Kuwait Banking Industry

Report Contents

Analyst

Jyoti Prakash Singh
j.singh@capstandards.com
+965 22258822 ext.513

Capital Standards (CSR)
Al Nassar Tower, 11th Floor,
Fahad Al-Salem St., Kuwait City
P.O.Box 26620, Safat, 13127 Kuwait
Office: +965 2225 8822
Email: services@capstandards.com
Website: www.capstandards.com

Industry Overview

Summary

Kuwaiti banking system is one of the strongest in the MENA region benefiting from a robust financial profile, strong support mechanism and limited competition from foreign banks. The banking system is in the evolvement phase experiencing increasing competition, diversification, and product innovation which could pressure profitability. The banking system's strength stems from a supportive government policy, further assisted by higher than average capitalization, adequate profitability, and ample liquidity. This largely offsets the risks related to operating in a mono-line economy with a narrow customer base, and limited business opportunity. Capital Standards believes that the Kuwaiti banking system will remain protected despite entry of foreign banks to operate in Kuwait, given the nature of protectionism by the Central Bank of Kuwait (CBK) and the narrowness of the market.

Banks in Kuwait benefit from a robust economic prospect driven by high oil prices, rapid expansion of retail banking, and a rising stock market. However it is worth noting that banks have large exposures to the real estate and stock market, which is very volatile in nature. Concentration risk remains a real issue in terms of loans and deposits. Kuwaiti banks' balance sheets reflect a high concentration of lending to the real estate sector and to personal banking activities. This is driven by the limited lending opportunities for banks, given the dearth of corporate business. Hence we expect retail banking business to remain the main driver of business growth. CBK is constantly strengthening regulations, to regulate risk and tighten management of asset quality. The Central Bank has a strong track record of intervention when systemic risk is at stake.

Economic Risk

Oil-driven economy with limited diversification opportunity

Kuwait is a small, relatively open economy with proven crude oil reserves of about 96 billion barrels (15 km^3), i.e. about 10% of world reserves. Petroleum accounts for nearly half of the country's GDP, 90% of export revenues, and 95% of government income. The government is proceeding slowly with reforms. It inaugurated Kuwait's first free-trade zone in 1999 and will continue discussions with foreign oil companies to develop fields in the northern part of the country. Hydrocarbon industries account for well over 95% of the Kuwaiti economy. Diversification of the economy into manufacturing industries remains a long-term issue.

Weakening economic growth, on account of global crisis

The world economies have witnessed an economic slowdown triggered by the US subprime crisis. The International Monetary Fund (IMF) has projected that the world economy might recede at a rate of 1.3% in 2009, the lowest since World War II after witnessing high growth of 5.2% in 2007 and 3.2% in 2008. However, on a positive note, the trend is likely to reverse with the growth rebounding to 1.9% in 2010. The Middle East region's GDP, which registered healthy real growth rate of 5.7% and 6.3% during 2006 and 2007, is anticipated to slow from 5.9% in 2008 to 2.5% in 2009. Kuwait's real GDP grew at a compounded annual growth rate of 7.4% during 2004-2007 led by crude surplus backed robust economic development. Higher Oil revenue generates substantial fiscal and external current account surplus, thereby enabling the country to build up its net foreign assets. Given the impending global economic crisis, Kuwait's real GDP growth is expected to decline by 0.7% in 2009 before improving to 4.4% in 2010. Growth in the service sector, including financial services, logistics, telecommunications and retail, which account for around 40% of nominal GDP, is expected to be modest in 2009-10. Slowdown in economic growth, strengthening of the US dollar and government's commitment to extend its subsidies is likely to reduce inflation from 10.5% in 2008 to 7.0% and 5.6% in 2009 and 2010, respectively.

Kuwait Macro Economic Statistics	2008	2009E	2010E	2011E	2012E	2013E
Key Indicators						
Real GDP growth (%)	8.5	(0.7)	4.4	5.2	5.5	5.2
GDP per head (US$ at PPP)	41,976	41,518	42,154	42,901	43,637	44,474
Consumer price inflation (av; %)	10.5	7.0	5.6	4.5	4.0	3.2
Budget balance (% of GDP)	25.3	9.8	13.8	13.5	17.7	18.7
Current-account balance (% of GDP)	42.7	21.8	27.4	21.9	25.3	24.1
Exchange rate KD:US$ (av)	0.269	0.284	0.287	0.278	0.274	0.273
Population (mn)	3.4	3.5	3.6	3.7	3.9	4.1
Household consumption per head (US$)	12,630	13,200	14,060	15,460	16,620	17,360

Source: CBK

Stable operating environment

Politics in Kuwait remains complex. The Emir remains the ultimate executive authority. Important policy decisions will continue to be arrived at through internal negotiations within the ruling Al Sabah family, which are rarely made public. However, disputes between the Al Sabah-dominated government and the National Assembly (parliament) are expected to persist, despite the shift in the political balance in parliament following the May 2009 election, in which the liberal, secular and Shia blocs performed surprisingly well, at the expense of the once dominant Sunni Islamist groupings. In the medium term, political scene is likely to remain unchanged, with frictions between the conservative parliamentary majority and the government, significantly curtailing policy-making.

