UAE banking perspectives 2018

Change on the horizon

March 2018

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Foreword

Major developments in technology, regulation, culture and governance will have a transformative effect on the current and future landscape of the UAE banking sector.

Over the years, the United Arab Emirates (UAE), and Dubai in particular, has become known as the key financial hub for the Middle East and one of the world’s leading financial centers. We have recently seen a renewed drive to move the country to a global innovation center, with a number of exciting initiatives announced and embarked upon in recent times, ranging from some of the first Artificial Intelligence, blockchain and FinTech initiatives of their kind, globally.

But with technological innovation, there is the growing risk of more aggressive cyber-attacks on individual companies, as well as countries as a whole, resulting in a greater need for vigilance and continued focus on enhancing existing regulations and introducing new ones in response. This effort, together with existing international and local initiatives to improve the stability of the global financial system, requires continued focus from both regulators and the banking sector – a situation that is more complicated for those with extensive operations across multiple jurisdictions.

In addition, continued policy uncertainty due to both global and regional political change in recent times, has presented banks with the need to explore new solutions and/or markets, to grow and diversify their businesses in an economic environment manifesting muted growth forecasts in the immediate- and mid-term.

Against this backdrop, banks are assessing how they can use new and innovative technologies to differentiate themselves from their rivals. Competition is no longer limited to traditional banks, but also to new, disruptive entrants to the market. Banks also find themselves having to invest to comply with ever more stringent and complex regulations.

In UAE banking perspectives 2018, as well as our analysis of the key financial indicators for the past year, and evaluating where we are in the roll-out of recently released legislation and regulations, we also look at the latest developments in innovation and regulation that we see emerging, globally and in the UAE, that the local banking sector players should be preparing for.

This is the third annual UAE Banking Perspectives we have produced. It complements our GCC listed banks results report, which highlights some of the key financial trends, challenges and opportunities for the banking industry in the region.

As a team, we look forward to discussing these themes with you in the coming weeks, and undertake to continue to update you as we see these evolve.

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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, blue-chip 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.

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# Contents

- **Foreword**  
  2

- **Executive summary**  
  4

- **Performance highlights**  
  6

## Technology

- **Blockchain: waiting is not an option**  
  10

- **AI: intelligence gathering**  
  12

- **Banks and FinTech: friends or foes?**  
  14

- **Cyber security: beating the challenge**  
  16

## Regulation

- **VAT: potential pressure on the bottom line**  
  20

- **Anti-money laundering: readiness benchmarked**  
  22

- **IFRS 9: embedding into business as usual**  
  24

- **IFRS 16: the challenge for banks**  
  26

- **Is Basel III turning four?**  
  28

## Culture and governance

- **Culture: the root of misconduct?**  
  32

- **Sustaining good governance**  
  34

## Key banking indicators

- **About KPMG**  
  41
Executive summary

Innovation through technology will enable banks to improve operational efficiency, augment revenue and reduce risk, whilst enhancing customer experience. This may offset growing cost pressure as a result of muted top-line growth and increasing costs of compliance with new regulation.

We have seen an increasingly disruptive banking sector emerge over the last year, particularly in technological advances, which has heightened the degree of both opportunity and threat. At the same time, new – often tighter – regulation has come into force, or is coming soon, much of which may have an impact on banks’ bottom line. At the same time, banks are generally in better shape compared with a few years ago, which is being further enhanced by new corporate governance regulations that should provide for a more sustainable economy.

Perhaps more than any other development, blockchain has dominated financial news in recent years with a number of exciting initiatives already announced across the UAE. Around 60% of UAE CEOs indicate they expect to invest in blockchain technology this year1. In a maturing and innovative environment like the UAE banking sector, there is no doubt we will see more pilot projects and live projects emerging using permissioned blockchain across both public and private sectors. This may allow smaller entities to conduct business at a lower cost, while enjoying similar security, transparency and interoperability benefits.

The banking sector has often been in the forefront of adopting new technologies, and Artificial Intelligence (AI) is no different. 90% of UAE CEOs are considering how to integrate basic automation with AI2. We are seeing an increasing trend where AI is applied in customer engagement, to drive greater loyalty, provide pervasive security protection and reduce operational cost.

With a wave of new FinTech players emerging with solutions covering most of the complex aspects of the banking value chain, it is clear that although banks have the upper hand when it comes to scale and resources, they have to collaborate with FinTechs to innovate, in order to stay relevant.

The way customers expect to interact with banks has changed significantly: they now demand omni-channel access. This is resulting in a rapid adoption of electronic channels in the banking sector and money increasingly moving in a digital manner. At the same time, we have seen a consequently marked increase in cyber security breaches and fraud. Cyber security has over the last five years been one of the top ten priorities in the board room. Leading banks have now formalized their cyber security strategy and governance to respond to this threat and also to pro-actively adapt to new regulations in order to succeed – and outpace – competitors. We explore some of the key consideration for organizations. VAT also came into effect in the UAE on 1 January 2018, against challenging timelines. It will have far-reaching implications for banks’ profit margins since banks can only recover a small fraction of the total VAT incurred, because most services provided are VAT exempt. It will be interesting to see how they manage their pricing policy in future.

Over the last year we have seen a renewed focus from banks to assess the robustness and effectiveness of their Anti-Money Laundering (AML) and sanctions compliance programs. This is partly due to the next Financial Action Task Force (FATF) review that is due in the UAE during 2019. Our review of a number of banks highlighted that, although most banks performed well or fairly well in terms of governance, training and assurance, there was a shortfall in monitoring, with three of the eight banks potentially requiring some remedial work.

International Financial Reporting Standard (IFRS) 9 came into effect on 1 January 2018. Although most banks technically have been able to meet the date of initial implementation, much more refinement of processes will have to be done before IFRS 9 will become business as usual. The inter-dependency between the IT, Finance and Risk functions also highlights the need for a revised governance framework. In addition, whilst the increase in provisions is not as severe as in Europe, they are substantial and will require banks to reflect on the profitability of some business lines in their current format.

Banks in the UAE have many leasing arrangements that will now be in the ambit of the new IFRS 16 standard which becomes effective on 1 January 2019. Branches, ATMs, IT infrastructure and outsourcing arrangements to name a few will have to be assessed to evaluate the
impact on their financial statements, operations and capital requirements, which can be significant. Banks cannot afford to delay and should conduct an impact assessment as soon as possible. This assessment will be more complex for banks with a geographically dispersed networks with more lease commitments, and may take longer to conduct.

The Basel III amendments (also referred to as Basel IV) to credit and operational risk are likely to be implemented in the UAE. This is expected to result in a reduction in the capital adequacy ratios for most banks. The methodology to calculate the amended numbers will require adjustments to systems as well as collection of additional data requirements.

The opportunity to deliver value and improve risk management by paying more attention to corporate culture is significant. The banking leaders of today have a unique opportunity to create a cultural framework that will last a lifetime. Only by grasping this opportunity can banks provide the basis upon which trust can be restored and maintained in the sector over coming years.

