مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

Financial Stability Review

September 2012

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Preface

Welcome to the first UAE Central Bank Financial Stability Review. As the title indicates, this is not a full-fledged report. Nonetheless, it gives the reader key information about financial stability in the United Arab Emirates during the year 2011.

The UAE managed to have a good year in 2011 despite a difficult international environment; it achieved an overall balance of payments surplus and respectable growth while maintaining a low inflation environment.

Thanks to ample capital and satisfactory profitability, UAE banks were able to weather the impact of a further increase in non-performing loans and constitute additional provisions. Liquidity remained at an acceptable level as demonstrated by banks investing AED 80 billion in the Central Bank's Certificates of Deposits as at the 31st of December 2011.

While most of this review is of a factual nature, there is a concise and relevant analysis regarding the resilience of the banking sector and its exposure to the real estate sector. The last part of the report refers to the introduction of new regulations aiming at reinforcing our prudential framework, as well as the preparation of our banks towards the implementation of Basel III requirements, in particular the introduction of minimum liquidity ratios.

Finally, I would like to thank Securities and Commodities Authority for contributing to the review with a presentation of the UAE Stock Market developments.

Sultan Bin Nasser Al-Suwaidi

Governor

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Objective of the Financial Stability Review

By issuing this report, Central Bank of the UAE intends to provide key information to major participants in the industry and allow them a better understanding of risks in the UAE financial sector.

Definition of Financial Stability

Financial stability describes a steady state in which the financial system, comprising of banks, other financial institutions and financial markets, efficiently performs its key functions, such as allocating resources, spreading risk as well as settling payments, and is able to do so even in the event of shocks, stress situations and periods of profound structural changes.

This edition is published in September 2012 and is based on data and information available as at 31 December 2011, unless stated otherwise.

Executive Summary

The UAE economy has shown sustained resilience towards global and domestic challenges. The well diversified economy alongside the established infrastructure have enabled the UAE to maintain its position as one of the leading emerging economies in the region.

After the economic contraction of the year 2009 where GDP at constant prices decreased by 4.8%, led by a fall in manufacturing and real estate, the UAE economy has recovered. Economic growth reached 1.3% in 2010 and 4.2% in the year 2011. The prospects for 2012 are encouraging with the non-oil GDP growth expected to reach around 4%.

Inflation, which is monitored through the Consumer Price Index (CPI), was close to zero during the year 2011(+ 0.2%). The low inflation level during 2011 was driven mainly by the drop in housing prices by 4.9% while food prices increased by 7.8%. Despite some degree of uncertainty regarding price movements in the near future, it is likely that inflation will remain moderate in line with IMF estimate of 1.5% for 2012.

Banks operating in the UAE are well equipped to deal with major stress scenarios and contingencies. Banks' high capital adequacy levels, together with robust provisioning policies and high profitability, enhance their capability to cope with major global or domestic stress. Looking forward, the UAE banking system will continue to show a high level of resilience to future shocks due to the following factors:

- A conservative and traditional banking model with a strong focus on the UAE.
- Sound financial indicators.
- Low dependence on overseas funding.
- A capped real estate exposure.
- A high loss absorbent capability as demonstrated by stress testing.

The Central Bank is regularly reviewing and upgrading its regulations with the objective to ensure a sound and robust financial system. As part of this process, the following regulations were introduced during the year 2011: regulations for classification of loans and determining their provisions and regulations regarding bank loans and services offered to individual customers. The Central Bank has also undergone a number of quantitative impact studies on the implementation of Basel III and is currently in the process of finalizing a new liquidity regulation, which will be based on the Basel III Accord[1].

The CBUAE has put into action a series of initiatives to strengthen the payment systems which is contributing to the stability of the financial system of the UAE. The initiatives focus on improving operations efficiency, strengthening security, reducing the use of cheques and adjusting the legal framework in the UAE.

With regards to financial markets, the UAE has taken significant steps towards achieving the "Emerging Market" status. As global economic conditions and liquidity condition improve, the UAE is positioned to capitalize on its structural and economic advancements.

[1] This regulation has been introduced in July 2012

Domestic Economic Outlook

Overview

The UAE economy showed resilience in the face of the corrections that took place in the local real estate and securities markets on the one hand and in the face of the spill-over from the international financial crisis on the other hand. This resilience is mainly due to high, albeit volatile, oil prices and the good performance of tourism and other services. Non-oil exports also played a supporting role during this period as the UAE economy is more anchored to the growing markets in the Gulf region, Asia and Africa.

Economic Growth

Following the boom years, economic growth in the UAE turned negative in 2009 (-4.8%). This was due mainly to a drop in trade by 8.0%, oil and natural gas by 8.5%, the real estate sector by 13.2%, and manufacturing by 14.1%.

Table 1-1: GDP growth in the UAE (2007-2011)

Year	2007	2008	2009	*2010	*2011
Total GDP	3.2%	3.2%	-4.8%	1.3%	4.2%
Oil GDP	-7.0%	-2.3%	- 8.5%	1.0%	6.7%
Non-Oil GDP of which:	9.3%	6.0%	-2.9%	1.4%	3.1%
- Manufacturing	1.9%	10.3%	-14.1%	6.9%	3.0%
- Construction	10.0%	10.3%	1.7%	2.4%	3.2%
- Wholesale & Retail Trade	5.9%	2.7%	-8.0%	3.1%	2.8%
- Real Estate	16.1%	2.6%	-13.2%	0.1%	0.7%
- Transport & Communication	17.9%	11.8%	3.0%	-3.3%	4.0%

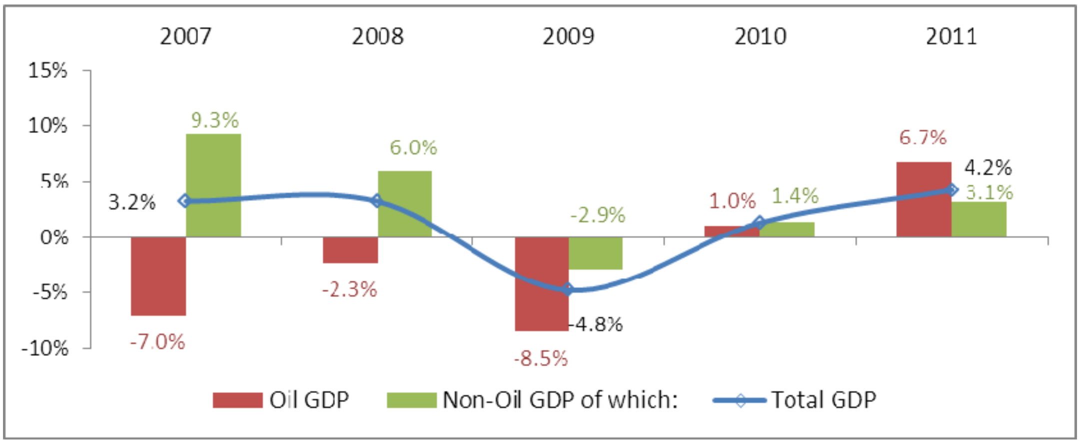
Source: National Bureau of Statistics

** Estimated*

A recovery started the following year, with GDP at constant prices increasing by 1.3%. The sectors registering positive growth included the real estate sector (0.1%), construction (2.4%), trade (3.1%) and manufacturing (6.9%). The recovery consolidated further in 2011, with GDP, at constant prices, growing by 4.2%, due to 6.7% growth in oil GDP and 3.1% growth for non-oil GDP.

The following chart illustrates the annual growth in both oil and non-oil GDP.

Chart: 1-2. UAE GDP Growth (in %)



Source: National Bureau of Statistics for 2007-2010, FSU Staff

As regards the prospects for 2012, the UAE economy may achieve better results than IMF estimate of 3.5% growth, for the following reasons:

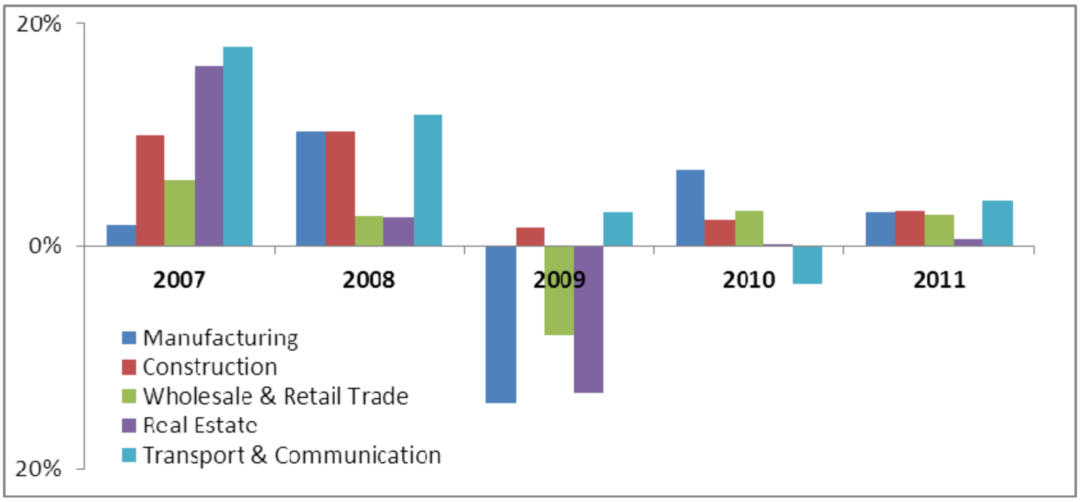
(1) Dubai may achieve 4% growth or more as it was stated in the Dubai Economic Outlook for the year 2012.

(2) An equally high growth is expected in the Emirate of Abu Dhabi following the recent decisions to create two new industrial clusters and to go on with some landmark projects.

(3) Increased public spending in the Northern Emirates, and

(4) Expected high oil prices for the whole year.

Chart: 1-3. UAE GDP Growth – Per Sector (in %)



Source: National Bureau of Statistics for 2007-2010, FSU Staff

Inflation

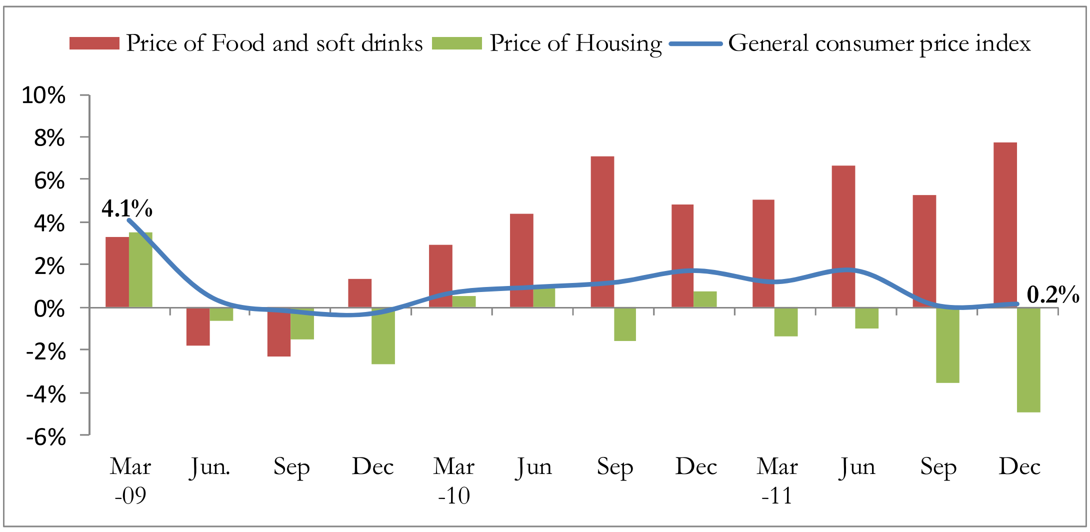
As illustrated by chart 1-4, the year-to-year changes in the general consumer price index decreased during 2009, and it became negative starting July 2009. Year to year CPI started to increase in March 2010 and it continued until September 2011 when it reached 0.1%, before becoming negative in the following two months.

For the year 2011 as a whole, CPI inflation was just 0.2%. This near-zero inflation average hides, however, a divergence between housing prices decreasing by 4.9% and food prices increasing by 7.8%.

Year to year decline in housing prices started in June 2009 (-0.6%), then the decline accelerated starting July 2011 (-2.4%), reaching - 4.9% in December of the same year. Food prices have been increasing on a year-to year basis during most of the period under review, reaching a peak of 7.1% in September – October 2010 and 7.8% in December 2011.

Despite the high degree of uncertainty regarding price movements in the near future, it is unlikely that CPI inflation will reach an uncomfortable zone in the UAE as long as housing prices are decreasing or at least stabilizing and the increase in imported prices is limited to international inflation given the Dirham's fixed peg to the US dollar.

Chart: 1-4. UAE Inflation Indicators (Year-to-Year change)



Source: National Bureau of Statistics for 2009-2011, FSU Staff

Oil Prices

Despite a successful diversification of the economy, oil-GDP at current prices represented 26.4% of total GDP in the UAE in 2009, 30.9% in 2010 and 38.4% in 2011. In addition, higher oil prices impact on other activities due to the fact that part of the oil income is brought back into the domestic banking system depending on the government's needs. As a result, resident deposits increases which allows banks to provide more credit.

Brent oil prices decreased by 36.6% in 2009. This was followed by an increase by 28.7% in 2010 and by 39.4% in 2011, reaching an average of $111.0 per barrel in 2011.

Special Focus

Tourism

A rebound in tourism and other related activities gave a boost to the economic recovery. In Dubai, the main touristic hub of the country, the number of hotel guests reached 7.6 million in 2009, 8.3 million in 2010 and 9.1 million in 2011. The hotel occupancy rate reached 70% in 2009 as well as in 2010 and 74% in 2011.

Domestic Investment

Total fixed capital formation did not play an expansionary role in 2011. Its share in GDP increased from 25.5% in 2009 to 28.4% in 2010; then it decreased to 27.4% in 2011. This was due to a decrease in the share of the public sector investments while the private sector maintained its investments at about 19% of GDP.

As regards Foreign Direct Investment flows inward, the balance of payments data show that it reached the amount of AED 14.7 billion in 2009, AED 20.2 billion in 2010, and AED 28.2 billion in 2011.

