INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/96

KUWAIT

FINANCIAL SYSTEM STABILITY ASSESSMENT

April 2019

This Financial System Stability Assessment paper on Kuwait was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with Kuwait. It is based on the information available at the time it was completed on March 11, 2019.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

© 2019 International Monetary Fund

INTERNATIONAL MONETARY FUND

KUWAIT

FINANCIAL SYSTEM STABILITY ASSESSMENT

March 11, 2019

Approved By
James Morsink and Aasim M. Husain

Prepared By
Monetary and Capital Markets Department

This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Kuwait in April–May 2018. The FSAP findings were discussed with the authorities during the Article IV consultation mission in January 2019.

- The FSAP team was led by Amina Lahreche (IMF) and Ilias Skamnelos (WB), and included Thor Jonasson (IMF) and Haocong Ren (WB) as Deputy Mission Chiefs, Anastasia Guscina, Abdullah Haron, Hideo Hashimoto, Peter Lõhmus, Rafel Moyà (all IMF), John Groom (IMF expert), Marc Schrijver, Valeriya Goffe, Ghada Teima (all WB), and Eddy Rodriguez, Prasanna Seshachellam and Matthew Sullivan (all WB experts). Yunhui Zhao (IMF) led the banking sector stability analysis during the scoping mission.

- The mission met the Governor of the Central Bank of Kuwait, the Minister of Finance, the Vice Chairman (Acting Managing Director) of the Capital Markets Authority, and staff in their respective agencies. It also met other high-ranking public officials, and senior representatives of local and foreign banks, credit rating agencies, auditors, law firms, financial sector representatives, and industry associations.

- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.

- This report was prepared by Amina Lahreche and Thor Jonasson, with contributions from the members of the FSAP team. Shiyuan Chen and Kiran Sastry provided research assistance, and Christine Luttmer, Margarita Aguilar, and Vanessa Guerrero provided administrative support.

CONTENTS

Glossary 3

EXECUTIVE SUMMARY 4

MACROFINANCIAL SETTING 7

VULNERABILITIES AND RISKS 12

SYSTEMIC RISK ASSESSMENT 14

FINANCIAL SECTOR OVERSIGHT 16

A. Regulatory and Supervisory Framework 16

B. Oversight and Management of Systemic Risks 18

C. AML/CFT 19

FINANCIAL SAFETY NETS, BANK RESOLUTION, AND CRISIS MANAGEMENT ARRANGEMENTS 19

MANAGING SYSTEMIC LIQUIDITY 21

DEVELOPMENTAL CHALLENGES 22

A. Developing Capital Markets 22

B. Promoting Access to Finance for SMEs 23

BOX

1. Financial Safety Nets and Islamic Finance 21

FIGURES

1. Macrofinancial Environment 8
2. Financial Sector Indicators 13
3. Stress Test Scenarios and Results 15

TABLES

1. FSAP Key Recommendations 6
2. Financial Sector Structure, End-2017 9
3. Selected Economic Indicators, 2014-24 24
4. Financial Soundness Indicators, 2011–Sept 18 25

ANNEXES

I. Risk Assessment Matrix 26

II. Macroprudential Tools and Instruments 27

III. Contingent Claims Analysis of the Banking Sector 29

IV. Previous FSAP Recommendations 31

V. Top-down Stress Test Matrix (STeM) for the Banking Sector: Solvency and Liquidity Risks 35

Glossary

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
CAR	Capital Adequacy Ratio
CBK	Central Bank of Kuwait
CCA	Contingent Claim Analysis
CCB	Countercyclical Capital Buffer
CDS	Credit Default Swaps
CMA	Capital Markets Authority
D-SIB	Domestic Systemically Important Banks
DD	Distance to Distress
DIS	Deposit Insurance Scheme
DSTI	Debt Service-to-Income
EDF	Expected Default Probabilities
ELA	Emergency Liquidity Assistance
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
FSO	Financial Stability Office
FVCDS	Fair Value Credit Default Swaps
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
IAH	Investment Account Holders
IC	Investment Companies
IFSB	Islamic Financial Services Board
IOSCO	International Organization of Securities Commissions
LCR	Liquidity Coverage Ratio
LTV	Loan-to Value
MOCI	Ministry of Commerce and Industry
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
OMO	Open Market Operation
OTC	Over the Counter
PSIA	Profit-Sharing Investment Accounts
RR	Recovery and Resolution
SME	Small- and Medium-Sized Enterprise
SSB	Shariah Supervisory Board

EXECUTIVE SUMMARY

Since the 2010 FSAP, the financial system has withstood the real-life stress test of a severe drop in oil prices and the authorities have strengthened their framework. Banks, which constitute the largest part of the financial sector, have maintained high capital ratios, comfortable liquidity buffers, and high provisions, while nonperforming loans (NPLs) reached historic lows in 2017. The authorities proactively developed their regulatory and supervisory framework, notably by implementing Basel III for banks and establishing a regulatory and supervisory agency for capital markets, the Capital Markets Authority (CMA).

Kuwait's limited economic diversification (characteristic of small oil-dependent economies) is directly reflected in the bank-centric financial sector. Banks have high concentrations to single borrowers, large depositors, and sectors, as well as significant common exposures. Risks to the financial sector are mostly external, stemming from oil price shocks, geopolitical tensions, and global financial developments. The risks are mitigated by sizeable sovereign financial assets, and by the ability of public entities to provide liquidity through large deposits.

Stress tests suggest that banks are resilient to a wide range of shocks. The banks follow simple business models, funding themselves through deposits and extending credit to the domestic private sector, with a large share of lending to government employees, and they have limited foreign exchange (FX) mismatches. Solvency stress tests, which assume—based on historical patterns—that government spending is sustained during periods of oil price correction, identify minor capital shortfalls in three banks under a severely adverse scenario, while banks would remain well above the regulatory floor under an adverse scenario. Interest rate and FX risks appear to be well managed and are unlikely to destabilize the banking sector. Single factor sensitivity analyses point to limited vulnerabilities, when compared to the current levels of bank capital, arising from single borrower and sectoral credit concentration. The abundance of liquidity allows most banks to comply with the prescribed liquidity ratios, even under severe stress, although buffers would be reduced.

The supervisory regime is effective, although there is room for improvement in certain areas. The Central Bank of Kuwait (CBK) updates its supervisory framework on an ongoing basis to incorporate international best practices, and the supervisory approach is appropriate. Further improvements could include enhanced integration of on- and off-site supervision, a strengthened consolidated supervision framework, and bolstered inspections of banks' foreign-owned branches to improve the supervision of cross-border operations. Islamic banking—which accounts for 39 percent of assets—is exposed to specific operational risks, including regarding the interpretation of Shariah compliance, and would benefit from a centralized Shariah board at the CBK.

The recently developed regulatory framework for capital market participants and products is an important step, but some gaps remain. The CMA should establish a strict separation of commercial and securities market activities of licensed persons to isolate risks. On the supervisory front, the CMA should gradually shift from a comprehensive compliance-based approach towards risk-based supervision.

The authorities have made important progress in strengthening the macroprudential framework. The CBK has established a Financial Stability Office (FSO) to monitor systemic risks and has been publishing annual financial stability reports since 2012. The institutional setting should be further strengthened by assigning an explicit financial stability mandate to the CBK. The authorities should also establish a formal coordination mechanism between the agencies overseeing the financial sector—the proposed Financial Stability Committee (FSC) is a welcome step in this direction. To enhance the effectiveness of its macroprudential toolkit, the CBK should focus on filling data gaps and calibrating macroprudential tools.

The liquidity management framework has served the CBK well. The ample liquidity in the banking system provides comfort but limits banks' exposure to—and potentially their ability to manage—normal fluctuations in liquidity. The CBK is well equipped to absorb the excess liquidity that stems from the country's sizeable oil revenues. Improvements should include a refinement of the liquidity forecasting framework and a strengthening—and periodical testing—of both liquidity-absorbing and supplying tools.

The crisis management framework and financial safety net arrangements should be strengthened and further operationalized. Since the last FSAP, the CBK has been working toward strengthening the crisis management framework for the banking sector through several actions. A bank-specific insolvency framework has been incorporated into the draft commercial insolvency law; the framework for Emergency Liquidity Assistance (ELA) has been improved; and the CBK is contemplating the establishment of a stand-alone bank resolution unit, independent of supervision. While some elements are already in place, a more comprehensive, structured and formalized framework for corrective actions and bank recovery and resolution is needed. In addition, the existing blanket guarantee on deposits should be gradually unwound and replaced with a suitably structured Deposit Insurance Scheme (DIS), once pre-conditions are met. The large Islamic banking sector introduces an additional layer of complexity, as the authorities need to ensure the development and implementation of Shariah-compliant solutions for crisis management, recovery and resolution, and deposit insurance of Islamic banks.

The diversification and resilience of the economy would benefit from better financial inclusion of SMEs. The National Fund strategy should be adjusted to refocus activities from direct financing to leveraging financial intermediaries (e.g., through co-financing, on-lending, and risk sharing). Further efforts should focus on enabling the market for SME finance, including the adoption of a new insolvency law and of a secured transaction law, the establishment of an electronic registry for movable collateral, improvements in credit reporting on commercial lending, and a gradual relaxation of the interest rate cap. In addition, the authorities should encourage competition through alternative financial instruments and players.

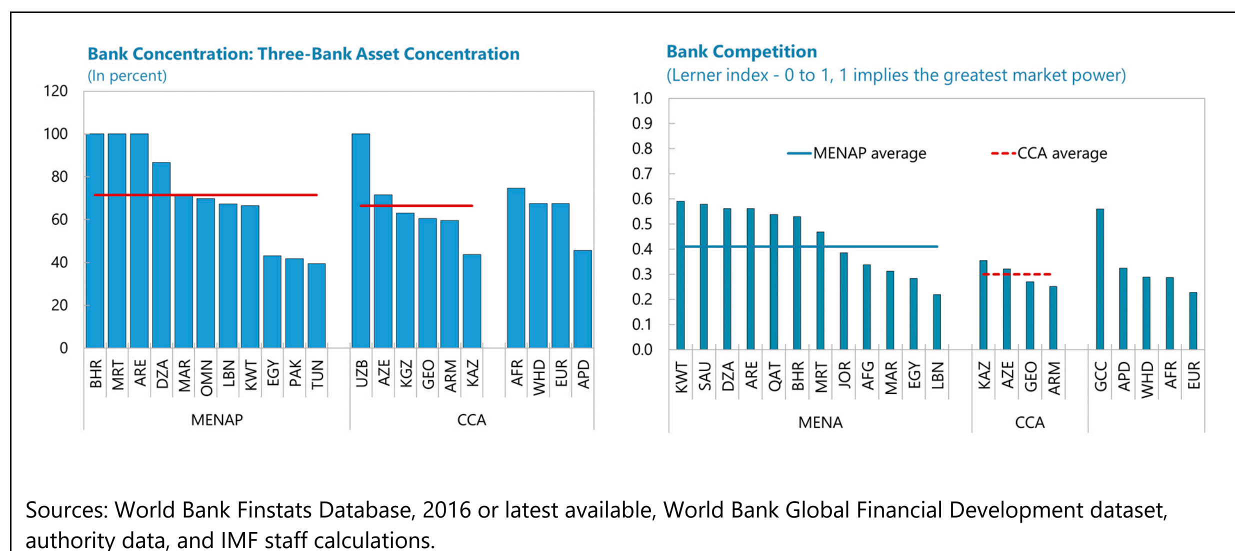
	Table 1. Kuwait: FSAP Key Recommendations	
	Recommendation	**Timing** a/
	Banking Supervision	
1	Strengthen the CBK powers and capacity to exercise consolidated supervision	MT
2	Establish supervisory colleges, conclude the MOUs with relevant authorities, resume the inspection program and increase the frequency and depth of on-site inspections of foreign-owned branches of Kuwaiti banks	ST
3	Proceed in setting up the centralized Shariah board at the CBK	MT
	Capital Markets Supervision	
4	Adopt a risk-based approach to supervision; identify and manage emerging and systemic risks; periodically review regulatory perimeter	MT
	Systemic Risk Oversight	
5	Create a financial stability committee with a clear mandate and powers to collect and share information, and make recommendations, and assign the CBK as a macroprudential authority, providing it with a clear financial stability mandate	MT
6	Fill data gaps in household debt and develop a real estate price index	MT
	Managing Systemic Liquidity	
7	Extend and develop the liquidity forecasting framework	ST
8	Ensure bank are resilient to sudden variations in excess liquidity and consider developing other tools	ST/MT
9	Extend the collateral universe for reserve-supplying operations and periodically test facilities with banks	MT
	Financial Safety Nets	
10	Formally designate the CBK as a banking sector resolution authority, with a mandate to preserve financial stability	MT
11	Pass and implement the special resolution regime for banks	ST
12	Develop proposals to remove the blanket guarantee on deposits and establish a DIS, including Shariah-compliant component, after preconditions are met	LT
	Capital Markets Deepening and Development	
13	Broaden the governance of the market development program to include other authorities and entities	ST
	SME Access to Finance	
14	Strengthen credit infrastructure by adopting the secured transaction law and insolvency law, establishing an electronic movable collateral registry and improving credit reporting on commercial lending	MT
15	Introduce a gradual relaxation of interest rate caps for SMEs	MT

a/ (ST) = within one year; medium-term (MT) = one to three years; long-term (LT) = three to five years.

