



KUWAIT

SELECTED ISSUES

December 2014

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KUWAIT

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November 5, 2014

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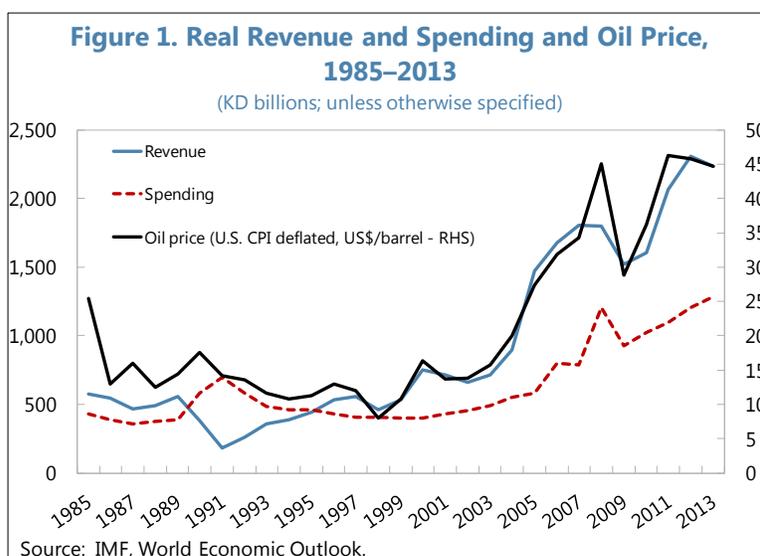
DESIGNING AND IMPLEMENTING FISCAL POLICY FOR THE MEDIUM TERM¹

Kuwait's highly volatile fiscal revenues and a non-diversified economy imply that fiscal policy has two important goals: (i) to smooth spending and build precautionary and intergenerational savings; and (ii) to facilitate economic diversification. Going forward, successfully formulating and implementing medium-term fiscal policy require parallel efforts to strengthen the annual budget process and macroeconomic forecasting through fiscal strategy, including medium-term fiscal and expenditure frameworks, and to build and enhance capacity at the Ministry of Finance through the macro-fiscal unit.

A. Introduction

1. **Kuwait's economy is highly dependent on oil income and is vulnerable to oil price volatility.** Oil revenues accounted for about 81 percent of total government revenues, including investment income, in 2013. Real revenues exhibited high volatility (Figure 1), which warrants smoothing of spending.

Nonetheless, despite being less volatile than revenues, spending also showed considerable volatility, affecting consumption and welfare (Figure 1).² In addition, the drop in real spending in the 1980s and 1990s when oil prices fell substantially, suggests that the buildup of precautionary savings or a buffer of liquid and safe assets is important to protect the economy against negative income shocks. Realizing this, Kuwait has

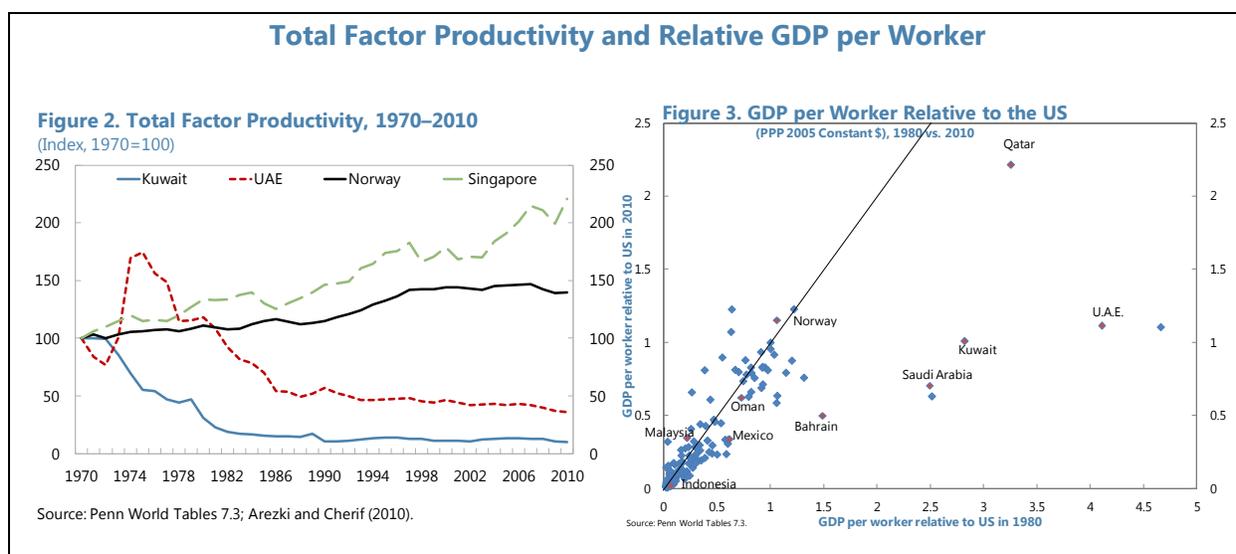


¹ Prepared by Fuad Hasanov.

² Standard deviation of the growth rate of real oil prices, revenues, and spending was 0.3, 0.25, and 0.16, respectively, during 1986–2012.

operated a Future Generations Reserve Fund (FGRF) for the benefit of future generations, permitting oil assets to be diversified into long-term financial investments.³ The size of the FGRF and other reserve funds was estimated at about \$500 billion in 2013.

2. The concentration of the economy in oil and the prevailing growth model have resulted in declining productivity, crowding out of the non-oil tradable sector, and large public employment. Total factor productivity (TFP) has declined and stagnated since 1970, especially if compared to some other countries. Relative (to the US) income per worker has fallen since 1980 from about three times the US income to about the US level (Figures 2–3). The tradable sector has become essentially oil-based, with oil exports constituting 86 percent of total exports of goods and services in 2013, suggesting very little export diversification. Most of Kuwaiti nationals, 70 percent, have opted out working in government jobs, which are mostly highly paid.



3. Fiscal policy has a major role to play in supporting macro-stability and diversification. Depending on one large and volatile source of income such as oil, smoothing expenditure, investing, and building reserves are important. It is, however, not sufficient because the current growth model of relying on oil income, government spending, and public jobs would not support productivity gains, diversification, and sustainable growth. In this regard, in addition to smoothing spending and building reserves for precautionary and intergenerational purposes, fiscal policy for the medium-term has another important objective in Kuwait, that of facilitating the development of

³ The FGRF was established in 1976 with 50% of the General Reserve Fund (GRF) balance. In addition, 25% of all state revenues, including the net income of the GRF, are transferred to the FGRF annually. Kuwait Investment Authority (KIA) manages FGRF assets.

the non-oil tradable sector.⁴ Public investment becomes one potential instrument to use, and how much to invest and in which projects are important questions to be addressed.

4. **The conduct of fiscal policy in achieving expenditure smoothing, a reserve build-up, and the development of the tradable sector requires several important elements.** These include (i) a fiscal strategy, including medium-term macroeconomic and fiscal frameworks, the allocation of revenues among current spending, investment, and saving, and a medium-term expenditure framework with spending ceilings and public investment program; and (ii) the annual budget designed to support these reforms and linked to a medium-term expenditure framework. Based on international practice, the paper provides the main elements of the fiscal strategy and its link to the budget process and provides a way to the design and implementation of fiscal policy in Kuwait.

5. **A comprehensive reform agenda to support prudent medium-term fiscal policymaking includes formalizing the development of a medium-term fiscal strategy and medium-term orientation within the annual budget process.** This could be achieved by developing three important elements: (i) medium-term macroeconomic framework, which would provide multiyear projections of key economic variables such as GDP, inflation, oil prices, exchange rates, current account, and labor market indicators; (ii) medium-term fiscal framework (MTFF), which would provide multiyear targets or ceilings on aggregate fiscal variables such as overall spending, deficit, and debt; and (iii) medium-term budget or expenditure framework (MTBF or MTEF), which translates the overall budget envelope into a set of multiyear expenditure ceilings and policies for main spending units (e.g. ministries). Comprehensive and transparent reporting is crucial to ensure accountability and credibility.

B. Medium-Term Frameworks and Fiscal Strategy

Importance of medium-term approach to fiscal policy

6. **The annual budget cycle encourages more procyclical policy responses during booms and busts.** Delinking the annual budget from the short-term volatility in oil revenue, and basing spending decisions on a longer-term perspective is particularly important in preventing volatile annual revenues from translating into expenditure fluctuations that can destabilize the economy and reduce the quality of government spending. During good times when oil prices or production rates are high, a multiyear framework can help governments resist the pressure to increase spending and build up reserves, which can be used in bad times without compromising long-term policy objectives. Medium-term fiscal and expenditure frameworks can help protect priority expenditures and maintain the strategic focus of policy plans. In addition, medium term fiscal framework improve the budget process and outcome through greater clarity of policy objectives, predictability in budget allocations, comprehensiveness of coverage, and transparency in the use of resources.

⁴ For more details on diversification in the GCC countries, see Cherif and Hasanov (2014).

7. **The foundation for the medium-term revenue and expenditure projections is a credible annual budget, which is yet to be fully met in Kuwait.** The annual budget is based on a very conservative oil price assumption, which is consistently much lower than actual oil prices. As a result, budget outturns have deviated from budgets. The budget process in Kuwait does not have a medium-term focus and follows largely an annual and input-oriented approach, which hampers focusing on strategic priorities of the government and ministries and the monitoring of output and performance. It also renders it difficult to reprioritize spending in response to short-term fiscal developments. In addition, forecasting of revenue and expenditure has only begun at the newly established macro-fiscal unit at the Ministry of Finance and has yet to be fully integrated in the budget process. The fiscal forecasting capacity is further hindered by lack of regular updates of macroeconomic forecasts and lack of independent validation of forecasts. The work on improving data quality, coverage, and frequency is ongoing at the Central Statistical Office and should continue. In Kuwait, like in other resource-rich countries, using more realistic oil price assumptions in the preparation of the budget is key in avoiding consistent deviations of actual oil prices from the budget and the ad-hoc elements in spending decisions that they often cause.

Fiscal strategy as a vehicle of medium-term fiscal policymaking

8. **A simple medium-term framework with a fiscal strategy document should be first put in place.** More specifically, in the short term, a simple MTEF would provide a projection of the fiscal balance, non-oil balance and include estimates of government revenues and spending at a more aggregate level. A fiscal strategy document would incorporate the MTEF and translate it to a statement on medium fiscal policy priorities. This document could also contain fiscal risk analysis, indicating the sensitivity of fiscal plans to varying assumptions regarding the economy, the hydrocarbon sector, contingent liabilities, and other uncertain events (see Appendix for more details). In a second stage, a simple MTEF could provide guidelines (envelopes) to line ministries to prepare medium-term spending plans. In the medium term, reforms should aim at developing a more binding framework.

9. **A full and effective medium-term framework requires several critical prerequisites, including (i) accurate medium-term macroeconomic forecasts, (ii) a comprehensive and unified top-down budget process, and (iii) credible annual budgets.** These requirements which are based on the experiences of countries that have successfully introduced MTEF, explain why the adoption of MTEFs is a relatively recent phenomenon, with mixed success rates. In addition, challenges specific to resource-rich countries include the difficulty to assess long-term fiscal sustainability in the face of uncertain prices and resource stocks and to translate long-term fiscal sustainability into intergenerational equity while responding to investment needs and ensuring high-quality projects.

10. **A fiscal strategy is guided by government objectives and fiscal responsibility principles.** As argued above, the government's major objectives include smoothing spending and building precautionary and intergenerational savings and facilitating the development of the non-oil tradable sector. In addition to being guided by these important objectives, fiscal policy should also follow prudent fiscal management principles. In many countries, these include (i) maintaining prudent

levels of public debt for fiscal sustainability; (ii) pursuing policies to moderate cyclical fluctuations in economic activity; (iii) exercising prudent management of public sector assets, liabilities, and fiscal risks to avoid burdening future generations; and (iv) ensuring predictability in the level of tax rates and bases.

11. **The top-down budget process provides a foundation for formulating the fiscal strategy and strengthens fiscal discipline.** First, the aggregate expenditure should be decided based on the fiscal strategy, MTF, and fiscal rules where applicable, and not by summing up spending of individual ministries. Second, total expenditure should be allocated to ministries to arrive at expenditure ceilings. The Ministry of Finance should focus on establishing and monitoring total expenditure levels rather than negotiating the details of various spending proposals. Line ministries would have the flexibility to propose expenditure details within the respective ceilings. However, the Ministry of Finance would still need to scrutinize the credibility of expenditure projections by line ministries.
12. **A flexible approach to building a fiscal strategy incorporates a three-year horizon, a rolling framework, and an annual update.** The three-year rolling framework is used by many countries such as France, Sweden, the UK, Australia, and New Zealand. The rolling nature of the framework means that the first year's targets and ceilings are fixed and binding while those in the second and third years are indicative (e.g. Australia and New Zealand). The fiscal strategy is updated each year and needs to consider updated forecasts, changes in policy, and progress against fiscal principles and rules. Thus, in the following year, the indicative ceilings and targets would form the basis for the update while the deviations from these targets would be rationalized.
13. **Given the binding aggregate spending ceiling, the medium-term fiscal framework could make explicit provisions for an uncommitted budget margin to deal with uncertainty in budget items.** The size of this margin should be at least 1 percent of expenditure in the first year; 2 percent in the second year; and 3 percent in the third year, in line with international practice. Of the total margin, 1 percent of expenditure per year should be ring-fenced for contingencies in each of the three years, which should be sufficient to meet any unexpected budget overruns. Rules governing allocation of this reserve for contingencies as well as for other purposes needs to be clearly established.
14. **To improve accountability and credibility of fiscal policy, the mid-year and annual fiscal reports should analyze the implementation of fiscal strategy and progress against the fiscal principles and rules.** The reports should also update the macroeconomic forecasts and report on the fiscal outturns. These reports should mirror the contents of the fiscal strategy and be published on the ministry of finance website.

Incorporating the Development Plan into the fiscal strategy and strengthening capital budgeting

15. **Incorporating priorities and projects of the five-year Development Plan into the fiscal strategy and the annual budget requires strengthening of the capital budgeting process and public investment program.** The existing procedures and processes in Kuwait do not facilitate

efficient rationalization of resources to meet government priorities. The translation of the Development Plan into policy actions is lacking although the four-year government action plan has to be drafted as the new government takes office or new parliament is elected. First time this year, the Development Plan and the annual budget were submitted to parliament at the same time. Capacity to analyze and rank capital projects is underdeveloped, while implementation, monitoring and evaluation of capital projects are weak. Competition of capital investment across different sectors is not systematic.

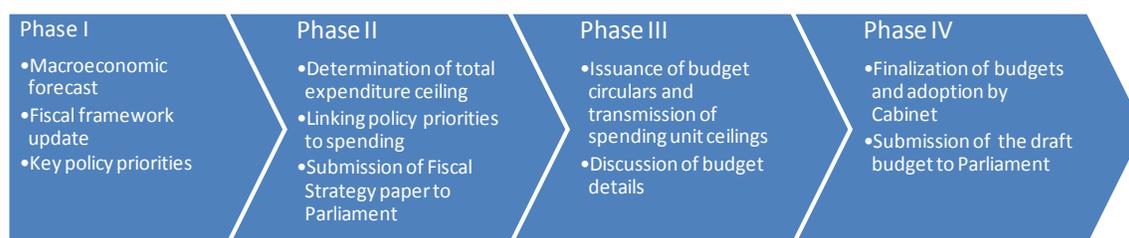
16. A well-functioning capital budgeting process includes:

- Establishing priorities – The fiscal strategy incorporating the Development Plan objectives could be used for this purpose. Line ministries could use their fiscal strategy submissions to the ministry of finance to propose projects for funding in line with spending ceilings and sectoral objectives.
- Encouraging competition for resources – A database of capital project proposals and approved capital projects with the web capability could be developed. The information could include expenditures, physical progress, delays, cost overruns, cost-benefit analysis, and various project progress details. As a result, project ranking from economic and financial perspective should be facilitated. All project proposals across different sectors would be ranked to encourage competition across sectors. Some countries (e.g. Chile) have introduced funds in which the capital spending envelope is open to competition across sectors.
- Strengthening selection and review processes – Once ranking criteria have been determined, a project appraisal and review process could be established to propose projects to be accepted or rejected. Establishing a centralized gateway process to analyze and rank capital project proposals could improve the efficiency of public investment, which is lacking (see Selected Issues Paper in this volume). A gateway process is an institutional arrangement that empowers the minister of finance to stop or suspend a capital project that cannot demonstrate efficiency or that could endanger overall fiscal discipline. However, responsibility for policy design remains with the sponsoring line ministry. The UK has the gateway system at the Cabinet level that reviews and analyzes capital projects.
- Ensuring adequate funding – Once reviews had taken place and the capital projects had proved to have satisfactory performance, funding for continuation of existing projects would take precedence over new proposals. New projects would only be considered when funding for existing projects had been allocated. Any project not securing full funding should be deferred or cancelled. The medium term nature of funding capital projects should be incorporated into the fiscal strategy and be within the expenditure ceilings.
- Improving accountability of capital project performance – Frequently updated reports of the project progress should be published on the ministry of finance website, indicating important project status information.

An illustrative timeline for incorporating fiscal strategy into the updated budget process

17. **For effective medium-term fiscal policy, it has to be linked to the annual budget process.** The design and implementation of the fiscal strategy would be an integral part of the new budget model. The indicative calendar and sequencing of the updated budget process is shown schematically below (see Table 1 for more details):

18. **In the first and the second phases, the fiscal strategy document is prepared.** In the first phase, macroeconomic projections and fiscal and expenditure frameworks are updated for the upcoming budget year and two outer years. Key policy priorities in line with the Development Plan



and the government action plan are specified. In the second phase, total expenditure ceiling is determined for the medium term while spending ceilings for main spending units (e.g. ministries) are specified in line with policy priorities. The ministry of finance (with input from line ministries) clearly specifies the no-policy-change assessment of expenditure and the impact of spending initiatives proposed that are within the aggregate expenditure ceilings for the medium term. A process of the prioritization of spending and linking policy priorities to spending needs to take place. Similar to Ireland and New Zealand, a review team of senior officials and advisers led by the ministry of finance and supported by the cabinet could be set up to deal with this challenge. The review team could also work with ministries and other entities to develop proposals for significant policy, regulatory, service and consequent expenditure changes to support government policy priorities and goals. Once the cabinet agrees on the fiscal strategy document with the binding aggregate spending ceiling for the upcoming budget year and indicative ceilings for the second and third year, it is submitted to parliament. The top-down approach thus enables the cabinet and parliament to focus on overall fiscal policy rather than get mired in details of the budget discussions.

