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September 26, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **United Arab Emirates—Financial System Stability Assessment**

This paper provides background information to the staff report on the 2001 Article IV consultation discussions with the United Arab Emirates (SM/01/233, 7/19/01), which is tentatively scheduled for discussion on Friday, October 12, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the United Arab Emirates indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Abrams (ext. 38822) and Mr. Bartholomew (ext. 39721).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, October 4, 2001, and to the Arab Monetary Fund, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

UNITED ARAB EMIRATES

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and the Middle Eastern Departments

Approved by Stefan Ingves and Paul Chabrier

September 25, 2001

The Financial System Stability Assessment is based on the work of the joint IMF-World Bank mission that visited the United Arab Emirates (U.A.E.) as part of the Financial Sector Assessment Program (FSAP) February 10–22, 2001 and March 31–April 12, 2001. Meetings were held with the senior management and staff of the Central Bank of the United Arab Emirates (CBU), the Ministry of Finance and Industry, the Ministry of Economy and Commerce (MOEC), and the Ministry of Justice, as well as with representatives of various banks, insurance companies, securities exchanges, securities clearing houses, securities firms, money exchange houses and professional associations, the legal and auditing professions, and Dubai Internet City. The findings of the FSAP mission were discussed with the authorities on May 28, 2001 in the context of the 2001 Article IV mission.

The mission team included Richard Abrams (Mission Chief, IMF/MAE), Patrick Conroy (Deputy Chief, WB/FSD), Philip Bartholomew (IMF/MAE), Jesper Dockir (Financial Services Authority (FSA), Denmark), Tomas Hladek (Czech National Bank), Peter Kyle (WB/LEG), Rodney Lester (WB/FSD), Gareth Rees (FSA, United Kingdom), Andrea Schaechter (IMF/MAE), John Wilson (IMF/MED), and Susana Otero (assistant, IMF/OMD).

The U.A.E.'s financial sector and financial sector supervision are developing unevenly. The financial sector is dominated by well-supervised banks, which pose minimal near-term systemic risk. While the payment systems are simple and far from state-of-the-art, they are well managed, and systemic risks are limited. On the other hand, the insurance and securities industries are less developed and vulnerable, and there is a pressing need to strengthen supervision in both sectors. Neither sector is, however, systemically important at this time. The legal framework is generally sound, but needs to be modernized, and legal and regulatory clarity improved.

The report is divided in two sections. The first presents a staff report on the main findings and overall assessments, while the second provides summary assessments of observance of standards and codes in banking, payments, and transparency in monetary policy, banking supervision, and payment system oversight.

The main authors are: Messrs. Abrams and Bartholomew, and Ms. Schaechter (all IMF).

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List of Acronyms

ADIA	Abu Dhabi Investment Authority
ADSM	Abu Dhabi Securities Market
BCBS	Basel Committee for Banking Supervision
BCCI	Bank of Credit and Commerce International
BCP	Basel Core Principle
BoD	Board of Directors of the CBU
CBU	Central Bank of the United Arab Emirates
CCS	Check Clearing System
CDs	Certificates of deposits
CP	Core Principle
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
DFM	Dubai Financial Market
FATF	Financial Action Task Force
GCC	Gulf Cooperation Council
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
ISIS	Insurance Supervision Principles of the International Association of Insurance Supervisors
IT	Information Technology
LIBOR	London Interbank Offered Rate
MFP Code	Code of Good Practices on Transparency in Monetary and Financial Policies
MOEC	Ministry of Economy and Commerce
MOFI	Ministry of Finance and Industry
NBAD	National Bank of Abu Dhabi
NPL	Non-performing loans
OTC	Over-the-counter
ROA	Return on assets
ROE	Return on equity
RTGS	Real-time gross settlement system
Securities Authority	The Emirates Securities and Commodities Market and Authority
SRO	Self-regulatory organization
TTTS	Testkey Telex Transfer System
U.A.E.	United Arab Emirates

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. EXECUTIVE SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **The development of the financial sector and of financial sector regulation and supervision has been uneven in the United Arab Emirates (U.A.E.).**[1] The financial sector is dominated by a well-established banking industry, which is effectively supervised, and systemic risk in the sector appears to be well contained over the near term. Systemic risks in the payment systems are also well contained. Risks in the insurance and securities sector appear greater; on the other hand these sectors are small, and at this time are not seen as systemically important. Weaknesses in the supervisory structures in both the insurance and the securities sector give particular cause for concern.

2. **The U.A.E. has used its wealth to cushion financial sector shocks and has the authority to recapitalize systemically important financial institutions, but always while imposing strict measures to contain moral hazard.** As a result, the financial system appears to be quite resilient to systemic shocks in the near term. Instead, systemic risks are likely to emerge over the medium term as the financial system further develops and evolves through the expansion of capital markets, changes in communication and computer technology, and possibly the entry of new banks.

3. **The banking system appears strong.** Banks are broadly profitable and show signs of improving credit quality. Banking products are generally simple, and bankers appear to understand the risks they undertake. To test the resilience of the banking system a series of stress tests were conducted. The tests indicate that only substantial deterioration in loan quality could lead to problems in some banks. Other tests raised less cause for concern. If the peg to the U.S. dollar is maintained, banks' exchange rate risk is minimal, but even if the peg were changed unexpectedly—which is most unlikely—the risk to banks would be small. In addition, banks face little interest rate risk, since most assets are short term and well matched to their liabilities, and the system has ample liquidity—more than enough to weather a serious liquidity crisis. Nevertheless, care will be needed to ensure that the banks, and bank policies, keep pace with the evolution and development of the U.A.E.'s financial sector.

4. **The banking sector is buttressed by strong banking supervision.** This function at the Central Bank of the U.A.E. (CBU), which was upgraded in the mid-1990s in part as a response to certain significant failures, was found to be well managed, staffed by competent professionals, and fully or largely compliant with most Basel Core Principles (BCPs). Indeed, in many cases actual practices appeared more up-to-date and detailed than the underlying regulations and circulars. While weaknesses were identified, the systemic threats from these shortcomings were minor. The two improvements that were seen as being of the highest priority under current economic and financial conditions included: (1) enhancing the

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[1] For a summary of recommendations, see Section V.

supervision of groups containing banks, insurance companies and securities firms through regular contact between the CBU and other financial sector supervisors, and by ensuring that the CBU has assured access to the prudential returns of financial companies in such groups; and (2) establishing procedures to pre-approve stock holdings in banks exceeding 5 percent of outstanding shares. In addition, thus far, the CBU has conducted many important activities (licensing, crisis resolution, payment system overdrafts) on an hoc basis; however, should the banking sector become more dynamic, the CBU will need to deal with such activities in a more structured manner.

5. **Domestic securities markets are small and undeveloped, and have been plagued with problems, such as insider trading.** Until recently, all securities trading was over-the-counter, although formal securities exchanges were opened in Dubai and Abu Dhabi in 2000. Trading on the new exchanges is light, and only a portion of traded shares are listed on either of the exchanges.

6. **Securities regulation is at an early stage of development. A new securities law was introduced in 2000, largely in response to serious market difficulties in 1997 and 1998.** The law created the Emirates Commodities and Securities Authority (Securities Authority), and required all shares to be listed on a licensed exchange and dematerialized. While the Securities Authority has issued the regulations as specified in law, trained operational staff have not been hired, and it has yet to receive a budgetary allocation. The slow start up of the Securities Authority has hurt market confidence. There is also a need to rationalize the regulatory responsibilities of the various ministries and organizations with purview in the securities sector, including the Securities Authority, the CBU, the Ministry of Economy and Commerce (MOEC), and the securities markets.

7. **The insurance sector is small, reflecting the U.A.E.'s small population, an underdeveloped life insurance markets, and government provision of pensions.** The domestic companies are largely involved in non-life classes, and two foreign branches dominate the area of life insurance. Generally, the major U.A.E. insurers and the leading foreign life insurers are sound and well capitalized, while the financial position of certain other categories of insurers may be more problematic.

8. **Insurance supervision is weak.** Supervision is carried out by the Insurance Companies Division (ICD) of the MOEC. The ICD lacks the capacity to effectively carry out its supervisory function. There is no designated Insurance Commissioner, and only 3 of the 17 ICD staff involved in insurance supervision (one of whom is the head of the ICD) appear to possess appropriate qualifications and experience. On a related matter, the MOEC has proposed amendments to the insurance law/regulations, which on the whole will represent distinct improvements, but even if enacted, would still leave major gaps in the statutory law (including governance, market conduct, and international cooperation). Accordingly, the authorities need to undertake a full review of the insurance law, before amendments are issued. Constraints inhibiting industry rationalization also need to be reviewed.

9. **The legal framework governing the financial sector is generally sound, and the judicial system works reasonably well.** The Banking Law deals comprehensively with the establishment and powers of the CBU, currency matters, the organization of banking and finance and other matters typically found in central bank legislation.[2] The legislation supporting the commercial sector is also generally satisfactory although it does need to be rationalized, and certain reforms are needed. There is also a need for greater clarity and certainty in the system. A number of specific recommendations were made to improve the legal framework. Some of the more important included: (i) making legal provision for improved minority shareholder rights; (ii) improving corporate governance provisions and simplifying company formation procedures; (iii) developing better registration procedures for movable property; and (iv) clarifying the law relating to the ownership, transfer, and charging of real estate.

10. **The assessment of observance of the *Core Principles for Systemically Important Payment Systems* (CPSIPS) found that, while the two systemically significant payment systems, the check clearing and the Telex Transfer systems, were simple and far from state-of-the-art, they worked well.** The staff felt that these systems were sufficiently secure, and concluded that risks were reasonably well controlled. Problems could, however, arise if volume increases, since the payment systems rely heavily on manual procedures. Another potential vulnerability is the CBU's practice of granting unsecured overdrafts to banks, although the CBU limits the associated risk through strict internal credit review procedures and a high penalty rate. Nevertheless, these risks could be better controlled by requiring that all such lending be against proper collateral. Over the medium term, a move is advisable to a more advanced automatic system that would give the payment system both increased capacity and greater protection from operational risks, including moving from a T+1 system for check settlement (that is, settlement the day after presentation) to same day settlement.

11. **The authorities take money laundering very seriously.** The practice is statutorily illegal in the U.A.E., and the authorities understand their responsibilities for eliminating it. Concerns arise, however, because of the country's leadership position in the gold trade and money remittances—two markets that are perceived as vulnerably to money laundering—as well as its high level of activity in trade and financial reflows coupled with its policy of open and free capital flows.

12. **The CBU is in the process of formalizing anti-money laundering regulations consistent with the existing statute for institutions in its jurisdiction.** These new regulations are predicated on the principle of "know-your-customer" and are enforced through use of "suspicious activity reporting" and transactions-based examination, particularly of banks and money changers. Originally, this was to be introduced as part of the new Banking Law, but to expedite implementation, the authorities are now planning to

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[2] The UAE is in the process of finalizing a new banking law.

introduce the same changes as an amendment to the existing Law. In addition, the gold industry—including bullion and jewelry purchases and sales—is heavily regulated by local emirate law enforcement agencies, with know-your-customer rules and receipting of all transactions.

13. **The U.A.E. has successfully resolved several bank failures in its 30-year history. Since the mid-1980s nine institutions were resolved.** In eight cases, this involved either merging several institutions or reconstituting a single one into a new entity, while the one other case was a liquidation. In all cases, supervisory intervention involved replacement of management. Most bank failures involved some CBU liquidity support, which was provided at a penalty rate. In the eight non-liquidation cases, some form of recapitalization—either by existing shareholders, new shareholders, or a government authority—was involved. In all cases, the resolution process was ad hoc, but the necessary bridge financing was made available and supervisory change-of-control intervention was swift and severe so that the process of allocating losses could therefore be deferred.

14. **The authorities have expressed a clear aversion to deposit insurance, even though the Bank of Credit and Commerce International (BCCI) liquidation did involve a limited depositor protection plan for small accounts.** While the failure resolution process lacks transparency, the public is aware of both the special case depositor protection plan and unprotected creditor losses.

15. **The financial system has ample liquidity, although arrangements for its provision can be complex.** There is no domestic government securities market other than for certificates of deposit issued by the CBU, which are in principle, but not in practice, tradable among banks. The domestic securities market is underdeveloped, but banks have access to foreign securities markets, and banks hold foreign government securities. The interbank lending market is extensive, but much of the activity is with foreign banks. A secondary market for securities would enhance system liquidity, but this development is not expected to occur to any significant degree in the foreseeable future.

16. **The staff assessed the U.A.E.'s observance of the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (Transparency Code) in the areas of monetary policy, banking supervision, and payment systems.** The findings were mixed. The CBU observes most good transparency practices in conducting monetary policy and banking supervision, but some important transparency practices still need to be improved. Transparency practices in payment systems operations are even weaker. One weakness, which also applies to other financial sector supervisors, is the need to more actively seek inputs from stakeholders when contemplating changes in laws, regulations, technical requirements, policies, or otherwise. In addition, to improve transparency, the CBU should publish more information on itself and its operations, including regularly publishing information on its responsibilities and activities, and reporting more detailed data, including details on the balance sheet of the CBU, and data on monetary operations and the financial sector. The central bank should also help ensure that market participants have access to full sets of its circulars, notes, and regulations, possibly by placing them on its new website.

II. Macroprudential Environment and Overview of Financial System

A. Economic and Macro Environment

17. **The U.A.E. has, on average, achieved strong growth in recent years, as resources have been directed into infrastructure and development.** Crude oil output, the main export, ranged between 2.1 million and 2.4 million barrels a day during the last half of the 1990s,[3] with annual export values ranging from US$9.4 billion up to US$19 billion. Although oil remains a significant pillar of the economy, its share in real GDP has gradually reduced to about 30 percent.

