

بنك الكويت المركزي
CENTRAL BANK OF KUWAIT



RESILIENCE IN THE FACE OF ADVERSITY

FINANCIAL
STABILITY REPORT | **2020**

بِسْمِ اللّٰهِ الرَّحْمٰنِ الرَّحِیْمِ



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H.H. Sheikh Nawaf Al-Ahmad Al-Jaber Al-Sabah



The Crown Prince of the State of Kuwait

H.H. Sheikh Mishal Al-Ahmad Al-Jaber Al-Sabah



The Prime Minister of the State of Kuwait

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Dr. Mohammad Y. Al-Hashel

Governor,
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PREFACE

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.

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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.

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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 dedicated Financial Stability Office (FSO) has been set up with a mandate to continuously examine the developments in the financial sector. The Financial Stability Report (FSR) is the flagship annual publication of the FSO, evaluating the performance of various components of the financial system and serving as a key surveillance tool for CBK.

We are pleased to release our 9th FSR for the calendar year 2020, a publication examining all aspects of the financial system. In light of the unprecedented events experienced worldwide, this year's report saw an overhaul in terms of both topics covered and depth of analysis. The FSR has been revamped to accommodate the new developments resulting from the Covid-19 crisis, while simultaneously upholding its analytical essence. Chapter 1 sets the stage by examining global and regional economic developments, presenting key economic indicators to put into perspective the magnitude of the crisis. Chapter 2 gives an overview of the Kuwaiti financial system, highlighting key attributes and developments as the year progressed. Chapter 3 examines key risks faced by the banking system, inspecting multiple angles of credit, liquidity, market, and operational risks faced by banks during the year and going forward. Chapter 4 exhibits the strength of local banks, analyzing

both profitability and resilience to provide a robust assessment. Chapter 5 presents developments in local asset markets, namely, the real estate and equity markets and the potential risks to financial stability. Finally, chapter 6 examines payment and settlement systems, including the resilience of the payment infrastructure and the role e-payments played during the pandemic.

Through the publication of FSR, we intend to promote transparency and encourage informed public discourse on various developments

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in the financial system. We hope that the analysis contained in our report will help all stakeholders form a better understanding of the key issues and facilitate appropriate policy initiatives to address any potential challenges.

We pray to Allah the Almighty to grant success to our efforts and endeavors and to enable us to achieve the welfare of our beloved country, under the patronage of His Highness the Amir, Sheikh Nawwaf Al-Ahmad Al-Jaber Al-Sabah, His Highness the Crown Prince, Sheikh Mishaal Al-Ahmad Al-Jaber Al-Sabah, and His Highness the Prime Minister, Sheikh Sabah Al-Khaled 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, Data Conventions and Disclaimer

This Financial Stability Report (FSR) primarily examines the performance of the key components of the local financial system for the calendar year 2020 using December 31st, 2020 as the cut-off date. All amounts are in Kuwaiti Dinar (KD), unless specified otherwise.

When referring to the local banking system, data is on a consolidated basis, including both conventional and Islamic banks within Kuwait as well as their subsidiaries and branches abroad. Due to some data limitations, we have not covered the performance of 12 foreign branches in Kuwait (which account for about 3.2% of the consolidated banking system). 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 the payment & settlement systems within Kuwait only.

Data Sources: The report relies on CBK data as well as Thomson Reuters and Bloomberg for Chapter 1, data from Boursa Kuwait and the Ministry of Justice for Chapter 5.



Abbreviations

AFS	Available for Sale
ATM	Automated Teller Machines
AUB	Ahli United Bank Kuwait
BCBS	Basel Committee on Banking Supervision
Bpd	Barrels per day
CAR	Capital Adequacy Ratio
CBK	The Central Bank of Kuwait
CBOE VIX	Chicago Board Options Exchange - Volatility Index
CCBS	Cross-Currency Basis Swaps
CET1	Common Equity Tier 1
CIC	Currency in Circulation
CMA	Capital Markets Authority
CoBK	Commercial Bank of Kuwait
Covid-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CRWA	Credit Risk-Weighted Assets
EGOV	Various government transactions online
E-Payment	Electronic Payment
EU	European Union
FC	Foreign Currency
FEM	Fixed Effect Model
FVIS	Fair Value through Income Statement
FX	Foreign Exchange
GBP	British Pound Sterling
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HQLA	High Quality Liquid Assets
HTM	Held to Maturity
IB	Islamic Banking
ICE Bank of America	Intercontinental Exchange Bank of America
ICR	Internal Controls Reviews
IFI	Islamic Financial Institutions
IFRS	International Financial Reporting Standard
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IPO	Initial Public Offering
ISO	Information Security Management Systems
IT	Information Technology

Abbreviations

JPY	Japanese Yen
KASSIP	Kuwait's Automated Settlement System for Inter-participant Payments
KCB	Kuwait Credit Bank
KD	Kuwaiti Dinar
KFH	Kuwait Finance House
Knet	The Shared Electronic Banking Services Co.
LIBOR-OIS	London Interbank Offered Rate - Overnight Index Swap
LTV	Loan to Value
M1	A narrow measure of money
MM	Main Market
MSCI	Morgan Stanley Capital International
NBK	National Bank of Kuwait
NGDP	Nominal Gross Domestic Product
NIM	Net Interest Margin
NPL	Non-Performing Loans
NPLR	Non-Performing Loans Ratio
NSFR	Net Stable Funding Ratio
OFI	Other Financial Institutions
OPEC+	Organization of the Petroleum Exporting Countries
OPG	Online Payment Gateway
P/B Ratio	Price to Book Ratio
P/E Ratio	Price to Earnings Ratio
PG	Payment Gateway
PM	Premier Market
POS	Point of Sale
Q1	Quarter 1
Q2	Quarter 2
Q3	Quarter 3
Q4	Quarter 4
REM	Random Effect Model
ROAA	Return on Average Assets
ROAE	Return on Average Equity
RWA	Risk-Weighted Assets
SMEs	Small and Medium-sized Enterprises
USA	United States of America
USD	United States Dollar
WTI	West Texas Intermediate
YOY	Year-Over-Year
YTD	Year to Date

FSR 2020 Executive Summary:

The Covid-19 pandemic proved to be the most significant health crisis in modern history, leading to unprecedented impact on both lives and livelihoods. Triggered by an invisible virus, the global economic landscape was shaped by the fight against the virus, and witnessed a halt in activity as lockdowns-induced constraints materialized on both supply and demand. The economic impact, while severe on a global level, varied between geographies and within sectors. The unprecedented policy response from health, monetary, macro-prudential, and fiscal authorities was swift and decisive. The path to a recovered global economy seemed elusive despite the prompt enactment of substantial monetary and fiscal easing measures. However, by the start of the second half of 2020, the impact of the unprecedented measures was clear. The path to recovery, however, seemed uneven across sectors and economies. As concerns of limited fiscal space gained momentum, the dialogue shifted to emphasize the efficient allocation of support measures. Later in the year, the global economy witnessed significant progress towards recovery, as policy response measures started to pay off and optimism thrived on vaccine-related developments. In parallel, concerns of permanent damage and shifts in the business landscape were labeled under the now more familiar term, *the new normal*. In addition, and as a consequence of the combination of unconventional monetary measures and the historically high liquidity injected into the global economy, inflation fears surfaced. This comes as a translation of a classic concern of dealing with a crisis, which is to risk planting the seeds of another.

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Because of unconventional monetary measures and historically high liquidity injected, inflation fears surfaced reflecting a classic concern of dealing with a crisis, which is to risk planting the seeds of another

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Locally, the journey was no different. In fact, Kuwait experienced a twin-shock caused by the plunge in oil prices and the consequently widening fiscal deficit. Early steps to dampen the shock were shouldered by the Central Bank of Kuwait (CBK). A wide array of monetary and macroprudential tools were swiftly activated to shield financial stability and to position banks as shock absorbents rather than shock propagators. However, the unprecedented disruption caused by the crisis posed challenges extending beyond monetary aspects. As such, and considering CBK's mandate and the corresponding tools, the Council of Ministers established the Higher Steering Committee for Economic Stimulus, chaired by the Governor of CBK. The committee sought to mitigate the impact through comprehensive recommendations such as supporting private sector employees and schemes to resolve potential evacuation of tenants. Bearing in mind the liquidity-centric ramifications of the crisis, a stable liquidity environment was critical to the economic success of the mentioned measures. As illustrated by a comfortably liquid banking sector, steps taken by CBK in this regard build on efforts expended over the past decade, efforts that translate CBK's philosophy of utilizing prosperous times to prepare for potential challenges. This philosophy bore fruit during the ongoing crisis, as banks were not only able to weather the first year of the crisis, but to fulfill their role of providing liquidity while maintaining resilience. This is in stark contrast to the Global Financial Crisis, where banks were in general a channel of stress rather than a catalyst for recovery.

This year's Financial Stability Report covers a unique year from additional angles. The following paragraphs focus on the main highlights from the report sections.



Global & Regional Economic Developments

The Global Purchasing Managers Index which is a high-frequency gauge of economic activity, reached all-time lows. As a result, job markets globally took a hit with global unemployment reaching all-time highs. Oil-reliant economies were dealt a double-blow. Oil markets personified the magnitude of the crisis as near-term contracts for Brent Crude cratered while those for WTI went into negative

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Oil markets personified the magnitude of the crisis as near-term contracts for Brent Crude cratered while those for WTI went into negative territory for the first time in history

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territory for the first time in history. Authorities were prudent in reacting to the fallout, as lessons learned from the Global Financial Crisis translated into massive fiscal and monetary support measures. The implementation of such measures proved difficult for some countries given already overstretched budgets. As a result, borrowing was prevalent for both governments and corporates, highlighted by a surge in issuances. As a consequence of the monetary and fiscal measures, and fueled by supply-constraints, inflation concerns gained momentum by the end of the year.

Local Financial System Overview

Assets:

The Kuwaiti financial system continues to be bank centric. On a consolidated basis, the local banking sector accounts for more than 80% of the financial system's total assets. Despite the pandemic-driven contraction in nominal

GDP, the banking sector maintained a positive trajectory with total assets up 2.9% YOY reaching KD 85.3bn. These assets are equivalent to 263% of nominal GDP, and are spread across 11 banks, five conventional, five Islamic and one specialized. Growth in Islamic banks' assets outpaced their conventional counterparts, with their share increasing to 45% up from 42% in 2019.

Loans:

Highlighting banks' success in fulfilling their intermediation role through a challenging year, aggregate loans growth rate reached 4.8%. Large corporates continued to be the dominant borrowers, accounting for 71.1% of the KD 54.3b gross loan portfolio albeit growing at a slower pace when compared to Households. The lower perceived risk of Households contributed to the 8.5% growth, with the segment now representing 25.2% of the total loan portfolio. The Real Estate sector is the primary beneficiary of outstanding financing for corporates, and second to Households in terms of the total loan portfolio, both accounting for 47.5% of all outstanding loans. Loans to SMEs contracted as heightened risk aversion and overall uncertainty led to lower financing to generally vulnerable SMEs.

Deposits:

Given the lockdowns and resulting obstacles to typical spending channels, deposits witnessed an increase of 4.1%, driven by Individuals' deposits. The increase, further fueled by moratoriums, exhibits individuals' confidence in local banks. Total banking system deposits reached an all-time high of KD 61.1bn of which 78.1% were sourced locally.

Banks' Risks

Credit Risk:

The Covid-19 crisis inevitably contributed to the 43% increase in Non-Performing Loans (NPLs) reaching KD 1.1bn, yet the NPL ratio maintained healthy levels at 2%. Newly added NPLs were approximately KD 1bn, mainly driven by the Real Estate sector, in line with its share of the total lending portfolio. Consistent with trends seen globally, both Services and Construction sectors experienced the highest YOY increases of 183% and 128% respectively. It is worth noting that the KD 1.1bn newly added NPLs were largely

offset by write-offs enabled by an ample stock of provisions. As provisions were utilized for the write-offs, and coupled with the increase in NPLs, the coverage ratio declined, yet remains very healthy at 222% in 2020 from 271% in 2019.

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Despite pandemic implications, the NPL ratio and the provisions coverage ratio remain at very healthy levels

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Liquidity Risk:

Despite the risks of a crisis-induced liquidity crunch, banks remain flush with liquidity as reflected by the Net Stable Funding Ratio and Liquidity Coverage Ratio, at 115% and 184% respectively. The comfortable liquidity levels facilitated by the higher individual deposits and macro-prudential measures culminated in a historically high lending capacity. Total liquid assets of less than three months remained steady on an absolute level but declined relative to total assets.

Market Risk:

Market risk-weighted assets remained relatively flat at 1% of total risk-weighted assets, or KD 0.6bn. Banks' investment books grew at a slower pace than the five-year average growth rate of 6.3%, at 3.8% or KD 519.6mn. Of these investments, approximately 80% are in fixed income while 14.6% are in equities. The bulk of banks' investments (56.9%) are classified as Available for Sale (AFS), while Held to Maturity (HTM) and Fair Value through Income Statement (FVIS) investments account for 37.9% and 5.2% respectively. Overall, banks resorted to highly liquid instruments to enhance profitability while maintaining flexibility to deploy liquidity needed.

Operational Risk:

Challenging operating conditions were reflected through elevated operational risk indicators. The bulk of operational losses were attributable to clients, products, and business practices which accounted for 46% of total operational losses. The average employee churn rate among banks improved to 10% from the 17% observed during 2019, likely reflecting CBK's directives

in this regard and support measures targeting private sector workers by the state. This year also marked the development and execution of an Operational Risk oriented stress-test tool at CBK, with results providing assurance of the banking sector's operational resilience.

Banks' Profitability & Resilience

Profitability:

Despite the unprecedented challenges, banks still managed to register net income attributable to shareholders of KD 455mn, down 52.3% from the previous year. KD 176mn of the decline in total net profit stemmed from deterioration in operating income, while KD 337mn was a result of provisions on loans and other financial assets. Profitability and efficiency indicators reflected

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Banks managed the unprecedented challenges by maintaining profitability and demonstrating resilience under hypothetical stress scenarios

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the impact, as return on average equity and return on average assets fell to 4.8% and 0.6% respectively, from 9.5% and 1.2% at the end of 2019. Banks continued to maintain their revenue structure, where core banking operations dominated the composition of income.

Resilience:

Banks maintained adequate capitalization, with the capital adequacy ratio (CAR) 0.5 percentage point higher at year end reaching 19%. Capital levels were reinforced throughout the year with higher issuances, as banks took advantage of low interest rate conditions. Most new issuances came in the form of Tier 2 securities, increasing total Tier 2 capital to 12.6% of banks' capital, up from 9.8% in 2019. Banks demonstrated resilience under hypothetical top-down stress scenarios including a crash in the Real Estate sector and

accelerated fiscal deterioration. However, based on the results, the most impactful scenario would be a crisis similar in scope and severity to the ongoing pandemic. All in all, the aggregate banking sector CAR remained above the BCBS minimum requirement of 8% across the spectrum of scenario severity.

Domestic Markets

Real Estate:

The real estate market was brought to a slowdown at the onset of the crisis, as lockdown measures resulted in transactional frictions. Markets somewhat recovered with the easing of restrictions but remained under pressure amid government-induced demographic reforms and weak oil prices. The residential real estate segment demonstrated the most strength in terms of transactional volume and

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The clouded outlook and expected demographic shift affected both Commercial and Investment properties

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value. The residential segment benefitted from the clouded outlook faced by the investment properties segment, which was a result of expected demographic shifts. That, along with higher individual disposable income, pushed more investors into residential properties. On the other hand, commercial properties struggled to stay afloat amidst the economic downturn. Banks' exposure to real estate in the form of lending (corporate, retail and construction) climbed to KD 25.7bn, approximately 47% of the total loan portfolio. Real estate constituted 66% of total bank collaterals, highlighting significant exposures to the market.

Equities:

Banks continued to dominate Boursa Kuwait in terms of total market capitalization, accounting for 57% of the market. Consistent with the effects

seen globally, the All-Share Index plummeted at the onset of the crisis, falling 30.5% to below year-open levels. Kuwaiti markets trailed the global recovery, ending the year 11.7% below year-open levels. Covid-19 effects manifested in the local stock market in the form of elevated volatility where annualized volatility reached 23.3% in contrast with 2019's 9.3%. Higher investor participation also contributed to the excess volatility, as volume and value picked up in the lead up to Kuwait's inclusion in the MSCI emerging markets index. An all-time high in daily traded value was recorded on the day of the official inclusion, resulting in a surge in net foreign inflows of KD 406mn on a single day. Banks' exposures to listed local equities remain within sound thresholds, representing 4% of their investments and 12% of collaterals. Banks also proved to be resilient to hypothetical domestic equity market shock scenarios of the CBK's stress test.

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Banks' exposures to listed local equities represent 4% of their investments and 12% of collaterals

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Payment & Settlement Systems

E-payment and cashless solutions played a central role during the crisis, proving to be highly effective in mitigating the health risks associated with traditional transactions. This was evident in K-Net¹ online payment gateway transactions which surged by a historic 89.2% in terms of

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The trends witnessed in payments highlight some of the structural shifts resulting from the pandemic, in particular, the accelerated push towards digitalization

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volume and 120.8% in terms of value in 2020. This highlights society's growing adoption and confidence in electronic payment. On the other hand, point of sale usage fell by 5.4% in terms of volume, and the number of ATM and plastic card issuances declined for the first time in a decade, a potential representation of the extent of disruption caused by the crisis. Whether this trend-break stems from a shift in behavior, and whether these shifts will revert to pre-crisis or persist in the long-run remains to be seen.

The trends witnessed in payments highlight some of the structural shifts resulting from the pandemic, in particular, the accelerated push towards digitalization. Evident in both consumer and financial markets, the rapidly developing financial landscape tested the agility of regulators. CBK embraced these accelerated trends by expanding on previous efforts that emphasized infrastructure, cybersecurity, and requirements related to banks' IT strategies. This stance aims to empower and encourage the banking sector to not only maintain relevance, but to also exemplify its leadership on the digital front. Banks' success in adapting to these developments is a crucial complement to their risk management efforts.

Outlook:

With some jurisdictions still under lockdown, travel restrictions generally in place, and masks still mandatory, the crisis is not over yet. Earlier vaccination of the masses would be central to limiting this pandemic and thus securing a sustainable recovery. On the economic front, public and private debt remains at historically high levels and inflation has spiked in some of the advanced economies, though the recent rise is likely to be transitory as it is driven by supply disruptions and base effects. This could lead to an earlier

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Major monetary and fiscal authorities need to skillfully orchestrate the unwinding of their extraordinary policy support to avoid a sharp tightening of financial conditions

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¹ K-Net is a national company providing electronic banking services in Kuwait.

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Local banking sector has sufficient buffers to withstand possible credit quality deterioration in 2021 allowing it to fulfill its role as a catalyst for recovery

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than expected unwinding of the currently accommodative monetary stance, generating sharp correction in asset prices and tighter financial conditions in developing economies.

Locally, even though the impact of the pandemic on banks did not fully materialize in 2020, the banking sector successfully navigated the first year of the crisis. Despite the possible increase in NPLs by 2021, the banking sector should be able to fulfill its role as a catalyst for recovery, as highlighted by CBK's stress-test results. On an individual level, however, banks differ in terms of their ability to endure projected stress e.g., an unexpected extension of the ongoing crisis. This is natural as both the starting point and the relative stress endured through the year varied across banks. All in all, as the pandemic recedes, the sector remains well positioned to recover fully. Prudently, and as highlighted by recent stress-tests, the two main risk scenarios are a Real Estate sector shock and an escalated fiscal deterioration. While the Real Estate sector can rely on strong market dynamics to minimize the corresponding risk, the prevention of escalated fiscal deterioration requires collaborative efforts.

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As monetary and macro-prudential tools are not sufficient by their own, CBK continues to stress the importance of comprehensive reforms to address challenges in a holistic manner

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As the battle against the virus continues and fiscal challenges grow in complexity and magnitude, it is pertinent to point out that the recovering oil prices do not resolve nor address the structural imbalances and challenges faced by Kuwait. CBK continues to stress the importance of paving the way for comprehensive reforms to address these challenges in a holistic manner, rather than through costly partial reactions. While monetary and macro-prudential tools are essential, they are not sufficient by themselves. This historical crossroad requires decisive steps and a collaboration of efforts between all stakeholders, especially in the economic and political fronts. In translation of its mandate, CBK remains vigilant and agile towards ensuring a stable and innovative banking sector that is a conduit of a sustainably prosperous economy.

CHAPTER 1

GLOBAL & REGIONAL

ECONOMIC

DEVELOPMENTS



This year was marked by unprecedented events, most clearly reflected by global and regional economic indicators. This chapter touches on a range of economic indicators, setting the stage for the successive chapters.

Volatility and uncertainty dominated financial markets, leading policymakers to choose between lives and livelihoods

Given the local financial system’s sensitivity to global and regional economic developments, it is imperative to understand the transmission channels between the two in order to form a holistic view of local financial stability drivers. Towards that end, this section analyzes the key transmission channels such as oil prices, foreign exchange, and financial markets. By forming a solid and continuous understanding of these developments, a strong foundation is established to paint a forward-looking picture of the local financial system.

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With a very high volatility, major business cycle events that would usually take years to unfold were condensed within twelve months

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Volatility and uncertainty were the dominant themes of the year 2020. As the most volatile year on record, major business cycle events that would usually take years to unfold were condensed within twelve months.

As the news of the Covid-19 crisis initially emerged in Asia, the Shanghai Composite Index dipped while other global indices continued an upward trend through February (figure 1.1).

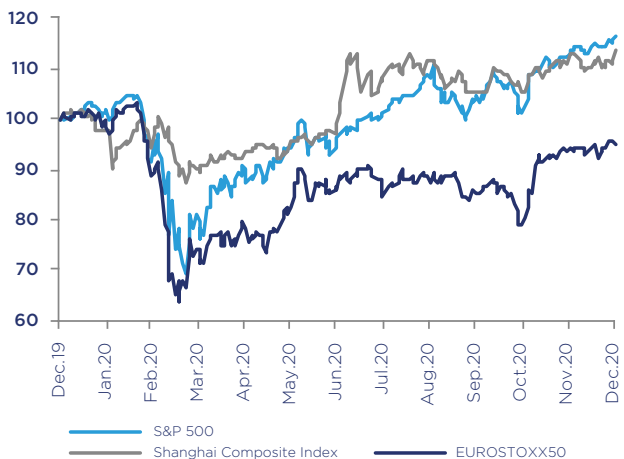
However, as the virus extended its reach, authorities were forced to “press hard on the breaks” on economic activity to avert a health crisis.

Once the impact of lockdown measures on economic activity became evident, global indices suffered sharply. Subsequently, policymakers faced the dilemma of choosing between lives and livelihoods as unemployment soared to all-time highs (figure 1.2) and economic activity took a sharp nosedive.

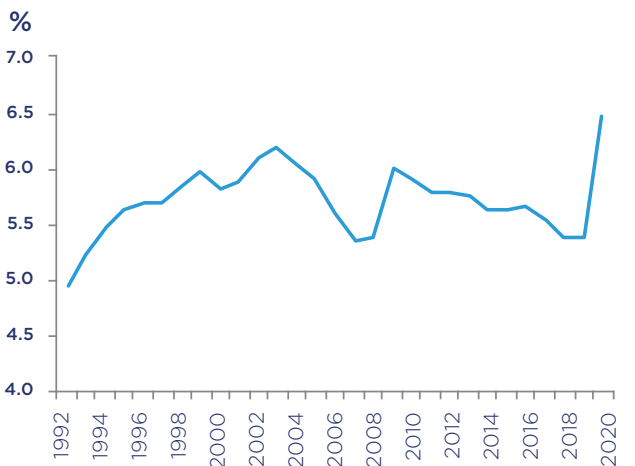
JP Morgan Global Composite PMI, a high-frequency economic activity indicator, reached all-time lows in April as lockdowns and restrictions’ impact materialized (figure 1.3).

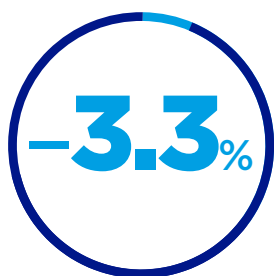
In response, policymakers worldwide deployed unprecedented fiscal and monetary stimulus measures to cushion the blow levied by the Covid-19 pandemic. Consequently, the price

1.1 Equity Markets (rebased)



1.2 World Unemployment Rate





Global GDP recorded a **3.3%** contraction in 2020

action of global indices varied to reflect the effectiveness and perceived success of authorities' Covid-19 responses. The Shanghai Composite Index experienced a less severe drop than its global peers and a quicker rebound due to both the swiftness of containment measures and high compliance. In contrast, the Eurostoxx 50 lagged its global peers. The US can be considered an outlier in this regard. Despite the severe and prolonged virus spread, the exceptional fiscal spending and monetary easing levels enabled the index to swiftly record all-time-highs.

Public spending and the historically low interest rate environment played a clear role in cushioning the pandemic-induced blow to the economy and financial markets. According to the IMF, global GDP recorded a 3.3% contraction in 2020, an improvement of 1.6 percentage points compared to June's projection of a 4.9% contraction in GDP. In parallel, global debt spiked substantially to record levels (figure 1.4).

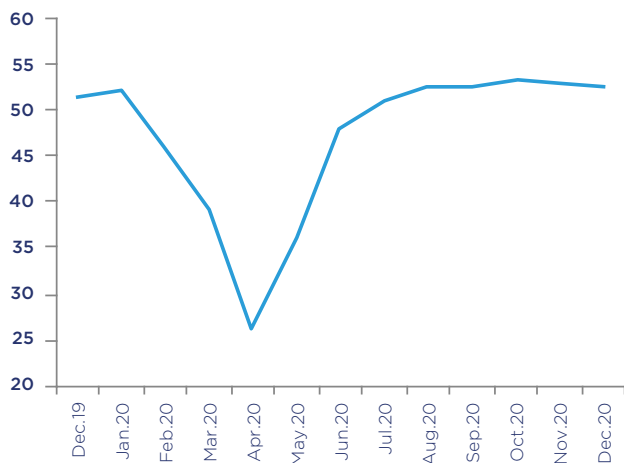
As costs to sustain the adopted measures mounted, the dialogue shifted to targeted support and the timing of suspending such

measures. As a result, policymakers faced another precarious situation fueled by an increasingly limited fiscal space. On one side, the risk of premature suspension amidst an uncertain and uneven recovery path, and on the other side, an overextended continuation that could fuel an aggressive reach-for-yield behavior in markets. The latter raised concerns of asset bubbles and heightened financial fragility, a translation of a classic dilemma when motivating recovery from a crisis may risk sowing the seeds of another.

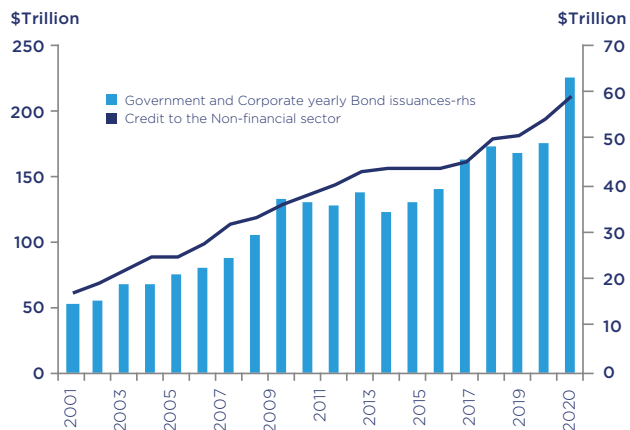
Global financial markets were prone to bouts of volatility

The developments of the virus flew under the markets' radar for quite some time. However, a sense of angst started to grapple with markets once the virus moved into Italy in late February. Financial markets, as a result, witnessed a severe "risk-off" episode as volatility started to rise substantially in all asset classes. For instance, the CBOE VIX¹ index surpassed its previous all-time peak during the Global Financial Crisis and settled at 83 on March 16 (figure 1.5).

1.3 J.P.Morgan Global PMI, Composite



1.4 World Debt



¹ This index, also known as the "Wall Street's fear index", is a measure of implied stock market volatility derived from S&P 500 option prices.

1.5 CBOE VIX



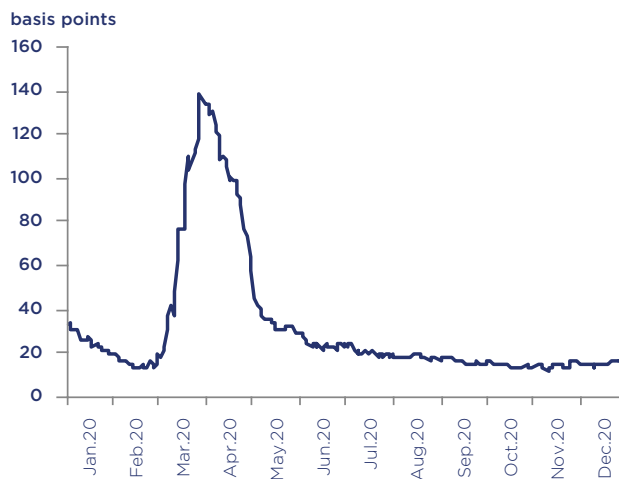
No asset class was spared the selloff as the highly liquid and deep US treasury market experienced an unusual bout of volatility. After the typical de-risking environment that pushed yields lower, safe-haven US treasuries sold off unpredictably and caused yields to recoil sharply. The brief recoil was attributed

1.6 Bank of America Move Index vs Fed Treasury holdings



to the “dash for cash episode”, exacerbated by

1.7 LIBOR-OIS Spread



margin calls, where investors, including foreign financial institutions and sovereigns, needed to raise dollar liquidity.

These events called for major central banks to step in and relieve the strains witnessed in markets through the deployment of their asset purchase programs. For example, as the Federal Reserve announced open-ended treasury purchases, the ICE Bank of America Move Index² started trending downwards as the asset purchases supported other measures in driving the recovery (figure 1.6).

Fueled by market panic, acute dollar funding strains emerged

The scarce and expensive dollar supply, a classic symptom for a global crisis and panic episodes, was evident as market participants were less willing to lend the safe-haven currency. As a result, LIBOR-OIS spreads³ spiked materially higher at the onset of the crisis (figure 1.7).

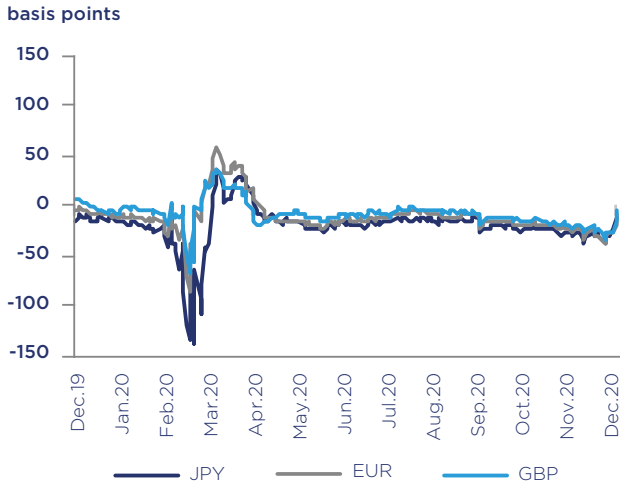
The dollar funding strains were also evident in the sharp movements in the currency derivatives market as the cross-currency basis swaps⁴ (CCBS) moved deeper into negative territory (figure 1.8).

2 The ICE BofA MOVE Index tracks implied volatility in the US treasury market through deriving option prices of selected maturities in the treasury market.

3 The spread compares the difference between the borrowing costs of banks in the unsecured market (3-month LIBOR) and a risk-free rate (Overnight Indexed Swap) that is based on the Federal Funds Rate. Higher spreads indicate stress in money markets and the broad banking system.

4 This market is used as an alternative to secure direct funding in the interbank market of the desired funding currency.

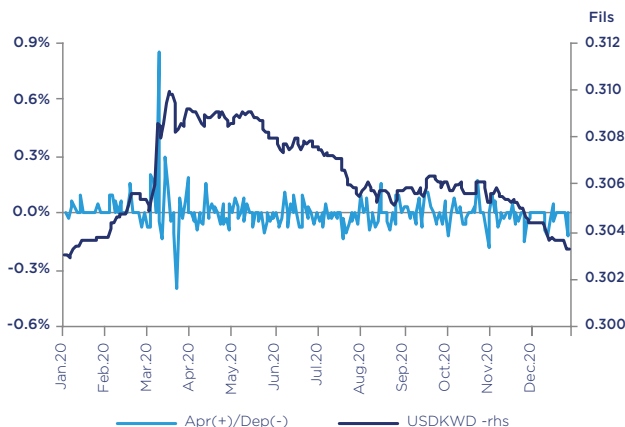
1.8 Cross-Currency Basis Swaps



The shift showed that investors looking to fund their USD needs via other currency holdings were willing to pay a premium in the cross-currency swaps market. After recoiling higher as a function of central bank liquidity injections in the market, CCBS reverted to their normal ranges once the initial shock abated.

Similarly, in the FX spot market, the USD took center stage as market participants took shelter in the greenback and pushed it higher against most crosses within the first quarter. At the height of the crisis, USD/KWD peaked at 0.3099, its highest rate since the re-introduction of the currency basket system in 2007 and marked a 2.3% appreciation of the USD against the KWD for the year to date (figure 1.9).

1.9 USDKWD Exchange Rate



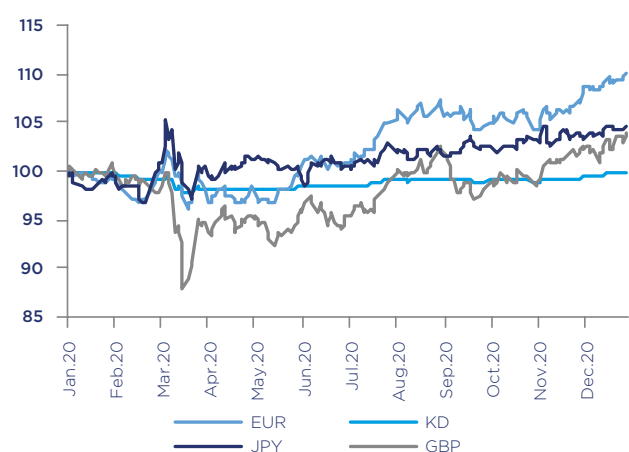
After its peak, the USD/KWD exchange rate generally faced a downdraft throughout the most part of the year as investors gradually started pricing out the risk premium embedded in the USD and started drawing their 2021 recovery narrative.

Tempered by the movements of other currencies in the basket, the USD/KWD exchange rate reverted to its pre-crisis levels, with the KWD slightly depreciating against the USD by 0.07%. However, the USD/KWD exchange rate fluctuations remained relatively contained compared to other crosses, as the basket peg proved to have suppressed significant gyrations against key currencies (figure 1.10).

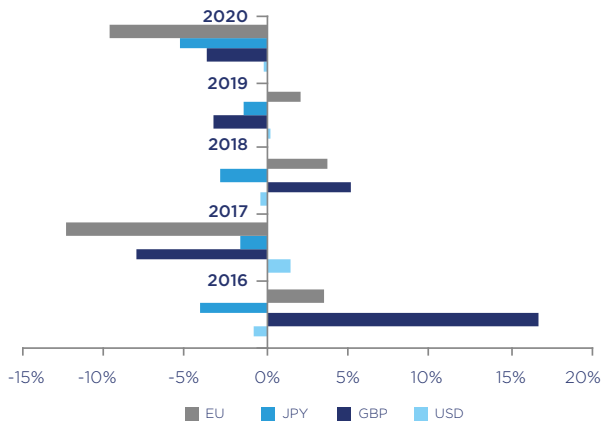
While USD/KWD exchange rate recorded a reading above its 5-year average, the pair witnessed the least realized volatility when compared to other currency pairs, further highlighting the shock-absorbent peg in this tumultuous year.

In terms of other key currencies, the Euro's modest performance in the first half of 2020 was followed by an outperformance as EU leaders agreed on a stimulus plan to lift the trading block from its deep recession. Investors grew more comfortable with the Euro and pushed it higher as it appreciated against the USD and KWD by 9.68% and 9.75% respectively given that one of the major drivers of the euro's underperformance in the past years was the trading bloc's struggle to consolidate a fiscal union (figure 1.11).