A strong corporate governance culture is regarded as one of the main pillars of maintaining and growing a sustainable economy. Current regulations in the UAE, as well as new draft regulations, have been issued that set a clear tone in line with the country’s development agenda, which is focused on building a sustainable economy. The changes are likely to affect banking operations, as well as create demand for new financial products. Regulators are likely to require banks, when making investment and lending decisions affecting new clients and suppliers, to consider sustainability. Forward-looking banks will ensure they are correctly positioned to take advantage of the changing landscape.
Performance highlights

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Abbas 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 assessment to full review of front-office supervision, product control, treasury, risk and operations), including extensive work with regard to derivatives and structured transactions.
Capital Adequacy Ratio (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>2016</th>
<th>2017</th>
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<td></td>
<td>18.6%</td>
<td>18.7%</td>
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Return on equity (%)

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<td></td>
<td>13.3%</td>
<td>13.5%</td>
<td>0.2%</td>
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Return on assets (%)

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<tbody>
<tr>
<td></td>
<td>1.7%</td>
<td>1.7%</td>
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Liquidity ratio (%)

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<tr>
<td></td>
<td>31.8%</td>
<td>33.0%</td>
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Non-performing loan ratio (%)

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<td></td>
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Cost-to-income ratio (%)

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<tr>
<td></td>
<td>35.8%</td>
<td>35.9%</td>
<td>0.1%</td>
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Source: KPMG analysis of released figures for the top 10 listed banks. See also Key banking indicators on pages 36 to 39.
Technology
Blockchain has dominated the news in the last couple of years, notably amongst public sector entities and banks. The Dubai government launched a blockchain strategy in 2016 with the goal of becoming the world’s first blockchain administration by 2020. Abu Dhabi Global Markets (ADGM) recently announced key initiatives using blockchain to facilitate the regulatory requirements of know-your-customer (KYC) processes. In November 2017, RAK Bank launched remittance services using blockchain start-up Ripple (which is used by several of the world’s top 100 banks). More recently, the Central Bank of the UAE (CBUAE) announced a joint project with the Saudi Arabian Monetary Authority (SAMA) to use blockchain to issue a digital currency for cross-border transactions between the two countries.

Blockchain is an online, encrypted database. Transactions related to documents, shares and financial products, trade and contracts and digital currency, for example Bitcoin, can be implemented, processed and verified. Using a cloud-based network, blockchain technology is believed to be safe, i.e. inherently resistant to modification.

At a global level, blockchain is being considered by many as a panacea to the multiple challenges banks are facing in settlement and clearing, collateral management, KYC, trade finance or digital identities. With growing enthusiasm on future growth among the banking CEOs (77% of CEOs of banks worldwide), implementing disruptive technologies like blockchain is as high as third on the initiatives agendas, behind greater speed to market and fostering innovation.

**Action required now**

Last year 60% of the CEOs we spoke in the UAE expected to invest in blockchain. In our next annual survey (to be published in Q3 2018), it will be interesting to see how many of them will have actually invested or are waiting until the technology and applications mature.

Our view remains similar to other technological trends disrupting the industry: waiting is not an option. Technology advancement today appears to expand exponentially, at least much faster than a decade ago, and early adopters may gain a larger market share. Still, the banks have multiple opportunities to reshape their business models and integrate or develop blockchain-based processes or products, to create further competitive advantage.

This new phase focuses on improving the middle- and back-office applications, by either eliminating unnecessary operations or by integrating FinTech solutions into legacy applications.

Under increasing regulatory pressure, customer demands and potential profitability erosion, the focus is to simplify and rejuvenate legacy processes or products, starting from simple application upgrades to completely overhauling IT architectures and internal processes around deployment methodologies, risk, security, application testing and procurement. With multiple market studies estimating that blockchain can significantly reduce a bank’s infrastructure cost, it is no wonder that over 70% of banks worldwide are experimenting with permissioned blockchain.

**New links**

We have analysed the validity of exploring and implementing blockchain applications from three objectives: improving operational efficiency, increasing revenue and reducing risk. Applications related to trade financing for domestic and international transactions can achieve all three objectives. User cases related to company records keeping, syndicated loans or over-the-counter (OTC) derivatives would likely bring significant advantages to the operational efficiency and risk reduction.

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Banks and other financial institutions that have explored using blockchain have started with cross-border payments for reconciliation and verification, with live implementation at leading international banks and other financial institutions. Digital Identifiers and KYC related initiatives have also seen increased blockchain adoption.

During our discussions, proof of concept testing and through projects implementation we identified four key factors that have the potential to accelerate the adoption of blockchain in UAE banking:

- Detailed development of industry-wide use cases: business and IT must work together to identify clear pain points that can be solved using blockchain, and outline, where needed, if sub-parts of the existing processes might be migrated to blockchain. Such cases would require agreed business and regulatory rules.

- Increased guidance from regulators on the governance model of such decentralized ledgers, and granting permission to experiment on certain, agreed topics.

- Willingness of one or more large banks to implement and lead various pilots. These would not only validate the technology but also the return on investment and additional value created.

- On-board multiple partners to create wider business potential and tackle data governance and interoperability.

In a maturing and innovative environment like the UAE banking industry, there is no doubt we will see more pilots and live projects using permissioned blockchain. We believe that the future is a healthy mix of public and private blockchain infrastructure, which would allow smaller entities to conduct business at a lower cost, while enjoying similar security, transparency and interoperability benefits.

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“Our view remains similar to other technological trends disrupting the industry - waiting is not an option”
The latest KPMG UAE CEO Outlook (https://assets.kpmg.com/content/dam/kpmg/ae/pdf/UAE-CEO-outlook.pdf) survey found that over nine in ten chief executives in the UAE are considering how to integrate basic automation with Artificial Intelligence (AI) and cognitive processes. Four fifths believed that digital means in general were not being used as effectively as they could be, to connect with customers.

The banking sector has often been in the forefront of adopting new technologies and AI is no different. Investment banking, and trading in particular, has advocated as far back as 2011 for technology and advanced mathematical models to automate investment transaction execution.

We have recently seen automation and intelligence gaining traction in deal-making areas. JP Morgan launched Emerging Opportunities Engine, a predictive platform to help clients identify whether they should issue or sell equity; Goldman Sachs also published a plan in early 2017 to automate 146 steps of an Initial Public Offering process (IPO).

Automated portfolio management (or robo-advisors) - a combination of mathematical algorithms and machine learning aimed to calibrate the financial portfolio to the desired goals and acceptable risk thresholds - has come to the fore since 2013.

Earlier versions of AI and machine learning were employed to help detect fraud and security risk by using a complex set of rules. The newer algorithms involve active risk and security protection, adjusting in real time to potential and real threats by continuously analyzing streams of transaction data, internally and from outside sources. Lending and underwriting have also been areas with a predilection for machine-learning algorithms in an effort to improve the accuracy of defaults and reduce the insurance risk on particular products like health insurance.

Lately, AI is being employed to increase customer engagement, drive greater loyalty, provide pervasive security protection and reduce operational cost.

Intelligence quotient
At the same time, the fear that AI will displace jobs is, in our perspective, a fallacy. A more likely scenario is that AI will transform jobs, not eliminate them. Take the example of customer call centers: employing chat-bots to answer typical FAQs on new products reduces the need for staff. But at the same time it requires manpower to structure and classify the existing knowledge base, and also to ‘train’ the algorithms to provide adequate answers. Smart technology, after all, still needs smart people.

Specialist chat-bots companies have the chance to be life savers for many banks, by providing better service to their customers, without the need to invest in developing complex AI technology. We foresee this trend reaching the UAE this year, with many banks looking to further differentiate in customer engagement, while continuing with cost-optimization schemes.

The increased quality and efficiency obtained through the introduction of robotic process automation (RPA) is further enhanced by combining it with AI. For example, some banks are exploring automated decision-making based on sentiment analysis (using AI/machine learning), through extracting data from millions of emails and other data sources.

