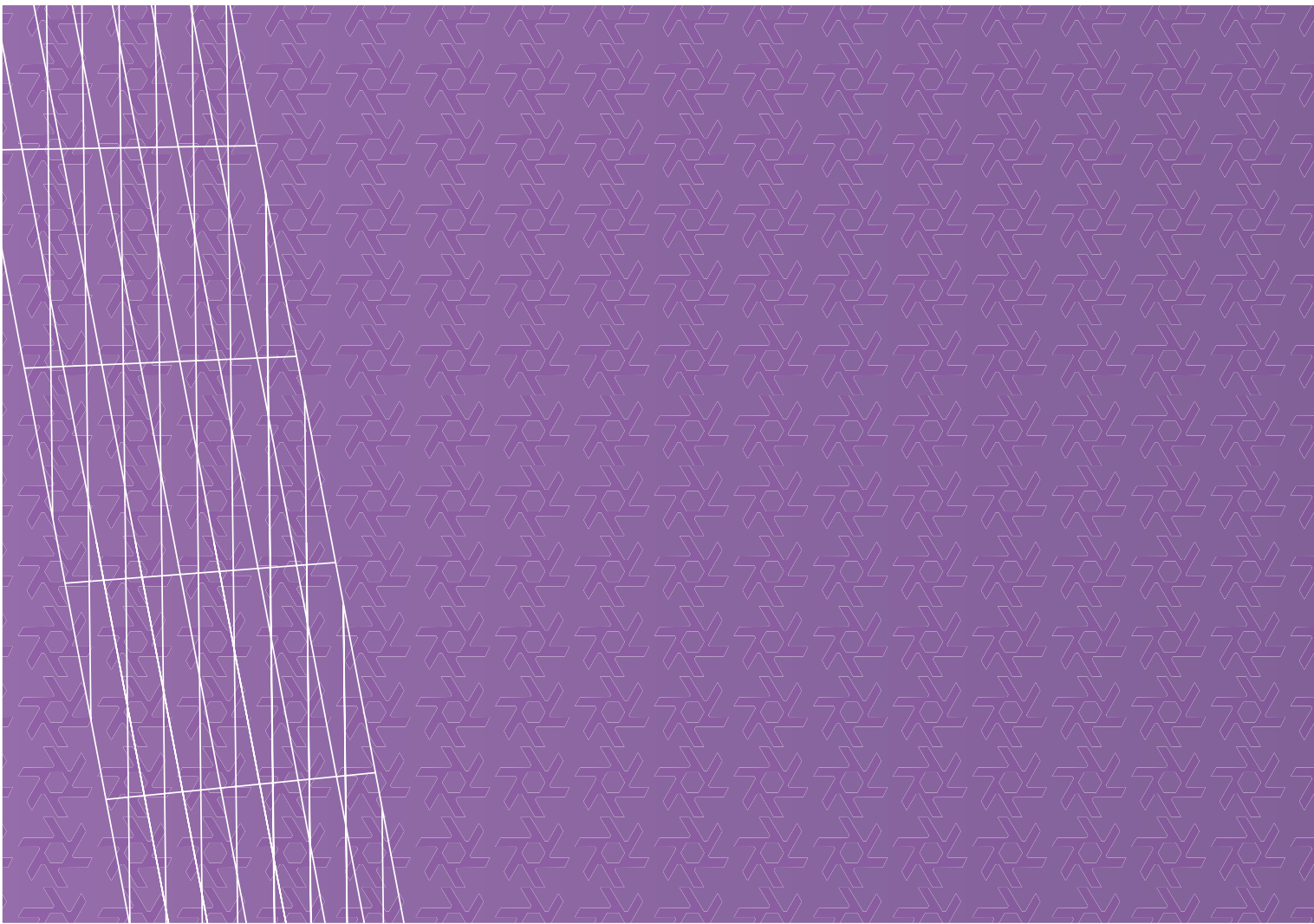


# Financial Stability Report 2018





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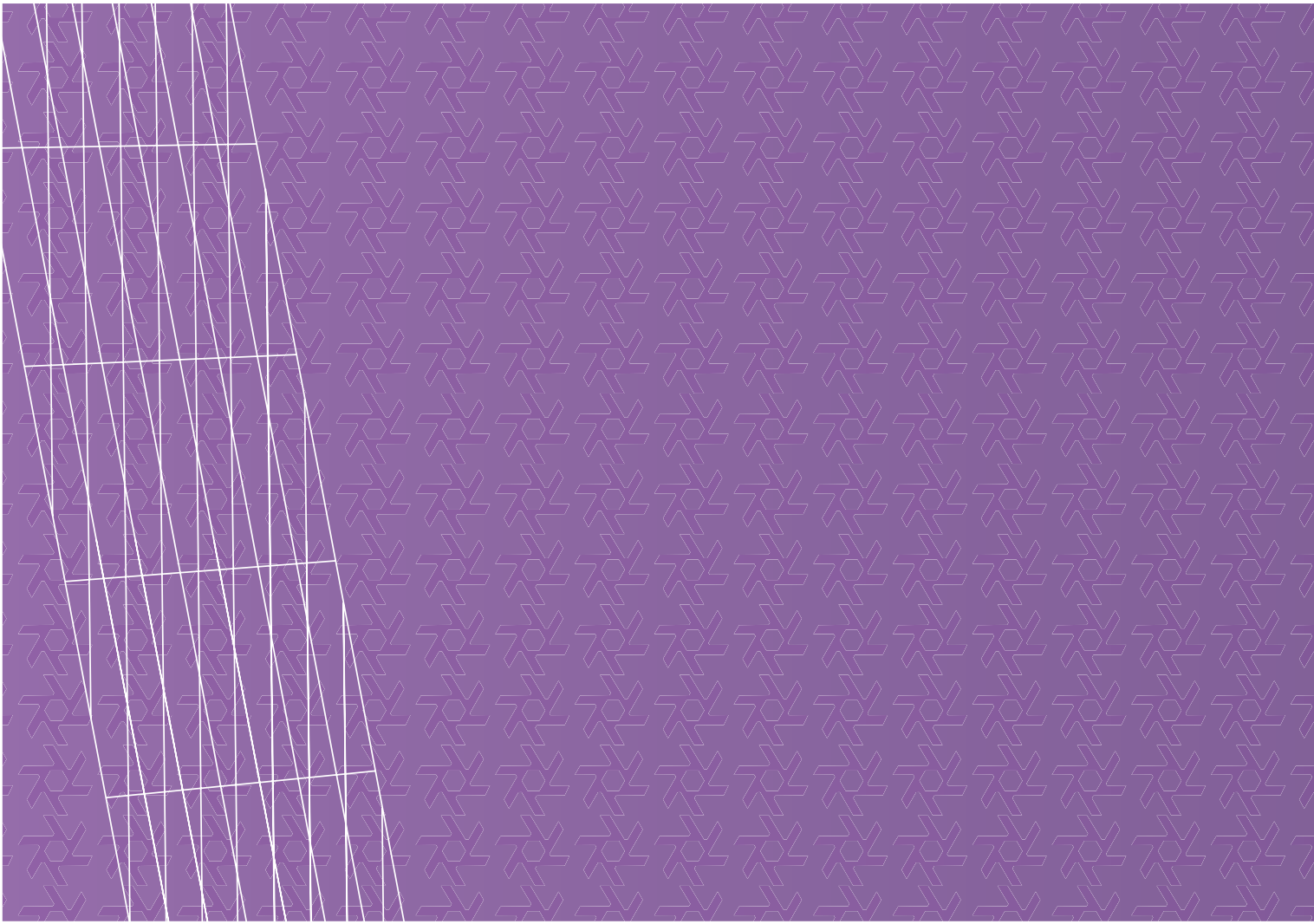
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# Financial Stability Report

for the calendar year 2018

Financial Stability Office  
Central Bank of Kuwait

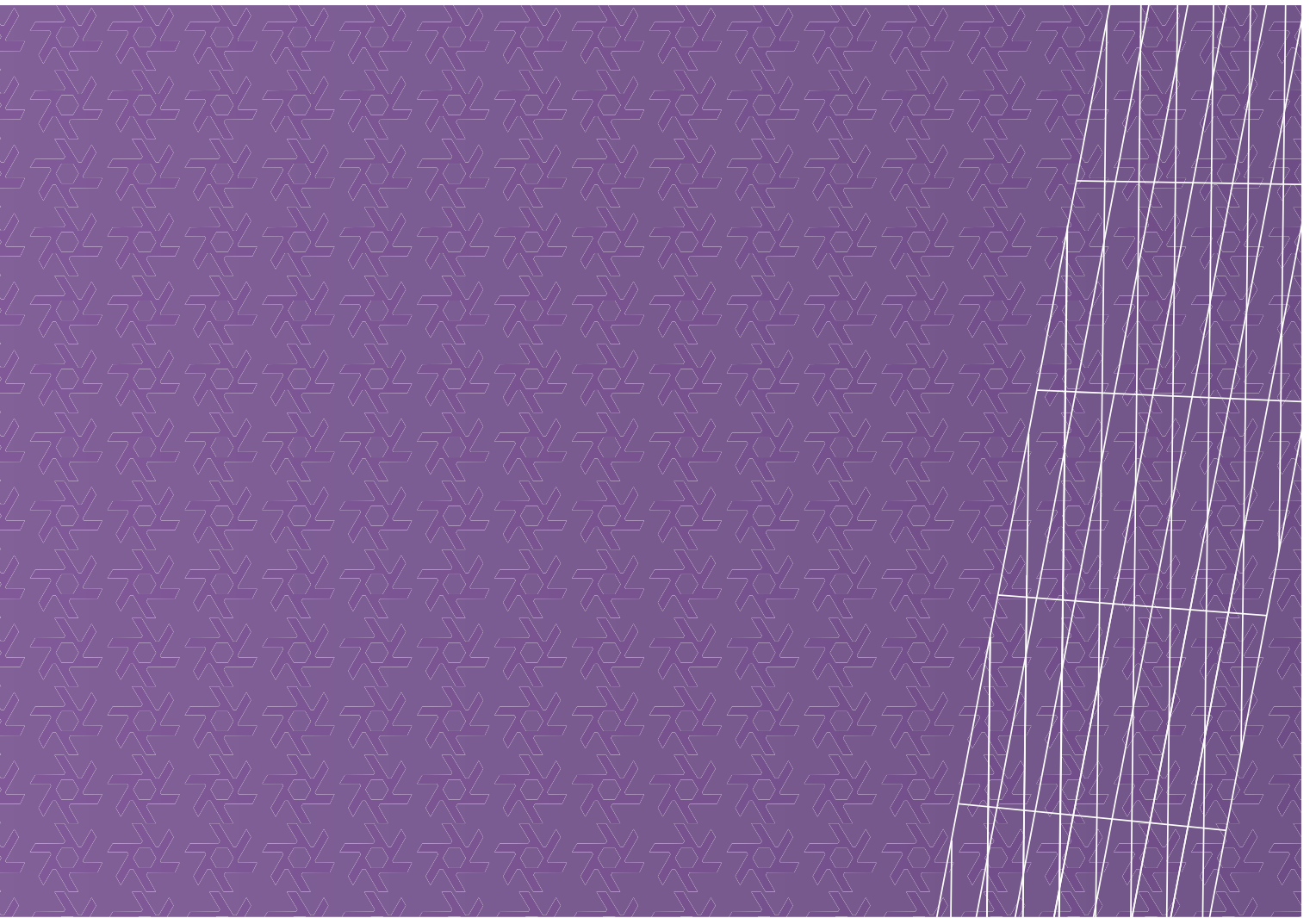


بِسْمِ اللّٰهِ الرَّحْمٰنِ الرَّحِیْمِ



**H. H. Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah**

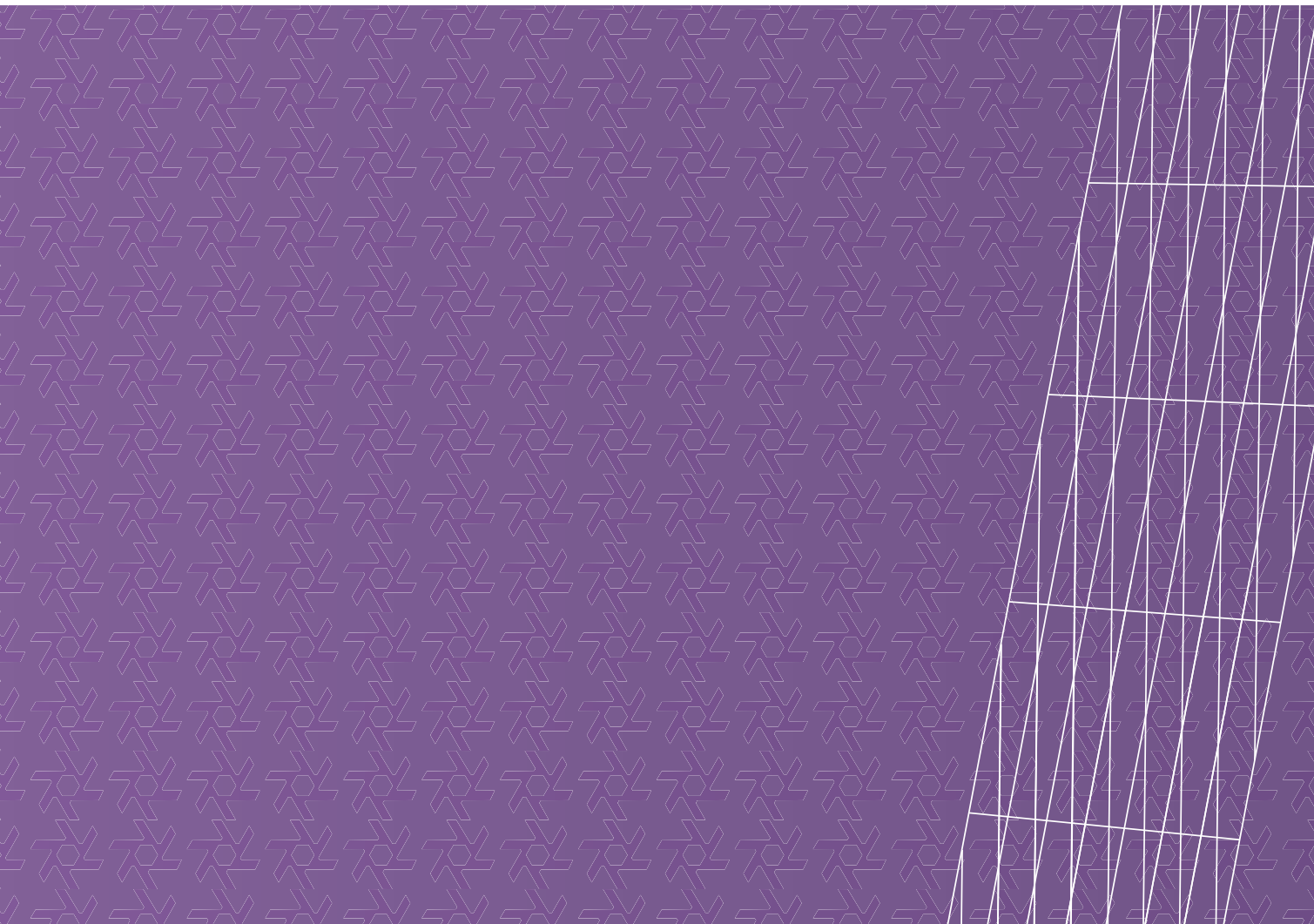
The Amir Of The State Of Kuwait





**H. H. Sheikh Nawwaf Al-Ahmad Al-Jaber Al-Sabah**

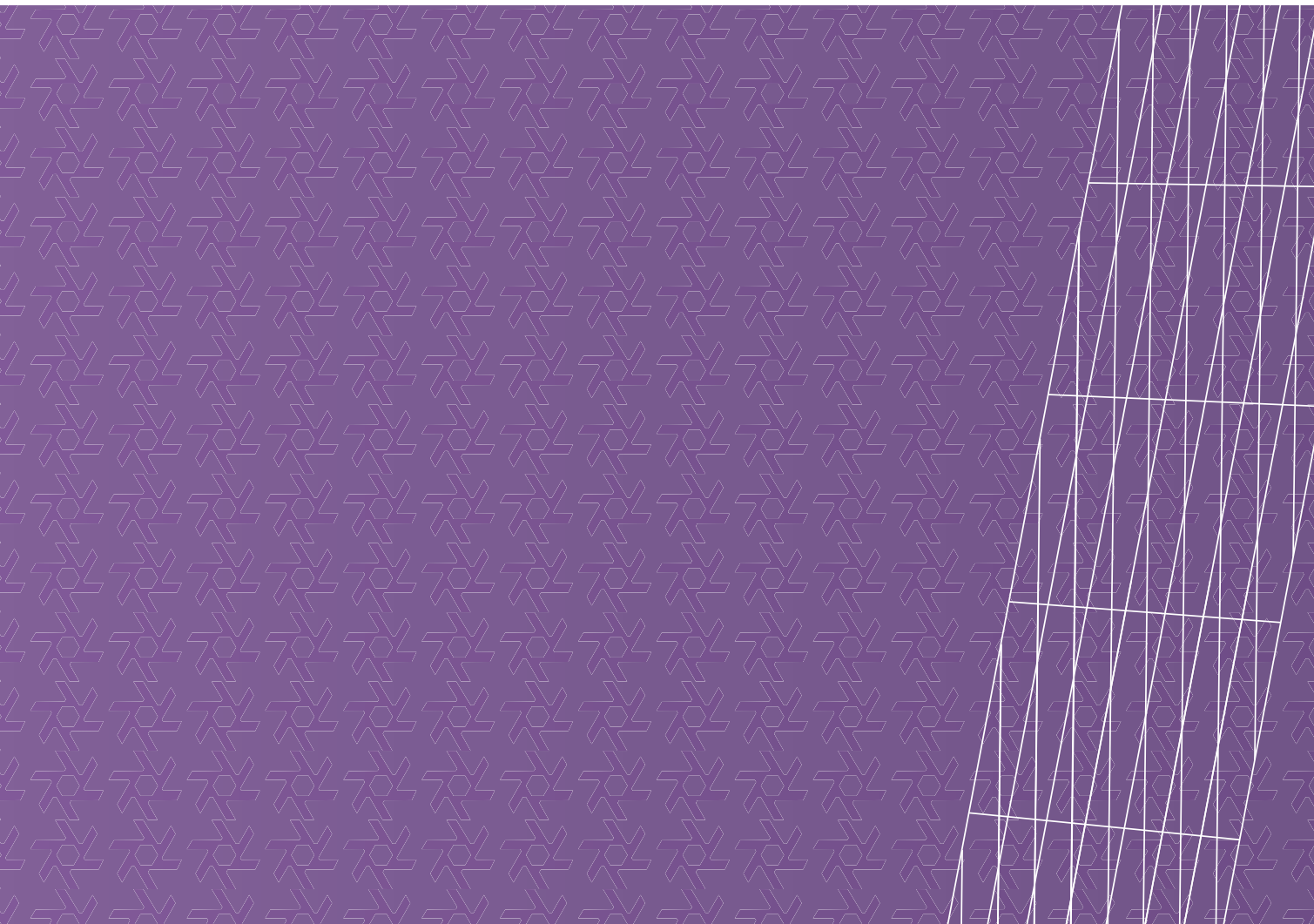
The Crown Prince Of The State Of Kuwait





**H. H. Sheikh Jaber Al-Mubarak Al-Hamad Al-Sabah**

The Prime Minister Of The State Of Kuwait



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# TABLE OF CONTENTS

Preface	III
Coverage and Data Conventions	V
Executive Summary	VII
Chapter 1: Banks' Financial Intermediation	1
Box 1.1 : Revised Instructions on Housing and Personal Loans	11
Chapter 2: Banks' Risk Assessment	13
Box 2.1: Islamic Finance: A Universal Value Proposition	23
Chapter 3: Profitability, Solvency & Resilience	33
Chapter 4: Domestic Markets	43
Box 4.1: Bursa Kuwait: Market Development Project	61
Chapter 5: Payment and Settlement Systems	67
Box 5.1: Leveraging Fintech While Ensuring Financial Stability	75







*Financial stability refers to 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.*

*The Central Bank of Kuwait (CBK), being the lead regulator of Kuwait's bank-centric financial system, devotes considerable resources and attention to ensure a sound and stable financial system in the country. A separate Financial Stability Office (FSO) has been set up with the mandate to regularly examine the developments in the financial sector. The Financial Stability Report (FSR) is a 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.*

*We are pleased to release our 7<sup>th</sup> FSR for the calendar year 2018, an annual publication composed of five chapters covering all three aspects of the financial system: institutions, markets and infrastructure. We dedicate the first three chapters to 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, by 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 financial market. Finally, chapter 5 examines the performance of retail and large-scale payment and settlement systems in Kuwait.*

*Through the publication of FSR, we intend to promote transparency and encourage informed public discourse on various developments in the financial system. We hope that the analyses contained in our report will help all stakeholders form a better understanding of the key issues and facilitate appropriate policy initiatives to address any potential challenges.*

*We pray to Allah the Almighty to grant success to our efforts and endeavors and to enable us to achieve the welfare of our beloved country, under the patronage of His Highness the Amir, Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, His Highness the Crown Prince, Sheikh Nawwaf 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*





*This Financial Stability Report (FSR) primarily examines the performance of the key components of the financial system for the calendar year 2018 (CY18) using December 31<sup>st</sup>, 2018 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 is based on the consolidated banking system data, including both conventional and Islamic banks within Kuwait and their subsidiaries and branches abroad. Due to some data limitations, we have not covered the performance of 12 foreign banks' branches in Kuwait (which account for about 3.3% 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.*

***Data Sources:** Discussion in Chapters 1 to 3, first two sections of Chapter 4 (Money & FX Markets) and Chapter 5 is based on the data from the CBK. The last two sections of Chapter 4, Boursa Kuwait & Real Estate Market, are based on the data from the local bourse, Thomson Reuters and the Ministry of Justice.*





Kuwaiti banking system continued to remain sound and stable during the year under review (CY-2018). Credit off-take was driven largely by lending to households, oil & gas and banks, though growth in overall assets was weighed down by stagnant investments amid non-issuance of government debt since the expiration of public debt law. Banks' asset quality improved further, as non-performing loan ratio (NPLR) declined for the ninth year in a row to reach a historically low level of 1.6%, thanks in part to the countercyclically built precautionary provisions supporting the requisite write-offs. Capital adequacy levels stayed robust, liquidity remained ample and net income posted strong gains.

Collectively, these trends highlight a resilient banking sector that has remained unscathed despite the oil rout of 2014-16 or any of its lag effect. The encouraging performance trajectory of the Kuwaiti banking sector can be ascribed to both industry specific factors as well as the broader operating conditions. To start with, Kuwaiti banks entered the low oil price environment from a position of strength, with robust capital adequacy levels, low and declining NPLR, and a high level of provisions – prudently built during relatively benign times under the proactive guidance of the CBK. Strong financial buffers also helped the government ramp up capital spending right in the midst of an oil price shock, somewhat neutralizing the impact of lower oil prices on domestic economic environment. Recovery in oil prices in the recent past, despite its growing volatility, has further strengthened government's fiscal and external position and buoyed confidence. Though the projects awarded (reflecting capital spending commitments) markedly slowed down in 2018 on account of technical and structural issues, construction of projects approved in earlier years continued to support the non-oil activity.

Following paragraphs highlight some of the key developments, in 2018, in the banking sector, domestic markets (money, foreign exchange, stock and real estate markets) and the payment & settlement systems in Kuwait.

### **Banking System:**

**Financial Intermediation:** Banking system assets, on consolidated basis, grew by 4.3% in 2018 on the back of higher private sector credit off-take. Lackluster growth in investments amid non-issuance of public debt weighed down on overall asset expansion. Still, domestic credit by Kuwaiti banks was up 4.9%, compared to 3.9% observed in 2017.

Credit off-take picked up

Lending to the households segment increased by 7.8%, making it the top recipient of bank credit for the fourth year in a row (in terms of the amount outstanding). Credit to the real estate sector, on the other hand, contracted by 0.7% after growing by 4.4% in 2017, notwithstanding the strong recovery in real estate market which picked up pace as the year drew to a close.

Growth in banks' investments plateaued amid non-issuance of domestic sovereign bonds after the expiry of public debt law in late 2017. Reflecting a bid to search for alternatives, lending to other banks increased sharply, making it the third key recipient of fresh lending in 2018. Likewise, banks' investments in other fixed income securities as well as to the GCC increased. While the growth in banks' consolidated deposits moderated to 2.4% as deposits from abroad contracted by 1.9%, the banking system continued to enjoy a stable funding base with time deposits accounting for 66% of the total deposits.

**Credit Risk:** Asset quality of the banking system has visibly improved over the years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, further dropped to a historically low level of 1.6% (1.3% on domestic, Kuwait- only basis) as of December 2018, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR over the current decade is particularly evident if the existing NPLR (1.6%) is compared with the double-digit NPLR (11.5%) recorded in 2009.

NPLR dropped to a historically low level (1.6%)

The improvement in asset quality in 2018 came in part from the active write-off policy supported by countercyclically-built ample provisions. Going forward, some NPL formation is not unlikely, though at a slower pace and from a low base. Still, the coverage ratio (available provisions to NPLs) remains robust at 254% (367.6 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. Moreover, CBK has not adopted a unidirectional, 'higher-the-better' policy towards provisions; instead, banks were encouraged to use such provisions to write-off bad loans whenever warranted, as exhibited by the net drawdown in available provisions both in 2017 and 2018.

....and coverage ratio further improved to 254%

Sectoral analysis of NPLs indicates that the decline in NPLR has been driven by drop in trade & industry as well as real estate & construction sectors. However, given that NPLR is at a historically low level, there is limited scope for further contraction in sectoral NPLs. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased. Industry

breakdown reveals that conventional banks account for 56.5% of total NPLs, closely in line with their share in gross loans (56.8%).

**Market & Liquidity Risks:** Banks' equity investments make up around 15.7% of banks' total investments, and use of firms' equities as collaterals accounts for 19% of banks' overall collaterals; while these numbers are slightly higher than in 2017, the banks' exposure towards equity market has broadly declined over the last few years. Liquidity in the banking sector has remained ample, with banks' respective LCRs comfortably above the minimum benchmark (90% for 2018) or even against the ultimate benchmark of 100% (due in 2019).

Liquidity remained ample during the year

**Profitability:** Banks' net income, on a consolidated basis, grew by 18% during 2018 compared to 9% a year earlier, lifting average ROA and ROE to 1.3% and 10.7% respectively. Improvement in banks' core-banking activities, mostly in the form of net interest income, supported industry profits. By banking groups, Islamic banks recorded stronger growth in their net income at 22.5% compared to 15.9% of their conventional counterparts. The impact of IFRS 9 implementation was also muted, thanks to the already sufficient levels of banks' loan loss provisions. Efficiency of the banking sector improved further as their cost to income ratio declined to 37%, though conventional banks continued to remain more cost efficient on average than Islamic banks.

Banks' net income posted strong gains

**Solvency:** Kuwaiti banks continued to maintain a robust loss-absorption capacity with the overall capital adequacy ratio at 18.3%, well above CBK's 13% minimum. Banks' strong capital adequacy was largely driven by high quality CET1 capital, which accounted for 83.8% of their total capital. Banks' leverage ratio, at 10.3%, also stayed well above 3% benchmark proposed by the Basel Committee, indicating banks' strong 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.

Capital adequacy stayed robust at 18.3%

### **Domestic Markets:**

**Money & FX Markets:** CBK hiked its policy rate for the fourth year in a row, pushing the discount rate to 3%, a level last seen in 2010. Still, CBK skipped three of the four rate hikes by the Fed in 2018 alone, reflecting relative independence of its monetary policy stance (given KD's peg to a basket rather than USD alone) to support domestic credit and growth. The year 2018 was however marked by non-

issuance of government debt after the expiration of public debt law since October 2017. As a result, outstanding balance of public debt dropped to KD 3.5 billion in 2018. Amid ample liquidity and non-issuance of government debt, CBK's liquidity absorption surged, primarily through one-week interventions and tawarruq. In the foreign exchange market, KD depreciated against USD and JPY by 0.5% and 2.6% in 2018. On the other hand, KD gained against GBP and Euro, by 5.0 % and 3.6% respectively, largely in line with the performance of these currencies against the USD.

Expiration of public debt law stalled new issuance

KD's peg to a basket helped reduce exchange rate volatility

**Boursa Kuwait:** Boursa Kuwait posted healthy gains with the All-Share Index and the Premier Market Index closing the year by gaining 5.2% and 9.9%, respectively. However, the Main Market Index covering small to mid-size companies closed in red, shedding 1.9%. The year 2018 witnessed the implementation of the second phase of the market development project introducing new indices and newly segmented markets. Overall trading activity slowed down despite a surge in international flows lured by Boursa Kuwait's inclusion in the FTSE Russell emerging market index. In terms of sector performance, Banks outperformed other sectors gaining 14.4% and accounting for 53% of overall trading value during 2018.

