

بنك الكويت المركزي  
CENTRAL BANK OF KUWAIT



# FINANCIAL STABILITY REPORT

---

2021



---

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

---



The Amir of the State of Kuwait

**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

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



# BOARD OF DIRECTORS

---



**Basel A. Al-Haroon**  
The Governor  
Chairman of the Board of Directors



**Muhammad M. Al-Anzi**  
Acting Undersecretary  
Ministry of Commerce  
and Industry



**Aseel S. Al-Munifi**  
Undersecretary,  
Ministry of Finance



**Mustafa J. Al-Shamali**  
Private Sector



**Nasser A. Al-Roudan**  
Private Sector



**Ahmed Y. Al-Sager**  
Private Sector



**Osama M. Al-Nisf**  
Private Sector

Index	Page
<b>Preface</b>	16
<b>Coverage, Data Conventions &amp; Disclaimer</b>	18
<b>Table of Abbreviations</b>	20
<b>Executive Summary</b>	22
<b>Chapter 1: Global and Local Economic Developments</b>	29
Global Developments	30
Local Developments	33
Box 1.1: Climate Change	41
<b>Chapter 2: Local Financial System Overview</b>	45
Banking Sector	46
Investment Companies	50
Exchange Companies	50
Box 2.1: CBK's Institutional Framework	52
<b>Chapter 3: Banks' Risks</b>	59
Credit Risk	60
Liquidity Risk	64
Market Risk	67
Operational Risk	71
Box 3.1: CBK Cybersecurity Framework	75
<b>Chapter 4: Banks' Profitability &amp; Resilience</b>	79
Profitability	80
Resilience	83
Box 4.1: Implications of Basel's External Credit Ratings Approach for Exposures to Banks on the Local Banking System	87
<b>Chapter 5: Payment &amp; Settlement Systems</b>	90
Box 5.1: The Local Shift Towards Digital Banking	96

# PREFACE



**Basel A. Al-Haroon**

Governor,  
Central Bank of Kuwait

**This edition marks a decade of publishing CBK's flagship report which covers key developments regarding the local financial system.**

---

While the year 2020 was challenging on various fronts, the significant repercussions of the COVID-19 pandemic started to subside in 2021. Namely, with the nationwide vaccination programs, the virus's spread and mobility challenges were controlled which provided some respite to the economy. However, some challenges related to the accommodative monetary policies adopted worldwide along with the supply chain disruptions continue until today. Such challenges could directly compromise financial stability.

Locally, the Central Bank of Kuwait (CBK) is entrusted with preserving financial stability which refers to the resilience of the financial system to unanticipated adverse shocks. In doing so, CBK follows a clearly defined framework to vigilantly monitor arising challenges, conduct risk-based analyses, and utilize proactive intervention tools.

Moreover, as part of CBK's role in maintaining stability, promoting transparency, and enriching public discourse, it is a pleasure to present the 2021 Financial Stability Report (FSR). This edition marks a decade of publishing CBK's flagship report which covers key developments regarding the local financial system. The report also demonstrates how the Kuwaiti banking sector started to reap what it has sown, as it emerged from the unprecedented circumstances strong and prepared for upcoming challenges.

Consisting of five chapters and five boxes, the FSR sets the stage in Chapter 1 by

examining global and local economic developments, presenting key economic indicators along with an overview of the performance of key markets. Chapter 2 gives an overview of the Kuwaiti financial system, highlighting key attributes and developments of the banking sector as the year progressed. Chapter 3 examines key risks faced by the banking system, inspecting multiple angles of credit, liquidity, market, and operational risks during the year and going forward. Chapter 4 exhibits the strength of local banks, analyzing both profitability and resilience to provide a thorough assessment of the sector. The report concludes with Chapter 5, which examines an integral part of the financial system: the payment and settlement infrastructure. We hope that the analysis contained in the report will help all stakeholders form a better understanding of key issues and facilitate appropriate policy initiatives to address any potential challenges.

Towards the end, 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 Nawaf Al-Ahmad Al-Jaber Al-Sabah, His Highness the Crown Prince, Sheikh Mishal Al-Ahmad Al-Jaber Al-Sabah, and His Highness the Prime Minister, Sheikh Ahmad Nawaf Al-Ahmad Al-Sabah, may Allah bestow on them good health and continued success.





## **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 2021 using December 31st, 2021 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 along with one specialized bank. Due to some data limitations, we have not covered the performance of 12 foreign branches in Kuwait (which account for about 3% 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.

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



## Abbreviations

<b>AT1</b>	Additional Tier 1
<b>ATM</b>	Automatic Teller Machines
<b>BBL</b>	Barrel of Crude Oil
<b>CAR</b>	Capital Adequacy Ratio
<b>CBK</b>	Central Bank of Kuwait
<b>CET1</b>	Common Equity Tier 1
<b>CMA</b>	Capital Markets Authority
<b>CPI</b>	Consumer Price Index
<b>EPL</b>	Equity Purchase Loans
<b>ESG</b>	Environmental, Social, and Governance
<b>EUR</b>	Euro
<b>FC</b>	Foreign Currency
<b>FVOCI</b>	Fair Value through other Comprehensive Income
<b>FVPL</b>	Fair Value through Profit or Loss
<b>FX</b>	Foreign Exchange
<b>GBP</b>	British Pound Sterling
<b>GCC</b>	Gulf Cooperation Council
<b>GDP</b>	Gross Domestic Product
<b>IMF</b>	International Monetary Fund
<b>ISO</b>	International Organization for Standardization
<b>JPY</b>	Japanese Yen
<b>KASSIP</b>	Kuwait's Automated Settlement System for Inter-Participant Payments

## Abbreviations

<b>KD</b>	Kuwaiti Dinar
<b>KIA</b>	Kuwait Investment Authority
<b>NGDP</b>	Nominal Gross Domestic Product
<b>NIM</b>	Net Interest Margin
<b>NPL</b>	Non-Performing Loans
<b>NPLR</b>	Non-Performing Loans Ratio
<b>OCI</b>	Other Comprehensive Income
<b>OECD</b>	Organization for Economic Co-operation and Development
<b>OPEC+</b>	Organization of the Petroleum Exporting Countries
<b>P&amp;L</b>	Profit and Loss Statement
<b>POS</b>	Point of Sale
<b>PPT</b>	Percentage Point
<b>ROAA</b>	Return on Average Assets
<b>ROAE</b>	Return on Average Equity
<b>RWA</b>	Risk-Weighted Assets
<b>SWIFT</b>	Society for Worldwide Interbank Financial Communications
<b>T2</b>	Tier 2
<b>TRY</b>	Turkish Lira
<b>USD</b>	US Dollar
<b>YOY</b>	Year-Over-Year

## EXECUTIVE SUMMARY:

Ultra-loose policy and soaring financial asset prices were the highlights of 2020 as the effects of the Covid-19 pandemic spread beyond the health aspect. With mobility restrictions obstructing normal economic activity, monetary and fiscal authorities moved swiftly to combat the unprecedented economic fallout and cushion the blow to those most vulnerable. As such, with interest rates maintained at historical lows and large-scale asset purchases sustained through the year, financial asset markets continued to display exuberance in 2021. On the pandemic front, despite the virus decreasing in lethality with new strains proving less deadly, risks and uncertainty regarding the economic recovery remained elevated. With the uneven distribution of vaccines, progress in overcoming the pandemic varied between countries. Coupled with increased globalization and reliance on international trade routes, the unsynchronized bounce-back from virus-related impediments fueled supply-demand mismatches. This in turn induced a global supply-chain crisis as developed countries with high vaccination rates saw demand bounce-back – exacerbated by pent-up demand – faster than the production capacity of developing countries who are integral to global supply-chains. As a result, inflation, which was mostly elusive post the Global Financial Crisis, came back stronger than ever in the first half of the year and reached levels not seen in decades by year-end.

Domestically, a sense of normalcy was somewhat returned to economic operations with most restrictions gradually lifted as the year commenced. Global supply constraints reflected positively on the domestic economy on one side, as rising oil prices supported economic activity and induced optimism. Coupled with pent-up demand, the rise in oil prices supported a surge in activity in both consumer and financial markets, with consumption surging and trading reaching historical highs. These benefits came at a cost however, with rising price levels and chronic shortages in consumer goods. The magnitude of rising prices in Kuwait was lower than other countries, as fiscal policies absorbed some of the imported price impact. On the banking side, results were promising as banks comfortably absorbed the credit implications of the crisis.

**While the recovery was ongoing during 2021 across markets, caution remained elevated as uncertainty did not completely abate.**

Hence, the Central Bank of Kuwait decided on the gradual lifting of support measures for banks, which were initiated amid the crisis and included relaxed regulatory requirements on capital and liquidity.

Against this backdrop, the following paragraphs present the main highlights from this year's Financial Stability Report.

## Global & Local Developments

### Global Developments:

In 2021, global growth was estimated at 6.1%. This recovery was clearly visible in larger economies with higher vaccination levels and more advanced fiscal support. Negative real interest rates drove the S&P 500 to an outperformance relative to its peers, with gains of 27%. In the currency market, the USD appreciated against its main trading pairs as a result of a rise in treasury yields. With regards to the oil market, the hasty rollout of the Covid-19 vaccines along with the growth of the economy and constrained oil output resulted in Brent, WTI, and Kuwait Export Crude prices gaining 50%, 55%, and 56%, respectively.

### Local Developments:

Domestically, while the non-oil sector staged a modest rebound due to robust domestic consumption, Kuwait's real GDP is expected to grow a tepid 1.3% in 2021. Growth is expected to pick up in 2022 given the rise in oil prices, with the International Monetary Fund's forecasts expecting an 8.2% expansion in real GDP. Accordingly, the fiscal deficit for FY2021/2022 has decreased to 7.4% of the forecasted GDP given the rise in oil prices. While persistent, price pressures in Kuwait remained tame relative to global counterparts due to the secondary



impact of energy prices on components of the Consumer Price Index basket and subsidization of certain goods and services. As such, inflation averaged 3.4% during the year, largely driven by rising food prices.

The domestic real estate market bounced back in 2021, as transactional obstacles were mostly lifted, and interest rates were maintained at historically low levels. Accordingly, total trading value for the year surged to KD 3.8bn, 35.5% above the 5-year average. The increased activity was largely attributable to the Residential segment, which saw total transaction value 123% higher than the 5-year average, compared to the Investment and Commercial segments at 19% and 70% lower respectively. As such, Residential real estate value rose an estimated 19% on average across governorates. On the other hand, Investment and Commercial segments saw weakening fundamentals, with occupancy for the former

and retail rents for the latter both continuing to decline. General trends indicate a shifting investor preference to the Residential segment given its perceived lower risks.

This year proved to be a positive year for domestic equity markets with lower overall volatility, greater liquidity, and more diversification in traded securities. Boursa Kuwait displayed positive performance after lagging in the 2020 equity market rally, with the market cap increasing by 28.5% to reach KD 41.4bn. The rally was driven by the oil price recovery and low CBK discount rates. In terms of percentage gains, Consumer Services outperformed with a return of 62.5%, while Financial Services and Insurance Companies gained 57.1% and 47.3%, respectively. As prices recovered so did market depth, with total value and volume traded increasing by 26.9% (KD 13.6bn) and 62.4% (84.5bn) respectively.

## Local Financial System Overview

### Assets:

The banking sector continues to represent the core of the local financial system, with assets growing by 6.5% to reach KD 90.9bn by year end. The driver of this positive growth was the 7.7% increase in banks' loan portfolios. The ratio of assets to nominal GDP dropped to 227% due to the 24% increase in NGDP post-pandemic. On the contrary to 2020, conventional banks' assets grew at a rate faster than Islamic banks' assets at 8% versus 4.8% respectively. With regards to investment companies, the number of licensed companies dropped by 19%, reaching 47, in line with its 5-year downward trend. In terms of assets, the larger proportion continues to belong to Islamic companies with assets of KD 2.8bn compared to conventional investment companies' KD 2.3bn. On the other hand, exchange companies' assets grew by 4% reaching KD 263mn in 2021, while the number of companies continued on its 5-year decline downwards trajectory.

### Loans:

Low interest rates led to a broad-based increase in borrowing with total loans reaching KD 58.5bn by year-end. The Households and Real Estate sectors accounted for the bulk of outstanding loans, at 26% and 20% respectively. Lending to the Banks' sector followed with an increase of KD 0.8bn, while Services increased by KD 0.7bn. Outstanding loans in the Oil & Gas sector reached an all-time high of KD 3.4bn due to Kuwaiti banks' loan syndication to local companies' projects. On the other hand, loans issued to the Trade and Construction sectors both declined, reaching KD 4.6bn and KD 2.5bn, respectively. In terms of regional breakdown, loans to Kuwaiti borrowers continue to represent the largest share at 72.6%, while loans to GCC borrowers accounted for 10.9% from 9.6% in 2020.

### Deposits:

Consistent with the trend over the past 5 years, deposits continued on a gradual upwards trajectory in line with the growth of the economy. Total banking sector deposits reached KD 62.7bn in 2021, growing by 2.5% compared to

the year prior. Deposits abroad rose by KD 1.3bn due to the expansion of operations overseas, leading to a slight decline in the share of local deposits to 76.5%. Dependence on public sector deposits remains lower than that of the private sector, with the latter being the main source of funds for banks. As such, retail deposits made up 56.5% (KD 35.4bn) of total deposits.

## Banks' Risks

### Credit Risk:

The lingering effects of the pandemic on credit quality were still noticeable in 2021, albeit to a milder degree. The Household sector was the main driver of the growth in credit financing, with outstanding loans increasing by 12.3% or KD 1.7bn, a growth rate not seen since 2013. This was due to Covid-induced forbearance policies, which allowed households to delay loan settlements, as well as extremely low borrowing rates offered by banks. Newly added NPLs remained relatively stable compared to historical levels, representing 1.7% of the performing loan portfolio, with Households being the largest contributor in-line with its size. The NPLR dropped to an all-time low of 1.4% by year end, largely due to CBK's prudent provisioning framework, with NPL coverage at 310%. This underscores the banking sector's ability to realize additional NPLs without incurring large losses.

### Liquidity Risk:

Liquidity ratios experienced a slight pull-back in 2021, which was due to healthy growth in lending in light of the reopening of the economy and return to operational normalcy. With that said, banking sector deposits rose to an all-time high of KD 62.7bn, of which term deposits –considered a stable source of financing – continued to account for the largest portion. The increase was driven by individuals and corporates, which now account for 78% of total deposits, with government deposits decreasing during the year. This represents a positive trend of greater private sector involvement where deposits tend to be stickier and less costly to source and maintain. Deposits remain sufficient to support expansion in loan growth, and Basel III ratios further underscore the abundance in liquidity, with the NSFR and LCR at 111% and 183% respectively.

**Market Risk:**

Market risk-weighted assets remained miniscule in 2021, representing 1% of total RWAs. Fixed income and equity investments grew in 2021, increasing 3% and 6% respectively with the total investment book growing 3%. The bulk of investments remain in fixed income at 81%, with the remaining 19% in equities and real estate. There is a noticeable increase in market sensitivity, as investments held at fair-value through other comprehensive income and fair-value through profit and loss represented 66.2% of total investments, up from 62.1% last year. With that said, banks continue to display resilience towards market related movements, where a hypothetical 150 basis points upward shift in interest rates, a real estate price correction, and an equity market shock demonstrated limited impact on banks' balance sheets.

**Operational Risk:**

Operational losses reached approximately KD 7.4mn 2021, but remained relatively insignificant at 0.8% of the three-year average total gross bank income. In response to external fraud which usually stems from lack of awareness, CBK and the Kuwait Banking Association started the "Diraya" campaign. This initiative aimed to spread awareness among users of banking services and better protect customers' interests. Average employee churn rate<sup>1</sup> increased to 15% from 10% in 2020, largely due to normalization dynamics where pre-pandemic levels were around 17%. Looking forward, simulations of operational tail losses remain promising, at merely 9% of the sector's profits. As at the end of the year, all local banks along with key sector players have actively aligned themselves to the requirements of the Cybersecurity Framework issued by CBK in February 2020, further underscoring operational readiness.

## Banks' Profitability & Resilience

**Profitability:**

As markets recovered in 2021, the banking sector's profits increased by 96% ending at KD 961mn. Improved asset quality and a clearer outlook led to a 44% reduction in provisions, positively affecting the sector's bottom line. Interest income and interest expenses both saw a decline, resulting in the net interest margin ending at a historical low of 2.4%. Enhanced returns from investments in higher yielding countries, in addition to larger dividends received bolstered income from investments, which contributed 5.6% of net income versus 1.6% in 2020. As such, while not completely recovering to pre-pandemic levels, efficiency and profitability bounced back with the ROAA and ROAE increasing to 1.1% and 9.1% respectively. Higher issuances and growth in assets slightly weighed on the respective performance indicators.

**Resilience:**

Banks demonstrated solvency and resilience with the capital adequacy ratio reaching an all-time high of 19.2% in 2021. Despite the capital inflows seen during the year, the share of CET1 capital declined to 76.6% mainly attributed to additional tier 1 capital levels increasing at a faster rate. The CET1/RWA ratio declined slightly by 0.2 percentage points largely due to foreign exchange losses. With that said, the CET1 ratio remains comfortably above Basel III and CBK minimum regulatory requirements of 7% and 9.5% respectively at 14.7%. In a more forward-looking indicator of the banking sector's ability to withstand unforeseen shocks, Kuwaiti banks continued to demonstrate resilience with capital levels exceeding Basel III minimum requirements under all three scenarios of CBK's hypothetical stress tests.

<sup>1</sup> The employee churn rate estimates the percentage of employees leaving the organization per year.

## Payment and Settlement Systems

Preference for E-payments over paper-based transactions was prevalent for the second year running. The value and volume of paper-based transactions dropped below the five-year average, while E-payment transaction volume and value grew 49% and 34%, respectively. While the number of E-payment mediums in 2021 increased, indicating an ease of access, the number of physical branches remained somewhat stable. With regards to ATM data, non-cash transactions grew at a faster rate compared to ATM transactions in terms of value and volume. The growth of E-payments is further driven by the demand for online transactions, which represent 43% of total non-cash transactions and reached an all-time high in 2021. Furthermore, point of sale machines increased at a rate faster than ATMs, exceeding the 5-year average at 9.2%, while the number of ATMs rose by 5.2%, which highlights the preference of E-payments and the general transition away from cash.

## Outlook:

With much of the health impact realized, the focus now turns to dealing with the economic fallout from the pandemic. Aggressive efforts to tackle the economic impact of the Covid-19 crisis have led to irregularities in markets in the form of excessive speculation and high debt levels. This may have led to the mispricing of financial assets, which are at relatively elevated levels despite correcting in the first half of 2022. On the geopolitical front,

the war between Russia and Ukraine has led to heightened tensions globally, affecting world trade and further adding fuel to the inflation inferno. These vulnerabilities may be tested as monetary authorities around the world rush to reign in levels of inflation that have not been seen in decades. As such, these developments are culminating in the perfect storm and cast uncertainty over the probability of a soft-landing.

Given its unique profile, the lingering effects on the economy have been distinct in Kuwait. While froth in the Kuwaiti equity prices has not been as glaring as it was in other countries, Residential property prices have risen at an unprecedented pace in 2021. While there has been a small correction in early 2022, elevated levels may be particularly problematic given the significance of real estate in Kuwait as a core asset and its widespread adoption in investing. The rise in oil prices has provided some respite on the fiscal side, although it has been met with higher subsidies given rising prices. Higher oil revenues alone, however, are not a reason to be complacent, as policy-makers must take advantage of current favorable fiscal conditions to implement longer-term reforms that address chronic structural imbalances and stimulate non-oil sectors. On the banking sector front, banks have once again proved their strength by comfortably absorbing the direct pandemic effects. Forward looking stress-test results further instill confidence in the local banking sector which is demonstrating continued resilience. Nonetheless, vigilant monitoring and precautionary measures are vital as we enter a new period of tighter financial conditions and elevated volatility. To that end, CBK continues to push for proactive intervention, leveraging a host of monetary and macro-prudential measures to ensure the soundness and stability of the financial sector.

**Vigilant monitoring and precautionary measures are vital as we enter a new period of tighter financial conditions and increased volatility.**





**CHAPTER 1**  
**GLOBAL**  
**AND LOCAL**  
**ECONOMIC**  
**DEVELOPMENTS**

---

Given the local financial system’s sensitivity to global economic and financial market developments, it is imperative to understand the transmission channels between the two to form a holistic view of local financial stability drivers. As such, this section analyzes the key transmission channels such as financial, foreign exchange (FX), and oil markets. We also explore the performance of key domestic markets (Boursa Kuwait and real estate) throughout 2021. By gaining a solid and continuous understanding of these developments, a strong foundation is established to identify vulnerabilities and opportunities for enhancing local financial stability.

# Global Developments

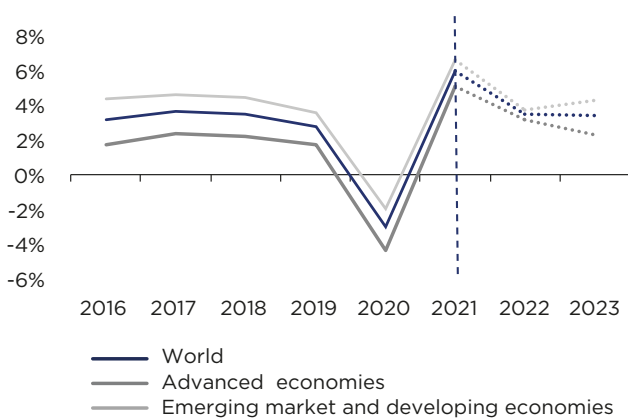
After the steep contraction of 3.1% in 2020, a recovery in the global economy began to take place in 2021 (figure 1.1) with the International Monetary Fund (IMF) estimating global growth of 6.1%. The recovery was pronounced in economies with large macro-economic and fiscal support measures, and whom have had a larger share of their populations vaccinated.

Despite these growth prospects, uncertainty has not abated, as the global recovery is subject to downside risks due to ongoing supply chain bottlenecks (figure 1.2). Such bottlenecks further fuel inflationary pressures, which in turn nudge policy makers to contemplate commencing on an earlier than projected monetary policy liftoff. Policy makers must consider the tradeoffs of policy normalization (lower growth and higher unemployment) against keeping tabs on inflationary pressures and avoiding the de-anchoring of inflation expectations. That said, implied volatility in funding markets, a function of risk-free rate outlooks, increased with the term structure of USD swaption shifting upwards in 2021 (figure 1.3).

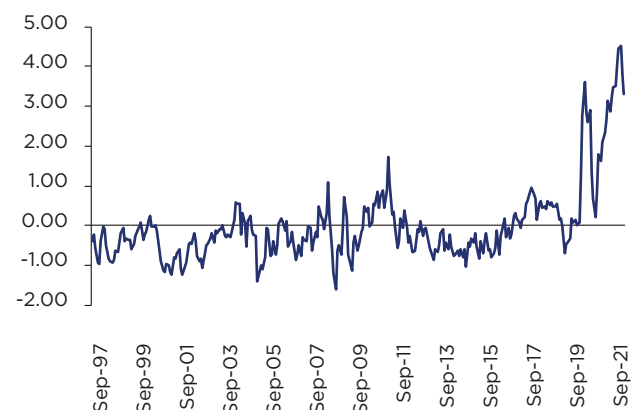
Policy makers will also have to weigh the elevated global debt levels left behind post-pandemic (figure 1.4). While the large increase in debt was necessary to protect lives and livelihoods, it is likely to levy some implications on government finances by bringing rise to financial stability risks. Throughout the pandemic and even prior to the crisis, a large portion of government debt was absorbed by central banks via their quantitative easing programs and accommodative funding conditions, which in turn caused debt servicing costs to reach historical lows in 2020 (figure 1.5)<sup>1</sup>. As such, the unwinding of the extraordinary support measures will likely have an impact on global debt markets and government finances, which may ultimately lead to debt sustainability issues.

## Ongoing supply chain bottlenecks fueled inflationary pressures, nudging policy makers to contemplate an earlier than projected monetary policy liftoff.

1.1 Real GDP Growth



1.2 Federal Reserve Bank of New York’s Global supply Chain Pressure Index



<sup>1</sup> Sample of 16 Advanced Economies and 4 Emerging Economies, calculated as the average of short term and long-term rates multiplied by Debt/GDP ratio.

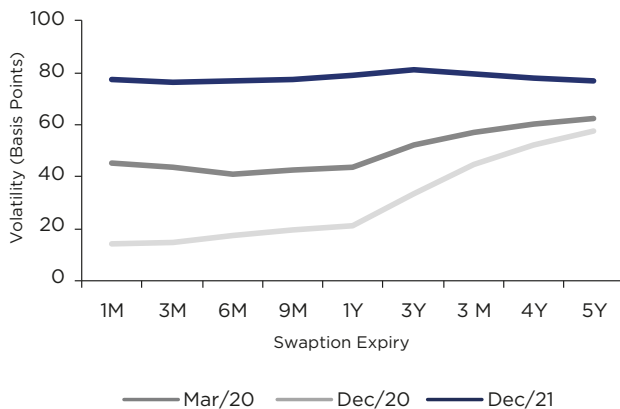
## Equity markets

Coming out of a volatile year, market participants continued revising their recovery narratives. The distribution of vaccines and easing of lockdown measures, followed by an economic rebound, further improved the outlook for equities. As such, the S&P 500 continued to outperform its peers (figure 1.6) as it notched a 27% gain, while the Eurostoxx and Shanghai Composite index registered gains of 21% and 5% respectively in 2021. Part of this strength is attributable to the prevalent negative real interest rate conditions, which in turn supported flows to risk assets such as corporate bonds and equities. For instance, junk bond yields adjusted for inflation, for the

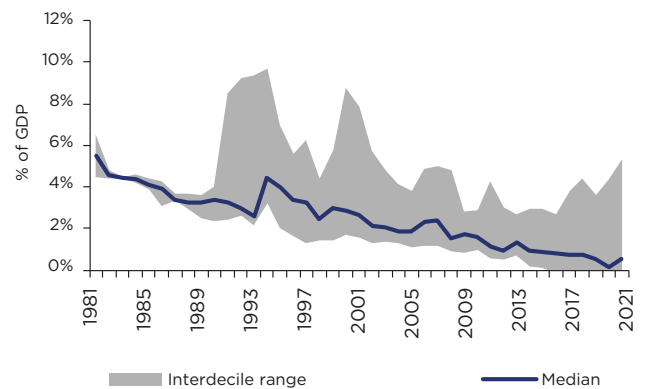
first time, sank into negative territory on both sides of the Atlantic, while various equity market indices traded at elevated price/earnings ratios.

As inflationary pressures persist, however, policy makers will be inclined to tighten monetary conditions, and by extension, market pricing will adjust. Sharp adjustments in real rates may create disruptive moves in risk assets, especially in emerging market economies where flows have been prevalent after the Covid-19 shock. As such, policy makers' forward guidance is now more important than ever, as shedding light on the path forward for markets is key to avoiding unwarranted financial market gyrations.

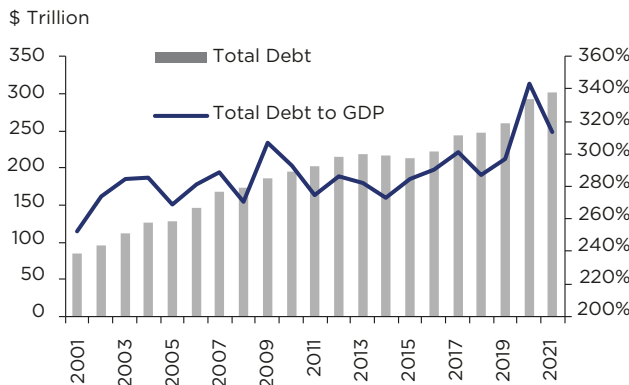
### 1.3 Term Structure of a 2 year USD Swaption (Implied Volatility)



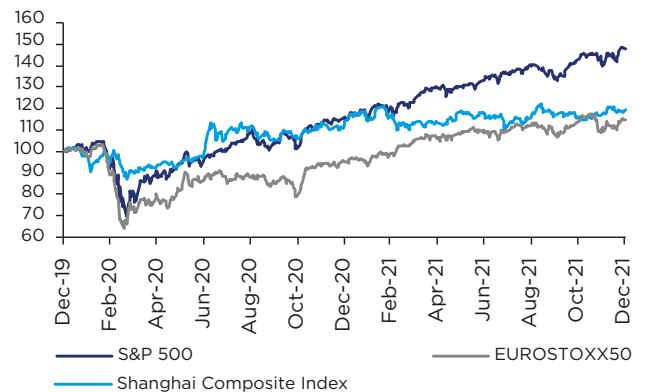
### 1.5 Debt Servicing Costs



### 1.4 World Debt



### 1.6 Equity Markets (rebased)



**FX markets:**

With markets continuing to draw their recovery narratives in the first half of 2021, the dollar was relatively range bound (figure 1.7). This trend was due to expectations that the US Federal Reserve (Fed) would maintain its accommodative monetary policy stance in the near term. Towards the second half of 2021 however, the dollar was bid well as it commenced on an upward path. These moves were in part driven by persistent inflationary pressures, which gave rise to increasing US Treasury yields and caused the dollar’s major trading pairs to depreciate against it in 2021.

After registering a stronger performance against the USD in the first half of 2021, the GBP was prone to overall market sentiment towards the end of the year with concerns rising over a deteriorating global economic outlook (figure 1.8). This was reinforced by rising global energy costs and the emergence of the Omicron variant. After avoiding a hike in November, the Bank of

England surprised markets by delivering a 15 basis points rate hike in December, and became the first advanced-economy central bank to raise rates following the Covid-19 crisis. This eventually caused the GBP to pare back some of its losses, settling 1.4% lower against the USD.

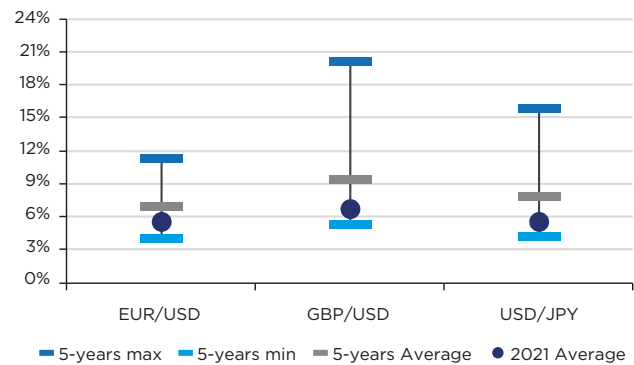
With the absence of a change in monetary policy stance<sup>2</sup>, the JPY was exposed to exogenous factors and was largely on the offer. Widening interest rate differentials between the US and Japan exacerbated these moves, especially given the JPY’s status as a funding currency. Additional headwinds in the form of a faltering economic rebound in the first half of the year caused the JPY to notch a decline of 10.5% against the USD in 2021.

As the year progressed, and akin to the movements in the JPY, the EUR depreciated against the dollar with widening interest rate differentials lending the USD some strength. As such, the EUR registered a yearly decline of 7.7% against the USD. Moreover, due to negative yields and low volatility (figure 1.9), the EUR has been

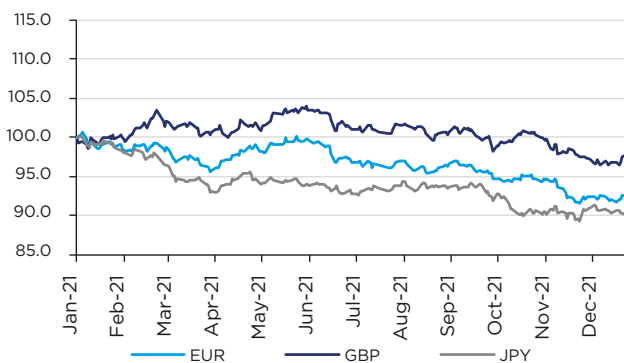
**1.7 Dollar Index**



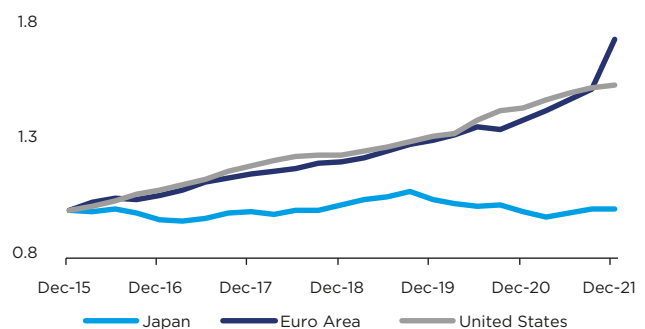
**1.9 Realized Volatility (90-day)**



**1.8 Currencies against USD (rebased)**



**1.10 Local Currency Debt Security Issuances from Foreign Non-Bank Issuers (Rebased)**



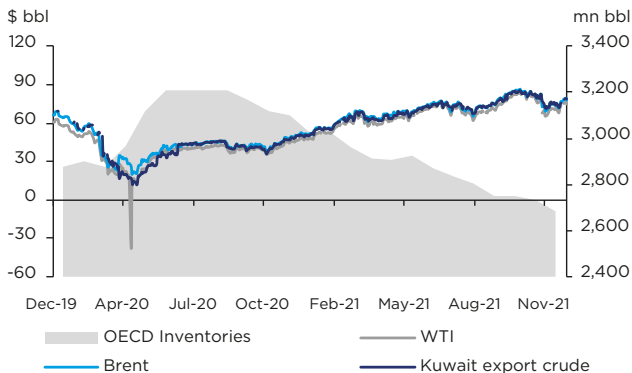
<sup>2</sup> Monetary policy remains extremely accommodative with negative short-term rates and yield curve control policies in place since 2016.

experiencing increased adoption as a funding currency (figure 1.10) as EUR denominated debt security issuances from foreigners has been on the rise. That said, this rising popularity could expose the EUR to additional risks that are associated with funding currencies such as unexpected volatility from carry trade unwinds.