In June 2009, Kuwait entered into a pact with other GCC countries to establish a monetary union to better integrate the GCC economy. UAE which is the second largest GCC country opted out of the project. This is not expected to have any negative impact on the project; however, due to the unexpected withdrawal of UAE, this project will now commence in the year 2013. Economic growth in 2009 is going to be challenging and has partially eroded previous gains achieved. However the benefits gained over periods of high growth are solid and was not significantly impacted by the global crisis. The country's geopolitical risk remains high, which however is mitigated to some extent by good international alliances, and relative domestic social stability.

Industry Risk & Characteristics

Mono-line industry characterized by High volatility

Over-dependence on Oil and the public sector makes it difficult to develop many profitable investment opportunities outside the limited scope of real estate, trade and stock market activities. This has translated into the concentration of bank lending into Consumer loans, Real estate, Construction and Trade finance at the expense of lending to the Industrial sector. Some of these lending opportunities are even more restricted considering the large share of expatriate population whose access to bank credit is limited by virtue of many regulations including those related to real estate and corporate ownership. This lack of business diversity coupled with a liquidity crunch and negative sentiment, is one of the biggest challenges for the banking sector.

The economic meltdown in October 2008 has left the banking sector with a crippling portfolio of Non-performing loans. In the strive to expand the scope of their activities beyond traditional banking services and into activities such as Investment and Insurance, local banks need a proper regulatory framework to play the role of Universal banks, and in order to effectively face competition from domestic investment and insurance companies. Local banks are also expected to face more competitive pressure when Kuwait opens up its domestic market to foreign banks by virtue of its membership in the World Trade Organization.

Banking system concentrated, and dominated by two local banks

The banking industry in Kuwait is challenging and is characterized by high competition among domestic banks. Generally, the entry barriers are high; this is because it is very costly to initiate a new bank considering the resources, expertise of staff and competition considered in the process. In Kuwait, the entry barriers are higher considering the smaller number of banks in Kuwait (6 Commercial, 3 Islamic, 1 Specialized and 7 foreign bank branches, along-with the Central Bank of Kuwait) compared to 30 banks in Bahrain and 36 banks in Dubai alone. It is reasonable to conclude that the risk of local competition on larger banks is limited considering the high entry barriers enforced by the regulator.

The structure of the banking sector is fairly concentrated. The National Bank of Kuwait (NBK) is more than twice the size of the next largest, the Gulf Bank, in terms of assets and deposits. Together, they own around fifty percent of the assets of conventional banks and dispense around the same proportion of total banking credit. The impact of excessive government intervention in the economy in general and in the banking sector in particular, is in the form of administrative control, subsidized loans, equity injections and bail-outs. Another salient feature of Kuwaiti banks is the mixed nature of their ownership. Except for NBK, which is almost entirely owned by the private sector, the government is a shareholder in the rest of the banks.

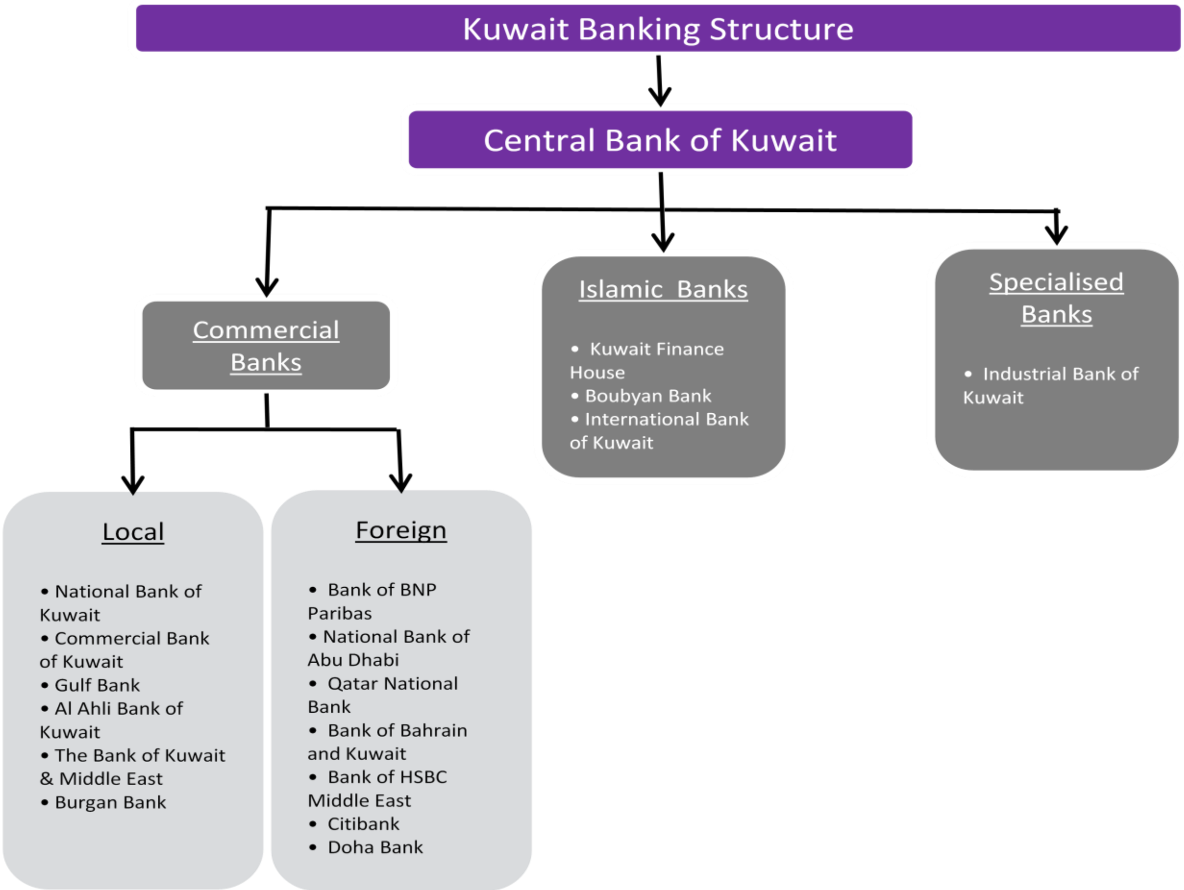
The banking industry in Kuwait is highly protected, given that the founder of a bank is required to be a publicly traded company, and the paid-up capital should be at least KWD75mn. The founder is also obligated to obtain a license from the Kuwaiti government and the Central Bank–which is extremely difficult. The CBK law 32/1968 prohibits the ownership of one person or legal entity of over 5% of the bank’s capital. In addition, the Central Bank reserves the right to modify any of those requirements at any time. Given the difficulty of the process and the legal restrictions that limit ownership percentages; the small number of banks in Kuwait is understandable. That small number gives the already established banks in Kuwait immeasurable advantage. The competition has been limited and every bank has had a stable market share throughout the years.