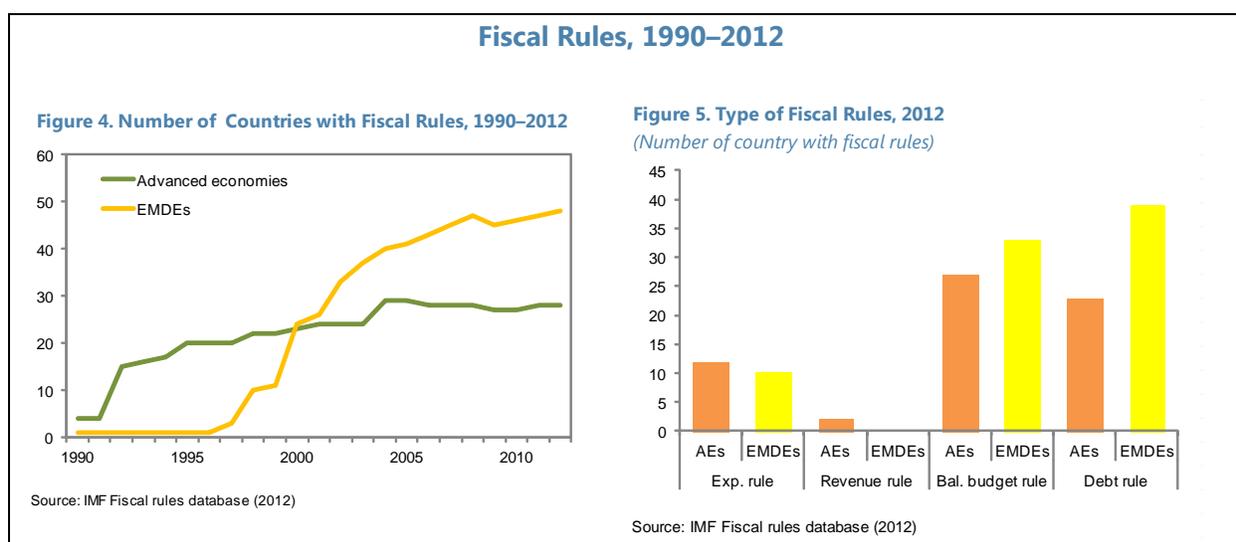
19. **In the third and fourth phases, the preparation of budget details start finished by the submission to parliament for approval.** The Ministry of Finance issues budget circulars and transmits expenditure ceilings to main spending units that start preparing their budget requests within those ceilings. Line ministries can take the initiative to identify savings to finance new policies. The Ministry of Finance continues to monitor that the total expenditure level is in line with the aggregate ceiling for the upcoming year and that the impact of spending plans for the medium-term by main spending units is not underestimated. While ceilings remain indicative for the period beyond the budget year, they should be regarded as binding on all spending units' plans that have implications for spending beyond the budget year. The budget is prepared using the latest macroeconomic forecast and payroll and other fiscal data. For instance, personnel spending for each ministry needs to be based on the actual number of persons on the payroll and latest payroll data,

while unfilled posts could be included in the ministry of finance budget estimates to be released when the post is filled. After the draft budget is finalized, it is submitted to parliament. Since parliament has already approved the total spending level through the adoption of the aggregate expenditure ceiling, and has been informed of the allocation to main spending units, the discussion of the budget in parliament should not lead to an increase of total expenditure, but rather focus on the allocation of the expenditure to policies, budget lines, and appropriations.

Towards fiscal rules – anchoring fiscal targets in the fiscal strategy

20. **A well-designed fiscal rule could be considered as a way of reinforcing multiyear fiscal framework, as it provides an anchor for the formulation of medium-term fiscal targets or ceilings.** Different fiscal rules have very different implications for the way fiscal policy delivers fiscal policy objectives and responds to shocks, and policymakers' choice of appropriate fiscal rules is thus key in ensuring its success.

21. **Many countries have resorted to fiscal rules.** Fiscal rules are of several types: expenditure, revenue, budget balance, and debt. Each rule has its advantages and disadvantages.⁵ As illustrated in Bova, Carcenac, and Guerguil (2014), the number of emerging and developing countries with fiscal rules increased substantially in the 2000s (Figure 4). Debt and balanced budget rules are used more frequently than expenditure and revenue rules (Figure 5). Usually debt rules involve certain debt ceilings (e.g. 60 percent of GDP in the European Union), while budget rules use balanced budget in structural or cyclically-adjusted terms (that is, adjusting for economic cycles). Expenditure rules usually involve restraints on the growth rate of spending, for instance, in line with nominal GDP growth. Many countries also use a combination of these rules, usually debt and balance rules, which could mitigate some of the shortcomings of each rule used separately.



⁵ See Schaechter et. al. (2012).

Table 1. Indicative Calendar for Main Stages in the Budget Process

Main Stages	Proposed Period
Updating the fiscal strategy, including macroeconomic forecasts, fiscal and expenditure frameworks for the budget year and the next two years.	Mar.-Apr.
Consideration and approval by the government of the updated fiscal strategy for the budget year and the next two years, together with expenditure ceilings for main spending units (e.g. ministries).	Apr.-May.
Finalization of the fiscal strategy document and its submission to parliament.	Jun.
Discussion of the fiscal strategy document by parliament and its budget and finance committees.	Jun.-Jul.
Issue a budget call circular: transmission of expenditure ceilings and framework letters to main spending units (line ministries), specifying the macroeconomic and fiscal context within which main spending units develop their budget requests.	Aug.
Mid-year review of the implementation of the fiscal strategy and annual budget, and submission of a report to parliament.	Sep.-Oct.
Updating of fiscal strategy and the medium-term expenditure ceilings necessitated by the changes in the macroeconomic forecasts; approval of recommended changes and notification to main spending units of these changes. Submission of proposed budgets and estimates for the budget year and the next two years by main spending units to the ministry of finance. Review, negotiation, and finalization of draft budget estimates by the ministry of finance. The annual budget documents should include information on its alignment with the fiscal strategy and require explanations of any deviations of the draft annual budget from the fiscal strategy.	Sep.-Nov.
Cabinet approval of draft budgets and budget laws based on main spending units' draft budgets, together with a budget policy statement and the updated fiscal strategy for the budget year and the next two years.	Dec.-Jan.
Submission of draft budgets and budget laws to parliament.	End-Jan.
Approval of the budget and budget laws.	End-Mar.

22. **In commodity exporters, standard fiscal rules are modified to take account of fiscal sustainability or commodity price volatility.** In addition to the standard rules, non-resource balance rules and structural balance rules have been used (Baungsgaard et. al. 2012). Non-resource balance rules take into account fiscal sustainability issues and use indicators based on the permanent income hypothesis (PIH), while the structural balance rules adjust for the volatility of commodity prices (e.g. Chile and Russia). Katayama (2012) explores the application of fiscal rules to Kuwait and concludes that non-oil primary balance rule or expenditure rule would have resulted in reduced spending, increasing saving by an additional 25–40 percent of GDP in the five-year period. However, these rules also have their shortcomings. The structural balance rule, while useful in restricting the government from overspending in case of higher-than-expected oil prices, does not provide the

optimal amount of spending and saving given the oil production profile, high volatility, and persistence of oil income. The PIH model provides the optimal solution, which is an annuity value that can be consumed forever based on a net present value of oil wealth. It addresses the intergenerational equity concerns but does not deal with income volatility and is sensitive to parameter specifications such as the real interest rate, growth, and oil prices and production that go far into the future.

23. **An alternative rule to anchor fiscal targets is a modified expenditure rule that uses a finite-horizon precautionary saving model with investment.** The model incorporates investment that affects the growth path, and the finite horizon allows bypassing making stringent assumptions into the infinite future and incorporates the oil depletion profile while focusing on the relevant short and medium term decision horizon (Cherif and Hasanov 2013). For Kuwait, current spending is expected to exceed the optimal path (50 percent of permanent income) while the actual investment rate is below the optimal investment rate of 20 percent of permanent income (Figures 6–7). These projections are based on a projected decline in oil prices in the medium term (baseline scenario). In addition, since investment in the model directly contributes to the growth of tradable income, investment is to be allocated toward the development of the tradable sector to support growth.⁶

24. **The model also provides the optimal amount of saving after the decision on spending and investment is made.** The optimal 30 percent of permanent income is accumulated in safe and liquid assets as it provides insurance in case of negative income shocks. Kuwait Investment Authority (KIA), the country's sovereign wealth fund, already has accumulated a large amount of foreign assets, some of which are considered safe and liquid such as short-term government bills. The foreign asset accumulation is also made possible by the existing rule that a 25 percent of oil income received by the government goes to the Future Generations Reserve Fund managed by KIA, while the budget surplus is accumulated in the General Reserve Fund.

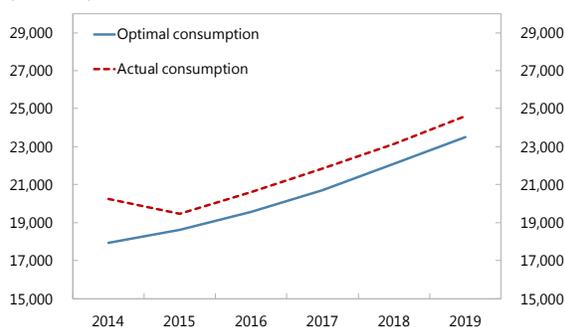
25. **Given the volatile nature of resource revenues, Kuwait could benefit from a flexible fiscal framework rather than a permanent strict numerical target.** As discussed above, the framework would include (i) principles for fiscal policymaking, (ii) a requirement for the government to set a target for one or more fiscal indicators, (iii) the content of the fiscal strategy statement in which those targets are set, (iv) the arrangements for reporting performance against those targets; and (v) an escape clause to deal with exceptional circumstances which prevent the government from meeting its fiscal objectives. Procedural rules in a volatile environment thus argue for allowing the Ministry of Finance the flexibility to change its quantitative fiscal targets within a principle-based framework. This indeed suggests a trade-off between a rigid fiscal rule with high risks of becoming obsolete and a flexible yet less credible rule. In that respect, having explicit revision clauses in place (e.g., targets to be reassessed at the revision of the fiscal strategy, for example) would help avoid undermining the credibility of the framework with too frequent changes.

⁶ For more details, see Hasanov (2013) and Cherif and Hasanov (2013).

Current and Investment Spending, 2014–19

Figure 6. Optimal vs. Projected Current Spending, 2014–19

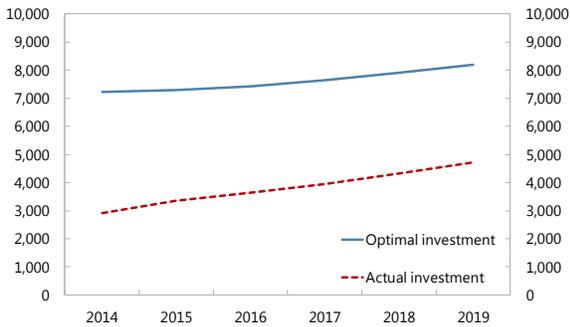
(KD millions)



Source: IMF staff calculations.

Figure 7. Optimal vs. Projected Investment Spending, 2014–19

(KD millions)



Source: IMF staff calculations.

26. **The escape provisions should be specified to cover the acceptable reasons for departing from the fiscal principles and rules, including targets and limits.** Changes could be permitted when any of the following applies: (i) national security requirements; (ii) natural disasters; (iii) change in the coverage of a budget that affects a policy, target, or limit; (iv) change of government; and (v) material change in the macroeconomic indicators or assumptions underpinning the macroeconomic and fiscal forecasts. Any such changes should be explained in the fiscal strategy, including: (i) reasons for departing from the fiscal principles or rules; (ii) measures the government intends to take to return to compliance; and (iii) period of time the government expects to take to return to compliance with the fiscal principles or rules.

C. Concluding Remarks

27. **With a need to diversify away from oil—a major and volatile source of income for the government of Kuwait—fiscal policy has to pursue several objectives.** Volatility of oil prices calls for smoothing of spending as well as accumulating safe and liquid assets. Diversification away from one source of income argues for investments in the non-oil tradable sector. The conduct of fiscal policy in achieving these goals would require several important elements: (i) a fiscal strategy, including medium-term macroeconomic and fiscal frameworks, the allocation of revenues among current spending, investment, and saving, and a medium-term expenditure framework with spending ceilings and public investment program; and (ii) the annual budget designed to support these reforms and linked to a medium-term expenditure framework.

28. **The fiscal strategy design and implementation on yearly basis are based on a few key areas such as:**

- Determining targets or ceilings for major fiscal parameters for a three-year rolling framework with binding next budget year and indicative two outer years;
- Establishing a clear process for expressing policy objectives and their link to expenditure;

- Exercising a clear top-down approach and process for defining ministerial spending ceilings; and
- Integrating the MTEF, including public investment program, in the budget process.

29. **The illustrative budget sequencing with the fiscal strategy spearheading medium-term fiscal policymaking and linked to the annual budget process would support fiscal policy implementation.** In addition, the design of procedural fiscal rules and aggregate expenditure ceilings should be explored, which should guide aggregate spending envelope and provide an anchor for fiscal policy. Lastly, the goals and initiatives of the government's Development Plan need to be incorporated into the fiscal strategy and help steer the implementation of the government's policy priorities. These would help the government to better achieve its two major goals of smoothing spending and building precautionary and intergenerational reserves as well as facilitate the diversification process.

Appendix I. The Main Components of the Fiscal Strategy

- **Macroeconomic forecasts:** The fiscal strategy contains information on the macroeconomic situation and outlook and forecasts for:
 - (a) The forthcoming budget year and two further years, actual results for the two years prior to the current year (prior to the forthcoming budget year), and the estimated results for the current year of the economic aggregates that are most relevant to the fiscal strategy, including:
 - (i) GDP and its components;
 - (ii) consumer prices and deflators;
 - (iii) unemployment and other labor market indicators;
 - (v) oil and gas prices and production;
 - (vi) exchange rates and other relevant prices;
 - (vii) current account, external reserves, and the balance of payments;
 - (viii) assumptions underpinning the forecasts;
 - (ix) forecasts from international organizations or private sector institutions.
 - (b) Medium-term macroeconomic forecasts affecting fiscal policy, targets or limits for fiscal rules and compliance with the fiscal responsibility principles.

- **Fiscal framework:** The fiscal framework section of the fiscal strategy contains fiscal forecasts, including the government's planned fiscal aggregates for:
 - (a) The forthcoming budget year and two further years, actual results for the two years prior to the current year (prior to the forthcoming budget year), and the estimated results for the current year, including:
 - (i) expenses by total, aggregated economic classification, and functional classification;
 - (ii) revenues by classification, showing types of revenues;
 - (iii) overall and primary balance of revenues and expenses for the consolidated budget;
 - (iv) capital expenditures;
 - (v) level of debt, assets, borrowing/saving, and transfers to the Reserve Funds;
 - (vi) any other information the minister of finance determines is material to the fiscal strategy;
 - (vii) key assumptions on which the above numbers are based;
 - (viii) sensitivity analysis, taking account of possible changes in macroeconomic conditions.

(b) Forecasts for the medium term used in formulating fiscal policies in the fiscal strategy (such forecasts would take account of the impact of changes in demographics and other factors).

- **Fiscal policy:** The fiscal framework section of the fiscal strategy also contains the government's fiscal policy for the forthcoming budget year and two subsequent years, including:

(a) An explanation of the fiscal policies in relation to fiscal responsibility principles and fiscal rules, and any temporary measures to be implemented to ensure compliance, including measures to moderate cyclical fluctuations and process for their reversal;

(b) Revenue policy, including planned changes to taxes and policies affecting oil revenues and other revenues;

(c) Deficit policy, including deficit limits required by or implied by the fiscal rules;

(d) Debt policy and an analysis of debt sustainability;

(e) Asset policy and intergenerational fiscal sustainability analysis;

(f) Expenditure policy, including expenditure priorities, aggregate expenditure intentions, including for the consolidated budget and other budgets; and expenditure ceilings and other targets or limits implied by or required by the fiscal rules;

(g) Fiscal risk statement, including contingent liabilities, any commitments not included in the fiscal forecasts, and all other circumstances which may have a material effect on the fiscal and economic forecasts and which have not already been incorporated into the fiscal forecasts;

(h) Summary table of all fiscal targets or limits for the fiscal rules for the forthcoming budget year and two further years, actual results for the two years prior to the current year (prior to the forthcoming budget year), and the estimated results for the current year;

(i) An assessment of the consistency of the planned fiscal policy, aggregates, and targets or limits for fiscal rules with the fiscal responsibility principles, including a statement of government initiatives to improve policy, service delivery, and the quality of spending, initiatives to reduce barriers to business and to encourage private sector growth;

(j) An explanation of the relationship of the revised fiscal strategy to the previous fiscal strategy and explanation of any significant changes.

- **Medium-term expenditure framework:** The fiscal strategy contains the government's medium-term expenditure framework for spending units such as line ministries for the forthcoming budget year and two subsequent years, and has information on:

(a) The expenditure priorities and their rationale, including an explanation of how government intends to improve policy, the efficiency and effectiveness of service delivery, the quality of its

regulatory activities, and its initiatives to reduce barriers to business and encourage private sector growth in various sectors;

- (b) Any expenditure ceilings in addition to those required by fiscal rules;
 - (c) Expenditure presented by a spending unit or groups for proposed expenditure by economic classification, functional classification, and other methods of presentation;
 - (d) The public investment program based on the Development Plan, including priorities and rationale, estimated results for the current year and forecast costs for the forthcoming budget year and two succeeding years related to expenditure ceilings;
 - (e) Actual and forecast nonfinancial performance information at a suitable level of aggregation linked to the budget to show what is planned to be provided and achieved for the proposed expenditure (starting at a time when the government is ready to pursue performance assessment).
- **Statement of responsibility:** The fiscal strategy contains a statement of responsibility signed by the prime minister and the minister of finance attesting to the reliability and completeness of the information in the fiscal strategy and its compliance with the law.

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EFFICIENCY OF PUBLIC INVESTMENT IN KUWAIT—A PRELIMINARY ASSESSMENT¹

Higher capital spending by government should be accompanied by improved efficiency of public investment. Public investment in Kuwait (excluding oil related investment of public enterprises) has remained on average unchanged (as share of GDP) and underperformed successive budget allocations. Government will need to increase capital spending to enhance social and physical infrastructure and boost non-oil growth. If well spent, higher public investment would support economic diversification and job creation for Kuwaitis in the private sector. Although economic appraisals are undertaken for large projects, though not uniformly, several aggregate indicators suggest that Kuwait has space to further improve the quality and efficiency of public investment.

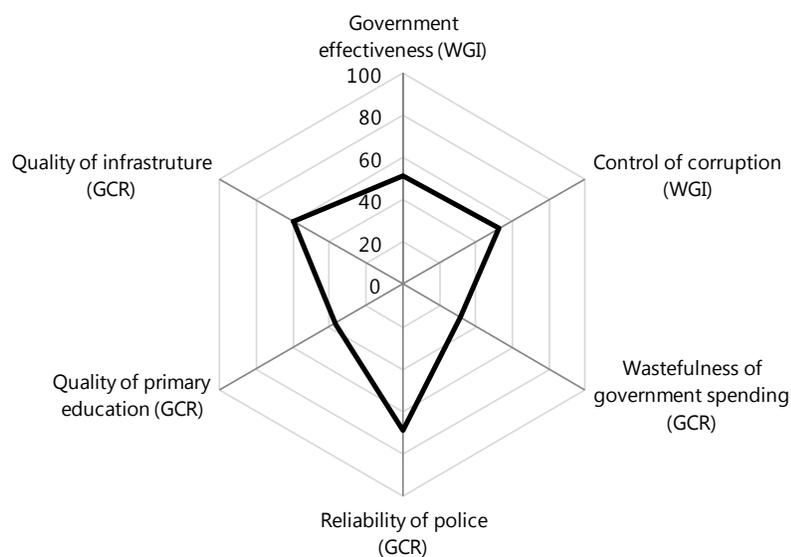
A. General Effectiveness of Public Spending

1. **There is room to improve overall government effectiveness as revealed by various surveys.** While a proper assessment of spending effectiveness requires granular information about government objectives and spending allocation, survey indicators help to broadly assess public spending effectiveness. The 2013 World Bank's Worldwide Governance Indicators score Kuwait 51 and 53, out of 100, in terms of government effectiveness and control of corruption, respectively, the lowest among GCC countries. Transparency international's 2013 Corruption Perception Index scores Kuwait 44 out 100, same as Saudi Arabia, but below the rest of its GCC peers. The World Economic Forum's Global Competitiveness Report scores Kuwait 60 (out of 100) in overall quality of infrastructure; but more poorly at 31 and 37 in terms of wastefulness of government spending and quality of primary education, respectively (Figure 1).

2. **Government effectiveness in Kuwait lags behind similar high per capita income countries and GCC peers.** There is a tendency for high-income countries to observe high perceived government effectiveness, since as countries grow richer the opportunity cost of resources increases, and the incentives to make better use of them also increases (for instance, higher wages typically reflects a higher value of time, which increases the incentive for having less time consuming provision of services). For Kuwait, perceived government effectiveness compares unfavorably with similar income per capita countries (for instance, Japan, Austria, and Netherlands) as also with other GCC countries (Figure 2).

