Crucial Concerns of the Central Bank of Kuwait about Treating the Conditions of the Banking and Financial Sector in Kuwait [1]

It is my pleasure to address you on a subject that currently attracts considerable interest from those concerned with treating the banking and financial sector in Kuwait. Also, I am pleased to be given this opportunity to shed light on the concerns of the Central Bank of Kuwait about this matter, and explain the background of such concerns and their expected outcome.

Knowing that the subject of today's address has been discussed by many others from various perspectives and points of view, and that there is a draft decree law prepared recently by the Cabinet of Ministers to deal with the banking and financial sector conditions which has been submitted to the National Council for study, my talk today will not be a repetition of what has already been said or a comment on that. Rather, I would like through my talk to objectively present before you the facts and clearly explain the background for Central Bank concerns and their underlying justifications.

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(1) Delivered on February 23, 1992, in Kuwait, on the occasion of the lecture organized by the Kuwait Alumni Society.

I hope to be able, through this talk and my answers to your subsequent queries, to contribute to clarifying a number of issues that may be unclear with regard to the measures taken to reform the conditions of the banking and financial sector, and to participate in the efforts aimed at going beyond the consequences of the treacherous Iraqi aggression against Kuwait on the national economy in general and the banking and financial sector in particular, in order to achieve what we all aspire to, for our beloved country to prosper and progress.

I will briefly mention the current conditions of the banking and financial sector in the country and the government approach toward it, as well as the resulting crucial concerns of the Central Bank of Kuwait about dealing with these conditions. The Central Bank translates these concerns into action through its views, policies and procedures. My talk will also include reference to the reflection of the debt problem solution on domestic economic conditions, in addition to future outlooks for reforming the course of the banking and financial sector through mergers.

First: Current Conditions of the Banking and Financial Sector, and the Government Approach to it

The banking and financial sector is the artery of economic activity and its most significant pillar due to the prominent role it plays in financing the development process and activating the economic momentum. This outstanding role explains the concern of the authorities all over the world to confront the problems of this sector and their endeavors to have a strong and stable banking and financial sector, which reflects the strength of the domestic economy in general.

It is well known that this sector has since the early eighties faced various events and obstacles, the most important of which were the securities market crisis, the Iraq-Iran war and the decline in oil revenues. These resulted in an economic recession which led to a decline in the performance of many debtors, a decrease in the value of assets and reduction in the revenues of domestic activities. This was accompanied by expansion in the volume of debts because of the continued calculation of interest accumulating over time, which resulted in the emergence of the difficult debt problem, as debtors defaulted on servicing and repayment of their debts.

The problem was aggravated by destruction and pillage during the detestable Iraqi invasion and occupation of Kuwait and the ensuing sharp fall in the value of most customer assets that were not destroyed or looted, especially real estate and stocks. In addition, during the occupation all economic activities were totally paralyzed and owners of economic activity stopped their various businesses for almost a year.

These events and obstacles together disrupted the vital role of the banking and financial sector in promoting economic activity in Kuwait and exposed it to many problems, which had they continued, would have had a negative influence on the confidence in this sector, locally and internationally.

According to the Difficult Credit Facilities Settlement Program which was passed by the Cabinet of Ministers in August 1986, the State is obliged to protect the rights of depositors in Kuwaiti banks, and maintain the equities of shareholders in local banks as declared at the end of 1985. Taking this into consideration, leaving this sector without government intervention might lead to the collapse of many of its units. This would result in a severe disturbance in transactions and adverse effects on various economic activities in the country as well as a run on banks by depositors to withdraw their deposits from banking and financial sector units. Consequently, if the State does not intervene to protect the units of this sector from shocks, the State will have to incur a large and immediate cash burden to meet its obligations toward depositors and shareholders' rights that these units will default to honour, over and above the adverse effects of the loss of confidence in this sector which would require a long period of time to restore.

