Real Estate Risk for Kuwaiti Banks

Consultancy and Research Department

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EXECUTIVE SUMMARY

Both the residential and investment real estate markets in Kuwait have been very active in the past few years, with prices doubling since mid-2010.

While there are strong fundamental reasons for high and rising prices, such as population growth, household formation and a backlog of supply of new residential dwellings, recent price movements may have been accentuated by speculative activity. Affordability levels are currently low by historic standards, and rental yields are below the lows experienced at the peak of the previous cycle, prior to the global financial crisis. According to IBS calculations, the average rental yield on investment real estate across the entire country stood at 3.0 percent in the first quarter of 2015.

While our analysis suggests a cautious approach from stakeholders, it is too early to tell whether the current cycle is peaking; and if so, whether the real estate market will experience a hard or soft landing. At present the outlook is unclear; prices appear to have stabilized but are not necessarily falling.

Perhaps the most pressing concern for the banks is that from the end of 2010 to the end of the first quarter 2015, 68 percent of system-wide loan growth, excluding loans to nonbank financial institutions, was driven by the real estate sector (‘installment credit’ to households and ‘real estate credit’ for investment purposes). A slowing real estate market will therefore have negative consequences for the banking sector’s growth outlook.

On a positive note, Kuwaiti banks are in a strong condition to weather market disruption as they are very well provisioned and have high Basel III capital ratios. The Central Bank of Kuwait has played an important role in ensuring that prudential standards are high.

Long-standing regulations regarding installment credit to households (27 percent of the aggregate loan book) imply that the risk of default on these loans is very low and is, at any rate, unconnected with residential real estate prices. Higher levels of risk pertain to loans for investment real estate (26 percent of the aggregate loan book); especially given that loan growth in this area appears to have been driven since 2010 by relatively small, non-Stock Exchange-listed businesses.

Going forward, it is important that regulators remain vigilant and are willing to adjust standards, such as loan-to-value ceilings and capital charges, to fit market conditions.
INTRODUCTION

In this study, we use publicly available information, primarily from the Central Bank of Kuwait, Kuwait Finance House (KFH) and Kuwait International Bank (KIB), to assess whether the residential and investment real estate markets in Kuwait present a risk to the local banks, and by extension to the broader economy.

In Section 1, we examine price movements in real estate from the first quarter of 2007 until the first quarter of 2015.

In Section 2, we discuss some of the factors that could explain why prices have doubled since mid-2010 and whether the market has become ‘overheated’. In assessing market conditions we use standard measures, such as affordability and rental yields. We also look at market ‘fundamentals’ such as population growth, household formation and the supply of new dwellings, to assess the likelihood that speculative motives have played a role in the recent price run-up.

In Section 3, we examine the risk that the real estate market poses to the banking sector. We review the role that real estate has played in loan book growth in the past 10 years and the exposure that banks currently have to real estate. We also discuss prudential standards at the banks as well as the Central Bank of Kuwait’s oversight. We finish the study by addressing the issue of how to construct a real estate index in Kuwait.

This study focuses on residential and investment real estate; that is on dwellings. We do not discuss commercial real estate in this report. While this sub-sector is of course important to the Kuwaiti economy, the ‘fundamental’ factors that affect demand and supply for commercial space are different in type from those that affect dwellings, such as population growth, household formation and the supply of residential units. It should also be noted that commercial real estate transactions made up only 12 percent of total transactions, by value, in 2014.

Finally, it should be stressed that this study is not intended to guide investor opinion; but rather to aid banks in the management of risk. IBS does not invest in real estate, nor does it offer advice to those that do.
SECTION 1: Residential and Investment Real Estate Prices Since 2007

Section 1.1 Residential real estate

Charts 1 shows the direction of residential real estate prices per square meter from the first quarter of 2007 until the first quarter of 2015. Specifically, we have created indices using data published by KFH and KIB.

While the construction of both indices falls short, methodologically speaking, of best practice (see Section 3), the data clearly indicates that prices have risen rapidly in the past few years. Indeed, there is a great deal of similarly between KIB’s and KFH’s data even though the methods which each bank has used to generate their respective data sets differ significantly. It should also be said that the pattern of price changes, including a slowdown in year-over-year price increases in recent quarters, matches recent reporting and anecdotal evidence.

