White Paper for the Economic Growth Pillar

Accelerating Kuwait's economic growth and diversification by supporting the development and transformation of the financial sector

مركز الكويت للسياسات العامة
Kuwait Public Policy Center

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I. Abstract

Kuwait's financial services sector is fairly robust and broad-based for the size of the country's economy. This sector plays a leading role in the national economy, yet it has been performing below its full potential in recent years. Both market and regulatory factors are hindering further growth in this sector. This paper highlights the opportunities and challenges facing the financial sector and offers appropriate policy recommendations to enhance its contribution to the national economy.

II. Introduction

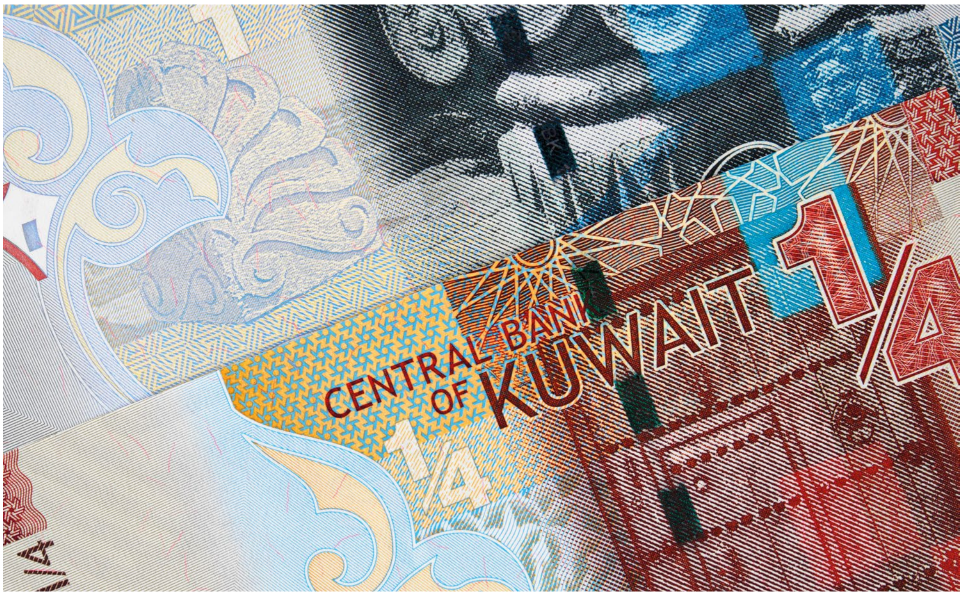
Over the past ten years, Kuwait's financial sector has weathered a storm on two fronts - oil price volatility and rapid technological change. Twice in the past decade, oil prices have risen and fallen dramatically. These swings have stressed the government's budget and the national economy, and they have also forced the financial sector to seek diversification through new products and services.

Today, the financial services sector is dramatically different than it was only a few years ago. Changes made in response to price volatility and advancing technology work alongside changes necessitated by an evolving regulatory landscape. Taken together, these factors have limited the financial sector's ability to take on a larger role in the national economy.

The changes occurring in the sector today are a response to the ever-changing forces of customer expectations, regulatory requirements, technology, demographics, new competitors and shifting economics. What is unique today is the rapid pace of change. Historically, the industry has transformed itself slowly – evolutionary change. Today's change is more revolutionary.

For this paper, representatives of four local financial institutions and one foreign financial institution currently operating in Kuwait provided their views on the current state of the sector. We asked about the opportunities and challenges facing this sector and discussed their suggestions on ways to mitigate risks, improve performance and increase the sector's contribution to the national economy. The following paper incorporates their comments and views into a broader-based report on this topic. At the end, we offer our suggestions for policy changes that we believe will enable the financial sector to take on a larger role in the national economy.

III. Current landscape of the financial sector



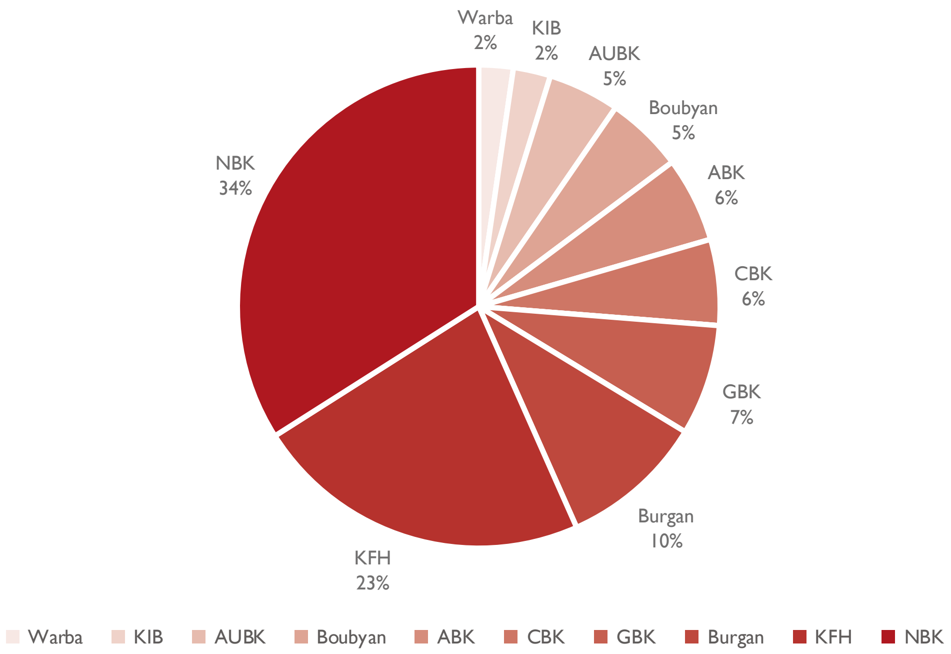
Kuwait's financial services sector is well developed and broad-based for the size of the country's economy. The Central Bank of Kuwait (CBK), the country's banking regulator, takes a conservative approach, some would even call it an over-protective one, playing a more active role in the oversight of local banks than do the banks in the region's other countries. Although this can hinder the growth and development of this sector in a growing economy, it can also protect the financial sector and the economy during a period of economic slowdown. Case in point, Kuwait's banking system weathered the Global Financial Crisis better than other banking systems in the region.

a. Competitive environmentng of the National Health Plan 2030

Though Kuwait's banks are stronger today than they were ten years ago, to the credit of the CBK, risks remain as the global economy heads into the next recession. The sector also will face risks if the government slows its spending plans from what it has outlined in the Future Vision 2035 Plan, a blueprint for transforming the country's energy sector and the cascade of effects that such a transformation will have throughout society.

FIGURE 1

Total assets of Kuwait's 10 retail banks



Source: GCC Listed Banks Results - Shifting Horizons, Year-ended 31 December 2017. April 2018, KPMG.