Security will continue to be a hot topic with the advancement of both AI-powered counter-threat solutions. As the world moves more towards voice-interaction, we will likely see greater integration of banks’ mobile apps and wearables with voice-powered robotic applications. The imperative to provide users with the platform they want to interact with must be matched at the same time with the privacy and security legal and ethical compliance.

To effectively use AI and machine learning as a competitive differentiator, banks will first need to identify the business use cases and understand what and where the relevant data are available; then cleanse, classify and augment it with outside, potentially unstructured data. Once the use cases are implemented, monitor the performance improvement and continue to train the models for greater accuracy.

We believe driving early AI adoption by focusing on clear, achievable outcomes and taking incremental steps will provide a good and safe platform for the banks to drive innovation and achieve short and long term success.
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Cristian specializes in mobility, omni-channel transformations, analytics, process consulting and the project management of large and complex implementations. He has worked extensively on strategy and digital transformation engagements, having worked across Europe and the Middle East with blue-chip clients. Cristian has also led multiple mobility and omni-channel strategy and delivery engagements for banking and government clients across the GCC and North Africa.

“A more likely scenario is that AI will transform jobs, not eliminate them”
Traditionally, banks would take end-to-end ownership of providing all aspects of their products and services to customers. They would go to great lengths to identify potential clients, market and sell their products and services to them, and thereby earn interest or a fee-based income.

Eventually, there was some decoupling of the value chain as the outsourcing trend emerged. Banks started to outsource various aspects of their value chain, such as call centers, sales teams, card issuance and so on, to third-party service providers, whilst benefiting from cost savings. At the same time, banks continued to retain the more complex aspects of their value chain in-house, such as know-your-customer (KYC), client on-boarding, risk and liquidity management, and reporting.

However, in the last couple of years, a cohort of FinTechs has emerged offering specific solutions across most of these aspects of the banking value chain. Unlike most banks, which are lumbered with corporate bureaucracy, legacy systems and processes, and costly infrastructure, FinTechs are often able to bring their products and services to market in a more effective and efficient manner.

In fact, the scale and extent to which FinTechs have emerged, was evident in the recently concluded Abu Dhabi Global Market (ADGM) FinTech innovation challenge, where over 160 FinTechs came forth with solutions for 15 different problem statements. The finalists showcased an array of solutions based on blockchain, robotics and AI.

These FinTechs can broadly be categorized into three types, those that:

a) Sell to a bank: including those geared towards parts of the banking value chain that are generally invisible to the customer, such as transaction monitoring, customer analytics, regulatory reporting

b) Sell through a bank: these help the bank to better serve its customers with, for example, authentication, chat bots, robo-advisors, and financial management

c) Compete with a bank: these solutions focus on peer-to-peer transactions including payments, remittances, lending, borrowing, mobile wallets, where FinTechs are able to offer customers lower transaction costs, more conveniently, anytime, anywhere.

It would be natural to assume that the first two types of FinTech solutions could bring much needed innovation in the banking sector, as they would help banks derive operational efficiencies whilst improving customer experience. Based on our extensive discussions with banking clients in the UAE, however, the extent to which they are embracing these solutions is still fairly low. Banks either cite regulatory constraints or in other cases opt to establish in-house innovation centers to develop their own solutions, which, in many instances, tend to be costlier and more time-consuming, rather than seek to embrace a FinTech solution.

As for the third category, FinTech solutions that compete directly with a bank on specific aspects of the value chain, banks do not appear to be worried, as they believe that when the time is right, they can always acquire them.

At the same time, despite the agility and nimbleness of FinTechs, banks also have the upper hand when it comes to scale and resources, something that most FinTechs need in order to grow their business from scratch. In such circumstances banks and FinTechs could look for ways to collaborate in a mutually beneficial manner.

Banks and FinTechs, however, both still have a long way to go when it comes to taking banking to the next level. Existing efforts, even from the FinTechs, have largely been iterative and incremental. Organizations are still
trying to find ways to offer the typical banking products (current account savings account (CASA), credit cards, loans and payment services) in a more convenient, cost-effective manner, rather than thinking about how today’s – and tomorrow’s – bank actually needs to look and feel like.

Friends or foes, banks need to collaborate with FinTechs to innovate in order to stay relevant.

When the world’s largest transportation company (private taxi hire), the largest accommodation company (online holiday rental), the largest retail companies (online books and other goods) and the largest media company (a video search engine) are all pure play technology companies with none of them having had a legacy conventional business to begin with, then how long will it be before the world’s largest financial services company becomes a technology one? Will it be a bank that embraces FinTech or a FinTech that fully embraces banking? Based on current form, it is more likely to be the latter, I would say.

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“Will it be a bank that embraces FinTech or a FinTech that embraces banking?”
The pace of technology-enabled innovation has increased exponentially over the last decade, resulting in new business opportunities in the banking industry, such as digital branding (via mobile and internet channels), Augmented Reality (AR) and Virtual Reality (VR)-based banking channels, blockchain-based transactions and the Internet of Things (IOT)-based payments. Transactions are being processed faster, free, and in a user-friendly manner.

These evolutions have fundamentally changed the way customers expect to interact with banks. They now demand an omni-channel presence, improved client experience, secure transactions, and better control over fraud and data privacy.

These issues have made cybersecurity one of the top ten priorities in the board room, as any breach could undermine the trust that customers have in their bank, and therefore affect the future profitability and sustainability of the organization. Banks in the UAE are no different and are ready to make suitable investments in cybersecurity. They should consider investing in cyber-security from a consumer-centric point of view. Based on our global expertise of delivering cyber-security solutions and our experience of creating digital solutions for banks, we believe there are seven key capabilities that are strategic to secure digital solutions for clients and build greater trust in the organization:

**Cyber specifics**
Cyber security strategy & governance and cyber security defense & response are the traditional blocks of security. These translate into a number of specific areas, as follows:

**Consumer Identity and Access Management**
Provides a single identity across multiple channels for users to access their accounts, manage their preferences, and manage their credentials in a secure manner. It also provides a mechanism to gather data to understand customer needs and preferences.

**Advanced Authentication**
Changing technologies and increased security concerns have almost rendered passwords obsolete. In order to meet both security and customer requirements, multiple, advanced authentication options, such as biometrics and push notifications, will likely need to be offered. Higher assurance credentials can be leveraged to increase the security assurance of a user for higher risk transactions, such as balance transfers and trades.

**Secure by Design**

**Device Security**

**Secure Transactions**

**Privacy**

**Privacy Regulatory Compliance**

With the rapid growth of Financial Services technology and the adoption of electronic channels, money is increasingly moving in a digital manner. But along with the advances we have seen a marked increase in cyber-security breaches and fraud. What can banks do to meet the challenge, asks Sheikh Shadab Nawaz.
New technologies, such as cloud and mobile, are driving customers to want to access their accounts from any channel, at any time, from anywhere. This is resulting in significant changes in architecture. In order to adapt to these changes, security ought to be designed into the architecture and development lifecycle, across different channels and technologies.

The proliferation of different devices poses new security risks. Understanding and adapting to the security of different devices and digital interfaces that the consumer connects with is essential to minimizing account takeover and malware introduction.

As digital financial transactions are becoming more commonplace, securing the mechanisms that enable each transaction is critical to successfully compete in the omni channel and completely mobile environment.

**Up close and personal**

Banks handle a significant amount of personal information. Although regulations for handling this data vary from region to region, any personal information collected should be managed in accordance with the local regulations and only used with the consent of the owner of the information.

