

## **Macro Prudential Policy The Experience of the Central Bank of Kuwait<sup>1</sup>**

**His Excellency Mustafa Jassem al-Shamali, Deputy Prime Minister and Minister of Finance**

**Esteemed guests**

**May the peace and blessings of God be upon you.**

I would like to welcome you all to Kuwait, a country that feels honored to host this conference, organized by Euromoney, in order to discuss a number of economic and financial topics that have gained importance since the eruption of global financial crisis. I would like to express my gratitude to the conference organizers for inviting me to speak about Macro Prudential Policies, which have become among the most important topics within regulatory and supervisory frameworks. Its importance has been highlighted in the wake of the financial crisis, which exposed the inadequacy of micro prudential regulatory and supervisory frameworks in protecting the soundness of the whole financial system and underscored the importance of supporting the micro framework with more holistic approaches of macro prudential policies in order to limit systemic risk and to protect the financial system as a whole.

Before I speak about the experience of the Central Bank of Kuwait (CBK) and its regulatory and supervisory measures in the area of Macro Prudential Policies, I deem it appropriate to first briefly define macro-prudential policies, their goals, and the tools within a scope that makes it easy to evaluate our experience in this regard, and to present an overview of CBK vision as to the main pillars that could promote macro prudential policies and their implementation.

Macro prudential policies are those which use the prudential tools to limit systemic risks or obstacles that might affect a financial system's capability to continue providing key financial services which could in case of disruption, result

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<sup>1</sup> This is a translation of the speech, originally delivered in Arabic, by His Excellency Dr. Mohammed Y. Al-Hashel, Governor of the Central Bank of Kuwait in the Euromoney Conference, held in Kuwait on 8<sup>th</sup> April 2013.

in serious consequences for the real economy. In this context, macro prudential policies focus on the interconnectedness between financial institutions and their overlapping relations with markets, as well as the exposure of these institutions to risks originating from the adverse fluctuations in macro-economic performance. These policies also focus on the behavior of financial system in creating economic cycles in order to limit the risks of widespread financial crises, which could have a high cost on national economy . According to a number of studies that discussed macro prudential policies and tools in the wake of the global financial crisis, there was a common consensus that most of these tools fall under the scope of policies related to credit, investment, liquidity, capital adequacy and those which aim at reducing systemic risks related to financial imbalances in these areas .

### **Esteemed audience,**

I will now briefly go over the experience of the CBK in the field of macro prudential policies, starting with our most important supervisory control measures and tools in the fields of banking and finance since the early nineties. These measures have been constantly evaluated and modernized to keep up with the developments in the banking industry. Though such tools and measures seem to be directed at protecting the financial positions of individual institutions, but they actually fall into the context of macro prudential policy tools, as they are mainly directed to limit risk of credit concentration, investments concentration, and the risks related to liquidity and capital flow, which are the main targets of the efforts directed to reduce systemic risks.

I will start with the macro prudential tools in the field of bank credit control. The Central Bank of Kuwait has issued a number of rules and regulations, the most important of which I would like to mention in chronological order as such:

- 1- Regulations issued in 1995 concerning the maximum limits for credit concentration of any single customer, connected parties with interlinked interests, subsidiary and affiliated companies as well as large credit concentration. The CBK has adopted conservative prudential policies, according to which the maximum limit for credit liabilities of any single customer toward a bank shall not exceed 15% of the bank's capital base.

- 2- Regulations issued in 1995 concerning banks extension of consumer loans and personal installment (housing) loans. These regulations were subject to modifications aiming at protecting individuals from over borrowing and over consumption. In this context, the CBK has kept modernizing and refining these directives, and they were most recently amended in March 2008. According to these amendments a new maximum limits have been established upon which the monthly installment of consumer loans and installment of housing loans obtained by the customer from all lenders shall not exceed 40% of customer's net monthly salary (after deductions) or continuous monthly income, Moreover, this limit should not exceed 30% for loans to retired persons. These modifications were accompanied by a series of other control measures including those related to interest calculation and new maximum interest rates limits.
- 3- Regulations issued in 1997 concerning maximum limits for financing trading in securities. According to these regulations the maximum limit for such credit facilities should not exceed 10% of the total facilities extended to residents or 25% of the bank's capital base, whichever is lower. These supervisory measures take into consideration the sensitivity of market risks and their impact to systemic risks.
- 4- The Central Bank also released directives in 2004 that set a maximum limit of 80% ratio of loans to deposits aiming to control the acceleration of growth in bank's loan portfolio. The CBK was one of the first central banks to implement such macro prudential tool. The CBK then released new directives in 2012, including control measures that tie loans to maturity structure of bank's liabilities. These new regulations allow banks to reach a maximum loan ratio of 100% against their long-term funding sources and a lower maximum ratio of 75% against their short-term sources. The purpose behind such mechanism is to incentivize banks to further reduce their maturity mismatches and to enhance stability of their funding sources which are the basic elements to avoid accumulation of financial imbalances in the banking sector that might prompt a systemic crises.
- 5- Since 2008, the Central Bank has directed banks towards building precautionary provisions in addition to specific and general provisions. Such guidelines are within the context of CBK macro prudential tools aiming to

support the coverage of the non-performing loans. This policy has proven to be effective in enhancing total provisions and improving the coverage ratio for non-performing loans as an extra buffer to limit systemic risks.

Regarding macro prudential tools in the field of liquidity the Central Bank of Kuwait issued instructions to banks in 1997 concerning the harmony between liabilities and assets, fixing a 20% minimum limit ratio of liquid assets to deposits that banks must keep in the form of high-quality liquid assets. This tool aims at reducing the financial imbalance in banks' balance sheet structure.

