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# A Comparative Study of Basel III Liquidity Framework's "Liquidity Coverage Ratio": Compliance and Performance between Islamic Banks and Conventional Banks in the State of Kuwait

## Abstract

**Aim of the Paper**: To propose some recommendations based on the finding for the conventional and Islamic banks in the sample of the study and to submit the experience of the research sample, first, to all the relevant regulatory authorities who deal with the supervision and control of conventional and Islamic banks in their banking system and second, to the decision makers in the conventional and Islamic banks to gain their bank's compliance and better performance of Liquidity Coverage Ratio.
**Study Design**: Comparative study of Liquidity Coverage Ratio's compliance and performance between 4 national Islamic banks and 4 national conventional banks.
**Sample and Data**: The sample contains of 4 conventional and 4 Islamic banks in the Kuwaiti national banking system. The data were quantitative "LCR figures" of the sampled banks and were gathered from their official websites (secondary data).
**Results**: Both the conventional and the Islamic banks showed that were compliant and had the same efficient and effective level of LCRs performance
**Conclusion**: The paper presented recommendation on bank solo level, banking sector level, regulatory authority level and international organizations level.

***Keywords***: Basel III; Central Bank of Kuwait; High Quality Liquid Assets; Liquidity Coverage Ratio; Net Cash Outflow.

## Introduction

After the financial crisis of 2007, the standards setting organizations in the world such as the Basel Committee and IFSB found that the banking system had

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suffered from liquidity scarcity in the global market. The level of effect varied between conventional and Islamic banks, therefore they introduced the stricter prudential regulation of Basel III and a new liquidity framework. The regulatory and supervisory authorities of the central banks and the banking system faced a challenge in complying with the new liquidity framework and more specifically with the Liquidity Coverage Ratio (LCR), since it concerned a stress liquidity scenario of 30 days, unlike the Net Stable Funding Ratio (NSFR) which posited a longer stress scenario of one year. The challenging new liquidity ratio LCR is planned to be a minimum regulatory requirement of 100% throughout the world by 2019. The present study will analyses the experience for the banking system (via a sample of conventional and Islamic banks) in Kuwait of LCR in order to answer the concerns of regulatory authorities from the perspective of their supervision and control and the concerns of conventional and Islamic banks around the world from the perspective of their ability to comply with the threshold of 100% in 2019 and their effective compliance performance afterwards. This research has unique features; it comparatively analyses conventional and Islamic banks with reference to the same subject of concern. In addition, this research deals with the sophisticated prudential guidelines of the Basel III LCR, which is still undergoing a learning process in many jurisdictions and in the banking industry and the researches in this domain are relatively scare.

## Research objective

The objective of the present research is to propose some recommendations for the conventional and Islamic banks in the sample of the study, as well as for the regulatory authorities of the banking system. This study would first submit the findings of the research sample to all relevant regulatory authorities who deal with the supervision and control of conventional and Islamic banks and, second, to the decision makers in the conventional and Islamic banks to gain better compliance with LCR and better performance.

## Research methodology

The research approach was inductive. It started from a specific observation of the current practices of the sample of conventional and Islamic banks in Kuwait in terms their comparative analysis of LCR compliance and performance. The purpose is to address conventional banking and Islamic banking systems' general LCR compliance and their performance on the global market. The data, which was taken from official websites, consisted of "LCR figures" of the sampled banks from the first quarter of 2016 to the fourth quarter of 2018. Then, the conventional and Islamic banks were comparatively analysed to show their LCR compliance and performance. The findings answered the following three questions. First, which had better LCR's compliance: Islamic or conventional banks in Kuwait and why? Second, which of the two types of banks had better LCR performance and why? Finally, what future can be predicted for both Islamic and conventional banks with reference to LCR's performance and compliance?

## Population and sample of the study

Of the 23 banks in Kuwait, the sample was consisted of 4 conventional banks (the National Bank of Kuwait, Commercial Bank of Kuwait, Gulf Bank, and Burgan Bank) and 4 Islamic banks (Kuwait Finance House, Boubyan Bank, Warba Bank, and Kuwait International Bank). The most data was accessed from the first quarter of 2016 to the fourth quarter of 2018. One should note that Kuwait presents one of the best examples of LCR compliance in the region, as a circular from the Central Bank demands a high degree of disclosure about this matter.

