

UAE

Supervisory approach for conventional and Islamic banks

Saeed Al-Hamiz

Executive Director
Banking Supervision and Examination Department

s.alhamiz@cbuae.gov.ae



مصرف الامارات العربية المتحدة المركزي
Central Bank of the United Arab Emirates

The current regulation



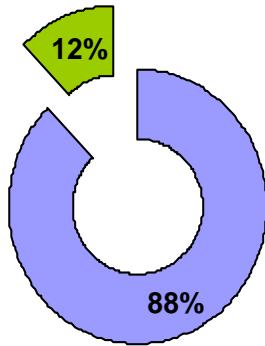
- **Applicable to both categories:**
 - Federal Law (10) of 1980
 - All other regulations issued by the Central Bank.
- **Specific to Islamic financial institutions:**
 - Federal Law (6) of 1985



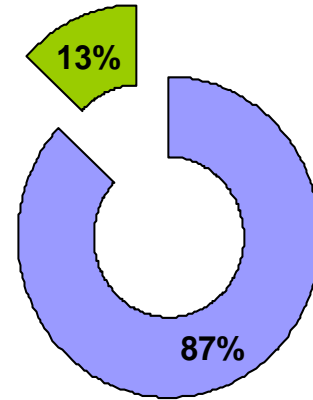
مصرف الإمارات العربية المتحدة المركزي
Central Bank of the United Arab Emirates

UAE's market share: Equity & Profitability

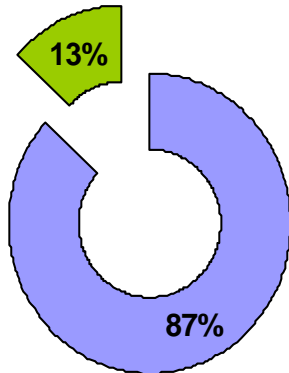
■ Total Assets all banks ■ Islamic banks assets



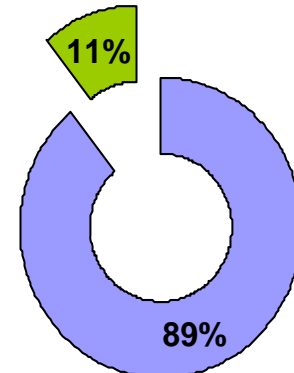
■ Total capital base all banks ■ Islamic capital base



■ Total deposits all banks ■ Islamic banks deposits



■ Total profits all banks ■ Islamic banks profits



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.**



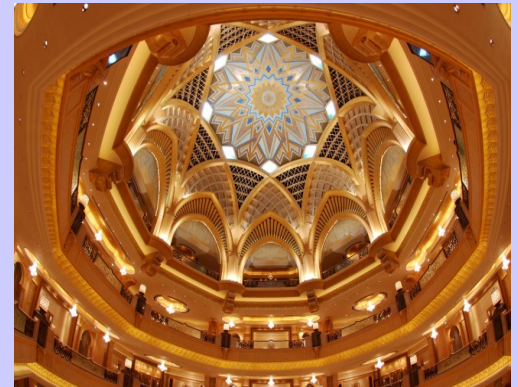
The risk focussed examination.

