Explaining Long-Term Trends in Kuwaiti Banks’ Profitability

Consultancy and Research Department

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EXECUTIVE SUMMARY

In 2006, the Kuwaiti banks, in aggregate, delivered a return on assets (ROA) of 3.3 percent. By 2014, ROA had fallen by two-thirds to 1.1 percent. This study finds the main causes in the decline in profitability when comparing 2006 to 2014 to be:

- **Net interest/finance margins.** The margin fell from 3.4 percent in 2006 to 2.9 percent in 2014, accounting for 20.2 percent of the drop in overall profitability, as easy monetary policy caused lending rates to fall by more than deposit rates. As rates start to normalize globally, net interest/finance margins in Kuwait should start to widen. All the same, we expect this to be a slow process and that ultimately, the Central Bank of Kuwait's discount rate is unlikely to return to pre-crisis levels for an extended period of time. All of which means that it is prudent only to expect margins to recover half of the decline from 2006.

- **Yield on securities, derivatives, and investments in associates.** The declining yield on securities investments and derivatives exposure accounted for 31.7 percent of the decline in profitability; the decline in the yield on investments in associates accounted for 8.6 percent of the drop in profitability. Together, these factors accounted for 40.3 percent of the decline in profitability. With the advantage of hindsight, it is clear that Kuwaiti banks were taking on too much risk in the years leading up to the financial crisis, helping them deliver very high ROAs. Since the crisis, the banks have significantly reduced risk; firstly, by shifting much of their investment portfolios to lower risk fixed income securities, and secondly, by reducing and in some cases eliminating exposure to high risk associates. Both because of the changing attitude to risk and the less-than-exciting outlook for global markets, we do not envisage either the yield on securities and derivatives or the yield on investments in associates increasing significantly from current levels.

- **Fees and commission income.** The share of these sources of income to net interest/finance income has fallen, accounting for 7.7 percent of the decline in ROA. While the share of fee income appears to have remained stable, commissions have most likely declined as the average daily value of trading in the Kuwait stock market has fallen by over 80 percent since the crisis. If market turnover starts to recover, then commissions will likely increase but, as of writing, it is unclear what the catalyst would be for such a development.

- **Provision for credit losses.** Provisioning costs rose significantly in the aftermath of the financial crisis, and have remained elevated ever since. Increased provisions accounts
for 16.5 percent of the difference between ROA in 2006 and 2014. However, by 2014, the banks had succeeded in building up provisions to a level that is almost twice non-performing loans/receivables. While this has been painful from a profitability perspective, it should serve the banks well going forward. It is also likely that this process has now been completed; so our expectation is that from 2015, overall provision charges as a percent of net interest/finance income should return to 2006 levels.

- **Staff and administration costs.** The burden of staff and administration costs on net interest/finance income, fee income and commissions has risen from 33.1 percent to 43.5 percent, accounting for 13.7 percent of the drop in profitability. While the Kuwaiti banks still benefit from a low cost base, we do not anticipate declines in the cost-to-income ratio in the coming years.

Looking forward, we expect the banks to regain around half of the decline in the net interest/finance margin; and return to the pre-crisis level of annual provisioning charges. By virtue of a ‘reversal to the mean’ in these two categories (one income, one expense), assuming no significant improvements in the other factors listed above, the Kuwaiti banks’ return on assets would recover to 1.7 percent; still short of the 3.3 percent achieved in 2006 but internationally regarded as healthy.
INTRODUCTION

This study examines and explains the trends in the profitability of the Kuwaiti banking sector from 2006, just before the 2008 financial crisis, until 2014. Specifically, we show why profitability, as measured by return on assets (net income divided by average total assets), fell from 3.3 percent in 2006 to 1.1 percent in 2014. Given our explanation of the past, we conjecture on the future evolution of profitability.

We are concerned with the efficiency and success with which assets are put to use to generate profits. While it is well understood that increased profitability is positive for shareholders, the study is premised on the belief that higher profitability, in a properly regulated and competitive banking sector, provides a social benefit to all; specifically, a better use of assets frees resources and generates more capital for additional financial intermediation. To this extent, this study does not address the related, but separate issue, of the outlook for growth in net profits.

