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Navigating the year ahead

Financial Services Regulatory Barometer
Middle East 2018

As the financial services landscape rapidly evolves, firms have a unique opportunity to transform their operating and business models. They can take advantage of the changing regulatory and economic environment to refresh their strategies, rethink their processes and identify new ways to increase efficiencies while reducing risks. Adaptation and agility will be key to success in the year ahead.

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Foreword

Regulatory requirements have been a major contributor to how financial institutions have evolved since the financial crisis. The influx of regulatory initiatives has forced many firms to reconsider their business models, in terms of new restrictions as much as new opportunities. This is in turn influencing the types of risks they are willing to take. And the shift is understandable – regulatory misdemeanours can have costly financial, reputational, and regulatory repercussions.

Many of the changes are driven by the international community, where the lessons learned from the crisis are working their way through the regulatory agenda in various forms. In the Middle East, we face the challenge of interpreting these requirements to suit the needs of our own unique financial services market, where the products, players, market maturity, and existing regulatory environment vary greatly to those in Europe and the US (where many international standards are set).

We also arguably face different regulatory risks and therefore have different regulatory priorities. These include the impact of the sustained low oil price on the availability and cost of liquidity, the risks from existing and perceived financial crime activities, the rise of non-performing loans (NPLs), and balancing a range of complex objectives (such as financial sector growth, financial inclusion, financial stability, and market safety).

Against this backdrop, we developed **Deloitte's first Middle East Regulatory Barometer**. With this Outlook, we set out our view on how regulations are shaping banks across the region, what their core regulatory priorities are, and what they consider to be the greatest risks or challenges. We also identified what the industry can do better, ranging from increased collaboration between banks to restructuring loans for companies to prevent defaults, to steps regulators can take to increase supervisory efficiency and clarity on expectations.

We considered it important to develop a Deloitte industry-wide view of the existing and future regulatory environment across the Middle East. It is a complex time and most of the challenges are not unique, therefore working together to exact change or identify more effective solutions is always an optimal outcome.

In this context, we are delighted to present Deloitte's Middle East Regulatory Barometer 2018, which looks at the challenges and opportunities that are shaping the industry.

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Top 10 regulatory priorities for the Middle East

Our outlook for banking regulation

The top 10 regulatory priorities are set out in the following pages together with our views on how each will affect the financial services sector and regulators across the Middle East.

1. Regulatory framework development
2. Cross-border compliance
3. Financial crime compliance
4. Financial stability
5. Recovery and resolution planning
6. Capital calibration
7. Risk and compliance culture
8. Conduct risk
9. Data and regulatory reporting
10. Technology and innovation

Regulatory framework development

Creating frameworks that effectively respond to existing and emerging risks

Regulatory frameworks require enhancements to stay current and effective, particularly as the markets they regulate evolve. This includes identifying new regulatory requirements for new market entrants, and ensuring existing laws, regulations and policies are clear and enforceable and can be applied to new and emerging business models.

Many existing regional frameworks require upgrades in whole or in part and regulators face dilemmas of whether to amend them piecemeal or to create new ones altogether. With the range of new regulations coming in, this is a good time to be asking the question.

It is not just the Middle East that faces the issue of whether regulatory frameworks are fit-for-purpose, if they target the right risks, and if they do so effectively. The issue is prevalent across both developed and developing economies. And sometimes, it is time to just start over again. A notable example is the UK's decision in the wake of the financial crisis to overhaul its own regulator, the Financial Services Authority ('FSA'), by splitting it into the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA'). Amongst the reasons given were the weaknesses that were identified in the regulatory approach during the financial crisis, such as the shortcomings of the "light-touch" regulatory approach, the need for more scrutiny of conduct risk, and an evolving need to focus on future and emerging risks as well as on the resolvability of firms. The PRA and FCA are aiming to do this more effectively, including by adopting a more intrusive regulatory approach. In short, they've identified what doesn't work and are trying something new – which they hope does.

That isn't to say that the Middle East needs to follow suit and adopt an intrusive regulatory approach; if anything, it is unlikely that an approach used in the UK is required for the Middle East market. But some core and targeted changes could prove beneficial.

Regulatory framework development

There are a number of core characteristics that are widely considered to make regulatory regimes more effective. These include ensuring they are:

- Proportionate and suitable for the regional market;
- Clear and transparent;
- Capturing existing and emerging risks posed by firms on an individual and market-wide level;
- Capable of reacting where changes are required; and
- Reflecting the needs of the local financial services market, the risks it poses to the local economy, and the complexity of the business undertaken.

With this in mind, the regulatory authorities in the Middle East may wish to aim for elements of the approaches adopted in economies such as the UK and the US, but should also consider how these can be adapted for local purposes. At this stage, that is likely to ensure doing the core elements properly, including building technical expertise, moving towards reviewing more qualitative risks posed by banks (such as risk, governance, and conduct risks), and ensuring its expectations are clear to the market. Having a solid foundation is a great place to start.

It is important to accept that there is no one-size-fits-all solution for regulatory frameworks; determining whether they are effective will require an assessment of their suitability, flexibility and transparency.

Regulatory framework development

Although there is no one-size-fits-all solution for regulatory frameworks, there are a few common weaknesses across some of the Middle East regulatory authorities that could be addressed through enhancing the different regulatory frameworks with similar solutions.

Potential enhancements to the regulatory framework

Common weaknesses	Changes required
Lack of clarity and transparency on requirements and expectations	Online access to all laws, regulations and policies
Inconsistent application of requirements	Industry regulatory working groups to ensure supervisory consistency*
Regulatory outputs often unclear or insufficient	Improve regulator's external communications

A deeper regulatory understanding of impact would then help build confidence in the local regulatory regime.

Regulators should focus on...

...conduct risk as this area is gaining importance internationally.

Share more information on cyber threats.

Consult more regularly and clearly with the industry, providing greater input to banks.

*This may vary by local regulatory authority

Cross-border compliance

Managing regulatory expectations across Financial Services groups

A particular challenge faced in the region is balancing requirements set by international standard-setting bodies with the needs of the local market. Adapting these requirements is time-consuming and requires an understanding of what is and isn't going to work locally. A key challenge that many banks looking to expand face is that they will have to recognise and meet the requirements of the jurisdiction in which they plan to expand: the more complex the group becomes, the more complex regulatory compliance becomes. This lack of harmonisation creates heightened non-compliance risks and increases the cost of compliance, particularly at a group-wide level.

Banking remains a highly globalised industry. While an increasingly interconnected world provides ample opportunities for banks to grow, there are also undeniably greater risks and compliance issues involved. Middle East banks, in particular, are recognising the need to think (and act) globally – not only to mitigate against a relatively small, oversaturated local market, but also to better serve international clients seeking reliable, easy banking wherever they go. While the standards set by bodies such as the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS) are globally recognised and can facilitate harmonisation across different countries and regions, the idiosyncrasies of the local market still matter for a range of reasons.