MACROFINANCIAL SETTING

1. Kuwait is an oil-dominated economy that has proved resilient to shocks since the last FSAP in 2010. Prudent fiscal management allowed the country to record high fiscal and external surpluses and build strong financial buffers during periods of high oil prices. The resulting fiscal space allowed the authorities to smooth the impact of low oil prices after 2014 and to support growth through sizeable investment spending (Figure 1). Banks remained liquid throughout the period of low oil prices, and equity prices, after declining from 2014 through to 2016, have been recovering somewhat in 2017 and 2018.

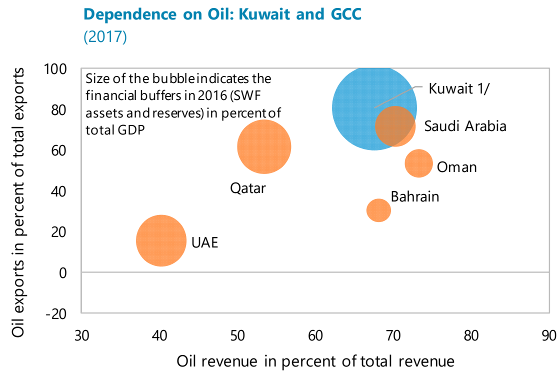
2. The financial system is bank-centric, with Islamic finance playing a significant role. Financial system assets stood at 252 percent of GDP at end-2017 (Table 2) and are mostly held by the banking sector, which is itself dominated by two major banks. Foreign banks operate through branches, and account for less than four percent of consolidated banking assets. The non-bank financial sector, which is dominated by investment companies (ICs), has been declining in importance since the GFC. The insurance sector is under-developed: its assets account for less than one percent of GDP. While conventional finance dominates, the Islamic banking sector is one of the largest in the world in terms of its share in consolidated banking assets (40 percent), and 55 percent of assets held by investment companies (ICs) are managed according to Islamic finance principles.



Sources: World Bank Finstats Database, 2016 or latest available, World Bank Global Financial Development dataset, authority data, and IMF staff calculations.

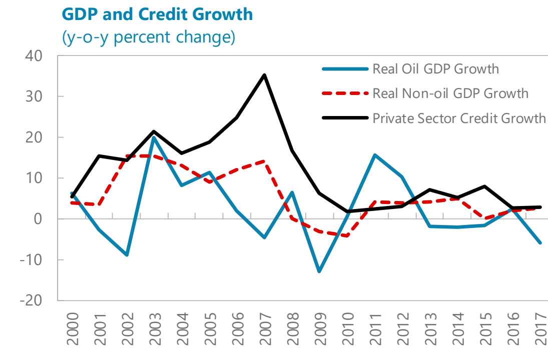
Figure 1. Kuwait: Macrofinancial Environment

Kuwait is a heavily oil-dependent economy with large fiscal buffers

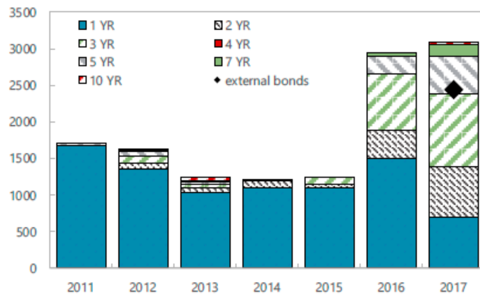


1/ For Kuwait, the size of the bubble includes KIA (470 percent of GDP) and CBK (28 percent of GDP) assets.

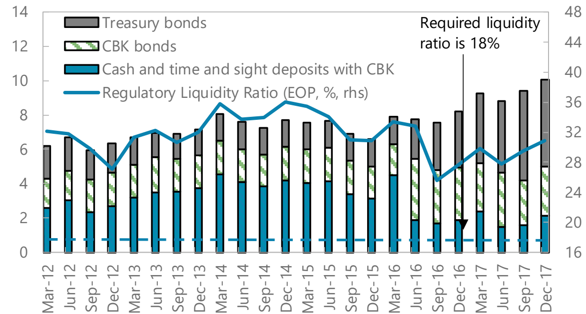
GDP and private sector credit growth slowed down as oil prices declined



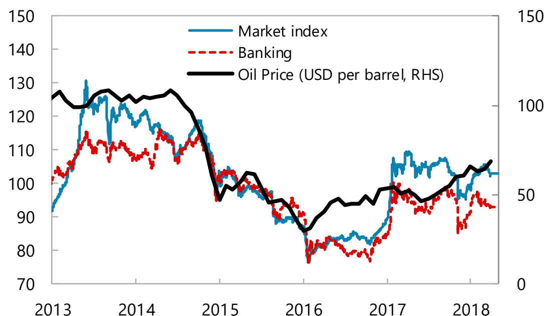
The financing need created by low oil prices was met by sovereign bond issuances ...



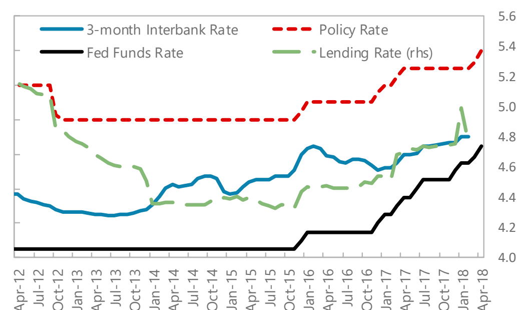
... leading to a rebalancing of the ample liquid asset holdings by banks.



Equity prices are tightly related to oil prices



Monetary policy is related to developments in US



Sources: Kuwaiti authorities; sovereign Wealth Fund Institute; and IMF Staff calculations.

Table 2. Kuwait: Financial Sector Structure, End-2017

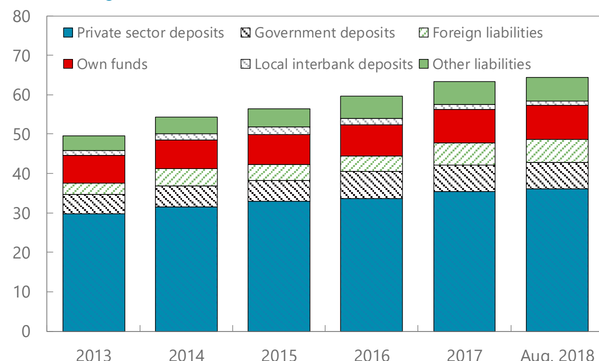
	Number	Total assets			
		KD million	USD million	Percent of total	Percent of GDP
Commercial banks	**23**	**76,684**	**253,824**	**90.9**	**211.5**
Top 10 banks (stress test universe)	10	72,834	241,081	86.3	200.9
Of which: Islamic	5	28,683	94,941	34	79.1
Specialized banks	1	671	2,221	0.8	1.9
Foreign-owned banks and branches [1/]	12	3,178	10,519	3.8	8.8
Non-bank financial institutions	**110**	**7,695**	**25,470**	**9.1**	**21.2**
Investment companies	68	7,486	24,779	8.9	20.6
Foreign-exchange companies	42	209	692	0.2	0.6
Total	**133**	**84,380**	**301,357**	**100**	**211.5**

Sources: Central Bank of Kuwait and IMF staff calculations.

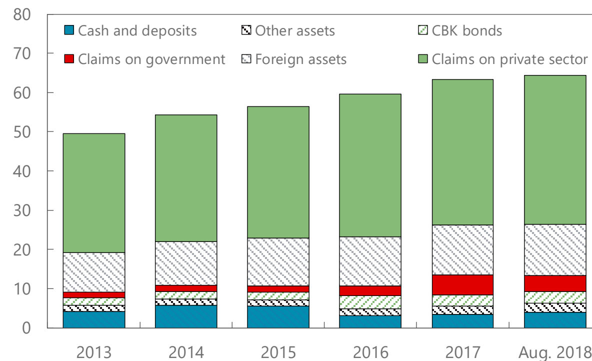
[1/] Foreign branches do not include Ahli United Bank, which is already included in the top 10 banks. One of the foreign-owned branches is Islamic.

3. Banks operate relatively simple business models and continued to see their activity grow despite the fall in oil prices. Assets are dominated by claims on the domestic private sector and by net foreign assets. Domestic credit is concentrated on the household sector (43 percent), where installment loans for home purchase and repair dominate, and on the real estate and construction sectors (28 percent). Funding is mostly originated through deposits (two-third of total). At the system level, the capital adequacy ratio (CAR) remained consistently well above the minimum requirement of 13 percent, hovering between 17.5 and almost 19 percent between 2011 and 2017. The liquidity ratio—supported by the large oil-financed government spending—remained comfortably above the 18 percent regulatory requirement, reaching 27.8 percent in June 2017 and further improving through September 2018. Asset quality improved steadily despite the slowdown in growth, with NPLs hitting a low of 1.9 percent at the end of 2017, with a provisioning coverage ratio of 230 percent. Despite conservative provisioning requirements, profits have been stable. In addition to prudent regulation and supervision, the banking sector benefited from general government support to the economy: an increase in public sector deposits partly offset a slowdown in private sector deposit growth, and countercyclical public spending supported credit growth, credit quality, and financial stability. Banks also proactively maintained the quality of their balance sheets by actively writing off non-performing assets against provisions (Figure 3 and Table 3).

Banks are mostly funded by deposits…

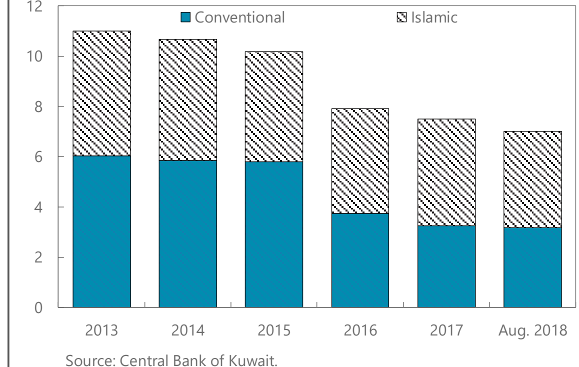


… and lend domestically.



Source: Central Bank of Kuwait.

