

Financial Stability Report 2016



Central Bank of Kuwait



CENTRAL BANK
OF **KUWAIT**

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Financial Stability Report

for the calendar year 2016

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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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 5th FSR for the calendar year 2016, 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 2016 (CY16) using December 31st, 2016 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 4.7% 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 low and volatile oil prices, banking system in Kuwait remained sound and stable during the year under review (CY2016). Domestic credit posted positive though slower 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 marginally slower pace than in 2015. These trends collectively highlight that the 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 the last two years can in part be ascribed to higher public spending which helped limit 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, the two concerns which thankfully did not materialize. 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 broadly supported consumer spending, though consumer confidence remained weak until Q3-2016 amid hike in fuel prices.

Positively, oil price (for Kuwaiti Export Crude-KEC) have more than doubled from around \$19 per barrel in January 2016, in large part due to the OPEC deal in November 2016 to cut production. Though the rebound in oil prices surely offers a breathing space 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. Some measures have already been introduced, like the increase in fuel prices in September 2016. In addition, Ministerial Resolution No. 28 of 2017 has been issued in March 2017 for higher electricity and water tariffs to be applicable on certain dates during 2017, though at a lower level than was envisaged in 2016. Still, further progress needs to be made on all fronts: rationalizing expenditures, reforming 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.

Banking System:

Financial Intermediation: Banking system posted visibly slower growth in 2016 as its consolidated assets increased by a modest 1.85%, though growth in domestic assets was relatively healthier at 3.1%. Increase in domestic credit, at 2.9%, was also much slower compared to 8.5% in 2015, in part due to base effect as well as loan repayments. Lending to the households grew by 5.8%, which made the household sector the top recipient of bank credit second year in a row. On the other hand, bank credit to real estate sector contracted by 3.4% as real estate market softened further. Given that bulk of lending to households (84.9% in 2016) has been in terms of installment loans for repair and purchase of private homes, banks combined exposure to real estate sector was 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 record low levels. Banks also increased their investments in government securities amid growing issuance of sovereign debt. On the liability side, growth in banks' consolidated deposits slowed down further to 2.4%, though domestic deposits grew at a better pace, posting 4.8% increase in 2016. Yet the banking system continued to enjoy a stable funding base as 63.6% of the total deposits were placed in the time deposit category.

Growth in assets and credit off-takes slows down

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 further dropped to a historically low level of 2.2% (1.8% on domestic, Kuwait-only basis) as of December 2016, 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 evident if the existing NPLR (2.2%) is compared with the double-digit NPLR (11.5%) observed in 2009. Going forward, some NPL formation is not unlikely, though at a slower pace and from a low base, as NPLR in certain segments has already bottomed out. Still, the coverage ratio (available provisions to NPLs) remains robust at 237% (316%, 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 2.2% ...

...with coverage ratio reaching a historically high level of 237%

Sectoral analysis of NPLs indicates that the decline in NPLR has been somewhat broad based with some of the key sectors experiencing a contraction in their respective NPLRs. One noticeable exception was the real estate and construction

sector, which posted an increase in NPLR (reaching 3.2% as of December 2016), in part due to lower gross credit extended to the real estate sector. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased, similar to that from the domestic operations. Industry breakdown reveals that conventional banks account for 59.4% of total NPLs, almost in sync with their share in gross loans (59%).

Market & Liquidity Risks: Banks' exposure to the equity markets, though still significant, has been on a steadily declining trend; equity investments make up around 19.2% of banks' total investments, and use of firms' shares as collaterals accounts for 19.1% of banks' overall collaterals. Banks' liquidity levels have remained healthy with interbank rates edging lower. Newly introduced liquidity coverage ratio 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. Positively, banks' funding structure has improved further, with increasing reliance on time deposits and diminishing role of non-core liabilities.

Liquidity remained healthy during the year

Profitability: Banks' net income, on consolidated basis, grew by 5.8% in 2016, at a marginally slower pace compared to 7% growth recorded in 2015. Higher interest income, lower loan loss provision expense and lower non-interest expense collectively helped improve the industry's net income. Both return on assets as well as on equity inched up as growth in net income outpaced the growth in assets and equity. By banking groups, conventional banks accounted for 62.6% of the industry profits and 60.7% of the industry assets. Cost to income ratio slightly deteriorated because of conventional banks though they still, on average, remained 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 18.6%, well above the CBK's 13% requirement for 2016. 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 10.1%, well above 3% benchmark proposed by the Basel Committee, indicating banks' strong 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 strengthened further to reach 18.6%

Domestic Markets:

Money & FX Markets: For the second year in a row, CBK raised its discount rate by 25 bps in December 2016, pushing its policy rate to 2.5%, a level last seen in 2012. As evident from the scale of liquidity absorption as well as interbank rates, liquidity conditions eased further as the year drew to a close, in part due to rebound in oil prices after OPEC agreed to cut production. While some other GCC countries tapped international markets, Kuwait opted to raise funds domestically, given the comfortable liquidity conditions at home. Accordingly, public debt worth KD 2.95 billion was raised in 2016 compared to KD 1.25 billion in 2015. As a result, balance of public debt increased from around 1.6 billion KD in 2015 to 3.3 billion KD in 2016. During the same period, overall issuance of CBK bonds/related tawaruq declined by 11.5%. In the foreign exchange market, KD depreciated against USD by 0.9% in 2016 while appreciating against GBP and EURO by 16.8% and 3.7% respectively; diverging growth trajectories and monetary policies across major economies influenced the exchange rates, while GBP in particular was hit hard after Brexit vote and the ensuing uncertainty about the outcome of its trade negotiations.

Public debt issuance more than doubled as government tapped domestic market

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

Stock Exchange & Real Estate Markets: Boursa Kuwait closed the year with Price Index up by 2.4% as oil price rebound during the last quarter helped the market reverse its losses of the first nine months. Kuwait-15 was however down by 1.7% while weighted index remained flat, reflecting poor performance of large cap stocks. In general, market moved closely in tandem with fluctuations in oil prices.

Boursa closed the year 2.4% up, on the back of oil price rebound

Kuwait's real estate market retreated for the second year in a row, after enjoying positive growth for five consecutive years between 2010-14. Activity was markedly slower, both in terms of number (off 21.4%) and sales value (down 23.1%) of the deals made. Segment-wise, sales in both residential and investment segments contracted by 30.3% and 33.4% respectively, though commercial segment grew by a solid 26.3%. Decline in residential segment was in part due to increasing supply of housing units by the government while growing preference for small-ticket single apartment transactions subdued overall sales in the investment segment. Yet the real estate prices in general only softened moderately, averting any major 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 unlikely, could test the resilience of the banking sector, given banks' three-dimensional exposure to the real estate market in terms of loans, investments and collaterals.

Real estate sales contracted for the second year in a row

Payment & 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. During 2016, value of ATMs and point of sale (POS) based transactions posted growth of 3.2% and 5.6% respectively. These growth trends, while positive, are considerably subdued when compared to the ones observed in 2015 and underscore the slowdown in household consumption amid weakened consumer confidence. Sales of consumer durables, typically more sensitive to economic outlook, witnessed a noticeable contraction, though the overall consumption was supported by steady hiring in the public sector. 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 16.6% and 7.4%, respectively reaching 1,991 and 46,513 machines by December 2016. Moreover, branch network also continued to expand (particularly for Islamic banks), bringing total bank branches in Kuwait to 421 in 2016 from 414 in 2015 as Islamic banks opened seven new branches. 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 (66%). In general, though e-transactions account for 98.1% of all transactions in terms of volume, paper-based transactions (through cheques) still have a sizeable share (53%) in terms of value. Finally, KASSIP¹, the real time gross settlement system in Kuwait, handled 1.8 million transactions worth KD 299 billion in 2016.

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

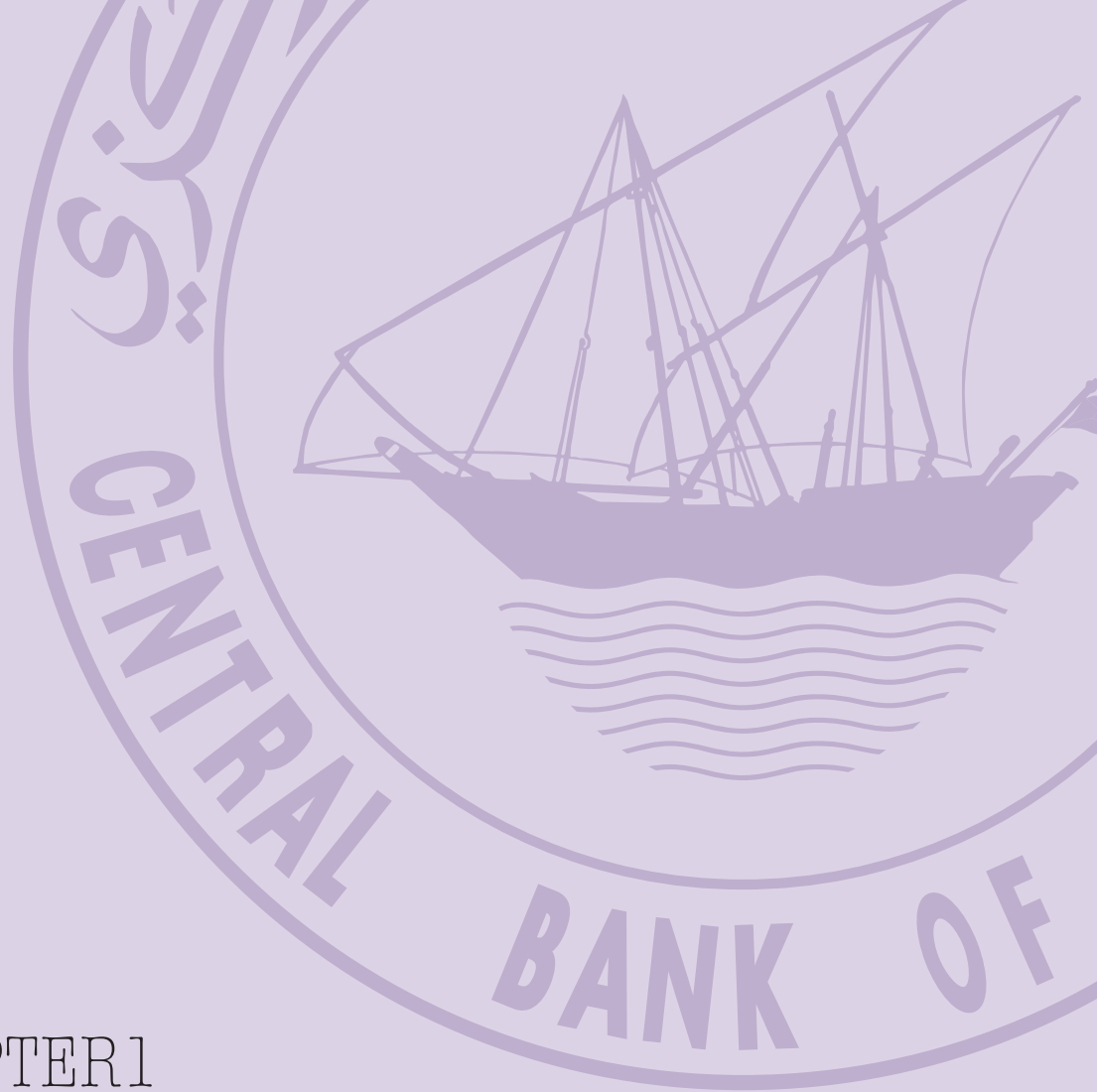
Outlook:

Going forward, growth in private sector credit is likely to remain healthy amid ongoing emphasis on capital spending under Kuwait National Development Plan labeled as 'New Kuwait' to turn the country into a leader in finance, trade and culture. Moreover, OPEC deal to cut production last year has helped oil prices stage a decent recovery, though recent extension of the deal to another 9 months did not lift prices further. 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 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.

Banking sector would remain resilient

¹Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP).

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. In fact, NPLR in certain segments like real estate has already bottomed out, though NPL formation going forward would be at a slower pace and from a very low base. Liquidity would also remain healthy as there is no pressure on the banking sector to finance government's budgetary needs. In fact, the government is well placed to tap international markets if required; it has successfully raised USD 8 billion already in March 2017 from international markets, and at spreads more favorable than its GCC peers. In view of the foregoing, 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

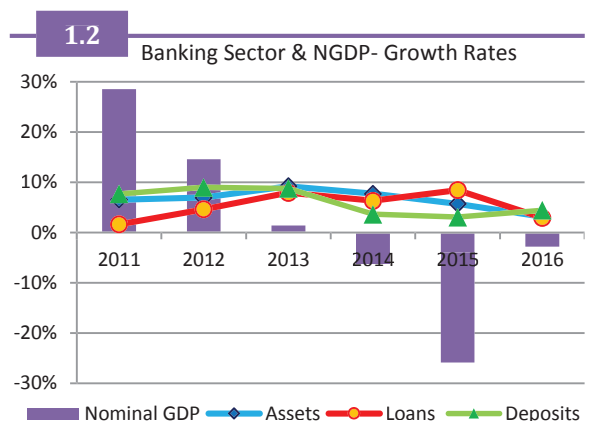
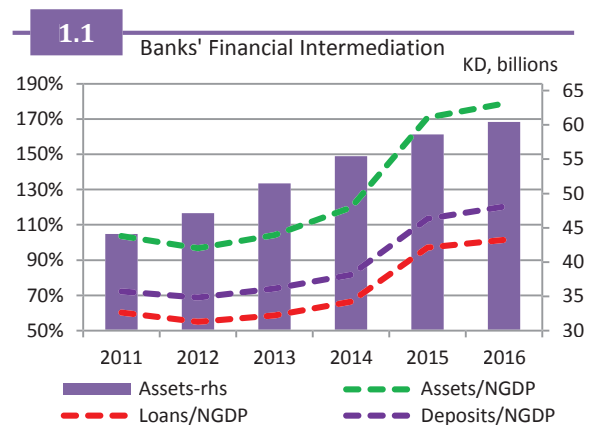
2019

Banking system posted visibly slower growth in 2016 as its consolidated assets increased by a modest 1.85%, though growth in domestic assets was relatively healthier at 3.1%. Increase in domestic credit, at 2.9%, was also much slower compared to 8.5% in 2015, in part due to base effect and loan repayments. Lending to the households grew by 5.8%, which made the household sector the top recipient of bank credit second year in a row. On the other hand, bank credit to real estate sector contracted by 3.4% as real estate market softened further. Given that bulk of lending to households (84.9% in 2016) has been in terms of installment loans for repair and purchase of private homes, banks combined exposure to real estate sector was 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 record low levels (see Chapter 2). Banks also increased their investments in government securities amid growing issuance of sovereign debt. Finally, growth in banks' consolidated deposits slowed down further to 2.4%, though domestic deposits grew at a better pace, posting 4.8% increase in 2016. Yet the banking system continued to enjoy a stable funding base as 63.6% 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 2016, though at a much slower pace than what was observed in 2015. Accordingly, intermediation ratios, measured in terms of key banking variables relative to the nominal GDP, inched up further (Figure 1.1)¹.

Marginal increase in financial intermediation ratios during 2016 was both on account of a relatively muted growth in the key banking variables (i.e. assets, loans and deposits) and significantly reduced contraction in the nominal GDP amid modest recovery in oil prices. Specifically, while consolidated assets, loans and deposits increased in 2016 by 1.85%, 1% and 2.4% respectively, nominal GDP shrank by 2.82% (compared to a much sharper drop of 25.9% in 2015), resulting in further improvement in intermediation ratios (Figure 1.2).



¹The 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 3.26 billion.

²Nominal GDP for 2016 has been taken from the IMF's World Economic Outlook database of April 2017.

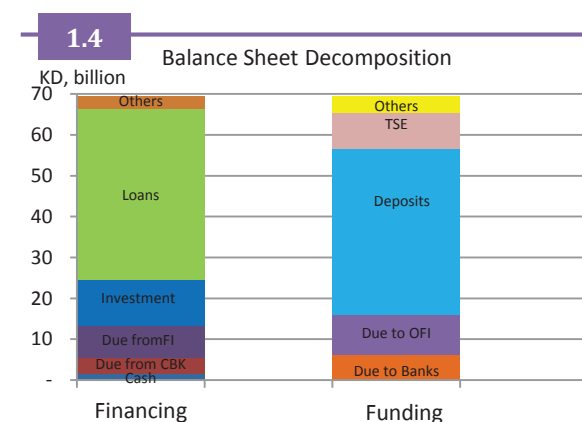
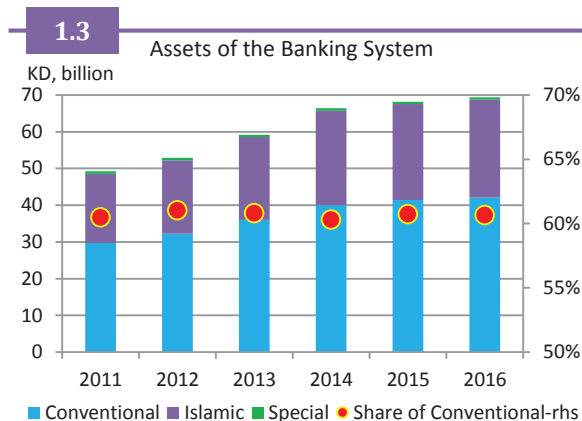
In general, banks' role as financial intermediaries has ensured a fairly high degree of financial inclusion in Kuwait. For instance, The World Bank's latest database on financial inclusion reveals that 73% of the population above the age of 15 years in Kuwait has an account with a formal financial institution.

Financial system continues to remain bank-centric

Kuwait's financial system continues to remain bank-centric, as the banking sector³ accounts for around 84% of the domestic financial sector. Investment companies are the second major player in the domestic financial system with around 12% share as of December 2016. 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 22.3% of the consolidated banking system.

When viewed on a consolidated basis⁴, conventional banks dominate the overall banking system, with 60.6% share as of December 2016; however, their share has remained broadly the same over the years (Figure 1.3). Islamic banks, with 38.4% share in consolidated banking system, represent one of the 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 60.2% of the total assets as of Dec. 2016 (Figure 1.4).



³ Domestic banking sector including foreign banks' branches within Kuwait.

⁴ Consolidated data includes Kuwaiti banks' subsidiaries & branches abroad (see footnote 1).

Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 16.4% share in total assets. On the liabilities side, deposits account for 58.4% of total liabilities, indicating a healthy deposit base to help Kuwaiti banks befittingly perform their intermediation role.

Growth in consolidated banking assets noticeably slowed down

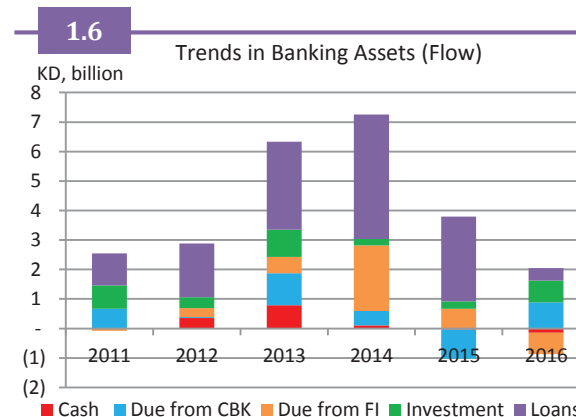
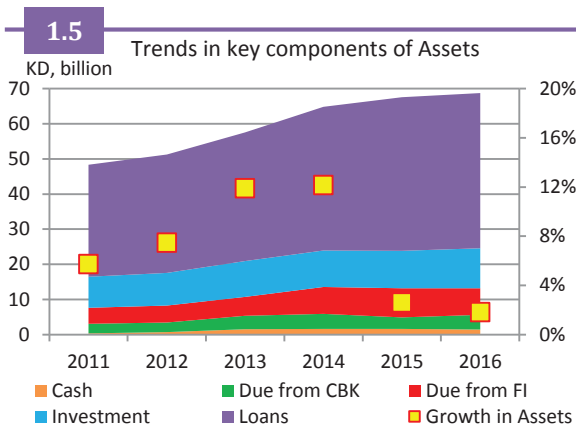
During 2016, consolidated banking assets posted significantly slower growth of 1.85%, even when compared to 2.6% observed in 2015 (Figure 1.5). Specifically, assets worth KD 1.26 billion were added to the banking system, putting total assets at KD 69.4 billion by December 2016. However, it was markedly slower expansion compared to the addition of KD 7.2 billion in 2014, though less significant when compared to the increase of 1.7 billion in 2015.

As evident from the flow data for the key components of banks' assets, slower asset growth was essentially because of sharp slowdown in credit growth, bulk of which came from banks' operations abroad. Moreover, 'Due from Financial Institutions' which includes both interbank lending and placements, also contracted sharply, compared to positive growth in 2015. (Figure 1.6).

On the other hand, 'Due from CBK', which reflects banks' placements with CBK, posted a strong recovery in 2016, increasing by 880 million after contraction of KD 987 million in 2015; this suggests the easing liquidity conditions, and is also reflected in CBK's greater liquidity absorption (mopping up of the excess liquidity from commercial banks through interventions/tawarruq) during 2016 (see Chapter 4 for details).

.....amid lower credit off-take, particularly from abroad

During 2016, banks' consolidated loan portfolio expanded by another KD 424 million, posting barely

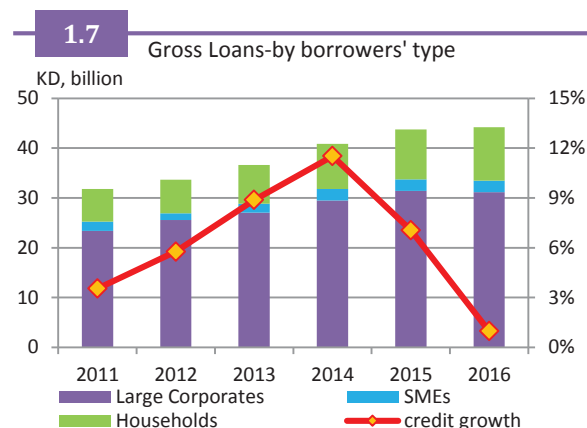


1% growth (Figure 1.7). This was the slowest growth in years, and can largely be explained by the contraction in banks loans portfolios in GCC (mostly in Saudi Arabia and Bahrain), Asia, and Europe. On the domestic front, growth in private sector credit off-take was still somewhat better, at 2.9%, though significantly lower than 8.5% recorded in 2015. It was in part due to basis effect on account of sharp increase in lending in December 2015; moreover, a reportedly large repayment of corporate debt by a single borrower (of around KD 700 million) in October 2016 also dampened the credit figures for the year in review.

