beginning

Let me start with the past.

Around 38 years ago, in the same city as we are meeting today, a pioneer, Sheikh Ahmed Al-Yasin, envisioned the possibility of establishing an Islamic bank. Back in the mid-1970's, many would have considered it mere daydreaming. After all, there was hardly any role-model of Islamic finance to emulate. In the words of Sheikh Al-Yasin himself, thinking of establishing an Islamic bank was *'like swimming against the tide'*. It was a time when only conventional banks were in vogue; we ourselves had six of them in Kuwait. So it required a big leap of faith to establish an Islamic bank when there was virtually no example to learn from. Despite these challenges, Kuwait witnessed the establishment of Kuwait Finance House (KFH) - not only the first Islamic bank in Kuwait - but also one of the very first established anywhere in the world.

It was a humble start; with only four employees, KFH opened its doors to the public for the first time on August 31st 1978. I doubt anyone imagined that it would one day become a leading Islamic bank, with 8,000 employees and operations spanning across seven regions of the world.

The growth of Islamic finance as an industry is equally impressive. This is however hardly

⁸ Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait, on the occasion of IMF-CBK Islamic Finance Conference, 11th November, 2015, Kuwait City.

surprising, as the basic principles of Islamic finance deservedly have a universal appeal, irrespective of religious beliefs.

Adam Smith, the father of modern economics, argued that it is the pursuit of self-interest by individuals that leads, somewhat unintentionally, to the welfare of society as a whole. Islamic teachings, however, offer a more encompassing guide by making the broader interests of society central to our efforts. Fourteen centuries ago, the Prophet Muhammad (peace be upon him) said: *أَجِبْ لِلنَّاسِ مَا تُحِبُّ لِنَفْسِكَ* 'Wish for the mankind what you wish for yourself'.

This is the 'golden rule' of a good society, a principle that has been conveyed by almost every major religion or ethical tradition. It goes beyond Adam Smith's idea of an *invisible hand* in the sense that society's welfare is not an accidental outcome. Rather, the golden rule requires that anything that harms a society is prohibited, even if it is beneficial for the individual.

And the golden rule epitomizes the concept of justice which is central to Islamic finance. Justice, in economic context, requires at least two things; proper allocation of resources for the welfare of the entire society, and sharing of risk and reward.

Since banks mobilize savings from a large group of people and lend to relatively fewer borrowers, there is an element of asymmetry in banks' resource mobilization on the one hand, and resource allocation on the other. This necessitates that banks, in the world of Islamic finance, lend to those who can use these savings to benefit the whole of society – by making productive investments and creating more jobs.

However, in recent years, excessive liquidity amid unconventional monetary policies has mostly fueled asset growth, with limited impact on real economic activity. As Madame Lagarde rightly pointed out in one of her speeches last year, *'there is too little economic risk-taking and too much financial risk-taking'*.

Islamic finance, by establishing an inseparable link between finance and the real economy, encourages economic risk taking that helps improve growth and create jobs. It requires that credit must be provided for productive investments, not for conspicuous consumption or speculative activities.

And such a business philosophy makes perfect sense, regardless of religious beliefs. Warren Buffet, the legendary investor of our time, was once quoted in Fortune Magazine, comparing three types of investment:- First, currency based investments, which he considered *'the most dangerous though investors mostly considered them safe'*. Second, *'investments in assets like gold that never produced anything'*. Yet he favored the third type; *'investments in productive assets, whether businesses, farms or real estate'* - and this is precisely what Islamic finance also requires banks to do - to promote investments in productive assets so that the entire society can benefit.

More importantly, Islamic finance goes a step further, as it also requires the sharing of profits and losses. That is not only important from the justice standpoint but also to ensure financial stability. Lenders would have the incentive to monitor the quality of investments being made if they have to share the risks and rewards.

Therefore, Islamic finance, in its true spirit, not only curbs speculative activities but also discourages excessive risk taking. Moreover, it promotes the kind of economic risk taking which benefits all of society, not just affluent investors.

2-Islamic finance of the present: a niche market with huge potential for growth

Let me now turn to the present state of Islamic finance.

From the establishment of the first Islamic bank in Kuwait around four decades ago, we now have five domestic Islamic banks that collectively account for 39% of domestic banking assets. This is the third highest share of Islamic banks operating in any country with a dual banking system - where conventional and Islamic banks operate in parallel. Globally, Kuwait has the fifth largest share of Islamic banking assets and the third largest share of Islamic funds.

And it is not only in Kuwait that the Islamic finance industry has taken off in recent decades. Estimates suggest that the global market for Islamic financial services, as measured by *Shari`ah* compliant assets, has crossed USD 2 trillion by now, a quantum leap from USD 150 billion in the mid-1990's. Last year, the *sukuk* market witnessed debut issuances from the governments of four non-OIC countries -- the UK, Hong Kong, Luxembourg, and South Africa which indicates the growing popularity of *sukuk* beyond the Muslim world.

As these trends highlight, Islamic finance is neither a novelty nor is it restricted to Muslim countries only. Over the past decade, the industry has transformed itself from being a niche market to a viable alternative for consumers of conventional finance, irrespective of their religious beliefs. Today Islamic banks serve millions of customers across the Middle East, South-East Asia and beyond, offering a variety of *Shari`ah*-compliant products and services.

While it is indeed a remarkable achievement, Islamic finance has **significant potential** for further growth. Let me very briefly point out three such areas:-

First, both within Asia and MENA, the regions where Islamic finance has a greater footprint, there is substantial scope for investments in infrastructure. Amid the growing populations in some countries and mass urbanization in others, the needs for a modern infrastructure are immense, ranging from airports to power plants and dams to highways. These investments are invariably backed by tangible real assets and thus ideal candidates for Islamic finance.

Second, the world is increasingly recognizing the importance of investments that are socially responsible and environmentally sustainable. And given the similarity in their business philosophies, Islamic finance can be a natural choice for socially responsible investments.

Third, in many developing countries a majority of the public still remains hugely under-served by a formal financial system, if not entirely unbanked. For instance, World Bank data on financial inclusion for 2015 reveals that only 45.5% of the adult population has a bank account in South Asia, and merely 14% in the MENA region - incidentally, these two regions are home to more than 1.3 billion Muslims, around 82% of entire Muslim population.

These numbers collectively highlight that Islamic banks have the potential to reach millions of un-served customers. 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 exploitative, informal money lenders.

3. Islamic finance in the future; building institutional capacity for further growth

Let me now turn to the future.

Neils Bohr, Nobel laureate in Physics, said a century ago: *'Prediction is very difficult, especially if it is*

about the future’. And, may I add; prediction is even more difficult, if it is about the future of finance.

So, instead of attempting to predict the future, I would like to discuss what needs to be done to help the Islamic finance industry reach its potential. In this regard, the role of four types of institutions is critical not only in providing an enabling environment for a sustainable and resilient industry, but also in bringing current practices closer to the true spirit of Islamic finance.

First, consider the legal institutions, which offer the necessary infrastructure that, among other things, helps protect property rights and enforce contracts.

Hernando de Soto, a Peruvian economist emphatically wrote about the countries with poor legal infrastructure arguing that: “...the 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 contended that in the absence of effective legal institutions, inhabitants of such countries are just custodians of ‘dead capital’ --- ‘dead’ because while they may own plenty of resources, either they can’t prove legal ownership or they can’t efficiently use them in various transactions, given the inadequacy of legal institutions.

Both for their social and economic implications, Islamic principles lay great emphasis on honoring obligations and fulfilling commitments. The Holy Quran specifically exhorts us by saying, يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ ‘O believers, fulfill your obligations’. Strong institutions ensure it does happen, by protecting property rights, enforcing contracts and thus helping reinforce mutual trust in societies.

Second, take the role of academic institutions. Muslim societies were once recognized for their contribution to various academic disciplines, ranging from alchemy to astronomy and mathematics to medicine. Today, the scholarly work being produced in our societies is more of an individual effort than anything at the institutional level.

Due to this lack of capacity building at the institutional level, efforts of otherwise dedicated individuals have remained divergent and fragmented. Many with profound knowledge of Islamic jurisprudence know little about modern finance. And our experts on conventional finance, in general, are inadequately equipped to understand the implications of various *Shari`ah* injunctions. A study reveals that the top ten scholars in Islamic finance account for 67% of all chairman positions of *Shari`ah* boards. No wonder that Islamic banks struggle to find candidates for their *Shari`ah* boards who can suitably guide them in offering innovative products.

Third, consider the regulatory institutions. Effective regulation of Islamic finance is a daunting task, particularly in a dual banking system. Additionally, the peculiar nature of Islamic finance poses its own challenges in terms of designing a robust regulatory regime.

Take the case of Basel III reforms for example, where detailed guidance has been provided by the Basel Committee for Banking Supervision (BCBS) for the implementation in a conventional setting. However, for Islamic financial institutions, limited relevant guidance is available, if at all.

This undoubtedly requires the use of discretion by respective regulators. But the greater use of discretion is bound to create differences across countries and may increase the risk of regulatory arbitrage yet, importantly, such reforms were meant to foster a higher level of convergence among regulatory regimes.

Fourth, high responsibility also falls on Islamic financial institutions to make efforts in offering products and services that reflect the spirit of Islamic finance and are not just merely compliant with *Shari`ah* requirements. This requires building capacity to do better research and offer innovative services. Moreover, Islamic financial institutions need to operate with the aim of promoting social justice in their allocation of resources.

Given these challenges, it is not possible for any one of these four types of institutions to make a meaningful difference on its own. Each institution, from academic to regulatory and legal to financial, has a distinct yet mutually reinforcing role to play. While individually insufficient, collectively these institutions provide the very foundation for a dynamic and resilient Islamic finance industry and are thus the pre-requisites for its sustainable growth.

Finally, allow me to share a few concluding thoughts.

Current economic and financial trends are a constant reminder that the world needs a better system. The inherent fragility of modern finance is quite evident. And in recent years, the unfolding of events like manipulating currencies, rigging LIBOR and miss-selling mortgages has intensified the debate about the role of incentive structures and ethics.

Amid the growing concerns about excessive risk taking and ethical drift, Islamic finance can play a role by offering a financial system based on strong underlying principles. A system, which if implemented in its true spirit, will bolster growth, create jobs, reduce poverty and address inequality. A system, which will channel credit into productive investments - not into speculative activity or wasteful consumption - and a system, which will promote investments that are socially responsible and environmentally sustainable.

However, for such a system to deliver, we must shift our focus from a *Shari`ah*-compliant model to a *Shari`ah*-based model. Compliance is easy and can possibly be achieved without reforming institutions. But ensuring a *Shari`ah*-based financial system will require fundamental changes not only in the finance industry but also in the very way our societies function. And that is why building institutional capacity is of paramount importance.

Undoubtedly, it is an uphill task, but not an impossible one and collectively we surely can. As Tagore once wrote, '*You can't cross the sea by merely standing and staring at the water*'. All of us need to play our part in achieving that enviable goal, the goal of putting together a system that is ethically right, socially just, financially stable, and economically productive.

Thank you very much.



CHAPTER 2

BANKS' RISK ASSESMENT

2015

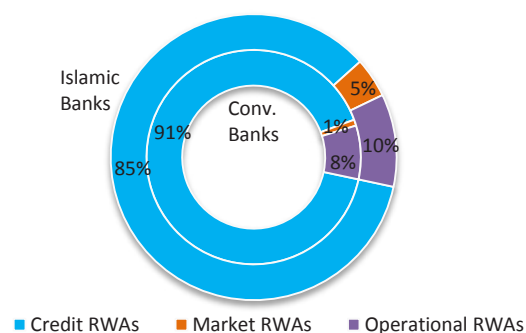
2 Banks' Risk Assessment

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, on a consolidated basis, has dropped to a historically low level of 2.4% (1.9% on domestic, Kuwait- only basis) as of December 2015, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the last few years is particularly visible if the existing NPLR (2.4%) is compared with the double-digit NPLR (11.5%) observed in 2009. Moreover, the coverage ratio (available provisions to NPLs) have reached 205% (275 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. While flow of non-performing loans (NPLs) under different classifications reveals some buildup of new NPLs, loans under 'loss' category have clearly diminished. Sectoral analysis of NPLs indicates that the decline in NPLR has been broad based with many of the key sectors experiencing a contraction in their respective NPLRs. One noticeable exception was the household sector, which posted a marginal increase in NPLs, though its infection ratio remains fairly contained (2.5% as of December 2015). Geographically, the share of NPLs originating from banks' operation in the GCC and Africa regions has marginally increased. Industry breakdown reveals that conventional banks account for 57.8% of total NPLs, almost in sync with their share in gross loans (60%). Banks' exposure to the equity markets, though still significant, has been on a steadily declining trend; equity investments make up around 22.8% of banks' total investments, and use of firms' shares as collaterals accounts for 22% of banks' overall collaterals. Finally, banks' liquidity levels have remained healthy despite some tightening in the interbank market. Newly introduced liquidity coverage ratio also highlight that banks are comfortably above the minimum benchmark (70% for 2016) or even against the ultimate benchmark of 100% which would be effective in 2019.

Though credit risk accounts for most of the RWAs.....

Given the traditional nature of banking business in Kuwait, credit risk understandably remains the most significant when viewed in terms of risk weighted assets. Accordingly, credit *risk weighted assets* (RWAs) of both Islamic and conventional banks have continued to account for the bulk of their total RWAs as of December 2015 (*Figure 2.1*). The distribution of RWA is somewhat more dispersed for Islamic banks when compared with their conventional counterparts as the nature of Shariah-compliant financing transactions entails a larger variety of risks. The insignificant contribution of market risk in overall RWAs is in part because of banks' relatively smaller trading portfolios. Moreover, calculation of RWAs

2.1 Distribution of Risk Weighted Assets (RWAs)



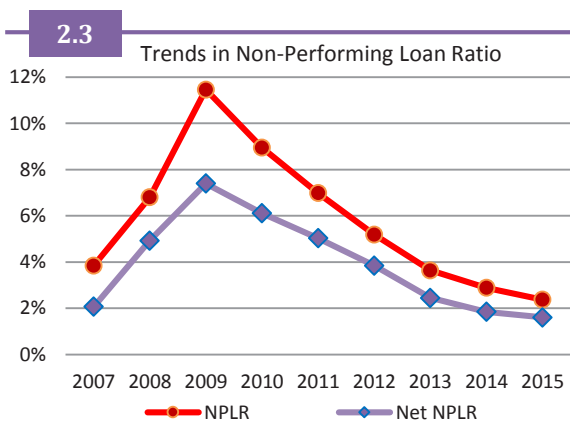
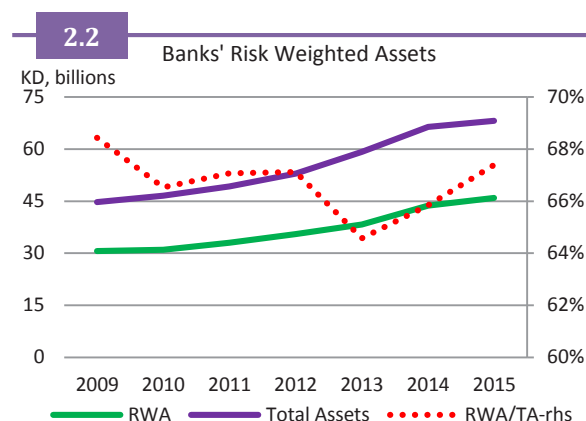
under Basel III specifically excludes interest rate risk in the banking book.

During 2015, overall RWA increased by 5%, at a much slower pace than the double digit growth (14.4%) recorded a year earlier. It was essentially because of the growth in assets also markedly slowed down (to 2.6%) during 2015, in part due to divestiture of foreign assets by some Kuwaiti banks. Still the ratio of RWA to total assets inched up to 67.4% in 2015 from 65.8% a year earlier, suggesting a mild shift towards riskier assets (Figure 2.2).

...banks' portfolio remains quite healthy with NPLR at record low

Yet the credit risk, which constitutes the bulk of RWAs of both Islamic and conventional banks, has continued to slide further. Specifically, the absolute value of non-performing loans (NPLs) of the banking sector steadily declined for the sixth year in a row, dropping to the lowest level since 2007. Trend in Net NPLs (i.e. Gross NPLs less specific provisions) also reveals a similar pattern, peaking in 2009 with a continuous decline afterwards. This remarkable contraction in the infected portfolio over the years has been made possible by banks' strenuous efforts in line with CBK's instructions and through its active engagement.

Against this backdrop, the NPL ratio (NPLR) edged further down to 2.4% as of December 2015, significantly lower than the pre-crisis ratio of 3.8% observed in 2007 (Figure 2.3). The historically low level of NPLR underscores significant improvement in the health of the banking system, when viewed in terms of credit exposures. Understandably, the pace of decline in NPLR has somewhat tapered as most of the credit portfolio is already performing and the scope for any major improvement is quite limited. Net NPLR has also been on a receding trend since 2009 and has reached a historically low level of 1.6% in 2015 due to lower NPLs in absolute terms.