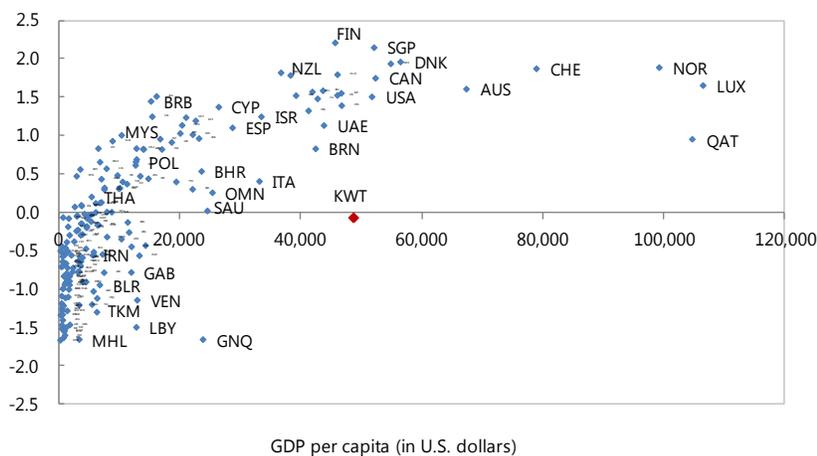
¹ Prepared by Sergio L. Rodriguez. This note draws on current work at the IMF on public investment efficiency. In particular, see *Making the Most of Public Investment in Oil Exporting Countries*. International Monetary Fund, Staff Discussion Note, forthcoming.

Figure 1. Selected Indicators Helpful to Assess Effectiveness of Public Spending
(Percentile)



Sources: 2013 World Bank Government Indicators (WGI) and 2013–14 Global Competitiveness Report (GCR).

Figure 2. Perceived Government Effectiveness and GDP per Capita, 2013

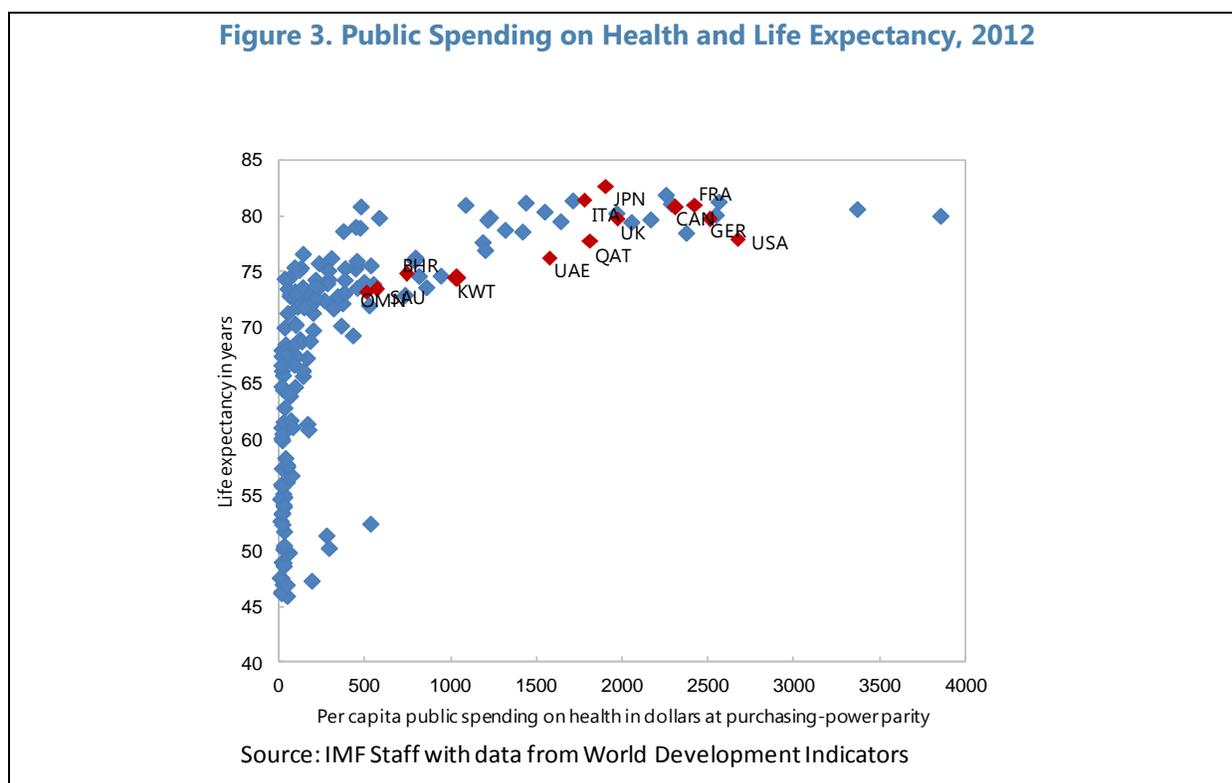


Source: World Bank Worldwide Governance Indicators; IMF

3. Public spending on health and education is high, but appears relatively inefficient.

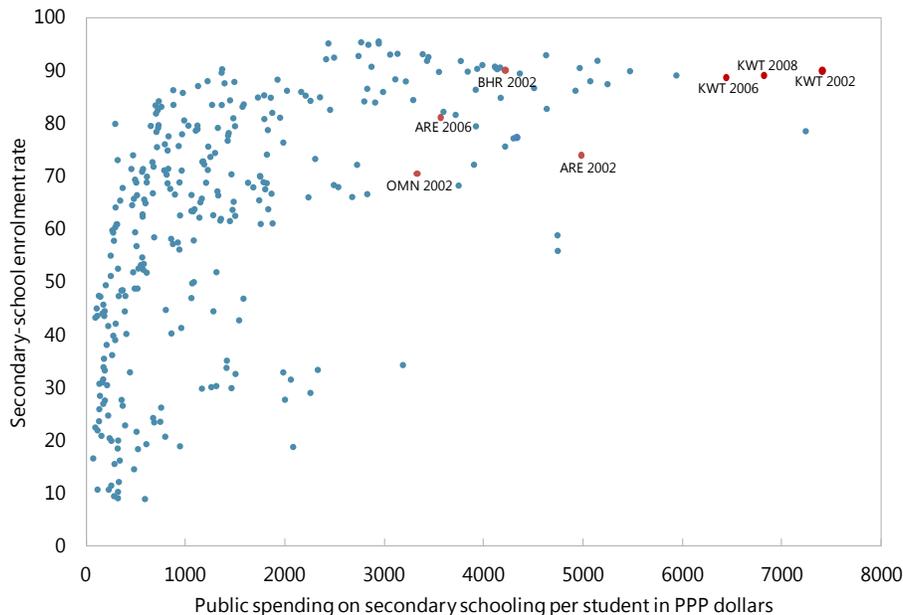
Assessing efficiency requires a direct comparison of outcomes and inputs. Comparing public spending on health and education with outcomes in terms of life expectancy and enrollments rates could provide a broad idea about spending efficiency in Kuwait. In both cases, Kuwait appears to have unexploited efficiency gains:

- Relative to other countries, Kuwait’s per capita public spending on health (about \$1,000 at purchasing power parity (PPP)) is relatively high (twice the world average), particularly considering that its population life expectancy is 74 years; amount spent per year of life expectancy is about \$14 in Kuwait, compared with less than \$10 in Bahrain, Oman, and Saudi Arabia. Other countries with similar life expectancy spend considerably less than Kuwait (for instance, Bahamas, and the Slovak Republic). While current public spending is only one of many elements affecting life expectancy—as it does not capture previous investments on health, private spending on health, as well as climate, diet, and life styles—this finding suggests that there is room for improvement (Figure 3).



- Similar findings emerge when comparing public spending on secondary education per student with secondary education enrollment rates. Kuwait spends about \$7,800 per student (at PPP) and has an enrollment rate of 89 percent, about \$88 per percentage point of enrollment; countries with similar or higher enrollment rates—such as Poland, Hungary and Serbia—spend considerably less per student. When compared with its GCC peers, public spending per percentage point of enrollment is higher in Kuwait than in Bahrain, Oman, Saudi Arabia and the UAE, where they range between \$40 and \$55, also suggesting scope for improving efficiency. This metric is, however, imperfect, since it only approximates inputs for producing higher enrollment rates; it does not consider previous investments, or private spending on education, and does not capture quality, or the ability of students to read and solve mathematical problems (Figure 4).

Figure 4. Public Spending and Enrollment Rates in Secondary Education



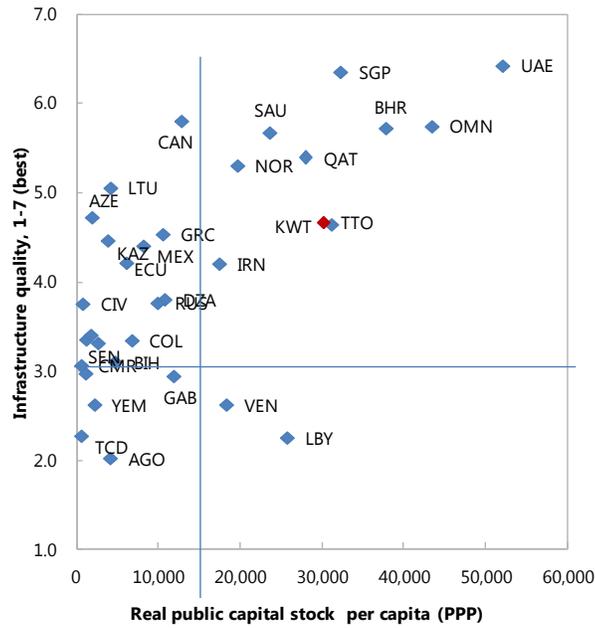
Source: Grigoli (2014, figure 6).

B. An Assessment of the Efficiency of Public Investment

4. **This section assesses the efficiency of public investment by looking at infrastructure related indicators.** In general, survey results on the quality of infrastructure, and aggregate technique analysis that compare public investment per capita and the quality of infrastructure, point to the need for Kuwait to improve the outcome of public investments. Analysis based on unit cost of transport infrastructure projects suggests caution when assessing efficiency, since cost overruns could be high in these projects. A proper assessment of investment efficiency for these projects would require a cost-benefit analysis.

5. **The overall quality of Kuwait's infrastructure is perceived of only moderate quality.** While Kuwait's public capital stock per capita is relatively high, the perceived quality of its infrastructure is relatively low (Figure 5). The most recent World Economic Forum's Global Competitiveness Indicators ranked Kuwait 59 (out of 148 countries), with score of 4.4 (maximum score = 7), in terms of quality of infrastructure, slightly above the global average score of 4.3. The quality of its port and air transportation infrastructure, however, was scored 4.1 (ranked 74) and 4.0 (ranked 93), respectively, below global average scores (4.2 for ports and 4.4 for air transportation). Kuwait ranks low, particularly when compared with other high income countries (for instance, Finland, Germany and Singapore), and ranks the lowest among GCC countries (Figure 6).

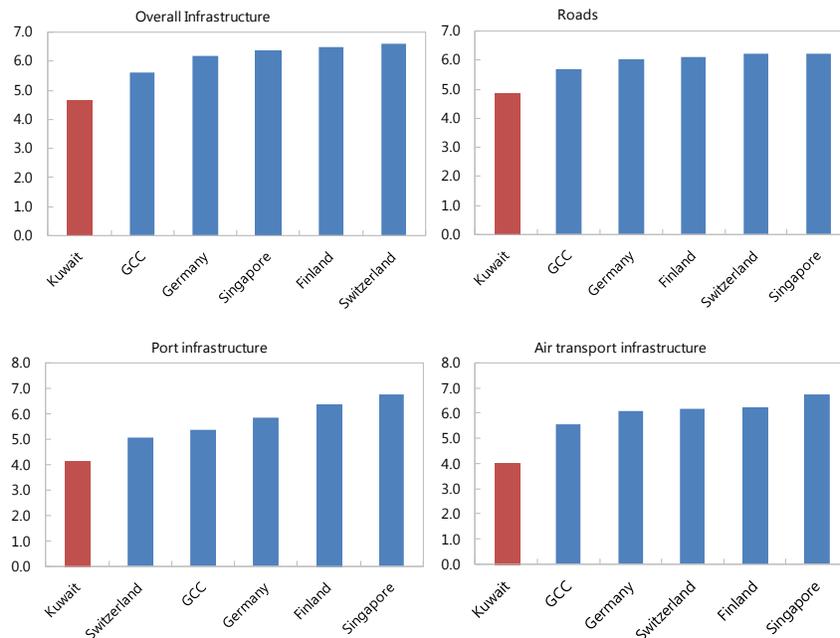
Figure 5. Public Capital Stock and Quality of Overall Infrastructure, 2013



Sources: Global Competitiveness World Economic Forum and World Penn Tables

Figure 6. Global Competitiveness Indicators, 2013

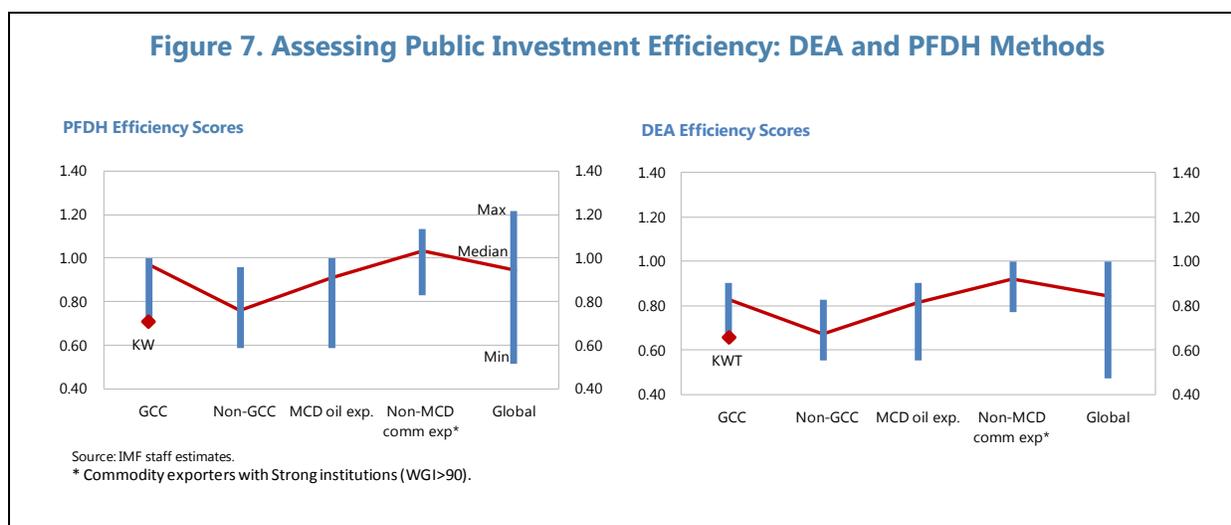
(=minimum, 7=maximum)



Source: Global Competitiveness Indicators, World Economic Forum.

6. **The efficiency of public investment is assessed using two techniques that measure how well countries transform inputs (resources) into outputs (infrastructure).** Specifically, efficiency can be measured using the Data Envelope Analysis (DEA) and the Partial Free Disposal Hull (PFDH).² The main difference between these approaches is that the DEA compares each country against a fixed country sample, whereas the PFDH makes the comparison against repeated randomized subsamples, thus reducing sensitivity to outliers. In the analysis reported here output (the quality of infrastructure) was approximated using the infrastructure subcomponent of the Global Competitiveness Indicators, while inputs were measured as the real public capital stock per capita in purchasing power parity terms, provided by the World Penn Tables. Under both methods, a higher score implies greater efficiency.

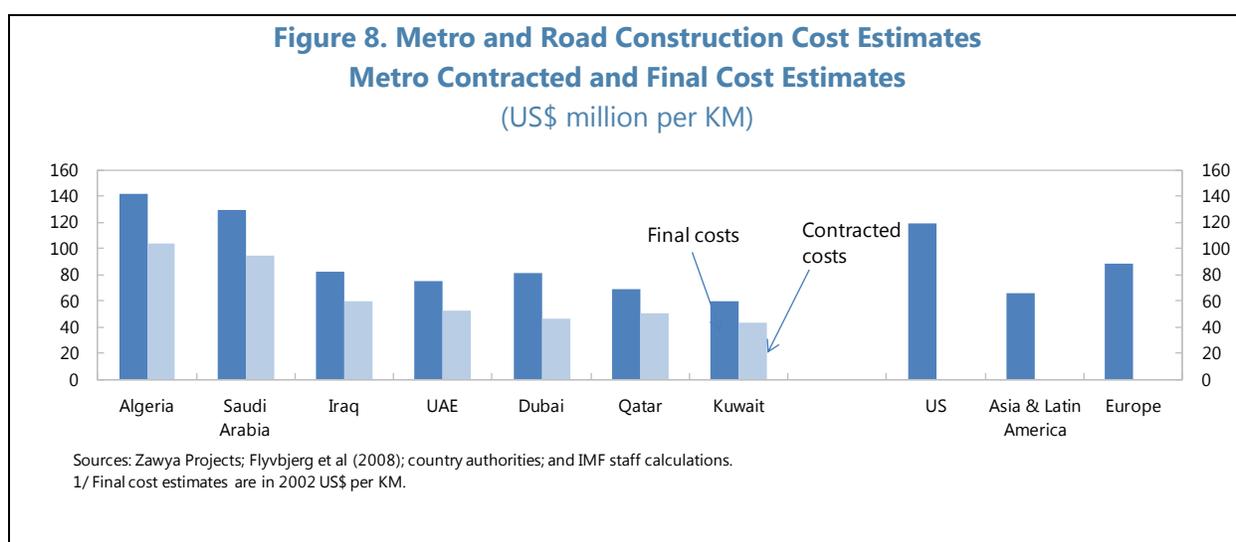
7. **Results from the analysis suggest that Kuwait's public investment efficiency compares unfavorably with other countries, including other GCC countries (Figure 7).** Kuwait needs to strengthen efforts to improve the quality of its infrastructure. The DEA results suggest that Kuwait's score is among the lowest in the GCC and non-GCC oil exporters. Comparing Kuwait with some advanced economies with strong institutions such as Canada, Chile, and Singapore, suggests that there is significant scope for improving efficiency in Kuwait. Results based on the PFDH method are broadly similar.



² Data Envelope Analysis (DEA) is a non-parametric linear programming technique used to estimate measures of technical efficiency. It measures the relative efficiency of units (for example, branches, firms or countries) by comparing how far their input-outputs are from an efficiency frontier. The efficiency frontier is a linear combination of the best input-output observations; it is a piece-linear surface that *envelops* the data. The Partial Free Disposal Hull (PFDH), instead of benchmarking a decision making unit relative to the best performing peer in the sample, it compares each unit against the best performer in a subsample of peers; several subsamples are randomly created with replacement, with the efficiency frontier built using the subsample results. The PFDH methodology attenuates the impact of extreme observation on the estimated efficiency, a weakness of the DEA approach.

8. **The efficiency of public investment could also be assessed by examining the construction costs of large public infrastructure projects.** Cost estimates are based on project-level data for MENA oil-exporting countries, using the Zawya database. The analysis considers metro projects and large scale road projects (i.e. roads longer than 20 kilometers). Unit costs are estimated on the basis of contracted prices and planned capacity (i.e. they are not necessarily the actual costs). Other factors that could affect the unit costs (e.g. quality, technical complexity, etc.) are not taken into account.

9. **Contracted metro construction costs per kilometer in Kuwait are lower compared with other GCC countries (Figure 8).** Nevertheless, the cross-country variation in these estimates (from \$44 million per kilometer in Kuwait to \$94 million per kilometer in Saudi Arabia), even within the GCC, points to uncertainty about the final costs of these projects and flags the possibility of substantial costs escalation. Flyvbjerg and others (2002) find an average cost overrun of 45 percent for rail related projects, with a higher average overrun (65 percent) for projects outside Europe and North America. The experience of Dubai shows that final costs exceeded the contracted price by 75 percent.



