



Central Bank of Kuwait



# Financial Stability Report 2014

CENTRAL BANK  
OF KUWAIT

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# Financial Stability Report

for the calendar year 2014

Financial Stability Office  
Central Bank of Kuwait



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



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



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

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

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

*We are pleased to release our 3<sup>rd</sup> FSR for the calendar year 2014, an annual publication composed of five chapters covering all three aspects of the financial system: institutions, markets and infrastructure. We dedicate the first three chapters to coverage of the banking sector, the most significant component of our financial system. Chapter 1 assesses the role and performance of banks, both conventional and Islamic, as financial intermediaries, by highlighting trends in both credit allocation and deposit mobilization. Chapter 2 evaluates the risks faced by the banking system, covering various dimensions of credit, market and liquidity risks. Chapter 3 examines the trends in profitability and solvency of the banking system and its resilience against a variety of major shocks, both endogenous and exogenous under different financial and economic stress scenarios. Chapter 4 explores the key developments in money, foreign exchange, equity and real estate markets, the four key components of our domestic financial market. Finally, chapter 5 examines the performance of retail and large-scale payment and settlement systems in the country.*

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

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

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



## COVERAGE AND DATA CONVENTIONS

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*This Financial Stability Report (FSR) primarily examines the performance of the key components of the financial system for the calendar year 2014 (CY14) using December 31<sup>st</sup>, 2014 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 3.8% of the consolidated banking system) but we intend to make it part of our analysis in the future. Therefore, readers are cautioned that our consolidated banking system data differs from the Kuwait only data that is available on CBK's website. The last two chapters of the report cover, respectively, performance of the domestic markets and payment & settlement systems within Kuwait only.*

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



The year under review (2014) marked another year of positive developments for the Kuwaiti banking sector. Banks' non-performing loans reached a historically low level, coverage ratio climbed further, and net income sharply increased.

Specifically, the banking system, on a consolidated basis, posted double-digit growth for the second year in a row; assets grew by 12.2% during 2014 with all key components making positive contributions. In particular, banks' consolidated loan portfolio expanded by an impressive 11.5% during the year, the strongest growth recorded in the last five years. There were visible signs of improvement in credit off-take on the back of strong growth for household credit, followed by the real estate sector. In general, credit to all key economic sectors posted positive growth, except for the investment companies where ongoing deleveraging led to a further contraction in lending, by 15% in 2014 on top of a 21.3% decline recorded a year earlier. Finally, banks' deposits registered growth of 7.8% on the back of contribution by both domestic and foreign operations of Kuwaiti banks. The banking system continued to enjoy a stable funding base as 61.8% of the total deposits were placed in the time deposit category.

Banking assets posted double digit growth for the 2<sup>nd</sup> year in a row

Asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has dropped to a historically low level of 2.9% (2.3% on domestic, Kuwait- only basis) as of December 2014, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress that has been made in bringing down the NPLR in the last few years is particularly visible if the existing NPLR (2.9%) is compared against the double-digit NPLR (11.5%) observed in 2009. Moreover, the coverage ratio (available provisions to NPLs) have reached 164% (214.1 %, if viewed on domestic basis), well above the pre-crisis ratio of 87% recorded in 2007. These positive developments in both NPLR and coverage ratio collectively exhibit the success of the CBK and local banks' endeavors in improving the asset quality of the banking system.

Both the level and ratio of NPLs have dropped to a new low, with coverage ratio reaching a historically high level

Flow of non-performing loans (NPLs) under different classification categories also reveals a noticeable slowdown in the buildup of new NPLs as loans 'under monitoring' category have clearly diminished. Sectoral analysis of NPLs indicates that the decline in NPLR has been quite broad based, with virtually all major sectors experiencing a contraction in their respective NPLRs. While the household sector posted a marginal increase in NPLs, its non-performing loan ratio remains among

the lowest of all sectors (2.2% as of December 2014). Geographically, the share of NPLs originating from banks' operation in the GCC and Asia regions has more than doubled. Industry breakdown suggests that conventional banks account for 51.7% of total NPLs, compared to their relatively higher share in gross loans (59.8%). Banks' exposure to the equity market remains considerable, notwithstanding the declining trend in recent years; equity investments make up around 23.8% of banks' total investments, and use of firms' shares as collaterals account for 27.4% of banks' overall collaterals. Finally, banks' liquidity levels continue to remain strong and help ensure a stable funding base. Though the current scale of banks' reliance on non-core liabilities (such as interbank borrowings) is still limited, the upward trend warrants monitoring.

Banks' net income, on consolidated basis, surged by 26.5% during 2014; a confluence of factors led to this positive development, including improved interest income, lower non-interest expenses and declining provision expenses. Consequently, both return on assets as well as equity experienced a concomitant improvement as growth in net income outpaced the growth in assets and equity. By banking groups, conventional banks accounted for 65.6% of the industry profits and 60.3% of the industry assets. Cost to income ratio marginally came down as Islamic banks efficiency improved. Yet conventional banks on average still remain significantly more cost efficient. Capital adequacy ratio (CAR) of the banking sector marginally declined in 2014, both due to the implementation of Basel III standards as well as relatively higher growth in RWAs compared to banks' capital. However, at 16.9% by December 2014, CAR of the banking industry was still well above the CBK's requirement of 12%. Group-wise, CAR of Islamic banks stayed marginally higher than their conventional counterparts. Results of CBK's quarterly stress testing exercise reveal that banks, individually and collectively, have been able to withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

*Banks' net income surged by 26.5% while capital adequacy ratio remained well above the CBK's requirement*

While the scale of liquidity absorption somewhat tapered during 2014 in comparisons to fairly high levels in 2013, the banking system continued to remain highly liquid. Liquidity absorption from conventional banks through interventions was generally higher than from Islamic banks through Tawaruq, unlike in 2013 where Tawaruq operations took the lead. Moreover, CBK's mop up exercise relied, almost entirely, on the use of one-week instruments, further reducing the share of one-month arrangements. In the case of CBK bonds, around 75% of the issuance in terms of value was in 3-month maturities as share of 6-month maturities edged further down.

*The banking system remained liquid*

In the foreign exchange market, USD appreciated against key currencies as the Fed wound down its quantitative easing and expectations of a lift-off on interest rates strengthened amid improving economic outlook for the US economy. While KD depreciated against USD by 3.7% during 2014, this depreciation was by a significantly lower margin compared to the decline of some other major currencies against the USD. For instance, JPY, EUR, and GBP were down against the USD by 14.4%, 12.8%, and 5.8% respectively. On the other hand, KD appreciated against JPY, EUR, and GBP by 9.3%, 8% and 2%, respectively. With the CBK's policy of pegging KD to a basket of currencies, the net impact of diverging trends in exchange rates was largely neutralized, ensuring a more stable exchange rate than it would have been possible by pegging to USD alone.

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

The Kuwait Stock Exchange (KSE) was down by 13.4% during 2014, despite the gains made in the first nine months as plummeting oil prices in part weighed down the market performance. In general, large cap stocks posted better performance, particularly during the first half of 2014. The real estate market maintained its double-digit growth, with all segments exhibiting positive trend. However, the signs of increasing demand pressures amid supply constraints were visible in the residential sector.

*KSE closed the year 13.4% down; Real estate market maintained double digit growth*

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. With regards to the developments in the retail payments segment, use of ATMs and point of sale (POS) related transactions, when viewed in terms of value of transactions, have witnessed growth of 6.4% and 14.8% respectively during 2014. During the year under review, the share of ATM related transactions was higher (58%) in value while that of POS transactions was higher in terms of volume (60%). To facilitate the increasing use of e-banking, relevant infrastructure has also been growing in Kuwait; during 2014, the number of ATMs and POS machines grew by 10.6% and 20.9%, respectively reaching 1,632 and 38,316 machines by December 2014. This was the strongest growth in e-banking infrastructure during the last six years. Banks' branch network also witnessed steady expansion across Kuwait as 19 new branches were established in 2014, bringing the total bank branches in Kuwait to 419. While electronic based transactions account for 97.4% of all transactions in terms of volume, paper-based transaction (through cheques) still has a sizeable share (55.5%) in term of value. Finally, KASSIP, the real time gross settlement system in Kuwait, handled 1.33 million transactions worth KD 304 billion in 2014.

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



## CHAPTER 1

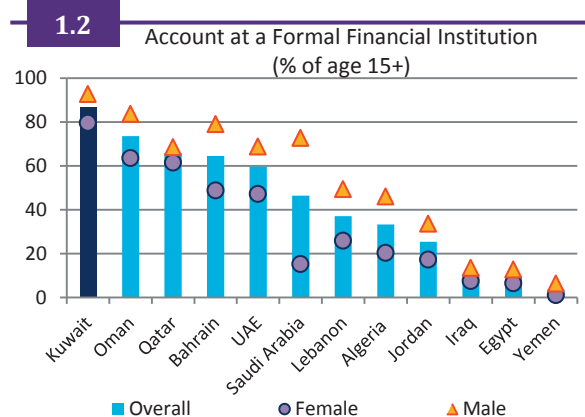
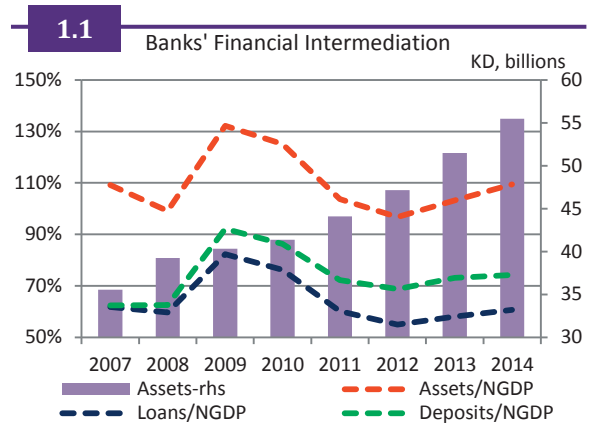
### **BANKS' FINANCIAL INTERMEDIATION**

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The banking system, on a consolidated basis, posted double-digit growth for the second year in a row; assets grew by 12.2% during 2014 with all key components making positive contributions. In particular, banks' consolidated loan portfolio expanded by an impressive 11.5% during the year, the strongest growth recorded in the last five years. There were visible signs of improvement in credit off-take on the back of strong growth for household credit, followed by the real estate sector. In general, credit to all key economic sectors posted positive growth, except for the investment companies where ongoing deleveraging led to a further contraction in lending, by 15% in 2014 on top of a 21.3% decline recorded a year earlier. Finally, banks' deposits registered growth of 7.8% on the back of contribution by both domestic and foreign operations of Kuwaiti banks. The banking system continued to enjoy a stable funding base as 61.8% of the total deposits were placed in the time deposit category.

#### Banks' intermediation has ensured extensive financial inclusion

Financial intermediation by the banking sector continued to improve further in 2014, though at a relatively slower pace than that observed in 2013. Accordingly, intermediation ratios, measured in terms of key banking variables relative to the nominal GDP, inched up further (*Figure 1.1*)<sup>1</sup>. Notwithstanding the slow down, banks' intermediation has pushed financial inclusion in Kuwait to a fairly high level. For instance, The World Bank's 2014 database on financial inclusion reveals that 86.8% of the population above the age of 15 years in Kuwait has an account with a formal financial institution. Moreover, gender-wise breakdown indicates that 92.7% males and 72.8% females above the age of 15 years maintain an account. These numbers suggest that Kuwait has the highest level of financial penetration compared to other countries in the Middle East & North Africa (MENA) region (*Figure 1.2*). Additionally, both male and female customers have fairly similar levels of access to finance, when it comes to maintaining an account. As discussed in detail in *Box 1.1* of our previous Financial Stability Report, the level of financial inclusion in Kuwait is fairly high in other respects as well, putting Kuwait in the lead across the MENA region.



<sup>1</sup> The data used in Figure 1.1 and 1.3 is for the domestic banking sector only, unlike our discussion in the rest of the chapter which is based on consolidated data (including operations of Kuwaiti banks' subsidiaries & branches abroad).

During 2014, the improvement in intermediation ratios was due to a combined effect of relatively higher growth in key banking sector indicators (i.e. assets, loans and deposits) coupled with sluggish growth in the nominal GDP (Figure 1.3). Specifically, while loans and deposits increased in 2014 by 6.2% and 3.2% respectively, nominal GDP expanded by 1.7%<sup>2</sup>, helping intermediation ratios to post some improvement. The trend in intermediation ratios for earlier years can be explained by a much higher fluctuations in the nominal GDP.

### Financial system continues to remain bank-centric

Kuwait has a bank-centric financial system, with the banking sector<sup>3</sup> accounting for around 80.6% of the domestic financial sector. Investment companies are the second major player in the domestic financial system with around 15.2% share as of December 2014. Investment funds, insurance companies, and exchange companies constitute the rest. The domestic banking sector consists of five conventional, five Islamic and one specialized bank. Moreover, Kuwaiti banks have a sizeable presence in numerous other countries, with total assets of their subsidiaries and branches abroad accounting for 20.4% of the consolidated banking system.

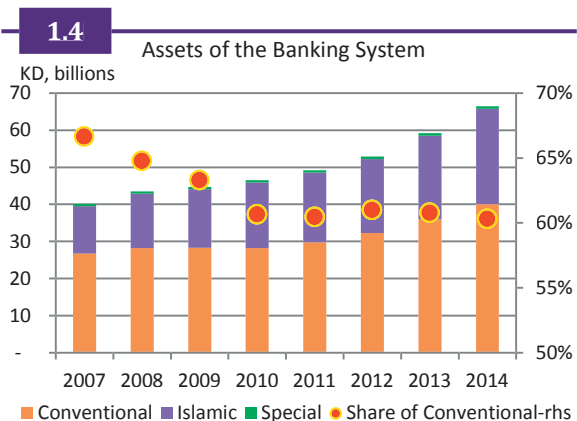
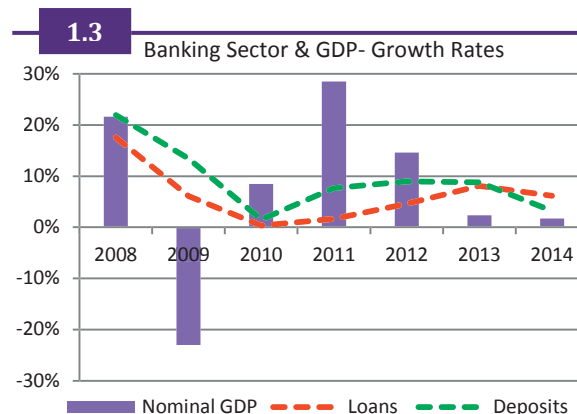
When viewed on a consolidated basis<sup>4</sup>, conventional banks dominate the overall banking system, with 60.3% share as of December 2014; however, their share has remained broadly the same in the last five years (Figure 1.4). Islamic banks, with 38.7% share in consolidated banking system, represent one of the most significant networks of Islamic banks in any country with a dual banking system. The strong presence of Islamic and conventional banks underscores the effectiveness of CBK's endeavors in ensuring a level playing field for both types of banks and also provides customers a variety of choices to fulfill their banking needs.

<sup>2</sup>GDP data for 2014 is based on the IMF forecast.

<sup>3</sup>Here banking sector refers to Kuwaiti banks' domestic operations as well as foreign banks' branches within Kuwait.

<sup>4</sup>This discussion is based on the consolidated data which includes Kuwaiti banks' subsidiaries & branches & abroad.

However, due to some limitations in the breakdown of the data, these numbers exclude 12 foreign bank branches in Kuwait with combined assets of KD 2.6 billion.

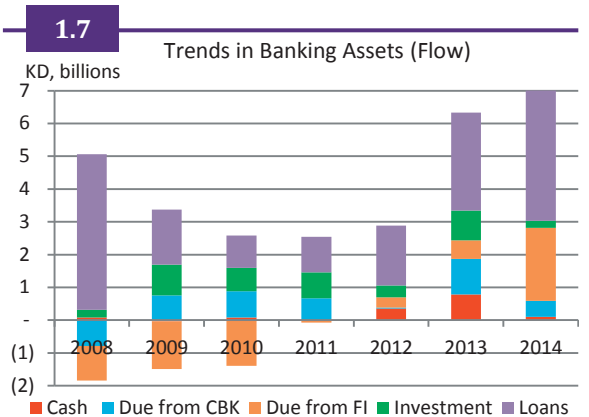
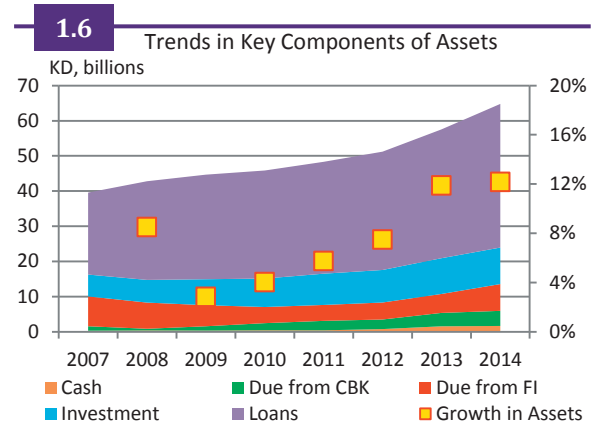
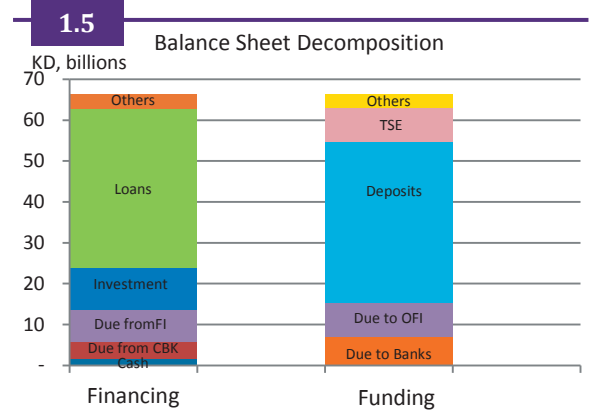


Decomposition of the balance sheet of the banking system highlights the prevalence of traditional instruments expected in a bank-centric financial system. For instance, loans account for as much as 61.5% of the total assets as of December 2014 (*Figure 1.5*). Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 15.6% share in total assets. On the liabilities side, deposits account for 59.4% of total liabilities, indicating a healthy deposit base to help Kuwaiti banks befittingly perform their intermediation role.

*Banking sector posted double-digit growth for the second consecutive year*

On the back of strong growth in 2013 (11.9%), banking sector assets marked another year of double-digit growth (12.2%) (*Figure 1.6*). During 2014, assets worth KD 7.2 billion were added to the banking system, putting total assets at KD 66.4 billion by December 2014. Both in absolute and growth terms, this was the most significant expansion recorded in the last seven years; it seems that the banking sector, which experienced much slower growth in the wake of global financial crisis of 2007-08, was finally on a high growth trajectory. A look at the asset composition of banks reveals that both loans and investments remained the two major components of the banks' balance sheet, collectively accounting for 77.2% of total assets as of December 2014.

