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

Financial Stability Report

2013

Preface

I am pleased to contribute this message to the Financial Stability Report for the year 2013. This is the second such report and it covers the developments that took place during the year under review.

The report focuses on the build-up of vulnerabilities in the financial system. It includes an analysis of the developments in the real estate sector and the banks' exposure to the sector, an overview of the macro-prudential measures available to deal with the risks and their applicability to the UAE, as well as a discussion of the liquidity situation in the system.

The report also covers new regulations which aim to strengthen our prudential framework in line with the latest international developments and Basel III guidelines.

The UAE economy remained on a healthy track in 2013, continuing the satisfactory performance of the previous year. GDP growth was driven by high oil prices, robust performance of tourism, trade and transport sectors and recovery in the real estate sector.

I would also like to thank the Securities and Commodities Authority and the Insurance Authority for their contributions to this report.

Sultan Bin Nasser Al-Suwaidi

Governor

Objective of this Financial Stability Report

By issuing this report, Central Bank of the UAE intends to provide key information to major participants in the industry in order to 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 continue to do so in the event of shocks, stress situations and periods of profound structural changes.

The report is based on data and information available as at 31 December 2013, unless otherwise stated.

Data source is Central Bank of the UAE unless stated otherwise.

Table of Contents

Executive Summary

The UAE economy has recovered from the aftermath of the global financial crisis, supported by high oil prices, an increase in real estate activity and robust performance of tourism, trade and other services. The credit cycle passed its lowest point and credit growth was in line with GDP growth.

A systemic risk assessment of the banking system, whether looking at the absolute level of loan to GDP ratio, the credit to GDP ratio gap or at the liquidity levels, demonstrated the strong resilience of the system. Nevertheless, vulnerabilities exist, as identified in this report, and are closely monitored by the Central Bank. A traditional review based on the International Monetary Fund (IMF) key financial soundness indicators confirms the continuous improvement over the period.

The global financial crisis has prompted an intense debate on the role of macro prudential policies in limiting the accumulation of risks and imbalances. The report analyses the macro prudential instruments available to maintain financial stability in the UAE, their usefulness and likely impact on the credit cycle and the wider economy.

The report analyses the main driver of the recovery in the UAE – real estate, which along with oil, tourism, trade and transport contributed to the economic upturn in 2013.

The Central Bank is in the process of updating its regulations in line with international best practice. The report covers such initiatives on real estate, Basel III implementation, large exposures, exchange businesses, finance companies and investment companies, as well as the timeline envisaged to implement these regulations.

The Insurance sector, regulated by the Insurance Authority, has been showing healthy growth over the year under review and continues to contribute positively to the UAE economy.

Finally, the UAE stock markets, regulated by the Securities and Commodities Authority (SCA), experienced a strong recovery supported by increased profits from listed corporates, positive global and domestic investors' sentiment and continued participation of foreign investors. These positive developments in the UAE stock market have resulted from the inclusion of UAE markets in the MSCI Emerging Market Index as of May 2014.

1 Domestic Economic Review

1.1 Economic Growth

The UAE economy has recovered from the downturn that took place in the real estate and securities markets. Economic recovery continues to take place with GDP having grown by 5.0% at constant prices in 2013, according to IMF recent estimates.

Accelerating economic growth in 2013 was attributable to accelerating non-oil GDP growth reaching 5.4% in 2013. In contrast, slower growth in oil production and lower exports resulted in 4.0% growth in oil GDP. The strength of the non-oil sector was driven by a rebound in real estate activity and ongoing strength in the trade, tourism and transport sectors. In addition, indicators suggest a significant contribution from investment activities, emanating in part from the announcement that Dubai will host Expo 2020.

Total investment (Gross Fixed Capital Formation) represented around 20% of GDP in 2013, unchanged from 2012. Public sector investment decreased from 7.1% of GDP in 2012 to 6.3% of GDP in 2013, whereas the share of the private sector investment increased from 12.5% to 13.2%.

Non-oil exports contributed to both economic growth and the goal of economic diversification through 2013, increasing 11.9%. Such strength indicates the increased importance and interconnectedness of the Gulf region on UAE's economic performance. Similarly, emerging markets in Asia and Africa contributed significantly to UAE non-oil exports.

Improving foreign demand provided an important boost to the economic recovery in the UAE. Total exports and re-exports of goods increased by 8.3% in 2013 due to a 2.5% increase in hydrocarbon exports and an 11.9% increase in non-hydrocarbon exports.

Table 1. Growth of GDP, at constant prices, in the UAE (2009 – 2013). Preliminary Estimates for 2013. Source: National Bureau of Statistics and IMF for 2013

	2009	2010	2011	2012	2013e
Total GDP	-4.8%	1.7%	3.9%	4.4%	5.0%
Oil GDP	- 8.9%	3.8%	6.6%	6.3%	4.0%
Non-Oil GDP of which:	-2.9%	0.7%	2.6%	3.5%	5.4%
- Manufacturing	-14.1%	2.6%	9.1%	1.2%	
- Construction	1.7%	-0.7%	-2.5%	0.1%	
- Wholesale & Retail Trade	-8.0%	2.1%	0.1%	0.6%	
- Real Estate	-13.2%	-0.2%	3.0%	6.3%	
- Transport & Communication	3.0%	0.7%	3.2%	2.4%	

The tourism sector made a sizeable contribution to the UAE economy in 2013. In Dubai, passenger traffic increased 15.1% in 2013. Increased passenger arrivals saw the average hotel occupancy rate increase to 80% in 2013, compared to 78% in 2012. Similarly, average daily room rates were 6.8% higher. In Abu Dhabi, increased passenger arrivals resulted in hotel occupancy rates rising from 60% in 2012 to 67% in 2013. Average daily room rates were a little lower in 2013, down 1.4%.

1.2 Inflation

Consumer price inflation was relatively benign in 2013 with the CPI general index increasing 1.4% year-on-year. However, inflationary pressures appeared to have increased through 2013. Rising property prices and rents resulted in the year-on-year increase in the housing component of the CPI from negative 2.6% at the end of 2012 to positive 0.3% in December 2013.

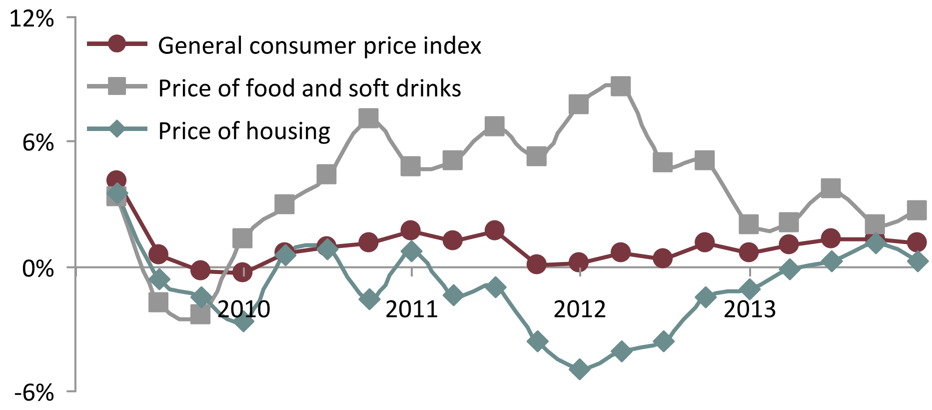

Figure 1. UAE inflation indicators (y-o-y change). Source: National Bureau of Statistics.

1.3 Balance of Payments

The surplus in the trade balance increased from AED 484.7 Bn in 2012 to AED 503.7 Bn in 2013, largely reflecting an increase in non-hydrocarbon exports.

The balance of services, including travel, transport, freight, insurance and government services is traditionally negative. The deficit of the balance of services increased from AED 176.6 Bn in 2012 to AED 197.4 Bn in 2013. The balance of transfers was also negative as net transfers to the rest of the world increased by AED 13.4 Bn Year-on-Year. Therefore the surplus of the current account decreased by 6.2%, from AED 253.3 Bn in 2012 to AED 237.5 Bn in 2013.

Meanwhile, the financial account balance registered a deficit of AED 163.7 Bn in 2013, due to a net outflow of funds of AED 44.8 Bn and AED 118.9 Bn by the private sector and by the public sector, respectively.

Foreign direct investment (Inward) increased from AED 35.3 Bn in 2012 to AED 38.5 Bn in 2013.

Overall, the balance of payments increased from AED 36.3 Bn in 2012 to AED 77.3 Bn in 2013, thereby adding AED 41 Bn to the net foreign assets of the UAE.

Table 2. The UAE Balance of Payments. Preliminary Estimates for 2013. Source: National Bureau of Statistics

(in AED Mn)	**2011**	**2012**	**2013**
Current Account Balance	187,110	253,260	237,546
Trade Balance (FOB)	391,470	484,708	503,694
Total Exports of Hydrocarbon	409,876	440,649	451,620
Total Exports of Non-Hydrocarbon	260,254	354,168	396,414
Re Exports**	439,101	488,657	542,596
Total Exports & Re Exports (FOB)	1,109,231	1,283,474	1,390,630
Total Imports (FOB)	-717,761	-798,766	-886,936
Services (NET)	-160,564	-176,570	-197,448
Investment Income (NET)	404	1,092	650
Transfers (NET)	-44,200	-55,970	-69,350
Financial Account	-109,147	-145,752	-163,670
a. Private Capital	2,853	-30,752	-44,770
b. Foreign Direct Investment (Net)	20,200	24,763	25,717
- Foreign Direct Investment Outward	-8,000	-10,500	-12,800
- Foreign Direct Investment Inward	28,200	35,263	38,517
c. Enterprises of Public Sector	-112,000	-115,000	-118,900
Errors and Omissions	-61,342	-71,203	3,414
Overall Balance	-16,621	36,305	77,290

2 Systemic Risk Assessment

2.1 The Credit Cycle

After a few years of sluggish growth, bank credit growth picked up pace in 2013, growing by 9.2% compared to 3.5% in 2012. The growth was underpinned by strong economic recovery, and is no surprise as the global economy continued its gradual recovery from the aftermath of the Global Financial Crisis (GFC).

The UAE was heavily impacted by the GFC in much the same way as the developed economies. As a result, real-estate and equity prices declined to very low levels and did not show meaningful signs of recovery until the second of half of 2011, well behind key developed economies. This means that the current recovery in asset prices has a "catch up" element to it which also applies to credit growth. It is interesting to note that the recovery gained momentum after large GREs' debts were restructured and real estate prices bottomed out in 2011.

Table 3. Credit cycle and growth of the economy. Preliminary Estimates for 2013. Sources: National Bureau of Statistics, IMF and CB.