Foreign Demand

Foreign demand gave an important boost to the economic recovery in the UAE. While in 2009, total exports and re-exports of goods (FOB) decreased by 19.8%, due to 33.5% and 15.1% decrease in hydrocarbon exports and re-exports, respectively, total exports and re-exports of goods increased by 11.3% in 2010 due to 16.0% and 9.9% increase in hydrocarbon exports and re-exports, respectively.

In 2011, total exports and re-exports of goods increased by 31.9%, due to 49.5% increase in hydrocarbon exports and 21.7% increase in non-hydrocarbon exports.

The Balance of Payments

High oil prices and the performance of non-hydrocarbon exports led the surplus of the trade account of the balance of payments to increase from AED 154.6 billion in 2009 to AED 179.9 billion in 2010 and to AED 292.0 in 2011.

The balance of services and transfers are traditionally negative in the UAE (i.e., the related flows of funds leaving the country are higher in value than the flows coming in). The deficit of the balance of services reached AED 100.2 billion in 2009, AED 111.5 billion in 2010 and AED 135.1 billion in 2011, while net transfers to the rest of the world reached AED 37.4 billion, AED 41.4 billion and AED 44.2 billion, respectively. As a result the surplus of the current account of the balance of payments was much lower than that of the trade balance, reaching AED 28.8 billion in 2009, AED 26.6 billion in 2010 and AED 112.7 billion in 2011.

The financial account of the balance of payments witnessed a deficit of AED 35.6 billion in 2009 and a surplus of AED 18.5 billion in 2010. In 2011, the deficit reached AED 60.4 billion, due to an outflow of funds by the public sector to the amount of AED 95 billion. The overall balance of payments remained negative in 2009 to the amount of AED 22.5 billion; it then became positive in 2010 and 2011, to the amount of AED 26.9 billion and AED 16.6 billion respectively, thereby adding to the net foreign assets of the Central Bank.

Table: 1-5. The UAE Balance of Payments

(2010-2011)

(End of period, in millions of AEDs)

	2010	2011*
Current Account Balance	26,595	112,694
Trade Balance (FOB)	179,872	291,951
Total Exports of Hydrocarbon	274,109	409,876
Total Exports of Non-Hydrocarbon	187,335	227,953
Re Exports*	322,778	396,494
Total Exports & Re Exports (FOB)	784,222	1,034,323
Total Imports (FOB)	-604,351	-742,372
Services (NET)	-111,511	-135,133
Investment Income (NET)	-366	75
Transfers (NET)	-41,400	-44,200
Financial Account	18,457	-60,354
a. Private Capital	28,457	34,646
- Foreign Direct Investment Outward	-7,400	-8,000
- Foreign Direct Investment Inward	20,200	28,200
b. Enterprises of Public Sector	-10,000	-95,000
Errors and Omissions	-18,120	-35,719
Overall Balance	26,932	16,621

* Preliminary Estimates Subject to Revision
Source: National Bureau of Statistics for 2010-2011

Financial Soundness Indicators (FSIs)

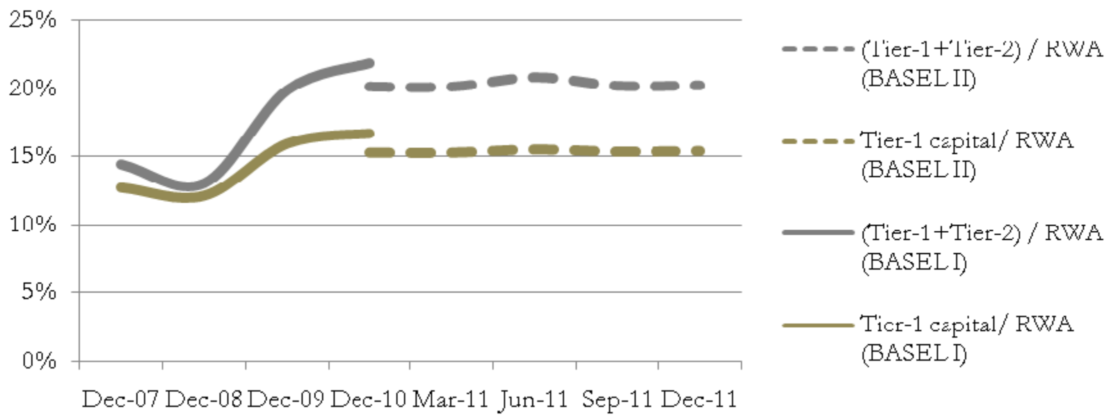
The Central Bank of the UAE through its Financial Stability Unit constantly assesses the soundness of its banking system. The FSU looks at various indictors which enable it to understand the current financial and economic trends. Four main areas are covered; capital adequacy, asset quality, profitability and liquidity. The FSIs enable the Central Bank to track as well as benchmark the performance of the UAE banking system to other regional and global banking systems.

As shown in the section below, the Financial Soundness Indicators (FSIs) used are not merely derived from IMF recommendations but also broadened by the FSU staff to cover other areas relevant to the UAE banking system.

Capital Adequacy

The UAE banking system is considered to be one of the highest capitalised banking systems in the region. Banks in the UAE are required to hold a minimum of 12% Capital Adequacy Ratio and 8% Tier 1 ratio. As of December 2011, national banks had 21.2% CAR and 15.7% Tier 1 ratio, while foreign banks' CAR stood at 16.7% and Tier 1 ratio at 13.1%. Therefore, on average, banks operating in the UAE are holding close to twice the regulatory Tier 1 capital requirement (15.2% Tier 1 as at December 2011).

Chart: 2-1. Capital Adequacy Ratio*



Source: Central Bank of the UAE, FSU Staff estimate
*National Banks Only

In summary, the core capital buffer held by UAE banks, over their regulatory requirement, amounts to around AED 100 billion. This buffer introduces a significant level of comfort to the UAE based banks, especially national banks. As issues with major corporate entities are being resolved through either the rescheduling or restructuring of part of their loans, having a sizable capital buffer in place will help reduce the impact of any adverse outcome.

Asset Quality

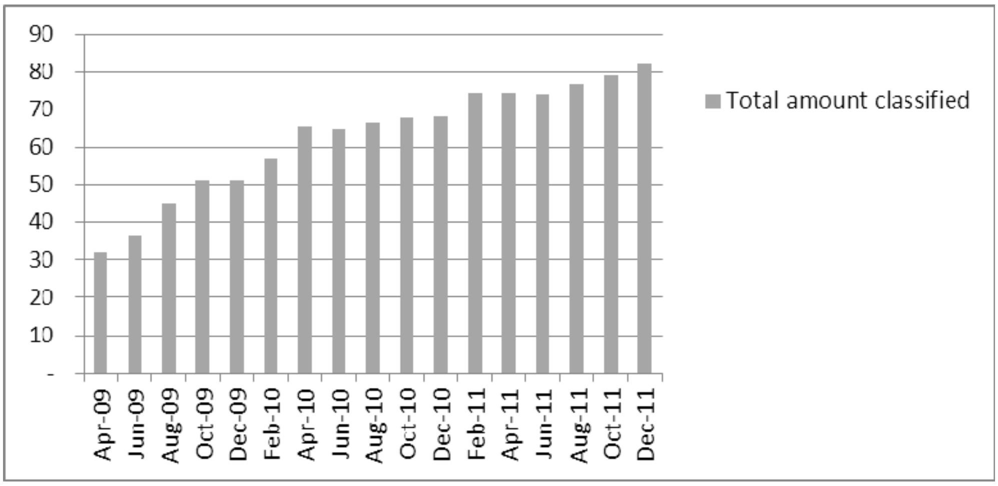
The asset quality of the UAE banking system is monitored by FSU on a macro-basis. Among the set of indicators available to assess banks' asset quality, NPL ratio and Provision Coverage ratios are the most used by regulators.

Non-performing Loans (NPL):

As of December 2011, the UAE banking system had an NPL ratio of 7.2% representing total classified loans of AED 82.4 billion. While a further deterioration in the NPL ratio could take place, this ratio is believed to be getting closer to the peak. As banks are currently finalising major restructuring deals with various entities, their NPLs will likely increase to reflect the new terms and conditions and peak around an average of 8% to 9%.

Chart: 2-2. Non-performing Loans NPL

AED: Bn



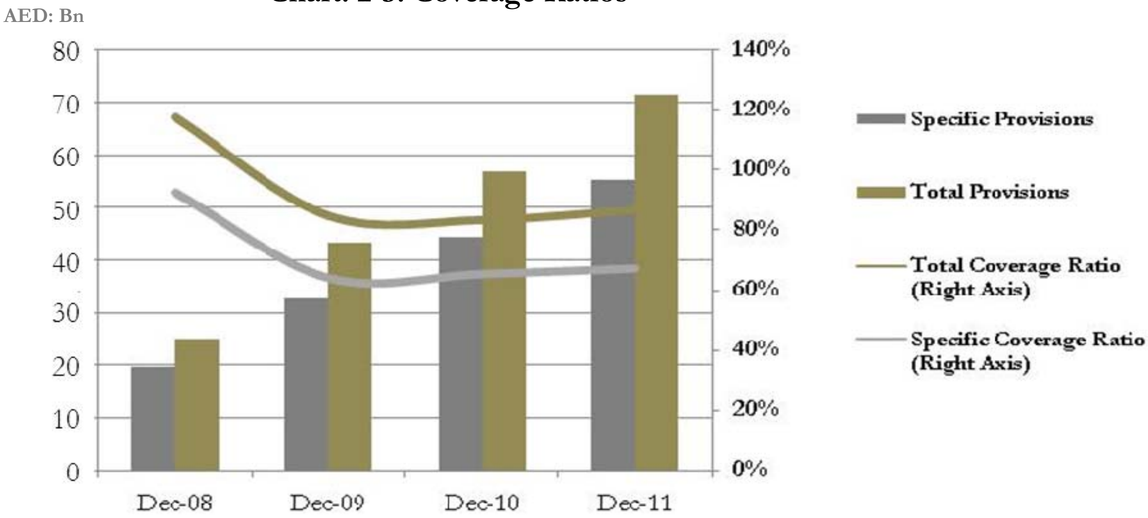
Source: Central Bank of the UAE, FSU Staff estimate

Provisions Coverage ratios:

Two coverage ratios are monitored, specific provisions coverage ratio and total provisions coverage ratio (collective and specific). As of December 2011, the UAE banking system had a total coverage ratio of 87%, which means that the stock of provisions held by banks (collective and specific) covers 87% of their total classified loans. This level of coverage is considered to be adequate by international standards.

If only specific provisions are taken into account, the ratio of specific coverage would be equal to 67%. The high coverage ratio reflects the active provisioning strategy adopted by banks. During the year 2011, banks increased their specific provisions & interest in suspense by AED 11 billion to reach a total of AED 55.3 billion. On the other hand, collective provisions increased by AED 3.8 billion during 2011 to reach AED 16.3 billion, representing 1.15% of total Risk Weighted Assets of banks.

Chart: 2-3. Coverage Ratios



Source: Central Bank of the UAE, FSU Staff estimate

While banks were significantly increasing their collective and specific provisions, both coverage ratios decreased from their December 2008 peak. This was simply due to the increase in classified loans as illustrated by the chart 2-2. During the year 2009, banks increased their total provisions by AED 18.4 billion and their classified loans by AED 30 billion. This has caused the coverage ratios to drop during the year 2009. The ratio started to pick-up post year 2009.

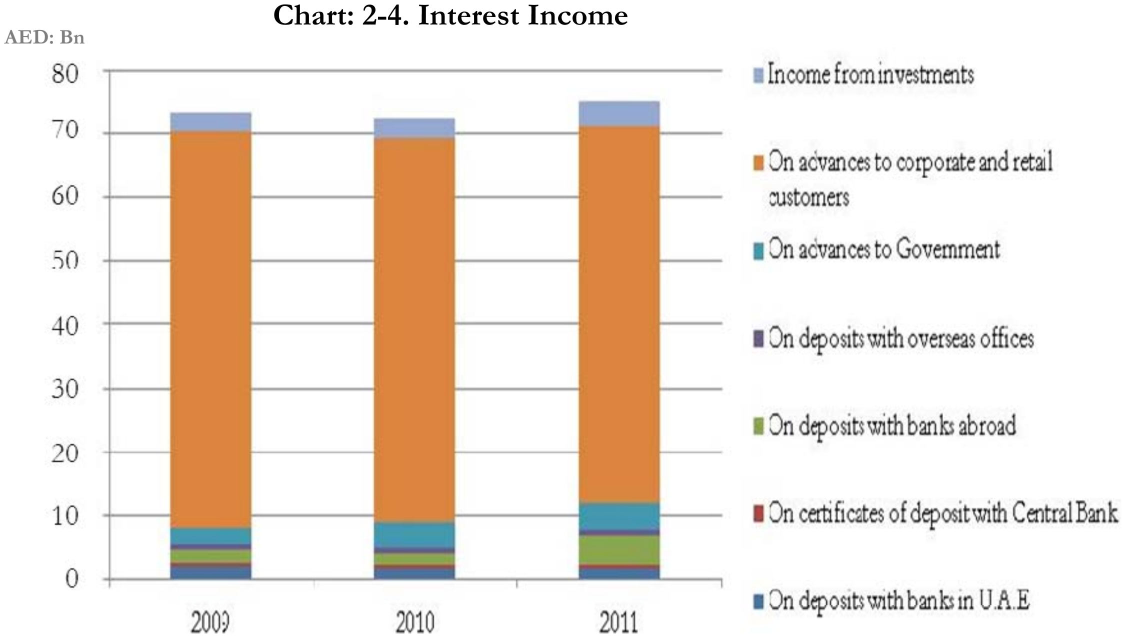
Besides the above two indicators for asset quality, the Financial Stability Unit conducts a semi-annual stress test, testing the capital and asset quality of banks operating in the UAE. The objective of the stress test is to assess the resilience of the UAE banking system and identify any potential shortfalls that banks might face in the short-and-medium terms.

Profitability

Banks had a total profit of AED 26.6 billion during 2011, compared to AED 22.5 billion during 2010. As a result, ROA has increased to 1.54% during 2011 versus 1.36% for 2010. The increase in profit during 2011 was mainly driven by the increase in banks' net interest margins. While the interest expense by banks dropped by 6.9% YOY, their interest income increased by 3.8% during the same period.