Boursa Kuwait closed the year up by 5.2% amid FTSE upgrade

**Real Estate Market:** The real estate market staged a strong recovery after three years of overall contraction, surging by 51.5% in terms of total sales values. All three segments posted solid gains, with sales in the investment segment in particular sharply picking up (by 142%). Notwithstanding banks' sizeable exposure to the real estate market, both in terms of loans and collaterals, banking sector in general appeared quite resilient to any potential correction in the real estate market, as highlighted by our stress test results.

Real estate sales staged strong recovery amid resurgent investment and commercial segments

#### **Payment & Settlement Systems:**

Both retail and large-scale payment systems continued to grow, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. During 2018, the value of transactions made through e-banking facilities comprising automated teller machines (ATMs), points of sales (PoS), and Knet's online payment gateway (Knet OPG) grew by 2.6%, 14.3%, and 58.1%, respectively. Growth trends in retail transactions underscore a healthy improvement in household consumption amid improving consumer confidence on the back of decent growth in wages and public sector jobs. Even though e-banking accounts for majority of transactions by volume (98.5%), the bulk of transactions are still paper-based (cheques) in terms of value. To facilitate the increasing use of e-banking, necessary infrastructure like PoS and ATM machines grew by 16.6% and 13.1% in

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

2018, reaching 59,547 and 2,378 machines. Bank branches in Kuwait also expanded, primarily of Islamic banks, to reach 425 total local branches by the end of 2018.

### Outlook:

Going forward, banking sector is expected to remain sound and stable over the near term. Asset quality is likely to remain healthy, though an uptick in NPLR from its existing level (1.6%) can't be ruled out, given the slim margin for its further decline. Still, high provisions would continue to support an active write-off policy, helping banks avoid any serious formation of infected loans on their books. In fact, ample provisions have already helped banks smoothly transition towards IFRS-9 rules where applicable (as banks are required to maintain provision under the CBK rules or the IFRS-9 standards, whichever is greater). Liquidity levels will also remain comfortable, and resumption in government debt issuance (subject to the passage of public debt law) will offer banks additional opportunities to invest in risk free government paper. Banks' profitability is likely to stay healthy on the back of better economic conditions, marginally higher interest income, improved credit off-take, lower provisions and a modest increase in NPLs, if at all. In view of the foregoing, the domestic banking sector is generally well placed to remain resilient in the near term. However, the risks emanating from banks' foreign operations can increase, particularly in countries with challenging security and/or economic conditions.

Banking sector is expected to remain resilient

On the broader economic front, Kuwait's heavy reliance on oil for its exports, revenues, and overall economic activity remains a key vulnerability, exacerbated by the increasing volatility in oil prices (and, to some extent though less significantly, even in the output which has been influenced by OPEC targets). While high financial buffers help the government adopt a countercyclical fiscal policy, increasing public sector wage bill will make the future path less sustainable. The OPEC+ agreement of December 2018 and its extension in mid 2019 for another nine months has supported oil prices and government revenues, providing further breathing space. Yet only comprehensive fiscal and structural reforms will eventually enable Kuwait to wean itself off oil dependence. Thanks to its enormous financial savings and low public debt, Kuwait can afford the reforms to be smooth and gradual as long as the measures are sustained.

Heavy dependence on oil accentuates vulnerabilities....

The government has already introduced a few measures in the past, albeit at a modest scale, like the fuel price hike of 2016 and higher electricity and water tariffs in 2017. Better revenue collection and higher health premium for expats have also improved non-oil receipts. Still, further progress needs to be made on multiple fronts: rationalizing current expenditures, reforming generous subsidies, increasing non-oil

...necessitating requisite structural reforms

revenues, creating incentives for nationals to work in the private sector, and diversifying the economy in general are few of the areas that would continue to require unremitting attention. Without making tangible progress on requisite structural reforms, the country will remain vulnerable to oil price volatility, with its attendant risks to financial stability.



## CHAPTER 1

### BANKS' FINANCIAL INTERMEDIATION

2021

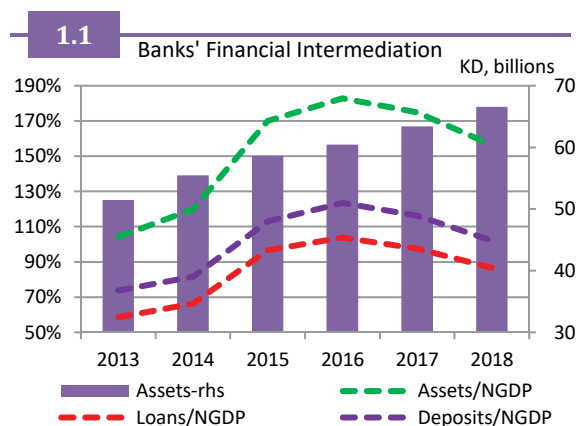


Banking system assets, on consolidated basis, grew by 4.3% in 2018 on the back of higher private sector credit off-take. Lackluster growth in investments amid non-issuance of public debt weighed on overall asset expansion. Still, domestic credit by Kuwaiti banks was up by 4.9%, better than 3.9% rise observed in 2017. Lending to the households segment was up by 7.8%, making it the top recipient of bank credit (in terms of the amount outstanding) for the fourth year in a row. Credit to the real estate sector, on the other hand, contracted by 0.7% after positive growth of 4.4%, in 2017, notwithstanding the strong recovery in real estate market. Potentially, recovery in the real estate market did not help boost lending to the sector as major improvement came towards the tail end of the year. Banks' combined exposure to real estate sector has been almost half of their total credit portfolio, if housing loans to households for purchase, construction and repair of private homes are included. Yet the risk profile of housing loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, banks' credit portfolio, notwithstanding its apparent lack of diversification, has been fairly healthy with non-performing ratios at record low levels (see Chapter 2). Growth in banks' investments plateaued amid non-issuance of domestic sovereign bonds after the expiry of public debt law in late 2017. However, banks' investments in other fixed income securities as well as to the GCC increased. Finally, growth in banks' consolidated deposits moderated to 2.4% as deposits from abroad contracted by 1.9%. However, the banking system continued to enjoy a stable funding base with time deposits accounting for 66% of the total deposits.

#### Banks' intermediation has ensured broader financial inclusion

Financial intermediation, when measured in terms of key banking variables relative to the nominal GDP, marginally deteriorated on the back of much stronger growth in nominal GDP (denominator) compared to the expansion in assets, loans and deposits of the local<sup>1</sup> banking sector (Figure 1.1). Specifically, while assets, loans and deposits increased in 2018 by 5%, 4.2% and 3.2% respectively, nominal GDP posted an increase of 17.4%<sup>2</sup>, compared to its expansion of 9.7% in 2017.

Notwithstanding the drop in headline ratios, which is more of a mathematical outcome, banks' contribution



<sup>1</sup>The data used in Figure 1.1 is for local banking sector (including 12 foreign bank branches). However, unless otherwise specified, rest of the chapter is based on consolidated data, which includes operations of Kuwaiti banks' subsidiaries & branches abroad. Moreover, due to some data limitations, our discussion based on consolidated data will exclude 12 foreign bank branches operating in Kuwait with combined assets of KD 2.5 billion (representing 3.8% of domestic or 3.3% of consolidated banking assets).

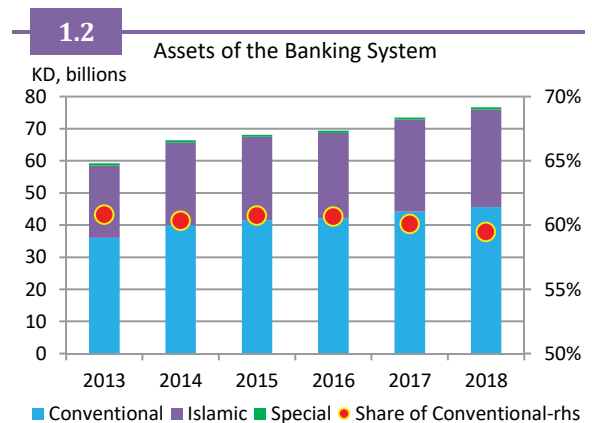
<sup>2</sup> IMF's World Economic Outlook database of April 2019. Real GDP, on the other hand, increased by 1.7% only.

as financial intermediaries has helped ensure a fairly high degree of financial inclusion in Kuwait. For instance, The World Bank's Global Findex database 2017 reveals that 80% of the population above the age of 15 years in Kuwait has an account with a formal financial institution, compared to 47% in the MENA region.

### *Financial system continues to remain bank-centric*

Kuwait's financial system continues to remain bank-centric, with the banking sector<sup>3</sup> accounting for around 89.3% of the domestic financial sector<sup>4</sup>. Investment companies are the second major player in the domestic financial system with around 9.1% share as of December 2018. Insurance and exchange companies constitute the rest. Domestic banking sector consists of five conventional, five Islamic and one specialized bank as well as 12 foreign bank branches. Moreover, Kuwaiti banks have sizeable presence in numerous other countries, with total assets of their subsidiaries & branches abroad accounting for 21.7% of the consolidated banking system.

When viewed on a consolidated basis<sup>5</sup>, conventional banks dominate the overall banking system, with 59.5% share as of December 2018; however, their share has remained broadly the same over the years (*Figure 1.2*). Still, Islamic banks, with 39.6% share in consolidated banking system, represent one of the most significant presence of Islamic banks in any country across the globe with a dual banking system. Strong presence of Islamic and conventional banks underscores the effectiveness of CBK's endeavors in ensuring a level playing field for both types of banks and also provides the customers an option to bank with the institutions of their choice.



<sup>3</sup> Domestic banking sector including foreign banks' branches within Kuwait.

<sup>4</sup> Here financial sector is being narrowly defined, and includes banks, investment companies, insurance and exchange companies.

<sup>5</sup> Consolidated data includes Kuwaiti banks' subsidiaries & branches abroad but excludes 12 foreign banks branches in Kuwait (see footnote 1 above).

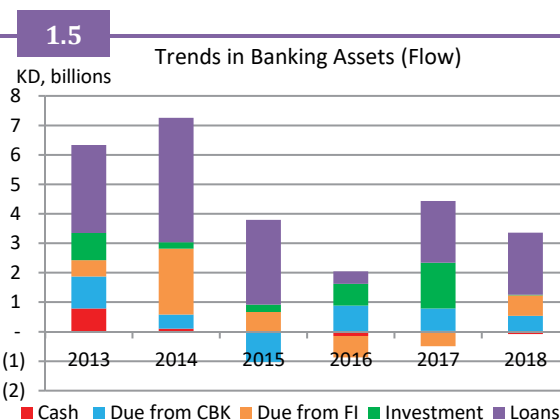
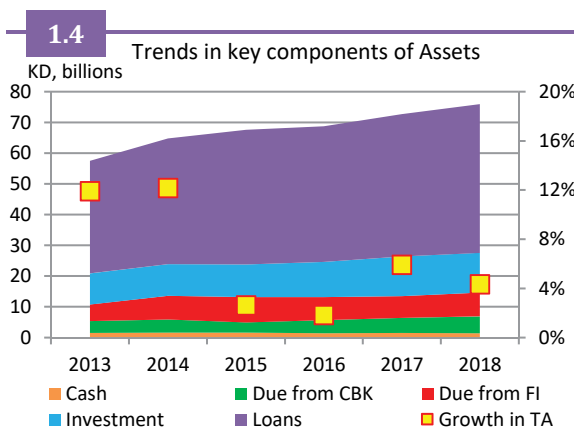
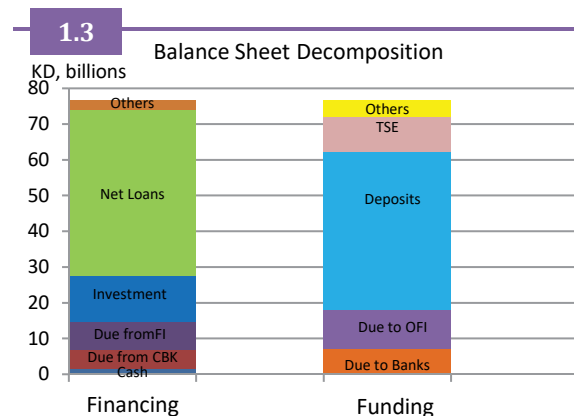
Decomposition of the balance sheet of the banking system highlights the prevalence of traditional instruments expected in a bank-centric financial system. For instance, net loans account for as much as 60.4% of the total assets as of December 2018 (Figure 1.3). Investments, comprising of exposures to 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 72.5% of total liabilities, indicating a healthy deposit base and a stable funding structure.

### Higher credit supports assets growth, despite lackluster growth in investments

During 2018, consolidated banking assets posted healthy growth of 4.3%, though lower than the 6% recorded a year earlier (Figure 1.4). Specifically, assets worth KD 3.2 billion were added to the banking system, pushing total assets to KD 76.7 billion by December 2018. Though lower than 2017 when assets worth KD 4.1 billion were added to the system, it was still a healthy expansion.

As evident from the flow data for the key components of the assets side, asset growth came on the back of better credit off-take and placements with other financial institutions (Figure 1.5). However, unlike the previous two years, banks' investments in 2018 recorded a sharp slowdown, as expiry of domestic public debt law virtually stalled new issuance since October 2017. To compensate for the drop in investments and find alternative sources of revenues, banks however increased their placements with other financial institutions i.e. 'Due from FIs'. Banks' placements with CBK (Due from CBK) also made a positive contribution, albeit at a marginally lower scale than in 2017.

Understandably, the most significant contribution came from banks' consolidated gross loan portfolio which expanded by another KD 2.1 billion, posting



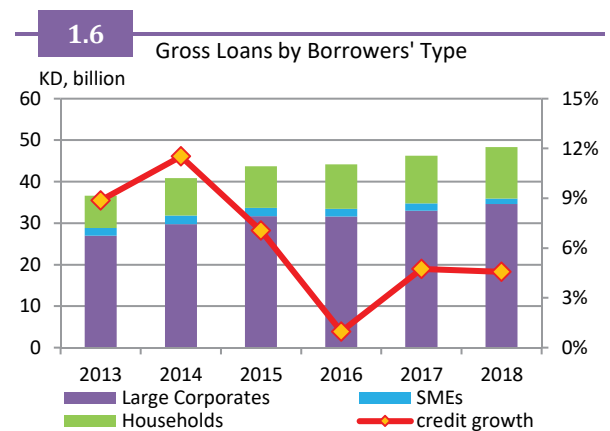
4.6% growth in 2018, only marginally lower than a year earlier (4.74%). Both domestic and foreign operations supported the higher credit extension, though domestic operations made much stronger contribution. Specifically, growth in domestic private credit off-take came in stronger at 4.9%, compared to 3.9% observed in 2017<sup>6</sup>. On the other hand, credit portfolio of banks' foreign operations expanded by 3.4%, at a much slower pace compared to 7.3% observed in 2017.

*Bulk of the credit is received by large private corporates, followed by households*

In terms of credit allocation to various types of borrowers, lending to large corporates accounted for around 71.6% of the total gross loans (*Figure 1.6*). The households sector was a distant second, with 25.7% share in overall credit and outstanding loans amounting to KD 12.4 billion as of December 2018. Though there was a mild shift from corporates to households in terms of credit allocation in the earlier two years, 2018 witnessed stronger allocation of credit to the corporates amid healthier non-oil GDP growth.

On the contrary, share of SMEs in overall lending declined from 3.8% in 2017 to 2.8% in 2018, as the banking sector reduced their exposure to SMEs. On its part, CBK has continued to incentivize banks to lend more to SMEs by using a preferential risk weight of 75% for SME finance, compared to the standard risk weight of 100%. However, given the abundance of funding available, in particular through the National Fund<sup>7</sup>, SMEs in Kuwait barely face any serious funding constraints.

The breakdown of banks' loans in terms of lending to the public and private sectors reveals that almost the entire lending was directed towards the private sector (96.7%), while the share of lending to the public sector was limited to a paltry 3.3% during 2018. Given



<sup>6</sup> Domestic credit provided by Kuwaiti banks. The year-end figure for 2017 were dampened primarily by write offs but also by some corporate repayments.

<sup>7</sup> In order to further support SMEs, the Kuwaiti parliament approved a new law in March 2013 to establish the 'Kuwait National Fund for SMEs Development'. The National Fund, in partnership with local banks aims to grant loans (under separate conventional and Sharia-compliant schemes) up to a maximum of KD 500,000 to eligible SMEs by contributing 80% of the funding, while the remaining 20% could potentially be provided by the partner bank(s).

the huge accumulation of financial assets over the last decade, the need for public sector to borrow from the banking system to meet its budgetary needs have remained quite limited. However, there was a modest increase in borrowing in recent years<sup>8</sup>, in part necessitated by the lower oil prices but also enticed by the relatively low interest rate environment.

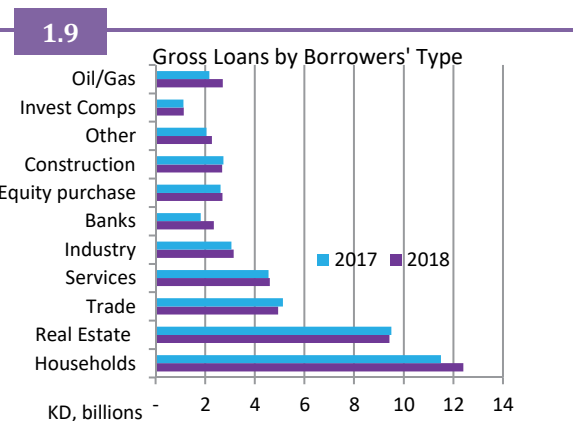
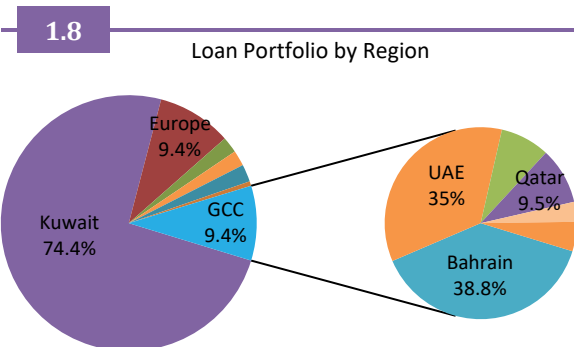
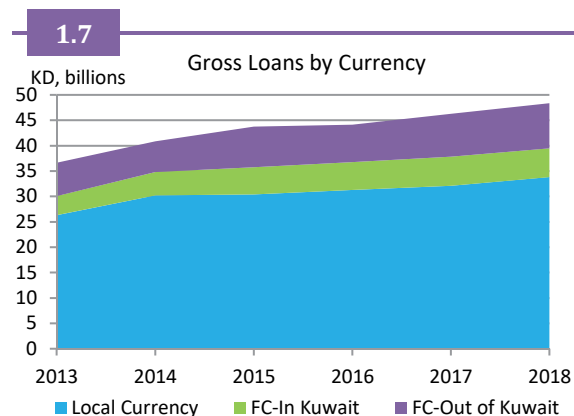
Currency-wise breakdown of the gross loans indicates that almost 70% of the overall lending was in the domestic currency, with the share of foreign currency (FC) marginally declining from 30.6% to 30.1% in 2018 (Figure 1.7). Within FC loans, around 61% in 2018 were granted by Kuwaiti banks' subsidiaries & branches abroad (FC-out of Kuwait).

Geographical breakdown of banks' lending portfolio reveals that out of banks' KD 48.36 billion of gross loans as of December 2018, almost KD 36 billion (74.4%) have been granted within Kuwait (Figure 1.8). The remaining 25.6% of the gross loans were disbursed across various regions, with both Europe and GCC accounting for 9.4% each. Within the GCC, banks' greatest credit exposure remained confined to Bahrain, followed by UAE and Qatar.

### Banks' lending is shifting towards relatively safer segments

Breakup of gross loans across various sectors indicates a mixed trend, with some segments receiving greater credit while others witnessing a contraction. Noticeably, loans to *households*<sup>9</sup> further expanded in 2018, highlighting banks' changing preference for low-risk exposures, a reflection of relative flight to quality. On the other hand, credit to the *real estate* and *construction* as well as to *trade* segments posted marginal contraction in 2018 (Figure 1.9).

Equity purchased loans, after declining in the last two years, posted an increase of 3.1% in 2018, though Boursa Kuwait-specific loans marginally dropped. Likewise, banks' lending to investment companies also inched up in 2018, bringing its share in banks' overall loan portfolio to 2.4%. While deleveraging in



<sup>8</sup> Expiry of public debt law has, however, stalled new borrowings since October 2017.

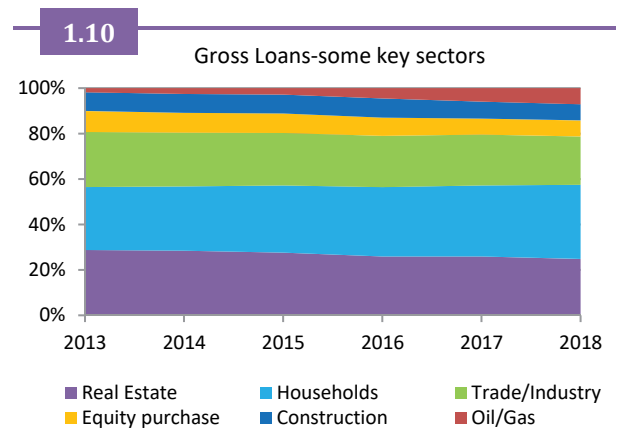
the investment companies that started in 2009 finally bottomed out in 2015, banks have continued to contain their exposure to the investment companies in general.

Lending to *oil/gas* also posted strong gains (25%) in 2018, though still from a low base; share of lending to *oil/gas* has increased steadily since the oil price shock of 2014, improving from 2.1% to 5.6% as many of the firms turned to bank financing. Finally, banks' lending to other banks surged by 29% compared to a contraction of 25% in 2017, driven both by non-issuance of government bonds as well as opportunities of better returns amid higher interest rates in certain countries.

Notwithstanding the above-mentioned shifts, the broader trend in loans over the years reveals that banks' collective exposure to key sectors have remained largely stable, with little indication of a sudden surge in any specific sector (*Figure 1.10*). While exposure to the household segment has steadily increased with somewhat attendant contraction in exposure to real estate and construction, this augers well for banks' asset quality. In general, a relatively stable trend in credit allocation suggests that banks have avoided the boom and bust cycles in their lending practices, underlining a conservative approach towards credit allocation. However, concentration remains high as four sectors (real estate, households and trade and services) account for almost 65% of the entire credit portfolio.

*...with increasing exposure to households*

Banks' credit to the households grew by 7.8% in 2018 to reach KD 12.4 billion, making *households* the top<sup>9</sup> recipient of bank credit in Kuwait, followed by the real estate sector (KD 9.4 billion). Though growth in household credit was slightly better than in 2017 (7.6%), it was still slower than the earlier five years (2011-15) of double-digit expansion, partly because of somewhat limited potential for significant rise in



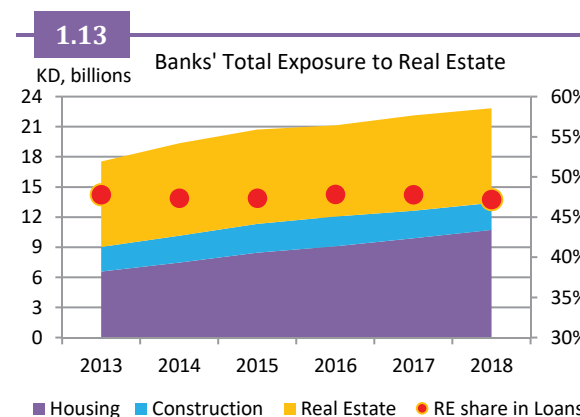
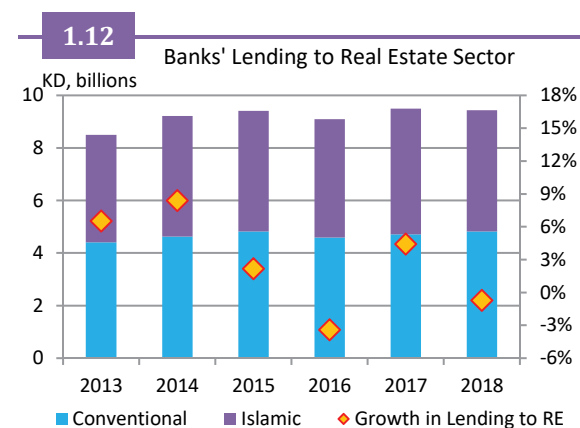
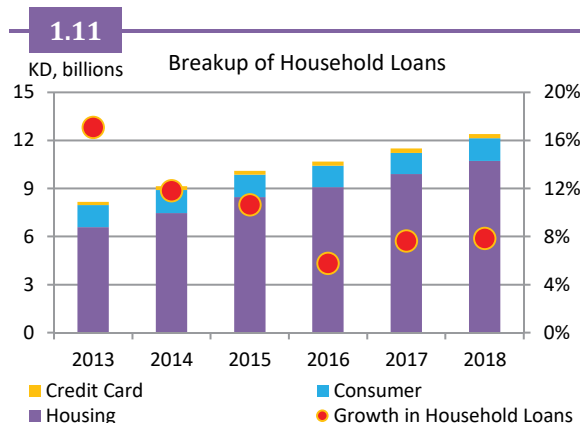
<sup>9</sup> In terms of total loans outstanding.

credit to *households*. CBK's recent instructions on personal loans are, however, likely to help further increase lending to households<sup>10</sup> (see *Box 1.1* for details).

Breakdown of household loans reveals that around 86.5% of the household loans have been *housing* loans, which are long term personal loans for repair and purchase of private homes (*Figure 1.11*). These loans are repaid in monthly installments over a period not exceeding 15 years. *Consumer* loans constituted the second major category of household loans with 11.4% share as of December 2018. Finally, credit card related loans made around 2.1% of overall household loans.

Banks' lending to the real estate sector contracted in 2018, albeit by a small margin (down 0.7%), despite a resurgent real estate market (up by 51.5% by overall sales in 2018) on the back of a particularly strong rebound in the investment segment<sup>11</sup> (*Figure 1.12*). This was the second year (2016 the first) in almost a decade when banks' lending to real estate posted a drop. As a result, share of the real estate loans in banks' overall credit portfolio further declined to 19.5% in 2018. Both conventional and Islamic banks had somewhat similar size of exposure to the real estate, with conventional banks' accounting for a tad higher share (51%) in 2018. Credit to construction sector also posted a decline during the year (by 1.8%), though less severe than in 2017 (by 7.9%).

Banks' combined exposure to the real estate can be viewed in terms of their lending to (i) real estate sector (ii) construction sector and, (iii) housing loans to the households (which are bulk of the household loans, taken for purchase, construction and repair of private homes). Adding up the lending under these three categories, banks' exposure to real estate accounts for almost half of their entire lending portfolio (*Figure 1.13*).



<sup>10</sup> CBK, in November 2018, issued new lending instructions, increasing the maximum limit of consumer loans to 25 times the net salary or a maximum of KD 25,000 from the earlier limit of 15 times or maximum of KD 15,000.

<sup>11</sup> See Chapter 4 for details.

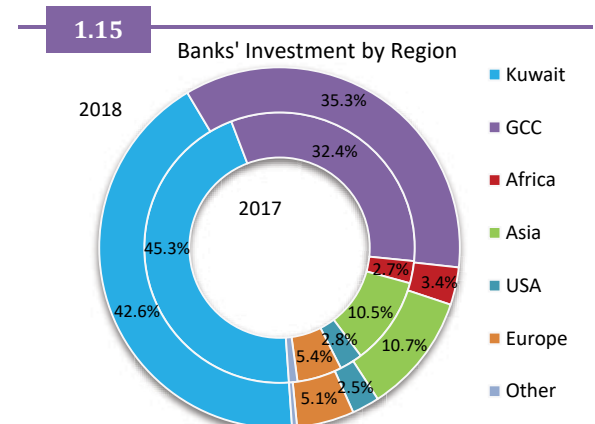
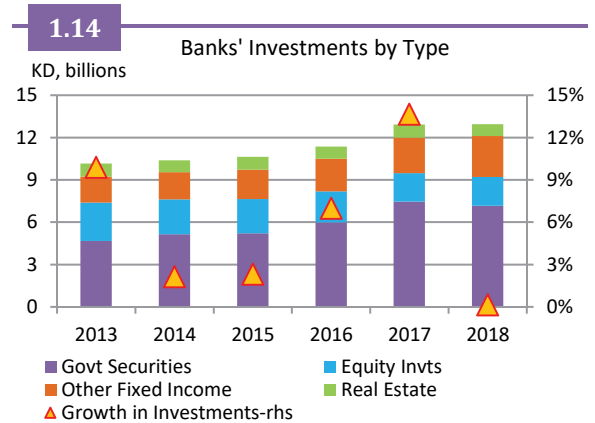
However, the risk profile of housing loans is markedly different from banks' direct lending to real estate and construction sector. Moreover, notwithstanding the apparent lack of diversification, non-performing loan ratio in the household and real estate & construction sectors has been at very low levels (1.7% and 2.6% respectively in 2018), indicating limited degree of infection (*see Chapter 2* for details). Moreover, the risk of further NPL formation, at least in the short term, is contained, thanks to the strong recovery in the real estate market in 2018.