Chart 1: Residential real estate prices per square meter double in less than five years

Sources: KFH Quarterly Local Real Estate Reports, KIB Quarterly Real Estate Market Summary Reports, IBS estimates and calculations
Chart 1 shows that residential prices per square meter were rising strongly leading into the global financial crisis, and then fell back sharply such that by mid-2010 they had retraced to early 2007 levels. Since then, prices have almost doubled; appearing to have stabilized since 2014, with some tentative signs that they may now be drifting marginally lower. But there is no clarity on this; KIB data for the second quarter 2015 (included in Chart 1), shows price increases quarter-on-quarter.

Chart 2 shows both the change in price per square meter in each quarter versus the same quarter in the previous year (using the average of KIB’s and KFH’s respective time series), as well as the annual number of transactions in the residential market. The chart confirms the rapid increase in prices (in 2012 and 2013, prices were rising at around 20 percent per year) as well as pointing to a recent slowdown in the market. The chart also shows the annual volume of transactions. It is fairly evident that the number of deals has moved in tandem with changes in pricing. That said, the spike in transactions in 2012 most likely reflects a law passed in 2008 that gave holders of un-developed land five years to dispose of the land or be subject to a financial penalty (in 2012). Finally, it should be noted that the total number of transactions in the first six months of 2015 was down 13.5 percent year over year, according to KIB data.

**Chart 2: A once ‘hot’ residential property market may be cooling off**

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Sources: KFH Quarterly Local Real Estate Reports, KIB Quarterly Real Estate Market Summary Reports, IBS estimates and calculations
Section 1.2: Investment real estate

Chart 3 tells a similar story for investment real estate. Prices per square meter are up by around 150 percent since the first quarter of 2007 with the increase focused on the period after 2010. And again, as with residential real estate, while the data is not entirely clear, there is some indication that the market is slowing.

One noticeable difference between Chart 3 and Chart 1 is the volatility in prices, particularly with regards to KIB’s data. This reflects the lower volume of investment real estate transactions versus residential real estate, and that each transaction is, by definition, more unique in nature. The index constructed using KFH’s data is much less volatile than the index constructed using KIB’s data, presumably because the former’s methodology deliberately aims to smooth out such quarterly volatility in prices.

**Chart 3: Investment real estate prices per square meter tell the same story as residential market**

Recent increases in prices per square meter also tallies with an increase in the number of transactions in the investment real estate market. As Chart 4 below shows, activity picked up in 2010, reaching a peak in 2013. Still, in 2014, the number of transactions remained below 2008, most likely reflecting the relative inactivity of investment and real estate companies (see Section 3 for further discussion) during this period.
As with residential real estate, the number of transactions appears to be falling in 2015. In the first six months of 2015, there were 809 transactions in total, down 23.2 percent year over year, according to KIB data. (Please note in Chart 4, the annual change in prices is calculated taking the average of the KIB’s and KFH’s time series).

Chart 4: Investment real estate may also cooling off

SECTION 2: Explaining Price Increases

2.1 Is the market ‘overheated’?

Establishing with certainty whether any particular asset market is overheated is notoriously difficult as good reasons can always be found to justify market conditions. Inevitably, it is only after prices fall that observers and participants can say for sure that prices had extended beyond fair value. The Kuwaiti real estate market may or may not be overheated: but at present, it is not even clear if prices are stabilizing or beginning to increase again after a short hiatus.

The two most common ways of assessing real estate market conditions are to examine affordability and rental yields. Affordability measures how much disposable income is being used up in paying for housing; the rental yield measures the rental return on investment, i.e. annual rental income divided by current investment cost.
Survey data published by the Central Statistical Bureau\textsuperscript{2} for 2000, 2007 and 2013 shows that affordability has declined. Using non-Kuwaitis as an example, we calculated the average portion of total household spending absorbed by housing costs, including utility bills, such as electricity and water. We focused on expenditure as data on household income was not available. Chart 5 below (left-hand panel) shows that, on average, affordability levels for non-Kuwaiti renters have deteriorated since 2007, as housing costs have made up an increasing proportion of total household expenses.