18. **The authorities have consciously diversified the economy.** The U.A.E. has developed its natural gas reserves and its aluminum industry—the two largest non-oil producing sectors of the economy. There are also a variety of industrial and financial ventures, especially in several free zones scattered around the country, many gold and jewelry enterprises, some agriculture, and active trade and shipping activities, including re-exports to neighboring countries. Tourism is increasingly important and actively sought.

19. **Although balance of payments statistics are not well developed, the U.A.E. usually enjoys a current account surplus, and central bank reserves tend to rise year by year.** The external assets of the Government of Abu Dhabi, which are administered by the Abu Dhabi Investment Authority (ADIA, Box 1), are substantially larger than the CBU holdings, and the U.A.E. government has negligible external debt, while public domestic debt is mainly bank borrowing by a few emirates.

Box 1. The Abu Dhabi Investment Authority

ADIA is owned by and an agent of the Government of Abu Dhabi, and is charged with managing financial assets belonging to the emirate, which it invests with an eye to capital preservation. Details of ADIA's operations are not published, but some aspects of its operations are known: (1) most of its assets are invested abroad, and are broadly diversified globally and by type of investment; (2) it also has sizable investments in several banks and other financial institutions in the U.A.E.; (3) its domestic investments are governed by the profit motive, although from time to time, the Government uses ADIA's resources to support fiscal operations.

The size of Abu Dhabi's assets as well as its willingness to deploy them, including those of ADIA, to help support the financial sector have contributed to both global confidence in the stability of the U.A.E.'s financial system and its ability to withstand financial shocks when they do arise.

[3] This figure includes condensates, which are not covered by the quotas.

20. **Inflation has remained low, usually in the 2–3 percent range** (Table 1). This is not surprising given the U.A.E. dirham's long-standing peg to the U.S. dollar, and the very open nature of the economy. There are few capital controls, and the dirham is freely convertible.

21. **The CBU is responsible for monetary policy, banking supervision, and the domestic payment system.** CBU monetary policy is based on maintaining the dirham's peg to the U.S. dollar, which, in turn, has imposed major constraints on monetary policy. Interest rates in the U.A.E. closely follow developments in dollar markets, as would be expected. Monetary growth generally is in moderate ranges, and usually is driven by credit demand in the private sector.

B. The Financial System

22. **The U.A.E. financial system chiefly comprises commercial banks, money exchange houses, insurance companies, and securities firms.**[4] There are no bank or financial holding companies, but there is some cross-over activity—chiefly through commercial bank ownership of downstream subsidiaries. The financial system is dominated by commercial banks. Restrictions on insurance companies include a requirement that 35 percent of their domestic assets be held in deposit accounts with commercial banks, although in practice this figure is closer to 50 percent. There is no government bond market, and efforts to start a capital market are at an early stage, and have been hampered by several serious cases of market malfeasance, including extensive insider dealing.

23. **The Banking Law (Union Law No. 10 of 1980) specifies that the CBU has jurisdiction over commercial banks, investment banks, financial institutions, monetary and financial intermediaries, and representation offices.** The CBU does not have jurisdiction over public credit institutions set up by law. Pursuant to the Securities Law, the securities industry is regulated by the recently established (but yet to be fully operational) Securities Authority, whose governing body comprises representatives and nominees from several ministries and the CBU. The MOEC supervises the insurance industry.

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[4] The description in this section focuses primarily on commercial banks, with brief mention of the insurance and securities sectors, and the payment systems. For more details on the insurance and securities sectors see Sections III.C and III.D, respectively; for money changers see Section III.E, and payment systems see Part II, Section III and IV.E.

Table 1. U.A.E.: Financial Soundness Indicators

(In percent, unless indicated otherwise)

	1996	1997	1998	1999	Prel. 2000
Economic growth					
Real GDP	4.9	8.1	0.3	0.5	5.8
Oil	0.0	7.2	-7.5	-4.5	6.5
Non-oil	7.8	8.6	4.5	2.9	5.5
Balance of payments					
Current account balance to GDP	8.1	8.2	-4.8	0.5	9.9
Share of crude oil exports in total exports	38.9	35.4	27.7	31.8	40.4
Central Bank foreign assets in months of imports	3.6	3.6	3.7	4.1	4.9
Central Bank foreign assets to total bank foreign liabilities	80.9	68.6	64.0	73.1	95.8
Central Bank foreign assets to M1	135.9	123.9	122.9	132.8	149.0
Central Bank foreign assets to base money	216.4	209.5	210.4	199.8	250.2
Exchange rate					
Dirham/US$ (end of period)	3.6710	3.6725	3.6725	3.6725	3.6725
Money and Credit (Changes in percent of beginning M2 stock)					
Broad Money (M2)	6.9	9.0	4.2	11.4	15.3
Foreign assets (net)	-0.6	-1.2	0.4	4.3	19.2
Domestic assets	7.4	10.3	3.8	7.1	-3.8
Inflation					
Consumer price index growth (period average)	2.6	2.1	2.0	2.0	2.0
Interest rates					
Lending rate (business loans, period average)	9.7	9.5	9.0.	10.6	9.6
Real interest rates 1/	2.1	2.5	2.8	3.6	4.7
Interest rate spread against U.S. dollar (in basis points) 2/	21.4	22.1	23.3	18.1	7.8
Banks and bank capital					
Commercial banks' capital to assets ratio 3/	20.8	19.4	20.0	20.5	20.2
Number of banks 4/	46	46	47	49	47
Lending					
Bank lending to private nonbanks to GDP	46.2	50.1	60.9	59.2	55.0
Foreign currency denominated lending to total lending	19.6	19.4	19.4	19.8	22.7
Asset quality					
Gross nonperforming loans/gross loans	15.2	14.4	13.5	13.6	12.7
Loan loss reserves/non-performing loans	88.6	89.6	89.5	86.1	86.0
Management efficiency					
Total expenses to total revenues	35.0	36.3	35.4	38.3	37.5
Earning per employee (in millions of AED)	0.25	0.27	0.28	0.23	0.27
Earnings/profitability					
Return on assets, commercial banks	1.9	2.0	2.0	1.5	1.8
Return on equity, commercial banks	17.1	18.3	17.7	12.8	14.9

	1996	1997	1998	1999	Prel. 2000
Average interest rates spread (in percentage points) 5/	4.4	4.5	4.5	4.5	4.5
Liquidity					
Maximum interbank rate spread (in basis points) 6/	5.6	5.7	5.3	6.3	6.7
Liquid assets to total assets	37.3	38.0	34.5	31.3	34.8
Deposits to M2	92.2	92.2	91.7	90.7	92.1
Foreign currency deposits to M2	19.9	19.6	20.0	21.2	22.4
Banks loans to private nonbanks to total deposits	101.5	106.0	116.8	113.6	105.4

Sources: Central Bank of the United Arab Emirates and staff estimates.

1/ Difference between average 3-months deposits rate (before 1998 time deposits rate) and inflation rate.
2/ Spread between one-month CBU CDs and one-month LIBOR (average; in basis points).
3/ BIS Tier I plus Tier II capital (net of deductions) to risk-weighted assets.
4/ Includes the one restricted-license bank.
5/ Difference between interest rates on local currency deposits and loans.
6/ Highest observed spread between 3-month local currency interbank rates for different banks.

24. **The banking sector is well capitalized, and profitable, and bank managers seem to have a good grasp of the risks faced**, although the strategy of some banks is to limit risk rather than to manage it (also see paragraph 33 for more detail). The banking system comprises 311 bank offices (headquarters offices plus branches) of 20 domestic commercial banks ("national banks"), 109 offices of 26 branches of foreign banks ("foreign banks"), and 213 offices of money changing houses, as well as a limited number of licensed specialized institutions (see Table 2). The structure of the sector has been stable for some time, because of a longstanding ban on new foreign entrants and a general desire to avoid mergers. However, there are pressures both to enter the system, since it is profitable, and to consolidate, to further enhance profitability.

25. **Commercial banks, comprising national banks, foreign branches and the money exchange houses, are geographically distributed among the emirates.** With the exception of Ajman, each emirate is home to at least one domestically owned bank. Most of the banks and money exchange houses are headquartered in Abu Dhabi or Dubai.

Table 2. U.A.E.: Structure of the Banking Industry, 1981–2000

	1981	1986	1991	1998	2000
National Banks					
Banks (Head Office)	21	19	19	20	20
Branches	111	138	160	264	291
Foreign Branches					
Banks (Head Office)	28	29	28	27	26
Branches	187	93	91	83	83
Total Number of Banks 1/	50	49	48	48	47
Total Banking Offices	348	280	299	395	421
Population per Office	3,233	5,817	6,406	7,003	7,382
Employees	n.a.	n.a.	9,088	13,679	14,621

Source: Central Bank of the United Arab Emirates.
1/ Includes one foreign bank with a restricted license.

26. **Three commercial banks operate as Islamic banks,** but the demand for Islamic banking services is considerable and some non-Islamic banks are permitted to offer selected Islamic banking products. There is a movement for existing banks to offer greater electronic banking services, and proposals to establish internet banking operations. The range of instruments offered by commercial banks is by-and-large quite simple, with few derivatives used except for simple hedging purposes.

27. **National banks have high levels of interbank deposits, and are net lenders to banks overseas**. At end-2000, national banks had nearly one fourth of their assets in deposits with other banks and almost 10 percent of their liabilities were due to other banks. Much of the interbank lending is placed with banks in other countries; less than 5 percent was due to or due from other national banks. Most of the interbank lending is placed or received in time deposits—typically of maturities around three months.

28. **Of the 20 national banks, 14 have some U.A.E. or emirate government ownership**, though none is wholly owned. Of these 14, five are majority owned, either separately or in combination with the federal authorities, an emirate government, or a ruling family. Minority ownership typically involves a single domestic government entity, but one bank is owned by the governments of three countries. In most cases, government ownership in national banks resulted from the resolution of particular banking sector difficulties.

29. **The U.A.E. has experienced nine bank failures since 1980** (see Section IV.B). There is no explicit deposit insurance system in place and none is planned; although a

formalized scheme was developed and used in the liquidation resolution of BCCI.[5] In other failures, resolution was through merger or recapitalization and most, if not all, resulted in creditors being covered through direct or indirect government payments.

30. **The U.A.E. securities markets are relatively small and undeveloped.** There are two exchanges, which both began operation in 2000. The Abu Dhabi Securities Market (ADSM) which lists the shares of 15 companies and the Dubai Financial Market (DFM) which lists the shares of 12 companies. The ADSM and the DFM each currently have about a dozen trading and clearing members. The DFM and the ADSM each operate their own automated clearance and settlement facilities. Both markets employ floor-based automated trading systems. Some over-the-counter trading still takes place, although the authorities are seeking to phase this out.

31. **There are 47 insurers operating in the U.A.E., including 21 locally incorporated companies (which are totally owned by nationals) and 26 branches of foreign companies**. The domestic companies are largely involved in non-life classes, while the branches of foreign companies dominate life insurance. At end-1999, the domestic insurance industry had net assets of approximately Dh 3.3 billion (with paid up capital of about Dh 1.5 billion). Much of the excess capital appears to be held by the leading Abu Dhabi companies, while some domestic companies, particularly motor insurance underwriters outside of Abu Dhabi, appear to be less well positioned.

32. **Monetary payment systems in the U.A.E. are operated by the CBU.**[6] The three payment systems are the check clearing system (CCS), the Testkey Telex system (TTS), and the SWITCH payment system (bank cards). All commercial banks licensed to operate in the U.A.E. are members of the CBU-operated payment systems. The first system is a paper-based settlement system that clears on T+1. Settlement through testkey telexes is on a same-day gross basis, but it is not a real-time system, since transactions are not necessarily irrevocable. SWITCH is the electronic net card clearing system. The CCS and TTS are systemically important for the economy. The TTS has the largest value of transactions and the SWITCH system has the largest number of transactions. However, securities clearing and settlement is conducted through facilities operated by the respective securities markets, the DFM and the ADSM, and overseen by the Securities Authority.

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[5] In the BCCI case, only creditors having deposit account balances of less than Dh 20,000 received full repayment. For accounts with balances exceeding Dh 20,000, creditors received partial repayment based on liquidation recoveries.

[6] The payment systems are not regulated by a specific "payments law," but the authority to operate the payment systems is derived from the Banking Law.

III. Financial System Risks and Vulnerabilities

A. Performance Measures of the Banking Sector

33. **The U.A.E.'s banking sector shows strong performance in asset, deposit, lending growth, asset diversification, capitalization, profitability, and efficiency.** Over the past five years, returns on assets average about 1.8 percent even though banks engage in limited off-balance sheet activities; regulatory capitalization averages about 20 percent (see Table 1) Although banks in the U.A.E. have relatively high levels of NPLs, most of which date back to the 1980s, supervisory efforts have ensured that these credits are identified and heavy provisions are made against them. As of December 31, 2000, gross assets of national banks, foreign branches, and the restricted licensed bank, but excluding overseas branches of national banks, were Dh 276 billion. National banks have held three-fourths of total assets over the past three years, with the largest national banks accounting for about two-thirds of total assets. About 43 percent of assets were held in claims on the private sector; approximately 33 percent were held as foreign assets.

34. **From year-end 1995 through year-end 2000, gross assets of commercial banks and foreign branches grew by over 50 percent, while loan loss provisions increased by less than 15 percent** (Table 3). This led to a six-year growth in net assets of 59 percent. Equity capital (including reserves and capital equivalencies) of commercial banks and foreign branches grew 71 percent during the period 1995–2000. Gross loans and advances to customers during the same period grew 52 percent, while net loans increased 65 percent. Deposit growth, including government deposits, and funds from abroad, was 57 percent.

