



UAE Banking perspectives 2020

**Adapting for new technologies,
regulations and culture**

April 2020

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| Foreword

It is my pleasure to introduce the fifth edition of our annual UAE Banking perspectives report. Our authors explore a gamut of topics of critical importance to the industry. We are living in challenging times; the Covid-19 pandemic has dramatically gathered pace in recent days, with fresh developments occurring almost by the hour. Many countries have declared national emergencies and are fighting to contain the virus' spread. It remains to be seen whether banking will respond in a way that amplifies or dampens the acute economic challenge. Issues demanding banks' full attention include business continuity plans (BCP) and contingency plans, government stimulus, organizational readjustments, tax and legal impact analysis, client needs, economic needs, regulatory compliance, adjustments to risk and impairment models, and revised business models and forecasts.

In addition, the financial services sector is facing unprecedented disruption in the face of developments as varied and far-reaching as the phase-out of LIBOR, the rising prominence of blockchain, the emergence of unconventional competitors, and new economic substance tax regulations. Globally, most banks recognize that several consumer transaction platforms will likely become their competitors in the future. They also tend to understand, however, that in today's economy, they need the strength and

reach of these consumer platforms to achieve some of their most ambitious digital transformation objectives.

The standing of UAE banks in the international market seems to be improving, with the sector remaining in a strong position, regardless of potential geopolitical uncertainty. Despite the challenges, banks continue to demonstrate resilience, and the Financial Accounting Task Force (FATF) review was very well received; its results should be published later this year.

There are some headwinds: containing costs remains a prime concern in a volatile market. In spite of this, banks are investing heavily in technology and innovation, as explored in this publication. They are also facing significant topline pressure on cost-to-income ratios.

Our subject matter experts shed light on major trends, challenges to overcome, and opportunities to harness. They examine issues falling under the umbrellas of three broad themes: innovation and technology; regulation and risk; and culture and responsibility. These articles complement our GCC listed banks' report, a comprehensive analysis of key financial indicators and issues relating to banks in the region.

We were delighted with the heartening response to last year's Banking perspectives; thank you for your overwhelming interest

and positive feedback. I hope you find the 2020 report equally stimulating, informative and engaging. I remain eager to hear your views, answer your queries, and discuss the contents of this publication with you.



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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 working with KPMG in London.





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Executive summary

As we enter an age of tremendous interconnectivity, many banks are keen to digitalize their customer experience, their services and their products, and expand beyond the confines of their traditional bricks-and-mortar service models.

In an era of dizzying technological innovation, most banks are modernizing every facet of their operations and working on becoming more trusted by their customers. Yet profound industry challenges remain, driven largely by rapidly evolving customer expectations and increasing regulatory scrutiny.

In the United Arab Emirates (UAE), one of the most notable trends we have seen over the past few years is an inclination toward **consolidation**, with prominent mergers including First Gulf Bank (FGB) and National Bank of Abu Dhabi (NBAD); Dubai Islamic Bank (DIB) and Noor Bank; as well as Abu Dhabi Commercial Bank (ADCB), Union National Bank (UNB) and Al Hilal. With around 50 banks serving a population of approximately ten million, the UAE could still be considered 'over-banked'. We therefore expect further consolidation to take place, while large-scale organic growth within

the banking sector is likely to be limited in the short to medium term. There has also been a focus on international acquisitions by two of the largest banks in the country, First Abu Dhabi Bank and Emirates NBD.

We have observed a healthy trend of increasing banking **profitability** over the past few years, with growth of 13.9% in net profit among the top ten UAE banks. The primary reason appears to be stronger non-interest income performance and certain one-off events, with revenues flowing in from fee income and lower credit provisioning. The initial, conservative view that was widespread when IFRS 9 was implemented is gradually disappearing.

The net income of commercial and Islamic banks operating in the Emirates capital amounted to around AED 15 billion during the first half of 2019, according to figures released by the Statistics Centre - Abu Dhabi (SCAD) in December 2019.¹ The

government is looking to boost the economy and diversify away from oil by aiming to improve its rankings in the Ease of Doing Business Index; the UAE placed a respectable 16th out of 190 countries in 2019.

On a more somber note, it may be advisable for banks to reassess their disclosure obligations regarding business risks related to the potential **impact of Covid-19** within the context of their local regulatory requirements. They should consider whether economic uncertainties and market volatility have affected accounting conclusions, or will do so in the near future. Additionally, they should evaluate whether events occurring after the reporting period, but before the financial statements for that period have been issued, require disclosure or possibly recognition. If banks anticipate reporting or filing delays due to the outbreak or travel restrictions, they should contact their relevant local regulatory bodies to discuss the details.





The Central Bank of the UAE (CBUAE) has been proactive in rolling out stimulus packages and has announced a comprehensive AED 256 billion 'Targeted Economic Support Scheme' to contain the repercussions of the coronavirus pandemic. The CBUAE is allowing banks to free-up their regulatory capital buffers to boost lending capacity and support the UAE economy; all banks operating in the UAE will have access to loans and advances extended at zero cost against collateral by the CBUAE. All banks will be allowed to tap into a maximum of 60% of their capital conservation buffer, and

those designated as systemically important will be able to use 100% of their additional capital buffer for matters of systemic importance. The CBUAE is also reducing the amount of capital banks have to hold for their loans to SMEs by 15 to 25%. This change, which is broadly in line with the minimum standards set by the Basel Committee, will facilitate further access of SMEs to financing, and the CBUAE will also revise the existing limit which sets the maximum exposure that banks can have to the real estate sector. Banks will be allowed to increase it to 30%, but will then be required to hold more capital. The sector

realizes the importance of the role it must play in these difficult times, and banks are concurrently making separate announcements to support their clients.

The Dubai and Abu Dhabi governments are also being proactive in rolling out **stimulus packages** with the intention of optimizing costs and supporting businesses. The packages include a number of initiatives aimed at reducing the cost of doing business and simplifying business procedures, especially in the commercial, retail, external trade, tourism, and energy sectors. They will be introduced soon and will be valid for three months, after which

time their impact on the UAE economy will be reviewed. Abu Dhabi has also announced 15 initiatives focused on supporting SMEs and easing the availability of loans to local companies. These measures are a part of “Ghadan 21”, an AED 50 billion development plan announced by Abu Dhabi in 2018 aimed at enhancing the competitiveness of the emirate.

They include the allocation of AED 3 billion to the SME credit guarantee scheme managed by the Abu Dhabi Investment Office to stimulate financing by local banks and enable SMEs to navigate the current market environment, allocation of AED 1 billion to establish a market maker fund, and the establishment of a new committee to review lending options to support local companies.

Despite the challenges presented by the pandemic, we are seeing an increasing focus on open, **connected banking**: successful organizations tend to be those that put their customers at the heart of their strategy. They leverage data to drive business growth. The concept of ‘**banking the ecosystem**’, which is an interconnected set of services where customers can fulfill a variety of needs in a single integrated experience, may represent the cornerstone of digital banking in the future. Banks across the UAE are also embracing **blockchain**, which offers benefits including operational efficiencies, reduction of intermediary costs, and a culture of transparency, without the traditional potential risk of inaccurate information transfer.

LIBOR’s decommissioning may have a significant impact on business and support functions of financial institutions: worldwide, almost USD 400 trillion worth of contracts are linked to LIBOR across the spectrum of financial

instrument.² Banks are likely to first develop capabilities to be able to transact and book in the new risk free rates (RFRs). Beyond identifying LIBOR exposures, banks could focus on developing their customer communication strategy, consider how they will amend customer contracts, and identify internal processes that reference LIBOR.

As regulatory bodies advocate **cyber security** measures as a priority, progressive banks recognize that it is not merely a ‘technology problem’ but a wider business challenge that requires business ownership and strategic development. The often have information-security risk management processes integrated with the enterprise risk management framework. Banks are also using **third parties to facilitate technology implementation**, in an effort to decrease costs, improve customer experience, and enhance their competitive edge.

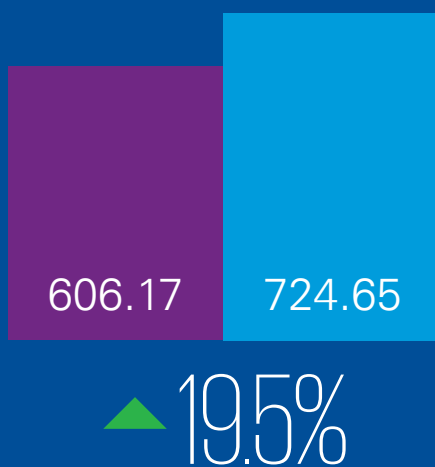
As banks’ models mature, new regulations and large exposure limits are forcing banks to de-risk their loan portfolios, and regulators are considering the implications of IFRS 9 and its local impact. The Basel III framework has undergone several modifications, including redefining requirements for credit, market and operational risk. Risk-weighted averages for exposures are rising, which means that banks need to increase their regulatory capital. From a governance oversight perspective, this represents a more sophisticated approach to regulation, with the need for an enhanced liquidity framework and the requirement to carry out increased stress testing.

Meanwhile **new tax regulations** introduce a legal requirement for UAE entities that perform certain “relevant activities” to locally maintain adequate economic substance. In the midst of this wave of regulatory reform, equally important are robust **corporate governance** and effective **talent management**. Corporate culture features heavily in the CBUAE’s new corporate governance regulations and standards, requiring banks to develop written codes of conduct, conflict-of-interest policies, insider-trading policies, and whistleblowing mechanisms. Digitalization has resulted in a need to connect with new market segments, and jobs across the financial sector are being re-shaped, which may signal demand for rapid upskilling.

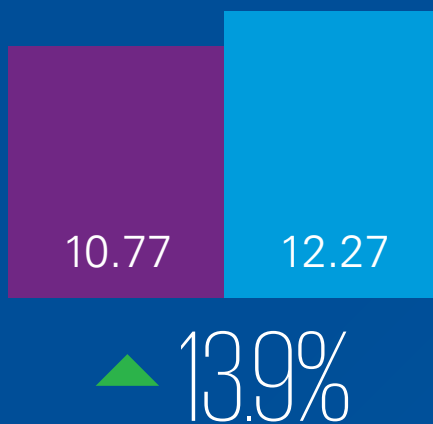
We believe the future is ripe for both growth and transformation. Banks that effectively leverage their digital assets, bolster cyber resilience and manage third-party risk will likely reap the benefits of increased revenue streams, regulatory compliance and enhanced operational efficiency.

Performance highlights

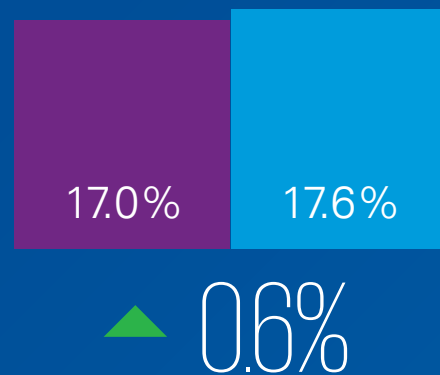
Total assets
(USD billion)



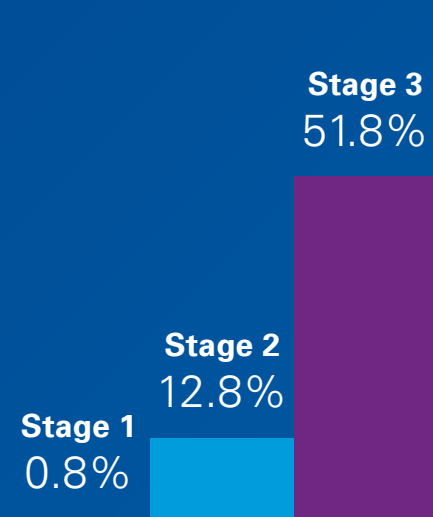
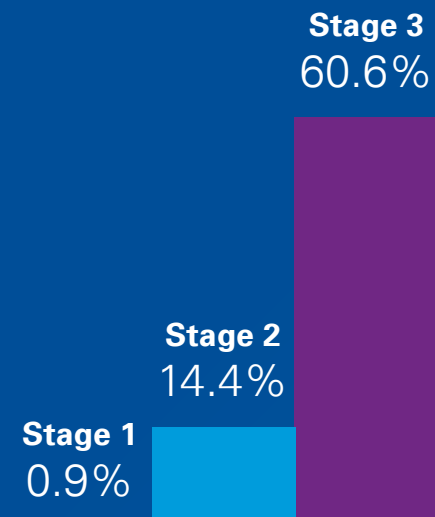
Net profit
(USD billion)



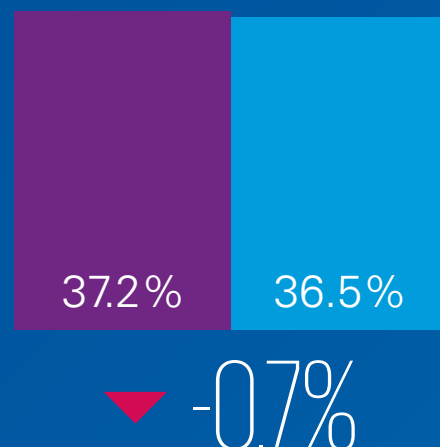
Capital adequacy ratio
(%)