**Chart 5: Rental housing less affordable and investment yields low by historic standards**

Examining recent rental yields since the second quarter 2008 tells a similar story. The right-hand panel in Chart 5 shows that the rental yield (the average of price per square meter per area divided by price per square meter of investment real estate per area) has fallen markedly since peaking in 2009; and at 3 percent is now below the level set on the eve of the financial crisis.

Our analysis of affordability and of rental yields neither proves nor disproves that Kuwait real estate prices are overheated. We can simply say that from a historical perspective prices are high.
2.2 ‘Fundamentals’ of Kuwait’s residential and investment real estate market

While the analysis presented in the previous section suggests that real estate has become expensive, relative to the past, it may be that the factors that have caused price increases in recent years will continue to support high expectations for the future. Specifically, in this section, we explore the hypothesis that prices reflect a fundamental mismatch between demand and supply of dwellings.

In this regard, much has been said about population growth dynamics and an increasing backlog of government provided housing for Kuwaiti nationals, both of which, in theory, provide strong fundamental reasons for increasing prices. We consider each of these fundamental factors in turn:

- Demand: population growth and distribution according to age

Kuwait has a young and rapidly growing population, factors that should support demand for new housing units. In the 10 years leading up to the end of 2013, according to data published by the Public Authority for Civil Information, the compound annual growth rate of Kuwaiti nationals was 3.3 percent. During this period the rate of change has slowed, for instance in the period from 2004 to 2008, the number of Kuwaiti nationals increased by over 3 percent each year (in 2005 by 3.9 percent); whereas in 2013 the annual increase was 2.4 percent. However, even at 2.4 percent, the growth rate is far above the global average, recorded at 1.3 percent in 2013.

Such high levels of growth will always go hand-in-hand with a relatively young population. Indeed, according to government data, at the end of June 2014, 47.3 percent of Kuwaiti nationals were under 20, and only 22.2 percent were over 40. Undoubtedly, such a young and growing population is supportive of increasing demand for housing, with higher rates of household formation an obvious corollary.

The growth of the non-Kuwaiti population is also supportive of demand for housing, provided by the owners of private investment real estate. In fact, the population of non-Kuwaiti residents has been growing at a faster rate than Kuwaitis: the compound annual growth rate in the 10 years leading up to the end of 2013 was 5.3 percent. Many of these ex-pats live with Kuwaiti families as members of staff or are placed in corporate housing and thus not all the living arrangements of non-Kuwaitis affect real estate demand. In addition, the data exhibits a great deal of volatility; in some years the increase is around 10 percent, in other years as low as 1 percent. It is unclear what drives such volatility, as we found no correlation between the annual growth rate and the state of the economy or oil prices. Nonetheless, the increase in the non-Kuwaiti population broadly supports the view that population dynamics underpin strong future demand for residential dwellings in Kuwait.
Supply: the backlog of government housing provided for Kuwaiti nationals

Ever since the government committed itself to providing land and housing for each Kuwaiti national at an affordable price, with credit offered, where needed, by the Kuwait Credit Bank, the supply of new units has fallen significantly behind demand. Chart 6 below demonstrates the ever-increasing backlog; there can be little doubt that there is a severe shortage of new dwellings in Kuwait. Intuitively, such an imbalance between supply and demand should cause increasing residential and investment real estate prices (e.g. landlords competing to purchase real estate in order to supply rental apartments to Kuwaitis on the government housing waiting list).

Chart 6: Backlog of housing for Kuwaiti nationals continues to grow

Source: Public Authority for Housing Welfare

All the same, there are ameliorating factors. For instance, a backlog in the public provision of housing for Kuwaitis may have less impact on prices than expected because many newly married couples continue to live in their parent’s villas for several years before receiving government housing, rather than buy in the private market or move into privately rented accommodation.