	Nominal non-oil GDP		Nominal oil GDP		Total Loans	
In AED Bn	Value	Growth	Value	Growth	Value	Growth
2002	310		94		191	
2003	342	10%	115	22%	226	18%
2004	385	13%	158	38%	277	22%
2005	436	13%	227	44%	395	43%
2006	511	17%	305	34%	537	36%
2007	626	23%	321	5%	718	34%
2008	731	17%	428	33%	1,014	41%
2009	684	-6%	252	-41%	1,059	4%
2010	724	6%	332	32%	1,088	3%
2011	777	7%	503	52%	1,143	5%
2012	843	9%	566	12%	1,184	4%
2013	890	5%	592	5%	1,294	9%

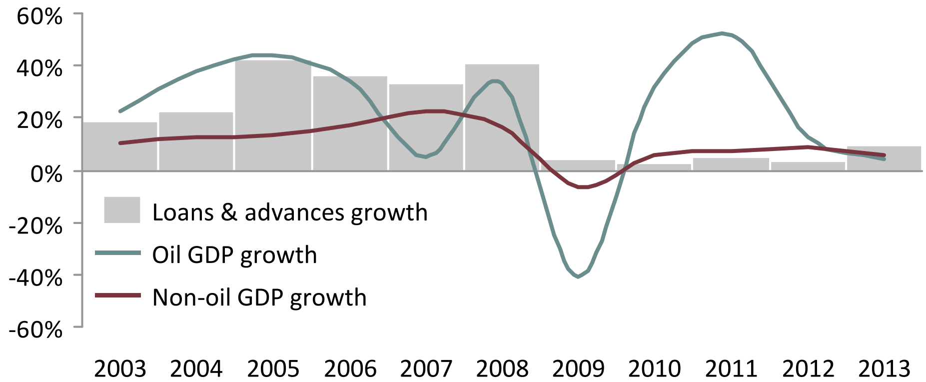

Figure 2. Credit cycle and growth of the economy. Preliminary Estimates for 2013. Sources: National Bureau of Statistics, IMF and CB.

Non-oil GDP is financed predominantly by bank credit while expansion in Oil GDP is primary cash funded and is unrelated to domestic credit, therefore GDP used in this section is the non-oil GDP. The recovery in non-oil GDP, which commenced in 2010 and accelerated in 2011 and 2012 encouraged banks to use the excess liquidity they held to increase financing to various sectors of the economy.

2.1.1 Credit expansion and GDP growth

An estimate of excess bank credit in the system is measured by comparing the credit growth rate with that of the GDP. The difference in growth rate is then applied to the loan book at the beginning of the year to estimate excess credit. Excess credit is usually a sign of build-up of vulnerabilities in the system as it is generally associated with an over valuation of assets.

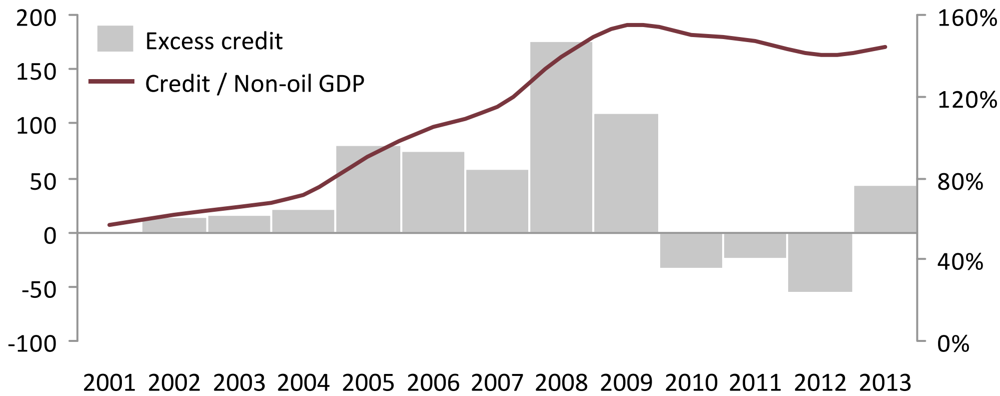

Figure 3. Excess bank credit growth in the UAE (AED Bn) and bank credit to non-oil GDP.

Figure 3 shows that the build-up of vulnerabilities started in 2005 with a large peak in 2008. This was followed by a period of deleveraging that took place post the GFC.

Based on a non-oil GDP growth of 5.5% and a bank credit growth of 9.2% for 2013, the estimated excess credit over GDP growth was around 3.7%.

2.1.2 Credit to GDP Gap

The Basel Committee on Banking Supervision (BCBS) has proposed the use of the credit-to-GDP gap as the reference point for initiating the process of building up the Basel III countercyclical capital buffers[1]. The underlying assumption is that, a positive gap, which indicates accelerating the ratio growth over its historical trend signals the build-up of system wide risk.

BCBS definition of credit supply includes credit provided by shadow banking and foreign lenders. The size of shadow banking system in the UAE is not material and therefore, it has not been included. Foreign banks' lending from outside the UAE, played a role in the excessive lending which took place pre-2008 but year on year data is not available and has therefore not been included.

This indicator was applied to the UAE banking system with the aim of assessing its ability to detect the build-up of vulnerabilities ahead of a crisis. In Figure 4, the underlying trend is measured using a one-sided Hodrick-Prescont (HP) filter[2] to calculate the long term trend of the credit to GDP ratio.

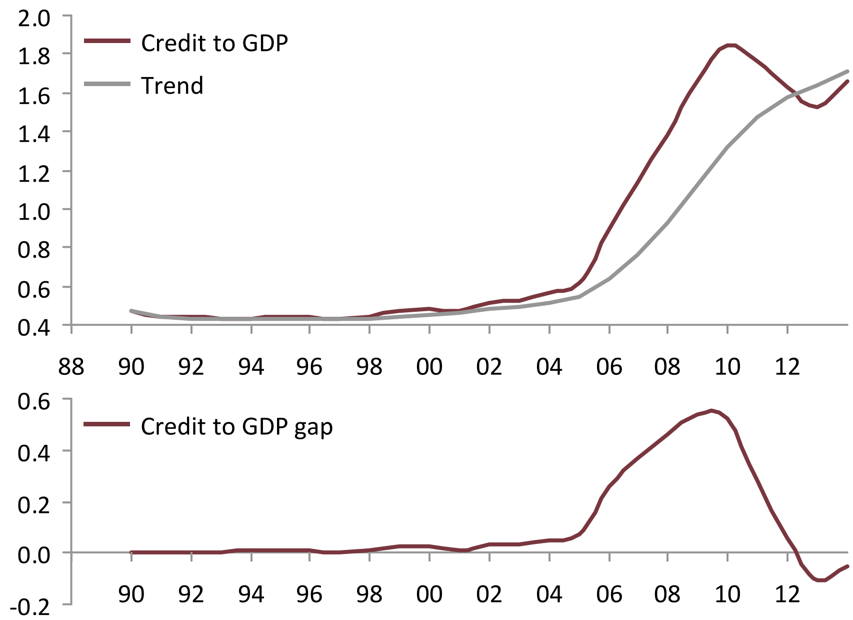

Figure 4. Credit-to-GDP ratio and its long term trend estimated using one-sided HP filter (top) and Credit-to-GDP ratio gap (bottom)

Research indicates that GDP and credit should grow at the same pace. A positive gap is an indication of excess credit building up in the system.

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[1] Basel Committee on Banking Supervision. *Guidance for national authorities operating the countercyclical capital buffer*, 2010.

[2] Robert J. Hodrick and Edward C. Prescott, "Postwar U.S. Business Cycles: An Empirical Investigation," *Journal of Money* 29(1997): 1-16.

HP filter correctly shows deviation from the long term trend starting in 2005 and accelerating sharply from 2007 onwards until 2009. At the end of 2013, credit-to-GDP ratio gap was negative at -0.04, suggesting that credit level in the UAE financial system could grow faster without creating major imbalances.

Regime change

Due to the high level of credit growth during the period from 2003 to 2008, the level of debt (credit to GDP) in the UAE has reached that of more developed economies. Therefore, a regime change test was performed on the full set of data. It showed that the UAE financial system experienced a regime change in 2007 due to the effects of this financial deepening. Accordingly the Credit to GDP ratio gap was recalculated from the date the change took place.

Taking the credit to GDP data from 2007 to 2013, HP filter estimates a positive gap of less than 0.5% of GDP between the ratio and its long term trend emerging at the end of 2013.

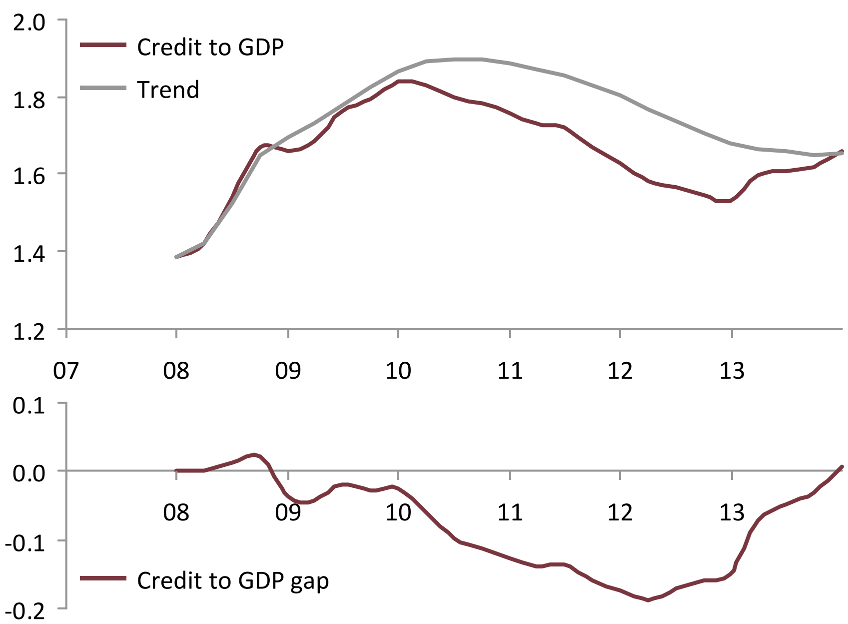

Figure 5. Credit-to-GDP ratio and its long term trend estimated using one-sided HP filter (top) and Credit-to-GDP ratio gap (bottom)

At the current level there is no build-up of vulnerabilities in the system. However, the trend is monitored closely by the Central Bank.

2.2 Liquidity Conditions

2.2.1 Loan to Deposit Ratio

A rising loan to deposit ratio is a useful indicator of financial stress. A low ratio implies that banks have more flexibility in funding their loans. This ratio however has less relevance in the UAE than in other countries as banks have a high average capital adequacy ratio (CAR) of 19%. Some of this capital will logically end up funding part of the loans book. This ratio is also traditionally higher in emerging economies where capital markets provide a small share of corporate funding needs.

