Institute of Banking Studies Research »

Are Kuwaiti Banks Sufficiently Prepared for the Future?

Consultancy and Research Department

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I. Executive Summary

Kuwait has a robust and well-regulated financial services sector. The country's banking regulator, the Central Bank of Kuwait, is a conservative regulator with more stringent oversight of local banks than other countries in the region. It currently supervises and regulates 11 Kuwaiti banks and 12 foreign banks. It also regulates the loan books of 56 finance and investment companies. Competition among these banks is high. The market is not considered to be over-banked. However, two banks dominate the market; National Bank of Kuwait and Kuwait Finance House. Total assets of these two banks represent 56% of the total assets in the banking sector.

The sector has shown resilience in the face of the slowdown in government spending caused by the collapse in the price of oil from 2014 to 2016. In addition, the Kuwaiti banking sector has proven to be more resilient than its peers in the GCC. Since 2016, the performances of Kuwait's banks have shown a steady improvement in nearly all key bank ratios. Banks have been able to maintain high capital adequacy ratios well above the 13% mandated by the Central Bank and per Basel III rules of 10.5%.

In terms of return on equity (ROE), Kuwaiti banks, have been slightly underperforming their peers in the GCC. This can partially be attributed to lower government spending and investment than expected as well as higher precautionary provisions held on bank balance sheets. However, the Kuwaiti banking sector has the lowest non-performing loan (NPL) ratio in the region, 1.3% compared to a GCC average of 2.9% as of year-end 2018. Banks in Kuwait, as well as the rest of the GCC, have maintained cost-to-income ratios (CIR) below their peers in other regions, including North America, Europe and Asia. The CIR for Kuwaiti banks in 2018 was 37.9%, compared to 41% in the GCC, 60.1% in the US, 59.5% in Japan, 76.1% in the UK and 80.7% in Germany.

With this in mind, there are four global economic and political trends that can impact the banking sector over the next few years;

i) the aging economic cycle;
ii) the shift away from fossil fuels and oil price volatility;
iii) rising interest rates;
iv) and a global trade war.

According to GSMA, an organization representing mobile operators, there were 375 million mobile users in the MENA region in 2017, or approximately 64% of the region's population. This figure jumps to 77% when only looking at the GCC region. Mobile use is extremely high in the GCC region with Kuwait having one of the highest mobile phone penetration rates in the world according to the GSMA.

The mass-acceptance of mobile banking in the country will no doubt force banks to be at the forefront of mobile banking trends in the coming years as Kuwait's young and tech-savvy population demand more mobile services from their financial institutions. There are three key trends that are shaping the future of the banking industry;

a) Mobile banking

Today, over 43% of all banking customers globally use mobile banking applications. This is from zero percent only eight years earlier. The appeal of mobile banking lies in its convenience, ease-of-use and better user experience. Over the next few years, mobile banking will continue to take on a larger role in managing customers' experience while physical branches become of lesser importance.

b) Blockchain

Blockchain in simple terms is a digital ledger. It's attractiveness to banks lies in its design, a blockchain is resistant to modification. It is an open, distributed ledger that can record transactions between two parties efficiently. These transactions once recorded are verifiable and permanent. Blockchain appeals to banks for its real-world applications and game-changing potential. Here are four areas where we see blockchain making an impact on banking:

i. Clearing and Settlement;
ii. Payments;
iii. Trade finance;
iv. Identification.

c) Non-bank competition/disruption

Over the past ten years, the biggest disrupter in the banking industry has been the migration towards mobile banking. The second most significant disputer has been the rise of competition from both inside and outside the industry. Companies such as PayPal are already known for their payment capabilities and are being used by millions of people around the world.

There has also been a rise competition from new banks and financial institutions who are capitalizing on the rise in popularity of mobile banking. This allows them to forego investing in a capital-intensive branch network and instead, focus on investing in technology and attracting customers through their lower cost structures.

The competitive landscape in Europe and the US is much different than in Kuwait and the rest of the GCC. For example, there are currently no online-only banks in Kuwait and the GCC. The key market disrupter for banks in Kuwait and region has been mobile banking.

This move has come primarily as a result of the country's young population who have been quick to adopt new technologies. There has also been a push by the Kuwaiti Government to modernize the economy and utilize the latest technologies as it moves towards more e-government services.

Banks in Kuwait have been facing the same challenges as banks in Europe, the US and Asia have been facing in terms of keeping up with changes in technology and customer preferences. The Central Bank of Kuwait, for its part, has taken on these challenges head-on. Instead of reacting to the rapid changes in banking technology, it has decided to be at the forefront of new innovations and developments. This can be seen by three recent developments within the CBK; instruction for the regulation of electronic payment of funds, the launch of the Regulatory Sandbox Framework and the development of the necessary infrastructure required to support a digital currency – Digital Dinar.

Kuwait's commercial banks have also taken a leap forward and have been rolling out new digital products and services aimed at fulfilling customers' demands. In addition to opening new smart branches in key areas, banks have been improving their overall digital offering, which places them at or above the level of their regional peers. This includes offering instant money transfers using the Ripple Blockchain network and allowing customers to apply for financing online or through mobile applications.

Overall, Kuwaiti banks have been very active in rolling out new and enhanced services to keep up with the latest advances in banking technology. This includes virtual credit cards and e-wallets, fingerprint identification and facial recognition, online credit card issuance, cardless cash withdrawals, and connecting to customers using social media and messaging applications.

Thus, banks in Kuwait are embracing these rapid changes in the industry are sufficiently prepared for the future; however, challenges still remain. This has to do with the speed at which advances in technology are taking place as well as the changing preferences of banking customers for new and enhanced banking services, especially via mobile banking platforms. The large investments in new technologies over the coming years may put pressure on bank performance.

1. Introduction

Over the past ten years, adoption of new technologies has transformed the banking industry globally. The industry today is much different than it was only a few years earlier. There is no other time in recent history where the banking industry was forced to change at such a rapid pace. In fact, many industry experts have predicted the fall of the traditional banking model as disruptive new entrants take away market share by offering customers a better experience through new technologies and channels.

However, despite the current disruptions in the industry, traditional banks have a bright future if they are willing adapt and innovate. There will be winners and losers over the next few years. The winners will be the institutions that choose to innovate and transform themselves in order to prepare for the future. The future will require banks to be agile and willing to change. The losers will be banks that fail to shift gear and change their business practices. These institutions will be at a high risk of being left behind as their business model becomes obsolete. Staying the same is not an option.

The current landscape has changed significantly from where it was 10 years ago in response to the evolving forces of customer expectations, regulatory requirements, technology, demographics, new competitors and shifting economics. What is unique about the change in the industry today the rapid pace at which it is occurring. The industry has historically changed slowly – evolutionary change. Today's change is more revolutionary.

Many of the industry leaders are innovating and experimenting with new products, delivery channels and analytics. With the move towards mobile banking and automation, these banks are also having to put a lot of resources on training and building systems that facilitate these changes. In addition, the banks at the forefront of innovation are choosing to reducing their branch networks in favor of investing in new technologies. However, they face intense competition from high-end fintech companies in providing a better experience for users.

What does all this mean for the banking industry in Kuwait? With the globalization of the industry, changes taking place in one part of the world are spreading to other regions. Banking customers in Kuwait have the same desires and expectations as customers in Europe and Asia. The quick adoption of mobile banking in Kuwait coupled with the rise in the importance of social media are putting pressure on the traditional banking model in the country. The challenges facing banks in Kuwait today is no different than the challenges banks face in other countries around the world. The question is, are banks in Kuwait preparing for the future?

2. Current landscape of the banking sector

Kuwait's financial services sector is robust and broad-based for the size of its economy. The Central Bank of Kuwait (CBK), the country's banking regulator, is a conservative regulator playing a more active role in oversight of local banks than other countries in the region. As such, Kuwait's banking system was able to weather to Global Financial Crisis better than other banking systems in the region.

a) Competitive environment

Though Kuwait's banks are stronger today than they were 10 years ago, to the credit of the CBK, there are still risks that they face as the global economy heads into the next recession. There are also risks the sector will face should the government slow its spending plans as outlined in its 2035 Future Vision Plan.

