TICG

KUWAIT INVESTMENT AUTHORITY,
KUWAIT FUND FOR ARAB ECONOMIC DEVELOPMENT &
OLIVER WYMAN JOINT COMPANY

KUWAIT'S $10 BN OPPORTUNITY IN FINANCIAL SERVICES

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INTRODUCTION

KUWAIT'S $10 BN OPPORTUNITY IN FINANCIAL SERVICES

In the second half of the 20th century, Kuwait's financial sector was regularly regarded as being at the forefront of the GCC. Multiple factors, however, including global and regional developments and increased competition, have resulted in an erosion of Kuwait's financial sector's positioning compared with other GCC centres. In this report we present a pulse check on Kuwait's financial services (FS) sector based on TICG research and interviews conducted with board members, CEOs, and other C-level executives from leading financial institutions in Kuwait. The dominant conviction that emerges is this: Instead of categorising Kuwait as another regional or international financial centre, it would be more beneficial to evolve the FS sector so that it works better for the real Kuwaiti economy. We estimate that doing so would create tangible value, leading to an increase of $10 BN in Kuwait's 2025 GDP and $55 BN cumulatively over the 10-year period 2016-2025.

This could lead to an additional 65,000-110,000 private sector jobs cumulatively, in both FS and non-FS, by 2025 (~15% of total cumulative job creation over the period in the base case). These new jobs would accommodate an estimated 30-50% of all Kuwaitis entering the workforce for the first time over the next decade. This translates into a 10-20 percentage point increase in the share of employed Kuwaitis working in the private sector, compared with the 2025 base case. It has the potential to reduce the government's wage bill by $5 BN and increase government non-oil revenues by $1 BN in the year 2025 (for these two metrics, a cumulative addition of $20 BN and $5 BN to the national account over the next 10 years).

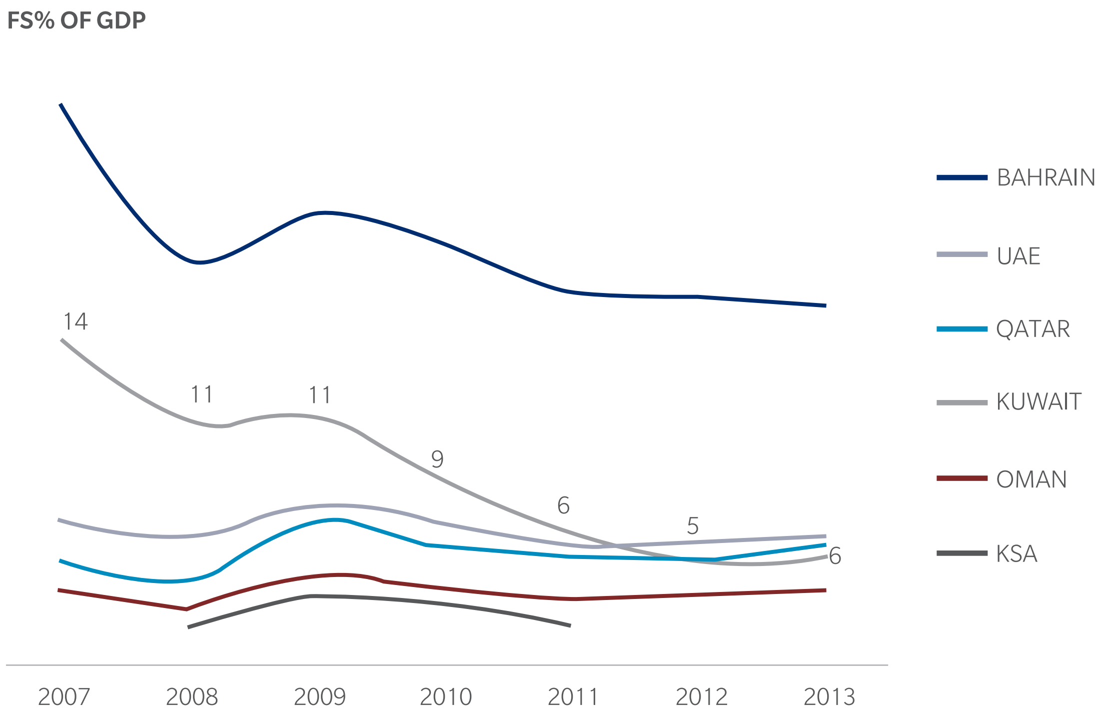
To ensure reform implementation, high-level guidelines are proposed, based on governance models found in other jurisdictions but modified for the Kuwaiti environment. We also present comparable case studies from countries with strong reliance on natural resources and financial services, respectively, which provide relevant lessons for Kuwait.

In addition to FS sector work, TICG has recently been involved in several wider reform projects in Kuwait. These include: (i) assessing the current Civil Service wage system and defining a new one that increases fairness and transparency, manages wage bill growth and government spending, and promotes high performance; and (ii) detailing Kuwait's national vision and revising the Kuwait Development Plan to ensure that it is driven by this vision and that it achieves its objectives in the most effective and efficient manner. Such projects play an instrumental role in helping Kuwait achieve the desired level of economic growth and sustainability. One key lesson learned from these experiences is that Kuwait should avoid trying to navigate a complex roadmap: rather, the country should focus on a limited and pragmatic set of initiatives.

