Institute of Banking Studies Research »

Quantifying the Impact of Basel III Capital Standards on Kuwaiti Banks

Consultancy and Research Department

May 2016

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EXECUTIVE SUMMARY

Basel III capital standards came into force in Kuwait at the end of 2014 with full implementation in 2016. As a result, the common equity Tier 1 (CET1) capital ratio was reduced by 2.7 percentage points for the consolidated banking sector, from 16.6 percent to 13.9 percent, according to IBS calculations. The key findings of this study are:

- 1.7 percentage points, around 60 percent, of the 2.7 percentage point reduction in the CET1 ratio was caused by changes to the definition of Tier 1 capital. In roughly equal proportions, the two main changes were stricter deductions for minority interests and full deductions for intangible assets.

- The remaining 1.0 percentage point reduction in the CET1 ratio (around 40 percent of the 2.7 percentage point total) was caused by changes in risk-weighting rules; specifically, an increase in the multiplier that converts operational and market risk capital charges into equivalent risk-weighted assets; and increases in the risk-weighting for certain investments and inventories and commodities.

- At the end of 2014, all the banks were in compliance with CET1 and Tier 1 minimum threshold capital ratios. According to IBS calculations and estimates, we expect all Kuwaiti banks to surpass the minimum capital thresholds in 2016, the first year of full Basel III implementation, including the surcharge for domestic systemically important banks.

- It is unclear whether the banks will increase their Tier 1 capital ratios under Basel III back to levels previously recorded under Basel II. Were they to do this (by choice, rather than compulsion), return on equity would fall by 1.0 percentage points for the sector as a whole, all other things being equal.

Please note that the findings and views expressed in this study reflect those of the authors and the Institute of Banking Studies. They do not represent the views of the Central Bank of Kuwait.

INTRODUCTION

During 2014, the Central Bank of Kuwait issued new rules for calculating regulatory capital ratios.[1] The new rules, known as Basel III, replaced Basel II, which had been applied since 2005. The Central Bank of Kuwait's version of Basel III represents the implementation in Kuwait of new standards and principles finalized by the Basel Committee in June 2011.[2] All Kuwaiti banks were required to conform to Basel III definitions by the end of 2014.

Capital adequacy standards have represented a core element of global banking supervision since the 1988 Bank for International Settlement Accord. Later iterations of the 1988 Accord (The 1996 Amendment, Basel II and Basel III) are all based on the same principle: banks should back their assets and exposures with prescribed amounts of loss-absorbent capital. In Kuwait, for instance, Basel II required that each banking group maintain a ratio of total capital to risk-weighted assets of at least 12 percent and that at least half of the capital, i.e. 6 percentage points, take the form of 'Tier 1 capital', the rest being made up of Tier 2 capital.

Basel rules include detailed instructions on what kinds of equity and reserves (shareholders' funds) constitute Tier 1 capital and what kinds of subordinated debt and general provisions can be included as Tier 2 capital. The rules also stipulate certain deductions that have to be made to Tier 1 and Tier 2 capital.

Basel rules also provide a 'standardized approach' to risk-weighting that is utilized by the Kuwaiti banks. For instance a loan to a qualifying small and medium-sized enterprise is risk-weighted at 75 percent under Basel III. So if a bank makes a loan to an SME of KD 100, KD 4.5 of the funding for the loan has to be in the form of Tier 1 capital ($100 \times 0.75 \times 6\% = 4.5$), the rest coming from various forms of liability funding (deposits, bonds etc.).

The replacement of Basel II by Basel III reflected the shared view that many banks around the world were not funding their assets and exposures with sufficient high quality loss-absorbent capital (share capital and retained earnings), and that insufficient capital backing had exacerbated the global financial crisis.

