1. A joint IMF-World Bank Financial Sector Assessment team visited Kuwait in early September 2003, at the request of the government of Kuwait and the central bank. This Financial Sector Assessment report is based on analyses undertaken during that mission.¹

2. The principal objective of the mission was to assist the authorities in evaluating the strengths, vulnerabilities, and key development opportunities in the financial system. The team sought to identify the measures that should be taken, both to avoid potentially destabilizing conditions and thereby reduce financial sector vulnerabilities, and to improve the foundation for a sound, efficient and deep financial sector that would contribute to economic development, particularly of the non-oil segment of the Kuwaiti economy. The mission also provided an assessment of the observance of international standards and codes in financial regulation and supervision covering three international standards and codes: the Basel Core Principles for Effective Banking Supervision; the Objectives and Principles of Securities Regulation; and the Anti-Money Laundering and Combating the Financing of Terrorism Standards. These standards assessments underpin the analysis and recommendations of this report.

¹ The mission consisted of Karl F. Habermeier (Mission Leader, IMF); Samir El Daher (Deputy Leader, World Bank); George Iden, Alessandro Giustiniani, Ibrahim Al Gelaqah, Joy Smallwood (all IMF); Tadashi Endo, Deane Jordan, Peter Kyle, and Richard Zechter (all World Bank); Richard Chalmers (UK Financial Services Authority); James Dingle (formerly Bank of Canada); Ashraf Shamseldin (formerly Egypt Capital Market Commission); and Michael Yuenger (US Office of the Comptroller of the Currency).
I. INTRODUCTION AND OVERVIEW

3. Over the past decade, Kuwait has made an impressive recovery from the economic damage caused by the 1990–91 war. Oil production and exports have been restored, and fiscal and external current account balances since the mid-1990s have reached surpluses on the order of 20 percent of GDP. The stock of foreign assets has recovered; the country’s infrastructure has been rebuilt; and public debt has been substantially reduced. Inflation, which in the first years after the war averaged 10 percent a year, has fallen to about 2 percent a year since the late 1990s. Economic activity continues to be highly dependent on oil. The oil sector generates about 90 percent of total export earnings, and more than two thirds of government total revenue, leaving fiscal and external balances subject to significant fluctuations. The government sector dominates most economic activities, including oil, transportation, telecommunications and utilities.

4. The authorities have succeeded in maintaining financial system stability in a difficult environment. Despite large fluctuations in oil prices, regional security threats, and large swings in the local equities market, the authorities have successfully used regulation and supervision to safeguard the stability of the banks, which are at the core of the financial system. However, vigorous regulatory and institutional reform, especially in the securities sector, is desirable in the interest of continued stability and greater financial efficiency. Although the government possesses sufficient wealth to offset even a major financial crisis without noticeable effect on present levels of consumption, the associated moral hazard has negative consequences for the performance of the economy.

5. The Kuwaiti financial system is sizeable and well developed. Besides commercial and specialized banks at the core of the system, it includes financial companies and investment funds, which have increased markedly in number in the last few years, as well as insurance companies and an active stock exchange. At the end of 2002, total assets of financial institutions amounted to more than 200 percent of nominal GDP, while stock market capitalization reached about 100 percent. Competition in financial markets – with the exception of the small insurance sector – is significant, with domestic institutions offering a wide range of consumer and business services.

6. The equities market is among the largest and most active in the Arab world, but it has historically shown large swings, and suffers from weak governance structures. Listed companies have a relatively narrow base, and equity prices have, once again, increased markedly reaching new record highs at the time of the mission. Regulation and supervision exhibit significant gaps and are scattered among a multiplicity of laws and agencies.

7. The number and relevance of non-bank financial institutions in Kuwait have increased significantly in the last few years. A relatively large number of investment companies, some of which operate according to Islamic Sharia, account for a large share of financial system assets. In addition they have sizeable off-balance sheet activities involving funds managed for customers in the form of investment funds or discretionary accounts. These investment companies would likely need more specific regulations and closer supervision of their investment and trading activities.

