The Banking Regulation Review

Fifth Edition

Editor
Jan Putnis

Law Business Research

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EDITOR'S PREFACE

The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as 'interim conclusions' because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks' corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks' capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on 'International Initiatives' and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barette and Gideon Roberton at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

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Jan Putnis
Slaughter and May
London
May 2014

Chapter 54

UNITED ARAB EMIRATES

Amjad Ali Khan and Stuart Walker[1]

I INTRODUCTION

The past year has seen a continuation of the substantial improvement in the performance of banks and financial institutions in the UAE. Provisioning for most non-performing loans is now complete and banks are once again aggressively competing for good assets. More importantly, profits are substantially higher than 2012.

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 of the UAE 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:

a Commercial banks: commercial banks are defined to include institutions that customarily receive funds from the public, grant loans, and that 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.

b Investment banks and companies: investment banks and companies manage portfolios on behalf of individuals or companies, advise clients on raising or placing equity and debt, subscribe to equity and debt instruments, prepare feasibility studies for projects, market shares and debt instruments and establish

1 Amjad Ali Khan and Stuart Walker are partners at Afridi & Angell.

and manage funds. Investment banks are distinguished from commercial banks principally in that they do not accept deposits for less than two years.

c Finance companies: finance companies provide corporate and consumer credit facilities but may not accept deposits from individuals.

d Financial intermediaries: financial intermediaries broker the purchase or sale of domestic or foreign shares or instruments.

e Monetary intermediaries: monetary intermediaries are foreign exchange dealers who purchase and sell currencies.

f Representative offices: representative offices are regional or liaison offices of foreign banks and financial institutions.

g Islamic banks, finance companies and investment companies: these institutions 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 finance, 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 shariah.

h Real estate banks and finance companies: these institutions specialise in funding real estate projects on a conventional or shariah-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 companies 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.

In recent years some banks incorporated in Member States of the Gulf Cooperation Council (GCC) have been allowed to establish fully fledged branches. GCC banks have also been allowed to acquire controlling stakes in UAE banks and financial institutions.

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 are not liable to pay tax in the UAE merely on account of such bilateral facilities or participation in syndications. 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. The Central Bank has wide powers to obtain information.

ii Emirates Securities and Commodities Authority

The Emirates Securities and Commodities Authority (SCA) regulates the securities markets in the UAE. All UAE banks are listed on one of the two onshore markets: the Abu Dhabi Exchange and the Dubai Financial Market. The SCA licenses all brokers, consultants and custodians who provide services related to listed securities. The Investment Funds Regulation issued by SCA in July 2013 transferred regulatory responsibility for the licensing and marketing of investment funds and for a number of related activities from the Central Bank to the SCA. The sale, marketing and promotion of foreign securities and funds in the UAE and the establishment of domestic funds requires the consent of the SCA.

iii 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 60 international banking institutions with a registered presence in the DIFC. Of these, approximately 50 per cent have actually applied for the authorisation to accept deposits. This reluctance on the part of some institutions 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 several years ago 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 issued regulations on a whole range of issues and ensures compliance with such regulations on the basis of a bank-examiner type approach.

In July 2012, the Central Bank issued a circular on liquidity as part of a phased implementation of Basel III. Its implementation was due to commence in January 2013 but has been postponed until further consideration of the requirements of the regulations. The qualitative requirements require banks to comply with 12 criteria when setting up their liquidity risk management and governance frameworks. Quantitative requirements require compliance with four ratios: a liquid assets ratio, uses (of funds) to stable resources ratio, a liquidity coverage ratio and a net stable funding ratio. Lenders were required to hold 10 per cent of their liabilities in 'high-quality liquid assets' from 1 January 2013. The regulations also prescribe the manner in which different categories of assets are to be risk-weighted. The implementation of the regulations, however, has been kept on hold until further directions from the Central Bank.