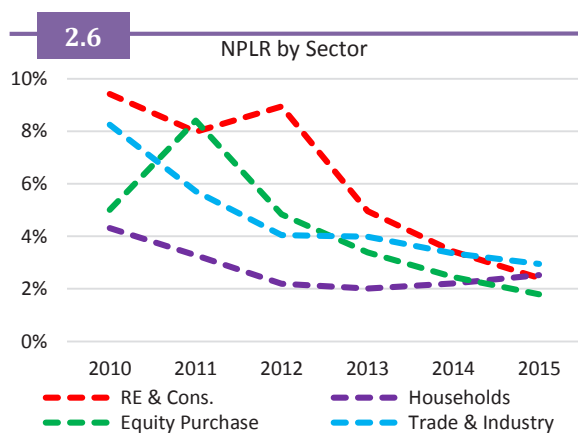
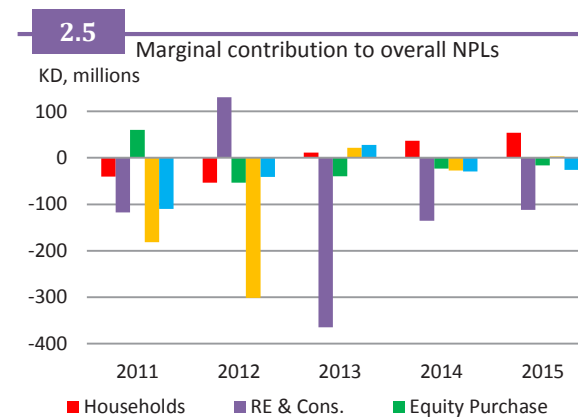
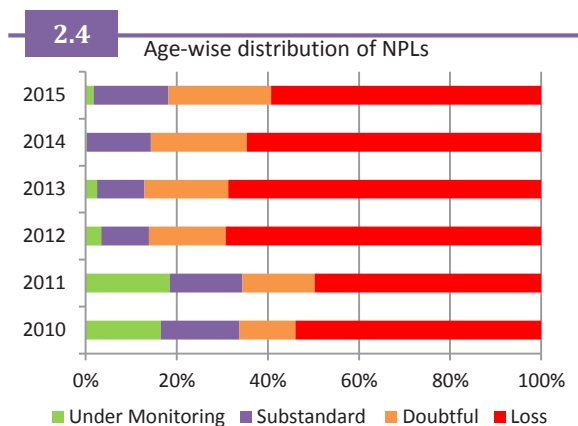


NPLs' classification by age profile indicates that the NPLs classified as 'Loss' are now at the lowest level in the last four years. Admittedly, the breakdown also reveals new additions to NPLs as both 'under monitoring' and 'substandard' categories post some expansion. Yet the marginal uptick in new NPLs is not unexpected, given the robust growth in credit off-take in 2015 and an increasingly challenging economic environment (Figure 2.4).

Sector-wise, decline in NPLs have been quite broad-based

Data for the marginal contribution of different sectors in the industry-wide NPLs reveals that contraction in infected loans has been broad-based, albeit with some noticeable exceptions. Major sectors have posted a decline in NPLs during 2015 except for the *household sector* which witnessed the third consecutive year rising NPLs (Figure 2.5). In terms of magnitude, the addition in households' NPLs was also the most significant since 2009. On the positive side, *real estate & construction* segment, the top recipient of bank credit, posted a major contraction, followed by *trade and industry*.

The broad based improvement in the health of banks' credit portfolio is also evident from the trend in sector-wise NPLRs (Figure 2.6). NPLR of equity purchase loans (EPLs) slipped further down, from 2.5% in 2014 to 1.8% in 2015, despite the poor performance of Kuwait Stock Exchange, which shed 14.1% in 2015. More importantly, NPLR for the *Real Estate & Construction* segment, which represents around 28% of banks' total credit portfolio, has also continued to slide, coming down from 3.4% in 2014 to 2.4% in 2015; this development is particularly remarkable given the sector's NPLR of above 8% only a few years back (in 2012). While the slowdown in real estate market was evident during 2015 (see Chapter 4 for details), real estate prices have largely held up well, with little detriment to banks' lending portfolio. Moreover, CBK also introduced appropriate macroprudential regulations in November 2013 to shield the banking system from excessive exposure to the real estate by imposing different

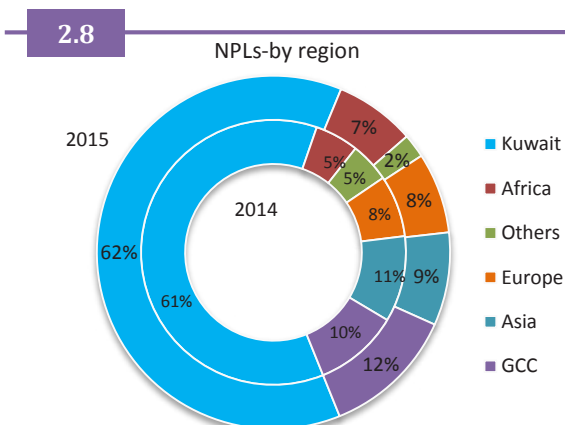
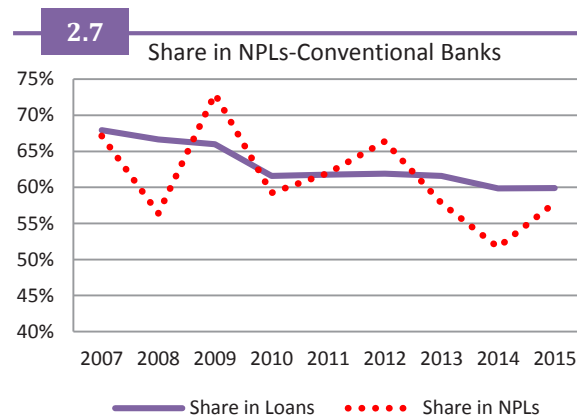


Loan-to-Value (LTV) ceilings depending upon the purpose of the loan (for details, see *Box.4.1* in the FSR of 2013).

On the other hand, NPLR for the *households* sector, has inched up from 2.2% in 2014 to 2.5% in 2015. The uptick in NPLR is in part due to an increasing share of the household sector in banks' gross loans, from 17.6% in 2009 to 23.1% in 2015. Moreover, infection level in the category of *installment loans*, which represent 83.8% of gross household loans, has also increased amid a slowing real estate market in Kuwait. Still, *households* NPLR at 2.5% is at a fairly low level, though the rising trend warrants close monitoring and the introduction of proactive measures if required. On its part, CBK has introduced a number of regulations, encompassing both micro and macro-prudential tools, to contain the possibility of infection in the household exposures⁹.

Segregation of NPLs by banks reveals that conventional banks' share in the industry NPLs have been more volatile, though their share in gross loans have remained broadly the same during the last few years (*Figure 2.7*). During 2015, conventional banks' contribution to industry NPLs inched up to 57.8%, broadly in sync with their share in gross loans (60%). However, such broad classifications across types of banks could be influenced by the performance of one major bank in that subgroup. For instance, the top four banks account for 70.5% of the total loan portfolio of the banking industry; thus, a sharp change in the quality of credit portfolio in even one of those banks can significantly alter the industry averages.

Geographical distribution of NPLs highlights that the contribution of domestic NPLs has only marginally increased to reach 62% in 2015 (*Figure 2.8*). While slightly higher than the share in 2014 (61%), it is still significantly lower than the share of domestic NPLs



⁹ For instance, these loans are primarily extended to Kuwaiti 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.

observed back in 2013 (75.8%). In relative terms, the domestic operating environment has been more conducive on the back of continued public spending which has remained strong despite the sharp decline in oil prices since mid-2014. This has helped contain any sharp increase in non-performing loans in the banking sector. Outside Kuwait, the contribution towards non-performing loans from the GCC and African region has slightly increased.

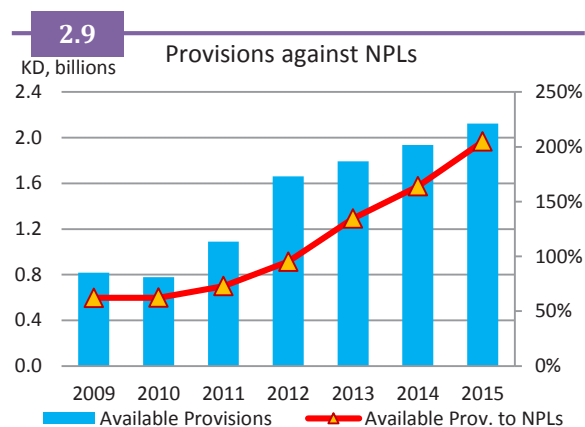
Banks' coverage ratio has continued its growth unabated

As required by the CBK, Kuwaiti banks have been building up additional provisions over the years to withstand any potential deterioration in their credit portfolios. During 2015, total available provisions grew by a healthy 9.8%, even surpassing 8% growth observed in 2014. As a result, *available provisions to NPL ratio* reached 205%, an all-time high in the last eight years, and substantially greater than the pre-crisis ratio of 87% (Figure 2.9). It was the combined effect of higher provisions and declining NPLs which pushed the ratio to a historically high level, providing banks a strong enough cushion to remain resilient in times of stress.

The breakdown of available provisions reveals that precautionary provisions have been on rise in particular. CBK has continued to press upon banks to accumulate 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 further.

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 2.3% as of December 2015. The bulk of the banks' investments (around 68.7% as of December



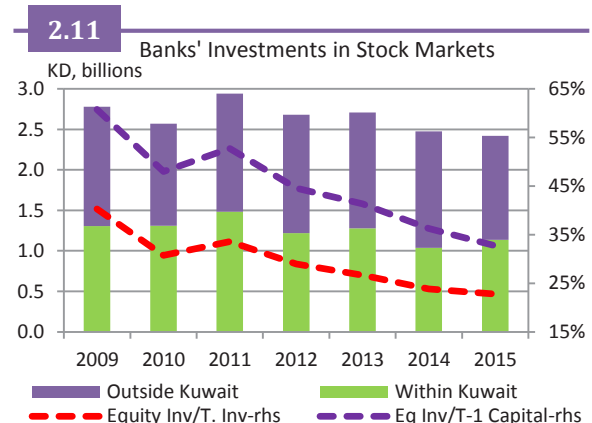
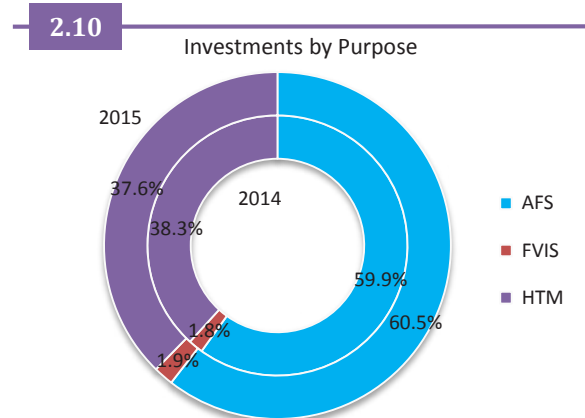
2015) are in fixed income instruments, out of which around 71.5% are in government bills/bonds etc while the major part of the rest are in corporate bonds.

Further breakdown of banks' investments reveals that around 60.5% have been placed under *Available for Sale* (AFS) category. Investments under *Held to Maturity* (HTM) represent the second major segment (37.6%) while *Fair Value through Income Statement* (FVIS) constitute an insignificant third (Figure 2.10). The bulk of investments held under AFS suggest that banks are keen to maintain a high level of liquidity to better manage their liquidity risk. Still, the share of HTM is sizeable and indicates the limited availability of desirable securities, prompting banks to hold these safer assets to maturity.

Despite the steady decline, bank' equity investments are significant

Kuwaiti banks' exposure to the stock market 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 exposures through their loan portfolios.

First, in terms of banks' direct exposure, banks' equity investments represent 22.8% of their total investments by end of 2015 (Figure 2.11). While still significant, the share of equity investments has dropped from a high level of 40.3% back in 2009. When viewed in terms of banks' Tier-1 capital, banks' equity investments were around 33%, at the lowest level in the last six years. These numbers suggest that while volatility in equity prices can affect banks' investment portfolios, their exposure to stock markets have visibly come down. Poor stock market performance during 2015 has also played its part in dampening banks' appetite for such exposures. In the case of some banks, higher equity investments are the result of debt for equity swaps made with their clients in the investment sector.

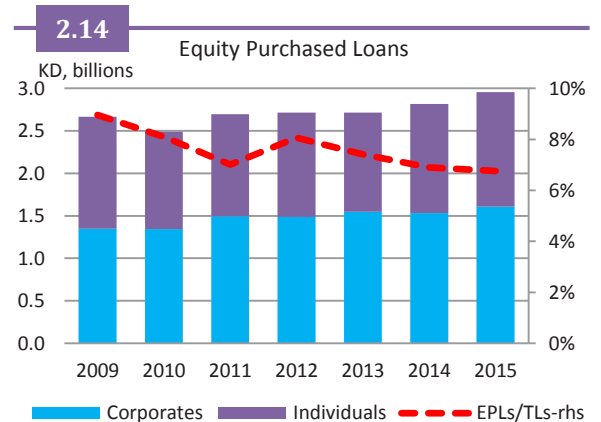
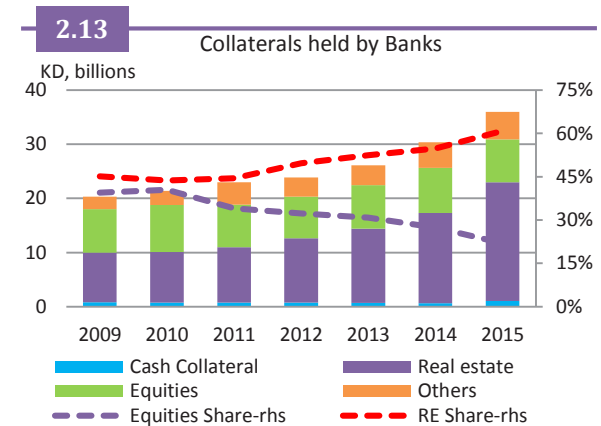
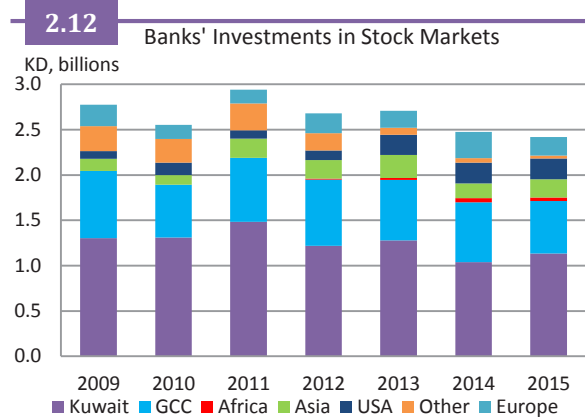


Against the backdrop of greater volatility in global stock markets during 2015, banks' overall equity exposure has somewhat declined. However, their exposure to Kuwait's equity market visibly increased from 42% to 47% of their total investments in stock markets during 2015 (Figure 2.12). On the other hand, banks' exposure to GCC markets have declined from 26.7% to 24% during the same period. With around 53% of banks' equity investments distributed across GCC, Asia and Europe etc., the diversification in banks' portfolio helps them withstand volatility in the stock market. However, as historical experiences suggest, correlations 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 22% of the total collaterals held by banks; the use of shares as collateral has been steadily receding since 2010 from a high of 40.5% (Figure 2.13). While banks' overall exposure to equity collateral stands drastically reduced, some banks are still significantly exposed to sharp swings in equity prices. On the other hand, share of real estate collateral has reached an all time high of 61% in 2015 from 43.7% in 2010; the steady increase in the share of real estate collateral poses its own set of unique risks, not the least because of the complications in liquidating such collaterals in the event of a default.

The third form of banks' indirect exposure to equity markets 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 6.8% of banks gross loan portfolio. The breakdown of these loans reveals that corporate sector has slightly higher share (54.4% in 2015) compared to individuals availing such facilities (Figure 2.14).

With around 5.1% share in banks' total non-performing loans, EPLs are a relatively small component of banks' risk exposure, both from the point of credit and market risk. Moreover, the NPLR

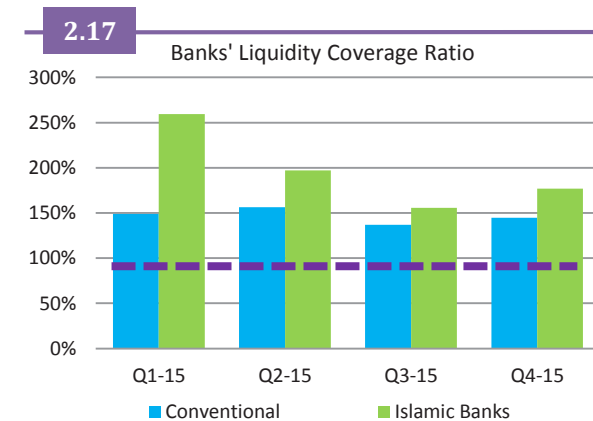
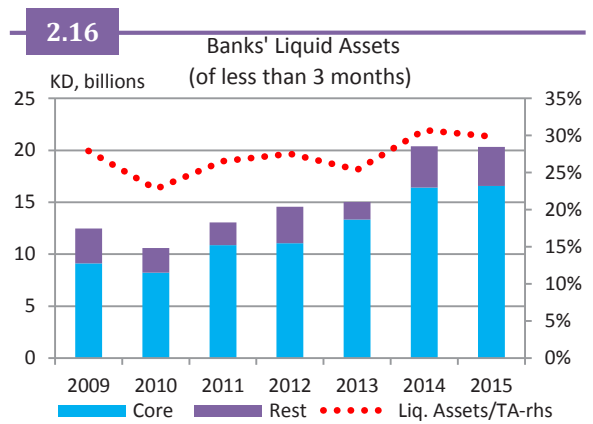
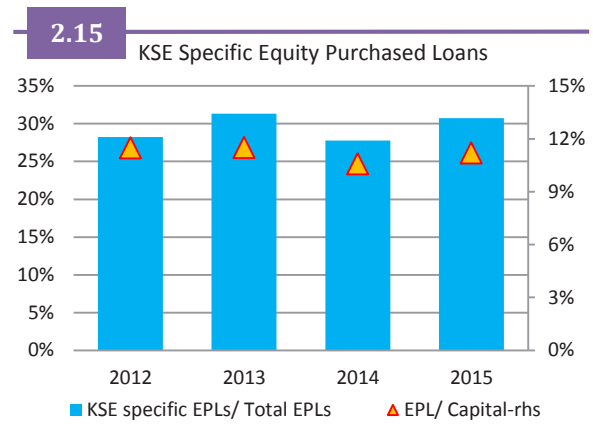


for EPLs was at 1.8% in December 2015, indicating a fairly healthy portfolio. With regards to banks' lending to residents for EPLs, CBK has put in place adequate caps to keep the exposure to KSE to acceptable levels. For instance, CBK requires that loans granted solely to residents to invest in listed companies may not exceed 10% of total facilities granted to residents, nor to exceed 25% of banks' overall capital. Judging by these regulations, banks' exposures are well below the regulatory benchmarks; for instance, *equity purchase loans to total residents portfolio* was at 2.8% in 2015 while *equity purchase loans to capital* stood at 11.2% in 2015 (Figure 2.15).