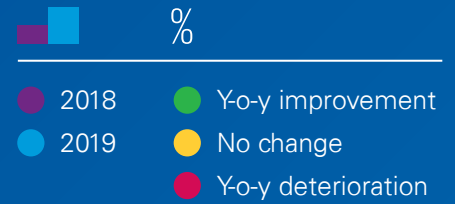
Coverage ratios on loans



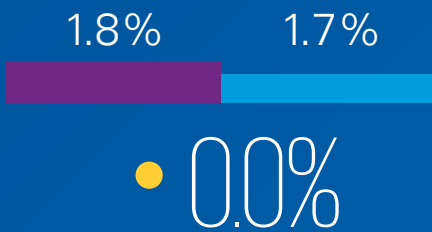
Cost-income ratio
(%)



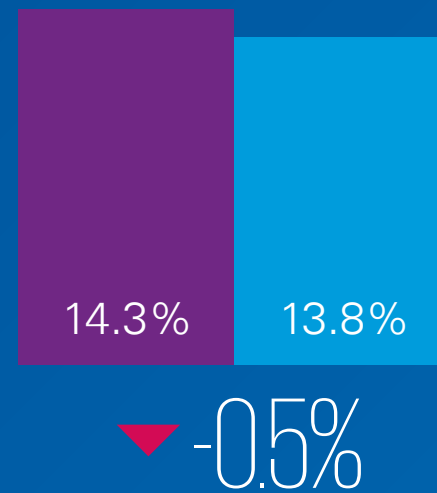
Key



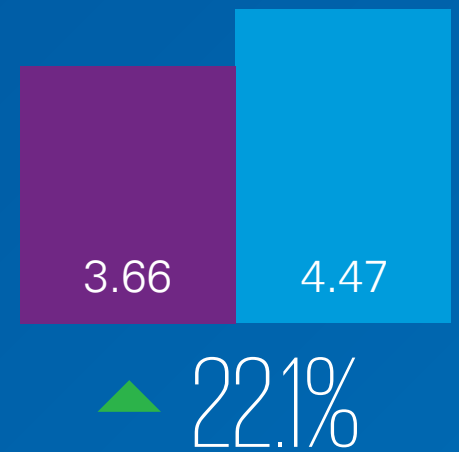
Return on assets (%)



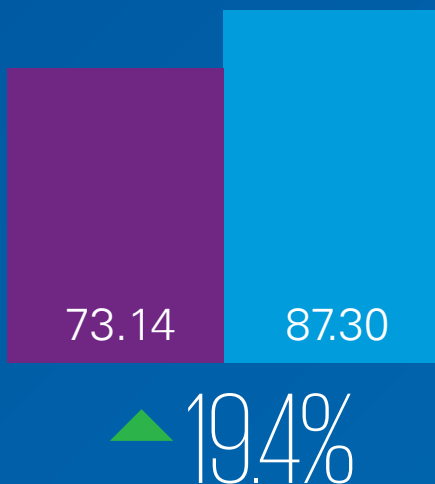
Return on equity (%)



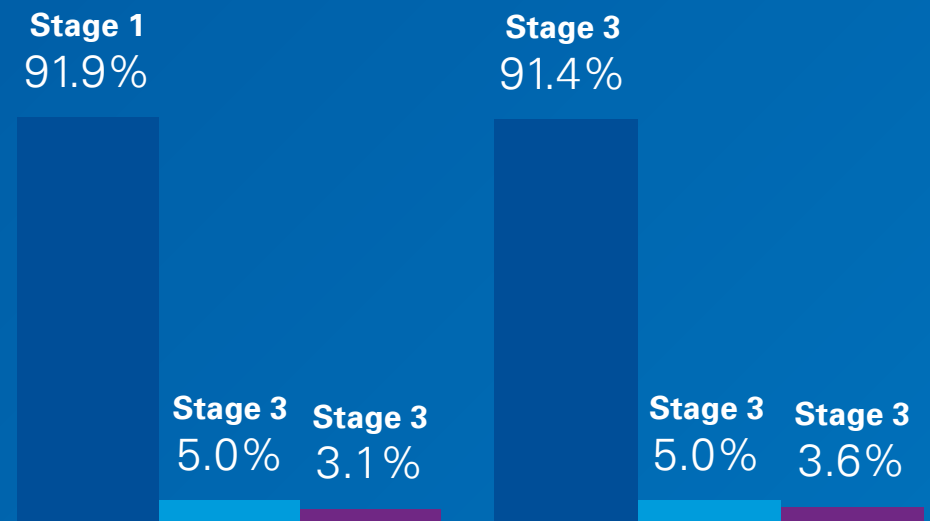
Net provision charge on loans and advances (financing assets for Islamic banks) (USD billion)



Regulatory capital (USD billion)



Total loans subject to ECL



Implications of Covid-19 for the banking sector

The World Health Organization has declared the Covid-19 coronavirus outbreak a pandemic. To weather the storm, strong operational resilience and business continuity planning is vital for banks, explains Emilio Pera.

Actions taken in response to the spread of Covid-19 have resulted in large-scale disruption to business, with more volatile asset prices and currency exchange rates, and a marked decline in interest rates in the majority of economies around the world. The ultra-low – or even negative – interest rate environment that has been created means banking margins can now be thin.

In these circumstances, diversification of revenues that includes fee income becomes important. Large international banks tend to be well-diversified across investment banking, wholesale and consumer lending, as well as asset and wealth management. But many smaller or mid-sized regional banks are less so; the crisis could become more challenging for them if it deepens further or carries on for an extended period.

Fintech and challenger banks may also potentially feel pressure, as they will unlikely be able to differentiate themselves by paying higher interest rates in the close-to-zero environment, while there could also be a 'flight to safety' as customers begin to place deposits with large, established players instead. Furthermore, phishing attempts related to Covid-19, unsecure remote connections to the office, and increased personal use of office equipment can increase banks' cyber risk. The cost of funding might increase for institutions with poor liquidity ratios or special funding needs, and a widening of haircuts on collateral is expected.

Action taken by regulators and local banks

Globally, central bank actions have been decisive and far-reaching. In the UAE, the CBUAE has taken several steps to support the sector. It is allowing banks to free-up their regulatory capital buffers to boost lending capacity. They will have access to loans and advances extended at zero cost against collateral by the CBUAE. They will be allowed to tap into a maximum of 60% of their capital conservation buffer, and those designated as systemically important will be able to use 100% of their additional capital buffer. The CBUAE is also reducing the amount of capital banks have to hold for their loans to SMEs by 15 to 25%, which will facilitate this sector's access to financing. In addition, the existing limit which sets

the maximum exposure that banks can have to the real estate sector is being revised. Banks will be allowed to increase it to 30% but will then be required to hold more capital.

Major banks in the UAE have been proactive in providing financial relief to customers, in line with the CBUAE's AED 256 billion economic stimulus package (a figure of AED 100 billion was announced on 14 March 2020 and this was increased on 5 April 2020). As well as the steps taken by local banks, measures implemented by some branches of international banks include: donating 0.5% of all debit card spend in the month of March to the drive to combat Covid-19; a 75% reduction in their monthly instalments with significantly lower interest; a repayment holiday without interest and fees for personal loans, mortgages and car loans; and school fees paid by credit card qualify for an instalment plan of up to six months starting from 0% interest with processing fees waived.

IFRS 9 and expected credit losses (ECL)

Concerns have been voiced about the effect of the relatively new IFRS 9 standard (and 'current expected losses' under US GAAP) which may force banks to take earlier provisions against bad loans. IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining expected credit losses (ECLs) in different circumstances. Several assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment; banks should not continue to apply their existing ECL methodology mechanically.

The challenge for banks is to incorporate into their measurement of ECLs the forward-looking information relating to the economic impact of Covid-19 that is available, without undue cost or effort at the reporting date.



On 27 March 2020, the IASB issued guidance on accounting for expected credit losses applying IFRS 9 Financial Instruments in light of the uncertainty resulting from the pandemic. It set out that in assessing forecast conditions, consideration should be given both to the effects of Covid-19 and significant government support measures being undertaken. It is likely to be difficult currently to incorporate the specific effects of Covid-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. If the effects of Covid-19 cannot be reflected in model or post-model overlays, adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored.

Indeed, in the current environment, IFRS 9 and the associated disclosures can provide much-needed transparency to users of financial statements. Several prudential and securities regulators have published guidance commenting on the application of IFRS 9 in the current environment, including CBUAE, and IASB encourages entities whose regulators have issued guidance to consider that guidance.

Lending institutions will need to analyze any such arrangements carefully to determine the appropriate accounting, i.e. they will need to assess whether there has been a change in the contractual terms of a financial instrument and, if so, whether it leads to a derecognition gain or loss, or a remeasurement of its amortized cost; [IFRS 9.5.4.3] and whether the arrangement indicates a "Significant Increase in Credit Risk" (SICR) or a credit impairment, or results in a partial write-off of the loan. [IFRS 9.5.5.12]

Additionally, if a government provides assistance to a bank and this in turn enables the lender to provide support to its clients, then the lender will need to consider how to account for that assistance – in particular, whether government grant accounting under IAS 20 Accounting for Government Grants and Disclosure of Government Assistance is required.

Banks will need to explain the significant impact of Covid-19 and the risks arising and how it is managing those risks. Some examples of specific disclosures may include the following:

- Information about the bank's credit risk management practices and how they relate to the recognition and measurement of ECLs. A bank may have changed its risk management practices in response to Covid-19, e.g. by extending debt relief to borrowers or by following specific guidance issued by governments or regulators. [IFRS 7.35F]
- Information on the assumptions that the bank has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year. [IAS 1.125]

These are indeed challenging times with more time needed to adequately assess total impact, hence some regulators in the Gulf Cooperation Council (GCC) have exempted banks from publishing Q1 results.

Next steps

Banks would be well advised to now perform a gap analysis on their crisis management framework and operating needs, considering different time horizons. They will need to prepare their systems, organization structure, products, and digital assets to offer government stimulus support to clients. Equally important is reviewing their digital transformation plan to reassess priorities and assess the launch of new services and products. Organizations that are most likely to overcome the challenges presented by Covid-19 are those that foresee and best prepare themselves for significant credit portfolio deterioration and liquidity repercussions, and build strong, comprehensive contingency plans.

Emilio Pera
Partner
Head of Audit
KPMG Lower Gulf



Illustrative checklist to navigate the Covid-19 crisis



Governance and operations

Clients

- Have you identified and classified your clients? Have you identified the riskier clients?
- Have you identified the clients' immediate needs? What are the exposure and provisions? Is it possible to offer them new products or do they need to be restructured?

Suppliers

- Do you know where your key suppliers are located? Do they have contingency plans in place to ensure the continuation of supply?
- Do you have key outsourced services? Are they sufficient? Do they have contingency plans?

Physical logistics

- Do you have clear instructions for you employees in teleworking, clear rotation schedules for employees in the central services? Have you established extra hours policies?
- Have you created clear instructions for branches? Do you have defined branches safety instructions?

Contracts

- Have you reviewed your contracts with key customers and suppliers to understand your potential liability, and how best to manage your legal risks?
- How will you respond if suppliers invoke force majeure clauses?

Inventory

- Have you assessed your inventory cover? Do you need to ring-fence inventory for particular customers in the case of shortages?
- Do you have the ability to track shipments in real time and therefore manage customer expectations?

Customer loyalty and demand

- How will you set expectations with customers? How can you recover the experience in the future?
- How well do you know your customers? Are you likely to lose customers to competitors/alternatives?
- How will a drop in consumer demand impact your long-term growth plans?



Financial and external factors

Awareness and communications

- Do you have a communications plan?
- Have you communicated with relevant customers, employees and suppliers?

Workforce availability

- How will you deal with the impact on your workforce? How can you ensure the safety of your employees while trying to maintain "business as usual" activities? Have you assessed the cyber security and health and safety risks associated with employees working from home?

Technology and system resilience

- Have your third party IT suppliers been impacted? Will this impact your SLAs and system support?
- Does your workplace/communications technology allow you to reduce travel and enable remote working?

Commercial plans

- How will your change plans and programs be impacted? Will project deadlines and investments need to be delayed? What impact does this have on your strategy and business models?

Governance

- Are you adhering to travel bans, and how will this impact your board governance, meetings and the way you run your business?
- Do you have the technology in place to support remote working?
- For legal coverage, have you identified how to document the additional requirements to meet commitments?
- Have you established crisis reporting processes?
- Have you updated the delegation of authority framework?
- Have you created business governance backup plans?



Business impact

Cash flow

- Have you reviewed and revised cash flow, working capital management and demand predictions?
- Have you performed simulations of the liquidity regulatory indicators?
- Have you reviewed your contingency plans and have you updated it with new market restrictions?

Financial stability

- How will your financial stability be impacted from further stock market declines and restricted funding?
- Will the completion of your financial statements be delayed? Is this likely to cause a delay to your audit opinions and therefore market communications?
- Have you analyzed the Central Bank and other government banks' stimuli?