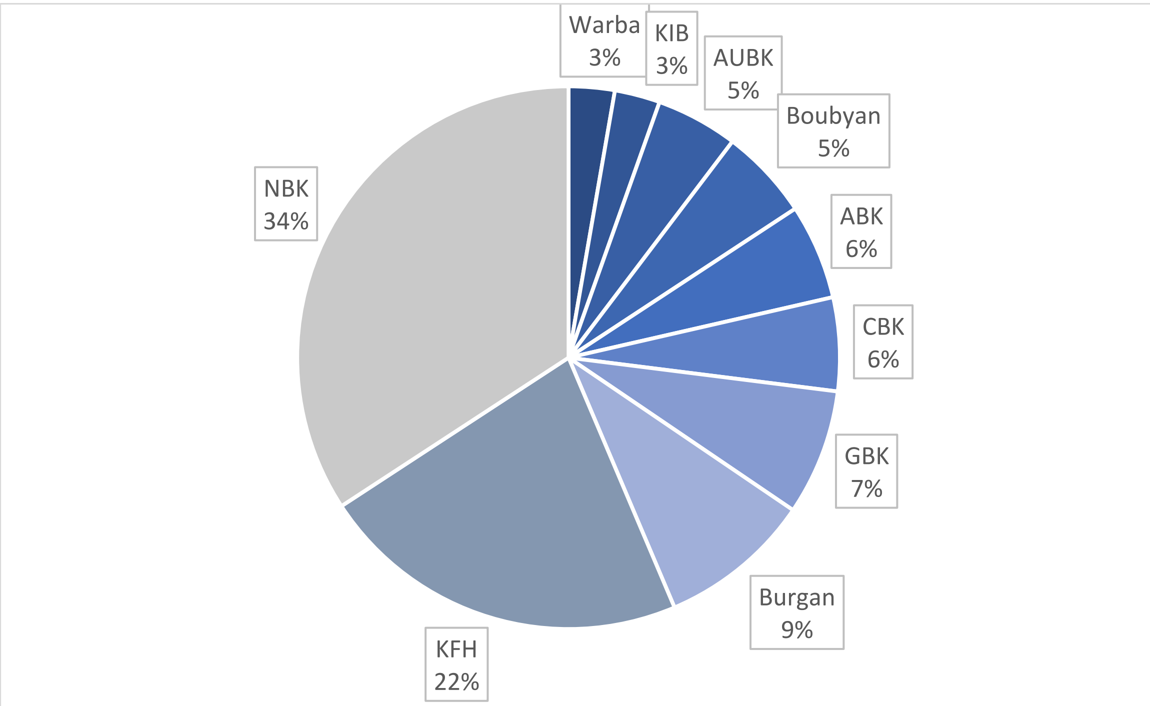


Figure 1: Total assets of Kuwait's 10 retail banks. Data source: GCC Listed Banks Results Year-ended 31 December 2018. June 2019, KPMG[i].

The Central Bank of Kuwait currently supervises and regulates 11 Kuwaiti banks and 12 foreign banks. It also regulates the loan books of 56 finance and investment companies[ii]. Of the 11 Kuwaiti banks, 10 serve the retail sector and one, The Industrial Bank of Kuwait, serves the industrial sector. There is intense competition among these banks for market share. However, two banks dominate the market; National Bank of Kuwait (NBK) and Kuwait Finance House (KFH). Total assets of these two banks represent 56% of the total assets in the banking sector (Figure 1).

b) Key financial ratios and cost efficiencies[iii]

Kuwaiti banks have proven to be resilient in the face of the slowdown in government spending in 2016 and 2017, which was caused by the collapse in the price of oil from June 2014 to January 2016. In 2017, Kuwait's economy experienced a brief recession as a result of this slowdown. In spite of this, however, Kuwaiti banks continued to show improvements in nearly all key financial ratios unlike some of their peers in the GCC, which were impacted by the slowdown in government spending in their respective countries. Over the past three years, performance of the banking sector has improved across most key performance indicators. This has been mainly attributed to improved government finances and a continued and sustained growth in consumer spending.

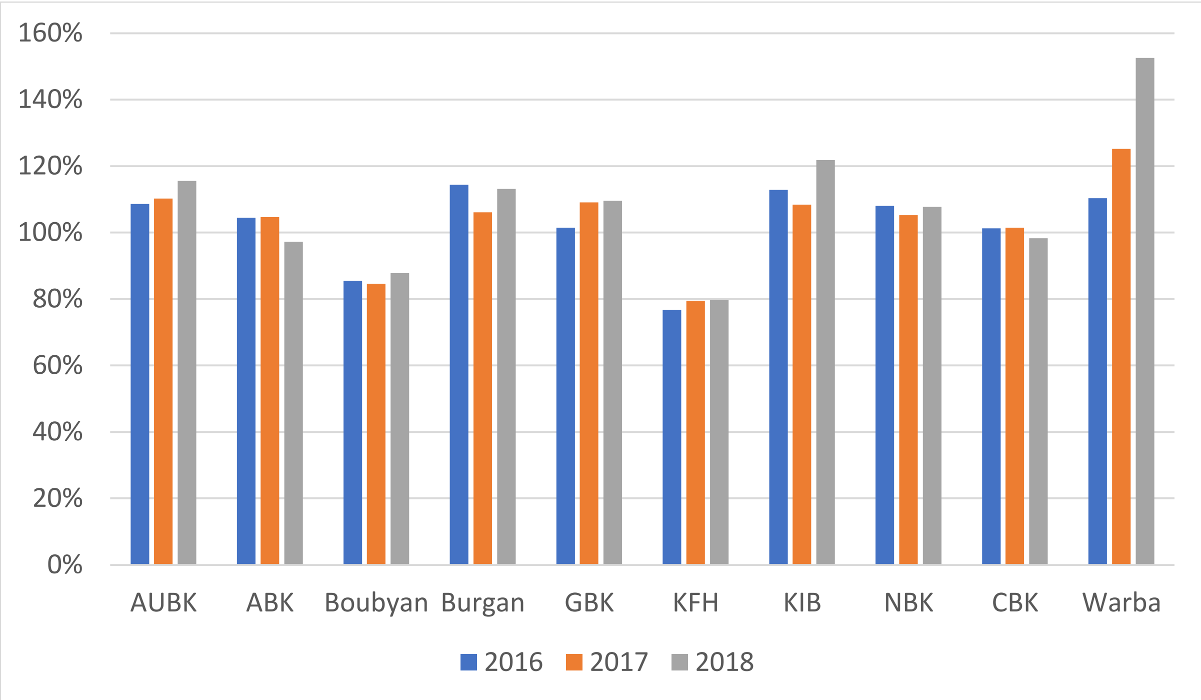


Figure 2: Loan/Deposit Ratio (LDR). Data Source: Central Bank of Kuwait and KPMG.

The loan-to-deposit ratio (LDR) has been slowly rising over the past three years driven by smaller banks' rise in lending. The LDR is used to assess a bank's liquidity by comparing a bank's total loans to its total deposits expressed as a percentage. A high ratio it means that the bank may not have enough liquidity to cover any unforeseen funding requirements. A low ratio indicates that the bank is underperforming and could be a sign of other problems within the bank. It is within range to expect smaller banks, such as Warba and Kuwait International Bank, to have a higher LDR ratio than the larger banks, such as National Bank of Kuwait and Kuwait Finance House. There has been a steady improvement in the LDR of Kuwaiti banks as can be seen in Figure 2.