1.10 Currencies against USD (rebased)



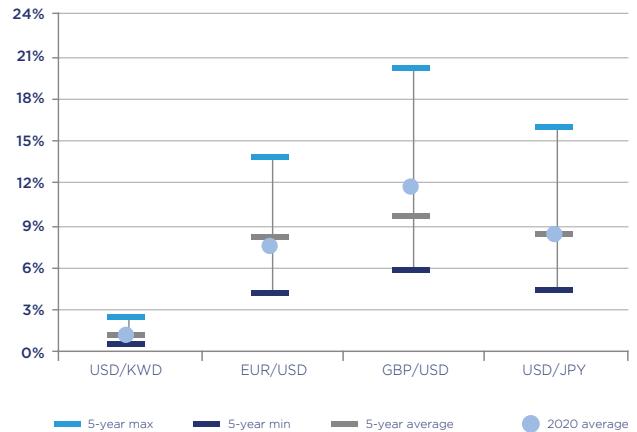
1.11
KD against major currencies



Moreover, headwinds faced by the dollar after the Fed’s adoption of its average inflation-targeting regime⁵ provided an additional boost for the Euro towards the fourth quarter of the year.

While the Bank of Japan maintained its dovish stance by keeping its benchmark rate anchored at -0.1% since January 2016, the JPY appreciated an additional 5.38% against the USD. The initial movements in the JPY were attributed to safe-haven flows as the deterioration in global risk sentiment drove flows into traditional safe-haven currencies. Subsequently, and as the year progressed, a broadly weaker dollar provided some tailwinds for the JPY, which as a result enabled the JPY to appreciate against the KWD by 5.42% and marked its fifth consecutive year of appreciation against the KWD.

1.12
Realized Volatility (90-day)

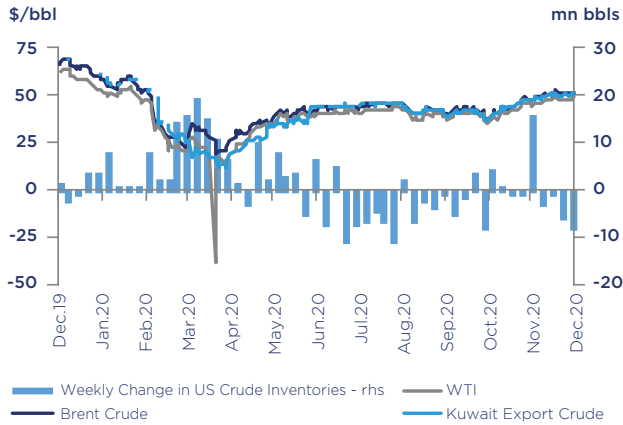


After reaching its trough in the first quarter, the pound sterling advanced as it benefited from a weakening dollar. Through the later part of the year, GBP gained ground as FX market participants started to price-in the passage of a Brexit trade deal that indeed surfaced during the final days of the year thereby averting a “cliff edge” outcome and ultimately enabling it to advance against the USD and KWD by 3.74% and 3.81% respectively in 2020. Moreover, the pound sterling was once again the most volatile cross given its relatively stronger correlation with the variations in global risk sentiment. In addition, other idiosyncratic factors such as the prospects of negative rates from the Bank of England and Brexit further increased its annualized volatility figures relative to its peers (figure 1.12).

“
The USD/KWD exchange rate fluctuations remained relatively contained compared to other crosses, as the basket peg proved to have suppressed significant gyrations against key currencies.
 ”

⁵ In contrast to its previous approach in which the central bank preemptively raised rates in anticipation of inflation, the Federal Reserve adopted an outcome-based approach that aims to let inflation briefly overshoot its mandated target in an aim of achieving inflation that averages 2% over time. The adoption of this regime essentially delays the prospects of rate hikes, which in turn keeps real US interest yields low and ultimately weighs on the USD.

1.13 Crude Oil markets



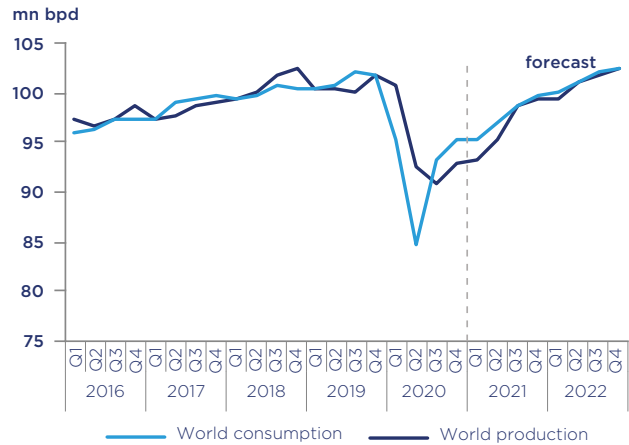
Oil markets were prone to extreme price swings, acting as a stark reminder for the oil dependent GCC region

At the onset of 2020, oil prices commenced on their downward trend as prices inched lower in anticipation of lower Chinese demand resulting from Covid-19 related lockdowns. As the virus proved more elusive in Asia, and started spreading beyond the region, the decline in oil prices started accelerating. However, in early March, as OPEC+ failed to reach an agreement regarding production cuts, and further demand destruction was already underway, oil prices plummeted (figure 1.13).

As adoption of lockdown measures was increasing during April, a concoction of record inventory builds caused by sinking demand and shrinking storage capacity proved toxic for the oil markets. Specifically, WTI plummeted into negative territory on April 20 largely due to contract holders having to accept physical deliveries of the commodity⁶. At the height of the crisis, the Energy Information Administration estimated that global demand fell to 81 million barrels per day (mn bpd) while global production remained unchanged at 100 mn bpd in April (figure 1.14).

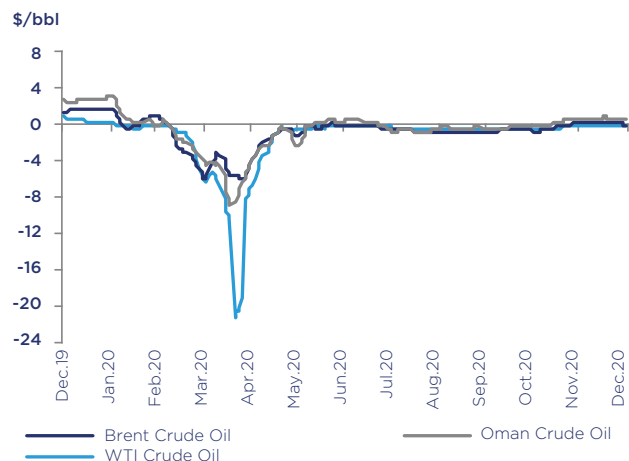
After the severe downward pressure throughout March and April, crude oil prices started trending upwards buoyed by firming fundamentals such as supply cuts, inventory

1.14 World liquid fuels production and consumption



drawdowns and recovering demand. While crude oil futures contracts were still trading in contango⁷ for most of the year, the near-term structure of the forwards market managed to shrink due to extraordinary steps taken by OPEC+ to stabilize prices. These steps came in the form of orchestrating record supply cuts whilst ensuring compliance throughout the year to maintain the deficit in the oil market and induce inventory drawdowns. Accordingly, and as markets were faced by the prospects of lower supplies and a recovery in global oil demand, time spreads between front month and third month deliveries began to tighten and in some instances turned positive and

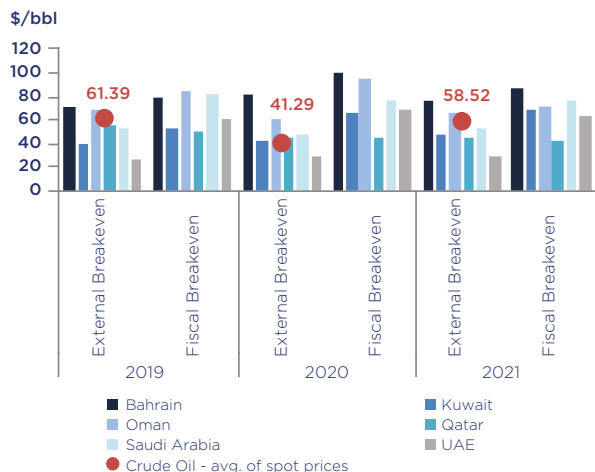
1.15 Crude Oil Futures Time Spreads (5-day moving average)



⁶ Unlike Brent crude futures, which has the option of cash settlements, WTI contract holders must accept physical deliveries in Cushing, Oklahoma.

⁷ Contango is a market structure where the front/prompt month contract trades lower to later month contracts. This structure implies current oversupply and induces inventory buildup.

1.16 Breakeven Oil Prices

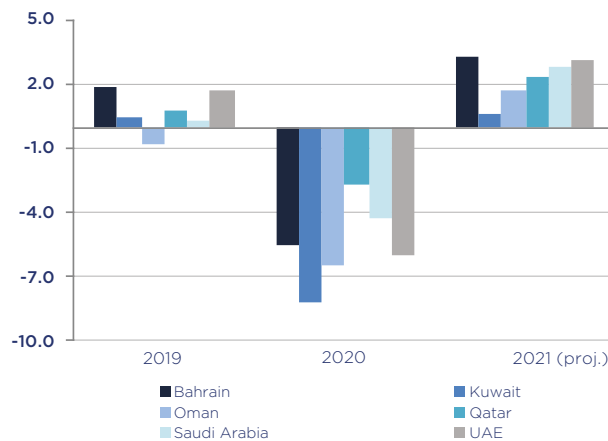


moved into backwardation⁸ in the later part of the year (figure 1.15). One of the likely factors contributing to the positive spread of Omani crude oil contracts was the solid demand that stemmed from Asia as countries in the Eastern hemisphere were witnessing a more pronounced recovery in oil demand.

Towards the end of the year, and as demand started to regain a footing, oil prices maintained their upward trend. However, with consumption still below its pre-crisis levels, OPEC+ maintained its production cuts well into end-2020 in an effort to bridge the oil market through any demand weakness.

The downdraft witnessed in the oil market caused crude oil prices to average \$41.3/bbl throughout the year, below the region’s fiscal and external break-even prices of \$76.1/bbl and \$52.0/bbl respectively.

1.17 Real GDP Growth



That said, the events and trajectory that oil markets experienced acted as a stark reminder for the oil dependent GCC region. The downdraft the oil market witnessed caused crude oil prices to average \$41.3/bbl⁹ throughout the year, an average that is well below the region’s fiscal and external breakeven prices¹⁰ of \$76.1/bbl and \$52.0/bbl, respectively (figure 1.16).

In light of the shock that the global economy and more specifically oil markets endured, GCC economies sustained heavy economic pressure as the oil contribution contracted in line with the OPEC+ supply cuts and the non-oil contribution was weighed down by public health measures (figure 1.17).

Given that most GCC countries require relatively high oil prices to address their fiscal deficits and the external vulnerabilities of their current accounts, the crisis has generated a sense of urgency in some countries to introduce and accelerate fiscal reform measures to address a potential downward trend in oil revenues.

In the face of declining oil revenues, GCC countries, with the exception of Kuwait, have variably turned to debt markets to address fiscal deficits, thereby rendering some more vulnerable to future shocks (figure 1.18).

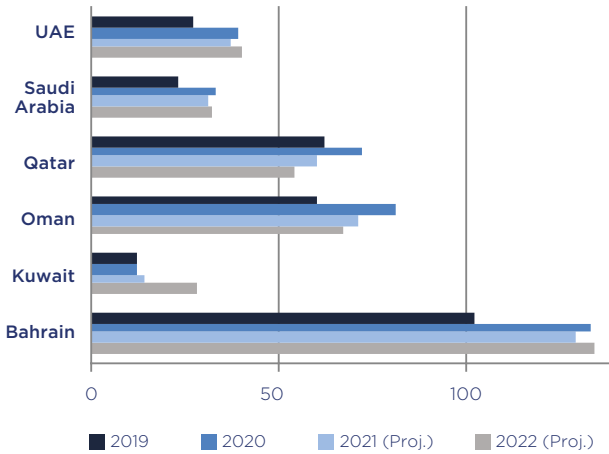
While a spike in the debt to GDP ratio may heighten the risks of financial fragilities, it highly

⁸ Backwardation is a structure that occurs when the front month contract trades at a premium to later deliveries thereby encouraging prompt selling and inventory drawdowns.

⁹ Average of WTI, Dated Brent & Dubai Fateh

¹⁰ Source, IMF

1.18 Total Government Gross Debt (%GDP)

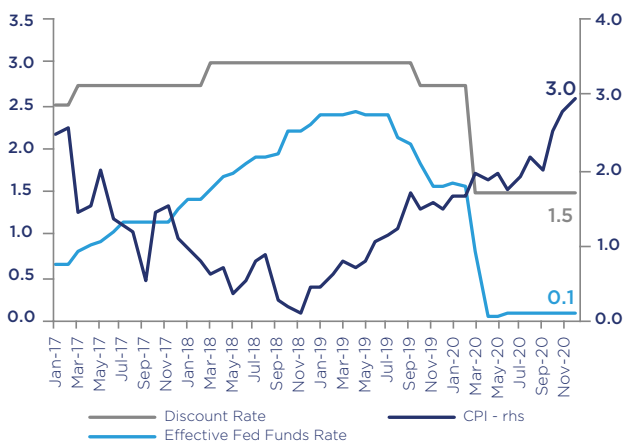


boils down to the utilization of the debt. For instance, funding critical infrastructural projects and well-targeted support measures will result in a net gain for the economy as it lays the groundwork for fiscal sustainability. In the case of funding support measures, it makes it more critical to target and time the withdrawals of the financed policy support measures as premature withdrawals may exacerbate the pressures on the private sector and by extension their lenders, banks.

Kuwait had its own set of challenges, leading the decline in GDP amongst its GCC counterparts

After reaching a trough of 0.09% in 2018, Consumer Price Index (CPI) commenced on its upward trend throughout the subsequent years. In part, the trend was driven by measures

1.19 Benchmark Rates & CPI (%)



put in place by CBK through its maintenance of policy rates, despite the upward trajectory of the Federal Funds Rate in the years prior to the crisis. However, as the crisis emerged, and coinciding with the 150bps cut in the Federal Funds Rate, CBK delivered two rate cuts during March, totaling 125bps (figure 1.19).

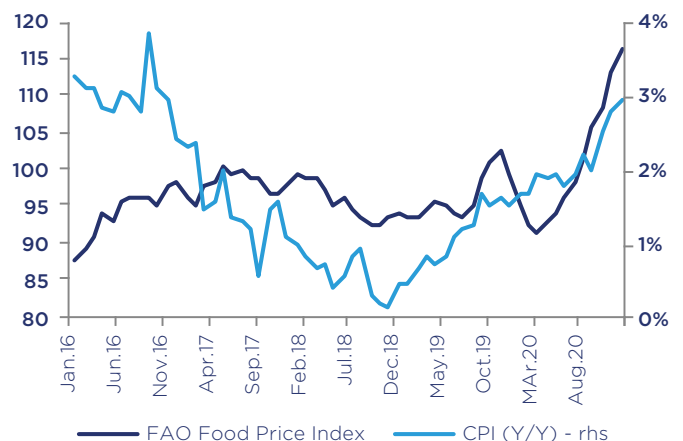
In contrast to the deflationary trend witnessed in major economies in the springtime, and despite the early rate cuts, local CPI remained relatively tame in the early stages of the pandemic. However, through the later part of the year, inflation started to pick up notably. Considering Kuwait's import oriented consumption patterns, the upward trend in inflation was on the back of historically low interest rates and rising food prices worldwide, which in turn translated into a pickup in the respective component (figure 1.20).

Moreover, supply side constraints in the form of higher shipping and input costs may have manifested itself into local inflation (figure 1.21).

That said, the CPI ended the year at 2.95%, its highest levels since December 2016, and averaged the year at 2.1%, 34 basis points higher than its 5-year average.

In terms of GDP, IMF estimates that Kuwait will lead the decline amongst its GCC counterparts, as the protracted health measures along with the reduction in oil revenues pushes the contraction of real GDP in 2020 to 8%. Moreover, the State's finances suffered, as according to the Ministry of Finance's latest data, the State's budget for the Fiscal Year 2020/2021 will mark its seventh consecutive deficit, swelling to KD 14 billion or 40.5% of forecasted GDP (figure 1.22).

1.20 CPI vs. World Food Price Index



“
While oil market conditions have improved, and despite the conservative \$30 oil price assumed in the fiscal year 20/21 budget, fiscal and macroeconomic reforms remain essential for Kuwait’s outlook.
 ”

Despite Kuwait having the lowest debt to GDP ratio in the region, it has not yet entered debt markets since 2017 to finance its spending due to the expiration of the public debt law. Instead, Kuwait opted for alternative sources of funding such as asset swaps between the General Reserve Fund and the Future Generations Fund. Given renewal of the aforementioned law, the IMF expects a more pronounced increase in its debt to GDP ratio relative to its GCC counterparts in 2021 and 2022, in part due to its low starting point. While oil market conditions have improved, and despite the conservative \$30/bbl price assumed in the fiscal year 20/21 budget, fiscal and macroeconomic reforms are still essential for Kuwait’s outlook.

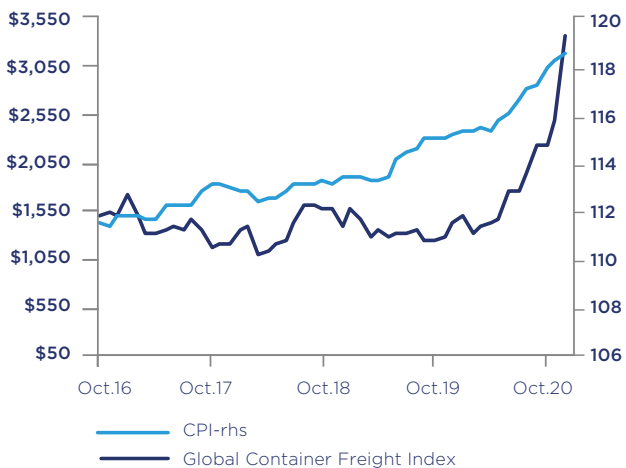
In the wake of the crisis, the Central Bank of Kuwait decisively and swiftly enacted monetary and macroprudential policy support measures¹¹ to bolster resilience of the financial sector and the local economy. However, and while financial and monetary stability play a key role in

forming the local economy’s outlook, they are insufficient on their own to ensure sustainable economic prosperity.

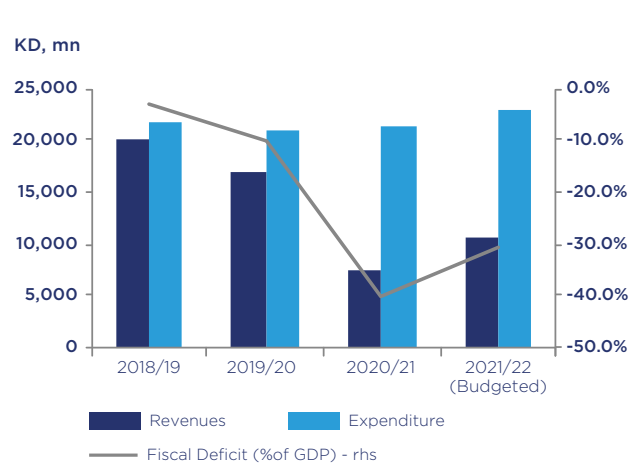
With that in mind, and in light of the accelerated green energy trend and the lessons drawn from recent crises, it is imperative to adopt a proactive stance towards comprehensive reforms. It is no longer affordable to rely on costly reactionary solutions, especially given the growing current expenditures facing the fiscal budget.

Infrastructural shifts in the State’s finances should form the groundwork for a robust non-oil economy through enhancing the efficiency of the government sector, enabling public-private partnerships and enhancing the contribution of the private sector in the non-oil economy. Ultimately, these reforms should pay dividends in reducing the pro-cyclicality of government finances and enhancing the stability of the local economy and consequently the financial system.

1.21
CPI vs. Global Container Freight Index



1.22
Kuwait’s Public Finances



¹¹ A detailed list of the measures taken by the Central Bank of Kuwait can be found in Box 1.1 titled “Measures by CBK to mitigate the impact of the Covid-19 pandemic”

BOX 1.1: MEASURES BY CBK TO MITIGATE THE IMPACT OF THE COVID-19 PANDEMIC

Covid-19 pandemic has triggered a combined health and economic crisis like no other. Soon after its outbreak in most countries including Kuwait in late February, economic activity came to a sudden stop in a matter of weeks, particularly in the hardest hit services sector, albeit recovering partially once the first wave of infections tapered. Further complicating matters, oil prices plummeted in early March after the OPEC+ talks broke down. Collectively, the triple whammy of collapsing oil prices, surging Covid-19 infections and contracting economic activity posed a serious threat to both lives and livelihoods.

To mitigate the impact of this unprecedented health and economic shock, the Central Bank of Kuwait (CBK), in its capacity as the country's monetary authority as well as the banking sector regulator, swiftly introduced a wide range of timely and targeted monetary and prudential measures to assuage the strains on banks, and in turn, on firms and households' balance sheets. These measures included slashing discount rate twice to a historic low, relaxing liquidity requirements by easing LCR, NFSR and regulatory liquidity ratio etc., releasing capital conservation buffer, and bolstering banks' lending capacity by enhancing maximum credit limits, reducing risk weights and softening LTV rules, to name a few. Other measures were also taken, in collaboration with the banking sector and K-net, to facilitate digital payments and reduce the need for cash-based transactions amid the pandemic.

What follows is a list of all such measures introduced by CBK, either directly or in cooperation with the banking industry. These measures have been classified by type (e.g. monetary or prudential etc.) and are arranged in a chronological order.

Monetary Policy:

March 2020

- Discount rate was slashed twice, by a cumulative 1.25 percentage points, bringing it down from 2.75% to 1.5%, a historic low.
- Overnight, one-week and one-month repo rates reduced to 1%, 1.25%, and 1.75% respectively.

October 2020

- Intervention rate was reduced by 0.125% on all tenors up to 10 years, including repo transactions, CBK bonds, time deposits, direct interventions, and public financing instruments.

Prudential Policy:

March 2020

- To ease the reporting burden, banks were instructed to postpone data submission for Q1 2020; instead, submission of only regular supervisory reports was required.

April 2020

- Capital adequacy ratio (CAR) was lowered from 13% to 10.5% by allowing banks to utilize their capital conservation buffers.
- Risk weights for SMEs were lowered from 75% to 25%, while also aligning the SMEs definition to that of the Kuwait National Fund.
- Banks' maximum lending limit was increased from 90% to 100%.
- Both LCR and NFSR were reduced from 100% to 80%.
- Regulatory liquidity ratio was reduced from 18% to 15%.
- Maturity Ladder Limits were increased by 10% for all buckets as follows:
 - From 10% to 20% for 7 days
 - From 20% to 30% for 1 month
 - From 30% to 40% for 3 months
 - From 40% to 50% for 6 months
- Loan to Value (LTV) ratio for investment real estate loans in residential areas was increased as follows:
 - Financing the Purchase of Land: from 50% to 60%
 - Financing Real Estate Purchase: from 60% to 70%
 - Financing Construction of RE: from 70% to 80%
- Banks were advised to exempt clients from the financing concentration limits in assessing any credit proposal which included important projects that add value to the local economy.

May 2020

- Banks were instructed to organize the repurchase and sale of banks' stocks. Banks were also required to provide CBK details of each transaction on a weekly basis.

July 2020

- Banks were advised about the application of IFRS-9 guidelines while accounting for losses incurred due to 6-months moratorium period for household loans and were allowed to gradually (25% per year) account for such losses in their CAR reports during 2021 to 2024.
- Banks were instructed regarding the postponement of scheduled payments of clients impacted by the pandemic, stipulating not to charge interest on the accrued/unpaid interest during the moratorium period.

Financial Stability:

March 2020

- Frequent meetings with banks' executive management were held to discuss the measures that were being taken to ensure financial stability.
- All local banks were required to urgently activate emergency and business continuity plans.
- Kuwait Banking Association announced a moratorium period of up to 6 months on bank loans including waiver of interest and charges (if any) for retail clients (including both citizens and expats) and SMEs.
- Affected customers of banks were allowed to postpone repayments for 6 months without incurring any penalty fees.
- Banks are instructed not to execute any sales of assets held as collateral against loans/financing unless the customer requests - until markets stabilize and economic conditions improve. In all such cases, banks were required to provide CBK with full details of the transactions.

April 2020

- Banks were instructed to adequately review the portfolio of each client, and all investment portfolios in addition to performing stress tests to assess their viability.

May 2020

- Banks were required to report on a weekly basis, the concessionary loans provided to clients impacted by the pandemic.

June 2020

- Against the backdrop of low oil prices and pandemic induced economic contraction, CBK conducted Covid-19 specific stress tests, identifying both bank and system level vulnerabilities guiding banks towards necessary steps to ensure their continued resilience.

July 2020

- Banks were instructed to submit quarterly reports, audited by external auditors, of their cost of financing to corporates and SMEs impacted by the pandemic.

Payments & Settlements:

March 2020

- CBK continued to perform its tasks related to the main operations, security procedures, payment and settlement systems and electronic clearing of checks during the leave period approved by the Cabinet.
- Banks were instructed to continue providing the basic financial services to the public without interruption, making banking services through electronic channels and points of sale (including cash withdrawals and deposits) available to carry out transactions quickly, efficiently and safely.
- Continuous maintenance of ATM machines was ensured, along with the availability of sufficient banknotes to meet any public needs without interruption. Processing of cheques as well as internal and external financial transfers were also continued uninterrupted.
- Call centers at banks continued to operate and answer all customer inquiries.
- Banks were advised to continue providing banking services to commercial companies supplying commodities linked to food security and community needs.
- Fees/charges on POS/ATM/Online Banking were waived for 6 months.
- The limit on contactless payments was increased from KD 10 to KD 25 to reduce the need for cash payments.
- CBK ensured continued provision of the necessary financial services to the public, including providing cash to banks around the clock, in addition to opening communication channels to provide the necessary support to banks to continue to perform their vital role in the economy.

Social Responsibility:

February 2020

- Banks, as well as the K-Net, were advised to provide hand sanitizers at all ATMs and POS machines.

March 2020

- Four-week isolation and sorting of banks notes was ensured before re-circulation. CBK also disinfected its vaults, bank note counters and sorting machines to protect the public.
- Banks were instructed to provide financial compensation and moral support to all workers from the banking sector during the vacation period approved by the Cabinet.
- CBK established a fund of KD 10 million, funded by Kuwaiti banks, to support state efforts to counter the impact of Covid-19 pandemic.

May 2020

- CBK, with the cooperation of local banks and K-Net, established an online platform for the distribution and exchange of Eidiya (i.e. exchange of money between families for the Eid occasion).

June 2020

- CBK published its own 'Return to Work' protocols, and oversaw similar protocols for banks and respective branches.

July 2020

- A circular was issued by CBK to all regulated entities to accept the Kuwait Mobile ID (electronic version of the civil ID).

September 2020

- The Institute of Banking Studies, under the supervision of CBK, continued to provide the Kafa'a Training Program for fresh graduates entering the banking sector via online platforms, utilizing modern E-learning methods.

CHAPTER 2

LOCAL FINANCIAL SYSTEM OVERVIEW



Kuwait has a bank-centric financial system, with the banking sector accounting for more than 80% of the domestic financial sector. Investment companies, exchange companies, and insurance companies constitute the rest. This chapter covers entities under the supervision of CBK, specifically banks, investment companies, and exchange companies.

Banking Sector

In terms of composition, the banking sector consists of 11 banks, five conventional, five Islamic and one specialized, as well as 12 foreign bank branches¹. Moreover, Kuwaiti banks have a sizable presence in numerous other countries, with total assets of their subsidiaries and branches abroad accounting for 21.2% of the consolidated banking system.

Despite a contracted nominal GDP, the banking sector maintained its positive trajectory

Amid the challenging year of 2020, the banking sector's assets recorded a relatively modest growth rate of 2.9% when compared to the 8.2% growth rate in the previous year (figure 2.1). In absolute terms, a total of KD 2.4bn were added to the banking system's assets which now stand at KD 85.4bn. As a result and as the pandemic's impact materialized on GDP, Assets to Nominal GDP ratio reached 263% in 2020. Similarly, and induced by the historically low rates and the Covid-19 environment, both loans and deposits increased during the year by 4.8% and 4.1% respectively which as a result pushed the Loans/NGDP and Deposits/NGDP ratios to 167% and 188% respectively (figure 2.2).

The current year continues to highlight the reliance of Kuwaiti banks on core lending activities. When examining the balance sheet composition, the prevalence of traditional instruments is clear (figure 2.3) as Net Loans account for 60.7% of total assets with a total of KD 51.8bn. Total investments, comprising of exposures to government securities, other fixed income instruments, equity and real estate, contribute 16.8% of total assets in 2020. In contrast, the share of Due from Financial Institutions decreased to 8.2% in 2020, in favor of a higher share by Due from CBK. Overall, and over the year, the balance sheet displayed a relatively consistent and stable composition.

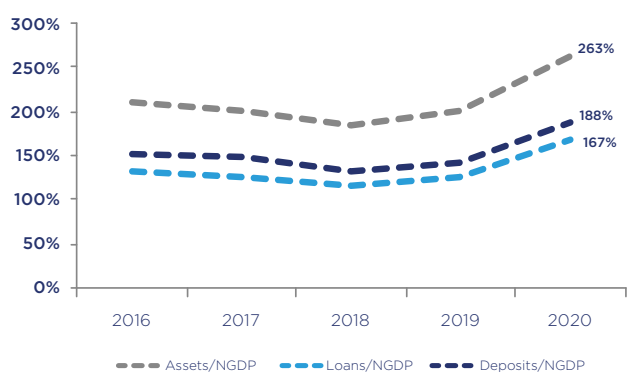
On the liabilities and equity side (figure 2.4),

it is evident that the balance sheet was mainly funded by deposits which account for 63.1% of the total liabilities compared with 59.3% in 2019.

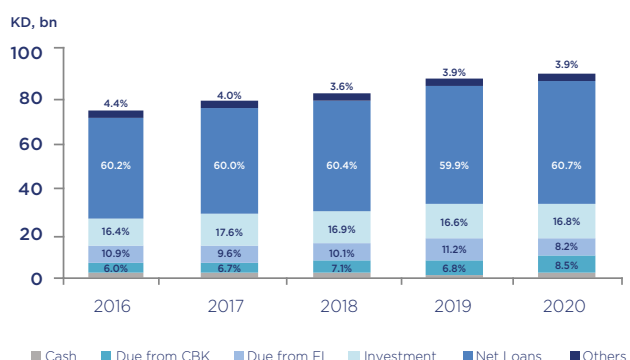
2.1 Banking System Assets



2.2 Banks' Indicators relative to NGDP

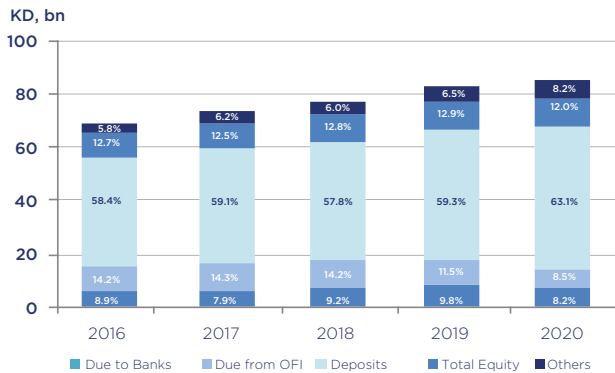


2.3 Decomposition of Assets



¹ Due to data limitations, the analysis does not cover the performance of foreign banks.

2.4 Decomposition of Liabilities and Equity



Moreover, the share of Due to Other Financial Institutions receded from 11.5% to 8.5% due to large withdrawals from a single institution. All in all, the banking sector demonstrated resilience in a challenging year, as they maintained a healthy deposit base and stable funding structure. Shareholders' equity posted a slight drop mainly attributed to losses of KD 334m related to the moratoriums for Consumer and Housing loans in 2020.

Islamic banks maintained growth in their share of the aggregate banking sector

With total assets of the banking system reaching KD 85.4bn, Islamic banks are steadily closing the gap between their conventional counterparts, as their share increased to approximately 45% of aggregate assets (figure 2.5). Up from 42% in 2019 and 40% the year before, the growth in assets is a result of two key factors. The first was a strong growth witnessed in a few Islamic banks which included Boubyan Bank's acquisition of Bank of London and the Middle East. The second factor was the 2.7% decline in conventional banks' assets during the year 2020.

2.5 Conventional & Islamic Banks' Assets



While it is natural for the relatively new Islamic banks to drive their segment in terms of growth, these developments highlight the success of the hybrid domestic banking system. The healthy competition, between segments and among individual banks, promotes customer choice and motivates higher quality services.

Unlike in 2008, banks played a key role in aiding the economic recovery amidst the pandemic

During 2008, banks globally appeared to be insufficiently capitalized and thus, contributed to the propagation of the crisis. In 2020 and aided by measures put in place by regulators and the relevant authorities, banks played a supportive role. In the face of a severe liquidity crunch caused by the pandemic, banks acted as facilitators for the recovery rather than a magnifying transmission channel of the initial shock. This role manifested in the 4.8% growth of the aggregate credit portfolio in 2020, a rate that is usually witnessed in normal years.

As a testament to the role banks played to support business finances, Corporate Loans grew by 5.2% during 2020. Still the largest share, Corporate Loans now represent 71.1% of

“

With total assets of the banking system reaching KD **85.4bn**, Islamic banks are steadily closing the gap between their conventional counterparts, accounting for **45%** of said assets.

”

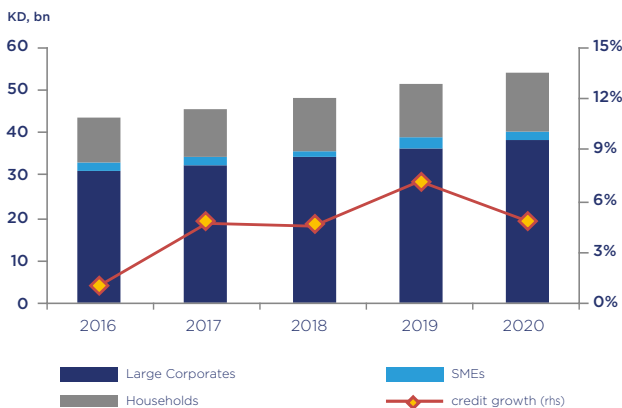
“
Household loans, the second largest and relatively less risky sector, grew by 8.5% during the year, the highest growth rate among all sectors.
 ”

the KD 54.3bn gross loan portfolio (figure 2.6)

Household Loans, the second largest and the relatively less risky sector, led in terms of growth, increasing by 8.5% during 2020. Household Loans now represent 25.2% of the total portfolio. This potentially highlights the overall conservative risk appetite, natural in a crisis. From a demand side, this growth can be seen as a positive indicator for consumption and expenditure as 2020 proved to be a challenging year in terms of economic activity. This recorded growth came despite the lack of typical consumption channels such as travel and lockdown measures that were put in place in early 2020. Other factors such as the historically low interest rates and loan postponements may have also motivated demand. Despite measures taken by CBK in this regard (e.g. lowered risk-weighting), banks’ risk perception of SMEs during a crisis year was an obstacle for growth, where loans to SMEs contracted during 2020. Moreover, banks may have delayed lending to SMEs in anticipation of the loan guarantee law which was approved in 2021. Loans to SMEs at end of 2020 account for 3.7% of the total loan portfolio.

Breakdown by currency shows that the banking system maintained a consistent level of currency exposure (local vs. foreign currency) during 2020 with lending in domestic currency

2.6 Gross Loans-by borrowers' type



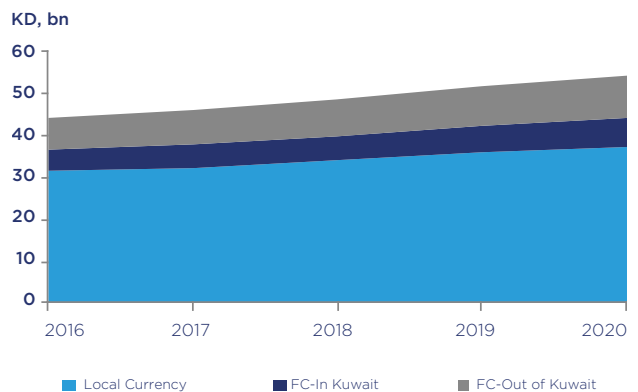
representing approximately 68.3% of gross loans (figure 2.7). This is considered a positive indicator as it signifies more money was directed and circulated within the local economy. In addition, it is worthy to note that around 60.9% of foreign currency (FC) loans were granted by Kuwaiti banks’ subsidiaries and branches abroad.