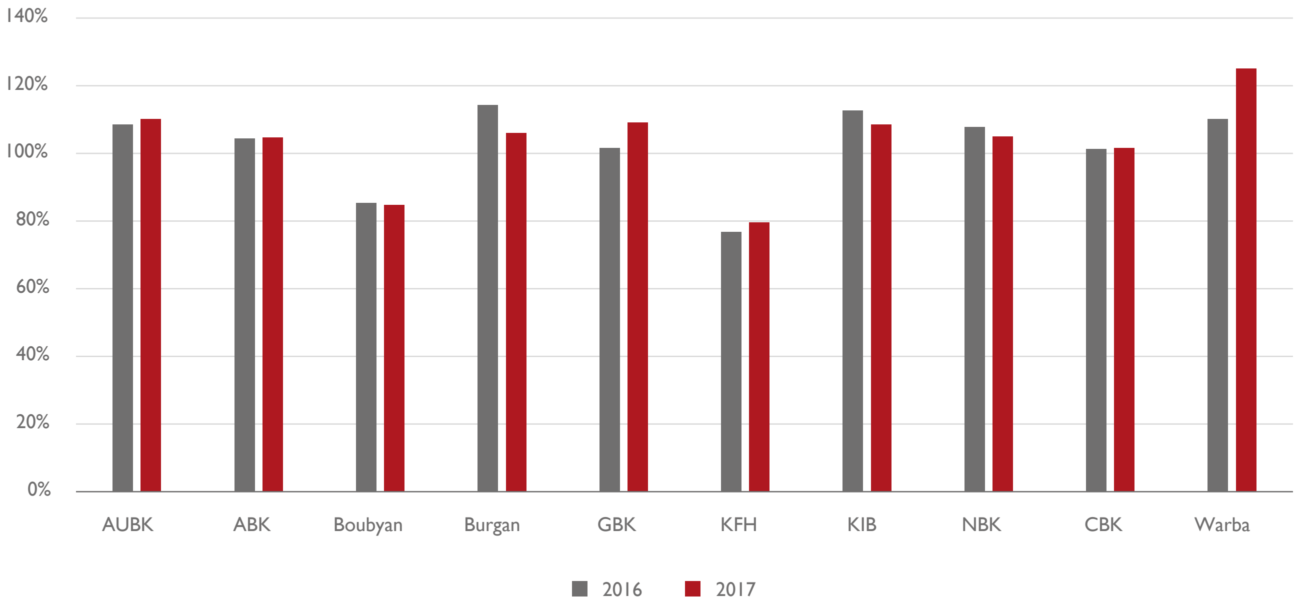
The Central Bank of Kuwait currently supervises and regulates 11 Kuwaiti banks, 12 foreign banks and 60 finance and investment companies.[i] Of the 11 Kuwaiti banks, 10 serve the retail sector and one, The Industrial Bank of Kuwait, serves the industrial sector. There is intense competition among these banks for market share. However, two banks dominate the market: National Bank of Kuwait (NBK) and Kuwait Finance House (KFH). The combined assets of these two banks represent 57% of the total assets in the entire banking sector (Figure 1).

b. Key financial ratios and cost efficiencies[ii]

Kuwaiti banks were affected by the collapse in the price of oil from June 2014 to January 2016. When the price recovered and stabilized, so, too, did the performance of Kuwait's banks. Over the past two years, performance of the sector has improved across the board. This primarily has been attributed to improved government finances and a continued and sustained growth in consumer spending.

FIGURE 2

Loan/Deposit Ratio (LDR)



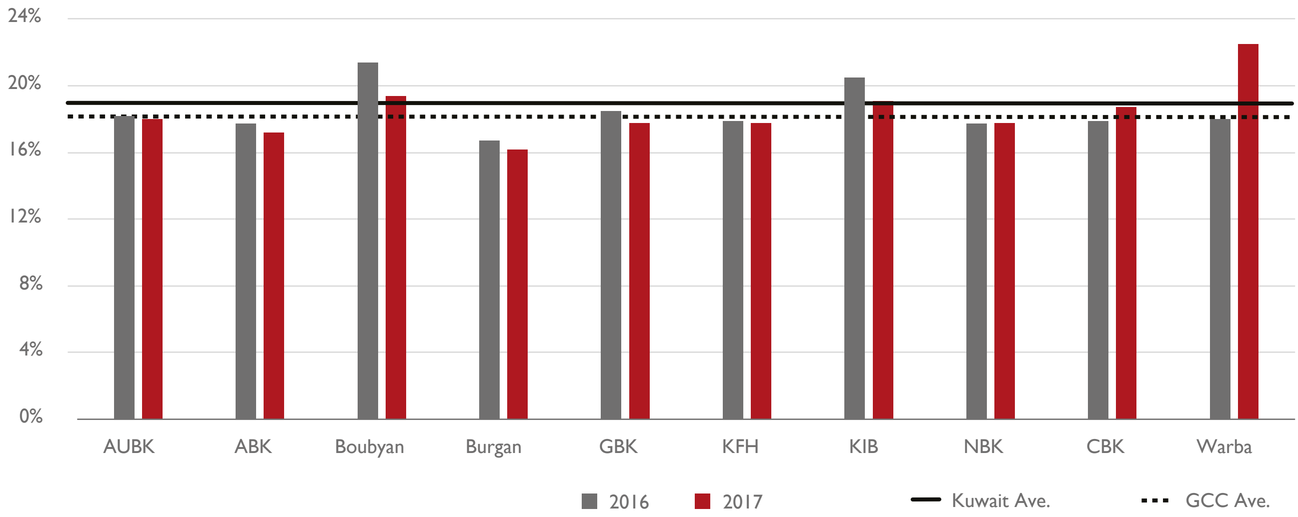
Source: Central Bank of Kuwait and KPMG.

The loan-to-deposit ratio (LDR) is one of many key financial ratios that have improved over the past two years. The LDR is used to assess a bank's liquidity by comparing a bank's total loans to its total deposits expressed as a percentage. A high ratio means that the bank may not have enough liquidity to cover any unforeseen fund requirements. A low ratio indicates that the bank is underperforming and could be a sign of other problems within the bank, as well.

There has been a steady improvement in the LDR of Kuwaiti banks as can be seen in Figure 2. An ideal LDR ranges between 80-90%. As of year-end 2017, only two banks in Kuwait had an LDR in this range, KFH and Boubyan Bank. Hence, the LDR for other banks is not ideal.

FIGURE 3

Capital Adequacy Ratio (CAR)

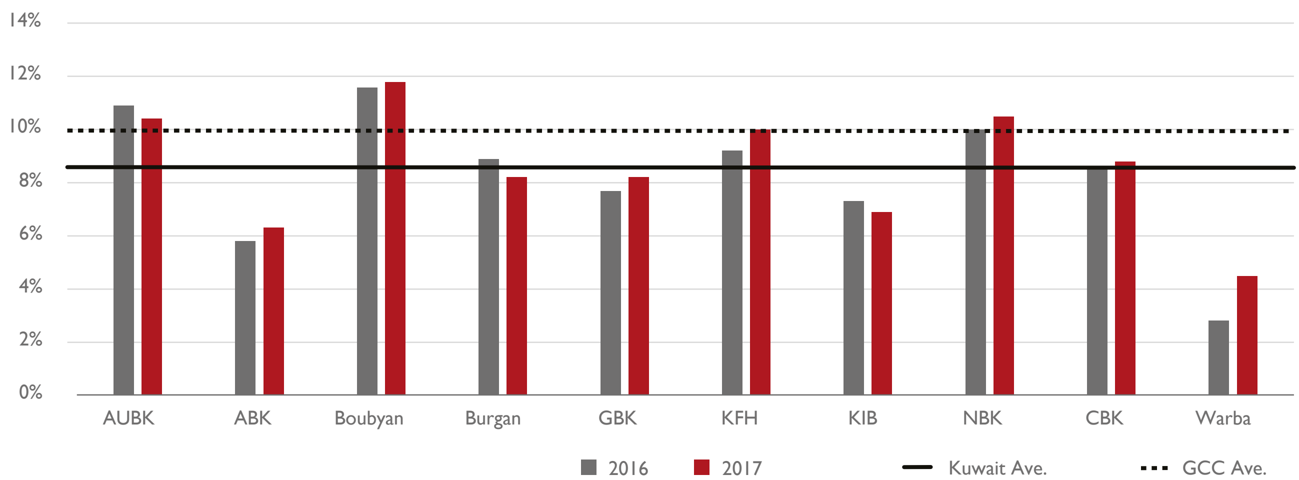


Source: Central Bank of Kuwait and KPMG.