Table 3. U.A.E.: Selected Assets and Liabilities of Banks, 1995–2000
(In billions of dirhams)

	1995	1996	1997	1998	1999	2000
Gross Assets	181	192	211	235	251	276
Provisions for Loan Loss	26	26	28	29	30	30
Net Assets	155	166	183	206	221	246
Gross Loans	102	106	117	135	147	155
Net Loans	76	80	90	106	117	125
Capital (including current year profits)	23	25	27	31	36	39
Deposits	93	94	99	106	118	143

Source: Data provided by the Central Bank of the United Arab Emirates.

35. **Asset quality, has been improving since the mid 1990s. NPLs have fallen to under 13 percent of gross loans, while provisioning for nonperforming loans stands at a comfortable 86 percent.** This occurred, in large part because of CBU efforts to improve reporting of nonperforming loans and enhanced provisioning.

36. **Banks in the U.A.E. have a fairly diversified portfolio.** About one-third of bank assets are held as foreign assets; another fifth is placed as interbank lending—with a major

portion being placed overseas, while one-half of bank assets are used to fund domestic lending. Banks have placed the greatest proportion of their funds in lending to the retail, wholesale trade, and construction sectors. There is little real estate lending, because most land is owned by the government or royal families, which often restrict land transfer.

37. **Returns-on-assets (ROA) and returns-on-equity (ROE) of national banks are strong.** During the past five years, ROA has ranged from 1.5 to 2.0 percent, while ROE has fluctuated from 12.8 to 18.3 percent. At year-end 2000, two banks reported losses (i.e., net income after provisioning, taxes, and extraordinary items), but both of these were branches of foreign banks.

38. **Commercial banks operate efficiently in the U.A.E.** The ratio of operating expenses to income has been about 35 percent in the last five years. Some bankers attribute this to low wages and salaries. There is, however, a concern that bank staff trained in the U.A.E. will leave the country for higher paying jobs elsewhere, putting upward pressure on the operating expenses of banks in the U.A.E.

B. Stress Tests

39. **As part of the assessment of structural vulnerabilities, stress testing was conducted on the national banking industry in the areas of credit risk, interest rate risk, foreign exchange risk, and liquidity risk.**[7] Detailed data were supplied by the CBU on individual banks and CBU staff cooperated in setting up and designing the stress tests. The results show that national banks, are well provisioned, have low interest rate risk, and low levels of foreign exchange risk, along with ample liquidity.

Credit risk

40. **U.A.E. banks have had considerable experience with bad loans, but improved monitoring and provisioning requirements have contributed to improved asset quality.** While the ratio of gross NPLs to gross loans had fallen to 12.7 percent for all banks at end-2000, the individual ratios varied from close to zero to 60 percent. At the same time, the overall ratio of provisions to NPLs was 86 percent, but the ratios at individual banks varied from 44 percent of classified loans to over 100 percent.

41. **The vulnerability of the national banks at end-2000 was tested with a series of one-period shocks.** A model was used to assess the impact of an arbitrary increase in NPLs

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[7] Consideration was given to modeling an oil price shock, but three factors rendered this exercise problematic. First, sufficient data on the impact of oil prices on NPLs were not available. Second, the banks and the CBU argued that this linkage is weak at best. Third, the government has ample resources available and recent changes in the budgetary process compensate for the impact of such shocks for a year or more, providing time for banks to adjust their portfolios.

on bank capital (measured on a Tier I basis) to illustrate system vulnerability. It was found that NPLs would have to increase by 30 percent—with 100 percent provisioning against the new NPLs—before any national bank exhausted its Tier 1 capital, while a doubling of NPLs, again with 100 percent provisioning against the new NPLs, would cause six national banks to become insolvent. If, on the other hand, NPLs were assumed to increase with provisioning at present-day proportion of 86 percent, a 30 percent increase in NPLs still would cause one failure, while a 100 percent increase would cause only four bank failures.

Interest rate risk

42. Banks in the U.A.E. typically try to match the maturity structure of their interest sensitive assets and liabilities, but as an industry, national banks take a net position. A repricing-gap model was applied to U.A.E. national banks reflecting their position at end-2000.[8] The CBU collects data with interest rate buckets chiefly designed for less than one-year maturities. Results show a cumulative gap for interest rate sensitive assets and liabilities for up to one year is minimal, only about Dh 34 million for the industry. Based on these data, the estimated net impact of a 1 percentage point increase in interest rates is minimal, approximately equal to a 1.6 percent increase in national bank capital. At the micro level, six national banks would experience a reduction in net interest income from an increase in interest rates, while 14 national banks would gain in net interest income.

Foreign exchange risk

43. **Most foreign exchange operations for U.A.E. national banks are in U.S. dollars, and the U.A.E.'s peg to the U.S. dollar is viewed as credible.** The U.A.E. has ample foreign currency reserves to maintain the peg or to at least not shock the markets in the unlikely event the peg would be altered or abandoned. Moreover, all U.A.E. economic units have strong incentives to maintain the present structure. Empirically, the exchange rate regime has been firmly in place, with only minor adjustments, since 1980. Nevertheless, for completeness, stress tests were made on the impact of an unexpected 20 percent depreciation of the dirham against the U.S. dollar, and an unexpected 20 percent appreciation. Since most banks are long in U.S. dollars, a depreciation would help banking system profitability, and no bank would even have its current year's income wiped out. A surprise appreciation would, however, wipe out the annual income of three banks. The risk-weighted capital ratios of two of these banks would also fall to under 10 percent, with one's falling to 2 percent.

44. **Exposure to foreign exchange rate risk in other currencies is limited.** The banking system as a whole has a net open foreign currency position in non-U.S. dollars of

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[8] A repricing-gap model constructs the gap between interest rate-sensitive assets and interest rate-sensitive liabilities for each of several maturity buckets. The cumulative gap measures the cumulative change to the difference between asset and liability maturity categories as the maturity increases.

less than 2 percent of capital. No national bank has an open foreign currency position of more than 20 percent of capital, with all but two having positions of less than 5 percent for an individual currency and for their entire exposure to non-U.S. dollar currencies. Bank foreign currency positions have been relatively stable. Assuming a worst case scenario where banks experienced a 25 percent appreciation on short positions and a 25 percent depreciation on long positions, the banking industry would lose less than 2 percent of capital, and no banks would suffer annual losses.

Liquidity risk

45. **National banks in the U.A.E. are reasonably liquid, with funds and placements largely with banks abroad.** At end-2000, national bank holdings of cash, assets with the CBU, and funds due from other banks cover nearly three-fourths of customer deposits and funds due to other banks. Most liquid assets are placed with non-resident, international banks.

46. **To assess the effects of deposit withdrawals, a 15 percent shock to customer deposits was assumed.** The magnitude of this shock is similar to the biggest deposit shock the U.A.E. has faced, when deposits fell 16 percent during July–August 1990. Such a scenario would reduce the liquidity ratio of the five large banks by about 11 percentage points, but would have only a marginal impact on the liquidity ratio.[9]

C. Securities Markets

47. **The U.A.E. securities markets are relatively small, underdeveloped and not systemically important.** While securities have been traded in the U.A.E. since the 1970's, prior to 2000 this activity was conducted primarily through an informal, and unregulated, over-the-counter (OTC) market. The absence of effective regulation and reliable and accurate market information, combined with the closely held nature of many of the publicly held companies, created a perception that the market was susceptible to abuse by insiders as well as other forms of market malpractice. Following market disruptions in 1997 and 1998, the U.A.E. authorities decided that an effective regulatory regime was needed to address the negative market perceptions and improve the integrity of the markets.[10] This concern

[9] The liquidity ratio is the sum of banks' cash assets with the CBU and due from banks to the sum of customer deposits and due to banks. Interbank deposits with over three months to maturity are excluded.

[10] During 1997 and 1998, the U.A.E. securities markets were characterized by extreme price volatility. It was believed that market manipulation and insider dealing contributed to this condition, as well as the availability of 100 percent margin financing provided by many commercial banks. The financial positions of many brokers and investors were severely eroded during this period, forcing many out of the markets completely. As a result, restrictions were placed on commercial banks with respect to margin lending.

prompted the enactment of Federal Law No.(4) of 2000 concerning the U.A.E. Securities and Market Authority and the creation of the Securities Authority. The loss of investor confidence precipitated by these events has yet to be restored, and market activity remains minimal.

48. **In response to the above events, in March 2000, the Dubai Financial Market (DFM) commenced operations.** This market is owned by the emirate of Dubai, and its Board of Directors comprises government officials and industry representatives. No members of the DFM are on the Board. Only the shares of Dubai companies are traded on the DFM.

49. **In November 2000, the Abu Dhabi Securities Market (ADSM) was established.** The nature and scope of the governance and organizational structures as well as the operations of ADSM are similar to those of the DFM. Currently, the only shares eligible for trading on the ADSM, are those of Abu Dhabi companies. In late summer 2001, steps were taken to link the exchanges and to develop a share index.

50. **As of April 2001, U.A.E. market capitalization was equivalent to about 37 percent of GDP.** Ninety-three joint stock companies have issued shares to the public of which perhaps half might be considered liquid. The shares of 15 companies are listed on the ADSM and the shares of 12 companies on the DFM. The ADSM has 11 trading and clearing members, and the DFM has 12. Of the total market capitalization, roughly Dh 27 billion can be attributed to shares traded on the DFM (approximately 33 percent) while roughly Dh 14 billion can be attributed to shares traded on the ADSM (approximately 16 percent). The shares of the 66 unlisted companies continue to be traded over-the counter.

D. Insurance

51. **The insurance industry appears well capitalized on an aggregate basis and there is little or no systemic risk arising from the sector to the banking industry or the overall economy.** Some companies (mainly outside Abu Dhabi) are, however, exposed to highly competitive retail insurance classes such as motor insurance. While the non-life market accounted for about 80 percent of the Dh 2.7 billions of the industry's premium income in 1999, non-life premiums have been static in recent years, while life insurance premium income increased by more than three fold in the 1990s.

52. **Most industrial and commercial risks, which are mainly written by national insurers are reinsured, with premium retention ranging from 7 percent for fire to 13 percent for transport-related classes.** Thus the insurers essentially act as agents and are able to collect low risk fees, in the form of commissions from the reinsurers. During 1995–1999, the average ratio of claims to premiums (or loss ratio) was 50 percent for fire and 54 percent for transport, and no adverse trends are emerging.

53. **The smaller risks such as motor, personal accident and theft, which can form a viable local portfolio, have higher retention levels**. Approximately 60 percent of the overall accident and liability class premiums are held in the U.A.E. These retained classes,

and motor in particular, are currently areas of heavy competition, and loss ratios have been increasing, rising from 56 percent in 1994 to 77 percent in 1999.

54. **The U.A.E. insurance non-life market is overcrowded, particularly in the highly competitive motor market, and the supervisor is attempting to force rationalization by raising minimum capital levels.**[11] There appear to be, however, substantial nonfinancial reasons inhibiting mergers and withdrawals. In addition, there has been a moratorium on the entry of foreign insurers since 1986.

55. **The life insurance market has been growing, and the market share of foreign life insurers has been large and stable.** The market share held by foreign branches rose from 58 percent to 71 percent over the 1991 to 1994 period and has been above 70 percent ever since, most life insurance policies are sold to professional expatriates.

56. **Asset risk is a mixed story. Insurer deposits with banks (required to be at least 35 percent of "technical" liabilities) have been gradually reduced as a proportion of investments, from a high of 75 percent in 1995 to 50 percent in 1999.** The bulk of the balance is held in relatively risky equity style investments, reflecting limited access to the secure negotiable debt instruments that underpin most insurance asset portfolios elsewhere. However, foreign life insurers in practice may invest up to 100 percent in funds backing foreign currency policy liabilities offshore (many of which are investment linked and carry little liability risk for the insurer).[12]

57. **The domestic industry is already heavily capitalized in aggregate and the new rules on capitalization will probably further increase capital in the sector.** Allowing for a minimum Dh 50 million, or Dh 100 million for 21 national insurers (depending on whether they write one or both of life and non-life) would result in a minimum capital of approximately US$400 million for a net premium income of approximately US$190 million.

E. The Remittance Industry and Money Changers

58. **The U.A.E. has a long history of money changers engaged in foreign exchange and remittances, both locally and within the region.** Remittances are a form of third party payment system whereby an individual may transmit money to a second party within the U.A.E. or to and from other countries. These services are used heavily by the U.A.E.'s large expatriate community, as well as consumers in many other countries. While many countries prohibit money changers, the U.A.E., as do all Gulf countries, licenses, regulates, and supervises the industry in the U.A.E. through the central bank. The industry comprises 100 houses with 212 offices throughout the country. As of December 1999, the exchange

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[11] Under a 1995 decree, minimum capital for life and non-life separately is being raised in two tranches from Dh 10 million to Dh 50 million by mid-June 2001.

[12] Although this does not seem permissible under a strict reading of the insurance law.

houses held assets of Dh 566 million backed by capital of Dh 211 million. In 1999, the industry earned Dh 86 million.

59. **Money changers use banks, other exchange houses, or agents related to all sorts of financial or real sector enterprises to receive and take remittances.** While the system may appear informal on the surface, its contractual arrangements are formal and U.A.E. money changers offer foreign exchange services, brand-name travelers checks, and wire transfers. The business is well established and has a reputation for inexpensive remittances and low charges for exchanging foreign currencies. Money changers cannot accept deposits, and the money they remit is treated as an account payable. Most balance sheet activity relates to receivables and payables associated with the transfer of money balances.