RECENT IMPROVEMENTS BUT A STORY OF DECLINE OVERALL

Kuwait has many assets, including high oil revenues and a population that is proud of its national heritage of private-sector drive and entrepreneurial spirit. This history led to Kuwait's financial sector regularly placing at the forefront of the GCC in the second half of the 20th century. Kuwait has the oldest sovereign wealth fund in the world (established in 1953), the first stock exchange in the region (initiated in 1977), and a thriving financial sector, which accounted for a significant ~14% of GDP in 2007 (the second highest in the GCC after Bahrain). In that year, the oil sector accounted for ~50% of GDP.

EXHIBIT 1: WEIGHT OF FS SECTOR IN GCC COUNTRIES

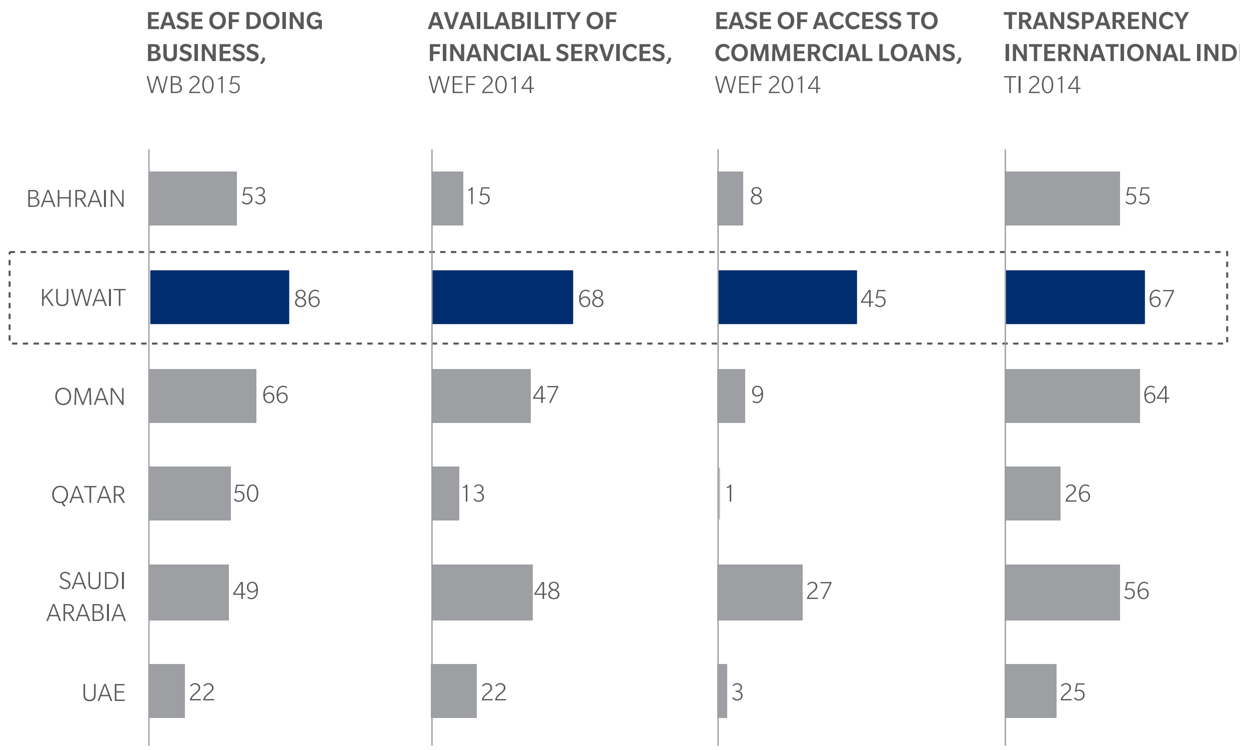


	2007	2008	2009	2010	2011	2012	2013
KUWAIT OIL SECTOR % OF GDP	50%	57%	47%	49%	56%	58%	56%

Source: Country Bureaus of Statistics, Cooperation Council for the Arab States of the Gulf Secretariat General, TICG analysis

However, multiple factors, including global and regional developments and increased competition, have eroded Kuwait's financial sector's positioning compared to other GCC centres. Today, Kuwait ranks low across many economic and financial sector indicators. It is ranked 86th in ease of doing business, 68th in availability of financial services, and 45th in ease of access to commercial loans (see Exhibit 2). Kuwait is excluded from the Global Financial Centres Index (GFCI), which ranks the competitiveness of financial centres around the world. Kuwait's Stock Exchange (KSE) has been in decline since the 2008 crisis: the value of traded shares dropped by ~84% between 2008 and 2014, while the market capitalisation of listed companies dropped by ~49%. Those elements, along with a lack of transparency (Kuwait ranked 67th in the world in the 2014 Transparency International index, the lowest in the GCC), have contributed to the KSE remaining on MSCI's Frontier Markets Index. By contrast, the UAE and Qatar Exchanges were promoted to Emerging Markets in 2013, and KSA's is expected to join them in 2017. In addition, FDI outflows from Kuwait are the highest among GCC countries, while inflows rank in the lower half for the region. Finally, anecdotal evidence from interviews puts the percent of Kuwait's private wealth that is located in foreign markets at 60-80%, an indication of the level of confidence Kuwaitis have in their own financial sector.