Basel III differs from Basel II in the following key ways:

- Far more attention is paid to high-quality common equity capital. While the minimum capital ratio that the banks will have to report will be 13 percent (versus 12 percent under Basel II), 9.5 percentage points will have to be made up by 'common equity Tier 1 capital' (CET1) and 11.0 percentage points by Tier 1 capital. (Note: CET1 capital forms part of Tier 1 capital). Under Basel II, Tier 1 capital only had to account for half of the total capital, i.e. 6 percent of risk-weighted assets. While there are transitional arrangements with regards the application of Basel III: for instance, the minimum Tier 1

ratio in 2014 was 10.0 percent; in 2015 it is 10.5% (see Table 1 below); by 2016, not including the capital charge for domestic systemically important banks (D-SIBs) or the countercyclical capital buffer, the banks will have to meet the following minimum thresholds:

$$\frac{Tier\ 1\ Capital}{Risk - weighted\ assets} \geq 11\% \qquad \frac{Total\ Capital = Tier\ 1 + Tier\ 2}{Risk - weighted\ assets} \geq 13\%$$

- Items that were previously included in Tier 1 capital under Basel II now have to be deducted, such as the value of intangible assets.
- Risk-weighting for a limited number of assets and exposures has been increased in Basel III relative to Basel II in the standardized approach followed by Kuwaiti banks.
- Under Basel III more capital is required to back market and operational risks.

Table 1: Transitional arrangements for applying Basel III guidelines

	2014	2015	2016
Minimum CET1 ratio (including conservation buffer)	8.5%	9.0%	9.5%
Minimum Tier 1 capital ratio (see discussion below on the difference between CET1 and Tier 1)	10.0%	10.5%	11.0%
Minimum total capital ratio (Tier 1 plus Tier 2 capital)	12.0%	12.5%	13.0%
Capital surcharge for domestic systemically important banks (composed of CET1 capital)	0%	0%	0% - 2%
Countercyclical capital buffer (composed of CET1 capital)	0%	0%	0% - 2.5%

Source: Central Bank of Kuwait

With reference to Table 1, it is important to note the following:

- The banks are allowed to comply with the total capital ratio threshold entirely with common equity Tier 1 capital; there is no requirement for them to have 'additional Tier 1 capital' or Tier 2 capital in their capital structure.
- Some banks are likely to have to meet a threshold for the CET1 ratio of more than 11 percent, due to the imposition by the Central Bank of Kuwait of a D-SIB capital surcharge. However, as of writing, the Central Bank of Kuwait is yet to finalize the method and surcharge for the banks. In Section 3 of this report, we present IBS's estimate of the D-SIB surcharge for each bank. It should be noted that this estimate is based on our own methodology and does not reflect the methodology currently being developed by the Central Bank of Kuwait.
- Rules are yet to be published for the countercyclical capital buffer. In our opinion, the current economic outlook suggests that, most likely, the countercyclical capital buffer will be set at zero in 2017.

The primary purpose of this study is to show how the changes to the definition of capital and to the standardized risk-weightings contained in Basel III affected the capital ratios reported by each back (and in aggregate) at the end of 2014. To do this, we have estimated what the Basel II Tier 1 capital ratio would have been at the end of 2014 and compared this with the reported Basel III ratio.

It should be noted that our findings are estimates. It should not be assumed that we have perfectly quantified the effects of Basel III on reported capital ratios as our calculations are based on published annual reports and Basel III disclosures, rather than on internal company data. In addition, please note that the consolidated numbers in Sections 1 and 2 of this report do not include Kuwait International Bank, as KIB did not publish the necessary Basel II disclosures relating to 2013. However, KIB data is included in Section 3 as full Basel III disclosure was provided in the 2014 annual report.

BASEL III VERSUS BASEL II

Table 2 presents the IBS estimates of the impact of Basel III on the capital ratios of each of the Kuwait Stock Exchange listed banks; as well as the consolidated commercial banking sector. For instance, for the banking sector as a whole, according to our calculations the Basel III common equity Tier 1 (CET1) ratio was 13.9 percent; had Basel III not been implemented the equivalent ratio would have been 16.6 percent, 2.7 percentage points higher. Of this, 1.7 percentage points, around 60 percent, relates to changes in the definition of regulatory capital; 1.1 percentage points, around 40 percent, relates to changes to the risk-weighting of certain assets and exposures.