In performing this analysis, we have disaggregated return on assets into its constituent parts. In the context of banking, net profit is constituted, in the main, by net interest/finance income, investment income, fees and commission income, less provision charges for bad credit, and staff and administrative costs; and the assets utilized to generate those earnings. By breaking down profitability in this way, we have been able to quantify in a precise way what has changed for the banks since 2006, reducing ROA by two-thirds.

This study focuses on the consolidated private Kuwaiti banking system, rather than on any one individual bank. In order to reconcile 2006 and 2014 profitability, we have aggregated the banks which have operated throughout the period in question. The specific banks included are Al Ahli Bank of Kuwait, Bank of Kuwait and the Middle East/Ahli United Bank, Burgan Bank, Commercial Bank of Kuwait, Gulf Bank, Kuwait Finance House, Kuwait Real Estate Bank/Kuwait International Bank and National Bank of Kuwait. Throughout the study, the consolidated income statement and balance sheet items of these banks are referred to as the Kuwaiti banks. We have not included the Industrial Bank of Kuwait in our consolidation as it is a government-owned bank run on a different model to the other banks, all of which are listed on the Kuwait Stock Exchange.

Finally, it should be stressed that this study is not intended to guide investor opinion. Its focus is on return on assets not return on shareholders’ equity and there is no commentary on the relative valuations of each bank’s share price in the stock market. IBS does not invest in the stock market or offer advice to those that do.
1: Explaining the Decrease in Profitability: Overview

In 2014, Kuwaiti banks generated net profit of KD 688.8 million utilizing an average of KD 61.9 billion of assets over the year (the average of year-end 2014 and year-end 2013 total assets). In 2006, the same banks reported net profit of KD 827.6 million utilizing average assets of KD 25.3 billion. Return on average assets, hereby referred to as ROA, fell from 3.3 percent in 2006 to 1.1 percent in 2014.

Table 1 reconciles ROA in 2006 and 2014. In so doing it demonstrates why the banks are less profitable now than there were before the crisis.

Table 1: Multiple Reasons for Banks’ Lower Profitability

<table>
<thead>
<tr>
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<th>2006</th>
<th>2014</th>
<th>Increase in net profit in 2014 if performance had matched 2006 KD millions</th>
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<tbody>
<tr>
<td>Net interest/finance margin</td>
<td>3.4%</td>
<td>2.9%</td>
<td>271.7</td>
</tr>
<tr>
<td>Yield on securities investments and derivatives exposure</td>
<td>12.0%</td>
<td>3.5%</td>
<td>426.8</td>
</tr>
<tr>
<td>Yield on investments in associates</td>
<td>18.0%</td>
<td>2.5%</td>
<td>116.4</td>
</tr>
<tr>
<td>Share of income from fees and commissions</td>
<td>32.0%</td>
<td>24.7%</td>
<td>104.2</td>
</tr>
<tr>
<td>Provision for credit loss burden</td>
<td>13.0%</td>
<td>28.6%</td>
<td>221.8</td>
</tr>
<tr>
<td>Staff and administration costs burden</td>
<td>33.1%</td>
<td>43.5%</td>
<td>184.9</td>
</tr>
<tr>
<td>Yield on investment property</td>
<td>9.4%</td>
<td>6.2%</td>
<td>20.4</td>
</tr>
<tr>
<td>Net profit as reported</td>
<td>KD 25,331 million</td>
<td>KD 61,885 million</td>
<td></td>
</tr>
<tr>
<td>Return on assets</td>
<td>3.3 percent</td>
<td>1.1 percent</td>
<td></td>
</tr>
<tr>
<td>Re-stated net profit had 2014 performance matched 2006</td>
<td>KD 2035.0 million</td>
<td>= 688.8 + 1,346.2</td>
<td></td>
</tr>
<tr>
<td>Restated ROA had 2014 performance matched 2006</td>
<td>3.3 percent</td>
<td></td>
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Sources: Kuwaiti Banks’ annual reports, IBS data and calculations

Table 1 shows there to be seven factors that have weighed on the banks’ profitability when comparing performance in 2014 to 2006:

- **Net interest/finance margin** (= net interest/finance income divided by average interest/finance earning assets). Applying the 2006 net interest/finance margin to 2014 average interest/finance earning assets would have generated an additional KD 271.7 million in profits in 2014. Actual net interest income in 2014 was KD 1,427.0 million.

