Liquidity Risk in the Banking Sector
The Central Bank of Kuwait Experience*

السلام عليكم ورحمة الله وبركاته

Esteemed Governors and attendees,

I am pleased to have been invited to speak in this session of the IFSB council meeting, the theme of which – I believe – will engage in a meaningful discussion amongst us, as we strive to develop innovative solutions that will fortify our financial institutions, instill confidence, and ensure a resilient and prosperous future for our economies.

Before broaching into *Liquidity Risk in the Banking Sector*, it might be worthwhile to set the scene on what has caused the recent crunch that disturbed the financial sector and led to failure of certain banks. I'm sure you don't need to recall the circumstances that led to worldwide deployment of ultra-loose monetary policies and the massive fiscal stimulus to revive the economy. These motivational policies, along with the supply chain disruptions and the geopolitical and military tensions globally have led to inflationary pressures that put monetary policymakers in an unfavorable paradox:

- The high levels of debt that deemed the system sensitive to any sharp interest rate increases, and
- The accelerating inflation rates that topped the list of pressing risks hindering the economic recovery.
- Associated risks of affecting the weak economic growth.

As such, monetary tightening was inevitable.

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* Speech delivered by His Excellency the Governor of the Central Bank of Kuwait, Basel A. Al-Haroon, in the 42nd Council Meeting of the Islamic Financial Services Board (IFSB), held in Riyadh, Kingdom of Saudi Arabia on August 16, 2023.

While major economies as well as many developing economies are now reaping what their policymakers have sown, the quick trend of monetary tightening ushered in a new period of economic challenges, particularly in the realms of credit and liquidity. With the recent banking failures casting immediate shadow on the financial landscape at that time, one must be grateful that the incidents were very specific in nature and were controlled in terms of magnitude with no systemic impact. Nonetheless, and as always, there is no room for complacency. We need to seize this rich opportunity of lessons learned that demand immediate attention and collaborative action.

In my speech today, I will touch on the key lessons learned from the recent banking failures, and the Central Bank of Kuwait’s response thereto, as well as the findings that came out of it. I will finally conclude with some recommendations and discussion-spurring questions that might stimulate the ideas and help steer the future conversation towards fruitful solutions.

The year 2023 witnessed the failure of multiple banks that were indirectly affected by the tightening monetary policy. In US: Silicon Valley Bank (SVB), First Republic Bank (FRB) and Signature Bank, and the Credit Suisse in Switzerland. However, the collapse of the Silicon Valley Bank (SVB) stands out as the most significant. This serves as a unique case study verifying that traditional soundness indicators may not be sufficient individually in measuring a bank’s true risks, and must be viewed holistically as part of wider analytical scope. Furthermore, it can ultimately help us uncover potential flaws and weaknesses in supervisory monitoring tools and prompt us to build on current regulatory safety measures.

The failure of SVB can be attributed to a combination of factors stemming from both the bank's *internal operations* and *regulatory oversight*. Internally, the bank faced challenges related to asset-liability mismatch, inadequate risk management, unchecked and uncontrolled rapid expansion, as well as the relatively high concentration in depositors. These bank-specific characteristics and the contractionary monetary policy cultivated a bank-run catalyst.

Despite the bank was affected by the tightening of monetary policy, which was needful from a macro perspective to address many economic problems such as curbing high inflation, it’s worth saying that the imprudent management of the bank and the wrong investment decisions were the main causes of the SVB failure. Also, from a regulatory perspective, the insufficient supervisory requirements due to the adoption of size-based proportionality unfortunately paved the way for the bank's risky behavior. For example, the size of SVB fell below the predetermined threshold, which exempted the bank from applying key liquidity ratios, such as the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR).

Your Excellencies,

As we are all aware that the failure of the bank raised the fears of the financial community and global markets about the expansion of its repercussions on the US economy as a whole, and the transmission of its contagion to the global banking sector. Therefore, once the developments in the world financial markets began to unfold, the Central Bank of Kuwait requested all Kuwaiti banks to conduct sensitivity analysis on their investment portfolios, under the assumption that all investments are repriced at their current fair market value, including those which are classified as *Held to Maturity*, in addition to stressing their interbank books. Assuming *extreme* shocks to the yield curve and severe *Loss-Given-Default* assumptions, Kuwaiti banks still demonstrated solid capital buffers and resilient liquidity ratios. This exercise provided us with the comfort of having a solid, well-grounded regulatory framework, along with proactive supervisory measures.

In terms of the regulatory framework, the Central Bank of Kuwait has been at the forefront of countries implementing BCBS's capital and liquidity standards issued post the Global Financial Crisis. In doing so, we made sure that the guidelines directed towards Islamic banks include prudent leeway that allow for a level playing field. Moreover, and in order to compensate for the lack of sufficient Shariah compliant profit-generating *High-Quality Liquid Assets*, the Central Bank of Kuwait was one of the pioneering institutions founding the IILM. On the local front, the Central Bank of Kuwait issues Shariah-compliant liquidity intervention instruments that qualify as High-quality liquid assets (HQLA) for the Islamic banks.