Kuwait offers a robust banking system regulated closely by the Central Bank of Kuwait. The CBK is responsible for supervising Kuwait's commercial (conventional and Islamic) and specialized banks, as well as the foreign bank branches. As many as 17 banks dominate the banking scene (as of March 2009) (Source: CBK)

CBK was established by virtue of the Law No. (32) of 1968 concerning Currency, the Central Bank of Kuwait and the Organization of Banking Business. It replaced the Kuwaiti Currency Board, which had been established by virtue of the Amiri Decree No. 41 of 1960. The establishment of CBK was to administer the role of the monetary and financial policy in the pursuit of social and economic development in the country.

CBK started operating on the 1st of April 1969 as specified in Article 15 of Law No. 32 of 1968, with the objective:

1. to issue currency on behalf of the State
2. to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies
3. to direct the credit policy to assist social and economic progress and increase national income
4. to supervise the banking system in the State of Kuwait
5. to serve as Banker to the Government, and
6. to provide financial advice to the Government



Mashreq Bank (UAE) opened its Kuwait branch in Nov 2009 with a capital of KWD15mn

Islamic Banking Industry

Conventional banks compete with a growing number of Islamic financial institutions

Kuwait has developed a preference for Islamic financial services over conventional ones, the profits from which have started to fade and is burdened with high debt levels driven by the crisis. Shariah-compliant financial services have shown healthy growth in the State of Kuwait during recent years, becoming a potential competitor for both conventional banks and investment houses. Kuwait Finance House was the first Islamic bank to be set up in Kuwait in 1977. As per CBK reports, the Islamic finance sector consisting of Islamic banks and Islamic Investment companies have a combined market share of more than 26% of the domestic banking and financial sector. Bank of Kuwait and Middle East is another conventional bank which is in the process of converting itself into an Islamic bank. CBK has been the supervisory body for Islamic finance since 1990. The growing number of Islamic financial institutions is expected to increase competition and CBK believes that currently the market for Islamic financing is concentrated. Creativity and innovation has helped in the growth of Islamic finance industry in Kuwait. This has enabled them to bring out competitive products appealing to the Muslim population.

The Islamic financial sector in Kuwait has been enjoying a steady and healthy growth rate since its inception. There were 54 registered Shariah-compliant investment companies in the country as of February 2009, according to the CBK. Even though the Islamic banks have fared better with respect to conventional institutions in the case of recent equity market corrections, the general deterioration in investment portfolio and investor confidence has actually made fund-raising difficult. In order to improve the efficiency and competitiveness of Islamic banks, it is necessary to focus on Innovation and product development. Innovation has been major driver of growth over the years. Recent innovation has helped in developing products which are able to compete with the products and services of the conventional financial institutions. However we believe more innovation is needed in order to meet the demand for complicated, as well as profitable, Islamic financial instruments driven by the exponential growth in the Islamic Finance Industry globally. Innovative solutions are also required in order to enhance their liquidity and product features in order to keep pace with market dynamics.