The Capital Adequacy Ratio (CAR) is a measure of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures. Kuwaiti banks have been able to maintain high ratios, well above the 13% mandated by the CBK[iii] and per the voluntary global regulatory framework set out in the Basel III rules (10.5%).[iv]

FIGURE 4

Return on Equity (ROE)

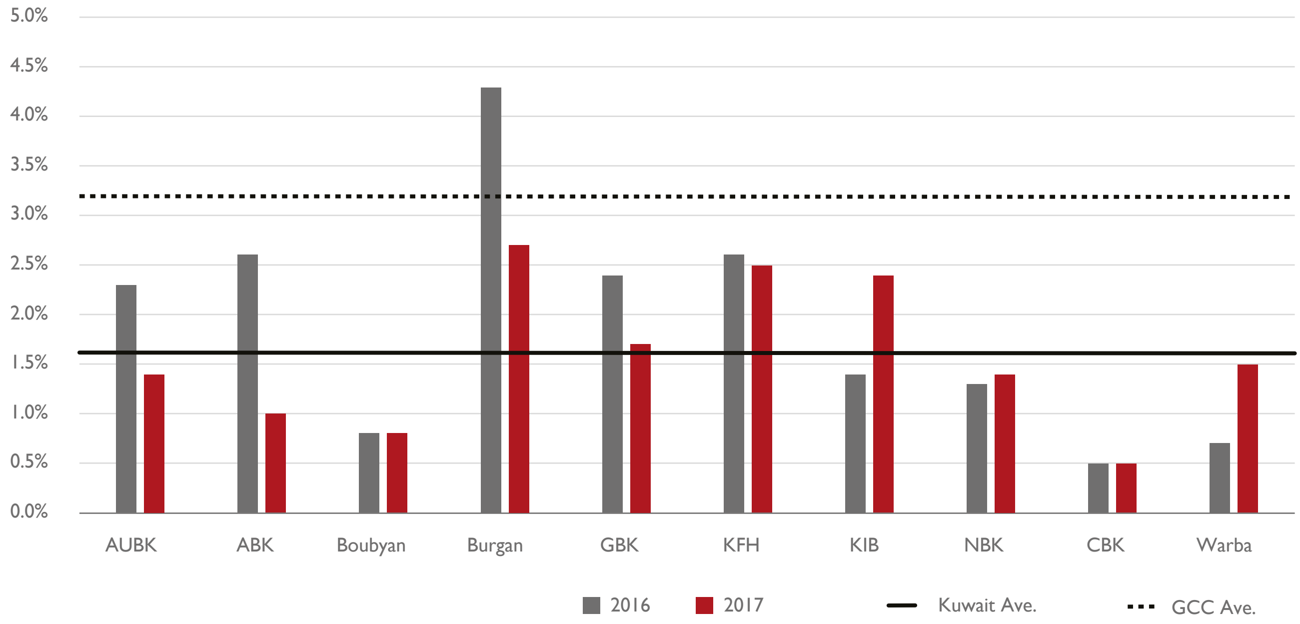


Source: Central Bank of Kuwait and KPMG.

Kuwaiti banks, however, have been underperforming their peers in the GCC in terms of Return on Equity (ROE) as can be seen in Figure 4. Five banks - Ahli United Bank of Kuwait (AUBK), Boubyan Bank, KFH, NBK and Commercial Bank of Kuwait (CBK) - have performed better than their peers in Kuwait. Whereas Warba Bank and Ahli Bank of Kuwait (ABK) had the lowest ROE.

FIGURE 5

Non-Performing Loans (NPLs)

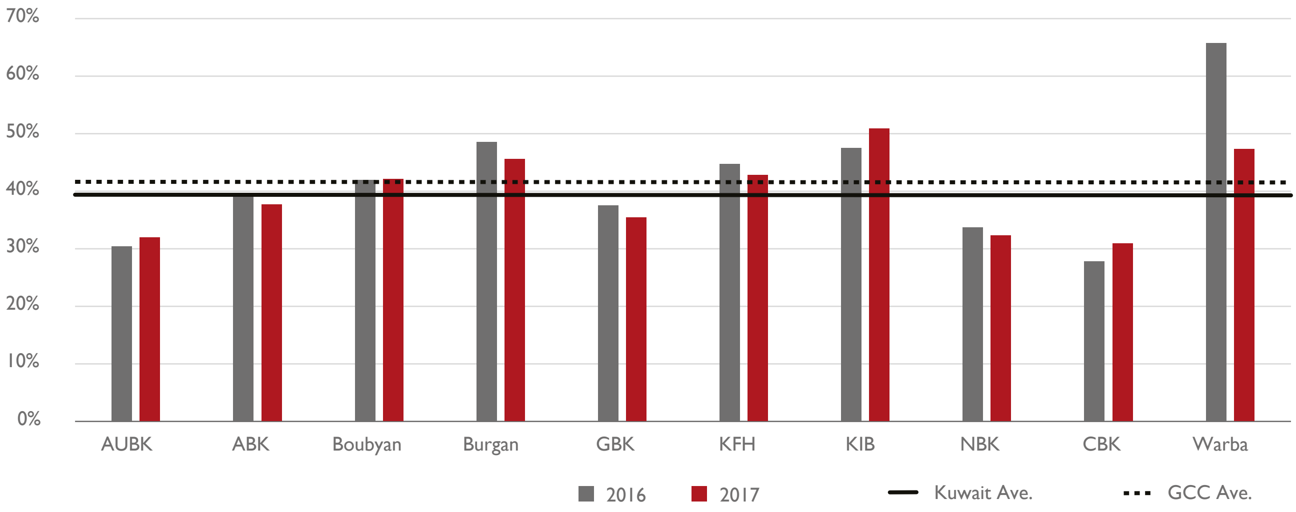


Source: Central Bank of Kuwait and KPMG.

A bright spot for Kuwait's banks compared to their GCC peers has been their low non-performing loan (NPL) ratio, as can be seen in Figure 5. This is mainly due to the Central Bank's high provision requirements and close monitoring of all banks' bad loans, defined as a loan whose payment is more than 180 days late. A ratio below 2% is considered to be excellent for a country's banking system. Banks in Bahrain and the UAE, in particular, have had a tougher time lowering their NPLs below 2%.

FIGURE 6

Cost/Income Ratio (CIR)



Source: Central Bank of Kuwait and KPMG.

Banks in Kuwait, as well as the rest of the GCC, have maintained cost-to-income ratios (CIR) below their peers in other regions, including North America, Europe and Asia. The CIR for Kuwaiti banks in 2017 was 39.7%, compared to 41.6% in the GCC, 58.9% in the US, 62.4% in Japan, 76.8% in the UK and 71.5% in Germany.

c. The relationship between economic growth, government spending and the financial sector

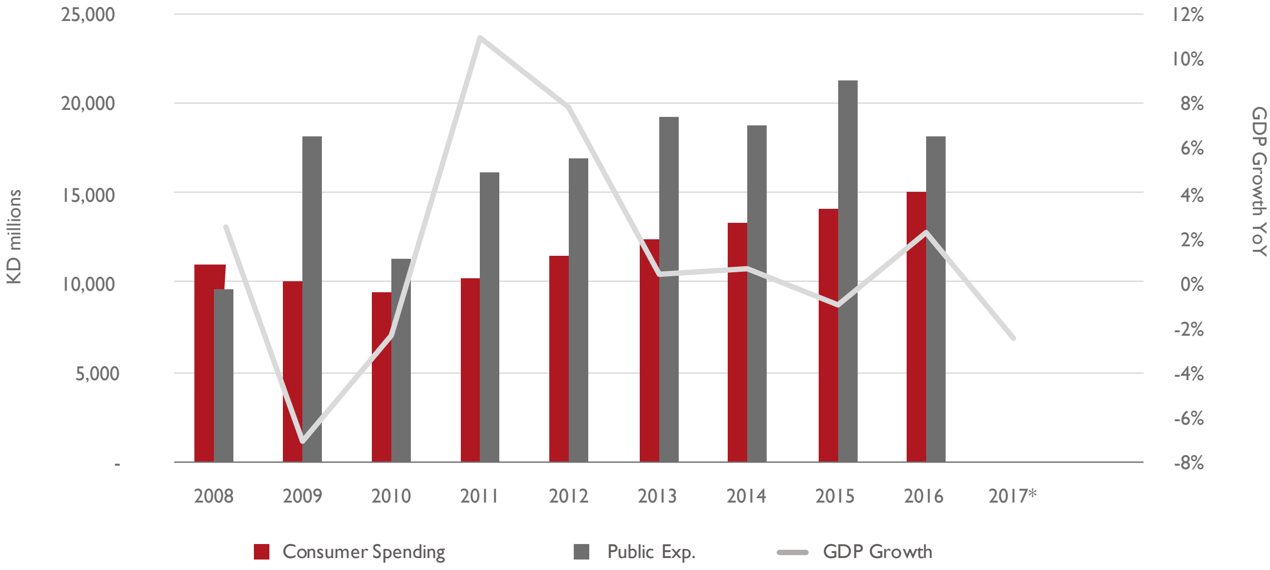
The national economy is highly dependent on two factors for growth, public spending and consumer spending. It sometimes is possible for a country to maintain economic growth if just one of these factors declines, but never if both fall. This can be seen in Figure 7, where from 2008 to 2010, both government and consumer spending declined, causing a sharp economic contraction. The economic contraction in 2017 was driven by a sharp decline in public spending that followed the collapse of oil prices. By contrast, consumer spending during this period was still rising.