- **The yield on securities investments and derivatives exposure** (= investment income less relevant impairment charges plus net gains from foreign exchange and derivatives
transactions divided by average investments in non-Kuwaiti government securities). Applying the 2006 yield on securities and derivatives to 2014 average investments in non-Kuwaiti government securities would have generated an additional KD 426.8 million in profits in 2014. Actual investment income less relevant impairment charges plus net gains from foreign exchange and derivatives transactions was KD 173.6 million.

- **Yield on investments in associates** (= share of results in associates less relevant impairment charges divided by average investments in associates). Applying the 2006 yield on investments in associates would have generated an additional KD 116.4 million in profits in 2014, representing an increase of 625.3 percent in income from associates. Actual share of results in associates in 2014 was KD 18.6 million.

- **Share of income from fees and commissions** (= fees and commissions income divided by net interest income). Applying the 2006 share of income from fees and commissions would have generated an additional KD 104.2 in profits in 2014, representing an increase of 29.5 percent in income from fees and commissions. Actual fees and commission income in 2014 was KD 352.8 million.

- **Yield on investment property** (= investment property income less relevant impairment charges divided by average investment property assets). Applying the 2006 yield on investment property would have generated an additional KD 20.4 million in profits in 2014, representing an increase of 29.3 percent in income from investment property. Actual investment property income in 2014 was KD 173.6 million.

- **Provision burden** (= provision charge for credit losses as a percentage of net interest/finance income). Applying the 2006 provision burden to 2014 net interest/finance income would have generated an additional KD 221.8 million in profits in 2014, representing a decrease of 54.4 percent in provision charges. The actual provision charge for credit losses in 2014 was KD 408.0 million.

- **Staff and administration costs burden** (= staff and administration costs as a percentage of net interest/finance income, fee income and commissions). Applying the 2006 staff and administration costs burden to 2014 net interest/finance income, fee income and commissions would have generated an additional KD 184.9 million in profits 2014, representing a decrease of 23.9 percent in staff and administration costs. Actual staff and administration costs in 2014 were KD 773.3 million.
This study focuses on the six main determinants of the change in ROA, without considering in more detail the decline in the investment property yield, which has only had a minor impact on overall profitability.

Chart 1 below provides a quick overview of all the factors accounting for the decline in ROA from 3.3 percent in 2006 to 1.1 percent in 2014.

**Chart 1: Explaining the decline in profitability between 2006 and 2014: at a glance**

- Decrease in net interest/finance margin, 20.2%
- Decrease yield on securities investments and derivatives exposure, 31.7%
- Increase in provision for credit loss burden, 16.5%
- Decrease in yield on investments in associates, 8.6%
- Decrease in yield on investment property, 1.5%
- Increase in share of income from fees and commissions, 7.7%
- Increase in staff and administration costs burden, 13.7%
- Decrease in yield on investments in associates, 8.6%

Sources: Kuwaiti Banks’ annual reports, IBS data and calculations
2: Explaining the Decrease in the Net Interest/Finance Margins

In 2014, the banks’ net interest/finance margin was 2.89 percent, 55 basis points lower than in 2006, reflecting that during this period, the yield on earning assets (net interest/finance income divided by interest/revenue earning assets) fell by more than the cost of funding those assets (net interest/finance expense divided by interest/revenue earning assets).

That said, both the yield on earning assets and the cost of funding those assets have declined: the former from 7.47 percent in 2006 to 4.26 percent in 2014, the latter from 4.02 percent to 1.37 percent. The decline in both yield and cost was a result of the Central Bank of Kuwait’s decision to reduce its discount rate in response to the global financial crisis. Indeed, between 2006 and 2014 over 99 percent of the variation in both the annual yield and the annual cost of funding can be explained by changes in the year-end Central Bank of Kuwait’s discount rate. The left-hand pane in Chart 2 demonstrates this almost perfect correlation.

The correlation between the yield on earning assets and the Central Bank of Kuwait’s discount rate is to be expected given that the Bank sets maximum limits on lending rates across a whole range of categories of credit. However, while interest rates on deposit and savings accounts have been liberated from all controls since 1995, given the extremely high correlation between the Central Bank of Kuwait’s discount rate and the cost of funding earning assets, it is evident that the banks also adjust deposit rates and returns in tandem with changes in the discount rate.

Even so, a comparison of the left-hand and right-hand panes in Chart 2 shows that small timing differences in the response of funding costs and lending rates to changes in the Central bank of Kuwait’s discount rate have driven fluctuations in the net interest/finance margin, affecting overall profitability.

