

Key Messages: Asset-quality metrics remain solid but concentration remains the biggest risk. Islamic banks had a 38% market share of total banking system assets at end-1H18. Islamic banking activities are only undertaken by Islamic banks as the Central Bank of Kuwait (CBK) does not permit conventional banks to operate through Islamic windows.

Asset Quality: Impaired financing ratios have improved since the financial crisis. The average impaired financing ratio remained stable in 1H18. Financing impairment charges (FICs)/average gross financing ratios fell in 1H18 due to better underwriting standards and as banks no longer needed to build high loss allowances. Islamic banks are more exposed to the real estate sector as they are allowed to establish non-financial real estate subsidiaries.

Performance: Operating profitability metrics have improved due to lower FICs and remain above conventional banks'. The net financing margin also remains above conventional banks' and improved slightly in 1H18 mainly due to KFH, which has significant high margin non-Kuwaiti activities, particularly in Turkey. KFH is the largest Islamic bank in Kuwait, with 60% of Islamic and 26% of total banking sector financing. The discussed merger between KFH and Bahrain's AUB would create one of the largest Islamic banks in the region.

Funding and Liquidity: The average Fitch-calculated gross financing/deposits ratio has been almost flat, benefitting from Islamic banks' strong retail franchises (particularly KFH and Boubyan). Term corporate-customer deposits are the main source of funding, which includes Profit-Sharing Investment Accounts (PSIAs). Deposit concentration remains high, except for KFH due to its high proportion of retail deposits. Islamic banks rely less on market funding. The CBK deposit guarantee covers Islamic banks including unrestricted PSIAs.

Capital and Leverage: Fast financing growth has resulted in a reduction in capital ratios, which remain adequate for the banks' risk profiles. While the equity/assets ratio was 1.5% higher for conventional banks at end-1H18, Islamic banks tend to have higher regulatory capital ratios due to a 50% Alpha factor applied to risk-weighted assets to account for the loss-absorption capacity of PSIAs.

Centralised Regulatory Framework: In 2018, the CBK Shariah Supervisory Governance instructions became effective, introducing best practice for Islamic banks. The CBK is working on a draft law to create a centralised sharia board to oversee Islamic banks. This is likely to increase standardisation and lead to greater market confidence. CBK regulations take account of Islamic banks' specificities, such as the Alpha factor and direct investment in real-estate.

Main Expectations for 2019: Asset quality will remain sensitive to concentration risk and volatility in the real estate sector. Financing growth is expected to remain above that of conventional banks in the mid-single digits as Islamic banks build their franchises and as Islamic banking is gaining momentum in Kuwait, in particular with retail customers.



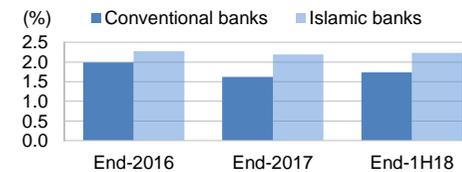
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Asset Quality

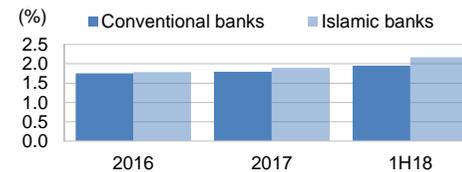
Impaired financing/gross financing



Source: Fitch Ratings, Fitch Solutions, Banks

Earnings & Profitability

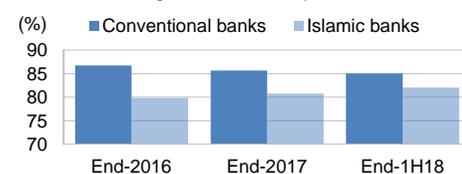
Operating profit/risk-weighted assets



Source: Fitch Ratings, Fitch Solutions, Banks

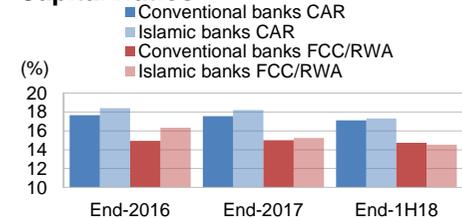
Funding & Liquidity

Gross financing/customers' deposits



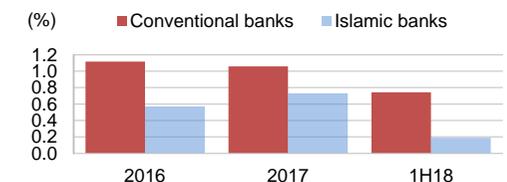
Source: Fitch Ratings, Fitch Solutions, Banks

Capital Ratios



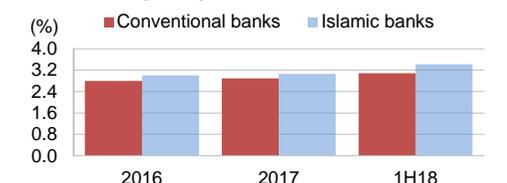
Source: Fitch Ratings, Fitch Solutions, Banks

FICs/average gross financing



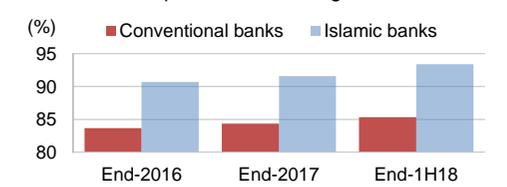
Source: Fitch Ratings, Fitch Solutions, Banks

Net financing margin



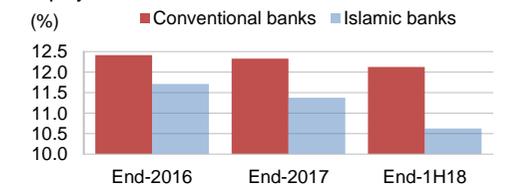
Source: Fitch Ratings, Fitch Solutions, Banks

Customers' deposits/total funding



Source: Fitch Ratings, Fitch Solutions, Banks

Equity/assets



Source: Fitch Ratings, Fitch Solutions, Banks

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