Banks' liquidity level has only marginally tightened

Banks liquid assets of less than three months have marginally come down from KD 20.4 billion in 2014 to reach KD 20.3 billion in 2015 (Figure 2.16). 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 81.5% of the overall liquid assets in 2015. Moreover, as a component of total assets, core and liquid assets accounted for 24.3% and 29.8% respectively as of December 2015. Collectively, banks' liquid assets have posted only a marginal drop during 2015.

Banks' healthy liquidity level is also evident from their Liquidity Coverage Ratio¹⁰ (LCR); while CBK has been monitoring the LCR during 2015, the regulation will be formally applicable from 2016 at 70% and will be gradually increased to reach 100% by 2019. As evident from the data available for 2015, both conventional and Islamic banks have been well above the impending 70% or the ultimate benchmark of 100% (Figure 2.17). Islamic banks have typically maintained a higher LCR compared with their conventional counterparts, though the gap between the two types of institutions has narrowed down

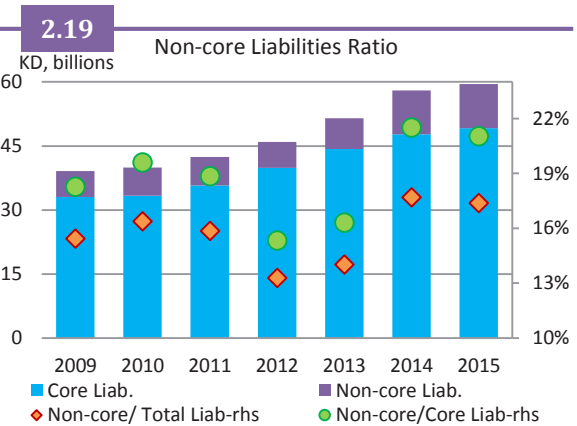
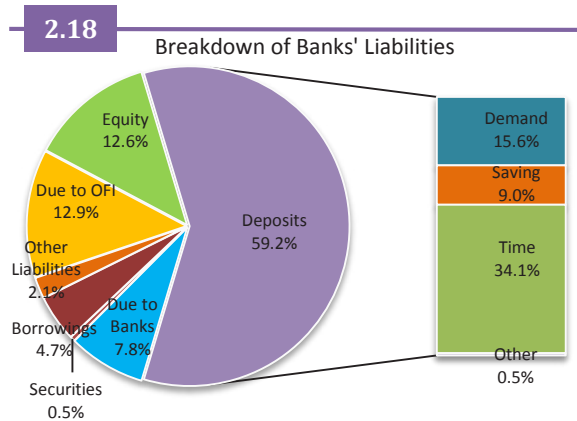


¹⁰ CBK issued instructions about LCR in December 2014, requiring banks to report their LCR positions starting from 2015 for monitoring purpose. As a result, data is only available for 2015.

during the second half of 2015. Higher LCR of Islamic banks is primarily due to their lower net cash outflows though they face limited availability of Shariah-compliant high-quality liquid assets both domestically and across borders (see *Box 2.1*).

Breakdown of banks' liability structure reveals that deposits account for the bulk of their funding base (59.2%) in 2015 (*Figure 2.18*). Within deposits, time deposits represent around 34.1% of the overall funding base and around 63% of total customer deposits. A sizeable share of time deposits provides Kuwaiti banks with a relatively 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.

Though banks' funding structure is still largely reliant on stable deposits, there has been a perceptible shift towards the increasing role of non-core liabilities (essentially interbank borrowings) compared to core liabilities like deposits since 2012; positively, this trend has reversed during 2015 as non-core liability ratio has slightly declined (*Figure 2.19*). Given the volatile nature of wholesale funding which can be swiftly influenced by market sentiments, reliance on non-core liabilities to support the growth in assets can increase the funding liquidity risk for the banking system. While the scale of banks' dependence on non-core liabilities is limited at present and has somewhat declined in 2015, any reversal in the trend would add towards higher funding risk.



Basel III Liquidity Standards

Banks routinely face liquidity risk because of their critical role in maturity transformation i.e. offering deposits with relatively shorter tenors (or even withdrawable on demand) while extending credit facilities for longer-term. While liquidity risk has been a major risk faced by banks, originally there were no formal liquidity standards proposed by the Basel Committee on Banking Supervision (BSBC), which continued to focus on banks' capital adequacy both in its Basel I & II capital accords. However, the experience during the global financial crisis of 2007-08 brought to fore the implications of poor liquidity risk management as a number of banks, while otherwise well capitalized, came under tremendous stress amid evaporating funding market liquidity.

Drawing on that experience, BCBS introduced Basel-III liquidity standards in 2010¹¹ with an aim to strengthen the resilience of banking sector in times of liquidity stress. The framework includes two minimum quantitative requirements:-

- 1) Liquidity Coverage Ratio (LCR) that aims to strengthen banks' capacity to withstand liquidity stress of short-term nature i.e upto 30 days. It requires banks to hold sufficient stock of unencumbered high quality liquid assets (HQLA) that could be readily used to meet the net liquidity outflows over a thirty-day stress period. While presence of the LCR will not preclude banks from taking on liquidity risk, it will ensure that banks have sufficient liquidity buffers to withstand a short-term liquidity strain.
- 2) Net Stable Funding Ratio (NSFR) that aims to ensure banks do maintain a stable funding structure commensurate with the composition of their assets and off-balance sheet activities. The standard thus reduces banks' dependence on short-term sources of funds (like wholesale funding) and also highlights the risk of financing.

In line with the recommendations of BCBS, CBK issued its LCR regulations in 2014¹² (NFSR regulations were issued later in 2015). As per BCBS, LCR could be defined as:-

$$\text{Liquidity Coverage Ratio (LCR)} = \frac{\text{High Quality Liquid Assets (HQLA)}}{\text{Net Cash Outflows within 30 days}} \geq 100\%$$

The numerator above includes assets that could be readily converted into cash without a loss of value. The denominator is net of cash outflows (which are linked by specific rates to outstanding balances of all liabilities and off balance sheet items) and cash inflows (which are calculated by multiplying expected receivable rates to the current outstanding contracts). Table 1 below provides a summary of HQLAs along with the relevant liquidity factors.

CBK has introduced LCR in a phased manner, setting a benchmark of 70% in 2016 which would later reach 100% by 2019. Banks were required to submit, along with existing liquidity reports, their LCR reports on monthly basis in 2015 primarily for monitoring purpose. Though monthly LCR is used of for regulatory compliance, banks are also required to report their daily LCRs as well as LCRs by major currency. To enhance transparency, banks are also obliged to release the

¹¹ 'Basel III- International framework for liquidity risk measurement, standards and monitoring', December 2010. Revised version with specific coverage of LCR and NSFR was issued in January 2013 and October 2014 respectively.

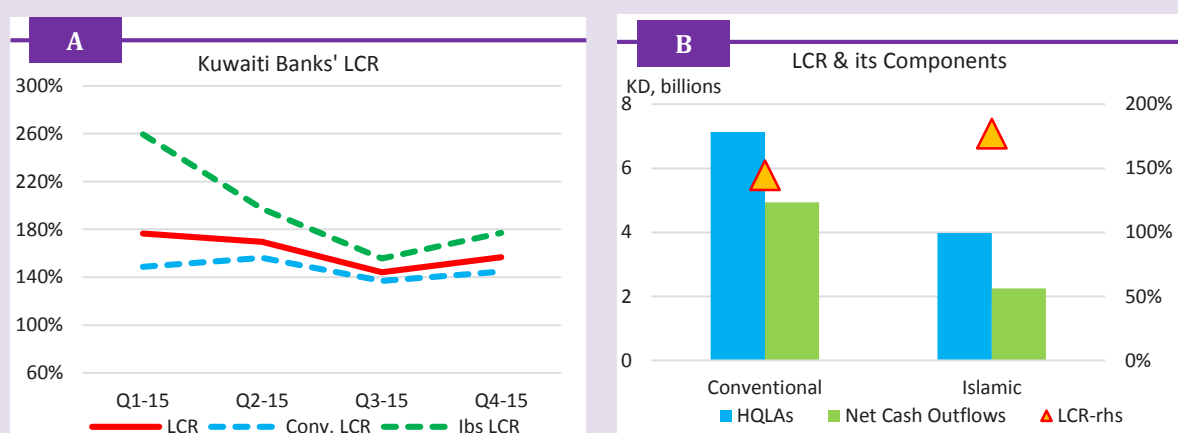
¹² <http://www.cbk.gov.kw/en/cbk-news/announcements-and-press-releases/press-releases.jsp?kcp=1~n5Jn2tEVfwdWHwta9TTDikO6y4gVgV1SoAO4hsuL.Pbc>

calculations and results of their LCRs to public for the benefit of all stakeholders.

Table 1: Summary of High Quality Liquid Assets

	Liquidity Factor
Assets-Level 1 <ul style="list-style-type: none"> ▪ <i>Coins and bank notes</i> ▪ <i>Due from CBK</i> ▪ <i>Qualifying marketable securities from sovereigns, central banks, PSEs, and multilateral development banks</i> ▪ <i>Qualifying central bank reserves</i> ▪ <i>Domestic sovereign or central bank debt for non-0% risk-weighted sovereigns</i> 	100%
Assets-Level 2A <ul style="list-style-type: none"> ▪ <i>Sovereign, central bank, multilateral development banks, non-financial institutes or it's subs., non-bank or it's subs. covered bonds and PSE assets qualifying for 20% risk weighting</i> 	85%
Assets-Level 2B <ul style="list-style-type: none"> ▪ <i>Debt instruments/Sukuk/ commercial papers of non-financial institute</i> ▪ <i>Qualified equity investment</i> ▪ <i>Other assets (subject to CBK approval)</i> 	50%

Kuwaiti banks' LCR results for 2015 reveal that industry average remained above 140% for all quarters, well above the regulatory benchmark of 70% for 2016 or the global benchmark of 100% for 2019 (Figure A). The divergence in the LCR between Islamic and conventional banks observed during the first quarter of 2015 broadly disappears in the later quarters, suggesting some reporting issues at the start of banks' compliance to new liquidity standards.



Islamic banks' higher LCR is in part due to their relatively greater reliance on *retail deposits*, which attracts lower run off factor (10% to 25%). On the other hand, conventional banks greater reliance on *unsecured wholesale funds* attract higher runoff rates which results in higher cash outflows. As a result, conventional banks have lower LCR in spite of their higher HQLAs when compared to Islamic banks (Figure B).

CBK has also issued its NFSR¹³ regulations, which aims to promote stable funding structure appropriate to the composition of banks' assets. NFSR helps determine how much of long term assets are backed by stable (long-term) funding and reveals any gap between the two. NFSR is defined as the ratio of the available amount of stable funds to the required amount of stable funding and it must be at least 100% i.e.

$$\text{Net Stable Funding Ratio (NFSR)} = \frac{\text{Available Amount of Stable Funding (ASF)}}{\text{Required Amount of Stable Funding}} \geq 100\%$$

While CBK released instructions on NFSR in October 2015, banks will start submitting their NFSR reports from 2016.

¹³ <http://www.cbk.gov.kw/en/cbk-news/announcements-and-press-releases/press-releases.jsp?kcp=1~n5Jn2tEVfwdWHwta9TTDigxfNOEQswE4/8Pr56fGWao>



CHAPTER 3

PROFITABILITY, SOLVENCY & RESILIENCE

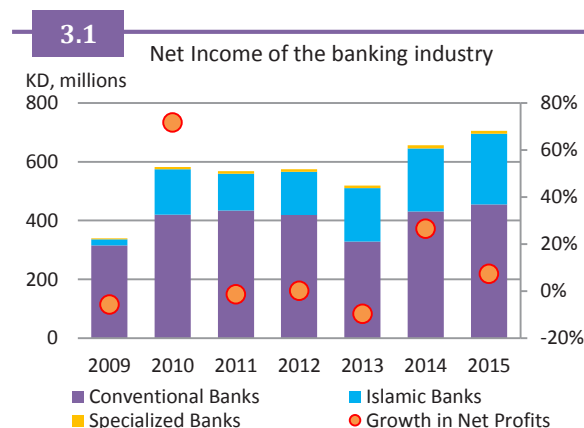
2015

3 Profitability, Solvency & Resilience

Banks' net income, on consolidated basis, grew by a modest 7% in 2015, at a much slower pace compared to 26.5% growth recorded in 2014. Both return on assets as well as equity experienced a marginal improvement as growth in net income outpaced the growth in assets and equity. Though non-interest income recorded positive growth after experiencing contraction in 2014, growth in interest income in 2015 was barely half of what was observed a year earlier. By banking groups, conventional banks accounted for 64.5% of the industry profits and 60.7% of the industry assets. Cost to income ratio marginally came down with improvement in efficiency of Islamic banks. Still conventional banks, on average, remained significantly more cost efficient than their Islamic counterparts. Capital adequacy ratio (CAR) of the banking sector further improved to reach 17.5%, well above the CBK's 12.5% requirement for 2015. Though the improvement in CAR was largely driven by conventional banks in 2015, Islamic banks continued to maintain capital adequacy ratios above their conventional counterparts, which in part also explains their lower efficiency ratios. Banks' leverage ratio was 9.7%, well above 3% benchmark proposed by the Basel Committee, indicating banks' capacity to extend credit without the risk of breaching the leverage ratio. Results of CBK's quarterly stress testing exercise reveal that banks, individually and collectively, have been able to broadly 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, grew by 7%

Profitability of Kuwaiti banks posted a healthy growth in 2015, albeit at a much slower pace when compared with a year earlier; banks' net income after tax¹⁴, on a consolidated basis, grew by 7% in 2015 to reach KD 705 million (Figure 3.1). Despite its slower pace, growth in net income was significant given the challenging operating environment in the wake of collapse in oil prices since mid-2014. Moreover, rise in net income was particularly noticeable when viewed against 2011-13¹⁵, a period marked by either almost flat or negative growth in net income. Higher interest and non-interest income and lower non-interest expenses contributed towards improved net income of the banking industry. Both Islamic and conventional banks made a positive contribution



¹⁴Based on profit share of banks' shareholders.

¹⁵In 2013, the drop in net income was in part due to the disappearance of the one-off impact of exceptional gains recorded by a major bank in 2012 on its shareholding of another domestic bank. After adjusting for this unusual item which bolstered net income in 2012, the decline in earnings in 2013 appears muted.

towards industry's profits, with their net income growing by 11.8% and 5.6% respectively.

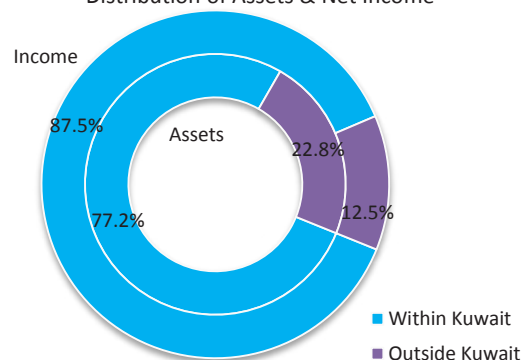
Breakdown of the net income among domestic and foreign operations reveals that 12.5% of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad. Though the share of income from foreign operations have come down from 15% in 2014, it still represents a sizeable contribution to consolidated income, signifying the importance of banks' foreign operations. However, when compared with the banks' share of assets abroad (22.8%), share of income is disproportionately lower (12.5%), suggesting that foreign operations in general have not been as profitable as were domestic operations (*Figure 3.2*). This in part can be attributed to the deteriorating economic and security situation in some of the countries where Kuwaiti banks' subsidiaries operate, particularly in comparison to relatively stable economic conditions in Kuwait despite the collapse of oil prices.

...helping return ratios inch up further

Amid rising net income of the banking sector, both average return on assets and equity improved further in 2015 though the pace somewhat diminished (*Figure 3.3*). Specifically, return on average equity (ROAE) improved from 8.2% in 2014 to 8.3% in 2015; likewise, return on average assets (ROAA) also inched up by 4 basis points to reach 1.03% in 2015. Improvement in return ratios was on account of relatively stronger growth in net income (7%) compared to much slower growth (around 3%) in both assets and equity of the banking system. While the pace of increase in return ratios slowed down when compared to 2014, the trend was still positive. During the earlier three years (2011-13), return indicators were steadily falling due to a 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 for 2012 when net income grew by a meager, yet positive 0.2%).

