UAE
Supervisory approach for conventional and Islamic banks

Saeed Al-Hamiz

Executive Director
Banking Supervision and Examination Department

s.alhamiz@cbuae.gov.ae
The current regulation

- **Applicable to both categories:**
  - Federal Law (10) of 1980
  - All other regulations issued by the Central Bank.

- **Specific to Islamic financial institutions:**
  - Federal Law (6) of 1985
UAE’s market share: Equity & Profitability

- **Total Assets all banks**: 88%
  - Islamic banks assets: 12%

- **Total capital base all banks**: 87%
  - Islamic capital base: 13%

- **Total deposits all banks**: 87%
  - Islamic banks deposits: 13%

- **Total profits all banks**: 89%
  - Islamic banks profits: 11%
The Central Bank’s objectives

- Maintain stability & confidence in the UAE financial system.
- Protect the consumer.
- Central Bank rules and regulations to be strictly adhered to.
- Fight financial crime.
The risk focussed examination.

- Gradually introduced in the UAE early 2001

- Higher focus on bank’s management processes.

- Concentrate on those areas that expose an institution to the greatest risks.

- Transactions testing logically planned on those areas that represent the greatest potential risks.
The main rationales of a RFE (1).

• **Robust Corporate Governance.**
  – Active Board & Senior management oversight.
  – Strong internal Risk Management framework.
  – Comprehensive internal controls

• **Effective processes mitigate risks.**
  – Strategy, Identification
  – Measuring, Monitoring
  – Controls
The main rationales of a RFE (2).

• Main risks to be assessed.
  – Credit
  – Market & Liquidity
  – Operational
    – IT and Money Laundering
    – Legal & Reputational
• Actual verification by targeted samplings.
• Camels rating & risk maps.
• Main report/ transmittal letter.
Under this design, management of credit risk and asset quality will be reviewed across the **end to end credit risk management process** and quality drivers.

<table>
<thead>
<tr>
<th>Quality Drivers</th>
<th>Credit Risk Processes</th>
</tr>
</thead>
<tbody>
<tr>
<td>People</td>
<td>Business Support &amp; Planning</td>
</tr>
<tr>
<td></td>
<td>Origination</td>
</tr>
<tr>
<td></td>
<td>Credit Assessment</td>
</tr>
<tr>
<td></td>
<td>Sanctions &amp; Drawdown</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Control</td>
</tr>
<tr>
<td></td>
<td>Collections &amp; Recovery</td>
</tr>
<tr>
<td>Sub-processes</td>
<td></td>
</tr>
<tr>
<td>Compliance</td>
<td></td>
</tr>
</tbody>
</table>

**Credit Risk Processes**

- Business Support & Planning
- Origination
- Credit Assessment
- Sanctions & Drawdown
- Control
- Collections & Recovery
The operational risk processes are those processes undertaken by the bank to manage operational risk in judgmental environments ...

<table>
<thead>
<tr>
<th>Process</th>
<th>Begins with ..</th>
<th>Includes ..</th>
<th>Ends with ..</th>
<th>Key Process Outputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Plan</td>
<td>Recognition of risk at board level</td>
<td>Cascading the importance of operational risks throughout the organisation with full board support</td>
<td>Ongoing</td>
<td>Clear direction across the organisation</td>
</tr>
<tr>
<td>Identification</td>
<td>Recognition of risk across functions</td>
<td>Effectiveness of internal risk management and control function, Bank policy</td>
<td>Management statement on policy</td>
<td>Formulation of risk mitigation plan</td>
</tr>
<tr>
<td>Measurement</td>
<td>Staff education program</td>
<td>Communication of policy, feedback and feedforward</td>
<td>Ongoing</td>
<td>Risk mitigation</td>
</tr>
<tr>
<td>Control</td>
<td>Self examination</td>
<td>Technology protection and physical custody, peer audits, access authorities, segregation of duties, project evaluation.</td>
<td>Ongoing</td>
<td>Business continuity plan</td>
</tr>
<tr>
<td>Monitor</td>
<td>Feedback</td>
<td>Evaluation of feedback from reporting lines</td>
<td>Ongoing</td>
<td>Controlled transaction</td>
</tr>
<tr>
<td>Resolution of Events</td>
<td>Feedback</td>
<td>Evaluation of feedback from reporting lines</td>
<td>Ongoing</td>
<td>Improved systems</td>
</tr>
</tbody>
</table>
Key influences on Risk Profile

