

Financial Stability Report 2017



CENTRAL BANK OF KUWAIT



CENTRAL BANK
OF **KUWAIT**

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Financial Stability Report

for the calendar year 2017

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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TABLE OF CONTENTS

▪ Preface	III
▪ Coverage and Data Conventions	V
▪ Executive Summary	VII
▪ Chapter 1: Banks' Financial Intermediation	1
Box 1.1: Banking Regulation: looking back and looking ahead	9
▪ Chapter 2: Banks' Risk Assessment	15
Box 2.1: Financial Stability and Economic Resilience in Challenging Times	23
▪ Chapter 3: Profitability, Solvency & Resilience	29
▪ Chapter 4: Domestic Markets	39
▪ Chapter 5: Payment and Settlement Systems	57
Box 5.1: Fostering a Stable & Inclusive Financial System	61



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 6th FSR for the calendar year 2017, 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 Kuwait.

Through the publication of 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 any potential 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 2017 (CY17) using December 31st, 2017 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 4.3% 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 last two sections of Chapter 4, Boursa Kuwait & Real Estate Market, are based on the data from the local bourse and the Ministry of Justice, respectively.*



Kuwaiti banking system continued to remain sound and stable during the year under review (CY-2017). Growth in credit moderately picked up, despite some corporate repayments bringing down the year-end aggregates. Banks' non-performing loan ratio continued its steady decline for the eighth year in a row to reach a historically low level, thanks in part to the countercyclically built precautionary provisions supporting the requisite write-offs in 2017. Capital adequacy levels stayed robust, liquidity remained ample and net income posted healthy gains.

Collectively, these trends underscore the resilience of the banking sector that has remained unscathed despite the oil rout of 2014-16 or any of its lag affects. The encouraging performance trajectory of the banking industry can be ascribed to both industry specific factors and broader operating conditions. Internally, Kuwaiti banks entered the low oil price environment from a position of strength, with already low and declining NPLR and a high level of provisions justifiably built during benign times under the proactive guidance of the CBK. Externally, government's capital spending continued unabated, drastically limiting the impact of falling oil prices on domestic economic environment. By using ample financial buffers as well as borrowings, both domestic and international, government's expansionary fiscal policy supported economic activity and buoyed confidence, creating a conducive operating environment for local banks.

Following paragraphs highlight some of the key developments in the banking sector, domestic markets (money, foreign exchange, stock and real estate markets) and the payment & settlement system in Kuwait.

Banking System:

Financial Intermediation: Banking system posted visibly healthier growth in 2017 with its consolidated assets increasing by 7.4% on the back of higher private sector credit off-take and growing investments. Increase in domestic credit, by 3.9%, was marginally better than the year before though partly dampened by some corporate loan repayments. Lending to the households segment was up by 7.6%, making it the top recipient of bank credit for the third year in a row. Real estate sector also enjoyed positive growth of 4.4%, bucking the trend of 2016 (-3.4%) amid partial recovery in the real estate market on the back of a resurgent residential segment. Banks also increased their investments in government securities amid growing issuance of sovereign debt across the GCC region. Growth in banks' consolidated deposits also picked up to 7%, with domestic deposits posting 6.6%

Growth in assets and credit off-takes moderately picked up

increase in 2017, helped in part by oil price rebound. Consequently, the banking system continued to enjoy a stable funding base with time deposits accounting for 64.7% of the total deposits.

Credit Risk: Asset quality of the banking system has visibly improved over the 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 1.9% (1.3% on domestic, Kuwait- only basis) as of December 2017, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the recent past is particularly evident if the existing NPLR (1.9%) is compared with the double-digit NPLR (11.5%) observed in 2009.

Both the level and ratio of NPLs have dropped further, with NPLR at a new low (1.9%)

The improvement in asset quality in 2017 came in part from the active write-off policy supported by countercyclically-built ample provisions. Consequently, the coverage ratio (available provisions to NPLs) marginally came down, underscoring the fact that CBK has not adopted a unidirectional, 'higher-the-better' policy towards provisions; rather, it has allowed banks to use such provisions, built in benign times, to write-off bad loans whenever warranted. Still, the coverage ratio remains robust at 230% (317 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007.

...and coverage ratio at 230%

Sectoral analysis of NPLs indicates that the decline in NPLR has been quite broad based with all key sectors experiencing a contraction in their respective NPLRs, with the equity purchase loan segment posting the largest drop in absolute terms. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased. Industry breakdown reveals that conventional banks account for 54% of total NPLs, relatively lower than their share in gross loans (58.3%).

Market & Liquidity Risks: Banks' exposure to the equity markets has been on a steadily declining trend; equity investments make up around 15.6% of banks' total investments, and use of firms' shares as collaterals accounts for 18.8% of banks' overall collaterals. Banks' liquidity levels have remained healthy, with banks' LCR comfortably above the minimum benchmark (80% for 2017) or even against the ultimate benchmark of 100% (due in 2019). Positively, banks' funding structure has improved further, with increasing reliance on time deposits and diminishing role of non-core liabilities.

Liquidity remained ample during the year

Profitability: Banks' net income, on consolidated basis, grew by 8.9% in 2017, at a relatively stronger pace compared to 5.8% growth recorded in 2016. Higher interest and non-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 61.5% of the industry profits and a nearly proportionate 60.1% of the industry assets. Efficiency of the banking sector improved further as their cost to income ratio declined to 38.8%, though conventional banks continued to remain, on average, more cost efficient than their Islamic counterparts.

Banks' net income posted healthy gains

Solvency: Capital adequacy ratio (CAR) of the banking sector, though down by 2 bps on the year, was still robust at 18.45%, well above the CBK's 13% requirement for 2017. Islamic banks, as a group, continued to maintain capital adequacy ratios above conventional banks, in part due to 50% alpha factor as well as the use of leased assets as risk mitigants. Banks' leverage ratio, at 10.1%, stayed 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 stayed robust at 18.45%

Domestic Markets:

Money & FX Markets: CBK hiked its policy rate for the third year in a row, pushing the discount rate to 2.75%, a level last seen in 2010. Around the same time, in March 2017, government raised \$8 billion from its debut international bond sale that was greatly oversubscribed, attracting bids worth \$29 billion. The government also continued to tap the domestic banking sector, raising KD 3.1 billion compared to KD 2.9 billion in 2016. As a result, outstanding balance of public debt reached KD 4.7 billion in 2017. Still, domestic liquidity conditions eased further during the year, in part due to rebound in oil prices amid extension in OPEC+ agreement to cut production. In the foreign exchange market, KD appreciated against USD by 1.4% in 2017 while depreciating against Euro and GBP by 11.7% and 7.4% respectively; exchange rates were influenced by the improvement in relative prospects for growth and interest rates in UK and EU compared to the US.

US\$ 8 billion raised through debut international bond sale

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

Boursa Kuwait: Boursa Kuwait recorded healthy gains with its Price Index increasing by 11.4% amid anticipation of FTSE upgrade, Omantel's purchase of Zain shares and better economic fundamentals in general. Boursa's weighted index (WI)

Boursa closed the year 11.4% up, amid anticipation of FTSE upgrade

was up by 5.6%, putting Kuwait as the second best performing market in the GCC. Sector-wise, industrial and banks posted double-digit gains while trading activity visibly improved.

Real Estate Market: The real estate market declined by 7.1% in terms of sales value, contracting for the third year in a row. While sales in the residential segment staged a strong rebound (up 21.7%), overall market was weighed down by the poor performance of investment and commercial segments that were down 19.2% and 37.4% respectively. Activity in the investment segment was hurt by oversupply of investment buildings, somewhat higher water and electricity tariffs, and slower growth in expat labor, all pushing rental yields down. Increasing preference for small-ticket single apartment transactions also subdued sales. Still, banks in general appeared quite resilient to a downturn in the real estate market, notwithstanding their high exposures both in terms of loans and collaterals.

Real estate sales staged partial recovery amid resurgent residential segment

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 2017, value of ATMs and point of sale (POS) based transactions have posted growth of 4.2% and 10.1% respectively. These growth trends are visibly better, particularly in the case of POS, when compared to the ones observed in 2016 and underscore healthy recovery in household consumption amid improving consumer confidence. During the year, the share of ATM related transactions was higher (55%) in value while that of POS transactions was greater in terms of volume (68%). In general, though e-transactions account for 98.3% of all transactions in terms of volume, paper-based transactions (through cheques) still have a sizeable share (54.3%) 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 2,103 and 51,072 machines by December 2017. The number of branches however marginally declined to 419 amid the closure of a few Islamic bank branches.

Retail transactions hint at the healthy recovery in consumer spending

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

Outlook: Going forward, growth in private sector credit is likely to pick up 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. Strong rebound in oil prices will provide the additional fillip for continued capital spending, as well as supporting deposit growth. We expect the NPLR to stay around its current level, though a slight uptick in the ratio can't be entirely ruled out, given the marginal scope for its further decline. Still, high provisions would continue

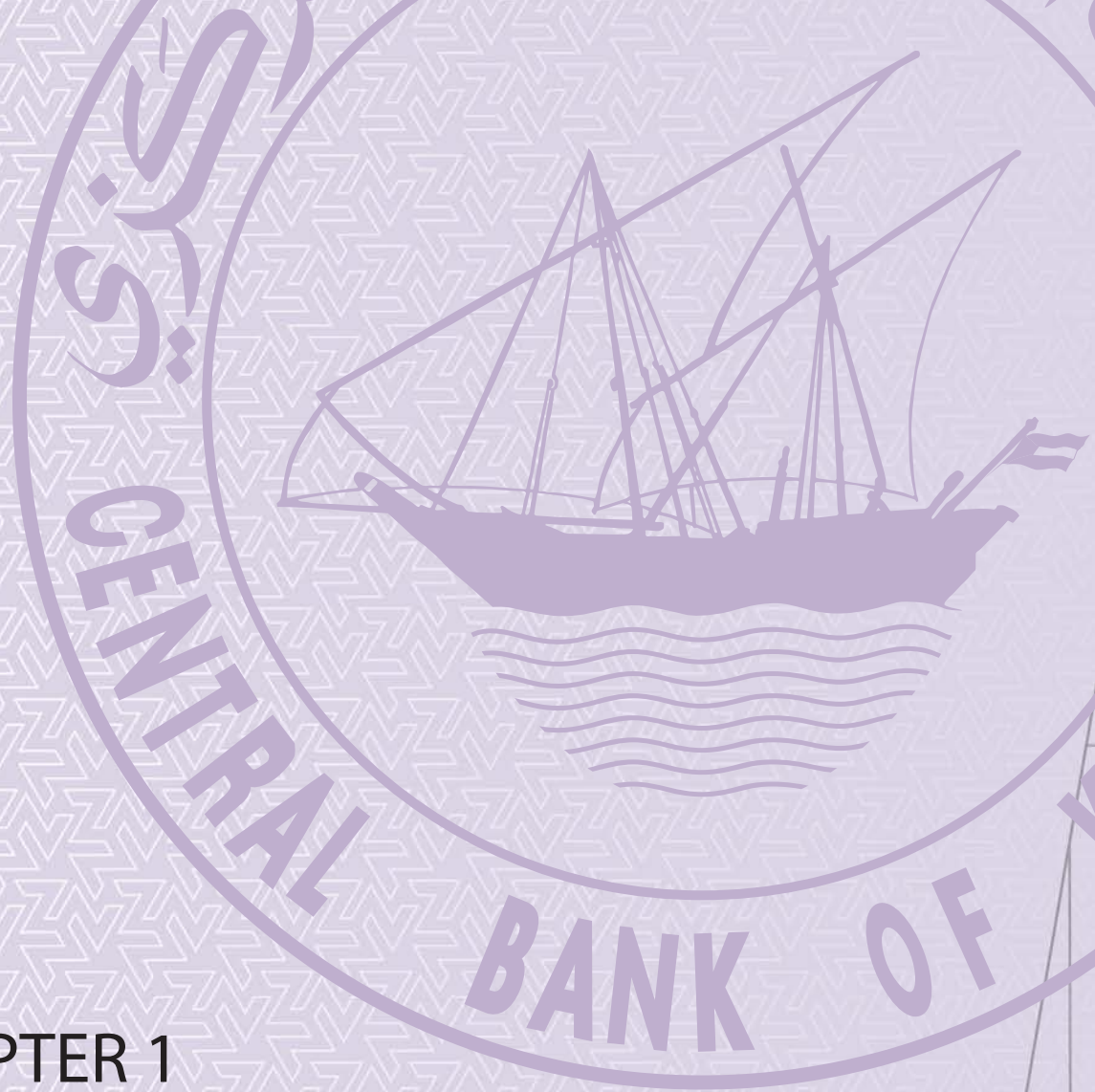
Banking sector would remain resilient

to support an active write-off policy, helping banks eschew any serious formation of infected loans on their books. Ample provisions will also help banks avoid any negative impact of the impending IFRS-9 rules. Liquidity levels will also remain comfortable, further supported by higher oil prices which will translate into greater deposit mobilization and lower budgetary borrowings from the banking sector. Banks' profitability is likely to improve, amid better economic conditions, increasing confidence, marginally higher interest income, lower provisions going forward and a very modest increase in NPLs, if at all. In view of the foregoing, the domestic banking sector is generally quite well placed to remain resilient in the near term. However, the risks emanating from banks' foreign operations can increase, particularly in countries with challenging security and/or economic conditions.

On the broader economic front, the price for Kuwaiti Export Crude has more than trebled from a worryingly low point of \$19 per barrel back in January 2016, thanks to the first OPEC+ agreement implemented later that year. If the price remains around its current level, oil revenues will improve further amid greater output on the heels of new OPEC+ production targets starting from July 2018. The strong rebound in oil price would surely offers additional breathing space to the government, though only comprehensive fiscal and structural reforms will eventually enable Kuwait to wean itself off oil dependence. Thanks to its enormous financial savings and low public debt, Kuwait can afford the reforms to be smooth and gradual as long as the measures are sustained.

Oil price rebound offers an opportunity for comprehensive reforms

The government has already introduced a few measures in the recent past, albeit at a modest scale, like the fuel price hike of 2016 and higher electricity and water tariffs in 2017. Better revenue collection and higher health premium for expats have also improved non-oil receipts. Still, further progress needs to be made on many 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. It is hoped that the recent resurgence in oil prices would not be taken as an excuse to delay necessary reforms as such an approach will keep the country vulnerable to future volatility in oil prices, with its attendant risks to the resilience of the banking sector.



CHAPTER 1

BANKS' FINANCIAL INTERMEDIATION

2021

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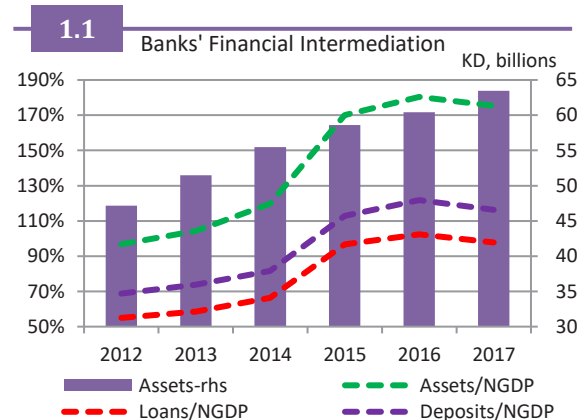
Banks' Financial Intermediation

Banking system posted visibly healthier growth in 2017 with its consolidated assets increasing by 7.4% on the back of higher private sector credit off-take and growing investments. Increase in domestic credit, by 3.9%, was marginally better than the year before though partly dampened by some corporate loan repayments. Lending to the households segment was up by 7.6%, making it the top recipient of bank credit for the third year in a row. Real estate sector also enjoyed positive growth of 4.4%, bucking the trend of 2016 (-3.4%) amid partial recovery in the real estate market on the back of a resurgent residential segment. Given that bulk of lending to households (86% in 2017) 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, banks' credit portfolio, notwithstanding its apparent lack of diversification, 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 across the GCC region. Finally, growth in banks' consolidated deposits picked up to 7%, with domestic deposits posting 6.6% increase in 2017, helped in part by oil price rebound. Consequently, the banking system continued to enjoy a stable funding base with time deposits accounting for 64.7% of the total deposits.

Banks' intermediation has ensured extensive financial inclusion

Financial intermediation, when measured in terms of key banking variables relative to the nominal GDP, marginally deteriorated on the back of much stronger growth in nominal GDP (denominator) compared to the expansion in domestic assets, loans and deposits¹ (Figure 1.1). Specifically, while domestic assets, loans and deposits increased in 2017 by 5%, 3.2% and 3.2% respectively, nominal GDP posted an increase of 8%², unlike its contraction of 2.8% in 2016.

Notwithstanding the drop in headline ratios, which is more of a mathematical outcome, banks' contribution as financial intermediaries has helped ensure a fairly high degree of financial inclusion in Kuwait. For instance, The World Bank's global finindex data reveals that 79.8% of the population above the age of 15 years in Kuwait has an account with a formal financial institution.



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 3.18 billion (representing 5% of domestic or 4.32% of consolidated banking assets).

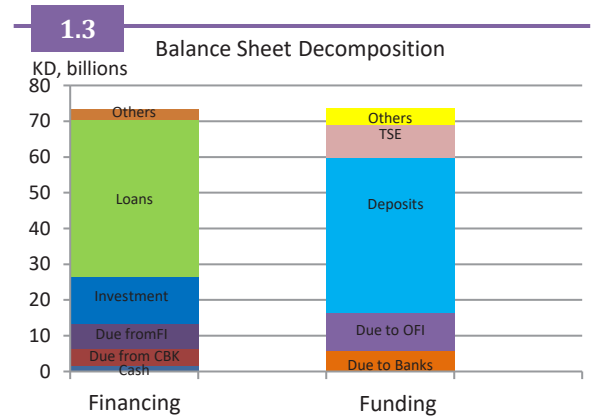
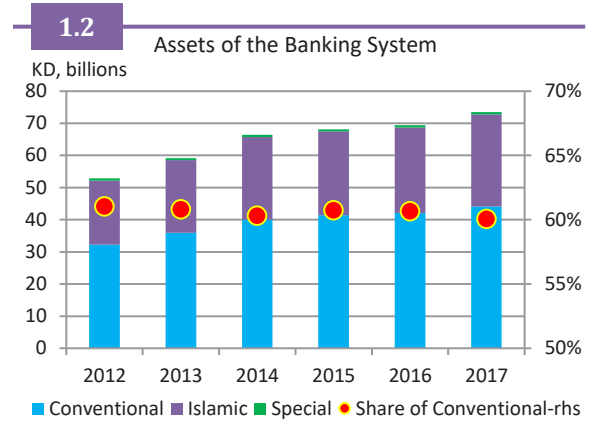
² IMF's World Economic Outlook database of April 2018.

Financial system continues to remain bank-centric

Kuwait’s financial system continues to remain bank-centric, with the banking sector³ accounting for around 88% of the domestic financial sector⁴. Investment companies are the second major player in the domestic financial system with around 10.5% share as of December 2017. Insurance 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 22.4% of the consolidated banking system.

When viewed on a consolidated basis⁵, conventional banks dominate the overall banking system, with 60% share as of December 2017; however, their share has remained broadly the same over the years (*Figure 1.2*). Still, Islamic banks, with 39% 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 the option to bank with the institutions of their choice.

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% of the total assets as of Dec. 2017 (*Figure 1.3*). Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 17.6% share in total assets. On the liabilities side, deposits account for



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

⁴ Here financial sector is being narrowly defined, and includes Banks, Investment Companies, Insurance and Exchange Cos.

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

59.1% of total liabilities, indicating a healthy deposit base and a stable funding structure.

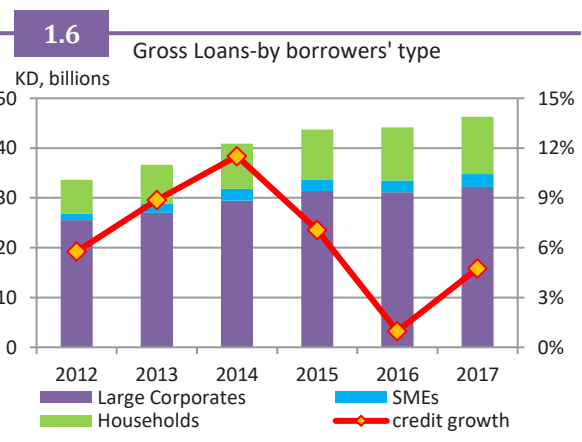
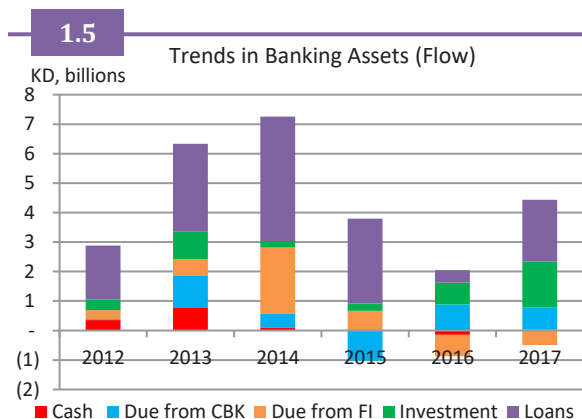
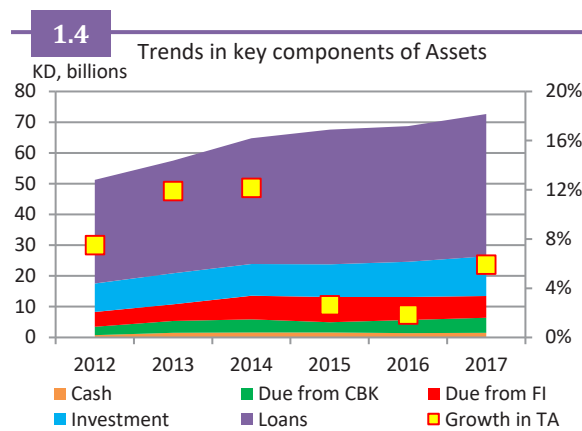
Higher credit and growing investments support assets growth

During 2017, consolidated banking assets posted much healthier growth of 6% compared to the lackluster growth (1.85%) observed in 2016 (Figure 1.4). Specifically, assets worth KD 4.1 billion were added to the banking system, pushing total assets to KD 73.5 billion by December 2017. This was a markedly stronger expansion compared to the addition of KD 1.26 billion in 2016.