8. The insurance sector is small, its development is constrained by economic and social policies, and there is significant room for improvement in its regulation and supervision. The
predominant role of the government in the economy limits the market for non-life insurance, as government assets are not commercially insured, while the generous social welfare system has dampened the demand for private life and health insurance. Regulators have limited entry; and domestic insurance companies rely heavily on reinsurance, acting mainly as brokers rather than underwriters. Regulation and supervision are based on an outdated law that is missing many of the key elements of a modern insurance supervision regime. A revised legal framework that includes the creation of an independent supervisory agency and the upgrading of supervisory capacity is a high priority.

9. Kuwait’s regulatory and supervisory framework for anti-money laundering (AML) activities has recently been strengthened, including through enactment of new legislation. However, clear vulnerabilities exist in the AML and CFT systems, and early action should be taken to address these.

II. KEY FINANCIAL DEVELOPMENT ISSUES

A. Banking System

10. The Kuwaiti banking system is characterized by a limited number of banks. The sector includes seven commercial banks, one of which operates according to Islamic principles, two specialized banks and one branch of a foreign bank. Though the government holds controlling interests in two banks, most of the banks are privately owned and usually controlled by a related group of shareholders. The banking market is concentrated, with the two largest banks accounting for about half of local banks’ total assets, loans and deposits.

11. The steady growth of banking activity, mainly funded through retail deposits, has gone hand in hand with some improvements in banks’ financial performance. By and large, banks are well capitalized, highly liquid, and the quality of their assets has improved over time, albeit unevenly. The average capital adequacy ratio remains well above the statutory minimum of 12 percent. Stress tests indicate that the banking system could withstand significant shocks. Sensitivity to market risk is limited owing to the short maturity structure of interest-bearing instruments, while foreign exchange risk has been contained by strict enforcement of prudential requirements. Liquidity is adequate, and Kuwait’s large foreign reserves allow for the provision, if necessary, of ample lender-of-last resort support in both domestic and foreign currency.

12. Banks may be more sensitive to credit risk. For example, sufficiently adverse macroeconomic developments, such as a significant drop in oil prices combined with a sharp correction in real estate and equity prices, might have an adverse impact on the financial soundness of Kuwaiti banks. Most banks appear able to absorb a fairly pronounced deterioration in asset quality. However, some institutions show a particular sensitivity to price declines in the equity and real estate markets, although overall the exposure of the banking system to these risks appears to be manageable as well. Even so, these exposures should be carefully monitored by supervisors, and banks should be required to take action to reduce their vulnerability.
Banking Regulation and Supervision

13. The Kuwaiti authorities have made some progress in the past two years in bringing their banking supervision system in line with international standards and practices. Under Kuwaiti law, the CBK is responsible for the supervision, regulation, and licensing of deposit and non-deposit taking financial institutions operating in Kuwait. This authority includes investment companies. One exception, however, to this authority has been Islamic banks. Legislation was enacted to bring all Islamic banks under CBK supervision beginning in December 2003, while new Islamic banks would need to be licensed by the CBK. The CBK strictly enforces prudential safety and soundness standards and requirements through both on- and off-site supervision programs, and significant progress has been made in developing an early warning system. The CBK requires banks to institute comprehensive risk management programs that are commensurate with the size, nature, and scope of each bank’s operations. The banks’ risk management programs must address credit, liquidity, interest, market, and operational risks. Central bank requirements that the banks implement sound internal control systems and comprehensive internal and external audit programs buttress the banks’ risk management programs.

14. An update of the 2000 assessment of compliance with the Basel Core Principles has been carried out as part of the FSAP. The assessment shows Kuwait as compliant or largely compliant with most of the core principles and subprinciples. However, the core principles related to consolidated supervision, information sharing, share transfers, international cooperation, and operations of foreign banks are yet to be observed. The ability to share confidential supervisory information with appropriate governmental authorities and foreign bank supervisors would enhance domestic and international supervisory cooperation, as well as the consolidated supervision of the banks and their related parties.