- 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

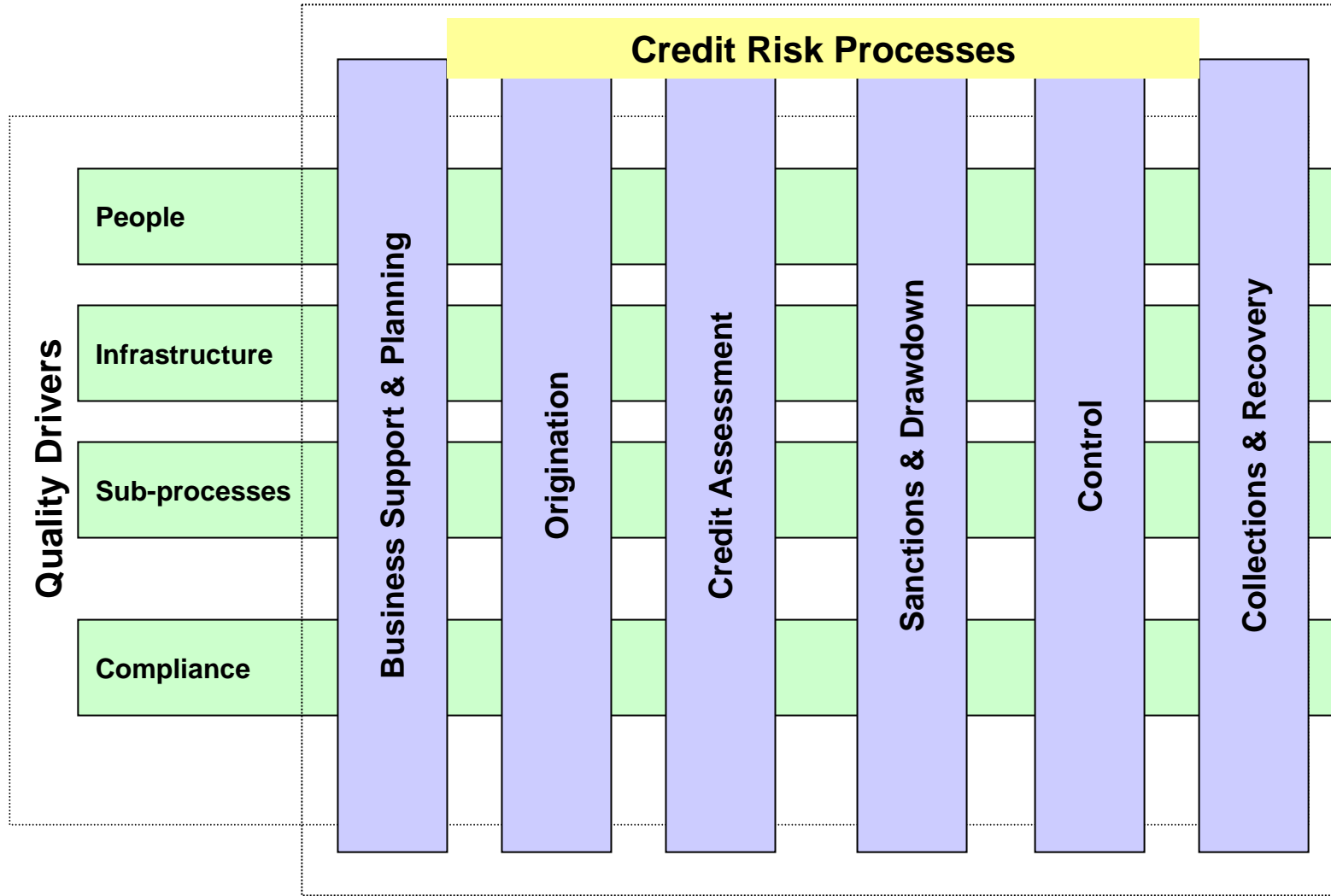


The main rationales of a RFE (2).

- 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

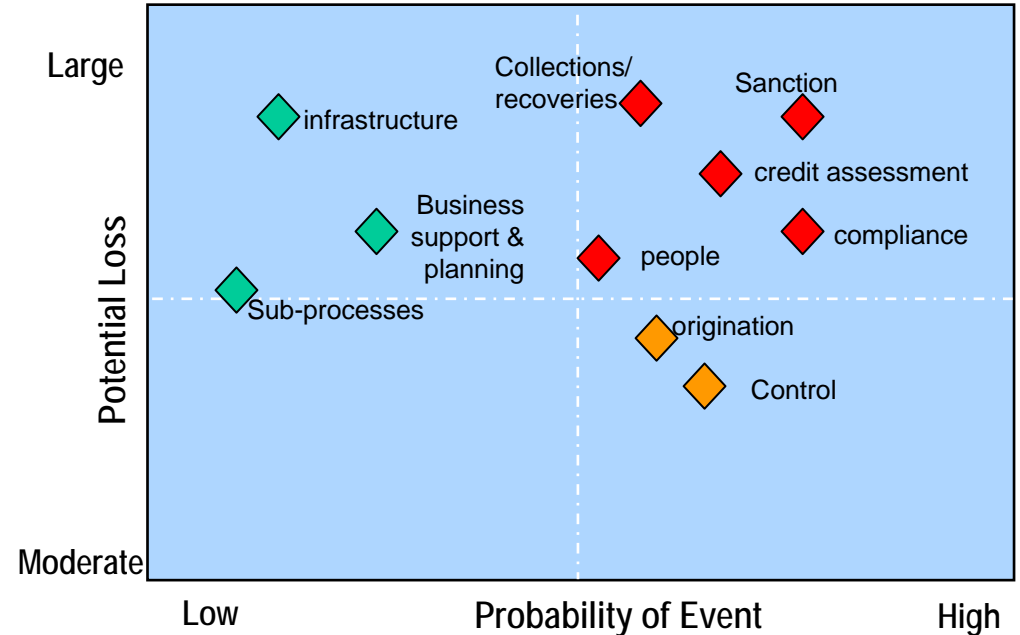


The operational risk processes are those processes undertaken by the bank to manage operational risk in judgmental environments ...

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

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

Quality Drivers

People

Are the people in the institution performing to a level that would result in a world class credit risk management team, given the right infrastructure, processes and compliance? Do we have the right culture to support the organisational values?

Infrastructure

Do the people in the institution have the right tools, M.I.S and organisational structure in place that will allow them to develop world class credit risk management policies and processes? Is this infrastructure being used appropriately?

Sub-processes

Are the processes in the institution designed to minimise errors, maximise efficiency, make compliance easy and non compliance difficult? Do the processes result in the right outcome? Are these processes being used effectively?

Compliance

Are the key processes in the institution that impact risk fully understood and compliant to policy and procedure? Are these policies and procedures being adhered to?

