UAE banking perspectives 2019

A digital, regulated and sustainable tomorrow

April 2019

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Foreword

Our evaluation of the key financial indicators for the past year suggests a positive outlook for the banking environment in the UAE, with promising profit growth that has only slightly been tempered by the introduction of new accounting standards.

I am pleased to introduce you to the fourth edition of our annual UAE banking perspectives publication. We examine pertinent issues and trends affecting the global banking industry today, with a particular focus on the United Arab Emirates (UAE). Our subject matter experts have shared their views on key topics, identified the main challenges faced by the banking sector and proposed strategies to combat these. We are grateful for the high level of interest generated by previous editions; in this publication we elaborate on a broad spectrum of themes, ranging from effective governance to Islamic finance.

In the constant drive for growth, banks would do well to swiftly adapt to a shifting regulatory and consumer landscape. Banks need not, however, be overtly cautious of venturing into uncharted territory. Rather, they can pioneer practices and products that cater to gaps in the market or improve operational efficiency and competitive positioning.

Technological innovation and a flourishing demand for Islamic financial institutions can disrupt the industry, while risk functions must contend with challenges like the replacement of the London Interbank Offered Rate (LIBOR).

Over the past year, the UAE Central Bank has issued a range of directives that clearly signal the UAE’s intent to align with global best practice in terms of prudent market regulation and consumer protection. In addition, the Financial Action Task Force (FATF) evaluation of the UAE is expected to begin this year, and will trigger an independent review of anti-money laundering (AML) and sanctions compliance rules.

Banks could consider encouraging a healthy corporate culture, and practices that are in line with the sustainability agenda. Strides in digital innovation can be exploited to their full potential as traditional banking methods are transformed by processes like customer identity and access management (CIAM).

This publication complements our GCC listed banks results report, which sets out some of the key financial indicators and issues of the day for the banking industry in the region.

On behalf of KPMG Lower Gulf, we look forward to delving deeper into the topics discussed within this publication, and exploring how your organization can make the most of the opportunities that lie ahead.

Emilio Pera
Partner and Head of Financial Services

Emilio leads KPMG’s financial services practice in the Lower Gulf (the UAE and Oman). He has worked in the financial services industry – both as a consultant and as a banker – for almost 30 years and has been based in the UK, the Middle East and Africa. He has led a number of risk, finance and credit advisory engagements, including leading governance and cost-efficiency reviews. Emilio has been the lead partner on the external audits of a number of major, bluechip financial institutions in Africa, the UAE. He was a member of the IAASB’s ISA540 task group with a focus on revising the standard in preparation for the audit of IFRS 9.

Emilio Pera
Partner | Head of Financial Services
T: +971 4 403 0323
M: +971 56 508 5073
E: emiliopera@kmpg.com
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While economic growth has been somewhat muted over the past year, the top 10 UAE banks have enjoyed a healthy surge of 11.5% in net profits. This occurred in the wake of the replacement of IAS 39 with IFRS 9 at the beginning of 2018. It transformed banks’ approach to the assessment of impairments in their loan portfolios and added another capital conservation buffer. Higher current provisions and more stringent Liquidity Coverage Ratio and Net Stable Funding Ratio calculations seem to have led to a spike in the cost of liquidity. IFRS 9 adjustments were passed through retained earnings, which in turn triggered an adverse impact on the Capital Adequacy Ratio and Return on Equity. Despite a promising financial year, financial institutions must contend with an incursion of new regulations and a burgeoning demand for innovative new products and systems to meet consumer demands in a market that is increasingly digitally enabled.

Across the banking sector, companies have embraced innovation teams. However these can suffer from limited authority, lack of resources, and inadequate support from senior stakeholders. A structured management process, and a more open-minded approach to solving problems may help drive the innovation agenda. Improved communication and collaboration between departments and with regulators will help banks remain agile in the face of the gamut of technological advances like fintech.

With the advent of the digital revolution, many banks are turning to customer identity and access management (CIAM) to build stronger relationships with their customers. CIAM’s features facilitate addressing numerous customer needs, delivering personalized experiences, intelligent solutions, protection against cyber fraud and ease of digital interaction. The success of implementing CIAM, however, will depend on factors like the ability of a vast variety of stakeholders to work together, and how readily users embrace learning new software.

Meanwhile, risk functions of banks must exercise constant vigilance to cope with an influx of challenges: the London Interbank Offered Rate (LIBOR) is being phased out, gradually being replaced with alternatives such as risk-free rate (RFR) benchmarks. There are likely to be operational issues in the early stages, and banks will need to reduce LIBOR exposures and build demand for RFR-linked products. Information asymmetries will require a clear client communication strategy, and outstanding hedge relationships and other agreements may need to be amended. Along with changes to valuation tools and risk models, banks would be well advised to consider the interaction between LIBOR transition and the implementation of the Fundamental Review of the Trading Book (FRTB).

Operational risk is becoming an increasingly significant area of focus. Headwinds may take the form of cyber threats, third-party concerns, trading, conduct and culture issues, anti-money laundering fines and sanctions, or stress-testing requirements. In 2018, the Central Bank of the UAE (CBUAE) published a number of regulations as well as a ‘Standards’ release which stipulates what banks should be doing to achieve best practice. It points out the main areas for banks to focus on are: governance, identification and assessment, control and mitigation, business continuity management, information technology and systems, and reporting.

To an extent, a specific subset of risk, financial crime risk, can be reduced via a step-by-step method. This would involve reviewing the compliance risk assessment framework and the monitoring program, to validate the annual compliance plan, transaction monitoring and know-your-customer procedures. Technological developments like machine learning could be leveraged to maximize operating efficiencies, and risk mitigation measures designed and implemented to ensure compliance with the regulatory provisions on AML and sanctions. The UAE is anticipating its Financial Action Task Force (FATF) Mutual Evaluation to be held in 2019, and independent evaluations of local banks’ AML and sanctions compliance frameworks have been undertaken to prepare for this.

The waxing crescent of the Islamic financial market is becoming systemically important as the GCC consolidates its position as a globally significant economic hub. The growth of Islamic finance may be sustained by addressing some key points. These include the ‘form over substance’ debate and the need for harmonization of standards. There is a pressing need for greater transparency, more Islamic banking experts, and strengthening the public’s confidence in the Shari’ah compliance of the products and services being offered.
With the arrival of a number of new local and international regulations, the scope of the compliance function is broadening, requiring skills that can consider risks facing the banks more holistically. Internal Audit’s (IA) role is also becoming wider, with banks required to publish their IA charter and review it every three years (as per CB UAE Internal Controls, Compliance and Internal Audit Standards 161/2018, Article 4.14). Self-evaluation of the board committee’s effectiveness will assist those charged with governance in the bank to formulate a clear plan of action to bring its operations in line with best practice, a process which may be aided by the appointment of an independent facilitator.

In conjunction with a strong control environment and robust regulatory procedures, equally vital is management’s approach to corporate culture, in particular: power distance, uncertainty avoidance, individualism versus collectivism and masculinity versus femininity. The UAE is home to a colorful mélange of nationalities, with 88.5%² of its population composed of expatriates. Resolving differences and having open conversations to build a respectful and productive environment becomes key in such an ethnically diverse milieu.

Finally, as banks internationally now include certain performance measures beyond key financial indicators, sustainability reporting is emerging as an essential consideration within the UAE. While there may be some regulatory and policy gaps, banks are beginning to include environmental and social data to exhibit greater responsibility towards their stakeholders. Sustainability disclosures may help banks access new markets, and implement more rounded risk management processes.

Stakeholders tend to no longer want their banks to simply exceed their financial targets, but to formulate a canny, forward-looking strategy for the long term.