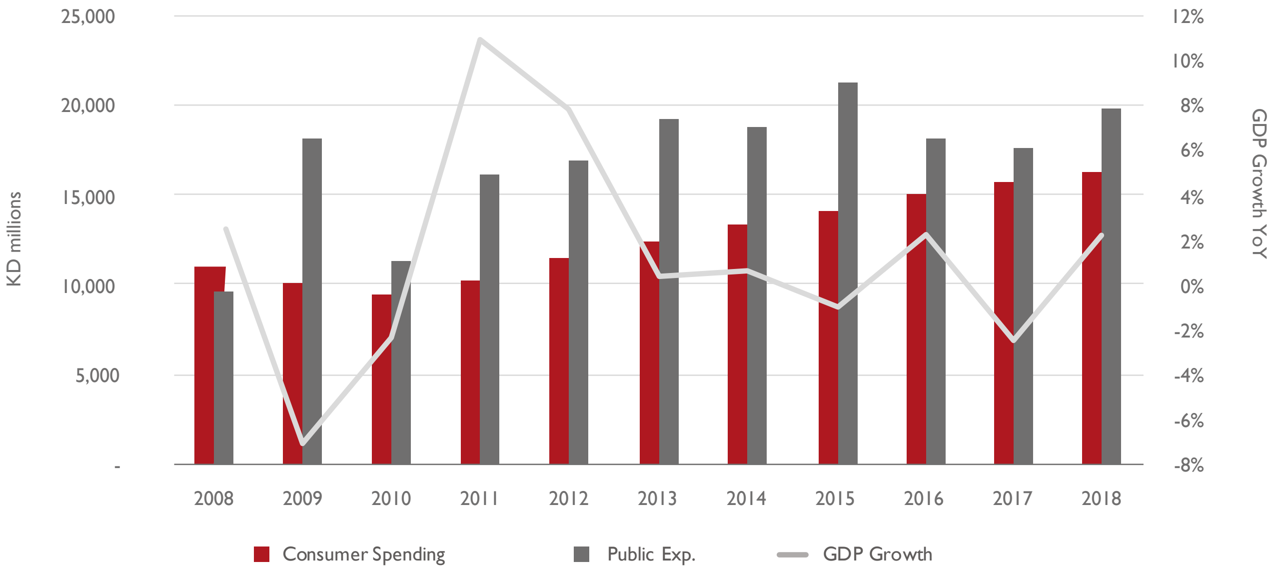
Lower oil prices have a direct impact on government spending, while consumer spending is more independent. Both factors affect the financial sector, though to varying degrees. The current structure of this sector is heavily reliant on lending to the private sector for growth, especially consumer-related real estate lending. The volatility of government spending over the past decade has forced banks to seek stable revenue growth elsewhere, especially among consumers.

Consumers, however, are not immune to economic contractions, as we saw from 2008 to 2010. Another period of lower government spending coupled with lower consumer spending would severely impact the financial sector. A key determinant of whether the national economy will experience another such contraction is the price of oil.

FIGURE 7

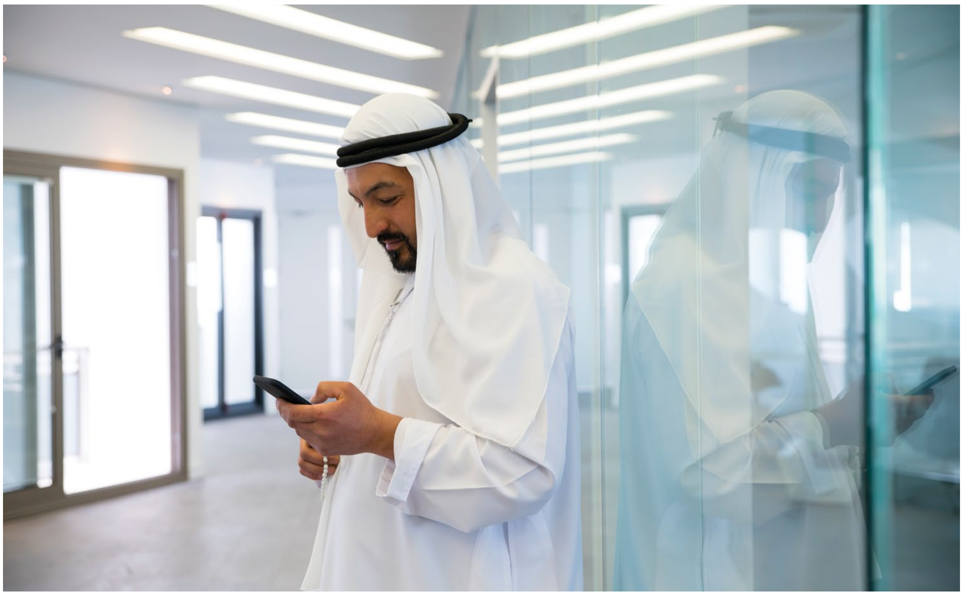
Public spending and consumer spending compared with year-on-year GDP growth rate. 2018 consumer spending is estimated





Source: Kuwait Ministry of Finance, Central Statistics Bureau, Trading Economics.

IV. Opportunities and challenges facing the financial sector



The main obstacle to the growth of the financial sector has been the national economy's dependence on a single commodity for the vast majority of government revenues and as the most significant contributor to economic growth. Other factors have contributed to this as well; these issues will be discussed later in this paper.

But the financial sector also is poised to capitalize on some exciting opportunities that are being driven by advances in financial technology (Fintech) and by a greater customer appetite for improved products and services. In seeking a better experience from their financial service provider, customers are remaking the entire financial service sector.

a. Top trends in the financial sector

As of 2017, there were five billion mobile users worldwide according to GSMA, an organization representing mobile operators. Of that number, 57% used smartphones. In the MENA region, there were 375 million mobile users in 2017, or approximately 64% of the region's population. This figure jumps to 77% when looking only at the GCC region.[v]

Needless to say, mobile use is extremely high in the GCC region with Kuwait having one of the highest mobile phone penetration rates in the world, according to the GSMA. Kuwait also has among the world's highest rate of social media and mobile application use.

With the mass-acceptance of mobile banking in the country, banks will no doubt be forced to be at the forefront of mobile banking trends in the coming years; Kuwait's young and tech-savvy population will demand more mobile services from their financial institutions.

Two trends are reshaping the industry globally and locally - mobile banking and blockchain.

1. Mobile banking

Mobile banking began in the late 1990s with the launch of SMS services, which made it easy to send messages en masse. Mobile banking was further facilitated by the Wireless Application Protocol (WAP) services, which allowed mobile phones to access the Internet. But mobile banking as we know it today did not get started until 2010, alongside the success of Apple's iPhone and Google's Android-enabled devices. It is no wonder, then, that the phenomenal success and use of mobile banking applications came alongside the explosion in smartphone use.

Today, over 43% of all banking customers globally use a mobile banking application on a daily or at least weekly basis. The rate of use was zero just eight years earlier.[vi]

The appeal of mobile banking lies in its convenience, ease-of-use and overall better user experience than visiting a traditional bank branch. Banking customers today wish to access their accounts around the clock with the same services offered on their smartphone as are being offered at their local branch. Over the next few years, mobile banking will continue to grow in importance while physical branches become less significant.

2. Blockchain

The first live use of blockchain was in January 2009 with the launch of Bitcoin, the world's first decentralized digital currency. There has been much buzz in the market surrounding blockchain. In reality, however, much of that has to do with Bitcoin and other cryptocurrencies, and not with the underlying technology – blockchain - behind them

Blockchain, in simple terms, is a digital ledger. Blockchain is resistant to data modification – a highly attractive feature. It is an open, distributed ledger that can efficiently record transactions between two parties. These transactions, once recorded, are verifiable and permanent.

Regardless of the hype and rapid volatility surrounding cryptocurrencies, blockchain is here to stay. Banks, especially, have been attracted to blockchain for its real-world applications and game-changing potential. Here are four areas where we expect blockchain to make the most impact on banking:

i. *Clearing and Settlement* – Transactions can be cleared almost instantaneously, are verifiable, permanent and can be done at a fraction of the current cost.

ii. *Payments* – Seamless, instant, cheap and verifiable international payments.

iii. *Trade finance* – Blockchain offers a practical solution in trade finance, which still relies on documents being sent by post and fax.

iv. *Identification* – Blockchain may be used for digital identification and know-your-customer (KYC).

b. Opportunities

Despite the oil price volatility of recent years, the financial sector still has several promising opportunities for growth - on both the regulatory side as well as the market side.