Some young families may choose not to buy a house because, under the rules, ownership of a property disqualifies a household from receiving a government plot; thus a family that bought a house would miss out on being allocated property at a steep discount to market prices.
However, far more importantly, many young Kuwaiti families stay with their parents because they cannot afford to buy a villa of their own. Indeed, while one can imagine that many Kuwaitis are not happy waiting up to 20 years for a house; with maximum finance available from the Kuwait Credit Bank of KD 70,000 per household, there is simply no alternative, as residential values are far too high for ‘ordinary’ Kuwaitis to afford. (According to KIB data, the average price per square meter in the whole of Kuwait was KD 685 during the second quarter 2015; based on this price, a 400 square meter plot would be valued at KD 274,000. The price per square meter in a popular residential governorate, such as Hawali, is significantly higher, around KD 1,000 per square meter).

The problems and issues raised by the current right to housing granted to all Kuwaiti nationals has been explored in detail in a paper published by the London School of Economics; thus those arguments are not further rehearsed in this study. For the purposes of this report, it is sufficient to note that there does appear to be an extreme shortage of housing in Kuwait, and this is reflected in the relative high price of property.

All the same, as discussed, there are reasons why some of this demand may not translate into ‘effective’ demand in the market. After all, while the fundamental dynamics of demand and supply (population growth and the PAHW backlog) have not changed significantly in recent years, prices since the beginning of 2007 have gone through a period of relative stability followed by rapid increases. Fundamentals therefore do not necessarily rule out the role of more speculative motives in recent price movements.

2.3 The role of speculation

Before proceeding, it is important to be clear about what we mean by speculation. The traditional meaning is all too obvious: investors driven by ‘irrational exuberance’ to make profits who are less concerned by fundamentals than they should be. But here, we are also including in the speculative motive certain actions that are precipitated by market conditions. For instance, it may be that the timing of a purchase of residential or investment real estate is brought forward by several years because the purchaser, having surveyed market conditions, expects prices to continue increasing at current rates, and is therefore spurred into action for fear of missing out on gains, or being priced out of the market.

One indication of speculation is increasing transaction volumes; and this has certainly been witnessed in the residential real estate market (see Chart 2). All the same, it should be noted that the actual number of transactions, around 6,299 in 2014 is small, objectively speaking.

The picture for investment real estate volumes is slightly less clear (see Chart 4). No doubt, there has been an increase in the number of transactions since the low of 2008, but total volumes remain significantly below 2007 levels. The most likely explanation for this is the lack of
activity from Stock Exchange listed real estate and investment companies. Prior to the financial crisis, these institutions were very active players in the market, yet financial problems witnessed from 2008 on appear to have made them relatively dormant. As will be further discussed in Section 3, it appears that increasing activity in investment real estate has been undertaken by ‘non-corporate’ entities, such as individuals and small family businesses.

Evidence for this last point can been seen in Chart 7 which shows that the number of fund units issued by Kuwait’s largest real estate investment fund, managed by Al Markaz, has increased by 267 percent from the end of 2010 to June 2015. Clearly, investment real estate has attracted a lot of interest from small-scale investors.

**Chart 7: Al Markaz Real Estate Fund: Fast Grower**

![Bar chart showing the number of fund units outstanding at year end (millions).](Source: Kuwait Stock Exchange)

What may have caused increased levels of speculation? Chart 8 below shows the performance of the Kuwaiti Stock Exchange, Kuwaiti residential real estate and the S&P 500 index of U.S. industrials (used as a proxy for global stock markets). What’s fairly evident is that in the low global interest rate environment, which has incentivized investors to search for higher-yielding assets most likely carrying a higher risk, Kuwait stands out from other countries. With few alternative investments (the stock market has remained unpopular with investors, and other domestic capital markets remain under-developed), money has flowed into real estate.

Chart 8 also throws up another interesting observation, depending on whether the time series begins in the first quarter of 2007 or in the second quarter of 2010. In the shorter time span (right-hand panel), we can see that Kuwaiti residential real estate prices have performed almost
entirely in line with the U.S. stock market (ignoring exchange rates movements which were relatively minor). However, on a longer-term basis going back to 2007 (left-hand panel), Kuwaiti residential real estate has significantly outperformed equities; largely because while real estate prices held up in Kuwait in the wake of the financial crisis, equity indices around the world fell dramatically.