Table 2: Summarizing the Impact of Basel III in Kuwait, 2014

	Basel III Common Equity Tier 1 or CET1 ratio 2014, as reported	CET1 ratio, applying Basel II Tier 1 capital definitions	CET1 ratio, applying Basel II Tier 1 capital definitions and Basel II risk-weighting rules	Percentage point difference between Basel III and Basel II
Ahli United Bank	14.4%	15.4%	16.0%	1.6%
Al Ahli Bank of Kuwait	22.7%	22.7%	25.4%	2.7%
Boubyan Bank	16.9%	16.9%	18.0%	1.1%
Burgan Bank	9.4%	12.1%	12.6%	3.2%
Commercial Bank of Kuwait	16.9%	17.3%	18.6%	1.7%
Gulf Bank	14.3%	14.3%	15.3%	1.0%
Kuwait Finance House	13.5%	15.3%	16.4%	2.9%
National Bank of Kuwait	13.2%	15.7%	16.6%	3.4%
Warba Bank	29.8%	29.8%	33.1%	3.3%
Consolidated	*13.9%*	*15.6%*	*16.6%*	*2.7%*

Sources: Banks' annual reports, IBS calculations

Table 2 shows how the impact of Basel III on reported CET1 ratios varies significantly by bank. The impact is largest on NBK, the CET1 ratio would have been 3.4 percentage points higher under Basel II; the impact is smallest on Gulf Bank.

The largest three banks in Kuwait measured by total assets – NBK, KFH and Burgan Bank are affected more than the other banks by changes in Basel III to the definition of capital (the difference between column 1 and column 2). This reflects, in the main, the stricter deductions required under Basel III for minority interest. Larger banks tend to have more subsidiaries and more complex group structures often giving rise to more minority interests.

A note on Common Equity Tier 1 versus Tier 1 capital ratios:

In Table 2, we have reconciled Basel III CET1 ratios with Basel II CET1 ratios. The Basel II CET1 ratio is what we believe the CET1 ratio would have been had Basel III rules not come into force.

That said, it should be noted that Basel II did not in fact include the CET1 ratio; instead the narrowest definition of capital was Tier 1 capital. The biggest difference between CET1 capital and Tier 1 capital is that the latter allows for the inclusion of certain forms of non-common equity capital such as preferred shares. The focus on CET1 as opposed to Tier 1 capital was significant in some countries, such as the United States, where many banks had issued trust preferred securities, enabling them to meet Tier 1 capital standards while minimizing the equity share capital they used to back assets. In Kuwait, as Table 3 shows, the differences between CET1 capital ratios and Tier 1 ratios are either non-existent or marginal. As of the end of 2014, only Burgan Bank reported a significant difference in the two ratios.

Table 3: Little difference between Common Equity Tier 1 and Tier 1 capital ratios in 2014

	Basel III Common Equity Tier 1 capital ratio	Basel III Tier 1 capital ratio
Ahli United Bank	14.4%	14.5%
Al Ahli Bank of Kuwait	22.7%	22.7%
Boubyan Bank	16.9%	16.9%
Burgan Bank	9.4%	12.2%
Commercial Bank of Kuwait	16.9%	17.0%
Gulf Bank	14.3%	14.3%
Kuwait Finance House	13.5%	14.8%
Kuwait International Bank	23.2%	23.2%
National Bank of Kuwait	13.2%	13.3%
Warba Bank	29.8%	29.8%
Consolidated	*14.2%*	*14.6%*