² https://www.globalmediainsight.com/blog/uae-population-statistics/
Performance highlights

**Total assets (US$ billion)**

- 2023: 623.82
- 2022: 578.40
- Change: 7.9%

**Net profit (US$ billion)**

- 2023: 10.93
- 2022: 9.80
- Change: 11.5%

**Cost-to-income ratio (%)**

- 2023: 37.47
- 2022: 35.90
- Change: 1.6%

**Net impairment charge on loans and advances (US$ billion)**

- 2023: 2.96
- 2022: 3.40
- Change: -12.9%

**Regulatory capital (US$ billion)**

- 2023: 77.05
- 2022: 79.40
- Change: -3.0%
Key

- Blue: 2017
- Yellow: Yo-y improvement
- Light blue: 2018
- Orange: No change
- Red: Yo-y deterioration

Capital Adequacy Ratio (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>17.33%</td>
</tr>
<tr>
<td>2018</td>
<td>18.70%</td>
</tr>
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Return on equity (%) 2017: 13.50%, 2018: 13.70%, increase of 0.2%

Return on assets (%) 2017: 1.70%, 2018: 1.71%, no change

Liquidity ratio (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>33.00%</td>
</tr>
<tr>
<td>2018</td>
<td>33.52%</td>
</tr>
</tbody>
</table>

Non-performing loan ratio (%)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1</td>
<td>4.30%</td>
</tr>
<tr>
<td>Stage 2</td>
<td>3.13%</td>
</tr>
<tr>
<td>Stage 3</td>
<td>3.13%</td>
</tr>
</tbody>
</table>

Total loans subject to ECL – by stage as at 31 December 2018 (%)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1</td>
<td>91.8%</td>
</tr>
<tr>
<td>Stage 2</td>
<td>5.1%</td>
</tr>
<tr>
<td>Stage 3</td>
<td>3.1%</td>
</tr>
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</table>

Coverage ratios on loans – by stage (%)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Ratio</th>
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<tbody>
<tr>
<td>Stage 1</td>
<td>68.6%</td>
</tr>
<tr>
<td>Stage 2</td>
<td>61.1%</td>
</tr>
<tr>
<td>Stage 3</td>
<td>14.3%</td>
</tr>
</tbody>
</table>

Return on equity (%) 2017: 0.0%, 2018: 1.70%, increase of 1.71%

Return on assets (%) 2017: 0.0%, 2018: 1.71%, increase of 1.71%
Innovation and technology
In an era where traditional banking methods are gradually being usurped by fintech and digital banking, the industry must remain alert and responsive to technological developments. Umair Hameed explores strategies to enable innovation in the sector.

Most banks and other financial institutions have increasingly been recruiting specialists to spearhead innovation as a formal business discipline. At the same time, a number of financial free zone entities such as Abu Dhabi Global Market (ADGM) and Dubai International Financial Centre (DIFC) have launched regulatory sandboxes to encourage the development of new and innovative financial products and services.

Whilst the financial industry harbors a sincere intent to innovate, it appears there is still some way to go, before this desire becomes a tangible and visible reality from a customer experience perspective.

Across the financial services spectrum, from basic retail and commercial banking, to wealth management, it is observed that there has generally been a paucity of innovation in the products and services being offered in the market. Today, digital banking appears to be more of a ‘renovation’ of the service delivery channel than true ‘innovation’, a process that has long since occurred in other industries such as e-commerce. Banking services that were accessible at physical branches or websites are now being offered through smart phone apps. In essence, many banks have emulated and replicated what was happening elsewhere, albeit with a time lag, than having truly innovated.

Opening sometime soon
Even with the ostensibly innovative banking apps that have been launched in the UAE (and in other countries), many appear to be front-end platforms with limited integration with the back-office service-delivery operations. As a customer of one of the banks in the UAE, I recently tried to apply for a new savings account through their mobile app, hoping that the process would be a truly digital one. It was surprising to see a screen pop up, requesting me to populate my name, contact details etc., all of which the bank already had. Upon submission, a message was displayed proclaiming that a bank’s representative would call me back within two days to discuss next steps. The representative never called and instead I ended up going into the branch to get the account opened. The process to open the account had not changed in substance: it was only the initiation that the bank had ‘innovated’.

Cognizant of the challenges and opportunities for banks to enhance their innovation capabilities, KPMG launched its Digital Village in the UAE as an Innovation Centre. Based on extensive experience of working with banks in other parts of the world and in the UAE, there are some factors that we believe may lead to accelerating innovation for here:

1. **Senior stakeholder commitment:** While some banks have verbally committed to driving innovation, they have not always dedicated adequate funds and human resource support for the innovation team. Most innovation teams set up by banks are still largely a one-person show. In the absence of resources to work with, there is only so much the lone innovator can do on their own.

2. **Empowerment:** Although the Head of Innovation is given the responsibility of – and accountability for – driving the innovation agenda, he or she often has limited influence or authority over the different ‘siloes’ of customer experience, business development, and digital channels, which can further exacerbate the issue.

3. **Process for managing innovation:** Whilst innovation requires some unstructured and unconventional thinking, there is nevertheless a need for a structured process to manage innovation. It is advisable that banks ensure innovation of products and services have an appropriate lifecycle, passing through the stages of ‘ideation’ (ideas creation), acceleration (proof of concept), pilot and finally implementation, rather than taking a haphazard approach.
4. **Proactive collaboration:** For innovation to happen, internal and external stakeholders ought to be collaborating proactively. Internal turf battles, apprehensions with approaching the regulator, and limited know-how on how to truly engage customers through the product design and delivery life cycle, can all hinder the innovation process.

5. **Fear of failure:** For organisations to excel at innovation, employees should not have a fear of a failure or retribution. Senior stakeholders can encourage employees to “try and eventually succeed” rather than not try at all.

6. **Key performance indicators (KPIs) and metrics:** Employees tend to perform in line with how they will be measured. Introducing specific KPIs and metrics that track performance and progress of the innovation agenda, not just of the Head of Innovation, but rather of every single employee in the bank, could go a long way to making the workforce more conscious of the need to innovate.

7. **One size does not fit all:** Innovation is about solving problems. Just as there are many problems to solve, there are many possible solutions. As problems evolve, the way in which we solve them also ought to evolve.

As both FinTech and the proliferation of Islamic financial institutions disrupt the banking industry, the need for banks to rapidly adapt to change, by pioneering and testing new practices, has become more pressing than ever before.

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**Umair Hameed**  
Partner | Advisory  
T: +971 5 0658 4486  
E: uhameed@kpmg.com  

Umair is a management consultant with 15 years’ experience advising and collaborating on complex business transformation initiatives across the Middle East, North Africa, South-East Asia, the USA and Europe. He has a particular focus on Financial Services innovation, FinTech and RegTech.

“Today, digital banking seems more of a ‘renovation’ of the service delivery channel than true ‘innovation’.”
The future of banking looks to be customer centric. As digital transformation has gathered pace, effective CIAM has become a key business driver within the United Arab Emirates (UAE) banking sector. Clients would like to have faster and more frequent access. There are five key customer needs that make CIAM a strategic enabler for the UAE banking sector:

1. **Ease of digital interactions:** Customers expect their banks to enable a seamless user experience in terms of onboarding and authentication across multiple channels e.g. internet banking, mobile banking, call centers, automated teller machines, and augmented reality interface. Mature CIAM environments may enable customers to complete identity verification or know-your-customer (KYC) processes online, saving UAE banks cost and time to maintain an offline KYC process.

2. **Personalized experiences:** The viability of modern banking institutions relies on their ability to adapt to shifting customer expectations. Not all expectations are alike, so they are looking for personalized experiences that reflect their individual security preferences. Mature CIAM environments enable seamless use of preferred authentication techniques across different channels, with enhanced contextual security and behavioral analytics capabilities.

3. **Intelligent solutions:** UAE customers expect faster solutions to their unique financial needs. Through the precept of a single digital identity that connects customer relationships across different channels, banks’ intelligent platforms can offer customers the products best suited to their financing needs. Such capabilities may transform the competitive landscape within the banking sector.

4. **Exercise privacy needs:** Customers want to exercise their privacy rights – for example, consent management and personal data access rights – seamlessly across different banking channels. Legislative changes also require UAE banks to implement robust data privacy capabilities (e.g. General Data Protection Regulation (GDPR)). Regulators around the world are enforcing harsher penalties for banks that allow personal data loss and unauthorized use of personal data.

5. **Protection against cyber frauds:** Cyber-attacks and fraud techniques, internationally and in the UAE, are increasing in terms of sophistication and impact, adding complexity to the balance between customer experience and security. Single identity can help build better oversight and control by UAE banks over any cyber security breaches by removing the overhead costs of managing multiple identities and associated access rights.