Chart 8: Kuwait real estate best performer since 2007

Resilient prices in the wake of the financial crisis could well be viewed as proof that fundamental demand and supply factors have supported prices throughout the cycle; such a conclusion would help allay fears that the current market is significantly overheated. Additionally, it may be that with limited investment options inside Kuwait, investors view real estate as the only viable place to invest; thus money flowed into this asset class from other, seemingly more risky, investments, keeping prices up. The relative lack of alternative investment options in Kuwait may also allay fears that liquidity in the market will dry up. All the same, poor portfolio diversification raises the risk of a ‘herd’ mentality if the market turns down; making any downturn possibly more dramatic in nature.

Of course, none of the data proves that real estate prices in Kuwait have boomed to unsustainable levels and/or that the market will ‘correct’ in an unruly fashion. But the performance of real estate, when placed in a domestic and international context should, at the
very least, be a cause for increased vigilance going forward on the part of participants and their counterparties, as well as regulators.

To conclude, there are clear fundamental reasons why prices are high; but increasing prices also tends to draw in speculative participants. In turn, the more markets are driven by speculative motives, the greater the role that sentiment plays; and the more likely it is that real estate market conditions in Kuwait could be affected by increased volatility in global asset markets.

**SECTION 3: Managing Risk**

Manias and panics in various assets markets are a central feature of financial and economic history. The key lesson of past experiences, too rarely learned or too quickly forgotten, is that speculative excesses are exponentially more dangerous, from a standpoint of systemic risk, when they are financed by credit, as opposed to savings. Put simply, if banks are funding speculation, then the outcome from any ensuing downturn is far more likely to derail the economy than if losses are born from savings. This is because of the highly leveraged nature of a bank, which means that capital can be wiped out with a relatively small credit losses; say around 10 percent of the total loan book.

**3.1 Tracking Kuwaiti Banks’ Exposure to Real Estate**

Chart 9 below illustrates that over the past 15 years, the banks have increased their exposure to real estate. The left-hand panel, in particular, shows that exposure rose steadily, from around 30 percent of the total loan book in 2000, to over 50 percent at the end of the first quarter 2015. Currently that exposure is fairly evenly divided between consumer installment loans and real estate loans. The former refers to loans to individuals primarily for renovating or purchasing a private residence; the latter is a loan to a company or individual for the purposes of an investment real estate business. The loan could be for land, construction or the purchase of a fully functional property.

Currently, exposure in the loan book is split evenly between consumer installment loans and real estate loans. This has not always been the case. For instance, the left-hand panel shows that at the end of 2010, real estate loans formed a larger part of the loan book than consumer installment loans.

The varying proportions in the loan book between the two different kinds of real estate lending are explained by the varying growth rates in each respective segment over time. The right-hand panel shows, for instance, that between 2010 and the end of March 2015, the growth in consumer installment lending accounted for around 60 percent of total loan growth, whereas real estate lending accounted for only 25 percent of total loan growth. This contrasts strongly
with the period 2005 through 2010, during which real estate lending accounted for a higher proportion of total loan growth than consumer installment lending.

**Chart 9: Tracking the banks’ increasing exposure to real estate**

Most importantly of all, the right-hand panel above shows that between the end of 2010 and the end of the first quarter 2015, 69 percent of total loan growth, excluding loans to nonbank financial institutions, was accounted for by real estate, in one form or another. In short, the banks have become heavily dependent on real estate to grow their core business. While consumer installment lending has grown at a compound annual growth rate of 13.9 percent, and real estate lending at a compound rate of 5.1 percent, the remainder of the loan book has grown at 1.4 percent per year.

Regardless of the systemic risks that falling real estate prices, were that to happen, could pose to the banking system (see Section 3.2), a weaker real estate market, with lower volumes, is bound to lead to lower loan growth rates for the banks as a whole.