Government and public health requirements

- Do you have dedicated resource(s) reviewing public health requirements and other related government announcements and ensuring that you stay informed?
- Have you assessed your obligations as an employer to the health and safety of employees?

Commercial plans

- How will your change plans and programs be impacted? Will project deadlines and investments need to be delayed? What impact does this have on your strategy and business models?

Economy disruption

- How will you maintain trust with your customers and assure them that financial institutions are still safe?
- Are you prepared for massive withdrawals?
- How will a drop in cash inflows affect your cost base and profitability?
- Are you able to support your clients with new products?
- Are you able to offer clients the government stimulus, and if so, how much?



Innovation and technology



Moving towards connected banking

Customer-focused banks need specific business capabilities to meet customer expectations and drive growth. Farhan Syed explains how they can deliver a connected experience that could elevate the customer beyond channel interactions.

For the last two decades, banks have been extending their services to new channels, devices and touchpoints. These include delivering banking apps to access balances and pay bills anywhere, anytime; providing real-time approvals and instant access to credit via credit card apps; and offering online mortgage apps via smartphones, laptops, smart watches and voice-assisted devices. The result: a 1,000% increase in the number of customer touchpoints.

As customer interactions increase, bank executives tend to see revenue decrease due to the number of channels required for service. For example, banks have added phone apps with mobile deposits; yet, their customers still require access to physical infrastructure like automated teller machines (ATMs) and branches. Under this scenario, the promise of reducing channel costs by adding digital services has not generally been realized.

To compete more effectively, capture the inherent value in digital channels and reduce the cost-to-serve of traditional channels, banks could adapt by attempting to remove organizational silos and aim to align the entire organization around the customer. This goes far beyond front-office and customer-facing functions. It involves aligning six key stakeholder groups: customers; employees; partners; and alliances; front-, middle-, and back-office functions; and the broader digital ecosystem.

Making connections

KPMG commissioned Forrester Consulting to conduct a study to gain a better understanding of success factors in delivering a company's customer agenda. The research shows that when companies move away from the limitations of operating in functional silos and towards what KPMG defines as a 'connected enterprise' –

an organization that is connected and aligned across businesses, functions and channels – they are likely to outperform their competitors. While eight in ten banks were placing a "high or top priority" on being connected, many banks were just "checking the box" when it came to customer centricity. They tended to focus on multi-channel tactics masquerading as a connected-enterprise strategy. For those banks investing in a more customer-centric approach, four in ten indicated that they had positive return on investment (ROI) metrics and for most expectations were exceeded.

To align the front, middle and back office around the established customer agenda can be an enormous challenge without a properly structured and orchestrated approach. It starts with understanding the organization's important customers and then building the business around them. That means aligning core operations, policy administration, claims management, financial management and other back-office and support functions with the aim of creating the best experience for those customers.

The need for customer centricity is now being felt across the C-suite. KPMG International's 2019 Survey of global CEOs in the banking sector found that less than half believe they are achieving ROI from their investment in customer experience. In a separate survey of more than 3,000 global CIOs and other IT executives conducted by KPMG and Harvey Nash in 2018, 55% cited "enhancing customer experience" as a top business priority.

Anticipating needs, responding with agility

Generally successful organizations are those that put their customers at the heart of their strategy, planning

and execution and continually ask “what does this mean to my customers?,” “what is the impact on my customers?” and “how will my customers respond?”

They are insight driven: these companies know their customers at a profound level; they know their physical and their psychological needs and, consequently, they are able to craft market-leading propositions. They are continually listening to customer feedback in real time and creating experiences that are inspirational and motivational.

They practice customer foresight to anticipate customer needs: generally many are organized around the customer, with ‘test and learn’ being a way of life. They are organized to respond quickly and to execute efficiently and effectively, so that in many cases they meet the need just as the customer realizes they have one.

Banks should therefore strive to become distinguishable by the degree to which their customer experience efforts are integrated and connected. The boundaries between their front and back offices are blurring and they are intimately close to their customers and driven to innovate by the insights they gain. Customer-centric corporates today are structuring their businesses in new and exciting ways. They are seeing customer experience as a source of commercial value; not just a differentiator versus competition (although it certainly is also that) but a mechanism for potential superior profitability.

Farhan Syed

Partner

*Head of Advisory
KPMG Lower Gulf*



'Banking the ecosystem': using data to enhance customer experience

The manifold ways in which people interact with financial services are swiftly evolving. Banks' operating models should therefore remain agile or risk obsolescence. Abbas Basrai explains why data is set to be a crucial area of differentiation amongst banks in the future.

We are at the cusp of a new decade, one that can shape the future of banking; change being a constant. In the United Arab Emirates (UAE), we are eagerly awaiting the launch of the first digital-only banks in the coming months. Globally, technology and telecom companies are seeking expansion into financial services to build and strengthen customer relationships across every aspect of their lives.

We believe those banks that are likely to be successful in the long run may be the ones that have a comprehensive data strategy, and that can leverage their data to enhance customer experience and business growth.

With margins likely continuing to be squeezed and global macroeconomic uncertainty set to carry on for the time being, we expect leading banks to design

innovative and forward-looking business and operating models. The most successful banks will likely be those that embrace technology and adopt artificial intelligence (AI), and related digital solutions.

It is advisable that banks embrace creativity when it comes to digitalization. Truly creative banks may seek to partner with technology and consulting firms to build their own AI-enabled solutions, which can then be taken to market as a new revenue stream for the banks.

The notion of 'open banking' has been central to financial services in the recent past. Open banking is a model in which data is shared between multiple, unrelated entities. Although the notion of customer focus is hardly revolutionary, the implications for banks and other traditional financial services firms can be far reaching and warrant thorough strategic analysis.

Opening up

Open application programming interfaces (APIs) are often mentioned in connection with open banking and data sharing. While APIs can be powerful enablers, they are not the sole means through which data can be shared. China is proof that, given suitable market conditions, it is possible for data-sharing models to enjoy widespread acceptance and adoption without public sector involvement—the most successful examples being the superapps WeChat and Alibaba.

Whilst open banking could be of great benefit to customers, it may also result in hurdles in some areas, for example cyber security, changing business models, and regulatory oversight.³



A potential security difficulty, for example, could lie in the potential paucity of universal technical standards. Liability could also be a worry: involving third-party providers in the banking process can accentuate the risk of fraudsters getting access to clients' financial records information. And lack of awareness of what open banking can do can make clients less likely to consent to their data being shared. This might restrict financial institutions and fintech firms' capacity for inventiveness.

In certain jurisdictions, screen scraping (using a computer program to copy data from a website) and reverse engineering are still

common. These practices can create a challenge for banks of balancing security against accessibility. At the same time, there are an increasing number of third parties who are being given access to data, making it essential they collaborate to mitigate problems of inconsistency. The UK appears to have taken a lead in open banking, with the regulator aiming to establish a new framework.

The UAE Central Bank (CBUAE) has announced that it is to launch a FinTech Office to support financial innovation within the country and position the Central Bank (CB) as the coordinating authority for fintech activities. CB governor, Mubarak Rashid Al Mansouri, said the office

would establish fintech-sector prudential and market-conduct regulatory requirements, and ensure the CB was an enabler and facilitator of UAE-based fintech activities.⁴

Regulators in the Gulf, have introduced a few new fintech-related initiatives. In October 2019, the UAE Securities and Commodities Authority published draft regulations that would govern crypto-assets, thus establishing norms for an assortment of industry players.

At the same time, Abu Dhabi Global Market has established an electronic structure designed to assess applications from firms seeking to set up a digital bank.

A single platform

Another important aspect is the logic of 'banking the ecosystem', which is an interconnected set of services where customers can fulfill a variety of needs in a single integrated experience. This integration of services may represent the cornerstone of digital banking in the years to come. There is no reason why banks should be limited to offering only traditional core banking services and should not be able to integrate products and services from a variety of providers, all focused on helping the consumer simplify their daily lives without leaving a bank's portal. This would, in theory, create a differentiated experience that can improve customer satisfaction, increase loyalty and generate additional revenue streams. It is not essential this model be delivered by a traditional bank.

A good analogy would be the non-financial travel ecosystems that help travelers secure flights, accommodation, rental cars, tour guides and even restaurant and entertainment options. Now compare that to an expat moving to the UAE, opening a bank account, and securing a place to live (communicating with real estate companies and brokers), insurance (via an insurance broker), transport (via auto dealers), furniture and domestic appliances (via stores and supermarkets). There should be no need to visit different platforms: the market could move from a 'product-push' sales mentality to a proactive one that encourages 'needs-driven' solution offerings.

Take WeChat, for instance, which enables users to send messages, make payments, invest, order taxis, buy bus tickets and more, from a single integrated system. Today, customer experience expectations are set by non-financial organizations (Google, Amazon, Facebook, and Apple, among others). This is potentially why we are increasingly seeing the development of ecosystems connecting banks, fintechs, marketplaces, and other digital platforms into a single environment, with services available within a few clicks.

A clear strategy is key

By initiating such ecosystems, banks can place themselves at the center of customers' financial journeys. For example, small and medium-sized enterprises (SMEs) spend a significant proportion of their time on non-business activities, such as banking, tax, bookkeeping and payroll management. More important, many may be facing challenges about accessing basic banking services due to the difficulty of assessing their businesses' profitability and accurately quantifying their risk exposure. By creating an ecosystem that goes beyond servicing the core financial needs of SMEs to integrate their broader needs as well, banks can establish themselves as a vital component of the SME lifecycle.

To understand the direction in which a bank should position its digital ecosystem, it should identify its strengths in terms of products, services and client base. It can then define targets and objectives, for example, targeting millennials, or the 'unbanked' population.

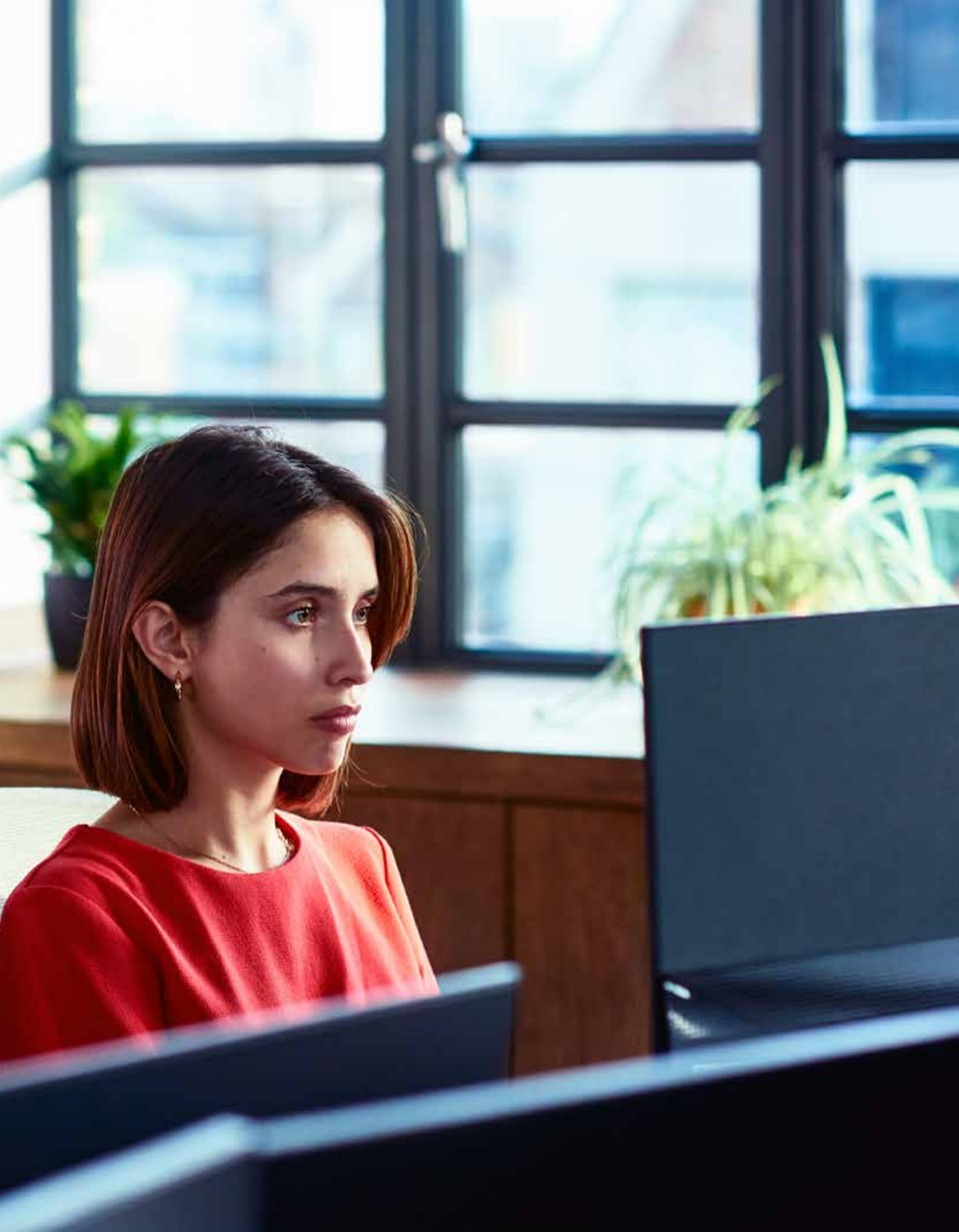
Offering digital-banking platforms is now almost a prerequisite but is not solely enough in the context of meeting user expectations, set by high-quality daily experience with entertainment or social-media platforms. Building a secure, stable foundation upon which to lay the groundwork is key. This may take the form of building a data management platform that enables cross-functional data collection, and transferring data to the cloud. Building APIs, and taking advantage of innovations in data analytics, are logical next steps.