**Many benefits**

CIAM plays an integral role in providing a secure interface between the customer and banking applications through a seamless customer experience at extreme scale and performance, no matter which channels customers use to engage with the bank. It enables multiple functionalities to turn mere customer experience into true customer engagement, for instance:
– Unified identity – A single identity is used to manage access to accounts and preferences across multiple channels. This provides a ‘360-degree view’ of the customer by tracking not only customer identity but also the customer’s relationship within the bank’s ecosystem, such as interfaces with the sales team, business partners and other banking units.

– User registration: An easy to use registration interface spans multiple channels, allowing customers to register once and use services across web, mobile, automated teller machine (ATM), call center or any other emerging channels.

– Single sign-on: Users may move between screens and applications seamlessly, without interruption.

– Advanced authentication: Balancing security requirements with the customer experience requires advanced authentication techniques, e.g. biometrics and voice recognition, for high risk banking transactions.

– Preference management: An easy to use interface allows users to manage their account profile and preferences, such as credentials, notifications, consent, access grants.

– Device Profiling: Out-of-band validation of customer devices at the time of registration would validate a device that belongs to an authorized user (separate from user authentication).
Unification of functions

CIAM involves multiple business and risk management functions. Its transformation can be initiated by business functions to improve the customer experience, or by risk management to address fraud risk, cyber risk, or compliance risk.
Managing headwinds

By investing in CIAM capabilities, UAE banks may elevate their digital identity management to enhance the way they provide value to customers. However, there are several challenges to consider:

- Involvement of a wide variety of stakeholders: CIAM implementation will involve stakeholders from different business units, including legal, compliance, cyber security and privacy. The success of CIAM implementation will depend upon common understanding and clear expectations amongst all the stakeholders of the bank. This can be a daunting task for any project manager.

- Too many priorities: Involvement of stakeholders from different areas, background, mindsets and viewpoints can lead to multiple and conflicting priorities. Prioritizing demands at an early stage in the process is critical to avoiding project delays. An essential part of the planning process is drawing a distinction between what people want and the actual outcome that is important for the bank, bearing in mind the constraints of time, effort and money.

- Lack of business involvement in the actual implementation: Business stakeholders play a larger role at the outset of the process. IT departments are, however, held accountable when it comes to actual implementation of the CIAM solution. The end result may often be a CIAM solution that does not quite meet the expectations of business users. It is important to keep all stakeholders well informed during every stage of development and implementation, so that course corrections can be made as needed.

- Lack of product training: Because CIAM impacts so many aspects of a bank, it is not possible for every affected party to have experience working with the platform. If business users are unable to effectively navigate the CIAM platform, it is unlikely they will want to continue using it on a regular basis.

- Poor user experiences: Legacy systems are designed primarily around security for well-established reasons. However, personalized experience is key to engage with today’s customers. It is not only important to store customer information in a centralized and secure manner, but also to ensure that this data is available for use in real-time in an optimum manner that serves the needs of the customer.

- Lack of scale: Whilst employee, partner and vendor identities are generally measured in the thousands, customer identities are often measured in the millions. Lack of an architecture that can deliver performance requirements regardless of the volume, variety or velocity of incoming data streams, may degrade the user experience.

- Security and privacy of personal data: Customer data often contains personal information which is sensitive and subject to a variety of laws and regulations, both UAE-specific and international. So the CIAM technology that collects and manages this data is likely to be a major concern for security, compliance, legal and audit departments.

Thus it is vital to adequately plan CIAM implementation with a defined set of priorities (use cases) and the ultimate objectives of an enhanced customer experience clearly delineated. Continuous involvement from different stakeholders within the bank should be encouraged, while concurrently ensuring compliance with security, privacy and other legal requirements.

Sheikh Shadab Nawaz
Associate Director | Head of Cyber Security, IT Advisory
T: +971 4 424 8973
E: snawaz1@kpmg.com

Shadab has thirteen years’ experience in cyber security; information technology (IT) governance, risk and compliance (GRC); data, software and cloud security; and IT Disaster Recovery. He has worked on over 100 complex technology projects across a number of industry verticals, including banking and financial institutions; telecommunications; retail; oil & gas; aviation and government. He has been based in the Middle East, India and South East Asia. Shadab holds a bachelor’s degree in electrical engineering, a master’s in IT and a post-graduate diploma in systems management. His current research interests focus on security analytics, breach investigation and cyber insurance.

“CIAM plays an integral role in providing a secure interface between the customer and banking applications through a seamless customer experience.”
Regulation and risk
Headwinds as banks prepare for LIBOR transition

The phasing out of the London Interbank Offered Rate (LIBOR) will likely trigger an upheaval within the operations of financial institutions globally. Steve Punch addresses how the risks associated with its replacement could be managed.

LIBOR is currently the reference interest rate for millions of contracts globally, ranging from syndicated loans and retail mortgages to complex derivative products. However, LIBOR’s central role in the financial system appears to be coming to an end. Following the 2012 rate-fixing scandals, substantial efforts have been made to improve rate setting. However, significantly reduced volumes of interbank unsecured term borrowing, which is the basis for LIBOR, is calling into question its ability to continue playing this central role. Consequently, LIBOR is now based on less reliable expert judgment, which may inherently be vulnerable to manipulation.

Risk-free rate benchmarks
In 2017 the UK’s Financial Conduct Authority (FCA) announced that after 2021 it would no longer persuade or compel panel banks to submit the rates required to calculate LIBOR. In its stead, there is now a clear global direction of travel towards alternative risk-free rate benchmarks (RFRs) based on actual transactional data. The transition from LIBOR to RFRs could introduce considerable costs and risks for financial institutions if not managed properly. The proposed alternative rates are calculated differently and payments under contracts referencing the new rates will likely differ from those referencing LIBOR.

The transition will most likely change a bank’s market risk profiles, requiring changes to risk models, valuation tools, product design and hedging strategies. In addition, financial institutions which have approval to use their own internal models to calculate regulatory capital for their trading book exposures will also need to consider the interaction between LIBOR transition and the implementation of the Fundamental Review of the Trading Book (FRTB).

Determining an action plan
Given the degree of uncertainty and complexity, LIBOR transition is likely to be a significant transformation program for banks. In practice, transition planning will require mobilizing a cross-business unit and geography transition program clarifying the individual accountabilities for the steering committee. The key activities include:

- Identifying financial exposures and defining the approach to transition
- Launching RFR-linked products and building RFR volumes
- Transitioning the back book/legacy trades
- Switching off LIBOR processes and infrastructure

Containing risk
A disorderly transition from LIBOR could be detrimental to financial institutions as well as to the broader market. There is, therefore, a strong incentive to identify and manage delivery risks as early and efficiently as possible to avoid problems in the future. The table shows how this might be done.
The process of moving from IBORs to the new RFRs does not appear to be straightforward or without risk as uncertainties remain about the practicalities of transition – including whether IBORs will remain in existence post 2021. LIBOR transition is expected to be unlike any other transformation program and the risks are significant. Boards would do well to devise a planning strategy for individual banks, as well as the wider financial industry. The complexity and scope of the task ahead does not look to allow room for complacency or inertia.

Steve Punch
Director | Head of Financial Risk Management
T: +971 4 356 9870
E: spunch1@kpmg.com

Steve has 25 years’ experience in Australia, UK, Japan, New Zealand and Hong Kong. He has worked for several blue-chip, international investment banks and has also been an independent consultant to a number of other, large global banks across Finance, Risk and Compliance. Before joining KPMG in 2011, Steve was a Director at UBS Investment Bank in Hong Kong leading a regional ASPAC initiative covering 16 countries from Japan to India to Australia. He has a particular interest in evolving banking regulation as a means to building stronger banking systems.

“The transition will likely change banks’ market risk profiles.”