Market capitalization of GCC Islamic banks fell since the peak oil price in mid 2008. The Financial Times estimates this fall to be as severe as 45.0%. On the positive side, there is less exposure to lower credit rated assets for Islamic banks compared to their conventional counterparts. However, competition is likely to intensify as commercial banks, such as National Bank of Kuwait, venture into Islamic financing. As a protective measure, the government announced on January 2009 its plans to issue Sukuk and other Islamic-financing instruments to assist investment firms in raising funds. The assets of these companies would be used as collateral for the bonds. This would particularly help firms operating in the Islamic finance sector, enabling them to access funds that meet the requirements of the Shariah laws.

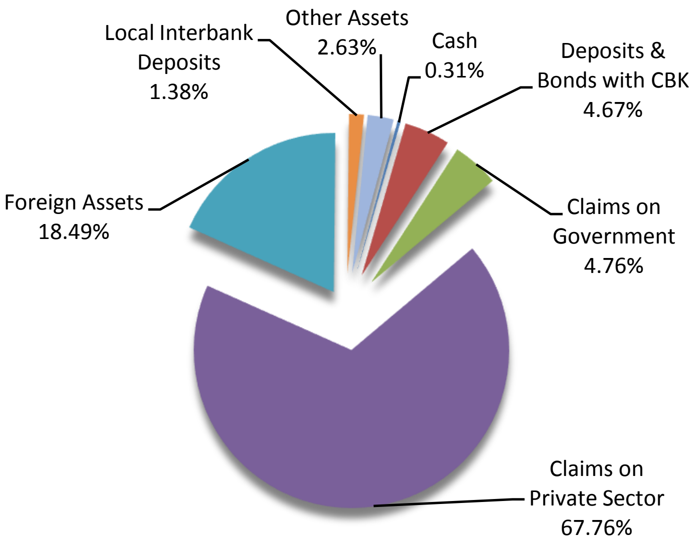
The presence of an appropriate legal and regulatory authority is vital for the development and greater transparency of the Islamic Finance sector. This is especially relevant due to the complex nature of the Sharia compliant investments and also the continual innovation of new products of varying types and degrees of risk. The availability of a better regulatory framework can assist the authorities in proposing policies and providing support to these institutions. The key aspects of this regulatory framework should correspond to their particular nature and at the same time also address issues related to financial services such as, management of contracts, bankruptcy, collateral and asset recovery. Globally the importance of regulatory bodies have increased, driven by the need to keep track of more complex financial instruments issued by the financial institutions. This would provide better transparency and accountability for the activities of these institutions.

Industry Analysis

Strong asset growth driven by high oil-prices and the desire to diversify

The total assets of the banking sector was KWD39.2bn at the end of 2008, after growing at a modest 10.7% during the year compared to a 31.7% achieved during 2007. This shows a stabilization in the growth rate after an exceptional growth in 2006 and 2007, which is again the slowest asset growth achieved since 2004 (1.4% yoy). Asset growth in 2008 was driven primarily by loans to private sector specifically, credit disbursements to the residents with an added contribution from the foreign assets which grew by KWD1.2mn during the year. The deposits with foreign banks increased by 13% yoy, and at the same time foreign investments grew by 27% in 2008. This increase in foreign assets were completely offset by the decline in the deposits placed with the Central Bank and outstanding CBK bonds by KWD1.0bn. Aggravating this the local interbank deposits also declined by KWD 710mn with most of it coming in H2FY08.
The average monthly growth of assets were extremely low at 1.0% in 2008 due to the CBK's earlier stance on bringing down the inflation by limiting the asset growth, which declined from higher levels of 2.3% achieved in 2007 and 1.9% in 2006. The credit to residents forms approximately 60% of total assets (57% in 2007) which has increased by a healthy 17.5% yoy in 2008 but still much lower that the growth rate of 34.9% achieved during 2007. The average monthly statistics of credit to residents' growth for the full year of 2008 stood at 1.6% which has declined from 2.5% for 2007.

Asset Breakup of Kuwaiti Local Banks for August 2009



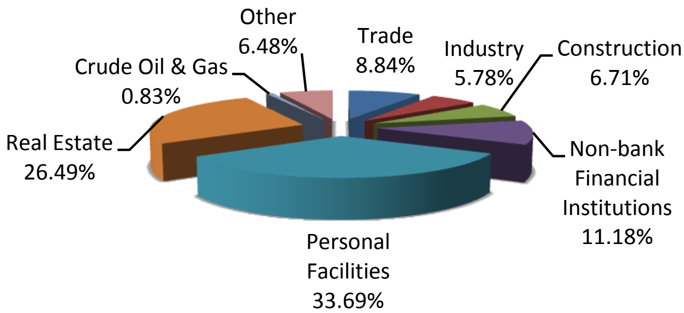
High proportion of untested loan portfolio

The growth in the banking sector loans has increased by 17.5% yoy, which is far lower from that achieved in 2007 (35% yoy). The total banking sector loans as of December 2008 were KWD23.7bn, while 2006 and 2007 were exceptional years with extraordinary growth rates. Going forward anything above early double digits may still be deemed as a potent attempt at growth. Analyzing the growth in absolute figures of bank loans since the beginning of the decade states that the growth achieved in 2008 is only second to 2007, which justifies that 2008 was a very good year in terms of loan growth. However the strong loan growth has resulted in a high proportion of unseasoned loan portfolio which was further weakened by the global crisis. Kuwait banks have registered a strong increase in the amount of problematic loans resulting in higher provisions and pressure on profitability. Kuwaiti banks have also piled up a sizeable amount of illiquid investment portfolios mostly in the volatile real estate sector. Banks in the year 2008 and 2009 had to write of a significant portion of their investments eroding profit and equity base. The investments were mostly characterized by availability of liquidity in the last few years driven by high Oil prices, resulting in borrowing of short term funds.