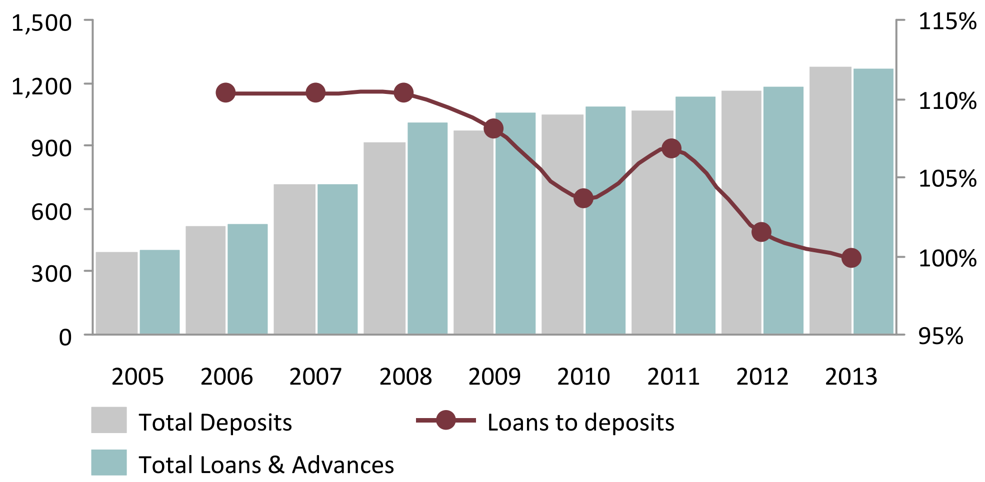

Figure 6. Deposits and loans and advances (in AED Bn) and loans and advances to deposit ratio

2.2.2 Lending to Stable Resources Ratio

Since 1986, UAE banks have been required to keep their loans and advances to their stable resources below a 100% threshold. The ratio, called the Lending to Stable Resources Ratio, is computed as follows:

- Loans and advances include all loans net of provisions, financial guarantees issued less guarantees received, and interbank placements with a residual maturity more than 3 months.
- Stable resources include capital and reserves[3], interbank deposits with a remaining maturity of more than 6 months, 100% of customer deposits with a remaining maturity of more than six months, 85% of all other deposits.

On average, the ratio has been met over the period monitored.

[3]After deducting goodwill and other intangible assets, fixed assets, unquoted investments and investments in subsidiaries and affiliates.

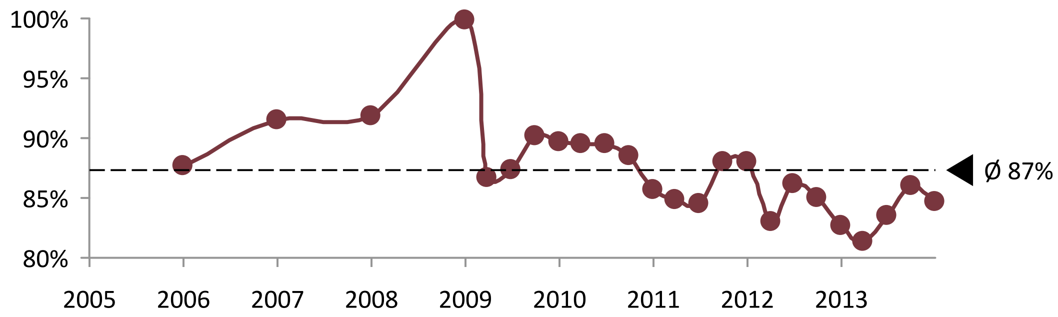

Figure 7. Lending to stable resources ratio

2.3 Banks' Net Liquidity at the Central Bank

The Central Bank monitors two indicators to assess the liquidity of the banking sector held at the Central Bank: net total liquid assets placed by banks with the Central Bank and total collateralised funding provided by the Central Bank.

2.3.1 Net Total Liquid Assets

Figure 8 shows the net total liquid assets placed by banks with the Central Bank including current account balances, reserves requirements and CDs (net of repo-ed CDs or the use of any other Central Bank standing facilities).

CDs issuance is not driven by monetary policy considerations; they allow the banks to place excess liquidity at a risk free return. The chart shows a rising trend in line with the ample liquidity in the market. At the end of December 2013, banks' net liquidity with the Central Bank stood at AED 217 Bn which represents 12.5% of the banks' total assets, up from 9.2% as at the end of 2012.

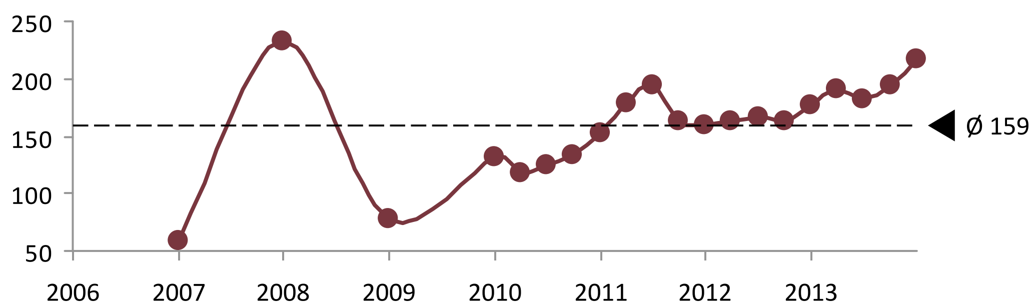

Figure 8. Net liquidity of the banks (in AED Bn)

2.3.2 Collateralized Funding by the Central Bank

Since December 2008, the collateralised lending provided by the Central Bank has reduced substantially and has disappeared completely by the end of 2011. This is the result of the comfortable liquidity position enjoyed by banks.

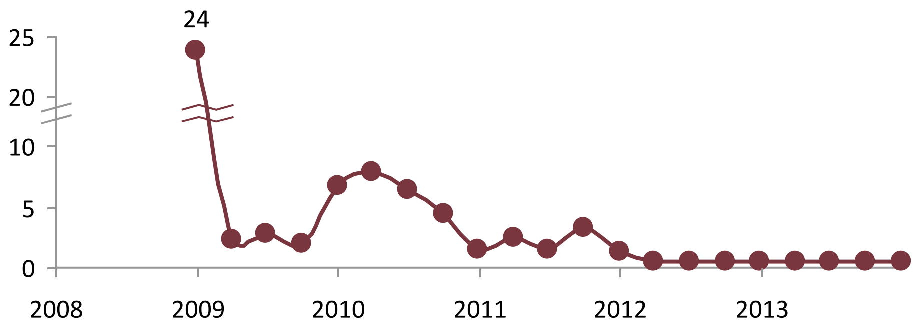

Figure 9. Collateralised funding (in AED Bn)

2.4 Dependence upon Foreign Funding

National banks have a limited dependency on offshore funding. Figure 10 shows that when national banks in the UAE provided excessive credit from 2005 to 2008, they became net borrowers, and were exposed to liquidity crunch at the advent of the Global Financial Crisis. In the recent past, this trend has reversed and national banks are now net lenders to international money markets.

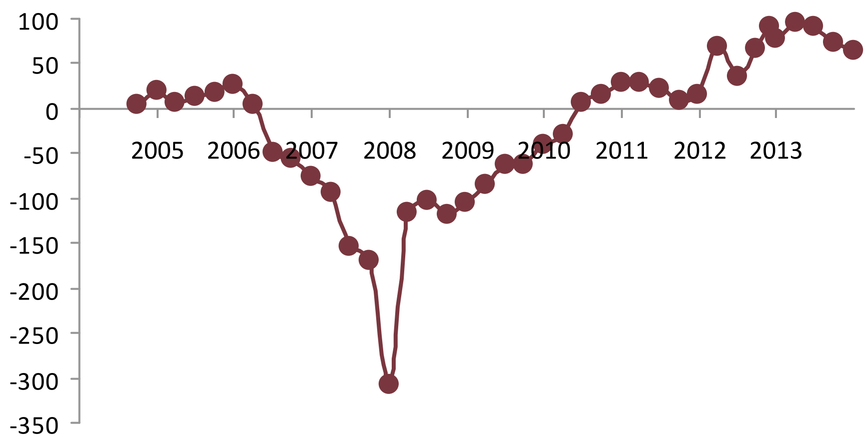

Figure 10. Net interbank lending by national banks (in AED Bn)

In the absence of a Dirham bond market and long term domestic institutional investors, foreign capital markets are the predominant channel for national banks to raise medium to long term funding. Figure 11 shows that as a percentage of total deposits, capital market funding increased but remained stable at around 9% over the reported period.

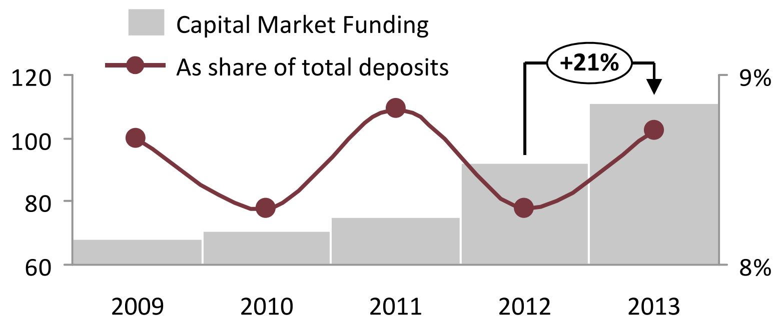

Figure 11. Capital market funding (national banks) in AED Bn and as percentage of total deposits.

Figure 12 shows non-resident deposits in the banking system and their share of total deposits.

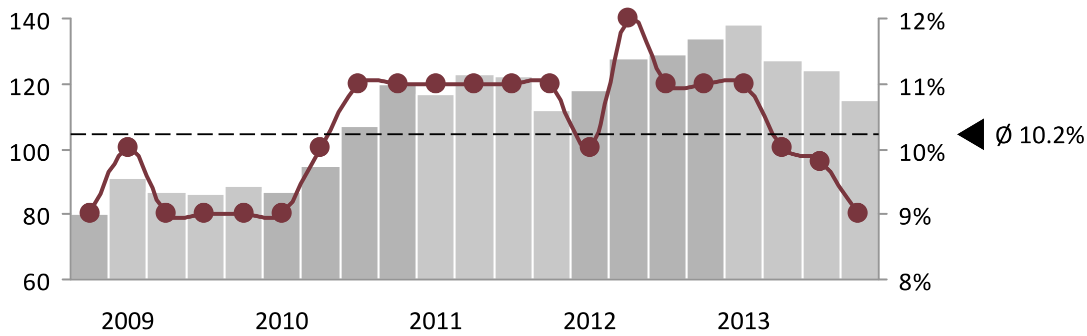

Figure 12. Non-resident deposits (AED Bn) and their share in total deposits (all banks)

3 Financial Soundness Indicators

The Financial Soundness Indicators (FSIs) were developed by the IMF and are an important component in the Central Bank's financial sector surveillance framework.

They provide aggregate measures of the current financial health and soundness of financial institutions. Used in combination with other indicators, they are useful in assessing financial stability and detecting the build-up of systemic risks.

3.1 Capital Adequacy

UAE local banks remain highly capitalised with a capital adequacy ratio of 19% as at the end of December 2013, slightly below the 21% figure as at the end of December 2012. This was because a large number of banks, fully or partially, repaid the Ministry of Finance tier 2 capital granted in 2009. Tier 1 capital stood at 17.2% and was relatively unchanged from 2012.

Banks continue to maintain high levels of capital to address risks that are not captured in Pillar 1 of Basel II, such as the concentration risk in their loan portfolios and the rescheduling or restructuring of some corporate loans.

Due to the high level of capital, Non-Performing Loans provisions could increase by AED 114 Bn (117%) and the banks would still remain above the 12% minimum regulatory requirements.