As evident from the flow data for the key components of the assets side, stronger asset growth came on the back of better credit off-take and higher investments (Figure 1.5). Similar to last year, banks' investments continued to climb, supported by the greater issuance of sovereign debt within the GCC. While bank's placements with CBK (*Due from CBK*) were marginally lower in 2017, they still made a positive contribution contrary to *'Due from FIs'*.

However, the most significant contribution came from banks' consolidated loan portfolio which expanded by another KD 2 billion, posting 4.7% growth. This was a marked improvement compared to the credit growth of a meagre 1% (rise of KD 424 million) in 2016. Both domestic and foreign operations supported the higher credit growth, though foreign operations made relatively stronger contribution. Specifically, credit portfolio of banks' foreign operations expanded by 7.3%, in sharp contrast to the contraction of 5.4% observed in 2016. On the domestic front, growth in private credit off-take was also marginally better at 3.9%, compared to 3.3% recorded in 2016. However, the year-end increase in assets was partly dampened by some corporate repayments during the second half of 2017.

In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 69.6% of the total gross loans (Figure 1.6). A distant second was the households sector, with 24.9% share in overall credit and outstanding loans



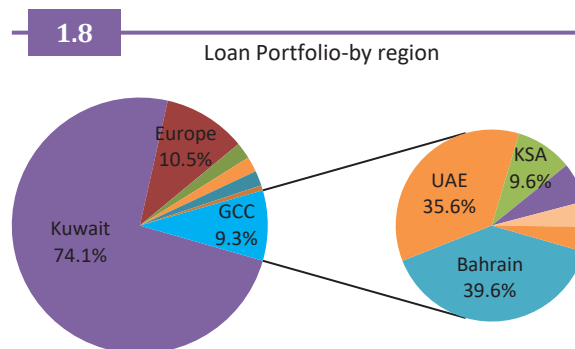
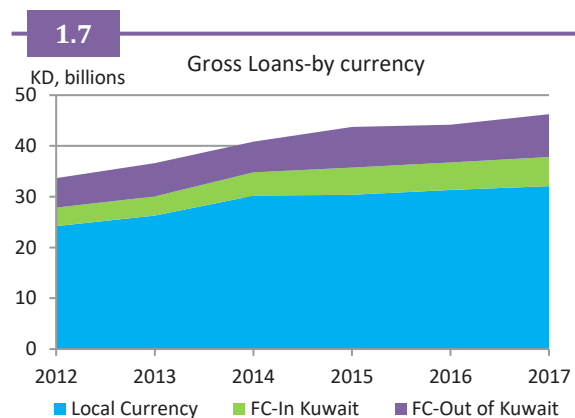
amounting to KD 11.5 billion as of December 2017. Though still moderate, there has been a shift from corporates to households in terms of credit allocation as the share of household sector has somewhat increased during the last few years.

Additionally, share of SMEs in overall lending slightly improved to 5.5% in 2017. 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%⁶.

The breakdown of banks' loans in terms of lending to the public and private sectors reveals that almost the entire lending was directed towards the private sector (96.9%), while the share of lending to the public sector was limited to a paltry 3.1% during 2017. Given the huge accumulation of financial assets over the last decade, the need for public sector to borrow from the banking system to meet its budgetary needs have remained limited. However, there has been a modest increase in borrowing in recent years, in part necessitated by the lower oil prices but also enticed by the low interest rate environment.

Currency-wise breakdown of the gross loans indicates that almost 69.4% of the overall lending was in the domestic currency, with the share of foreign currency (FC) marginally inching up to 30.6% from 29.1% in 2016 (Figure 1.7). Within FC loans, around 59.6% in 2017 were granted by Kuwaiti banks' subsidiaries & branches abroad (FC-out of Kuwait).

Geographical breakdown of banks' lending portfolio reveals that out of banks' 46.2 billion of gross loans as of December 2017, almost KD 34.3 billion (74.1%) have been granted within Kuwait (Figure 1.8). The remaining 25.9% of the gross loans were disbursed across various regions, with Europe and GCC accounting for around 10.5% and 9.3% respectively. Within the GCC, banks' greatest credit exposure was



⁶ In order to further support SMEs, 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).

confined to Bahrain, followed by UAE and Saudi Arabia.

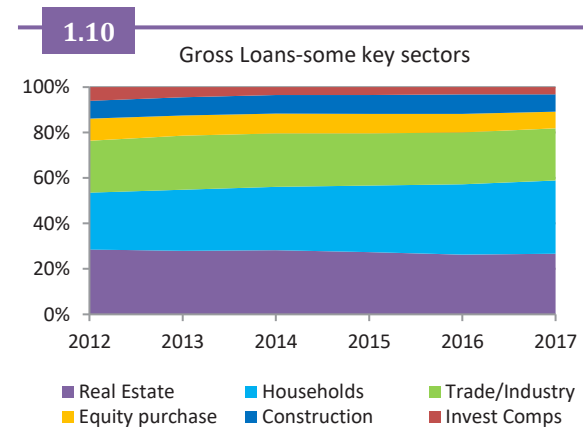
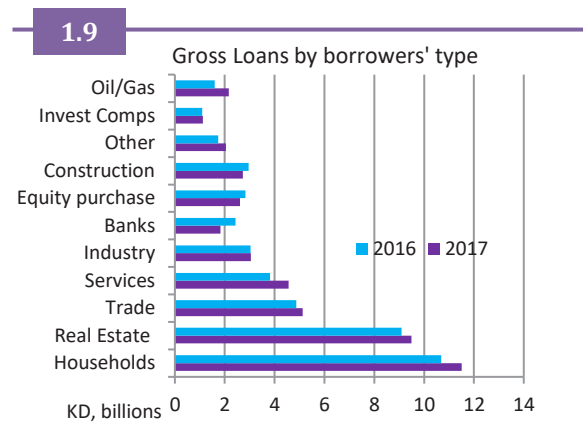
Banks' lending is shifting towards relatively safer segments

Breakup of gross loans across various sectors indicates a mixed trend, with some segments receiving greater credit while others witnessing a contraction (Figure 1.9). Noticeably, loans to *households* further expanded in 2017, highlighting banks' changing preference for low-risk exposures, a reflection of relative flight to quality. Credit to the *real estate* segment also posted positive growth after marginally contracting in 2016. Banks' lending to investment companies also inched up in 2017, bringing its share in banks' overall loan portfolio to 2.4%. While deleveraging in the investment companies that started in 2009 finally bottomed out in 2015, banks have continued to contain their exposure to the investment companies in general. Finally, lending to both *services* and the *oil/gas* sectors were also higher during 2017 compared to a year earlier.

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 1.10). 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 & services) account for almost 66.4% of the entire credit portfolio.

...with increasing exposure to households

Banks' credit to the households grew by 7.6% in 2017 to reach KD 11.5 billion, making *households* the top recipient of bank credit in Kuwait, followed by the real estate sector (KD 9.5 billion). Though growth in household credit was better than in 2016 (5.8%), it was still slower than the earlier five years of double-



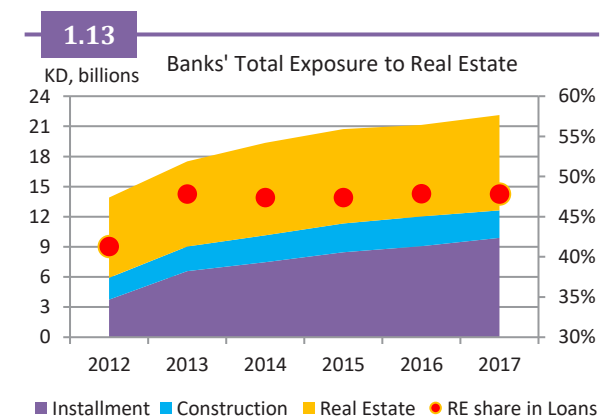
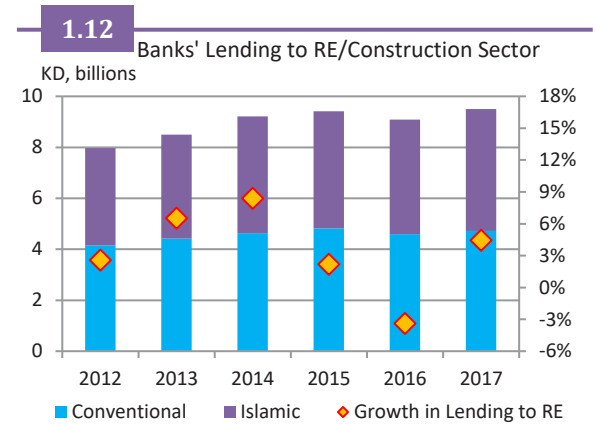
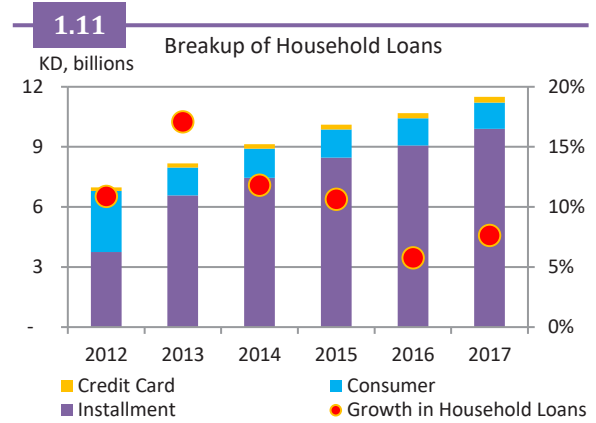
digit expansion, partly because of limited potential for further increase in credit to *households*.

Breakdown of household loans reveals that around 86% of the household loans have been *installment loans*, which are long term personal loans for repair and purchase of private homes (Figure 1.11). 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 11.5% share as of December 2017. Finally, credit card related loans made around 2.5% of overall household loans.

Banks' lending to the real estate sector increased by 4.4% in 2017 as the real estate market partially recovered on the back of a strong rebound in the residential segment (Figure 1.12). Despite the increase in absolute amount, the share of real estate loans in banks' overall credit portfolio marginally declined from 20.6% to 20.5% during 2017 as other sectors witnessed much stronger growth in credit. Both conventional and Islamic banks had somewhat similar size of exposure to the real estate, with conventional banks' accounting for a tad higher share (50.4%) in 2017.

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 9.5 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 1.13).

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



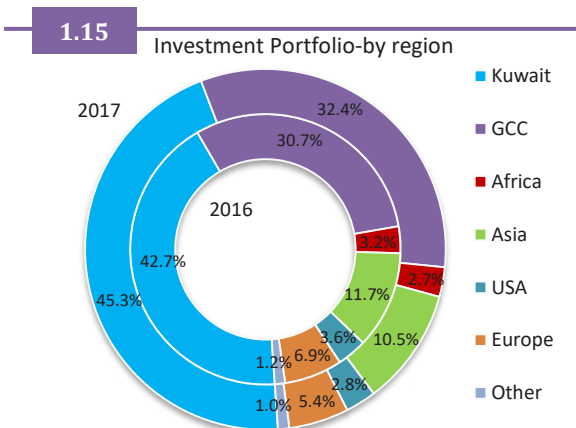
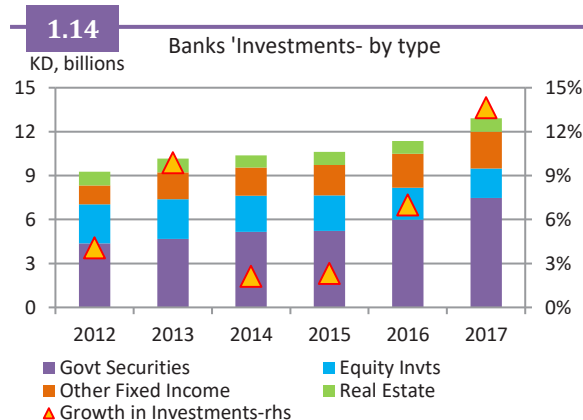
estate & construction sectors has been at low levels (1.9% and 2.8% respectively in 2017), indicating limited degree of infection (see Chapter 2 for details). Moreover, the risk of further NPL formation, at least in the short term, is contained, thanks to the partial recovery in the real estate market on the back of strong residential segment performance in 2017. As highlighted in Chapter 4, this suggests the presence of genuine demand in the market, notwithstanding an element of speculation which somewhat correlates with oil prices.

Banks' investments post strongest growth in years

Banks' investment portfolio posted strong growth of 13.6% in 2017 compared to 7% in 2016, in particular because of the rise in sovereign debt issuance (Figure 1.14). Investments' breakdown reveals that out of KD 12.9 billion of total investments, around KD 7.4 billion (57.8%) were placed in government securities as of December 2017.

Banks' exposure to other fixed income securities, which is the second major component, also posted a healthy growth of 8.8% in 2017; as a result, its share reached 19.4%, of banks' total investments. Banks' equity investments formed the third major category with 15.6% share in total investments. On the other hand, banks' investments in associates recorded a marginal contraction (down 1.9%) in 2017.

Geographical distribution indicates that banks' investments within Kuwait increased declined from 42.7% in 2016 to 45.3% in 2017 on the back of Bursa Kuwait's strong performance, particularly in the first and third quarter of 2017. Likewise, banks' exposure to GCC witnessed an expansion (Figure 1.15). On the other hand, banks' investments in Africa, Asia and Europe were down in terms of their share in total investments. These trends collectively underscore the improving quality and diversification of banks' investment portfolios as banks have reduced exposures to riskier markets.

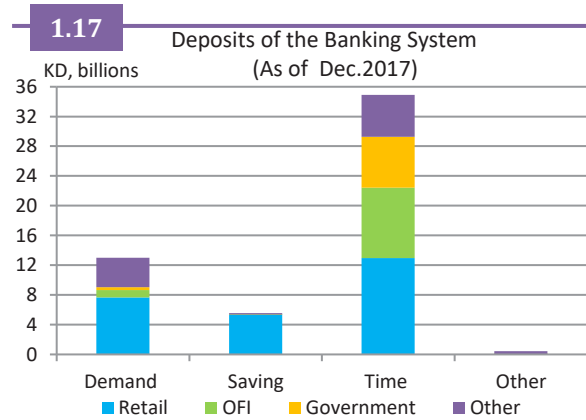
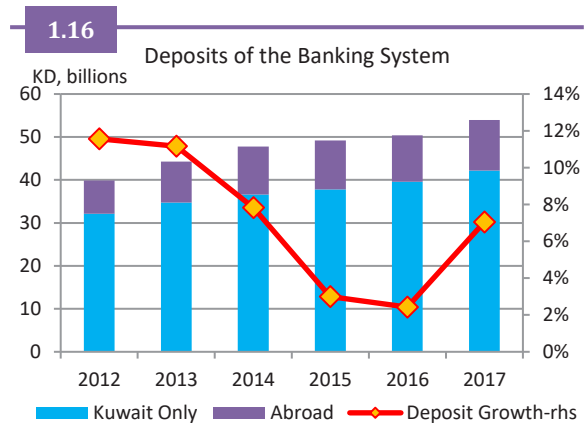


Growth in deposits posted a healthy rebound

Growth in banking system deposits picked up in 2017, increasing by 7%, compared to much slower growth of 2.4% recorded a year earlier (*Figure 1.16*). Deposits both within Kuwait and abroad enjoyed healthy growth, increasing by 6.6% and 8.8% respectively. Overall, deposits reached around KD 54⁷ billion as of December 2017, with domestic deposits accounting for 78.3% of total deposits of the consolidated banking system. Amid the healthy rebound in deposits from abroad, the share of such deposits marginally improved from 21.4% in 2016 to 21.7% in 2017.

Time deposits represent around two-thirds of banks' deposits

Breakdown of deposits reveals that time deposits account for around 64.7% of the total deposits, highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress (*Figure 1.17*). Retail deposits are well diversified into three different categories (demand, saving and time), in line with the consumers' transaction and precautionary demands for money. Finally, the deposits of other financial institutions (OFI) and government are predominantly placed as time deposits which further adds to the stability of banks' funding base.



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

Banking Regulation- looking back and looking ahead⁸

Your Excellencies, Distinguished Guests,

Sabah-al-khair and a very good morning.

I am very delighted to return to this forum, 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, this event has become a valuable forum to discuss issues that are relevant for the region, and exchange ideas on key financial sector developments.

As this year marks the 10th anniversary of global financial crisis, it is fitting to reflect upon the past, assess where we stand at present, and consider what lies ahead of us.

Looking back

Let me start with the past.

A decade back, few had imagined that a subprime mortgage crisis in the US would soon engulf a major part of the global financial system. As we all know now, the financial meltdown that followed had serious economic consequences; global output sharply declined, growth significantly slowed down and unemployment soared across the world, particularly in advanced economies.

Globally, cumulative output loss since the GFC has been a hefty 25% of the world's GDP; these estimates don't include the social costs associated with high unemployment and lost output. Within the US alone, around nine million jobs were lost, and eight million homes were foreclosed. In many countries, public at large felt abandoned, as income inequalities widened.

Equally significant for the financial services industry was the loss of public trust. Ethical drift and poor incentive structures led to a range of violations, from widespread mis-selling of mortgages to manipulation of LIBOR, that not only undermined the public confidence in the financial sector, but also caused a huge reputational loss.

The exorbitant costs of the GFC, both monetary and reputational, prompted global community to work together in restoring financial sector stability.

⁸ Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait in the 13th 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 13, 2017 in Abu Dhabi, UAE.

What we have achieved so far

Ten years on, and the journey of building a resilient financial sector still continues. Nonetheless, thanks to the efforts of the global regulatory community, significant safeguards have been put in place to mitigate the risk of a similar crisis in the future.

Though banks in the MENA region were generally well capitalized and prudently regulated, regulators across the region have further refined their existing regulations along with the implementation of Basel III reforms.

For instance, capital adequacy regime has been enhanced, with higher and better quality capital. Additional *capital conservation buffer* and *countercyclical capital buffer* requirements have also been put in place to help banks maintain additional cushion and limit the buildup of systemic risk. Likewise, *leverage ratio* has been phased in as a backstop to CAR. And the implementation of *Liquidity Coverage Ratio* and *Net Stable Funding Ratio* have further strengthened banks' capacity to withstand liquidity stress and to make their funding structure more stable.

Thanks to these regulatory reforms, banks in our region entered the low oil price environment from a position of strength. Reflecting the impact of the drop in oil prices, fiscal deficit for the MENA oil exporters has surged from 1.1% of GDP in 2014 to 10.6% of GDP in 2016. Yet there are hardly any major signs, at least so far, of deterioration in banks' resilience in general – despite the fact that banks are in this low oil price environment for over three years now.

Indeed, the degree of resilience varies from country to country. Yet the broader presence of financial sector stability across the oil exporting countries underscores the fact that banks in these economies have weathered the oil rout quite well. This would not have been possible without strengthening our regulatory regime and building buffers in benign times.

Even the concern that increasing burden of regulations might reduce banks' capacity to lend appears unfounded. For instance, while banks' minimum capital requirement has increased, we have not observed a noticeable impact on the availability of credit. Financial Stability Board has also made a similar observation.

In fact, the soundness of our banks has not only helped them weather a challenging macro environment, but has also enhanced their capacity to deliver on their primary objective of credit intermediation.

What lies ahead of us

While a great deal of progress has been made, reforming regulations is a continuous process, a journey rather than a destination.

So we need to consider what lies ahead of us.

First, we should take stock of what we have already put in place, determine the effectiveness of our measures, and examine if there are any unintended consequences. We need to assess if our

regulatory reforms have been over or under done; whether we are too stringent to stifle innovation, or too lax to ignite instability. And despite the wide-ranging reforms, possibly some of the risks are still not adequately captured.

Consider the current risk charge for operational risk under Basel III. In recent years, the scale and sophistication of cyber-attacks have increased significantly; hardly a month passes without the news about a major breach in personal data affecting millions of customers. For instance, a cyber-attack on Equifax, a credit reporting firm, compromised the private data of 143 million customers in the US. Despite the increasing scale and sophistication of cyber-attacks, banks continue to treat such risks the way they used to do so a decade back. At least this is our impression by looking at the risk weighted assets reported by our banks which barely reflect the true scale of operational risk they face today.

Second, as we assess the adequacy and effectiveness of our new regulations, we need to examine if potential benefit of greater financial stability truly justifies the banks' cost of compliance with new measures. In setting prudential limits, we can't simply follow a 'higher-the-better' rule. After all, we don't want to be just resilient. We want to be '*efficiently resilient*'. We aim to design and build a regulatory regime that, at best, helps avoid any financial turmoil, and at least limits the very potential of even the buildup of a crisis. And in doing so, we need to justify the costs that new regulations entail.

This brings me to the third point of *proportionality* in regulation. Cost of compliance does vary across institutions, as larger banks enjoy economies of scale. Moreover, with the increasing complexity in regulation, smaller banks might be at a disadvantage, which has implications for competition in the banking sector.

So our regulations need to be not only commensurate with the risks, but also with the sophistication of the institutions involved. While many of the regulations have a degree of proportionality already embedded, there is some scope for further reducing the compliance costs for smaller banks. However, every regulator needs to carefully consider the costs and benefits in their own domestic context as no one size fits all. In the end, as Einstein put it, it is desirable to '*make everything as simple as possible but not simpler*'.