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

Credit Risk Processes

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

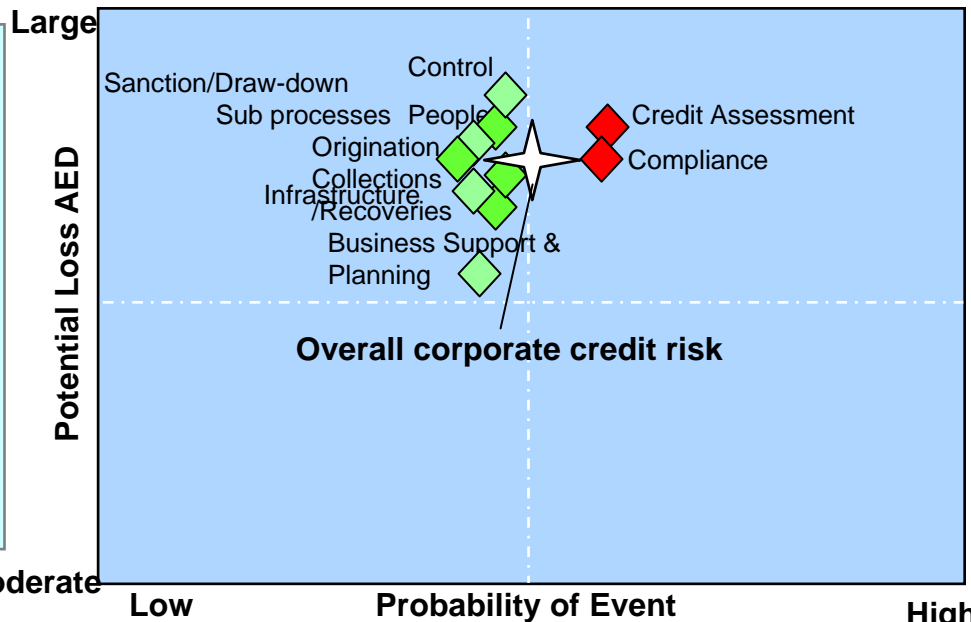
Key influences on Risk Profile

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

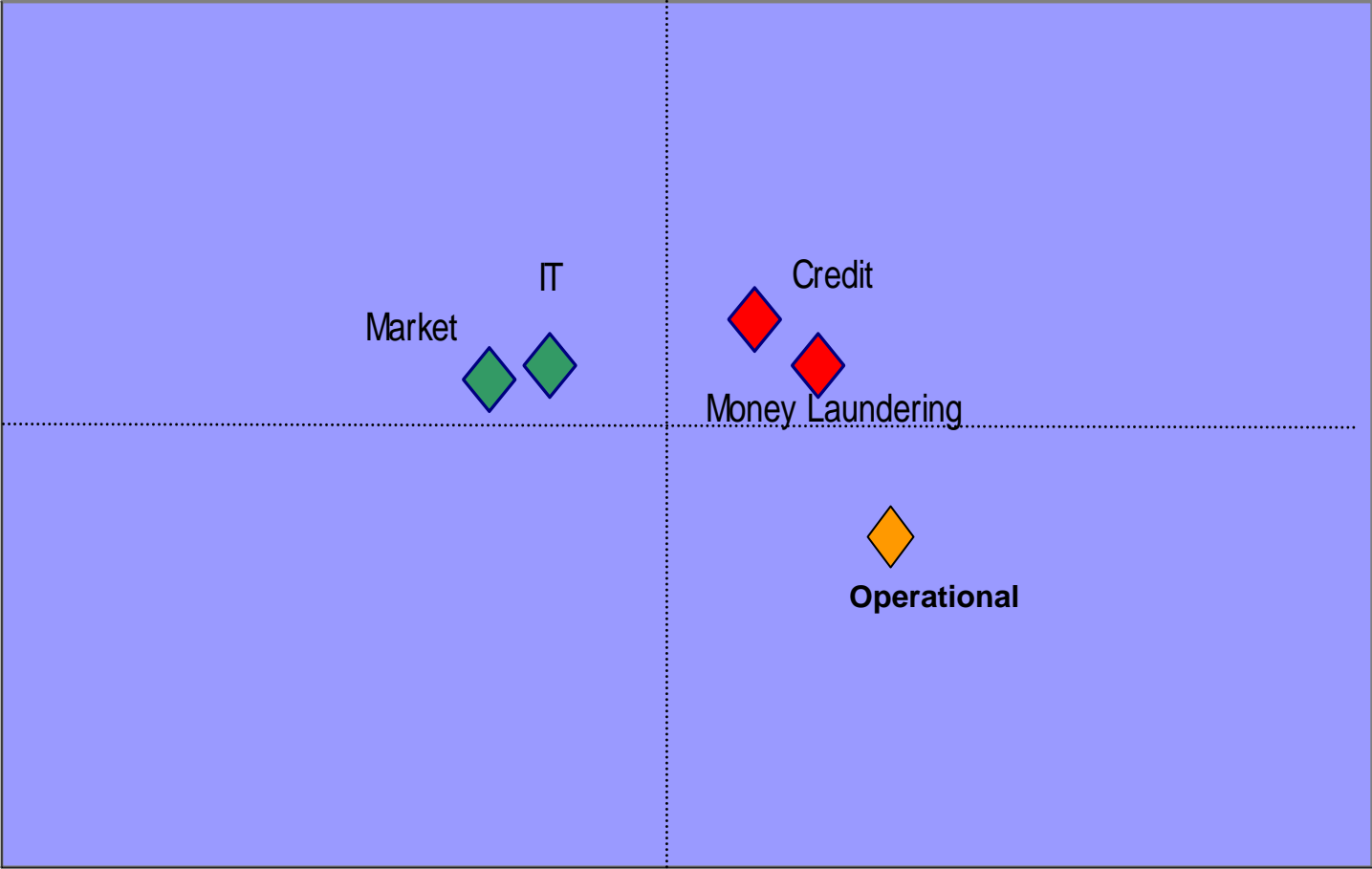
Key action points arising from this review

1. Credit assessment processto 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 ...



Bank Name :

Retail Credit Risk Management Dashboard

Risk Event & Indicators (REIs)

Quarter ended :

1 Leading Indicators

1.1	New Credit Policy	↑
1.2	Credit Policy Review	↑
1.3	New Products	↑
1.4	Staff Turnover	↑

2 Lagging Indicators

2.1	Classified Loans/Total Loans	↓
2.2	Delinquencies	↓
2.3	Lending Portfolio Movement	↑
2.4	Policy Exception Referrals	↑
2.5	Provisions	↓
2.6	Quality of Portfolio	↓
2.7	Risk Charge A	↓
2.8	Risk Charge B	↓
2.9	Risk Charge C	↓
2.10	Risk Return	↓
2.11	Skips	↓
2.12	Write Off to P&L	↓

3 People/Infrastructure

3.1	Business Strategy Changes	→
3.2	Business Radar	→
3.3	Organisation Restructures	→
3.4	Sales Performance A(Assets)	→
3.5	Sales Performance B(Income)	→
3.6	Staff Incentive Program	→

4 Other Information

4.1	Buy outs	→
4.2	Expatriate Risk	→
4.3	Fees & Other Charges/Total Inc.	→
4.4	New to Borrowing	→
4.5	Risk Grade Movement	↓
4.6	Risk Grade of New Business	↓
4.7	Recoveries A	↓
4.8	Recoveries B	↓
4.9	Sales Performance Current	↓
4.10	Sales Performance Past	↓
4.11	Top ups	↓

5 Internal Reports

5.1	Internal Audit Report	↑
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6 External

6.1	Consultant's Report	↑
6.2	External Auditor Report	↑

7 Credit Cards

7.1	Cards per Employee	↑
7.2	Card Business Quality	↑
7.3	Portfolio Utilisation	↑
7.4	Card Cash Usage	↑
7.5	Loss Ratio	↑
7.6	Profit Per Card	↑

↑ = Red = High Risk
→ = Amber = Medium Risk
↓ = Green = Low Risk

Bank Name :

Corporate Credit Risk Management Dashboard

Risk Event & Indicators (REIs)