- High transaction volume and dollar turnover
- Downturn in re-export trade
- High concentration of risk in construction sector which is now facing stagnation
- Frequent occurrence and exposure to trade fraud (Documentary Credit and Global Fraud)
- Re-engineering issues
- Introduction of new initiatives such as internet banking and e-commerce

Key risks to be assessed in this review

1. sanction
2. collections
3. credit assessment
4. compliance
5. people
<table>
<thead>
<tr>
<th>Quality Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>People</strong></td>
</tr>
<tr>
<td><strong>Infrastructure</strong></td>
</tr>
<tr>
<td><strong>Sub-processes</strong></td>
</tr>
<tr>
<td><strong>Compliance</strong></td>
</tr>
</tbody>
</table>

**Islamic Banks** - each of the above quality drivers importance is raised when evaluating an Islamic bank. With newly developing products, the regulator would need to assess more carefully the adequacy of skills at the bank to manage the risks arising from the contracts being developed.

Alongside the compliance aspects with respect to the shariah aspects, there is added emphasis on contractual obligations of a very detailed nature, therefore, the regulator needs to be satisfied that robust controls are put in place by the bank and are effectively administered and implemented.
Supervisory Approach to Islamic Banks

☐ Key considerations

1. **Profit Sharing Investment Accounts (PSIA)** - Funding sources differ to a large extent – PSIAs bear a share of the risk of the assets in which their funds are invested. Consequence being that if the institution loses money then these account holders should share in the loss. However, in a thriving economy such scenarios may not arise, question arises what happens in a downturn. One possible impact could be a run on the bank with deposit holders looking to invest their funds elsewhere. Impact for the regulator, therefore need to limit the potential for such a scenario.

2. **Compliance with Sharia** - Account holders and indeed others transacting with an Islamic institution would expect compliance with the Islamic jurisprudence. Consequence for the regulator could be a negative impact to the banking system due to a loss of reputation for the institution.

☐ Supervisory Response

1. **Transparency and disclosure** becomes more significant in an Islamic banking environment as the IAH should be provided transparent information on how funds are being utilised and the extent of risk undertaken, the supervisor therefore, may have an added responsibility to be robust in regulating pillar 3 disclosures by Islamic banks.

2. **Strong Corporate Governance and Strict risk management structures** should be enforced within these institutions with the regulator monitoring and ensuring the ‘use test’ with respect to effective risk management.
<table>
<thead>
<tr>
<th>Process</th>
<th>Begins with</th>
<th>Includes</th>
<th>Ends with</th>
<th>Key Outputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Support &amp; Planning</td>
<td>Initiation of planning process from finance</td>
<td>Loss forecasts, Involvement in the planning process, Reserve Adequacy Tests, Ongoing Portfolio Monitoring, etc</td>
<td>Delivery of plan to Group Finance</td>
<td>Business Plan - revenues &amp; expenses Portfolio Direction Advice to business</td>
</tr>
<tr>
<td>Origination</td>
<td>Initiation of new marketing plans</td>
<td>Financial forecasts, including loss forecasts, development of solicitation strategies, relationship building</td>
<td>Solicitation to customers</td>
<td>Financial forecasts Sales direction Advice to business</td>
</tr>
<tr>
<td>Credit Assessment</td>
<td>Receipt of loan application</td>
<td>Financial analysis, Customer Credit Rating and Security Indicator calculation, Credit Memo preparation, approval conditions, letter of offer, policies</td>
<td>Application decision delivered to customer</td>
<td>Application decision</td>
</tr>
<tr>
<td>Sanctions &amp; drawdown</td>
<td>Loan approval</td>
<td>Security checks, security perfection, documentation, funds transfer</td>
<td>Funds delivered to customer</td>
<td>Funds to customer New Account</td>
</tr>
<tr>
<td>Control</td>
<td>Loan approval</td>
<td>Ongoing customer management including annual reviews, Day One excesses, monitoring, covenant compliance</td>
<td>Account closure/Expired facilities</td>
<td>Appropriate management actions</td>
</tr>
<tr>
<td>Collections &amp; Recovery</td>
<td>Collections event</td>
<td>Delinquency calling, transfers exit/retain strategies, provisioning, charge-offs and recoveries</td>
<td>Balance sold or not collectable</td>
<td>Account to order Write-offs Recoveries</td>
</tr>
</tbody>
</table>


Key influences on Risk Profile

Internal
- Name Lending and other credit assessment process weaknesses.
- Large exposures are in excess of Central Bank’s 25% threshold.
- High lending concentration in Government and Quasi Government institutions.
- High concentration in Construction lending.

