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# THE BANKING REGULATION REVIEW

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SECOND EDITION

EDITOR  
JAN PUTNIS

LAW BUSINESS RESEARCH

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Second Edition

Editor

JAN PUTNIS

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## Chapter 42

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# UNITED ARAB EMIRATES

*Amjad Ali Khan and Stuart Walker\**

### I INTRODUCTION

The UAE is a federation of seven emirates, all of which (with the exception of Dubai and Ras Al Khaimah) are part of the federal judicial system; the emirates of Dubai and Ras Al Khaimah have separate judicial systems.

The Dubai International Financial Centre ('DIFC') is a financial free zone located within the Emirate of Dubai. The DIFC has been in existence for approximately six years, and it has its own body of laws (completely separate from the laws applicable within the UAE), its own court system and its own regulator, the Dubai Financial Services Authority ('DFSA'). There are approximately 500 entities either incorporated within or registered within the DIFC. Of these, approximately half are regulated as financial service providers by the DFSA.

The past two years have been most challenging for banks and banking regulators in the UAE. Although banks had similar challenges in the late 1970s and in the mid-1980s, when the economies of the region suffered negative growth, few bankers currently in the UAE have memory of those downturns. On a more positive note, the size and complexity of the current challenges in the UAE banking sector reflect its entry into the mainstream of international banking and commerce.

2008 saw a great number of banking and financial transactions in the UAE including jumbo-syndications, bond and *sukuk* issues and IPOs. Earlier in 2006 and 2007, speculation relating to the possible appreciation of the dirham and its delinking from the US dollar resulted in a steady inflow of billions of US dollars into the UAE banking sector. As a result dirham deposits with banks grew to record amounts and banks reacted with generous credit lines to corporates while consumer assets grew at annual rates in excess of 25 per cent for several years. Non-resident banks also substantially increased their exposure to the UAE private and public sector. However, the UAE government's

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\* Amjad Ali Khan is managing partner and Stuart Walker is a partner at Afridi & Angell.

decision in 2008 not to depeg the dirham from the US dollar resulted in the speculative deposits to withdraw from the UAE. Simultaneously, the international financial crisis began to impair the portfolios of several large UAE banks and locally it became apparent that the massive investment in real estate would result in an equally massive oversupply. The UAE construction and real estate sector fared well till late 2008 when real estate prices crumbled, liquidity dried up, the economy shrank, there were substantial lay-offs, and there was a noticeable reduction in the population on account of the departure of large numbers of expatriates.

The sectors in the UAE worst hit by the crisis are real estate, construction and banking. Real estate activity has fallen to a fraction of previous levels. Construction of a number of potential projects has been cancelled, while construction of several existing projects has been suspended or abandoned. Banks have had to take substantial write-offs in their real estate, construction and consumer loan portfolios and have greatly restricted fresh loans.

In response to the crisis the Central Bank of the UAE ('Central Bank'), the federal UAE government and the emirate governments have responded with a variety of measures.

## **II THE REGULATORY REGIME APPLICABLE TO BANKS**

### **i UAE**

The regulatory framework for banking in the UAE is based on Federal Law No. 10 of 1980 concerning the Central Bank, the monetary system and the organisation of banking ('the Banking Law'). Under the Banking Law, the Central Bank was created and entrusted with the issuance and management of the country's currency and the regulation of the banking and financial sectors.

The Banking Law provides for the licensing and regulation by the Central Bank of the following financial institutions.

Commercial banks are defined to include institutions that customarily receive funds from the public, for granting loans, and which issue and collect cheques, place bonds, trade in foreign exchange and precious metals, or carry on other operations allowed by law or by customary banking practice. Investment banks are distinguished from commercial banks principally in that they do not accept deposits for less than two years.

Investment companies manage portfolios on behalf of individuals or companies, subscribe to equity and debt instruments, prepare feasibility studies for projects, market shares and debt instruments and establish and manage funds.

Finance companies provide corporate and consumer credit facilities but may not accept deposits from individuals. Financial intermediaries broker the purchase or sale of domestic or foreign shares or instruments. Monetary intermediaries are foreign exchange dealers who purchase and sell currency. Representative offices are regional or liaison offices of foreign banks and financial institutions.

Islamic Banks, finance companies and investment companies are regulated by the Central Bank under Federal Law No. 6 of 1985 regarding Islamic Banks, Financial Institutions and Investment Companies. Islamic banks undertake all the activities of

a commercial bank and additionally can own assets financed by them. Islamic finance companies may provide personal and consumer, property, vehicle and trade financing, issue guarantees and enter into foreign exchange contracts with corporate entities, subscribe to shares, bonds and certificates of deposits, accept deposits from corporate entities and manage investment vehicles. All Islamic institutions must operate in accordance with the principles of Islamic sharia.

