

The Problem of Difficult Bank Loans and Its Reflection on the Financial Sector and the Kuwaiti Economy ⁽¹⁾

First, I would like to thank my colleagues in the Faculty of Commerce for inviting me to lecture on the problem of difficult debts and its reflection on the financial sector and the Kuwaiti economy.

From my own daily experience I have learnt that everything in life is double-faced, good and bad. Being always optimistic, I have chosen the good face to set the tone of this lecture. However, it is important to note that my speech is not primarily intended to be a scientific lecture on a certain topic; rather it is an elaboration of the measures already adopted against an outstanding problem. Your inquiries and comments will be of great help to me and I will be satisfied with the reward of being initiative in this respect.

To start with, I would like to say that despite the precautionary measures that are usually taken by banks when extending credits to their clients, it is a normal phenomenon in banking to see certain clients fail to meet their obligations towards banks. Banks in all countries build up certain financial provisions to meet doubtful debts. Therefore, the problem of difficult bank debts is not expected to emerge in normal economic

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conditions, and if any problem does exist in such circumstances, it will be minor and controllable, affecting one or a limited number of banks. From this standpoint, talking about the problem of difficult bank debts will be centered on those debts that constitute a major portion of bank loan portfolios and assets as well, a fact that these debts have adverse effects on the banks' credit-worthiness and liquidity, which are too great to be ignored.

These problems, which are generally suffered by all banks, take place during severe economic cycles that might lead to an impressive economic depression, affecting either the whole economy or certain major sectors which play a leading role in economic activity.

Before demonstrating the effects of difficult debts on the financial sector and the Kuwaiti economy, attention must be drawn to the relationship between the financial sector and other economic sectors. The economy and the financial sector have mutual effects. Many examples can be taken from economic history, particularly the 1929 crisis which took place in the New York Stock Exchange, then spread out to all other economic sectors, not only in the United States but in most countries of the world. Between 1930 and 1932 five thousand banks failed in the U.S.A., causing about 9 million people to lose all or part of their holdings, and about 25% to 40% of the labor force to be unemployed. The earnings of an ordinary farmer dropped from U.S.\$ 1000 to 290 U.S.\$, agricultural land dispossessions were doubled as their landlords failed to redeem them. On the other hand, business profits bottomed out to zero, the average of failing business companies grew by 50%, consumption expenditure decreased considerably and savings from

income totally diminished. Generally speaking, this crisis had bad consequences on economic systems in many industrial countries. Examples of the crisis consequences show how far the financial and economic sectors are interrelated on the one hand, and how important it is to move quickly to contain the economic crises and stop their consequences from being diffused in the economy, on the other.

Causes of bad debt problem in Kuwait:

To recognise the effects of bad debt problem on the financial sector and the domestic economy it is necessary first to identify the causes of the problem itself. And whereas details of this problem are so far familiar to everybody in Kuwait, I would briefly point out the major factors of this problem within a context that would elaborate the nature of the relationships between the financial sector and other sectors.

In the early 1980's several changes led to the abnormal economic boom between 1979 and 1982. The tangible increase in the absolute figures of domestic public expenditure coincided with the increase in public revenues, when crude oil prices peaked in 1981. Further, in 1981 the world interest rates generally began to take a downward trend, when interest rates on the U.S. dollar fell by 22% during 1980 and went on falling until they reached 9% in 1982, which led to an increasing tendency for capital location at home. The increase in liquidity surplus with the banking system, coupled with an increase in the demand for money for speculation purposes, led dealing in the stocks of companies in the parallel market to take a feverish speculative trend that shifted quickly to the stocks of the Kuwaiti companies listed in the official market. This development led to a sharp increase in the market value of

financial assets, resulting in an increase in the value of real and other assets, particularly with the expansion in swap transactions which developed a big credit market apart from the organised market. It is evident that the non-diversification of financial assets in the economy, such as treasury bills and bonds and other instruments, will make investors concentrate on both the stock and real estate markets.

During the second half of 1982, a number of factors reacted to create conditions adverse to those which had dominated the Kuwaiti economy over the previous three years. One of the most important factors was the sharp decline in asset prices, particularly stocks and real estate as a result of the Securities Market crisis, an inevitable crisis that came in the wake of an abnormal stage when the growth rates deviated from their normal course, whether as a result of an impromptu development expansion or a wave of speculation pushing up prices to levels not reflecting real values. On the other hand, the ongoing Iran-Iraq war and other factors had a direct effect on this crisis. Within the context of talking about the sharp decline in asset prices, it is noteworthy to mention that the general share price index of Kuwaiti companies listed in the official market dropped from 554 at the end of March 1982 to 239 at the end of 1984 and to a lesser level at the beginning of 1985. This decline was sharper in the share price index of certain sectors. Real estate prices recorded a parallel decline that could be noticed through price index changes in all areas in Kuwait. If we take the average of the simple index as an indicator of these changes - despite the statistical limitations of this index - it is noticeable that the average price index of investment land (1. 1. 1979 =100), dropped from 206 during 1982 to 95 during 1985. Further, the average simple price index of commercial land dropped from 294 during 1982 to 137 during 1985.