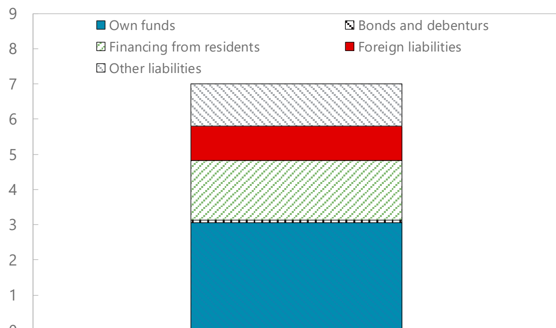
4. The IC segment has shrunk significantly since the GFC, under challenging market conditions and tightened regulation. The business models of ICs vary widely. Since 2008, they have been shifting away from proprietary investment towards asset management and financial services. With the establishment of the Capital Markets Authority (CMA) in 2011, Is have also been subject to enhanced regulation and supervision. They have reduced their leverage, relying increasingly on own funds (48 percent of total funding in February 2018), while local bank financing declined from 40 to 23 percent of total funding between 2016 and 2018. The interconnectedness between ICs and banks—an important source of systemic risk at the time of the last FSAP—has declined substantially, as the exposure of banks to ICs fell from 12 percent of total banking assets during the GFC to 2.4 percent in 2017. On balance sheet, ICs are mainly exposed to foreign assets (about one third of total assets) and domestic financial investments (23 percent).



Source: Central Bank of Kuwait.

Investment companies are largely funded by own funds…

Investment Companies: Liabilities
(As of August 2018; In billions of KD)



…and hold diversified investment portfolios

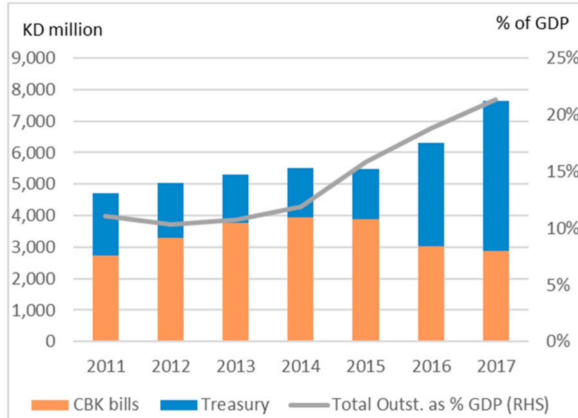
Investment Companies: Assets
(As of August 2018; In billions of KD)

Sources: Central Bank of Kuwait and IMF staff calculations.

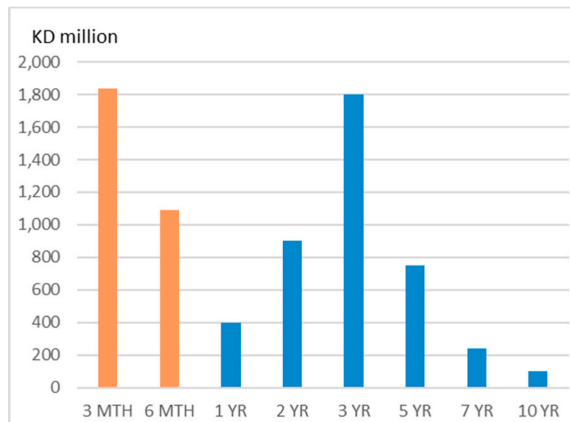
5. Capital markets development is limited.

- *The bond market is nascent*. Between 2015 and 2017, the government increased issuances of 2- to 10-year maturity bonds to cover its funding needs and extend the risk-free yield curve. The CBK issues 3- and 6-month bonds and Tawarruq for liquidity management purposes. Risk-free securities—around 20 percent of GDP in total—are almost entirely held by banks to maturity. Consequently, there is no secondary market or market yield curve.

Domestic Government Bonds and Tawarruq Outstanding

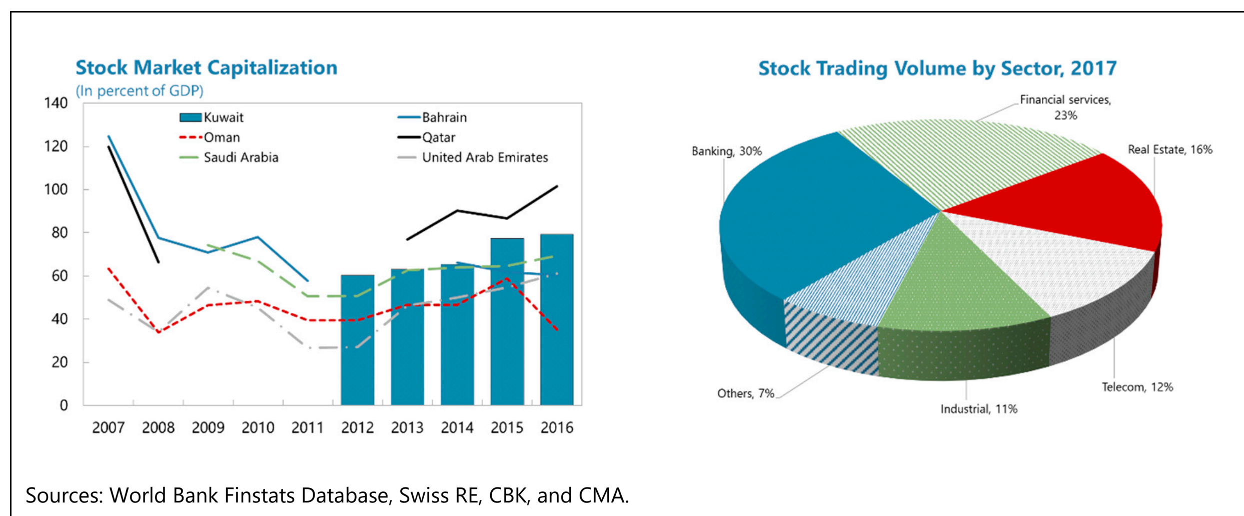


Government Bonds and Tawarruq Outstanding by Maturity, May 2018



Sources: World Bank Finstats Database, Swiss RE, CBK, and CMA.

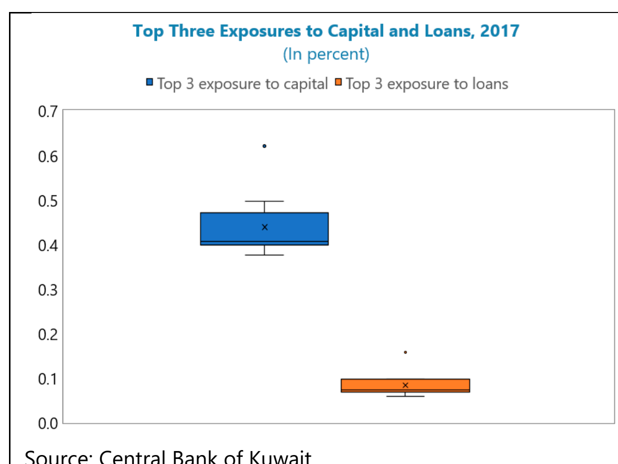
- *By capitalization, the stock market is the second largest in the GCC in percent of GDP, but its liquidity is limited.* At the end of 2017, 177 companies were listed, with banks, followed by other financial services, industry, telecom, and real estate, making up most of the listings. However, turnover was limited, representing 20 percent of a market capitalization equivalent to 80 percent of GDP.



Sources: World Bank Finstats Database, Swiss RE, CBK, and CMA.

VULNERABILITIES AND RISKS

6. Oil-dependency and the small size of the economy define Kuwait's financial vulnerabilities. Banks have high concentrations to single borrowers, large depositors as well as significant common exposures (Figure 2). They also have sizeable sectoral concentrations, notably in real estate. Banks have been looking for growth opportunities outside of the country and expanded foreign operations, increasing foreign assets to 20 percent of their assets. While FX mismatches appear negligible due to the small net open positions, the growth of foreign operations may pose a challenge to effective supervision.

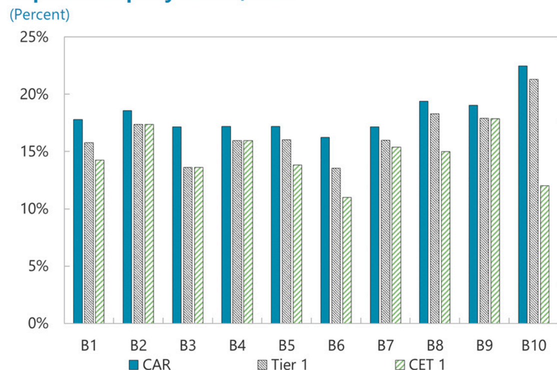


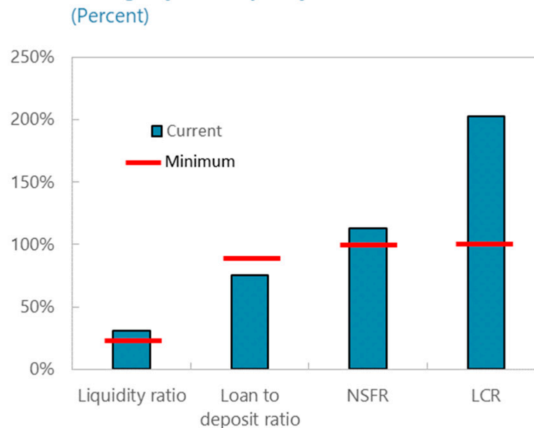
Source: Central Bank of Kuwait.

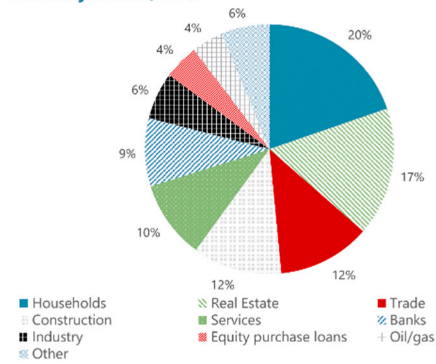
7. Islamic banks present a similar risk profile to conventional banks, but face additional operational risks related to Shariah compliance. The Islamic banking sector has for the most part a simple corporate structure, and its business model is very similar to the one of conventional banks: banks are mostly performing financing operations and rely essentially on deposits-like funding on the liability side. However, they face specific operational risks related to possible divergences of interpretation regarding the Shariah-compliance of their products.

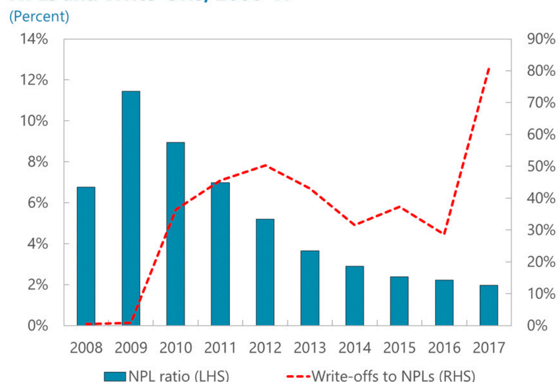
8. Risks to the financial sector stem mostly from external shocks, but large buffers are major mitigating factors. Oil price shocks, geopolitical tensions and global financial developments are the main source of risks (Appendix I), and could affect credit quality, deposit growth, financial conditions, investor confidence and asset valuations. Large buffers in the banking sector and ample public-sector resources would however be available to mitigate financial sector risks.

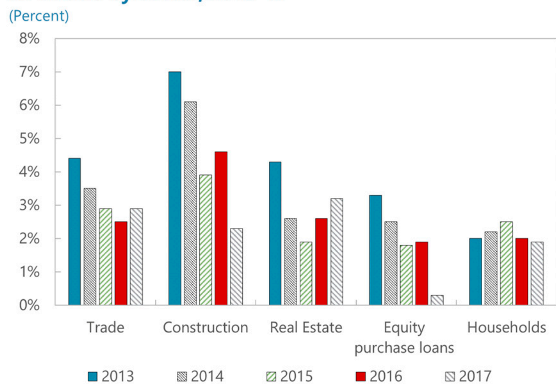
Figure 2. Kuwait: Financial Sector Indicators

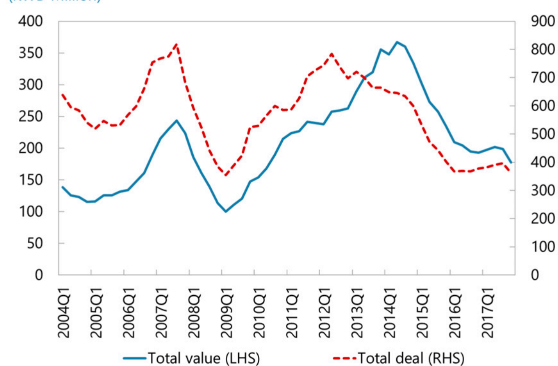












Sources: CBK and IMF staff calculations.