60. **Some of these institutions are privately and/or closely held.** Others have substantial or full ownership by banks in other countries within the region—typically from countries receiving high volumes of business. All transactions must receive a receipt. Computerized records are maintained to show all transactions and are subject to supervisory scrutiny. The size of payments is typically small, but some larger, business-related remittances are handled. "Know-your-customer" procedures and suspicious activity surveillance is used to monitor transactions.

F. Money Laundering

61. **In the view of the U.A.E. authorities, money laundering has traditionally been closely connected to narcotics and gambling and they see an effective fight against these activities as the cornerstone to counteracting money laundering.** The fight against money laundering has until recently mainly been regulated through the Federal Law on Fighting Narcotics and Psychotropic Substances No. 14 of 1995, supplemented with an extensive "know-your-customer" regulation for banks.

62. **Recognizing that technological developments have broadened the scope of money laundering techniques, the authorities created the National Anti-Money Laundering Committee under the chairmanship of the Governor of the CBU.** The Committee consists of representatives from a number of ministries (justice, finance, and economy) and from the banking sector and foreign exchange dealers. Its main objective is to identify ways to prevent money laundering, to issue regulations on the subject, and to coordinate preventive efforts among U.A.E. authorities.

63. **The CBU has issued regulations concerning money laundering, and the forthcoming revision to the banking law, as well as a proposed amendment to the existing law, contain further anti-money laundering measures.** The CBU regulatory and supervisory approach is predicated on the strong application of the know-your-customer principle and is enforced through use of "suspicious activity reporting" and transactions-based examination, particularly of banks and money changers.

64. **The U.A.E.'s role as an important transit country for traded goods and for many gold dealers makes the country vulnerable to money laundering efforts.** The gold

industry, including both bullion and jewelry purchases, is heavily regulated by local emirate law enforcement agencies—with know-your-customer principles and receipting of transactions. One area of particular concern to the gold and remittance industries is that because capital flows are unrestricted, outflows are not as well scrutinized as inflows.

65. **The U.A.E.'s efforts to attract further trade and financial services by establishing free-trade zones and possible offshore banking can increase the risk of entrepreneurial money launderers.** To address this, expanded efforts in regulation and supervision could prove necessary. Weak supervision of insurance companies and other nonbank financial institutions may also increase the risk of money laundering.

IV. Adequacy of Risk Management Arrangements

A. Prudential Oversight of Securities and Insurance

66. **The legal, regulatory, institutional, and operational framework applicable to the oversight of the financial system was reviewed and, assessments were made of the degree of observance of selected international standards or best practices.** This included assessing the banking supervision function using the *Basel Core Principles for Effective Banking Supervision* (BCP); the payment systems with *the Core Principles for Systemically Important Payment Systems* (CPSIPS); and the transparency practices in monetary policy, banking supervision, and payment systems with the *Code of Good Practices on Transparency in Monetary and Financial Policies* (Transparency Code). The findings are summarized in Section II of this report. However, summaries of the findings with respect to the regulation and oversight of the securities and insurance sectors are presented below, because the mission decided it was not appropriate to make technical assessments of compliance with the *Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions* (IOSCO) or with the *Insurance Supervision Principles of the International Association of Insurance Supervisors* (IAIS).[13]

Securities regulation and oversight

67. **Securities regulation is at a very early stage of development in the U.A.E.** Accordingly an assessment using the IOSCO's Objectives and Principles of Securities Regulation was not seen as useful. However, the authorities have indicated that the development of the capital markets, and in particular the securities markets, is an important initiative.

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[13] However, these principles are used as a backdrop for the analysis of the securities and insurance sectors in sections III C. and III D., respectively.

68. **The body charged with regulatory oversight responsibility of the securities markets is the Securities Authority,** which was established pursuant to Federal Law No. 4 of 2000. The Securities Authority is managed by a Board of Directors comprising nine members as follows: two persons representing the MOEC; two persons representing the Ministry of Finance and Industry; one the CBU; and four with appropriate expertise and specialization nominated by the Minister of Economy and Commerce and the Minister of Finance and Industry. The Minister of Commerce and Industry serves as Chairman, and currently the CBU representative is the Governor. This body is in the early stages of development, and to date has approved nine sets of regulations, including those covering securities clearance and settlement, market transparency, broker licensing, listed companies, securities markets and arbitration. The Securities Authority's operational capacity is currently extremely low, since it has no budget and no permanent staff.

69. **Considerable work needs to be done to make the Securities Authority operational.** At present, it has no full time staff, and should correct this situation by hiring a group of properly trained staff if the Authority is to become credible. In addition, it does not yet have its own budget, which may call into question its autonomy. There is also some confusion regarding the respective responsibilities of the Securities Authority, the CBU, and the MOEC.

Insurance supervision

70. **Because of the lack of systemic significance of the insurance sector and its early stage of development, a full assessment of compliance with the IAIS Core Principles was not conducted.** Insurance supervision is seriously hampered by organizational problems and a shortage of experienced and qualified staff. In addition, it receives insufficient statistical information from the insurance companies to carry out an effective risk based off-site inspection process. Proposed changes to the insurance law, with the exception of certain investment rules, are highly desirable, but this still represents a patchwork approach. They do not cover some critical areas, which are either completely absent (for example, confidentiality) or are based on out-of-date circulars and whose existence is not widely recognized (for example, market conduct).

B. Bank Exit Policy and Method of Failure Resolution

71. **The U.A.E. has successfully resolved nine financial institution failures since the mid-1980s.** For the most part, the resolutions were made through a merger of banks, although one resolution involved a major liquidation effort. In each case, supervisory intervention included replacement of management and selected employees. All but two cases entailed some liquidity support from the CBU. Such support was subject to the imposition of the penalty interest associated with CBU advances, but the CBU was at times liberal in terms of the timing of repayments.

72. **Eight cases involved some form of recapitalization—either by existing shareholders, new shareholders, or a government authority—thus implicitly protecting**

depositors and other creditors, including to at least some extent the pre-existing shareholders. Much of the present day government ownership of certain banks date to these resolutions. In all cases, the resolution process was ad hoc, typically involving more than one government authority. Bridge financing was made available, where necessary and supervisory change-of-control intervention was swift and far reaching, thus making it possible to defer loss allocation. In some cases shareholders lost all of their stake, while in others, shareholders' equity was diluted by capital injections from government or ruling-family sources.

73. **The U.A.E. authorities have expressed a clear aversion to deposit insurance based on moral hazard concerns**. Because of this position, no explicit deposit insurance system is in place and none is planned; but a formalized scheme was used to protect small depositors in the liquidation resolution of BCC Emirates, the U.A.E. subsidiary of BCCI. Ultimate resolution of bank failures resulted in most, if not all, depositors and creditors being covered through direct payment or as a result of a takeover/merger resolution technique. Although the failure resolution process is not transparent, the public is aware both of the special case depositor protection plan and unprotected creditor losses.

C. Systemic Liquidity and Markets

74. **The combination of balance of payments surpluses and the fixed exchange rate policy have provided the banking system with ample liquidity with only rare exceptions.** At end-2000 the ratio of CBU's net foreign assets to base money stood at nearly 250 percent. To absorb excess liquidity the CBU offers certificates of deposits (CDs) with maturities ranging from 1 to 18 months, which are sold on tap daily at rates slightly below LIBOR (8–16 basis points). At end-2000 the stock of CDs amounted to Dh 15.6 billion.

75. **While most interbank placements are with banks abroad, the domestic interbank foreign exchange market is very liquid.** Only when margins become too wide, do banks carry out transactions with the CBU, which stands ready to buy and sell unlimited amounts of U.S. dollars at rates of Dh 3.6730 and Dh 3.6720, respectively. Interbank activity in dirhams is entirely in deposits; neither repo nor sell/buy-back operations are conducted.[14] The relatively narrow spreads between the lowest and highest rates with different banks (about seven basis points for three-months deposits) indicate that there is little or no market segmentation.

76. **The CBU has four instruments to satisfy banks' short-term liquidity needs—reserve averaging, early redemption of CDs, U.S. dollar swaps, and overdrafts.** The system of required reserve averaging allows banks to draw down their required reserves to

[14] No data are available on the volume of daily interbank transactions.

zero for a maximum of five days in a six-day period.[15] Banks can redeem CDs daily. Since the penalty is minimal, no secondary market for CDs has developed despite CDs being tradable. To encourage domestic interbank activity, the CBU should consider making early redemption of CDs more costly. CBU CDs have also discouraged interbank market development. The CBU can, within limits, also inject temporary dirham liquidity through U.S. dollar swaps. Despite some shortcomings in the CBU's policy instruments with regard to market development, they have, together with exchange market intervention, proved adequate to both maintain the peg and manage liquidity in the system.

77. **The CBU may also allow banks to temporarily overdraw their dirham current accounts without demanding explicit collateral.** Typically there are a few incidents of overdrafts per month which are repaid the following day. However, the CBU has allowed the overdraft facility to be used to provide lender-of-last-resort support.

78. **There have been three episodes over the past 20 years in which the CBU has provided overdrafts for more than seven days without collateral based on decisions of the CBU's Board of Directors.** The latest was in 1998, when a fraud caused financial troubles at Dubai Islamic Bank and led customers to temporarily withdraw their deposits. Five banks received liquidity assistance for several months at end-1990, when they were faced with heavy deposit withdrawals because of depositors' concerns caused by the Gulf War. In the mid-1980s, the mergers of three problem banks in Dubai into the recapitalized Emirates Bank International and three problem banks in Abu Dhabi into the newly created Abu Dhabi Commercial Bank were accompanied by temporary financial support of the CBU—in all cases the overdrafts were repaid with interest.

D. Financial Sector Legislation

79. **Despite its relative youth, the U.A.E. has made remarkable progress in developing a legal framework that is reasonably sound and comprehensive in relation to the banking and financial sectors.** The applicable laws provide the necessary foundation for the normal range of domestic and international legal transactions. At the same time, there appear to be a number of "gray" areas within the overall legal framework, which often make it necessary to find creative ways to get around the strict application of the laws in order to complete the transaction. Some of the features that attracted comment in this respect were: differences in the application of the federal laws as between the federal and emirati authorities; differences in interpretation of similar legal provisions by the judges; a tendency for the authorities to impose requirements not strictly authorized by the law; difficulties associated with the taking and enforcement of security; and a general reluctance to resort to

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[15] Reserve ratios are 1 percent on time deposits and 14 percent for deposits in current, savings, and call accounts. All bank reserves with the CBU are unremunerated. While reserve averaging is permitted, banks have to maintain the required balances both on average of a 6-day period and over the month as a whole.

the courts to resolve commercial disputes. Nevertheless, the U.A.E.'s legal system has served the country well and there appear to be no fundamental weaknesses. In the longer term, however, as the U.A.E. seeks to reinforce its position as a leading financial and banking center, it will need to modernize its key financial and commercial laws in order to develop a single, clear, predictable and consistently applied legal framework.

80. **The legislation governing commercial transactions is also satisfactory although it is characterized by a number of unusual features.**[16] The Law on Commercial Companies of 1988 and the Law of Commercial Procedure of 1993 are comprehensive in scope, but need to be updated in light of modern corporate and financing practices. The distinction between commercial and civil transactions is confusing and the procedures governing the formation of companies seem unduly complex. Accessibility to the Land and Commercial Registers was another matter that attracted some criticism.

81. **The taking and enforcement of security is complicated and uncertain with respect to both real and personal property.** Enforcement is regarded as problematic, uncertain, and time-consuming. The procedures appear to differ between emirates, debtors, and assets. Execution of a court judgment essentially involves a second hearing before the court that handles execution of judgments. This entails further delay and the method of enforcement is generally outside the control of the creditor. Where land is taken as security, it may be freely sold in all emirates except Abu Dhabi. However, the procedures are often unclear. The U.A.E. would benefit from adopting a single law that specifically provides for the ownership of real estate, the manner of transfer, and the regime governing execution of mortgages over real estate. Doubts concerning the ability to recover collateral have led to the widespread use of personal and government guarantees. Although the use of foreign choice of law provisions is common, this is somewhat unsatisfactory given that evidence suggests that it is difficult to persuade domestic courts to enforce foreign judgments.

82. **Significant advances have been made in developing a robust and respected court system and judiciary.** Judges are regarded as independent and free of corruption. Court costs are minimal and the procedures are reasonably efficient, particularly in Dubai. However, for religious as well as practical reasons taking a party to court is very much a matter of last resort. There is a perception in the financial sector and the legal community that judges are not as familiar with complex commercial issues as they should be and that judgments are reversed on appeal too frequently. Most judges come from outside the U.A.E. and the quality varies considerably, although the proportion and caliber of local judges is improving rapidly. In commercial cases, judges frequently rely on the use of experts, a practice which generally appears to work satisfactorily. Although the Sharia principles

[16] One such feature involves the approval of a company's Articles of Association. In addition to the typical requirements with respect to the inclusion of all prescribed information, a determination must be made regarding the commercial viability of the company's prospective business activities prior to its registration.

underlie all legislation, this rarely gives rise to difficulties. Commercial disputes are resolved in the commercial courts in accordance with commercial laws and principles.

V. Recommendations for Reform and Action

83. **The most pressing recommendations relate to the need to improve securities regulation and insurance supervision, while changes to improve the legal and regulatory framework are becoming increasingly important.** Although the banking sector and payment systems represent the two most systemically important components of the financial system, systemic risks in these sectors appeared to be reasonably well contained in the near term. Efforts to strengthen banking supervision and payment systems should continue to ensure that financial market development proceeds in a sound and prudent manner to avoid a resurgence of significant vulnerabilities. A number of recommendations were also advanced to improve the transparency of the CBU's operations.