Understanding how regulations, such as the UAE National Electronic Security Authority (NESA), EU General Data Protection Regulation (GDPR) and others, play a part in the organization's digital strategy is essential in order to succeed and outpace competitors. Increasing regulatory pressure from the US, the UK, Europe and elsewhere require adjustments in technology configurations, and security requirements are increasingly being enforced. New global regulatory pressures will play a significant role in how Financial Services institutions interact and collect data on their consumers. This needs to be aligned and understood with the overall organizational digital strategy.

In our 2017 UAE CEO Outlook survey (https://assets.kpmg.com/content/dam/kpmg/ae/pdf/UAE-CEO-outlook.pdf), it was clear that chief executives would be paying more attention to – and investing more in – cyber security in coming years. Yet finding staff with appropriate skills is a challenge: as many as 84% of UAE CEOs reported that human capital is currently one of the biggest challenges they face when it comes to tackling this issue. These CEOs, however, believe that such risks, if tackled adequately, can further prompt innovation in products and services.

UAE CEOs are more likely (84% compared with 53% of their global counterparts) to see cyber security as a way of prompting product and service innovation. Over two-thirds see investment in cyber security as an opportunity to generate new revenue streams and innovate, rather than being just an overhead.

We don’t think there are many board meetings or executive meetings in the UAE where the cyber threat isn’t discussed. If companies aren’t concerned, they probably should be.

**Sheikh Shadab Nawaz**

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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.

“If companies aren’t concerned, they probably should be”
Regulation
The government succeeded in introducing VAT in the UAE with effect from 1 January 2018, against challenging timelines. The UAE VAT Decree-Law was released in late August 2017 with the corresponding Executive Regulations only published on 28 November 2017.

The standard rate of VAT is five percent with some goods and services qualifying to be either zero percent or exempt of VAT. Saudi Arabia is the only other GCC member state that went live with a VAT system on the same date, and the remaining Gulf States are expected to follow suit from early 2019.

Many financial services are VAT-exempt. As a general rule, margin-based products, such as those generating interest income (loans, mortgages, provision of credit, and operation of bank accounts) are exempt of VAT. This will have no direct impact on the end consumer as they will not be charged VAT. However, there could potentially be a substantial impact on the profitability of the banks since banks will not be able to claim credit for any VAT incurred on expenses related to the making of these exempt supplies.

The UAE VAT law also specified services on which customers will be charged five percent VAT. These are any financial services where an explicit fee, commission, discount or rebate is levied. Fees for account applications, money transfers, check books, account statements, ATM charges are now subject to VAT. Favorably for the banks, VAT incurred on costs directly related to making these taxable supplies will be recoverable.

**Cost of VAT?**

Our global experience indicates that banks tend to recover only a small fraction of the total VAT incurred on expenditure as a result of their exempt income, as it can be very difficult for banks to directly attribute their costs to specific revenue streams. The vast majority of costs therefore fall into the overhead category, which includes general expenses such as lease of premises, utilities, professional fees and marketing, to name a few.

An added complexity is that the UAE VAT legislation's standard method for apportioning VAT incurred on overhead costs to determine the recoverable VAT is based on the use of the VAT paid on expenses (see diagram for an illustration of how this works in practice). The legislation does not allow a change in apportionment method to achieve a ‘fair and reasonable’ VAT recovery until January 2019, at the earliest.

Future acquisitions of Capital Assets (from a VAT perspective, where the VAT-exclusive value paid exceeds AED 5m) will result in an increased administrative burden as the use of these assets will need to be monitored over their VAT economic life (ten years for buildings, five years for any other capital asset). Any change in use could result in either a payment or repayment of VAT to or from the Federal Tax Authority (FTA).

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### Apportionment of Input Tax

For a Taxable person that makes exempt and taxable supplies, the VAT incurred on expenses can be categorized as follows:

<table>
<thead>
<tr>
<th>Tax incurred on expenses</th>
<th>Tax directly attributable to EXEMPT SUPPLIES</th>
<th>Non-Recoverable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Input Tax not attributable to specific supplies (e.g., overheads)</td>
<td>Recoverable according to apportionment calculation</td>
<td>Recoverable</td>
</tr>
<tr>
<td>Tax directly attributable to TAXABLE SUPPLIES</td>
<td>Recoverable</td>
<td></td>
</tr>
</tbody>
</table>

Apportionment calculation:

\[
\text{Apportionment calculation} = \frac{\text{Recoverable Tax}}{\text{(Recoverable Tax + non-Recoverable Tax)}} \times \text{Overhead}
\]
**Pricing issues**

As banks grapple with the new VAT regime and the high compliance costs associated with mandatory VAT registration, it will be interesting to see how they manage their pricing policy from now on. International trends would indicate that the banks will increase their fees to compensate for the additional, hidden costs.

Where banks suffer significant, irrecoverable VAT costs, and/or treat existing taxable fees as VAT inclusive, there may be incentives to cut costs in other areas. As there is no VAT charge on employee salaries or using own resources, banks that currently outsource services, such as back-office activities or call centers, may elect to bring these services in-house to mitigate potential, irrecoverable VAT costs. We believe it quite probable that banks will eventually be forced to increase prices to their customers to maintain their current profitability.

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In 2018 we will see the consolidation of compliance transformation that banks embarked upon during the previous year, when they began to rigorously assess the robustness and effectiveness of their Anti-Money Laundering (AML) and sanctions compliance programs. This is because the FATF mutual evaluation of the UAE in 2019 is driving a host of regulatory initiatives and supervisory actions. As the banking regulator, the Central Bank of the UAE (CBUAE) has been proactive to ensure the sector is ready when the FATF evaluators arrive.

The UAE will not be immune to the changing competitive landscape in the form of new financial technology (FinTech) organizations, which are likely to push financial evolution further.

**Benchmarking**

As a result of performing our AML and sanctions compliance framework assessments, between June and December 2017, we have acquired substantial insight to the various AML programs adopted by local banks. At the dawn of this new era of compliance, we can see the areas where some of the banks we reviewed outshone their peers and where their areas for improvement seem to converge, as shown in the diagram.

The banks we reviewed seem to be running at two speeds, with those clustered around the green zone being the ones having a higher standard of compliance as opposed to those nearing the red zone, i.e. requiring significant remedial work. While most banks we surveyed performed well or fairly well in terms of governance, training and assurance, there was a shortfall in monitoring with three banks. But the survey showed that an urgent focus area for most banks should be to establish a structured compliance risk assessment framework across all business areas along the lines of their international

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**Benchmarking components of an AML and sanctions framework**

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<thead>
<tr>
<th>Component</th>
<th>Bank 1</th>
<th>Bank 2</th>
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<th>Bank 4</th>
<th>Bank 5</th>
<th>Bank 6</th>
<th>Bank 7</th>
<th>Bank 8</th>
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<tr>
<td>Governance</td>
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<td>4</td>
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<td>8</td>
<td>6</td>
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<tr>
<td>Compliance risk assessment</td>
<td>2</td>
<td>6</td>
<td>4</td>
<td>7</td>
<td>1</td>
<td>3</td>
<td>5</td>
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<td>Monitoring</td>
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<td>Assurance</td>
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<td>Training</td>
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</table>
peers (seven out of eight banks performed poorly in this regard). This would involve integrating AML risk into the overall business risk management strategy and enable the banks to understand and prepare for the real AML risks they may face as a by-product of the surge in the sophistication of technology, innovation in the financial services market and the resourcefulness of criminals.