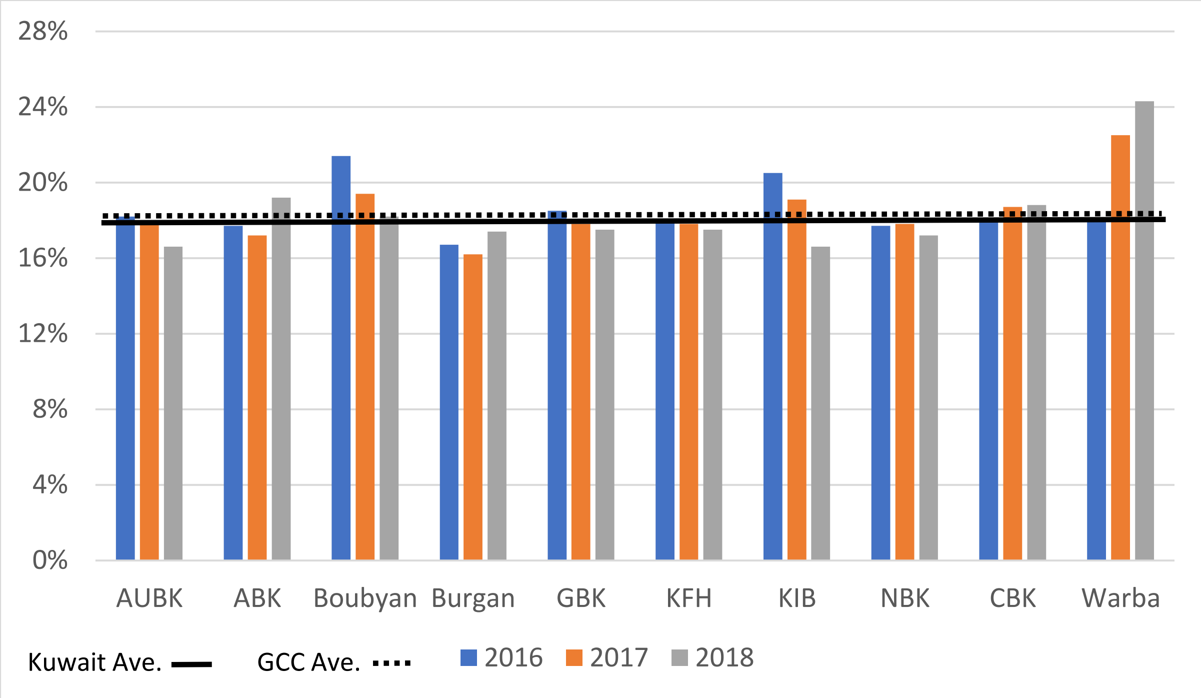


Figure 3: Capital Adequacy Ratio (CAR). Data Source: Central Bank of Kuwait and KPMG.

The Capital Adequacy Ratio (CAR) is a measure of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures. Kuwaiti banks have been able to maintain high ratios well above the 13% mandated by the CBK[iv] and per Basel III rules (10.5%)[v].

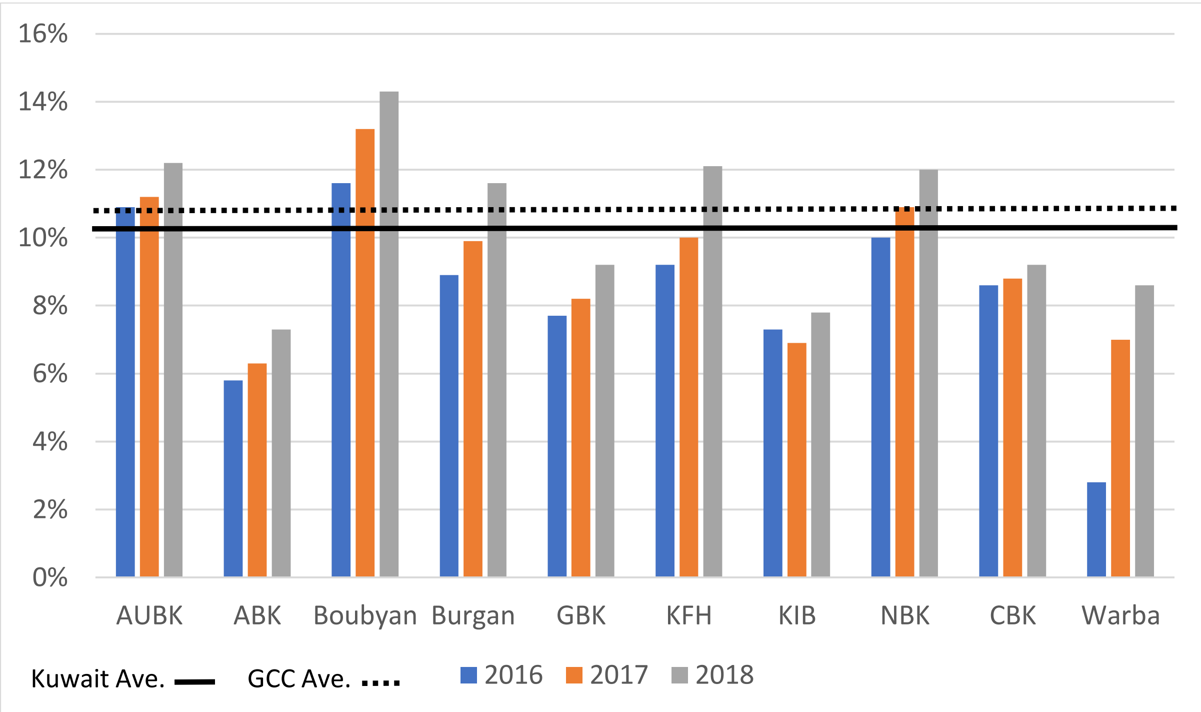


Figure 4: Return on Equity (ROE). Data Source: Central Bank of Kuwait and KPMG.

Kuwaiti banks, however, have been slightly underperforming their peers in the GCC in terms of Return on Equity (ROE) as can be seen in Figure 4. Five banks; Ahli United Bank of Kuwait (AUBK), Boubyan Bank, Burgan Bank, KFH and NBK, out-performed their peers in Kuwait in 2018. Whereas, Warba Bank and Ahli Bank of Kuwait (ABK) under-performed during the same period.

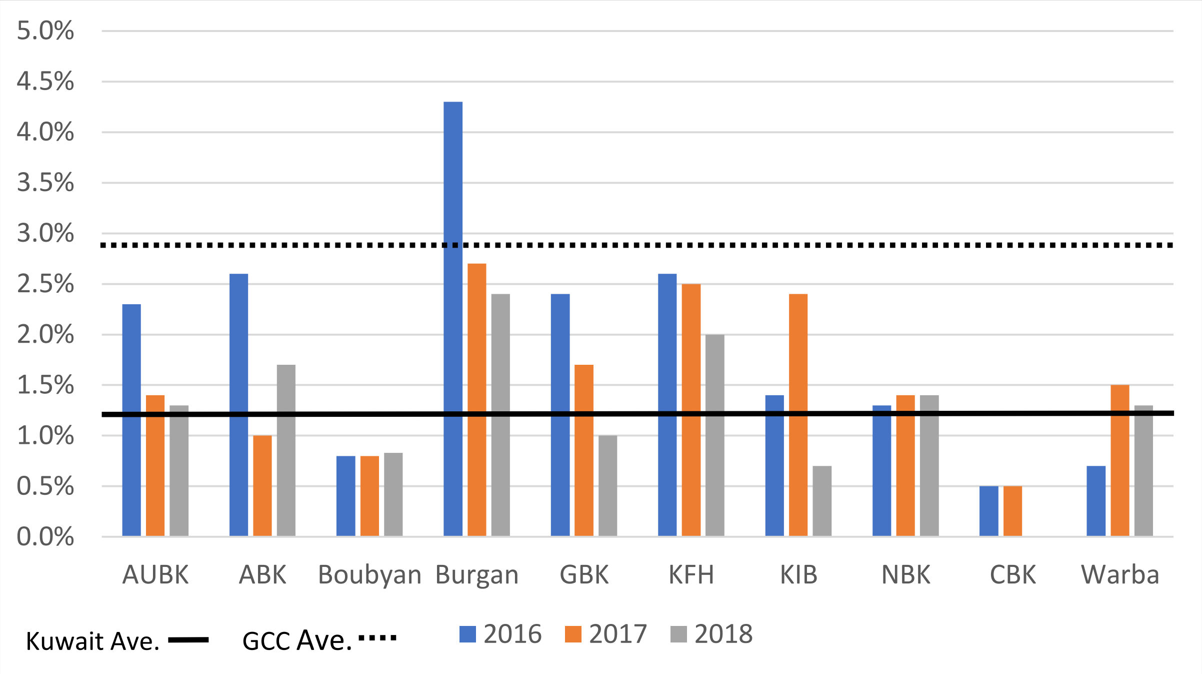


Figure 5: Non-Performing Loans (NPLs). Data Source: Central Bank of Kuwait and KPMG.

The Kuwaiti banking sector has the lowest non-performing loan (NPL) ratio in the GCC. Kuwait's banks have been very successful in lowering this ratio over the past three years, as can be seen in Figure 5. In fact, the Commercial Bank of Kuwait, for example, reported a 0% NPL ratio in 2018. This sector-wide low ratio is due to higher asset quality, higher provisions requirements and close monitoring by the CBK of all banks' bad loans. A ratio below 2% is considered to be excellent for a country's banking system.