Regulatory opportunities

Banks in Kuwait have been facing the same challenges as banks in Europe, the U.S. and Asia in terms of keeping up with ever-changing technology and customer preferences. The Central Bank of Kuwait (CBK), for its part, has directly embraced these challenges. Instead of reacting to the rapid changes in banking technology, it has stepped to the forefront of innovation and new developments, creating new opportunities for the financial sector along the way. This can be seen by three recent developments within the CBK: the launch of the Regulatory Sandbox Framework; the development of a digital currency – Digital Dinar[vii] ; and investment in analytics.

On 26 November 2018, the CBK launched the Regulatory Sandbox Framework,[viii] a structure that allows financial institutions to live-test their product and service innovations on a small scale while regulators closely monitor them. The purpose of this Sandbox is two-fold. First, it allows financial institutions to test the feasibility of their innovations in a real-world, yet controlled, environment. Second, it provides regulators an opportunity to better understand the nature of the product or service. The live-testing will determine whether the existing regulatory framework is sufficient, or if new regulations are needed.

This Sandbox is part of the CBK's efforts to support and regulate the fast-paced innovations taking place in banking technology. It also puts forward its objective of serving the local economy while simultaneously, protecting consumers from any risks arising from abuses or security breaches.

The CBK has announced that it is developing a digital currency, to be called the Digital Kuwaiti Dinar, and e-wallets to hold those Digital Dinars. These two digital products would allow the CBK to facilitate digital payments and exchanges against tokenized assets. With the rapid rate at which digital currencies and digital payments are advancing, the CBK is proactively taking the right steps to be ready for the future.

In addition to the Sandbox and Digital Dinar initiatives, the CBK is investing in analytics and artificial intelligence (AI). [ix] These steps will help the CBK gain a faster and more accurate understanding of information and facilitate the move away from paper and manual transactions. This will affect the way the CBK interacts with other banking regulators around the world, reduce expenses and improve overall efficiencies.

Market opportunities

The key market disrupter for Kuwaiti banks has been mobile banking. The country's young population has quickly been adopting new technologies – including mobile banking. Simultaneously, the Kuwaiti government has been moving toward more e-government services as part of its effort to use technology to modernize the nation's economy.

In recent years, technology has truly changed the way Kuwaitis bank. From mobile banking to contactless payments, technology is reshaping the financial services industry as we know it; financial institutions continue to face increased pressure to adapt to their clients' rapidly-evolving tastes. A recent EY survey of 2,000 Kuwaiti banking customers found that

89% would be prepared to switch banks in order to have a better digital experience.[x] The survey also found that they would also be willing to pay more for digital convenience.

Kuwait's commercial banks have also taken a leap forward and have been rolling out new digital products and services aimed at fulfilling their customers' evolving preferences. In addition to opening new smart branches in key areas, banks have been improving their overall digital offering, which places them at or above the level of their regional peers. The following are some of the latest technological advances in the Kuwaiti market:

1. Smart Branches

Several banks have launched e-branches or "smart branches" in recent years, most notably, Kuwait Finance House (KFH) and National Bank of Kuwait (NBK). Last November, KFH unveiled its KFH-GO: Digital Self-Banking Station.[xi] It is the first fully-automated, 24/7 e-branch with an advanced range of self-service instruments that use the latest in banking technologies. This branch highlights the fundamental shift in the functionality of bank branches going forward as they move toward offering customers greater convenience, simplicity and speed. KFH views this launch as a first step towards opening similar branches as part of its future plans for enhanced e-banking services that cater to its young customers.

National Bank of Kuwait has also been opening e-branches and digital customer care centers.[xii] The digital customer care centers differ from e-branches in that they serve as enhanced sales centers for banking products, along with meeting customer needs. The centers are equipped with iPads for customers to access information about products and services as well as access their online banking accounts. Customers also have the option of using the iPads to conduct day-to-day transactions, such as making payments and transferring funds between their accounts. Visually-impaired customers can access voice services, including text-to-speech functionality, in both English and Arabic.

2. Blockchain Payments

Kuwaiti banks have also been embracing blockchain in international payments. Last December, National Bank of Kuwait (NBK) started offering a new remittance service using RippleNet's blockchain technology.[xiii] Ripple, also known as XRP, is a real-time gross settlement system, currency exchange and remittance network created by Ripple Labs Inc. in the U.S. It has gained strong acceptance among banks globally for its low cost and instant payment transfers. NBK is currently using Ripple under the name "NBK Direct Remit," which currently is available only in Jordan .

Beginning in January 2019, KFH began operating an instant cross-border remittance service, known as "Instant International Transfer," using Ripple's Blockchain technology. There is no fee for remittance transactions, one of the benefits of Ripple and Blockchain; the service is currently only being offered to customers transferring money in Saudi Riyals via KFH's partnership with Al-Rajhi Bank. The bank plans on expanding this service to more countries and currencies. Plans are also in the works to offer "Instant International Transfer" service using the mobile application or through KFH online.

3. Online Financing

Banking customers can now apply for financing without having to visit a branch. Existing banking customers at KFH and Boubyan Bank, for example, can apply for Murabaha financing online or through smart branches, mobile applications and smart ATMs.

Enhanced customer experience

Over the past few years, Kuwaiti banks have been rolling out new and enhanced services to keep up with the latest advances in banking technology. They include:

- Virtual credit cards and e-wallets – Customers can store specific banking cards on their mobiles or have online-only cards that enhance the safety and security of online transactions.
- Fingerprint and facial recognition – This allows customers to log on to their mobile banking services using their fingerprint or facial recognition, bypassing the need to type in a password.
- Online credit card issuance – This service lets customers apply for credit cards online or by using the mobile application without the need to visit a branch.
- Cardless cash withdrawal – This service allows customers to withdraw cash for ATMs without the need for their banking cards. Customers can instead use their ID cards, along with codes sent to their mobile phones for identity verification.
- Connecting to customers – Banks have proven to be successful at connecting with younger customers by using their preferred choice of communication – social media. This includes using popular services such as Twitter and Instagram, and also includes one-on-one messaging applications such as WhatsApp.

c. Challenges

The transformation of the financial services industry over the past decade has been mainly driven by customer demand for new and improved services and experiences. This will continue to be the leading factor driving change in the industry over the coming decade. There are, however, other factors that are impacting banks' ability to prepare for the future. They include regulatory challenges and market challenges.

Regulatory challenges

The CBK has traditionally been cautious about enacting new regulations or allowing new technologies into the industry without fully studying their impact. This approach can, at times, place Kuwaiti banks at a disadvantage against their international peers. Digital signatures offer an example of this problem. Implementing a way to accept digital signatures will streamline banking operations, reduce branch visits and reduce paperwork and costs. Banks in Kuwait are advocating for the use of digital signatures, which is a cornerstone that must be in place in order to offer a broader array of online services. Today, customers must still go to a branch to sign documents for certain transactions, such as account openings and new loans, services that could more efficiently be completed online.

Another regulatory problem is the CBK's approach to banking regulations. Several bankers have expressed the need for the regulator to be less "protective" than it has been since the Global Financial Crisis of 2008. Bankers argue for lifting limits on lending rates and consumer lending amounts as well as lessening the provisions rate. Bank provisions are balance sheet items representing funds set aside by a bank to pay for anticipated future losses. Some bankers in Kuwait believe that this high provision rate is no longer necessary, as banks have some of the lowest NPL ratios in the GCC. Being required to set aside higher provisions detracts from banks' ability to lend more, thus affecting their performance.

The rapid rise in demand from customers for new financial products and services is another challenge for the CBK. As banking migrates online, the need for branch visits will decrease dramatically. Alongside this shift, customers will be seeking new banking products, such as mortgage financing and other financing tools, to match their lifestyles. The speed at which mobile banking is developing is also forcing banks to launch new products at a faster rate to satisfy these growing needs. Bankers, however, believe that the CBK's procedures take too long and are cumbersome, which slows banks' ability to launch new products.