A key issue with cross-border compliance concerns methodologies used in applying regulations. Even though, in theory, capital requirements may be the same across different countries, in practice, methodologies for risk-weighting assets will vary across these jurisdictions. This will change the portion of a bank's balance sheet to which requirements are applied and therefore raises concerns amongst local banks about level playing fields. Differences between methodologies will also complicate the process for local banks trying to enter other countries' financial markets. Such banks would do well to engage with both their local regulator and international standard-setting bodies sooner rather than later. They should address concerns, seek clarification where needed, and signal their intentions to be fully compliant in the jurisdiction(s) in which they plan to grow. Continuous regulatory engagement can ensure banks avoid needless errors, amplifying operational and reputational risks, particularly during a sensitive period of market entry abroad.

Cross-border compliance

In the Middle East region, regulatory agendas and new legislation and initiatives have typically not been standardised, with both implementation dates as well as some core details differing between jurisdictions. For example, Basel III implementation has differed, with Saudi Arabia being deemed compliant with the rules by the Bank for International Settlements (BIS) in September 2015, and UAE only announcing implementation as late as 2017, with no significant details yet announced.

As for the regulators and standard-setting bodies, they can take key steps to pre-empt cross-border compliance issues for banks down the line.

These include:

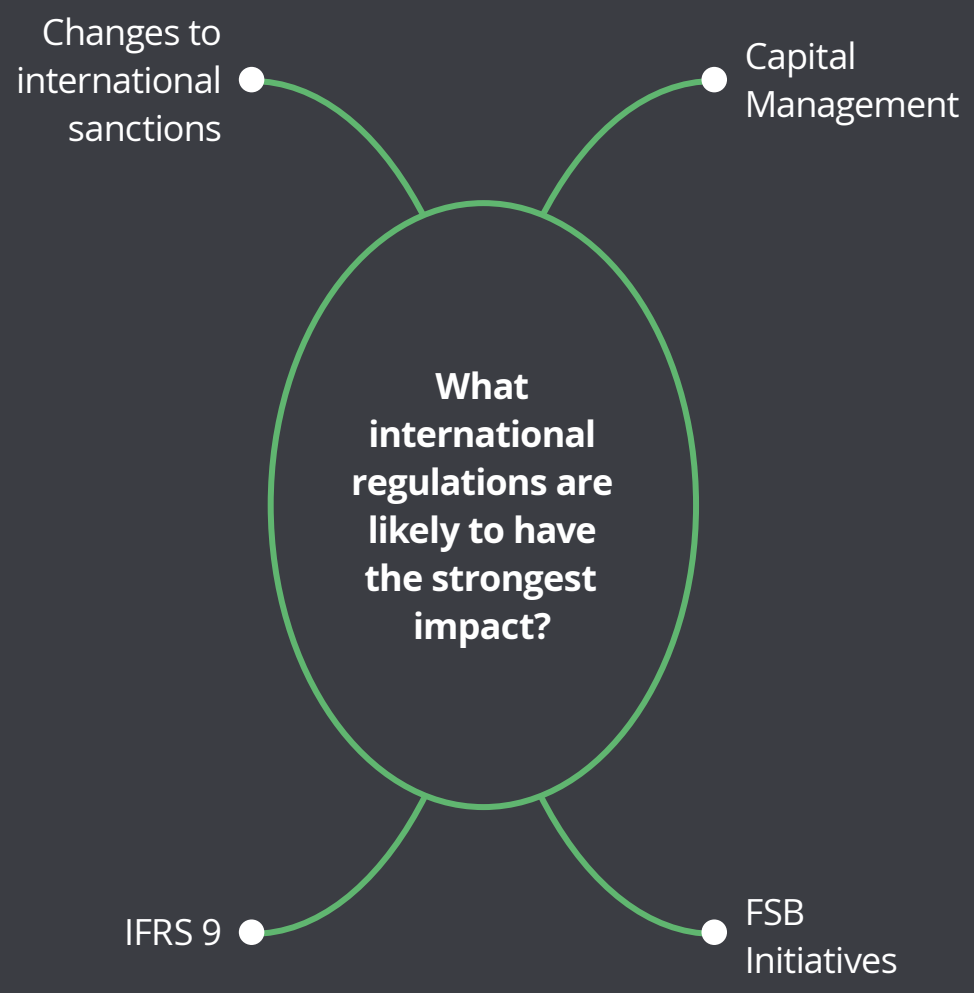
- Providing tailored guidance – easily accessible and/or available online – on specific cross-border compliance scenarios and how to address them;
- Building on the work of forums, such as the Basel Consultative Group or the FSB regional subgroups, that facilitate supervisory dialogue with non-member countries, recognise country constraints and monitor effects of regulatory reforms on evolving markets; and
- Conducting additional assessments for equivalence to facilitate harmonisation.

After all, non-compliance will be a headache for the regulators after the fact, just as much as for the banks. Banks, regulators and standard-setting bodies should be proactive, innovative and coordinated in order to best address the key issues outlined; the new legislation being developed for FinTech companies is a good opportunity to work on alignment and coordination across the Middle East.

A key issue with cross-border compliance Concerns methodologies used in applying regulations. Differences between methodologies will also complicate the process for local banks trying to enter other countries' financial markets.

Cross-border compliance

Banks in the Middle East are undoubtedly aware of and concerned about international regulations, their complexity and certain inconsistencies in expectations. Particularly, the below international regulations are likely to impact local banks the most.



The associated costs of compliance and non-compliance

Costs of governance

Within the costs of governance, there has been an increase in compliance and non-compliance costs over the past few years. This is expected to continue, also increasing the need to measure the effectiveness and added value of compliance to banks.

Costs of compliance

- Staff (FTEs and part-time): salaries, benefits, training
- Wider education/ communications programs
- Office space
- Associated technology costs

Costs of non-compliance

- Financial penalties
- Remediation costs
- Suspension of business/ business disruption costs
- Impact on cost of capital
- Impact on market share

KPIs

Financial crime compliance

Proactively tackling financial crime while meeting regulatory obligations

Combatting financial crime remains challenging, not only because of the constantly evolving nature of threats, but also the growing compliance costs financial institutions face. Technology could play a key role in managing these costs in the future.

For now, taking a proactive approach is important, to identify and address vulnerabilities, maintain awareness of regulatory requirements, and ensure communication channels remain open between all concerned parties.

Financial crime compliance continues to pose a substantial risk to financial institutions. An increasing focus of regulators on compliance and enforcement – augmented by more robust tools and techniques – has prompted the industry to devote greater resources to meeting evolving expectations.

Today's compliance and enforcement environment has prompted institutions to more fully integrate financial crime within their institution's overall risk management framework. Expanded use of innovative technologies and processes – including cognitive technologies and robotic process automation – can boost effectiveness, making it more of a proactive approach whilst simultaneously reducing costs.