In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 70.5% of the total gross loans. A distant second was the households sector, with 24.2% share in overall credit and outstanding loans amounting to slightly above KD 10.7 billion as of December 2016. 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 during the last few years.

On the other hand, share of SMEs in overall lending slightly decreased to 5.3% in 2016. In order to encourage lending to SMEs, CBK has incentivized banks by using a preferential risk weight of 75% for SME finance, compared to the standard risk weight of 100%. 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 aims to grant loans (under separate conventional and Sharia-compliant schemes) up to a maximum of KD 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 (97.9%), while the share of lending to the public sector was limited to a paltry 2.1% during 2016. With huge accumulation



of assets over the last decade, the need for public sector to borrow from the banking system to meet its budgetary needs have remained limited.

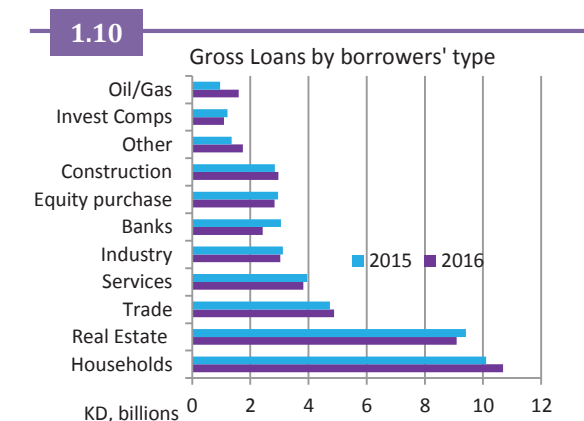
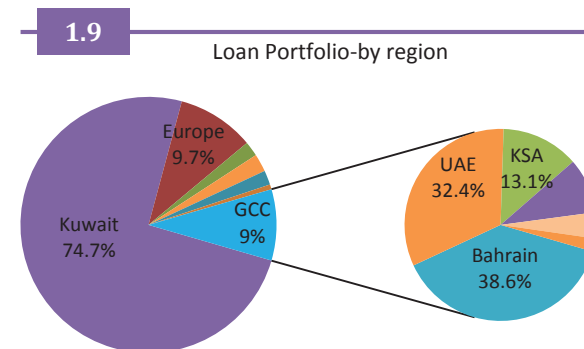
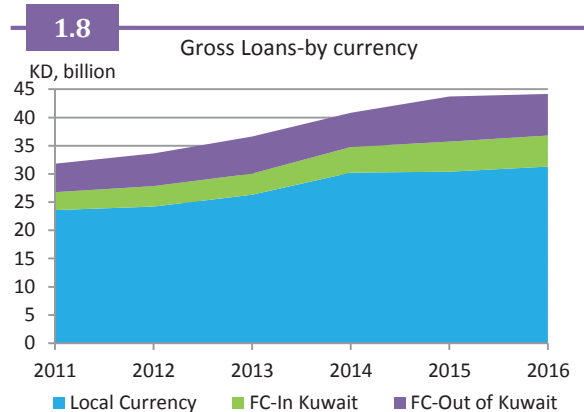
Currency-wise breakdown of the gross loans indicates that almost 71% of the overall lending was in the domestic currency, with the share of foreign currency (FC) marginally dropping to 29.1% from 30.5% in 2015 (Figure 1.8). Within FC loans, around 57.4% in 2016 were granted by Kuwaiti banks' subsidiaries & branches abroad (FC-out of Kuwait).

Geographical breakdown of banks' lending portfolio reveals that out of banks' 44.2 billion of gross loans as of December 2016, almost KD 33 billion (74.7%) have been granted within Kuwait (Figure 1.9). The remaining 25.3% of the gross loans have been distributed across various regions, with Europe and GCC accounting for around 9.7% and 9% respectively. Within GCC, banks' greatest credit exposure is confined to Bahrain, followed by UAE and Saudi Arabia.

Banks' lending is shifting towards relatively safer segments

Breakup of gross loans across various sectors indicates a mixed trend, with some segments receiving greater credit while others witnessing a contraction (Figure 1.10). Noticeably, households' share in bank credit further expanded in 2016, while that of real estate segment contracted first time after almost a decade of positive growth. The shift in banks' lending away from real estate and towards households underscores banks' changing preference in favor of low-risk areas, signifying their flight to quality.

Banks' lending to investment companies, after posting positive growth in 2015 by bucking the trend of earlier years, again contracted by 10% during 2016, bringing its share in banks' overall loan portfolio further down to 2.5%. While deleveraging in the investment companies, which started in 2009, finally bottomed out in 2015, reduction in banks' exposure to the sector in 2016 again hints at banks' preference for less risky exposures.



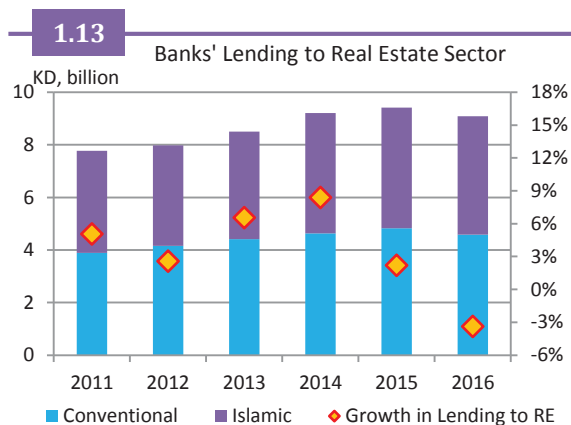
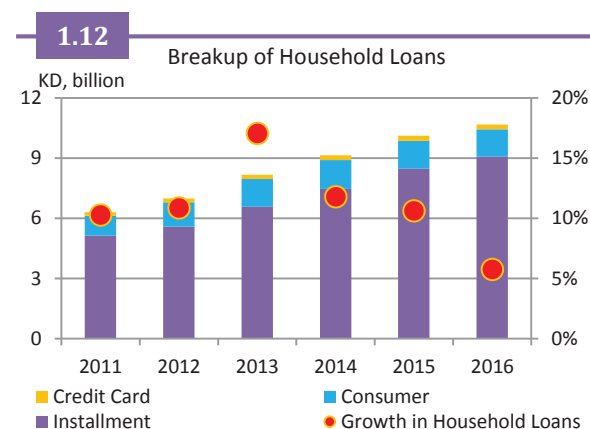
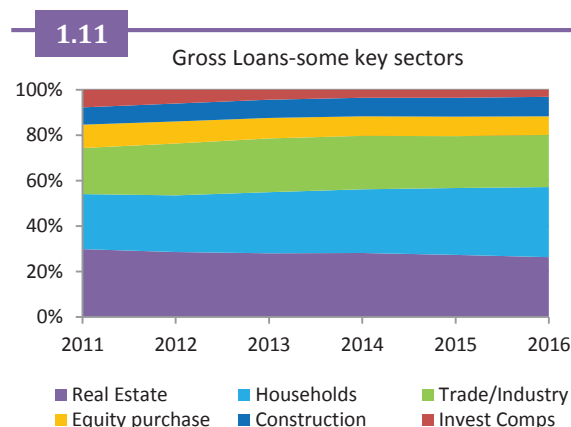
Notwithstanding the above-mentioned shifts, the broader trend in loans over the years reveals that banks' collective exposure to key sectors have remained largely stable, with little indication of a sudden surge in any specific sector (*Figure 1.11*). A relatively stable trend in credit allocation suggests 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.

...with increasing exposure to households and declining to RE

Banks' credit to the households grew by 5.8% in 2016 to reach KD 10.7 billion, making household sector the top recipient of bank credit in Kuwait followed by the real estate sector (KD 9.1 billion). However, the growth in household credit in 2016 was much slower compared to the earlier five years of double-digit expansion (*Figure 1.12*).

Breakup of household loans reveals that around 84.9% 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 12.6% share as of December 2016. Finally, credit card related loans made around 2.5% of overall household loans.

Banks' lending to the real estate sector contracted (by 3.4%) in 2016 for the first time in almost a decade amid a noticeable softening of real estate market in Kuwait (*Figure 1.13*). As a result, share of the real estate loans in banks' overall credit portfolio marginally declined from 21.5% to 20.6% during 2016. Both conventional and Islamic banks had somewhat similar size of exposure to the real estate,



with conventional banks' accounting for a tad higher share (50.5%) in 2016.

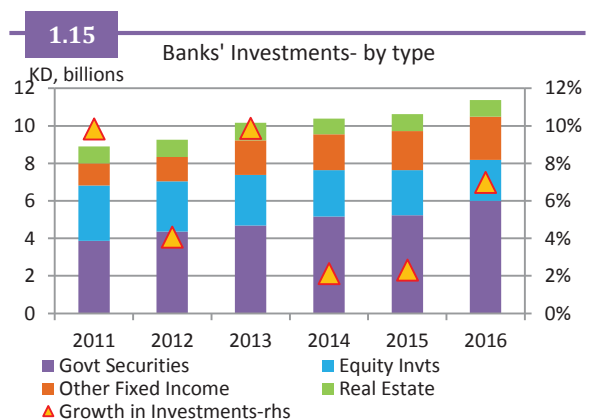
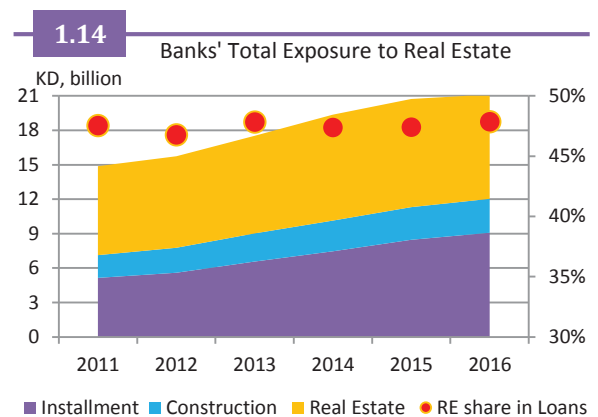
Given the fact that bulk of the household loans are being used for repair and purchase of private homes, banks' overall exposure to the real estate is significantly greater than what appears from their direct lending of KD 9.1 billion. Banks' combined exposure to the real estate can be viewed in terms 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 1.14*).

However, 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% and 3.2% respectively in 2016), indicating limited degree of infection (*see Chapter 2*). Additionally, as highlighted in Chapter 4, though the real estate market sales has markedly slowed down in terms of sales values, decline in the real estate prices have been relatively more moderate, suggesting the presence of genuine demand in the market, notwithstanding the element of speculation which somewhat correlates with oil prices.

Banks' equity investments retreated amid falling stock prices

Banks' investment portfolio posted a healthy growth of 7% in 2016 compared to 2.3% in 2015, in particular because of the rise in sovereign debt issuance (*Figure 1.15*). Investments' breakdown reveals that out of KD 11.4 billion of total investments, around KD 6 billion (52.7%) were placed in government securities as of December 2016.

In the last few years, banks' exposure to other fixed income securities has also been on the rise; its share reached 20.3% on the back of 11% increase during



2016, representing the second highest component of total investments. Banks' equity investments formed the third major category with 19.2% share in total investments. On the other hand, banks' *investments in associates* recorded a major contraction (down 9.3%) in 2016.

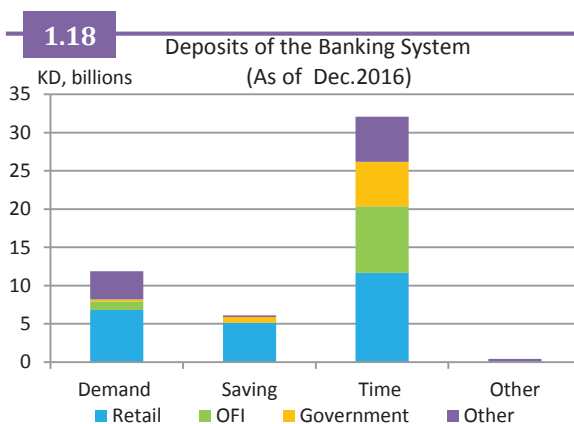
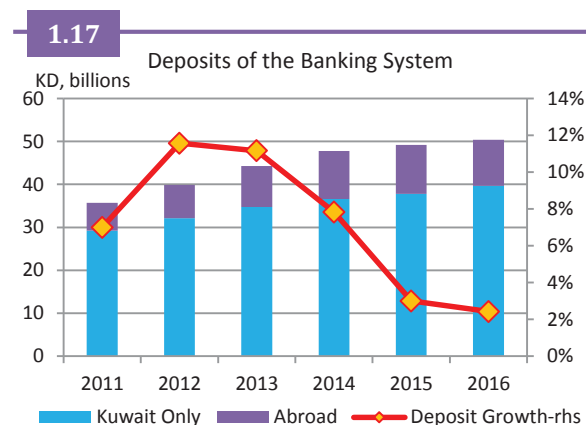
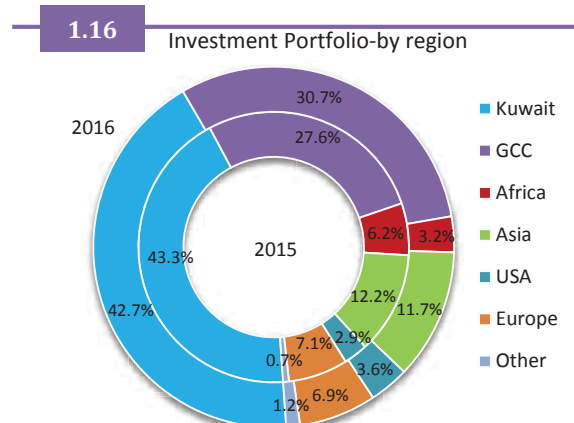
Geographical distribution indicates that banks' investments within Kuwait marginally declined from 43.3% in 2015 to 42.7% in 2016. Moreover, banks' investments in Africa almost halved while those in Asia and Europe were also down in terms of their share in total investments. On the other hand, banks' exposure to GCC and USA witnessed an expansion (*Figure 1.16*). These trends collectively underscore the improving quality and diversification of banks' investment portfolios as banks have reduced exposures to riskier markets.

Growth in deposits markedly declined

During 2016, banking system deposits posted slower growth of 2.4%, on the back of similar growth (3%) a year earlier (*Figure 1.17*). While domestic deposits witnessed 4.8% growth, overall growth in deposits was held back by the decline in deposits (of 5.6%) raised through subsidiaries and branches abroad. Overall, deposits reached KD 50.4⁵ billion as of December 2016, with domestic deposits accounting for 78.6% of total deposits of the consolidated banking system. Amid the contraction in deposits from abroad, the share of such deposits marginally came down from 23.2% in 2015 to 21.4% in 2016.

Around two-thirds of banks' deposits are time deposits

Breakdown of deposits reveals that time deposits account for around 63.6% of the total deposits, highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress (*Figure 1.18*). Retail deposits are well diversified into three different categories (demand, saving and time), in line with the consumers'



⁵ This includes government and private deposits as well as 'due to other financial institutions'.

transaction and precautionary demands for money. Finally, the deposits of other financial institutions (OFI) and government are overwhelmingly placed as time deposits which further adds to the stability of banks' funding base.

Funding Sustainable Development Goals⁶

Excellencies, Distinguished guests, Ladies and Gentlemen,

Assalam-o-Alaikum! *Sababal-khair* and a very good morning.

I am very delighted to be here today. At the outset, I would like to convey my sincere appreciation for the commendable vision and leadership of H.H. Sheikh Mohammed bin Rashid Al Maktoum.

I am also thankful to H.E. Mr. Abdullah Al-Qarqawi for inviting me to speak before this august gathering. And I want to congratulate Dubai Chambers of Commerce for organizing this conference of great significance and for their laudable efforts to promote Islamic economic system.

It is particularly heartening to see the desirable broader context of the conference, ranging from the role of philanthropy to innovations and Islamic finance to halal industry. This all-encompassing nature of the conference reflects the true essence of an Islamic economic system that permeates into all areas of our lives; indeed, restricting it to a few segments would be defying its ubiquity.

This session is centered on the topic of ‘Funding for the Sustainable Development Goals (SDGs) through Blended Finance’. When I first received the invitation for this thought-provoking topic, I asked myself: Is funding a challenge for SDGs, particularly when the world is seemingly awash with liquidity? And if it is, is it the very nature of SDGs which makes availability of funding difficult or is it just the scale of these ambitious goals that poses a challenge? And more critically, how best to address this funding issue? Should we fix the gaps in existing stream of financial flows or promote an economic system that shares the same philosophy underpinned by SDGs. Today, I will try to offer my perspective on these questions.

SDGs and the funding challenge

To recollect, at the start of this millennium, world leaders agreed to fight poverty in its many dimensions. This overarching vision was translated into United Nations’ 8 Millennium Development Goals. Concerted and collaborative efforts on the global level helped lift more than a billion people out of extreme poverty, along with improving health and education and promoting human development in general. Encouraged by the success of MDGs, a new set of Sustainable Development Goals were launched in September last year, setting the global development priorities and aspirations for 2030. The proposed 17 SDGs are far more ambitious and holistic than their predecessors as they embrace the notion that development needs to be

⁶Keynote Speech delivered by H.E. Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait at the Global Islamic Economy Summit, 11th October, 2016, Dubai, UAE.

economically, socially and environmentally stable. While truly noble in objectives, these goals would remain unaccomplished unless we secure sufficient funding.

But one might ask: should funding really be a problem when there is ample global liquidity available? After years of ultra-loose monetary policies pursued by major central banks around the world, yields on bonds are at historically low levels, compelling global investors to desperately hunt for yield. Assets of the top 1,000 global banks alone are around \$115 trillion, many of them facing a serious squeeze in their profit margins amid virtually zero if not negative interest rates.

Thus looking at the potential amount of funding globally available, one might think that funding is not necessarily a binding constraint to achieve SDGs. However, reality is quite different, as generating sufficient funds for SDGs remains a major challenge. And this issue has both quantitative and qualitative dimensions.

First, let us consider the quantitative side. The sheer scale of required funding is substantial due to the all-encompassing nature of SDGs. By some estimates, around \$3.5 to 5 trillion is needed every year to make desirable progress on SDGs. To put this into perspective, global sovereign wealth funds collectively hold around \$7.4 trillion of assets. So even if this entire amount is allocated for SDGs, it would barely fulfil the funding needs for two years. Or consider the scope of generating funds through Shariah-compliant modes; Islamic finance industry, despite its impressive growth in recent years, collectively accounts for just over \$2 trillion, even after including the *sukuk* market. These numbers highlight a yawning gap between available and required funding for SDGs.

Second and more critical aspect of funding is qualitative in nature. Irrespective of the amount of funding globally available, major part of it cannot be readily channeled for SDGs, given their nature of a 'public good'. Because most of the SDGs aim to make sustainable progress in social, economic and environmental aspects of our societies, these projects may not be initially profitable enough to lure in private finance. Moreover, societies that need such investments the most may be too poor to pay the market price. And for many of the less developed and low income countries, to tap the global market for raising funds remains a serious challenge due to their poor creditworthiness.

Therefore, the role of governments in helping meet the funding needs, at least at the earlier stages, remains critical to help crowd in private sector investments. Yet the limited fiscal space available to most of the governments, given expenditure rigidities, leaves little room for maneuvering, especially in the absence of accompanying structural reforms.

Achieving SDGs in an Islamic economic system

Under these circumstances, answering the question of how to fund SDGs would probably be too narrow a focus. I believe we need to think about a financial --- rather an economic system that is naturally aligned with the key themes of SDGs.

The role of Islamic economic system deserves serious deliberations, given its genuine concern both for the people and the planet. Let me briefly highlight a few points of relevance here.

First, Islamic economic system promotes allocation of resources for the welfare of the entire society. By establishing an inseparable link between finance and the real economy, it encourages economic risk taking that helps improve growth and create jobs. Under such a system, credit must be channeled for productive investments, not for conspicuous consumption or speculative activities. And it necessitates the sharing of profits and losses, which are critical for ensuring justice and reducing income inequalities.

As we have observed even in recent years, deviation from these principles have resulted in financial meltdowns, with catastrophic social and economic costs. Even amid substantial monetary support, we have seen *too much financial risk-taking* but *too little economic risk-taking*, the kind which the world direly needs to create jobs and lift growth.

Second, the value-driven nature of an Islamic economic system requires individuals to be as considerate about the needs of their fellow human beings as they are for themselves. As Prophet Muhammad (peace be upon him) said: *أَجِبْ لِلنَّاسِ مَا تُحِبُّ لِنَفْسِكَ* 'Wish for mankind that what you wish for yourself.' This is the 'golden rule' of a good society where individuals' actions are aligned with the collective benefits of the entire humanity. And by extension, it promotes values where anything harmful for the society is prohibited, even if it is beneficial for an individual.

This ethical approach to economic activities is particularly relevant in the case of SDGs where significant progress can be made by limiting, if not completely eliminating, the way our consumption and production patterns seriously damage our environment and pollute our societies. As Quran commands us, *كُلُوا وَاشْرَبُوا وَلَا تُسْرِفُوا إِنَّهُ لَا يُحِبُّ الْمُسْرِفِينَ* 'Eat and drink: But waste not by excess, for Allah loves not the wasters'. In fact, Prophet (peace be upon him) have urged us not to waste water even if we are on the banks of a flowing river.

Unsurprisingly, this concern for nature's precious resources resonates well with the modern world's emphasis on sustainability. For instance, United Nations have viewed sustainable development in a similar fashion by arguing that development is sustainable when it *'meets the needs of the present without compromising the ability of future generations to meet their own needs'*. Likewise, investors around the globe are now adopting sustainable, responsible and impact (SRI) investing strategies.

This discussion, while broader in context, makes it obvious that the Islamic economic system promotes values that are universal, irrespective of our religious beliefs. As Sheikh Mohammed bin Rashid Al Maktoum said in his speech at this conference last year, *'Islamic economy is not merely a tool for producing commodities and growing wealth; it is an incubator of values and ethics that elevate and advance human beings'*.

In addition to the broader similarities, key principles of Islamic economic system are directly related to a number of specific SDGs. For instance, Islamic conjunctions on profit and loss

sharing finance can help address injustice and reduce inequalities aimed under SDG 10. Likewise, Islamic prohibition of harmful activities aims to promote peace in societies, a key aspect of SDG 16.