Fast growth in Real estate and Personal lending sector are causes of concern

Different economic sectors have maintained their respective share unchanged in 2008, over the previous year. Personal loans still contribute to the major share of total credit disbursed, standing at 33% in 2008, with respect to 35% from 2007. This category depicted the slowest growth during the decade during the previous year, increasing only by 7%. Consumer loans remained comparatively stagnant over the previous year declining 1% yoy. Whereas loans against purchase of securities which forms the major part of the personal loans segment (36%) has increased by a massive 30% yoy. Apart from this installment loans that form 56% of personal loans and 19% of total loans achieved a healthy growth of 14.4%. Overall the highest growth in the incremental loans were contributed by the personal loan segment which increased by 22.1 percentage.

Sectoral Breakup of Cash Credit Facilities of Kuwaiti Local Banks for August 2009



Funding Profile

Liabilities driven by Private and Government deposits

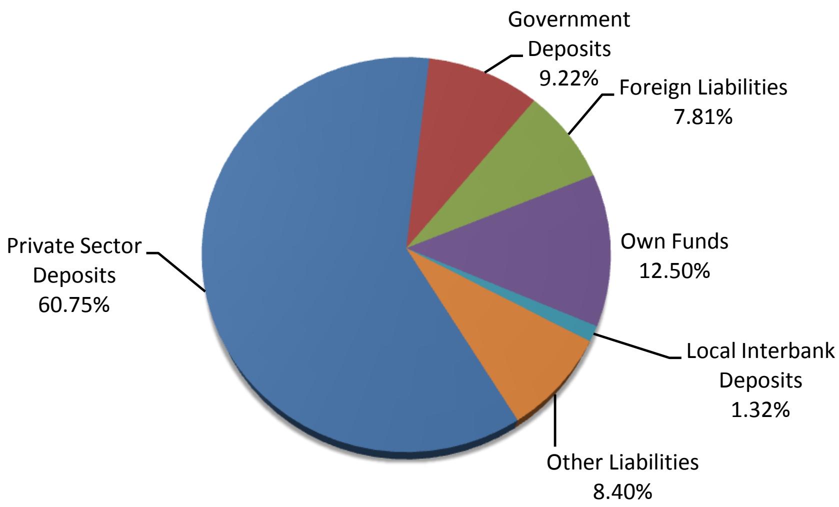
The total liabilities of the banking sector were reported to be KWD34.8bn at the end of 2008. The growth of 12.1% yoy achieved is actually dampening when compared to the growth of 30.4% achieved during 2007. We believe that the growth is still at sustainable levels which is usual after a high growth phase and is very much in line with the 10 year CAGR of 11.8%.

The key drivers of the liabilities in 2008 were mainly private and government deposits, unlike 2007 where it was chiefly driven by foreign liabilities. The share of private sector deposits in the total incremental liabilities increased from 44% to 77% from 2007 to 2008 respectively, thereby increasing their share from 59% in 2007 to 61% in 2008. As noted previously the rise in the private sector deposits is mainly attributable to the growth in fixed deposits. The government deposits and foreign liabilities have remained prominent in 2008 due to the extraordinary changes witnessed within these liability heads.

Deposits Still on a Roll, Especially with an Increasing Role from the Government

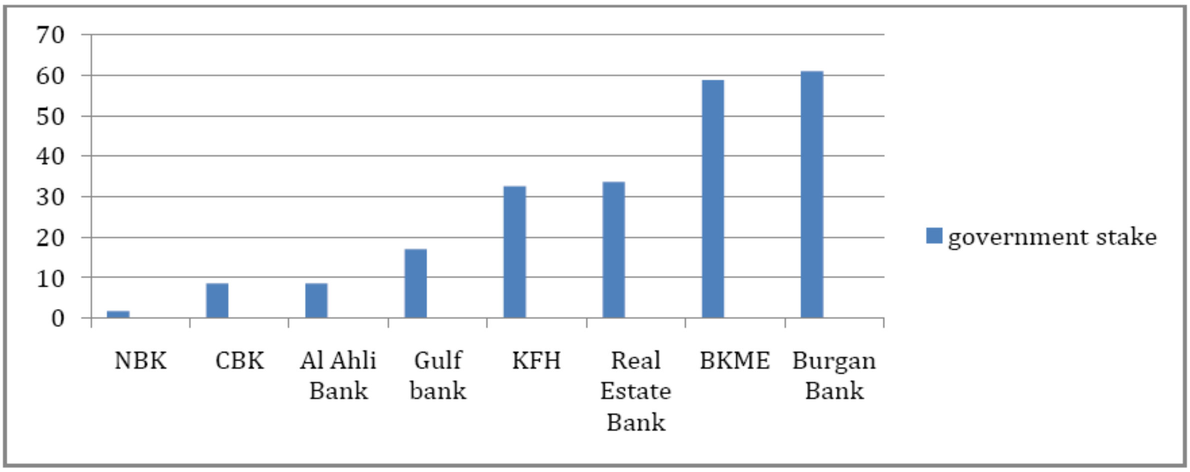
The banking sector deposits have shown exceptional growth rate of 22% yoy, standing at KWD24.8bn at the end of 2008. This has outpaced the growth in loans and advances. This rise has very much been in line with the growth during the last two years of boom and substantially higher than the 15-year CAGR of the deposits. Maturity mismatch is still a weakness for banks given the limited access to long term funds. Liquidity profile of Kuwaiti banks remains sound driven by large holding of cash and money market instruments.