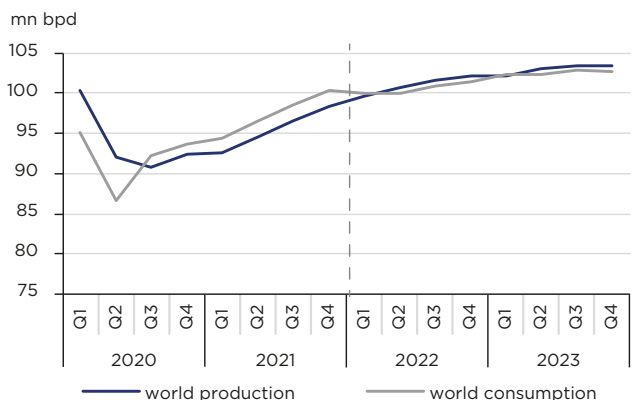
**Crude Oil markets:**

After weathering a tumultuous year, crude oil prices were provided with some respite in 2021 as Brent, WTI, and Kuwait Export Crude prices registered yearly gains of 50%, 55% and 56%, respectively. Such price action was driven by a mix of demand side and supply side factors. On the supply side, the decline in output from both OPEC+ and non-OPEC members helped maintain a tight market as conveyed in OECD crude oil inventories (figure 1.11). On the demand front, the acceleration of the Covid-19 vaccine rollouts coupled with robust economic growth enabled consumption to outpace production (figure 1.12). Despite prices falling in November due to the emergence of the Omicron variant, losses were partly pared back by the end of

**1.11**  
**Crude Oil Markets**



**1.12**  
**World Liquid Fuels Production and Consumption**



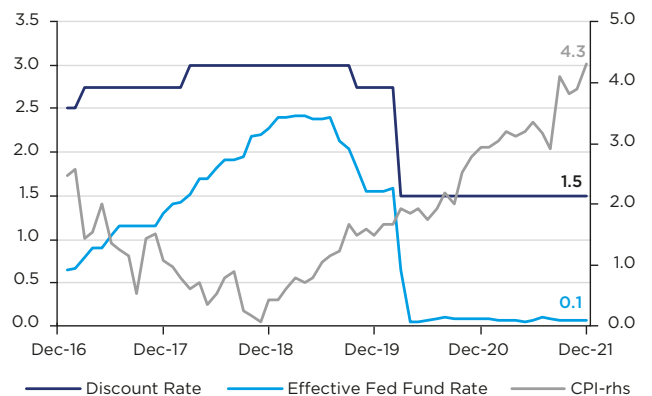
the year as concerns eased and some crude oil production went offline. With oil prices rising during much of 2021, crude oil prices averaged \$71 per barrel of crude oil (bbl) for the year compared with \$42/bbl in 2020.

**Local Developments:**

In line with the trend witnessed globally, Kuwait's Consumer Price Index (CPI) ended the year at 4.3%, its highest level since November 2011 (figure 1.13). While persistent, price pressures in Kuwait remained tame relative to global counterparts due to the secondary impact of energy prices on components of the CPI basket. Persistence was due to the import-oriented consumption patterns, which in turn translated into broad based price increases in the basket's components. Global supply side disruptions and robust consumer demand managed to consistently nudge the CPI basket higher on a monthly basis. This in turn translated into rising food prices, which contributed to the majority of the change in the CPI basket at year-end. In addition, and along with the one-off increase in education costs, the housing services (largest CPI component) nudged inflation higher. As such, inflation averaged 3.4% in 2021, well above last year's average of 2.1% and 1.65 ppts higher than its 5-year average.

In terms of the Kuwaiti Dinar (KWD), it benefited from its peg to an undisclosed basket, which enabled the net impact of the diverging currencies to be somewhat neutralized and insured stability in the exchange rate (figure 1.14). As such, the USD/KWD exchange rate closed 0.25% lower (i.e. in the KWD's favor) by year-end.

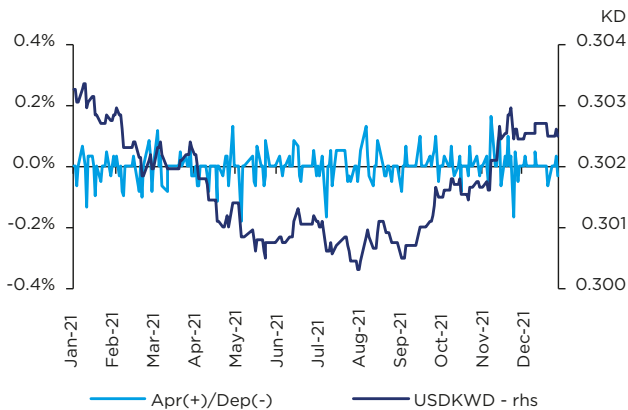
**1.13**  
**Benchmark Rates & CPI (%)**



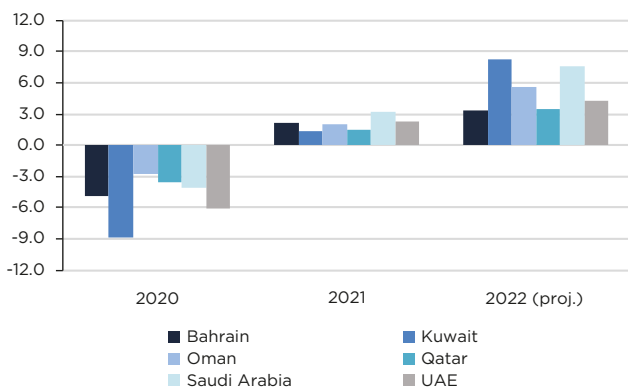
The IMF forecasts that Kuwait's real gross domestic product (GDP), after registering the largest decline amongst GCC peers in 2020, will witness a tepid 1.3% growth in 2021 (figure 1.15). While the non-oil sector staged a modest rebound due to robust domestic consumption, the economy's high oil dependence and scheduled end of OPEC+ production increases (ends first half of 2022) were the main drivers of the low growth expectations. In addition, a decrease in the deficit was witnessed reaching 7.4% of the forecasted GDP (figure 1.16) due to the rise of average oil prices<sup>3</sup>.

It is worth noting that the rise in oil prices has affected the FY2022/2023 budget where the expected deficit is expected to reach KD 0.1bn. This improvement is expected to provide some respite for the General Reserve Fund, which has seen its assets decline in 2020 due to funding needs and the expiration of the public debt law.

**1.14**  
**USDKWD Exchange Rate**



**1.15**  
**Real GDP Growth**

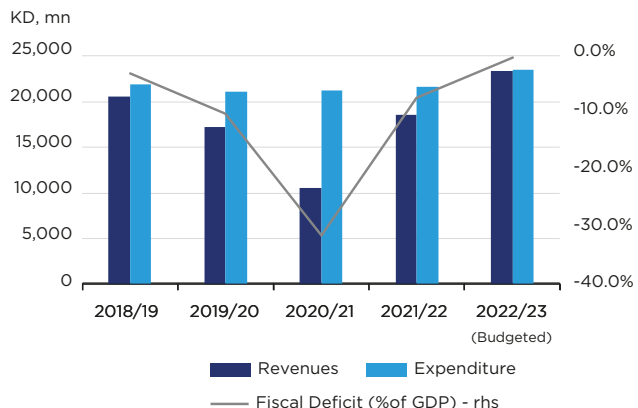


**KWD benefited from its peg to an undisclosed basket, which somewhat neutralized gyrations and insured monetary stability.**

That said however, broadening the revenue base and the state's sources of funding are critical to keep financial fragilities in check. While an increase in debt renders borrowing governments slightly more vulnerable, the current debt levels<sup>4</sup> and utilization of the debt remains a key element in assessing its productivity for Kuwait. For instance, debt leveraged to deliver a set of sustainable economic reforms, such as funding critical infrastructure projects and invigorating private sector contribution, would be considered a net gain.

Moreover, and in light of the global shift towards sustainability, it would be prudent to leverage the current backdrop in crude oil markets, more so when considering that such strength in the market is driven by rather extraordinary factors. Hence, expediting the transition to a more sustainable economy and bringing about structural reforms to enhance the efficiency of the government sector and enabling the private sector to play a larger role in the economy is key. Such transition can alleviate funding pressures on the government's finances and lay the groundwork for a more robust and sustainable economy.

**1.16**  
**Kuwait's Public Finances**



3 FY2021/2022 budget assumes that the average oil production is 2.4 mn bbl/day and the average oil price is \$45/bbl, however the actual average oil price was \$80.7/bbl. Moreover, the FY2022/2023 budget assumes that the average oil production will increase to reach 2.73 mn bbl/day with an average oil price of \$80/bbl.

4 Standing at 8.7% of GDP, Kuwait's debt to GDP ratio is the lowest amongst its GCC peers (37.4%).



**Boursa Kuwait:**

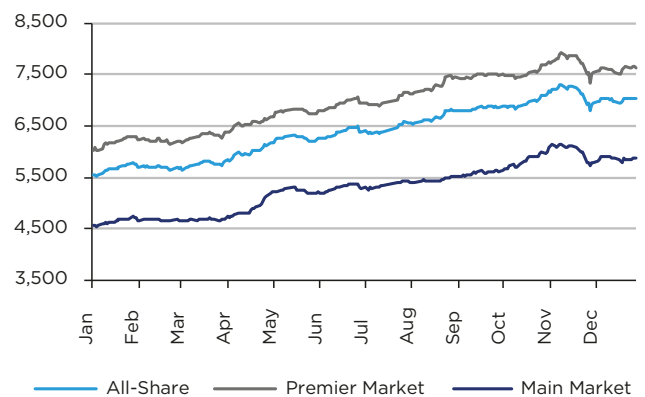
After lagging in the global equity market rally of 2020, Boursa Kuwait closed the gap in 2021. Despite the ongoing pandemic, the market cap of Kuwaiti equities jumped by 28.5% during the year to reach KD 41.4bn. These gains came in light of strong profits that reached pre-pandemic levels as vaccine rollouts returned some normalcy to the economy. While pandemic implications remained, including multiple new variants of Covid-19, Boursa Kuwait proved its resilience and continuity.

Kuwaiti equities experienced robust growth in 2021 as volatility subsided (7.3% annualized volatility vs. 23.3% in 2020). The value-weighted All-Share Market Index covering all listed stocks reached a peak of 7,318 points (32% YTD gain) on the 11th of November (figure 1.17), before falling off to close at a yearly gain of 27%. The steady appreciation was supported by both the

recovery in oil prices (which local markets have shown a consistent relationship with) along with historically low CBK discount rates. As such, some of these gains were erased towards the end of the year, in-line with a 15% drop in Brent crude prices. Accordingly, all indices experienced large gains during the year. The Main 50 index (includes top 50 most liquid stocks in the Main Market) led its peers, increasing 31.7%, while the broader Main Market Index was up 29.3%. The Premier Market index (includes largest most liquid companies), on the other hand, reported slightly lower gains of 26.2%.

**The market cap of Kuwaiti equity markets jumped by 28.5% to reach KD 41.4bn.**

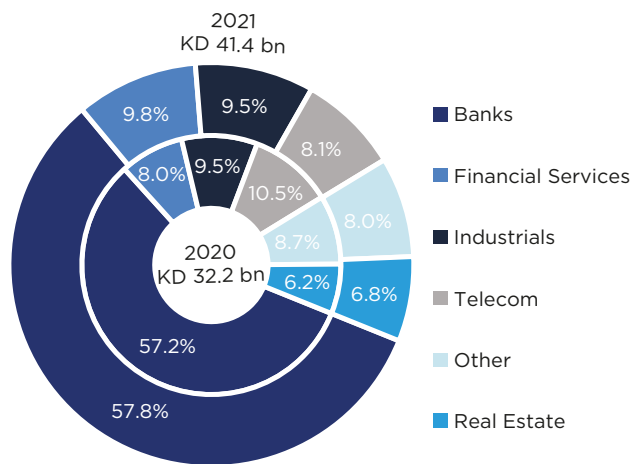
**1.17**  
**Boursa Kuwait Indices**



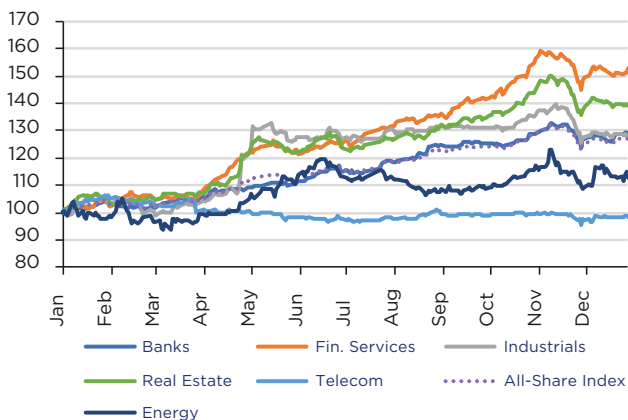
The growth in terms of total value can largely be traced back to Banks, the dominant sector in terms of size (figure 1.18), who saw their market cap grow by KD 5.5bn (30%). Despite its size, the banking sector consists only of 11 companies, indicating potential concentration that could magnify systemic risk. Consumer Services was the top gainer in percentage terms, growing 62.5% during the year, followed by Financial Services and Insurance companies with gains of 57.1% and 47.3%, respectively. This growth was driven by a surge in profits after many sectors recorded lower profits or losses over the course of 2020.

While all sectors recovered in 2021, the magnitude varied (figure 1.19)<sup>5</sup>. The outperformance in the Financial Services sector was mainly driven by large profits, with the sector registering KD 325.5mn in net income for the year, compared to losses close to KD 15mn in 2020. The rebound in this sector specifically underscores the

1.18 Market Cap Sectoral Distribution



1.19 Sectoral Indices (rebased)

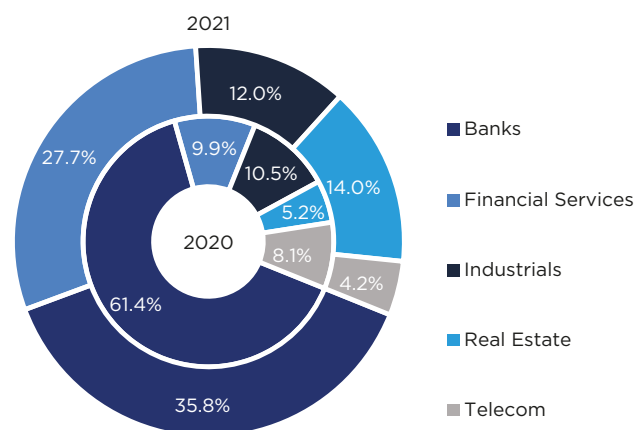


5 Excluding sectors with negligible size.

improvement in investor sentiment through the year as pandemic-related uncertainty subsided and markets returned to normalcy. The Telecommunications sector was the only one to close lower for the year. This came after said sector was the top performer in 2020, and among the few to close in the green. That said, given the non-cyclical nature of the Telecommunications sector, where it is dominated by three large-cap, mature, and low-growth companies (highlighted by an average dividend payout ratio of 80%), its price stability is justified. Banks fared relatively well, with lower required provisions enabling an 80% surge in profits. Lower provisions were justified, due to abating uncertainty and ample stocks of existing provisions, a result of prudent supervision over the years.

Parallel to the price recovery, total volume for 2021 rose 62.4% to 84.6bn shares, with total value traded increasing 26.7% to KD 13.6bn. Trading increased steadily early in the year, slowed down in the summer due to cyclical effects, before surging in the run-up to the November correction which saw the highest activity. Despite strong growth in overall activity, Premier Market stocks saw a decrease of more than 10% in traded value with only a negligible increase in volume. This constitutes a positive development, where securities listed in the supposedly less liquid market are starting to be more actively traded, which will lead to gains in terms of price discovery, lower volatility, and overall market efficiency. The bulk of these securities were in the Financial Services sector, which accounted for 27.7% of total value traded in the market versus 9.9% in 2020 (figure 1.20). This increase was broad-based within the Financial Services sector, where almost all listed securities saw a surge in value traded. Likewise, Real Estate and Industrials also increased their portion of

1.20 Sectoral Share in Trading Value

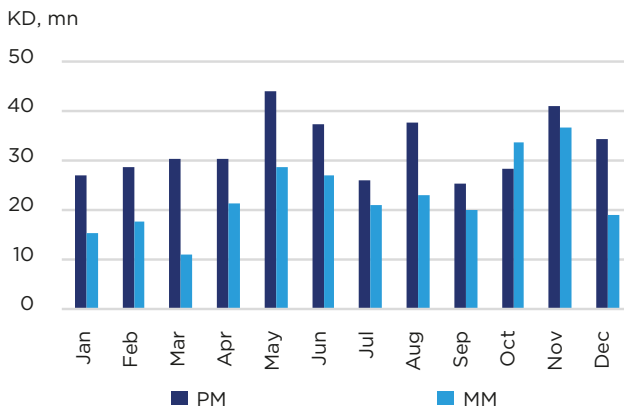


**Consumer Services outperformed other sectors with a return of 62.5%, followed by Financial Services and Insurance Companies.**

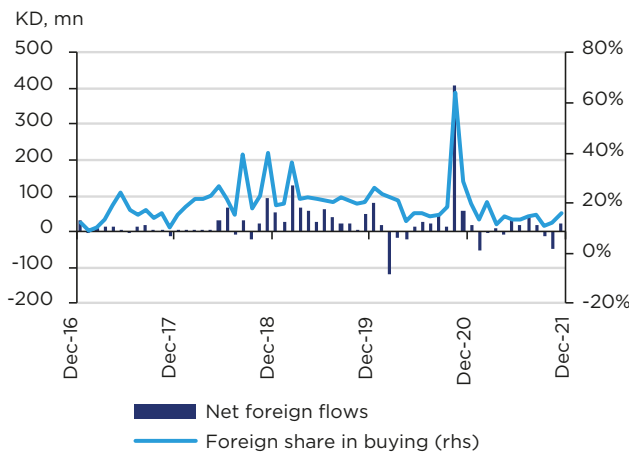
total value traded, which came at the expense of Banks who experienced a 26% drop. Ultimately, these developments contribute positively to financial stability through lower concentration, greater efficiency, and higher liquidity.

Accordingly, market depth was greatly enhanced in the Main Market, with Average Daily Traded Value (ADTV) increasing more than threefold in 2021 to KD 22.8mn (figure 1.21). The Premier Market on the other hand saw ADTV fall by 11% to KD 32.5mn, largely due to the base effect after Boursa Kuwait's inclusion in the MSCI Emerging

**1.21 Average Daily Traded Value**



**1.22 Net Foreign Flows into Boursa Kuwait**



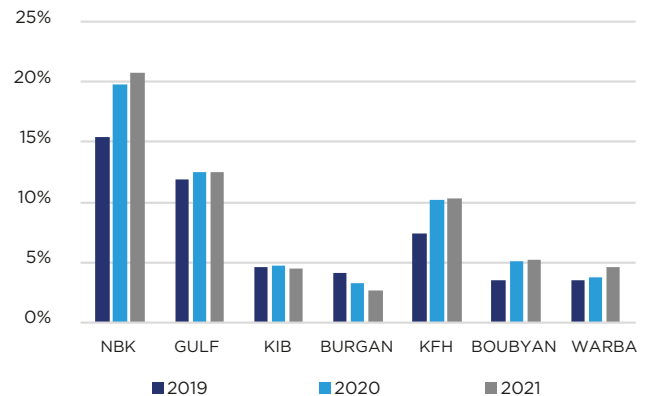
Markets Index resulted in large foreign inflows to the Premier Market in 2020. Removing the disproportionate effect of index inclusion yields a modest 3% growth in said market for 2021.

The increased activity largely stemmed from domestic investors, with foreign share in buying reverting back to pre-inclusion levels (figure 1.22). Total net foreign flows remained high, albeit lower than the years preceding the MSCI inclusion (2018/2019). These dynamics are understandable as foreign investor rebalancing is expected to take place periodically given that the local market is now included in a widely tracked global index.

Foreign ownership of domestic banks continued to rise steadily (figure 1.23)<sup>6</sup> as investment flows increased globally. Warba was the only bank not included in the MSCI Emerging Markets Index who saw an increase in proportion of foreign ownership. Burgan on the other hand, saw a continuation of foreign investors decreasing their ownership, after experiencing an influx of foreign investors in 2019. From a financial stability perspective, the increase in banks' foreign ownership is generally a positive indicator, as a geographically diverse investor base limits market contagion that could occur in a locally induced crisis. However, these investments also increase the sensitivity of the local financial system to global market developments and sudden outflows of hot money.

All in all, 2021 was a positive year for domestic equity markets from a financial stability perspective, with greater market depth and liquidity, diversification in traded securities, and lower overall volatility. Higher volatility is expected and is already

**1.23 Foreign Ownership in Banks**



<sup>6</sup> Commercial Bank of Kuwait, Ahli Bank of Kuwait, and Ahli United Bank (AlMutahed) were excluded due to having negligible foreign ownership (<1%).

being seen in 2022 with persistently depressed prices resulting from geopolitical tensions and the tightening of financial conditions to combat inflationary pressures. Market participants, whether institutional or individual, must prepare for a potentially large market correction that is growing more likely by the day.

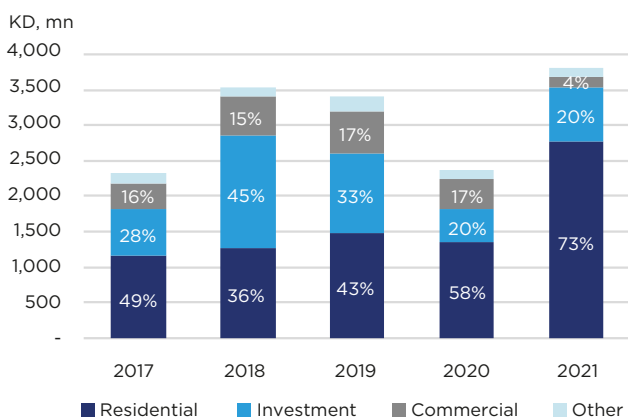
### Domestic Real Estate Market

Similar to the effects seen in other markets, activity in the real estate market picked up in 2021 as transactional obstacles such as curfews and lockdowns were mostly lifted, and interest rates were maintained at historically low levels. Total transaction value for the year was KD 3.8bn (figure 1.24), 35.5% above the 5-year average. The bounce-back in activity was,

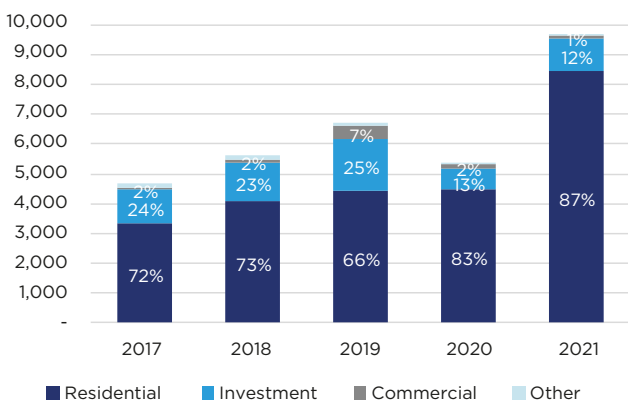
however, mostly uneven with transaction value for the Investment, Commercial, and Other segments coming in at 19%, 70%, and 5% lower than their respective 5-year averages. As such, the elevated activity in the market was largely attributable to the Residential segment, which saw total transaction value 123% higher than its 5-year average.

The average transaction value in the Residential segment since the beginning of 2015 was around KD 333 thousand, versus KD 722 thousand and KD 4.6mn for the Investment and Commercial segments, respectively. As such, more activity in the relatively more liquid Residential segment led to a surge in the markets transaction volume to 9,723 deals in 2021 (figure 1.25). Similarly, the Residential segment's transaction volume vastly outpaced its 5-year average, with volume in the other three segments coming in below their respective averages. Behavioral factors may have played a part in these dynamics, where more time spent at home during the pandemic may have led to greater importance of home ownership. These trends may also indicate a shift in investor preference in light of elevated risks, as potential tenants of these properties tend to be high income locals with stable employment. This contrasts with tenants in the Investment segment which tend to be lower-income expats with relatively less stable employment given the shift to "Kuwaitization".<sup>7</sup> Likewise, tenants for Commercial properties are also considered riskier given their pro-cyclicality coupled with uncertain economic conditions.

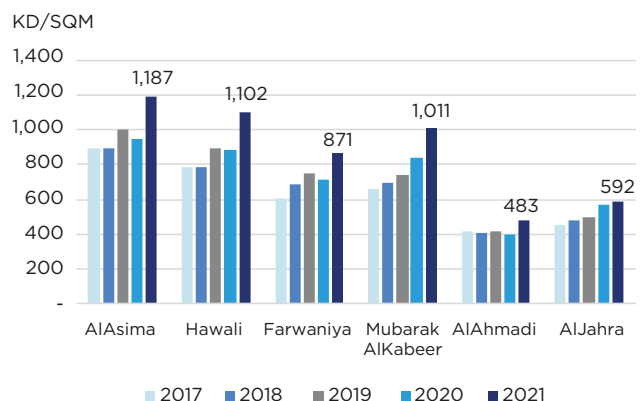
1.24 Real Estate Sales Value



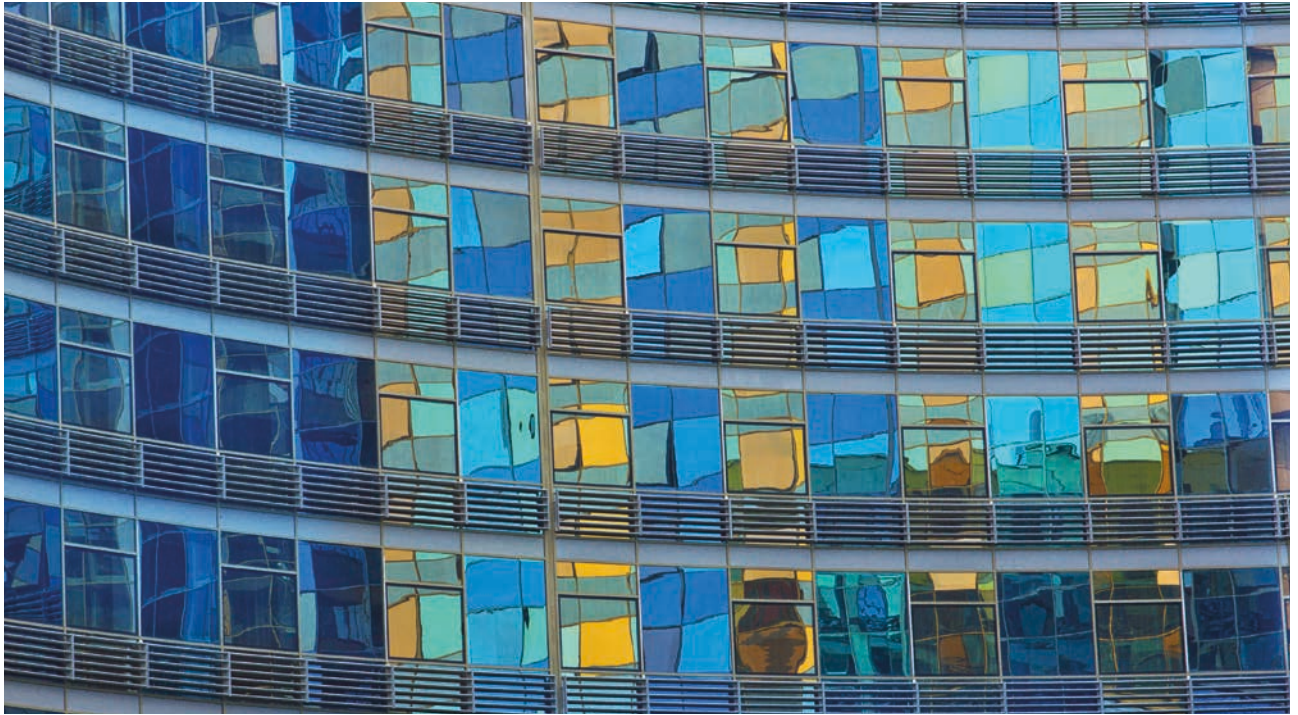
1.25 Real Estate Transaction Volume



1.26 Average Residential Real Estate Prices



7 A mandate dictating minimum proportions of Kuwaiti employees for both public and private sector jobs.



**Total local real estate transaction value was 35.5% above the 5-year average, largely attributable to the Residential segment.**

While decreased liquidity in Investment and Commercial properties relative to historical levels raises concerns as many of these investments are leveraged, overvaluation does not seem to be an issue as markets have been steadily pricing in the fundamental weakness.

Consistent with the trends seen in trading activity, Residential real estate prices rose steeply in 2021, increasing 19% on average across all six governorates (figure 1.26)<sup>8</sup>. This annual growth rate is the highest since 2013 and compares with the estimated 26.5% growth seen in 2008 prior to the Global Financial Crisis. The surge in prices can largely be explained by a shift in investor preference, moving away from properties with riskier tenants given the abovementioned factors. Coupled with historically low financing rates, these factors culminated in the perfect

conditions to induce excess demand in the segment. On the supply side, Residential unit growth is also more constrained, growing at a slower pace than demand. To put it into perspective, total existing residential houses (occupied and unoccupied) are estimated at 161,000<sup>9</sup>, in contrast with 94,379<sup>10</sup> standing orders for public housing as at the end of 2021. These dynamics are largely due to limited land available for development.

Given relatively low transaction volume and heterogeneity within the Investment and Commercial segments, alternative indicators were found to be more relevant in assessing performance. These include occupancy rates for Investment buildings and retail rents for Commercial properties. As such, results of recent surveys covering more than 7,000 properties across 20 districts conducted by Real Estate Market Intelligence (REMI) confirmed the persistent weakening in the Investment segment, with occupancy levels continuing to decline (figure 1.27). After showing some strength in 2019, occupancy in Investment buildings dropped at the onset of the Covid-19 pandemic and continued to fall through 2021.

<sup>8</sup> As per deals registered at the Ministry of Justice excluding extreme outliers, combining buildings and land plot deals.

<sup>9</sup> Real Estate Market Intelligence (REMI) estimates based on satellite imagery. May not reconcile with the Public Authority for Civil Information (PACI) as some units are under construction (no PACI number issued).

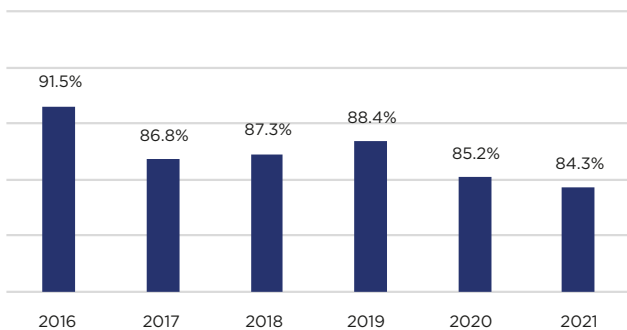
<sup>10</sup> Source: Public Authority for Housing Welfare.

This coincides with a 5.7%<sup>11</sup> drop in non-Kuwaiti residents between the end of 2019 and the second quarter of 2021, which was largely a result of active governmental policies to rebalance Kuwait’s demographics.

Consistent with the weak trends in transaction value, Commercial real estate rents continued to soften in 2021 (figure 1.28). As opposed to the Investment segment which depends in large part on the country’s demographics, Commercial properties are heavily dependent and largely correlated with economic activity. That said, and despite the boom in spending with lockdowns lifted and pent-up demand released, retail space was bid down. While consumer behavioral shifts and higher reliance on online transacting may have contributed to the persistent weakness, general trends indicate the segment has been softening even before the Covid-19 crisis. These indicators of structural imbalances in the segment further support the case for investors to shift towards the more resilient Residential segment and may have been a driving factor in its outperformance.

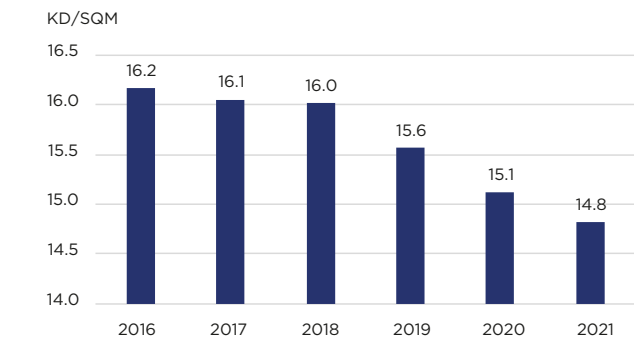
Looking forward, Residential real estate will grapple with two opposing dynamics that make the price outlook uncertain. On one hand, weakness in Investment buildings seems persistent given continued demographic shifts and oversupply. Coupled with the downward trajectory of the Commercial segment, these factors contribute to the attractiveness of Residential properties as the preferred investment instruments. On the other hand, continued development in public housing and distribution of lands by the Public Authority for Housing Welfare (PAHW) will increase supply in the market and relieve some of these price pressures. The most notable residential projects on the horizon include AlMutlaa Residential City (1,739 of 28,288 land plots distributed), and South Abdullah AlMubarak (915 of 3,260 land plots distributed). Other longer-term projects that are currently in the planning and tendering phase include South Saad AlAbdullah and South Sabah AlAhamad, expected to introduce 22,152 and 20,380 residential plots respectively. Retail space is expected to see an influx in supply with the 380,000 square meters Assima mall completed in 2021 and the 116,000 square meters Al-Khiran outlet under development. On the macro side, expectations of increasing rates support the bear argument, with higher required rates of return likely to put downward pressure on properties in all segments of the market.

**1.27 Investment Buildings Occupancy**



Source: REMI

**1.28 Average Retail Space Rent**



Source: REMI

<sup>11</sup> Source: The Public Authority for Civil Information (PACI).

## BOX 1.1:

### Climate Change

Around the world, countries have been placing more weight on the importance of climate change as its consequences become more pressing and the data becomes clearer. Climate change refers to the shift in temperature and weather patterns over the long-term mainly due to the large amounts of greenhouse gasses emitted into the atmosphere, ultimately spurring global warming. Under these atmospheric shifts, economic spill overs are inevitable, as supply and demand fluctuations arise in a range of different industries. This box explores the latest global efforts in tackling the effects of climate change, the role of the financial system, and finally, the regulatory responsibility of central banks in preserving financial stability in the face of such environmental risks.

#### Global Perspective

Recently, there have been increasing initiatives by leading global organizations to encourage and support both the public and private sectors to have a more positive impact on the environment. The two main milestones that have paved the way are the 2015 Paris Climate Protection Agreement (legally binding and adopted by 196 parties) and the United Nations 2030 Agenda for Sustainable Development. Both initiatives encourage commitment to reduce emissions and create a more sustainable future. Moreover, and with regards to initiatives specific to the banking and finance industry, the Financial Stability Board (FSB) put together the Task Force on Climate-related Financial Disclosures (TCFD) in 2015. It aims to enhance the financial industry's level of voluntary and consistent reporting of climate-related risk. Another key advancement is the Network for Greening the Financial System (NGFS) which was established in 2017 by a group of central banks and supervisors. Its aim is to share best practices and help in the development of financial sector environmental risk management,

as well as encouraging the financing of a sustainable economy. The Basel committee has also been working on proposing principles that help improve climate-related financial risk management. In addition, key rating agencies (Fitch, Moody's, and S&P) now incorporate, to a certain extent, climate-related factors into their sovereign credit rating methodologies. These are just some of the recent efforts to fuel the global momentum on climate change, highlighting the growing importance of the issue and prevalent care in the field.

#### Local Perspective

In the case of Kuwait, climate change is evident, with temperatures projected to increase by 1.2-1.4°C by 2050. Precipitation is projected to decrease by 15-25% by 2050 compared to the baseline data recorded from 1986 to 2005, according to the Environment Public Authority. However, despite being susceptible to climate change, Kuwait is ranked 65 out of 182 countries in the ND-GAIN Index<sup>1</sup>, and is classified as well positioned with few challenges.

Kuwait is actively working to comply with best practices and global trends on climate change. It was an early signatory to the United Nations Framework Convention on Climate Change and has signed various international agreements related to climate change including the Paris Agreement. In November 2021 at the United Nations Climate Change Conference (COP26) summit, His Highness the Prime Minister Sheikh Sabah Khaled Al-Hamad Al-Sabah affirmed Kuwait's target to cut its total emissions by 7.4% by 2035. There have been several milestones reached that support Kuwait in achieving this goal. For example, the Kuwait Institute for Scientific Research developed the ambitious Shagaya Renewable Energy Park<sup>2</sup>, in an effort to leverage renewable energy as a sizable source of electricity nationally. In addition, the Kuwait Integrated Petroleum Industries Company's recently completed one of the region's largest Liquefied Natural Gas Import Facilities, which

1 The ND-GAIN Country Index summarizes a country's vulnerability to climate change and other global challenges in combination with its readiness to improve resilience. Source: University of Notre Dame Global Adaptation Index Country Index.