Quarter ended :

1 Leading Indicators

1.1	New Credit Policy	↑
1.2	Credit Policy Review	↓
1.3	New Products	↓
1.4	Staff Turnover	↓

2 Lagging Indicators

2.1	Advances to Deposits	↓
2.2	Classified Loans/Total Loans	↓
2.3	Corporate Loans/Total Assets	↓
2.4	Credit Derivatives	↓
2.5	Fees & Non Fund Inc./Total Inc.	↓
2.6	Industry Concentration	↓
2.7	O/s Name Lending	↓
2.8	Net Portfolio Growth-Funded	↓
2.9	Net Portfolio Growth-Unfunded	↓
2.10	Overdues	↓
2.11	Credit Policy Exception Referrals	↓
2.12	Provisions	↓
2.13	Quality of Portfolio	↓
2.14	Risk Charge A	↓
2.15	Risk Charge B	↓
2.16	Risk Return	↓
2.17	Unfunded/Funded	↓
2.18	Utilised Limits	↓
2.19	P&L Charge	↓

3 People/Infrastructure

3.1	Business Strategy Changes	→
3.2	Business Radar	→
3.3	Organisation Restructures	→
3.4	Sales Performance A(Assets)	→
3.5	Sales Performance B(Income)	→
3.6	Staff Incentive Program	→

4 Other Information

4.1	Classification Downgrades	↓
4.2	Overseas Exposure	↓
4.3	Expatriate Risk	↓
4.4	Excesses	↓
4.5	Geography Concentration	↓
4.6	Gross Portfolio Growth	↓
4.7	Loans to Total Assets	↓
4.8	Overdue Reviews	↓
4.9	Recoveries A	↓
4.10	Risk Grade of New Business	↓
4.11	Risk Grade Movement	↓
4.12	Sales Performance Current	↓
4.13	Sales Performance Past	↓
4.14	Watch List/OLEM	↓

5 Internal Reports

5.1	Group Audit Reports	↑
5.2	Group Credit Committee	↑
5.3	Branch/Department	↑

6 External Reports

6.1	Consultant's Report	↑
6.2	External Auditor Report	↑

↑ = Red = High Risk

→ = Amber = Medium Risk

↓ = Green = Low Risk

Populating a Risk map

Scenario 1

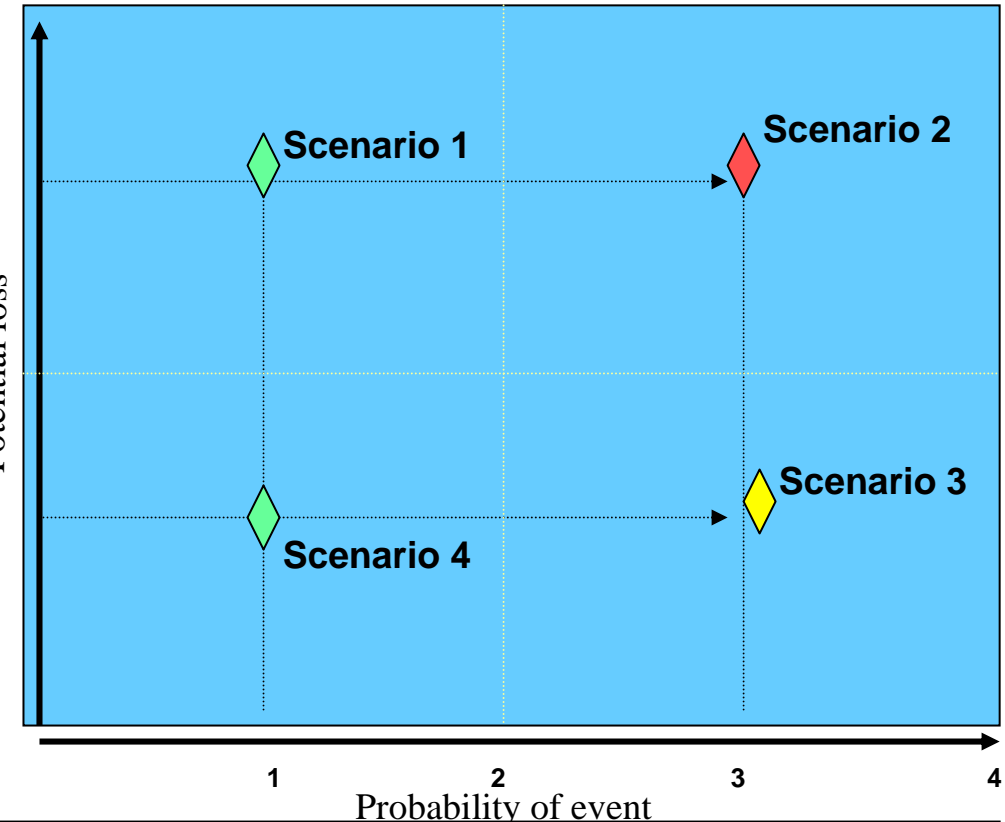
- Good control (1 on the x-axis)
- High risk-taking bank (ie high loans to deposit ratio, say 75%)
- Ranked as 'green' owing to good control environment within the bank. Low risk of loss.