In terms of geographical distribution, loan allocation reveals a similarly concentrated portfolio across regions. Naturally, Kuwait attained the lion’s share with 72.9% of the total, while the remaining portion was distributed across Europe and the GCC countries (figure 2.8). When compared to 2019, loans granted to clients in Europe edged up to 11.1% from 9.6%, while loans to the GCC region declined to 9.6% from 10.6%.

The Household and Real Estate sectors continued to be the largest recipients of bank credit

In terms of the sectoral breakdown, the Households and Real Estate sectors collectively represent 46.6% of the lending portfolio. Growth in the Industry and Services sectors, both of which were negatively impacted by the Covid-19 crisis, was also observed during 2020 at 10.5% and 9.8% respectively. Growth

2.7 Gross Loans-by currency



The bulk of the loan portfolio remains concentrated domestically at **72.9%**, while loans to European and GCC borrowers account for 11.1% and 9.6% respectively.

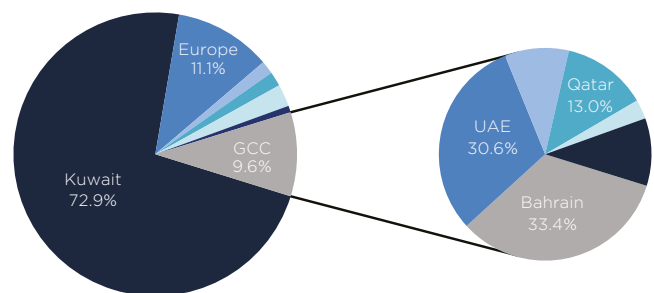
in the remaining sectors (primarily Trade, Equity Purchase and Construction) remained relatively muted during the year as a result of low economic activity and write-offs of non-performing loans (figure 2.9). Overall, Kuwaiti banks have followed a conservative approach by avoiding sudden changes in lending practices, thereby mitigating the risk of a material shift in their risk profiles and aiding a stable recovery path post-pandemic.

Despite market volatility, banks managed to achieve a 3.8% growth rate in their investment portfolios

Relative to the growth of 6.7% witnessed in 2019, banks' total investments experienced a modest growth rate of 3.8% during 2020. The banking sector's investment portfolio, which accounts for 16.8% of total assets, grew by KD 520mn, mostly in the form of fixed income investments. The total investment portfolio stood at KD 14.3bn at year-end (figure 2.10).

In terms of value, investments in government securities remained flat in 2020, while their share in total investments declined by 1.7 percentage points to reach 55%. Other Fixed Income Securities represent approximately 25.5% of the total, up from 21.4% in 2019. Equity

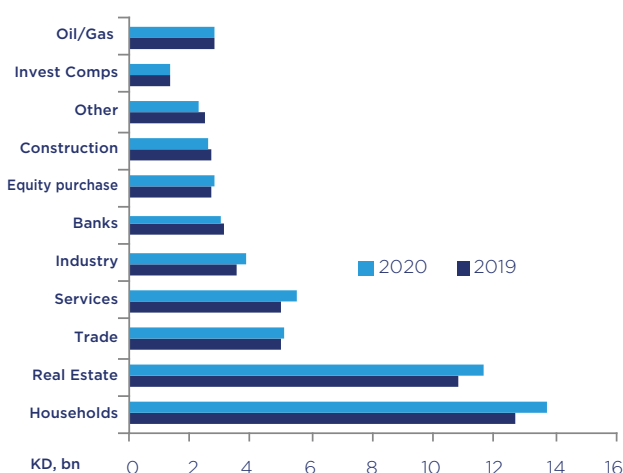
2.8 Loan Portfolio-by region



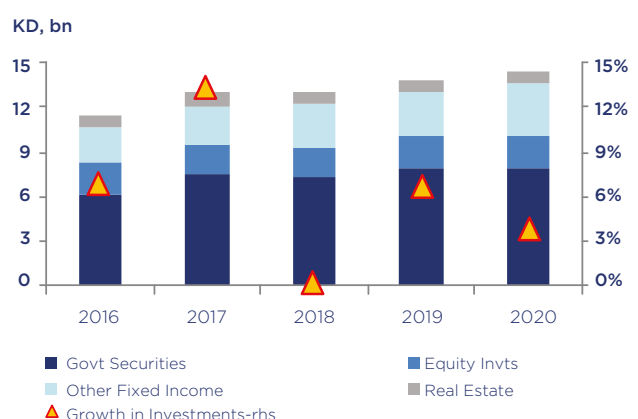
and real estate investments on the other hand witnessed a slight decline both in terms of value and share at 14.6% and 5% respectively, compared to 16.1% and 5.9% in 2019.

The geographic allocation of the investments (figure 2.11) reveals continued concentration of investments within the GCC countries at 69.2% (including Kuwait) in 2020. However, this concentration declined compared to the previous year's 73.2%. Moreover, the distribution indicates that banks' investments within Kuwait declined for the third year in a row, from 45.3% in 2017 to 31% in 2020. The declining exposure to sovereign debt securities can be mainly attributed to the lack of sovereign domestic

2.9 Gross Loans by borrowers' type



2.10 Banks' Investments- by type

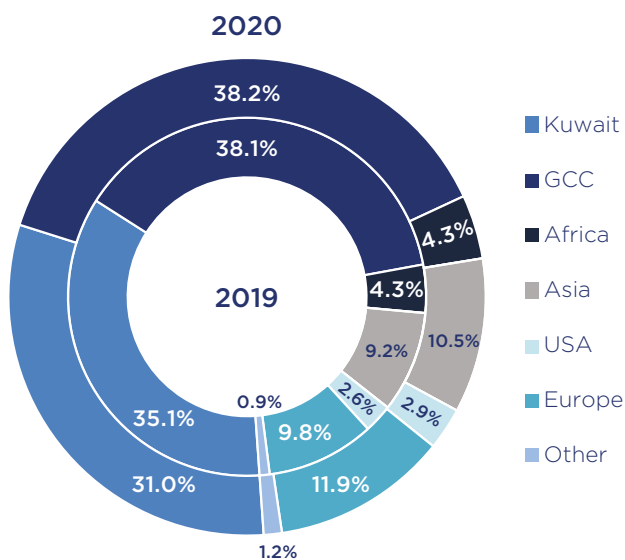


debt issuances, a primary driver of banks' local investments. The diversification away from Kuwait positively contributed towards growth in investments in Europe and Asia. On the other hand, investments in the GCC, USA, and Africa posted minor movements in their share during 2020.

Fueled by constrained spending, retail deposits grew to an all-time high, offsetting the decline in deposits from Other Financial Institutions

Total deposits in the banking system reached

2.11 Banks' Investments - By Region



an all-time high of KD 61.1bn, of which 78.1% were in the form of local deposits. Despite the Covid-19 induced lockdowns and social distancing measures, deposits grew by 4.1% in 2020 compared to 6.4% in 2019 (figure 2.12). The lower growth rate witnessed in 2020 was influenced by the gradual yet significant withdrawals stemming from a single depositor.

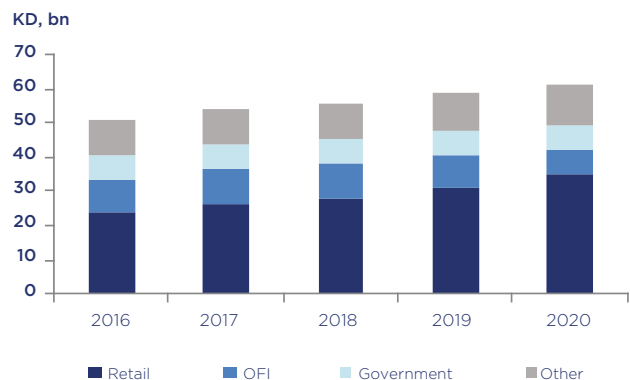
In terms of type, the breakdown of depositors shows that the increase was driven by the private sector, namely individuals and corporates (figure 2.13). Retail deposits witnessed a significant increase as they rose by KD 4.0bn during the year, representing more than 56% of total deposits. While this demonstrates confidence in the local banking system by the public, banks should be mindful that these private deposits may revert to their typical levels once lockdowns, closures, and travel restrictions are lifted.

Deposits from Other Financial Institutions on the other hand, witnessed a sharp decline. This was mainly due to the shift in the investment strategy of one of the sector's largest depositors. Although historically, the mentioned depositor was a major source of funding for the local banking system, it no longer holds a significant share as banks succeeded in diversifying their funding sources.

2.12 Deposits of the Banking System



2.13 Deposits of the banking system



“

The number of licensed Islamic finance and investment companies have continued to decline over the years, falling from **35** companies with total assets of KD **3.5bn** in **2019**, to **32** companies with total assets of KD **3.2bn** in **2020**.

”

Investment Companies

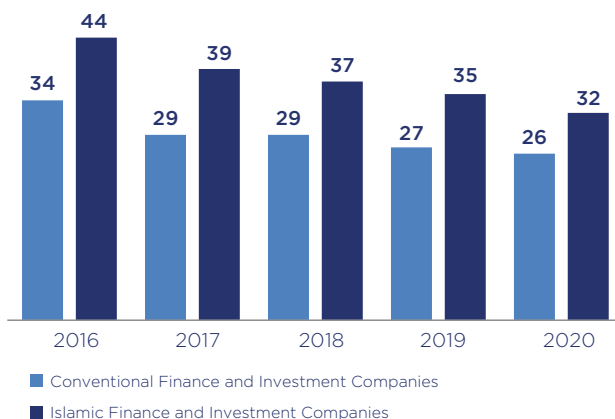
Over the years, the number of licensed investment companies (including one finance company) regulated by CBK have gradually decreased to 58 companies from 78 in 2016² (figure 2.14).

Given banks' dominance over financing services, investment companies struggled to justify compliance costs resultant from the simultaneous adherence to the Capital Markets Authority's (CMA) and CBK's regulations, pressuring them to discontinue financing activities. Naturally, the decrease led to a simultaneous decline in aggregate assets for both conventional and Islamic companies as they reached KD 5.8bn in 2020, representing a 7.8% yearly decline.

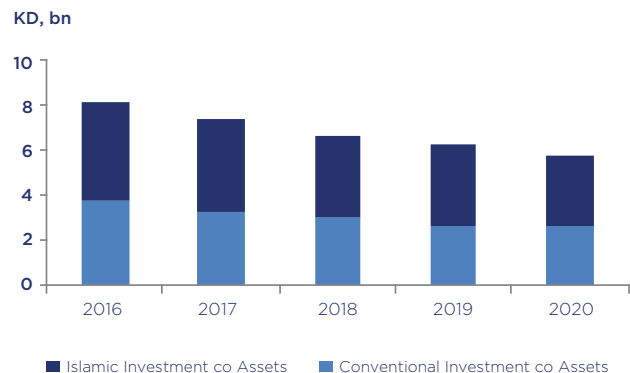
The number of licensed Islamic finance and investment companies have continued to decline over the years, falling from 35 companies with aggregate assets of KD 3.5bn in 2019 to 32 companies with aggregate assets of KD 3.2bn in 2020 (figure 2.15).

In percentage terms, this marks a relatively sharper decline of 10.3% when compared to the decline of 2.9% witnessed in the previous year. On the other hand, aggregate assets of conventional investment companies recorded a moderate decline of 4.4% during 2020, totaling KD 2.6bn (9.7% in 2019). Based on average assets per company, the decline would be less significant at 0.7% for conventional and 1.9% for Islamic companies. Interestingly, the declining trend flattened during the year 2020

2.14
Number of Investment Companies



2.15
Investment Companies' Assets



² In this section, investment companies with financing activities are included, and since there is a single financing company, figures for both financing and investment are titled "Investment Companies".



Exchange Companies

Total number of exchange companies has been on a declining trend over the past few years, dropping from 41 to 40 companies in 2019, then further down to 38 companies by 2020.

Despite the decreasing number of companies, the asset base of the industry demonstrated resilient growth, reaching an all-time high of KD 254mn in 2020 (figure 2.16).

Compared to the previous year's 15.5%, this year posted a moderate growth rate of 11.1%. The effective assets growth rate, measured as growth rate in average assets per company, revealed a 16.9% growth during 2020.

Exchange companies have continued to post increasing revenues, with profitability reaching all-time highs

Exchange companies have recorded higher revenues and greater profit margins during 2020. The primary source of income for exchange companies, which accounts for more than two thirds of the total, continues to be the Sale of Currencies (figure 2.17). Other Income consists of commissions, transaction fees, bank interest among others. It is worth noting that the 29.4% increase in revenues is attributed to the exodus of expats from the country during 2020,

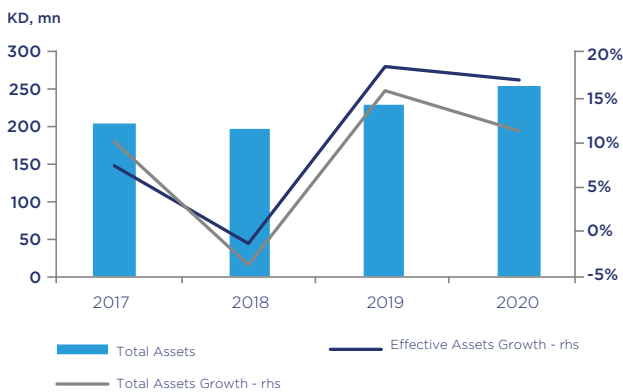
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The continued growth and performance of exchange companies is a positive indicator, adding more diversity to the financial system.

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Despite the decreasing number of exchange companies, the asset base of the industry demonstrated resilient growth, reaching an all-time high of **KD 254mn** in 2020

2.16
Exchange Companies Assets

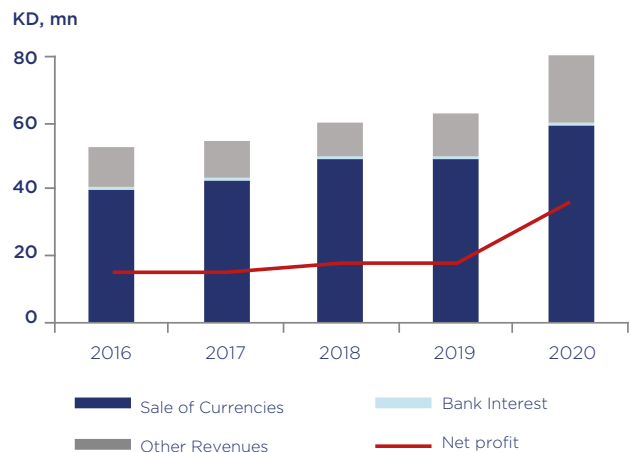


which pushed the sale of currencies upwards and contributed towards higher margins.

Key financial indicators such as the return on assets (ROA) rose significantly during the year, and reached 14.3% from 7.9% in 2019 (figure 2.18). Similarly, the return on equity (ROE) nearly doubled during the year, reaching 26.1%.

The growth and performance of exchange companies is a positive indicator for the financial system as a whole, adding diversity and dimensionality to the industry.

2.17
Components of Profitability:
Exchange Companies



2.18
ROA & ROE: Exchange Companies



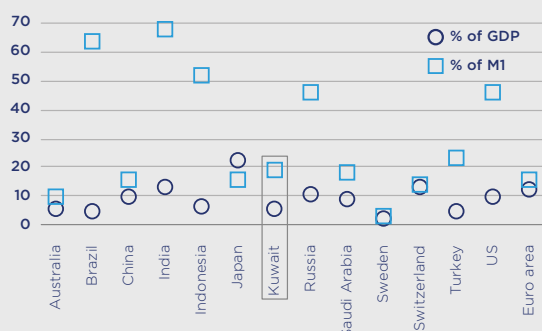
BOX 2.1: CASH OR CASHLESS: WHERE ARE WE HEADING?

In recent years, the growing penetration of digital technologies has drastically changed the payment landscape by offering greater convenience, better efficiency and higher inclusion. The widespread popularity and adoption of e-payments have also fueled a raging debate about the future of cash. Impressed by the growing footprint of digital payments, some observers argue that cash would soon become irrelevant, if not eliminated.

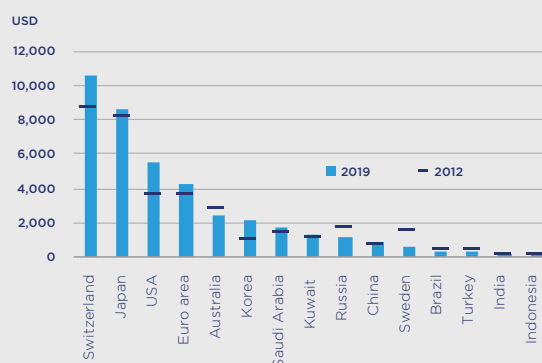
Contrary to such claims about its sharp decline or the ultimate demise, cash usage remains strong in a broad range of countries, including many advanced economies. While currency in circulation (CIC), against certain benchmarks, has declined in a few countries, the overall trends by no means exhibit its visibly diminished role, let alone disappearance. The media headlines about the imminent death of cash, using the example of countries like Sweden, appear somewhat overblown.

Indeed, CIC as a percentage of GDP in Sweden has been receding and now stands at a historically low level of 1.3% (Figure A). However, Sweden is an exception even among the group of advanced nations. For instance, the same ratio for Switzerland, Euro area, and the US stands at 12.1%, 11.1% and 8.3% respectively and is substantially higher in the case of Japan (21.3%)¹. For Kuwait, it was around 4.6% in 2019 compared to 7.3% for the neighboring Saudi Arabia. Relatively higher ratios for advanced countries might appear intriguing, given their

A
Currency in circulation (CIC) in 2019



B
CIC per inhabitant



technological advancements. However, strong foreign demand for international currencies like US dollar, Japanese yen, euro and Swiss franc partially explains elevated CIC ratios in these economies. In the case of Japan, its aging population may also have somewhat contributed towards their greater preference for cash.

¹ Data has been taken from the Bank for International Settlements (BIS) and is latest of 2019.

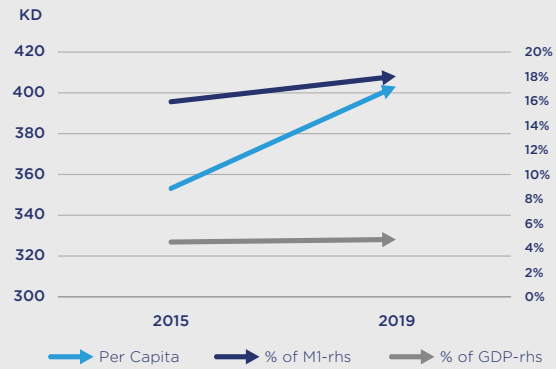
The continuing significance of cash is also evident from the percentage share of CIC within the narrow definition of money (M1). Among the selected economies exhibited in Figure A, the share is highest for India (65%) and lowest for Sweden (2.1%). Again, as the public in Sweden has largely moved away from cash, its presence remains strong in many other economies, including the Euro area.

Similar trends could also be spotted in the data for CIC per inhabitant across some select economies (Figure B). Compared with 2012, CIC per inhabitant has increased in 2019 for Japan, Korea, Saudi Arabia, Switzerland, USA and European Union, though dropping in economies like Australia, Russia, Sweden and Turkey². Despite the considerable variation across countries, the overall trend between 2012 to 2019 points towards steady use of cash in many economies and runs counter to the arguments that cash is vanishing.

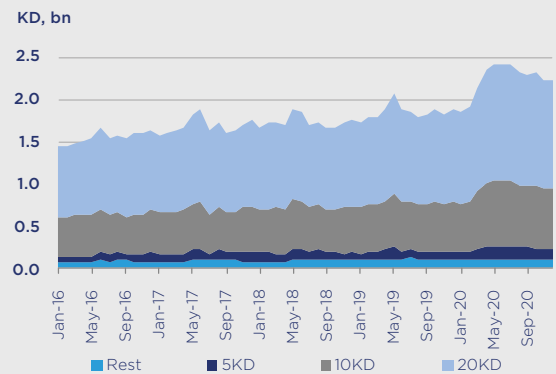
In the case of Kuwait, the share of CIC has increased on virtually every criterion, whether as a percentage of GDP and M1 or in per capita terms (Figure C). Specifically, CIC per capita has increased from KD 353 in 2015 to KD 402 in 2019. Share of CIC in M1 has also improved, from 16% to 18% during the same period. Admittedly, CIC as percentage of GDP has inched up just marginally, from 4.3% to 4.5%. Still, these trends collectively underscore the fact that significance of cash in Kuwait remains strong and is by no means declining.

If anything, Covid-19 pandemic has given cash a new lease of life, with CIC in Kuwait sharply increasing during the early months of the outbreak (March to June 2020) (Figure D). Though the rising trend in CIC has tapered off since July 2020, the level still remains elevated by historical standards. The initial surge in CIC might partially be due to the limitations faced by

C Kuwait-CIC Over Time



D CIC by Denomination

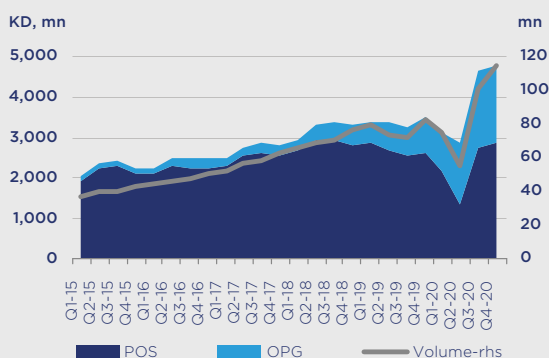


retailers in depositing back the cash with banks, given reduced operating hours or even closure of many bank branches from March to June. Yet a part of the rise in CIC could also be attributed to precautionary demand for money, as panic driven cash hoardings typically surge in uncertain times. Recent research by Ashworth & Goodhart (2020) highlights such spikes in cash hoardings across major economies since the outbreak of the pandemic³.

2 ibid

3 Ashworth, J and C A E Goodhart (2020), 'Coronavirus panic fuels a surge in cash demand', VoxEU.org, 17 July, 2020.

E
Value & Volume of Transactions



While the presence of cash in Kuwait remains strong, and has rather increased over time or even during the pandemic, this does not negate the fact that both the use and popularity of electronic payments are also growing strongly. Over the years, value of transactions executed through POS terminals as well as the K-net’s Online Payment Gateway (OPG) have steadily increased (Figure E). The trend in volumes (number of transactions) also paints a similar picture. Moreover, significance of OPG has also sharply grown in recent years, albeit from a fairly low base when compared with the value of transactions made through POS terminals. In particular, the surge in online shopping during the pandemic has cemented the role of OPG as a popular means of payment. The only aberration in the rising trajectory of transaction values and volumes is the precipitous collapse around March 2020, reflecting the impact

of Covid-19 induced lockdowns and ensuing contraction in economic activity. Still, transactions have posted a strong V-shaped recovery since the easing of lockdowns, with both values and volumes initially surpassing the pre-pandemic levels on the back of pent up demand⁴.

The rising trend in the use of electronic payments in Kuwait is duly supported by the growing e-banking infrastructure (Figure F). For instance, the number of POS terminals have more than doubled from 31,686 in 2013 to over 71,926 in 2020. During the same period, number of plastic cards have increased from 3.6 to 4.9 million.

The foregoing discussion highlights a parallel rise in both electronic payments as well as the currency in circulation in Kuwait. Similar trends have been observed in many other countries. This obviously contradicts with the general perception that the growing adoption of digital payments has decimated the use of cash. Probably it is a mistake to treat digital payments as some perfect substitute for cash. While a considerable degree of substitution is certainly possible, our analysis suggests that such substitution is neither perfect nor taking place fast enough. It appears that even as cash’s traditional function as a medium of exchange is increasingly being captured by the digital platforms, cash still enjoys a sizeable role as a store of value⁵.

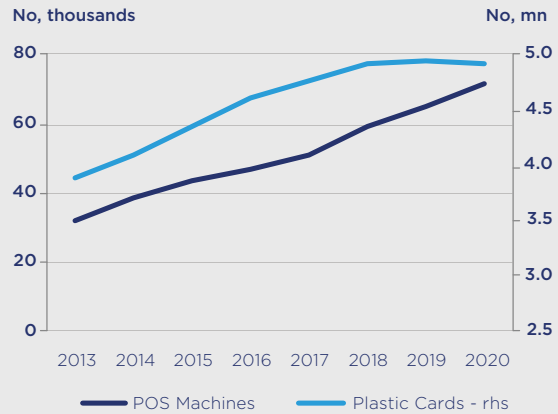
4 See Box 6.1 for details.

5 In some countries, cash use even for everyday transactions is still fairly high. For instance, in Germany, almost 74% of the POS transactions in 2017 were reported to have been made through bank notes and coins. A recent survey indicates that cash usage has declined during the pandemic, though still accounting for 60%.

Heightened uncertainty this year has potentially reinforced this aspect further. This explains the surge in cash holdings in Kuwait (and elsewhere) amid the pandemic even at a time where bulk of the transactions were taking place through e-payment portals⁶.

Against this backdrop, the future of cash does not seem as bleak as proponents of digital payments might foresee. Though it is reasonable to expect that the use of cash in our economies will eventually go down, it would not necessarily be out soon enough. Rather record low interest rates might even bolster the appeal for cash as opportunity cost in terms of forgone returns has collapsed. Moreover, the risks associated with the digital payments, like cyber-attacks rendering the payment systems inaccessible or potential exclusion of less literate and/or

F E-banking Infrastructure in Kuwait



aging population, may also help cash stay relevant. These elements suggests that the outlook, at least in the near term, is seemingly skewed more towards a 'less cash' than a 'cashless' society.

⁶ As highlighted in Box 11, CBK took a number of steps to promote the use of e-payments, given the risk of Covid-19 transmission through notes. Such measures included waiver of fees/charges on POS/ATM/Online Banking for 3 months as well as the increase in the limit on contactless payments from KD 10 to KD 25 to reduce the need for cash payments.

CHAPTER 3

BANKS' RISKS





The key to ensuring a sound financial system lies in prudent supervision and proactive risk identification. The quantification of potential risks faced by the banking system, and ultimately, financial stability, is crucial to gain a clear perspective on the magnitude of potential losses faced by the financial sector. Hence, this chapter examines the four key risks faced by banks; credit, liquidity, market, and operational risk, and their implications on financial stability.

CREDIT RISK

Crisis implications elevated credit risk; however, actions such as loan moratoriums helped mitigate it

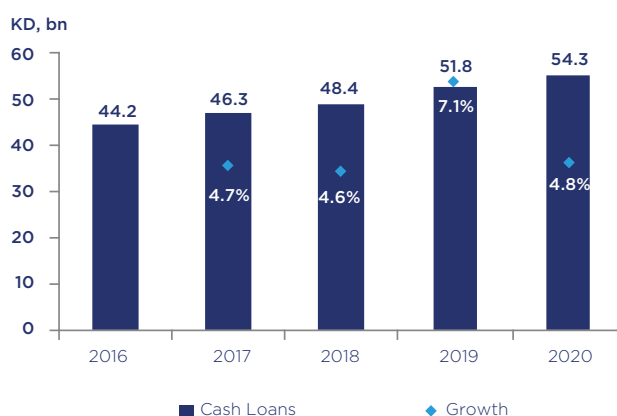
The consequences from the Covid-19 crisis were far-reaching and left almost no economic sector untouched. Given banks' exposure to the various impacted sectors, credit risk implications put banks' resilience under scrutiny. Highlighted by the dominance of credit risk-weighted assets (CRWA) within the total RWAs (91%), the transmission channel to the banking sector was clear and significant. Although the bulk of these credit exposures come in the form of loans to economic agents, they also manifest in dealings with other banks (interbank deals or placements) and fixed income investments in the form of counterparty credit risk.

Amid the pandemic and the uncertain, uneven recovery path, the anticipation and subsequent quantification of credit losses proved to be challenging. Consistent with the effects observed globally, Kuwaiti banks experienced heightened credit risk and increased credit losses as the crisis unfolded. However, loan moratoriums put in place to curb these negative implications partially alleviated pressure exerted on borrowers. As a result of the temporary halting of debt service payments, the recognition of credit losses was partially deferred.

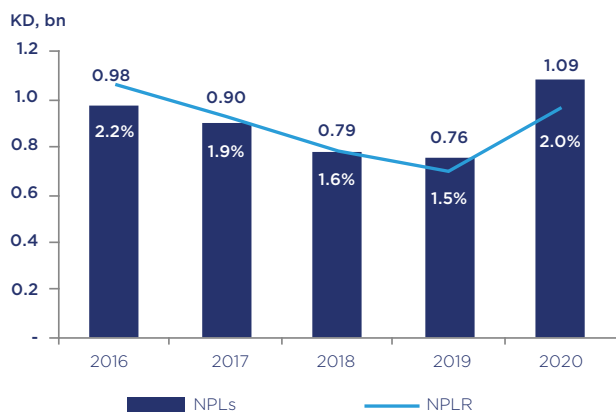
Measures introduced by CBK helped maintain the positive growth in credit facilities

Banks played a counter-cyclical role during the crisis, growing the aggregated loan portfolio by 4.8% to KD 54.3bn by year-end (figure 3.1). This growth was partially enabled by macroprudential measures in the form of the easing of capital and liquidity requirements, which gave banks extra capacity to lend. Thus, banks were able to provide the liquidity support enabling borrowers to prevent the transformation of a liquidity crunch to a solvency threat (refer to

3.1 Loan Portfolio



3.2 Non-Performing Loans



Box 1.1 for more information on measures taken during the crisis). From the borrowers' side, demand for loans was supported by historically low rates, and anticipation of another round of loan postponements may have also played a role in fueling the demand.

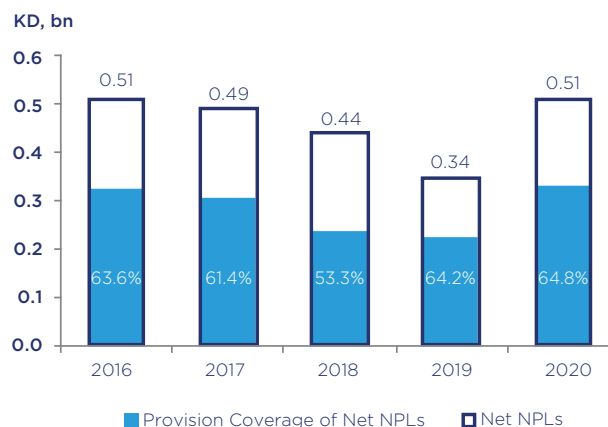
All in all, the monetary policy stance and macroprudential policy measures may have spurred loan growth, although it remained in-line with figures seen during 2017 and 2018.

The non-performing loans ratio (NPLR) increased slightly, yet remains at historically low levels

The NPLR experienced its first increase since the Global Financial Crisis (GFC), rising 0.5 percentage points to 2%. Although these figures partially reflect the crisis's impact, the implications may appear fully once the effects of the loan moratoriums and other support measures dissipate.

Total outstanding NPLs saw a KD 332mn (43.8%) yearly increase by the end of 2020 (figure 3.2). Newly added NPLs were almost three times the size of the YOY increase at KD 1bn, but were mitigated by KD 505mn of write-offs. These write-offs were enabled by a healthy

3.3 Net NPL Coverage



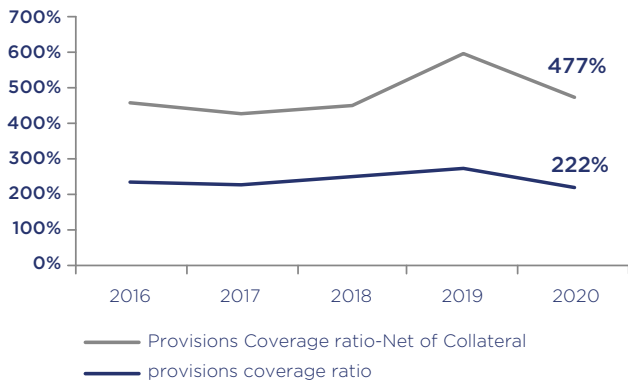
stock of provisions formed over the past years, which proved to be fruitful in the midst of the crisis.

The Real Estate sector was the main driver of outstanding NPLs in absolute terms, contributing KD 124mn of the total YOY increase. However, in relative terms, this is expected as loans to the Real Estate sector constitute the majority of banks' credit portfolios. Consistent with the effects seen globally, the Services and Construction sectors experienced the highest YOY increases of NPLs in relative terms (183% and 128% respectively), as social distancing measures and lockdowns materially hampered demand and supply channels. The clouded outlook also contributed to the halting of budgeted construction projects as future economic conditions became uncertain.

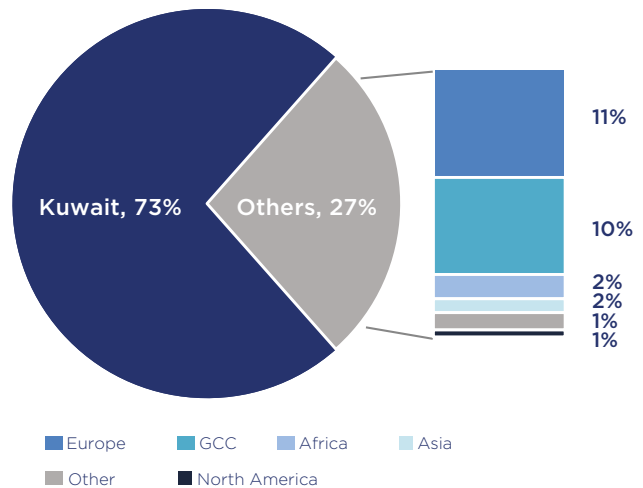
As the year unfolded, provisions also increased, both in the form of general (precautionary) provisions and specific provisions charged against NPLs. NPLs remain well covered, where specific provision coverage of net NPLs (net of collateral coverage) stood at 64.8% by year-end (figure 3.3). Total provisions remain abundant, covering 477% and 222% of net and total NPLs respectively (figure 3.4).

Banks succeeded in maintaining healthy asset quality and played a counter-cyclical role during the pandemic.

3.4 Provision Coverage Ratio



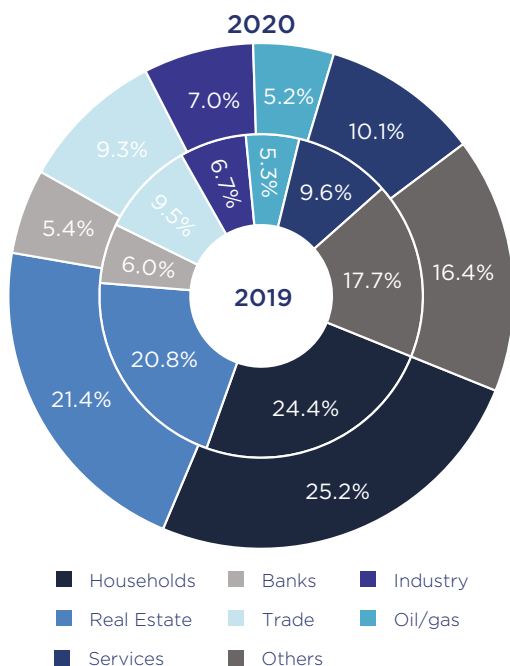
3.6 Loan Portfolio Geographical Distribution



Local banks' loan portfolio remains concentrated in Real Estate and Household sectors

Banks' loan portfolios continue to be exposed to concentration risks, specifically, in Real Estate and Household borrowers (figure 3.5). Household borrowers increased their share in the total loan portfolio by 0.9 percentage

3.5 Loan Portfolio Sectoral Distribution



points during 2020 to 25.2%. Government relief measures coupled with a large portion of the workforce being government sector workers (mitigating job losses and insuring household income) contributed heavily to this increase. Loan moratoriums may have also fueled this increase, as individuals expecting a blanket deferral of loans were more likely to borrow. Similarly, the portion of loans to the Services sector increased, a positive signal indicating support to vulnerable borrowers who might have otherwise defaulted.

As expected, the aggregated loan portfolio is concentrated domestically with loans to local borrowers comprising 73% (figure 3.6). Loans extended to European borrowers represent the second highest portion in the loan portfolio at 11%, most of which are deployed in Turkey. These exposures may amplify the existing credit risks amid a persistently high inflation rate in Turkey and a volatile currency. However, under CBK's supervision, such exposures are taken into account by banks' risk management and are reflected in the formation of provisions.