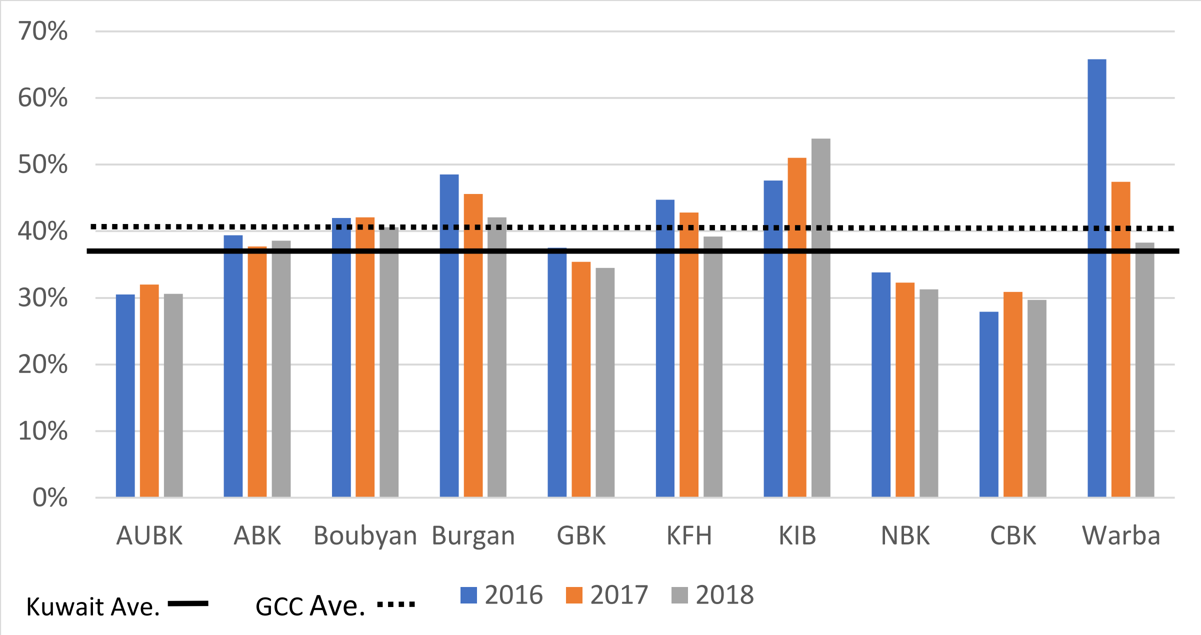


Figure 6: Cost/Income Ratio (CIR). Data Source: Central Bank of Kuwait and KPMG.

Banks in Kuwait, as well as the rest of the GCC, have maintained cost-to-income ratios (CIR) below their peers in other regions, including North America, Europe and Asia. The CIR for Kuwaiti banks in 2018 was 37.9%, compared to a GCC average of 41%. The CIR for banks in Kuwait and the rest of the GCC continues to be much lower than in other regions according to S&P Global. The average CIR for banks in the US was 61.6%, 59.5% in Japan, 76.1% in the UK and 80.7% in Germany[vi].

c) Is Kuwait over-banked?

With the 23 foreign and domestic banks operating in Kuwait, the country is not over-banked when compared to its peers in the GCC as can be seen in Table1. Within the GCC, Bahrain is the most over-banked, followed by Qatar and the UAE respectively. Another measure would be to compare the number of bank branches to a country's total population. However, we believe that the number of licensed banks in the country gives a better indication of the competitiveness in the market.

	Kuwait	*Bahrain*	*Qatar*	*Oman*	*UAE*	*KSA*
Domestic Banks	11	43	11	7	23	12
Foreign Banks	12	55	7	9	28	16
Total	23	98	18	16	51	28
Population (million)	4.62	1.44	2.36	3.49	9.70	33.09
Banks/Population	4.98	67.96	7.62	4.58	5.26	0.85

Table 1: Banks per population in the GCC. Source: Central banks of each respective country, The Public Authority for Civil Information and CIA World Factbook.

An issue of more concern is the size of the banks in the country. Two banks in Kuwait; NBK and KFH, dominate the industry with 56% of total banking assets. The remaining eight banks hold 44% of total banking assets. Thus, the Kuwaiti banking sector is dominated by two banks, one conventional and one Islamic.

3. Global economic and political factors impacting Kuwait's economy and banking sector

There are four global trends that can impact the national economy and the banking sector; the aging economic cycle, the shift away from fossil fuels, rising interest rates and a global trade war. These four trends are described below;

I. Aging economic cycle and slowing GDP growth

The current economic growth cycle, which has lasted longer than all previous economic cycles, is mature and the most likely scenario over the next year or two is that this cycle changes from a growth cycle to a contractionary cycle (recession).

There are already signs of wide-spread economic slowdown around the world, with the exception of the US, which has seen a sustained rise in economic growth. Outside of the US, GDP growth in the three largest economies; the EU, China and Japan, are all trending lower.

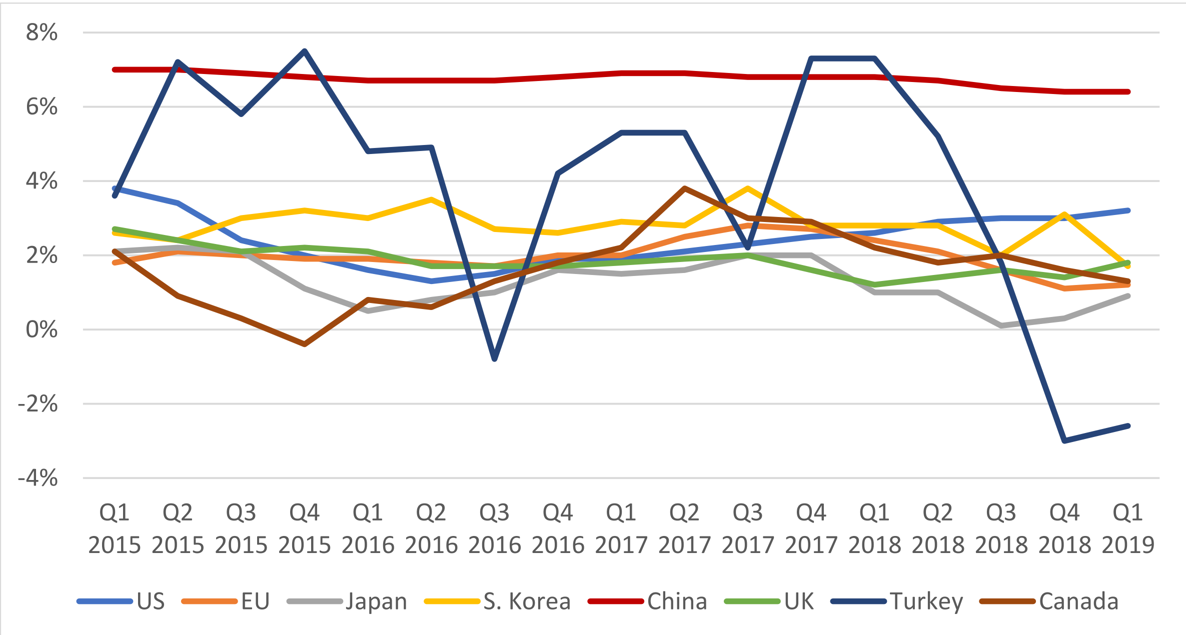


Figure 7: GDP growth rates in select developed and emerging markets. Data Source: Trading Economics.

The latest GDP figures from the EU show GDP growth slowing to 1.2% as of Q1 2019 compared with a 2.7% in Q4 2017. In 2017, by the way, the EU witnessed its highest GDP growth rate since 2007, which is another sign of how anemic growth has been across the EU. The primary reason for this is the fact that the EU has been unable to fix the structural problems in its economy and GDP growth has suffered as a result. This lackluster growth coupled with rising debt levels places the EU in a high-risk position during the next economic downturn.

GDP growth in China has also slowed down to 6.4% in Q1 2019, which was its lowest recorded growth rate in 28 years[vii]. Economic growth in China has been slowing down for years. The Chinese government has been trying to manage a slowdown so that it does not affect the wider economy. We believe that the economy will slow down faster than the government expects as recent economic indicators have been reported below expectation. As a result, the trend towards slower GDP growth in China also means slower growth in demand for oil, which has been the largest source of new oil demand over the past decade.

In January 2019, the International Monetary Fund (IMF) lowered its global growth forecast for 2019 from 3.7% to 3.5% citing the trade war between the US and China along with economic weakness in EU countries, namely Germany and Italy, as reasons for this lower forecast[viii].

II. Weaker outlook on oil price

Over the past ten years we witnessed the price of oil collapse twice. This phenomenon had never occurred prior to this period. Over the course of an 18-month period, From January 2007 to July 2008, the price of oil shot up nearly 200% reaching a record high of USD 143/bbl. An impressive rise by any standard.

