



CENTRAL BANK OF KUWAIT



FINANCIAL STABILITY REPORT 2012



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Financial Stability Report

for the calendar year 2012

Financial Stability Office
Central Bank of Kuwait



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



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



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

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PREFACE

Financial stability means that the financial system, covering financial institutions, markets and infrastructure, continues to ensure the efficient allocation of financial resources and fulfills its key macroeconomic objectives even during times of stress.

The Central Bank of Kuwait (CBK), as the leading regulator of the financial system, devotes considerable efforts and resources to ensure a sound and stable financial system in Kuwait. A separate Financial Stability Office (FSO) has been set up with the mandate to examine trends in the financial system and identify vulnerabilities early on. The Financial Stability Report (FSR) is the flagship publication of the FSO, evaluating the performance of various components of the financial system, and serving as a key surveillance tool for the CBK by identifying critical risks and providing early warnings for potential threats to systemic stability.

This FSR, the first being published by the CBK, is composed of five chapters covering all three aspects of the financial system: institutions, markets and infrastructure. We dedicate the first three chapters for the coverage of the banking sector, the most significant component of our financial system. Chapter 1 assesses the role and performance of banks, both conventional and Islamic, as financial intermediaries, thus highlighting trends in both credit allocation and deposit mobilization. Chapter 2 evaluates the risks faced by the banking system, covering various dimensions of credit, market and liquidity risks. Chapter 3 examines the trends in profitability and solvency of the banking system and its resilience against a variety of major shocks, both endogenous and exogenous under different financial and economic stress scenarios. Chapter 4 explores the key developments in money, foreign exchange, equity and real estate markets, the four key components of our domestic market setup. Finally, chapter 5 examines the performance of retail and large-scale payment and settlement systems in the country. At the end of each chapter, some relevant discussion on topical issues has also been provided.

By publishing our maiden FSR, we intend to further promote transparency and generate debate among stakeholders about how best to ensure the continuation of a stable and robust financial system. Indeed, more than eighty countries as well as key multilateral institutions like the IMF and the European Central Bank have been publishing annual or semi-annual FSRs to increase awareness about the developments in the financial systems at domestic and international levels. Through this FSR, we hope to help our readers form a better understanding of the financial system in Kuwait and generate a constructive debate about myriad trends in our financial landscape.

Finally, we seek the assistance of the Almighty in our pursuit of prosperity and stability of our cherished homeland and express our gratitude to His Highness the Amir, Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, His Highness the Crown Prince, Sheikh Nawaf Al-Ahmad Al-Jaber Al-Sabah, and His Highness the Prime Minister Sheikh Jaber Al-Mubarak Al-Hamad Al-Sabah, may Allah bestow on them good health and continued success.

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



COVERAGE AND DATA CONVENTIONS

This Financial Stability Report (FSR) primarily examines the performance of the key components of the financial system for the calendar year 2012 (CY12) using December 31st, 2012 as the cut-off date. All amounts are in Kuwaiti Dinar (KD), unless specified otherwise.

Our analysis of the banking system in the first three chapters of this FSR is based on consolidated banking system data, including both conventional and Islamic banks within Kuwait and their subsidiaries abroad. Due to some data limitations, we have not covered the performance of 11 foreign bank branches in Kuwait (which accounts for about 4.2% of the consolidated banking system) but we intend to make it part of our analysis in the future. Therefore, readers are cautioned that our consolidated banking system data differs from the Kuwait only data that is available on CBK's website. The last two chapters of the report cover, respectively, performance of the domestic markets and payment & settlement systems within Kuwait only.



Executive Summary

Kuwait has a bank-centric financial system, with the banking system accounting for 78% of the domestic financial sector. Moreover, with the transfer of investment companies¹ to the Capital Market Authority (CMA), the banking system also constitutes the most significant component of the Central Bank of Kuwait's regulatory ambit. Accordingly, our discussion about financial intermediation, risks and resilience of the financial system is essentially focused on the banking sector. However, we separately cover the performance of domestic markets and payment & settlement systems in Kuwait.

Kuwait's bank-centric financial system has experienced positive developments during 2012

During the year under review (2012), the banking system has experienced positive developments on almost all fronts, ranging from strong growth in assets and deposits to a visible drop in non-performing loans (NPLs) and gains, albeit modest, in profits. Specifically, during 2012, assets of the banking system, on a consolidated basis, witnessed strong growth of 7.5%, the highest in the last four years. Growth in assets was fairly broad based as all key components made positive contributions, though banks' investment portfolio experienced relatively slower growth due to contraction in banks' equity investments. Banks' exposure to Eurozone, with only 6.5% of their total investments and 7.6% of their gross loans, is well contained. On the deposit mobilization side, banks' deposits recorded an impressive growth of 11.6% on the back of strong contribution by both domestic and foreign operations of Kuwaiti banks. With 65% of banks' deposits in the time deposit category, the banking system has been able to enjoy a stable funding base. Moreover, the presence of a formal deposit guarantee law in Kuwait has effectively eliminated the risk of deposit runs, further cementing the funding stability in the banking system.

Growth in assets and deposits have been strongest since 2008

The risk profile of the banking system reveals that given the traditional nature of banking, credit risk appears the most significant risk for Kuwaiti banks, accounting for 90% of their risk-weighted assets. Positively, credit risk has been receding in the last few years, with a perceptible drop both in gross and net NPLs, thanks to banks' better risk management and conservative lending practices in accordance with CBK's instructions and active encouragement. Accordingly, the NPL ratio has come down from 7% in 2011 to 5.2% in 2012. Analysis of the NPLs by age also reveals a visible slowdown in the buildup of new NPLs as loans 'under monitoring' and 'substandard' categories have sharply dropped in 2012. These trends are also supported by the drop in NPLs in all the key sectors including investment companies, with the only exception of the real estate sector. Industry analysis suggests that conventional banks account for 66.4% of the total NPLs,

Both the level and ratio of NPLs have visibly dropped

¹ Except for their financing activities which are still regulated by the CBK. Investment companies are the second major player in domestic financial system with around 21% share as of December 2012. Exchange companies, insurance companies and funds constitute the rest.

compared to their share of 61.9% in gross loans. Sector-wise, the household sector appears the least infected. Geographically, banks have limited NPLs from their loans to the European region (around 3% of banks' total NPLs).

Banks' liquidity levels have been fairly strong and the funding base quite stable. Yet, banks' equity investments are significant, making up to 29% of their total investments and the use of firms' shares as collaterals accounts for 32% of banks' overall collaterals. In case of some banks, higher equity investments reflect the debt to equity swaps they have made with investment companies in the past.

Banks enjoy ample liquidity and stable funding base

Data for banks' operating performance reveals that during 2012, banks' net income registered a modest gain of 1.25% to reach KD 574.9 million. Islamic banks improved their share in the industry profits though conventional banks still account for more than two-thirds of the total profits. Capital adequacy levels of the banking sector have been robust around 18.2%, when viewed in terms of Basel II capital requirements. Results of CBK's Quarterly Stress Testing Exercise reveal that banks are well placed to withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro economic scenarios.

Banks' net income recorded a modest gain and capital adequacy has remained strong

A look at the performance of the domestic markets reveals that the money market remained fairly liquid during 2012, with the inter-bank rates at historically low levels. The CBK slashed its discount rate by 50 basis points to 2% in October 2012. Issuance of short term treasury bills dropped to nil since May 2012, as issuance of CBK bonds, particularly of six months' maturity, surged during 2012. Furthermore, CBK has issued treasury bonds of longer maturities to extend the sovereign yield curve to longer maturities and to provide a benchmark for pricing corporate debt. FX market remained stable with Kuwaiti Dinar (KD) slightly depreciating against some key currencies except for Japanese Yen where it registered strong appreciation. During the year, reserves held by CBK also touched new highs and import coverage ratio improved further.

Money market has remained liquid and FX market stable

The Kuwait Stock Exchange (KSE) remained buoyant during early 2012, but slow activity later led to only modest gains for the entire year. Introduction of a new trading system and a new index (Kuwait-15) were some other key developments at the local bourse. Yet the market remained shallow with only a few sectors like financial services, real estate and banks accounting for most of the market activity. Real estate market during 2012 grew by 16% in terms of value of the deals, with all segments recording positive growth, including commercial segment which had experienced contraction in the previous three years.

KSE was particularly buoyant during early 2012; Real estate market observed positive growth in all segments

Performance of the payment and settlement systems in Kuwait reveals that both retail and large-scale payment systems have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. In case of retail payments, use of ATMs and point of sale (POS) related transactions have witnessed a growth of 6% and 15%, respectively, during 2012, when viewed in terms of value of the transactions. During the year, share of ATMs related transactions was higher (62%) in value while that of POS transactions was higher in terms of volume (54%). E-banking infrastructure has also been growing in Kuwait, as the number of ATMs and POS machines witnessed a growth of 15% and 11%, respectively reaching 1,428 and 28,432 machines by December 2012. While electronic based transactions account for 97% of all transactions in terms of volume, paper based transactions (through cheques) still have a sizeable share (56%) in terms of value. Large-scale payment system (KASSIP) handled 1.02 million transactions worth KD 294 billion during 2012.

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

In the months ahead, credit growth may remain subdued on account of slower progress in the implementation of the Kuwait Development Plan amid political stalemate. Yet credit off-take is likely to be somewhat stronger in the household sector on the back of higher disposable incomes of Kuwaiti citizens and improvements in domestic real estate and stock market. Banks are also likely to continue the expansion of their foreign operations, which already account for around 13.4% of their consolidated net income, to diversify away from a narrow financing base on the domestic front. Growth in NPLs is hoped to further taper off, with better risk management by the banks and improvements in the real estate market where banks still have significant exposure. A buoyant stock market is also likely to help improve the value of banks' equity collaterals. However, given the undiversified nature of the domestic economy, banks' exposures would remain concentrated, warranting a delicate balance between providing the requisite financing to maintain adequate growth while containing over exposures and ensuring better diversification of credit portfolios, both in domestic and foreign operations.

Improving economic environment augers well for banks but concentrations need to be adequately managed



CHAPTER 1

BANKS' FINANCIAL INTERMEDIATION

2022

1

BANKS' FINANCIAL INTERMEDIATION

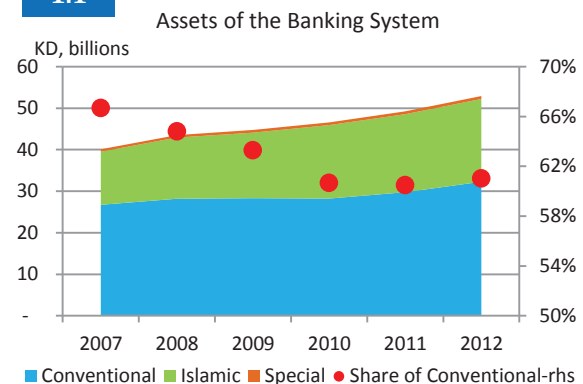
During the year under review (2012), the banking system assets, on consolidated basis, witnessed strong growth of 7.5%, the highest in the last four years. Growth in assets was fairly broad based as all key components made positive contributions, though banks' investment portfolio experienced relatively slower growth due to contraction in equity investments. Banks' exposure to the Eurozone, with only 6.5% of their total investments and 7.6% of their gross loans, is well contained. Finally, banks' deposits recorded an impressive growth of 11.6% on the back of strong contribution by both domestic and foreign operations of Kuwaiti banks. With 65% of banks' deposits in the time deposit category, the banking system enjoys a stable funding base.

Conventional banks account for around 61% of the banking system

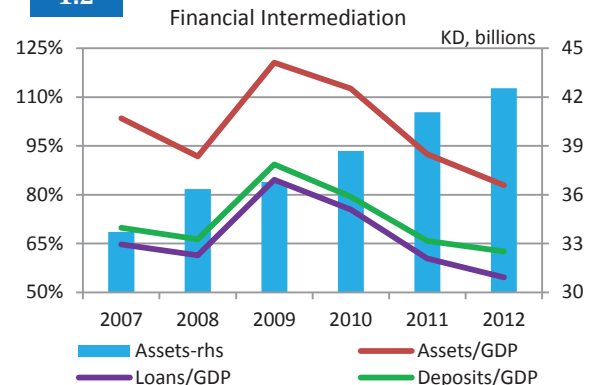
Kuwait has a bank-centric financial system composed of eleven domestic banks, including five conventional, five Islamic and one specialized bank. Conventional banks, with 61% share as of December 2012 in the banks' total assets of 52.89 billion¹, dominate the overall banking system, though their share has slightly come down over the last few years, albeit with some improvement during 2012 (*Figure 1.1*).

While there has been steady growth in banking assets, trends in financial intermediation, as measured by key banking variables with respect to nominal GDP, have exhibited fluctuations over the years (*Figure 1.2*). However, it is more due to sharp changes in the GDP than in the banking variables; for instance, Kuwait's GDP dropped from 39.6 billion in 2008 to 30.5 billion in 2009, thus significantly improving the intermediation ratios. In later years (from 2010 onwards), the intermediation ratios have tapered off due to much stronger growth in GDP than in the banking sector variables².

1.1



1.2



¹ These numbers are based on consolidated data that includes Kuwaiti banks' subsidiaries abroad. However, due to some data limitations, this data does not cover 11 foreign bank branches in Kuwait that account for 4.2% of the consolidated banking assets.

² For instance, while banking assets increased by 7.5% during 2012, nominal GDP was up by 15.7%.

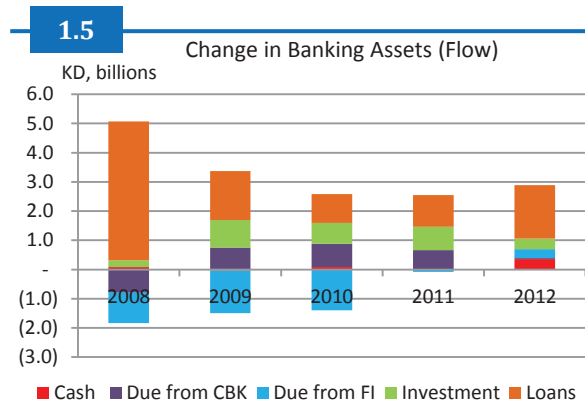
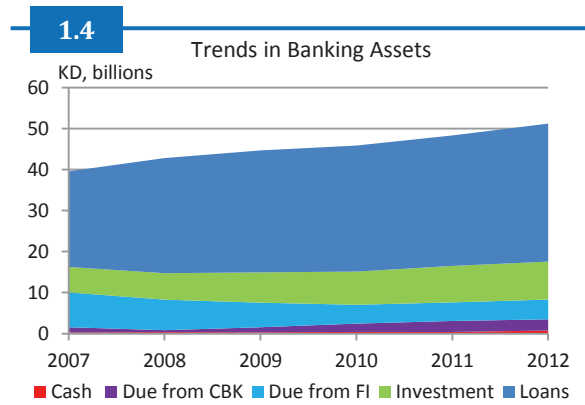
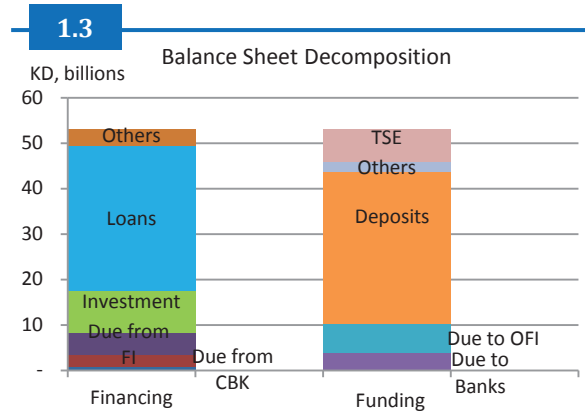
Kuwait's banking system remains fairly traditional

By looking at the balance sheet composition, it becomes obvious that the banking system is dominated by traditional instruments. On the assets side, loans understandably constitute the bulk, with net loans accounting for 60% of the total assets as of December 2012. Investments, comprising of exposures to government securities, other fixed income instruments, equity investments and real estate investments, form the second major category with 17% share in total assets. On the liabilities side, deposits account for 63% of the total liabilities, indicating a healthy deposit base to help Kuwaiti banks befittingly perform their intermediation role.

Growth in banking assets (7.5%) was highest in the last four years

During 2012, the banking assets grew by 3.7 billion to reach at 52.89 billion, representing growth of 7.5% during the year, strongest growth since 2008. A look at the asset composition of banks reveals that both loans and investments have not only remained the two major components of the banks' balance sheet but have also increased their share over the years (*Figure 1.4*).

Flow data for the key components of banks' assets indicates that growth in assets was broad based, with positive contribution by all the key components in overall asset growth, in particular from loans which increased by 1.83 billion during the year. (*Figure 1.5*). Contrary to previous years, banks also closed the year 2012 with a sizeable increase in their cash holdings. 'Due from Financial Institutions' which includes both interbank lending and placements, also made a positive contribution on the back of greater foreign currency placements among banks, after experiencing contraction in the last four years, albeit a mild one in 2011. In particular, interbank lending has been falling since 2008 while placements have remained somewhat stable.



Growth in banks' investment portfolio slowed down due to contraction in equity investments

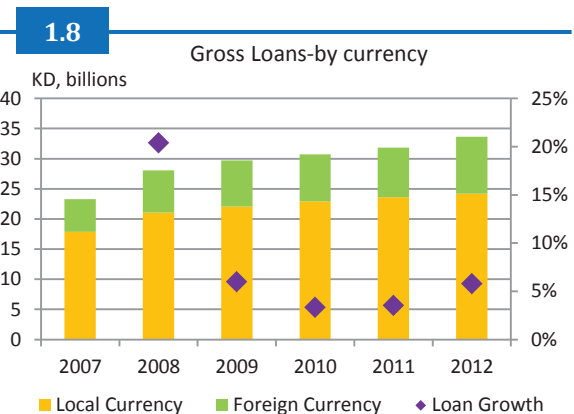
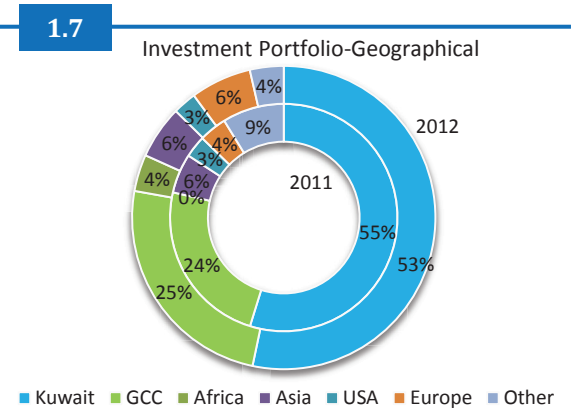
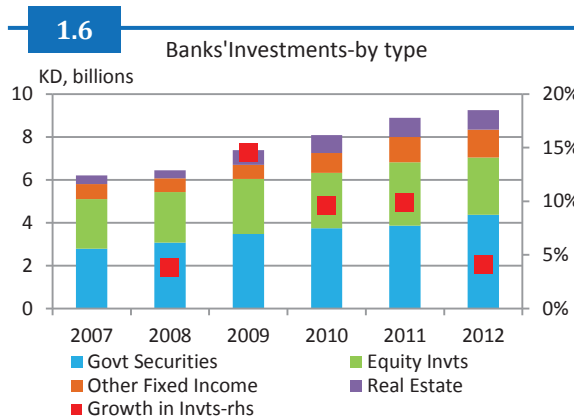
Banks' investments portfolio witnessed a much slower growth rate of 4.07% during 2012, compared to almost double digit growth in the earlier three years period (2009-11), essentially because of 9.4% contraction in equity investments. Break up of investments reveals that out of total 9.25 billion of investments, around 4.37 billion (47%) were placed in government securities as of December 2012 (Figure 1.6). Banks' equity investments formed the second major category with 29% share in total investments. In the last few years, banks' exposure to other fixed income securities have increased, though their share still remains around 14% for 2012.