## Results

### 1. Which had better LCR compliance: Conventional or Islamic banks and why?

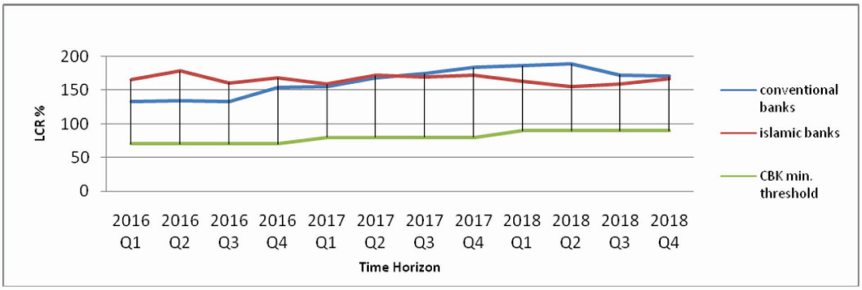
The final LCR averages of conventional and Islamic banks are compared with the minimum Central Bank's thresholds required for compliance during the period of the study, and are summarised below:

| Banks in Kuwait | 2016 Q1 | 2016 Q2 | 2016 Q3 | 2016 Q4 | 2017 Q1 | 2017 Q2 | 2017 Q3 | 2017 Q4 | 2018 Q1 | 2018 Q2 | 2018 Q3 | 2018 Q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Conventional banks | 132.4% | 133.4% | 132.4% | 152.9% | 154.6% | 167.8% | 174.05% | 183.11% | 185.91% | 188.81% | 172.19% | 169.88 |
| Total Islamic banks | 164.58% | 177.89% | 160.49% | 167.24% | 158.59% | 171.84% | 168.4% | 171.05% | 162.7% | 154.99% | 158.96% | 166.96 |
| Central Bank of Kuwait minimum LCR thresholds | 70% | | | | 80% | | | | 90% | | | |

The LCR average figures for both conventional and the Islamic banks show that both complied with the Central Bank's minimum thresholds required, viz. 70% in 2016, 80%in 2017 and 90% in 2018, and have far exceeded them. However, Islamic banks outperformed conventional their conventional counterparts in 2016. In the following year, conventional banks' LCRs became very competitive and in the third quarter of 2017 rose slightly above the Islamic banks' performance. In 2018, conventional banks' LCRs average continued to rise until the third quarter. In the last quarter, however, conventional and Islamic banks' averages of LCRs performance were relatively close at 169.88% and 166.96%, respectively. To conclude, conventional and Islamic banks are similar in LCR compliance based on LCR trends in 2016, 2017 and 2018.

**2. Which had better LCR performance: conventional or Islamic banks and why?**

The overall averages of LCR performance of conventional and Islamic banks during the period of study are presented below:




As can be seen, the overall LCR performance trend of Islamic banks in 2016 outperformed that of conventional banks', because conventional banks such as Burgan, Commercial, and Gulf banks suffered from a sharp decline in LCR when their net cash outflows increased. This resulted in a lower LCR performance trend in most of the quarters in 2016, while the Islamic banks greatly exceeded conventional banks' LCR average. However, in 2017, conventional banks tried to move upwards to keep up with the general market trend, and so did Islamic banks, apart from Warba, which increased its net cash outflow in the last quarter of 2017. This act not only led to a decline in LCR below that of other Islamic banks, but it also affected the whole LCR average for Islamic banks as a whole. In 2018, the conventional banks' average of LCRs trend became very competitive and outperformed the Islamic banks' average of LCRs trend. However, the conventional banks' average of LCRs trend declined to closely reach the Islamic banks' average, due to a reduction in conventional banks' total HQLA from 8,900,514 to 8,080,665. This may lead to the fact that both Islamic and conventional banks are willing to be in the same common market trend. In conclusion, the trend performance of conventional banks' and Islamic banks' LCRs has shown that they intersect twice, first in the middle of the study period and second, relatively intersect in the end of the study period, which may indicate in general that both conventional and Islamic banks have a similarly efficient and effective level of LCR performance.