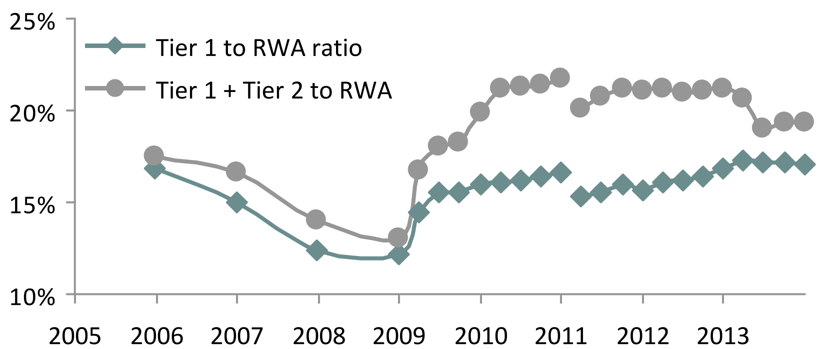

Figure 13. Tier 1 and tier 1 + tier 2 capital to risk weighted assets (RWA) (calculated according to Basel I methodology before and according to Basel II after 2011).

3.2 Asset Quality

Asset quality is measured using three indicators: NPLs, provision coverage ratio and loan rescheduling.

3.2.1 Non-Performing Loans (NPLs)

This ratio is defined as loans that are in arrears for more than 90 days to total loans and is calculated on a gross basis[4]. As at December 2013, the UAE banking system had an NPL ratio of 8.4% representing total classified loans of AED 107 Bn. It appears that NPLs ratio has peaked. The stock of NPLs started to gradually decline in the last quarter of 2013 for the first time since 2007. This development is supported by IMF research[5] which indicates that NPLs on average tend to peak 5 years after the start of a real estate crisis.

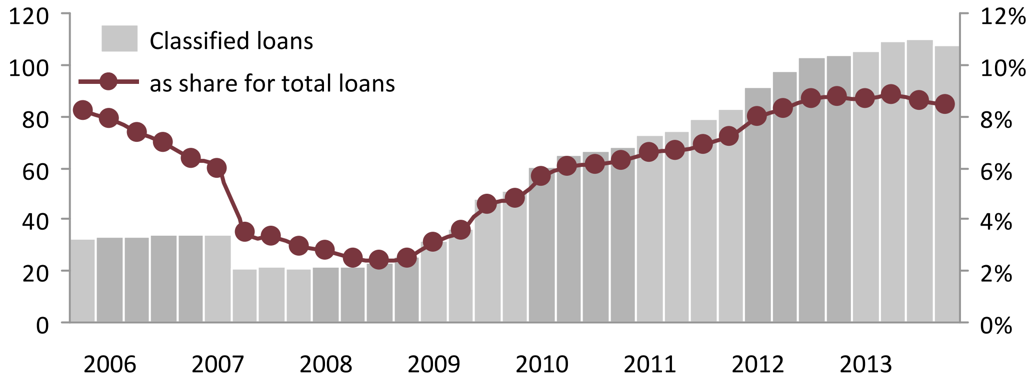

Figure 14. Classified loans in AED Bn and as share of total loans

3.2.2 Provision Coverage Ratio

NPLs coverage has remained relatively flat over the monitored period at around 85% to above 90% on the note of declining NPLs. Banks have increased provisions by a total of AED 72 Bn since December 2008. To put this into perspective, the amount represents (a) close to 3 years of banks' profit before the crisis, or (b) 3.9 times the stock of provisions at the end of 2008. These figures show the severity of the crisis which affected the banking system, and the strict requirements adopted by the Central Bank. It also demonstrate the ability of banks to constitute the necessary provisions from annual profits.

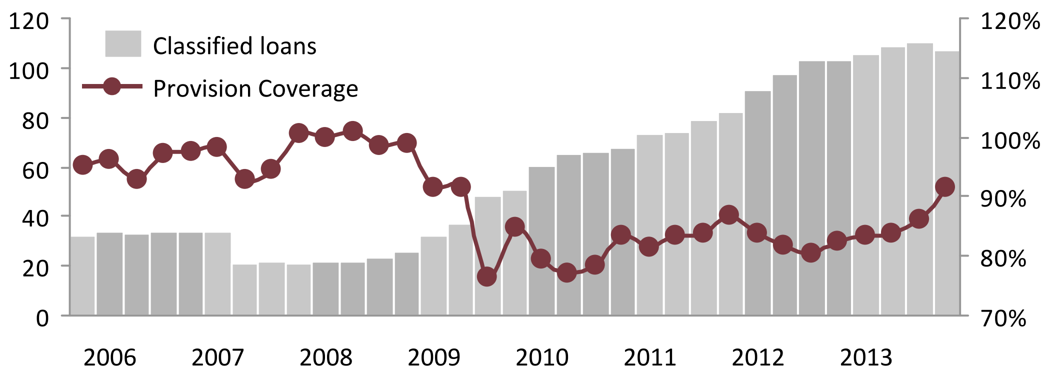

Figure 15. Classified loans in AED Bn and provision coverage

[4] Provisions are not deducted from the NPLs figures.

[5] Luc Laeven and Fabian Valencia, "Systemic Banking Crises: A New Database". IMF, WP/08/224, 2008.

Provisioning level stood at 92% of total NPLs at December 2013. The provision coverage level is adequate given that NPLs do not result in full losses and do not take into account collateral held by banks.

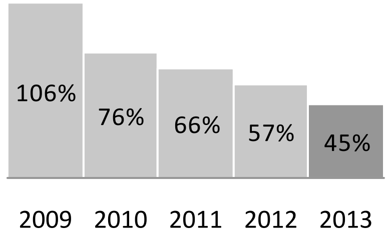

Figure 16. Net provision charges to total profit

Improvement in economic performance has helped NPLs level stabilise in banks therefore requiring them to take less provisions to maintain their level of provision coverage. The net provision charges as a percentage of net profit decreased from a high of 106% in 2009 to 45% in December 2013.

3.2.3 Loan Rescheduling

A loan whose maturity has been extended while its' terms (including principal or interest) have remained largely unchanged is said to be rescheduled; this process is undertaken in order to accommodate borrowers' temporary cash flow shortfalls.

Rescheduled loans are not classified as nonperforming and consequently, provided that the borrower has not become delinquent before or after the rescheduling, a provision is not required. Rescheduled loans decreased by 15% during 2013.

Rescheduled loans with a bullet repayment amounted to AED 12.8 Bn as at the end of 2013 and are considered more prone to problems than other loans whose principal is gradually repaid over the loan term. The Central Bank monitors rescheduled loans carefully to avoid late recognition of any consequent deterioration.

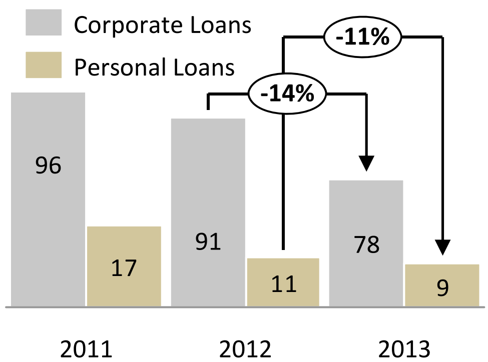

Figure 17. Rescheduled corporate and personal loans in AED Bn

3.3 Earnings

Banks had an aggregate net profit of AED 31.6 Bn in 2013 compared to AED 26.5 Bn in 2012. The high level of profitability of UAE banks indicates a strong internal capital generation capacity.

3.3.1 Net Interest Margin

The steady increase in banks' profits since 2009 is largely driven by the growth of banks' net interest margins (NIMs).

Table 4. Profitability of banks

	2009	2010	2011	2012	2013
Net interest income (AED Bn)	41.7	44.1	48.9	49.1	53.3
Net interest income / gross interest income	56.6%	60.8%	64.8%	66.9%	72.4%
Gross interest income/ gross loans & adv.	6.9%	6.7%	6.6%	6.2%	5.8%

The NIM (net interest income over gross interest income) increased from 56.6% in 2009 to 72.4% in 2013, reflecting a decline in banks funding cost over the period.

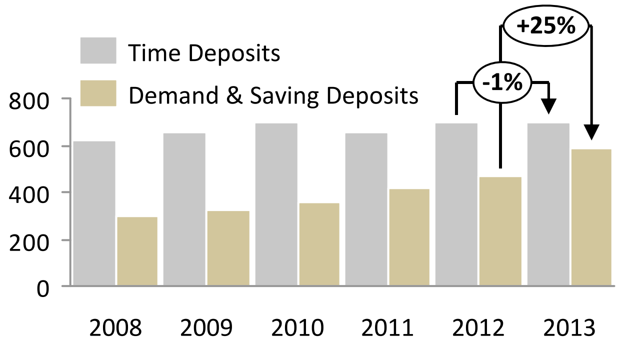

Figure 18. Deposit structure in AED Bn

This decline in the funding cost is explained in Figure 18 which shows the proportion of demand and savings deposits to total deposits. The ratio has increased from 33% in 2009 to 46% in 2013. Traditionally, savings and demand deposits are less costly than time deposits.

The large amount of liquidity available in the market has reduced the competition for deposits among lenders and the prevailing low interest rate environment has made depositors less prone to move their money from *at call* into *time* deposits.

3.3.2 Non-Interest Income

Non-interest income (NII) remained largely stable, at AED 23 Bn level with fee income from brokerage and commission being the main component. NII also includes income from trade finance and related services.

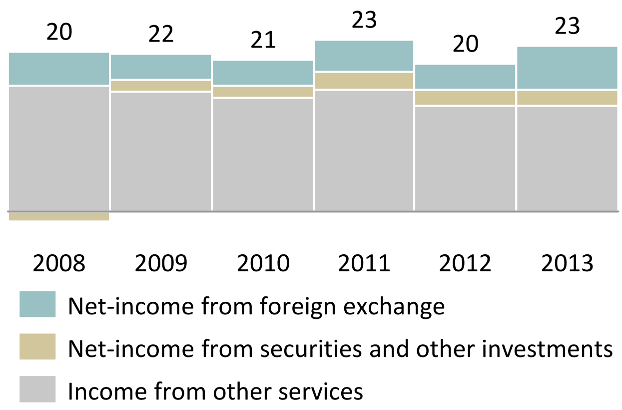

Figure 19. Non-interest income of banks in AED Bn

3.3.3 Profitability

The ratio of non-interest expenses to gross income is an indicator of banks' operational efficiency. Non-interest expenses, essentially staff, premises and IT cost, remain well under 40% of total gross (interest and fees) income.

Figure 20. Profitability of the banks (2013 ROE and ROA figures have been annualized).

3.4 Liquidity

The Central Bank also monitors liquidity in the banking system by measuring two ratios at the banks' level:

- Ratio of liquid assets to demand liabilities
- Ratio of liquid assets to total assets

Liquid assets are made of cash and reserves held at the Central Bank, Central Bank CDs and eligible government bonds. Demand liabilities exclude overnight interbank.

The ratio of liquid assets to demand liabilities declined from the peak reached in 2009 and 2010. This can be explained by the market shift from time deposits to demand and savings deposits, illustrated in Figure 21.