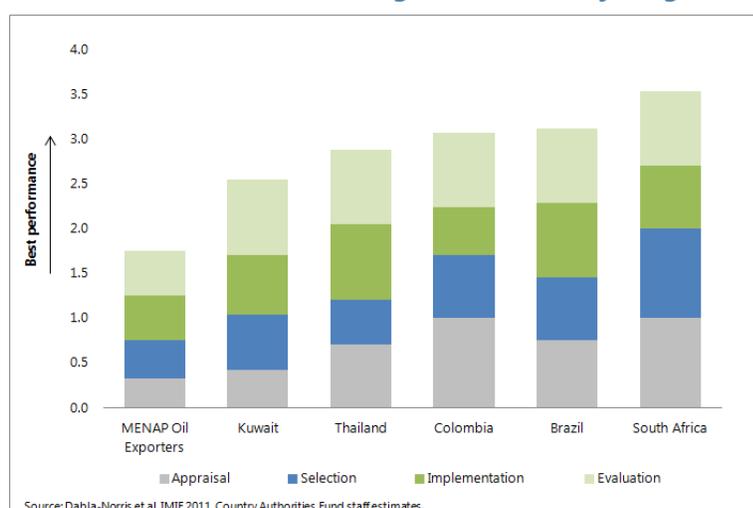
10. **The construction cost of one large road project in Kuwait is in the lowest-end of costs for similar projects in the region.** The estimated per-kilometer-per-lane cost of the only road project in Kuwait considered in this analysis is about \$0.2 million. In contrast, costs range from \$0.5 million to \$1 million in the UAE and from \$0.7 million to \$7.4 million in Qatar. The Muscat Expressway in Oman, completed in 2012, for example, cost close to \$350 million, compared to a contract value of \$330 million, a six percent overrun. However, a proper assessment of investment efficiency for these projects would require not only accounting for the costs, but also to taking into consideration the benefits of the project for the whole economy, i.e. a cost-benefit analysis.

C. Quality of the Public Investment Management System and Policy Recommendations

11. **Kuwait needs to strengthen the control process of the investment cycle (appraisal, selection, implementation, and evaluation), learning from experiences in other in other countries, while it continues building strong institutions.** These are important elements for securing high returns on investment projects. In the near-term authorities could adopt a general strategy to raise the oversight of public investment projects, and over the medium-term revamp the framework for managing public investments.

12. **The processes that are used to manage public investment can be examined using the Public Investment Management Index (PIMI).** This index measures the quality of the institutions that influence the efficiency of public investment in the four main stages of the investment cycle: appraisal, selection, implementation, and evaluation.³ Kuwait's scores are based on a self assessment of Ministry of Finance on the basis of the survey developed by Dabla-Norris and others (2011). Since the self-assessment covers only central government spending, its findings are limited to a fraction of the overall public investment in Kuwait.

Figure 9. Public Investment Management Index by Stages of Project Cycle



³ It was developed by Dabla-Norris and others (2011) for 71 countries using diagnostics of countries' public investment management systems conducted by The World Bank, budget survey databases, donor assessments, and expert surveys.

13. **Kuwait performs significantly better than oil exporters in the MENA region in terms of PIMI scores, but it falls behind compared to other emerging market economies.** The self assessed PIMI components indicate that Kuwait performs better than the average for oil exporters in the MENA region (Figure 9). Kuwait emerges relatively stronger when implementing and evaluating projects than when appraising and selecting them.

14. **Several actions are needed over the near-term and medium-term to enhance the efficiency of public investment.** Actions in the near term would include adopting a general strategy to raise the oversight of public investment projects by increasing the transparency of such projects, preparing an infrastructure needs assessment, and assessing the state of the public investment management system. Over the medium term, the framework for managing public investment should be revamped, particularly by strengthening the medium-term expenditure framework, the appraisal of investment projects, and by introducing a systematic ex-post evaluation of projects. To further strengthen project appraisal and selection, the authorities could improve transparency of appraisal standards, introduce an independent review of appraisals, and adopt medium-term planning to facilitate clear and consistent selection of projects. Kuwait could learn from experiences of other resource rich countries, like Chile and Norway, when establishing a public investment management framework. Strong institutions can play crucial role in increasing public investment efficiency.

SMALL AND MEDIUM ENTERPRISES: PURSUIT OF GROWTH AND DIVERSIFICATION IN KUWAIT¹

A. Role of SMEs in Economic Development and Employment

1. **Globally, small and medium enterprises (SMEs) account for a significant share of output and employment.** The estimated number of micro, small, and medium-size enterprises is somewhere between 420 and 510 million worldwide, of which between 80 and 95 percent are located in developing markets. SMEs account for a significant share of employment, contributing up to 45 percent of employment and up to 33 percent of GDP in developing countries, with estimated contributions increasing significantly to 62 percent and 64 percent, respectively when SMEs operating in the informal sector are counted.² The private sector accounts for 90 percent of the jobs created worldwide, of which SMEs contribute to more than 50 percent. In emerging economies, SMEs account for about two-thirds of the formal jobs in the private sector.³

B. Constraints Facing SMEs

2. **Access to finance is a significant problem for SMEs.** According to World Bank enterprise surveys, approximately 45–55 percent of formal SMEs need credit but do not have access to it, and 21–24 percent have access to some credit but identify financing as a constraint. Ballpark estimations set the worldwide financing gap between US\$3.2 and US\$3.9 trillion, of which 66 percent is located in emerging markets. Estimates show that only 8 percent of bank lending goes to SMEs across the Middle East and North Africa (MENA) region and even less in GCC countries at 2 percent.⁴ Studies for the MENA region identify the lack of appropriate collateral (ranked as the single biggest obstacle), high interest rates, lack of needed contacts, and lack of business skills as the main financing constraints facing SMEs and estimate a credit gap of \$160 to \$180 billion for the MENA region.⁵

3. **SMEs also face a number of nonfinancial barriers.** Supporting legal and regulatory framework, ineffective government supporting mechanisms, high tax rates, lack of transparency,

¹ Prepared by Sergio Rodriguez and Ananthakrishnan Prasad.

² International Finance Corporation (IFC). *Scaling-Up SME Access to Financial Services in the Developing World*, Washington, DC; IFC, November 2010

³ International Finance Corporation (IFC). *Small and Medium Enterprise Finance: New Findings, Trends and G-20/Global Partnership for Financial Inclusion Progress*, Washington, DC; IFC, August 2013

⁴ World Bank/Union of Arab Banks Survey of 130 banks in *Overcoming Constraints to SME Development in MENA Countries and Enhancing Access to Finance*, IFC Advisory Services in the Middle East and North Africa, 2013.

⁵ Al-Yahya, K. and J. Airey. *Small and Medium Enterprises in MENA: Leveraging Growth Finance for Sustainable Development*. Heart and Mind Strategies, Shell Foundation and Citi Foundation. February 2013, and IFC and McKinsey & Company. *SME Banking Opportunity in MENA*, MENA SME Banking Conference, May 2013.

absence of reliable data sources, and absence of specific market niches represent important nonfinancial barriers for SMEs. Other barriers include concerns about entrepreneurs' management competency and weak risk management bank practices.

C. Cross-Country Experience in SMEs Development

4. **Globally, government policy has aimed to support the creation of an enabling environment for SMEs through targeted or integrated approaches to lowering the financial and nonfinancial barriers.** France, Korea, and Malaysia, for instance, are following an integrated approach aimed at strengthening financial sector laws and regulation, and strengthening public support schemes. SPRING Singapore, an enterprise development agency under the Ministry of Trade and Industry, works with partners to help enterprises in financing, capability and management development, technology and innovation and access to markets. Further, as the national standards and accreditation body, SPRING develops and promotes internationally recognized standards and quality assurance infrastructure. Malaysia's National SME Development Council (NSDC) and SME Corp Malaysia created the framework that follows a three-phased approach: (i) strengthening the infrastructure for SME development; (ii) building capacity of domestic SMEs; and (iii) enhancing access to financing. France, Singapore, and India have created credit bureaus to reduce information asymmetry. China embarked upon a reform of its movable collateral framework to encourage financing against valuable movable assets. Other measures include a range of initiatives, from the development of leasing legislation in Jordan and Kosovo to the set-up of mandatory SME lending targets for banks in India, to entrepreneur summer training for 10–14 year-olds in Mexico.

5. **There are programs to support innovation through early stage financing to SMEs in most advanced economies.** Lerner (1996) shows empirically that firms that benefitted from the US Small Business Innovation Program (SBIR), which provided more than \$6 billion in funding between 1983 and 1995, grew significantly faster than comparable firms. After the failure to attract multinationals to a newly created Science Park in 1980, Taiwanese Venture Capital (VC) initiative provided financial incentives and tax credits to encourage the set up of firms (Kuznetsov and Sabel 2011). Seed Fund provided matching capital contributions to private VC funds. Two funds were established and run by US-educated Chinese invited to relocate there. The venture proved successful and large banks and corporates started creating their own VC funds. Even conservative family conglomerates followed suit and started investing in information technology businesses. By the late 1980s, the VC industry growth was well underway.

6. **The “insurance” for the tradable sector and access to financing are a second set of policies that countries have used.** These are provided through development banks, VC funds, and export promotion agencies. Given the long horizon of potential returns and high risk involved, cheap credit, grants, and access to equity funding would facilitate risk-return tradeoff choices conglomerates and SMEs would have to make.

7. **In the GCC region, governments have implemented programs to strengthen the SME sector.** Support programs in the GCC focus on distributing targeted loans and grants through government funding, collateralizing private-sector loans, providing business services, infrastructure,

and training for national entrepreneurs and workforce. However, there is scope for fostering synergies between different institutions by enhancing coordination, systematic evaluation, and exchange of information to complement and harmonize a diverse range of programs.

D. SMEs Development in Kuwait

8. **For the GCC, including Kuwait, SMEs are relevant as a potential source of job creation for nationals and economic diversification.** An estimated 880,000 SMEs exist in the region. About 85 percent of these are located in Saudi Arabia, 7 percent in the United Arab Emirates and the rest in the remaining GCC countries.⁶ In Saudi Arabia SMEs represent 95 percent of registered companies, compared with 90 percent in Oman and Kuwait, and 75 percent in Qatar. There are, on average for the GCC, 16 SMEs per 1,000 people, which account for 25 percent of employment, significantly below the global average of 30 SMEs per 1,000 people or 40 percent of employment. SMEs have a dominant presence in trading and construction, with room for expansion in manufacturing; for instance, in the UAE, Saudi Arabia, and Bahrain SMEs in manufacturing accounts for only 5, 12, and 14 percent of total SMEs, respectively.⁷

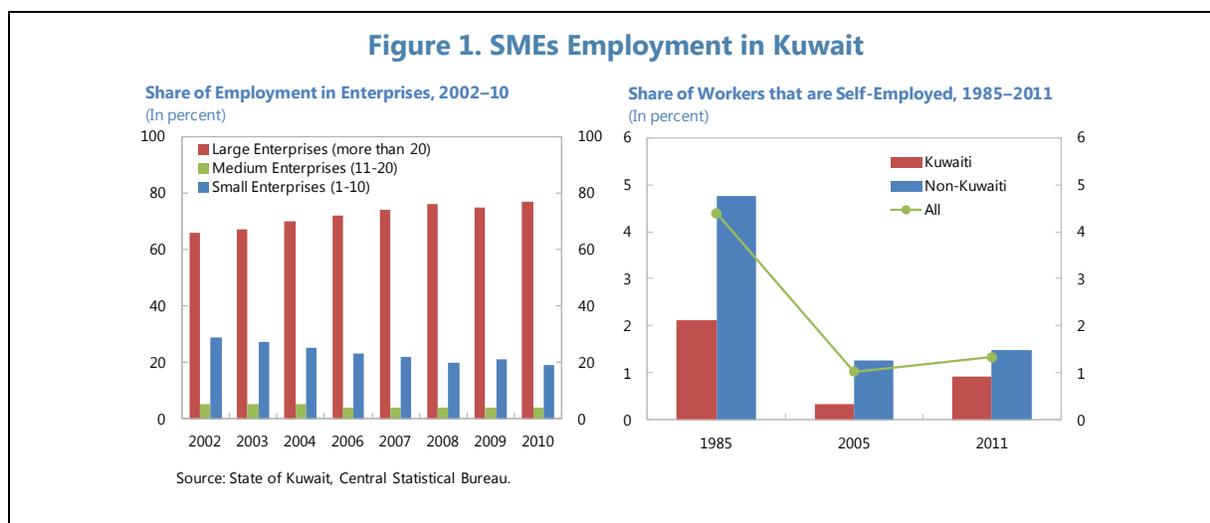
9. **Information related to SMEs in Kuwait is not easily available, and are dated.** According to the Industrial Establishment Survey (2012), 90 percent of the 5,500 industrial establishments in Kuwait employ less than 20 workers; only 12 percent of the jobs in industrial establishments are occupied by Kuwaitis. IFC and McKinsey data indicates that on the whole there are 12 SMEs per 1,000 people, contributing to 50 percent of employment. Data from Kuwait's Central Statistics Bureau (CSB) suggest that firms with less than 20 employees account for about 22 percent of employment; self-employed represent about 1.5 percent of employment (Figure 1).⁸ 40 percent of SMEs are in wholesale/retail trade and hotels and restaurants, and 33 percent in construction and industry.⁹

⁶ See International Finance Corporation (IFC) and McKinsey Database (2010). More recent estimates place the number of SMEs at 1.1 million, with Saudi Arabia accounting for about 63 percent. See Kuwait SMEs – Accelerating Economic Diversification. Markaz Research, August 2014.

⁷ Hertog, Stephen. Benchmarking SME Policies in the GCC: A Survey of Challenges and Opportunities. EU-GCC, Chamber Forum. Brussels 2010

⁸ International Finance Corporation (IFC) and McKinsey Database (2010)

⁹ Gulf Investment Corporation Weekly Economic Digest, Vol.3, Issue 109, January 31, 2013.



10. **Kuwait recently established a Fund to support SMEs and contribute to diversifying the economy with welcome features.** Kuwait established the National Fund for Support and Development (Fund) of SMEs in April 2013, with capital of KD2 billion (approximately US\$7 billion).¹⁰ The Fund was created to contribute to economic development, diversify the economy, and generate job opportunities for nationals by supporting SMEs. Its mandate is to finance up to 80 percent of establishment costs, up to a ceiling of KD500,000 excluding land value and other assets, and to finance a maximum amount of about KD400,000 to a feasible SME or project repayable over a 15-year period at a maximum fee of 2 percent of the amount financed. A one-stop shop would facilitate the quick processing of the loans. Its main role includes providing financing, technical assistance, including through business incubators, as well as develop and train human resources, and encourage innovation.¹¹ The law constituting the Fund defines SMEs as having (i) up to four Kuwaiti employees and maximum capital of KD250,000 (small-sized), and between five and fifty employees and maximum capital of KD500,000 (medium-sized). The law also prescribes that SMEs should be owned by Kuwaiti nationals and shall employ Kuwaitis in accordance with the schedule set by the Board of the Fund; owners should be fully dedicated to manage the firm. With SMEs accounting for about 50 percent of licenses (about 27,000) granted to new businesses, but receiving only about 2.3 percent of total corporate loans, this initiative is a step forward in reducing the funding gap.

¹⁰ Law No. 98 of 2013. Concerning the National Fund for Support and Development of Small and Medium-Sized Enterprises, The Official Gazette of Kuwait, Ministry of Information, April 2013

¹¹ With this Reform, Kuwait also consolidates through the Fund SMEs support previously provided by the Industrial Bank of Kuwait (Support of Kuwait Craft Activities and Small Project Finance established in 1998) and the General Investment Authority (established in 1997).

E. Remaining Challenges

11. **Going forward, accelerated innovation and cultural change will play a major role in the success of this initiative.** Although we do not expect the SME Fund to have an immediate impact on the overall economy in the near-term, since the utilization of funds and subsequent hiring by businesses requires time to be implemented, the government is on the right track as this plan deals directly with the structural issues faced by the country, namely, rising youth unemployment, and the ballooning public sector employment.

12. **The role of the newly established Fund should be to encourage accelerators and incubators to set up and grow.** Incubators with university links, coupled with research and development funds, would support the promotion of technology transfer and commercialization. Kuwait and Saudi Arabia, for example, have very low spending on R&D compared to other oil exporters. Another important factor is that the link between universities and industry needs to be strengthened.¹²

13. **For ensuring that the Fund meets its objectives, it should systematically measure its performance and the impact on Kuwait's economy.** While the general view is that SMEs contribute to net job creation, policy makers should be prudent when implementing SMEs support to reach the Fund's objectives.¹³ For instance, experience on support to SMEs points to the following considerations:

- **Ages of SMEs.** Studies for the US indicate that after controlling for firm age, SMEs do not create more jobs than larger firms, with small mature businesses having negative net job creation. They also report that startups contribute substantially to both gross and net job creation. Policies that target businesses of certain size, while ignoring the role of age, will likely have limited success in improving net job creation.
- **Structural dynamics of job creation.** SMEs support programs should be mindful of the structural nature of how firms enter, exit, and survive over time as survival rates for new firms decline rapidly—80 percent in year one, but fall to 50 percent by year five (estimates for the US). There may be a natural rate of firm failures not related to financial or nonfinancial barriers.

¹² A relevant example is the Massachusetts Institute of Technology's (MIT) Technology Licensing Office which facilitates investment in development of discoveries and inventions at the University. For instance, in 2012, about 200 patents were issued and 16 funded companies were established.

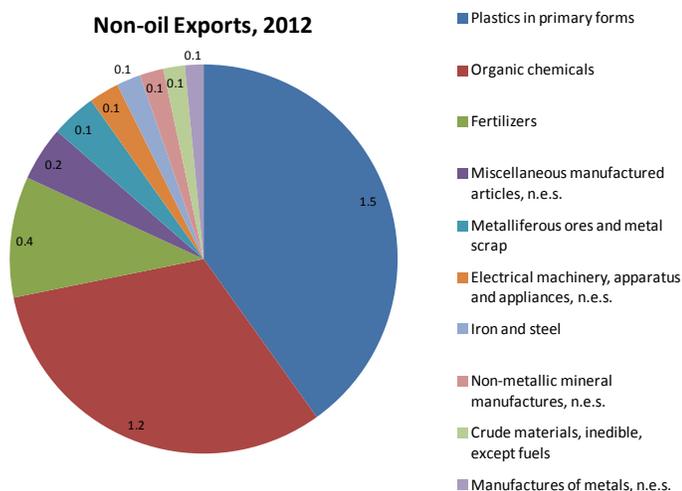
¹³ IFC Jobs Study. Assessing Private Sector Contributions to Job Creation and Poverty Reduction. Washington DC; IFC, January 2013; Haltiwanger, J. Jarmin, R. and Miranda, J. Who Creates Jobs? Small versus Large versus Young. *The Review of Economics and Statistics*, Vol. XCV, Number 2, May 2013. Pages 347–361; Strangler, D. and Kedrosky, P. Neutralism and Entrepreneurship: The Structural Dynamics of Startups, Young Firms, and Job Creation, Kaufman Foundation Research Series: Firm Formation and Economic Growth, September 2010; and Coelho, M. de Meza, D. and Reyniers, D. Irrational Exuberance, Entrepreneurial Finance, and Public Policy. *International Tax and Public Finance*, 11, 391–417, Kluwer Academic Publishers, The Netherlands, 2004

- **Entrepreneur cognitive biases.** SMEs support programs should take into account that entrepreneurs consistently overestimate their chance of success. For instance, business founders in New Zealand consistently believed their probability of failing was less than half the historical rate, and estimated rewards considerable higher than average. Identifiable cognitive biases create distortions and inefficiencies, and policies for increasing lending to SMEs could be welfare reducing.¹⁴

14. **The success of the government's efforts to develop SMEs will depend on a sectoral commitment to providing value-added services and linking them to the supply value chains of large corporations.** More generally, the government can foster linkages between public enterprises and SMEs to promote their development. A potential way to achieve this could be to create a program similar to the Ireland's National Linkage Promotion Program (1987–92). Started by the Industrial Development Authority, the program brought together multinational corporations (MNCs) and potential suppliers to facilitate local sourcing. The MNCs targeted were in the electronics industry, who contributed costs for the first two years of the program and provided technical assistance together with state technical agencies. The SMEs were thoroughly assessed for participating in the program and selected together with MNCs. In the 5-year program operation, MNCs increased locally sourced materials from 9 percent to 19 percent of their purchases. Oman has recently mandated an allocation of at least 10 percent of public tenders to SMEs, and for public enterprises to allocate 10 percent of their contracts to SMEs, but it is too soon to assess the success of the program.