Money Market

15. Kuwait has a relatively active interbank market, although several factors constrain the market at present, including generally high levels of liquidity in banks. A few major corporate customers also participate in this market. The bulk of activity is in interbank deposits of one month, although some of the deposits are for three months, one week, and overnight. Most of this lending is unsecured, and participants therefore set individual limits on their counter parties. In addition to the interbank market, the CBK frequently auctions treasury bills of three and six months’ maturity.

Lender of Last Resort, Deposit Insurance and Crisis Management

16. In recent years, the CBK has not needed to provide emergency lending to the banking sector. Contingency procedures exist should they be required. The CBK has authority to engage in emergency lending with power to provide loans and advances in emergency cases for up to six months, with adequate collateral. In the past, the CBK has provided broad emergency support to banks (in the context of the Al-Manakh financial crisis in 1982, and the Iraqi invasion of 1990). The government has been implicitly guaranteeing all bank deposits in Kuwait. The authorities, however, decided to remove this implicit guarantee and communicate this decision to the public, as they realized that the system increases moral hazard, reduces market discipline, and could
prove costly to the government. In preparation for the removal of the guarantee (as of April 2004), the banking supervision department had introduced special liquidity requirements on banks which became effective in October 2003 and required banks to maintain a liquidity ratio that depends on the bank’s “CAMEL” rating and other measures of financial strength.

17. The authorities have no plan to implement deposit insurance when the guarantee is removed. Their rationale is that the bulk of deposits are held by large depositors, who, because of cost considerations probably would not be covered by any deposit insurance scheme. Moreover, these large depositors are aware of the systemic repercussions of their actions. By contrast, small depositors do not account for a very significant proportion of total deposits, are not a threat to systemic stability, and may be compensated in ways other than by deposit insurance.

B. Securities Markets

Equities Market

18. Kuwait has become the most active stock market among the Arab stock exchanges in terms of turnover ratios. The first official stock exchange was opened in April 1977, and in the wake of the 1982 Al-Manakh crisis was reorganized as the Kuwait Stock Exchange (KSE). Trading on the KSE was opened to Gulf Cooperation Council (GCC) citizens in May 1988, and to all foreigners in August 2000. Stock exchange trading is fully automated with the Kuwait Automated Trading System (KATS) introduced in 1998. The Kuwait Clearing Company (KCC) electronically carries out the settlements of all trades executed on the KSE and safe-keeps all securities traded on the KSE for investors. Stockbrokers are licensed to carry out intermediate trades on the KSE. However, their functions are limited to order executions through terminals of the KATS and administrative operations for investors. Any other capital market activities are either unregulated or outside the jurisdiction of the principal regulator, the Market Committee. These activities include investment advisory and fund management services by investment companies, which are supervised by the CBK.

19. One source of concern is the rapid rise of the stock market in recent years, reflecting high liquidity in the system, declining interest rates, and limited investment opportunities available to the private sector. Since it bottomed out in early 2001, the KSE index has been almost constantly on the up trend, reaching record highs in 2003, with market capitalization exceeding 100 percent of GDP (with further gains in 2004). A sharp decline in equity prices, which could be triggered by a shock such as an interest rate hike, an oil price decline, or political turbulence in the region, could result in the insolvency of some investors. Moreover, since a substantial portion (about one-third) of total stock market capitalization is accounted for by banks, steep declines in prices of bank stocks could have adverse effects on the public’s perception of banks’ situation. Given the liquidity of the market, the affluence of investors, and the robustness of the trading and settlement systems, the market needs to diversify product lines, and liberalize participation of foreign intermediaries in the market.