<table>
<thead>
<tr>
<th>Identification of key potential risks</th>
<th>Potential early mitigants</th>
</tr>
</thead>
</table>
| The broader impact of transition, including operational issues and existing regulatory rules, may lead to delays. | – Educating senior stakeholders about requirements of the transition program
– Ring-fencing adequate time and resources in their transition plans to address operational issues and the ways in which LIBOR may be integrated into other processes |
| Financial exposures to LIBOR continue to grow and lead to systemic risk by issuing new LIBOR-linked contracts. | – Target reducing LIBOR exposures and consider ways in which they can build demand in RFR-linked products over the course of the next few years
– A client communication strategy, underpinned by rigorous program controls, is required
– Implement segmentation of customers impacted by transition |
| There are information asymmetries, inadequate disclosures and conflicts of interest as moving from legacy products to RFR-linked product gives rise to conduct risk. | |
| Contractual continuity gives rise to legal risk as methodologies for calculating LIBOR and RFRs differ. LIBOR may become unavailable even though products referencing it remain in force. | – When identifying financial exposures, firms should analyze the contractual language used and the counterparties that will be affected. The vast majority of contracts that run beyond the end of 2021 will need to be amended to deal with the permanent discontinuation scenario.
– Banks should monitor liquidity in both legacy LIBOR and new RFR-linked products across jurisdictions and should also assess whether a term rate is essential for all parts of the market.
– The preferred Alternative RFR for US jurisdictions would be secured overnight financing rate (SOFR), having the Federal Reserve as the RFR administrator, while the UK would have the reformed sterling overnight index average (SONIA) with the Bank of England as the administrator. |
| Insufficient RFR liquidity makes it difficult to build a curve and price products. As the proposed alternative rates are mostly overnight rates, derivation of term structure for new rates is not defined. However, even if term-adjusted reference rates are produced, payments will still differ from the LIBOR rates, creating significant valuation differences | – Banks should identify their LIBOR exposures and outstanding hedge relationships, consider whether amendment is needed and, if it is, evaluate how their existing hedges might be affected by it. |
| Accounting implications may result in de-recognition of contracts or discontinuation of hedge relationships. | |

Identification of key potential risks

Potential early mitigants

– Educating senior stakeholders about requirements of the transition program
– Ring-fencing adequate time and resources in their transition plans to address operational issues and the ways in which LIBOR may be integrated into other processes

– Target reducing LIBOR exposures and consider ways in which they can build demand in RFR-linked products over the course of the next few years
– A client communication strategy, underpinned by rigorous program controls, is required
– Implement segmentation of customers impacted by transition

– When identifying financial exposures, firms should analyze the contractual language used and the counterparties that will be affected. The vast majority of contracts that run beyond the end of 2021 will need to be amended to deal with the permanent discontinuation scenario.
– Banks should monitor liquidity in both legacy LIBOR and new RFR-linked products across jurisdictions and should also assess whether a term rate is essential for all parts of the market.
– The preferred Alternative RFR for US jurisdictions would be secured overnight financing rate (SOFR), having the Federal Reserve as the RFR administrator, while the UK would have the reformed sterling overnight index average (SONIA) with the Bank of England as the administrator.
– Banks should identify their LIBOR exposures and outstanding hedge relationships, consider whether amendment is needed and, if it is, evaluate how their existing hedges might be affected by it.
Managing operational risk effectively

The hazards of various types of operational risk are wide ranging. Steve Punch takes a look at how bankers and regulators navigate compliance with a new standard, the identification of control weaknesses that leave institutions susceptible to fraud, and the need for stronger governance frameworks.

In recent years, banks globally and here in the UAE were occupied by the implementation of IFRS 9. This tended to dwarf all other competing priorities for the Risk and Finance teams. Regulators, too, appeared to be significantly engaged in the implementation of IFRS 9 and spent considerable time and resources reviewing calculated expected credit loss (ECL) charges under the new rules. Operational risk has now become a heightened area of focus for financial institutions as the industry wrestles with challenges arising from cyber threats, third-party concerns, trading, conduct and culture issues, anti-money laundering fines and sanctions, stress-testing requirements, and technological innovations driving greater opportunities for process automation and digitization.

The Basel Committee on Banking Supervision (BCBS) first released Principles for the BCBS 195, Sound Management of Operational Risk in 2011. A review by the committee undertaken in 2014 highlighted that banks globally had not sufficiently implemented these principles which culminated in an additional BCBS paper, Review of the Principles for the Sound Management of Operational Risk, BCBS 292.

Taking notice of this, the Central Bank of the UAE (CBUAE) issued draft Operational Risk Standards and Operational Risk Regulations in 2016. Finalized and issued in August 2018 under CBUAE Operational Risk Standards and Regulations 163/2018, we are seeing this is as part of a growing trend across the Gulf Cooperation Council (GCC). Several regulators have recently issued new rules or are refining existing rules relating to operational risk that are in line with international best practice.

Capital and guidance from Central Bank
Operational risk is often regarded as the most challenging risk for both regulators and banks. The rationale for this is that nothing can prevent a bank from experiencing a significant adverse event. Ultimately, allocation of Pillar 1 capital (the regulator’s core measure of a bank’s viability, usually common stock and disclosed reserves) is designed to at least encourage bank boards and senior management to discuss how best to manage operational risk.

In most cases, Pillar 1 capital will likely be lower than the loss history for nearly all banks. The first reason is that ‘boundary events’ tend to get lumped 100% under credit risk losses, with no allowance for apportionment for related operational risk failures involved in credit losses, such as inappropriate models, insufficient monitoring or fraud. Secondly, losses resulting from operational risk generally tend to be under-reported, primarily due to the potential consequences and lack of awareness by bank staff.

The August 2018 regulations laid out by the CBUAE are accompanied by a separate ‘Standards’ release which provides additional clarity on what banks should be doing to achieve best practice. The key areas for banks’ attention under the Operational Risk Standards are: governance, identification and assessment, control and mitigation, business continuity management, information technology and systems, and reporting.

Due to the inherently qualitative nature of managing operational risk (through implementing a robust internal control environment coupled with strong process-level controls), many banks tend to believe that they are already “best in class” with respect to their operational risk framework. Accordingly, regulators often see the need to spell out principles, standards and rules for banks to follow. The Risk Based Supervisory approach adopted by CBUAE should ensure that a spectrum of results are possible when viewing how banks apply the new standards.
KPMG’s recent experience working with several GCC banks on operational risk initiatives implies there may be room for improvement in enhancing operational risk frameworks and how the seven operational risk event types (as defined by the Basel Committee) are managed. The event types comprise:

- Internal fraud
- External fraud
- Employment practices and workplace safety
- Clients, products, and business practice
- Damage to physical assets
- Business disruption and systems failures
- Execution, delivery, and process management

In particular, mitigating internal and external fraud losses is an area that is receiving significant focus from regulators and banks. It is observed that several banks are undertaking fraud risk framework reviews, whilst others are identifying material processes susceptible to fraud and carrying out fraud risk assessments.

**Next steps**

It seems there is much work for banks to do as they strive toward operational risk excellence, including:

- Further positioning the operational risk management framework so that it is fully aligned with the banks’ strategy and viewed as an enabler of strategic change, business performance, and customer experience

- Elevating first and second lines of defense (LOD) involvement and results in strengthening risk culture

- Enhancing first LOD communication and escalation of issues outside of established risk appetite

- Improving the communication between the first and second LODs on emerging risks and changes to the internal and external environment

- Deploying end-to-end process risk assessments across business lines and divisions to develop a more complete picture of risk, dependencies, hand-offs, and redundant controls

- Expanding convergence efforts beyond risk taxonomies and rating scales to drive increased efficiencies and more effective analysis and management of risk

- Enhancing control testing to create more dynamic and efficient monitoring, escalation and management of exposure

- Establishing robust operational risk dashboards supported by integrated data and tools to deliver consistently meaningful reporting to business lines, risk teams, executive management, and the board.

Steve Punch
Director | Head of Financial Risk Management

**T:** +971 4 356 9870
**E:** spunch1@kpmg.com

Steve has 25 years’ experience in Australia, UK, Japan, New Zealand and Hong Kong. He has worked for several blue-chip, international investment banks and has also been an independent consultant to a number of other, large global banks across Finance, Risk and Compliance. Before joining KPMG in 2011, Steve was a Director at UBS Investment Bank in Hong Kong leading a regional ASPAC initiative covering 16 countries from Japan to India to Australia. He has a particular interest in evolving banking regulation as a means to building stronger banking systems.
Financial institutions in the UAE are preparing for the country’s FATF Mutual Evaluation later in 2019. The publication of the results would be critical for the image and reputation of the country’s financial services sector, as the outcome is likely to play a profound role in determining the way the UAE’s anti-money laundering (AML) regime is perceived globally.