Flow data for the key components of banks' assets further exhibits that growth in assets was broad based, with positive contribution from all the key components in overall asset growth, in particular from loans which increased by KD 4.2 billion during 2014 (*Figure 1.7*). 'Due from Financial Institutions' which includes both interbank lending and placements, also posted a sharp increase; as highlighted in Chapter 4, demand for interbank deposits was particularly strong among some foreign banks aiming to hedge their

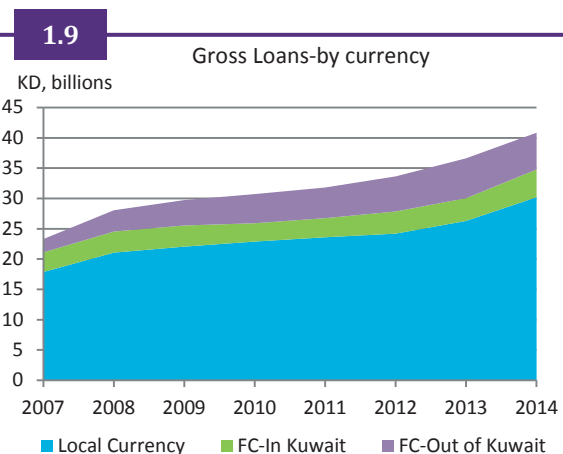
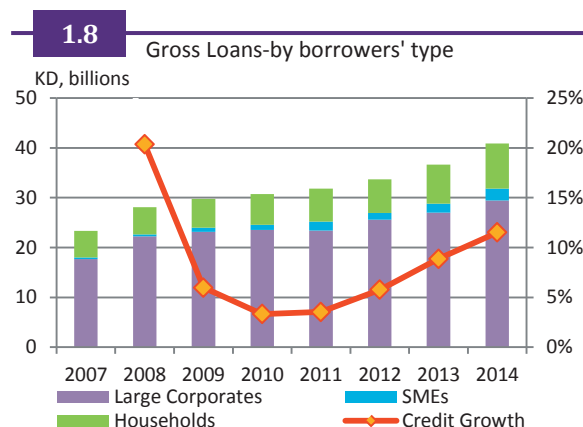


USD/KD swap exposures. On the other hand, contribution from *Cash* and *Investments* dropped significantly compared to 2013. *Due from CBK*, the third major component, posted a marginal drop as CBK's liquidity absorption exercise somewhat tapered, particularly its mopping-up of excess liquidity from commercial banks through interventions (see Chapter 4 for details).

### Credit off-take has been the strongest in the last five years

During 2014, banks expanded their consolidated loan portfolio by another 4.2 billion, posting the strongest growth (11.5%) observed in the last five years (*Figure 1.8*). Credit to residents grew by 6.2%, maintaining a positive trend, albeit at a relatively slower pace when compared with the 8.1% growth recorded in 2013. In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 72.1% of the total gross loans. A distant second was the households sector, with 22.2% share in overall credit and outstanding loans amounting to KD 9 billion as of December 2014. Though still limited, there has been a shift from corporates to households in terms of credit allocation as the share of household sector marginally improved during 2014. The share of SMEs in overall lending also inched up to reach around 5.7% in 2014. With a view to generate additional employment and business growth, the government has endeavored to increase the role of SMEs by formally setting up a *National Fund for the Development of SMEs* with KD 2 billion of capital. However, unless SMEs expand significantly, a major shift in credit allocation away from corporates and households is unlikely in the medium term.

Currency-wise breakdown of the gross loans indicates that almost 3/4<sup>th</sup> of overall lending was in domestic currency, with the share of foreign currency (FC) loans slightly decreasing to reach 26% by the end of 2014 (*Figure 1.9*). Within FC loans, around 57% in 2014 were granted by Kuwaiti banks' subsidiaries & branches abroad (FC-out of Kuwait).

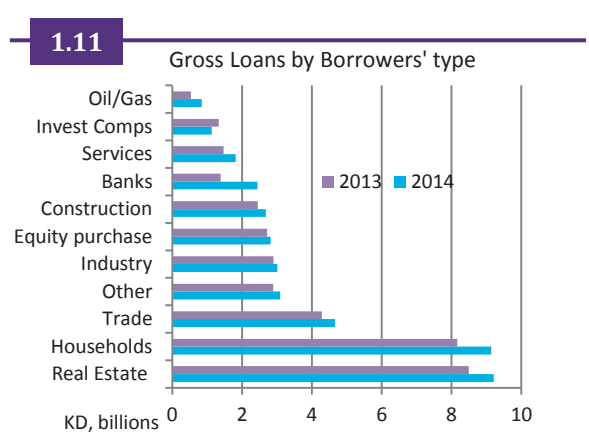
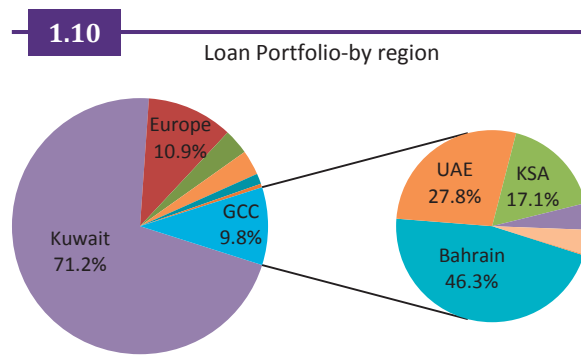


Loans' breakdown in terms of lending to the public and private sectors reveals that almost the entire lending was directed towards the private sector (98.9%), while the share of lending to the public sector further slipped to 1.1% during 2014. With strong revenue profile of the public sector on the back of robust current account and budget surpluses over the last decade, the need for public sector to borrow from the banking system has remained minimal. The strong financial profile of the public sector has also helped Kuwait avoid the issue of private sector crowding out that countries with frequent government borrowing from the banking sector typically experience.

Geographical breakdown of banks' lending portfolio reveals that out of banks' 40.8 billion of gross loans as of December 2014, KD 29 billion (71.2%) have been granted within Kuwait (Figure 1.10). The remaining 28.8% of the gross loans have been distributed across various regions, with Europe and GCC accounting for around 10.9% and 9.8% respectively. In particular, the share of domestic lending in gross portfolio has declined from 76.3% in 2013 as other regions (Europe & GCC) have received somewhat higher credit in 2014. Within GCC, banks' greatest credit exposure is primarily to Bahrain, followed by UAE and Saudi Arabia.

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

Breakup of gross loans across various sectors indicates that lending to real estate and households sectors collectively accounted for around 45% of the total gross loans. As of December 2014, real estate and households had outstanding credit worth around KD 9.2 and KD 9.1 billion respectively (Figure 1.11). In general, all the key sectors observed a growth in credit utilization, except for the investment companies. In continuation of the trend in previous years, outstanding loans to investment companies contracted by another 15% in 2014 on the top of a 21.3% retreat recorded a year earlier. Consequently, the share of loans to investment companies further



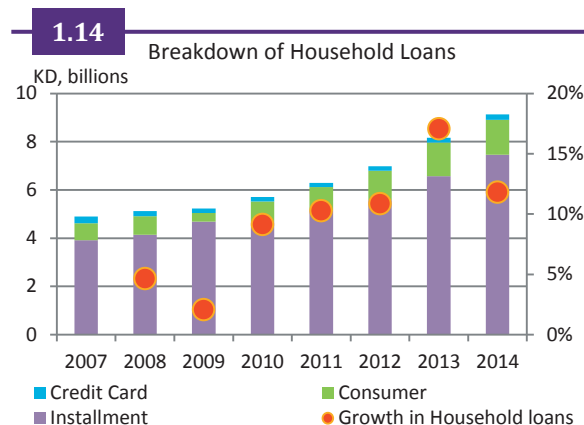
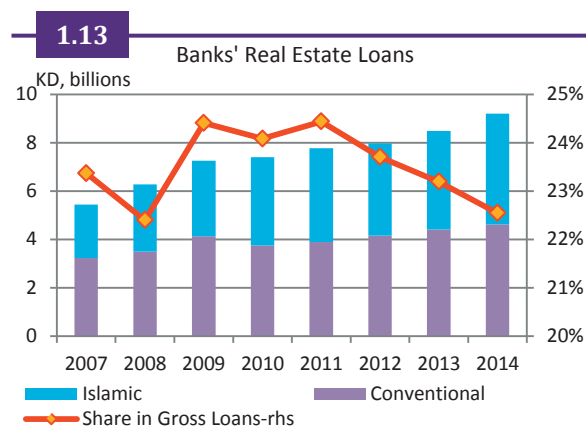
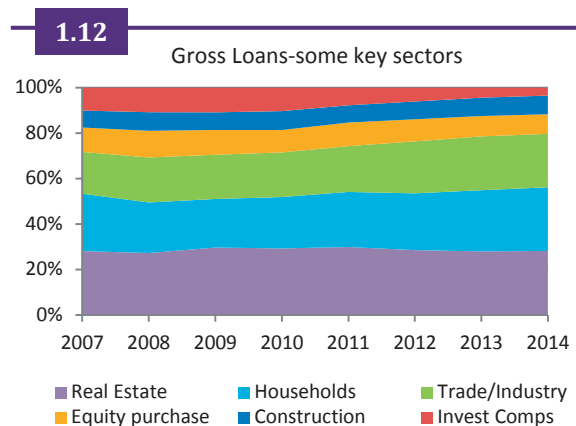
edged down to 2.8% of banks' overall portfolio in 2014, indicating banks' diminishing credit exposure amid investment companies' ongoing deleveraging.

The trend in loans over the years reveals that banks' collective exposure to key sectors have remained broadly stable, with little indication of a sudden surge in any specific sector (*Figure 1.12*). A relatively stable trend in credit allocation suggests that banks have avoided the boom and bust cycles in their lending practices, underlining a conservative approach towards credit allocation. However, concentration remains high as three sectors (real estate, households and trade/industry) account for almost 2/3<sup>rd</sup> of the entire credit portfolio, though the level of concentration has marginally dropped as share of the aforementioned three sectors have come down from 65.1% in 2013 to 63.7% in 2014.

#### Real estate & households are leading recipients of bank credit

Amid double-digit growth in the real estate sector on the back of strong growth in the *investment real estate* segment in particular, bank lending to real estate grew by 8.4% during the year under review, the strongest growth recorded since 2010. However, share of the real estate loans in banks' overall credit portfolio marginally declined from 23.2% to 22.5% during 2014 (*Figure 1.13*). Still, lending to real estate remained the most significant component of banks' loan portfolio. Both conventional and Islamic banks collectively lent/financed almost equal amounts, though conventional banks had a slightly higher share (50.3%) as of December 2014.

In terms of lending to the households, banks' credit grew by 11.8% in 2014 to reach KD 9.1 billion, only marginally lower than the amount received by the real estate sector (KD 9.2 billion) in 2014. While growth in household credit was lower compared to 2013 (17.1%), it was still in double digits for the fifth consecutive year (*Figure 1.14*). Breakup of household loans reveals that around 81.7% of the household loans have been *installment loans*, which are long term



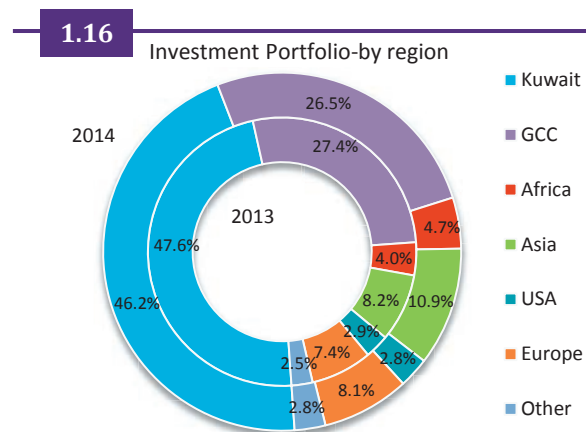
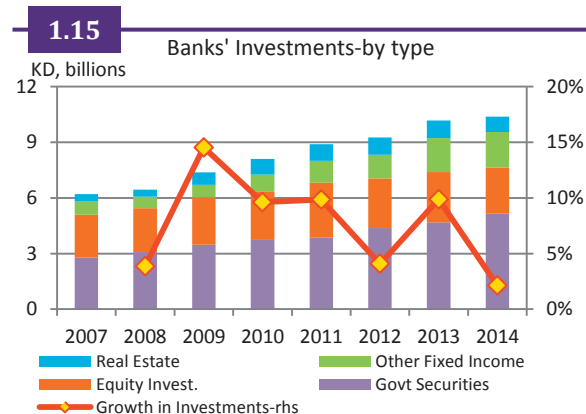
personal loans for repair and purchase of private homes. These loans are repaid in monthly installments over a period not exceeding 15 years. Consumer loans, meant for purchase of consumer durables or to cover educational/medical expenses, constituted the second major category of household loans with 15.8% share as of December 2014. Finally, credit card related loans accounted for around 2.5% of overall household loans.

Considering 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 higher than what appears from their direct lending of KD 9.2 billion to the real estate sector. Moreover, extension of installment loans from commercial banks also indicates strong borrowing needs of consumers amid high property prices and insufficient lending by the Kuwait Credit Bank.

*Banks' equity investments retreated amid falling stock prices*

Banks' investment portfolio posted a modest growth of 2.1% as both equity investments and real estate investments declined by 8.6% and 12.1% respectively during 2014. However, investments in government securities went up by 10.2% during the year. (Figure 1.15). Investments' breakdown reveals that out of KD 10.4 billion of total investments, around KD 5.2 billion (49.7%) were placed in government securities as of December 2014. Banks' equity investments formed the second major category with 23.8% share in total investments. In the last few years, banks' exposure to other fixed income securities has been on the rise in particular; in 2014, it reached 18.5% of overall investments compared to 13.9% in 2012.

Geographical distribution of the investments indicates that banks' investments within Kuwait marginally declined from 47.6% in 2013 to 46.2% in 2014. Moreover, a slight decrease in banks investments in GCC was also observed. On the other hand, banks' exposure to some other regions went up, particularly in the countries within Asia, Africa and Europe (Figure 1.16).



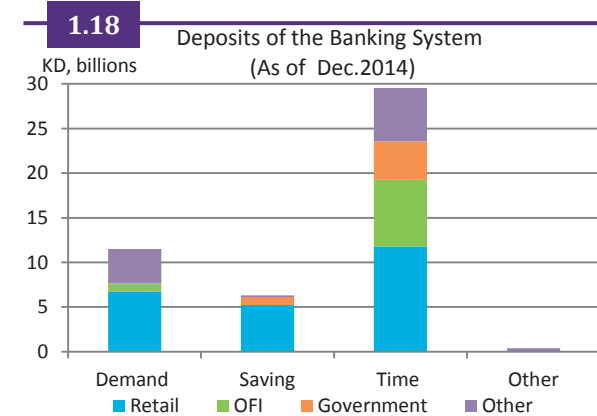
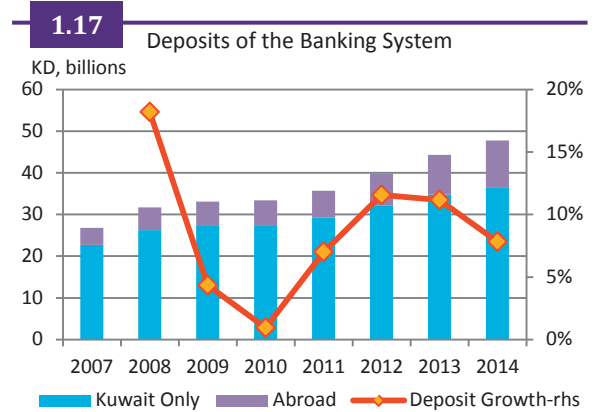
1.16). These trends collectively underscore improving diversification of banks' investment portfolios.

*While still strong, growth in deposits has somewhat slowed*

During 2014, banking system deposits posted growth of 7.8%, compared to the double-digit growth recorded in the earlier two years (Figure 1.17). Deposits raised through subsidiaries and branches abroad grew at a much stronger pace (17.2%) compared to the growth in domestic deposits (5.3%) though the growth in both categories was somewhat slower than in 2013. Overall, deposits reached KD 47.7<sup>5</sup> billion as of December 2014, with domestic deposits accounting for 76.6% of total deposits of the banking system. Over the years, the share of deposits from abroad has been slowly increasing due to the growing expansion of Kuwaiti banks abroad. Specifically, this share has gone up from 15% in 2007 to 23.4% in 2014.

*Around two-thirds of banks' deposits are time deposits*

Breakdown of deposits reveals that time deposits account for around 61.8% of the total deposits, highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress. Retail deposits are well diversified into three different categories (demand, saving and time), in line with the consumers' transaction and precautionary demands for money (Figure 1.18). Finally, the deposits of other financial institutions (OFI) and government are overwhelmingly placed as time deposits. Given the strong fiscal profile of the government, presence of its deposits in the time deposit category further adds to the stability of banks' funding base.



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



## CHAPTER 2

### **BANKS' RISK ASSESSMENT**

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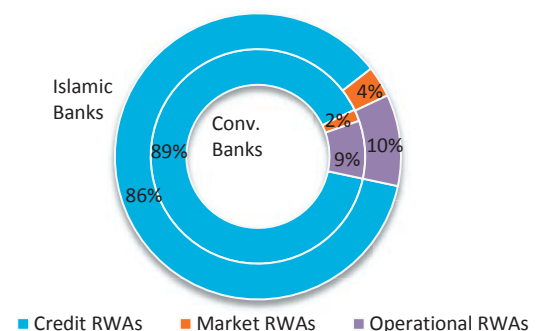
Asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has dropped to a historically low level of 2.9% (2.3% on domestic, Kuwait-only basis) as of December 2014, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress that has been made in bringing down the NPLR in the last few years is particularly visible if the existing NPLR (2.9%) is compared against the double-digit NPLR (11.5%) observed in 2009. Moreover, the coverage ratio (available provisions to NPLs) have reached 164% (214.1%, if viewed on domestic basis), well above the pre-crisis ratio of 87% recorded in 2007. Flow of non-performing loans (NPLs) under different classification categories also reveals a noticeable slowdown in the buildup of new NPLs as loans 'under monitoring' category have clearly diminished. Sectoral analysis of NPLs indicates that the decline in NPLR has been quite broad based, with virtually all major sectors experiencing a contraction in their respective NPLRs. While the household sector posted a marginal increase in NPLs, its infection ratio remains among the lowest of all sectors (2.2% as of December 2014). Geographically, the share of NPLs originating from banks' operation in the GCC and Asia regions has more than doubled. Industry breakdown suggests that conventional banks account for 51.7% of total NPLs, compared to their relatively higher share in gross loans (59.8%). Banks' exposure to the equity market remains considerable, notwithstanding the declining trend in recent years; equity investments make up around 23.8% of banks' total investments, and use of firms' shares as collaterals account for 27.4% of banks' overall collaterals. Finally, banks' liquidity levels continue to remain strong and help ensure a stable funding base. Though the current scale of banks' reliance on non-core liabilities (such as interbank borrowings) is still limited, the upward trend warrants monitoring.

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

Credit risk is understandably the most significant of all risks confronted by the Kuwaiti banks, given the traditional nature of their business primarily providing conventional credit facilities. Accordingly, credit *risk weighted assets* (RWAs) of both Islamic and conventional banks constitute the bulk of their total RWAs as of December 2014 (Figure 2.1). Given the unique nature of their business, Islamic banks have slightly greater exposure to both market and operational risks when compared with their conventional counterparts. The insignificant contribution by market risk in overall RWAs is on account of banks' relatively smaller trading portfolios. Moreover, calculation of RWAs under Basel III excludes interest rate risk in the banking book.

