JOINT GUIDANCE NOTE TO BANKS AND FINANCE COMPANIES ON THE TREATMENT OF IFRS 9 EXPECTED CREDIT LOSS PROVISIONS IN THE UAE IN THE CONTEXT OF THE COVID-19 CRISIS (the “Joint Guidance”)

15 April 2020

EXECUTIVE SUMMARY

This Joint Guidance proposes practical solutions to manage the impact of economic uncertainty on Expected Credit Loss (“**ECL**”) while remaining compliant with the globally accepted International Financial Reporting Standards (“**IFRS**”). It is suggested to employ the flexibility embedded in the IFRS 9 framework to cope with the Covid-19 crisis.

Banks and finance companies are required to group clients that are offered payment deferrals; some of which will be part of the Targeted Economic Support Scheme (“**TESS**”) while some others will not. For clients *not* benefitting from payment deferrals specific grouping is *not* required however a critical assessment of the mechanical IFRS 9 stage migration is needed.

This grouping exercise is expected to be gradual and iterative. It should start as soon as sufficient, reasonable and supportable information is available. For consistency and practical purposes, the period of applicability of this interim solution is expected to be in line with that of the TESS scheme.

Grouping of clients benefitting from payment deferrals will be performed according to the impact of the crisis on clients as follows: (i) those that are temporarily and mildly impacted (“**Group 1**”); and (ii) those that are significantly impacted (“**Group 2**”).

Group 1 clients are not expected to face substantial changes in their creditworthiness, beyond liquidity issues, caused by the Covid-19 crisis. Consequently, their assigned “stage” under IFRS 9 should remain the same for the duration of the crisis.

Group 2 clients are expected to face substantial changes in their creditworthiness, in addition to liquidity issues that will be addressed by payment deferrals. For this Group:

- Where there is sufficient deterioration in credit risk to trigger a migration to stage 2, this migration should take place.
- Due to the possibility of future economic upturn, these clients will not normally be migrated to stage 3, based on their financial performance. In exceptional circumstances, stage 3 migration can be triggered during the crisis if clients’ business models are no longer sustainable.

In addition, banks and finance companies are *not* encouraged to re-calibrate IFRS 9 models during the crisis due to the high degree of uncertainty surrounding its economic consequences. Rather, input adjustments and judgmental overlays should be considered.

Exposure at default should incorporate realized additional drawdowns occurring because of the crisis. Banks and finance companies should also consider overlays to account for weaknesses in the predictive power of models during the crisis.

Banks and finance companies are not expected to update macroeconomic scenarios in their ECL systems immediately. Rather, they are encouraged to (i) estimate the impact of new scenarios by assessing a range of possible outcomes on ECL separately and, (ii) based on these estimations, gradually introduce judgmental overlays on top of ECL with the view that scenarios should be re-introduced in their ECL systems no later than **September 30, 2020**. Dedicated governance should be put in place to thoroughly assess and review the overlays before they are added to IFRS 9 ECL.

Finally, comprehensive specific disclosures are required to ensure transparency on (i) the grouping process and its outcome, (ii) the design of the economic forecasts, (iii) any adjustment to model input and (iv) any judgmental overlays, where applicable.

1. BACKGROUND

As the Covid-19 virus spreads across the globe, economic consequences will follow both in the short- and long-term. The Central Bank of the UAE (the "**CBUAE**") has already taken relief measures under the Targeted Economic Support Scheme ("**TESS**"), effective from 15th March 2020. The economic disruption and the relief measures will have an effect on the financial accounts of banks and finance companies operating in the UAE, including the Dubai International Financial Centre ("**DIFC**") and the Abu Dhabi Global Market ("**ADGM**"). This effect needs to be appropriately reflected by the existing financial reporting framework. The principles-based nature of International Financial Reporting Standards ("**IFRS**") is open to significant interpretation. The CBUAE, together with the Dubai Financial Services Authority (the "**DFSA**") and the Financial Services Regulatory Authority (the "**FSRA**"), as the banking regulators in the UAE's financial free zones (collectively the "**Regulators**"), believe that additional guidance is needed.