15. **Promoting exports of certain existing industries, developing oil downstream operations, and creating new industries would be one way to promote viable SMEs.** With more than 95 percent of goods exports in oil and refined oil products, the rest are in other items such as plastics, chemicals and fertilizers. Promoting certain existing industries, for instance in chemicals, and developing oil downstream industries would be a first step. The

strategy should capitalize on the importance of technology in the oil industry such as in seismic, drilling, and extraction operations, with the support of joint ventures and eventually local firms, providing oil services. Promoting local content in the oil industry requires relevant human capital,



¹⁴ Coelho, M. de Meza, D. and Reyniers, D. Irrational Exuberance, Entrepreneurial Finance, and Public Policy. *International Tax and Public Finance*, 11, 391–417, Kluwer Academic Publishers, The Netherlands, 2004

technology, and know-how. The state should actively pursue developing these skills and knowledge by investing in research and development, partnering with foreign and local universities, encouraging students to pursue science and engineering majors, and attracting scientists and engineers from other countries to lead this process forward. Kuwait Institute for Scientific Research (KISR) seems to be ideally placed to coordinate and engage various agencies. In addition, since oil is used substantially in power generation, there is room to encourage lower power consumption (e.g. by reducing across-the-board electricity subsidies) to release oil for other uses. Modernizing refineries, as Kuwait Petroleum Corporation (KPC) is currently pursuing, would also support developing local talent, technology, and know-how. Finding a niche in downstream operations, for instance, in petrochemicals, is another avenue to pursue. The newly established Fund in Kuwait has the mandate to support local firms and create needed support functions.

16. **Creation of jobs for nationals in the public sector and proliferation of subsidies for nationals employed in the private sector negatively affect the development of SMEs.** The increase in the number of jobs and salaries in the public sector since 2011 reduces the incentives of Kuwaitis to set up an SME and makes it more attractive for young Kuwaitis to secure public employment. In addition, the proliferation of subsidies for nationals in the private-sector reduces the incentive of Kuwaitis to become SME entrepreneurs.

17. **A multifaceted policy strategy is needed to enhance private-sector job opportunities for nationals.** Policies should aim to level the field between public and private employment, and to increase the employability of national labor by fostering its productivity (education and vocational training); reduce the perception among nationals of entitlement to public-sector jobs (by reducing government job creation and rationalizing the wage bill), and improve the matching mechanism for nationals seeking employment in the private sector (wage and training subsidies, unemployment benefits conditional on training, and public information and search support for job opportunities).

KUWAIT ISLAMIC BANKING: AN ASSESSMENT OF STABILITY RISKS

A. Introduction¹

- 1. Islamic banking in Kuwait has expanded rapidly and is now systemically important in the domestic financial market and in global Islamic finance.** Kuwait operates a dual system where Islamic financial institutions and conventional banks co-exist. The Islamic finance industry includes banks, investment companies, investment funds, and the *Takaful* or insurance industry. At end-June 2014, banks accounted for 84.1 percent of the total financial system's assets, and Islamic banks accounted for 39 percent of banking system assets. At the global level, Kuwait has the fifth largest share of Islamic banking assets and the third largest share of Islamic funds. In addition, the largest Islamic bank is systemically important in the domestic market and has substantial cross-sector and cross-border operations.
- 2. The Central Bank of Kuwait (CBK) has adapted its regulatory framework to address the unique features of Islamic banking and to strengthen stability.** The CBK introduced a special section in the law governing banking business in Kuwait, and regulates Islamic and conventional banks in a manner that ensures a level playing field in the banking industry. The regulations subject Islamic banks to prudential requirements relating to liquidity, capital adequacy, large exposures, related-party lending and corporate governance without prejudice to Islamic Sharia principles. Islamic banks are also expected to implement Basel III regulations within the same timeframe as conventional banks.
- 3. This paper analyses developments in Kuwait's Islamic banking sector, and discusses some options to ensure its continued stability.** It reviews the performance and operations of Islamic banks in Kuwait; assesses the potential risks and vulnerabilities facing Islamic banks, and discusses the role of the regulatory and supervisory frameworks in mitigating the identified risks. Based on the analysis, the paper discusses options for further strengthening the resilience of Islamic banks and the financial stability of the sector in general. The paper focuses on the banking sector and discusses other Islamic financial segments, such as the investment companies, only to the extent that they present risks for the banking sector.
- 4. The remainder of the paper is structured as follows:** Section II provides an overview of Kuwait's Islamic financial sector in terms of scale, structure, financial performance and the regulatory environment. Section III discusses the sources and nature of risks facing Kuwait's Islamic banking sector. Drawing on this analysis, Section IV offers policy options for consideration.

¹ Prepared by Inutu Lukonga

B. Overview of Kuwait's Islamic Finance Industry

Scale and Structure of the Industry

5. **Kuwait is a significant global player in the Islamic finance industry.** The global share of Islamic banking assets domiciled in Kuwait was estimated at 6 percent as of June 2013, making it the fifth largest, while Islamic funds accounted for 9 percent, which is the third largest share [Kuwait Finance House Research and Islamic Financial Services Board 2014a]. The sukuk market is, however, small and has been dominated by corporates issuing outside Kuwait. Kuwait Finance House (KFH), the largest Islamic bank in Kuwait, is playing an increasingly important role in internationalizing Islamic financial services, and currently has presence in Bahrain, Turkey and Malaysia. Through its shareholdings in a number of other Islamic financial institutions, KFH has emerged as a global player in the Islamic financial services industry.

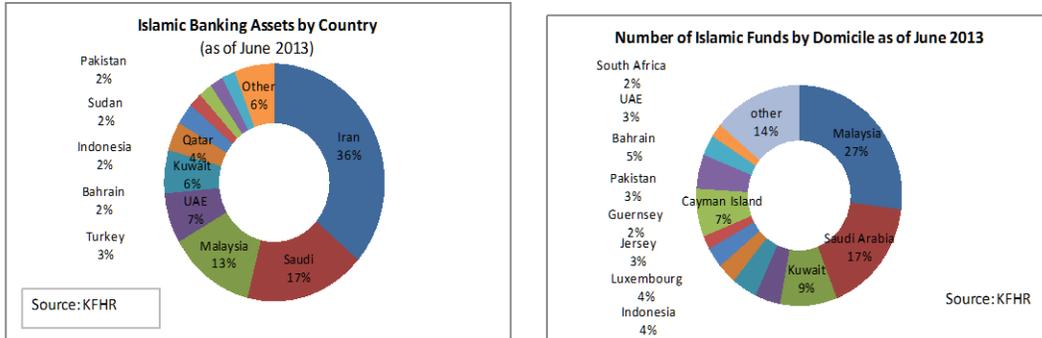
6. **Islamic banks constitute a major component of Kuwait's national banking and of the overall financial system.** At end-June 2014, Kuwait's banking system consisted of 11 locally registered commercial banks and 12 branches of foreign banks, with a combined market share of 84.1 percent of total financial system assets. Five of the locally registered commercial banks and one branch of a foreign bank were conducting business in accordance with Sharia principles.² The market share of the local Islamic banks has increased from 23 percent of banking system assets at end-2005 to 39 percent by end-June 2014. KFH accounts for 70 percent of the Islamic banking segment and 26 percent of banking system assets (Figure 1).

7. **The government has played an important role in the development of Islamic banking.** As of December 2013, two of the banks (KFH and Warba Bank) were largely controlled by the government through shareholding by various government enterprises, most notably the Kuwait Investment Authority (Appendix 1). There is cross-ownership in other banks (Boubyan, and Ahli United Bank (AUB), with Kuwait Pension Fund and the Bahrain Social Insurance Organization having significant ownership stakes in AUB. Kuwait International Bank (KIB) is, by contrast, owned by industrial companies, and Boubyan bank is a subsidiary of the largest conventional bank.

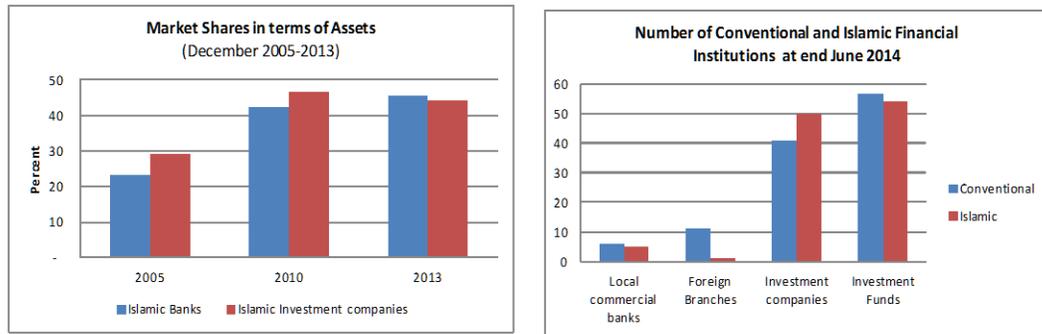
² The five banks operating on Islamic principles are Kuwait Finance House (KFH), Boubyan Bank, Kuwait International Bank (KIB), Al Ahli United Bank (AUB) and Warba Bank.

Figure 1. Significance of Islamic Finance in Kuwait

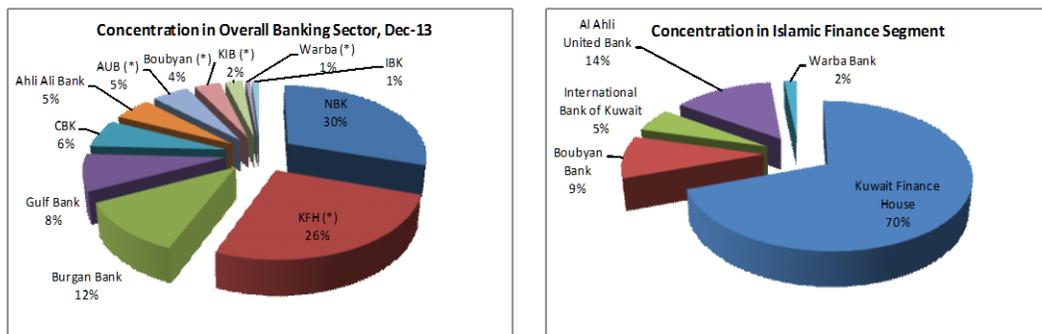
Kuwait is a major player in the global Islamic finance industry



And in the domestic market, Islamic based finance has gained market share to become systemically important



And the largest Islamic bank is systemically important



Note: (*) indicates Islamic bank

Source: Company Reports and Central Bank of Kuwait

8. **Some of the Islamic banks have cross border operations and/or conglomerate structures that include both financial and non-financial corporates as subsidiaries or associates** (Table 1).³ KFH, the largest Islamic bank, has 16 subsidiaries that span banking, investment companies (ICs), real estate development, infrastructure and industrial developments, computers, aircraft leasing and management consultancy. It also has substantial cross border banking operations in Turkey, Malaysia, and Bahrain as well as real estate and other ICs in Cayman Islands and Saudi Arabia. The others either include associate companies in non financial corporations in which they have a 50 percent shareholding or include subsidiaries of investment and insurance companies.

Table 1. Corporate Structure of Kuwait Islamic Banks

	Total	Subsidiaries by Sector			Cross Border Operations	
		Banking	NBFI	Non financial corporations	Number of countries	Names of countries
Kuwait Finance House	16	3	8	5	Turkey, Malaysia, Bahrain, Cayman Islands and 5 Saudi Arabia.	
Boubyan bank	2	0	2	0	Subsidiary of NBK which has operations in UK, Switzerland, Lebanon, Cayman Island, Iraq and Egypt	
Ahli United Bank	1	0	1	0	Subsidiary of AUB Bahrain and group has subsidiaries in Iraq, Kuwait, Egypt and UK	
Kuwait International Bank 1/	3	0	2	1		
Warba	0	0	0	0		

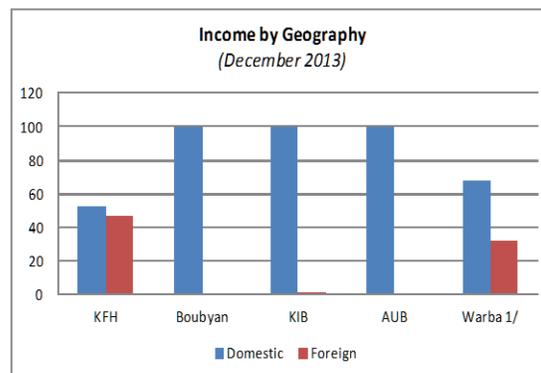
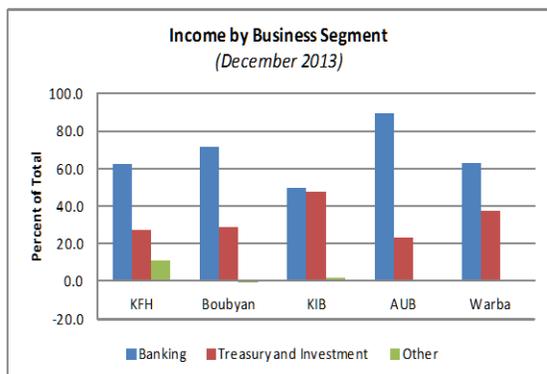
Source: Company Reports
1/ Includes associates in which KIB has a 50 percent stake

9. **Although Investment activities are integral to Islamic banks' business, banking operations are the main source of income.** Kuwait's Islamic banks offer a broad range of Sharia-compliant financial services, including banking, purchase and sale of properties, leasing, and own-account and agency project construction, as well as other trading activities. However, banking activities contribute over 60 percent of income in four of the five local Islamic banks, and the balance is largely accounted for by both treasury and investment activities. The income from banking operations of Boubyan, AUB, and KIB comes mainly from exposures within Kuwait, hence domestic developments have a significant impact on the performance of these banks. For KFH, which has a more geographically diversified corporate structure, and Warba with assets exposed to markets outside Kuwait, the incomes from abroad comes mainly from within the MENA region. Therefore regional developments affect the performance of the two banks (Figure 2).

³ The associates referred to here are those where the stake is 50 percent.

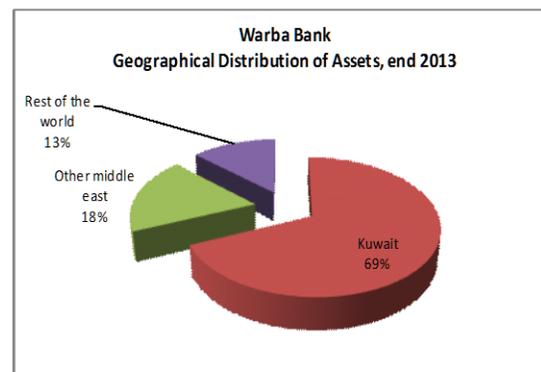
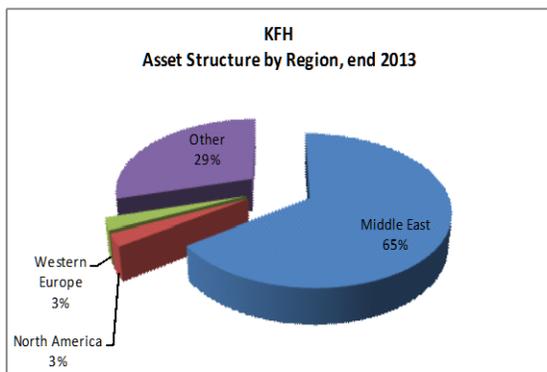
Figure 2. Sources of Income by Geography

With few exceptions, domestic banking operations are the main source of income



1/ For Warba this refers to assets

and for those with foreign operations, the regional market dominates

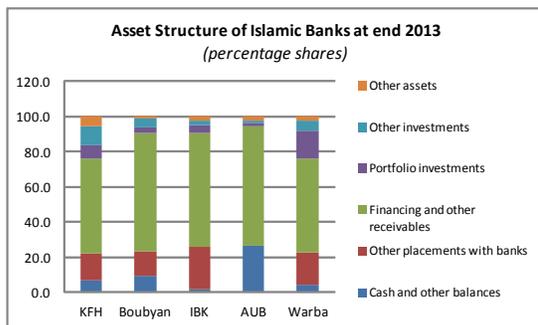


Source: Company Reports

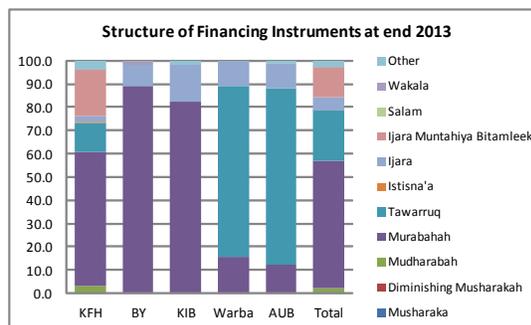
10. **The assets of Kuwait’s Islamic banks mainly include non-profit and loss sharing (non PLS) based instruments that have a debt-based relationship.** Financing items, which are concentrated in real estate, personal loans and inter-bank lending, account for between 50 percent and 70 percent of the total assets of banks and most transactions are in the form of *Murabaha* and *Wakala*, followed by *Ijara* and to a limited degree *Istisna’a* transactions (see Appendix 3 for definitions). As with Islamic banks in many other countries, the share of equity and other partnership-based instruments like *Musharakah* and *Mudarabah* are negligible in the balance sheets. Investment activities are relatively moderate in magnitude and include management of direct equity and real estate investments as well as international leasing. Off-balance-sheet commitments, which range between 10 percent -20 percent, include letters of credit, acceptances and guarantees (Figure 3). These are predominantly in the form of performance and advance payment guarantees for government projects, and the government is the credit risk as long as the company performs according to the terms contract.