Banks' investment exposure to Eurozone is quite marginal

Geographically, a little more than half of the banks' investment portfolio consists of investments within Kuwait, followed by a quarter placed within GCC countries (Figure 1.7). The remaining around 22.2% of the portfolio is distributed across many regions, including Africa, Asia and Europe etc. More importantly, banks investment portfolio has a minimal exposure to the crisis-hit Eurozone, with only 6.5% share in banks' total investments, thus saving banks from any serious implications despite ongoing concerns about Eurozone countries, particularly about the peripheral economies.

Almost all the lending has been to private sector, mostly in LCY

During 2012, banks extended 1.8 billion of new loans, registering growth of 5.76% (Figure 1.8). Bulk of these loans (72%) was in local currency (LCY), though the share of foreign currency loans inched up from 26% in 2011 to 28% in 2012. Loans' break up in terms of lending to public and private sector reveals that banks extended 98% of their loans to private sector, with remaining 2% to the public sector, essentially to some state-owned enterprises. Share of public sector



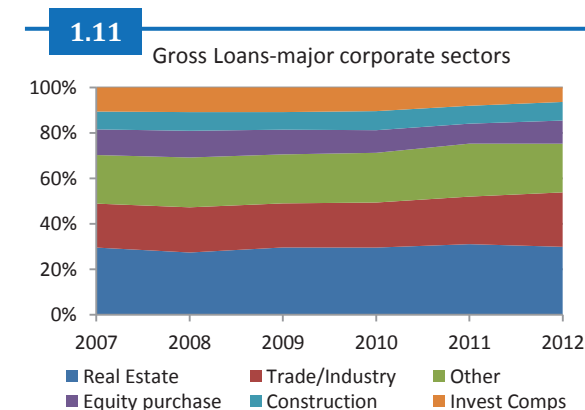
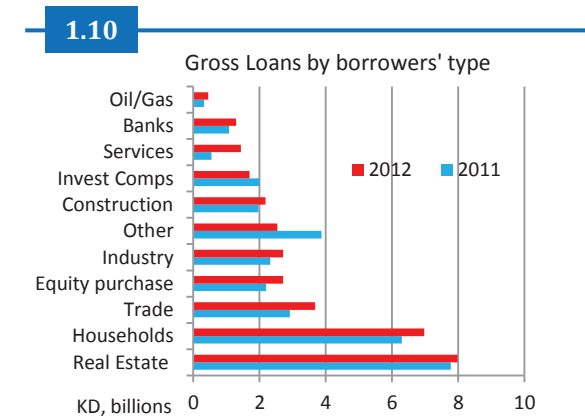
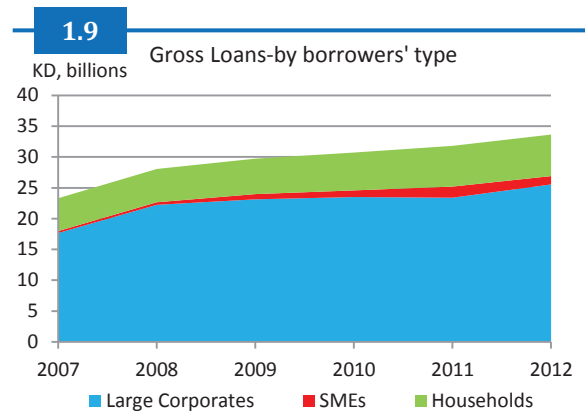
lending has remained almost flat around 2% in the last few years. With strong revenue profile of the public sector on the back of robust current account and budget surpluses over the last decade, the need for public sector to borrow from the banking system remains minimal.

In terms of types of borrowers, large corporates account for around 3/4th of total gross loans; as of December 2012, loans worth 25.6 billion were outstanding against these large corporates (*Figure 1.9*). Share of SMEs in overall lending has been fairly small, around 4% during 2012. In terms of credit allocation, banks' second biggest exposure remains towards the households. As of December 2012, loans outstanding against the households were around 6.97 billion, accounting for 20% of banks' gross loans.

Credit to all sectors recorded positive growth, except for the investment companies

Breakup of gross loans across various sectors reveals that loans extended to real estate sector and to households account for around 45% of the gross loans. As of December 2012, real estate and households had outstanding credit worth around 8 and 7 billion respectively (*Figure 1.10*). During 2012, almost all sectors experienced positive growth in credit, except for *investment companies* and *others*. Banks have been reducing their exposure to investment companies for the last few years; accordingly, the share of loans to investment companies in banks' gross loan portfolio has dropped from 9% in 2009 to 5% by 2012.

The trend in loans over the years reveals that banks' exposure to key sectors has remained fairly stable, with little indication of sudden surge in any specific sector (*Figure 1.11*). While the loans are concentrated in few key sectors, stability of the credit allocations suggests that banks have avoided the boom and bust cycles in their lending practices, underlining a conservative approach towards credit allocation.

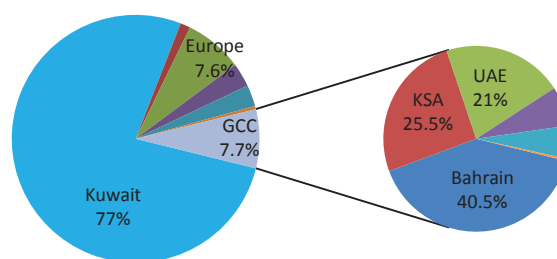


Geographically, banks' loan portfolio is well diversified

Out of banks' 33.65 billion of gross loans as of December 2012, 25.9 billion (77%) have been granted within Kuwait (Figure 1.12). The remaining 23% of the gross loans are distributed among various regions, with Europe and GCC each accounting for around 7.7%. Within GCC, banks' greatest exposure is to Bahrain, followed by KSA and UAE. Geographical distribution of banks' loan portfolio reveals that banks' exposure to troubled peripheral economies in Europe is particularly well contained.

1.12

Loan Portfolio-by region

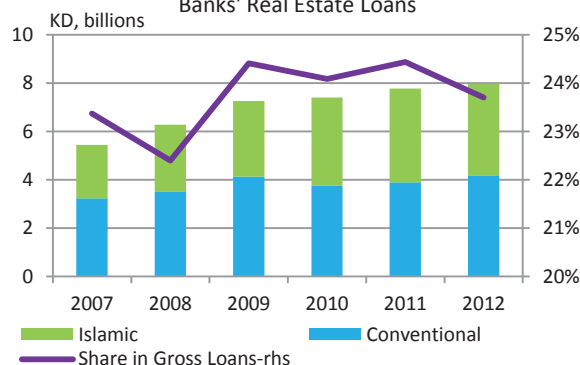


Banks' greatest credit exposure is to the real estate segment

Banks' most significant exposure is towards the real estate firms as these loans account for around 23.7% of banks' gross loan portfolio (Figure 1.13). Loan growth in this segment has been fairly muted in the last three years, with only 2.6% growth in 2012, compared to well above 15% growth in 2008 and 2009. Lending to real estate segment is almost equally divided into conventional and Islamic banks, with later accounting for 48% of total real estate loans during 2012.

1.13

Banks' Real Estate Loans

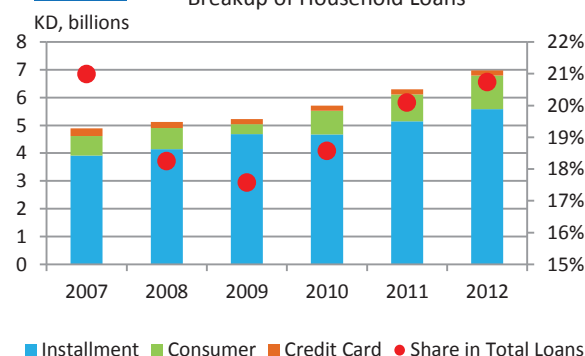


...followed by household segment which maintained double digit growth

Bank credit to household sector increased by 10.9% during 2012, slightly higher than the growth of 10.3% recorded during 2011. With 6.98 billion of outstanding credit, household sector loans account for around 20.7% of banks overall credit portfolio, up from 17.6% in 2009. Around 80% of the household loans have been *installment loans*, which are long term personal loans for repair and purchase of private homes (Figure 1.14). These loans are repaid in monthly installments over a period not exceeding 15 years.

1.14

Breakup of Household Loans



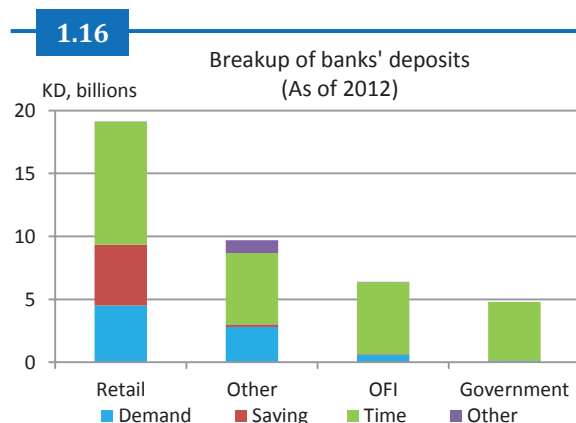
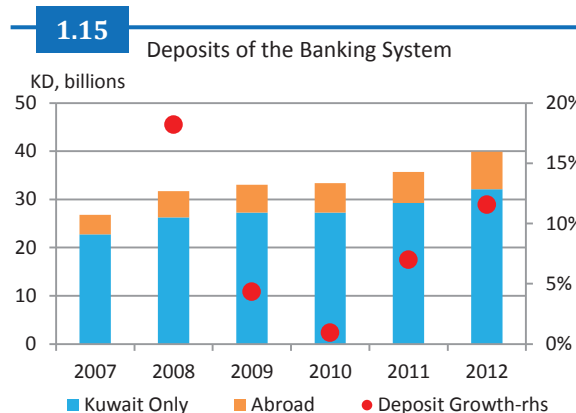
consumer loans have been slightly on rise in recent years, after shrinking to around 7% in 2009. Finally, credit card related loans make around 2.6% of household loans.

Growth in household loans can be explained by factors like lower cost of borrowing due to CBK’s cut in discount rate, as well as strong growth in personal income on the back of increase in salaries and wages of public sector employees in particular. Since household loans are backed by salaries of employees, strong rise in salaries during 2012 (which were up by 29% compared to a rise of 7% during 2011) had a positive effect on credit take-off by the household sector.

Banks’ deposit mobilization recorded robust growth in 2012

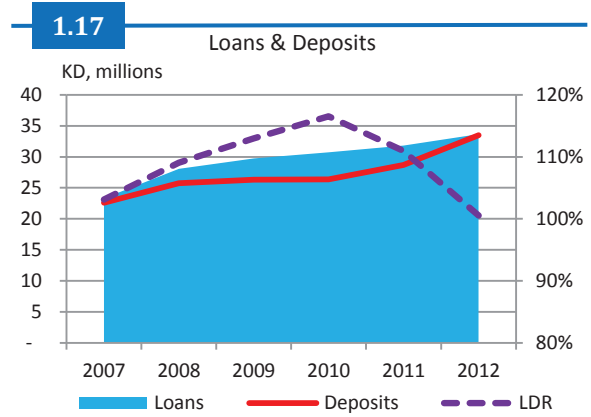
Overall deposits of the banking system have reached 39.85³ billion as of December 2012, recording an impressive growth of 11.6% over 2011 (Figure 1.15). Domestic deposits which account for 81% of total deposits of the banking system were up by 9.9% on the back of strong increase in salaries, of public sector employees in particular. Deposits raised through branches and subsidiaries abroad surged by 19% during 2012 as Kuwaiti banks expanded their operations abroad.

Breakdown of deposits reveal that retail deposits account for around 48% of total deposits. In terms of types of deposits, retail deposits are unsurprisingly well diversified, considering both their transaction and precautionary demands for money (Figure 1.16). Other financial institutions (OFI) and government deposits are overwhelmingly placed as time deposits. For the banking system as a whole, time deposits account for around 65% of the total deposits, highlighting the strong and stable deposit base of the banking system capable of providing stability under times of liquidity stress.



³ This includes government and private deposits as well as ‘due from other financial institutions’.

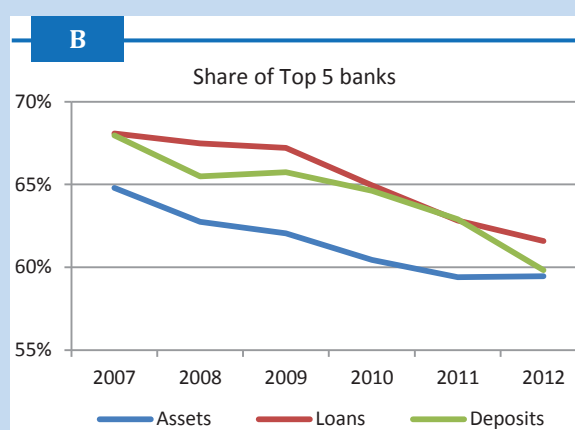
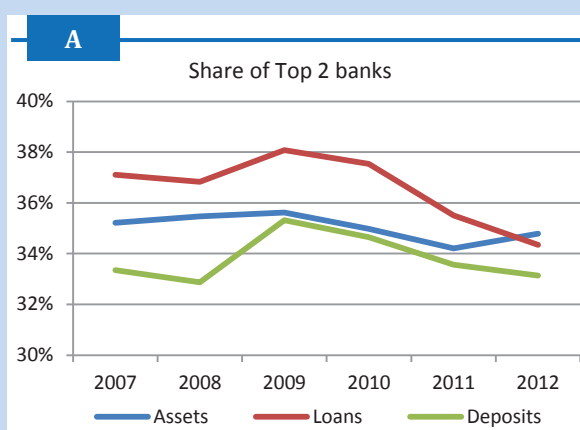
Since 2010, growth in deposit mobilization has been stronger than in loan portfolio, resulting in a steady decline in the loan-to-deposits (LDR) ratio⁴ (Figure 1.17). It is pertinent to mention that CBK no longer uses a simple LDR as a regulatory tool because it has designed a multi-purpose and a more comprehensive approach, effective since May 2012 (see Box 1.2).



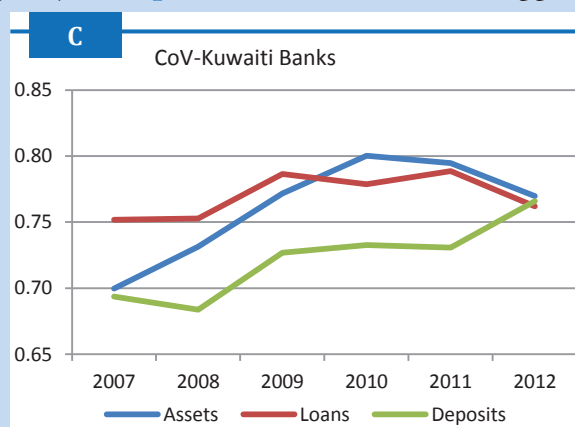
⁴ Here deposits only include government and private deposits, thus excluding 'due to OFIs'.

Concentration in the domestic banking sector⁵

Concentration in the banking sector can be measured in variety of ways. The **M-Concentration ratio**, a fairly simple measure, highlights the market share of *M* big participants in the industry. For instance, in case of Kuwait, the concentration ratio, when measured for top 2 and top 5 banks reveal that concentration ratio has dropped over the years since 2007. However, the drop in concentration is more pronounced in case of top 5. The share of top 2 banks, particularly when viewed in terms of assets, has remained fairly stable over the years. This suggests that while competition for assets has grown between banks 3 to 5 (ranked by assets), the top two banks have been able to retain their market share. In case of loans, the drop has been more pronounced in case of top 2 banks, suggesting higher competition in credit disbursements.



While simple concentration ratios like share of Top 2 or Top 5 banks indicate the level of concentration in industry, these measure fail to depict the dispersion around the mean, which can be viewed by using **coefficient of variation (CoV)**. As *Figure C* indicates, CoV has dropped during 2012 both in terms of assets and loans, suggesting lower dispersion around the mean and thus less concentration. In case of deposits, the CoV have been on the rise, depicting growing concentration in the banking sector. So it seems that while smaller banks are catching up in terms of overall assets and credit disbursement, larger banks still have clear advantage when it comes to deposit mobilization.

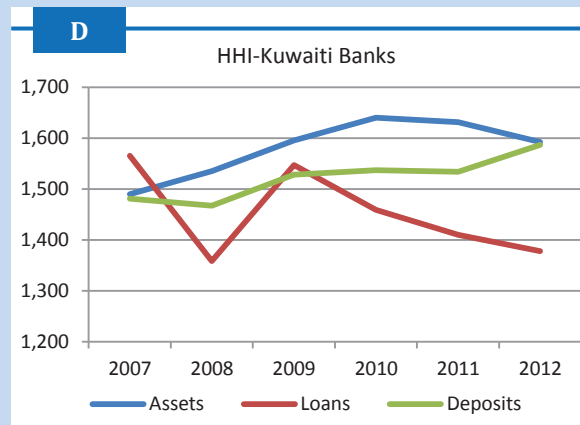


While both M-concentration ratio and CoV offer useful insights about the level of concentration in the banking industry within Kuwait, both measures fail to take into account the number of banks operating in the industry. Admittedly, the link between number of banks and the level of

⁵ This box is based on domestic banking system, using Kuwait only data.

competition is not straight forward, as there might be strong competition despite fewer banks or little competition despite large number of banks. Still, the numbers of banks play an important role in overall competition analysis, an aspect that can be captured by using Herfindhal-Hirschman Index (HHI). It takes into account both the relative size as well as the number of banks in the industry. HHI assumes the value of 10,000 if there is a single bank in the industry (i.e. monopoly), while its value approaches zero when the banking system consists of a large number of banks of relatively equal size.

Figure D exhibits the trend in HHI over the period, with HHI for loans depicting a significant drop in recent years. As highlighted by CoV as well, it appears that loan market is growing more competitive while the deposit side is still experiencing increasing concentration where larger banks seem to have clear advantage, potentially because of their extended branch networks and thus greater outreach.



Loans to funding ratio as a regulatory tool

In May 2012, Central Bank of Kuwait (CBK) put into effect the new regulations regarding loan to funding ratio which were issued a year earlier and were run on parallel basis with existing Loan to Deposit Ratio (LDR) prescribed as 85%.

Specifically, through a circular dated 10th May, 2011 CBK (i) expanded the liability-base by introducing new categories of liabilities now permissible for determining loan-able funds and (ii) divided liabilities in terms of three different maturities, setting different loanable cut-offs for each maturity.

First, in addition to the three categories of deposits already eligible for calculation, (Private Deposits, Government Deposits and Deposits of Financial Institutions), the new regulation adds four new categories, viz. Interbank Deposit, Long and Medium Term Loans, Certificate of Deposits, and Bonds/*Sukuks*. The introduction of new categories will increase the amount of banks' available funds for lending. Further, inclusion of bonds and *sukuks* would hopefully promote their usage and demand, thus supporting capital market development.

Second, the new regulation gives different treatment to deposits, depending upon their maturity profile. For instance, banks are now allowed to lend up to 100% of their deposits of longer maturities (above one year) but only up to 75% for short maturities (like three months or lower). Higher haircut for short term deposits was aimed to further curtail the risk of any potential asset-liability mismatch. It is also to help banks develop a more stable funding base, since now banks would have the incentive to raise more deposits of longer maturities (for instance, deposits of more than one year are fully loan-able i.e. no haircut applied).