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Blockchain coming to the fore

UAE banks are hopping on the blockchain bandwagon as it begins to transform the way the banking industry operates. Paritosh Gambhir expands on its many advantages as well as its potential risks.



Digital ledgers and peer-to-peer networks are fast becoming the “new normal” among future-facing companies, reshaping how the world transacts. Banks can consider which processes may be ripe for blockchain transformation—for instance, Know Your Customer (KYC), derivatives or securities trading, payments, and customer experience.

Blockchain is a shared digital record of transactions or information of value, between two or more parties. Traditionally, online validation requires multiple systems that can be coordinated by multiple parties. Blockchain potentially enables a more integrated solution. It is a decentralized, distributed ledger. This potentially means that transactions are shared, replicated and authenticated in real time on computers located at every node, thus promising verifiability independent of a single source. Transactions are stored in batches inside “blocks” that become part of a contiguous “chain,” with each block time-stamped and continuously verified by the blocks that precede and follow it. This makes the ledger permanent and virtually tamper proof.

Many organizations across the UAE have embraced blockchain. For instance, Emirates NBD’s ‘Cheque Chain’ has integrated blockchain into issued cheques to strengthen their authenticity and minimize potential fraud. Cheque Chain utilizes a unique quick response code which is printed on every leaf of newly issued cheque books. The code registers each cheque on the bank’s platform. After the cheque is received and cleared, bank staff can validate the cheque’s authenticity and access its source at all times, thereby helping to reduce the risk of forgery.⁵

Ahead of the curve

Meanwhile, the Dubai Land Department, in partnership with UAE-based Mashreq Bank, has released a blockchain-based mortgage platform, which can serve as a repository for mortgage records. It is also designed to enable confirmation that mortgages comply with registration policies. Dubai is also aiming to be the first city to offer blockchain-based payment solutions to its residents.

Emcredit, a state-backed subsidiary of the Department of Economic Development, is working on releasing ‘emCash’, a digital currency.⁷ After all, the intention of the pseudonymous creator of Bitcoin was to work “on a new electronic cash system that’s fully peer-to-peer, with no trusted third party,” and to create a network that prevents double spending.⁸

The World Economic Forum (WEF) recently published a white paper analyzing learnings from more than 60 governmental and non-governmental entities across the UAE that are actively exploring or implementing blockchain. It estimated that “by adopting blockchain technology, the UAE government expects to save AED 11 billion (USD 3 billion) in transactions and documents processed routinely, 398 million printed documents annually and 77 million work hours annually.”⁹

A cornucopia of benefits for banks

Research indicates that investment banks worldwide could save up to USD 10 billion by using blockchain to enhance the efficiency of clearing and settlement. Similarly, trade finance could be revolutionized by the technology. To date, it still tends to rely on paper-based methods like letters of credit and bills of lading, which require physical stamping. Digitizing this is a distant prospect but has the potential to be game changing.

Blockchain utilizes self-executing protocols that automatically link all support parties to the transaction, thereby saving time and process costs. Banks may reap the advantages of a consortium, including operational efficiencies, reduction of intermediary costs, and a culture of transparency, without the traditional potential risk of inaccurate information transfer. Each counterparty may obtain data directly from the source rather than via another involved party, minimizing the probability of error.

Eight banks in the UAE are collaborating with Etisalat Digital to develop a new blockchain-based trade finance solution, ‘UAE Trade Connect’.¹⁰ Banks that have signed up include First Abu Dhabi Bank (FAB), RAKBANK, Emirates NBD, Commercial Bank of Dubai, National Bank of Fujairah, Mashreq Bank, Abu Dhabi Islamic Bank (ADIB), and Commercial Bank International. The platform will aim to help banks address the risks of double financing and fraud, validating trade transactions and checking whether they have already been financed through another bank.

There are also applications in trade finance. For example, it is possible for consumers on a blockchain to include their bank as a node and give consent to provide account details to suppliers of their choosing, potentially providing real time settlement and freeing up collateral. Doing so can help side-step lengthy transaction times and credit processes.

More benefits

Faithful, accurate verification of customers and counterparties underpins the credibility of every banking system. A shared digital utility to record customers' identities and keep them updated could be invaluable to the industry. Blockchain may be the answer due to its cryptographic protection and ability to share a constantly updated record with multiple stakeholders.¹¹

Dubai International Financial Centre (DIFC), Mashreq, and Norbloc, the leading Know Your Customer (KYC) and client onboarding fintech regionally headquartered in DIFC, are jointly launching the region's first production-ready blockchain KYC data-sharing consortium in the first quarter of 2020, in line with the UAE Blockchain Strategy 2021. It is expected to facilitate faster, more secure onboarding and exchange of supporting documentation via advanced distributed technologies.¹²

Some challenges

Banks should first identify the problem they are trying to solve, rather than incorporating technology without a purpose. There are concerns around the application of enterprise blockchains, including challenges of governance around a consortium, and decision-making capabilities.

1. Overall governance, risk management and compliance support are essential to any blockchain implementation. Given that there are different users — sometimes even competitors — involved in the blockchain, companies need to be very clear on specific roles and responsibilities related to the blockchain
2. Companies cannot underestimate security requirements or make assumptions regarding blockchain defense mechanisms. It is advisable to identify and verify checks on security and network monitoring processes to reduce risks associated with smart contracts or other attacks
3. With blockchain's immutability, data on a blockchain potentially cannot be deleted. In a use case where customer information is included in a blockchain transaction, blockchain participants may find themselves in breach of privacy regulations (e.g. General Data Protection Regulation (GDPR) Article 17) if they cannot comply with a request of a customer enacting their 'right to be forgotten'
4. Banks need to understand the risks that come with blockchain and determine what internal controls are required in order to ensure that every link along the chain is performing as expected. Following the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework may help in the critical stages, as can working with blockchain consultants who have already travelled the implementation path
5. Organizations should ask themselves how they are building a stable, scalable blockchain. What sort of consensus mechanism (the process of the various blockchain participants validating a transaction) will be built into the blockchain (proof of work, proof of stake, proof of authority)? Considerations include how much data can be processed, protocols around on and off chain management, and whether it is built to be sustainable and meet future needs.

As organizations adopt the technology, the costly compliance, reporting, and internal control requirements that are typically associated with it will likely decrease. This is especially true if the intent is to integrate blockchain into an existing financial or risk system or another legacy process. Knowing and understanding the technology and the risks, and establishing organization-wide controls are considered essential first steps to unlocking its vast potential.

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When is blockchain needed?

Applying blockchain to a situation only makes sense if the following are true...



01 Multiple parties sharing and replicating data?
Inter-organizational; inter-organization; or public



02 Multiple parties updating data?
Multiple participants recording and propagating data concurrently



03 'Semi-trust' between parties?
– Conflicting interests; or
– Parties don't trust each other; or
– Siloed data undesirable



04 Rules governing participants are uniform?
Usually participants have equal permissions.
Although, private blockchains can give different rights to different users



05 Rules do not change often?
Once issued, smart contracts can't be edited. Changes to blockchain platforms is controversial and consensus to change is difficult. Although it is dependent to the platform



06 Objectivity and immutable logging of information
An indelible and unbiased 'truth' of historic events



A person wearing a blue suit is holding a black pencil and pointing at a piece of paper attached to a dark green chalkboard. The paper has some faint, illegible markings. The background is a solid dark grey.

Regulation and risk



Tick tock... the end of LIBOR

Regulators have stipulated that firms should transition away from the London Interbank Offered Rate (LIBOR) to alternative overnight risk-free rates (RFRs), a move that may impact financial institutions worldwide. Abbas Basrai stresses why the scale and complexity of this change should not be underestimated.

Inter Bank Offered Rates (IBORs) have a key role in financial markets and underpin trillions of dollars in financial products. However, regulators globally have signaled that firms should transition away from LIBOR to alternative overnight RFRs before December 2021. Financial institutions, industry working groups, and regulators around the globe are now working against the clock to manage and implement this almost inevitable transition.

LIBOR's decommissioning may affect—and pose risks to—most business and support functions of financial institutions. To put the magnitude of the change in context, it is estimated that nearly USD 400 trillion worth of contracts are linked to LIBOR across the spectrum of financial instruments.¹³ RFRs have been designed to overcome the



pitfalls of these rates, from minimizing reliance on expert judgment and ensuring a better reflection of the risk-free rate, to avoiding certain past LIBOR rate-related malpractice or misdemeanors.

LIBOR currently supports a vast range of financial products and valuations across multiple jurisdictions — from loans, mortgages and leases to bonds and securitizations, derivatives and more. In the UAE, it is estimated that about one-quarter of all financial products in banks reference LIBOR. A large GCC bank recently noted in its annual report that approximately one-third of its contracts reference LIBOR. Global regulators have indicated that the current construct underpinning LIBOR is likely to be unsustainable and a potential threat to global financial stability. Across the GCC, regulators are preparing

for the transition away from LIBOR. In January 2020, the Central Bank of Bahrain released a “Dear CEO” letter requesting banks to identify their exposures and develop an implementation roadmap for new RFRs. Other GCC regulators are also establishing working groups to discuss the challenges. It is unclear yet how regulators will deal with regional IBORs, such as in the Emirates (EIBOR), Saudi Arabia (SAIBOR) and Bahrain (BHIBOR).

What should banks do next?

On an international level, banks may find it challenging to navigate a largely uncertain environment and the transition’s potential impact on their products, infrastructure, services, customers — and reputation. This creates an imperative to identify individual LIBOR-based references, decipher problematic

legal language, and develop a solution on time. Navigating the IT changes to major applications alone could take several months. Beyond internal preparation for the transition and, how effectively they communicate those changes to the market could be critical.

Given their exposure to LIBOR-based products, banks in Europe and the US could be leading with the implementation of their transition programs. Banks in the UAE could therefore leverage the approach taken by their international counterparts. The transition path adopted has been similar across jurisdictions and has three initial steps.

First, an internal working group could be established that includes key stakeholders from across the bank. Working groups in most banks are being championed by either the Finance or Treasury function, and may include representatives from Risk, Legal, Operations, and IT, as well as customer-facing business lines such as Retail and Corporate. Most banks have formed a separate internal project management office (PMO) to help coordinate the project with internal and external stakeholders.

Second, banks can plan to undertake an initial impact assessment to identify where LIBOR exposures may exist on the balance sheet, irrespective of their size. This could be segmented in different ways (by geography, product and customer for example), and could extend to trading book activities that reference LIBOR.

In addition to the contracting and customer impact, banks may also have references to LIBOR in other non-customer facing activities such as procurement contracts, models, accounting processes and spreadsheets that will need to be identified and included in the change

program. For example, banks will need to consider changes with respect to their trading books on instruments that reference LIBOR. Another consideration is how accounting teams will contend with the significant potential effect of LIBOR reform on both internal and external financial reporting.

Third, after all impacts have been identified, banks could develop a transition roadmap that articulates how and when these impacts will be managed.

A framework for banks

Before offering non-LIBOR rates to customers, banks are likely to first develop capabilities to be able to transact and book in the new RFRs. Beyond identifying LIBOR exposures, banks could focus on developing their customer communication strategy, consider how they will amend customer contracts, and identify all internal processes that reference LIBOR. All this needs to be completed before the fast-approaching December 2021 deadline!

Automation as a solution to the LIBOR challenge likely promises ongoing business benefits and advantages that go beyond identifying contracts and required changes. Digital capabilities unlocked by a smart LIBOR solution is likely to enable financial institutions to access the applicability of Artificial Intelligence (AI) in key areas such as risk management, compliance, operational resilience and more.

Time is running out

Experience tells us that we are not generally seeing what is considered an appropriate sense of urgency in the global banking sector, despite the formidable task ahead and its tight timeline. In the UK, for example, financial regulators recently noted their surprise over the “very different

states of readiness for dealing with the transition and associated risks demonstrated by plans submitted.” They also urged banks not to take a “wait-and-see” approach.

But sector players are not entirely to blame for allegedly being slow off the mark on this complex journey. They can unfortunately face troubling circumstances given the number of dependencies associated with the transition, the necessity of clarifying guidance from standard setters, and the need for potential intervention from both regulators and legislative bodies to address significant hurdles. However, banks should not further delay taking action: there is no time to lose. Tapping into AI is likely to give organizations a fast and reliable solution to today’s—and tomorrow’s—business challenges.