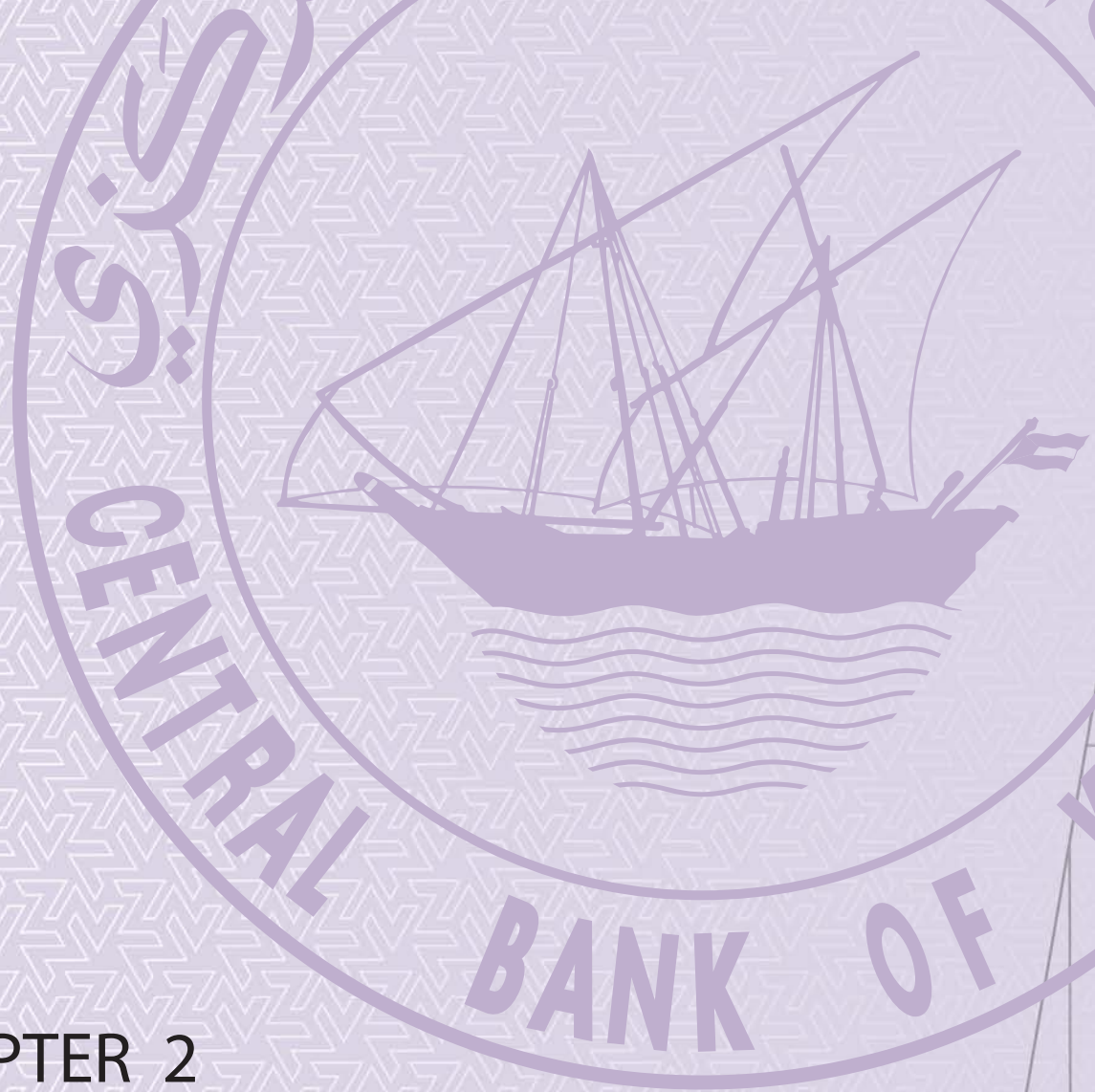
Fourth, supervision needs to play its part as regulations alone can only go that far. It is effective supervision that enables us to vigilantly examine banks' performance and gives us the agility to mitigate emerging risks before they materialize. It is also easier to adapt our supervisory approach to evolving risks instead of constantly tweaking the regulatory rulebook. So we should continue to reexamine our supervisory toolkit and build our capacity.

Fifth, with the growing footprint of financial technologies, we face a delicate act of balancing the risks and rewards coming from innovations. In principal, we need to regulate innovations in an *enabling* and *proportionate* manner, using a tiered process of introducing rules in accordance with the risks involved. That is why regulators are increasingly adopting a 'regulatory sandbox' approach to provide a testing ground for innovative products or services. This approach would

help harness the potential of innovative technologies without exposing the entire financial system during the early stages of exploration and development.

To conclude, I am pleased to be here as this forum provides a valuable platform to discuss issues of mutual concern. With the rapidly evolving nature of banking and financial markets, we can't fully predict what will come next. Therefore, we, the regulators, need to be, as Churchill said, 'awake to the tips of our fingers'.

Thank you for your attention.



CHAPTER 2

BANKS' RISK ASSESSMENT

2021

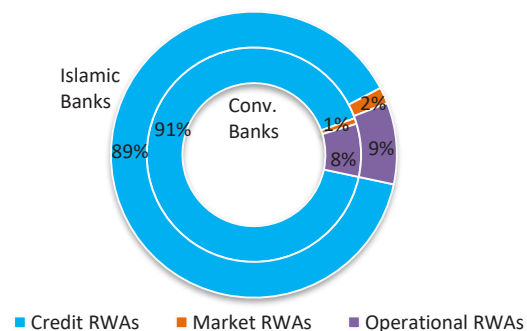
Asset quality of the banking system has visibly improved over the years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has further dropped to a historically low level of 1.9% (1.3% on domestic, Kuwait- only basis) as of December 2017, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the recent past is particularly evident if the existing NPLR (1.9%) is compared with the double-digit NPLR (11.5%) observed in 2009. The improvement in asset quality in 2017 came in part from the active write-off policy supported by countercyclically-built ample provisions. Consequently, the coverage ratio (available provisions to NPLs) marginally came down, underscoring the fact that CBK has not adopted a unidirectional, 'higher-the-better' policy towards provisions; rather, it has allowed banks to use such provisions, built in benign times, to write-off bad loans whenever warranted. Still, the coverage ratio remains robust at 230% (317 %, 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 quite broad based with all key sectors experiencing a contraction in their respective NPLRs, with the equity purchase loan segment posting the largest drop in absolute terms. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased. Industry breakdown reveals that conventional banks account for 54% of total NPLs, relatively lower than their share in gross loans (58.3%). Banks' exposure to the equity markets has been on a steadily declining trend; equity investments make up around 15.6% of banks' total investments, and use of firms' shares as collaterals accounts for 18.8% of banks' overall collaterals. Finally, banks' liquidity levels have remained healthy, with banks' LCR comfortably above the minimum benchmark (80% for 2017) or even against the ultimate benchmark of 100% (due in 2019). Positively, banks' funding structure has improved further, with increasing reliance on time deposits and diminishing role of non-core liabilities.

While credit risk accounts for bulk 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 2017 (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 greater variety of risks. On the other hand, insignificant contribution of market risk in overall RWAs is in part because of banks' relatively smaller trading portfolios.

2.1

Distribution of Risk Weighted Assets (RWAs)



During 2017, overall RWA increased by 6.6%, at a relatively stronger pace than the 4% growth recorded in 2016. It was essentially because the growth in assets also markedly increased (by 5.9%) during 2017, compared to 1.8% in 2016. Consequently, the ratio of RWA to total assets inched up to 69.2% in 2017 from 68.8% a year earlier, suggesting a mild shift towards riskier assets (*Figure 2.2*).

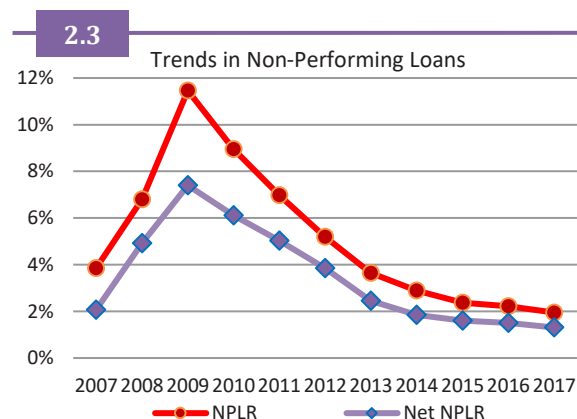
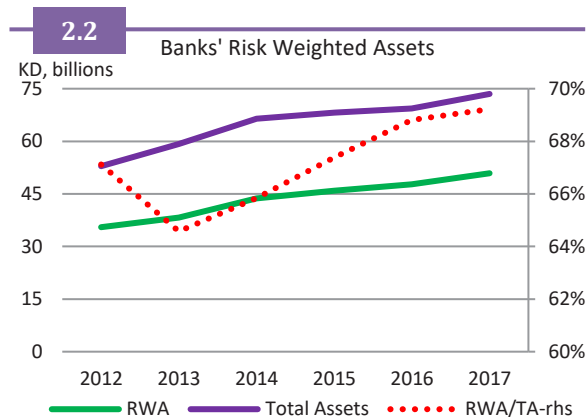
...banks' asset quality remains healthy with NPLR at record low

Yet the credit risk, which constitutes the bulk of RWAs of both Islamic and conventional banks, has continued to slide to historically low levels. Specifically, the absolute value of non-performing loans (NPLs) of the banking sector has steadily declined for the eighth 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.

As a result, the NPL ratio (NPLR) in 2017 edged further down to 1.9%, half of the pre-crisis ratio of 3.8% recorded in 2007 (*Figure 2.3*). Understandably, the pace of decline in NPLR has tapered as most of the credit portfolio is already performing and the scope for any major improvement is quite limited. Net NPLR has also been on a receding trend since 2009 and has reached a historically low level of 1.3% in 2017. Taken together, these trends in NPLR (both gross and net) underscore a major improvement in the asset quality of the banking sector, made possible by banks' strenuous efforts in line with CBK's instructions and active engagement with the industry.

...helped in part by high coverage ratio

In particular, CBK has required banks to countercyclically build provisions over the years in order to better cope with any potential deterioration in their asset quality. As a result, *available provisions to NPL ratio* reached 230% in 2017, though at a marginally lower level when compared to the all-time

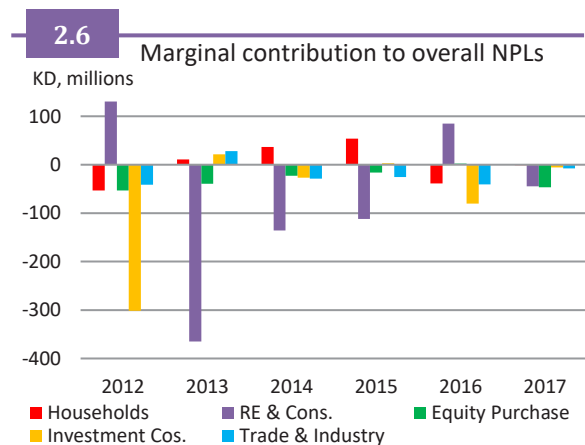
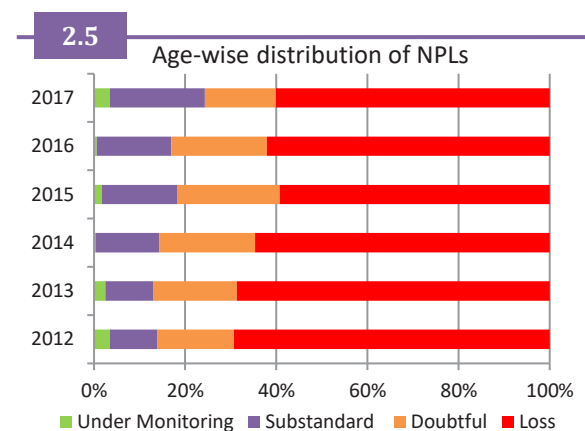
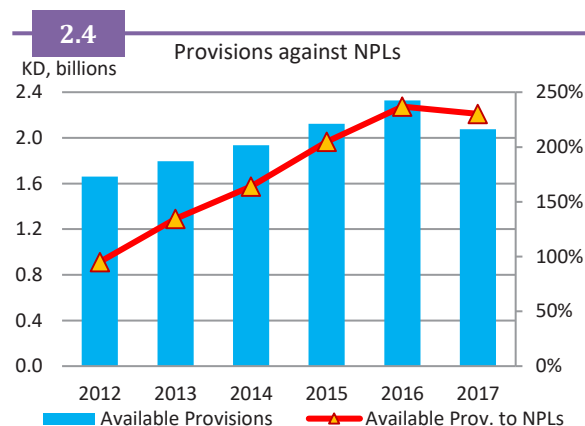


high of 237% in 2016 (Figure 2.4). The drop in coverage ratio came as banks used these provisions to write off some bad debt, in line with the spirit of a countercyclical measure released in time of need. This indicates that CBK has not adopted a unidirectional, ‘higher-the-better’ policy towards provisions; rather, it has allowed banks to use such provisions, built in benign times, to write-off bad loans whenever warranted. Still, even at its current level (230%), coverage ratio is quite high and would continue to provide the banking industry a strong cushion in times of stress.

NPLs’ classification by age profile indicates that the share of two riskier categories (‘loss’ and ‘doubtful’) has come down from 83.1% in 2016 to 75.7% in 2017, both due to slower buildup of new NPLs as well as banks’ active cleaning of their books, thanks to the availability of abundant provisions already made (Figure 2.5). Going forward, some NPL formation is not unlikely, given the rising NPLs under the first two categories (‘under monitoring’ and ‘substandard’), which represented a combined share of 24.3% in 2017 compared to 17% in 2016. However, new NPLs will accumulate from a low base and at a slower pace, and banks have sufficient provisions to comfortably manage any potential deterioration in asset quality.

Sector-wise decline in NPLs has been broad-based

Data for the marginal contribution of different sectors in the industry-wide NPLs reveals that contraction in infected loans has been quite broad-based. All key sectors have posted a decline in NPLs during 2017, reflecting the widespread improvement in banks’ asset quality (Figure 2.6). In particular, NPLs to *real estate and construction* sector posted a noticeable drop in 2017 (44.5 million), in stark contrast to its rise (85.2 million) a year earlier. Likewise, NPLs of *equity purchase loans* category also declined significantly. Collectively, this marks a very positive development as two of the riskier sectors for banks’ credit, in terms of exposure to real estate and stock market, have registered a noticeable drop in their respective NPLs from an already low level.

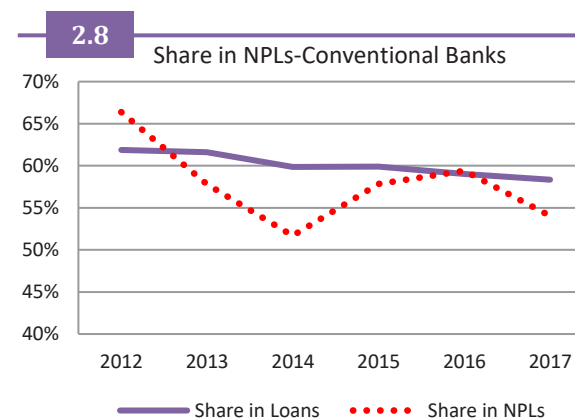
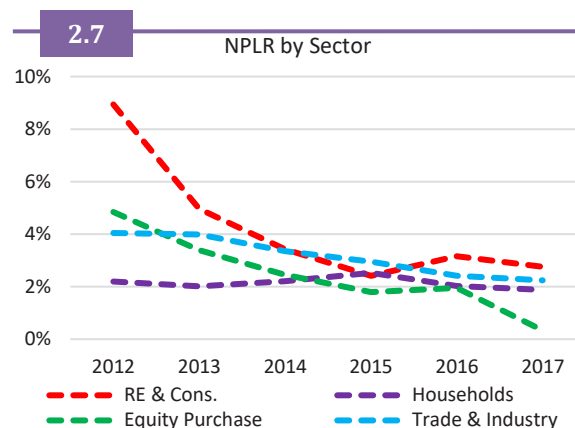


Sector-wise NPLRs also reflect a declining trend in the infection ratio, though the scale of decrease understandably varies across sectors. For instance, NPLR for the *real estate and construction* sector has come down from 3.2% in 2016 to 2.8% in 2017 (Figure 2.7). Both the rise in gross loans to the sector and partial recovery in the real estate market, though largely driven by a resurgent residential segment, has underpinned the improvement in asset quality.

The sharpest decline was however observed in the case of NPLs in *equity purchase loans* segment, as its infection ratio plummeted from 2% to 0.3% in 2017. The sector was in part helped by better performance of Boursa Kuwait which was ranked 2nd best performing market in the GCC in 2017 (see Chapter 4, Section 3 on Stock Market).

The improvement in the NPLR of *household* segment is both due to lower NPLs and higher gross loans granted. Specifically, there has been a steady increase in the share of household sector in banks' gross loans, reaching 24.9% in 2017. Moreover, infection level in the category of *installment loans*, which represent 86% of gross household loans, has also remained quite contained, with NPLR of 1.7%. On its part, CBK has introduced a number of regulations, encompassing both micro and macro-prudential tools, to contain the possibility of infection in the household exposures⁹.

Segregation of NPLs by banks reveals that conventional banks' share in the industry NPLs have been relatively more volatile, though their share in gross loans have remained broadly the same during the last few years (Figure 2.8). During 2017, conventional banks' contribution to industry NPLs moved down to 54%, comparatively lower than their share in gross loans (58.3%). 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



⁹ For instance, these loans are primarily extended to Kuwaiti nationals, provided the payments are not above 40% of their salaries (net of all deductions). Moreover, the interest rate charged on these loans is capped at 3% above the prevailing discount rate set by the CBK. Furthermore, since these loans are typically smaller in magnitude and are granted to numerous individuals, the overall portfolio is well diversified with a much lower risk profile.

account for 68.6% of the total loan portfolio of the banking industry; thus, a sharp change in the quality of credit portfolio in even one of those banks can significantly alter the industry averages.

Geographical distribution of NPLs highlights that the share of domestic NPLs has decreased over the last year, accounting for 61% of the total NPLs in 2017 (Figure 2.9). In general, domestic operating environment has been relatively more conducive on back of continued public spending as well as the rebound in oil prices. Outside Kuwait, the contribution towards non-performing loans from the GCC and Europe has inched up while that from Africa and Asia has remained the same.

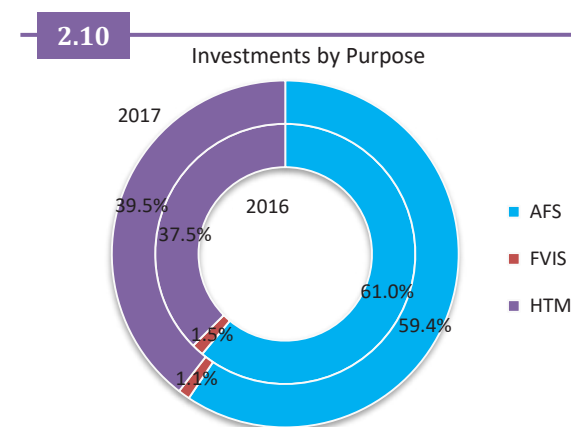
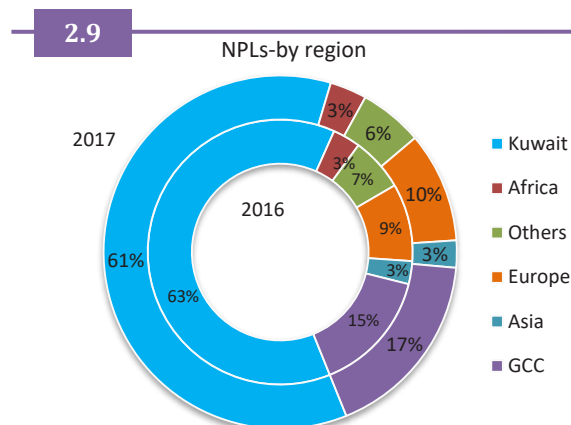
Market risk remains the smallest component in overall RWAs

Given the traditional nature of Kuwaiti banks' operations, market risk remains a fairly small component of the overall RWAs, accounting for a meager 1.9% as of December 2017. The bulk of the banks' investments (around 77.3% as of December 2017) are in fixed income instruments, out of which around 74.8% 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 59.4% have been placed under *Available for Sale* (AFS) category. Investments under *Held to Maturity* (HTM) represent the second major segment (39.5%) 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



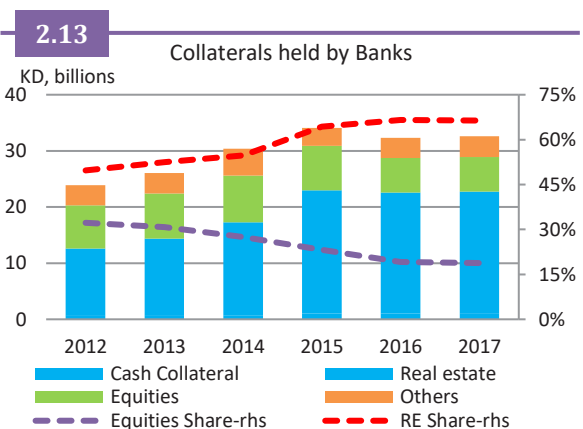
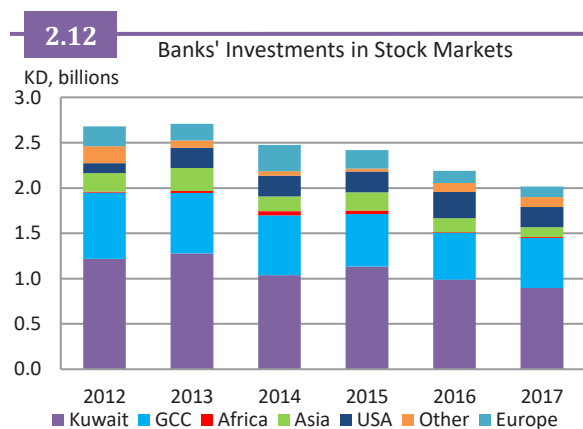
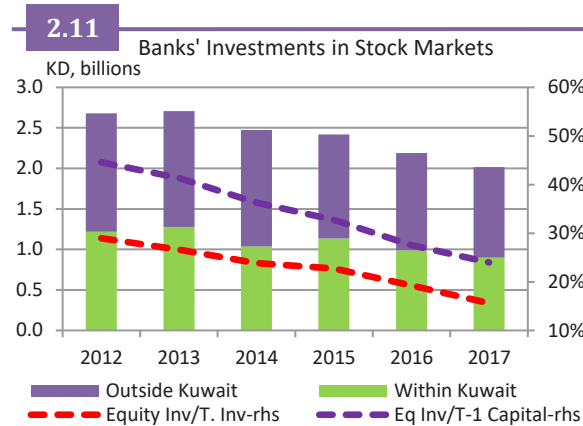
investments, use of shares as collateral in lending and loans for purchase of shares. The first aspect covers banks' direct exposure to the equity market while the other two highlight the banks' indirect exposures through their loan portfolios.