Collectively, these changes were aimed to:

- Increase the amount of loan-able funds, thus boosting the supply of credit,
- Improve the asset-liability matching by using different haircuts for liabilities of different maturities, and
- Encourage usage and demand for debt instruments like bonds and *sukuks*, thus contributing towards capital market development

In general, LDR, as a measure of liquidity, has been used to evaluate a bank's ability to repay depositors and other creditors without incurring excessive costs and while continuing to fund growth. While it was a popular regulatory tool in 1980s and 1990s, LDR started to lose appeal as introduction of modern financial techniques enabled banks to maintain lending growth despite relatively high LDR, at least in financially sophisticated markets. For instance, securitization of loans made it possible for banks to expand their loan books by selling off old loans. However, LDR gained currency again after global financial crises of 2007-08 where some of the countries used it to restrict credit growth.

In the following paragraphs, we illustrate how some other countries have used LDR as a regulatory tool.

- In **Austria**, the authorities introduced in March 2012 a variant of LDR, viz. the Loan-to-Local-Stable-Funding ratio (LLSFR), as a monitoring tool of business model sustainability of their banks which had major subsidiaries (and thus significant market share) in Central, Eastern and South Eastern Europe (SESEE). It was observed that the Austrian banks' subsidiaries that entered the 2008 financial crises with a LLSFR above 110 percent were significantly more likely to exhibit higher loan loss provisioning rates than those below the thresholds. In particular, an IMF study found that aggregate LDR (used as a proxy for LLSFR due to lack of data) in 2008 for such Austrian banks was a good predictor of deterioration in asset quality in the next two years. A high LDR appeared to be a useful symptom of lax credit standards associated with an inappropriate internal pricing of risk, observed the IMF. This suggests that LDR could be a useful proxy to monitor the possible buildup of credit risk besides its more obvious role as an indicator of liquidity risk.
- In **China**, the China Banking Regulatory Commission (CBRC) has kept the LDR at 75%. In fact, CBRC has put in place a complex risk management system since early 2010. The system involves supervision of 13 different indicators, including capital adequacy, liquidity and loan quality. Under the system, regulators can adjust various regulatory thresholds as necessary. For each regulatory indicator, there is a target value, a trigger value, and a legal value. The legal maximum value for LDR is 75 percent. But it is unclear what the consequences are for banks that exceed the target or trigger levels. CBRC has been changing target LDR for individual banks. For instance, in the first quarter of 2012, CBRC raised the target LDR for Industrial and Commercial Bank of China (ICBC) and China Construction Bank (CCB) to 63 percent and 70 percent, respectively, from 62 percent and 68 percent last year.
- In **USA**, state-wise LDR is used to determine whether a bank will be allowed to open or acquire a branch outside of its home state. In particular, section 109 of Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 prohibits a bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. If a bank's statewide LDR is at least one-half of the published host state LDR, the bank is considered compliant. Federal Deposit Insurance Corporation (FDIC) publishes the LDR for each state on annual basis. The data for June 2011 reveals that state-wise LDR ranged from a low of 47% in Delaware to a high of 111% in Utah.



CHAPTER 2

BANKS' RISK ANALYSIS

2022

2

BANKS' RISK ANALYSIS

Given their traditional nature of banking, credit risk appears the most significant risk for Kuwaiti banks, accounting for 90% of their risk-weighted assets. Positively, credit risk has been receding in the last few years, with a perceptible drop both in gross and net non-performing loans (NPLs). Accordingly, the NPL ratio has come down from 7% in 2011 to 5.2% in 2012. Analysis of the NPLs by age also reveals a visible slowdown in the buildup of new NPLs as loans 'under monitoring', and 'substandard' categories have sharply dropped in 2012. These trends are also supported by the drop in NPLs in all the key sectors including investment companies, with the only exception of the real estate sector. Industry analysis suggests that conventional banks account for 66.4% of the total NPLs, compared to their share of 61.9% in gross loans. Sector-wise, household sector appears the least infected. On the other hand, the real estate sector has a much higher infection level. Geographically, banks have limited NPLs from their loans to the European region. Banks' liquidity levels have been fairly strong and funding base quite stable, further supported by the presence of a formal law to protect all deposits within Kuwait. Finally, banks' equity investments are significant, making up around 29% of their total investments while the use of firms' shares as collaterals account for 32% of banks' overall collaterals.

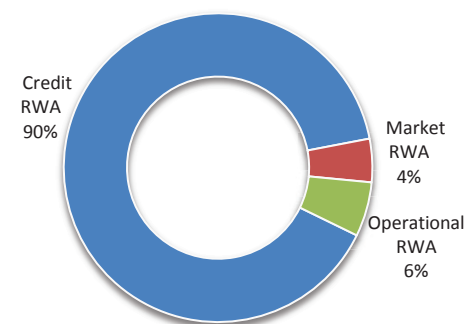
Credit risk accounts for 90% of the risk-weighted assets

Credit risk is understandably the most significant of all risks confronted by Kuwaiti banks, given the traditional nature of their banking operations primarily geared towards providing conventional credit facilities (Figure 2.1). On the other hand, market risk remains marginal both because of banks' relatively smaller trading portfolios and since the risk weighted assets (RWAs) are calculated under Pillar-1 of Basel II which excludes interest rate risk in the banking book.

Collectively, banks' RWAs stand around 36.5 billion as of December 2012, or 69.1% of banks' total assets (Figure 2.2). Share of RWAs compared to total assets has inched up by 2 percentage points over 2011 when it was around 67.1%. This has been on account of relatively higher growth in RWAs than in total assets, essentially because of stronger growth in loan portfolio where most of the clients were assigned 100% risk weight under Basel II, since they were within the unrated category.

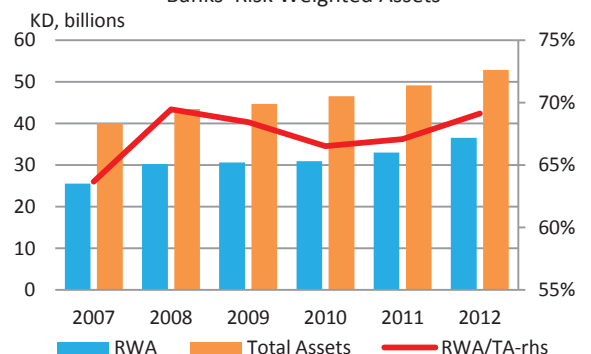
2.1

Distribution of Risk Weighted Assets (RWAs)



2.2

Banks' Risk Weighted Assets

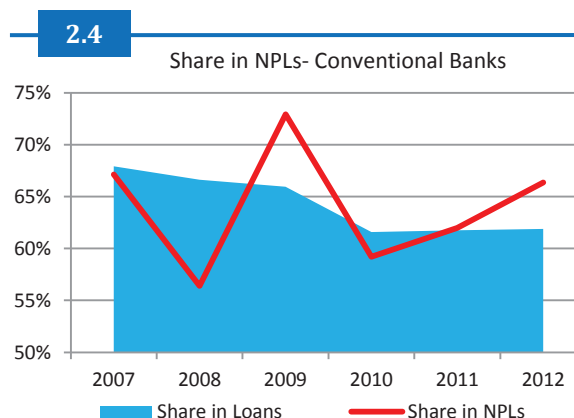
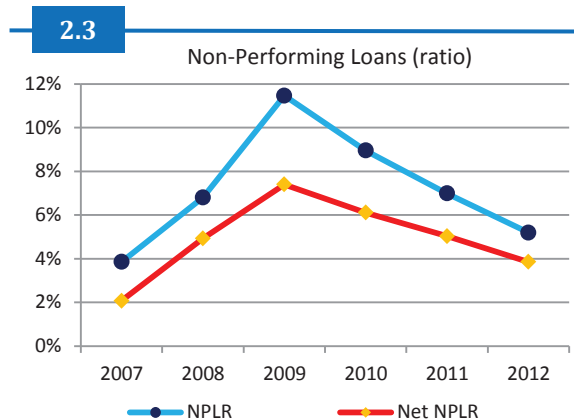


Both the size and ratio of NPLs have been lowest in the last five years

Non-performing loans (NPLs) of the banking sector have come down to their lowest level in the last five years, thanks to the strenuous efforts made by banks on CBK’s instructions and active encouragement. In fact, the NPLs have been steadily declining since 2009, suggesting that banks have been able to arrest the growth in infected portfolios quite early on and thus without much damage. Net NPLs (Gross NPLs less specific provisions) also reveal a similar trend, peaked in 2009 and followed by a steady decline thereafter. Additionally, NPLs break up by age also indicate that not only overall NPLs have come down but the built up of new NPLs has also significantly dropped, with the share of loans ‘under monitoring’ and ‘substandard’ categories, the first two categories in NPLs age-wise classification, visibly lower in 2012.

With the steady decline in NPLs, the NPL ratio (NPLR) has also come down to 5.2% by Dec-2012, lowest in the last five years (Figure 2.3). Given that credit risk constitutes the bulk of banks’ RWAs, drop in both the size and ratio of NPLs indicates significant improvement in the health of the banking system. Net NPLR have also been sliding since 2009, as banks, on the instructions of the CBK, have ensured sufficient levels of provisions.

Break up of NPLs by type of bank reveals that conventional banks account for 66.4% of the industry’s total NPLs as of December 2012 (Figure 2.4). During the last few years, share of conventional banks in NPLs have inched up, surpassing their share in total loans (61.9% in 2012). Given the fact that some key players can significantly influence the industry average (as top 5 banks account for 2/3rd of the total domestic loan portfolio), some of the fluctuation are quite narrow based, driven by a few banks.



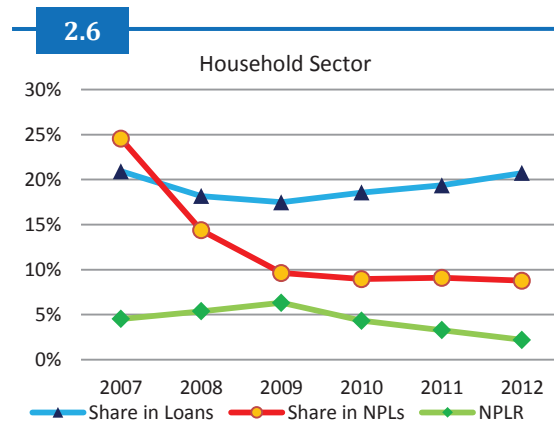
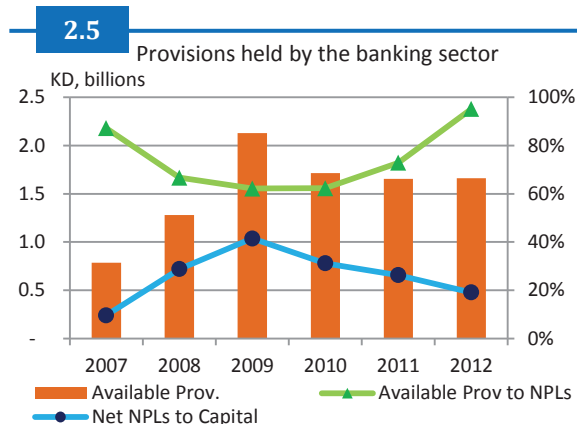
Banks' NPLs are adequately covered

As required by the CBK, Kuwaiti banks have been building up additional provisions since the start of global financial crises in 2008 to withstand any potential deterioration in their credit portfolios. While the accumulation of provisions have somewhat slowed down in recent years, it is because a significant level of provisions have already been achieved, evident from the rising *available provisions to NPL ratio* (Figure 2.5). The breakup of available provisions reveals that while the general provisions have remained somewhat stable over the years, the share of precautionary provisions has been on rise while that of specific provisions has dropped. Understandably, as the buildup in NPLs has slowed down, the need for specific provisions have also tapered off. On the other hand, banks continue to accumulate precautionary provisions to better provide for any potential infection in their loan portfolios. Consequently, the *net NPLs to capital ratio* (indicating the fraction of banks' capital that could be hit by NPLs) have been steadily declining in recent years, confirming the adequacy of provisions held by banks.

Sectoral distribution of NPLs reveals that household sector is least infected

NPLs break up by sector reveals that household sector accounts for only 9% of the total NPLs while having a share of 21% in banks' loan portfolio (Figure 2.6). This makes the household sector least infected with an infection ratio of 2.19% as of December 2012. Since household loans have been granted to many individuals, this portfolio is well diversified with far lower infection ratio.

On the other hand, real estate sector accounts for a significant portion of total infected portfolio of the banks, given the fact that around a quarter of banks' lending has been allocated to the real estate sector.



Data for the stock of NPLs across various sectors exhibit that all key sectors have been able to reduce their NPLs during 2012 except for the real estate sector. Even in case of investment companies, which saw their NPLs significantly increasing up to 2010, NPLs have sharply come down in the last two years on the back of ongoing restructuring in the sector.

Geographical distribution of NPLs reveals that around 79.6% of NPLs are within Kuwait, broadly in line with the fact that banks have disbursed around 77% of their loans within Kuwait (*Figure 2.7*). Outside Kuwait, infection level in the European region is well contained, with a marginal share of 3.5% in total NPLs.

Liquidity risk remains well contained, with banks' liquidity levels at fairly high levels

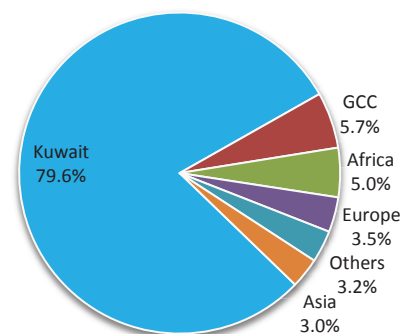
Banks' liquid assets of less than three months have been on a rising trend since 2010 and have reached above 14.44 billion by December 2012, accounting for 27.31% of their total assets (*Figure 2.8*). Bulk of these assets have been under core liquid assets, including cash and cash equivalents, deposits with CBK, government securities, CBK bills, and deposits with banks etc.

Banks' funding structure is well supported by stable deposit base

Customer deposits account for a little above 2/3rd of the banks' funding base as of December 2012 (*Figure 2.9*). Within deposits, time deposits constitute the bulk, 39.6% of overall funding base and around 59.3% of total customer deposits. A sizeable share of time deposits provides Kuwaiti banks a comfortably stable funding base to adequately perform their role as financial intermediaries. Moreover, since Kuwait has formally enacted the law since 2008 to protect all bank deposits, the risk of bank runs have also been effectively eliminated, particularly when the government has strong ability to honor any such obligations.

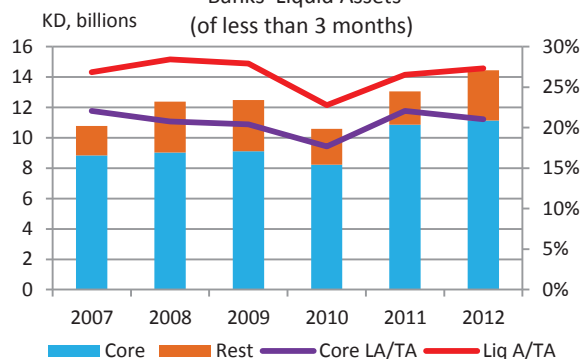
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NPLs -by region



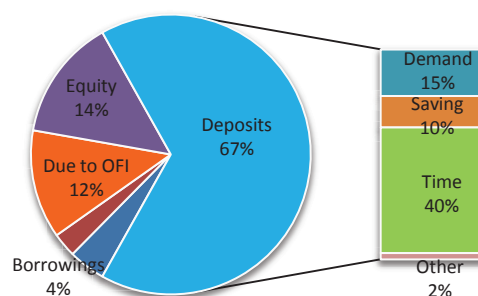
2.8

Banks' Liquid Assets (of less than 3 months)



2.9

Funding Structure of the Banking System



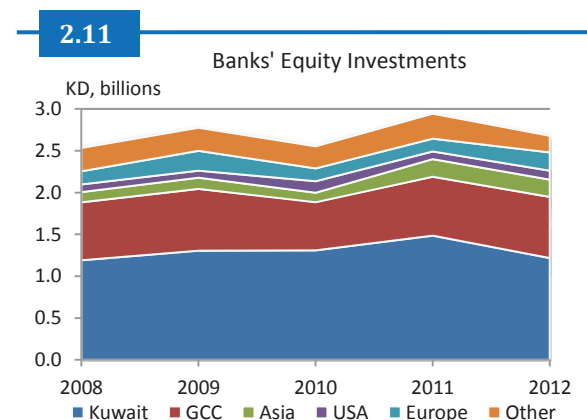
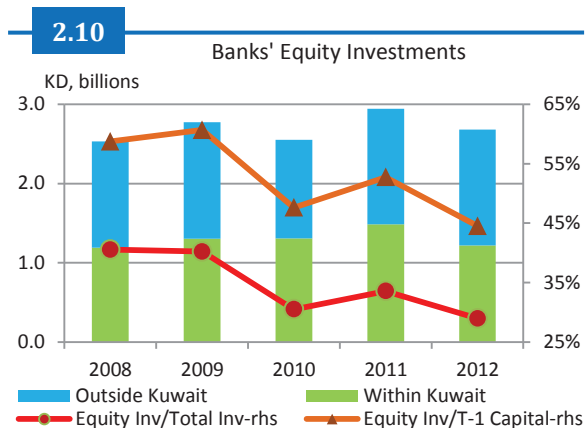
Despite a recent drop, banks have significant equity investments

A key aspect of market risk faced by Kuwaiti banks is their exposure to stock market, which can be viewed in terms of three different aspects; banks' direct investments, use of shares as collateral in lending and loans for purchase of shares. The first aspect covers banks' direct exposure to equity market while the other two highlight the banks' indirect exposure, through their loan portfolios.

First, in terms of banks' direct exposure, banks' equity investments represent 29% of their total investments by end of 2012 (*Figure 2.10*). While the share of their equity investments has dropped from around 40.2% back in 2009, it is still quite sizeable. When viewed in terms of banks' Tier-1 capital, banks' equity investments are around 45%, again a high percentage, though at the lowest level in the last five years. These numbers suggest that banks are vulnerable to sharp swings in equity prices. In case of some banks, higher equity investments are the result of debt for equity swaps made with their clients in the investment sector.

In terms of regional distribution, banks' half of equity investments are within Kuwait, though its share has dropped from 50% to 45% in 2012 (*Figure 2.11*). On the other hand, banks' exposure to GCC and European equity markets has inched up from 24% to 27% and 5% to 8% respectively during the same period. With around 55% of banks' equity investments distributed across GCC, Asia and Europe etc., the diversification in banks' portfolio helps them withstand sharp swings. However, as historical experiences suggest, correlation across markets increase during times of stress, eroding the benefits of diversification that otherwise seems substantial in good times.

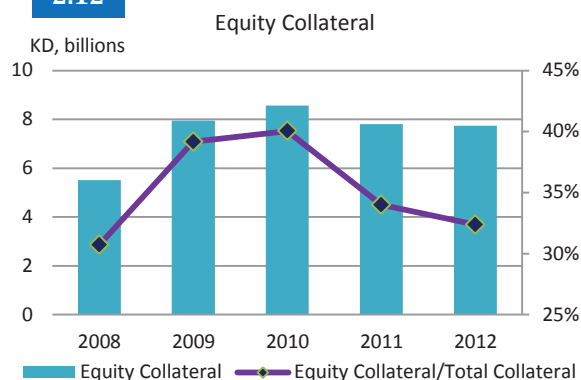
Second, in terms of banks' indirect exposure, equity collaterals constitute around 32% of the total collaterals held by the banks. The use of shares as collateral has dropped in recent years, from as high as



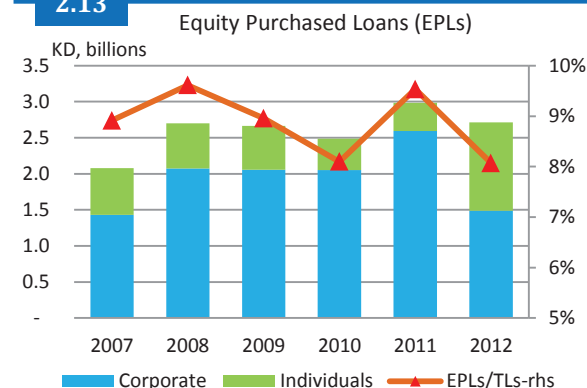
40% of all collaterals in 2010 to around 32% in 2012 (*Figure 2.12*). With equity collateral accounting for around one third of banks' overall collateral, banks are exposed to sharp swings in equity prices as such events may erode the values of their collaterals.