All the same, an important question remains: why has consumer installment loan growth been that much stronger than real estate loan growth, even while prices in both segments have been increasing at a similar rate? The answer to this question can be found by examining Chart 10 below.
The left-hand panel of Chart 10 shows how inactive Kuwait stock exchange listed nonbank financial institutions, including real estate companies, have been since the financial crisis. Up until 2009, investments in real estate were growing rapidly, seemingly funded by bank borrowings. Since then and up until the end of 2014, there has been little change in either the aggregate amount of borrowings or the aggregate carrying value of real estate investments.

The behavior of these listed companies contrasts strongly with non-listed private ‘other’ investors, as shown in the right-hand panel. Here we see a fairly rapid expansion of borrowing related to real estate, with total outstanding borrowing up by 128 percent between the end of 2010 and end of 2014. In other words, the compound annual growth rate in real estate lending of 5.1 percent in this period, relatively low compared to double-digit consumer installment loan growth, hides some important details. Listed nonbank financial institutions have grown their lending by 0.4 percent per year compounded; therefore non listed entities must have grown their borrowings for real estate investment by 22.8 percent per year compounded.

Loan growth of this magnitude is high and may be of concern given that many borrowers are likely to be small, family businesses. Such activity may provide more evidence that speculation has played an important role in recent price increases.

Chart 10: Recent borrowing to fund investment real estate activity outside of listed companies
3.2 Regulatory oversight

Given the banks’ high exposure to real estate in recent years, it is vitally important that regulators keep a close eye on prudential standards in the banking sector. The good news is that since the 2008 global financial crisis, central banks across the world have become acutely aware of the systemic risk that real estate poses. Indeed, Basel III capital and leverage standards were written precisely in order to enable banks to absorb higher levels of credit and market losses, without risking insolvency.

The Central Bank of Kuwait has been proactive in ensuring that domestic banks meet the very highest prudential standards, both with regards capital and provisioning. According to IBS calculations, provisions for credit losses in the Kuwaiti banking sector stood at 175 percent of non-performing loans at the end of 2014; far higher than U.S. commercial banks which recorded an equivalent figure of 75 percent.\(^8\)

With regards capital, according to the Central Bank of Kuwait, the banks’ consolidated Basel III capital adequacy ratio stood at 16.9 percent at the end of 2014\(^9\), far above the minimum Kuwaiti requirement of 12.5 percent, and over twice the minimum of 8 percent prescribed by the Basel Committee for Banking Supervision.\(^10\)

In short, Kuwaiti banks’ balance sheets are well positioned to withstand significant disruptions, were they to occur, in the real estate market.

- Residential/Installment credit risk

There are a number of reasons to believe that regardless of residential real estate price increases the risk of installment credit default for the banks is low. First and foremost, given that the maximum value of an installment loan is KD 70,000, it is unlikely that these loans have been used as a major source of finance to buy residential units. As discussed above, the average price of a villa is approaching KD 300,000. With only 6,300 residential units being exchanged in 2014, it seems more likely that the vast majority of buyers were cash buyers not needing external finance.

From a regulatory and oversight perspective, this is good news: potential losses, most likely unrealized, borne by savers are far less damaging to the financial system and the economy, than losses borne by borrowers.

Instead, strong growth in installment credit probably reflects an uptick in home renovation. Increasing household formation and rising residential prices may have caused more borrowing, as families have chosen to accommodate growing numbers by expanding the size of their villa,
rather than by buying a new home. Outstanding installment credit may also have grown as a result of rising salaries, especially in the government sector.

It is also of course possible that rising residential real estate values have encouraged owners to renovate their houses, perhaps given the assumption that any investment will enhance the value of the villa and will be recouped (possibly with a profit) if the villa is sold at a later point in time.

Regardless of the motivation to borrow, the risk of default is not connected to the value of the property precisely because an installment loan is not a mortgage and repossession/foreclosure is not permissible in Kuwait. Instead, the loan is considered a consumer loan and is included in strict regulations that limit total consumer credit monthly payments to no more than 40 percent of monthly salary (after all deductions). This regulation is effective in limiting household leverage and protecting banks from downside risk.