EXHIBIT 2: GCC COUNTRY GLOBAL RANKINGS – SELECT INDICATORS



Note: World Bank ranking out of a total of 189 countries. WEF rankings out of a total of 144 countries. CPI ranking out of a total of 174 countries.
Source: World Bank (WB), World Economic Forum (WEF), Transparency International (TI)

The goal of the 2020 Kuwait vision for the FS sector, drafted in 2007, was for Kuwait to become a niche regional financial centre focused on wealth management and capital markets. However, leaders within this sector now doubt that Kuwait will successfully compete for investors with KSA, Dubai, Abu Dhabi, or Qatar. As one interviewed executive put it: "The boat has sailed on Kuwait becoming a regional financial centre". Another executive cautioned: "Kuwait should not aspire to become a regional centre like KSA, UAE, and Qatar. There is no need for another one". However, Kuwait has strong fundamentals (#11 in GDP per capita, #6 in oil reserves, 96% literacy rate, 41% of population under 25). And the leaders we interviewed believe that the financial services sector has a responsibility to further support the real economy. Said one interviewee: "It is a strategic interest for Kuwait to develop its financial services sector. This will not only support the economy but also create well-paying jobs for Kuwaitis". There is therefore an essential need to assess Kuwait's FS sector and identify means by which to address key pain points and impediments to growth.

AN URGENCY FOR CHANGE

Kuwait stands at an inflection point today. Oil prices are down and, according to the Ministry of Finance, Kuwait's revenues from oil in the 2014-2015 fiscal year have shrunk by 37% compared to the 2012-2013 fiscal year. Its demographic structure, characterized by a young population, will lead to ~230,000 Kuwaitis entering the workforce over the next 10 years (net increase in Kuwaiti workforce of ~175,000). TICG's research for the Kuwait National Vision has identified an urgent need for change. Our forecasts suggest that the current approach of absorbing ~80% of the labour market into public service is not sustainable and could lead to a budget deficit as early as this year. Indeed, in January 2015 the cabinet approved the budget for the 2015-2016 fiscal year, projecting a ~$23 BN deficit; the government's wage bill comprised the single largest expenditure component, projected to account for ~52% of total government expenditure. Furthermore, based on publicly available data, and assuming an oil price of $45/barrel and a growth in public expenditures of 2% per annum (in contrast to the ~9% average over the past three years), our forecasts indicate that the General Reserve will be depleted by 2025.

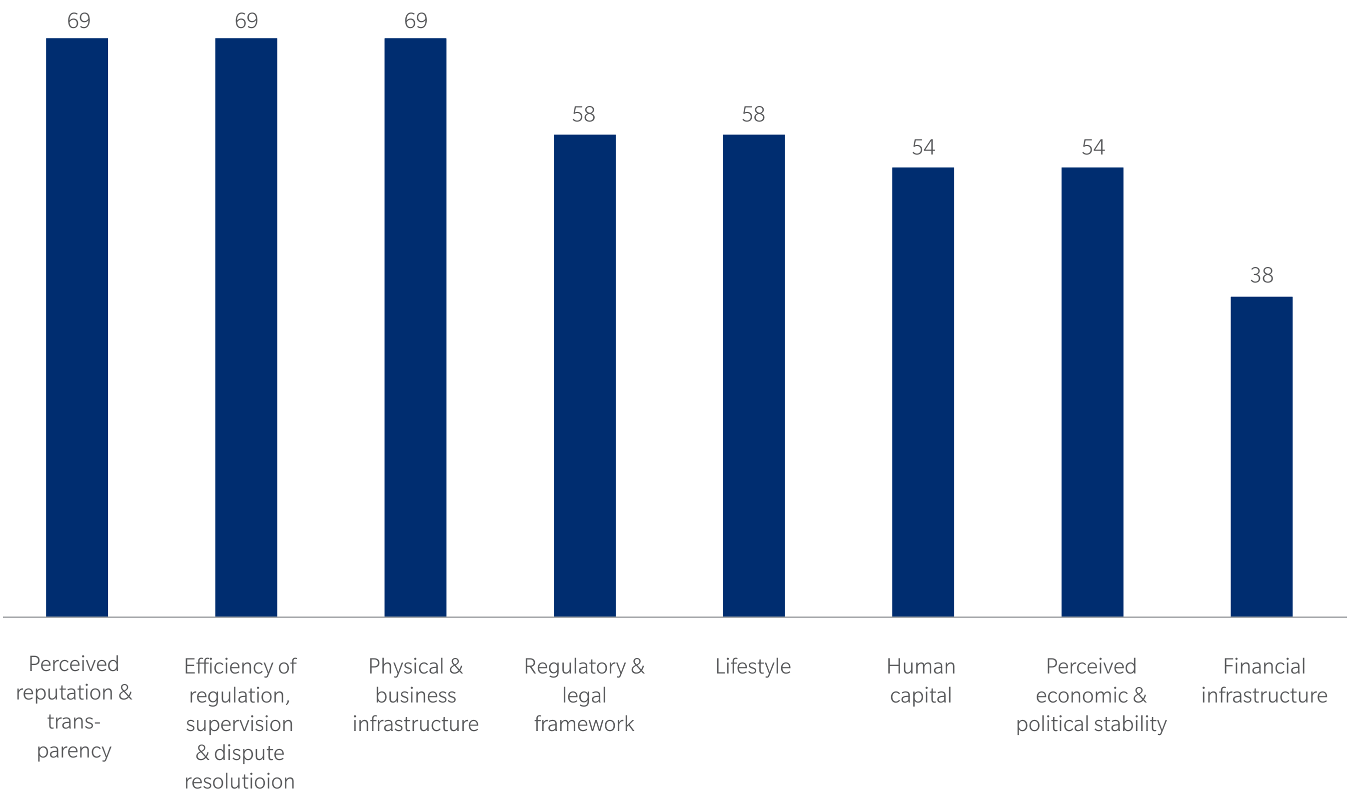
"We do face challenges with human capital. There is a supply of good Kuwaiti talent but the problem is the large demand from the public sector, which is more secure and better paid; whereas internationally public sector jobs are not as well paid as private sector jobs"

We asked leaders of 30 major financial institutions in Kuwait to identify and rank the pain points in their sector. Regulation was identified as a clear pain point, with three dimensions: the perception of regulation, its effectiveness, and the framework design. All interviewees acknowledged the instrumental role that regulators played in protecting the economy through multiple financial crises (the NPL ratio had, for instance, decreased from 8.9% in 2010 to 3.8% in 2014) as well as the various improvements that are taking place (e.g. higher provisioning levels, introduction of comprehensive corporate governance framework, move towards Basel III, and the Central Bank of Kuwait announcement of the launch of an automated cheque clearing system in May 2015).