Another form of banks' indirect exposure has been in terms of loans granted to customers (both individuals and corporates) for trading in shares. These loans, termed as equity purchase loans (EPLs), make up around 8% of banks gross loan portfolio, thus within the limit of 10% set by CBK (*Figure 2.13*). The breakup of these loans reveals that traditionally corporates have been the key beneficiaries of these loans except in 2012 where the share of individuals availing such facilities has sharply increased. With around 8% share in banks' non-performing portfolio, EPLs are a key component of banks' risk exposure, both from the point of credit and market risk.

2.12



2.13



Financial Regulation in Turbulent Times⁶

The global financial crisis have taken a heavy toll, both in terms of lost output and erosion of financial wealth at personal, national and international level. Four years on, the regulators continue to contemplate about how to help recover the battered financial system and to avoid recurrence of such financial catastrophes in future.

No wonder, we have seen a slew of regulatory responses aimed to address the vulnerabilities of financial markets and institutions. For instance, Basel Committee has endeavored to improve the quality and transparency of capital base, introduced a minimum global standard for funding liquidity, and has proposed a leverage ratio. Volcker, Vickers, and Liikanen commissions in US, UK and EU respectively have attempted to tame the ‘casino’ nature of investment banks by prohibiting banks to trade for their own profits and ring fencing them from their retail counterparts. Financial Stability Board has proposed ways to build an effective resolution regime to handle the failure of systemically important financial institutions. Recently, it has also called for more oversight of \$67trn world of shadow banking. At national levels, financial regulators have responded in variety of ways in their quest for financial stability.

These efforts by regulators around the globe, both at national and supranational level, remind us of the challenges in building the architecture that is capable of withstanding the financial turmoil we have experienced in recent years. Against this backdrop, I would like to reflect upon as how we need to approach financial regulation, along with sharing a few examples from our own endeavors at the Central Bank of Kuwait (CBK).

First, a regulatory response, particularly a post crises one, need to avoid a knee jerk approach to fix the financial system. While it is tempting if not compelling under myriad of social, economic and political pressures to over react after a crisis than before, yet this ‘cyclicality’ in regulation needs to be eschewed. It is because such an approach is likely to be too late to deflate the bubbles but too stifling to give recovery a chance. Regulators can’t compensate for their complacency, perceived or real, in good times by over reacting in bad times. Rather this runs the risk of accentuating the very cycles that financial regulation should ideally be curing. For instance, if profligacy led to massive debt accumulation during boom years, an intransigent take on austerity in the midst of recession may do little than exacerbating the downturn.

CBK, being cognizant of these complications, have tried to adopt a balanced and gradual approach in implementing financial regulation, aiming to improve the resilience of the system through its rules but without jeopardizing the recovery or undermining the solvency of our financial institutions. For instance, we have required banks over the last few years to keep building precautionary provisions, over and above the specific and general provisions, to help them better manage a potential rise in portfolio infection that is likely to take place in times of

⁶ This article, by H.E. Dr. Mohammad Y. Al-Hashel , Governor, Central Bank of Kuwait first appeared in The Banker Magazine’s special ‘Davos Issue’, published in January 2013.

slack economic activity.

Second, we need to address the culture where gains are personal while losses are borne out by the public. In this regard, the principles of sound compensation practices to reduce incentives towards excessive risk taking, issued by the Financial Stability Board, are a step in the right direction. Similarly, Basel Committee's recent efforts to strengthen the quality, transparency and consistency of bank capital are commendable. However, at CBK, we have required our banks since mid-1990s to maintain capital adequacy ratio (CAR) of 12%, well above the global norm of 8%. Further, bulk of our banks' capital consists of core Tier 1 capital. While our CAR requirements might have appeared too conservative in good times, this prudence has served us well. Capital is undoubtedly expensive but not more than bank failures and consequent bailouts. Third, it is desirable to aim for fewer but comprehensive regulations that can accommodate various objectives to the extent possible, taking into account the interconnectedness of banks' myriad activities. Failure to integrate regulations would result in umpteen rules which may not only be self-competing and confusing but can also create opportunities for regulatory arbitrage. This necessitates that regulators take a holistic view of the measures they adopt, as number of rules can be reduced without compromising their effectiveness.

This was the consideration behind CBK's recent attempt to refine its existing loan-to-deposit ratio (LDR). Typically, a simple LDR is used to set a ceiling (or even a floor if so required) to influence credit growth. Yet this approach treats different banks similarly by allowing them to lend the same percentage, irrespective of the maturity profiles of their deposits. Instead, we have formulated a multipurpose measure, linking bank lending to a *wider* and *stable* funding base. To begin with, we have used different haircuts for deposit of different maturities, allowing long term deposits to be 100% loan able (i.e no haircut) but applying a haircut of 25% on short term deposits. This has incentivized banks to mobilize deposits of longer tenures, thus complementing our existing liquidity regulations to further reduce maturity mismatches. Moreover, we have linked bank lending to an expanded funding base by including bonds and *sukuks* to help develop the capital market.

Fourth, formulation of financial regulations should take into account the long-term consequences, the unintended ones in particular. Understandably, all regulations have unintended consequences which are much harder to visualize than the intended ones. That is why it is imperative to design regulation with strenuous effort to conceive what might go wrong, as it would. Basel I is a case in point. While the capital accord made a contribution in terms of standardizing the capital requirements for banks across the globe, it also incentivized banks to restructure their portfolios in order to reduce their regulatory capital needs without curtailing their risks.

Fifth, regulators need to appreciate that desirable outcomes may not be immediately practical. Case of deleveraging is quite illustrative in this regard. While it is indeed desirable to ensure deleveraging in consumer, banking and government finances that has been built during the past decade, it is unlikely to be concurrently achieved without compromising economic recovery particularly in times of slack growth.

Sixth, regulators at domestic levels need to understand that adopting global best practices still requires a sound understanding of the local environment. After all, domestic regulators cannot outsource their job when it comes to taking effective measures. Banking industry is quite dynamic where any regulation would obsolesce soon, requiring domestic regulators to build the capacity to respond in time before it is too late.

Admittedly, effective regulation of the financial system is a tall order and more so in today's complex world of finance. Yet the cost of poor regulations is simply colossal. Some estimates suggest that current global financial crises have cost the world a whopping 15 trillion dollars and still counting. This scale of financial losses with attendant socio-political consequences is a reason strong enough to prompt the regulators to rise to the challenge of ensuring a stable financial system that is conducive for growth and long-term development.



CHAPTER 3

PROFITABILITY , SOLVENCY AND RESILIENCE

2022

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PROFITABILITY, SOLVENCY AND RESILIENCE

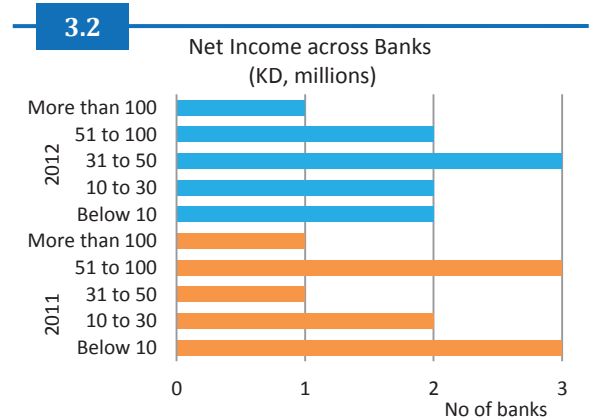
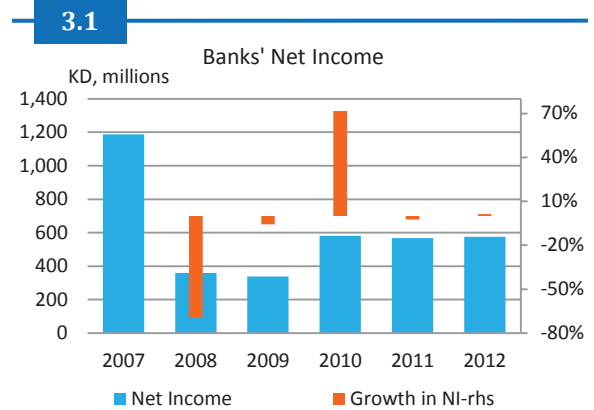
During 2012, banks' net income registered a modest gain of 1.25% to reach KD 574.9 million. Islamic banks regained their share in industry profits though conventional banks still account for more than two-thirds of the total profits. Capital adequacy levels of the banking sector have been robust, when viewed in terms of Basel II capital requirements. Results of CBK's Quarterly Stress Testing Exercise reveal that banks are comfortable in withstanding various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

Banks' earnings recorded modest growth during 2012

During 2012, Kuwaiti banks managed to record modest improvement in their earning performance. On a consolidated basis, net income after tax increased by around 84 million to reach KD 574.9 million by Dec-2012, registering 1.25% growth over the previous year (Figure 3.1).

A look at the distribution of profits among various banks highlights the shift across various ranges of net income (Figure 3.2). For instance, while the number of banks earning less than 10 million dropped from three in 2011 to two in 2012, the number of banks with net income in the range of 31 to 50 million inched up.

During the past couple of years, several Kuwaiti banks have taken the initiative to expand their operations abroad, either through branches or subsidiaries. Data for distribution of profits among domestic and foreign operations during 2012 reveals that as much as 13.4% (around KD 76.8 million) of the consolidated net income was contributed by subsidiaries and branches of Kuwaiti banks abroad.



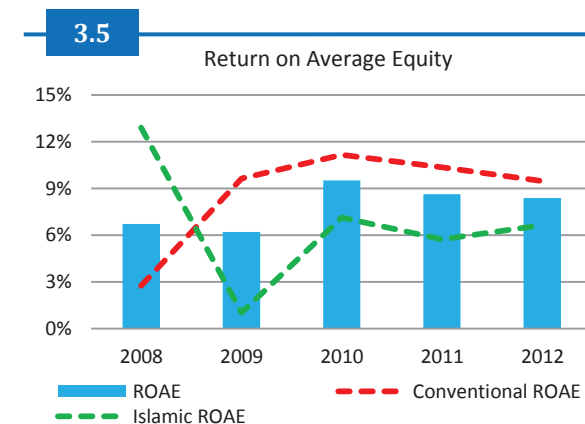
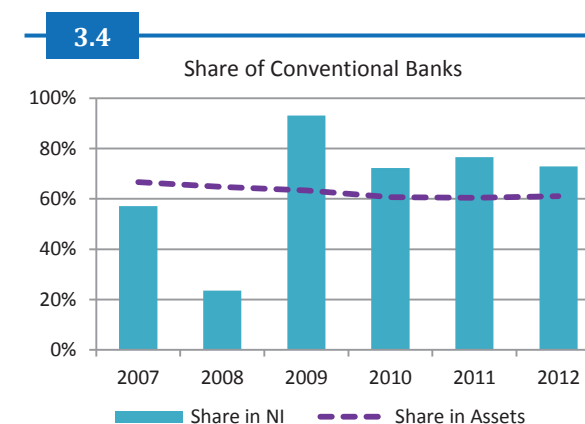
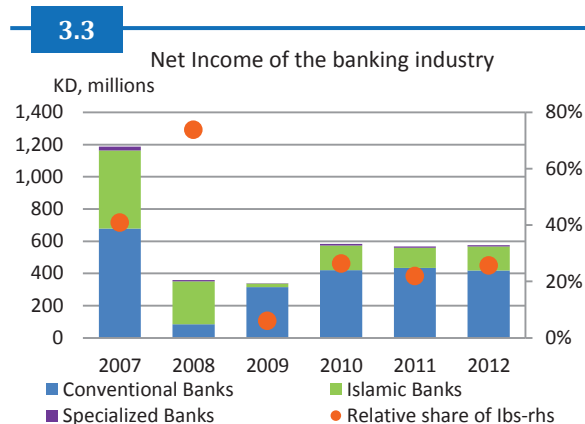
Despite the recent improvement in IBs' profits, conventional banks still hold major share

During the year under review (2012), while profits of conventional banks (on aggregate basis) have remained somewhat flat, Islamic banks (IBs) have managed to improve their share in aggregate profits. As a result, now Islamic banks account for around 26% of total industry profits, compared to 22% in 2011 (*Figure 3.3*). A major reason for rising share of Islamic banks has been the drop in their provision expense (which was down by 17.7% during 2012). However, the composition of net profits for the industry reveals that conventional banks still account for the bulk of industry profits. In fact, over the last four years, their share in profits has exceeded their share in total banking assets (*Figure 3.4*).

The data for return on average equity exhibits trends similar to the ones about banks' net income as described above (*Figure 3.5*). Islamic banks, which were placed significantly lower compared to their conventional counterparts, have managed to catch up in recent years. The gap between ROAE of conventional and Islamic banks which was as high as 8.6% in 2009 has come down to 2.8% by end-2012. However, the share of Islamic banks in industry profits has been subject to various swings. For instance, 2008 saw the share of Islamic banks in industry profits jumping to 74%, with an immediate reversal the very next year as the share plummeted to a meager 6%. The unprecedentedly high share of Islamic banks in 2008 was essentially due to significant losses at one of the conventional banks, which drastically reduced the overall size of conventional banks' profits.

Interest Income registered a positive growth after four years

During 2012, banks' interest income grew by 4.73% to reach KD 1.9 billion compared to a contraction of 0.26% in 2011 (*Figure 3.6*). This is the first time since 2008 that interest income has registered a positive growth, thanks to relatively stronger growth in banks'



credit portfolio. During the year, interest expense witnessed a mild growth of 0.9% compared to 14% drop in 2011. The combined effect of these two trends has been a rise in Net Interest Income (NII) by 6.27% to reach KD 1.39 billion in 2012. While NII had experienced a similar growth in 2011 (6.63%), that was primarily due to contraction in interest expenses. On the other hand, growth in NII in 2012 is essentially because of higher interest income, as interest expense has remained almost flat.

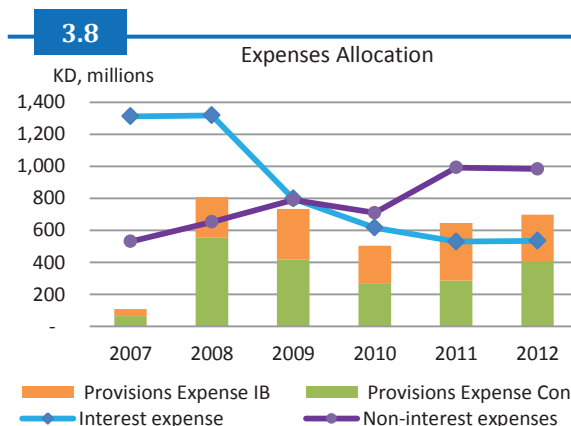
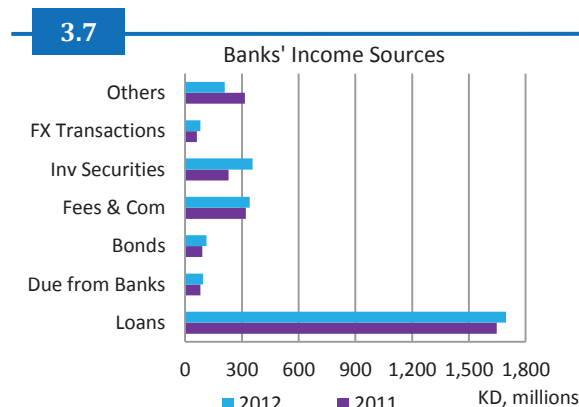
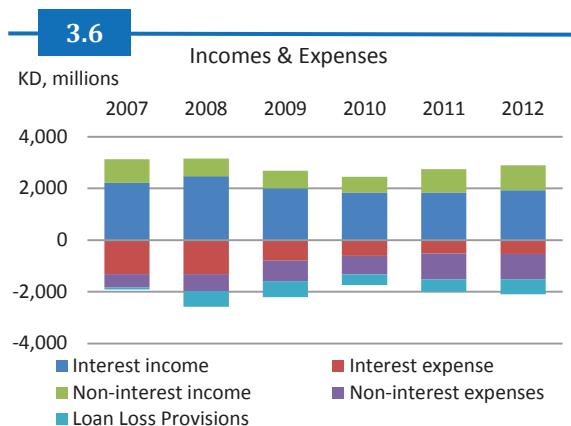
Traditional lending continues to be the main source of income

Banks in Kuwait have continued with traditional focus on lending activities, a more stable source of income than from volatile trading activities as experienced by some global banks. Understandably, most of the interest income came from the loan portfolio, accounting for as much as 59% of total income and 88% of total interest income (Figure 3.7). Break up of interest income from loans reveal that 52% were from credit facilities granted to retail clients (mainly households and individual clients), while remaining from lending to corporates.

During 2012, gains from investment securities registered a strong growth of 54.84%, though it can partly be explained by lower base value. Break up reveals that income for investment securities was up mainly because of gains in equity trading activities, followed by gains from bonds and bills.

Provisions have been the key driver for non-interest expenses

While the growth in provisions expense was more pronounced in 2011 (26.5%), the rising trend has continued in 2012 as well, with provisions expense up by 8% to reach KD 706 million (Figure 3.8). Banks have been required by CBK to take preemptive precautionary measures following a conservative approach. Accordingly, banks have taken serious efforts in recent years by reducing unhealthy exposures and building up strong provisions.

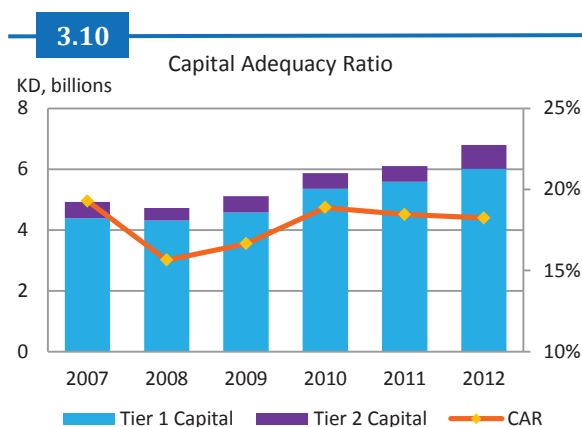
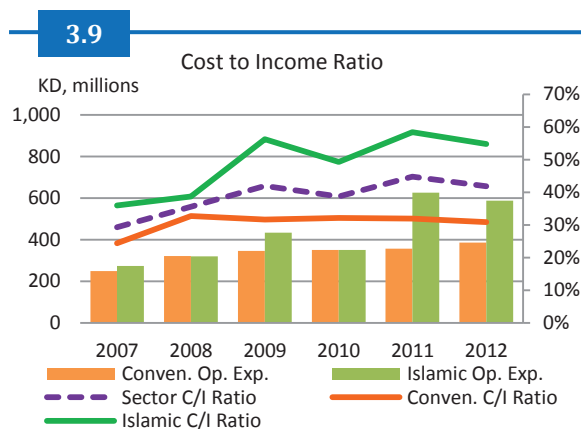


Conventional banks have better efficiency indicators

Banks' operational efficiency has marginally improved as cost to income ratio has eased down in 2012 (Figure 3.9). The improvement in operational efficiency has been more pronounced in case of Islamic banks, though they still face significantly higher cost to income ratio when compared with conventional counterparts. In general, the operating environment for Islamic banks is more challenging, given Shariah restrictions on certain products/services otherwise available to conventional banks, making even normal operations like liquidity management more challenging. Further, transaction costs for Islamic banks are generally higher, both on account of higher legal and Shariah requirements to execute the same transactions. Finally, high level of operating expenses for Islamic banks also stem from their non-banking subsidiaries which inherently are associated with higher operating expenditures.