2 This project was officially opened in February 2019 and sets the foundation for future renewable energy projects locally through the installation of a 50 mega-watt (MW) solar power plant, a 10 MW wind farm, and a 10 MW photovoltaic plant. The goal is to ultimately reach the government's master plan of generating approximately 3.2 GW of electricity through renewable means by 2030.

will help Kuwait move towards cleaner fuel to generate electricity and help supply oil refineries and petrochemical industries' growing demand.

On the capital market front, Boursa Kuwait set a strategy that seeks to “align, create, and integrate” corporate sustainability into its mission<sup>3</sup> through climate change responsibilities and environmental, social, and governance (ESG) efforts at large. Kuwait is also trying to improve its carbon footprint on a global scale through sustainable investing. Specifically, the Kuwait Investment Authority (KIA) is implementing a sustainable finance framework developed by the One Planet Sovereign Wealth Fund Working Group (OPSWF), of which KIA is a founding member. Their aim is to support the Paris Climate Agreement within the asset management space.

### Role of Banks and Implications on Financial Stability

As global initiatives put in the effort to create a more sustainable world, there is increasing pressure on banks to ensure they avoid climate-related financial risks. Despite the global effort to move towards a low-carbon economy, climate change issues continue to materialize into two main types of risks. Physical risk – which is the economic cost and financial losses that may arise from climate change – and transition risk – which is the risk that arises from the transition to lower carbon state. In terms of physical risk, more frequent and more intense heat waves, flooding, and freezing temperatures can impact banks depending on the parts of the world they are exposed to. Specifically, banks may experience heightened operational risks such as challenging working conditions and increased fluctuations of economic value due to physical damage of assets as well as the instability of the affected region. Physical risk may also translate into other risks to banks as highlighted in Figure 1. In terms of transition risk, there could be a demand shift in different economic sectors such as energy, agriculture, manufacturing, and construction for more environmentally suitable endeavors. Corporate failure as well as closure of factories before the end of their useful lives may occur as a result. This gives rise to credit risks, as industries heading towards obsolescence experience heightened credit deterioration.

Figure 1

Relevant Climate Change Risks	
Physical Risk	Transition Risk
Damage to physical assets	Change in consumer preferences
Workability and livability	Shifts to different energy sources
Deterioration of sustainability	Change in regulation and policies
Risks to Banks	
Credit Risk	
Reputational Risk	
Operational risk	
Market Risk	

It is important that banks move towards aligning their goals and mandates with key environmental efforts, because – as financial intermediaries – banks can be drivers of change and catalysts in the green transition. Additionally, banks can responsibly manage their own financial exposures by focusing their investment activities in sustainable and green initiatives. With the increasing interest in ESG investing, many investors are directing their funds towards environmentally friendly projects, and several banks around the world are following suit. For example, there has been a growing demand for sustainable debt instruments, which aim to finance sustainable projects relating to ESG objectives. The global sustainable debt issued in 2021 was \$1.6 trillion, making the total issuances to-date exceed \$4 trillion. Green bonds, which are bonds issued to finance climate-related projects, make up 45% of this amount. Strong growth is expected in ESG issuance within the GCC region over the coming years because of the growing demand, especially for Islamic ESG funds. Particularly, Saudi Arabia’s Arab Petroleum Investments Corporation and Saudi’s Public Investment Fund are making bold advancements within the region in the ESG bond space. KIA, being a founding member of the OPSWF, is also likely to help move this space forward.

In Kuwait, physical risk can be assessed through foreign and domestic exposure. Regarding local

<sup>3</sup> For more details please visit Boursa Kuwait’s website (<https://www.boursakuwait.com.kw/en/sustainability>).

banks' exposure (via subsidiaries) to foreign countries that are ranked as highly vulnerable to climate change and in some cases low in readiness, only 2.6% of total Kuwaiti bank assets are situated within these countries. Therefore, physical climate change risk stemming from foreign business operations is limited. As mentioned earlier, Kuwait is ranked number 65 in the same index, putting it in the top 40% of countries and is well positioned in the face of climate change.

With regards to transition risk, banks are making moves towards more sustainable financing. Over the past five years, there have been growing efforts from Kuwaiti banks to increase their exposure to the green space (figure 2). As of 2021, investments in primary brown sectors account for merely 12.4% in fixed income and 0.6% in equities (figure 3). In terms of the loan portfolio, only 9.4% of loans are attributed to

primary brown sectors. These statistics are commendable, and if this data continues to trend in favor of sustainability, the implications that both physical and transition risks have on banks will be minimal.

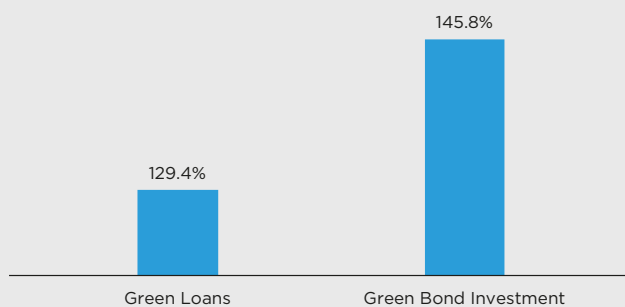
Overall, it is important for Kuwaiti banks to take on this responsibility in order to not fall behind as the rest of the world and the region progresses towards greener balance sheets. There have been some notable efforts by a number of local banks in supporting the ESG and climate change cause through initiatives and reporting. The Central Bank of Kuwait (CBK) applauds these efforts and encourages other banks to follow suit.

### The Role of the Central Banks

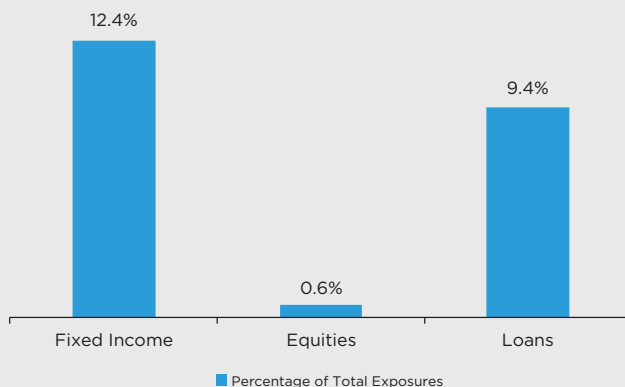
Banking regulators around the world are fully aware of the importance of their role in the fight against climate change and in safeguarding financial stability. The TCFD and the NGFS were two of the major movements that really helped kick-start the drive of central banks and regulatory institutions to take climate change seriously. Such proactive approaches will equip regulators with the required skills to carry out their core mandates. The network provides useful tools and resources that can help CBK promote relevant policy decisions and adequate supervisory practices around climate change and financial risk. Additional efforts by CBK include: capacity building, engaging with stakeholders, as well as putting together an in-house team focusing on climate change to ultimately drive CBK's climate change agenda.


Given the long-term and slow nature of the implications of climate change, proactive and steady initiatives are crucial to avoid sudden adjustments that may shock markets and consumers. CBK stresses that local banks meet their responsibilities of managing their financial exposures and help finance a green agenda. It is critical that banks plan and operate proactively and not dismiss the significance of a green agenda. Despite the risks arising from climate change, banks can benefit from emerging opportunities, including new projects with sustainable mandates such as energy developments, carbon-managing projects, and other innovations. Operating within a green parameter could help banks draw in new investments, gain recognition, have more resilient balance sheets, potentially improve their credit ratings and ultimately help Kuwait move closer to achieving its 2035 vision.

**Figure 2**  
Kuwaiti Banks' Green Exposure



**Figure 3**  
Share of exposures to 'Brown Sectors'





**CHAPTER 2**  
**LOCAL**  
**FINANCIAL**  
**SYSTEM**  
**OVERVIEW**

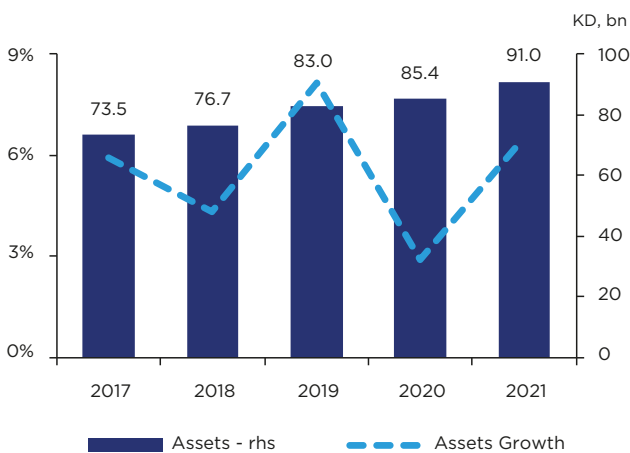
---

Similar to other economies, the local financial system consists of different entities including banks, insurance companies, and investment companies, governed by a set of rules and regulations. The Central Bank of Kuwait (CBK) is specifically mandated with the regulation of banks, finance companies, and exchange companies. In cooperation with the Capital Markets Authority (CMA), CBK shares a dual supervisory role on investment companies. This section covers the performance of the institutions under CBK’s regulation, which include five conventional banks, five Islamic banks, one specialized bank, and 79 investment and exchange companies. The analysis covering banks will describe key changes on their balance sheets. A deeper analysis of key risks is covered in chapter 3 of this report.

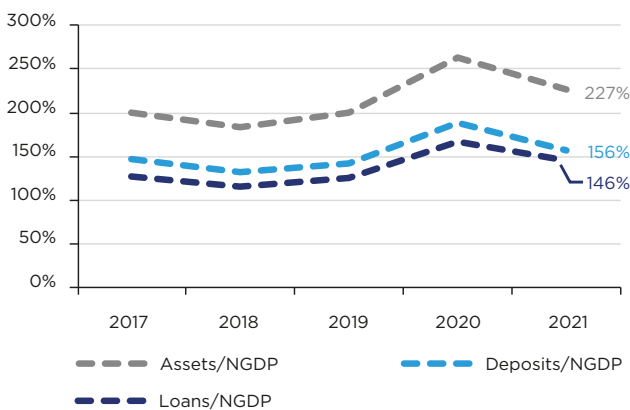
## Banking Sector

In the fallout of the pandemic, the local economy saw a gradual recovery in 2021 attested by the growth in the IMF’s estimated nominal gross domestic product (NGDP). This growth was mainly supported by the spread of vaccines, the removal of mobility and travel restrictions, as well as the rebound in oil prices. As such, the banking sector, which accounts for the vast majority of the domestic financial system,

### 2.1 Banking System Assets



### 2.2 Banks’ Indicators relative to NGDP



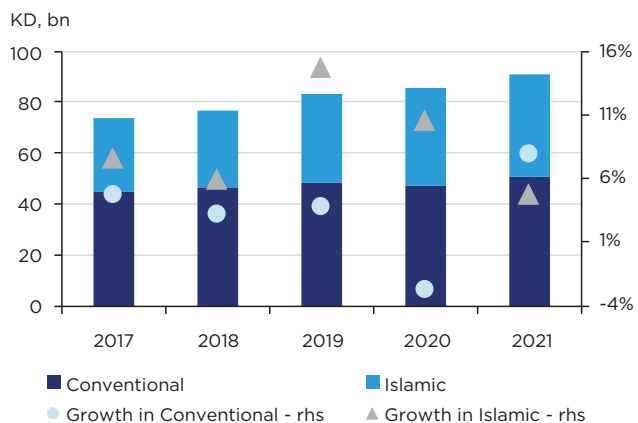
### Banks’ total assets registered growth of 6.5% in 2021, surpassing the average for the past five years.

was positively impacted. Banks’ total assets registered a growth rate of 6.5% in 2021 (2.9% in 2020), surpassing the average rate for the past five years, to reach KD 91.0bn (figure 2.1). This positive performance was largely supported by the expansion of the banks’ lending portfolios which grew by 7.7%. Moreover, banks have a sizeable global presence with assets of their foreign subsidiaries and branches accounting for 22.1% of total assets.

Despite the growth in assets, the ratio of assets to NGDP has decreased from 263% in 2020 to 227% in 2021. This drop was due to the aforementioned growth of NGDP, which registered a 24% increase in 2021 compared to a drop of 22% in 2020. A similar effect was also reflected in the ratios of loans and deposits to NGDP, which reached 146% and 156% respectively in 2021, down from 167% and 188% in 2020 (figure 2.2).

The year 2021 also witnessed the reversal of a persistent trend in terms of the banking industry

### 2.3 Conventional & Islamic Banks Assets



segments, as conventional banks grew at a rate exceeding that of Islamic banks (figure 2.3). After conventional banks' assets dropped by 2.7% in 2020, they increased by 8% to reach KD 50.0bn by the end of 2021. Islamic banks on the other hand witnessed a slowdown in their growth rate (4.8% in 2021 compared to 10.6% in 2020) to reach KD 40.4bn. The slowdown in Islamic banks' asset growth is not necessarily indicative of active downsizing. Instead, it is driven by the banks' preference to utilize existing sources of funds to finance activities.

In terms of business, local banks continue to rely on core activities, as the share of net loans reached a 10-year high in 2021, contributing KD 55.9bn or 61.6% of total assets (figure 2.4). This increase was at the expense of the investment portfolio which saw its share dropping from 16.8% to 16.2%. In addition, the share of balances due from CBK reached 7.2%, decreasing in value to KD 6.5bn as banks seized higher yielding opportunities in

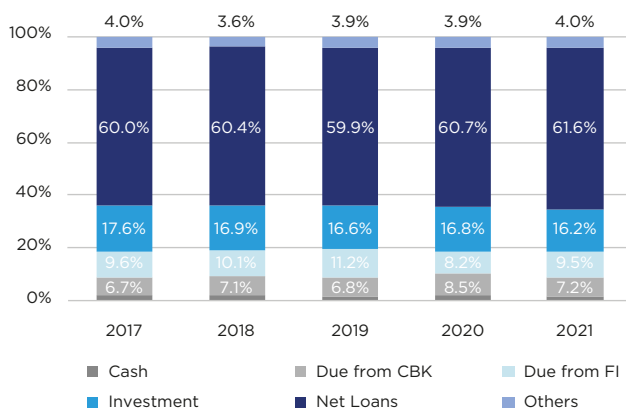
light of the economic recovery. Overall, the slight changes seen in the assets' structure reflect the continued focus towards lending activities.

**Loans:**

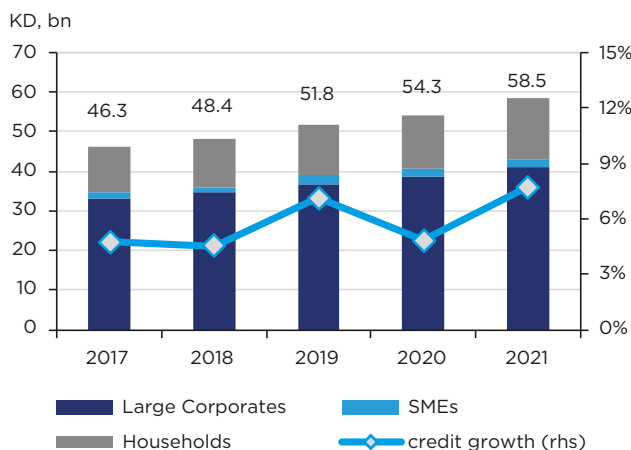
As financial intermediaries, Kuwaiti banks continue to expand their loan portfolios to perform their roles sufficiently. Total loans increased by KD 4.2bn to reach KD 58.5bn in 2021 (figure 2.5). This growth was mainly driven by cheaper loans in light of low rates, and was directed to all types of obligors: Large Corporations, Small and Medium Enterprises (SMEs), and Households. Household loans increased the most, at KD 1.7bn, and made up more than a quarter of the total lending portfolio (26.3%). Banks typically prefer the Households sector due to the diversification and stability of borrowers' income (mostly government employed).

In terms of sectoral growth, and as pointed out above, Households continues to be the dominant sector (figure 2.6). The Banks and Services sectors came next with increases of KD 0.8bn and KD 0.7bn in loans respectively. The borrowing banks were mainly domestic and investment grade GCC banks. Moreover, loans to the Oil & Gas sector reached their highest level at KD 3.4bn, with the increase attributable to a syndication of loans from Kuwaiti banks to finance expansionary projects of local companies. The Trade and Construction sectors both shrank in 2021, reaching KD 4.6bn and KD 2.5bn respectively. Overall, the credit portfolio is considered concentrated in Household and Real Estate loans (26% and 20% of total cash loans, respectively) despite the abovementioned developments.

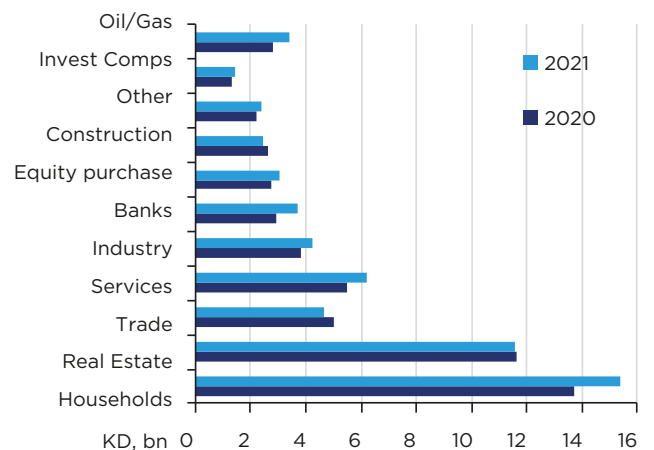
**2.4  
Decomposition of Assets**



**2.5  
Gross Loans-by borrowers' type**



**2.6  
Gross Loans by Sector**



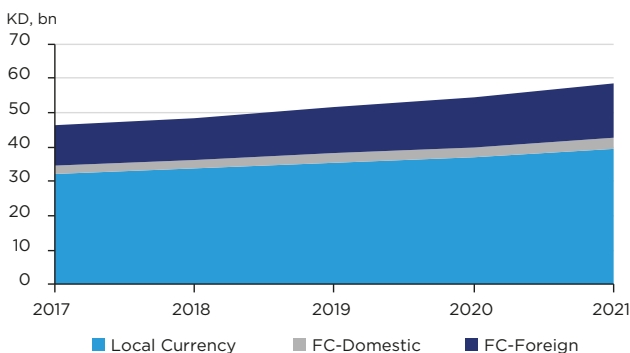
In terms of currency, loan allocation remained consistent over the years where local currency accounted for 67.5% of total gross loans (figure 2.7). Loans granted domestically in foreign currency (FC) have increased by KD 0.74bn, with their share reaching 18.1% of FC loans. Likewise, loans granted in FC abroad increased by KD 1.07bn, yet their share of total FC loans outstanding declined from 84.3% to 81.9%.

The geographical distribution of the lending portfolio was largely unchanged. Loans to domestic borrowers took the lions share at 72.6% of the portfolio (figure 2.8), while the remaining portions were distributed across European and GCC countries. The share of loans in Europe declined in 2021, from 11.1% to 9.6%, mainly due to the depreciation of the Turkish Lira (TRY). The share of GCC loans on the other hand increased from 9.6% to 10.9% in 2021, mostly routed to the Services, Banks, and Oil & Gas sectors in Qatar, UAE, and Oman.

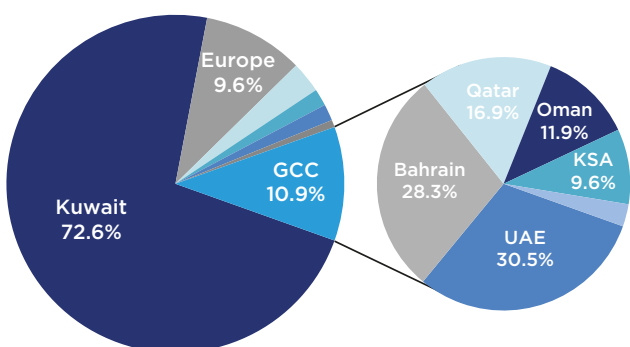
**Investments:**

Investment books, the second largest contributor to the banking sector’s assets, registered a 3% growth in 2021 to reach KD 14.7bn (figure 2.9). Due to their preferential regulatory treatment

**2.7 Gross Loans-by currency**



**2.8 Gross Loans - by region**

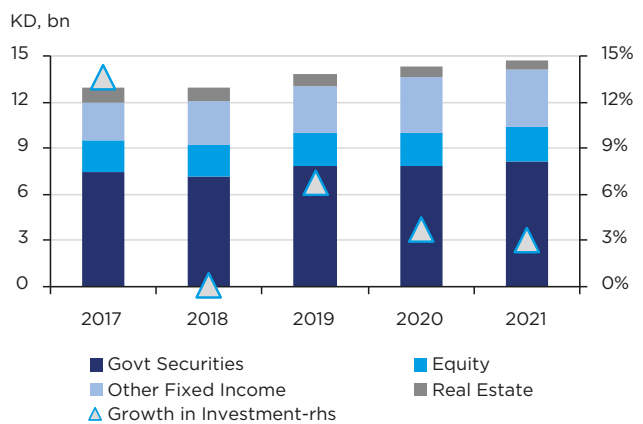


**Investments in GCC countries continued to dominate, accounting for almost 70% of banks’ investment portfolios.**

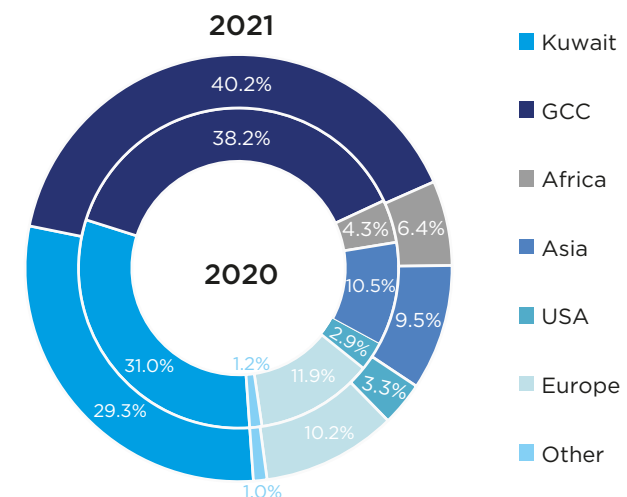
and lower risk profile, fixed income instruments issued by governments continued to be the favored investment for banks, making up 55% of the portfolio. Other fixed income securities accounted for 26%. As for equity investments, their share recovered slightly in 2021 to reach 15% with a total value of KD 2.2bn. Real estate investments continued to shrink, falling by 10% as a result of divestments of several properties from Europe and the Kingdom of Saudi Arabia (KD 23.4mn and KD 20.0mn, respectively).

As for the geographical allocation, investments in GCC countries (including Kuwait) continue to

**2.9 Banks’ Investments - by type**



**2.10 Banks’ Investments - by region**

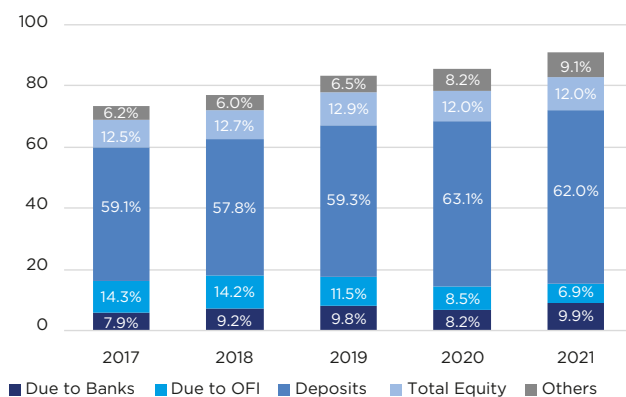


dominate the portfolio, accounting for almost 70%. In terms of value, GCC's investments exceeded pre-pandemic levels at KD 10.3bn compared to KD 9.9bn and 10.1bn in 2020 and 2019, respectively (figure 2.10). Local banks investments in Kuwait dropped for the fourth year in a row, reaching KD 4.3bn in 2021 compared to KD 5.5bn in 2018 (29.3% compared to 42.6% of total investments, respectively). This was mainly due to the lack of sovereign domestic debt issuances as a result of the expiration of the public debt law, a primary driver of banks' local investments. Moreover, banks investments in Africa increased by KD 327mn to settle at KD 949mn, which in turn drove their share to increase by 2.1 ppts to 6.4% in 2021. This uptrend was mostly from investments of banks' subsidiaries in Egyptian sovereign bonds. Furthermore, US investments saw an uptick, while European and Asian investments went the opposite direction, decreasing by KD 199mn and KD 97mn, respectively. The larger decrease in the European investments this year was mainly driven by Turkish bonds, which experienced a decline in value due to the depreciation of the TRY. Also, the divestment of real estate in Europe further contributed to the decline.

### Liabilities and Equity:

On the liabilities and shareholders' equity side of the balance sheet, there was a notable drop in the share of Deposits and Dues to Other Financial Institutions (OFI) (figure 2.11). This was mainly driven by a decline in the balances of a key government entity's deposits, as well as the deposits of a key financial institution. Nonetheless, deposits remain above the levels witnessed before the pandemic and continue to represent the main source of funding for banks.

### 2.11 Decomposition of Liabilities and Equity

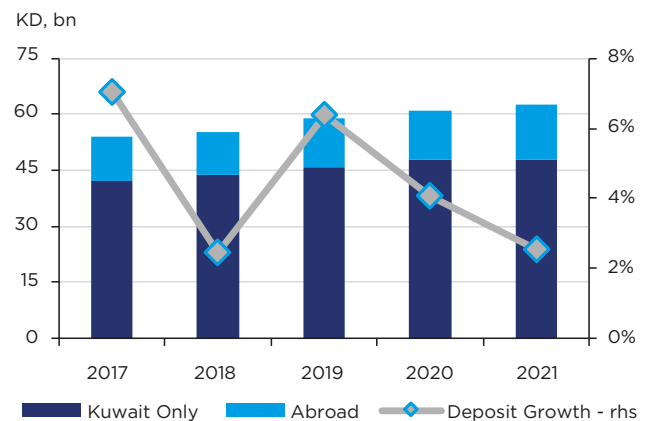


### The bulk of bank deposits were sourced from the local private sector.

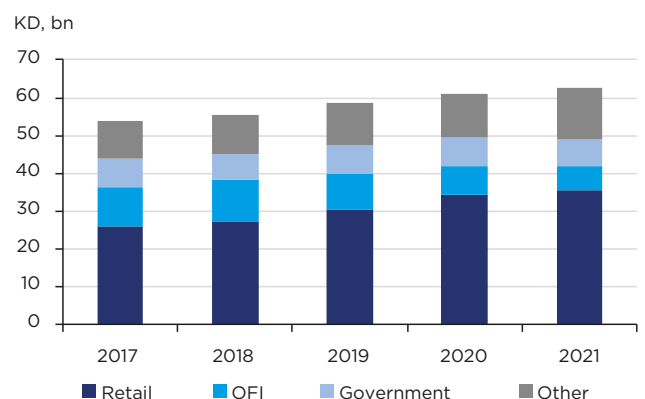
Furthermore, the share of balances Due to Banks increased, accounting for 10% of total funding compared to 8.2% in 2020. Finally, a KD 1.3bn increase in other liabilities was due to an increase in other borrowed funds including issuances.

The banking system's deposits grew by 2.5% in 2021 to reach KD 62.7bn, 76.5% of which were local deposits. This share has decreased by 1.6 ppts from 2020 as deposits abroad increased by KD 1.3bn in 2021 due to banks expanding their foreign operations (figure 2.12). Banks largely depended on the private sector for funding, where retail deposits reached KD 35.4bn by the end of the year and accounted for 56.5% of total deposits (figure 2.13). Furthermore, other deposits reached KD 13.6bn compared to KD 11.7bn the year before, mainly due to the increase in corporate deposits at the subsidiaries of a single bank.

### 2.12 Deposits of the Banking System



### 2.13 Deposits - by type

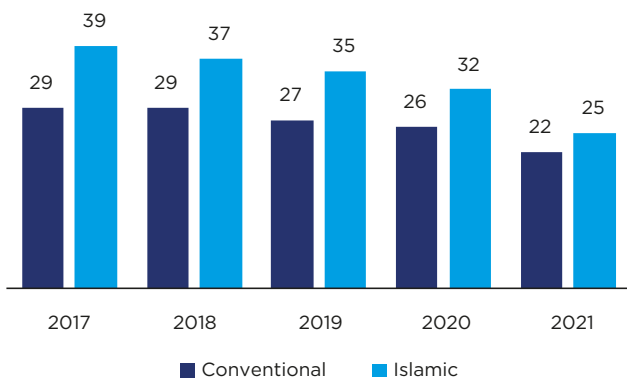


# Investment Companies

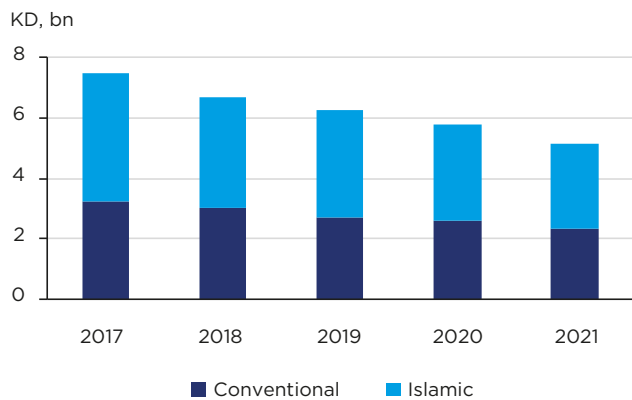
The number of licensed investment companies (including one finance company) continued its decline over the past five years. By the end of 2021, 47 investment companies were regulated by CBK compared to 68 companies in 2017 (figure 2.14). The year 2021 witnessed a 19% drop in the number of companies, mainly due to compliance costs resulting from the simultaneous adherence to both CMA and CBK regulations, pressuring the companies to forgo their unused financing licenses.

As for the breakdown of the licensed investment companies in terms of their adherence to Sharia rules, it was noticed that the number of Islamic companies declined from 39 in 2017 to 25 in 2021. Islamic investment companies continued to hold the largest share in assets despite the overall decline (KD 2.8bn in 2021 compared with KD 3.2bn in 2020) (figure 2.15). Conventional companies on the other hand had a total asset base of KD 2.3bn in 2021, down from KD 2.6bn the year before. This decline in assets across both conventional and Islamic companies is due to the drop of the number of regulated entities mentioned above.

**2.14**  
Number of Investment Companies



**2.15**  
Investment Companies' Assets



# Exchange Companies

Similar to the trend witnessed in investment companies, the number of exchange companies has been on a downwards trajectory over the past five years, with their total number declining from 42 in 2017 to 32 in 2021 (the year 2021 alone witnessed a 16% decline). These discontinuations are largely due to smaller, less established companies unable to meet the latest regulations set by CBK. In line with global guidelines, these regulations were put into action in late 2014 to better regulate the sector and ensure its soundness. Despite this drop, total assets managed to record an increase of 4% in 2021, reaching a new high of KD 263mn (figure 2.16) and indicating a smaller weight of the delisted companies.

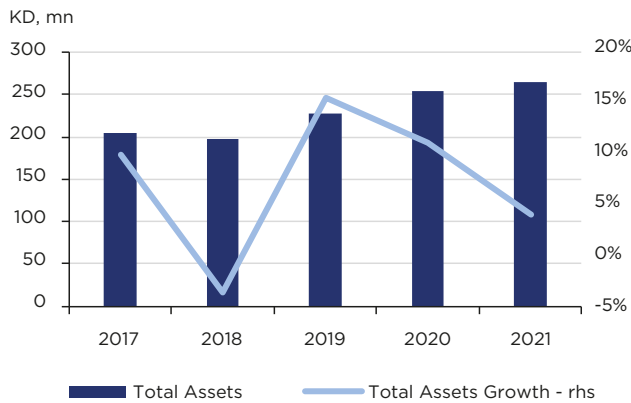
Exchange companies continued to demonstrate elevated profitability, with their net profits recording a growth of 24% to reach KD 45mn at the end of 2021 (figure 2.17). This growth is considered moderate when compared to the 103% growth seen in 2020, which stemmed from the increase in currency sales and remittances. Similarly, 2021's bottom line profits are also

attributable to core activities, as currency sales and remittances accounted for 72% of total revenues. Other revenues, which include commissions, transaction fees, and bank interest also witnessed an increase of KD 5mn. This healthy performance translated into improved profitability indicators as the return on average assets (ROAA) and return on average equity (ROAE) both increased, reaching 17.4% and 32%, respectively, versus 15.1% and 26.1% in 2020 (figure 2.18). This demonstrates the soundness of the exchange company sector, further contributing to the solid pillars of the Kuwaiti financial system.

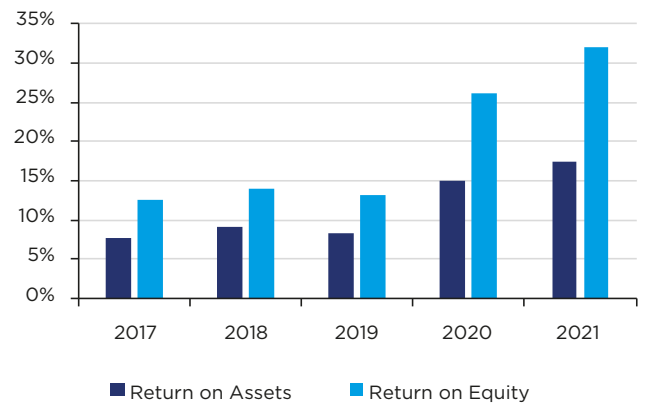
The outlook for Kuwait’s financial system remains positive as the banking sector transitions into the post-crisis phase. Aided by the Central Bank of Kuwait’s prudent monitoring and guidance,

Kuwaiti banks came out of the pandemic on stronger footing, recording healthy growth in credit and more sustainable sources of funding. Looking forward, unsustainable trends, such as the continued expansion in retail lending, is expected to reverse as we enter into an era of higher interest rates and costlier borrowing. On the flip side, the shrinking of the Construction and Trade sectors is expected to reverse in light of strengthening oil prices. Given the expected developments, the upcoming period necessitates heightened vigilance as monetary authorities rush to abruptly tighten policies, increasing the risks of a potential recession. Nonetheless, Kuwaiti banks remain sufficiently capitalized and provisioned, able to absorb any unanticipated market volatility or sudden credit deterioration.