## 2.1

Distribution of Risk Weighted Assets (RWAs)



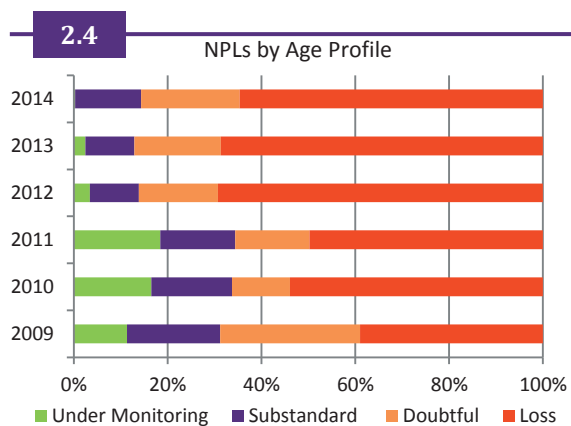
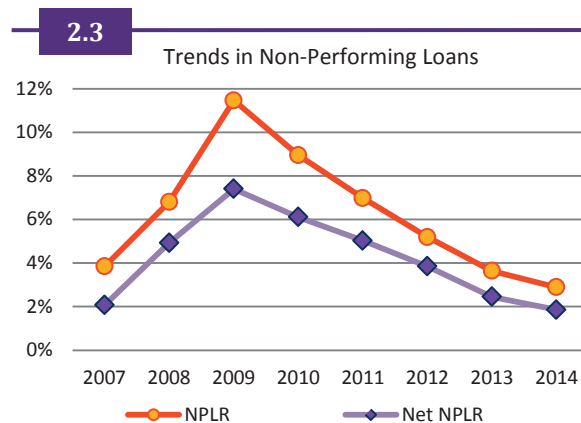
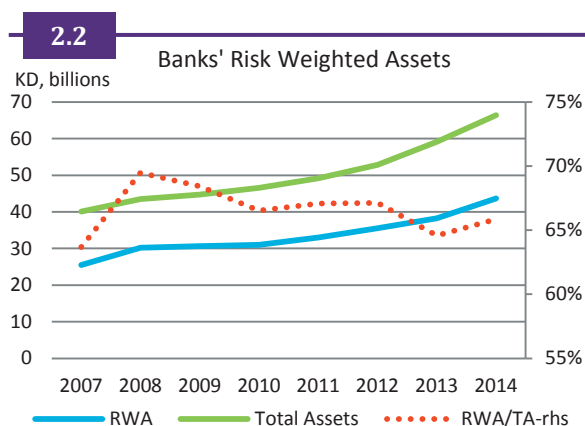
Comparison between RWAs and total assets (TA) of the banking sector can provide some indication of the magnitude of risks in the asset base; as of December 2014, RWA/TA inched up to 65.8%, from 64.6% a year earlier (*Figure 2.2*). While total assets registered strong growth (12.2%), growth in RWA was even higher (14.4%), leading to a marginal increase in the RWA/TA ratio.

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

It is particularly encouraging that credit risk, which constitutes the bulk of RWAs of both Islamic and conventional banks, stands fairly confined. Specifically, the absolute value of non-performing loans (NPLs) of the banking sector has steadily declined for the fifth consecutive year, due to the strenuous efforts made by banks on CBK's instructions and active encouragement. Understandably, the pace of decline in NPLs has somewhat diminished as most of the credit portfolio is already performing and the scope for further improvement is quite limited. As a result, the outstanding NPLs are at the lowest level since 2009. Net NPLs (i.e. Gross NPLs less specific provisions) also reveal a similar trend, climaxing in 2009 with a smooth decline afterwards.

Consequently, the NPL ratio (NPLR) has edged further down to 2.9% as of December 2014, significantly lower than the pre-crisis ratio of 3.8% observed in 2007 (*Figure 2.3*). The historically low level of NPLR underscores significant improvement in the health of the banking system, when viewed in terms of credit exposures. Net NPLR has also been on a receding trend since 2009 and has reached a historically low level of 1.9% in 2014 as banks, on the instructions of the CBK, have built up sufficient provisions.

Breakdown of NPLs' classification by age profile also indicates that not only the overall NPLs have come down but the built up of new NPLs has also tapered off. It is evident from the negligible share of loans in



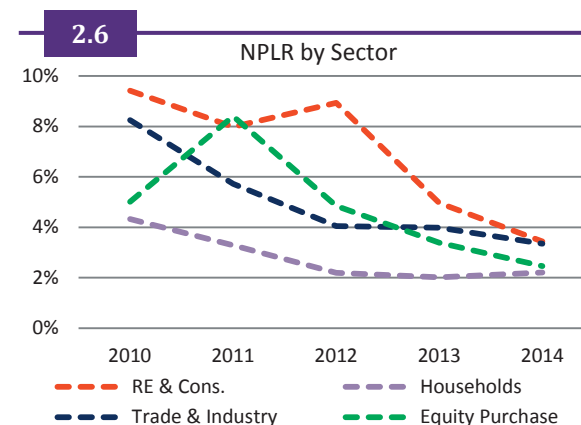
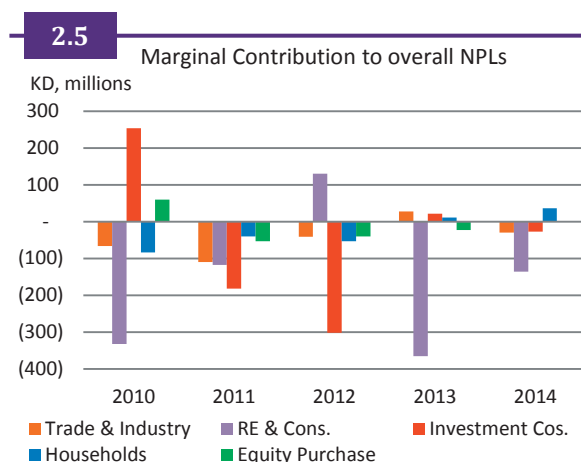
2014 classified as ‘*under monitoring*’, the first category in NPLs’ age profile (Figure 2.4).

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

Data for the marginal contribution of different sectors in the industry NPLs reveals that contraction in infected loans has been fairly broad-based (Figure 2.5). All major sectors have posted a decline in NPLs during 2014 except for the *household sector* which witnessed positive, though limited, growth in NPLs. Decline in NPLs has been particularly significant in the case of *real estate & construction* segment, followed by the *investment companies*. Banks’ exposure to investment companies, once a significant part, now stand at a meager 2.8% of their total lending; while the NPLR for the investment companies is among the highest, their impact on the banking sector is quite limited as this portfolio has been reduced to an insignificant level.

The broad based improvement in the health of banks’ credit portfolio is also evident from the trend in sectoral NPLRs (Figure 2.6). The household sector has remained the least infected, notwithstanding the nominal rise in the absolute NPLs; this is evident from its lowest NPLR when compared with other sectors. Over the years, a number of CBK regulations, encompassing both micro and macro-prudential tools, have helped keep the non-performing loans in the households sector at the minimum. For instance, these loans are primarily extended to nationals, provided the payments are not above 40% of their salaries (net of all deductions). Moreover, the interest rate charged on these loans is capped at 3% above the prevailing discount rate set by the CBK. Furthermore, since these loans are typically smaller in magnitude and are granted to numerous individuals, the overall portfolio is well diversified with a much lower risk profile.

Positively, NPLR for the *Real Estate & Construction* segment has also been steadily declining, coming down from 5% in 2013 to 3.4% in 2014. This reduction in NPLR is particularly encouraging as the



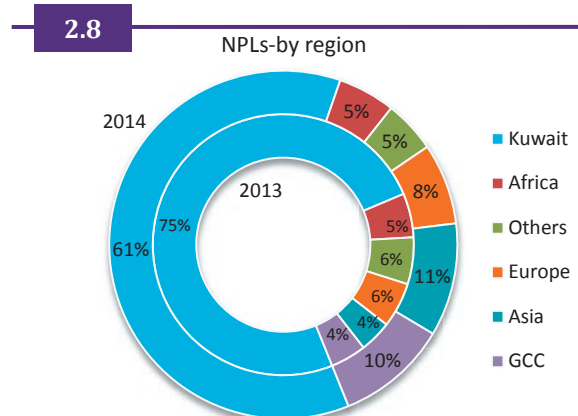
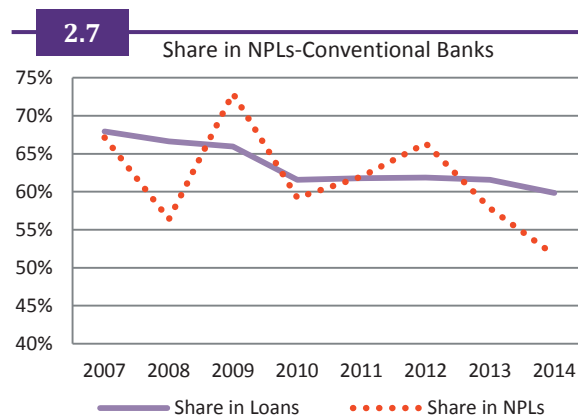
*Real Estate & Construction* represents around 29.1% of banks' total credit portfolio which experienced some serious impairment in the wake of the global financial crisis of 2007-08. Banks have benefited from the continuous improvement in the domestic real estate market during the last few years (see Chapter 4 for details). Moreover, CBK introduced appropriate macroprudential regulations in November 2013 to shield the banking system from excessive exposure to the real estate by imposing differentiated Loan-to-Value (LTV) ceilings depending upon the purpose of the loan (for details, see *Box.4.1* in the FSR of 2013).

Segregation of NPLs by type of banks reveals that conventional banks' share in the industry NPLs have been falling during the last three years, though their share in gross loans have remained broadly the same. As a result, conventional banks' contribution to industry NPLs in 2014 stands at a disproportionately lower level (51.7%) compared to their share in gross loans (59.8%) (*Figure 2.7*). It is pertinent to mention that the broad classifications across types of banks could be influenced by the performance of one major bank in that subgroup. For instance, the top four banks account for 72.2% of the total loan portfolio of the banking industry; thus, a sharp change in the quality of credit portfolio in even one of those banks can significantly alter the industry averages.

Geographical distribution of NPLs highlights that the contribution of domestic NPLs has noticeably come down from 74.7% in 2013 to 61.4% in 2014 (*Figure 2.8*). In relative terms, the domestic operating environment has been more conducive, resulting in better performance of banks' credit portfolio. Outside Kuwait, the contribution towards non-performing loans from the GCC and the Asia regions has noticeably increased, from 4% each in 2013 to 10% and 11% respectively in 2014.

*Banks' coverage ratio has continued its growth unabated*

As required by the CBK, Kuwaiti banks have been building up additional provisions since the start of the global financial crisis to withstand any potential



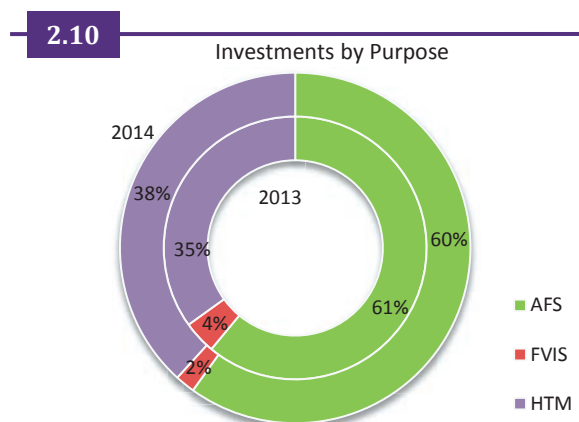
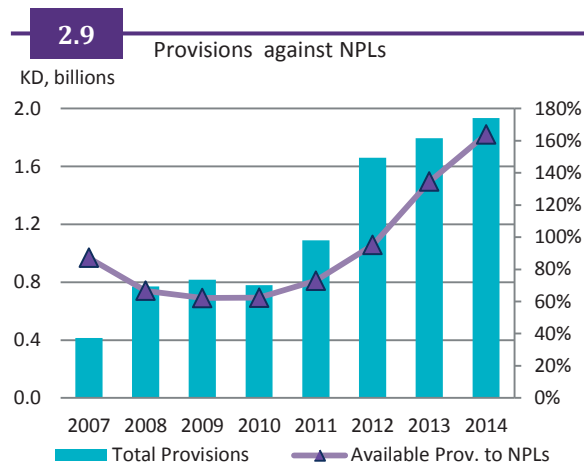
deterioration in their credit portfolios. During 2014, total available provisions witnessed a growth of almost 8% on the top of 8.1% growth in 2013. Accordingly, the *available provisions to NPL ratio* reached at 164%, an all-time high in the last seven years, and significantly greater than the pre-crisis ratio of 87% (Figure 2.9).

A breakdown of available provisions reveals that precautionary provisions have been on rise in particular. CBK has continued to press upon banks to accumulate such provisions to help them better withstand any possible deterioration in the quality of their credit portfolios. These provisions are counter cyclical in nature, as the build-up of these provisions in relatively benign times would enable the banking sector to better cope with any potential downturns, without compromising their ability to extend credit.

#### Market risk remains the smallest component in overall RWAs

Given the traditional nature of Kuwaiti banks' operations, market risk remains a fairly small component of the overall RWAs, accounting for a meager 2.4% as of December 2014. The bulk of the banks' investments (around 68% as of December 2014) is in fixed income instruments, out of which three quarters are in government bonds while the rest is in corporate bonds.

Breakdown of investments reveals that around 60% of banks investments have been placed under *Available for Sale* (AFS) category. Investments under *Held to Maturity* (HTM) represent the second major segment (38%) while *Fair Value through Income Statement* (FVIS) constitute an insignificant third (Figure 2.10). The bulk of investments held under AFS suggest that banks are keen to maintain a high level of liquidity to better manage their liquidity risk. Still, the share of HTM is sizeable and indicates the limited availability of desirable securities, prompting banks to hold these safer assets to maturity.



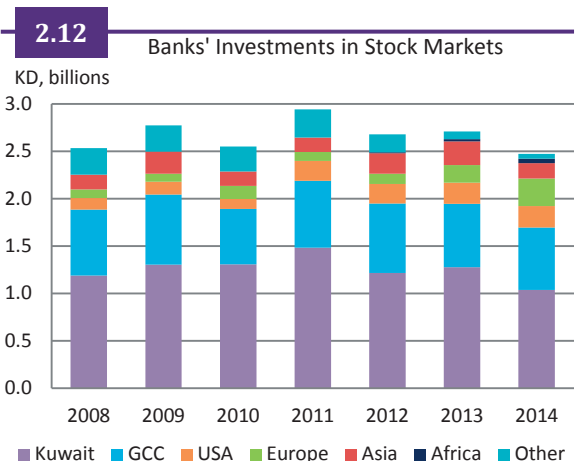
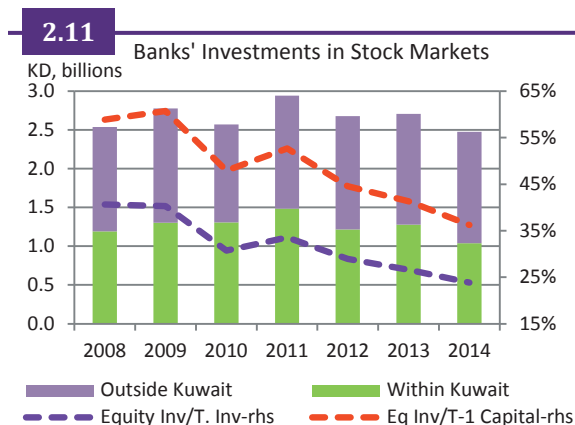
*Despite the steady decline, bank' equity investments are significant*

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

First, in terms of banks' direct exposure, banks' equity investments represent 23.8% of their total investments by end of 2014 (*Figure 2.11*). While the share of equity investments has dropped from a high level of 40.3% back in 2009, it is still a significant component of banks' total investments. When viewed in terms of banks' Tier-1 capital, banks' equity investments were around 36%, at the lowest level in the last five years. These numbers suggest that while banks have significantly reduced their exposure to equity investments over the years, they are still vulnerable to the volatility in equity prices. In the case of some banks, higher equity investments are the result of debt for equity swaps made with their clients in the investment sector.

Amid poor performance of the domestic stock market in 2014 (during the last quarter in particular, as discussed in Chapter 4), banks' exposure to the domestic equity market has noticeably come down, from 47.2% to 41.9% during 2014 (*Figure 2.12*). On the other hand, banks' exposure to GCC and European markets have increased from 24.7% and 6.9% to 26.7% and 11.6% respectively during the same period. With around 58.1% of banks' equity investments distributed across GCC, Asia and Europe etc., the diversification in banks' portfolio helps them withstand volatility in the stock market. However, as historical experiences suggest, correlations across markets increase during times of stress, eroding the benefits of diversification that otherwise seems substantial in good times.

Second, in terms of banks' indirect exposure, equity collateral constitutes around 27.4% of the total



collaterals held by banks. The use of shares as collateral has been receding, from a high of 40.5% of all collaterals in 2010 to 27.4% by 2014 (Figure 2.13). With equity collateral still accounting for more than a quarter of the total collaterals, banks could be exposed to sharp swings in equity prices. However, the steady increase in the share of real estate collateral poses its own unique risks, not the least because of the complications in liquidating such collaterals in the event of a default.

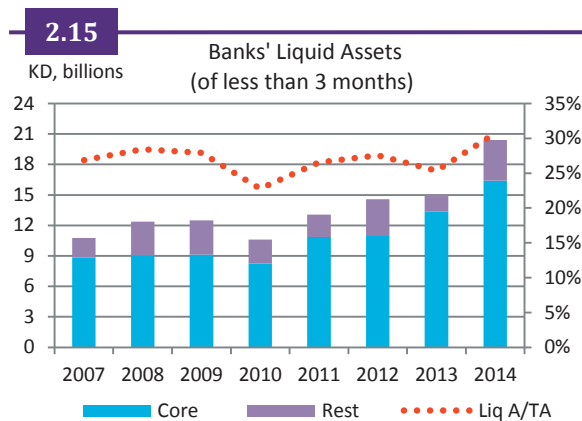
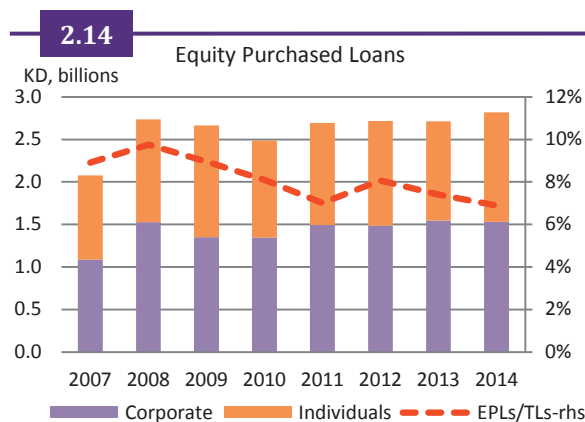
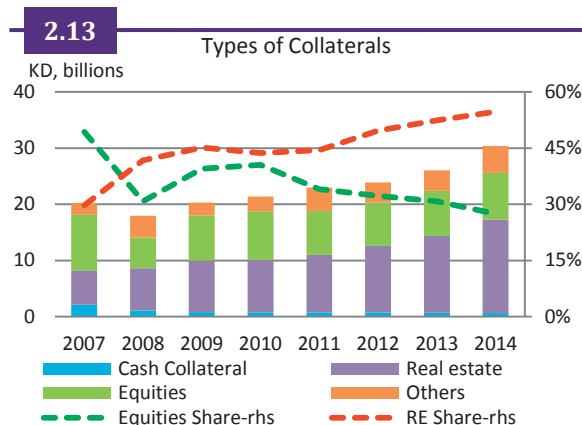
The third form of banks' indirect exposure has been in terms of loans granted to customers (both individuals and corporates) for trading in shares. These loans, termed as equity purchase loans (EPLs), make up around 6.9% of banks gross loan portfolio. With around 5.8% share in banks' total non-performing loans, EPLs are a key component of banks' risk exposure, both from the point of credit and market risk. However, the NPLR for EPLs was at 2.5% in December 2014, suggesting a fairly low level of infection. The breakdown of these loans reveals that corporate sector has slightly higher share (54.3% in 2014) compared to individuals availing such facilities (Figure 2.14).

