Press Statement by His Excellency, the Governor of the Central Bank of Kuwait concerning publication of the Financial Stability Report for 2015

His Excellency the Governor of the Central Bank of Kuwait (CBK), Dr. Mohammad Y. Al-Hashel, announced the publication of the Financial Stability Report (FSR) for 2015 - the fourth in a series of reports published by the CBK as part of its efforts to promote transparency and encourage informed public discourse on various developments in the financial system.

His Excellency the Governor mentioned that FSRs issued by the CBK analyse and highlight economic and financial developments in terms of their effect on financial stability and the resilience of the financial system to unanticipated adverse shocks. A financial system, consisting of institutions, markets and infrastructure, can be viewed as stable if it continues to ensure, even in times of stress, an efficient allocation of financial resources and fulfillment of its key macroeconomic objectives. Given the colossal social and economic costs of any financial crisis, maintaining financial stability is a key objective of central banks and regulatory authorities around the globe.

Dr. Al-Hashel further explained that this fourth FSR is composed of five chapters:

- **Chapter 1** assesses the role and performance of banks - both conventional and Islamic - as financial intermediaries.
- **Chapter 2** evaluates the risks faced by the banking system.
- **Chapter 3** examines the trends in profitability and solvency of the banking system and its resilience to 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 the domestic financial market.
- **Chapter 5** examines the performance of retail and large-scale payment and settlement systems in the country, significant components comprising Kuwait's financial system and stability.

This fourth FSR addresses the key developments in the Kuwaiti financial system, which are summarized as follows:

1) The banking system in Kuwait remained sound and stable during the year under review (CY2015). Domestic credit posted a healthy growth, banks' non-performing loan ratio continued its steady decline to reach a historically low level, coverage ratio climbed to a new high, capital adequacy levels stayed robust and net income grew positively, albeit at a much slower pace than in 2014. These trends collectively highlight that banking sector, at least so far, has weathered the oil rout fairly well. While banks entered the low oil price environment from a position of strength, the positive outcome observed in CY15 can in part be attributed to higher public spending which helped contain the impact of falling oil prices on domestic economic environment. Banks' resilience would have come under pressure had there been a scaling back of public investments or a major correction in real estate prices. Backed by ample financial buffers, the government commendably ramped up infrastructure spending despite the sharp drop in oil revenues. Moreover, stable employment conditions for Kuwaiti nationals coupled with positive growth in wages supported consumer spending in general, except for the sale of durables which was influenced by a cautious outlook.

2) After two years of double-digit growth, banking system posted a much slower expansion when viewed on a consolidated basis; assets grew by a muted 2.6% during 2015. However, growth in domestic assets was much healthier at 5.7% on the back of strong growth in domestic credit which was up by 8.5% compared to 6.3% in 2014. Lending to the households was particularly strong at 10.6%; household sector turned out to be the top recipient for bank credit in 2015, surpassing the real estate sector. However, as the bulk of lending to households (83.8% in 2015) has been in terms of installment loans for repair and purchase of private homes, banks' combined exposure to real estate sector reached almost half of their total credit portfolio. Yet the risk profile of installment loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, notwithstanding the apparent lack of diversification, banks' credit portfolio itself has been fairly healthy with non-performing ratios at low levels. On the liability side, growth in banks' consolidated deposits slowed down to 3% compared to 7.8% in 2014. Domestic deposits grew only a tad better, posting 3.3% increase in 2015. However, the banking system continued to enjoy a stable funding base with 63% of the total deposits placed in the time deposit category.

3) Asset quality of the banking system has visibly improved over the last few years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has dropped to a

historically low level of 2.4% (1.9% on domestic, Kuwait- only basis) as of December 2015, well below 3.8% last observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the last few years is particularly visible if the existing NPLR (2.4%) is compared with the double-digit NPLR (11.5%) recorded in 2009. Moreover, the coverage ratio (available provisions to NPLs) have reached 205% (275 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. Such positive developments in both NPLR and coverage ratio collectively exhibit the success of the CBK and local banks' endeavors in improving asset quality of the banking system. While flow of non-performing loans (NPLs) under different classifications reveals some buildup of new NPLs, loans under 'loss' category have clearly diminished. Sectoral analysis of NPLs indicates that the decline in NPLR has been broad based with many of the key sectors experiencing a contraction in their respective NPLRs. One noticeable exception has been the household sector, posting a marginal increase in NPLs, though its non-performance ratio remains fairly contained (2.5% as of December 2015). Geographically, the share of NPLs originating from banks' operation in the GCC and Africa regions has somewhat increased. Industry breakdown reveals that conventional banks account for 57.8% of total NPLs, almost in sync with their share in gross loans (60%).