### Growth in banks' investments plateaued

Banks' investment portfolio posted paltry growth of 0.1% in 2018, exhibiting sharp slowdown compared to 13.6% growth observed in 2017 (*Figure 1.14*). The key driver was contraction of 4% in government securities during 2018 because of non-issuance of sovereign debt in Kuwait after the expiry of domestic public debt law. Investments' breakdown reveals that out of KD 12.9 billion of total investments, around KD 7.2 billion (55.4%) were placed in government securities as of December 2018.

Banks' exposure to other fixed income securities, which is the second major component, however posted double-digit growth of 15.4% in 2018; as a result, its share further improved to 22.4%, of banks' total investments. Banks' equity investments formed the third major category with 15.7% share in total investments though growth in this segment remained insignificant (1%). On the other hand, banks' investments in real estate contracted by 9.8% in 2018, with its share dropping to 6.4% in banks' total investments.

Geographical distribution indicates that banks' investments within Kuwait declined from 45.3% in 2017 to 42.6% in 2018 as non-issuance of domestic debt reduced banks' exposure to sovereign debt. However, banks' exposure to GCC witnessed an expansion, with the share reaching 35.3% (*Figure 1.15*). Likewise, share of banks' investments in Africa,



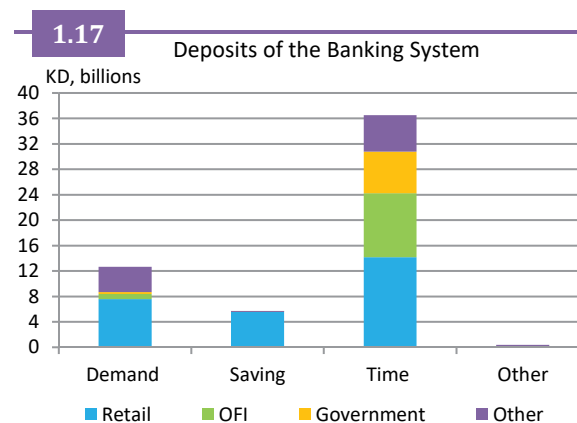
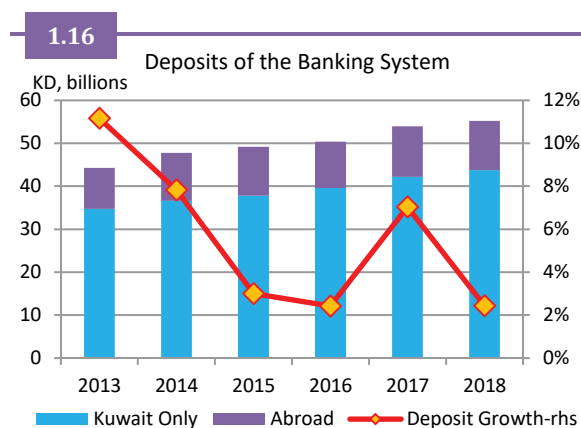
Asia also inched up while those in USA and Europe posted marginal declines.

### Growth in bank deposits slowed down

Growth in banking system deposits slowed down in 2018 to 2.4%, compared to much healthier growth of 7% recorded a year earlier (Figure 1.16). While deposits within Kuwait expanded by 3.6%, overall growth was weighed down by contraction in deposits from abroad (down 1.9% in 2018). Overall, deposits<sup>12</sup> reached around KD 55.2 billion as of December 2018, with domestic deposits accounting for 79.2% of total deposits of the consolidated banking system. Amid the retreat in deposits from abroad, the share of such deposits marginally declined from 21.7% in 2017 to 20.8% in 2018.

### Time deposits represent around two-thirds of banks' deposits

Breakdown of deposits reveals that time deposits accounted for around 66% of the total deposits by the end of 2018, highlighting the stable funding base of the banking system capable of providing stability under times of liquidity stress (Figure 1.17). Retail deposits are well diversified into three different categories (demand, saving and time), in line with the consumers' transaction and precautionary demands for money. Finally, the deposits of other financial institutions (OFI) and government are predominantly placed as time deposits which further adds to the stability of banks' funding base.



<sup>12</sup> This includes government and private deposits as well as 'due to other financial institutions'.



## Revised Instructions on Housing and Personal Loans

The Central Bank of Kuwait issued its new instructions to banks and investment/ financing companies concerning the rules and regulations for granting personal loans for consumer & housing purposes and issuance of credit cards<sup>13</sup>. The newly promulgated instructions include important changes to loan caps, early repayment conditions, and the responsibilities of lenders. These revisions are based on a thorough analysis of the existing guidelines, international best practices, banks' recommendations and consumer feedback. This box sheds light on the key changes introduced and their potential economic impacts.

The household/retail lending market in Kuwait is comprised of three main products, namely housing loans, consumer loans and credit cards - all of which are linked to the borrower's net monthly income. Housing loans are long term personal loans granted for the purchase, construction or renovation of private homes. They are capped at KD 70,000 and repaid in monthly installments over a period not exceeding 15 years. Consumer loans are general-purpose loans with a maximum maturity of 5 years meant for personal consumption such as car purchases, education/medical expenses, or the purchase of durable goods. The amount of the loan may not exceed 25-fold a client's salary or KD 25,000, whichever is lower. The CBK regulates the household lending market by enforcing a strict cap on the debt servicing to income ratio (DSTI) in addition to the absolute loan amounts, as mentioned above. Currently, the DSTI is capped at 40% for employees and 30% for retirees, i.e. the total monthly debt servicing payments may not exceed 40% of an employee's (30% of a retiree's) net monthly salary.

The new instructions increased the cap on consumer loans from KD 15,000 to KD 25,000 or 25-fold the net monthly salary, whichever is lower. This limit adjustment comes after 14 years from the last adjustment made in 2004<sup>14</sup>. Since then, the compounded average inflation rate totaled 67% (2004-2017), resulting in a much lower effective loan cap when measured in real terms. For an example, a car priced at KD 15,000 in 2004 would be priced around KD 25,000 today. Average salaries have also witnessed a significant increase over the same period, allowing for a higher borrowing level. Therefore, the new maximum amount for consumer loans can be viewed as an adjustment for inflation. Furthermore, the limits on housing and consumer loans are now independent of each other, allowing eligible consumers to borrow up to a total amount of KD 95,000. Previously, there was an absolute limit of KD 70,000 on the sum of both loans.

Several constraints incorporated in the new guidelines will help avoid the risk of excessive borrowing and inflationary pressures. First, the cap on DSTI was kept unchanged at 40% for employees and 30% for retirees. This ensures that only those with sufficient income can utilize the higher limits. A simple analysis of existing households suggests that the DSTI, rather than loan caps, is the main restricting factor for most households. Second, the instructions clarified

<sup>13</sup> The instructions, which came into effect on November 14<sup>th</sup>, 2018, replaced previous instructions in this regard. A copy of these instructions is available on CBK's website: [www.cbk.gov.kw](http://www.cbk.gov.kw)

<sup>14</sup> In 2004, the cap on consumer loans was increased from KWD 10,000 to KWD 15,000.

the definition of income to include only an employee's net salary, as shown on his pay slip and net of all listed monthly deductions, plus any national labor allowance<sup>15</sup>. This restricts the types of admissible income, and thereby prevents lending institutions from considering less reliable sources of income when calculating a client's DSTI. Third, the lenders' advisory role towards their clients has been further strengthened. They are required to examine a client's monthly financial commitments and advise and clarify the potential risks and consequences of growing obligations or adverse financial conditions. Clients are also to be given a two-day reflection period before making a final commitment.

Significant adjustments to the regulations governing reorganization of the terms and conditions of loan contracts<sup>16</sup> were also introduced in the new instructions. Retirees are now able to extend their loan terms beyond the stated maximum loan tenor by up to 5-years for housing loans and 1-year for consumer loans, allowing them to reduce their monthly payments upon retiring. Moreover, in the case of revising a contract that would result in early repayment, Islamic/conventional lenders are now obliged to waive their profit/interest receivable for the remaining period. This supercedes the previous practice whereby some Islamic institutions required clients to pay all unrealized profits before any modification to the loan tenor.<sup>17</sup> Moreover, eliminating this practice will foster competition among banks allowing for a smoother transfer of loans from one bank to another.

The new guidelines strike a balance between the rights of both borrowers and lending institutions. The CBK aims to promote deliberate lending practices that accommodate consumers' needs while facilitating healthy growth in the domestic banking sector. On the one hand, eligible consumers will have the ability to finance their basic needs under a well-governed system that protects their rights. On the other hand, lending institutions will find additional venues for growth while developing an effective compliance process for granting such loans.

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<sup>15</sup> The national labor allowance is a monthly allowance issued to nationals working in the private sector to encourage private sector employment.

<sup>16</sup> Reorganizing the terms and conditions of loan contracts refers to one of the following conditions: 1) Modifying the loan tenor and/or monthly installments 2) Refinancing loans, and 3) Rescheduling loans granted to clients pre-retirement.

<sup>17</sup> Previously, it was at the discretion of the lender whether to refund any of the unrealized profits. Had this practice persisted, borrowers of these institutions may not benefit from rescheduling because their monthly payments would not necessarily decline after extending their loan tenure.



## CHAPTER 2

### BANKS' RISK ASSESSMENT

2021



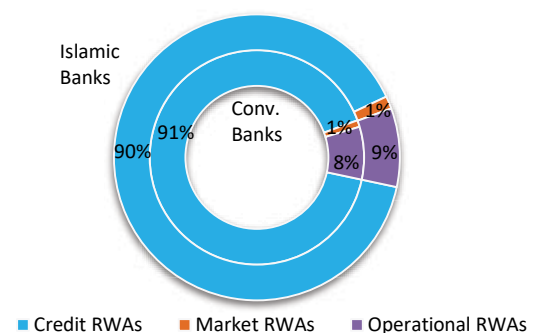
Asset quality of the banking system has visibly improved over the years, exhibited by a steady decline in both the gross and net non-performing loan ratio (NPLR). The gross NPLR, on a consolidated basis, has further dropped to a historically low level of 1.6% (1.3% on domestic, Kuwait- only basis) as of December 2018, well below 3.8% observed in 2007 before the global financial crisis struck. The impressive progress in bringing down the NPLR in the last few years is particularly evident if the existing NPLR (1.6%) is compared with the double-digit NPLR (11.5%) observed in 2009. The improvement in asset quality in 2018 came in part from the active write-off policy supported by countercyclically-built ample provisions. Going forward, some NPL formation is not unlikely, though at a slower pace and from a low base. Still, the coverage ratio (available provisions to NPLs) remains robust at 254% (367.6 %, if viewed on domestic basis), substantially greater than the pre-crisis ratio of 87% observed in 2007. Moreover, CBK has not adopted a unidirectional, 'higher-the-better' policy towards provisions; rather, it has allowed banks to use such provisions to write-off bad loans whenever warranted, as exhibited by the drop in available provisions both in 2017 and 2018. Sectoral analysis of NPLs indicates that the decline in NPLR has been driven by drop in trade & industry as well as real estate & construction sectors. However, given that NPLR is at historically low level, there is limited scope for further contraction in sectoral NPLs. Geographically, the share of NPLs originating from banks' operations in the GCC and Europe has marginally increased. Industry breakdown reveals that conventional banks account for 56.5% of total NPLs, almost in line with their share in gross loans (56.8%). Banks' equity investments make up around 15.7% of banks' total investments, and use of firms' shares as collaterals accounts for 19% of banks' overall collaterals; while these numbers are slightly higher than in 2017, the banks' exposure towards equity market has broadly declined in the last couple of years. Finally, banks' liquidity levels have remained healthy, with their respective LCRs comfortably above the 100% benchmark (due in 2019).

While credit risk accounts for bulk of the RWAs.....

Given the traditional nature of banking business in Kuwait, credit risk understandably remains the most significant when viewed in terms of risk weighted assets. Accordingly, credit *risk weighted assets* (RWAs) of both Islamic and conventional banks have continued to account for the bulk of their total RWAs as of December 2018 (*Figure 2.1*). The distribution of RWA is somewhat more dispersed for Islamic banks when compared with their conventional counterparts as the nature of Shariah-compliant financing transactions entails a greater variety of risks. On the other hand, insignificant contribution of market risk in overall RWAs is in part because of banks' relatively smaller trading portfolios.

### 2.1

Distribution of Risk Weighted Assets (RWAs)

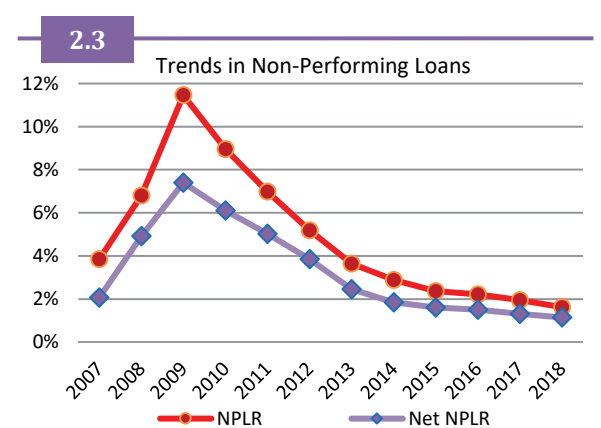
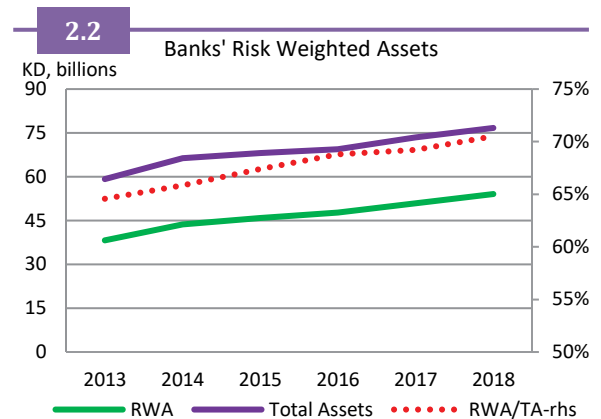


The ratio of RWA to total assets marginally increased to 70.5% in 2018 from 69.2% a year earlier, primarily as the volume of credit increased, though to borrowers with lower risk weights (Figure 2.2). It was despite the relatively slower growth in both the numerator (RWA) as well as denominator (Total Assets) in 2018; specifically, overall RWA increased by 6.3%, a tad slower than 6.6% recorded in 2017. Likewise, total assets posted a growth of 4.3% in 2018 compared to 5.9% a year earlier. Still, given the greater size of overall assets, the ratio of RWA to total assets inched up.

*...banks' asset quality remains healthy with NPLR at record low*

Yet the credit risk, which constitutes the bulk of RWAs of both Islamic and conventional banks, has continued to slide to historically low levels. Specifically, the absolute value of non-performing loans (NPLs) of the banking sector has steadily declined for the ninth year in a row, dropping to the lowest level since 2007. Trend in Net NPLs (i.e. Gross NPLs less specific provisions) also reveals a similar pattern, peaking in 2009 with a continuous decline afterwards.

As a result, the NPL ratio (NPLR) in 2018 edged further down to 1.6%, significantly lower than the pre-crisis ratio of 3.8% recorded in 2007 (Figure 2.3). Understandably, the pace of decline in NPLR has somewhat tapered in the last few years (though 2018 posted sharper decline) most of the credit portfolio is already performing and the scope for any major improvement is quite limited. Net NPLR has also been on a receding trend since 2009 and has reached a historically low level of 1.1% in 2018. Taken together, these trends in NPLR (both gross and net) underscore a major improvement in the asset quality of the banking sector, made possible by banks' strenuous efforts in line with CBK's instructions and active engagement with the industry.



...helped in part by high coverage ratio

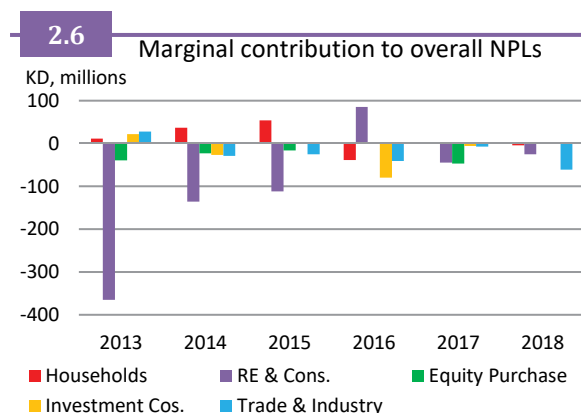
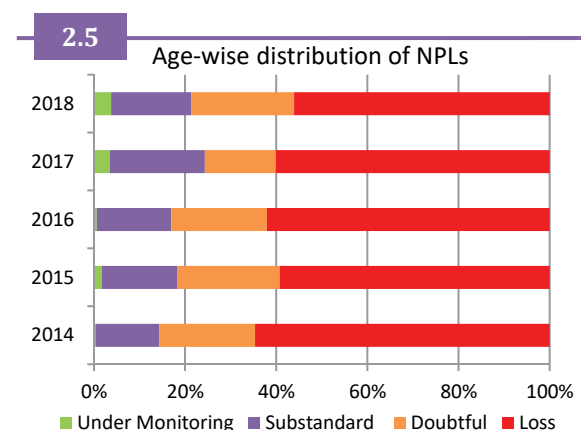
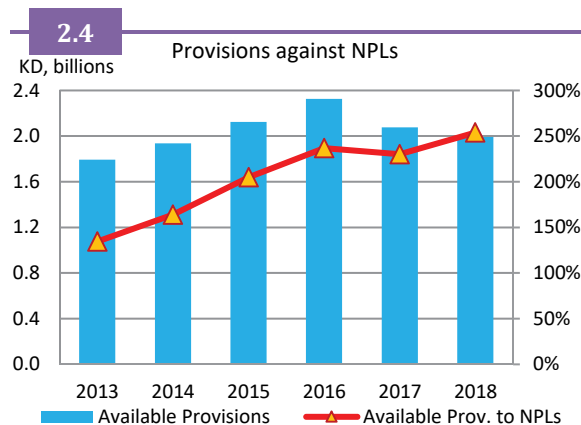
In particular, CBK has required banks to countercyclically build provisions over the years in order to better cope with any potential deterioration in their asset quality. As a result, *available provisions to NPL ratio* reached 254% in 2018, a historically high level (Figure 2.4). Moreover, CBK has not adopted a unidirectional, ‘higher-the-better’ policy towards provisions; rather, it has allowed banks to use such provisions, built in benign times, to write-off bad loans whenever warranted. This for instance is evident from the drop in available provisions both in 2017 and 2018 as well as the decline in coverage ratio in 2017 (though it recovered in 2018 as stock of NPLs significantly declined).

NPLs’ classification by age profile indicates that the share of NPLs under *loss* category has come down to 56.1%, lowest in the last seven years (Figure 2.5). Even the NPLs under first two categories (*‘under monitoring’* and *‘substandard’*) have declined in 2018 in absolute terms, though their share has been influenced by a much sharper decline in NPLs under the *loss* category. Going forward, some NPL formation is not unlikely, though new NPLs will accumulate from a historically low base and at a fairly slower pace. Still, given the abundant provision already made, banks should be able to comfortably manage any potential deterioration in asset quality.

Sector-wise decline in NPLs has been broad-based, though muted

Data for the marginal contribution of different sectors in the industry-wide NPLs reveals that contraction in infected loans has been fairly muted in 2018, simply because there is little additional scope for a further decline in the stock of NPLs (Figure 2.6). Still, NPLs of *trade & industry* as well as *real estate and construction* sector have declined further in 2018, collectively reducing the stock of NPLs by another KD 86 million.

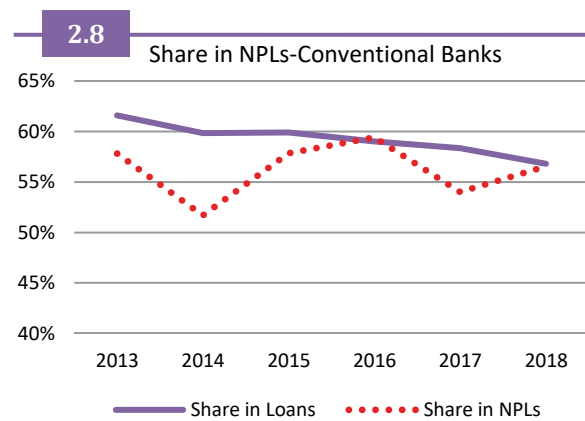
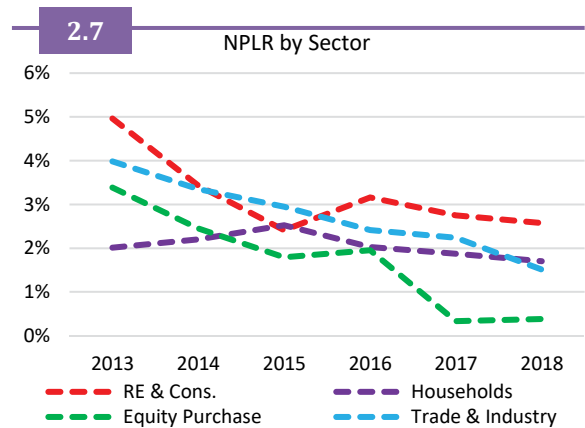
Sector-wise NPLRs also reflect a declining trend in the infection ratio, though the scale of decrease



understandably varies across sectors. For instance, NPLR for the *real estate and construction* sector has come down from 2.8% in 2017 to 2.6% in 2018 (Figure 2.7). While the gross loans to the sector have declined, lower NPLs (of the real estate segment) amid active write-offs and strong recovery in the real estate market in 2018, largely driven by a resurgent investment and commercial segment, has underpinned the improvement in asset quality. Somewhat greater decline was however observed in the case of NPLs in *trade and industry* segment, as its infection ratio dropped from 2.2% to 1.5% in 2018.

The improvement in the NPLR of *household* segment is both due to lower NPLs and higher gross loans granted. Specifically, there has been a steady increase in the share of household sector in banks' gross loans, reaching 25.7% in 2018. Moreover, infection level in the category of housing loans, which represent 86.5% of gross household loans, has also remained quite contained, with NPLR of 1.6%. On its part, CBK has introduced a number of regulations, encompassing both micro and macro-prudential tools, to contain the possibility of infection in the household exposures<sup>18</sup>.

Segregation of NPLs by banks reveals that conventional banks' share in the industry NPLs have been relatively more volatile, while their share in gross loans have been slowly but gradually declining (Figure 2.8). During 2018, conventional banks' contribution to industry NPLs inched up to 56.5%, almost coinciding with their share in gross loans (56.8%). However, such broad classifications across types of banks could be influenced by the performance of one major bank within that group. For instance, the top four banks account for 67.4% of the total loan portfolio of the banking industry; thus, a sharp change in the quality of credit portfolio in even one of those banks can significantly alter the industry averages.



<sup>18</sup> For instance, these loans are primarily extended to Kuwaiti nationals, provided the payments are not above 40% of their salaries (net of all deductions). Moreover, the interest rate charged on these loans is capped at 3% above the prevailing discount rate set by the CBK. Furthermore, since these loans are typically smaller in magnitude and are granted to numerous individuals, the overall portfolio is well diversified with a much lower risk profile.

Geographical distribution of NPLs highlights that the share of domestic NPLs has decreased over the last year, accounting for 62% of the total NPLs in 2018 (Figure 2.9). In general, domestic operating environment has been relatively more conducive on back of continued public spending as well as the rebound in oil prices. Outside Kuwait, the contribution towards non-performing loans from the GCC and Europe has inched up while that from Africa, Asia and the rest has come down.

*Market risk remains the smallest component in overall RWAs*

Given the traditional nature of Kuwaiti banks' operations, market risk remains a fairly small component of the overall RWAs, accounting for a meager 1.2% as of December 2018. The bulk of the banks' investments (around 77.8% as of December 2018) are in fixed income instruments, out of which around 71.2% are in government bills/bonds etc while the major part of the rest are in corporate bonds.

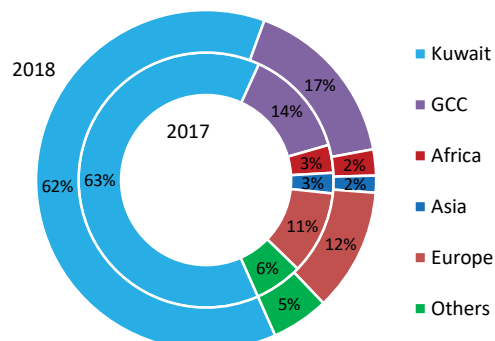
Further breakdown of banks' investments reveals that around 55.3% have been placed under *Available for Sale* (AFS) category. Investments under *Held to Maturity* (HTM) represent the second major segment (42.7%) while *Fair Value through Income Statement* (FVIS) constitute an insignificant third (Figure 2.10). The bulk of investments held under AFS suggest that banks are keen to maintain a high level of liquidity to better manage their liquidity risk. Still, the share of HTM is sizeable and indicates the limited availability of desirable securities, prompting banks to hold these safer assets to maturity.

*Banks' exposure to stock markets has been steadily declining*

Kuwaiti banks' exposure to the stock market can be viewed in three different dimensions; banks' direct investments, use of shares as collateral in lending and loans for purchase of shares. The first aspect covers banks' direct exposure to the equity market while the other two highlight the banks' indirect exposures through their loan portfolios.

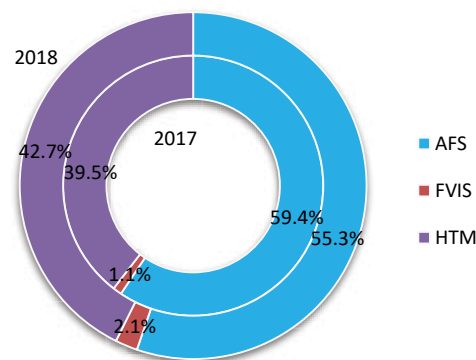
2.9

NPLs-by region



2.10

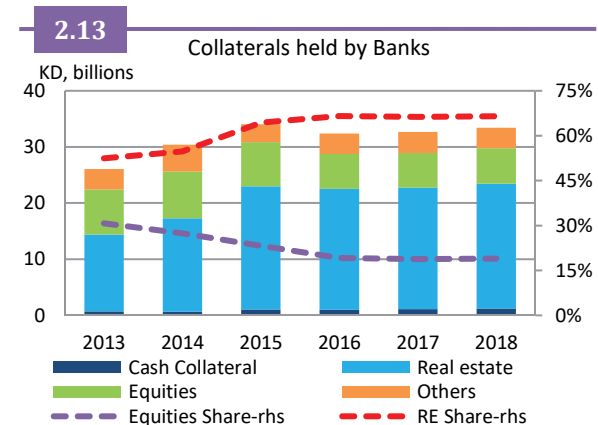
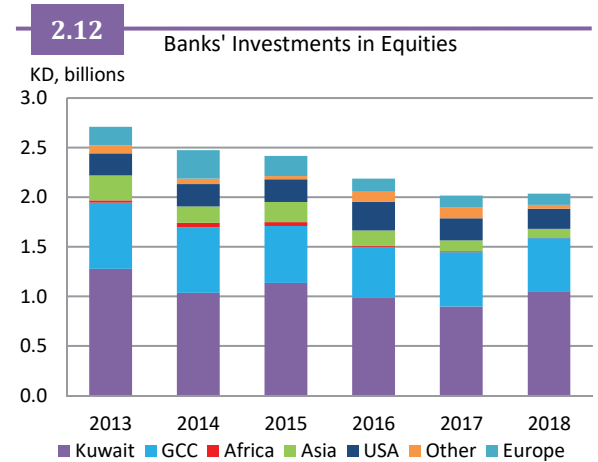
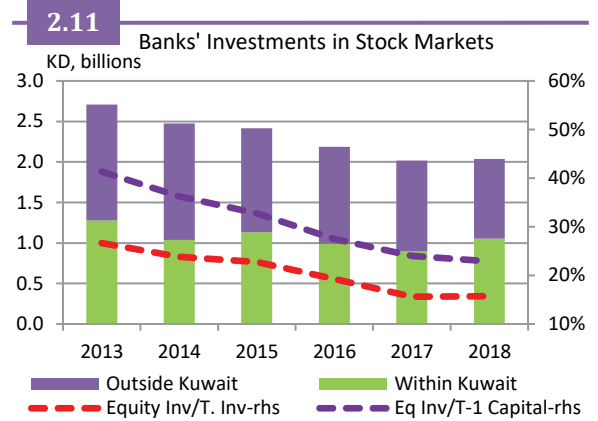
Investments by Purpose



First, in terms of banks' direct exposure, banks' equity investments represent 15.7% of their total investments by end of 2018 (Figure 2.11). While sizeable, the share of equity investments has halved during the last six years when compared to 29% back in 2012. Likewise, banks' equity investments against their Tier-1 capital have steadily dropped to reach 23%, at the lowest level in the last nine years. These numbers indicate that banks have actively reduced their exposure to stock markets, potentially as higher sovereign debt issuance in the region after the oil price shock of 2014 has provided banks an attractive investment alternative.