When it comes to the Middle East, banks are becoming increasingly proactive about financial crime compliance. The vast majority of those we deal with have a dedicated unit and conduct enhanced due diligence in-house.

The fundamental challenge of financial crime compliance is that critical portions of the requirements are risk-based, which presents challenges to both the regulators and banking industry as they seek to determine what preventive actions are sufficient given the risks posed within individual institutions and across industries and geographies.

Another challenge is monitoring emerging criminal threats and risks and integrating them into the compliance program. Criminals are constantly altering and seeking new money laundering and fraud schemes to exploit compliance system vulnerabilities. Maintaining the awareness and flexibility to adjust institution controls to meet these evolving threats will be crucial.

Financial crime compliance

In recent years, some banks have removed bank accounts and/or services from customers or counterparties that they associate with higher money laundering risk. This has been termed "de-risking". The decision to de-risk may have short-term benefits, but it could have unintended consequences that are far-reaching and severe, in particular the marginalisation of customers in developing markets and jurisdictions deemed high risk. To avoid having this occur in the Middle East, countries will need to demonstrate that a sound AML/CFT framework is in place, and will need to coordinate on a cross-border compliance level.

As financial institutions move forward in aligning themselves with international best practices, their respective compliance units will have to ensure full understanding of their obligations and support at every level of the organisational hierarchy. Effective financial crime compliance, therefore, will require enhanced communication both internally, with senior management, and externally, with regulators. A well-thought-through financial crime compliance program therefore appears to be a prominent goal for companies in the Middle East.

Escalating compliance costs have prompted a focused effort to identify opportunities for increased efficiencies while maintaining the quality of controls.

Financial crime compliance

Banks in the Middle East are becoming increasingly proactive about financial crime compliance. The vast majority of those we deal with have a dedicated unit and are focusing their efforts on training and improving standards, processes and procedures. Making a detailed assessment of where banks are on the below spectrum is the first step in avoiding the inevitable pitfalls of a not well thought through financial crime compliance program.

The spectrum of financial crime compliance programs

Characteristics and activities of a reactive FC compliance program

- Transaction lookbacks
- KYC remediation
- Regulatory order response
- Patchwork data and technology implementation
- Organisational friction
- Lax culture of compliance
- High talent turnover
- Lack of transparency

Characteristics and activities of a proactive FC compliance program

- Risk Assessments and gap analysis
- Independent testing
- Deliberate technology updates
- Meaningful trainings
- Cross channel risk analysis
- Program transformation Proper customer onboarding
- Monitoring and screening
- Information sharing

Financial stability

Providing regulators with the powers they need to maintain financial stability

The development of macro-prudential institutions and supervision frameworks has been accelerated post-crisis with powers varying across jurisdictions. Various measures are now being implemented in many jurisdictions with most aiming to constrain lending, particularly in the real estate sector.

In the Middle East we have seen limited formal powers implemented, although buffers such as the countercyclical buffer are due to, or already have been, implemented across the various jurisdictions as part of Basel III compliance. The mechanism by which it is set will be interesting to understand, as well as the correlation it will have to perceived systemic risks posed by individual institutions, specific sectors and the market as a whole.

Financial markets have recently experienced share-price declines due to unforeseen circumstances. Saudi Arabia has been undergoing a major clean-up which media outlets have termed a 'Corruption Shakedown'. Although the initiative aims to improve the country's economy over the long term, the 'Shakedown' seems to have had an unplanned negative effect on the local and global economy. Share prices in major banking, technology and hospitality industry companies have fallen due to the detention of certain key Saudi Arabian royals and businessmen. This is due to the high shareholding in these companies by some of the implicated individuals. Earlier this year, the region had also witnessed a conflict between Qatar and its neighboring GCC countries. The effects of this were felt with a major impact on macroeconomic factors, due to the decline in trade as a result of trade embargoes placed upon Qatar by its neighbors.

The Middle East financial services markets have also suffered from some strain in recent years, including an increase in NPLs where the debtor flees the country, as well as increased fraud risk. This suggests that the market could face a range of systemic risks in the medium to longer-term, which increase the need for macro-prudential measures to limit fallout. But these systemic weaknesses are not unique – every market faces them. And it is not just risks that are market-wide that create issues: the Global Systemically

Financial stability

Important Financial Institutions (G-SIFI) regime aims to identify individual institutions within the market that are so interconnected and important that they too can cause systemic risks if they suffer from a failure or near-failure. Risks to financial stability can arise in a multitude of ways and therefore responsive and wide-ranging regimes are being considered. In Europe, for example, authorities are currently focused on developing a more binding and comprehensive macro-prudential framework, both by strengthening laws and institutions and broadening the kinds of firms and risks that they should examine (e.g. insurance firms, shadow banking). Aside from G-SIFIs, which are important for financial stability worldwide, Regional or Domestic Systemically Important Banks (R-SIBs or D-SIBs) also exist. While these banks may not be active globally, in their respective jurisdictions, their failure could have significant knock-on effects on financial stability. As such, these banks may have additional requirements on top of the standard ones that they already have to meet, including meeting additional capital buffers (potentially similar to the Total Loss-Absorbing Capacity (TLAC) requirements set for G-SIFIs), additional supervisory reviews, or plans for orderly resolution if the banks were to fail. Unlike the prescriptive approach followed for G-SIFI, the framework for D-SIBs allows a significant degree of national discretion in order to accommodate the structural characteristics of individual jurisdictions. While tangible actions have been more limited in the Middle East, there is a growing awareness of the impact of D-SIBs on financial stability in the region. For example, the Central Bank of Oman issued a consultative document for its D-SIBs framework but, as of writing, it is yet to finalise the method and surcharge for the banks.

Systemic weaknesses may exist in every market; the question is whether regulatory frameworks have the power to identify and minimise those weaknesses in order to best manage financial stability.

Financial stability

Financial stability is "a condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities."

European Central Bank

What financial stability measures are coming into force under Basel III framework?

Basel III

Pillar I	Pillar II	Pillar III
Enhanced minimum Capital & Liquidity Requirements	Enhanced Supervisory Review Process for Firm-wide Risk Management & Capital Planning	Enhanced Risk Disclosure & Market Discipline

...including macro-prudential tools to decrease systemic risk

"The risk of disruption of financial services that is (i) caused by an impairment of all or parts of the financial system, and (ii) has the potential to have serious negative consequences for the real economy."

IMF/BIS/FSB paper Oct 2009

G-SIFI – To reduce the probability that a financial institution deemed systemic defaults or goes bankrupt, through higher loss absorbency capacity requirements in the form of higher capital buffer

D-SIFI – To limit the direct financial impact, that is, idiosyncratic risk, and subsequent contagion effect on the economy of systemic risk, should this organisation eventually default or go into bankruptcy.