#### Banks' have maintained strong liquidity levels

Banks liquid assets of less than three months have witnessed a rising trend since 2010; during 2014, liquid assets (of less than three months maturity) were up by KD 5.3 billion to reach KD 20.4 billion (Figure 2.15). A breakdown between core and non-core liquid assets reveals that core liquid assets (including cash and cash equivalents, deposits with CBK, government securities, CBK bills, and deposits with banks etc.) represent 80.5% of the overall liquid assets in 2014. Moreover, as a component of total assets, core and liquid assets accounted for 24.7% and 30.7% respectively as of December 2014.

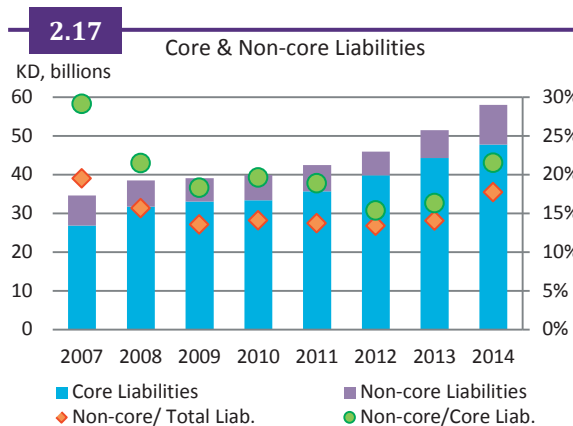
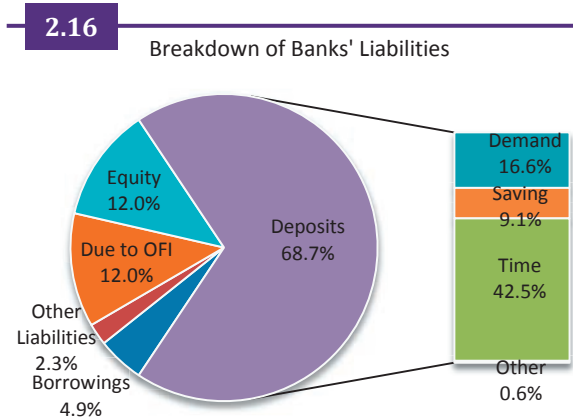
#### Banks' non-core liabilities have been on rise

Customer deposits represent 68.7% of the banks' funding base as of December 2014 (Figure 2.16).



Within deposits, time deposits constitute the bulk, accounting for 42.5% of the overall funding base and around 61.8% of total customer deposits. A sizeable share of time deposits provides Kuwaiti banks with a comfortably stable funding base to adequately perform their role as financial intermediaries. Moreover, since Kuwait formally enacted the Deposits Guarantee Law in 2008 to protect depositors, the risk of bank runs has also been effectively eliminated.

Though banks' funding structure is still largely reliant on stable deposits, there is a perceptible shift towards the increasing role of non-core liabilities (essentially interbank borrowings) compared to core liabilities like deposits (*Figure 2.17*). Given the volatile nature of wholesale funding which can be swiftly influenced by market sentiments, growing reliance on non-core liabilities to support the growth in assets can increase the funding liquidity risk for the banking system. While the scale of banks' dependence on non-core liabilities is limited at present, the trend warrants monitoring.





## CHAPTER 3

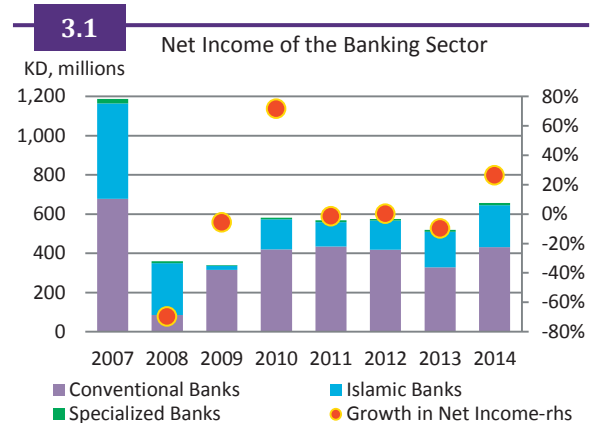
### PROFITABILITY , SOLVENCY AND RESILIENCE

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Banks' net income, on consolidated basis, surged by 26.5% during 2014; a confluence of factors led to this positive development, including improved interest income, lower non-interest expenses and declining provision expenses. Consequently, both return on assets as well as equity experienced a concomitant improvement as growth in net income outpaced the growth in assets and equity. By banking groups, conventional banks accounted for 65.6% of the industry profits and 60.3% of the industry assets. Cost to income ratio marginally came down as Islamic banks efficiency improved. Yet conventional banks on average still remain significantly more cost efficient. Capital adequacy ratio (CAR) of the banking sector marginally declined in 2014, both due to the implementation of Basel III standards as well as relatively higher growth in RWAs compared to banks' capital. However, at 16.9% by December 2014, CAR of the banking industry was still well above the CBK's requirement of 12% for 2014. Group-wise, CAR of Islamic banks stayed marginally higher than their conventional counterparts. Results of CBK's quarterly stress testing exercise reveal that banks, individually and collectively, have been able to withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

*Net income, on a consolidated basis, surged by 26.5% in 2014*

Profitability of Kuwait banks posted a strong recovery in 2014 after experiencing noticeable contraction back in 2013<sup>6</sup>; net income after tax<sup>7</sup>, on a consolidated basis, surged by 26.5% in 2014 to reach KD 656 million from KD 519 million a year earlier (*Figure 3.1*). It was the first year to record a solid growth in banks' net income, after three consecutive years of either almost flat or negative growth. In the previous years, banks' profits were restrained, in part, by higher provisions. However, with significantly improved asset quality and coverage ratios of the banking sector (see Chapter 2), the need for additional provisions in general has come down. While each bank made a positive contribution to industry's net income, three of the conventional banks registered a particularly strong growth in their profits.



<sup>6</sup>In 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.

<sup>7</sup> It is based on profit share of banks' shareholders.

Breakdown of the net income among domestic and foreign operations reveals that 15% of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad (Figure 3.2). Though the share has marginally come down from 16.4% in 2013, it still represents a sizeable contribution to consolidated income, thus signifying the importance of banks' foreign operations.

...lifting up return ratios after three consecutive years of decline

Amid rising net income of the banking sector, both average return on assets and equity noticeably improved in 2014 after three consecutive years of steady decline (Figure 3.3). Specifically, return on average equity (ROAE) ascended from 6.9% in 2013 to 8.2% in 2014; likewise, return on average assets (ROAA) also inched up by 10 basis points to reach 1% in 2014. Return ratios visibly improved in 2014 as the growth in banks' net income (26.5%) far outpaced the growth in both equity (8.9%) and assets (12.2%). During the earlier three years (2011-13) return indicators were steadily falling due to a much stronger growth in equity and assets of the banking system on the one hand and negative growth in net income on the other (except for 2012 when net income grew by a meager 0.2%).

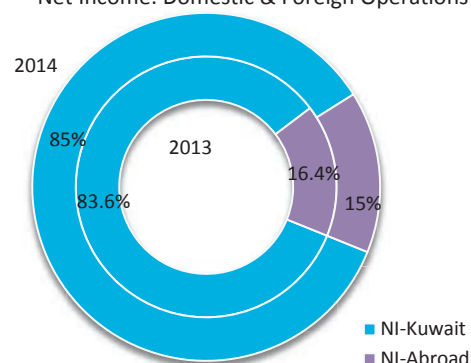
During 2014, the gap between industry-wide returns<sup>8</sup> and those enjoyed by the Islamic banks somewhat increased after sharply narrowing in 2013 (Figure 3.4). For instance, the ROAE of Islamic banks was lower by 5.2 percentage points in 2009 when compared with the industry ROAE<sup>9</sup>; however, the gap narrowed over the years though 2014 witnessed a reversal in the trend. ROAA has followed a similar trend, though less pronounced, given the much larger size of assets compared to equity. The marginal increase in the return differentials during 2014 was both due increasing equity and asset base of Islamic banks as

<sup>8</sup> 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.

<sup>9</sup> Calendar year 2008 was an outlier in the sense that Islamic banks enjoyed a visibly positive differential in returns viz-a-viz the overall banking industry; however, this was primarily due to serious losses incurred by a conventional bank which turned the industry ratios in favor of Islamic banks.

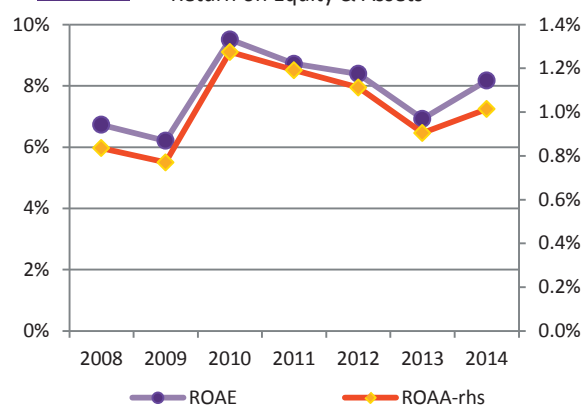
### 3.2

Net Income: Domestic & Foreign Operations



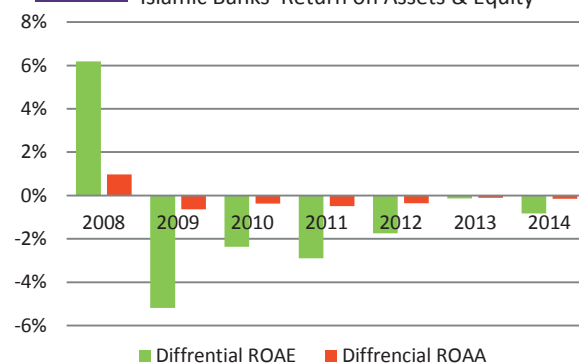
### 3.3

Return on Equity & Assets



### 3.4

Islamic Banks' Return on Assets & Equity



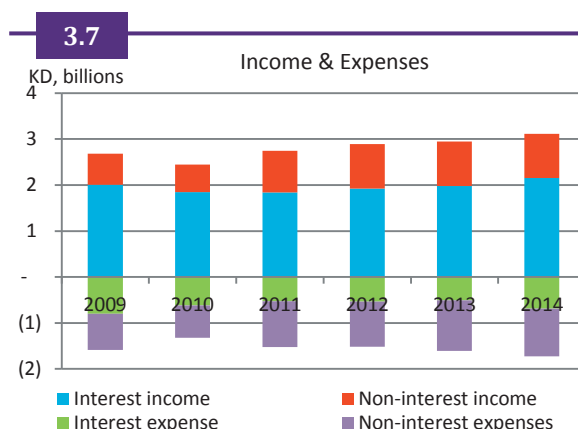
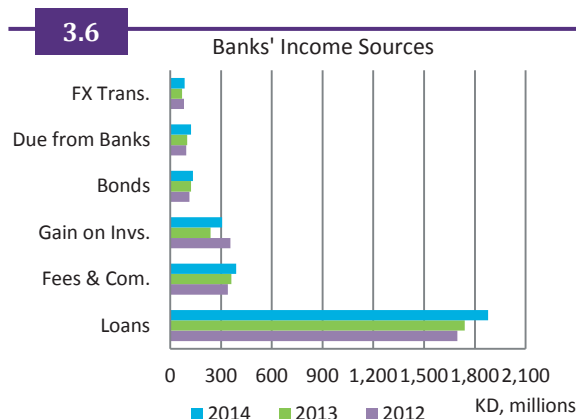
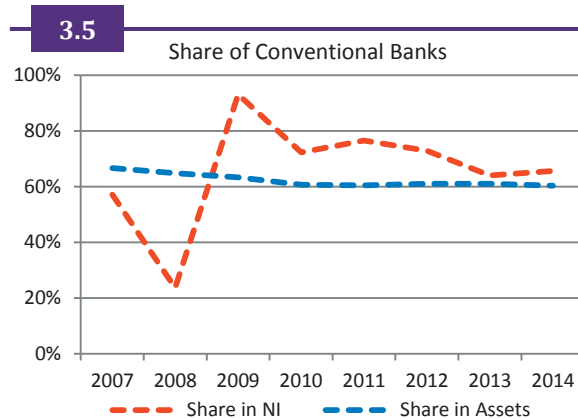
well as on account of a much stronger growth in conventional banks' profits (as implicit in Figure 3.5).

Comparison between share in net income and share in assets reveals that conventional banks account for around 65.6% of the industry profits, well above their 60.3% share in total assets (Figure 3.5). Conventional banks' share in industry profits was disproportionately higher back in 2010 but have gradually come down amid increasing share of Islamic banks. Admittedly, these trends are only true at the group level as differences in performance among individual banks remain wide.

In line with the historical trends, banks continued to generate the bulk of their income from their loan portfolio (Figure 3.6). Specifically, income from loans accounted for 87.2% of banks' interest income and 60.3% of their total income in 2014. Moreover, the breakup of interest income from loans reveals that 57.2% came from credit facilities granted to retail clients while the remaining 42.8% from lending to corporates. Fees & Commissions represented the second major source of income, followed by gains on investment securities.

#### *NII was weighed down by a sharp increase in interest expenses*

Interest income posted growth of 8.7% in 2014, compared to the relatively modest increase of 2.9% in 2013 (Figure 3.7). During the same period, banks also witnessed a sharp increase (34.4%) in their interest expenses which weighed down on the net interest income (NII). Consequently, banks' NII slightly contracted (-0.2%) during 2014, despite the noticeable improvement in their interest income. On the other hand, both non-interest income and non-interest expenses were down by 0.6% and 5.1% respectively during 2014. As discussed earlier, the overall net income still improved significantly, thanks to the favorable trend in two major components, namely the rise in interest income and the drop in non-interest expenses.



Another key contribution to banks' profitability was from the lower provisioning expense. After three years of double-digit growth, 2014 witnessed a sharp contraction of 24.4% in the loan loss provisions expense as declining trend in the non-performing loans slowed down the pace of additional provisions (see Chapter 2). Accordingly, provision expense dropped from KD 677 million in 2013 to KD 511 million in 2014 (Figure 3.8).

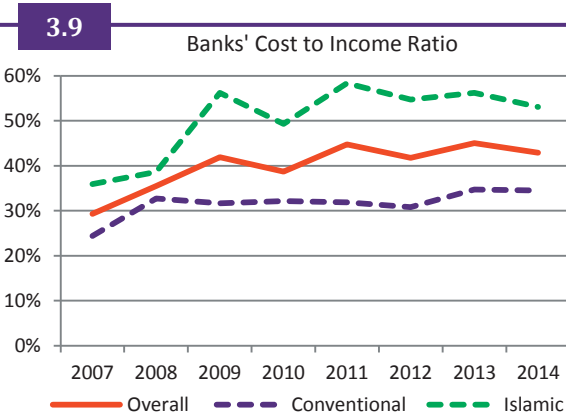
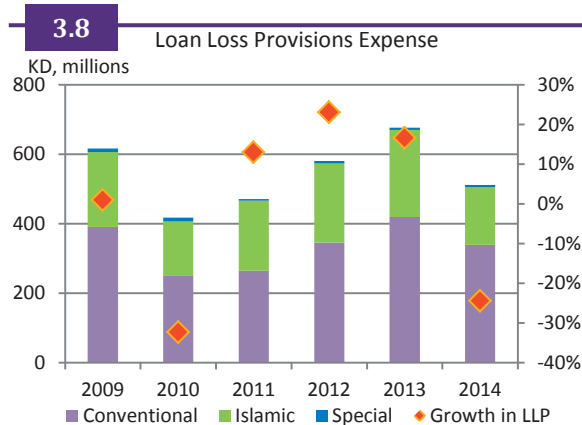
### Conventional banks continue to exhibit better efficiency

Banks' operational efficiency marginally improved during 2014, as reflected by a decline in the cost to income ratio from 45% in 2013 to 42.9% in 2014 (Figure 3.9). This was primarily driven by 11.9% decline in the operating costs of Islamic banks during 2014. In the case of conventional banks, cost to income ratio remained almost flat as growth in their gross income was offset by a similar growth in their operating costs.

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

### Banks' CAR remains high by global standards

Kuwaiti banks have consistently maintained high capital levels, given CBK's strong focus on ensuring a stable financial system where a robust capital adequacy plays a critical role. During 2014, banks'



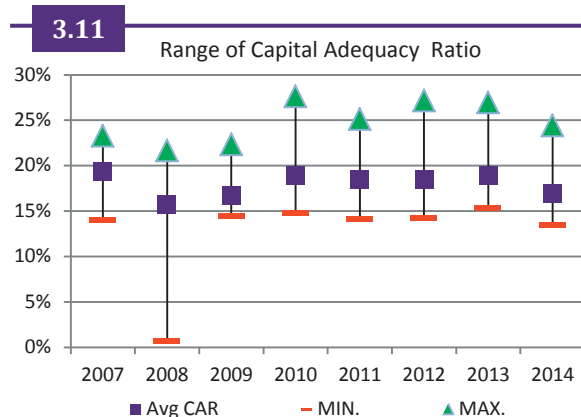
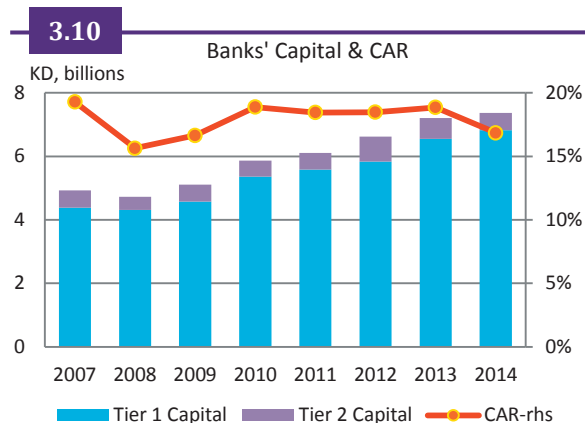
capital adequacy ratio<sup>10</sup> (CAR) on consolidated basis declined to 16.9%, compared to 18.9% in 2013 (*Figure 3.10*). However, this decline is in part due to the implementation of Basel III capital adequacy standards; if viewed in terms of Basel II calculations, banks' CAR in fact further improved to 19.3% in 2014. Another reason for the slide in CAR was the relatively stronger growth in banks' RWAs (14.4%) compared to the growth in their total capital (2.3%) during 2014.

Even at 16.9% (under Basel III calculations), banks' CAR is fairly high and well above the CBK's requirement of 12% for 2014<sup>11</sup>. Moreover, the breakdown of banks' capital indicates that the share of Tier-1 capital further improved in the overall capital; as of December 2014, Tier-1 capital accounted for around 92.6% of banks' total capital, in comparison to 90.9% in 2013. Strong capital adequacy driven by high quality Tier-1 capital underscores the strength of the Kuwaiti banking system capable of withstanding significant shocks.

Data for individual banks reveals that even the lowest CAR maintained by a single bank was 13.5%, well above the minimum requirement of 12% set by the CBK (*Figure 3.11*). In fact, the minimum CAR maintained by any single bank was never lower than 13.5% during the last seven years, except in 2008 when one of the conventional banks experienced significant losses due to its exposure to some derivatives products. In that particular case, capital injection in the said bank was swift enough to avoid any serious repercussions for the banking system in general, as the minimum industry CAR was restored to 14.4% the very next year (2009).

#### *Islamic banks maintained marginally better capital adequacy*

The marginal slide in the CAR of the banking industry, as highlighted above, is also reflected in the



<sup>10</sup> Capital adequacy numbers in this section are based on Basel III for 2014 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.

<sup>11</sup>CBK has set the required CAR at 12.5% for 2015 and 13% for 2016.