**Defining what good looks like**

What should a robust compliance risk assessment framework entail? Key components would include:

- **Securing involvement of the business in the risk-assessment process.** Whilst Compliance possesses an acute understanding of AML risks, it is the business, as the firm’s front line of defense, which is ultimately most knowledgeable of the clients’ profiles, their transactional behavior and the processes the business has put in place by way of mitigating controls. It is therefore more suited to identify and measure the financial crime risks faced by the bank.

- **Nominating a compliance risk-assessment champion for each business area to act as the focal contact point.** This would ensure efficiency and effectiveness in the process as there is a single, defined communication channel between Compliance and the business area for all risk assessment-related matters and optimal utilization of resources.

- **Implementing an automated solution for conducting compliance risk assessments.** Rather than wasting valuable time and resources through manual processes, banks should consider deploying a standardized platform with which to measure financial crime risk objectively, produce meaningful and visually-appealing reports for management, and establish action plans to address any areas for development.

One of the benefits to banks for performing a compliance risk assessment is the ability to stay ahead of the game in the light of potentially disruptive innovation, for example through the advent of cryptocurrencies such as Bitcoin. Providers of cryptocurrency exchange platforms are fast-emerging as potential rivals of banks, as they make it easier to transfer funds between two parties and can do so with minimal processing fees.

**Cryptic clues**

Incidentally, the anonymous nature of cryptocurrency transactions, coupled with the absence of a mandatory AML regulatory framework that would require, for instance information on the source of funds behind the transactions, makes them well-suited for illicit activities such as money laundering and tax evasion at all three stages of: placement, layering and integration.

By undertaking a thorough compliance risk assessment, banks would be able to evaluate both the competitive risk as well as the money laundering risk they face from, for example, cryptocurrency. Banks should avail themselves of opportunities presented. It is only through their understanding of the risks posed by new products and services that banks can develop a suitable framework to take that business on board and all the benefits such an approach has to offer, instead of denying access altogether – and essentially not participating.

The assessment of their AML program gave banks the opportunity to pinpoint the areas they should turn their attention to and formulate a remediation roadmap that will take them to the next level. One of these areas, for most banks, is financial crime risk assessment. We encourage banks to embrace the internal upheaval that may ensue from the performance of a comprehensive compliance risk assessment, and to use it to drive effective financial crime risk management throughout their organization. This way they will achieve a balance between regulation and innovation whilst contributing to a common good: upholding the integrity and stability of the financial system in both the UAE and around the world.

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Most banks across the world have completed the implementation projects over the last few months, if not years, under the much-awaited International Financial Reporting Standards (IFRS) 9. The conceptual transition from incurred loss to expected credit losses has been completed. IFRS 9 has impacted banks across the world and changed the way they approach and view the impairment process. The standard has brought about far-reaching changes in many areas such as financial reporting, risk management, capital management, regulatory reporting, data sourcing and collection, governance framework and IT systems. The standard has, in many ways, integrated the Risk, Finance and IT functions of bank.

In the UAE, when we analyze the FY2017 results from the top 5 banks, we see the increase in provisions is substantial. While the rise is not as severe as in many European banks, it is still likely to bring changes to the way banks conduct business.

Technically, most banks have been able to meet the date of initial implementation, but we believe it will take a while before IFRS 9 becomes business as usual. Current IT systems need to change significantly to calculate and record changes requested by IFRS 9 in a cost-effective and scalable way, and data sources and models need to be further enhanced.

Adequate infrastructure and systems should be made available for data, for example, recording collateral information, costs and recoveries used in loss given default (LGD) calculation. Models that have been implemented need to be validated and monitored continuously to ensure smooth transition now, and effectiveness in future. All these changes include substantial investment in terms of resources and time from the bank’s perspective.

**Reinforcing sound governance**

The inter-dependency between the IT, Finance and Risk functions puts forward the need for a revised governance policy. This includes a structure comprising a board of directors, steering committee, working group committee and technical working group committee. The Central Bank of the UAE (CBUAE), Basel Committee for Banking Supervision (BCBS) and Global Public Policy Committee (GPPC) and other such bodies have all recommended minimum standards of governance to ensure that the implementation of IFRS 9 is appropriately supported. The implementation of these governance measures will need careful consideration and time.

IFRS 9 is expected to result in some of the business lines and the products becoming less viable than others. Provisions under IFRS 9 are point-in-time, thereby being closely related to the economic cycle. Banks are expected to reconsider the lending to those sectors that are sensitive to the economic cycle. Likewise, loans with longer duration and bullet payments are likely to come under increased pressure due to the effect of higher expected credit loss (ECL). Portfolio strategy ought to be adjusted in order to prevent this increase in volatility.

Profitability is affected currently and will be impacted in various ways in the future as well. Increased current provisions lead to decreased profitability. The implementation of Basel III, together with IFRS 9, will lead to increased cost of capital for banks since the capital adequacy ratio will increase to 16% by 2019 with an additional capital conservation buffer.

Additionally, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements make liquidity more expensive, affecting profitability and hence capital. This has implications for the pricing of products, deal origination, maturity and amortization of products offered.

Given the scale and scope of the impact of IFRS 9, implementation efforts are likely to continue as banks refine and work on the supporting areas – or infrastructure – to ensure all facets of the standard run smoothly. Bhaskar Sahay takes us through the important aspects.
Credit management
Credit management practices will also be impacted in the future as banks will have to estimate forward-looking expected loss over the life of the financial facility and monitor for ongoing credit-quality deterioration. The credit benchmarks have become higher and more relevant; costs and recoveries will have to be captured and monitored frequently.

Banks may have to revise performance indicators, incentives and compensation schemes to reflect IFRS 9 adjusted profitability. Collections team would have to start their work sooner, considering the 30 days past due (DPD) threshold for significant increase in credit risk (SICR). Shocks on the economy would require vigorous monitoring and transferring of borrowers from stage 1 to stage 2. Such monitoring will lead to an increase in collection and recovery costs.

The relationship manager has a pivotal role in an IFRS 9 scenario. She or he has a role in structuring and pricing the product for the obligor, collecting the instalments and being the first point of contact to obtain credit information from the customer.

The role of the business teams is likely to be more onerous with the incentive structures tied to an appropriate risk-adjusted profitability metric, such as return on risk-weighted assets, return on risk-adjusted capital or economic value added.

Given the hard work invested by banks in the earlier stages of IFRS 9 implementation, banks should start afresh setting up a project plan for the next phase to make it become business as usual. The plan should also include provisions to ready the bank for regulatory scrutiny. The date of implementation is a job well begun but only partially done.

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Bhaskar’s responsibilities include: leading clients through emerging accounting challenges, specifically IFRS 9, IFRS 15 and IFRS 16; advising on difficult accounting transactions, especially during mergers and acquisitions; and guiding senior stakeholders on accounting matters. His focus is on the integration of the risk and financial data to achieve business outcomes while meeting compliance requirements.

He has extensive experience in revenue recognition, financial instruments, business combinations and lease accounting, and has worked in India, Australia and the UAE.

“Banks should start setting up a project plan for the next phase to make it become business as usual”
IFRS 16: the challenge for banks

IFRS 16, the new leases standard which replaces IAS 17, will have significant implications for lessee banks’ balance sheets and consequently on their operations and regulatory capital requirements. Yusuf Hassan assesses what banks should be doing now.

