

Macro prudential Policies and Financial Stability and their Interactions with the Monetary Policy

In the Name of Allah, Most Gracious, Most Merciful

Your Excellency, the Minister for Finance,

Our Distinguished Guests,

Peace and Blessings of Allah Be Upon You,

On this auspicious day of our beloved Kuwait and in front of this eminent gathering, I would like to voice pride over naming His Highness the Amir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, may Allah protect him, as a "Humanitarian Leader" and proclaiming Kuwait as an "International Humanitarian Center" by United Nations, beseeching the Almighty to grant His Highness a long and healthy life and endlessly bestow upon our country His abundant Blessings and Graces.

I should like also to express my pleasure in participating in this conference, organized by "Euromoney" and hosted by the State of Kuwait, and my sincere appreciation for the kind invitation to speak to this august gathering of professionals, industry specialists and other interested parties and to extend my heartfelt gratitude to the organizers for organizing the conference in such an excellent manner, and in deciding its agenda.

I will discuss in my speech today certain aspects of financial stability and macro prudential policies and how they relate to the conduct of monetary policy, as well as touching on some aspects of how the Central Bank has endeavoured to implement certain aspects of Basel III guidelines as well as drawing up regulations focused on residential real estate finance within the context of establishing macro prudential policies that aim to both strengthen and support financial stability.

Therefore, to some extent my speech today draws upon and embellishes some of the topics discussed in this conference in April of last year with respect to Central Bank of Kuwait's experiences in the area of macro prudential supervision - in particular those policies relating to i) corporate governance; ii) capital adequacy; iii) liquidity; iv) financial investments; v) periodic stress testing; and vi) the persistent and enduring efforts to

* Speech of H.E. the Governor of the Central Bank of Kuwait, Dr. Mohammad Y. Al-Hashel in Euromoney Conference held in the State of Kuwait on 09 September 2014

improve indicators of financial soundness in the banking sector - in line with the Central Bank's continued endeavours to limit systemic risks within the financial system.

Furthermore, I shall outline today some of the Central Bank's efforts in implementing macro prudential policies with a focus on Basel III capital adequacy instructions and residential real estate finance regulations.

Before proceeding, however, it is perhaps important to note how a central bank undertakes its role in the financial sector. Historically, central bank primary function has been to set monetary policy –in doing so indirectly affecting the overall level of prices within a particular economy, and thus fostering a measure of financial stability. For decades central bank overriding role has been to set monetary policy and to contain inflationary pressures – particularly for those central banks that pursue an independent monetary policy. In turn monetary policies of the central bank are directed through the financial system, and which rely heavily upon that system being intrinsically sound and financially robust so that such policies are implemented effectively. Financial institutions falling under the regulatory umbrella of a central bank are an essential conduit for monetary policy and thus have the potential to significantly affect the overall level of economic performance of a particular country. Therefore, importance of the banking and financial sector and soundness of its units' conditions are correlated with it not only for being one of the main economic sectors affecting, and affected by, the overall trends of economic performance but also, at the same degree of importance, the core link and the essential channel for the conduct of the central bank's monetary policy.

The recent global financial crisis and its repercussions, some of which are still being felt today, suddenly focused attention on the link between monetary stability on one side, and what is now called financial stability on the other, and how both are closely connected in terms of establishing economic stability.

One of the most important lessons learned from the global financial crisis is how effective instruments of monetary policy – i.e., interest rate targets, can be in establishing financial stability. In this respect, there is a barely unanimous consensus that the monetary policy instruments are relatively "blunt", and this could be the secret of their success in the past when monetary stability, by definition, is a "macro" goal that correlates not only with the level of prices within certain economic sectors but also on the overall level of prices within a specific economy. Consequently, there was broad agreement between central banks as to what constituted monetary

stability, its effect on financial stability and the range of instruments used in pursuit of such objectives.

Likewise, financial stability has received a lot more attention since the outbreak of the recent global financial crisis. Central banks now place more importance and pay additional attention to the way that monetary policy and financial stability are linked. The blunt instruments of monetary policy are now considered insufficient on their own to achieve financial stability and it is in this regard that a whole area of regulation, known as 'Macro prudential Policies' have come to the fore, to be used by central banks as a means of creating the foundation for a stable financial and banking sector. Hence, there is a conspicuous need for what is today called macro prudential policies designed and directed to achieve the financial stability. Also, interactions of monetary and macro prudential policies within the dual and pivotal role of banking and financial sector reveals itself.

And so, the "**Macro Prudential Policy**" constitutes a major element within the regulatory and supervisory frameworks given that the flames of the financial crisis revealed insufficient micro prudential policies to ensure soundness of the banking and financial system as a whole but they should be supported with more holistic approaches of macro prudential policies in order to limit systemic risk and protect the financial system. **Macro prudential policies are those which use prudential instruments to limit systemic risks and prevail over obstacles that may affect a financial system's capability to continue to provide basic financial services and which, in case of disruption or instability, result in serious consequences for the real economy.** Therefore, in this context macro prudential policies focus on the interaction of banking and other financial institutions and their overlapping relationship in financial markets as well as their exposure to risk resulting from adverse fluctuations in macro-economic performance and economic cycles. Macro prudential policy aims to maintain financial stability through the use of appropriate prudential instruments so as to withstand financial imbalances and limit contagion from widespread financial crises. Such crises are perceived in resulting in a high cost to a nation's economy and necessitate the introduction of measures and processes to contain the acute effects of financial effects on the real economy.