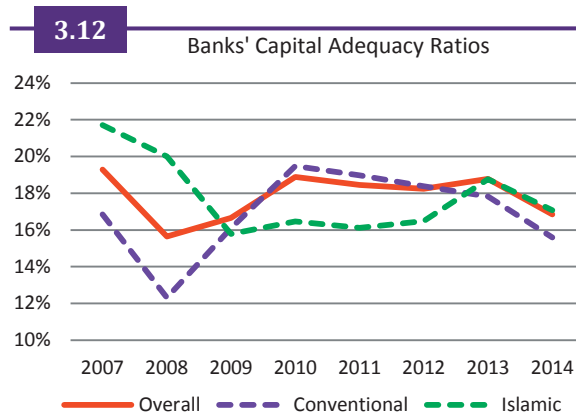
group-wise CARs of Islamic & conventional banks. Specifically, Islamic banks' CAR dropped from 18.8% to 17.1% in 2014, compared to that of conventional banks which was down from 17.8% to 15.6% during the same period (Figure 3.12).

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

#### *Banks' loss absorption capacity has strengthened further*

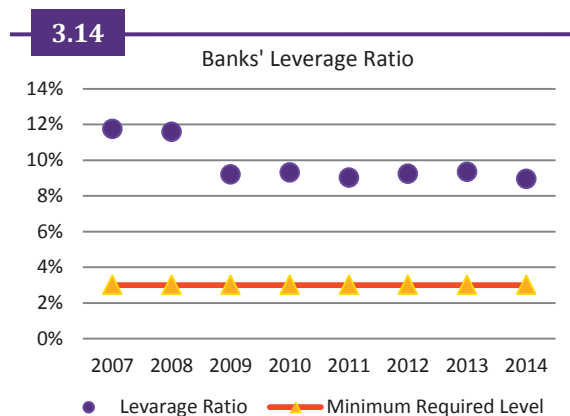
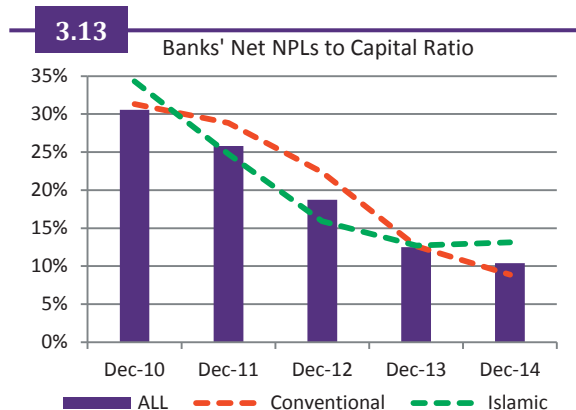
Thanks to strong capital adequacy levels and higher provisions, banks' *net NPLs to capital ratio*, an indicator of the fraction of banks' equity that can be wiped out due to loan losses, has dropped further, reaching 10.4% by December 2014 (Figure 3.13). While the conventional banks have witnessed a declining trend similar to the industry average, Islamic banks observed their net NPLs to capital ratio slightly edging up. That was primarily because of somewhat higher growth in Islamic banks' net NPLs (4.9%) than in their capital (1.4%) in 2014.

Leverage ratio<sup>12</sup> of the banking industry was 8.9% as of December 2014, 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 remains considerable, reflecting the cushion that Kuwaiti banks can use to expand their credit portfolio without breaching the global norms on leverage ratio<sup>13</sup>.



**Table 3.1** Banks' Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	2013	2014	2013	2014	2013	2014
Conventional	17.8%	15.6%	15.7%	14.4%	11.8%	10.8%
Islamic	18.8%	17.1%	19.2%	15.7%	12.6%	11.2%
All Banks	18.8%	16.9%	17.4%	15.6%	12.5%	11.1%



<sup>12</sup> Tier 1 Capital/Total Exposures (Non-Risk Weighted, both On & Off balance sheet).

<sup>13</sup> For a detailed discussion on Leverage Ratio, see Box 3.1 at the end of this chapter.

### Banking sector appears resilient against major shocks

The 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 2014, applying various macro and micro level scenarios of different severities.

Our results show that banks<sup>14</sup> in general were able to maintain high capital adequacy even after the impact of severe shock to the system calibrated under various scenarios (*Figure 3.15*). While the impact of shock was understandably different on individual banks, the lowest after-shock CAR of an individual bank was recorded at 8.9%.

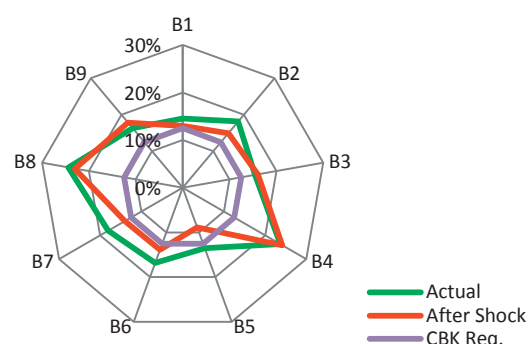
Given the much larger share of credit portfolios in the overall asset base, banks appeared more vulnerable to the deterioration in the quality of their loan/financing portfolio, particularly in specific sectors such as real estate. However, comparison of our stress test results over the years reveal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

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

<sup>14</sup> Two banks have been removed from Figure 3.15 due to their very high CARs as their inclusion would have distorted the graph.

### 3.15

Banks' Resilience against Shocks



**Box: 3.1****Leverage Ratio: benefiting from a non-risk weighted measure**

Firms routinely have to decide how much of their activities must be financed through debt rather than equity. Since debt servicing is tax deductible, there are obvious incentives to operate with some degree of financial leverage. Leverage is particularly important for banks as it allows them to take significantly large exposures than what they can achieve through direct investment of their own funds, thus substantially increasing the potential gains (or losses). No wonder banks are highly leveraged institutions where equity barely finances a fraction of their overall activities (around 5% on average). In comparison, 10 largest listed non-financial companies in the world have a debt: equity ratio around 50%.

Given the fractional reserve nature of banking, leverage is indispensable; however, too much of it has serious implications. For instance, the absence of adequate regulations on leverage allowed the banks to sharply expand their balance sheets to unsustainable levels, accentuating a credit boom which ultimately burst in 2007-08. As we elaborate below, capital adequacy regulations relying on risk weights were not effective in containing the surge in leverage. A study by the Bank of England highlights that in the run-up to the global financial crisis, leverage for a group of major international banks surged by 30% while their RWAs fell by 15%<sup>15</sup>. With few exceptions, most of the regulators focused on capital adequacy (where banks were generally compliant) but barely put any limits on leverage.

The buildup of excessive leverage before the crisis as well as the protracted and painful process of deleveraging afterwards paved the way for the introduction of a formal leverage ratio (LR). The Basel Committee on Banking Supervision (BCBS) first introduced the LR in 2010 to serve as a complement to the existing risk based capital requirements. After revising the ratio in 2013, BCBS issued a final version at the start of 2014<sup>16</sup>, proposing a minimum LR of 3%, i.e.

$$\frac{\text{Equity}}{\text{non-weighted Exposures}} \geq 3\%$$

where

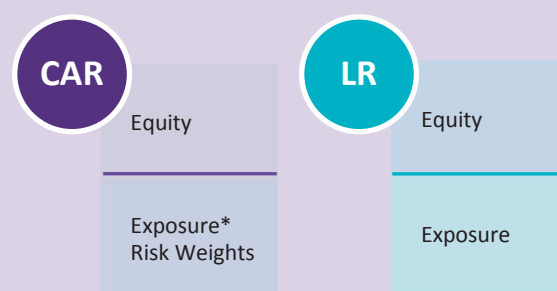
Numerator	Denominator*
<ul style="list-style-type: none"> <li>• Common Equity Tier 1 Capital</li> <li>• Additional Tier 1 Capital</li> </ul>	<ul style="list-style-type: none"> <li>• On-Balance Sheet Assets</li> <li>• Derivative Exposures</li> <li>• Securities Financing Transactions</li> <li>• Off-Balance Sheet Exposures</li> </ul>

<sup>15</sup>Haldane, A (2013), “Constraining discretion in bank regulation”, Bank of England. The studies covers the period between end-2004 and end-2007 for a sample of 17 major international banks.

<sup>16</sup> For details, see ‘Basel III leverage ratio framework and disclosure requirements’, BCBS, January 2014.

\*This illustration is somewhat simplified; for details, see the BCBS’s paper mentioned above.

In simple terms, leverage could be described as a relationship between a bank's equity and its non-weighted exposures. The primary difference between capital adequacy ratio (CAR) and LR can be explained using a stylized representation of the two ratios. As evident from the accompanying illustration, though the capital adequacy ratio relies on risk weights, leverage ratio uses non-weighted exposures in its calculation<sup>17</sup>. Either ratio has its own limitations if applied in isolation; however, their concurrent application would be mutually reinforcing in ensuring a sound financial system.



*Benefits of the Leverage Ratio:*

- As obvious from the definition of the LR, it is simple to implement and easy to monitor. Given its simplicity, its implementation would be convenient even for countries with limited technical expertise. Simplicity of the LR also creates a level playing field for all types of banks. This was not the case with CAR where more sophisticated banks had the capacity and resources to apply advanced models to determine (typically lower) risk weights while the banks using simple methods (i.e. standardized approach) found their capital requirements to be on the higher side.
- By its very construction, leverage ratio is not susceptible to different accounting treatments or calculation methodologies (as in case of risk weighted assets), thus making it a particularly convenient indicator to compare across the regions.
- LR is a useful tool against *model risk*. Given the risk-insensitive nature of the leverage regulations, exposures are summed up ignoring their risk characteristics, thus eliminating the potential to *game the system* by either deliberately or inadvertently using the wrong model. On the contrary, CAR being a risk sensitive measure required banks to determine risk weighted assets, thus creating the potential to under estimate or under report the true nature of risks. Consequently, banks' RWAs before the global crisis were falling when their leverage was on a steady rise. LR can guard against the uncertainties linked to the estimation of risk weights in the banks' internal models.
- LR is visibly effective in addressing *unsustainable balance sheet expansion* and therefore can be used as an important macroprudential tool to address procyclicality. Empirical evidence suggests that banks' leverage is procyclical as it surges during boom and falls during bust<sup>18</sup>. As expansion and contraction of banks' balance sheets amplify the credit cycle, use of LR can help dampen the procyclicality.
- LR also protects against the risk of sharp deleveraging by limiting the scope of excessive leverage in the first place. For banks with lower risks weights, LR can serve as a binding requirement, curtailing their credit expansion. This helps in times of crisis as both the banks

<sup>17</sup>While there are significant differences between the two ratios, this over-simplified comparison is just to highlight a particular aspect of the LR; its use of non-weighted exposures.

<sup>18</sup> Adrian, T and H S Shin (2010), "Liquidity and Leverage", *Journal of Financial Intermediation*, 19, 418-437.

and the economy in general are in less need to deleverage. Countries with no LR regulations in place saw a swift buildup of the leverage before the crisis and a protracted process of deleveraging afterwards. Had a suitable leverage ratio been in place, the procyclicality in the credit cycle would have been adequately restrained<sup>19</sup>.

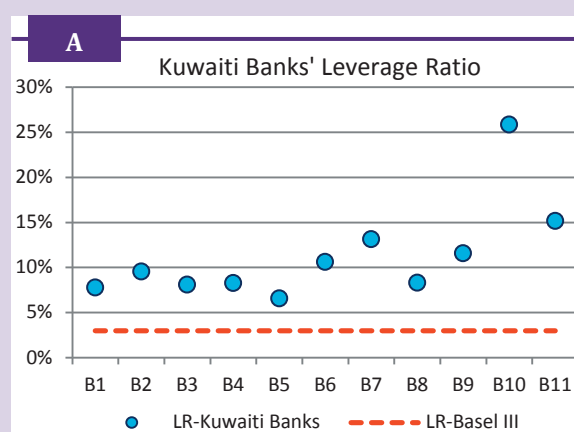
#### *Limitations of the Leverage Ratio:*

- While leverage ratio is effective in addressing certain types of risks (specifically model risk and the risk of unsustainable credit growth), it is by no means a substitute for risk-sensitive capital adequacy ratio. Though referred as a backstop measure, LR is essentially a useful complement to the existing regulatory tool kit. Both CAR and LR need to be applied in conjunction (as they address different types of risks) and not by way of frontstop or backstop tools.
- Since LR is risk insensitive (ignores the riskiness of exposures), a binding LR may create the incentives for banks to shift their exposures to riskier assets. This explains why LR, or any other regulation for that matter, is not effective in isolation.
- LR can potentially lead to greater deleveraging than required under capital adequacy regulations as banks, even with less risky assets, may need to deleverage just to comply with a binding LR. However, an effective LR would contain the sharp buildup of leverage in the first place, this reducing the need for swift deleveraging that has caused fire sales in the past.

In the earlier months of adoption, LR can serve as a useful disclosure requirement, even if it is not binding. For instance, by comparing LR and CAR, regulators can somewhat assess whether the capital adequacy calculations have been manipulated by a given bank. A drop in a bank's RWA at the time of its increasing LR can potentially indicate some under reporting of true risks. So the LR can serve as a useful monitoring tool even if it is not initially binding.

#### *LR regulations in Kuwait*

Central Bank of Kuwait issued its regulation on leverage ratio in October 2014, with detailed instructions for Islamic and conventional banks separately<sup>20</sup>. In general, conservative lending practices coupled with strong capital base have well placed the banks in Kuwait to meet the new regulations on LR. Even the granular analysis of individual banks' data reveals that all the banks have maintained a leverage ratio above the benchmark of 3% (*Figure A*).

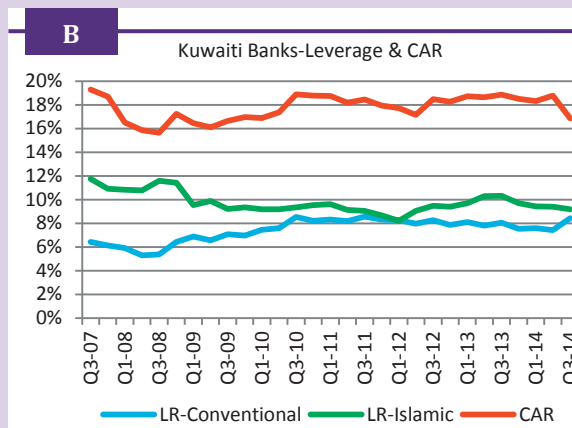


<sup>19</sup>While the U.S. had a simple leverage ratio in place even before the global financial crisis, it failed to serve the purpose as the leverage ratio only covered on-balance sheet exposures. With increasing financial innovation causing a drastic shift of exposures off the balance sheets, that ratio proved inadequate to capture the changing nature of risks. This experience highlights the fact that even regulations that appear useful at a given point in time can lose effectiveness as banks adopt and shift their risks elsewhere.

<sup>20</sup>For details, see <http://new.cbk.gov.kw/en/images/PressStandard21Oct14AR-10-115753-2.pdf>

For instance, as of December 2014, the lowest leverage ratio of any Kuwaiti bank was 6.57%, still more than double the 3% requirement.

Historical trend for Kuwaiti banks reveals that banks have generally maintained a leverage ratio well above the recently proposed 3% benchmark<sup>21</sup>. In particular, conventional banks seem to have operated with more financial gearing than their Islamic counterparts (*Figure B*). Possibly, some of the Islamic banks may have pursued a more conservative strategy in their credit exposures, thus increasing their LR.



<sup>21</sup> The data for both CAR & Leverage Ratio is based on Basel II, except for Q4-2014 where Basel III methodology has been used. Given the shift from Basel II to Basel III, the historical trend is more of an indication than a precise estimate and should be interpreted accordingly.



## CHAPTER 4

### DOMESTIC MARKETS

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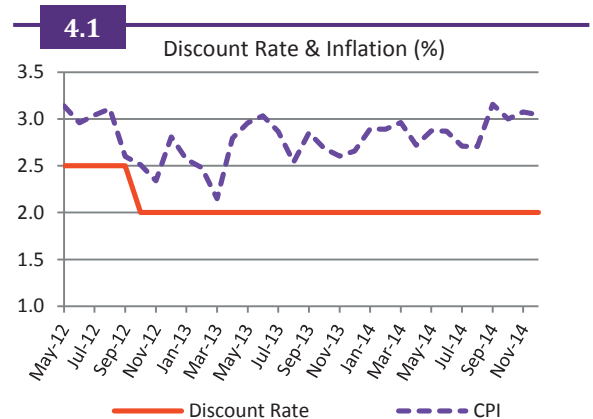
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While the scale of liquidity absorption somewhat tapered during 2014 in comparisons to fairly high levels in 2013, the banking system continued to remain highly liquid. Liquidity absorption from conventional banks through interventions was generally higher than from Islamic banks through Tawaruq, unlike in 2013 where Tawaruq operations took the lead. Moreover, CBK's mop up exercise relied, almost entirely, on the use of one-week instruments, further reducing the share of one-month arrangements. In the case of CBK bonds, around 75% of the issuance in terms of value was in 3-month maturities as share of 6-month maturities edged further down. In the foreign exchange market, USD appreciated against key currencies as the Fed wound down its quantitative easing and expectations of a lift-off on interest rates strengthened amid improving economic outlook for the US economy. While KD depreciated against USD by 3.7% during 2014, this depreciation was by a significantly lower margin compared to the decline of some other major currencies against the USD. With the CBK's policy of pegging KD to a basket of currencies, the net impact of diverging trends in exchange rates was largely neutralized, ensuring a more stable exchange rate than it would have been possible by pegging to USD alone. The Kuwait Stock Exchange (KSE) was down by 13.4% during 2014, despite the gains made in the first nine months as plummeting oil prices in part weighed down the market performance. In general, large cap stocks posted better performance, particularly during the first half of 2014. The real estate market maintained its double-digit growth, with all segments exhibiting positive trend. However, the signs of increasing demand pressures amid supply constraints were visible in the residential sector.

### Money Market:

*With inflation still moderate, discount rate remained unchanged*

CBK kept unchanged its discount rate in 2014, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in KD<sup>22</sup> (Figure 4.1). The discount rate was last slashed by 50 basis points on 3<sup>rd</sup> October, 2012 to bring it down to 2%. With the inflation rate still hovering around 3%, prevailing trend in prices did not warrant a change in discount rate. By keeping interest rate at 2%, CBK also aimed to help increase the private sector credit off-take, given its important contribution towards non-oil economic sector. The existing interest rate environment has remained conducive in ensuring the continuous attractiveness of the local currency deposits, particularly in comparison to the historically



<sup>22</sup> For instance, banks can charge up to 3% above discount rate on consumer and housing loans, up to 2.5% above discount rate on commercial loans of less than one year and up to 4% above discount rate on commercial loans of above one year maturity.

low levels of interest rates prevailing in many of the advanced countries. However, steady appreciation of USD is likely to exert some influence on depositors' choice of currency for their savings.