International Financial Reporting Standards (IFRS) 16 Leases, applicable for periods beginning after 1 January 2019 (early adoption permitted), brings significant enhancements in accounting requirements for leases. Lessees, that is the entity that takes assets on lease, are most affected by these changes. Instead of recognising a periodic lease expense over the lease term for operating leases, as under International Accounting Standard (IAS) 17, lessees are required to recognise most of the leases on the balance sheet. Interestingly, IFRS 16 does not change the way lessors classify and account for their leases.

UAE banks have many leasing arrangements that will now be in the ambit of the new IFRS 16 standard: branches, automated telling machines (ATMs), IT infrastructure, outsourcing arrangements and many more. As such, IFRS 16 will have significant implications for the lessee-banks’ balance sheets and consequently on their operations and even regulatory capital requirements. Importantly, it will also change how they assess their obligors’ balance sheets.

**How will accounting for lessees change?**

Presently, IAS 17 requires lessees to recognise a periodic lease expense on a straight-line basis over the term for operating leases. IFRS 16, on the other hand, will require lessees to recognise most operating leases on their balance sheets as a right-of-use (ROU) asset and a corresponding lease liability. There is no significant change in the accounting for leases currently defined as finance leases. Lessees will subsequently recognise amortization expense on the ROU asset and interest expense on the lease liability. As the interest expense depends on the declining balance of the lease liability, total expenses arising from the lease contract will be higher during the initial years of the lease contract, similar to finance lease accounting under IAS 17.

**Impact on balance sheet**

Companies with operating leases will appear to be more **asset-rich**, but also more heavily indebted

**Impact on profit and loss**

Total lease expense will be **front loaded** even when cash rentals are constant
It is also important to note that IFRS 16 allows lessees to opt for a method similar to IAS 17 in accounting for their operating leases when the leases under consideration have a term of 12 months or less, and they do not contain a purchase option. In addition, for low-value assets, lessees may choose to retain accounting for leases similar to IAS 17. However, IFRS 16 does not provide a quantitative threshold for assets to qualify as ‘low-value’. UAE banks will have to exercise significant judgment in applying guidance under the new standard.

**The impact on a bank’s capital and operations**

UAE banks commonly enter into long-term operating leases for many assets. Under current principles, leased assets are not recognised on a bank’s balance sheets. However, under IFRS 16, such off-balance sheet leases are expected to become on-balance sheet, and result in an increase in the total assets and total liabilities of the bank.

Grossing up of the balance sheet will impact the capital adequacy ratio (CAR) computation for banks. Since operating leases are not currently recognised on the balance sheet, the regulatory requirement to hold capital against such lease liabilities does not arise. On the date of implementation of IFRS 16, the recognition of the ROU asset and the lease liability may result in banks being required to set aside further capital.

The Central Bank of the UAE (CBUAE) has not yet issued guidance in relation to IFRS 16 or its impact on prudential reporting and CAR reporting of banks in the UAE. It is essential, nevertheless, for banks to evaluate the potential impact of the new standard on their capital requirements.

In addition, some banks enter into sale-and-leaseback transactions to manage their capital or liquidity requirements. Since all long-term leases will now have to be recognised on the balance sheet, such sale-and-leaseback transactions may no longer provide the lessee banks with a source of off-balance sheet financing.

**The client impact**

Banks also need to anticipate how IFRS 16 will affect the way they do business with their customers. Since the impact of IFRS 16 will extend to the banks’ borrowers, who may have substantial operating lease commitments, significant training would be required for the business to review the change in presentation in the financial statements. The additional liabilities on the balance sheet translate to reduced ability to be able to meet their debt covenants.

As a result, borrowers may seem to be stressed even though nothing in essence has changed. This could also have an impact on the expected credit loss calculations, and could increase the pressure on capital. Banks would either need to allow more headroom on the debt covenants to their clients, or to retain the use of the current lease accounting for the debt covenants.

In conclusion, IFRS 16 is likely to have significant implications for banks’ financial statements, operations and capital requirements. Banks should therefore consider conducting an impact assessment as soon as possible. This assessment will be more complex for geographically dispersed bank networks with more lease commitments, and may require more time to conduct. With IFRS 9 implementation projects safely out of the way, we recommend that banks should ensure they set up the processes, systems and controls necessary to comply with IFRS 16.

**“Banks should consider conducting an impact assessment as soon as possible”**

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Yusuf leads our Accounting Advisory Services function for KPMG Lower Gulf and is the Head of Department of Professional Practice (DPP) in the Middle East and South Asia region. He is responsible for assisting our clients with technical IFRS related issues, in particular advising on: the interpretation and application of IFRS to specific transactions and scenarios; the implementation of the latest IFRS developments; standard setting processes; and regional IFRS issues. Yusuf has provided IFRS assistance to a wide range of blue chip clients in various industries across the Middle East. He has conducted IFRS training in South Africa and across the Middle East and has presented at a number of regional IFRS seminars.
Is Basel III turning four?

How will the reforms to Basel III affect banks in the UAE?

Steve Punch looks at the implications for risk capital calculation.

The Basel III framework is a central element of the response of the Basel Committee on Banking Supervision to the global financial crisis. Released in June 2011, the original Basel III reforms were primarily aimed at strengthening the capital base of banks and introduced two new liquidity metrics: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

Since then, the Basel Committee has been busy drafting numerous new standards, including redefining requirements for credit, market and operational risks. These are expected to provide greater risk sensitivity when it comes to how banks are required to manage risk, especially credit risk. The aim is to allow the banking system to support the ‘real economy’ through the economic cycle.

Some industry leaders, including KPMG, have termed these fresh requirements as ‘Basel IV’. The Committee, however, views these as the final touches to the 2011 edition of Basel III, and not the implementation of a new ‘Basel IV’ framework.

The new standards are expected to impact the risk-weighted assets (RWAs), and off-balance-sheet exposures weighted according to risk, for all banks. RWAs are an estimate of risk that determines the minimum level of regulatory capital a bank must maintain to deal with unexpected losses. A prudent and credible calculation of RWAs is an integral element of the risk-based capital framework.

In December 2017, the Basel Committee published a number of significant amendments in Basel III: Finalizing post-crisis reforms. These reforms complement the initial phase of the Basel III measures announced in 2010. The 2017 reforms seek to restore credibility in the calculation of RWAs and improve the comparability of banks’ capital ratios. They address weaknesses that were revealed by the global financial crisis and provide a foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities. The main changes that will affect banks in the UAE are around changes to calculation of regulatory capital for all Pillar 1 risks, namely credit, market, and operational risk.

Raising the standard

Most banks around the world and indeed all banks in the UAE use the standardized approach (SA) to determine credit risk capital. Under this approach, supervisors set the risk weights that banks apply to their exposures to determine RWAs. This means that banks do not use their internal models to calculate risk-weighted assets.

Under the recently released Basel changes, it is expected that RWAs for retail customers and financial institutions exposures will rise, thereby requiring banks to hold more regulatory capital against those exposures. The main changes to the SA for credit risk will:

### Residential real estate

- **Repayment not dependent on property cash flows**
- **LTV** > 100%: 70%
- 90% < LTV < 100%: 50%
- 80% < LTV < 90%: 40%
- 60% < LTV < 80%: 30%
- 50% < LTV < 60%: 25%
- LTV < 50%: 20%

Risk weight
– Enhance risk sensitivity while keeping the SA for credit risk sufficiently simple
– Provide for a more detailed risk-weighting approach instead of a flat risk weight, particularly for residential and commercial real estate
– Reduce reliance on external credit ratings
– Require banks to conduct sufficient due diligence when using external ratings
– Have a sufficiently detailed non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings

For example, under current rules residential mortgages carry a risk weight of 35%, irrespective of loan-to-value (LTV). Under the new rules, LTV will be the determining factor that will drive the risk weight.