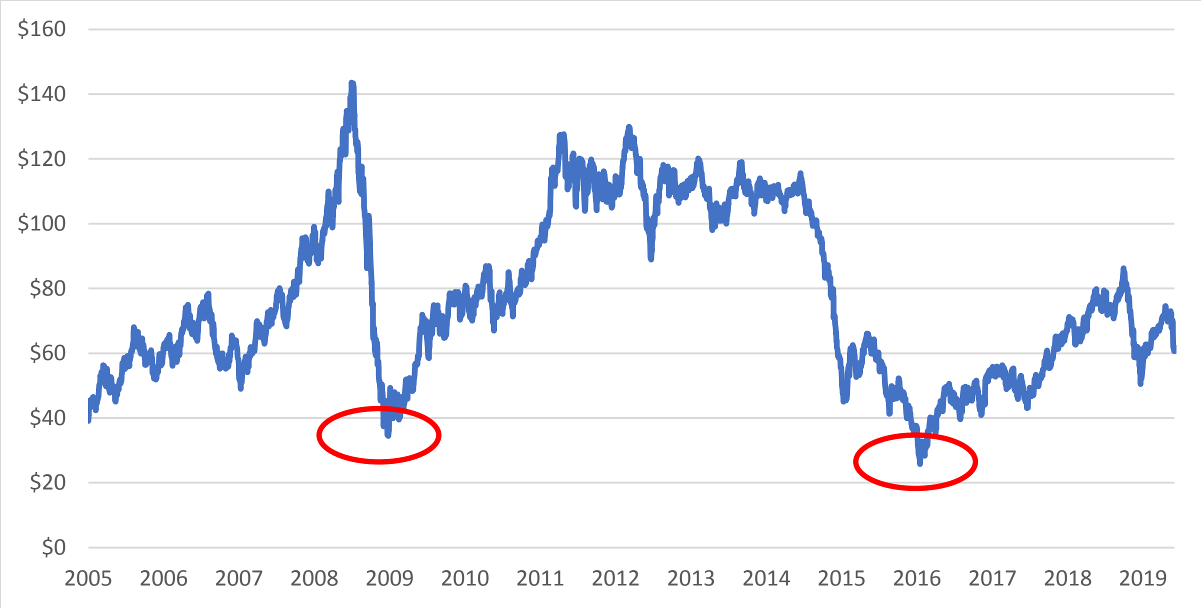


Figure 8: Price of Brent Crude per barrel in USD from January 2005 to 6 June 2019 highlighting both oil price collapses. Data source: Thomson Reuters and Trading Economics.

It was then followed by the fastest price collapse in the commodity's history falling over 75% over the next 5 months to settle at around USD 34/bbl. It took one year for the price to recover above USD 80/bbl and stayed above that price for the next four years. In June 2014, the second collapse began, falling over 78% over the next 19 months. It took nearly two years for the price to recover above USD 80/bbl. As can be seen in Figure 8, price collapses occur suddenly and fall at a faster rate than the price rise period. Since 2008, the price of oil has been unable to reach a new high, and in fact, has been unable to rise up above USD 100/bbl where it had traded for nearly four years. Thus, the price of oil will remain volatile and its direction will be dependent on the strength of the global economy.

III. Rising interest rates

Since 2009, world-record low interest rates were set by the leading central banks as a way to stimulate the global economy after the financial crisis. Ten years later, most central banks are still worried about raising rates believing that their economies have become too dependent on record low interest rates. Some economists view this as a permanent state of central bank economic support and stimulus.

The US Federal Reserve was one of the few central banks that raised rates over the past few years. This has had a noticeable impact on emerging markets as we witnessed last year with first Argentina's currency collapse, followed by Turkey and other emerging markets. Emerging markets were first to feel the pain of rising rates due to their foreign currency borrowings. In times of rising economic growth, borrowing more can help increase the rate of growth. On the flipside, in a slowing economy rising debt will only amplify a country's economic problems, especially if they are in foreign currencies.

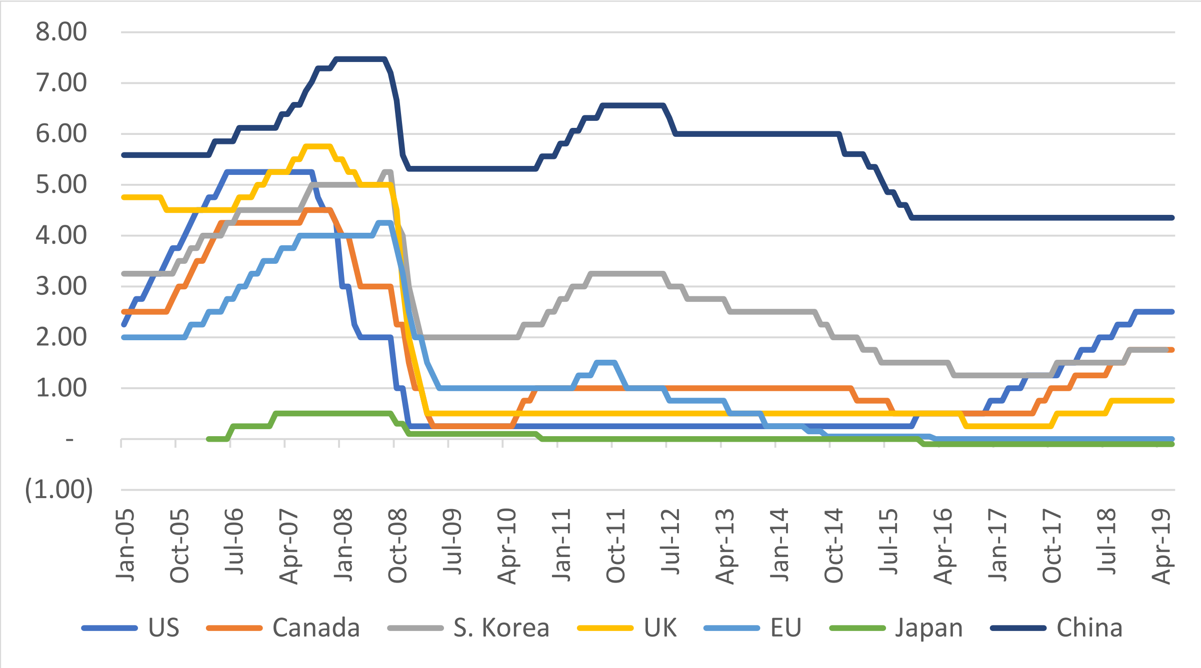


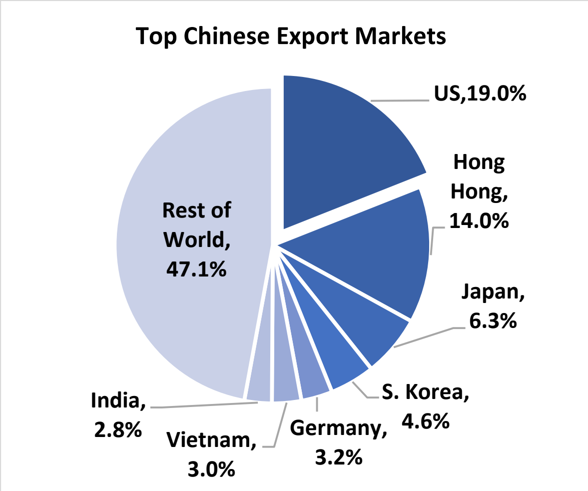
Figure 9: Effective central bank policy interest rates from 2005 to June 2019. Source: Trading Economics.

Higher interest rates in the US are driving US dollars back to the country seeking safety, while emerging markets struggle to keep their currencies stable versus the dollar in order to be able to pay back their foreign currency debts. This can be seen today by the near record high US stock indices and poor stock market performance of emerging markets dependent on foreign capital such as Egypt, Mexico, Pakistan and Turkey. The Federal Reserve has recently started lowering rates again as it has become concerned with the global growth outlook.

IV. Global trade wars

Trade wars are not a problem on their own. They are a symptom of other problems in the global economy, namely, unsustainably high national debts coupled with lower than expected GDP growth. The current trade war between the US and China has been going on since March 2018 and has begun to affect global trade.

Higher tariffs between the two countries have been implemented in stages as both sides try to negotiate an end to the dispute. The longer it takes for both sides to reach an agreement, the greater impact it will have on the global economy.



