FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Kuwait's Outlook to Negative; Affirms at 'AA'

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Fitch Ratings - Hong Kong - 02 Feb 2021: Fitch Ratings has revised the Outlook on Kuwait's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'AA'.

KEY RATING DRIVERS

The revision of the Outlook reflects near-term liquidity risk associated with the imminent depletion of liquid assets in the General Reserve Fund (GRF) in the absence of parliamentary authorisation for the government to borrow. This risk is rooted in political and institutional gridlock that also explains the lack of meaningful reforms to tackle double-digit fiscal deficits and the expected weakening of Kuwait's fiscal and external balance sheets, although these will remain among the strongest of Fitch-rated sovereigns.

Without passage of a law permitting new debt issuance, the GRF could run out of liquidity in the coming months without further measures to replenish it. Depletion of GRF liquidity would sharply limit the government's ability to make good on its spending obligations and could result in significant economic disruption. Our base case is that government will replenish the GRF to avoid depletion even without any new legislation by parliament, and that debt service (about KWD400 million or 1% of GDP in 2021) would in any case continue in a timely manner. Nevertheless, a degree of uncertainty remains.

The authorities have shown commitment to avoiding a liquidity crisis and have flexibility to take extraordinary measures, but the timing of a sustainable funding solution remains unclear. In August, parliament passed legislation removing the automatic requirement to transfer 10% of revenue from the GRF into the much larger Future Generations Fund (FGF). This allowed for the reversal of the transfer for the fiscal year ending March 2019 (FY18), and followed the purchase of liquid assets from the GRF by the FGF. The GRF still has a broad range of illiquid assets that could also be transferred to the FGF, including the Kuwait Petroleum Corporation (KPC). The GRF could also borrow from the FGF, as it did during the Iraqi invasion in 1990-1991, although this is not an option that the government is considering at this stage. Under Kuwait's constitution, the Amir could issue decrees with the force of law, although this option would be politically contentious, in our view.

Passage of the debt law, deficit reduction and fiscal reform continue to be beset by entrenched political divisions and fiscal rigidities, with over 70% of government spending consisting of salaries and subsidies and about 80% of Kuwaiti nationals employed in the public sector. With political parties banned, members of parliament (MPs) tend to be elected on narrow, populist platforms and frequently conflict with an appointed government. This trend is likely to continue after gains by the opposition in the December 2020 elections. In January 2021, the government resigned after opposition MPs moved to "grill" the prime minister, although the Amir swiftly re-appointed him. The prime minister, a senior royal family member, was appointed after the last government resignation in November 2019. Another no-confidence motion in October 2020 was forestalled by the passing of the late Amir.

We expect the general government deficit to widen to about KWD6.7 billion (20% of GDP) in FY20, including in revenue the estimated investment income of the Kuwait Investment Authority (KIA), which is not officially disclosed and mostly relates to the FGF. We expect revenues to fall 33% to a little over KWD14 billion (42% of GDP), driven by lower oil prices and production. Spending will be in line with the previous fiscal year at KWD21 billion (62% of GDP), slightly below the final budget. The government allocated a total of KWD740 million (less than 2% of GDP) in additional spending to fight the coronavirus and support the private sector, which was offset by savings elsewhere, including lower subsidies, which vary with oil prices.

Fiscal deficits will likely remain in the double digits in the medium to long term and lead to a gradual but steady deterioration of Kuwait's balance sheet strengths, barring significant fiscal reforms or a rebound in global oil demand. We expect a fiscal deficit of about KWD7.5 billion (21% of GDP) in FY21, assuming an average oil price of USD45/bbl and average production of 2.4 million bbl/day. Under the same assumptions, the recent draft government budget plans for a broad-based increase in spending to KWD23 billion (about 65% of GDP), but we expect that the actual spending increase will be lower. We estimate that at current oil production levels, oil prices would need to average USD80/bbl for the budget to be in balance.

Under the government's reporting convention, which does not include KIA investment income in revenue, we estimate the fiscal deficits would be even larger at about KWD10 billion (30% of GDP) in FY20. This roughly corresponds to the government's funding need, as the bulk of KIA assets and investment income relate to FGF, which would require parliamentary approval to access.

Kuwait's 'AA' IDRs also reflect the following key rating drivers.

Kuwait's public sector balance sheet will likely remain among the strongest of any Fitch-rated sovereign, even assuming little fiscal reform and no recovery in oil prices or production. We estimate the foreign assets of the KIA, mostly in the FGF, at around USD581 billion at end-2020, accounting for the bulk of Kuwait's sovereign net foreign asset position of 652% of GDP. We estimate that the KIA total likely increased on the back of strong financial returns in 2020, despite drawdowns from the GRF. Government debt/GDP is among the lowest among Fitch-rated sovereigns, at around 17% in 2020, and passage of the debt law allowing KWD20 billion of borrowing by the central government could take this to 50-60%, just above the median for 'AA' sovereigns.