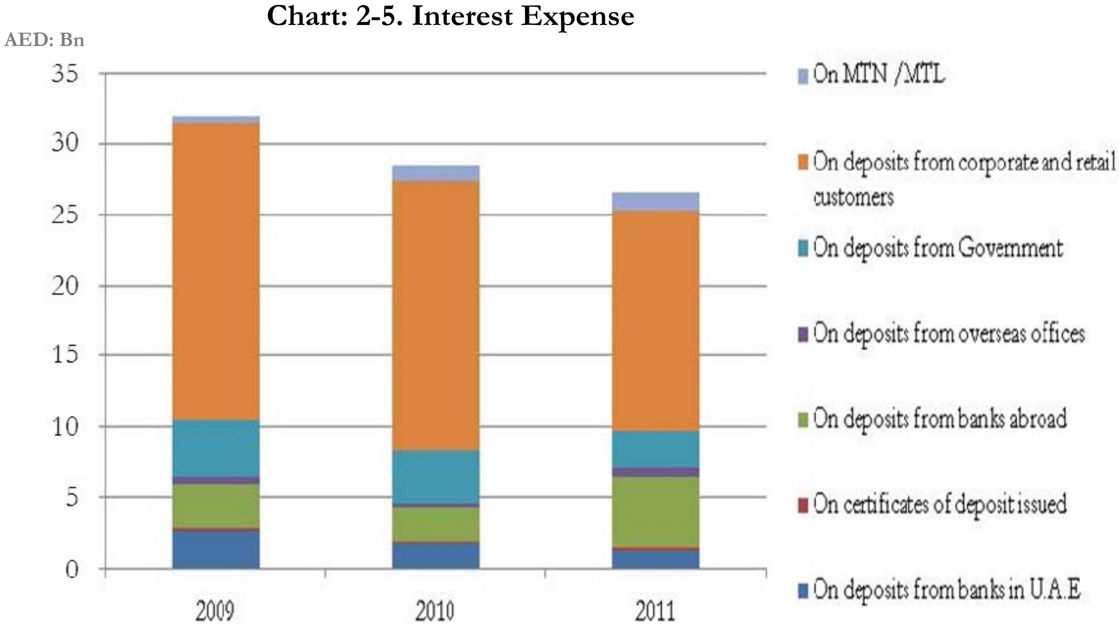
The UAE banking system was able to maintain sound levels of profit even during periods of stress. As shown by chart 2-4, banks were able to increase their interest income on deposits with banks abroad by AED 3.2 billion during the year 2011, which is an increase of 200% from December 2010 levels. On the other hand, the decrease of interest expense was largely driven by the decrease of interest paid on advances to other customers (retail & corporate), which has dropped by AED 3.5 billion during the year 2011. The shift of time deposits to demand and saving deposits which took place during the year 2011[2] (refer to chart 2-11), has played a major role in the reduction of interest expense paid on deposits. This trend should be reversed with the planned introduction of a new liquidity regulation.

Chart: 2-4. Interest Income



Source: Central Bank of the UAE, FSU Staff estimate

Chart: 2-5. Interest Expense



Source: Central Bank of the UAE, FSU Staff estimate

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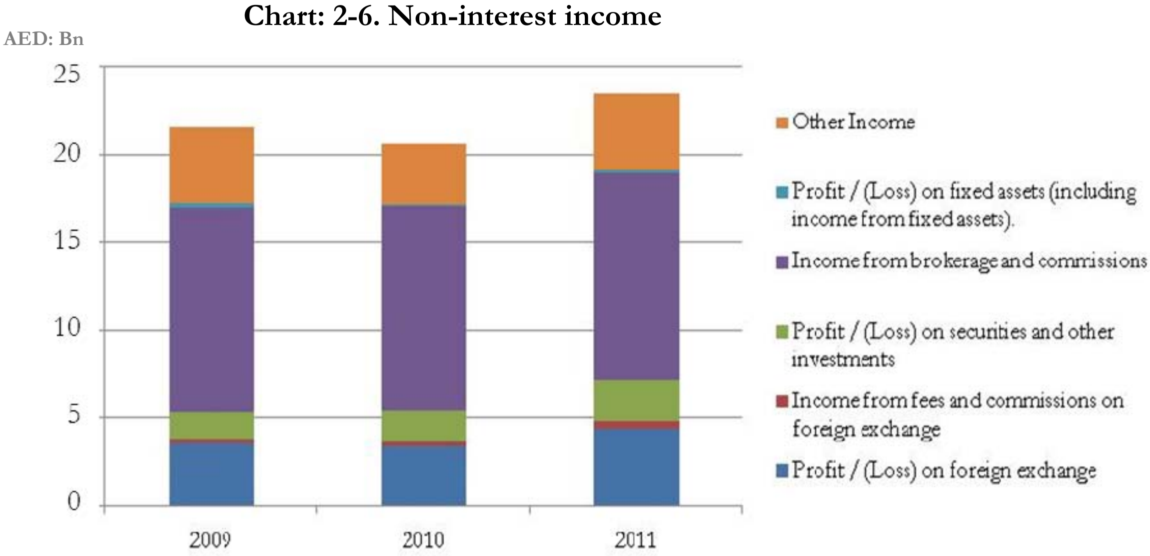
2 Time deposits during 2011 decreased by AED 43 billion and demand & saving deposits increased by AED 63 billion.

Banks' non-interest income has also increased by AED 2.8 billion during the year 2011, the increase was mainly driven by the profit made on foreign exchange (which represented 36% of the increase of non-interest income).

Chart: 2-6. Non-interest income



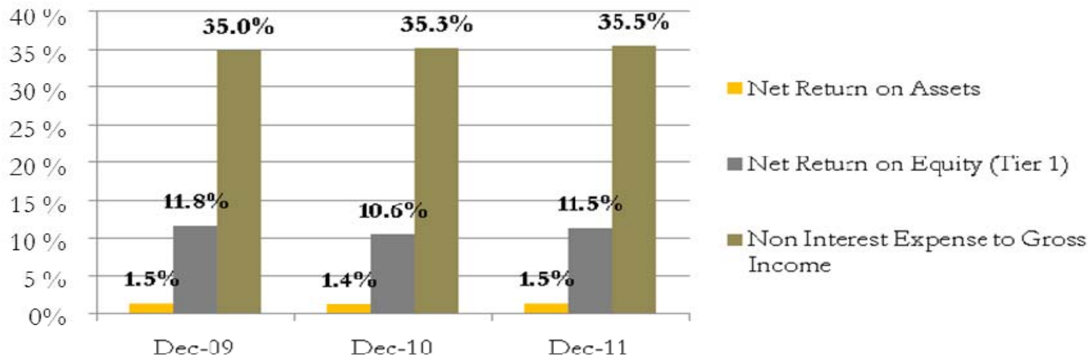
Source: Central Bank of the UAE, FSU Staff estimate

Chart: 2-7. Profitability Ratios -1-

		Dec-10	Dec-11
ROA	1.22%	1.36%	1.54%
Net Interest Income / Interest Income	56.6%	60.8%	64.8%
Operating Expenses / Total Profit	120.07%	105.76%	99.24%
Net Provision Charges / Total Profit	106%	76%	66%

Source: Central Bank of the UAE, FSU Staff estimate

Chart: 2-8. Profitability Ratios -2-



Source: Central Bank of the UAE, FSU Staff estimate

Liquidity & Funding

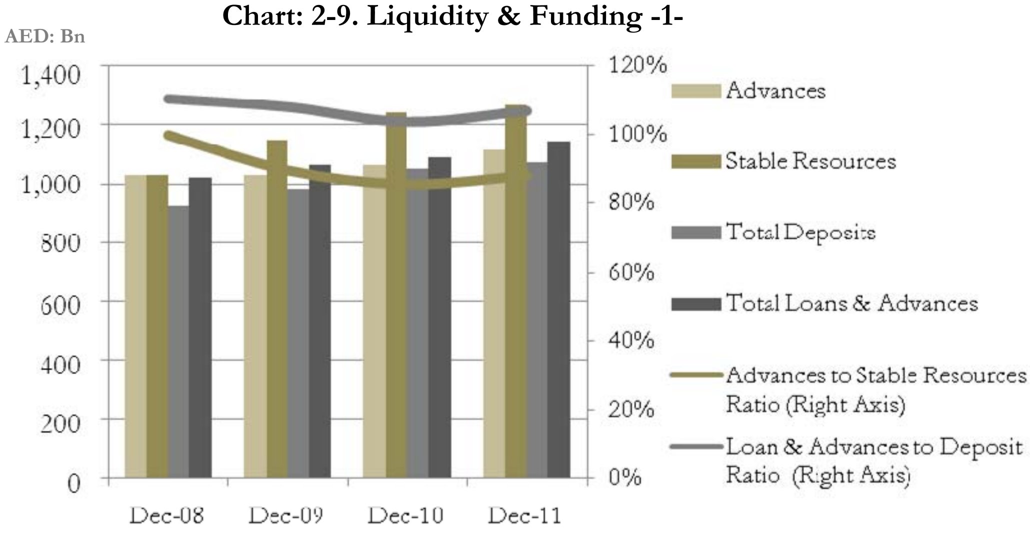
Banks' liquidity is monitored through a set of indicators and ratios. At the moment Advances to Stable Resources Ratio "ASRR" is currently the only regulatory ratio related to liquidity with which banks must comply. This ratio indicates the level of stable resources being held by banks to back their advances. Banks operating in the UAE are required not to exceed an ASRR of 100%.

As illustrated by chart 2-9, the surge of banks' credit growth in 2008 had pushed the ASRR close to the 100% by the end of that year. In December 2008, banks reached an ASSR of 99.9%. The year 2009 witnessed a correction that helped banks revert the ratio back to its previous levels. While advances saw a moderate growth of 0.14%, stable resources increased by a significant 11.5% during the year which led the ASRR to drop back to 89.6%..

As of December 2011, the ASRR stood at 88% supported by the substantial holding of stable resources and the moderate credit growth. The improvement on ASSR was due to slow down in credit demand and tight credit standards by banks.

It is also worth mentioning that banks' Loan to Deposit ratio reached 106.8% as of December 2011, compared to 110.5% as of December 2008.

Chart: 2-9. Liquidity & Funding -1-



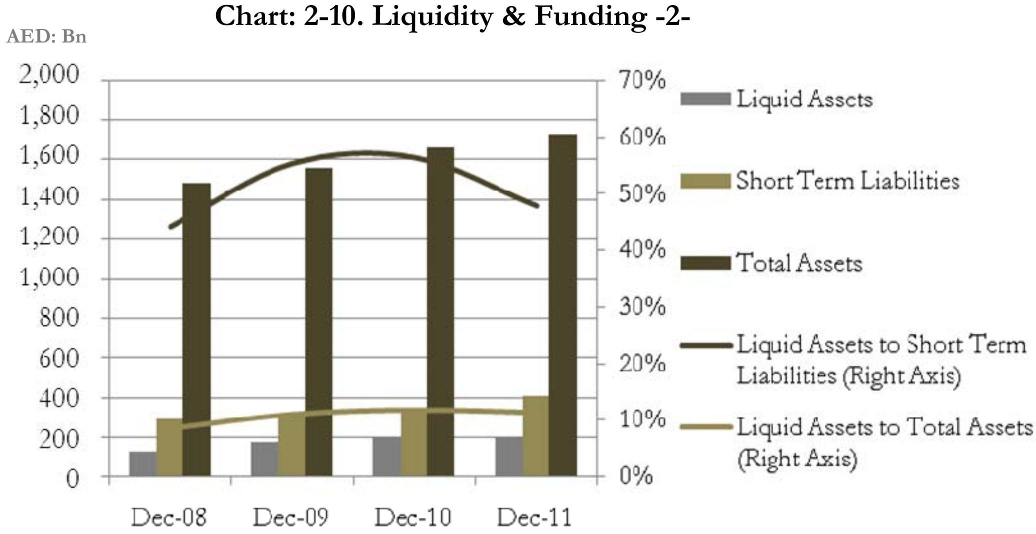
Source: Central Bank of the UAE, FSU Staff estimate

Other liquidity indicators such as Liquid Assets to Short Term Liabilities & Liquid Assets to Total Assets are also monitored. As illustrated by chart 2-10, the two ratios, "Liquid Assets to Short Term Liabilities" and "Liquid Assets to Total Assets" are below 2010 levels.

The ratio of Liquid Assets to Short Term Liabilities for banks operating in the UAE peaked during December 2009 and December 2010 at 55% and 56% consecutively. The increase was due to banks parking their excess cash in liquid assets as they slowed down their lending activity. As of December 2011, the ratio stood at 47.8%, below the 2009 and 2010 levels, but still above the December 2008 level of 44.2%. Banks have witnessed minimal growth of their liquid assets during the year 2011, while their short term liabilities increased by 18.3% during the year. The increase of short term liabilities was partially due to the shift of some time deposits to demand and saving deposits as illustrated by the chart below.

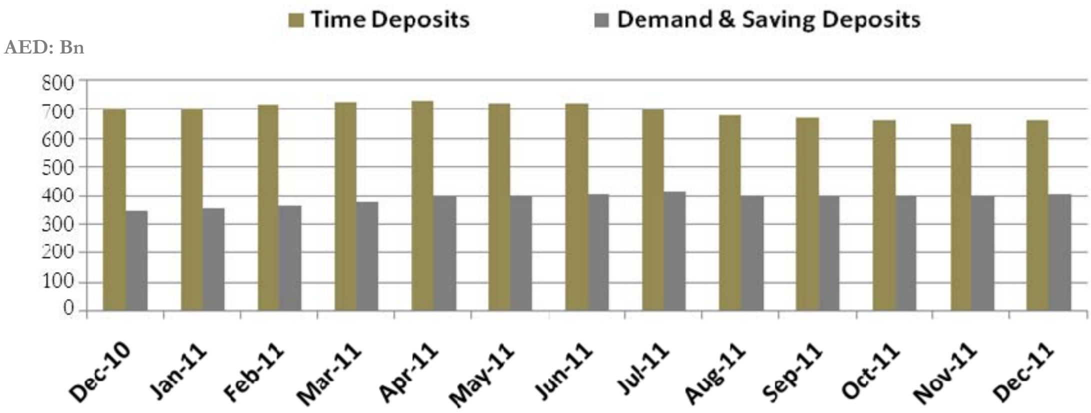
Liquid Assets to Total Assets have also dropped by 0.5% from the end of the 2010 level of 11.7% to 11.2% as of December 2011.

