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")

4 April 2020

EXECUTIVE SUMMARY

This Joint Guidance proposes practical solutions to manage the impact of economic uncertainty on Expected Credit Loss, while remaining compliant with globally accepted 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 part of the Targeted Economic Support Scheme (TESS). Such grouping will be performed according to the impact of the crisis on those clients as follows:

- Those that are temporarily and mildly impacted ("**Group 1**"); and
- Those that are significantly impacted ("**Group 2**").

Group 1 clients are not expected to face substantial changes in their creditworthiness, beyond liquidity issues, over the duration of the TESS or the period during which they are subject to stresses arising from Covid-19, whichever is the shorter. Consequently, their assigned "stage" under IFRS 9 should remain the same, at least for the duration of the scheme or their distress, whichever is the shorter.

Group 2 clients are expected to face substantial changes in their creditworthiness, in addition to liquidity issues addressed by the TESS.

- 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 a future economic upturn, these clients will not normally be migrated to stage 3, based on their financial performance for the duration of the program. In exceptional circumstances, stage 3 migration can be triggered during the TESS program if clients' business models are no longer sustainable.
- Banks and finance companies should continue to treat clients, that are not part of the TESS, as per their existing IFRS 9 policies for the purpose of determining their stage.

Banks and finance companies are not encouraged to recalibrate 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 exceptional drawdowns occurring because of the crisis. Generally, banks and finance companies should also consider overlays to accounts for weaknesses in the predictive power of models during the crisis.

Banks and finance companies are not required to incorporate the updated macroeconomic forecasts into ECL until **September 1, 2020**. However, dedicated governance should be put in place to review thoroughly these forecasts before they are used to compute IFRS 9 Expected Credit Loss.

Finally, comprehensive specific disclosures are required to ensure transparency in the grouping process, the design of the economic forecasts, any adjustment to model input and/or any judgmental overlay.

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 Abu Dhabi Global Market ("**ADGM**"), and this effect needs to be appropriately reflected by the existing financial reporting framework. Given that the principles-based nature of International Financial Reporting Standards ("**IFRS**") are open to significant interpretations, 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 globally accepted financial reporting standards, 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 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 overlay.

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 overlay 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 DEFAULT

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 rating.

2.1. Wholesale Clients (including SMEs)

2.1.1. TESS Clients

Clients entering the TESS program will temporarily cease payments of principal and/or interest/profit. Their facilities may be re-scheduled or restructured, typically without a loss of net present value. In some cases, additional credit lines may be offered. The TESS also states under point 9.1. c), that the IFRS 9 staging for TESS clients will remain unchanged for the duration of the scheme. This is based on the presumption that most of those clients have not experienced 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 be adjusted to allow migrations when needed. However, 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. Those would most likely fail to recognize the scale of various support measures being put in place by the government authorities and central banks, both globally and in the UAE. **For that reason, we hereby present further guidance as set out below**.

DPD 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. Additionally, for TESS clients, all other factors usually driving SICR should be carefully evaluated, without automatic triggers, in particular those resulting in the revision of PD and rating, for the duration of the scheme. Clients are expected to leave the TESS scheme by its expiry date or earlier if there is reasonable evidence that regular business activity has resumed.

Banks and finance companies should separate TESS clients in two groups based on dedicated analyses:

- Group 1: clients that are *temporarily and mildly* impacted by Covid-19.
  - For these clients, the actions taken under the scheme 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 change in their creditworthiness.
  - For these clients, banks should hold the view that, despite entering the TESS, there is not a sufficient deterioration in credit quality to trigger a stage migration. These clients will remain in their current stage, at least for the duration of the scheme, or their distress, whichever is the shorter. For instance, this would apply to industries that are expected to return rapidly 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 TESS clients are not expected to migrate to IFRS 9 stage 3 based on their financial performance, for the duration of the program. In exceptional circumstances, such stage 3 migration can be triggered during the TESS program 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 TESS clients, particularly indications of potential inability to pay any of their obligations as and when they become due.

These 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:

- 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.
- For clients with large exposures, analyses are expected to be performed on a case-by-case basis. For clients with smaller 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 segregation. For example, in his context, a client could be considered as large if it belongs to the top 50 clients ranked by the size of exposure at default ("**EAD**") or contributes to the cumulative 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.
- 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.
- Considerations related to parent / government guarantee and collateral should also be included in the grouping decision, as such decision should consider potential credit enhancement.

Given the above factors, it is expected that the assessment will be more reliable at an individual account/obligor level rather than at a portfolio level. Banks and finance companies are expected to complete this grouping effort once reasonable and supportable information is available and once the degree of uncertainty surrounding the Covid-19 crisis has reduced. In other words, once there is sufficient clarity that either (i) the economic implications are likely to be mild or (ii) the crisis is unlikely to stop anytime soon and the economic implications are likely to be severe.

The Regulators expect that such analysis will be completed by **September 1, 2020**. In the meantime, all clients subject to the TESS scheme 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.

Return to stage 1: For clients classified in Group 2, 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 the TESS clients only, migration 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. Such payments qualify only when clients are no longer supported by the TESS scheme.