Sources: Banks' annual reports

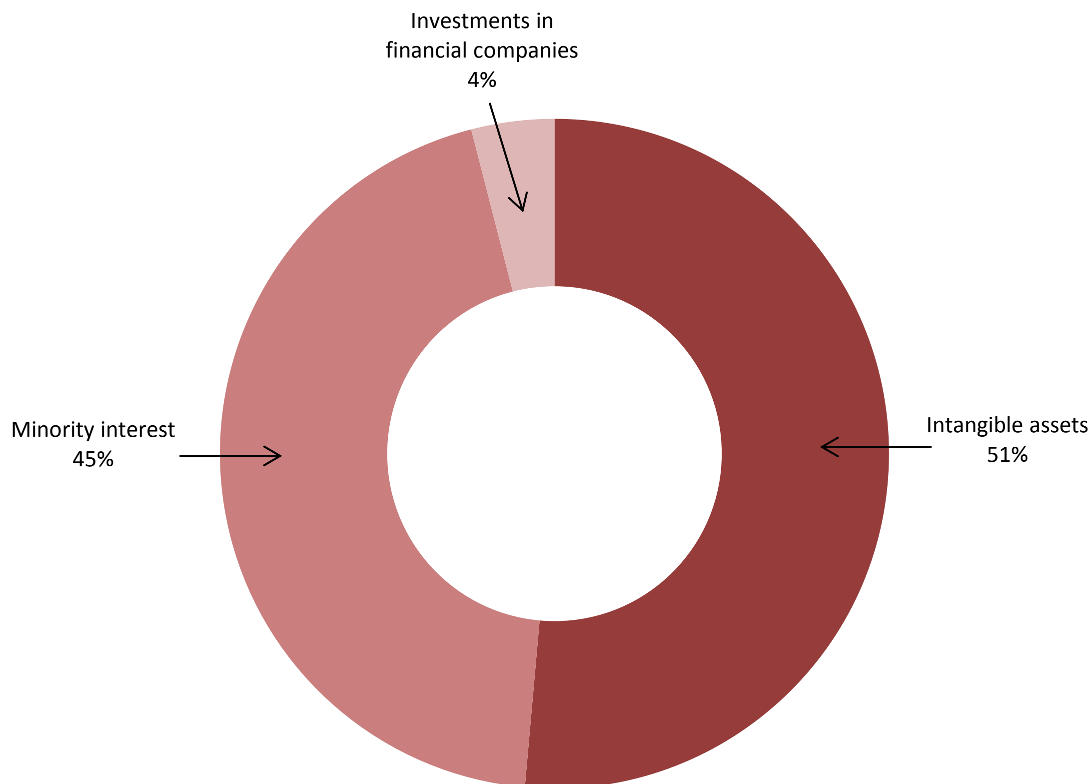
Basel II only required that half the total capital of the banks, that is 6 percent out of the 12 percent minimum capital adequacy ratio be composed of Tier 1, the remainder being allowable Tier 2 capital. Basel III focuses predominantly on CET1; by 2016 each bank will have to report a minimum CET1 ratio of 11.0 percent and total capital ratio of 13.0 percent. In other words, under Basel III what matters is the CET1 capital ratio; which is why this study focuses on CET1 capital and less on 'additional Tier 1 capital' (the difference between CET1 capital and Tier 1 capital) and Tier 2 capital. Indeed, as we discuss in Section 3 below, most Kuwaiti banks use CET1 almost exclusively to comply with the total capital adequacy ratio.

1. Tightening the definition of capital

The guiding principle behind changes in the definition of capital is a focus on ensuring that only capital that has full loss-absorbant capability is included in CET1.That said, as many of the changes were designed with complex banking systems in mind, only a few affect the calculation of capital in Kuwait. Even so, as Table 1 showed, these limited number of changes did have a material impact.

Overall, changes in the way capital is calculated in Basel III relative to Basel II reduced the consolidated banking sector's CET1 capital ratio from 15.6 percent to 13.9 percent, according to IBS calculations. As Chart 1 shows below, two factors accounted, in fairly equal proportions, for the decline in the ratio.