This Joint Guidance is issued pursuant to the powers vested, respectively, in (i) the CBUAE under the Central Bank Law, No. (14) of 2018 regarding the Central Bank & Organization of Financial Institutions and Activities (the "**Central Bank Law**"), (ii) the DFSA under Article 36 of the Regulatory Law, DIFC Law No.1 of 2004 and (iii) the FSRA under section 15 of the Financial Services and Markets Regulations 2015.

Paragraph 5.5.17 of the IFRS 9 standard states that Expected Credit Loss ("**ECL**") used as to determine accounting provisions must be *"an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes*". It must be based upon "*reasonable and supportable information that is available without undue cost or effort at that date about past events, current conditions and forecasts of future economic conditions*". In other words, the ECL must be point-in-time and forward looking in a way that is not overly optimistic nor overly pessimistic. However, the exceptional circumstances surrounding the Covid-19 crisis make this exercise challenging because of the uncertainty regarding its economic consequences.

This Joint Guidance is necessary to ensure (i) harmonization across the UAE banking sector, and (ii) that provisions are appropriately calculated. This Joint Guidance proposes practical solutions to manage the impact of economic uncertainty on ECL, while remaining compliant with IFRS. This implies meeting the accounting requirements of an accurate and point-in-time estimation of risk, while recognizing that this decision process needs to be adjusted in the current environment. The Regulators hold the view that the flexibility embedded in the IFRS 9 framework should be employed to cope with the current crisis. This Joint Guidance presents a mixture of adjustments offered by the IFRS 9 principles, such as individual assessment, portfolio assessment, macroeconomic adjustment and management overlays.

At this point-in-time, banks and finance companies are not required to update model parameters to account for this crisis. Rather, banks and finance companies are required to adjust inputs, consider model outputs critically and make use of temporary, judgmental overlays if necessary.

For foreign banks operating in financial free zones as branches, they can choose to follow this Joint Guidance or guidance issued by their home country relevant authorities, if any.

2. STAGING AND DEFAULTS

IFRS 9 requires banks and finance companies to assess, at each reporting date, whether the credit risk of a financial instrument has increased significantly since its initial recognition. For that purpose, it relies on the concept of Significant Increase in Credit Risk ("**SICR**"). Clients subject to SICR have their ECL computed over the lifetime of their facility (stage 2) instead of the one-year horizon applicable otherwise (stage 1). SICR is generally driven by several quantitative and qualitative factors, under the discretion of banks and finance companies, and reviewed by external auditors. Amongst others, common drivers of SICR are clients' number of days-past-due ("**DPD**"), increase in probability of default ("**PD**") and change of credit rating.

2.1. Repayment Events and Staging Implications

Over the next few months, banks and finance companies are likely to witness a range of facility repayment events, directly or indirectly, linked to the Covid-19 crisis. These events should *not* automatically trigger SICR. The nature of such events is set out below, as well as their staging implications.

