# Press Statement: CBK Announces the Publication of the Financial Stability Report for the Year 2019 and Kuwaiti Banks' Stress Test Results

The Governor of the Central Bank of Kuwait (CBK) Dr. Mohammad Al-Hashel announced the issuance of CBK’s 2019 Financial Stability Report, the eighth report prepared and issued as the bank seeks to boost transparency by providing reliable information and statistics on the Kuwaiti banking and finance sector.

The Governor stated that FSRs analyze the latest economic and financial developments in terms of their impact on financial stability and the extent to which the banking system is able to face and overcome shocks and continue to fulfill its role of providing financial services and of serving all sectors of the national economy. Dr. Al-Hashel pointed out the topics covered by the report’s five chapters. Chapter 1 addresses banks’ role and performance as financial intermediaries and sheds light on trends in credit distribution and deposits activity. Chapter 2 is dedicated to assessment of risks facing the banking system and addresses the different aspects of credit, market, and liquidity risk. Chapter 3 meanwhile provides an analysis of trends in the banking system’s profitability, solvency, and ability to withstand internal and external shocks within different financial and economic stress scenarios. As for Chapter 4, it covers developments in the monetary, foreign currency, stocks, and real estate markets, which make up the four main components of the country’s financial market. Lastly, Chapter 5 introduces an analysis of the performance of the payments and settlement systems in the State of Kuwait.

The Governor stressed that the COVID-19 pandemic brought about immense global change and altered outlooks. In the midst of its fight against a pernicious yet invisible enemy, uncertainty has taken over all horizons and the world is now on a different trajectory than that of start of 2020. The FSR, the Governor pointed out, used 2019 data as basis for its assessment of risks and vulnerabilities in the banking sector, local markets, and the payments and settlement systems. The report did not however neglect the sharp turn of events over the last few months and its impact on undermining the significance of any assessment based on historical data.

A detailed assessment of the COVID-19 impact on financial institutions, local markets, and infrastructure is to be assessed in the next FSR, the Governor said, as the recent changes in the banking system's financial soundness indicators barely reflect the scale and severity of the crisis.

On a positive note, Dr. Al-Hashel remarked that data for the current year clearly indicate that the banking sector has entered this pandemic-driven crisis from a position of considerable strength. With robust capital adequacy, ample liquidity, substantial provisions and the healthiest asset quality, the banking sector has remained a source of strength and a vital component of the support mechanism for the impending economic recovery. In contrast to the experience of the 2008-2009 financial crisis when banks were visibly vulnerable.

The CBK Governor addressed, briefly, the main findings in the report as follows:

**<u>Financial Intermediation:</u>**

1) The Kuwaiti banking sector's assets, on a consolidated basis, grew by 8.2% in 2019 on the back of higher private sector bank credit and growth in investment. The total value of these assets reached KD 83.0 billion.
2) Bank credit, on a local level, grew by 5%, similar to the rate recorded in 2018. Growth in household credit tapered to 1.8%, weighed down by deceleration in housing loans even as consumer loans spiked. Still, the households segment remained the top recipient of bank credit for the fifth year in a row. Meanwhile, credit extended to the real estate sector recorded the best growth seen in a decade at 14.3% after a marginal contraction in 2018.
3) Growth in bank deposits increased from 2.4% back in 2018 to 6.4%, on the back of expanding deposits from both within and outside Kuwait. The banking sector has a stable funding base, as time deposits constitute 67.1% of overall deposits, and have the support of a strong capital base. These indicators undoubtedly reflect factors conducive to financial stability.

**Asset Quality**

4) The Kuwaiti banking sector's asset quality continued improving over the past few years. This was exhibited by the steady decline in non-performing loans ratio (NPLR), which reached a historical low of 1.5% on a consolidated basis as on December 2019 (1.3% on a local level). The impressive progress in bringing down the NPLR is particularly evident when compared with the double-digit NPLR (11.5%) observed in 2009.
   Coverage ratio (Available Provisions to NPLs) continued improving as well to reach 270.6% compared to 254% back in 2018. The ratio was even higher at 326.8% on banks' local level. These high ratios assures the banks' soundness indicators, which are an indication of financial stability.

**Profitability**

5) Profitability remained at good and reassuring levels, although heightened competition and a drop in interest margins had overshadowed the banking sector's profitability bringing down net income attributed to shareholders by a slight 0.7%. This was also reflected in a slight drop in return on average assets and return on average equity, which reached 1.2% and 9.5% respectively.

