March/April 2023
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# KUWAIT

## SPECIAL REPORT

PUBLISHED IN PARTNERSHIP WITH:

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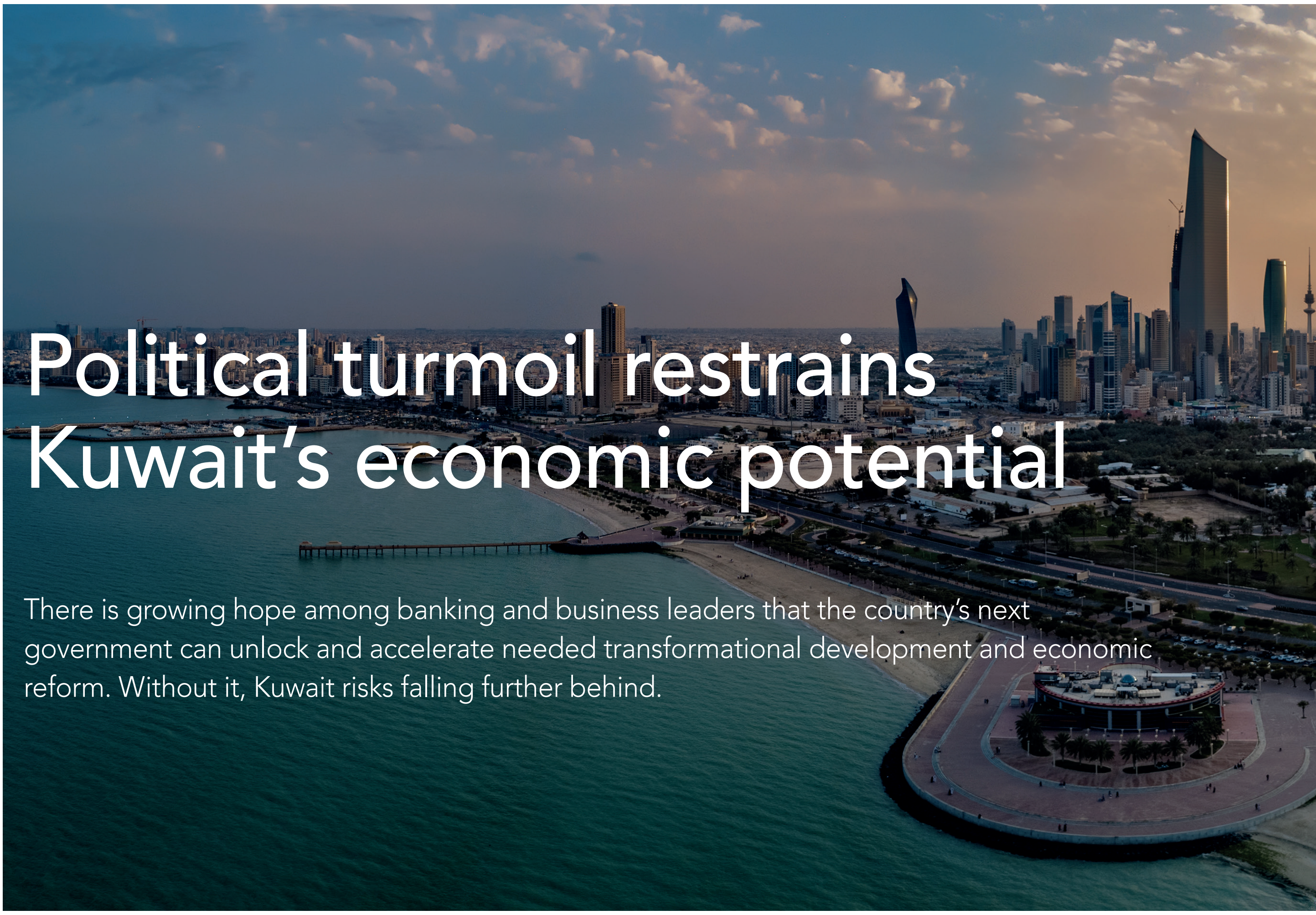

# Political turmoil restrains Kuwait's economic potential

There is growing hope among banking and business leaders that the country's next government can unlock and accelerate needed transformational development and economic reform. Without it, Kuwait risks falling further behind.

Kuwait was once at the vanguard of political and economic development in the Gulf. It was the first Gulf state to establish an elected parliament, the first to create a sovereign wealth fund, and the first to set up a modern stock exchange.