Chart 2 (right-hand pane) shows that the net interest/finance margin dropped by half a percentage point between 2006 and 2007, recovered to between 3.1 and 3.2 percent during the years 2008 to 2013, only to drop back to 2.9 percent in 2014.
To understand the decline in the net interest/finance margin requires examining the changes from 2006 to 2007, the period of stability from 2007 to 2013, and finally, what happened in 2014:

- **2006 to 2007.** In one year, the net interest/finance margin dropped from 3.44 percent to 2.87 percent. This was primarily driven by a steep rise in the cost of funding interest/revenue earning assets. During this year lending to the Kuwaiti private sector grew at a relatively high 34.9 percent versus 26.3 percent in 2006 and 19.9 percent in 2005, according to Central Bank of Kuwait data.³ With such strong growth it is easy to imagine that increased competition globally for funding led to higher funding costs. It should also be noted that stiff competition to grow loan books among local banks put slight downward pressure on average lending rates even while the Central Bank of Kuwait’s discount rate moved marginally higher.

- **2007 to 2013.** During these years, net interest/finance margins remained in a tight band between 3.07 percent and 3.18 percent. In 2008, loan growth slowed to 17.5 percent and interbank rates fell globally, funding costs therefore returned to 2006 levels, allowing for a moderate recovery in the net interest/finance margin, even while lending rates began to fall. After 2008, following global monetary policy trends, the Central Bank of Kuwait cut its discount rate from 6.0 percent to 2.0 percent. Nonetheless, this did not substantially affect the net interest/finance margin as lending rates and funding...
costs were reduced in equal measure.

- **2013 to 2014.** Net interest/finance margins fell by 18 basis points to 2.89 percent in 2014. This reflects an 8 basis point decline in the yield on earning assets and a 10 basis points increase in funding costs. The increase in funding costs may reflect marginal tightening of monetary policy globally (the U.S. Federal Reserve, for instance, has terminated its program of asset purchases known as quantitative easing). The decrease in yield may reflect the on-going replacement in the loan book of older loans/receivables advanced when rates were higher with newer loans/receivables advanced in a lower rate environment.

### 2.1 Outlook

Given the outcome of 2014, without changes in the Central Bank of Kuwait’s discount rate, it is likely that net interest/finance margins will remain at current levels, or may even drift slightly lower (as continued replacement of the loan book tends to lower yields across the whole loan portfolio). In the long run, when the global rate environment starts to turn and interest rates begin to rise to more normal levels, Kuwaiti banks should benefit.

This conclusion appears to accord with what the banks themselves are saying. National Bank of Kuwait, for instance, stated in its 2014 annual report that an increase in Kuwaiti Dinar based interest rates of 25 basis points would have added KD 5,904 thousand to 2014 net profits, all other things being equal. While this only represents 2.2 percent of net profits, if extrapolated to take account of a situation in which the Central Bank of Kuwait’s discount rate returned to the pre-crisis level of 6 percent (from 2 percent currently), net profits would increase by KD 94,464 thousand or 34.5 percent of net profit; presumably because the yield on earning assets would rise at a faster rate than the cost of funding those earning assets.

In short, the world is still living through a period of extraordinarily easy monetary policy as a result of the financial crisis. Likely, the increase in global interest rates will be slow and it will be a number of years, if at all, until we witness a return to pre-crisis levels. Some economists in fact take a somewhat pessimistic viewpoint on global growth potential. That combined with the persistence of the global savings glut may imply that interest rates persist at levels lower than before the financial crisis. All of which means, in the context of Kuwait, that it is prudent only to expect margins to recover half of the decline from 2006.
3: Explaining the Decrease in the Yield on Securities Investments and Derivatives Exposure

Of the factors accounting for the banks falling profitability, declining yields on securities investments, foreign exchange transactions and derivatives exposure is the largest contributor. Chart 3 demonstrates that since 2006 investment yields have fallen significantly.

Chart 3: Investment yields have trended downwards for a number of years

The chart shows the impact of the financial crisis on the banks’ investment activities. During 2006 and 2007 the banks were able to deliver a yield of over 12 percent; since 2008 the yield after deducting impairment charges has remained below 4 percent. Yields during the crisis years reflect the poor performance of financial markets, both in Kuwait and globally. They also reflect elevated impairment charges, some of which may relate to equity investments in local Kuwaiti investment companies, many of which suffered financially during the crisis.

