Obstacles Confronting the Banking and Financial Sector in the State of Kuwait

The course followed by the banking and financial sector influences the national economy; as such, this sector must be equipped for a more effective role within the economy. The banking and financial sector can attract and increase national savings and direct them to the best investment outlets, so that they can effectively contribute to an optimum allocation of economic resources. This will, in turn, enhance the possibility of achieving stable and sustained economic growth. In this regard, it is also well-known that the increase in the efficiency of financial intermediation reflects positively on the growth rates and development patterns of the national economy.

The development of the banking and financial sector is an ongoing process driven by continuous developments in the economic environment within which this sector operates, as well as by the continuum of technological advancement, new financial and banking instruments and new operations occurring in the banking industry at an ever-accelerating pace. Therefore, the ability of any country's banking sector to develop, and its readiness to assimilate advances in the banking industry, play a preponderant role in its development.

In addressing the course followed by the banking and financial sector in the State of Kuwait, it will be useful to highlight the major obstacles it has faced to date, be they self-generated and as such directly emanating from the banking and financial sector, or of an across-the-board nature faced by the national economy in general and impacting on the performance of the banking and financial sector.

First : Self-Generated Obstacles Deriving from the Banking and Financial Sector

These obstacles are mainly exemplified by the following issues:

1. ***The Structure of the Banking and Financial Sector***

   A look at the number of banking and financial system units in Kuwait reveals an excess in these units, which is also termed as "over banking" in light of the capacity of the local banking and financial market. Most of these units are small in size, which limits their ability to compete. I have on many occasions advocated restructuring the banking and financial system units through mergers, for instance, in order to create strong banking and financial units capable of withstanding competition and providing more efficient banking and financial services.

   Perhaps the present trends witnessed on the global scene stand as proof of the dawning of a new era of banking conglomeration within the broader phenomenon of the emergence of major economic blocs. This is being exemplified by mergers and acquisitions among major worldwide banks in the pursuit of broader and more ambitious objectives.

2. ***The Lack of Efficient Managers and Professionals in Many Banking and Financial System Units***

Sound management is a critical element in the success of any economic institution. Management has an increased importance in banking and finance due to the fact that these operations are of a particularly technical and ever-developing nature.

However, the lack of cadres possessing the technical and practical qualifications required for key positions has led some banking and financial units over a period of time into unsound credit and investment policies lacking appropriate vision, and non-compliance with sound professional practices such as efficient follow-up of the uses of funds in credit and investments, thus leading to a high volume of bad debts and investments. This phenomenon became noticeable in the eighties, in the aftermath of the Souk Al-Manakh crisis, and reached such a magnitude that the State was forced to intervene through the Difficult Debt Settlement Program in 1986.

3. *The Failure to Develop Internal Policies and Systems with the Required Speed and Efficiency*

Banking and financial activity is, generally speaking, a dynamic undertaking. For banking and financial units to keep abreast of the ever-accelerating changes in the profession, they have to develop their policies and systems with regard to credits and investments, and financial adequacy and liquidity, as well as internal supervisory systems and risk assessment and management systems for all their activities.

However, the fact is that most of the banking and financial units are unaware of these requirements and have not taken the initiative to develop their internal financial systems due to the lack of sufficient technical cadres and their hesitation towards shouldering the cost of modernizing their systems. As a result, the banking and financial practices which were in effect in the seventies have persisted over time, despite the developments pervading the banking and financial industry at an ever-accelerating pace.

4. *The Prevailing Impression on the Part of the Banking System that the Government will Support the Banks*

By end of 1985, the State had committed itself to safeguard the financial position of Kuwaiti banks, including the protection of shareholders' rights. It had further announced that it would guarantee depositors' rights in these banks by virtue of the 1986 program for the settlement of difficult debts. This led to the erroneous conception by some banking and financial units that the State would be ready to rescue them in case of any difficulty whatsoever. The result was slackness on the part of most of these units in the development of appropriate risk measurement and assessment systems, as well as in adopting the required precautionary measures with regard to confronting such challenges on a sound basis. Although the State has withdrawn its guarantee of shareholders' rights, within the framework of the Decree Law No. 32 of 1992 and the Law No. 41 of 1993 and its amendments regarding the purchase by the State of bad debts and the means of their collection, it still nevertheless guarantees depositors' rights. In fact, such previous commitments by the State were exceptional and temporary, and were dictated by particular circumstances. They cannot therefore be expected to last forever. As a result, these units should seriously consider taking appropriate action to develop and modernize their method of work, setting up the needed systems for the assessment and management of risks they may face in the conduct of their activities, and laying down the necessary plans for confronting crises and emergency situations.

