

Financial Stability amid Innovations and Reforms¹

Your Excellency, the Deputy Prime Minister, Minister of Finance, and Acting Minister of Oil,
Distinguished Guests,
Sabah-al-khair and a very good morning.

I am delighted to return to this forum for the fourth consecutive year. And thank you Mr. Banks for your kind introduction and for inviting me to speak before this august audience.

The conference this year is centered on the topic of ‘Meeting the challenges of financial innovations and reforms’. In line with this broad agenda of the conference, I would like to speak about both *financial innovations* and *reforms* – the two key forces of changes currently sweeping across the financial and economic landscape and their implications for the financial sector stability.

In the first part of my speech, I will talk about financial innovation, the opportunities it offers and the challenges it poses. In the second part, I will discuss reforms, particularly in the financial sector and their role in making our banking sector more resilient. Finally, I will also touch upon the need for broader economic reforms which are critical to foster sustainable economic growth.

¹ Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait at the Euromoney Conference held on 27th September, 2016, Kuwait City

Financial innovations

Technological innovations are radically changing the way we conduct business, interact with each other or consume various products and services. Industries like transport and hoteling have already been shaken up by the likes of Uber and Airbnb. Financial sector, essentially an 'information industry', is also experiencing a major transformation fueled by advances in technology.

While the influence of modern technologies is now ubiquitous, let me briefly highlight a few areas of finance where the developments are particularly significant.

First, technology is supporting the outreach of formal financial services to the millions of otherwise unbanked customers. According to the World Bank, the poorest 20% of the world population is more likely to have access to a mobile phone than to clean water and sanitation. Capitalizing on this opportunity, a number of countries have managed to swiftly expand access to finance in recent years. For instance, Tanzania has more than doubled the percentage of adults with bank accounts through e-money services. And digital IDs have helped add 200 million new bank accounts in India.

It is pertinent to mention that here in Kuwait, we have already achieved a level of financial inclusion that is truly impressive by global standards; World Bank's data reveals that 86.8% of the population above the age of 15 years in Kuwait has an account with a formal financial institution, compared to a meager 14% in the Middle East region.

Second, programming breakthroughs like blockchain are potentially transforming the way we verify transactions and enforce contracts. By allowing parties to transact without central intermediaries, blockchain can strip off costs, reduce inefficiencies and enhance customer services. Reportedly, it can enable cross border payments without correspondent banks and can lower settlement times from around 3 plus days to a few seconds.

Hosts of other innovations are reshaping the way we transfer money or obtain credit. For instance, mobile wallets are enabling payments by smart phones, peer-to-peer lending is providing new sources of financing and robo-advisors are offering financial advice.

While undoubtedly exciting, these developments bring in their own unique risks and challenges. I would like to flag a few of them, particularly from the standpoint of financial stability.

First, cyber security risk is becoming an increasingly major part of banks' operational risk profile. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely and on a massive scale. Though such occurrences are still rare, the impact is massive, both in financial and reputational terms.

Second, financial technology firms or fintechs are unbundling parts of the finance value chain, offering financial services directly to customers. Apart from increasing competition and squeezing banks' profits, fintechs are moving part of the banking business to shadow banking which remains lightly regulated, if at all. Likewise, tech-enabled peer-to-peer lending and crowdfunding may exacerbate procyclicality and the scale of shadow banking.

Third, we may witness the emergence of new systemically important digital financial firms. The tech world already reflects a winner-takes-all phenomenon as few firms like Google and Apple enjoy huge presence in their respective areas; greater role of these firms in providing financial services may create a completely new set of unregulated too-big-to fail institutions with their own unique risks.

As this discussion indicates, innovations are by nature a disruptive force, causing a considerable degree of instability. Therefore, regulators face a daunting task of keeping financial systems safe and stable while continuing to ensure the convenience and efficiency that modern technologies offer. Indeed, it is a delicate balance to achieve, as we want neither to stifle innovation nor to undermine financial stability. Similar to when navigating unfamiliar domains, we need to remain agile, adaptive and proactive – this will ensure reaping the enormous benefits of financial innovations and at the same time limiting their downsides.

Reforms in the banking sector

Let me now turn to the second part of my speech, i.e. reforms. Since it is a very broad topic, I will confine my discussion to some key regulatory reforms in the banking sector, given their direct relevance to the Central Bank of Kuwait's (CBK) mandate of financial stability.

As we have experienced in the past, stress in the financial sector can come from a variety of sources; it is hard to predict when or where the turbulence would emanate from. Consider the stress that financial markets have suffered from in recent years. In 2013, it was the US taper tantrum, in 2014 it was the oil prices collapse, in 2015 it was China's rebalancing and this year it was Brexit, just to quote a few examples. These events were markedly different in geographical origin and root causes but were common in rattling the global markets.

Against this backdrop, ensuring a resilient banking system capable of withstanding a variety of shocks is no easy task. And these shocks are not only exogenous; the banking system itself is in a state of flux amid evolving risks, in part due to the very financial innovations I just talked about.