Similarly, Islamic financial instruments such as Sukuk can be used to mobilize resources to finance water and sanitation projects (SDG-6), sustainable and affordable energy (SDG-7), build resilient infrastructure (SDG-9) and provide shelter (SDG-11). And the focus of Islamic finance on real economic activity can help foster growth and generate employment, well in sync with SDG-8.

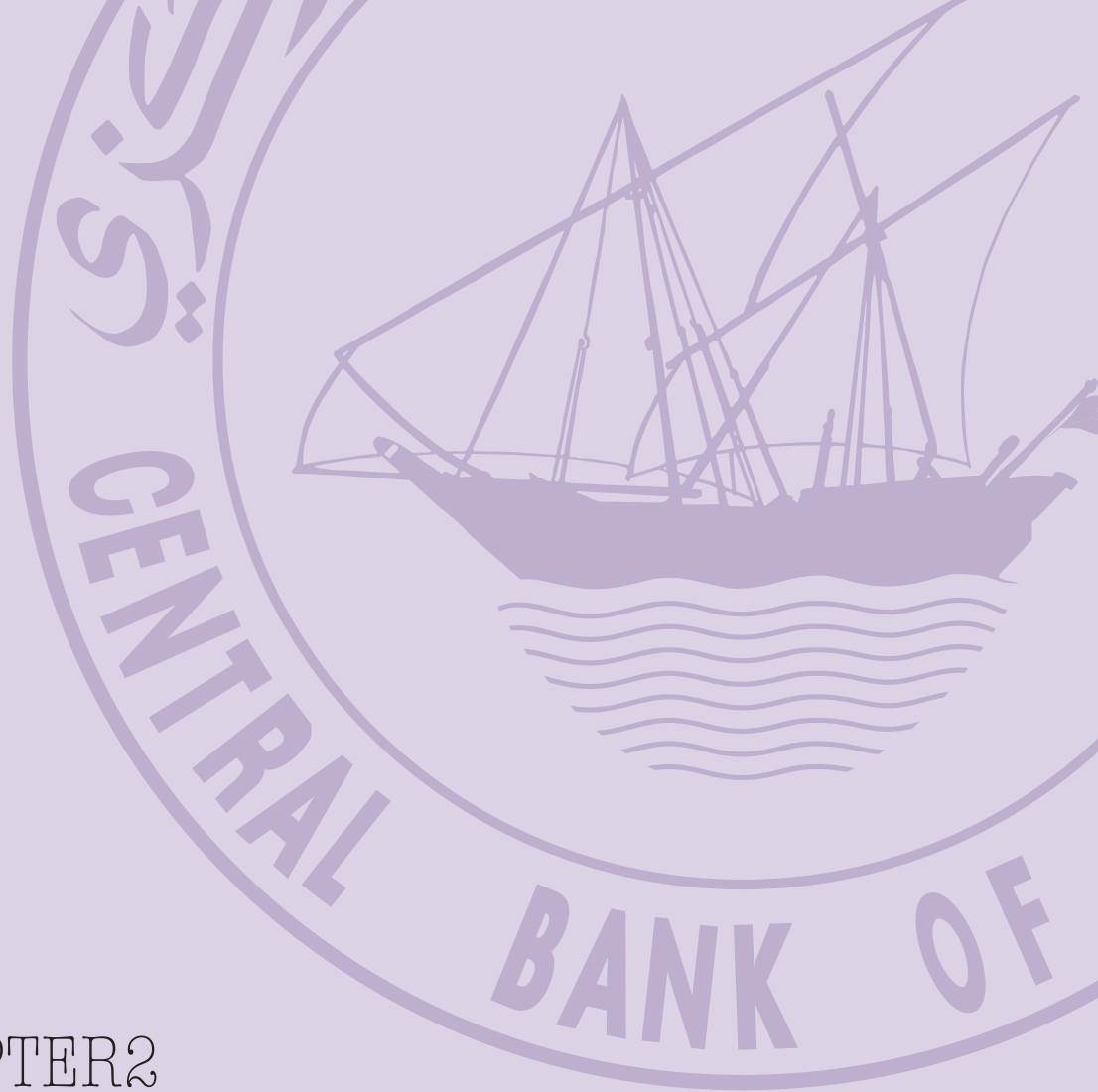
Last but not least, Islamic philanthropy programs or re-distributive instruments such as *zakat* (alms), *sadaqah* (charity) and *awqaf* (religious endowments) can play a vital role in alleviating poverty (SDG-1), eliminating hunger (SDG-2), improving health (SDG-3) and reducing inequalities (SDG-10). Admittedly, it would require a paradigm shift in our mind set to treat these instruments not merely as part of a ritual but as a strategic tool for sustainable development. Moreover, governments would need to gain public trust and enhance their capacity to efficiently collect and effectively redistribute these funds –not just for short-term consumption support but for long-term capacity building with a lasting impact on our societies.

Conclusion

To conclude, this discussion makes it evident that Islamic economic system, once implemented in its true spirit, could greatly facilitate the achievement of SDGs. Understandably, the challenge is to shift our focus from a *Shariah compliant* to a *Shariah based* model of finance where Islamic banks do not merely mimic the conventional system. That would require collective efforts on the part of governments, legislators, regulators, practitioners, and academics to help create a conducive environment where Islamic economic system can flourish -- which in turn would help achieve the broader socio-economic development in a sustainable manner. While it is indeed a daunting task, but as Einstein once put it, ‘in the middle of difficulty lies opportunity’. Pursuit of SDGs may offer this opportunity for Islamic economy to realize its ultimate potential.

I look forward to hear the valuable views of our distinguished panelists as only by capitalizing on our collective wisdom can we offer solutions to these pressing issues.

Thank you for your attention.



CHAPTER 2

BANKS' RISK ASSESSMENT

2019

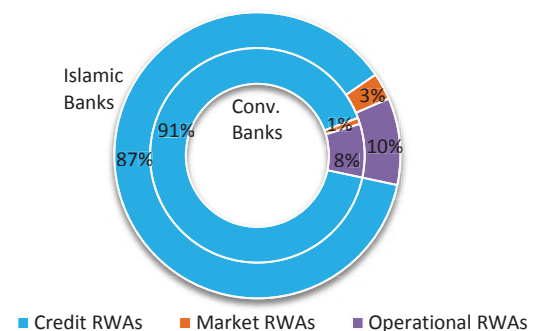
Asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has further dropped to a historically low level of 2.2% (1.8% on domestic, Kuwait- only basis) as of December 2016, 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 evident if the existing NPLR (2.2%) is compared with the double-digit NPLR (11.5%) observed in 2009. Going forward, we do expect some NPL formation, though at a slower pace and from a low base, as NPLR in certain segments has already bottomed out. Still, the coverage ratio (available provisions to NPLs) remains robust at 237% (316 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. Sectoral analysis of NPLs indicates that the decline in NPLR has been somewhat broad based with some of the key sectors experiencing a contraction in their respective NPLRs. One noticeable exception was the real estate and construction sector, which posted an increase in NPLR (reaching 3.2% as of December 2016), in part due to lower gross credit extended to the real estate sector. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased, similar to that from the domestic operations. Industry breakdown reveals that conventional banks account for 59.4% of total NPLs, almost in sync with their share in gross loans (59%). Banks' exposure to the equity markets, though still significant, has been on a steadily declining trend; equity investments make up around 19.2% of banks' total investments, and use of firms' shares as collaterals accounts for 19.1% of banks' overall collaterals. Finally, banks' liquidity levels have remained healthy. Newly introduced liquidity coverage ratio 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. Positively, banks' funding structure has improved further, with increasing reliance on time deposits and diminishing role of non-core liabilities.

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 2016 (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.

2.1

Distribution of Risk Weighted Assets (RWAs)



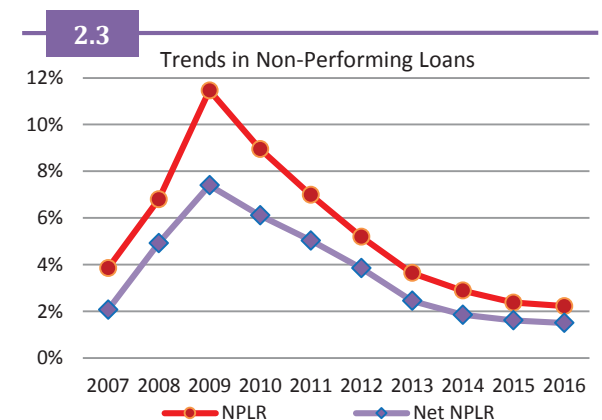
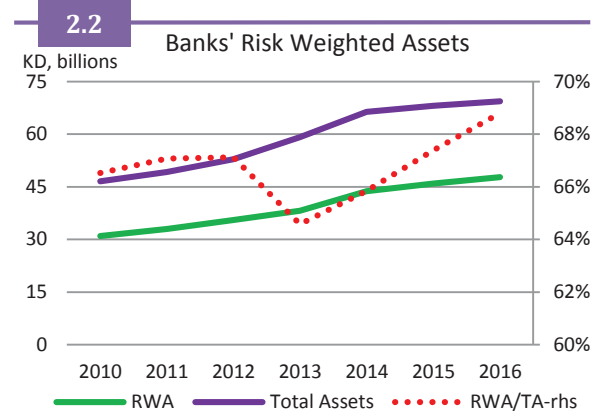
The insignificant contribution of market risk in overall RWAs is in part because of banks' relatively smaller trading portfolios. Moreover, calculation of RWAs under Basel III excludes interest rate risk in the banking book for Pillar-1 capital charge.

During 2016, overall RWA increased by 4%, at a relatively slower pace than the 5% growth recorded in 2015. It was essentially because the growth in assets also markedly slowed down (to 1.8%) during 2016. Still the ratio of RWA to total assets inched up to 68.8% in 2016 from 67.4% 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 has steadily declined for the seventh 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 with the industry.

During 2016, the NPL ratio (NPLR) edged further down to 2.2%, 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 visibly tapered as most of the credit portfolio is already performing and the scope for any major improvement is quite limited. In fact, NPLR in some key segments has already bottomed out. Net NPLR has also been on a receding trend since 2009 and has reached a historically low level of 1.5% in 2016 due to lower NPLs in absolute terms.



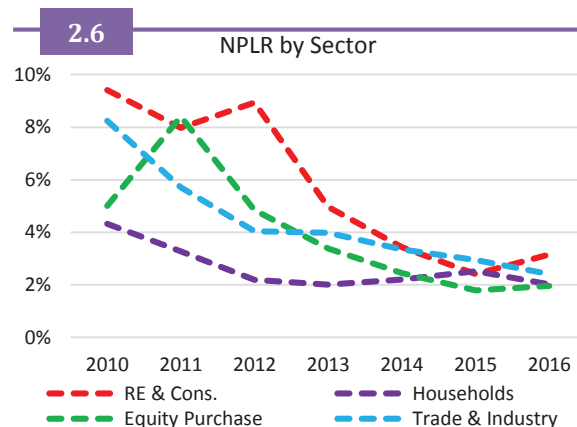
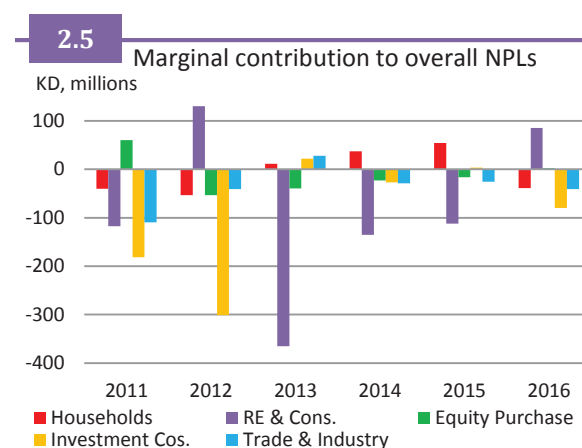
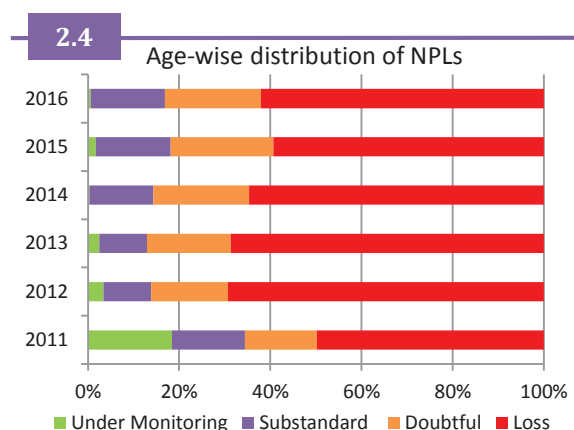
NPLs' classification by age profile indicates that the buildup of new NPLs has actually slowed down compared to 2015, as the combined share of first three categories ('under monitoring', 'substandard' and 'doubtful') has somewhat declined (Figure 2.4). Going forward, some NPL formation is not unlikely, albeit from a low base and at a slower pace, given the potential lagged effect of low-oil price environment on banks' asset quality.

Sector-wise, decline in NPLs has been mixed

Data for the marginal contribution of different sectors in the industry-wide NPLs reveals that contraction in infected loans has been somewhat broad-based, albeit with some noticeable exceptions. Key sectors have posted a decline in NPLs during 2016 except for the *real estate and construction sector* which witnessed an increase in NPLs after three consecutive years of a decline trend (Figure 2.5). Even in terms of magnitude, the addition in real estate and construction NPLs was the most significant since 2012. On the positive side, NPLs to *investment cos.* posted a major contraction, followed by *trade and industry* and *households* segments.

Sector-wise NPLRs reflect a converging trend in the infection ratio, though with some obvious differences across sectors. (Figure 2.6). For instance, NPLR for the *households* sector has come down from 2.5% in 2015 to 2% in 2016. Likewise, the NPLR for *trade and industry* segment has also declined from 2.9% to 2.4% during the same period.

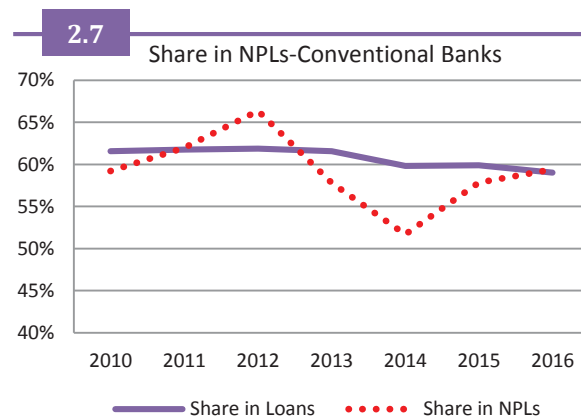
The improvement in NPLR of *household* segment is in part due to a steady increase in the share of household sector in banks' gross loans, from 18.6% in 2010 to 24.2% in 2016. Moreover, infection level in the category of *installment loans*, which represent 85% of gross household loans, has also remained well contained, with NPLR of 1.8%. 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 exposures⁷.

Real Estate & Construction segment has bucked the declining trend in overall infection ratio as its NPLR posted a noticeable increase, from 2.4% in 2015 to 3.2% in 2016. With the softening of the real estate market during the last two years (see Chapter 4 for details), some deterioration in the asset quality was expected. Moreover, part of the increase in NPLR is also because of lower amount of absolute credit extended to this segment; in fact, this is the first time in the last eight years that credit to *real estate and construction* contracted (by 1.7% in 2016) as banks, noticing the slower real estate market, has reduced their exposures. On its part, CBK's proactive introduction of appropriate macroprudential regulations (in November 2013) helped 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). Similar to the trend in *real estate and construction*, NPLR for *equity purchase loans (EPLs)* has also inched up, from 1.8% in 2015 to 2% in 2016 as domestic stock market remained under pressure during the early part of 2016.

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 2016, conventional banks' contribution to industry NPLs inched up to 59.4%, in close sync with their share in gross loans (59%). However, such broad classifications across types of banks could be influenced by the performance of one major bank within that group. For instance, the top four banks account for 69.1% of the total loan



⁷ 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.

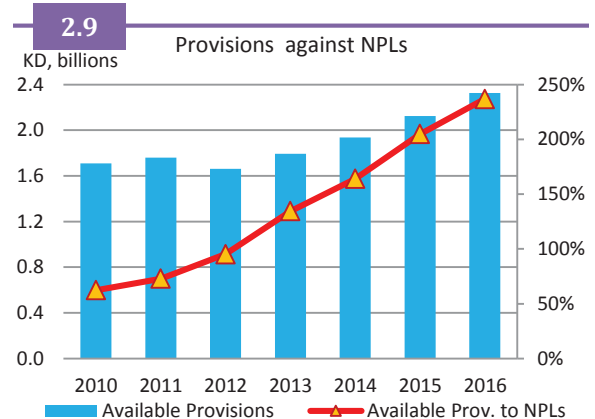
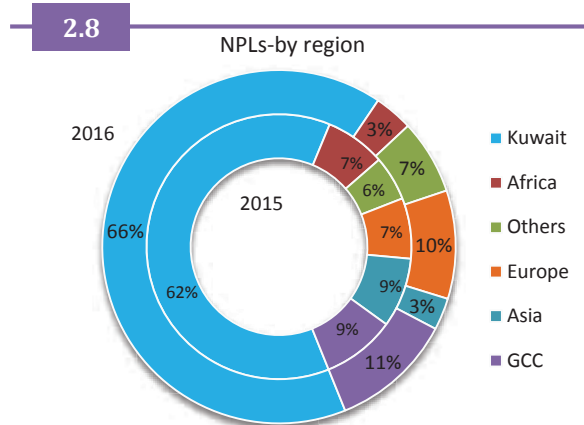
portfolio of the banking industry; thus, a sharp change in the quality of credit portfolio in even one of those banks can significantly alter the industry averages.

Geographical distribution of NPLs highlights that the share of domestic NPLs has increased over the last year, accounting for 66% of the total NPLs in 2016 (Figure 2.8). While the domestic operating environment has been relatively supportive on back of continued public spending, slower real estate market has resulted in somewhat higher NPLs. Outside Kuwait, the contribution towards non-performing loans from the GCC and Europe has inched up while that from Africa and Asia has significantly come down.

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 quality of their credit portfolios. During 2016, total available provisions grew by a healthy 9.5%, on the back of 9.8% growth observed in 2015. As a result, *available provisions to NPL ratio* reached 237%, an all-time high in the nine years, and substantially greater than the pre-crisis ratio of 87% (Figure 2.9). Both higher provisions and lower overall NPLs in absolute terms helped pushed the ratio to a historically high level in 2016, providing banks a strong enough cushion in times of stress.

The breakdown of available provisions reveals that precautionary provisions have been on rise in particular, posting a double digit growth during the last few years. 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 their build-up was initiated in relatively benign times.



Market risk remains the smallest component in overall RWAs

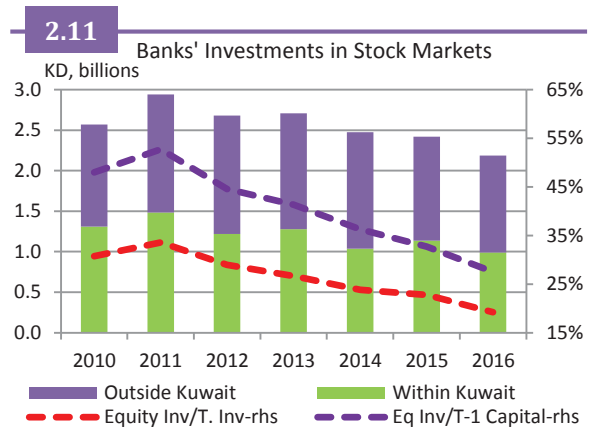
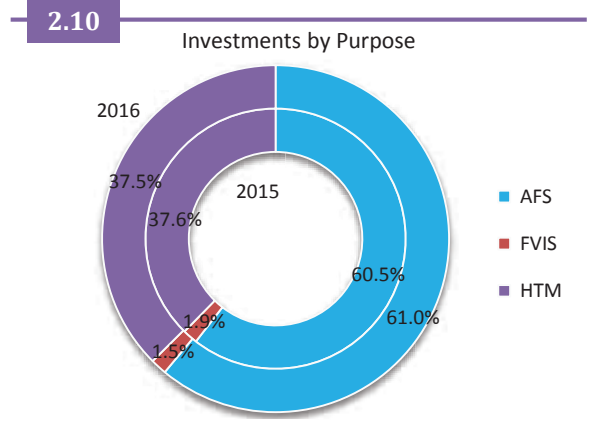
Given the traditional nature of Kuwaiti banks' operations, market risk remains a fairly small component of the overall RWAs, accounting for a meager 1.6% as of December 2016. The bulk of the banks' investments (around 73% as of December 2016) are in fixed income instruments, out of which around 72% are 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.

Banks' exposure to stock markets has been steadily declining

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 19.2% of their total investments by end of 2016 (*Figure 2.11*). While still significant, the share of equity investments has dropped from a higher level of 33.6% back in 2011. When viewed in terms of banks' Tier-1 capital, banks' equity investments were around 28%, at the lowest level in the last seven years. These numbers suggest that while volatility in equity prices can affect banks' investment portfolios, their exposure to stock markets

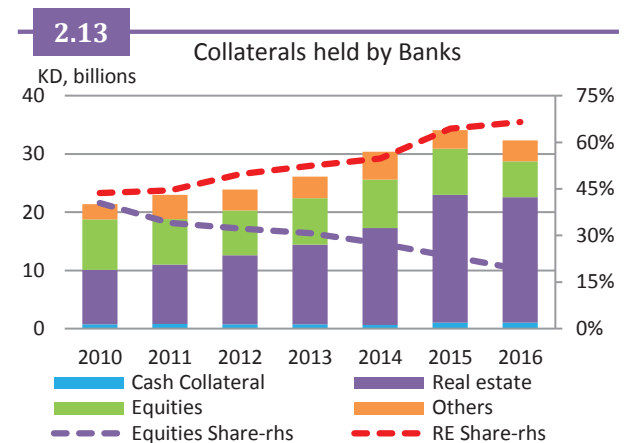
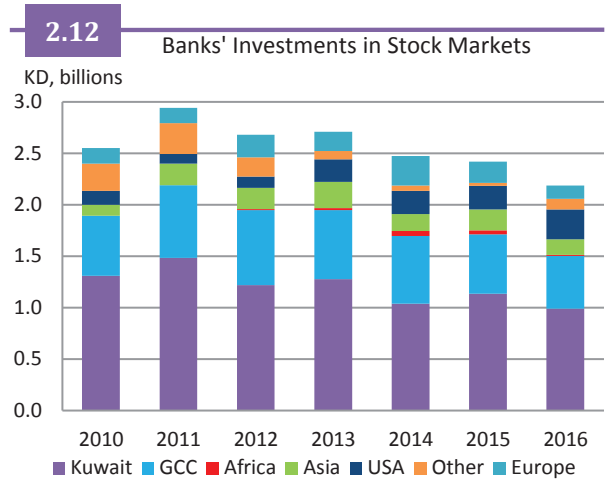


have markedly come down. Poor stock market performance, particularly during the earlier part of 2016, has also played its part in dampening banks' appetite for such exposures. In the case of some banks, higher equity investments are the result of debt for equity swaps made in earlier years with their clients in the investment sector.