Countercyclical buffer – To protect the banking sector from periods of excessive aggregate credit growth often associated with system wide risk.

Recovery and resolution planning

Developing a stronger risk culture through preparing for the worst

Recovery and resolution planning gained prominence in the wake of the financial crisis, as a means of undertaking pre-emptive planning to determine what actions firms can take in stressed conditions and whether their structures and business models are resolvable. These remain important, particularly as they are now being applied to non-banking institutions and other market players. Many of the bankruptcy laws in place across the Middle East region are new, untested, or considered to be insufficient to help an ailing company restructure itself sufficiently to stay in business. This is particularly true for banks in distress, which provide core services to their clients and whose failure can have wide-ranging implications. As such, many countries have passed specialised legislation on how failures or near failures in the financial services industry should be dealt with. How the Middle East governments approach this in coming years will be important to watch.

Recovery and resolution planning, also known as "living wills", as the name suggests, is composed of two separate yet complementary exercises. Both assume a severe financial stress, whether market-wide, or idiosyncratic, has occurred. Recovery planning considers the steps a bank can take if the bank starts to move towards failure, whereas resolution planning considers what an orderly resolution for the bank would look like.

Although such plans are required in an increasing number of foreign jurisdictions, they are still not a formal requirement across all the Middle East jurisdictions. This may be due to a number of reasons, not least of which has been the Middle East's sometimes limited insolvency provisions, which made resolution planning both on behalf of the bank as well as the regulator largely unhelpful due to the assumptions that would need to be incorporated.

Where local Middle East firms have created plans, there is some concern that these can often fall short of international leading practice. A key reason is the lack of detail or the heavy reliance placed on the presumption of government bail-outs. There is also an element of senior management engagement that is often thought to be missing, as only senior management can decide on whether some of the strategic and high-impact recovery actions are likely to be taken.

Recovery and resolution planning

They therefore have to be engaged in the process of considering what types of stresses are the biggest risks to their institution, and identify recovery actions to respond to these.

But this senior management engagement is one of the key reasons that such plans provide regulators with a valuable supervisory tool; they enable supervisors to review the group structure and raise challenges, while understanding the risk culture of the bank and senior management in particular.

Although it is unlikely that anyone would suggest that RRPs will act as a panacea against failures, they are useful and thoughtful exercises that banks should be undertaking.

The new bankruptcy law is an excellent chance to start the dialogue again with firms, and for the regulator to begin reviewing companies to understand whether they have properly considered such scenarios.

The persistently low oil prices mean that this is also a good opportunity for governments to place more of the burden for managing potential failures on senior management. Ultimately, no one wants a failure and having a plan does not necessarily lower the likelihood of it happening – but it can help both sides consider the worst case scenario and be realistic about it.

In their planning, firms are expected to move beyond identifying theoretical plans to demonstrating their preparedness to be resolved.

Recovery and resolution planning

Recovery and resolution planning mechanisms are aimed at ensuring that banks can be stabilised, restructured or removed from the marketplace in an orderly fashion at the earliest possible stage. In the Recovery Phase the bank works to restore financial stability through liquidity and capital management, fundraising and disposals. If this is unsuccessful, the bank is placed into Resolution and the Authorities take over, using specialised powers to ensure an orderly resolution.

When?	Business as usual	Recovery	Resolution
Bank's Solvency (Financial Health)	Recovery threshold conditions breached. **Recovery Plan invoked.**	Successful recovery This period could be hours or months dependant on the nature of the event(s) driving the decline. Catalysts such as sudden media exposure could force the institution into resolution	Resolution threshold conditions breached. **Resolution invoked.** Viable businesses are restructured Non-viable functions wound down
What's going on?	• Monitoring Early Warning Indicators (EWIs).	• Execute recovery actions • Eg. Emergency liquidity facilities, fund raising, disposals etc.	• Execute resolution strategy • Stabilise the bank (eg. through bail-in) then restructure
Who's in charge?	The Bank		The Resolution Authorities

Capital calibration

Ensuring firms and regulators continue to prioritise financial resilience

A key result of the crisis, and Basel III in particular, is the reassessment of what the "right" amount of capital is. This is a complex topic and opinions on the exact number vary greatly, although generally there has been consensus that more and higher quality capital was required.

Although international Basel III implementation deadlines are approaching, the final details of some of the Middle East countries regimes have not yet been announced. As such, local banks still face some uncertainty on the details of what they will need to comply with, as well as the challenges of quantifying their risks in light of sometimes limited data and local expertise.

Basel III is an international standard that needs to be met by G20 countries, and which many other jurisdictions will strive to adopt in some format. As full Basel III implementation nears, banks in the Middle East are considering what this will mean locally.

At this time not all the Middle East Basel regimes have been announced in their entirety. For initiatives such as Basel, the devil is often in the detail, as they say.

Therefore, it will be important for the remaining Middle East countries to confirm how their Basel III interpretation will look as soon as they can to give banks as much time as possible to prepare. This will also help banks stagger and plan for their costs of compliance and avoid situations within which numerous banks are attempting to raise capital over a short time-frame.

Equally, banks can also start preparing proactively, which is important. Holding enough capital should not strictly be contingent on regulatory requirements, but should also be reflective of what banks know they need and their risk profiles. Although we have seen some banks planning for expected changes, others are waiting for solid confirmations of exactly what will be required, and are potentially losing an opportunity to show that they understand

Capital calibration

that regulatory compliance isn't just about meeting minimums, and that management could be planning, albeit with some understandable uncertainties, for incoming rules already.

At a wider international level the question does remain whether more capital requirements, which now include numerous buffers, particularly for the largest domestic, regional or global banks, are the best answer. With additional requirements expected, including local versions of minimum requirement for own funds and eligible liabilities (MREL) and total loss-absorbing capacity (TLAC), it is understandable that banks worry not only about the quantum of capital, but the complexity of the overall regime. Unfortunately, it is unlikely that in the future the emerging patchwork of requirements is scrapped for a simplified model, although in our humble opinion – that might be the most productive way forward.

An organisation should take great care to determine whether its capital requirements are reflective of the organisation's risks.

Capital calibration

The majority of banks in the Middle East have strong capital adequacy ratios. However, in order to ensure financial resilience, banks need to be capital efficient, not just merely sufficient. The modelling of risks, in particular operational and conduct risk, remain complicated and the local market suffer from a dearth of relevant data and talent.

What's the long-term vision?

The Middle East does generally gold-plate Basel III requirements and therefore on paper the banks look like they are very well capitalised.

Banks in the Middle East are traditionally better capitalised than their Western peers due to the conservative nature of regulators

However, banks need to be capital efficient, not just sufficient. In determining the appropriate response, banks should focus on the actions that are most likely to affect long-lasting and significant change to the structure and financial position. These actions will ensure that banks are not merely showing capital compliance, but are addressing concerns at their source and implementing long-lasting solutions.