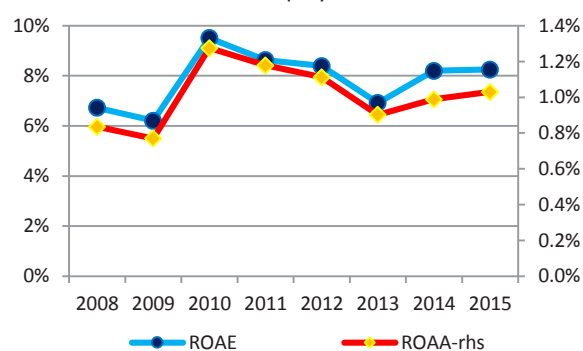
3.2

Distribution of Assets & Net Income

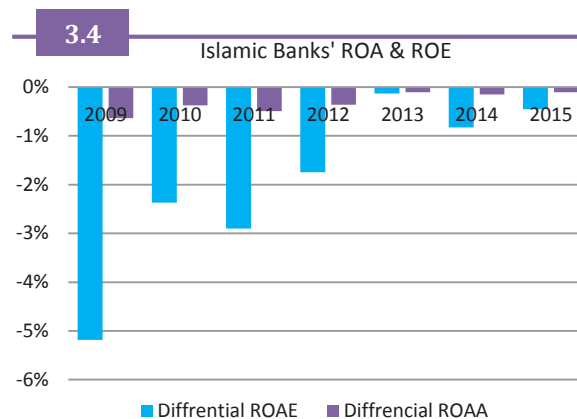


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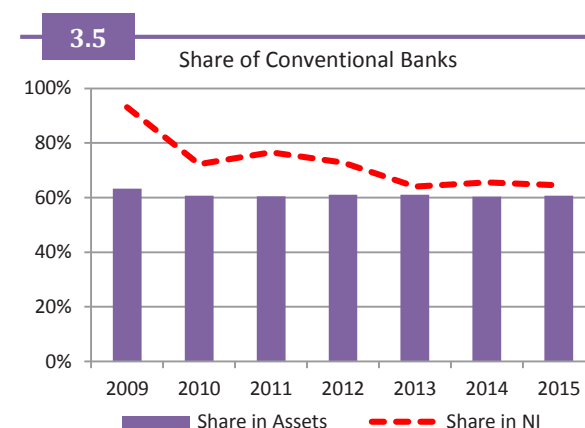
Return on Equity & Assets



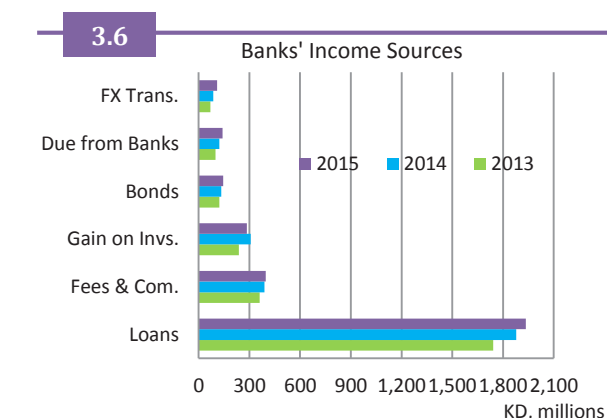
During 2015, the gap between industry wide returns¹⁶ and those enjoyed by the Islamic banks marginally narrowed after posting an increase in 2014 (Figure 3.4). The trend in general indicates that return ratios for Islamic banks have become fairly similar to their conventional counterparts, unlike some earlier years (2009-12) when ROAE of Islamic banks was considerably lower than that of the industry. ROAA has also followed a similar trend, though less pronounced, given the much larger size of assets compared to equity.



Comparison between share in net income and share in assets reveals that conventional banks account for around 64.5% of the industry profits, only marginally greater than their share (60.7%) in total assets (Figure 3.5). Conventional banks' share in industry profits was disproportionately higher back in 2010 but have gradually come down amid increasing share of Islamic banks. Admittedly, these trends are only true at the group level, as differences in performance among individual banks remain wide.



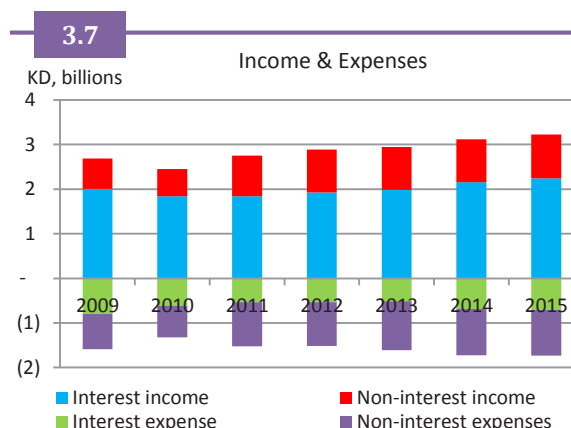
In line with the historical trends, banks continued to generate bulk of their income from their loan portfolios (Figure 3.6). Specifically, income from loans accounted for 86.3% of banks' interest income and 60% of their total income in 2015. Moreover, the breakup of interest income from loans reveals that 54.5% came from credit facilities granted to retail clients while the remaining 45.5% from lending to corporates. Fees & Commissions represented the second major source of income, followed by gains on investment securities. In general, all sources of income made a positive contribution in 2015 except for *gains on investment securities*, which was weighed down by the poor performance of equities both within and outside Kuwait. Income from FX transactions surged by 28.3%, though from a very small base, as evident from its share in banks' income sources.



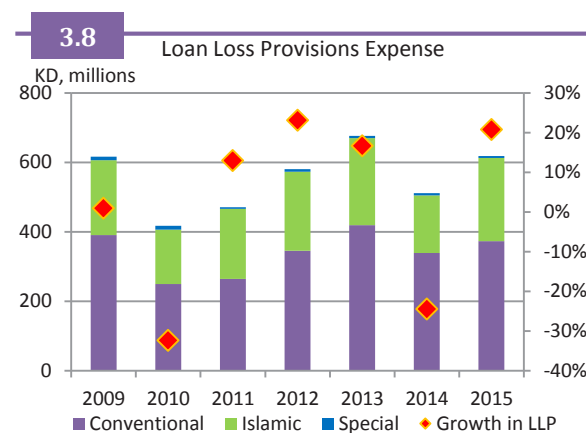
¹⁶ Differential ROAE = ROE of Islamic Banks – ROAE of the banking industry. A negative differential means Islamic banks lag behind the overall banking industry in terms of ROE. Differential ROAA can be interpreted likewise.

NII was weighed down by higher provision expenses

Interest income posted a much slower growth of 4.1% in 2015, compared 8.7% growth registered in 2014 (*Figure 3.7*). On the positive side, growth in interest expenses (2.9%) was also muted, compared to a sharp increase (34.4%) in their interest expenses during 2014. Consequently, banks' net interest income (NII) increased by 4.7% during 2015, compared to its contraction (-0.2%) in 2014. While non-interest income also posted a moderately positive growth (2.3%), greater provisions expense and somewhat lower reduction in non-interest expense led to a relatively slower, though positive, growth in banks' net income in 2015.

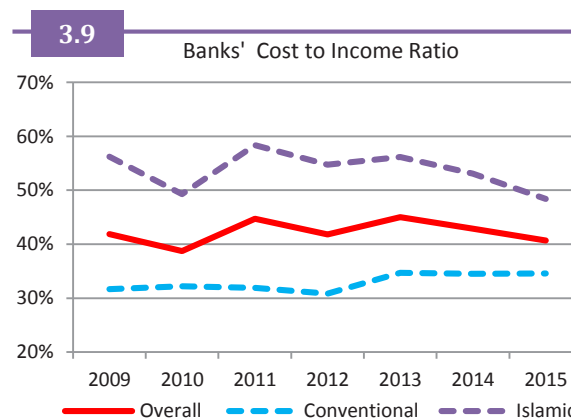


In particular, the growth in loan loss provisions expense was particularly strong. After a sharp contraction of 24.4% in 2014, the loan loss provisions expense surged by 20.8% during 2015, pushing provision expense to KD 617 million from 511 million in 2014 (*Figure 3.8*). Growth in provision expense was relatively stronger in the case of Islamic banks, posting an increase of 43.9% in 2015. However, the rise in provision expense was not due to specific provisions as Islamic banks experienced significant drop in NPLs (-23%) during the year.



Conventional banks continue to exhibit better efficiency

Banks' operational efficiency marginally improved during 2015, as reflected by a decline in the cost to income ratio from 42.9% in 2014 to 40.7% in 2015 (*Figure 3.9*). This was primarily driven by 7% decline in the operating costs of Islamic banks during 2015. In the case of conventional banks, cost to income ratio remained almost flat as growth in their gross income was offset by a similar growth in their operating costs.



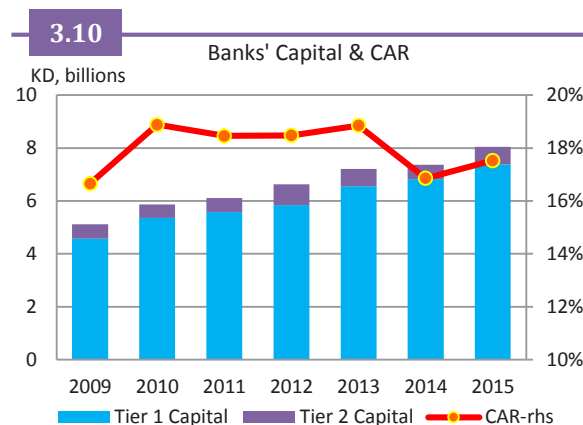
Still, on average, conventional banks appear significantly more efficient than Islamic banks, at least when viewed in terms of cost to income ratio. Higher cost to income ratio for Islamic banks has a variety of

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 otherwise 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 remains high by global standards

Kuwaiti banks continued to maintain high capital levels, given CBK's strong focus on ensuring a stable financial system where a robust capital adequacy plays a critical role. During 2015, banks' capital adequacy ratio¹⁷ (CAR) on consolidated basis improved from 16.9% in 2014 to 17.5% in 2015 (*Figure 3.10*). Despite experiencing a decline in CAR in 2014 due to the implementation of Basel III capital adequacy standards, banks were able to expand their capital base in 2015 even in a challenging economic environment. At 17.5%, banks' CAR stood at a fairly high level and well above the CBK's requirement of 12.5% for 2015¹⁸.

The improvement in CAR was essentially due to relatively stronger growth in banks' total capital (up by 9.2%) compared to the growth in their RWAs (5%) in 2015. The breakdown of total capital reveals that both Tier-1 and Tier-2 posted positive growth, increasing by 8.2% and 21.3% respectively. Stronger growth in Tier-2 also explains marginal increase in its share (8.3%) in banks' total capital, though the bulk (91.7%) was still represented by Tier-1. Banks' strong capital adequacy level driven largely by high quality Tier-1 capital underscores the strength of the banking system in weathering major stress scenarios.



¹⁷ Capital adequacy numbers in this section are based on Basel III for 2014 onwards and on Basel II for all the previous years. Given the marked shift in calculation methodology in 2014 (from Basel II to Basel III), historical trends should be interpreted accordingly.

¹⁸CBK has set the required CAR at 12.5% for 2015 and 13% for 2016.

Data for individual banks reveals that even the lowest CAR maintained by a single bank was 15.2%, well above the minimum requirement of 12.5% set by the CBK for 2015 (Figure 3.11). In fact, the minimum CAR maintained by any individual bank never dropped below 14% during the last seven years, except in 2014 when it slipped to 13.5%, primarily on account of Basel III implementation.

Islamic banks maintained marginally better capital adequacy

Bank-wise data reveals that the marginal improvement in the CAR of the banking industry, as highlighted above, was primarily due to an increase in the CAR of conventional banks from 15.6% to 16.6%. On the other hand, Islamic banks' CAR remained almost flat at the level observed in 2014 (Figure 3.12).

Other indicators of capital adequacy also reveal similar trends as system-wide improvement in various ratios has been largely on account of conventional banks while the capital adequacy profiles of Islamic banks have remained almost the same. Still, Islamic banks continued to exhibit higher capital to RWAs as well as better Tier-1 to RWAs ratios compared to conventional banks. (Table 3.1). However, this broad categorization of Islamic and conventional banks does not reflect the difference across individual banks in terms of their 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, further dropped to 8.7% by December 2015 (Figure 3.13). While both the conventional and Islamic banks witnessed a declining trend, net NPLs to capital ratio for the former group was significantly lower (7.4%) than Islamic banks (11.1%). Even in the case of Islamic

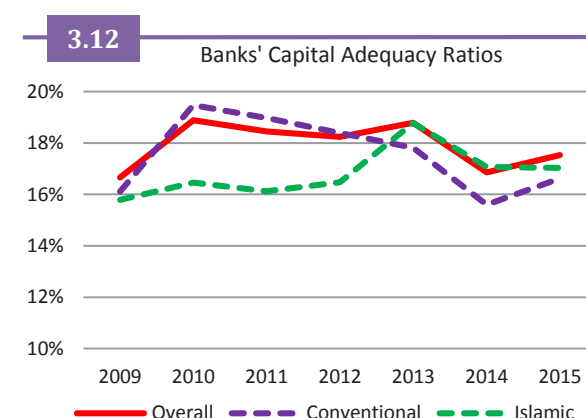
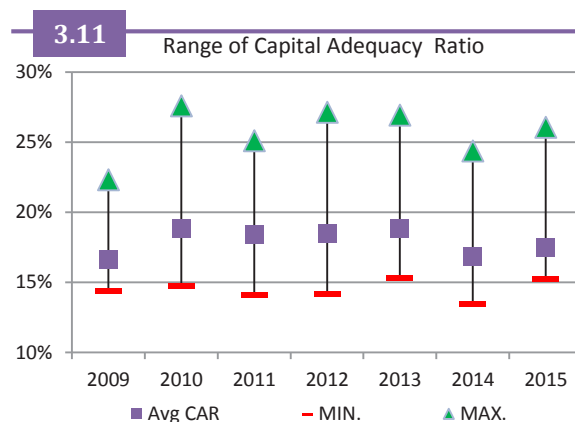
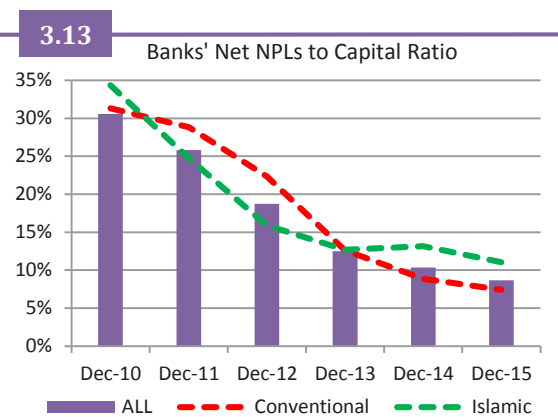


Table 3.1 Banks' Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	2014	2015	2014	2015	2014	2015
Conventional	15.6%	16.6%	14.4%	15.0%	10.8%	11.9%
Islamic	17.1%	17.0%	15.7%	15.8%	11.2%	11.3%
All Banks	16.9%	17.5%	15.6%	16.1%	11.1%	11.8%



banks, their net NPLs dropped by 13.1% in 2015, marginally bringing their net NPLs to capital ratio down.

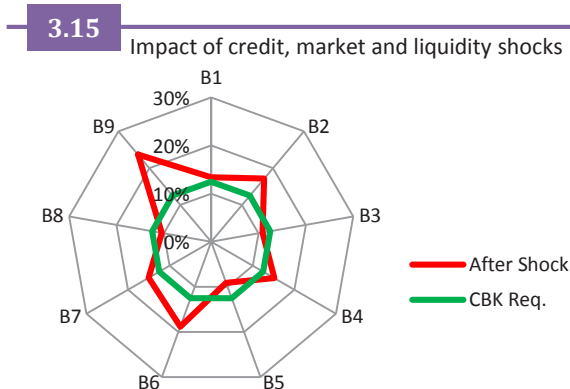
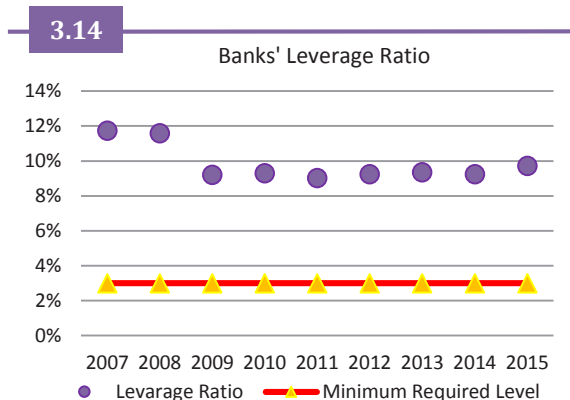
In addition to banks' strong capital adequacy ratios (a risk-sensitive measure), their overall leverage ratio¹⁹ was 9.7% as of December 2015, not only well above the global minimum of 3% but also higher than the more stringent 6% proposed by US regulators for their systemically important banks (Figure 3.14). The gap between Kuwaiti banks' leverage ratio and global minimum proposed by the Basel Committee on Banking Supervision increased further in 2015, reflecting the large cushion that Kuwaiti banks can use to expand their credit portfolios 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 conducted using the data as of December 2015, applying various macro and micro level scenarios of different severities and for an extended period.