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

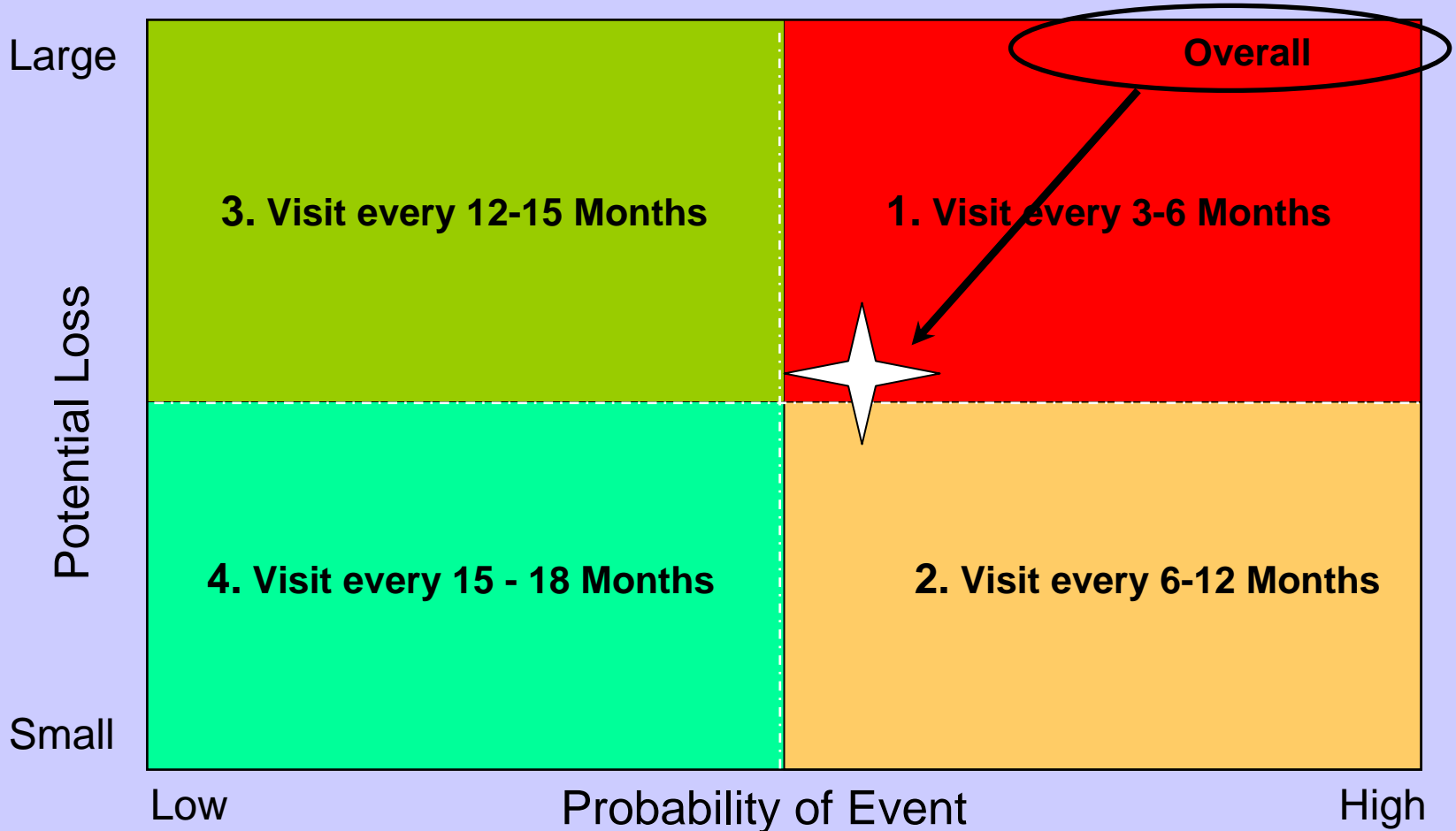
- Weak control (3 on the x-axis)
- Low risk-taking bank (ie low loans to deposit ratio, say 25%)
- Ranked as 'amber' - requiring some regulatory focus, but without the gravity of a 'red'. High risk of immaterial loss.



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.