Which risk category seems to be the most difficult to model/quantify?

Credit risk

Market risk

Conduct risk

Banks appear not to have particular issues for the quantification of such risks

Operational risk

Broad definition and inadequate data for quantification make it difficult to model operational risk

Risk and compliance culture

Ensuring firms and regulators continue to prioritise financial resilience

International standard-setting bodies are expected to continue to focus on reviewing the culture of financial services firms. Regionally this will mean firms will need to define and embed a common culture, specifically one that resonates from the top of the firm across all business areas and jurisdictions. Meanwhile, regulators will have to define their expectations and begin considering how they will assess whether firms are fostering positive behaviours, and, where change is necessary, how they ensure effective culture change is happening.

Many of the problems and failures during and after the financial downturn – some of them criminal – were rooted in poor cultural foundations. In response, US and UK banking regulators, the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision are increasingly focusing on the importance of culture at banking institutions.

One of the key findings by an FSA Board report into the failure of a leading UK retail bank, was that the bank suffered from an inadequate risk culture, particularly at a Board level.

This highlighted the importance of the tone at the top, and started what is an ongoing trend towards senior ownership of the culture of the institution.

But ultimately, what is meant by culture? It is difficult to define, but we see it as largely including: individual accountability, risk culture, and fostering longer-term view of risks and business, ethics and morals.

Culture is inherently difficult to monitor because it requires a subjective approach to supervision and therefore may require many regulators to change their approaches and their thinking.

Culture reviews will also require senior management at banks to start monitoring whether they are satisfied with the culture at their individual institutions and to consider how to evolve the culture, which can be a difficult task. No single action will fix it and success can lie in numerous initiatives and is likely to incorporate an ongoing evolution. What does remain clear is that the tone at the top matters.

Risk and compliance culture

In many ways a shift towards understanding and reviewing culture is long overdue and very much required – and not because we've observed chronically weak cultures across banks, but because a weak or high risk-taking culture can often be the root cause of other issues that arise within institutions. It also forces banks to take a long and hard look at themselves and their behaviours.

This last point makes regulatory-imposed culture reviews a powerful tool in regulators' toolkits as it allows them to push management to make changes even where all the formal rules are met from a regulatory perspective, which in turn helps move regulators from undertaking regulation to undertaking supervision. This is like to be a key tool that Middle East regulatory authorities will be developing, if they aren't working on it and undertaking such reviews already.

Our understanding of risk and compliance culture may vary, but its importance within financial institutions is undeniable.

Risk and compliance culture

A key to sustainable risk culture is developing, attracting, and retaining talent. Regulators are increasingly looking at staffing levels, training, compensation structures, and performance management programs to determine if they promote a sound risk culture. Also, proper messaging of risk considerations in compensation and training programs is important – including clear messaging about negative repercussions where warranted.

How can the quality of corporate governance be assessed?

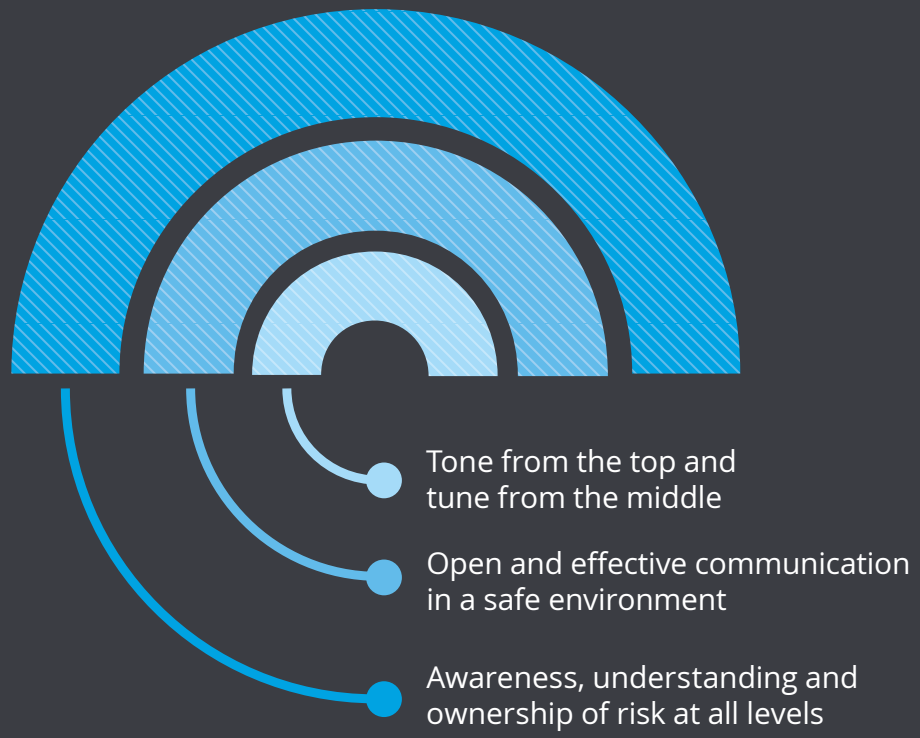
There are several ways to measure risk culture:

- Surveys
- Staff interviews

Surveys and staff interviews are the most common and the easiest.

- Focus groups
- External stakeholder interviews
- Social media reviews
- Review of operational processes
- Training

Key success factors



Conduct risk

Working towards fair customer outcomes and minimising misconduct risks

Despite the focus on conduct risk at an international level, especially after the financial crisis, it appears a limited amount has been done to develop an understanding of the area across the region. This is expected to be the next key focus for regulators, and is expected to be welcomed by consumers. Key challenges for firms will include ensuring conduct risk is understood across the business, and managing it, particularly negative selling behaviours. Meanwhile, regulators will need to develop their capabilities to ensure they can appropriately monitor firms and use fines and other tools as credible deterrents.

Conduct risk often goes hand-in-hand with culture – it is the behaviour of the bank towards its clients and therefore an outward expression of the bank's culture. This is gaining prominence in the region and is often mentioned as amongst the next key areas of regulatory focus.

In the aftermath of the crisis, there was acknowledgement that conduct risk had not had sufficient focus from some regulators, most notably the FSA in the UK, which was later dismantled into the PRA, which focuses on prudential issues, and the FCA, which leads on conduct risks.

At this time, there are minimal overall requirements on conduct risk issues in the Middle East region and from what we see, there is still a limited understanding of what the risk actually entails. At its core, conduct risk is the risk that a bank does not ensure the delivery of fair customer outcomes, which touches on almost every part of the bank's interactions with its consumers. It involves providing clients with appropriate overviews of products and their risks, giving them sufficient information to make informed decisions, offering products that are relevant to them, undertaking fair selling practices, and being transparent about any conflicts of interest (e.g. where the broker is receiving inducements), amongst others.