- Payment deferrals: A large number of clients are expected to be offered payment deferrals by which they will temporarily cease payments of principal and/or interest/profit. Their facilities may be re-scheduled or restructured, and in some cases, additional credit lines may be offered. The TESS scheme issued by the CBUAE intends to facilitate this process by offering zero-cost funding to banks and finance companies. Regulators recognise that some clients will also benefit from payment deferrals outside of the TESS scheme, as banks and finance companies may voluntarily offer payment deferrals to clients outside of this programme. Consequently, the pool of clients benefitting from payment deferrals will comprise both 'TESS clients' and 'non-TESS clients'.
- Staging for TESS clients: The TESS circular amended on 4 April 2020 states under point 9.1. d), that the IFRS 9 staging for TESS clients shall normally remain unchanged for the duration of the scheme. This is based on the presumption that most of these clients will not experience a significant increase in credit risk by virtue of their eligibility for the scheme. In reality, the range of situations will vary and a tailored approach is necessary to align with IFRS principles. Therefore, the aforementioned stage migration principle contained in the TESS needs to be interpreted to allow migrations when needed. *Further guidance is given in section 2.2 below.*
- SICR Issues: In light of these repayment arrangements and of the government support scheme, the existing mechanisms in place within banks and finance companies to trigger SICR may not be appropriate to address the exceptional circumstances of this crisis. These mechanisms would most likely fail to recognize the scale of various support measures being put in place by government authorities and central banks, both globally and in the UAE. In addition, even certain clients *not benefitting* from repayment arrangements can be indirectly impacted by the Covid-19 crisis and therefore the SICR triggers currently in place, should be applied cautiously and subject to exercise of judgement.
- Rebuttable Presumption: More specifically, IFRS 9 includes a rebuttable presumption that a facility with more than 30 DPD has undergone a SICR. However, this assumption is likely to be rebutted for clients benefitting from exceptional payment deferrals due to the crisis. For these clients, DPD should no longer be used as a relevant automatic indicator of SICR. Instead it should be frozen at the date of facility rescheduling. DPD can be used again as a relevant indicator when the client leaves the scheme, if the client encounters delays in payment

thereafter. Additionally, all other factors usually driving SICR should be carefully evaluated, without automatic triggers, in particular those resulting in the revision of PD and internal/external credit ratings, for the duration of the crisis.

2.2. Interim Solution: Categorisation

In light of the points mentioned above, for the purpose of staging updates, banks and finance companies are encouraged to apply judgment and consider clients as explained below - for wholesale and retail clients respectively.

The Regulators expect that such analysis should start as soon as sufficient, reasonable and supportable information is available. This process is expected to be gradual and iterative as the degree of uncertainty surrounding the Covid-19 crisis reduces through time. Until decided otherwise by bank and finance company management, all clients benefitting from payment deferrals will remain in their current stage, unless movement to a lower stage is motivated by events such as bankruptcy, fraud or skip of owners and senior managers. For consistency and practical purposes, the period of applicability of this interim solution is expected to be in line with that of the TESS scheme because, at this point in time, the TESS duration is a relevant benchmark for the crisis duration.

2.2.1. Wholesale Clients (including SMEs)

For clients *not* benefitting from payment deferrals, the SICR mechanisms in place would continue to be applied but with judgmental overrides, when deemed appropriate. This means that stage migrations automatically triggered should be analysed and understood, with the option to be stopped if clients are expected to recover relatively quickly, once the Covid-19 crisis is over. This remains in line with the spirit of IFRS 9, which requires an assessment of the lifetime creditworthiness of a facility.

For clients benefitting from payment deferrals (all TESS clients and some non-TESS clients) instead of relying on the mechanistic SICR triggers in place, banks and finance companies should separate these clients into two groups based on dedicated analyses, using the following principles:

- **Group 1**: clients that are *temporality and mildly* impacted by the Covid-19 crisis.
    - For these clients, the payment deferrals are believed to be effective and thus the economic value of the facilities is not expected to be materially affected. These clients are expected to face liquidity constraints without substantial changes in their creditworthiness.
    - For these clients, banks should hold the view that, despite being subject to payment deferrals, there is insufficient deterioration in credit quality to trigger a stage migration. These clients will remain in their current stage, at least for the duration of the crisis, or their distress, whichever is the shorter. For instance, this would apply to industries that are expected to rapidly return to normal business conditions, once confinement policy decisions are over.
- **Group 2**: clients that are expected to be *significantly impacted* by Covid-19 in the long term.
    - These clients are expected to face substantial changes in their creditworthiness beyond liquidity issues. For these clients, there is sufficient deterioration in credit risk to trigger a migration to stage 2, and this migration should take place.

- Due to the possibility of later economic rebound, these clients are not expected to migrate to IFRS 9 stage 3 based on their financial performance during the period of the crisis. In exceptional circumstances, such stage 3 migration can be triggered by liquidation/ bankruptcy caused by (i) non-financial events (such as fraud) or (ii) significant disruptions threatening the long-term sustainability of the clients' business model.
- Consequently, banks and finance companies must continue to monitor the creditworthiness of these clients, particularly indications of potential inability to pay any of their obligations as and when they become due.