However, most interviewees said that an exceedingly risk-averse approach of control over incentives is stifling the sector, leading to a lack of competition and innovation. One executive stated: "The regulators are protecting the stability of the financial system but doing so excessively". Another executive echoed that opinion: "Regulation is key but the level of control is the most stringent in the GCC". The regulatory environment has made access to financing a constant challenge for the private sector, especially SMEs. Another executive noted: "Regulations need to be adjusted to improve access to financing. For instance, the retail loan spread cap makes it difficult for SMEs to borrow since only low-risk loans are given".

Beyond physical infrastructure and lifestyle, two areas that are especially complex to address, another key challenge identified by most of the interviewees is the availability of human capital. A high Kuwaitisation ratio requirement coupled with a small pool of talent has made employee acquisition and retention a major challenge within the financial sector. The fact that the private sector must compete for talent against comparably high-paying, but significantly lower-pressure, public sector jobs, provides the wrong incentives for job seekers. One interviewee directly addressed this issue: "We do face challenges with human capital. There is a supply of good Kuwaiti talent but the problem is the large demand from the public sector, which is more secure and better paid; whereas internationally public sector jobs are not as well paid as private sector jobs". Another executive took this thought further: "The hiring of so many Kuwaitis in easy public sector jobs has created an environment that hinders the hard-work mentality".

EXHIBIT 3: KEY FS SECTOR PAIN POINTS



Source: TICG interviews with Kuwait FS industry leaders

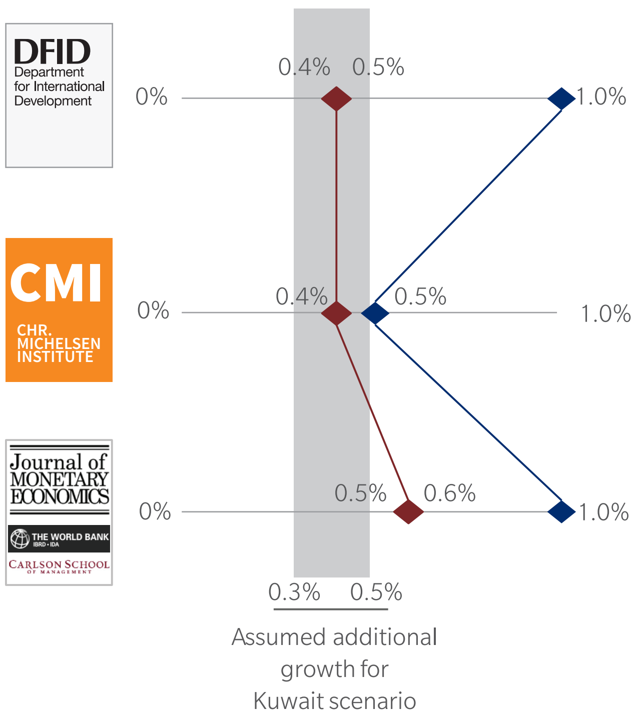
THE $10 BN OPPORTUNITY

The FS sector is a critical component of any nation's economy; how well it works is a key factor in determining how the rest of the economy functions. To illustrate, consider how the 2008 financial crisis plunged economies into recessions around the world. In addition to providing substantial employment, a modern FS sector provides three fundamental services to the rest of the economy: credit provision, liquidity, and risk management services.

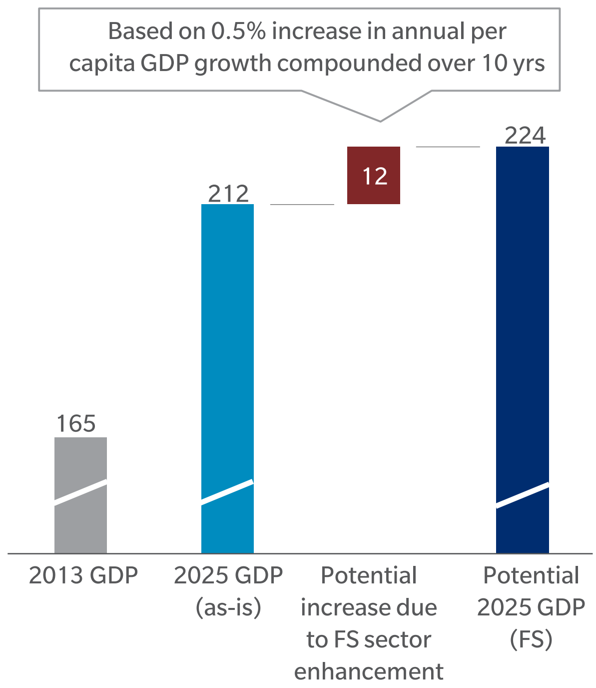
These services comprise a crucial building block for private sector development, and therefore the FS sector is essential to economic growth. Numerous studies have been performed attempting to quantify the impact of FS sector development on economic growth[1]. The weight of the evidence shows that FS sector development provides a critical contribution to growth, particularly in emerging markets. In return, growth generates greater demand for financial services,