To instill these changes in the Middle East would likely require banks to ensure initial as well as ongoing training for their staff, in particular those responsible for sales and those who interact with customers (e.g. helpline staff, complaints staff, etc.). It will also involve creating a strong set of rules and ensuring regulators have the right powers, which would likely include a strong

enforcement arm that investigates and acts in instances of conduct risk failures – this is particularly important because it would act as a credible deterrent and help ensure banks take any consumer protection regulations seriously from the beginning.

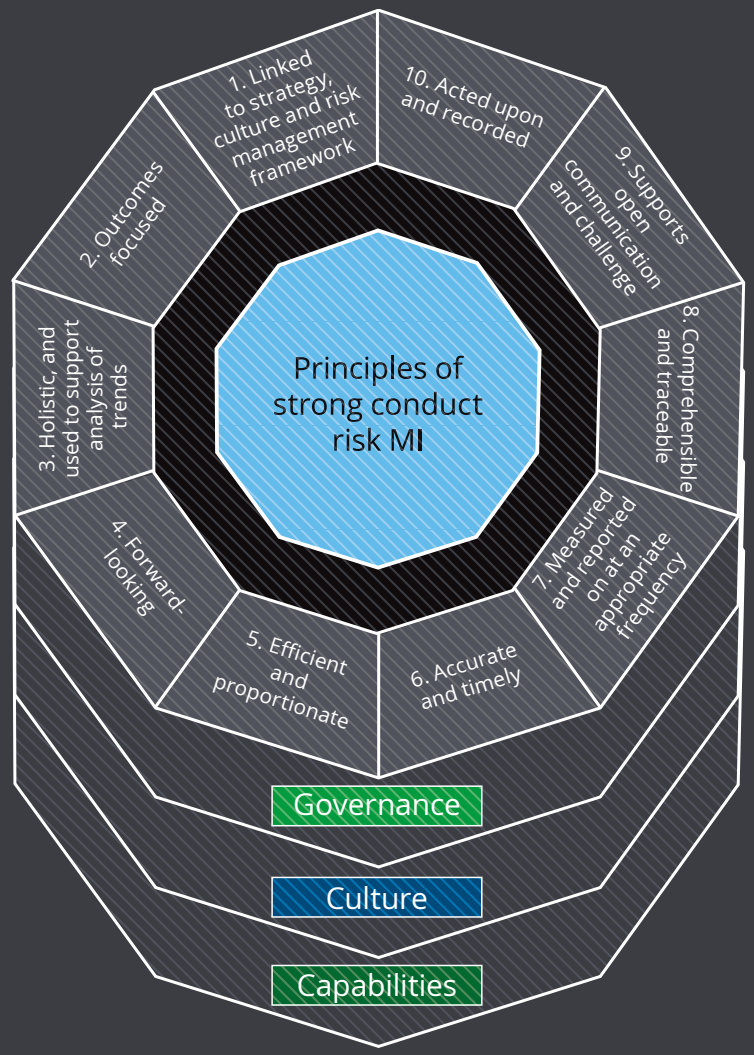
All in all, this is an important area where reforms and actions could be considered long overdue.

Conduct risk failures, particularly those resulting in regulatory action, can have a major impact on a company's reputation and the way it is perceived by customers for years to come. Companies would do well to implement good controls and understand their conduct risk exposure proactively.

Conduct risk

Conduct risk is undoubtedly an important area of focus for regulators going forward. However, there is no one-size-fits-all framework that can be put in place to assess it. Building on current international regulatory and supervisory expectations and our experience of what works well in practice at banks, we have identified the below ten principles of strong conduct risk Management Information (MI). While the precise way firms achieve strong conduct risk MI will be unique to them, we believe that these 10 principles serve as a sound foundation for conduct risk MI across all financial services firms. Strong MI, in turn, keeps management informed and able to act where they need to.

What areas should banks focus on?



Data and regulatory reporting

Understanding and adapting to new incoming requirements in effective and efficient ways

Expectations related to data quality, risk analytics, and regulatory reporting have risen dramatically since the financial downturn. At a minimum, regulators now expect reporting for capital, liquidity, and resolution planning to be more timely, accurate, and precise. Simply having the raw data is not enough; firms must be able to aggregate the data and perform advanced analysis in order to inform key decisions.

The largest banks have long faced these higher expectations, which were formally laid out in international guidance by the Basel Committee on Banking Supervision in 2013 (BCBS 239). However, in recent years regulatory reporting problems across the banking industry have more broadly called into question the credibility of data used for capital distributions and other key decisions. The Federal Reserve Bank in the US in particular is requesting specific details on the data quality controls and reconciliation processes that firms are using to determine the accuracy of their regulatory reports and capital plan submissions.

Improving the quality and timeliness of data and analytics requires proper planning and direct attention from management, as well as significant investments into IT infrastructure and the firm's subject matter expertise. At most firms, there are significant opportunities to retire costly legacy systems, reduce headcount for manual interventions, and avoid reputational risk with regulators and the public. Having more timely risk data and analytics is essential for making risk/return tradeoff decisions that maximise resiliency and shareholder returns.

Firms may want to consider a top-to-bottom evaluation of their governance and systems infrastructure for risk and finance data to ensure they have the capabilities necessary to meet the ever-expanding needs of internal stakeholders, investors, and regulators over the long run. Such an evaluation should focus particular attention on past data quality issues and the degree of manual intervention required to address them.

Data and regulatory reporting

Technological innovation could in the future facilitate and improve regulatory reporting. For example, machine learning and cognitive technology could help banks with more complex, high-volume and repeatable regulatory tasks by reducing the risk of human error and identifying duplicated controls. The provision of machine readable regulation could lead to greater automation, speeding up the implementation process and therefore reducing the associated costs of change. More efficient implementation would encourage more efficient reporting.

In order to effectively leverage such technologies in the future, banks within the Middle East should first take steps to ensure the necessary data infrastructure, tools and methodologies are in place. Looking forward, expectations about data quality and regulatory reporting are bound to increase; to meet them, firms would do well to develop and utilise appropriate resources over time.