The above grouping decisions should take into consideration the specific circumstances of clients in the context of the Covid-19 outbreak. Banks and finance companies should perform analyses by incorporating at least the following principles:

a) Grouping decisions should rely on a mixture of quantitative analysis and a judgmental approach based on the views of clearly identified subject matter experts within banks.

b) Grouping decisions should be in line with the spirit of IFRS 9 stages; relying on the assessment of credit risk over the lifetime of facilities. Hence the necessary distinction between clients that are impacted over the short term vs. long term.

c) It is expected that clients will face a range of impact intensity and duration. Therefore, grouping will be achieved by establishing cut-offs based on expert judgment. Industries and sectors could be used as a commonly accepted starting point for segmentation.

d) For clients to which banks and finance companies have a material exposure, analyses are expected to be performed on a case-by-case basis. For clients with less material exposures, analyses should be performed on a portfolio basis and be based on credit risk drivers, typically industry, tenor and rating. It may be useful to set appropriate materiality thresholds for the purpose of client segregation. For example, in this context, a client could be considered material if it belongs to the top 50 clients ranked by the size of exposure at default ("**EAD**") or contributes to the cumulative top 30% of the total wholesale portfolio EAD. Banks and finance companies with less than 50 clients would therefore treat their entire portfolio on a case-by-case basis, for the purpose of this exercise.

e) For the purpose of establishing priorities in this grouping exercise, banks and finance companies are expected to organize their portfolio by materiality and susceptibility to the crisis, and start with the most material/susceptible segments. It is expected that the assessment will be more reliable at an individual account/obligor level rather than at a portfolio level.

f) Ultimately, banks and finance companies should assess if their clients have put in place appropriate measures to cope with the crisis, in particular, decisions related to the management of their cash position, inventories, fixed costs and financial costs.

g) Considerations related to parent/government guarantee and collateral should also be included in the grouping decision, as such decision should consider potential credit enhancement.

<u>Return to stage 1</u>: For wholesale clients classified in Group 2 *during the crisis*, banks and finance companies may consider migrating them back to stage 1 once there is clear evidence that customers are no longer impacted by the Covid-19 crisis. The analysis of staging upgrade must be performed at least at the same granularity employed for staging downgrade. For those clients that migrated to stage 2, a return back to stage 1 needs to be supported by three consecutive monthly payments or one payment if the payment intervals are longer than two months (typically quarterly), provided that there is reasonable evidence supporting an improvement in creditworthiness. For TESS clients in particular, such payments qualify only when clients are no longer supported by the TESS scheme.

2.2.2. Retail Clients

For clients *not* benefitting from payment deferrals, the SICR mechanisms in place would continue to be applied. As judgmental overrides are practically challenging to implement for retail portfolios, other solutions should be envisaged to manage the unwarranted consequences of an automatic stage migration as follows:

- Banks and finance companies are encouraged to take pre-emptive initiatives towards clients to help them anticipate financial difficulties and potentially avoid deterioration of credit risk and consequential trigger of stage migrations. For instance, this can be achieved by clear communication to clients about payment deferral schemes (as part of TESS or not) and a process for them to report difficulties.
- Banks and finance companies are also encouraged to undertake regular analysis by segments in order to identify spikes in migrations, which can subsequently be used to inform necessary updates of accounting policy.

For clients benefitting from payment deferrals (all TESS clients and some non-TESS clients), instead of relying on the mechanistic SICR triggers in place, banks and finance companies should separate these clients into two groups based on dedicated analyses.

- Group 1: clients that are *temporarily and mildly* impacted by Covid-19. These clients will remain in their current stage; and
- Group 2: clients that are expected to be *significantly impacted* by Covid-19 in the long term. These clients will migrate to stage 2. Migration to stage 3 will normally not occur for the duration of the program, unless motivated by specific circumstances.