Liabilities Breakup of Kuwaiti Local Banks for August 2009



Ownership Structure

The government intervention in various forms like administrative control, equity injections, subsidized loans and bail-outs has been of immense support and has had a positive impact on the efficiency and performance of the banking sector. A salient feature of the Kuwaiti banks is their mixed ownership structure. Except for NBK which is mostly a privately owned bank the government has notable shareholding in the rest of the banks.



Source: CBK, Annual reports

Prominent local family businesses have a strong presence in Kuwait banks. These families are well connected and respected, and have a lengthy track record in the financial industry. Uplift is not provided for family ownership since they often do not wish to dilute their interest and their capacity to provide resources to finance growth or support is often unknown.

System Support

Government's interventionist approach to crisis

1982:- CBK converted the banks' minor bad debts into cash and major debts into government bonds after the sharp correction of the unofficial stock market, the Souq Al Manakh, in 1982. Additionally the Kuwait Investment Authority – the investment arm of the government, purchased the stocks of large number of companies to prevent the stock prices from falling.

1990-91:- The authorities again intervened during the Gulf War of 1990-1991 where several Kuwaiti banks faced financial deterioration. The initial step was to write off a major portion of consumer and housing loans taken by Kuwaiti nationals. The government also took care of a large portion of the banks' problem loans in exchange for long term government debt bonds in 1992.

Economic stimulus package a boost to the banking system

The economic recession has led to a severe liquidity crunch across all sectors, primarily affecting the construction and real estate, and is expected to affect the performance of the banks that remain highly exposed to these sectors. Sighting this, most commercial banks have increased their provisions during 2008, as a precaution against possible deterioration in the quality of their assets. However the Central bank's initiative to boost liquidity into the system is expected to positively benefit the banking sector. The Economic Stimulus package guarantees up-to 50% of the new credit facilities that would be provided by the banks to the local companies over the next two years. Additionally, it will provide a guarantee for 15 years against any drop in the value of investment in real estate portfolios held by local banks along with old loans to local companies. KIA the government's investment arm also intends to buy any unsubscribed shares of any listed companies and banks seeking for capital thereby supporting them to regain momentum. This combined with a cut in the key discount rate has provides hope in tough times enabling banks with the strength to overcome the economic crisis.

Legal System

Satisfactory though scope for improvement

Capital Standards takes into account the time required to foreclose a residential mortgage as a good measure to estimate the efficiency of the legal system of the country. Kuwait being a rich country with high hydrocarbon reserves is expected by the locals to provide welfare to its citizens. On top of which foreclosure of primary residential properties is explicitly prohibited under the Kuwaiti Law. In addition, it is against the Islamic beliefs to foreclose a residential mortgage, even if it were allowed by law, banks especially Islamic would have been unwilling to attempt to deprive a Kuwaiti citizen of his primary residence, fearing a loss of reputation. Procedures for recovering debts can be satisfactory for cases excluding requisition of owner-occupied property, although the process can be implemented. At Capital Standards we view the laws governing the Kuwait's financial and commercial sector as satisfactory, though not possibly detailed or business friendly as it has to be. Kuwait is also not well placed with respect to enforcing of contracts. The law governing the operations of the Central Bank gives it full independence and responsibility to supervise banking activities and provide a comprehensive regulatory framework to operate within. Despite the enduring weaknesses in its governance the steps taken by CBK towards modernizing governance practices in Kuwaiti banking, is appreciative to an extent. At the same time the laws adopted for governing the operations of the financial markets lack an orderly regulatory framework and lags far behind as per international standards.

Regulatory & Supervisory Environment

The Central Bank is benefited by only 10 local banks and 8 foreign bank branches to supervise. The CBK issues laws and regulations focused at strengthening the Kuwait banks and keeping with international standards. The examples of which can be sighted as raising the Capital Adequacy Ratio from 10% to 12% and announcing the government's full support to local banks by providing a 100% guarantee on all customer deposits after the global economic recession hit the GCC countries. A supportive regulatory environment is provided by the Central Bank's willingness and ability to support the local banks. Licensing process adopted for banks in Kuwait is very stiff, and it is almost impossible to get a license for a new bank. The regulations on the international banks are very strict as only 8 banks operate and only one branch license is allotted for each. Above all the Central Bank conducts routine checks on liquidity, internal control, and risk management to ensure the health of the Kuwaiti Banking system. The above factors indicate that Kuwait has a protective regulatory environment.

