Press Statement by His Excellency, the Governor of the Central Bank of Kuwait concerning publication of the Financial Stability Report for 2014

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 2014 - the third in a series of reports published by CBK as part of its efforts to enhance transparency and to make available reliable information and statistics related to the Kuwaiti banking system and financial sectors.

His Excellency the Governor mentioned that FSRs issued by 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, thus maintaining the provision of efficient financial services at the macroeconomic level.

Dr. Al-Hashel further explained that this third 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.

Important highlights in the third FSR are summarized as follows:

1) The consolidated banking sector balance sheet marked another year of double-digit growth. During 2014, assets worth KD 7.2 billion were added to the banking system, putting total assets at KD 66.4 billion by year-end - i.e. growth of 12.2% versus 11.9% in 2013. Both in absolute and growth terms, this was the most significant expansion recorded in the last seven years. Growth of the consolidated balance sheet of banks reveals, in part, that the increased international activity of Kuwaiti

banks remains robust and accounts for 20.4% of the consolidated balance sheet, thereby providing a major source of banks' income that reduces reliance on local sources and strengthens their stability.

2) Banks expanded their consolidated loan portfolio by another KWD 4.2 billion, posting the strongest growth (11.5%) observed in the last five years. At the domestic level (Kuwaiti banks and foreign banks' branches in Kuwait), credits granted to national economic sectors rose from KWD 29 billion as of December 2013 to KWD 30.8 billion in December 2014 representing an increase of KD 1.8 billion and a yearly growth rate of 6.2% (i.e., less than the growth rate of 8.1% recorded in the last year). However, the growth rate in 2014 reveals the upward trend of credit off-take compared to 0.4% in 2010, 1.6% in 2011 and 5% in 2012. In addition, growth of banking credit encompasses most of the local economic sectors including installment (housing) loans and loans granted to the real estate sector. By December 2014, such facilities totaled KWD 16 billion, i.e. an increase of KWD 1.4 billion compared to December 2013, and a yearly growth rate of around 9.4%, which is higher than the growth rate of the total loan portfolio.

3) Asset quality of the banking system visibly improved over the last few years, and the gross non-performing loan ratio (NPLR), on a consolidated basis, dropped to a historically low level of 2.9% in December 2014. The improvement of asset quality demonstrates the success of the CBK and local banks in their combined endeavours over the last years to analyse and assess the quality of loan portfolios in accordance with the strict implementation of the relevant standards. As a consequence NPLR, at the domestic level, edged down from 7.1% as of December 2011 to 4.9% as of December 2012, 3.2% as of December 2013 and 2.3% as of December 2014, - i.e., visibly lower than the pre-crisis ratio.

   Moreover, the coverage ratio (available provisions to NPLs), on a consolidated basis, reached 164% as of December 2014. The coverage ratio for domestic loans has continued to grow improving from 71.8% as of December 2011 with an upward trend to reach 214.1% as of December 2014. All these ratios exhibit soundness of Kuwaiti banks' financial indicators.

4) Profitability of Kuwaiti banks posted a strong recovery in 2014 after experiencing a noticeable contraction back in 2013; net profits attributable to shareholders of Kuwaiti banks (conventional and Islamic banks and the Industrial Bank of Kuwait) surged by 26.5% in 2014 to reach KWD 656.4 million from KWD 519.0 million a year earlier, representing an increase of KWD 137.4 million. Amid rising net income

of the banking sector, average return on assets inched up from 0.9% as of December 2013 to 1% as of December 2014, and average return on equity increased from 6.9% in 2013 to 8.2% in 2014.

5) The Capital Adequacy Ratio (CAR) of the banking sector was still well above the requirements of Basel III - the new standard adopted by Kuwaiti banks within a comprehensive set of reforms. Reports submitted by Kuwaiti banks indicate full compliance within the terms of Basel III as the CAR of Kuwaiti banks is still well above the CBK's requirement of 12% for 2014, which is higher than Basel requirement of 10.5%. As of December 2014, the CAR of Kuwaiti banks, on a consolidated basis, as per Basel III stood at 16.9%. Moreover, the share of Tier-1 capital accounted for around 92.6% of banks' total capital. Strong capital adequacy, driven by high quality Tier-1 capital, underscores the strength of the Kuwaiti banking system and thus demonstrates its ability to withstand significant shocks. Thanks to the CBK's persistent efforts and strong focus on ensuring a stable financial system where a robust capital adequacy plays a critical role, Kuwaiti banks have consistently maintained high capital levels and are therefore able to withstand possible ramifications resulting from the global financial crisis as well as strengthening regulatory capital and enhancing the capital quality.

