Executive summary

It has been a tumultuous last 12 months for banks, despite decisive and far-reaching central bank actions that have supported the economy. Banks continue to persevere in an environment characterized by low interest rates and having to deal with issues relating to counterparties' creditworthiness and provisioning.

While organic growth has been minimal, in the United Arab Emirates (UAE), one of the most notable trends we have seen over the past few years is an inclination toward consolidation. With around 50 banks, plus new digital banks coming up, serving a population of approximately ten million, the UAE could still be considered 'overbanked'. Further merger and acquisition activity, therefore, may well take place.

During 2020, net profit for the top 10 UAE banks in our analysis has dropped on average by 41% compared with 2019. This decrease is due to the significant increase in the provision charge on loans with banks expecting higher losses and customer defaults as a result of the pandemic. Non-performing loans (NPL) ratio also increased to 4.4% percent in 2020. Net Interest Margin continues to be under pressure because of record low interest rates, exacerbated by increased competition. Despite this, the Capital and liquidity position remains strong.

The challenge for banks in 2021 will be to effectively extract value from data to help them focus on their most profitable segments. With revenue pressure expected to continue, the only way banks are likely to maintain profit margins is by strictly managing costs. Underlying this is the need to bolster back-end functions, which tend to be driven by people and paper, rather than merely focusing on what is visible to the customer. The imperative for strong IT infrastructure is more relevant than ever as lockdowns have rendered invaluable effective remote-working technology.

In a precarious market, banks are being forced to consider alternative models utilizing cutting-edge technology, including **Banking as a Platform** (BaaP), which allows third-party FinTech developers to build products and services on behalf of bank customers. There is now a broad range of FinTech applications for loans, payments, investing, wealth management, and other services.

Banks can **overhaul their operating models** by considering a combination of partnerships and alliances, technology incubators, FinTech acquisition, investments, and transformation of their internal capabilities. They will need to rethink the customer experience by leveraging 'design-thinking' as an approach to identify the customer journeys that prompt digital offerings from the platform. Banks should be increasingly training their employees to guide customers toward platform-based services. The process, risk, and control framework should be realigned, and the control environment will likely need to be extended to third parties.

Today's customer is generally seeking a self-service, seamless, automated, and omnichannel experience – with minimal waiting time. To enable this, banks across the Middle East are digitalizing complex processes and end-to-end customer journeys across the front, middle and back offices. It remains to be seen whether banks are truly delivering on the promises they make to their customers, but the outlook is promising. The UAE has a strong regulatory foundation for the launch and operations of digital-only banks.

Technology is not, however, a universal panacea; wider implications around legacy infrastructures and data repositories remain. This has led several banks to consider alternative services that can support customer demands for consistent execution and provide for consolidated data storage and near real-time reporting – at lower operating costs. **Managed services companies can help banks outsource certain functions.** Banks can thereby optimize their footprint, business continuity planning (BCP) strategy, and total cost of operations.

In times of uncertainty, canny **liquidity management** can be vital. Recently, we have seen a surge in NPLs for the majority of banks worldwide; many have booked higher provisions. Banks should perform adjustments to their credit risk models to increase responsiveness to external factors and improve the accuracy of their market predictions. They would also be well advised to consider reviewing their Risk function.

In some cases, the only – or optimal – approach may be to **restructure rather than liquidate** the exposure through collateral sale resulting in shutting down the customer's business. There exist several tools to do this effectively. In certain scenarios, liquidation may result in a better outcome than restructuring, for instance when the ongoing cost of solving the problem outweighs the value of current assets.

It seems unlikely that banks can continue to maintain their competitive edge without effectively leveraging digital transformation to match their customers' evolving expectations and behavior.

They can optimize their customers' seamless digital journey by outlining a framework that aims to provide a coherent digitalization. This should be based on the current tech maturity, positioning of the bank, providing next-best-action recommendations, and proposed processes elimination.

Cloud computing has presented consumers with stronger security and privacy tools, and improved measures for detecting, responding to, and preventing security breaches. This can ease the burden for IT functions. By migrating to the cloud, banks can leverage solutions that are inherently better suited to manage six key operational risks: cybersecurity, digital sovereignty, the remote workforce and customers, third party, technology, and facility.

Automation and AI are instrumental not only in driving operational efficiencies but can play a key role in boosting employee satisfaction. The **people aspect** of technology cannot be disregarded: it can help staff focus on the more fulfilling parts of their job, freeing them from monotonous, tedious tasks that can be done by a machine. Over the coming years, banks are projected to increase their reliance on robotic process automation (RPA) technologies to conduct human resources (HR) functions like onboarding and talent acquisition[1]. This should be combined with a focus on upskilling and reskilling employees through investment in learning and development initiatives.

Meanwhile, the local tax landscape has seen a slew of **new legislation transforming the sector**, in a move towards greater transparency. Examples of developments over the past few years include the Automatic Exchange of Information ("AEOI") regimes in compliance with the US Foreign Account Tax Compliance Act ("FATCA") and the OECD's Common Reporting Standard; Economic Substance Regulations ("ESR"); regulations around the Ultimate beneficial owner ("UBO"); Country by Country Reporting ("CbCR"); and UAE value-added tax (VAT).

Keeping up with technological innovation is only part of the puzzle: the overarching concern for any bank's operations is **robust regulatory compliance and governance**. In the UAE, over the last two years alone, local authorities have issued or revised many regulations to enhance financial stability. New ones pertaining to banks include those issued by the UAE Central Bank, such as the Corporate Governance and Risk Management regulations. The Federal Government recently published an updated Banking Law, Anti-Money Laundering (AML) Law, and Companies Law. To succeed in an environment characterized by continual change, banks must adopt compliance frameworks that are mature and flexible, possibly using existing ones as a starting point.

Regional regulators have also issued **regulations related to internal controls over financial reporting** (ICOFR). Globally, ICOFR was introduced by the Sarbanes–Oxley Act of 2002 (SOX). The UAE Central Bank's Internal Controls, Compliance, and Internal Audit regulation of 2018 states that the board and senior management of banks are responsible for implementing an adequate internal control framework that identifies, measures, monitors, and controls all risks. Unlike their US and UK counterparts, however, local banking regulators do not generally mandate periodic reviews on the effectiveness of ICOFR systems.

An integral part of robust corporate governance is the **statutory audit.** The relationship between auditors and audit committees (ACs) plays a critical role in good governance. The discussion of the audit should not be considered as merely an 'agenda item' for the AC at quarter and year ends, but as an opportunity for the external auditor to provide independent insight on matters discussed in the AC meeting. We would also encourage more frequent bilateral (regulator and auditor) and trilateral meetings (including the bank) to create a better understanding of the audit approach taken.

Regulators, standards setters, audit committees, and investors—indeed, the full spectrum of stakeholders—expect a culture of transparency and strong governance. They are seeking enhanced clarity and consistency of metrics being reported; faithful, complete disclosures; and greater assurance around the governance and culture framework of an organization. Banks are witnessing a time replete with dissonances: great technological advancement tempered by the potentially catastrophic implications of the pandemic. Customer retention will be key, and retention strategies can be supported with digital transformation drives. Banks should deliver on the promises they make to customers, ensure their experience is seamless, and fortify their control environment against the threats that abound.