First, in terms of banks' direct exposure, banks' equity investments represent 15.6% of their total investments by end of 2017 (Figure 2.11). While sizeable, the share of equity investments has halved during the last five years when compared to 29% back in 2012. Likewise, banks' equity investments against their Tier-1 capital have steadily dropped to reach 24%, at the lowest level in the last eight years. These numbers indicate that banks have actively reduced their exposure to stock markets, as higher sovereign debt issuance in the region has provided banks an attractive investment alternative.

Banks' overall equity exposures has also declined in absolute terms by around KD 170 million to reach KD 2 billion in 2017. Geographical breakdown reveals that banks' exposure to local bourse represents 44.5% of their total investments in stock markets during 2017, marginally lower than 45.2% in 2016 (Figure 2.12).

On the other hand, banks' exposure to GCC markets have increased from 23.4% to 27.3% during the same period. With around 55.5% 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 18.8% of the total collaterals held by banks (Figure 2.13). In fact the use of shares as collateral has been steadily receding since 2010 from a high of 40.5%. While banks' overall exposure to equity collateral stands drastically reduced, some banks are still significantly exposed to



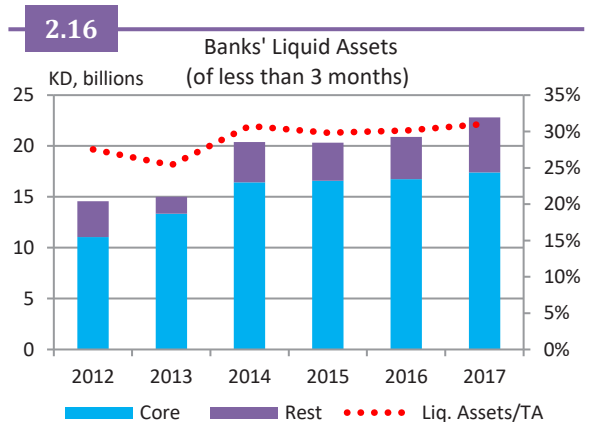
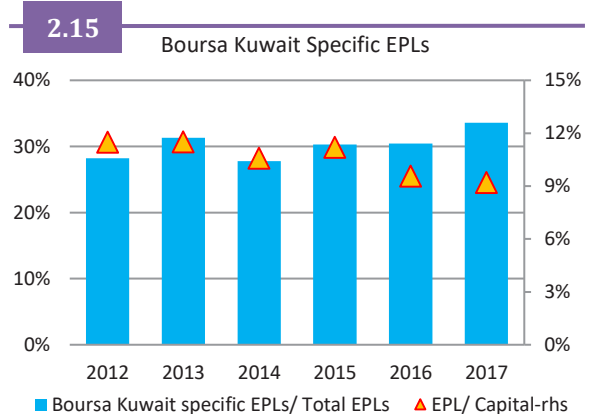
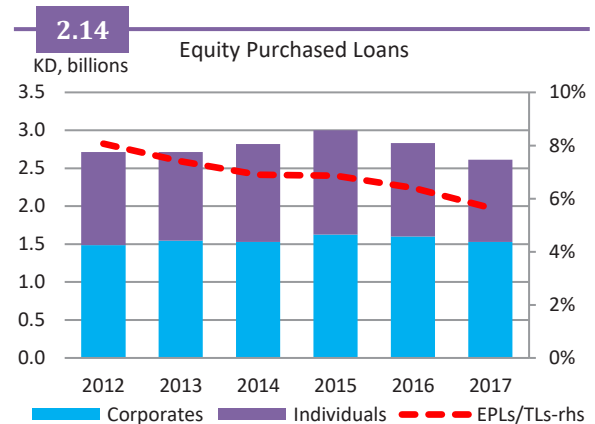
sharp swings in equity prices. On the other hand, share of real estate collateral has reached 66.3% in 2017 from 43.7% in 2010; the steady increase in the share of real estate collateral poses its own set of unique risks, not the least because of the complications in liquidating such collaterals in the event of a default.

Third, banks' indirect exposure to equity markets also emanates from the loans granted to customers (both individuals and corporates) for trading in shares. These loans, termed as equity purchase loans (EPLs), make up around 5.7% of banks gross loan portfolio. The breakdown in terms of recipients reveals that *corporates* account for 58.6% of these loans with *individuals* receiving the rest in 2017 (Figure 2.14). However, representing only 1% of banks' total non-performing loans, EPLs remain quite insignificant component of banks' risk exposure. Additionally, banks' EPL portfolio is quite healthy with NPLR of a meager 0.3% in 2017.

With regards to banks' lending to residents for EPLs, CBK has put in place adequate caps in order to keep the exposure to the local bourse 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 2.5% in 2017 while *equity purchase loans to capital* stood at 9.2% in 2017 (Figure 2.15).

Banks' liquidity level remains healthy

Banks liquid assets of less than three months tenor increased by 9% to reach KD 22.8 billion in 2017 (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 76.3% of the overall liquid assets in 2017. Moreover, as a component of total

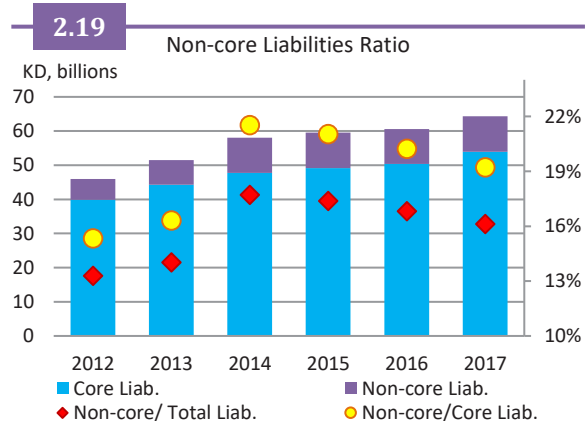
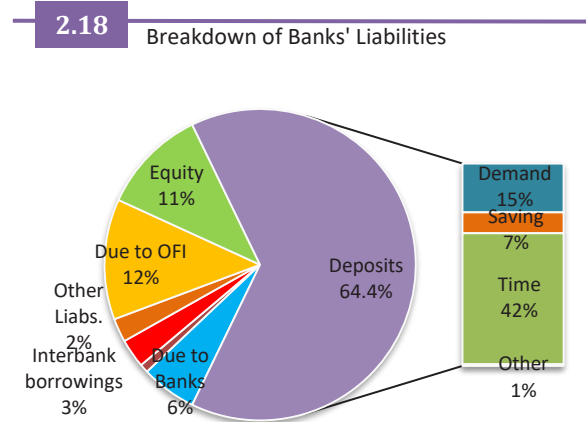
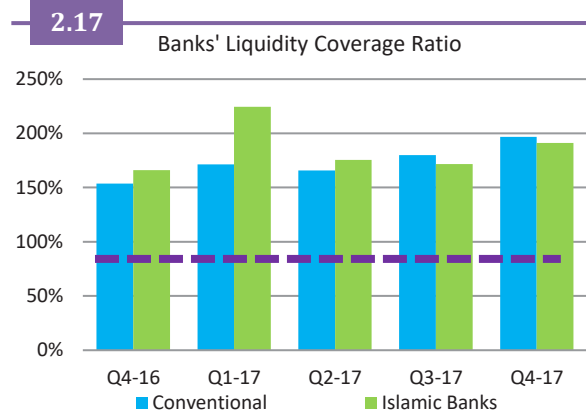


assets, core and liquid assets accounted for 23.7% and 31% respectively as of December 2017.

Banks' healthy liquidity levels are also evident from their Liquidity Coverage Ratio (LCR); while CBK has 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 2017, both conventional and Islamic banks are well above the 80% benchmark (for 2017) or even ultimate benchmark of 100% due in 2019 (*Figure 2.17*). While the LCR of Islamic banks was somewhat higher in the first two quarters of 2017 when compared with conventional banks, the trend has reversed during the second half of 2017.

Breakdown of banks' liability structure reveals that deposits account for the bulk of their funding base (64.4%), relatively higher even when compared to 58.4% in 2016. Within deposits, time deposits represent around 41.7% of the overall funding base and around 65% of total customer deposits (*Figure 2.18*). 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 three years after exhibiting an increase during the earlier years (*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 further.



Your Excellency, the Deputy Prime Minister and Minister of Finance,

Distinguished Guests,

Sabah-al-khair and a very good morning.

I am delighted to return to this forum for the fifth 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 “Financial Challenges and Financing Opportunities”, a topic very relevant to the core mandate of the Central Bank of Kuwait. CBK, both as the monetary and regulatory authority, has a distinct role to play in ensuring a smooth flow of national savings to productive investments.

That is why we see our mandate to preserve monetary and financial stability not as the final objective in itself, but a mean towards an end - the end being robust economic growth and shared prosperity where financial sector plays its due role.

Probably we should remind ourselves of the implications when regulatory bodies fail to effectively deliver on their mandates. Incidentally, this year marks the 10th anniversary of global financial crisis, which originated as a subprime mortgage crisis in the US but soon engulfed a major part of the global financial system. The financial meltdown that followed had serious economic consequences; global output sharply declined, growth significantly slowed down and unemployment soared across the world, particularly in advanced economies. By some estimates, cumulative output loss since the GFC has been a hefty 25% of the world’s GDP; these estimates don’t include the social costs associated with high unemployment and lost output.

Equally significant for the financial services industry was the loss of public trust. Ethical drift and poor incentive structures led to a range of violations that undermined the public confidence in the financial sector and caused a huge reputational loss.

Given that experience, how can we avoid the repeat of a similar crisis? As Soren Kierkegaard, a Danish philosopher once put it, ‘life must be understood backwards, but it must be lived forward’. It is in this spirit that the global regulatory community, by learning from the experience of GFC, has put in place significant safeguards to mitigate the risk of a similar crisis in the future. While the banking system in Kuwait remained unscathed during the GFC, CBK has continued to refine its existing regulations and has also introduced a host of new measures, in line with the best global practices.

¹⁰ Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait at the Euromoney Conference held on 26th September, 2017, Kuwait City.

Ensuring a robust regulatory regime

Let me first highlight a few of the steps that CBK has taken on the regulatory front and how our banks fare against the new measures.

First, we have enhanced our capital adequacy regime by setting out higher and better quality capital. As highlighted in our flagship *Financial Stability Report* for 2016, CAR of the banking industry stands at 18.6%, well above the Basel benchmark. We have also put up additional capital requirements, upto 2%, for our systemically important banks. Furthermore, our additional *capital conservation buffer* and *countercyclical capital buffer* requirements aim to help banks to maintain additional cushion and limit the buildup of systemic risk.

Second, we have also put in place a simple *leverage ratio* as a backstop to CAR. Again, Kuwaiti banks stand at 10.1%, substantially higher than the 3% global benchmark.

Third, we have further strengthened banks' capacity to withstand liquidity stress and to make their funding structure more stable by implementing *Liquidity Coverage Ratio* and *Net Stable Funding Ratio*. Admirably, in both ratios, our banks are already well above the minimum benchmark. Fourth, asset quality has also visibly improved, with banks' non-performing loan ratio steadily declining to reach 2.2%, a historically low level. We have also ensured, based on thorough analyses, the justified buildup of sufficient provisions; consequently, coverage ratio has climbed to a record high of 237%. And while the banks in many advanced economies are struggling to remain profitable, growth in our banks' net income has remained healthy.

What these indicators collectively signify is the ability of Kuwaiti banks to play their role in credit intermediation with an ultimate aim to support economic growth. We believe that the soundness of our banking system has not only helped them weather a challenging macro environment but has also enhanced their capacity to deliver on their primary objective.

It is pertinent to emphasize that CBK doesn't follow a 'higher-the-better' rule to regulations. We aim to be prudent but in a balanced way, carefully weighing the costs of each measure against its benefits. In the end, we don't want to be just resilient. We want to be '*efficiently resilient*'. We aim to design and build a regulatory regime that, at best, helps avoid any financial turmoil and at least limits the very potential of even the buildup of a crisis.

We also need to appreciate that such a degree of resilience in our banking sector is not by some accident; CBK, along with the banking community, has worked diligently to achieve this, by proactively building buffers and by being prudent despite the pressures to ease up.

Addressing emerging risks

I have just described a few of the regulatory tools we have introduced during the last few years. However, a constantly changing business environment and a dynamically adapting banking system require us to remain vigilant for the upcoming risks.

A key driver of this change, as we all know, is the growing footprint of latest technologies in our lives. Obviously, financial sector is not immune to these developments; rather it is at the center stage of such progress, evident from the increasing role of financial technology firms or fintechs in the finance value chain.

The influence of financial technologies is now ubiquitous. The use of mobile network operators and digital IDs are enabling payments, savings, credit and insurance products which were not feasible a decade back. Technology is also supporting the outreach of formal financial services to the millions of otherwise unbanked customers. And hosts of other innovations, like mobile wallets, crowd-funding and robo-advisors are reshaping the way we transfer money, pay bills, obtain credit or make investments.

A delicate balance for central banks is to determine how far to go in embracing fintechs without compromising safety and stability of our systems. On the one hand, President of the Deutsche Bundesbank has suggested that central banks may consider issuing their own digital currencies. But on the other hand, incidents like a recent cyber-attack on credit reporting firm Equifax that compromised the personal information of 143 million US customers highlight the risks involved. To address this dilemma, CBK has adopted a ‘regulatory sandbox’ approach to provide a testing ground for innovative products or services. Our approach to regulate innovations is both *enabling* and *proportionate*, as we aim to use a tiered process of introducing rules in accordance with the risks involved.

To make this process a success, we are bringing all stakeholders on board, which not only include financial institutions but also the fintechs behind innovative products. Our collaborative efforts are meant to provide new entrants with innovative solutions a level playing field to operate but without exposing the entire financial system during the early stages of exploration and development.

Achieving macroeconomic resilience

In the final part of my speech, let me say a few words about the broader economic context we operate in. As I pointed out at the outset, financial system is a conduit between savers and investors, thus playing a central role in allocating scarce resources and supporting economic growth and employment.

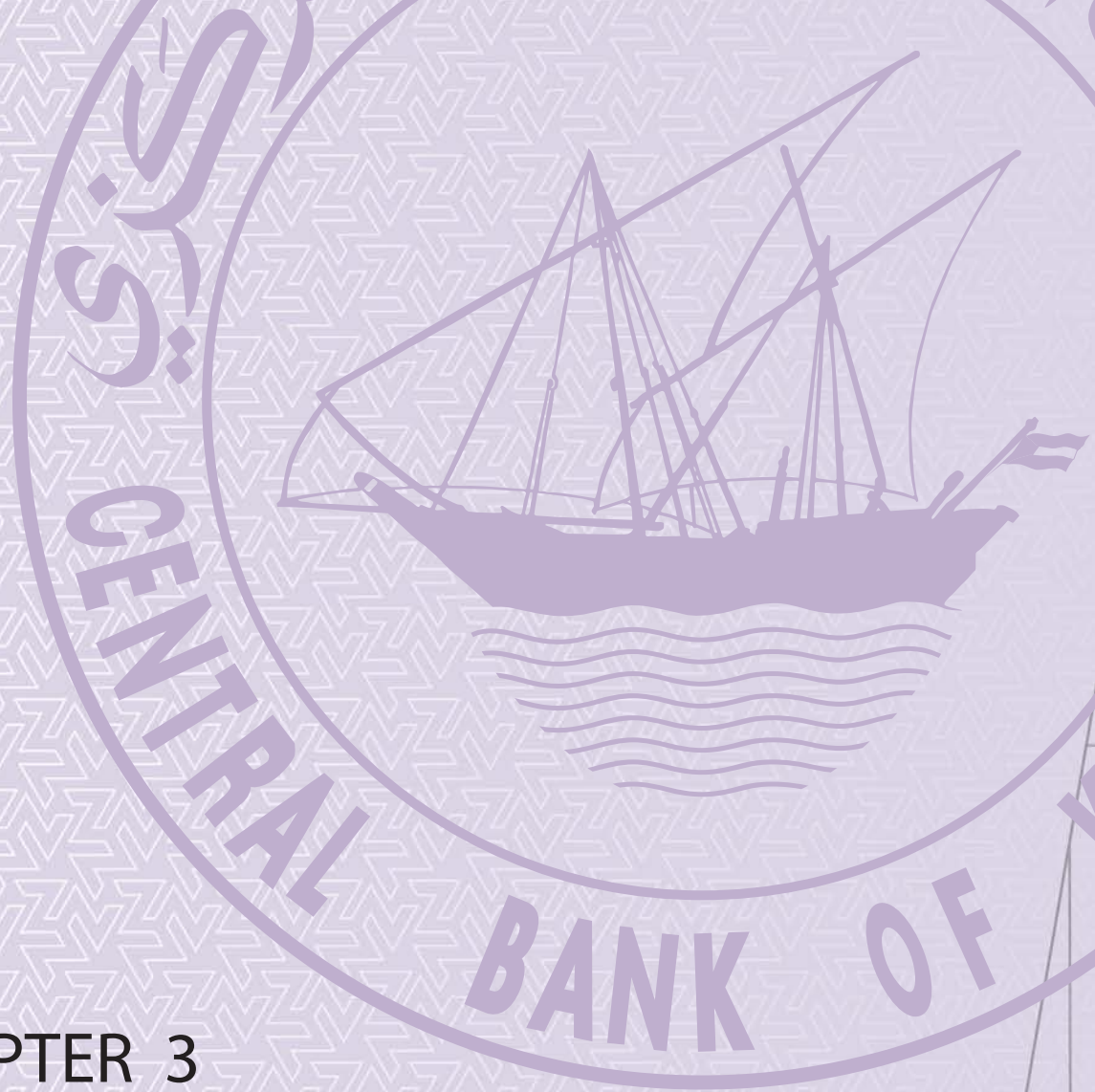
Given the close link of the financial system to the broader economy, it is easy to imagine how a weak economic environment can undermine the stability of a financial system. So far, our banking sector has weathered the low oil price environment fairly well. For over three years into these challenging conditions, our banks have not only remained sound and stable but have also enhanced their capabilities and resilience. However, I must emphasize that banks’ capacity to remain resilient must not be taken for granted; a weak economic environment would ultimately put an otherwise stable banking system under stress.

On a positive note, the government has taken some difficult yet necessary steps to enhance macroeconomic resilience and strengthen fiscal sustainability. Still, progress on many structural fronts is needed; further rationalizing expenditures, increasing non-oil revenues, reforming labor market, increasing private sector role and in general diversifying the economy are some key areas

that would continue to require unremitting attention. Our high fiscal buffers provide us some breathing space; that means we can gradually introduce economic reforms provided the momentum is sustained.

To conclude, we at the CBK have made strenuous efforts in maintaining monetary and financial stability in these testing times. Yet a sound banking sector is only a pillar that is necessary but not sufficient to maintain the stability of the overall economic architecture; equally essential are requisite economic and structural reforms to preserve macroeconomic sustainability.

On our part, at the CBK, we will remain, as Churchill said, 'awake to the tips of our fingers'. Thank you for your attention.



CHAPTER 3

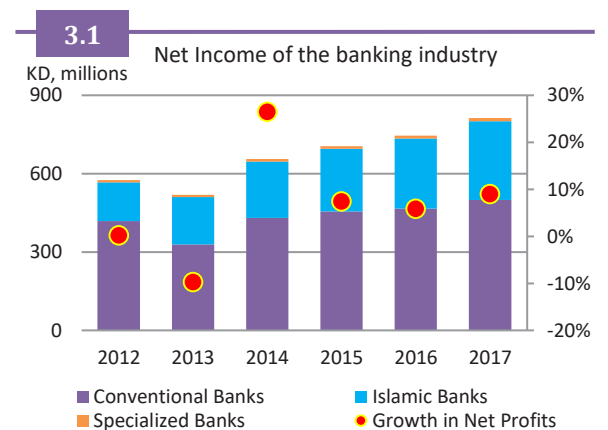
PROFITABILITY , SOLVENCY & RESILIENCE

2021

Banks' net income, on consolidated basis, grew by 8.9% in 2017, at a relatively stronger pace compared to 5.8% growth recorded in 2016. Higher interest and non-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 61.5% of the industry profits and a nearly proportionate 60.1% of the industry assets. Efficiency of the banking sector improved further as their cost to income ratio declined to 38.8%, though conventional banks continued to remain, on average, more cost efficient than their Islamic counterparts. Capital adequacy ratio (CAR) of the banking sector, though down by 2 bps, was still robust at 18.45%, well above the CBK's 13% requirement for 2017. Islamic banks, as a group, continued to maintain capital adequacy ratios above conventional banks, in part due to 50% alpha factor as well as the use of leased assets as risk mitigants. Banks' leverage ratio, at 10.1%, stayed 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, grew by 8.9%

Profitability of Kuwaiti banks posted a relatively healthier growth in 2017 when compared with a year earlier; banks' net income after tax¹¹, on a consolidated basis, increased by 8.9% to reach KD 812.6 million (Figure 3.1). Overall recovery in economic activity, underpinned by healthy growth of non-oil sector, and the rebound in oil prices improved operating environment. Moreover, lower loan loss provisions expense, higher interest income coupled with moderate growth in interest expenses and better non-interest income collectively helped improve the net income of the banking industry. In general, banks' profitability has invariably recorded positive growth in recent years except for the year 2013¹².



¹¹Based on profit share of banks' shareholders.

¹²In 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 2017, Islamic banks posted a much stronger growth in their net income (12.4%) than conventional banks (7%).