Market challenges

The banking sector faces internal and external forces, many of which are driven by trends in the global economy. Kuwait's economic dependence on oil has placed it in a precarious situation. Oil prices have – twice in the last decade - collapsed by more than 70%. In the last part of 2018, they fell by 45%. These sudden price drops directly impact the national economy and the banking sector.

The banking sector needs to diversify into new products and services in order to better withstand the next collapse in oil prices, global recession or international financial crisis. Banks are currently over-exposed to the Kuwaiti real estate sector both on the commercial side and the retail side. The reasons for this are twofold. First, credit-based lending along with investment company financing was severely impacted in 2008 and has not fully recovered. Real estate has shown to be a stable asset to lend against versus traditional credit. Second, the government has been slower than expected in launching its planned infrastructure and investment projects. Kuwait banks were hoping to be the leading financiers of these planned projects, but they have been slow to materialize. This high exposure to the real estate sector has also been flagged as problematic by the leading rating agencies monitoring Kuwait's banks – Fitch, Moody's and S&P.

V. New products and services for the financial sector

This challenge can be met by introducing new products and services to the market, allowing banks to diversify away from their dependence on one sector of the economy and stimulate further economic activity in other sectors. These are discussed below.

a. New products

Kuwaiti banks report that the limited number of products they offer curtails their growth. Other GCC countries, including Saudi Arabia, Bahrain and the United Arab Emirates, have a wider portfolio of offerings, which has helped banks there to grow. The following are some of the key products absent from the Kuwaiti market:

1. Mortgages

There is currently no mortgage law in the country. Having a mortgage law in place would not only stimulate growth in the financial sector, but also alleviate much of the pressure on one of the biggest social issues facing the country – the housing shortage.

The existing limit on housing loans is KD 70,000. This is not adequate, because the average home price in the country costs more than three times the loan limit. Banks and consumers have voiced their concerns for years about this low limit. But barring a mortgage law, there is very little chance that this limit will be raised.

In the GCC, Saudi Arabia and the UAE have mortgage laws in place.

2. Securitization

Allowing banks to securitize their loans and financings offers four benefits to the financial sector and national economy.

First, it would alleviate pressure on banks by allowing them to sell their loans/financings, free up their balance sheets and lower their concentrations in certain economic sectors. Second, it would enhance competition among banks, and would especially help to put smaller banks on a more equal footing with the two large banks (NBK and KFH). These banks are currently restricted in the amount they can lend/finance due to the size of their balance sheets.

Third, securitization would help develop an active secondary market for trading such securities. This can also stimulate the growth of investment products for the local market, including sovereign funds and pensions funds, as well as other investors seeking local, fixed-income products.

Fourth, securitization complements the mortgage market. Securitization of mortgages has been one of the key stimulants of economic growth in developed countries. We must take note here, however, to differentiate between mortgage securitization and sub-prime mortgage securitization. The former has proven to be a positive economic stimulant to economic growth while the latter has been proven to increase the risk in the financial system.

3. Corporate and government bond market

In March 2017, the Kuwaiti government issued its first bonds in recent memory. The $8 billion issue is being used to finance the country's growing budget deficit, following the playbook of other GCC countries.[xv] The government granted foreign banks a majority of the sales, angering local banks. This bond sale received over $20 billion in offers from investors, highlighting the enormous demand for Kuwaiti sovereign debt.

Some bankers believed that the government as well as the CBK did not want local banks to take on the largest share of this bond offering due to fears of becoming overexposed to this sector. However, banks have been trying to diversify away from the real estate sector and Kuwait sovereign debt is the safest choice for them.

A related issue is the lack of an active bond market in the country, which has been primarily blamed on the government. Government bond issuance is what stimulates the overall bond market and establishes the benchmark rates for the country. This also encourages corporates to issue bonds instead of going the traditional route of seeking bank lending.

Therefore, a bond market is necessary to foster development of the financial sector and the national economy. The government should establish a bond issuance program and allow local banks increased participation.

4. Blockchain contracts

Blockchain products have been launched into the local market, and additional products are expected as more banks begin integrating blockchain technology. As an example, "smart contracts," also known as Blockchain contracts, are being used in trade finance.[xiii]

This technology greatly improves both speed and efficiency and also lowers the cost in trade finance, which is a market segment in great need of modernization. Most trade finance documentation is still done by post or fax. In May 2018, HSBC Bank in the UK became the first bank to use Blockchain contracts in trade finance.[xvi]

5. Other products

There will always be a need to launch new or improved products and services, whether for the corporate or retail market. Regulators can help by providing a level playing field, making rules and regulations transparent and removing obstacles to development. This will allow the financial sector to innovate and determine for itself the best products and services to offer. The CBK has already shown its willingness to be on top of these innovations, first, by establishing a Regulatory Sandbox Framework and, second, by allowing the use of Blockchain for payment transfers.

b. Enhanced services

Kuwaiti banks have proactively enhanced their customers' experience by using the latest technologies, especially in mobile banking. But two additional service enhancements are needed in the market:

1. Digitization

Globally, the financial sector is rapidly moving towards digitization. Blockchain is only one tool being used. There are other ways the financial sector is employing digitization to improve efficiencies, reduce manual tasks and decrease operating costs.

Digital signatures and digital checks are two innovations already implemented in other markets, but not yet in Kuwait. There is also a big movement toward back-office automation, which includes artificial intelligence (AI) also known as data analytics. Local banks have not actively invested in this yet, but they may soon follow the CBK's lead in this area. Going digital saves time in many ways. Customers need not waste time going to the branch, employees reduce the amount of time spent with customers printing and signing documents and back office filing time also is reduced.

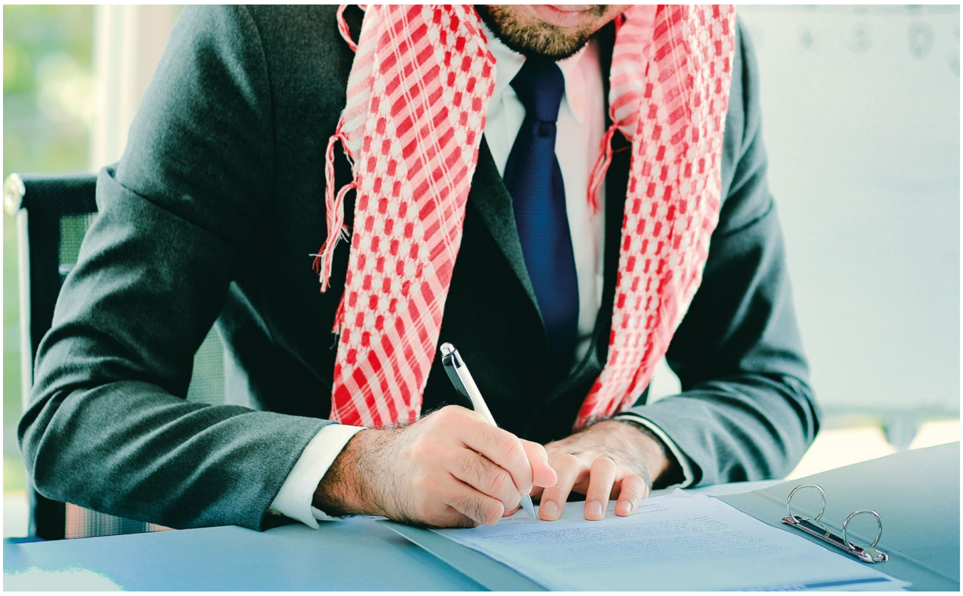
2. KYC

Know-your-customer (KYC) is a vital for banking. Regulators hold banks responsible for checking customers' identities in order to prevent illegal activities, such as money laundering, and hold them accountable (i.e. fine them) if the vetting process is breached.

Banks have been trying for years to set up shared digital records of customers' identities and keep them updated. They have so far failed to find the right formula, but blockchain experts believe that blockchain would be a good solution. It has cryptographic protections and an ability to share with multiple parties records that are updating continuously. Technology giants, such as Microsoft are working on blockchain solutions for identity verification. Here, too, expect testing and implementation of such programs to be a few years away.

In the meantime, large global banks are proceeding with testing and implementing data analytics using AI machine learning to spot patterns and discrepancies in customer KYC data. Data analytics can complement blockchain identification and we can expect both to gain wide-spread use in the coming years.