EXHIBIT 4: POTENTIAL GDP IMPACT OF KUWAITI FS SECTOR ENHANCEMENT

RANGE OF INCREASE IN AVERAGE ANNUAL REAL PER CAPITA GDP GROWTH ASSOCIATED WITH INCREASED FINANCIAL DEVELOPMENT
EMPIRICAL EVIDENCE, NON-EXHAUSTIVE



POTENTIAL DIRECT GDP IMPACT OF KUWAITI FS SECTOR ENHANCEMENT



Note: 0.5% additional per capita GDP growth leads to a CAGR of 2.6% instead of the base case of 2.1% for the 10 years 2016-2025
Source: International Monetary Fund, Department for International Development (UK), Journal of Economic Cooperation and Development, Chr. Michelsen Institute (Norway), Journal of Monetary Economics, TICG analysis. Assumes a US$/KWD exchange rate of 3.31

1. Sample of studies analyzed for this study: (1) Financial intermediation and growth: causality and causes; Ross Levine, Norman Loayza, Thorsten Beck; Journal of Monetary Economics; 2000 – (2) The influence and effects of financial development on economic growth; Susanne Risla Andersen; Chr. Michelsen Institute; 2003 – (3) The importance of financial sector development for growth and poverty reduction; Policy Division; Department for International Development; 2004 – (4) Quantifying the impact of financial development on economic development; Jeremy Greenwood, Juan Sanchez, Cheng Wang; Review of Economic Dynamics; 2012 – (5) Reassessing the impact of finance on growth; Stephen Cecchetti, Enisse Kharroubi; Bank for International Settlements; 2012 – (6) Rethinking financial deepening: stability and growth in emerging markets; IMF staff discussion note; 2015

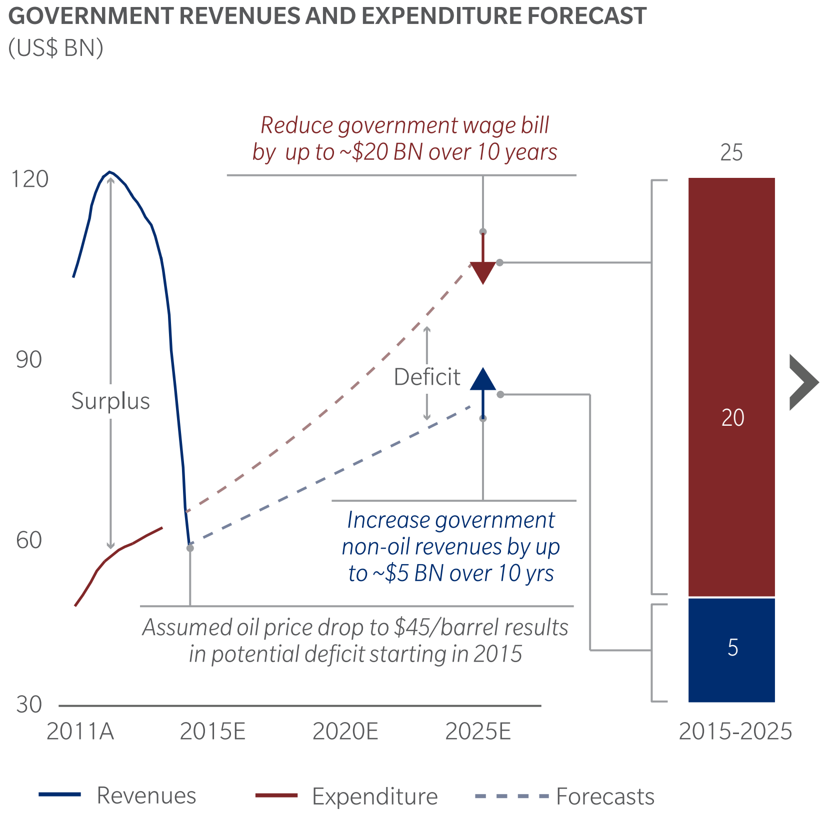
and hence induces an expansion of the financial sector itself. Appendix provides details on the methodology used to forecast the indicators in this section.

Our estimate of the potential upside of FS sector enhancement on Kuwait's economic growth is based on a conservative evaluation of benchmarked empirical evidence. The impact of FS sector development on economic growth differs across countries, time periods, and modelling techniques, but in many cases falls between 0.4% and more than 1.0% increase in average annual GDP per capita growth (see Exhibit 4). The base-case 2025 Kuwait GDP is calculated based on IMF data and projections (updated in March 2015) as well as historical growth rates.

A more efficient and effective Kuwaiti FS sector has the potential to significantly catalyse the real economy. For this report, we have taken a conservative assumption of the benchmarked empirical evidence, with a projected increase in average annual per capita GDP growth of just 0.3% to 0.5% over the coming decade. When compounded annually with population forecasts from Oxford Economics (4MM by 2020), this GDP growth adds $7-12 BN to Kuwait's GDP in the year 2025.

Growth in the real economy will have a multiplier effect on the FS sector, which could increase banking revenues by as much as $600-1,000 MM by 2025 (a description of the estimation methodology can be found in the appendix).