Chart: 2-10. Liquidity & Funding -2-



Source: Central Bank of the UAE, FSU Staff estimate

Chart: 2-11. Deposits Behaviour



Source: Central Bank of the UAE, FSU Staff estimate

The year 2011 was a volatile year in terms of deposits inflow and outflow. During the first 4 months of the year, banks' deposits base increased approximately by AED 80 billion, of which 28% was government deposits. After April 2011, the flow of deposits reversed and accelerated till November 2011 when deposits started to pick-up again.

During this period banks saw a reduction of AED 75 billion in deposits from their peak of April 2011. The inflow of deposits into the system during the first half of 2011 followed by the outflow during the second half could be attributed to various factors such as:

- Regional instability and the UAE's perception as a safe haven.
- FX volatility where the strength of the US Dollar versus other currencies played a major role in the remittances market.
- Global liquidity situation.
- Debt repayments by major resident depositors to their foreign lenders.

Overall, during 2011 total deposits grew by AED 20.1 billion (1.9% YOY).

Banks' holding of the Central Bank's CDs peaked during May 2011 at AED 124 billion due to the influx of deposits into the system. In the second half of the year 2011, banks' holding of CDs retreated to AED 80 billion by December 2011 due to the outflow of deposits.

Looking Forward: Resilience of the UAE banking system

To achieve immunity from financial crisis is difficult to achieve, simply because of the fact that banking systems are based on risk – return mechanism. The aim of the Central Bank is to identify early signs of risks and threats to its financial system and to utilise available macro-prudential policy measures to mitigate the potential impacts of these risks before they gain traction.

It is also the objective of the Central Bank to ensure that UAE financial institutions have the ability to withstand plausible events of stress.

What makes the UAE banking system resilient?

There is not one unequivocal unit of measurement for financial stability. The assessment of financial stability is based on a combination of a broad set of indicators. The section below discusses the main elements which contribute to the resiliency of UAE banks.

A conservative mainly retail banking model with a strong focus on the UAE

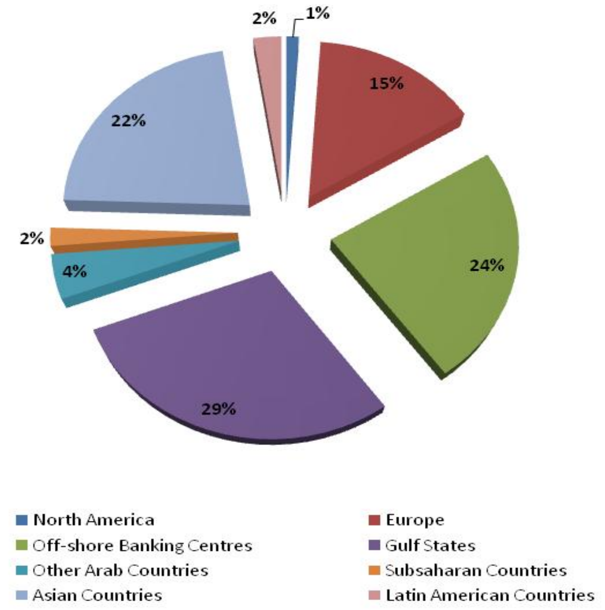
The UAE banking system could be characterised as a traditional model with limited overseas exposure (As of December 2011, the total resident assets represented more than 85% of banks' total assets.) After the volatile years of 2005 - 2008, the UAE banking system is considered to be more mature and stable.

Due to its domestic nature, the UAE banking system is currently generating stable growth and profit, despite challenging economic environment. While the domestic focus of the UAE banking system enabled it to weather external risk factors, it has made it vulnerable to other risks. Reliance on name lending and credit risk concentration reflect the stage of the country's economic development (an emerging market where government owned enterprises are the driving force behind the development of its economy and hence financing is largely directed at government and GRE projects).

UAE banks have largely avoided the three financial crises faced by the financial community as a whole during the past five years: the Subprime Crisis, the Global Financial Crisis which followed and more recently, the Euro Debt Crisis. Investments of UAE banks in subprime assets did not exceed 0.03% of their total assets. They also do not currently hold any debt issued by peripheral European countries.

The country exposure of banks operating in the UAE (loans & advances excluding Interbank) is shown in chart 3-1, and amounts to AED 93.9 billion or 5.1% of their total assets. As shown in the chart underneath, those assets are predominantly located in the GCC (29%), followed by Offshore Financial Centres (24%), Asia 22% and Europe (15%).

Chart: 3-1. Banks operating in the UAE: Cross Country Exposure

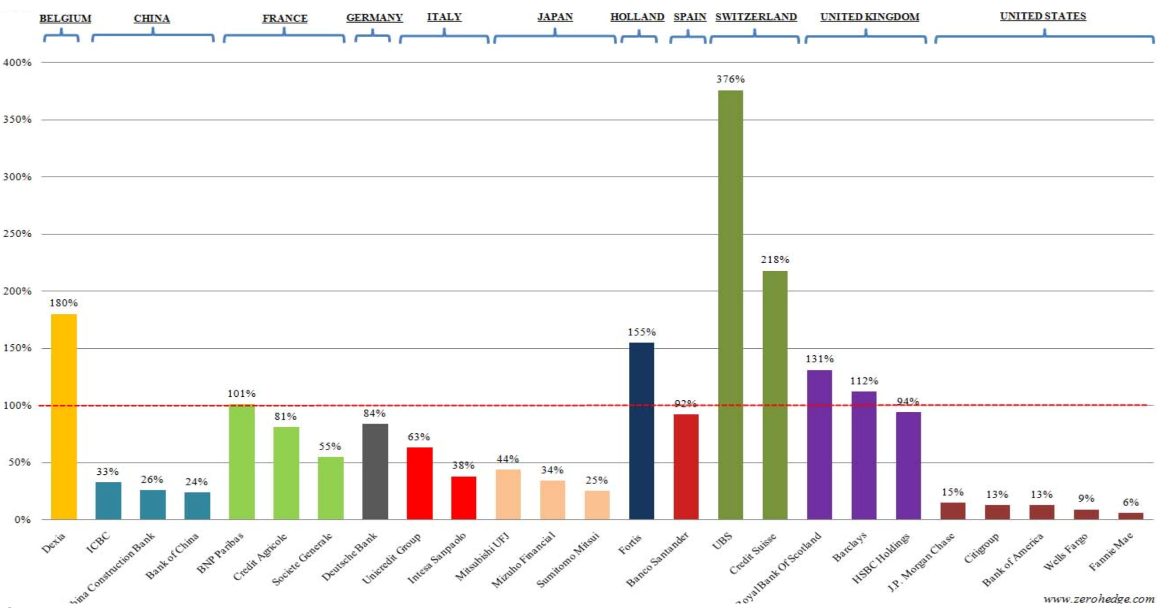


Source: Central Bank of the UAE, FSU Staff estimate

Crisis containment capabilities

In developed economies, there has been a gradual upward trend in the ratio of large banks' total assets as a percentage of their countries' GDP; from a level of 50% to 100% in the mid 60s; this ratio has now risen above 200% for the largest European banks.

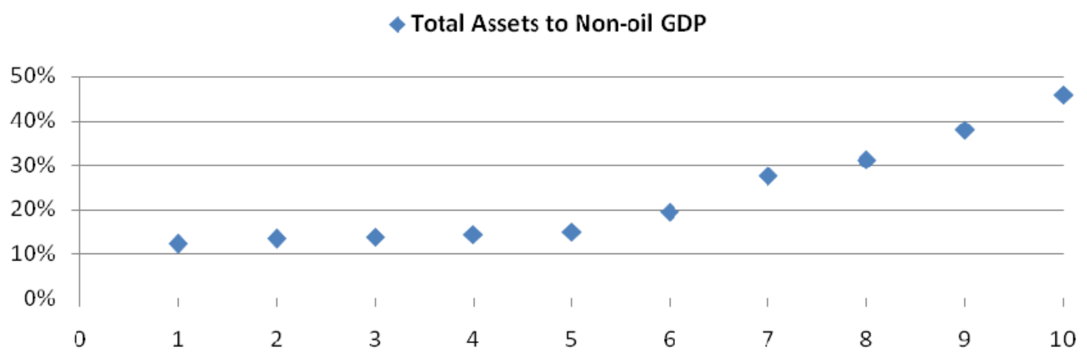
Chart: 3-2. Total Asset –to- Home Country GDP (Top 25 Global Banks)



Source: JP Morgan

Only ten banks in the UAE have a ratio of total assets as a percentage of the country's non-oil GDP, above 10% and the chart below presents this ratio for the top ten banks in the UAE. Of these ten banks, two are foreign banks.

Chart: 3-3. Banks operating in the UAE (With Total Assets -to- Non-Oil GDP Exceeding 10%)

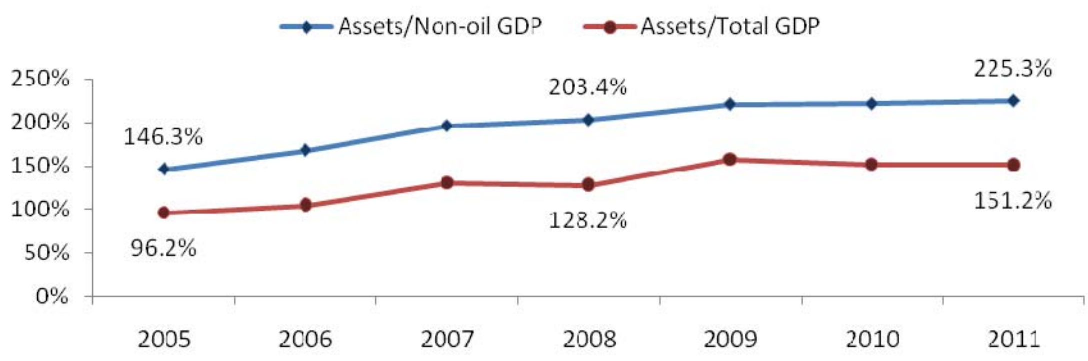


Source: Central Bank of the UAE, FSU Staff estimate

Based on the criteria of size, it would appear that no single bank is beyond the ability of the Central Bank to act as lender of last resort until its shareholders find a permanent solution.

The other question which arises is whether the UAE banking assets to GDP ratio is high by international standards?

Chart: 3-4. UAE Total Banking Assets to GDP



Source: Central Bank of the UAE, FSU Staff estimate

Over the period 2005 - 2008, the UAE banking sector witnessed high growth rates on the back of strong economic growth in the UAE as well as the region, fuelled by a booming stock market at the beginning of that period, together with a booming real estate market throughout the stated period - both trends were encouraged by negative real interest rates. Accordingly, the ratio of UAE banks' total assets to non oil GDP increased from 146% in 2005 to the current 220% level in 2011. The sharp increase of banks' assets was driven by a combination of lending to GREs and real estate related lending fuelled by a robust growth of deposits with UAE banks. While in years previous to 2005, banks' loan book had grown in line with the GDP's growth, the new economic environment triggered a divergence between the two rates.

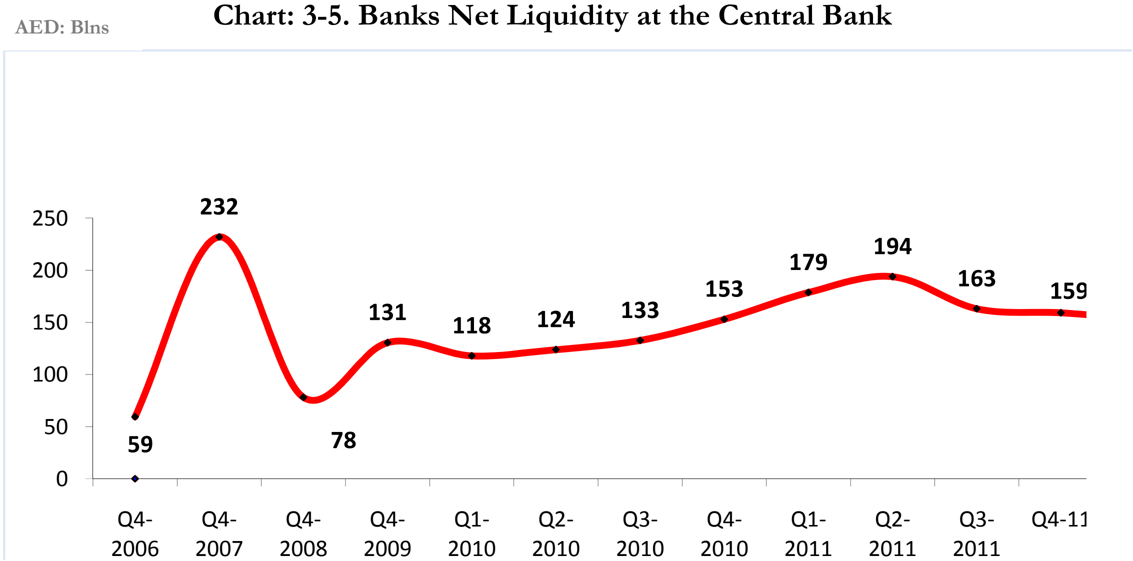
This growth rate was not sustainable on a long term basis and a correction took place in 2009. The correction was initially triggered by the Global Financial Crisis. The year 2009 turned out to be a year of transition which saw a contraction of both the GDP growth and the loan book growth. Since 2010, loan book growth has started to move in line with the country's GDP growth, reflecting a much healthier lending environment.

In other jurisdictions the ratio of total banking assets to GDP is generally lower. Due to minimal reliance on capital markets for financing in the UAE, corporate rely largely on bank lending to finance their needs and this is reflected in the high banking assets to GDP ratio.

Banking sector liquidity

In the UAE, CDs issuance is not driven by monetary policy consideration. These instruments are a store of liquidity for banks that provide them with a risk free return.
The chart 3-5 is one of the indicators which are regularly monitored by the Central Bank to assess the overall liquidity in the banking sector. The chart shows the net total liquid assets placed by the banks with the Central Bank, namely current account balances, reserves requirements and purchased CDs (net of any use of Central Bank liquidity facilities).