It should also be noted that the yield in 2008 includes derivatives losses of around KD 60 million reported that year by Gulf Bank. While, this amount was very material in the context of Gulf Bank’s own income statement, it was not enough to push the yield on securities investments and derivatives exposure into negative territory for the combined banking sector.
Chart 3 also illustrates the investment yield without deducting impairment charges. The difference between the lines demonstrates the extent to which write-downs in long-term holdings have affected investment yields. On the one hand, it shows that impairment charges are declining; the gap between the lines has narrowed significantly in the last two years. On the other hand, however, it continues to show that impairment charges remain elevated; thus the banks may still be working through some of the financial crisis-related issues in their investment portfolios. Finally, the chart demonstrates that whether we deduct impairment charges or not, the yield on investments, while increasing, remains significantly lower than before the crisis. Why might this be so?

Relatively low yields may partly relate to the on-going weak performance of the Kuwait stock market which, generally speaking, has not shared in the strong rally seen in major global equity markets. But it is likely that the banks have equity holdings outside of Kuwait – in the U.S. and Europe, and would have seen some benefit from those exposures. Thus an additional factor weighing down performance has been the marked increase in risk aversion since the crisis. Chart 4 below shows the shift in asset allocation from equities to fixed income when comparing 2006 and 2014.

Chart 4: Asset allocation to fixed income securities increased as the equity weighting declined

Sources: Kuwaiti Banks’ annual reports, IBS calculations
Note: As before, the data presented here reflects the consolidated accounts of Al Ahli Bank of Kuwait, Bank of Kuwait and the Middle East/Ahli United Bank, Burgan Bank, Commercial Bank of Kuwait, Gulf Bank, Kuwait Finance House, Kuwait Real Estate Bank/Kuwait International Bank and National Bank of Kuwait. It should be noted that Al Ahli Bank of Kuwait and Kuwait Real Estate Bank did not distinguish their 2006 investment holdings, thus these banks data are not included in the 2006 chart.

Chart 4 shows that prior to the crisis there was a high investment weighting in equities and other investments (predominately private equity holdings and managed funds), and a low
weighting in safer fixed income securities, which accounted for 12 percent of the portfolio. At the end of 2014, this had almost fully reversed, with investments in fixed income making up 68 percent of the portfolio.

Given the extraordinarily low interest rates globally, it is not surprising that yields remain low. Simply put, if 70 percent of the portfolio is invested in fixed income securities yielding, say, 1.5 percent per annum, then to achieve a return of 4 percent, the remainder of the portfolio would have to generate a return just short of 10 percent. Since 2009, the main Kuwait Stock Exchange price index has achieved this in only one year.

3.1 Outlook

The financial crisis significantly affected the performance of the banks’ investment portfolio. Going forward, there is likely to be some relief as impairment charges continue to decline. For instance, as with provisions for credit losses, we can reasonably expect the eventual work-out of any long-standing issues with regard to holdings in local investment companies. Nonetheless, much of the reduction has already occurred; further decreases in the impairment charge, as Chart 3 showed above, would only result in the investment yield rising by around 1 percentage point, rather than the 10 percentage points needed to re-attain the investment yield in 2006.

It may be that in the future the Kuwaiti banks will again generate high yields from their investment portfolios. But even if this were to happen, there is no guarantee that those yields will be sustainable. Indeed, taking on more risk, were the banks willing to do this, is no guarantee of permanently higher yields. In the context of this study, we believe that it would be imprudent to assume a recovery in the investment yield will follow as a matter of course.

Moreover, it is quite possible that the banks’ preference for risk will not change markedly in the short or long term. The regional perspective is dominated by oil price declines and continued political instability. At the same time, from a global perspective, having performed very strongly for a number of years, equity markets in the U.S. and Europe may also remain within a relatively tight band for some time in an environment of uncertainty with sentiment further dampened by the expectation of rising interest rates, led by the Federal Reserve. Both regionally and globally, there is little in the short term that would seem to entice the banks to start taking on more risk.