Banks' overall equity exposures have inched up by 1% (up KD 20 million in absolute terms) to reach KD 2 billion in 2018. Geographical breakdown reveals that banks' exposure to local equities represents 51.7% of their total investments in equities during 2018, highest share in over a decade on the back of better performing local bourse (Figure 2.12). On the other hand, banks' exposure to GCC equities have marginally declined from 27.2% to 26.2% during the same period. With around 48.3% of banks' equity investments distributed across GCC, Asia, Africa, Europe and USA etc., the diversification in banks' portfolio helps them withstand volatility in the stock market. However, as historical experiences suggest, correlations 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 collateral constitutes around 19% of the total collaterals held by banks (Figure 2.13). In fact the use of shares as collateral has steadily receded since 2010 from a high of 40%, leveling off in recent years. While banks' overall exposure to equity collateral stands drastically reduced, some banks are still significantly exposed to sharp swings in equity prices. On the other hand, share of real estate collateral has reached 66.5% in 2018 compared to 43.7% in 2010. Despite plateauing in the last three years around 66%, higher



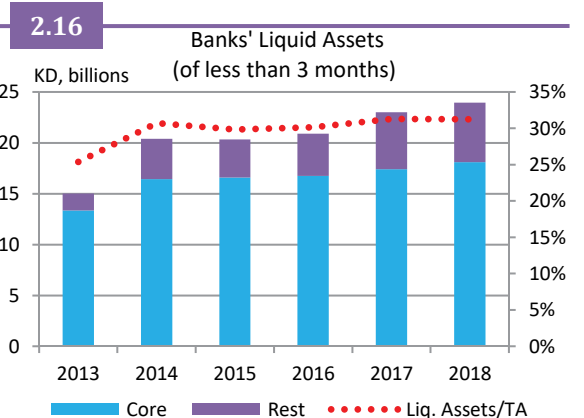
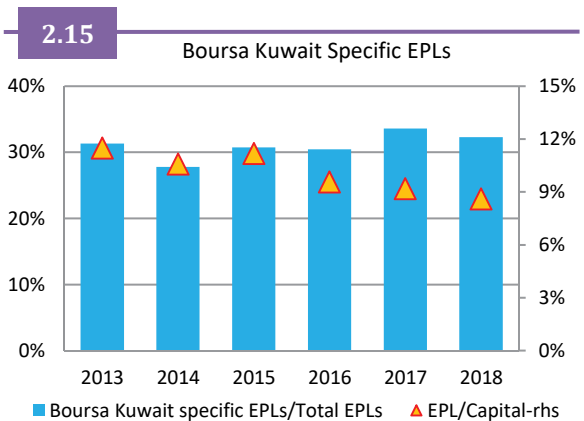
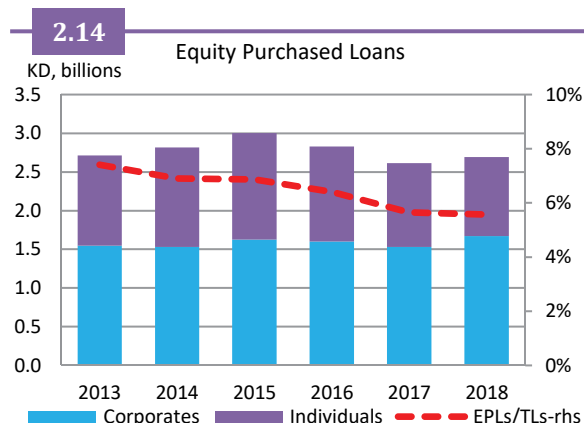
share of real estate collateral poses its own set of unique risks, not the least because of the complications in liquidating such collaterals in the event of a default.

Third, banks' indirect exposure to equity markets also emanates from the loans granted to customers (both individuals and corporates) for trading in shares. These loans, termed as equity purchase loans (EPLs), make up around 5.6% of banks gross loan portfolio. The breakdown in terms of recipients reveals that *corporates* account for 62.1% of these loans with *individuals* receiving the rest in 2018 (Figure 2.14). However, representing only 1.3% of banks' total non-performing loans, EPLs remain quite insignificant component of banks' risk exposure. Additionally, banks' EPL portfolio is quite healthy with NPLR of a meager 0.4% in 2018.

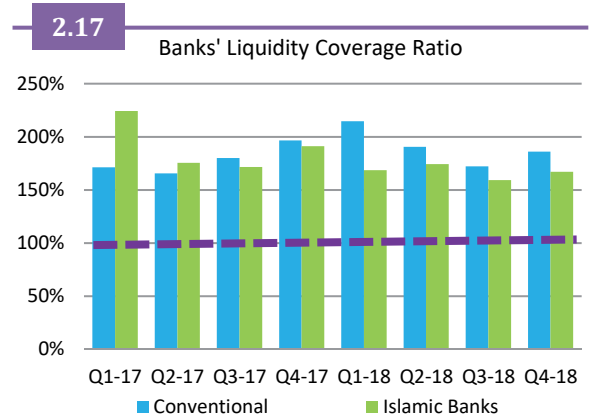
With regards to banks' lending to residents for EPLs, CBK has put in place adequate caps in order to keep the exposure to the local bourse to acceptable levels. For instance, CBK requires that loans granted solely to residents to invest in listed companies may not exceed 10% of total facilities granted to residents, nor to exceed 25% of banks' overall capital. Judging by these regulations, banks' exposures are well below the regulatory benchmarks; for instance, *equity purchase loans to total residents portfolio* was at 2.4% in 2018 while *equity purchase loans to capital* stood at 8.6% in 2018 (Figure 2.15).

### Banks' liquidity level remains healthy

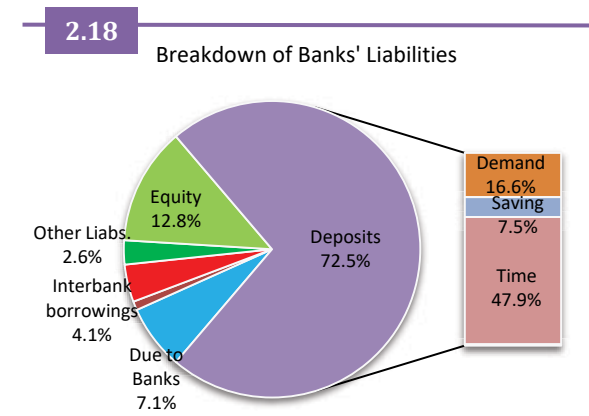
Banks liquid assets of less than three months tenor increased by 4.2% to reach around KD 24 billion in 2018 (Figure 2.16). A breakdown between core and non-core liquid assets reveals that core liquid assets (including cash and cash equivalents, deposits with CBK, government securities, CBK bills, and deposits with banks etc.) represent 75.5% of the overall liquid assets in 2018. Moreover, as a component of total assets, core and liquid assets accounted for 23.6% and 31.2% respectively as of December 2018.



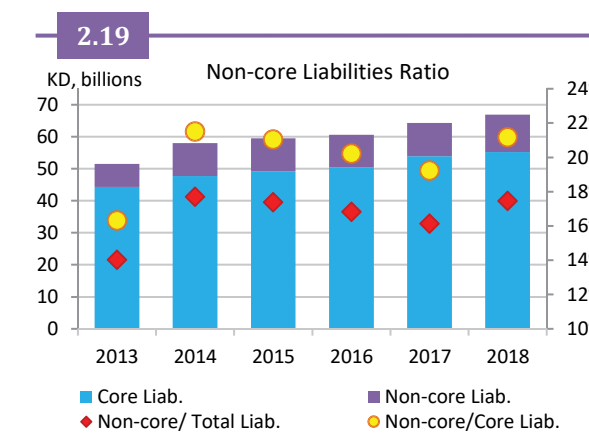
Banks' healthy liquidity levels are also evident from their Liquidity Coverage Ratio (LCR); while CBK has been monitoring the LCR during 2015, the regulation has been phased in from 2016 at 70% and will be gradually increased to reach 100% by 2019. As evident from the data available for 2018, both conventional and Islamic banks are well above the 90% benchmark (for 2018) or even the final benchmark of 100% due in 2019 (*Figure 2.17*). In general, the LCR of conventional banks have been somewhat higher when compared with Islamic banks, except for the first two quarters of 2017.



Breakdown of banks' liability structure reveals that deposits account for the bulk of their funding base (72.5%) in 2018. Within deposits, time deposits represent around 47.9% of the overall funding base and around 66% of total customer deposits (*Figure 2.18*). A sizeable share of time deposits provides Kuwaiti banks with a relatively stable funding base to adequately perform their role as financial intermediaries. Moreover, since Kuwait formally enacted the Deposits Guarantee Law in 2008 to protect depositors, the risk of bank runs has also been effectively eliminated.



Though banks' funding structure is still predominantly reliant on stable deposits, there is a marginal increase in the non-core liabilities (essentially interbank borrowings) compared to core liabilities like deposits (*Figure 2.19*). Given the volatile nature of wholesale funding which can be swiftly influenced by market sentiments, reliance on non-core liabilities to support the growth in assets can increase the funding liquidity risk for the banking system. While the scale of banks' dependence on non-core liabilities is quite limited at present, the trend warrants monitoring.



## Islamic Finance: A Universal Value Proposition <sup>19</sup>

Representative of the patron of the conference, His Highness the Amir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, His Excellency Dr. Nayef Falah Al-Hajraf, Minister of Finance, His Excellency Dr. Abdul Latif bin Rashid Al Zayani, Secretary-General of Gulf Cooperation Council, Excellencies, Governors of central banks and monetary authorities, Dr. Bello Lawal Danabatta, Secretary-General of the Islamic Financial Services Board, Distinguished Guests, Ladies and Gentlemen,

*Assalam-o-Alaikum* and a very good morning.

I would like to start by expressing my deepest gratitude to His Highness the Amir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah for kindly patronizing this global conference on Islamic finance. I would also like to express my profound thanks to the representative of His Highness the Amir, His Excellency Dr. Nayef Falah Al-Hajraf, for being with us today.

It is the guidance and wise leadership of His Highness that has enabled us not only to grow our economy in the last decade, but also to build one of the safest and most robust financial systems in the region, with a dual banking system that has facilitated the growth of both Islamic and conventional finance.

It gives me great pleasure to welcome you today to this prestigious global forum on Islamic finance. I am deeply indebted to all the honorable ministers, governors of central banks, heads of regulatory and supervisory authorities, heads of financial institutions and other distinguished guests for joining us today.

In particular, I would like to thank the Islamic Financial Services Board (IFSB), and its Secretary General Dr. Bello Lawal Danabatta, for their support in organizing this joint conference, in conjunction with the IFSB annual meeting.

I would also like to sincerely thank the staff of the IFSB and my dedicated colleagues at the Central Bank of Kuwait for their efforts in making this conference a success.

The IFSB, established in 2002, is recognized today as the leading international standard-setting body for Islamic finance, promoting the development of a prudent and transparent Islamic finance industry.

The Central Bank of Kuwait, one of the founding members of the IFSB, has long recognized the importance of its work in issuing and/or adapting international standards for the specificities of the Islamic finance industry, and the complementary role that the institution plays alongside other international standard-setting bodies such as the Basel Committee on Banking Supervision.

As the current Chairman of the IFSB, I am extremely pleased by the growth and development of this international institution, which has expanded in the last 15 years from its nine founding members to 185 members today, which include 75 regulatory and supervisory authorities in 57 jurisdictions.

<sup>19</sup>Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor of the Central Bank of Kuwait & Chairman of the IFSB 2018 at the CBK-IFSB Islamic finance conference on May 2nd, 2018 in Kuwait City, Kuwait.

To begin with, let us remind ourselves that we must always be mindful of the fact that the ultimate objective of all our efforts is to ensure prosperity, provide high living standards and promote the broader welfare of the whole society on a sustainable footing. Similar to this, we all, in our different capacities and roles, must strive for this objective and ensure that our actions and initiatives are aligned to this goal.

With that said, I feel that this august gathering comes at a suitable time for the Islamic finance industry. The world today faces numerous economic and social challenges that require a collective approach. Market volatility, limited economic diversification, lack of social engagement, poverty and unemployment are just some of the issues that communities are facing around the world. Islamic finance can help in addressing many of these challenges, subject to adherence to its core values.

That is why we are hosting this event under the theme *‘Islamic Finance: A Universal Value Proposition’*, because we feel that Islamic finance offers a global value proposition, to governments, corporates and consumers, both Muslim and non-Muslim, that can drive sustainable and inclusive economic growth, and shared prosperity for all, since it is built on globally accepted ethical principles.

Building on the success of the previous conference, which the Central Bank of Kuwait organized in collaboration with the International Monetary Fund in 2015, I believe this event serves as a platform for all industry stakeholders to discuss and highlight the role of Islamic finance in the broader national economic agenda, to facilitate discussions to collectively address industry challenges, and to promote greater global cooperation.

In this respect, I would like to share a few thoughts on how we envision the Islamic finance industry contributing to these objectives. My speech is set to cover three key aspects of this debate. I will start by providing a very brief overview of the global economic environment and challenges that we still face, despite the progress made over the last decade. I will then reflect on how Islamic finance can be leveraged to address many of these issues, in light of examples from around the world. And finally, I will briefly touch upon what is required to ensure that the Islamic finance industry reaches its true potential.

### **Setting the Context – Global Environment and Challenges**

Let me start by reflecting on where we stand today in terms of the global environment and challenges, focusing on three key perspectives: economic growth, financial stability, and social development.

Firstly, ten years on from the unprecedented Global Financial Crisis the global economy has come a long way. According to the IMF, global economic growth has been on the rise. It reached 3.8% in 2017 for the first time since 2011. Unemployment at the global level has also come down, from a high of 6.2% in 2009 to 5.7% in 2017, according to the World Bank.

Secondly, we have seen significant improvement in global financial stability. In general, the global financial system has continued to strengthen, thanks to the implementation of various reforms and regulatory initiatives including Basel III standards, risk-based supervision, enhanced corporate governance, stress testing, and the growing use of macroprudential measures.

Finally, significant progress has also been made on social development in the last decade. For instance, according to the World Bank, the percentage of the global population living in extreme poverty has declined from 15% to less than 10% in the last decade.

Despite the progress that has been made in the last decade, many economic and social challenges still persist, with different economies proving to be vulnerable to emerging risks, slower growth, and volatility in financial markets. Also, the recent economic gains are unevenly distributed across countries, and the economic prospects for many remain challenging.

Let me briefly reflect on some of these challenges.

One of the key factors driving economic volatility is the fluctuation in commodity prices. The impact of declining prices can be devastating for developing countries, with over 95 developing countries depending on commodities for at least 50 percent of their export earnings. On the other hand, a recent IMF study found that the full impact of declining oil prices is not clear, and there may not be a net positive economic impact for the global economy in general.

In any case, volatile commodity prices remain a major concern for the global economy, highlighting the need for countries to invest in diversifying their economies to sustain growth. But this is not an easy task for governments. For example, it is estimated that US\$10 trillion will be required to fund infrastructure projects that are designed to support economic diversification efforts in Asia and MENA by 2020.

Second, there are concerns being raised about the state of financial stability globally. Despite recent regulatory reforms and initiatives, the evolving macro-economic conditions could have implications for financial sector stability.

Consider the case of unconventional monetary policies adopted by major central banks in the wake of the Global Financial Crisis. These policies have been helpful in supporting economic recovery and ensuring market stability after the crisis. However, their unwinding could have serious implications not only for financial markets but also for emerging economies, with a potential risk of capital outflows and exchange rate volatility. Moreover, divergence in monetary policies across the advanced countries would make an orderly exit much more challenging for the global economy.

There is also evidence of excessive risk-taking fueled by record low interest rates. According to the IMF's latest Global Financial Stability Report, several countries and institutions have utilized the low interest rate environment to pile on greater debt. According to the Institute of International Finance, global debt has grown from US\$167 trillion to US\$237 trillion over the last decade, and is now at 318% of global GDP. This translates to a debt of over US\$30,000 per capita. And with current low interest rates projected to increase in the medium term, potentially causing capital outflows and depreciation of domestic currencies in emerging markets, this is likely to create repayment and servicing pressures for institutions and countries.

On the other hand, lower interest rates have also seriously dented banking sector profits in many countries. A study by the IMF pointed out that one third of global banks, with US\$17 trillion in assets, are struggling to sustain profitability.

Third, there are still significant challenges for social development. For instance, unemployment is a major issue for most countries around the world. Today, there are over 200 million unemployed in the world, and a further 200 million are classed as underemployed. Moreover, an additional 600 million jobs will be needed globally in the next 15 years to absorb the projected growth in the global workforce.

Financial exclusion also remains a major challenge for many countries. According to the World

Bank, an estimated 2 billion adults around the world do not have access to banking services. Moreover, the SME sector, which is a key driver of economic growth and employment in any market, continues to be underserved by the financial sector, particularly in developing countries. It is estimated that 70% of all micro, small and medium-sized enterprises in emerging markets lack access to credit, with the total credit gap being as high as US\$2.6 trillion.

All of these factors have a major impact on global poverty. Around 800 million people continue to live in extreme poverty conditions, having to live on less than US\$1.9 per day.

These are all important macro-level issues which stakeholders will need to address in a collective manner. And it is here that we feel Islamic finance has a role to play globally. Through its distinct value proposition, Islamic finance can help drive inclusive economic growth and strengthen financial stability, which in turn can support social development, as I will explore shortly.

### **Islamic Finance – A Universal Proposition**

Financial intermediation has a critical role to play in supporting communities to achieve their ultimate objective, as I outlined earlier. As Thomas Jefferson put it: “*The care of human life and happiness.... is the first and only object of good government*”. And banking, being the dominant segment of financial intermediation, is the greatest contributor towards achieving this objective.

The conventional banking industry is already playing a major role in this regard. It is a mature and long-established industry, with adequate depth and sophistication. It has the ability to effectively contribute to the global economy given that it employs proper corporate governance and ethics.

On the other hand, modern Islamic finance, including Islamic banking, is at an early stage of its development. Yet the Islamic finance industry provides a universal value proposition for all. Its core values include profit and loss sharing, transactions linked to real assets, a focus on responsible and ethical investments, and prohibitions on speculative transactions, synthetic instruments, and industries that do not benefit the community. These core principles have universal appeal among governments, corporates and consumers, among developed and emerging markets, and for Muslims and non-Muslims alike. Through these core principles, the industry has the potential to support inclusive growth across the value chain, increasing productivity and providing economic and social benefits to the entire society.

Here in Kuwait, we have experienced these benefits first hand. Kuwait has always been a pioneer when it comes to Islamic finance. Looking back, it is impossible to appreciate the birth of the Islamic finance industry without recognizing the tremendous contributions of their late Highnesses the Amirs Sheikh Sabah Al-Salim Al-Sabah and Sheikh Jaber Al-Ahmad Al-Sabah (Rahimahum Allah) for providing a legal environment for Islamic finance in Kuwait.

It was their late Highnesses who supported the late Sheikh Ahmed Al-Yasin (Rahimahum Allah) to realize his vision of establishing an Islamic bank in the mid-1970s, when there was virtually no Islamic finance model to emulate or learn from. Despite this challenge, Sheikh Al-Yasin persisted, with the support of other likeminded individuals, to establish Kuwait Finance House (KFH) – not only the first Islamic bank in Kuwait, but also one of the very first to be established anywhere in the world. He described the challenge of establishing an Islamic bank as being ‘like swimming against the tide’.

The seeds he sowed for the industry have blossomed. And the Islamic finance industry in Kuwait,

which started with a single branch and four employees in 1978, has grown today to make up to 40% of the country's banking sector, with five Islamic banks, KD29 billion (US\$96 billion) in assets, 600 branches, and over 12,000 employees.

Leveraging on the examples of Kuwait and other pioneering markets, the global Islamic finance industry has grown exponentially during the last four decades. According to most estimates, the industry now accounts for US\$2.2 trillion in assets. Today there are over ten countries, operating a dual banking model, where Islamic banks hold over 20% of banking sector assets, reflecting their systemic importance. In addition, 44 countries to date have introduced some form of legislation or regulations to support the development of their domestic Islamic finance industries.

Although, the growth of Islamic finance has been impressive over the last four decades, its penetration is still only approximately 2% of the global finance industry. While over 80 countries are implementing some form of Islamic finance, the industry remains small outside of a handful of core markets in the Middle East, North Africa, and South and Southeast Asia.

Still, the Islamic finance industry, with its universal value proposition of inclusiveness, can help address many of today's economic, social and financial challenges, subject to necessary conditions such as implementation of relevant Islamic finance standards, corporate governance, ethics, and proper risk management, to which I alluded earlier.

First, for economic diversification, Islamic financial instruments can play an important role. One Islamic financial instrument used extensively for this purpose is Sukuk. In the last four years alone, Sukuk have been used by over 20 sovereign governments from around the world, Muslim and non-Muslim alike, to raise over US\$100 billion of funding for various projects and initiatives across Africa, Asia, Europe and the Middle East. Sukuk not only help institutions raise funding and deepen capital markets but also help governments build infrastructure and provide support in achieving the Sustainable Development Goals.

Second, we have the impact of Islamic banking on the overall financial stability of a country. Islamic finance can have a positive impact on financial stability through the implementation of its core values such as profit and loss sharing, connectivity of financial transactions with real assets, and the prohibition of speculative transactions, synthetic financial tools and investments in harmful industries. Numerous studies from the World Bank and the IMF have highlighted that Islamic finance offers an inclusive and stable operating model, provided it remains true to its core values and is built on a solid foundation.

Finally, social development is another area where the core principles of Islamic finance can be leveraged. For instance, governments can use Islamic finance for financial inclusion. Many countries introduced Islamic finance during the 1980s and 1990s with the primary motivation of promoting financial inclusion for people who otherwise would have been excluded from the financial system. In recent years, international institutions such as the World Bank and the IMF have increasingly identified Islamic finance as a critical industry to address the issue of financial exclusion across the world. A recent study from Ernst & Young on Banking in Emerging Markets shows that Shariah-compliant products – through leveraging the support of appropriate technology infrastructure – can bring up to 150 million unbanked customers into the financial system in the next three years.

The core principles of Islamic finance mentioned earlier are also naturally aligned to the needs of the SME segment. This link has been substantiated by research from various institutions, including the World Bank, which published a study in 2014 that found that the greater the

number of Islamic banks per 100,000 adults in a country, the lower the proportion of SME firms that identified access to finance as a major constraint.

Given the salient features I have discussed, we have to ask ourselves: “What would be the impact, globally, if the industry was able to reach its full potential?” Our empirical analysis indicates that if developed globally, Islamic finance assets could grow to approximately US\$7 trillion in the next decade, based on the best-case scenario. This growth would mean the industry nearly triples in ten years, contributing an additional US\$4 trillion per annum to the global economy, and creating an additional 150 million jobs. But the industry would still remain a fraction of the global finance industry, at approximately 3%. We have to ask ourselves if we are happy to remain a niche segment, or if we are willing to take the appropriate actions to unlock the true potential of the industry.

### **Islamic Finance Building Blocks**

The extensive expansion of Islamic civilization across the east and west is reflected in its unique and impressive domes. Symbolically, the Islamic finance industry can be viewed as one of those domes based on solid foundations – i.e., the noble values of Islam – supported by the following four pillars:

- Legislation
- Regulation
- International Islamic Finance Bodies
- Islamic Financial Institutions

This infrastructure sits beneath a dome richly decorated with eye-catching engravings. This is the Islamic finance industry as viewed by its customers and beneficiaries, whether they are individuals or communities.

Building on what I said about the broad and inclusive nature of Islamic finance, in addressing global economic and social challenges we must also recognize that the Islamic finance industry is still at an early stage of its development, and we need to support it with a solid foundation. In this regard, four key pillars are critical, not only in providing an enabling environment for a sustainable and resilient Islamic finance industry, but also in bringing current practices closer to the core values of Islamic finance.

#### 1- Legislation and Legal Framework

First and foremost is the role of legislation. It is legislation that drives the direction of the Islamic finance industry in any country, and provides the necessary infrastructure for the establishment, operations and oversight of the industry. It is critical that legislation is flexible and evolves along with the needs of the industry, with an aim to put the industry on the right path to long-term sustainable growth.

In addition to supportive legislation, the role of legal institutions in offering the necessary infrastructure that, among other things, helps protect property rights and enforce contracts is pivotal for the industry. With both social and economic implications, Islamic principles lay great emphasis on honoring obligations and fulfilling commitments. It is not without reason that the longest verse in the longest Surah of the Quran (282: Al-Baqarah), known as the verse of debt (Ayat Al-Dayn), speaks about financial transactions, the rights of the debtor, and the responsibilities of the creditor among other topics. Likewise, Surat Al-Ma’ida opens by speaking about contracts and obligations:

“O you who believe! Fulfil (your) obligations”. And in “يا أيها الذين آمنوا أوفوا بالعقود” Surat Al-Isra:34 we are advised: “وأوفوا بالعهد إن العهد كان مسؤولاً” “And fulfil (every) covenant. Verily, the covenant will be questioned about”.

## 2 – Regulation

After legislation comes the key role of regulation, in terms of designing a robust regulatory and supervisory regime. Due to the specificities of Islamic finance, having in place effective regulation is a daunting task, particularly in dual banking systems.

Regulation in this context has two key aspects: the roles played by regulatory authorities and those charged with ensuring Shariah compliance.

Regulators need to strike a balance between establishing and enforcing minimum international standards for sound regulatory and supervisory practices, protecting consumers and safeguarding systemic stability, and at the same time facilitating the growth, innovation and sustainability of the industry.

Moreover, regulators need to address the evolving needs of the industry. In the ever-changing landscape of today’s financial industry, regulators must provide a robust framework for addressing issues that stem from innovation, disruptive technologies such as FinTech, cyber-security risk, and other recent developments. They also need to view technology not as a threat to be resisted but as an opportunity to be embraced, though with a clear understanding of the attendant risks and appropriate safeguards.

Furthermore, the Islamic finance industry not only has to be compliant with standard supervisory requirements but must also be in line with Sharia principles. Therefore, supervisors need to promote a strong Sharia governance framework along with effective Sharia auditing and independent oversight.

## 3 - International Islamic Finance Bodies

Supporting the role of regulators, international Islamic finance bodies also have a critical role to play in the regional and global integration of the Islamic finance industry. Institutions such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Market (IIFM) and the International Islamic Liquidity Management Corporation (IILM) play a pivotal role in the global Islamic finance industry, setting standards and providing products and financial instruments that support the growth and depth of the global Islamic finance industry.

The industry today requires an integrated approach between international bodies and standard setters to promote cooperation between Islamic and conventional finance across countries, as well as intra-agency coordination.

International standard-setting bodies also have a role in promoting standardization of products, services and supervisory practices across Islamic finance markets, to promote greater global cooperation and increase consumer confidence in the industry.

It is important that these international Islamic finance bodies coordinate their activities and play a complementary role rather duplicating efforts. In this regard, the platform such as this conference

offers provides excellent opportunities for these bodies to collaborate.

#### 4 - Islamic Financial Institutions

Finally, the fourth pillar without which the picture can never be complete is represented by the Islamic financial institutions themselves. It is the market players who translate the principles and thoughts of Islamic finance into reality in the form of products and services. These institutions have to ensure that the products and services they offer are not only Sharia-compliant, but also aligned to the spirit of Sharia and the core principles of Islamic finance. If they adhere to these principles correctly, these institutions will undoubtedly serve to promote inclusive economic growth, social development and financial inclusion.

One of the areas that Islamic financial institutions need to focus on is research and development (R&D). The focus on R&D should bring innovation in introducing new products and services aligned to the principles of Sharia and the needs of the community, and should address the issue of product concentration in their portfolios.

Currently, according to the IFSB, 68% of all Islamic banks' financing assets are concentrated on Murabaha, followed by 14% for Ijara. The other types of Islamic financial products collectively make up only 18% of total financing assets.

This high concentration and lack of product diversification is a key issue for the industry, especially as many of the assets offered under Murabaha are based on commodity Murabaha, which makes only a limited economic contribution due to its structure.

Generally, a key issue has been replication of the conventional banking model by some Islamic banks. Instead of focusing their efforts on building a Sharia-based model, they have adopted a Shariah-compliance strategy solely by tweaking existing conventional products. This approach has resulted in serious deviation from the key principles of Islamic finance and hindered true innovation.

So instead of focusing on Murabaha, for instance, the industry could have more frequently used Salam and Istisna, which involve development of real economic assets and can thus have a significant impact on the economy. Our analysis shows that focusing on these two products would make available approximately US\$800 billion in the next five years for the development of real assets covering key economic sectors including manufacturing, construction, and agriculture. This would also lead to product diversification and greater productivity and inclusiveness, which would have a multiplier effect throughout the wider economy. This is the true spirit of Islamic finance.

In order to strengthen the role of each institution I described under the four pillars, capacity building is critical. There is a need to shift the focus from individual or fragmented efforts to a more collective and coordinated institutional approach to address the needs of the industry.

For any structure, physical or financial, to remain stable and strong, it requires ongoing maintenance. In a similar manner, the industry also requires ongoing capacity building along with continuous research and development. It needs to train professionals and sharpen their skills, enabling them to not only cope, but also drive the growth and development of the Islamic finance industry. In this regard, the role of academic institutions and Sharia scholars is critical.