During 2016, banks' overall equity exposure has declined in absolute terms. In particular, their exposure to Kuwait's equity market came down from 47% to 45.2% of their total investments in stock markets during 2016 (Figure 2.12). On the other hand, banks' exposure to US markets have increased from 9.4% to 13.3% during the same period. With around 54.8% of banks' equity investments distributed across GCC, Asia, Africa, Europe and USA 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 19.1% 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 66.6% in 2016 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 6.4% of



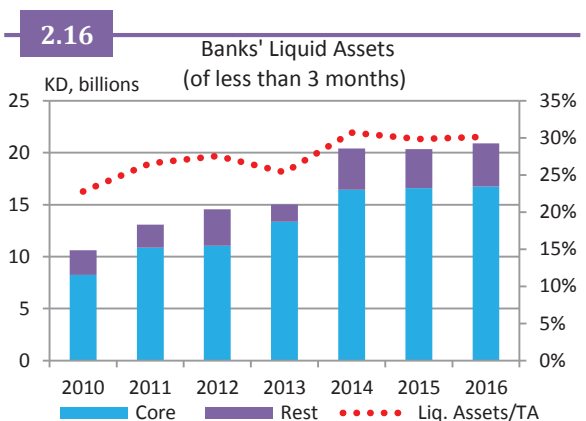
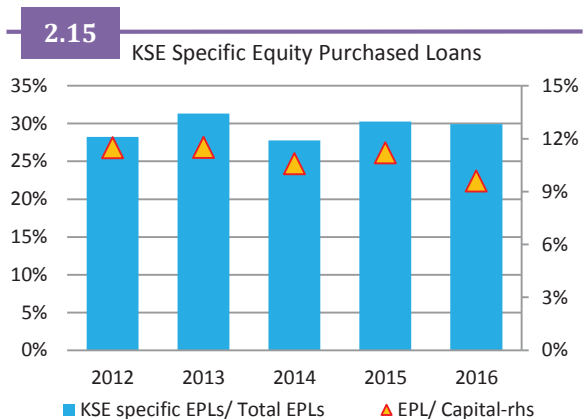
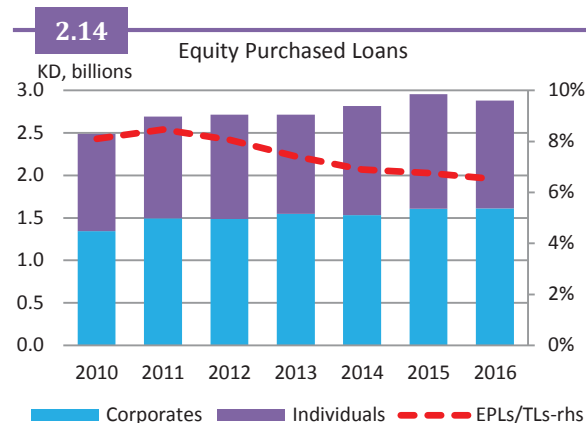
banks gross loan portfolio. The breakdown of these loans reveals that corporate sector has slightly higher share (54.4% in 2015) compared to individuals availing such facilities (Figure 2.14).

With around 6.4% 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 2% in December 2016, 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 2.6% in 2016 while *equity purchase loans to capital* stood at 9.6% in 2016, same as observed in 2015 (Figure 2.15).

Banks' liquidity level remains healthy

Banks liquid assets of less than three months tenor have marginally increased from KD 20.3 billion in 2015 to reach KD 20.9 billion in 2016 (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 80.1% of the overall liquid assets in 2016. Moreover, as a component of total assets, core and liquid assets accounted for 24.1% and 30.1% respectively as of December 2016. Collectively, banks' liquid assets have posted a marginal improvement of 3% during 2016.

Banks' healthy liquidity level is also evident from their Liquidity Coverage Ratio⁸ (LCR); while CBK has



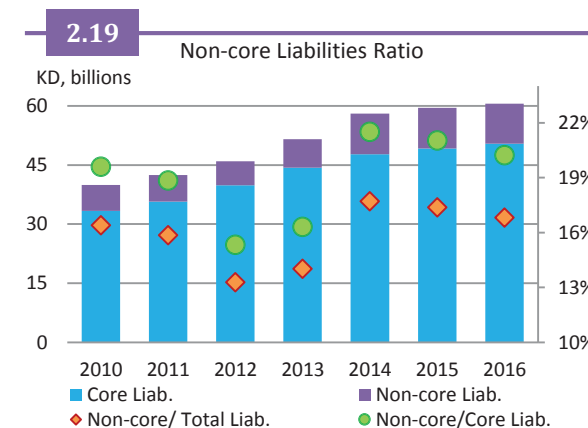
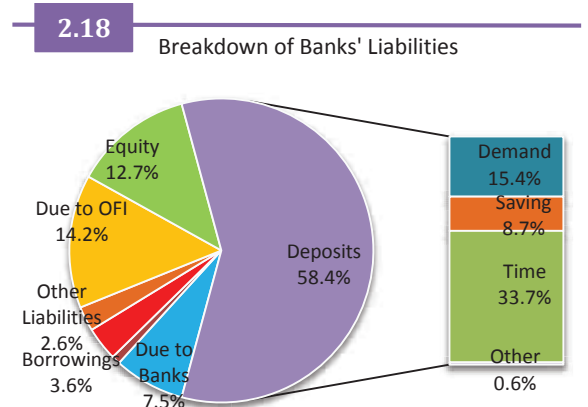
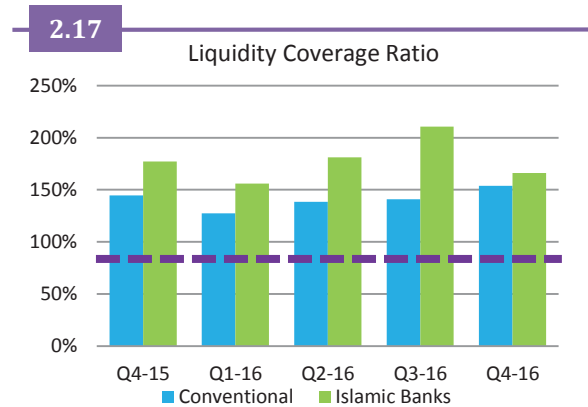
⁸ CBK issued instructions about LCR in December 2014, requiring banks to report their LCR positions starting from 2015 for monitoring purpose. As a result, data is only available from 2015 onwards.

been monitoring the LCR during 2015, the regulation has

been phased in from 2016 at 70% and will be gradually increased to reach 100% by 2019. As evident from the data available for 2016, both conventional and Islamic banks have been well above the 70% benchmark for 2016 or even 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 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 in FSR-2015).

Breakdown of banks' liability structure reveals that deposits account for the bulk of their funding base (58.4%), though marginally lower when compared to 59.2% in 2015 (Figure 2.18). Within deposits, time deposits represent around 41% of the overall funding base and around 57.7% 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.

Banks' funding structure is largely reliant on stable deposits; positively, the share of non-core liabilities (essentially interbank borrowings) has posted a decline during the last two years after exhibiting an increase during 2012-14 (Figure 2.19). Given the volatile nature of wholesale funding, declining contribution of non-core liabilities to support the asset growth is likely to help reduce banks' funding liquidity risk.



Ensuring Stability in Turbulent Times⁹

Your Excellencies, Distinguished Guests,
Sabah-al-khair and a very good morning.

I am very delighted to be here today, and I am grateful to H.E. Dr. Abdulrahman A. Al Hamidy for inviting me to speak before this august gathering. Thanks to the active collaboration of the Basel Committee on Banking Supervision, Financial Stability Institute, and the Arab Monetary Fund, these high-level meetings provide a valuable forum for exchange of views, for the regulators and supervisors in the region.

The agenda of this conference adequately captures key developments, issues and challenges that we need to focus our attention on. Today, I would like to touch upon two major forces that have swept across the financial world. First is the tech-driven revolution, which has brought its own set of risks and rewards. Second is the wide range of measures that have been introduced to strengthen the resilience of our banking systems.

Let me start with the innovations first.

Innovation; opportunities and risks

Tech-driven innovations have unleashed drastic changes in the way we conduct business, interact with each other, or consume various products and services. Financial sector, essentially an ‘information industry’, is experiencing a major transformation, fueled by advances in technology. Though the imprint of modern technologies is now ubiquitous, let me briefly highlight a few areas of finance, where the developments are particularly significant.

To start with, technology is supporting the outreach of formal financial services to the millions of otherwise unbanked customers. According to the World Bank, the poorest 20% of the world population is more likely to have access to a mobile phone, than to clean water and sanitation. Capitalizing on this opportunity, a number of countries have managed to swiftly expand access to finance in recent years. Globally, number of adults who were previously out of formal financial system has dropped by 20% during 2011-14 alone. As these encouraging trends suggest, digitalization offers an unprecedented opportunity to improve access to finance to the millions of people who have remained financially excluded so far.

Likewise, programing breakthroughs like blockchain are potentially transforming the way we verify transactions and enforce contracts. By allowing parties to transact without central intermediaries, blockchain can strip off costs, reduce inefficiencies, and enhance customer

⁹ Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait in the 12th High Level Meeting for the Middle East & North Africa Region, jointly organized by the Basel Committee on Banking Supervision, the Financial Stability Institute and the Arab Monetary Fund, held on December 7, 2016 in Abu Dhabi, UAE.

services.

Most of other innovations are reshaping the way we transfer money or obtain credit. For instance, mobile wallets are enabling payments by smart phones, peer-to-peer lending is providing new sources of financing, and robo-advisors are offering financial advice. While undoubtedly exciting, these developments bring in their own unique risks and challenges.

I would like to flag a few of them, particularly from the standpoint of financial stability.

First, cyber security risk is becoming an increasingly major part of banks' operational risk landscape. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely and on a massive scale. Though such occurrences are still uncommon, the impact is substantial, given the high degree of interconnectivity of our systems and markets.

Second, fintechs are unbundling parts of the finance value chain, offering financial services directly to customers. Apart from increasing competition, and squeezing banks' profits, fintechs are moving part of the banking business to shadow banking which remains lightly regulated, if at all. Likewise, tech-enabled peer-to-peer lending and crowdfunding can further expand the scale of shadow banking, and may also exacerbate procyclicality.

As this discussion indicates, innovations are by nature a disruptive force, causing a considerable degree of instability. Therefore, regulators face a daunting task of keeping financial systems safe and stable, while continuing to ensure the convenience and efficiency that modern technologies offer.

To ensure that, we must strengthen our own capacity to identify, monitor and mitigate the risks from technological innovations. This would require closer cooperation with the banking industry as well as among regulators, both within a country and across the borders. Yet that is not enough; we also need to leave our comfort zones and engage with other stakeholders, primarily the tech firms themselves.

Ultimately, as regulators, we wish neither to stifle innovation nor to undermine financial stability – and it is indeed a very delicate balance to achieve. Similar to when navigating unfamiliar domains, we need to remain agile, adaptive, and proactive – this will ensure reaping the enormous benefits of financial innovations, yet limiting their downside.

Let me now turn to the second part of my speech.

Regulatory reforms; costly but essential

Banking regulation has been another major area witnessing far-reaching reforms. Driven by the experience of global financial crisis, banking regulation, under the able leadership of the Basel Committee, has witnessed a major overhaul. Strenuous efforts have been made to improve resilience of banking systems across the globe.

These measures are vitally important, given the increasing uncertainty of when or where the next shock would emanate from. Consider the stress that financial markets had to face in recent years.

In 2013, it was the US taper tantrum, in 2014 it was the collapse in oil prices, in 2015 it was rebalancing in China, and this year it was Brexit, just to quote a few examples. These events were markedly different in geographical origin and root causes but were common in rattling the global markets.

Against this backdrop, ensuring a resilient banking system capable of withstanding a variety of shocks is no easy task. And these shocks are not only exogenous; the banking system itself is in a state of flux amid evolving risks, in part due to the very financial innovations I just talked about.

This call for continuously upgrading our regulatory regime. Accordingly, we in Kuwait, like our colleagues in the region, have not only refined our existing regulations to reflect the best global practices, but have also introduced a host of new measures.

The journey brought its own set of challenges, and I would like to point out one in particular, to benefit from the presence of our esteemed colleagues from the BIS. Similar to other jurisdictions with dual banking system, we have a sizeable presence of Islamic banks in Kuwait. Yet we found limited relevant guidance for the application of Basel III on Islamic financial institutions, if at all. For the most challenging aspects of Basel III reforms, it has been left to the discretion of individual regulators to figure out how best to apply the proposed rules to Islamic banks.

However, the use of discretion, though well intended, is bound to create differences across countries, and more so in the case of Islamic finance where the lack of consistency in *Shari`ah* interpretations makes the task even harder. Consequently, we may witness diverging approaches to regulation of Islamic banks across jurisdictions, with the risk of regulatory arbitrage.

Going forward, we also need to recognize that ensuring stability, of a constantly adapting banking system, cannot be left to regulation alone. Therefore, we need to strengthen our supervisory capacity to suitably complement our revamped regulatory regimes. Only through effective supervision can we ensure that banks are truly compliant with our regulations. Moreover, better supervisory oversight would also give us the agility to mitigate emerging risks before they materialize.

Having said that, it must be acknowledged that we can't regulate every aspect of the banking system. Ultimately, banks should assume prime responsibility for their actions and behaviors. Being dependent on public confidence, banks can ill afford to operate with weak corporate governance or poor risk culture. This necessitates that banks maintain robust corporate governance standards, duly supported by strong internal controls, and prudent risk management.

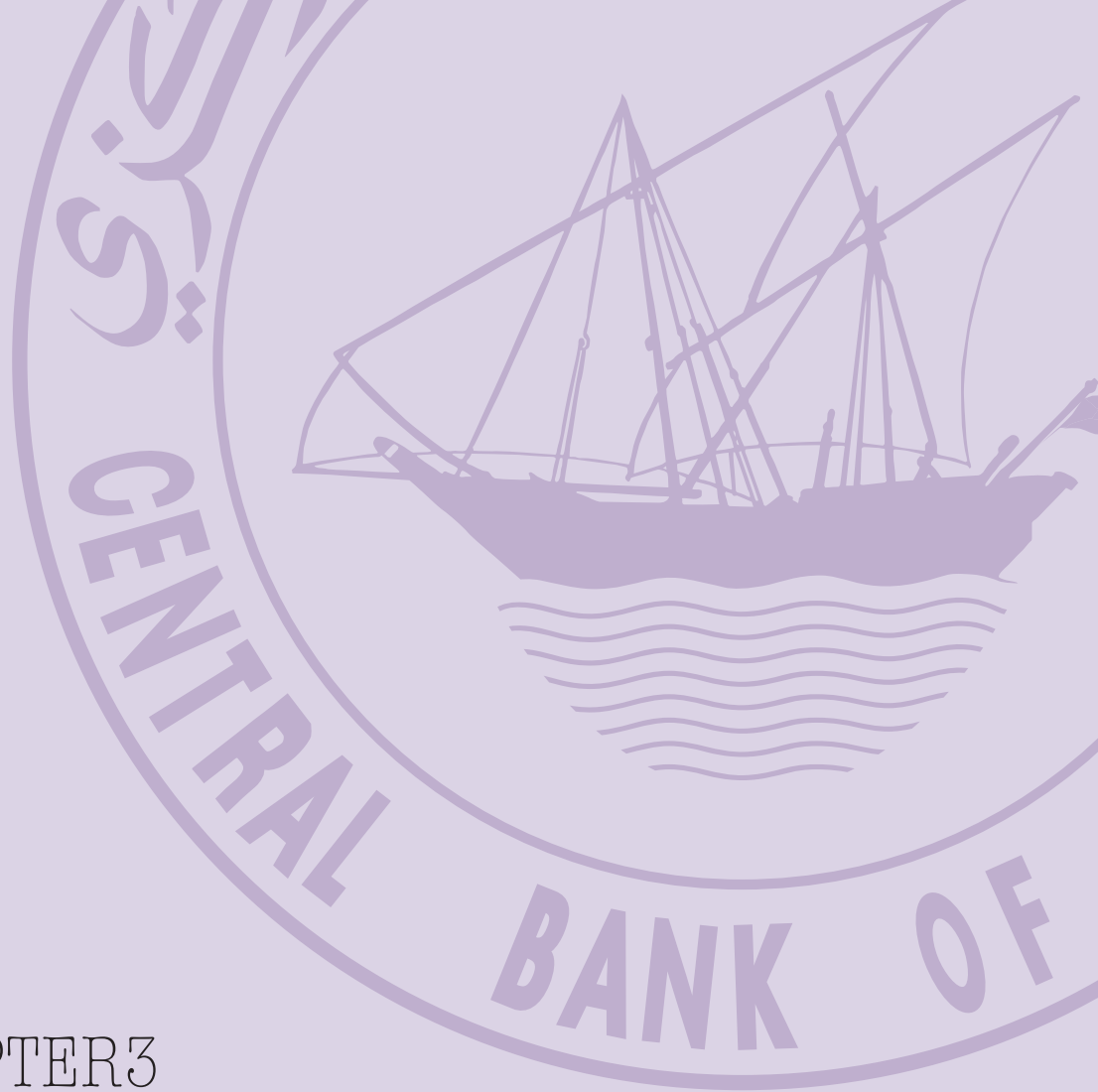
We are fully cognizant that these regulatory measures are costly for banks; nonetheless, costs of any financial crisis, both in financial and social terms, are far more substantial. Therefore, it is only wise and rational to strengthen the capacity of our banks in benign times. I believe our proactive approach has actually paid off, as banks in our region generally entered the low oil price environment from a position of strength.

Yet banks' resilience is not infinite and may come under severe pressure if necessary economic and structural reforms are dropped - or even delayed. Hence, we should not lose sight of the broader economic context in which our financial systems operates. After all, the banking sector is just a component of the overall economic landscape, though a very crucial one. While ensuring banking stability is critical, it is only a necessary condition for overall economic stability – and not a sufficient one.

Given the strong feedback loop between the overall economy and the financial sector, regulation can't be the 'only game in town' to maintain financial stability. Equally critical are economic and structural reforms that are essential for a stable macroeconomic environment where financial sector can flourish.

Towards that end, we, as the central bankers, must continue to provide sound policy advice to our governments, supporting them in better addressing the challenges that our economies face. It is because only broader economic stability would ensure financial soundness and cement the gains of our regulatory reforms.

Thank you for your attention.



CHAPTER 3

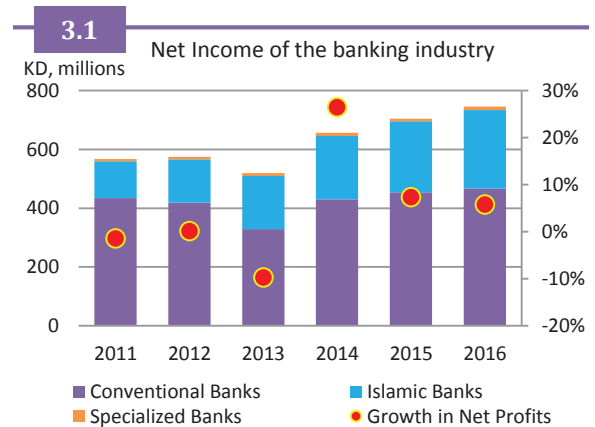
PROFITABILITY, SOLVENCY & RESILIENCE

2019

Banks' net income, on consolidated basis, grew by 5.8% in 2016, at a marginally slower pace compared to 7% growth recorded in 2015. Higher interest income, lower loan loss provision expense and lower non-interest expense collectively helped improve the industry's net income. Both return on assets as well as on equity inched up as growth in net income outpaced the growth in assets and equity. By banking groups, conventional banks accounted for 62.6% of the industry profits and 60.7% of the industry assets. Cost to income ratio slightly deteriorated because of conventional banks though they still, on average, remained more cost efficient than their Islamic counterparts. Capital adequacy ratio (CAR) of the banking sector further improved to reach 18.6%, well above the CBK's 13% requirement for 2016. Though the improvement in CAR was largely driven by conventional banks in 2016, Islamic banks continued to maintain capital adequacy ratios above their conventional counterparts, in part due to 50% alpha factor as well as the use of leased assets as risk mitigants. Banks' leverage ratio was 10.1%, well above 3% benchmark proposed by the Basel Committee, indicating banks' strong 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, was up by 5.8%

Profitability of Kuwaiti banks posted a healthy growth in 2016, albeit at a slightly slower pace when compared with a year earlier; banks' net income after tax¹⁰, on a consolidated basis, grew by 5.8% in 2016 to reach KD 745.8 million (Figure 3.1). Despite its marginally slower pace compared to 2015, 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 2011-13¹¹, a period marked by either almost flat or negative growth in net income. Higher interest income, lower loan loss provisions expense and lower non-interest expense collectively helped improve the net income of the banking industry.



¹⁰Based on profit share of banks' shareholders.

¹¹In 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.