VI. Government's role in enhancing economic growth and diversification through its support of the financial sector



The leading international agencies, such as the International Monetary Fund (IMF), World Bank and World Economic Forum (WEF), have been encouraging governments to promote growth in Public-Private Partnerships (PPPs) as well as embark on privatization programs and launch initiatives to support Small- to Medium-Sized Enterprises (SMEs) in their respective countries. Kuwait offers programs for all of these, in addition to a plan for attracting foreign direct investment (FDI), in the country's short-term and long-term Development Plan known as Future Vision 2035.

The current shortcomings in the country's financial sector include a limited product offering, limited investment opportunities and a lack of depth in local capital markets. The programs mentioned above are able to solve these issues and place the country on the path to meet the targets set forth in the Future Vision 2035 plan.

a. Public-Private Partnerships (PPPs)

Public-private partnerships (PPPs) are a partnership between a government agency and a private-sector company to finance, build and operate specific projects, such as public transportation networks, toll highways, parks, hospitals and other types of public infrastructure and utilities. A single public-private partnership can include multiple private partners. PPPs tend to be long-term in nature with contract periods in the range of 25-30 years or longer.

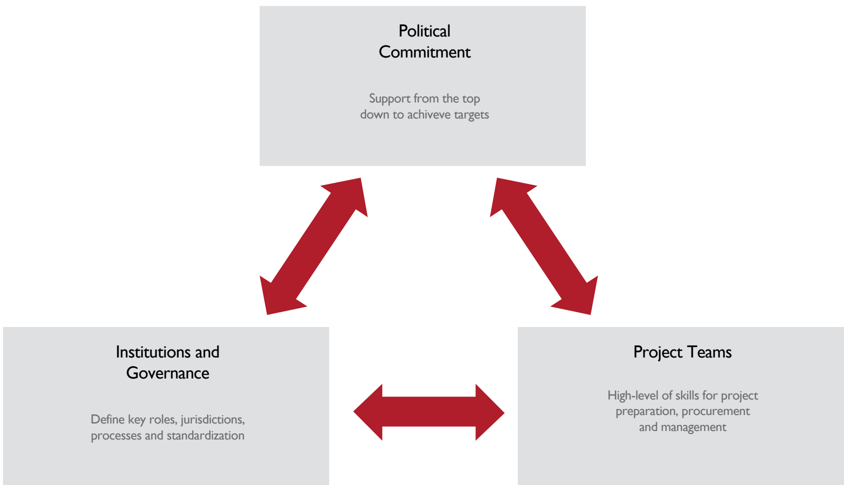
Financing comes partly from the private sector but requires payments from the public sector and/or users over the project's lifetime. The private sector participates in designing, completing, implementing and funding the project, while the public partner focuses on defining and monitoring compliance with the objectives. Risks are distributed among the public and private partners according to the ability of each to assess, control and cope with them.

PPPs can be attractive to governments on several fronts. First, such partnerships can allow a project to be completed earlier or make it possible in the first place if the government lacks funds. Second, private sector technology and innovation help provide better public services through improved operational efficiency. Third, the partnerships help to diversify the economy, which makes the country more competitive and attractive for further investment. The public sector, for its part, provides incentives for the private sector to deliver projects on time and within budget.

Healthy and successful PPP programs have several defining features: strong competition; bankability – ability to get financing; lower risk of renegotiations; secure value for money – government guarantees; and efficiency gains through clear cost savings. The World Bank has outlined three institutional pillars that are needed to increase the probability of PPP success.

FIGURE 8

The three pillars for PPP success



Source: The World Bank.

1. Political commitment

In many countries, the very idea of private sector management, operation or ownership of "public services" is foreign, and securing buy-in for PPPs requires significant political leadership. Government leaders at all levels and across multiple ministries must ensure support for PPPs.

2. Institutions and governance

Transparency and standardization are key to attracting credible, high-quality bidders to projects. Firms considering bidding on a PPP need to know their bids will be reviewed in a timely manner using transparent and standardized processes. Potential bidders may perceive as especially risky projects that are subject to approval from different branches of government, such as a parliament. From an investor's perspective, it is preferable to navigate the project approval process prior to offering an actual bid.

3. Project teams

A highly-qualified governmental technical team that understands the market and its requirements and limitations can ensure clarity and consistency throughout the process. A qualified technical team in government is more important for contract management during the implementation phase.

All three pillars are necessary to ensure success. The entire PPP framework will be compromised if only two of the pillars are strong. Therefore, the government must strengthen all three pillars before embarking on a PPP program. This might not be a quick process, but having the right foundation is the essential first step for any country looking to gain experience, create confidence in its PPP program and achieve lasting results.

Having the right foundation not only will attract high-quality potential bidders to a project, but also will attract financial service firms locally and internationally to bid competitively on financing it. The competitive bidding will lower the overall cost of the project and the cost to the government.

The financial sector in Kuwait has a high interest in participating in PPPs. But the current governmental commitment, transparency and slow decision-making process make government projects risky for them.

b. Small and Medium-Sized Enterprises (SMEs)

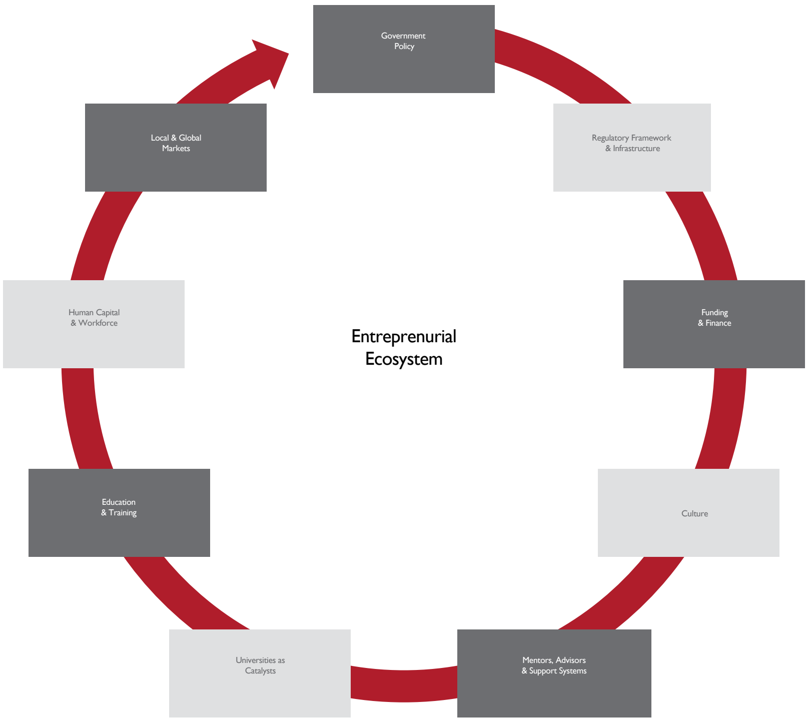
The definition of Small and Medium-Sized Enterprises (SMEs) differs from country to country. In Kuwait, the Fund for SME Development defines an SME as a company with fewer than 50 employees and financing needs that do not exceed KD 500,000. [xviii] The KD 2 billion fund was established following passage of law number 98 of 2013. The fund's goal is to support the growth and development of SMEs in the country.

The SME sector is vital to any economy because it comprises a majority of economic activity in the private sector, which in developed and emerging countries' economies ranges from 40% to 50%, according to the World Bank. The number of SMEs in Kuwait is high, particularly in retail and non-financial services, but their overall contribution to the economy is marginal, approximately 3% of GDP. This is concerning when compared with other economies.

To understand the barriers to growth, the World Bank in 2014 surveyed 502 Kuwaiti SMEs.[xix] Over 35% of respondents viewed the business licensing and permitting processes as the main obstacles to growth. Respondents also viewed labor regulations, regulatory uncertainty, and administrative corruption as significant issues. The shortage of an adequately educated workforce was also cited by 24% of the survey's respondents. The process of obtaining a business license was found to take an average of 41 days, and dealing with other government regulations took anywhere from 14% to 20% of a manager's time.

FIGURE 9

The entrepreneurial ecosystem



Source: World Economic Forum.

Developing a vibrant SME sector in the country is vital for securing future economic growth and diversification. As such, the government has begun addressing the issues affecting SME growth. While the launch of the National Fund was a step in the right direction, to date it has failed to achieve its targets. SME owners blame bureaucracy and red tape in applying for funding - along with changes in management and procedures - as other reasons for the fund's failure to meet its objectives.