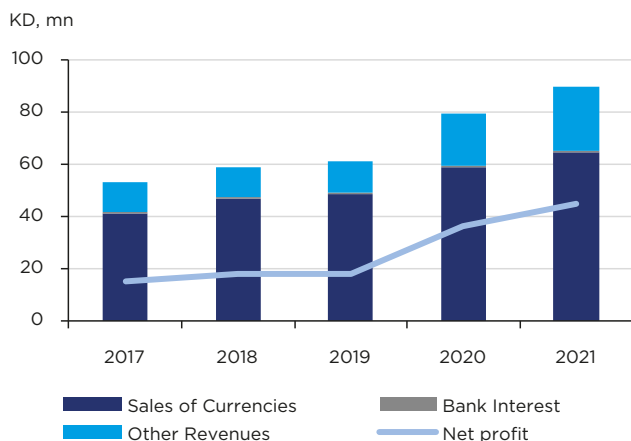
**2.16 Exchange Companies Assets**



**2.18 ROAA & ROAE: Exchange Companies**



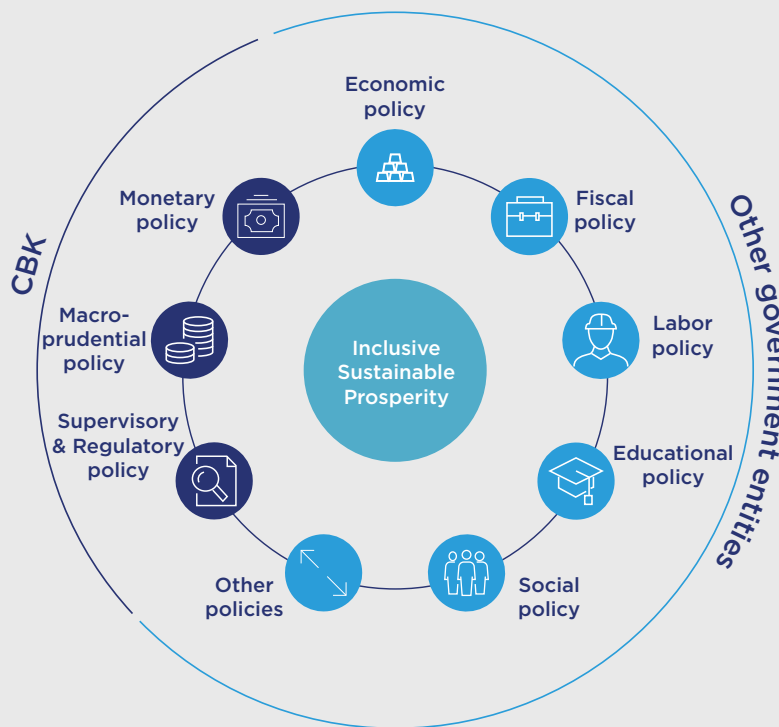
**2.17 Breakdown of Exchange Companies' Revenues**



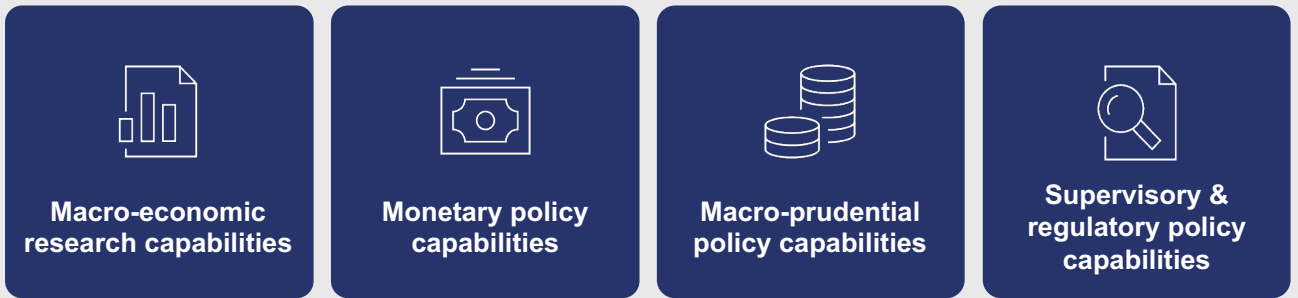
## BOX 2.1:

# CBK's Institutional Framework

In its continuous pursuit of inclusive and sustainable prosperity, the Central Bank of Kuwait (CBK) leverages monetary, macroprudential, supervisory and regulatory policies mandated to it by Kuwaiti law. While these policies alone are insufficient in ensuring prosperity without the alignment and support of other economic policies, their prudent and sound implementation is instrumental in promoting monetary stability and financial stability. Given the authority bestowed upon it, CBK strives to implement these policies to the highest degree possible for the optimal benefit of the broader economy.



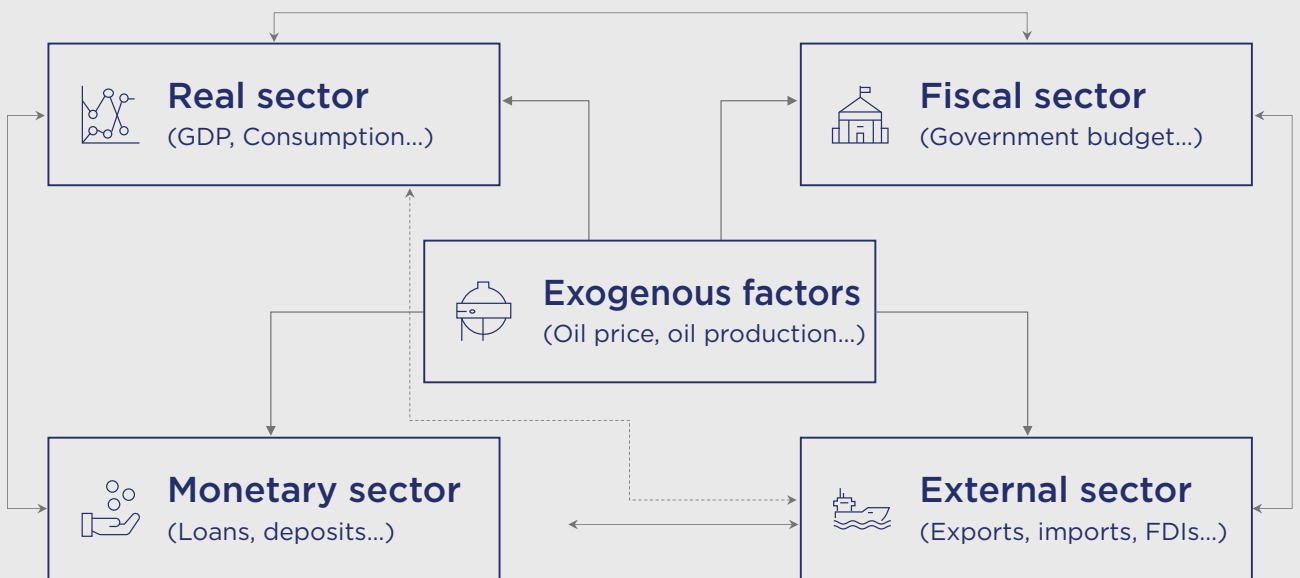
Achieving this mandate requires robust and comprehensive models based on a sound framework that combines scientific and expert-based approaches to guide decision-making. In a shifting and complex environment, upgrading abilities is crucial given mounting exogenous and endogenous considerations. Economies and individuals are more connected than ever, magnifying the speed and severity of crisis spread, while also rendering traditional response tools insufficient. Endogenous considerations include the fast-paced shift to digitize processes, introducing new risks, with a simultaneous increase in Kuwaiti banks' appetite to expand abroad. To accommodate for factors in an ever-shifting environment, CBK has upgraded its framework in four areas: macro-economic research, monetary policy, macro-prudential policy, and supervisory & regulatory capabilities. As part of the enhanced framework, new tools were added to reflect the latest global advances in technology and supervision. These consist of a dynamic macro-economic forecasting model, advanced monetary policy capabilities, a state-of-the-art stress testing tool, and next level supervision capabilities.



In upgrading these abilities, CBK leveraged best practices from major central banks to ensure covering ever-growing complexities, new crisis archetypes and additional risk exposures facing the economy and banking sector. This enables more informed decision-making and ultimately provides greater benefit to the broader economy.

### Macro-economic Research Capabilities

The enhanced macro-economic model has been expanded to cover wider macro-variables, in-depth analysis and forecasting of economic indicators, and what-if scenario capabilities. The model was built around key economic sectors that play a fundamental role in the local economy, with defined linkages and interactions between real, fiscal, monetary, and external sectors to capture Kuwait-specific intricacies and relative importance of different variables.



Given Kuwait’s reliance on international trade, exogenous macro-variables, such as oil prices and inflation in countries of import, play a significant role in the domestic economy. Hence, economic conditions of key trading-partners were analyzed to assess impact on the Kuwaiti economy. These serve as inputs to the new model and enable more comprehensive forecasts. Other key inputs include exchange rates, oil exports and production costs, global trade, capital formation, and domestic credit.

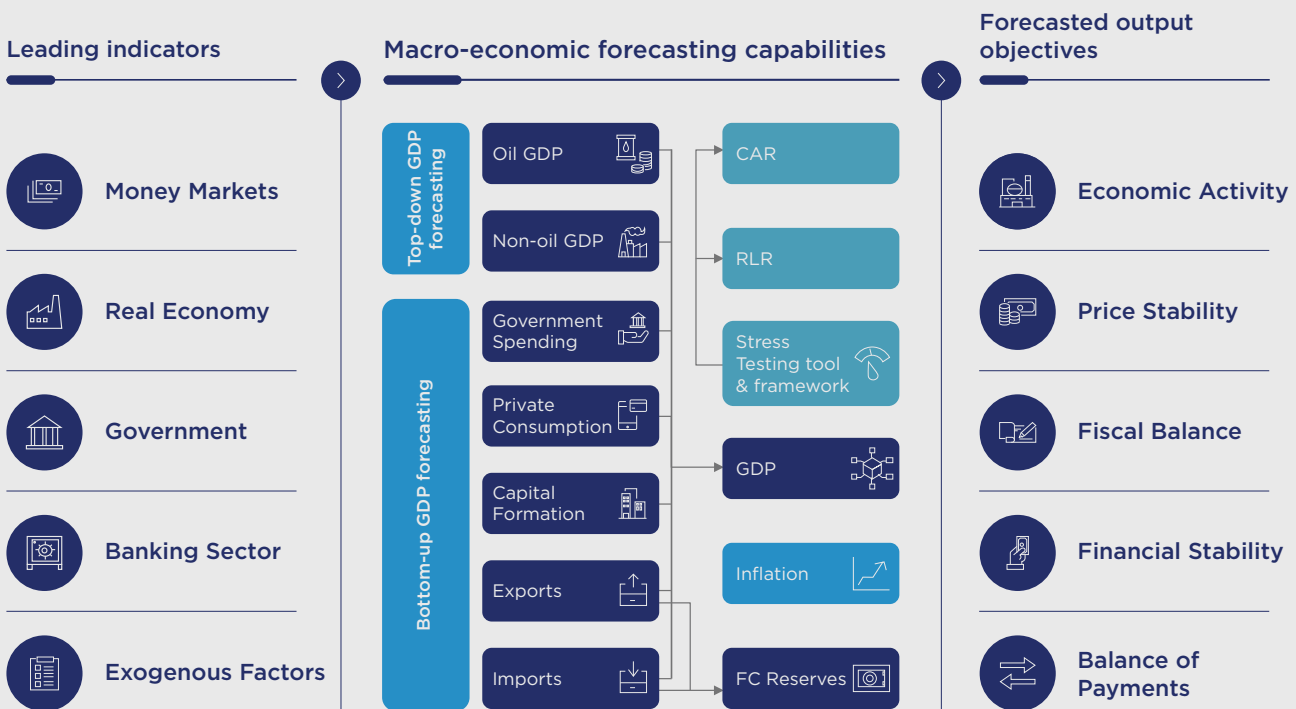
To develop optimal forecasting models, more than 200 regressions were tested for key variables using advanced statistical techniques, with the most robust models chosen. For example, the GDP forecasting model utilizes a combination of top-down and bottom-up approaches, complemented by expert input to enhance and validate model results. The top-down forecast relies on regression models to directly estimate oil and non-oil GDP, while the bottom-up approach forecasts key components of GDP (such as government spending, consumption, capital formation, and the trade

balance) by regressing each variable individually. The output from both approaches is then put under further scrutiny in the form of expert analysis to arrive at a final forecast for GDP. These results would serve as the foundation for setting monetary and macro-prudential policies, representing a baseline scenario for all other analyses.

### Monetary Policy Capabilities

The revamped monetary policy framework benefits from a structured and integrated macro-economic foundation. Dynamic macro analysis leveraging economic nowcasting and forecasting is overlaid on this foundation to support informed decision-making and is complemented by a comprehensive intervention toolkit linked to the output of the new model.

The new model consists of a dashboard that gauges key output objectives, which include price stability, economic activity, financial stability, fiscal budget, and trade & balance of payments. These output objectives are analyzed internally with targets and thresholds clearly defined and fed into the macro-economic forecasting model presented above to forecast the key output objectives. A blend of leading indicators covering money markets, real economy, government, banking sector, and other exogenous variables are also monitored and analyzed.



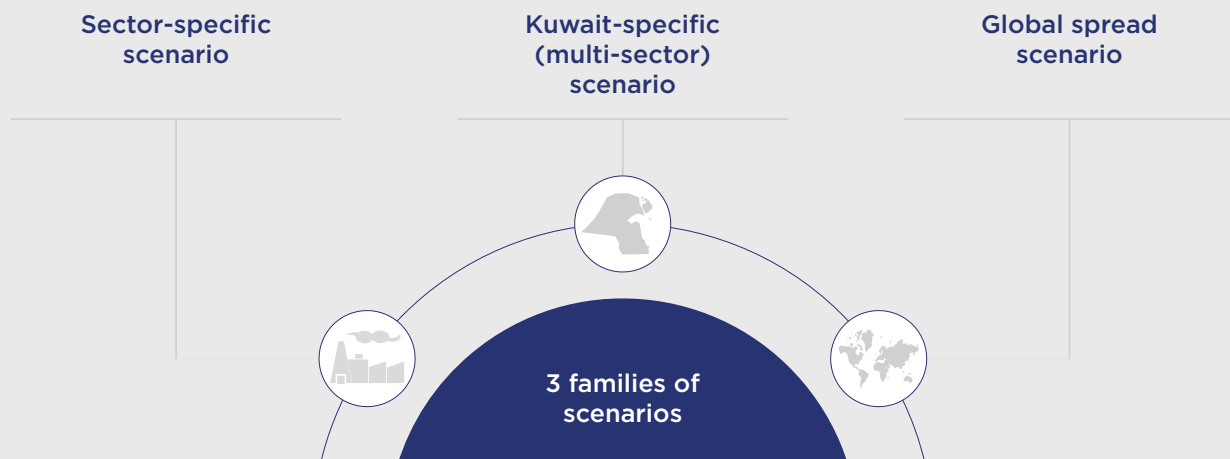
Based on these results, the new model would then combine both the leading indicators and forecasted output objectives using probability weights to yield an Economic State System (ESS). The dashboard of the ESS then displays the forecasted output objectives and leading indicators as sustainable, overheating, stagnant, or crisis based on the model run.

A clearly defined monetary policy intervention toolkit is then linked to the forecasted economic state, streamlining decision-making while considering forward-looking factors. These intervention tools include but are not limited to interest rates, open market operations, reserve requirements, short and long-term facilities, and FX interventions. In addition, more focused tools were added to CBK’s monetary analysis capabilities including an updated liquidity forecasting with currency-in-circulation modelling, FC reserves optimization, and tools detecting potential FX speculation trades.

## Macro-prudential Policy Capabilities

To further enhance macroprudential policy setting and guide interventions, CBK developed a state-of-the-art top-down stress testing tool which proved to be highly adaptable to the shifting economic landscape experienced amid the Covid-19 crisis. It benefits from flexible scenario setting abilities, high data granularity, second-round effect capabilities, and a stress scenario spanning over three years. Moreover, the new framework is comprehensive in quantifying potential macro-risks faced by the banking sector, with the ability to precisely model and quantify credit, investment book, interest rate, and liquidity risks' impact on banks.

The methodology followed in setting the scenarios and arriving at the stressed results starts at the macro-economic level, whereby a hypothetical disturbance in the economy triggers a shock that finds its way to the banking sector. To capture as many sources of risks as possible, three families of scenarios are set each year and run quarterly, comprising of a sector-specific, country-specific, and global spread shocks. These scenarios are set internally based on prevalent and forecasted economic conditions, CBK's team outlook, and expectation surveys of key players in the industry. Scenario narratives are then developed to identify the primary impacted macro-variables. Key transmission channels are mapped to different sectors of the economy, benchmarking to historical events to gauge potential impact magnitudes. The macro effects are then quantified into risk factors affecting the banking sector's soundness indicators.

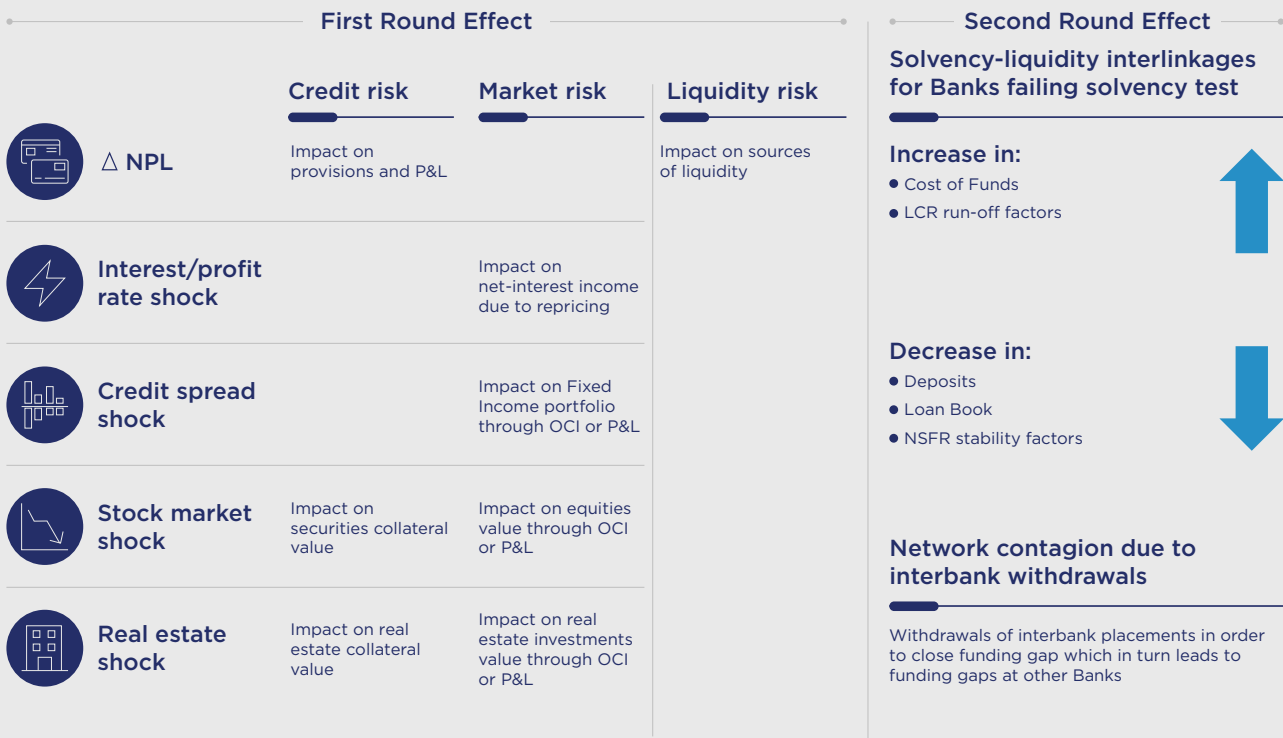


The initial shock is modeled with a direct first-round impact on banks through several channels: credit risk, market risk (investments and interest rates), and liquidity risk.

The credit risk impact mechanism follows a credit loss approach based on non-performing loans (NPL) and collateral data. Incremental NPL assumptions are applied on a sub sector level for each scenario and are modelled over three years. Collateral haircuts are applied based on both collateral type and geographical location. Conversion assumptions on unutilized and non-cash facilities are incorporated to simulate conditions under a stress scenario. Blending these factors yields expected credit losses, which are compared with total provisions and a target coverage ratio. The shortfall in provisions from the minimum coverage ratio would be required from banks, consequently leading to a hit in their profit and loss statement (P&L).

The expected impact on the investment book is modelled based on asset classes. For bond portfolios, both credit spread shocks and downgrade assumptions are applied, where bond duration was used for the former to compute potential losses. Downgrade assumptions are used to quantify impact on liquidity and capital ratios resulting from a change in risk-weights. Equity beta is used to model the impact of the shock on P&L or other comprehensive income (OCI) based on accounting classification and, consequently, capital. Real estate shocks are also incorporated for Islamic banks holding direct real estate investments, hitting P&L or OCI.

During crises, interest rates tend to fluctuate whether due to shifting liquidity conditions or supervisory interventions. Thus, interest rate risk is simulated dynamically where interest rate shifts are applied to assets and liabilities repricing only in the period relevant to the scenario shock. Interest income and expenses are also incorporated based on new interest rates and new borrowing/lending assumptions during the crisis period. Consequently, liquidity is affected through volatility and instability of deposits.



Given the intertwined nature of financial systems today and the prevalent systemic risks, second round effects are also incorporated into the model. These come in the form of solvency-liquidity interlinkages for banks failing the solvency test and network contagion due to interbank withdrawals. Failing the solvency test is defined as falling short of minimum capital requirements, triggering the application of more severe assumptions that entail higher cost of funds, higher deposit run-offs, higher assumed runoffs in calculating liquidity ratios, and a decrease in short-term lending. Consistent with the conditions in a crisis, network effects are modelled through the interbank market, reflecting increases in banks' funding needs with simultaneous decreases in sources of funding. This squeeze in liquidity would hit the interbank market and increase funding costs, all of which would translate into losses on banks' P&L.

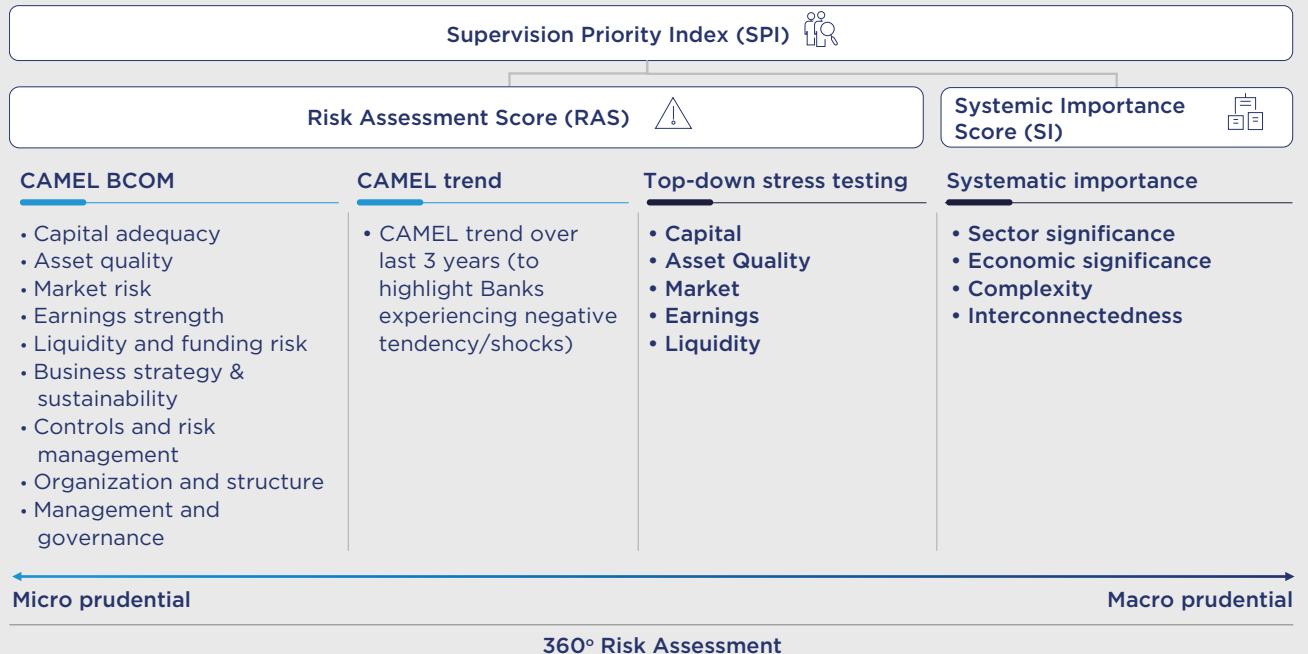
After generating individual bank results from the three scenarios, a regulatory dialogue is initiated with the banks to highlight vulnerabilities and required enhancements. In case of consistently negative results, a comprehensive toolkit of prudential interventions has been identified and may be deployed. Based on the severity of results, interventions may range from limits on risky exposures, to general de-risking and the introduction or increase of capital and liquidity buffers (among other interventions).

### Supervisory Policy Capabilities

CBK's supervisory policy has been refined to incorporate global best-practices and leverage successful supervisory models and experiences, while being tailored to the nature of the local financial system. The entire operating model was revamped to promote an agile supervisory framework and a more forward-looking approach to facilitate early intervention. Data gathering

and analysis processes have been significantly upgraded, allowing for advanced data analytics.

The existing CAMEL BCOM model used in supervision was improved, with 45+ CAMEL metrics and 25+ new BCOM dimensions. The BCOM questionnaire was upgraded with 130+ questions to enable higher quality risk assessment, while the CAMEL approach was enhanced with a trend assessment for better understanding of individual banks. The revamped model has also been integrated with the new top-down stress testing results, further increasing its forward-looking capacity. The output of these models flows directly into a newly developed comprehensive 360° dashboard, allowing for quick and clear detection of vulnerabilities on a bank-by-bank basis.



All existing supervision tools have been integrated into a Supervisory Priority Index (SPI) tool, which combines the CAMEL BCOM derived risk assessment score, CAMEL trends, stress-testing results, and systemic importance for each bank. Given these scores, the SPI will enable better implementation of a risk-based supervision strategy. Scores include low, medium, or high supervisory priority, as well as the components contributing to the final SPI score. Prioritization of supervision enables a more efficient allocation of effort, where banks that pose elevated risks to individual stakeholders or the system are put under more scrutiny and inspection.

### Synergies to Promote Financial Stability

Although there are certain policies that directly affect financial stability, it is far from a standalone issue that can be resolved using a single framework. Thus, the continuous improvement of models and tools that examine different elements of the economy remain instrumental in fulfilling a financial stability mandate. Macro-analysis capabilities such as rigorous economic research and robust forecasts serve as a foundation for all analysis and stress-tests by allowing for a forward-looking evaluation of future conditions. Reliable monetary policy tools help optimize decision-making, relieving monetary pressures and instilling trust in financial intermediaries. Agile supervision tools help tackle and identify micro risks before they exacerbate into systemic threats. Enhancing these different tools creates synergies that, with proper alignment with other economic policies, will help promote financial stability and bring us closer to our continuous pursuit of inclusive and sustainable prosperity.



**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

Total bank credit exposures, which consist of loans, fixed income investments, and interbank placements, grew by 8.5% in 2021. Apart from Kuwait, which took the lions-share, credit growth was most prominent in the USA, Egypt, and the Kingdom of Saudi Arabia. The increase in exposures to the USA was almost all in the form of interbank placements, the majority of which were in high quality counterparties. Those placements were a result of the influx of dollar funding, mainly stemming from the banks' issuance of additional tier 1 (AT1) and tier 2 (T2) securities.

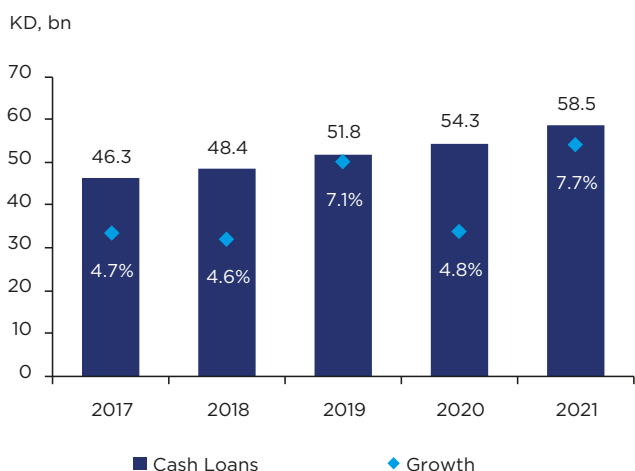
Loans were the primary contributor in the growth of credit exposures, increasing KD 4.2bn (7.7%) year-over-year (YOY) (figure 3.1). Despite being relatively high, growth remained within historical bounds (10-year average annual growth at 6.3%). The growth in credit financing was dominated by the largest sector, Households (figure 3.2), where outstanding loans grew KD 1.7bn (12.3%). This represents a growth rate not seen since 2013. The effects of the pandemic were rather peculiar on Household sector loans, where it induced large growth relative to pre-pandemic levels (1.8% growth in 2019). This phenomenon can be explained by multiple factors, the most important of which are: forbearance policies and historically low rates. Two 6-month Household loan forbearance policies were implemented in Kuwait over the course of the pandemic (one in

### Households dominated credit growth, where outstanding loans grew by 12.3%, a growth rate not seen since 2013.

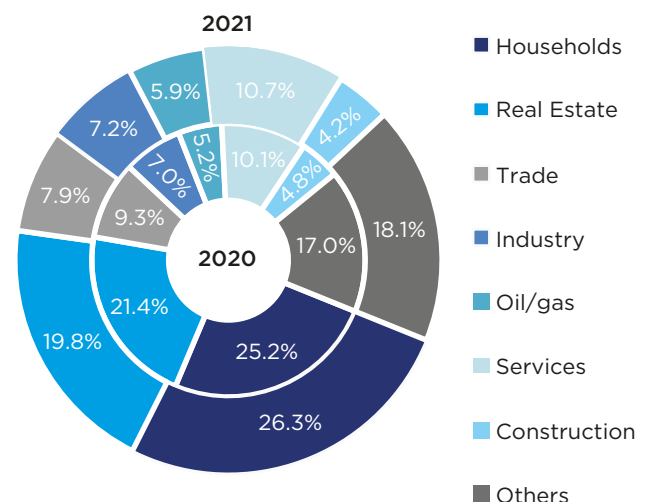
2020 and one in 2021), with approximately 69% of Household loans opting to defer loan servicing in 2021. The lack of settlements during those two periods magnified the growth in the overall loan portfolio. Historically low borrowing rates, where some banks even offered zero-interest loans as a means to increase competitiveness, further fueled the growth in this sector. These dynamics however, do not represent elevated risk levels, as the Household sector has been historically robust given large employment of these borrowers in the governmental sector.

In general, newly added NPLs remained tame relative to historical levels, at KD 885mn or 1.7% of the performing loan portfolio (figure 3.3). Households contributed the most to these delinquencies, at KD 182mn. Despite being large on an absolute basis, this value is relatively immaterial, at 1.3% of the Household sector's performing loans. As expected, unemployed borrowers were seen to default more, with new NPLs making up 11.5% of their performing loans. On the corporate side, equity purchase loans (EPL) and real estate loans saw a surge in delinquency. New real estate NPLs were concentrated in the first two quarters as effects

### 3.1 Loan Portfolio



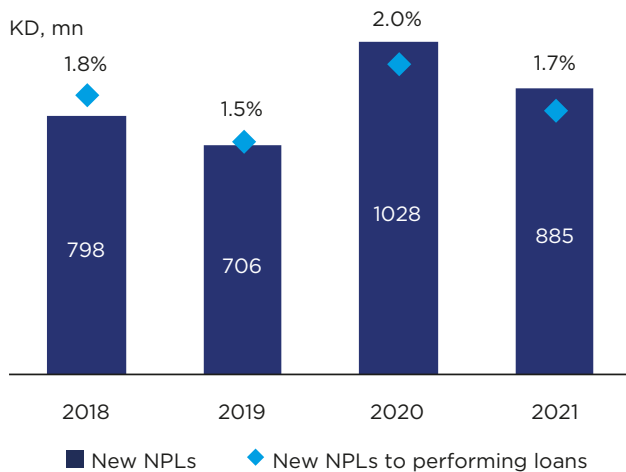
### 3.2 Loan Portfolio Sectoral Distribution



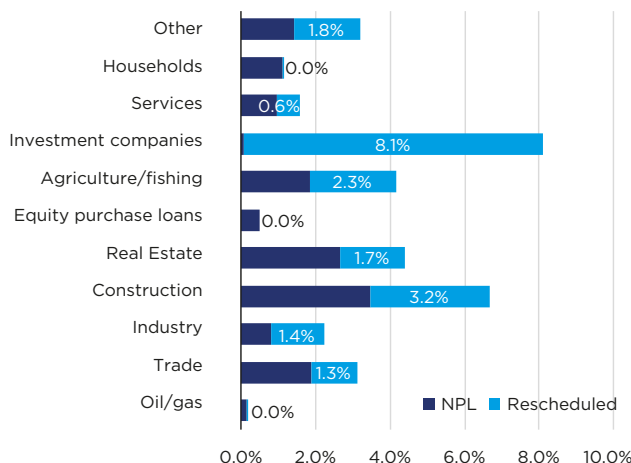
from loan forbearance policies in 2020 (ended September 2020) subsided, while new EPL NPLs stemmed from clients related to a single large borrower. With these increases, new NPLs to performing loans for these sectors stood at 2% and 5.7%, respectively.

In a more forward-looking indicator, rescheduled loans can be used as a potential signal of borrower distress before being classified as non-performing. Investment companies have the most notable relative amount of rescheduled loans (figure 3.4), which are primarily legacy assets going back to the Global Financial Crisis. These assets are not a cause for concern as banks have been gradually disposing of them, with the rescheduled loan ratio reaching 8.1% in 2021 down from 25.8% in 2016. The construction sector has seen inherent weakness, which was exacerbated by the Covid-19 crisis, with the

### 3.3 Newly Added NPLs



### 3.4 NPL + Rescheduled



### Newly added NPLs remained tame relative to historical levels, at 1.7% of the performing loan portfolio.

rescheduled loans ratio increasing to 3.2% from 2.8% in 2020. Industry surveys indicate negative sentiment for this sector, which may potentially appear in the form of credit deterioration.

In line with the increases in NPLs, the KD 647mn in write-offs largely stemmed from the real estate and EPL sectors. CBKs prudent provisioning framework, which encourages building buffers in economic booms, enabled these write-offs with minimal impact on banks' positions. As a result, the non-performing loans ratio (NPLR) fell to an all-time low of 1.4% by the end of the year (figure 3.5), and is one of the lowest in the region. Provisioning remains abundant, with NPL coverage one of the highest in the region at 310% (figure 3.6). These provisions have the capacity to absorb a 3.8 percentage point increase in the NPLR (with the conservative assumption of 100% coverage), i.e. the NPLR can rise to 5.2% before requiring any additional provisions. Netting collaterals brings the coverage ratio up to 673%, with almost all collaterals on NPLs (95%) being real estate assets. Although these assets are illiquid and subject to model-derived valuations, they benefit from lower price volatility.