SYSTEMIC RISK ASSESSMENT

9. The macro-financial scenarios used to stress the banking system reflect the risk assessment for Kuwait (Appendix I). The baseline scenario is in line with the April 2018 IMF World Economic Outlook projections. The hypothetical stress scenarios assume a gradual ("adverse") and a sharp and permanent ("severely adverse") shock to oil prices, equivalent to the 5th percentile of the distribution of prices between 1980 and 2017 (or a "once in 20 years" shock). The resulting negative impacts on output and market confidence in turn entail a deterioration of the real estate market and the quality of banks' loan books. The model accounts for the historical behavior of government spending, which has tended to be sustained during periods of oil price correction, thereby supporting economic activity and, consequently, the resilience of the banking sector. Both the solvency and liquidity stress tests (performed on end-2017 data) covered the 10 largest banks by assets.

10. The banking sector appears resilient under the solvency stress tests, reflecting banks' large capital buffers and high asset quality at the start of the stress test. While severe stress would affect the capital position of some banks, the recapitalization cost would be limited in comparison to the country's ample financial resources.

- *Banks are resilient to both the adverse and the severely adverse scenarios.* In the adverse scenario, the average CAR for all banks would remain well above the regulatory floor. Under the deep and protracted recession resulting from the severely adverse scenario, three banks would experience a limited shortfall (equivalent to 0.9 percent of GDP[1]), but the system-wide CAR would remain above the regulatory floor. A contingent claim analysis similarly underscores the resilience of the banking system (Annex III).

- *Vulnerabilities associated to sectoral and individual concentration risks appear manageable.* Under the sensitivity analysis, assuming a hypothetical default of the five largest borrowers and a 50 percent recovery rate, five banks would not fulfill the regulatory capital requirements; the total shortfall would be limited, amounting to 0.5 percent of GDP. The household and real estate sectors constitute a sizeable part of bank exposures. A 20 percent default with zero percent recovery in any of the two sectors would leave four banks with capital deficiencies, albeit of small magnitude (0.3 percent of GDP).[2]

- *Market risk appears well managed***.** FX and interest-rate shocks have little impact on banks' solvency, partly due to low net open positions.

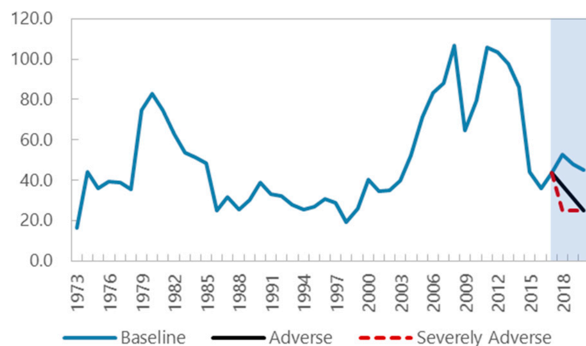
---

[1] While capital in those banks would be below the Kuwaiti regulatory requirement, it would still be above the Basel III minimum requirement.

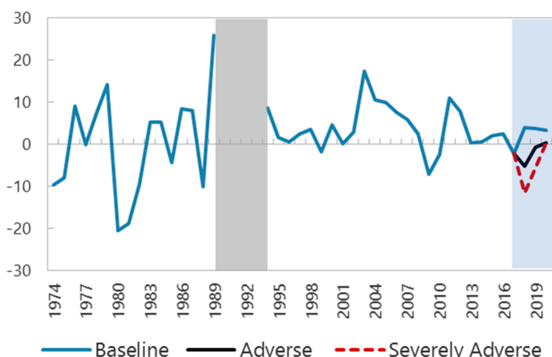
[2] This would constitute an extreme shock, as household credit is mostly issued to public sector employees and backed by wages. In the absence of a housing mortgage market, real estate lending is limited to investment and commercial real estate.

Figure 3. Kuwait: Stress Test Scenarios and Results

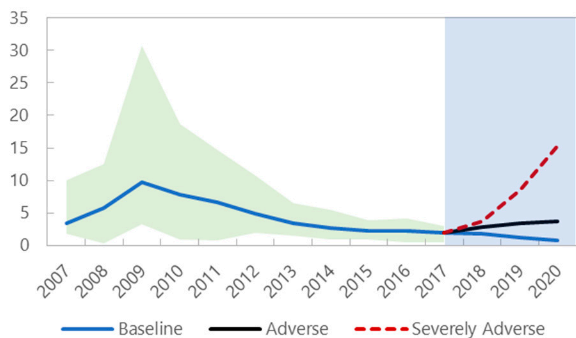
Real Oil Price, 1973-2020
(Percent, Base Year 2010)



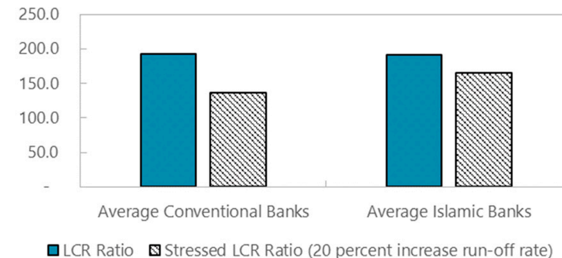
Real GDP Growth, 1974-2020 [1/]
(Percent)



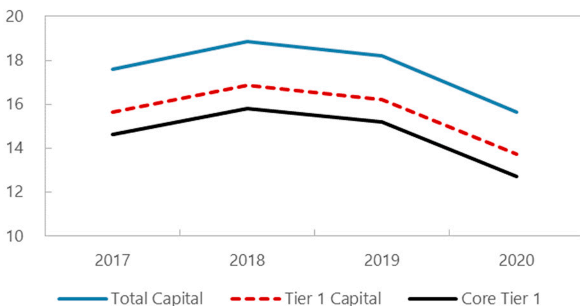
Stress Test NPL Projections, 2007-2020 [2/]
(Percent)



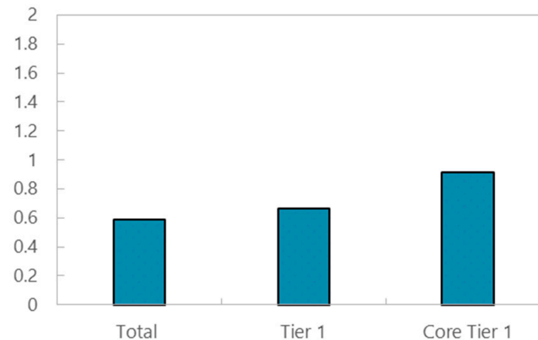
Liquidity Coverage Ratio Stress Test, 2017
(Percent)



Aggregate Capital Severely Adverse Scenario
(Percent)



Aggregate Capital Needs as Percent of GDP
(Percent)



Sources: CBK and IMF staff calculations.
[1/] Estimations did not include the 1992-1993 war period.
[2/] Green bands represent individual banks' maximum and minimum NPL ratios.

11. Liquidity stress tests also point to the resilience of the banking sector. The liquidity tests used two different approaches: (i) a sensitivity check of banks' liquidity coverage ratio (LCR) to potential funding outflows; and (ii) an analysis of the net stable funding ratio (NSFR). All banks would comply with the CBK Basel III transitioning requirement for the LCR (90 percent ratio in 2018) under both short-term funding stress and severe stress, and all but one would comply with the fully-loaded LCR ratio of 100 percent. Transitioning arrangements were in place before the full implementation of the NSFR regime at the end of 2018. At the end of 2017, the average NSFR ratio for the entire system already reached 112.5 percent, with only one bank not reaching the Basel III fully-loaded NSFR levels of 100 percent.[3]

FINANCIAL SECTOR OVERSIGHT

A. Regulatory and Supervisory Framework

Banking Sector

12. The supervisory framework, which the CBK updates regularly, is effective. The CBK has been proactive in incorporating best international practices, for instance by implementing the LCR (2017) and NSFR (2018), by developing guidance on Shariah supervisory governance for Islamic banks (2016), and consistently following up on FSAP recommendations (Appendix IV).

13. There would be merit in further strengthening the CBK's autonomy and supervisory powers. Both the Ministry of Finance (MOF) and Ministry of Commerce and Industry (MOCI) are represented in the CBK Board. While the MOF is involved in certain supervisory decisions (e.g., issuance of regulation, issuance of bank license, and approval of certain enforcement actions), it does not interfere in the day-to-day operations of the CBK. Nevertheless, a clarification of the framework would be warranted, and the authorities should consider legislative changes to remove the MOF's influence over the CBK's decision on licensing, closure, and certain remedial actions.

14. The supervisory approach could be further refined to better assess the risk profile of banks, strengthen consolidated supervision, and enhance cross-border supervision.

- *Banks risk profile.* The CBK has a well-developed supervisory approach (CAMEL-BCOM[4]), and both the on- and off-site supervision departments have a deep and granular understanding of banks. Further improvements could be achieved by better integrating the information from both departments; enhancing the forward-looking assessment of the banks' risk profile; and supporting generalist supervisors with risk-specialists. Additionally, to further strengthen the resilience of the banking sector, the CBK could draw on the existing Supervisory Review and Evaluation Process to set bank-by-bank capital requirement targets, based on their risk profile and systemic importance.

[3] The NSFR requirement is applicable as of 2018, with a phase-in period.

[4] Capital-Asset-Market Risk-Earnings-Liquidity and Business Strategy-Control-Organizational Depth-Management.

- *Consolidated supervision.* The group structure of parts of the Kuwaiti banking sector—Islamic banks can be at the heart of complex structure, and banks can be owned by a mixed group—can complicate the task of the supervisor. There is no clear framework to deal with banks that are part of a (banking) group. In addition to encouraging Islamic banks to simplify their group structure, the CBK has developed a practice of consolidated supervision of banks and relies on its de facto power to access information related to activities of parent and affiliated companies to satisfy itself that risks stemming from group structures are well monitored. It would benefit from seeing those powers to collect information on group entities formalized and enhanced.

- *Cross-border supervision*. CBK communications with the host supervisors of Kuwaiti banks are mostly carried out on an ad hoc basis, although the CBK has one formalized Memorandum of Understanding (MOU) with the China Banking Regulatory Commission. There are no supervisory colleges, although for GCC counterparts, the GCC quarterly meeting provides a platform for supervisory authorities to exchange information. To strengthen cross-border supervision, the authorities should conclude MOUs with relevant foreign supervisory authorities, resume inspection programs as planned, and increase their frequency and depth.

15. The regulatory framework for Islamic banks is adequate and could be upgraded to clarify the respective role of the CBK and Shariah boards on issues related to Islamic finance.[5] Conventional and Islamic Banks are subject to the same supervisory framework and follow International Accounting Standards. The framework is, however, adjusted for Islamic banks: the CBK has adopted the IFSB standards for capital requirements;[6] it has developed liquidity management instruments based on Tawarruq contracts; and it has established fit and proper criteria for Shariah boards members and Islamic bank staff in charge of Shariah compliance. The respective roles of the CBK and Shariah boards on issues related to Islamic finance could, however, be clarified. Currently, cases of diverging opinions related to Shariah matters among members of the SSB are settled by the Fatwa Board in the Ministry of Awqaf and Islamic Affairs. This situation could expose the CBK to any final decision conflicting with financial stability. Current efforts to set up a centralized Shariah Board in the CBK, with the ability to expedite the resolution of divergences between bank Shariah boards, are commendable and could promote consistency across SSBs.[7]

[5] The regulatory framework for Islamic banks was assessed against the Core Principles for Islamic Finance Regulation (Banking Sector).

[6] The framework distinguishes between profit-equalization reserves belonging to the shareholders and to investment account holders.