Even so, the Central Bank of Kuwait has shown its awareness of recent market dynamics; in November 2013 it “proactively issued a new set of measures to protect the individuals as well as the banking system from potential over-exposure to the housing market.” These measures included setting new stringent loan-to-value (LTV) ceilings on small ‘investment’ developments in residential areas, e.g. 50 percent on the purchase of undeveloped land, 60 percent for existing real estate, and 70 percent for construction only.

In introducing these new regulations, the Central Bank of Kuwait has shown that it is very much acting in the vanguard of central banking thought and practice. For instance, one of the main conclusions that came out of the global financial crisis was that a heavy reliance on monetary policy (interest rates) is an insufficient safeguard against over-exuberance in the financial sector. Instead, in addition to increased capital standards (Basel III), regulators now appreciate the need to be more proactive in monitoring and controlling risk. So-called ‘macro-prudential’ measures include direct action on the asset side of banks’ balance sheets, such as setting and changing loan-to-value ceilings. Introducing such measures marks a much needed change in central banking orthodoxy of the last 30 to 40 years.

The Central Bank of Kuwait’s decision to introduce new LTV measures in November 2013 was likely taken to ensure that lending standards were being maintained at a time of high activity in the residential real estate market. Indeed, it may be that these measures were influential in taking the steam out of the market, with the aim of guiding the market to a ‘soft landing’. After all, it should be noted from Chart 1, that residential real estate price growth started to slow in early 2014, before any possible negative affect on sentiment from oil price declines.

The Central Bank of Kuwait has shown strong leadership in their approach to macro-prudential regulation. All the same, it should be noted that these regulations only impacted small three-
story developments in governorate-designated residential areas such as Salwa or Mishref, rather than the densely populated areas with high-rise developments such as in Salmiya and Hawalli.

- Investment real estate credit risk

The risk associated with investment real estate lending is higher than installment lending. Prices have risen rapidly in recent years and it is likely, as discussed above, that many of the participants buoying the market were small businesses that were borrowing to invest.

Evidence that credit has been a factor in pushing up prices comes from Central Bank of Kuwait data on collateral, which shows that a fairly rapid increase in the use of real estate as collateral in the recent market run-up. In 2010, for instance, real estate collateral totaled roughly KD 10 billion, just under 30 percent of all collateral in the system. In 2014, real estate collateral totaled around KD 18 billion, just over 50 percent of total collateral.\(^\text{13}\)

One concerning conclusion would be that the 22.8 percent compound annual growth in real estate lending (excluding listed investment and real estate companies) during this period denotes a significant number of purchases with low loan-to-value ratios made possible with pre-existing buildings put up as collateral.

As with the residential real estate market, regulatory changes enacted by the Central Bank of Kuwait may have slowed the market. Specifically, between 2014 and 2018, the amount of real estate collateral that banks can use to mitigate Basel capital charges is being reduced by 10 percentage points each year, from 50 percent in 2013 to zero percent in 2018. Increasing the capital charge for lending using real estate as collateral should raise each banks’ lending interest ‘hurdle rate’ and could therefore reduce lending at the margin.

The outcome of these rule changes is uncertain, but it provides another example of how the Central Bank of Kuwait can regulate in a dynamic fashion to address market over hearting. All the same, one key takeaway from recent history is that regulators need to be vigilant and active. If market conditions change, then regulations, such as the loan-to-value ceiling or capital charges, should be tightened or loosened. In a new post-financial crisis world of regulation we should expect rules and regulations to move counter-cyclically with market conditions.

3.3 Developing a real estate market index

Managing and regulating risk effectively requires accurate and timely data. In regards to real estate, a never-ending source of risk to any banking system, an index of prices is a pre-requisite. As of writing, we are not aware of the existence of a formal index of residential or investment real estate prices in Kuwait.
In the process of writing this study, we have constructed indices using data from Kuwait Finance House and Kuwait International Bank to track residential and investment real estate prices.