Our results reveal that banks²⁰ in general were able to maintain high capital adequacy even after the impact of severe and protracted 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 9.1%.

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 the



¹⁹ Tier 1 Capital/Total Exposures (Non-Risk Weighted, both On & Off balance sheet).

²⁰ Two banks have been removed from Figure 3.15 due to their very high CARs as their inclusion would have distorted the graph.

real estate. 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 the 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 in general remained liquid even under conditions of stress, highlighting banks' sufficient liquidity levels. However, it is pertinent to point out that the resilience of the banking sector would come under pressure if operating environment turns and stays negative for an extended period.



CHAPTER 4

DOMESTIC MARKETS

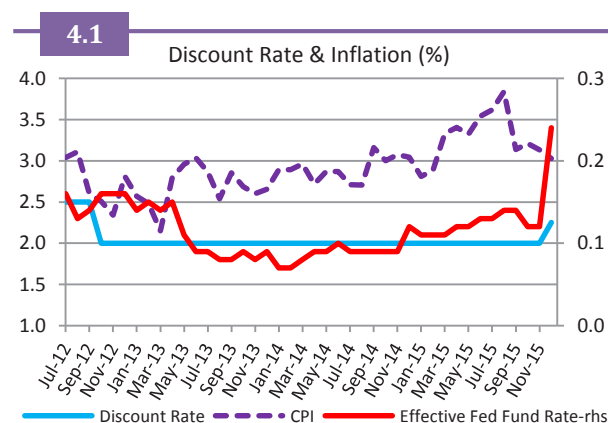
2015

CBK raised its discount rate by 25 bps in December 2015; domestic interbank rates had started to climb a few months earlier in anticipation of the increasing likelihood of an impending lift-off by the Federal Reserve. Both the scale of liquidity absorptions as well as interbank rates indicate that liquidity in the banking sector, while still healthy, has slightly tightened; accordingly, absorption both in terms of interventions and Tawaruq for shorter maturities visibly tapered by the close of 2015. CBK's mop up exercise relied, almost entirely, on the use of one-week instruments, further reducing the share of one-month arrangements. In the case of CBK bonds, around 69% of the issuance in terms of value was in 3-month maturities. In the foreign exchange market, KD depreciated against USD by 3.6% in 2015 while appreciating against EURO and GBP by 6.7% and 0.9% respectively; diverging growth trajectories and monetary policies across major economies influenced the exchange rates. Moving in lockstep with oil prices, KSE closed the year down in double digits (14.1%) as the absence of a domestic catalyst left the market more attuned to global developments; large cap stocks retreated by 15% (Kuwait 15 index) despite banks' healthy profits. Finally, the real estate market, after enjoying positive growth for five consecutive years (with a particularly robust expansion in 2014) markedly slowed down, both in terms of number and sales value of the deals made. The retreat was broad based as all three segments (residential, investments and commercial) contracted significantly as protracted fall in oil prices weighed on investors' sentiments. Yet the real estate prices seemingly held up well, averting any major correction; this suggests the presence of genuine demand as well as investors' preference to stay put. Though quite unlikely, any tail event (like a sharp correction in the real estate prices) would seriously test the resilience of the banking sector, given banks' significant exposure to the real estate market, both in terms of loans and collaterals.

Money Market:

Discount rate up by 25 bp on the heels of Fed's lift-off

On the monetary policy front, CBK raised its discount rate by 25 bps, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in KD²¹ (Figure 4.1). The decision, made on December 16, 2015, came shortly after the Federal Reserve (Fed) finally executed its well-anticipated lift-off after years of excessive quantitative easing. Though KD's peg to a basket of currencies rather than the USD alone enables CBK to pursue an independent monetary



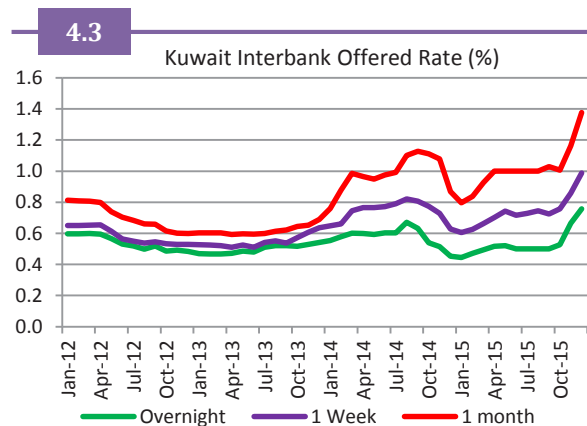
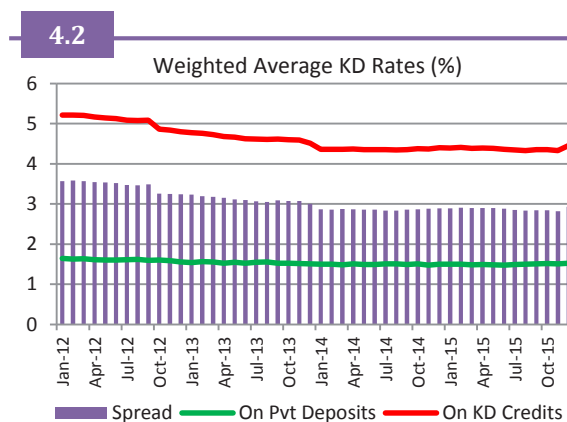
²¹For instance, banks can charge upto 3% above discount rate on consumer and housing loans, upto 2.5% above discount rate on commercial loans of less than one year and upto 4% above discount rate on commercial loans of above one year maturity.

policy, the move was aimed at retaining the attractiveness of the national currency as a store of domestic savings. This was the first change in the policy rate since CBK last slashed its discount rate by 50 basis points on 3rd October, 2012 to bring it down to 2%.

With inflation rate still hovering around 3%, prevailing trend in prices did not warrant a change in discount rate. Yet the marginal increase in the policy rate helped CBK signal its commitment to maintain continued attractiveness of the domestic currency, particularly in comparison to the historically low levels of interest rates prevailing in many of the advanced countries. On balance, the 25 bps raise in discount rate is unlikely to have a perceptible impact on the credit off-take; yet, it would potentially support banks' efforts in attracting more deposits.

With the hike in discount rate, the spread between lending rate on KD-based credits and weighted average rate on KD deposits inched up to an average of 2.88 percentage points, compared to 2.86 percentage points during 2014 (Figure 4.2). The marginal rise in spread was more due to an improvement in the lending rate on KD-based credits, which edged up to 4.37% compared to 4.36% in 2014. On the other hand, weighted average rate on KD deposits remained almost stable during 2015. While the full pass-through of an increase in discount rate would be visible over time, typically, a hike in policy rates lead to a quicker and stronger change in lending rate than in deposit rates.

In the interbank market, KD interbank offered rate started the year 2015 on a declining trend, as liquidity conditions improved after the initial concerns regarding the impact of falling oil prices on the banking sector somewhat waned (Figure 4.3). However, the interbank market experienced an uptick in rates later during the first quarter of 2015, as speculations about the KD/USD parity pushed up 1-year KD forward rates. Yet liquidity remained healthy in the months ahead, with rates staying stable. In the



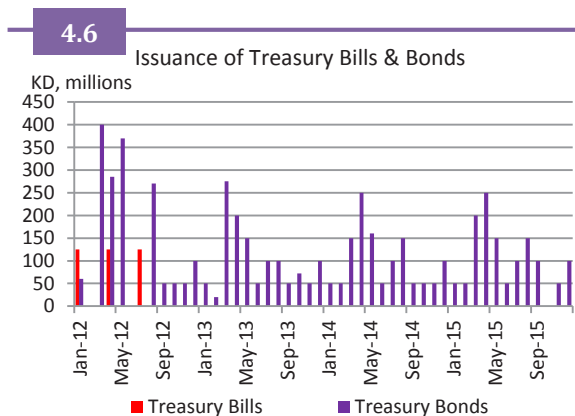
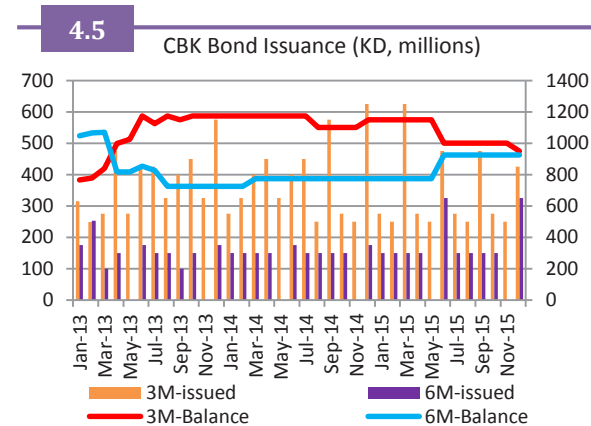
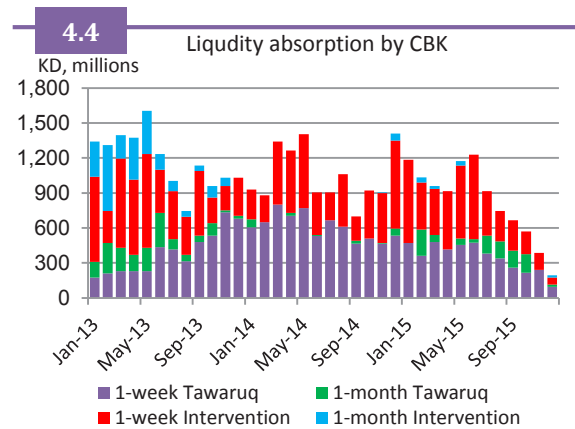
last quarter of 2015, interbank rates started moving up again, as market’s anticipation of an impending Fed’s lift-off strengthened. The 1-month offered rate closed the year at 1.4% on the back of a marginal shift in CBK’s monetary policy stance.

Amid somewhat tightening liquidity conditions, absorption by the CBK visibly tapered by the tail end of 2015 in comparison to the average of previous two years (Figure 4.4). Moreover, data by various maturities reveal that the share of both one-week interventions and Tawaruq²² increased further during the year, relegating the absorption under monthly maturities to historical lows. In principle, CBK’s monetary operations continued to maintain sufficient systemic liquidity while smoothing out fluctuations caused by periodic variations in the volume of funds introduced or withdrawn from the banking system.

Bulk of CBK’s bond issuance was of shorter maturity

During 2015, overall issuance of CBK bonds was down by 3.3%, with total issuance worth KD 5,950 million compared to KD 6,150 million in 2014. Bonds of 3-months maturity remained a preferred choice over those of 6-months tenor, despite a 10.9% drop in its issuance during 2015 (Figure 4.5). On the other hand, 6-months bonds experienced a growth of 19.4%, as bonds worth KD 1,850 were issued in 2015 compared to KD 1,550 million in 2014. Consequently, share of 6-months bonds in total issuance of CBK bonds increased from 25% in 2014 to 31% in 2015. While issuance was largely in 3-months bonds (almost 69% of all bond issuance in 2015), data for the outstanding value reveals convergence in both 3 and 6-month tenors.

The year 2015 was the third in a row without any issuance of T-bills; 3-month T-Bills were last issued in July 2012 while issuance of 6-months T-bills was suspended much earlier, back in 2009 (Figure 4.6). It appears that notwithstanding the pressure on fiscal



²²It 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*.

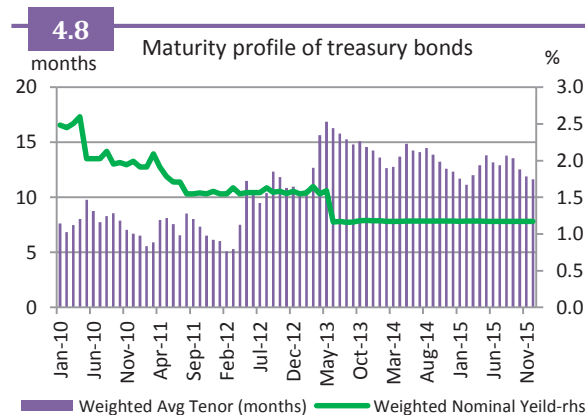
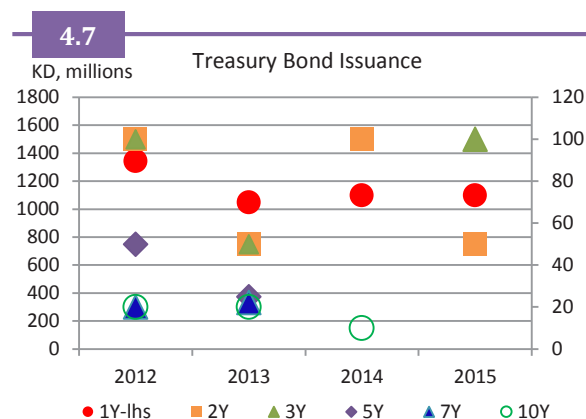
and balance of payment positions amid record low oil-prices, the need for issuance of public debt remained muted even in 2015. This is however likely to change going forward as the government has expressed its intention to tap both domestic and international markets.

Banks' appetite for longer-term CBK bonds has been tepid

Despite the absence of government borrowing from the banking sector to support budgetary expenditures, CBK has continued to issue treasury bonds aiming to extend the sovereign yield curve to longer horizon and help establish a meaningful benchmark for the pricing of corporate debt. During 2015, treasury bonds worth KD 1,250 million were issued; yet the outstanding balance stayed the same at 1,587.3 million since June 2014. This suggests that the recent issuance of CBK bonds has just been enough to replace the maturing amounts, without any impact on the total amount of outstanding debt.

Maturity-wise breakdown of treasury bonds over the last few years particularly highlights CBK's efforts to issue bonds of longer maturities (*Figure 4.7*). However, it appears that market's appetite for bonds of longer maturities have been muted at best, given the scale of under subscription. Accordingly, only bonds of 1, 2 and 3-year maturities were issued in 2015, contrary to the issuance of 5, 7 and 10-year bonds during 2012-13. That also explains why the bonds of 1-year maturity continue to dominate the overall issuance in terms of value.

As a result, we have not seen further increase in the weighted average tenor of the treasury bonds; after increasing from 9.3 months (annual average) in 2012 to 14.3 months in 2013, weighted average tenor slid back to 12.6 months in 2015 (*Figure 4.8*). Banks are apparently reluctant to lock into higher maturity bonds amid historically low interest rates which are likely to go up. For instance, the market in particular expects two more rate hikes of 25 bps each from the Fed during 2016, which might prompt other central banks in the region to follow suit.



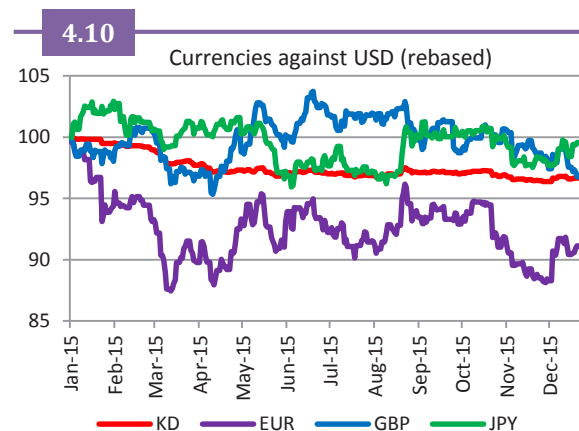
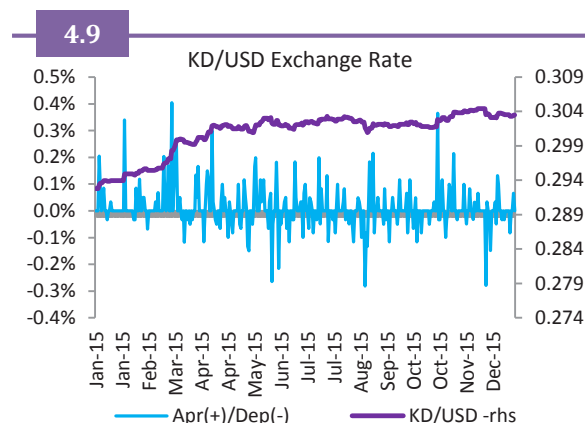
Foreign Exchange Market:

Strengthening USD led to a further depreciation in KD

KD/USD exchange rate experienced marginal depreciation in the first quarter of 2015 though it remained fairly stable during the last three quarters (*Figure 4.9*). Compared to 2014, fluctuations in the exchange rate were fewer and mostly within a narrow range of $\pm 0.2\%$.

Among the key currencies, USD continued its upward trend not only against KD but a number of other currencies. Specifically, greenback closed 2015 with a 9% rise against major currencies, marking its third consecutive annual gain. USD's appreciation was driven by factors like the growing differential in growth trajectories among the advanced economies as well as the increasing divergence in their monetary policies. In 2015, US economic performance was a bright spot in an otherwise uncertain global economic outlook amid lackluster performance of major advanced economies, slowdown in China and contraction in many of the emerging markets. Thanks to the improving growth prospects for the US, Fed not only completely unwound its quantitative easing program but also raised the target range for federal funds rate by 25 bps in December 2015, its first rate-hike since 2006. However, other central banks like the Bank of Japan as well as the European Central Bank continued to pursue ultra-loose monetary policy in their efforts to ward off deflationary threats, boost credit off-take and lift economic growth.