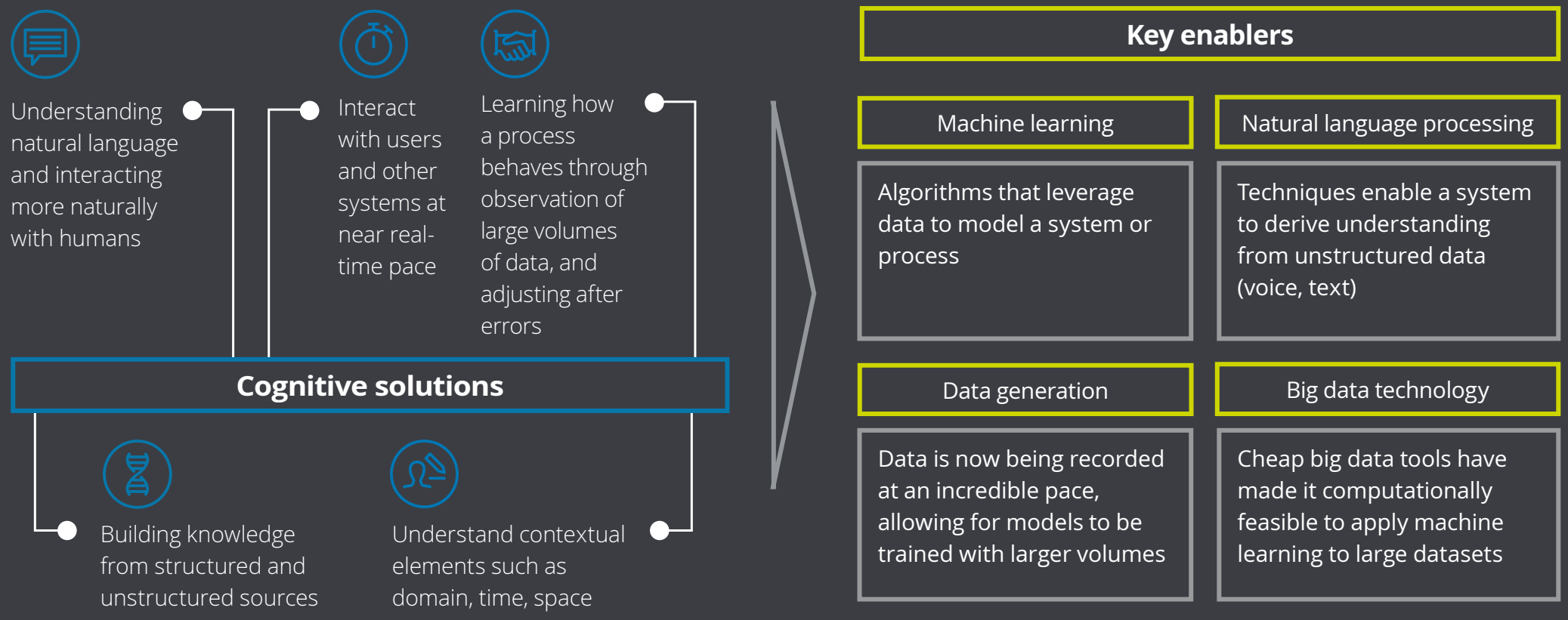
Having more timely data analytics is essential for making risk/return trade-off decisions to maximise resiliency and shareholder returns. We've also seen financial institutions apply data analytics to segment the customer bases at a more granular and accurate level.

Data and regulatory reporting

As expectations and concerns about reporting requirements grow, new technologies, such as cognitive computing, could eventually be leveraged to the benefit of both banks and regulators in the Middle East.

Cognitive computing – replacing or improving human response

Cognitive solutions could facilitate and improve regulatory reporting. Some key enablers of these technologies are outlined below.



Technology and innovation

The need for all of us to learn how to keep up with the times

Technology must remain close to the top of firms' agendas. Established players will need to invest in technology, not only to satisfy the needs of their clients, but also to compete with new emerging alternatives, such as crowdfunding and digitised or cashless payment systems.

These are expected to challenge the existing banking business model and if such investments are not undertaken, banks may see their businesses shrink. As such technologies emerge in the Middle East, it will also be important to identify the required regulatory changes to deal with associated risks, such as financial crime, without stifling growth and innovation.

Incoming technological advancements in finance can be equally exciting as well as worrying; established players can find themselves behind and regulators can often struggle to adapt their regimes to new business models and associated risks. We have already seen in other jurisdictions that some banks have either exited markets or changed how they participate in them, often leading to an influx of nonbank financial companies that aim to take their place. A key risk of this is that these companies have tended to be less regulated, thereby decreasing regulatory oversight of certain risks within the system. This shift is prompting regulators to examine the potential risks to overall financial system stability. What's more, it creates new risks and challenges for the banks themselves, since exiting an existing market is rarely easy or instantaneous; also, shifting participation to another market presents a whole new set of risks.

The Middle East has seen a number of firms appear over the last few years, including crowdfunding companies and digital payment providers. Compared to similar institutions their numbers are low, but they are visible because they are new and more easily accessible for users. They also pose consumer protection concerns and may provide loopholes to providers of similar services; if they are less regulated, companies have an incentive to use

crowdfunding platforms or digital payment providers to access the market. These types of companies pose numerous issues for regulators, from how to define the objectives of the regulatory framework, to how to meet emerging risks, which can evolve or develop more quickly than those posed by traditional banking models. Relatively speaking the new tech companies in the Middle East market remain a small portion of the overall market; in regulating these, it is therefore important that the framework is proportionate and ensures market safety, while also allowing for growth.