84. **Against this backdrop, key recommendations for each major topic are presented in order of importance.**

A. Securities

- Ensure that the Securities Authority's commences operation as soon as possible.
- Begin the staffing exercise for the Securities Authority immediately, since having adequate, qualified staff will greatly enhance the perception of market integrity.
- Rationalize the regulatory responsibilities of the Securities Authority, the CBU, the MOEC, as soon as possible, in order to effectively communicate the results to the markets.
- Complete linkage of the electronic trading/clearing operations of the two securities exchanges.
- Continue effort to develop the corporate debt market and increase the participation of nonbank financial institutions such as pensions, insurance companies, and mutual funds.

B. Insurance

- Increase the staff of the Insurance Division of MOEC to include more individuals with the skills needed to carry out off-site analyses and on-site inspections. An appropriate official should also be appointed as the U.A.E. Insurance Commissioner.
- Conduct a full review of the insurance law and regulations with a view to bringing it up to current best practice, while allowing for the unique U.A.E. context. In the interim the proposed amendments to the insurance law should be put on hold.

- Develop a deeper and more liquid market for local property and securities by allowing some portfolio investment in key sectors by foreign insurers operating in the domestic market.

- Review the constraints inhibiting industry rationalization, with a view to making it more desirable for domestic companies, and easier for foreign branches to merge.

C. Legal, Regulatory and Judicial Systems

- Enact the proposed amendments to the companies' legislation and make provision for improved minority shareholder rights, better corporate governance and simplified company formation procedures. Improve operation of and accessibility to the Company Register.

- Improve registration procedures for movable property and creating mechanisms for the registration of non-possessory pledges.

- Simplify the law relating to the ownership, transfer, and charging of real estate, including improving operation and accessibility of the Land Registry.

- Enact the proposed amendments to the Banking Law.

- Consider providing specialized training for judges to enhance their capacity to effectively adjudicate commercial matters.

D. Banking and Banking Supervision

- Provide adequate lead time to banking and other supervisors, as well as financial market participants, to ensure that significant structural changes can be safely and effectively implemented.

- Develop a strategy to further reduce NPLs.

- The following weaknesses were identified in the Basel Core Principles assessment:

  - Improve the supervision of groups containing both banks, insurance companies and securities firms by having regular contact between the CBU and insurance supervisor and securities regulator, and ensuring that the CBU has defined access to the prudential returns of insurance companies in such groups.

  - Establish procedures to pre-approve holdings in listed banks exceeding 5 percent, as required in the new securities regulation. The principle of pre-approval should also be extended to unlisted banks.

- Issue CBU guidelines or circulars requiring banks to have adequate policies and procedures for the identification, measurement and control of market risk and the introduction of explicit requirements for banks to have a comprehensive risk management process to identify, measure and control material risks. (A CBU pilot study on risk-based supervision is now under way).

- Include off-balance sheet items and interbank exposures to U.A.E. banks with maturities of less than 12 months in the definition of large exposures.

- Protect bank staff members who report suspicious transactions in good faith to the CBU from being held liable (amendment to the Banking Law has been proposed).

E. Payment System

- Review CBU procedures for providing overdrafts and implement a system whereby the central bank only lends to banks against proper collateral. Also consider publication of overdraft procedures.

- Consider greater automation and computerization of the existing systems to prepare for increases in transaction volume and reduce reliance on manual procedures. In the interim, consider limiting the value of different types of transfers—a minimum amount for a Telex Transfer and a maximum amount for a check.

- In the medium term, move to a more advanced automatic system that would give the payment system both increased capacity and greater protection from operational risks. This might include moving from a T+1 system for check settlement to same-day settlement. Consideration should also be given to the risks involved with introducing the new real-time gross settlement system to replace the TTTS.

F. Transparency

- All financial sector regulators and supervisors should more actively seek comments from stakeholders, including the private sector, when they are contemplating changes in laws, regulations, technical requirements, and policies.

- The CBU should publish more information on itself and its operations. This should include regular information on its responsibilities and activities, and more detailed data on the CBU balance sheet, on monetary operations, and on the financial sector, including the financial situation of the overall banking system;

- The CBU should help ensure that market participants have access to full sets of its circulars, notes, and regulations, possibly by placing them on its website.

SECTION II—REPORT ON THE OBSERVANCE OF STANDARDS AND CODES

This section reviews the observance of and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which supervisory and regulatory frameworks have been adequate to address the potential risks in the financial system.

Detailed assessments were based on a peer review process under the supervision of Richard Abrams (Mission Chief; IMF) and Patrick Conroy (Deputy Chief; World Bank), as part of the Financial Sector Assessment Program (FSAP). The assessments were prepared using information provided by the United Arab Emirates (U.A.E.) authorities, including self-assessments and fieldwork during missions in February and March/April 2001. The assessor teams comprised Jesper Dockir (Danish Financial Supervisory Authority) and Gareth Rees (Financial Supervisory Authority, United Kingdom) for the *Basel Core Principles for Effective Banking Supervision;* Tomáš Hládek (Czech National Bank) and Philip Bartholomew (IMF) for the *Core Principles for Systemically Important Payment System (CPSS);* and Andrea Schaechter (IMF) for the *Code of Good Practices on Transparency in Monetary and Financial Policies.*

Banking supervision was found to be well managed and staffed by competent professionals. The Central Bank of the U.A.E. (CBU) was found to fully or largely comply with the Basel Core Principles (BCP) with only a few exceptions. One unusual aspect of the BCP assessment was that actual supervisory and prudential practices were in some cases reported to be stricter and more up-to-date than the underlying regulations and circulars would indicate. The key areas where compliance could be strengthened include: capital charges to market risks, both on- and off-balance sheets; exchange of information between banking and nonbanking supervisors in the U.A.E.; and pre-approval of ownership of banks (significant holdings).

The CPSS assessment found that, while the two systemically significant payment systems, the check clearing and the telex transfer systems, were simple and far from state-of-the-art, they nevertheless, worked reasonably well and were secure. The main short-term concern is that the payment system permits overdrafts by national banks that are not conventionally collateralized.

The findings with respect to the Transparency Code assessment were mixed. While the CBU observes most good transparency practices in conducting monetary policy and banking supervision, observance is somewhat weaker in payment systems operations. In particular, transparency of the CBU's system and policies of overdrafts could be improved. Other areas that could be further strengthened include publishing more detailed data, information on the CBU's activities and financial sector developments, and intensifying the public consultation process for regulatory changes.

The U.A.E. authorities indicated broad agreement with these assessments and are preparing to implement several of the recommendations made by the mission.

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

85. During February 10–22 and March 31–April 11, 2001, a joint mission of the World Bank and the International Monetary Fund visited the United Arab Emirates (U.A.E.) as part of the Financial Sector Assessment Program (FSAP). The mission's work included conducting an assessment of compliance with the *Basel Core Principles for Effective Banking Supervision*. The assessment was used to identify any weaknesses in the supervisory structure and for developing a prioritized action plan for strengthening banking supervision.

B. Information and Methodology Used for Assessment

86. The assessment focused mainly on the legal framework for banking supervision and the actual methods used to supervise the banks. The Central Bank of the U.A.E. (CBU) conducts annual on-site inspections of all banks. This extensive on-site inspection program is combined with an off-site supervision group that assesses banks on a quarterly basis.

87. The assessment was conducted by Jesper Dockir, Danish Financial Supervisory Authority, and Gareth Rees, Financial Supervisory Authority, United Kingdom. It was based mainly on information provided by the staff of the supervision department of the CBU, both through interviews and a questionnaire. Further information was derived from a review of the *Union Law 10 of 1980 Concerning the Central Bank, the Monetary System*, and *Organization of Banking* (the Banking Law). The assessment also benefited from interviews with officials from a number of domestic and foreign banks, the U.A.E. Bankers Association, and several lawyers and bank auditors.

C. Institutional and Macroprudential Setting, Market Structure—Overview

88. The main features of banking supervision in the U.A.E. are described in the Banking Law. This Law gives the CBU full responsibility for banking supervision and grants it powers to issue circulars to regulate banks' activities. Although the Banking Law dates to 1980, the legal framework for banking supervision remains reasonably up to date because the CBU over the years has been able to keep the overall legal framework for banking supervision reasonably updated by issuing a large number of circulars and letters to implement any necessary improvements. An amended Banking Law is currently being prepared.

89. The supervisory authority is an integrated part of the CBU and is the sole supervisor of banks. There are 47 banks operating in the U.A.E., of which 27 are foreign banks. The U.A.E. permits four categories of banks—commercial banks, Islamic banks, restricted banking license banks, and investment banks. Commercial and investment banks are defined in the Banking Law. Islamic banks are not defined in the law but are governed by *Federal Law No. 6 of 1985 concerning Islamic Banks, Financial Establishments, and Investment Companies*. In principle, Islamic banks are simply commercial banks adhering to Sharia-principles. For supervisory purposes, all banks are treated in exactly the same manner. The

CBU has the sole power to license such institutions. The Board of Directors of the CBU (BoD) decided in 1982 not to grant further licenses to branches of foreign banks, and only one domestic institution has been granted in the last five years.

90. In some areas, supervisory practice exceeds what is set forth in the regulation. For example, during inspections the CBU ensures that lending to major shareholders is carried out on an arm's-length basis even though this is not explicitly required by regulation. In such cases, the assessment has taken account of actual practices.

D. General Preconditions for Effective Banking Supervision

91. The Banking Law gives the CBU extensive powers to issue instructions of both a general and specific nature to banks. Whereas the general instructions normally are given through circulars and general letters, individual instructions are often given following an on-site inspection. The instructions can be of a quantitative or a qualitative nature. Should a bank fail to comply with instructions, the CBU can impose administrative penalties. Although the imposition of penalties is optional, and no licenses have been revoked in the last five years, penalties are frequently imposed.

92. The Banking Law defines banks through their activities. While investment banks, in principle, do not take deposits with maturities of less than two years, commercial banks receive funds from the public in the form of demand, notice, or time deposits, as well as placements of debt instruments or deposit certificates.

93. Since 2000, banks have been required to publish their annual accounts in accordance with the International Accounting Standards (IAS). These accounts must be approved by the CBU before publication. Since no specific guidelines have been issued for banks in relation to the IAS accounting, the main responsibility for ensuring that accounts meet the standard lies with the external auditors.

94. Foreign banks operating within the U.A.E. are subject to a regulatory regime similar to domestic banks, including the same type of inspection program. The Banking Law requires that branches of foreign banks maintain separate accounts for all their operations in the U.A.E., which should be drawn up on a consolidated basis. Foreign banks are also required to allocate capital for their U.A.E. branch operations, with each branch considered a stand-alone entity for regulatory requirements, including capital, liquidity and large exposures. Home country supervisors are given access to local branches on a regular basis.

E. Main Findings

95. The basis for supervisory activities is set out in the Banking Law, which gives the CBU responsibility for banking supervision and the sufficient autonomy to conduct its assignments independently from short-term political pressures. The supervision department consists of about 75 field examiners and 25 off-site supervisors. The department relies heavily on foreign experts. While this reliance may appear to leave it vulnerable to staff leaving the CBU, there are no budgetary constraints which may limit the employment of such

experts and the terms offered by the CBU have been such as to attract well qualified foreign experts.

96. All banks are subject to an annual on-site inspection and continuous off-site supervision. Although the supervision of banks in the U.A.E. is efficient and of high quality, the current CBU supervision methods are based on a highly stable banking sector where changes (i.e., establishment of new banks, mergers, and banking crises) can be effectively dealt with on an ad hoc basis. Should the banking sector become structurally more dynamic, the CBU will be forced to deal with such changes in a more structured manner.

97. The only financial conglomerates in the U.A.E. combine banks and insurance companies. Supervision of such groups is weak, in part due to the comparatively limited resources used to supervise the insurance industry in the U.A.E. In addition, there is no regular contact between the CBU and insurance supervisors, and the CBU does not have access to prudential returns for insurance firms owned by banks.

The Basel Core Principles can be grouped in the following categories:

Legal framework (CP 1)

98. The section of the 1980 Banking Law guiding supervision is considered reasonably effective and current because the CBU has issued a number of circulars and letters to keep the overall regulatory framework reasonably up to date. An amendment to the Banking Law has been finalized. However, the proposed amendments do not limit the basic autonomy of the CBU or its ability to supervise banks.

99. The Banking Law gives the CBU extensive powers to issue both general and specific instructions to banks. Whereas the general instructions are normally given through circulars and general letters, individual instructions are often given following an on-site inspection. The instructions can be of a quantitative or a qualitative nature. If a bank fails to comply with instructions, the CBU can impose administrative penalties.

Licensing and structure (CP 2-5)

100. The Banking Law states that the Board of Directors "shall establish the requirements to be met and the procedures to be followed in applying for a license," but the CBU has not set forth explicit criteria which must be met to qualify to receive a banking license. In practice, the licensing criteria are consistent with those applied to operating banks. The lack of explicit requirements/guidelines has limited implications, since domestic applications are rare and can be handled on an ad hoc basis, while applications from foreign banks are not being approved at present. The ban on new foreign entrants, however, is being reconsidered and, should the U.A.E. open up the market to new foreign banks, there may be a substantial increase in the number of applications for banking licenses. In this case, specific licensing criteria should be established.

101. The CBU supervises three bank categories: commercial banks, Islamic banks, and investment banks. Commercial and investment banks are defined in the Banking Law. Islamic banks are not defined in the Banking Law but are in principle commercial banks adhering to Sharia principles. For supervisory purposes, all banks are treated in exactly the same manner. Although the use of penalties is optional for the CBU and no licenses have been revoked in the last five years, penalties are frequently imposed.