The fixed income portfolio shows relative geographical concentration in GCC issuers

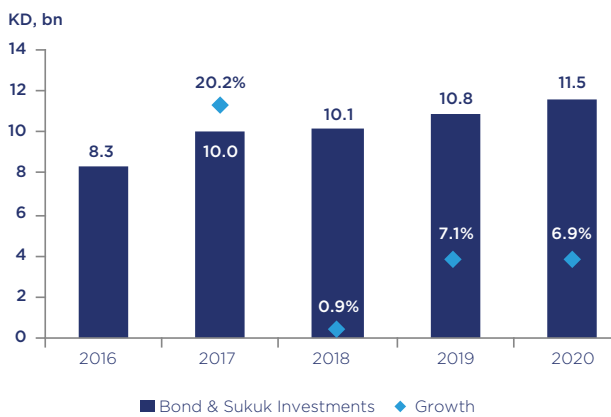
Regarding credit risk within fixed income investments, banks continued to increase their exposures, albeit at a slower pace than that seen during 2019 (figure 3.7). Approximately 32% of the KD 11.5bn fixed income portfolio



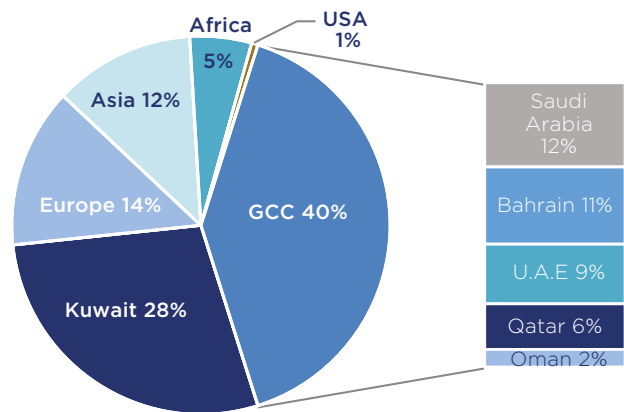
The credit quality of counterparties to Kuwaiti bank placements remains robust, where **80.3%** of interbank dues are held by institutions with an investment grade rating



3.7 FI Investments



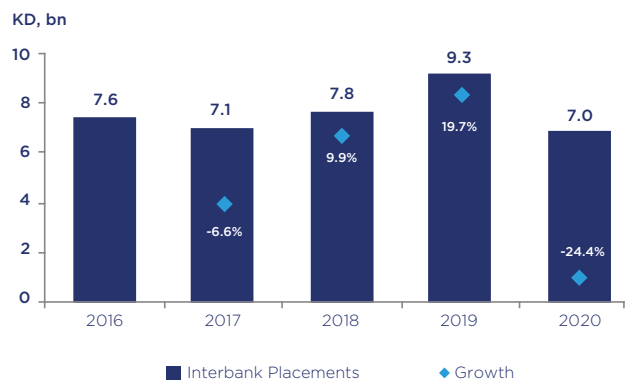
3.8 FI Investment Geographical Distribution



consisted of non-investment grade securities, raising concerns in the face of a potential virus resurgence and possible economic deterioration.

The fixed income portfolio shows relative geographical concentration, as 68% of the securities are issued by GCC borrowers (figure 3.8). This concentration may result in vulnerability to regional shocks, both political and economic, given the relative economic and structural resemblance between GCC nations. Local banks are however familiar with this environment, growing accustomed to operating and managing risks within these markets. Turkish exposures (classified under Europe) also face elevated credit risk by the threat of runaway inflation, and consequently, currency volatility as mentioned above.

3.9 Interbank Placements



Local banks have refrained from risky yield-seeking activities that may prevail in a low interest rate environment

In contrast, the third main credit exposure, interbank dealings and placements, decreased by 24.4% from the previous year (figure 3.9),

highlighting easy monetary conditions and the resultant lower demand for liquidity and liquid instruments. This was seen in both KD and FC denominated placements, each falling by 39% and 21% respectively. The decrease in interbank exposures provides some assurance, as lower exposures reduce the likelihood of a credit event at a single bank flowing through to other banks and inducing a systemic shock.

The credit quality of counterparties to Kuwaiti bank placements remains robust, where 80.3% of interbank dues are held by institutions with an investment grade rating (figure 3.10). The relatively low dealings with banks rated below investment grade (8.9%) provide reassurance by indicating that, to an extent, banks have refrained from risky yield-seeking activities that may prevail in a low interest rate environment.

Low risk exposures represent a higher portion of total credit exposures

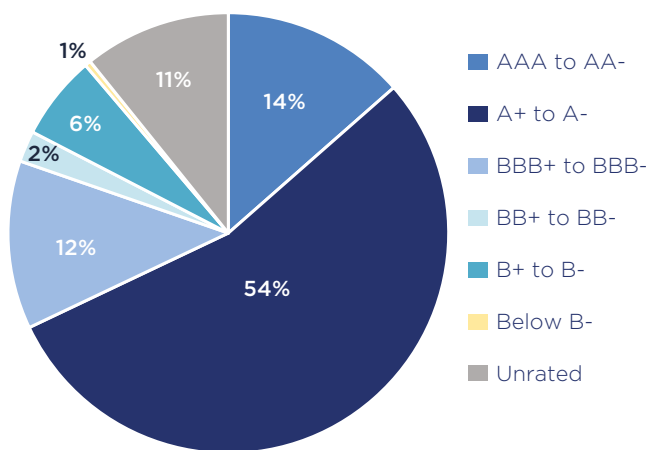
Aggregating all credit exposures and

benchmarking the result against total CRWAs provides useful insight on the overall level of credit risk in the banking sector. As at year-end, total credit exposures remain above CRWAs, a positive indicator signaling a greater portion of assets with a credit risk-weight below 100% (figure 3.11). CRWAs, however, have been growing at a faster pace than total credit exposures over the past four years (6.5% vs. 5% annual growth rate).

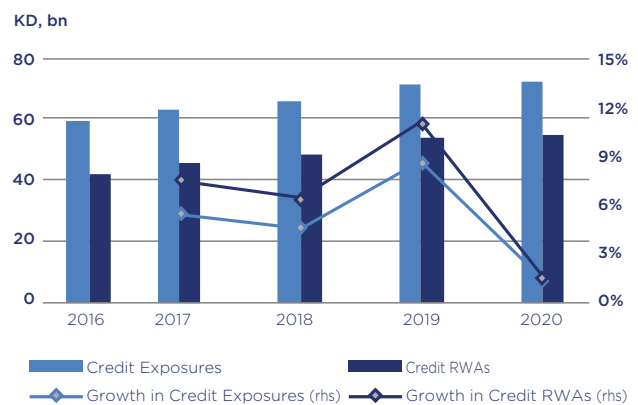
The rise in system-wide credit risk requires closer scrutiny going forward

The expectation of further credit quality deterioration in 2021 necessitates pre-emptive and pro-active measures to mitigate any unexpected shock to the resilience of the banking system. Banks remain well provisioned with KD 2.1bn of available provisions in excess of provisions on specific NPLs. These provisions represent 5.9% of net performing loans (net of collateral coverage) with the capacity to absorb a 3.8 percentage point increase in the NPLR.

3.10 Credit Quality of Interbank Counterparties



3.11 Credit Exposures Vs Credit RWAs





Liquidity Risk

Liquidity risk can be broadly defined as the probability of failure to meet short-term financial obligations. Due to the inherent nature of banks' operations, and the relative reliance on short-term liabilities (deposits) to fund longer-term assets (loans), it is an inevitable risk for a bank to face and manage. The scope, however, extends well beyond these two main components. One key trait of liquidity risk is its "snowball" nature, whereby a liquidity crunch, or a perceived liquidity struggle for that matter, may make acquiring liquidity costly and difficult.

The significance of liquidity risk is further highlighted by the role it played in the two severely impactful crisis episodes, the GFC and the ongoing Covid-19 crisis. However, liquidity related lessons drawn from the GFC were a key factor in dampening what otherwise would have been a more damaging Covid-19 shock.

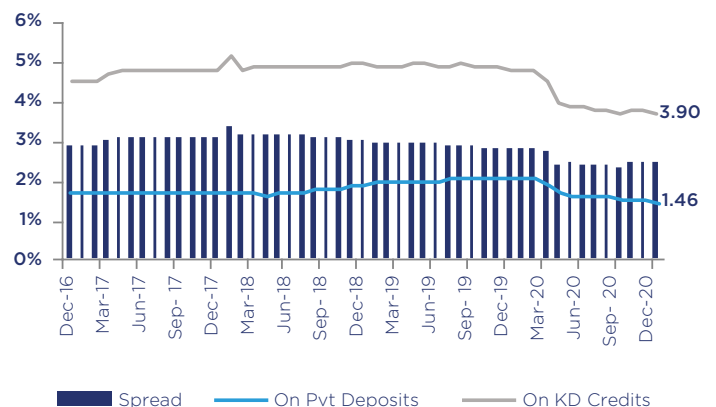
Due to the nature and severity of the crisis, a liquidity crunch was expected, yet regulation helped steer the economy in the right direction

Locally, a prudent yet accommodative regulatory environment supported the existing comfortable liquidity conditions. The most significant traits were the presence of five liquidity requirements, the existence of the Deposits Guarantee Law introduced in 2008, along with other measures taken early in the crisis to widen banks' lending capacity (figure 3.12). For further details, please refer to Box 1.1 "Measures by CBK to mitigate the impact of Covid-19 pandemic".

3.12 Regulatory Liquidity Ratios - Pre and Post Adjustment

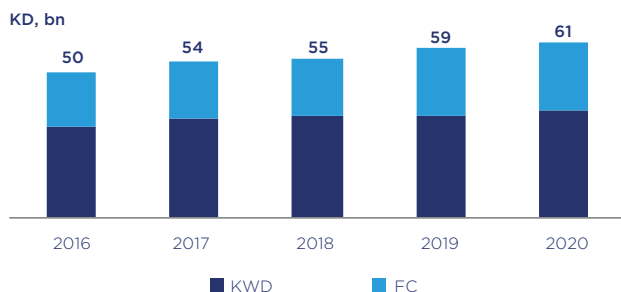
Regulatory Requirement	pre-Relaxation Limit	Post-Relaxation Limit
LCR	100% minimum	80% minimum
NSFR	100% minimum	80% minimum
RLR	18% minimum	15% minimum
MLL	90% maximum	100% maximum

3.13 Weighted Average KD Rates (%)



To draw a broad picture of the local liquidity environment banks operate in, it is relevant to

3.14 Banking Sector Deposits

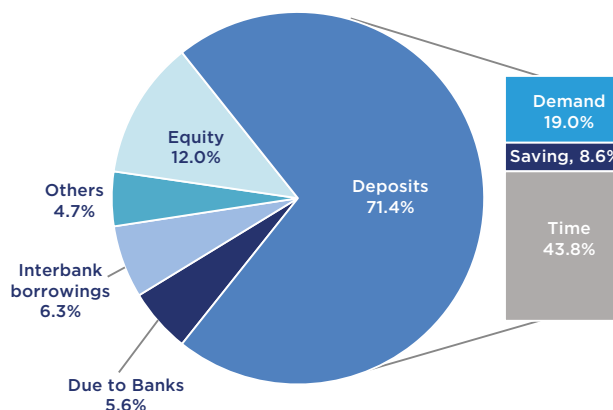


focus on the main source of funds, deposits, and their main drivers. Due to the nature and severity of the crisis, a liquidity crunch was expected. Therefore, in an aim to motivate liquidity flow and ease its allocation towards needing sectors, key monetary policy rates were slashed during the year. As a result, the average return on KD denominated local deposits declined by 25%, compared to an increase of 8% in 2019 (figure 3.13). The weighted-average yield on local currency deposits declined to 1.46% from 1.95%. The drop in yield is expected, as easing monetary conditions materialized in an already liquid banking sector.

Deposits continued to rise despite historically low monetary rates

Despite the historically low key monetary rates, the banking sector was able to maintain the upward trajectory in deposits, reaching an all-time high of KD 61bn (figure 3.14). Led by retail deposits, the increase can be considered contrary to the theoretically expected decline that typically results from lower deposit returns. From a behavioral standpoint, lockdown measures and the resultant obstacles in the face of typical expenditure channels, culminated in the continued growth in deposits supply, and consequently, the banking sector's liquidity. It is worth noting, however, that given the nature and type of the increased deposits, a potential reversal is likely, as the increase theoretically correlated with temporary pandemic related

3.15 Breakdown of Banks' Liabilities & Equity



conditions.

While the deposits composition has been relatively stable over a long time, interesting developments prevailed during 2020. Specifically, the banking sector deposits base was heavily composed of large depositors (e.g., government and semi-government entities). Sharp drops and trend-breaks were witnessed in some of the entities' deposits during the year. However, aided by the spike in retail deposits, banks were successful in managing the historical decrease in this significant segment.

The increase in total deposits boosted their dominating share of the aggregate-level liability structure, accounting for 71.4% of the funding base in 2020 (figure 3.15). While the overall composition has been relatively stable over the years, both Demand and Savings deposits witnessed a 24% spike. The net increase in the share of Demand deposits indicates the growth in less sticky deposits. However, in absolute terms, time deposits still constitute a large portion of the deposit base. Moreover, since Kuwait formally enacted the Deposits Guarantee Law in 2008 to protect all depositors, the risk of bank runs has also been effectively eliminated.



Despite the historically low key monetary rates, the banking sector was able to maintain the upward trajectory in deposits, reaching an all-time high of KD 61bn.



The growth in deposits, coupled with banks' borrowings through bond issuances, were the main contributors to the increased liquidity in the banking system.

Non-core liabilities, mainly interbank borrowings, play an important role when it comes to the banks' needs of short-term liquidity. Given the volatile nature of wholesale funding, which can be swiftly influenced by market sentiments, reliance on non-core liabilities to support the growth in assets can increase the funding liquidity risk for the banking system. Both core and non-core liabilities maintained their upward trajectory, increasing by 4.1%, and 3.8% respectively, while maintaining a relatively stable share of total liabilities when compared with 2019 (figure 3.16).

Lending capacity soared to relatively high levels

The growth in deposits, coupled with banks' borrowings through bond issuances, were the main contributors to the increased liquidity in the banking system. However, and given the prevailing conditions and uncertain business environment, the increased liquidity was not fully channeled to the economy. Mostly, the channeled liquidity either took the form of loans to the real sectors of the economy, or used to purchase liquid assets ready to be deployed whenever necessary.

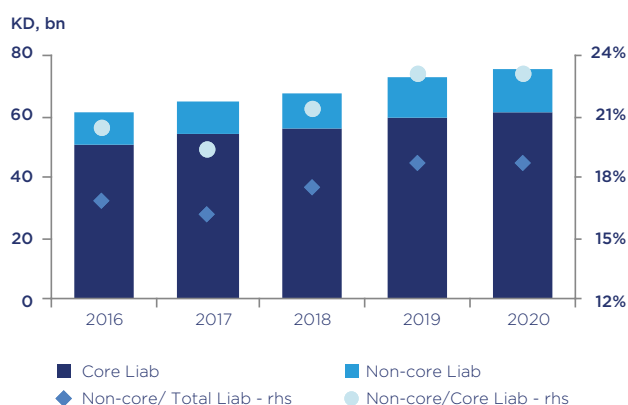
Further facilitated by the macroprudential

measures mentioned above, Kuwaiti banks' lending capacity surged, where the loans to available sources of funds ratio stood at 75.2% (figure 3.17). This indicates healthy utilization of lending capacity, keeping in mind the measures that eased liquidity conditions, while maintaining a buffer in the face of uncertainty. With a maximum allowed lending limit of 100% (90% before Covid-19 relaxation), banks still have KD 13.0bn available to lend.

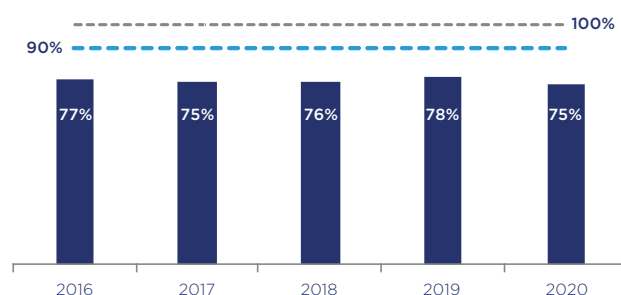
To further elaborate on this key indicator, it is essential to refer to both the demand-side (numerator, loans) and the supply-side (denominator, sources of funds). As described earlier, banks witnessed a spike in liquidity stemming from increased deposits and allowing banks to have a generous room to grow further in lending. On the other hand, as uncertainty cast its shadows and curfews were introduced locally, businesses were reluctant to borrow. Meanwhile, banks were conservative in terms of lending, especially to new clients, given the crisis related uncertainties. To adapt to these circumstances, banks maintained regular growth levels in loans while investing the excess funds in liquid assets.

This is demonstrated on the assets side of the balance sheet. The banking sector's liquid assets,

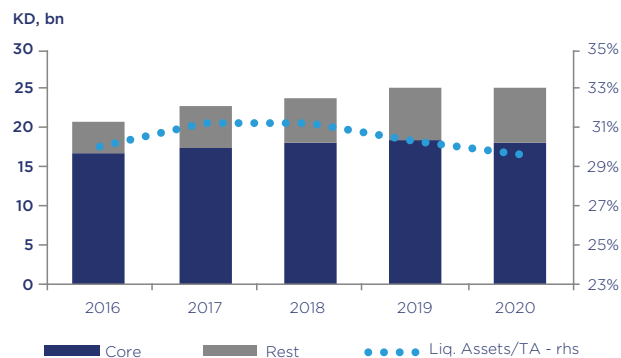
3.16 Non-core Liabilities Ratio



3.17 Maximum Lending Limit



3.18 Banks' Liquid Assets (of less than 3 months)



of less than three months tenor, reveals a rise of a mere 0.74% to reach KD 25.3bn in 2020 (figure 3.18). 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) represent 71.9% of the overall liquid assets. Moreover, as a share of total assets, liquid assets accounted for 29.7% as of December 2020.

While at a first glance this may seem as if banks utilized most of the sources of funds in financing non-liquid assets such as extending loans and/or purchasing investment instruments, it was not the case. Banks' lending and investment portfolios increased by 4.8% and 3.8% respectively in 2020, while Balances with CBK increased by 28.1% (KD 1.6bn). Core liquid assets experienced a net decline mainly due to the bigger drop in Due from Banks. This can be evident in the increase

witnessed in key regulatory liquidity ratios (figure 3.19). Banks resorted to increasing Balances with CBK to deploy excess liquidity while simultaneously maintain flexibility.

As fluctuations in the banking system's liquidity were mostly reflected in weekly interventions, the longer-term intervention instruments were stable overall

With the absence of new public debt issuances¹, the increase in banks' liquidity, specifically in their current accounts at the central bank, necessitated a rise in CBK's interventions. Amid halted issuance of government bonds, CBK liquidity absorption increased by 23% during the year, reaching a total of KD 24.6bn compared to 22% in 2019 (figure 3.20). Overall, the year was underscored with heightened volatility in terms of excess liquidity in the system and the corresponding liquidity intervention, as some periods witnessed relatively high levels of absorption while in others, interventions were subdued. Commodity-backed Tawarruq instruments grew by 43% in 2020 compared to 91% in 2019. An increase of 10.5% was seen in 1-week interventions with conventional banks during 2020 compared to 1.6% in 2019, resultant from high liquidity levels.

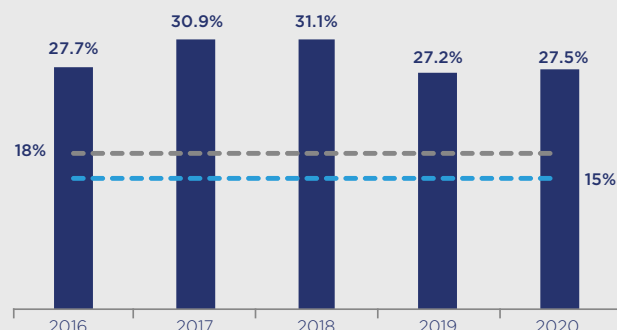
As fluctuations in the banking system's liquidity were mostly reflected in weekly interventions, the longer-term intervention instruments were mostly stable. During the year, CBK issued a total of KD 8.68bn in bonds, KD 5.64bn of which

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 71.9% of the overall liquid assets.

¹ Since the expiration of the public debt law in October 2017, no new Treasury bonds or Tawarruq instruments have been issued which resulted in a constant decline in the overall public debt balance to KD 1.05bn as of 31 December 2020, starting from 4.97bn at the time of issuance (September 2017)

3.19

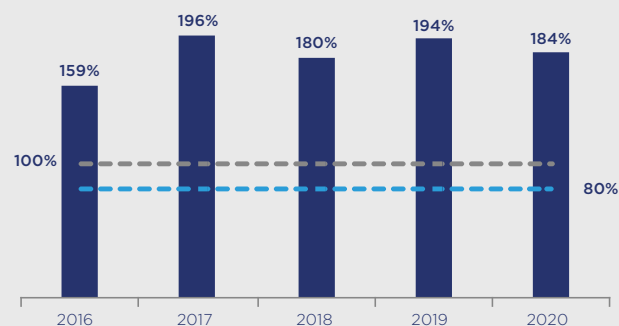
Regulatory Liquidity Ratio



Ratio of Balance with CBK, Government Treasury Bills and Bonds or any other financial instruments issued by CBK to customers' KD-deposits.

While a few banks utilized the relaxed limits and fell in the range between the old (18%) and new (15%) minimum requirement, the consolidated Kuwait banks stand comfortably above the pre-relaxation limit despite the increase in customer deposits, as the increase in balances held with CBK was higher.

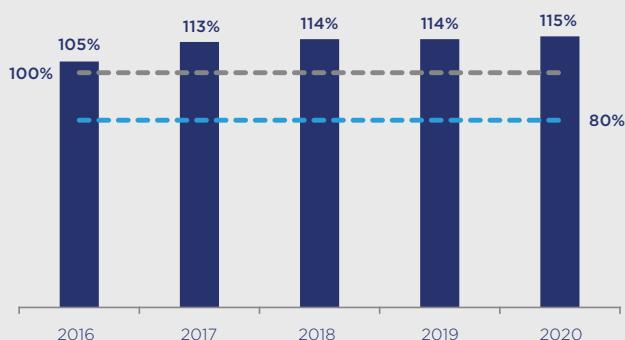
Liquidity Coverage Ratio



Ratio of High Quality Liquid Assets (HQLA) to the net cash outflows expected within the next 30 days.

While the nature of the LCR may tend to be volatile, the ratio stood close to the five years average, well above both the new (80%) and old (100%) limits. In 2020, the HQLA increased by 13%. However, the increase the net cash outflows outplacced it as 19% (resultant from a slight increase in expected outflows and a decrease in expected inflows).

Net Stable Funding Ratio



Ratio of Available State Sources of Funds (ASF) to Required Stable Sources of Funds (RSF)

The one percentage point increase in the NSFR ratio is due to the increase in deposits which are reflected in the numerator as sources of funds. Moreover, the denominator RST slightly decreased due to the rise in liquid assets that are assigned stability factors of 0%. This further secured the ratio above the minimum regulatory requirements (80% and 100%)

had maturities of 3-months, and KD 3.04bn with 6-month maturities. CBK sustained the overall balances of the 3-month instrument at KD 1.4bn and the 6-month balance at KD 1.5bn (figure 3.21).

Overall, the Kuwaiti banking sector continues to exhibit ample liquidity. Fortunately, and despite the liquidity-oriented challenges posed by the Covid-19 crisis, the concerns that may arise in the system pertain to the abundance of liquidity rather than the lack of it. In this regard, and in relation to the relaxed requirements, it is worth noting that considerations of lifting easing measures are continuously re-evaluated. Once deemed practical, CBK will enact the required regulatory measures to ensure continued stability from both a liquidity and solvency perspective.



Market Risk

Despite market RWAs accounting for a mere 0.98% (KD 0.6bn) of total RWAs (KD 61bn) (figure 3.22), understanding these exposures remains key to gaining a holistic understanding of risks faced by the sector.

Banks' investment books grew modestly over the year

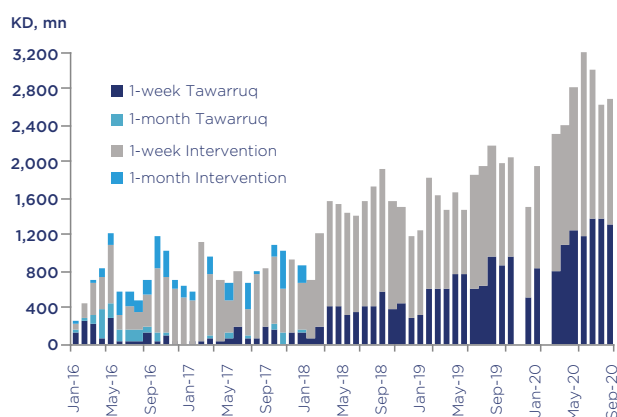
Banks' investment books grew by KD 519.8mn during 2020, marking a relatively modest growth rate of 3.8% (2.5 percentage points below the five-year average). The second quarter of the year marked the largest quarterly growth rate in the sector's investment portfolio since Q2 of 2010, growth which was mainly concentrated within a single Islamic bank. This bank's investment portfolio experienced a large spike in European fixed income securities

(Sukuk). Overall, the historically high quarterly growth can largely be seen as a result of banks capitalizing on the relatively attractive valuations post the severe sell-off seen globally in Q1.

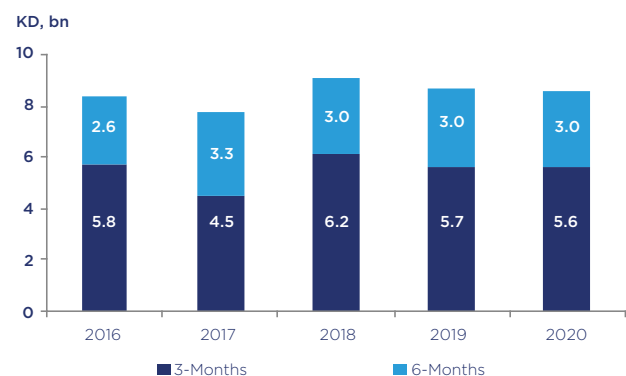
Fixed income remains the investment asset class of choice for banks

Breaking down investments by asset class, fixed income maintained the lion's share due to its favorable treatment under various regulatory requirements. In line with the global increase in debt levels, and more specifically bond issuances, fixed income investments increased by 7% in 2020, while equity and real estate investments witnessed declines of 6% and 12% respectively (figure 3.23). The decline in real estate investments was largely

3.20 Liquidity absorption by CBK



3.21 CBK Bond Issuance



Despite the liquidity-oriented challenges posed by the Covid-19 crisis, the concerns that may arise in the system pertain to the abundance of liquidity rather than the lack thereof.

attributable to a single bank's investment book in the Kingdom of Bahrain, which experienced some reclassifications, and to a lesser extent, impairments of investment properties.

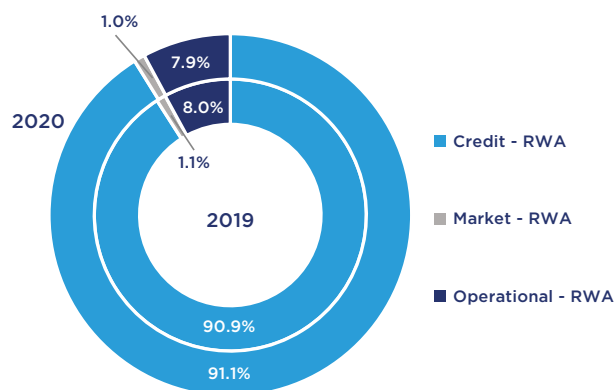
As the Islamic segment continues to cement itself in the banking system, Islamic banks' investment books and their share of fixed income investments continued to grow at a rapid pace (figure 3.24). The upward trajectory was facilitated by the increase in sharia-compliant alternatives, which in turn helped Islamic banks diversify their exposures whilst maintaining adequate regulatory ratios. The growing selection of sharia-compliant investments enabled Islamic banks to diversify their revenue streams. This was reflected through higher interest income from investments.

Banks' investments held under the Available for Sale category inched up slightly

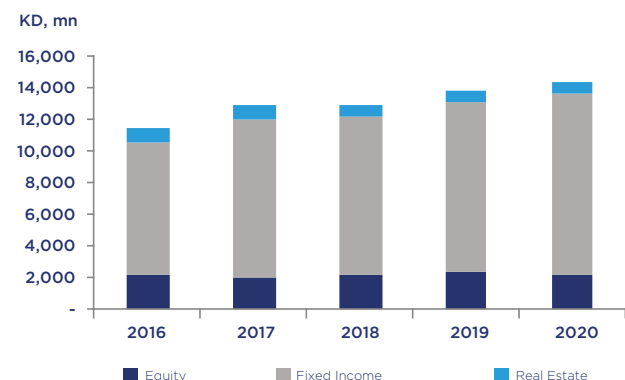
Breakdown by purpose reveals that 56.9%

of banks' investments were held under the Available for Sale (AFS) category (figure 3.25). The bulk of investments held under AFS suggest that banks are keen to maintain a high level of liquidity to help mitigate liquidity risk should the need arise. It is worth noting, however, that while highly beneficial from a liquidity standpoint, these investments expose banks to market risks, given that they are marked-to-market. This may cause banks to incur unrealized losses reflected in equity through the comprehensive income statement. On that note, the banking sector's AFS portfolio continued its upward trend, ticking modestly higher at 2% compared to the 24% increase seen in 2019. Moreover, and as investments classified under the AFS category grew, the equity coverage ratio² continued its decline, reaching 125.2% by year-end (figure 3.26). The current level of the ratio highlights the ability of local banks to easily absorb large valuation losses and impairments that may arise from their investments.

3.22 Risk Weighted Assets

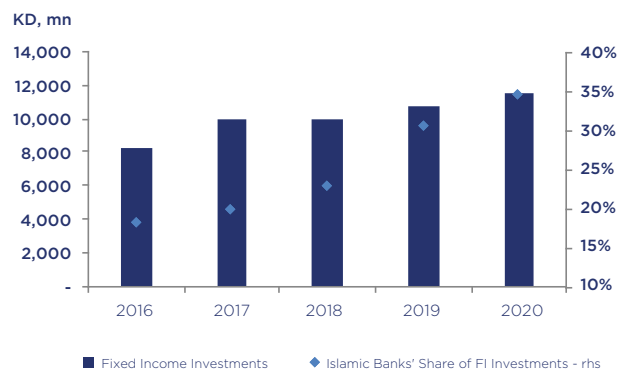


3.23 Banks' Investments by Category



² Ratio is computed by dividing shareholders equity over AFS investments.

3.24 Fixed Income Investments

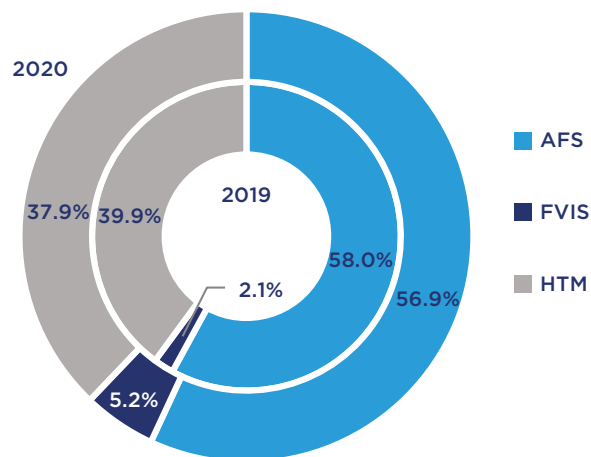


The Held to Maturity and the Fair Value through Income Statement categories also experienced slight changes

Held to Maturity (HTM) investments represent the second largest classification at 37.9% of total investments. The sizable share of these investments reflects the nature of banks and their consequent need to dampen fluctuations resultant from mark-to-market treatment on their investment book.

While Fair Value through Income Statement (FVIS) constitutes a relatively insignificant third classification, it is worthy to comment on the increase of 3.1 percentage points or KD 455.1mn that this category witnessed. The increase of FVIS investments was largely driven by growth of KD 312mn in Europe of which KD 299mn was concentrated within a single bank as it witnessed similar trends in its other investment classifications. In line with a slight shift in the abovementioned bank's investment strategy aimed at diversifying its non-loan related revenue streams, its overall exposure to Europe has reached 40%, more than three-times the system wide exposure to Europe. While this reflects the bank's ability to utilize its abundant liquidity, it may raise the possibility of country and concentration risks, as these investments are prone to idiosyncratic shocks.

3.25 Investment by Purpose

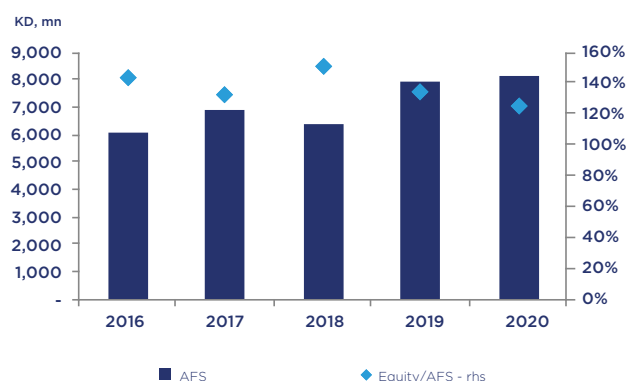


Foreign exchange risks remained subdued

In terms of foreign exchange (FX) risk, and when looking at its main source which is banks' unhedged exposures to a foreign currency, the banking systems' inherent risks that arise from FX dealings remain quite tame.

Relative to their peers, some banks appear to maintain larger open positions, mostly attributed to natural exposures stemming from their structural positions (e.g. subsidiaries). However, it is worth noting that unhedged FC bond issuances, if exceeding a given bank's set limit on FX open positions, are subject to CBK's approval. Moreover, and given the proportion of the overall FX open positions to total regulatory capital, the risks that emanate from them do not constitute a significant threat to either the liquidity or the solvency of a single bank or the overall banking system (figures 3.27).

3.26 Total AFS portfolio



Interest rate risk was carefully monitored

Taking into account the maturity transformation typically resultant of banks' core operations, the near-term repricing gap indicates that while limited, banks are exposed to interest rate increases. On a system-wide basis, however, differences in banks' operations and by extension, their repricing gaps become evident as the exposures of conventional and Islamic banks diverge in the medium term (2-4 years). Based on the gaps related to these maturities, conventional banks (and to a much lesser extent, Islamic banks) seem to have positioned themselves to benefit from the normalization of interest rates from their recent lows. In line with the expected trajectory of benchmark interest rates (namely the Federal Funds Rate), more assets are scheduled to reprice within the above-mentioned period.

On the flip-side, and if central banks (including CBK) maintain their accommodative stance, lower

for longer interest rates may pose a threat to the banking sector's profitability as margins become compressed. As such, towards the second half of the year, CBK delivered a supplementary rate cut on its repo and bond rates to provide some respite for banks' cost of funding.

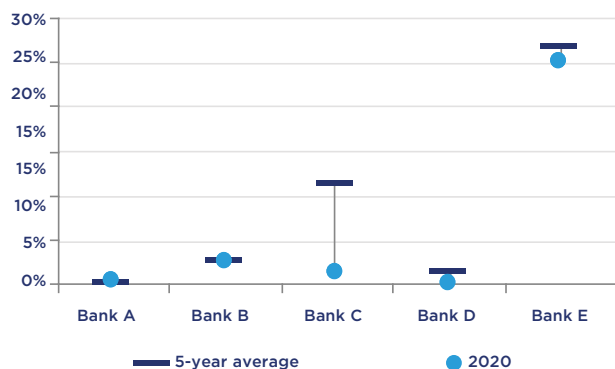
Moreover, and on the back of the lower interest rate environment, banks may still be enticed to increase their fees and investment income to compensate for the overall lower margins. For further details on banks' profitability trends amid the low interest rate environment, refer to Box 4.1 "Determinants of banks' profitability".

Banks may also ramp up their lending as their loans are repriced at lower rates. While at face value such growth in loans is welcome, given that it targets value-adding sectors. Banks may also be enticed to adopt aggressive lending practices with relaxed requirements, leading to heightened risks to the overall stability of the system. CBK continues to adopt a proactive approach to monitoring in this regard, setting in place timely mitigants to safeguard financial stability.