With strong Tier-1 capital, banks' capital adequacy have remained robust

Kuwaiti banks have consistently maintained high capital levels, given CBK's strong focus on ensuring a stable financial system where robust capital adequacy plays an important role. By end-2012, banks' capital adequacy ratio (CAR) on consolidated basis averaged around 18.2%, compared to 18.5% in 2011 (Figure 3.10). The slight drop in CAR is because of relatively higher growth in Risk Weighted Assets (RWAs) during 2012. Still, at 18.2%, CAR for Kuwaiti banks is significantly higher than global standards. Moreover, break up of banks' capital level reveals that Tier 1 (core) capital accounts for around 90% of banks' total capital, highlighting the robust quality of capital. Kuwaiti banks appear to have also benefited from strong support by their shareholders who were available to make required capital injections in the past.



...with all banks having minimum CAR above 12%

Individually, all local banks have maintained capital levels above the 12% minimum CAR requirement set by the CBK. CBK has adopted Basel II standards for capital adequacy since 2005 and is already in the process of implementing Basel III standards. Preliminary estimates suggest that Kuwaiti banks are well poised to meet the Basel III capital requirement (see Box 3.1). Such high level of CAR underscores the strength of banks in Kuwait and is a key indicator of a stable banking system capable of withstanding any major shocks. Category wise, conventional banks have higher capital adequacy ratio than Islamic banks (Table 3.1). However, the gap between the two categories, particularly when viewed in terms of Tier 1 to RWA, has reduced significantly by Dec-2012.

Thanks to strong capital adequacy levels and higher provisions, banks' net NPLs to capital ratio, an indicator of the fraction of banks' equity that can be wiped out due to loan losses, has dropped significantly in the last three years (Figure 3.11).

CBK's stress tests indicate the resilience of the banking system

CBK conducts a regular stress testing exercise on quarterly basis to gauge the level of resilience of the banks at individual levels as well as on industry wide basis (see Box 3.2 for details). Using the data as of December 2012, various macro and micro level scenarios were considered.

Our results show that none of the banks failed the stress tests, encompassing different macro and micro scenarios (Figure 3.12). After-shock capital adequacy of all the banks remained well above the 12%. While bank 3 and bank 7 experience somewhat greater falls in their CARs, still their CARs remain above 12% benchmark.

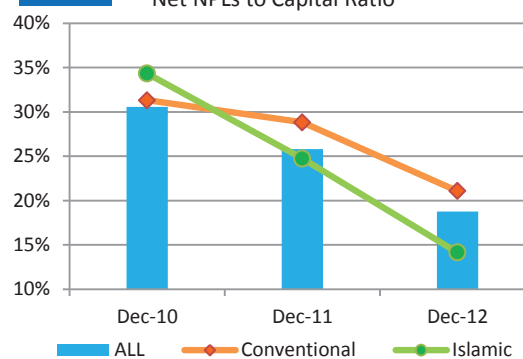
Understandably, banks appeared more vulnerable to the deterioration in the quality of their loan/financing portfolio, particularly in specific sectors such as real

Table 3.1
Banks' Category-Wise Solvency Ratios

	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	Dec-11	Dec-12	Dec-11	Dec-12	Dec-11	Dec-12
Conv. Banks	19.0	18.4	17.1	16.0	12.2	12.3
Islamic Banks	16.1	16.5	15.7	16.3	11.4	12.0
All Banks	18.5	18.2	16.9	16.4	12.4	12.6

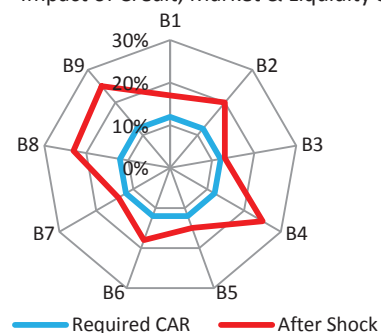
3.11

Net NPLs to Capital Ratio



3.12

Impact of Credit, Market & Liquidity Shock



estate and to a less extent towards investment companies. However, comparison of our stress test results over the years reveal that banks have strengthened their ability to withstand shocks even in these sectors by putting up additional capital and building more provisions.

In case of market risk shocks, banks had relatively greater exposure to a drop in asset prices through direct exposures to equity and real estate investments as well as indirectly through collateral coverage. On the other hand, banks' vulnerability to interest rate and foreign exchange risks remained limited.

Finally, shocks related to liquidity crunch showed that banks remained liquid even under conditions of severe liquidity stress, highlighting banks' strong levels of liquidity.

Basel III Capital Requirements & Kuwaiti Banks

The global financial crisis has generated broad consensus on the need to effectively regulate and supervise systemic banking institutions in the form of maintaining sufficient levels of capital and liquidity to absorb shocks arising from financial and economic stress. *Basel III* is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. The following table provides an overview of the various measures to be implemented under the Basel III framework:-

Time Line	2013	2014	2015	2016	2017	2018	As of January 2019
Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer				0.625%	1.250%	1.875%	2.5%
Minimum Common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.750%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs, and financials)		20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Conservation Buffer	8.0%	8.0%	8.0%	8.625%	9.250%	9.875%	10.5%
Capital Instruments that no longer qualify as non-core Tier 1 Capital or Tier 2 Capital	Phased out over 10 year horizon beginning 2013						
Leverage Ratio	Parallel Run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2018					Migration to Pillar 1	

Purple shading indicates transition periods, Green shading indicates period of implementation.

These measures aim to promote more integrated management of market and counterparty credit risk, stronger provisioning practices (forward looking provisioning), strengthen the capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities financing transactions, raise the capital buffers backing these exposures, reduce pro-cyclicality and, provide additional incentives to move OTC derivative contracts to central counterparties etc.

Going-concern and gone-concern capital

Under Basel III, banks' total capital needs to be 8.0% of their risk-weighted assets (*Table 2*). Total capital is divided into two broad categories: Tier I capital and Tier II capital (with the elimination of Tier III capital found in Basel II). Broadly speaking, Tier I capital is what is available to absorb losses on a 'going-concern' basis, or capital that can be depleted without placing the bank into insolvency, administration or liquidation. Tier II capital is capital that can absorb losses on a 'gone-concern' basis, or capital that absorbs losses in insolvency prior to depositors losing any money.

Tier I capital

Tier I capital is in turn comprised of both Common Equity Tier I capital (CET1) and Additional Tier I capital. Common Equity Tier I capital (CET1) is the core form of capital and includes common equity and retained earnings. The required ratio of Common Equity Tier 1 capital to risk-weighted assets will go up from 2% to 4.5% followed by stricter regulatory adjustments (*Table 2*). These new capital requirements will be progressively phased in between 1 January 2013 and 1 January 2015.

Additional Tier I capital mainly consists of instruments issued by the bank which are able to meet specific criteria (and are not included in Common Equity Tier I capital). Basel III has introduced stricter criteria for

determining what constitutes Additional Tier I capital in order to ensure these instruments absorb losses of a bank on a going-concern basis. Furthermore, the minimum total Tier I capital requirement under the Basel III will increase from 4% to 6% (Table 2), and will be progressively phased in between 1 January 2013 and 1 January 2015.

As a Percentage of its Risk-Weighted Assets	Capital Requirements							Additional Macro-prudential overlay	
	Common Equity			Tier 1 Capital		Total Capital		Counter-Cyclical Buffer	Additional loss-absorbing capacity for SIFIs
	Minimum	Conservation Buffer	Required	Minimum	Required	Minimum	Required		
Basel II	2			4		8			
Memo:	Equivalent to around 1% for an average international bank under the new definition			Equivalent to around 2% for an average international bank under the new definition					
Basel III	4.5	2.5	7	6	8.5	8	10.5	0-2.5	Systemic Capital surcharge for SIFIs

Capital conservation buffer

The introduction of a capital conservation buffer under Basel III will require an additional 2.5% of Common Equity Tier I capital (CET1) to be held over and above the absolute minimum requirements. This buffer is intended to be available to be drawn down during periods of stress. If the buffer falls below 2.5%, progressive capital distribution constraints will be imposed until the bank manages to restore the buffer back to its intended levels.

Counter-cyclic capital buffer

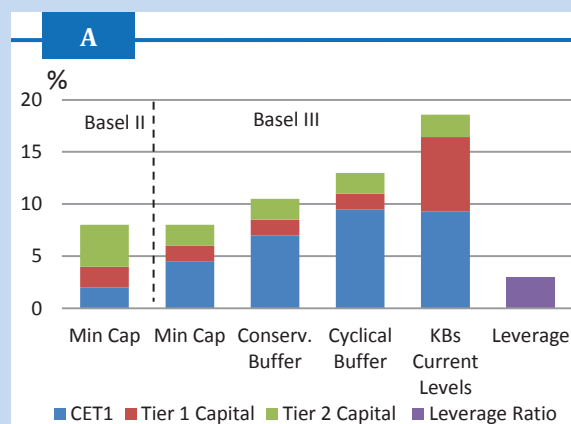
A separate counter-cyclical buffer has also been introduced to ensure that the banking sector's capital requirements take account of the macro-economic environment in which banks operate. This buffer will range between 0 to 2.5% of a bank's risk-weighted assets and will be determined by the relevant regulator in each jurisdiction. The regulator will determine the level of the buffer according to its perception of the systemic risk that has built up in the banking system as a result of excess credit growth.

Leverage ratio

The Basel Committee has also introduced a new non risk-weighted leverage ratio to prevent banks building-up excessive on- and off-balance sheet leverage. A minimum Tier 1 leverage ratio of 3% of bank exposure is currently being tested by the Basel Committee, which generally follows the accounting measure of exposure.

Capital Adequacy of the Kuwaiti Banks

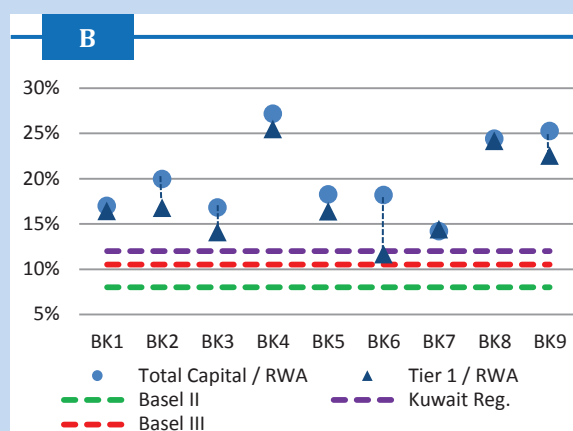
Kuwaiti banks have been able to maintain strong levels of capital adequacy under Basel II with around 90% of their capital consisting of core capital (Tier 1). The aggregate level of Tier1 capital/RWA for the Kuwaiti banks is around 16.4% of which CET1/RWA is around 56.6%, indicating strong quality of banks' capital (Figure A).



A look at disaggregated data reveals that Tier 1 Capital to RWA for each individual Kuwaiti bank⁷ is currently above 12% (*Figure B*), with an industry average of 16.4%.

In May 2008, the central bank of Kuwait applied certain amendments to the instructions regarding Basel II, where a much more conservative approach was adopted by

- Increasing the risk weight to 100% for consumer and installment loans (housing) which otherwise carries preferential risk weight under Basel II.
- Applying risk weight at 150% for credit facilities granted by banks to finance speculative trading in shares and real estate activities, irrespective of the borrower's credit rating in this regard.
- Excluding the interim retained profits from the components of the capital base, reported under subordinated capital in Tier 2, to stabilize capital adequacy levels.

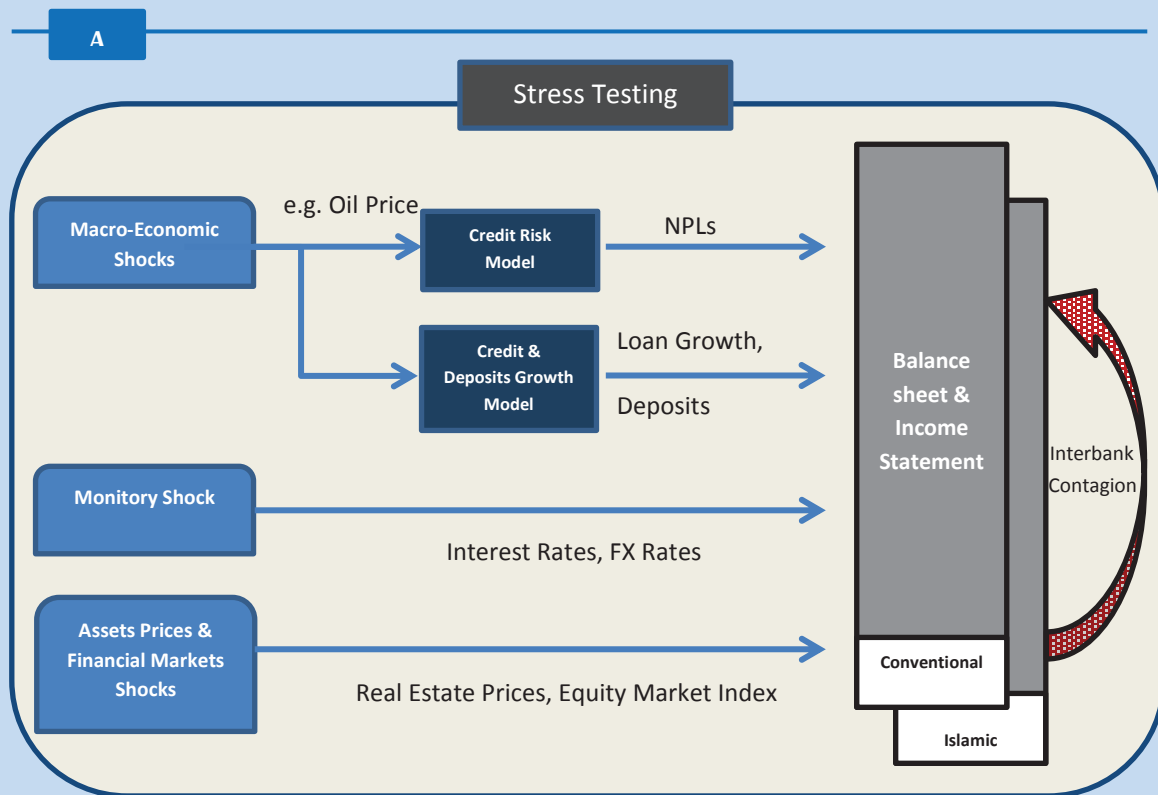


⁷ Except IBK which is considered a specialized bank and depends on equity items as its main funding source because the bank is not allowed to collect deposits.

Stress Testing at the CBK

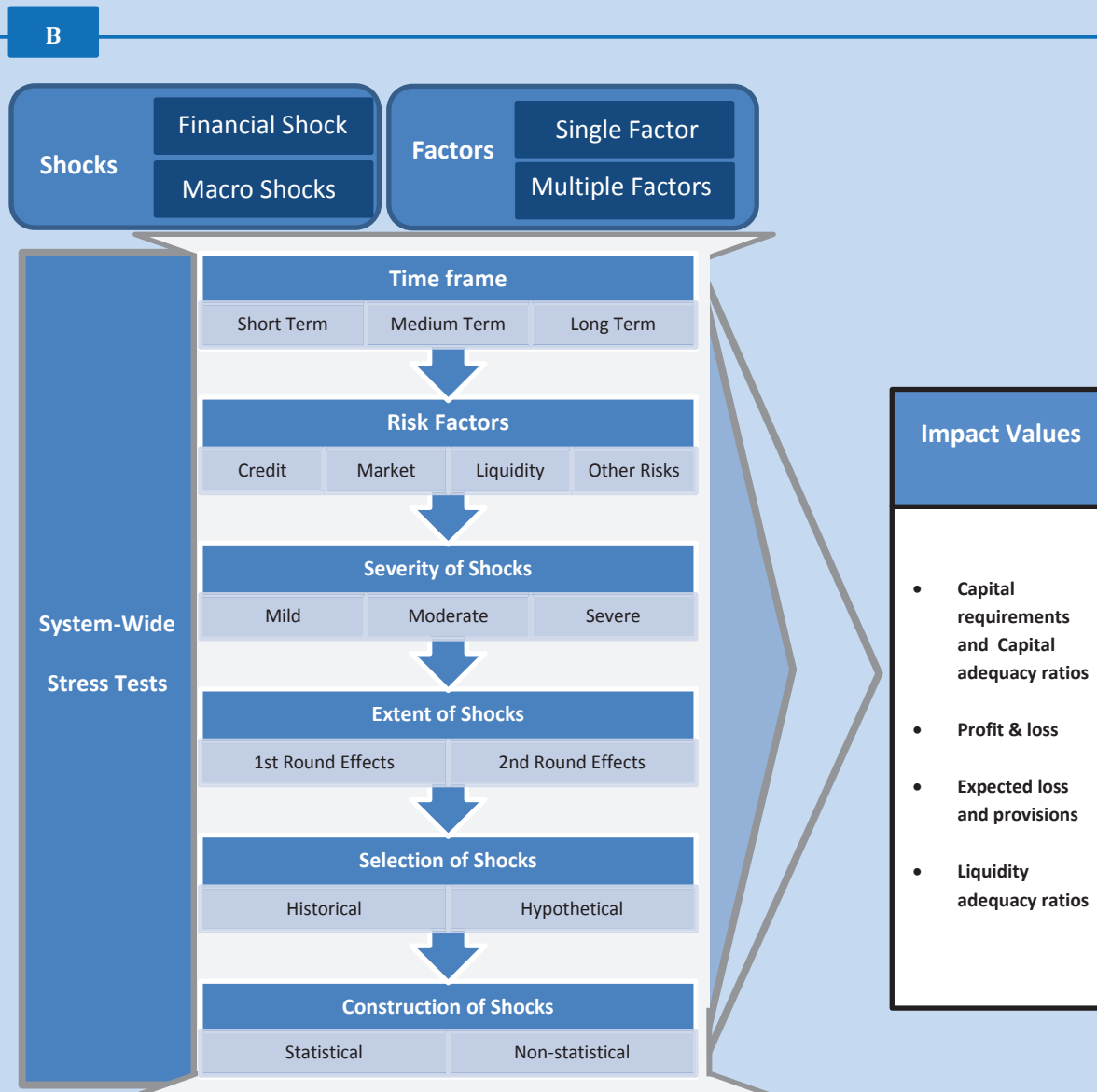
CBK revamped its in-house stress testing system in 2010 to further strengthen and complement its banking sector assessment. Since then, stress tests are regularly conducted on quarterly basis and the results are used to assess the resilience of the individual banks as well as the industry as a whole against various shocks.

The stress testing framework is structured around single factor (sensitivity analysis) and multiple factors (scenario simulation) shocks. Banks’ financial data is linked with macroeconomic shocks under different scenarios to test the resilience of the banking sector (*Figure A*).



The dynamic nature of the exercise provides a more realistic insight into banking sector vulnerabilities than sensitivity analysis or a static stress test exercise. Each of the single and multiple factor shocks on the individual banks is quantitatively translated into the extent of loss, capital shortfall, and liquidity shortfall. The aforementioned outputs are then used to complement the primary risk assessment rating of each bank. This reflects the performance of the bank under stress scenarios and to identify additional key risks.

The main building blocks of the stress-testing framework are shown in *Figure B*.



The stress testing model requires the selection of various options regarding time frame, risk factors, extent and severity of shocks etc. Stress tests are conducted by defining a number of micro and macro scenarios to assess the resilience of individual banks and the overall industry (i.e. aggregation of the individual banks) to various shocks and risk factors.