External
- Competition from other banks

Potential loss analysis

<table>
<thead>
<tr>
<th></th>
<th>AED mn.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Bank Assets</td>
<td>10,000</td>
</tr>
<tr>
<td>Total corporate loans and advances</td>
<td>8,000</td>
</tr>
<tr>
<td>Provisions for corp. loans/advances</td>
<td>500</td>
</tr>
<tr>
<td>Cash Collateral</td>
<td>500</td>
</tr>
<tr>
<td>Total AT RISK corp. loans/advances</td>
<td>7,000</td>
</tr>
<tr>
<td>At-risk as % of assets</td>
<td>70%</td>
</tr>
<tr>
<td>Corporate advances to assets</td>
<td>80%</td>
</tr>
</tbody>
</table>

Key action points arising from this review

1. Credit assessment process to be made more robust.
2. Large exposures regulations to be complied with

Composite Risk | Amber

Asset Quality       | Satisfactory
Classified loans / Total loans | 0.8%
Additional provision  | Nil
Resultant Risk Map

Bank ...

- Market
- IT

- Credit
- Money Laundering

- Operational
Bank Name:
Corporate Credit Risk Management Dashboard
Risk Event & Indicators (REIs)

### Leading Indicators

<table>
<thead>
<tr>
<th>1.1 New Credit Policy</th>
<th>1.2 Credit Policy Review</th>
<th>1.3 New Products</th>
<th>1.4 Staff Turnover</th>
</tr>
</thead>
</table>

### People/Infrastructure

<table>
<thead>
<tr>
<th>3.1 Business Strategy Changes</th>
<th>3.2 Business Radar</th>
<th>3.3 Organisation Restructures</th>
<th>3.4 Sales Performance A(Assets)</th>
<th>3.5 Sales Performance B(Income)</th>
<th>3.6 Staff Incentive Program</th>
</tr>
</thead>
</table>

### Lagging Indicators

<table>
<thead>
<tr>
<th>2.1 Advances to Deposits</th>
<th>2.2 Classified Loans/Total Loans</th>
<th>2.3 Corporate Loans/Total Assets</th>
<th>2.4 Credit Derivatives</th>
<th>2.5 Fees &amp; Non Fund Inc./Total Inc.</th>
<th>2.6 Industry Concentration</th>
<th>2.7 O/s Name Lending</th>
</tr>
</thead>
</table>

### Other Information

<table>
<thead>
<tr>
<th>4.1 Classification Downgrades</th>
<th>4.2 Overseas Exposure</th>
<th>4.3 Expatriate Risk</th>
<th>4.4 Excesses</th>
<th>4.5 Geography Concentration</th>
<th>4.6 Gross Portfolio Growth</th>
<th>4.7 Loans to Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Internal Reports

<table>
<thead>
<tr>
<th>5.1 Group Audit Reports</th>
<th>5.2 Group Credit Committee</th>
<th>5.3 Branch/Department</th>
</tr>
</thead>
</table>

### External Reports

<table>
<thead>
<tr>
<th>6.1 Consultant's Report</th>
<th>6.2 External Auditor Report</th>
</tr>
</thead>
</table>

= Red = High Risk  
= Amber = Medium Risk  
= Green = Low Risk
Scenario 1
• Good control (1 on the x-axis)
• High risk-taking bank (ie high loans to deposit ratio, say 75%)
• Ranked as ‘green’ owing to good control environment within the bank. Low risk of loss.

Scenario 2
• Weak control (3 on the x-axis)
• High risk-taking bank (ie high loans to deposit ratio, say 75%)
• Ranked as ‘red’ owing to poor control environment within the bank. High risk of material loss.

Scenario 3
• Weak control (3 on the x-axis)
• Low risk-taking bank (ie low loans to deposit ratio, say 25%)
• Ranked as ‘amber’ - requiring some regulatory focus, but without the gravity of a ‘red’. High risk of immaterial loss.