**Streamlining treatment**
The financial crisis also highlighted weaknesses in calculating capital requirements for operational risk, or the risk of loss due to inadequate or failed internal processes, people and systems, or from external events. The capital requirements were not deemed enough to cover the losses incurred by some banks. And the sources of such losses – including those related to fines for misconduct or poor systems and controls – are also hard to predict using internal models.

The 2017 reforms were therefore designed to:
– Simplify the framework by replacing the four current approaches with a single standardized approach
– Make the framework more risk-sensitive by combining a refined measure of gross income with a bank’s own internal loss history over ten years
– Make it easier to compare RWAs from bank to bank by removing the options to use multiple approaches or to use internal models

The 2017 Basel III amendments to credit and operational risk are likely to be implemented locally in the UAE on 1 January 2022. They will probably have some impact on processes and regulatory capital values, due to the overall increase on RWAs. Overall, it is estimated that for banks in Europe, this will lower the capital adequacy ratio (CAR) by approximately 50-70 basis points, with a similar effect on UAE banks. The methodology for calculating these values will also require adjustments to systems as well as the collection of additional data requirements.

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“The main changes that will affect banks in the UAE are around calculation of regulatory capital, namely credit, market, and operational risks.”
Culture and governance
Culture: the root of misconduct?

Culture has moved rapidly up the global agenda of financial institutions in recent years, with increasing interest in the UAE. The opportunity to deliver value and improve risk management by paying more attention to culture is significant, argues Luke Ellyard.

The one common thread through the myriad of regulatory and innovation challenges facing the banking sector today is that an adequate response is only possible if you have a strong and positive corporate culture. This goes well beyond legalistic conformity to detailed rules. Banks also need to ask themselves some fundamental questions about their desired culture and values, and how these are reflected across their organization – and be prepared before regulators ask them much the same questions.

It is now widely accepted that a less than desirable culture was at the root of the 2007-2008 global financial crisis and that the ‘soft stuff’, i.e. poor leadership, behavior and informal norms, can no longer be ignored. The response by global regulators and the business community largely missed the fact that a focus on ‘hard controls’ is not enough: culture plays a significant role.

Instances of misconduct, for example professional misbehavior, ethical lapses and compliance failure, have also been reported with troubling frequency, many of which have resulted in negative financial impact on customers and markets, with significant monetary and reputational costs to financial firms. The underlying reasons for this misconduct lie principally in the underestimation or ignorance of the role of culture and conduct in any given organization.

Now some banking regulators, such as the Dutch Central Bank, have responded by incorporating culture considerations into their supervisory (oversight) guidance. These developments are triggering a sea change in governance, risk management, and internal audit focus.

Increasing focus on culture
Although the UAE banking sector has not been publicly affected by scandals relating to misconduct, of late the regulators in the UAE have started to look at organizations’ culture, behavior and standards of conduct. They have been focused on how they can prevent or manage similar issues that have arisen globally. The opportunity to deliver value and improve risk management through more focused attention on culture is significant.

What is ‘culture’ and why does it matter? Culture is the intangible that is reflected in the choices and behavior of a firm’s employees. The values, goals, and priorities chosen by a firm to define ‘business success’ work together to create a firm’s culture. ‘Good culture’ is marked by specific values – integrity,

A strong and positive culture can:

- **Reduce**
  - The risk of misconduct

- **Diminish**
  - The risk of regulatory scrutiny
  - The risk of related supervisory action and monetary fines, as well as diminish other potential costs, such as operating or capital charges

- **Strengthen**
  - Asset quality

- **Attract and Retain**
  - Highly qualified talent that similary values a strong positive culture behavior, and reduce counter productive behavior and employee turnover

- **Promote**
  - Innovation and new product development designed to serve customers

- **Protect**
  - The life of the brand

- **Enhance**
  - A firm’s reputation with:
    - Customers/clients (who perceive the firm to be looking out for their interests)
    - Employees and management (who have an alliance with a postive corporate citizen)
    - Shareholders
    - Regulators (who perceive the firm to be less risky, i.e., more “safe and sound”)

KPMG
trust, and respect for the law—carried out in the spirit of a fiduciary-type duty toward customers. That means keeping the customer’s best interest at the heart of the business model and having a social responsibility toward maintaining market integrity.

It embodies the ethics of reciprocity (treating others as you yourself would wish to be treated) at all points of interaction between a firm and its customers, and between the employees of the firm. This would foster an environment that is conducive to timely recognition, escalation, and control of emerging risks and risk-taking activities that are beyond a firm’s risk appetite. A strong and positive culture can help address some of the challenges, as shown in the diagram.

Culture is a complex but highly valuable asset for organizations operating in competitive markets such as the UAE. It is therefore important to observe, monitor and change their culture over time to support the successful realization of the organization’s vision and strategic priorities. The focus here is on the risk culture of a firm and related behavior, and not on all other aspects of corporate culture.

**Questioning culture**

Given the current industry challenges, it is the right time for UAE banks to ask themselves some fundamental questions about their desired culture and values and how these are reflected across their organization.

In order to set up the tone of culture within a financial institution, we believe that the board members and senior management, as the leadership of their organizations, are directly responsible for establishing and maintaining their firms’ culture. Regulators consider that to restore or maintain public trust it is imperative that each firm implement business strategies that place the interests of customers (retail, commercial, and wholesale) and the integrity of the markets ahead of profit maximization.

That is, they must conduct business in the ‘right’ way (right price, right allocation, right product, fair treatment followed by ongoing execution) – doing what they should rather than what they can. Beyond this directive, limited regulatory guidance has been made available and firms are largely responsible for defining their own parameters of a ‘good culture’.

Creating truly sustainable, ethical cultures may mean in some cases abandoning policies and practices that have served UAE banks well in the past. This will require some tough decisions for banking executives, as they look to create the culture of their institutions for generations to come.

Culture change will take years, perhaps a generation. Decisions made by banking executives today have the potential to shape the future success of their institutions. The banking leaders of today have a unique opportunity to create a cultural framework that will last a lifetime. Only by grasping this opportunity can banks provide the basis upon which trust can be restored and maintained in the coming years.

**“Good culture is keeping the customer’s best interest at the heart of the business model”**

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Luke leads KPMG’s financial services audit practice in the UAE. 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 also 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.
A strong corporate governance culture is regarded as one of the main pillars of maintaining and growing a sustainable economy; the UAE’s development agenda is focused on building a sustainable economy. This has been re-iterated in the Federal National Vision, Abu Dhabi’s Economic Vision 2030 and Dubai’s Vision 2021. And, as the banking industry has the ability to facilitate these vision goals, the regulators have begun to institute sweeping corporate governance reforms, with the aim of ensuring overall financial stability.

Regulators in the UAE have recently released guidelines on corporate governance, aligned to global leading practices. One of the areas of focus is the quality and diversity of a bank’s board of directors. Board members must collectively possess adequate expertise and a deep working knowledge of all key functions and businesses of the bank. Furthermore, their skills sets and expertise must be commensurate with the size, complexity and risk profile of the bank.