To get an indication on the degree of sectoral concentration and borrowers' interconnectedness, top 50 borrowers and their

### 3.5 Non-Performing Loans

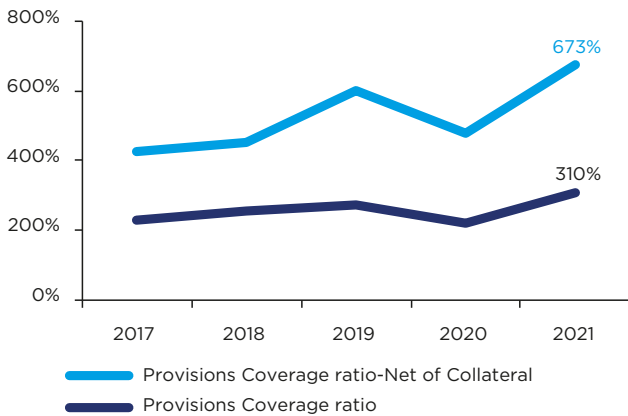


related parties<sup>1</sup> at each bank were aggregated by sector and assessed. These came out to more than 700 borrowers with total facilities (cash and non-cash) equal to approximately KD 25.9bn, or 36.7% of the industry's total facilities. Given the nature of the Oil/gas and EPL sectors, they exhibited the highest borrower concentration. The IFRS 9 staging of the Top 50 borrowers demonstrates that they are mostly high quality/performing clients (figure 3.7). To get a sense of the risks inherent, a hypothetical shock was applied. The shock was based on the borrowers' internal credit ratings and would go up to a 100% decline in the loan value for the

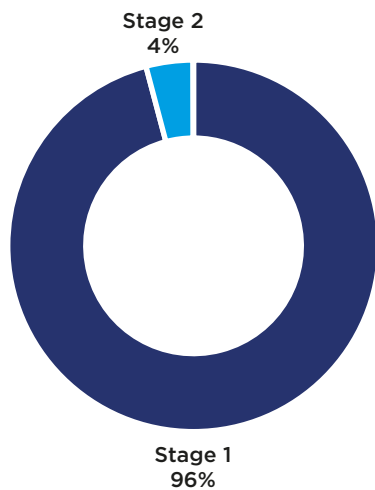
captured through the shock on related parties, which is applied based on the nature of their relationship to the main client. Results showed that banks remain comfortably above minimum CBK capital requirements after applying the hypothetical shock.

Apart from loans, fixed income and interbank exposures make up a noticeable portion of banks' total credit exposures at KD 20.6bn (26.1% of total). As at the end of 2021, most of these exposures were to issuers rated as investment grade (figure 3.8). The 10.2% increase from the year prior was also dominated by high quality issuers.

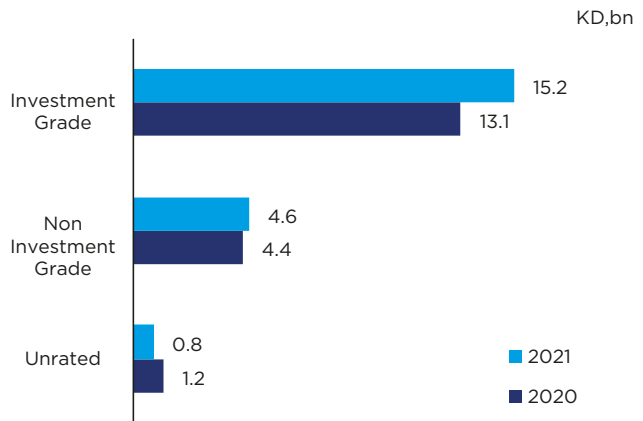
**3.6 Provision Coverage Ratio**



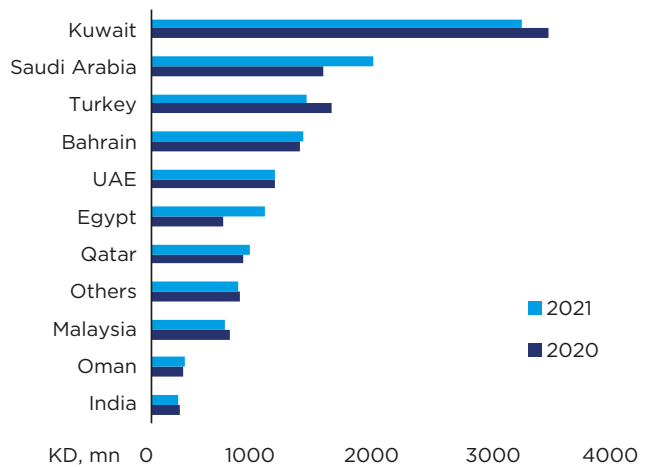
**3.7 IFRS 9 Staging of Top 50 Borrowers**



**3.8 Credit Rating (FI investments and Interbank placements)**



**3.9 FI Investments Geographical Distribution**



lowest rated borrowers. Interconnectedness is

<sup>1</sup> Includes guarantors, shareholders, subsidiaries, and others.

Fixed income investments, which made up 15.1% of credit exposures, grew a mere 3.1% (KD 377mn) over the course of the year, with noticeable increases in issuances from GCC and North African issuers (figure 3.9). These investments were largely dollar-denominated and went to sovereign, financial institution, and oil sector issuers. Turkish investments experienced a notable decline of KD 200mn during the year, stemming from a single bank. This was largely due to the approximate 45% decline in TRY’s value, where 37% of said investments are TRY-denominated. Despite these losses being due to currency movements as opposed to credit deterioration, sustained imbalances and elevated inflation in Turkey may potentially lead to borrower distress as economic conditions deteriorate.

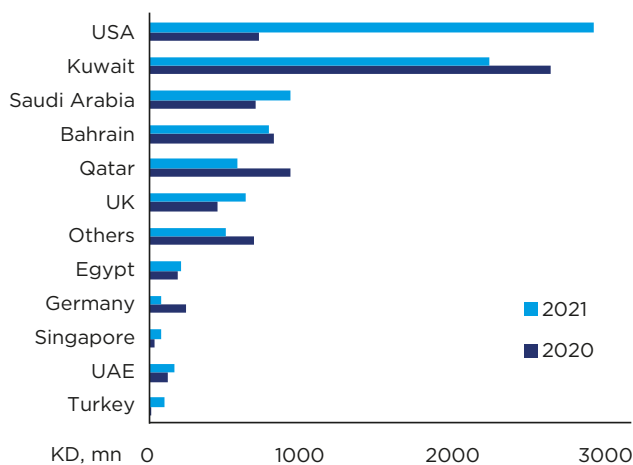
Interbank exposures made up 11.0% of all credit exposures by year end. These exposures increased by 23% during the year due to normalization dynamics, after interbank placements plummeted by 24.4% in 2020. The largest increase was to USA based counterparties which rose almost KD 2.1bn (figure 3.10). This change came in light of local banks experiencing an influx of dollar funding resulting from elevated AT1, T2, and other issuances, where a single bank issued KD 1.81bn between November 2020 and September 2021. This suggests that the surge in dollar interbank assets may steadily decline as banks deploy these funds to more productive uses. Counterparties to

**Existing provisions have the capacity to absorb a 3.8 percentage point increase in the NPLR.**

Kuwaiti bank placements remained of high quality, with 84% rated as investment grade.

Looking ahead, loan growth in import-dependent sectors like Trade and Construction may rebound as supply-chain disruptions get ironed out. These frictions, however, have persisted into the first half of 2022, casting uncertainty on the trajectory of the recovery. Robust oil prices provide some support for Oil/gas company borrowing, with overheating demand justifying potential capacity increases. If sustained, higher oil prices may also provide support for the Construction sector which is highly dependent on government spending. While Household borrowing was bolstered by extended loan forbearance, the historically high growth rates are expected to normalize as debt servicing resumed. With inflation picking up, potential monetary tightening measures and prospects of higher interest rates raise credit risk implications. This is especially true given the toll that the pandemic has taken on corporate balance sheets and consumer behavior. That said, the domestic banking sector remains well-provisioned, with buffers ready to absorb unexpected economic deterioration.

**3.10 Interbank Placements Geographical Distribution**



# Liquidity Risk

Liquidity is dynamic and influenced by various factors, which can give rise to risks affecting the ability of fulfilling short-term financial obligations. Managing liquidity risk is essential for banks as their core function involves maturity transformation, with short-term deposits used to fund longer-duration assets such as loans and investments. Thus, prudently managing and monitoring liquidity risk is necessary to avoid exacerbating any adverse shocks, as was the case during the Covid-19 crisis whereby the banking sector demonstrated its sound liquidity management supported by CBK’s vigilant and forward-looking oversight.

As various macroeconomic factors can potentially impact liquidity in the market, health and economic effects of the Covid-19 pandemic are still somewhat present. CBK’s proactive and prudent policy, along with the accommodative regulatory stance since the outbreak of the pandemic in 2020, enabled banks to withstand the crisis. The banking sector witnessed an accumulation of funds in the form of deposits in 2020, due to the disruption to business activities and restrictions on travel, along with the effect of loan moratoriums. Also, the uncertainty around the course of the pandemic prompted banks to place such funds in high-quality liquid assets, boosting liquidity ratios.

A year later, in 2021, and as life started returning to normal due to mass vaccinations, lifting of restrictions and eventually the reopening of businesses, the uncertainty relatively subsided. Despite these developments, deposits in the banking sector continued to grow, albeit at a slower pace than the year prior. This in turn led to slightly lower liquidity ratios by the end of the year, and despite that, the ratios remain well

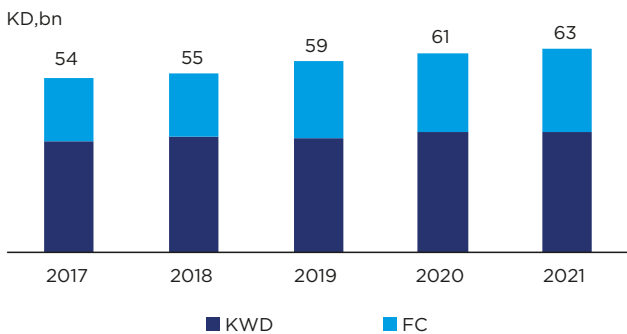
## Banking sector deposits reached an all-time high of KD 63bn, mostly made up of stable time deposits.

above the minimum regulatory thresholds.

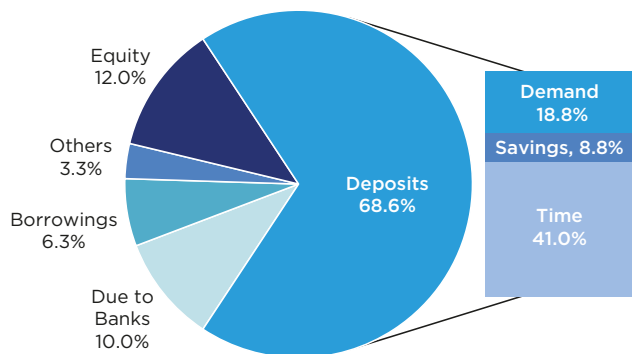
As noted, the banking sector deposits maintained their upward trajectory in 2021, reaching an all-time high of KD 63bn and registering a growth of 2.5%, compared to 4.1% in 2020 (figure 3.13). This was mainly driven by the rise in retail and corporate deposits, as government and other financial institution deposits declined. This was reflected in aggregate deposit composition, as the share of retail and corporate deposits combined constitutes 78% of total deposits by year end, slightly higher compared to a share of 76% in 2020. The increase in total deposits was seen on a consolidated basis, while throughout the same period the deposits on a standalone basis remained relatively stable. Additionally, non-resident deposits grew by 14.2% in 2021, accounting for 29% of total deposits. While this adds diversity to the deposit base, vigilant monitoring is required given non-resident deposits are relatively less stable. It is necessary that banks dedicate further efforts towards attracting and retaining more stable local depositors.

In viewing the structure of total liabilities and equity (figure 3.14), the share of total deposits – despite the previously mentioned annual increase – declined by 2.8 pts accounting for 68.6% in 2021 compared to 71.4% in 2020. This shift in the structure was tied to the growth of balances due to banks and borrowings, as well as the rise in shareholders’ equity to reach a historical level of KD 10.8bn mainly due to capital issuances. The share of time-deposits

### 3.13 Banking Sector Deposits



### 3.14 Breakdown of Banks’ Liabilities & Equity



(considered a stable source of funding) to total liabilities and equity declined on an annual basis as it accounted for 43.8% of the total in 2020. Regardless, they still represent the largest share of the deposit base.

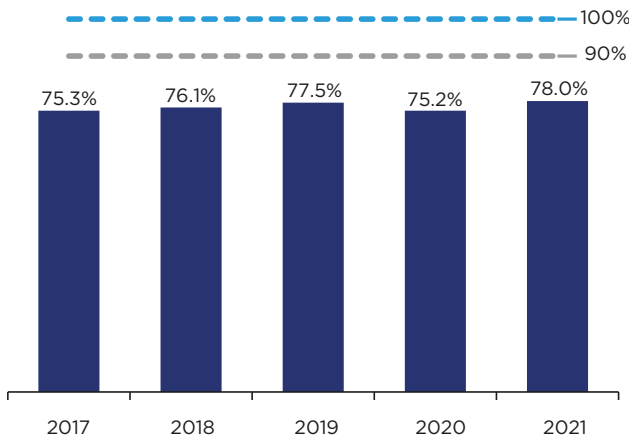
As CBK’s policy stance is counter-cyclical, 2020 witnessed the introduction of macroprudential measures aimed to counteract the emerging pressures on the financial sector due to the pandemic. Throughout 2021, banks continued to expand their lending portfolios, which showed the decline of the negative concerns linked to the pandemic. In parallel with the increase in retail and corporate deposits as mentioned prior, the additional funds were deployed in the form of loans. As such, the ratio of loans to total available sources of funds (Maximum Lending Limit “MLL”) increased on a YOY basis to reach the pre-pandemic level of 78% (figure 3.15). Moreover, banks still have room to expand lending by about KD 12bn to the real economy (considering the 100% maximum lending limit). This provides reassurance that banks have adopted a prudent approach to lending. By

taking a closer look at the factors affecting the ratio of loans to available sources of funds, the 7% increase in lending drove the ratio higher. Additionally, data revealed that the lion’s share of credit facilities was directed to the Households and Oil & Gas sectors, whose risks are relatively clear and on the lower-end. For more details on the banking sector’s credit portfolio, refer to the “Credit Risk” section of this report.

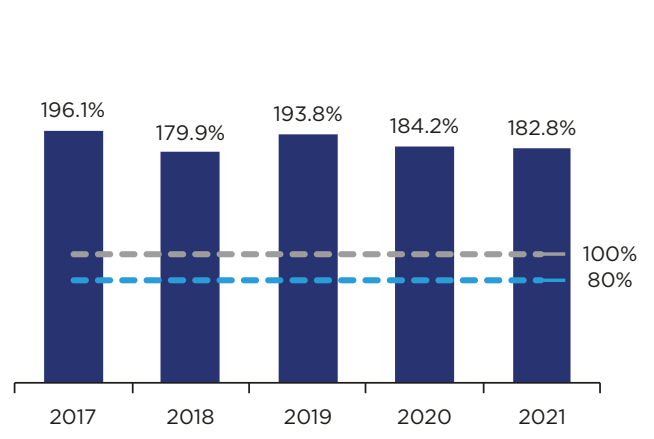
With regards to the other liquidity ratios, the net stable funding ratio (NSFR) – which includes banks liquidity requirements for one year and above – saw a 4.5 ppts decline (figure 3.16) driven by higher required stable funding which is linked to the increase in loans. Despite this marginal decline, the ratio remains comfortably above CBK’s required minimum.

The liquidity coverage ratio (LCR) remained in-line with the level seen last year (figure 3.17). While the value of high-quality liquid assets (HQLA) increased on a YOY basis, the ratio saw a negligible decline due to higher expected 30-day net outflows, which grew 8.4% following a rise in retail deposits (result in higher expected

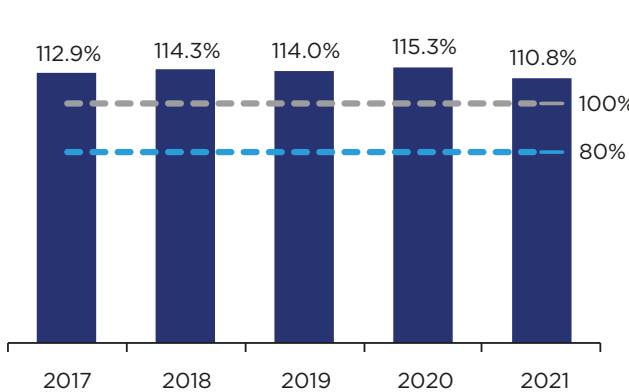
**3.15**  
**MLL**



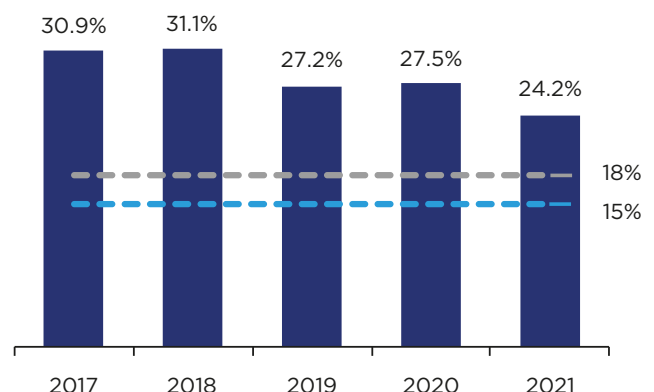
**3.17**  
**LCR**



**3.16**  
**NSFR**



**3.18**  
**RLR**



cash outflows). It is worth noting that the rise in HQLA during 2021 was lower than that witnessed in 2020 (7.5% against 13%) due to the decline in balances with CBK.

Although the regulatory liquidity ratio (RLR) contracted by 3.3 ppts on a YOY basis to reach 24.2%, banking sector liquidity remains above the minimum levels (figure 3.18). This decline was due to the abovementioned contraction in balances with CBK, specifically in the current account. Total liquid assets – which includes the current account – contracted by 12.7%, while KD local deposits were relatively stable.

As stated earlier, the reduction in banks’ available liquidity due to the expansion in credit facilities is depicted in figure 3.19. Short-term bank liquid assets (less than 3 months) fell by 1.1% on a YOY basis to stand at KD 25bn by the end of 2021. This represents a continuation of the trend seen since 2019, with the ratio of liquid assets to total assets falling 2 ppts on a YOY basis. These short-term liquid assets are divided into core liquid assets (including cash and cash equivalents, CBK bills and due from banks) and other assets. By the end of 2021, core liquid assets represented 75.6% of total liquid assets, versus 72% the year prior, a positive indicator of short-term liquidity for the banking sector.

In part of CBK’s role, money supply in the local banking system is managed in accordance to Kuwait’s monetary policy. Despite banks’ balances with CBK (current accounts and term deposits) dropping by KD 745mn (10.2%) in 2021, CBK’s intervention slightly increased (figure 3.20). It is worth noting that the growth in liquidity absorption was minimal, at 3% (23% in 2020) reaching KD 25.3bn. This slowdown is attributed to the 25% decline in current account balances held with CBK during the year due

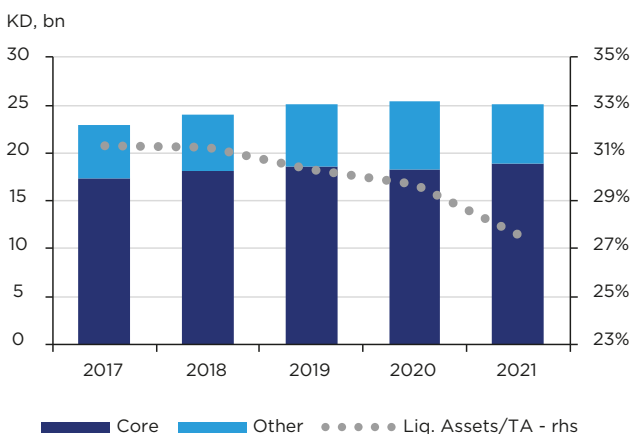
to the gradual recovery of local and global economic conditions. The recovery improved banks’ appetite to extend credit and reduced the need for CBK interventions.

By closely examining the type of interventions, the increase was mainly driven by higher Tawarruq instruments for Islamic banks. These instruments grew 20.6% (KD 2.2bn) versus a 10% (KD 1.4bn) decline in the comparable instruments for conventional banks. Consequently, Islamic banks’ share of the total interventions was 51% compared to 49% for their conventional counterparts. The demand of those Tawarruq instruments increased over the past years, in-line with the growth of Islamic banks’ share of the local banking sector. The importance of having such instruments is further emphasized in light of the scarce Shariah-compliant liquid alternatives available compared to those for conventional banks.

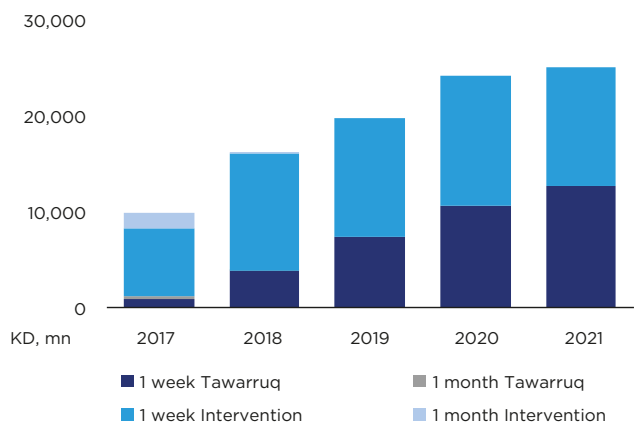
As a result of the relative stability of liquidity in the banking sector during the year, the overall issuances of longer-term intervention instruments slightly decreased to KD 8.4bn versus KD 8.6bn in 2020 (figure 3.21). This was mainly driven by a decline in the 3-months bonds by 12.8%, while the 6-months bonds increased by 15.8%. Again, this stability in liquidity conditions and CBK interventions was largely driven by the economic recovery in 2021.

Additionally, the abundance of liquidity available in the banking sector was supported by CBK’s prudent policy in years leading up to the crisis. Ample liquidity enables the sector to withstand challenging liquidity conditions, as seen during 2020. Once the uncertainty subsided, banks stood resilient and registered improved operating results in 2021. Hence, CBK announced the gradual un-winding of supporting

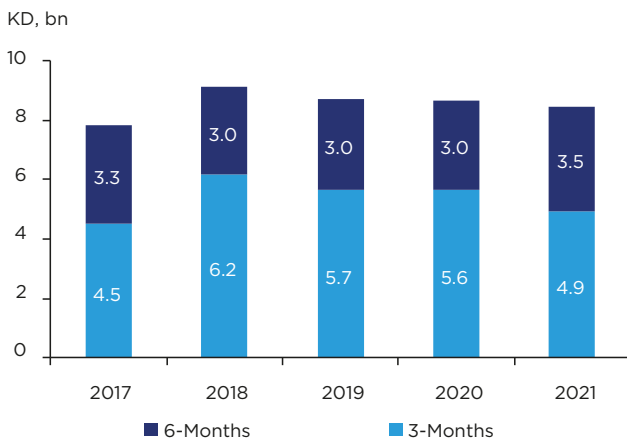
**3.19 Banks’ Liquid Assets (of less than 3 months)**



**3.20 CBK Interventions**



### 3.21 CBK Bond Issuance



measures starting early 2022 to eventually fully return to pre-crisis levels by 2023. Banks were early notified of the gradual return to pre-pandemic regulatory requirements to ease the transition and compliance with regulatory limits without compromising their role as financial intermediaries in the economy.

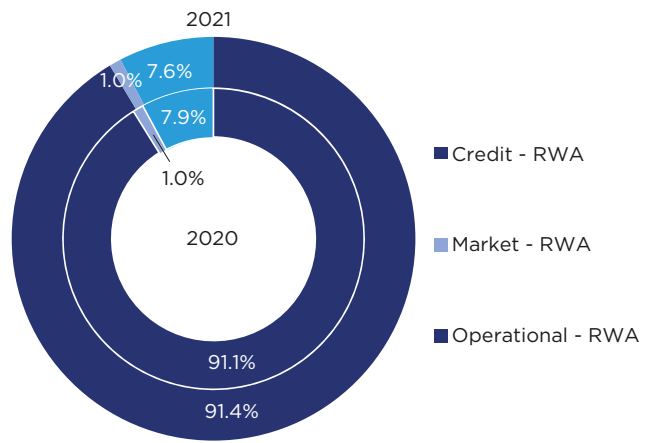
**Banks have ample space to lend while comfortably meeting all liquidity requirements.**

## Market Risk

For banks, market risk stems from exposure of financial instruments and assets to adverse market price and/or rate movements, ultimately leading to potential losses. In terms of risk weighted assets (RWA), the Market category is the smallest component, standing at 1% (KD 0.6bn) in 2021 (figure 3.22). The relatively small contribution of market risk is largely due to the small trading portfolios of banks and CBK's prudent guidelines. Nevertheless, investigating these exposures sheds light on specific bank operations and gives a more holistic view of the inherent risks.

Banks investment books grew at a rate of 3% in 2021, a slower pace than the previous two years (2.4 pts below the five-year average). Both Fixed Income and Equity investments grew in 2021, increasing 3.0% and 6.0%, respectively, compared to 6.9% and -5.7% in 2020. Naturally, fixed income remains the largest investment exposure for Kuwaiti banks, representing 81% of total

### 3.22 Risk Weighted Assets

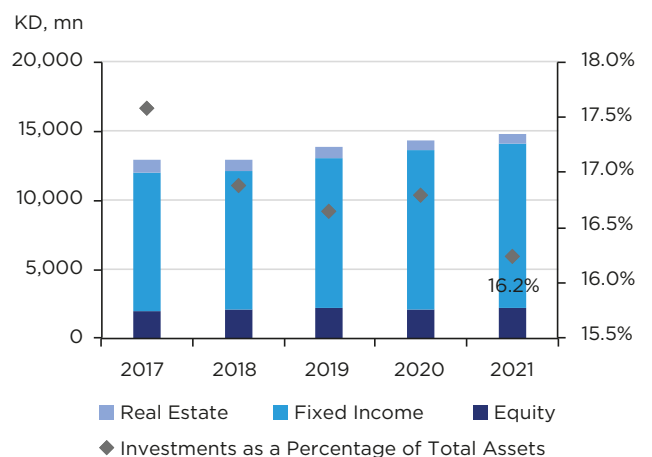


investments (figure 3.23). Overall, investments are representing a lower amount of total assets over time – falling by 1.3 pts over the past 5 years to reach 16.2% in 2021 – a positive indicator showing lower reliance on investment returns and thus lower market sensitivity. Kuwaiti banks remain reserved in their investment strategies, evident by the sector's proportionately dominant fixed income investments.

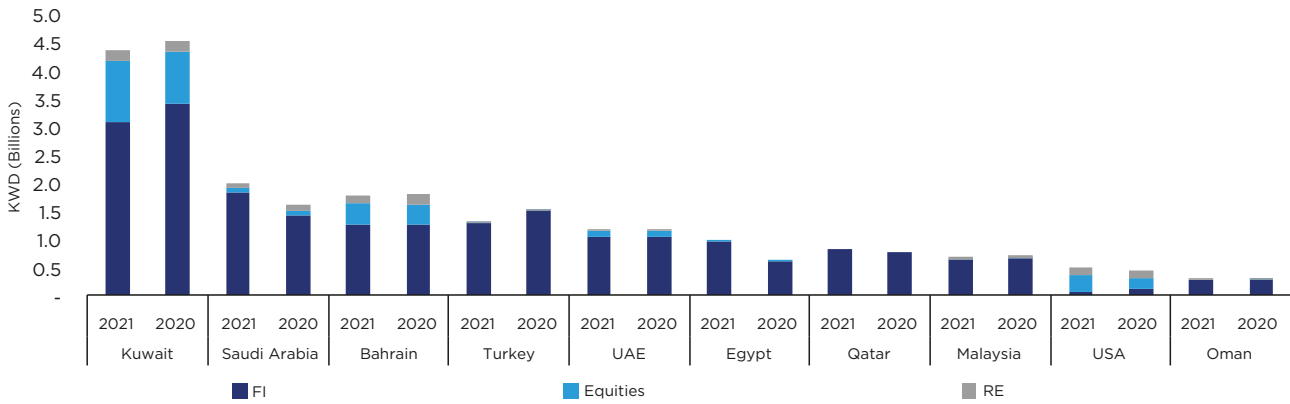
Unlike the previous two years, investment growth was not concentrated within European investments. Moreover, the total YOY increase was mainly driven by heavy investment in the GCC and North Africa (figure 3.24). Interestingly, this year posted the largest annual decrease in

**The year 2021 saw increasing investments in the GCC and North Africa, with fixed income continuing to dominate banks' investment books.**

### 3.23 Banks' Investments by Category



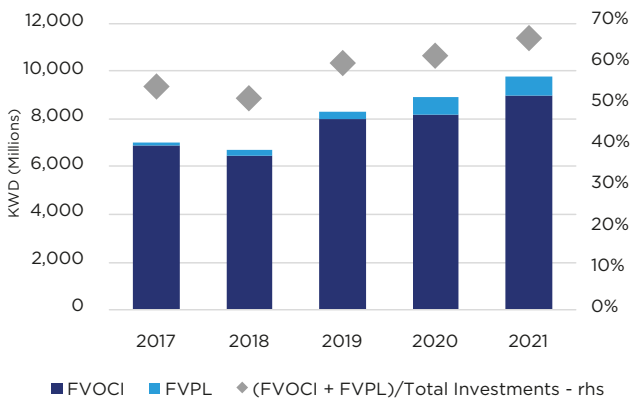
3.24  
Kuwaiti Banks Investments (Top 15 Countries)



European investments on record<sup>2</sup>, mainly driven by Turkish bonds which experienced some decline in value as a result of the inflationary environment, and subsequent devaluation of the TRY. In addition, there was a large decline in Kuwaiti investments, decreasing for the fourth consecutive year (the first time on record), albeit at a slower rate than the previous two years. Lower exposures stemmed mainly from corporate bonds and government bonds, due to divestment of the former and maturity of the latter. It is worth noting that the public debt law was not passed, meaning Kuwaiti banks are unable to rollover matured sovereign debt instruments and generally have fewer options to invest in high quality domestic fixed income.

Overall, investment market sensitivity continued to rise, with investments classified at fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVPL) constituting 66.2% of total investments versus 62.1% in 2020 (figure 3.25). FVOCI investments witnessed a 10% growth in 2021 compared to 2% in 2020, mainly driven by increased fixed income exposures to the GCC and North Africa. Despite the benefits of lower income volatility (as these investments are directly booked under capital), they render banks' capital more vulnerable. Nevertheless, large OCI investments for banks are reasonable given banks' business models and their need for dynamic liquidity management with minimal impact on operating results. Investments classified at FVPL accounted for 5.4% of total investments, up from 5.2% last year. The continuation of this trend indicates a growing vulnerability to potential market volatility. High risk-management abilities are crucial in properly mitigating any disruptive volatility stemming from these exposures.

3.25  
FVOCI and FVPL Investment Portfolio

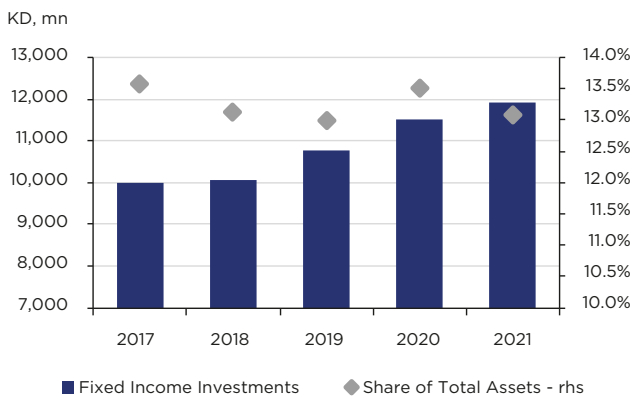


Accounting for the bulk of investments, fixed income investments made up 13.1% of total assets (figure 3.26). These investments grew by 3.3% YOY compared to 6.9% and 7.1% in 2020 and 2019, respectively. This slowdown in growth was partly due to the low interest rate environment which rendered low-risk bond investments less attractive. Banks generally invest in fixed income as an opportunity to secure low risk steady income in liquidity and liability management strategies (e.g. duration matching and cash flow matching). Hence, the prevalent financial conditions may have increased banks' risk appetites.

Fixed income investments give rise to interest rate risk which can be proxied by duration. The bulk of

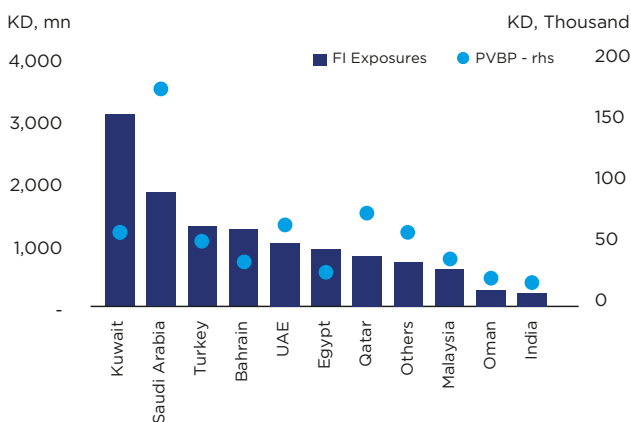
2 Since 2007

### 3.26 Fixed Income Investments



Kuwaiti bank investments were dollar-denominated (KD 6.4bn) leading to large USD duration exposure with a price value of a basis point of KD 1.95mn (change in value for a 1 basis point change in US interest rates). Duration exposure to currencies including the Malaysian Ringgit, Euro, Egyptian Pound, Turkish Lira, and Kuwaiti Dinar is also relatively high (figure 3.27)<sup>3</sup>. As at the end of 2021, the Federal Reserve, the Central Bank of Kuwait, the European Central Bank, the Central Bank of Egypt, and the Central Bank of Malaysia are all prepared to raise interest rates in the near-term. As a result, there may be relatively higher risk to the fixed income exposures denominated in these jurisdictions. Turkey, on the other hand, is keen on keeping rates low, which although decreases interest rate risk, may lead to credit deterioration as higher inflation is tolerated.

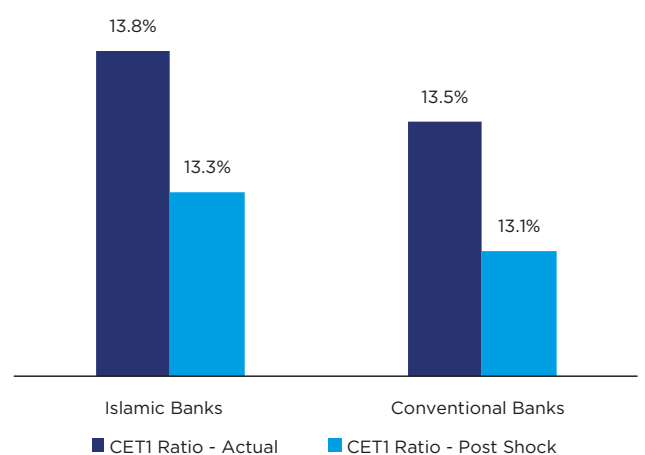
### 3.27 FI Country Exposures



Despite conventional banks decreasing fixed income exposure in 2021, weighted average duration increased, highlighting higher sensitivity to interest rate swings. Islamic banks, on the other hand, experienced a decline interest rate sensitivity. Risks prevalent in conventional banks' higher interest rate sensitivity are highlighted by a hypothetical 150 basis point upwards parallel shift in rates, which resulted in a 0.5 ppt and 0.4 ppt impact on Common Equity Tier 1 (CET1) for Islamic banks and conventional banks, respectively<sup>4</sup> (figure 3.28). The effects are overall moderate on CET1 levels, which remain comfortably above minimum requirements.