The sharp decline in the values of financial and real assets in the wake of the securities market crisis precipitated negative effects on the financial positions of the private sector, both individuals and companies. Averages of demand for consumption declined and the consumption pattern that prevailed during the abnormal economic boom had changed, particularly with the feeling that the wealth of individuals and institutions was decreasing as a result of a decline in the value of assets. Furthermore, the drop in oil prices had adverse effects on the private sector's expectations about the momentum of economic activity in view of the waning optimistic outlook towards growth rates of public expenditure, which constituted the main driving force of economic activity. These factors altogether precipitated a drop in the performance rates of many companies and institutions, which prevented many clients from servicing their debts and meeting their obligations towards banks, particularly with the sharp decline in the value of collateral with these banks on the one hand, and the difficulty of its liquidation on the other. As a result of the above, the problem of the so-called "difficult debts" appeared in the financial and banking arena.

Reflection of the difficult debt problem on the financial sector and the Kuwaiti economy in general:

1- Effects on the financial positions of banks :

To have an intensive analytical look at the reflections of the difficult debt problem on the financial sector and the Kuwaiti economy, we must first highlight the distinctive feature of the organisational and administrative structure of the banking system in Kuwait. In their organisation and administration, banks in Kuwait follow the "Branch Banking" system. This organisation is based on the existence of a limited number of banks, the services of which cover the whole country through a wide network of

branches conducted by the main office. Despite the privileges of this organisation, as compared with the "independent unit banking" system, banks under the "Branch Banking" system, will be affected by any financial crisis, because these banks are small in number on the one hand, and because they are interconnected on the other.

Therefore, unless the problem of difficult debts were settled, the financial positions of the Kuwaiti banks would deteriorate by the adverse effects of these debts on their liquidity, profitability and credit-worthiness. Furthermore, a crisis of confidence in the banks would arise, resulting in bad consequences on the banking system in Kuwait in particular and the Kuwaiti economy in general.

2- Negative effects on the flow of credit and the momentum of economic activity :

We all know that banks have a significant status in the capitalist economic systems. They were described as the heart of the capitalist economic body, and with money as their blood. Further, banks play a major role in economic development and in generating money. Therefore, banks' solvency and financial positions being jeopardized, their role as a financial intermediary in the economy will be impaired, credit flow will be adversely affected, and the loss of depositors' confidence in banks will damage the mechanism of the economy's momentum. Therefore, most prominent economists believe that bank supervision is one of the most important functions of central banks and the maintenance of confidence in the banking system is one of the primary objectives of monetary policy. Furthermore, the sound position of the banking system is mainly reflected in the banks' solvency, as once banks enjoy sound financial positions, the monetary authorities will be able to employ the

instruments of monetary policy with a view to realizing the ultimate goals of these policies.

The repercussions of the difficult debt problem on the economic situation in Kuwait may appear through slackened domestic activity, reflected by the trends of credit growth between 1983 and 1986. At the end of December 1983, credit facilities from commercial banks to residents totalled KD 3845 million, then increased to KD 4313 million at the end of December 1986, i.e. an increase of KD 468 million or about 12% during three years (annual average of 4%). It can also be noticed from credit distribution over the different economic sectors that 97% (KD 452 million) of that increase represented increases in personal and real estate loans; the major portion of the increase in bank credit during these three years represented the accumulated interest, which means the absence of remarkable growth in credit facilities. The credit facilities of some major sectors such as trade, industry and agriculture sectors recorded negative growth rates.

It can be noted in this respect that the economic recession, as a result of the decline in demand, was reflected in the decrease in the growth rate of the consumer price index, which took a downward trend from 4.7% in 1983 to less than 1% in 1986. Further, the decline in the balance of documentary credits opened by banks to customers to finance imports reflected the deceleration in the momentum of trade activity. The balance of these credits decreased from KD 341 million in 1984 to about KD 284 million in 1986. Also, it is noteworthy to mention that the negative effects of the difficult debt problem on banks' activities in particular, and on the economy in general, directly affected the performance rates of the banking system, as it is noticed from the GDP distribution that the ratio of the financial institutions' contribution to the non-oil GDP dropped

between the years 1983 and 1986 due to a decrease in that sector's contribution to the total GDP.

3- Pessimistic outlook and the problem's psychological impact:

Undoubtedly, if reflections of the debt problem on the financial system and the local economy were to be left unsettled or without the intervention of the concerned authorities, they would deepen pessimism and the problem itself would become complicated and more difficult, particularly if certain factors are taken into account, such as the nature of the correlation between the banking system in Kuwait and the international financial markets, the narrow base of the Kuwaiti economy and the importance of both the financial and banking institutions and the capital element in this economy. Furthermore, the bad debt problem, in its primary stages, had a psychological impact on individual debtors, who were greatly anxious about their future economic and social positions should legal proceedings be taken against them by creditor banks.