**Solvency and weathering shocks**

6) Kuwaiti banks maintained high capability to weather shocks and operate under stressed conditions with the overall capital adequacy ratio at 18.5%, well above CBK's minimum requirement of 13%. Kuwaiti banks' strong regulatory capital base largely driven by high quality common equity tier 1 capital, which accounted for 81% of their total capital. This indicates a robust loss-absorption capability.
7) Leverage ratio in the banking sector came to 10.7%, also above the Basel minimum requirement of 3%. This ratio is geared to reinforce banks' solvency, taking into account that, unlike the capital adequacy ratio, the Leverage Ratio is a non-risk-weighted measure that is calculated using total

bank assets, including those on and off balance sheet. This is an additional tool towards reducing systemic risk and bolstering financial stability. The Kuwaiti banks' available buffers, in terms of capital adequacy and leverage ratios, coupled with abundant liquidity, reflect great expansion capacity, most specifically in terms of extending credit facilities to the various sectors of the national economy.

**Market, Liquidity Risk**

8) Equity investments came to 16% of banks' total investment, while the use of firms' shares as collaterals accounts for 19.6% of banks' overall collaterals. Risk of equity market remains limited in view of CBK regulatory controls concerning the maximum limits for loans extended to clients for the purpose of purchase of equity.
9) Banks still enjoy ample liquidity levels, whereby they comfortably exceeded the Basel III Liquidity Coverage Ratio and Net Stable Funding Ratio requirements.

**Local Markets**

10) As for monetary policy developments, the Governor pointed out the following:

- The Central Bank of Kuwait, in October 2019, reduced the discount rate by a quarter-percentage point to 2.75%.
- Amid ample liquidity and with no issuances of public debt instruments, CBK's liquidity absorptions surged to maintain stability of the local interest rate structure in order to provide an environment that is conducive to economic growth and to bolster the attractiveness and competitiveness of the national currency.
- When it comes to the exchange rate policy, the report discussed changes in the Dinar's exchange rate against major currencies throughout 2019, and reflected the relative stability of said rate, which is pegged to a weighted basket of the currencies of the State of Kuwait's main trade partners. The

fluctuations in the exchange rate against the US Dollar was within a narrower range, compared to the fluctuations seen in the greenback's exchange rate against other main world currencies. This attests to the relative stability of the exchange rate of the Kuwaiti Dinar and its sustained purchasing power, which undoubtedly supports monetary stability.

11) Boursa Kuwait, led by a strong banking sector, posted solid gains in 2019, outperforming its GCC peers and other emerging markets. Market indicators recorded significant gains on the back of the Market Development Project and prospects of further upgrades.
12) The report also discussed the real estate market's performance that recorded a growth of 10% in total number of transactions and a drop of 3% in total value of sales.

**<u>Payment and Settlement Systems</u>**

13) Both retail and large-scale payment systems continued to grow, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. During 2019, growth in the value of transactions made through e-banking facilities (ATMs, PoS machines, and Knet's OPG) increased to 11.8%, compared to 10% a year earlier. This growth was mainly due to double-digit expansion in PoS transactions. Meanwhile, the share of Knet OPG in overall payments, both by value and volume, continued to post robust growth. Collectively, the value of transactions using PoS and Knet OPG in 2019 exceeded ATM cash withdrawals, reflecting the growing use of electronic methods of payment. While transactions through e-banking accounted for the most in terms of volume (98.8%), paper-based transactions through cheques still accounted for a significant share in terms of value. To facilitate the increasing use of e-banking, the necessary infrastructure continued to expand. The number of PoS and ATM machines grew by 9.1% and 12.5%, respectively reaching 64,990 and 2,675 machines by the end of 2019. With the increasing adoption of technology by banks and its widespread usage among customers, the number of branches declined by 13 to reach 412 local branches.

**<u>Stress tests</u>**

In order to assess the banking sector's resilience and shock absorption capacity amid the COVID-19 induced lockdowns and the associated drop in oil prices, the CBK instructed banks to conduct comprehensive stress tests on both their investment and credit portfolios taking into account client-level exposures. The new stress test scenarios must incorporate the impact of the pandemic as well as the effect of the lockdown on customers' cash flows. The banks must also examine the net impact of these developments on their main indicators of profitability, capital adequacy, liquidity, and asset quality. The CBK then held lengthy discussions challenging banks' submissions and discussing the results of their stress testing exercise.