2.1.2. Non-TESS Clients

Wholesale clients that are not adversely affected by the Covid-19 crisis do not qualify for relief under the TESS program. For these clients, the SICR mechanism should continue to be applied as per banks and finance companies' existing IFRS 9 staging policy and the CBUAE IFRS 9 Guidance note dated March 2018.

However, banks and finance companies should bear in mind that the general disruption in business activity is likely to impact all clients, even indirectly. Consequently, covenant breaches resulting from the Covid-19 crisis should not automatically trigger a SICR or lead to a stage migration. Banks and finance companies should apply judgement in the case of breaches of existing loan covenants, such as, (i) breaches resulting from temporary changes in the borrowers' reported earnings, (ii) suspension of business or other 'material adverse event' clauses, (iii) modification of the audit report, (iv) unavoidable delays in providing unaudited or audited financial statements, covenant compliance certificates, or third-party valuations.

Return to stage 1: For the purpose of consistency, non-TESS clients that have migrated to stage 2 during the period of the TESS scheme can migrate back to stage 1, using the same criteria as for TESS clients, once there is clear evidence that they are able to service their credit obligations. This means that such migration 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 the avoidance of doubt, this rule does not apply to clients that have migrated to stage 2 prior to the start of the TESS program.

2.2. Retail Clients

2.2.1. TESS Clients

For the clients entering the TESS, DPD can no longer be used as a relevant indicator of SICR. DPD should be frozen as of the date of entry of a given client into the scheme. DPD can be used as a relevant indicator again when the client leaves the scheme. Additionally, for TESS clients, all other factors usually driving SICR should be ignored, in particular increase in PD and adverse change of credit score, for the duration of the scheme.

Similarly, to wholesale clients, retail clients entering the TESS should be separated in two groups. A similar rationale applies as follows:

- 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:

- Case-by-case analyses may be practically challenging for retail clients. Instead, portfolio and/or product analyses might be more appropriate.
- 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.
- When possible, banks and finance companies should assess whether clients' employment and financial situation 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 temporarily salary reduction or employment loss, (ii) clients' financial leverage and (iii) residency status.
- 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.
- For the purpose of segregation, it might be necessary to systematically collect additional information from clients entering the scheme.

Regulators expect that such grouping analysis will be completed by **September 1, 2020**.

2.2.2. Non-TESS Clients

For retail clients that are not adversely affected by the Covid-19 crisis and thereby do not qualify for the TESS program, the SICR mechanism should continue to be applied as per banks and finance companies' existing IFRS 9 staging policy and the CBUAE IFRS 9 Guidance note dated March 2018.

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:

- Firstly, exceptional drawdowns permitted under TESS should be reflected in the calculation of EAD.
- Secondly, any other realized drawings under loan contracts such as revolving facilities and overdrafts are also expected to impact EAD.
- Thirdly, 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 overlay 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 financial 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 do 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.

Consequently, and in order to avoid excessive disparity amongst banks and finance companies' macroeconomic forecasts, banks and financial companies are not expected to incorporate the updated forecasts into ECL until **September 1, 2020**. Subsequent to this date, banks and finance companies should follow their existing process for the production of economic scenario forecasts. Furthermore, 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.

When banks and finance companies are in a position to use economic forecasts to generate PDs and LGDs, they need to be mindful of lags currently employed in their macro models. The modelled lags are likely to be longer than observed in reality during this specific crisis.

Finally, banks and finance companies also have the option to employ add-ons at portfolio or product level in order to holistically reflect changes in the economic environment, provided that the decision-making process and results are fully documented and disclosed.

5. DISCLOSURES

The Regulators require transparency across the UAE banking sector during this crisis. It is essential that banks and finance companies provide additional relevant and comprehensive disclosures related to ECL computation in their 2020 Q1 audited financials and subsequent audited reporting until the end of the Covid-19 crisis.

Banks and finance companies shall report material changes that occurred in their books since December 2019, susceptible to impact of ECL. This disclosure should contain detailed information related to each of the items listed below, and any other items the bank deems relevant:

- The proportion of TESS clients per portfolio or product, for wholesale and retail clients.
- When identified, the proportion of Group 1 and Group 2 clients as defined in this Joint Guidance, per portfolio, with their associated exposure, ECL, stage and average PD and LGD. Information on TESS clients shall be disclosed, for instance, in terms of size of counterparts, industry, rating and product types.
- A breakdown of exposures associated with staging migrations covering TESS and non-TESS clients.
- The changes in EAD since December 2019 and the expected future changes.

In addition, banks and finance companies should disclose their approach employed during this exceptional period to assess ECL components and the required grouping of TESS customers. This disclosure should contain detailed discussion related to each of the below items, and any other items the bank deems relevant:

- The dedicated crisis-focused governance put in place for the purpose of grouping decisions, macroeconomic scenario adjustment and any other management overlay.
- Quantitative analyses performed with the information available.
- Assumptions and judgements supporting the estimation of ECL components.
- Any update made to the macro forecasts.
- Any judgmental overlay implemented at portfolio of product level.