Figure 3. Balance Sheet Structure of Islamic Banks

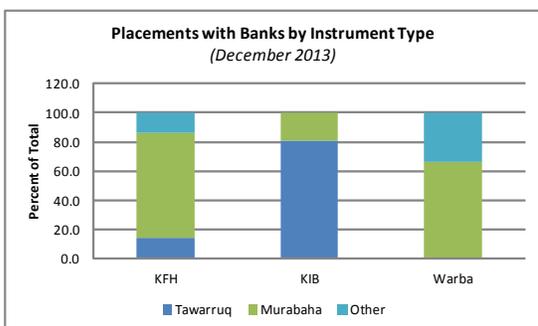
Financing items account for the bulk of Islamic banks assets



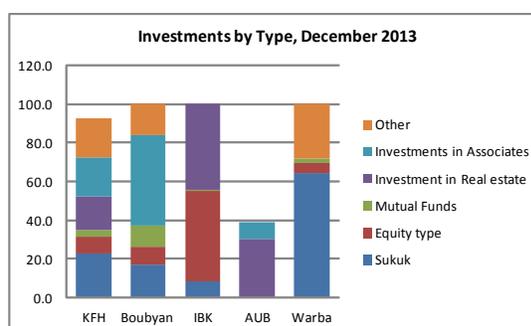
Most of the financing involve Murabaha transactions



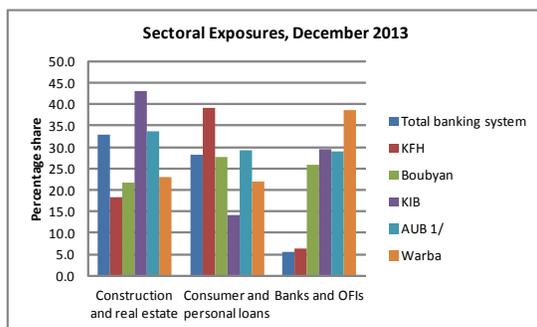
Murabaha is also used in transactions with other banks and financial institutions



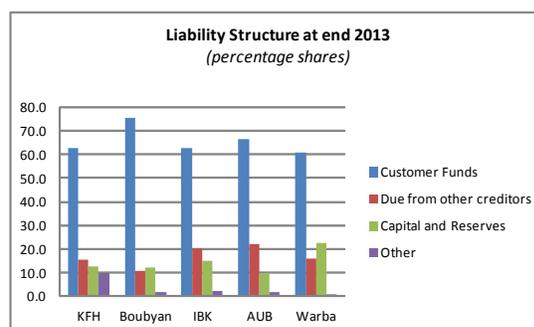
Investments are mainly in Sukuk, equities and in associate companies



The lending and investments are largely to the real estate and financial institutions



And the assets are mainly funded by customer deposits



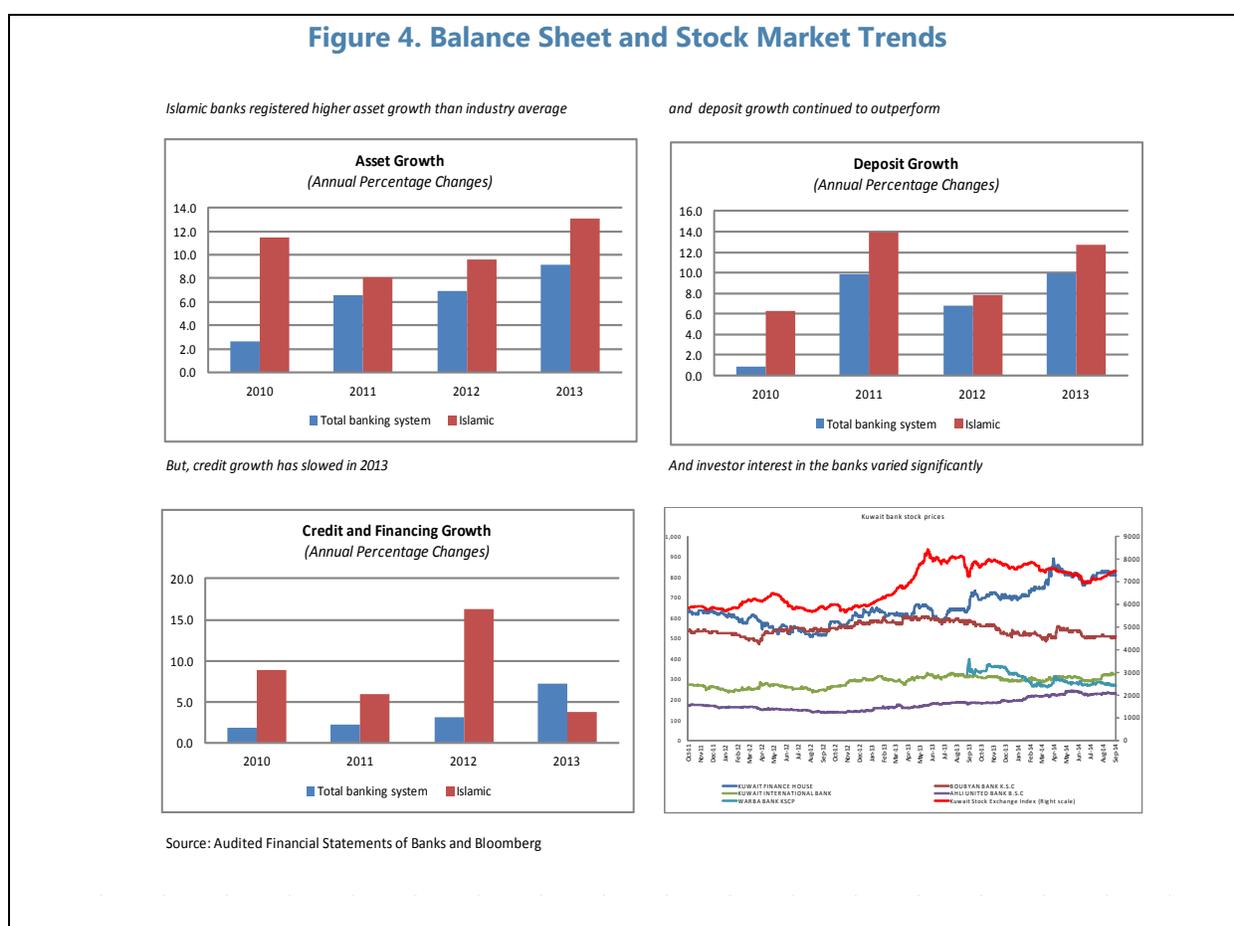
Source: Audited Financial Statements of Banks included in Annual Reports of the Banks

Note: 1/ Data for AUB was not sufficiently disaggregated to discern the share of consumer and personal loans, thus the figure may include other exposures

11. **Islamic banks, like their conventional counterparts, have a healthy funding base with a strong deposit franchise and healthy liquidity profile.** Over 60 percent of the assets are funded by customer deposits, which include profit-sharing investment accounts (PSIA). The contracts on the liability side include *Mudaraba* contracts as well as non-PLS contracts comprising (*Murabaha* and *Tawarruq*). Funds due to other financial institutions are quite significant accounting for between 10 percent and 22 percent.

Performance

12. **Islamic banks continued to register strong asset growth underpinned by rapid growth in deposits, but efficiency indicators were weaker (Figure 4).** Asset and deposit growth for Islamic banks exceeded the banking industry's average growth. Cost-to-income ratios were higher for Islamic banks for several reasons: (i) the operating environment for Islamic banks was more challenging given Sharia restrictions on certain products/services that are otherwise available for conventional banks; (ii) the costs of meeting legal and Sharia requirements to execute the same transactions are higher; (iii) non banking subsidiaries are associated with higher operating expenditures and (iv) there are industry concentrations that result in developments in the selected banks disproportionately impacting the overall aggregates. Performance on the stock market varied across the banks, with KFH performing strongly while others were more in line with overall market trends.



C. The Regulatory Framework

13. **Islamic banks are regulated by the CBK.** In light of the special nature of Islamic banks, particularly with respect to resource mobilization and uses, a Law was issued in 2003 that gave the CBK powers to regulate the licensing and activity of Islamic banks. The law on Islamic banks was

introduced as a special section (10) in the existing Law governing banking business in Kuwait. It subjects Islamic banks to the same rules as conventional banks, except as provided in the said Section 10 and without prejudice to the Islamic Shari'a principles.⁴ Exceptions to take account of the nature of Islamic banks business models are addressed through regulations.

14. **In addition to providing the standard intermediation functions of banks, the law allows local banks to establish subsidiaries that operate on the basis of Islamic principles and for foreign banks to establish branches.** Islamic banks are also allowed to conduct financial and direct investment operations, whether on their own account or on the account of other parties or in partnership with others, including establishment of companies or holding equity participations in existing companies or companies under establishment, which undertake various economic activities, in accordance with both Islamic Shari'a principles and controls laid down by the Board of Directors of the central bank.

15. **CBK regulations are designed to ensure a level playing field for both conventional and Islamic banks, while taking into account the unique features of Islamic banking.** The minimum paid-up capital is KD 75 million and KD 15 million for local banks and branches of foreign banks, respectively. The prudential regulatory and supervisory framework takes into consideration international best practices for effective supervision with adaptations to suit the Islamic banking business. Islamic and conventional banks are subject to the same prudential requirements with regard to liquidity, capital adequacy, Large Exposures (LE), and asset classifications, albeit with some modifications in the technical details to reflect the differences in the instruments employed.⁵ Non compliance of prudential regulations attract financial penalties.

16. **Key components of other regulations include the following:** board and senior management oversight, comprehensive assessment of risks, stress testing, internal controls review, and risk reporting and monitoring. The CBK also requires banks to conduct a variety of stress tests. Guidelines have been issued for implementing capital adequacy regulations under Basel III, liquidity guidelines are under preparation and leverage ratios are expected to be issued by the end of the year.

17. **Financial infrastructures continue to undergo reforms and are being adapted to take account of the unique features of Islamic banking.** The credit registry, designed to assist banks in assessing borrower credit-worthiness, serves conventional and Islamic banks equally. The CBK offers Shari' a compliant Lender of Last Resort (LOLR) facility to Islamic banks through the use of *Tawarruq* based on commodity *Murabahah* instrument. The blanket guarantee introduced in 2008 also covers deposits of Islamic banks, including unrestricted profit-sharing investment accounts (PSIA). Reforms

⁴ Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and the organization of banking

⁵ For instance, Islamic banks are allowed to risk weight assets at 50 percent if they are funded by investor deposits rather than current accounts.

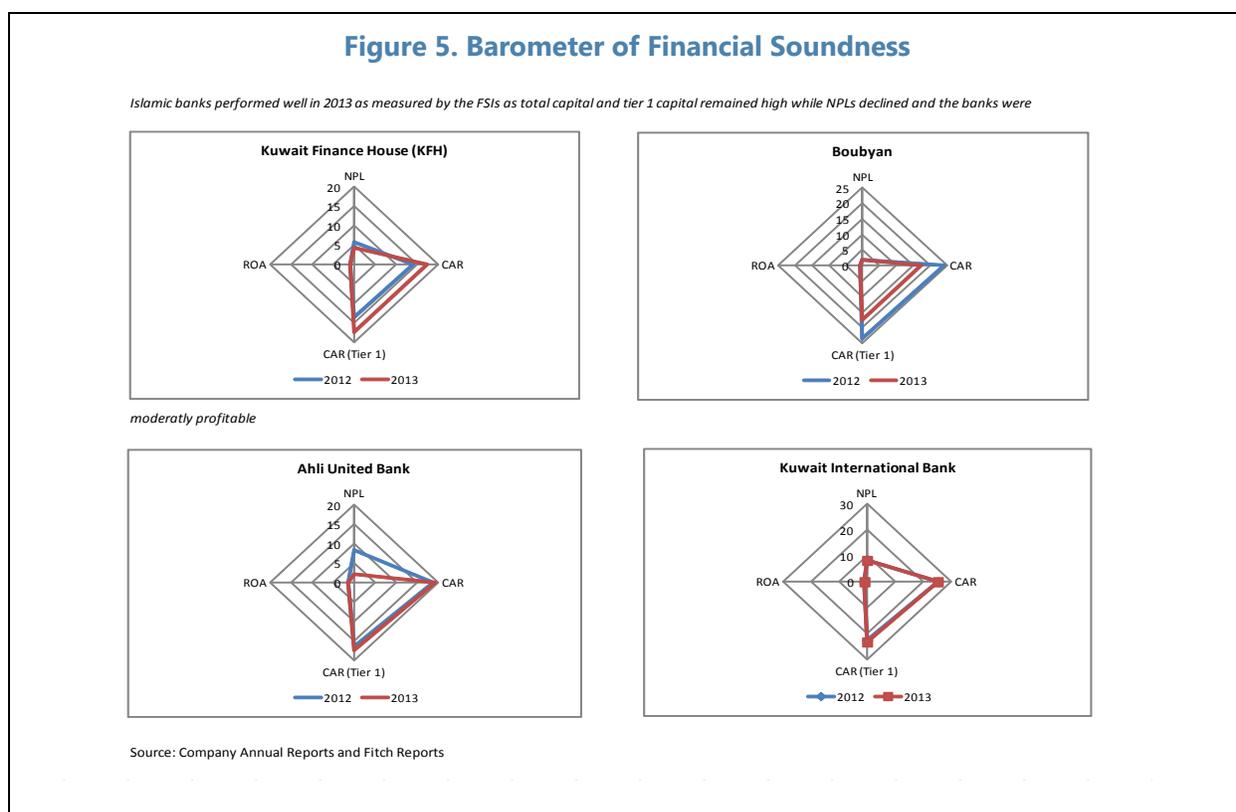
are ongoing to strengthen the insolvency regime in collaboration with the World Bank, but these will need to be accompanied by reforms at commercial courts and the judiciary infrastructure.

18. The law provides for an independent Shari'a Supervisory Board for each Islamic bank.

In case of a conflict of opinion among members of the Shari'a Supervisory Board concerning a Shari'a rule, the board of directors of the designated bank may transfer the matter to the Fatwa Board in the Ministry of Awqaf and Islamic Affairs, which shall be the final authority on the matter. The opinion of the Sharia Board has to be provided in the banks' annual reports.

D. Financial Stability Issues

19. The financial soundness indicators of Islamic banks are favorable (Figure 5). Overall capital adequacy ratios (CARs) and Tier 1 capital remained high, between 18 percent and 25 percent, with one bank reporting a high of 47 percent. With one exception, CARs improved further in 2013 on the back of a favorable economic environment. Nonperforming loans (NPLs) declined to below 3 percent—with some exceptions where the ratio has remained around 8 percent. The main factors driving down the NPLs are a pickup in loan growth and continued write-offs of loans.



20. Many of the risks to which Islamic banks are exposed are similar to those facing conventional banks. Since the assets of Islamic banks in Kuwait are predominantly invested in non-PLS-based instruments (*Murabaha* and *Ijara* and to a limited degree *Salam* and *Istisna'a*), the core risks include credit, market, and operational risks. The lack of diversification of the economy

contributes to sectoral concentrations for both conventional and Islamic banks, particularly in real estate and equity. Given the focus of Islamic banks on tangible assets for credit facilities, their exposure to real estate is higher.

21. **However, there are also some risks that are either unique to Islamic banks or are more pronounced.** The link between Islamic finance to real productive economic activities translates into conglomerate corporate structures that include non financial corporations in the banking groups, where as conventional banks face more restrictions in terms of their equity investments in non financial corporations. Others are, the limited Sharia-compliant financial markets and instruments that complicate liquidity management for Islamic banks and accentuate liquidity risk. In addition, Sharia compliance that, if not followed, could entail reputational risk.

22. **The scale and complexity of corporate structures of the larger Islamic banks could present challenges for risk management, supervision and resolution.** The largest Islamic bank is systemically important with extensive cross sector and cross-border operations, some of which are in offshore centers reputed for lax supervision. Others either include non financial corporations, investment companies or insurance companies among the subsidiaries. Such corporate structures, though central to the business model of Islamic banks, create potential for related-party lending as well as contagion from other parts of the group, particularly from the unregulated non-financial corporations. Since operations of regulated entities within the group are affected by risks arising from all subsidiaries in the group and the interaction of those risks, management as well as supervisors requires a consolidated view of the groups to ensure appropriate oversight. CBK currently supervises banking groups on a solo and consolidated basis, and monitors related party lending and intra-group exposures. Nevertheless the presence of non financial companies and cross-border operations against the backdrop of cross-country differences in the pace with which regulations for Islamic banks are being adopted, complicates risk identification, monitoring and supervision. In the event of bankruptcy, cross-country differences in legal frameworks and enforcement of legal rights could complicate the resolution process.

23. **Efforts are continuing to enhance liquidity management for Islamic banks, but structural constraints remain that affect the scope for Islamic banks to effectively and efficiently manage liquidity risk.** The CBK has introduced a *Tawarruq* instrument based on commodity *Murabahah* concept to manage liquidity at Islamic banks, and the banks also have access to LOLR facilities. However, Sharia compliant investment-grade financial instruments are limited since the government has not been issuing Sukuks, because of its substantial fiscal surpluses and constraints posed by the absence of legislation. Islamic banks also have to compete with conventional banks for sukuks, there are no secondary markets for sukuks as investors tend to buy and hold while the pricing and size of recent issues have also not adequately addressed the needs of the sector. The limited financial instruments could be binding particularly as banks try to comply with Basel III.

E. Conclusions

24. **Kuwait's Islamic banks are playing an increasingly important role in financial intermediation.** The Islamic segment of the banking industry is currently performing well. Banks' balance sheets show greater reliance on debt-based instruments such as *Murabaha* and *Ijara*; thus the risk profile for Islamic banks has a considerable degree of similarity with conventional banks.
25. **The regulatory and supervisory framework has been strengthened, and provisions have been included to adapt the regulatory framework to Islamic banking.** The CBK's regulations—requiring the restructuring of complex conglomerate structures in existing banks, placing limits on the type of non financial activities to be permitted for new banks, further strengthening capitalization under Basel III, and implementing macroprudential policies to minimize systemic risks—augur well for financial stability. An enabling environment that includes continued strong supervision, availability of Sharia-compliant investment-grade financial instruments and well-functioning supporting legal and financial infrastructures is needed to facilitate the development of Islamic banks and strengthen financial stability.
26. **Islamic banks have been strengthening their risk management systems, but there is scope for improving risk management practices.** The implementation of group-wide capital and liquidity planning, as well as the integration of stress testing in the risk management framework, mitigates potential risks. However, sectoral concentrations, including in the portfolios of banks with more geographically diversified asset structures, exposes the banks to the risk of a sharp downturn in the real estate and stock markets.

Appendix 1. Ownership Structure of Islamic Banks

Kuwait: Ownership Structure of Islamic Banks			
<i>Locally Incorporated Banks</i>			
Name of Bank	Major shareholders	Country	Shareholding
Kuwait Finance House	Kuwait Investment Authority (KIA)	Kuwait	24.08
	Public Authority for Minors Affairs (PAMA)	Kuwait	10.48
	Kuwait Awqaf Public Financial	Kuwait	8.29
	Public Institutions for Social Security (PIFSS)	Kuwait	6.02
Boubyan	National Bank of Kuwait	Kuwait	58.3
	Commercial Bank of Kuwait	Kuwait	19.9
Kuwait International Bank	Al Hoda for Hotels and Tourism;		17.59
	Al Baraka Kuwait Trading Company		6.06
Ahli United Bank	Ahli United Bank (Bahrain)		74.9
Warba	General Authority for Investment	Kuwait	24
	Public Investment for Social Security	Kuwait	5
	Other (nationals)	Kuwait	71
Branch of Foreign Bank			
Al Rajhi Banking	Al Rajhi Bank, owned largely by the family and Saudi Government via the General Organization for Social Insurance	Saudi Arabia	56
Source: Company Annual Reports and Audited Accounts			

Appendix 2. Products Offered by Islamic Banks

Locally Incorporated Banks	
Bank	Products Offered
Kuwait Finance House	Banking Shari'a compliant products and services, covering real estate, trade finance, investment portfolios, commercial, retail and corporate banking and is available in Kuwait, Kingdom of Bahrain, Kingdom of Saudi Arabia, United Arab Emirates, Turkey, Malaysia, and Australia
Boubyan	Banking services to individuals, institutions, companies or corporations, funds, different investment portfolios, other commercial services, and financing services for individuals and companies.
Kuwait International Bank	Acceptance of Deposits, Financing Transactions, Direct Investment, Murabaha (auto, real estate and commodities), Ijara Muntahia Bittamleek (Lease-to-own) , Istisna'a, Tawarruq, Credit Cards, Wakala and other products. Corporate projects and finance, Treasury Services, Issuing Letters of Credit (L/Cs), Letter of Guarantee (L/Gs) and Real Estate Dealings and Management of Properties
Ahli United Bank	Banking operations covering credit and deposit services provided to customers; correspondent banking, clearing, money market, foreign exchange, Sukuk, other treasury and miscellaneous operations, proprietary investment, securities trading activities and fiduciary fund management activities; and Waad or Islamic forward foreign exchange agreements, acceptances, LCs and guarantees
Warba	Banking services and investment products to corporate customers, in addition to providing commodity and real estate murabaha finance and Ijarah facilities; consumer finance, credit cards, deposits and other branch related services; local and international Murabaha and other Islamic financing primarily with banks & financial institutions; direct equity, real estate investment and other investments.
Branch of Foreign Bank	
Al Rajhi Bank	
Source: Company Annual Reports	

Appendix 3. Descriptions of Islamic Financial Products

Murabahah	Murabaha is a sale agreement for commodities and real estate to “a promise to buy” customer, at a price comprising of cost plus agreed profit, after the Bank has acquired the asset.
Wakala	Wakala is an agreement whereby the Group provides a sum of money to a customer under an agency arrangement, who invests it according to specific conditions in return for a fee. The agent is obliged to return the amount in case of default, negligence or violation of any terms and conditions of the wakala;
Ijarah	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An Ijarah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijarah contract.
Ijarah Muntahia Bittammc (or Ijarah wa Iqtina)	A form of lease contract that provides a separate promise of the lessor giving the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value or by means of a Hibah contract.
Istisnaa*	Istisna'a is a sale contract between a contract owner and a contractor whereby the contractor based on an order from the contract owner undertakes to manufacture or otherwise acquire the subject matter of the contract according to specifications, and sells it to the contract owner for an agreed upon price and method of settlement whether that be in advance, by installments or deferred to a specific future date.
Musharakah	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the Musharakah agreement, while losses are shared in proportion to each partner's share of capital.
Restricted investment accounts	The account holders authorize the institution offering Islamic financial services to invest their funds based on Murabahah or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Salam	An agreement to purchase, at a pre-determined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyer makes full payment of the purchase price upon conclusion of a Salam contract. The commodity may or may not be traded over-the-counter or on an exchange.
Sukuk	Sukuk is plural of the Arabic term sakk which means certificate, legal instrument or deed. Sukuks, also known as Islamic bonds, are certificates that represent a proportional undivided ownership rights in tangible assets or a pool of predominantly tangible assets or a business venture. Funds raised through issuance of sukuk should be applied to investment in specified assets rather than for general unspecified purposes. This implies that identifiable assets should provide the basis for Islamic bonds.
Unrestricted investment accounts	The account holders authorize the IIFS to invest their funds based on Musharakah contracts without imposing any restrictions. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
Tawarruq	Tawarruq is a sale agreement whereby the customer buys commodities from the Bank on a deferred payment basis and then immediately resells it for cash to a third party.