In this regard I would refer to the Central Bank of Kuwait's experiences dating as far back as the early-1990s in implementing controls and regulations, now considered intrinsic in terms of commonly-accepted macro prudential guidelines and policy.

In line with industry developments, the Central Bank of Kuwait has itself continued to adjust and, where necessary, improve its oversight and regulation by implementing, particularly, the regulatory standards issued by Basel Committee for Banking Supervision including Basel III set of financial reforms. In keeping with best international practices we aim to strengthen the banking and financial sector's ability to manage and be resilient to risk – thereby reinforcing the pillars of financial stability in the country and without lessening their ability to develop their businesses profitably and efficiently.

Within this context I should like to briefly touch upon two elements of supervision that exemplify the Central Bank's approach toward macro prudential policies aimed at strengthening the financial stability of Kuwait.

Firstly in June of this year, 2014, CBK issued regulations regarding Basel III Capital Adequacy Standard in a final form to both conventional and Islamic banks having adopted in December 2013 the regulatory capital structure and the transitional phase for implementation thereof in the light of the outcomes of the Quantitative Impact Study "QIS" that reflect banks' ability to meet Basel III capital adequacy standard requirements. In conformity with Basel Committee decisions, CBK regulations included the same macro prudential instruments provided under the said standard such as setting additional capital requirements in the form of conservation capital buffers, counter-cyclical capital buffer and additional capital requirements for those banks identified as domestically systemically important banks "D-SIBs" with the aim to provide stronger capital bases for such banks and enhance their resilience and capability to withstand the financial stress.

The Central Bank is also making good progress in acting other elements of the Basel III reforms such as Leverage Standard and Liquidity Standards based on a well-conceived time-frame incorporating the findings from the QIS study. Local banks' stable sources of funds and the ability to reduce overreliance on short-term funding are being further enhanced by the adoption of certain other Basel III recommendations, whilst the macro prudential instruments in the form of non-risk based leverage ratio is viewed as a supplementary mechanism supporting the capital adequacy ratio framework based on a bank's risk exposure.

Secondly, having identified overheated acceleration in extension of credit to finance residential real estate accompanied by a noted increase in the price of property, CBK issued in November 2013 instructions to local banks, investment companies and financing companies concerning regulations as they pertain to individual customers for the purchase and/or development of properties located in residential areas. This type of financing is identified

as being of particular importance bearing in mind the basic needs of citizens and its relevance with respect to the portfolios of individual lenders. Instructions have, therefore, been issued as a means of supplementing existing regulations regarding consumer and installment loans as well as representing a macro prudential approach.

Attention by CBK to setting the regulation governing the residential real estate finance activity is *ipso facto* based on its perception of the importance of such activities for, and their influence on, the soundness of banking and financial sector conditions. In this respect, it deems appropriate to mention what *Sir Jon Cunliffe*, Deputy Governor for Financial Stability of the Bank of England, said in his speech at the International Festival for Business conference, Liverpool in July 2014 that the Bank of England cannot address the imbalance between the supply and demand for houses in the UK, as it cannot build a single house, and, as a regulatory authority, it must focus on the risks to financial stability and to the economy. He mentioned that the main risk arising from the housing market is the risk that house prices continue to grow strongly and this increase in prices leads to higher and more concentrated household indebtedness - in short, the risk that more people take on higher debt relative to their income as they have to stretch further to buy homes.

Thereupon, instructions and regulations issued by CBK affirmed the requirements that clear and objective limits for residential real estate finance should be set, extension of finance should be based on a complete credit study of the customer's creditworthiness and financial position, and verification is required to ensure that the customer's net cash flow is sufficient to serve his/her obligations on their due dates.

In addition, the aforesaid regulations stipulated the maximum limit of loan to value ratio of the property to be financed to establish the prudential considerations in such type of finance in line with the relevant international standards. With the intention to preserve the customers' interests and hedge against risk of market fluctuations, such regulations affirmed transparency upon extension of finance by informing the customer of the rates of interest and return and the effects of any potential changes - especially in case of rising interest rates - bearing in mind interest rates are currently at their lowest historical levels, so as to keep the customer abreast of all potential finance burdens. Equally important, a maximum limit of finance term up to ten years should be fixed in order for the customer not to remain under the pressure of debt obligations for decades. This is particularly relevant insofar as real estate mortgage law is still in its infancy in Kuwait.

Ladies & Gentlemen,

Finally, I observe that the global banking and financial industry is witnessing a new era of structural and regulatory reform aimed at strengthening monetary and financial stability and in the long run establishing overall economic stability. Therefore, we, the regulatory authorities and banking and financial units, should derive benefits from such reforms by adopting the correct approach in developing our banking and financial systems in view of the regional and international experiences, as well as implementing the best international practices taking into consideration the vital role of banks in the national economy and their deep relations with the society.

Once again, a welcome to you, our honorable guests. I hope this conference provides a good opportunity for the exchange of thoughts and ideas, and it is my sincere wish that we all come away with innovative recommendations for all what we discuss.

Peace and Blessings of Allah Be Upon You

9 September 2014