Therefore, within the framework of government direction in Kuwait to tackle the problems of the main economic sectors in the country, and to set principles for dealing with such problems so as to enhance the performance and develop these sectors, the government has taken upon itself to adopt decisive measures to treat the difficulties of the banking and financial sector. These measures have focused on three major dimensions:

1- Restoring the units of the banking and financial sector to their normal condition, by relieving them from the difficult debts problem concerning Kuwaiti debtors.

2- Facilitating payment by debtor customers and their guarantors according to their individual ability to repay debts in view of their financial positions, while reducing, as much as possible, the burden to be borne by the government to this effect.

3- Focusing on restructuring the units of the banking and financial sector through mergers, as solving the difficult debts problem alone will not be enough in itself to reform the course of this important sector.

Second: Crucial Concerns of the Central Bank of Kuwait about Solving the Difficult Debts Problem

Within the framework of government directions for solving the problems of the banking and financial sector, the Central Bank, while trying to propose solutions to the difficult debts problem, has examined, analyzed and studied thoroughly various available alternatives. It has also looked into their applicability. Within this framework, it was not appropriate to solve the customers' debts problem through implementation of the rules and regulations of the Difficult Credit Facilities Settlement Program which was issued in 1986, and allowing Kuwaiti clients not currently subject to this program to join it, especially since the problem has been exacerbated. The funds needed for support according to this alternative have become too huge and cannot be accommodated without liquidating investments to raise the needed support funds, which would not be less than KD 10 billion, and depositing them with the banks without interest until these banks are able to build up the required provisions during a period of up to ten years at least.

The government, through committees set up for this purpose, has surveyed all the studies and views expressed in this regard by various concerned bodies and individuals. This effort resulted in the Cabinet of Ministers decision issued in its meeting on December 19, 1991 regarding the solution to the difficult debts problem. This decision aims to do the following:

1- Maintain and protect depositors’ rights, by creating appropriate conditions for the units of the banking and financial sector to return to their normal positions through cleaning their balance sheets of difficult debts.

2- Reinforce the confidence of customers and international financial institutions in the local banking and financial sector. This would increase the ability of the units of this sector to deal with these institutions to finance the rebuilding and reconstruction phase and stimulate the momentum of economic activity, thus reinforcing confidence in domestic economic conditions in general, and in turn reducing capital outflows and encouraging capital to settle in Kuwait.

3- Facilitate repayment by debtors and their guarantors according to their financial positions, in order to motivate them to conduct and develop their businesses and remove obstacles in their achieving this goal. This would reflect positively on the whole economic situation in the country.

4- Reduce as much as possible the burden to be borne by the government to solve the debts problem and apportion this burden over a suitable period of time.

This solution will be accompanied by the removal of government guarantees to the rights of shareholders' equities in Kuwaiti banks. Also the Central Bank will recover the support funds it has deposited on behalf of the government with the local banks, according to the timeframe it will determine. Thereby, these banking and financial sector units will undertake the consequences of the decisions they take in their varying activities, and will be responsible for any resulting risks, under the supervision and instructions of the Central Bank of Kuwait.

The proposed solution can be summed up as follows: the Central Bank of Kuwait, as the representative agency of the government, will purchase Kuwaiti customers' debts to local banks and financial companies as on 1/8/1990, plus interest due since 2/8/1990 to the date of purchase. The debts to the Kuwait Finance House that will be purchased are the balances of Kuwait debtors as of 1/8/1990. All these debts will be transferred to the Central Bank of Kuwait along with their personal and physical collateral.

The purchased debts will be scheduled along with the debtor clients and their guarantors according to their individual financial ability and cash flows as revealed through the financial positions submitted from their side. Based on these positions, the scheduling terms will be set, whether with regard to annual installments, schedule period or the rate of interest, which shall not exceed 7% per annum on the amount of debt.

In the framework of such scheduling, debtors and their guarantors will be granted a three-year grace period starting from the debt purchase. The scheduled debts will be limited to the purchased debts minus the interest for the period from 2/8/1990 to date of purchase, because such interest was calculated on customers' debts for a period during which the debtors did not carry out any business due to the circumstances of the occupation. The period of the schedule will not exceed twenty years at most, including the grace period, in order to enable the debtors to resume and develop their businesses during the grace period in various sectors, without inhibiting them from doing so.