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SHADOW BANKING IN KUWAIT¹

Continued cooperation between supervisory bodies and regulators will enable proper monitoring and containment of potential risks emanating from shadow banking. While measures of shadow banking vary widely for Kuwait depending on the definition used, regulation and supervision should focus on institutions and activities that pose systemic risks to financial stability. Increased monitoring of shadow banking (activities and entities) including expanding data coverage for Other Financial Corporations operating in Kuwait, together with a formal macroprudential policy framework, would allow for a reliable and comprehensive identification, assessment and containment of systemic risks.

A. Definition and Size

1. **No single definition of shadow banking exists.** Shadow banking is often identified within **entities** that are less regulated than a traditional bank and lack a formal safety net. Some definitions focus instead on non traditional instruments or markets (**activities**), such as unregulated/lightly regulated bank-like intermediation, MM funding of credit, and intermediation with maturity and/or liquidity transformation via securitization. Alternatively, the Financial Stability Board (FSB, 2013a)'s broad definition of shadow banking comprises "credit intermediation involving **entities and activities** outside the regular banking system." Lastly, an alternative definition of shadow banking (IMF GFSR, October 2014) is based on **nontraditional funding** – in this view, financing through noncore liabilities by banks and nonbank institutions is considered shadow banking, independently of the entity that carries it out.
2. **To some extent, the difficulty in developing a precise but all-encompassing definition stems from the large differences in shadow banking activities across countries.** In advanced economies, shadow banking typically includes a network of multiple financial entities and activities that decompose the process of credit intermediation between lenders and borrowers into a sequence of discrete operations. In developing economies, these chains are usually absent, with shadow banking taking a more straightforward intermediation role between ultimate lenders and ultimate borrowers. Given available information and the structure of Kuwait's financial system, shadow banking will be estimated under the activity and entity/broad definitions.
3. **Estimates of the size of shadow banking worldwide vary, partly due to definitional differences, and don't include Kuwait.** Shadow banking, broadly defined, is estimated at around one quarter of total credit intermediation worldwide (IMF GFSR, October 2014).² Advanced countries show the largest shadow banking systems including in the US, euro area, and UK, amounting, in

¹ Prepared by Mariana Colacelli. This note draws on current work at the IMF on shadow banking "Shadow Banking Around the Globe: How Large, and How Risky?" GFSR, Chapter 2, October 2014.

² Similarly, with information on Other Financial Intermediaries from Flow of Funds data, FSB estimates the global shadow banking system at \$60 trillion in 2007 and 2010.

2012, to around 200 percent of GDP in the US and euro area, and close to 400 percent in UK. In emerging market economies it has been growing rapidly, especially China, reaching around 50 percent of GDP in 2012. On the other hand, Pozsar and others (2013) estimate shadow banking for the US at around 100 percent of GDP in 2012, by adding up all liabilities relating to securitization activity as well as short-term money market transactions not backed by deposit insurance.

4. **Across countries and over time, the main factors behind different types of shadow banking growth are found to be similar: regulatory arbitrage, ample liquidity and search for yields, real economy needs, and complementarities with the banking system** (IMF GFSR, October 2014). Tight regulation of banks (in particular, stringent capital requirements) often induces growth in shadow banking activities. In addition, low real interest rates and a compression of term spreads tend to be associated with a more rapid growth of shadow banks. Shadow banking activities tend to grow particularly strongly when there is a confluence of ample liquidity and tighter banking regulation. In addition, complementarities with the rest of the financial system often play a role. The growth of pension and insurance funds is associated with higher growth of shadow banks, reflecting a demand for shadow banking services. The continued growth of shadow banking in emerging market economies is, to some extent, a natural byproduct of the deepening of financial markets, with a concomitant rise in pension, sovereign wealth, and insurance funds. However, in China, the explosion of wealth management products is also a main force behind the observed growth.

5. **While shadow banking complements traditional banking by expanding credit access or providing liquidity, it also poses risks.** During the global financial crisis, some shadow intermediaries in advanced countries had high leverage and were vulnerable to runs when investors withdrew funds at short notice. This led to fire sales of assets, which increased the financial turmoil by reducing asset values and therefore further spreading the stress to traditional banks. Since the global financial crisis, regulatory reforms coordinated by Financial Stability Board have called for greater disclosure of asset valuations, improved governance, and ownership reforms, plus increased monitoring and regulation of shadow banks.

B. Mapping Shadow Banking in Kuwait

6. **Commercial banks and investment companies (ICs) are the bulk of Kuwait's financial sector (Table 1).** As of mid-2014 there are 23 operating banks (including 12 branches of foreign banks) and 91 operating ICs; banks' assets constitute 130 percent of GDP while ICs' assets amount to 60 percent of GDP (Figure 1).^{3,4} The financial sector also includes insurance companies, finance companies and foreign exchange companies, which comprise a combined 1.5 percent of GDP, while

³ The term "investment company" in Kuwait covers firms with a wide array of activities, mainly direct and indirect investment in various sectors (real estate, industry, and agriculture), asset management, wealth and portfolio management, and financial advisory and brokerage services.

⁴ Since the global financial crisis, deleveraging in the IC sector contributed to a decrease in the size of the financial sector from over 270 percent of GDP in 2009 to around 190 percent by mid-2014 (note that these figures do not account for pension funds' assets because of lack of data for the earlier period).

assets holdings of the public pension fund amount to an estimated 42 percent of GDP, with 20 percent in Kuwait.⁵ Lastly, recent legislation allows the establishment of special purpose vehicle (SPV) entities but there are none to date.

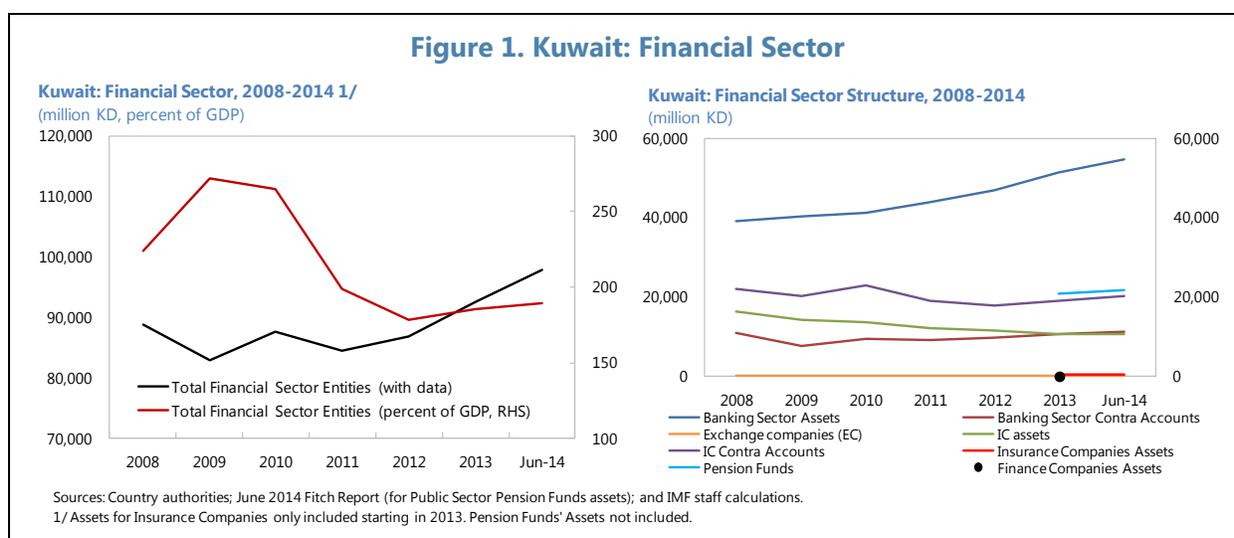
Box 1. Risks from Shadow Banking

Supervisory authorities and regulators should focus on shadow banking that poses risks to the stability of the financial system. Systemic entities and activities, including those showing significant interconnectedness with the rest of the financial sector, should be a monitoring priority. Relevant risk dimensions include specific risks of each business model and its potential for spillovers:

- **Run risk:** Since shadow banks perform credit intermediation, they are subject to a number of bank-like sources of risk, including run risk, stemming from credit exposures on the asset side combined with high leverage on the liability side, and liquidity and maturity mismatches between assets and liabilities. However, these risks are usually greater at shadow banks because they have no formal official sector liquidity backstops and are not subject to bank-like prudential standards and supervision.
- **Agency problems:** The separation of financial intermediation activities across multiple institutions in the more complex shadow banking systems tends to aggravate underlying agency problems (Adrian, Ashcraft, and Cetorelli, 2013.)
- **Opacity and complexity** constitute vulnerabilities, since during periods of stress investors tend to retrench and flee to quality and transparency (Caballero and Simsek, 2009).
- **Leverage and procyclicality:** When asset prices are buoyant and margins on secured financing are low, shadow banking facilitates high leverage. In periods of stress, the value of collateral securities falls and margins increase, leading potentially to abrupt deleveraging and margin spirals (FSB, 2013b; Brunnermeier and Pedersen, 2009).
- **Spillovers:** Stress in the shadow banking system may be transmitted to the rest of the financial system through ownership linkages, a flight to quality, and fire sales in the event of runs. In good times, shadow banks also may contribute substantially to asset price bubbles because, as less regulated entities, they are more able to engage in highly leveraged or otherwise risky financial activities (Pozsar et al, 2013).

Source: Presentation of risks extracted from "Shadow Banking Around the Globe: How Large, and How Risky?," GFSR, October 2014.

⁵ June 2014 Fitch Report estimate.



7. **Under the current legal framework, the prudential regulation and supervision of the banking sector is conducted by the Central Bank of Kuwait (CBK).** With a general mandate, “to control the banking system in the State of Kuwait” (Article 15 of Law No. 32 of 1968), the CBK performs on-site and off-site supervision of banks and finance companies. It also oversees exchange companies and the lending portfolio of the ICs, empowered by a ministerial decree.⁶

8. **Ministry of Commerce and Capital Market Authority (CMA) are the regulatory authorities for most non-bank financial institutions in Kuwait.** The regulation of the securities market has been modernized and is conducted by the **CMA** since 2011.⁷ CMA is empowered to issue licenses to operate in the Kuwaiti stock exchange, and to enforce prohibitions on money laundering and inside trading. Legislation also specifies its regulatory and supervisory role over ICs. According to CMA, there is a derivatives market in Kuwait but it is rather small and is hence unregulated. The CMA coordinates

Table 1. Kuwait: Financial Sector Structure
(June 2014 or latest available)

	Mill KD	% Total Assets	% GDP
Banks	66,242	55.4	128.2
Banking Sector Assets	54,906	45.9	
Banking Sector Contra Accounts	11,336	9.5	
Finance Companies Assets	58	0.0	0.1
Exchange Companies	145	0.1	0.3
Investment Companies (IC) Assets	30,859	25.8	59.7
IC - on balance sheet	10,640	8.9	
Islamic IC	4,794		
Conventional IC	5,846		
Consumer Financing by IC	765		
IC - Contra Accounts	20,220	16.9	
Islamic IC	1,730		
Conventional IC	18,490		
Investment Funds Assets	1,555		
Insurance Companies Assets	549	0.5	1.1
Public Sector Pension Fund	21,694	18.1	42.0
SPV Entities	-	0.0	0.0
Total	119,547	100.0	231.4

Sources: June 2014 CBK statistics; Finance Companies assets reported by CBK for December 2013; Insurance Company assets estimated from 2014 MCM TA report; Public Sector Pension Funds assets from June.

⁶ Securitized lending by banks or ICs, while nonexistent in Kuwait, would also fall under CBK regulation.

⁷ A new law approved in 2010 replaced previous legislation pertaining to securities and capital markets, and provides better regulation to and enhances transparency of Kuwait’s securities markets. The CMA commenced its supervisory role of securities markets in September 2011.

with the CBK, based on a Memorandum of Understanding.⁸ Insurance companies, in turn, are regulated by the **Ministry of Commerce** exclusively, based on 1961 legislation. The insurance industry in Kuwait is rather small. It focuses primarily on insuring property and business, but also offers coverage for expats' health insurance, for third party liability insurance for cars, and for life insurance. The latter is the most dynamic line of business as its insurance market share has increased from less than 10 percent in 2004 to more than 30 percent in 2012. Insurance companies provide loans against life insurance premia without proper regulation. The Ministry of Commerce established recently a department of risk management to oversee insurance companies' assets. SPV entities also fall under the regulation of the Ministry of Commerce.

9. **Measures of shadow banking for Kuwait vary widely between 2 and 60 percent of GDP depending on the definition used, and are subject to important data limitations.** Given available information, shadow banking for Kuwait is measured under the entity and activity definitions (Table 2). If we include in shadow banking those **entities** that are more lightly regulated than a traditional bank and lack a formal safety net in Kuwait, we would include the proprietary and fiduciary assets of ICs (that include MM funds), and SPVs amounting to around 60 percent of GDP in shadow banking for 2013. However, because of lack of data, this measure does not include other entities that would also fall under shadow banking, including Chit funds,⁹ other funds extending credit, and other unlicensed companies extending credit. Alternatively, measuring as shadow banking those **activities** in non traditional instruments or markets, we include consumer financing by ICs, insurance companies' loan book, and retail/department store lending, amounting to around 2 percent of GDP in shadow banking for 2013. However, due to the lack of data, the 2 percent may understate the scale of shadow banking activities. Depending on specifics, the unmeasured activities may include derivatives markets, credit extended by other funds, Chit funds' lending, and lending by other unlicensed companies.

⁸ Meetings between the two institutions take place every four to six weeks.

⁹ Chit funds (Jameyas) are unregulated money lending activities undertaken by individuals or companies (Ministry of Commerce).

Table 2. Kuwait: Financial Sector and Shadow Banking, 2008–14
(Mill KD)

	2008	2009	2010	2011	2012	2013	Jun-14	Shadow Banking Entity	Shadow Banking Activity	Regulator
Financial Sector Entities:										
Banks	50,101	47,990	50,882	53,289	56,963	62,059	66,242			CBK
Banking Sector Assets	39,241	40,321	41,380	44,082	47,145	51,486	54,906			
Banking Sector Contra Accounts	10,860	7,670	9,502	9,208	9,818	10,572	11,336			
Finance Companies Assets	NA	NA	NA	NA	NA	58	NA			CBK
Exchange companies (EC) /1	109	112	116	125	128	149	145			CBK
EC Assets	105	107	110	118	122	143	139			
EC Contra Accounts	4	5	6	7	6	6	6			
Investment Companies (IC)	38,621	34,792	36,647	31,084	29,657	29,832	30,859	X		CBK loan book / CMA rest
IC assets /2	16,440	14,366	13,590	12,131	11,625	10,777	10,640			
Islamic IC	7,452	6,742	6,363	5,330	5,069	4,770	4,794			
Conventional IC	8,987	7,623	7,227	6,801	6,556	6,007	5,846			
Consumer financing by IC on-balance sheet	1,967	1,384	1,149	1,041	926	825	765		X	
Islamic IC	955	630	517	465	389	298	352			
Conventional IC	1,012	754	632	576	538	527	413			
IC Contra Accounts	22,182	20,426	23,057	18,953	18,032	19,055	20,220			
Islamic IC	3,252	2,924	2,652	2,271	1,791	1,762	1,730			
Conventional IC	18,930	17,503	20,405	16,682	16,241	17,293	18,490			
Investment Funds Assets	2,761	2,016	2,049	1,611	1,420	1,469	1,555			
MM Funds /3	2,252	NA	NA	NA	NA	NA	NA			
Insurance Companies Assets /4	NA	NA	NA	NA	NA	515	549			Min Commerce
Pension Funds	NA	NA	NA	NA	NA	20,942	21,694			
Public Sector Fund (PFISS) /5	NA	NA	NA	NA	NA	20,942	21,694			No
SPV Entities /6	0	0	0	0	0	0	0	X		Min Commerce
Other Activities/Entities:										
Securitized lending	0	0	0	0	0	0	0			CBK
Banks non-core lending (including car sales)	NA		X	CBK						
Derivatives market	NA		X	No						
Insurance companies loan book (ie lending against life insurance premia) /7	NA	NA	NA	NA	3	3	NA		X	Min Commerce, with no proper regulation
Retail/Dept store lending /8	NA	57	55	51	47	42	NA		X	No
Other Funds extending credit	NA	X		CMA						
Chit funds (Jameyas)	NA	X		No						
Other unlicensed companies extending credit	NA	X		No						
Total Financial Sector Entities (with data) /9	88,831	82,895	87,644	84,499	86,748	92,613	97,795			
Total Financial Sector Entities (pct of GDP)	224.2	271.8	265.0	198.8	178.0	185.7	189.3			
Total "Shadow Entities" (with data)	38,621	34,792	36,647	31,084	29,657	29,832	30,859			
Total "Shadow Entities" (pct of GDP)	97.5	114.1	110.8	73.1	60.9	59.8	59.7			
Total "Shadow Entities" (pct of banking sector assets)	77.1	72.5	72.0	58.3	52.1	48.1	46.6			
Total "Shadow Activities" (with data)	1,967	1,441	1,204	1,091	977	870	765			
Total "Shadow Activities" (pct of GDP)	5.0	4.7	3.6	2.6	2.0	1.7	1.5			
Total "Shadow Activities" (pct of banking sector assets)	3.9	3.0	2.4	2.0	1.7	1.4	1.2			

Notes:

- 1/ 2014 value corresponds to March data
- 2/ Total assets on balance sheet
- 3/ 2008: Mutual Funds Assets info from 2010 FSAP
- 4/ Estimated from 2014 MCM TA report
- 5/ Asset holdings estimate from June 2014 Fitch Report (around 20 percent of assets in Kuwait)
- 6/ Recent legislation allows the establishment of SPV entities though there are none at this time
- 7/ CBK estimate for 2013 used for 2013 and 2014
- 8/ CBK measure (data from CINET - including retailers like Xcite and Eureka)
- 9/ Total doesn't include Pension Funds Assets as data are missing before 2013

10. **Estimates of shadow banking for Kuwait appear small from the activity perspective, while they appear on the high side relative to other emerging countries from the entity/broad perspective.** Notably, the entity measure of shadow banking has been decreasing for Kuwait since 2009, related to the deleveraging process of the IC sector (Table 2). Moreover, increased supervision and regulation of the IC sector since the global financial crisis has contributed to strengthening of the financial sector. As of end-2013, ICs' borrowing from local banks amounts to less than 18 percent of their total liabilities, they play a limited role in the repo market, and they have a small participation in money markets.¹⁰

11. **Like in other countries, for Kuwait, factors behind shadow banking growth seem to include ample liquidity and search for yields, regulatory arbitrage, and complementarities with the banking system.** From limited evidence for Kuwait for the period 2008-2013, we find evidence that high availability of liquidity and low term yields are associated with faster growth in shadow banking. Also, growth in total assets of the banking system is positively correlated with shadow banking growth. Relative to other emerging markets, Kuwait shows comparable measures of official supervisory powers and higher overall capital stringency which is consistent with regulatory arbitrage contributing to a larger shadow banking sector in Kuwait.¹¹ While we lack details on activities of institutional investors, the issue of rising pension and sovereign wealth fund's assets is a potential additional factor that may affect demand for shadow banking in Kuwait.¹²

C. Conclusions and Recommendations

12. **Financial regulation and supervision should focus on both entities and activities within the financial sector, with a greater focus on systemic risk.** As described, shadow banking emerges due to a variety of reasons. However, not all shadow banking activities are undesirable, as they provide important complementarities to the banking system. A decomposition of shadow banking entities and activities by function and level of risk may serve as a guide to identify systemic stability risks. The important question is if shadow banking brings about systemic risks. Regulators need to be concerned about the interconnections, dangerously high leveraged activities, and risky transformations.