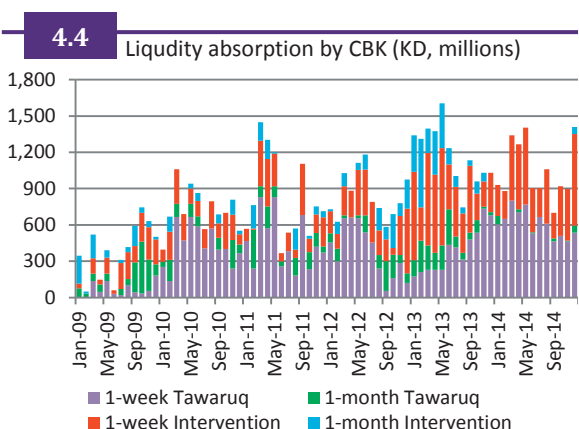
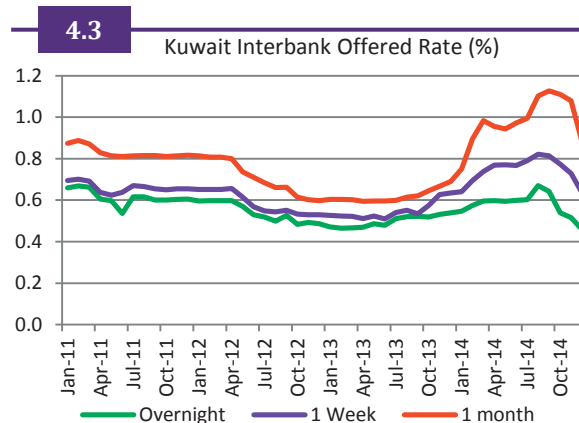
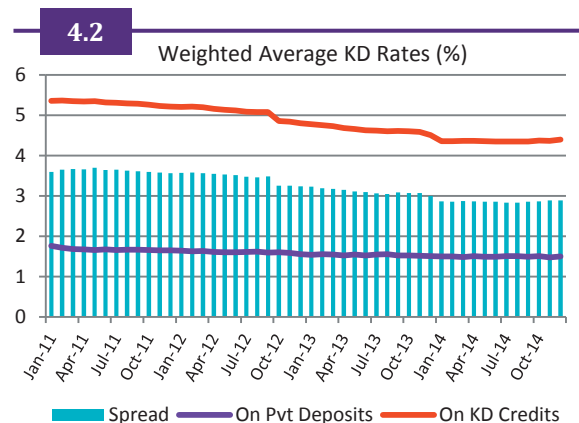
While the discount rate remained unchanged, the gap between lending rate on KD-based credits and weighted average rate on KD deposits narrowed further (*Figure 4.2*). Consequently, the spread reached around 2.86 percentage points on average during 2014, compared to 3.11 percentage points during 2013. The marginal drop in spread was more due to a decline in lending rate on KD-based credits, which eased to 4.36% in 2014 compared to 4.65% in 2013. The increasingly narrow spread between lending and deposit rates underscores the presence of a healthy competition in the Kuwaiti banking sector.

Notwithstanding the excessive liquidity in the market (as highlighted below), KD interbank offered rate observed a noticeable increase, starting from early 2014; the uptick was more pronounced in the 1-month rates (*Figure 4.3*). Apparently, some foreign banks were taking significant amounts of KD deposits in order to cover their USD/KD swap exposures. However, the interbank rates visibly dropped as the year drew to a close.

#### Banking system continued to enjoy high liquidity levels

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. During 2014, while the scale of liquidity absorption by the CBK somewhat tapered when compared with a year earlier, the banking system continued to enjoy high levels of liquidity. Moreover, data by various maturities reveal that the share of both one-week interventions and Tawaruq<sup>23</sup> increased further during the year, relegating the absorption under monthly maturities to historical lows (*Figure 4.4*).

<sup>23</sup>It 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*.



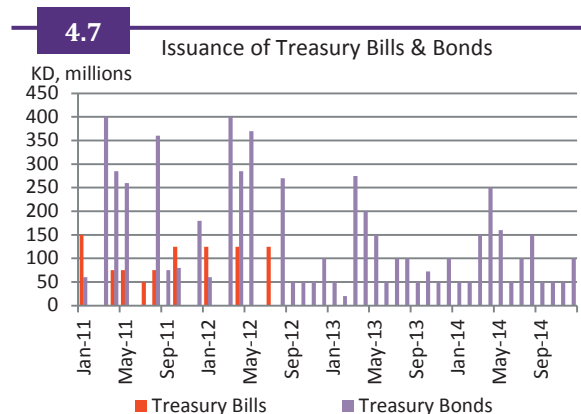
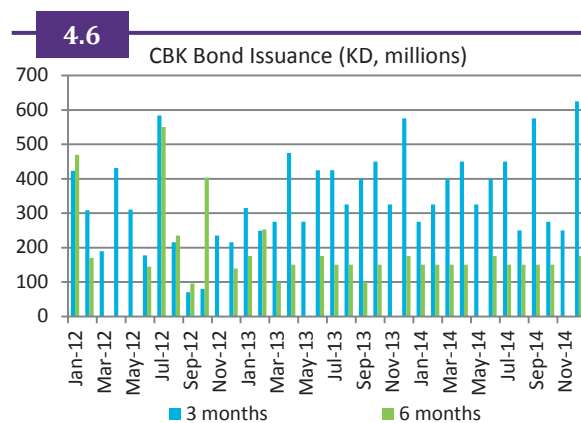
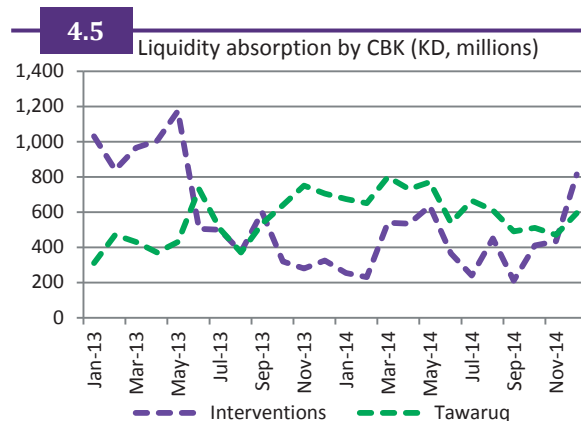
Unlike the trend in early 2013 where most of the liquidity absorption was from the commercial banks (through *interventions*), 2014 witnessed a steadily higher level of liquidity absorption from Islamic banks through Tawaruq arrangement (*Figure 4.5*). The last quarter of 2014 however registered a shift in trends as CBK mopped up relatively higher amounts from the conventional banks.

#### Bulk of CBK's bond issuance was of shorter maturity

During 2014, overall issuance of CBK bonds was up by a marginal 1%, with total issuance worth KD 6,150 million compared to KD 6,092 million in 2013. The break up in terms of tenors reveals that bonds of 3-months maturity remained a preferred choice over those of 6-months maturity, in continuation of the trend observed in 2013 (*Figure 4.6*). Specifically, 3-months bonds worth KD 4,600 million were issued in 2014, compared to KD 4,514 million in 2013. On the other hand, 6-months bonds experienced a contraction of 1.8%, as bonds worth KD 1,550 million were issued in 2014 compared to KD 1,578 million in 2013. As a result, share of 6 month bonds further dropped to 25% (from a significantly higher 41% in 2012).

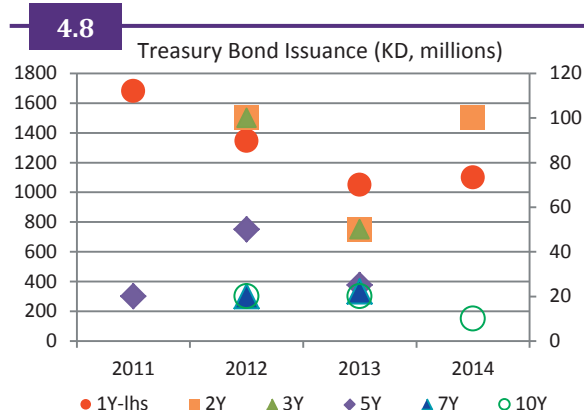
#### ...eliminating the need for the issuance of treasury bills

During 2014, treasury bonds worth KD 1,210 million were issued, compared to KD 1,217 million in 2013. With strong fiscal and balance of payment positions, need for issuance of public debt was understandably subdued. In particular, issuance of treasury bills have continued to remain on hold; since July 2012, CBK has not issued any treasury bills of 3-months maturity (*Figure 4.7*). Moreover, in the case of treasury bills of 6-months maturity, the last issue was around five years back, in 2009. Non-issuance of treasury bills can be explained by the growing 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.

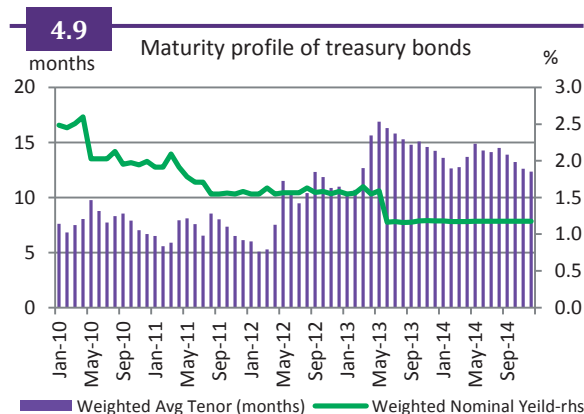


*CBK has aimed to extend the sovereign yield curve*

Breakdown of treasury bonds of various maturities over the last few years reveal that CBK has endeavored to issue bonds of longer maturities in recent years. For instance, in 2012, bonds with maturity of 3, 7 and 10 years were issued, followed by another issue of various maturities in 2013. During 2014, a ten-year bond worth KD 10 million and two 2-year bonds worth KD 100 million were issued (Figure 4.8). By increasing the issuance of relatively longer term bonds, CBK has been trying to extend the sovereign yield curve over a longer horizon and help establish a meaningful benchmark for the pricing of corporate debt. But if compared with the earlier two years, maturity profile in 2014 has somewhat shifted towards shorter end as market does not seem very keen for bonds of longer maturities. Attempts by the CBK to introduce a longer term KD benchmark yield curve by issuing bonds of longer tenor have, at occasions, been frustrated by banks' under subscription of these issues. That also explains why the bonds of one-year maturity continue to dominate the overall issuance. During 2014, one-year bonds worth KD 1,100 million were issued, marginally higher than KD 1,050 million in 2013.



As a result, we have not seen further increase in the weighted average tenor of the treasury bonds; after increasing from 9.3 months (annual average) in 2012 to 14.3 months in 2013, weighted average tenor marginally dropped to 13.5 months in 2014 (Figure 4.9). Banks are seemingly reluctant to lock into higher maturity bonds amid historically low interest rates. Moreover, weighted nominal yield has remained flat around 1.18% during 2014.



**Foreign Exchange Market:**

*KD depreciated against USD like other major currencies...*

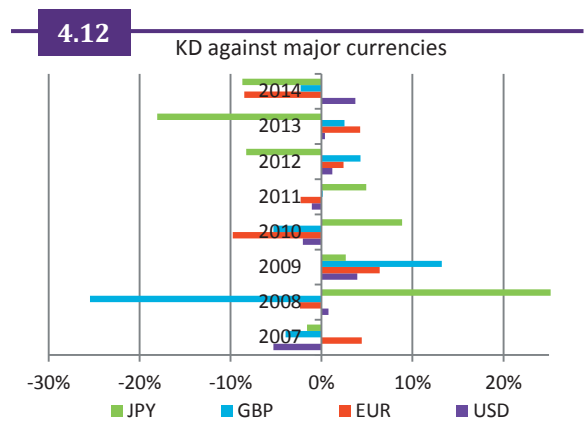
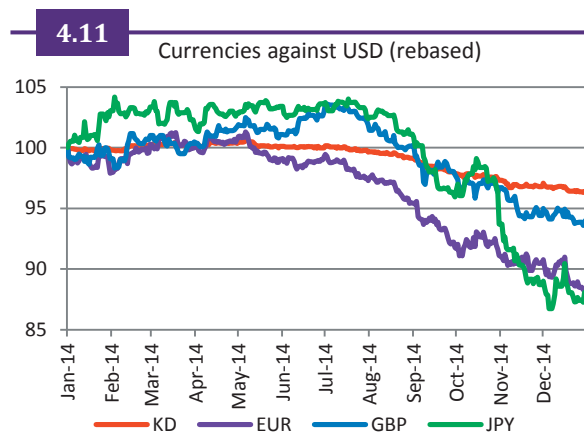
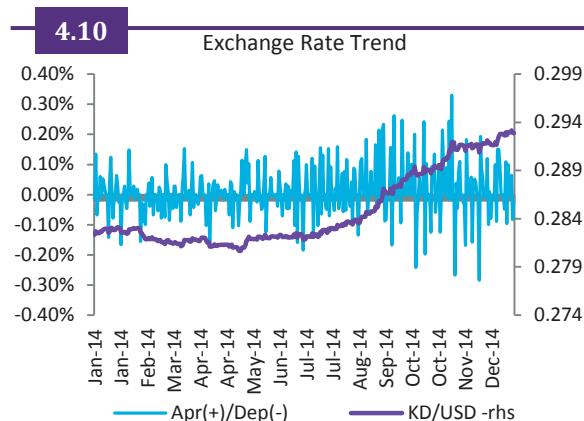
KD/USD exchange rate remained fairly stable during the first half of 2014, with fluctuations around a narrow range of  $\pm 0.2\%$ . However, USD witnessed a steady appreciation against KD during the latter half

of 2014 as a confluence of factors put the exchange rate under pressure (Figure 4.10). Specifically, the greenback appreciated as US economy gained momentum, leading the recovery among otherwise lackluster performance of major advanced economies. Strengthening performance of the US economy prompted the Federal Reserve (FED) to first taper off and later completely unwind its quantitative easing program where FED had been lately injecting USD 65 billion a month in the market. The USD climbed as investors poured money into US Treasuries amid improving economic outlook and increasing expectation of an interest rate hike by the FED in 2H-2015.

...though by a significantly lower margin

For the afore-mentioned reasons, the USD appreciated not only against KD but against all major currencies; however, depreciation in KD was still relatively moderate in comparison (Figure 4.11). Specifically, KD depreciated by 3.7% against USD in 2014, while JPY, EUR, and GBP were down 14.4%, 12.8%, and 5.8% respectively. The relatively greater depreciation of both JPY and EUR was also on account of diverging monetary policy stances viz-a-viz the FED; while the FED was winding down its quantitative easing program amid signs of a solid recovery in the US, Bank of Japan and European Central Bank were still pursuing ultra-loose monetary policies to ward off deflationary threats.

Thanks to its peg to a basket of currencies and not merely to the USD, the KD depreciated against USD by a lower margin than it would have been otherwise. On the other hand, the KD appreciated against JPY, EUR, and GBP by 9.3%, 8% and 2%, respectively (Figure 4.12). 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 volatility in exchange rates has been largely neutralized. For these reasons, the CBK has kept the KD pegged, since 20<sup>th</sup> May 2007, to an undisclosed special weighted basket of currencies of countries that



share significant financial and trade relations with the State of Kuwait.

### Kuwait Stock Exchange (KSE):

*Amid falling oil prices, KSE closed the year 13.4% down*

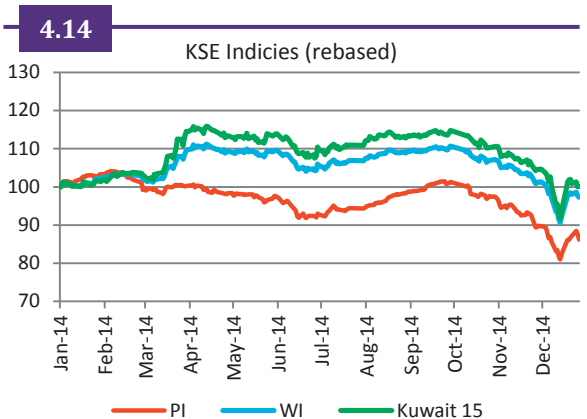
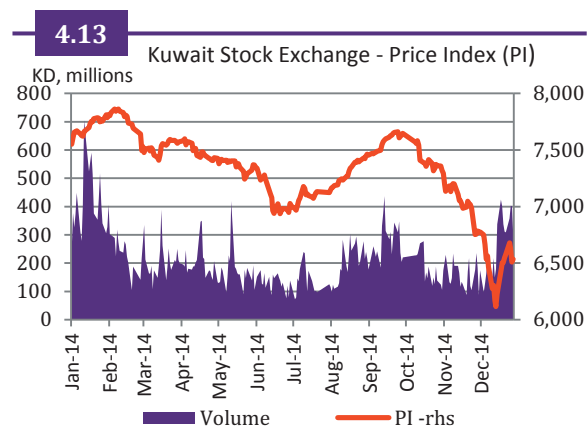
Price Index (PI), the broad based index of the KSE, closed the year on a negative note, shedding 13.4% of its value in 2014, notwithstanding its positive performance in the third quarter (*Figure 4.13*). The Weighted Index (WI), another key indicator better representing Kuwait's large-cap companies, experienced a relatively smaller correction of 3.1% year-on-year (YoY). Finally, the Kuwait-15 Index, first launched in May 2012 and covering 15 highest ranked companies in terms of liquidity and capitalization, was marginally down by 0.8% YoY.

*Unlike in 2013, retreat in PI was the most significant*

A comparison between KSE's three indices across the year reveals the obvious divergence between PI and the other two indices (WI & Kuwait-15) representing large-value stocks (*Figure 4.14*). While PI performed significantly better than both WI and Kuwait-15 in 2013, thanks to a strong rally in the small cap stocks, its performance markedly reversed in 2014, closing the year 13.4% down. On the other hand, large cap stocks enjoyed better performance during 2014, particularly during the first quarter. The only time when the KSE witnessed a broad based improvement was the third quarter of 2014 when all three indices performed well, though falling oil prices completely wiped out these gains in the last quarter of 2014.

*Monthly data reflects the diverging trend in indices during 1H-14*

From January 2014, the KSE got off to a good start as PI recorded a gain of 2.7% during the month. While the value-weighted index somewhat trailed behind, it also posted a 1.6% gain during January. However, the trajectory for both indices soon diverged as the rest of 1H-14 witnessed a steady retreat in PI (month-on-

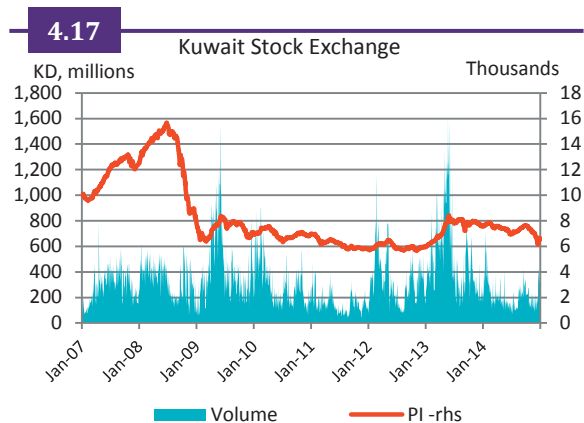
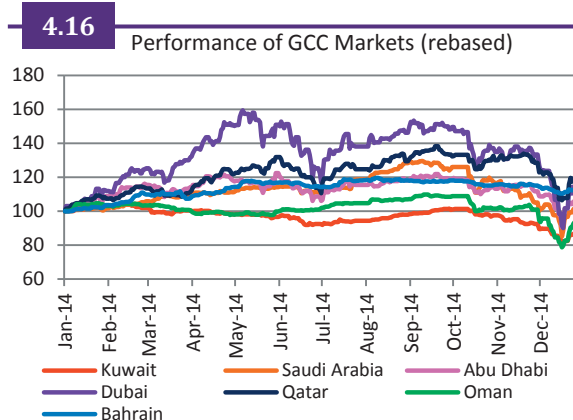
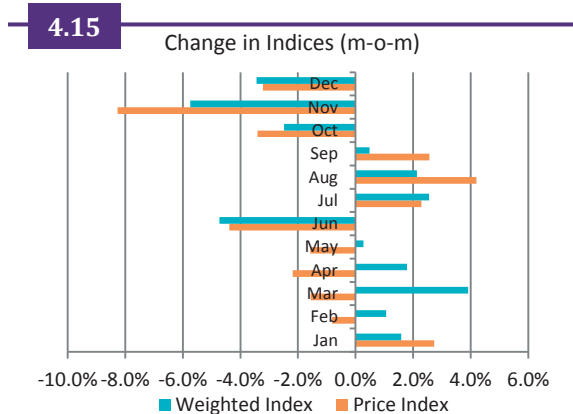


month basis) while WI continued to gain till May 2014 (Figure 4.15). The rally in large cap stocks kept WI buoyed; the value-weighted index gained 3.9% during March, thanks to the strong performance of the banks' stocks in particular. However, the momentum dissipated in May 2014 despite good profit announcements. The KSE was particularly bearish in June with both WI and PI declining as deteriorating political situation in Iraq and renewed domestic political tensions weighed on the market performance. Though the entire GCC region experienced a correction in June, the KSE was the only market in the region (when viewed in terms of PI) that recorded a loss (7.7%) during the first half of 2014, though the stock market in Oman barely escaped the negative returns (Figure 4.16). Market correction was most significant in the case of Dubai's stock market as investors were rattled by rumors of widespread layoffs in Arabtec (builders of Burj Khalifa), resulting in widespread panic.