Chart: 3-5. Banks Net Liquidity at the Central Bank



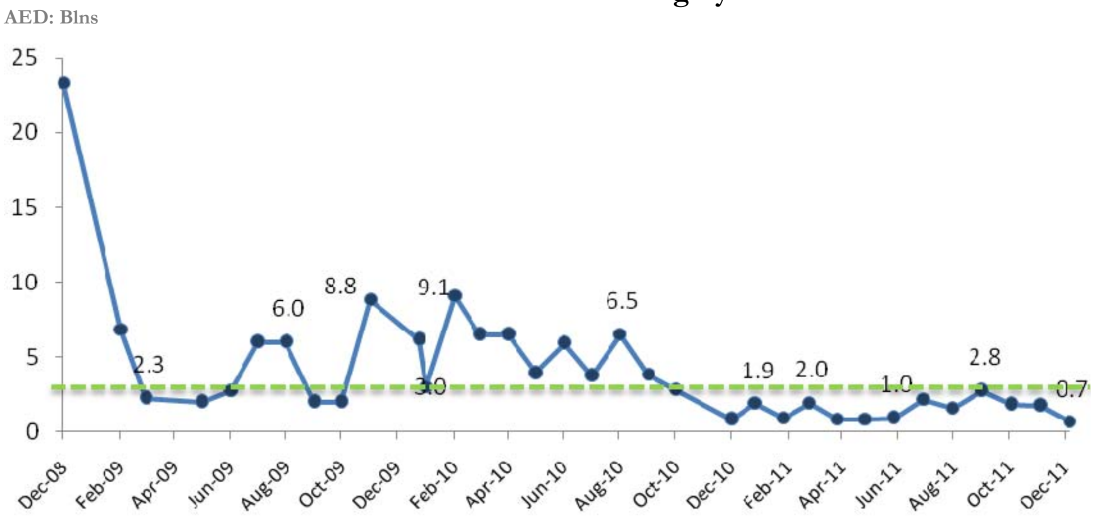
Source: Central Bank of the UAE, FSU Staff estimate

Not surprisingly, the lowest part of the curve corresponds to the last quarter of 2008, which was the most critical period of the Global Financial Crisis. At that point, the banking sector liquidity placed with the Central Bank accounted to only 5.26% of the banks' total assets[3]. The current situation is a lot more comfortable, as at the end of the year 2011, banks' net liquidity with the Central Bank stood at AED 159 billion, and representing 9.17% of their total assets[4].

It is worth adding that at the peak of the financial crisis during late 2008, the Central Bank intervened and provided the needed liquidity support to banks which ensured the stability of the UAE banking system.

This was achieved by providing AED 25 billion of collateralised loans to the system. This amount was about 2% of banks' total assets. Also the capital injections (Tier 1 & Tier 2) in local banks by the Departments of Finance of local governments, Ministry of Finance and banks' shareholders were key factors in stabilising the banking sector, which was confirmed by the level of borrowings from the Central Bank (down to less than 3 billion at the end April 2009). As shown by chart 3-6, the collateralised liquidity provided by the Central Bank varied between AED 5 to 10 billion for the larger part of 2009, before gradually receding to the AED 0.5 to 3 billion range in the last 12 months, indicating that the banking system has reached a comfortable liquidity position.

Chart: 3-6. Total Collateralised Funding by the Central Bank



Source: Central Bank of the UAE, FSU Staff estimate

Low dependence on overseas funding

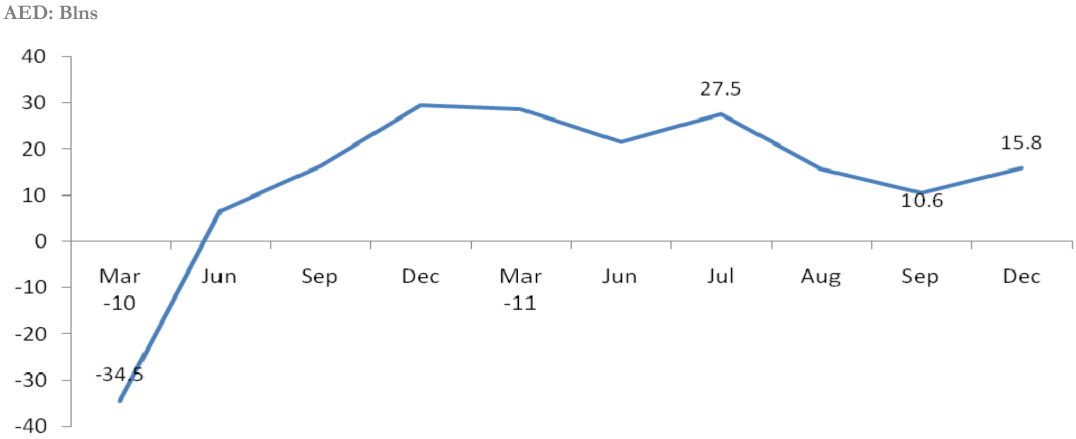
There is limited reliance on foreign funding by local banks to fund their operations. There is limited reliance as well on non-resident deposits, relative to resident funding.

- Reliance on foreign interbank market decreased by the middle of 2010, when local banks' non-resident interbank lending began to exceed their non-resident interbank

[3] Total Banking Assets by end of 2008 = AED 1,481 billion
[4] Total Banking Assets by end of 2011 = AED 1,733 billion

borrowing. This trend has continued and now local banks are net creditors, to the tune of AED 16 billion at the end of December 2011.

Chart: 3-8.UAE Local Banks Net Non-Resident Interbank

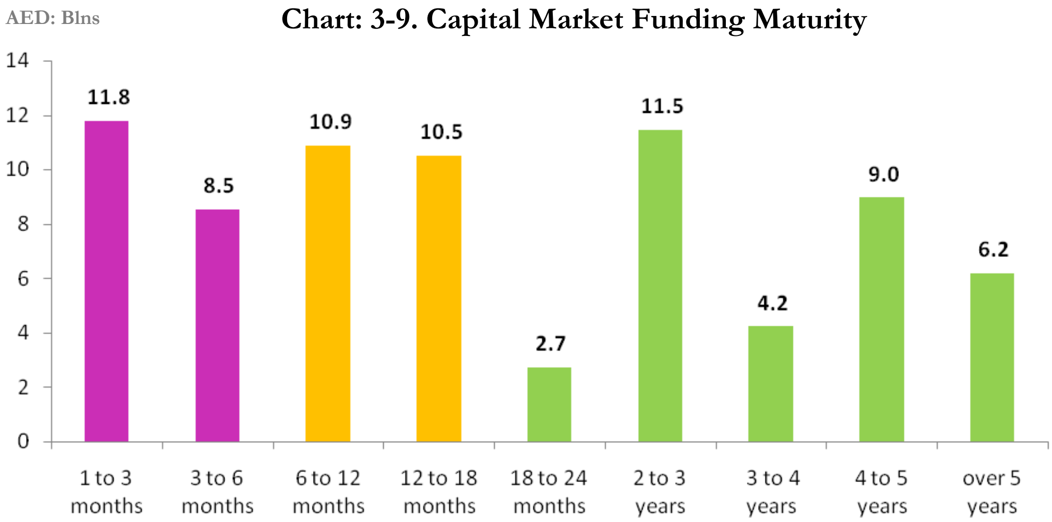


Source: Central Bank of the UAE, FSU Staff estimate

This is due to the continued organic growth of resident deposits and the modest surge in non-resident deposits, the latter taking place in the second half of 2010. Therefore, local banks' dependency on foreign interbank markets to fund part of their operations is quite limited, which is a major positive development from the situation prevalent in 2008.

- The second source of foreign funding is the Debt Capital Market. As of December 2011, they represented less than 7% of the funding liabilities of local banks and have been around AED 75 billion for the last two years. In view of the lack of medium term funding available domestically to UAE banks, they represent a welcome source of long term funding. The chart 3-9 shows the maturities' buckets of the various capital markets funding programs of banks currently outstanding. The Central Bank keeps a close watch on the various funding programs run by banks.

Chart: 3-9. Capital Market Funding Maturity

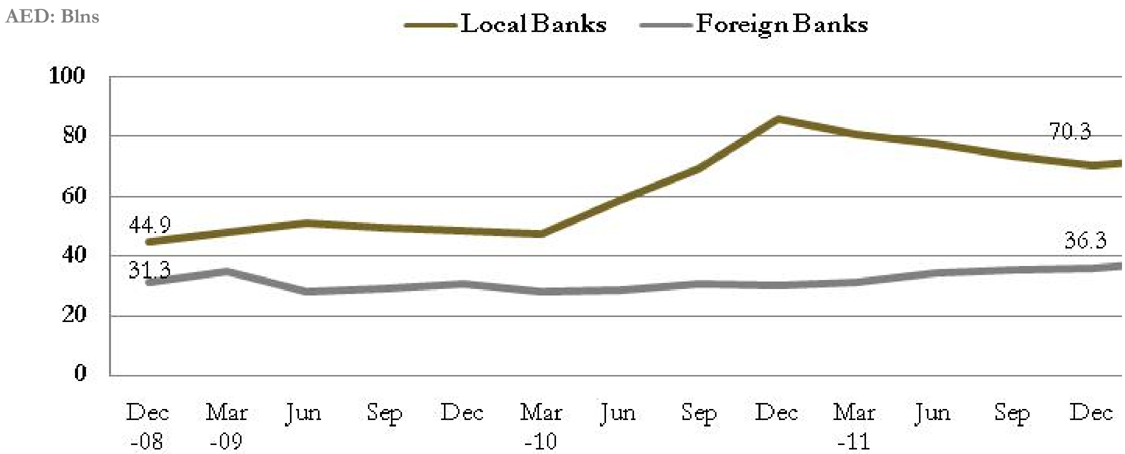


Source: Central Bank of the UAE, FSU Staff estimate

The Bank for International Settlements estimates that from the funding provided to the UAE by non-residents, two thirds are originated from Europe. The gradual worsening of the Euro crisis will have some influence on the capital inflows, in particular because of the de-leveraging followed by European banks. However, banks operating in the UAE have managed to diversify their funding into the Middle East and Asia by having successfully issued medium term notes in the later part of 2011 and early 2012 to the tune of USD 2 billion in these markets.

- Traditionally non-resident deposits have been stable at around the AED 75 billion level. In the second half of 2010, capital inflows were driven by an arbitrage opportunity between dirham and dollar rates propelled by the near zero policy rates and liquidity expansion in developed economies. By the end of 2010, non-resident deposits had increased to AED 120 Bn.

Chart: 3-10. Non-Resident Deposits



Source: Central Bank of the UAE, FSU Staff estimate

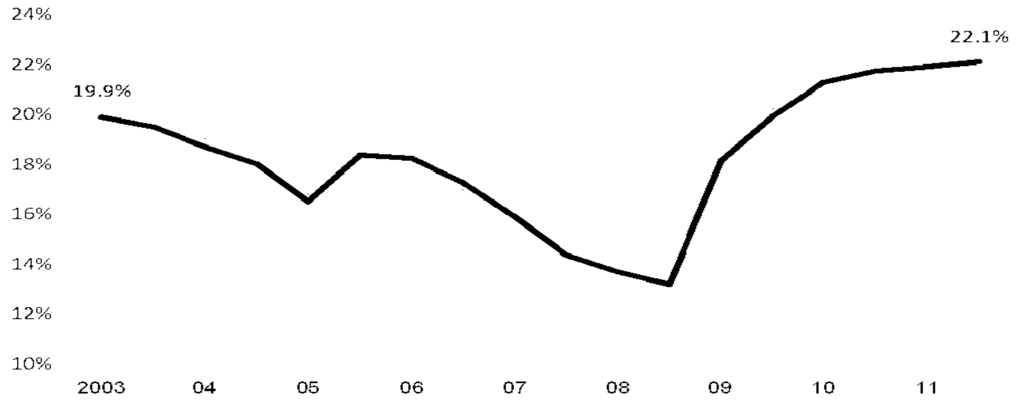
This expansion of non-resident deposits could have been a source of concern for financial stability as it could have resulted in a build-up of macroeconomic imbalance leading to an asset price bubble. This did not happen as we saw a corresponding rise in Central Bank CDs' outstanding which effectively sterilised a majority of these inflows.

High capital levels

At 21.2% capital adequacy ratio (Tier 1 and Tier 2) and 15.7% for Tier 1 capital, UAE local banks enjoy a high level of capital adequacy. As the UAE is an emerging economy and in order to mitigate the concentration of risk due to the high share of GREs' in the economy, the Central Bank requires banks to hold capital in excess of the Basel Committee recommendation. At the end of 2011, banks were required to maintain a minimum CAR of 12%, with 8% minimum Tier1 capital.

It is worth mentioning that Tier 2 capital is exclusively made of subordinated loans, mainly provided by the Ministry of Finance; the MOF Tier 2 loan agreements were signed effective 31 December 2009 with a maturity of 7 years and repayable in one single instalment by December 2016.

Chart: 3-7. UAE Local banks regulatory capital (Tier 1 & Tier 2) to risk weighted assets



Source: Central Bank of the UAE, FSU Staff estimate

A real estate exposure closely monitored

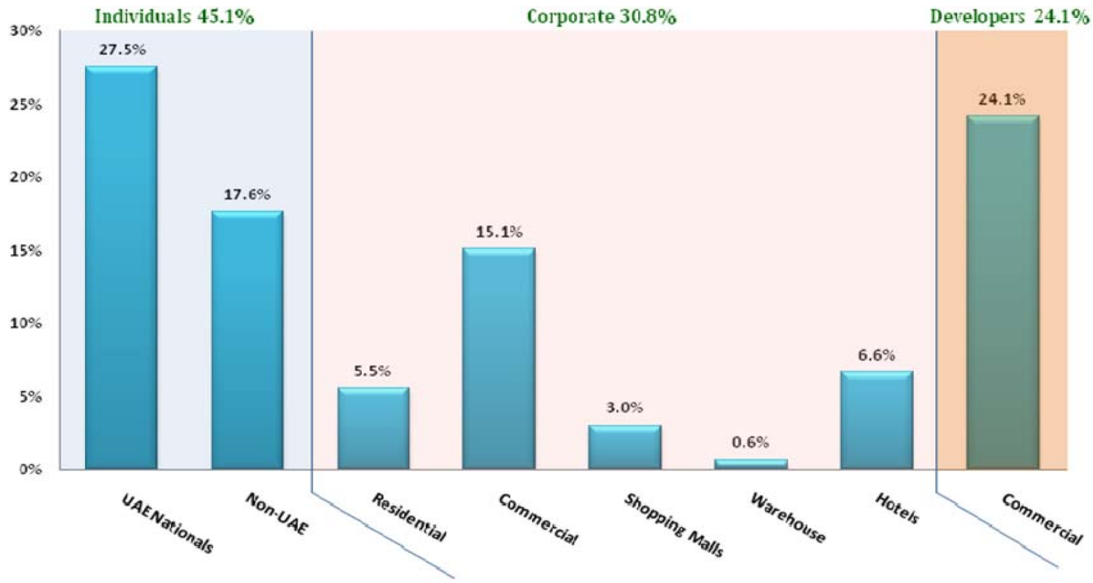
As we have learnt from other countries' experiences (for example US savings and loans crisis in the 80s, Japan and Sweden in the 90s, and more recently the subprime crisis) that real estate booms and busts can have far-reaching consequences for a country's banking system. The IMF has identified 46 systemic banking crises in which more than two thirds were preceded by boom-bust patterns in house prices.