13. **To begin with, increased data coverage and data sharing among regulators, plus enhanced monitoring and disclosure of shadow banking measures are essential.** CBK, CMA and Ministry of Commerce should continue their cooperation and strengthen the monitoring of shadow banking (activities and entities). Efforts should be made to expand data coverage, including for

¹⁰ May 2013 Capital Standards report "Mutual Fund Industry" indicates that assets under management of mutual funds domiciled in Kuwait under the asset type of "Money Market" amount to only KD 57 million.

¹¹ Regulatory data (2011 indices) from Barth et al (2013). WEO country group for emerging countries and developing countries used as a reference for Kuwait, including around 80 countries with data for the different indices.

¹² Sovereign wealth fund's assets in Kuwait are estimated at 270 percent of GDP while the public sector pension fund holds around 42 percent of GDP in assets.

Other Financial Corporations operating in Kuwait and activities related to derivatives markets. Reports on ICs, MM funds, and other investment funds should be periodically produced by CMA. Ministry of Commerce should compile regular reports on insurance companies. Reporting of shadow banking measures in regular publications is recommended. Coordination of these monitoring efforts could be carried out under an institutional framework for macroprudential oversight that clearly outlines functions and powers of involved agencies.

14. **Without stifling financial intermediation, authorities should follow policies that would contribute to the containment of risks.** With an institutional framework for macroprudential oversight in place, the relevant authority may impose regulation on shadow banks directly or indirectly by targeting banks' exposures to shadow banks. Examples include restrictions on MM funds redemptions and regulatory ratios on ICs. Alternatively, under certain conditions, authorities may consider extending the public safety net to (systemically) important shadow banking markets or entities, or they may change certain features of bankruptcy law. Lastly, coordinated efforts between the monetary and fiscal authorities may help address the underlying causes for shadow banking.

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WHY IS MACROPRUDENTIAL POLICY (MAPP) IMPORTANT IN KUWAIT?¹

A. Introduction

1. **In resource-rich countries, including Kuwait, economic, credit, and asset prices cycles are volatile as they move closely with the oil price cycle (procyclicality in credit and assets markets).** Higher oil revenues lead to large government fiscal surpluses; increases in government spending boost activity in the non-oil sectors of the economy (prominence of real estate as an asset class for investment and collateral) and increase liquidity in the banking sector (Figure 1). When these positive factors reverse, they cause considerable difficulties due to (1) undiversified nature of the economy; (2) concentration of bank exposures; (3) relatively underdeveloped fixed-income and derivatives markets limiting the range of liquidity and risk management tools; (4) need to broaden monetary operations and risk management tools to cover Islamic banking activities; and (5) absence of formal crisis resolution frameworks and insolvency regimes.²

2. **Fiscal policy is the key tool for managing aggregate demand in Kuwait despite time lags in implementation, rigidities in government spending, and limited domestic taxation.** But given the limited scope for an independent interest rate policy under fixed exchange rate regimes, macroprudential policies have and are playing an important role in managing financial cycles, containing the build-up of risks and absorbing shocks.

3. **Kuwaiti financial system is characterized by a high degree of interconnectedness.** Ownership linkages in the financial system are complex with close connections among industrial and commercial groups, banks, sovereign, and investment companies. Large industrial and commercial groups have banks as affiliates. The Kuwaiti government—through different government agencies—has stakes in some banks. Banks in turn own investment companies, albeit to a limited extent, and also provide industrial and commercial group and investment companies with credit as part of their banking business. Investment companies also have participations in banks and industrial and commercial groups.

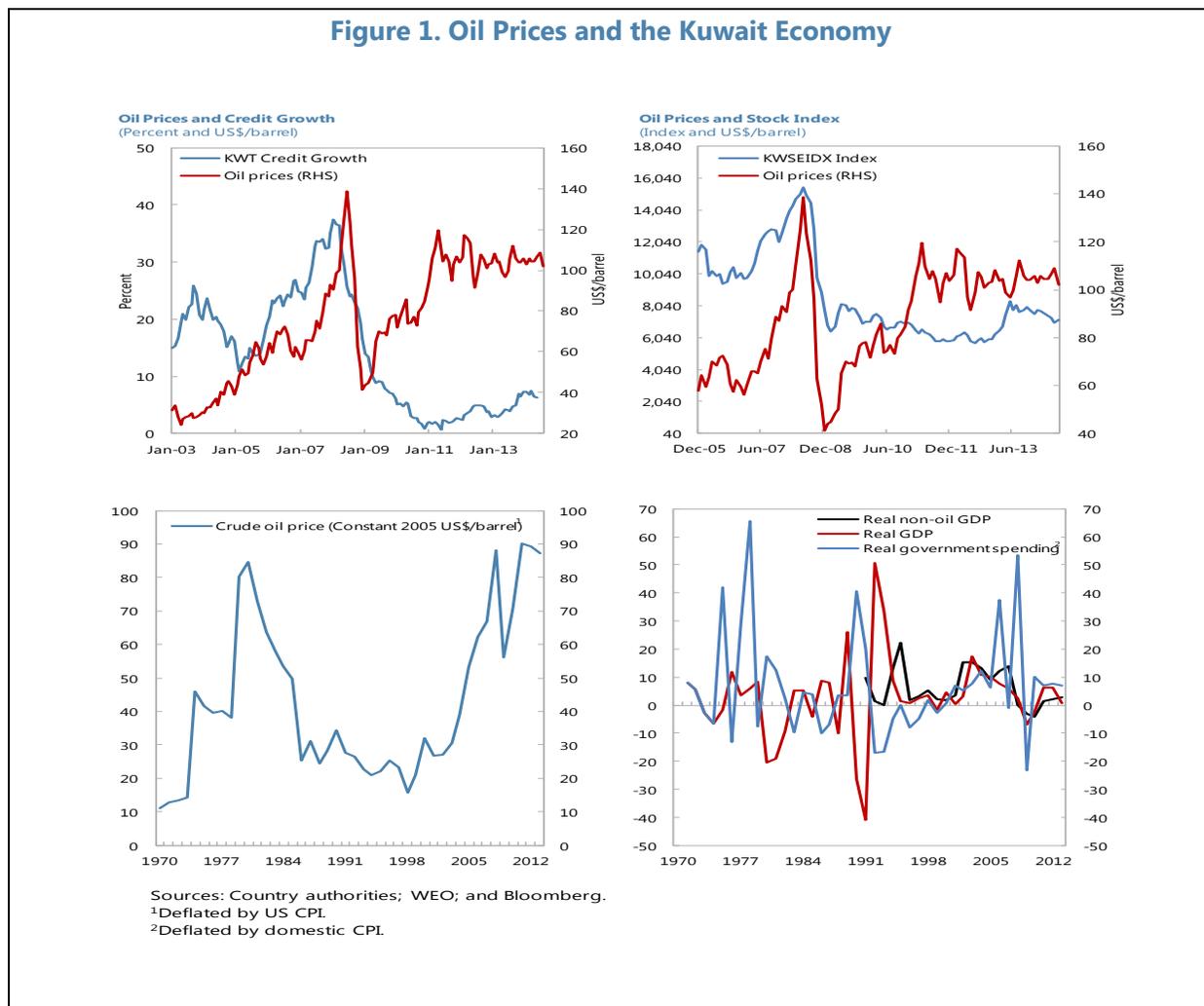
4. **The interconnectedness among banks, industrial and commercial groups, sovereign and investment companies can pose a risk to the financial system and the economy during periods of stress.** The 2009 crisis, which resulted in the insolvency of some investment companies and stress on the banking system is a reminder that the current interconnectedness in the financial system can propagate and exacerbate financial and real shocks. The bankruptcy of an industrial or

¹ Prepared by Ananthkrishnan Prasad.

² Macprudential Policy in the GCC Countries, Arvai, Prasad, and Katayama, International Monetary Fund, Staff Discussion Note SDN/14/01, March 2014.

commercial group could lead to a large stress in the banking system not only through lending relationships but also through ownership linkages.

Figure 1. Oil Prices and the Kuwait Economy



B. Current Institutional Arrangements for MaPP in Kuwait

5. **Under the current legal framework, the prudential regulation and the supervision of the banking sector is conducted primarily by the Central Bank of Kuwait (CBK).** The newly established Capital Markets Authority (CMA) commenced its supervisory role in September 2011. CMA bylaws have been passed, specifying its supervisory role over investment companies, delineating its responsibilities and the coordination process between the CBK and CMA.³ All

³ Until the establishment of the CMA, the Kuwait Stock Exchange, a self-regulated authority, was charged with supervising brokerage firms, entities engaged in portfolio management, and the Kuwait Clearing Company, as well as banks' and ICS' activities related to securities trading and portfolio management on account of third parties.

investment companies (ICs) are now under dual supervision by the CBK and CMA, and the two regulators meet regularly to ensure coordination based on a Memorandum of Understanding.

6. **Insurance companies, in turn, are regulated by the Ministry of Commerce exclusively, based on 1961 legislation.** The insurance industry in Kuwait is rather small (less than one percent of bank assets). It focuses primarily on insuring property and business, but also offers coverage for expats' health insurance, for third party liability insurance for cars, and for life insurance. The latter is the most dynamic line of business as its insurance market share has increased from less than 10 percent in 2004 to more than 30 percent in 2012. Insurance companies provide loans against life insurance premia without proper regulation. The Ministry of Commerce established recently a department of risk management to oversee insurance companies' assets.

7. **The CBK has made significant progress in recent years with regard to financial stability issues.** A new Financial Stability Office (FSO) has been formed drawing from interdepartmental competencies including supervision and macro economic analysis and is reporting directly to the Governor. Significant progress has been made on the analytical front and identification of tools that would be used to assess systemic risk. These include a quarterly off-site surveillance report, banking sector stress testing, and an early warning system (EWS) that incorporates macro and micro economic and financial indicators that would be used to signal sector-wide weaknesses.

C. Current macroprudential toolkit in Kuwait

8. **The CBK has introduced a number of macroprudential tools, which have strengthened banks' capital position and liquidity (Table 1).** The CBK has used several prudential tools since the 1990s, and it started using several macroprudential instruments as a policy tool to cope with the impact of the 2008 global crisis and its aftermath, including: (i) a capital buffer (risk-weighted-capital-asset ratio of 12 percent); (ii) a sector-specific capital buffer applicable in particular to real estate lending (150 percent); (iii) a fixed ratio for general provisions; (iv) a liquidity requirement measured through a ratio of total deposits (18 percent); (v) a debt-to income (DTI) ratio (capped at 40 percent); (vi) a limit on domestic currency loans for nonresidents; (vii) concentration limits (15 percent of all related counterparties per customer); and (viii) restrictions on credit provision with the aim of minimizing maturity mismatches. While most of these tools were introduced with a traditional prudential view, some of them during the 1990s, recent decisions have been taken from a macroprudential perspective. In general, the CBK does not use time-varying prudential instruments—although it is planning to introduce them as it adopts Basel III.

Table 1. Macroprudential Instruments in the GCC Countries

	BAHRAIN	KUWAIT	OMAN	QATAR	SAUDI ARABIA	UAE
Countercyclical capital requirements	No	No	No	No	SAMA has encouraged Saudi banks to increase their capital on a countercyclical basis. During the period 2003-2007, capital of the banking system increased 2.5 times; between 1992 to 1997 the capital of banks rose by 100%.	No
General provisions	Discretionary provision requirement.	Fixed level: 1% of cash items & 0.5% of non cash items	Fixed level: 2% of the outstanding performing 'personal loans' and 1% of outstanding performing 'other loans.'	Yes. 1.5%	Fixed level: 1%. Banks have been directed to maintain NPL ratio of over 100 percent during upcycle.	Gradually being raised to 1.5% of credit risk weighted assets that do not have a specific provision against them.
Dynamic provisioning	No	No	No	No	No	No
Leverage ratios (capital to assets)	Yes. 5% for retail banks and 10% for wholesale banks	No	No	No	Yes. [Deposit/(Capital+Reserve)] Not to exceed 15 times. In addition SAMA has introduced Basel leverage ratio since 2011.	No
Reserve requirements on bank deposits	Yes. 5% of total deposits.	No	Yes. 5%.	Yes. 4.75%.	Yes. 7% on demand deposits. 4% on time and saving deposits.	Yes. 14% for demand deposits; 1% for time deposits
Limits on real estate exposure	Yes. 30% cap on real estate lending of banks as share of total bank lending.	No	Yes. 60 % of the bank net worth or 60 % of all time and savings deposits other than government and inter-bank deposits, whichever is higher.	Yes. For conventional banks, real estate lending not to exceed 150% of bank's capital and reserves (Tier 1). For Islamic banks, investment in real estates should not exceed 25% of the bank's capital and reserves.	Yes	Yes. 20% of deposits. Current definition of real estate exposure: loans for the construction of commercial and residential buildings.
Limits on other sectoral exposure	No	Lending to shares should not exceed 10 percent of total lending.	Yes. Limits on personal loans: 40% of total credit. Housing loans: 10% of total credit. Non-residents: 5% of Net worth. Aggregate non-resident exposure: 30% of Net worth	Banks may not provide customers with any finance for the purposes of trading in securities	No.	Regulation pending on large exposure limits for aggregate exposure to local governments and government-related entities.
Loan-to-value (LTVs) ratios	No limit (business practice is around 80%)	For residential loans for vacant plots, 50 percent of the cost of the property; the percentage would go up to 60 percent if the property is an existing home, or 70 percent if it is a new building to be constructed	No limit (business practice is around 80%)	70% for individuals, 60% for commercial companies	Yes. For mortgage and real estate finance companies the regulations impose an LTV of 70%.	Regulation on differentiated LTVs for nationals and expatriates, as well as for first and second properties is pending.
Debt/Loan-to-income (DTI/LTI) ratios	Yes. Maximum debt service ratio of 50% of monthly salary.	Yes. Maximum debt service of 40%, and for pensioners at 30%.	No	Yes. Credit to individuals capped at 50% of monthly salary and allowances, not to exceed QR 2.5 million per person.	Yes. Total monthly repayments (for both personal loans and credit cards) should not exceed 33% of a borrower's salary.	Yes. Borrowing limits for personal loans: (i) 20 times of salary or monthly income; (ii) loan tenor of 48 months (iii) debt-service ratio of 50 percent of the borrower's monthly salary.
Limits on loan-to-deposit ratios	Yes. A voluntary 60-65% for most banks and 70-75% for those without large investments outside loans.	LTD ratio replaced by a maximum available funding, with the following limits: (i) Remaining maturity up to 3 months: 75%; (ii) remaining maturity from 3 months until one year: 90%; and (iii) remaining maturity more than one year: 100%.	Yes. 87.5%	Yes. 90% for credit ratio (loan-to-deposit ratio).	Yes. 85%.	Yes. Max 100% for the Advances to Stable Resources Ratio.
Ceiling on credit or credit growth	No	No.	No	No	No, but credit growth is an important indicator followed by SAMA on a monthly basis; especially credit to the private sector.	No
Liquidity requirements	Yes. 25%. Liquid assets/total assets	Yes. 18%. Liquid assets /domestic currency customer deposits.	Yes.	Yes. 100%. Current assets / liabilities weighted by liquidity characteristics	Yes. 20%. Liquid assets/deposits. In addition, SAMA has introduced Basel LCR and NSFR since January 2012.	Basel III-type regulation is pending.
Caps on foreign currency lending	No	FX loans can only be extended to borrowers with FX cash flows.	Yes. Lending to non-residents in foreign currency abroad is limited to 5% of net worth.	FX loans can only be extended to borrowers with foreign currency cash flows.	No	No
Limits on foreign exchange positions	No	No	Yes	Foreign currency liabilities cannot exceed foreign currency assets.	No	Up to banks' internal risk management systems
Limits on exposure concentration (individual large exposure, % of total capital)	Yes. 15% of regulatory capital.	Yes. 15%, with aggregate large exposures limited to no more than 400%.	Yes 15%.	Yes. Max limit of credit facilities to a single borrowing group is 20% of bank capital and reserves. Total credit facilities granted to all customers and their borrower groups, at 10% or more of bank's capital and reserves, must not exceed 600% of bank's capital and reserves. Total credit facilities granted to related parties must not exceed 100% of bank's capital and reserves.	Yes, the legal limit is 25%. In practice the limit is 15%.	Yes. 25% for commercial public sector entities, 7% for private sector and individuals.

Sources: Country authorities and IMF staff

D. Strengthening macroprudential policy

9. Kuwait is ahead of many countries in implementing some macroprudential measures.

However, there is still scope for refining the existing macroprudential institutional and policy framework to better manage financial cycles. In particular, further steps could be taken in a phased manner to build appropriate buffers and to limit credit booms in good times. Such steps would include the following:

- **Strengthening the institutional arrangements.** A more formal and transparent macroprudential institutional and policy framework would help ensure that responsibilities and coordination among regulators and other relevant parties are well-established. The CBK should play an important role in MaPP as it brings expertise and has incentives to mitigate systemic risks. A formal mechanism of coordination or consultation across policies aimed at financial stability would help strengthen the process of identification and effective mitigation of systemic risk. **Strengthening the EWS to identify and monitor systemic risks, with macro stress testing becoming an integral part of systemic surveillance.** The EWS can include a set of quantitative indicators as well as qualitative aspects.
- **Refining the existing macroprudential toolkit in a phased manner by:**
 - Building and maintaining sizeable capital buffers in the banking sector. The CBK has already introduced changes as part of adopting Basel III capital requirements. The central bank has redefined regulatory capital to improve the quality of capital to absorb losses and increased the minimum limit for capital adequacy ratio from 12 percent to 13 percent in two phases over two years, beginning 2014.
 - Introducing time varying loan-to-deposit and loan-to-value ratios to help alleviate booms in credit and asset markets during good times. As several high credit growth and asset price boom-bust episodes in the GCC show, containing retail and real estate lending is crucial to protect the financial system and can help prevent overheating. These instruments could include caps on sectoral LTV ratios (e.g., on commercial real estate), or modifications to the existing ones, like the DTI ratio. Changes would aim at making these instruments dynamic and not keeping them fixed over time.⁴ Empirical evidence from other countries, like Hong Kong SAR and Singapore, shows that they strengthen the resilience of the financial system. In addition, evidence from Korea suggests that they limit possible price bubbles.
 - Using sectoral exposure limits, particularly for real estate, to limit the build-up of excessive exposure to targeted sectors or borrowers. Given the undiversified nature of the economy, real estate is a particularly important asset class. While internationally, and in Kuwait as well,

⁴Commercial properties suffered a larger price decline in several GCC countries, including Kuwait, after 2008 compared to residential real estate, reflecting the overinvestment in this segment.

the focus has been mainly to cap LTVs for individual mortgages, this approach is not sufficient. The low share of residential properties financed by mortgages, and the importance of lending to developers for both residential and commercial purposes, raises the importance of caps on real estate exposure. Limits on real estate exposure have been employed by GCC countries other than Kuwait and Saudi Arabia. Special consideration is needed to define real estate exposure appropriately. To prevent excessive lending to the sector, the definition should encompass all finance activities related to the purchase and construction of buildings in which the bank depends on real estate or real estate collateral as a source of repayment.

- **Implementing structural measures over the medium term to support macroprudential policy by:**
 - Developing domestic interbank money and debt markets to support liquidity management. The Basel III liquidity requirements should give an impetus to domestic debt market development in Kuwait.
 - Modernizing the insolvency regimes, and strengthening crisis management and resolution systems. A good credit reporting system with information that allows lenders to assess the indebtedness and creditworthiness of individual and corporate borrowers is essential. Crisis management and resolution systems are generally weak, and miss essential elements such as an explicit deposit guarantee scheme. As a final point, continuously improving disclosure standards as well as risk management practices in the financial sector is of utmost importance to mitigate systemic risk in Kuwait.