Micro Scenario & Assumptions:-

On the micro side, as many as nine different scenarios are used, in addition to a baseline scenario, to assess the vulnerabilities of banks to the different risk factors. These scenarios cover credit, market and liquidity risks and are divided into three levels of severity (mild, moderate and sever).

The main assumptions and variables applied in the macro level are the following:

- *Credit:* A group of assumptions targeting the credit portfolio mainly through negative growth in the credit portfolio, increase in NPLs, decrease in the collateral coverage ratios available to the bank.

- *Market & Liquidity*: A group of assumptions targeting investment portfolio, off-balance sheet items, and liquidity items, mainly through a decline in the rate of return of the bank's investment portfolio, increase on the amount of impairment of such investments, and a deposit run on both time and demand deposits.
- *Credit, Market & Liquidity*: combines all assumptions set in both the 'Credit' and 'Market & Liquidity' Scenarios mentioned above.

Macro Scenarios & Assumptions:-

On the macro side, a macro-economic stress scenario with 3 levels of severity: Mild, Moderate, and Severe. The main assumptions and variables applied in the macro level are the following:

- *Deterioration in Real Economy with Impact on Banks Earnings*: scenario which simulates decrease in oil prices and/or cut-backs on government-sponsored projects (NDP) which would further affect overall GDP and corporate sector profits. Balance sheets of corporate sector will be adversely affected on weaker aggregate demand and decreasing ability to repay debt. In addition, banks' internal capital generation will be affected due to slowdown in overall economy and reduction in earnings.
- *Severe Equity & Asset Price Crisis*: scenario which assumes a sharp decline in equity and asset prices on the back of weak investors' confidence. The macroeconomic transmission is first through household and corporate sector balance sheets as a result of lower GDP and profits. Investment and real estate companies are especially affected due to devaluation of their investment portfolios where NPL rates increase dramatically for these sectors. Severe haircuts on collateral will also adversely affect banks' provisioning rate.
- *Liquidity Dry-Up and Deposit Run*: scenario which assumes a reduced liquidity in interbank market (e.g. banks reaction to restore their liquidity position by cutting credit lines to other banks) leading to increased cost of interbank borrowing. In addition, depositors start withdrawing money from "weaker" banks into perceived "safer" banks generating liquidity dry up.



CHAPTER 4

DOMESTIC MARKETS

2022

The money market remained fairly liquid during 2012, with the inter-bank rates at historically low levels. The CBK slashed its discount rate by 50 basis points to 2% in October 2012. Issuance of short-term treasury bills dropped to nil since May 2012, as issuance of CBK bonds, particularly of six months maturity, surged during 2012. Furthermore, treasury bonds of longer maturities were issued to extend the sovereign yield curve to longer maturities and provide a benchmark for pricing corporate debt. The FX market remained stable with KD slightly depreciating against some key currencies except for JPY where it registered strong appreciation. During the year, reserves held by the CBK touched new highs and import coverage ratio improved further. The Kuwait Stock Exchange (KSE) remained buoyant during early 2012, but slow activity later led to only modest gains for the entire year. Introduction of a new trading system and a new index (Kuwait-15) were some other key developments at the KSE. Yet the market remained shallow with few sectors like financial services, real estate and banks accounting for most of the market activity. The real estate market during 2012 grew by 16% in terms of value of deals, with all segments recording positive growth, including commercial segment which had experienced contraction in the earlier three years.

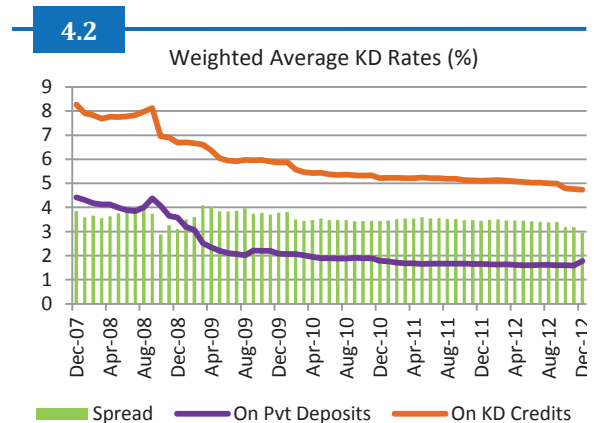
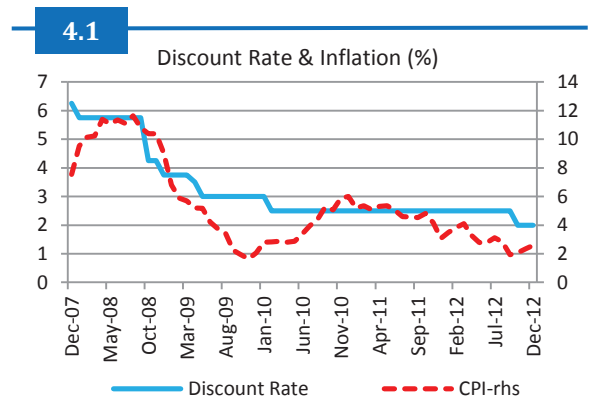
Money Market:

CBK cut discount rate by 50 bps in October 2012

CBK, on 3rd October, 2012, slashed the discount rate by 50 basis points to 2%. Discount rate is the key benchmark rate in Kuwait, serving as a reference rate to calculate other interest rates charged on various lending facilities in Kuwaiti Dinar⁸. This reduction in discount rate in October 2012 was the first since February 2010 when the rate was cut from 3% to 2.5% (Figure 4.1). Amid falling inflation, the discount rate cut was meant to further encourage investment and boost economic activity.

Spread has tapered off during the last quarter of CY12

In line with the cut in discount rate, the lending rate on KD-based credits also eased during the last quarter of 2012. At the same time, weighted average rate on deposits in KD also adjusted down, though marginally inching up at the close of 2012. These trends have caused the spread to taper off, particularly in the last quarter of 2012 (Figure 4.2).



⁸ For instance, banks can charge up to 3% above discount rate on consumer and housing loans, up to 2.5% above discount rate on commercial loans of less than one year and up to 4% above discount rate on commercial loans of above one year maturity.

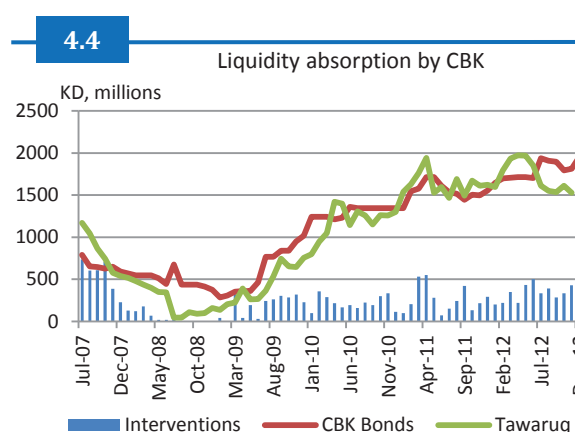
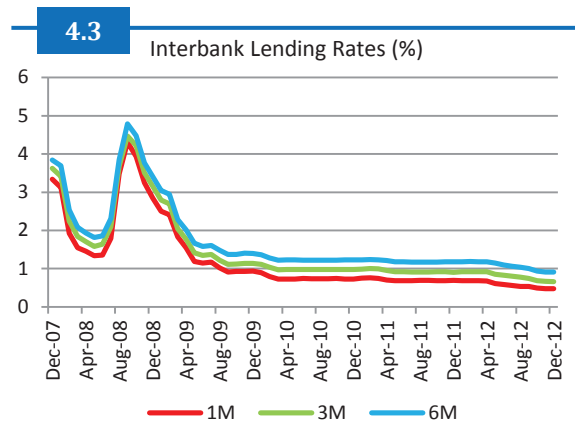
Decline in interbank rates highlights excess liquidity

Since 2009, interbank rates have been on a smoothly declining trend, highlighting the presence of sufficient liquidity in the market (Figure 4.3). Rates at the end of 2012 were at particularly low levels, indicating the presence of excess liquidity in the market.

In general, interbank market has followed the developments in discount rate. The spike in interbank lending rates during the second half of 2008 is a reflection of stress in money market amid liquidity crunch. However, the incident was not unique to Kuwait as markets all around the world came under stress after the failure of Lehman Brothers. CBK, during this time of stress, injected additional liquidity in the market. In line with the needs of that time, liquidity absorption by CBK dropped significantly (Figure 4.4). Moreover, the government, through the Kuwait Investment Authority (KIA), also placed higher amounts of deposits to help banks meet any liquidity needs. In fact, Kuwaiti banks were also able to attract deposits internationally, thanks to the enactment of a formal deposit guarantee law in Kuwait⁹.

CBK's liquidity management is aimed to stabilize the market

During 2012, CBK's liquidity management has aimed to stabilize the level of excess liquidity in the market and to avoid significant fluctuations. Over the years, while CBK's interventions to suck up excess liquidity have remained somewhat stable, the use of CBK bonds and Tawaruq¹⁰ has gained far more significance (Figure 4.4). As discussed above, the sharp decline in all indicators of liquidity absorption is evident during 2008 as market in Kuwait came under stress on the outbreak of global financial crises.



⁹Law No. (30) issued on 3rd November, 2008.

¹⁰It is an important tool for liquidity management, where banks can place excess liquidity with the central bank both on short and long term basis, using a mechanism similar to commodity *murabaha*.

Issuance of T-Bills comes to a halt since May 2012

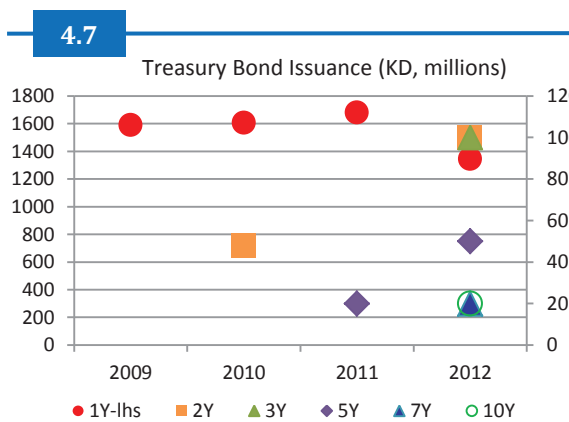
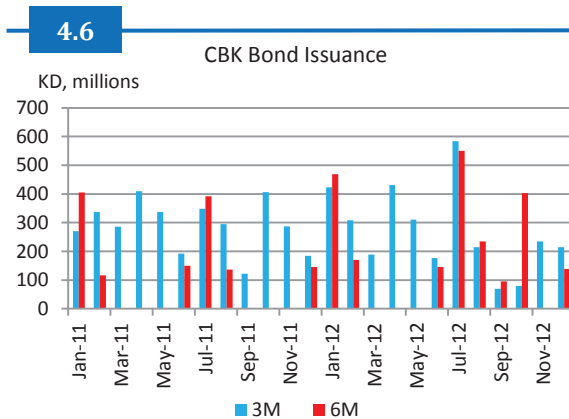
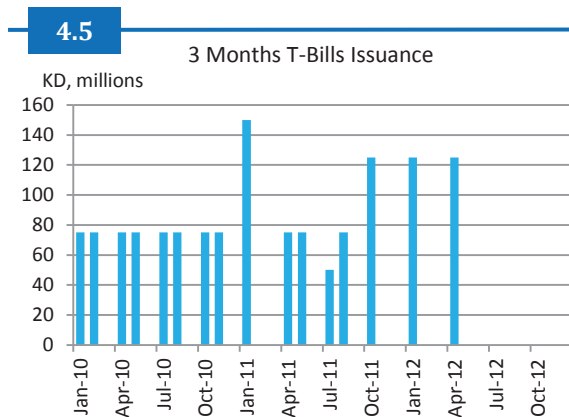
During 2012, CBK has tried to reduce the focus on short term bonds in its efforts towards liquidity and monetary management. This choice away from the short term instruments is evident in both the patterns of treasury bills and treasury bonds (for details of key instruments, see Box 4.1). In case of 3-month treasury bills, which are issued on behalf of the government, CBK has not issued any such instruments since May 2012 (Figure 4.5). Given the excess liquidity in the market, government would have been able to borrow on fairly low rates; so the CBK, by not issuing T-bills, intended to avoid depressing the saving rates. Moreover, no treasury bills of 6 months maturity have been issued in the last three years (as the last issue was in 2009).

...with CBK 6-month bonds becoming the instrument of choice

During 2012, issuance of CBK bonds was up by 13%, with total issuance worth KD 5,443 million compared to KD 4,821 million in 2011. Furthermore, the break up between 3 months and 6 months tenors reveals that bonds of longer maturities have experienced a sharp rise during 2012 (Figure 4.6). Specifically, 6 months bonds observed a strong annual growth of 64%, as their issuance surged from KD 1,345 million in 2011 to KD 2,206 million in 2012. On the other hand, 3 month bonds experienced a contraction of 7%, as bonds worth KD 3,237 million were issued in 2012 compared to KD 3,476 million in 2011. As a result, share of 3 month bonds in total issuance of CBK bonds have dropped from 72% in 2011 to 59% in 2012.

CBK is aiming to develop a longer term yield curve

Another key development has been the growing use of longer tenor treasury bonds during 2012 (Figure 4.7). For instance, in 2012, bonds with maturity of 3, 7 and 10 years have been issued for the first time in recent years. Bonds of 2 and 5 year maturities were



also issued again, since their first issuance in 2010 and 2011 respectively. The CBK's focus on long term bonds is aimed to extend the sovereign yield curve to longer horizon and help establish a meaningful benchmark for the pricing of corporate debt.

Notwithstanding the issuance of longer term bonds of various maturities, bonds of one year maturity, with issuance worth KD 1,345 million in 2012, still account for bulk of the overall issuance. In fact, banks' response to longer term bonds was muted, causing CBK to reduce the size of issuance in certain cases.

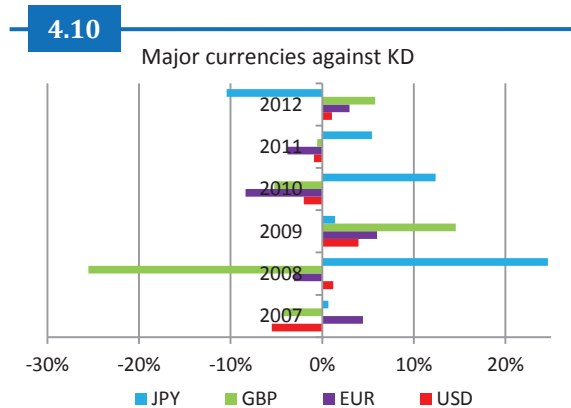
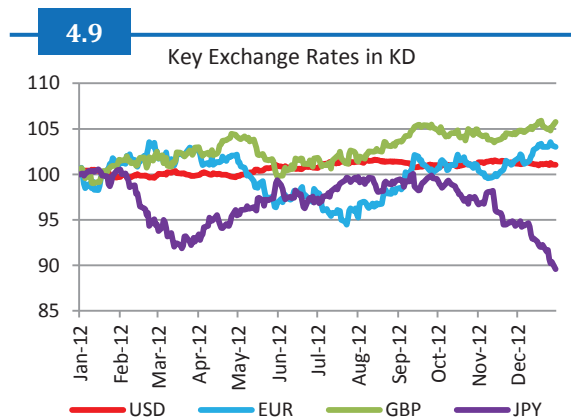
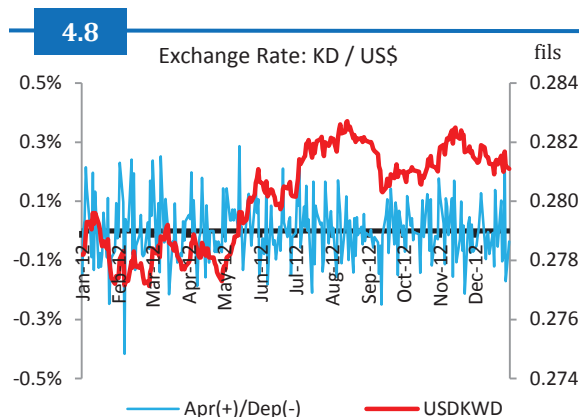
FX Market:

KD has been fairly stable against key currencies except its strong appreciation against JPY

Exchange rate, measured in terms of KD per unit of USD, reveals that KD has depreciated by 1.2% during the course of 2012, closing at 0.2811 by Dec-12 (*Figure 4.8*). While the first five months of 2012 witnessed some appreciation in KD, the local currency started depreciating against the dollar from June 2012 onwards. However, the exchange rate parity between KD and USD has remained fairly stable, with almost all the fluctuations around a narrow range of 0.3%.

In fact, compared to other key currencies, KD appears to have far less fluctuations against USD (*Figure 4.9*). During 2012, KD depreciated against both Euro and GB Pound. On the contrary, KD registered significant appreciation against Japanese Yen. Depreciation in JPY has been on account of Bank of Japan's easy monetary policy.

The above mentioned developments in KD exchange rate can also be viewed from (*Figure 4.10*). Interestingly, it is the first time in many years that JPY has registered a visible depreciation against KD. Otherwise, JPY has been on a consistently appreciating trend against KD, with a major appreciation realized in 2008. During 2012, GBP and



Euro have also appreciated against KD (as they did against USD), though these currencies recorded depreciation in the year 2010 and 2011.

As a matter of fact, since 20th May 2007, Central Bank of Kuwait has returned to peg the KD to an undisclosed special weighted basket of currencies of countries that share financial and trade relations with the State of Kuwait. Earlier, between 2003 to 2007, CBK followed a USD peg at KD 0.29963:USD1 with a $\pm 3.5\%$ band.

Both reserves & import coverage has further improved

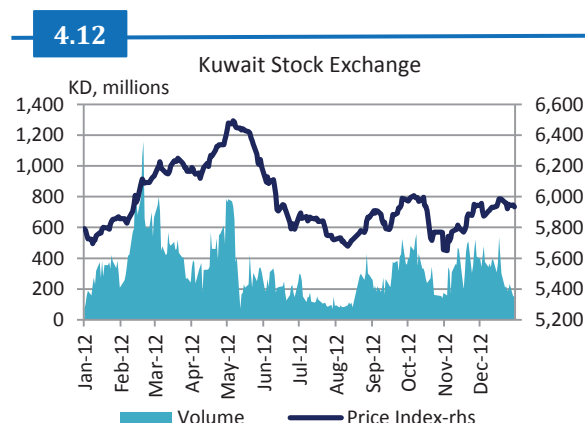
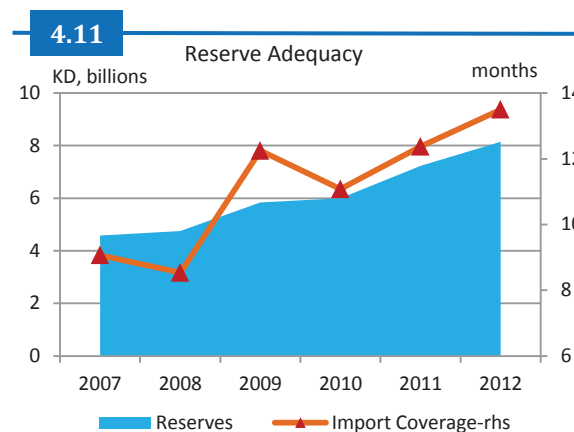
Total foreign exchange reserves, held by the CBK, were up by 917 million to reach KD 8,147.7 billion, registering a growth of 12.7 percent during 2012 (*Figure 4.11*). With foreign exchange reserves at its new high, import coverage ratio has accordingly improved to well above 13 months, showing that reserves are adequate to cover current level of imports for more than a year¹¹. Rise in foreign exchange reserves and thus import coverage ratio has been on account of strong oil prices which have helped Kuwait enjoy robust current account surpluses in recent years.