The UAE real estate market witnessed a similar pattern, a boom during the years 2005 to 2007 followed by a bust in 2008. Fortunately banks avoided a major crisis largely because of the high concentration of the development activity in the hands of government related institutions which benefited from the government support at a crucial time. This has enabled the bust cycle to evolve in a controlled environment and limited the systemic spill-over.

The total banking sector exposure to real estate (based upon the purpose of the loan), after provisions amounts to AED 232 billion (gross AED 243 billion). The net amount represents 21.5% of banks' total deposit base and 21.3% of their total net loans and advances.

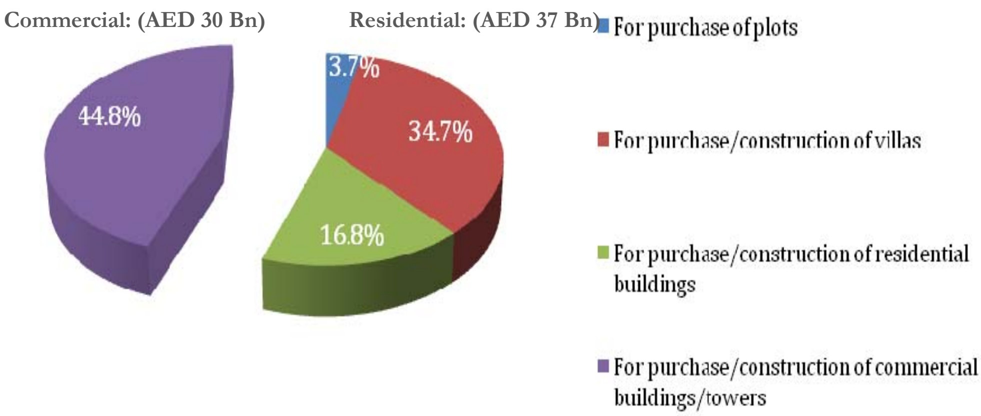
The following charts illustrate the nature of the borrowers and the real estate segments where money is deployed.

Chart: 3-10. Banks operating in the UAE: Real Estate Exposure break-down



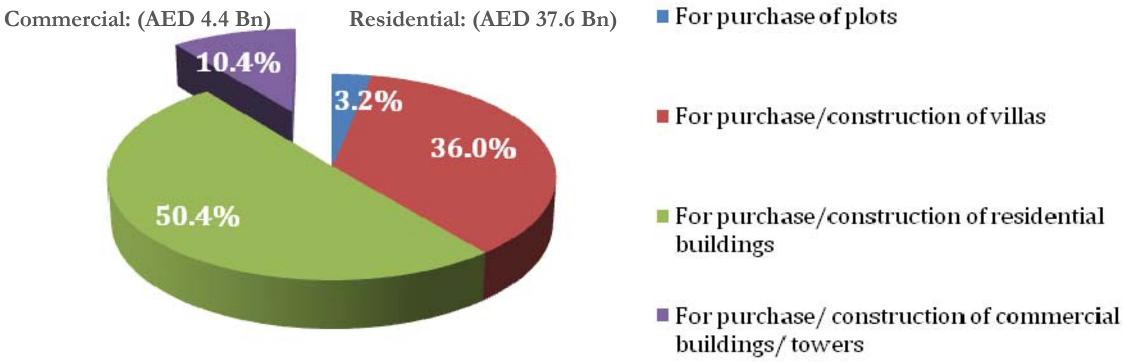
Source: Central Bank of the UAE, FSU Staff estimate

Chart: 3-11. UAE Nationals Exposure to Real Estate



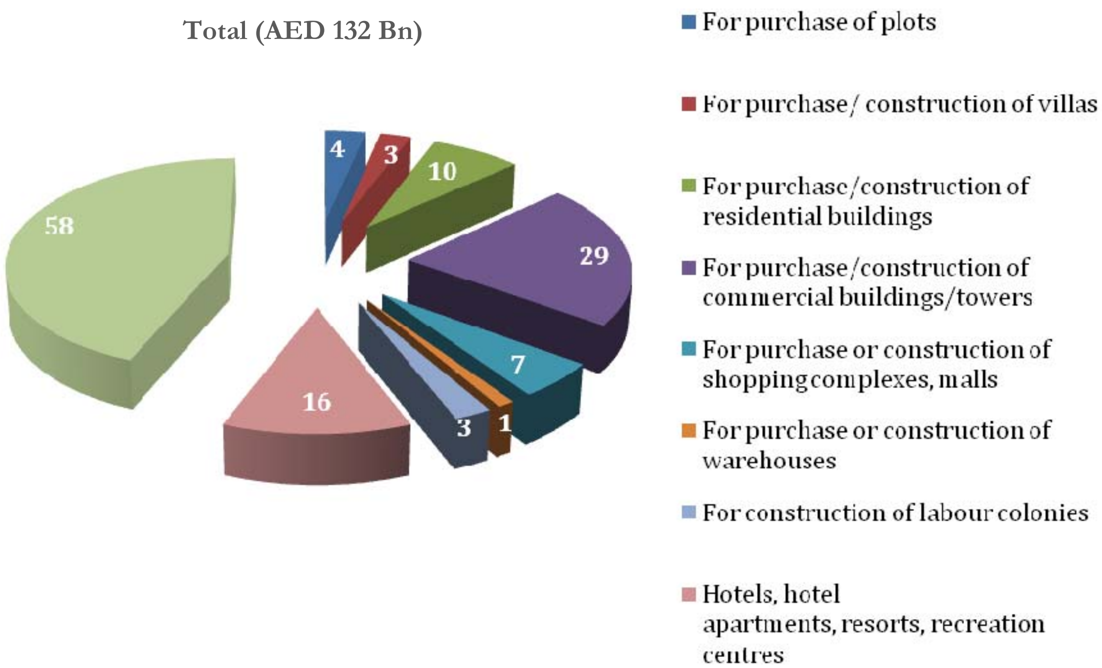
Source: Central Bank of the UAE, FSU Staff estimate

Chart: 3-12. Non-UAE Nationals Exposure to Real Estate



Source: Central Bank of the UAE, FSU Staff estimate

Chart: 3-13. Corporate Exposure to Real Estate



Source: Central Bank of the UAE, FSU Staff estimate

Stress testing[5]

The burst of the real estate bubble in the Emirates during 2008, together with the general slowdown of economic activity as a consequence to the Global Financial Crisis and in particular its impact on the GREs, have caused a deterioration of the banks' quality of assets. Non-Performing Loans (NPL) have increased over the period, with an average of 7.2% for all banks at the end of December 2011.

The stress test exercise

The Central Bank conducts bi-annual stress tests with the objective of assessing local banks capital adequacy in situation of assets quality deterioration. Any additional increase in nonperforming loans as a result of the stress test must be accompanied by an increase in specific provisions. This further increase in provisions is then deducted from banks' capital.

The resilience of banks in the test is measured with reference to their ability to maintain a capital adequacy ratio above the minimum level prescribed by the Central Bank, currently 12% of their risk weighted assets.

Although the stress test does not capture any deterioration in the quality of local banks' investment portfolios, it provides a good indication of the ability of local banks to withstand a general economic downturn in our market.

The context

The stress tests were based upon the two following scenarios:

Scenario 1:

Economic conditions deteriorate and NPL for each bank is assumed to rise from its current level to 15% of the total loan book. As an example, a bank with 8% NPL ratio is now saddled with a 15% ratio; this 7% increase must be 75% provisioned and this provision is deducted from the bank's capital.

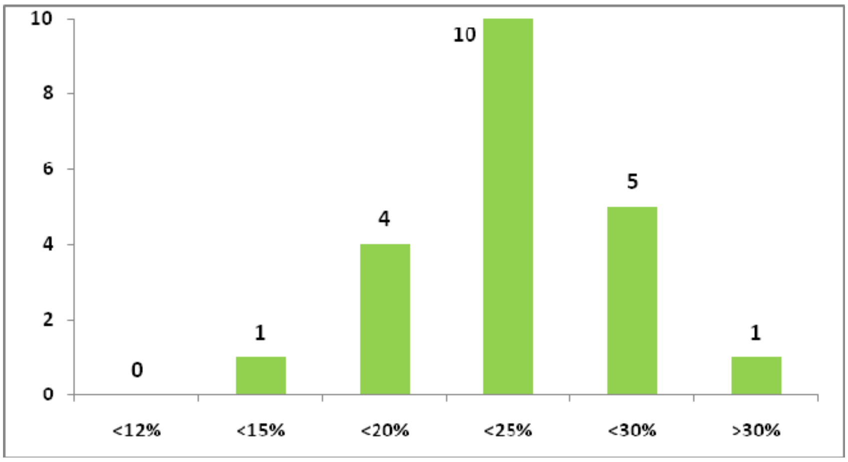
Scenario 2:

It recognises that the assets quality can differ from one bank to another. Accordingly, the NPL ratio is recalculated taking into account an increase of 50%, 75 % and 100% from the level reported by each bank at the end of 2011. Again using the example of the same bank with 8% NPL ratio, this bank is now tested with the NLP rising to 12%, 14% and 16% of its risk weighted assets. Similar to the first scenario, 75% of the increase on NPL for each bank will be provisioned and deducted from the bank's capital.

[5] Local Banks only

CAR before the tests

The chart here below shows the number of local banks in each CAR bucket at the end of 2011 and before any stress test was carried out.



Source: Central Bank of the UAE, FSU Staff estimate

Result of the stress tests

These two stress tests, although reflecting two extreme situations, were satisfactorily passed by all concerned banks. The results show that banks hold enough capital buffers to address major stress scenarios which could result in significant deterioration in the quality of their loans and advances.

Improved infrastructure and banking regulations

The Central Bank is regularly reviewing and upgrading regulations with the objective to ensure a sound and robust financial system. The following regulations were introduced during the year 2011.

Regulations for Classification of Loans and determining their Provisions

On the 11th of Nov' 2010, the Central Bank issued regulations (No 28/2010)[6] concerning the classification of nonperforming loans, the suspension of profit/interest and the provisions to be passed for corporate, credit cards, personal and car loans. The objective of the regulations is to set a common framework to all banks for classifying loans and advances to customers, in line with the standards adopted by the Basel Committee and international best practices.

Banks are required to classify their loans and advances in 5 categories, according to their conditions. For corporate, banks are required to constitute a minimum provisions for those loans and advances classified as non-performing (substandard, doubtful and loss). For retail exposures, banks are required to make provisions based upon the number of days past due.

The circular reaffirmed that interest on loans that have been provisioned or loans where interest is overdue for 90 days or longer must not be credited to the profit and loss account, but to a suspense account.

A clarification and guidance manual of the regulation was issued on the 31st of Jan 2011. Banks were directed to implement best practices, notably the requirement to recognise default after 90 days, regardless of the ownership of the concerned entities.

Regulations regarding bank loans and services offered to individual customers

On the 23rd of Feb' 2011, the Central Bank introduced a new regulations (No 29/ 2011) with regard to bank loans and other services offered to individual customers. This regulation aims at preventing individual customers from taking loans which they would struggle to repay at a later stage, causing unsustainable financial burden on them.

The main features of this new regulations are to revise the maximum amount that one individual could borrow (20 times his monthly income), and introduce a maximum debt service ratio (50% of regular income). Terms and conditions for applying for car loans and the minimum salary to qualify for credit cards were also introduced.

[6] This regulation replaced circular 313 of 1984.

The regulation also introduced limits on fees, service charges and commissions charged to individual customers, with the objective of curbing excessive fees charged by some banks.

Basel III

In response to the Global Financial Crisis, the Basel III reforms have been introduced with the objectives of reducing the frequency of financial crisis and mitigating its impact if it does happen. The key objective is to reduce the probability and severity of future crises by introducing stronger regulatory capital and liquidity requirements as well as more intense supervision. It also aims at reducing the cost to the economy of bailouts and providing regulators with more time to act.

For the UAE, this reform means mostly the introduction of global liquidity standards to address short-term and long-term liquidity mismatches and the introduction of additional capital buffers and a leverage ratio.

As far as liquidity is concerned, during the course of 2011, the Central Bank held a series of consultative meetings with banks in order to introduce a new liquidity regime taking into account the peculiarities of our market, in particular concerning the availability of liquid assets and the absence of long term debt capital market; in line with the recommendations of the Basel Committee for Banking Supervision, new regulation will come into force in 2012.

Payment and Settlement Systems Oversight

Payment Systems

Payment systems play a major role in the stability of any financial system. As such, the CBUAE regulates and oversees the following systemically important payment systems.

- **UAE Funds Transfer System- (UAEFTS)**
  It is owned and operated by the CBUAE.

  The UAEFTS is the Central Bank's real-time gross settlement system (RTGS). In 2011 alone, the UAEFTS processed 8.6 million transactions and settled AED 8 trillion, which is an increase of 11% in volume from 2010.

- **Image Cheque Clearing System (ICSS)**

  ICCS was introduced in July 2008 and features cheque truncation and T+0 settlement i.e. settlement taking place on the same day the cheque is cleared. In 2011, ICCS processed 8.6 million items and settled AED 1.1 trillion

- **UAESWITCH (national ATM-Sharing scheme)**

  Launched in 1996, the UAESWITCH allows cardholders to obtain service at ATMs throughout the Gulf region. The system processed AED 87 billion in transactions in 2011.

- **Wages Protection System (WPS)**

  The Central Bank introduced WPS in September 2009 in order to meet the objectives of the Ministry of Labour. The WPS provides a safe, efficient and robust mechanism to allow the timely payment of employees' wages. All banks and money exchanges registered with the Central Bank can act as agents to this system.