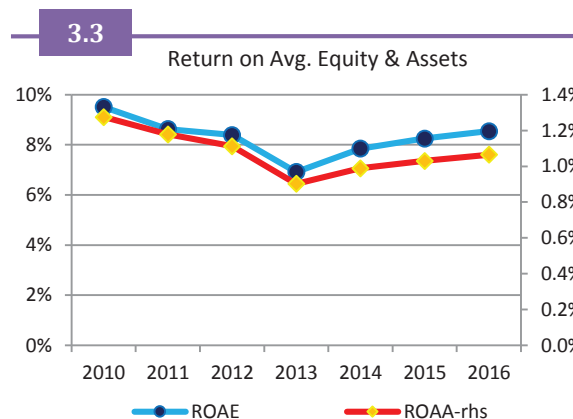
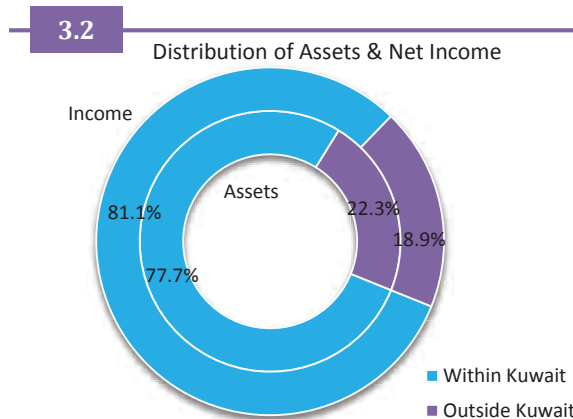
While both Islamic and conventional banks made a positive contribution towards industry's profits in 2016, Islamic banks posted a much stronger growth in their net income (11%) than conventional banks (2.7%).

Breakdown of the net income among domestic and foreign operations reveals that 14% of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad, signifying the importance of banks' foreign operations. However, when compared with the banks' share of assets abroad (22%), share of income is relatively lower (18.9%), 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 low oil price environment.

...helping return ratios inch up further

Amid rising net income of the banking sector, both average return on assets and equity improved further in 2016 (Figure 3.3). Specifically, return on average equity (ROAE) improved from 8.3% in 2015 to 8.5% in 2016; likewise, return on average assets (ROAA) also inched up by 4 basis points to reach 1.07% in 2016. Improvement in return ratios was on account of relatively stronger growth in net income (5.8%) compared to much slower growth (around 2%) in both average assets and equity of the banking system. 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%).

Comparison between share in net income and share in assets reveals that conventional banks account for

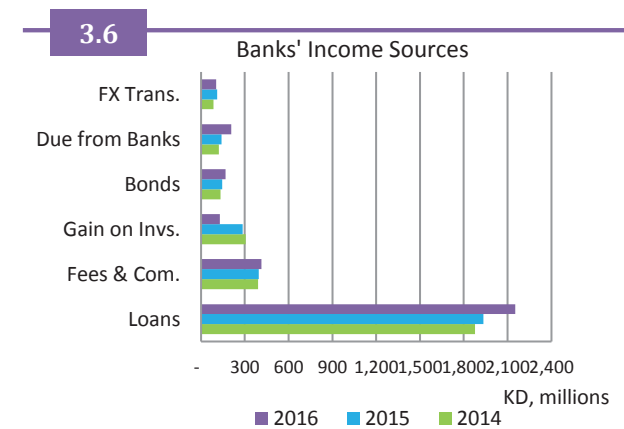
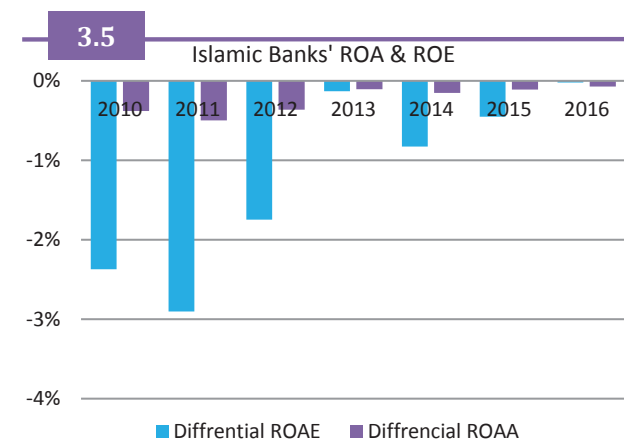
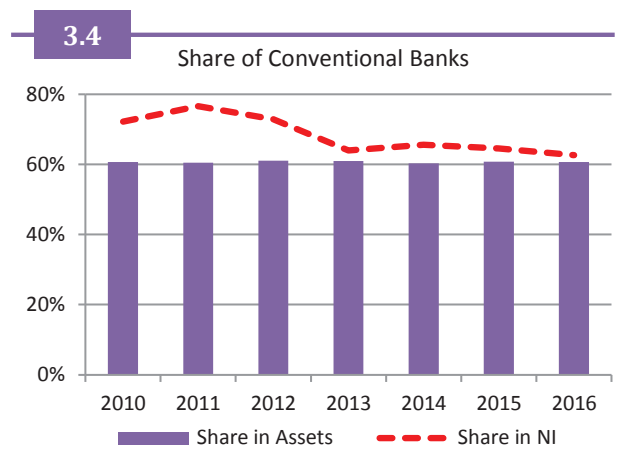


around 62.6% of the industry profits, only marginally greater than their share (60.7%) in total assets (*Figure 3.4*). Conventional banks' share in industry profits was disproportionately higher back in 2011 but have gradually come down amid increasing share of Islamic banks. Admittedly, these trends are only true at the group level, as differences in performance among individual banks still remains.

The gap between industry wide returns¹² and those enjoyed by the Islamic banks have continued to shrink, reaching a level where return ratios for Islamic banks have become similar to their conventional counterparts (*Figure 3.5*). This is in contrast with the trend in some earlier years (2010-12) when ROAE of Islamic banks was considerably lower than that of the industry. ROAA has also followed a similar trend, though marginally less pronounced, given the much larger size of assets compared to equity.

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 84.2% of banks' interest income and 66% of their total income in 2016. Moreover, the breakup of interest income from loans reveals that 52.5% came from credit facilities granted to retail clients while the remaining 47.5% from lending to corporates. Fees & Commissions represented the second major source of income, followed by due from banks.

In general, all sources of income made a positive contribution in 2016 except for *gains on investment securities*, which experienced a noticeable drop both because of a bank's divesture of its equity investment in one of its associated companies and also because of poor equity market performance for the most part of 2016. Income from *FX transactions* also posted a marginal decline during 2016.



¹² 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 up by lower provision expenses

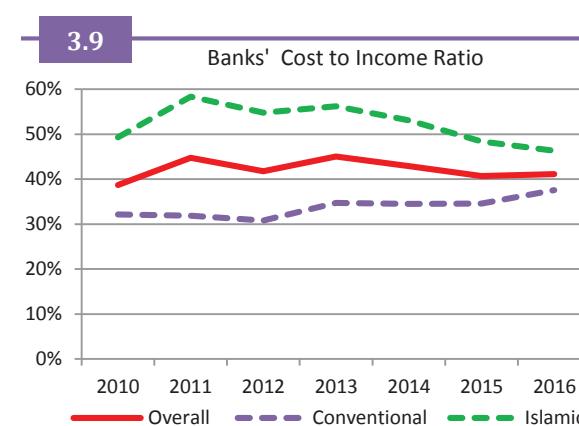
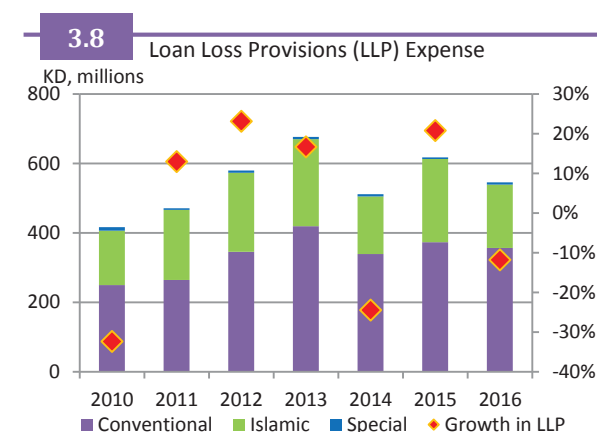
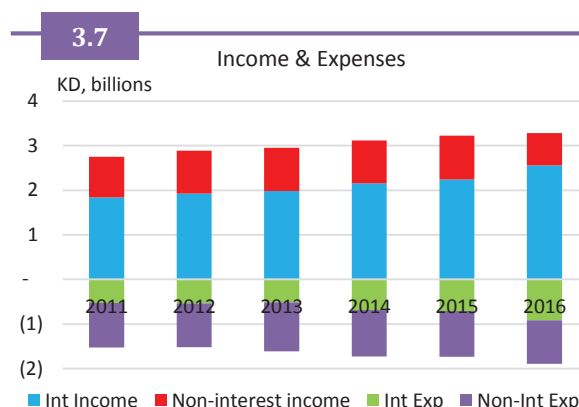
Interest income posted a much stronger growth of 14% in 2016, compared to 4.1% growth in 2015 (Figure 3.7). Consequently, banks' net interest income (NII) increased by 6.7% during 2016, compared to 4.7% in 2015. While banks' non-interest income posted a decline of 26.2% during 2016, lower provision expenses and non-interest expense helped net income post a positive growth.

In particular, loan loss provision expenses posted a noticeable contraction (11.7%) in 2016, in sharp contrast to its double digit growth (20.8%) in 2015 (Figure 3.8). In absolute terms, loan loss provision expenses dropped to KD 545.3 million from 617.8 million in 2015. The reduction in provision expenses was much stronger in the case of Islamic banks (23.6%) when compared to conventional banks (4.5%) during 2016.

Conventional banks continue to exhibit better efficiency

During 2016, banks' operational efficiency slightly deteriorated, as reflected by an increase in the cost to income ratio from 40.7% in 2015 to 41.1% in 2016 (Figure 3.9). This was primarily driven by conventional banks' increase in their operating cost by 8% compared to 2015. In the case of Islamic banks, cost to income ratio improved further during 2016, as evident from its declining trend.

Still, on average, conventional banks appear relatively more efficient than Islamic banks, though the gap between the two groups is steadily narrowing, 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



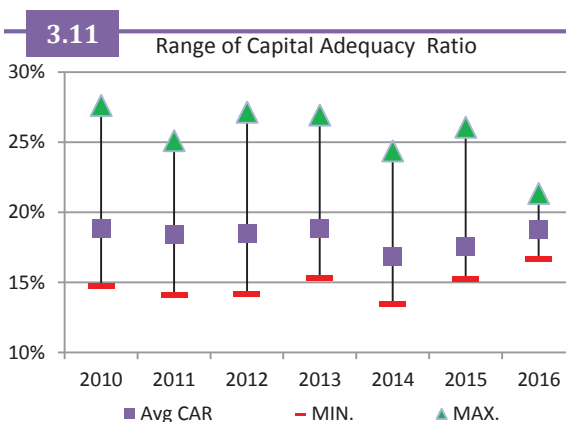
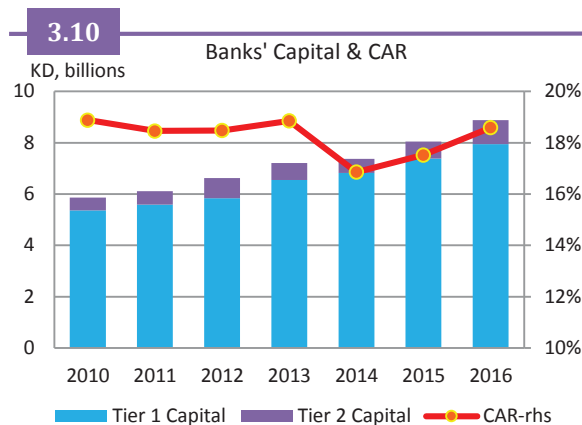
account of higher legal and Shariah requirements to execute the same transactions. Third, high level of operating expenses for Islamic banks also stem from their non-banking subsidiaries which inherently are associated with higher operating expenditures.

Banks' CAR remains strong by regulatory benchmarks

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 2016, banks' capital adequacy ratio¹³ (CAR) on consolidated basis improved from 17.5% in 2015 to 18.6% in 2016 (*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 over the next two years, even in a challenging economic environment. At 18.6%, banks' CAR stood at a fairly high level and well above the CBK's requirement of 13% for 2016.

The improvement in CAR was essentially due to relatively stronger growth in banks' total capital (up by 10.3%) compared to the growth in their RWAs (4%) in 2016. The breakdown of total capital reveals that while both Tier-1 and Tier-2 posted positive growth, the former category witnessed a particularly sharp increase (7.7% and 39.4% respectively). As a result, Tier-2 share also marginally increased to 10.4% in banks' total capital though the bulk (89.6%) 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.

Data for individual banks reveals that even the lowest CAR maintained by a single bank was 16.7%, well above the minimum requirement of 13% set by the CBK for 2016 (*Figure 3.11*). In fact, the minimum CAR maintained by any individual bank never



¹³ 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.

dropped below 14% during the last seven years, except in 2014 when it slipped to 13.5%, primarily on account of Basel III implementation. Moreover, the range between lowest and highest CAR of individual banks has also significantly narrowed over the years, suggesting a strong capital adequacy level across all banks.

Islamic banks maintained marginally better capital adequacy

Classification in terms of Islamic and conventional banks also reveals that the improvement in the CAR of the banking industry in 2016 was due to an increase in the CAR of both conventional and Islamic banks from 16.6% & 17.0% to 17.6% & 18.4% respectively (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 both conventional & Islamic banks. Still, Islamic banks continued to exhibit higher *capital to RWAs* as well as better *Tier-1 to RWAs* ratios compared to conventional banks, in part because of their 50% *alpha* factor as well as the use of leased assets as risk mitigants (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 7.4% by December 2016 (Figure 3.13). While both the conventional and Islamic banks witnessed a declining trend, net NPLs to capital ratio for the former group was slightly lower (7.2%) than Islamic banks (7.9%). In the case of Islamic banks, their net NPLs dropped by 21.1% in 2016 which helped their net *NPLs to capital ratio* slide further.

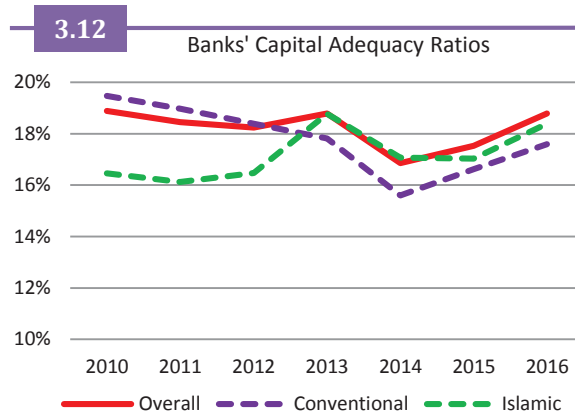
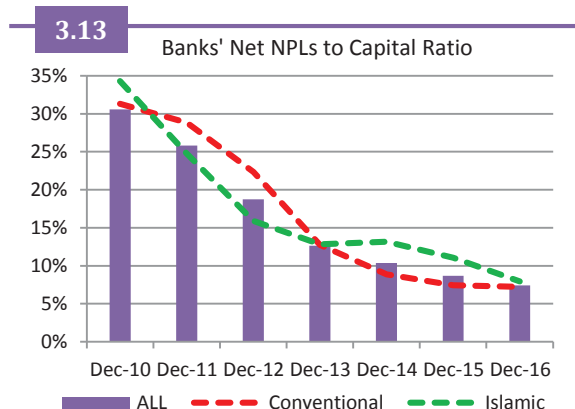


Table 3.1 Banks' Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	2015	2016	2015	2016	2015	2016
Conventional	16.6%	17.6%	15.0%	15.4%	11.9%	13.1%
Islamic	17.0%	18.4%	15.8%	16.9%	11.3%	12.2%
All Banks	17.5%	18.6%	16.1%	16.7%	11.8%	12.8%

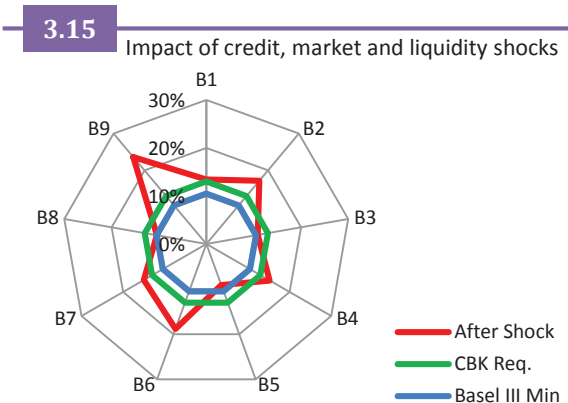
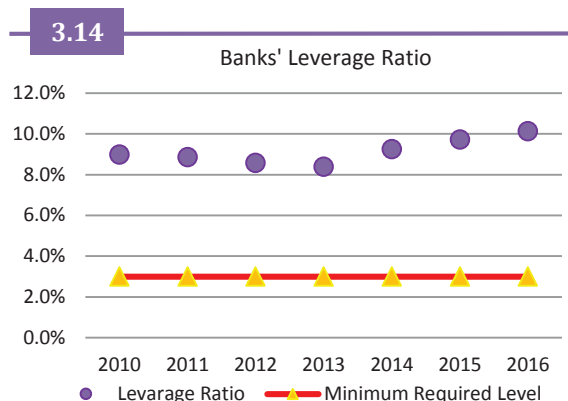


In addition to banks' strong capital adequacy ratios, a risk-sensitive measure, their overall leverage ratio¹⁴ (a non-risk weighted measure) was 10.1% as of December 2016, not only well above the global minimum of 3% but also higher than the more stringent 6% proposed by US regulators for their systemically 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 2016, 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 2016, applying various macro and micro level scenarios of different severities and for an extended period. Our results reveal that banks¹⁵ 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%.

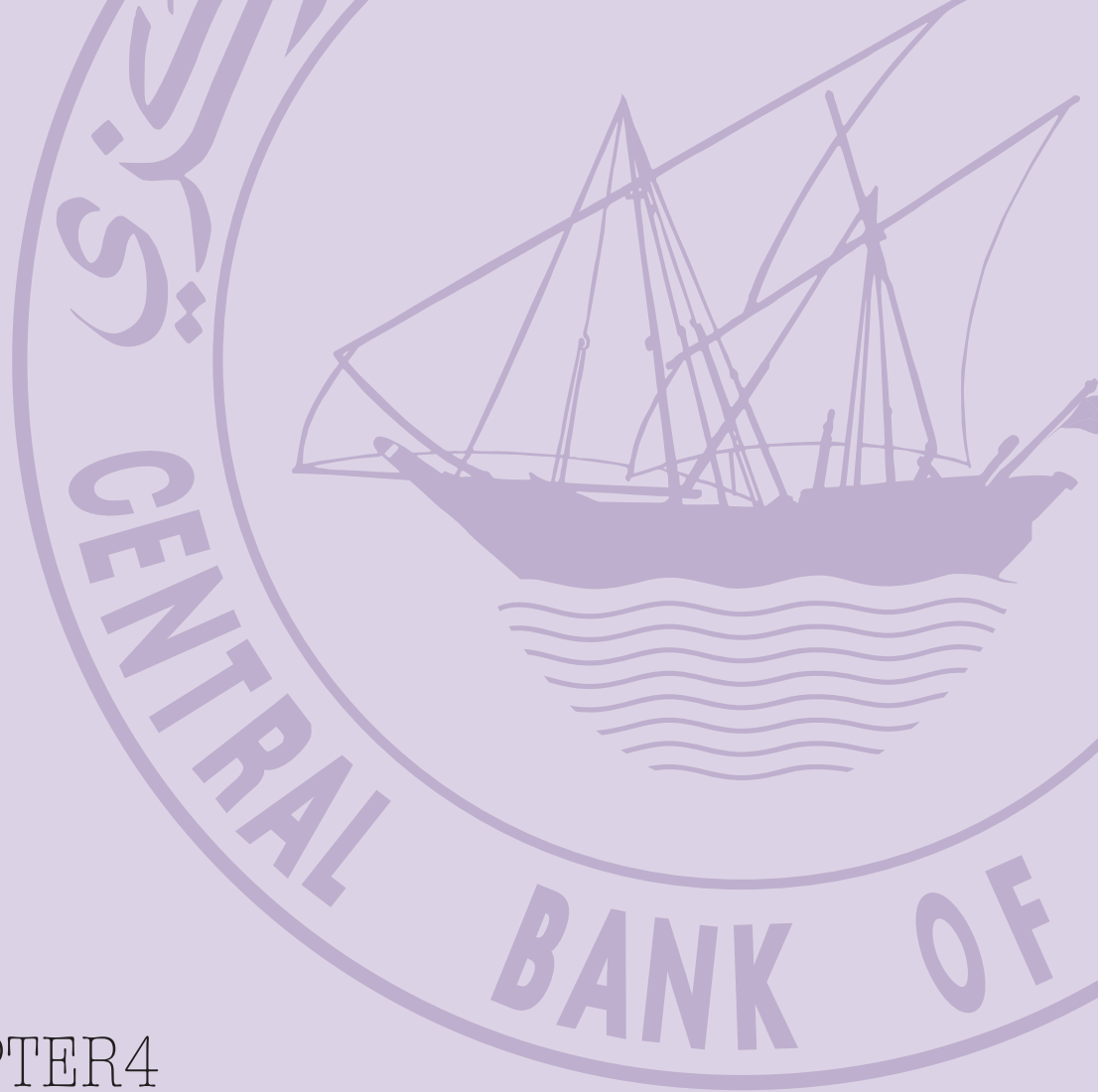
Given the much larger share of credit portfolios in overall asset base, banks appeared more vulnerable to the deterioration in the quality of their loan/financing portfolio, particularly in specific sectors such as the real estate. However, comparison of our stress test results over the years reveal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



¹⁴ Tier 1 Capital/Total Exposures (Non-Risk Weighted, both On & Off balance sheet).

¹⁵ Two banks have been removed from Figure 3.15 due to their very high CARs as their inclusion would have distorted the graph.