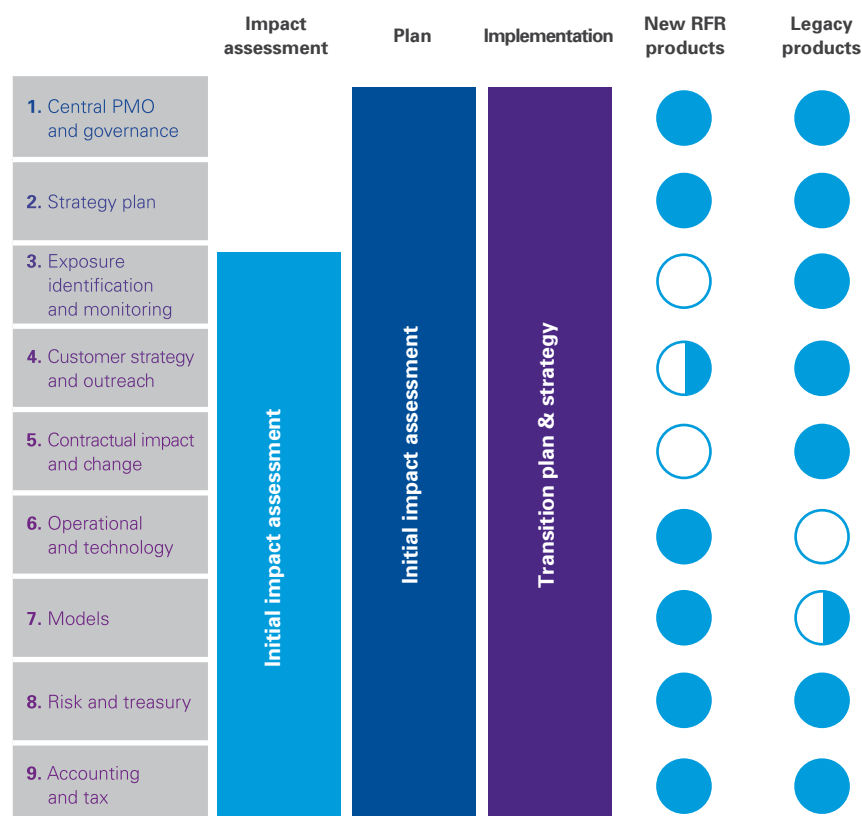
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LIBOR transition framework- phases





Maturity of cyber security

When considering cyber security, banking institutions should remain abreast of evolving regulatory direction. Sheikh Shadab Nawaz describes how they can adapt their strategies appropriately and allocate necessary resources to satisfy compliance demands – without creating inflexible controls.

Banks in the Gulf region are probably at the forefront in terms of investing in cyber security capabilities. This is mainly driven by the following factors:

- Banks inherently tend to have minimal appetite for cyber risk
- The myriad local and global regulations that have to be complied with, depending on the jurisdictions in which they operate
- The variety of hackers potentially targeting banks and the wider financial services sector, including nation state actors, organized crime groups, hacktivist groups and individual hackers
- The imperative to build strong digital capability for customers across all channels, with the need for securing complex business inter-dependencies by connecting authorities, partners, vendors and suppliers within the banking ecosystem.

These factors represent the increasing gravity of cyber risks posed to banks, but also indicate a promising shift in the cyber-risk management approach adopted by banks operating in the United Arab Emirates (UAE).

Currently, the more progressive banks recognize cyber security is not purely a 'technology problem' but rather a wider business challenge that requires business ownership and strategic development, with clear, aligned support from technology teams. These banks tend to have their information-security risk management processes closely integrated with the overall enterprise risk management framework, to ensure every risk decision is made based on their defined-risk appetite. Chief Information Security Officers (CISOs) have generally reoriented their focus from just 'keeping the lights on' to being fully cognizant of the business side of these issues.

We also note a push for business ownership of the cyber function, by linking it more directly to business risk, and justifying the necessary levels of investment as an integral part of the banks' strategy to harness digital opportunities.

A tricky regulatory landscape

Regulatory authorities have generally identified the cyber agenda as a priority. Banks in the UAE share a common challenge in managing mounting global, regional and local regulations that can create cumbersome compliance obligations. Prominent local regulations include the UAE Central Bank's (CBUAE) requirements to comply with the information assurance standard, the strengthening of digital channels, and implementing card-security roadmaps.

While the CBUAE now frequently issues notices related to cyber security, some banks can find it difficult to connect the dots and identify priorities. It released multiple relevant circulars in 2019, on topics including:

1. Compliance assessment vis-à-vis UAE information assurance standard (CBUAE/BSD/2018/2510)
2. Credit card/debit card/ATM card/pre-paid card security (CBUAE/BSD/C/2019/2094)
3. Email and internet security (CBUAE/BSD/N/2019/2095)
4. Security of banks' digital channels e.g. internet, mobile, etc. (CBUAE/BSD/N/2019/3793).

The above circulars mandate multiple cyber security controls spread across multiple areas or domains. Some of the controls are repetitive e.g. vulnerability assessment and penetration testing control in CBUAE/BSD/C/2019/2094 is reiterated in CBUAE/BSD/N/2019/3793. Banks are finding it difficult to keep track of the large volume of circulars and prioritize implementation of relevant policies. However, we understand that the CBUAE is mainly focusing on the

first circular at this point in time and has asked all banks to submit a report by the end of March 2020.

In our experience, it appears most banks and other financial institutions in the UAE have assessed the extent of their compliance with the UAE information assurance standard and obtained management commitment to implement the steps required to achieve compliance.

While “security by design” is the mantra for most leading banks operating in the UAE, some banks are still fettered by the boundaries of “security by compliance.” This latter approach can no longer be sufficient, as exposure to potential financial fraud like corporate payment processing breaches, retail customer account hacks, and fraudulent transactions to unknown accounts are no longer the only cyber risks banks must consider. The emergence of innovations like open banking, the second Payment Services Directive (PSD2), blockchain-based customer transactions, and artificial intelligence (AI) based smart platforms have the potential to transform the banking ecosystem and require an agile, continuous integration and delivery approach to customer security. Banks therefore ought to rethink their internal controls to secure digital banking solutions and detect and deter fraud.

The limitations of security by compliance

Within the UAE banks, there can be marked convergence between cyber, anti-money laundering (AML) and fraud-risk management, as financial institutions begin to tackle these issues in a more integrated and holistic manner. There is also greater management focus on cyber security operations, and revamping Security Operations Centers (SOCs) to create more dynamic defenses and to better leverage cyber threat intelligence.



Some banks have achieved encouraging results through training employees to develop cyber scenarios, thereby building an understanding of the nature of cyber incidents and their impact on the business. These banks are tailoring information-security training to raise awareness of specific threats (including gamification that engages their audiences), rather than providing standard training.

We have seen an increase in cyber simulations with an organization-wide focus. These are aimed at increasing cyber-security awareness among senior management, business users and technical teams. They also serve to assess the effectiveness of existing incident detection, and response and recovery plans. Typically, these simulations are delivered through an advanced online-simulation platform.

We have also observed a greater focus by banks on the cyber risks arising from third-party service providers (partners, vendors and

suppliers). They have been evaluating the security controls of these vendors, scrutinizing what data are being shared with outsiders, and conducting cyber-security simulations that involve testing the suppliers’ connections and personnel.

There is also a great degree of collaboration and intelligence-sharing amongst banks in the UAE, and increasingly amongst regulators. This trend is likely to mature and include the wider community: an immensely positive development that reflects our view that cyber risk is not solely a technology problem but one that must be addressed from a business perspective.

Sheikh Shadab Nawaz
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Compliance through innovative technology-third party risk management

New technology can make the world a smaller and better-connected place, but one that is potentially more vulnerable to financial crime. Katerina Pagoni describes the manifold advantages of using a third- party dependent operating model to help combat this risk.

In the wake of the Financial Action Task Force (FATF) Mutual Evaluation of the UAE in 2019, banks in the country are eagerly waiting for the results to be published later this year. This may constitute a key driver of any changes that the regulators will require from the financial services industry and of any resultant remediation programmes that banks will need to instigate. Considering that assessment of the effectiveness of the banks' anti-money laundering programmes was in the spotlight during the Mutual Evaluation,

it is probably safe to assume that innovative technology, as a potential enabler of efficiency, will be at the top of banks' strategy agendas.

Criminals can thrive in conditions of uncertainty. They may be quick to exploit windows of opportunity presented by inconsistent application of changing regulations, automation, and innovation programmes that are still in a pilot phase, as well as workforces that are yet to reach the required level of competency.







The imperative for an innovative operating framework

The burden is likely to fall on the banks to define a new operating model that is agile and streamlined, can adapt to emerging financial crime risks and perpetual regulatory change, and leverage technology advances.

In their effort to keep up with the pace of expected regulatory change and technological advancement, many banks are turning to third parties to facilitate technology implementation and inform their business strategy in a cost and scale-efficient way. The possible benefits gained from adopting such an approach can be multiple: it may decrease costs, enhance the customer experience, hasten speed-to-market and augment their competitive edge. Through the integration of bank-held customer data with the data on publicly

available sources, a system that is enabled by artificial intelligence (AI) can employ the same cognitive process to evaluate content as a researcher – without the constraints of human-based research.

Banks are often at varying stages of consideration or implementation of financial-services solutions. Some suggested areas of focus where technology may improve effectiveness and reduce potential human error can include:

- Know Your Customer (KYC) and Customer Due Diligence (CDD) services: despite being a core anti-money laundering requirement and an area of significant investment by many banks, poor execution can be a reality for many organizations. This can result in costly remediation programs, regulatory fines, a detriment to customer experience and reputational damage

- Sanctions compliance: existing screening systems often result in the production of large volumes of false positive alerts and require constant updating due to evolving sanctions regimes, particularly in the Middle East region, and the increasing number of payments and customers. This may translate to a high headcount for the bank and longer transaction times for the customer
- Anti-money laundering transaction monitoring: the regulators are increasingly focusing on banks' transaction monitoring controls as these are key in preventing, detecting and responding to potentially suspicious transactions.

Three lines of defense

Opening the door to third parties, however, may come at a price. There could be a need to implement a robust third-party risk management program for adequate oversight of the relationship and monitoring of third-party risks. These may entail reputation risk, data loss, customer privacy violations, sanctions breaches and poor execution of KYC and Customer Due Diligence (CDD) requirements.

In order to best prevent, detect and respond to such risks, banks could consider establishing a comprehensive financial-services framework constructed in accordance with the 'three lines of defense' principle. It should aim to help organizations identify:

- a) factors that should be taken into consideration to address potential third-party risks
- b) processes that would be required to mitigate these risks during the entire third-party relationship lifecycle.

The additional processes and internal controls required for onboarding and managing third-party relationships could be integrated in the existing framework of the first line of defense. The requirements for oversight and monitoring of the new risks posed by these relationships is likely to come under the remit of the second and third lines of defense.

By turning to third parties for innovative and automated solutions to meet their compliance responsibilities, strategic objectives and customer demand, banks could bear a financial cost. Nonetheless, this could be offset by the multiple rewards they stand to reap after such implementation, such as:

- **Customer:** enhanced customer experience through implementation of the latest technology solutions and automation, which accelerate the KYC and CDD processes, and meet customer demand for:
 - a) access to products and services;
 - b) enhanced protection of their data and privacy
- **People:** people transformation through the upskilling of resources, who will be equipped to work at an organization that is likely to be better positioned for success
- **Process:** likely to have faster, cheaper, scalable and smart financial crime compliance processes that fulfil regulatory anti-money laundering and that can combat the financing of terrorism requirements, can administer large volumes of data at minimum effort and employ artificial intelligence technology that could replicate human analysis
- **Systems:** innovative applications that:
 - a) require less time from the first line of defense to conduct KYC and CDD processes whilst allowing for increased focus on business development;
 - b) enable the second and third lines of defense to reduce the time spent on fire-fighting and instead adopt a more proactive approach in identifying hotspots and potentially preventing issues before they occur.

Navigating the challenges

The likelihood of a successful outcome of the use of third-party innovative solutions for mitigating financial crime risk could be measured by the implementation of a third-party risk management program. This can provide banks with the requisite governance and

internal controls framework and an understanding that by onboarding the third party's solution, the organization is not exposed to a level of risk that is incommensurate with its risk profile. It would therefore benefit from the arrangement through:

- Innovation and technology transformation, but likely not at the cost of increasing financial crime risks
- Compliance with regulations on anti-money laundering and combating the financing of terrorism, without hindering business strategy, growth and competitive edge
- Consistent risk-based approach to risk assessment and due diligence of third parties prior to executing contracts and for ongoing monitoring of the relationship.

Many banks are struggling with both the rate of change within the financial services industry and the global interconnectivity afforded by technology. In such an environment, adopting third-party innovative solutions is an option for banks to meet their multiple targets with regulators, shareholders and customers. Being at the forefront of the global effort to uphold the integrity of the financial system, banks tend to look to innovative technology to best assist them in keeping the perpetrators of fraud and financial crime at bay which may, in turn, prove a worthy enabler.

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The accounting black box: banking sector disruption

As banks wrestle with the challenges wrought by several new accounting standards, Bhaskar Sahay focuses on three of the most critical issues that he expects to affect the business, risk management, and the credit functions, respectively.