In the longer term, it is not unreasonable to conclude that there has been a fundamental shift in managements’ perspective on risk. Cleary, this section on investment yields and the next on associates show that, prior to the crisis, the banks were taking on a higher level of risk than now considered prudent. Changes in management teams and increased supervision and regulation suggest that the asset allocation changes shown above in Chart 4 may be permanent.
4. Explaining the Decrease in the Yield on Investments in Associates

Many of the banks gain significant exposure to other financial services companies both within and outside Kuwait by acquiring stakes which are over 20 percent yet under the 50 percent threshold that would transfer management control to the acquirer (and require full consolidation in the accounts). Generally accepted accounting principles require banks to report every year their share of each associates’ earnings and shareholders’ funds.

Chart 5 below shows that the yield delivered by associates suffered greatly during the financial crisis and remains very low compared to 2006 and 2007. Indeed, in 2009 and 2010 the yield on investments in associates was -6.5 percent and -5.7 percent respectively.

Chart 5: Profitability from associates collapsed and remains depressed

Given the volatility in profitability being delivered by associates, it appears that these financial institutions were taking on a great deal of risk. In fact, over 95 percent of the banks’ investments in associates come from two banks: National Bank of Kuwait and Kuwait Finance House:

- National Bank of Kuwait’s loss from associates in 2009 was a result of its holding in Boubyan Bank. (It was not until 2012 that Boubyan became a subsidiary of NBK). In 2009, Boubyan reported investment losses and elevated impairment charges as a result of its investments in money market funds and other securities.\(^9\)
- Kuwait Finance House’s associates reported significant losses in 2009 and 2010, with smaller losses in 2011. These losses appear to have come predominantly from KFH’s
holdings of two companies, First Investment Company and A’ayan Leasing and Investment Company, both registered in Kuwait.  

4.1 Outlook

In parallel with the banks’ investment portfolios, there have been significant changes to risk attitudes since the financial crisis. Boubyan is now under the management control of NBK and by the end of 2014 had 68 percent of its available-for-sale investment portfolio invested in Sukuk. KFH no longer lists First Investment Company and A’ayan Leasing and Investment Company as associates.

It is our expectation that these changes represent a permanent shift in risk management practices at the banks, undertaken by the banks themselves and supported and encouraged by the Central Bank of Kuwait.

5. Explaining the Decrease in the Share of Income from Fees and Commissions

While the core business of a bank is to advance credit to customers thereby generating interest/finance income, banks also earn income from charging their customers fees for other services rendered and from commissions for buying and selling investments on behalf of the customer. One way of measuring the success of the banks in generating this additional income is to track, over time, fee and commission income as a percentage of net interest/finance income. A key part of a bank’s long-term success is its ability to sell additional products to core customers; often referred to as cross-selling across product lines.

Chart 6 shows that between 2006 and 2014 there was a steady decline in fees and commissions as a percentage of net interest/finance income, from 32.0 percent in 2006 to 24.7 percent in 2014 (slightly up on 24.2 percent recorded in 2013).

The cause appears to be related to a drop off in commissions from stock dealing on behalf of customers. Chart 6 also shows (right-hand scale) the average daily value of trading in the Kuwait stock market for each year. In 2007 the average daily value of trading in the stock market was KD 149 million; in 2014 it was KD 25 million. In a simple regression, we found that 45 percent of variation in the share of income coming from fees and commissions were explained by the average annual value of transactions in the Kuwait stock market.  

Given the low number of observations and the use of annual averages, the finding should be considered high.

Furthermore, given the high ‘y-intercept’ value of 24 percent, the regression appears to suggest that fee income has remained fairly stable as a proportion of net interest/finance income; even if the value of stock market trading had been zero, fee and commission income would still have
accounted for 24 percent of net interest/finance income. It therefore looks as if falling commission income has been the driver of the declining ratio of fee and commission income to net interest/finance income; and that this has occurred as the stock market has lost significant liquidity.

Chart 6: Commissions decline in line with stock market activity

![Chart showing the correlation between fee and commission income as a percentage of net interest/finance income and daily average value of trading in the Kuwait stock market, KD hundred millions.](image)

Sources: Kuwait Stock Exchange, Kuwaiti banks' annual reports

5.1 Outlook

Increasing fee income should certainly be a priority for the banks going forward; cross-selling is always one way to increase revenues and profitability. However, in the context of this study, it would be inappropriate to factor in a material increase in the share of income coming from fees without a detailed examination of each bank’s strategy.