Regulation and Supervision of the Equities Market

20. The regulatory environment for the securities market generally does not conform to the International Organization of Securities Commission (IOSCO) objectives and principles or to the
preconditions necessary to satisfy them. In particular, the development of the market is hampered by the lack of a comprehensive and appropriate legal framework. Due to a multiplicity of laws and agencies, the principal agency, namely the Market Committee (MC), has not been delegated appropriate powers and responsibilities to enable it to act as an independent regulatory agency or to oversee the development of an efficient, fair, and transparent securities market. Inspection, investigation, and surveillance powers of the regulating agency need to be improved and should have a clear process. Standards for market entry and prudential pre-requisites for licensing are not sufficient. Regulations related to the issue market and to intermediaries are also inadequate. Individuals are not licensed and no proficiency requirements are in place for service providers. Owners, founders, operators and managers need to be subject to a strict fit and proper assessment. Accounting and auditing standards that are internationally accepted are not fully enforced across-the-board. While the CBK enforces such standards for the institutions it supervises, this is generally not the case for other commercial entities.

21. Though investment companies provide advisory services, stockbrokers are prohibited from providing such services. As a result, information intermediation, which is at the core of a capital market mechanism, is largely absent. In addition, the market lacks mechanisms that, inter alia, may allow the regulators to signal their policy intentions. Desirable medium-term steps to be taken that would help to bring the securities regulatory and supervisory system into closer conformity with international standards are set out in paragraph 38. The Stock Exchange is working toward strengthening securities markets and has produced a comprehensive four-year work plan (“Kuwait Stock Exchange Development Strategy”). Other changes in the regulatory and legal framework would help to improve the functioning of the market and to mitigate prolonged one-way movements, including for instance adjustments in the regulation of margin trading by dealers and/or speculators.

Government Bond Market

22. A more developed government bond market may help stimulate the provision of long-term finance and enhance the contribution of the financial sector to economic growth, particularly of the non-oil business segment of the economy (including, for example, potential private sector financed infrastructure projects). A wider range of government debt instruments could be useful in the conduct of monetary policy through open market operations (repos) as well as for smoother functioning of the inter-bank market. Moreover, their availability across the maturity spectrum is often useful to set reference prices for – and constitutes a needed adjuvant to – the downstream development of other debt instruments, such as corporate and agency debt, long-term bank CDs, or mortgage-backed securities. They also help institutional, and possibly individual, investors achieve more balanced portfolios. A well developed government securities market is not necessarily inconsistent with a budget surplus environment (there are country examples where government securities have been issued and used as a catalyst for financial market development, despite the government strong fiscal position). The government may want to assess steps to develop the market for treasury securities, and establish objectives for size, range of maturities, and liquidity created by active market-makers. Although there is a cost associated with the issuance of government debt, the benefits noted above may also be substantial.
Corporate Bond Market

23. The development of a corporate bond market would be desirable to provide a long-term funding source to the real economy and alleviate stresses on the banking system by allowing banks to increase the share of their longer-term resources. The corporate bond market in Kuwait is small compared to the country's bank loan and equity markets, although banks have, in a limited way, been issuing bonds as a source of funds for consumer loans. Corporate bonds in the Kuwaiti market are seldom traded, though they are listed on the KSE. They are either in bearer form or in book-entry form, and settle at the Kuwait Clearing Company.