The ratio of liquid assets to total assets showed a substantial improvement from a low of 8.5% in 2008 to over 12% in December 2013.

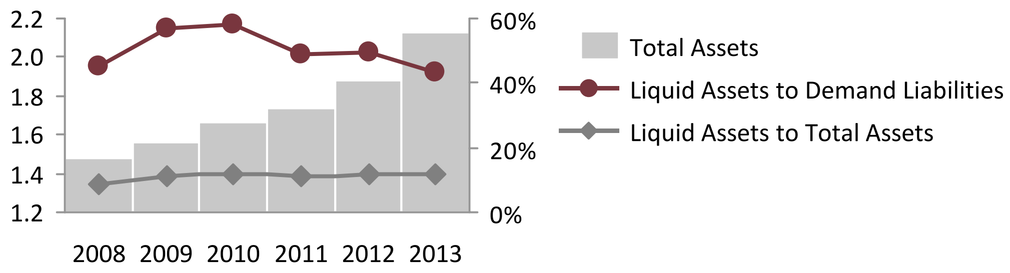

Figure 21. Liquidity at banks. Assets in AED Bn.

While there is short-term volatility in the level of deposits, total deposits steadily increased during the year.

Table 5. Total deposits growth.

	2009	2010	2011	2012	2013
In AED Bn	53	70	20	99	111
Percentage	6%	7%	2%	9%	10%

4 Regulatory Development

Regulatory development is a key focus for Central Bank of the UAE. The strategic objective of the Central Bank is to ensure that the regulatory framework for financial institutions under its supervision is designed to:

- foster sound and robust financial institutions;
- protect consumers; and
- enable the financial sector to develop with prudence.

The Central Bank is reviewing and updating existing regulations so that they are in line with international best practice and take account of the specifics of the structure of the UAE economy and market. New regulations are being introduced where gaps in the regulatory framework are identified.

Over the next few years, the regulatory reforms introduced by the Basel Committee for Banking Supervision under the Basel III framework, will significantly influence the development of the capital and liquidity regulations for banks operating in the UAE. Enhancing consumer protection will also remain a priority for the Central Bank in the development of the regulatory framework.

Throughout 2013 the Central Bank has been working towards developing and enhancing the regulatory framework for financial institutions in a number of important areas. Arising from this process the Central Bank has prioritised the following regulations for 2013 and 2014:

4.1 International Regulatory Standards

Given the regional importance and recent growth of the financial services industry in the UAE, the Central Bank has always sought to prioritize the adoption of internationally agreed regulatory standards. The Central Bank is fully committed to strengthen the regulation, supervision and practices of banks in line with international regulatory standards.

The substantive and wide-ranging prudential reform package issued by the Basel Committee in December 2010, known as Basel III, which complements the Basel II framework and its enhancements by focusing on the quality and quantity of available regulatory capital at banks and the introduction of a new liquidity regime, will affect banks operating in the UAE.

4.1.1 Regulations Regarding Capital

In order to maintain and enhance the strength and resilience of the UAE banking sector, the Central Bank is revising the regulatory capital requirements for banks operating in the UAE. The new capital regime will be aligned with the Basel III capital framework and will include requirements for enhanced capital in terms of quality and quantity and the application of a new leverage ratio. The definition of capital will also change with a higher emphasis on paid-up capital, retained earnings and disclosed reserves. Stricter rules will apply to regulatory adjustments.

In accordance with Basel III, the timeframe for full implementation of the new capital regime is end of 2018. The Central Bank intends to begin the engagement process with banks towards implementing the new capital regime, including consultation on the new regulations, in the second half of 2014.

4.1.2 Regulations Regarding Liquidity

The prudent management of liquidity is vital to the proper functioning and resilience of individual banks and the banking sector overall. In order to enhance the prudential liquidity framework for banks operating in the UAE, the Central Bank is currently in the process of finalising new liquidity regulations. The regulations emphasize the need for each bank to have a proper liquidity risk management framework in place to minimize the likelihood of a liquidity stress occurring and also minimize the impact on the bank should such a stress occur.

In developing such a framework, the Central Bank will require each bank to hold sufficient liquid assets that are of the highest quality to ensure that they will be able to meet their individual liquidity needs on an on-going basis - especially in a stress scenario.

The regulations will take into account national discretions outlined in the Basel III liquidity standards and the timescales for implementation of the Liquidity Coverage Ratio (LCR) will be in line with those set by the Basel Committee on Banking Supervision.

The Central Bank expects to issue these regulations in the second half of 2014. The Central Bank will be engaging closely with all banks to ensure a smooth implementation of the LCR in the UAE.

4.2 Other Regulations

4.2.1 Regulations Regarding Concentration Risk

The need to diversify risk is a key principle in banking. The importance of placing limits on banks' exposures to large borrowers and concentrated credit risk in general is well known. A large exposures regulatory framework seeks to contain the maximum loss to a bank in the event of a failure of a counterparty so that the bank's solvency position is not threatened.

The Central Bank wishes to ensure that the banking system remains appropriately protected from over exposure to any single or connected parties. With this aim in mind, the Central Bank has made certain important enhancements to the Large Exposure regulatory framework for banks operating in the UAE. The changes include the introduction of caps on exposures to local governments and government related entities and the requirement to include off-balance sheet exposures in arriving at the individual and aggregate large exposure limits.

Following consultation with the industry, the Central Bank issued the final regulations on large exposures in the last quarter of 2013.

4.2.2 Regulations Regarding Mortgage Loans

The Central Bank has introduced regulations regarding the granting of mortgage loans to individuals. The main purpose of these regulations is to develop an effective framework of mortgage underwriting standards in financial institutions and create transparency for consumers. The regulations include caps on loan-to-value and debt burden ratios and a requirement for financial institutions to have proper processes and procedures in place to properly assess the borrower's ability to repay the loan.

In introducing these regulations, the Central Bank wishes to ensure that banks, finance companies and other financial institutions providing mortgage loans to individuals do so in accordance with best practice.

The regulations also seek to provide the Central Bank with policy response options which, if required, can be used at a macro level to help towards the prevention of an excessive build-up of risks in the mortgage market. Under the regulations, the Central Bank may set lower 'loan to value' or 'debt burden' ratio requirements for all financial institutions to adhere to, if economic or market circumstances warrant such action.

Following consultation with the industry the Central Bank issued the final regulations on mortgage loans in the last quarter of 2013.

4.2.3 Regulations Regarding Finance Companies

The regulations for finance companies (conventional and Islamic) are currently under review. The objective is to enhance the organization, development and regulation of finance companies in the UAE in the context of the overall financial sector.

In revising these regulations, the Central Bank wishes to ensure that finance companies in the UAE are operating within transparent and well-defined organizational structures and operations, are prudently managed within acceptable regulatory risk limits and have the necessary financial resources to support their business.

Arising from this review, the Central Bank expects to bring forward a regulatory questionnaire for consultation with the industry in 2014.

4.2.4 Regulations Regarding Money Exchange Business

The regulations for Money Exchange Business were reviewed by the Central Bank in 2013. The Central Bank is seeking to enhance the regulatory framework for money exchange business in the UAE to ensure the continued development of this sector in a planned and prudent manner. The new regulations are designed to protect both the institution and consumer alike and ensure that risks in the business are properly managed within a well-defined control framework.

Arising from this review, the Central Bank issued new "Regulations Regarding Licencing and Monitoring of Exchange Business" in January 2014.

5 Payment Systems and Oversight

5.1 Payment Systems

The Central Bank is responsible for promoting efficiency and soundness of payment systems in the UAE which is crucial in ensuring financial stability. In order to achieve this mandate the Central Bank owns and operates a number of key payment systems in the UAE.

5.1.1 Existing Systems

UAE Funds Transfer System (UAEFTS)

UAEFTS is the Central Bank's real-time gross settlement system (RTGS). In 2013, UAEFTS processed nearly 20 million transactions worth over AED 8.3 Tn.

Image Cheque Clearing System (ICCS)

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 2013, ICCS cleared nearly 30 million cheques worth AED 1.3 Tn

UAESWITCH (national ATM-sharing scheme)

Launched in 1996, the UAESWITCH allows cardholders to obtain service at ATMs throughout the Gulf region. In 2013, the system switched nearly 90 million transactions and dispensed around AED 106 Bn in cash.

Wages Protection System (WPS)

The Central Bank has developed an electronic payment system to serve the needs of the Ministry of Labour. Launched in 2009, the system was to provide a safe, efficient and robust mechanism for paying employees' wages; it has been successful with minimum amendments since then. In 2013, WPS processed over 40 million transactions worth over 147 Bn

5.1.2 New Systems

UAE Direct Debit System (UAEDDS)

Launched in June 2013, UAEDDS offers a new method of paying recurring bills such as insurance premiums, loan repayments and utility bills. It is expected that this service will cause a significant reduction in the use of cheques in the UAE. In 2013, DDS processed 8 thousand transactions worth over AED 20 Mn.

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5.2 Payment Systems Oversight

The Payment Systems Oversight Unit (PSOU) was established in 2009 with the mandate to assess, monitor and foster the development of payment systems in the UAE. The PSOU was also given the responsibility for ensuring information security and guide the implementation of the Financial Market Infrastructure Principles.

5.3 PSOU Work on Payment Systems

PSOU oversees payment systems to ensure their safety and efficiency; this includes a thorough risk assessment of payment infrastructure. Risk mitigating measures are applied as necessary. Recent initiatives to further improve payment systems in the UAE include:

- Promoting legal changes that benefit electronic payments such as finality, netting and zero hour clauses;
- Adoption of the latest Bank for International Settlements (BIS) Principles for Financial Market Infrastructure (PFMI).

The PSOU has updated its assessment criteria and methodology in light of the new published principles by the BIS.

5.4 Further developments

The Central Bank recognises the importance of payment systems and the need for security, certainty and confidence. The Central Bank is currently working on new initiatives like upgrading old systems, introducing new services and introducing best international standards.

The common thread underlying all these activities is the Central Bank's vision in supporting financial stability.

6 Macro-prudential policy and instruments

Macro-prudential policy complements the micro-prudential supervision and focuses on the interactions between financial institutions, markets, infrastructure and the wider economy.

It works through a set of macro prudential instruments calibrated to limit excessive build-up of risk during an upswing in the business cycle. It also aims to increase the resilience of banks in the face of an increase in systemic risk. In the UAE, the use of macro-prudential policy and associated instruments gains special importance given the limited scope of monetary policy as a result of the long standing fixed peg regime.

This section is based on the paper "Operationalising the selection and application of macro-prudential instruments" issued by the Bank of International Settlements in December 2012

6.1 The use of macro-prudential instruments (MPI)

There are a number of key macro prudential instruments that are already at the disposal of the Central Bank which could be implemented if the need arises. These instruments are highlighted below in three broad groups depending on their impact on the banks' balance sheets.