Payment Systems Oversight

The Payment Systems Oversight Unit (PSOU) was created in April 2009 to supervise payment systems in general and to ensure their compliance with the Core Principles for Systemically Important Payment Systems issued by the Bank for International Settlements (BIS).

New Developments

Monetary Policy Framework

The Central Bank of the UAE is aiming to make changes to its monetary policy framework by installing a discount window to enable banks to borrow intra-day and overnight funds from the Central Bank. This planned facility will be called the Marginal Lending Facility

(MLF). The MLF will be an electronic platform which will be integrated to a domestic Central Securities Depository (CSD) and the UAE Fund Transfer System. The MLF will have interfaces with international CSDs. Banks under the supervision of the Central Bank may sign up to such a facility and will have to maintain eligible collateral with approved CSDs to enable MLF borrowings.

This facility will improve liquidity management practices within the UAE and support money markets if there are liquidity shortfalls. It will also support the development of collateralized debt markets and long term capital market as commercial banks will be inclined to invest in securities that are defined as eligible securities – this process will facilitate the implementation of Basel III liquidity standards.

IBAN

The recent adoption of the international bank number (IBAN) in the UAE in 2011 increased the efficiency of electronic funds transfers by reducing the inaccuracy of payment transfer instructions. The UAEFTS RTGS system went through a series of changes to further improve the efficiency of transfers by implementing straight through processing (STP) and providing enhancement of message types for institutional and customer transfers.

EMV mandate in Credit and Debit Cards

The CBUAE mandated in 2011 that credit and debit cards issued in the UAE should be compliant with EMV Chip & PIN (standard for credit and debit payment cards based on chip card technology). The adoption of EMV in the UAE market is expected to improve security in card transactions by reducing the level of fraud in the UAE market. The full adoption in the market is expected by 2014.

UAE Direct Debit System (UAEDDS)

The UAEDDS system is a direct debit system currently being developed in the CBUAE and is predicted to go live at the end of 2012. It will offer an alternative method of effecting recurring payment transactions for utility services such as telephone bills, electricity bills, insurance premiums, card payments and loan repayments.

The UAEDDS system falls in line with the strategy to reduce the use of paper instruments such as cheques in the UAE.

Legal Framework

The CBUAE is proposing some changes in the legal framework in order to strengthen the soundness of the payment systems in the UAE. One of the proposals is to formally recognize payment and netting finality in the law.

At the moment, finality is only recognized through the rulebook of the UAEFTS system.

Stock Market review (2010-2011)[7]

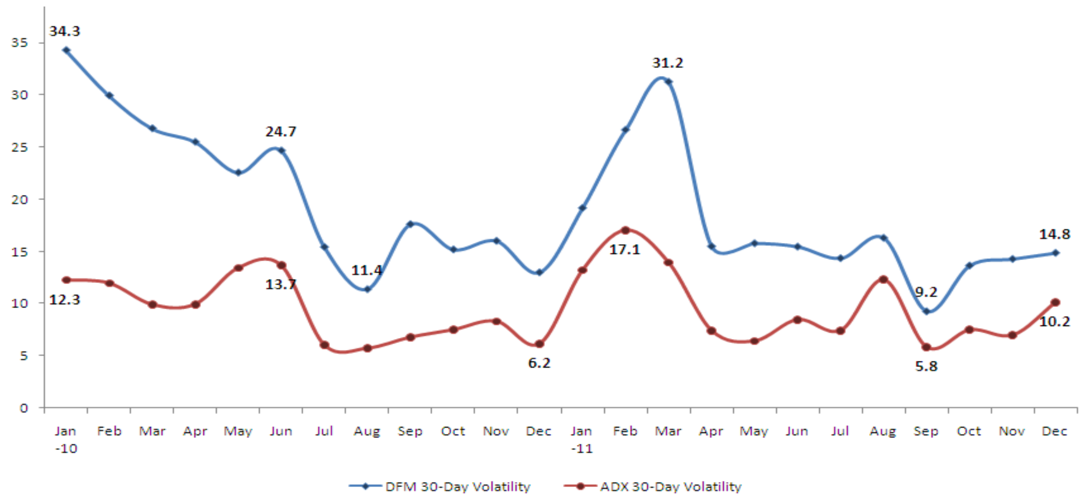
Volatility of stock market returns

Volatility is a measure of the risk of price moves for a security, share prices in this case, calculated from the standard deviation of day to day logarithmic historical price changes. Volatility, particularly that implied by option prices, is used as an indication of investor sentiment between the two extremes: euphoria (very low volatility) and panic (very high volatility). In the graph below, the 30-day price volatility equals the annualized standard deviation of the relative price change for the 30 most recent trading days' closing price, expressed as a percentage for UAE markets.

Volatility has been steadily declining on both the Abu Dhabi Securities Market (ADX) and the Dubai Financial Market (DFM) since the beginning of 2010. Against this trend, a notable spike in Q1 2011 was likely the effect of the Arab Spring including the shut-down of the main MENA stock exchange in Egypt for almost eight weeks between January and March 2011.

During that period, volatility rose across the MENA region, including the GCC, indicating investors feared spillover effects on other financial markets and potential spread of political problems. As the political situation clarified, volatility came back to its normal trend in the UAE's financial markets, as investors made the distinction regarding political stability in the Emirates. After averaging 25% and 14% in the DFM and ADX respectively during Q1 2011, over the remainder of 2011, volatility levels of the UAE stock exchange has continued their long term declining trend and averaged a 14% and 8% decline; almost a quarter from 2010 average levels.

Chart: 5-1. Volatility of Stock Market Returns



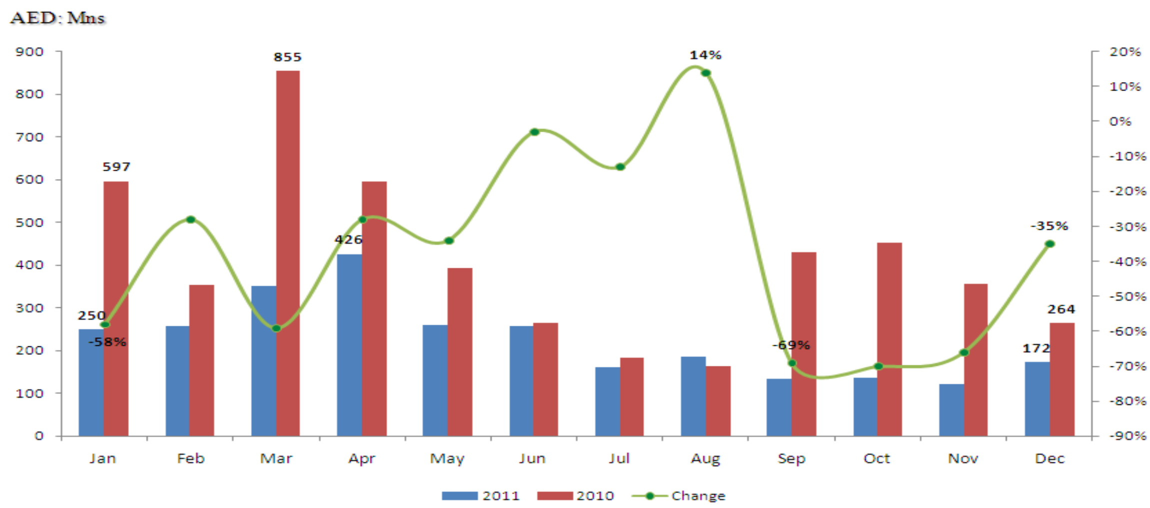
Source: Securities & Commodities Authority, SCA RMU Staff estimate

[7] Contributed by Dr. Ryan Lemand, SCA Head of Risk Management Unit.

Value of trades

Daily average values traded in the UAE stock markets[8] have experienced a generalized decline during 2010 and 2011. An historic low was set in November 2011 with average daily trading of AED 120 million. Thin trading values create a liquidity risk for stock markets participants: investors attach a higher liquidity risk premium to stock valuation, limiting the attractiveness of the stock market as a source of capital for companies. The multi-year downtrend in daily trading has reversed in Q1 2012; the main contributing factors include the publication of better than anticipated results of UAE listed companies for the year 2011, liquidity injections[9] in Europe, and positive economic data[10] out of the US.

Chart: 5-2. Daily Average Value Traded



Source: Securities & Commodities Authority, SCA RMU Staff estimate

Net value of purchases of UAE stocks by non-UAE citizens

Compared to 2010, foreign investors have returned as net purchasers of UAE stocks during 2011. Over the past two years, however, the percentage of daily trading attributable to non-UAE citizens has remained unchanged at 42%. In the context of the economic uncertainty prevalent over the period covered by this report, this outcome shows the commitment of foreign investors to participate in the UAE stock markets. Key event risk was linked to the missed MSCI upgrade in December 2010 and June 2011, but this did not translate to significant outflow of foreign investment from the UAE stock markets.

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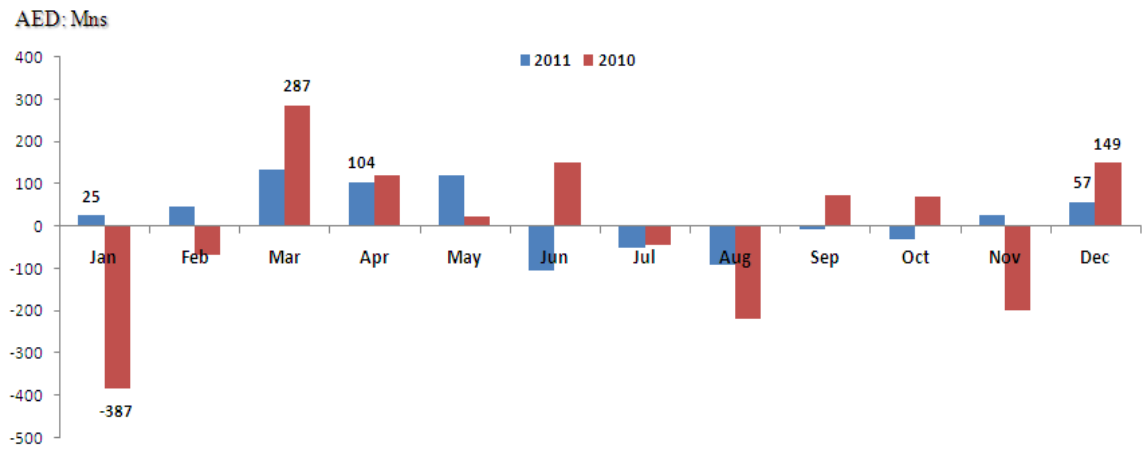
[8] UAE stock markets are Abu Dhabi Securities Market and Dubai Financial Market

[9] The European Central Bank lent to European banks EUR 489bn (AED 2.3 trillion) via its Long Term Refinancing Operation (LTRO) on December 22nd, 2011 and then EUR 530bn (AED 2.6 trillion) on March 1st, 2012 in another LTRO operation.

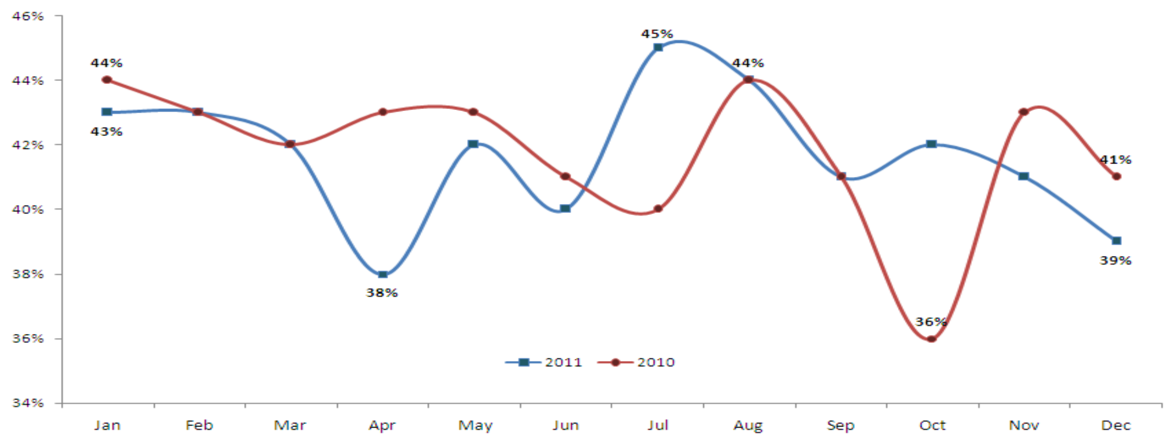
[10] US GDP grew 3% in Q4 2011 and non-farm payroll increased by more than 200,000 jobs every month from November 2011 to February 2012.

Chart: 5-3. Net value of purchase of UAE stocks by non-UAE citizens



Source: Securities & Commodities Authority, SCA RMU Staff estimate

Chart: 5-4. Proportion of daily value traded by non-UAE citizens

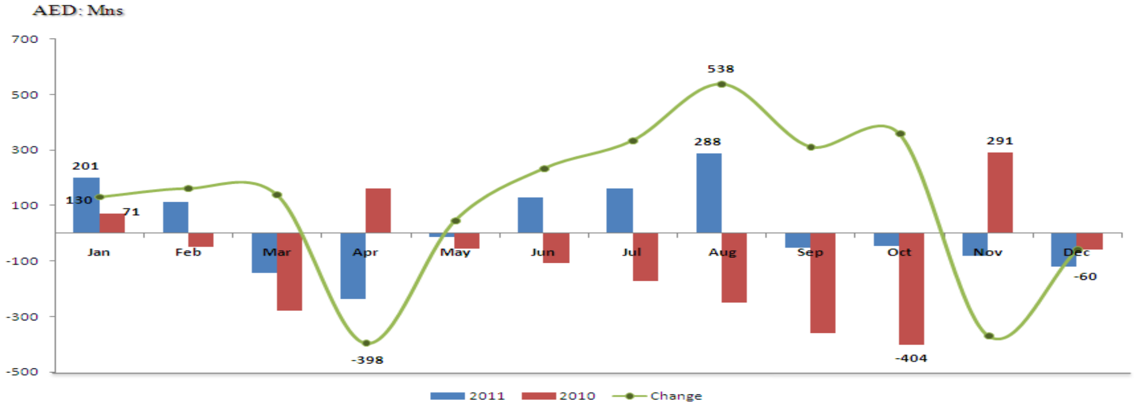


Source: Securities & Commodities Authority, SCA RMU Staff estimate

Net value of purchases of UAE stocks by individual investors

Individual investors shifted from being net seller in 2010 to net purchaser of UAE stocks in 2011.