Kuwait Stock Exchange (KSE):

Kuwait's bourse remained buoyant in early 2012

During 2012, the main KSE Price Index (PI) was up by 2.1%, registering a modest gain over 2011 (*Figure 4.12*). The other key index, the Weighted Index (WI), which essentially captures the large cap stocks, gained 3% during the year.

The market started the year 2012 on a positive note and February witnessed a noticeable improvement, as PI recorded a gain of over 3.3%. Higher liquidity in the market was evident from greater volumes



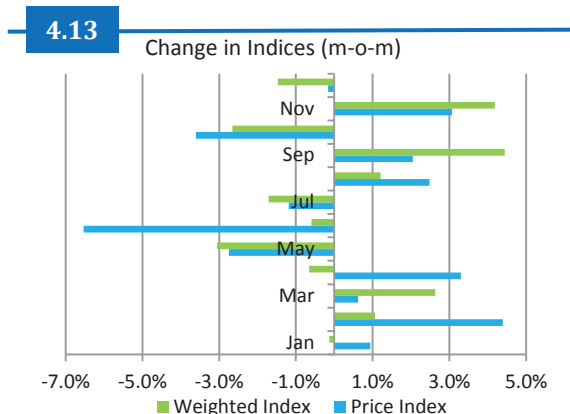
¹¹It is pertinent to mention that these numbers barely capture the true level of reserves that Kuwait holds. While Figure 4.11 is based on the reserves held by CBK, Kuwait Investment Authority (KIA), country's sovereign wealth fund with strong global presence, has substantial amount of reserves at its disposal which are not part of our analysis. Taking those reserves into account will put reserve coverage ratio into many years.

traded. The market rally continued in March as well (Figure 4.12), as formation of the new government, positive developments at the Capital Market Authority-CMA (resolution of issue about three commissioners and CMA's relaxation of fund regulations), and improved global outlook helped improve the market sentiments.

...but faced losses from May to July 2012

The next three months (May to July 2012) saw the reversal in gains made in the first quarter of 2012 (Figure 4.13). In May, PI and WI were both down by 2.7% and 3.1% respectively. Importantly, on May 13, 2012, KSE launched new index (Kuwait-15) and a new trading system (X-stream). Launch of new trading system was partly responsible for weak performance in May, 2012 as well as global stress visible in international financial markets amid renewed worries about EU debt and general weakness in major economies. The month of June also witnessed losses amid renewed tension between legislative and executive branches of the government in Kuwait. Early vacation schedule also caused a slowdown in market activity. In July, market further went down amid slower activity during the holy month of Ramadan, with the PI hitting 5720.37, an eight-year low.

From August onwards, market experienced a flip-flop trend, gaining in one month and losing in the next. For instance, PI observed some gains in September as the speech by H.H. the Amir about the commitment for economic development was well received by the market. In particular, Kuwait-15 index registered a gain of 5%, highest since its launch in May 2012. However, October again witnessed noticeable losses amid escalating political tensions. Market recovered in November as interventions by the KIA boosted the volumes and improved sentiments but December recorded small losses as market remained cautious amid somewhat uncertain political situation.



While 2012 was positive, market's new normal is at far lower level

A look at other key indicators for the local bourse reveals that market's total volume more than doubled during 2012, reaching 83.1 billion shares compared to 38.3 billion in 2011 (*Table 4.1*). Moreover, the total value traded witnessed an increase of 19% to reach at KD 7.2 billion during the year. While market capitalization slightly decreased during 2012 (1.4%) the drop was much smaller than the one experienced in 2011 when market cap was down by 19%. Finally, the number of listed companies was down by 15 in 2012. In fact during August 2012, as many as 22 companies were suspended from trading as some firms were not able to submit their financials in time while others lost a major part of their capital. Since not all of these were actively traded companies, their suspension had no significant impact overall.

While the KSE closed on a positive note in 2012, the market have traded at considerably lower level compared to its peak level experienced before the advent of financial crises in mid-2008 (*Figure 4.14*). It seems that PI has settled for a 'new normal' of around 6,000, around 60% down from the 15,500- plus level experienced in mid-2008.

High cap stocks performed better during most of 2012

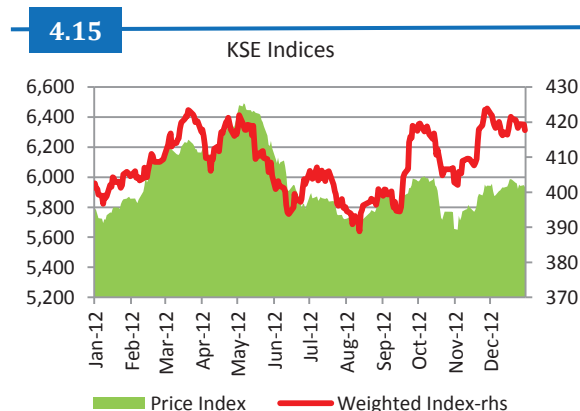
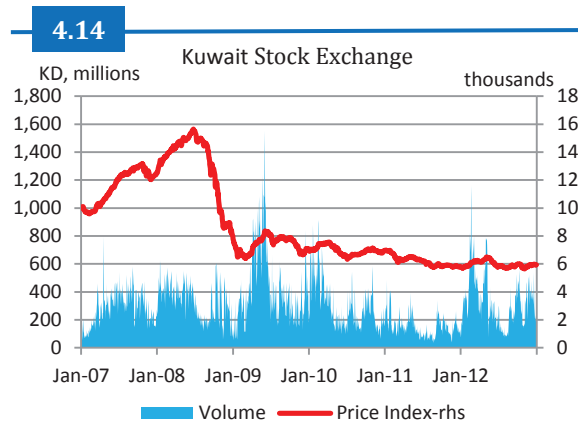
A comparison between KSE Price Index and Weighted Index reveals that small capitalization stocks performed better during May and June as PI was higher than WI during these months in particular (*Figure 4.15*). Yet, in general, large capitalization stocks (blue chip companies) outperformed during most of the months of 2012, reflected by better performance of WI.

Sector wise indices put real estate as the top performer

On May 13, 2012, KSE launched a new trading system and companies have been reclassified, in line with International Classification Benchmark, into 15

Table 4.1: Key Indicators of Kuwait Stock Exchange

	2009	2010	2011	2012
KSE Price Index	7005.3	6955.5	5814.2	5934.3
Market Cap (KD, bil)	30.2	36.3	29.3	28.9
Total Value (KD, bil)	21.8	12.5	6.1	7.2
Total Volume (bil)	106.3	74.7	38.3	83.1
No. of Deals (,000)	1,938	1,254	617	1,196
Companies Listed	204	217	214	199



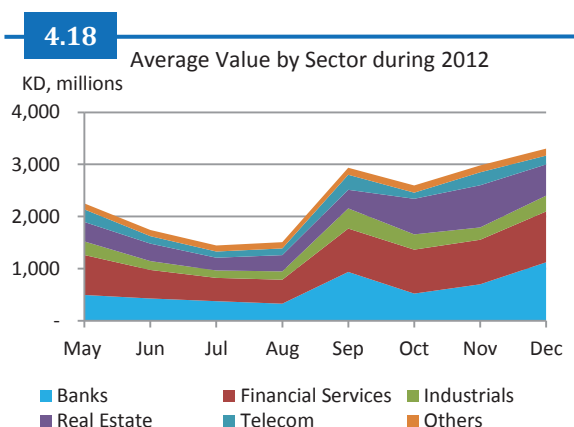
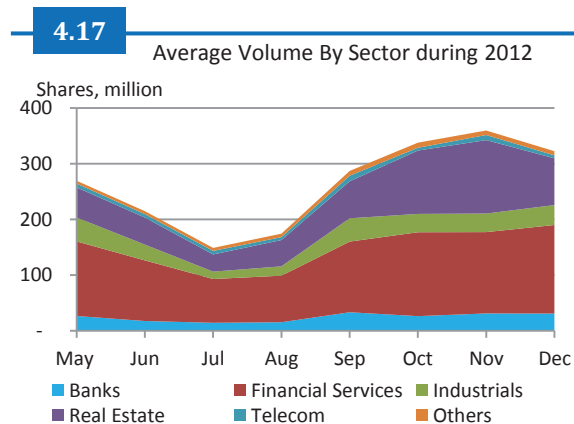
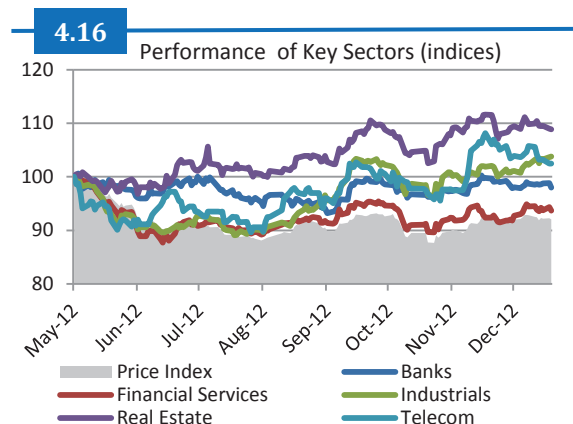
new sectors compared to the previous classification of eight sectors (see Box 4.2). Data since the introduction of new classification reveals that *real estate index* has significantly outperformed the overall PI, gaining around 9% by the close of 2012 (Figure 4.16). Telecom sector has also performed well (up by around 4% by December 2012), though it started off at a fairly lower level and only gained momentum in the last quarter of 2012. The Financial Services Sector has trailed the PI very closely, though ending the year on a negative note (down by 6% since May 2012).

Two sectors account for over 60% of market volume

Two sectors, *Financial Services Sector* and *Real Estate Sector*, collectively account for as much as 60% of the average monthly market volume, highlighting the lack of depth in stock market (Figure 4.17). The fact that Financial Services Sector accounts for around 47% of the total market volume explains why its index have followed the overall PI so closely (Figure 4.16). *Banks* and *Industrial* sectors also have around 9% to 12% share each in the total market volume. Collectively, these four aforementioned sectors cover almost the entire market.

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

When viewed in terms of average monthly value, *Banks* sector also appears to be a key player (Figure 4.18). Their share in average market value has been around 26% in the last quarter of 2012, much higher than their share in market volume. Given the relatively higher prices for some key banks' shares, the greater contribution of banking sector in overall market value is understandable.



Real Estate Market:

Real estate's contribution in GDP has come down

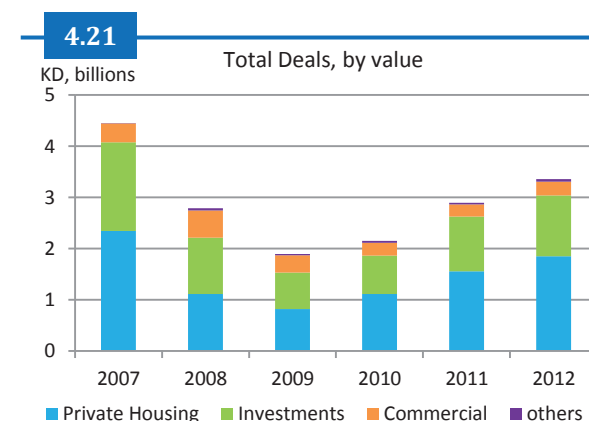
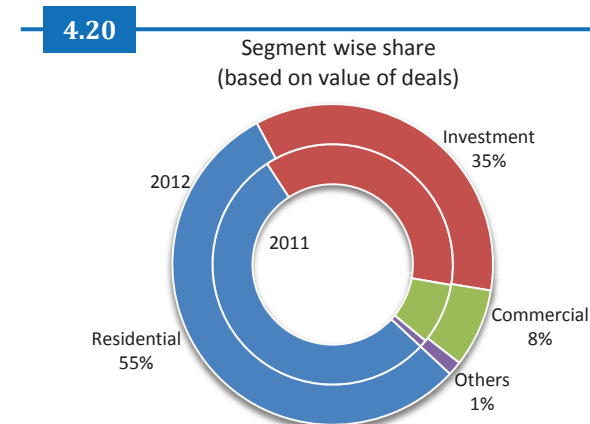
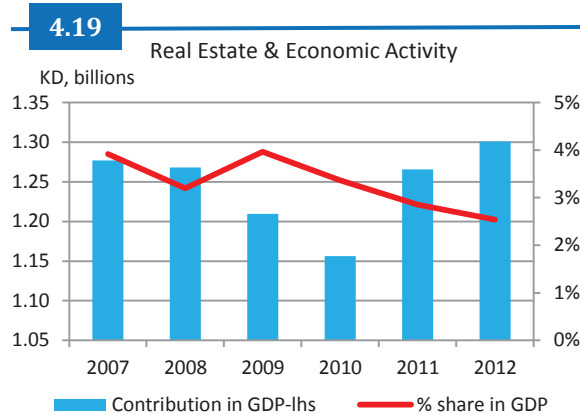
Traditionally, real estate sector has made noticeable contribution in Kuwait's economy in terms of its share in the nominal GDP. However, this share has been on a declining trend, essentially due to a much stronger growth in the nominal GDP on the back of strong oil revenues. Accordingly, share of the real estate has dropped from 4% in GDP in 2009 to 2.5% in 2012, despite the rise in real estate activity, as evident from the increase in its absolute contribution in KD terms (Figure 4.19).

Residential sector accounts for bulk of the market

The three key components of the real estate market in Kuwait include *Residential*, *Investment* and *Commercial* real estate properties. Residential real estate constitutes the bulk of overall market, in terms of total value of deals made (Figure 4.20). For instance, residential sector accounted for around 55% of total value of deals made during 2012, followed by investments (35%) and commercial (8%) segments. Compared to 2011, residential sector's share in overall market has slightly inched up from 54% to 55% while share of the investment sector has dropped from 37% to 35% during the same period. On the other hand, commercial sector's share in overall market has remained almost flat around 8% during 2012.

All segments observed positive, albeit slower, growth

While the real estate market has recovered from its lowest point in 2009, it is still well below the peak level of activity witnessed in 2007 before the outbreak of global financial crisis (Figure 4.21). During 2012, total deals worth KD 3.35 billion were recorded, compared to KD 2.89 billion during 2011, registering a rise of around 16%. Numbers of deals were up by 21.7% to reach 10,003 deals in 2012 compared with 8,217 deals in 2011.



While the growth in the outgoing year has been evidently positive, it is still lower than the growth registered in 2011 when market was up by 34.4% if viewed in terms of total value of deals (*Figure 4.22*). However, relatively slower growth in 2012 can be partially explained by the base effect, as market had already made a significant recovery in 2011.

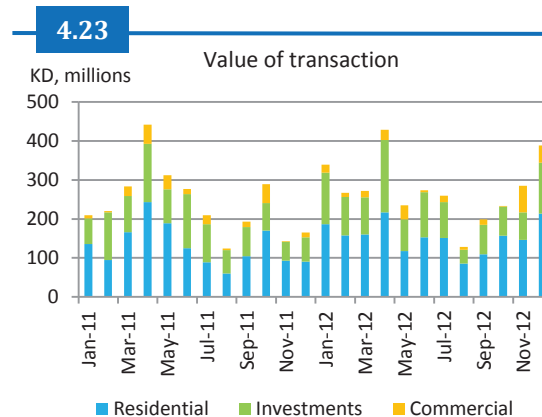
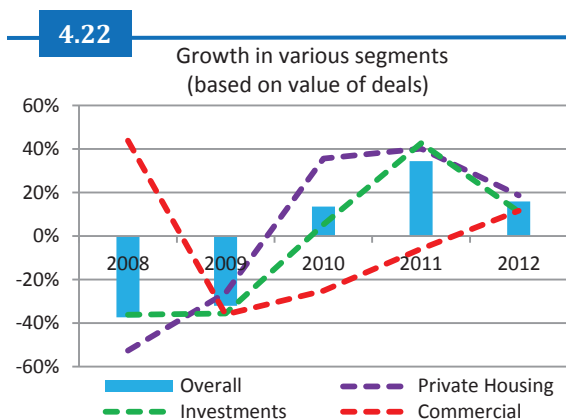
Commercial segment bounces back after three years' contraction

While the real estate market has clearly recovered from the sharp contraction it experienced in 2008 and 2009, there are obvious differences in growth trajectories across various segments. The commercial real estate segment, which was the last to experience negative growth during 2008-09 market contraction, has also been the slowest to recover since then. However, during 2012, this segment grew by 12%, experiencing first positive growth since 2008 (*Figure 4.22*). Other two segments, private housing and investments have experienced positive growth since 2010, though growth in 2012 has slowed down, partially because of the base effect.

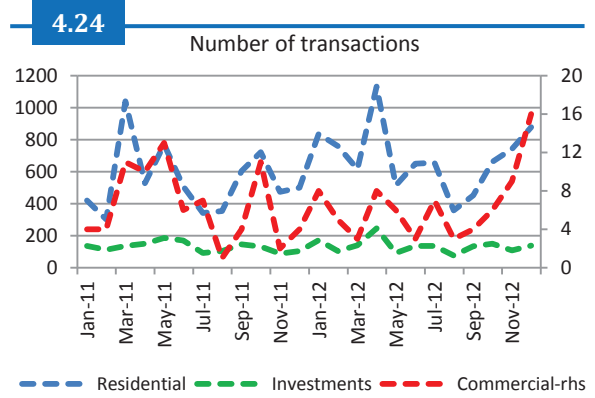
Weather and vacations dictate the seasonality in the market

During 2012, activity in real estate market exhibited somewhat similar fluctuations as observed during 2011 (*Figure 4.23*). For instance, the market remained least active during August in particular and 3rd quarter in general on account of holy month of Ramadan, high temperatures in summer and associated vacations. On the other hand, the month of April, inexplicably, appeared to be the most active.

In terms of number of transactions, highest activity was observed in residential segment, followed by investment and commercial segments. These patterns are dictated by overall size of each segment in overall real estate market. With residential segment accounting for 55% of the market, it is



equally responsible for highest number of transactions executed (Figure 4.24). A cyclical pattern, influenced by the seasonality, is also visible in all segments, though less so in case of *investments* segment due to scaling of the graph.



Money Market Instruments in Kuwait

Central Bank of Kuwait (CBK) has a number of instruments at its disposal in regulating liquidity levels to ensure monetary stability. These include discounting and rediscounting of banks' commercial papers, swap operations, direct interventions in money market through deposits and issuance of treasury bills, treasury bonds and CBK bonds.

Treasury Bills & Treasury Bonds:

Both treasury bills and treasury bonds are issued by CBK on behalf of Government of Kuwait. These instruments serve as a tool for CBK's monetary policy as well as for commercial banks' liquidity management. CBK issues treasury bills and bonds in the denomination of KD 1000, 10,000, 50,000, 250,000 and 500,000. Both instruments are eligible for minimum reserve requirement of 18% set by CBK. Both instruments are also eligible for repo transactions where CBK offers one day, one week and one month repo agreements. Banks that have a clearing account with CBK can purchase or sell bills and bonds for their own account or on behalf of customers. Both the bills and bonds are traded in an interbank over-the-counter secondary market.

Treasury bills are issued for 3 and 6 month tenors and generally reissued at maturity. Treasury bonds are issued for one to ten year maturities. In case of bonds, one year maturity issue is most common though in recent years longer tenure bonds have also been issued.

CBK Bonds:

Unlike treasury bills and bonds, CBK bonds (as the name suggests) are issued on behalf of CBK itself. These bonds serve the sole purpose as a tool for CBK's monetary policy management. Bonds are issued in

Monetary Policy Instruments in Kuwait (for the year 2012)			
		Number	Amount
Treasury Bill	Issued	4	250.0
	Matured	6	375.0
Treasury Bond	Issued	25	1635.0
	Matured	21	1728.0
CBK Bond	Issued	37	5443.0
	Matured	36	5044.0

denominations of KD 50,000, KD 100,000, KD 500,000 and KD 1,000,000. Banks that maintain a clearing account with CBK can buy or sell these bonds, but for their own accounts only (as clients are not allowed to buy CBK bonds). These instruments are eligible for minimum reserve requirement of 18% as well as for Repo transactions.