In pursuit of ensuring that the financial services sector is ready when the FATF evaluators arrive, the Central Bank of the UAE (CBUAE) mandated an independent evaluation of their AML and sanctions-compliance frameworks. First for the national banks in 2017, and subsequently the branches of foreign banks and the exchange houses in 2018.

Having completed the assessments for multiple financial institutions between 2017 and 2018, KPMG gained some insight into the AML programs adopted by financial institutions. Most financial institutions performed well in terms of governance, training and assurance, and two areas were highlighted for potential improvement: risk assessment and monitoring.

The reality is that Compliance functions have been striving to strike a balance between ensuring effective management of regulatory developments and reducing compliance cost. This appears to be turning into an increasingly challenging task, as the cost of compliance is rising exponentially with the accelerating pace of regulatory change.

A step-by-step method
The question arises how organizations can simultaneously prepare for the FATF evaluators, meet strategic compliance objectives, minimize compliance cost and effectively manage financial crime risk.

The answer may lie in a three-fold approach:

a) RemEDIATE the areas for development identified through the recent assessment of the AML program. Hence, in view of the outcome of the assessments, financial institutions should prioritize a review of:

i) the compliance risk assessment framework aimed to ensure it covers all business areas and enables them to identify and adequately prepare for money-laundering risks. These are continuously evolving with the entry of new financial products and players in the competitive market, as well as with Fintech developments such as digital finance and cryptocurrency

b) Achieve operating efficiencies through, for example, integration of intelligent automation and innovative technology into the existing technology infrastructure. Compliance leaders could explore and leverage new technology capabilities to automate their compliance activities alongside similar transformations being undertaken by their business counterparts. For instance, robotic process automation (RPA) can assist in retrieving data for money-laundering investigations and scanning public databases for changes to laws, rules and regulations. Machine learning may be used to identify risks using public information and historical outcomes of previous investigations. Meanwhile, cognitive technology may be used, capable of mimicking aspects of human judgment to, for example, interpret transaction activity.

c) There should be a greater focus on effectiveness by ensuring that key risks are clearly understood, and mitigation measures are designed and implemented to ensure compliance with the regulatory provisions on AML and sanctions.

As the UAE gears up for the Financial Action Task Force (FATF) Mutual Evaluation, Katerina Pagoni contemplates how banks can build more robust anti-money laundering and sanctions compliance frameworks, through the effective use of technology.
Clear protocol and canny investment

Moreover, in the process of re-assessing their AML regime, financial institutions should not overlook their conduct risk management program. Money-laundering scandals and the ensuing enforcement actions continue to plague the financial sector. We can therefore expect regulators to remain keenly focused on business ethics and the demonstrable actions taken by financial institutions, both proactively and reactively, to prevent and manage misconduct. In order to be operational and effective, the compliance risk management and conduct risk management programs should be aligned and governed by clear escalation and reporting protocols.

Banks are likely to benefit from compliance-driven investment in technology, systems and innovation that will equip them for fighting increasingly sophisticated financial crime. This should complement business-driven investment in strategic tools that empower sustainable growth and revenue.

Katerina Pagoni
Associate Director | Head of Anti-Money Laundering and Sanctions services (Forensics)
T: +971 4 424 8979
E: kpagoni@kpmg.com

Katerina has 20 years’ experience of working with global financial institutions in: money-laundering deterrence, sanctions, regulatory compliance and business risk management. Her recent MBA from Imperial College Business School (London) included a thesis on how global financial institutions can concurrently be exemplary compliant with no hindrance to organizational entrepreneurship and innovation.

“...The question arises how organizations can simultaneously prepare for the FATF evaluators, meet strategic compliance objectives, minimize compliance cost and effectively manage financial crime risk...”
The future of Islamic finance

The demand for Islamic finance is growing substantially, creating opportunities for experts to enhance industry standards and develop market-leading innovative solutions. Abbas Basra ponders the steps that need to be taken to retain the momentum of the industry’s expansion.

Islamic financial assets were estimated to be valued at USD 2 trillion in 2018, and are expected to grow in excess of 30% over the next two years, reaching USD 3.2 trillion by 2020. Some of the fastest growing economic hubs include the Gulf Cooperation Council (GCC) region, Indonesia and Turkey. Muslims constitute approximately a quarter of the world’s population, and are expected to grow to 29.7% by 2050. Research indicates, however, that there is a significant opportunity worldwide to include Muslims in the formal financial system, and Islamic finance is also an attractive alternative for non-Muslims.

Islamic finance has become widely accepted in global financial markets with sukuk (Shari’ah-compliant bonds) issuance totaling USD 44.2 billion worldwide in the first half of 2018. Several conventional banks have set up Islamic windows. The UAE’s vision is well defined to establish its position as the global capital of the Islamic economy. With significant growth over the last 30 years, Islamic finance is well established as an alternative finance offering in global markets. As the sector matures, however, there are a number of areas requiring attention in order to sustain and accelerate this growth. These can include the ‘form over substance’ debate, the need for increased transparency, a requirement for harmonization of standards, more Islamic banking experts, and reinforcing the public’s confidence that the products and services being offered conform to Shari’ah principles. These issues are examined below.

Towards compliance

External Shari’ah audits can address the last challenge. Compliance with Shari’ah is the backbone of the global Islamic financial industry and a unique value proposition offered by the industry to its stakeholders.
Generally, internal Shari’ah auditors have the task of providing assurance over whether the financial institutions’ activities are performed in accordance with the rules set by the institution’s Shari’ah board. While this model has provided an additional layer of control, details are not typically disclosed to the public.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) has already made significant strides in enhancing standards. Some local regulators have implemented more robust governance frameworks and several have created a central Shari’ah authority. A centralized model is increasingly being adopted across the industry, with Oman, Bahrain, Malaysia, Indonesia and Pakistan having established unified, government-established Shari’ah boards in recent years. This is a trend that is anticipated to spread to other jurisdictions, which are likely to learn from one another.

We believe greater Shari’ah governance efforts will be high on the agenda of regulators as the industry becomes systemically important in certain countries. This will in turn increase the credibility of the industry and boost stakeholder confidence.

Towards harmonization
Increased transparency is likely to help address the ‘form over substance’ debate. In theory, deposit holders are entitled to share not only the profits related to the activities that their deposits finance, but are also required to shoulder their burden of the losses. This principle has likely not been applied consistently in the past and no Islamic bank has transferred any losses to customers over the past 30 years⁶. Nevertheless there has been steady progress towards the implementation of this principle in recent years. An example is the Malaysian authorities’ decision to make such accounts truly loss absorbent from June 2016⁷, giving customers the option of choosing between loss-absorbent accounts and non-loss absorbent accounts.

In addition, we understand that only a handful of Islamic banks disclose their profit and loss sharing formulae, profit equalization reserves, or investment risk reserves. The latter were created to help smooth the return on deposits during volatile economic conditions and reduce liquidity risk.

If the Islamic finance marketplace is to achieve a measure of global unity as regards its legal framework, the standards should be harmonized. At present, basic transactions, including sukuk issuance, can be complex and time consuming due to a lack of standardized legal and Shari’ah documentation. This is made more challenging by the fact that different markets may have different definitions of what is and is not Shari’ah-compliant. Which means Shari’ah documentation cannot be easily applied across borders. The process of issuing a sukuk should be as straightforward as issuing a conventional bond but this is not usually the case at present.

Towards innovation
The shortage of Islamic banking experts and a possible lack of innovation have created a gap in the market for the creation of new products that do not have a similar counterpart in conventional finance. There seems to be a strong imperative for new blood in the industry. Innovation requires expertise, including dedicated and well-trained personnel to research new ideas, their commercial application and the development of novel concepts.

Necessity can be the mother of invention: a problem may encourage stakeholders to exert every creative effort to solve the problem. The Muslim world is ready for pioneering banking solutions that will fulfil their financial requirements while allowing them to remain true to their religious values. It is the collective responsibility of scholars, regulators, bankers and government legislators to take heed of and respond to its needs.