*3<sup>rd</sup> quarter gains reversed in the 4<sup>th</sup> quarter as oil prices nosedived*

On the back of investors' optimism for the first half year results, the KSE witnessed a broad based recovery in July 2014 as both WI and PI gained, the latter index recovering after a steady decline in the earlier five months. The redound continued into August and September as well, in part due to better corporate results, positive economic outlook and receding political tensions in the region. During Q3-14, WI and PI rose by 5.3% and 9.3% respectively.

However, the last quarter of 2014 recorded a reversal of all the previous gains as plummeting oil prices sent the stock markets in the entire GCC region into a sharp fall. The fall in oil prices, first driven by an excessive supply of the oil amid moderate global demand, was further accentuated by OPEC's decision in November 2014 to maintain production. The local bourse closed the year on a negative note, with PI down 13.4% in 2014, thus shedding all the gains made earlier. While the performance of the KSE in 2013 had rekindled the



hope for steady recovery, the gains proved short lived as PI slid back to its low of the recent years (Figure 4.17).

*Market capitalization went down by 4.1% in 2014*

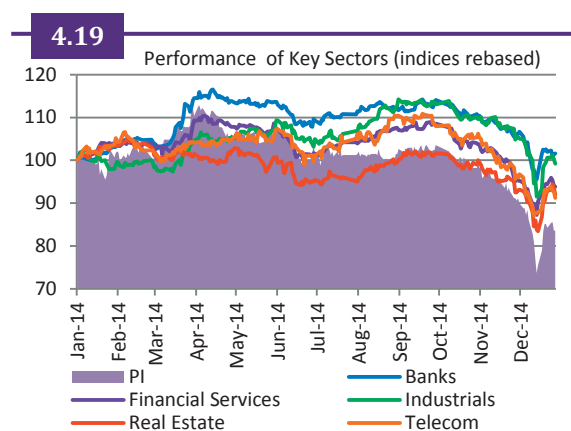
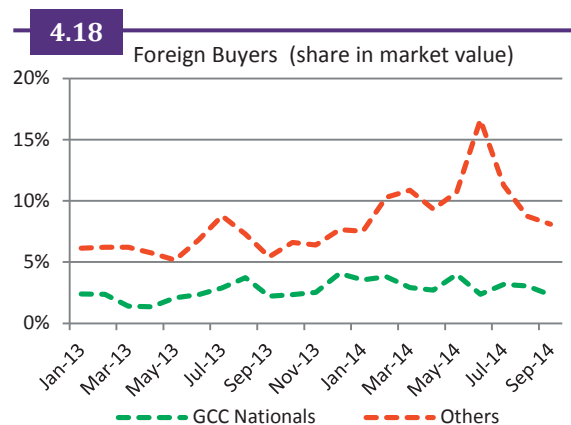
Given the lackluster performance of the local bourse as we discussed above, market capitalization posted a decline of 4.1%, from KD 31 billion in 2013 to 29.7 billion in 2014 (Table 4.1). Other indicators like total value, volume and number of deals also dropped significantly. A quick comparison since 2012 reveals that market activity failed to capitalize on the strong gains recorded in 2013.

For a few months, KSE also witnessed greater participation from the foreign buyers, particularly of the non-GCC origin (Figure 4.18). The share of foreign investors, if viewed in terms of market value, registered a visible increase, particularly in June despite that the market in general was bearish. This was essentially because KSE's weight on different frontier indices increased as stock markets of both UAE and Qatar were upgraded by MSCI to the 'Emerging Market Status'. However, the share of investors from GCC countries remained marginal, hovering around 3% on average<sup>24</sup>.

*Banking & industrial sectors enjoyed the most gains during the first nine months*

While all the sectors closed the year down except for the *Banking* which gained a meager 0.8% during 2014, some of these sectors performed particularly well until the 3<sup>rd</sup> quarter of 2014. For instance, *Banking* sector recorded a gain of 11.4% while *Industrial* sector was up by 13.3% when viewed in terms of first nine months of 2014 (Figure 4.19). The rally in the banking sector was visibly strong in the earlier months of 2014, also reflected in the performance of the WI. Understandably, all these gains were wiped out in the last quarter amid a sharp

	2011	2012	2013	2014
KSE Price Index	5814.2	5934.3	7549.5	6535.7
Highest	6999.4	6492.4	8430.7	7863.0
Lowest	5764.3	5650.0	5934.3	6115.6
Market Cap (KD, bil)	29.3	29.0	31.0	29.7
Total Value (KD, bil)	6.1	7.2	11.1	6.1
Total Volume (bil)	38.3	83.1	126.5	53.0
No. of Deals (,000)	617	1,198	2,136	1,186
Companies Listed	214	199	196	193



<sup>24</sup> While the data for the last three months of 2014 was not available at the time of writing, the waning interest of foreign buyers could be assumed as the KSE started its descent amid falling oil prices.

descent in oil prices. *Telecom*, *Real Estate* and *Oil & Gas* were the worst performers, retreating by 17.7%, 8.9% and 8.1% respectively during the year under review.

*Two sectors account for around 3/4<sup>th</sup> of the market volume*

*Financial Services Sector* and *Real Estate Sector*, collectively accounted for as much as 71.9% of the average monthly market volume in 2014, compared to their combined share of 73.8% during 2013 (Figure 4.20). The high level of concentration in terms of market volume suggests that the depth & diversity of the stock market has remained at fairly low levels. *Banks* and *Industrial* sectors also had around 7.7% and 10.8% share respectively in the total market volume. Collectively, the aforementioned four sectors covered almost the entire market.

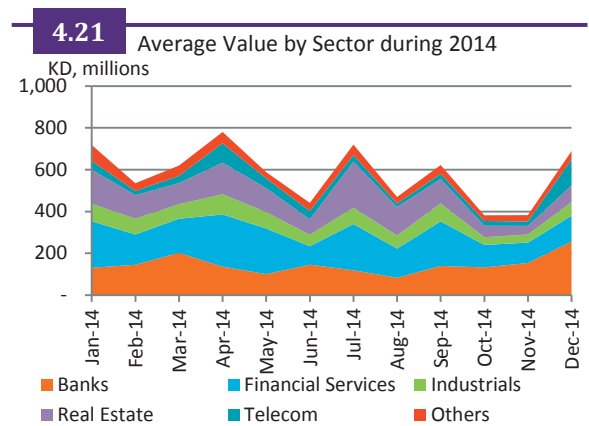
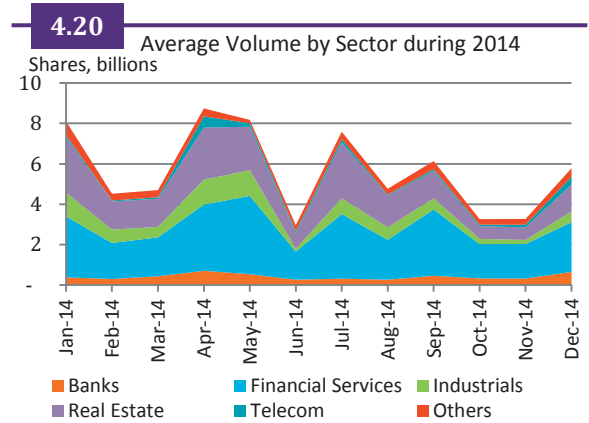
*...though market is somewhat less concentrated in terms of value*

When viewed in terms of average monthly value, *Banks* and *Financial Services* accounted for 55% of total market value in terms of monthly average for the year 2014. Unlike in the case of market volume, here *Banks* also appear quite significant, accounting for as much as 26.2% of the market value. In particular, due to better performance of the banks' stocks, share of *Banks* in overall monthly average value has gone up (Figure 4.21). On the other hand, share of the real estate has visibly dropped during 2014; the increasing share of *Banks* and declining contribution of *Real Estate* in terms of average value is also evident from the fact that the first nine months of 2014 in general witnessed a better performance in large cap stocks.

**Real Estate Market:**

*Steady drop in the share of residential sector indicates supply constraints*

The real estate market in Kuwait can be broadly classified into three segments, namely *Residential*, *Investments* and *Commercial* real estate properties. If

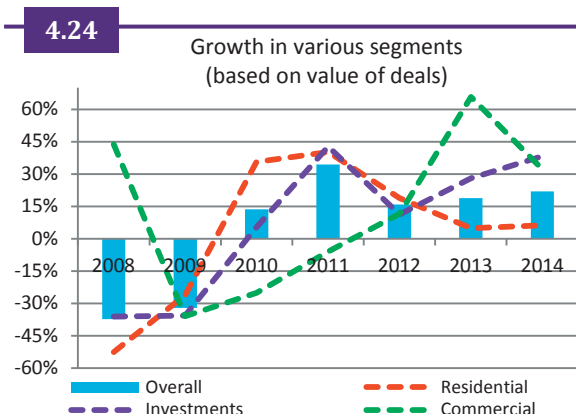
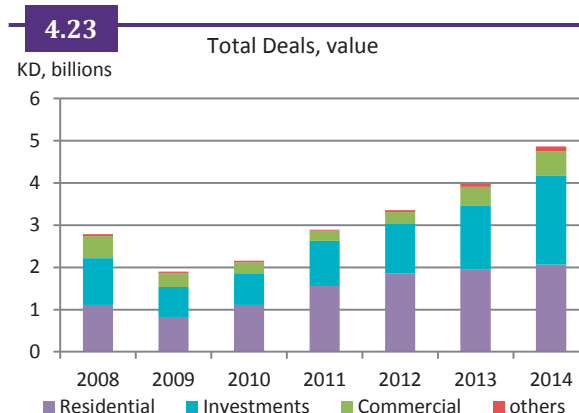
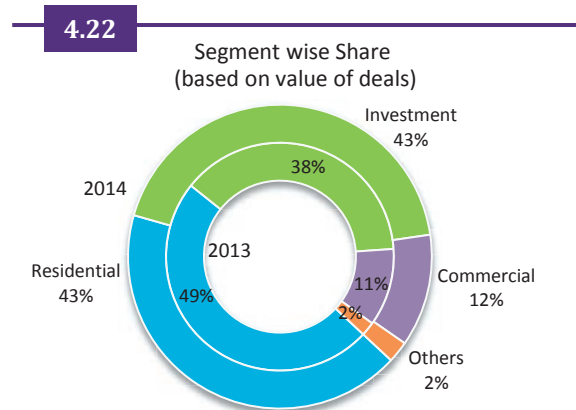


viewed in terms of total value of the deals made, share of *Residential* segment, also labeled as private housing, dropped from 49% in 2013 to 43% in 2014. On the other hand, contribution from the *Investment* (apartments/buildings) segment recorded a noticeable increase from 38% to 43% during the same period (Figure 4.22). In particular, share of *Residential* segment has been on a steady decline in recent years, dropping from 55% in 2012 to 43% by 2014. This trend signifies the intensifying supply constraints in the *Residential* segment amid pent-up demand for private housing by the local population.

*Real Estate market remain buoyed, with the investment segment exhibiting strong growth in particular*

The real estate market has continued to perform well since the start of its recovery in 2010 (Figure 4.23). During 2014, total deals worth KD 4.86 billion were recorded, compared to KD 3.98 billion during 2013, registering a rise of around 22%. This growth was on top of double-digit growth rates recorded in the earlier four years since 2010.

However, there have been visible differences in growth trajectories of various segments, when viewed in terms of value of deals. For instance, while the *Residential* segment grew by 6.2% in 2014 (marginally higher than 4.9% recorded 2013), the potential for growth was much higher had it not been for the supply constraints (Figure 4.24). On the other hand, *Investments* segment registered a strong growth of 38.3% on the back of an already impressive growth of 28% recorded in 2013; presence of constant demand for housing from a sizeable expatriate population and the potential for decent returns for local investors have made this segment a particularly attractive investment. Finally, growth in *Commercial* segment, though still robust, has somewhat moderated from 66% in 2013 to 32.3% in 2014. In general, sharp swings in this sector are common given the small number of high value transactions that can strongly influence overall growth trends.



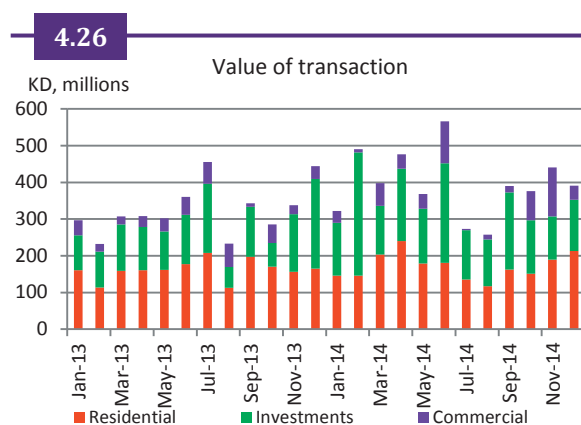
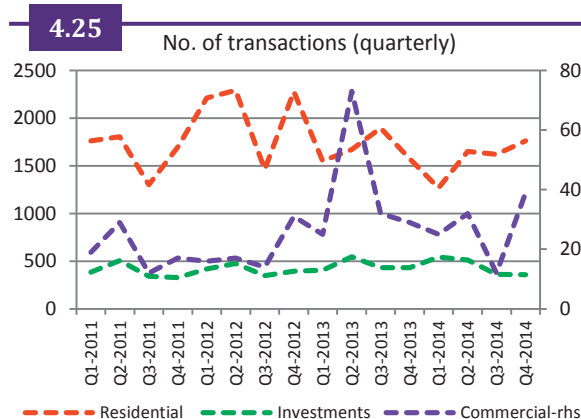
*Growth in sales values indicates rising prices*

Total deals in 2014 were down by 5.2%, dropping from 8,735 deals in 2013 to 8,277 last year. All three segments recorded a drop in the number of deals executed during 2014. In the *Residential* segment, number of deals dropped by 5.8%, from 6,687 deals in 2013 to 6,299 deals in 2014; considering the fact that deals in this segment also dropped by 18.9% during 2013, the steady decline in the number of deals (along with increasing value) indicates supply constraints in the private housing sector amid strong demand (Figure 4.25). Moreover, slow-down in deals in the *Residential* segment could in part also be attributed to the CBK's instructions issued in late 2013 imposing certain controls on the funding granted to high-worth customers for their purchase/development of real estate. The other two segments also recorded a drop in the number of deals, with *Investments* off by 2.4% and *Commercial* down by 32.1%. While the data for the number of deals alone is a poor indicator of the developments in the real estate market, given the inherently heterogeneous nature of the real estate, the rising sale values amid falling number of deals signify a rising trend in prices.

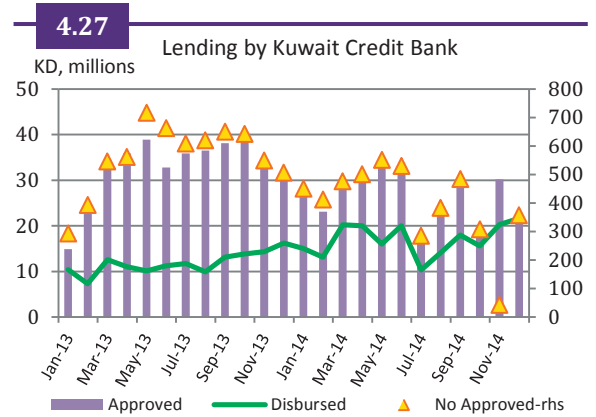
Analysis of the monthly transactions during 2014 reveals some seasonality in the data; July and August were the least active months amid the peak of summer season and reduced activity due to Ramadan and Eid-al-Fitr holidays (Figure 4.26). Three months recorded sales of more than KD 475 million, including February, April and June. In particular, record setting sales worth more than KD 578 million were recorded in June 2014, as all three segments posted strong activity.

*KCB's loan disbursement increases while approvals slow down*

Kuwait Credit Bank (KCB), an independent banking institution owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing loans to Kuwaiti nationals for purchase, construction or renovation. During 2014, total value of loans



approved dropped by 22.8%, from KD 394.4 million in 2013 to KD 304.3 million last year (*Figure 4.27*). This could be largely attributed to the lower number of loans approved; 5,070 loans were approved in 2014, compared to 6,745 loans in 2013. However, the amount of approved loans in 2014 was still quite high when compared with the trend of earlier few years as loans worth KD 186.2 million and KD 117.7 million were approved in 2012 and 2011 respectively. On the other hand, total value of disbursed loans increased by 44%, from KD 141.6 million in 2013 to 204.1 million in 2014. Given the higher number and value of loans approved in 2013, growth in disbursements during 2014 was understandably strong as borrowers started receiving loan tranches.



## Box: 4.1

### Falling oil prices and Kuwait's Banking System

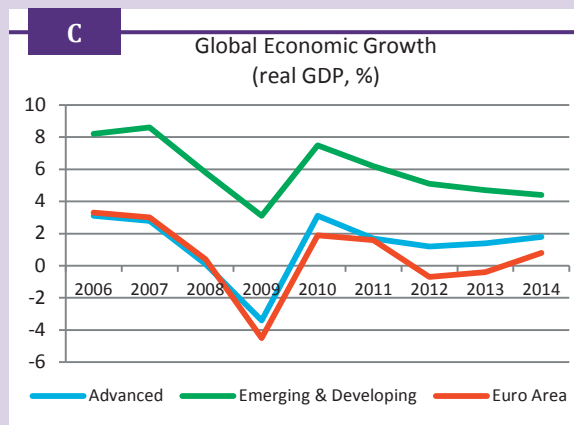
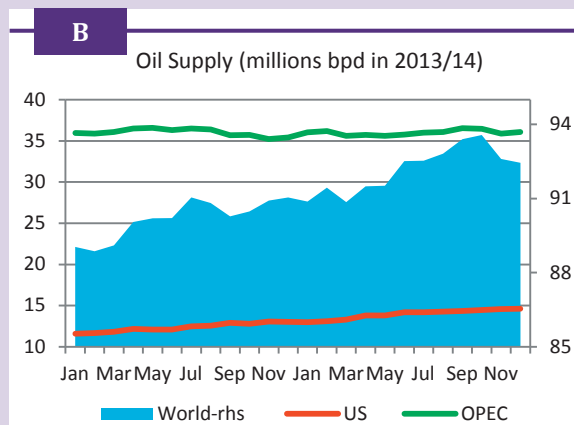
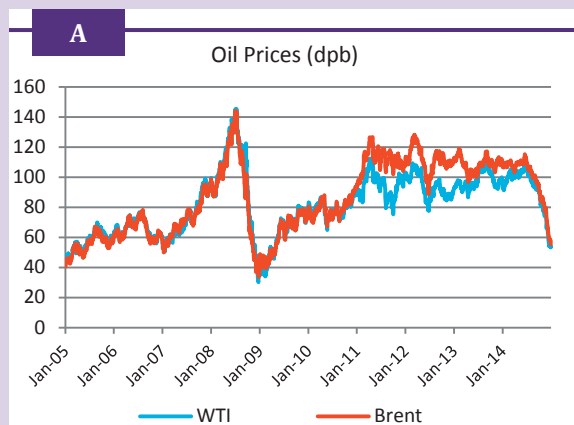
Oil prices have been on a swift descent since July 2014. After hovering above \$100 per barrel (dpb) for a few years, price of Brent has plummeted by more than 50% during the second half of 2014, hitting a five-year low of \$55 dollars by the year-end (*Figure A*). In this box, we first examine the reasons behind this persistent decline in oil prices and then explore its potential implications for Kuwait, in particular with reference to the domestic banking system.