The Central Bank of Kuwait will authorize the Kuwaiti banks to manage the purchased debts, including all procedures relating to scheduling and following up collection and recovery of these debts.

In the framework of such scheduling, the debtors and their guarantors will mortgage their assets which were either already mortgaged or free, against the purchased debts, provided that the value of these assets does not exceed the value of the debt. Debtors and guarantors will be obligated to provide additional mortgages should the value of mortgaged assets decline.

In the framework of this scheduling, trading in the mortgaged assets will be allowed through the local banks and investment companies, according to regulations and arrangements determined by the Central Bank, taking into consideration the balance between flexibility that permits the management and development of these assets in a way that achieves the interests of the national economy and security of the rights of the purchasing party.

The proposed solution facilitates debtors' repayment of their obligations toward the banking and financial sector; it is similarly their duty to deal in the same spirit with their Kuwaiti debtors, especially those who carry out their activities under the installment system. It is known that several companies that are indebted to units of the banking and financial sector deal in commercial credit with each other, and sell to a large number of citizens on an installment basis. As the debts of these companies to the banking and financial sector will be scheduled according to their financial ability, these companies should deal in the same spirit with their debtors and facilitate their debtors' repayment of their obligations. This aims at expanding the positive effect to include the largest number of Kuwaiti debtors and their guarantors.

The banking and financial sector will partly contribute to the cost of buying the debts, by utilizing the total increase in shareholders' equities declared after 1985, and the identified provisions, after excluding a portion of them to meet the risks of the unpurchased debts of non-Kuwaiti customers, both resident and non-resident, as well as the uncovered risks of the financial investments portfolio.

This sector also will contribute 50% of its general provisions, secret reserves and any other financial surpluses. Furthermore, the units of the banking and financial sector will be obligated to return the excluded provisions which will be left with them, once they are no longer needed, to the State by deducting these provisions from the volume of issued bonds.

Obviously, buying the debts does not mean writing off debts of debtors and their guarantors as one might think. This is absolutely untrue, as the party representing the government shall replace banking and financial sector units as creditor in order to reschedule debts of debtors and guarantors according to their financial abilities, and to avoid the situation where banking and financial sector units demand repayment in spite of their inability, leading to execution on their assets, and maybe to the bankruptcy of many of them, which would adversely affect various economic activities. On the other hand, this could lead to abnormal increases in the supply side, other things being equal, and consequently to deterioration in the price of assets, which have already declined due to the brutal Iraqi invasion of Kuwait, thus reflecting negatively on all citizens who own investment assets, and not only the debtors.

On the other hand, in accordance with the proposed solution, debtors whose debts do not exceed KD 250 million shall be allowed to enter into immediate settlements according to their financial positions and the principles and controls set by the Central Bank of Kuwait.

These immediate settlements should mitigate the administrative costs of managing, collecting and mortgaging the assets of the large numbers of debtors, in spite of the smallness of their total indebtedness. This issue will be given priority in the implementation of the solution because it includes a large segment of customers, while the relative importance of their indebtedness diminishes.

As regards the cost to and burden on public funds, I would like to consider some important points included in the decision of the Cabinet of Ministers regarding the debts solution, so that there is a clear picture of the Central Bank's prime concerns about the burden of the solution on public funds. These points are as follows:

1- The purchase will be limited to Kuwaiti customers' debts to units of the banking and financial system as on 1/8/1990. Therefore, the units of this sector shall have to deal with the indebtedness of the rest of their customers, whether non-Kuwaiti residents or non-residents, in accordance with the same principles followed previously as well as taking any future risks resulting from these debts, or related to new credit facilities or other investment transactions. This is what we mean by banks bearing the consequences of their own decisions.

2- The government will not incur an immediate cash burden as a result of buying the debts, because the Central Bank as representative of the government will issue long-term bonds for the purchase value of debts. These bonds will be paid in tranches, the maturities of which will be determined in conformity with the scheduling of debts with the debtors and their guarantors, and for a period not exceeding twenty years. These bonds will bear a variable interest rate to be determined annually by the Central Bank of Kuwait after considering the cost of funds at the Kuwaiti banks.