102. The new securities legislation requires the CBU to pre-approve holdings in listed banks exceeding 5 percent, but procedures for such pre-approvals have not been established by the CBU. Unlisted banks are only required to publish significant changes in holdings in their annual report.

Prudential regulations and requirements (CP 6-13)

103. The regulatory framework is basically sound and follows international standards to a large extent.

104. The CBU has set a minimum risk-weighted solvency requirement of 10 percent for banks. This ratio, however, is only calculated concerning credit risks and certain off-balance sheet items. There are no capital requirements for market or other risks. Capital requirements are the same for domestic banks and branches of foreign banks where solvency is calculated based on the allocated capital and the risk-weighted assets of the U.A.E. branch. The U.A.E. has a single entity insolvency regime and, in the event of insolvency of a foreign bank, the U.A.E. branch operation is not ring-fenced from the rest of the bank. While the Banking Law contains references on how the CBU should react when a bank's capital falls below the minimum capital level (Dh 40 million), there are no explicit provisions as to how the CBU should react if a bank's risk-weighted solvency ratio falls below 10 percent.

Governance (CP 14, 21)

105. The CBU has issued regulations concerning a bank's responsibilities for formulating and implementing a prudent credit policy including a number of detailed requirements (including "know-your-customer" and provisioning). The CBU verifies that proper credit policies and procedures are in place when carrying out on-site inspections of banks. As part of their prudential requirements, the CBU also requires banks to set up sound administrative and accounting procedures and adequate internal control systems to identify and control large exposures.

Money laundering (CP 15)

106. Money laundering is currently only regulated through circulars. The circulars establish extensive requirements for banks to establish anti-money laundering procedures, including systems to identify and report suspicious transactions and to identify new customers. A bank's compliance with requirements is verified during the annual on-site inspections. To strengthen its effort to counteract money laundering, the CBU exchanges information on the subject with other banking supervisors overseas. The current regulation

has some shortcomings of a more formal nature, such as a lack of legal protection of a bank's staff members who report suspicious transactions in good faith (this will be introduced with the proposed amendment of the Banking Law). Another weakness is that there is no requirement that banks have a formal policy statement on ethical and professional behavior.

Methods of ongoing supervision (CP 16-20, 22)

107. The extensive on-site inspection program is combined with off-site supervision that assesses banks on a quarterly basis. The effectiveness of these inspections benefits from unhindered access to banks' books, accounts, documents, and the like, granted to the CBU by the Banking Law. The on-site inspection program assures regular contact between supervisors and banks.

108. The CBU requires banks to provide a number of monthly and quarterly reports. The frequency of the returns can be increased if there are concerns about the bank. To assess the banks on the basis of these returns, the CBU uses a risk assessment model based on the U.S. CAMEL model for its off-site assessment of banks. While on-site inspections result in an overall assessment of a given bank (rating), this is not done for off-site inspections. The outcome of the off-site risk assessments, however, are a component of planning for on-site inspections.

Cross border banking (CP 23-25)

109. Contact takes place between CBU supervisors and foreign supervisors from countries where U.A.E. banks have opened a branch or where a bank has opened a branch in the U.A.E.. The contact, however, is event driven and not formalized in the form of a Memorandum of Understanding or similar arrangement.

110. So far, no U.A.E. banks have asked to open branches in a country with secrecy laws. If such requests should arise, the CBU would deal with them on a case-by-case basis. In general, such requests cannot be expected to be accommodated.

Table 4. Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	The CBU is granted administrative and budgetary autonomy by the Banking Law. The Law also sets out the objectives of the CBU's supervisory assignments and grants it extensive powers to regulate the banking sector through circulars and to verify banks' adherence to the legislation. The supervisory department is an integrated part of the CBU's budget, and its resources have been substantially increased in the last three years. There is no regular contact with other supervisors of financial companies, such as insurance companies, and no exchange of prudential returns.
Licensing and Structure (CPs 2–5)	The Banking Law defines banks and prevents any other institution from using the term "bank" (and similar expressions) in the name of their business. The CBU is the only licensing body for banks. The few applications received from domestic entities are dealt with on an ad hoc basis. In 1982, the Board of Directors of the CBU suspended the granting of licenses to foreign banks. The CBU has to pre-approve holdings exceeding 5 percent of banks listed on a licensed market. This provision has not been extended to unlisted banks. A 25 percent limit is imposed on banks' holdings (including bonds) in commercial companies. No distinction is made between financial companies and other.
Prudential Regulations and Requirements (CPs 6–15)	The overall regulatory framework is sound. Credit policies appear good, as do procedures for loan classification and loss provisioning, but there are weaknesses in large exposure regulations and no effective comprehensive risk management framework. Market risk regulations will need to be developed as the U.A.E. market develops. To bring the anti-money laundering regime in line with international best practices, revised regulations have been introduced recently and new legislation should be enacted soon.
Methods of Ongoing Supervision (CPs 16–20)	The CBU has an extensive on-site inspection program (all banks are inspected annually) combined with a supporting off-site supervision assessing banks on a quarterly basis. The extensive on-site inspection program assures regular contact between supervisors and bank management. The supervisory staff are predominantly experts who have a thorough experience in the field from prior positions. The CBU validates supervisory information through the annual on-site inspections.
Information Requirements (CP 21)	International accounting standards were implemented for banks in 1999. Major accounting firms audit most banks. The CBU monitors auditors' performance and has removed firms because of the poor quality of their work. There are no formal regular meetings with auditors.
Formal Powers of Supervisors (CP 22)	The Banking Laws grants powers to the CBU in two ways. First, the supervisors are granted an almost unlimited power to request changes to policy, organization, and similar items. These requests may be of a general or individual nature. Second, the supervisors are given a number of sanctions to impose on the banks should they not comply with the law. The sanctions cover the entire range from not reacting to a formal request to revoking a bank's license.

Cross-border Banking (CPs 23–25)	Relationships with overseas banking supervisors appear to be good with exchange of information, regular meetings (with some), and mutual access to overseas operations (although there are no formal Memoranda of Understanding or similar agreements). The CBU supervises the overseas operations of U.A.E. banks and, if it believes it is necessary, performs on site examinations. Foreign branches are supervised in a similar way to local banks.

F. Supervisory Response and Recommended Next Steps

Supervisory response

111. Supervisors have drawn up a prioritized action plan based in large part on this assessment. The plan is awaiting management approval.

Recommended action

Issues of highest priority

- CP 1(6): There should be regular contact between the CBU and insurance regulators to enhance supervision of groups containing both banks and insurance companies. The CBU should have access to prudential returns for insurance companies in such groups.

- CP 4: The new securities legislation requires the CBU to pre-approve holdings in listed banks exceeding 5 percent. Procedures for such pre-approvals should be established by the CBU. The principle of pre-approval should also be extended to unlisted banks.

- CP 12: The CBU should issue guidelines or circulars requiring banks to have adequate policies and procedures related to identification, measuring and control of market risk.

- CP 9: Off-balance sheet items and interbank exposures to U.A.E. banks with a maturity of less than 12 months should be included in the definition of large exposures.

- CP 13: The CBU should introduce explicit requirements for banks to have a comprehensive risk management process to identify, measure and control material risks. (A risk management system is being developed by the CBU and is currently being tested with some selected banks).

- CP 15: Members of bank staff who report suspicious transactions in good faith to the compliance officer or directly to the CBU should be protected from being held liable (protection is included in a proposed amendment to the Banking Law and in the proposed new Banking Law).

Issues of medium-term priority

- CP 1: Communication of banking regulation should be improved. At present, it is unclear which circulars and notices are in effect and which have been withdrawn. Circulars and notices are issued by date, and are not grouped by topic or adequately cross-referenced. Communication of the important information in extant circulars and notices to banks (and examiners) could be improved by grouping and indexing them into related topics, in binder format (or loose-leaf), which is regularly updated. Similar benefits could be achieved by placing all circulars on the CBU's new website.

- CP 3: Specific criteria for licensing should be set in order to enhance transparency for both current and potential banks and ensuring that applications are treated in a consistent and efficient manner even if the number of applications should increase substantially.

- CP 6: The risk-weighting of exposures to other Gulf Cooperation Council (GCC) countries should be brought into line with the principles of the Basel Capital Accord. Since this type of exposure is relatively limited for U.A.E. banks, this principle should have limited economic consequences.

- CP 10: The CBU should introduce explicit requirements that loans to major shareholders be granted on an arm's-length basis (bring the legislation up to practice).

- CP 6 and 12: The CBU should introduce capital requirements for market risk and other risks. This will become increasingly relevant with the development of the financial markets in the U.A.E. Furthermore, with the upcoming revised Basel Capital Accord, certain credit risks will rely on data related to market and other risks.

- CP 15: The CBU should require all compliance officers (or other senior officers) to be explicitly responsible for ensuring that the bank's money laundering policies and procedures, at a minimum, comply with U.A.E. statutory and regulatory requirements.

- CP 15: All banks should have a policy statement on ethics and professional behavior that is clearly communicated to all staff.

Issues to be addressed in the long term

- CP 1(5): There should be explicit protection of supervisors against lawsuits for actions taken while discharging their duties in good faith.

- CP 19 and 21: To enhance transparency of supervisory practices and requirements, the CBU should hold regular meetings with auditors.

II. CPSS CORE PRINCIPLES FOR PAYMENT SYSTEMS

A. General

112. The assessment of the stability, efficiency, and soundness of the U.A.E.'s payment systems was undertaken as part of the Financial Sector Assessment Program missions held during February 10–22 and March 31–April 11, 2001. The primary purpose of the assessment of *Core Principles for Systemically Important Payment System (CPSS)* was to identify any potential vulnerabilities to which the domestic payment systems may be susceptible, as well as to assess the potential systemic risks posed thereby to the financial system. The assessment was also used as a basis for developing a prioritized action plan for strengthening and modernizing the payment system.

B. Information and Methodology Used for Assessment

113. The assessment focused primarily on two systems, the Testkey Telex Transfer System (TTTS) and the check clearing system (CCS), which together with the internal accounting and settlement system of the CBU constitute the backbone of the U.A.E.'s payment system. Both systems are systemically important and are owned and operated by the CBU, which also takes the lead in payment system modernization. The direct participation in both systems is compulsory for all licensed banks. The TTTS is mainly used for large value transactions, while the CCS is primarily used for retail payments.

114. The assessment was conducted by Tomáš Hládek, a payment system expert with the Czech National Bank, with the participation of Philip Bartholomew (Senior Economist, Monetary and Exchange Affairs Department, IMF). It was based mainly on information provided by CBU staff and derived from a review of the Banking Law and other relevant documents. The assessment also benefited from interviews with CBU officials, officials of several domestic and foreign banks, and the Dubai Financial Market. The authorities were very helpful in their cooperation.

C. Institutional and Market Structure—Overview

115. Monetary payments are made through three payment systems operated by the CBU (the CCS, the TTTS, and the SWITCH systems). The CCS is a paper-based settlement system that clears on T+1 (that is, the day after they are presented at the CBU). Although settlement through the TTTS is on a same day gross basis, it is not done in real-time (i.e., not all transactions are deemed irrevocable). SWITCH is the electronic net card clearing system (for automatic teller machine transactions and bank cash deposits and withdrawals from the CBU) owned and run by the CBU. The TTTS handles the highest value of transactions, while the SWITCH payment system has the largest number of transactions.

116. The backbone of the U.A.E.'s payment system is formed by the CBU and the licensed banks. The commercial banks provide most of the payment services to the general public, as well as to the federal and emirates' governments. The CBU operates the payment systems with all settlement activities conducted through accounts maintained at the CBU. The CBU

also takes the lead in proposing payment system policy initiatives and reforms. Every commercial bank maintains several accounts in both dirhams and foreign currencies with the CBU. Dirham-denominated current accounts are used for all settlements of cash withdrawals and deposits, as well as transactions processed through the SWITCH payment system, the TTTS, and the CCS. The main rules governing these payments are in the circulars issued by the CBU. The CBU also performs the supervisory function for the payment system and has primary oversight responsibility for compliance with the circulars.

117. Currently the securities markets in the U.A.E. are small and underdeveloped. Legislation governing the establishment and operation of the securities markets was enacted in November 2000 (Federal Law No. 4 of 2000). Securities markets were established in both Abu Dhabi and Dubai in March 2000 and November 2000, respectively. Prior to the enactment of the new law, and the establishment of these markets, all securities transactions were conducted in an informal and unregulated over-the-counter market The Abu Dhabi and Dubai Securities Markets currently trade the shares of 15 and 12 companies, respectively. Each exchange operates its own securities clearance and settlement facility in which all shares eligible to be traded are immobilized. Each market requires that all members permitted to trade maintain a settlement account at a designated bank for purposes of money settlement. The CBU plays a significant role in the operation of the securities markets as well. This role, however, may soon change in light of the recent creation of the Emirates Securities and Commodities Authority, the agency charged with the primary responsibility for regulatory oversight of the securities markets.

D. General Preconditions for Effective Payment Systems

118. Although payment systems in the U.A.E. are not governed by a specific payments law the Banking Law gives the CBU the authority to operate and oversee the payment system. Chapter Two, Article (5), paragraph (4) specifies that the CBU shall "...organize and promote banking and supervise over the effectiveness of the banking system according to the provisions of this Law." Article (18), paragraph (9) states that the Board of Directors of the CBU shall "establish clearing houses…." These two provisions, together with several others, permit the CBU to run a fully centralized accounting system, through which all interbank payments are settled.