Against this backdrop, USD unsurprisingly continued its upward trend vis-a-vis a number of other currencies; yet the depreciation in KD was still relatively moderate and exchange rate remained relatively stable (*Figure 4.10*). Specifically, KD depreciated against USD by around 3.6% in 2015, compared to its depreciation of 3.7% in 2014. While GBP was down by almost the same percentage as KD, GBP/USD experienced far more volatility. EURO/USD closed the year 8% lower, as ECB



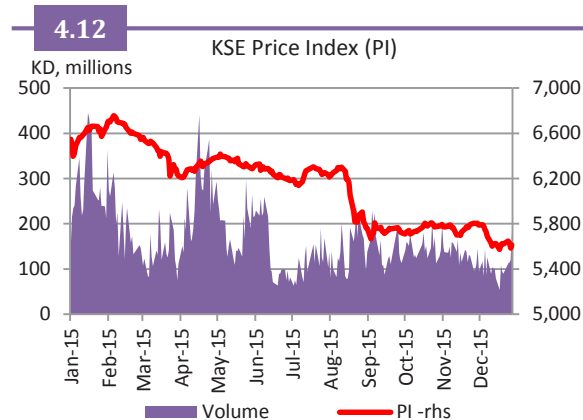
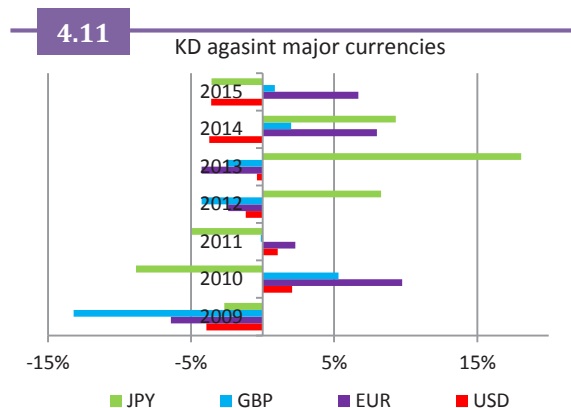
continued with its bond-buying program and nudged the deposit rates into negative territory. JPY however benefited from its safe haven status despite its excessive quantitative easing, leaving JPY/USD almost unchanged by the end of 2015. However, in general, global currencies experienced significant adjustments amid declining commodity prices, divergent prospects for growth and monetary policies across major economies, and slowdown in China etc.

Thanks to its peg to a basket of currencies and not merely to the USD, KD depreciated against USD by a lower margin than it would have otherwise. On the other hand, KD appreciated against EUR and GBP, by 6.7% and 0.9%, respectively (*Figure 4.11*). KD's peg against a basket of currencies has shielded Kuwait from imported inflation resulting from the volatility in such currencies and has ensured a more stable exchange rate where the net impact of diverging currencies has been largely neutralized. That helps explain why CBK has kept the KD pegged, since May 2007, to an undisclosed special weighted basket of currencies of countries that share significant financial and trade relations with the State of Kuwait.

Kuwait Stock Exchange (KSE):

KSE witnessed broad retreat second year in a row

Price Index (PI), the broad based index of the KSE, closed the year considerably lower, shedding 14.1% in 2015, notwithstanding a few months of positive performance (*Figure 4.12*). This came on the heels of 13.4% drop a year earlier. Steady decline in oil prices, slower growth in China, diverging monetary policy stance of major central banks and geopolitical tensions—all added to the uncertainty and influenced investors' sentiments, particularly in the absence of a strong domestic catalyst. The Weighted Index (WI), another key indicator essentially representing Kuwait's large-cap companies, performed only a tad better, closing the year 13% down. Finally, the Kuwait-15 Index, first launched in May 2012 and covering 15 highest ranked



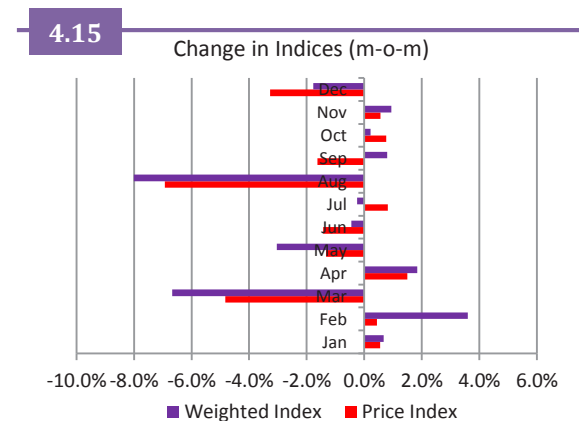
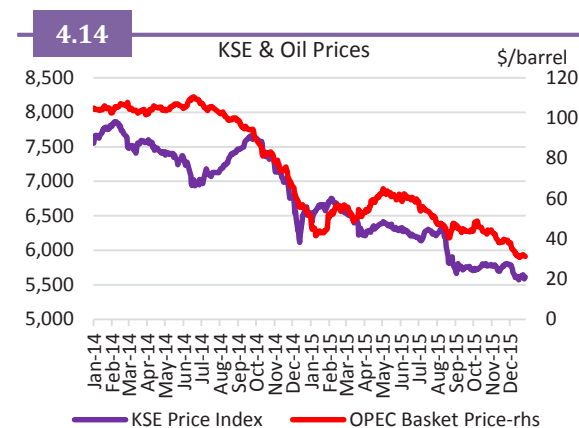
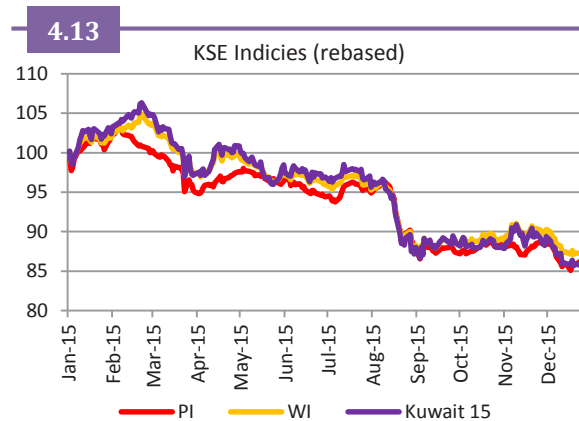
companies in terms of liquidity and capitalization, was off by 15% in 2015.

During 2015, the retreat in the stock market was quite broad-based, as evident from similar declines in all three indices (*Figure 4.13*). This was in sharp contrast to the previous two years where PI and WI experienced significantly diverging trends; for instance, PI performed significantly better than both WI and Kuwait-15 in 2013, thanks to a strong rally in the small cap stocks. Later, its performance markedly reversed in 2014 as the index was off 13.4% compared to relatively muted decline in WI (3.1%) and Kuwait-15 (0.8%). In 2015, though the large cap stocks did enjoy a brief rally during the first two months and again a better performance in April, trajectory of all three indices visibly converged as the year progressed, registering somewhat similar drops by the close of 2015.

That explains the lack of a strong domestic catalyst, which further exacerbated the influence of international developments. Even on the domestic front, challenging economic situation kept the sentiments bearish. Given Kuwait's reliance on hydrocarbon as the main source of income (as it accounts for around 80% of government revenues), stock market continued to fall in tandem with oil prices (*Figure 4.14*).

Monthly data reveals a few months of positive activity interspersed with sharp retreats

KSE got off to a positive start in January 2015 despite a steady decline during the last three months of the previous year (2014). Gains strengthened in February amid recovery in oil prices and improved sentiments globally. While the gains in PI were still muted, value-weighted index (WI) was up by 3.6% in February, supported by decent profitability in the banking sector and strong growth in telecom sector (*Figure 4.15*). However, March witnessed a sharp reversal in earlier gains as equities took a hit globally amid weak economic performance in advanced as well as emerging economies. Moreover, mounting tensions in Yemen and related security concerns also depressed



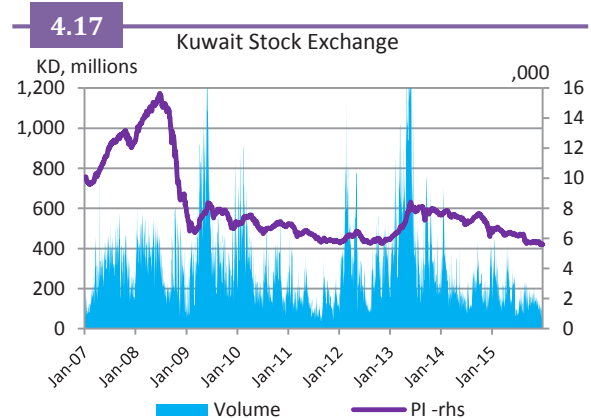
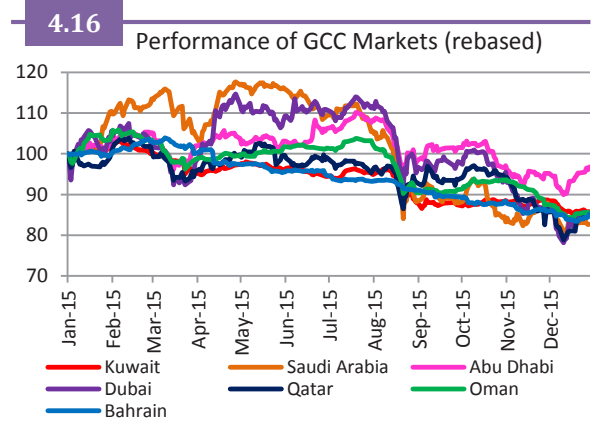
sentiments. These developments led to a decline in PI and WI in March by 6.7% and 4.8% respectively. As a result, the first quarter of 2015 witnessed 3.9% and 2.7% drop in PI and WI respectively, notwithstanding the announcements of corporate earnings and dividend.

In the second quarter of 2015, KSE experienced good gains in April amid somewhat reduced geo-political tensions, temporary recovery in oil prices and better corporate results. However, recovery in KSE was still significantly subdued when compared with stronger rallies in some of the regional markets like in Saudi Arabia and Dubai (*Figure 4.16*). The gains however proved fleeting as KSE turned negative in May and closed H1-2015 almost 5% off ytd.

KSE started the second half of 2015 on a slower note with Ramadan (the month of fasting) and summer season in full swing. August however witnessed a plunge in many stock markets as the rout in Chinese equity market sparked a global meltdown. GCC markets tumbled, with Saudi and Dubai taking a major hit. In Kuwait, PI and WI declined by 6.9% and 8% respectively.

KSE somewhat recovered in September though many of the regional markets continued to decline. Still, the overall sentiments remained negative and several companies expressed their intention to delist from the KSE. While October and November were marginally positive for KSE, both PI and WI further declined in December, respectively closing the year 14.1% and 13% down and nullifying any gains made in few months of positive activity.

The PI closed 2015 below 6,000 mark which appears to be a new normal. In fact, PI has not climbed much beyond 8,000 mark since 2008 when it last nosedived from a peak of above 15,000. (*Figure 4.17*). Given the current level of KSE, the pace for further deterioration is seemingly limited as the market has already shed its gains and is trading at historic lows.



Market capitalization went down by 11.9% in 2015

Given the lackluster performance of the local bourse, market capitalization posted a decline of 11.9%, from KD 29.7 billion in 2014 to 26.2 billion in 2015 (Table 4.1). Deterioration was far worse in other key indicators like the total value, volume and number of deals etc.; for instance, total value went down by 36.1% while volume was off 21.7% during 2015.

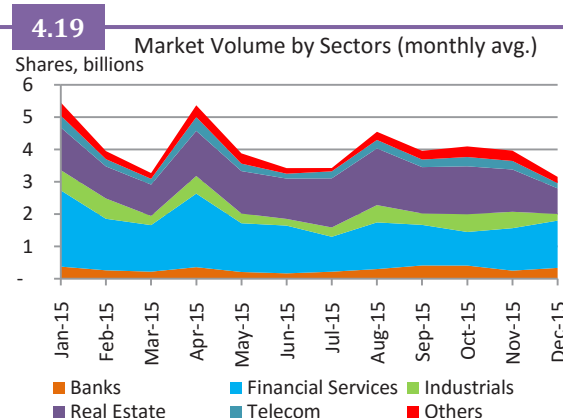
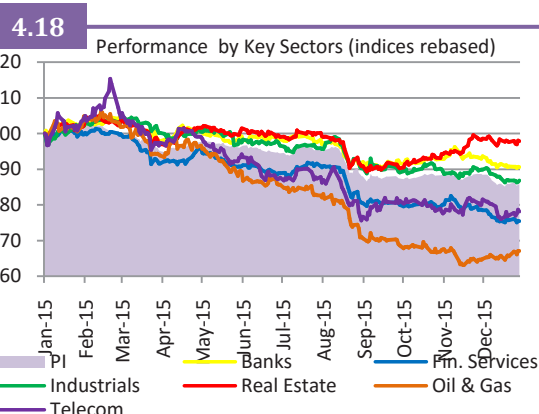
KSE's performance in terms of various sectors also reveals a somewhat positive start in early 2015, followed by a broad retreat in all sector, albeit with different intensities. While all the key sectors closed the year down, *Oil & Gas* was understandably the worst performing, shedding 34% during 2015 as oil prices continued to sink (Figure 4.18). *Financial Services* sector lost 24.3%, as poor stock performance across the globe negatively influenced companies' portfolios and profitability. *Banking*, which represents almost half of KSE's market capitalization, was off by 10% despite healthy profits as deteriorating macroeconomic environment left investors jittery. *Telecom* sector was down by 24.1%, despite a visibly strong start in the first quarter of 2015 as listing of a major local telecom operator, Viva, attracted strong buying activity. *Real Estate* sector did relatively well, making decent recovery in the last quarter of 2015, though closing the year 1.9% down.

Two sectors account for around 70% of the market volume

Financial Services Sector and the *Real Estate Sector*, collectively accounted for as much as 69.3% of the average monthly market volume in 2015, compared to their combined share of 71.9% during 2014 (Figure 4.19). The high level of concentration in terms of market volume suggests that the depth of stock market has remained at fairly low levels. *Banks*, *Industrial*, and *Telecom* sectors also had around 10%, 7.1% and 6% share respectively in the total market volume. Collectively, aforementioned five sectors covered almost 92.3% of the entire market in terms of volume.

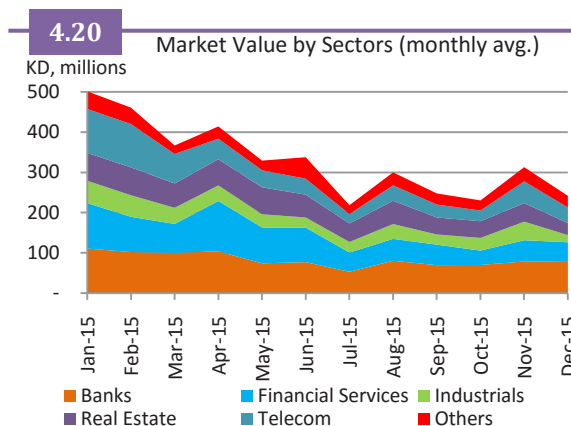
Table 4.1: Key Indicators of Kuwait Stock Exchange

	2012	2013	2014	2015
KSE Price Index	5934.3	7549.5	6535.7	5615.1
Highest	6492.4	8430.7	7863.0	6755.1
Lowest	5650.0	5994.0	6115.6	5571.9
Market Cap (KD, bil)	29.0	31.0	29.7	26.2
Total Value (KD, bil)	7.2	11.1	6.1	3.9
Total Volume (bil)	83.1	126.5	53.0	41.5
No. of Deals (,000)	1,198	2,136	1,186	961
Companies Listed	199	196	193	190

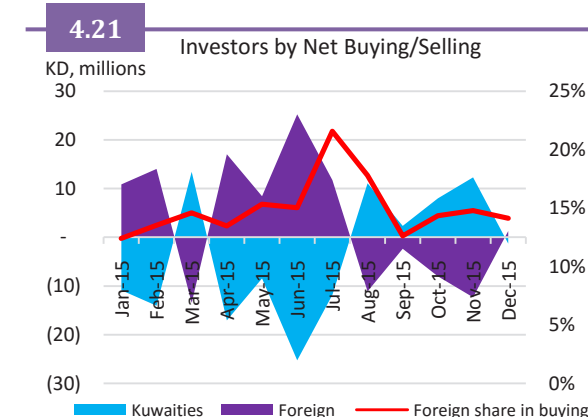


..though market is somewhat less concentrated in terms of value

When viewed in terms of average monthly value, *Banks* and *Financial Services* accounted for 47.1% of total market value in terms of monthly average for the year 2015, compared to 54.5% a year earlier. Unlike in the case of market volume, here *Banks* also appear quite significant, accounting for as much as 25.7% of the market value (Figure 4.20). During 2015, share of *Telecom* almost doubled to reach 15.3% compared to 7.1% in 2014. On the other hand, share of the real estate visibly dropped, reaching 21.3% of average monthly value compared to 28.3% during 2014.



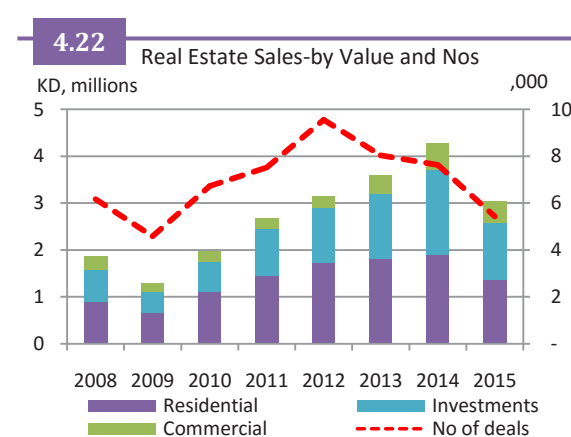
Breakdown of trading by investors' origin reveals that the foreign investors were net buyers in KSE up to July 2015, barring the month of March (Figure 4.21). Moreover, the share of foreign investors in buying domestic stocks, if viewed in terms of market value, registered a steady increase, reaching 21.6% by June 2015²³. However, with the rout in Chinese stock market in July 2015, the flight to quality led foreign investors to reduce their exposures from many of the frontier markets and KSE was no exception.