Chart: 5-5. Net value of purchases of UAE stocks by individual investors



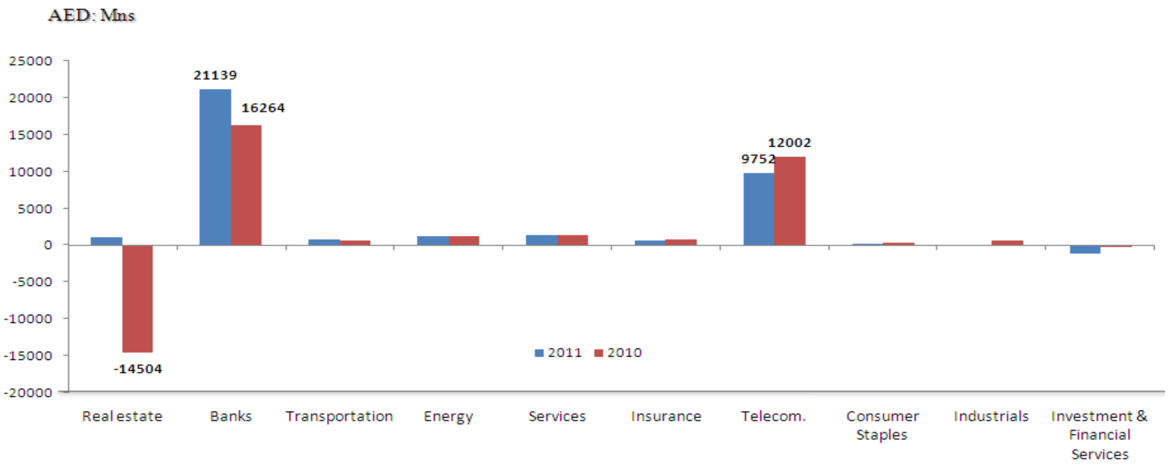
Source: Securities & Commodities Authority, SCA RMU Staff estimate

UAE listed companies: 2011 performance review

Net income of UAE listed companies by sector

The 90% net profit increase in 2011 of UAE listed companies compared to 2010 has been a major driver of stock market performance when such results were announced in the first quarter of 2012. In other words, the positivity linked to the net income almost doubling had not impacted financial markets in 2011 itself. In 2010, the only sectors dragging the markets down were real estate and investment & diversified financial services, while the banking sector sprung back to profitable economic activity in the UAE in 2010 and accelerated in 2011.

Chart: 5-6. Net Income of UAE listed companies by sector



Source: Securities & Commodities Authority, SCA RMU Staff estimate

Financial ratios by sector, excluding the banking sector:

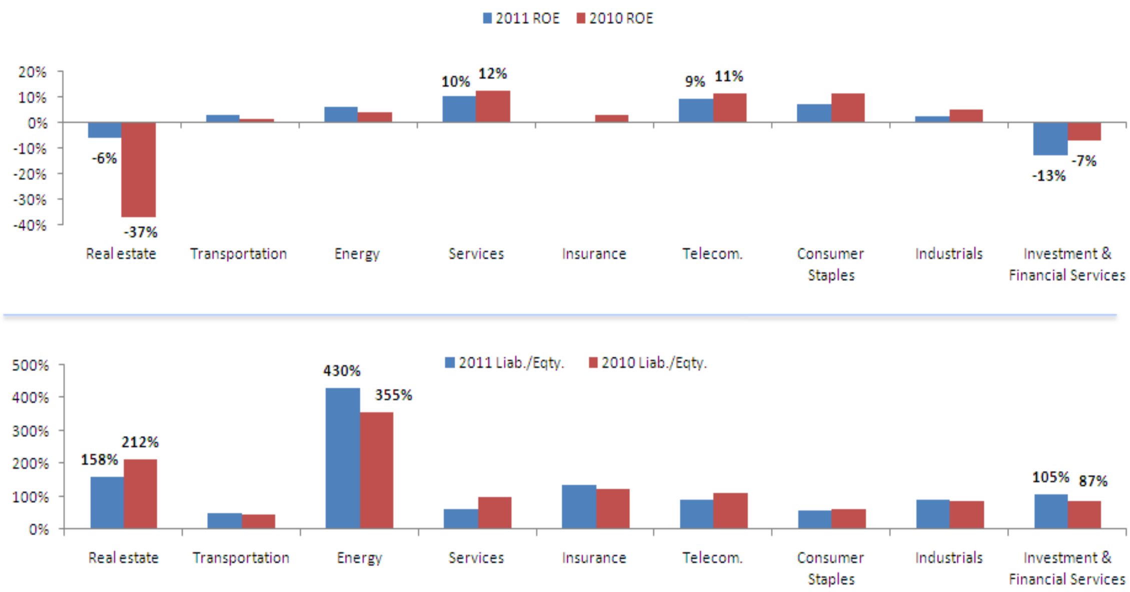
The key real estate sector has continued its systemically important deleveraging trend as it reduced its leverage[11] ratio by 25% to 158% in 2011 from 212% in 2010. Such deleveraging has come mainly in the form of write-downs of asset values which impacted the sector's profitability, resulting in yet another negative Return on Equity of -6% in 2011. This, however, is a marked improvement from the large losses suffered in 2010.

Looking at the wider market, companies in the UAE have tended to reduce their leverage as profitability recovers. The only sectors that saw the negative combination of increasing leverage and decreasing profitability were mainly investment & diversified financial services and industrials sectors while insurance saw a mild deterioration in the indicators.

While core sectors of the UAE economy, real estate and banking, are securing their positions, other pro-cyclical sectors are expected to benefit from economic growth forecasted for 2012 and the positive sentiment that started to build up on the back of strong recovery signs in the world's largest economy.

The main risk to this scenario could be linked to capital structure fragility of individual companies (debt refinancing) or further shocks coming from the ongoing European Union's solvency crisis.

Chart: 5-7. Financial Ratios by Sector



Source: Securities & Commodities Authority, SCA RMU Staff estimate

[11] As measured by the ratio of total liabilities over shareholder's equity

Concluding remarks

The UAE's objective of achieving "Emerging Market" status is coming closer thanks to several contributing factors.

First is the implementation of a comprehensive framework of rules and regulation to allow the development of the markets. The UAE Securities markets' regulation has introduced the following regulations:

- Financial Analysis Regulation
- Corporate Governance Regulation
- Delivery Versus Payment (DVP)
- Mutual Funds Regime
- Investment Management Regulation
- Custody Regulation*
- Short Selling Regulation
- Securities Lending and Borrowing Regulation
- Market Maker Regulation.

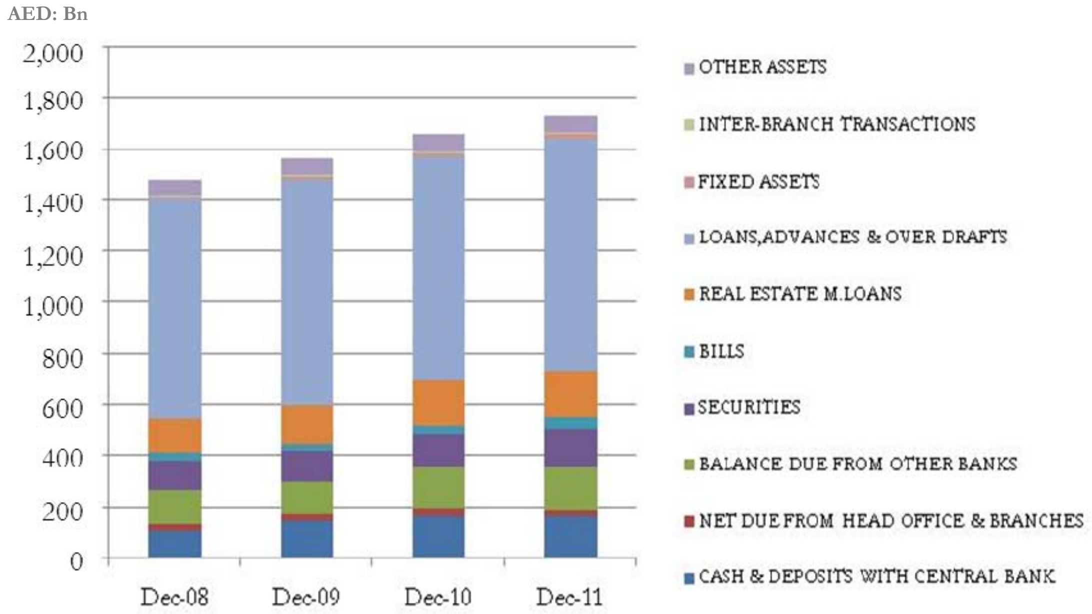
The second contributing factor is increasing of market participation by companies and by investors: stable economic growth, foreign and institutional investment, and the substantial value of trading are all key aspects to consider in assessing this factor.

The third contributing factor is acknowledgement by international investors' bodies, including index managers such as FTSE or MSCI, which ultimately means international investment reaching the UAE stock markets when searching for "Emerging Market" exposure.

The combination of these three factors over the years 2010 and 2011 shows that the UAE has made significant steps forward toward achieving "Emerging Market" status, but lacked the catalyst of global economic stability. As the global economic conditions improve and liquidity is restored, the UAE stand to capitalize on its structural and economic advancements.

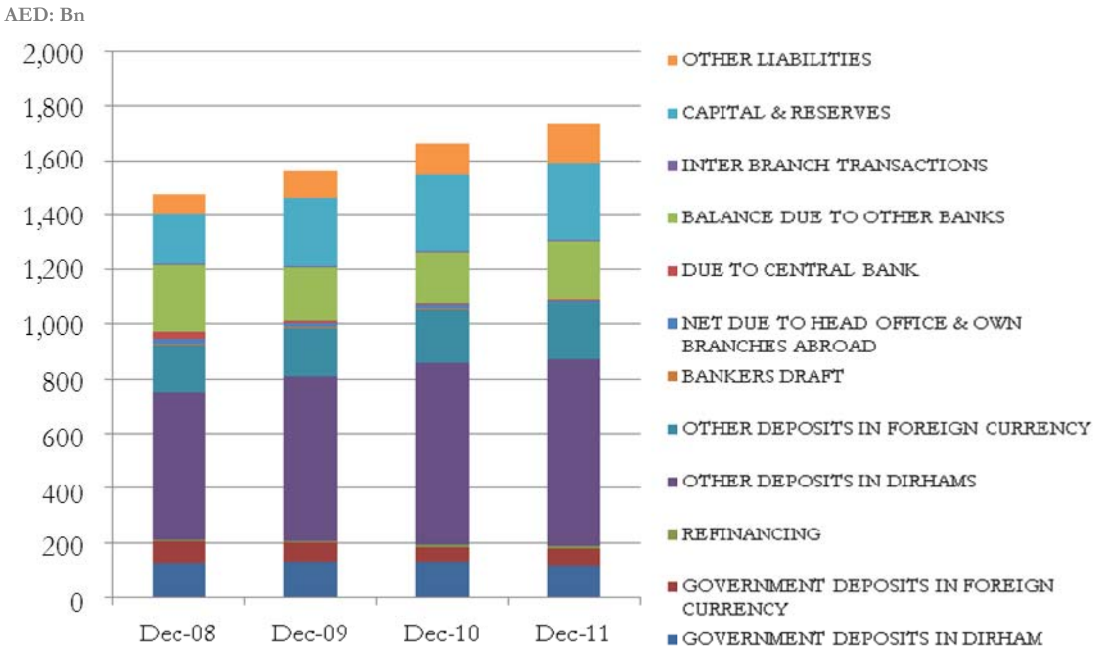
Appendix: Banks' consolidated data

Total Assets



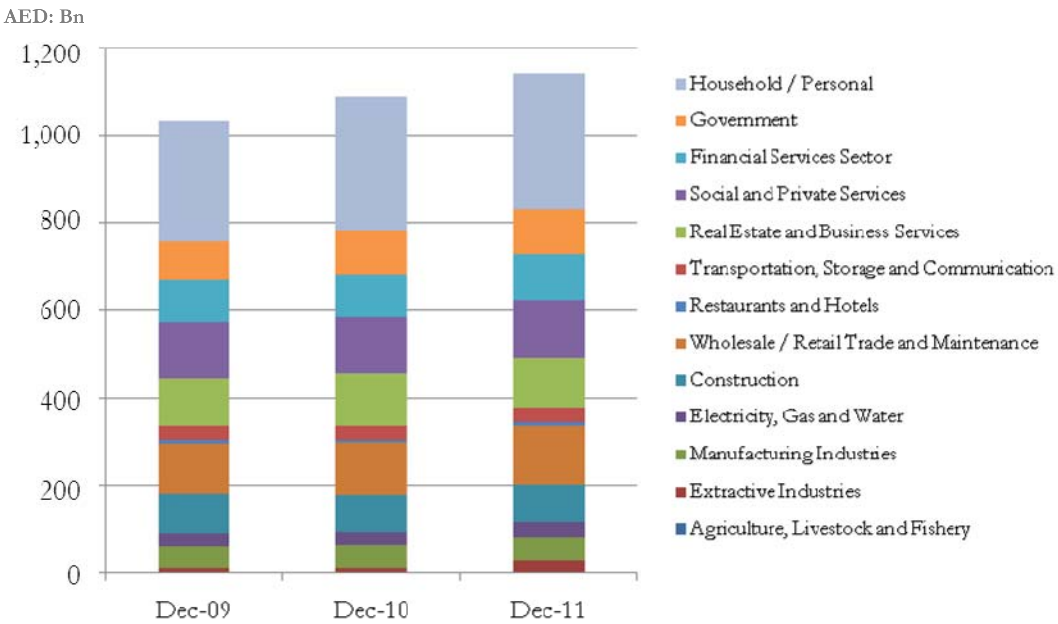
Source: Central Bank of the UAE, FSU Staff estimate

Total Liabilities



Source: Central Bank of the UAE, FSU Staff estimate

Loan & Advances Sectors Distribution



Source: Central Bank of the UAE, FSU Staff estimate