119. Each licensed commercial bank maintains three accounts with the CBU. For payments settlement, banks have a single current account in dirhams. Another dirham account is for reserve maintenance. A third account is held only in U.S. dollars for reserve requirements against foreign exchange-denominated deposits (all foreign exchange is converted to U.S. dollars upon deposit).

120. Two main systems, the TTTS and the CCS, have been developed on the basis of the above-mentioned legislation. Telex transfers are manually input into the internal accounting system of the CBU using paper-based information. These transfers are settled at the CBU on a same day gross basis. Check clearing has two phases: on the first day, sorting and netting procedures take place and banks are informed of the results on the afternoon of the value date

(i.e., the day of the checks presentation to the CBU's system) and checks, which have to be covered by specific banks are then passed on to them. In the second stage the banks verify all of the checks, and banks may return uncovered or incorrect checks until 9:00 a.m. of the following day. New net positions are then calculated based upon checks not returned. The final settlement is completed following these procedures in the same way as telexes. Accounting data are manually entered into the system.

E. Main Findings

121. The CBU's procedures and systems applicable to payments are sufficient, practical and efficient and appear adequate to meet current U.A.E. banking needs. Significant aspects of the system, however, are labor intensive. A proposed new project is being developed, however, to replace telexes with a newly structured method of communication. The proposed system is planned to be phased in by end-2001.

122. The CBU may grant overdrafts to commercial banks facing temporary liquidity shortages. Such overdrafts are granted infrequently and they are not automatic. When they are granted, however, the CBU does not require the posting of specific collateral to cover the total obligation. The CBU has internal procedures governing its overdraft operations. All overdraft requests are reported to the Governor for prior approval. Although CBU decisions on overdrafts involve senior staff, and ultimately the governor, the process is carried out on a case-by-case basis and would appear to be labor intensive. In lieu of demanding specific collateral to cover the overdraft, the CBU relies upon its own information regarding the balance of the bank's dirham account held for its legal reserve position, and its holdings in U.S. dollar accounts.

123. Securities markets are relatively small and underdeveloped. As such, no comprehensive assessment of the payments aspects of these markets was conducted.[17] However, the CBU is involved in the process of further developing these markets, and intends to continue to play a meaningful role in the clearing and settlement aspects thereof.

124. The CCS uses a T+1 settlement cycle. A delayed settlement is used because the system suffers a high percentage of returned items and to shorten general clearance time for checks in the system. Typically, 4 percent to 6 percent of checks are returned.[18]

125. Most other aspects of the payment systems were found to be near or up to international standards, although further developments in all areas are desirable, especially from a technical point of view. It is not clear how long the current system will be able to

[17] Both the Dubai Financial Market and the Abu Dhabi Securities Market operate their own clearance and settlement facilities using T+2 and T+1 settlements, respectively.

[18] This results in part from the practice of banks accepting post-dated checks in lieu of collateral or formalized liens.

operate efficiently and effectively given the heavy reliance on manual systems and processes. The mission therefore recommends that the CBU consider implementing a new interbank payment system based on real-time gross settlement (RTGS). Such an RTGS system would include features considered industry standards, and would increase the capacity, soundness, and effectiveness of the system as well as reduce its vulnerability. Development of a same day check clearing settlement should also be considered.

Table 5. Main Findings of Assessment of Observance of CPSS Core Principles for Payment Systems

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	There is a need for new rules in the near future (at a minimum a circular) enabling the CBU to arrange interbank transfers.
Understanding of the system's impact on risks; and procedures for the management of risks (CPs 2–3)	The CBU may grant banks overdrafts, which are generally made on an ad-hoc basis. Although internal CBU procedures are in place, the system is not fully transparent, and access to the overdraft facility is not assured.
Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4–5)	The check clearing system settles in T+1 as once checks are accepted, transactions are irreversible. This form of finality, as practiced, poses no serious finality risk since the CBU monitors all transactions in settlement.
Assets for settlement (CP 6)	No action required.
Security and operational reliability; and contingency arrangements (CP 7)	Procedures on payments require considerable manual input.
Practical for the markets and efficient for the economy (CP 8)	Based on current volumes and values transacted, the system works efficiently. But since procedures in payments require considerable manual inputs, significant changes will be required as payment volumes increase.
Objective and publicly disclosed criteria for participation (CP 9)	No action required.
Governance of the system should be effective, transparent, and accountable (CP 10)	The CBU may grant overdrafts. The conditions for the banks to obtain such credits are determined on a case-by-case basis. Although internal CBU procedures are in place, the system is not fully transparent and access to the overdraft facility is not assured.
Responsibilities of the CBU in applying the Core Principles (CP 11)	The CBU owns and operates all monetary payment systems.

F. Authorities' Responses and Recommended Next Steps

Authorities' responses

126. The CBU is in large part in agreement with the assessment of observance of CPSS draft core principles for payment systems. The check clearing system meets today's needs, but the CBU will continue to study potential improvements in anticipation of expansion of

the system and the feasibility of settling accounts on the same day. The CBU plans to develop a program to both learn from other countries' experience with payment systems and share the U.A.E.'s experience with their systems. The CBU will study ways to keep the U.A.E.'s payment systems modern, efficient, and safe. Considerable attention is being given to introduction of the new RTGS. At this time, the CBU views collateral as unnecessary for overdrafts given the procedures in place that assure repayment and collection of interest.

127. The CBU has decided to develop a new system of communication to replace telex transfers, which it recognizes are based on an obsolete technology. It will not only upgrade the security standard, but it will reduce many of the manual activities of its staff. Under the proposed system all transfers, which are now sent by telex and manually input into the settlement system, will be typed by the commercial banks and sent to the CBU by secured "extranet" communication. The system will require no special application at the premises of commercial banks, other than requiring that they have a personal computer with an Internet browser. The only change the CBU will need to make is to alter its internal control procedures to ensure that the new system does not allow any unexpected overdrafts.

Recommended next steps

128. The mission suggests that the CBU staff study these more advanced payment systems and decide which of their features could be incorporated into the U.A.E.'s financial environment. The best way would be to visit payment systems experts and officials from countries which have either similar historical background (Gulf states) or countries which are considered to have advanced check clearing or RTGS systems (e.g., Switzerland, the United States., Japan, Germany, France, and similar countries). The CBU should consider having key staff visit other payment systems, both check-based and giro-based, to observe how they operate and engage in general discussions of payment system development. CBU staff would also benefit from regular internal policy discussions, both regarding comparative studies and present-day operations.

129. The CBU should consider greater automation and computerization of the system (to increase the number of transfers and create greater protection). The CBU could also consider limiting the value of different types of transfers—a minimum amount for a telex transfer and a maximum amount for a check.

130. The CBU should review all procedures and reframe them to ensure all central bank credits are made against proper collateral to protect the CBU from financial exposure.

131. The CBU should move to a same-day settlement system after careful consideration of restructuring consequences. Currently, banks are required in the 24-hour period between initial presentation and second-day action to accept or reject a check presented that is drawn against them. Acceptance is irreversible except in the most extreme cases of subsequent problems with the check's validity. This arrangement not only requires a T+1 settlement system, it leads to high levels of returned items.

132. To acquire knowledge of the required new technologies, including communications, IT security standards, system software, database environments, and development tools, the CBU's Banking Operations Department should not only closely cooperate with the IT Department, but should have at least one specialist on payments with the knowledge of the above mentioned IT areas.

III. Assessment of Observance of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies

A. General

133. The following considers the transparency practices of monetary and financial policies in the United Arab Emirates as they relate to the principles underlying the Fund's *Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). The assessment was undertaken under the auspices of the IMF–World Bank Financial Sector Assessment Program (FSAP) and comprises the areas of monetary policy, banking supervision, and payment systems.

B. Information and Methodology Used for Assessment

134. The assessment was prepared by Andrea Schaechter (Economist, Monetary and Exchange Affairs Department, IMF) in cooperation with the U.A.E. authorities. The results of the assessment presented here are based on self-assessments by the Central Bank of the United Arab Emirates (CBU), responses from the CBU to questionnaires, legislation and regulations, documents and publications provided by the authorities to the mission, discussions with the CBU, the Emirates Banks Association, and market participants during the February and March/April 2001 missions. The authorities were most helpful in their cooperation. Their comments on earlier drafts of the detailed assessment have been incorporated.

C. MFP Transparency Code—Monetary Policy

Legal framework, institutions, and market structure—overview

135. The legal framework for conducting monetary policy by the CBU is set forth in the Banking Law and supporting regulations. The CBU has maintained a fixed peg to the U.S. dollar since November 1980. It fully accommodates requests for sales and purchases of U.S. dollars at the official selling and buying rates. The aim of its monetary policy operations is to maintain the peg; thus its operations are generally accommodating ones. The CBU's main policy instrument is the daily issuance of CDs on tap. CDs can also be redeemed early with a small penalty. To satisfy temporary liquidity needs, the CBU also conducts foreign exchange swap operations with banks. Reserve requirements are levied on time, savings, and current deposits as well as net short-term dirham placements abroad. All deposits at the CBU are unremunerated.

Main findings

136. The CBU observes most good transparency practices regarding monetary policy, but still has to address some important weaknesses. The main weaknesses relate to the lack of detail in: (i) reporting on monetary operations, the CBU's balance sheet, and macroeconomic developments; (ii) describing and explaining its the monetary policy framework and instruments; and (iii) disclosing the relationships with the government.

Clarity of roles, responsibilities, and objectives

137. The ultimate objectives of monetary policy and monetary policy instruments are defined in the Banking Law. Monetary policy objectives are to "maintain stability of (the currency) internally and externally," "ensure its free convertibility into foreign currencies," and "achieve a steady growth of the national economy." The Banking Law does not provide any weighting of the objectives in case of conflicts, but in practice the CBU has maintained a fixed peg to the U.S. dollar since November 1980. Officially, however, the dirham is pegged in a band to the SDR, even though this peg is not being adhered to in practice.

138. The CBU's governing body is its Board of Directors (BoD) consisting of the Chairman, the Deputy Chairman, the Governor of the CBU, and four other members, who are all appointed by a Union Decree after approval of the Council of Ministers for terms of four years; terms that may be renewed several times. According to the Banking Law the CBU is accountable to the President and the Minister of Finance to whom it must submit balance sheet statements, reports on the monetary and banking situation, an annual activity report, and, upon request, other information.

139. Disclosure of information on the relationship between the CBU and the government could be further enhanced. While the agency roles of the CBU and the conditions for advances to the Government are clearly set out in the Banking Law, the amount of government deposits held with the CBU does not meet legal requirements. In addition, neither the annual amounts of net profits transferred to the government nor the process of determining these amounts to transfer have been publicly disclosed.

Open process for formulating and reporting of policies

140. Most good transparency practices for formulating and reporting monetary policy are observed. The CBU informs the public immediately after decisions have been taken about changes in the setting of monetary policy instruments and their underlying rationale. Operating procedures are outlined in circulars that are sent to all financial institutions and the media and issued periodically as a book. Public consultation is sought for most important technical adjustments. Macroeconomic developments are described in the annual *Economic Bulletin* and the *Annual Report*. Inflation and real sector developments are only reported upon in the *Annual Report*. However, neither of the reports analyze the developments nor provides an outlook for future developments. The CBU has no publication that explicitly outlines and explains its monetary policy framework and how it operates its policy

instruments. Moreover, there is no public reporting on transactions in CDs and foreign exchange operations, but interest rates of the CDs issued are posted daily on Reuters.

Public availability of information on financial policies

141. The CBU has three main publications—the quarterly *Statistical Bulletin,* the annual *Economic Bulletin* (published in August with data up to June) and the *Annual Report.* In the year 2000, no *Statistical Bulletin* was published because of technical difficulties, but all issues for that year were released in March 2001. The future publication lag is estimated to be 40 days. The CBU launched its website on April 1, 2001, and intends to continuously expand the information content of the site. The U.A.E. does not subscribe to the GDDS or the SDDS. It publishes its balance sheet in the above three presentations and monthly in the *Official Gazette* (with a lag of about two months). The main shortcomings are that balance sheet presentations do not provide enough detail; credit and deposits are not separately shown for the private and public sector; foreign and domestic assets are not distinguished; and overdrafts by banks cannot be identified from the balance sheet since they are included in other assets. Measures taken regarding emergency financial support are released ex post through press releases.

Accountability and assurances of integrity by financial agencies

142. The Governor of the CBU appears on request before the Federal National Council and the Emirates Consulting Councils to report on the performance of the CBU in achieving its objectives and the state of the economy and financial system. The CBU must submit its audited financial statements to the President and the Minister of Finance and Industry no later than three months after the close of the financial year. The financial statements are prepared in accordance with International Accounting Standards. The Banking Law stipulates that the accounts of the CBU be audited annually by one or more auditors selected by the BoD. There have been several independent auditors over the years. A summary of the audited balance sheet is published in the *Annual Report*. Notes to the accounts, any qualifications to the statements, and information on accounting policies are not disclosed.

143. General standards for the conduct of personal financial affairs of the members of the BoD are set out in the Banking Law. Staff regulations prohibit the exploitation of conflicts of interest. Staff regulations are not published, but are available upon request. Internal governance procedures of the CBU are not publicly disclosed. There are no formal legal protections for CBU staff, but members of the staff act formally in the name of the CBU. Legal action can only be taken against the central bank, itself, and not against individual employees unless there is evidence of misconduct.