Table 6. Macro-prudential Instruments

Capital-based instruments	Liquidity based instruments	Asset-based instruments
Capital adequacy ratio	Central Bank reserve requirements	Loan-to-value ratio
Sectorial capital requirements (increasing risk weights applied to assets in a particular sector).	Liquidity coverage ratio/ Liquid assets ratio	Debt-to-income ratio
	Loans to stable resources ratio/Net stable funding ratio	Large exposure limits / Sector concentration limits

These UAE regulations were initially introduced to enhance the resilience and limit the risks at the individual bank level. Calibrating them in a manner that takes into account system wide risks and vulnerability makes them effective macro prudential instruments as well.

6.2 Timing of MPIs

A number of financial stability indicators can be used to signal the build-up of vulnerabilities.

A key challenge in using an indicator approach to recommend action is determining the appropriate thresholds or buckets for the indicators and how to interpret the signals in the overall financial stability context. Any application of MPIs requires careful trade-off between capturing the build-up of vulnerabilities early enough to avoid a crisis and maintaining an environment supportive of long term economic growth.

6.3 Analysis of MPIs available to the Central Bank

6.3.1 Capital-based instruments

Capital based instruments impact the resilience of the banking system by increasing the banks' capital cushions and therefore their ability to absorb losses.

These capital based MPIs can also be used to target specific assets by increasing their risk weights, this generally discourages banks from lending to these sectors given the higher capital required against loans extended to the targeted sector.

Effectiveness and limitations in reducing the build-up of risk

A long term economic impact assessment conducted by the Basel Committee on Banking Supervision (BCBS) shows a 1% increase in total common equity (TCE) capital to Risk Weighted Assets (RWA) leads to between 20% and 50% reduction in the likelihood of systematic crisis, depending on the initial level of capital.

In absolute terms, the higher the initial capital levels the lower is the marginal impact. For instance, increasing capital ratios from 10% to 11%, decreases the probability of banking crises from 1.4% to 1.0% over a one year time horizon. The average Tier 1 capital adequacy ratio for UAE banks under Basel II standardised approach is around 17.1% as at December 2013. This corresponds to an average probability of a banking crisis over one year period below 0. 3%.[6]

Impact on GDP and credit growth

The macro-economic assessment group 2010 study showed that GDP growth reduces by 0.09% for every 1% increase in capital ratio.

Empirical evidence also shows an overall credit reduction between 1% and 2% for every 1% increase in capital which should help slowdown excessive credit growth.

UAE experience and applicability

In 2009 as a response to the global financial crisis, the capital adequacy ratio was increased for UAE banks to 12 %, which is 4 percentage points higher than the international norm at the time. Capital based instruments however have limited usefulness to control the credit cycle given the high excess capital cushions held by UAE banks.

6.3.2 Liquidity-based MPIs

Liquidity-based MPIs are generally wide reaching ratios that have an impact on the availability and cost of funding for new loans.

They also impact the banks' holding of liquid assets and their funding structure, increasing their resilience to liquidity shocks.

[6] Basel Committee on Banking Supervision. *Guidance for national authorities operating the countercyclical capital buffer*, 2010.

Effectiveness and limitations in reducing the build-up of risk

In general, there is scarcity of information and large uncertainty on how liquidity based MPIs will operate. This is mainly due to the inconsistent liquidity ratios previously applied by different jurisdictions.

The macro-economic assessment group 2010 study suggests that the introduction of the net stable funding ratio (NSFR) leads to 10% – 20% reduction in the likelihood of systematic risk.

Impact on GDP and credit growth

BCBS long term economic impact assessment (2010) showed that NSFR and LCR reduce GDP growth by 0.08 percentage points.

Basel III impact studies suggest that the introduction of the liquidity coverage ratio (LCR) could reduce lending volume by 3%.

An important limitation when using liquidity based MPIs is their unclear interaction with monetary policy, particularly how the use of the liquidity based instruments will affect the demand for Central Bank liquidity facilities.

UAE experience and applicability

The loans to stable resources ratio (LSRR) and the reserve requirements were never used as MPIs previously. However, these instruments as well as the upcoming Basel III liquidity ratios could be used to achieve macro-prudential objectives.

These instruments enhance the resilience of banks and thus the capacity of the financial system to absorb liquidity shocks.

6.3.3 Asset based MPIs

Asset-based MPIs target the demand side of credit by limiting the ability of borrowers to use the collateral they own to obtain credit. These measures can be used to target certain sectors for example by lowering loan to value ratio (LTV) against commercial property or listed equities.

Effectiveness and limitations in reducing the build-up of risk

Asset based MPIs increase the resilience of banks by increasing the resilience of the borrowers. In addition, tighter LTV reduce the sensitivity of households to income loss and assets price shocks.

Impact on prices and credit growth

These MPIs decrease the availability of credit by limiting funding for certain borrowers and thus slow down real credit growth and assets price appreciation. One study[7] shows that

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[7]Kenneth Kuttner & Ilhyock Shim, "Taming the Real Estate Beast: The Effects of Monetary and Macroprudential Policies on Housing Prices and Credit," RBA Annual Conference Volume. Alexandra Heath, Frank Packer and Callan Windsor (ed.), *Property Markets and Financial Stability*, Reserve Bank of Australia, 2012.

tightening LTV or the debt to income ratio (DTI) by 10 percentage points reduce credit growth by 1 to 2% and house prices by 2 to 5 percentage points.

Unlike other MPIs, asset based measures have no direct impact on the bank funding cost or the price of credit.

UAE experience and applicability

The Central Bank has in place a maximum DTI ratio of 50% which can be varied up or down to impact the credit cycle. The Central Bank has also introduced a LTV ratio which limits the amount banks can lend against residential real-estate and shares. These measures can mitigate against excessive increase in property prices or stock markets when fuelled by bank credit.

It is important to note that the impact of these measures is on the availability of credit. Where an asset boom is fuelled by cash purchasers the asset based ratios have limited impact. In this case other measures, outside the scope of the Central Bank's direct control, may be applied.

6.3.4 Other MPIs

A number of alternative measures that are outside the scope of supervisory authorities and Central Banks have been used in other countries with a mixed degree of success. They include capital controls, levelled registration fees, capital gains tax as well as financial transaction tax.

7 Real Estate

7.1 Real estate and financial stability

The real estate sector is a major component of any economy. Strength of the real estate sector was one of the core factors behind a period of economic growth worldwide prior to 2007, while the bust in multiple real estate markets was one of the triggers for the global financial crisis that unfolded since 2007.

There are three features of the real estate sector that are relevant to financial stability. First, real estate assets can be considered as consumption good and an investment at the same time. Therefore, prices of real estate depend on both (1) demand for consumption factors such as changes in population or income of residents and (2) expected change in value of the properties relative to other investments.

Second, real estate has a long production cycle. As the period from the decision to make a greenfield investment to the sale or lease of the constructed property can be spread over a few years, as such supply adjustments to changes in demand is relatively slow. This creates periods of insufficient and excessive supply which contributes to real estate price volatility. Finally, real estate development heavily relies on debt as both construction and ownership are often funded with borrowed funds.

The real estate sector consists of many sub-sectors with each having a different impact on the financial sector and the overall economy. This report concentrates on housing, the biggest subsector of the real estate market in the UAE.

7.2 Residential real estate market in the UAE

The UAE real estate market has developed rapidly in the last 12 years. The growth was mostly driven by high population growth rates - between 2003 and 2012, the UAE population increased by 173% or by more than 5.8 million people. Price growth peaked in the second half of 2008 with growth rates in some areas of Dubai exceeding 70% a year. Within six months of the peak, the trend reversed and a down cycle kicked with prices finally bottoming out in mid-2011 in Dubai and at the end of 2012 in Abu Dhabi. Ever since, there has been a constant rise in prices in these markets.

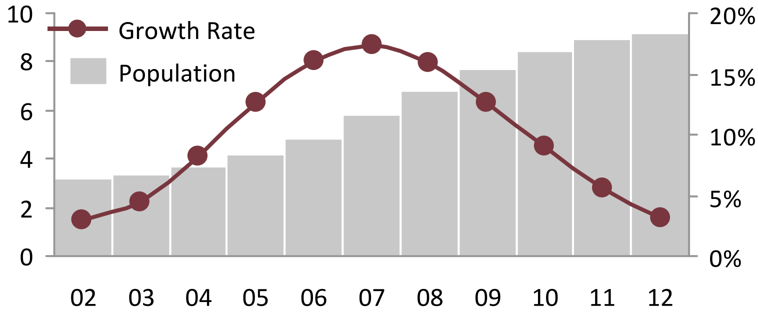


Figure 22. UAE population in Mn and population growth rate. Source: World Development Indicators

7.2.1 Developments in 2013

In 2013 average residential sale prices surged by 24% in Dubai and 21% in Abu Dhabi. Price recovery rate and the speed of recovery so far have been highly location dependent with nearly all freehold developments demonstrating higher growth rates than the city average. That would suggest that non-GCC citizens are a significant force behind increased demand for residential property in Dubai.

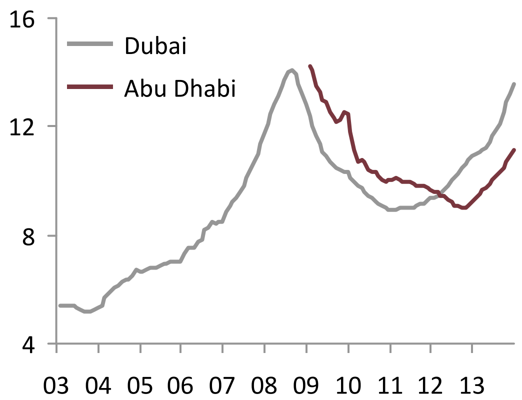


Figure 23. Average monthly prices of residential property (AED Th. /Sq. m.). Source: REIDIN.com

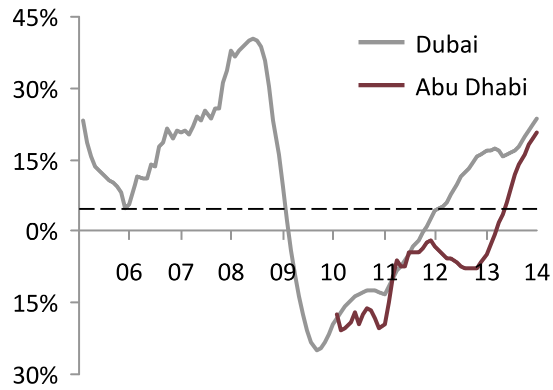
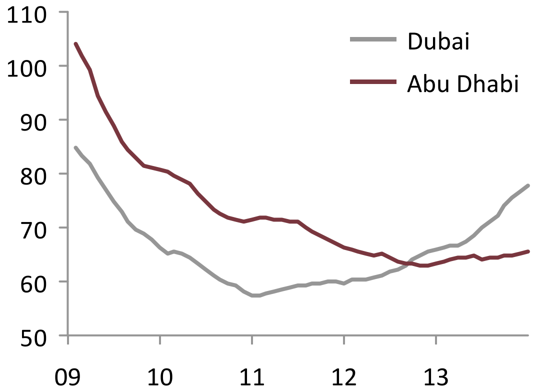


Figure 24. Year on year price changes of residential property prices (dotted line marks long term average growth rate). Source: REIDIN.com

While in all areas, recovery of rental prices started at least a few months before the sale prices had bottomed, growth rate of rents was significantly lower than the increase in prices. Thus rental yields have been decreasing in all locations. Areas with the highest price growth have experienced the sharpest decrease in rental yields.