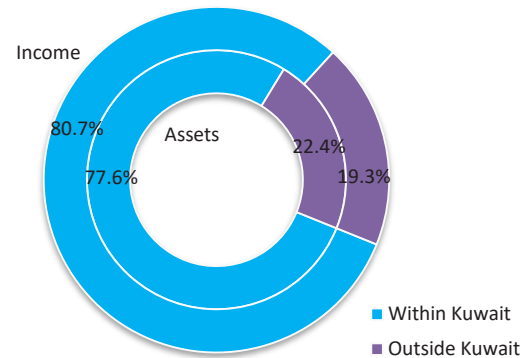
Breakdown of the net income among domestic and foreign operations reveals that 19.3% of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad, signifying the importance of banks' foreign operations. However, when compared with the banks' share of assets abroad (22.4%), share of income was relatively lower (19.3%), suggesting that foreign operations in general have been marginally less profitable than domestic operations¹³ (Figure 3.2). This in part can be attributed to the challenging economic and security situation in some of the countries where Kuwaiti banks' subsidiaries operate, particularly in comparison to relatively stable economic conditions in Kuwait on the back of strong economic fundamentals and visible recovery in oil prices.

...helping return ratios inch up further

Amid rising net income of the banking sector, both average return on assets and equity improved further in 2017 (Figure 3.3). Specifically, return on average equity (ROAE) improved from 8.5% in 2016 to 9% in 2017; likewise, return on average assets (ROAA) also inched up by 6 basis points to reach 1.12% in 2017. Improvement in return ratios was on account of relatively stronger growth in net income (8.9%) compared to growth in average assets (5.9%) and equity (4.3%) of the banking system. This is in sharp contrast with the 2011-13 period when return indicators were steadily falling due to a much stronger growth in equity and assets of the banking system on the one hand and negative growth in net income on the other (except for 2012 when net income grew by a meager, yet positive 0.2%).

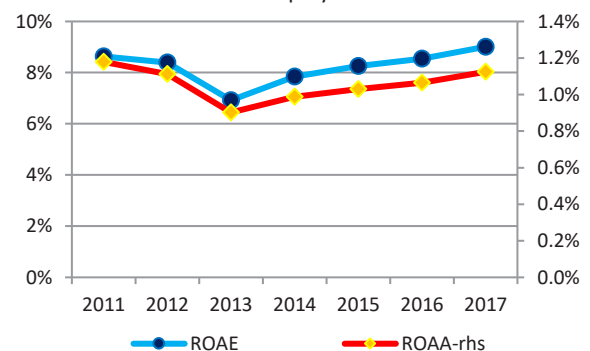
3.2

Distribution of Assets & Net Income



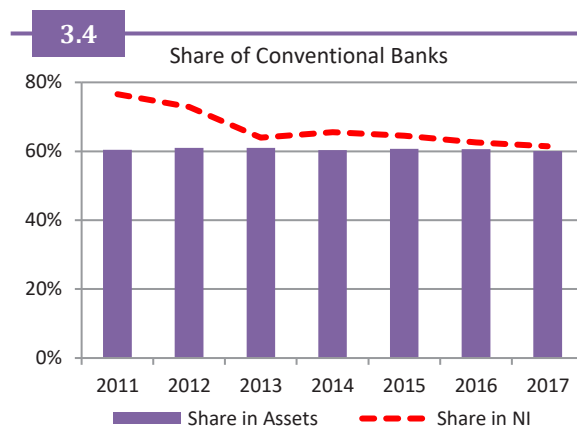
3.3

Return on Equity & Assets

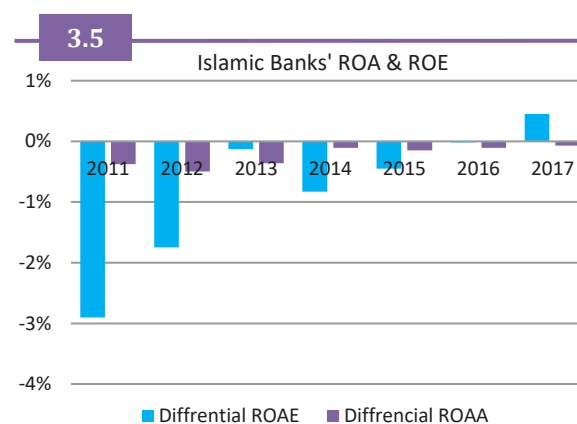


¹³ Still, banks' current share of income is fairly commensurate with the size of their assets abroad, compared to the situation two years back when income share was disproportionately lower (12.5%) against the share of assets abroad (22.8%).

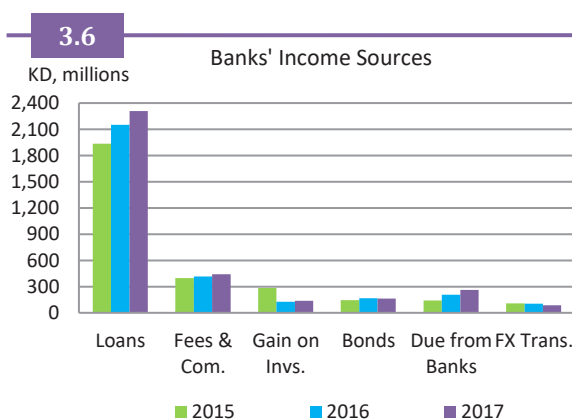
Comparison between share in net income and share in assets reveals that conventional banks account for around 61.5% of the industry profits, only marginally greater than their share (60.1%) in total assets (*Figure 3.4*). Conventional banks' share in industry profits was disproportionately higher back in 2011 but has gradually come down amid increasing share of Islamic banks. Admittedly, these trends are only true at the group level, as visible differences among individual banks still remain.



The gap between industry wide returns¹⁴ and those enjoyed by the Islamic banks have steadily shrunk over the years, thanks to relatively higher growth in Islamic banks' net income. In fact, 2017 witnessed the ROAE of Islamic banks surpassing the industry average for the first time, resulting in a positive differential ROAE (*Figure 3.5*). This is in stark contrast with the trend observed in some earlier years (2011-12) when ROAE of Islamic banks was considerably lower than that of the industry. ROAA has also followed a similar trend, though marginally less pronounced, in part because of 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 82.4% of banks' interest income and 64.4% of their total income in 2017. Moreover, the breakup of interest income from loans reveals that 49.6% came from credit facilities granted to retail clients while the remaining half (50.4%) from lending to corporates. Fees & Commissions represented the second major source of income, accounting for 12.3% of the total income. The year also witnessed noticeable increase in income from interbank placements, representing 7.3% of banks' total income.



In general, most sources of income made a positive contribution in 2017 except for *fx transactions* which

¹⁴ 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.

was 16.3% lower during the year. Income from bonds also posted a marginal decline of 1.6% during 2017.

NII was lifted up by higher income and slower growth in interest expenses

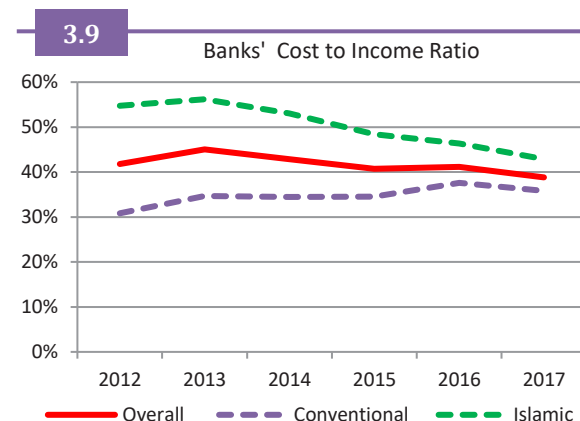
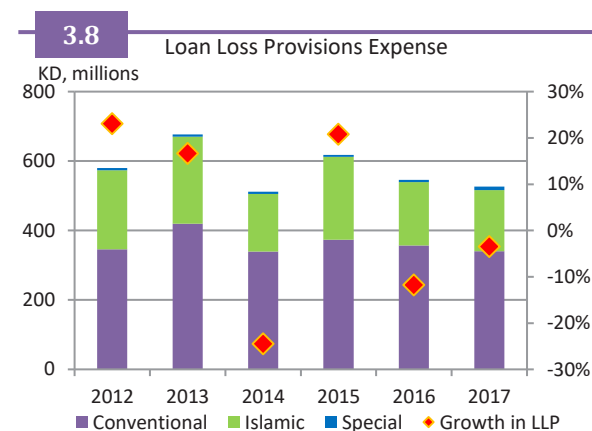
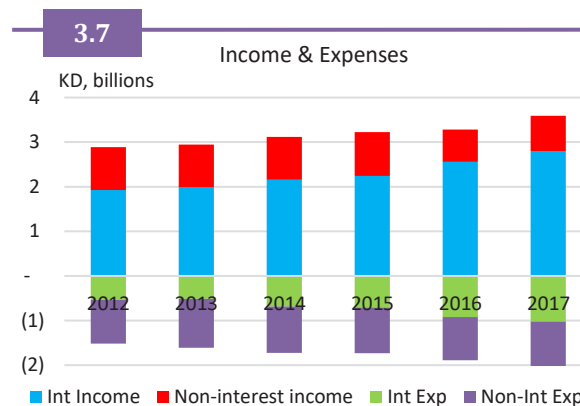
Interest income recorded decent growth of 9.6% in 2017, though slower when compared to 14% growth in 2016 (*Figure 3.7*). Still, banks' net interest income (NII) increased by 8.6% during 2017, compared to 6.7% in 2016 essentially because of relatively lower increase in interest rate expense. Moreover, banks' non-interest income, which was down 26.2% in 2016, staged a recovery (up by 8.5%), helping net income post a positive growth, as did lower loan loss provision expense.

In particular, loan loss provision expense was down by 3.4%, albeit less pronounced than in 2016 when it dropped by 11.7% (*Figure 3.8*). In absolute terms, loan loss provision expenses dropped to KD 526 million in 2017 from 545.3 million in 2016. The reduction in provision expenses was relatively greater in the case of conventional banks (-4.7%) when compared to Islamic banks (-3.4%) during 2017.

Conventional banks continue to exhibit better efficiency

During 2017, banks' operational efficiency marginally improved, as reflected by a decline in the cost to income ratio from 41.1% in 2016 to 38.8% in 2017 (*Figure 3.9*). Higher gross income helped both conventional and Islamic banks in reducing their cost to income ratios, notwithstanding the slight increase in their operating costs during the year.

Still, on average, conventional banks appear relatively more efficient than Islamic banks, though the gap between the two groups has steadily narrowed, 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 robust by regulatory benchmarks

Kuwaiti banks continued to maintain high capital levels, given CBK's strong focus on ensuring a stable financial system where robust capital adequacy plays a critical role. During 2017, banks' capital adequacy ratio¹⁵ (CAR) on consolidated basis slightly came down, from 18.6% in 2016 to 18.45% in 2017 (*Figure 3.10*).

Still, at 18.45%, banks' CAR stood at a fairly high level and was well above the CBK's requirement of 13% for 2017. The marginal decline in CAR was essentially due to relatively stronger growth in banks' RWA (up by 6.6%) compared to total capital (5.7%) in 2017. Other indicators of capital adequacy also point towards similar trends, with a few of the key indicators posting a slight drop in 2017 (*Table 3.1*).

The breakdown of total capital reveals that both Tier-1 and Tier-2 posted positive growth, witnessing an increase of 5.8% and 5.7% respectively. As a result, share of Tier-2 capital remained flat at 10.4% in banks' total capital with their bulk (89.6%) 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, a fact attested by our stress test results as well.

Islamic banks maintained marginally better capital adequacy

Classification in terms of Islamic and conventional

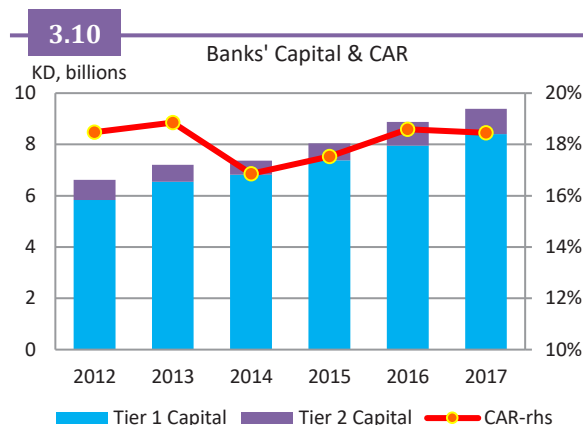


Table 3.1 Banks' Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	2016	2017	2016	2017	2016	2017
Conventional	17.6%	17.5%	15.4%	15.3%	13.1%	13.1%
Islamic	18.4%	18.2%	16.9%	16.6%	12.2%	12.3%
All Banks	18.6%	18.4%	16.7%	16.5%	12.8%	12.8%

¹⁵Capital 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.

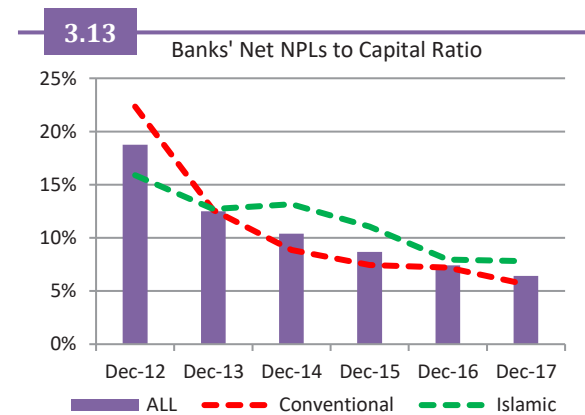
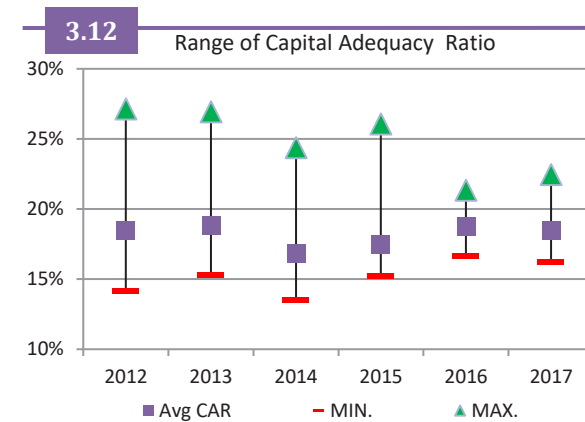
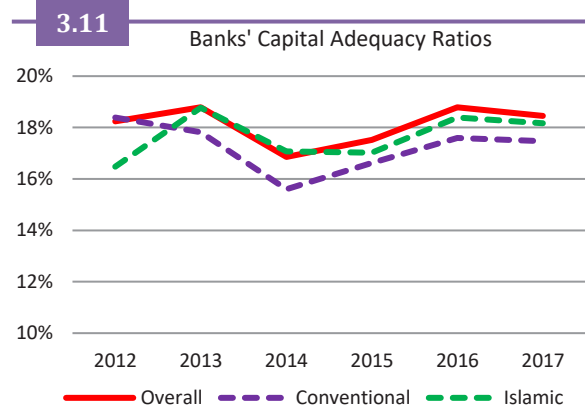
banks also reveals the marginal decline in the CAR of the banking industry in 2017. As highlighted above, this was the result of relatively stronger growth in RWA compared to capital adequacy.

However, Islamic banks as a group, continued to maintain a better capital adequacy level, reflected by their CAR of 18.2% compared to 17.5% of conventional banks (Figure 3.11). Similar trend was visible in other adequacy measures like Tier-1 to RWAs ratio, as evident from the table above. Islamic banks' better capital adequacy ratios are in part because of their 50% *alpha* factor as well as the use of leased assets as risk mitigants. However, this broad categorization of Islamic and conventional banks does not exhibit the difference across individual banks in terms of their capital adequacy ratios.

Data for individual banks reveals that even the lowest CAR maintained by a single bank was 16.2%, well above the minimum requirement of 13% set by the CBK for 2017 (Figure 3.12). In fact, the minimum CAR maintained by any individual bank never dropped below 14% during the last seven years, except in 2014 when it slipped to 13.5%, primarily on account of Basel III implementation. Moreover, the difference between lowest and highest CAR of individual banks has significantly narrowed over the years, suggesting that robust capital adequacy is fairly distributed across banks and not merely a result of some outliers.

Banks' loss absorption capacity has strengthened further

Thanks to strong capital adequacy levels and higher provision levels, 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 6.4% by December 2017, from 7.4% a year earlier (Figure 3.13). Improvement in the loss absorption capacity of conventional banks was greater, as their net NPLs to capital ratio dropped to 5.6%, compared to 7.8% of Islamic banks. In the case of conventional banks, their net NPLs dropped by 18% in 2017 which helped their *net NPLs to capital ratio* slide further.

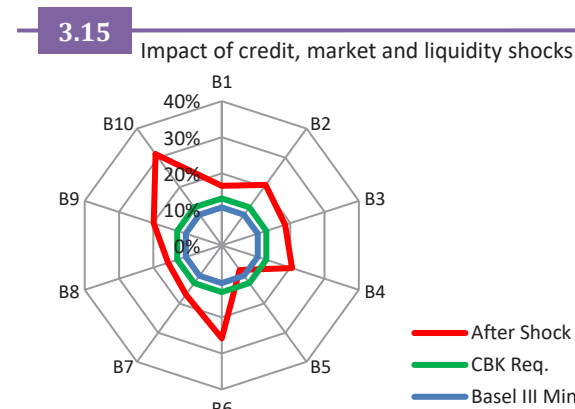
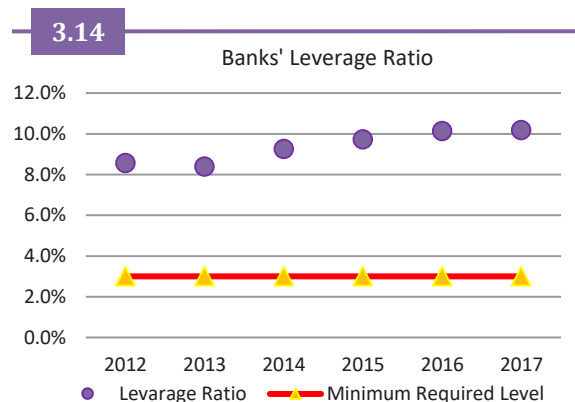


In addition to strong capital adequacy ratios (a risk-sensitive measure), banks' overall leverage ratio¹⁶ (a non-risk weighted measure) was also quite robust at 10.2% as of December 2017, not only well above the global minimum of 3% but also higher than the more stringent 6% proposed by US regulators 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 2017, reflecting the large cushion that Kuwaiti banks can use to extend further credit without breaching the global norms on leverage ratio.

Banking sector appears resilient against major shocks

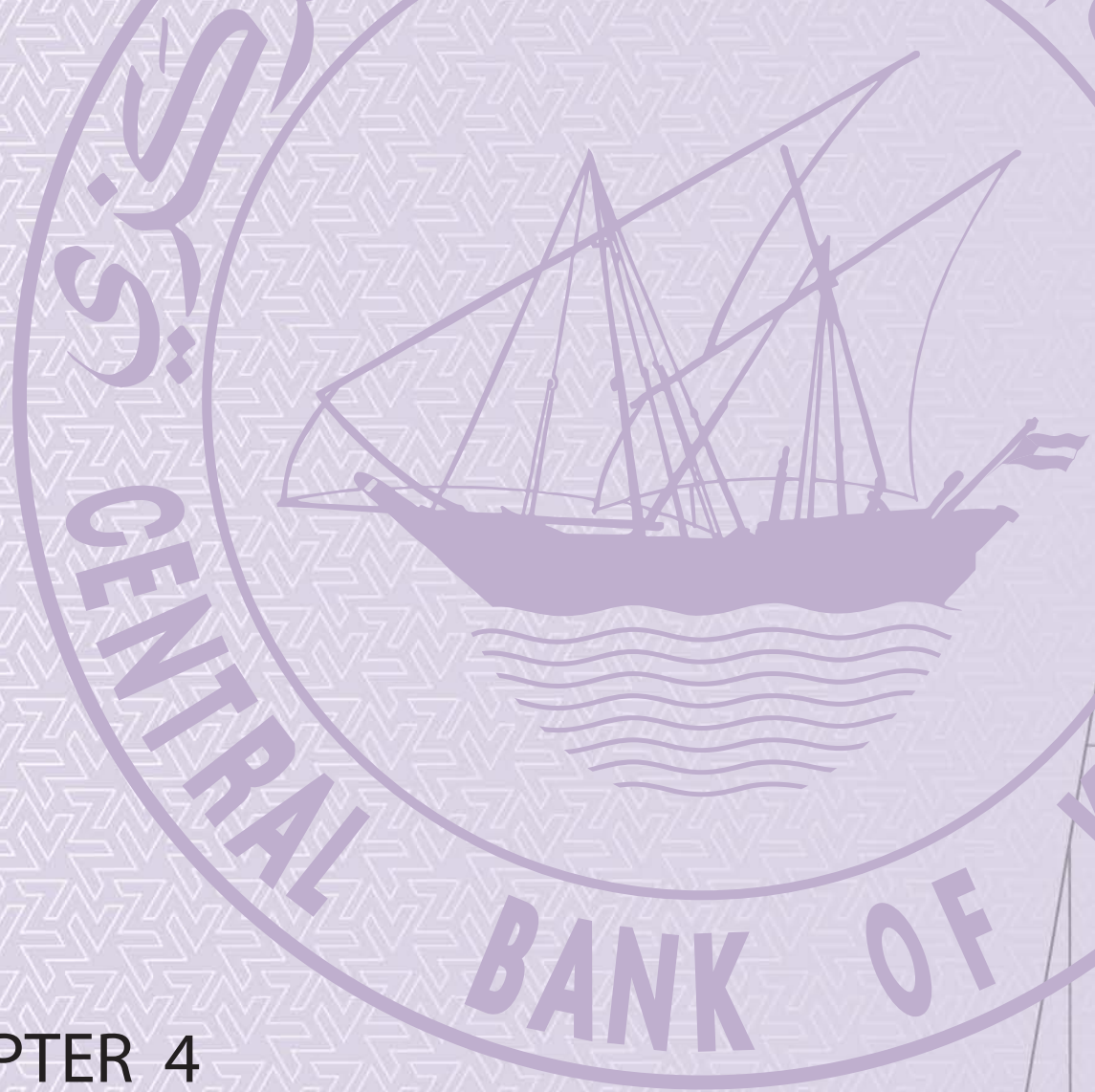
CBK conducts in-house stress testing exercises on a quarterly basis to determine the level of resilience of individual banks as well as of the entire banking sector (for details, see *Box 3.2* in the FSR of 2012). In line with past practice, quarterly stress tests were conducted using the data as of December 2017, applying various macro and micro level scenarios of different severities and for an extended period. Our results reveal that banks 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 came down to nearly 8.5%.