Chart 1: Two-key changes in the calculation of regulatory capital in Kuwait



Sources: Banks' annual reports, IBS calculations

- *Minority interests (non-controlling interests).* Previously under Basel II, the Central Bank of Kuwait reserved the right to "adjust the amount of….minority interests that may be included in capital base in the event the capital from such minority interests is not available to the locally incorporated bank."[3] In most cases (Burgan Bank being the only exception), in 2013 the banks were allowed to include all minority interest in Tier 1 capital. However, under Basel III, banks are only allowed to include the amount that is above the minimum requirement – known as the surplus.[4] In 2014, only 44 percent of consolidated minority interest was eligible for inclusion in CET1 capital.

- *Intangible Assets*. Previously, with the exception of goodwill arising on acquisition, there was no deduction to Tier 1 capital for intangible assets. Under Basel III "with the exception of mortgage servicing rights, the full amount is to be deducted net of any associated deferred tax liability which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards."[5]

2. Changes in the calculation of risk-weighted assets

As explained in the introduction to this study, the Basel framework requires that banks back their assets and exposures with regulatory capital. In 2014, the Kuwaiti banks were required to meet or surpass a 12 percent regulatory capital threshold i.e. total regulatory capital divided by risk-weighted assets had to be greater than 12 percent.

As Table 4 below shows, the denominator in the capital ratio calculation, risk-weighted assets, is composed of credit risk exposure, operational risk exposure and market risk exposure. In 2014 in Kuwait, credit risk made up 82.9 percent of total risk-weighted assets. Credit risk weightings are applied to a bank's loan book and other assets held in its 'banking book', such as bonds held to maturity. An example was provided in the introduction showing how the risk-weighting is applied to a corporate loan in Kuwait.

In 2014, 13.5 percent of total risk-weighted assets were related to operational risk. This is the risk of losses from situations where the bank's procedures fail to work as they are supposed to or where there is an adverse external event such as a fire in a key facility. A 'capital charge' is calculated by applying various weightings (known as beta-factors) to the gross revenue of each business segment. The capital charge is then multiplied up so that it can be expressed as an equivalent amount of risk-weighted assets.

The third element of risk-weighted assets, market risk, reflects risk in trading book positions associated with changes in interest rates and stock market fluctuations; as well as risks in both trading and banking books associated with fluctuating foreign exchange rates, and commodity and options prices. As with operational risk, the capital charge is multiplied up so that market

risk is expressed as an equivalent risk-weighted asset. In 2014, 3.6 percent of total risk-weighted assets held by the Kuwaiti banks were derived from market risk.

Table 4 breaks down total risk-weighted assets into its constituent parts. It also shows that there was a significant increase in the ratio of risk-weighted assets to total assets between 2013 and 2014, caused by the switchover from Basel II to Basel III, from 63.7 percent to 70.0 percent.

Table 4: Changes in Basel III regarding operational risk cause of increased risk-weighting

	2014			2013		
	Risk-weighted assets KD Millions	Percentage of total risk-weighted assets	Multiplier	Risk-weighted assets KD Millions	Percentage of total risk-weighted assets	Multiplier
Credit risk	38,471	82.9%		34,422	90.4%	
Operational risk	6,258	13.5%	12.5	2,682	7.0%	8.33
Market risk	1,670	3.6%	12.5	989	2.6%	8.33
Total risk-weighted assets	46,398	100.0%		38,093	100.0%	
Total assets	66,282			59,809		
Risk-weighted assets as a percentage of total assets	70.0%			63.7%		

Sources: Sources: Banks' annual reports, Bayanati, IBS calculations

In 2013, market risk and operational risk together accounted for 9.6 percent of total risk-weighted assets; in 2014, these two risk factors account for 17.1 percent of total risk-weighted assets. This increase was a direct result of a change to the multiplier used to convert the capital charge into equivalent risk-weighted assets from 8.33 to 12.5.[6] According to IBS calculations, the resulting regulatory capital required to back exposure to operational risks increased from 15.4 percent of 'gross income' in 2013 to 22.7 of gross income in 2014.[7]

Had the multiplier not been increased, the percentage of risk-weighted assets to total assets would have been 66.0 percent, according to our calculations.