4) Banks' exposure to the equity markets, though still significant, has been on a steadily declining trend; equity investments make up around 22.8% of banks' total investments, and use of firms' shares as collaterals accounts for 22% of banks' overall collaterals. Banks' liquidity levels have remained healthy despite some tightening in the interbank market. Newly introduced liquidity coverage ratio also highlight that banks are comfortably above the minimum benchmark (70% for 2016) or even against the ultimate benchmark of 100% which would be effective in 2019.

5) Banks' net income, on consolidated basis, grew by a modest 7% in 2015, at a much slower pace compared to 26.5% in 2014. Both return on assets as well as equity experienced a marginal improvement as growth in net income outpaced the growth in assets and equity. Though non-interest income recorded positive growth after experiencing contraction in 2014, growth in interest income in 2015 was barely half of what was observed a year earlier. By banking groups, conventional banks accounted for 64.5% of the industry profits and 60.7% of the industry assets. Cost to income ratio marginally came down with improvement in efficiency of Islamic banks. Still conventional

banks, on average, remained significantly more cost efficient than their Islamic counterparts.

6) Capital adequacy ratio (CAR) of the banking sector further improved to reach 17.5%, well above the CBK's 12.5% requirement for 2015. Though the improvement in CAR was largely driven by conventional banks in 2015, Islamic banks continued to maintain capital adequacy ratios above their conventional counterparts, which in part also explains their lower efficiency ratios. Banks' overall leverage ratio was 9.7% in 2015, well above 3% benchmark proposed by the Basel Committee, indicating banks' capacity to extend credit without the risk of breaching the leverage ratio. Results of CBK's quarterly stress testing exercise reveal that banks, individually and collectively, have been able to broadly withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

7) CBK, in lockstep with the Federal Reserve, raised its discount rate by 25 bps in December 2015. Domestic inter-bank rates were on ascent few months in advance of CBK's move, largely in anticipation of an impending lift-off by the Federal Reserve. Both the scale of liquidity absorptions as well as interbank rates indicate that liquidity in the banking sector, while still healthy, has slightly tightened; accordingly, absorption both in terms of interventions and Tawaruq for shorter maturities visibly tapered by the close of 2015. CBK's mop up exercise relied, almost entirely, on the use of one-week instruments, further reducing the share of one-month arrangements. In the foreign exchange market, KD depreciated against USD by 3.6% in 2015 while appreciating against EURO and GBP by 6.7% and 0.9% respectively; diverging growth trajectories and monetary policies across major economies influenced the exchange rates.

8) Kuwait Stock Exchange, moving in lockstep with the protracted decline in oil prices, closed the year down in double digits (14.1%) as the absence of a domestic catalyst left the market more attuned to global developments; large cap stocks retreated by 15% (Kuwait-15 index) despite banks' healthy profits. Kuwait's real estate market also markedly slowed down both in terms of number and sales value of the deals, after enjoying positive growth for five consecutive years (with a particularly robust expansion in 2014). The retreat was broad based as all three segments (residential, investments and commercial) contracted significantly as steady fall in oil prices weighed on investors' sentiments. Yet the real estate prices seemingly held up well, averting any serious correction; this suggests the presence of genuine

demand as well as investors' preference to stay put. However, materialization of an extreme tail event like a sharp correction in the real estate prices, though highly unlikely, could test the resilience of the banking sector, given banks' significant exposure to the real estate market, both in terms of loans and collaterals.

9) Both retail and large-scale payment systems in Kuwait have been steadily growing, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. During 2015, value of ATMs and point of sale (POS) based transactions posted growth of 5.2% and 13.2% respectively. These growth trends are similar to the ones observed in 2014 and underscore the resilience of household consumption in Kuwait despite a challenging economic environment. There are, however, signs of a slowing trend in the sales of consumer durables. To facilitate the increasing use of e-banking, necessary infrastructure in Kuwait has also been expanding; the number of ATMs and POS machines grew by 4.7% and 13.1%, respectively reaching 1,708 and 43,322 machines by December 2015. Moreover, branch network also continued to expand (particularly for Islamic banks), bringing total bank branches in Kuwait to 422.

In summary, the Governor indicated that growth in private sector credit is likely to remain healthy amid ongoing emphasis on capital spending. Moreover, oil market is heading towards a more balanced position. The Kuwaiti banking sector, which has remained unscathed so far, is likely to benefit further from this relatively improved outlook on domestic front. And the banking sector is well placed to remain resilient in the near term, though the capacity to withstand various shocks does vary across banks.

His Excellency, the Governor concluded by pointing out that the Financial Stability Report for 2015 is available on the CBK official website.

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