After a few years of contending with sweeping accounting and regulatory changes in the wake of IFRS 9 *Financial Instruments*, IFRS 16 *Leases*, and IFRS 15 *Revenue from contracts with customers*, the financial services sector could claim some downtime before bracing for the next wave of challenges. 2019 saw considerable merger related activity, whereby banks' chief financial officers (CFOs) continued to burn the midnight oil as they grapple with potential accounting complexities in a rapidly evolving business environment.

Given the relatively low liquidity in the sector, corporates have been working with banks to structure factoring-type arrangements. The objective is to offload trade receivables from corporates' balance sheets. The transactions

are aimed towards achieving lighter, more streamlined balance sheets. They may also increase the corporates' ability to approach banks for additional funding.

The de-recognition requirements should be carefully analyzed to ensure there is a substantial transfer of risks and rewards relating to the de-recognized portfolios. One of the issues to consider, for the corporate entity seeking to lighten its balance sheet, is to decide whether the cash flows to the financial instruments have expired. If this is the case, the solution is uncomplicated.

In case they have not expired, an analysis is required to assess whether the corporate entity has transferred its right to collect the proceeds from debtors (to the bank that undertakes factoring) or has assumed an obligation to pay the

proceeds to another entity (the factoring bank). If either of this is true, the corporate is required to assess if there has been a substantial transfer of risks and rewards. This is done by comparing the corporates' exposure before and after the transfer, to the variability in the present value of the future net cash flows from the assets being derecognized.

In many instances, one of the risk factors is credit risk. Assessing if substantial risk and reward has been transferred is complex and often includes the use of judgement, statistical techniques, and estimation. The existence of recourse, credit guarantees, or enhancements may affect the analysis, and their impact needs are to be carefully considered. The theory is relatively simple but putting the principles into practice requires careful deliberation.

Consolidation of special purpose vehicles

In the same vein as the factoring, banks may also be expected to seek avenues to offload their non-core assets (i.e. property, plant and equipment, as well as land and property classified as investment property) from their balance sheet. This is aimed at strengthening their balance sheets, monetization, and improving regulatory and other market related ratios. However, given the consolidation requirements of IFRS 10 Consolidated financial statements, due care needs to be taken to understand that any assets that are de-recognized do not get added back to the asset base through the consolidation process. The nature and purpose of the set-up of these vehicles may render them vulnerable to failing to meet the consolidation requirements. If the transferee entities are consolidated, the purpose of the transfer is not met.

Two years have now passed since the implementation of IFRS 9. While many banks have validated their expected credit loss (ECL), models, a complete assessment of the functioning and the impact on the bank's behavior and, in turn, of financial stability, requires time evidence and reliable data. The validation process is coming under increased scrutiny from regulators, with stakeholders paying close attention to risk management, especially possible reputational repercussions for the bank. Given that two incremental years' worth of additional data is now available, banks need to focus on those aspects of the expected ECL that could potentially contribute to procyclical behavior, the conditions under which such behavior is expected to arise, and what steps should be taken to address it. Models are expected to be validated and benchmarked with external comparable sources.

Another important point for banks to consider is the competence and independence of the model validation team, which is likely to operate within a robust governance framework. Banks aim to implement a framework where they are able to include scenario-based analyses and build a unified framework for stress testing, IFRS 9 and business/capital planning.

Lens of the credit function: leasing

Following the discussion of IFRS 16 IN 2019, discussion on accounting issues could not conclude without the judgments, estimates, data gathering, disclosures and accounting for leases under IFRS 16. IFRS 16 results in recognition of all leases on the balance sheet. This resulted in grossing up of the balance sheet with a right-of-use asset and corresponding lease liability. While the impact of IFRS 16 has generally not been very material

given the size of a typical bank's balance sheet, IFRS 16 has had a more significant impact on borrowers. The credit department should understand the nuances of IFRS 16 implementation, striving to ensure that customers' financial statements are appropriately evaluated.

This requires an assessment of the practical expedients applied, judgements, estimates and disclosures. For two entities' business performance to be comparable, judgments on the lease tenure, discount rates, variability clauses in leases, lease definition and the efficient use of practical expedients should be considered concurrently.

The alignment of accounting with risk management has resulted in accounting issues being closely integrated to business needs and, in certain instances, becoming deal breakers for potential transactions. 2020 is expected to be an exciting year for the industry, and we are optimistic about the opportunities available to meet the accounting and regulatory needs of the evolving banking sector.

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KPMG Lower Gulf*





A matter of substance

The global tax environment that banks operate in is evolving as a result of the implementation of the Base Erosion and Profit Shifting (BEPS) initiative. In 2019, the UAE introduced a legal requirement for entities that perform certain “relevant activities” to locally maintain adequate economic substance. David Fernley simplifies its intricacies.

Global corporate tax reform is being driven by the G20 countries and the Organization for Economic Co-operation and Development (OECD). Due to BEPS and the creation of a European Union (EU) list of non-cooperative tax jurisdictions (“blacklist”) many low tax jurisdictions have implemented economic substance requirements. Economic substance can broadly be considered to consist of employees, premises, management and costs.

The UAE economic substance regulations were enacted on 30 April 2019, and the UAE was subsequently removed from the EU blacklist as a result. This is positive news for banks as the blacklist status was causing general concerns for foreign counterparties interacting with UAE banks. It does, however, introduce further tax compliance requirements for banks across their UAE legal entity structure and operations.

Defining relevant activities

The regulations introduce a legal requirement for UAE entities that perform certain “relevant activities” to locally maintain adequate economic substance, in line with the level and type of activity they undertake. The law also requires that the entity must undertake its key business activities in relation to relevant activities “core income generating activities” (CIGA) in the UAE.

There are also various regulatory filing requirements that need to be met in order to comply with the regulations, and there are financial fines and penalties (revocation of license and/or information exchange with foreign governments) in case of non-compliance.

“Relevant activities” consist of any of the following businesses licensed in the UAE, (mainland and/or free trade zones):

- Banking
- Insurance
- Investment fund management
- Lease finance
- Headquarters
- Shipping
- Holding company
- Intellectual property
- Distribution and service centers.

Companies that have at least 51% direct or indirect UAE government ownership are currently out of the scope of the regulations.



Key takeaways for UAE banks

- Whilst UAE banks generally have significant UAE substance, the devil is in the detail with regard to meeting the economic substance requirements. Substance needs to be considered per the UAE entity or branch, and per relevant activity
- UAE banks are required to perform an economic substance impact assessment and gap analysis across their legal entity structure and remediate accordingly
- The substance regulations also apply to UAE branches of foreign banks
- Similar substance rules have also been enacted in commonly used legal entity jurisdictions such as Bermuda, the British Virgin Islands, the Cayman Islands, Isle of Man, Guernsey and Jersey
- “Substance” is often referred to in a number of tax contexts depending upon the tax issue at hand. For example, an entity that meets the UAE economic substance test does not automatically qualify to receive a UAE tax residence certificate; nor does it automatically qualify for double tax treaty relief in a foreign market
- Banks that apply a group transfer pricing policy will be better placed to justify compliance with the economic substance rules.

Maturing regulatory regimes

As a result of the global focus on tax evasion, UAE banks and banks globally have been required to comply with the US Foreign Account Tax Compliance Act (FATCA) and the OECD’s Common Reporting Standard (CRS) for a number of years. These are often referred to as “automatic exchange of information”

(AEOI) or “customer tax transparency” regimes. These regimes broadly require banks to identify and record the tax residence of their account holders and report this annually to their local authority. The local authority then shares this information with tax authorities globally, as relevant.

UAE banks invested resources in implementing compliance frameworks for these regimes between 2014 and 2017. Since implementation, global interpretations and practices have had time to evolve and tax authorities in various countries have begun audit and enquiry activity in to local banks’ AEOI compliance. There is an expectation from the OECD that tax authorities in all countries proactively monitor compliance of local banks in this manner and enforce the requirements robustly. Governments will be peer-reviewed on this.



AEOI: what should UAE banks do now?

Against this backdrop many banks globally are performing AEOI health check exercises, bearing in mind the following considerations:

- Test of design: Is the existing AEOI compliance and governance framework fit for purpose in today's environment?
- Test of effectiveness including sample testing and data analytics: Has the bank's compliance programme been effective since implementation? Is remediation required?
- Is the bank's end-to-end AEOI technology framework fit for purpose?
- How does the bank get assurance on the ongoing effectiveness of the AEOI programme, e.g. through periodic healthchecks, reporting?

- How does AEOI impact the customer experience through the Know Your Customer(KYC)/ anti-money laundering (AML) process and beyond? Can this be improved or optimized given developing practice in the market?
- Training: do customer-facing and compliance staff have the correct, up to date training?

AEOI may expose banks to financial risks in relation to fines, penalties and the cost of compliance. There are also significant reputational risks. The customer data that is reported is extremely sensitive in nature—essentially the customer's personal data and financial data on their account balances and movements. Aside from the obvious data protection concerns, any inaccuracy could result in a bank's customer receiving tax audits or enquiries from

foreign tax authorities. The diligence required to be performed by the bank also impacts the customer onboarding journey. Therefore, banks that are yet to carry out health checks would be well advised to conduct rigorous internal reviews to ensure compliance with all relevant regulations, or risk serious pecuniary, legal, and reputational damages.

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Culture and sustainability





Leveraging corporate culture as a strategic asset

Successfully embedding a robust corporate culture continues to be one of the key focus areas for banks in the UAE. Maryam Zaman and Luke Ellyard emphasize the importance of establishing corporate culture policies, communicating these effectively to stakeholders, and conducting stringent reviews.

The trope “culture eats strategy for breakfast” may be hackneyed but remains relevant. While canny strategizing can help set targets, it is likely that a strong corporate culture contributes to achieving them. A bank’s corporate culture is the collection of written and unwritten norms, principles, values, and attitudes which govern its activities, and is of great interest to all stakeholders of a bank. Strong corporate culture practices can signal transparency and accountability to shareholders, provide greater certainty to depositors and borrowers, and inspire confidence in the stability of financial markets on the part of regulators. Strong corporate culture practices may also serve to demonstrate, to wider society, the fairness of the financial system and its commitment to sustainable growth.

It is not surprising that corporate culture features extensively in the Central Bank of the UAE (CBUAE)’s new corporate governance regulations and standards. Issued on 18 July 2019, these require banks to develop written codes of conduct, conflict-of-interest policies, insider-trading policies, and whistleblowing mechanisms. The responsibility of establishing and approving these policies and mechanisms is assigned to the board, which is also responsible for establishing a strong internal control environment to ensure the new policies are fully implemented and adhered to across the bank. By placing the responsibility of establishing corporate culture policies and practices with the board, the CBUAE aims to reiterate that a strong corporate culture is crucial to the health of the banking system. And that it is likely to be successfully embedded within a bank if the board is held accountable for its effective implementation.



Prioritizing culture and leading by example

Banks in the UAE generally have an understanding of what constitutes good corporate culture, and possess the knowledge and expertise needed to develop appropriate policies and mechanisms. Indeed, many major UAE banks already have these policies in place. The 2019 KPMG Audit Committee Pulse Survey found that corporate culture is one of the priorities of regional audit committee members—further proof that banks often recognize the importance of corporate culture to business outcomes.

Banks do, however, face challenges in implementing these mechanisms and assessing the strength of their corporate culture. In order to successfully implement culture-specific policies, banks may consider including periodic culture-related training and awareness sessions; disclosures of potential and actual conflicts; related party transactions; personal share dealings; and periodic declaration of conformance with the policies, procedures and code of ethics. All these elements could be included as part of employees' key performance indicators (KPIs) and linked to their compensation structure. It may be advisable therefore for senior management and the board of directors to lead by example and set the tone from the top.

Continuous and repetitive communication across the bank is essential for successful implementation. Banks cannot expect their employees to understand and implement the policies if they only hear about them on rare occasions.

Review procedures

As a next step, when planning a review of corporate culture, the following indicators may be considered:

- Management's view of risk culture, results of external assessments, and employee feedback in an effort to gauge the tone being communicated from the top
- The number and nature of customer complaints and attrition rates to ascertain whether customers are being treated fairly
- The number and nature of employee complaints and attrition rates to ascertain whether employees are being treated fairly
- Timeliness and accuracy of public disclosures as a measure of openness and transparency
- Social media and news coverage to assess the bank's reputation.

When conducting a culture assessment, reviewers should be aware that assessing these indicators in isolation to one another may lead them to incorrect conclusions. For example, a low number of whistleblowing calls may indicate a robust ethical environment. However, a low number of whistleblowing calls, coupled with high employee attrition rates, can be a sign of reluctance on the part of employees to speak up and report unethical and illegal activities. Conclusions therefore should be arrived at based on a holistic assessment of corporate culture indicators.

These indicators can be measured during standalone culture reviews covering the bank as a whole. This approach may include culture reviews in risk-based internal audit plans or as part of the bank's ethics and compliance monitoring program.

The role of internal audit

Another approach is to assess culture through a soft-controls review while conducting internal audits. Soft controls, such as management attitude and behavior, would have an impact on the operating effectiveness of hard controls (e.g. policies, procedures, rules) and can frequently be the root causes of financial, operational, regulatory and reputational risk.