Scenario 4
• Good control (1 on the x-axis)
• Low risk-taking bank (ie low loans to deposit ratio, say 25%)
• Ranked as ‘green’ - requiring low regulatory focus.
Supervisory Matrix

Potential Loss

Large

1. Visit every 3-6 Months
2. Visit every 6-12 Months
3. Visit every 12-15 Months
4. Visit every 15 - 18 Months

Small

1 – Red – High Risk
2 – Amber -Moderate to High Risk
3– Lime - Medium Risk
4– Green - Low Risk

Overall

Probability of Event

Low
High
“X” Bank credit risk profile

Potential Loss

Large
- infrastructure
- Business support & planning
- Sub-processes
- origination
- Collections/recoveries
- Sanction
- credit assessment
- people
- compliance
- Control

Low

Potential Loss

Small

Resultant Risk Map

Low Probability of Event High

Potential Loss

Low

Small

Probability of Event High

Black – Credit File Sample
Blue – CAD Ratio
Yellow – Risk Charge (% of total assets)

1 – Red – Visit every 3-6 months
2 – Amber – Visit every 6-12 months
3 – Lime – Visit every 12-15 months
4 – Green – Visit every 15-18 months
Risk Profiles of Banks A, B, C

Credit Risk

Operational Risk

IT Risk

AML Risk
The Scoring cards.

<table>
<thead>
<tr>
<th>Credit Risk</th>
<th>Market Risk</th>
<th>Liquidity Risk</th>
<th>Operational Risk</th>
<th>Legal, &amp; Reputational</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key Processes</strong></td>
<td><strong>Key Processes</strong></td>
<td><strong>Key Processes</strong></td>
<td><strong>Key Processes</strong></td>
<td><strong>Key Processes</strong></td>
</tr>
<tr>
<td>Strategy</td>
<td>Strategy</td>
<td>Strategy</td>
<td>Strategy</td>
<td>Strategy</td>
</tr>
<tr>
<td>Identification</td>
<td>Identification</td>
<td>Identification</td>
<td>Identification</td>
<td>Identification</td>
</tr>
<tr>
<td>Measurement</td>
<td>Measurement</td>
<td>Measurement</td>
<td>Measurement</td>
<td>Measurement</td>
</tr>
<tr>
<td>Monitoring</td>
<td>Monitoring</td>
<td>Monitoring</td>
<td>Monitoring</td>
<td>Monitoring</td>
</tr>
<tr>
<td>Controls</td>
<td>Controls</td>
<td>Controls</td>
<td>Controls</td>
<td>Controls</td>
</tr>
</tbody>
</table>

**Sub-processes**

- **Strategy**
  - Business planning & objectives
  - Risk/reward
  - Portfolio

- **Identification**
  - Credit Assessment
  - Risk concentration
  - Capture

- **Measurement**
  - Internal rating models
  - Economic capital
  - Data integrity

- **Monitoring**
  - Portfolio management
  - Exception reporting
  - Indicators

- **Controls**
  - Action on Exceptions
  - Internal audit/review
  - Provisions
  - Policy enforcement
  - Collections
  - Segregation

---

**Market Risk**

- **Strategy**
  - Business support & Planning
  - Risk/reward

- **Identification**
  - Credit Assessment
  - Risk concentration
  - Capture

- **Measurement**
  - Internal rating models
  - Economic capital
  - Data integrity

- **Monitoring**
  - Portfolio management
  - Exception reporting
  - Indicators

- **Controls**
  - Action on Exceptions
  - Internal audit/review
  - Provisions
  - Policy enforcement
  - Collections
  - Segregation

---

**Liquidity Risk**

- **Strategy**
  - Business support & Planning
  - Risk/reward

- **Identification**
  - Parameters affecting market risk
  - Product evaluation

- **Measurement**
  - Internal rating models
  - Economic capital
  - Data integrity

- **Monitoring**
  - Portfolio management
  - Exception reporting
  - Indicators

- **Controls**
  - Action on Exceptions
  - Internal audit/review
  - Provisions
  - Policy enforcement
  - Collections
  - Segregation

---

**Operational Risk**

- **Strategy**
  - Business support & Planning
  - Risk/reward

- **Identification**
  - Parameters affecting liquidity
  - Capture
  - Market limitations

- **Measurement**
  - Internal rating models
  - Economic capital
  - Data integrity

- **Monitoring**
  - Portfolio management
  - Exception reporting
  - Indicators

- **Controls**
  - Action on Exceptions
  - Internal audit/review
  - Provisions
  - Policy enforcement
  - Collections
  - Segregation

---

**Legal, & Reputational Risk**

- **Strategy**
  - Policy on documentation
  - Interaction with outside agencies
  - Dynamic agenda
  - Resourcing

- **Identification**
  - Centralised expertise
  - Strong KYC culture
  - Indicators
  - Risk register

- **Measurement**
  - Key indicators

- **Monitoring**
  - Feedback
  - Market intelligence
  - Record keeping and escalation

- **Controls**
  - Action on Exceptions
  - Policies

---
Thank you