Second: General Obstacles

Following up on the course taken by the banking and financial sector in Kuwait requires addressing the obstacles which faced the national economy in general and impacted on the performance of the banking and financial system in particular. These obstacles can be summarized in the following:

1. The Dominance of the Public Sector in Overall Economic Activity

The basic characteristics of the local economic structure are the consequences of public economic policies adopted and enforced over more than three decades, which resulted in structural imbalances, most salient among which is the dominance of the public sector over all aspects of economic activity. Consequently, the private sector's activity has become closely linked to domestic public expenditures. Furthermore, in light of the limited investment opportunities available to the private sector, and its meager role in the domestic economy, a significant portion of its activity has been centered in speculative operations in financial and real estate assets in a quest for quick profits. This has reflected directly on the growth pattern of the banking and financial sector from the following perspectives:

First: Missed opportunities for the long-term financing of public projects, which have been funded from the State budget rather than by the private sector through the intermediation of the banking and financial sector units.

Second: Continuation of a relatively traditional pattern in private sector demand for financial and banking services, in light of its limited role in the domestic economy, which has not generated sufficient pressure or incentives to prompt the banking and financial sector to develop new funding and financial instruments.

It is therefore necessary to emphasize that it is impossible to achieve a developed banking and financial sector without a client base which requests developed services and whose demand for such services is sufficient to elicit a positive response from the banking and financial sector.

As a result, it has become necessary to redefine the State's role in the national economy within the context of a policy aimed at limiting public sector dominance over economic activity, thereby leading to a broader and more efficient private sector role. This will impact positively on the demand for banking and financial services. It has also become necessary to present businessmen with incentives in their continuous quest for new investment opportunities and innovative financial services in line with the ever-accelerating pace of world financial market developments.

2. ***The Al-Manakh Market Crisis***

The Al-Manakh crisis occurred as a result of the overextension of credit by banking and financial units to fund speculation in shares of companies, which - in most cases - were fictitious. These credits were extended without proper prior assessment and without compliance with banking rules applied in this regard. This generated the banking and financial system's difficult debt problem and significantly affected the financial position of the banking and financial system units, thereby leading to the necessity for State intervention with remedial legislation, exemplified by the Difficult Debt Settlement Program.

3. The Brutal Iraqi Occupation of the State of Kuwait

The Kuwaiti economy suffered major losses and damage as a result of the brutal Iraqi invasion. These losses encompassed public and private institutions as well as citizens. The banking and financial sector was particularly affected, and it proved difficult to remedy its conditions within the framework of the existing rules; thus, exceptional and innovative remedial measures became necessary.

4. The Safeguards Against Foreign Competition Provided by Local Banking Legislation

Protection provided against foreign competition by local banking legislation reduced the incentives for local banking units to provide advanced services and develop human resources and administrative and technical methods in line with the latest global advancements.

Furthermore, current legislation has not facilitated the participation of foreign investment, the broadening of the scope of the Kuwaiti economy, and the upgrading of the efficiency of its activities. These regulations are, for example, those concerning the income tax and the maximum allowed level of foreign participation in Kuwaiti companies' equity. All this has left the Kuwaiti economy almost closed, with transactions limited to dealing with assets and demand for services, including those of banking and finance.

It can be said with all fairness and objectivity that today the banking and financial sector in the State of Kuwait has succeeded to a certain extent, through its continual efforts over the past period, in establishing sound bases and principles which have evolved considerably from what they used to be. This is reflected in improved bank performance, as local banks came to realize profits in 1996 and 1997 whose aggregate value reached KD 163.7 million and

KD 189.4 million respectively, i.e. much higher than the profits of KD 86.1 million achieved in 1989, before the brutal Iraqi invasion.