In fact, the 2019 KPMG Audit Committee Pulse Survey found that 39% of Middle Eastern regional audit committee members, compared with 23% in the US and Canada, and 33% in Europe, are considering including culture and soft control reviews in their internal audit plans.

Most UAE banks submitted an implementation road map of the new corporate governance regulations and standards to CBUAE by the end of December 2019. Full implementation is required by July 2022. As a next step, banks could also introduce corporate culture reviews. This could be challenging but important, as it would kick-start the long process of transforming corporate culture from a source of risk into a carefully managed strategic asset.

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Having the right people to stay relevant

The ability to respond with agility to the environment begins with pre-empting the talent impact of disruptive technologies in financial institutions, as Marketa Simkova explains.

Banks in the Middle East are being called upon to act and address upcoming market disruption. Globally, with the healthy growth of fintech, the industry is increasingly technology-enabled, challenging and changing the very foundations of the classical banking model. In the UAE, the competitive backdrop has prompted many banks to think of new, nimble and agile ways to serve the market, capitalizing on advances in technology while also adhering to Central Bank regulations.

Globally this rise of digitalization has resulted in increased regulatory requirements and customer-experience mandates, and a need to connect with new market segments.

Many jobs across the financial sector are therefore being re-shaped or introduced as either multi-faceted or very specialized, which may imply demand for rapid upskilling. The talent should be agile, adaptable and capable of addressing a variety of disruptions. Consequently, adapting and re-shaping the Human Resources (HR) function can be high on the agenda for many business leaders today.

At the same time, the frontline is changing. Shifting demographics, work preferences and aspirations affect what engages, motivates and inspires people. The people agenda is now broader and wider than before, as market forces have diminished

KPMG Future of HR survey 2020 results

Responses from HR Leaders in the global Banking, Financial services, and Insurance (BFSI) industry*

66%

of HR leaders can use workforce planning to achieve agility and dynamism in the workforce

82%

felt that up to 40% of the workforce needs to be upskilled digitally in the near future

40%

think that preparing for the workforce of the future and identifying new ways to create value will top the people agenda in 2-3 years

23%

are confident in attracting, retaining or developing talent required by growth objectives

compensation as the sole motivation driver. Shaping the workforce of the future needs to be supported with an in-depth understanding of the needs of millennials and Generation X, both from the demand (skills that are needed) and the supply side (skills as well as workers' philosophy and aspirations). Clarity on the people agenda by organizational leadership will pave the way for successful recruitment, reskilling and retention initiatives to drive the desired change.

Integration, separation and human capital

Another key regional trend in the banking sector that is likely to impact the people agenda is increased merger and acquisition (M&A) activity. As the industry seeks to reap the benefits of consolidation in a marketplace that can be crowded, fragmented and expensive, HR and culture may play a key role in the long-term success of such deals. Consideration of transition-treatment mechanisms, future resourcing requirements, attrition mitigation and firm-specific challenges may accelerate the path to stabilization, which can directly translate to competitive advantage.

Addressing the "right" change

Customer experience speaks directly to the employee experience. As the service delivery model evolves for financial services, customer interaction has shifted towards greater digital interaction. As a consequence, much of the service delivery of banks to their customers now is online and is less physical (walk-in branches). The back office of the banks (IT department) is therefore tending to manage the front office (customer interface and experience).

With the rise in alternate manpower solutions (such as outsourcing, contracting, gig working, freelancing) in the back-office function, the financial services sector is realizing the associated benefits, but also undertaking the inherent risks of ensuring quality and meeting regulatory requirements.

Efforts to mitigate such risks internally and with service providers pose challenges especially with respect to the need for constant upskilling, building a stronger sense of customer orientation amongst outsourced staff, and meeting in-country value (ICV) generation requirements.

Workforce re-shaping and change is often seen as the preferred response to fast changing market conditions in the form of outsourcing of operations, workforce optimization or even major reskilling/upskilling internal talent. Maintaining a positive employee experience while administering such change can mean the difference between maintaining a high-performing culture or losing the benefits associated with employee engagement and ownership.

The changing landscape of the financial services sector is an opportunity that can be exploited by shaping a workforce with forward-looking skills whilst outsourcing transitional skills over time. Institutions that are focused on building the right portfolio of people should be well placed to realize the benefits.

KPMG People & Change Advisory Outlook – Talent in Banking

- The Future of HR Survey revealed that 67% of global respondents in the BFSI sector are looking to redirect workforce planning efforts to foster greater agility and dynamism in the workforce. Despite this, 54% are seeking to upskill less than 20% of their existing workforce with new digital capabilities
- The people agenda should focus on equipping the firm with a future-ready workforce in anticipation of potentially disruptive changes to come, e.g. Emiratisation, digitalization
- The focus should now shift to adopting newer models and techniques of people management, which involve empowering employees and adjusting to a new normal of coexistence with automation at the workplace.

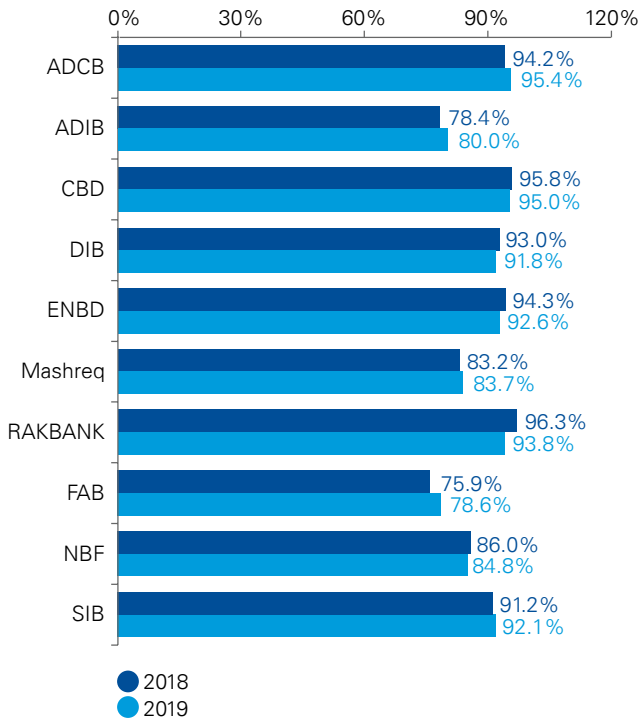
Shaping a forward-looking workforce is an emerging concept in several industries. In the BFSI sector, however, it is a critical success factor that can enable business sustainability and growth in a dynamic, fast-paced environment.

Marketa Simkova
Associate Partner
Head of People
& Change
KPMG Lower Gulf

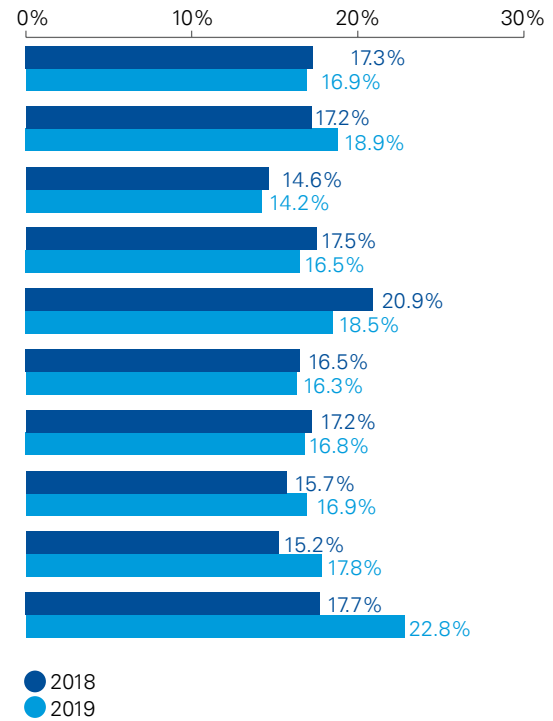


Key banking indicators

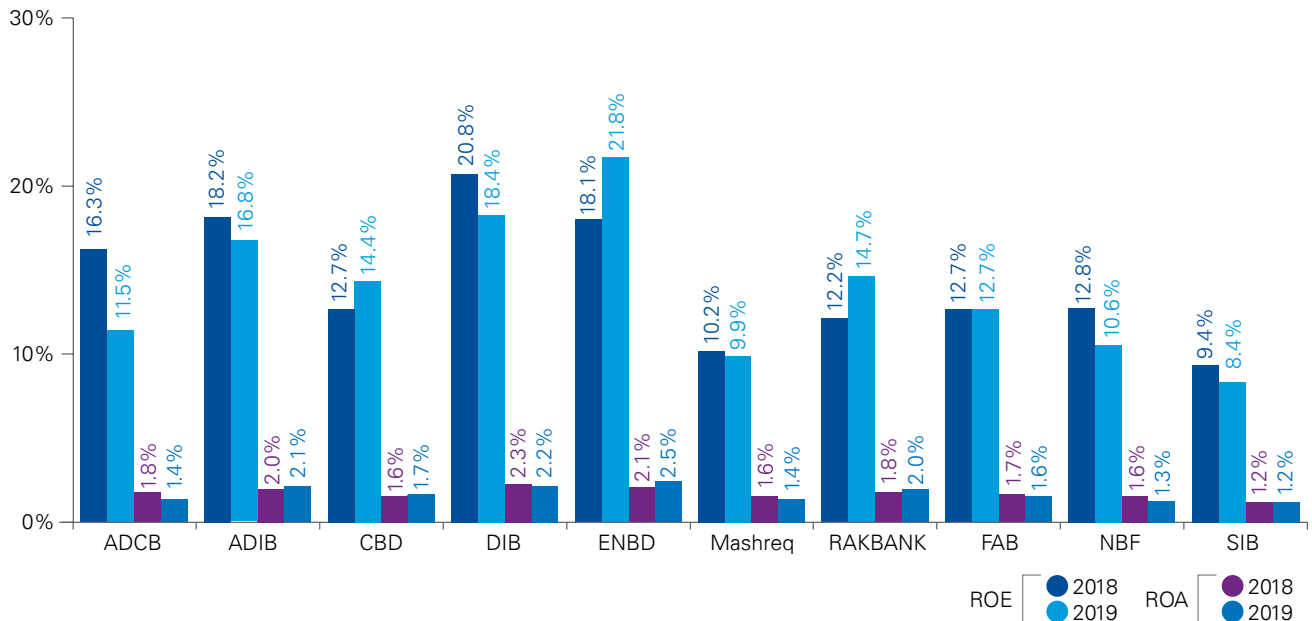
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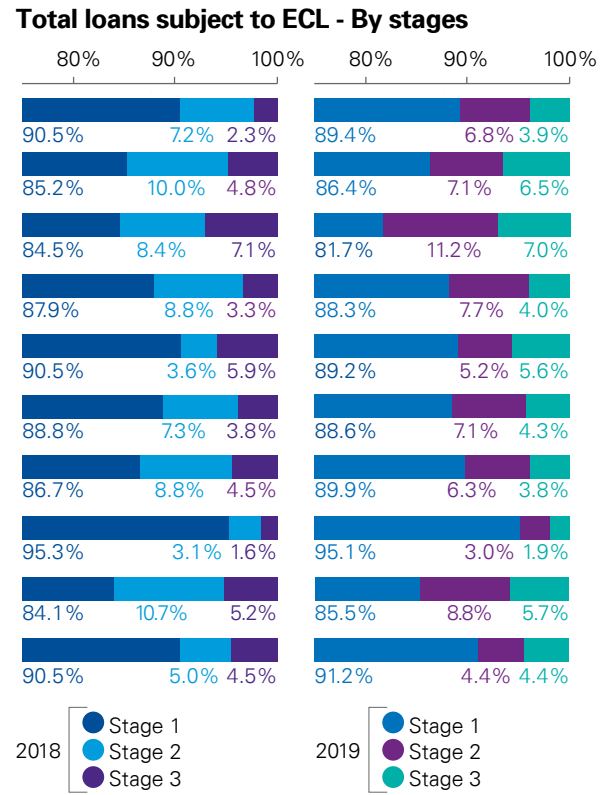
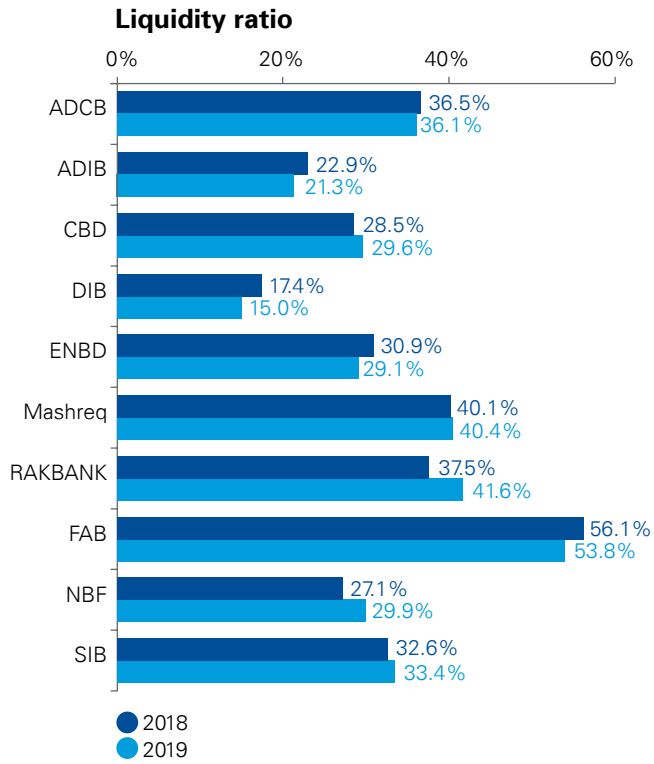