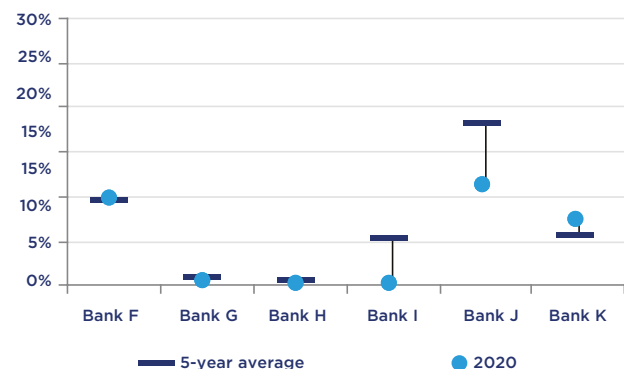
3.27

FX open positions as a % of Regulatory Capital

Islamic Banks



Conventional Banks





OPERATIONAL RISK

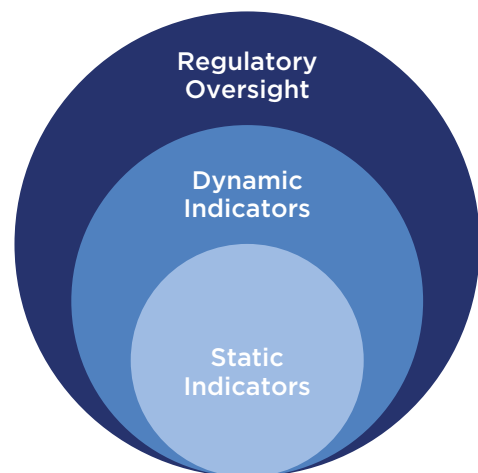
Against a backdrop of an unprecedented operating environment, operational risks gained more attention as logistical disruptions heightened vulnerabilities. Operational risk, according to the Basel Committee on Banking Supervision (BCBS), is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events together with legal risk³. Despite the seemingly straightforward definition, and the recent strides of progress in quantification efforts, it remains difficult to reduce the entirety of operational risk to a single metric. Interestingly, a given entity faces operational risk by “simply existing” compared to other risks that are borne through active business decisions.

In parallel to its increased prominence, operational risk evolved as operations grew in complexity and as reliance on technology increased. This trend was also matched by the increased recognition by regulators worldwide, and the continuous pursuit by banks to further understand, assess and effectively manage these risks.

CBK is continually evolving its operational risk management approach in line with global standards

Locally, and driven by the fat-tailed⁴ nature of operational risk and the inherent challenge to quantify its financial implications, CBK’s efforts extended beyond the typical quantitative metrics through its adoption of a hands-on approach⁵ to its monitoring and supervision. The relevant regulatory frameworks are continuously developed, guided by global

3.28



³ Basel III: Finalizing post-crisis reforms (Bank of International Settlements, December – 2017)

⁴ Extreme-loss distribution, whereby an unlikely event may cause disproportionate financial damage.

⁵ E.g., Customer Protection Unit, extensive rounds of inspections around the year, Internal Control Reviews, and the establishment of the Higher Committee of Shari’ah Supervision. For further details on the latter, please refer to refer to Box 3.1 titled “Formation of a Higher Committee of Shari’ah Supervision”.



Total operational losses recorded during 2020 represent a mere 0.04% of banks' 3-year average gross income.



standards, and applied through both on-site and off-site supervision. The regulatory approach and reporting rely on both static and dynamic indicators of operational risk (figure 3.28). Specifically, static observations such as failures, fines, gaps, and dynamically generated indicators such as value-at-risk (derived loss-distributions).

Despite there being some operational losses recorded during the year, they were relatively low

The analysis below sheds light on key operational risk indicators pertaining to the local banking sector followed by highlights from CBK's dynamic regulatory framework.

A look into aggregate loss incidents reveals that 2020, despite the pandemic-induced operational complications, recorded significantly lower total losses compared to 2019. In contrast to 2019, a year with losses driven by the KD 300,000 – 1,000,000 category, 2020 witnessed the majority of loss incidents in the category below KD 20,000. This high in frequency yet low in magnitude composition may be considered as an opportunity for banks to detect and resolve triggers that surfaced during a rare set of conditions resulting from the crisis. For example, the Employment Practices and Workplace Safety category witnessed a spike, recording the largest number of reported incidents, albeit at an insignificant value as many incidents did not result in direct financial losses.

Overall, the total operational losses recorded in 2020, relative to the average gross income of local banks for the past three years, were a mere 0.04%. While this may indicate insignificance, it is important to reiterate the tail risk structure of potential losses and the relatively sentiment-sensitive and competitive nature of the local banking sector, whereby indirect financial

damage may result from operational failure. In terms of type, the largest portion of KD operational losses in 2020 is attributed to the Clients, Products, and Business Practices category, despite the relatively low number of incidents (figure 3.29).

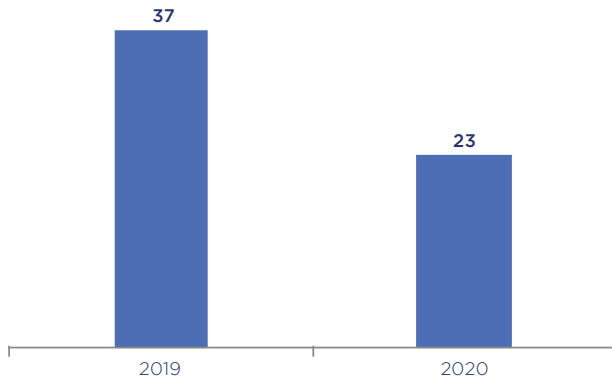
Legal resilience improved, as the amounts paid by banks in lawsuits this year was around half of that paid last year

To complement the abovementioned facets of operational losses, exploring the magnitude and frequency of lawsuits helps assess an important aspect of banks' legal resilience. In 2020, the amount of KD 23mn was paid by banks in lawsuits compared with around KD 36.6mn in 2019 (figure 3.30). Specifically, six out of ten banks witnessed a decline in lawsuit payments in 2020 relative to 2019. The decline might have been driven by lower business activity, e.g. low

**3.29
2020 Operational Losses by Type**



3.30
Total amount sued against the bank (KD,mn)

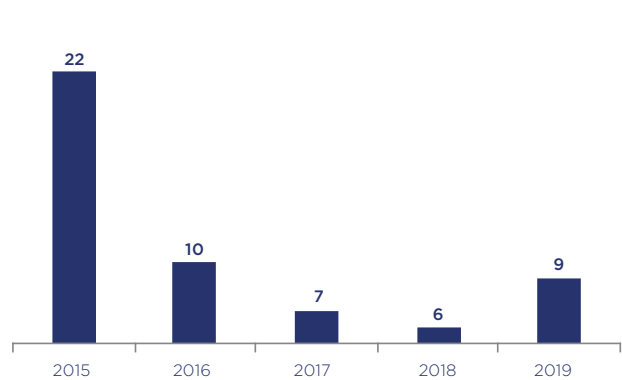


volume of potential lawsuit triggers, and courts closure during the lockdown. It is worth noting that due to the closure, the backlog of lawsuits and the consequent payments could materialize in 2021.

Moreover, and looking ahead, the milestone transition away from LIBOR for financial institutions is a potential catalyst for operational challenges globally. Specifically, and given LIBOR’s integration in the local banking system, linked contracts without fallback clauses may raise complications and consequent risks of loss. However, the local banking system’s exposure to the previously mentioned contracts remains limited. Furthermore, CBK ensures adequate awareness and dissemination of information in this regard to aid banks in achieving a smooth transition.

In contrast to the trend witnessed in lawsuit payments, high-risk findings⁶ by the Internal Controls Reviews (ICR) increased in 2020. The total number of ICR findings increased from six recorded against two banks in 2019, to nine

3.31
High Risk Audit Findings



against four banks in 2020 (figure 3.31). Overall, seven of the nine findings have already been resolved with adequate corrective measures.

Given the underlying economic conditions, CBK’s on-site supervision conducted extensive inspection rounds to ensure operational standards were not compromised. As indicated by the imposed fines, banks demonstrated their ability to sustain the effectiveness of internal controls despite the pandemic-induced disruption. Specifically, and compared to the previous year, the total number of fines stood at 42, concentrated within two banks, down from 60 fines in 2019 (figure 3.32).

Employee churn rates among banks improved this year

During crises, workforces tend to experience severe shifts and displacement. Compared to global trends, however, local pandemic implications are considered mild in this regard. Compared to the aforementioned indicators, churn rates may be dismissed as a non-

“

Banks’ employee churn rate witnessed significant improvement, despite the challenging operating environment

”

⁶ Observations witnessed at banks, by external auditors, that require an immediate investigation and the necessary corrective action.

As of February 2020, CBK was recognized and certified by ISO for upholding exemplary standards in ‘Information Security Management System’ (ISO 27001-2013).

threatening metric. However, a critically and consistently high churn rate may impair a bank’s operational stability. After all, and despite the digitization trends, a sufficiently stable human capital can be the main source and driver for any organization’s success.

Locally, churn rates⁷ can be used as a reference to further understand the destabilizing impact, if any, on banks. Notably, these rates are agnostic to the underlying cause of the increase whereby it may be attributed to the employer’s restructuring, cost cutting, or the employee’s own decision.

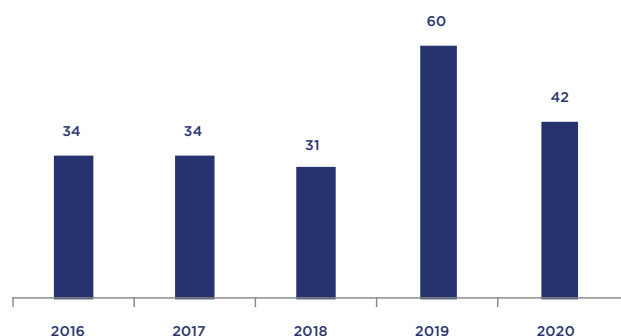
Overall, in 2020, the average employee churn rate among banks was 10%, a substantial improvement considering the conditions, from the 17% witnessed in 2019. Improvements in the churn rate were seen across the board (figure 3.33). The trend witnessed among banks was driven by two factors, on one hand the working

environment imposed by the crisis provided less of an incentive for employees to shift between jobs. On the other, CBK’s guidance and State’s support measures to maintain staffing led to employers becoming reluctant towards laying off their staff. Interestingly, and as news regarding the vaccine surfaced and uncertainty slightly subsided, the employee churn rate for Q4 2020 doubled on a quarterly basis from 2% to 4%. This potentially indicates that the increase was primarily led by the employees’ choice to explore opportunities rather than employers’ choice of dealing with stressed conditions through cutting costs.

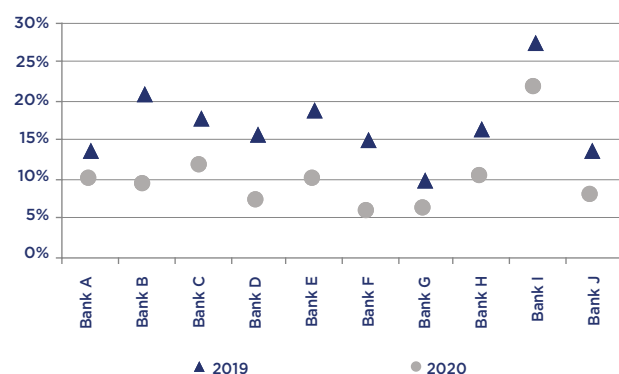
Digitization is a key aspect of operational risk that is continually being monitored and assessed

Considering the digitalization trends, duly encouraged by CBK⁸, banks sought to develop

3.32 Penalties from CBK



3.33 Employee churn rate



7 The employee churn rate estimates the percentage of employees leaving the organization per year.

8 H.E. The Governor’s “The battle for relevance” speech and CBK’s directives aimed at encouraging banks to enhance IT Strategy frameworks and fill the relevant high-level positions.



and diversify their digital platforms. This pace of development necessitates an equal or faster enhancement and adoption of prudent cybersecurity frameworks, as naturally, a broader range of digital channels translates into a wider scope of potential cyber threats.

The responsibility and sensitivity of banks' handling of these aspects gains more importance considering the varied level of digital literacy from the users' side. This is highlighted by the majority share of operational losses attributed to Clients', Products, and Business Practices.

In an effort to mitigate this phenomenon, CBK and local banks collaborated on a nationwide campaign 'Diraya' to raise awareness to potential threats targeting clients. The term Diraya, an Arabic term translating to "to be well-informed", targets increasing public awareness, including broader topics such as banks' role as financial intermediaries, and the importance of the security of personal information to avoid fraud. The underlying philosophy is that however sophisticated and pro-active banks' preventive measures are, an aware and well-informed client is the most potent and effective building block of a sound banking environment.

In addition, CBK supported banks' adoption of the best practices and standards in terms of core

systems and processing frameworks. To lead by example, as of February 2020, CBK was recognized and certified by ISO for upholding exemplary standards in 'Information Security Management System' (ISO 27001-2013). As information security management systems represent the main conduit of sensitive data across financial institutions, and due to the extreme importance of upholding the highest standards in governing these systems, CBK issued a Cybersecurity Framework⁹. This framework requires banks to comply with the outlined standards, and resulted in 8 out of 11 banks to gain the ISO certification (ISO 27001-2013).

To gauge and assess the soundness of these systems, metrics include the duration and depth of incidents, with emphasis on cyber risks as the impact could be potentially destabilizing to the overall banking sector.

In an aim to match this significance, the Cyber Security Framework serves to facilitate knowledge sharing among banks and utilize the lessons drawn from each incident. As stipulated by the framework, an Information Security Working Group is established as a forum for collaborative discussions on cybersecurity controls, prevailing best practices and technology. The workings and discussions of the group aim to culminate in the advancement

⁹ Cybersecurity Framework for Kuwaiti Banking Sector, (CBK, February - 2020).

and maturity of the Kuwaiti banking sector's cyber security.

Insurance continues to play an important role in mitigating operational risk

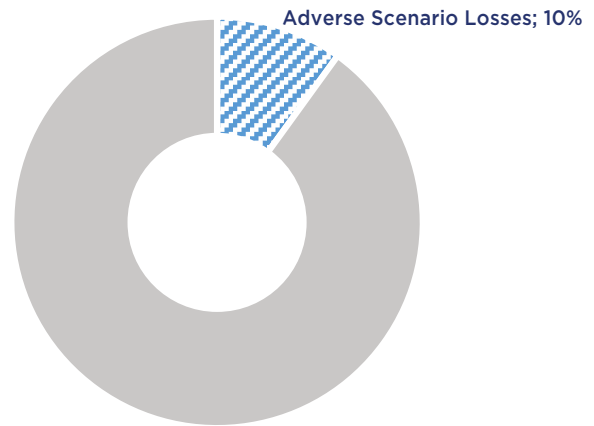
In relation to the risk of unforeseen and significant financial impact that may arise due to operational risks, insurance constitutes a direct shock-absorber. Considering the historically mild financial magnitude of banks' operational failures, the respective insurance coverage levels instill comfort. As at the end of 2020, nearly 29% of total operational risk insurance coverage is directed towards Clients, Products, and Business Practices, while 27% is assigned to the Damage to Physical Assets incidents category. For information technology (IT), including cyber risk, assigned coverage represents around 3% of total insurance coverage.

CBK conducts several simulations derived from both aggregate and bank level loss distributions in order to better foresee and assess operational risks

Lastly, and while historical operational losses and incidents are key inputs in assessing operational risks in terms of triggers and magnitude, a forward-looking approach is a natural fit to how operational risks tend to materialize. Towards that end, CBK conducts several simulations derived from both aggregate and bank level loss distributions.

In 2020, two main simulations were utilized to assess banks' operational loss severity. Specifically, Simulation 1 is based on the aggregate banking sector's severity loss, while Simulation 2 combines the sector's frequencies and severity losses drawn from a specialized operational risk database. Furthermore, a tail-event was added to each of the two simulations, bringing the total to four different variations, each with its corresponding results.

3.34 Gross Income (3-yr avg.)



In the most adverse scenario, banks would collectively record a maximum loss of KD 270mn. In relative terms, the maximum loss the banking sector could endure represents no more than 10% of local banks' combined average gross incomes in the past three years (figure 3.34). While significant, especially considering other simultaneous sources of stress, the extreme case highlights banks' strong financial position, allowing them to weather extremely adverse operational failures. The aim was to maintain and enhance banks' financial strength, and lower maximum loss despite the extreme assumptions. The latter can be achieved by the contribution of each bank towards a collective effort that aims to cement the local banking sector's leading position in resilience and soundness metrics.

As demonstrated by a uniquely challenging year, efforts exerted in comfortable times pay well in dividends through tough and unforeseen challenges. CBK spares no effort in building a regulatory environment that is conducive to a vigilant and a pioneering stance on risk management, especially the rapidly developing operational risk.



Two simulations were utilized to assess banks' operational loss severity, with losses representing no more than 10% of banks three year average gross income in the most severe scenario.



BOX 3.1: FORMATION OF A 'HIGHER COMMITTEE OF SHARI'AH SUPERVISION'

Kuwait has been among the earliest few countries to establish modern day Islamic banking, with the country witnessing the launch of its first Islamic bank 42 years back. Since then, Islamic banking has grown in size and significance, reaching systemic proportions of the overall banking sector¹. At present, five local Islamic banks account for almost 45% of the total assets of the banking system in Kuwait, as of December 2020 (Figure A). Given their collective size, share of Islamic banks in Kuwait's overall banking system is the second highest in any country with a dual banking system (i.e. where both conventional and Islamic banks operate in parallel).

An obvious requirement for any Islamic bank is its comprehensive and continuous adherence to the Shari'ah principles in all its products and services as well as operations and governance. Shari'ah non-compliance is therefore a major risk for Islamic banks, with profound consequences in terms of potential loss of reputation and business. Depending upon the frequency and severity, such non-compliance can even have systemic implications, posing threat to overall financial stability.

While the arrangements to ensure Shari'ah compliance in banks vary across countries, three setups are common: banks with their own Shari'ah boards, a national Shari'ah board, or a combination of the first two (i.e. a hybrid model). Islamic banks in Kuwait have their own, in-house Shari'ah boards that ensure banks' adherence to Shari'ah principles in all deals and activities, approving

A
Islamic Banks in Kuwait



various products, reviewing business activities and conducting Shari'ah audits. CBK issued comprehensive instructions on Shari'ah supervisory governance in December 2016², aimed at strengthening the role and governance of banks' in-house Shari'ah boards.

However, the need for a national level Shari'ah board can hardly be overemphasized, for a variety of reasons. **First**, in-house Shari'ah boards at individual banks, while playing a valuable role at their respective institutions, have considerable leeway in determining Shari'ah compliance or otherwise; yet the variation in views inadvertently leads to divergence of opinions even within a jurisdiction, adding an additional but unnecessary layer of complexity to Islamic finance. The heterogeneity of opinions and fatwas also make product standardization difficult, investors wary and public confused.

¹ Islamic Financial Services Board (IFSB) treats Islamic banking as systemic if its share in a given banking system exceeds 15%.

² https://www.cbk.gov.kw/en/images/governance-islamic-banks-122719_v50_tcm10-122719.pdf

Second, multiple Shari'ah boards without a supervisory authority at the national level could pose the risk of Shari'ah arbitrage, prompting a race to the bottom where products could be tweaked to achieve the lowest compliance denominator but without necessarily complying with the spirit of Shari'ah. Such a situation may entice issuers to cherry pick the banks for certain deals if they find some Shari'ah boards relatively lenient than others.

Third, while differentiating views could support innovations, differences about the key principles can cause confusion and stifle growth of Islamic finance as an industry. For instance, sukuk structures that are subject to various interpretations would fail to attract a wider investor base, thus keeping the markets shallow.

These issues highlight the paramount need for an overarching Shari'ah authority to harmonize the principles and structures at the national level, which in turn could help maintain public trust in Islamic finance and promote wider acceptance of this industry.

It was against this backdrop that CBK, on October 5, 2020, announced the formation of a Higher Committee for Shari'ah Supervision³, as first approved by CBK Board on 1st September 2020.

The committee, to be housed within CBK, has been tasked with the following key responsibilities:

- Offer its advice and opinion to CBK on Shari'ah compliance of financial transactions⁴ between CBK and Islamic financial institutions (IFIs) subject to its supervision⁵,
- Propose general guidelines for products and services offered by IFIs,

- Propose controls to regulate the business of Shari'ah supervision bodies at different IFIs,
- Conduct internal and external Shari'ah audit,
- Govern the activities related to Fatwa and Shari'ah Supervision at IFIs,
- Pre-approve candidates for membership on Shari'ah boards at IFIs,
- Issue final decisions where deliberations of Shari'ah supervision bodies are inconclusive, and
- Present Shari'ah-based opinions on matters referred to it by the courts or arbitration centers relating to issues of Islamic banking and finance business.

The inaugural members of the Higher Committee, appointed for a three-year renewable term, include the following four *fiqh* and Islamic banking specialists:

Dr. Essa Z. E. Shaqra - Chairman

Dr. Khaled M. Y. Boodi - Member

Mostafa Syed H. A. Alzelzelah - Member

Dr. Motlaq J. M. Aljaser - Member

The formation of higher committee will help promote standardization of products and services offered by IFIs while also increasing transparency and improving Shari'ah governance. The committee will also play a critical role in enhancing the quality of supervision of the IFIs, thus strengthening market discipline and improving market depth & liquidity.

³ Law No. (3) of the year 2020

⁴ Such as instruments of monetary policy and liquidity management.

⁵ Here IFIs include Islamic banks and Islamic financing companies, which fall under CBK's regulatory purview.

CHAPTER 4

BANKS' PROFITABILITY & RESILIENCE



This chapter aims to examine the soundness of the banking sector. This is done by first analysing key profitability indicators, followed by the examination of solvency measures to gauge the system’s resilience.

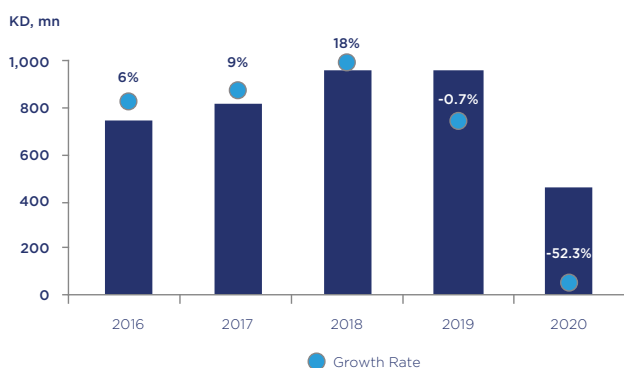
PROFITABILITY

Covid-19 understandably put pressure on banks’ profitability

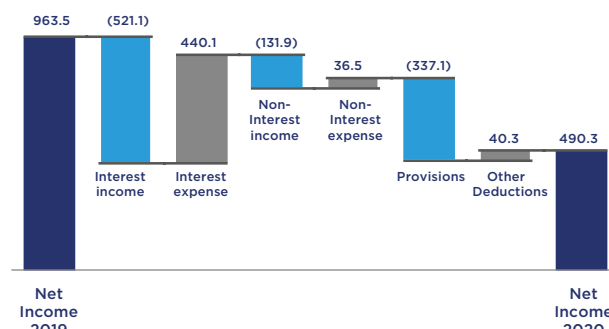
In terms of banks’ profitability, the pandemic caused a shock comparable to that witnessed during the GFC. The effects of the Covid-19 crisis were irrefutable, as aggregate net income attributable to shareholders during 2020 fell to KD 455mn, down 52% YOY (figure 4.1). This represents an 11-year low for earnings, hovering at levels last reached during the GFC where aggregate income fell to KD 340mn. The impact from the Covid-19 crisis was exacerbated by a steep decline in oil prices, as expectations of weak growth translated into a weaker appetite for capital investments and consequently, financing.

The main contributors to the decline in net income were lower interest income and higher provisions. The decline in interest expense resultant from the decrease in interest rates was insufficient to offset the simultaneous decline in interest income (figure 4.2). The deterioration in operating profitability was driven by lower interest income resulting from loan postponements and lower interest rates. Non-interest income also fell, driven by both declining fee income (mainly due to the waiver of K-NET fees for 6 months) as mobility restrictions hampered operations, and lower returns on investments. Higher provisions, incurred to face uncertainty and a potentially prolonged crisis served as the last hit to bottom line earnings.

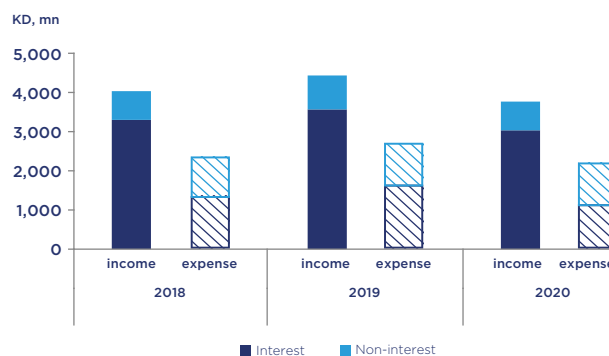
4.1 Banks’ Net Income Attributable to Shareholders



4.2 Change in Net Income (KD, millions)



4.3 Breakdown of Income & Expenses



A closer look into core earnings reveals that interest income fell by KD 521m, a 15% drop for the year (figure 4.3). Although interest expense fell more in percentage terms (27%) as a result of lower interest rates, the decline was not sufficient to cover the earnings gap in KD terms, as net interest income declined by 4.1%. The squeeze in interest income was mainly driven by a decline in interest on corporate facilities and dealings with other banks.

Banks were able to sustain a healthy portion of their core activities

Breaking down gross income highlights banks’ ability to maintain their reliance on core activities as a main profitability driver. Net interest income constituted a marginally higher

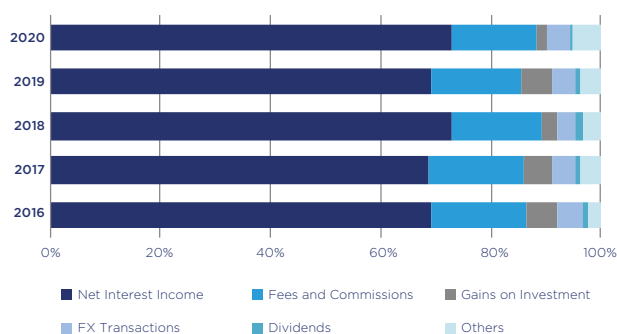
share (71.9%) of gross income in 2020 (figure 4.4). As expected during a crisis, the share of gross income from investments shrunk by 4.1 percentage points, representing merely 1.6% of gross income for 2020.

Banks' efficiency declined due to a lower interest environment and harsher operating conditions

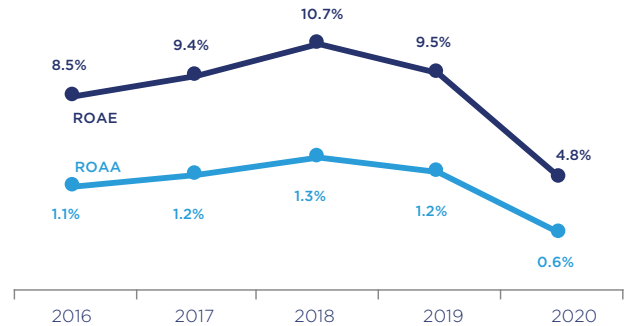
A lower interest rate environment coupled with harsher operating conditions contributed to a decline in both bank profitability and efficiency. Return on average assets (ROAA) and return on average equity (ROAE) both slid to all-time lows as the crisis unfolded (figure 4.5). ROAA was squeezed in its numerator and denominator, as average assets swelled to all-time highs. This growth in size was financed by higher leverage (in the form of deposits and borrowings) as the change in average shareholders' equity throughout the year remained relatively flat while private and government deposits grew approximately 9.5% (KD 4.7bn). The decline in ROAE was mainly due to the decline in bottom-line earnings as average shareholders' equity remained relatively unchanged. Despite average equity remaining flat, total shareholders' equity fell by 4.5% YOY in 2020. The 6-month loan

Banks maintained profitability despite lockdowns, borrower credit deterioration, and moratoriums on retail loans

4.4 Breakdown of Gross Income

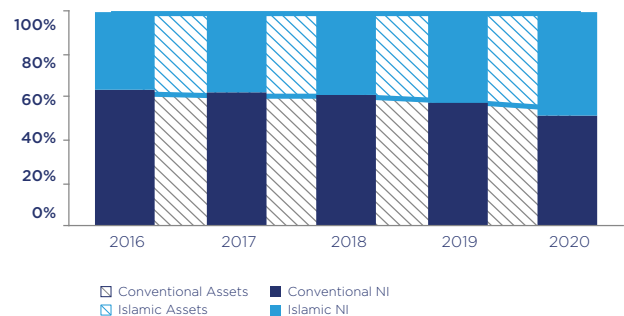


4.5 ROAA and ROAE



postponements offered by banks contributed to this decline, as the losses (KD 334mn) were a direct hit to retained earnings.

4.6 Share of Net Income & Assets



Islamic banks continued to increase their share of total industry profits

The Islamic banking segment's growth in market share continued through the crisis, where Islamic banks captured 48% of the industry's total profits, a 6 percentage point increase from last year's 42% (figure 4.6). This segment level outperformance, however, can be largely attributed to a single bank from each segment. On one side, a conventional bank adopting a conservative write-off approach, dragged down segment-level net income; while on the other, a single Islamic bank recorded higher interest income from Turkish Lira bonds. Islamic banks also benefit from the unique nature of their deposit liabilities, which grants them the ability to reduce profits paid on deposits in response

“ Consistent with the trend seen in prior years, Islamic banks continued to close the gap in total industry profits. ”

to a decline in net income. Overall, conventional banks’ net income contracted by 58% for 2020 in contrast with 46% for their Islamic counterparts. Similarly, Islamic banks continued the growth trend, increasing their share in total industry assets by 3 percentage points to 45%. This increase was driven by Islamic bank expansion along with a simultaneous shrinking of conventional bank assets.

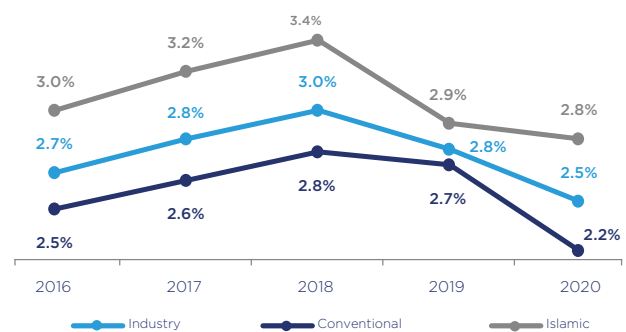
Interest margins contracted in both banking segments

At first glance, it appears that Islamic bank profitability remained more resilient than that of their conventional counterparts based on year-end net interest margins (NIM) (figure 4.7). Upon further inspection, it appears that this was mainly due to higher bond income at a single bank as mentioned previously. This higher income is attributable to the large exposures to Turkish fixed income securities, coupled with the rising interest rate environment in Turkey. Indeed, upon inspecting the NIMs of the other Islamic banks individually, it becomes apparent that the Islamic segment did not grossly outperform the conventional segment. This was evident in three of the five banks in the Islamic banking segment who had a NIM ratio lower than 2%. Conventional banks saw a severe drop in their NIM, the bulk of which was driven by lower interest income from corporates relative to the year prior.

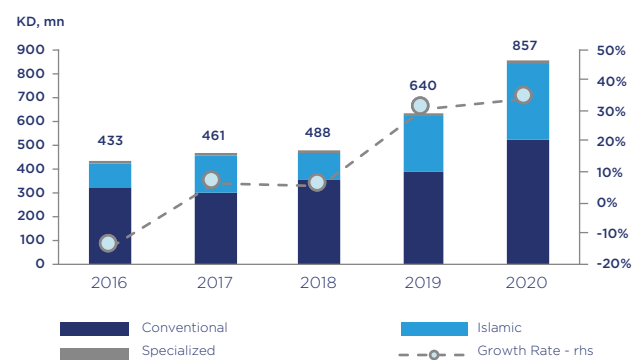
Higher provisions acted as a shield from systemic risk

Net loan loss provisions charged increased 34% YOY (figure 4.8). In contrast with 2019 where the surge in provisions was from idiosyncratic factors and the bulk of provisions were concentrated in two banks, this year’s spike stemmed from a systemic shock. Hence, all banks were contributors to the increase in

4.7 Net Interest Margin



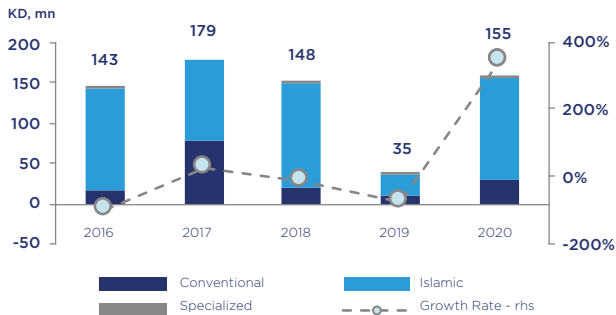
4.8 Net Loan Loss Provisions



provisions in the face of an uncertain economic outlook. Net loan loss provisions formed during 2020 represent an all-time high in KD terms, which provides reassurance in case of prolonged uncertainty. The crisis highlighted the importance of sufficient provisioning as banks were able to face financial stress from a position of strength given the healthy stock of provisions accumulated over the years.

Despite conventional banks contributing the lion’s share of provisions on loans, Islamic banks were responsible for the bulk of provisions on

4.9 Provisions on Other Financial Assets

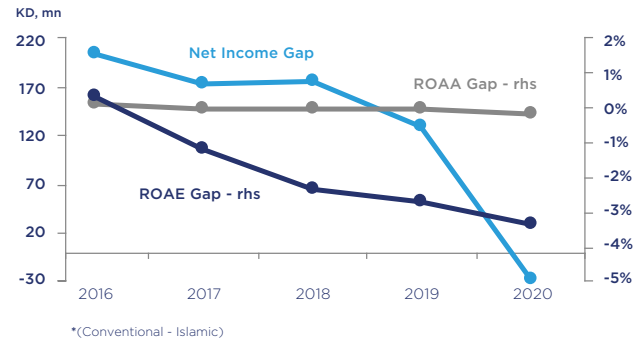


other financial assets (figure 4.9). This surge can, however, be traced to a single bank which accounted for 81% (KD 125mn) of the total industry increase. The avoidance of banks in partaking in excessive investing provides reassurance from a systemic risk perspective, as it minimizes excessive market exposures.

The financial landscape remains competitive between the two segments

Consistent with the trend seen in prior years, Islamic banks continued to close the gap in total industry profits, overtaking conventional banks for the first time since 2008 (figure 4.10). As mentioned above, a large portion of these profits were attributable to an idiosyncratic factor, which propelled total Islamic bank profits. The ROAA gap remained relatively flat as Islamic banks efficiency gains were muted due to a 13% growth in average assets. The average

4.10 Conventional vs Islamic Gap*



level of equity sustained during the year was relatively unchanged for both segments, which contributed to sending the ROAE gap further into negative territory as conventional banks faced a more dramatic decline in profits.

The Islamic banking segment continued to cement itself in the local banking scene, managing to close the gap in operating efficiency against its conventional counterpart (figure 4.11). Despite conventional banks managing to cut operating expenses by 6% relative to Islamic banks' 1%, the decrease was not sufficient to compensate for foregone gross income which was down 13%. The fact that the deterioration (increase) in conventional banks' cost-to-income ratios stemmed from the crisis-induced decline in profits rather than an increase in operating costs suggests that the deterioration may not be persistent.

Despite conventional banks managing to cut operating expenses by **6%** relative to Islamic banks' **1%**, the decrease was not sufficient to compensate for foregone operating income which was down **13%**.

4.11 Operating Efficiency



Box 4.1: DETERMINANTS OF BANKS' PROFITABILITY

As financial intermediaries, banks play a key role in the provision of credit to firms and individuals. This role assumes further significance in a financial system that is bank-centric in nature, as is the case in Kuwait. Yet banks' ability to continue the provision of credit even in the worst of economic conditions is contingent upon their own soundness and stability. As Covid-19 pandemic has brought to the fore, only a resilient and stable banking system can be part of a solution mechanism in helping a country navigate a sharp economic downturn.