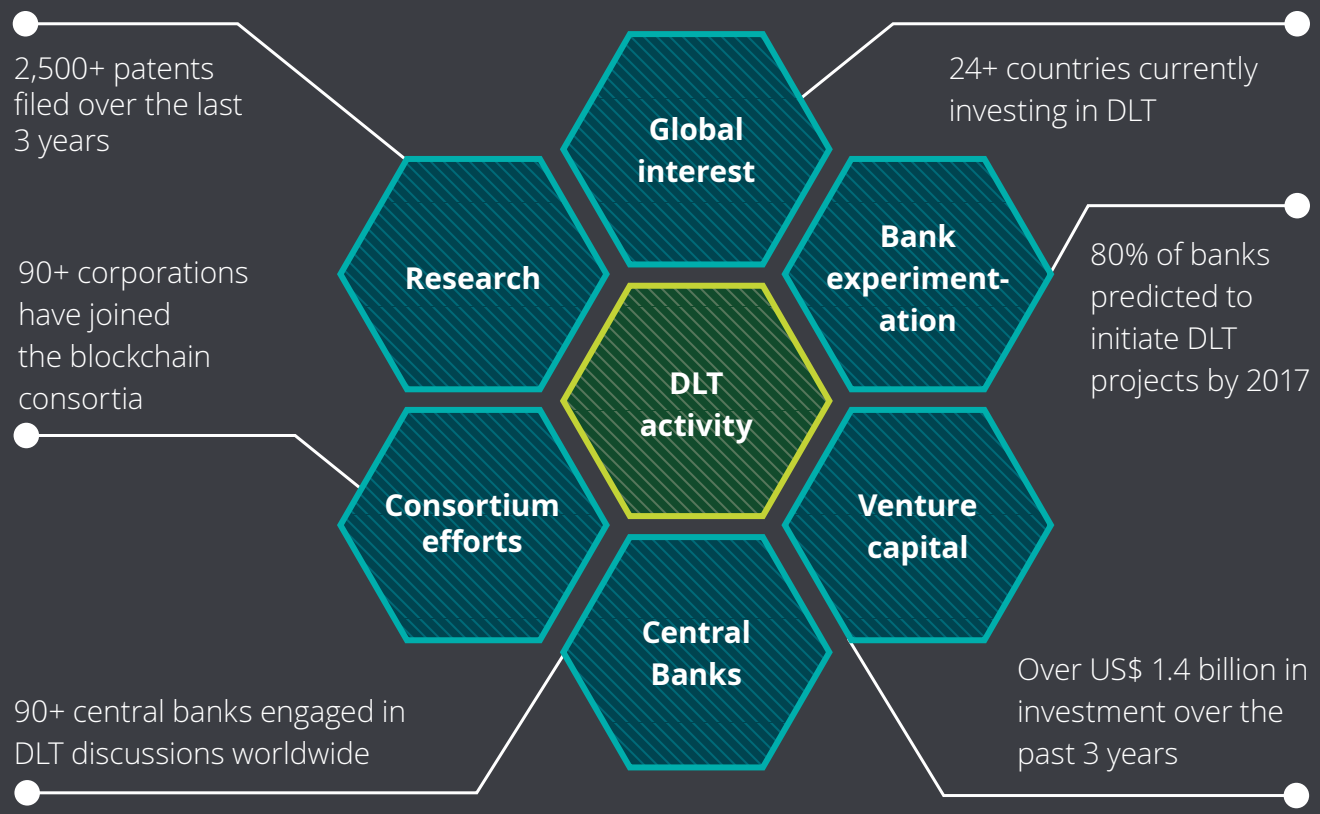
Industry research also reveals ongoing and increasing cyber-security threats in the Middle East, which we have seen manifest in recent phishing attacks in Saudi Arabia and malware attacks on UAE's banking system. With the increasing focus on cyber-security by international regulators and media houses, regulators in the Middle East, like elsewhere, will have to grapple with new threats and the impact of transformative new technologies on the broader infrastructure of financial services. Such technologies include cloud computing, blockchain and biometrics. While these developments may drastically improve the experience of banks' customers, they pose unprecedented challenges not only for regulators, but also to the security and integrity of the financial system worldwide. By increasing our global connectivity, for example, such technologies could render financial institutions more vulnerable to previously localised threats, as well as exposing consumers to new potential breaches. By most accounts we can agree the system will need to adapt – the question will be how efficiently and safely it will do so.

Traditional financial services firms should carefully consider the impact disruptive technologies will have on their business models – those that are prepared for potential innovations and that adapt stand a far greater chance of not becoming obsolete.

Technology and innovation

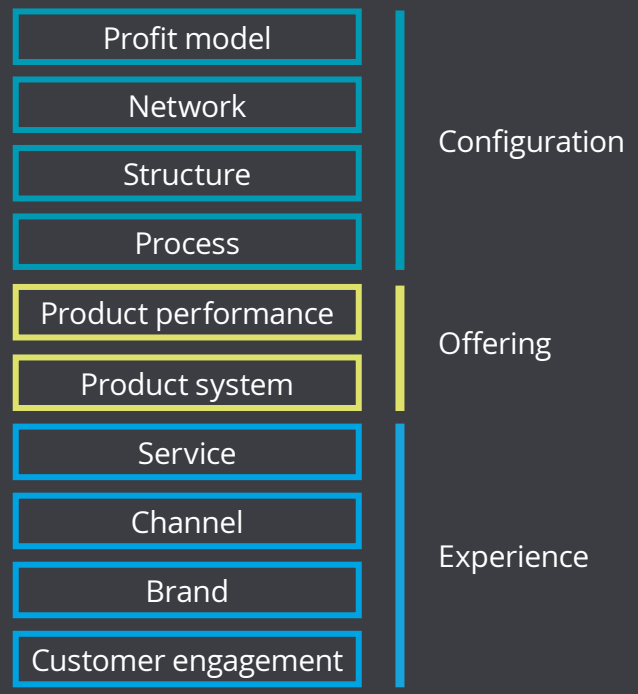
As firms harness artificial intelligence and data analytics to offer tailored customer experiences, supervisors will focus on the potential unintended consequences. Regulators must also make efforts to keep up with other emerging technologies and their transformative impact on financial services.

Distributed ledger technology (DLT), more commonly called "blockchain", is transforming the financial services ecosystem



The ten types of innovation – a tool to diagnose and enrich innovation

The types on the left side of the framework are the most internally focused; as you move towards the right side, the types become increasingly apparent and obvious externally.



It's time for an attitude change...

In building stronger regulatory, compliance, risk management and audit capabilities, banks are gaining important new business acumen

Here are **five ways** financial institutions can take advantage of the new regulatory reality to drive organisational change, efficiency, effectiveness and growth.

1 Use compliance to drive new ways of doing business

Simply collecting information that is required by regulators isn't enough. Smart organisations will develop an in-depth understanding of what the regulations mean. Realising the implications better than the competition is an avenue for offering innovative products that others will not have thought of.

2 Focus on capital efficiency, not just capital sufficiency

Financial institutions should work to balance requirements to hold sufficient capital reserves.

3 Push compliance into and throughout the business

Traditionally, financial institutions put compliance in its own "box," separate from normal business and with little engagement between business and compliance units beyond the bare minimum. This limited the opportunity for these groups to work together.

4 Hire experts

Hiring experts increases the chances for gaining industry insights into how regulations will affect customers, product offerings and business models of the FIs. Doing so can enable the FIs to concentrate on other revenue generation aspects of the business.

5 Work with the regulators

Remember: FIs and their overseers share a common goal. We encourage FIs to communicate their insights and ideas before issues occur and to work with regulators to develop mutually satisfactory solutions before they're needed rather than after.

How we can help you

Our dedicated team of regulatory and financial crime experts understand the specific needs of the Middle East market; from helping meet new international regulations, to advising on the challenges posed by the local market, we are here to guide clients through the evolving regulatory landscape.

Advise

Design

Remediation

Investigations

New laws and regulatory frameworks

Helping regulators and firms meet a range of regulatory challenges, including:

- Proactive and reactive responses to regulatory change initiatives
- Regulatory strategy development
- Regulatory inspections
- Regulatory framework development
- Market reforms and integration

Prudential

- Capital management
- Liquidity management
- Risk management
- Contingency planning
- Governance
- Risk models

Conduct

- Treating customers fairly
- Remediation programs
- Reviews & mapping
- Framework development
- Training

Financial crime compliance

AML

- Compliance control programs
- Customer/Product risk models
- Remediation exercise
- KYC/CDD review
- Suspicious activity monitoring
- AML Training

Sanctions

- Regulatory response support
- Remediation and lookback exercises
- Training
- Data integrity and cleansing
- System mapping and scenario testing
- Economic and trade sanctions

Regulators

Banks

Insurers

Other financial institutions

Notes

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