On the positive side, we are comforted by the fact that Islamic finance education has a strong presence in non-Muslim countries, which demonstrates the universal appeal of Islamic finance. Of the 680 Islamic finance education providers around the world, 34% are in non-Muslim countries.

However, if we look at the role of academic institutions, it is evident that there is a major gap between Islamic finance theory and practice, and that educational institutions are yet to produce 'job-ready' graduates for the industry. Academia has to take a lead in this area, developing curricula that balance the theory of Islamic finance and market-aligned programs while still promoting product innovation and leadership.

Despite some progress in capacity building, we still have a long way to go. As evident from a recent survey conducted by the IFSB, 82% of Islamic finance markets suffer a shortage in qualified talent, while 60% of Islamic finance professional still require further training and skill development.

In addition, one of the key challenges the industry has faced has been the limited number of scholars that sit on multiple Sharia boards. If we look at the industry overall, it seems well balanced, with 1,075 scholars sitting on the board of 1,400 Islamic financial institutions. But a closer examination highlights the problem, with eight scholars having over 30 board seats each. This scarcity is a challenge for the industry, but it doesn't stop here. In fact, this scarcity extends further with three scholars having over 70 board seats each.

This leads to issues in product stagnation and in industry innovation and compliance, among others. It is imperative that all stakeholders come together with Sharia scholars to address this issue for the sake of the overall development of the Islamic finance industry.

Given the challenges we face today, it is not possible for any of these four pillars to make a meaningful difference on its own. Each pillar, from legislation to regulation and standards-setting to Islamic financial institutions, has a distinct yet mutually reinforcing role to play. While individually insufficient, collectively these institutions provide a solid foundation for a dynamic and resilient Islamic finance industry and are thus the pre-requisites for its sustainable and inclusive growth.

We are very privileged to have these different stakeholders representing different parts of the world at this conference. And we are confident that the discussions that take place today will lead to actionable recommendations that we can collectively take forward for the development of the global Islamic finance industry, which will in turn drive sustainable inclusive growth and shared prosperity for all. It is necessary to combine our efforts and work collectively to reach such results. Architect Hassan Fathy gives us a great example on the outcome of collective efforts by saying: "One person cannot build a house, yet ten persons can build ten houses".

## **Conclusion**

In conclusion, I would like to go back to what I said at the beginning of this address about the ultimate objective, which is to ensure prosperity, provide high living standards, and promote the broader welfare of society on a sustainable footing. And as it has been demonstrated, Islamic finance can play its due role in supporting the achievement of this objective.

Islamic finance offers a universal proposition to address the key economic and social challenges that we face today, but only if we do it properly, and build the industry on a solid foundation of

the key pillars. To this end, each of us has an important role to play in the industry's development, if the industry is to reach its true potential.

Around 40 years back, establishing an Islamic bank was swimming against the tide, as late Ahmed Al-Yasin described it. However, considerable progress has been made in the last four decades and establishing an Islamic bank is no more a challenge. In fact, the Islamic finance industry has all the institutional support it needs to flourish.

So we need to ask ourselves:

- How do we ensure that Islamic finance plays its due role?
- Are we doing enough to support the industry reach its true potential? And if yes, then
- Why is the industry still only 2% after four decades?

I hope that the discussions by the distinguished panelists and thought leaders that take place today will go a long way in addressing some of these issues, as we work together for the development of the industry.

And I am confident that this conference will produce concrete and strategic recommendations that different stakeholders can take forward and implement to build a strong foundation for a global Islamic finance industry that is ethically right, socially just, financially stable, and economically productive.

Thank you very much.



## CHAPTER 3

PROFITABILITY, SOLVENCY & RESILIENCE

2021



### 3

## Profitability, Solvency & Resilience

The banking sector in Kuwait continues to improve its soundness and resilience by generating higher profitability levels while maintaining strong loss absorption capacity. Banks' net income, on a consolidated basis, grew by 18% during 2018, compared to 9% recorded a year earlier, lifting return on average assets and equity to 1.3% and 10.7% respectively. Improvement in banks' core-banking activities, mostly in the form of net interest income, supported industry profits. Banks managed to grow their NII despite relatively faster growth in their interest expense. By banking groups, Islamic banks net income recorded stronger growth at 22.5% compared to 15.9% of their conventional counterparts. Nevertheless, conventional banks account for 60.4% of the industry profits and a nearly proportionate 59.5% of the industry assets. Furthermore, having sufficient levels of loan loss provisions, the implementation of IFRS 9 did not result in significant increase in overall provisions. Efficiency of the banking sector improved as their cost to income ratio declined to 37%, though conventional banks continued to remain, on average, more cost efficient than their Islamic counterparts. In terms of solvency, Kuwaiti banks continued to maintain a robust loss-absorption capacity with the overall capital adequacy ratio at 18.3%, with high quality CET1 capital accounting for 83.8% of total capital. Finally, results of CBK's quarterly stress testing exercise further attests to banks' resilience. Broadly speaking, banks were able to withstand various shocks in credit, market and liquidity simulated under a wide range of micro and macro-economic scenarios.

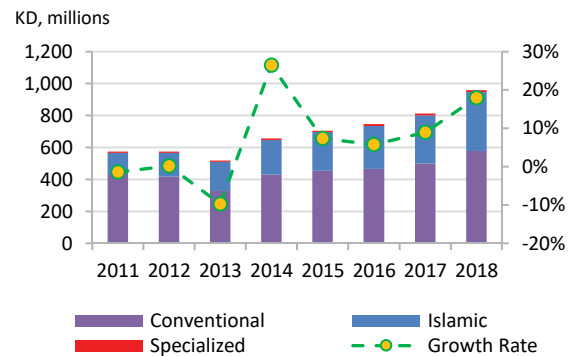
Overall profitability further improved during 2018.

Profitability of Kuwaiti banks continued to improve during 2018, reaching its highest level since the global financial crisis. On a consolidated basis, banks' net income after tax<sup>20</sup>, increased by 18% totaling KD 959 million (Figure 3.1). Overall improvement in profitability was supported by increasing oil prices, which in turn lifted investor sentiment and aided to a healthier operating environment. Higher growth in non-oil GDP<sup>21</sup> further supported banks' profitability.

While both Islamic and conventional banks positively contributed towards overall income growth, Islamic banks recorded stronger growth at 22.5% compared to the 15.9% of their conventional counterparts. Consequently, Islamic banks' share of industry profits increased from 37.0% in 2017 to 38.4%, drawing closer to their relatively stable share of industry assets (39.6%) (Figure 3.2).

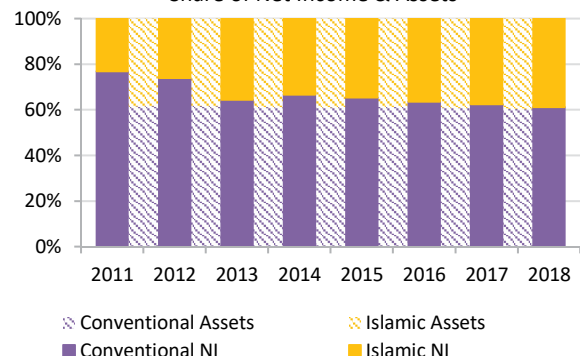
### 3.1

Banks' Net Income After Tax



### 3.2

Share of Net Income & Assets



<sup>20</sup> Share of banks' shareholders in the net income (i.e. after deducting share of non-controlling interest).

<sup>21</sup> Based on initial estimates of Central Statistical Bureau.

Core banking activities are generating the majority of gross profits.

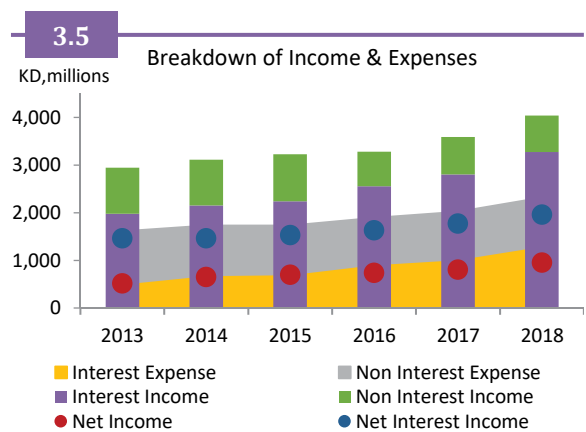
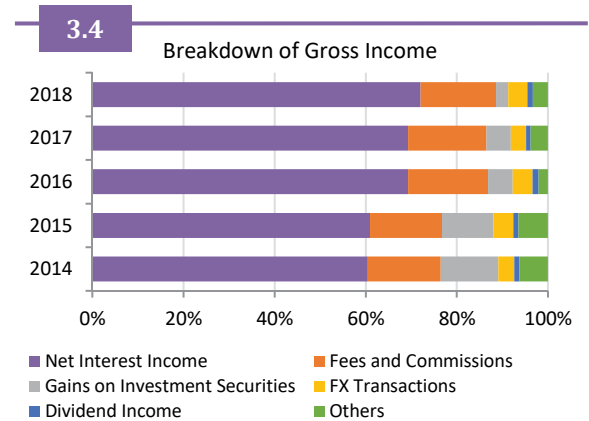
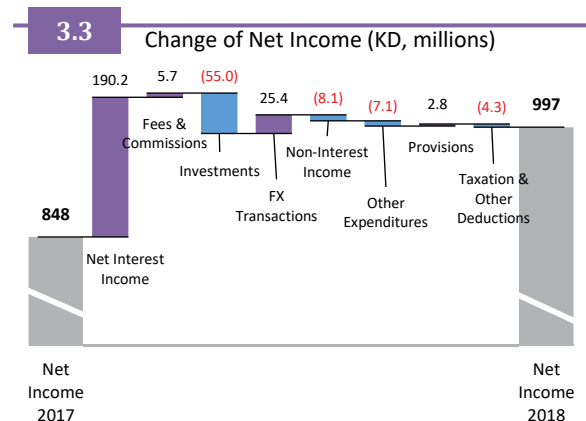
Total net income (both attributed to banks' shareholders and noncontrolling interest) increased by KD 149 million in 2018, reaching KD 997 million. This increase is largely attributable to improvements in net interest income (NII), FX transactions, fees & commissions and a slight reduction in total additional provisions (Figure 3.3).

Breakdown of overall income reveals that the majority of industry profits came from core banking activity. NII accounted for 72% of overall income up from 69.3% a year before (Figure 3.4). Income from loans made up 78.0% of interest income, most of which (65.4%) generated from credit facilities granted to corporate clients. Fees & Commissions came in second place, accounting for 16.6% of total income.

Gains on investment securities contracted from 5.3% to 2.7% in 2018, partly reflecting the downsizing of banks' investment portfolio. Banks holdings of investments as a ratio of assets dropped from 17.6% to 16.9%. Income from bonds and bills accounts for 41% of total gains from investment securities.

NII improved despite relatively faster growth in interest expenses.

Banks managed to grow their NII by 10.7% despite relatively faster growth in their interest expense. Interest expense increased by 27.4% during 2018, faster than the 16.8% increase in interest income (Figure 3.5). CBK's decision to increase repo rates four times and increase the discount rate only once during 2018 partly influenced these trends. Furthermore, banks' non-interest income, was slightly down in 2018 (-2.8%), a drop essentially driven by the decline in gains on investment securities.



Kuwaiti Banks were sufficiently equipped with the necessary buffers limiting the effect of the implementation of IFRS 9 in 2018.

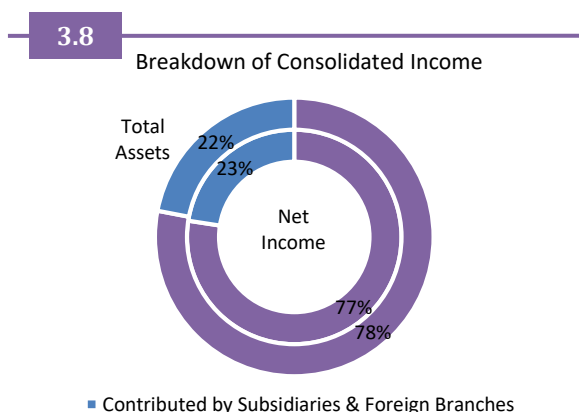
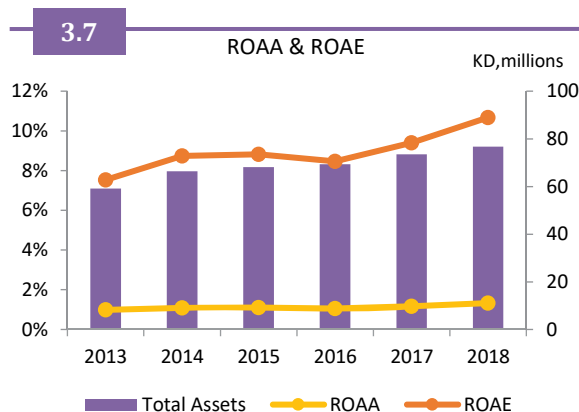
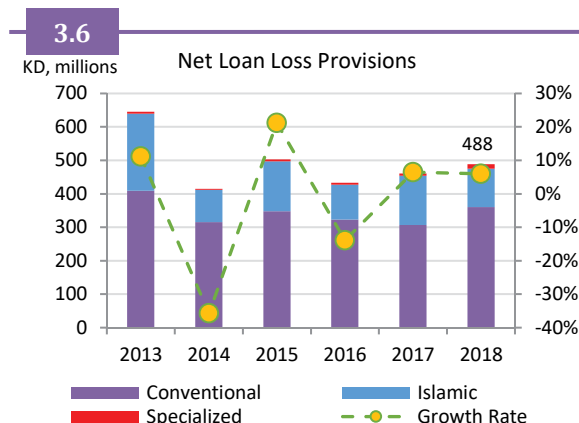
Banks hold provisions against their loan portfolio as well as against other financial assets. During 2018, net loan loss provisions (LLP) recorded a KD 27.5 million increase while provisions against other financial assets dropped by KD 30.3 million, resulting in a slight reduction in the provisions expense. Implementation of the International Financial Reporting Standard 9 (IFRS 9) during 2018 did not result in excessive levels of expected credit losses since Kuwaiti banks already hold adequate levels of precautionary provisions.

Further analysis reveals a divergence in net LLP growth between Islamic and conventional banks. While Islamic banks' net LLP contracted by 22.3%, conventional banks saw a 17.5% increase in net LLP (Figure 3.6). This increase was mainly driven by an unaccustomed application by a single conventional bank to write-off all nonperforming loans in 2018. Overall, similar to 2017, growth in net LLP remained at 6%, and total provisions expense to average assets stayed at 1%.

*Banks' main profitability indicators carry on improving in 2018, with the ROAE reaching a double-digit figure...*

Amid rising net income of the banking sector, both return on average assets (ROAA) and return on average equity (ROAE) continued to improve during 2018. Banks managed to grow their balance sheets at a steady rate, and their profitability at a higher, yet stable pace. To be precise, assets and equity grew by 4% and 6% respectively, while net income grew at an impressive 18%. This resulted in a 10 bps increase in ROAA to reach 1.3%, and a 130 bps increase in ROAE to reach 10.7% (Figure 3.7).

Breakdown of net income among domestic and foreign operations reveals that 22.6% of the consolidated net income was contributed by



subsidiaries and foreign branches, consistent with their share (21.7%) in total assets (figure 3.8).

*...and demonstrating higher competitiveness, a signal of a healthier industry.*

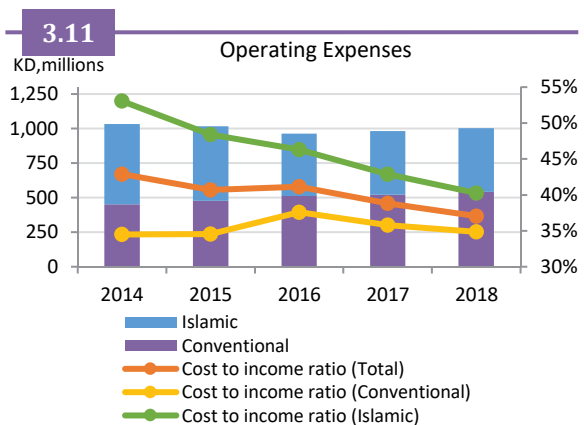
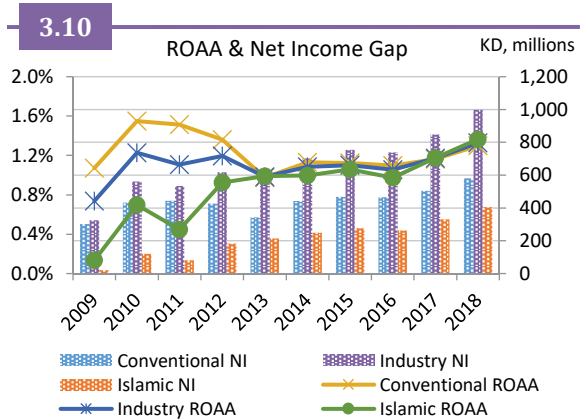
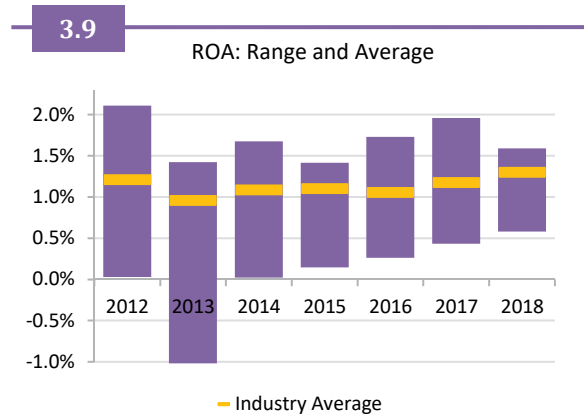
Bank-level data reveals that all banks were profitable during 2018. In fact, the narrower range of ROA between different banks indicates that previously less profitable banks are now effectively catching up with their peers (Figure 3.9). As competition has intensified, banks are forced to enhance their efficiency and provide better products and services to their clients.

The gap between conventional banks' ROAA and that of their Islamic counterparts has diminished, influenced by higher gains in the profitability of Islamic banks (Figure 3.10). Islamic banks were less saturated in the past few years allowing greater room for growth and improvement. In 2018, ROAAs of Islamic banks surpassed that of the industry average. This is in stark contrast with the trend observed pre-2013 when ROAA of Islamic banks was considerably lower than that of the industry.

*Conventional banks continue to exhibit better efficiency.*

Banks' operational efficiency continued to improve during 2018, largely influenced by efficiency gains in Islamic banks. This is reflected by a drop in cost to income ratio from 38.8% in 2017 to 37.0% in 2018 (Figure 3.11). Higher gross income helped both conventional and Islamic banks in reducing their cost to income ratios, notwithstanding the slight increase in their operating costs during the year.

Still, on average, conventional banks appear relatively more efficient than Islamic banks, though the gap between the two groups has steadily narrowed, when viewed in terms of cost to income ratio. Higher cost to income ratio for Islamic banks has a variety of reasons. First, operating environment for Islamic banks is somewhat more challenging, given Shari'ah restrictions on certain products/services otherwise



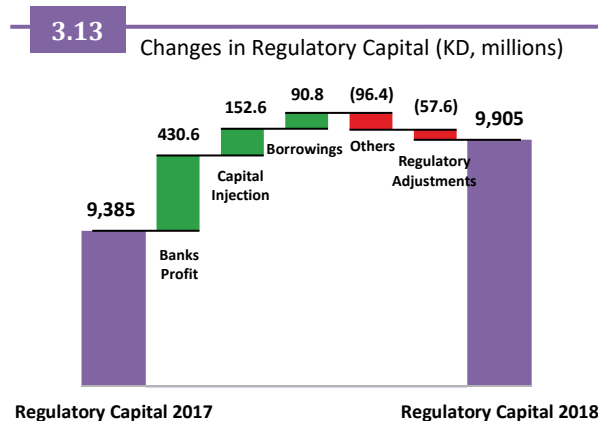
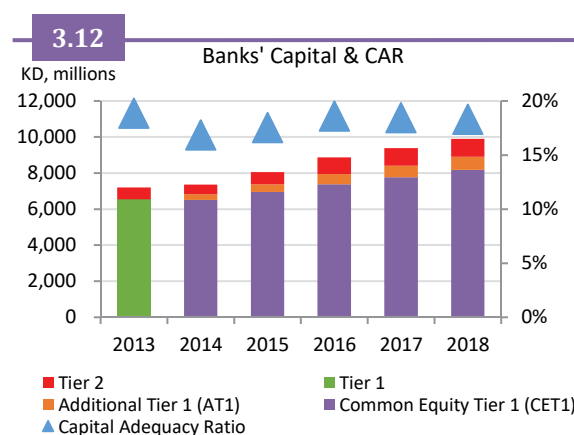
available to conventional banks, making even normal operations like liquidity management more challenging. Second, transaction costs for Islamic banks are generally higher, both on account of higher legal and shari'ah requirements to execute the same transaction. Third, high level of operating expenses for Islamic banks also stems from their non-banking subsidiaries, which inherently are associated with higher operating expenditures.

*Kuwaiti banks continued to maintain a robust loss-absorption capacity.*

Given CBK places strong emphasis on ensuring a stable financial system where robust capital adequacy is critical, Kuwaiti banks continued to demonstrate strong loss-absorption capacity as evident from their high capital adequacy levels. As of December 2018, the system-wide CAR stood at 18.3%, well above CBK's requirement of 13 %.

During 2018, system-wide capital adequacy ratio (CAR) slightly came down, from 18.4% in 2017 to 18.3% in 2018 (Figure 3.12). The marginal decline was driven by relatively faster growth in banks' RWAs (6.3%) compared to the growth in total regulatory capital (5.5%). The increase in RWAs, however, was primarily driven by increased exposure to borrowers with relatively higher credit quality (i.e. lower risk weights). Moreover, the complete de-recognition of real estate as a credit risk mitigant partly contributed to the marginal decrease in CAR<sup>22</sup>.

A closer look at the movement in regulatory capital during 2018 reveals that the increase in capital was mostly concentrated in higher quality tier 1 capital. Improved profitability, successful capital injections, and issuance of perpetual debt instruments that qualify for Tier 1 inclusion were the main contributors to capital (Figure 3.13).



<sup>22</sup> As per CBK's Capital Adequacy Ratio - Basel 3 Guidelines issued in 24/6/2014, real estate is to be derecognized as an eligible collateral. A transitional period ending in 2018 is given to allow banks a gradual application on a straight-line basis (10% per year for 5 years).

Other indicators of capital adequacy also point towards similar trends, with a few of the key indicators posting a slight drop in 2018 (Table 3.1). The breakdown of total capital reveals that banks' strong capital adequacy level is largely driven by higher quality Common Equity Tier 1 capital (CET1). Specifically, 83.8% of banks capital was in the form of CET1, of which 45.3% was common shares and share premium (Figure 3.14). This underscores the strength of the banking system in weathering major stress scenarios, a fact attested by our stress test results as well.

*The gap between Islamic banks and conventional banks CAR have narrowed down significantly*

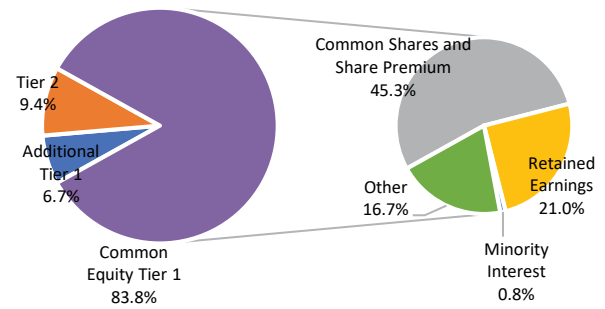
A comparison between the capital adequacy of Islamic and Conventional banks reveals that the gap between their capital ratios narrowed down significantly despite Islamic banks' 50% alpha factor and their ability to use leased assets as credit risk mitigants (primarily for Ijarah) (Figure 3.15). This was more due to a decline in the CAR of Islamic banks rather than an improvement in the CAR of conventional banks. However, in terms of the quality of capital, Islamic banks hold relatively higher quality capital instruments with tier 1 ratio equivalent to 16.2% compared to 15.4% for conventional banks. This broad categorization of Islamic and conventional banks does not exhibit the difference across individual banks in terms of their capital adequacy ratios.

Data for individual banks reveals that even the lowest CAR maintained by a single bank was 15.7%, well above the 13% minimum for 2018 (Figure 3.16). In fact, the minimum CAR maintained by any individual bank never dropped below 14% during the last eight years, except in 2014 when it slipped to 13.5%, primarily on account of Basel III implementation. Moreover, the range between the lowest and highest CAR of individual banks has significantly narrowed over the years, suggesting that robust capital adequacy is fairly distributed across banks and not merely a result of some outliers.

	Capital to Assets		Tier 1 to RWA	
	2017	2018	2017	2018
Conventional	13.1%	13.6%	15.3%	15.4%
Islamic	12.3%	12.2%	16.6%	16.2%
Industry	12.8%	12.9%	16.5%	16.5%

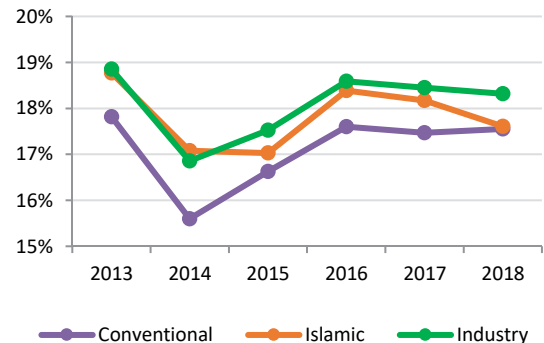
### 3.14

Breakdown of Capital



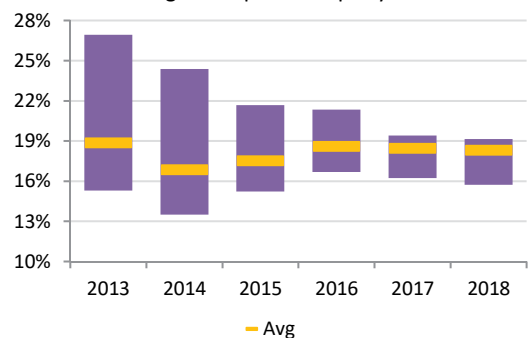
### 3.15

Capital Adequacy Ratio



### 3.16

Range of Capital Adequacy Ratio



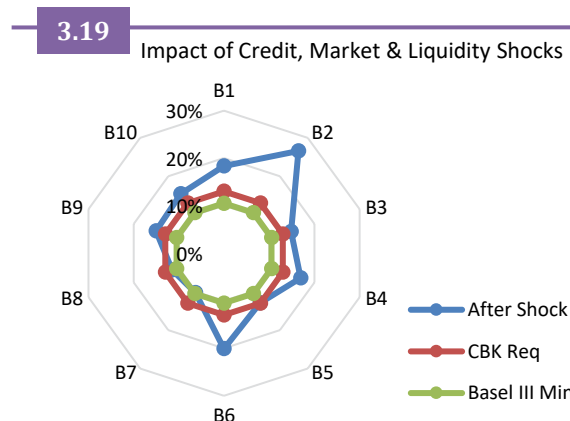
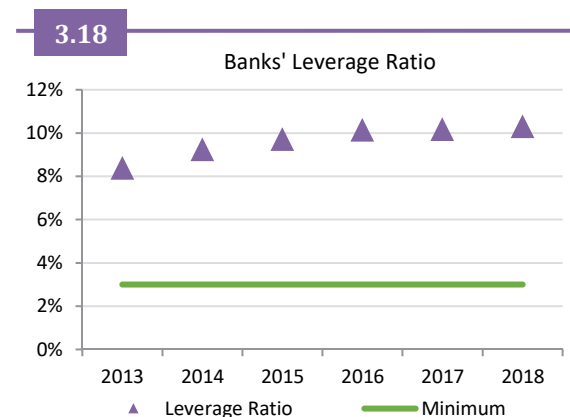
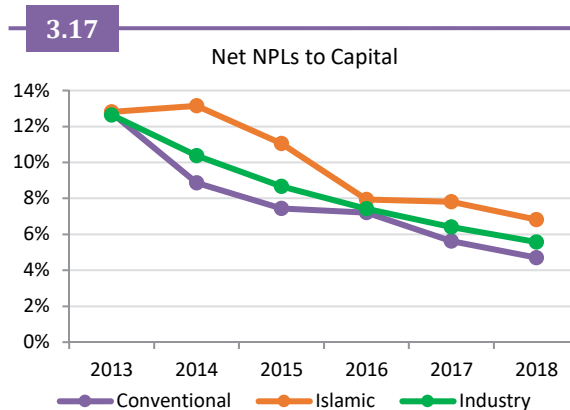
### Banks have higher capacity to withstand losses from NPLs

Banks' net NPLs to capital ratio, an indicator of the fraction of banks equity that can be wiped out due to loan losses, further dropped from 6.4% in 2017 to 5.6% by the end of 2018 (Figure 3.17). Both conventional and Islamic banks saw similar improvement in their net NPLs to capital ratio. This consistent improvement in net NPLs to capital ratio further illustrates CBK's focus on ensuring a stable financial system where asset quality and capital adequacy play a vital role.