[7] Since the FSAP, the authorities have proposed draft amendments to the CBK law establishing a centralized Shariah Board at the CBK.

Capital Markets

16. The CMA supervisory approach is effective but could be strengthened and would benefit from moving to an enhanced risk-based approach. The CMA joined the IOSCO in 2017; it has issued most of the regulations needed for market participants and capital market products, has active off- and on-site supervision programs and has taken enforcement action through its disciplinary panel and the external Capital Markets Court. It effectively fulfills all the essential regulatory and supervisory functions. Further developments should include stronger rules on *licensing requirements*, to limit licensed participants to activities within the purview of CMA; enhanced clarity regarding the *perimeter of products* that licensed brokers are allowed to offer to clients; and introduction of a *regulation for local credit rating agencies*. In addition, although the supervisory approach of the CMA is comprehensive in terms of the areas and entities to investigate, it should consider moving from a mainly compliance-based approach towards risk-based supervision. This would entail identification and management of systemic risks arising in the capital market, and regularly reviewing the perimeter of regulation.

B. Oversight and Management of Systemic Risks

17. The authorities have made considerable progress in strengthening the macroprudential policy framework since the 2010 FSAP. While there is no formal macroprudential authority, the CBK has been conducting macroprudential policy effectively: it has established an FSO, which has been publishing annual financial stability reports since 2012. In addition to implementing the Basel III regulations for capital and liquidity adequacy, it has broadened its macroprudential tools (Appendix II), actively used forward-looking loan loss provisioning, and introduced sectoral tools. In parallel, the CMA has been strengthening the oversight of ICs. Remaining on the CBK's agenda is the finalization of the Counter Cyclical Buffer (CCB) and Domestic Systemically Important Banks (D-SIB) framework, including the publication of a buffer guide, and measures to ensure international reciprocity in CCB regulation. The CBK should also consider disclosing the identification methodology for D-SIBs, with a view to enhancing the communication of policy intention, strengthening its signaling effect, and increasing policy impact.

18. The responsibility of financial stability should be explicitly assigned, and a formal coordination mechanism established. The CBK does not have an explicit financial stability mandate, and though it has broad powers to collect information to monitor systemic risks, including from non-regulated entities, information sharing with other institutions is constrained by law. Given the multiple agencies overseeing the financial sector, and historically close relationship between financial stability and fiscal policy, a formal inter-agency coordination mechanism would be useful to foster collective policy actions. The planned FSC is a welcome step in that direction. It will be important to assign the CBK a clear financial stability mandate and a lead role in inter-agency information sharing, ensure that the FSC membership covers all relevant institutions, and grant it the power to recommend policies to committee members. A comply or explain mechanism would be useful to ensure transparency and accountability. The CBK should play a leading role in the committee, given the dominance of banks in the financial system.

19. Going forward, the CBK could focus on calibrating its macroprudential tools to enhance their effectiveness and should maintain its leading role in filling data gaps. The countercyclical capital buffer (CCB) stands ready to be activated, and the CBK has put in place targeted sectoral tools (cap on loan-to value (LTV), debt service-to-income (DSTI) ratios; and sectoral risk-weights). Calibration would require the authorities to continue their efforts to fill data gaps, including on the distribution of LTV and DSTI ratio over time and on household debt. The availability of a real estate price index would enhance transparency in the market, facilitate communications between the authorities and market participants, and strengthen market monitoring.

C. AML/CFT

20. Kuwait has made significant progress in enhancing its AML/CFT framework in recent years. Since its AML/CFT evaluation by the Middle East and North Africa Financial Action Task Force in 2011, main achievements have included the amendment of the AML/CFT Law in 2013, the adoption of a framework for implementing targeted financial sanctions in 2014, and the enhancement of the governance and operational capacity of the Financial Intelligence Unit (FIU). Kuwait's assessment against the current AML/CFT standard is scheduled to take place in 2021.

21. The authorities should focus on the effective implementation of a risk-based approach to AML/CFT, and of a targeted financial sanctions regime. The 2012 Financial Action Task Force (FATF) standard puts greater emphasis on a risk-based approach to AML/CFT, including for supervision. Kuwait complies with TF-related targeted financial sanctions and should implement the existing framework. Going forward, the authorities should adequately mitigate the ML/TF risks identified. They should finalize an AML/CFT action plan based on the findings of the risk assessment and share it with relevant stakeholders, adopt a risk-based approach to AML/CFT supervision, effectively implement TF-related targeted financial sanctions, and enhance the operational independence of the FIU.

FINANCIAL SAFETY NETS, BANK RESOLUTION, AND CRISIS MANAGEMENT ARRANGEMENTS

22. The CBK has been strengthening the crisis management framework and financial safety net arrangements. The lack of a special resolution regime for banks and ICs, issues related to the blanket guarantee of deposits, and weaknesses in financial crisis framework were the main gaps identified in the 2010 FSAP. Since then, the authorities have worked toward strengthening the legal framework for bank insolvency, which is incorporated in the draft corporate insolvency law; they have improved the framework for ELA; and the CBK is contemplating the establishment of a dedicated unit for crisis management and resolution issues.

23. Formally designating the CBK as a resolution authority and attributing it an explicit responsibility to maintain financial stability would bolster the existing framework. The CBK has a *de facto* mandate to maintain financial stability. It has powers to impose restrictions on banks

and require remedial actions when they fail to meet regulatory requirements or come under stress. Banks are also required to prepare contingency plans as part of annual Pillar II exercises.

24. The CBK should strengthen its powers to deal with troubled banks. In particular, the legal framework should clearly authorize the CBK to assume control of a non-viable bank and should allow it to address a range of bank distress situations. This should be supported by enhancements to the triggers system, including the establishment of explicit triggers for entry into resolution; and by requirements for all D-SIBs and medium-sized banks to maintain recovery plans. Finally, the ELA policy framework could be strengthened, through a clear definition of the terms and conditions of the ELA window, and by anchoring the ELA to a statutory objective of promoting financial stability in the CBK Law.[8]

25. The blanket deposit guarantee should, as a priority, be gradually unwound and replaced with a suitably structured DIS, once the pre-conditions are met. At the moment, all deposits are covered by a guarantee reintroduced in 2008. This arrangement contributes to financial stability, in a legal and constitutional environment that is not organized yet to accommodate swift corrective action or resolution for troubled financial institutions. However, it may generate moral hazard and reduce market discipline on bank; it is also costly to the government. The future DIS, which should be capped at a level that adequately protects retail depositors, could start as a simple "paybox" scheme—where the deposit insurer merely collects funds and pays out to depositors—and could in due time be expanded to include purchase and assumption transactions. Given the structure of the financial sector, it should also be designed with a component for Islamic Banks. There are challenges in developing Shariah-compliant solutions for both DIS and recovery and resolution framework, which could understandably delay the unwinding of the blanket deposit guarantee (Box 1).[9]

[8] Following the FSAP mission, the authorities have prepared a draft law assigning the CBK an explicit financial stability mandate and creating a Financial Stability Committee.

[9] The IFSB's has called regulators to allow conventional deposit protection schemes to cover deposits with Islamic banks, until a Shariah-compliant solution is identified.

Box 1. Financial Safety Nets and Islamic Finance

Sustaining Shariah compliance at every stage of recovery and resolution (RR) of an Islamic bank presents complexities. Those include notably (i) Shariah compliance of the sale of debt-type contracts (e.g., Murabahah) either at a discount or to non-Islamic entities; (ii) need to obtain the consent of the Investment Account Holders (IAHs) to carry out a range of actions that affect their rights and interests (e.g., identifying their share of assets); (iii) provisions to enable IAHs to exercise their rights; (iv) need to ensure Shariah compliance of liquidity support mechanisms and of various resolution tools (e.g., bail-in). In addition, resolutions require to harmonize creditor hierarchies with Shariah and to address the uncertainty over the treatment of profit-sharing investment accounts (PSIAs) based on Muḍarabah or Wakalah contracts, due to the conflict between their contractual terms and their actual risk-return profile.

Kuwait has achieved progress on a number of aspects of a RR framework for Islamic banks. The CBK allows the issuance of eligible Additional Tier 1 capital instruments with bail-in features based on Murabahah contracts. Kuwait also covers investment accounts under its blanket guarantee for all types of bank deposits.

The authorities should consider establishing a dedicated RR regime for Islamic banks. The key issues to be addressed include (i) determining the set of available recovery and resolution tools; (ii) ensuring Shariah-compliance of public declarations of insolvency by the resolution authority; (iii) formulating guidelines on the pre-positioning of contracts to facilitate the execution of recovery and resolution tools (e.g., the sale of Murabahah and Tawarruq contracts); (iv) achieving clear identification of the ownership of profit equalization and investment risk reserves in resolution, through disclosure requirements or by specific contractual terms of the investment account; (v) and, enabling potential avenues for group support in a Shariah-compliant manner.

It is important for the CBK to identify the necessary pre-positioning measures and provide guidance for implementing them. These pre-positioning measures involve: (i) the pre-approval of recovery and resolution plans of Islamic banks by their SSBs; (ii) issuing Basel III eligible capital using Mudarabah or Wakalah contracts; (iii) introducing disclosures on whether product-level requirements of an Islamic bank would continue to be maintained by a potential conventional buyer; (iii) identifying the types of contracts that need prior consent for a sale, and whether such consent can be sought at contract inception; (iv) taking the actions required to enable sales of assets in PSIAs as a recovery/resolution option, including contractual insertions into PSIA contracts that give IAHs consent to novate or transfer to a suitable new Muḍarib in the event of a predefined stress.

MANAGING SYSTEMIC LIQUIDITY

26. The CBK monetary policy framework is oriented towards maintaining the exchange rate peg versus an undisclosed currency basket. The CBK sets a discount rate and offers facilities that establish an interest rate corridor (ranging from unremunerated deposits to the overnight lending facility). The overall excess liquidity generated by oil proceeds and government expenditure

is reflected in banks' balance sheets: banks easily meet the regulatory liquidity ratios and carry comfortable buffers, which has supported their resilience to recent shocks. Excess liquidity also explains the limited interbank activity and the CBK's market operations, which are focused on banks meeting their prudential requirements.

27. The CBK has long-standing experience and is well-equipped to absorb the excess liquidity that stems from the country's ample oil revenues. Several tools are available to manage liquidity, ranging from three- and six-month CBK bills, which are tendered regularly; to one-week and one-month time deposits offered by the CBK to banks, at its discretion, on a bilateral basis. The CBK also has facilities to provide liquidity via overnight, one-week or one-month repos; three-month FX swaps; a discount and rediscount system of commercial papers for terms up to one year; and overnight lending (the standing facility). These are seldom used, or tested, by the banks.

28. Improvements could include a refinement of the liquidity forecasting framework and a strengthening of both liquidity-absorbing and supplying tools. In due time, this would support a reduction in excess liquidity that will be needed for financial markets to develop and for banks to manage their liquidity in the interbank market. It would also help alleviate the heavy responsibility that is de facto put on the central bank, which is currently the first port of call in the event of non-emergency liquidity needs—a role normally assigned to money or bond markets. Regular testing exercises of both regular liquidity and ELA procedures with the banking sector could also help ensure the framework is operational at all times.

29. Further developments in the liquidity management framework could include a reserve requirement and a streamlining of the CBK's monetary operations framework. At the moment, the CBK implements five liquidity ratios and one of these, the regulatory liquidity ratio, operates as a *de facto* reserve requirement. Should the CBK decide to rationalize those liquidity ratios, it could consider setting up a fully-fledged reserve requirement ratio. The CBK's monetary operations framework has served the CBK well and could be streamlined in time, while meeting its objectives and retaining discretion. A streamlined framework would include a deposit rate, a discount rate and a lending facility, which would set the boundaries for market interest rates in support of the exchange rate peg. Introduction of a daily OMO could also be considered as part of the toolkit for short-term liquidity management.