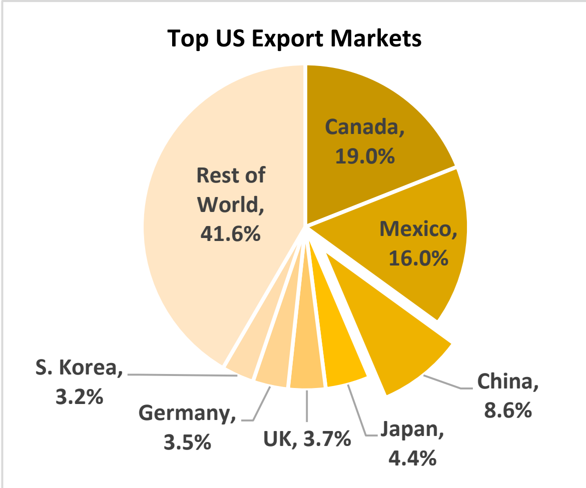


Figure 10: Top export markets for China and the US, respectively, as a percentage of the country's total exports in 2017. Source: Trading Economics.

China, however, is in a weaker position than the US. It is far more dependent on exporting to the US than the US is to exporting to China. Therefore, higher tariffs on both sides will disproportionately harm China more than the US. The escalation of the trade war has already begun to impact global economic growth. This, in turn, can directly impact oil prices and Kuwait's economy. In addition, it's important to note that China and the US are Kuwait's largest trading partners respectively.

4. Global banking trends that are changing the future of the industry

As of 2017, there were 5 billion mobile users worldwide according to GSMA, an organization representing mobile operators, with 57% of users using smartphones. In the MENA region, there were 375 million mobile users in 2017, or approximately 64% of the region's population. This figure jumps to 77% when only looking at the GCC region[ix].

Needless to say, mobile use is extremely high in the GCC region with Kuwait having one of the highest mobile phone penetration rates in the world according to the GSMA. The use of social media and mobile applications in Kuwait are also among the highest in the world.

With the mass-acceptance of mobile banking in the country, banks will no doubt be forced to be at the forefront of mobile banking trends in the coming years as Kuwait's young and tech-savvy population demand more mobile services from their financial institutions.

a) Mobile banking

Mobile banking began in the late 1990s with the launch of SMS services and later Wireless Application Protocol (WAP) services on mobile phones. Mobile applications or "apps" did not come to market until 2010 alongside the success of Apple's iPhone and Google's Android-enabled devices. It is no wonder then that the phenomenal success and use of mobile banking applications came alongside the explosion in smartphone use.

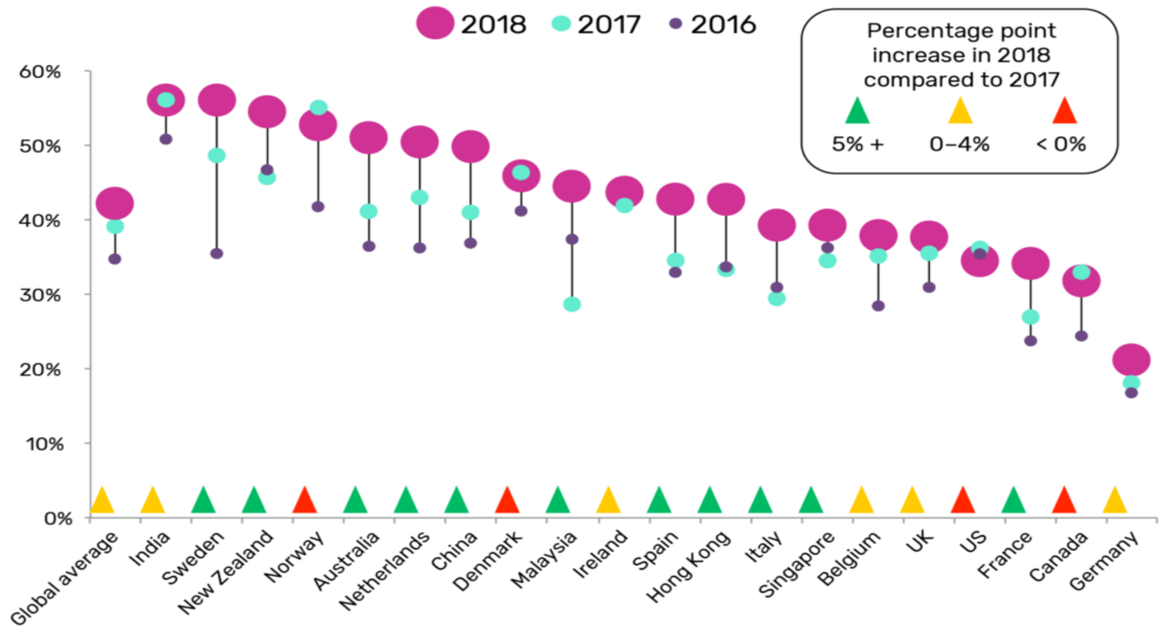


Figure 11: Proportion of online consumers with a current account who use mobile banking on a daily or weekly basis. Source: GlobalData's Retail Banking Insight Survey.

Today, over 43% of all banking customers globally use a mobile banking application on a daily or at least weekly basis. This is from zero percent only eight years earlier[x]. In Kuwait, the statistics of mobile and online banking use vary from bank to bank. In 2018, mobile banking use in Kuwait ranged from 11% to 92% of total banking customers, depending on the bank. Whereas, online banking use ranged from 7% to 39% of total banking customers over the same period. What is clear, however, is that mobile banking use has become more popular than online (web browser) banking[xi].

The appeal of mobile banking lies in its convenience, ease-of-use and overall better user experience than visiting a traditional bank branch. Banking customers today are looking for access to their accounts around the clock with the same services offered on their smartphone as are being offered at the branch. Over the next few years, mobile banking will continue to take on a larger role in managing customers' experience while physical branches become of lesser importance.

b) Blockchain

The first live use of blockchain was in January 2009 with the launch of Bitcoin, the world's first decentralized digital currency. There has been a lot of buzz in the market surrounding blockchain, however, much of it has to do with Bitcoin and other cryptocurrencies more than the underlying technology behind them – blockchain.

Blockchain in simple terms is a digital ledger. What is attractive about it is that by design, a blockchain is resistant to modification of the data. It is an open, distributed ledger that can record transactions between two parties efficiently. These transactions once recorded are verifiable and permanent.

Regardless of the hype and rapid volatility surrounding cryptocurrencies, blockchain is here to stay. Banks especially have been attracted to blockchain for its real-world applications and game-changing potential. Here are four areas where we see blockchain making an impact on banking:

i. Clearing and Settlement

Currently, the cost of clearing securities transactions cost banks and stock exchanges billions of dollars per year[xii]. The current system is managed by an outdated and bureaucratic system of messages and manual reconciliation. This includes recording securities transactions such as loans, mortgages and other real estate transactions. There is a big opportunity for blockchain to revolutionize this industry. Using blockchain, these transactions can be cleared almost instantaneously, be verifiable, permanent and can be done at a fraction of the current cost.

ii. Payments

Over the past few years, central banks across the world have been exploring the potential for shifting parts of their payments systems to blockchain technology. Central banks are realizing the potential of blockchain to modernize their payment systems.

The banking industry, however, is not sitting idle waiting for central banks to decide on what blockchain technology to use. They have instead began experimenting with and using blockchain to settle payments using existing technologies, such as Ripple – a cryptocurrency designed for payment settlement, as well as developing their own technologies using blockchain as a backbone.

Swift, the bank-owned messaging system used for the settlement of international payments, has been testing Ripple to settle payments and has so far been pleased with its speed and lower cost. However, it said that the technology is not yet ready for mainstream use[xiii]. Switzerland's UBS Bank has developed its own utility settlement coin, which aims to create a digital currency for use in financial markets by issuing tokens convertible into cash on deposit at central banks[xiv].

iii. Trade finance

Trade finance is another area that is still mostly based on paper, such as bills of lading and letters of credit. Blockchain seems like an obvious solution, especially since many parties are involved in such transactions including, banks, shipping companies, trade agents, freight providers, ports, customs and insurers. Most trade finance documents are currently being sent by post or fax.

However, in order to modernize and digitize trade finance, all parties involved must also digitize their process, including the banks. The market is moving in this direction as the time and cost benefits are clear to all parties involved. It will, however, take several years to develop and implement.

ix. Identification

Know-your-customer (KYC) is a vital for banking. Regulators hold banks responsible for checking customers' identities in order to prevent illegal activities, such as money laundering, and hold them accountable (i.e. fine them) if they are any breaches in this process.