The grouping decisions should take into consideration the specific circumstances of clients in the context of the Covid-19 outbreak, including at least the following principles:

a) Case-by-case analyses may be practically challenging for retail clients. Instead, portfolio and/or product analyses might be more appropriate.

b) Grouping decisions should rely on a mixture of quantitative analysis and a judgment-based approach based on the views of clearly identified subject matter experts within banks and finance companies.

c) When possible, banks and finance companies should assess whether clients' employment and financial situations are likely to be impacted temporarily or over the longer term. More specifically, banks and finance companies should consider at least (i) the severity of the impact on the sources of income, typically, whether clients are subject to temporary salary reduction or employment loss, (ii) clients' financial leverage and (iii) residency status.

d) If possible, the industry/sector associated with retail clients' employment should be taken into consideration in the grouping analysis. The treatment of industries for retail clients should be consistent with that of wholesale clients.

e) For the purpose of segregation, it might be necessary to systematically collect additional information from clients entering the TESS scheme and other payment deferral initiatives that banks and finance companies wish to put in place outside TESS.

Return to stage 1: For retail clients classified in Group 2 *during the crisis*, banks and finance companies may consider migrating them back to stage 1 once there is clear evidence that customers are no longer impacted by the Covid-19 crisis. The analysis of staging upgrade must be performed at least at the same granularity employed for staging downgrade. For clients benefitting from deferrals during the crisis, that migrated to stage 2, a return back to stage 1 can occur after 6 months of performing payments. For TESS clients in particular, such payments qualify only when clients are no longer supported by the TESS scheme.

3. EXPOSURE AND RECOVERY

Exposure at Default ("**EAD**"), which is one of the parameters for the computation of ECL, should be estimated by incorporating the context of the Covid-19 crisis as follows:

a) Additional drawdowns occurring during the crisis should be reflected in the calculation of EAD.

b) Any other realized drawings under loan contracts such as revolving facilities and overdrafts are also expected to impact EAD.

c) The predictions made by statistical EAD models are likely to deviate from realized drawdowns during the crisis. Therefore, banks and finance companies should critically assess the expected exposures under off-balance sheet facilities, in particular across wholesale and retail clients. If necessary, temporary add-ons and overlays can be considered, rather than model recalibration. It is essential that overlays are the subject of high-quality governance, given the unprecedented nature of the current situation.

The Covid-19 crisis is also expected to impact loss given defaults ("**LGD**"). Banks and finance companies should take the necessary steps to understand the implication of the crisis on the drivers of LGD, including but not limited to (i) the cash situation of clients, (ii) the value of collateral and (iii) the enforceability of guarantees. In light of the potential illiquidity of certain types of collateral during the crisis, banks and finance companies are encouraged to consider the appropriateness of their valuation methods. Finally, for government guarantees, banks and finance companies should analyze whether such support should be incorporated in the LGD of the facility or considered as a separate reimbursement.

For the duration of the Covid-19 crisis, we would normally not expect any re-calibration of the LGD models, unless such re-calibration is necessary to rectify deficiencies identified prior to the Covid-19 crisis.

4. MACROECONOMIC OVERLAY

As per the IFRS 9 accounting rules, ECL should incorporate forward looking information in the form of a macroeconomic overlay. The purpose of this overlay is to adjust the estimation of PD, LGD and EAD, in order to incorporate not only backward looking statistical data, but also forward-looking assessment. This is especially important if future economic developments are expected to be significantly different from past experience. The macroeconomic scenario inputs are expected to impact all clients.

Under the IFRS 9 framework, banks and finance companies are expected to update the macroeconomic forecasts, in order to reflect the likely change in the economic environments (in both the UAE and abroad). However, the Regulators recognize the high degree of uncertainty surrounding the economic consequences of the Covid-19 crisis and therefore the challenges of constructing meaningful and accurate economic forecasts at this point in time. In addition, the UAE economy is materially dependent on the performance of the global economy, therefore the evolution of Covid-19 related government policies implemented throughout the world will also impact the UAE economic forecasts.