Leverage ratio, a non-risk weighted measure that works as a backstop for CAR, is also evident of banks' robust loss absorption capacity. As of December 2018, the system-wide leverage ratio stood at 10.3%, well above Basel's minimum requirement of 3% (Figure 3.18). Over the past three years, banks were able to maintain relatively high leverage ratios by simultaneously growing both their balance sheet and their capital levels at healthy rates.

### Kuwaiti Banks are resilient to a wide range of shocks

CBK conducts in-house stress testing exercises on a quarterly basis to determine the level of resilience of individual banks as well as of the entire banking sector (for details, see Box 3.2 in the FSR of 2012). In line with past practice, quarterly stress tests were conducted using the data as of December 2018, applying various macro and micro level scenarios of different severities and for an extended period. Our results reveal that banks in general were able to maintain high capital adequacy even after the impact of severe and protracted shock to the system, calibrated under various scenarios (Figure 3.19). While the impact of a shock was understandably different on individual banks, the lowest after-shock CAR of an individual bank came down to nearly 10.2%, with a maximum aggregate capital shortfall of KD 414.5 million or 1.0% of GDP.



Given the much larger share of credit portfolios in the overall asset base, banks appeared more vulnerable to the deterioration in the quality of their loan/financing portfolio, particularly in specific sectors such as the real estate. However, comparison of CBK's stress test results over the years reveals that banks have strengthened their ability to withstand shocks even in these sectors by putting up additional capital, building more provisions and reducing their riskier exposures.

In the 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 a liquidity crunch showed that banks, in general, remained liquid even under conditions of stress, highlighting their sufficient liquidity levels. However, it is pertinent to point out that the resilience of the banking sector would come under pressure if the operating environment deteriorates or turns negative for an extended period.



# CHAPTER 4

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## DOMESTIC MARKETS

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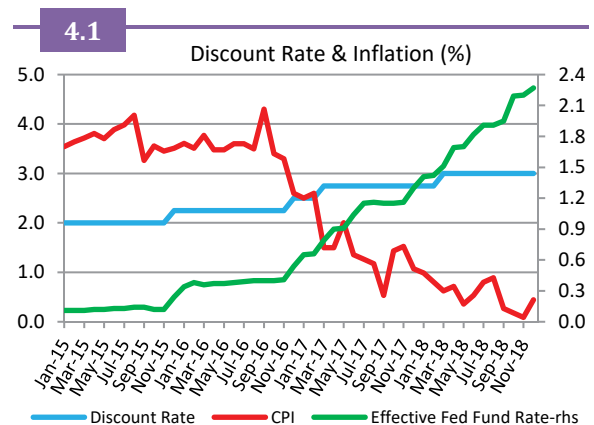


CBK hiked its policy rate for the fourth year in a row, pushing the discount rate to 3%, a level last seen in 2010. The year 2018 was marked by non-issuance of government debt after the expiration of public debt law since October 2017. As a result, outstanding balance of public debt dropped to KD 3.5 billion in 2018. Amid ample liquidity and non-issuance of government debt, CBK's liquidity absorption surged, primarily through one-week interventions and tawarruq. In the foreign exchange market, KD depreciated against USD and JPY by 0.5% and 2.6% in 2018. On the other hand, KD gained against GBP and Euro, by 5.0% and 3.6% respectively, in line with the performance of these currencies against the USD. In the local equity market, Boursa Kuwait posted healthy gains with the All-Share Index and the Premier Market Index closing the year on a positive note, gaining 5.2% and 9.9%, respectively. The Main Market Index covering small to mid-size companies closed in red, losing 1.9%. The year 2018 witnessed the implementation of the second phase of the market development project introducing new indices and newly segmented markets. Overall trading activity slowed down despite a surge in international flows related to the inclusion in the FTSE emerging market index. In terms of sector performance, Banks outperformed other sectors gaining 14.4% and accounting for 53% of overall trading value during 2018. Finally, the real estate market staged a strong recovery after three years of overall contraction, surging by 51.5% in terms of total sales values. All three segments posted solid gains, with sales in the investment segment in particular sharply picking up (by 142%). Despite banks' sizeable exposure to the real estate market, both in terms of loans and collaterals, banking sector appeared quite resilient to any potential correction in the real estate market.

### Money Market:

CBK raised discount rate by 25 bps during 2018, skipping Fed's other three rate hikes

For the fourth year in a row, CBK raised its discount rate by 25 bps, the key benchmark rate serving as a reference rate to calculate other interest rates charged on various lending facilities in KD<sup>23</sup> (Figure 4.1). The decision to increase discount rate from 2.75% to 3% was announced on 21<sup>st</sup> March, 2018, immediately after the Federal Reserve (Fed) raised its target federal funds rate by 25 bps. At 3%, CBK's discount rate reached the highest level since February 2010.



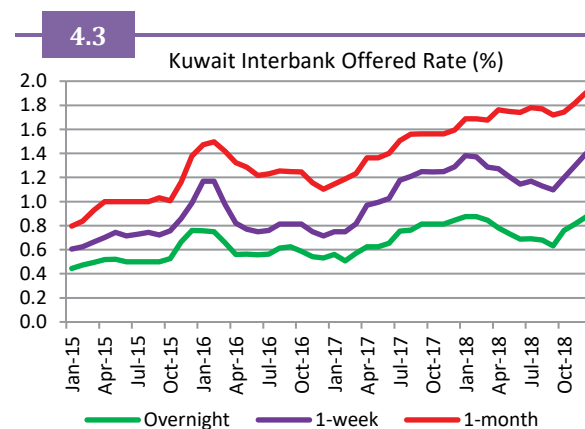
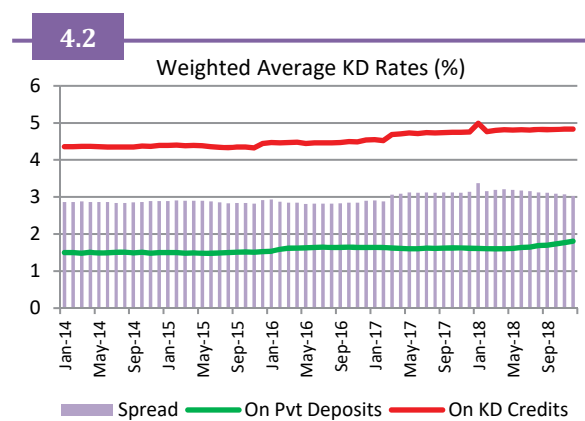
<sup>23</sup>For instance, banks can charge up to 3% above discount rate on consumer and housing loans, up to 2.5% above discount rate on commercial loans of less than one year and up to 4% above discount rate on commercial loans of above 1-year maturity.

The marginal increase in the policy rate helped CBK signal its commitment to maintain continued attractiveness of the Kuwaiti dinar as a store of domestic savings, particularly in comparison to the historically low levels of interest rates prevailing in many of the advanced countries. On balance, the 25 bps raise in discount rate is unlikely to have a perceptible impact on the credit off-take<sup>24</sup>; yet, it would potentially support banks' efforts in attracting more deposits.

Apart from the afore-mentioned rate increase in March, CBK skipped the three other rate hikes by the Fed in June, September and December 2018, in part due to significantly lower domestic inflation which closed the year averaging 0.6%, a 17-year low. Overall CPI was held down by declining food and housing prices, the two major components accounting for almost half of the CPI basket.

While CBK skipped three rate hikes in 2018 to support credit off-take, it used other monetary policy tools like repo rates to help banks pass on relatively higher return on KD deposits, thus ensuring continued attractiveness of KD for domestic savers. As a result, weighted average return on KD deposits inched up from 1.61% in 2017 to 1.81% by the end of 2018 (Figure 4.2). On the other hand, weighted average rate on KD based credit posted a much smaller increase, edging up to 4.83% by the end of 2018, compared to 4.75% a year earlier.

In the interbank market, overnight and weekly KD interbank offered rates started the year 2018 on a declining trend, though the one-month rate continued to rise amid expectations of policy rates hikes (Figure 4.3). Overnight and one-week rates were potentially influenced by abundant shorter-term liquidity, including from government deposits, prompting the central bank to mop up such liquidity through its one-week interventions and *tawarruq*.



<sup>24</sup> In fact, domestic credit posted healthier growth in 2018 (up 4.9%) compared to an increase of 3.9% observed in 2017.

### Non-issuance of government debt marked the year

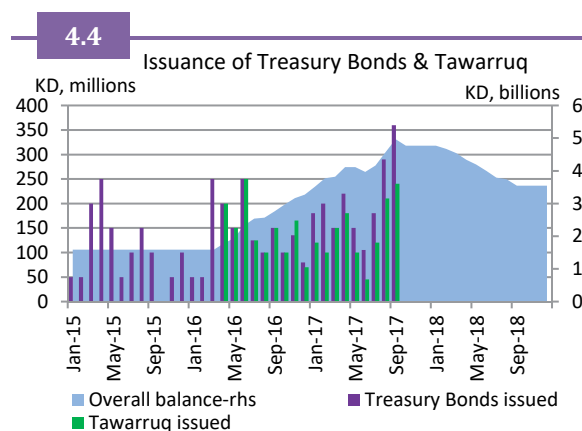
Given the expiration of public debt law since October 2017, 2018 witnessed no new issuance of the treasury bonds and *tawarruq*, resulting in overall balance to drop steadily (Figure 4.4). This was in sharp contrast to 2017 when treasury bonds worth KD 1,835 million were issued during the year, in addition to KD 1,265 million of *tawarruq*-based instruments. Lack of government debt issuance, both through conventional and *shariah*-compliant instruments, limited banks' options to invest in risk-free government paper, and potentially more so for the Islamic banks which typically face relatively greater difficulties in finding high quality liquid assets for investment.

Regarding the T-bills, 2018 was the sixth year in a row without any issuance; 3-month T-Bills were last issued in July 2012 while issuance of 6-months T-bills was suspended much earlier, back in 2009. Non-issuance of treasury bills can be explained by the greater usage of shorter maturity CBK bonds that provide CBK more flexibility and greater control both in terms of wider distribution of the bonds as well as in setting the target rates.

In 2018, Kuwait did not return to the international bond market either, after raising \$8 billion<sup>25</sup> from regional and international investors in March 2017. Depending upon issuance in the year ahead, Kuwait can attract sizeable funds inflows, given the imminent inclusion of Kuwait and other four (except Oman) GCC sovereigns in the JP Morgan Emerging Market Bond Index with an assigned weight of 11.3% in the index.

### ...resulting in sharp increase in liquidity absorption by CBK

Strong liquidity conditions in the banking sector, amid non-issuance of government debt, resulted in sharp increase (up 65%) in liquidity absorption by the CBK



<sup>25</sup> The issuance was greatly oversubscribed, with more than 778 orders totaling \$29 billion. Total issuance had two separate tranches; a \$3.5 billion, 5-year tranche sold at a yield of 2.887% or 75 basis points (bp) over US Treasuries, and another \$4.5 billion, 10-year tranche offering a yield of 3.617% or 100bp over US Treasuries.

in 2018, compared to 14.5% growth a year earlier (Figure 4.5). Specifically, conventional interventions surged by 42.8%, while those against *tawarruq*<sup>26</sup> also increased sharply, by over three times of the figures observed in 2017.

Moreover, data by various maturities reveal that almost the entire liquidity absorption exercise during the year was driven by one-week interventions, largely from conventional banks and accounting for 76.2% of total interventions. The use of one-month intervention and *tawarruq* remained limited and was primarily confined to the first quarter only. In principle, CBK's monetary operations continued to maintain sufficient systemic liquidity while smoothing out fluctuations caused by periodic variations in the volume of funds introduced or withdrawn from the banking system.

...as well as its bond issuance, after retreat of three years

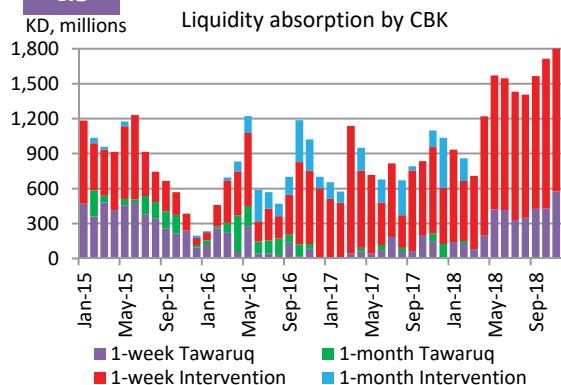
In part to compensate for the lack of government debt issuance, overall issuance of CBK bonds/*tawarruq*<sup>27</sup> increased by 16.8% in 2018, reversing the declining trend of last three years, to reach KD 9,140 million. The overall issuance was solely driven by 3-months tenors (up by 36.7%), while issuance of 6-months tenors posted a decline of 10.2%. By the end of 2018, the combined outstanding balance of CBK bonds/*tawarruq* was KD 2,930<sup>28</sup> million, somewhat equally divided between two tenors (Figure 4.6).

## Foreign Exchange Market:

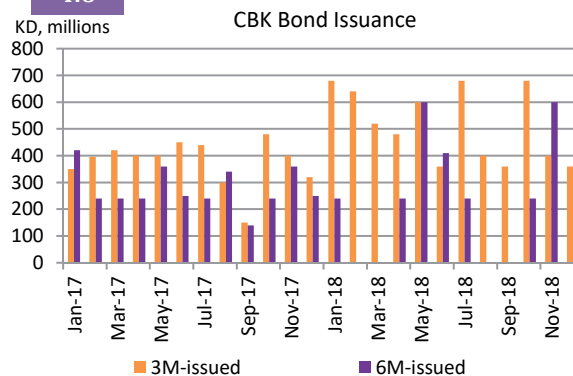
*Strengthening USD led to a further depreciation in KD*

KD/USD exchange rate experienced an appreciating trend for the first four months of 2018, though losing some ground during the second half of the year. Consequently, KD closed the year by slightly

### 4.5



### 4.6



<sup>26</sup>It 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*.

<sup>27</sup>Tawarruq based instruments were used in 2016. In the Figure 4.5, earlier data includes only CBK bonds.

<sup>28</sup> The total outstanding balance would reach KD 2,988 if we include KD 58 million of CBK *tawarruq* of over one year period as well.

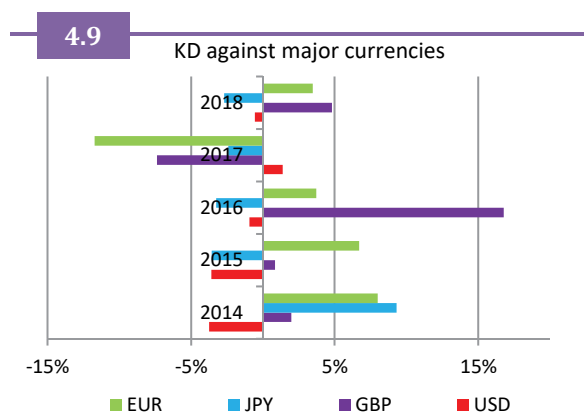
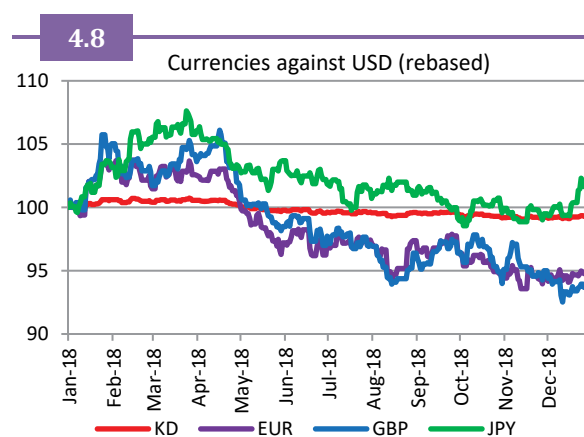
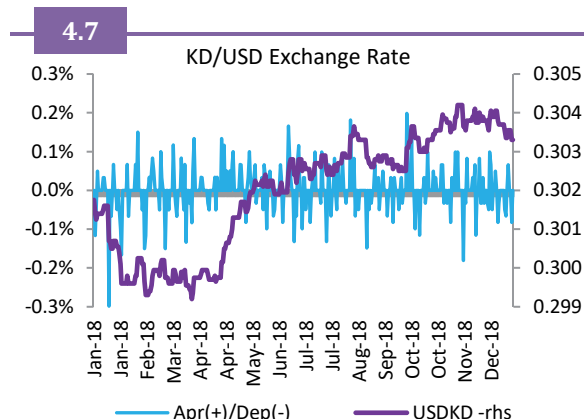
depreciating (by 0.5%) against USD (*Figure 4.7*). In general, fluctuations in the exchange rate were fewer and mostly within a narrow range of  $\pm 0.2\%$ .

Depreciation in KD against USD was still quite modest compared to some other major currencies and the KD/USD exchange rate remained broadly stable (*Figure 4.8*). Greenback, however, appreciated by 5.8% against GBP and 4.2% against Euro in 2018 despite appreciation of both currencies during the first quarter of the year. This was in sharp contrast to the significant depreciation of USD against some major currencies in 2017, marking its weakest annual performance in 14 years. On the other hand, JPY, closed the year 2.4% up against the USD, despite losing some ground in the last quarter.

Exchange rates were influenced by the change in relative prospects for growth and interest rates between US, UK and EU. In particular, GBP was weighed down by the lingering uncertainty surrounding Brexit. Euro area economies also were affected by weaker global demand (and thus lower exports), prohibitive US tariffs and political strife in France and Italy. In Japan, the central bank continued to pursue its ultra-loose monetary policy in its efforts to ward off deflationary threats, boost credit off-take and lift economic growth. JPY gained only 2.4% against the USD, though the rally in the first quarter of 2018 was much stronger.

In terms of KD's performance against key currencies, KD depreciated against USD by 0.5%, compared to its appreciation of 1.4% in 2017. KD also depreciated against JPY by 2.6%, reflecting similar gains by JPY against the USD (*Figure 4.9*). On the other hand, KD appreciated against GBP and Euro, by 5.0% and 3.6%, respectively, in line with the performance of these currencies against the USD.

In general, KD's peg against a basket of currencies has shielded Kuwait from imported inflation resulting from the volatility in such currencies and has ensured a more stable exchange rate where the net impact of diverging currencies has been somewhat neutralized.



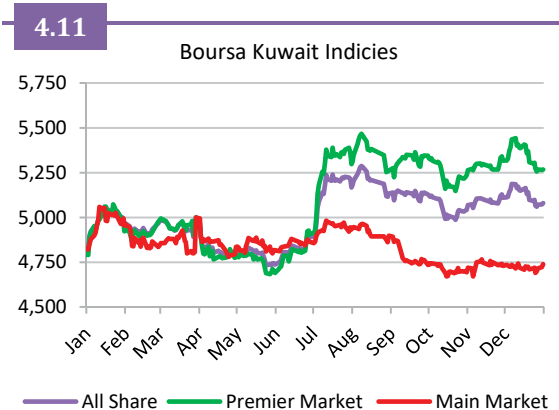
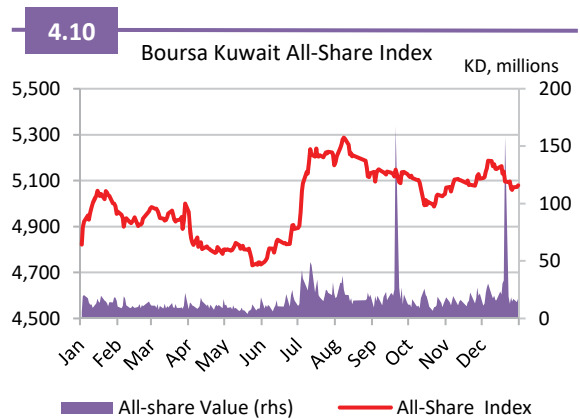
That helps explain why CBK has kept the KD pegged, since May 2007, to an undisclosed special weighted basket of currencies of countries that share significant financial and trade relations with the State of Kuwait.

## Boursa Kuwait<sup>29</sup>:

### *The local bourse posted healthy gains*

All-Share Index, Boursa Kuwait’s new market-cap weighted index covering companies listed in both the premier and main markets, closed the year on a positive note gaining 5.2%, slightly lower than last year’s 5.6%. The market was driven primarily by strong third quarter performance as foreign interest picked up prior to the effective date of Boursa Kuwait’s FTSE promotion. Premier Market Index, Boursa Kuwait’s flagship market-cap weighted index, covering stocks listed in the market’s premier segment closed the year gaining a strong 9.9%. The Premier Market segment includes blue-chips that are top ranked in terms of liquidity and market capitalization. Finally, The Main Market Index covering small to mid-size companies with liquidity below the premier market’s threshold, closed the year in red, losing 1.9% (Figure 4.10).

A closer analysis of the performance of the three indices reveals that all three were moving relatively in tandem during the first half of the year (Figure 4.11). The second half, however, witnessed a clear divergence in performance as the premier market scored healthy gains while the main market continued its lackluster performance. Gains in the premier market surged around June/July as investors started building up their holdings of stocks listed for inclusion in the FTSE’s index—almost all of which are in the premier market. Moreover, since the premier market accounts for more than two-thirds of the total market capitalization, it had a greater impact on the All-Share Index.



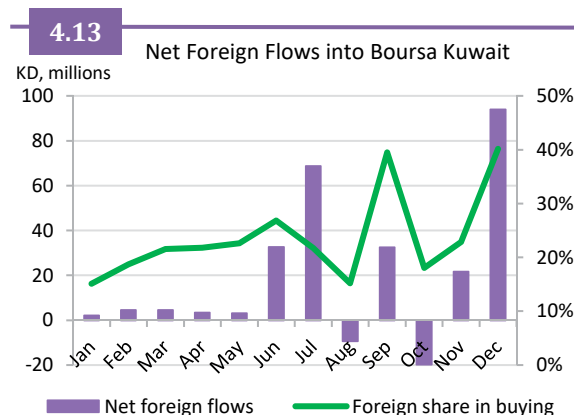
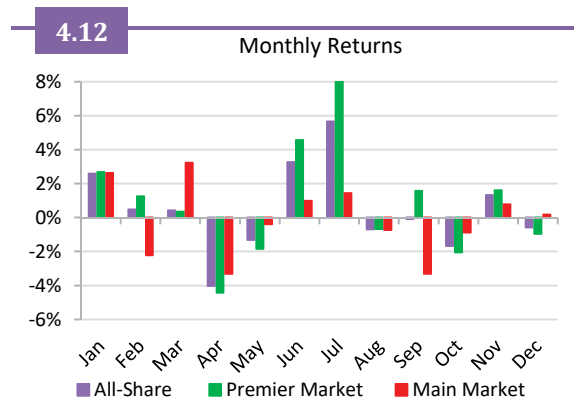
<sup>29</sup> Boursa Kuwait launched its new indices in April 2018. Backfilled data for the prior months were obtained from Thomson Reuters.

International interest in Bursa Kuwait continued its upward trend in 2018. Net foreign inflows totaled KD 237.6 million during 2018, scoring an all-time high. This represents a KD 144.9 million increase over last year's KD 92.7 million in net foreign flows. Along the same line, share of foreign buy-positions almost doubled during the year, averaging 25%—i.e., international investors were the buyers of one fourth of all stocks sold during 2018. This surge in foreign interest had a positive impact on overall market performance.

#### Monthly data highlights strong gains in mid-2018

Analysis of monthly data highlights that all three indices got off to a good start in January as expectations of healthy corporate earnings helped boost returns (Figure 4.12). The market slowed down during February and March with the All-Share Index scoring almost flat returns. All-Share Index took its first dive in April losing 4% of its value and wiping out its YTD gains. April also witnessed the implementation of the second phase of the market development plan introducing newly segmented markets. Although, the move was aimed at attracting investors and restoring liquidity, the initial market reaction during April was underwhelming. The market continued its lackluster performance in May before staging a slight recovery in June.

The market scored its best performance in July gaining 5.7% on the heels of strong performance in the premier market. Net international flows picked up after Bursa Kuwait's addition to the MSCI emerging market watch list late June (Figure 4.13). Additionally, the successful IPO of *Integrated Holding Company* -a crane operator- positively impacted the market. August returns, however, were partially influenced by the global sell-off of equities amid trade war concerns between the US and China. September and December witnessed historical trading levels due to inflows related to the FTSE inclusion. A spike in trading value is visible on the 20<sup>th</sup> of both months



(Figure 4.10). However, early profit taking resulted in softer fourth quarter returns.

#### Trading activity softened despite growing market capitalization

Given the healthy overall performance of the local bourse, market capitalization improved to 29.1 billion up from 27.5 billion in the year before (Table 4.1). Trading activity, however, witnessed a large decline, as evident from the noticeable drop in the total value, volume, and number of deals during 2018. This was in sharp contrast to the large gains reordered in the prior year.

In terms of number of listed companies, the increase witnessed in 2018 was mainly attributed to the new segmentation rather than IPOs. Deteriorating market liquidity amidst tougher governance requirements by the Capital Markets Authority (CMA) pushed cost of compliance higher, reducing the benefits of listing for smaller firms in particular. On the other hand, the resultant *elite* status of the premier market segment brought about positive spillovers, motivating the IPO of *Integrated Holding Company*—which saw an oversubscribed private placement, signaling high demand for quality stocks.

#### Boursa Kuwait showed modest performance relative to its GCC peers while outperforming other emerging markets

Analysis of the GCC markets highlights significant variation in annual returns during 2018 (Figure 4.14). The Qatari market staged a sharp recovery gaining 20.8% compared to last year's -18%. Markets of Abu Dhabi, Saudi Arabia, and Kuwait all finished in green gaining 11.7%, 8.3%, and 5.2%, respectively. Increasing oil prices (for most of 2018) amid improving growth prospects further supported returns. The Bahraini market ended the year almost flat gaining a mere 0.4%. On the other hand, both Oman and Dubai finished in red for the second year in a row, with Dubai taking the biggest hit, shedding around 25% during 2018.

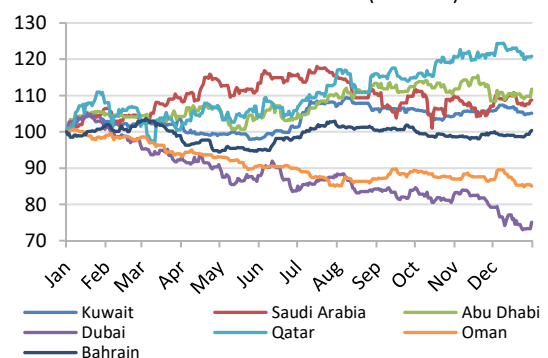
Table 4.1: Key Indicators of Boursa Kuwait

	2016	2017	2018*
All-Share Index	4,575.2	4,830.4	5079.6
Premier Market Price Index	4,541.2	4,793.5	5267.4
Main Market Price Index	4,762.5	4,827.9	4738.6
Market Cap (KD, bil)	26.2	27.5	29.1
Total Value (KD, bil)	2.9	5.7	4.1
Total Volume (bil)	30.3	50.2	21.4
No. of Deals (,000)	713	1,194	925
Companies Listed	185	157	163

\*excludes auction market

4.14

GCC Market Returns (rebased)

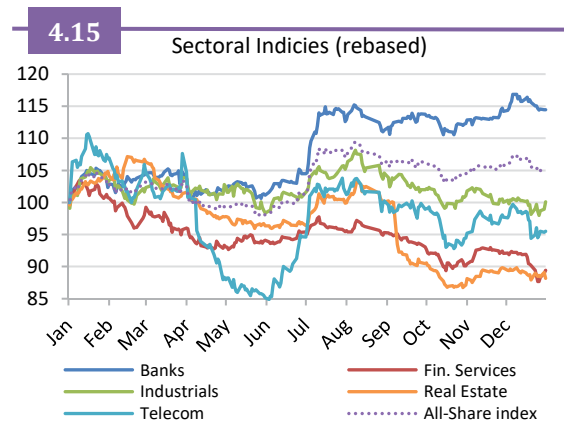


While Bursa Kuwait demonstrated below average performance relative to its GCC peers, it significantly outperformed other emerging markets. Emerging equities had a tough year in 2018 with the MSCI's Emerging Markets Index shedding 14.6%. Tighter financial conditions and softer growth in Asian economies weighed on index performance. Also trade war concerns between the US and China had its toll on emerging markets' returns.

### *Banks posted double-digit gains*

Market performance in terms of various sectors<sup>30</sup> highlights a large variation in returns, with one sector posting large annual gains and the others recording material losses (Figure 4.15). Specifically, *Banks* closed the year with double-digit returns, gaining 14.4% on the back of strong industry profits and growing foreign flows. *Industrials* were almost flat gaining a mere 0.1%. On the other hand, *Real Estate*, *Financial Services*, and *Telecommunications* closed the year in red losing 11.8%, 10.6%, and 4.5%, respectively. During 2018, Bursa Kuwait adopted FTSE Russell's industry classification benchmark—a comprehensive, well-recognized standard, for categorizing securities. Such a move facilitates market's transparency and adherence to international standards encouraging foreign portfolio investments.