#### Why oil prices have nosedived?

The falling oil prices are the result of a confluence of factors, both on the demand as well as the supply side. The primary reason appears to be a glut in the market; oil supply has been increasing steadily over the last few years, with the growing contribution of U.S. shale (*Figure B*). Moreover, contrary to the market expectations, conflicts in Libya and Iraq has left the oil supply from these countries almost unaffected. To top it all, OPEC has done little to stem the slide in prices; rather their decision in late November 2014 to maintain the current production level despite the increasingly excess supply and falling prices has only reinforced the downward spiral. Seemingly, some of the OPEC

countries, particularly with lower breakeven prices and/or substantial financial assets, have opted to sustain the current production levels with an aim to maintain (and possibly gain) market share. Arguably, this strategy has an additional benefit of rendering the otherwise expensive investments in alternative energy sources almost unfeasible, thus reducing the threat of competition from non-conventional producers.

On the demand side, slower growth in the world economy has kept the demand for energy products low. Most of the advanced economies have experienced weaker-than-expected growth; the only bright spot has been the visible recovery in the U.S. economy. In the euro area, lingering legacies of the financial crisis continue to weigh on the recovery (*Figure C*). Looming concerns about deflation has prompted the ECB to launch its €60 billion a month bond-purchase stimulus.



Japanese economy slipped into technical recession during the third quarter of 2014 though weakening yen and lower oil prices are likely to help. Emerging markets have also been down to a slower growth trajectory; China's double-digit growth of the past decade is no longer possible as the economy matures and potential for investment growth declines. Russia is facing a bleak outlook amid falling oil and biting sanctions. Collectively, weaker-than-projected growth in many countries has dampened the demand for oil.

Some developments in the financial markets have also played their part, albeit in a much more limited way. The dollar has continued to climb, amid a solid recovery in the U.S. economy and increasing likelihood of an interest rate hike by the Fed later in 2015. Appreciation of the dollar along with falling energy prices have doused investor's appetite to invest in oil futures as traditionally investors have expected oil prices to go down when dollar gains. Furthermore, strong dollar also makes oil imports expensive. Accordingly, markets have witnessed massive liquidation of long positions in the oil market, from July to October 2014 in particular.

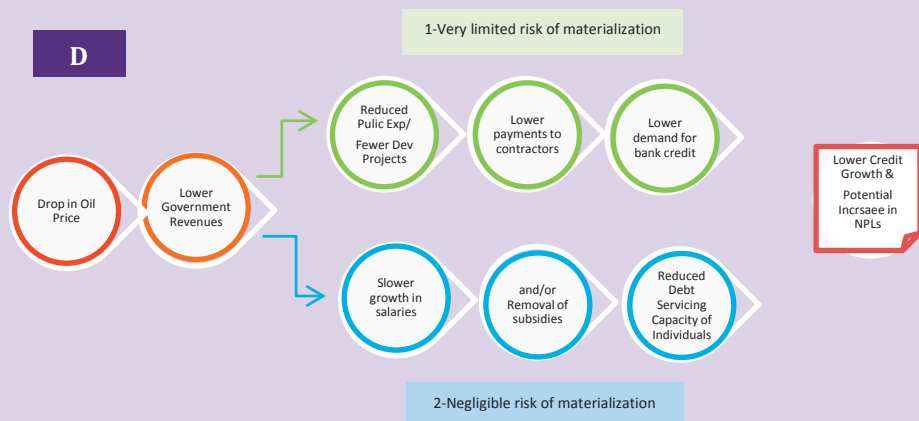
To conclude, while a variety of factors have precipitated the fall in oil prices, excess supply is the primary trigger, both on account of increasing share of U.S. shale and uninterrupted production from the OPEC nations. While the net impact of lower oil prices on the global economy would be positive, oil-exporting countries are bracing for diminished revenues.

#### **Oil shock and the banking sector in Kuwait**

The oil sector plays a dominant role in Kuwait's economy as it contributes around 63% to Kuwait's GDP, 86% to country's total exports of goods and services and above 80% to government revenues. While these numbers undoubtedly indicate Kuwait's high dependency on oil, they don't necessarily imply a commensurate level of vulnerability. In fact, given Kuwait's lowest break-even oil price and ample financial assets, the country is far less vulnerable to falling oil revenues than almost any other oil exporting nation.

To understand how the drop in oil prices and the attendant reduction in government revenues can possibly affect the banking sector, we postulate two broad channels of transmission (*Figure D* on next page). Starting with the hypothetical path-1 in the diagram, lower government revenues can potentially affect the pace of mega development projects, reducing the demand for bank credit from various private contractors. However, government has expressed its commitment to continue with its ambitious development plan for 2015-2019 notwithstanding of the steep fall in oil prices.

Regarding our hypothetical case of path-2, though the pace of growth in salaries and wages would surely taper off, we do not see a reversal either. Again, the government has emphasized that it would not cut wages. While some fuel related subsidies have been withdrawn, the measure has a limited affect in general. It rather reflects the efforts of the government to capitalize on the current period of lower oil prices as an opportunity to introduce much-needed reforms. Moreover, individuals are unlikely to face any debt servicing issues as CBK has already put in place stringent measures to protect both the consumers as well as the lending banks. For instance, CBK regulations require that individuals' debt servicing must not exceed 40% of their



monthly incomes, providing sufficient cushion even under a scenario of stalling wage-growth. The NPLR (non-performing loan ratio) for the consumer loan segment is among the lowest of any major sector, reflecting healthy consumer credit portfolios of Kuwaiti banks.

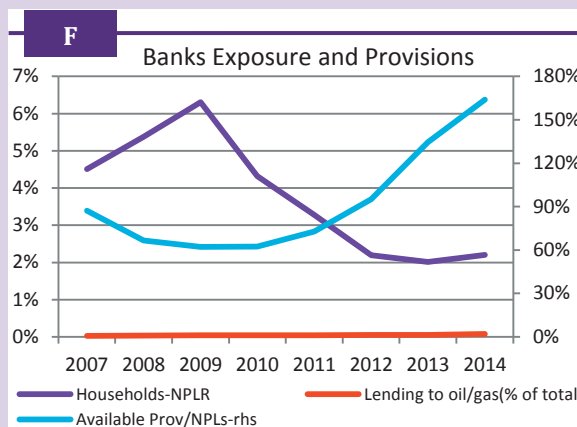
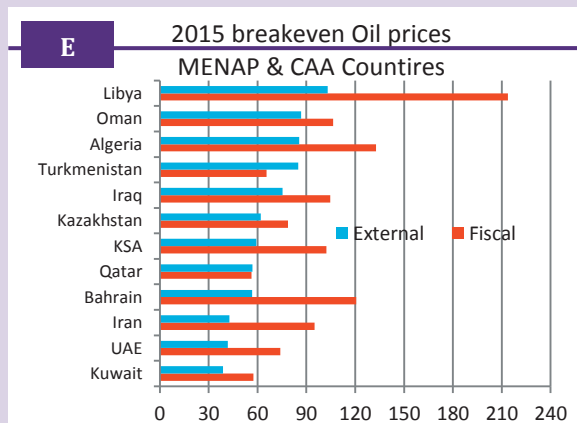
On balance, lower oil prices are unlikely to have a perceptible impact on the banking sector NPLs, though credit off-take might somewhat slow down. An IMF paper published in 2009 has pointed out that the *direct* impact of oil prices on banks' profitability is insignificant<sup>25</sup>. Using data for 145 banks in 11 oil-exporting countries, the paper indicates that oil price shocks have *indirect* effect on banks' profitability (particularly in case of investment banks) channeled through country specific macroeconomic and institutional variables. So unless the oil prices seriously affect the macroeconomic activity in general, the effect on banking sector would be muted.

In the case of Kuwait, a number of mitigating factors, both at the level of macro economy and the banking sector, proffer another reason for optimism.

- On the macro front, government's commitment to continue with its development plan is backed by its ability to fund mega projects by using substantial savings the country has accumulated through its fiscal surpluses since 1995. Moreover, Kuwait's gross public debt is quite low (around 7% of its GDP) and banks are awash with liquidity; so the government can conveniently borrow in domestic currency if it chooses not to use its existing financial assets. Moreover, international borrowing would be equally easy to secure, given Kuwait's strong credit rating of Aa2 and its impeccable record of debt servicing even under very difficult circumstances. It is pertinent to mention that the scope of higher borrowing by the government is more of a theoretical proposition; in reality, government has ample financial resources at its disposal though it can opt for some mix of borrowing (e.g. issuing sukuk) and/or utilizing its financial assets.

<sup>25</sup> Poghosyan, Tigran and Heiko Hesse, 2009, "Oil Prices and Bank Profitability: Evidence from Major Oil-Exporting Countries in the Middle East and North Africa," IMF Working Paper 09/22 (Washington: International Monetary Fund).

- Second, Kuwait's breakeven oil price is among the lowest, compared to any other country in within the GCC or elsewhere. According to the IMF's recent estimates for 2015<sup>26</sup>, Kuwait's external breakeven price is the lowest while the fiscal breakeven is very close to that of Qatar (*Figure E*). Admittedly, if fiscal expenditures continue at their current pace amid lower oil prices, the breakeven price for Kuwait would escalate in future.
- Third, Kuwaiti banks enjoy strong capital adequacy ratios, stable funding and ample liquidity. Nonperforming loans have been at the lowest in recent years and provisions at the highest level, thanks to CBK's proactive measure to countercyclically build an additional cushion for any potential losses (*Figure F*). Moreover, banks' exposure to the oil sector is almost negligible; so even a slowdown in the oil sector would not affect the banks' credit portfolios. Though household credit constitutes a significant part of banks' overall lending, the portfolio is least infected, with the lowest NPLR among major sectors (see Chapter 2 for details).



These factors collectively underscore the resilience of the banking sector in Kuwait to an oil price shock. In line with the IMF's findings mentioned above, we see limited direct impact of oil prices on banks' performance in the short run. However, if the oil prices remain at current level for an extended period, possibility of some second round effect on the banking sector cannot be overlooked.

<sup>26</sup> Published in the *Regional Economic Outlook Update*, dated January 21, 2015



## CHAPTER 5

### **PAYMENT AND SETTLEMENT SYSTEMS**

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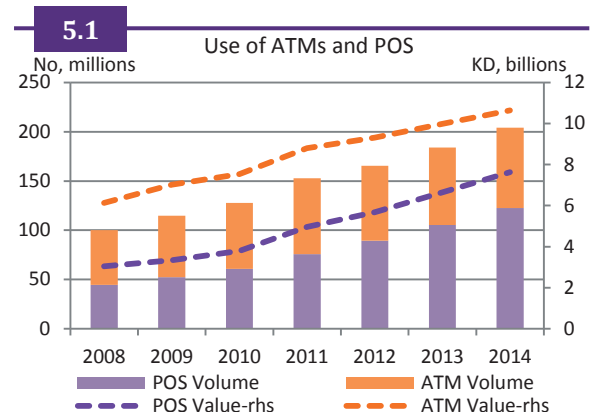
Both retail and large scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. With regards to the developments in the retail payments segment, use of ATMs and point of sale (POS) related transactions, when viewed in terms of value of transactions, have witnessed growth of 6.4% and 14.8% respectively during 2014. During the year under review, the share of ATM related transactions was higher (58%) in value while that of POS transactions was higher in terms of volume (60%). To facilitate the increasing use of e-banking, relevant infrastructure has also been growing in Kuwait; during 2014, the number of ATMs and POS machines grew by 10.6% and 20.9%, respectively reaching 1,632 and 38,316 machines by December 2014. This was the strongest growth in e-banking infrastructure during the last six years. Banks' branch network also witnessed steady expansion across Kuwait as 19 new branches were established in 2014, bringing the total bank branches in Kuwait to 419. While electronic based transactions account for 97.4% of all transactions in terms of volume, paper-based transaction (through cheques) still has a sizeable share (55.5%) in term of value. Finally, KASSIP, the real time gross settlement system in Kuwait, handled 1.33 million transactions worth KD 304 billion in 2014.

#### The use and infrastructure of e-banking has been steadily rising

With the growing use of information technology and increasingly secured systems, transactions through electronic banking (e-banking) have been steadily growing, reflected in the growth of point-of-sales (POS) and automated teller machine (ATM) transactions (*Figure 5.1*). Operated by K-net, POS and ATMs represent the retail payment system in Kuwait, essentially used for the bulk of mainly low-value payments transactions.

During 2014, ATM-based transactions witnessed a growth of 6.4% with regards to the value of transactions to reach KD 10.6 billion compared to KD 9.9 billion in 2013. Similarly, the number of ATM transactions also witnessed a growth of 3.8% to reach 81.5 million transactions. Still, the share of ATM based transactions (out of total ATM & POS based transactions) continued to decline further, from 60% to 58% in terms of value and from 43% to 40% in terms of volume (number of transactions).

On the other hand, the share of POS transactions (out of total POS and ATM based transactions



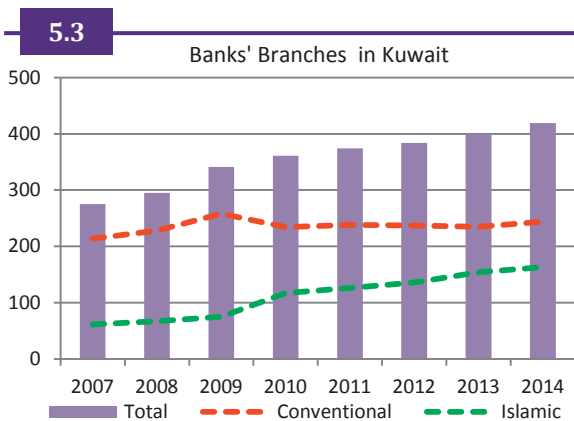
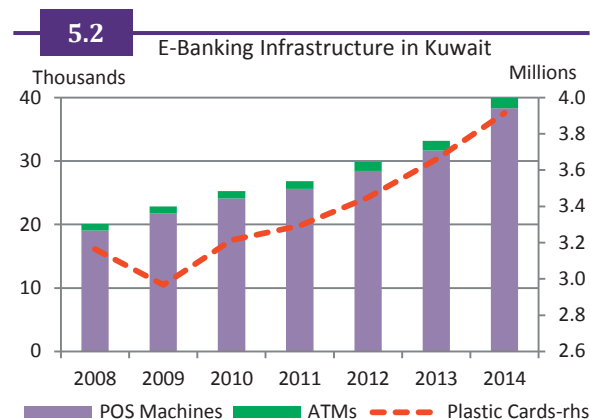
combined) further inched up during the year to reach 60% in terms of volume and 42% for the value of total transactions. Transactions worth KD 7.6 billion were conducted through POS in 2014, registering a growth of 14.8% compared to 2013. The number of transactions through POS also posted a growth of 16.3% to reach 122.5 million transactions in 2014.

As the above discussion highlights, transactions through both ATMs and POS have been steadily growing, though with greater share of POS transactions in terms of volume and of ATMs in terms of value. The ubiquitous nature of e-banking is largely because of the convenience, flexibility and security that it offers. Further, retailers offering discounts on online purchases have also promoted the use of e-banking. Banks are equally keen to promote e-banking as it helps keep the operational costs down by reducing the number of visitors for cash-related transactions.

*Growth in e-banking infrastructure has been particularly strong*

Growth in electronic banking has been adequately supported by the growing retail payment infrastructure in Kuwait. During 2014, the number of POS machines and ATMs witnessed a growth of 20.9% and 10.6%, respectively reaching 38,316 and 1,632 machines (Figure 5.2). This was the strongest growth in both POS terminals and ATMs observed in the last six years. The issuance of new plastic cards (debit and credit cards) also posted 7% growth in 2014, with total plastic cards reaching 3.92 million, around 84.2% of which were debit cards.

Notwithstanding the increasing presence of e-banking, banks' branches also continued to rise. During 2014, 19 new branches were added to the existing banking network in Kuwait, pushing the total number of branches to 419 (Figure 5.3). Specifically, both Islamic and conventional banks added nine branches each while a Chinese bank opened its first branch in Kuwait. Still, the number of branches for



conventional banks (244) has remained significantly higher when compared to Islamic banks (163).

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

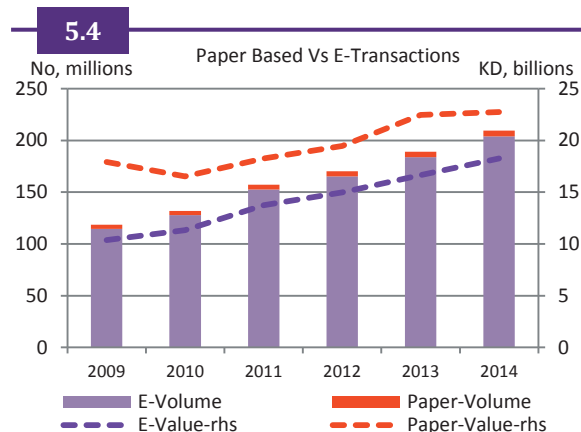
Thanks to the convenience, flexibility and security that e-banking has been providing, it understandably dominates overall transactions in terms of volume (i.e. number of transactions) (Figure 5.4). For instance, e-banking transactions during 2014 accounted for almost 97.4% of all transactions (e-banking & paper-based). Specifically, the number of e-banking transactions reached 204.03 million in 2014, posting 11% growth compared to 2013. On the other hand, only 5.37 million transactions during 2014 were paper-based.

However, if viewed in terms of value, paper-based transaction still account for a major, albeit declining share. For instance, during 2014, the share of paper-based transactions in terms of value was around 55.5%. Though even there, e-banking is catching up, as its share in terms of value (amount) has gone up from 37% in 2009 to 44.5% in 2014.

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 still seemingly conducted through paper-based modes.

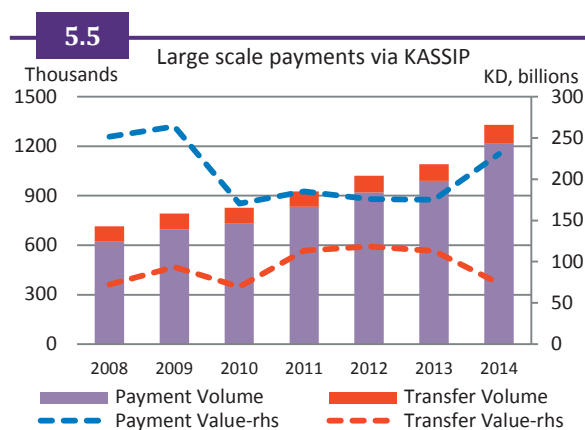
*Majority of the transactions handled through KASSIP are payment related*

Since 2004, the CBK has put in place a real time gross settlement system called as *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 day of the next business day.

Typically, transactions settled through the KASSIP consist of *payments* and *transfers*, with the former involving a third party (customers) and latter between banks. In 2014, 1.33 million transactions were handled by the KASSIP, registering a growth of 22% compared to 2013. Similarly, value of transactions also grew by 6%, as total transactions worth KD 304 billion were handled in 2014 compared to KD 288 billion in 2013. On a daily basis, the KASSIP handled an average of 5,315 transactions worth KD 1.22 billion, playing a critical role in overall payment system of Kuwait. Payment transactions made up the bulk of transactions handled through the KASSIP during 2014, both in terms of volume and value (Figure 5.5)



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