The index constructed using KIB’s data represents the average of separate indices created for each governorate; data is taken directly from the Ministry of Justice. The index constructed using KFH’s data also represents the average of indices for each governorate, but each governorate’s index has been created by taking the average of indices constructed for each sub-area in the respective governorate, where available. Unlike KIB data, KFH’s data is based on its own appraisals and some subjective judgement on which properties are ‘representative’ of each area’s real estate market.

We believe that the results provide a very useful guide to the recent history of real estate prices in Kuwait. However, from a purely methodological standpoint, these indices are significantly weaker than best practice, as represented in the U.S. by the S&P/Case-Shiller Home Price Index for 20 metropolitan areas.

The S&P/Case-Shiller index is based on the aggregated value of residential real estate in 20 metropolitan areas. Using census data, collected every 10 years, a count is made of the number of single-family homes in each of the 20 areas. Average values per home are derived from sales data from official state government registers of sales and purchases.

Key to S&P/Case-Shiller methodology is the use of *sales pairs*.14 The calculation of the average sales price is based on tracking the sales values of the same individual homes; for example a single home that has changed ownership in 1990, 1996, 2005 and 2012. Each time the same home is exchanged, the data can be incorporated into the database of home prices. Unless the index is based on the data of individual homes selling and re-selling, it is always likely to be distorted because like-for-like comparisons cannot be guaranteed; after all, every dwelling is different in some way.

Ministry of Justice-published data in Kuwait on each transaction would potentially be ideal to construct such an index. However, the quality of data is relatively poor; often no address is provided on the record, save for naming the area in which the dwelling is based. At the very least, the Ministry would have to include with each transaction record the property’s serial number. As things stand, few details of the property are provided – such as its age and condition; thus using this data to compare the price of two very similar dwellings is challenging.

More problematic, however, is the low number of transactions. The S&P/Case-Shiller index is appropriate in the U.S. because homes are regularly bought and sold; one dwelling may change hands several times in the space of 20 years; and of course there are countless millions of homes. The low number of transactions in Kuwait combined with the long length of time that families remain in their villa makes Kuwait an inappropriate setting for such an index.
It is unlikely now or in the foreseeable future that the highest standard of index will become available to track real estate prices in Kuwait. However, as discussed and evidenced in this study, sufficient data is available to create indices that track real estate prices, and such indices, we believe, provide invaluable information.

**CONCLUSION**

In this study, we sought to examine recent trends in the real estate market in Kuwait and to assess the risks that these trends may present. Using publicly available data we constructed indices for residential and investment real estate, all of which showed that prices have roughly doubled since 2010. Standard techniques for assessing the condition of the market, such as affordability and rental yields, show that prices are high by historic standards. Price movements since 2010 may have been exacerbated by speculative activity.

While we believe prudent management and regulation has limited the downside risks from a systemic perspective, banks and regulators must be vigilant. It should be stressed that if the real estate market slows banks will experience a slowdown in overall loan growth.

The Central Bank of Kuwait has already acted to tighten lending standards for certain residential real estate transactions and has set very high capital standards, far above minimum Basel III requirements. Even so, best practice regulation requires constant monitoring and a willingness to adjust regulations, such as loan-to-value ceilings and capital charges that act on the advance of credit.
ENDNOTES

3 For instance, see Kuwait Times, April 5th, 2014, Kuwait Property Sales Surge in Early 2014, http://news.kuwaittimes.net/pdf/2014/apr/05/p04.pdf
12 Ibid.
ABOUT THE IBS CONSULTING AND RESEARCH TEAM

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Dr. Payne joined IBS in September 2014. Previously, he was senior economist at Bloomberg Government, based in Washington D.C., where he authored numerous studies on Dodd-Frank, Basel III, and U.S. monetary and fiscal policy. Prior to that, based in London, he was Vice President of Asian equities for JPMorgan and fund manager of Emerging Market equities at F&C Asset Management. He began his career at PriceWaterhouse Coopers, where he qualified as a chartered accountant. He holds a bachelor’s degree from Cambridge University, England, and masters and doctorate degrees from the London School of Economics. His book, “The Consumer, Credit and Neoliberalism: Governing the Modern Economy” relates economic theory to monetary and banking policy in the U.K. and U.S. leading up the financial crisis of 2008.

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