Banks have been trying for years to set up shared digital records of customers' identities and keep them updated. So far, they have failed to find the right formula. Blockchain experts believe that blockchain is the solution because of its cryptographic protection and its ability to share a constantly updated record with many parties. Technology giants, such as Microsoft are working on blockchain solutions for identify verification. Here too, expect testing and implementation of such programs to be a few years away.

In the meantime, banks are proceeding testing and implementing data analytics using artificial intelligence (AI) machine learning to stop patterns and discrepancies in customer KYC data. Data analytics can complement blockchain identification and we expect both will gain wide-spread use in the coming years.

c) Non-bank competition/disruption

Over the past ten years, the biggest disrupter in the banking industry has been the migration towards mobile banking. The second most significant disputer has been the rise of competition – start-ups from both inside and outside the industry. In a recent interview with CNBC, Deutsche Bank CEO John Cryan, said that he spends most of his time thinking about how his bank can remain competitive with companies that are not banks. How, for example, can a bank be competitive in payments versus companies that purport to make payments, but are not regulated by financial regulators?[xv]

Companies such as PayPal are already known for their payment capabilities and are being used by millions of people around the world. Newer start-ups, such as TransferWise, are also looking to transform the industry by increasing the speed and reducing the cost of payment transfers. PayPal, which already has a strong market share in this sector has been looking to reinvent itself amid rising competition for newer companies with newer technologies or processes.

On the other side of the industry, there has been rising competition from new banks and financial institutions who are capitalizing on the rise in popularity of mobile banking. This allows them to forego investing in a capital-intensive branch network and instead, focus on investing in technology and attracting customers through their lower cost structures.

Goldman Sachs, for example, successfully launched an online retail bank called Marcus in 2016 in the US. Within two years, Marcus was able to attract 1.5 million customers with deposits of over $23 billion[xvi]. The success of this paved the way for the bank to launch Marcus in the UK in September 2018. The bank attracted over 100,000 customers in the first three months since it opened[xvii].

Several other online-only banks have launched in the UK, including N26, Smile, Moneta, Monzo and Revolut. So far, they have been experiencing similar success as Marcus. Monzo, for example, reached 1 million customers in its first year and has been reporting that it is opening 20,000 new accounts per month, with little advertising[xviii]. These online start-ups pose a big threat to traditional banks as they choose to invest in technology over building a branch network. The mass-acceptance of mobile banking has made this possible.

5. Are Kuwaiti banks embracing these trends?

The competitive landscape in Europe and the US is much different than in Kuwait and the rest of the GCC. There are currently no online-only banks in the country, nor does there appear to be a push by the CBK to allow for such banks. In fact, there is no sign of any new entrants coming to the market soon. Kuwait already has a well-banked market and rules on foreign banks in the country have eased somewhat allowing for them to open new branches.

The key market disrupter for banks in the country has been mobile banking. This move has come primarily as a result of the country's young population who have been quick to adopt new technologies. There has also been a push by the Kuwaiti Government to modernize the economy and utilize the latest technologies as it moves towards more e-government services.

In recent years, technology has truly changed the way Kuwaitis bank. From mobile banking to contactless payments, technology is reshaping financial services industry as we know it, and financial institutions are coming under increased pressure to adapt to their clients' rapidly evolving tastes. A recent EY survey of 2,000 Kuwaiti banking customers found that 89% would be prepared to switch banks in order to have a better digital experience[xix]. The survey also found that they would also be willing to pay more for digital convenience.

Though Kuwait's banks have been rolling out new mobile banking services and utilizing social media to connect with their clients, the challenge for them will be in how quickly they can adapt to the rapidly changing demands of their customers.

a) The Central Bank of Kuwait

Banks in Kuwait have been facing the same challenges as banks in Europe, the US and Asia have been facing in terms of keeping up with changes in technology and customer preferences. The Central Bank of Kuwait, for its part, has taken on these challenges head-on. Instead of reacting to the rapid changes in banking technology, it has decided to be at the forefront of new innovations and developments. This can be seen by three recent developments within the CBK; instructions for the regulation of electronic payment of funds, the launch of the Regulatory Sandbox Framework, and the development of the necessary infrastructure required to support a digital currency – Digital Dinar[xx].

On 26 November 2018, the CBK launched the Regulatory Sandbox Framework[xxi].
A regulatory Sandbox is a framework under which financial institutions can live test their new product and service innovations on a small scale, while being closely monitored by regulators. The purpose of this Sandbox is two-fold. First, it allows financial institutions to test the latest financial technology (fintech) in a real-world, yet controlled, environment. Second, it provides regulators an opportunity to better understand the nature of the product or service. This will determine whether the existing regulatory framework is sufficient, or if new regulations are needed.

This Sandbox is part of the CBK's efforts to support and regulate the fast-paced innovations taking place in banking technology. It also puts forward its objective of serving the local economy while at the same time, protecting users of these products and services against any risks arising from abuses or security breaches.

As for the development of a digital currency, the CBK has announced that development of a Digital Kuwaiti Dinar is in the works. Alongside this is the development of e-wallets to hold Digital Dinars. The benefit for the CBK to work on such a project would be to facilitate digital payments and exchange against tokenized assets. With the rate at which digital currencies and digital payments are advancing, the CBK is taking the right steps today to be ready for the future.

In addition to the Sandbox and Digital Dinar initiatives, the CBK is investing heavily in analytics and artificial intelligence (AI)[xxii]. The objective of this would be to help the CBK gain a smoother, faster understanding of information and facilitate the move away from paper and manual transactions. This will affect the way the CBK interacts with other entities, reduce expenses and improve overall efficiencies.

<u>b) Commercial banks</u>

Kuwait's commercial banks have also taken a leap forward and have been rolling out new digital products and services aimed at fulfilling their customers' growing demands. In addition to opening new smart branches in key areas, banks have been improving their overall digital offering, which places them at or above the level of their regional peers. The following are some of the latest technological advances in the Kuwaiti market:

i. Smart Branches

Several banks have launched e-branches or 'smart branches' in recent years, most notably, Kuwait Finance House (KFH) and National Bank of Kuwait (NBK). In November 2018, KFH unveiled its KFH-GO: Digital Self-Banking Station"[xxiii]. It is the first fully-automated 24/7 e-branch with an advanced range of self-service instruments using the latest banking technologies. The branch highlights the fundamental shift in the image of bank branches going forward towards more convenience, offering simplicity and speed for customers. KFH views this launch as a first step towards opening similar branches as part of its future plans for enhanced e-banking services to cater to its young customers.

The new e-branch is not permanently staffed and contains state-of-the-art XTMs, or smart ATMs, with the capability of communicating directly with the telephone service personnel in audio and video calls via XTM machines. Customers can access more than 30 services, including cash withdrawals without a card through the mobile phone using QR codes. Other services available at this branch include applying for Murabaha business transactions, requesting credit cards and prepaid cards, updating data and phone numbers, activating bank cards, and opening new accounts.

National Bank of Kuwait has also been opening e-branches and digital customer care centers[xxiv]. The digital customer care centers are different from e-branches in that they are designed more as an enhanced sales center for banking products as well as serve existing customer needs. The centers are equipped with iPads for customers to access information about products and services as well as access their Online Banking. Customers also have the option of using the iPads to conduct day-to-day transactions. In addition, there are also voice services for visually impaired customers including text-to-speech functionality in English and Arabic.

ii. Blockchain Payments

Kuwaiti banks have also been embracing blockchain in international payments. In December 2018, National Bank of Kuwait (NBK) started offering a new remittance service using RippleNet's blockchain technology[xxv]. Ripple, also known as XRP, is a real-time gross settlement system, currency exchange and remittance network created by Ripple Labs Inc. in the US. It has gained strong acceptance among banks globally for its low cost and instant payment transfers. NBK is currently using Ripple under the name "NBK Direct Remit," which is only available in Jordan for the time being.