This necessitates the need for continuously upgrading our regulatory regime. Accordingly, CBK, over the past few years, have not only refined its existing regulations to reflect the best global practices, but have also introduced a host of new measures, in line with the recommendations of the Basel Committee.

Let me very briefly point out only a few of the steps we have taken. First, we have enhanced our capital adequacy regime by setting out higher and better quality capital for our banks to further strengthen their loss absorbing capacity. We have also put up additional capital requirements for our systemically important banks. Furthermore, our additional *capital conservation buffer* and *countercyclical capital buffer* requirements would respectively enable banks to maintain additional cushion and would help contain the buildup of systemic risk. Secondly, we have introduced a simple *leverage ratio* as a supplementary measure to ensure that banks do not become overly leveraged. Last but not least, we have implemented two new liquidity standards; *Liquidity Coverage Ratio* and *Net Stable Funding Ratio*

which are aimed to improve banks' capacity to withstand liquidity stress and to make their funding structure more stable.

Admittedly, ensuring stability of a constantly evolving banking system can't be left to regulation alone. So we have also strengthened our supervisory capacity, which suitably complements our revamped regulatory regime and enables us to vigilantly examine banks' true compliance with our regulations. Moreover, our supervisory function gives us the agility to mitigate emerging risks before they materialize.

Despite these efforts, we are aware that we can't regulate and supervise every aspect of the banking system. Ultimately, the banks should assume prime responsibility for their actions and behaviors. Given the paramount importance of public confidence, banks can ill afford to operate with weak corporate governance or poor risk culture. Therefore, we have issued comprehensive guidelines to make banks' corporate governance more robust, supported by strong internal controls, prudent risk management and meticulous compliance.

We recognize that compliance with our regulatory measures is costly for banks; nonetheless, the cost of any financial crisis is way too steep; so it is only wise and rational to strengthen the capacity of our banks in benign times. By requiring banks to do so, CBK's proactive approach paved the way for our banks to enter the low oil price environment from a position of strength. Without the robust buffers that we diligently built in good times, the banking sector would not have been able to withstand the stress so well.

As we have noted in our flagship *Financial Stability Report* for 2015 released in July, banking system in Kuwait has remained stable despite the challenging economic environment. Banks' non-performing loan ratio has continued its steady decline to reach 2.4%, a historically low level. Compare it to the NPLR of 11.5% back in 2009 and you would notice the substantial progress that our banks have made in cleaning their balance sheets. At the same time, the coverage ratio has climbed to a record high of 204%, substantially greater than the pre-crisis ratio of 87% observed in 2007. In terms of newly introduced liquidity coverage ratio, our banks are comfortably above the minimum benchmark of 100% required by 2019. And even banks' net income have registered positive growth at a time when international

banks are facing a distressing squeeze on profits amid low interest rate environment.

On the capital adequacy side, our banking system has stayed robust at 17.5%, well above the CBK's 12.5% requirement for 2015. Banks' overall leverage ratio at 9.7% is also substantially higher than the 3% global benchmark. And banking credit has posted a very healthy growth of 8.5% in 2015. This indicates that CBK's focus on financial stability has by no means restricted our banks' ability to support the real economic activity in Kuwait. Rather we believe that the soundness of our system has enabled our banks to continue lending despite a challenging macro environment.

Need for broader economic reforms

This brings me to the final part of my speech. Here I would like to briefly touch upon the need for economic and structural reforms that are critical for sustainable economic growth.

Based on the few statistics that I shared earlier, it is obvious that our banks, at least so far, have weathered the oil rout fairly well. However, you would appreciate that banks' capacity to remain resilient is not infinite; a weak economic environment would ultimately put an otherwise stable banking system in considerable stress, eroding its resilience over time.

Though CBK is leaving no stone unturned in upgrading its regulatory regime and enhancing its supervisory focus, financial regulation can only go that far; it can't be the 'only game in town' because it is too narrow a tool to address macroeconomic and structural issues. Banking sector, no matter how stable, is only a component of the overall economic landscape and its stability can't obviate the need for economic reforms.

Fortunately, our financial buffers and low public debt provide us some breathing space; therefore, our economic reforms can be gradual, as long as the momentum is sustained. And I shall emphasize that the modest recovery in oil prices seen earlier this year is no excuse for complacency as only comprehensive fiscal and structural reforms would ultimately enable Kuwait to wean itself off oil dependence. Rationalizing expenditures, maximizing

non-oil revenues, promoting private sector development, and diversifying the economy are few of the areas, which would continue to require unremitting attention.

Conclusion

To conclude, CBK has made strenuous efforts in maintaining monetary and financial stability in these testing times. Our success is evident from the healthy trends in various financial indicators, a few of which I shared today. Yet financial and monetary stability is just a necessary but not a sufficient condition for the overall economic stability. Only the requisite economic reforms will help achieve revenue and economic diversification and will create a stable economic environment conducive for job creation and sustainable growth.

Thank you for your attention.

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