Simultaneously, the CBK coordinated with an international consultant to conduct a top-down stress test based on scenarios that take into account the implications of the pandemic and its impact on supply and demand both locally and globally, as well as the effect of the sharp decline in oil prices and how it altered the State's fiscal policy and public spending.
Plausible economic recovery scenarios were analyzed taking into account two main factors. First, the effectiveness of the public health response in controlling the spread and human impact of the pandemic. Second, the effectiveness of the economic policy response in mitigating recessionary dynamics caused by the pandemic. The analysis focused on two main scenarios:

1) **A muted 'U' shaped recovery scenario** which assumes a gradual resumption of business, a 30% drop in revenues for impacted sectors, and **economic recovery taking a whole year.**
2) **An extended 'U' shaped recovery scenario** assuming a gradual resumption of business with the possibility of repeated lockdowns in case of new waves of infection. In this scenario, average revenue loss of impacted sectors drops by 40% and **full economic recovery takes up to two years.**

Undoubtedly, there would be greater impact on banks' performance in case of the second scenario in view of the longer recovery period. Both scenarios assume that the real estate sector and the stock market would suffer shocks that would lead to notable deterioration in banks' asset quality including the value of their investments, their financing portfolios, and their equity and real estate collaterals. The results of the more severe extended 'U' shaped scenario reveals that the average capital adequacy ratio of Kuwaiti banks would drop to 11.6% in 2020, well

above Basel's minimum CAR requirement of 8% (after excluding the 2.5% capital conservation buffer).
In light of these results, and in line with CBK's prudential and proactive approach in ensuring the resilience of the banking sector, banks were requested to submit capital plans outlining appropriate actions to be taken to support their capital bases and ensure their resilience even under such severe scenarios. The plans must utilize the most suitable and viable options including capital increases, eligible tier 1 issuances, and restructuring of the bank's financing and investment portfolios.

As for outlook, the Governor said the banking sector is expected to maintain its stability, though its resilience and strength would depend on the duration and severity of the crisis, and the ramifications might vary from bank to bank. Despite the extraordinary conditions the Kuwaiti economy is experiencing, bank credit continues to post good growth due to low borrowing cost amid unprecedentedly low interest rates, and companies' greater capital requirements, particularly those that suffered revenue shortfall. On the other hand, asset quality might slowly decline. Furthermore, economic challenges, compressed net interest income, and the need for greater provisions to cover potential deterioration in asset quality might put additional strains on banks' profitability.

In this regard, the Governor noted that the CBK, within an economic stimulus framework, had taken pre-emptive and swift actions to strengthen its accommodative monetary policy by bringing down the discount rate twice in March 2020 to reach a historic low of 1.5%, aiming to cut the cost of borrowing and to boost overall demand to stimulate economic activity. The central bank also amended some of its supervisory instructions to expand banks' lending capacity.

From a wider economic perspective, the challenges posed by the health and economic crisis are bound to stifle growth. Lockdown-induced contraction coupled with lower and volatile oil prices will cripple both oil and non-oil GDP. Growing deficit, inability to borrow, and absence of economic and fiscal reforms would constrain public finances. Dr. Al-Hashel said that while the immediate priority should be addressed to mitigating the pandemic-driven sharp decline in economic activity, this crisis clearly underlines the deep-rooted structural imbalance where the State heavily relies on oil revenues and where it also plays the role of the main employer for the national workforce. Once the economy is back on track, strenuous efforts will be required to implement comprehensive fiscal and structural reforms to diversify the economy beyond oil. Without serious progress along this track, he stressed, the State would remain vulnerable to fluctuating oil prices and its risks to financial stability.

In conclusion, the Governor pointed out that the CBK had benefited from its past experiences of dealing with the repercussions of the Global Financial Crisis as it sought to build a stronger, more resilient banking system. Gains from that decade-long exercise are evident in the soundness of our banks, which instead of being recipients, are helping intermediate the various relief measures announced by the government. He expressed hope that the COVID-19 crisis would inspire the same spirit of interaction and cooperation on a national level and pave the way to build a well-diversified, resilient, and sustainable economy going forward.

Having concluded his statement, the Governor noted that those interested in the report may obtain a full copy of the 2019 FSR from CBK's official website (www.cbk.gov.kw).

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