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

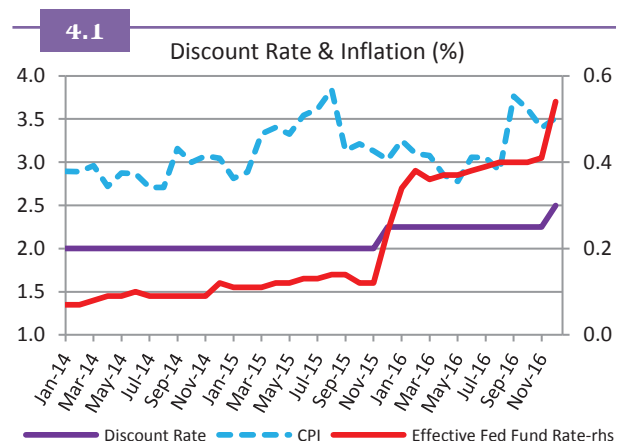
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For the second year in a row, CBK raised its discount rate by 25 bps in December 2016, pushing its policy rate to 2.5%, a level last seen in 2012. As evident from the scale of liquidity absorption as well as interbank rates, liquidity conditions eased further as the year drew to a close, in part due to rebound in oil prices after OPEC agreed to cut production. With government turning to the banking sector to finance part of its budgetary needs, public debt worth KD 2.95 billion was raised in 2016 compared to KD 1.25 billion in 2015. As a result, balance of public debt increased from around 1.6 billion KD in 2015 to 3.3 billion KD in 2016. During the same period, overall issuance of CBK bonds/related tawaruq declined by 11.5%. In the foreign exchange market, KD depreciated against USD by 0.9% in 2016 while appreciating against GBP and EURO by 16.8% and 3.7% respectively; diverging growth trajectories and monetary policies across major economies influenced the exchange rates, while GBP in particular was hit hard after Brexit vote and the ensuing uncertainty about the outcome of its trade negotiations. Boursa Kuwait closed the year with Price Index up by 2.4% as oil price rebound during the last quarter helped the market reverse its losses of the first nine months. Kuwait-15 was however down by 1.7% while weighted index remained flat, reflecting poor performance of large cap stocks. In general, market moved closely in tandem with fluctuations in oil prices. Finally, the real estate market retreated for the second year in a row, after enjoying positive growth for five consecutive years between 2010-14. Activity was markedly slower, both in terms of number (off 21.4%) and sales value (down 23.1%) of the deals made. Segment-wise, sales in both residential and investment segments contracted by 30.3% and 33.4% respectively, though commercial segment grew by a solid 26.3%. Decline in residential segment was in part due to increasing supply of housing units by the government while growing preference for small-ticket single apartment transactions subdued overall sales in the investment segment. Yet the real estate prices in general softened moderately, averting any major 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 unlikely, could test the resilience of the banking sector, given banks' three-dimensional exposure to the real estate market in terms of loans, investments and collaterals.

Money Market:

CBK raised discount rate by 25 bps to 2.5%

For the second year in a row, CBK raised its discount rate by 25 bps in December 2016, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in KD¹⁶ (Figure 4.1). The decision to move discount rate to 2.5% from existing 2.25%, announced on December 14, 2016, came immediately after the Federal Reserve (Fed) raised its target federal funds rate by 25bp for the second time in almost a decade.



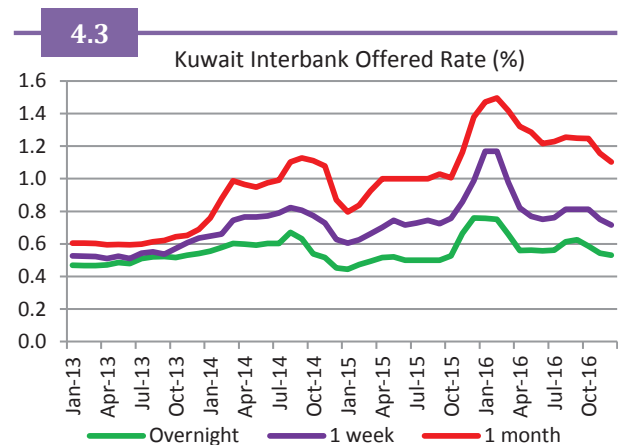
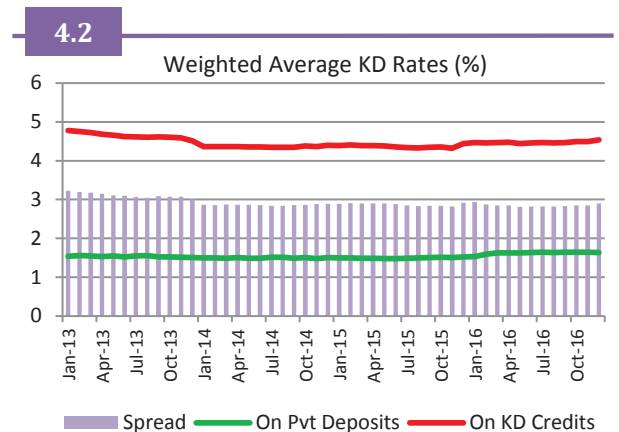
¹⁶For instance, banks can charge up to 3% above discount rate on consumer and housing loans, up to 2.5% above discount rate on commercial loans of less than one year and up to 4% above discount rate on commercial loans of above 1-year maturity.

With this second increase of 25bp, CBK pushed its discount rate to 2.5%, reaching back to the level observed in October 2012¹⁷.

With inflation rate still hovering around 3.5%, prevailing trend in prices did not warrant a change in discount rate; even the impact of the hike in fuel prices in September 2016 was broadly offset by lower food and housing inflation. Yet the marginal increase in the policy rate helped CBK signal its commitment to maintain continued attractiveness of the national currency as a store of domestic savings, 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 slightly narrowed to an average of 2.85 percentage points, compared to 2.87 percentage points during 2015 (Figure 4.2). The marginal decline in spread was more due to an improvement in the weighted average rate on KD deposits, which edged up to 1.62% compared to 1.50% in 2015. On the other hand, weighted average lending rate on KD-based credits remained almost flat during 2016.

In the interbank market, KD interbank offered rate started the year 2016 on a rising trend, on the heels of CBK's first discount rate hike in December 2015. However, as liquidity conditions improved after recovery in oil prices, interbank rates trended downwards (Figure 4.3). Rates further declined in the last quarter as OPEC deal to cut production helped oil prices stage a decent recovery, further easing liquidity conditions. While the CBK increased its discount rate again, following Fed's rate hike in December 2016, interbank rates still edged lower,



¹⁷ CBK had slashed its discount rate by 50 basis points on October 3, 2012 to bring it down from 2.5% to 2%.

reflecting improved sentiments; 1-month offered rate closed the year at 1.1%, compared to 1.4% in December 2015.

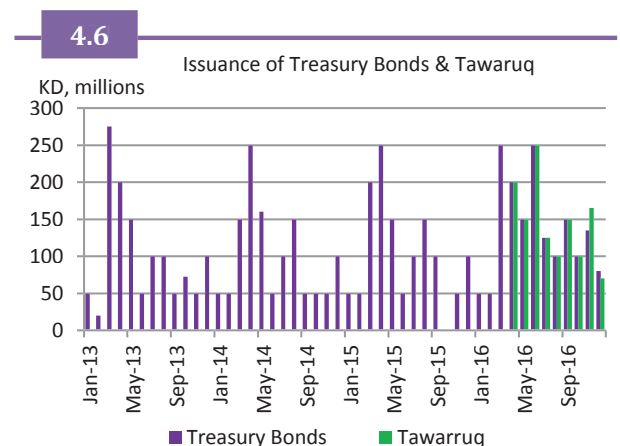
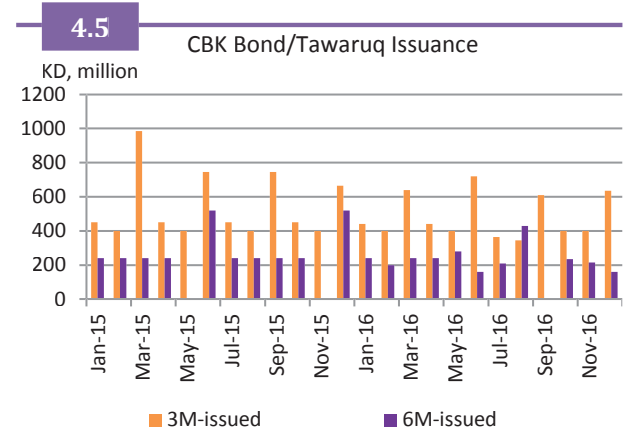
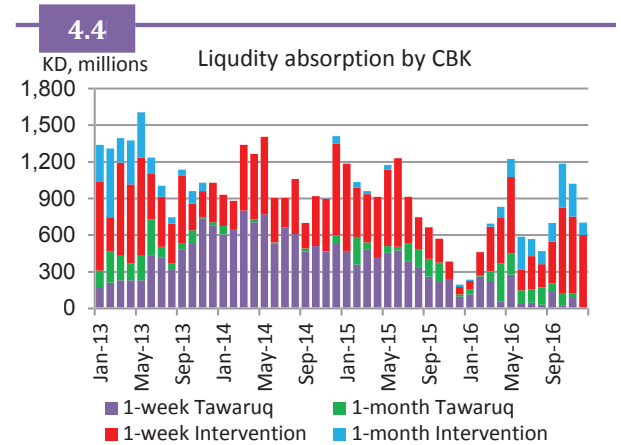
Amid improving liquidity conditions, absorption by the CBK ascended by the last quarter of 2016 in comparison to 2015 (Figure 4.4). In particular, share of interventions significantly increased compared to *tawarruq*¹⁸, accounting for 71.3% of the total absorptions in 2016 compared to 48.1% in 2015. Moreover, data by various maturities reveal that the one-week *tawarruq* declined significantly during the year. 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.

CBK's bond issuance dropped by 11.5%

During 2016, overall issuance of CBK bonds/*tawarruq*¹⁹ dropped by 11.5%, with total issuance worth KD 8,405 million compared to KD 9,500 million in 2015 (Figure 4.5). Issuance of both 3-months and 6-months tenors posted a decline, of 11.4% and 11.8% respectively. By the end of 2016, the combined outstanding balance of CBK bonds/*tawarruq* of both tenors was KD 2,685 million.

...amid rising issuance of treasury bonds and related *tawarruq*

With the government deciding to tap the banking sector for part of its budgetary financing needs, 2016 witnessed a significant rise in issuance of both treasury bonds and its *shariah* compliant equivalents (Figure 4.6). Treasury bonds worth KD 1,640 million were issued during the year, in addition to KD 1,310 million of *tawarruq* based instruments. The issuance of both conventional and *shariah* compliant bonds not only allowed the government to raise funds from the banking sector but also provided the banks an



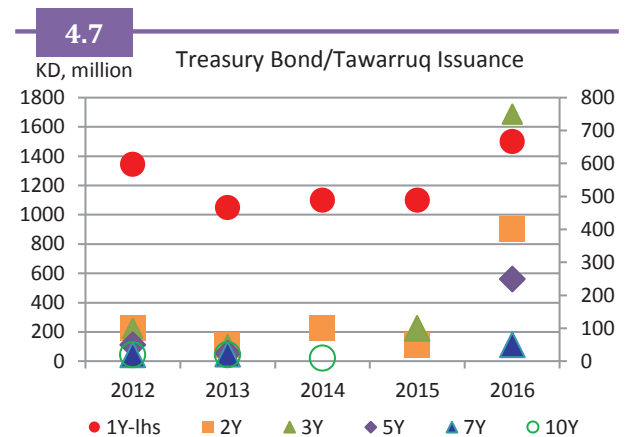
¹⁸It is an important tool for liquidity management, where banks can place excess liquidity with the central bank both on short and long-term basis, using a mechanism similar to commodity *Murabaha*.

¹⁹Tawaruq based instruments were used in 2016. In the Figure 4.5, earlier data includes only CBK bonds.

opportunity to invest in risk-free government paper, in particular for the Islamic banks which typically face difficulties in finding high quality liquid assets for investment.

Regarding the T-bills, 2016 was the fourth year in a row without any issuance; 3-month T-Bills were last issued in July 2012 while issuance of 6-months T-bills was suspended much earlier, back in 2009. Non-issuance of treasury bills can be explained by the greater usage of shorter maturity CBK bonds that provide CBK more flexibility and greater control both in terms of wider distribution of the bonds as well as in setting the target rates.

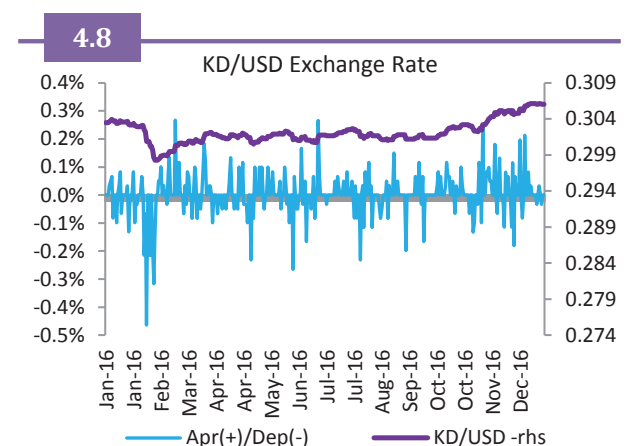
In terms of tenor, bonds/*tawarruq* issuance ranged from 1 year to 7 years, with former still representing relatively greater share of the total issuance (*Figure 4.7*). In total, 1-year bonds/*tawarruq* worth KD 1,500 million were issued during the year, compared to issuance of KD 1,100 million in 2015. More importantly, issuance of longer term instruments of 2 to 7 years reached KD 1,450 million, highest in recent years. Greater issuance of longer term bonds/*tawarruq* would help extend the sovereign yield curve to longer horizon and help establish a meaningful benchmark for the pricing of corporate debt. The trend would also enable the government save on interest rate payments in an increasing interest rate environment while also reducing the risk of roll-over.



Foreign Exchange Market:

Strengthening USD led to a further depreciation in KD

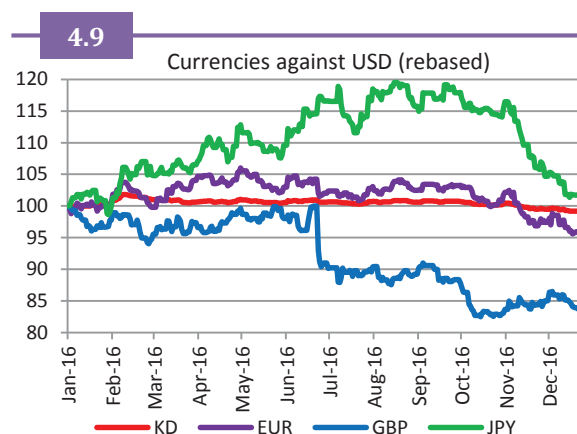
KD/USD exchange rate experienced marginal appreciation in the first two quarters of 2016, and remained fairly stable during the third quarter. However, KD closed the year by slightly depreciating (0.9%) against USD (*Figure 4.8*). In general, fluctuations in the exchange rate were fewer and mostly within 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. 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. During 2016, US economy gained further steam and unemployment rate dropped to 4.6%, lowest since 2007. This was in contrast with the rest of the advanced world where growth much slower, though improving. Bolstered by the health of its economy, USD Fed raised its key interest rates by 0.25% in December 2016, its second hike in a decade (first was in December 2015). 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 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 broadly stable (Figure 4.9). Specifically, KD depreciated against USD by around 0.9% in 2016, compared to its depreciation of 3.6% in 2015. Though GBP experienced modest depreciation during the first couple of months, its value plummeted against USD after the Brexit referendum on June 23, 2017. Even in later months, uncertainty about the outcome of UK's impending negotiations with its trading partners and its impact on country's competitiveness continued to weigh on the performance of GBP. EURO closed the year 4% lower against USD, as ECB continued with its bond-buying program.

JPY, however, benefited from its safe haven status despite excessive quantitative easing by the Bank of Japan, experiencing steady appreciation till September 2016. Following the results of US presidential election, all major currencies depreciated against USD as hopes of stronger growth under new administration intensified. USD strengthened further amid Fed's



interest rate increase in December 2016, also supported by market expectations of faster rate hikes in 2017.

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 GBP and EUR, by 16.8% and 3.7%, respectively. KD's appreciating against GBP was particularly significant in the wake of UK referendum results and ensuing uncertainty (Figure 4.10).

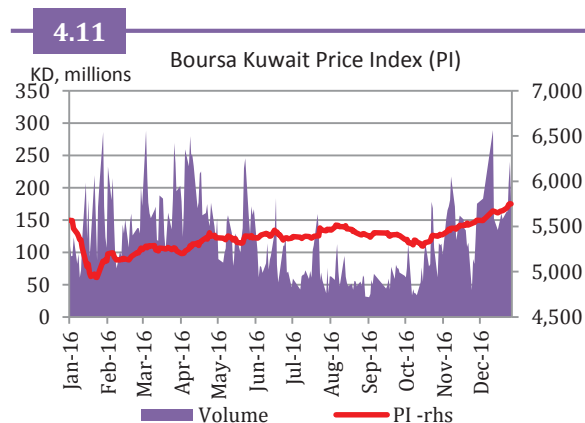
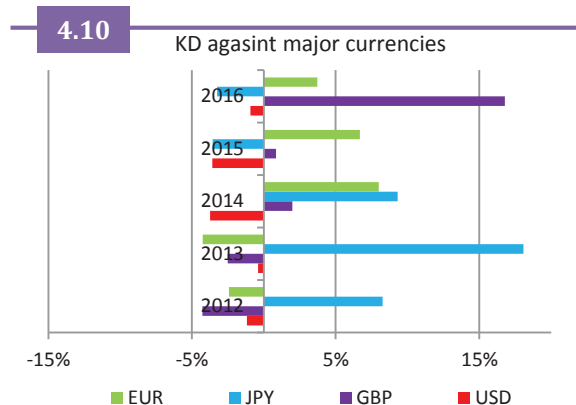
In general, KD's peg against a basket of currencies has shielded Kuwait from imported inflation resulting from the volatility in such currencies and has ensured a more stable exchange rate where the net impact of diverging currencies has been largely neutralized. That helps explain why CBK has kept the 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.

Boursa Kuwait:

Local bourse closed in green, thanks to last quarter gains

Price Index (PI), the broad based index of Boursa Kuwait, closed the year on a positive note, gaining 2.4% during 2016, notwithstanding a tumultuous start to the year and finishing first nine months down (Figure 4.11). Though marginally positive, the performance of PI was still visibly better compared to its 14.1% retreat observed in 2015. The Weighted Index (WI), representing Kuwait's large-cap companies, was almost flat, gaining a meager 0.42% during the year. Finally, the Kuwait-15 Index, covering 15 highest ranked companies in terms of liquidity and capitalization, was down by 1.71% in 2016 as 11 out of 15 stocks in the index posted a decline.

Given the absence of a strong domestic catalyst, factors like volatility in oil prices, diverging monetary policy stance of major central banks,

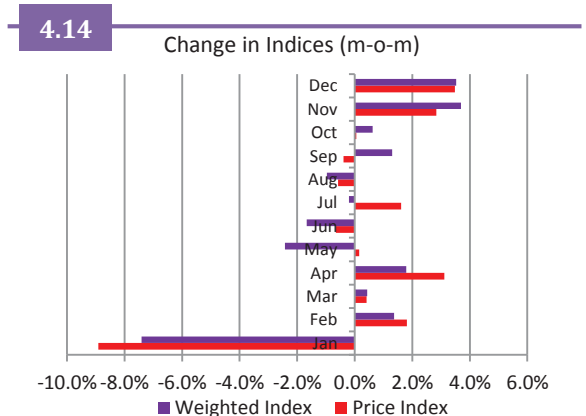
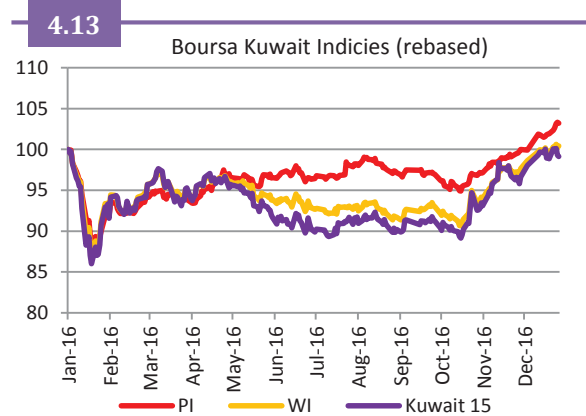
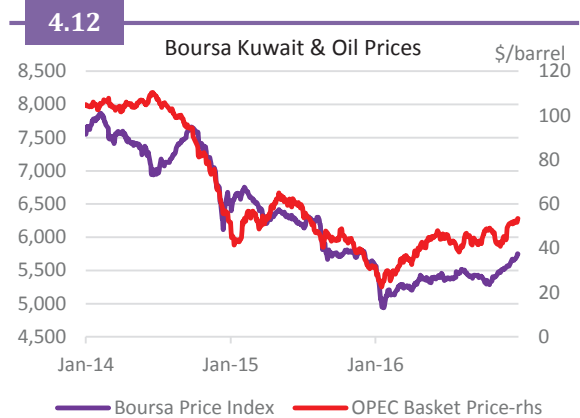


slower growth and increasing financial risks in China, and geopolitical tensions—all added to the uncertainty and influenced investors' sentiments. Even on the domestic front, challenging economic situation kept the sentiments bearish. Given Kuwait's reliance on hydrocarbon as the main source of income, the market continued to move in tandem with oil prices (*Figure 4.12*).

Comparison between the performance of different indices reveals that all three indices sharply deteriorated in January 2016, and continued to witness somewhat similar trend upto May. From June onwards, PI held ground while value weighted indices retreated (*Figure 4.13*). All three indices recorded ytd losses upto the third quarter of 2016, though posting a rebound in the last quarter amid recovery in oil prices. PI closed on a more positive note than the other two indices, signifying better performance of small cap stocks. Even the performance of WI and Kuwait-15 was relatively better, compared to 2015 when they were respectively down by 13% and 15%.

Monthly data highlights a poor start but positive ending to the year

Boursa Kuwait got off to a negative start in January 2016 on the back of a poor 2015 when PI witnessed a 14.1% drop (*Figure 4.14*). Sharply lower oil prices and sluggish global growth were partly responsible. Domestic market staged a modest recovery in February as oil prices improved though international markets posted declines amid concerns over growth in major economies. March witnessed a lackluster performance, though both PI and WI marginally improved. The last two months of the first quarter witnessed better performance on account of modest recovery in oil price, notwithstanding the disappointing financial results of firms listed on Boursa Kuwait. In particular, real estate and non-bank financial services showed further signs of weaknesses.



In the second quarter of 2016, local boursa experienced good gains in April. However, recovery in domestic market was still significantly subdued when compared with stronger rallies in some of the regional markets like Dubai and Oman (Figure 4.15). Moreover, the gains proved fleeting as Boursa Kuwait turned negative in May and June, closing H1-2016 almost 4.5% off ytd.