The New Index & Trading System at KSE

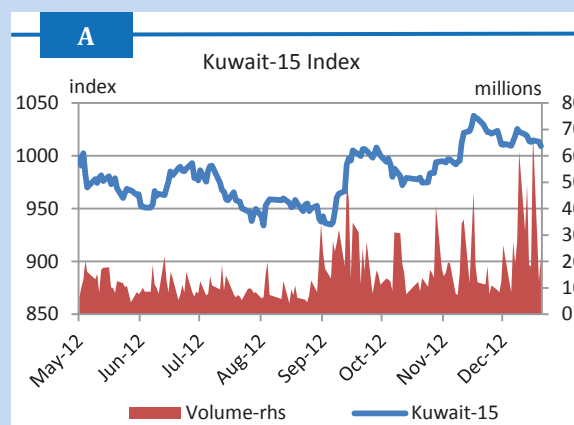
On May 13, 2012, Kuwait Stock Exchange (KSE) launched a new weighted index (Kuwait-15), a new trading system (X-stream), and defined new sector classifications. Following paragraphs briefly describe these developments.

1-Kuwait-15 Index

Kuwait-15 is a market capitalization weighted index which has been constructed to better mirror the local economy. The new index is in addition to the other two existing indices (price index and weighted index) and includes 15 highest ranked companies in terms of liquidity and size (capitalization). With inclusion of top 15 companies, index will be easier to track and its returns will no longer be distorted by companies that are seldom traded. So it will simplify the process of index investment for fund managers and foreign investors, reduce transaction costs and minimize tracking error as managers invest in 15 companies instead of 105. The index can represent a basis for index-linked products such as index derivatives, indexed funds, exchange traded funds (ETF's) and structured products.

The new index will be reviewed bi-annually and list of companies will be updated accordingly. During the time of the review, KSE will publish a 'Reserve List', consisting of three to five companies that will be used to replace current ones in the index (by the highest ranked company on Reserve List) in case of change or deletion of any existing company on the index. Selection process for the Kuwait-15 index will start with top 50 companies based on market capitalization & value traded where each company will be assigned a weight for market capitalization (75%) and value traded (25%) separately. Based on the weights calculated, top 15 companies will be selected to form the index.

Since its inception in May 2012, Kuwait-15 gained 1 percent, closing on 1009.09 by Dec 2012 (*Figure A*). Volumes have been particularly higher in the last quarter of 2012. In its current construction, updated in November 2012, the new index is banks heavy, with as many as eight banks in the index, and seven of them among the top 10 companies in the index.



2- New Sector classification:

The new classification, covering 15 sectors including a parallel market sector, is in line with international standards, and is intended to improve comparisons with global indices and provide more transparent information to investors & fund managers. The Industry Classification Benchmark (ICB), one of FTSE International limited products, was chosen because it was designed to provide standardized industry definitions, accurately reflecting companies' core business operations. This consistency enables benchmarking and closer comparison between KSE's listed companies and those around the world. The consequent transparency will attract

foreign investors to the Kuwaiti market, resulting in higher liquidity.

3: New Trading System (X-Stream)

On May 13, 2012, a new trading system (X-Stream) replaced the current (KATS) system. The new system is one of NASDAQ OMX'S products, used in more than 15 countries worldwide. The new system allows simultaneous trading of different types of products and is highly flexible. The new system is intended to improve transparency, support larger trading volumes, and offer more flexibility. Following table compares the key aspects of new trading system with the old system.

	KATS	X-Stream
Quantity units	'Board lots rule' 'Odd-Lot Market'	Quantity units have been eliminated
Priority criterion for matching during auctions	'Time-Price' priority	'Price-Time' priority
Waiting time for order modification/cancellation	5 minutes	Eliminated
Increasing order quantity	-----	New feature of increasing order quantity which will invalidate the order time priority.
Clearing commission	500 Fils per trade	Not charged for trades with value less than 50 KD
Order books	Market by price (MBP) book	-MBP book -Market by order (MBO) book (individual orders)
Forward market mechanism	Quotes entered by market makers	Order- driven market
Forward market trades' price	Price is chosen by the broker	Best price for the investor
Quantity limits for forward trades	-----	-Min. 5000 shares - Max. 100000 shares
Price index values	Shows with one decimal place	Shown with 2 decimal places

Box: 4.3

Role & Performance of the Saving and Credit Bank

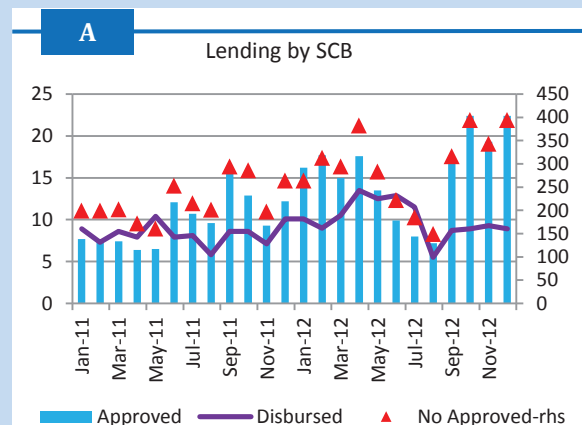
Saving and Credit Bank (SCB) is an independent banking institution owned by the government, operating under the preview of the Minister of State for Housing Affairs. The members on the board are appointed by the Minister. The bank was established in 1970 by law No. 30 of 1965 with capital of 2500 million KD, with an aim to grant housing and social loans to Kuwaiti nationals.

Specifically, SCB grants the following types of loans:

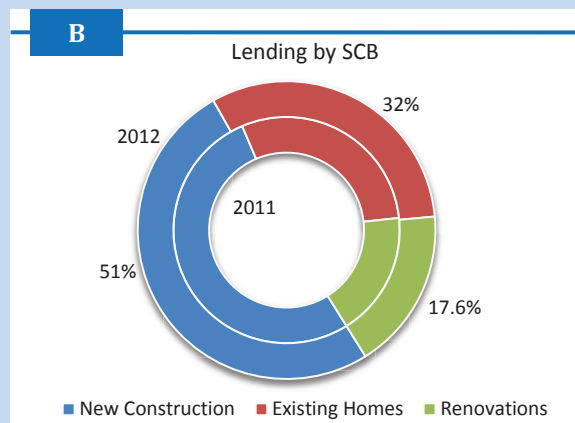
- Housing loans up to 70,000 K.D for purchasing existing houses or the construction of new ones. These loans are payable in installments without interest over a period of 60 years. The amount of installment payment varies depending on the loan amount. For loans greater than 30,000 K.D, the monthly payment is 10% of the personal income/salary or 100 K.D, whichever is greater.
- Granting social loans for newly married citizens up to 6000 K.D, of which 2000 K.D is a grant/endowment while remaining 4000 K.D is an interest-free loan.

During 2012, loans worth KD 186.2 million were approved, registering a rise of 58% compared to 2011 (*Figure A*). In terms of number of loans, 3,539 loans were approved in 2012 compared to 2,643 loans in 2011. In particular, the last quarter of 2012 witnessed the most loans being approved.

Understandably, disbursements trailed behind approvals, as loan approved are availed in tranches, depending upon the pace of construction cycle. The seasonality in Kuwait's real estate market, primarily dictated by summer weather and vacations was equally visible in loan approvals and disbursements at the Housing Credit Bank.



During 2012, around half of the total loans disbursed by SCB were for the construction of new homes, followed by purchase of existing homes (32%) and renovations/additions (17.6%) (Figure B). Given the growing demand of new homes, loans for new constructions are likely to remain a dominant part of SCB's lending portfolio.





CHAPTER 5

PAYMENT AND SETTLEMENT SYSTEMS

2022

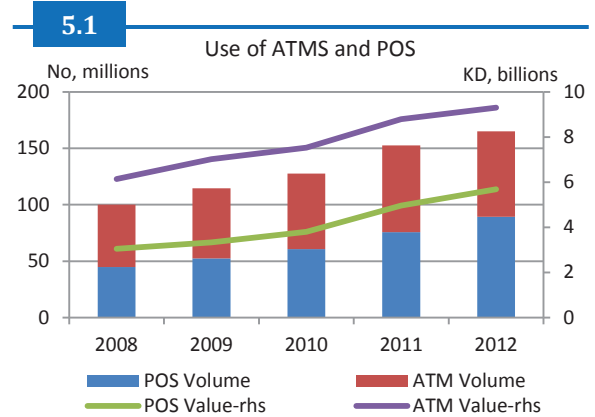
Both the retail and large-scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. In case of retail payments, use of ATMs and point of sale (POS) related transactions have witnessed a growth of 6% and 15%, respectively, during 2012, when viewed in terms of value of transactions. During 2012, share of ATMs related transactions was higher (62%) in value while that of POS transactions was higher in terms of volume (54%). E-banking infrastructure have also been growing in Kuwait, as number of ATMs and POS machines witnessed a growth of 15% and 11%, respectively reaching 1,428 and 28,432 machines by December 2012. While electronic based transactions account for 97% of all transactions in terms of volume, paper based transactions (through cheques) still have a sizeable share (56%) in term of value. Large-scale payment system (KASSIP) handled 1.02 million transactions worth 294 billion during 2012.

While the use and infrastructure of e-banking is on rise...

Retail Payment Systems are designed and used for a large volume of relatively low value transactions. With the growing use of information technology and increasingly secured systems, transactions through the E-banking have been on the rise in Kuwait. Accordingly, ATM and point of sale (POS) transactions that are operated by K-net (*see Box 5.1*) have exhibited a steady increase in the past five years (*Figure 5.1*).

During 2012, share of ATM based transactions (out of total ATM and POS based transactions) dropped from 64% to 62% in terms of value and from 50% to 46% in terms of volume (number of transactions). In terms of growth trends, the value of ATM transactions increased by 6% to reach KD 9.3 billion compared to KD 8.8 billion in 2011. On the other hand, numbers of ATM transactions were slightly down, by 1.4%, in 2012 at 75.8 million compared to 76.9 million transactions in 2011.

In case of POS, value of transactions conducted through the POS machines reached KD 5.68 billion in 2012, registering a growth of 15% compared to 2011 when value of these transactions was recorded around KD 4.96 billion. In terms of the number of

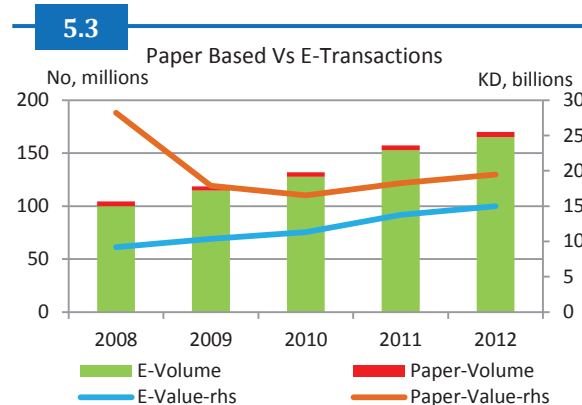
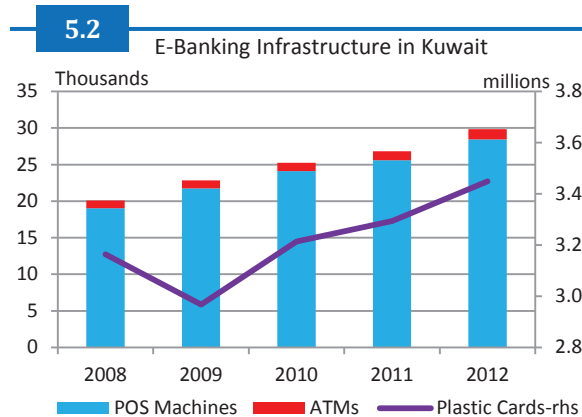


transactions through POS, growth of 18% was observed in 2012 as transactions reached 89.48 million compared to 75.81 million transactions in 2011. The growing use of electronic banking is understandable, given the convenience of cashless transactions. Further, retailers offering discounts on online purchases have also promoted the use of e-banking. On banks' part, this trend helps them keep the cost of operations lower by reducing the number of visitors for cash related transactions.

Growth in electronic banking has been adequately supported by the growing retail payment infrastructure in Kuwait. During 2012, the number of ATMs and POSs machines witnessed a growth of 15% and 11%, respectively reaching 1,428 and 28,423 machines by December 2012 (Figure 5.2). Moreover, issuance of new plastic cards (debit and credit cards) also registered a 5% growth in 2012, with total plastic cards reaching 3.4 million, around 85% of which are debit cards.

Paper based transactions appear significant in terms of value

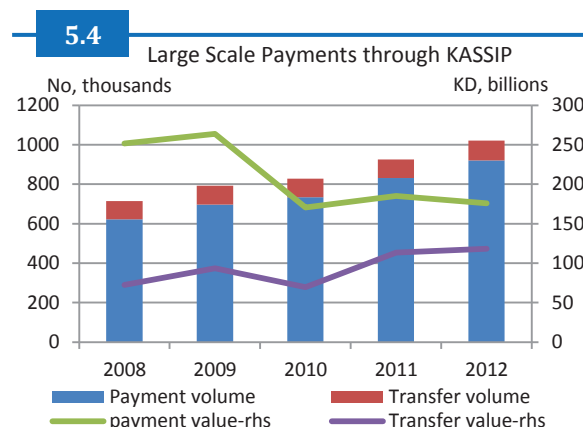
With growing use of e-banking, the share of paper based transactions, when viewed in terms of number of transactions (volumes) have become insignificant (Figure 5.3). For instance, during 2012, only 3% of around 170 million transactions were conducted through cheques. However, as we would expect, the share of paper-based transactions in terms of value still remains significant around 56% during 2012. Though even there, e-banking is catching up, as its share in terms of value (amount) has gone up from 25% in 2008 to 44% in 2012. Accordingly, e-banking is also becoming a key part of payment system even in terms of value, with transactions worth 15 billion were conducted through e-banking during 2012, compared to 20 billion through cheques.



Majority of transaction handled through KASSIP are payment related

Real time gross settlement system has been put in place in Kuwait since August 2004, known as the Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP). The main purpose of this system is to swiftly process large value payments in addition to large number of low value transactions.

Typically, transactions settled through KASSIP consist of *payments* and *transfers*, with the former involving a third party (customers) and later between banks. Bulk of the transactions handled through KASSIP are related to payments (*Figure 5.4*). During 2012 alone, as many as 1.02 million transactions were managed through KASSIP, registering a growth of 10.2 percent compared to 2011. In terms of value of transactions, 2012 witnessed a slight drop of 1.5%, as total transactions worth KD 294 billion were handled compared to KD 298.5 billion in 2011. On daily basis, KASSIP handles an average of 4,084 transactions of KD 1.17 billion, playing a critical role in overall payment system of Kuwait.

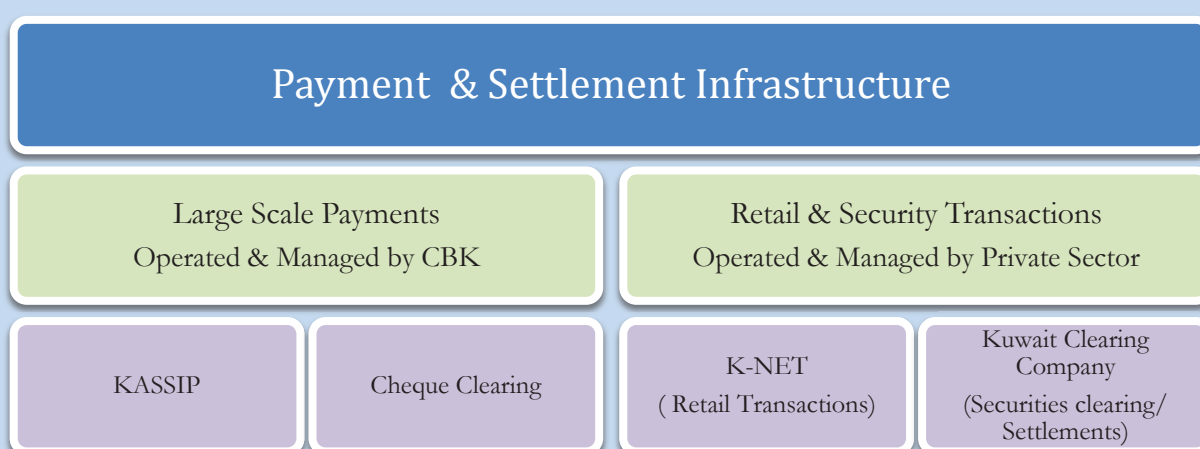


Box: 5.1

Payment System Infrastructure in Kuwait

The Bank for International Settlements (BIS), in its principles for financial market infrastructures issued in 2012, defines payment system as “a set of instruments, procedures, and rules for the transfer of funds between or among participants; the system includes the participants and the entity operating the arrangement”.

In Kuwait, the payment system infrastructure can be broadly classified into what is managed by CBK and what is operated by the private sector (Figure below)



Kuwait's Automated Settlement System for Inter-Participant Payments (KASSIP):

KASSIP, a real time gross settlement system in Kuwait, was implemented on August 5th, 2004 to mainly handle interbank related large value payments. KASSIP also processes large number of low value payments. Moreover, KASSIP has been used by CBK in sending and receiving its own payments and those for its customers like government entities, international institutions, overseas banks, and investment companies. Secured electronic networks are used for transmission of payments between participants and KASSIP, essentially through two networks; SWIFT and CBK-Net. KASSIP works in compliance with the principles for financial market infrastructures, as issued in 2012 by the BIS.

KASSIP offers variety of services like message handling through SWIFT and CBK-Net, payment processing, settlement and liquidity management etc. The system not only processes inter-participant payments on regular basis but also provides support for numerous other banking transactions like interbank-cheque clearing, monetary policy operations, sale and redemption of treasury bills and bonds, payments made between various government entities and participants of KASSIP, and cash transactions etc.

Clearing System in CBK:

Clearing operation is the process of exchanging cheques, in CBK clearing room, between participating banks. Each bank represents all the cheques that have been deposited by its clients which are drawn on other banks. CBK then handles the clearing process by identifying the net credit or debit balances. To assure accuracy and swift processing of cheques and as a step forward to apply the Automated Cheques Clearing Project, CBK has used MICR system in posting the received cheques from banks through the clearing system.

K-Net:

Retail payment system in Kuwait (K-Net) is managed Shared Electronic Banking Service Company (K.S.C.C). The company was established in 1992 and is owned by nine domestic and a foreign bank operating in Kuwait. Since 1994, the company has ensured secure and efficient setup for the financial transaction, connecting all banks in Kuwait. It has offered variety of services including ATMs and point of sale service, payment gateway for E-commerce and E-Government, Government Electronic Payment Project (Tasdeed), and cheque book printing etc.

Kuwait Clearing Company:

Kuwait Clearing Company (KCC) is the central clearing, settlement and depository entity for the securities market in Kuwait. It was established in 1982 for the purpose of handling issues related to the collapse of the unofficial stock market in Kuwait (Souk Al-Manakh crises). The crises also led to establishment of Kuwait Stock Exchange (KSE) in 1983 as an official stock market with an aim to organize and regulate the stock market in the country. Later in 1986, KSE authorities appointed KCC an agent for clearing and settlement of all securities transactions.

KCC plays critical role in clearing and settlement services for listed & unlisted securities as well the derivative transaction executed on KSE. It also provides other services to help manage the risks and secure and facilitate investors' transactions. Main beneficiaries of the KCC include KSE, brokers, investors, investment firms, mutual fund, banks, issuing companies and foreign clearing, settlement and depository entities. KCC offers services accounts, mortgage/pledge accounts, clearing and settlement services, registrar services, trusty and custody services, derivatives market dematerialization/re-materialization, initial public offer management, and depository services for corporate debt instruments etc.