Inspection & Reporting

Relatively tight supervision; however implementation is key

The supervisory function of the CBK has developed and improved over the past few years with the advice sought from the international financial institutions and outside consultants. CBK has appointed 28 onsite inspectors and 33 offsite supervisors and financial analysts to overview the activities of all the 16 banks and 82 investment companies operating in Kuwait. CBK also invests in training for the constant improvement of its human capital. Even thought there is no team currently, that is dedicated to inspect each institution; CBK aims for an average cycle of 2.5 years for each institution depending on its size and range of activities. A credit bureau was set up in April 2003, which collates all relevant pieces of information on consumer loans granted by Kuwaiti banks, investment companies, and other companies that sell goods on a monthly installment basis. It is a platform aimed at the sharing of information for the collective management of risks pertaining to retail lending (including residential real estate financing), and also helps banks to fully comply with the CBK's regulations.

CBK follows a well organized method of offsite supervision where banks are required to submit a multitude of standardized returns periodically. Reporting requirements are comprehensive including returns indicating compliance with the Central Bank's administrative measures. CBK requires that the financials of each bank be audited and approved by two separate auditors. Even though this provides comfort as to the quality and accuracy of the banks' financials on the flip side it adds to the already significant regulatory cost in the system.

Accounting Policies

Early adoption of Basel norms resulting in improved transparency

Kuwaiti banks follow International Financial Reporting Standards (IFRS) except for International Accounting Standards (IAS) 39. CBK has replaced this specific requirement for collective provisioning for a minimum general provision. IFRS 7 and the amendments to IAS 1 were adopted by the banks in 2007, which has improved the level of quality of disclosures. The decision of CBK to adopt Basel II in 2005 has enhanced the level of reporting. The public disclosure of these banks have elevated above regional standards. The unaudited quarterly financial statements published by Kuwaiti Banks show a fair degree of detail when compared to regional peers.

Conclusion

Kuwaiti banks, like most of the banks in the MENA region, have escaped the ongoing crisis primarily due to limited global exposure, and absence of sophisticated derivatives with underlying toxic assets. Kuwaiti banks enjoy strong financial performance, solid capitalization, and good asset quality. The banks' financial performance remains volume-driven as interest margins are pressured by the price competition. At the same time barriers of entry are high. Threats from foreign competition, especially in the retail segment, are therefore limited in the short to medium term. Business volumes should remain at high levels, although we expect CBK's tougher stance on lending to translate into lower growth rates than those witnessed over the past three years. On the funding side, core deposit growth, although increasing fast has been overtaken by that of loans, putting pressure on interest margins. Banks have increasingly resorted to interbank deposits to accommodate the lending momentum in the country. Regulatory pressure has recently been stronger to curb fast lending growth and inflation. Medium term challenges facing Kuwaiti banks are: controlling asset quality, maintaining good capitalization, and refining risk management.

Overall, the banking system has benefited from a shift towards a risk-based evaluation approach through improved identification, understanding and measurement methods of the key risks faced by banks. Whilst banks' reporting transparency and disclosure have improved, there is still scope for improvement particularly with regard to disclosure of ownership and corporate governance practices. Additionally, we believe that there is scope for improvement with regard to the regulator's transparency

Average Projects under Construction in 2008 reached KWD 129.9 mn, almost equal to the average 2008 growth in loans to KWD 131.78 mn. Construction was not completely financed by loans, as loans in 2008 for the individual companies do not match their respective Projects under Construction in 2008. For example, Al-Tijaria's 2008 loans almost doubled their 2008 Projects under Construction and United Real Estate's 2008 loans more than tripled their 2008 Projects under Construction. This indicates that although many companies continued to expand and build in 2008, the projects may have not been entirely financed by loans. Borrowed funds not used for Projects under Construction may have been used for other purposes, such as maintaining financial flexibility and meeting payments due during the period for completed developments and projects.

Appendix

I - Regulatory Requirement Applicable to Kuwait Banks

Provisioning

In March 2007, the CBK issued a circular amending the basis of making minimum general provisions on facilities (in lieu of IAS39 (International Accounting Standards) requirements for collective impairment provisions), changing the mandatory rate to 1% from 2% for funded facilities and 0.5% for non-funded facilities. These new rates have been applied from Jan. 1, 2007, on the net increase in facilities. The general provision as of this date, in excess of the 1% for funded facilities and 0.5% for non-funded facilities, has been retained as general provision until further directive from the CBK. This move by the CBK triggered a system-wide decrease in new loan-loss provision generation in 2007. Banks must post provisions of 20%, 50%, and 100% for the portions of their loan portfolios that are 90 days, 180 days, and 360 days, respectively, past due (after deducting collateral value).