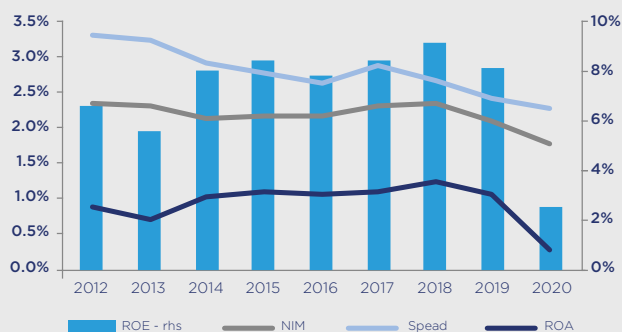
In turn, banking sector resilience is underpinned by both robust capitalization and healthy profitability, latter being the first line of defense against any adverse shock. Retained earnings are also a key source of capital, enabling banks to build buffers over time. However, given the record low interest rate in Kuwait and rising credit risk amid Covid-19 induced economic contraction, it is worth examining the implications for Kuwaiti banks' profitability. After all, low levels of profitability, if stretched over prolonged periods, can deplete buffers and risk impeding the very process of credit intermediation by

compromising banks' own soundness.

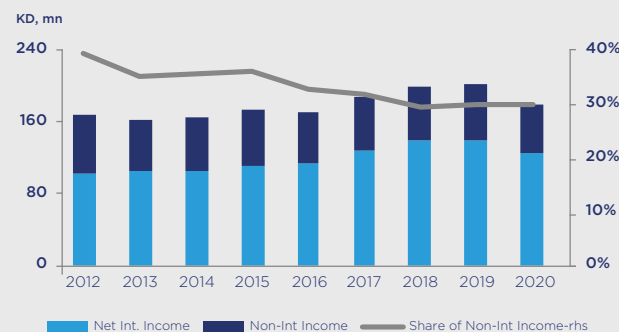
While the banking sector in Kuwait has maintained healthy profits over the years, profitability has come under pressure of late¹ (Figure A). Unsurprisingly, the year 2020 has witnessed a sharp deterioration in all indicators of profitability, with Return on Assets (ROA), Return on Equity (ROE), Net Interest Margin (NIM) and Spread² posting their lowest levels since 2012. While the unprecedented health and economic shock inflicted by the Covid-19 pandemic has undoubtedly dented banks' profits quite severely³, deterioration in profitability indicators had started a year earlier, as the declining trend in all ratios for 2019 exhibits. The pandemic induced troubles have largely accelerated this trend. In general, lower interest rates and higher competition has depressed profits. At the same time, share of non-interest income in gross income has tapered off over the years (Figure B). Consequently, Kuwait banks on average are more reliant on interest income today than they were in the past; yet interest income has witnessed a squeeze, in part due to aforementioned factors.

A closer look at ROA for individual banks

A
Banks' Profitability-Domestic Operations



B
Banks' Sources of Income



1 This box is based on the data for the domestic operations of 10 Kuwaiti banks.

2 Expressed here as: Interest income from loans/Total Loans) - (Interest Expense on deposits/Total Deposits)

3 Moratorium on loan repayments during 2020 coupled with rise in provisioning expense and drop in net interest income amid record low rates have all contributed to lower profits.

C ROA by Bank

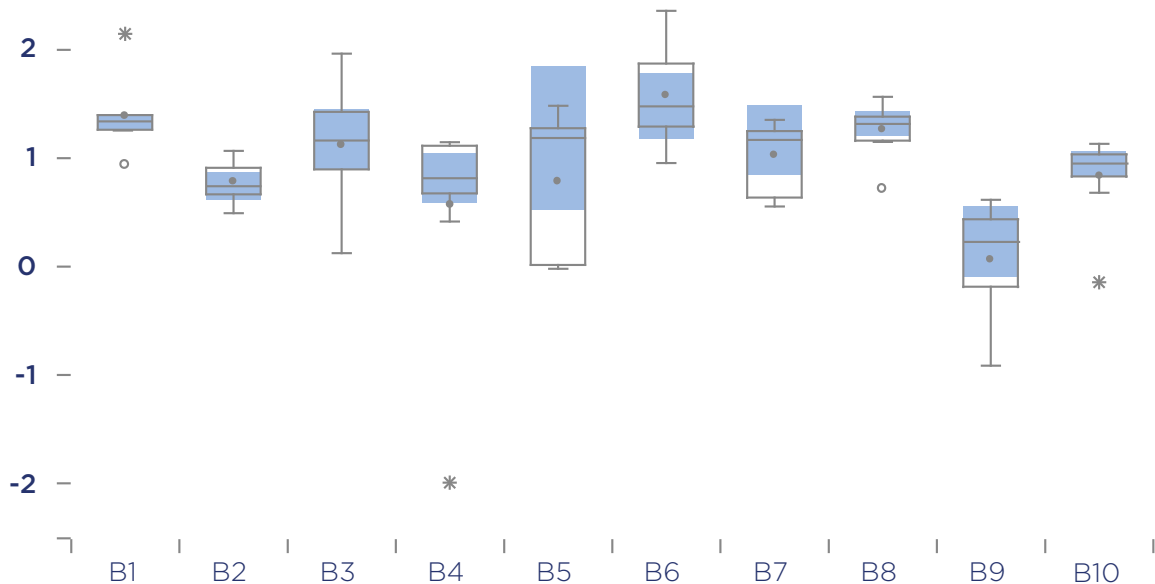


exhibit the expected cross sectional variation in returns⁴ (Figure C). For instance, while Bank 6 has managed higher ROA on average, it has also experienced much greater dispersion than Bank 2. This volatility in returns on assets is particularly high for Bank 5 while Bank 9 has the lowest average ROA.

Apart from the heterogeneity in banks' profitability ratios that is evident from the above graph, it is worth asking what factors potentially drive the overall profitability of Kuwaiti banks. To answer this question, we conduct an empirical analysis using bank specific factors as well as market structure and macroeconomic variables. Our baseline empirical models follow the framework of Ho and Saunders⁵ (1981) and its subsequent extensions⁶. Specifically:-

Fixed Effect Model (FEM):

$$ROA_{i,t} = \alpha_i + \beta_1 X_{i,t}^B + \beta_2 X_{i,t}^M + E_{i,t}$$

where X^B and X^M are vectors of theoretically motivated bank-specific and market structure & macroeconomic variables respectively.

Random Effect Model (REM):

$$ROA_{i,t} = \alpha + \beta_1 X_{i,t}^B + \beta_2 X_{i,t}^M + w_{i,t}$$

where the component error term consists of which is bank-specific error component and which is the standard error term.

We have used annual data from 2012 to 2020 for domestic operation of 10 Kuwaiti banks.

4 The line inside the box depicts the median value while the dot shows the mean. White dots represent outliers, while stars are extreme values.

5 Ho, T.S., and A. Saunders (1981), "The determinants of bank interest margins: theory and empirical evidence." *Journal of Financial Quantitative Analysis* Vol. 16, pp. 581-600

6 Almarzoqi, R and Naceur, S.B. (2015), «Determinants of bank interest margin in the Caucasus and Central Asia», IMF WP/15/87

ROA, the dependent variable, is a simple and commonly used measure of bank profitability, exhibiting the ability of a bank to generate profits from its asset management function.

Bank-specific variables include:

- **Efficiency:** measured by the ratio of operating expenses to total assets. As higher operating cost erodes net income, a negative coefficient on this variable is expected.
- **Income diversification:** measured by the ratio of non-interest income to gross income. Banks' ability to generate non-interest income (primarily fee and commission income) provides them with an alternative source of revenues, in addition to their core source (i.e. net interest income). Banks that can manage to diversify their income sources are likely to be more profitable. Accordingly, the coefficient on this variable is expected to have a positive sign.
- **Risk aversion:** proxied by capital to assets, as higher ratio reflects greater risk aversion by the bank management. Expected sign on this variable is somewhat ambiguous. Banks with higher capital adequacy ratios are safer and can borrow on better terms which should reduce their funding cost. Yet higher risk aversion may restrict banks' lending to high quality borrowers only, which is likely to reduce their net income.
- **Credit risk:** proxied by the ratio of loan loss provisions to gross loans. Higher credit risk is expected to depress net income. Therefore, expected sign on this variable is negative. Alternatively, specific provisions to gross loans can also be used as it is likely to better reflect the current level of credit risk.
- **Liquidity risk:** proxied by ratio of liquid assets (with maturity of less than 3 months) to short term liabilities. Greater level of liquid assets compared to short-term liabilities would increase banks' resilience against short-term liquidity shock. Moreover, strong liquidity profile should also keep banks' borrowing cost lower. However, maintaining higher levels of liquidity is likely to depress profitability.

- **Structural variables** include Size (proxied by the log of total assets or gross loans) and Concentration (measured by the Herfindahl-Hirschman Index for loans and deposits separately). Lastly, macroeconomic variables include CBK' policy rate, inflation rate and growth in non-oil GDP. Results are reported in Table -1 below.

Empirical findings:-

First, we consider the bank-specific determinates of profitability. It appears that efficiency, income diversification and risk aversion are key variables influencing banks' ROA. In both fixed and random effect estimates, results are significant (at 1% significance level for efficiency and risk aversion). For instance, the negative sign for efficiency indicates that higher operating costs have strong impact on reducing profits while the positive sign of income diversification suggest a direct relationship between banks' ability to generate non-interest income and profitability. The positive coefficient of risk aversion suggests that banks with better capital adequacy ratios can raise funds cheaper (as they are conceived safer by investors) which helps improve their profitability. In general, given the statistical significance of these bank specific variables in both estimates, it can be argued that banks have a fair degree of control over the drivers of their profitability.

Credit risk (available provisions to gross loans) appears significant only under REM model. Moreover, the sign on credit risk is sensitive to the ratio we use in our regressions. When available provisions to gross loans is used as a proxy for credit risk, the sign of the coefficient appears negative. It however turns positive when we use specific provisions to gross loans instead.

The contradiction in signs could be explained by the difference in numerator in both ratios. To start with, total (available) provisions to gross loans, while used in literature, may not be a good proxy for credit risk in our case where judgmental provisions constitute a sizeable share

of total provisions⁷. Since judgmental provisions are forward looking by design (to serve as a buffer against credit shocks in the future), they might be a poor indicator of the existing level of credit risk. Second, and as an upshot of the first point, the coefficient has a negative sign because available provisions enter our regression equation essentially as a cost item rather than an indicator of credit risk. Third, end of the year data that we have used in our estimates could mask considerable variation during the year

and could therefore be a weak proxy of the true nature of credit risk.

The sign of the coefficient for credit risk turns positive when specific provisions are used. This suggests that banks might be generating higher returns by essentially lending to risky borrowers to being with - hence a direct relationship between credit risk and profitability. Additionally, the coefficient on credit risk, when specific provisions are used, is statistically significant under both FEM and REM.

Table 1: Determinants of Banks' profitability (ROA)

	FEM		REM	
	Coefficient	SE	Coefficient	SE
<u>Efficiency</u>	<u>-1.620***</u>	<u>0.380</u>	<u>-1.430***</u>	<u>0.301</u>
<u>Income Diversification</u>	<u>0.332**</u>	<u>0.153</u>	<u>0.313**</u>	<u>0.1423</u>
<u>Risk Aversion</u>	<u>0.093***</u>	<u>0.032</u>	<u>0.077***</u>	<u>0.027</u>
<u>Credit Risk</u>	<u>-0.109</u>	<u>0.079</u>	<u>-0.123*</u>	<u>0.064</u>
<u>Liquidity Risk</u>	<u>-0.009</u>	<u>0.011</u>	<u>-0.007</u>	<u>0.010</u>
<u>Policy Rate</u>	<u>0.719***</u>	<u>0.120</u>	<u>0.715***</u>	<u>0.120</u>
<u>Inflation Rate</u>	<u>0.137**</u>	<u>0.055</u>	<u>0.138**</u>	<u>0.055</u>
<u>Non-oil GDP growth</u>	<u>0.013</u>	<u>0.014</u>	<u>0.012</u>	<u>0.014</u>
<u>Constant</u>	<u>0.000</u>	<u>0.005</u>	<u>0.000</u>	<u>0.005</u>
<u>R-square</u>	<u>0.695</u>		<u>0.463</u>	
<u>F test (p-value)</u>	<u>0.000</u>		<u>0.000</u>	
<u>Hausman Test (p-value)</u>			<u>1.000</u>	
<u>Observations</u>	<u>90</u>		<u>90</u>	

***p<0.01, **p<0.05, *p<0.1.

In different specifications, liquidity risk appears insignificant, though with the negative sign, suggesting that maintaining higher liquidity levels could reduce banks' profits.

Market structure variables like bank size and concentration in the loans⁸ appear insignificant and have therefore been dropped from the final model. It seems being a bigger bank or having a greater

⁷ Judgmental provisions, driven by regulatory guidance, on average account for almost half of the total available provisions between 2002-2020.

⁸ We have also used HHI for deposits but results remain insignificant.

market share in loans or deposits may not necessarily translate into better profits, unless the bank is efficient and has diversified income streams.

On the macroeconomic side, CBK's policy rate appears highly significant in all specifications. In addition to a few bank-specific variables mentioned earlier, discount rates is arguably a key determinant of banking sector profits. The presence of interest rate caps in Kuwait might have further reinforced the pass through from discount rates to banking sector profitability. Inflation is also statistically significant and has a positive effect on ROA. However, growth in non-oil GDP, used as a proxy for domestic business cycle, appears insignificant as a driver of profitability.

Profitability under low interest rate environment:

Given the strong statistical significance of policy rate in determining banking sector profitability, the current record low rates are likely to keep banks' profits muted. This would be particularly true of banks that are chiefly dependent on a classical earning model of maturity transformation and have limited share of non-interest income.

However, it will be a mistake to overlook the positive side of low interest rate environment. After all, lower interest rates can support banking sector profits by boosting credit growth. Second, lower rates can help keep borrowers' debt servicing cost low, thus reducing potential delinquencies and limiting the provisioning expense. Therefore, despite the challenges that a low interest rate environment is likely to pose for banks' profitability, banks can attenuate this impact somewhat by pursuing healthy credit growth, as long as such expansion is not achieved at the cost of credit quality.

The record low rates and the consequent supersession in net interest income would also require banks to diversify their revenue streams by increasing non-interest income and/or by improving operational efficiency. Operating cost could potentially be contained by going increasingly digital in delivery of products and services, though it could necessitate greater upfront investment on IT infrastructure, particularly for banks with antiquated IT systems.

Apart from low interest rate environment, profitability will also remain under pressure, given the unprecedented health and economic shock that continues unabated. While the payment moratoriums in 2020 and other policy relief measures have kept the infection levels at manageable levels so far, the full impact of Covid-19 shock on banks' loan portfolios has yet to materialize. As moratoriums have expired and outlook is still uncertain, credit quality could come under renewed pressure, thus increasing provisioning expense and further constraining profits.

With profits under pressure, expectations of higher returns from investors may prompt banks to take excessive risk, not least as record low rates could lead to an underestimation of borrowers' debt servicing risk once rates normalize. To boost revenues, some banks might be tempted to either operate with thin capital buffers and/or indulge in riskier lending practices. However, both approaches to enhance revenues are at odds with the notion of financial stability. Therefore, it is critical for banks to pursue realistic targets of profitability and adopt to changing business conditions sooner than later. Efforts to swiftly return to pre-Covid profits levels, particularly in the absence of enhancing efficiency or diversifying revenues, could jeopardize the longer-term stability of the banking system.

RESILIENCE

Kuwaiti banks ended the year with enhanced capitalization

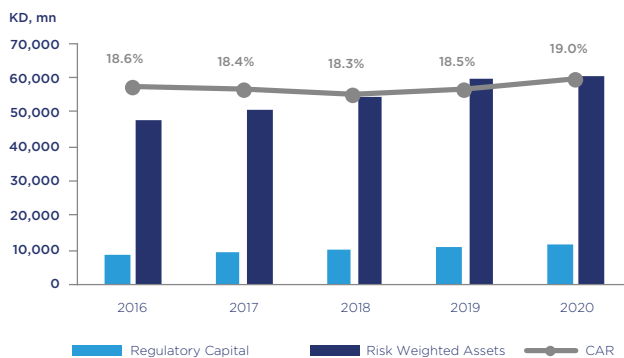
Kuwaiti banks demonstrated resilience and robust loss absorbing abilities, where despite the ongoing crisis, the industry managed to increase its capital adequacy ratio (CAR) by 0.5 percentage points YOY to 19% (figure 4.12). Both capital and RWAs grew from their 2019 levels, with capital increasing at a faster rate enabling the net increase in the CAR.

Banks took advantage of the global low interest rate environment to borrow, most of which came in the form of Tier 2 issuances

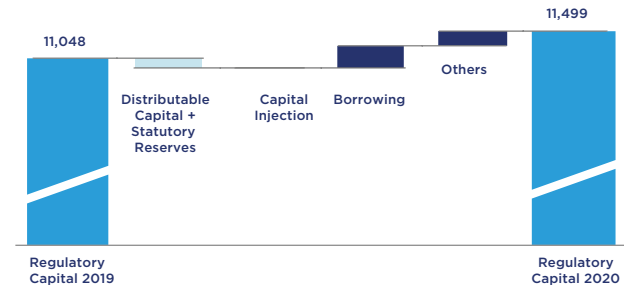
Although the decline in aggregate bank profits lowered capital, the decline was more than compensated for with increased borrowing in the form of subordinated Tier 2 issuances (figure 4.13). These issuances were mainly dollar-denominated and were all oversubscribed (up to 9 times), highlighting global investors' confidence in Kuwaiti banks. This enabled banks to maintain payment of dividends (albeit at lower levels), reassuring investors while simultaneously upholding adequate capitalization.

The additional issuances during 2020 contributed to the declining share of Common Equity Tier 1 (CET1) in proportion to the capital base, representing 78.5% of total capital at year-

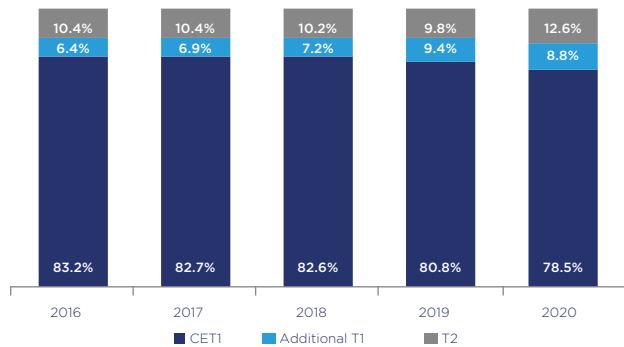
4.12 Capital Adequacy Ratio



4.13 Changes in Regulatory Capital (KD, million)



4.14 Capital Composition

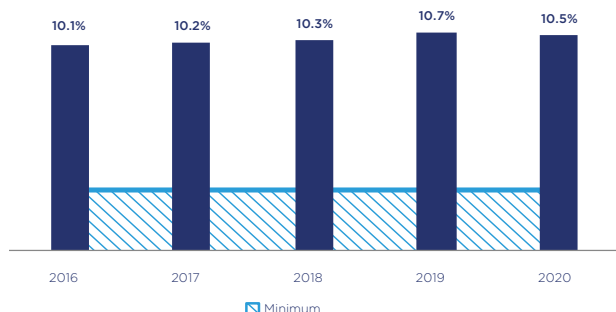


end (figure 4.14). Additional Tier 1 capital's share in total capital also declined, as banks opted to increase issuance of Tier 2 securities given favorable borrowing conditions. Although CET1 decreased in its share of total capital, the CET1/RWA ratio remains at 14.9%, well above both Basel III and CBK's minimum requirements of 4.5% and 7%¹. The sustained dominance of CET1 in banks' capital structure highlights continued robust loss-absorption capacity.

“ Both capital and risk-weighted assets grew from their 2019 levels, with capital increasing at a faster rate, enabling a net increase in the CAR. ”

¹ Minimum post-easing, where the minimum pre-easing was 9.5%. See Box 1.1 for more details.

4.15 Basel III Leverage Ratio



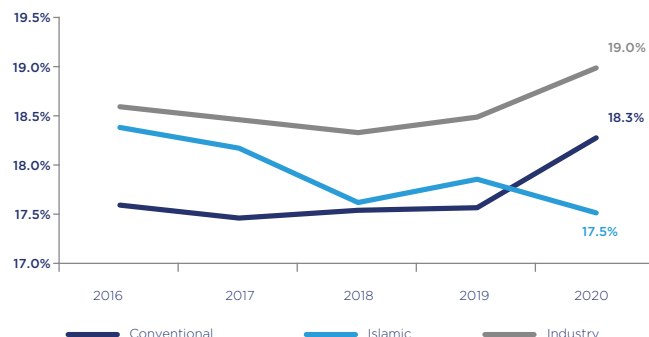
Banks' leverage remained subdued

In another indication of the local banking system's resilience, Kuwaiti banks managed to weather the crisis with a modest decrease in the Basel III leverage ratio, a measure of Tier 1 capital to all non-risk weighted exposures (figure 4.15). Although Tier 1 capital increased YOY, the ratio shed 0.2 percentage points to reside at 10.5% as exposures increased at a higher rate. The mild deterioration indicates the success of banks in playing a countercyclical role during the crisis by increasing financing to economic participants. Still, the ratio remains comfortably above CBK's minimum requirement of 3%.

Conventional banks fared better than their Islamic counterparts in terms of solvency

Conventional banks' CAR increased by 0.7 percentage points from the year prior to 18.3%, while Islamic banks' fell by 0.4 percentage points to 17.5%. This underperformance came in despite Islamic banks benefitting from a 50% risk-sharing adjustment factor on risk-weighted assets funded by unrestricted investment accounts (alpha-factor) (figure 4.16)². Although both segments participated in Tier 2 issuances to reinforce capital levels, Islamic banks also experienced a simultaneous increase in credit risk-weighted assets. This expansion drove the divergence in CAR between the two segments, as conventional banks' RWAs increased by a mere 0.8% in contrast with the Islamic banks' 5.6%. Conventional banks also managed to close the gap in Tier 1 capitalization, as the Islamic Tier 1 ratio fell 0.8 percentage points to 15.7% while conventional banks' remained flat at 15.5% (figure 4.17).

4.16 Conventional vs Islamic CAR

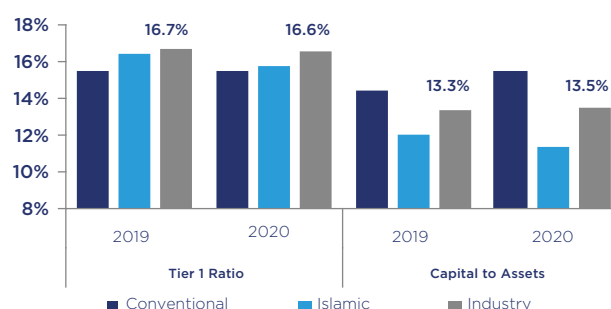


“
Conventional banks' CAR increased to 18.3% by year-end relative to Islamic banks' 17.5%, despite the latter benefiting from 50% risk-sharing adjustment factor on risk-weighted assets.
 ”

All banks maintained healthy capital adequacy levels individually

The capitalization of individual banks continued to converge in 2020, clustering around a CAR of 18% (excluding IBK) (figure 4.18). The outlier, an Islamic bank, saw an increase in its CAR as a result of large issuances. Banks that have previously lagged benefitted from the convergence, managing to close the gap and improve their CAR over the past few years.

4.17 Other Solvency Ratios by Sector



² Average industry CAR being above both Islamic and conventional is due to the inclusion of a specialized bank (Industrial Bank of Kuwait) that is not included under either sector.



Despite the increase in the net NPLs to capital ratio, the banking system remains sufficiently provisioned to absorb the entire yearly increase in net NPLs



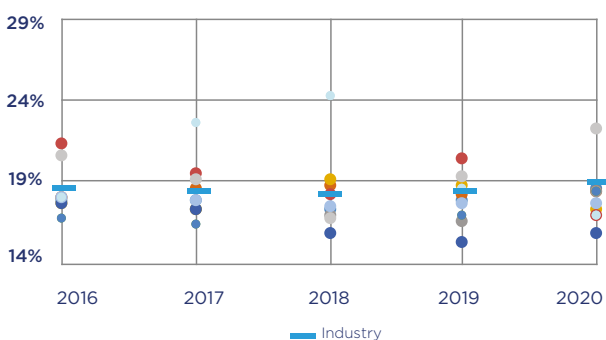
Non-performing loans increased relative to capital

Net NPLs to Capital, a ratio measuring the percentage of banks capital exposed to NPLs not covered by specific provisions, climbed to a 3-year high of 6.6% (figure 4.19). The move was driven by a 42% (KD 223mn) surge in net NPLs to a year-end level not seen since 2014. This ratio however only takes into account specific provisions charged against non-performing loans, and disregards general provisions which have increased by 14.2% (KD 242mn) during the year. Taking these provisions into consideration, the banking system is capable of absorbing the entire yearly increase in net NPLs. It is worth noting that a large portion (53.5 %) of loans classified as non-performing are backed by collaterals, lowering the need to form provisions on said loans.

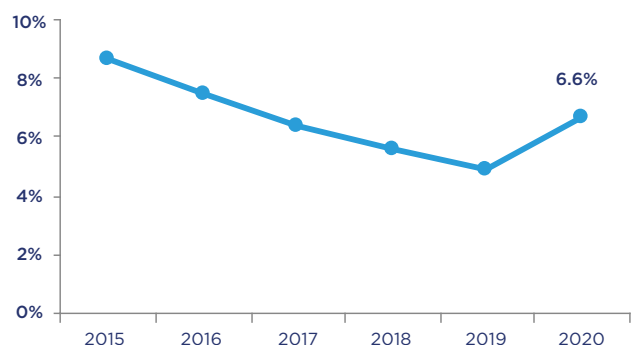
Stress testing highlighted individual bank and system-wide vulnerabilities

In assuring the soundness and resilience of the banking sector, the Central Bank of Kuwait (CBK) supervises stress testing exercises conducted using two approaches; bottom-up and top-down. The bottom-up approach consists of assumption-setting by the banks, followed by a thorough assessment of results by CBK. This approach plays a key role in identifying vulnerabilities of an individual bank and formalizing the bank's role of prioritizing its own risk assessment. The top-down exercise however, takes a more holistic approach, where stress in an individual sector or the broader economy is reflected on the financial system. In addition to identifying individual banks' vulnerabilities, the top-down stress tests are crucial in testing system-wide resilience through the modelling of macro-linkages and identification of potential sources of systemic-risk.

4.18
Distribution of Banks' CAR



4.19
Net NPLs to Capital





The revamped stress testing framework proved to be highly adaptable to the shifting economic landscape of the crisis, as the results demonstrated its effectiveness in quantifying credit, investment book, and interest rate risks' impact on banks.

The implementation of CBK's new top-down stress testing framework proved valuable

The year 2020 saw the implementation of CBK's new top-down stress testing framework, drawing insights and relevant optimizations from the on-going crisis. The new model enabled flexible scenario setting, enhanced utilization of granular data, and second-round effect capabilities. The revamped framework proved to be highly adaptable to the shifting economic landscape of the crisis, as the results demonstrated its effectiveness in quantifying credit, investment book, and interest rate risks' impact on banks.

Tailor-made scenarios with a focus on domestically relevant economic factors

Scenario setting involved three archetypal scenarios with increasing degrees of impact severity on GDP. Scenario 1 entailed a sectoral shock in the form of a real estate market collapse. Scenario 2 consisted of a country-wide shock in the form of extreme fiscal contraction hitting multiple sectors. Scenario 3 revolved around a global shock represented by a prolonged Covid-19 crisis.

High domestic reliance on real estate comes in the form of investments, collaterals, and banks' respective financing exposures. Thus, a severe drop in real estate prices would be transmitted through the aforementioned channels, in addition to the exertion of pressure on the construction sector. The core impacted macro-variables would be a drop in GDP and real estate prices, potentially leading to an increase in government expenditures. Impact on GDP is expected to be moderate as the scenario is assumed to last for two years.

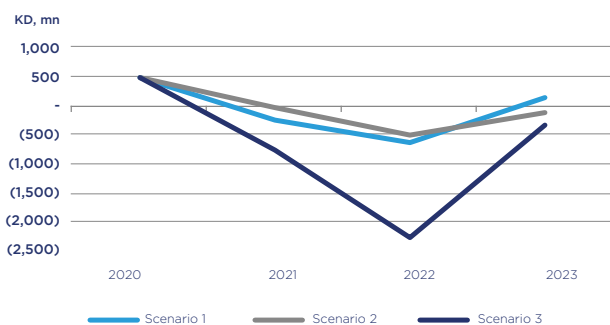
The second scenario revolves around Kuwait's fiscal dominance and economic reliance on government spending (whether in the form of wages, subsidies, or capital projects), where a sudden tapering in this spending would likely have a material and direct impact on the economy. Under this scenario, the key changes in macro-variables would be a decrease in oil revenues, GDP, and government expenditures. Impact on GDP is expected to be adverse and last for three years, while the transmission mechanism would be far-reaching in terms of affected economic sectors.

The final scenario entails a widespread global shock, as is currently being experienced amid the Covid-19 pandemic. Global economic

contraction rooted in both demand and supply disruption would lead to sharply lower oil prices and asset values for the next four years. The key macro-variables under this scenario would be lower GDP, oil revenues, and government expenditures while unemployment would increase. Impact on GDP is expected to be highly adverse.

Results emphasized the significance of real estate in the local economy, as the sector-specific shock on real estate resulted in a higher hit to banks profits than the country-wide shock stemming from fiscal contraction (figure 4.20). The more dramatic hit under Scenario 1 was a result of mounting incremental NPLs, as banks have relatively high loan exposures to real estate. The impact from Scenario 2 is more persistent in the longer-term, as negative loan growth underscored by decreased economic growth weighs down on bank profits. Results seem milder under Scenario 2 due to the shock being system-wide, and not focused on a sector that local banks are concentrated in (i.e. real estate). Under Scenario 3, severe incremental NPLs along with the triggering of second-round effects result in the dramatic fall in 2022 profits. These effects come in the form of increased costs of funds as the bank that falls below the solvency threshold³ faces run-offs on deposits and higher costs on short-term funding from other banks. Although NPL assumptions differ between sectors, all sectors are hit including the historically robust Households sector. Net income manages to bounce-back in the third year as the economic effects of the virus dissipate.

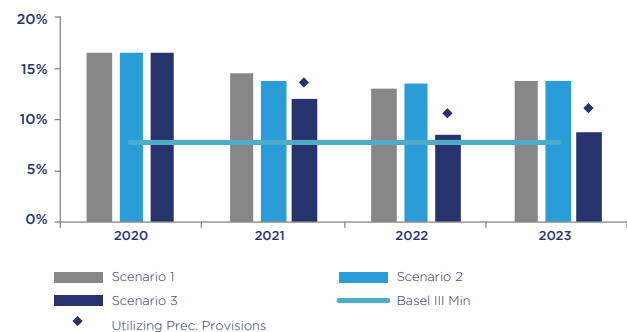
4.20 Net Profit Under Stress Scenarios



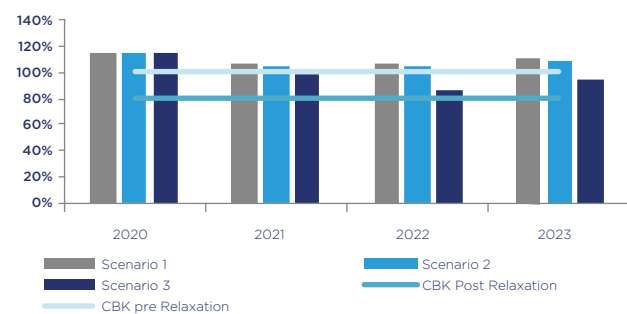
Similarly, the effects on solvency are more dire under Scenario 1, as demonstrated by the CAR⁴ in 2022 (figure 4.21). The CAR remains comfortably above the Basel III minimum of 8%, only coming close to breaching it in the second year of stress under Scenario 3. Allowing banks to utilize precautionary provisions, formed specifically to absorb unanticipated shocks, lifts the CAR on average by around 2 percentage points across all years of Scenario 3.

Liquidity remains at healthy levels during all years of Scenarios 1 and 2, with banks only facing liquidity issues under the most severe scenario as second-round effects kick in (figure 4.22). Lending capacity remains robust under all years of all scenarios as the maximum lending limit remains comfortably below its 100% threshold, ensuring banks have sufficient capacity to maintain their role in financing economic activity.

4.21 CAR% Under Stress Scenarios



4.22 NSFR Under Stress Scenarios



3 Threshold placed at a CAR of 11.5%. Represents level that may lead to increased perception of risk from the market.

4 The difference between the CAR presented for 2020 and the one presented earlier in the section was due to a 100% alpha factor assumption on Islamic banks during the stress test. This assumption was put in place to maintain conservativeness.

CHAPTER 5

DOMESTIC

MARKETS



Markets play a key role in an economy’s facilitation and efficient allocation of resources. Ensuring stability in said markets is crucial to garnering investor confidence and sustaining economic growth. The Kuwaiti economy relies primarily on real estate and equity markets, which dominate the investment scene. This chapter aims to examine both of these markets, and highlight key financial stability implications stemming from them.

Real Estate¹

In 2020, the novel coronavirus led the government to impose lockdown measures, directly impacting the operations of public and private institutions. As a result, the facilitation of real estate transactions was significantly hampered. The effects may be attributed to both economic-driven stress and operational-driven volatility. The fluctuations in the real estate market that took place during the year – particularly within real estate transactions – were primarily operations-driven. Despite the key operational issues, there were some other interesting dynamics at play during the year. This section explores how the real estate market at large fared during the pandemic, while also examining the relationships between the banking sector and the real estate market.

Although the real estate market had a rough start to the year, several idiosyncratic factors helped it regain momentum in the second half

The year started off relatively normal, with real estate transactions taking place as usual. It was not until the end of Q1 that the market

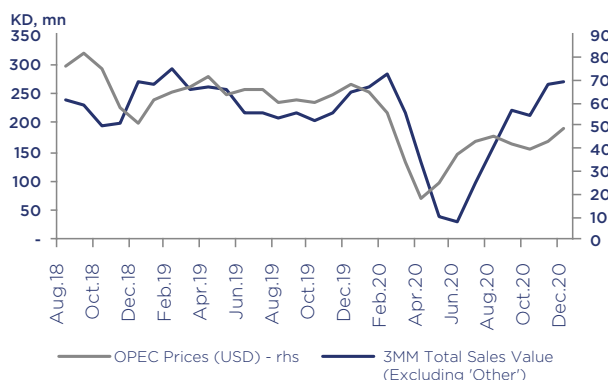
5.1



experienced notable disruption caused by the pandemic. Moreover, lockdowns were enforced and were not lifted until the end of Q2. As a result, it limited – and in some cases halted – the operations of participants in the market.

Coupled with the easing of lockdown measures, several idiosyncratic factors helped the real estate market regain momentum in the second half of the year (figure 5.1). Firstly, the rebound in oil prices towards the end of Q2 helped reinstate a degree of confidence in the country’s economic outlook, indirectly helping keep real estate prices relatively stable (figure 5.2). In addition, when authorities decided to lift the lockdown measures, many consumers – particularly Kuwaiti nationals working in the public sector whose salaries were not affected by the pandemic – had several months’ worth of savings that they were eager to spend. The strong consumer spending helped commercial retailers gain back much of their lost revenues, ultimately supporting the Commercial real estate segment from extended stress. Another factor that helped the real estate market regain momentum was CBK’s discount rate cuts to 1.5%. This – to a degree – encouraged residents, businesses, and investors to borrow and carry

5.2 Real Estate Sales and Oil Prices



¹ Disclaimer: In 2020, the Ministry of Justice changed the way it publishes real estate data. As extreme outliers were treated, presented data might slightly vary from this FSR and previous FSRs.

“

Ambitious residential projects with the potential to boost supply of at least 45,000 residential units are expected to come online in the coming years. Such projects include Hessah Al-Mubarak District, Al-Mutlaa Residential City, and South Saad Al-Abdullah City.

”

out real estate transactions, boosting market activity. Furthermore, because travelling was restricted, individuals resorted to buying beach houses as an alternative outlet for their travel needs. Sales of beach houses hit record highs during Q2, the bulk of which were concentrated in Sabah Al Ahmad Sea City.

Looking forward, the market is on track for numerous developments. Ambitious residential projects with the potential to boost supply of at least 45,000 residential units² are expected to come online in the coming years. Such projects include Hessah Al-Mubarak District, Al-Mutlaa Residential City, and South Saad Al-Abdullah City.