The CBK also implements prudential tools pertaining to investment concentration. In 1994, it issued directives to banks requiring that (i) the book value of the financial portfolio should not exceed 50% of the bank's capital base, (ii) that investment in securities issued by one company and its related parties should not exceed 10% of the bank's capital base, and (iii) that the nominal value of said investments should not exceed 10% of the capital of the company issuing those securities (stocks, bonds and other securities). This policy has been effective in reducing the risk of banks' exposure towards financial markets.

Concerning prudential tools in the field of capital adequacy, I find it appropriate to point out first that in light of the importance of such tools and the attention they have garnered in the context of regulatory and supervisory frameworks on an international level, the Basel III reforms included a series of regulatory standards aiming at anchoring the principles of macro prudential policy through strengthening capital requirements especially for systemically important banks , as well as increasing risk weights for certain types of banks assets .

In this context, since 1997, the CBK has implemented a minimum ratio of 12% capital adequacy, significantly higher than the international norm of 8%, in accordance with the Basel II standards. The actual capital adequacy ratio reached 18% for all Kuwaiti banks at the end of December 2012. furthermore, the majority (above 89%) of our banks' regulatory capital is in the form of high quality Tier 1 capital. The CBK also prudently set the risk weights of various forms of banks exposures, i.e. raising the risk weights for banks lending to finance trading in shares and real estate. Such prudential policies have proven to be quite effective in times of stress as our banks were able to face the global financial crisis with high capital adequacy ratios. It proves that even if

conservative capital requirements are costly, they are far less costly than the failure of banks and consequent bailouts .

In the same vision, and since the outbreak of the global financial crisis, CBK has undertaken a number of prudential measures aimed at strengthening the banking sector and increasing its resilience to resist any financial and economic shocks, along with the development of supervisory frame work mechanisms that promote banking control measures, especially in the area of risk management, including the ICAAP, capital quality and adequacy, and stress testing conducted independently both by the CBK and the Kuwaiti banks.

The CBK also issued instructions to banks in June 2012 concerning rules and regulations of corporate governance that go hand in hand with international standards, taking into account the lessons from the global financial crisis and reflecting the best possible practices. These regulations also include directions to improve the environment of banking business and to contribute towards financial stability.

In the context of what has already been said, I must indicate that the CBK has established a Financial Stability Office, which has taken on the tasks of ensuring the role of the central bank regarding macro prudential policies aiming to maintain financial stability. Within the context of required coordination and cooperation with other authorities, the CBK has signed agreements (MOUs) with the Capital Markets Authority (CMA) and the Ministry of Commerce and Industry. Efforts are also underway to sign additional similar agreements (MOU) concerning financial crisis management.

To complete the discussion about our experience in the field of macro prudential policies, I must underline the fact that the CBK takes into account the impact of implementing monetary policy tools on financial stability. In the light of the Kuwaiti economy's exposure to the world economy and given the absence of restrictions on foreign exchange transfers, the CBK takes into account the impact of changes in the international interest rates on money flows to mitigate financial imbalances that could affect the economy. In this regard, the CBK takes into consideration the important objective of managing liquidity in the banking system and to maintain the attractiveness of the Kuwaiti Dinar as a main source to banks in providing credit to various sectors of the real economy. The CBK also manages its exchange rate policy to maintain the relative stability of the

Kuwaiti Dinar exchange rate in order to smooth out the impact of wide fluctuations in the exchange rate of foreign currencies, thus reducing the imported inflationary pressures on the Kuwaiti economy. Obviously, the monetary policy adopted by the CBK takes into account the importance of enhancing both financial stability as well as monetary stability, a key element in the context of ensuring coordination between the instruments of monetary and macro prudential policies.

### **Esteemed audience,**

Following what I have mentioned, I would like to summarize our vision about the fundamental elements that we intend to put in place to further improve our macro prudential supervisory approaches:

- 1- Expanding the regulatory framework to the entire spectrum of institutions and markets in a context of coordination and harmonization among regulatory and supervisory authorities to expand participation level by including all parties involved in the promotion of financial stability.
- 2- Improving awareness of the importance of risk management in banks and other financial institutions to be through a holistic vision that takes into account the changes that might affect the macroeconomic with their consequences on the banking and financial situation. This also includes regular stress-tests to be conducted by financial institutions. In this sense, we stress the importance of adopting and implementing sound corporate governance standards given their importance in reducing systemic risks and preserving financial stability.
- 3- Allocating sufficient oversight on Systemically Important Financial Institutions (SIFIs) and addressing the issue of interlinked exposures among financial institutions.
- 4- Promoting the role of the Central Bank in the area of financial stability given that such stability is one of the essential requirements for an effective monetary policy. The Central Bank is also the final source of liquidity being a Lender of Last Resort, which is again a crucial element for maintaining financial stability.

- 5- Directing monetary policy tools in the context of coordination with macro prudential policy tools by way of evaluating the conflict that could arise between the goals of monetary policy and financial stability. Moreover, combining the tasks of macro prudential policies with those of micro supervision shall lead to a more efficient macro prudential policy through easy access to information and the analysis of the links between financial institutions and the real economy.
- 6- Promoting the CBK transparency concerning the implementation of its regulatory and supervisory policies as well as the implementation of its tools and their mechanisms in the field of monetary policies.

Lastly, as part of our ongoing efforts to reinforce the role of the Central Bank of Kuwait in promoting financial and monetary stability in Kuwait, we will keep on developing the tools of micro and macro prudential policies which aim at strengthening the banking sector, improving its resilience to withstand shocks and reducing systemic risks.

I would like to thank you all for your kind attention, and may the peace and blessings of God be upon you.

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