DEVELOPMENTAL CHALLENGES

A. Developing Capital Markets

30. The CMA has launched an ambitious plan to support capital markets development. The first phase included T+3 settlement, delivery-versus-payment, segregated market tiers, standardized tick sizes and market makers. The completion of the first phase led to the elevation of Kuwait by FTSE Russell to Emerging Market status. Those measures, however, have yet to show their full impact; as an example, although a market maker framework has been created, no intermediaries have registered as market makers yet. Further success will require establishing appropriate market conditions and involving a broad range of stakeholders, beyond the CMA itself. To develop the

government debt market, the authorities will need a regular issuance calendar, directed by an asset-liability management strategy, and a market-based auction process. Priorities in the *corporate securities market* should include developing market making and setting up an OTC market for listed corporate securities subject to appropriate governance and disclosure regulations. Finally, the authorities should facilitate a *short-term commercial paper market* based on a shelf registration program

B. Promoting Access to Finance for SMEs

31. The financial inclusion of SMEs is an important priority of Kuwait Vision 2035. SMEs represent an important source of job creation and economic diversification but in Kuwait, as in many countries, their access to credit is constrained. A 2017 WBG Business Confidence survey based on a sample including mostly mid-sized and small enterprises found access to finance to be the second largest constraint to business, after access to permits and licenses. This is reflected in the low share of bank credit to SMEs, around 2.5 percent of total bank loans in 2017.

32. Strengthening existing institutions, supporting the market for SME finance, and expanding financial instruments could support SME financial inclusion. A first step would be for the authorities to adopt a uniform national definition for SMEs, to support analytical and policy work. The National Fund for SME Development should refocus its activities away from direct financing, towards on-lending through financial intermediaries; it could also develop risk-sharing instruments, such as a partial credit guarantee scheme.

- Policies to support the market for SME finance are needed. These include the adoption of a new secured transaction law and the establishment of an electronic registry of movable assets; enhancements to the credit bureau infrastructure, including the establishment of a fully-fledged credit bureau for commercial lending; and revamping the insolvency law. The authorities could also consider a gradual relaxation of the interest rate cap to unlock bank lending to SMEs.

- The authorities may also want to consider fostering competition through alternative financial instruments and players, including fintech—provided they are appropriately regulated, notably to avoid consumer protection concerns. Other alternatives to bank finance include the expansion of leasing and the introduction of factoring. Finally, financial products and services should reflect SME's changing financial needs throughout their life cycle, with the promotion of patient capital and venture capital addressing the needs of the smallest, newest SMEs, potentially with the support of the National Fund.

Table 3. Kuwait: Selected Economic Indicators, 2014–24

					Est.	Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Oil and gas sector											
Total oil and gas exports (billions of U.S. dollars)	97.6	48.5	41.5	49.6	65.7	58.3	59.6	60.2	60.9	62.1	63.6
Average oil export price (U.S. dollars/barrel)	96.5	49.0	41.0	53.4	70.6	61.5	61.4	60.6	60.1	60.2	60.6
Crude oil production (millions of barrels/day)	2.87	2.86	2.95	2.70	2.74	2.79	2.86	2.93	2.99	3.05	3.11
	(Annual percentage change, unless otherwise indicated)										
National accounts and prices											
Nominal GDP (market prices, in billions of Kuwaiti dinar)	46	34	33	36	43	41	43	45	47	49	52
Nominal GDP (market prices, in billions of U.S. dollars)	163	115	109	120	141	137	143	150	156	163	172
Real GDP [1]	0.5	0.6	2.9	-3.5	1.7	2.5	2.9	2.9	2.5	2.7	2.9
Real oil GDP	-2.1	-1.7	3.9	-7.2	1.2	2.0	2.5	2.5	2.0	2.0	2.0
Real non-oil GDP	4.9	4.2	1.4	2.1	2.5	3.0	3.5	3.4	3.2	3.7	4.0
CPI inflation (average)	3.1	3.7	3.5	1.5	0.7	2.5	2.7	4.7	3.9	3.0	3.0
CPI inflation (eop)	3.0	3.0	2.6	1.0	1.1	2.8	3.0	6.0	3.2	2.8	2.8
Unemployment rate (Kuwaiti nationals)	5.0	4.7	3.3	…	…	…	…	…	…	…	…
	(Percent of GDP at market prices)										
Budgetary operations [2]											
Revenue	67.4	52.3	52.8	58.9	60.9	58.6	58.0	58.7	57.2	55.8	54.6
Oil	51.9	35.4	34.5	38.0	43.7	40.1	39.2	37.8	36.8	35.9	35.1
Non-oil, *of which:*	15.4	16.9	18.3	20.9	17.1	18.4	18.9	20.8	20.4	19.9	19.4
Investment income	10.6	13.3	14.6	16.5	13.0	13.9	14.3	14.7	13.9	13.5	13.0
Expenditures [3]	48.8	52.7	52.3	50.8	48.3	50.5	51.0	51.9	51.9	51.7	51.1
Expense	43.3	45.0	44.2	42.6	40.6	42.3	42.6	43.3	43.4	43.1	42.7
Capital	5.4	7.7	8.1	8.2	7.7	8.2	8.4	8.6	8.6	8.5	8.4
Balance	18.6	-0.3	0.5	8.1	12.6	8.0	7.0	6.7	5.2	4.2	3.4
Balance (after transfer to FGF and excl. investment income)	2.3	-17.5	-17.9	-12.6	-5.2	-10.4	-11.6	-12.3	-13.0	-13.5	-13.7
Domestic financing (net)	-0.7	-1.2	6.5	1.8	-2.7	2.4	2.3	2.2	1.4	2.0	1.9
External financing (net)	-1.6	18.8	11.4	10.8	7.9	8.0	9.3	10.1	11.6	11.5	11.8
Non-oil balance excl. investment income (percent of non-oil GDP) [4]	-102.5	-88.3	-83.8	-86.5	-87.8	-85.7	-84.7	-81.3	-78.9	-77.2	-75.3
Excluding oil-related subsidies and benefits (percent of non-oil GDP)	-81.2	-77.5	-74.8	-77.4	-77.2	-76.4	-75.8	-72.8	-70.8	-69.3	-67.7
Total gross debt (calendar year) [5]	3.4	4.7	10.0	20.7	14.8	17.8	21.0	26.2	31.1	34.7	38.4
	(Percent change; unless otherwise indicated)										
Money and credit											
Net foreign assets [6]	3.6	-2.1	8.7	-3.1	10.0	2.7	5.6	7.5	6.1	6.5	6.9
Claims on nongovernment sector	5.2	7.6	2.9	2.8	4.1	6.1	6.7	8.0	7.2	7.1	7.4
Kuwaiti dinar 3-month deposit rate (year average; in percent)[7]	0.8	0.8	1.1	1.5	2.3	…	…	…	…	…	…
Stock market unweighted index (annual percent change) [7]	-3.8	-16.5	-0.2	12.8	11.8	…	…	…	…	…	…
	(Billions of U.S. dollars, unless otherwise indicated)										
External sector											
Exports of goods	104.5	54.5	46.5	55.1	71.6	64.6	66.3	67.3	68.4	70.2	72.3
Of which: non-oil exports	7.0	6.0	5.0	5.6	5.9	6.3	6.7	7.1	7.5	8.1	8.7
Annual percentage change	-2.8	-14.1	-15.7	10.6	6.6	6.2	6.1	6.1	6.1	7.1	8.1
Imports of goods	-27.0	-26.5	-27.0	-29.5	-31.3	-32.5	-33.7	-35.2	-36.6	-38.2	-40.1
Terms of Trade (ratio, annual percent change)	-12.2	-42.5	-12.5	21.9	23.1	-11.0	0.1	-0.7	-0.2	-0.3	0.1
Current account	54.4	4.0	-5.1	7.1	18.0	10.2	11.4	11.9	10.4	10.0	9.5
Percent of GDP	33.4	3.5	-4.6	5.9	12.7	7.4	8.0	8.0	6.6	6.1	5.5
International reserve assets [8]	32.3	28.3	31.2	33.5	37.0	37.2	38.8	41.1	43.0	45.3	47.9
In months of next year's imports of goods and services	7.4	6.5	6.5	6.6	7.0	6.8	6.8	7.0	7.0	7.1	7.2
Memorandum items [7]:											
Exchange rate (U.S. dollar per KD, period average)	3.52	3.32	3.31	3.31	3.31	…	…	…	…	…	…
Nominal effective exchange rate (Percentage change)	1.5	3.1	0.9	0.8	-0.4	…	…	…	…	…	…
Real effective exchange rate (Percentage change)	2.0	5.0	2.7	0.8	-2.7	…	…	…	…	…	…

Sources: Data provided by the authorities; and IMF staff estimates and projections.

[1] Calculated on the basis of real oil and non-oil GDP at factor cost.

[2] Based on fiscal year cycle, which starts on April 1 and ends on March 31.

[3] Starting FY2016/17, there has been a reclassification of expenditure items.

[4] Excludes investment income and pension fund recapitalization.

[5] Excludes debt of Kuwait's SWF related to asset management operations.

[6] Excludes SDR holdings and IMF reserve position.

[7] For 2018, based on latest available data.

[8] Does not include external assets held by Kuwait Investment Authority.

Table 4. Kuwait: Financial Soundness Indicators, 2011–Sept 18

(In percent)

	2011	2012	2013	2014	2015	2016	2017	Sep-18
Capital adequacy								
Regulatory capital to risk-weighted assets	18.5	18.5	18.9	16.9	17.5	18.6	18.4	18.0
Regulatory Tier I capital to risk-weighted assets	16.9	16.0	17.1	15.6	16.1	16.7	16.5	16.1
Capital to assets	12.4	12.6	12.2	11.1	11.8	12.8	12.8	12.4
Loan composition and quality								
Oil/gas	1.1	1.6	1.5	2.2	2.4	3.4	4.3	5.2
Trade	10.5	12.1	13.0	12.8	11.7	11.8	11.9	11.3
Industry	7.1	7.9	7.8	7.3	6.9	6.7	6.5	6.3
Construction	12.1	12.6	12.2	11.9	12.0	12.3	11.6	11.2
Real estate	19.6	19.2	18.9	18.5	17.5	16.6	16.6	15.5
Equity purchase loans (corporate)	5.8	3.5	3.4	3.0	3.0	2.9	2.6	2.8
Agriculture/fishing	0.2	0.3	0.3	0.4	0.3	0.3	0.2	0.4
Financial Institutions	13.1	11.2	10.4	11.9	14.0	13.3	11.8	12.4
Of which: investment companies	6.1	4.3	4.0	3.1	2.9	2.6	2.0	2.1
Of which: banks	3.7	6.7	5.7	8.0	10.5	9.8	8.8	9.3
Public services	1.7	2.6	1.8	2.2	2.2	1.8	1.8	1.8
Households	17.0	19.4	20.0	20.2	20.5	20.7	20.9	21.5
Of which: credit card advances	0.5	0.5	0.5	0.5	0.5	0.5	…	0.4
Of which: installment loans	12.9	13.2	14.4	14.8	15.5	16.1	16.8	17.7
Of which: consumer loans	2.2	2.9	3.0	2.9	2.5	2.4	2.3	2.1
Of which: equity purchase loans (individuals)	1.4	2.9	2.6	2.6	2.5	2.2	1.8	1.7
Other	11.8	9.5	10.7	9.7	9.6	10.3	11.7	11.7
Gross non-performing loans to total loans	7.3	5.2	3.6	2.9	2.4	2.2	1.9	2.0
NPLs net of specific provisions to total loans net of specific provisions	5.3	3.8	2.5	1.9	1.6	1.5	1.3	1.4
Total provisions to gross NPLs	…	95.1	134.6	163.9	204.8	236.9	230.2	214.3
NPLs net of specific provisions to Tier I capital	28.7	51.6	34.0	11.2	9.5	8.3	7.2	7.9
Loans to shareholders, parent companies, & directors to total loans	2.3	2.6	6.3	3.6	3.7	3.8	3.7	3.0
Large exposures to Tier I capital	105.3	100.4	87.2	97.1	101.1	94.7	105.5	112.7
Specific provisions to gross loans	2.1	1.4	1.2	1.0	0.8	0.7	0.6	0.7
Profitability								
Return on Average Assets (ROAA)	1.1	1.2	1.0	1.1	1.1	1.1	1.2	1.3
Return on Average Equity (ROAE)	8.1	9.1	7.4	8.7	8.8	8.5	9.5	10.4
Net interest income to gross income	47.6	48.1	49.9	47.1	47.6	49.9	49.5	49.3
Non-interest income to gross income	33.1	33.4	32.8	30.8	30.5	22.1	21.9	20.0
Trading and foreign exchange income to gross income	10.0	14.9	10.4	12.5	12.1	6.8	6.0	5.0
Non-interest expenses to gross income	36.1	34.0	37.2	33.4	31.8	29.6	27.7	25.0
Non-interest expenses to average assets	2.1	1.9	1.9	1.6	1.5	1.4	1.4	1.4
Personnel expenses to non-interest expenses	36.8	39.0	41.7	41.1	49.3	53.4	56.0	55.3
Liquidity								
Core liquid assets to total assets [2]	22.1	21.0	22.5	24.7	24.3	24.1	23.7	22.9
Core liquid assets to short-term liabilities	36.3	34.8	30.3	32.7	31.7	31.4	30.9	29.8
Liquid assets to total assets	26.5	27.3	25.4	30.7	29.8	30.1	31.0	30.9
Liquid assets to short term liabilities	43.7	45.2	34.1	40.6	38.9	39.1	40.5	40.3
FX- loans to total loans	25.8	28.1	28.2	26.0	30.5	29.1	30.6	30.0
FX- deposits to total deposits	33.8	34.6	30.7	37.0	38.8	33.2	37.8	36.0
FX- liabilities to total liabilities	11.4	14.5	18.9	18.8	30.2	…	…	28.8
Deposits to assets	58.3	63.3	62.2	59.4	59.2	58.4	59.1	58.2
Loans to deposits	110.9	100.5	99.5	103.6	108.3	108.9	106.5	109.3
FX- loans to FX-deposits	84.6	81.5	91.4	72.8	85.3	95.7	86.3	91.2
Sensitivity to market risk								
Net open FX position (overall) as percent of Tier I capital	…	10.2	8.1	7.7	18.0	…	…	…
Off-balance sheet operations as percent of assets	25.4	26.3	27.8	28.5	28.2	32.1	32.2	32.0
Gross asset position in derivatives as a percentage of tier I capital	…	41.1	65.3	75.0	139.7	…	…	…
Gross liability position in derivatives as a percentage of tier I capital	…	40.9	65.1	75.0	139.7	…	…	…
Equity exposure to capital	43.7	37.5	35.3	29.6	28.1	24.8	21.9	22.1