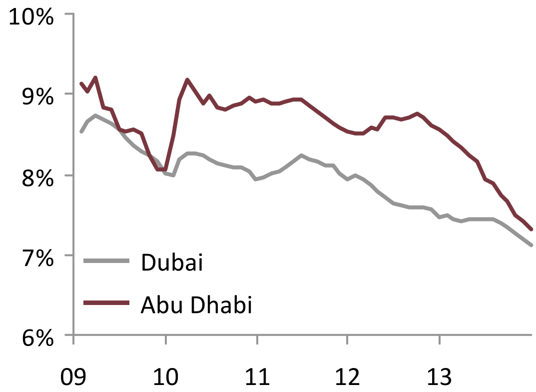


Figure 25. Residential rental prices (AED/Sq. m.). Source: REIDIN.com

Figure 26. Residential rental yields. Source: REIDIN.com

Deviations of rental yields from long term averages are commonly used to identify imbalances in the housing market and considered to be a reliable indicator of the state of the property cycle. Current average rental yields in Dubai and Abu Dhabi are approximately 70 and 130 basis points below historical averages, which could indicate growing imbalances – overheating real estate market.

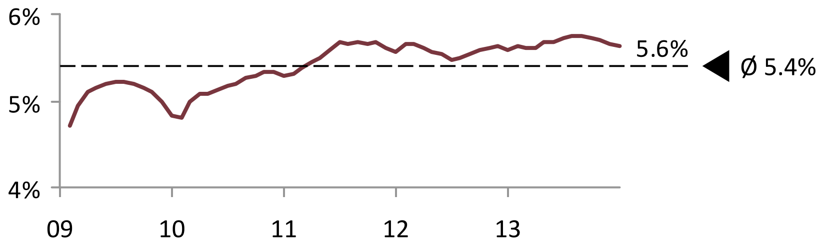


Figure 27. Dubai residential real estate risk premium (Dubai residential property rent yield – EIBOR (12M))

If residential property is considered purely as an investment good, rental income should be treated as a return on investment. In that case, the real estate risk premium[8] rather than rental yield should be used to assess discrepancies in the market since it measures property returns relative to alternative investment opportunities. Dubai residential real estate premium estimated as difference between rental yields and Emirates Interbank Offered Rate (EIBOR) indicates that decline in rental yields over the last three years are comparable to decline in returns in the money market.

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[8] Additional compensation required by an investor in order to invest in real estate.

7.2.2 Real Estate price and its long term trend

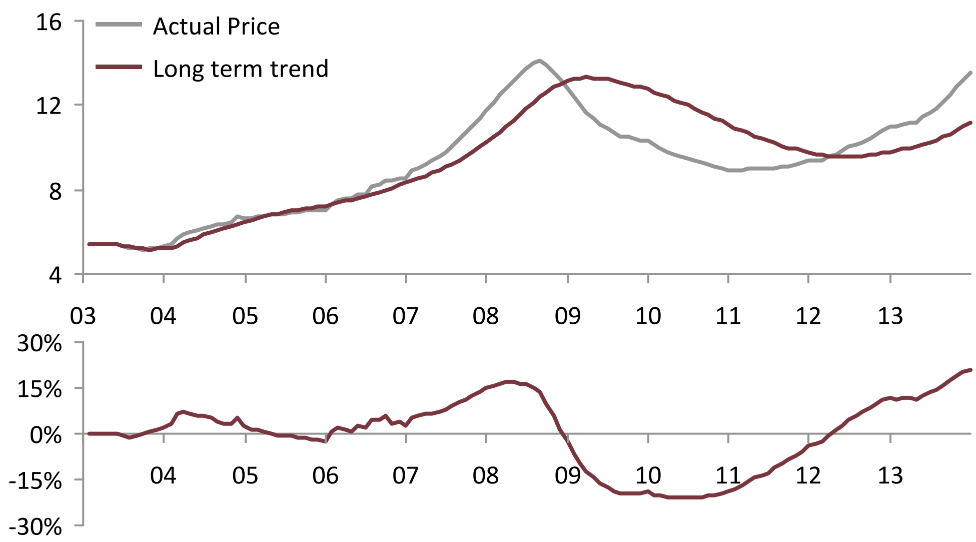

Figure 28. Top chart: Dubai average residential real estate sale price (AED Th / sq. m) and long term price trend. Bottom chart: deviation from long term trend.

A one-sided Hodrick-Prescott (HP) filter was used to decompose price movement of real estate prices in Dubai into cyclical and long term trend. A positive gap can be seen since mid-2012 and has been increasing at a steady pace.

7.3 Interconnectedness of financial and real estate sectors

While the importance of the real estate sector for the overall economy cannot be neglected, it is not part of the financial sector and therefore price and volume dynamics should not directly affect financial stability. A major market correction, however, could harm lenders to the real estate sector, as falling prices would reduce the repayment capacity of real estate developers.

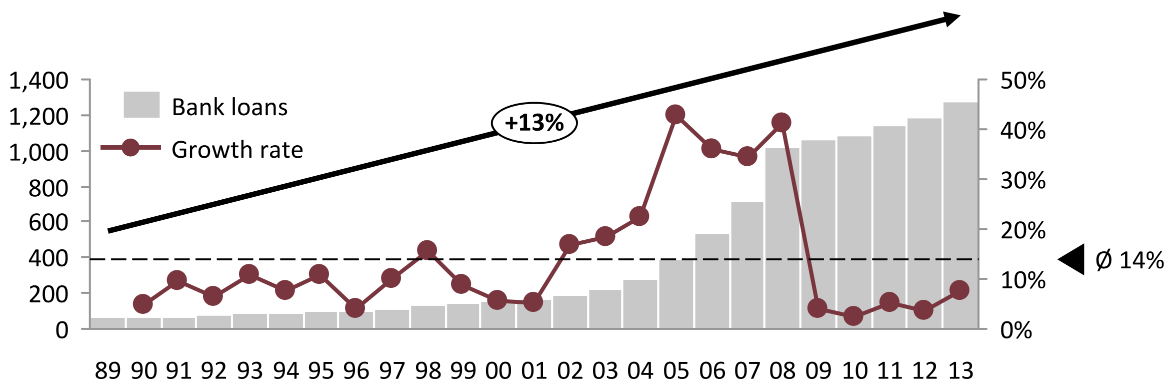

Figure 29. Bank loans and their growth rate

While pre 2008 crisis period was marked by a rapid credit growth, the current recovery is not. Furthermore, UAE banks play a relatively minor role in the real estate sector[9] as their exposure to the segment totals AED 287 Bn or less than 23% of total loans.

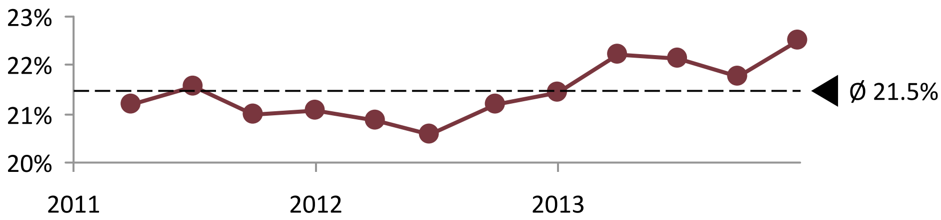

Figure 30. Bank real exposure as share of total loans

Banks maintained a relatively stable share of real estate related lending in their portfolios over the last three years. Real estate related lending accelerated slightly in 2013, with growth rate above 10% or one percentage point higher than the overall loan book growth.

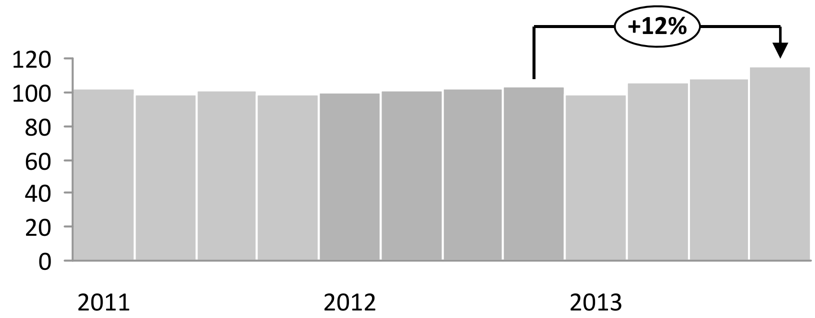

Figure 31. Total residential real estate related lending (AED Bn)

Most recent changes in real estate exposure of the banking sector reveal some impact of the current market recovery. Bank finance for the purchase of residential property increased by 12% in 2013 or by AED 12.7 Bn. While this indicates that banks were increasingly participating in financing the real estate recovery, the funds provided by the banking sector was only enough to finance the purchase of less than 30% of the residential properties that were completed in 2013. Therefore bank lending cannot be considered a significant driver of real estate prices. In other words, analyses of banking data support the hypothesis that the current market recovery is mostly driven by equity buyers and/or reliance on external funding sources.

7.4 Conclusions

Monitoring development in the UAE real estate markets and the banks' exposure to it remains a core financial stability priority. While managing real estate lending related risk is primarily the responsibility of individual banks, the goal of the Central Bank is to ensure that under adverse scenarios the financial system functions properly. Central Bank regulations, such as the cap on banks' real estate exposure and the mortgage loans regulations issued in November 2013, contribute to the resilience of the banking system and mitigate the impact of any shock on UAE's financial institutions.

[9] Real Estate exposure is defined using the purpose of the loan as opposed to the source of repayment,.

8 The Insurance Sector[10]

8.1 Introduction

The insurance sector plays an important role in the UAE economy. Not only because of its direct contribution to the national economy but also by facilitating the operation of other sectors such as logistics, services, health and transport. Investing insurance premiums also supports economic development and maintains positive competitiveness between insurance companies. The Insurance Authority monitors solvency of insurance companies by applying its laws and regulations aimed at protecting the rights of the beneficiaries of insurance policies.

The performance of the sector has been robust in 2012 with improvement in almost all financial ratios. Total assets of the sector were AED 48.5 Bn in 2012 up from AED 41.4 Bn in 2011. Written premiums of all types of insurances amounted to AED 26.3 Bn, an increase of 9.5% compared to 2011. The profitability of the sector also increased from AED 0.3 Bn in 2011 to over AED 1 Bn in 2012.

The sector's total invested funds increased from AED 25.6 Bn 2011 to AED 28.7 Bn in 2012 out of which 48% were investments in shares and bonds and 32.4% investments in deposits. Shareholder's equity of national insurance companies has also increased to AED 15.3 Bn in 2012 from AED 13.8 Bn in 2011.

8.2 Insurance Companies

There are 61 Insurance Companies operating in the UAE of which thirty four are national companies and twenty seven are foreign companies.

- The number of companies carrying out all insurance activities i.e. life insurance, operations of fund accumulation and property and liability insurance is eleven national companies and two foreign companies. Ten of the national companies are carrying out Takaful insurance.
- The number of companies carrying out only property and liability insurance is twenty national companies and seventeen foreign companies.
- The number of insurance companies carrying out only life insurance and operations of fund accumulation is two national companies and eight foreign companies.
- There is only one company carrying out credit export insurance.