Capital adequacy

CBK endorsed the application (of the standardized approach) of the Basel II capital adequacy requirements to conventional domestic banks as of Dec. 31, 2005, thereby making Kuwait the first country to apply these standards. The minimum capital adequacy ratio is set at 12%. Banks have also started disclosing Pillar III in their annual reports since 2007.The CBK is preparing instructions to Islamic banks for the application of the revised Basel II standards. CBK raised in May 2008 the risk-weighting on consumer and housing loans from 75% to 100%, while assigning a 150% risk-weight to real estate loans and facilities to finance share purchases (with exceptions).

Liabilities guarantee

Kuwaiti authorities do not issue guarantees for borrowings by non-public enterprises and has also removed the banks' blanket deposit guarantee in 2004 (with debate to replace it with a funded deposit insurance scheme).

Large exposures

Exposure to a single group is subject to a legal lending limit of 15% of equity. The exposure includes all types of securities, but is net of collateral in the form of cash or government securities. Exposure to a single bank is limited to 10% of equity. Lending to related parties is discouraged, and monitored tightly by the Central Bank. Lending to board directors has to be approved by three-quarters of the board of directors and must be collateralized.

Personal lending

Regulatory efforts and refinements have been made to complement the 80:20 customer loans to customer deposits ratio. Under this regulation, a bank's customer loan portfolio may not exceed 80% of its customer deposits. Further refining of previous circulars for banks and investment companies, which were introducing amendments to the rules and regulations on the granting of consumer and other installment loans, have also been made in March 2008, and these include:

- Reduction of the interest rate calculated for this type of loans to 3% above the Discount Rate instead of 4%.
- Changing the method of charging interest by fixing the interest rate for five years from the date of the loan, to be then reviewed and changed up or down by not more than 2%, instead of the current method of changing the interest rate whenever the Discount Rate is changed.
- Reduction of the monthly installment due from a client to 40% of net salary or monthly income, instead of the current 50%, in case of working clients. As for pensioners, the ceiling is lowered to 30%.

- Consumer loans are now defined as personal medium-term loans to finance personal consumption of goods, durables, education, and health care, to be repaid on monthly installments over a maximum period up to years.
- Installment loans (residential loans) are now defined as personal long term loans to finance non commercial purposes, especially to finance the maintenance or purchase of personal housing units, to be repaid on monthly installments over a maximum period up to 15 years.

Related-party lending

The significant presence of family ownership in Kuwait banks poses the potential risk that credit and personnel decisions are not based on merit, resulting in name lending. On a positive note, however, related-party lending at Kuwait banks is limited and tightly controlled by the Central Bank.

Foreign exchange

The sum of a bank's open foreign exchange positions must not exceed 15% of its equity. The largest exposure for Kuwaiti banks is to the U.S. dollar. The Kuwaiti dinar has been de-pegged from the dollar since 2007.

Liquidity

A bank must invest at least 20% of its domestic customer deposits in T-bills and bonds, or any other instruments issued by the CBK, in addition to their balances within the CBK. Such liquidity requirements are in place to curb credit growth and limit banks' loan leverage.

Ownership

It is prohibited for non-Kuwaiti investors (GCC and foreign) to exceed the ownership of 49% in the capital of any individual bank, except after attaining a preceding approval from the Council of Ministers, and after consulting of the Central Bank of Kuwait. In April 2004, the CBK endorsed the application of executive procedures that put limits on the ownership structure of Kuwaiti banks by setting the maximum limit for any shareholder at 5% of a bank's capital, unless prior consent is obtained from the CBK and excluding government entities and positions existing prior to this law. The Banking Law was amended in January 2004 to allow foreign banks to operate in Kuwait. An amendment to the Banking Law passed by parliament in January 2004 also enabled foreign banks to establish local branches

Source: CBK and other reports

II - Banking System Snapshot

Kuwait Banking Competitive Landscape	Type	Branches	Assets	Tier 1 Ratio	NPLs /Gross Loans
			USD Bn	%	%
Locally incorporated commercial banks					
National Bank of Kuwait (NBK)	Conventional	64	43.01	14.7	1.95
Kuwait Finance House (KFH)	Islamic	44	37.87	21.73	1.93
Gulf Bank (GB)+	Conventional	42	19.41	13.82	12.68
Commercial Bank of Kuwait (CBoK)	Conventional	50	15.47	13.84	5.23
Al Ahli Bank of Kuwait (ABK)	Conventional	20	10.91	13.17	2.51
Burgan Bank (BB)	Conventional	21	14.06	8.97	1.41
Bank of Kuwait & The Middle East (BKME)	Conventional	21	8.03	12.71	3.05
Kuwait International Bank (KIB)	Islamic	8	3.78	14.09	3.46
Boubyan Bank (Boubyan)	Islamic	12	3.02	21.82	0.21
Industrial Bank of Kuwait (IBK)	Specialized	1	1.99	64.74	2.93
Branches of foreign banks					
Bank of Bahrain & Kuwait	Branch	1	-	-	-
BNP Paribas Bank	Branch	1	-	-	-
HCBC Bank Middle East	Branch	1	-	-	-
National Bank of Abu Dhabi	Branch	1	-	-	-
Citibank	Branch	1	-	-	-

*Number of branches and assets as of Dec 2008, ex- head offices. GB +recapitalized, as of 31/01/09
Source: CBK, Capital Standards

DISCLAIMER