Instilling an SME culture in the country starts from the top and encompasses not only the government sector, but also the financial sector, educational sector and more, as can been seen in Figure 8. The government has been streamlining processes and easing some obstacles, but it also must prioritize private sector involvement.

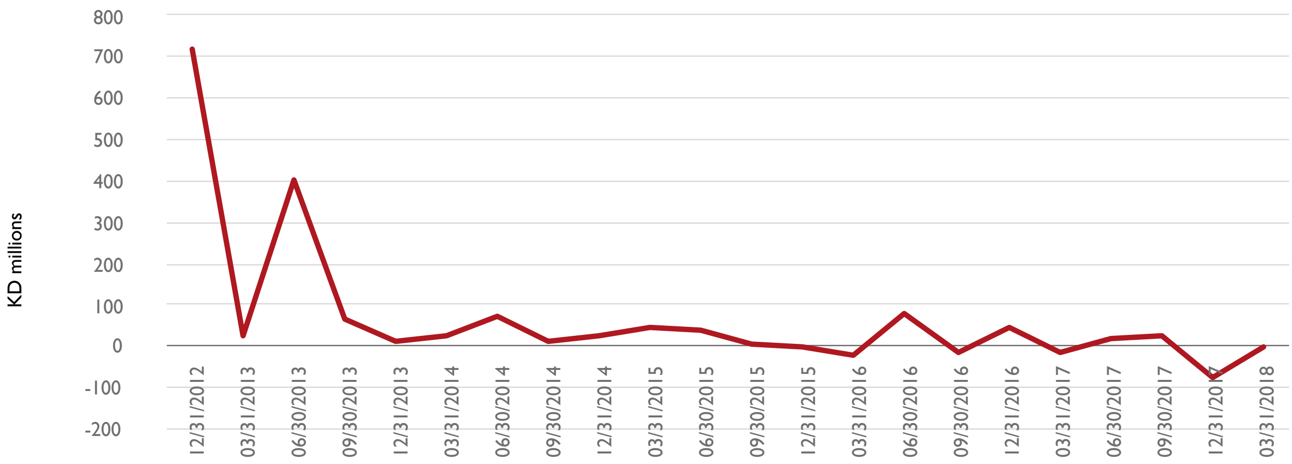
In particular, the involvement of the financial sector in funding SMEs can be more effective than the existing program. The track record of the National Fund should be a motivating factor for government decision-makers to consider partnering with the private sector in launching other SME funds managed and operated by the private sector. In addition, private sector SME funds supported by the government can be more cost-effective and reduce the impact on government finances.

c. Foreign direct investment (FDI)

FDI in Kuwait has been virtually non-existent over the past five years, according to statistics from the Central Bank of Kuwait. While the government has made progress in promoting FDI in the country - including enacting Law No. 116 of 2013, which established the Kuwait Direct Investment Promotion Authority (KDIPA) - it has still fallen short of its objectives.

FIGURE 10

Foreign direct investment coming into the country



Source: Central Bank of Kuwait.

KDIPA's mandate is to attract FDI to Kuwait by promoting the country as a lucrative investment destination. It is also tasked with helping streamline business registrations, and processes and procedures related to the country's business environment, thus enhancing Kuwait's competitiveness. The authority has had some success in attracting foreign investment from major corporations including, General Electric, Huawei and McKinsey. It has also assisted SMEs in the country in attracting foreign partners to form local joint ventures and gain from their international expertise.

Overall, however, the red-tape and bottlenecks the agency was hoping to overcome were never removed, they were simply handed over to KDIPA to act as a facilitator for foreign investors entering the country. Laws and procedures were not changed at other ministries, such as the Ministry of Commerce & Industry, to address foreign investors' concerns over red tape and bureaucracy.

Kuwait has most of the right ingredients already in place for attracting FDI, including an atmosphere of political stability, a relatively open economy, free movement of capital, a stable national currency and low inflation. The key missing ingredient is governmental commitment across all ministries and agencies, similar to the three pillars of success for PPPs mentioned above.

d. Privatization

Privatization is at the heart of Kuwait's economic modernization and liberalization plans, yet the program has stalled over parliamentary disagreement on the path forward. There is also a need to amend Law No. 37 of 2010 regarding the regulation of privatization programs, an effort that has stalled in parliament and no date has been set on when it will be brought up for a vote. Thus, the Supreme Council on Privatization has been unable to kick-start its program of selling off state-owned enterprises, including public utilities.

The enactment of the privatization law was cheered by the financial sector only to see no action come from it. Local banks and investors would especially benefit from playing a large role in investing in these enterprises. Having a robust privatization law in place would not only kick-start the government's much-anticipated program, it would also be a key resource in attracting international financial institutions to participate in the acquisition and financing of these enterprises.

VII. Conclusions and policy recommendations

Kuwait's financial sector has proven to be resilient over the years, despite the volatility in oil prices. Key financial ratios in the sector have been improving in recent years, which can be attributed to improved government finances and a sustained and steady growth in consumer spending.

The biggest changes in the financial sector over the past decade have come from advances in technology. The traditional banking model, which calls for growth through and expansion of a network of branches, is no longer viable. In today's highly competitive environment, banks must instead invest in technology and deploy new products and services. Customer appetites for new and improved services will be the driving force in this sector over the coming years.

The financial sector is embracing these changes and finding new opportunities. However, challenges and obstacles are preventing this sector from reaching its full potential. In addition, the government has the largest role to play in promoting the growth and development of the financial sector, which goes hand-in-hand with its Future Vision 2035 plan of enhancing economic growth and diversification. The programs in place for supporting PPPs, SMEs, FDI and privatization will directly impact the financial sector.

Therefore, policy-makers and financial regulators should take careful note of them and seek ways to effectively nurture them. Our policy recommendations, which are based on our research and engagement with key stakeholders, follow.

Policy Recommendations:

Competitiveness and Risk

- Improve the competitive landscape. Two banks dominate the local market, while the remaining eight banks play a smaller roll. This creates a risky financial sector. An ideal scenario would be to have four large banks in the market. There are three ways to improve the competitive landscape:

    1. Allow existing foreign banks to operate on an equal footing with local banks, which will give them a larger share of the local market.
    2. Encourage smaller banks to merge creating larger institutions, as has already occurred in other GCC markets.
    3. Allow banks to securitize their assets/loans (see below).

Products, capital markets and regulations

- Allow banks to securitize their assets and loans, which will be a prerequisite to developing an active capital market. This will enable smaller banks to compete more equally with larger banks in lending and project financing.
- Draft a national mortgage law that paves the way for banks to offer mortgages. This will help address the housing shortage crisis and create a more stable secondary housing market.
- Increase the limits on bank lending and financing while taking into consideration customer debt-loads and bank risk appetites.
- Lower the provisions for banks, which have impeded lending growth. Kuwaiti banks already have low NPL ratios.
- Create a government bond program whose main objective is to stimulate the development of a national bond market. This will attract local and foreign investors as well as encourage the private sector to issue bonds.
- Consider the establishment of a national deposit-guarantee company, similar to the U.S. FDIC. This will alleviate pressure on the CBK to be over-protective and allow the liberalization of some regulations.

Government's role

- Expedite law amendments required to pave the way for launching the privatization program. This has the potential to become the largest economic stimulus to the local economy.
- Mandate the sovereign wealth fund to invest a portion of its assets in the local capital market. This would support all of the government's economic programs and stimulate the growth and development of the financial sector. It also would boost Kuwait's attractiveness as an investment destination to foreign investors.
- Get serious about attracting foreign investment in the country by removing the bureaucracy and red tape across all ministries and departments.
- Secure the political commitment for PPPs as a first step in building the infrastructure for a PPP program. This includes buy-in from all relevant governmental departments as well as having a clear plan, a clear decision-making structure and transparency in the bidding process. This will attract financial institutions to these projects and help reduce the impact on government finances.

- Support the establishment of private sector SME funds, fully or partially guaranteed by the government, as a way to speed capital deployment into the sector and reduce costs. Public sector SME funds are costly and do not work.
- Change the current structure of the National SME Fund to be a fund of funds whereby capital is deployed to multiple private sector SME managed funds. Thus, the private sector would manage the investments and the government would provide oversight.
- Support the development of national SME incubators in partnership with the private sector.

End Notes

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