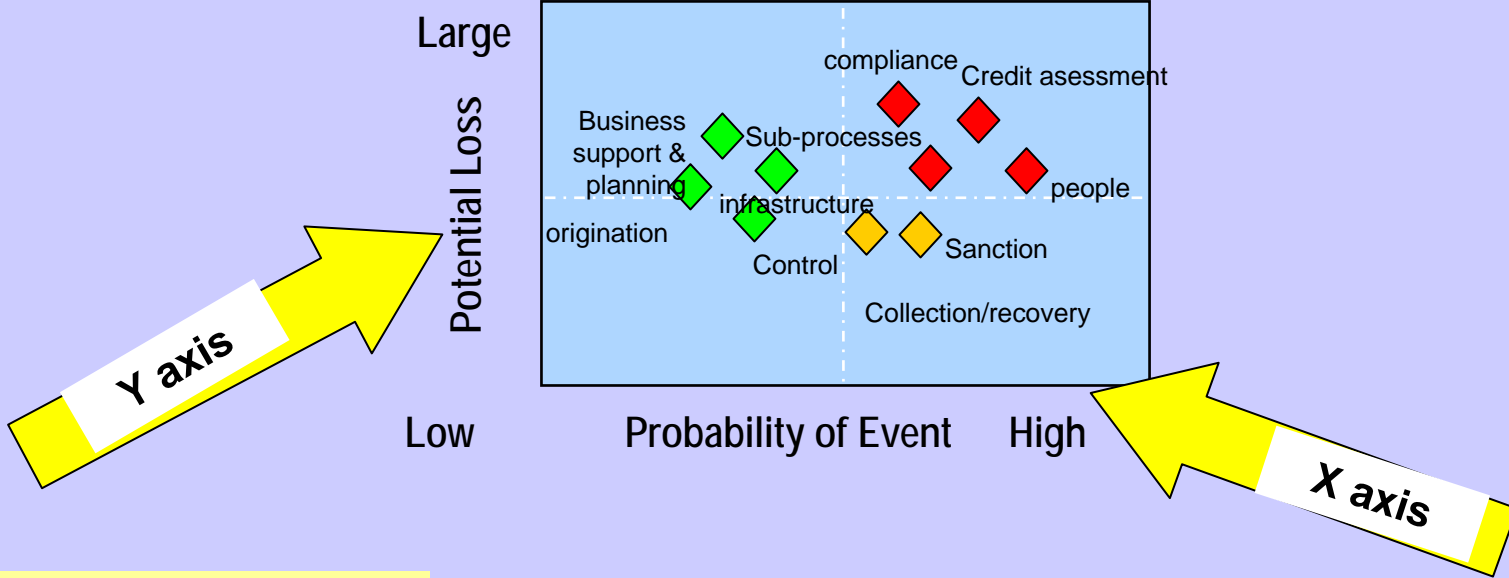
Supervisory Matrix



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

Overview

Credit Risk Map



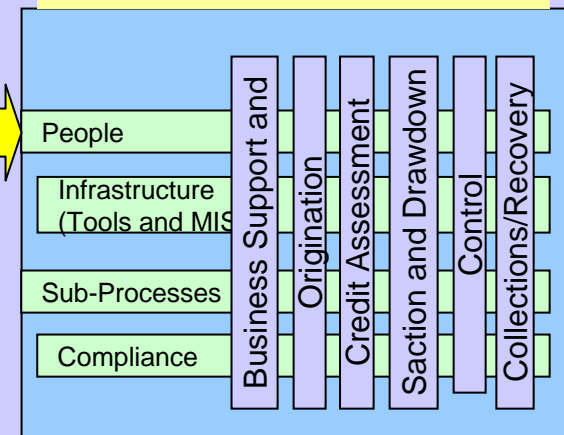
Financial data

First Gulf Bank						
Balance Sheet as at 30.06.02						
	Gross Assets	Risk Free Assets	Net Assets	% Total Assets	Net Assets	% Total Assets
Assets						
Market Risk						
Cash and balance with CB	110	110	0	2.7	-	3.4
CBs purchased from CB	155	155	0	3.8	-	9.7
Bank balance	57	57	0	1.4	1.4	1.7
Placements with Banks	431	431	0	10.4	10.4	13.2
Investments (net of prov of 19)	1,021	1,021	0	24.7	24.7	31.3
Sub total Market	1,774	265	1,509	42.9	36.5	54.4
Credit Risk						
Gross Corporate Credit	2,458	276	2,182	59.5	52.8	75.3
Less:						
Interest in Suspense	-203	-	-203	5.4	5.1	6.8
Provision	-307	-	-307	7.4	7.4	9.4
Net corporate credit portfolio	1,942	314	1,628	47.0	39.4	59.5
Less:						
Gross Retail Credit	65	-	65	1.6	1.6	2.0
Interest in Suspense	0	-	-	-	-	0.0
Provision	0	-	-	-	-	0.0
Net retail credit portfolio	65	0	65	1.6	1.6	2.0
Fixed assets -net	111	-	111	2.7	2.7	3.4
Other assets	240	-	240	5.8	5.8	7.4
Total Assets	4,132	579	3,553	100.0	86.0	
Liabilities						
Capital	374	-	374	9.1	9.1	11.5
Reserves	210	-	210	5.2	5.2	6.6
Current period profits	37	-	37	0.9	0.9	1.1
Total Capital and Reserves	621	-	621	15.2	15.2	19.2
Total Deposits	3264	239	3,025	79.0	73.2	100.0
Other liabilities	241	-	241	5.8	5.8	7.4
Total Liabilities	4,132	4,132	100.0	100.0		
Contingent liabilities						
Letters of Credit	649	-	649	13.3	-	16.8
Letters of Guarantees	2,099	-	2,099	50.7	-	64.2
Acceptances	126	-	126	3.0	67.0	3.6
Forward Exchange	2,188	-	2,188	52.9	-	67.0
Others	322	-	322	7.6	-	9.9