At this point in time, updating macroeconomic scenarios in ECL engines is subject to major challenges: (i) using a single set of scenarios amongst many different alternatives is rather arbitrary, (ii) the unprecedented level of government intervention invalidates the historical relationships between credit risk and economic variables, therefore the PD generated from these macro models needs to be critically reviewed, and (iii) lags employed in macro models between the macro variables and the dependent variable (typically PD or LGD) are likely to be incorrect.

Consequently, and in order to avoid inappropriate macro overlays and excessive disparity amongst macroeconomic forecasts, banks and finance companies are not expected to update macroeconomic scenarios in their ECL engine immediately. Rather, they are encouraged to proceed as follows:

a) Estimate the impact of new scenarios by assessing a *range of possible outcomes* on ECL separately, outside of the ECL production environment, as new information becomes available.

b) Based on these estimations, gradually introduce judgmental overlays on top of ECL, with the view that scenarios should be reintroduced in ECL systems, no later than **September 30, 2020**. Overlays can be applied at portfolio, industry or product levels to holistically reflect changes in the economic environment. The overlay estimation process should be **rigorously documented**. The objective of this process is to establish a view on the susceptibility of portfolios to the macro environment, without solely relying mechanically on existing models.

c) Subsequent to this date, banks and finance companies should follow their existing process for the production of economic scenario forecasts and ECL computation. However, whilst the generation of macro forecasts will be *less* challenging due to the *reduction* of uncertainty, the macro models are still likely to be inadequate as per the challenges mentioned above. Consequently, adjustments might still be necessary.

In terms of process, in light of the exceptional circumstances, banks and finance companies are required to establish dedicated crisis-focused governance, in order to (i) undertake benchmark analyses using relevant sources, (ii) seek the view of economists and subject matter experts, (iii) ensure that key macro factors driving ECL are still relevant for the present circumstances and (iv) adjust the economic forecasts iteratively, as new information becomes available.

Finally, for the duration of the Covid-19 crisis, aside from scenario inputs, we do not normally expect any *re-calibration* of the macro models, unless such re-calibration is necessary to rectify deficiencies identified prior to the Covid-19 crisis.

5. DISCLOSURES

The Regulators require transparency across the financial sector in the UAE and the financial free zones. It is essential that banks and finance companies provide additional relevant and comprehensive disclosures related to ECL computation in their interim financial statements and annual financial statements as required. Banks and finance companies should include necessary disclosures, both qualitative and quantitative.

Each institution should tailor the disclosures to its specific circumstances in the context of the Covid-19 crisis and update the disclosures accordingly based on events and conditions that are relevant at the time of issuing the financial statements. Banks and finance companies must ensure compliance with IAS34 for interim reporting and IFRS7 for annual reporting and are expected to consult with their auditors on the details of the disclosures. At a minimum, the Regulators expect banks and finance companies to provide the following information; up to and including Q1 2021 financial reporting:

Quantitative information

- The disclosures should contain information on the <u>proportion of clients benefitting from deferrals</u> per portfolio or product, for wholesale and retail clients.
- When identified, the <u>proportion of Group 1 and Group 2 clients</u> as defined in this Joint Guidance, per portfolio, with their associated exposures and ECL.
- The <u>amount of macro overlay</u> added to ECL per portfolio or product as explained in this Joint Guidance.
- The total <u>changes in EAD</u> since December 2019.
- <u>Stage migrations</u> estimated as EAD by portfolio since December 2019.
- For wholesale clients, the <u>change of ECL split by industry</u>, since December 2019.
- For retail clients, the <u>change of ECL split by products</u>, since December 2019.

Qualitative information

In addition, banks and finance companies should disclose the approach employed during this exceptional period to assess ECL components and the required grouping driving stages. This disclosure should at a minimum contain detailed discussion related to each of the below items:

- The dedicated crisis-focused governance put in place for the purpose of grouping decisions, macroeconomic scenario adjustment and any other management overlays.
- Analyses performed with the information available at that point in time.
- Assumptions and judgements supporting the estimation of ECL components.
- The rationale behind updates made to the macro forecasts.
- Any judgmental overlays implemented at portfolio or product level.