Moreover, it was Kuwait that for years provided financial assistance to other less-developed states such as Qatar and the UAE.

Yet, in the past few years, the country's pioneering verve has faded, leaving its economy languishing – both in terms of size and pace of growth – compared to its regional peers, which are undergoing more rapid economic transformation, propelled by substantial investment programmes.

Can Kuwait catch-up? A robust set of economic fundamentals are cause for optimism.

Kuwait has some of the largest oil reserves of any country and one of the lowest breakeven prices in the Gulf. The sovereign wealth fund, Kuwait Investment Authority, is the third largest in the world, with assets under management of over $730 billion.

There is acknowledgement from Kuwait's leaders that the country needs to use these funds to diversify the economy away from oil, bolster the investment climate and improve living standards. Ready to play its part in helping fund Kuwait's future is a well-capitalised banking sector, which has emerged relatively unscathed from the pandemic. Kuwait's blue-chip corporations have ample access to liquidity at home and abroad. The country's inclusion in the MSCI Emerging Markets index in 2020 has brought a new wave of foreign investors.

"There are a lot of positive developments emerging," says Samer Alabed, CEO of HSBC in Kuwait. "There are all the necessary components for the country to achieve its goals."

Kuwait's economic potential is there for all to see. The problem, however, is the country's long-running struggle to take advantage of the assets it has at its disposal.

"There's a frustration among business leaders, and even some of the political leaders, at the pace of progress on economic development," says Tariq Al-Rifai, managing director of the Quorum Centre for Strategic Studies. "You see a lot of push for rapid development across the region. Unfortunately, you haven't really seen much of this in Kuwait."

Similar to its regional peers, Kuwait has its own aspirational plan: Kuwait Vision 2035, which emerged under the previous Emir in 2017. Al-Rifai notes that on some of the targets – workforce development and skills training for instance – the government has

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done reasonably well. But there has been far less success on major goals like economic diversification and the evolution of Kuwait into a financial and trade hub.

An SME fund to help finance the next generation of Kuwaiti companies was set up in 2015, but had only lent out a tiny fraction of its capital by the time the pandemic hit, according to Kuwaiti advisory firm Markaz. Movement on large-scale infrastructure projects such as Silk City and a port on Boubyan Island, announced years ago, has been somewhere between slow and glacial.

**Tariq Al-Rifai, managing director, Quorum Centre for Strategic Studies**

Eight years on from the first emergence of Vision 2035, the country's economic fortunes look as intertwined as ever with the global oil price.

"Kuwait as a whole, lags behind regional peers in managing the energy transition and diversifying the economy," says Zeina Nasreddine, a credit analyst with S&P. "It remains one of the most hydrocarbon dependent economies in the GCC with a very high share of GDP, exports and fiscal revenues derived from hydrocarbons."

As to what is curtailing Kuwait's economic advances, this is one question where people on all sides of the debate agree: politics.

**A house divided**

On the one hand, Kuwait has a proud civic history of democratic engagement and fractious politics is nothing new. But in recent years, the political system has slid from simply unstable to completely broken. A fresh example of this came on March 19, when Kuwait's Constitutional Court ruled that last September's parliamentary election was void and that the previous parliament must be reinstated.

By this time, Kuwait was into its sixth week without a government after the cabinet resigned in January.

This latest resignation marked two years of more or less constant turmoil. MPs' efforts to question the then prime minister over claims of constitutional irregularities, the handling of the pandemic and various corruption issues led to a cabinet resigning back in January 2021. MPs then attempted, unsuccessfully, to block the swearing in of a new – in their eyes insufficiently reformed – cabinet in April that same year. By November 2021, the government had resigned again.

The next cabinet lasted until April 2022, before resigning ahead of a no-confidence vote against the prime minister. In late September 2022, in what was the sixth general election in the last 10 years, Kuwaitis elected a new parliament and another cabinet was sworn in. This was the cabinet that lasted until January this year.

"Even by the standards of Kuwaiti politics things have been getting more dysfunctional," says Kristian Coates Ulrichsen, fellow for the Middle East at Rice University's Baker Institute. "Parliament and the government have been getting less capable of working together over

**Kuwait's National Assembly. Political gridlock has frustrated the country's transformation**

the last three or four years."

The root of this dysfunction stems in part from a design flaw. Parliament consists of 50 MPs, but the cabinet that forms the government is not drawn from this pool of elected representatives. Instead, it is the Emir that appoints key ministers, including the prime minister. There is, however, a strong tradition of MPs questioning the government - to the extent that cabinets will sometimes resign rather than face parliamentary probing.