EXHIBIT 5: POTENTIAL IMPACT OF FS SECTOR ENHANCEMENT ON KUWAIT'S NATIONAL ACCOUNTS



IMPACT OF REFORMS ON GOVERNMENT NATIONAL ACCOUNTS

- These reforms could increase government non-oil revenues[1] by ~$5 BN over coming 10 years...
- ...while translating into 10-20% migration[2] of jobs from public to private sector, reducing government wage bill by up to ~$20 BN by 2025
- Combined impact of reforms could be additional ~$25 BN to the national account by 2025

1. Fees on profits and international trade/transactions, etc.

2. Increase in share of employed Kuwaitis working in the private sector.

Source: International Monetary Fund, Department for International Development (UK), Journal of Economic Cooperation and Development, Chr. Michelsen Institute (Norway), Journal of Monetary Economics, International Labor Organization, Kuwait Ministry of Finance, Kuwait Central Statistical Bureau, OPEC, KPC, TICG analysis. Assumes a US$/KWD exchange rate of 3.31

Consequently, the total direct GDP growth resulting from an enhancement of the FS sector, excluding third-stage growth effects, is projected to be $8-13 BN, averaged at $10BN, by 2025. Much of that growth will come from the private sector as credit, liquidity, and risk management services become more sophisticated and more accessible. The SME segment, which was flagged by several interviewed executives as being "under-banked", would benefit greatly from such a shift.

A revitalized FS industry could lead to an additional 65,000-110,000 cumulative private sector jobs (both FS and non-FS jobs) by 2025, or approximately 15% of total cumulative job creation in the base case. The additional jobs would employ an estimated 30-50% of all Kuwaitis that enter the workforce over the next decade and could result in a 10-20 percentage point increase in the share of employed Kuwaitis working in the private sector compared to the 2025 base case. A change of this magnitude has the potential to reduce the government's wage bill by $5 BN and increase government non-oil revenues by $1 BN in the year 2025; respectively, for these two metrics, a cumulative change of $20 BN and $5 BN will accumulate over the next 10 years, adding $25 BN to the national account (a description of the estimation methodology can be found in the appendix). Reforms to FS sectors have created comparable economic growth in many markets around the world. In Exhibit 6, we present case studies of Norway and Mauritius, countries with a relatively strong reliance on natural resources and financial services, respectively.

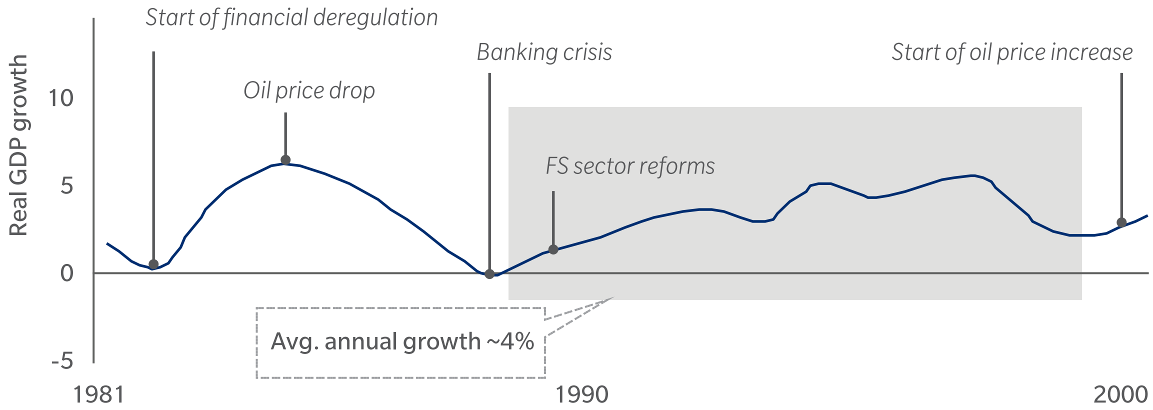
Norway's growth and employment performance after financial deregulation in the 1980s and the post-banking crisis reforms of the early 1990s has been consistently strong. It has even been suggested that the banking crisis actually had an ultimately favourable effect by encouraging structural and economic policy reforms, such as the introduction of flexible inflation targeting, the strengthening of Norway's financial supervisory authority (including a shift in approach to "active risk-based supervision") and tax reforms.

Similarly in Mauritius, strong economic growth directly followed changes to the Mauritian financial system under the financial liberalisation program in the 1980s and 1990s. Reforms undertaken as part of that program included, among other things, interest rate liberalisation and abolition of credit ceilings. The outcome was very strong GDP growth on the back of solid expansion of the FS sector.