Most sectors posted positive first quarter returns on the back of strong January performance, with *Telecommunications* gaining 7.6% followed by *Banks* at 4.7% and *Industrials* at 3.9%. *Financial services*, however, shed 4.2% of its value during the first quarter. The market took a dip in the second quarter when all sectors retreated, with April marking the year's worst performing month. Uncertainty about the implications of the newly segmented market had its toll on second quarter returns. The more volatile performance of *telecommunications* was influenced



<sup>30</sup> The sectoral analysis was limited to sectors that accounted for at least 5% of overall trading value in 2018. These were *Banks*, *Industrials*, *Telecommunications*, *Real Estate*, and *Financial Services*. Collectively they account for 93% of total trading value in 2018.

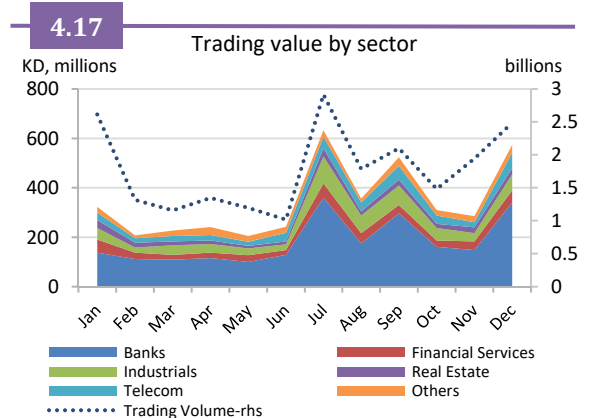
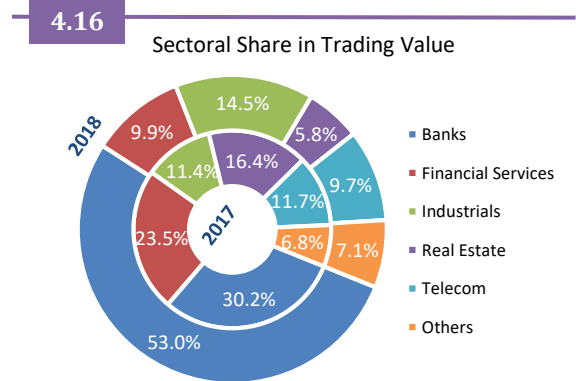
primarily by idiosyncrasies pertaining to *Zain* stock’s volatility and sector weightage.

The third quarter logged strong market performance with *Banks* gaining 8.9% supported by strong international flows. This was in sharp contrast to the 6.5% drop in *Real Estate*—a sector that had 39 of its 40 stocks listed in the main market and none listed in the FTSE Index. While *Banks* held ground in the fourth quarter, other sectors continued their lackluster performance.

*Banks accounted for more than half of the trading value...*

When viewed in terms of trading value, *Banks* accounted for 53% of total trading value in 2018 compared to 30.2% in the year before. This large increase is largely attributed to Banks' attracting the largest share of FTSE related inflows. Also, Kuwait loosened its rules related to foreign ownership in local banks lifting a previous cap of 49%. Foreigners can now own up to 100% of local banks, pending CBK’s approval for ownership exceeding 5%. The decision aims at facilitating foreign investments in the country’s growing banking sector. *Industrials* and *Telecommunications* accounted for 14.5% and 9.7% of trading value, respectively. *Financial Services* and *Real Estate* both saw a considerable retreat in their share of total trading value, with *Financial Services* dropping from 23.5% in 2017 to 9.9% and *Real Estate* dropping from 16.4% to 5.8% (Figure 4.16).

Trading value got off to a modest start in January before slowing down in the next five months. Activity picked up in July on the back of marked improvement in *Banks* and *Industrials*. *Industrials* were supported by the successful IPO of crane operator *Integrated Holding Company*, while strong foreign flows buoyed trading in *Banks*. September and December recorded strong trading value on the back of FTSE related flows and Boursa Kuwait’s upgrade to the S&P Dow Jones Emerging Market Index in December (Figure 4.17).



When viewed in terms of the coefficient of variation in monthly trading value, *Real Estate* posted the most stable trading value throughout the year followed by *Financial Services* and *Telecommunications*. On the other hand, *Banks* and *Industrials* exhibited significantly higher degree of volatility in terms of trading value influenced by volatile foreign flows and post-IPO trading in *Industrials*.

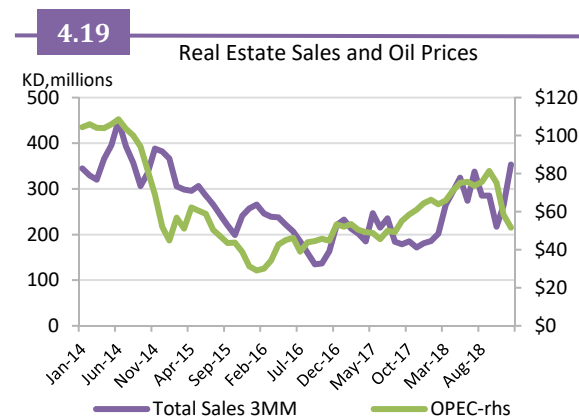
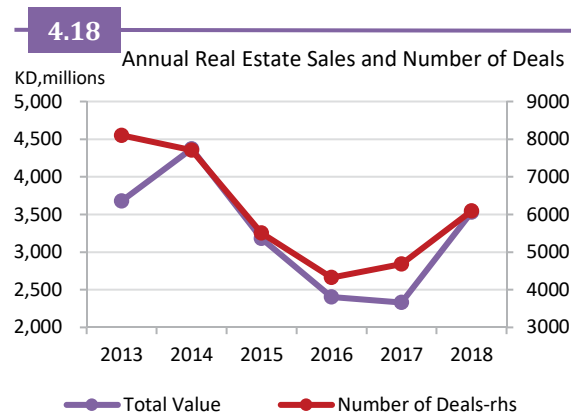
## Real Estate Market<sup>31</sup>:

### *Real Estate sales posted a sharp recovery in 2018*

The real estate market witnessed a strong rebound as annual sales grew for the first time since 2014. Moreover, when viewed in terms of the number of transactions executed, the market closed on a positive note for the second year in a row (*Figure 4.18*). The increased activity was accompanied by a slight increase in prices amid improved investor sentiment.

Sales in the real estate market have been on a declining trend since 2015, largely influenced by bearish market sentiments amid falling oil prices and increasing geopolitical risks (*Figure 4.19*). Expectations of a possible market correction further dampened demand. The last two years, however, witnessed a gradual recovery as fears of market correction gradually dissipated. Continued capital spending by the government despite fiscal deficits helped lift confidence. Moreover, the lack of local investment alternatives with similar risk-adjusted returns further supported the real estate market.

During 2018, real estate sales grew by a staggering 51.5% reaching KD 3,530 million compared to 2,330 million in 2017. The performance of the real estate market was visibly better when compared to the negative growth rates (-3%, -25%, and -27%) observed during years 2017, 2016, and 2015, respectively. The number of transactions also



<sup>31</sup> This section is based on data from Ministry of Justice and Kuwait Credit Bank. Unless otherwise specified, ‘contracts’ (deals registered with MOJ) data has been used, thus excluding any ‘agencies’ data.

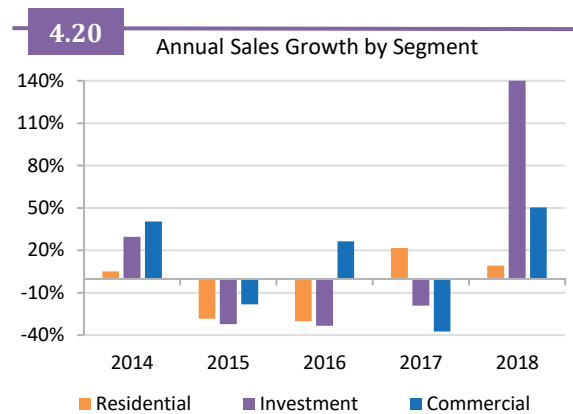
witnessed a significant increase of 30% reaching 6,093 deals, compared to 4,685 deals completed in 2017. The healthy improvement in the market was largely driven by strong activity in the *investments* segment.

*The investments segment recorded a 142% growth in sales during 2018...*

Analysis of the trends in sales within various segments reveals strong growth in the three main segments of the market (Figure 4.20). The *investments* segment, after three years of consecutive contractions, posted an impressive 142% increase in 2018. Improvements in *investments* were supported by the relatively stable rental yield in 2018 compared to the drop seen in the year before. Moreover, marginal growth in expatriates amid continued governmental capital spending helped sustain rental demand. Also, the non-residential electricity and water tariff increases enacted in 2017 could have had a lower impact than previously anticipated by investors.

The *residential* segment continued to grow, albeit at a slower pace. The 9% increase in *residential* sales in 2018 came after a 22% increase in 2017. *Residential* sales reached KD 1,260 million up from KD 1,154 million in 2017. While the residential segment has been on a clear upward trend over the past two years, it remains below the activity level of 2015. It is pertinent to point out that the demand for residential housing can be negatively impacted by increased interest rates or governmental housing distributions. On the other hand, a potential mortgage law, if passed by the parliament, could boost demand in this segment.

The *Commercial* segment, the most volatile of all three segments, staged a strong rebound in 2018. Specifically, sales grew by 50% compared to last year's 37% decline. Stronger non-oil GDP growth in addition to business-friendly governmental reforms supported the segment. Generally, sharp swings in this segment are common given the small number of

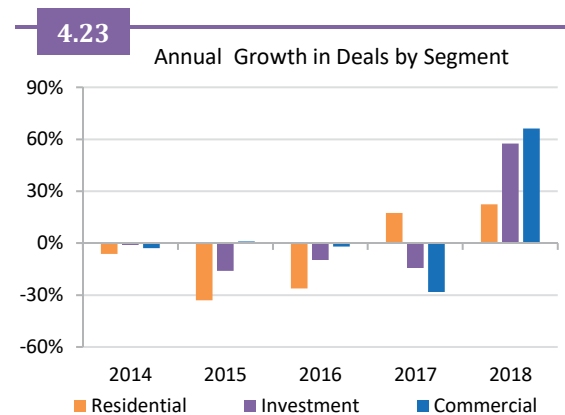
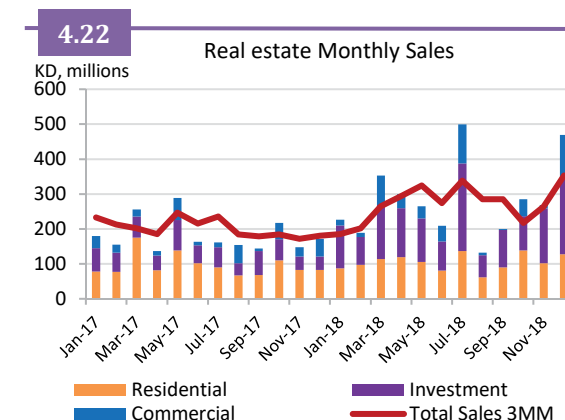
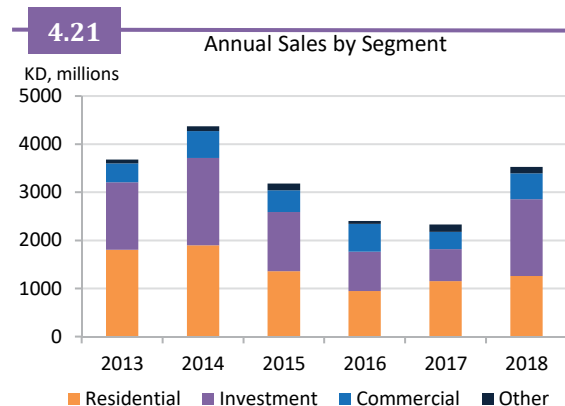


high-value transactions that can strongly influence overall growth trends.

Stronger growth in the *Investments* segment amid softer growth in the *Residential* segments resulted in a change in their contribution towards overall sales. *Residential* sales constituted 36% of total sales, down from 50% in 2017. On the other hand, *investment's* share of sales recorded a double-digit increase from 28% to 45%, the highest it has been in years. *Commercial* sales, however, maintained its 15% share of sales. The share of “*other*” segment, which includes sales of warehouse, technical, and Industrial real estate among others, dropped to 4% (*Figure 4.21*).

Analysis of monthly data shows that the real estate market showed significant improvement in sales as average monthly sales reached KD 294 million, up from KD 194 million in the previous year (*Figure 4.22*). The market got off to a good start in January on the heels of a resurging *Investments* segment—a segment that has been on a downtrend since mid-2014 reaching historically low levels towards the end of 2017. Activity picked up in March 2018, recording first-quarter gains of 47% compared to Q4-2017. The market gradually lost momentum during the second quarter as it coincided with the holy month of Ramadan. July recorded the best performance of the year driven by large gains in all three segments. The market then took a dip in August before gradually recovering in the following months. Real estate sales closed the year with a strong December pushing the three-month moving average to pre-2015 levels.

In terms of number of deals, total deals were up 30% in 2018 continuing its uptrend for the second year in a row. Unlike in 2017 when growth was driven by *residential* deals, 2018 witnessed double-digit growth in all three segments. *Residential* deals were up 22% reaching 4,108 deals (*Figure 4.23*). This was an improvement over 2017’s already strong 17% increase. *Investment* deals were up 57%, staging a strong rebound from the downtrend seen over the past four years. In fact, *investment* deals reached 1,754



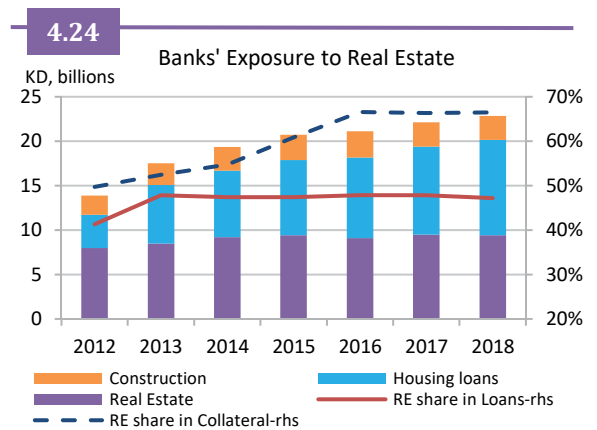
deals, the largest in more than eight years. On similar lines, the *commercial* segment scored a 66% increase reaching 118 deals. These record high numbers in both *Investments* and *Commercial* deals signal healthy growth prospects in the nonoil sector.

Although the real estate market staged a strong recovery during 2018, it is still pertinent to point out the risks the banking sector is likely to face if a major correction in the real estate market took place.

To start with, banks have significant credit exposure to the real estate market, either directly through financing the real estate and construction sector, or indirectly through consumer housing loans (previously known as instalment loans). As evident, this exposure has been steadily rising since 2012 reaching KD 22.8 billion in 2018 (Figure 4.24). The share of real estate loans, however, remained relatively stable over the past five years slightly shy of 48%. On a positive note, growth in real estate loans was driven by the relatively safer housing loans.

In addition to the lending exposures (both direct and indirect), real estate also constitutes the bulk of banks' collaterals. Over the years, use of real estate as collateral has noticeably increased, accounting for 66.5% of banks total collateral in 2018. Finally, banks also have exposure in terms of their real estate investments, which is particularly true in the case of Islamic banks. This collectively highlights banks' three-dimensional exposure to the real estate market, i.e., through lending, collaterals, and investments.

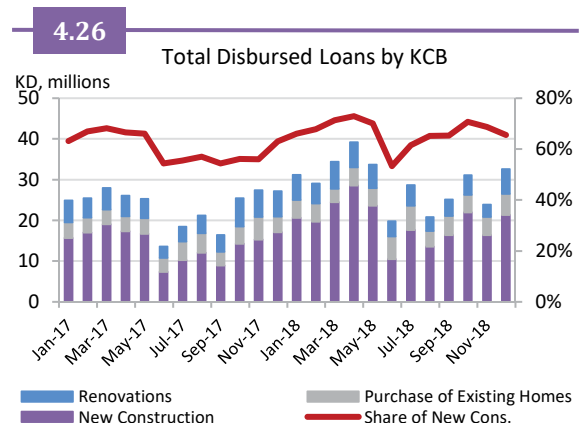
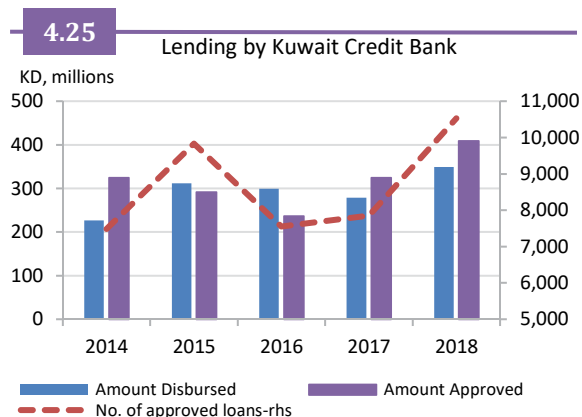
As discussed earlier, real estate market has staged a strong recovery in 2018. Yet, any serious deterioration in economic conditions may dent investors' confidence, with the potential of precipitating a plunge in the real estate market. Though quite unlikely, if such tail event materializes, the double whammy of rising loan infections and sinking collateral values can seriously test the resilience of the banking sector.



Kuwait Credit Bank (KCB), an independent banking institution wholly owned by the government and operating under the preview of the Minister of State for Housing Affairs, continued to provide housing loans to Kuwaiti nationals for purchase, construction, or renovation of residential real estate.

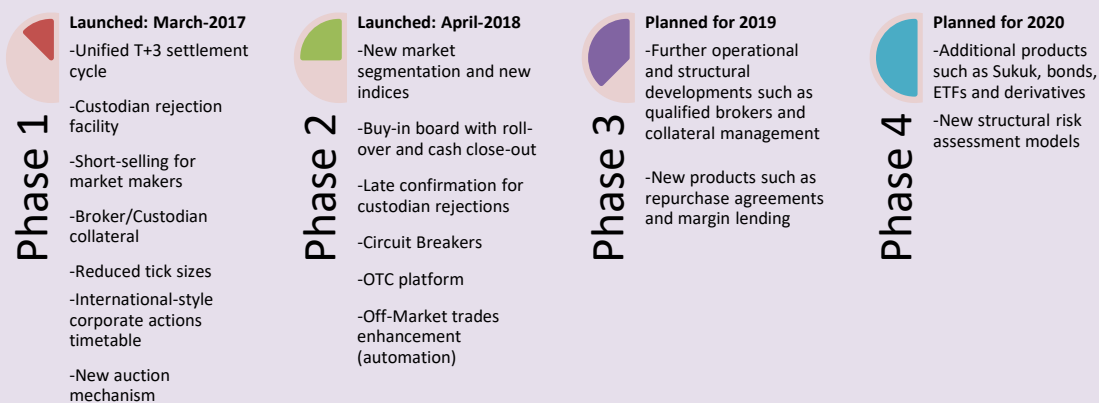
KCB loans posted strong growth during 2018, with both approved and disbursed loans reaching new highs. Specifically, total value of approved loans grew by 26% to KD 408.7 million, compared to KD 324.4 million in 2017 (*Figure 4.25*). The number of approved loans reached 10,528 loans in 2018, scoring a 34.1% increase. On similar lines, value of disbursed loans grew by 25.2%, from KD 279 million to KD 349.2 million during the same period. The evident growth in KCB's loan portfolio is in part due to the large governmental housing distributions seen in the last two years.

In terms of usage, around 67.2% of the disbursed amount was for new constructions, compared to 61.3% in 2017 (*Figure 4.26*). On the other hand, share of disbursed loans for renovation continued its downtrend, dropping from 21.2% to 17% during the same period. As the bulk of loan approvals and disbursements are still for new constructions, this would not only help add more homes to the national stock of housing, but should also boost construction activity. During 2018, share of loans used to purchase existing homes declined slightly from 17.4% to 15.7%.



Boursa Kuwait: Market Development Project<sup>32</sup>

Economists have long emphasized the importance of financial development in facilitating economic prosperity and growth<sup>33</sup>. Developed financial markets contribute to economic growth by efficiently identifying investment opportunities, reducing the cost of capital, increasing savings mobility, and improving risk-taking. In Kuwait, the domestic equity market is undergoing major developments through the 'Market Development Project' to bring it in-line with international standards. Primarily, the project targets improving the market's infrastructure and efficiency, thereby increasing international inflows and improving market liquidity. The project is being supervised by Kuwait's Capital Market Authority (CMA) and is jointly executed by Boursa Kuwait and the Kuwait Clearing Company (KCC). To ensure proper implementation, the planned developments have been broken down into four phases providing stakeholders an adequate transitional period.



This multi-phased project is considered the most significant structural reform since the inception of Kuwait's Stock Exchange<sup>34</sup>. The first phase introduced several infrastructural and operational improvements, namely the unified settlement cycle (T+3) and the resulting delivery versus payment (DVP). These improvements are in-line with international practices and provide adequate time for international investors to transfer their funds after executing a trade, overall smoothing their trade cycle. The second phase –launched in April 2018– introduced new market segments and indices along with an updated market rulebook. The rulebook is a comprehensive document listing the regulations governing the operational aspects of the stock exchange. The third and fourth phases are planned for implementation in 2019 and 2020, respectively<sup>35</sup>.

Phase 2, the focus of this box, introduces a bundle of essential market developments that are key to achieving the project's goals. Market segmentation, common to leading exchanges such as London Stock Exchange, Deutsche Börse and NASDAQ, is a major part of this phase. The new segments are defined based on average daily traded value

<sup>32</sup> Source of market data: Thomson Reuters & Boursa Kuwait.

<sup>33</sup> Levine, Ross. "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature*, June 1997, 35(2), pp. 688-726.

<sup>34</sup> Kuwait Stock Exchange in 1983. In 2016, the CMA granted Boursa Kuwait the official license to be the sole operator of Kuwait Stock Exchange.

<sup>35</sup> Launch dates may be updated by CMA/Boursa Kuwait.

(ADTV), market capitalization, price-to-par ratio, years of operations, and disclosures. Based on these criteria, stocks are segmented into three new markets: Premier Market (PM), Main Market (MM), and Auction Market. A brief overview of the three new markets is presented below<sup>36</sup>:

Premier Market	Main Market	Auction Market
<ul style="list-style-type: none"> <li>• <b>Key Continuing Obligations</b> <ul style="list-style-type: none"> <li>• Minimum ADTV - KD 109,000</li> <li>• Minimum Market Cap: KD 154,000,000</li> <li>• Price-to-par ratio shall not fall below 1 at the end of the year</li> <li>• Quarterly analyst conference calls</li> <li>• Bilingual and timely disclosures</li> </ul> </li> <li>• <b>Enlistment Requirements:</b> <ul style="list-style-type: none"> <li>• Total fair value of shares not owned by controlling shareholders: KD 45,000,000</li> <li>• Minimum number of shareholders: 450 each with a minimum ownership of KD10,000</li> <li>• Minimum of 7 years in operation</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>Key Continuing Obligations:</b> <ul style="list-style-type: none"> <li>• Minimum ADTV: KD 27,250</li> <li>• No minimum market capitalization</li> </ul> </li> <li>• <b>Enlistment Requirements:</b> <ul style="list-style-type: none"> <li>• Total fair value of shares not owned by controlling shareholders: KD 15,000,000</li> <li>• Minimum number of shareholders: 450 each with a minimum ownership of KD 5,000 or 225 each owning a minimum of KD 10,000</li> <li>• Minimum of 3 years in operation</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Includes low liquidity stocks that do not meet the MMs' threshold.</li> <li>• Not available for new enlistments.</li> <li>• Stocks are auctioned twice a day, each for 15 minutes.</li> <li>• Not included in any index</li> </ul>

Listed companies in the PM and the MM segments are required to comply with their respective continuing obligations to avoid demotion. An annual review is conducted to assess each company's status (promotion, demotion or maintenance). Companies due for demotion are given a one year grace period prior to demotion. Results of the annual review along with each segment's updated thresholds are then published. In general, this places pressure on companies to improve their liquidity levels in order to earn or sustain a desired segment. Furthermore, the new market segmentation distinguishes "blue-chips" and imposes higher governance and transparency requirements to maintain their PM status. It also encourages companies in the MM segment – enticed to reap the benefits of PM inclusion –to adopt better transparency and governance practices and attract liquidity.

As of April 1<sup>st</sup> 2018, the PM included 16 stocks whereas the MM included 147 stocks. Despite fewer stocks in the PM, it represented 63.0% of overall market capitalization, whereas the MM represented 36.9%. The Auction Market, however, included 13 stock representing only 0.2% of the market capitalization. Given the insignificance of the auctions market, the analysis will focus on the PM and MM segments.

It is noteworthy that 61 out of the 147 stocks (41%) in the MM are flagged for demotion, due to lack of adequate liquidity levels. This high ratio indicates that the segment is in a transitional phase. Some of the flagged companies have extremely low liquidity and often no trading activity, therefore negatively skewing the segment's (and market's) indicators. To smoothen this transitional phase, the CMA has extended the grace period for flagged companies in the MM. The following sections explore the new market indices, global impression, and liquidity trends coinciding with the recent domestic market developments.

<sup>36</sup> Thresholds values in the table are for 2018. The values are updated and announced during the annual review.

## New Indices

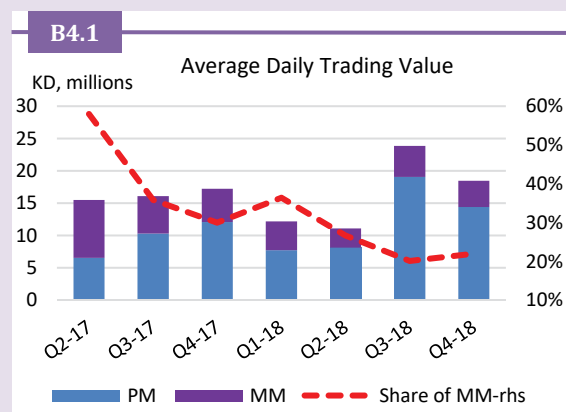
Boursa Kuwait launched new market-cap weighted indices that better reflect the performance of the new market segments. The *All-share Index* is the overall market index covering stocks listed in the PM and the MM. Additionally, the *PM Index* and the *MM Index* both correspond to their respective segments. Stocks in the Auction Market are not represented in any index. These market-cap weighted indices provide higher quality benchmarks for measuring market performance, and facilitate the introduction of new investment instruments. Moreover, Boursa Kuwait’s adoption of the new indices resolves the concern where small market-cap stocks disproportionately influenced the perceived market performance of the previously used Price Index. Lastly, indices for the 13 market sectors are also part of the new addition.

## Global Impression

One of the early signs of the project’s success was Boursa Kuwait’s inclusion in the Financial Times Stock Exchange (FTSE) Russell’s emerging market index, following the improvements launched in Phase 1. Soon thereafter, S&P Dow Jones announced Kuwait’s inclusion with an emerging market classification effective in 2019, and Morgan Stanley Capital International (MSCI) added Boursa Kuwait to its emerging market watch-list. This increased global recognition of Boursa Kuwait resulted in foreign inflows mainly targeting PM stocks, and improved the segment’s liquidity. The foreign inflows, primarily attributed to large institutional investors, help boost market credibility. Such investors are generally well informed and tend to invest in well-governed, transparent and highly liquid stocks, therefore increasing the demand for higher quality stocks.

## Liquidity: Trends Pre and Post-Segmentation

To gain insight on the impact of the newly introduced changes, analyzing liquidity conditions pre- and post-segmentation is essential. For the period prior to segmentation, the MM and PM were reconstructed by backfilling the data, thus allowing for better comparison<sup>37</sup>. Stocks in the now MM comprised around 58% of overall trading value as of Q2-2017. By the end of 2018, however, their share fell to merely 22% (*Figure B4.1*).

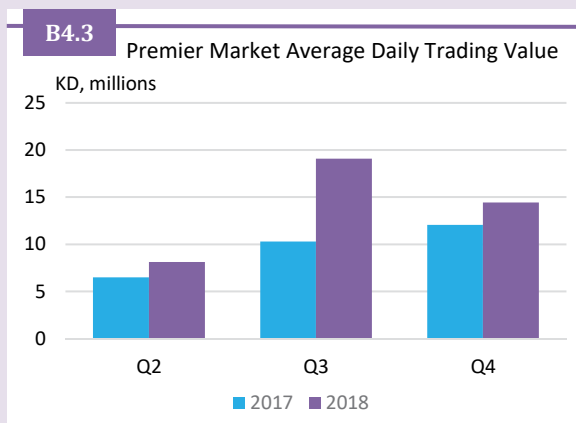
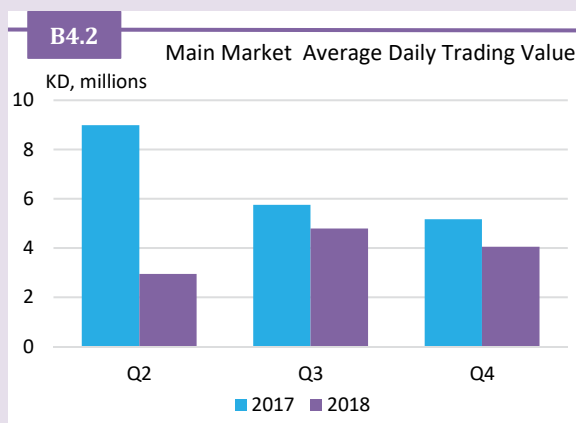


Average daily trading value posted a 20% increase during the three quarters post-segmentation compared to the three quarters before. This increase in ADTV was mainly driven by the PM gains vis-à-vis MM’s decline. Specifically, the PM posted a 38% increase,

<sup>37</sup> Segment composition as of April 1<sup>st</sup> 2018 is used throughout the analysis. Later changes in composition are not reflected to maintain consistency between the pre and post-segmentation periods.

while ADTV in the MM dropped by 22% ultimately leading to a change in their share in overall trading activity.