Abbas Basrai
Partner | Financial Services
T: +971 4 403 0484
E: abasra1@kpmg.com
Abbas is a banking specialist and focuses on audit and advisory services within the financial services sector. He has considerable experience of working with banks (both conventional and Islamic), sovereign wealth funds, investment and asset management companies and private equity funds. He has a particular interest and experience in the accounting, regulatory and control aspects of banking operations from risk assessments to full reviews of front office supervision, product control, treasury, risk and operations functions, including extensive work with regard to derivatives and structured transactions. Abbas qualified as a chartered accountant (ICAEW) while with KPMG in London.
Culture and sustainability
Globally, the regulatory environment is becoming more stringent for financial institutions, and the UAE is no exception. The Central Bank of UAE (CBUAE) issued a number of regulations in the second half of 2018. These are all in line with the regulator’s aim to enhance the governance, risks and controls environment across the banking sector, and to encourage financial institutions to adopt international leading practices.

The regulations and standards pertaining to internal controls, compliance, and internal audit issued by CBUAE came into effect in October 2018. Their objective is to strengthen the internal control environment of banks in order to meet the changing market conditions and ensure the soundness and stability of the banking sector.

While the regulation does not specifically mention any internationally recognized frameworks, the five elements of the internal control framework it has defined is closely aligned to that of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Although most large banks in the UAE have defined internal control processes, they would be well advised to reassess their frameworks by conducting a diagnostic review of their existing target operating model, policies and procedures across the three lines of defense.

Keeping pace with regulatory changes
Additionally, it is advisable for banks to also revisit their board and board committees’ (particularly the audit committee) terms of reference and agendas. Along with adequacy of coverage, the board and board committees need to reassess the quality of discussions surrounding internal controls, compliance and internal audit. It is important to determine whether the board committees have access to senior management, are asking the right questions and receiving appropriate information on areas such as the impact of new technologies, emerging risks and risk limits, compliance observations and upcoming regulatory changes. This could help enable the board and board committees to set the correct tone at the top and take relevant and timely strategic decisions.

Another key requirement is to have a strong and capable compliance function that can keep pace with the increasing regulatory obligations. Banks are also advised to update their compliance policies and procedures, streamline their activities and ensure they have an effective and comprehensive monitoring program in place. In order to maintain independence and objectivity of this function from the operations of the bank, it is important to clearly articulate the dual reporting lines to the chief executive and board or board committee. The Compliance function is also required to be audited by the independent internal audit function.

Preventing money laundering and terrorism financing
With greater international pressure on the region to counter terrorist funding, the accountability and responsibility of compliance functions has also increased. Traditionally, job descriptions of compliance officers were limited to reporting of suspicious transactions pertaining to anti-money laundering (AML) and combating the financing of terrorism (CFT). Now their duties have broadened to include bi-annual assessments of and reporting on AML and CFT frameworks, as well as operational review for identification of money laundering and terrorist-financing activities. Without a complete regulatory repository, skilled compliance personnel and an experienced head of compliance, banks may find themselves struggling to cope with the new regulatory environment.
Internal Audit’s traditional role is also evolving from performance of appraisals to that of a strategic partner to the stakeholders of the bank. The function is required to stay abreast of the emerging risks, rapidly changing regulatory requirements and business challenges. Further, to increase transparency and accountability to the public, banks need to publish their internal audit charter on their website and review it every three years.

“Along with adequacy of coverage, the boards need to reassess the quality of discussions surrounding internal controls, compliance and internal audit.”
### Internal Audit

- **Perception:** Does Internal Audit meet the expectations of its stakeholders (i.e. Audit committee, executive management, senior management, etc.) by adding value to the bank and enhancing business processes?

- **Positioning:** Is internal audit independent and objective, and is the function viewed as a valued contributor to the bank’s strategy?

- **People and skills:** Does Internal Audit have the right people strategy (internal auditing skill sets, relevant qualifications, technical expertise in the core and support functions of the bank – including IT, cyber security, regulatory compliance, risk management) to achieve its objectives?

- **Technology:** Does the Internal Audit use technology (e.g. testing and filing of work plans)?

- **Processes:** Are Internal Audit’s processes* efficient, effective, and aligned with the Institute of Internal Auditors (IIA) standards and leading practices?

  *NB: internal audit processes subject to the review may include the following:

  - Does Internal Audit have adequate and approved policies and procedures?

  - Is there an annual risk assessment process (in collaboration with Senior Management and the Board)?

  - Does the risk based internal audit plan cover potential emerging risks, new projects which are prone to high risks? Does the risk based internal audit plan include an appropriate mix of audits between the core and support functions and consulting engagement?

  - Is there sufficient time spent in audit planning? Is the audit scope comprehensive, relevant and appropriate? Does internal audit utilize data analytics in the audit planning phase?

  - Are the entrance and exit meetings effective in communicating the purpose, scope and results of the Internal Audit?

  - Are audits executed in line with the IIA standards and leading practices?

  - Are audit observations clearly, objectively and adequately reported in the Final Internal Audit Report (e.g. was the IA Report clearly understood, well-written, and organized?)

  - Are follow up audits conducted regularly and are the results communicated to the Board Audit Committee on a timely manner?

### Compliance

- **Policies and procedures:** Does the Compliance function have comprehensive and up-to-date policies and procedures?

- **Communication and training:** Does Compliance engage in regular and frequent communications and training programs for all of the bank’s key stakeholders (including board and employees)?

- **Technology:** Does Compliance use technology to support its compliance program (testing, training records, etc.)?

- **Compliance monitoring:** Does Compliance monitor and track regulatory change on a timely basis? Is a compliance risk assessment conducted to evaluate the residual risks of all regulations? Does it conduct transactional, process and control testing? Is third party and employee compliance due diligence included in Compliance’s monitoring program?

- **Issues management and investigations:** Does Compliance respond to government investigations/exams/inspections in an effective and timely manner? Are response plans and processes for investigating alleged non compliance appropriate and formally approved?

- **Reporting:** Is there periodic reporting to management and the board/board subcommittees on relevant compliance matters? Are all required regulatory reporting submitted completely, accurately, and in a timely manner?

- **People and skills:** Are the roles and responsibilities pertaining to compliance clearly defined and communicated to all stakeholders? Are performance management and compensation/incentives of those charged with compliance matters in line with the applicable regulatory requirements?

### Areas subject to assessment

Carrying out annual assessments of the internal control framework, compliance function, and internal audit function by the board is another area that banks should think about addressing in the short term. As per the new regulations, the board of directors/board committees are now also required to obtain an independent external evaluation of the compliance and internal audit functions every five years. The potential elements subject to such a review may include the following:
Strong self-review processes
Another area of importance is annual self-evaluation of the board and the board committee’s effectiveness (a requirement in the draft CBUAE corporate governance guidelines). In Oman, the Capital Markets Authority has made it mandatory to conduct a board and board committee self-assessment via its Code of Corporate Governance. With increasing responsibility, it is imperative that the board and board committees measure performance against their set objectives. Rather than being a tick-box exercise, the results of the evaluations should provide actionable plans to improve effectiveness of agendas and discussions. The board may consider appointing an independent facilitator to ensure transparency of the process and unbiased results.

The changing regulatory requirements mark a clear shift to a more regulated environment as prevalent in American, European and some Asian financial sectors. Not only are banks required to ensure compliance with the current regulations but forward-looking banks may try to adopt leading practices from developed markets to meet the demands of key stakeholders.

Maryam M Zaman
Director
T: +971 56 683 3050
E: mzaman@kpmg.com

Maryam has over 13 years of advisory experience with KPMG and currently leads the Financial Services Internal Audit, Risk, and Compliance services for KPMG Lower Gulf. Prior to joining KPMG in the Lower Gulf, Maryam spent four years providing corporate governance, internal audit, business process improvement, valuation, and structured finance-related advisory services at KPMG in the United States. Maryam’s expertise lies in banking, insurance, exchanges, capital markets, private equity, mortgage originators, investment banking and treasury management.
Cultural diversity in the UAE

The importance of fostering appropriate corporate culture has moved rapidly up the agenda of financial institutions, their regulators and their supervisors in recent years, both globally and in the United Arab Emirates (UAE). A primary driver of this in the US and UK has been the multiple instances of alleged misconduct in wholesale markets. In the UAE, we have recently noticed that the regulators have been increasingly focused on how they can prevent (or manage) similar culture and conduct issues from having significant impact on both customers and organizations. This trend suggests that it is not just a ‘western’ issue but one that is equally relevant locally; indeed, we are witnessing an increase in local interest in having culture assessments performed at banks.