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, building more provisions and reducing their riskier exposures.



¹⁶ Tier 1 Capital/Total Exposures (Non-Risk Weighted, both On & Off balance sheet).

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 deteriorates or turns negative for an extended period.



CHAPTER 4
DOMESTIC MARKETS

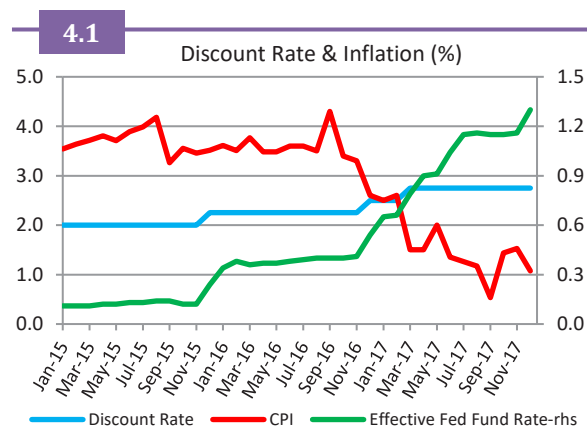
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CBK hiked its policy rate for the third year in a row, pushing the discount rate to 2.75%, a level last seen in 2010. Around the same time, in March 2017, government raised \$8 billion from its debut international bond sale that was greatly oversubscribed, attracting bids worth \$29 billion. The government also continued to tap the domestic banking sector, raising KD 3.1 billion compared to KD 2.9 billion in 2016. As a result, outstanding balance of public debt reached KD 4.7 billion in 2017. Still, domestic liquidity conditions eased further during the year, in part due to rebound in oil prices amid extension in OPEC+ agreement to cut production. In the foreign exchange market, KD appreciated against USD by 1.4% in 2017 while depreciating against Euro and GBP by 11.7% and 7.4% respectively; exchange rates were influenced by the improvement in relative prospects for growth and interest rates in UK and EU compared to the US. Boursa Kuwait recorded healthy gains with its Price Index increasing by 11.4% amid anticipation of FTSE upgrade, Omantel's purchase of Zain shares and better economic fundamentals in general. Boursa's weighted index (WI) was up by 5.6%, putting Kuwait as the second best performing market in the GCC. Sector-wise, industrial and banks posted double-digit gains while trading activity visibly improved. Finally, the real estate market declined by 7.1% in terms of sales value, contracting for the third year in a row. While sales in the residential segment staged a strong rebound (up 21.7%), overall market was weighed down by the poor performance of investment and commercial segments that were down 19.2% and 37.4% respectively. Activity in the investment segment was hurt by oversupply of investment buildings, somewhat higher water and electricity tariffs, and slower growth in expat labor, all pushing rental yields down. Increasing preference for small-ticket single apartment transactions also subdued sales. Still, banks in general appeared quite resilient to a downturn in the real estate market, notwithstanding their high exposures both in terms of loans and collaterals.

Money Market:

CBK raised discount rate by 25 bp during 2017, skipping two of the Fed's rate hikes

For the third year in a row, CBK raised its discount rate by 25 bps, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in KD¹⁷ (Figure 4.1). The decision to increase discount rate from 2.5% to 2.75% was announced on 15th March, 2017, immediately after the Federal Reserve (Fed) raised its target federal funds rate by 25bp. At 2.75%, CBK's discount rate reached the highest level since February 2010.



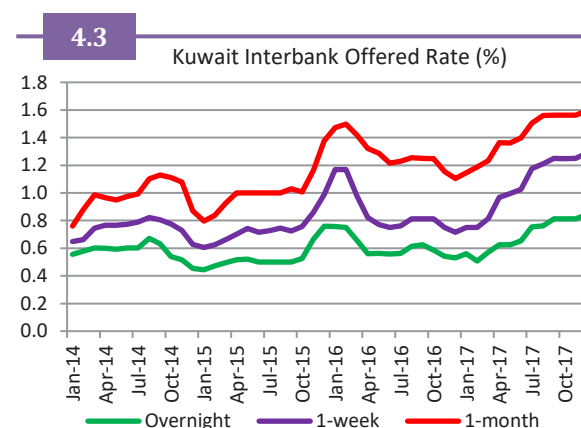
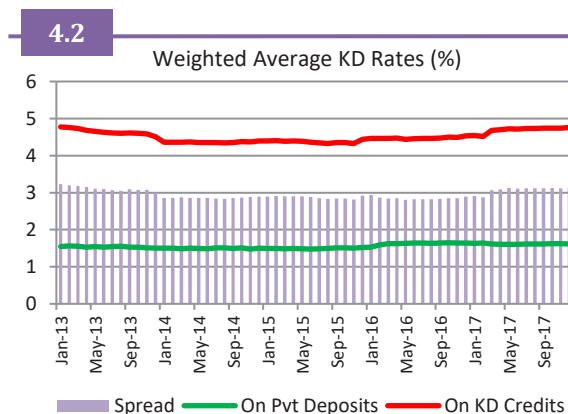
¹⁷For instance, banks can charge upto 3% above discount rate on consumer and housing loans, upto 2.5% above discount rate on commercial loans of less than one year and upto 4% above discount rate on commercial loans of above 1-year maturity.

The marginal increase in the policy rate helped CBK signal its commitment to maintain continued attractiveness of the Kuwaiti dinar 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.

Apart from the afore-mentioned rate increase in March, CBK skipped the two other rate hikes by the Fed in June and December 2017, in part due to significantly lower domestic inflation which closed the year averaging 1.3%, a 13-year low. Though inflation originally spiked following the fuel price hikes in September 2016, it was broadly offset by lower food and housing inflation.

With the hike in discount rate, the spread between lending rate on KD-based credits and weighted average rate on KD deposits slightly increased to an average of 3.08 percentage points, compared to 2.85 percentage points during 2016 (Figure 4.2). The marginal improvement in spread was more due to an increase in the weighted average rate on KD based credit, which edged up to 4.7% compared to 4.47% in 2016. On the other hand, weighted average rate on KD deposits remained almost flat during 2017.

In the interbank market, KD interbank offered rate started the year 2017 on a rising trend, on the heels of CBK's discount rate hike in December 2016. Another raise in the discount rate in March 2017 further supported the upward trend in interbank rates (Figure 4.3). While CBK skipped the rate hikes in both June and December, overnight repo rates were increased on both occasions by 25 basis points. Accordingly, interbank rates continued to edged higher, in part reflecting market expectations of potential future rate hikes; 1-month offered rate closed the year at 1.59%, compared to 1.1% in December 2016.



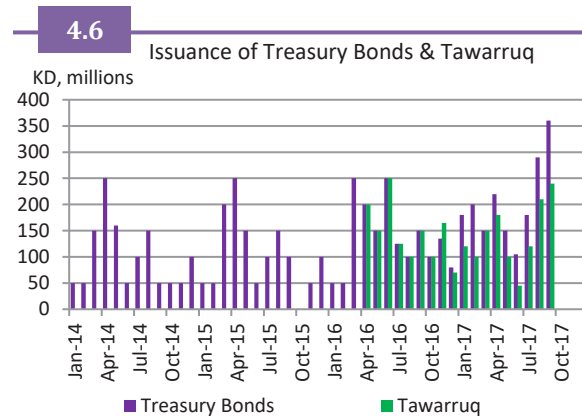
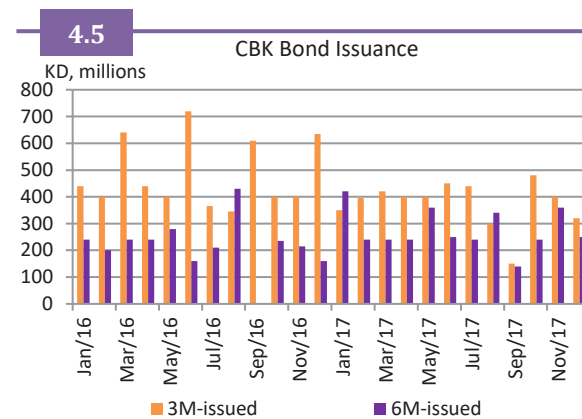
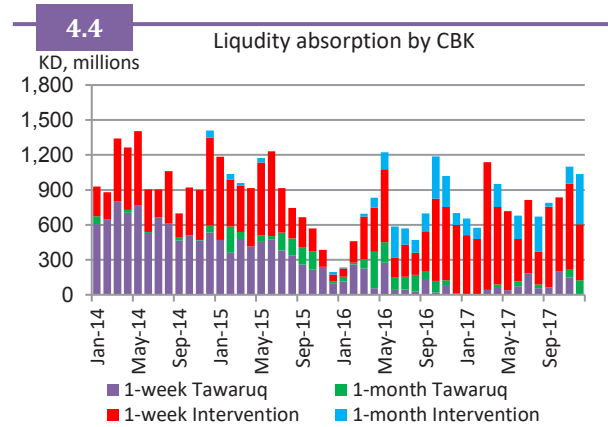
Amid improving liquidity conditions, absorption by the CBK during 2017 increased by 14.5% compared to the year earlier (Figure 4.4). In particular, share of interventions surged against *tawarruq*¹⁸, accounting for 88.2% of the total absorptions in 2017 compared to 71.3% in 2016. Moreover, data by various maturities reveal that the one-month *tawarruq* posted a noticeable decline though one-week interventions significantly increased. 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 for the third year

During 2017, overall issuance of CBK bonds/*tawarruq*¹⁹ dropped by 6.9%, with total issuance worth KD 7,825 million compared to KD 8,405 million in 2016 (Figure 4.5). Unlike in 2016 when issuance of both 3-months and 6-months tenors posted a decline, last year witnessed a shift in issuance towards 6-months tenors. By the end of 2017, the combined outstanding balance of CBK bonds/*tawarruq* of both tenors was KD 2,770 million.

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

During 2017, the government continued to tap the banking sector for part of its financing needs through the issuance of both treasury bonds and its *shariah* compliant equivalents, though the scale of *tawarruq* issuance marginally slowed down compared to 2016 (Figure 4.6). Specifically, treasury bonds worth KD 1,835 million were issued during the year, in addition to KD 1,265 million of *tawarruq*-based instruments. The issuance of both conventional and *shariah* compliant instruments not only allowed the government to raise funds from the banking sector but also provided the banks an opportunity to invest in risk-free government paper, in particular for the Islamic banks which typically face difficulties in



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*.

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

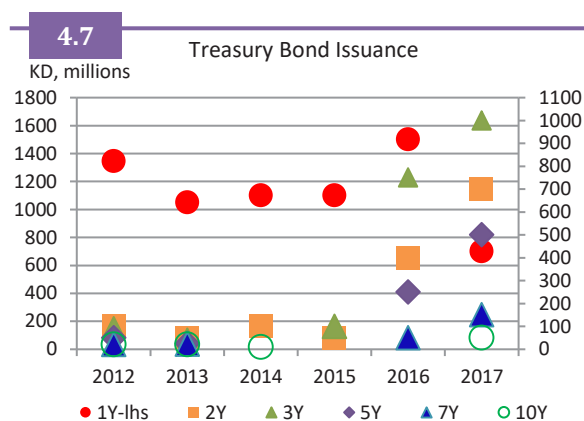
finding high quality liquid assets for investment. The last quarter of 2017 was, however, marked by no issuance of any bonds/ *tawarruq*-based instruments due to expiration of public debt law²⁰.

Regarding the T-bills, 2017 was the fifth 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 10 years, with relatively longer tenor bonds increasing in significance (Figure 4.7). In total, 1-year bonds/*tawarruq* worth KD 700 million were issued during the year, compared to issuance of KD 1,500 million in 2016; this was the lowest issuance of 1-year instruments in years, bringing down its share in total issuance to 23%. On the other hand, issuance of longer term instruments of 2 to 10 years reached a record high of KD 2,400 million compared 1,450 million in 2016. Greater issuance of longer term bonds/*tawarruq* is a positive shift as it would help extend the sovereign yield curve to longer horizon, providing a meaningful benchmark for the pricing of corporate debt. The trend would also enable the government to save on interest rate payments in an increasing interest rate environment while also reducing the risk of roll-over.

Kuwait's debut international bond issuance greatly oversubscribed

Kuwait also tapped international bond market in March 2017, raising \$8 billion from regional and international investors. The issuance was greatly oversubscribed, with more than 778 orders totaling



²⁰ The parliament's financial and economic affairs committee approved a new bill on January 7, 2018 allowing the government to raise the borrowing ceiling to KD 25 billion and to issue international debt upto 30 years (compared to a maximum tenor of 10 years in the past). The bill will also authorize the government to take public loans and borrow from local and international markets. However, the bill has yet to be passed by the National Assembly.

\$29 billion. Total issuance had two separate tranches; a \$3.5 billion, 5-year tranche sold at a yield of 2.887% or 75 basis points (bp) over US Treasuries, and another \$4.5 billion, 10-year tranche offering a yield of 3.617% or 100bp over US Treasuries. These spreads were lower than other GCC sovereign issues except for Abu Dhabi, reflecting strong confidence of international investors in Kuwait's sovereign debt.

Bulk of the 10-year debt was taken up by the US investors (51%) while European investors got the major share (46%) of the 5-year debt. This debut international bond sale issue will pave the way for establishing a sovereign benchmark yield curve, thus helping local firms tap into global capital markets as well.

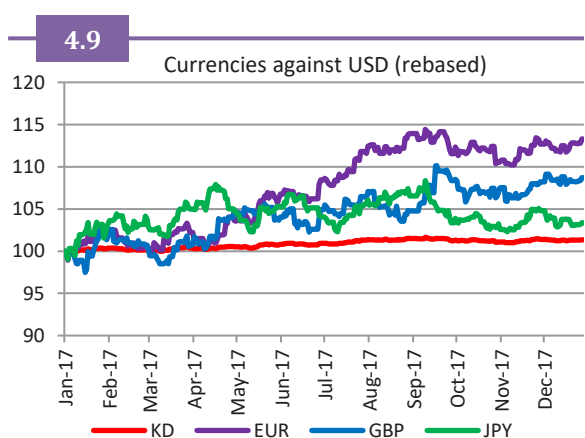
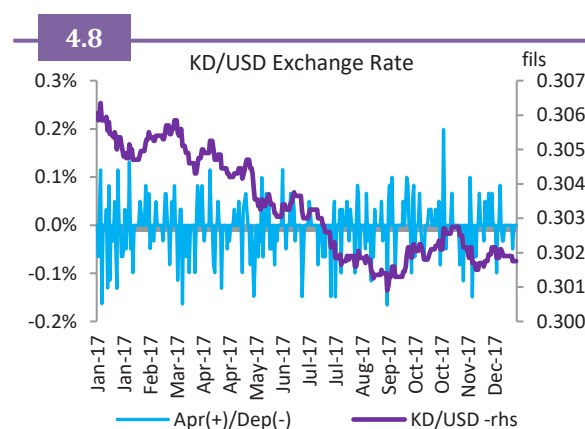
Foreign Exchange Market:

Strengthening USD led to a further depreciation in KD

KD/USD exchange rate experienced an appreciating trend for the first three quarters of 2017 in particular, though partially losing some ground in the last quarter. Still, KD closed the year by slightly appreciating (1.4%) against USD (*Figure 4.8*). In general, fluctuations in the exchange rate were fewer and mostly within a narrow range of $\pm 0.2\%$.

Compared to other major currencies, appreciation in KD against USD was still relatively modest and exchange rate remained broadly stable (*Figure 4.9*). Greenback posted significant depreciation against some major currencies, recording its weakest annual performance in 14 years. Even the three rate hikes by the Fed and passing of the tax reforms bill could not lift up the USD which was also, in part, dampened by the low inflation outlook as well as by the US government's apparent predeliction for a weaker dollar.

In essence, it was less of a declining USD and more of a rising Euro and GBP that played their part. Exchange rates were influenced by the change in relative prospects for growth and interest rates



between US, UK and EU. In particular, Euro and GBP gained as growth across these economies synchronized, catching up with the already strong economic performance in the US. Specifically, Euro which posted 4% drop in 2016 against the USD was up by 14% in 2017, its best performance since 2003, supported by ECB's accommodative monetary policy stance as well as the increasing prospects for better economic performance of the region in general. Bank of Japan continued to pursue its ultra-loose monetary policy in its efforts to ward off deflationary threats, boost credit off-take and lift economic growth. JPY gained only 3%, though the rally in the first five months of 2017 was much stronger.

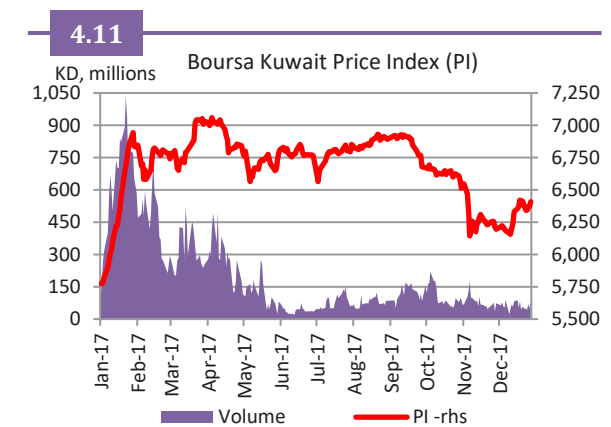
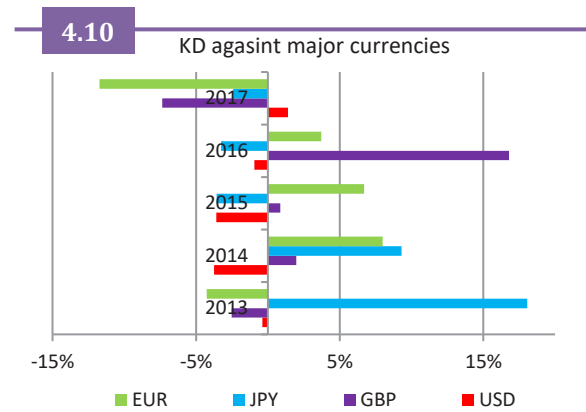
In terms of KD's performance against key currencies, KD appreciated against USD by around 1.4%, compared to its depreciation of 0.9% in 2016. On the other hand, KD depreciated against Euro (EUR) and GBP, by 11.7% and 7.4%, respectively. KD's depreciation against EUR and GBP, though significant, was largely because of these currencies gaining by similarly higher margins against the USD (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 somewhat 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 posts healthy gains during 2017

Price Index (PI), the broad based index of Boursa Kuwait, closed the year 2017 with a double-digit growth, gaining 11.5% on the back of strong first and third quarter performance (Figure 4.11). This was a marked improvement in PI compared to 2.4%



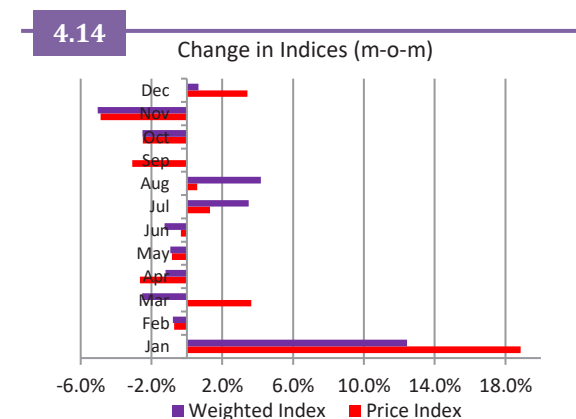
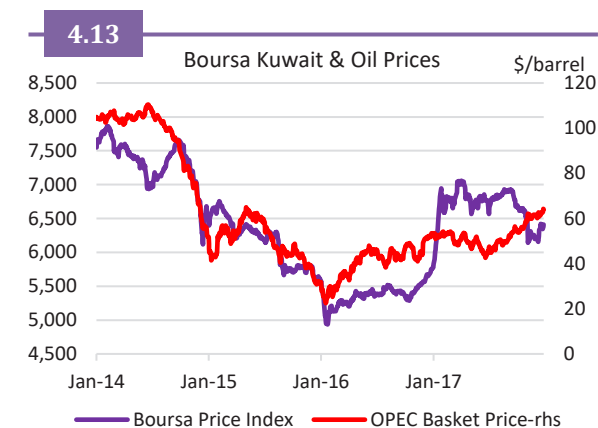
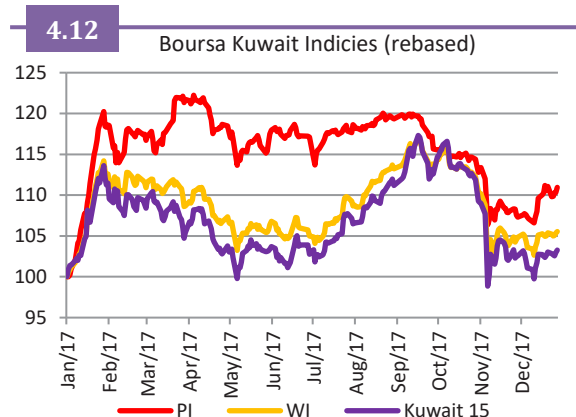
gain recorded in 2016. The Weighted Index (WI), representing Kuwait's large-cap companies, was up by a healthy 5.6%, making Boursa Kuwait the second best performing market within the GCC countries. Finally, the Kuwait-15 Index, covering 15 highest ranked companies in terms of liquidity and capitalization, posted a 3.4% increase in 2017 with poor fourth quarter performance largely wiping out the gains made in the third quarter.

Comparison between the three indices reveals that all three were off to a strong rally at the start of 2017 (Figure 4.12). While PI somewhat held ground in later months, value weighted indices continued to retreat during H1-17, though WI and Kuwait-15 posted a rebound in the third quarter in anticipation of Kuwait's upgrade to emerging market status by FTSE. PI closed the year on a more positive note than the other two indices, signifying better performance of small cap stocks in general.