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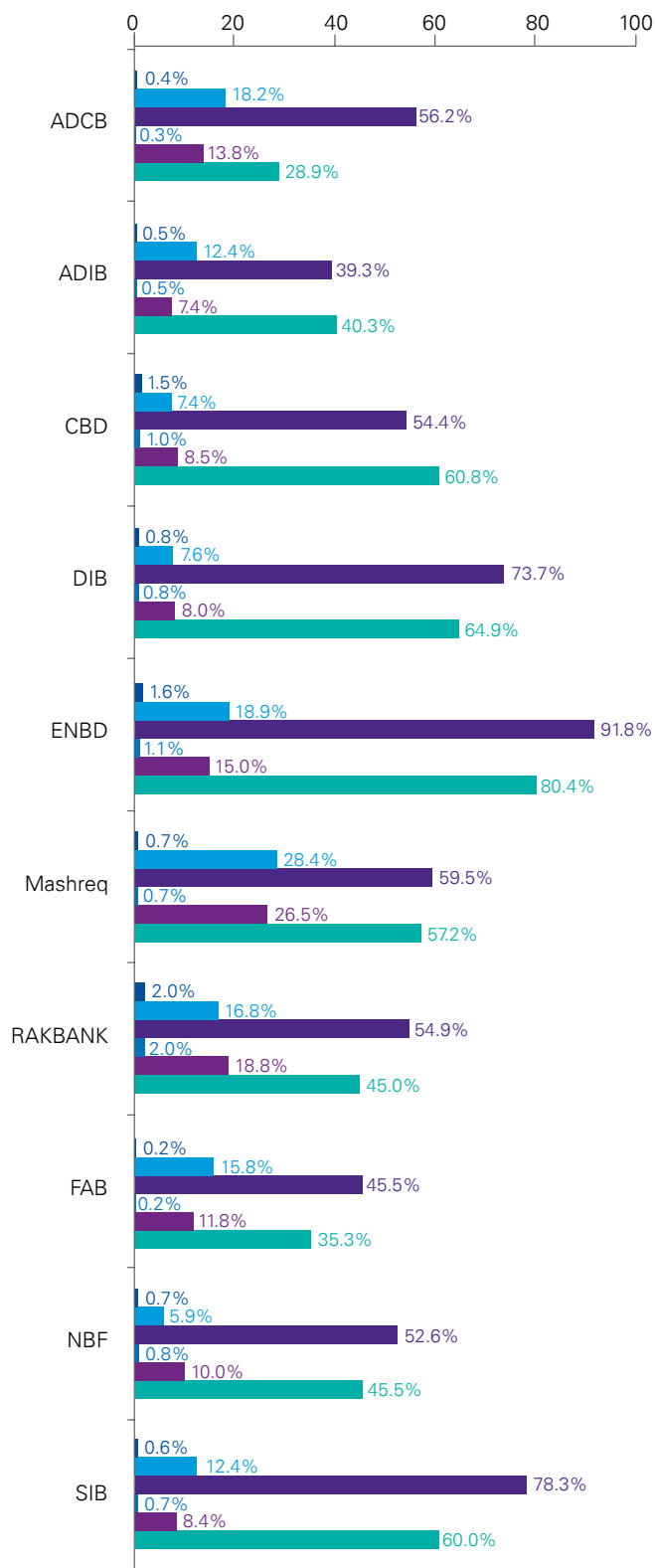


ROE/ROA



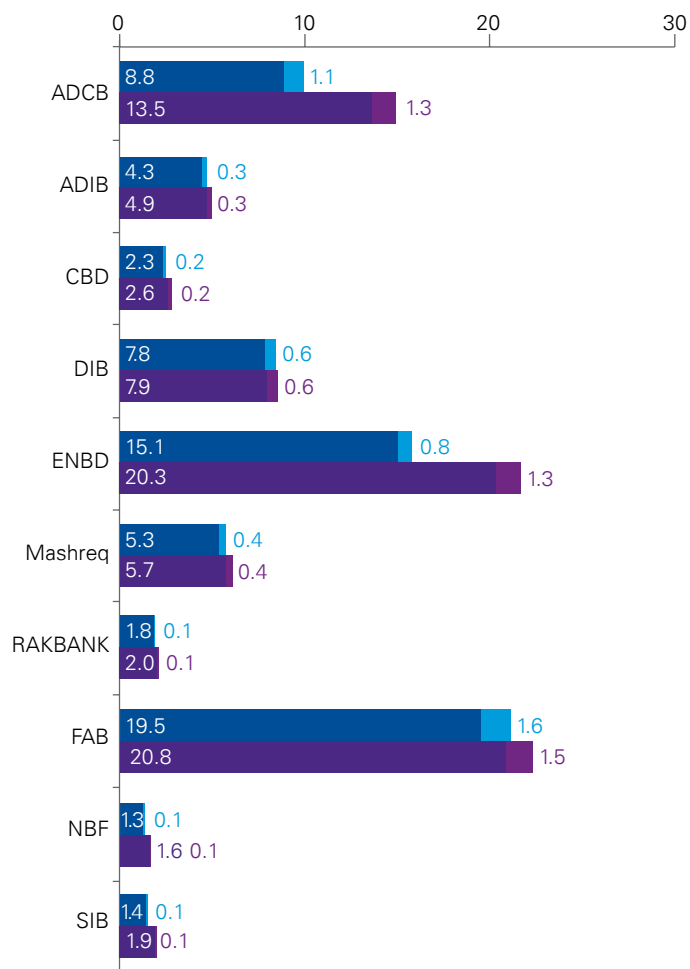


Coverage ratios on loans by stage

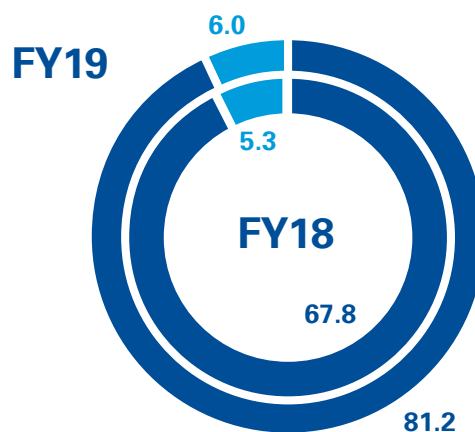


Regulatory capital

(US\$ billion)



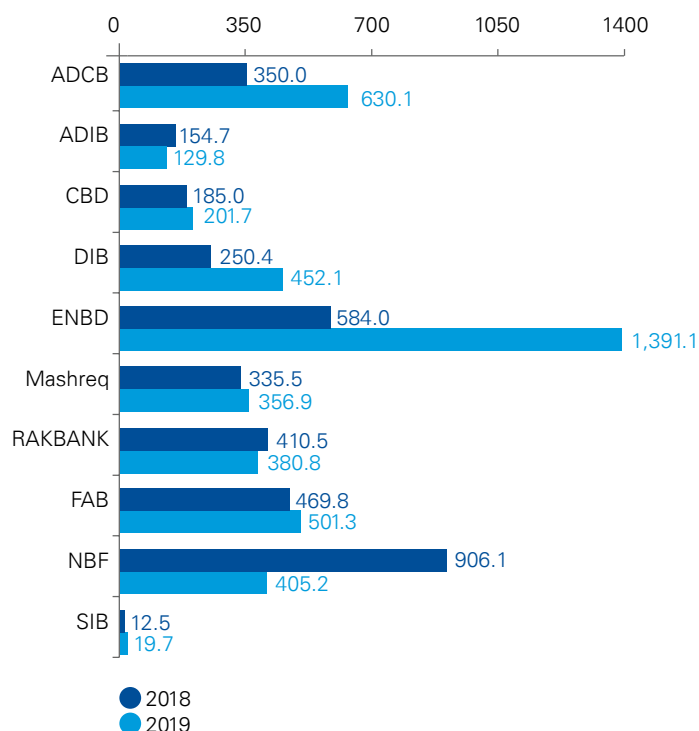
● Tier 1 capital 2018 ● Tier 2 capital 2018
● Tier 1 capital 2019 ● Tier 2 capital 2019



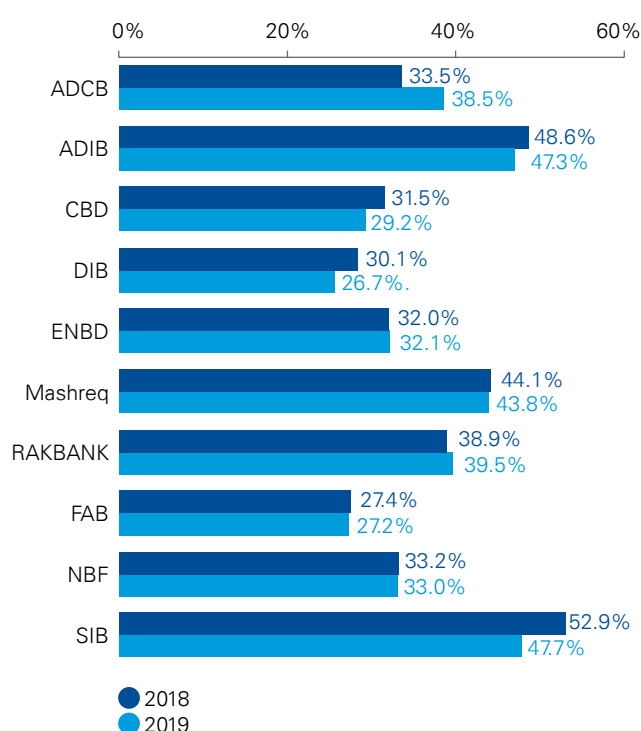
● Tier 1 capital
● Tier 2 capital

Net impairment charge on loans and advances

(US\$ million)



Cost-income ratio



Credit rating

Bank	Credit rating agency		S&P		Moody's		Fitch	
	Long-term issuer rating	Outlook	Long-term issuer rating	Outlook	Long-term issuer rating	Outlook	Long-term issuer rating	Outlook
ADCB	A	Stable	A1	Stable	A+	Stable	A+	Stable
ADIB	NA	NA	A2	Stable	A+	Stable	A+	Stable
CBD	Baa1	Negative	Baa1	Negative	A-	Stable	A-	Stable
DIB	NA	NA	A3	Stable	A	Stable	A	Stable
ENBD	NA	NA	A3	Stable	A+	Stable	A+	Stable
Mashreq	BBB+-	Stable	Baa1	Stable	A	Stable	A	Stable
RAKBANK	NA	NA	Baa1	Stable	BBB+	Stable	BBB+	Stable
FAB*	AA-	Stable	Aa3	Stable	AA-	Stable	AA-	Stable
NBF	BBB+	Negative	Baa1	Stable	NA	NA	NA	NA
SIB	A-	Stable	A3	Stable	BBB+	Stable	BBB+	Stable
Overall country rating	AA	Stable	Aa2	Stable	AA	Stable	AA	Stable

Note: NA = Rating not available on ThompsonOne, checked on 26 March 2020.

* For FAB, pro-forma financial statements are used for FY17 and FY18.

Islamic banks have been presented in italics.



Contributors

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 47-50.

About KPMG

Establishment

KPMG is a global network of professional firms providing audit, tax and advisory services. KPMG Lower Gulf was established in 1973, and now consists of more than 1,300 staff members, including over 100 partners and directors, across 6 offices. The KPMG member firms in the UAE and Oman form KPMG Lower Gulf.

KPMG is widely represented in the Middle East region and also has offices in Bahrain, Qatar, Egypt, Kuwait, Lebanon.

An international network of professionals

KPMG Lower Gulf is part of KPMG International Cooperative's global network of professional member firms. The KPMG network includes over 219,000 talented professionals in 147 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.

Deep industry knowledge

KPMG was the first major firm to organize itself along industry lines – a structure which enabled us to develop in-depth knowledge of our clients' businesses and to provide them with an informed perspective. Over the years KPMG has developed specialist industry and discipline groups to meet client requirements for professional advisors who understand and are experienced in all areas of business. We have significant experience across key geographies 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.

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KPMG Financial Services

Our team is well connected with KPMG's global banking network that brings together knowledge and experience from KPMG member firms around the world to help banks manage the challenges they are facing. In addition, the team regularly considers emerging issues

and studies accounting practices through benchmarking studies and other thought leadership publications. Our core audit teams draw support from this strong financial services practice globally to deliver valuable insights to organizations.

KPMG has experience in providing audit and other services to local banks and major multinational banks operating in the UAE, having advised many local banks on a range of risk and financial issues.

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77%

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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/ae

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