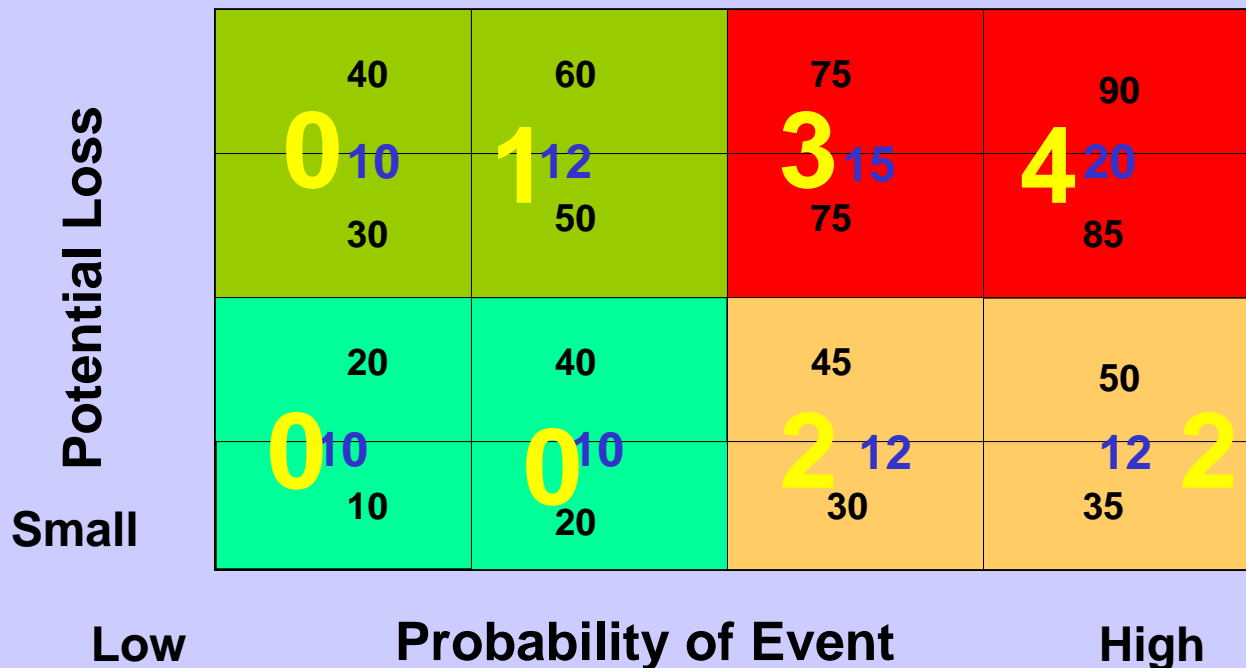
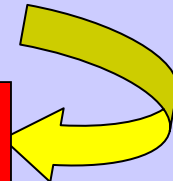
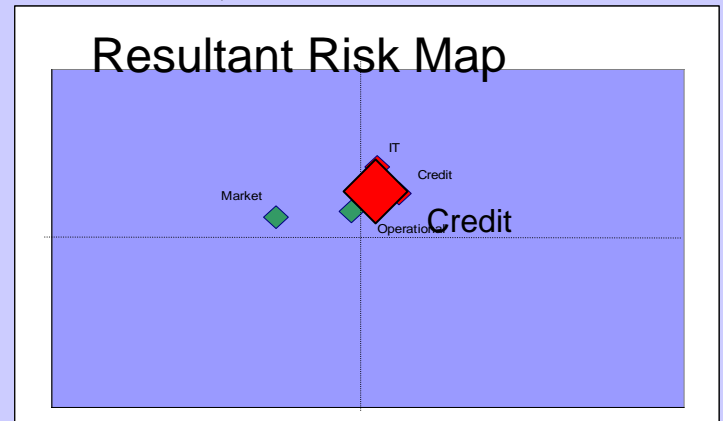
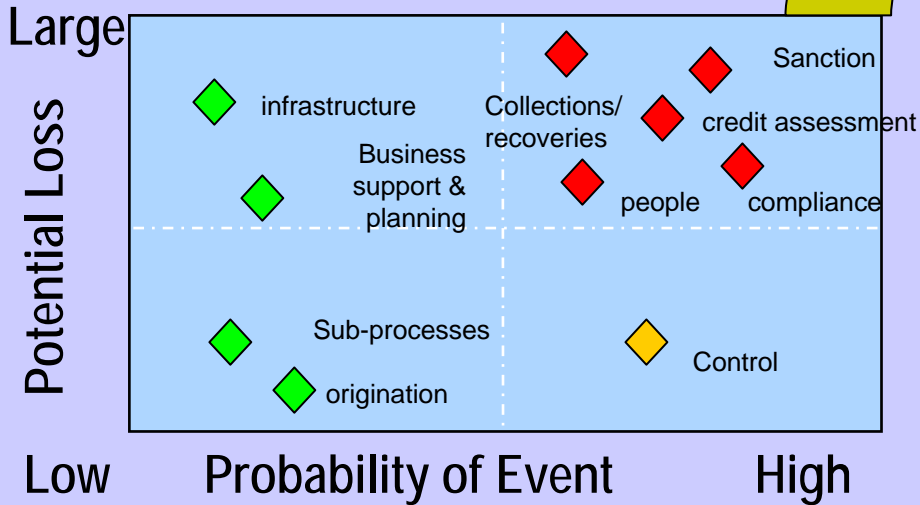
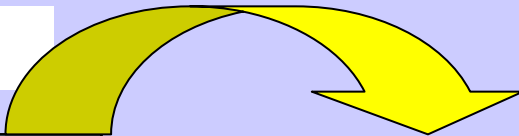
Balanced Scorecard

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Credit Risk Framework



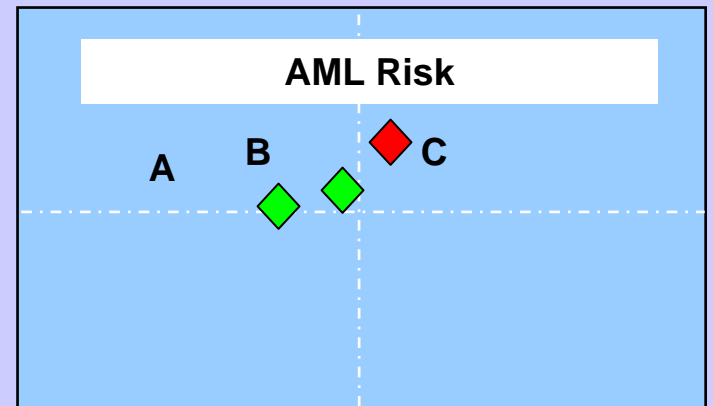
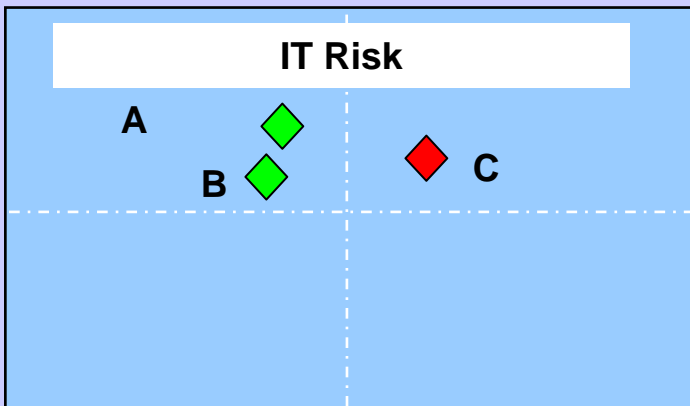
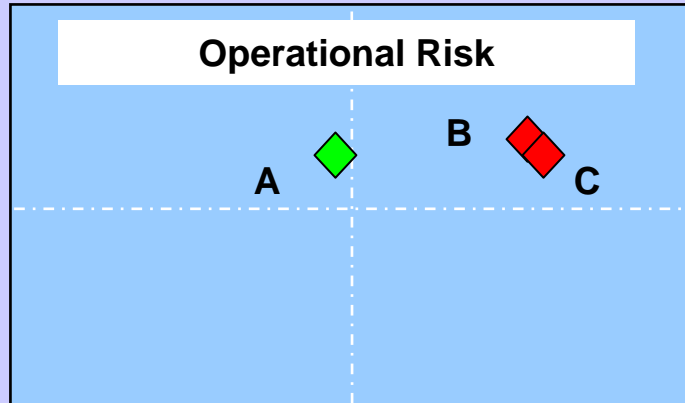
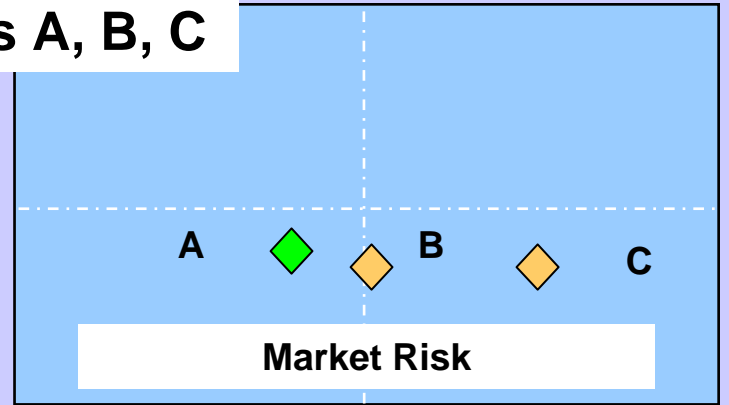
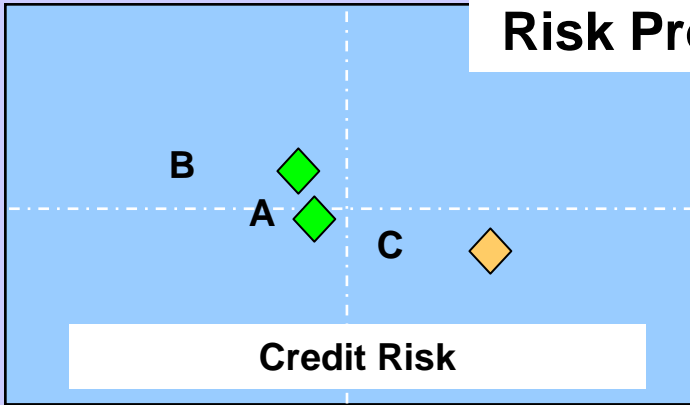
"X" Bank credit risk profile