But what are the ‘cultural factors’ that might drive behavior here in the UAE?

Literature on culture has mainly focused on the differences between companies in disparate countries with significant commentary on the differences between nationalities. In almost all countries there is usually a dominant nationality who will ‘define’ the cultural values and behavior of that country. But in countries where there are multiple nationalities, as in the UAE, a new layer of complexity is introduced.

Cultural melting pot

To understand how this could affect organizations, a good starting point is looking at the four dimensions9 widely considered to be the aspects of culture that are to an extent measurable relative to other cultures:

1. Power distance (PD) (from small to large): This measures the degree of inequality between superiors and subordinates. Large PD scores indicate cultures in which employees are seen as frequently afraid of disagreeing with their bosses and where bosses may be seen as autocratic or paternalistic.

2. Uncertainty avoidance (UA) (from weak to strong): This measures the extent to which the members of a culture feel threatened by ambiguous or unknown situations. Strong UA scores indicate cultures in which employees prefer greater predictability e.g. the need for written and unwritten rules.

3. Individualism versus collectivism: A society is more individual where ties between individuals are loose: everyone is expected to look after themselves and their family. Collectivism is the opposite, and describes a society that is integrated into a strong, cohesive in-group, which protects individuals in exchange for unquestioning loyalty.

4. Masculinity versus Femininity: A society is more masculine when emotional gender roles are clearly distinct. For example, men are supposed to be assertive, tough, and focused on material success, whereas women are supposed to be more modest, tender, and concerned with the quality of life.

Within nationalities with a high PD score, employees may be afraid to speak up, with the consequences for banks being that fewer people ‘speak up’ when they should to highlight conduct issues. When considered in comparison to other nationalities who may demonstrate lower degrees of uncertainty avoidance, this could be a potentially toxic mix in terms of the level of risk undertaken by a bank.

Applying the four dimensions framework

We have analyzed a sample of UAE residents, from a range of nationalities that represent significant percentages of the population, and considered where each nationality falls within the dimension scales. The table shows differing dynamics between groups of individuals. For instance, the relationship between an Indian manager and Arab employee may have very different dynamics compared with a UK manager and Filipino employee. It is important for banks’ management to understand the dynamics that work and the impact they may have in different areas across the bank. For example, in a control function, the need for people to be able to work with their bosses and speak up is critical, compared with a front line role where following a strict set of ‘engagement’ rules with customers is more important.

“Banks might do well to consider longer term KPIs in management compensation to further encourage a prolonged outlook”.

The UAE is a good example of how cultural groups work together, as we have one of the highest proportions of expatriates in the world (approximately 88.5%). The visa system links employees to their job but the forthcoming, new immigration laws, with proposed ten-year visas (compared with one to three years) suggested for certain professionals, will likely help encourage many individuals to view the UAE as a longer term or even permanent home.

Banks, however, might do well to consider longer term key performance indicators (KPIs) in management compensation to further encourage a prolonged outlook. Additionally, the fact that remuneration in many organizations here and around the world is driven by the annual revenue of the company could mean that short-term growth decisions may outweigh better, longer term options based on personal drivers. However, this is offset by the high levels of local ownership and the relatively high numbers of board members who own significant shares in banks, and therefore have interest in the creation of long-term value.

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**Typical nationality types in UAE companies (country scores)**

<table>
<thead>
<tr>
<th>Approx % of UAE population</th>
<th>Arab countries</th>
<th>Iran</th>
<th>UK</th>
<th>India</th>
<th>Pakistan</th>
<th>Bangladesh</th>
<th>Philippines</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>23%</td>
<td>5%</td>
<td>1%</td>
<td>28%</td>
<td>13%</td>
<td>7%</td>
<td>6%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Scale</th>
<th>Power distance</th>
<th>Uncertainty Avoidance</th>
<th>Individualism vs collectivism</th>
<th>Masculinity vs femininity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small = 1</td>
<td>Large = 100</td>
<td>80</td>
<td>58</td>
<td>35</td>
<td>77</td>
</tr>
<tr>
<td>Weak = 0</td>
<td>Strong = 100</td>
<td>68</td>
<td>59</td>
<td>35</td>
<td>40</td>
</tr>
<tr>
<td>Most individual = 100</td>
<td></td>
<td></td>
<td></td>
<td>48</td>
<td>14</td>
</tr>
<tr>
<td>Most masculine = 100</td>
<td></td>
<td></td>
<td></td>
<td>56</td>
<td>50</td>
</tr>
</tbody>
</table>

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**No ‘one size fits all’ cultural assessment in the UAE**

As regulators and other stakeholders push for ‘culture assessments’ of banks, it will be imperative that international models are not just applied directly but tailored for local cultures, particularly based on the nationalities prevalent in the firm. Management needs to be aware that what they consider ‘right behavior or practice’ may not be the most appropriate in a different nationality’s culture. They should therefore consider the impact of any ‘cultural change program’ being rolled out.

The UAE is unique in its cultural melting pot of its banks’ employees. It should therefore be recognized that complexity may make it difficult to reliably analyze without going into each individual bank to understand how the drivers inter-relate, including considering which nationalities are predominant at each level.

Only once we understand and appreciate the differences between the many cultural groups within a company and respect that each person is an individual, can we then look at how to overcome the differences. And use them to gain strategic advantage by connecting the different viewpoints.

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Luke Ellyard
Partner | Financial Services
T: +971 4 403 0322
E: lellyard@kpmg.com

Luke Ellyard is a financial services assurance partner in KPMG’s Dubai office. He specializes in the audits of local and international retail and corporate banks and asset management firms, including sovereign wealth funds, exchanges, private-equity houses and many DFSA regulated entities. He has provided specialist control and understanding input to a number of local, regional and global financial institutions and advised on UAE buy-side due-diligence exercises. Luke joined KPMG Lower Gulf in 2008, having spent nine years in KPMG London, including a three year secondment to the Tokyo office.
Several factors have contributed to the recent, heightened awareness of the importance of sustainability and its social, economic and environmental effects – particularly in the banking sector. The Paris Agreement on climate change and the UN’s sustainable development goals (SDGs) have resulted in a USD12 trillion\textsuperscript{14} market each year, and the potential for USD 90 trillion\textsuperscript{15} investment opportunities before 2030.

Changing investor concerns and increasing engagement in environment and social issues has given rise to emerging mandates and legislation. These include: the European Union’s mandatory disclosure on sustainability performance by the financial services sector for large public-interest companies and the Financial Stability Board’s Task Force on Climate Related Financial Disclosures (TCFD).

Larry Fink, CEO of Blackrock, one of the world’s largest investors, in his 2017 letter to investees stated “As wealth shifts and investing preferences change, environmental, social, and governance issues will be increasingly material to corporate valuations.”\textsuperscript{16}

Locally, both the Abu Dhabi Exchange and Dubai Financial Markets are now members of the Sustainable Stock Exchange Initiative (joining 83 global stock exchanges globally). In January 2019, 25 local entities\textsuperscript{17}— many of them banks – signed the Abu Dhabi Sustainable Finance Declaration, announcing their intent to advocate sustainable finance and investments focused on driving long-term socioeconomic and environmental development.

So what is the banking sector’s role in supporting the growing space of sustainable finance, and how is sustainability reporting supporting this trend?

“Sustainability reporting could also improve stakeholder engagement, brand reputation and social license to operate for banks, beyond the carbon footprint.”