Issuing bonds against the purchase of debts means that the government will not have to liquidate some of the assets it owns at an inappropriate time, and therefore incur unjustified losses due to this liquidation. On the other hand, the cash flows accruing from debtor customers and their guarantors will be used as one of the sources to repay the maturing tranches of these bonds and their interest.

To ease the burden on the government and public funds as much as possible, each party subject to the solution, whether the units of the banking and financial sector or the debtors and their guarantors, will be obligated to surrender partially or wholly any compensation funds received for damages due to the brutal Iraqi invasion, or revenues from land acquisition by the State, to the purchasing party should they benefit from such resources. These compensations and revenues will be considered a repayment element for debtors and their guarantors, or the value of bonds issued will be reduced by them.

Therefore, it is obvious that the Central Bank of Kuwait's purchase - in its capacity as government representative – of Kuwaiti customers' debts from the units of the banking and financial sector will lead to a total solution to this problem, and save from collapse many units of the banking and financial sector, where the State is a major shareholder in some of its units. This in turn might result in the protection of depositors' rights, which constitutes the main objective of the State. These deposits - representing total deposits with the local banks, Kuwait Finance House, and investment companies had reached KD 7.4 billion at the end of October 1991. These deposits do not include government or Central Bank deposits with these banks.

Third: The Reflection of the Debt Problem Solution on the Domestic Economic Situation

Treating the current economic situation for the national economy to recover its health, and then leading it steadily toward the horizons of economic development, is the responsibility of many entities which are intensifying their efforts in more than one direction simultaneously. The reason for these intensive and various efforts is the brutal Iraqi invasion of Kuwait. This invasion aggravated the economic problems accumulated previously, such as the problems related to the composition of the population, manpower, the number of the population, and the structural imbalance resulting from the domestic economy's heavy dependence on the oil sector. Moreover, the brutal Iraqi invasion created new problems because of its deliberate destruction and devastation that damaged the productive capabilities of both oil and non-oil sectors alike.

The concerns of the Central Bank of Kuwait about solving the difficult debts problem have taken into account, besides treating the banking and financial sector situation, the positive impact of this solution on the performance of the national economy. Cleaning the balance sheets of this sector will allow banks to operate normally, and perform their role in providing bank credit to domestic activities that have a significant role in activating the economic momentum in the country. In addition, solving the difficult debts problem will allow debtors and their guarantors to carry on their activities that are inter-linked with the activities of other sectors, as well as enabling them to repay their debts.

Fourth: Future Outlooks to Supplement Reforming the Course of the Banking and Financial Sector through Mergers

Solving the difficult debts problem will not be, in itself, sufficient to reform the course of the banking and financial sector Therefore, the Central Bank of Kuwait believes that restructuring the units of this sector through mergers is important to create suitable conditions for producing a strong, stable and active banking and financial sector, and achieving many positive results that will conform with trends increasingly prevailing abroad. Mergers will prepare the banking and financial institutions for the conditions that will emerge after 1992 and which - without mergers - will be difficult to keep up with.

The Central Bank of Kuwait reiterates that those banking and financial units which do not prefer mergers as a means to achieve its objectives have no choice but to increase their capital base by increasing their capital to the level the Central Bank deems appropriate for securing the soundness of their financial positions, maintaining their solvency, liquidity and reasonable profitability, and enabling them to adhere to international standards and supervisory instructions.

To sum up, the complexity and coherence of the relationship between the units of the banking and financial sector and its customers, both depositors and debtors, means that any harm to one party will affect the other parties if the problems of this sector are left unresolved, thus compounding the problem day by day, and increasing the cost of the solution as it is delayed. Therefore, implementing the Kuwaiti government's plan for reforming the course of the banking and financial sector will have results not limited to this sector alone. Hopefully, this reform will have several reflections that will positively affect the activities of other economic sectors, whether commercial, real estate or other investment activities.