Equities are an attractive investment for banks given their diversification, return enhancement, and liquidity (public equity) characteristics. Kuwaiti banks equity investments are both direct and through asset managers and investment funds. Although there are advantages to investing in equities, high exposure to listed equities can result in volatile net income and higher sensitivity to market movements, especially if they are held for trading purposes. Even though equity investments have inched up 6% in 2021 (figure 3.29.A) driven by a rally in Kuwaiti and US stock markets, banks' exposure remains minimal at 2.4% of total assets. This insignificance is further demonstrated by a hypothetical equity shock<sup>5</sup> where effects on both conventional and Islamic banks are mild (figure 3.29.B).

### 3.28 Sensitivity Analysis to Fixed Income Exposures

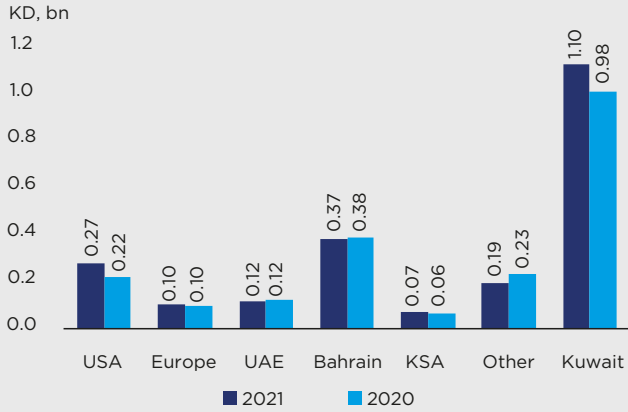


<sup>3</sup> Includes Amortized Cost investments which may not immediately reflect market losses.

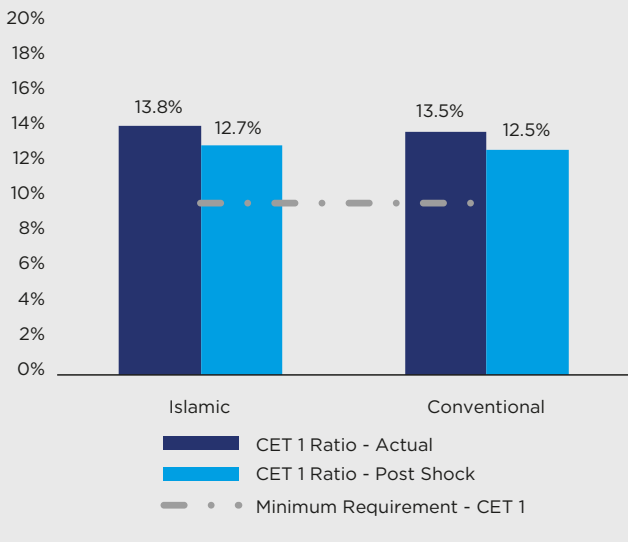
<sup>4</sup> The calculation assumes no hedging, and excludes bonds classified as held to maturity.

<sup>5</sup> The impact on banks CET1 Ratios if their respective total equity investments were shocked under a CVaR of 99.9%.

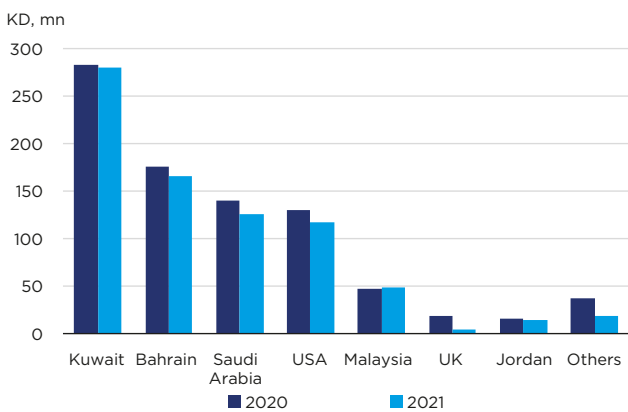
**3.29 A**  
Equity Investments by Country



**3.29 B**  
Sensitivity Analysis to Equity Exposures



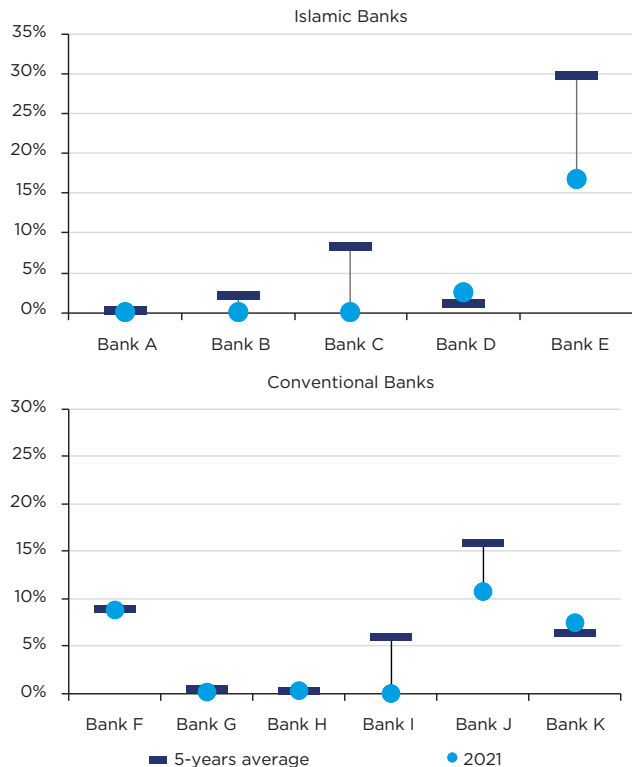
**3.30**  
Islamic Banks' Real Estate Investments by Country



**Equity market volatility had a minimal impact on the banking sector given negligible exposures, at 2.4% of total assets.**

The stable and inflation-hedging characteristics of real estate makes it an attractive diversifying investment for banks<sup>6</sup>. As of the end of 2021, total real estate investments made up 0.7% of total bank assets. From these investments, 70.5% were located in Kuwait, Bahrain, and Saudi Arabia (figure 3.30). Exposure to real estate investments continued to decline, falling 10% in 2021. This fall stemmed from US, UK, and Saudi Arabian investments, mainly driven by active divestment and partly by valuation losses. Banks' real estate investments have been on a steady decline over the past five years, falling 31% over that period. This downward trend is largely attributable to banks shifting away from real estate investments to focus more on financing activities. The anticipation of higher rates may have accelerated this trend, as it implies a potential correction in real estate

**3.31**  
FX open positions as a % of Regulatory Capital



<sup>6</sup> Only Islamic banks are permitted to directly invest in real estate assets.

**Banks proved resilient to hypothetical shocks in key traded assets.**

prices, where cash freed up to take advantage of potentially higher lending rates may seem like an attractive strategy. Given the small proportion real estate investments make up of total bank assets, price corrections are expected to have a minimal direct effect on banks.

Foreign exchange risk is the risk that banks may incur losses on FX exposures due to currency movements. This risk exists for all banks that have exposure to currencies other than their home currency, which gives rise to net open positions. For example, the TRY performed poorly in 2021, and thus banks who had exposure to the Lira were faced with the challenge of heightened FX risk. As a whole, however, the open positions of local banks in 2021 stayed within prudent limits, making up a minor portion of banks’ regulatory capital (figure 3.31) and thus not posing any material risk. Almost all banks are below their 5-year average relative FX open positions. This is largely because of the steady increase in total regulatory capital against the comparatively flat FX exposures for the same period – likely due to conservative pandemic-related developments and hedging.

As discussed above, Kuwaiti banks’ exposure to market risk in its different forms remains limited. Nonetheless, vigilance is crucial in the upcoming period as central banks around the world rush to tighten monetary conditions and rein in inflation. The effects are expected to be uneven across jurisdictions and markets, and may induce periods of elevated volatility. That said, given the relatively small market exposures and large buffers, Kuwaiti banks are expected to comfortably weather these upcoming shifts with minimal consequences on financial stability.

**Operational Risk**

While devastating on many fronts, the Covid-19 pandemic revealed many opportunities on others, specifically, improving the business

**Total operating losses in 2021 did not exceed 0.8% of the three-years average gross income of Kuwaiti banks.**

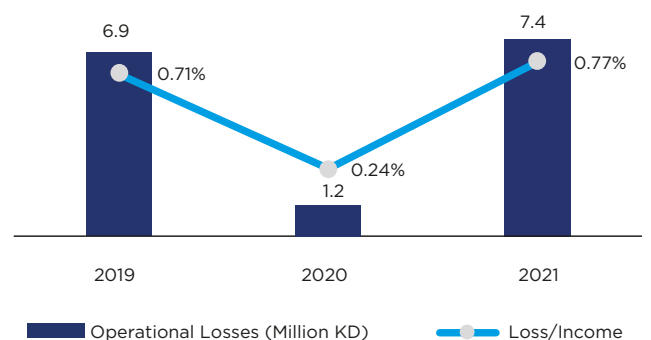
environment, revealing strengths and weaknesses in different sectors, re-evaluating risks, and reclassifying their weights according to severity. The pandemic also served as a true stress test that highlighted the importance of boosting resilience and operational efficiency, as well as directing more efforts towards risk management, specifically operational risk and its quantification. As conditions improve, the main lessons from the crisis help shape a more stable, sustainable future. When it comes to operational risk, this crisis proved that operational resilience is not limited to technological solutions, but also relies on strong internal systems and well-composed processes, premises, and personnel. Moreover, the Covid-19 pandemic shed light on the importance of looking into the impact of dependencies and interconnectivity through a holistic view that allows for evaluating direct as well as indirect risks, and bolstering of governance and compliance criteria.

According to the Basel Committee on Banking Supervision (BCBS), operational risk refers to risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, alongside legal risk<sup>7</sup>. Despite the seemingly straightforward definition and the 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.

The analysis below sheds light on the main operational risk indicators in the local banking sector and offers a view of the sector’s readiness to counter cyber security threats.

As the clouded horizon caused by the pandemic started wearing off and the banking sector was fully operational again, and alongside the

**3.32 Operational Losses**



7 Basel III: Finalizing post-crisis reforms, December 2017.

ever-growing financial innovations and swift digitization, total operational losses grew to reach KD 7.4mn in 2021. This does not necessarily indicate a decline in banks’ operational risk management; rather it is a consequence of the relatively lower operational loss seen the year before due to closures and partial operations (figure 3.32).

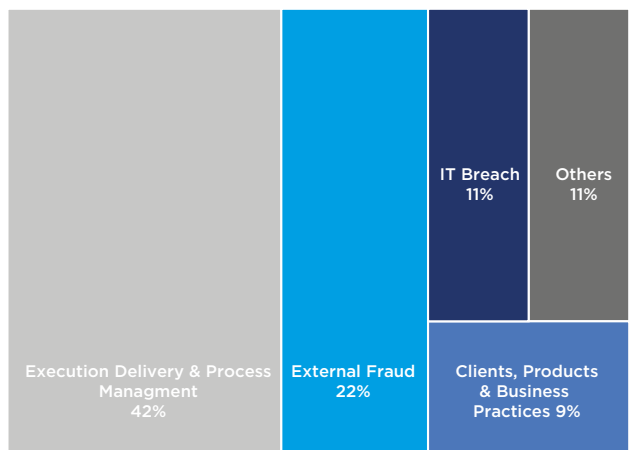
Despite the above, the total operating losses recorded in 2021 did not exceed 0.8% of the average total gross income of Kuwaiti banks for the past three years. While this may indicate that the losses are minor and not worthy of attention, it is important to re-emphasize the nature of operational risks that have a relatively high potential for large losses. Moreover, the competitive stance of the local banking sector and its sensitivity towards clients’ views and sentiments deem it necessary to manage risks,

as operational failures may result in indirect financial damages.

External Fraud incidents, along with cases involving Execution, Delivery and Process Management errors were the main types of operational risks in terms of volume and value in the year 2021 (figures 3.33 and 3.34). This is expected given the swift digitization processes and the increased dependence on technical solutions and services. It is worth noting that the majority of cases involving External Fraud are attributed to customers’ lack of awareness as they shared confidential banking data with third parties. To minimize such incidents, CBK, in cooperation with Kuwait Banking Association, is intensifying efforts to raise public awareness, and a key initiative in this regard is the “Diraya” campaign which was launched in the beginning of 2021.

In order to analyze and further understand operational risks, it is useful to look at indicators other than total losses registered during the year, such as penalties imposed on banks by regulatory authorities. CBK, within its on-site and off-site supervisory scope, imposes financial and non-financial penalties to discourage unsound activities, maintain disciplined practices, and

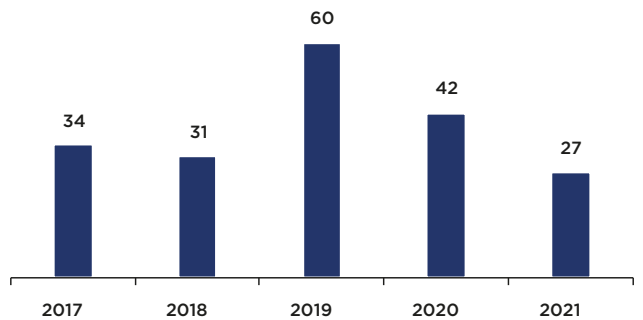
**3.33 Operational Loss Incidents - by type**



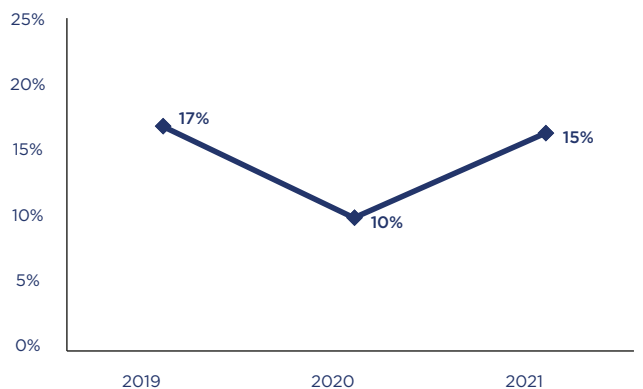
**3.34 Banking Sector’s Operational losses - by type**



**3.35 Penalties from CBK**



**3.36 Employee Churn Rate**



guard against lower quality of standards. As shown by the penalties imposed, banks proved their ability to maintain effective internal controls. Compared to the year before, the total number of inflicted penalties in 2021 dropped from 42 to 27 (figure 3.35).

Among other indicators that reflect operational risks is employee churn rate<sup>8</sup>. Notably, it is hard to determine the cause for an increase in this rate, as it could be attributed to restructuring the organization, or reducing costs & expenditures within an institution. It could also be a result of the employee’s own decision. Locally, employee churn rate does not constitute a major threat. However, a consistent increase in this rate could impair banks’ operational stability. After all, and despite the digitization trends, sufficiently stable human capital can be the main source and driver for any organization’s success.

As shown in (figure 3.36), the churn rate in 2021 increased to 15%, from 10% in 2020. This represents a slight lapse in the indicator of staff stability, particularly when compared to its level prior to the pandemic (17% in 2019). This could be mainly due to the global phenomenon known as “The Great Resignation”. The years 2020 and 2021 saw great numbers of employees voluntarily leaving their positions, either due to getting better offers, or shifting career and life related priorities post-pandemic. It is an undeniable truth that the pandemic has had an impact on the decisions taken by individuals and by communities. According to behavioral economics theories, such crises of great psychological toll have notable reactions

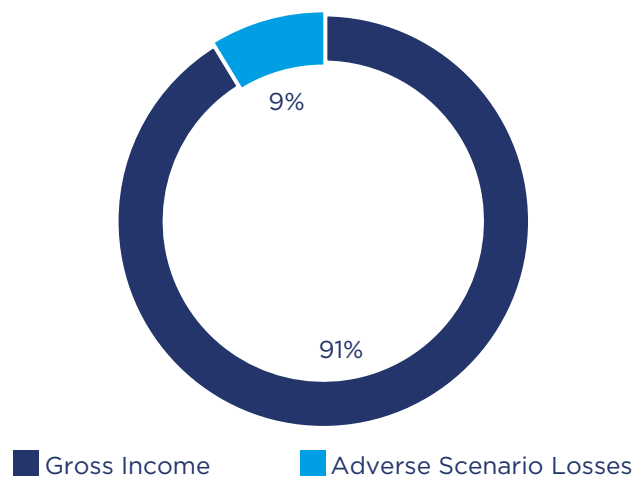
seen in the economic behaviors and decisions of individuals (work, investment, savings, spending, consumption, etc.).

Lastly, towards a forward-looking methodology of understanding potential operational risks and consequent damages, CBK conducts several simulations based on distribution of losses on both aggregate and bank-by-bank levels.

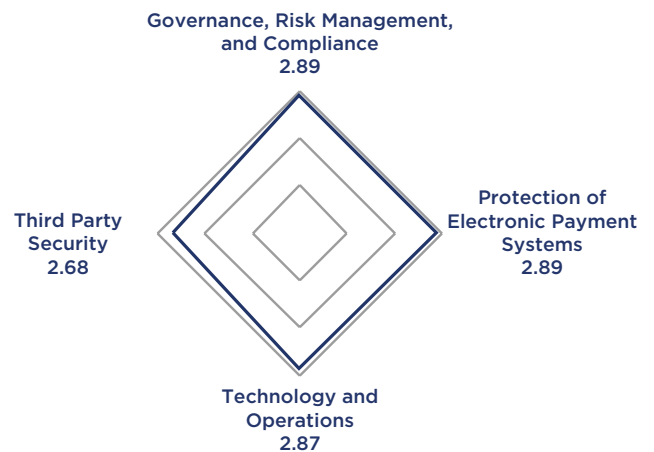
In 2021, two main simulations were conducted to evaluate severity of banks’ operational losses. The first simulation was based on severity of losses for the overall banking sector, while the second simulation focused on both the sector’s frequency and magnitude of losses derived from a specialized operational risk database. Furthermore, additional grave losses (tail-events) were postulated to each simulation, meaning there were four scenarios that yielded different results.

In the worst-case scenario, banks would collectively record a maximum loss of KD 261mn. Percentage-wise, this figure did not surpass 9% of banks’ average income in the past three years (figure 3.37). The results of the severe scenario highlight the banks’ strong financial position and their capability of withstanding extremely adverse operational failures. The objective is to maintain and bolster banks’ financial position and to reduce maximum losses caused by the severe postulations; this could be achieved through banks’ collective efforts to strengthen the banking sector’s leading position in resilience and soundness indicators.

**3.37**  
**Adverse Scenario Losses from Sector’s Gross Income (3-year Average)**



**3.38**  
**Cybersecurity Framework Assessment**



<sup>8</sup> The employee churn rate estimates the percentage of employees leaving the organization per year.

The following section summarizes the efforts of CBK and the local banking sector to minimize potential impact of operational risks, specifically the efforts in the area of cyber security.

After the issuance of CBK’s Cybersecurity Framework (CSF) in February 2020<sup>9</sup>, all local banks (Kuwaiti Banks and branches of Foreign Banks operating in Kuwait), along with key sector players: KNET and CI-NET, have actively aligned themselves to the requirements of the framework during the first round of implementation (2020-2021). The 2021 aggregate result (figure 3.38) reflects an overall sector alignment to the “CSF Security Baseline” framework requirements, though with varying degrees.

The highest performing areas were the “Governance, Risk, and Compliance” and the “Protection of Electronic Payment Systems”, both considered traditional domains, achieving a score of 2.89 out of 3.0. “Technology and Operations”, which is the core of Banking IT Infrastructure and Operations Security, follows with a close score of 2.87 out of 3.0. “Third Party Security”, comes last with a score of 2.68 out of 3.0, showing a considerable difference compared to the aforementioned areas. It is worth noting that managing “Third Party Security” in organizations proves to be a challenging endeavor not only locally, but globally as well.

Along with CBK who renewed its ISO27001-2013 certification in April 2021 to lead the sector by example, the year 2021 featured the compliance of all 11 Kuwaiti banks with ISO27001-2013, along with KNET and CI-NET. This international standard, which is part of CSF requirements, establishes a robust “Information Security Management System” within organizations, allowing it to become the main conduit of governance, data protection, operational and human resources security.

CBK, through leading the Information Security Working Group, continues to push the sector

### **All local banks along with KNET and CI-NET have aligned themselves to the requirements of CBK’s Cybersecurity Framework.**

to increase its alignment with CSF as well as international standards and best practices. By mandating the alignment to CSF and the obtainment of standard certifications, CBK continues to lead the sector in its journey to achieving “Cyber Resilience”.

As types of operational risks and their complexities increase, fears of severe, unexpected financial impact that could materialize arise. As a result, banks focus on bolstering the role of risk management by ensuring sufficient insurance coverage, which plays the important role of a direct buffer to absorb shocks. Considering that banking operational incidents had moderate financial impact historically, levels of insurance coverage for such incidents are reassuring. More specifically, 28% of the total value of insurance coverage for banks’ operations was allocated against damage to physical assets in the year 2021, while close to 25% was allocated to the category of operational incidents related to clients, products, and business practices. With the speed at which banking services are developing digitally, banks expanded the share of insurance allocated for operational risks resulting from information technology breaches, fraud, or downtime to reach 15% of the total insurance coverage.

A year full of unique challenges has clearly shown that effort exerted during good times pays off at times of crisis. Accordingly, CBK spares no effort in building and developing an organizational environment that adopts forward looking and prudential methods of risk management, most particularly in relation to the swiftly developing operational risks.

9 For further details on the Cybersecurity Framework, refer to box 3.1.

## BOX 3.1:

# CBK Cybersecurity Framework

### Overview

The importance of cyber security primarily comes down to the need to keep information, data, and devices private and safe. With recent developments in technology and the wide-scale adoption of digital services pushing the banking sector to more efficiency and competitiveness, cyber risks prove to be a major threat. As an ever-growing list of potential opportunities of exploitation arise, the need for organizations to have strong cybersecurity controls to mitigate cyber risks has been reinforced. The Central Bank of Kuwait (CBK) is responsible for supervising the Kuwaiti banking sector and, as the regulator, recognizes the importance of improving the banking sector's resilience to cyber-attacks. To support this inevitable global shift to digital banking, CBK institutes a Cybersecurity Framework (CSF), which applies to all local regulated entities within the banking sector to ensure consistent management of cybersecurity.

The CSF exists in the context of several strategic drivers that fundamentally influence the Kuwaiti banking sector, highlighting the necessity of a comprehensive framework. Appropriate controls are vital to ensure the stability and resilience of banks as they become increasingly dependent on third parties for facilities, infrastructure, technology management, and operational support. The increased number of cyber-attacks and their rising complexity continues to expose vulnerabilities, emphasizing the need for continuous improvement in cybersecurity controls, as well as the need for greater visibility and regulatory supervision as the sector increases its reliance on technology. In alignment with the National Cyber Security Strategy that identifies and outlines its vision for cybersecurity in Kuwait, the CSF will assist banks in managing their cyber risks and support the execution of the strategy.

### Objectives

The trifold objectives of the CSF define and address the multiple components needed to aid the sector as a whole. The first is to improve cyber resilience within the Kuwaiti banking sector by defining requirements that seek to enhance capabilities, preparedness, cooperation, information sharing, and standardization of the banks' cybersecurity approaches. The second objective focuses on the enhancement of the maturity of cybersecurity controls that are in place, as well as providing a mechanism to inform and mandate strategic security initiatives required to improve cybersecurity maturity. The final objective ensures that CBK executes its sectoral responsibility to provide appropriate levels of informed supervision and regulation to enhance cyber resilience.

## Core Principles

The CSF defines three core principles that enhances the banking sector’s cybersecurity and resilience capabilities. The core principles and their underlying components, tools and functions co-exist and operate as necessary to fulfill the objectives of the CSF (as illustrated below).

### 1. Governance, Risk Management and Compliance (GRC)



GRC enables banks to integrate and coordinate the Governance, Risk and Compliance initiatives within their business process. A holistic view of the GRC with respect to cybersecurity will enable the banks’ leadership to make informed decisions to efficiently manage cyber risks. While the banks’ boards of directors are accountable for cybersecurity, they may delegate responsibility to individuals or units within their organization who have the appropriate proficiency and qualifications.

A sound systemic risk assessment comprises of policies with a clearly defined criteria for risk acceptance and mitigation, as well as documentation of all risks. Such assessments enable banks to properly conduct their ongoing process of risk management which entails identifying, assessing, and addressing risks.

In terms of compliance, banks are expected to conform with the CSF and all relevant national laws and regulations, while aligning with industry best practices and international standards. Meanwhile, CBK continues to provide obligatory directives through its regulations and circulars to ensure its supervision initiatives are completely met.

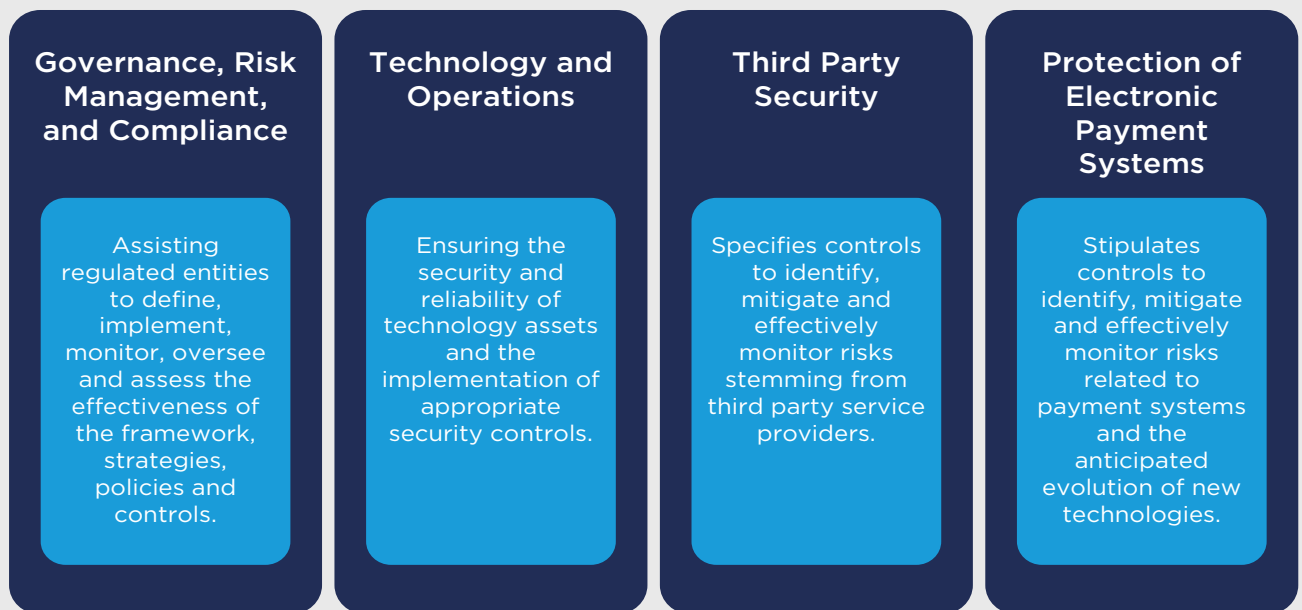
### 2. Collaboration

As the global technology landscape evolves with fast changing innovations that disrupt the financial markets, ultimately leading to increased cyber risks and threats, the need to foster collaboration is vital to exchange experiences and to improve transparency, preparedness, and response to cyber incidents in a timely manner. The CSF established the Information Security Working Group in 2016 as a permanent forum for collaborative discussions on cybersecurity controls and the maturity of the Kuwaiti banking sector, which includes sharing risk-related insights, trends, and best practices. Due to the volatile nature of cyber risks and their potential impact on the banking sector, it is imperative to increase awareness and to train both banks and the public (as seen appropriate) on specific issues relating to risks by using a range of tools such as campaigns, structured training programs and simulations.

The CSF also defines the Cyber Threat Intelligence Sharing (CTIS) strategy and functions to facilitate collaboration between banks in the discovery, analysis, understanding, and sharing of information about arising cyber threats globally, regionally, and locally. This collaboration promotes proactive measures for continuous improvement of cybersecurity controls. The CTIS strategy reinforces this collaboration platform with a Sectoral Computer Security Incident Response Team which provides analysis to support incident response efforts of a single entity, while safeguarding the others by sharing cyber intelligence.

### 3. Continual Improvement

The CSF classifies continual improvement as an essential category that drives the cyclical and event-based enhancement of cybersecurity maturity across the banking sector. This principal requires banks to implement cybersecurity baselines (minimum requirements as per the CSF), execute continual assessments of the effectiveness and maturity of those baselines, and prepare to respond to cyber-attacks in order to improve their overall cybersecurity posture. The baselines have been designed with proper consideration of CBK's regulations, instructions, guidelines, as well as prevalent international cybersecurity standards and frameworks such as the National Institute of Standards and Technology, International Organization for Standardization (ISO), Information Security Forum, Payment Card Industry, Center for Internet Security, CPMI<sup>1</sup> -IOSCO<sup>2</sup> Principles for Financial Market Infrastructures, and many other internationally-recognized frameworks and standards. CBK will monitor the implementation of these baselines and undertake necessary initiatives to improve the sectoral maturity. The four domains of baselines are:

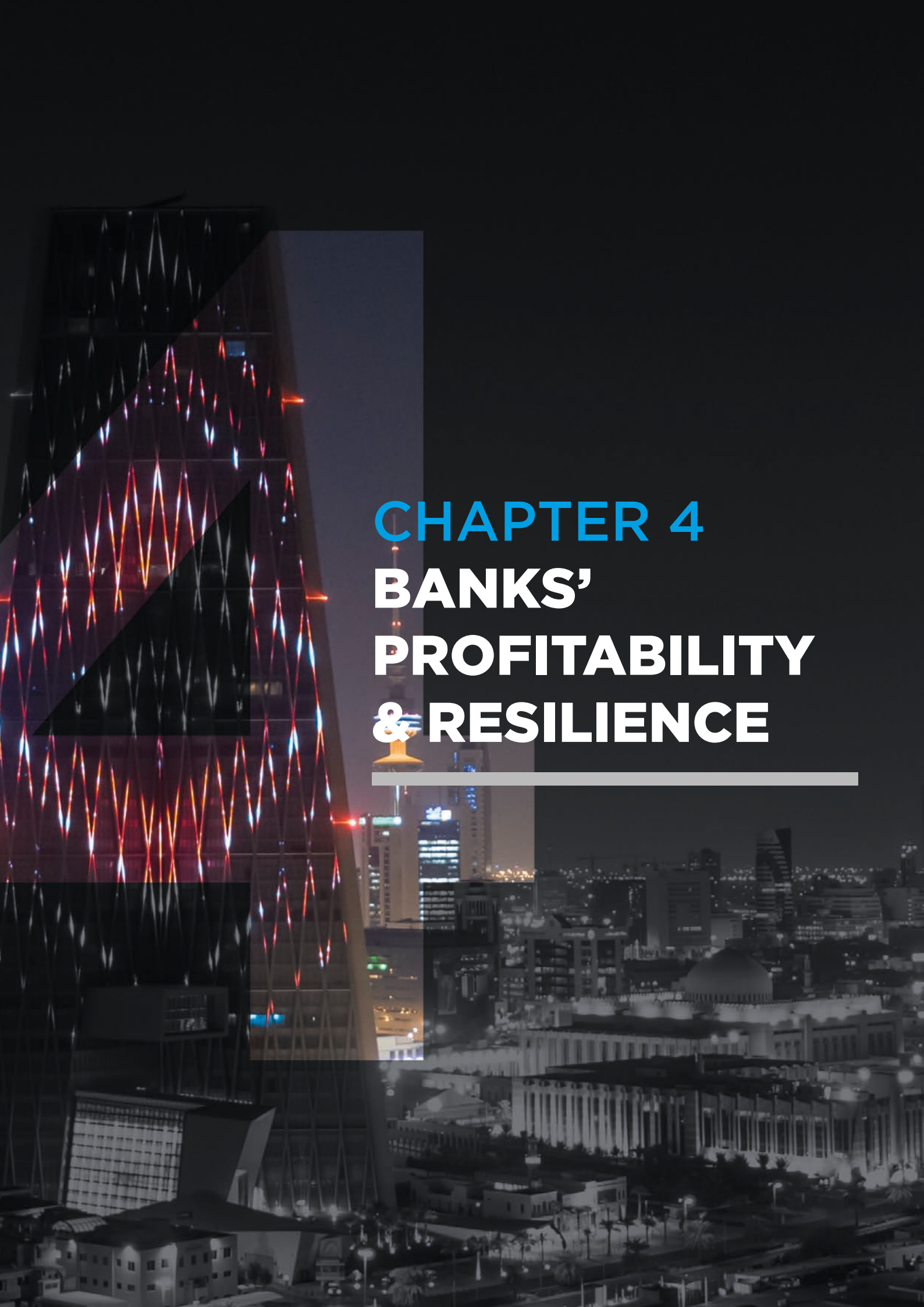


### Conclusion

Trusting the sufficiency of the banking sectors' own impulses to advance their defenses in the cybersecurity field is vital. However, supporting it with regulations and global accreditations such as the CSF and ISO certifications shall further instill confidence in the system. Having those multiple defense lines ensure that potential cyberattacks are prevented, disruption of financial services is avoided, loss is minimized, and broader financial stability is bolstered.

1 Committee on Payments and Market Infrastructures

2 International Organization of Securities Commissions



**CHAPTER 4**  
**BANKS'**  
**PROFITABILITY**  
**& RESILIENCE**

---

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

# Profitability

The Covid-19 pandemic had many negative implications on the banking sector, the most noticeable of which was a decline in net profits during 2020. In contrast, 2021 witnessed a gradual recovery driven by vaccine rollouts, economic reopening, and relaxation of travel restrictions, which in turn led to a better performance and higher oil prices. As a result, the Kuwaiti banking sector's net earnings attributable to shareholders surged by 96%, nearing pre-pandemic levels at KD 891mn (2019: KD 952mn) (figure 4.1).