The fact that the cabinet does not reflect parliament is one of two key sources of tension between MPs and the government, according to Coates Ulrichsen. The other is a strong strain of populism - the result of a ban on political parties that leads MPs to run on individual mandates and take populist positions on key issues. One of the most recurrent issues is debt relief, which contributed to the most recent cabinet resignation in January.

"That government resigned in the face of pressure from MPs to pass a debt relief bill," says Coates Ulrichsen. "Every few years you see MPs raising the issue that Kuwaitis are in debt and the government should help pay off the debt or at least pay the interest." The government, wary of setting a dangerous precedent, has no intention of passing such a bill.

**Gridlock**

This political set up is one that would reasonably be expected to produce both antagonism and agreement. But lately, agreement has been in short supply and to the detriment of economic reform. "When it comes to the reasons for slow progress, people on both sides point to political issues and political gridlock," says Al-Rifai.

Kuwait's leaders are trying to move forward on their economic programme, which is gradually assuming shape. But there is only so much that can be achieved with a hostile parliament that has grown increasingly distrustful of the government.

"In November 2022, we saw approval for the implementation of several Vision 2035 projects through a 2022-2026 plan" says Gabriele de Leva, senior country risk analyst at Fitch Solutions. "But we are already in late Q1 2023 and political bickering and the latest cabinet resignation have meant that progress on passing major laws has stalled."

Legislation and reforms stuck in the gridlock include a new national debt law that would allow Kuwait to tap international debt markets, the introduction of value-added tax as a new source of revenue and an update to the foreign investment law to help attract international capital. "Some of those laws are ready, others just need final amendments," says de Leva. "There's mounting frustration that the work has been done, but the laws can't proceed."

This has resulted in some unusual situations. The country has one of the largest external balance sheets. But parliament's refusal to pass the debt law meant that during the pandemic, Kuwait was reduced to running down its General Reserve Fund to cover the budget deficit.

**Zeina Nasreddine, credit analyst, S&P**

Nor is the debt law the only piece of legislation that has been waiting for years. A law allowing banks to provide mortgages – a product only the state-backed Kuwait Credit Bank can issue was drafted before the pandemic. This would have been a huge win for lenders, opening up a new product line and potentially leading to a smaller version of the recent mortgage boom in Saudi Arabia. Analysts factored in the upside to their projections, only to have to adjust their outlook in the face of political paralysis.

"I had the upside from that mortgage law in my Kuwaiti bank model starting 2022," says Rahul Bajaj, a financial sector analyst at Citi "Then I moved it back to 2023, then to 2024 and then I took it out. Firms in Kuwait say it will happen at some point, but right now it's stuck in this political conflict."

Similarly, key issues where legislation is part of the solution, notably land reform, are unsolvable while parliament and the government are at loggerheads. Even if banks were allowed to issue mortgages, housing is becoming prohibitively expensive. Local research house Marmore Intelligence reported in September last year that the residential price-to-income ratio in Kuwait is higher than in London or New York, and approximately three times that of Dubai.

The absence of a well-designed system for allocating land, and a ban on private companies trading residential property, has artificially restricted supply. Young Kuwaiti families receive land for housing, but the average waiting time is over a decade. There is a shortage of commercial and industrial construction, which hinders growth in sectors that could help diversify the economy and provide a new avenue of lending for banks. The manufacturing sector, for example, has real potential, but struggles to expand.

A World Bank-supported road map for land reform was created several years ago. This called for the creation of an efficient and transparent Land Authority, public land auctions and a database of land parcels. But there is still political disagreement over how such an authority should be created and Kuwaiti companies eager to grow remain hamstrung.

"I've talked to several large companies that are looking to expand their operations but there's no land for them," says Al-Rifai. "The money is there to fund these projects - but the government has to allocate the land."

On the other hand, if a Kuwaiti manufacturer is willing to turn to Saudi Arabia and take on a local partner, there is land made readily available. "Saudi has done a tremendous job of cutting red tape and making it an attractive place to do business - whereas Kuwait hasn't," says Al-Rifai.

> "Kuwait as a whole, lags behind regional peers in managing the energy transition and diversifying the economy. It remains one of the most hydrocarbon dependent economies in the GCC with a very high share of GDP, exports and fiscal revenues derived from hydrocarbons."