To comply with this requirement, banks will need to develop a skills matrix that includes knowledge and experience in financial reporting and internal controls, strategic planning, risk management, and corporate governance standards. In addition to having a deep understanding of regulatory updates (such as VAT and IFRS 9), board members also need to understand emerging technologies such as FinTech, RegTech, blockchain, and their potential disruption on their future banking operations and the financial sector in general. This may mean that board members will increasingly turn to independent, external experts for advice.

Risk reduction
Senior-management compensation practices are another focus area, particularly ‘material risk takers’. Their compensation must be based on the performance of the bank and should account for their bank’s risk profile and the risks’ time horizon. Employment contracts also need to include provisions to allow for the adjustment of compensation based on realized risks.

Some of the largest UAE banks already have a well-defined and transparent board selection and nomination process. Qualifications, skills and experience requirements are discussed and agreed at the bank’s board nomination and remuneration committee, prior to the appointment of a new candidate, to ensure the board collectively possesses a diverse set of skills. Smaller, local banks on the other hand have yet to put in place such a process and will now have to formalize the board nomination and selection process to ensure compliance with the new regulations.

As for senior-management compensation practices, variable compensation for material risk takers is yet to be widely adopted by UAE banks, large or small, to ensure alignment to risk profiles and time horizons. A few banks are, however, engaging external advisors to redefine their risk appetite and compensation packages or models, and to align themselves with the expectations of the regulators.

Reporting trends
These positive developments in corporate governance practices is a clear indicator as to the direction of local policymakers and further developments of broader reporting guidelines or standards are already emerging, with a particular focus on two areas: sustainability and governance (both already agenda items for the Emirates Securities and Commodities Authority (ESCA)). In fact, a few of the country’s leading banks have voluntarily started disclosing their sustainability practices in their annual reports, and have signed the Dubai Declaration on Sustainable Financing at the United Nations Environment Program (UNEP) Finance Initiative’s 14th Global Roundtable. Banks should also be aware of the possible opportunities...
(and risks), particularly relating to new products, services and debt structuring under sustainability mandates, for example Green Bonds. These regulatory changes are likely to affect banking operations, as well as create demand for new financial products. Regulators will likely require banks to consider sustainability when making investment and lending decisions, when selecting clients and suppliers, and also introduce a myriad of new regulatory disclosure requirements. More than ever, banks need to be forward looking and ensure that they are correctly positioned to comply with – and take advantage of – the changing regulatory environment.

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.

“Regulatory changes are likely to affect banking operations, as well as create demand for new financial products”
### Key banking indicators

<table>
<thead>
<tr>
<th>Bank</th>
<th>2016 LDR</th>
<th>2017 LDR</th>
<th>2016 CAR</th>
<th>2017 CAR</th>
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<tr>
<td>ADCB</td>
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<tr>
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</table>

- **LDR** (Liquidity Risk Ratio)
- **CAR** (Capital Adequacy Ratio)

**Minimum average regulatory CAR as of 31/12/2017: 12.0%**

- **ROE/ROA** (Return on Equity/Return on Assets)

<table>
<thead>
<tr>
<th>Bank</th>
<th>2016 ROE</th>
<th>2017 ROE</th>
<th>2016 ROA</th>
<th>2017 ROA</th>
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<tr>
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<td>16.2%</td>
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<tr>
<td>FAB</td>
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<tr>
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- **ROE** (Return on Equity)
- **ROA** (Return on Assets)
Source: KPMG analysis of released figures for the top 10 listed banks
## Regulatory capital

(US$ billion)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Tier 1 capital 2016</th>
<th>Tier 2 capital 2016</th>
<th>Tier 1 capital 2017</th>
<th>Tier 2 capital 2017</th>
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<td>1.3</td>
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<td>0.1</td>
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Net impairment charge on loans and advances (US$ million)

Credit rating

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<th>Bank</th>
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<th>S&amp;P</th>
<th>Moody's</th>
<th>Fitch</th>
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<td>Overall country rating</td>
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</tbody>
</table>

Source: KPMG analysis of released figures for the top 10 listed banks

UAE banking perspectives 2018
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 – Shifting horizons analyses and 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 is a provider of 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, helping them to mitigate risks and grasp opportunities. Established in 1973, KPMG Lower Gulf now consists of approximately 1,200 staff members, including more than 70 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.

In addition to its presence in the UAE, KPMG is widely represented in the Middle East and has offices in Saudi Arabia, Bahrain, Qatar, Egypt, Kuwait and the Lebanon.

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

KPMG Lower Gulf is part of KPMG International Cooperative’s global network of professional member firms. The KPMG network includes approximately 200,000 professionals in over 150 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.

Over the years, KPMG has developed specialist industry and discipline groups to meet client needs for professional advisors who understand and are experienced in a wide variety of business fields. We have significant experience across key geographic areas, and are engaged with leading industry players on a range of issues critical to the future of their industries. In addition to having many of the Middle East’s leading organizations and government-related entities as its clients, KPMG in the Lower Gulf has been party to numerous milestone engagements in the region.

KPMG Financial Services

We help clients navigate the increasingly complicated financial landscape towards a prosperous future. KPMG’s dedicated financial services practice in the UAE offers access to various key financial marketplaces. It delivers leading practice advice and recommendations through an up-to-the-minute understanding of the vital issues facing the local and international financial services industries.
High quality, independent financial statement audits are essential to maintaining investor confidence. Our audit professionals are committed to the public interest. They seek to challenge assumptions and unlock valuable insights based on a thorough understanding of an organization’s business and industry, and innovative audit methodologies and approaches. Understanding the financial performance of any business must be placed in the context of strategic priorities, risk appetites and competitive positioning. Our technology-enabled audit approach applies extensive data analytics to provide the necessary evidence confirming that critical controls and disclosures uphold the highest level of integrity.

— Audits of financial statements
— Audit-related services
— Audit data & analytics

Our high capability teams offer deep industry and technical knowledge, and market-leading tools to deliver solutions across every business and industrial sector. Our consultants assist clients to make better decisions that may reduce costs, enhance organizational effectiveness and develop appropriate technology strategies.

— People & Change
— Customer & Analytics
— Financial Management
— Operations
— Strategy & Economic Advisory
— IT Advisory

Our risk consulting practice combines the knowledge and expertise of over 100 partners, directors and professionals. We help organizations transform risk and compliance efforts into competitive advantage by applying a risk lens to corporate strategy. This improves risk intelligence and decision making, protects financial and reputational assets, and enhances business value.

— Forensic
— Business Process Management
— Accounting Advisory Services
— Internal Audit & Risk Compliance
— Climate Change & Sustainability

Our experienced investment professionals skilfully assess how opportunities to buy, sell, partner, fund or fix a company can add and preserve value. Our teams combine a global mind-set and local experience with deep sector knowledge and superior analytic tools to support clients. From assisting to plan and implement strategic change to measurably increasing portfolio value, we deliver tangible results.

— Capital Markets
— Valuations
— Debt Advisory
— Transaction Solutions
— Mergers & Acquisitions
— Restructuring

A business’s approach to tax is increasingly subject to public scrutiny and is now a major reputation driver. From company set-up to cross-border and transfer pricing solutions, we work with a wide range of national and multinational organizations to deliver effective tax solutions. Our tax professionals combine international experience with local knowledge to provide leading edge commercial tax strategies tailored to specific client needs.

— Inbound & indirect taxes
— Mergers, acquisitions and restructuring
— International tax services
— Transfer pricing
— Tax management consulting
— Global mobility services
— Automatic exchange of information
— VAT

Management Consulting

Risk Consulting

Deal Advisory

Tax