C. Insurance and Pensions

Insurance

24. The insurance sector in Kuwait is small, with total premium revenue equivalent in 2002 to about one percent of GDP. This level of insurance penetration is generally in line with other Gulf states, but is significantly lower than the 3.4 percent of GDP for emerging markets and 9 percent for advanced economies. The market is served by 7 Kuwaiti insurance companies – including two new insurers operating on Islamic principles – and 10 foreign insurance branches of Arab and western companies. Non-life insurance products account for about 75 percent of the market, life insurance products for the remainder. The four largest national companies, which are highly capitalized and profitable, accounted for about 75 percent of total premium income in 2002, benefiting from the requirement that only national companies may bid for insurance contracts from government-owned companies. National insurance companies have been relying heavily on reinsurance with international companies and, in this respect, they function more as insurance brokers than underwriters. There is potential for growth in the insurance sector. The non-life classes of business will most likely expand in line with the overall economy. Health insurance for foreign nationals – with premia lower than the health tax – has been growing rapidly. The life insurance market is also growing at a fast rate and holds significant potential. Integration with the GCC could provide opportunities for national companies in other GCC markets, and increase competition in the domestic sector. The insurance companies also could face more competition from market liberalization related to World Trade Organization accession. In such an environment, effective supervision would become more relevant and important.

25. Supervision of the insurance sector rests with the insurance department in the Ministry of Commerce and Industry. (The FSAP team conducted an informal assessment of the International Association of Insurance Supervisors core principles for insurance supervision.) The scope of regulation and supervision is defined by a dated law that is missing many of the key elements of a modern insurance supervision regime. The law includes adequate provisions for financial reporting and for supervisory staff to conduct on-site inspections, as well as a (high) minimum capital requirement and deposit reserve requirements. However, the focus of the law is on regulation and compliance, and the supervisor does not have the mandate, powers, or capacity to undertake a thorough analysis of possible financial and operational risks. As a consequence, in practice the insurance department has limited ability to go beyond compliance-oriented functions and to assess the operations of the companies.
Pensions

26. The Kuwait Public Institution for Social Security provides a retirement pension for Kuwaiti citizens. Under the scheme, civilian workers with 20 years experience receive 65 percent of their salaries upon retirement, with 2 percent for each additional year worked, the pension being subject to a cap (currently KD 1,250 per month). Recently, medium-term fiscal problems faced by the social security fund were addressed through a law instituting a minimum retirement age that is being phased in through 2020. According to actuarial calculations, these reforms will keep the social security fund in surplus until 2010, after which the fund will have to be tapped to meet payments and will be exhausted by 2026. Kuwait will have to engage in an ongoing process of gradual parametric reforms to the system for some time in order to keep the system solvent. Some state owned companies have supplemental pension plans for their employees and several private sector banks have been considering such plans. Given the reasonable level of retirement benefits provided through the social security fund, there is only modest potential for developing supplementary employer-based pension schemes in the private sector. One area in which reforms could be useful is in the strengthening of the benefit system for foreign national workers in developing a guarantee mechanism to deal with the risks of possible noncompliance by employers.

D. Other Non-bank Financial Institutions

Investment Companies and Funds

27. The number and relevance of non-bank financial institutions in Kuwait have increased significantly in the last few years. In 2003, Kuwait had 38 investment companies and 37 investment funds, of which, respectively, 11 and 5 operate under the provisions of the Islamic Sharia. Total assets of these institutions account for about a quarter of the financial system assets (this excludes the investment companies’ sizeable off-balance sheet activities part of which involve investments in domestic investment funds). While the activity of conventional investment companies is heavily concentrated in foreign markets, the core business of Islamic investment companies, which have been growing quickly in recent years, is focused on the domestic economy. In aggregate, both conventional and Islamic investment companies are well-capitalized. Investment companies are licensed and supervised by the CBK. Twenty-seven of the current investment companies are also listed on the KSE and therefore subject to KSE rules and regulations.