Changes to standardized credit risk weightings in Basel III versus Basel II in Kuwait were limited to two categories: investments in commercial entities above the materiality threshold (included in 'other exposures') and commodities inventories (only relevant to Islamic banks). Rule changes in these categories are reflected in Table 5 below, which shows an increase in the ratio of risk-weighted assets to total assets. In the case of inventory and commodities, the ratio of risk-weighted assets to total assets increased from 98.9 percent in 2013 to 149.2 percent in 2014, reflecting an increase in risk-weighting for three out of four categories from 125 percent to 187.5 percent.

Changes in the ratio of risk-weighted assets to total assets in the other categories reflect underlying shifts in each bank's banking book, having nothing to do with the move from Basel II to Basel III.

As a result of changes to Basel III affecting 'other exposures' and 'inventory and commodities', we estimate that risk-weighted assets increased by 1.8 percentage points; without the changes the percentage of risk-weighted assets to total assets would have been 68.2 percent and not 70 percent.

Table 5: Basel III impact limited to other exposures and inventory and commodities

Credit Risk exposure category	Percentage of total credit risk-weighted assets 2014	Risk-weighted assets to gross exposure 2014	Risk-weighted assets to gross exposure 2013
Cash	0.0%	0.0%	0.0%
Sovereigns	1.4%	4.7%	4.3%
International organizations	0.0%	4.4%	0.0%
Public sector enterprises	0.5%	37.2%	28.3%
Banks	8.1%	25.9%	24.9%
Corporates	43.9%	60.6%	60.6%
Regulatory retail exposure	22.1%	78.1%	82.6%
Retail housing loans eligible for 35%	0.2%	13.9%	9.8%
Past due exposures	1.1%	39.5%	28.5%
Other exposures[8]	16.5%	72.3%	64.1%
Overall excluding Islamic categories	**93.9%**	**48.5%**	**48.4%**
Inventory and commodities (Islamic banks only)	2.3%	149.2%	98.9%
Real estate investments (Islamic banks only)	3.4%	163.2%	161.4%
Sukuk and taskeek (Islamic banks only)	0.5%	61.3%	58.3%
Islamic banking categories	**6.1%**	**139.9%**	**127.7%**
Overall	**100.0%**	**50.5%**	**50.5%**

Sources: Banks' annual reports, IBS calculations

To summarize, had Basel III not been introduced the ratio of risk-weighted assets to total assets would have been 64.2 percent rather than 70.0 percent. Approximately one-third of difference between Basel III and Basel II was caused by the increase in the multiplier used to convert the operational risk and market risk capital charges into risk-weighted asset equivalent values; the remaining third by changes in the risk-weighting related to certain investments and inventories and commodities. In aggregate, these rule changes account for around 40 percent of the total effect of Basel III versus Basel II on the consolidated common equity Tier 1 ratio.

3. The effects of full Basel III compliance

Table 7 on the next page lists the CET1 capital ratio, Tier 1 ratio and total capital ratio at the end 2014, for each of the Kuwaiti banks. It also lists the minimum capital ratios required by Basel III, when fully implemented, and the average Tier 1 and total capital ratios reported by the banks in the past three years, under Basel II.

Basel III sets the minimum thresholds at 9.5 percent for the CET1 ratio, 11.0 percent for the Tier 1 ratio and 13 percent for the total capital requirement. However, in addition, the Central Bank of Kuwait has signaled its intention to write rules that will require certain domestic systemically important banks (DSIBs) to add between 0.5 and 2 percentage points of CET1 funding in relation to risk-weighted assets. For instance, the most systemically important banks, assuming a 2 percentage point capital surcharge, would be required to report a minimum CET1 ratio of 11.5 percent, and a total capital ratio of 15 percent.