No one can deny that the great efforts exerted by the country's economic management in the settlement of the bad debt problem, and even in the execution of different solutions, would normally be directed toward the continuous development of the economy's infrastructure with a view to achieving further economic and social welfare.

Efforts to settle the bad debt problem and curb its adverse results:

Since the beginning of the problem, the economic management in Kuwait has taken all necessary measures to face the problem and solve it.

These great efforts resulted in the announcement of the "Difficult Credit Facilities Settlement Program", which ordered the Kuwaiti banks and their debtors to commence immediately the settlement of difficult debts in accordance with the rules and regulations set by this program.

It is beyond the scope of this speech to discuss this program in detail, but within the context of this lecture I would like to elaborate some basic principles of this program which will constitute a solid basis for the solution of the debt problem and the positive interaction between the financial sector and the local economy.

The program stresses the importance of maintaining the sound position of the economic institutions in the country, as it allows debts to be settled partly or wholly through the creditor bank's contribution to the company capital, and by supporting the debtors' ability to pay through additional credit facilities extended to them if their businesses prove viable. Therefore, the program is set up on an economic philosophy based upon the promotion of economic activity, to curb any adverse effects of the debt problem on such activity and to maintain the economic achievements of the private sector. The program's emphasis on prohibiting collateral assets from being liquidated without special permission from the Central Bank is to safeguard these assets from depreciation, which is another aspect of the program's philosophy. Also, the regulations and rules contained in the program with regard to financial support to banks and refunding support money, the State's commitment through the Central Bank to maintain bank sound financial positions including the sanctity of shareholders' equity as declared on December 31, 1985 and the State's guarantee of depositors' rights with

these banks will give further confidence in the banking system and emphasize the serious efforts of the economic management in the country to settle this problem.

The positive results of the difficult debt settlement program, particularly the confidence it enhanced in both the financial system and the domestic economy, can be noticed in the trading activity in the stock market as an indicator of economic activity. It was further noticed, after the program, that the stock market showed a positive indicator of activity in all sectors. Also, the real estate market witnessed a noticeable improvement in its activity combined with a slowdown in the rates of price decline.

Before and after the settlement program, the Central Bank applied all possible means to maintain the liquidity of the banking system and to realize the necessary monetary balance. Further, taking into account that the effectiveness of monetary policies loses its power during crises, the Central Bank found it useless to apply certain monetary policies before finding solutions to the debt crisis. Therefore, after the announcement of the program, when the Central Bank realized that the settlement program was implemented well, it amended the structure of interest rates on the KD, effective 8/3/1987. The reduction in interest rates as specified in the new structure, combined with other factors, had direct positive effects on both share and real estate markets. Comparing the trading activity in the stock market on 10/3/1987 (two days after the application of the new structure of interest rates) with the trading activity on 28/2/1987 (a week before the application of the new structure of interest rates), it can be noticed that the stock market had witnessed noticeable trading activity represented in the growing increases in the quantities and prices of traded

shares. The share of the banking sector recorded positive growth rates (10% on the average). This rate reached 20% for both investment and real estate companies, 35% for industrial companies and 40% for services companies. Growth rates of traded quantities reached 750%, the number of transactions 50%, and the traded value 70%. Having indicated these changes, I would like to confirm that our primary concern is not to concentrate on the issue of growth in share prices, but rather on the growth in trading volume and market stability. And despite the lack of statistics on the activity in the real estate market, it is noticeable that the market has witnessed an improvement in both its activity and prices. The rate of rise in the shares of real estate companies, the average of which was 20%, can be taken as an indicator of the improvement in the real estate market. Due to the short period of application of the new structure of interest rates, no data are available on the activity in other sectors.

The number of positive indicators of the recovery in the economic activity and the positive results expected from the set of decisions enacted by the economic management in the country, including the decision on the new structure of interest rates and the other monetary procedures adopted by the Central Bank, are all expected to speed up the process of solving the difficult debt problem and to prevent the emergence of many non-performing loans. Further, these procedures will help many other loans to be settled. If the rise in the asset values of the economy is considered as one of these factors, the economic momentum associated with the continuous flow of money due to the availability of better opportunities for liquidation will help many debtors service their debts and meet their obligations.

As many factors bear positive indicators of recovery and more confidence in the economy, the Central Bank invites all concerned parties to benefit from this experience. We in the Central Bank are conscious of our role and responsibility in the present and future stages, in respect of both bank supervision and the enhancement of monetary policy with a more comprehensive role in the local economy. Further, increasing the degree of co-ordination between the fiscal and monetary policies, which has been evident recently, will be very effective in directing the course of economic activity. We are looking forward to seeing the results of the Central Bank's direct role in the national economy in co-operation and co-ordination with the economic management in the country.

Lastly, by answering your questions, I hope I can cast more light on certain issues covered briefly in my speech and can answer other questions about other points.