Circular No. 16/93 issued by the Central Bank governed large exposures incurred by banks. Large exposures were funded exposures. Banks were restricted from exceeding the maximum exposure per client or group. Circular No. 32/2013 was issued by the Central Bank in November 2013 to replace Circular No. 16/93. Now large exposures include funded and unfunded exposures and unutilised committed lines. Revised restrictions have been imposed with regard to lending to government and government-owned entities. Banks cannot lend sums exceeding 100 per cent of their capital to governments and their related companies or more than 25 per cent to an individual borrower. The rules also prescribe the manner in which different categories of assets are to be risk-weighted. The new Circular allows banks five years within which to bring their exposure within the limits prescribed by the circular.

The Central Bank has also issued specific circulars on capital adequacy requirements for banks in the UAE. Until 1993, all commercial banks were required to maintain a capital-assets ratio of 1:15, which was widely regarded as 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-assets ratio of 10 per cent.

In 2012 a circular was issued by the Central Bank to restrict mortgage loans to expatriates to 50 per cent of the value of a first home, and 40 per cent of the value of a second home. Loans to UAE nationals were capped at 70 per cent of the value of their first home and 60 per cent of their second home. At the request of the banks, the circular was reconsidered by the Central Bank and was reissued in October 2013. As reissued, the mortgage caps have been revised and banks are now permitted to grant mortgage loans to expatriates up to 75 per cent of the value of a first home, and up to 60 per cent of the value of a second. Loans to UAE nationals are capped at 80 per cent of the value of their first home and up to 65 per cent of the value of the second. If the value of the first home exceeds 5 million dirhams, the mortgage loan cap applicable to an expatriate and a UAE national is 60 per cent and 65 per cent respectively.

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. There are quarterly reporting requirements in respect of capital adequacy. The DFSA conducts themed reviews on a regular basis; previous reviews have focused 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. Recent reviews also looked at client take-on processes and suitability assessments.

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 I jurisdictions.

IV CONDUCT OF BUSINESS

i UAE

Local banks have a board of directors, a 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.

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.

There is currently little or no regulation of bank holding companies or subsidiaries.

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 from the Central Bank to changes in directors, senior management, shareholders (holding over 5 per cent equity), constitutional documents and capital.

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.[2] 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 12 principles, the final two 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, and principle 12 (remuneration practices), which states that an authorised firm must have a remuneration structure and strategies that are well aligned with the long-term interests of the firm, and are appropriate to the nature, scale and complexity of its business. 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.

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

2 Note that the principles are set out in the general module of the Rulebook, not the conduct of business module.

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-authorised 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

The UAE Central Bank has taken action to find a fine balance between the exposure risk of the banks and the requirements of the consumers contemplating investing in real estate.

ii DIFC

Recent policy and legislative changes in the DIFC include: the revamping of the markets regime to better align with the European Union's regime; the development of a corporate governance regime to align the governance requirements with international standard setters, particularly Basel and IAIS; drafting of prudential requirements to implement the Basel II and III framework; the introduction of a regulatory regime for credit rating agencies; and the enhancement of the DFSA's shariah governance regime.

VIII OUTLOOK AND CONCLUSIONS

As international standard-setters continue to upgrade their regimes it is anticipated that the DFSA will further amend the DIFC regulatory landscape to ensure closer adherence to those international standards. In addition, the banks and the financial institutions in the UAE will soon be required to comply with the US Foreign Account Tax Compliance Act (FATCA). The US and the UAE governments are likely to execute the FATCA Intergovernmental Agreement Model 1 in the near future. Once implemented, banks will be required to allocate sufficient resources towards FATCA compliance.

For its part, the Central Bank has taken various steps in the past three years in an effort to avoid the excessive leveraging that greatly affected the severity of the downturn of the UAE economy in 2009.

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 banks and leading multinationals in banking, financial and corporate transactions in the UAE and abroad. He specialises in banking and financial services including project finance, syndicated loans, treasury products and Islamic banking transactions.

Mr Khan has considerable experience in undertaking conventional, Islamic and private banking transactions. 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

Mr Walker regularly advises on financial services regulation, corporate finance, mergers and acquisitions and employment matters. Mr Walker leads the field in advising parties during Dubai Financial Services Authority (the DFSA) investigations and where necessary, negotiating settlements on their behalf. He was instructed by the first authorised firm to be fined by the DFSA and has since gone on to advise in connection with the majority of all DFSA investigations resulting in a public outcome.

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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