Bureaucracy is not just an issue for the private sector, in many ways it lies at the heart of Kuwait's limited headway on economic transformation. Fitch Solutions notes that capital spending is actually falling. Their forecast is for spending to drop to below 5% of GDP in the 2023/24 fiscal year, well below the 2015-19 average of 7.4%. This slump runs counter to almost every other aspect of the Kuwaiti budget – notably public wage subsidies and accrued public-sector payments – which will increase headline expenditure past 50% of GDP.

As to why much-needed capital spending is contracting, the answer seems to be more down to bureaucratic inactivity and a lack of institutional capacity than a shortage of funding. "Unless there's clear plans from the governments or the state entity as to how that capital will be used, the capital for investment is not allocated," says de Leva. "This means that lower capital spending is due to issues around planning and bureaucracy and not concerns around excessive spending."

**Banking sector solid**

All this paints a slightly dour picture of the country's prospects, but there is still an optimistic argument with weight behind it. Kuwaiti authorities have a genuine desire to improve and are clearly capable of progress. A three year equity market development project saw a host of reforms, including the removal of foreign-ownership restrictions on listed banks and simplification of requirements for investor registrations. The result was the country's inclusion in the MSCI Emerging Markets Index in late 2020 and billions of dollars in passive inflows.

**Samer Alabed, CEO, HSBC,Kuwait**

"A lot of beta funds now have to include Kuwait as part of the index, but you've also had Alpha investors keen to take a view on Kuwait because of the strong fundamentals," says Alabed.

The stock markets of UAE and Saudi Arabia tend to dominate the headlines, but Kuwait is laying the groundwork for a new round of public offerings. Although banks dominate the country's bourse, the exchange has streamlined the listing process and hopes to see conglomerates and government-owned companies go public.

"We're starting to see a more dynamic IPO market," says Alabed. "There are a few big ones coming in 2023 that will take the market by surprise."

The authorities are eager to see the market develop with the addition of derivatives, futures and additional reforms to draw in foreign capital. "The central bank and Capital Markets Authority have done a good job of laying down the foundations, but they don't want to stop there," Alabed says. "They want to make their market more transparent, more liquid and improve ease of access. They know they can't make Kuwait the biggest market, but they can make it the most sophisticated."

Kuwaiti firms not ready to list can still rely on a robust banking system for funding. Kuwaiti lenders are in relatively strong shape, having recovered well from the pandemic. Part of the credit goes once again to the regulator. "The central bank had been very conservative in the five or six years prior to Covid, which required banks to set aside high levels of provisions," says Bajaj. "So that conservatism actually helped during the pandemic and beyond."

The banking sector went into the pandemic with comparatively low non-performing loan ratios and provisioning buffers of over 200%. The government then provided broad-based support to households and businesses, helping support asset quality. Meanwhile, higher oil prices and rising interest rates have improved margins for most lenders, and stronger lending volumes have driven top line growth. "The banks' robust provisioning buffers and write-offs led to a significant reduction in cost of risk, driving their earnings' growth in 2022," says S&P's Nasreddine. "In fact, we saw some write backs offsetting already lower credit charges in 2022, partly due to improving operating conditions."

This has left the banks well placed to fund a new generation of infrastructure projects. Even despite a slump in awarded projects in 2022 – at KD832m ($2.7bn) the second lowest year since 2005, according to National Bank of Kuwait (NBK) – there were still signs of growth.

"Lending growth in 2022 was actually higher in Kuwait than you saw in Qatar or the UAE," says Bajaj. "But project lending isn't happening to the full potential that you might see without the political conflict."

NBK research did show a surge in awarded projects in the final quarter of 2022, of which more than half were construction sector projects. The bank thinks 2023 should be a far better year, with a pipeline of potential projects across transport, power, water and oil and gas. The political situation and gloomy outlook for capital spending notwithstanding, Kuwait is still building.

"Infrastructure is the sector I'm most bullish on," says HSBC's Alabed. "That includes real estate, because the housing market is still underserved. But you can also look at transportation, where there's a metro plan and a national rail plan."

Kuwait's lenders are among the strongest advocates for economic transformation, particularly the kind that drives true diversification. The main challenge banks face, says Nasreddine, is their high structural exposure to the real estate and construction sector.

Real estate risk is a perennial topic for the Kuwaiti banking sector; as it is in many Gulf countries. But there are tentative signs that the industry's exposure towards real estate is moderating. "Sector real estate exposures have gone down from around 22%-23% of the total loan book to 20% over the last five years, and trading loans have fallen from around 9.5% to 6.8%," says Bajaj. "What has increased is the share of retail loans, which has risen from around 35% to closer to 40%."