Kuwait's bank and non-bank private sectors are net external creditors and major investors in the rest of the region, reflecting relatively muted domestic growth prospects. This provides support to the current account balance and Kuwait's net international investment position, which we estimate at 675% of GDP in 2020. Kuwait's current account has been in surplus in all but two of the past 20 years.

Kuwait's fiscal and external metrics are particularly sensitive to changes in oil prices and production. We estimate that a USD10/bbl change in the average oil price from our baseline assumption would shift Kuwait's fiscal balance by around 6% of GDP. An additional 100,000 bbl/day of oil production would impact the fiscal balance by around 1.5% of GDP

We expect Kuwait's economy to stage a mild economic recovery this year as the dual shocks of oil production cuts and the coronavirus begin to fade. We estimate that real GDP contracted by about 7% in 2020, with the oil sector contracting by 9% and the non-oil sector by 4%. As global oil demand recovers and OPEC production quotas are phased out, there is potential for Kuwait to gradually raise output towards current production capacity of 3.1 million bbl/day (with KPC planning to expand capacity to 3.5 million bbl/day by 2025). The commissioning of refinery upgrades, KPC's clean fuels project and higher gas production could also support growth in 2021-2022.

Most structural features are weaker than the 'AA' category median, including World Bank Governance Indicators. The banking sector is well-capitalised and well-regulated, with an average Viability Rating (VR) of 'bbb'. The economy is one of the most heavily oil-dependent among Fitch-rated sovereigns, and we estimate that in 2020 oil contributed more than 90% of exports and 60% of total budget revenues (including investment income).

ESG - Governance: Kuwait has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Kuwait has a medium WBGI ranking in the 51st percentile.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Structural Features: Depletion of the GRF in the absence of a new debt law, legislation permitting access to the FGF or other extraordinary measures to ensure that the government can continue to make good on its payment obligations, including but not limited to debt service.

- Public Finances: Continued erosion of fiscal and external positions, for example due to a sustained period of low oil prices or an inability to address structural drains on public finances.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Public Finances: Adoption of a clear and sustainable government funding strategy, for example through passage of laws permitting regular debt issuance or access to FGF assets, accompanied by evidence that Kuwait's institutions and political system are able to tackle long-term fiscal challenges, for example through actions to implement a clear deficit reduction plan.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Kuwait a score equivalent to a rating of 'AA' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

We forecast that Brent crude will average USD45/bbl in 2021 and USD50/bbl in 2022.

Fitch assumes that regional conflicts will not directly impact Kuwait or its ability to trade.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

The KIA's assets are not officially reported by the government. Fitch estimates these assets by compounding the government's transfers into the KIA, using assumptions about returns and asset allocations that are informed by discussions with the KIA. Fitch benchmarks government transfers into the KIA and KIA investment income against the balance of payments. Fitch has sufficient confidence in these estimates to maintain the rating.

ESG CONSIDERATIONS

Kuwait has an ESG Relevance Score of 5 for Political Stability and Rights as WB Governance Indicators have the highest weight in the SRM and Kuwait is in a geopolitically unstable region and its internal politics are fractitious. This is therefore highly relevant to the rating and a key rating driver with a high weight.

Kuwait has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WB Governance Indicators have the highest weight in the SRM and are therefore highly relevant to the rating and a key rating driver with a high weight.

Kuwait has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as WB Governance Indicators have the highest weight in the SRM and are therefore relevant to the rating and a rating driver.

Kuwait has an ESG Relevance Score of 4 for Creditors Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Kuwait	LT IDR	AA Rating Outlook Negative	Affirmed	AA Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+
•	LC LT IDR	AA Rating Outlook Negative	Affirmed	AA Rating Outlook Stable
•	LC ST IDR	F1+	Affirmed	F1+
•	Country Ceiling	AA+	Affirmed	AA+
• senior	LT	AA	Affirmed	AA

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Krisjanis Krustins, CFA
Director
Primary Rating Analyst
+852 2263 9831
Fitch (Hong Kong) Limited
19/F Man Yee Building 60-68 Des Voeux Road Central Hong Kong

Cedric Julien Berry
Associate Director
Secondary Rating Analyst
+852 2263 9950

Jan Friederich
Senior Director
Committee Chairperson
+852 2263 9910

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Kuwait	EU Endorsed, UK Endorsed

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Sovereigns Middle East Asia-Pacific Kuwait