Gauging the future outlook for commission income is easier, as it appears to be dependent on turnover in the stock market. The government has clearly signaled its concerns with low stock market activity by transferring regulation to a new body, the Capital Markets Authority; and the CMA is currently investigating what actions can be taken to improve liquidity. This will be a long process; and while investors remain cautious of investing (see discussion in section 4.1), we believe any increase in the share of income coming from commissions cannot be guaranteed or even expected with any great certainty.
6: Explaining the Increase in the Provision for Credit Loss Burden

In a previous IBS study, *What is the Impact of Lower Oil Prices in Kuwait and on the Kuwaiti Banks*[^12], it was shown that non-performing loans/receivables as a percentage of gross loans/receivables have a high correlation with the more volatile elements of non-oil output that make up gross domestic product (specifically, manufacturing, construction, wholesale and retail trade, hotels and restaurant services and transport and communications). Changes in these elements of GDP explain 92 percent of the variation in the non-performing loans/receivables ratio[^13] in the years 2005 through 2013. As the annual change in these volatile elements of non-oil GDP turned negative in 2009 so non-performing loans/receivables to gross loans/receivables rose to 10 percent.[^14]

As Chart 7 shows, having peaked in 2009, the non-performing loan/receivables ratio has slowly been reduced; in 2014, the ratio fell back to pre-crisis levels. Chart 7 also demonstrates that this pattern is not specific to Kuwait. While the overall level of non-performing loans to gross loans has been lower among the U.S. commercial banking sector (data which does not include investment banking operations), the pattern has been the same over the past few years.

**Chart 7: Non-performing loans/receivables to gross loans/receivables has normalized at last**

Sources: Kuwait banks’ annual reports, IBS data and calculations, Federal Deposit Insurance Corporation

Not surprisingly, throughout this period, provisioning charges have eaten up a significant amount of profits. The left-hand pane of the Chart 8 shows the provision charge as a percentage of net interest/finance income from 2006 to 2014. At its peak, in 2008, the provision charge absorbed 60.2 percent of net interest/finance income. Comparative data from the U.S. is provided showing that Kuwaiti banks were far from unique in this regard.
Since 2011, Kuwaiti banks have continued to build up provisions against credit losses. As the right-hand pane shows in Chart 8, at the end of 2014 the provision for credit losses represented 175 percent of non-performing loans/receivables, significantly above the 149 percent pre-crisis peak. This compares very favorably with U.S. commercial banks, with an equivalent ratio of 75 percent at the end of 2014, less than 50 percent of the pre-crisis peak level of 171 percent reached in 2004.\textsuperscript{15}

The build-up of provisions to current levels has been at the request of the Central Bank of Kuwait that has impressed upon the banks the need to be able to withstand any possible deterioration in the quality of their credit portfolios. According to the Bank’s 2013 Financial Stability Report, “these provisions are counter-cyclical in nature, as the build-up of these provisions in relatively benign times would enable the banking sector to better cope with any potential downturns, without compromising their ability to extend credit.”\textsuperscript{16}

6.1 Outlook

The Central Bank of Kuwait has required the Kuwaiti banks to meet the very highest standards of provisioning. Regulators would likely point to a number of factors to justify the need for such high prudential standards, including regional, domestic and customer concentration, and the banks relatively high exposure to equities. Indeed, even though holdings of equities have been reduced, high indirect exposure via securities lending and collateral taking remains a concern at the Central Bank of Kuwait\textsuperscript{17} and at the IMF.\textsuperscript{18}
At the same time, Kuwait has been quick, or at least much quicker than the U.S. to return to pre-crisis levels of provisioning coverage (provisions as a percentage of non-performing loans RECEIVABLES). As the left-hand pane of Chart 8 shows, to get there, the Kuwaiti banks have ‘spent’ a lot more of their net interest/finance income on provisioning charges since 2011 than U.S. commercial banks. While this has had the effect of lowering profitability, by taking the cost up front, the Kuwaiti banks can probably now look forward to much lower provisioning costs in the coming years. This compares favorably to commercial banks in the U.S. which, presumably, will face a number of further years of high provisioning costs as provisioning coverage is slowly brought back up to pre-crisis levels.

In short, with provisioning cover now very high, we can expect provisioning charges as a percentage of net interest/finance income to drop back down to 2006 levels, enhancing profitability significantly.

7: Explaining the Increase in the Staff and Administration Costs Burden

Staff and administration costs as a percentage of net interest/finance income, fee income and commissions have increased from 33.1 percent in 2006 to 43.3 percent in 2014; this change effectively represents a loss of productivity. Around 60 percent of this deterioration has been caused by rising staff costs, 40 percent by administration costs.