ADTV data, compared on a year-over-year basis, further highlights the divergence in liquidity trends between the two segments. During Q2-2018, ADTV in the MM witnessed a 67% decline compared to last year's corresponding quarter. In fact, liquidity levels in the MM continued to deteriorate, year-over-year, during Q3 and Q4-2018 (Figure B4.2). This drop in ADTV is in stark contrast to the gains recorded in the PM (Figure B4.3). These results are consistent with the view that increased visibility of premier stocks resulted in a liquidity transfer from the MM to the PM post-segmentation. Moreover, the post-segmentation period witnessed large FTSE related inflows, and since most stocks listed for inclusion were in the PM, the segment witnessed a consequent rise in turnover. Improved liquidity levels and increased exposure to institutional investors emphasized the exclusivity of the PM, creating stronger incentives for firms to enlist or upgrade to this segment. In fact, Boursa Kuwait witnessed its first IPO in more than 8 years soon after market segmentation. The new enlistment was part of the PM, further underscoring the above-mentioned incentives.

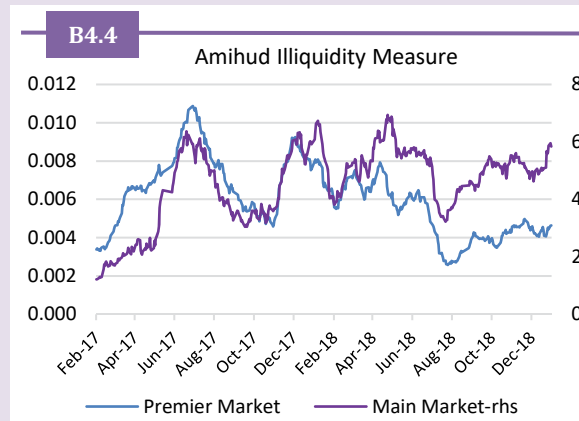


While trading value (turnover) is an acceptable proxy for overall market activity, it does not capture transaction costs nor the price impact of trades, both key facets of liquidity. To further analyze market liquidity, the price impact of trades is computed pre and post-segmentation. Amihud (2002)<sup>38</sup> developed a widely accepted illiquidity measure that captures the daily price response associated with one unit of trading value<sup>39</sup>. A higher Amihud measure (hereafter called *illiquidity*) corresponds to lower liquidity in the market, and vice versa.

<sup>38</sup> Yakov Amihud, 2002, Illiquidity and stock returns: cross-section and time-series effects, Journal of Financial Markets, Volume 5, Issue 1, Pages 31-56.

<sup>39</sup> The following equation is used to measure the Amihud (2002) measure:  $illiquidity = average\left(\frac{|r_t|}{trading\ value_t}\right)$ , where  $|r_t|$  is the absolute value of the stock return at day t and numerator is the trading value on day t. For each stock, the measure is averaged over monthly trading days, excluding days with zero trading. The illiquidity measure is then averaged over each segment's stocks to get the average illiquidity of the segment. Outliers (> 95<sup>th</sup> percentile) are replaced with the 95<sup>th</sup> percentile to avoid distorting the calculated averages. Figures scaled by 100,000.

The results show that MM's average *illiquidity* measure is substantially higher than that of the PM's, indicating a higher cost for demanding additional liquidity in the MM. Each segment is plotted on a separate scale due to the substantial difference in *illiquidity* levels (Figure B4.4). This is anticipated, as the segmentation criteria is largely based on liquidity thresholds.



Plotting each market's *illiquidity* measure pre and post-segmentation provides valuable insight. The PM recorded a noticeable decline in *illiquidity* during the post-segmentation period. The MM, however, was on an upward trend over the last two years, though, it did not record significant increases in *illiquidity* during the post-segmentation period. In essence, the difference between the MM and PM average *illiquidity* measures was generally increasing post-segmentation, implying a widening gap in liquidity performance between the two markets. In terms of price impact of trades, this supports the above-mentioned ADTV figures. However, given the short period since segmentation, it is early to develop a conclusive assessment of the impact on liquidity.

In conclusion, Phase 2 of the *market development project* is another step towards improving the infrastructure and efficiency of the domestic equity market. These developments have contributed towards enhancing international recognition and increasing foreign institutional investments. Additionally, the new segmentation motivates listed companies to improve their liquidity, transparency and governance standards to maintain or upgrade their segment. Moreover, the resultant increase in liquidity and exposure of premier stocks makes the PM more attractive for new investments and enlistments. Overall, changes implemented through the project are key towards attaining a well-performing, credible and efficient equity market that contributes towards the economy's prosperity and growth.





## CHAPTER 5

### PAYMENT AND SETTLEMENT SYSTEMS

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## 5 Payment and Settlement Systems

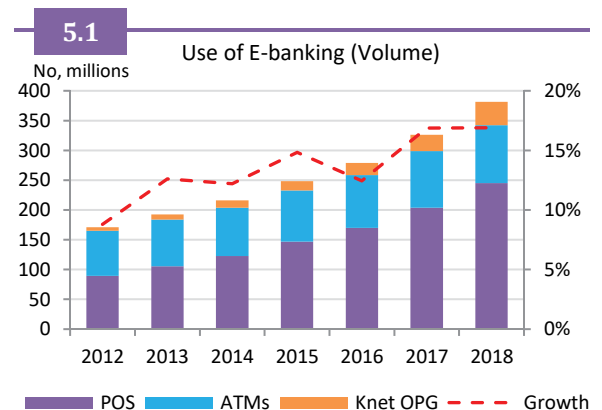
Both retail and large-scale payment systems continued to grow, exhibiting the increasing role of modern payment systems in facilitating a myriad of transactions on a daily basis. During 2018, the value of transactions made through e-banking<sup>40</sup> facilities comprising automated teller machines (ATMs), points of sales (PoS), and Knet's<sup>41</sup> online payment gateway (Knet OPG<sup>42</sup>) grew by 2.6%, 14.3%, and 58.1%, respectively. Growth trends in retail transactions underscore a healthy improvement in household consumption amid improving consumer confidence. During 2018, the value of transactions using PoS and Knet OPG collectively exceeded ATM cash withdrawals, reflecting the growing use of electronic methods of payment. Even though e-banking transactions by volume account for the majority of all transactions (98.5%), the bulk of the value still lies in paper-based transactions in the form of cheques. To facilitate the increasing use of e-banking, necessary infrastructure has expanded. The number of PoS and ATM machines grew by 16.6% and 13.1%, respectively reaching 59,547 and 2,378 machines by the end of 2018. The number of branches grew by around 1.2% to reach 425 total local branches, growth primarily driven by the increase in Islamic bank branches. Finally, KASSIP<sup>43</sup>, the real time gross settlement system in Kuwait, handled 3.0 million of interbank transactions worth KD 261.1 billion in 2018.

*The use of e-banking has been steadily rising, driven by PoS and Knet OPG*

With the growing use of information technology and increasingly secured online payment systems, transactions through e-banking have been steadily rising; this is evident from the increasing number of transactions being conducted through PoS, ATMs, and Knet OPG. These three e-banking facilities, operated by Knet, represent the retail payment system in Kuwait, essentially used for the bulk of mainly low-value payment transactions.

During 2018, the total number of e-banking transactions (volume) posted a 17% increase, similar to last year's growth. The growth was fueled by stronger activity in PoS and Knet OPG (Figure 5.1).

Specifically, POS transactions were up 20.4% reaching 245.2 million. Knet OPG transactions recorded even



<sup>40</sup> E-banking is a classification for the three key electronic banking facilities in Kuwait: ATMs, PoS, and Knet OPG.

<sup>41</sup> The Shared Electronic Banking Service Company (Knet) launched its service in 1994 in collaboration with local banks.

<sup>42</sup> Knet OPG is Knet's online payment gateway, which was introduced in 2004 allowing public and private institutions to collect funds for their products and services over the internet. It solely processes debit card payments.

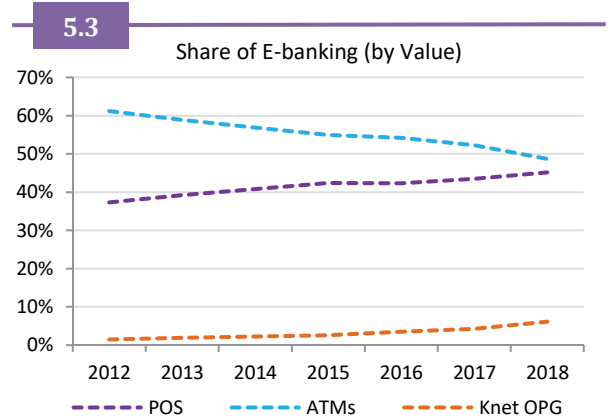
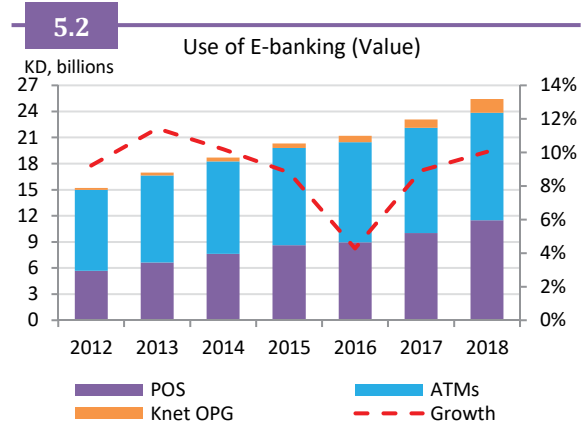
<sup>43</sup> Kuwait's Automated Settlement System for Inter-participant Payments (KASSIP) - launched in August 2004.

stronger growth at 42%, reaching 39.2 million transactions in 2018. Double-digit growth in PoS and Knet OPG is evident of the growing use of cashless payment methods in facilitating daily transactions. Moreover, ATM cash withdrawals experienced softer growth at 2.1% totaling 97 million transactions.

Positively, in line with the growth in number of transaction (volume), the overall *value* of e-banking transactions grew by 10.0% reaching KD 25.4 billion compared to a 8.9% increase in 2017 (Figure 5.2). Knet OPG continued to post impressive growth levels gaining 58.1% during the year reaching KD 1.56 billion. Similarly, PoS was up 14.3% totaling KD 11.5 billion. ATMs, the largest of all three, continued to grow albeit at a slower pace reaching KD 12.4 billion, up by 2.6% from 2017.

The pickup in retail transactions highlights a marked improvement in household consumption. A number of factors such as low inflation, improving employment trends for Kuwaiti nationals, and broader recovery in oil prices have all helped improve consumer sentiments with attendant recovery in the retail consumption and non-oil GDP. Consumption was also supported by the delay in VAT implementation.

Strong growth in PoS and Knet OPG amid slower growth in ATM resulted in a shift in their overall contribution towards overall e-banking usage. In particular, share of ATM in overall value of e-banking transactions continued to retreat reaching 48.7% down from 52.3% in 2017 (Figure 5.3). This was in sharp contrast to the uptrend in both PoS and Knet OPG. Specifically, share of PoS edged up to 45.2% compared to 43.5% in 2017 while share of Knet OPG reached 6.1% up from 4.3% in the previous year. Trends among different payment methods suggests growing usage of faster and more convenient electronic payments (PoS and Knet OPG) amidst softer usage of cash-based ATMs. Namely, cash-based payments no longer represent the dominant retail



payment method as cashless payments now account for 51.3% of overall transaction value.

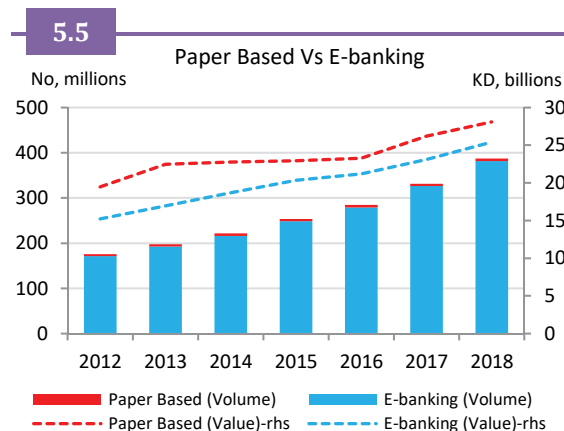
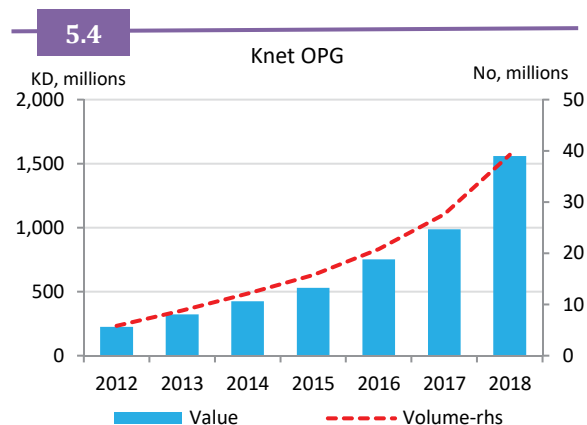
### *Knet's Online Payment Gateway recorded historic growth levels*

In Kuwait, Knet's online payment gateway represents the dominant platform for processing online retail transaction. Fueled by the surge in e-commerce businesses, Knet OPG witnessed significantly greater adoption over the past few years (*Figure 5.4*). Namely, overall transaction value posted a compounded annual growth rate of 43.4% over the past three years—much larger than the 9.9% seen in PoS. Transaction value reached KD 1.56 billion compared to KD 0.99 billion in 2017.

In terms of volume, 39 million transactions were cleared during 2018 up from 27.6 million in the year before. Greater Knet OPG usage is evident of the increasing adoption of electronic payment solutions. While e-payment solutions have clear efficiency gains, nevertheless, proper regulation and oversight is necessary to ensure their reliability, efficiency, and security. To this end, CBK introduced its instructions on the electronic payment of funds to ensure that the regulatory framework adapts to rapid advances in fintech applications (See *Box 5.1* for details).

### *Paper-based transactions remain significant in value, despite being much lower in volume*

When classifying transactions in terms of paper-based (i.e. cheques) versus e-banking transactions (ATMs, PoS, and Knet OPG), paper-based transactions remain significant in terms of value, despite being much smaller in volume (*Figure 5.5*). During 2018, paper-based transactions accounted for 52.5% of transaction value compared to 47.5% for e-banking transactions. However, in terms of volume, paper-based transactions account for only 1.5%. These patterns suggest that customers use e-banking more often for smaller sized transactions compared to paper-based transactions where the average size of transaction is much higher. The bulk of business related transactions are generally conducted through paper-based modes.

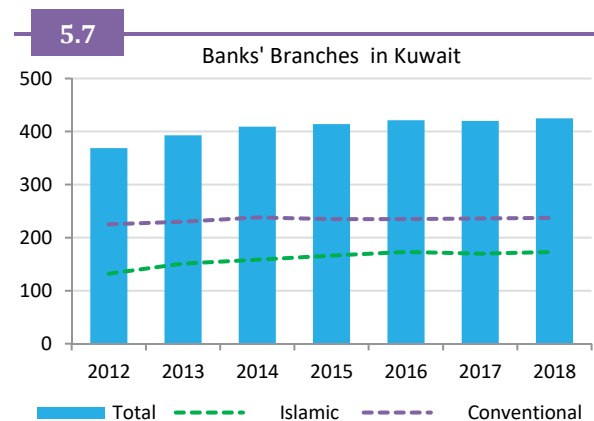
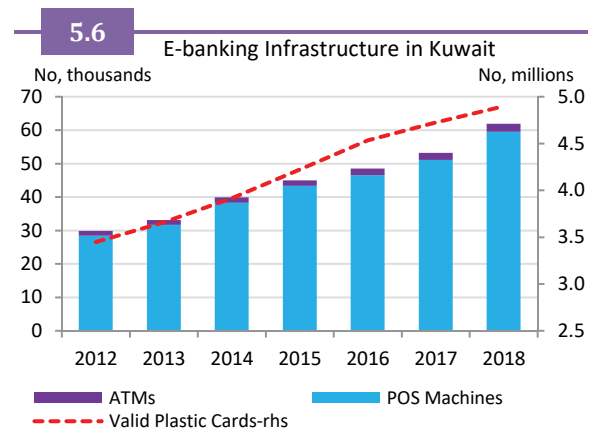


### E-banking infrastructure has continued to expand

To support the growing use of e-banking, payment system infrastructure is also expanding in Kuwait. During 2018, the number of PoS machines and ATMs witnessed a growth of 16.6% and 13.1% respectively, reaching 59,547 and 2,378 machines (Figure 5.6). Expansion in PoS network was particularly strong, as 8,475 new PoS machines were installed, a record high for the past ten years. The expansion of retail space and opening of large-scale shopping centers partly influenced this growth.

Similarly, expansion in the ATM network was particularly strong, as a 275 new ATM machines were installed, far greater than the 112 installed in 2017. Expansion in ATMs was not limited to the number of units installed, but also the services provided. Many banks started deploying smart ATMs offering services that were previously reserved for in-branch visits. Banks are continually developing their ATM facilities to remain competitive in a technology-driven market. Furthermore, valid plastic cards (debit and credit cards) posted 3.7% growth in 2018 with total plastic cards reaching 4.9 million, around 82.1% of which were debit cards.

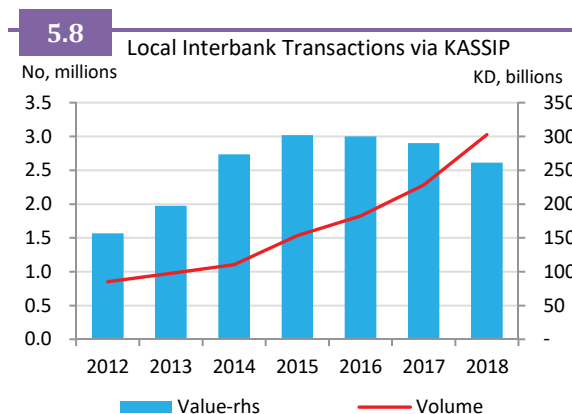
However, along with the increasing presence of e-banking, banks have also continued to add brick- and mortar branches to expand their outreach. During 2018, five new branches were added to the existing banking network in Kuwait, pushing the total number of branches to 425 (Figure 5.7)<sup>44</sup>. Specifically, Islamic banks opened three branches, conventional bank added one branch, and foreign banks added one branch. Consequently, the gap between Islamic and conventional branches narrowed further, though conventional branches (237) were still significantly greater than Islamic branches (173).



<sup>44</sup> This includes one branch of the specialized Industrial Bank of Kuwait as well as 14 branches of Foreign Banks in Kuwait. Head offices (23), representative office (3) and branches of Kuwaiti banks abroad (16) are excluded.

Since 2004, the CBK has put in place a real time gross settlement system called *Kuwait's Automated Settlement System for Inter-participant Payments* (KASSIP). The system processes large-value payments as well as a large number of low-value transactions. The CBK plays the role of a settlement agent, providing risk-free means of discharging large-value payments, as well as handling transfers between participating banks. As the name suggests, the system (KASSIP) provides for real time posting across accounts held at the CBK. Moreover, for each KASSIP participant, different liquidity support overdraft limits have been set by the CBK during the day (based on the collateral provided by the bank). These limits are available to participants between the start of day and interim cut-off only, whereas the amount of the limit at interim cut-off is re-established automatically at the start of the next business day.

In 2018, a total of 3.0 million transactions were handled via KASSIP, registering an increase of 32.6% during 2018 compared to a 25.2% increase in 2017 (*Figure 5.8*). The high volume of settlements in 2018 was driven mainly by low-value transactions. In terms of *value*, growth fell from last year, posting a drop of 10.0% compared to a drop of 3.3% and 0.6% in 2017 and 2016, respectively. In 2018, KASSIP settled KD 261.1 billion worth of transactions.





## Leveraging Fintech While Ensuring Financial Stability

The financial services industry is experiencing a “*Fintech revolution*”, where the application of technology is expected to have fundamental and potentially disrupting impacts. Developments in financial technology (i.e. Fintech) have led to numerous innovations such as mobile banking, electronic payments, crypto-assets, and blockchain among others. In Kuwait, electronic payment is one key area where Fintech innovations are especially visible. Knet’s online payment gateway (Knet OPG) recently recorded historically high growth levels fueled by strong growth in e-commerce businesses, and the demand for conveniently faster forms of payment. If current growth levels continue, online payment solutions is forecasted to become the dominant form of payment, exceeding PoS and ATM cash withdrawals (*Figure B5.1*)<sup>45</sup>. However, the current pace of Fintech innovations makes it nearly impossible to accurately forecast future trends.

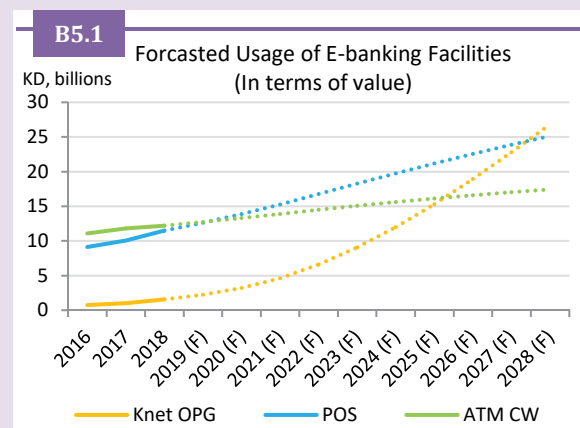
The rapid growth in electronic payments resulted in an emergence of new market players and ultimately a larger number of transactions handled outside the traditional banking system.

While new electronic payment platforms are efficient and convenient, they present new challenges relating to data privacy, cyber-security, and consumer protection. On their part, regulators need to be proactive and dynamic to ensure that the risks associated with e-payments are adequately managed and controlled without hindering innovation, ultimately maintaining financial stability.

To this end, and given its mandate to supervise and regulate the electronic payment of funds<sup>46</sup>, CBK issued *Instructions for Regulating the Electronic Payment of Funds*<sup>47</sup>. The new instructions are in line with international best practices, and add discipline to an emerging yet vaguely regulated market. In order to ensure that the newly introduced changes benefit all stakeholders and promotes sustainable growth, the CBK worked closely with relevant stakeholders to incorporate their views. Moreover, CBK also launched its Regulatory Sandbox Framework, which provides a safe testing environment for innovative Fintech solutions. Further details on both developments are discussed below.

### Instructions on the Electronic Payment of Funds

As per the instructions, electronic payment and settlement system providers can be classified as either an *Electronic Payment Infrastructure Provider (EPIP)* or an *Electronic Payment Agent (EPA)*. EPIPs



<sup>45</sup> Assuming that Knet OPG, points of sale (PoS), and ATM cash withdrawals will continue to grow at their current three-year compounded annual growth rate of 43%, 10%, and 4%, respectively. These growth rates are assumed to remain constant until 2022, after which growth gradually slows up to 2028.

<sup>46</sup> Law Number 20 for the year 2014 on Electronic Transactions gave the Central Bank of Kuwait the authority to supervise and regulate the electronic payment of funds.

<sup>47</sup> Issued in September 2018 (*Resolution No. 44/430*), see CBK’s website for a copy of the instructions.

are corporations registered with CBK to provide electronic payment and settlement services. Such companies provide the infrastructure necessary for processing electronic payments. Examples of potential *EPIPs* include banks, telecommunication companies, and Knet. On the other hand, *EPA*s are companies that use the infrastructure made available by *EPIPs*, such as servers, databases, and payment gateways, to run their electronic payment and settlement services. Most third-party e-payment applications would fall under this category. This broad classification (*EPIP* vs. *EPA*) helps reduce the legal burden and the cost of compliance for smaller firms. Both *EPIPs* and *EPA*s must register with CBK to legally operate in Kuwait, and a one-year grace period is given for existing firms to comply with the new instructions. Equally important is the central registry for *EPA*s and *EPIPs*, as it ensures effective communication, supervision, and risk assessment.

Fundamentally, both *EPIPs* and *EPA*s facilitate e-payments, though, registration requirements differ substantially between them. *EPIPs*, given their critical role, face more stringent requirements. They must be a shareholding company with a minimum paid-up capital of one million Kuwaiti Dinars. Also, *EPIPs* are responsible for ensuring that their agents (i.e. *EPA*s) comply with CBK's instruction and are properly registered with the CBK. *EPA*s, on the other hand, can be either a shareholding company or a limited liability company with a minimum paid-up capital of twenty thousand Kuwaiti Dinars. Both shareholding companies and limited liability companies are required by Kuwait's corporate law<sup>48</sup> to produce audited financial statements, ensuring better transparency and governance. The capital requirement is further reduced to ten thousand Kuwaiti Dinars for firms that join through CBK's Regulatory Sandbox (more on this below).

Innovations in electronic payments raise important issues regarding operational risks. Specifically, inadequate or failed internal processes/systems could result in monetary and reputational losses. Risks relating to data privacy, cyber-security, and consumer protection are also amplified. Moreover, if proper controls are not in place, e-payment platforms can be used for money laundry or other illegal activity. On account of this, the instructions place large emphases on ensuring that adequate measures and controls are in place to minimize and contain any operational failure. *EPIPs* and *EPA*s are required to adhere to the highest information security and confidentiality standards, and are prohibited from disclosing or allowing third-party access to client's data. Additionally, CBK's instructions require payment systems to conjointly comply with BIS's Principles for Financial Market Infrastructures (PFMI).

Furthermore, the instructions outline measures on daily dealing limits and risk coverage. *EPIPs* willing to carry out some of their work through *EPA*s, should set a cap on the agent's total daily dealing amount. *EPIPs* must also study the size of their exposure to each agent, and ensure that proper assurances (i.e. letters of guarantees or insurance policies) are in place to cover potential losses. Additionally, *EPIPs* must ensure that the policies and procedures of their agents are sufficient and comply with CBK's instruction. This includes ensuring full segregation between the funds of clients and agents, so that the client is isolated from any claims in the event of an agent's bankruptcy.

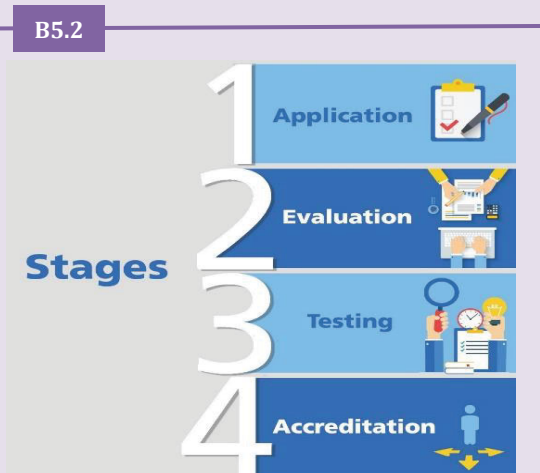
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<sup>48</sup> Law number (1) of 2016 on Promulgation of the Companies Law.

To ensure compliance, *EPIPs* and *EPAs* are subject to CBK's supervision and control. Moreover, CBK is entitled to site visits, full data access, and periodic reports. Additionally, CBK has the right to impose penalties and restrictions if violations are found. Penalties could eventually result in the suspension of the entire payment activity, given that the activity poses a risk to the public's interest.

### The Regulatory Sandbox Framework

Aiming to reduce barriers to innovation and further encourage Fintech entrepreneurship, CBK launched the Regulatory Sandbox Framework in November 2018. The framework provides a safe space to test innovative Fintech products and services before deployment into the local market. Participating firms benefit from fast-track approvals and lower capital requirements. Additionally, participants would also benefit from CBK's advice on the effectiveness and the extent of regulatory compliance of their products. As portrayed in *Figure B5.2*, the process starts by submitting an application to join the Regulatory Sandbox. The application is then carefully assessed and once accepted, it moves on to the testing stage.



To ensure compliance, the testing stage exercises operational and technical tests. Finally, an approval, conditional approval, or rejection decision is made at the end of the initial testing period. Since going live, CBK received several applications to join the framework, signifying the demand for such initiatives. Going forward, CBK expects that the sandbox initiative will encourage Fintech-related entrepreneurship and ultimately foster valuable solutions that will add value to Kuwait's banking sector and economy as a whole.

In conclusion, regulators must play a proactive role in facilitating innovation, while at the same time ensuring financial stability. The rapidly evolving Fintech space commands regulators to be vigilant and agile and when necessary introduce adequate regulations. CBK, through issuing its Instructions on the Electronic Payment of Funds while simultaneously launching its Regulatory Sandbox Framework, has aimed to strike a delicate balance between accommodating the FinTech boom and ensuring financial stability. As a result, CBK continues to foster inclusive sustainable prosperity.

تم بحمد الله