Given Kuwait's reliance on hydrocarbon as the main source of income, the market has historically moved closely in tandem with oil prices, with correlation between PI and oil prices around 81.4% during the last four years (Figure 4.13). However, there was visible divergence in 2017 as PI gained despite a declining trend in oil prices early in the year; the course reversed in the last quarter with oil prices exhibiting an increasing trend but PI posting a retreat. These trends suggest that factors other than oil prices, as highlighted below, were behind the momentum in Boursa Kuwait.

Monthly data highlights a strong start to the year but a weak last quarter

Boursa Kuwait got off to a strong start in January 2017, contrary to the retreat it observed during the same month in 2016 and particularly in 2015 when PI was 14.1% down (Figure 4.14). PI gained almost 19% while WI was up 12.4%, marking January as the best month for the Bourse in years. The rally was, in part, supported by Americana's acquisition in late 2016 as well as the expectations of Boursa's likely inclusion in



some emerging market indices. After a stellar January, market was in retreat during February.

March witnessed a lackluster performance of WI amid profit-taking, though PI recovered. In the second quarter of 2017, local bourse experienced retreat in general reaching its lowest point in June which also coincided with the holy month of Ramadan and summer season. Consequently, trading value dropped from KD 1.2 billion in January to KD 0.15 billion in June 2017. Yet the Bourse staged a recovery in the third quarter, averaging KD 351 million per month, amid improving economic fundamentals, anticipation of Kuwait's inclusion in FTSE Russel's secondary emerging market index and Omantel's purchase of Zain shares etc. The market however lost steam in the last quarter of 2017 amid rising political tensions.

Trading activity visibly improved despite ongoing delisting

Given the healthy overall performance of the local bourse, market capitalization improved to 27.5 billion after a year of remaining virtually flat (*Table 4.1*). Trading activity also increased significantly, as evident from the noticeable improvement in the total value, volume and number of deals during 2017. This was in sharp contrast to the double-digit drop in total value and volume in 2016.

On their part, both CMA and Boursa Kuwait launched a few initiatives to help revive market liquidity, including improving market infrastructure (Interim Post-Trade Model I), market segmentation, and stringent governance requirements, increasing the international recognition and visibility of the local bourse.

In terms of number of listed companies, the decline continued for the eighth year in a row, reaching 157 in 2017. A total of 27 companies were delisted during the year, more than four times the number seen in 2016. Tougher governance requirements by the Capital Markets Authority (CMA) and deteriorating liquidity pushed cost of compliance higher, reducing the benefits of listing for smaller firms in particular.

Table 4.1: Key Indicators of Boursa Kuwait

	2014	2015	2016	2017
Price Index	6535.7	5615.1	5748.1	6408.0
Highest	7863.0	6755.1	5753.4	7059.6
Lowest	6115.6	5571.9	4936.5	5775.03
Market Cap (KD, bil)	29.7	26.2	26.2	27.5
Total Value (KD, bil)	6.1	3.9	2.9	5.7
Total Volume (bil)	53.0	41.5	30.3	50.2
No. of Deals (,000)	1,186	961	713	1,194
Companies Listed	193	190	184	157

On similar lines, recent years have also seen fewer numbers of initial public offerings.

Boursa Kuwait outperformed most of its GCC peers but underperformed other emerging market

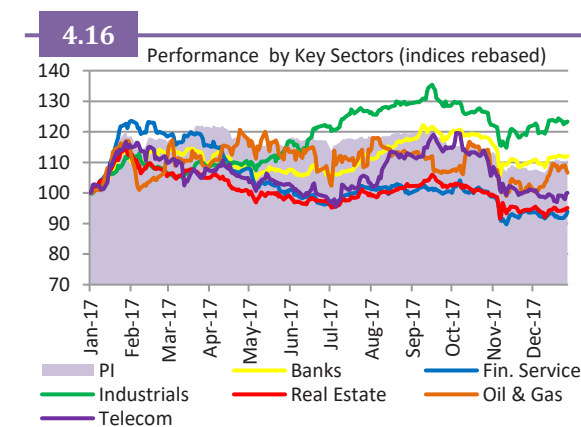
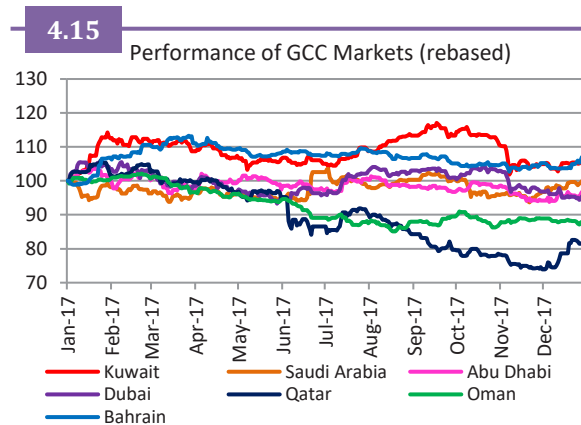
Analysis of the GCC markets highlights significant variation in annual returns during 2017. In weighted value terms, Bahrain finished the year up by 9.1%; Kuwait posted a gain of 5.6%, making local bourse the 2nd best performing market in the GCC region (Figure 4.15). The Saudi market ended the year almost flat gaining a meager 0.2%. Markets in UAE, Qatar, and Oman all finished in red, with the Qatari market taking the biggest hit, shedding around 18% during 2017.

While Boursa Kuwait did visibly better compared to its GCC peers, it underperformed other emerging markets. Emerging equities had a strong year in 2017 gaining more than 30%, according to MSCI's Emerging Markets index. Geopolitical instability and higher fiscal deficits continued to weigh on the performance of the GCC markets.

International interest in Boursa Kuwait picked up in 2017, with net foreign inflows increasing by KD 11.2 million to reach KD 92.7 million during the year, compared to a drop of KD 19.8 million in 2016. Foreign fund flows were driven by factors like strong 4Q 2016 / January 2017 performance, anticipation of FTSE upgrade and Omantel-Zain deal etc. The last quarter of 2017 was, however, marked by significant outflows amid increasing geopolitical tensions.

Industrial and banks post double digit gains

Market performance in terms of various sectors highlights a large variation in returns, with three sectors posting large annual gains while the rest recording material losses. Specifically, *Industrials*, *Banks*, and *Oil and Gas* sectors closed the year up 24.3%, 12%, and 7.4% respectively (Figure 4.16). On the other hand, *Financial Services*, *Real Estate*, and



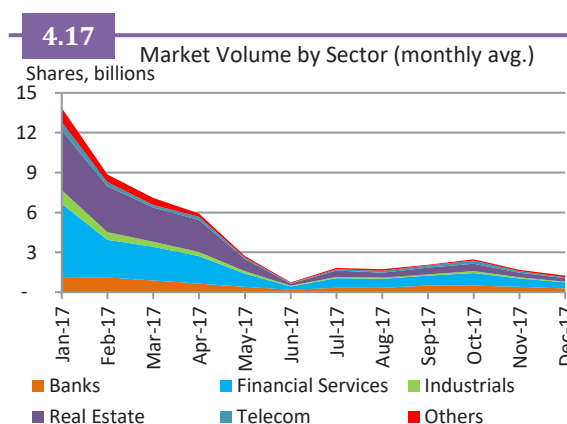
Telecommunications shed -5.2%, -4.6%, and -1.2%, respectively. The sector classification of Bursa Kuwait, however, can be somewhat misleading. For instance, the industrials sector includes *Agility*, a logistics company, and *Human Soft*, an educational company.

All sectors posted positive first quarter returns, driven primarily by the strong January rally, with *Financial Services* gaining 16.8% followed by *Industrials* at 9.6% and *Banks* (which represent almost half of Bursa Kuwait’s market capitalization) at 8.9%. The market slowed down in the second quarter when all sectors posted negative returns except for *Industrials* that gained 12% in the second quarter and 22.6% YTD. Within *Industrials*, most large-cap stocks posted strong gains. Specifically, *Agility’s* favorable settlement with the US government and *Human Soft’s* strong performance positively contributed to the sector’s value-weighted returns. The market recovered during the third quarter when most sectors recorded solid gains. The *Telecommunications* sector had an exceptional third quarter, gaining 18%, as the completion of the Zain-Omantel deal positively contributed to the sector’s returns.

Most sectors took a dip during the fourth quarter as political instability in the region dampened investor’s outlooks for the market. In particular, *Real Estate* sector closed the year 4.6% down as slower sales activity and softening prices in the investment segment of the domestic real estate market weighed on results. Likewise, *Financial Services*, a very volatile sector that includes many investment companies sensitive to the financial market’s performance closed the year losing 5.2%.

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 65% of the average monthly market volume in 2017, compared to their combined share of 62.7% during 2016 (*Figure 4.17*). Other three key sectors in terms of volume were *Banks*, *Industrial*, and *Telecom*,



accounting for 17.6%, 6% and 5.8% respectively. Collectively, aforementioned five sectors covered almost 94.3% of the entire market in terms of volume.

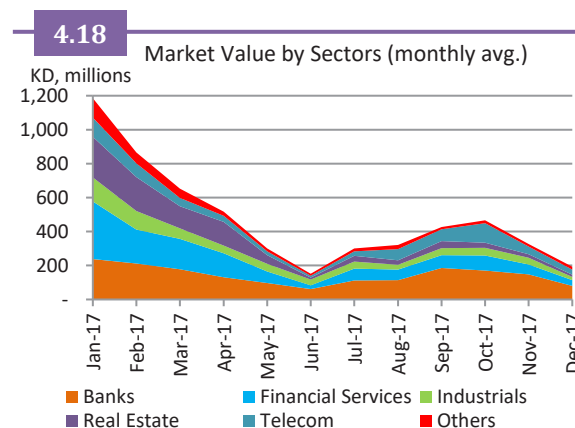
Volumes were high early on but exhibited a steady decline by the end of H1 as the summer season, coinciding with Ramadan, approached; volumes recovered somewhat later in the second half though still remained fairly low compared to the first quarter of 2017.

Trading volume data, in terms of the number of shares traded, is biased towards cheaper stock, which were mostly part of the *Financial Services* and *Real Estate* sectors. The high level of concentration in terms of market volume also suggests that the depth of the market has remained at fairly low levels.

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

When viewed in terms of average monthly value, *Banks* and *Financial Services* accounted for 55.7% of total market value for the year 2017, compared to 54% a year earlier. Unlike in the case of market volume, here *Banks* also appear quite significant, accounting for as much as 34.1% of the market value (*Figure 4.18*). The share of *Real Estate* improved to 13.7% of average monthly value during 2017, followed by *Telecom* (12.4%) and industrial (11.9%). The remaining sectors combined represented 6% of the average monthly trading value.

When viewed in terms of the coefficient of variation in monthly trading value, *Banks* posted the most stable trading value throughout the year followed by *Basic Materials*, *Telecommunications*, and *Industrials*. On the other hand, *Financial Services* and *Real Estate* stocks exhibited significantly higher degree of volatility in terms of trading value.



Real Estate Market:

Strong recovery in residential segment marred by a weak investment segment²¹

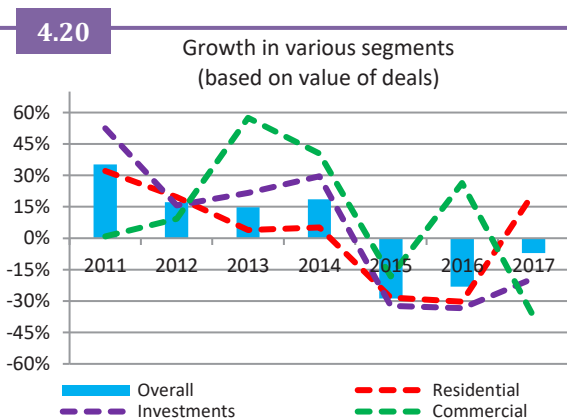
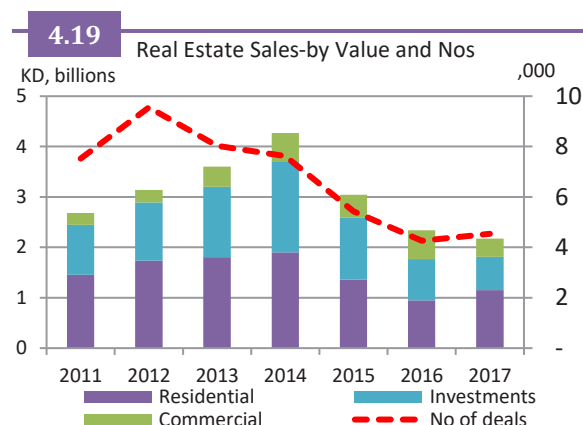
Despite a resurgent residential segment, real estate market posted an overall decline in total sales during 2017, though the drop was far more contained compared to the year earlier. In relative terms, the market appeared to improve, after two straight years of sharp contraction in sales and four years of steady decline in the number of deals.

During 2017, total sales were down by 7.1% to reach KD 2.17 billion compared to 2.3 billion in 2016²² (Figure 4.19). Positively, the number of transactions recovered for first time since 2012, recording 4,543 transaction in 2017 compared to 4,262 transactions in 2016, though still coming in at less than half of the peak level (9,554 in 2012).

...with an uneven recovery across segments

Trends in sales within various segments highlight that the correction in real estate market was driven only by the residential²³ segments, also labeled as private housing. The segment was up by 21.7% in terms of sales value, compared to a drop of 30.3% recorded in 2016 (Figure 4.20). Recovery in oil prices helped improve confidence in general; auctions in areas like Abu Fatirah and Funaitees were also supportive of revival in market activity. A closer look at the number of transactions executed reveals that activity in the residential segment was somewhat concentrated into four areas²⁴, which accounted for around a third of the segment's total transactions.

The drop in investments segment, by 19.2%, was somewhat modest when compared with a decline of 33.4% observed in 2016. Still, the segment recorded



²¹ 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.

²² Total sales here include residential, investment and commercial segments only.

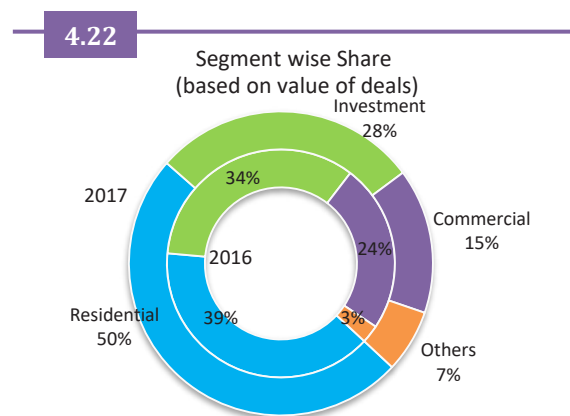
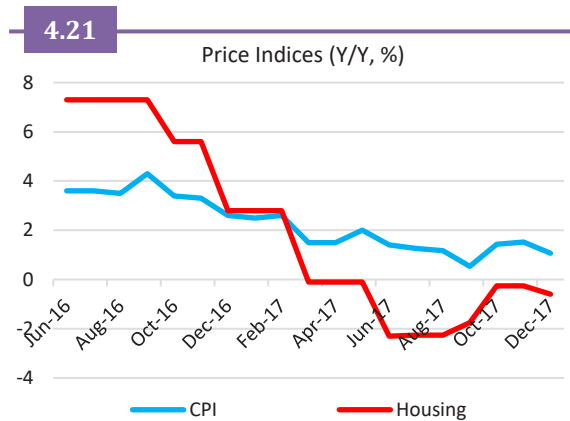
²³ The Real Estate market can be broadly divided into four sub-categories; residential (private housing), investment, commercial and others (see Figure 4.24 for respective share of each segment).

²⁴ The top four areas in terms of number of transactions were Sabah Al-Ahmad (seaside), Buftairah, Funaitees and Jaber Al-Ahmad.

third consecutive year of declining sales and fourth straight year of declining number of deals. A number of factors have been responsible for the lackluster performance of the investment segment. First, growing supply of investment buildings increased vacancy rates, further compounding the impact of slower growth in expat labor. This resulted in lower rental yields, as evident from the housing component of the consumer price inflation (*Figure 4.21*). Second, revised electricity and water tariffs that came into effect in 2017 also dampened the investment segment activity, potentially shifting some of the investors to residential segment. Third, investors' preference towards less expensive single investment apartments also played a role in depressing overall sales values.

Commercial segment, the most volatile of all three segments, posted a sharp contraction of 37.4% compared to an impressive growth of 26.3% in 2016; the number of transactions were also significantly lower compared to the last 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 ten major transaction.

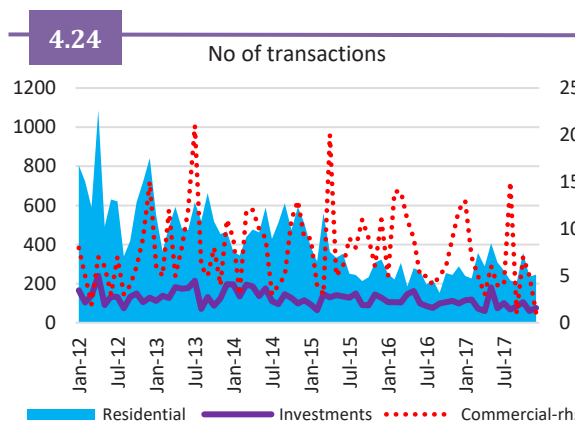
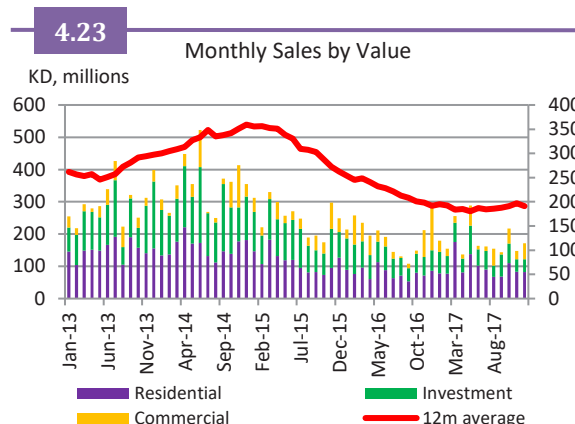
Strong growth in residential segment amid retreating sales in the other two segments (investments and commercial) resulted in a shift in their overall contribution towards total sales. In particular, share of *residential* segment surged from 39.5% in 2016 to 49.5% in 2017 (*Figure 4.22*). On the other hand, share of *investment* segment recorded a noticeable drop from 34% to 28.3% during the same period. Likewise, share of *commercial* segment contracted from 24% in 2016 to 15.4% in 2017. Finally, the 'others' segment, covering warehouses and other residual transactions left out of the three main segments, posted a strong growth, with its share reaching 7% of the total market.



Monthly data reveals a mixed performance, with few months of higher sales interspersed by slower activity

Analysis of the monthly transactions also reveals a declining trend in sales up to 2016 but a partial recovery in 2017 on the heels of improving residential segment (Figure 4.23). The market was off to a slower start in both January and February of 2017, after closing December 2016 on a high note. Strong rally in local bourse also lured investors towards stock market, further dampening sales in the real estate. March, however, logged a pick-up in sales on the back of better residential sales. Activity again turned south in April amid lackluster commercial and investment segments, with later recording lowest sales in seven months. May proved to be the best month of 2017 as sales in all three segments gained traction. Activity dampened again in the following months, in part due to summer season, which also coincided with the holy month of Ramadan. Real estate picked up pace in October again, with sales posting stronger growth. November, however, witnessed softer growth though the market staged a modest recovery in December.

In terms of number of deals, total deals in 2017 were up by 6.6%, posting first positive growth after four years of steady decline. Consequently, number of deals increased from 4,262 in 2016 to 4,543 last year (Figure 4.24). Specifically, it was the Residential segment that staged a strong recovery as number of deals increased by 17.3% to 3,358 in 2017. On the other hand, both Investments and Commercial segments were down, respectively, by 14.4% and 28.3%, reflecting a much stronger drop in number of deals compared to 9.7% and 2% recorded in 2016. In the case of investment segment, number of deals have steadily declined from 1,718 in 2014 to 1,114 in 2017, indicating muted interest of investors as rental income has come down and vacancy rates have increased, putting pressure on rental yields.



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

Against the backdrop of declining overall sales despite the strong recovery in residential segment, 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.

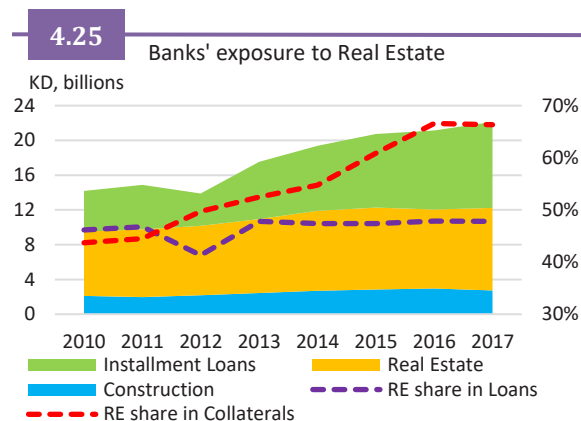
To start with, banks have significant credit exposure to the real estate market, either directly through financing the real estate and construction sector or indirectly through consumer installment loans. As evident, this exposure has been steadily rising since 2012 in particular and reached KD 21.6 billion in 2017 (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 66.3% of banks total collateral in 2017. 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, real estate market has staged a modest recovery, despite the lackluster investment and commercial segments. Yet any serious deterioration in economic conditions may dent investors' confidence, with the potential of precipitating a plunge in the real estate market. Though quite unlikely, if such a tail event materializes, the double whammy of rising loan infections and sinking collateral values can seriously test the resilience of the banking sector.