EXHIBIT 6: STRONG ECONOMIC GROWTH FOLLOWING FINANCIAL LIBERALISATION PROGRAMS

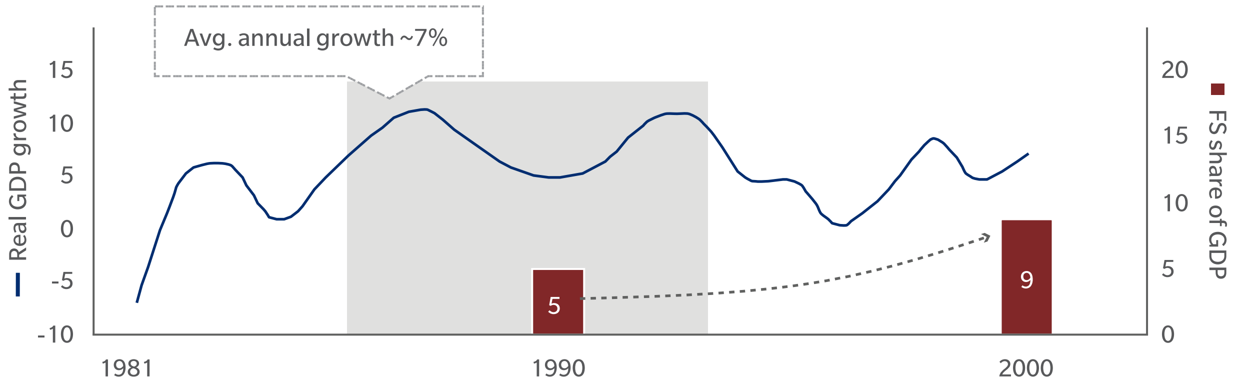
NORWAY

- Start of financial deregulation process in early 1980s. Reforms included deregulation of bond market, opening of stock market to foreign investors, removal of regulations pertaining to international capital movements, and abolishment of regulations pertaining to bank branch establishments
- Second wave of institutional and structural policy reforms launched in early 1990s. Reforms included strengthening of FSA Norway[1] and the Ministry of Finance, deregulation of international capital flows, strengthening of banks' risk management practices, tax reforms
- These reforms supported strong economic growth following drop in oil prices in mid-1980s and banking crisis in late 1980s



MAURITIUS

- Adjustment program launched in 1979 (support from WB, IMF)
  - Initial focus on price stabilization, reduction of gov. imbalances, containment of rapid credit expansion, etc.
  - Focus later shifted to liberalization of exchange and trade system, privatization, tax reforms, and institutional and financial reforms to liberalize FS sector
- By 1990s, FS sector liberalization, development, and world integration became major policy objective. Reforms between late 1980s and late 1990s included the liberalization of interest ratesabolition of credit ceilings on priority and nonpriority sectors, abolition of creditdeposit ratio, and increase of minimum risk weighted capital adequacy ratio from 8% to 10%



1. Financial Supervisory Authority of Norway

Note: Other factors also contributed to Mauritius' and Norway's growth (trade openness, product market reforms in e.g. telecom, energy, etc.)

Source: Center for Monetary Economics (Norwegian School of Management), Bank of Mauritius, University of Mauritius, World Bank Africa Success Stories Project, IMF, TICG analysis

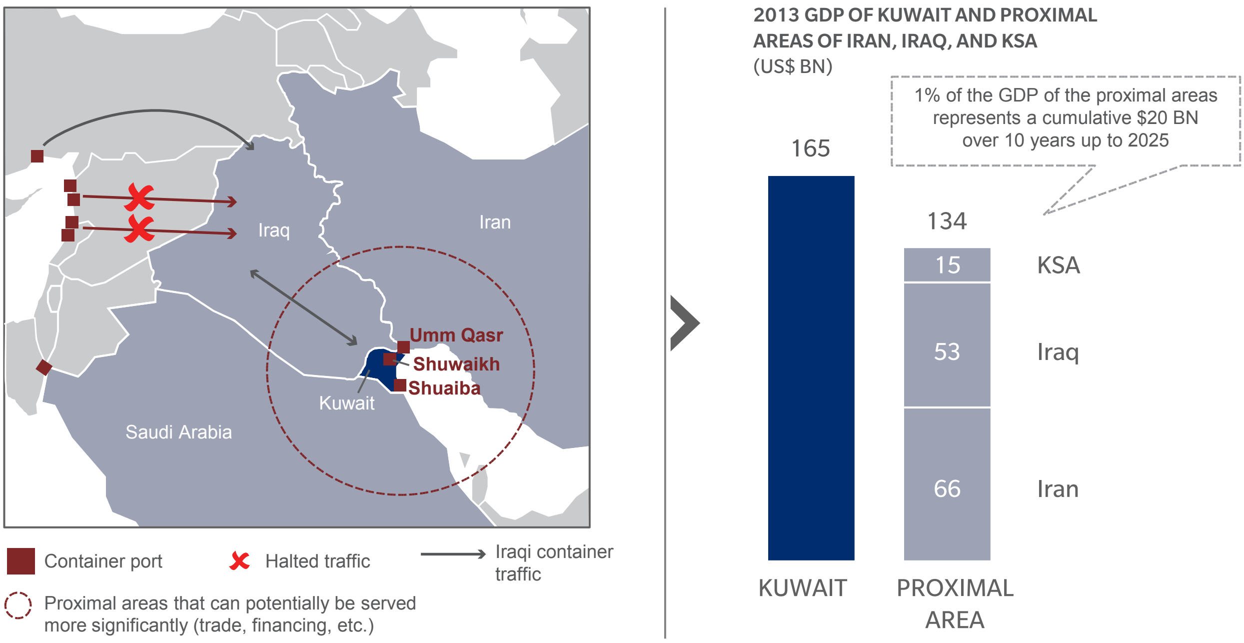
THE OPPORTUNITIES FOR GROWTH

In addition to the direct impact on GDP growth, a competitive FS sector would better position Kuwait's private sector to capture several potential indirect opportunities:

- Kuwait's latest National Development Plan, which was approved by Parliament in February 2015, envisages spending $116 BN on development projects over the coming five years. A significant share of that spending is expected to be financed by the private sector under PPP and BOT agreements, which can be further facilitated with a broader set of financial instruments.

- Kuwait is strategically located between three large economies – KSA, Iran, and Iraq – whose collective GDP was almost eight times that of Kuwait in 2013. As one interviewee underscored: "Regional trade has always been a backbone of Kuwait's economy and its financial sector". Thus a reformed FS sector (with stronger transaction banking products covering trade finance and cash management, better electronic channels, advanced credit and collateral modelling techniques for these lines of business, etc.), along with improved infrastructure (69% of interviewees scored the physical and business infrastructure of Kuwait as below average), would allow Kuwaiti businesses to leverage their location. This opportunity enables Kuwait to better serve the proximal areas in those countries – the north-east of KSA, the south of Iraq, and the west of Iran – whose GDP amounted to an estimated $135 BN in 2013, representing more than 75% of Kuwait's in that year.