The sector also has fourteen insurance agents, hundred and seventy brokers, eighteen consultant, sixty nine loss adjustors and thirty one actuaries.

[10] Contributed by The Insurance Authority

8.3 Volume of U.A.E Insurance Market and Insurance Benchmarks in 2012

8.3.1 Life Insurance and Operations of Fund Accumulation

Total underwritten premiums of life insurance and operations of fund accumulation amounted to AED 5.95 Bn. The share of national companies amounted to 30.3% while that of foreign companies was 69.7%.Total technical provisions of life insurance and operations of fund accumulation was AED 9 Bn.

8.3.2 Property and Liability Insurance

Total underwritten premiums of property and liability insurance were AED 20.3 Bn in 2012 up from AED 19 Bn in 2011, an increase of 6.8%. The share of national companies was 72.4% while that of foreign companies was 27.6%. The percentage of the national insurance companies' retention of underwritten premiums of property and liability insurance was 55.3%

Earned premiums of property and liability insurance were AED 19.8 Bn in 2012 and incurred losses before deduction of the re-insurance share was AED 13.5 Bn. The loss ratio before deduction of the re-insurance share was 68.1% in 2012 up from 55.7% in 2011. The Total technical provisions for properties and liabilities insurance was AED 8.8 Bn.

8.3.3 Insurance Regulations

The Insurance Sector in the United Arab Emirates is organized by Federal Law No. (6) Of 2007 on Establishment of the Insurance Authority and Organization of the Insurance Operations which came into effect as on 28 August 2007. The Board of Directors of the Insurance Authority is also empowered to issue regulations and notices to ensure the prudent operation of the insurance sector.

8.4 Challenges Facing the Insurance Sector

The key challenge facing the sector includes the number of insurance companies and brokers. Some of these companies/brokers are not profitable and in some cases risk management practices in these entities could be further improved. The consolidation in the sector should help address these issues and create more profitable, larger companies better able to compete and increase the efficiency of the market.

9 UAE Stock Markets[11]

UAE stock markets have been topping global rankings in 2013. UAE listed companies have generated 47.4 billion dirhams in profits over 2013 beating the 41.9 billion dirhams in 2012. With such fundamental drivers supporting investors' sentiments, market flow indicators have shown positive signs across the board. In particular: the trading volume is now above two billion dirhams per day on average, approaching pre-crisis level.

Other notable indicators of market health are the increased net investment by institutional investors to AED 2.4 Bn in 2013, the return of individual investors and the continued participation of foreign investors. These positive developments were capped by the inclusion of the UAE in the MSCI Emerging Market Index voted in June 2013, to be effective from May 2014. UAE indices closed 2013 strongly with Dubai being up 108% and Abu Dhabi going up by 63%.

In the first quarter of 2014 the positive trend has continued with fundamental data showing sustained profit growth, stock market indices have increased in the first quarter 2014 by 32% in DFM and 14% in ADX. At the time of writing companies have completed filing their financial reports for the first quarter 2014 and have again posted positive results: total net income of AED 15.4 Bn for the quarter, up 27% from the same period in 2013.

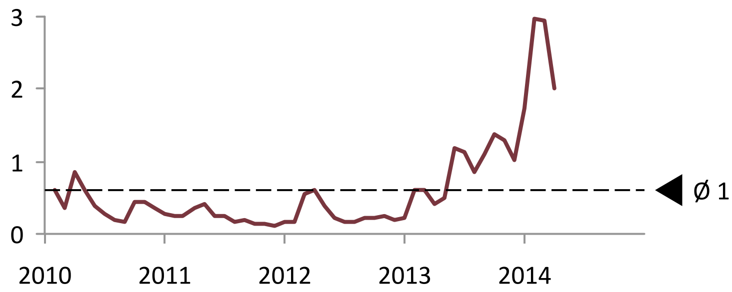

Figure 32. Daily Average Value Traded (AED Bn)

Daily average value traded has rebounded over the past two years to AED 2.6 billion per day in 2014 after reaching a low of AED 227 M in 2011.

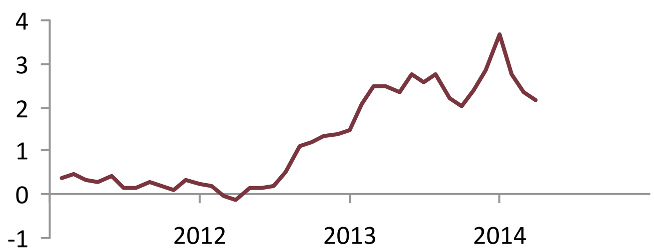

Figure 33. Net value of purchases of UAE stocks by non-UAE citizens over last 12 month (AED Bn)

[11] Contributed by Securities and Commodities Authority.

Foreign investors have been net buyers of UAE listed equities for three years from 2011 to 2013. In 2014 however, local investors have returned en masse to the market and have been net buyers for the first three months of the year.

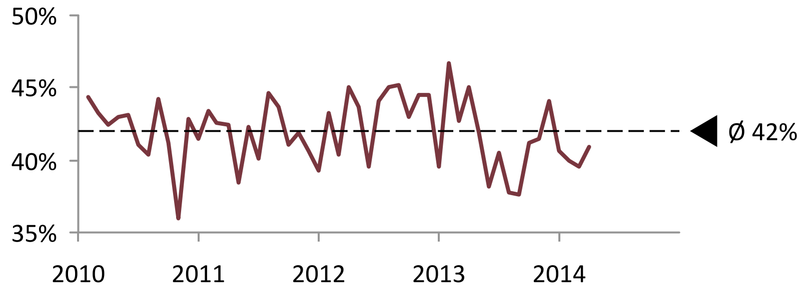

Figure 34. Proportion of daily average value traded by non-UAE citizens

The percentage of foreign investors in the UAE stock markets, which has been broadly unchanged at about 42% for several years, has started to decline in 2013 to 40% in the first quarter.

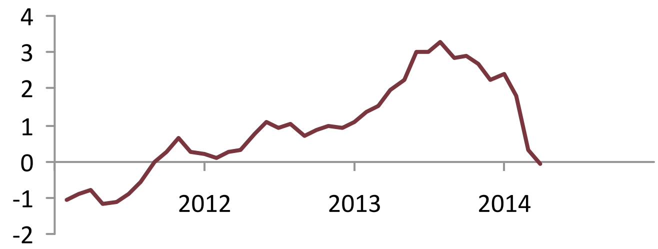

Figure 35. Net value of purchases of UAE stocks by institutional investors over last 12 month (AED Bn).

Institutional investors have been net buyers of UAE listed equities for 2011 to 2013. Starting in the second half of 2013, this trend has reversed and in the first quarter of 2014 institutional investors sold AED 1,258 Mn.

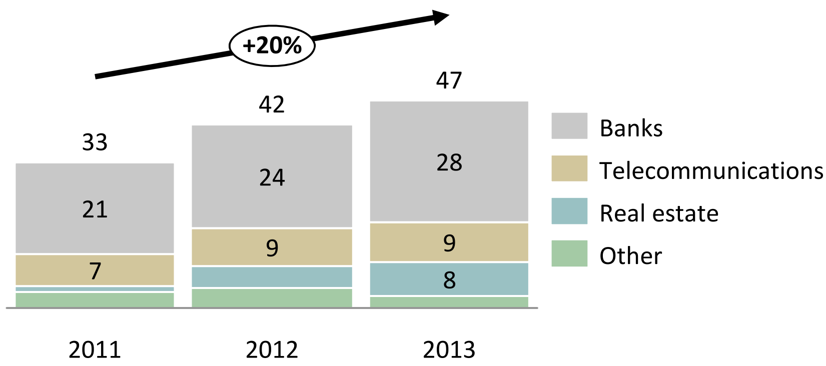

Figure 36. Net income of local UAE listed companies by sector (AED Bn)

The banking sector is the dominant net income producer among UAE stocks for the past three years. The real estate sector shows a notable improvement over the same period. No sector showed losses in 2012, while both Energy and Transportation sectors posted losses in 2013.

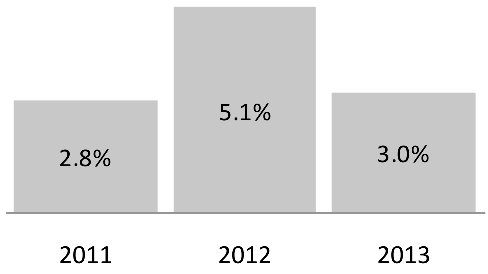

Figure 37. Return on Equity of UAE local listed companies (excluding banks)

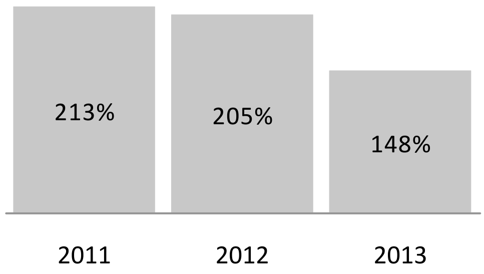

Figure 38. Liabilities divided Equity of UAE local listed companies (excluding banks)

In 2013 UAE listed companies had a combined net profit of AED 47.4 Bn, up from AED 41.6 Bn in 2012. However, Return on Equity ratio was 3%, lower than 5.1% in 2012. Real Estate sector companies have the highest profitability at 22%, while Transportation companies had the lowest ROE at -103%.

The leverage indicator also point to an improvement as it is declining again in 2013. The decline is driven largely by the financial services sector as legacy issues from the 2008-09 financial crisis, previously a drag on the sector, have been largely overcome.

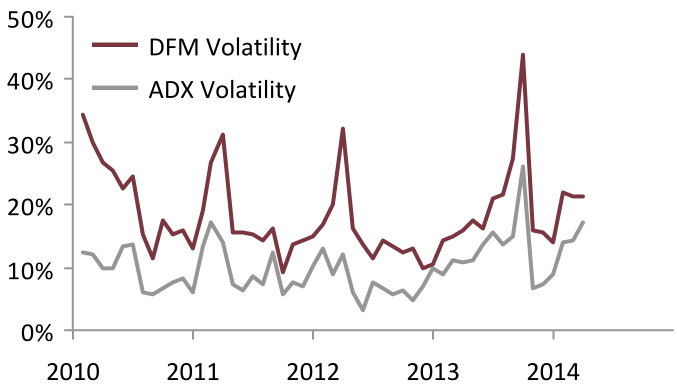

Figure 39. Dubai (DFM) and Abu Dhabi (ADX) stock exchanges 30 day standard deviation (annualized)

DFM stock market exhibits significant higher volatility than ADX on average. However, monthly volatilities on DFM stock market have subsided from 27% in the first half of 2010 and have been stable around 16% over the following three years, excluding a peak to 44% during the summer of 2013. In the first quarter of 2014, the indicator has averaged 22%.

On average, monthly volatilities on ADX stock market have subsided from 12% in the first half of 2010 and have been stable, averaging only 7%, during the following three years, excluding the spike in the summer of 2013 and seasonal increases during the first quarters of each year, including 2014.