28. However, closer attention to the liquidity position of investment companies might be called for in light of their growing importance in the Kuwaiti financial system. In the last two years, investment companies have increasingly relied upon bank credit as a source of financing. Concerns about their liquidity position might arise if mismatches in the terms and risk profiles of their assets and liabilities continued to widen. Some of the investment companies may be relying on credit lines from foreign banks; however, in difficult times these credit lines may be withdrawn and thus turn out to be elusive when most needed. The potential for systemic risk arising from the financial linkages between local banks and investment companies appears to be contained at present, reflecting CBK regulations limiting investment companies’ leverage and the relatively small local banks’ exposure vis-à-vis investment companies.
Leasing

29. Leasing is an important new emerging business in Kuwait and offers a potentially significant source of alternative financing for enterprises of all sizes, including SMEs. Leasing, relative to commercial credit, offers advantages in mitigating credit risk and makes it easier for firms to obtain financing. Recently, a small number of new leasing companies have been established, while previously only the Kuwait Finance House offered leasing. Currently, leasing is available mainly for vehicles and other transport facilities, with leasing firms reporting difficulties in entering the equipment leasing market due to the lack of a mechanism for title registration.

E. Financial Services to the Corporate and Housing Sectors

Enterprise Finance

30. Large, well established companies appear to be readily able to access short-term and medium-term credit from banks and investment companies, especially in the current financial environment of high liquidity. Small and medium enterprises (SMEs), however, have difficulty accessing credit particularly given the current interest rate caps that hinder banks’ and investment companies’ ability to price loans commensurate with the higher perceived risks of SME lending (including lower reliability of project information and the generally lower quality of SME collateral). Introducing greater flexibility in the interest rate structure would help ease this constraint and expand small business and related employment opportunities. Long-term credit is relatively scarce, even for prime corporate borrowers (apart from the products offered by the Industrial Bank of Kuwait). Banks have difficulty raising sufficient term funding, especially beyond 4 years. Thus, the development of a market for long dated securities (bonds) would be helpful in reducing corporate financial risks and promoting the emergence of new industries with long-term funding needs that match the long gestation periods of their investments. The pace of growth and diversification of the non-oil private sector could be aided strongly by a deepening of the financial sector and the availability of adequate financial instruments.

Housing Finance

31. Several banks are engaged in long-term lending to households for residential purposes, with such lending mostly salary-based (CBK has set a ceiling of 50 percent of monthly salary for the total repayment burden of borrowers). The development of a mortgage-based, private sector housing finance system would greatly help expand and diversify the availability of private sector funding for housing, while reducing lending risks in the financial sector. Recognition by the judicial system of creditors’ liens on owner-occupied residential property, combined with an effective foreclosure process in the event of default, is needed to facilitate the growth of an efficient residential mortgage market. Over time, commercial banks, and possibly other non-bank financial institutions that may be interested in entering the market, will need to raise long-term resources to fund their mortgage loans. Initially, some of them may be able to raise funding by issuing “plain vanilla” bonds. However, in order to help reduce financing costs and risks, and to tailor products to investors’ needs, new legislation may be required that permits the creation of simple mortgage bonds. In the longer-term, securitization processes could emerge to facilitate the
development of off-balance sheet sources of funding for primary mortgage lenders provided legislation is put in place that would enable loan originators to assign and transfer their rights and obligations associated with registered mortgages to securitization companies issuing mortgage-backed securities. In this regard, the efficient development of a mortgage market, especially for fixed-rate mortgages, would be facilitated by the presence of a long-term government bond market that could provide a benchmark for mortgage bonds and other securities.

Credit Information Systems

32. The creation of Ci-Net represents a major step forward in the development of credit information systems, and should help to improve significantly the behavior of individual borrowers and reduce credit risks for lenders. All financial institutions (e.g. banks, investment companies, and leasing companies) are members of Ci-Net, which shares information on the credit performance of the borrower and his compliance with CBK regulations regarding limits on personal borrowings. Previously, it was not possible for financial institutions to track borrower performance and compliance effectively.

F. Payments System

33. The Kuwaiti payments system is still strongly oriented to the use of banknotes for retail-level transactions, and checks continue to play a role in the settlement procedures of the equity clearing system. However, the banking community has made a significant start in the evolution toward electronic transactions. There is now a national network for shared ATMs and point of sale terminals (K-Net) for transactions initiated by bank (and other institution) debit cards. This network links some 7,000 terminals in Kuwait and is associated with the major international networks. For bank-to-bank transactions, the Special Clearing System operated by the CBK for 11 institutions continues to play a central role, and is efficient and satisfies the current needs of its users. The preparations for a real time gross settlement (RTGS) system are well advanced, but implementation has been delayed to mid-2004 by the uncertainties associated with the regional military activities of 2003. Public statements of the CBK’s objectives for the future of the payments system would be a step towards greater transparency.