EXHIBIT 7: REGIONAL OPPORTUNITIES THAT A COMPETITIVE KUWAIT COULD CAPTURE



Source: Country Bureaus of Statistics, TICG analysis. Assumes a US$/KWD exchange rate of 3.31

Such opportunities are contingent upon a stable Iraq and a sanction-free Iran, but they present a significant upside even if only a small portion is captured. One interviewed board member explained; “a lot of trade with Iraq is performed in cash because of the situation there. If Kuwait can somehow create a structure whereby calculated risk can be taken, it can become a payment and trade centre for Iraq”.

Other potential opportunities include: growth in the insurance market, the penetration of which (in terms of ratio of written premiums to GDP) stood at 0.6% in 2013, the lowest in the GCC; supporting SMEs via, among others, increased lending and improved related practices (behavioural scoring, credit guarantees, etc.); and growth in Islamic banking (Kuwait was home to ~10% of global Islamic Banking assets in 2007 versus ~6% in 2013). Kuwait could also consider revisiting its historical strengths in asset management.

To ensure the success of a reform program, it should not be undertaken as a major transformation with a complicated strategy that is challenging to communicate and difficult to implement. Instead, it should focus on practical steps that consist of incremental and digestible improvements. It should be led by a taskforce that is governed through a model based on best practices from other jurisdictions and adapted to the unique specificities of Kuwait. For example, in other markets where successful FS reform has been implemented, such a taskforce reported directly to the Prime Minister and included members from at least the Ministries of Finance, Economy/ Planning, and Commerce & Industry, as well as the Central Bank, CMA, and representatives from the private sector.

In some areas Kuwait has already begun the difficult work; it has launched multiple initiatives over the past few years aimed at improving the financial sector (e.g. new regulations for foreign retail banks). In addition, the Kuwait Development Plan identifies and outlines many FS sector policies ranging from reforming the current structure of the banking and insurance sectors (e.g. developing and increasing banking products and services) to activating and reviving the KSE (e.g. facilitating public offering and private placement) to reinforcing the regulatory role of the Central Bank (e.g. reviewing levels of local interest rates). The market has become aware of these initiatives, and many people expect that they will soon be implemented. However, these initiatives have not been prioritised as part of the implementation projects for the next two years. This misalignment of expectations could lead to market frustration and further erode confidence. In fact, part of TICG’s work for the National Vision entails optimising implementation by revising the Kuwait Development Plan to ensure that it is driven by the national vision and that it achieves its objectives in the most effective and efficient manner. Through that initiative, TICG has also identified other key projects not included in the Development Plan.

From the dozens of improvement initiatives discussed during our interviews with FS industry leaders and directors, we heard consistent themes: regulatory effectiveness, access to human capital, and private sector reform. However, the way to achieve these goals has not been clearly articulated. Now is the time to do so, as Kuwait’s financial sector has already been over-analysed, but actual fixes have been under-implemented.

We believe that Kuwait can start seeing benefits from reforms in less than two years, thus positioning itself on a path to realize much of the returns outlined in this report. According to the Oliver Wyman – Zogby Research 10th GCC Business Confidence and Government Reform Survey 2015 (which surveys over 200 C-level executives), general business confidence in Kuwait between 2014 and 2015 increased by 55 points, the highest increase in the GCC, followed by Qatar (33 point increase), KSA, and the UAE. On the heels of that survey, and given the significance of the potential upside of these reforms, we believe that the time for Kuwait to invest in change is now. Making incremental but meaningful improvements to key areas of the financial sector benefits, not only the FS sector, but the broader economy. The starting point in our view is the establishment of a joint task force to take ownership of this issue and lead the change.

APPENDIX

METHODOLOGY FOR CALCULATING IMPACT OF REFORMS ON JOB CREATION, FS SECTOR, AND NATIONAL ACCOUNT

Impact on job creation was estimated based on data obtained from the IMF and the Kuwait Central Statistical Bureau. Historical data on employment and average compensation were used to compute the ratio of total salaries to GDP (~45-47%). Using an inflation-based increase in average compensation, coupled with the potential increase in GDP, we determined the estimated number of additional jobs that could be created. Adding the bulk of these additional jobs to the private sector, and accordingly reducing public sector jobs through retirement, informed our estimate of the potential migration.

The total potential impact on the national account is the sum of the potential increase in government non-oil revenues and the potential decrease in the government's wage bill (due to greater employment of Kuwaitis in the private sector).

Other non FS-specific factors – such as general ease of doing business, the legal system, respect for property rights, and degree of transparency – will also play an important role in economic growth and FS sector development, and hence an important role in helping Kuwait realize the above-mentioned benefits. However, these have been kept constant for the purposes of these projections.

ABOUT TICG

Tri International Consulting Group (TICG) is a world-class management consultancy that combines extensive industry knowledge and deep Kuwaiti market understanding with specialised expertise in strategy, operations, risk management, and organisation transformation. Our professionals help clients optimise their businesses, improve their operations and risk profile, and accelerate their organisational performance to seize the most attractive opportunities.

TICG was founded as a joint venture between the Kuwait Investment Authority (KIA), the first sovereign wealth fund in the world, the Kuwait Fund for Arab Economic Development (KFAED), the first Arab international development institution, and Oliver Wyman, a leading global management consulting firm.

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