Source: CBK.

[1] Data are on consolidated basis.

[2] Core liquid assets include: cash and cash equivalents, deposits with CBK, government securities, CBK bills, deposits with banks, certificates of deposit with other banks which mature within three months.

Appendix I. Risk Assessment Matrix

Source of Risks	Overall Level of Concern	
	Relative Likelihood/Time Horizon	**Expected impact on financial stability**
Prolonged period of lower oil prices	**Low/Short to Medium Term**	**Medium/High** • *Liquidity risks*: Lower oil prices would affect liquidity in the banking system, as would larger domestic issuances to cover fiscal financing needs. • *Asset quality*: A softening of equity and real estate markets would impact banks' asset quality. • *Confidence*: Private-sector confidence would likely decline, potentially leading to an erosion of deposits and increasing funding costs. • *Concentration risks* would persist if the private sector is being crowded out because of higher domestic issuances to cover fiscal financing needs. • *Second round effects* could materialize on growth, asset quality and bank liquidity.
Tighter global financial conditions	**High/Short Term**	**Low/Medium** • *Funding, market and credit risks:* financial institutions would face tighter funding conditions both domestically and abroad. The government also has begun tapping international markets and could see the cost of funding increase for international issuances, with spillover effects on the funding costs of financial institutions.
Severe property price correction	**Low/Short to Medium Term**	**Medium/High** • *Asset quality*: Although banks have substantial loss-absorption capacity in terms of capital and loan-loss provisioning, the losses could be significant given high exposures to the real estate sector, both directly and indirectly through collateral and common exposures.
Regional geopolitical shocks	**High/Short to Medium Term**	**Medium** • *Confidence*: Investor confidence across the GCC could be affected. Subsequent capital outflows may lead to an erosion of the deposit base; higher financing costs would lead to tighter funding conditions. • *Asset quality:* Risks could increase for banks if growth slows down as a result of the confidence shock and leads to an accumulation of nonperforming assets.

Appendix II. Prudential Tools and Instruments

Policy tool	Objective	Description	Adoption Date	Implementing Agency
Countercyclical capital buffer	Broad-based	0-2.5 percent of RWAs. Not yet activated	December 2014	CBK
Capital conservation buffer	Broad-based	2.5 percent of RWAs	December 2014	CBK
Leverage ratio	Broad-based	A minimum of 3 percent	December 2014	CBK
Forward-looking loan loss provisioning	Broad-based	Forward-looking provision	March 2007	CBK
Cap on credit growth (Maximum lending limit)	Broad-based	Lending < 90% of qualifying funding	July 2004	CBK
Cap on LTV ratio	Household sector Corporate sector	Applied to residential property investment -50% (underdeveloped land) -60% (existing property) -70% (construction use only)	November 2013	CBK
Cap on LTI ratio	Household sector	Installment loans <KD 70,000 Consumer loans <KD 15,000 < 15 times of net monthly salary	April 1996	CBK
Cap on DSTI ratio	Household sector	Monthly installment <40% of net monthly salary <KD 15,000 <30% of net monthly income (retired)	April 1996	CBK
Limits on amortization periods	Household sector	Consumer loans < 5 years (*) Installment loans < 15 years *since June 2004 (initially 3 years)	April 1996	CBK
Limits on foreign-currency-denominated loans	Household sector Corporate sector	Not allowed unless the source of repayment is in the same currency	November 1999	CBK

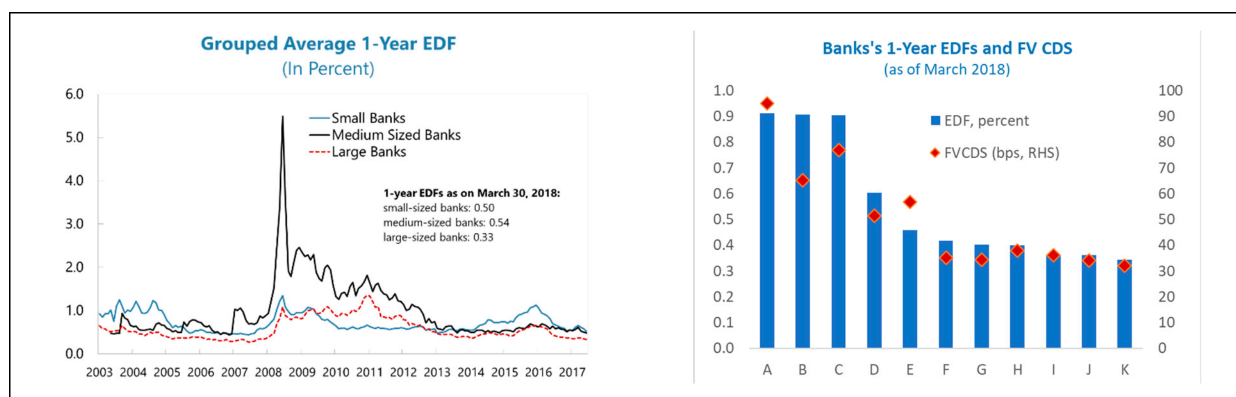
Policy tool	Objective	Description	Adoption Date	Implementing Agency
Sectoral capital requirements	Corporate sector	Risk weights: -SMEs: 75% -Real estate for trading purposes: 150% -Share for trading purposes: 150%	November 2013	CBK
Limits on KD loans to non-residents	Corporate sector	loans < KD 40,000,000, and granted against contract with the Kuwaiti government	May 1995	CBK
LCR	Liquidity	Phased in over 4 years: 70% (2016), 80% (2017), 90% (2018), 100% (2019)	January 2016	CBK
Liquid assets requirement	Liquidity	18% (*) ≤ liquid assets/customer deposits *since 2008 (initially 20%)	December 1997	CBK
Limits on maturity mismatches	Liquidity	Limits on cumulative gaps: (cash outflows-cash inflows)/customer deposits 10% (7days), 20% (1month), 30% (3months) 40% (6months)	October 1997	CBK
NSFR	Liquidity	100%<NFSR	January 2018	CBK
Cap on LTD ratio (Maximum lending limit)	Liquidity	Lending < 90% of qualifying funding	July 2004	CBK
Limits on foreign exchange positions	Liquidity	Trading limits set by the CBK for intraday and overnight positions (both gross and net)	September 1994	CBK
Capital surcharges for DSIB	Structural	0.5%-2.0% of RWAs	June 2014	CBK
Single borrower limit	Structural	15% of capital	April 1995	CBK
Limits on large exposures	Structural	Total exposures to large borrowers (exceeding 10% of capital) < 400% of capital	April 1995	CBK
Limits on sectoral exposures	Structural	Share lending <10% of total loans <25% of capital	May 1997	CBK

Appendix III. Contingent Claims Analysis of the Banking Sector

1. **For the 10 Kuwaiti banks that are publicly traded, equity prices can be used to derive measures of default risks.** This information, provided by Moody's CreditEdge database, can be used to provide additional background to stress tests. Estimates of expected default probabilities (EDF) and fair value CDS (FVCDS) from Contingent Claim Analysis (CCA) derivatives pricing model show that Kuwaiti banks are healthy and resilient. The results corroborate the conclusions of the stress-testing exercise.

2. **The estimates are based on Moody's EDF model,[1] a structural credit-risk model which based on an option-pricing approach to credit risk.** The three primary drivers of the model are asset value, default point, and asset volatility. Equity, equity volatility and default barrier information is used to derive a Merton-type risk indicator—a metric that summarizes all credit risk-related information. This "distance to distress" (DD) can then be mapped to the probability space to obtain the EDF metric for both corporates and financials.

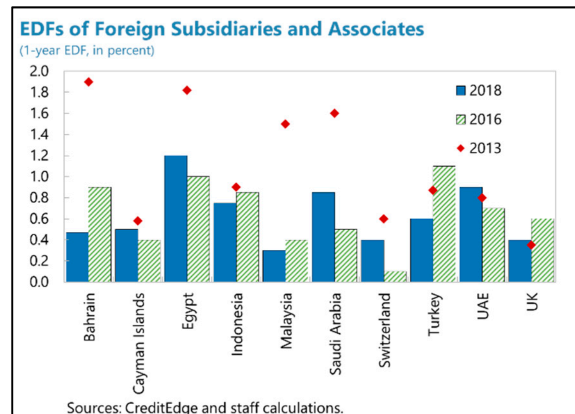
3. **The estimated EDFs for 10 Kuwaiti banks, for which data are publicly available, show that, following the spike in EDFs during the global financial crisis, the 1-year average EDF has declined for all banks and has remained very low for both large and medium-sized banks over the past 4 years.** At end-March 2018, the average EDF for large, medium and small-sized banks stood respectively at 0.33, 0.54, and 0.5 percent. As investment grade or near investment grade ratings have EDFs of less than 0.8 percent, this implies that all of Kuwait's banks in the sample are currently in a "safe zone."



[1] See Moody's "Credit Risk Modeling of Public Firms: EDF9" for the detailed description of modeling methodology. For further discussion of structural models based on option-pricing theory, see Crosbie and Bohn (2003), Ranson (2005), Caouette et. al. (2008), and Bohn and Stein (2009).