G. Legal System

34. The laws underpinning Kuwait’s financial and commercial sectors are generally satisfactory but not as comprehensive or business-friendly as might be expected. A notable feature of the commercial scene is the high level of control exercised by the authorities. The laws governing the operation of companies and bankruptcy, designed a generation ago, may not reflect modern international corporate practice. The laws regulating the operation of KSE and the public offering and trading in securities are incomplete and are not sufficient to meet international standards. By contrast, the CBK Law provides a sound and comprehensive framework for the regulation and supervision of the banking sector. The CBK has required banks to bring their governance practices into line with recent developments in this area (e.g. responsibilities and requisite experience of board members, credit facilities available to board members together with provisions dealing with capital, liquidity, anti-money laundering and related topics). KSE guidelines for corporate governance in listed companies are also fairly developed. However, the rest of the commercial sector may not be at the same level. Bankruptcy
provisions, comprehensive but based on dated French legislation, appear to be viewed mainly as
a mechanism for enforcing the payment of debts, and not as creating an efficient exit mechanism
for failed companies. Bankruptcy law should be included in any revision of the country’s
business environment legislation. The procedures for the recovery of debts and enforcement of
security appear satisfactory (except for owner-occupied residential housing), although the
process can be drawn-out.

H. Anti-money Laundering and Combating the Financing of Terrorism

35. Although Kuwait’s vulnerability to money laundering may be relatively low, there are
some clear deficiencies in the legal and regulatory framework. A major development in
strengthening the AML systems was the enactment of Law 35/2002, combined with the
implementation of subsidiary rules by the regulators. However, this legislation has yet to be
extended formally to cover the broad financial sector, and there are distinct variations in the level
of compliance testing applied to the sectors covered by the law (with notable weaknesses in the
gold and equities markets). Despite the progress made in recent years to strengthen the overall
AML system, there are areas in which further work is required as a matter of some urgency.
There is a need to restructure the financial intelligence unit (FIU) to give it greater independence
of operation; to lower the threshold for the filing of suspicious transactions reports; to exercise
control over the ownership and management of financial institutions; to criminalize insider
dealing and market manipulation; and to create effective gateways and procedures for
international co-operation with respect to both mutual legal assistance and regulator-to-regulator
exchange of information.

III. ELEMENTS OF A FINANCIAL SECTOR STRENGTHENING PROGRAM

36. This section presents some main elements of a program for further strengthening of the
financial sector, for which the implementation, over the short and medium term, would call for
coordinated policy decisions among the various competent agencies. It should not be viewed as a
comprehensive list of the recommendations identified by the FSAP team and reported to the
authorities. The World Bank and the IMF staff have offered to provide technical assistance as
appropriate in support of the implementation of the program, if the Authorities so request. The
World Bank is already involved in technical assistance in the area of housing finance.

A. Strengthening the Efficiency of the Banking Sector

37. The banking sector is at the core of Kuwait’s financial system. To strengthen further
banking sector efficiency, the authorities should:

- Enact amendments to the CBK law that enhance the independence of the CBK in its
capacity as banking regulator and supervisor. In this regard, legislative changes would
need to be considered to eliminate the involvement of the Ministry of Finance and
Economy in the CBK’s decisions on licensing, closure, and administrative actions, which
could ultimately compromise the independence of the CBK in implementing its
supervisory function.
• Continue to monitor closely banks' lending risks associated with the stock market and real estate sectors, further develop related stress testing procedures and capabilities within the banking supervision department, and be prepared to take quick supervisory action if necessary. Moreover, following the elimination of the blanket deposit guarantee, which reduces moral hazard, further steps are recommended to encourage economic agents to deal prudently with risk. This should entail the elimination of the possibility of bank bailouts, as well as bailouts of investors in the stock and real estate markets.