**Abdullah Al Mejhem, chief of private banking and consumer banking, Boubyan Bank**

This is mildly positive from a diversification standpoint, particularly as the regulator keeps a close eye on retail lending. "The central bank tightly controls how much money can banks earn on retail loans, what kind of retail products they can offer and the fees they can charge," he says. "It's a very regulated sector."

What would be even better for the banking sector, is the emergence of new capital-hungry industries like manufacturing and petrochemicals. But when it comes to project approvals, there is a distinction to be made between the sectors that show momentum and those that do not.

Looking at the jump in project approvals in late 2022, Kuwait Oil Company contracts were a major driver, while across the whole of that year transport was responsible for the largest share.

"Oil and gas projects almost always move forward," says de Leva. "We also expect to see progress on transport infrastructure projects like road maintenance and bridge construction. But this will have limited impact on growing the non-oil economy."

There were no project awards in the chemical or industrial sectors in 2022, according to NBK. The pipeline of green energy projects is similarly slim. "There really hasn't been much development on that side," says Al-Rifai.

**Slowing going for SMEs**

The largest Kuwaiti firms find themselves with ample liquidity, often able to drive forward projects from their own capex reserves. Smaller companies, however, face a tougher time raising funding. Yet creating the next generation of Kuwaiti corporates is key to the kind of transformation the country's leaders have in mind.

"The growth and development of small and medium-sized enterprises (SMEs) should be a priority for Kuwait's economic diversification objectives," says Abdullah Al Mejhem, chief of private banking and consumer banking at Boubyan Bank. "By assisting small and medium-sized enterprises, Kuwait can establish a more robust economy that is less dependent on oil earnings and better able to withstand economic shocks."

Many lenders have set up dedicated SME lending operations, only to run into the traditional problems in trying to bank small-scale firms.

"It is difficult for banks in Kuwait to manage the risks associated with lending to SMEs because of their limited access to financial data, lack of credit information, and the high-risk perception," says Al Mejhem. "The fact that these companies have a short credit history, a lack of collateral, and a smaller size - all of that puts them in the category of high-risk borrowers."

Nasreddine notes that SME lending continues to contribute a relatively small portion of the banks' overall lending portfolio, and S&P does not expect to see an acceleration. "This largely reflects the structure of the Kuwaiti economy which is substantially driven by government and public sector activity," she says.

The government is trying to bridge the gap, setting up a National Fund for SME Development with KD2bn ($6.5bn) in capital. But by the time the pandemic hit only KD151m ($491m) had been lent out, according to Markaz research. Critics point out that a large percentage of SME borrowers have come from service businesses like restaurants that have high failure rates. Markaz has suggested the fund be given additional capital and allowed to delegate its operations to the private sector while acting as a regulator. In an age of resurgent industrial policy, there is also an argument for pointing the fund towards favoured sectors.

"The SME fund is great and should be supported - but it should also target specific industries that the government wants to see develop," says Al-Rifai. "If they want to support technology-related businesses and light-manufacturing that might take longer to show profits then that should be explicit."

> "The central bank and Capital Markets Authority have done a good job of laying down the foundations, but they don't want to stop there. They want to make their market more transparent, more liquid and improve ease of access. They know they can't make Kuwait the biggest market, but they can make it the most sophisticated."

A reinvigorated, targeted SME fund is well within the bounds of possibility. So too is a burgeoning IPO landscape, and a slow but steady expansion of housing and transport infrastructure. The private sector is not ready to become an engine of growth - that will take complimentary public sector investment and reforms. But state-owned entities could take on more responsibility for driving the government's economic agenda.

To a large extent, however, how optimistic one is about Kuwait depends on how optimistic one can be about its politics. If the next government is able to make headway, as banking and business leaders dearly hope it can, that could unlock transformational development and economic reform. But the concern is that a new cabinet will simply represent another shuffling of a well-worn deck, producing a government that lasts only until the next round of parliamentary interrogation.

Kuwait has become used to muddling through on a reliable wave of oil revenue and foreign investments. But the costs of inaction are rising, just as the political outlook becomes harder and harder to predict.

"We are in a situation where this is uncharted," says Coates Ulrichsen

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EUROMONEY MARKETLEADERS

# Kuwait's banks jostle for position

In a highly competitive market, a select number of banks rose to the top across four key categories

In Euromoney's inaugural Euromoney Market Leaders rankings for Kuwait, only Kuwait Finance House (KFH) and National Bank of Kuwait (NBK) were recognised as market leaders in most or all of the four analysed categories, underscoring their leadership in the country's banking sector.