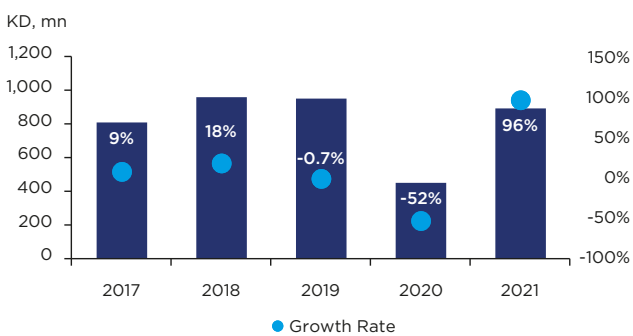
While the recovery has had a positive impact on the performance of both conventional and Islamic banks, the growth in net profits of conventional banks clearly exceeded that of their Islamic peers in 2021. The net profits of conventional banks increased by KD 279mn to reach KD 506mn by year end, compared to an increase of KD 163mn for Islamic banks to

## The Kuwaiti banking sector's net earnings attributable to shareholders surged by 96%, nearing pre-pandemic levels.

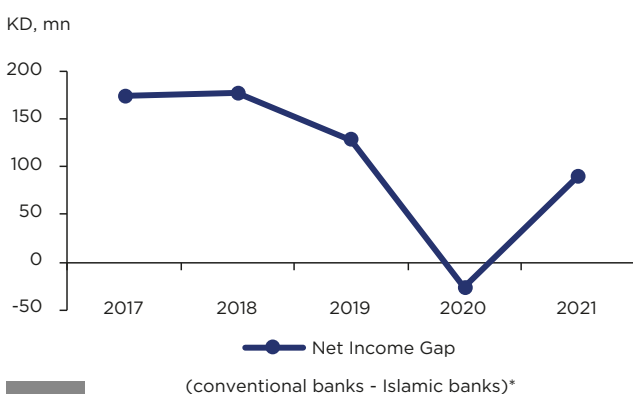
reach KD 416mn. Hence, the gap in gross profits increased to KD 90mn, but remained below the gap seen over the past decade when excluding 2020, which is considered an exceptional year (it witnessed a negative profit gap by KD 26.3mn in which the Islamic sector's profits exceeded their conventional peers.) (figure 4.2). Thus, conventional banks accounted for 53% of the sector's total profits versus 46% in the previous year, enabling them to return to pre-pandemic profit levels and outperform Islamic banks in terms of total profits. Conventional banks' share of total profits was consistent with their share of the sector's total assets at 55% (figure 4.3). One of the factors that contributed to the growth in conventional banks' profits in 2021 was the outlying performance of a single traditional bank, which incurred losses of KD 69.5mn in 2020 and recovered in 2021.

In terms of net income attribution, the sector was mainly affected by a 44% decline in provisions charged to the income statement (figure 4.4), which was driven by a decline in the uncertainty and improved asset quality. Though the provisions charged to the income statement have decreased and banks have written off bad debts of KD 647mn, the sector remains abundantly provisioned, enabling it to withstand potential stress and losses. Provisions for loan

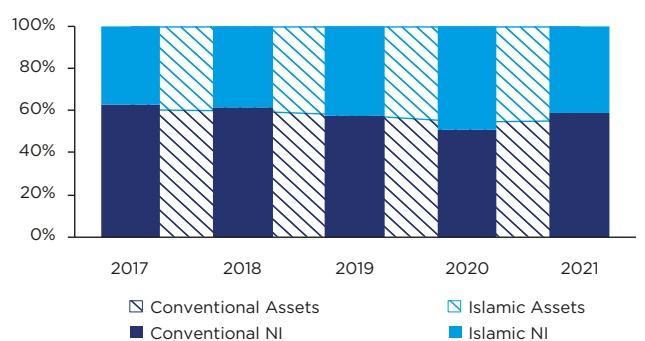
### 4.1 Net Earnings attributable to shareholders



### 4.2 Conventional vs Islamic Net Income Gap\*



### 4.3 Share of Net Profits and Assets



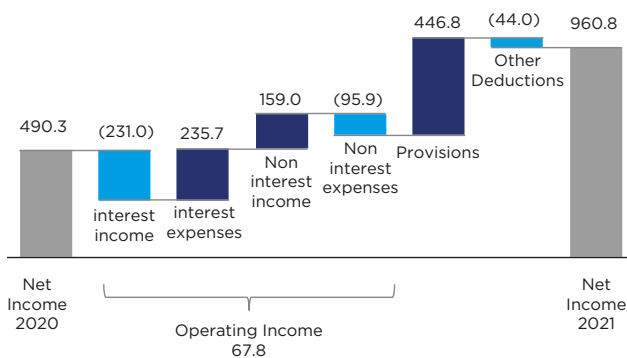
losses made over the year decreased by 39% to approximate their average level in the previous five years, while provisions for the other financial assets (mainly investments) dropped by 72% (figure 4.5). Conventional banks recorded 54% of total loan loss provisions, which was proportionate to their size compared to their Islamic counterparts. Islamic banks on the other hand, recorded the bulk of provisions on other financial assets, at 93% of the total amount. This is due to the nature of Islamic banks, whose articles of association allow them to enter into a broader range of investment instruments.

As depicted in figure 4.4, interest income decreased by KD 231mn, i.e. 7.6%, in light of the historically low interest rates. However, the decline in interest expenses was more accelerated, at KD 235mn or 20.3%, due to declining cost of time deposits which fell by 22%. Looking into the net interest margin (NIM) (figure 4.6), which is one of the main indicators of profitability by comparing interest income and expenses against interest-bearing assets, the data reveals a declining trend over the past years. This is mainly due to the low interest rate environment and intense competition, as well as

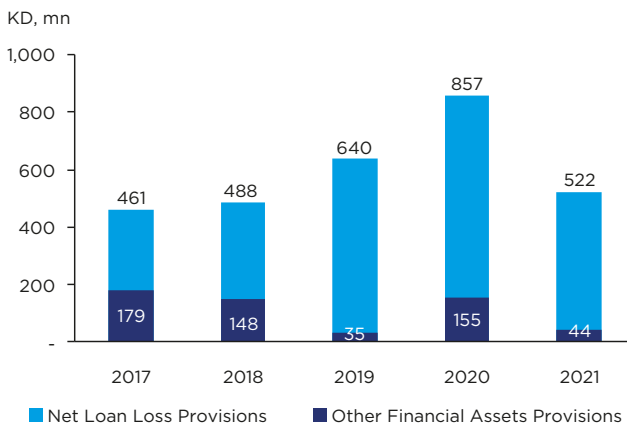
the healthy growth of assets. Consequently, the NIM settled at a historical low of 2.4% in 2021. While the net profit margin of Islamic banks in 2020 demonstrated their resilience due to their asset structures and repricing gaps, as well as higher returns on investments in Turkish instruments, the margin declined slightly during 2021. The drop was driven by lower returns on financing and a decline in dues from banks. Conventional banks on the other hand, maintained a stable NIM by the end of the year.

The Kuwaiti banking sector continues to demonstrate strength and resilience in its core operations, with net interest income (NII) contributing to 68% of gross income in 2021 (figure 4.7). While NII increased relative to 2020, its share of gross income declined (72% in 2020) due to the rise in investment profits' share. Backed by the recovery of the financial markets, banks' profits from investments increased by KD 114mn, or 4 ppts in its contribution to net income which stood at 5.6% compared to 1.6% in 2020. It should be noted that this improvement in investment profits was mainly driven by the exit of two Islamic banks from real estate investments which totaled KD 25.1mn,

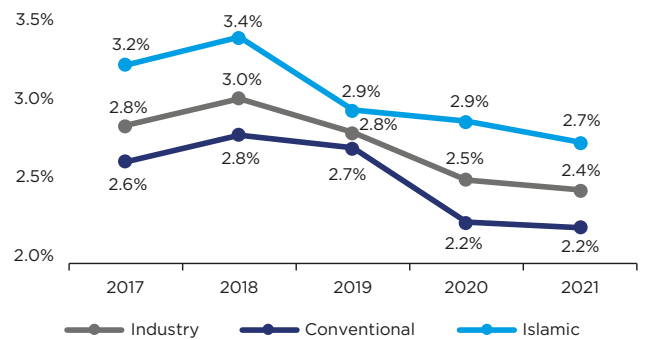
**4.4 Change in Net Income (KD, millions)**



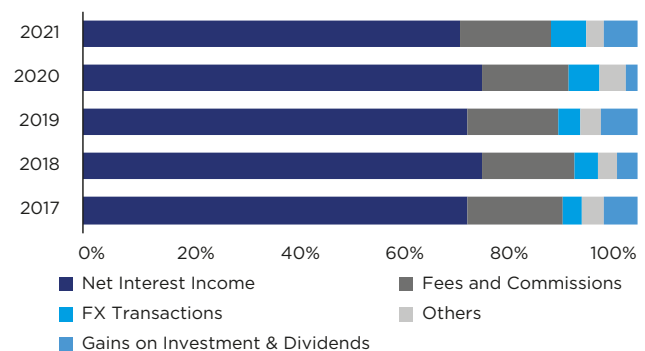
**4.5 Breakdown of Provisions**



**4.6 Net Interest Margin**



**4.7 Breakdown of Gross Income**



followed by a rise of KD 51mn stemming from equity trading. In addition, the rise in revenue realized from fees and commissions as well as FX transactions had the same impact on gross profit, both increasing to account for 16.4% and 6.3%, respectively.

The marked recovery and rise in profits during the year had a clear impact on the performance and efficiency of the banking sector, resulting in a rise in both the ROAA and ROAE (figures 4.8 and 4.9). Despite average assets inching up by 4%, mainly due to the growth of the loan portfolio, ROAA managed to increase from 0.6% to 1.1% at the end of 2021. Likewise, ROAE reached 9.1%, close to the pre-pandemic levels despite a slight rise in average equity (mainly

**The low interest rate environment and intense competition led to a historically low NIM of 2.4%.**

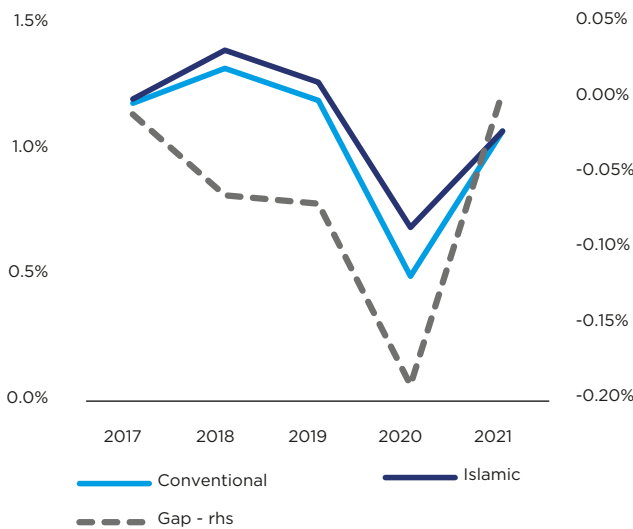
due to issuance of tier-1 bonds and capital increases by Warba Bank and Burgan Bank).

The gap in ROAA remained relatively stable due to growth in the assets of both conventional and Islamic banks by 8% and 5%, respectively. On the other hand, the gap in ROAE over the past five years has continued its downward path, mainly driven by Islamic banks who have seen profits grow at a faster pace than shareholders equity.

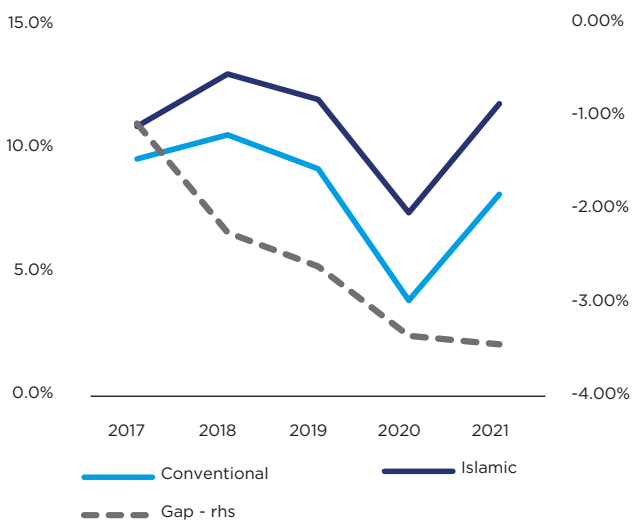
With regards to the operational efficiency of banks, the gap between the two sectors slightly increased. Although gross income increased by 6%, the impact was not material on the cost-to-income ratio, which rose by 1.7 pts and 1 ppt for conventional and Islamic banks, respectively. This was due to the increase in operating expenses (mainly in employee salary expenses) by 10% for conventional banks and 8% for Islamic banks (figure 4.10).

Overall, while 2021 saw recovery of economic activities, conditions are still under pressure from the unstable global economic and geopolitical developments. This requires caution and vigilant monitoring of the various dynamics. While most central banks are moving to tighten monetary policy, the impact of these policy shifts will not be immediately reflected in banks' profitability. This is especially relevant given the uncertain outlook that dominates the year 2022 in terms of the economic trajectory and heightened concerns of entering a recession.

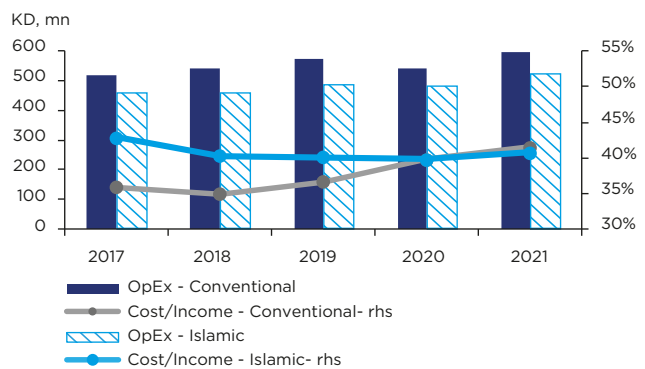
**4.8 ROAA**



**4.9 ROAE**



**4.10 Operating Efficiency**

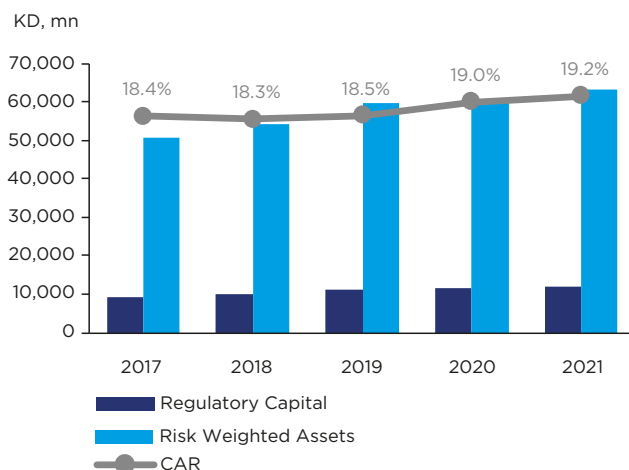


# Resilience

Kuwaiti banks successfully weathered the fallout from the crisis, with the capital adequacy ratio (CAR) increasing 0.3 ppts YOY to reach a new all-time high of 19.2% (figure 4.11). The rapid increase in RWAs over the past year was outweighed by the rebound of profits coupled with capital increases and debt issuances (figure 4.12). Banks took advantage of the low interest rate environment to shore up their capital base, which mainly came in the form perpetual debt (mostly dollar denominated). Issuances received great interest from investors, which was reflected by high demand (average oversubscription of 2.9<sup>1</sup> times). This underscores investors' continued confidence in Kuwait's banking system despite structurally induced downgrades. These strong foundations upon which the local banking sector is built enables banks to maintain resilience against unforeseen economic deterioration.

Despite the inflow of capital witnessed during the year (where two banks issued common equity), the CET1 share from the sector's capital composition slightly fell, from 78.5% to 76.6% (figure 4.13). This was largely due to AT1 capital levels growing at a faster pace and reaching 12.1% of total regulatory capital. Moreover, the CET1/RWA ratio slightly declined by 0.2 ppts, as the losses in FX revaluation reserves (in light of the Turkish Lira depreciation) slowed the pace of CET1 growth. Nonetheless, the CET1 ratio stands at 14.7%, comfortably above Basel III and CBK minimum regulatory requirements of 7% and 9.5%, respectively. These levels of high-

## 4.11 Capital Adequacy Ratio

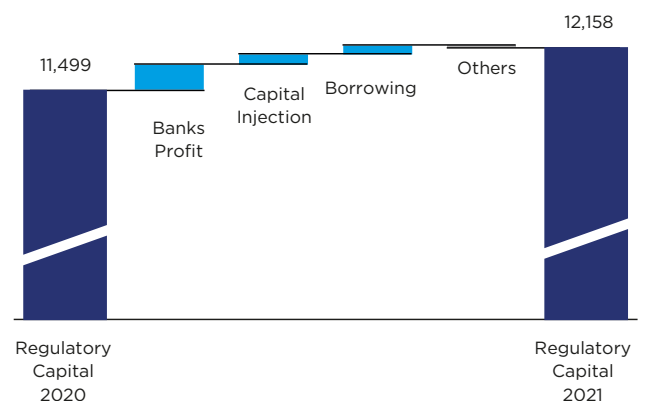


<sup>1</sup> Average of common equity, AT1, and T2 issuances.

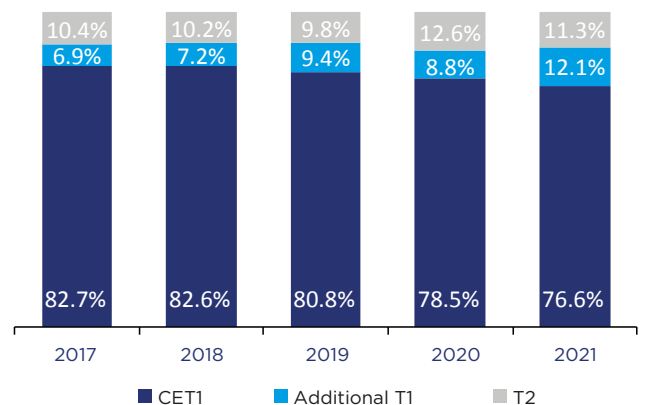
quality capital further highlight local banks' loss absorbing capacities.

Most Kuwaiti banks demonstrated high levels of capitalization on an individual basis, with the exception of a few banks that witnessed a decline in their CAR (figure 4.14). Banks who saw their CAR decrease had sizeable increases in risk-weighted assets and/or redemption in T2 issuances. Elevated issuances during 2021 caused lower dispersion of banks' CAR, as banks with low capitalization caught up to their peers. Among notable movements, an Islamic bank registered a major drop during the pandemic, reaching a new record low CAR of 16.4% from a 20.3% high in 2019. This drop was mainly due to its expansion and growing market share. Nevertheless, the bank has capital injection plans in place to address the decline.

## 4.12 Changes in Regulatory Capital (KD, million)



## 4.13 Capital Composition



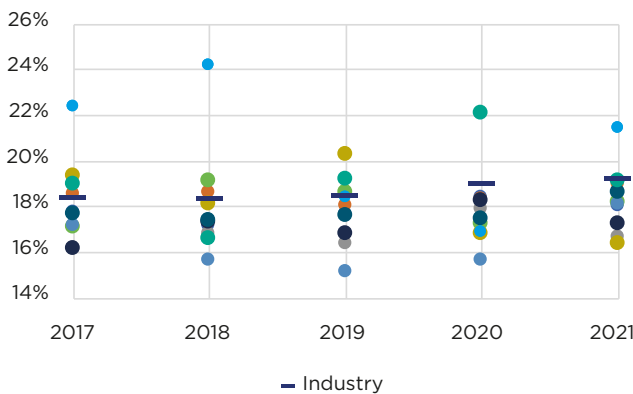
Evidently, Islamic banks benefitted more from the capital increases and debt issuances, as the segment's CAR witnessed an increase of 1 ppts to reach a new high of 18.5% (figure 4.15). To that end, it is worth mentioning that the Islamic segments regulatory capital growth outpaced its RWA growth, as opposed to the conventional segment that witnessed the opposite dynamic. In both segments, the fast-paced growth in RWAs was mainly driven by the loan book. While a single bank contributed to much of the increase in the conventional segment, Islamic banks saw RWAs grow across the board (excluding one bank that experienced a decline). Despite the fact that both Islamic and conventional banks raised similar levels of capital, the conventional segment's CAR saw a slight decline to 17.9%, while still remaining higher than pre-pandemic levels. On that note, it is worth mentioning that Islamic banks benefit from a 50% risk-sharing adjustment factor on assets funded by restricted and unrestricted investment accounts (alpha factor). The large growth in assets also led to a decline in other solvency ratios such as capital

**High investor demand for Kuwaiti bank issuances underscores investors' continued confidence in the local banking sector.**

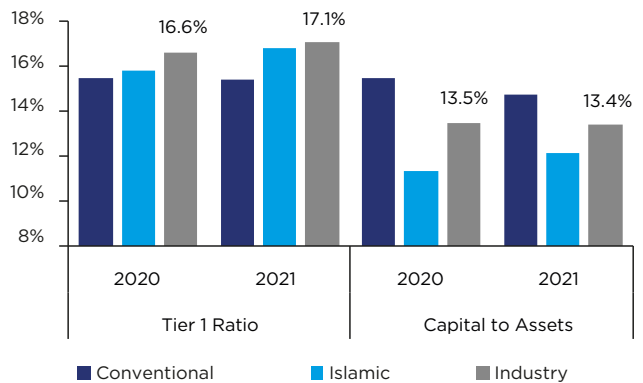
to assets, which fell for conventional banks (figure 4.16). In general, Islamic bank issuances were the main drivers of the increase in total industry capitalization.

In a separate measure of the banking sector's resilience, the Basel III leverage ratio, which measures total T1 capital to total exposures, reached a record-high of 10.8%, comfortably above Basel's minimum 3% (figure 4.17). These elevated levels were witnessed in both the Islamic and conventional segments, further confirming the banking sector's loss absorbing ability. With that, growth in capital remains robust, sufficiently supporting banks' expansionary trends and further instilling confidence in market participants.

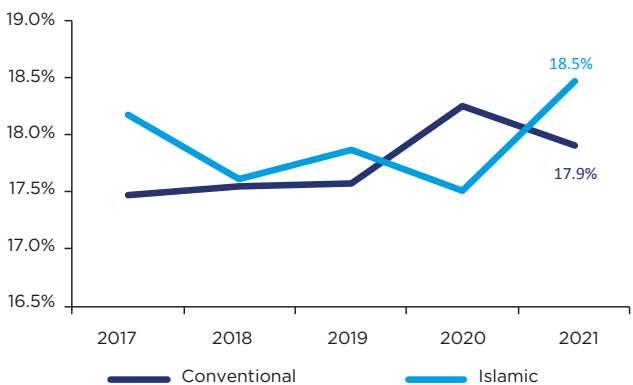
**4.14**  
**Distribution of Banks' CAR**



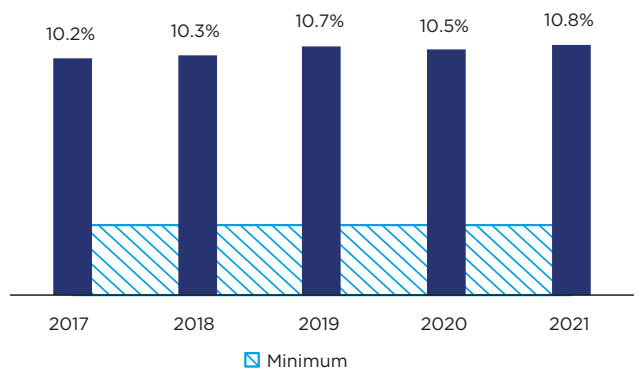
**4.16**  
**Other Solvency ratios by sector**



**4.15**  
**Conventional vs Islamic CAR**



**4.17**  
**Basel III leverage ratio**

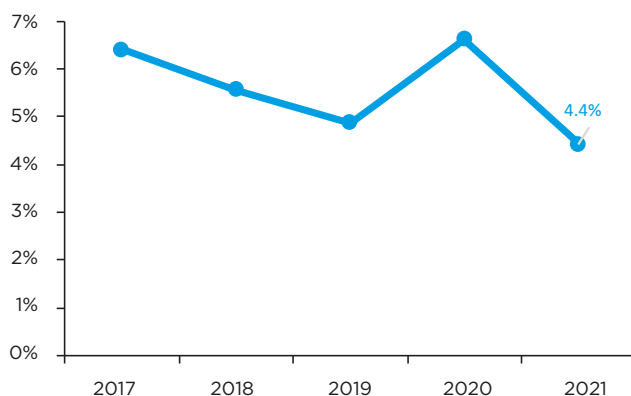


From another angle, net NPLs to capital calculates the potential risk to capital, measured as the banks' capital exposed to NPLs not covered by specific provisions. The system-wide ratio stood at 4.4% at the end of the year (figure 4.18). Islamic banks' net NPL to capital ratio was higher than their conventional counterparts at 6.5%, mainly due to a combination of higher total NPLs and a lower regulatory capital base. It is worth noting that conventional banks reached the lowest reported net NPL to capital at 3.0%, as NPLs dropped by 38%. Nonetheless, the sector continues to cover NPLs by accumulating ample stocks of provisions, with general provisions and precautionary provisions increasing 9.5% and 3.2% YOY. The accumulation of high provisions over the years, which is a result of the implementation of CBK's prudent provisioning framework, continued to play to banks' benefits.

As per CBK's new stress testing framework introduced in 2020, new scenario narratives were set for 2021 based on the prevalent risks to growth. Scenario 1, the sector specific scenario, entailed a sectoral shock in the form of a commercial real estate collapse. Scenario 2 consisted of a country-wide shock in the form of a sustained fiscal imbalance. Scenario 3 consisted of a global shock triggered by the inopportune withdrawal of support measures.

The first scenario was chosen based on the premise that increased exposures and a poor outlook make the commercial real estate sector vulnerable to shocks. This is especially true given the increases in commercial unit supply over the past few years, which may not be met with sufficient demand. In this scenario, the assumption of tighter fiscal policies puts downward pressure on household income, further dampening demand for goods and services

#### 4.18 Net NPLs to Capital



of businesses that tend to occupy commercial space. Moreover, the sector may have already endured behavioral shifts as consumers move away from brick-and-mortar shops towards the more convenient option, online shopping. That said, the commercial real estate sector crisis is assumed to last approximately 2 years, causing a moderate drop in GDP while having a low impact on government finances.

As for the second scenario, it assumes further sovereign rating downgrades as the country continues to be weighed down by sustained fiscal imbalances and the absence of governmental reforms. This in turn is translated into elevated capital outflows, as investors become more doubtful towards Kuwait's economic outlook. Ultimately, this weighs down on monetary policy, namely putting upward pressure on interest rates and downward pressure on foreign reserves. The crisis is assumed to last approximately three years, with a severe impact on both GDP and government finances through the proxy of lower oil prices.

The third scenario entails the inopportune withdrawal of support measures, leading to significant market disruptions and weighing down on market sentiment. This is inspired by the unprecedented levels of fiscal spending and ultra-loose monetary policy that was prevalent during and before the pandemic. As such, these factors fueled debt levels and consequently inflated asset, consumer, and producer prices. These inflationary pressures driven by both excess demand and supply-side shocks would lead policy-makers to abruptly tighten policies. This in turn causes ripples across markets, which are already vulnerable given inflated asset prices and excess debt, triggering a global economic crisis. The crisis is assumed to last approximately three years, with a severe impact on both GDP and government finances.

In the first scenario, the banking sector's geographically diversified profile plays to its benefit, where the shock primarily effects the domestic economy. As such, banks maintain ratios above CBK regulatory thresholds. The pronounced impact from scenario 2 stems from the accumulated NPLs from consumer-oriented sectors, as assumed economic stagnation erodes purchasing power and impacts the largest loan segment, retail, along with other consumer-oriented sectors. In addition, the assumed equity market shock pulls down net profits to negative territories (figure 4.19). 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. That said, the banking sector maintains strong capital levels above Basel III minimums (figure 4.20).

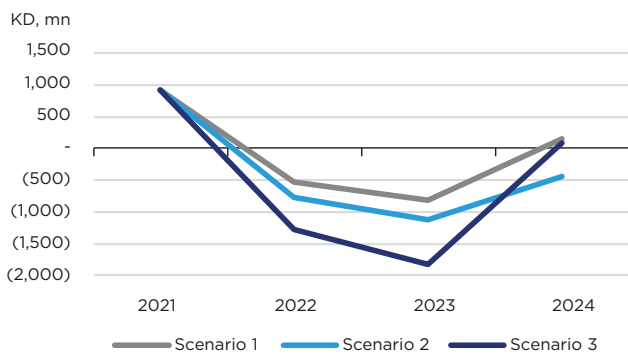
Under scenario 3, severe incremental NPLs along with the triggering of second-round effects result in the dramatic fall in profits during the first two years of the stress horizon. Second-round effects mainly come in the form of higher funding costs, as banks that fall below the solvency threshold face run-offs on deposits and higher costs on short-term funding. Net income manages to bounce-back in the third year as the economic effects of the crisis are contained. The CAR breaches CBK regulatory requirements but, nonetheless, remains above the Basel III minimum of 8%.

**The banking sector’s capital levels exceeded Basel III minimum requirements under all three scenarios of CBK’s top-down stress tests.**

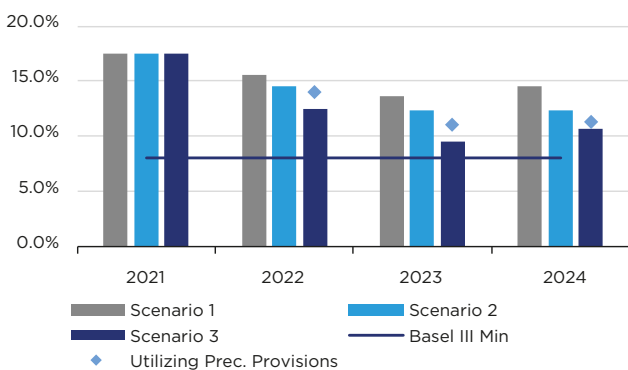
A complementary run is performed to better reflect conditions under a crisis, which allows banks to release all precautionary provisions accumulated over the years. These provisions were formed to serve at times of crisis. The complementary run also allows Islamic banks to benefit from the alpha factor (which is excluded in the presented results). Under these new assumptions that aim to more accurately model stress conditions, the CAR increases 2 ppts on average across all years of the three scenarios relative to the standard run.

Finally, liquidity remains at healthy levels during all years of Scenarios 1 and 2, with banks only facing liquidity issues<sup>2</sup> under the most severe scenario as second-round effects kick in (figure 4.21). Lending capacity remains robust under all years of all scenarios, as the maximum lending limit remains comfortably below its 100% limit. This ensures that banks have sufficient capacity to maintain their role in financing economic activity even during the most severe crises.

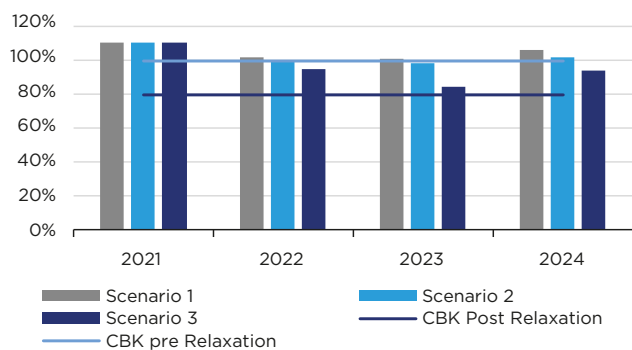
**4.19 Net Profit Under Stress Scenarios**



**4.20 CAR% Under Stress Scenarios**



**4.21 NSFR Under Stress Scenarios**



<sup>2</sup> Regulatory ratios are relaxed in times of crisis, as was the case during the pandemic, where NSFR limits are lowered to 80% and MLL lifted to 100%. As per CBK instructions, relaxation of regulatory ratios will be gradually lifted to pre-crisis levels starting from 1/1/2022.

## BOX 4.1:

# Implications of Basel's External Credit Ratings Approach for Exposures to Banks on the Local Banking System

Established in 1974, the Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks. Their Basel III regulatory framework, similar to Basel I and Basel II, aims to improve the soundness of the international banking system through enhanced supervision and regulation, with each version building on the last. As such, the final amendments to Basel III (to be phased in from 2023) indicate a tilt towards implementing the standardized approach as opposed to the use of internal models. If sanctioned by their supervisor and when using the former, banks are required to derive the respective risk weights through the External Credit Ratings Approach (ECRA) which assigns risk weights for each counterparty exposure based on ratings from external credit rating agencies.

As banks draw some of their ratings' strength from the implicit notion of government support, BCBS's revised ECRA for exposures to banks mandates<sup>1</sup> that the ratings used for calculating counterparty credit risk-weighted assets should exclude such support<sup>2</sup>. In essence, the committee prescribes that banks should utilize standalone ratings, which provide an assessment of the counterparty's intrinsic financial strength without taking into account implicit sovereign support from the home country. Even though sovereign support can be seen as a valuable source of security for the banking industry, it could potentially misconstrue the measure of idiosyncratic banking risk in the long-term. The aim of the new standards is to adequately capture such risks and allow for an additional cushion of capital – through assigning a higher risk weight for certain ratings buckets – to withstand any potential losses. This ultimately strengthens the resilience of the banking industry. In this box, we highlight how such instructions may affect risk weights for exposures to banks and explore the possible implications on the local banking sector.

According to a report published by Fitch Ratings in June 2021, implicit sovereign support is most prevalent in emerging markets. Therefore, it is essential to understand and assess the potential implications the new ratings and risk weights have on local banks. For consistency, Fitch's Issuer Default Rating (IDR) is used in the sensitivity analysis since it is the only agency that rates all Kuwaiti banks. Specifically, we use Fitch's standalone Viability Rating (VR) that excludes sovereign support. Hence, as per BCBS's instructions, such rating will be used to match counterparties with their appropriate risk weight as opposed to Fitch's IDR, which includes sovereign support.

The impact of the new standard can be assessed from both an asset and liability side. On the asset side, the application of higher risk weights on exposures to foreign banks that have high levels of sovereign support may affect capital adequacy ratios. On the liability side, however, the implications depend on the extent to which a foreign country's regulatory authority enforces the new standards, and thus precise effects on local banks are more uncertain. For example, foreign entities holding local bank bonds (i.e. a liability) may or may not decide to re-measure the risk of these bonds depending on two key factors: the extent to which the regulating authority implements the new standards, and the current level of their counterparty's VR.

<sup>1</sup> It should be noted that although the new rules will be phased in starting in 2023, the Basel Committee shall allow national supervisors and regulators to continue using banks' ratings that include implicit government support for up to five years (i.e. until 2028).

<sup>2</sup> BCBS defines implicit government support as "the notion that the government would act to prevent bank creditors from incurring losses in the event of a bank default or bank distress".

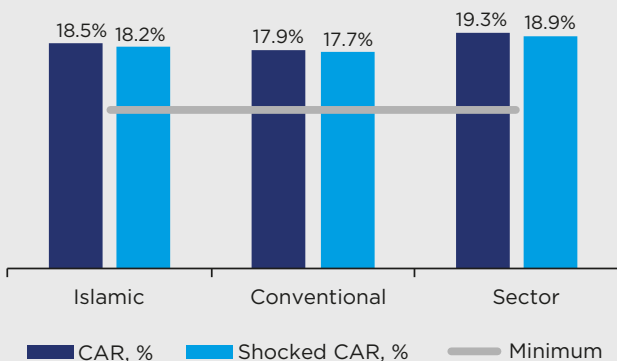
### Asset Side

Figure 1 illustrates the mild impact that the implementation of the new approach would have on the Capital Adequacy Ratio (CAR) of the Kuwaiti banking sector (both conventional and Islamic banks), with all banks remaining comfortably above minimum regulatory requirements. Banks may shuffle their exposures to foreign counterparties<sup>3</sup> (e.g. bank bonds, placements, etc.) in order to remain within their risk appetite and further limit the expected impact on solvency ratios. The actions taken by banks will likely depend on several factors such as current CARs and the level of exposure to foreign counterparties who have high levels of implicit sovereign support. For example, if a bank has a relatively low CAR, and maintains high exposures to counterparties who have sovereign support, the bank may be inclined to reallocate assets to exposures with lower risk weights.