We expect that the methodology to assign DSIB surcharges will be based on the Basel Committee's complex rules for calculating the global SIBs capital surcharges.[9] However, in order to simplify the matter, we have based our estimates of the DSIB capital surcharge in Kuwait (see Table 6) on the relative size of total assets, as at the end of 2014. Please note that our methodology has neither been confirmed nor checked by the Central Bank of Kuwait.

Table 6: IBS estimate of the DSIB capital surcharge

	Percentage of total assets of Kuwaiti private banks	IBS Estimate of DSIB capital surcharge, percentage points
Ahli United Bank	5.1%	0.5
Al Ahli Bank of Kuwait	5.3%	0.5
Boubyan Bank	3.9%	0.0
Burgan Bank	11.4%	1.0
Commercial Bank of Kuwait	6.2%	0.5
Gulf Bank	7.8%	0.5
Kuwait Finance House	25.2%	2.0
Kuwait International Bank	2.4%	0.0
National Bank of Kuwait	31.9%	2.0
Warba Bank	0.9%	0.0

Sources: Banks' annual reports, IBS estimates

As the Table shows, we have assumed that banks with over 20 percent of total Kuwaiti banking assets (both domestic and foreign) will be given a 2 percentage point DSIB capital surcharge; banks with between 15 and 20 percent of total assets a 1.5 percentage point surcharge; banks with between 10 and 15 percent of total assets a 1 percentage point surcharge; and banks with between 5 and 10 percent of total assets a 0.5 percentage point surcharge. We assume that smaller banks will be given no additional capital surcharge.

Table 7: No problem meeting Basel III capital requirements

	2014 Basel III			Basel III regulatory minimum, IBS estimate			Average Basel II 2011-2013	
	CET1 ratio	Tier 1 ratio	Total capital ratio	CET1 ratio	Tier 1 ratio	Total capital ratio	Tier 1 ratio	Total capital ratio
Ahli United Bank	14.4%	14.5%	15.7%	10.0%	11.5%	13.5%	16.8%	18.7%
Al Ahli Bank of Kuwait	22.7%	22.7%	23.7%	10.0%	11.5%	13.5%	24.9%	26.6%
Boubyan Bank	16.9%	16.9%	18.1%	9.5%	11.0%	13.0%	22.2%	22.3%
Burgan Bank	9.4%	12.2%	13.5%	10.5%	12.0%	14.0%	12.2%	17.9%
Commercial Bank of Kuwait	16.9%	17.0%	18.2%	10.0%	11.5%	13.5%	16.0%	19.0%
Gulf Bank	14.3%	14.3%	15.5%	10.0%	11.5%	13.5%	14.3%	17.0%
Kuwait Finance House	13.5%	14.8%	16.3%	11.5%	13.0%	15.0%	14.8%	15.0%
Kuwait International Bank	23.2%	23.2%	24.4%	9.5%	11.0%	13.0%	n/a	n/a
National Bank of Kuwait	13.2%	13.3%	14.5%	11.5%	13.0%	15.0%	17.2%	17.5%
Warba Bank	29.8%	29.8%	31.0%	9.5%	11.0%	13.0%	109.1%	109.7%

Sources: Banks' annual reports, IBS estimates and calculations

As things stand, there appears to be no issue with regards the banks meeting the minimum Basel III thresholds, including our estimate of the DSIB capital surcharge.

That said, Table 7 shows that most of the banks are reporting capital ratios that are lower than the ratios they reported, on average, in the last three years of Basel II (2011 through 2013). The question remains therefore as to whether the banks will choose to increase their capital ratios to bring them back to historic levels or whether they will continue to report lower Basel III ratios on the basis that surpassing the minimum threshold is sufficient.