- 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

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

Risk Profiles of Banks A, B, C



The Scoring cards.

	Credit Risk	Market Risk	Liquidity Risk	Operational Risk	Legal, & Reputational
Key Processes	<ul style="list-style-type: none"> ◆ Strategy ◆ Identification ◆ Measurement ◆ Monitoring ◆ Controls 	<ul style="list-style-type: none"> ◆ Strategy ◆ Identification ◆ Measurement ◆ Monitoring ◆ Controls 	<ul style="list-style-type: none"> ◆ Strategy ◆ Identification ◆ Measurement ◆ Monitoring ◆ Controls 	<ul style="list-style-type: none"> ◆ Strategy ◆ Identification ◆ Measurement ◆ Monitoring ◆ Controls 	<ul style="list-style-type: none"> ◆ Strategy ◆ Identification ◆ Measurement ◆ Monitoring ◆ Controls
Sub-processes	<ul style="list-style-type: none"> ◆ Strategy <ul style="list-style-type: none"> ➢ Business planning & objectives ➢ Risk/reward ➢ Portfolio ◆ Identification <ul style="list-style-type: none"> ➢ Credit Assessment ➢ Risk concentration ➢ Capture ◆ Measurement <ul style="list-style-type: none"> ➢ Internal rating models ➢ Economic capital ➢ Data integrity ◆ Monitoring <ul style="list-style-type: none"> ➢ Portfolio management ➢ Exception reporting ➢ Indicators ◆ Controls <ul style="list-style-type: none"> ➢ Action on Exceptions ➢ Internal audit/review ➢ Provisions ➢ Policy enforcement ➢ Collections ➢ Segregation 	<ul style="list-style-type: none"> ◆ Strategy <ul style="list-style-type: none"> ➢ Business support & Planning ➢ Risk/reward ◆ Identification <ul style="list-style-type: none"> ➢ Parameters affecting market risk ➢ Product evaluation ◆ Measurement <ul style="list-style-type: none"> ➢ Revaluation ➢ Independence ◆ Monitoring <ul style="list-style-type: none"> ➢ Real time access ➢ MIS ➢ Stress testing ◆ Controls <ul style="list-style-type: none"> ➢ Action on Exceptions ➢ Internal audit ➢ Segregation ➢ Processing 	<ul style="list-style-type: none"> ◆ Strategy <ul style="list-style-type: none"> ➢ Business support & Planning ➢ Liquidity contingency plan ➢ ALCO process ◆ Identification <ul style="list-style-type: none"> ➢ Parameters affecting liquidity ➢ Capture ➢ Market limitations ◆ Measurement <ul style="list-style-type: none"> ➢ Indicators ➢ Stress tests ➢ Behavioural models ◆ Monitoring <ul style="list-style-type: none"> ➢ MIS ➢ Scenario building ◆ Controls <ul style="list-style-type: none"> ➢ Action on Exceptions ➢ Middle office ➢ Audit ➢ Deal Processing 	<ul style="list-style-type: none"> ◆ Strategy <ul style="list-style-type: none"> ➢ Business support & Planning ➢ Policy ➢ Understanding ◆ Identification <ul style="list-style-type: none"> ➢ KRI ➢ Product Risk profiles ➢ Prioritising ➢ Risk register ◆ Measurement <ul style="list-style-type: none"> ➢ Data Generation ➢ Data collection ➢ Data verification ➢ Model ◆ Monitoring <ul style="list-style-type: none"> ➢ Quality assurance ➢ Recording and reporting ◆ Controls <ul style="list-style-type: none"> ➢ Resolution ➢ Limits on controllable risks ➢ Escalation 	<ul style="list-style-type: none"> ◆ Strategy <ul style="list-style-type: none"> ➢ Policy on documentation ➢ Interaction with outside agencies ➢ Dynamic agenda ➢ Resourcing ◆ Identification <ul style="list-style-type: none"> ➢ Centralised expertise ➢ Strong KYC culture ➢ Indicators ➢ Risk register ◆ Measurement <ul style="list-style-type: none"> ➢ Key indicators ◆ Monitoring <ul style="list-style-type: none"> ➢ Feedback ➢ Market intelligence ➢ Record keeping and escalation ◆ Controls <ul style="list-style-type: none"> ➢ Action on Exceptions ➢ Policies

Thank you