**3. What can be expected of both Islamic and conventional banks for future performance and compliance with LCR?**

Regarding LCR compliance, on the one hand, both conventional and Islamic banks successfully complied with the minimum thresholds required by the Central Bank of Kuwait, and even exceeded them. Therefore, the current figures indicate that the future of LCR compliance is well secured. On the other hand, it was obvious that some banks, both conventional and Islamic, suffered from unexpected increases in net cash outflow and decreases in HQLA. Hence, both conventional and Islamic banks should be more careful in their internal decisions that may affect LCR figures and, eventually, the overall trend of LCR performance in the future.

## Recommendations

Overall, both conventional banks and Islamic banks complied with the LCR minimum thresholds laid down by the Central Bank. However, the levels of LCR performance trend were not satisfactory since there were periods of fluctuation and instability. Recommendations for a better LCR performance trend for both conventional and Islamic banks for Kuwait banking sector and, indeed, for all banking systems elsewhere, can be made at four levels.

**1. At bank level:** It is recommended to estimate the ‘‘behaviour and effect of net cash outflow’’ at frequent intervals (daily, weekly, monthly, quarterly and yearly). LCR, as a stress scenario, could be included in the internal stress scenario, as part of the culture at the department level. This would improve the overall governance and decision making at the bank level.

**2. At banking sector level:** It is recommended that banks' top management need to update the risk and liquidity policy and procedures, and the five year strategy, so as to produce optimal and competitive performance of LCR trends and avoid the fluctuations which may result in a poor LCR performance trend.

**3. At the regulatory authority level:** It is recommended for all regulators or central banks to support the banking system by providing methods of assets that are eligible for HQLA status and that possess HQLAs' fundamental and market-related characteristics. These characteristics are, for example, short-term liquidity facilities guaranteed and/or offered by central banks, marketable securities for conventional banks, and *Shariah compliant marketable securities for Islamic banks*.

*This is because central banks' financial securities involve zero risk. Central banks are also encouraged to provide well-established and controlled secondary markets that comply with the Basel conditions, in terms of the ability of these markets to liquidate financial securities in periods of stress.*

**4. At international organizational level:** It is recommended that multilateral development banks and all other international organizations with the same concerns support the international banking system by issuing and/or guaranteeing financial securities and/or *Shariah* compliant securities, because multilateral development bank securities have the privilege of being classified as HQLA. It is also recommended that a well-established and organized secondary market that supports and complies with the Basel Committee's conditions be created, in order for banks to be able to liquidate financial securities in stressful periods.

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# الملخص

# نسبة تغطية السيولة بإطار بازل 3 في الالتزام والأداء بين البنوك الإسلامية والتقليدية في دولة الكويت: دراسة مقارنة

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**هدف الدراسة:** تقديم توصيات مبنية على نتائج البحث للبنوك المشاركة في العينة، والهدف الأخير تقديم تجربة دولة الكويت في الأجهزة الرقابية – من بنوك مركزية في العالم – المسؤولة في نطاقها الإشرافي والرقابي على نظام بنكي يشمل البنوك التقليدية والإسلامية، وكذلك تقديم التجربة لصناع القرار في البنوك التقليدية والإسلامية للاستفادة من التجربة والالتزام والأداء الفعال للالتزام لنسبة تغطية السيولة.

**منهجية الدراسة**: التحليل المقارن بين البنوك التقليدية الأربعة والبنوك الإسلامية الأربعة من حيث الامتثال لنسبة تغطية السيولة ومن حيث الأداء الفعال للالتزام بنسبة تغطية السيولة.

**البيانات وعينة الدراسة**: اعتمدت الدراسة المسحية على عينة مكونة من 8 بنوك وطنية (أربعة بنوك تقليدية وأربعة بنوك إسلامية) في دولة الكويت، واعتمدت على مصدر (معلومات ثانوية) بيانات كمية (مالية) للنسب تغطية السيولة للبنوك المغطاة في العينة.

**نتائج الدراسة**: تبيّن أن البنوك التقليدية والبنوك الإسلامية على درجة عالية من الالتزام بالمتطلبات النسبية، أما الأداء بالالتزام فتبين أن البنوك الإسلامية والتقليدية متساوية في قوة الأداء الفعال.

**الخاتمة**: قدمت الدراسة توصيات على مستوى البنك solo وعلى مستوى القطاع البنكي وعلى مستوى الأجهزة الرقابية والإشرافية وعلى المستوى الدولي من بنوك تنموية متعددة الأطراف.

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