• Consider amendments to the foreign investment laws to provide for the entry of foreign banks – which now can establish a presence in Kuwait only through the acquisition of up to a 40% stake in a local Kuwaiti bank – although the CBK will need to exercise vigilance in judging the effects on banking system soundness of changes in the competitive regime.

• Seek authority to share confidential information for supervisory purposes with appropriate domestic and foreign authorities.

B. Securities Market, Investment Companies and Insurance

38. Kuwait has one of the Arab world’s most active stock markets. To strengthen the operation of the market and its resilience to crises, the Authorities should:

• Enact a new Capital Markets Law creating a single and accountable authority with full powers to develop and regulate the securities market and industry, develop a unified code of prudential regulations, and define entry standards for all types of market intermediaries.

• Establish comprehensive inspection, investigation and surveillance systems to enforce good market and trading practices that prevent insider trading and market manipulation.

• Allow the market to diversify product lines, and liberalize participation of foreign intermediaries in the market. Steps could be considered to introduce more diverse financial products to complement stock market operations.

39. Investment companies are an important pillar in the Kuwaiti capital market. Their investment and trading activities should be disclosed in a more extensive and elaborate way. The authorities may wish to consider more specific regulations and closer supervision regarding the investment or trading practices of investment companies with consideration given to the introduction of risk-based capital requirements that reflect the risk profiles of their various lines of activities.

40. The Kuwaiti insurance sector has potential for further development and growth, and the authorities should enact a new insurance law and strengthen insurance supervision, preferably under an independent agency. A new law should include the elements of a modern insurance supervision framework as embodied in the Core Principles for Insurance Supervision, including independent status for the supervisory agency. In the near term, there is a need to strengthen the capacity of the insurance department of the Ministry of Commerce and Industry.
C. Provision of Financial Services to the Corporate and Housing Sectors

41. To promote access to credit by SMEs, there is a need to introduce greater flexibility in interest rates on lending in order to enable lenders to price better the risks of lending, including in particular to SMEs. To strengthen housing finance, lay the foundations for a residential mortgage finance system, and set the stage for risk-based pricing of longer-term loans, the authorities should consider steps to ensure that an efficient, low-cost system for registering property titles is in place. Moreover, the judicial system would need to recognize creditors’ liens on residential property, including owner-occupied residential property, and permit an efficient and predictable foreclosure process in the event of defaults on banks’ assets collateralized by residential property. The legal and regulatory framework for leasing should be further developed to help ensure efficient expansion of the industry, as Kuwait does not yet have a registry of moveable assets or equipment, or a commercial code that governs financial contracts or leases secured by property such as a firm’s equipment or receivables.

D. Payments System

42. For the payments system, the authorities view the continued implementation of an RTGS system as a high priority. In this context, there is a need to ensure that its regulations comply with the core principles on management of credit risks and liquidity risks, provide objective and publicly disclosed criteria for participation, and in general publicly disclose major policies. Moreover, to strengthen the integrity of the payment and transfer systems, the authorities should extend formally Law 35/2002 to cover the broad financial sector and exercise more control over ownership of financial institutions.

E. AML/CFT

44. Although Kuwait’s vulnerability to money laundering may be relatively low, there is a potential for further improvement in the legal and regulatory framework, despite the strengthening of the AML systems through the enactment of Law 35/2002. This includes the need to restructure the financial intelligence unit (FIU) to give it greater independence of operation; to lower the threshold for the filing of suspicious transactions reports; to exercise control over the ownership and management of financial institutions; and to create effective gateways and procedures for international co-operation with respect to both mutual legal assistance and regulator-to-regulator exchange of information.