Market started the second half of 2016 on a slower note amid lower activity due to summer season coinciding with Ramadan. Trading remained thin upto September, resulting in ytd losses on all three indices for Boursa Kuwait. The market finally recovered in November/December posting healthy gains as deal among OPEC producers to cut production helped oil prices staged a decent rebound. Sales of *Americana* to a UAE based investor also supported market recovery. Despite the recovery in the last quarter, PI closed 2016 below 6,000 mark which appears to be a new normal. In fact, PI has not crossed 8,000 mark since 2008 when it last nosedived from a peak of above 15,000. (Figure 4.16).

Market capitalization remained unchanged in 2016

Given the sluggish performance of the local boursa, market capitalization remained flat at 26.2 billion in 2016 (Table 4.1). However, trading activity significantly declined, quite similar to other GCC markets. In particular, indicators like the total value, volume and number of deals etc. posted a noticeable drop; for instance, total value went down by 26.4% while volume was off 27% during 2016. Number of listed companies also reduced from 190 to 185 during the year.

Domestic market's performance in terms of various sectors also reveals a sharp deterioration in the early 2016, followed by a mixed trend, as some sectors remained weak while others posted decent gains, particularly by the tail end of the year. Specifically, *Industrial* and *Telecom* sectors closed the year up by 17.9% and 11.3% respectively (Figure 4.17). Within

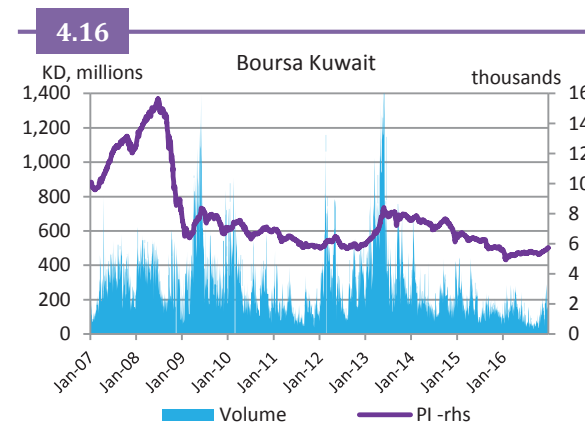
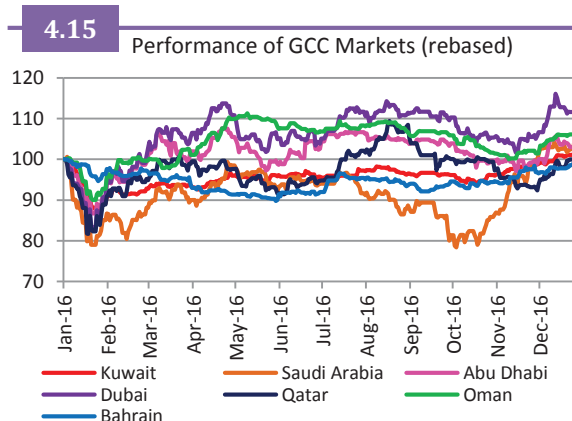


Table 4.1: Key Indicators of Boursa Kuwait

	2013	2014	2015	2016
Price Index	7549.5	6535.7	5615.1	5748.1
Highest	8430.7	7863.0	6755.1	5753.4
Lowest	5934.2	6115.6	5571.9	4936.5
Market Cap (KD, bil)	31.0	29.7	26.2	26.2
Total Value (KD, bil)	11.1	6.1	3.9	2.9
Total Volume (bil)	126.5	53.0	41.5	30.3
No. of Deals (,000)	2,136	1,186	961	713
Companies Listed	196	193	190	185

industrial, most of the large cap stocks posted gains; in *telecom*, gains by Zain and Ooredoo helped offset the losses in Viva. *Financial Services* sector gained 3.3%, as investment companies portfolios were affected by bearish equity markets across the GCC and lower fee incomes amid reduced trading activity.

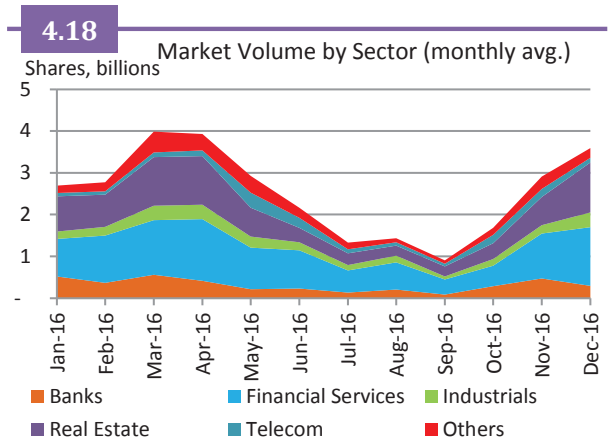
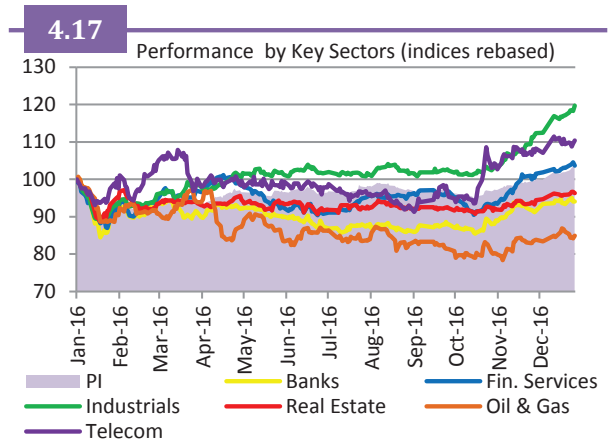
Among the sectors that lost ground, *Oil & Gas* was understandably the worst performing, shedding 15.2% during 2016 as oil prices remained volatile. *Banking*, which represent almost half of Boursa Kuwait's market capitalization, was off by 7% amid mixed results with some banks recording double digit growth in earnings while others posting declines. However, banks' earnings record improves once we adjust for one-time gain on sale of assets by one bank during the same period last year (Q1-15). *Real Estate* sector, despite some recovery in the last quarter of 2016, closed the year 4.8% down as slower sales activity and softening prices in the domestic real estate market weighed on results.

Two sectors account for around 2/3rd of the market volume

Financial Services Sector and the *Real Estate Sector*, collectively accounted for as much as 62.7% of the average monthly market volume in 2016, compared to their combined share of 69.3% during 2015. Volumes dropped as the summer season, coinciding with Ramadan, approached and reduced further as confidence waned, though posting a rebound in the last quarter of 2016 (Figure 4.18). The high level of concentration in terms of market volume suggests that the depth of the market has remained at fairly low levels. *Banks*, *Industrial*, and *Telecom* sectors also had around 12.5%, 8.7% and 6.4% share respectively in the total market volume. Collectively, aforementioned five sectors covered almost 90.3% of the entire market in terms of volume.

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

When viewed in terms of average monthly value, *Banks* and *Financial Services* accounted for 54% of total market value in terms of monthly average for



the year 2016, compared to 47.1% a year earlier. Unlike in the case of market volume, here *Banks* also appear quite significant, accounting for as much as 34.3% of the market value (Figure 4.19). During 2016, share of *Telecom* almost dropped to 10.5% compared to 15.3% in 2015. Likewise, share of the real estate continued to drop, reaching 12.3% of average monthly value compared to 16.7% during 2015.

Real Estate Market:

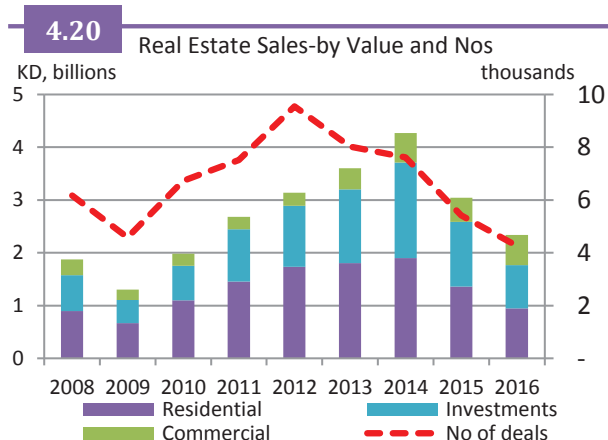
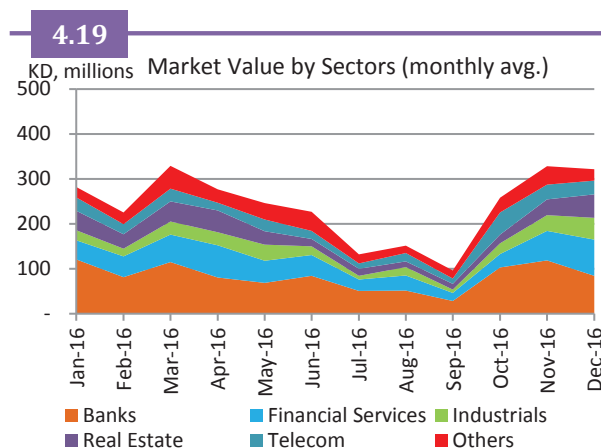
Market notably slowed down for the second year in a row²⁰

Real estate sector continued to slowdown for the second year in a row, after recording five consecutive years of positive growth from 2010-14, if viewed by sales value. Sales also dropped in terms of numbers of transactions made, a trend which moved south much earlier than the value of sales, suggesting a period of rising prices amid tighter supply and increasing speculation (2013-14).

During 2016, total sales were down by 23.1% to reach KD 2.3 billion compared to 3 billion in 2015²¹ (Figure 4.20). The number of transactions also continued to decline, recording 4,262 transaction in 2016 compared to 5,424 transactions in 2015. In fact, it was the lowest number of transactions recorded in almost a decade, and less than half of the peak level (9,554 in 2012). Moreover, investors also appeared inclined towards smaller ticket investments, particularly in the *investment*²² segment (apartments/buildings), as uncertain economic environment weighed down on investors' appetite to take large exposures.

...with sharp correction in residential and investment segments

Trends in sales within various segments highlight that the correction in real estate market was driven by



²⁰ 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.

²¹ Total sales here include residential, investment and commercial segments only.

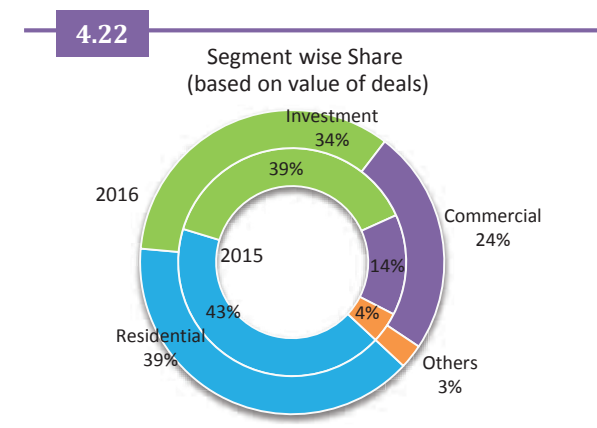
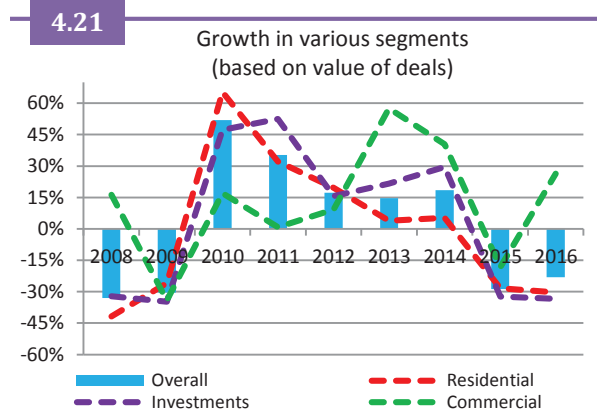
²² The Real Estate market can be broadly divided into four sub-categories; *residential (private housing)*, *investment*, *commercial* and *others* (see Figure 4.24 for respective share of each segment).

both *residential* and *investment* segments. For instance, the *residential* segment, also labeled as private housing, was down by 30.3% during 2016, on the top of an earlier decline of 28.4% in 2015 (Figure 4.21). Apart from the low oil price environment which continued to dampen consumer confidence, weaker sales in the residential segment were aggravated by the increasing distribution of land plots by the government. Specifically, the Public Authority for Housing Welfare distributed over 12,000 plots during 2016, on top of 15,240 units (homes, apartments and plots) in 2015.

The drop in *investments* segment, by 33.4%, came after a similar decline (of 32.3%) in 2015; increasing supply of investment buildings, slower growth in expat labor force, preference towards less expensive single investment apartments, rising uncertainty and investors' growing risk aversion in a challenging economic environment played their part in depressing sales.

On the other hand, *commercial* segment, the most volatile of all three segments, posted an impressive growth of 26.3% compared to a decline of 18.3% in 2015, despite that the number of transactions were almost similar during the two years. In general, sharp swings in this sector are common given the small number of high value transactions that can strongly influence overall growth trends. For instance, during 2016, almost half of the sales value in commercial segment was on account of eight major transaction.

Strong growth in commercial segment amid retreating sales in the other two segments (residential and investment) resulted in a shift in their overall contribution towards total sales. In particular, share of *residential* segment dropped from 42.8% in 2015 to 39.5% in 2016 (Figure 4.22). Back in 2013, residential segment accounted for almost half of the total sales in the real estate market. Similar trend was observed in the case of contribution from the *investment* segment, which recorded a noticeable drop from 38.5% to 34% during the same period. On the other hand, share of *commercial* segment sharply improved from 14 to 24%

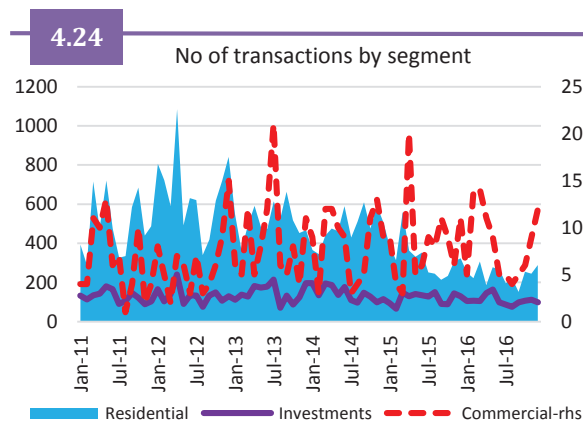
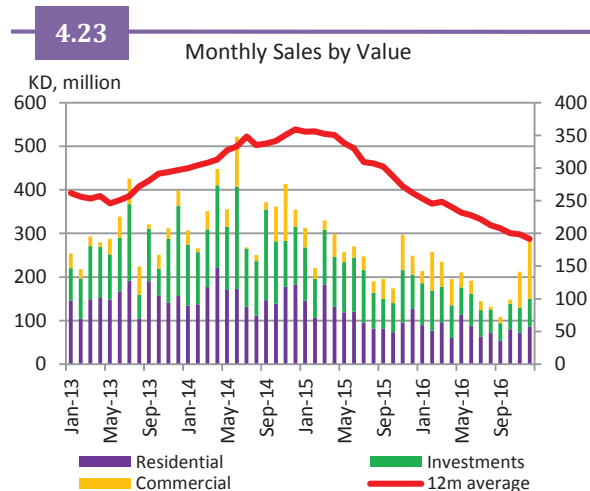


during 2016, on the back of strong growth in the segment.

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

Analysis of the monthly transactions during 2016 also reveals a steadily declining trend in sales (Figure 4.23). The market was off to a slower start amid record low oil prices, greater risk aversion and volatile financial markets in general; overall sales in January 2016 were lowest since 2011. Activity partially recovered in February on the back of better commercial segment sales. Next few months still witnessed a muted performance though investment segment improved in April. As have been observed in previous years, sales were considerably slower during the summer season, which also coincided with the holy month of Ramadan. Slower activity continued till the third quarter when market was down 27% ytd, both because of seasonal factors and lower consumer confidence. However, the market recovered during the last quarter as OPEC deal to cut production helped oil prices stage a modest recovery, also improving investors' sentiments.

In terms of number of deals, total deals in 2016 were down by 21.4%, dropping from 5,424 deals in 2015 to 4,262 last year (Figure 4.24). In the Residential segment, number of deals dropped by 26.3%, from 3,882 deals in 2015 to 2,862 deals in 2016. Likewise, Investments segment was off by 9.7%, though the Commercial segment posted a marginal decline of 2% 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



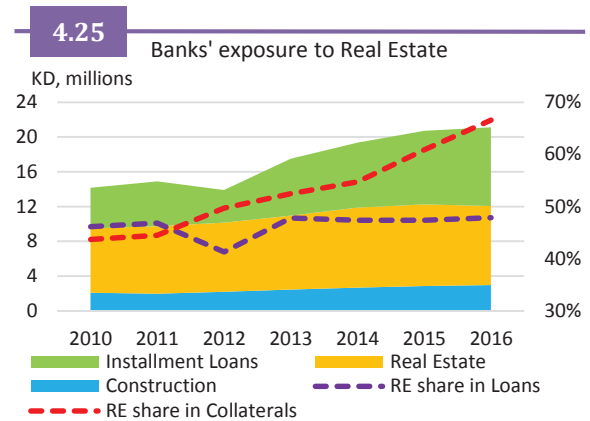
estate market and to strengthen financial stability (see *Box 4.1* in *FSR-2014*).

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 takes place, something less likely, takes place. Banks have significant exposure to the real estate market in terms of their lending, either directly through financing the real estate and construction sector or indirectly through consumer installment loans. As evident, this exposure has been steadily rising since 2012 in particular and reached KD 21.1 billion by 2016 (*Figure 4.25*).

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 66.6% of banks total collateral in 2016. And finally, banks also have exposure in terms of their real estate investments, which is particularly true in the case of Islamic banks. This collectively highlights banks' three-dimensional exposure to the real estate market, i.e. through lending, collaterals and investments.

As discussed earlier, correction in real estate prices have been somewhat modest 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 less likely, 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.

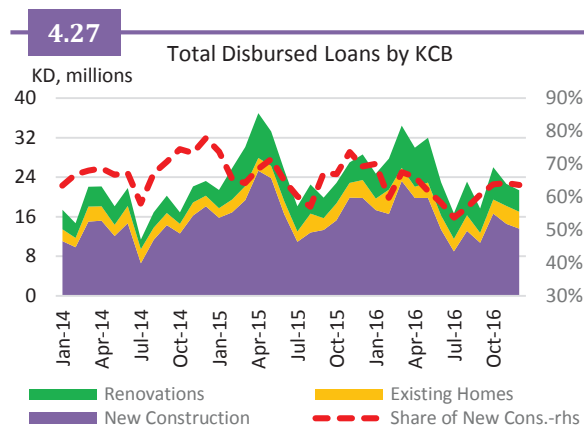
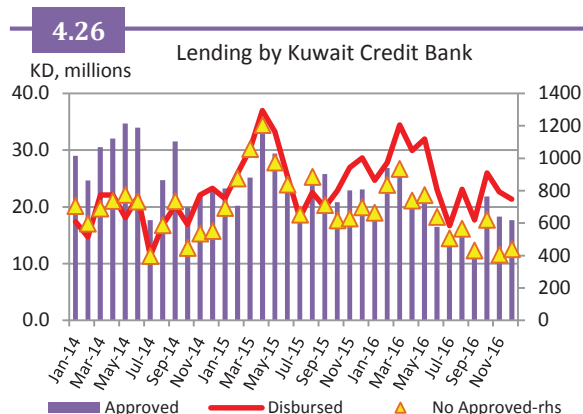


Approved and disbursed loans by KCB posted a decline

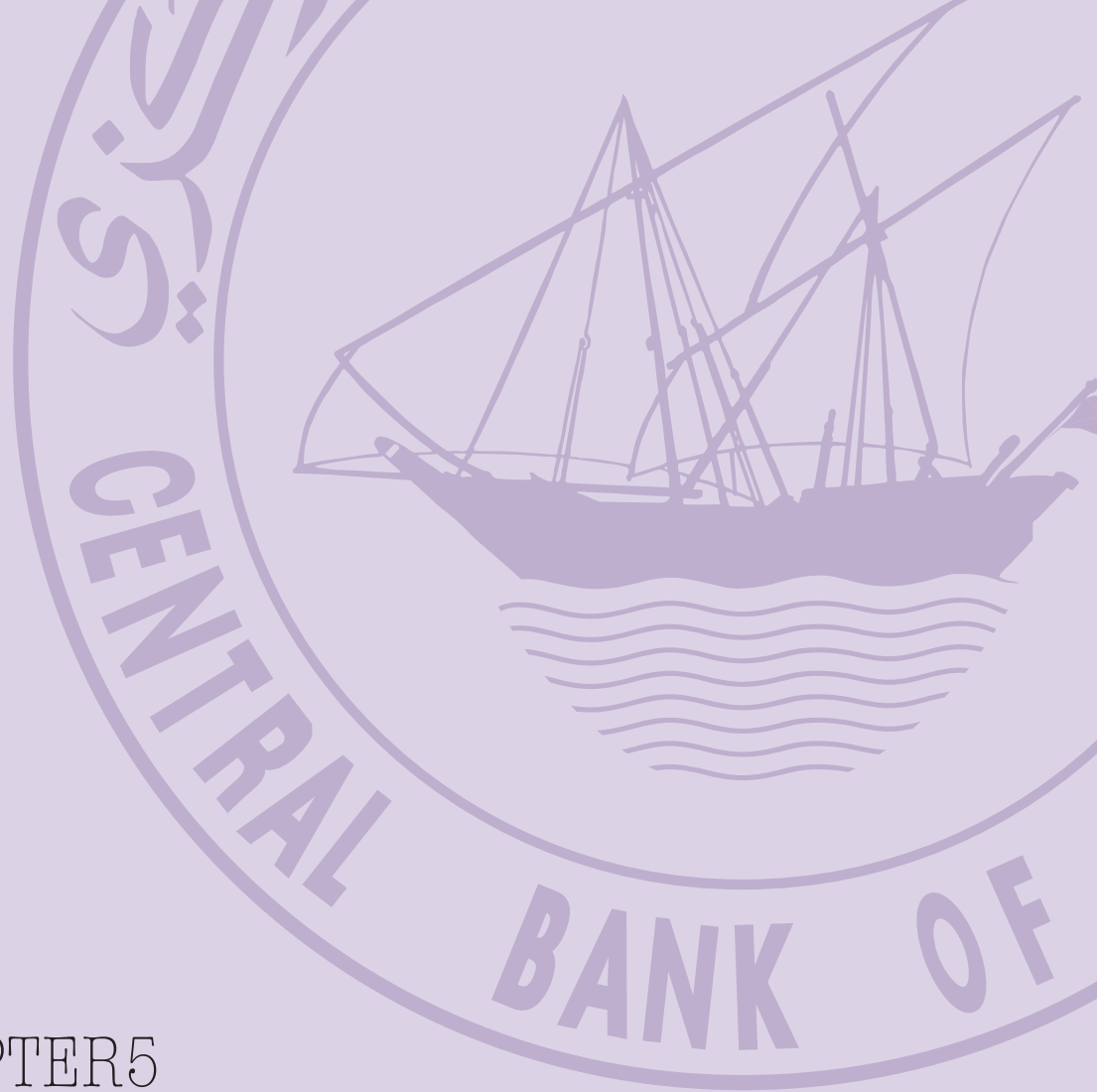
Kuwait Credit Bank (KCB), an independent banking institution wholly owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing loans to Kuwaiti nationals for purchase, construction or renovation.

