Comfort, not hope: How banks can sleep well at night

Mark Brown - Partner, Head of Projects - Banking and Finance / Projects
m.brown@tamimi.com - Abu Dhabi

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At the time of writing, three of Dubai's banks have released their annual results and each reported strong growth across the key metrics by which they are measured (profit, net income and assets). Buoyed by such positive news the industry can look forward to continued success into 2015.

The Central Bank of the UAE has helpfully assisted in getting a relatively current peek into the banking industry's future thinking by the release of its Credit Sentiment Survey. This is the first release of its kind by the Central Bank and the survey details UAE lending institutions' thoughts on credit sentiment based on responses from senior credit officers. Al Tamimi commends the Central Bank on this initiative as it will provide forward guidance against which eventual results can be measured that will create a deep pool of qualitative information over time. Moreover, it will help inform the lending industry and the public about what is an important area of the economy.

The results of the survey were widely reported at the time of release and revealed lenders' views on a number of important areas, including credit growth and credit standards in business and personal lending. Expectations of demand growth in each area was positive (although growth is slowing) and it will be interesting to see if this sentiment continues in the second release in April which will cover the first quarter of 2015 (especially given the trend in oil prices).

Of interest to the Al Tamimi banking team were the responses on credit standards and the factors attributable to any change in credit standards. For both business and personal lending credit standards, in the majority, had not changed—although, there was some easing in standards for personal lending. In both cases, the quality of the bank's asset portfolio was cited as being the paramount factor in any change in credit standards. Hence where the portfolio is poor, credit standards (interest rate margins, credit limits and collateralisation) should tighten and vice versa.

If an institution is doing well and views its portfolio as being in good shape a reasonable reaction may be to be more generous to customers against a positive economic backdrop. Credit and risk departments may be drawn into a state of comfort as they take heart in a stable economy and continuing demand. This is a common in any industry that is doing well as the good times make perceivably small problems (e.g. covenant oversights, minor payment delays) seem inconsequential. However, vigilance is a guiding principle for the defenders of any bank's asset quality.

One of the many tools in maintaining vigilance is to check the wellbeing of a portfolio though regular audits of a loan book. Undertaking a legal audit at the beginning of each year is a recommended method of confirming whether actual practice accords with bank policy and meets best practice. Such a review looks at a sample of transactions and their finance documents to (i) ensure all documents contemplated by the term sheet were obtained and duly signed; (ii) confirm all conditions precedent and subsequent were fulfilled; (iii) test the mechanics of the covenants to make certain they are operating as intended; and (iv) identify any omissions or areas for improvement taking into account the bank's usual procedures and the approach in the market. The benefits of receiving red flags at an early stage include better customer engagement and the maintenance of the lenders contractual rights under the finance documents.

At a broader level, the meta-results of these reviews are also are useful means of confirming if existing policies are correct, being applied properly or if standard documentation can be improved. For instance, choice of law and choice of jurisdiction within finance facilities is a perennial issue where the choice of a foreign law is common for large UAE-only transactions. The merit of the choice is always supportable but it requires a thoughtful decision for each transaction and policies that are not set with the right parameters can result in a lender's interests not being fully realised. Further if standard documentation has not been reviewed for a period of time, it may not reflect the latest legislation or best practice. By way of example, all banks would have needed to review and update their mortgage products following the release of the Mortgage Loan Regulations in October 2013.

The overall benefit of a legal review of the loan portfolio is that it gives an institution an immediate insight into existing practices to confirm if all is well and, if not, to take corrective action. Armed with this knowledge banks can sleep well with not just hope, but comfort, that their loan portfolio is robust.

For more information on the above please contact your usual Al Tamimi advisor or any member of the Banking & Finance Team.