6) Leverage ratio data reveals the ability of Kuwaiti banks to abide by this ratio in addition to other new ratios implemented by the CBK in 2014 within the framework of Basel regulations. The Leverage ratio of the banking industry was 8.9% as of December 2014 - well above the minimum of 3% required by CBK, as recommended by Basel Committee for Banking Supervision. Additionally, this ratio is intended to firm-up capital adequacy taking into account the computation of leverage ratios based on the overall "off" and "on" balance sheet assets of the bank, rather than the size of risk weighted assets as stated under capital adequacy regulations. Therefore, this ratio is considered an additional buffer to minimize systematic risks and strengthen financial stability.

7) Banks' liquid assets of less than three months witnessed a rising trend since 2010; during 2014, liquid assets were up by KWD 5.3 billion to reach KWD 20.4 billion. A breakdown between core and non-core liquid assets indicates that the core liquid assets accounted for 80.5% of the total liquid assets which, in turn, constitutes 30.7% of the total banks' assets. It is, therefore, clear that these high ratios of high quality liquid assets fortify the financial positions and soundness of financial indicators of banks and their resilience to unanticipated shocks without any adverse effect on financial stability.

Furthermore, the higher levels of liquidity maintained by Kuwait banks helped them to fulfill the requirements of the liquidity coverage ratio (LCR) introduced among the Basel III set of reforms and adopted by the CBK as of December 2014. This standard aims to ensure that banks can address liquidity risk over the short term by having an adequate stock of unencumbered high quality liquid assets to meet their liquidity needs for a 30 calendar day period in a liquidity stress scenario. The CBK resolved to adopt this standard based on a quantitative impact study, which reveals the ability of Kuwaiti banks to comply with the requirements of this standard at ratios on top of the required minimum of 100%. It goes without saying that this ratio exhibits the sound position of the banking sector as well as ensuring banks' ability to maintain their role in serving the national economy - even in stress circumstances.

8) In line with its monetary policy, the CBK kept unchanged Discount Rate at the historically low level of 2%, representing the key benchmark serving as a reference rate to calculate interest rates charged on lending facilities. By maintaining interest rates at this level the CBK also aimed to help increase credit off-take by the various sectors. The CBK routinely monitors movements in international interest rates and assesses their effect on the domestic economy and banking system. In addition, the CBK regulates domestic liquidity by absorbing excess banking system liquidity so as to influence interest rates and ensure the smooth flow of funds between the banking sector and national economic sectors whilst ensuring that sufficient liquidity is available to banks for financial expansion and reinvestment.

The KWD exchange rate remained stable throughout 2014 as a result of pegging the Kuwaiti Dinar to a basket of currencies of the countries that share significant financial and trade relations with the State of Kuwait. This arrangement assisted in shielding Kuwait from imported inflation resulting from the effects of foreign currency volatility and has ensured a more stable exchange rate where the net impact of volatility in exchange rates has been largely neutralized, in addition to providing the CBK with the necessary flexibility to reinforce financial and monetary stability in the country.

9) Stress tests conducted using data as of December 2014, applying various macro and micro level scenarios of different severities revealed resilience of individual banks as well as of the entire banking sector, supported by additional capital and excess liquidity that provided adequate buffers to withstand various shocks. Within the context of falling oil prices as from June 2014, the CBK subsequently made

certain amendments to the assumptions of stress testing scenarios to reflect these developments.

10) Due to the importance of up-to-date payment and settlement systems to financial stability, the report also highlights the development of payment and settlement systems in the State of Kuwait in terms of the number of transactions through automated teller machines (ATMs) and point of sales (POSs), and growth in volume of transactions carried out through Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP). Also, in line with endeavours to enhance the payment and settlement systems and reinforce the financial stability, the CBK, as of June 2014, started implementation of the automated cheque clearing system thereby providing valuable advantages to both the domestic banking system and the customers of banks.

11) In addition to the positive development reflected by the quantitative indicators supporting financial stability, Kuwaiti banks continued to improve their risk management procedures while adopting appropriate governance standards and regulations - including those issued by CBK in June 2012. Over the recent years, CBK has also developed its supervision approaches by applying risk-based supervisory processes and verifying compliance functions.

In summarising His Excellency the Governor indicated that the strong financial position of Kuwaiti banks and the qualitative and quantitative developments in their financial indicators are substantiated by reports published by the International Monetary Fund and in the credit ratings provided to banks by international rating agencies which, in turn, are reflected in the comparatively high sovereign credit ratings given to the State of Kuwait.

His Excellency, the Governor concluded by pointing out that the Financial Stability Report for 2014 is available on the CBK official website.

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