Table 6. Main Findings of Assessment of Observance of MFP Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy.	Improving transparency practices in the following areas is warranted. Government deposits with the CBU deviate from the Banking Law requirements. Neither net profits nor their allocation to the government are disclosed. The SDR peg rather than U.S. dollar peg is reported as the official peg.
II. Open process for formulating and reporting monetary policy decisions.	There is no publication that explains the monetary policy framework and policy instruments. Moreover, no data is provided on transactions in CDs and foreign exchange operations. Reporting on macroeconomic developments is not very detailed and mostly on an annual basis only. The meeting schedule of the BoD is not announced in advance.
III. Public availability of information on monetary policy.	There is a need to strengthen the reporting of monetary operations. The CBU balance sheet does not distinguish between credit and deposits for private and public sector or for foreign and domestic assets and liabilities; nor does it explicitly show overdrafts by banks. The U.A.E. does not subscribe to the GDDS or to the SDDS.
IV. Accountability and assurance of integrity by the central bank.	Notes to the accounts and information on accounting policies are not an integral part of the disclosed financial statements. Internal governance procedures exist but are not publicly disclosed.

Authorities' response and recommended next steps

144. The CBU was in broad agreement with the mission's assessment and stressed that it would address most of the issues raised. The staff commends the authorities for the recent launch of its website, on which it briefly describes its monetary policy objectives and responsibilities and has posted its *Annual Report* and quarterly *Statistical Bulletin*, as well as press releases and major circulars. The staff encourages the CBU to continuously expand the information disseminated through this new channel of delivering information. In particular, the CBU could make available through the internet a descriptive and explanatory note on its monetary policy framework and instruments, monthly balance sheet data, and data on monetary operations and the Banking Law.

145. The main steps the CBU should take to improve its transparency practices in monetary policy include: (i) regularly publishing more detailed information on the CBU's activities with regard to monetary policy (including data on transactions in CDs and foreign exchange operations) and macroeconomic developments; (ii) issuing a publication that explains the CBU's monetary policy framework and how it operates its instruments; (iii) reporting more details on its balance sheet (in particular, distinguishing explicitly credit and deposits for private and public sector; foreign and domestic assets and liabilities; and showing overdraft by banks); (iv) officially announcing the peg to the U.S. dollar rather than the SDR; (v) making notes to the accounts, any qualifications to the statements, and information on accounting policies publicly available; (vi) publishing speeches by the

Governor and senior CBU officials; (vii) disclosing more fully its relationships with the government; and (viii) disclosing information on the internal governance procedures.

D. MFP Transparency Code–Banking Supervision

Institutional and market structure—Overview

146. The CBU is the sole agency responsible for banking supervision and regulation. Its broad objectives and the institutional framework are set out in the Banking Law and in regulations. The Banking Law also specifies that the CBU has jurisdiction over investment banks, financial institutions, monetary and financial intermediaries, and representation offices. At end-2000, 20 domestic commercial banks with 291 branch offices and 27 foreign banks (including one restricted license bank) with 110 branches operated in the U.A.E. The structure of the banking system has been rather stable since the CBU has not licensed any new foreign bank since 1982.

Main findings

147. The CBU observes most good transparency practices in the area of banking supervision but some important transparency practices still need to be improved. Areas that can be further strengthened comprise: (i) explaining the CBU's objectives, responsibilities, and measures for banking supervision; (ii) publishing more details on the development in the financial sector, including the financial situation of the banking sector; (iii) consistently seeking public consultation prior to technical regulatory changes and explaining these to affected institutions; and (iv) reporting on banking supervisory activities.

Clarity of roles, responsibilities, and objectives

148. Roles, responsibilities, and objectives of the CBU with regard to banking supervision are defined in the Banking Law. It specifies the objective of the CBU as "to ensure the sound functioning of the banking system." It also stipulates that "the Bank shall organize and promote banking and supervise over the effectiveness of the banking system" and sets out specific responsibilities. These are also noted on the CBU's recently launched website. The importance of developing a sound banking system is explained in a 1996 CBU publication, which is now out of print, however. The Banking Law sets out the procedures for appointment, terms of office and criteria for removal, as well as broad modalities of accountability for the CBU's BoD (see description in the section on the observance of the Transparency Code for monetary policy). Relationships with other regulatory authorities do not exist.

Open process for formulating and reporting of policies

149. Most transparency practices for an open process for formulating and reporting of banking supervision policies are observed. The Banking Law stipulates a number of provisions and prohibitions. It specifies the measures and sanctions to be taken by the CBU with respect to banking supervision. Regulations, circulars and notes are published in the

Official Gazette as press releases immediately after decisions have been made and distributed to all banks and financial institutions. The most important new circulars are also published in the *Economic Bulletin* and the *Annual Report*. However, the *Annual Report* does not report on the CBU's banking supervisory activities. Since over time it has become difficult to track what regulations, circulars, and notes are in force for certain topics, it would be useful for the CBU to issue complete and updated packages of information presented by subject, for example in loose leaf-form.[19]

150. The CBU tends to discuss substantive technical changes with financial institutions. For example, the CBU contacts the Emirates Banks Association so as to provide input from Association members. Occasionally the CBU holds discussions with banks. Some market participants expressed the need to intensify discussions prior to enforcing new regulations. There are no formal procedures for information sharing and consultation between the CBU and other domestic and international financial agencies. However, the CBU regularly exchanges views with home supervisory authorities of foreign banks operating in the U.A.E.

Public availability of information on financial policies

151. While the CBU has three main publications in which it provides information about the banking sector, the central bank could further strengthen its efforts in reporting on banking supervision activities and the development of the financial system. In the *Economic Bulletin* and the *Annual Report,* the CBU provides a list of the number of banks, representative offices, money exchange houses, money and financial brokers, and other financial institutions compared to the previous year. It also lists all banks and other financial institutions by type and briefly describes aggregate data on commercial bank activity. Further data is provided in the quarterly *Statistical Bulletin,* some of which is given on an aggregate rather than consolidated basis. However, no information is provided on the financial situation of the banking sector and the development of other nonbank financial institutions.

152. The Governor and senior central bank officials, after authorization by the Governor, participate in seminars or discussions. Speeches are typically not published. The CBU also responds to questionnaires by local and foreign newspapers. The financial statements of the CBU do not explicitly reveal expenditure related to banking supervisory activities. They are disclosed as described in the section on monetary policy.

Accountability and assurances of integrity by financial agencies

153. Accountability and assurances of integrity by the CBU are broadly in observance with good transparency practices as described in the section on monetary policy. Deviations result from the lack of publication of notes to the accounts, any qualifications to financial

[19] In practice, the CBU prudential requirements have at times exceeded those set out in the Banking Law and supporting regulations and circulars (e.g., especially when dealing with other risks than credit risks and management shortcomings).

statements, and information on accounting policies and lack of publicly disclosing internal governance procedures.

Table 7. Main Findings of Assessment of Observance of MFP Transparency Code—Banking Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of banking supervisory agencies.	No action required.
VI. Open process for formulating and reporting of banking supervisory policies.	The CBU does not report on its supervisory activities other than issuing circulars and notes. Over time it has become difficult to track what regulations, circulars, and notes are in force for certain topics. Some market participants expressed a desire for more discussion of new regulations prior to their issuance.
VII. Public availability of information on banking supervisory policies.	Reporting on financial system developments could be more detailed. No information is published on the financial situation of banks or other financial institutions. The quarterly *Statistical Bulletin* was not published in 2000 due to technical problems, but all 2000 issues were published in March 2001.
VIII. Accountability and assurance of integrity by banking supervisory agencies.	Notes to the accounts and information on accounting policies are not an integral part of the disclosed financial statements. Internal governance procedures exist but are not publicly disclosed.

Authorities' response and recommended next steps

154. The CBU was in broad agreement with the assessment and stressed that it would address most of the issues raised. The CBU recently launched its website for a wider and faster dissemination of information. In the area of banking supervision, the website lists the central bank's responsibilities as the banking supervisor, the institutions licensed by the CBU, provides press releases and the most important circulars, and makes available the data on the banking sector as published in the 1999 *Annual Report*. As mentioned above, in the section on monetary policy, the mission also encourages the CBU to use its website to disseminate the Banking Law, circulars and regulations, and banking data.

155. The following are the staff's main recommendations to improve observance of good transparency practices in banking supervision. The CBU should: (i) update the 1996 document on the CBU's objectives and responsibilities and also explain the CBU's roles with regard to other financial institutions; (ii) regularly publish details on the development of the financial system, including the financial situation of banks and development of other financial institutions; (iii) issue complete and updated packages of information of circulars, notes, and regulations presented by subject rather than date or issuing a complete set of regulations in loose-leaf form; (iv) intensify contacts with banks prior to making technical regulatory changes; and (v) report regularly on banking supervisory activities.

E. MFP Transparency Code—Payment Systems Oversight

Institutional and market structure—overview

156. Payment systems in the U.A.E. are operated and overseen by the CBU. The three systems are the Check Clearing System (CCS), the Testkey Telex Transfer System (TTTS) and the SWITCH payment system (i.e., bank cards). The CCS is a paper-based settlement system that clears on the second day. Settlement through the TTTS is on a same-day, gross basis, but not in real-time (i.e., transactions are not irrevocable). SWITCH is the electronic net card clearing system owned and run by the CBU that settles on the same day. The CCS and TTTS are systemically important for the economy. The TTTS has the largest value of transactions, and the SWITCH system has the largest number of transactions.

Main findings

Clarity of roles, responsibilities, and objectives

157. Transparency with respect to the roles, responsibilities, and objectives of operating and overseeing the payment systems can be strengthened. The payment systems are not regulated by a specific payments law, but the authority to operate the payment systems is derived from Article 5(4) of the Banking Law that states that the CBU shall "organize and promote banking and supervise over the effectiveness of the banking system according to the provisions of this Law" and Article 18(9) which gives the BoD the responsibility to establish clearing houses. These two provisions, together with regulations, entitle the CBU to run a fully centralized accounting system, through which all interbank payments are settled. Further operational responsibilities are set out in circulars which are sent to all banks and published in the *Official Gazette.*

158. There is no public document that explicitly describes and explains the CBU's roles, responsibilities and objectives of operating and overseeing the payment systems and the functioning of the payment systems.

Open process for formulating and reporting of policies

159. Policies regarding the payment system are broadly transparent. The regulatory framework for the payment systems is set out in circulars and notes that are published in the *Official Gazette*, disclosed in press releases, and distributed to all banks and the media. The most important new circulars are also published in the *Economic Bulletin* and the *Annual Report.* Circulars and notes are summarized every five years in a book that covers the five-year period. Instructions (i.e., explanations) on how to apply the operating procedures are sent to all parties involved, including the Emirates Banks Association. They are not published, but they are available upon request. No specific regulations are disclosed for overdrafts upon which the CBU decides on a case-by-case basis. Moreover, monthly CBU balance sheets do not reveal the level of overdrafts, since they are included in other assets.

160. The CBU seeks public consultation regarding technical changes in cases where it expects disagreements from banks. The Emirates Banks Association, for example, is contacted to provide input from its members. The CBU also distributes questionnaires to banks and holds meetings with them.

Public availability of information on financial policies

161. In its quarterly *Statistical Bulletin,* the CBU provides data on check clearing. While in 2000, no *Statistical Bulletin* was published because of technical difficulties, all the issues in the year 2000 were published in March 2001. The recently launched website gives a brief overview of the check clearing system. In its *Annual Report,* the CBU does not report on activities and developments regarding the payment system. The Governor of the CBU appears on request before the Federal National Council and the Emirates Consulting Councils. He and senior central bank officials, after authorization by the Governor, also participate in seminars or discussions. Speeches are normally not published. The CBU also responds to questionnaires by local and foreign newspapers. The financial statements of the CBU do not explicitly reveal expenditures related to operating and overseeing the payment system. They are disclosed as described in Section II.III.c on monetary policy.

Accountability and assurances of integrity by financial agencies

162. Accountability and assurances of integrity by the CBU are broadly in observance with good transparency practices as described in the section on monetary policy. Deviations result from the lack of publication of notes to the accounts, any qualifications to financial statements, and information on accounting policies and lack of publicly disclosing internal governance procedures.

Table 8. Findings of Assessment of Observance of MFP Transparency Code—Payment Systems Oversight

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of payment systems oversight agencies.	Neither the CBU's roles, responsibilities and objectives of operating and overseeing the payment systems nor the functioning of the payment systems are publicly described and explained. Procedures for the overdraft facility are not publicly disclosed.
VI. Open process for formulating and reporting of payment systems oversight policies.	The CBU does not report on activities in operating and overseeing the payment system. Procedures for the overdraft facility are not publicly disclosed. Overdrafts are part of "other assets" in the CBU's balance sheet.
VII. Public availability of information on payment systems oversight policies.	The CBU does not report on activities in oversight of the payment system. Some information on emergency financial support is provided ex post.
VIII. Accountability and assurance of integrity by payment systems oversight agencies.	Notes to the accounts and information on accounting policies are not an integral part of the disclosed financial statements. Internal governance procedures exist but are not publicly disclosed.

Authorities' response and recommended next steps

163. The CBU was in broad agreement with the assessment and stressed that it would address most of the issues raised. The CBU recently launched its website for a wider and faster dissemination of information. In the area of payment systems, the website briefly describes the check clearing system. With the quarterly *Statistical Bulletin* now being posted on the website, data on check clearing is also available through this means. It would also be useful to post circulars and regulations relating to the payment systems.

164. The main recommendations to address existing weaknesses in transparency practices in the area of payment systems are: (i) issuing a document describing the functioning of the payment systems and the CBU's the role and objectives; (ii) disclosing procedures for overdraft and explicitly showing the amounts of overdraft in the CBU's balance sheet; (iii) issuing a binder with all current circulars, rules, and procedures governing the payment systems; (iv) including a section in the *Annual Report* on activities on operating and overseeing the payment system; and (v) providing more detailed *ex post* information on emergency financial assistance.