Barriers to sustainable development

Although there has been an increase in the dialogue and rhetoric regarding sustainable finance in the region, the mobilization of both private sector and government capital continues to be measured. Some of the key barriers to sustainable finance include:

- Regulatory and policy gaps (including uncertain and inconsistent regulatory/policy regimes and differing regulatory regimes across regions)
- Transfer of knowledge and skills from the developed world to the developing world, particularly in the area of project generation
- Technology innovation to reduce cost (new technology/improvements)
- Challenges of attracting and mobilizing finance/investment into emerging economies given the level of inherent risk and risk/reward balances
- Challenges and costs associated with relevant small ‘micro’ projects and/or the lack of large scale projects in the region
- Need for sound transparent disclosures (most importantly data) to support investment decisions and due diligence processes, analysis and emerging new valuation methodologies.

The role of sustainability reporting

With credit risk and valuation approaches increasingly shaped by environmental, social and governance-related input, there is a pressing need for better reporting and market disclosures. Financial data alone is no longer sufficient.

In the Middle East, banks are only beginning to leverage the available environmental and social data to inform actionable business insight. At the same time, they are gradually putting more emphasis on sustainability reporting – though there is room for improvement. In KPMG’s 2018 Corporate Responsibility Reporting Survey, of the top 100 largest organizations by revenue in the UAE, 37 percent of banks were reporting their sustainability performance. 18

In the banking sector, sustainability reporting may be useful in the following key areas:

- Sustainability considerations and analysis may allow banks to access new markets and explore new client engagement approaches. Examples include the Australian New Zealand Banking Group, which announced a sustainable finance target of USD 7.1 million, and appointed a head of sustainable finance. Locally, First Abu Dhabi Bank issued the only green bond in the market in 2017. We have also seen banks begin to introduce ‘green loans’ and SDGs social bonds.

- Banks are aiming to implement sound risk-management processes, which involves aggregating, managing and integrating sustainability data and metrics with financial data to help understand and reduce their risk exposure. The assessment of climate risk exposure across lending portfolios is an example.

- New sophisticated in-valuation approaches have emerged, where banks look to incorporate non-financial considerations into valuations, recognizing that the ability to see the whole picture is fundamental to valuing a company or asset. Considering sustainability related performance has been found to identify potential upsides, ‘alpha’, where companies manage such issues better than their peers. 20

- Sustainability reporting could also improve stakeholder engagement, brand reputation and social license to operate for banks. Other stakeholders such as consumers, governments and non-governmental organizations (NGOs) are demanding greater transparency and accountability.

Going beyond the minimum

Sustainability reporting goes beyond the carbon footprint and health and safety initiatives. Frameworks prescribe that companies should report on topics that are material to their company and their stakeholders. Financial institutions differ from most organizations in that their main impact is indirect, through their investments or lending portfolios, so sustainability performance should include both indirect and direct effects. Considerations include:

- Disclosure of sustainability or the environmental, social and governance (ESG) policy of the bank.

- Disclosure of the exposure to environment and social risks through lending and investments.

- Set targets and report on the impact made through lending and investment activities.

The lack of disclosure of sustainability data can represent a challenge. However this is gradually being addressed by governments in the region and stock exchanges. Christiana Figueres, former head, United Nations Framework Convention on Climate Change (UNFCCC), said that “Rivers of capital need to flow to assets and projects that are the right ones for the 2050 world we have to build.” 21 Organizations would be well advised to include sustainability reporting within this list of projects, as it can act as an enabler for sustainable finance and facilitate the promotion of sustainable development.

Increasingly, investors, employees, customers, and other stakeholders are calling for greater focus by banks on the long term, as set out in KPMG’s ESG strategy, and the long view – a framework for board oversight 2017. 22

Daniel Gribbin
Sustainability Services
T: +971442496513
E: dgribbin1@kpmg.com

Daniel joined KPMG Lower Gulf in 2018 as a Senior Manager in the Sustainability services team as a subject matter expert specializing in Global Reporting Initiative (GRI) reporting, strategy implementation development, corporate social responsibility, health and safety, and environmental management. Daniel has extensive industry experience working in the financial services, minerals and mining, logistics and consumer manufacturing industries.


Article co-authored by Hanife Ymer, KPMG Lower Gulf director as of 8 April 2019.
The ECL numbers presented within this report are on loans and advances (including financing assets for Islamic banks) for the top 10 listed banks in the UAE except ADCB, FAB and RAK Bank, where ECL numbers are presented on all financial assets measured.

The total net impairment charge is netted with total recoveries for the year. The recoveries reported in stage 3 movement may not represent total recovery as there were some cases where banks recorded recovery directly in the statement of profit and loss. Therefore we have adjusted stage 3 movement with the recovery amount (recorded directly) to compare the net impairment charge in stage 3 movement with net impairment charge reported in the statement of profit and loss.

Source: KPMG analysis of released figures for the top 10 listed banks
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<th>Bank</th>
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<th>Tier 1 capital FY18</th>
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**Regulatory capital (US$ billion)**

- **Tier 1 capital 2017**: FY17 73.0, FY18 71.4
- **Tier 2 capital 2017**: FY17 6.4, FY18 5.6
Net impairment charge on loans and advances (US$ million)

Credit rating

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<th>Fitch</th>
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| Overall country rating | AA | Stable | Aa2 | Stable | AA | Stable |

Source: KPMG analysis of released figures for the top 10 listed banks
The information in this report is based on our authors’ in-depth knowledge of the UAE’s financial services industry, allied with detailed analysis of banks’ financial performance. The GCC listed banks results report compares the performance of approximately 60 of the GCC’s leading listed banks. A snapshot of those findings is included on pages 36-39.
KPMG Lower Gulf Limited provides audit, tax and advisory services to a broad range of domestic and international clients across all sectors of business and the economy. We work closely with our clients, assisting them to mitigate risks and highlight opportunities. Established in 1973, KPMG Lower Gulf now consists of approximately 1,250 staff members, including more than 100 partners and directors, across six offices: Dubai (three), Abu Dhabi, Sharjah and Muscat. The KPMG member firm in the United Arab Emirates, along with the member firm in Oman, form KPMG Lower Gulf.

KPMG is widely represented in the Middle East and also has offices in Saudi Arabia, Bahrain, Qatar, Egypt, Kuwait, Jordan and the Lebanon. As well as having many of the region’s leading organizations and government-related entities as its clients, KPMG in the Lower Gulf has been party to numerous milestone engagements in the Middle East.

KPMG Lower Gulf is part of KPMG International Cooperative’s global network of professional member firms. The KPMG network includes approximately 207,000 professionals in over 153 countries around the world. KPMG in the UAE is well connected with its global member network and combines its local knowledge with international expertise, providing the outstanding sector and specialist skills required by our clients. KPMG was the first major firm of its kind to organize itself along industry lines—a structure which enabled us to develop in-depth knowledge of our clients’ businesses and provide them with an informed perspective.

KPMG Lower Gulf is closely collaborating with Abu Dhabi Global Market Academy (ADGMA), the Abu Dhabi Human Resources Authorities and Abu Dhabi Accountability authorities to deliver the program, Pre-Audit Qualification Training (PAQT).

Initially run over the next three years, in its first year it will provide more than 90 UAE nationals with the essential knowledge and training in relation to audit that will equip them to succeed in this field, and thus contribute to the growth and development of the local economy.

KPMG was proud to be an Official Supplier of the Special Olympics World Games Abu Dhabi 2019 and the Official Sponsor of the Global Youth Leadership Summit. We were delighted to contribute to the world’s largest humanitarian sporting event and global movement. This aligns directly with our values of inspiring confidence and empowering change, of inclusion and diversity, of passion and purpose. We are honored to be associated with such a momentous and meaningful event, and for the opportunity to contribute to making it a life-changing experience for everyone.
KPMG’s dedicated financial services practice in the UAE offers access to various key financial marketplaces. It delivers best practice advice and recommendations through an up-to-the-minute understanding of the vital issues facing the local and international financial services industries.

KPMG has experience in providing audit and other business services on a range of risk and financial issues to local and major multinational banks and insurance companies operating in the UAE.

Globally KPMG member firms provide professional services to:

- 64% of the World’s 500 largest banks
- 77% of the top financial services companies in the Global 1200
- 73% of the financial services companies in the Financial Times Global 500
- 92% of the largest banking companies in the Fortune Global 500

Details of all the services we offer can be found on our website: www.home.kpmg.com/ae/en/home
Supporting the Determined

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