This development in banking activity can be ascribed to the increase in operational profits, especially those realized from the net revenues derived from interest, and the continual increase in fees and charges, partly ascribable of banks offering broader and more developed services.

On the other hand, local bank liquidity improved significantly, as these banks overcame the problems they faced in performing their functions in the aftermath of the liberation in 1991. And, despite the fact that defining the liquidity policy is a task which each bank has to shoulder while observing the relevant supervisory rules and regulations, the liquidity system established lately by the CBK, and which is based on a maturity ladder, has allowed the allocation of fund inflows to offset outflows through a defined period of time, usually starting with assets and liabilities of immediate maturity. This direction is in line with global developments in banking supervision, which are in favor of the maturity ladder approach because of the many positive results it generates, especially in terms of providing the supervisory authority with a more accurate depiction of the liquidity situation of banking units.

With regard to the capital adequacy ratio of local banks, a regulation was implemented at end of 1992 setting at 8% the minimum obligatory capital adequacy ratio to be observed by local banks, according to the Basle Committee recommendations in this regard. This ratio was further increased to 12% as of end of 1997. Data provided by local banks show that they far exceeded the minimum required capital adequacy standard, as their average aggregate capital adequacy ratio had reached 22.4% by end of December 1997.

In light of the prevailing situation, it can be said that the steps taken to remedy the condition of the Kuwaiti banking system have resulted in noticeably upgrading the performance of local banks.

Third: Future Prospects

After addressing the obstacles faced by the banking and financial sector, the question that remains is: what are the future prospects with regard to correcting these obstacles?

In our opinion, the challenges of globalization and financial market liberalization translate into allowing an unencumbered dominance over the world market by major banking and financial conglomerates, which can muster tremendous capabilities in this regard. This will reduce the growth and development opportunities for smaller entities in these markets - even at the regional and local levels - especially as the regional and local market penetration by these conglomerates does not necessarily require their physical presence in light of the ever-evolving revolution in modern communications. Therefore, the Kuwaiti banking and financial units have no option in confronting these challenges but to enhance what they have already achieved in terms of rationalizing their positions and strengthening their capital structures, in addition to granting serious and prompt consideration to the merger option as a means of building strong banking entities capable of withstanding competition through providing advanced banking and financial services.

There are other future challenges, resulting from technological advances in the field of banking and finance. The continuous developments on the international banking scene reflect the diversification, increase and evolution in the requirements of bank customers. In addition to the basic functions and activities of banks, the technological upswing signified in the extensive reliance on computer facilities has led to new banking services which facilitate the customers' management of their bank accounts and their dealings with world financial markets.

For our banks to keep abreast of the continuing changes in the banking industry, like their counterparts in other countries, they have to continue investing in the development of their technological capabilities, so as to be able to meet the ever-increasing needs of their clients and achieve efficiency in their operations at the lowest possible cost and effort.

The uninterrupted advance in money and financial market instruments traded in the world markets also represent challenges for Kuwait's banking and financial units. Thus further efforts must be deployed to broaden and develop the money and financial markets in the State of Kuwait, such as by innovating KD-denominated debt instruments negotiable in the secondary market. Such efforts will help deepen and broaden the local financial markets, to the benefit of the overall economic activity, and will provide a significant opportunity for monetary policy to enhance its effectiveness and achieve its objectives.

Another future challenge concerns the development of national cadres in the banking and financial system units. Owing to its particular nature and capabilities, this sector is likely to assume a position of leadership among the other sectors in the period ahead, within the context of economic reform efforts and long-term development strategy. This sector has therefore to prepare itself to provide a larger contribution with regard to accommodating and developing the various national cadres in the banking and finance area.

These have been brief highlights in the development of the course followed by the banking and financial sector in the State of Kuwait during recent years, along with its significant obstacles. Our views concerning the challenges confronting the Kuwaiti banking and financial units and the opportunities available in the process of living up to these challenges have also been presented. Hopefully, the senior executives and managers of the banking and financial units in the State of Kuwait will have a sufficient perception of the magnitude of the upcoming challenges, coupled with a sincere desire to develop the capabilities of these units, that they will be able to cross the threshold into the twenty-first century and keep abreast of continuing world developments in banking and finance.