Real Estate Market:

*Sales slowed down after five years of positive growth*²⁴

After five consecutive years of positive growth, real estate market in Kuwait visibly slowed down in 2015, notwithstanding some healthy activity at the tail end of the year. It was the first drop in overall sales since 2009, the year when market experienced a serious retreat in the wake of global financial crisis. Total sales were down by 28.7% in 2015 to reach KD 3 billion compared to 4.2 billion in 2014²⁵ (Figure 4.22). The number of transactions also continued to decline,



²³ In general, since the upgrade of UAE and Qatar stock markets by MSCI, KSE's weight on different frontier indices have increased to the 'Emerging Market Status'.

²⁴ This section is based on data from Ministry of Justice and Kuwait Credit Bank. Unless otherwise specified, 'contracts' (deals registered with MOJ) data has been used, thus excluding any 'agencies' data.

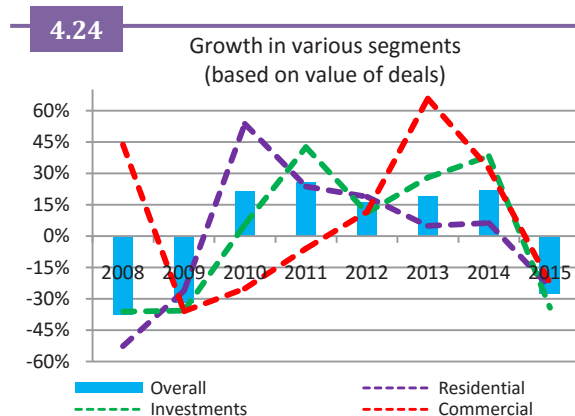
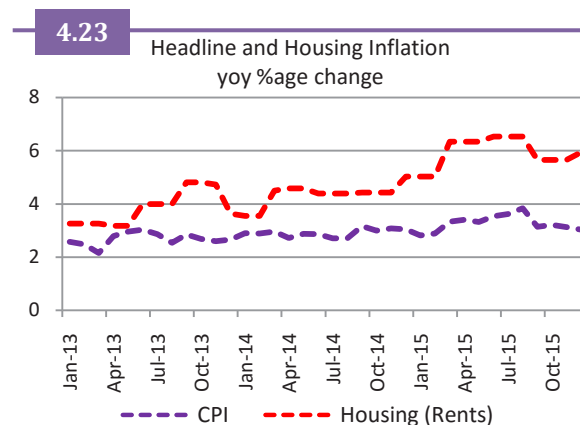
²⁵ Total sales here include residential, investment and commercial segments only.

recording 5,424 transaction in 2015 compared to 7,621 transactions in 2014. Moreover, investors also appeared inclined towards smaller ticket investments, particularly in the *investment* segment, as uncertain economic environment weighed down on investors' appetite to take large exposures.

The correction in the real estate market, though visible in both sales and numbers of transactions, was actually less acute as it came from a high base point, given the robust growth in sales recorded in 2014. While the drop in sales was the first after a steady growth since 2010, the number of transactions had started going down a year earlier (from 2013), at a time when sales (in terms of value) were still growing fast. The divergence in number and sales value of transactions was essentially due to supply constraints, particularly in the residential segment. This somewhat explains the limited correction in real estate prices, though rents have edged lower in recent months (Figure 4.23).

...with sharp correction in all three segments

Trends in sales within various segments highlight that the correction in real estate market was quite broad-based. Sales value dropped significantly in all three key segments²⁶, namely *Residential*, *Investments* and *Commercial* real estate properties. For instance, the *Residential* segment was down by 28.4% in 2015 (Figure 4.24). The drop in *Investments* segment, by 32.8%, was particularly sharp when compared with its impressive growth of 29.3% recorded in 2014; increasing supply of investment buildings, rising uncertainty and investors' growing risk aversion in a challenging economic environment played their part in depressing sentiments. Finally, growth in *Commercial* segment, the most volatile of all three segments, was down by 18.3% compared to robust growth of 40.3% in 2014. In general, sharp swings in this sector are common given the small number of high value transactions that can strongly influence overall growth trends.



²⁶ The real estate market can be broadly divided into four sub-categories; *residential (private housing)*, *investment*, *commercial* and *others* which had respective share of 44.1%, 39.2%, 12.8% and 4% as of December, 2015 (based on the value of deals).

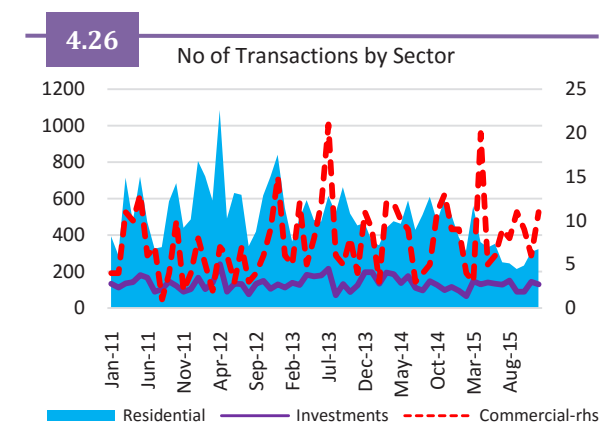
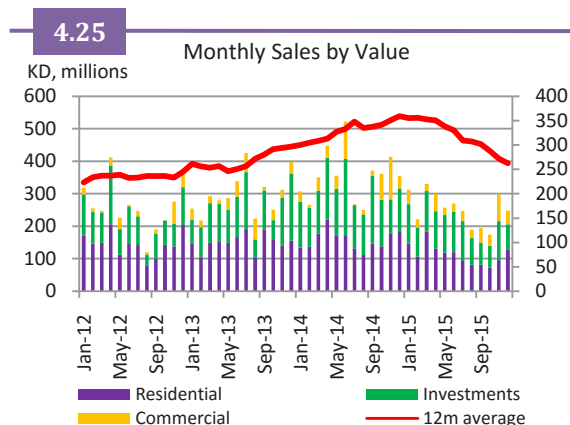
Monthly sales data reveals a similar slow down, albeit with a few months of positive growth

Analysis of the monthly transactions during 2015 also reveals a steadily declining trend in sales (Figure 4.25). While activity was healthy in the first quarter of 2015, it noticeably deteriorated in the 2nd quarter. As have been observed in previous years, sales were considerably slower during the summer season, which also coincided with Ramadan. However, sales were particularly low from August to October, as a number of developments dampened investors' confidence, including continuously falling oil prices, plunging world markets after the crash in Chinese stock market, impending lift off by the Fed, and escalating geopolitical tensions etc. Monthly sales during these three months were below KD 200 million, a level last observed in the summer of 2012.

In terms of number of deals, total deals in 2015 were down by 28.8%, dropping from 6,721 deals in 2014 to 5,424 last year (Figure 4.26). In the Residential segment, number of deals dropped by 33.1%, from 5,803 deals in 2014 to 3,882 deals in 2015. Likewise, Investments segment was off by 16.1%, though the Commercial segment posted a marginal increase of 1% in number of transactions. In the case of residential segment, number of deals have been steadily declining since 2012 (which posted a record 7,883 deals) amid increasing supply bottlenecks. Moreover, this declining trend could in part also be attributed to the CBK's instructions issued in late 2013 imposing certain controls on the funding granted to high-worth customers for their purchase/ development of real estate. These measures were meant to shield the banking system from excessive exposure to the real estate market and to strengthen financial stability.

Banks' exposure to the real estate market is multifaceted and significant, both through lending and collaterals

Against the backdrop of visible slow down in the real estate market, both in terms of number of deals



and sales value, it is pertinent to point out the risks that the banking sector is likely to face if a major correction in the real estate prices, something highly unlikely, takes place. Banks have significant exposure to the real estate market in terms of their lending, either directly through consumer installment loans or indirectly through financing the real estate and construction sector. As evident, this exposure has been steadily rising since 2012 in particular and reached KD 20.7 billion by 2015 (Figure 4.27).

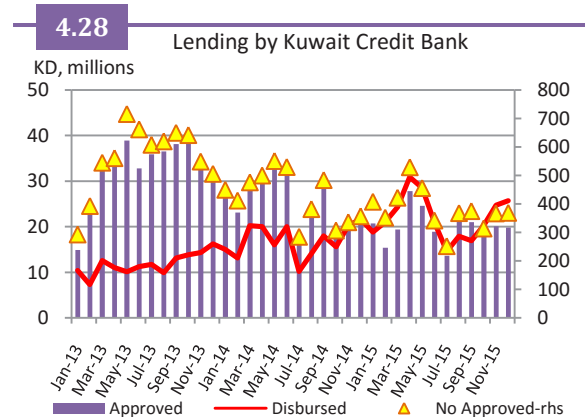
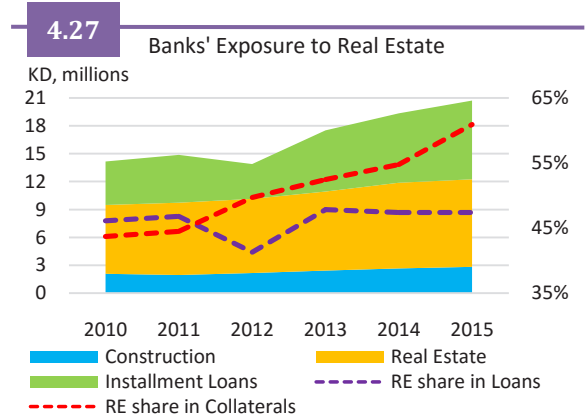
In addition to the lending exposures (both direct and indirect), real estate also constitutes the bulk of banks' collaterals. Over the years, use of real estate as collateral has noticeably increased, accounting for 61% of banks total collateral in 2015, compared to 44.5% in 2011.

As discussed earlier, correction in real estate prices have been fairly muted so far, despite a noticeable drop in both the number of deals and sales values. Yet any further deterioration in economic conditions may dent investors' confidence, with the potential of precipitating a plunge in the real estate market. Though quite unlikely, if such a tail event materializes, the double whammy of rising loan infections and sinking collateral values can seriously test the resilience of the banking sector.

While approvals declined, disbursement of loans by KCB posted strong growth

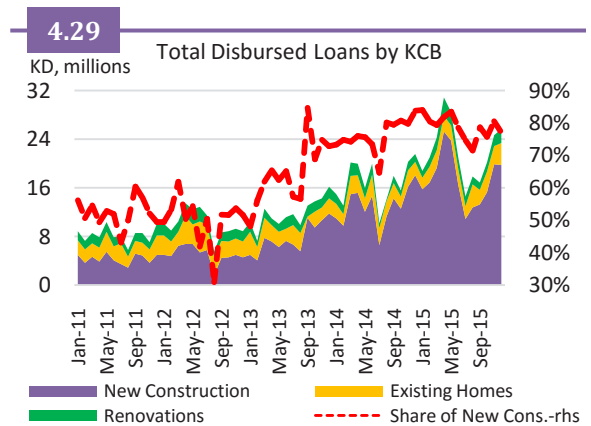
Kuwait Credit Bank (KCB), an independent banking institution wholly owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing loans to Kuwaiti nationals for purchase, construction or renovation.

After robust growth in both the number and value of approved loans in 2013, the trend has been declining. During 2015, total value of loans approved dropped by 20.8%, from KD 304.3 million in 2014 to KD 241.1 million last year (Figure 4.28). Likewise, the



number of loans approved also came down from 5,070 loans in 2014 to 4,554 loans in 2015. On the other hand, value of loans disbursed have continued to post strong growth (up by 29.1% in 2015) on the back of its robust growth (41%) in 2014; it appears that higher approvals in 2013 have lead to greater disbursements in later years as borrowers have started receiving loan tranches.

Historical trends also reveal that loans disbursements have significantly increased over the years (*Figure 4.29*). In terms of usage, around 80% of the disbursed amount was for new constructions. This marks a visible shift in usage of disbursed amount compared to a few years earlier; for instance, share of loans for new constructions was around 50% both in 2011 and 2012 and only started improving afterwards. The growing usage of loans for new construction would not only help add more homes to the national stock of housing but will also boost construction activity. On the other hand, the share of loans used to purchase existing homes have been on a declining trend, possibly because fewer existing homes are available for sale at a market clearing price.





CHAPTER 5

PAYMENT AND SETTLEMENT SYSTEMS

2015

5 Payment and Settlement Systems

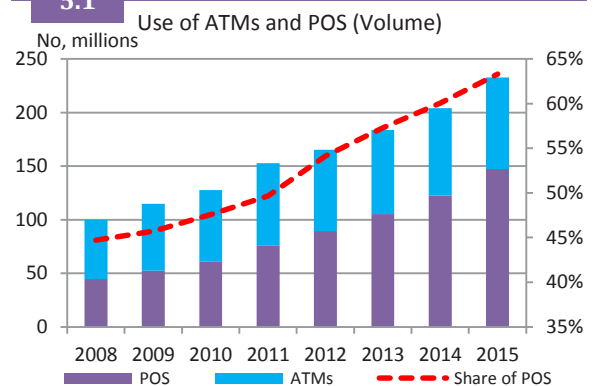
Both retail and large-scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. Regarding developments in 2015 in the retail payment segment, value of ATMs and point of sale (POS) based transactions have posted growth of 5.2% and 13.2% respectively. These growth trends are similar to the ones observed in 2014 and underscore the resilience of household consumption in Kuwait in spite of a challenging economic environment. There are, however, signs of a slowing trend in the sales of consumer durables. During the year, the share of ATM related transactions was higher (56%) in value while that of POS transactions was higher in terms of volume (63%). In general, though e-transactions account for 97.7% of all transactions in terms of volume, paper-based transactions (through cheques) still have a sizeable share (53.7%) in terms of value. To facilitate the increasing use of e-banking, necessary infrastructure in Kuwait has also been expanding; accordingly, the number of ATMs and POS machines grew by 4.7% and 13.1%, respectively reaching 1,708 and 43,322 machines by December 2015. Moreover, branch network also continued to expand (particularly for Islamic banks), bringing total bank branches in Kuwait to 422. Finally, KASSIP²⁷, the real time gross settlement system in Kuwait, handled 1.7 million transactions worth KD 314 billion in 2015.

The use of e-banking has been steadily rising

With the growing use of information technology and increasingly secured online payment systems, transactions through electronic banking (e-banking) have been steadily rising; this is evident from the increasing number of transactions being conducted through the point-of-sales (POS) and automated teller machines (ATMs) (Figure 5.1). Operated by Knet²⁸, POS and ATMs represent the retail payment system in Kuwait, essentially used for the bulk of mainly low-value payments transactions.

During 2015, the number of transactions (volume) through ATMs witnessed a growth of 4.8% to reach 85.4 million transactions. Yet the growth in number of transactions through POS was much stronger at 20.4%, pushing the total transactions to 147.5 million in 2015. Consequently, the share of POS transactions (out of combined POS and ATM based transactions) further inched up during the year to reach 63% in terms of volume and 44% for the value of total transactions.

5.1



²⁷ Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP) was launched in August 2004.

²⁸ The Shared Electronic Banking Services Company (Knet) launched its services in 1994 in collaboration with local banks.

Healthy growth in retail transactions exhibits resilient domestic consumption

Similar to the trends in number of transactions (volume), value of transactions also continued to increase steadily, both through ATMs and POS. Specifically, ATM-based transactions, in terms of value, grew by 5.2% to reach KD 11.2 billion compared to KD 10.6 billion in 2014 (Figure 5.2). Likewise, POS-based transactions posted a growth of 13.2% in 2015, as transactions worth KD 8.5 billion were conducted compared to KD 7.6 billion in 2014.

If viewed as a proxy for household consumption, steady growth in retail transactions underscores the resilience of domestic consumption in spite of a challenging economic situation. Apparently, even the sharp fall in oil prices have not dampened retail consumption so far, as national jobs are secure and wages are sticky downwards. However, there are signs that growth in sale of consumer durables have moderated, possibly because such purchases are more sensitive to consumers' perception of economic outlook.

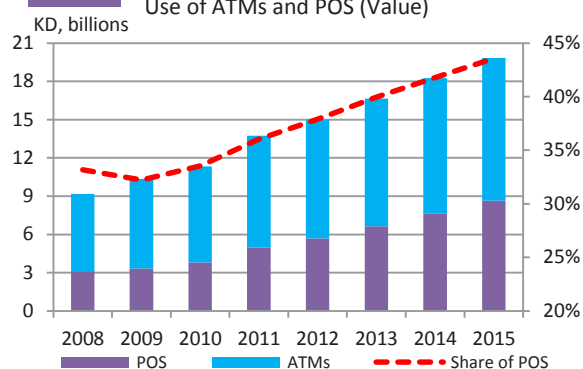
E-banking infrastructure has continued to expand

To support the growing use of e-banking, payment system infrastructure is also expanding in Kuwait. During 2015, the number of POS machines and ATMs witnessed a growth of 13.1% and 4.7% respectively, reaching 43,322 and 1,708 machines (Figure 5.3). Given that 2014 enjoyed an unusually stronger growth in the number of POS and ATMs (20.9% and 10.6%, respectively), further growth was understandably somewhat muted. The issuance of new plastic cards (debit and credit cards) also posted 7.6% growth in 2015, with total plastic cards reaching 4.2 million, around 83.4% of which were debit cards.