Real estate finance companies are finance companies that specialise in funding real estate projects on a conventional or sharia-compliant basis.

The Banking Law does not apply to statutory public credit institutions, governmental investment institutions and development funds, private savings and pension funds and the insurance sector.

While the Central Bank is the principal regulatory authority of banks and financial institutions in the UAE, such entities are also subject to additional registration and licensing requirements at the federal and emirate levels. Also the Federal Companies Law governs all commercial companies incorporated in the UAE and all foreign companies with branch offices in the UAE.

All commercial banks incorporated in the UAE must be established as public shareholding corporations under the UAE Companies Law and must be majority-owned by UAE nationals. A majority of directors of such companies must be UAE nationals. While for monetary intermediaries and investment companies the minimum UAE national shareholding requirement is 51 per cent, for finance companies, commercial banks and investment banks the minimum UAE national shareholding requirement is 60 per cent. Although branches of foreign companies established in the UAE are required to appoint a UAE national as a national agent, foreign banks are not required to have an agent.

The principal difference in the treatment of local and foreign commercial banks is that local banks are not subject to any taxation on their income, whereas foreign banks are subject to taxation at the emirate level. Normally this tax is 20 per cent of net income.

Non-resident banks grant bilateral credit facilities and also participate in syndications in the UAE. They are not deemed to be resident, domiciled or carrying on business in the UAE and not liable to tax in the UAE merely on account of such participation. The confidentiality of customer information by banks is not specifically provided for under the Banking Law, but the principle is recognised as a customary banking practice, and, implicitly, under certain regulations issued by the Central Bank. However, the Central Bank has wide powers to obtain information. The Central Bank recently entered into a Memorandum of Understanding with the Emirates Securities and Commodities Authority ('ESCA') pursuant to which certain regulatory authority of the Central Bank to regulate the offer and sale of foreign securities in the UAE was transferred from the Central Bank to ESCA. ESCA regulates the two onshore stock exchanges.

## ii DIFC

The DFSA has adopted a regulatory approach modelled, at least in part, on the FSA in the United Kingdom. The DFSA does not grant banking licences *per se*; it authorises

financial service providers to undertake specific financial services. The relevant financial services in respect of banks would include providing credit and accepting deposits. There are approximately 30 international banking institutions with a registered presence in the DIFC. Of these, only a very small number have actually applied for the authorisation to accept deposits. This reluctance to be a 'true' bank can be traced to two reasons. One, historically, DIFC entities were not able to deal with retail customers. This restriction was lifted recently but the business models of the vast majority of institutions within the DIFC has been to focus on corporate clients or high net worth individuals. The other reason that banks have been reluctant to apply for the 'accepting deposits' authorisation is that they remain unable to deal in dirhams or accept deposits from the UAE markets. Most of the banks that have set up in the DIFC have done so as branches of overseas companies; this has been done for capital adequacy reasons. Recently, however, it has been the policy of the DFSA to encourage banks to incorporate new subsidiaries within the DIFC and capitalise those subsidiaries to an acceptable level.

### III PRUDENTIAL REGULATION

#### i UAE

The Central Bank has a bank examiner-type approach to the regulation of the banking and finance sector. The Central Bank has issued regulations on a whole range of issues affecting the conduct of banking.

Banks are required to publish quarterly audited accounts and have their annual audited accounts approved by the Central Bank before they are published. Banks are required to obtain prior approval of the Central Bank to changes in directors, senior management, shareholders (holding over 5 per cent equity), constitutional documents and capital. However, a recent decision of the Federal Courts held that the Central bank cannot interfere with the right of a shareholder to elect a director in accordance with the provisions of the UAE Companies Law.

The Central Bank is responsible for the anti-money-laundering regime in the UAE and has a special department that implements Central Bank anti-money-laundering regulations.

The approval of the Central Bank is required for all branches, ATMs and CDMs, electronic business units and other physical premises required by banks. The Central Bank also regulates outsourcing of back-office and marketing functions.

For a number of matters, Central Bank approval is clearly required. However, various banks adopt different policies regarding Central Bank approvals. Local banks generally tend not to seek Central Bank approval while foreign banks generally are more inclined to seek Central Bank approvals or, at a minimum, notify the Central Bank. There is currently little or no regulation of bank holding companies or subsidiaries.

UAE banks are all publicly listed companies and must comply with the Central Bank law, UAE Companies law and Emirates Securities and Commodities Authority laws, all of which, *inter alia*, regulate management.

In summary, local banks have a board of directors, chief executive, a number of board committees and senior executives. There is currently no regulation of bonus



payments to management; bonus payments have, however, not been of a magnitude that requires regulation.

The Central Bank has adopted Basel II recommendations regarding regulatory capital. In 2009, the Central Bank issued regulations to commercial banks in the UAE to increase their minimum capital requirement by 30 June 2010 from 11 to 12 per cent. In recent months Central Bank has insisted that banks make adequate provisions for doubtful or bad loans.