The temporary fall in sales was driven by logistical and operational constraints

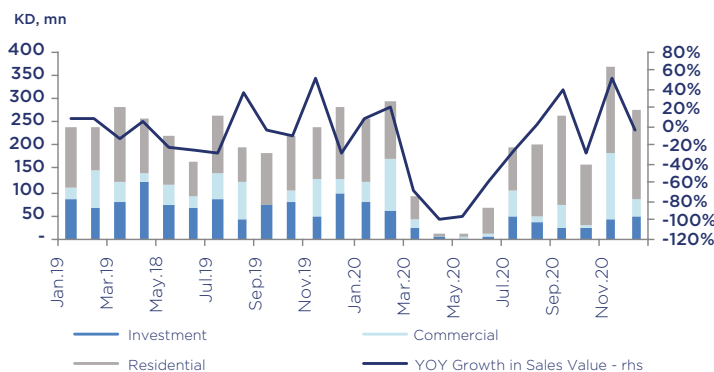
Looking at real estate sales overall, total transactional value and volume were down 23% and 18% respectively from their 2019 levels

(figures 5.3 and 5.4). Sales, however, picked up towards the end of the year for all three real estate segments, rebounding to near pre-pandemic levels. YOY growth bounced back after the lockdowns were lifted, suggesting that the temporary fall in sales was driven more by logistical and operational frictions rather than by pure economic distress.

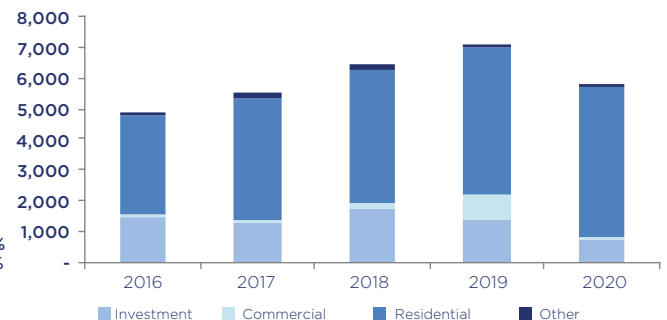
Sales in the residential segment were driven heavily by Sabah Al-Ahmad Sea City transactions

On the segmental level, Residential real estate ended the year with total transactional value 4.1% lower than that of 2019. Transactional volume, on the other hand, was up by 2.9% for the year. This drop in value and rise in volume is justified by a significantly larger number of deals that were transacted in relatively less expensive areas (namely Sabah Al-Ahmad Sea City). In addition, because of the lower prices, the Residential segment posted a notably strong rebound. Some investors capitalized

5.3 Real Estate Monthly Sales Value and YOY Growth



5.4 Annual Transaction Volume by Segment



2 Public Authority for Housing Welfare and Hessah Towers management.

on this by shifting their money from the Investment segment to the Residential segment. Interestingly, the Residential segment was the only one which posted positive YOY growth in transactions volume, partially suggesting relatively higher demand and confidence in the segment. The higher volume could also be attributed to the historically low interest rates which supported purchases.

Looking closer into prices over the past 15 years, according to CBK's Real Estate Index, the prices of Residential houses did not fluctuate as much as Investment buildings' prices. Similarly, Residential land prices do not fluctuate as much as Investment land prices. This further suggests that the Residential segment over the long-term is a relatively stable segment.

Although the investment segment was considered to be risky during the pandemic, it still attracted some investors due to the low interest rate environment

The Investment segment was particularly vulnerable to the pandemic. The year ended with sales value down by 55.6% relative to the previous year. Similarly, sales volume saw a 46.9% decline. This can partly be explained by investors' reservations during the uncertain year. Moreover, investors were likely to have

moved their money or invested in assets that are more on the low-end of the risk spectrum. Nevertheless, despite the risks, this segment did attract some investment particularly because of the low borrowing rates, making returns potentially more attractive. Even though the Investment segment is more volatile than the Residential segment, prices of both land and buildings fared relatively well as the year ended - dipping slightly in the first half, but regaining strength towards the end of the year.

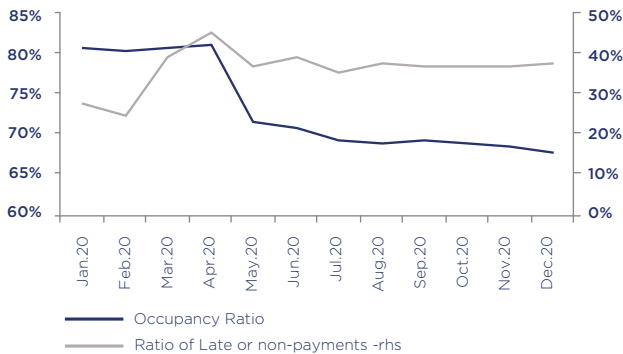
Commercial real estate transactions were low in volume but high in value

Commercial real estate is the third largest segment by value and volume. It ended the year relatively flat with total sales value falling a mere 0.7% from the year prior. Sales volume, however, fell by a dramatic 85.6% compared to 2019. It is clear that the deals struck within this segment are relatively small in number and are high in value. This is not necessarily a pandemic-specific phenomenon, as the Commercial segment posted notable variations historically. In addition, 2019 was an exceptional year in terms of Commercial real estate transactions - both by value and volume as the surge was driven by a high number of low value transactions that were concentrated in the Sabah Al-Ahmad area. This year was different however. It posted two of the highest months in terms of transaction



Sales of beach houses hit record highs during Q2, the bulk of which were concentrated in Sabah Al Ahmad Sea City.

5.5 Investment Real Estate

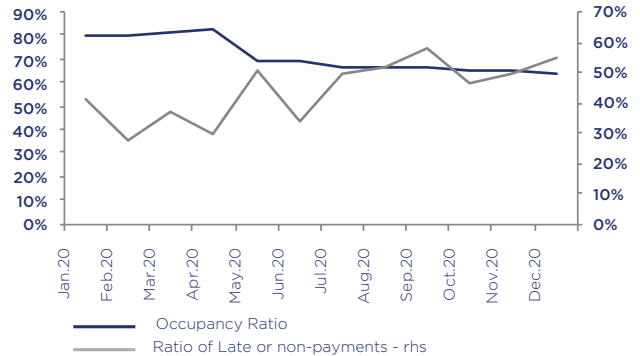


value since 2017, first in February, then again in November. February transactions value was driven by a small number of buildings located in Sharq and Al-Dhajej areas and land plots in Al-Jahra. November's peak on the other hand, was driven primarily by land plots sold in the Al-Jahra area.

Pandemic induced events resulted in rent collection issues

Looking closer into the Investment segment, according to a sample from Ajar Company³, the occupancy rate of Investment units fell by 12 percentage points YOY, ending the year at 67% (figure 5.5). The total number of late payments and non-payments however, jumped 61% YOY, and fell slightly by the second half of the year. It is worth highlighting that the average monthly rent for units categorized with late and non-payments was 18% lower than the

5.6 Commercial Real Estate



average monthly rent income per unit⁴ for the year. This suggests that lower-rent units were more susceptible to collection issues. Overall, Investment real estate held up relatively well despite the 134,000 expatriates⁵, representing 4% of the total expats, leaving the country during the year. The fact that most of these expatriates were low-income workers, the resultant price impact was mild. The periodic nature of rent contracts adjustment and, in some cases, flexible arrangements offered by landlords, culminated in lagged and dampened effects. It remains to be seen, however, if structural impact on rent would result from the shifts mentioned earlier. In fact, the number of units offering discounts increased by 161% YOY, peaking in May with 36% of occupied units offering discounts. Overall, though, Investment units' contractual rental income per unit did not change by much, increasing 3.2% for the year.

Ajar's data also indicates that the occupancy

“

Based on a sample, occupancy rates for Investment and Commercial real estate fell to **67%** and **64%** respectively by year-end.

”

³ A platform for rent collection and property management in Kuwait. The sample includes investment properties in Salmiya, Hawaly, and Farwaniya, and commercial properties in Sharq, Murqab, Bneid AlQar, Qeblah, Fahaheel, and Jabriah.

⁴ Based on the Residential segment of Investment properties.

⁵ Public Authority for Civil Information

“
Direct (investment purposes) and indirect (construction and housing purposes) real estate loans totaled KD 25.7bn, or 47.3% of banks' aggregated lending portfolios.
 ”

rate for Commercial units fell by 21.8% in 2020, ending the year at 64% (figure 5.6). This suggests that Commercial establishments struggled to stay afloat amidst the economic downturn. However, the ratio of units incurring late and non-payments increased to reach 55%. The number of discounts offered to tenants also increased throughout the year, peaking during Q2 at 16% and declining gradually to close the year at 2%. Overall, contractual rental income per unit from Commercial units fell by 11.1% YOY, with a sharp sustained decline in Q2.

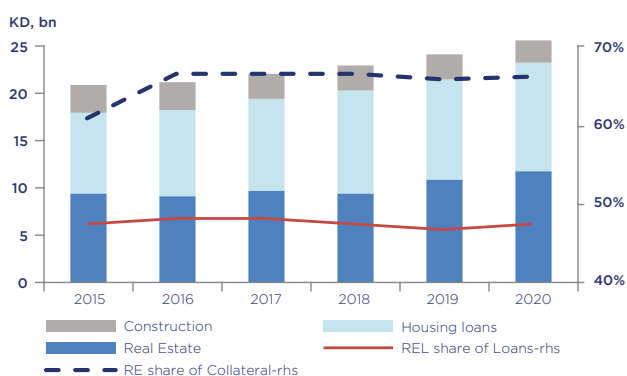
Although the data sourced from Ajar is not perfectly representative of the entire real estate market, it nevertheless provides a valuable indication of the performance of the Investment and Commercial real estate segments.

Despite the increase in the real estate sector's NPLs, overall NPLs remain at historically low levels

To dissect the multi-faceted connection between banking and real estate sectors, it is essential to analyze the different layers of banks' exposure to real estate. Specifically, real estate lending, real estate investments, and real estate as collateral.

Real estate lending can be both direct and

5.7 Banks' Exposure to Real Estate Lending



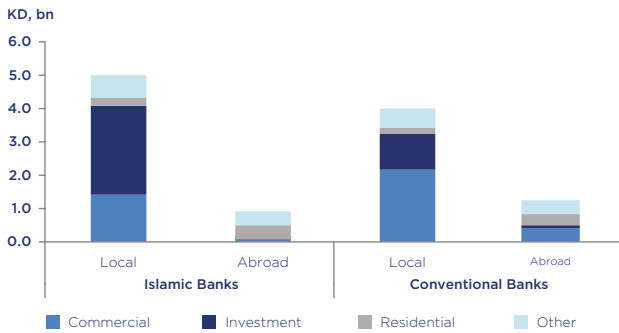
indirect. Loans granted to fund real estate purchases are considered direct, while loans granted for construction and housing⁶ purposes are considered indirect. In 2020, direct and indirect real estate loans accounted for 47.3% of banks' total lending portfolio at KD 25.7bn – slightly higher than the 46.5% seen in 2019 (figure 5.7). This figure remains consistent with that seen over the past five years.

Direct real estate loans grew by 7.8% YOY, settling at KD 11.6bn. Interestingly, apart from 2019, this year posted the highest YOY growth in real estate loans since 2014. This is partly attributable to the historically low discount rates observed in 2020. Looking at direct real estate loans, both local and abroad, the breakdown reveals that the bulk of the loans across all segments are located in Kuwait (figure 5.8). In particular, the share of local real estate loans out of total real estate loans is 85% for Islamic banks and 77% for conventional banks. In terms of real estate loan concentration in Islamic banks, 44% of loans were granted to the Investment segment. Conventional banks, on the other hand, have most of their local real estate loans (55%) concentrated in the Commercial segment.

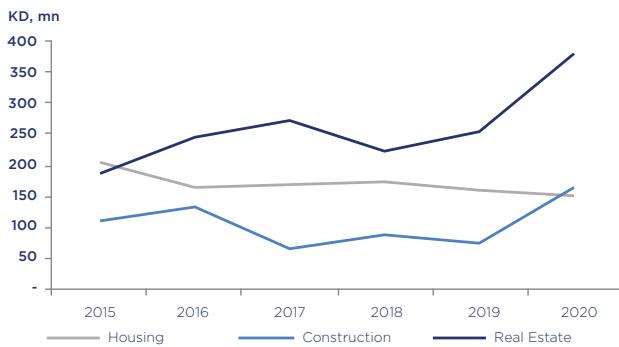
NPLs for Real Estate loans increased by 48.5%, totaling KD 379.2mn (figure 5.9). This increase was partly influenced by the lower income that landlords were receiving from tenants, particularly in the Investment segment – as indicated from Ajar's data. Construction loans fell by 2.6%, settling at a total of KD 2.6bn. Their corresponding NPLs grew by 127.9%, the equivalent of KD 165.1mn, as many projects were put on hold due to a shortage of staff amid airport closures. Finally, Housing loans grew by 7.8% to reach KD 11.4bn, while their NPLs fell by 4.9% settling at KD 150.4mn. Even though NPLs

⁶ Housing loans are personal loans backed by an individual's salary. As such, they differ in nature from real estate loans and construction loans in terms of transmitting real estate stress to banks.

5.8 Kuwaiti Banks' Real Estate Loans Concentration (2020)



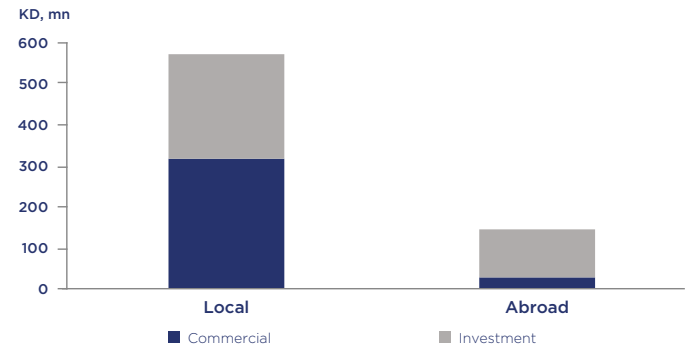
5.9 Real Estate Lending (Non Performing Loans)



related to real estate loans inched up slightly in 2020, overall NPLs remain at historically low levels.

Locally, only Islamic banks are permitted to directly invest in real estate. Around 80% of Islamic banks' real estate investments are located domestically (figure 5.10). Specifically, Islamic banks own the equivalent of KD 311mn in local Commercial real estate and KD 256mn in local Investment real estate, a healthy split. Abroad, Islamic banks own the equivalent of KD 116mn of Investment and KD 28mn of Commercial real estate. The fact that the bulk of Islamic banks' investments are situated within Kuwait is partly indicative of support for local economic development.

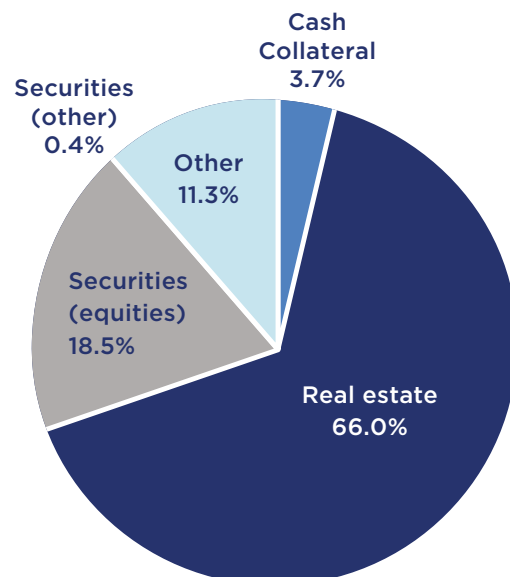
5.10 Islamic Banks Investments in Commercial Vs. Investment Real Estate Projects (2020)



There is a general sense of confidence and acceptance in the soundness of real estate assets as a form of loan collaterals

In terms of collaterals, real estate assets represented 66% of total loan collaterals by the end of 2020 (figure 5.11). This indicates the overall confidence and acceptance of the soundness and dependability of real estate assets. Given this dependence, the values of these collaterals remain vital so as to limit the potential exacerbation of credit risk. CBK is continually monitoring real estate values, collateral values, and the direct and indirect real estate loans through routine internal stress testing exercises.

5.11 Total Collateral by Type





Bursa Kuwait

The year 2020 was challenging for equity markets, as crisis-induced volatility and increased operational pressures tested markets globally. Bursa Kuwait proved its resilience, where despite an uncertain economic outlook, managed to ensure stability while simultaneously managing record foreign flows resulting from the successful inclusion of Kuwait in the MSCI Emerging Markets Index.

Banks led the decline in total market cap

Bursa Kuwait's market capitalization stood at KD 32.2bn by the end of 2020, down approximately KD 3.5bn (-9.8%) YOY (figure 5.12). The decline can largely be traced back to Banks, the dominant sector in terms of size. Banks shed 3.4 percentage points of their share in total market capitalization, mainly to the Telecommunications (Telecom) sector and the newly formed Utilities sector (0.9 percentage points each). The year 2020 saw the formation

of the Utilities sector with the listing of Shamal Az-Zour Al-Oula Power and Water Company K.S.C.P, which offered investors a chance to invest in Kuwait's first independently-owned power plant.

The listing of new companies introduced a new sector for investors to participate in

During the year, the market witnessed the delisting of six companies from mixed sectors and the addition of two new companies, bringing the total number of listed companies up to 171 from 163 the year prior (figure 5.13). Two new additions, Shamal Az-Zour Al-Oula Power and Water Company and Bursa Kuwait Securities Company, saw immense success in their Premier Market (PM) IPOs, where they were oversubscribed by 1.27x and 8.5x respectively. Financial Services continued to be the largest sector in terms of number of listed companies, followed by Real Estate and Industrials. The

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Bursa Kuwait’s listed company market capitalization stood at KD **32.2bn** by the end of **2020**, down approximately KD **3.6bn (-10%)** YOY. The decline can largely be traced back to Banks, the dominant sector in terms of size.

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combination of Banks’ small count (11 out of 171) and large market capitalization (57.2%) allows price fluctuations of a given bank’s stock, or of the banking sector as a whole, to heavily influence broad market value-weighted indicators which raises stability implications.

Valuations remain within a relatively reasonable range

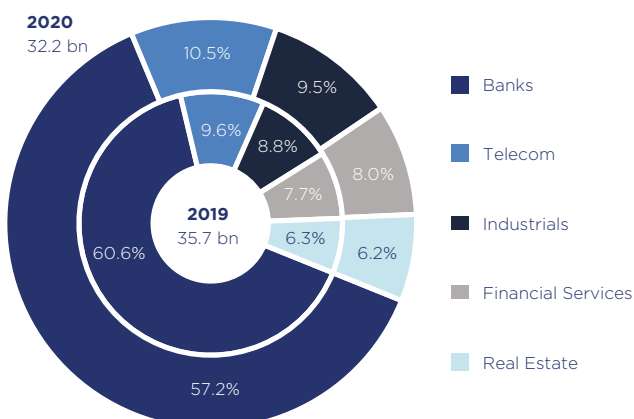
Relative to GCC peers, Kuwait’s equity market is the fourth largest in terms of total market cap at approximately USD 97bn (figure 5.14). Apart from Saudi Arabia and Qatar, all GCC countries’ market cap to GDP ratios fall under the 100% mark, signaling lower risk of inflated valuations and/or potentially lower market perception of growth prospects. Saudi Arabia’s extremely high (highest globally) market cap-to-GDP ratio can largely be attributed to the oil behemoth Aramco, which accounts for roughly USD 2tn of Saudi Arabia’s USD 2.4tn market cap. Overall, these valuations indicate that GCC equity markets may not have experienced

the liquidity-driven rally resulting from crisis-induced monetary and fiscal measures as was apparent in some other countries. In relative terms, this deems concerns of asset bubble formation and the subsequent overheating of markets less likely to materialize.

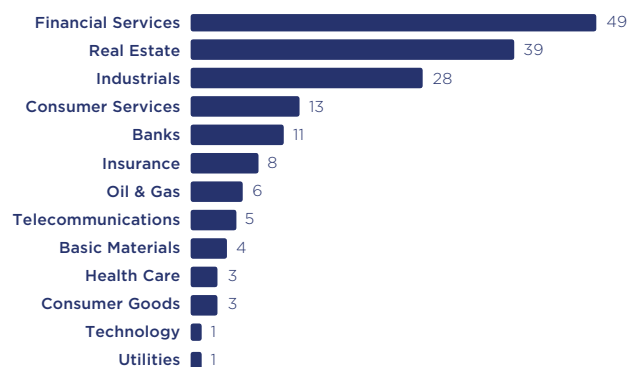
A sharp fall in equities was followed by a subdued recovery

Despite lagging early in January, the Kuwaiti equity market opened strong in 2020 on the back of momentum from the previous year. However, in-line with the effects seen globally, the local market experienced a sharp decline at the onset of the Covid-19 crisis. The value-weighted All-Share market index, covering all listed stocks, fell 30.5% from its year high of 6,393 points seen on the 19th of January, to a trough of 4,444 points on the 18th of March (Figure 5.15). A steady recovery from the March lows saw the gap shrink in half by October, to 14.8% below the January highs, as investors anticipated official inclusion in the MSCI

5.12 Market Cap Sectoral Distribution



5.13 Number of Companies



The value-weighted All-Share Market Index, covering all listed stocks, fell **30.5%** from its year high of **6,393** points seen on the 19th of January, to a trough of **4,444** points on the 18th of March.

Emerging Markets Index. Some of these gains were erased again as the All-Share index closed the year at 5,546 points (-11.7%).

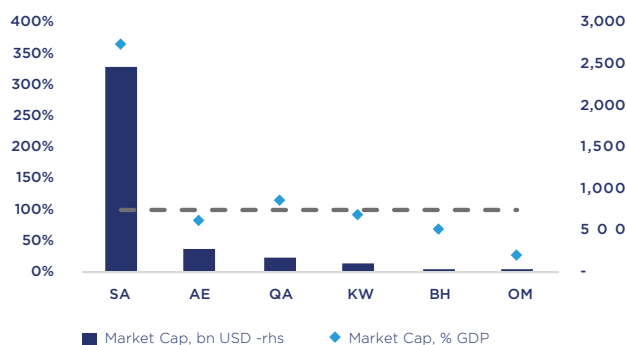
The Premier Market (PM), the flagship segment listing companies with high liquidity and medium to large market cap, was the primary driver of the recovery as the Main Market's⁷ (MM) bounce-back was more subdued (figure 5.16). This was mainly due to the moderate decline that the MM experienced in contrast with the PM. The MM fared slightly better than the PM for the year, with a return of -7.3% in contrast with the PM's -13.3%. It should be noted that stocks listed on the PM are more liquid and trade more actively than those in the MM. Thus, extreme price swings can occur in the MM as a result of thin-trading, which must be taken into account when comparing the performance of the two segments as a whole or individual stocks between segments.

Moreover, in February 2020, Boursa Kuwait launched the BK Main 50 index, which represents the top 50 MM stocks in terms of liquidity. As indicated by the average daily traded value, these leading MM stocks constitute an attractive segment compared to their peers. By highlighting these non-PM stocks, this new index seems to aim to address the potentially binary perception between PM stocks and the rest of the market.

Unexpected events contributed to heightened volatility

Volatility, driven by negative news headlines and shifting recovery prospects, was a recurring theme of the year, as material uncertainty and fluctuating developments cast shadows on investor sentiment and contributed to monthly swings (figure 5.17). Unfavorable news regarding the government's fiscal position, coupled with

5.14 Market Cap vs GCC

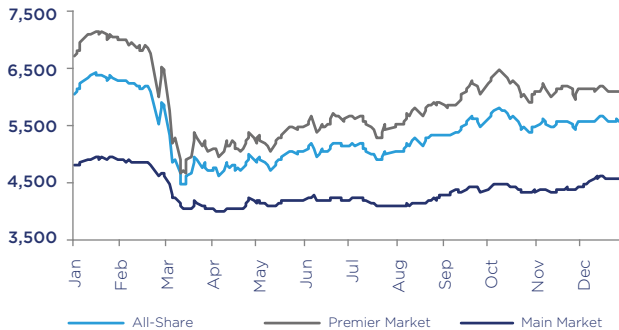


5.15 Boursa Kuwait All-Shares Index



⁷ After the discontinuation of the "Auction Market", the MM became the segment housing all shares that do not meet the requirements of the PM.

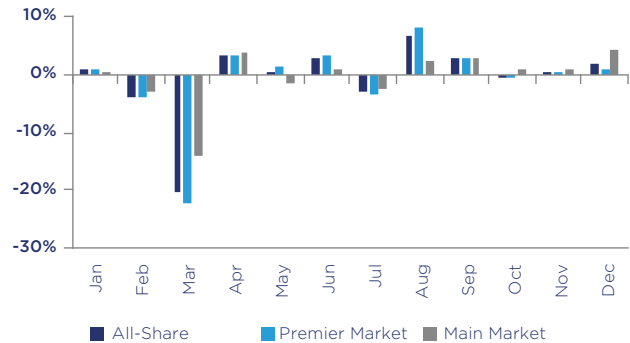
5.16 Boursa Kuwait Indices



quarterly earnings releases generally below expectations, acted as serious headwinds. Meanwhile, somewhat positive sentiment driven by anticipation of large foreign flows resulting from the inclusion of the Kuwaiti market in the MSCI Emerging Markets Index provided some form of support for prices. Annualized volatility in the All-Share index was 23.3% in contrast to the 9.3% seen during 2019.

Major domestic events also contributed to the large swings seen. On the 10th of June, an entire day of trading was cancelled in an unprecedented event aimed at mitigating the adverse effects of the spread of inaccurate information regarding banks' dividend distributions for 2020. Despite the cancellation, and in terms of the resultant price action, the All-Share index had fell by 1.4% and 2.7% in the subsequent trading days. The death of His Highness the Emir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah on the 29th of September

5.17 Monthly Returns



resulted in a 2.2% decline in the All-Share index. These losses were completely reversed when the market reopened on the 4th of October, as smooth succession measures prevailed.

Valuations strengthened during the second half of the year

Valuations fell sharply alongside markets as participants scrambled to price in the effects of the crisis (Table 5.1). Interestingly, the MM was more robust, with investors paying more per unit of earnings as soon as Q1. The second half of the year saw valuations pick-up, as earnings showed a lower-than-expected hit, inspiring confidence as well as a flock to safety. Companies listed in the MM experienced larger losses resulting in a negative price-to-earnings (P/E) ratio, while the price-to-book (P/B) ratio maintained an upward trajectory.

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The Main Market (MM) fared slightly better than the Premier Market (PM) for the year, with a return of **-7.3%** in contrast with the PM's **-13.3%**. It should be noted that stocks listed on the PM are more liquid and trade more actively than those in the MM.

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While all sectors were hit by the pandemic, the subsequent recovery was uneven. As was seen globally, non consumer-facing sectors proved more robust than their consumer-facing counterparts.
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Table 5.1

	PM		MM	
	P/E	P/B	P/E ⁸	P/B
Q 4 - 2020	21.17	1.97	-	0.90
Q 3 - 2020	20.23	1.97	-	0.87
Q 2 - 2020	11.87	1.64	17.01	0.79
Q 1 - 2020	10.19	1.42	11.12	0.77

The recovery was uneven between sectors

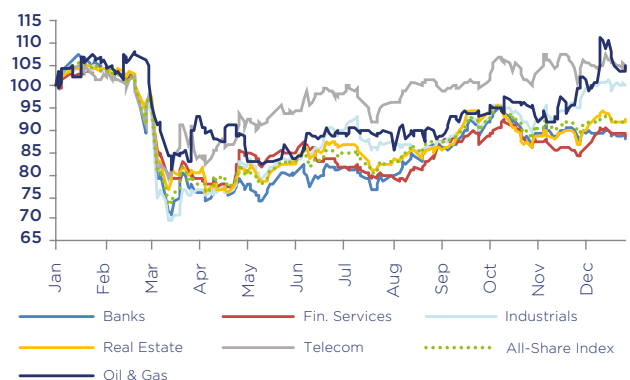
While all sectors were hit by the pandemic, their recovery was uneven. As was seen globally, non-consumer-facing sectors proved more robust than their consumer-facing counterparts. In Kuwait, Telecommunications led the broad-market recovery, managing to break even YTD as early as July, and remained comfortably above its year-open level by early October (figure 5.18). Industrials also managed to pare back losses, closing at year-open levels as economic activity picked up. While Banks were among the worst performing sectors, it is worth noting that a large part of that was attributable to the hit to profits stemming from higher provisions. These provisions serve as a buffer to absorb any potential credit deterioration resulting from a prolonged crisis. The hit in

profits also fueled uncertainty regarding banks’ ability to pay dividends, echoing the effects of the abovementioned events that unfolded on June 10th.

Boursa Kuwait trailed regional peers

After ending 2019 as the top regional performer, Kuwait’s equity market lagged behind its GCC peers in 2020 (figure 5.19). Boursa Kuwait’s rebound from the Covid-19 induced price crash was more subdued than regional peers, as political frictions hindered much needed economic reform in the face of a growing fiscal deficit. These reasons, coupled with one of the region’s largest non-oil GDP contraction forecasts, might have dampened investor confidence in Kuwaiti markets. Saudi Arabia led the region with the strongest yearly return of 3.6%, followed by Qatar which managed to close the year 0.1% in the green. Given that Boursa Kuwait’s underperformance comes after a year where it posted gains of 23.7%, the local market’s relative weakness may be partially attributed to investors correcting for excess froth, while simultaneously pricing in the previously listed concerns.

5.18 Sectoral Indices (rebased)



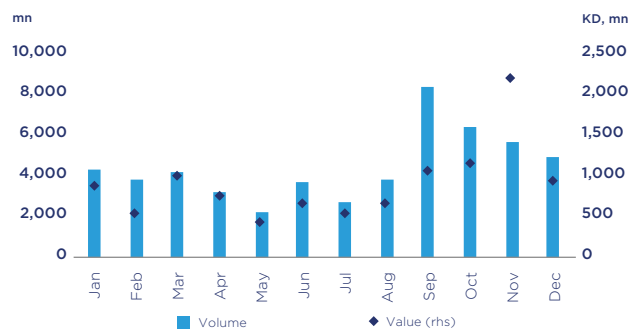
8 Negative P/E ratios for Q3 & Q4 are excluded for the MM.

An all-time high in daily traded value was recorded on the 30th of November, where **KD 961mn** changed hands as a result of foreign inflows from the **MSCI index** inclusion.

Activity surged as investors anticipated foreign flows stemming from Kuwait's inclusion in MSCI's Emerging Markets Index

Average monthly volume for 2020 was 4.3bn shares (figure 5.20), up 33% from last year's 3.3bn. The surge in volume traded began in September, as investors anticipated foreign inflows scheduled for the November 30th inclusion of Kuwait in MSCI's Emerging Markets Index. This surge in activity dissipated over the following months, hinting the increase in activity may have been a one-time spur in investor excitement rather than an organic expansion of the market. In terms of value traded, November recorded the highest reading of 2020, with KD 2.2bn traded. An all-time high in daily traded value was recorded on the 30th of November, where KD 961mn changed hands as a result of foreign inflows from the MSCI index inclusion. Interestingly, the trends between volume and value traded diverged during October and November in the run-up to the inclusion, as the former decreased in those two months while the latter increased. These moves highlight a possible tilt in investor preference towards more expensive/blue-chip stocks, as these were the companies expected to participate in the foreign inflows. Although the foreign flows mainly went into the PM segment, the MM saw

5.20 Volume vs Value Traded

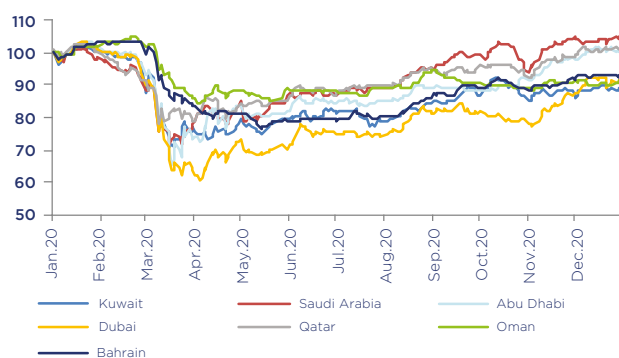


a positive spillover, experiencing an increase in value traded in the run up to the inclusion (figure 5.21).

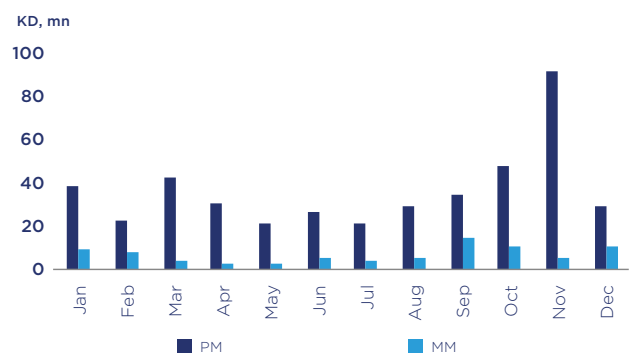
Foreign flows reached all-time highs

Continuing the trend that started mid-2018, foreign investors started the year as large net buyers (figure 5.22). These flows quickly reversed at the onset of the global market crash in March, with foreigners remaining net sellers until June. In the month of inclusion in the MSCI Emerging Markets Index (November), Boursa Kuwait saw a record KD 406mn in net foreign inflows, representing 64% of all traded value during November.

5.19 Performance of GCC Markets (rebased)



5.21 Average Daily Traded Value



Despite relative price underperformance, Banks continued to dominate trading value with little change from last year (figure 5.23). The top three sectors accounted for 82% of total trading value, with Banks accounting for 61% of total trading value even though the sector consisted of a mere 11 companies. This highlights a possible lack of depth in the equity markets on both a sectoral and company level, and raises concerns regarding price discovery and market efficiency.

Banks benefitted from a more diversified investor base

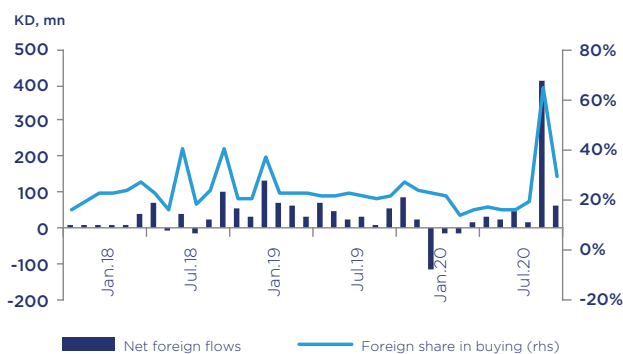
With the exception of Burgan Bank, Commercial Bank of Kuwait (CoBK), and AUB Kuwait (AlMutahed), foreign investors continued to increase the proportion of their holdings in Kuwaiti incorporated banks (figure 5.24)⁹. Consistent with their market cap, NBK,

KFH, and Boubyan experienced the largest increase in foreign ownership at 4.3, 2.7, and 1.6 percentage points respectively. AUB Kuwait and CoBK likely did not benefit from increased foreign investment due to their listing in the MM as opposed to the PM. From a financial stability perspective, the increase in banks' foreign ownership during 2020 is a generally positive indicator, as a geographically diverse investor base limits self-reinforcing dynamics that may occur in a locally induced crisis.