Approved and disbursed loans by KCB posted a decline

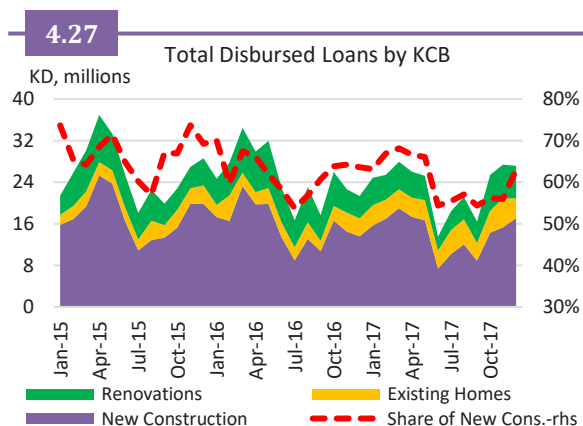
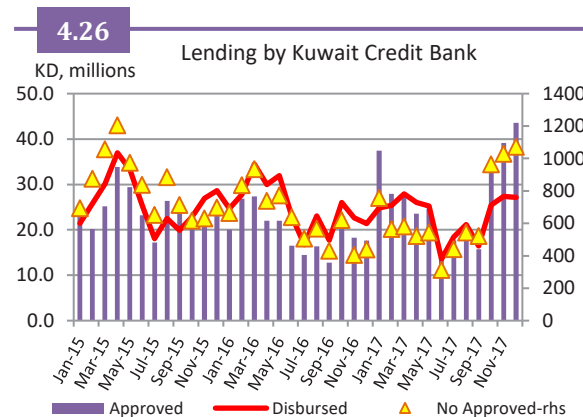
Kuwait Credit Bank (KCB), an independent banking institution wholly owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing



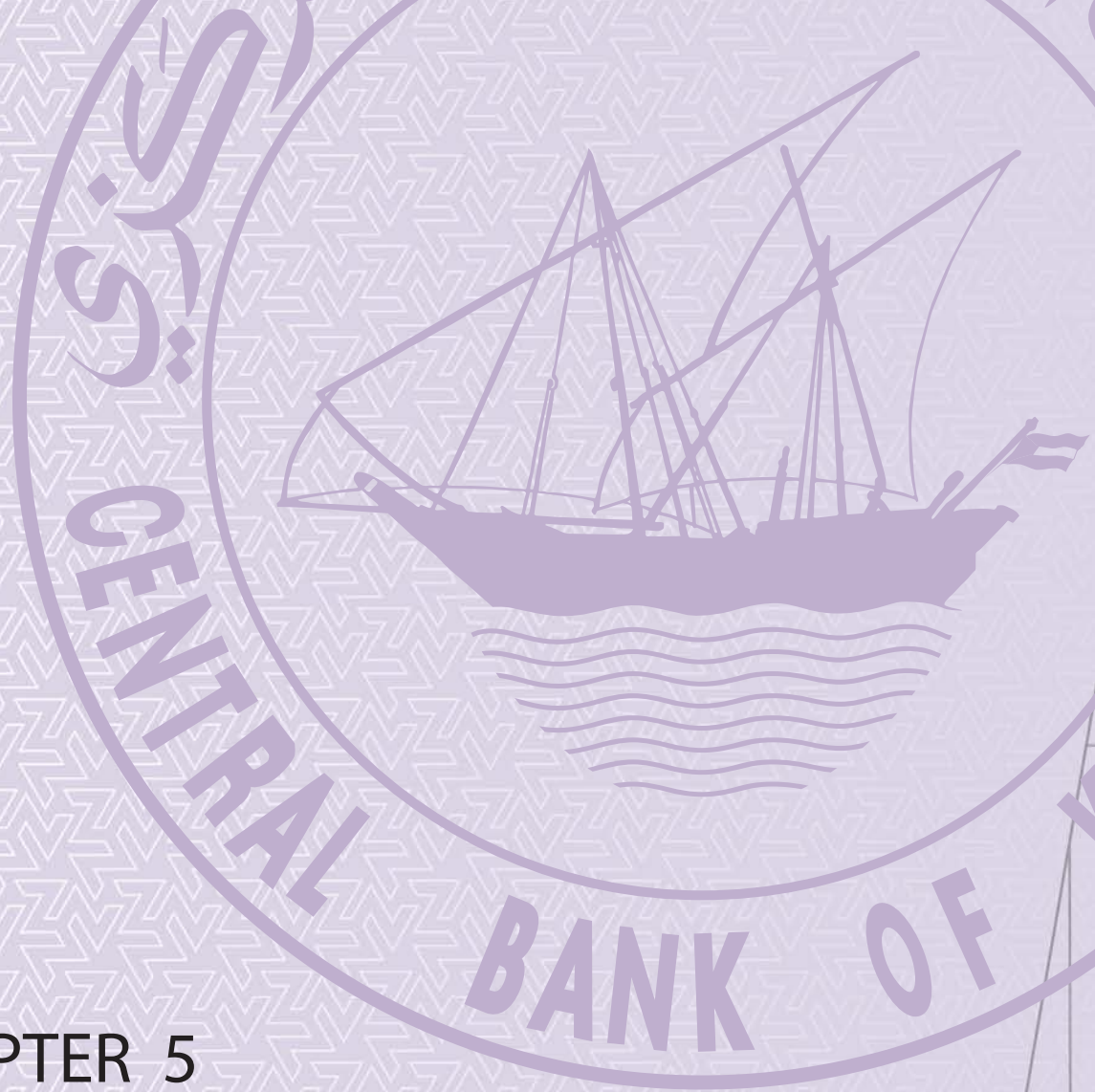
loans to Kuwaiti nationals for purchase, construction or renovation.

After posting a declining trend in all indicators during 2016 (in terms of both approved and disbursed loans), the value and number of approved loans improved in 2017. Specifically, total value of approved loans surged by 37.4% to KD 324.4²⁵ million, compared to 236.1 million in 2016 (Figure 4.26). The number of approved loans also posted a positive, albeit much slower, growth to reach 7,848 loans in 2017. On the other hand, value of loans disbursed declined by 6.8%, from KD 299.3 million to KD 279 million during the same period.

In terms of usage, around 61.3% of the disbursed amount were for new constructions, compared to 62.7% in 2016 (Figure 4.27). On the other hand, share of disbursed loans for renovation dropped from 25.3% to 21.2% during the same period. As the bulk of loan approvals and 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 2017, share of loans used to purchase existing homes also increased further to reach 17.4% of the total, as the relative softening of real estate market somewhat improved purchasing power of the buyers.



²⁵ This data also includes loans specifically extended to the disabled people for expansion/renovations of homes.



CHAPTER 5

PAYMENT AND SETTLEMENT SYSTEMS

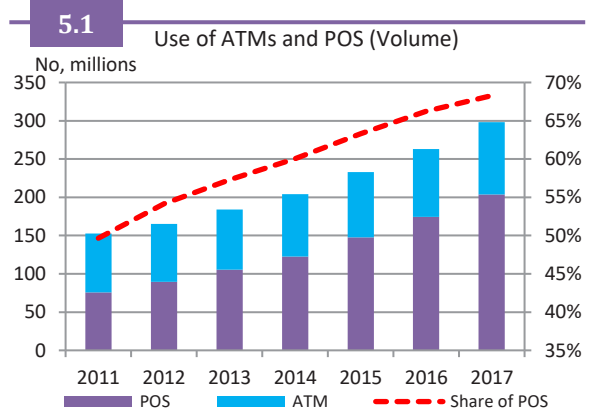
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Both retail and large-scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. During 2017, value of ATMs and point of sale (POS) based transactions have posted growth of 4.2% and 10.1% respectively. These growth trends are visibly better, particularly in the case of POS, when compared to the ones observed in 2016 and underscore healthy recovery in household consumption amid improving consumer confidence. During the year, the share of ATM related transactions was higher (55%) in value while that of POS transactions was greater in terms of volume (68%). In general, though e-transactions account for 98.3% of all transactions in terms of volume, paper-based transactions (through cheques) still have a sizeable share (54.3%) 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 2,103 and 51,072 machines by December 2017. The number of branches however marginally declined to 419 amid the closure of a few Islamic bank branches. Finally, KASSIP²⁶, the real time gross settlement system in Kuwait, handled 2.3 million of interbank transactions worth KD 20.8 billion in 2017.

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 Knet²⁷, POS and ATMs represent the retail payment system in Kuwait, essentially used for the bulk of mainly low-value payments transactions.

During 2017, the number of transactions (volume) through ATMs witnessed a growth of 6.5% to reach 94.6 million transactions. However, the growth in number of transactions through POS was much stronger at 16.9%, pushing the total transactions to 203.6 million in 2017. Consequently, the share of POS transactions (out of combined POS and ATM based transactions) further inched up during the year to reached 68% in terms of volume, while its share in terms of value moved to 45% of the value of total transactions.



²⁶ Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP) was launched in August 2004.

²⁷ The Shared Electronic Banking Services Company (Knet) launched its services in 1994 in collaboration with local banks.

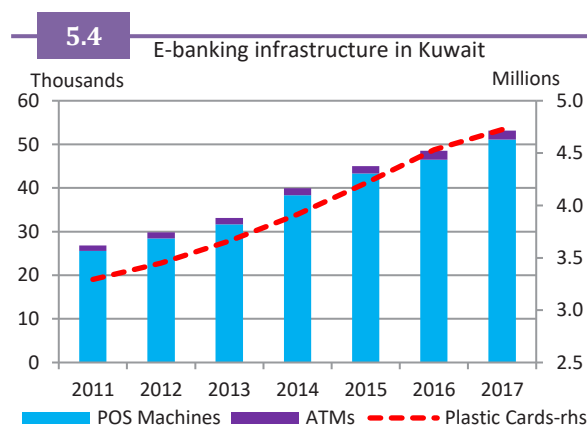
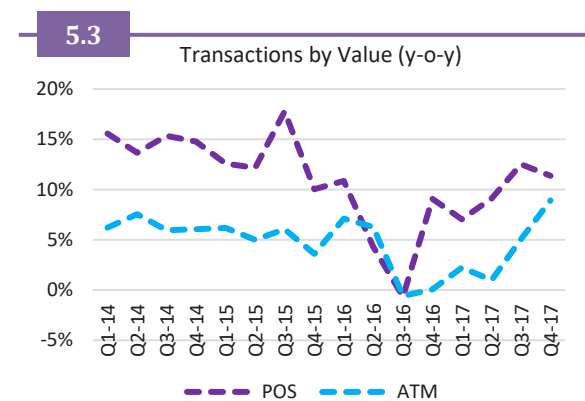
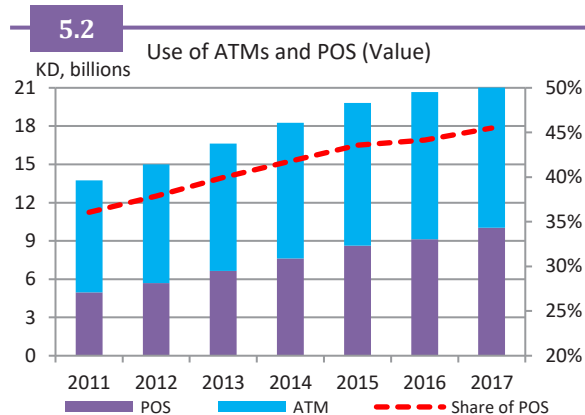
Household consumption rebounds amid improving consumer confidence

Positively, in line with the growth in number of transactions (volume), growth in the value of transactions visibly recovered during the year after recording a much slower pace in 2016. Specifically, ATM-based transactions, in terms of value, grew by 4.2% to reach KD 12.2 billion, compared to a growth of 3.2% in 2016 (Figure 5.2). Likewise, POS-based transactions posted a growth of 10.1% in 2017, posting visible recovery compared to 5.6% growth in 2016 which was lowest since 2008.

The pickup in retail transactions through ATMs and POS underscores a major turnaround in household consumption amid improving consumer confidence (Figure 5.3). A number of factors like slower-than-planned hikes in energy prices, relatively moderate spending cuts than originally envisaged, healthy employment trends for the nationals and broader recovery in oil prices have all helped in improving consumer sentiments with attendant recovery in the retail consumption and non-oil GDP. This has been in sharp contrast to the steep fall in the value of transactions recorded in 2016, in particular during Q3 in the wake of hike in fuel prices.

E-banking infrastructure has continued to expand

To support the growing use of e-banking, payment system infrastructure is also expanding in Kuwait. During 2017, the number of POS machines and ATMs witnessed a growth of 9.8% and 5.6% respectively, reaching 51,072 and 2,103 machines (Figure 5.4). Expansion in POS network was particularly strong, as a record 4,559 new POS machines were installed in Kuwait, far greater than 3,191 connected in 2016. Moreover, the issuance of new plastic cards (debit and credit cards) posted 4.2% growth in 2017 with total plastic cards reaching 4.7 million, around 82.5% of which were debit cards.



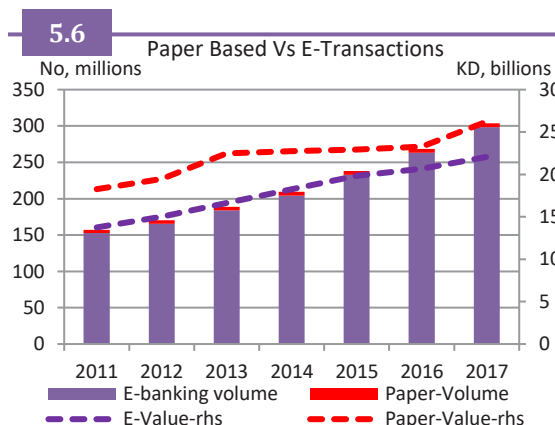
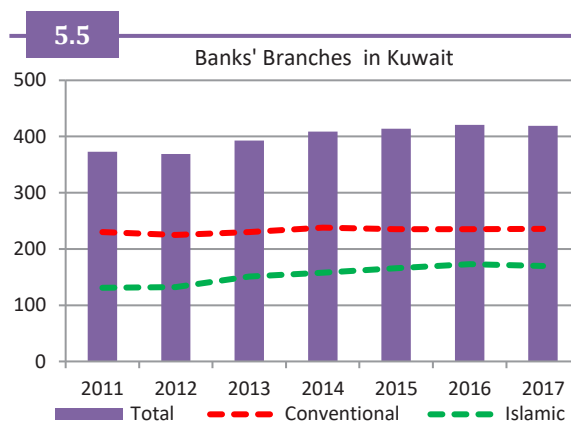
As the above trends highlight, e-banking has become ubiquitous, thanks to the convenience, flexibility and security that it offers. Furthermore, retailers offering discounts on online purchases have also promoted the use of e-banking. Banks are equally keen to promote e-banking as it helps keep the operational 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 2017, 7 new branches were added to the existing banking network in Kuwait, pushing the total number of branches to 419²⁸ (Figure 5.5). Specifically, Islamic banks closed three branches while one new branch of a conventional bank was added. Consequently, the number of domestic branches for conventional banks (236) remained significantly higher when compared to Islamic banks (170), though expansion of Islamic banking network over the years has narrowed the gap.

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 2017 accounted for almost 98.3% of all transactions (e-banking & paper-based combined). Specifically, the number of e-banking transactions reached 298 million in 2017, posting 13.4% growth compared to 2016. On the other hand, only 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 2017, the share of paper-based transactions in terms of value



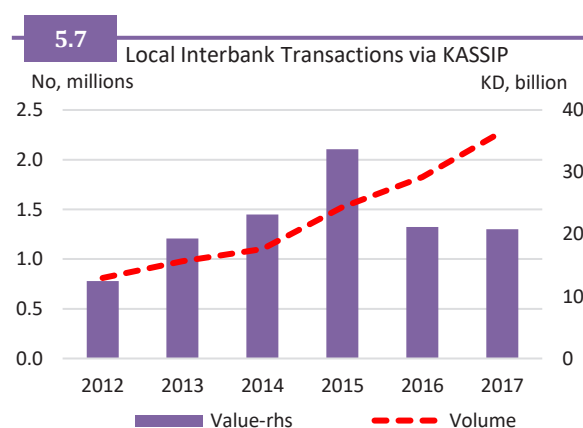
²⁸ This includes one branch of the specialized Industrial Bank of Kuwait as well as 12 branches of Foreign Banks in Kuwait (where 11 are conventional and one Islamic). Head offices (23), representative office (4) and branches of Kuwaiti banks abroad (16) are excluded.

was around 54.3%. Over the past few years, share of e-banking has stayed around 45%.

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 2017, 2.3 million transactions were handled by KASSIP, registering growth of 25.2% compared to 2016 (*Figure 5.7*). On the other hand, growth in terms of value marginally contracted (by 1.7%) during 2017 as transactions worth KD 20.8 billion were handled.



Fostering a Stable and Inclusive Financial System²⁹

Excellencies, Distinguished speakers, Ladies & Gentlemen,

A very good morning.

I would like to take this opportunity to thank Governor Cetinkaya for his kind invitation to deliver a keynote address in this conference. I am honored to have this opportunity of sharing my thoughts with such a distinguished audience.

This session is centered on the topic of ‘Fostering Stable and Inclusive Financial System’. In line with the broader scope of this session, I would like to speak about both *financial inclusion* and *stability* – the two objectives that have received increasingly greater attention from regulators and central banks in the last decade.

Why financial inclusion matters and where we stand

Let me start by discussing the significance of financial inclusion first. Research shows that financial inclusion, in the broader context of financial development, plays an important role in promoting long-term growth and reducing poverty. Access of finance helps reduce poverty by providing the poor a range of products and service to save and invest in.

Financial inclusion is also critical from a central bank’s perspective, given its implications for both monetary and financial stability. Exclusion of people and firms from a formal financial system significantly weakens the monetary policy’s transmission to the economy. Interest rate, as a monetary policy tool, can be more effective, the more inclusive a financial system is. And from financial stability standpoint, an inclusive financial system can help banks achieve a wider deposit base and a more diversified credit portfolio, thus strengthening financial sector resilience.

Notwithstanding these benefits, the state of financial inclusion in many countries suggest that a vast segment of the population is still either underbanked or completely unbanked. According to World Bank’s data on financial inclusion, around 2 billion people or 38% of the world’s adult population have no access to formal financial services. Particularly left out are the poor, women, youth, and people living in rural areas. Cost of opening and maintaining an account, onerous documentations and physical distance are some of the key constraints in access to finance. In Muslim countries, some people also opt out of conventional banking system for religious reasons.

Financial inclusion also varies substantially, both across the regions and income levels. For instance, in low-income countries, inclusion stands at 28% while it is around 91% in high-income

²⁹ Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait, at the at the OIC Conference held on 22nd September, 2017, Istanbul, Turkey.

countries. Regionally, account ownership is highest in East Asia and Pacific and lowest in the Middle East.

It is pertinent to mention that Kuwait has a fairly high degree of financial inclusion by global standards. Around 73% of the population above the age of 15 years in Kuwait has an account with a formal financial institution. Compare this to the Middle East region in general where account penetration stands at a meager 14%.

How technologies are helping increase access to finance

Thankfully, modern technologies are helping provide formal financial services to the millions of unbanked customers around the globe. In a world where the poorest 20% of the world population is more likely to have access to a mobile phone than to clean water and sanitation, mobile banking has tremendous potential to promote financial inclusion.

According to GSMA, the global association of mobile network operators, two third of the world population currently has a mobile subscription. Capitalizing on this opportunity, Tanzania has more than doubled the percentage of adults with transaction accounts, from 17.3% in 2011 to 39.8% in 2014 largely through e-money services. In Kenya, ‘M-Pesa’, a small-value electronic payment system that is accessible from ordinary mobile phones, is now serving over 20 million customers; half of the Kenya’s adult population uses ‘M-Pesa’ to transfer funds, pay bills, and purchase mobile airtime.

Secondly, the growing use of mobile phones and internet is generating huge amount of data, offering opportunities to better understand customers’ need and provide tailored services. By effectively using the digital trails of individuals’ payment and transfers like airtime top-ups and utility bill payments, fintechs are developing credit histories of individuals and SMEs, paying the way for extension of credit to such borrowers.

Thirdly, biometric technologies are creating the possibility of using agent based banking models and opening of accounts in distant locations. In India alone, digital IDs have helped add 200 million new bank accounts. Tech based face and voice recognition are helping verify new customers in novel ways, while reducing the burden of onerous documentation in opening low-value accounts.

What are the implications from financial stability standpoint?

Notwithstanding the unprecedented opportunities that fintechs offer for financial inclusion, we should also recognize the challenges that financial innovations can pose to the overall financial stability. Let me briefly point out a few such issues.

First, consider the case of fintechs which have unbundled parts of finance value chain and are offering some of the financial services directly to the customers. Banks have long relied on such firms to help them serve their customers better. But now fintechs are engaging in direct competition with banks. Probably it was under these competitive pressures that three major US

banks allowed instant payments, a market that has been largely captured by Apple Pay and PayPal's Venmo. Likewise, Competition and Markets Authority (CMA) in UK has required British banks to share, from 2018, their customers' data with third parties who can then advise how much could be saved using other lenders. Once implemented, this would further enhance competition in the banking sector with implications for financial stability.

Second, some observers reckon that the growing use of blockchain may reduce the role of banks as financial intermediaries. The technology even has the potential to eliminate the role of central depositories. Given its decentralized nature, distributed ledgers may relegate banks to a position of insignificance, unless banks adopt the platform early on and to their advantage.

Third, 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.

Fourth, 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.

Fifth, 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. Just a few weeks back, critical personal information of around 143 million US customers was stolen from Equifax, a leading credit reporting firm. And last year, Yahoo announced that accounts of around 1.5 billion users were affected by two separate hacks during 2013-14. Though such occurrences are still somewhat infrequent, the impact is massive, both in financial and reputational terms.

What regulators can potentially do?

Against this backdrop, 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. The dilemma is that the very technologies that promise enhanced access to finance also pose the risks to financial stability, if not managed well.

At the same time, we also need to recognize that ensuring '100% security' is not practically possible. As Gene Spafford, a security expert put it, 'the only truly secure system is the one that is powered off'. For anything else which is fully functional 24/7, potential for some glitches here and there would always remain and can only be minimized.

At the CBK, our approach in regulating innovations is both *enabling* and *proportionate*, as we aim to use a tiered process of introducing rules in accordance with the risks involved. That is why we

have adopted a 'regulatory sandbox' approach to provide a safe testing place for innovative products or services. The approach will help harness the potential of innovative technologies but without exposing the entire financial system during the early stages of development.

To conclude, in a dynamically changing business environment, we, the regulators, need to remain agile, adaptive and proactive, similar to when navigating unfamiliar domains. To quote Churchill, we need to be awake 'to the tips of our fingers'.

Thank you for your attention.