## ii DIFC

### *Relationship with the prudential regulator*

Firms authorised by the DFSA are required to notify the DFSA of all matters of which it could reasonably expect to be notified of. There are quarterly reporting requirements in respect of capital adequacy. The DFSA conducts themed reviews on a regular basis; recent reviews have focused heavily on prevention of money laundering and terrorism financing. The DFSA has also focused on authorised firms' compliance with restrictions imposed on dealing with (1) Iranian counterparties arising from the UN sanctions relating to non-nuclear proliferation; and (2) political exposed persons.

### *Management of banks*

The DFSA requires all financial institutions active in the DIFC to have adequate systems and controls in place to ensure that they are properly managed. There are a number of mandatory appointments (senior executive officer, chief financial officer, etc.). The individuals holding the mandatory appointment positions are subject to prior clearance by the DFSA. The DFSA does not impose any requirements or make any restrictions in respect of bonus payments to management and employees of banking groups.

### *Regulatory capital*

Those firms holding authorisations to accept deposits and provide credit fall into prudential category 1 (being the highest of categories 1 to 5). Category 1 firms have a base capital requirement of US\$10 million. The actual capital requirement may be significantly higher depending upon the volume of business being conducted and other factors set out in the DFSA Rulebook. As previously mentioned, historically, most banking groups established branches in the DIFC and were able to obtain waivers of the capital adequacy requirements on that basis. In short, they looked to their head office balance sheet as support for their DIFC functions. This approach is becoming less and less acceptable to the DFSA, particularly for smaller financial institutions coming from jurisdictions other than tier 1 jurisdictions.

## IV CONDUCT OF BUSINESS

### i UAE

The Banking Law, along with the various circulars and notices issued from time to time by the Central Bank, govern the conduct of business by banks in the UAE. Any violations of the Banking Law or any of the circulars or notices issued by the Central Bank would attract fines and additionally could attract other penalties such as warnings, reduction

or suspension of credit facilities granted to it, prohibition or restriction on carrying on certain activities or revocation of its licence to conduct banking business, depending upon the gravity of the offence. Accordingly, a bank may be subject to civil or regulatory liability under the Banking Law. There may also be occasions where a bank may be exposed to criminal liability under the UAE Federal Penal Code.

## **ii DIFC**

The DFSA Rulebook contains a detailed conduct of business module. The Rulebook is essentially a principle-based system. For example, principle 1 (integrity) states that an authorised firm must observe high standards of integrity and fair dealing. Principle 5 (marketing conduct) states that an authorised firm must observe proper standards of conduct in financial markets. There are 11 principles, the final being principle 11 (compliance with high standards of corporate governance), which states that an authorised firm must meet the applicable standards of corporate governance as appropriate considering the nature, size and complexity of the authorised firm's activities. A bank operating in the DIFC will be subject to civil liability under the various DIFC laws, regulatory liability in respect of the applicable DIFC laws such as the Market Law and the Regulatory Law, plus the provisions of the DFSA Rulebook. Depending on the relevant customer documentation, a bank in the DIFC may also be exposed to civil liability under the laws of the UAE outside the DIFC. Finally, there may be occasions where a bank in the DIFC would be exposed to criminal liability (i.e., under the UAE Federal Penal Code).

## **V FUNDING**

### **i UAE**

Under the Banking Law, commercial and investment banks must have a minimum paid-up capital. All foreign banks are required to allocate capital for their UAE operations. At least 10 per cent of the annual net profits of banks is required to be allocated to a special reserve, until such reserve equals 50 per cent of the bank's paid up capital or, in the case of a foreign bank, the amount allocated as capital for its UAE operations.

Additionally, the Central Bank has issued specific circulars on capital adequacy requirements for banks in the UAE. Until 1993, all commercial banks were required to maintain a capital-to-assets ratio of 1:15. This was widely regarded as being inadequate. In 1993, the Central Bank issued new risk-based capital adequacy rules based on the 1988 recommendations of the Basel Committee on Banking Regulations and Supervisory Practices. These rules require all commercial banks to maintain a risk-to-assets ratio of 10 per cent. The rules also prescribe the manner in which different categories of assets are to be risk-weighted.

The Central Bank has stated that the risk-to-assets ratio is only one of the factors it will consider when assessing the capital adequacy of each bank. It will also take into consideration such factors as the geographical or business sector credit concentration, policies, procedures and internal control systems of the lending bank.

**ii DIFC**

There is no Central Bank or equivalent within the DIFC and therefore banks registered within the DIFC must fund their activities through support from other branches of their international operations or debt issuance programmes of their own. As previously mentioned, deposit taking is not a significant source of funding for any institution in the DIFC.

**VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS**

**i UAE**

There is no specific definition of control (except in relation to determination of large exposures). 'Control' is generally viewed as a majority shareholding interest, a right to appoint the majority of the board of directors of a bank, or both. Any change in such control requires the prior approval of the Central Bank.

Transfer of customer relationships (e.g., deposits, loans, credit cards, accounts, investment products) generally requires customer consent. There is no statutory mechanism for transfer of such relationships.

**ii DIFC**

Any material change of control in a DFSA-authorized firm requires prior approval from the DFSA.

The DFSA Rulebook does not include detailed provisions regarding the methods by which banks may transfer all or part of their business (comprising deposits and possibly loan agreements and other assets) to another entity without the consent of the customers concerned. The ability of an institution to do this would be governed by the assignment clauses in their contractual documentation as interpreted in accordance with the DIFC Contract Law.

**VII THE YEAR IN REVIEW**

**i UAE**

***Central Bank action***

The Central Bank has taken the following principal measures to address the current issues in the UAE banking sector:

- a* launched a 50 billion dirham repo facility for banks;
- b* offered deposits of a total of 70 billion dirham to UAE banks;
- c* guaranteed deposits with UAE banks and UAE branches of foreign banks; and
- d* subscribed US\$10 billion in a government of Dubai bond issue.

There is currently a debate on whether the Central Bank should further ease liquidity in the interbank market where rates continue to be high.

*Emirate-level action*

The government of Dubai, following the announcement by Dubai World that it is seeking to restructure its debt, has established a tribunal in the DIFC to hear all claims against Dubai World and its subsidiaries. The decree setting up the tribunal also amends the DIFC Insolvency Law and makes such amended Insolvency Law applicable to any insolvency proceedings relating to Dubai World and its subsidiaries.

The government of Dubai has also set up an economic council to address issues arising from the economic crisis.

**ii DIFC**

The most significant regulatory action undertaken by the DFSA in the past two years has been the steps taken in respect of Damas, a local jewellery manufacturer and retailer, whose shares were listed on Nasdaq Dubai. Damas was not a financial services provider but was a reporting entity by virtue of its listing on Nasdaq Dubai (an exchange regulated by the DFSA). There were a series of corporate governance failures within Damas that led to the DFSA imposing record fines on various directors and the company itself. The entire board was required to step down and a new board has been appointed. The Damas matter has highlighted the gap between local standards of corporate governance and standards expected at an international level and imposed by the DFSA.

**VIII OUTLOOK AND CONCLUSIONS**

The DFSA has undergone a substantial overhaul of its collective investment funds regime in the past year. The intention of the overhaul was to attract additional asset managers and fund managers to the DIFC. Presently, only a small number of funds are actually domiciled in the DIFC but it is hoped that this will change. If there is a growth in funds domiciled in the DIFC and asset managers present in the DIFC, then there may be further moves by international banks to establish a presence in the DIFC. One of the things that has been slowing the number of applicants to the DIFC is the relatively high rent charged within the Centre. Again, it is hoped that steps will be taken to reduce the rents within the financial free zone to a more reasonable level.

UAE banks continue to take substantial reserves for non-performing loans each quarter. Unfortunately this is likely to continue in 2011. On the positive side the deficit of deposits to loans has been nearly made up and the deposit rates offered by banks have fallen.

## Appendix 1

---

### ABOUT THE AUTHORS

#### **AMJAD ALI KHAN**

*Afridi & Angell*

Amjad Ali Khan is the managing partner of Afridi & Angell. He represents foreign and local clients including private equity firms, banks and leading multinationals in banking, financial and corporate transactions in Dubai and abroad. He specialises in banking and financial services including project finance, syndicated loans, treasury products and Islamic banking matters.

Mr Khan has considerable experience in undertaking conventional, Islamic and private banking transactions and in advising private equity firms in relation to cross-border acquisitions. He has advised clients in private acquisitions and private equity transactions and management buy-outs. He has been involved in several project finance transactions in the UAE. He is also a regular speaker at banking seminars.

#### **STUART WALKER**

*Afridi & Angell*

Stuart Walker became a partner of Afridi & Angell in November 2008. Prior to joining the firm in 2003, Mr Walker was a solicitor in the banking department of Lovells in London.

Mr Walker regularly advises on financial services regulation, asset management and custody, corporate finance and advisory business and the establishment of and operation of collective investment funds. His particular area of specialisation relates to the regulation of financial services in the DIFC. He has advised in connection with a significant number of the enforcement actions undertaken by the DFSA.

Mr Walker is the co-author of the UAE chapter of *Financial Services Regulation in the Middle East*, Oxford University Press (2008), and has contributed articles to various publications including *International Financial Law Review*. He is a regular contributor to Euromoney's *Global Banking & Financial Policy Review*.

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