After robust growth in both the number and value of approved loans in 2015, there has been a declining trends in all indicators during 2016. Specifically, total value of approved loans dropped by 18.9% to KD 236.1²³ million (Figure 4.26). Likewise, the number of approved loans also came down to 7,549 loans in 2016. Moreover, the value of loans disbursed also declined from KD 312 million to KD 299.3 during the same period.

In terms of usage, around 63% of the disbursed amount were for new constructions, compared to 67% during 2015 (Figure 4.27). On the other hand, share of disbursed loans for renovation improved from 22% to 25% during the same period. As the bulk of loans disbursements are still for new constructions, it would not only help add more homes to the national stock of housing but will also boost construction activity. During 2016, share of loans used to purchase existing homes slightly increased, as the softening of real estate market somewhat improved purchasing power of the buyers.



²³ This data also includes loans specifically extended to the disabled people for expansion/renovations of homes.



CHAPTER 5

PAYMENT AND SETTLEMENT SYSTEMS

2016

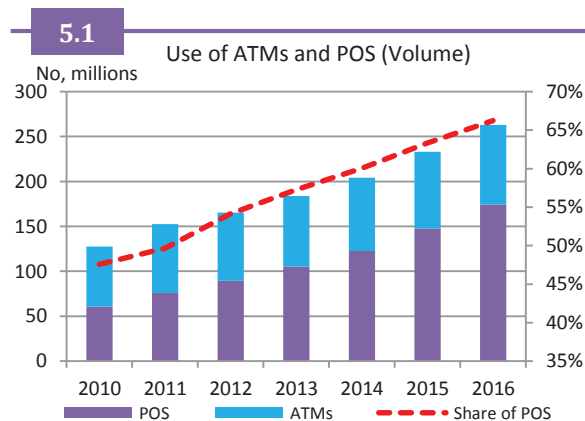
5 Payment and Settlement Systems

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. During 2016, value of ATMs and point of sale (POS) based transactions have posted growth of 3.2% and 5.6% respectively. These growth trends, while positive, are considerably subdued when compared to the ones observed in 2015 and underscore the slowdown in household consumption amid weakened consumer confidence. Sales of consumer durables, typically more sensitive to economic outlook, witnessed a noticeable contraction, though the overall consumption was supported by steady hiring in the public sector. 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 (66%). In general, though e-transactions account for 98.1% of all transactions in terms of volume, paper-based transactions (through cheques) still have a sizeable share (53%) 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 16.6% and 7.4%, respectively reaching 1,991 and 46,513 machines by December 2016. Moreover, branch network also continued to expand (particularly for Islamic banks), bringing total bank branches in Kuwait to 421 in 2016 from 414 in 2015 as Islamic banks opened seven new branches. Finally, KASSIP²⁴, the real time gross settlement system in Kuwait, handled 1.8 million transactions worth KD 299 billion in 2016.

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 Knet²⁵, POS and ATMs represent the retail payment system in Kuwait, essentially used for the bulk of mainly low-value payments transactions.

During 2016, the number of transactions (volume) through ATMs witnessed a growth of 3.9% to reach 88.8 million transactions. However, the growth in number of transactions through POS was much stronger at 18.1%, pushing the total transactions to 174.2 million in 2016. Consequently, the share of POS transactions (out of combined POS and ATM based



²⁴ Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP) was launched in August 2004.

²⁵ The Shared Electronic Banking Services Company (Knet) launched its services in 1994 in collaboration with local banks.

transactions) further inched up during the year to reached 66% in terms of volume, though its share in terms of value remained unchanged at 44% of the value of total transactions.

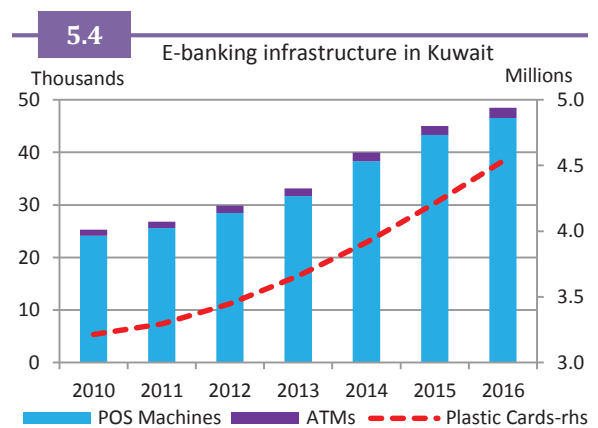
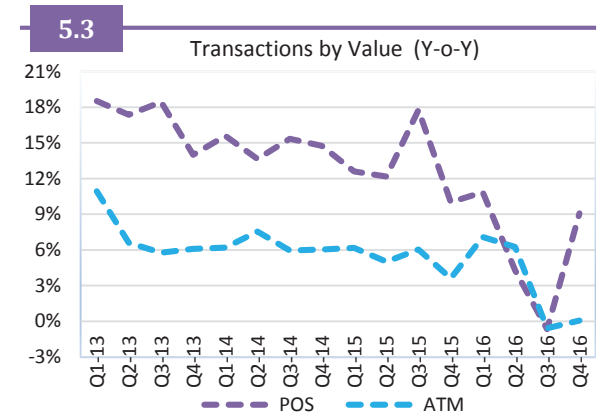
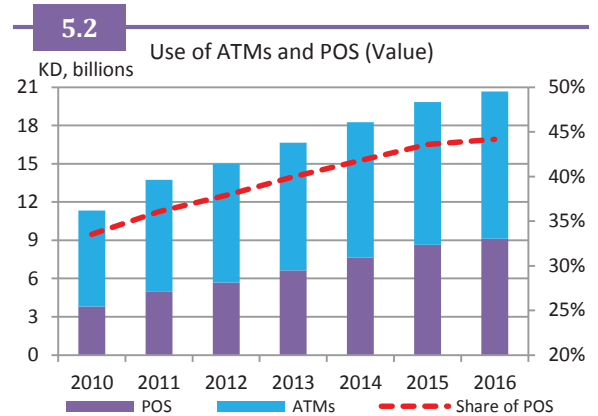
Though positive, slower growth in retail transactions exhibits weakened consumer confidence

Contrary to the trends in number of transactions (volume), growth in the value of transactions, though positive, slowed down during 2016. Specifically, ATM-based transactions, in terms of value, grew by 3.2% to reach KD 11.5 billion, compared to a growth of 5.2% in 2015 (Figure 5.2). On the other hand, POS-based transactions posted a growth of 5.6% in 2016, compared to its much stronger growth (13.2%) a year earlier. In fact, this was the first time since 2008 that growth in POS-based transactions was not in double-digits.

If viewed as a proxy for household consumption, muted growth in retail transactions underscores the slowdown in domestic consumption amid weakened consumer confidence. The demand for consumer durables, automobiles in particular, have witnessed a visible decline during 2016. When viewed on quarterly basis, y-o-y growth in value of transactions through ATMs and POS machines turned negative during Q3-2016, a period when government announced the hike in fuel prices (Figure 5.3). However, transactions recovered later during the fourth quarter, along with the rectory in oil prices. Domestic consumption was also supported by steady hiring of the nationals in the public sector and a modest increase in salaries.

E-banking infrastructure has continued to expand

To support the growing use of e-banking, payment system infrastructure is also expanding in Kuwait. During 2016, the number of POS machines and ATMs witnessed a growth of 7.4% and 16.6% respectively, reaching 46,513 and 1,991 machines (Figure 5.4). Expansion in ATM network was



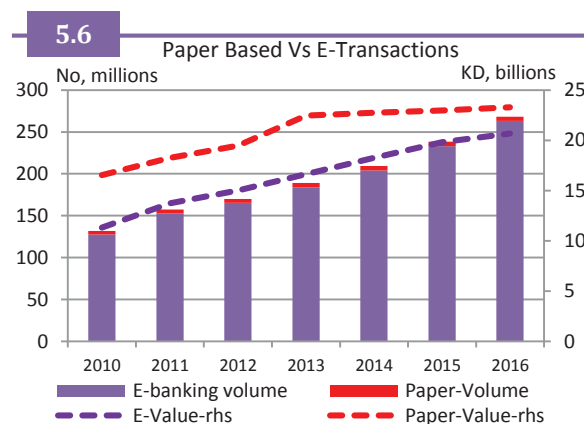
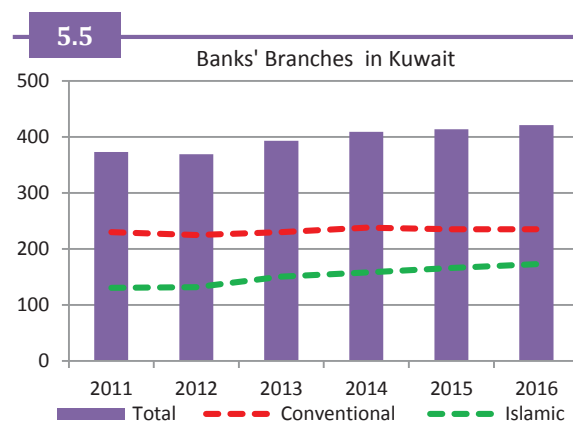
particularly strong, as a record 283 new ATM machines were installed in Kuwait, far greater than 76 installed in 2015. Moreover, the issuance of new plastic cards (debit and credit cards) posted 7.6% growth in 2016 with total plastic cards reaching 4.5 million, around 84% of which were debit cards.

As the above trends highlight, e-banking has become ubiquitous, thanks to the convenience, flexibility and security that it offers. Furthermore, retailers offering discounts on online purchases have also promoted the use of e-banking. Banks are equally keen to promote e-banking as it 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 2016, 7 new branches were added to the existing banking network in Kuwait, pushing the total number of branches to 421²⁶ (Figure 5.5). Specifically, Islamic banks opened seven new branches while branches of conventional bank remained unchanged. Still, the number of domestic branches for conventional banks (235) remained significantly higher when compared to Islamic banks (173), though expansion of Islamic banking network has reduced the gap over the years.

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 5.6). For instance, e-banking transactions during 2016 accounted for almost 98.1% of all transactions (e-banking & paper-based combined). Specifically, the number of e-banking transactions reached 263 million in 2016, posting 13% growth compared to 2015. On the other hand, only



²⁶ This includes one branch of the specialized Industrial Bank of Kuwait as well as 12 branches of Foreign Banks in Kuwait (where 11 are conventional and one Islamic). Head offices (23), representative office (4) and branches of Kuwaiti banks abroad (16) are excluded.

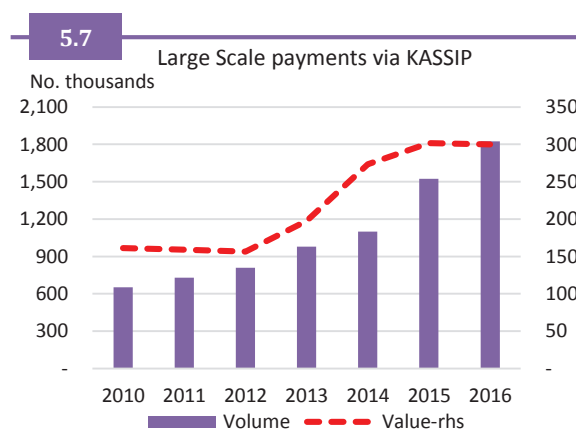
5.2 million transactions during the year were paper-based.

However, if viewed in terms of value, paper-based transaction still account for a relatively larger share compared to e-banking. For instance, during 2016, the share of paper-based transactions in terms of value was around 53%. Admittedly, even in value terms, e-banking is catching up, as its share has improved from 43% in 2013 to 47% in 2016.

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 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.

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.

In 2016, 1.8 million transactions were handled by KASSIP, registering growth of 19.7% compared to 2015 (*Figure 5.7*). On the other hand, growth in terms



of value marginally contracted (by 0.6%) during 2016 as transactions worth KD 299 billion were handled.

Financial Stability amid Innovations & Reforms²⁷

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

I am delighted to return to this forum for the fourth consecutive year. And thank you Mr. Banks for your kind introduction and for inviting me to speak before this august audience.

The conference this year is centered on the topic of ‘Meeting the challenges of financial innovations and reforms’. In line with this broad agenda of the conference, I would like to speak about both *financial innovations* and *reforms* – the two key forces of changes currently sweeping across the financial and economic landscape and their implications for the financial sector stability.

In the first part of my speech, I will talk about financial innovation, the opportunities it offers and the challenges it poses. In the second part, I will discuss reforms, particularly in the financial sector and their role in making our banking sector resilient. Finally, I will also touch upon the need for broader economic reforms which are critical to foster sustainable economic growth.

Financial innovations

Technological innovations are radically changing the way we conduct business, interact with each other or consume various products and services. Industries like transport and hoteling have already been shaken up by the likes of Uber and Airbnb. Financial sector, essentially an ‘information industry’, is also experiencing a major transformation fueled by advances in technology.

While the influence of modern technologies is now ubiquitous, let me briefly highlight a few areas of finance where the developments are particularly significant.

First, technology is supporting the outreach of formal financial services to the millions of otherwise unbanked customers. According to the World Bank, the poorest 20% of the world population is more likely to have access to a mobile phone than to clean water and sanitation. Capitalizing on this opportunity, a number of countries have managed to swiftly expand access to finance in recent years. For instance, Tanzania has more than doubled the percentage of adults with bank accounts through e-money services. And digital IDs have helped add 200 million new bank accounts in India.

It is pertinent to mention that here in Kuwait, we have already achieved a level of financial

²⁷ Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait, at the Euromoney Conference held on 27th September, 2016, Kuwait City

inclusion that is truly impressive by global standards; World Bank's data reveals that 86.8% of the population above the age of 15 years in Kuwait has an account with a formal financial institution, compared to a meager 14% in the Middle East region.

Second, programing breakthroughs like blockchain are potentially transforming the way we verify transactions and enforce contracts. By allowing parties to transact without central intermediaries, blockchain can strip off costs, reduce inefficiencies and enhance customer services. Reportedly, it can enable cross border payments without correspondent banks and can lower settlement times from around 3 plus days to a few seconds.

Hosts of other innovations are reshaping the way we transfer money or obtain credit. For instance, mobile wallets are enabling payments by smart phones, peer-to-peer lending is providing new sources of financing and robo-advisors are offering financial advice.

While undoubtedly exciting, these developments bring in their own unique risks and challenges. I would like to flag a few of them, particularly from the standpoint of financial stability.

First, cyber security risk is becoming an increasingly major part of banks' operational risk profile. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely and on a massive scale. Though such occurrences are still rare, the impact is massive, both in financial and reputational terms.

Second, financial technology firms or fintechs are unbundling parts of the finance value chain, offering financial services directly to customers. Apart from increasing competition and squeezing banks' profits, fintechs are moving part of the banking business to shadow banking which remains lightly regulated, if at all. Likewise, tech-enabled peer-to-peer lending and crowdfunding may exacerbate procyclicality and the scale of shadow banking.

Third, we may witness the emergence of new systemically important digital financial firms. The tech world already reflects a winner-takes-all phenomenon as few firms like Google and Apple enjoy huge presence in their respective areas; greater role of these firms in providing financial services may create a completely new set of unregulated too-big-to fail institutions with their own unique risks.

As this discussion indicates, innovations are by nature a disruptive force, causing a considerable degree of instability. Therefore, regulators face a daunting task of keeping financial systems safe and stable while continuing to ensure the convenience and efficiency that modern technologies offer. Indeed, it is a delicate balance to achieve, as we want neither to stifle innovation nor to undermine financial stability. Similar to when navigating unfamiliar domains, we need to remain agile, adaptive and proactive – this will ensure reaping the enormous benefits of financial innovations and at the same time limiting their downsides.

Reforms in the banking sector

Let me now turn to the second part of my speech, i.e. reforms. Since it is a very broad topic, I

will confine my discussion to some key regulatory reforms in the banking sector, given their direct relevance to the Central Bank of Kuwait's (CBK) mandate of financial stability.

As we have experienced in the past, stress in the financial sector can come from a variety of sources; it is hard to predict when or where the turbulence would emanate from. Consider the stress that financial markets have suffered from in recent years. In 2013, it was the US taper tantrum, in 2014 it was the oil prices collapse, in 2015 it was China's rebalancing and this year it was Brexit, just to quote a few examples. These events were markedly different in geographical origin and root causes but were common in rattling the global markets.

Against this backdrop, ensuring a resilient banking system capable of withstanding a variety of shocks is no easy task. And these shocks are not only exogenous; the banking system itself is in a state of flux amid evolving risks, in part due to the very financial innovations I just talked about. This necessitates the need for continuously upgrading our regulatory regime. Accordingly, CBK, over the past few years, have not only refined its existing regulations to reflect the best global practices but have also introduced a host of new measures, in line with the recommendations of the Basel Committee.

Let me very briefly point out only a few of the steps we have taken. First, we have enhanced our capital adequacy regime by setting out higher and better quality capital for our banks to further strengthen their loss absorbing capacity. We have also put up additional capital requirements for our systemically important banks. Furthermore, our additional *capital conservation buffer* and *countercyclical capital buffer* requirements would respectively enable banks to maintain additional cushion and would help contain the buildup of systemic risk. Secondly, we have introduced a simple *leverage ratio* as a supplementary measure to ensure that banks do not become overly leveraged. Last but not least, we have implemented two new liquidity standards; *Liquidity Coverage Ratio* and *Net Stable Funding Ratio* which are aimed to improve banks' capacity to withstand liquidity stress and to make their funding structure stable.

Admittedly, ensuring stability of a constantly evolving banking system can't be left to regulation alone. So we have also strengthened our supervisory capacity, which suitably complements our revamped regulatory regime and enables us to vigilantly examine banks' true compliance with our regulations. Moreover, our supervisory function gives us the agility to mitigate emerging risks before they materialize.

Despite these efforts, we are aware that we can't regulate and supervise every aspect of the banking system. Ultimately, the banks should assume prime responsibility for their actions and behaviors. Given the utmost importance of public confidence, banks can ill afford to operate with weak corporate governance or poor risk culture. Therefore, we have issued comprehensive guidelines to make banks' corporate governance more robust, supported by strong internal controls, prudent risk management and meticulous compliance.

We recognize that compliance with our regulatory measures is costly for banks; nonetheless, the cost of any financial crisis is way too steep; so it is only wise and rational to strengthen the capacity of our banks in benign times. By requiring banks to do so, CBK's proactive approach

paved the way for our banks to enter the low oil price environment from a position of strength. Without the robust buffers that we diligently built in good times, the banking sector would not have been able to withstand the stress so well.

As we have noted in our flagship *Financial Stability Report* for 2015 released in July, banking system in Kuwait has remained stable despite the challenging economic environment. Banks' non-performing loan ratio has continued its steady decline to reach 2.4%, a historically low level. Compare it to the NPLR of 11.5% back in 2009 and you would notice the substantial progress that our banks have made in cleaning their balance sheets. At the same time, the coverage ratio has climbed to a record high of 204%, substantially greater than the pre-crisis ratio of 87% observed in 2007. In terms of newly introduced liquidity coverage ratio, our banks are comfortably above the minimum benchmark of 70% for 2016. And even banks' net income have registered positive growth at a time when international banks are facing a distressing squeeze on profits amid low interest rate environment.

On the capital adequacy side, our banking system has stayed robust at 17.5%, well above the CBK's 12.5% requirement for 2015. Banks' overall leverage ratio at 9.7% is also substantially higher than the 3% global benchmark. And banking credit has posted a very healthy growth of 8.5% in 2015. This indicates that CBK's focus on financial stability has by no means restricted our banks' ability to support the real economic activity in Kuwait. Rather we believe that the soundness of our system has enabled our banks to continue lending despite a challenging macro environment.

Need for broader economic reforms

This brings me to the final part of my speech. Here I would like to briefly touch upon the need for economic and structural reforms that are critical for sustainable economic growth. Based on the few statistics that I shared earlier, it is obvious that our banks, at least so far, have weathered the oil rout fairly well. However, you would appreciate that banks' capacity to remain resilient is not infinite; a weak economic environment would ultimately put an otherwise stable banking system in considerable stress, eroding its resilience over time.

Though CBK is leaving no stone unturned in upgrading its regulatory regime and enhancing its supervisory focus, financial regulation can only go that far; it can't be the 'only game in town' because it is too narrow a tool to address macroeconomic and structural issues. Banking sector, no matter how stable, is only a component of the overall economic landscape and its stability can't obviate the need for economic reforms.

Fortunately, our financial buffers and low public debt provides us some breathing space; therefore, our economic reforms can be gradual, as long as the momentum is sustained. And I shall emphasize that the modest recovery in oil prices seen earlier this year is no excuse for complacency as only comprehensive fiscal and structural reforms would ultimately enable Kuwait to wean itself off oil dependence. Rationalizing expenditures, maximizing non-oil revenues, promoting private sector development, and diversifying the economy in general are

few of the areas, which would continue to require unremitting attention.

Conclusion

To conclude, CBK has made strenuous efforts in maintaining monetary and financial stability in these testing times. Our success is evident from the healthy trends in various financial indicators, a few of which I shared today. Yet financial and monetary stability is just a necessary but not a sufficient condition for the overall economic stability. Only the requisite economic reforms will help achieve revenue and economic diversification and will create a stable economic environment conducive for job creation and sustainable growth.

Thank you for your attention.