On administration costs, there is little that can be said given the lack of publicly available information on this category of spending. It may be that these costs have risen as the banks have increased investment in risk management and corporate governance in the wake of the financial crisis, while also implementing certain restructuring measures.

With regards to staff costs (a measure that includes many staff related costs in addition to salary), it is possible to quantify in more exact terms the effects of pay increases in excess of productivity gains. Chart 9 below includes two lines: 1) staff costs per employee and 2) staff costs per employee had they increased in line with revenue, i.e. net interest/finance income, fee income and commissions. In effect, the gap between the two lines represents a loss in productivity. Had staff costs per employee risen from KD 24,273 in 2006 in line only with increases in revenue, then by 2014, the cost per employee would have been KD 35,838. In other words, as actual costs per employee rose to KD 47,067 in 2014, around 50 percent of this increase can be explained by productivity INCREASES, 50 percent by pay increases in excess of revenue growth.
Chart 9: Staff costs increasing more than productivity

Sources: Kuwait Bank's annual reports, IBS calculations, Central Bank of Kuwait, Kuwait Today

There may be many factors accounting for the increase in staff costs as a percentage of net interest/finance income, fee income and commissions. For instance, rather than measuring staff costs as a percentage of revenue, a relatively volatile measure, the banks may be choosing to focus on alternative metrics of productivity and value-add. Alternatively, the banks may be responding to changes in labor regulations and investing more heavily in the development of Kuwaiti nationals in the workforce.19

7.1 Outlook

Without a clear picture of what has caused staff and administration costs to increase as a percentage of net interest/finance income, fees and commissions, it is difficult for us to envisage some of this lost productivity being regained. Indeed, a positive outcome going forward with regards to the banks’ overall profitability would be for staff and administration costs to be maintained at the current cost-to-income level. In short, we believe it is unlikely that the banks will be able to increase their overall profitability through addressing either staff or administration costs.

That said, as a final point, it should be noted that while staff costs as a percentage of net interest/finance income, fees and commissions have risen in the past few years, labor costs remain relatively cheap. For instance, while the Kuwaiti banks’ staff costs represented 26.9 percent of net interest/finance income, fees and commissions in 2014, the equivalent number in
the U.S. was 39.3 percent. There remains a definite cost advantage for banks operating in a city state like Kuwait.

**Conclusion**

In this study, we set out to explain why return on assets had fallen from 3.3 percent in 2006 to 1.1 percent in 2014. To do this we disaggregated return on assets in both years and directly compared each year’s performance.

As a result, we have determined that declining net interest/finance margins accounted for 20.2 percent of the decline; lower yields on securities and derivatives 31.7 percent; lower yields on investments in associates 8.6 percent; a lower share of fees and commission income to net interest/finance income 7.7 percent; increased provisions for credit losses 16.5 percent; and increased staff and administration costs relative to income 13.7 percent.

We believe that the provisioning cycle is largely complete and that net interest/finance margins are likely to increase as monetary policy starts to tighten globally, perhaps recovering half of the 50 basis point decline between 2006 and 2014. Without improvements to the other factors considered, we estimate that, as a result, ROA would increase to 1.7 percent.
ENDNOTES

1 Total assets have increased across all categories in roughly equal measure. Loans/receivables, the largest balance sheet category grew by 118 percent from KD 16.7 billion in 2006 to KD 36.4 billion in 2014.
2 In the regression for the yield on interest/finance earning assets: $R^2=0.9912$, $F(1,8)=790.9,p<0.0001$. In the regression for the cost of funding interest/finance earning assets: $R^2=0.9903$, $F(1,8)=714.1,p<0.0001$.
9 Sources: NBK financial statements 2009 through 2012; Boubyan Bank’s financial statements for 2009
11 $R^2 = 0.45$, $F(1,8)=5.74$, $p<0.05$; Sources: Kuwaiti banks' annual reports and the Kuwait Stock Exchange
13 $R^2 = 0.92$, $F(1,7)=76.65$, $p<0.001$
14 Ibid, pp. 15-16
15 Data from the Federal Deposit Insurance Corporation, Bank Data and Statistics, https://www2.fdic.gov/SDI/SOB/
17 Ibid., pp. 17-18
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