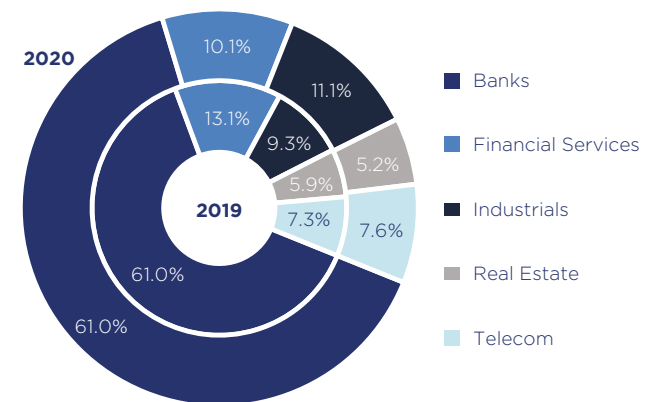
Banks' exposures to Bursa Kuwait remain within a tolerable threshold

The previously presented issues regarding the local equity market raise the question of what the implications are on the Kuwaiti financial system. Local banks are exposed to the local equity market directly through loans extended for the purpose of equity purchases, and direct

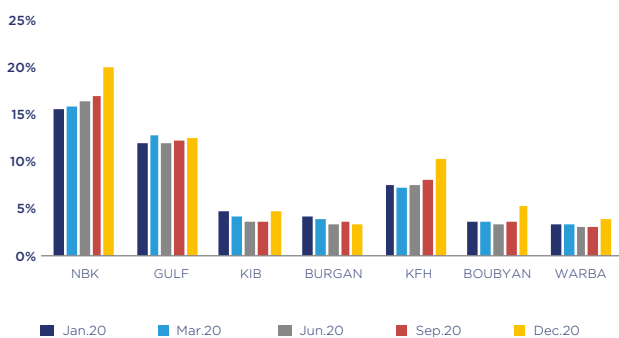
5.22 Net Foreign Flows into Bursa Kuwait



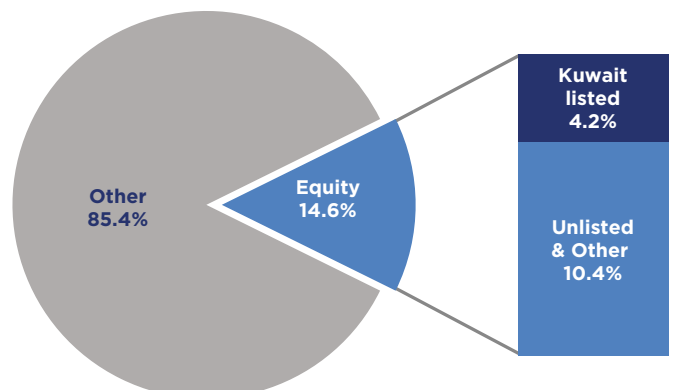
5.23 Sectoral Share in Trading Value



5.24 Foreign Ownership in Banks



5.25 Investments Distribution

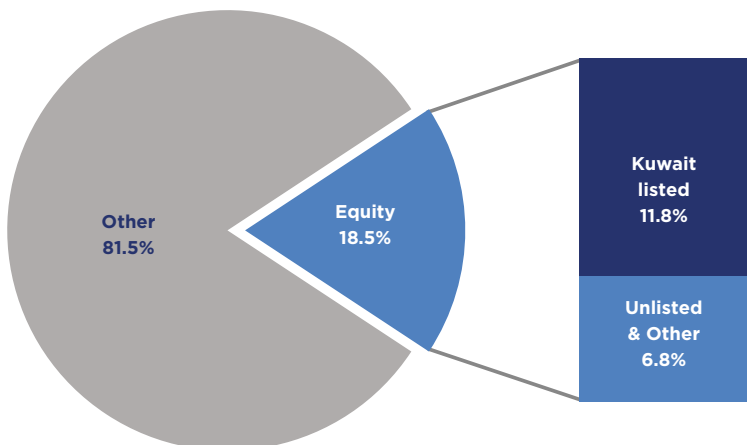


⁹ CoBK, ABK, and AUB Kuwait (AlMutahed) were excluded due to having negligible foreign ownership (<1%).

equity investments. These direct exposures represent a mere 1.8% of total bank assets, while loans used for investing in Boursa Kuwait are negligible at 1.8% of the industries' total loans. It should be noted that existing regulatory requirements curb banks' excessive exposure to Boursa Kuwait, where limits of 25% of banks' total capital and 10% of the total resident loan book are in place as maximum tolerable thresholds towards equity purchase loans.

Banks' equity investments make up 14.6% of their investment portfolio, a portion of which (4.2%) are listed on Boursa Kuwait (figure 5.25). Banks are also exposed to equities indirectly through collaterals held against loans. In this regard, equities listed on Boursa Kuwait constitute 11.8% of total bank collaterals, of which shares in banks make up the largest portion (figure 5.26). The relative concentration of collaterals in banks listed on Boursa Kuwait (4.7% of all collaterals) might, at a first glance, raise concerns as the linkage could magnify the effects of a crisis through greater contagion channels. In a crisis scenario where banks are assumed to seize and liquidate the collateral in the event of clients' default, a self-reinforcing effect could send broad equity markets into a downward spiral. This multiplier is further amplified as banks make up more than 60% of the total domestic market cap. Further pressure may arise on local banks' ability to raise capital, as lower prices translate into an increased cost of equity.

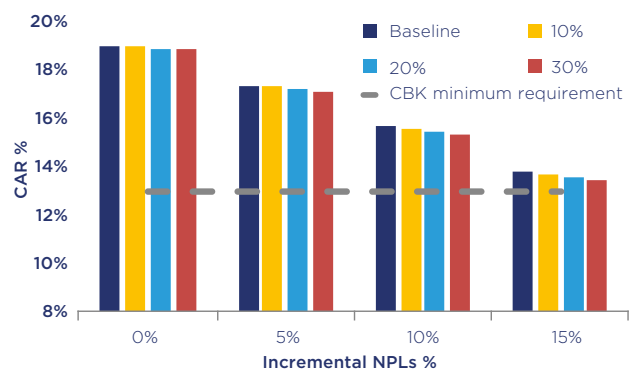
5.26 Collaterals Distribution



Banks remain resilient in the face of potential equity shocks

To assess the potential magnitude of a local equity price shock, scenario analysis was conducted with incremental NPLs and the severity of the equity shock as the two main variables. Results showed the ability of the banking sector to comfortably absorb the shock, as the effects on the CAR were relatively subdued (figure 5.27). The incremental NPL assumptions had a more prominent effect on banks than the actual equity shock assumptions, as the CAR of the banking sector fell to 13.5% in the most severe scenario. Still, the CAR remained comfortably above the 13% minimum mandated by CBK. Allowing utilization of precautionary provisions dampens the effects even further, where CAR is unchanged under the 5% incremental NPL assumption and only decreases to 15.5% in the most severe scenario.

5.27 Equity Shock Effect on CAR



CHAPTER 6

PAYMENT & SETTLEMENT SYSTEMS



In 2020, and on a global level, people’s sociological approach to life changed within a very short period of time. In tandem, there was notable acceleration in the advancement and adoption of a range of different technologies that helped individuals go about their lives with limited risk of getting infected by the virus (for further information on consumer behavior, refer to Box 6.1).

While electronic payment (E-Payment¹) solutions have been gaining wider adoption and further development, the pandemic played a clear role in expediting both aspects. This section explores electronic payment trends and the underlying systems, including local interbank payment and settlement systems.

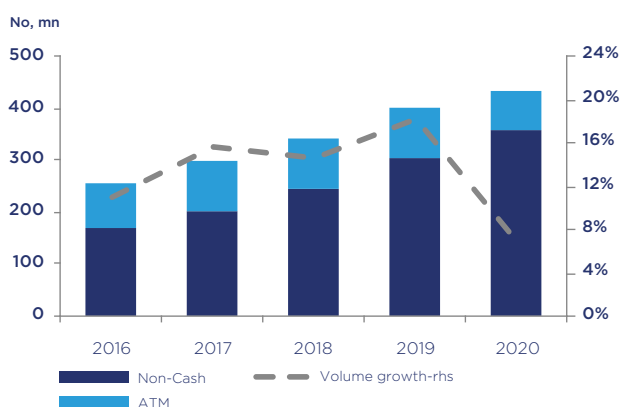
Although Covid-19 affected the usage of ATMs negatively, non-cash transactions notably grew

On a YOY basis, the volume of E-Payment transactions increased by 6.7%, far less than the 18.3% witnessed in 2019 (figure 6.1). This slowdown in transaction volume was primarily driven by the spread of the virus and the imposed lockdown measures. The impact was most significant in terms of Automated Teller Machines’ (ATMs) transactions, as they shrunk by 23.6% in 2020 (figure 6.2). Non-cash transactions², however, recorded a higher growth rate of 16.6%, as people were encouraged to avoid unnecessary cash usage. Transactions volume via Knet’s Payment

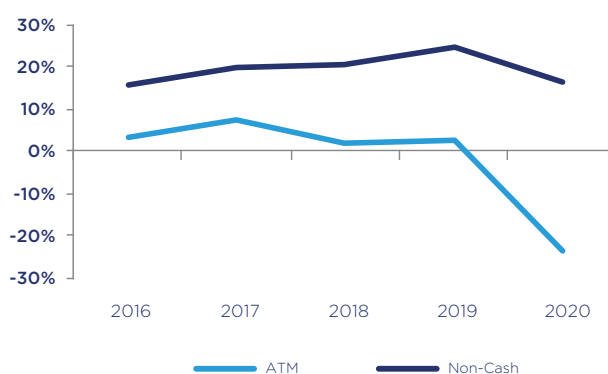
Gateway (PG) grew at a historical rate of 89.2% during the year (figure 6.3). POS usage on the other hand, dropped slightly at 5.4%, as far less people were able to use their bank cards at physical stores due to the lockdown measures that were imposed.

In contrast with the growth in volume, the value of E-payment transactions dropped slightly in 2020, falling by 1.1% compared to the 7.1% increase in 2019 (figure 6.4). As previously mentioned, lockdown measures were the main driver behind the drop in the value of E-Payment transactions. Moreover, the value of ATM transactions shrunk 18.9% during the year, while the value of non-cash transactions grew by 15.8% (Figure 6.5). The growth in the value of non-cash transactions was mainly supported

6.1
Use of E-Payment (Volume)



6.2
Growth Rate in E-Payment (By Volume)



Online payments surged by an impressive **121%** in value and **89%** in volume.

1 E-Payment is a classification that refers to the three electronic payment facilities in Kuwait: ATMs, POS, and Knet OPG.

2 Non-cash transactions include POS transactions (a physical system that allows for the processing and recording of transactions between a customer and a seller), and Knet PG (Knet’s payment gateway that allows public and private institutions to collect funds over the internet, which solely processes debit card payments).

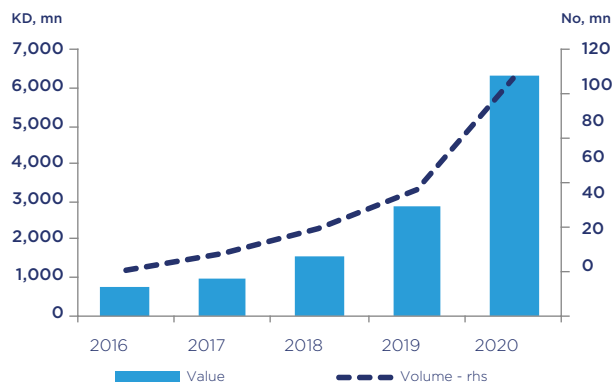
by the 120.8% growth in K-net PG in 2020. This strong growth in K-net PG is suggestive of society's growing acceptance and trust in electronic payments and underlying systems as a safe means of conducting high-value purchases. As mentioned earlier, 2020 posted an acceleration in the adoption of technology. This is clearly reflected in the share of E-Payment transactions by value, where the share of non-cash transactions increased by 9 percentage points in 2020 at the expense of ATMs (Figure 6.6).

Infrastructure trends accelerate amidst the pandemic

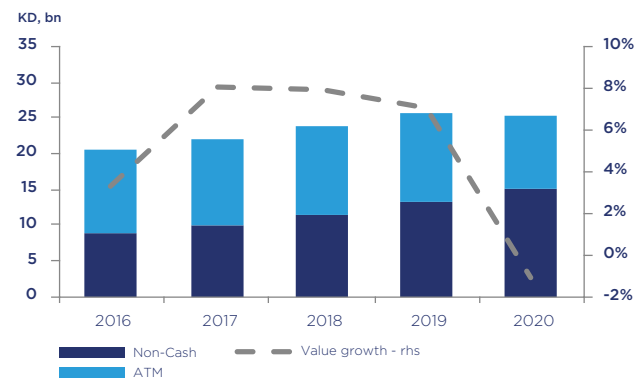
The trends that unfolded during the year were reflected by infrastructural shifts and

developments. The number of ATM machines in Kuwait shrunk for the first time in a decade, declining by 1.5% (40 machines) in 2020 compared to its 12.5% growth in 2019. In contrast, POS machines grew by 10.7% during the year compared to 9.1% in 2019. These growth figures are aligned with the theme of the year and the overall direction towards adopting payment technologies. Interestingly, the number of issued plastic cards³ decreased for the first time in a decade as well, shrinking by 1.2% (58,000 cards) (figure 6.7). While the slowdown in growth has been a steady trend for the past five years, lockdown measures introduced during 2020 accelerated the pace of the decline.

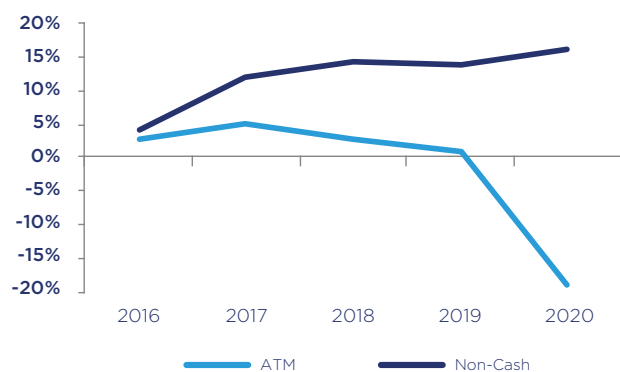
6.3 Knet Online Payment Gateway



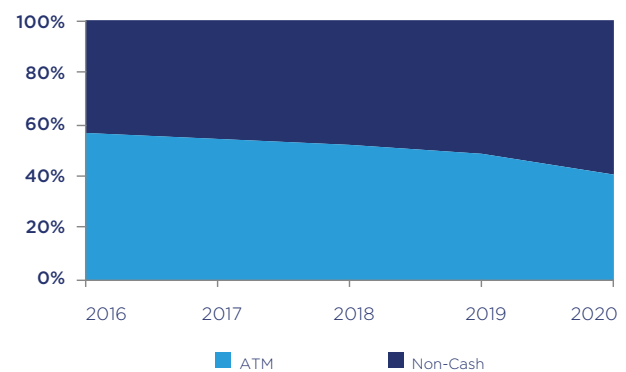
6.4 Use of E-Payment (Value)



6.5 Growth Rate in E-Payment (By Value)



6.6 Share of E-Payment (by Value)



³ Includes both debit and credit cards issued during the year.

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For the first time, the value of E-Payment transactions exceeded the value of paper-based transactions.
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A new service streamlined traditional practices

Typically, Eid occasions coincide with a spike in ATM transactions⁴. Considering the pandemic and the importance of reducing physical contact, CBK, in collaboration with Kuwaiti banks and Knet, introduced Eidity as a digital alternative to gifting cash. The service, first introduced in 2020 during Eid Al-Fitr, functions as an e-wallet that allows the public to send and receive money electronically in an easy and quick manner. The introduction of the service was another exemplification of the shift to non-cash transactions, as individuals started to send “Eidiya” online rather than in cash. Within a four day period, the platform processed 51 thousand transactions, with a total value of KD 1.9mn.

As bank customers become more tech-literate, the need for bank branches decreases

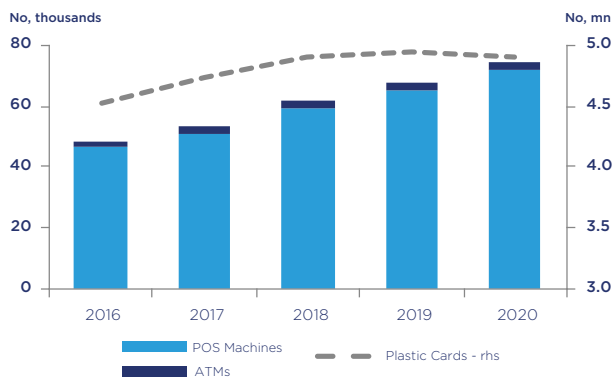
With the increased tech-literacy and adoption by the public, and the progress achieved by banks’ in developing more advanced, user-friendly mobile applications, the need for

physical bank branches slowly diminished. As such, bank branches have been following a generally declining trend (figure 6.8). Specifically in 2020, the total number of bank branches fell by 1.0 %, from a total of 412 in 2019 to 408 in 2020. Five out of the six branches closed were conventional banks. This declining trend may, however, reverse in the coming years as new residential areas reach completion, and new bank branches are needed to serve those areas.

E-Payments overtook paper-based transactions (by value) for the first time

For the first time on record, the value of E-Payment transactions exceeded the value of paper-based transactions (through cheques). This shift was fueled by the three-month lockdown period, and the longer closure measures limiting both public sector and private sector operations. The continued growth, however, indicates that E-banking solutions succeeded in providing an alternative to paper transactions when needed, particularly Knet PG, which signifies high confidence in

6.7 E-Payment Infrastructure in Kuwait

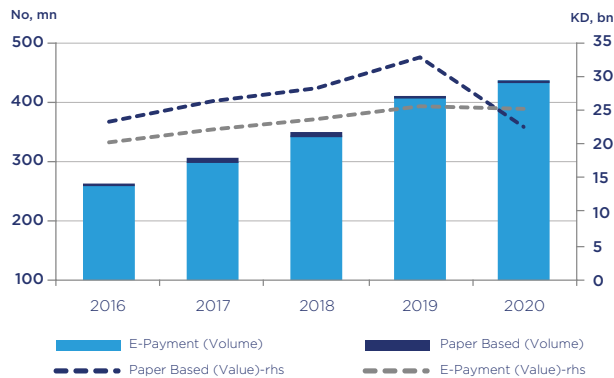


6.8 Banks’ Branches in Kuwait



⁴ People usually withdraw cash and give it as gift (Eidiyah) for the kids in celebration of the occasion.

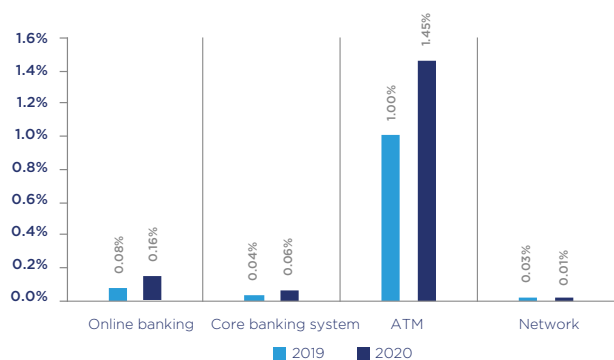
6.9 Paper Based Vs E-Payment



electronic payments. Despite the mentioned restrictions and the resultant decline, paper-based transactions still make up the bulk of the transacted value. In terms of volume however, paper-based transactions accounted for only 0.7% of the total transactions in 2020, down from 1.24% in 2019. In terms of value, they account for 47.0% of total transaction value in 2020, down from 56.2% in 2019 (figure 6.9).

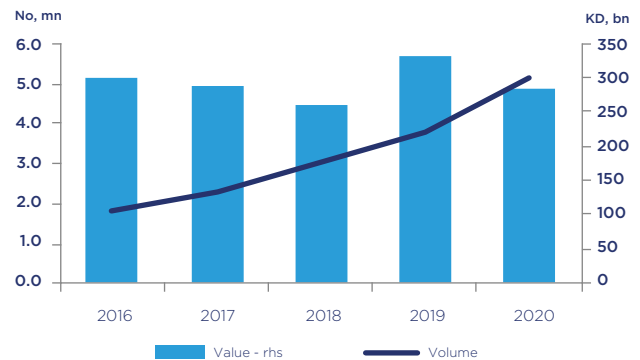
Since 2004, CBK has put in place a real time gross settlement system named Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP). The system processes a large volume of high value payments as well as low value transactions. CBK plays the role of a settlement agent, providing risk-free means of discharging large-value payments, as well as handling transfers between participating banks. As the name suggests, the KASSIP provides for real time posting across accounts held at CBK during the day, based on the collateral

6.11 Unplanned Systems` Downtime



5 For more information, please refer to box 5 in FSR 2018.

6.10 Transactions via KASSIP



provided by the bank. These limits are available to participants between the start of day and interim cut-off only, whereas the amount of the limit at interim cut-off is re-established automatically at the start of the next business day.

In 2020, the total volume of transactions reached 5.1 million. This represents YOY growth of 34.7%, the highest since 2015. In terms of value, the year witnessed a decline of 14.9% in the value of transactions processed through KASSIP (figure 6.10), mainly due to pandemic implications.

Unplanned system downtime remained quite tame when considering the disruptions the pandemic caused

CBK supervises and oversees the Electronic Payment Infrastructure Providers and the Electronic Payment Agents⁵, performing quality assurance and monitoring key risk indicators such as systems downtime (figure 6.11). During 2020, while unplanned systems downtime witnessed a slight uptick across most of the systems, such increase remains quite tame relative to the magnitude of the pandemic's disruptions. These figures instill confidence in the underlying payment infrastructure.

Overall, CBK's oversight function enables proactive intervention aimed at improving the safety, security, and efficiency of the payment infrastructure. This, in turn, safeguards consumers and helps sustain financial stability in the State of Kuwait.

Box 6.1: CONSUMER SPENDING AMID THE COVID-19 PANDEMIC

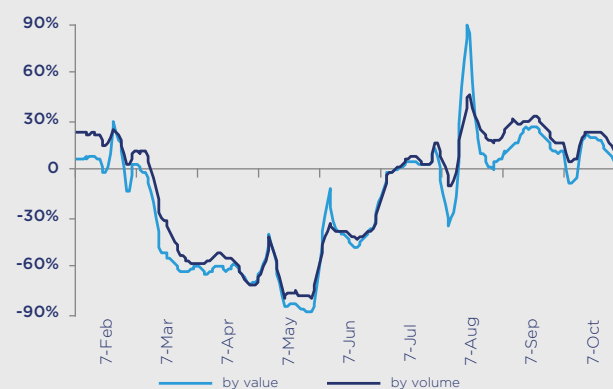
As the standard national accounts data arrives with a considerable lag, analyzing alternative high frequency data can help quantify the impact of Covid-19 pandemic on consumer spending in a detailed and timely manner. Payments data can be one such valuable source of information and could be used as a proxy for domestic consumption. In Kuwait, data from Knet¹ covers both values and volumes of transactions executed through ATMs, point of sale machines (POS) and Knet's online payment gateway² (OPG). This box capitalizes on such data to examine the trends in domestic consumption.

The evidence reveals three distinct phases of consumer spending since the outbreak of Covid-19 in Kuwait: (i) gradual slowdown in spending culminating into a precipitous collapse in tandem with the severity of the lockdowns imposed (ii) sharp recovery fueled by pent-up demand right after the removal of full curfew and relaxation in social-distancing measures, and (iii) deceleration in spending around the pre-pandemic levels. This pattern is particularly well captured by the POS data. Both the value and volume of transactions in 2020, when compared to a year earlier, began to decline soon after the government announced suspension of schools and commercial activities on March 12th, introducing a partial curfew a week later (Figure A). The year-over-year (YOY) growth in values and volumes plummeted at the outset of 3-weeks complete lockdown from May 10th, though spending briefly spiked just before the lockdown went into effect, reflecting the panic buying that was observed across the country. By the last week of May, the overall value of POS transactions had plunged by an unprecedented 87.3% compared to the same period in 2019.

The collapse in spending up to May 2020 was essentially driven by mobility restrictions rather than a serious loss of income. While consumers certainly cut discretionary spending and piled on mere essentials during that March-May period, it was primarily because most of the shops except groceries or pharmacies were closed. Those working in the vulnerable consumer facing sectors might have faced loss of income as well, but the drop in spending was far steeper and could largely be attributed to the lack of spending opportunities amid mobility restrictions.

The swift recovery in consumer spending, starting from June, confirms this notion and could be explained by a number of factors. First, spending surged once the full curfew was lifted, fueled by the pent-up demand from the public that was confined to homes for weeks and had not purchased much beyond basic necessities. Second, a certain degree of substitution from foreign to domestic consumption also played a role. A sizeable share of the population that could have travelled abroad for summer

A
Transactions Through POS in 2020
7 days Rolling avg, yoy Growth



1 The Shared Electronic Banking Service Company (Knet).

2 OPG, introduced in 2004, allows public and private institutions to collect funds for their products and services over the internet.

vacations had to stay back amid airport closures, thus spending more in Kuwait. Third, domestic consumption was helped by the fact that the employment level, at least of nationals working in the public sector, remained unscathed by the pandemic induced economic contraction. Fourth, lockdowns and travel restrictions produced considerable amount of forced savings among those with jobs intact, thus boosting their spending capacity³. Lastly, extensive policy support measures, payment moratoriums and solid growth in personal loans (facilitated by record low interest rates) were also instrumental in consumption rebound.

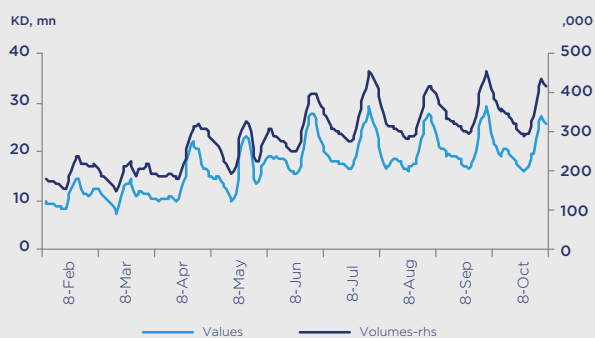
Consumer spending however started to lose steam during Sep-Nov period once the initial spending spree faded. Heighted uncertainty in general and imminent job losses in the private sector, particularly in the hard-hit travel and hospitality industry, possibly dampened consumer sentiments. Notwithstanding its recent deceleration, POS transactions have continued to post positive YOY growth during Q4. Whether this trend is sustainable is yet to be seen, particularly once the impact of payment moratoriums and policy relief measures wanes and job losses start to materialize - both from Covid-19 induced business failures

and government's efforts to address the demographic imbalance. Resumption of international travel will also reverse the substitution effect highlighted earlier, dampening domestic spending.

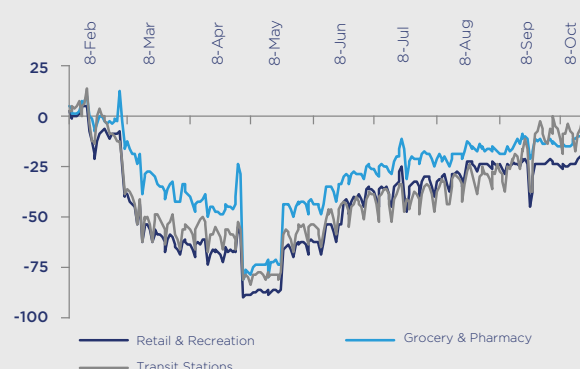
Still, domestic consumption has been resilient so far, also evident from Knet's OPG data⁴. More critically, both the values and volumes of transactions exhibit a steadily rising trend, notwithstanding the apparent seasonality in the data (Figure B). This is in contrast with the data from POS discussed earlier or from the ATMs covered below. The strong overall growth in OPG based transactions points towards the growing use and popularity of online shopping in Kuwait, a trend that has been intensified by the Covid-19 pandemic.

Unsurprisingly, OPG by its very design has benefited from the restrictions on physical mobility that the government imposed to contain the spread of Covid-19. While the use of ATMs and POS was greatly affected by lockdowns and stay-at-home orders, OPG gained traction with public increasingly switching to online shopping. For instance, Google's mobility data reveals that physical mobility in Kuwait started to decline, compared to the pre-pandemic levels, soon after the authorities suspended certain activities in

B
Transactions Through OPG in 2020
7 days Rolling Average



C
Physical Mobility Amidst Covid 19 (visits by purpose)



3 One evidence of rise in forced savings is the healthy growth in private sector deposits this year.

4 Data used in this box only represents online payments made through debit cards.

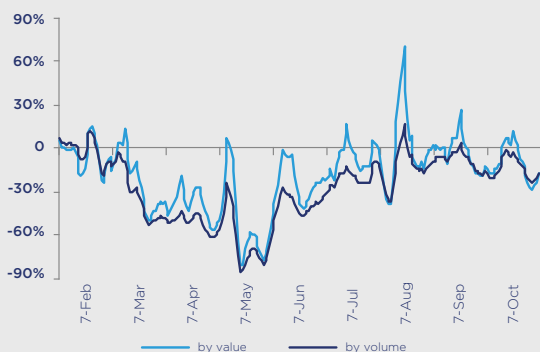
early March 2020 (Figure C). The trend oscillated in tandem with the degree of mobility restrictions imposed. During the countrywide 3-weeks full lockdown in May, the physical mobility plummeted to a record low, well over -75% when compared to its pre-pandemic levels. The 89% drop in visits to retail and recreation facilities was particularly steep and truly unprecedented. Even visits to grocery stores and pharmacies sharply declined, as rules like ‘one-visit a week through prior booking’ drastically contained movement. While physical mobility later recovered from the extreme lows of May, it was still lower when compared to pre-pandemic Jan-Feb benchmark. On the other hand, transactions through OPG in particular, and to a lesser extent through POS as well, have recorded strong YOY growth. This is yet another sign of the growing footprint of digital payments in Kuwait.

Data for the value and number of transactions made through the ATMs reveal a pattern somewhat similar to that of POS, though with obvious differences (Figure D). First, there is greater volatility in ATMs withdrawals, in part reflecting designated times when wages are

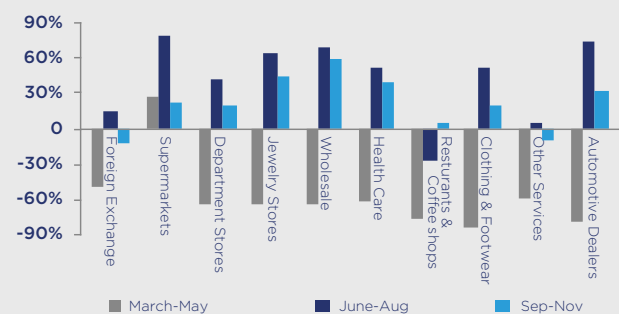
paid, which in turn shape some of the withdrawal patterns. More critically, YOY growth in number of transactions has remained mostly negative, even from September 2020 onwards, indicating that public is withdrawing cash far less often. The values of ATM based transactions have also not recovered as well as in the case of POS. These trends reflect the lower use of cash for transactional purposes to avoid the risk of contamination. But as highlighted in Box 2.1, though transactional demand for cash is clearly declining, cash in circulation remains high by historical standards. If anything, Covid-19 induced uncertainty has seemingly bolstered the appeal for cash as a store of value.

We have earlier discussed the resilience of domestic consumption using aggregate POS & OPG data. Analysis of the sector wise data offer additional insights, revealing considerable variation across the sectors and over time. For instance, disaggregated POS data indicate that almost all major sectors witnessed a sharp contraction in spending during the first three months (March-May)⁵ of the Covid-19 outbreak in Kuwait (Figure E)⁶. Foreign exchange (including remittances and currency exchanges), the largest

D
Transactions Through ATMs in 2020, 7 days Rolling avg, yoy Growth



E
Sector-wise Spending Through POS (Growth Against Prepandemic Levels)



5 Instead of the conventional quarter (April-June), March-May period has been used as it better represents the trajectory of social distancing measures introduced in Kuwait (and their impact on spending).

6 Figure E exhibits growth in sales compared to pre-pandemic average (of January-February 2020). Nine major sectors are shown in the figure, in descending order starting from the left in terms of their respective share in total sales through POS machines. These nine sectors collectively accounted for over 76% of all POS based transactions in 2020. See Table 1 below for individual shares of these sectors in total POS sales in 2020.

segment in POS by value, posted the least decline at 49% compared to pre-pandemic January-February benchmark while all other major sectors witnessed spending collapse by 70% on average. With 14% growth, supermarkets were the only exception, as spending on essentials continued unabated, even getting a boost since restaurant closures nudged people to cook at home more often.

The period from June to August began with the lifting of full curfew and growing relaxation in the social distancing measures. As a result, spending spiked across sectors, driven by pent-up demand. While positive, recovery in other sectors (up 6%) and foreign exchange (15%) was relatively modest, as other segments posted average growth of 63%. Restaurants and coffee shops however continued to bear the brunt of the social distancing requirements with their sales still down 26% compared to pre-pandemic levels. Sales remained dismal both because health-conscious consumers avoided dining out and restaurants were barred to serve in-house (which was later allowed but still reduced the serving capacity of restaurants).

During September-November period, as social distancing measures were further eased, most of the sectors recorded healthy growth, though signs of deceleration in spending were obvious among all the segments. Spending on restaurants and coffee shops also finally recovered, witnessing growth (6%) for the first time since the pandemic outbreak. On the other hand, both foreign exchange and other services registered a noticeable contraction, with the drop in former category indicating difficult job market conditions for the expat labor force.

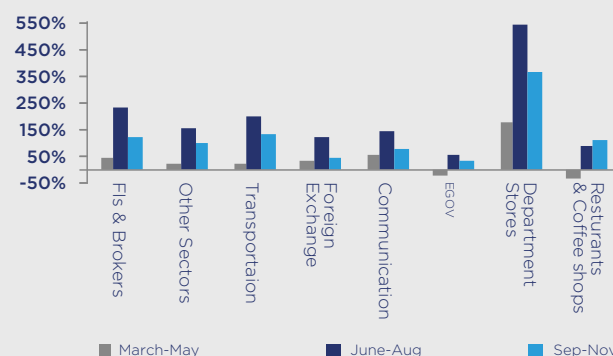
Quite a different picture emerges from the sector wise transactions data of the Knet's OPG (Figure F)⁷. Unlike the POS transactions, most of the sectors recorded strong growth on OPG platform

even during March-May 2020, a period that was otherwise marked by partial and full lockdowns and collapsing sales. This again underscores the growing importance of online shopping in Kuwait.

In particular, department stores enjoyed a stellar growth as online spending surged past 230% during March-May period compared to pre-pandemic level. Restaurants & coffee shops and EGOV (various government transactions online) were the only two major segments posting a decline, of 16% and 32% respectively, though both segments recovered in the next period. While sales decelerated across segments during Sep-Nov period, restaurants and coffee were able to post better sales compared to June-Aug; this suggests that the industry was finally able to adapt to new realities by increasingly offering home delivery options. That also explains why sales growth for restaurants and coffee shops was better on OPG platform than POS.

The foregoing discussion not only highlights shifting consumer preference for online shopping but also signifies that both businesses and government would gain by making their products and services available online. Compared to POS, spending through online channels have proved way more resilient even in

F Sector-wise Spending Through OPG (Growth Against Prepandemic Level)



⁷ Figure F exhibits growth in sales compared to pre-pandemic average (of January-February 2020). Eight major sectors shown here collectively accounted for over 94% of all OPG based transactions in 2020. See Table 1 for individual shares of these sectors in total OPG based sales.

the midst of an unprecedented health and economic crisis. While it is not clear how consumer behaviors would change once the life returns to normal, some of the habits formed during the pandemic are likely to stay, including the greater use of online shopping. Sectors that fail to adapt to changing consumer attitudes could end up losing business.

A comparison between the share of various segments in total sales on POS and OPG platforms can help determine the businesses that would particularly gain by strengthening their online presence (Table A). For instance, foreign exchange related transactions accounted for 20% of total POS in 2020, but lagged behind on OPG, with only 11% share. Likewise, supermarkets which represented 14% of all POS transaction value have been virtually absent on OPG, capturing a meagre 0.1% share (not shown

in the table). This reveals the upside potential for such businesses through greater investments in online shopping portals and home delivery options. It also appears that the government is making efforts to go increasingly digital, with EGOV transactions currently accounting for 10% of the OPG values. Moving more services online will reduce the need for visits to government offices, addressing overcrowding, saving precious public time, increasing convenience and improving efficiency.

While Covid-19 has been catastrophic for lives and livelihoods everywhere, the pandemic has also offered businesses and governments a unique opportunity to expand their digital foothold. Those failing to adapt would be swept aside by the rising tide of digitization.

Table A			
Share in POS total sales ⁸		Share in OPG total sales	
<u>Foreign Exchange</u>	<u>20%</u>	<u>FI & Brokers</u>	<u>27%</u>
<u>Supermarkets</u>	<u>15%</u>	<u>Other Sectors</u>	<u>17%</u>
<u>Department Stores</u>	<u>13%</u>	<u>Transportation</u>	<u>12%</u>
<u>Jewelry stores</u>	<u>7%</u>	<u>Foreign Ex</u>	<u>11%</u>
<u>Wholesale</u>	<u>5%</u>	<u>EGOV</u>	<u>10%</u>
<u>Health Care</u>	<u>5%</u>	<u>Communication</u>	<u>8%</u>
<u>Clothing & Footwear</u>	<u>4%</u>	<u>Department Stores</u>	<u>6%</u>
<u>Restaurants & Coffee shops</u>	<u>4%</u>	<u>Restaurants & Coffee shops</u>	<u>3%</u>
<u>Other Services</u>	<u>3%</u>	<u>Electronic Stores</u>	<u>2%</u>
<u>Automotive Dealers</u>	<u>3%</u>	<u>Business Services</u>	<u>1%</u>

⁸ Values in column reflect the share of each major segment out of total POS sale values from January to November 2020.

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