### Liability Side

From a liability side, detailed information on foreign banks (such as their detailed risk-weighted assets breakdowns, investment allocation, risk appetite, and the level of adherence to Basel III) are not easily accessible and are in some cases unavailable. Nonetheless, from a general standpoint, some possible implications on local banks could range from an increase in cost of funds to a reduction of the foreign counterparty’s exposures to local banks. Yet, it is worth mentioning that the local banking sector relies largely on local deposits for funding purposes, and that the sector’s foreign liability exposures are not particularly significant. Similarly, and in terms of debt capital markets funding, possible exposure reduction of local banks’ bonds owned by foreign entities may result in repricing for such securities, and raise cost of funding. However, it is worth noting that such severe implications are unlikely due to several factors. While demand, and by extension, the spreads of an issuer are the primary reference for pricing, other factors such as the order to fill and market liquidity also have some effect. That said, local banks, as underscored in their order book size/order to fill<sup>4</sup> or oversubscription ratio (median of x3.0 and mean of x4.5), have historically enjoyed robust demand, which drove their initial price guidance lower and decreased the cost of funding in previous issuances. Most local bank bonds are also usually held-to-maturity and are thinly traded<sup>5</sup>, which provides additional support to demand. Moreover, corporates and non-bank financial institutions that are not subject to BCBS standards could also help compensate for the demand that is potentially lost from foreign banks.

**Figure 1**  
Change in CAR after applying ECRA



It is worth noting that Kuwaiti banks have maintained a positive net foreign asset position i.e. net lenders, which ultimately means that the affects of the new standards are, for the most part, within CBK’s reach. On the other hand if local banks were net borrowers, then the opposite would be true i.e. implications would hinge on foreign countries and the extent to which their regulators implement the new standards. As such, the abovementioned factors provide an adequate cushion for local banks in the shift to standalone credit ratings and in turn are expected to have a marginal impact on the banking system.

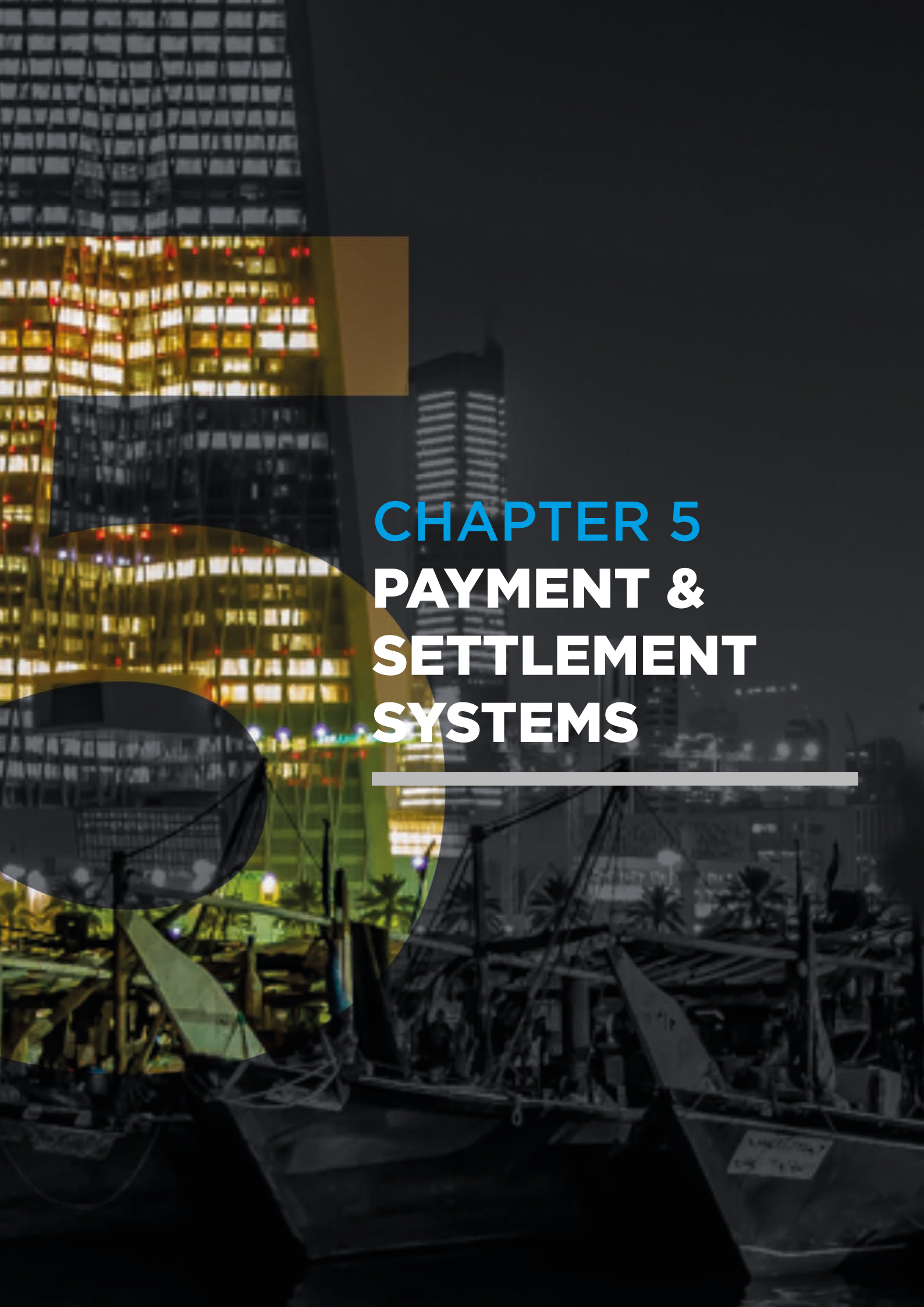
<sup>3</sup> As per CBK’s current Basel III regulations, counterparty exposures to local banks are assigned a flat 20% risk weight regardless of the entity’s credit rating. That said, projections in this paper assumes that such risk weights are applied to local bank exposures.

<sup>4</sup> Data is based on all local banks’ outstanding USD bonds. In particular, data covers 8 local banks and 17 issuances with issue dates ranging from 2017 to 2021.

<sup>5</sup> Based on the volume data of a sample (17 issuances dispersed amongst 8 issuers).

Looking ahead, ratings that disregard implicit sovereign support such as Fitch's VR may become a normal reference point for investors, and eventually even the new standard. As discussed above, even though foreign funding is not particularly high in local banks due to a stable deposit funding base, a shift towards the widespread adoption of this rating method (whether via regulators or via a shift in investors' standards) could impact the banking sector. Nevertheless, this scenario is unlikely to occur in the short to medium term, as it constitutes a substantial gyration from market conventions i.e. the use of long-term issuer ratings. Hence, the current impact of such a move to standalone ratings is expected to be nuanced on the local banking sector. Having said that, CBK urges banks to prepare for the specific changes in the new Basel III standards and to understand the potential effects on both their balance sheets and operations.





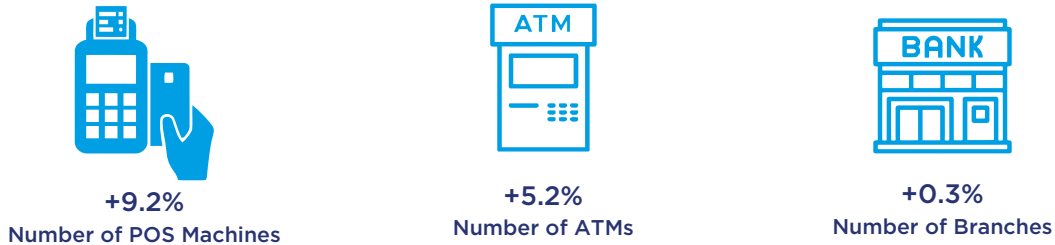
# CHAPTER 5 PAYMENT & SETTLEMENT SYSTEMS

---

Payment system infrastructure is the corner stone of financial markets and is imperative for the stability of the financial system. Throughout the year, the infrastructure continued to expand in parallel with increased transactions.

**2021 Payment Infrastructure Highlights**

(year-on-year)



In 2021, the number of electronic payment (E-payment) mediums available grew, whereas physical branches remained unchanged. To accommodate for this demand, Kuwait’s Automated Settlement System for Inter-Participant Payments (KASSIP) was re-launched to further support the infrastructure. The wider access to E-payment mediums combined with the higher reliance on contactless payment methods essentially fueled transaction growth. Equally, the upward trend of E-payments represents a pattern of preference for instantaneous and convenient payment mediums. These trends suggest a possible irreversible behavioral shift towards a digitized financial sector. In the following section, the trends of local transactions and electronic payments during 2021 are explored, along with an assessment of the payment systems.

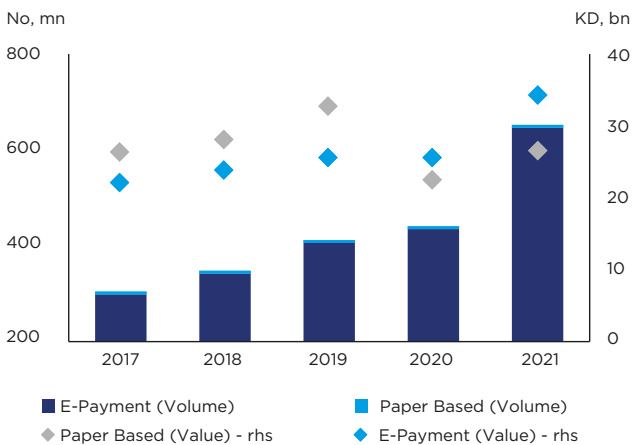
Prior to delving into the details of E-payments, it is useful to consider the number of transactions executed in 2021. The gap between paper-based

**E-payment transactions recorded historic double-digit growth in 2021.**

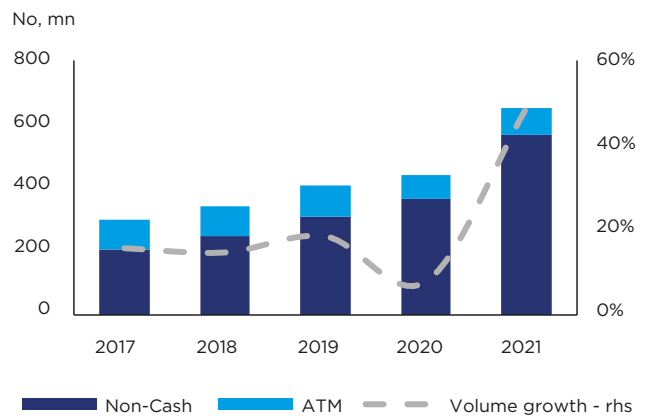
and electronic transactions further widened in 2021 (figure 5.1)<sup>1</sup>, highlighting the dominance of E-payments for the second consecutive year. Meanwhile, paper-based transactions, both in terms of value and volume, have fallen below the 5-year average. This trend is indicative of higher consumer confidence and increased accessibility of E-payment mediums.

The volume of E-payment transactions recorded historic double-digit growth of 49% in 2021 (figure 5.2). Similarly, the value of the transactions alludes to the same theme: E-payment dominance. The value of E-payment transactions recorded 34% growth in 2021 (figure 5.3), primarily driven by non-cash<sup>2</sup> transactions.

**5.1 Paper Based Vs E-Payment**



**5.2 Use of E-Payment (Volume)**



1 Paper-based transactions represent cheques presented to local banks while E-payments include transactions conducted via Point of Sale (POS) machines, Automatic Teller Machines (ATMs) and online payments.

2 Non-cash transactions include POS transactions and online payments.

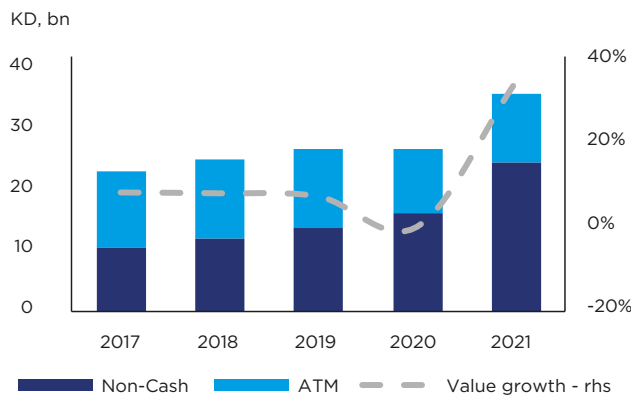
The growth in total non-cash transactions was nearly five times greater than that witnessed in traditional cash transactions, to which ATMs are used as a proxy (figure 5.4). As the year 2020 led to pent-up demand and a behavioral shift among consumers, the rebound in transactions during 2021 reflects the combined effects of debt moratoriums, eased health restrictions, and the re-opening of the economy. The combination of these factors was responsible for fueling transactions growth. In essence, the increase in total transactions was boosted by the reliance on transactions that are both cashless and contactless. In relative terms, the value of ATM transactions grew at a much slower pace compared to transactions executed via non-cash means (figure 5.5).

Furthermore, value of online transactions recorded their highest levels in 2021, driving the growth of E-payment transactions and constituting nearly 43% of total non-cash transactions (figure 5.6).

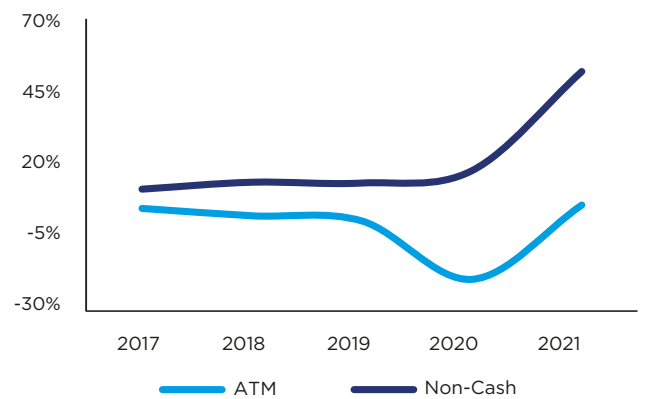
Additionally, several E-payment companies were established and started operating locally in recent years, giving broader access to E-payment solutions. Hence, an influx of transactions from various economic sectors - previously executed via cash settlement - are now included within E-payment transactions due to the accessibility, timely execution and overall efficiency of said solutions. These E-payment companies are currently within CBK's supervisory scope, ensuring efficiency and sustainability of payment mediums by guiding businesses to operate according to best practices and global standards.

Similarly, the payment infrastructure momentum picked up after decelerating in 2020 due to the hindering effects of the pandemic. POS machines increased at a rate surpassing ATM growth (figure 5.7), further underpinning the demand for E-payment mediums. In 2021, the number of POS machines grew at a rate faster than the 5-year average, at 9.2%. ATM growth

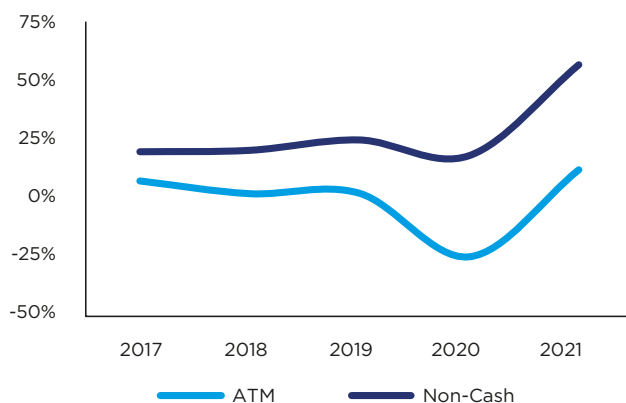
**5.3 Use of E-Payment (Value)**



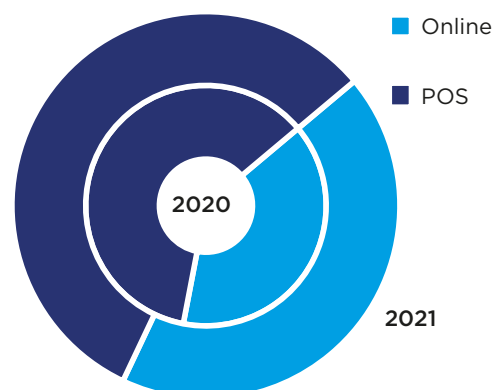
**5.5 Growth Rate in E-Payment (By Value)**



**5.4 Growth Rate in E-Payment (By Volume)**



**5.6 Breakdown of Non-Cash Transactions by Value**

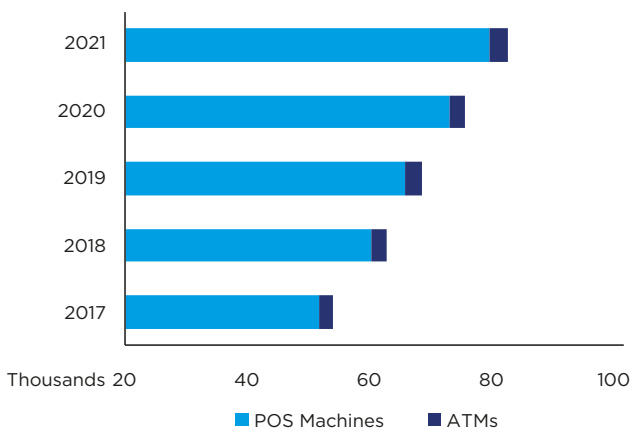


trailed behind on the other hand, registering a growth of 5.2%. These trends emphasize the shift towards non-cash payments and underscore their dominance.

In regard to plastic cards, by the end of 2021 the number of valid cards registered a slight increase. Debit cards increased by 0.4% to constitute 84% of total cards by the end of 2021. Credit cards represented the remaining 16% and witnessed a decline on an annual basis. Decline in total credit cards has been ongoing since 2019, despite the value of transactions sustaining an upward trajectory (with the exception of 2020). This diverging trend between number of credit cards and value of transactions suggests that banks' specialized loyalty campaigns (such as cash-back, and others) have managed to encourage customers to rely on a few credit cards, also reducing fees paid. Overall, the modest growth in cards - mostly due to debit cards - is closely tied to demographic changes (figure 5.8). For the past 5 years, the total number of nationals above the age of 15 maintained a steady 3% annual increase. Moreover, the growth rate in debit cards slowed down noticeably after the crisis, further underscoring a potential shift in consumer behavior.

In contrast to the modest upward trend in plastic cards, banks physical reach remained largely unchanged with branches reaching their lowest number in five years (figure 5.9). This comes as no surprise, as the local demographic has consistently demonstrated a preference for advanced electronic channels for financial services, which give access to the majority of

**5.7 E-Payment Infrastructure in Kuwait**

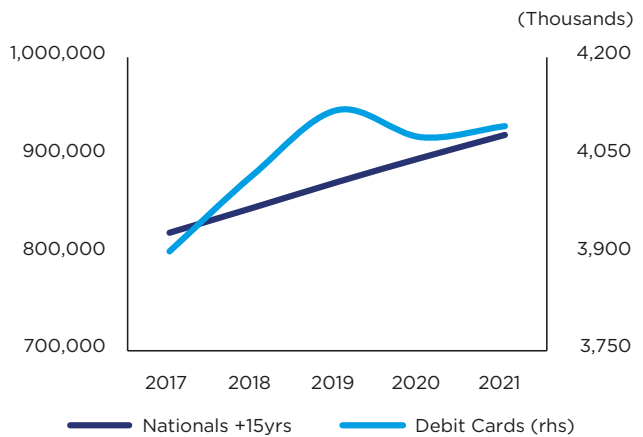


**The local banking sector witnessed the introduction of two “digital banks as a unit”.**

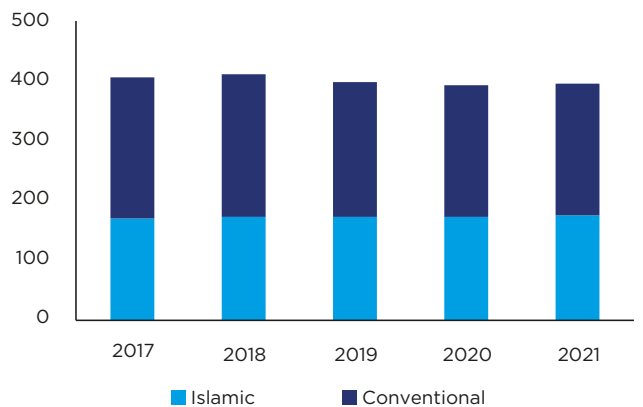
services provided at branches. Specifically, only Islamic banks increased the number of branches (four branches) available, whereas conventional banks closed three of their branches. A further decline in physical branches in the near future is possible against a backdrop of more digitized-services, which provide customers with the convenience of instantaneous and secure transactions within arm's reach<sup>3</sup>.

That said, in 2021 the local banking sector witnessed the introduction of two “digital banks as a unit”. One targets the younger demographic,

**5.8 Debit Cards**



**5.9 Banks' Branches in Kuwait**



<sup>3</sup> For further insight on digital banking refer to The Local Shift Towards Digital Banking Box.

while the other aims to provide financial services to low-income workers in Kuwait. The latter consists of a digital wallet that operates entirely through a mobile application to facilitate international fund transfers, which is a financial service frequently demanded by low-income workers. These milestones are merely the beginning of the digital transition, which will enable banks to adapt and benefit from efficiencies while simultaneously contributing to financial inclusion as well as infrastructure and economic development.

In line with the advancements in payment systems, CBK relaunched an enhanced version of the real time gross settlement system (KASSIP). The new system enables instantaneous settlement of all local payments and transfers between banks and customers via CBK’s secure Virtual Private Network (VPN) as the main settlement medium. KASSIP now employs best practices for payments & settlements and complies with international standards (ISO20022) related to Financial and Payment Messages, along with the Bank for International Settlements’ Principles for Financial Market Infrastructures. In comparison to the previous protocol whereby the settlements were executed via SWIFT, currently CBK’s KASSIP provides increased efficiency and enhanced security.

While the value of transactions executed via KASSIP continued on a downward trend, settling below its 5-year average and registering a 5% decline, the volume recorded a 32% growth, slightly below last year (figure 5.10). The decline in the value of transactions is mainly attributable to an increase seen in banks’ core funding (i.e. deposits), hence reducing the reliance on the interbank market, as well as the closure of a foreign bank. On the other

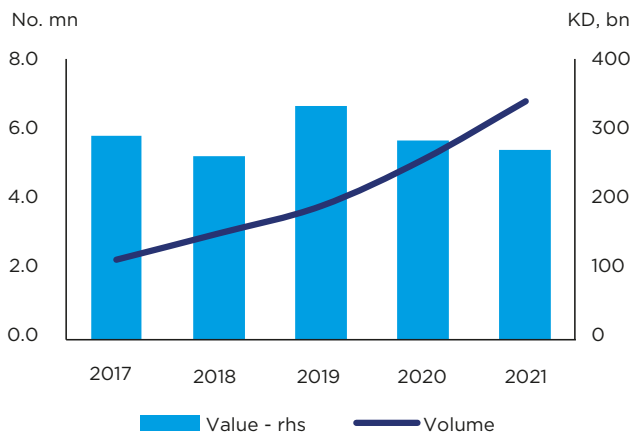
**In 2021, CBK relaunched an enhanced version of the real time gross settlement system (KASSIP).**

hand, the volume of transactions continued on an upward trend, supported by the re-opening of economy.

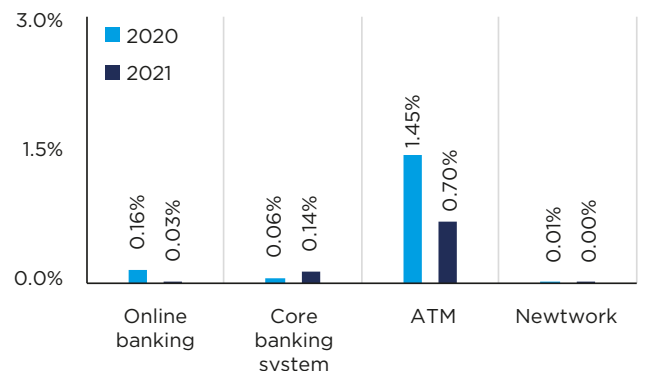
Lastly, and in line with CBK’s oversight and supervisory scope, the performance of payment infrastructure is vigilantly monitored. This is done by utilizing an array of Key Risk Indicators (figure 5.11) that provide a performance assessment to highlight the areas of strength and aspects that require further development. In an annual comparison, the indicators witnessed a broad improvement, and most importantly, unplanned downtime for both ATMs and Online Banking declined. This is despite the surge in the volume of transactions executed compared to 2020. Likewise, banks reported no unplanned network disruption, highlighting operational resilience despite the continuously evolving landscape. Although most indicators improved, unplanned downtime linked to banks’ core systems slightly increased. This was mostly due to third-party service providers, with two banks contributing to the modest increase seen in the sector’s average. Despite the minor increase, the sectors overall performance remains within tolerable bounds.

All in all, CBK’s oversight ultimately seeks to ensure having safe, efficient, and secure payment systems that facilitate transactions across various sectors of the economy. Thus, by ensuring the smooth and uninterrupted settlement of payments in the local economy, CBK reinforces the stability of the financial system in the State of Kuwait.

**5.10 Transactions via KASSIP**



**5.11 Unplanned Systems Downtime**



## BOX 5.1:

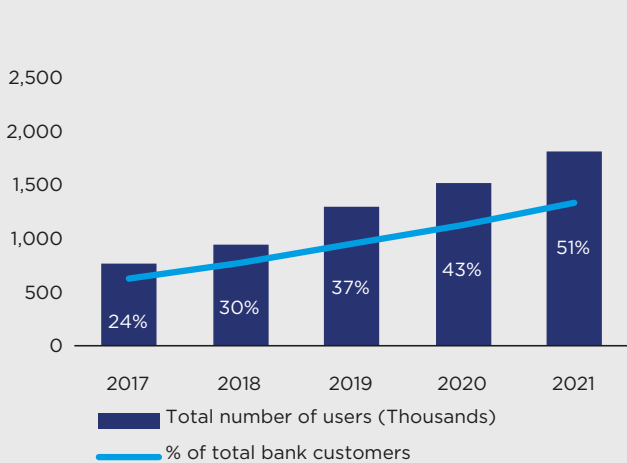
# The Local Shift Towards Digital Banking

Banks around the world are changing their ways of conducting business, transitioning from brick-and-mortar to digital. This global shift to digitization is altering the operational landscape and has an uneven effect on dynamics such as customer loyalty, banks’ efficiencies, and talent acquisition. While gains in areas like efficiency will be made, with McKinsey estimating “\$400 billion of savings in direct costs annually by shifting from traditional to digital accounts”<sup>1</sup>, challenges in other aspects such as competition and talent availability will arise. In an era of increased globalization where winner-takes-all dynamics have contributed to industry consolidations, competition to obtain and retain client loyalty is fiercer than ever. Changing demand for talent, where old skills are rendered obsolete and digitizing banks are unable to source employees with the necessary technological aptitudes, can effectively constrain the transformation and lead to inefficiencies. Given the complexity of the issue, this box aims to discuss the push to digital banking, including opportunities, considerations, and CBK’s facilitating role.

### Digital Banking in Kuwait

Digital banking, defined broadly as any banking service that can be completed online, has been domestically available since 1998, proliferating at an exponential rate since the mid-2000s. Increased demand for online services has been witnessed in the local banking sector, further propelled by the Covid-19 pandemic (figure 1). In the GCC region, digital banks have mostly been established by traditional banks, but that trend is expected to change soon as the region races to meet international e-banking standards. Domestically, CBK is an avid supporter of the move towards digitization, with initiatives including, but not limited to: the Fintech Regulatory Sandbox<sup>2</sup>, the Kuwait National Payment System<sup>3</sup>, the e-KYC framework<sup>4</sup>, and Open Banking. Following the global shift towards digital banking, the next step is the launch of digital banks domestically. There are a number of digital banking models, all requiring digital onboarding (such as e-KYC and e-Signature) to benefit from a complete digital offering for new customers. It is still unclear as to how the digital banking

**Figure 1**  
DB Platform Users



**Figure 2**  
Call Center Calls



1 McKinsey & Company -FinTechnicolour - 2016

2 An initiative allowing for startups and entrepreneurs to develop innovative products and services with support from CBK, safeguarding the stability of the financial and banking sector.

3 An online payment platform intended to improve the efficiency of the financial system.

4 The electronic Know Your Customer framework will ease the account opening process by making it electronic and more efficient.

industry will mature as the banking world races to shift and adapt to this modern approach, which makes the assessment of opportunities and risks essential.

## Opportunities

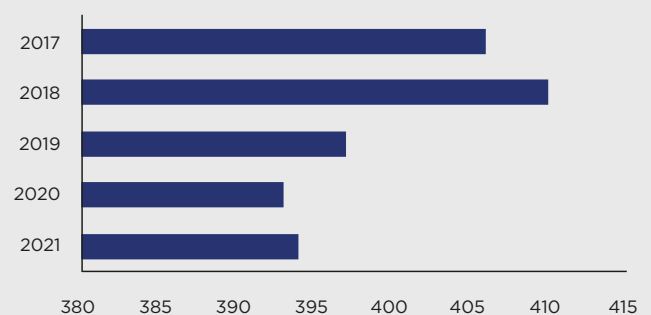
In an era of continuous innovation with increased dependency on technology and amplified customer expectations, switching to digital banking is proving to be of the utmost importance in order to maintain relevance and remain competitive in the banking industry. This, in turn, provides numerous opportunities in various aspects such as cost savings, new job offerings, increased cyber security, and real-time data analytics to forecast customer needs and offer better services. Opportunities to partner with financial technology (Fintech) companies to introduce newer, more efficient technology will arise, decreasing bank costs in the long run, and increasing job offerings for individuals with technological expertise. Latest figures show that the total annual industry cost to run all local bank branches amounts to approximately KD 129.5mn, while the total annual cost to maintain digital platforms is KD 12.4mn. This implies potential industry cost savings of approximately KD 117.1mn annually, all else being equal, if local banks decide to fully depend on digital platforms. Less reliance on human interaction to fulfill banking services is evident in call centers, where growth in agent calls (calls requiring a human operator) has been slowing (figure 2) and is expected to decline in the future, representing further cost-saving and efficiency increasing opportunities. These effects have been exacerbated by Covid-induced behavioral shifts, with new consumer segments being a force to reckon with, and subsequently stressing the importance of adopting digital services. As stated, these dynamics are expected to continue as more services that were previously only available through physical presence become accessible online. According to industry surveys, on average, banks expect the digitization of 26 services which were previously only available offline. These include, but are not limited to, approvals and issuance of facilities, opening minor accounts, updating KYC electronically, and cheque deposits.

## Considerations

The world is inevitably heading towards digitization, and this transition is not without its risks. Banks are starting to downsize, the number of physical branches is dropping, and some bank roles are slowly becoming obsolete (figure 3). Technological infrastructure development is not cheap; large investments in tech teams and frequent training sessions should be expected, as well as the need for constant updates, security controls, and maintenance due to the fast-paced nature of technological advancements.

On the upside, new job openings arise creating opportunities for digitally-skilled talents. However, the digital world is relatively new and ever evolving, so finding human resources with right expertise might prove to be difficult. While some banks opt to outsource their digital infrastructure, it might – if not managed properly – exacerbate the aforementioned risks. Furthermore, going digital increases cyber risk as seen following the Covid-19 outbreak where the world witnessed a huge threat to cyber security and personal data due to the rushed implementation of online services. To combat that, and to minimize disruption of activities, firm risk controls should be set, and implementation must be thoroughly thought out. Prioritizing the adoption of the latest advances in technology and security is paramount and remains to be an ongoing concern for all. Banks should promptly address the latest developments, as failure to do so may potentially lead to large losses. Considerations should also be made for services that will always require physical presence which, according to industry surveys, include cash transactions, deposit box services, and power of attorney services.

**Figure 3**  
Number of Local Bank Branches



## CBK Facilitation

In CBK’s constant efforts to encourage innovation and provide the best services to customers, the digital banking framework was developed to organize and facilitate digital banking services. The new framework introduced the establishment of standalone digital banks (DB), resulting in a total of three types of locally available DB’s as follows:

- Digital Bank as a Unit (Digital BU): a digital business unit within an existing traditional bank that shares the same balance sheet but under a different brand. Digital BUs already exist locally, including an initiative targeting the youth segment and another targeting unbanked individuals.
- Bank as a Service (BaaS): a partnership between a licensed bank and other players in the digital realm. It serves as an outsourcing agreement, where the third party provides BaaS to customers through the bank without needing to undergo a lengthy and costly licensing process to expand. Customers will benefit from this type of model as it incorporates innovative financial services with improved experience at lower costs. Banks will also benefit as they acquire clients through access to a partner client base, creating new revenue streams through service fees and cross-selling their own products on multiple platforms, such as third-party providers.
- Standalone Digital Bank: This bank is a new addition to the local banking sector; a standalone bank exists without the presence of a traditional bank prior to its initiation. A standalone digital bank usually operates under a universal banking license, with full digital services that are mostly reliant on cloud systems.

CBK is kick-starting the standalone digital banking journey by implementing the universal license. This license ensures fast implementation and is less complex compared to other licensing options available internationally, as it does not require amending local law. This makes it more feasible for applicants that are ready to submit their requests.

In order to approve applications for a license, CBK conducts a rigorous assessment based on international best practices. The assessment seeks to ensure two key goals: applicant readiness and market value-added. Verifying that applicants are fully capable and prepared is captured through the endeavor plans such as expertise, capabilities and safeguards (sufficient capital). Market value added on the other hand is demonstrating that the proposal brings benefits ranging from fostering competition, developing innovative services, and catering to underserved segments, without threatening the banking system’s stability. CBK’s assessment consists of seven dimensions covering purpose, potential risks and other evaluation metrics to facilitate a well-rounded assessment. Each dimension includes further detailed criteria (figure 4).

**Figure 4**  
Seven Dimensions Used to Assess Applicants



As CBK strives to promote and support the digital transformation locally, having such criteria assessment is key as CBK acknowledges the challenges that lie ahead. Enhancing supervisory capabilities and internal methods via adopting the appropriate tools to implement digitization within CBK is the first step towards a smooth digital transition. CBK is currently widening the employee talent pool and focusing on the development of its internal technical team, as well as the local banking industry, through knowledge-enriching programs and the latest tools.

### Takeaways

The digital world is dynamic, characterized by rapid speed, a high frequency of transactions, and a greater chance of security disruptions. Tomorrow's banks are expected to be one step ahead as they become more digitally enabled and better equipped to anticipate their customers' needs. With these new opportunities come new risks and threats to financial stability. In light of its role, CBK stands ready to facilitate the transition, striking a balance between fostering innovation while simultaneously addressing the risks to induce a vibrant financial system, protect the end consumer, and preserve financial stability.