The Central Bank of Kuwait has established a comprehensive Liquidity Regulatory Framework that assesses five key ratios: Liquidity Coverage Ratio

(LCR), Net Stable Funding Ratio (NSFR), Regulatory Liquidity Ratio, Maturity Mismatch, and the Maximum Lending Limit - which is somewhat similar to more widely known Loans to Deposits ratio. These ratios are applicable to all local banks – both conventional and Islamic – with the aim of fortifying them against adverse shocks, eliminating structural mismatches between assets and liabilities, and encouraging more stable sources of funds. While someone might argue that having five different liquidity ratios entails both monitoring and compliance burdens, our continuous assessments of the framework keeps proving the effectiveness of it. The ratios in our liquidity toolkit complement each other, as some serve short-term horizons, and others serve longer ones. They also differ in the nature of calculation, with some based on stressed factors using multiple assumptions, while others are straightforward requirements.

Fortunately, local Islamic banks have demonstrated their ability to comply with the set requirements for all the above-mentioned ratios, with comfortable buffers. Allow me to walk you through some of these figures that shows the competence of Islamic banks in meeting the liquidity requirements along with their conventional counterparts:

Ratios as of 31/3/2023	**Islamic**	**Conventional**
Liquidity Coverage Ratio	159%	157%
Net Stable Funding Ratio	116%	111%
Regulatory Liquidity Ratio	23%	24%
Loans to Available Sources of Funds	83%	79%

This genuine ample liquidity available at the Kuwaiti Islamic banks does not come at the expense of their profitability, as figures demonstrate that around 80% of the qualified liquid assets are profit generating. These assets mostly constitute the Central Bank of Kuwait's liquidity intervention tools, and Sukuk issued by The Islamic Development Bank (IDB), The International Islamic Liquidity Corporation (IILM) and GCC Sovereigns.

As for the supervisory measures, the Central Bank of Kuwait utilizes advanced tools to supervise banking units and detect unhealthy signals. These include well-developed stress testing tools and supervision capabilities in individual banking unit priority setting and supervision. Prioritizing supervision, through our Supervision Priority Index, enables more efficient allocation of efforts, where early interventions can be applied to banks that pose elevated risks. The internally developed index integrated the CAMEL BCOM score along with CAMEL trends, stress testing results, and the systemic importance score of each bank.

Distinguished members,

As I presented some aspects of the Central Bank of Kuwait's toolkit used to address liquidity in Islamic banks, I am confident that each one of Your Excellencies will have equally valuable tools. If put together, we can collectively have a solid framework that can support Islamic banks in having a level playing field with their conventional counterparts without jeopardizing their stability. Therefore, I will now shift focus to some ideas that are worth pondering on, in an effort to potentially bring us closer to viable solutions.

First of all, it is worth highlighting the lessons learned from the 2008 Global Financial Crisis, which cultivated in a wholesome resilient framework that proved functional in subsequent crises. Yet, as the financial systems navigate the everchanging environment, we need to be agile and proactive in responding to potential threats to avoid a Trojan Horse incident from trickling into the system and undermining its stability.

The events of early 2023 have shed light on various areas of weaknesses and grey areas that require addressing in order to strengthen the banking sector. **Firstly**, depositor's concentration, be it sectoral or name concentration needs to be pushed more into the spot-light, as it has been proven that having a Deposits' Insurance Scheme wasn't enough to prevent bank-runs. **Secondly**, *Duration Risk* and the credibility and reliability of different accounting classifications emerged as material sources of trouble. In times of stress, banks resorted to liquidating instruments that were initially *Held to Maturity* and recognized unaccounted for losses. We also saw that despite Islamic banks offering interest-free financial instruments, they still engage in various investments activities and face market risks, including duration risks which can severely impact their financial position. **Thirdly**, are the LCR and NSFR sufficient on their own to counter the different aspects of liquidity risks? As we have seen in Kuwait, while having five different liquidity ratios may be perceived cumbersome, but as highlighted earlier, our experience shows the importance of having back-stops. **Fourthly**, banks' proportional size should not come at the expense of financial stability. Besides Credit Suisse, most of the failing banks in 2023 were of relatively smaller size and regulators opted them out of some regulatory requirements. **Lastly**, intervening in the right time. Intervention refers to actions that authorities can take to stabilize and restructure a banking system in crisis. It is distinguished from prevention, which covers more forward-looking activities such as improving regulation and supervision, strengthening monitoring and incentives, and enhancing information transparency. While we are constantly spotting potential risks to banks, the extent of which those risks can affect the stability and soundness of the sector is not always clear, hence sometimes hindering our opportune intervention.

To that end, we have to continue our vigilant monitoring and proactive intervention to ensure the soundness and stability of our financial systems, leveraging the existing ties and the continuous fruitful dialogues taking place amongst us.

Thank you for your attention.