In January 2019, KFH has started operating an instant cross-border remittance service, known as "Instant International Transfer," using Ripple's Blockchain technology[xxvi]. There are zero fees for these remittance transactions, one of the benefits of Ripple and Blockchain, and the service is currently only being offered to customers transferring money in Saudi Riyals via KFH's partnership with Al-Rajhi Bank. The bank plans on expanding this service to include more countries and in different currencies. Plans are also in the works to offer the service using the mobile application or through KFH online.

iii. Online Financing

Banking customers can now apply for financing without having to go to a branch. Existing banking customers at KFH and Boubyan Bank, for example, can apply for Murabaha financing online or through smart branches, mobile applications and smart ATMs.

iv. Enhanced customer experience

Over the past few years, Kuwaiti banks have been rolling out new and enhanced services to keep up with the latest advances in banking technology. This includes;

- Virtual credit cards and e-wallets – This allows customers to store specific banking cards on their mobiles or have online-only cards for better safety and securing while making online purchases.
- Fingerprint and facial recognition – This allows customers to log-in to their mobile banking services using their fingerprint or facial recognition, bypassing the need to type in a password.
- Online credit card issuance – This service lets customers apply for credit cards online or using the mobile application without the need to go to a branch.
- Cardless cash withdrawal – This service allows customers to withdraw cash for ATMs without the need for their banking cards. Customers instead can use their ID cards along with codes sent to their mobile phones for identity verification.
- Connecting to customers – Banks have proven to be successful at connecting to their younger customers by using their preferred choice for communication – social media. This includes using popular services such as Twitter and Instagram, and also includes one-on-one messaging applications such as WhatsApp.

6. Challenges Kuwaiti banks face that are impacting their ability to prepare for the future

The transformation of the financial services industry over the past decade has been mainly driven by customer demand for new and improved services and experience. This will continue to be the leading factor of change in the industry over the coming decade. There are, however, other factors that are impacting banks' ability to prepare for the future. This includes, regulatory challenges and the pace at which technology is changing the industry dynamics and customer preferences.

a) Regulatory challenges

The CBK has traditionally been cautious about enacting new regulations or allowing new technologies into the industry without fully studying their impact. This approach can at times put Kuwaiti banks at a disadvantage with their international peers. The biggest challenge facing the regulator today is the rising demand from customers for new products and services. As banking migrates online, the need for branch visits will slow down dramatically. Alongside this shift, customers will be looking for new banking products to match their lifestyles, such as mortgage financing and other financing tools. The speed at which mobile banking is developing is also forcing banks to launch new products at a faster rate. The regulator must be prepared to address these new demands to ensure banks are able to satisfy their customers' growing needs. The CBK is already mitigating this challenge by launching its Regulatory Sandbox Framework.

b) Market and economic challenges

The banking industry faces internal and external forces, many of which are driven by trends in the global economy. Kuwait's economic dependence on oil has placed it in a volatile situation. The price of oil has collapsed by more than 60% twice in the past decade and by 45% in the last quarter of 2018. These sudden price drops directly impact the economy.

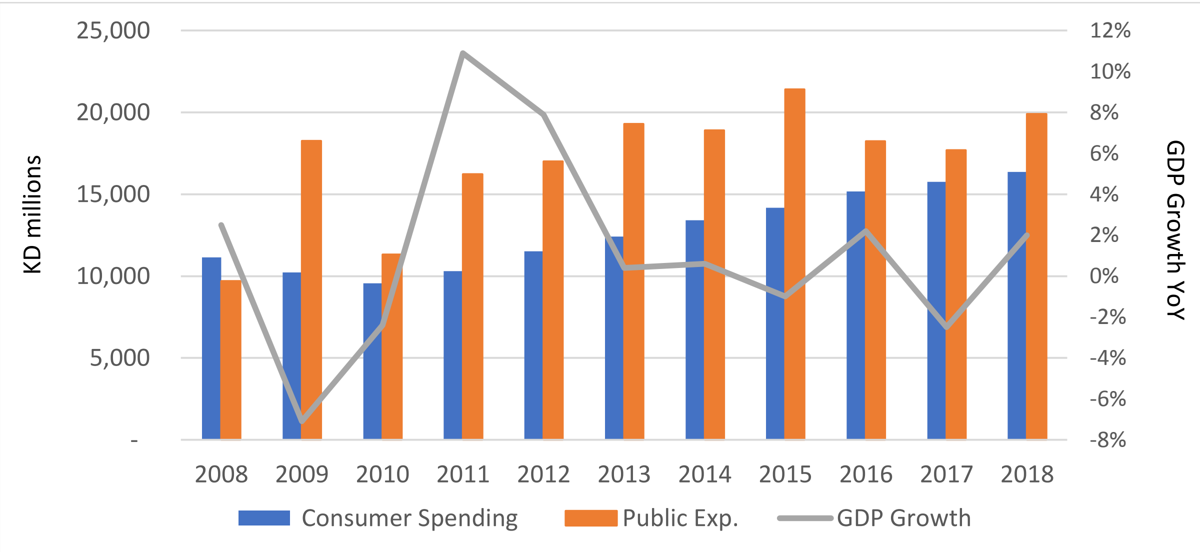


Figure 12: Public spending and consumer spending compared with year-on-year GDP growth rate. 2018 consumer spending is estimate. Data source: Kuwait Ministry of Finance, Central Statistics Bureau, Trading Economics.

The national economy is highly dependent on two factors for growth; government spending and consumer spending. Over the past decade, the government has had to drastically reduce its spending in light of collapsing oil prices. This has had a negative impact on the economy leading to recessions in both instances (2009 and 2017). What has supported the economy since 2010 despite the volatility in government spending has been the steady and consistent growth in consumer spending as can be seen in Figure 12. This steady rise in consumer spending is the main factor behind the financial sector's resilience over the past three years in spite of lower government spending.

Consumers, however, are not immune to economic contractions. In fact, consumer spending dropped in 2009 and 2010 as a result of the Global Financial Crisis. During this period, the financial service sector in Kuwait experience its worse performance in recent memory. Thus, another period of lower government spending coupled with lower consumer spending would negatively impact the financial services sector.

c) Threats from start-ups looking to disrupt the traditional banking model

As stated earlier, there are currently no licensed stand-alone online banks in Kuwait and the GCC. The threat for Kuwaiti banks in this area would come primarily from changes and disruptions taking place in other markets such as Europe and the US. As banking becomes borderless and digital, banking customers in Kuwait may find it advantageous to use international online banking platforms for their daily banking needs.

Cryptocurrencies are already held by Kuwaiti citizens and this digital money is being held outside the CBK's jurisdiction. As digital payment networks and cryptocurrencies become more widely used, we can expect to see more money migrating from traditional regulated banks to online payment networks residing in other countries. This is one reason the CBK decided to develop its own digital currency in order to be equipped when the time is suitable to issue a digital currency.

7. Conclusion

The biggest changes to the banking industry over the past decade have come from advances in technology. This, coupled with the high demands of customers for a better banking experience, which includes around-the-clock account access and mobile banking services.

The traditional banking model, which calls for growth through and expansion of branches networks is no longer viable. In today's highly competitive environment, banks must invest in technology and not high cost branches. Customer appetites for new and improved mobile banking services will be the driving force in the industry over the coming years.

Banks in Kuwait are embracing these changes and are sufficiently prepared for the future, however, challenges still remain. Much of it has to do with the speed at which advances in technology are taking place. This places a lot of pressure on banks to adapt quickly and direct their investments towards new technologies over physical branch expansion.

The banks that are best prepared for the future are the ones that have the capital necessary to invest in the latest technology. The high cost of such investments may affect the performance of smaller banks more than the larger banks. Kuwaiti banks overall are small by international standards and investment in technology will drive up their expenses, at least in the near term, as they prepare for the future.

ABOUT THE AUTHOR

Mr.Tariq Al-Rifai has been involved in banking and finance for over 22 years and is viewed as a leading authority on global and regional macroeconomic trends, Islamic finance and investment products. He has written for publications such as Euromoney and The Harvard Forum on Islamic Finance and is the author of Islamic Finance and the New Financial System: An Ethical Approach to Preventing Future Financial Crises, published in 2015.

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Mr. Al-Rifai is the founder and CEO of Quorum Centre for Strategic Studies, a London-based think tank dedicated to protecting GCC wealth. He is also an advisor to the United Nations Development Programme (UNDP) on Kuwait economic policy. Prior to this he served as the Head of Investor Relations and Economic Research at Kuwait Finance House in Kuwait. He also served as Director of Index Investment Strategy at S&P Dow Jones Indices (Dubai) and as Vice President of UIB Capital, a Chicago-based private equity firm which managed a $300 million Shariah-compliant investment portfolio.

Previously, Mr. Al-Rifai was Vice President of HSBC Bank's Islamic Finance Program in New York. In 1996, he founded Failaka Advisors, which was the first-ever organization to monitor and publish research on Islamic funds. Mr. Al-Rifai holds an MBA from DePaul University in Chicago and a Bachelor's degree in international finance from St. Cloud State University in Minnesota.

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