4. Fair value credit default swaps (FVCDS) spreads can also be used to measure the "true" credit risk of financial institutions. The FVCDS derived using CCA by Moody's Analytics are typically higher than market-based CDS spreads, reflecting the fact that default risk can be underpriced in market-based CDS due to the existence of either explicit or implicit government guarantees.

5. FVCDS, EDFs, and stress-test results all point to the same conclusion that Kuwaiti banks are resilient. They also provide broadly consistent relative ranking of their risk. Kuwaiti banks are becoming increasingly global, and while risks stemming from the potential default of their foreign associates and/or branches are small, those exhibit a level of volatility that warrants the attention of the supervisor.



Appendix IV. Previous FSAP Recommendations

Immediate Measures	Agency	Implementation	Update
Financial sector oversight			
Clarify regulatory and supervisory responsibilities for financial institutions between the CBK, CMA, and MOCI and initiate coordination for transition process to new oversight architecture	CBK/CMA/MOCI	Completed	An MOU was signed between CBK and CMA. Amendments to the MOU regarding the joint issues between MOCI and the CBK are under consideration.
Perform periodic stress tests of real estate and other major sectoral credit risks concentrations and review existing assessment of the way banks consider these risk concentrations in their ICAAP.	CBK	Completed	The FSO performs regular stress tests on all banks. The Supervision Sector revises stress tests and ICAAP prepared by banks.
Extend viability assessment to all systemically important ICs.	CBK	Completed	In 2011, the supervisory responsibility over ICs was shifted to the CMA. CBK issued a circular on Supervisory Standards for Financing Companies (26/01/2012). CMA revoked a number of licenses for ICs. The systemic importance of ICs declined.
Complete integration of ICAAP in on-site manual and start on-site examination on ICAAP in one bank as a pilot project.	CBK	Completed	The on-site supervision department prepared a manual for the ICAAP, which is used in on-site examinations.
Finalize qualitative and quantitative staffing enhancement program for the banking supervision department.	CBK	Completed	The qualitative and quantitative capabilities of all staff working in the Supervision Sector is developed on regular basis.

Immediate Measures	Agency	Implementation	Update
Short-term measures (3-9 months)			
Financial sector oversight			
Enhance framework for macro-prudential surveillance by establishing the FSU and initiate integrated supervision of systematically important sectors	CBK	Completed	CBK established the FSO and publishes annual financial stability reports. A 2015 IMF TA was provided for the development of the macroprudential toolkit.
Strengthen corporate governance rules by applying “fit and proper” test on board and management of new conventional banks	CBK	Completed	Article (68) of Law NO. (32) of 1968 refers to the conditions to be met by a person who becomes a board Member of a bank or executive authority, in addition to the resolution passed by the Central Bank of Kuwait Board of directors in this respect.
Issue a directive on conflict of interest requiring board members or senior management and staff to abstain from participating in decisions on credit granting in their favor and reduce the individual and aggregate limit for credit to related parties.	CBK	Completed	CBK has issued "Instructions concerning Rules and Standards of Corporate Governance in Banks" in 20/6/2012. The on- and off-site departments are in charge of following-up.
Continue the migration process from compliance-based supervision to risk-based supervision	CBK	Completed	A risk-based supervision system has been implemented, in both on-site inspections, and the off-site surveillance system.
Introduce quantitative and qualitative regulation to better monitor ICs’ financial soundness and improve corporate governance. Develop new licensing regime for ICs.	CBK/CMA	Completed	CBK prepared a comprehensive study to evaluate and classify investment companies according to their risks, based on six qualitative factors. Corporate governance instructions for ICs were issued in September 2013 by the CMA.

Immediate Measures	Agency	Implementation	Update
Establish funding and operational arrangements for deposit insurance, including by introducing a cap at a level that adequately protects depositors, but provides incentives to conduct due diligence.	CBK/MOF	In Progress	A 2015 IMF TA provided advice on establishing a deposit insurance and resolution framework from 24/8/2015 to 4/9/2015. CBK is currently studying the options provided by the IMF.
Establish an MOU on financial crisis management between key agencies CBK, MOF, CMA, and KIA.	CBK/MOF/ CMA/KIA	In Progress	The draft corporate insolvency law incorporates the recommendations of a 2017 IMF TA on the crises management and resolution framework; it includes provisions for a FSC
Medium-term measures (1-2 years)			
Financial sector oversight			
Consider widening collateral acceptance for ELA operations.	CBK	Completed	Collateral acceptance was widened, under the Central Bank of Kuwait Board Resolution No. (91/377/2011). The list of guarantees, issued under Central Bank of Kuwait Board Resolution dated 17/02/1979, was annulled.
Establish a special resolution regime that sets out a set of distinct bankruptcy procedures for financial institutions. Implement the remaining recommendations from 2004 FSAP	CBK	In progress	A corporate insolvency law was drafted based on a WB-provided TA, which includes a separate chapter for financial institutions, based on a 2015 IMF TA.
Liquidity management and financial market development			

Immediate Measures	Agency	Implementation	Update
Formulate a long-term plan for debt/sukuk market development, and start implementing it with a short-term market	CBK/MOF	In progress	CMA prepared a four-stage market development plan for capital market development and implemented the first two stages.
Real estate sector			
Develop a real estate market information database	MOCI	In progress	The CBK has developed real estate price index for internal monitoring purposes.
Review the prudential regime for CRE, with a view of strengthening it	MOCI	Partially implemented	The CBK has raised risk weight for real estate lending for trading purposes.
Insurance			
Enhance the visibility of the regulatory and supervisory function to develop effective supervisory process	MOCI	Not implemented	
Increase technical capacity of insurance department particularly regarding effective supervision	MOCI	Not implemented	
Restructure MTPL insurance to ensure that this compulsory product is sustainable, improves the reputation of the industry, and covers liabilities appropriately	MOCI	Not implemented	

Appendix V. Top-down Stress Test Matrix (STeM) for the Banking Sector: Solvency and Liquidity Risks wait

Domain		Assumptions
		Top-down by FSAP Team
BANKING SECTOR: SOLVENCY RISK		
1. Institutional Perimeter	Institutions included	• 10 largest banks
	Market share	• About 95 percent of banking sector assets
	Data and baseline date	• Supervisory data • Baseline date: 2017 Q4
2. Channels of Risk Propagation	Methodology	• Satellite models developed by the FSAP team • IMF MCM balance sheet stress test template (customized for Kuwait FSAP) • Reverse stress tests
	Satellite models for macrofinancial linkages	• Dynamic panel model for NPL projections (Fixed effect model; Arellano-Bover/Blundell-Bond model) • IMF balance sheet template for projections of other variables
	Stress test horizon	• 2017 Q4 – 2020 Q4
3. Tail shocks	Scenario analysis	Variables in the scenarios include: *oil price; interest rate; government expenditure* (to capture an important policy response given Kuwait's high buffer); *real GDP growth*. All variables are defined in real terms. • **Baseline scenario:** all variables follow the IMF WEO baseline projections (as of December 2017), except for real interest rate which is projected using a bivariate VAR model against real GDP growth. • **Adverse scenario:** features a "*gradual oil-price decline scenario*," where oil prices are assumed to fall to the 5th percentile of the distribution of real prices between 1980 and 2017. • **Severely adverse scenario:** features a "*sudden and persistent oil-price decline scenario*," where the oil price drop to the 5th percentile of the distribution of real prices between 1980 and 201.

Domain		Assumptions
		Top-down by FSAP Team
		In all scenarios, restricted *reduced-form* VAR models are used to pin down the paths of other variables that are consistent with the anchoring oil-price path. The VAR models are estimated using annual data back to the 1970s (excluding the Gulf War period, in which the data would severely distort the estimation). In particular, a trivariate-VAR model is used to project real GDP growth in the adverse and severely adverse scenarios (the other two variables being oil price and government expenditure); a bivariate-VAR model is used to project interest rate (the other variable being oil price), and a similar model is used to project government expenditure.
	Sensitivity analysis/one time add-on shock	All shocks occur over one year (2017 Q4 – 2018 Q4). Shocks include: • Case 1: • Interest rate hikes by 375 basis points. This is the largest one-year hike in the time series (1983 to 1984). • KWD depreciates against USD, Euro, Bahraini Dinar and Iraqi Dinar by 10, 30, 10 and 10 percent, respectively. These are the largest one-year drops since the beginning of the time series. • Counterparty concentration risk: all top three borrowers of each bank default, with 50 percent recovery. • Asset-class concentration risk: 10 percent of each bank's real estate exposures default, with zero recovery; and 10 percent of each bank's household exposures default, with zero recovery • Case 2: • Counterparty concentration risk: all top five borrowers of each bank default, with zero recovery. • Asset-class concentration risk: 20 percent of each bank's real estate exposures default, with zero recovery; and 20 percent of each bank's household exposures default, with zero recovery More justifications: The zero-recovery assumption in Case 2 accounts for the fact that the foreclosed assets take a long time to liquidate during a stress time, and the bank may become insolvent by the time the liquidation is completed.
4. Risks and Buffers	Risks/factors assessed (How each element is derived, assumptions)	• Credit losses • Losses from securities in the banking and trading books • FX risk • Counterparty concentration risk • Asset-class concentration risk
	Behavioral adjustments	• In the macro scenario-based solvency STs, RWAs are assumed to be constant. There are two countervailing effects: On the one hand, deleveraging, divestment strategies, and write-offs cause balance sheets to shrink and RWAs to reduce. On the other hand, in times of distress, default risks may increase and (expected) recovery rates may decrease, inducing RWAs to rise. The assumption of constant RWAs is equivalent to assuming that these two effects cancel out. • In counterparty and asset-class concentration analyses, RWAs are allowed to change. This is mainly to account for the fact RWAs are likely to immediately decrease under the shocks specified in the single-factor sensitivity analyses. For example, if all top five borrowers default with zero recovery, then the bank will likely recognize this loss and write off these exposures immediately, reducing the RWAs.

Domain		Assumptions
		Top-down by FSAP Team
		• When net profit was positive in the current period, banks are assumed to first use some of it to maintain stable CARs before paying dividends. • Other net income items, dividends, and taxes are based on macroeconomic scenarios and pre-determined rules.
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Changes in loan quality and provisions are based on satellite models. • Estimation of expected gains/losses on government and corporate bond holdings are derived in IMF MCM balance-sheet template.
	Regulatory, accounting, and market-based standards	• Minimum capital requirements are based on country-specific regulatory minimum for total and Tier 1 CARs. • CBK's proposals of capital conservation buffer, capital countercyclical buffer, and phase outs of some Tier 2 capital instruments are also taken into account. D-SIB Capital add-ons are not considered. • Basel II/standardized approach.
6. Reporting Format for Results	Output presentation	• System-wide CAR, and the amount of capital shortfall (if any). • Pass or fail (number of banks); recapitalization need as percentage of GDP (if applicable). • Impact of different result drivers, including profit components, losses due to realization of different risk factors. • The threshold average NPL ratio that would cause all banks' CARs to fall below the regulatory requirements.
BANKING SECTOR: LIQUIDITY RISK		
1. Institutional Perimeter	Institutions included	• 10 largest banks
	Market share	• About 95 percent of banking sector assets
	Data and baseline date	• Supervisory data • Baseline date: 2017 Q4
2. Channels of Risk Propagation	Methodology	• Modified LCR analyses.
3. Tail shocks	Size of the shock	• Shocks are reflected in the adjustment factors (e.g., run-off rates) that would be applied to cash outflows.
4. Risk and Buffers	Risks	• Funding liquidity risk • Market liquidity risk
	Buffers	• For LCR: high-quality liquid assets.
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Based on Basel III guidelines. • Adjusted to account for Kuwait-specific characteristics in collaboration with CBK.
	Regulatory standards	• For LCR: assessed against 80 percent (effective in January 2017) and 100 percent (effective in January 2019). • For NSFR: assessed against 100 percent (effective in January 2018).
6. Reporting Format for Results	Output presentation	• For modified LCR/NSFR analyses: pass rate, and average LCR. • For reverse liquidity STs: the average threshold parameter value that would trigger a liquidity shortfall of the bank.