For NBK in particular, it was recognised as a market leader in all four categories – investment banking, corporate banking, digital solutions and corporate social responsibility (CSR) – putting it ahead of its closest rival, KFH, which was recognised as a leader in corporate banking, digital solutions and CSR.

In total, nine banks were recognised as market leaders in Kuwait across these four categories, with HSBC the only global bank among a group otherwise dominated by local banks.

The London headquartered global bank was recognised as a market leader in investment banking along with local players NBK Capital, the investment banking arm of NBK, Markaz, an asset management and investment banking firm, and Kamco Invest, the asset management and banking group and subsidiary of Kipco, one of the Gulf region's biggest investment and diversified holding companies.

Of multiple initiatives by these banks to advance Kuwait's investment banking industry, Kamco Invest and HSBC separately led two notable developments – developing the country's private placement market, and developing a sustainable finance framework for banks in the country.

On the first, Kamco collaborated with Boursa Kuwait and the Kuwait Clearing Company on the execution of the first private placement since the implementation of OTC trading rules by the exchange. Secondly, HSBC advised Burgan Bank on establishing a sustainable finance framework in accordance with the International Capital Market Association and Loan Market Association Principles, the first bank in Kuwait to do so. The framework governs the deployment of proceeds from sustainability bonds and loans that finance projects and companies which are judged to deliver positive environmental and social impact.

**Beyond traditional banking**

On the corporate banking side, Gulf Bank was the only other bank to be recognised as a market leader alongside KFH and NBK, all of which demonstrated strength across key areas, especially in trade and supply chain finance, cash management, FX, and deposit account management.

In the third category, digital solutions, KFH and NBK together with Boubyan Bank and Kuwait International Bank were recognised as market leaders, showing leadership in several areas, particularly digital product and service innovation. For instance, KFH has introduced an instant remittance service using the blockchain-based RippleNet network, and NBK launched an augmented reality tool called My Card Spends, which enables customers to visualise their credit card expenditures on the mobile app.

Finally, Kuwait's market leaders in CSR are: Ahli United Bank; Gulf Bank; KFH; Kuwait International Bank; and NBK. Each of these banks have launched numerous and varied CSR-focused initiatives, all of which demonstrate how they see their responsibility to supporting Kuwaiti society.

Of many initiatives that could be highlighted, one that stands out is KFH's partnership with the Kuwait Society for the Handicapped – the first of its kind in the Kuwaiti banking sector – which involves the bank providing training to students with special needs across various departments.

**KUWAIT**

| CSR |
|---|
| **Market leaders** |
| Ahli United Bank |
| Gulf Bank |
| Kuwait Finance House |
| Kuwait International Bank |
| National Bank of Kuwait (NBK) |
| **Highly regarded** |
| Al Ahli Bank of Kuwait |
| Boubyan Bank |
| Commercial Bank of Kuwait |
| Markaz |
| Warba Bank |
| **Notable** |
| Burgan Bank |

| Corporate banking |
|---|
| **Market leaders** |
| Gulf Bank |
| Kuwait Finance House |
| National Bank of Kuwait (NBK) |
| **Highly regarded** |
| Ahli United Bank |
| Al Ahli Bank of Kuwait |
| Boubyan Bank |
| Commercial Bank of Kuwait |
| Warba Bank |
| **Notable** |
| Burgan Bank |
| Kuwait International Bank |

| Digital solutions |
|---|
| **Market leaders** |
| Boubyan Bank |
| Kuwait Finance House |
| Kuwait International Bank |
| National Bank of Kuwait (NBK) |
| **Highly regarded** |
| Ahli United Bank |
| Al Ahli Bank of Kuwait |
| Burgan Bank |
| Commercial Bank of Kuwait |
| Gulf Bank |
| Markaz |
| Warba Bank |
| **Notable** |
| HSBC |
| Industrial Bank of Kuwait |

| Investment banking |
|---|
| **Market leaders** |
| HSBC |
| Kamco Invest |
| Markaz |
| NBK Capital |
| **Highly regarded** |
| Al Ahli Bank of Kuwait |
| Gulf Bank |
| **Notable** |
| Boubyan Capital |
| Commercial Bank of Kuwait |
| Kuwait International Bank |
| Warba Bank |