The ubiquitous nature of e-banking is largely because of the convenience, flexibility and security that it offers. Further, retailers offering discounts on online purchases have also promoted the use of e-banking. Banks are equally keen to promote e-banking as it

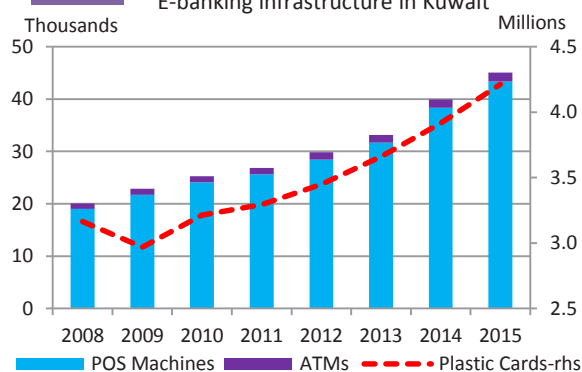
5.2

Use of ATMs and POS (Value)



5.3

E-banking infrastructure in Kuwait



helps keep the operational costs down by reducing the number of visitors for cash related transactions.

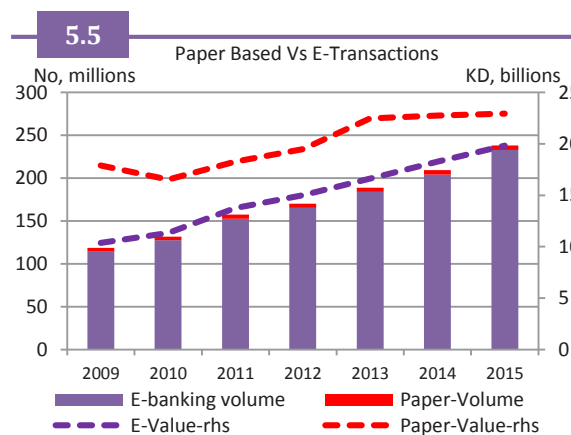
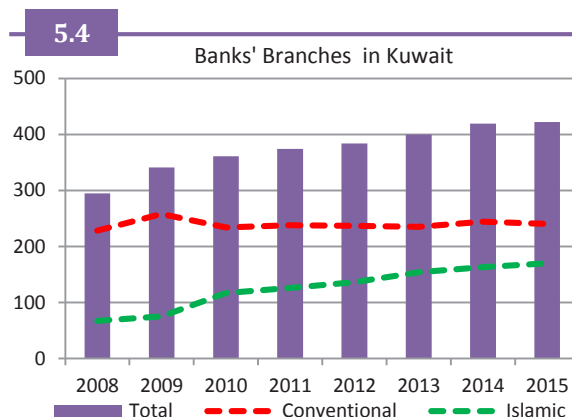
However, along with the increasing presence of e-banking, banks have also continued to add brick-and-mortar branches to expand their outreach. During 2015, 3 new branches were added to the existing banking network in Kuwait, pushing the total number of branches to 422²⁹ (Figure 5.4). Specifically, Islamic banks opened seven new branches while four conventional bank branches were closed. Still, the number of domestic branches for conventional banks (240) has remained significantly higher when compared to Islamic banks (170).

While much lower in volume, paper-based transactions remain significant in value

Thanks to the convenience, flexibility and security that e-banking offers, it understandably dominates overall transactions in terms of volume i.e. number of transactions (Figure 5.5). For instance, e-banking transactions during 2015 accounted for almost 97.7% of all transactions (e-banking & paper-based combined). Specifically, the number of e-banking transactions reached 232.92 million in 2015, posting 14.2% growth compared to 2014. On the other hand, only 5.36 million transactions during the year were paper-based.

However, if viewed in terms of value, paper-based transaction still account for a major, albeit declining, share. For instance, during 2015, the share of paper-based transactions in terms of value was around 53.7%. admittedly, even in value terms, e-banking is catching up, as its share has improved from 37% in 2009 to 46.3% in 2015.

These patterns suggest that while e-banking is gaining ground both in terms of volume and value, the significance of paper-based transactions in terms of



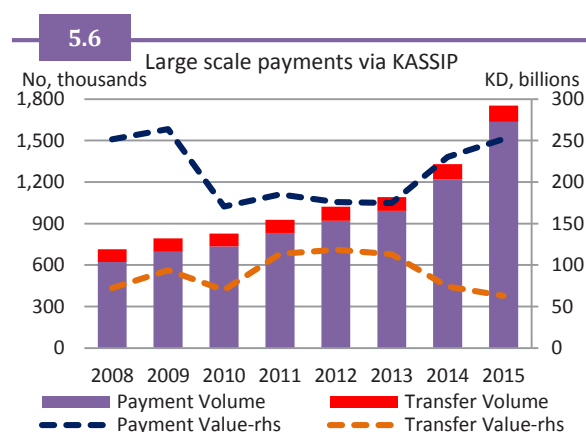
²⁹ This includes 12 foreign bank branches in Kuwait as well, where 11 are conventional branches and one Islamic. However, four banking kiosks (all conventional) and two branches of the specialized Industrial Bank of Kuwait are excluded.

value still remains. It appears that customers use e-banking more often but the average size of transaction is much smaller compared to paper-based transactions where average size of transaction is much higher. Bulk of business related transactions are generally conducted through paper-based modes.

KASSIP predominantly handles payment related transactions

Since 2004, the CBK has put in place a real time gross settlement system called *Kuwait's Automated Settlement System for Inter-participant Payments* (KASSIP). The system processes large value payments as well as a large number of low value transactions. The CBK plays the role of a settlement agent, providing risk-free means of discharging large value payments, as well as handling transfers between participating banks. As the name suggests, the system (KASSIP) provides for real time posting across accounts held at the CBK. Moreover, for each KASSIP participant, different liquidity support overdraft limits have been set by the CBK during the day (based on the collateral provided by the bank). These limits are available to participants between the start of day and interim cut-off only, whereas the amount of the limit at interim cut-off is re-established automatically at the start of the next business day.

Typically, transactions settled through the KASSIP consist of *payments* and *transfers*, with the former involving a third party (customers) and later between banks. In 2015, 1.75 million transactions were handled by KASSIP, registering strong growth of 32% compared to 2014. Growth in terms of value, though positive, was however much slower (3.3%) as transactions worth KD 314 billion were handled in 2015 compared to KD 304 billion in 2014. The slower growth in value was essentially due to significant decline in the value of *transfers* (Figure 5.6). As in the previous years, *payment* transactions continued to account for the bulk of all transactions handled through KASSIP, both in terms of volume (93% of all) and value (80%).



Your Excellency, the Minister of Finance,
Distinguished Guests,
Sabah-al-khair and a very good morning.

As always, I am pleased to be here. And thank you Mr. Banks for your kind introduction and for inviting me to speak before this august gathering of professionals, industry specialists and other stakeholders. I also commend you and your team on organizing this conference of great significance.

Today, I will be speaking about 'Innovations in Finance', or rather a few dimensions of it, to be more precise. It goes without saying that innovation has been one of the key drivers of growth, productivity and prosperity across the countries and over time. The role of innovations is well recognized in economic literature; Joseph Schumpeter, an Austrian economist, has expounded how the innovative entry of entrepreneurs serves as a disruptive force. He argues that it is "not...competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization..." To him, it is this process of '*creative destruction*' that helps lift growth and boost productivity.

In the field of finance, the role of innovations can be discussed from a variety of angles; after all, our modern world of finance is an innovation in itself, under a constant evolutionary cycle spanning over decades. Yet, given the broad nature of this topic, I would like to talk about innovations in finance from the standpoint of three key set of players; *central banks*, *financial institutions* and *technology firms*. These players have introduced innovative *policies*, *products* or *systems* in the face of incessantly changing demands of their respective mandates. Against this backdrop, I would like to share a few examples of innovative developments, along with a brief assessment of their risks and rewards.

Central banks and innovative policies

Let me start with the central banks. One relevant example of central banks' innovative approach towards policymaking has been the use of unconventional monetary policies (UMPs) in recent years.

You would recall that in the wake of global financial crisis, the central banks of major advanced economies provided substantial emergency liquidity support to their battered financial systems. Moreover, policy rates were swiftly slashed in successive intervals- for instance, Federal Reserve cut interest rate from above 5.25% in July 2007 to between 0-0.25% by January 2009. Likewise, Bank of England lowered its policy rate from 5.75% in July 2007 to 0.5% by March 2009. However, even as the policy rates hit the zero-lower bound through successive cuts, financial markets remained in turmoil, real output kept declining and threats of below-target inflation loomed large. As economic theory would tell us, central banks were confronted with a liquidity trap at the zero-lower bound. No longer being able to cut nominal rates any further, central banks in major advanced economies were compelled to adopt an innovative policy stance. So the central banks pursued UMPs, and rounds of quantitative and credit easing were introduced.

³⁰ Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait, on the occasion of Euromoney Conference, 15th September, 2015, Kuwait City.

It is true that the use of quantitative easing (QE) was not entirely a novel concept as the Bank of Japan had pursued the same back in 2001. However, the scale, the length and the impact of QE and other innovative measures introduced since 2008 have been unprecedented. The Federal Reserve alone conducted three different rounds of QE programs, purchasing financial assets worth more than USD 3.5 trillion- an amount roughly equal to the size of the Germany's economy. Similar measures were adopted by other major central banks.

On the positive side, these innovative policies have definitely helped in improving credit conditions, providing liquidity, bringing yields to historically low levels and lifting growth. Without such measures, we may have seen a repeat of conditions last observed during the Great Depression of 1930s. Though recovery is still somewhat fragile and uneven across the major advanced economies, the economic outlook has turned clearly positive in both the US and the UK.

Yet the pursuit of UMPs has also spawned the debate about their unintended consequences, their diminishing efficacy and their serious implications for global financial stability. I would like to highlight a few concerns in this regard.

First, the UMPs have helped pushed interest rates in many advanced countries to record low levels. In fact, rates in continental Europe has turned negative - which means borrowers are being paid to borrow. As the Bank for International Settlement (BIS) has pointed out in its latest Annual Report, 'boundaries of the unthinkable in monetary policy are being tested in the Continental Europe'. With interest rates at record low, risk taking has increased as investors continue to search for yield. Returns on risky and non-risky assets have sharply converged, evident from the extreme compression in sovereign credit spreads in the euro zone. This has increased the danger of mispriced sovereign risks. Moreover, with short-term rates at zero lower bound, investors are investing in long-dated securities at very low yields, pushing even term premium into negative territory. These investors are likely to suffer significant losses when long-term yields would ultimately normalize.

Second, with ultra-loose monetary policies, prices of financial assets have seen a rapid climb. This has increased the risk of a burst in the future particularly when the current level of liquidity is ultimately withdrawn.

Third, despite historically low interest rates, the impact on real economic activity has remained limited amid weak investments. As the International Monetary Fund (IMF) once put it, 'there has been a lot of *financial risk taking* but little *economic risk taking*'. The transmission of an easy monetary policy into the real economy has been limited, particularly in countries where banks' balance sheets remain weak.

Fourth, UMPs have also caused significant portfolio rebalancing amid shifting capital flows. Between 2009 to 2012, emerging markets (EMs) received about US\$ 4.5 trillion of gross capital flows, as investors rebalanced their portfolios away from US Treasuries in search of higher yields. We also witnessed the vulnerability of EMs in the summer of 2013 when the 'taper tantrum' led to a sharp reversal in capital flows. That experience also reminded us that UMPs have global implications, despite that the monetary policy mandates of the central banks are still domestic.

Fifth, despite enhanced communication of policy paths, the timing and pace of reversals in UMPs can rattle markets. In any case, orchestrating an orderly exit would not be easy. If central banks

exit too early, they run the risk of choking off otherwise nascent growth in their respective economies. If they exit too late, excessive liquidity may cause asset price bubbles, making the financial sector more vulnerable in future.

A related complication is the divergence in monetary policies across advanced countries; while US and UK are preparing for their first lift-off in over eight years, the ECB and BOJ are continuing with their ultra-loose policies. So even if entry into this innovative and unconventional territory of monetary policy has been well-coordinated, divergence in policy paths would make an orderly exit more challenging, not only for the countries concerned but for the global economy as well.

At this stage, let me highlight another equally important innovation in policymaking -the use of macroprudential tools. As we have learned from the recent global financial crisis, ensuring stability of individual banks through a microprudential approach would fail to preserve the stability of the system as a whole. With this realization, regulators are supplementing their existing microprudential toolkits with macroprudential measures which are aimed to address systemic vulnerabilities across institutions and over time. Though the concept is not entirely new, macroprudential policy is increasingly being recognized as a valuable tool to address specific financial stability issues where monetary policy appears too blunt a tool to be effectively used. However, challenges have also emerged about the appropriate calibration of macroprudential tools, effective coordination among various regulators and even the potential implications for central banks' independence.

Since I have discussed these issues in detail in my speech at this forum last September, I would prefer to move on to the next part of my discussion.

Financial institutions and innovative products

This brings us to the second set of players I mentioned at the beginning - financial institutions and their innovative products.

The pace of innovation in financial products and instruments has been particularly staggering in the run up to the global financial crisis. For instance, within 10 years leading up to 2007, the total outstanding value of interest rate swaps and other derivatives surged from \$75 trillion to \$600 trillion, almost eleven times the value of global GDP. During 2007 alone, the global derivatives market grew by almost 50%.

On the positive side, the development of innovative financial instruments has empowered institutions to conveniently fulfill their financial needs and effectively hedge their risks. Individuals are also better able to smooth out their consumption over time. Likewise, the availability of catastrophe bonds (or CAT bonds) and weather derivatives have helped countries better manage risks from natural disasters and adverse weather events.

But the growing complexity of financial instruments (e.g: CDO-squared) has also generated the debate whether financial innovations have gone too far. Warren Buffet once argued that complex financial instruments with opaque structures were 'financial weapons of mass destruction'.

In general, the pooling and dicing of risks has enabled investors to take risks that specifically suit their risk appetites. It has also resulted in cleaner pricing of various dimensions of risk. Yet the pooling of risks is also likely to reduce the screening of risk *ex ante* and monitoring of risk *ex post*, a problem which was quite evident in the case of subprime mortgages in the US. As we

witnessed, end-investors had little incentive to monitor the performance of loan originators, assuming originators had enough stakes in the securitization process. However, loan originators preferred to chase volume, thus seriously compromising on their lending standards. As this example highlights, the very strength of innovative products, which at first enabled us to pool and transfer risk, had in the end disastrous consequences amid misaligned incentives and poor regulatory oversight.

Given such experiences, we need to strike a balance by providing a conducive environment but at the same time ensuring that innovations serve a meaningful purpose and do not become an end in their own right.

Tech firms and innovative systems & processes

Let me now turn to the third and final point of my speech; the tech firms' innovative solutions. Instead of discussing the role of tech firms in finance per se, I would like to share a few examples of technology driven innovations and their effect on financial systems and processes.

Indeed, technology has virtually transformed everything in finance, from our trading platforms to payment networks. Consider stock exchanges where computer technology has revolutionized the trading of stocks in recent decades, making it faster and more efficient. Now, with electronic trading platforms, millions of transactions are daily conducted over computer screens with buyers and sellers spread across the globe.

Likewise, technology is helping the developing countries achieve financial inclusion at a scale that was unthinkable before. The ubiquitous presence of mobile phones in countries with limited banking outreach has helped provide a variety of financial products and services to otherwise unbanked or under-banked poor people.

While the transformative impact of modern payment and clearing systems is beyond argument, we also face the daunting task of keeping our systems safe, stable and, above all, up and running. You may recall that on July 18th this year, computer systems at the NYSE went down for nearly four hours in the middle of the day, bringing to a halt the epicenter of America's financial markets. And this was not the first event where technical glitches put the markets out of operation. In April last year, trading was halted briefly on Chicago Mercantile Exchange, the world's biggest future market. Likewise, NASDAQ went down in 2013 for three hours due to a software bug. While these episodes are still rare, the impact is massive, thanks to the substantial interconnectivity of our systems and markets.

Moreover, with the growing footprint of modern technologies, the nature of risks has also evolved significantly. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely and on a massive scale. While the chances of frauds like tempering with cheques, as shown in Spielberg's *'Catch Me If You Can'* are getting remote, the risk of cyber-attacks is on rise. In 2013, hackers stole the personal financial data of 70 million customers at 'Target', a major discount retailer in the US. The breach cost Target more than \$150 million and the CEO his job.

Yet in the final analysis, despite these concerns, modern technologies have increased the convenience, speed and even security of the way we make payments and conduct businesses. Hacking and other frauds make headlines simply because such events are so rare. Modern technologies have undeniably helped us keep our existing systems safe and stable, notwithstanding the occasional stumbles.

Conclusion

To conclude, every innovative policy, product or a system brings its own unique costs and benefits. It needs to be ensured that benefits of any such innovation must outweigh its costs, at least in the long run, if not immediately.

Admittedly, it is difficult to reliably predict the negative outcomes of an innovation. A key challenge is that our earlier experiences are a poor guide when it comes to determining the outcome or impact of innovations. Innovations are by their very nature a departure from the past. And ironically, the more radical is an innovation, the least useful are our past experiences.

Still, societies need to encourage innovation as maintaining the status quo is not a solution. After all, standing still would mean falling behind, particularly in a world that is pacing forward.

Thank you for your attention.

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