Were the banks to opt to deliberately increase their CET1 ratios, to offset the effects of Basel III, then as shown in Table 1, in aggregate they would need to increase their capital ratio by 2.7 percentage points. All other things being equal this would result in the sector as a whole needing an additional KD 1.2 billion of common equity, according to IBS data and calculations. Based on 2014 consolidated results, return on equity with this additional equity would fall by around 1 percentage point from 8.6 percent, as reported, to 7.6 percent.[10] The banks would be unable to pass on this 'hit' to profitability to customers, in the form of higher interest rates/profit margins, given interest rate ceilings set by the Central Bank of Kuwait; although the banks could, in theory, look to other segments of their businesses to recoup lost earnings.

This figure represents the most extreme estimate for the impact of Basel III on the banking sector's profitability. As this section has shown, in reality while Basel III has reduced capital ratios in Kuwait significantly, the banks remain in compliance and no further action is necessary. As such, it is equally arguable, with the exception of Burgan Bank which appears to have opted to operate closer to regulatory minimum capital thresholds, that Basel III has had little or no real impact on the profitability of the banks in Kuwait.

CONCLUSION

According to IBS calculations the Basel III common equity Tier 1 ratio as of December 31 2014 was 13.9 percent for the consolidated commercial banking sector. Had Basel III not been implemented the equivalent ratio under Basel II would, we calculate, have been 16.6 percent, 2.7 percentage points higher.

Of the decrease as a result of Basel III, 1.7 percentage points, around 60 percent, relates to changes in the definition of what can be counted as regulatory capital; 1.0 percentage points, around 30 percent, relates to changes in the risk-weighting of assets and exposures.

Including our estimates of the DSIB capital surcharge, we expect all Kuwaiti banks to surpass the minimum capital thresholds in 2016, the first year of full Basel III implementation.

ENDNOTES

[1] Central Bank of Kuwait, *CBK Announces the Implementation of the Instructions of Basel III Capital Adequacy Standard in its Final Format to All Local Banks*, http://www.cbk.gov.kw/en/cbk-news/announcements-and-press-releases/press-releases.jsp?kcp=1~n5Jn2tEVfwdWHwta9ITDijieWyczpeUSJ7PcJQ2WVqA
[2] Basel Committee for Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, June 2011, http://www.bis.org/publ/bcbs189.htm
[3] Central Bank of Kuwait, *Rules and regulations concerning capital adequacy standards Basel II*, Circular No. 2/BS/184/2005, p.9, http://www.cbk.gov.kw/en/images/Section-11-10-2746-2.PDF
[4] Central Bank of Kuwait, *Capital Adequacy Ratio – Basel 3 for Conventional Banks*, 24/06/14, pp.30-31
[5] Ibid., p. 33
[6] See paragraph 476 (p. 157) of Basel 3 guidelines and paragraph 249 (p. 76) of Basel II guidelines, Op. Cit.
[7] The operational risk capital charge is calculated by applying various factors to the gross income of eight different business lines. As we do not have access to the gross income of each business line, to show the effect of the move to Basel III we have contrasted required capital as a percentage of gross income in 2014 versus 2013. Please also note that, as per Basel III rules, we have taken the average of the current year and two previous years when calculating gross income.
[8] 'Investment and finance with customers', which is separated out in the Islamic banks Pillar III disclosure has been added to 'other exposures', where similar exposures are placed by conventional banks.
[9] Basel Committee on Banking Supervision, *The G-SIB Assessment Methodology – score calculation*, http://www.bis.org/bcbs/publ/d296.pdf
[10] Calculated using Institute of Banking Studies data, *Bayanati*.

ABOUT THE IBS CONSULTING AND RESEARCH TEAM

Dr. Christopher Payne, Head of Department

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 to the global financial crisis of 2008.

Fidaa E. Al-Hanna, Senior Researcher

Fidaa joined IBS in 1992. She holds a bachelor's degree in Business Administration, with a focus on banking and finance, from Kuwait University and is a qualified member of the Institute of Certified Professional Managers.

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