

Implications of Covid-19 for the banking sector

The World Health Organization has declared the Covid-19 coronavirus outbreak a pandemic. To weather the storm, strong operational resilience and business continuity planning is vital for banks, explains Emilio Pera.

Actions taken in response to the spread of Covid-19 have resulted in large-scale disruption to business, with more volatile asset prices and currency exchange rates, and a marked decline in interest rates in the majority of economies around the world. The ultra-low – or even negative – interest rate environment that has been created means banking margins can now be thin.

In these circumstances, diversification of revenues that includes fee income becomes important. Large international banks tend to be well-diversified across investment banking, wholesale and consumer lending, as well as asset and wealth management. But many smaller or mid-sized regional banks are less so; the crisis could become more challenging for them if it deepens further or carries on for an extended period.

Fintech and challenger banks may also potentially feel pressure, as they will unlikely be able to differentiate themselves by paying higher interest rates in the close-to-zero environment, while there could also be a ‘flight to safety’ as customers begin to place deposits with large, established players instead. Furthermore, phishing attempts related to Covid-19, unsecure remote connections to the office, and increased personal use of office equipment can increase banks’ cyber risk. The cost of funding might increase for institutions with poor liquidity ratios or special funding needs, and a widening of haircuts on collateral is expected.

Action taken by regulators and local banks

Globally, central bank actions have been decisive and far-reaching. In the UAE, the CBUAE has taken several steps to support the sector. It is allowing banks to free-up their regulatory capital buffers to boost lending capacity. They will have access to loans and advances extended at zero cost against collateral by the CBUAE. They will be allowed to tap into a maximum of 60% of their capital conservation buffer, and those designated as systemically important will be able to use 100% of their additional capital buffer. The CBUAE is also reducing the amount of capital banks have to hold for their loans to SMEs by 15 to 25%, which will facilitate this sector’s access to financing. In addition, the existing limit which sets

the maximum exposure that banks can have to the real estate sector is being revised. Banks will be allowed to increase it to 30% but will then be required to hold more capital.

Major banks in the UAE have been proactive in providing financial relief to customers, in line with the CBUAE's AED 256 billion economic stimulus package (a figure of AED 100 billion was announced on 14 March 2020 and this was increased on 5 April 2020). As well as the steps taken by local banks, measures implemented by some branches of international banks include: donating 0.5% of all debit card spend in the month of March to the drive to combat Covid-19; a 75% reduction in their monthly instalments with significantly lower interest; a repayment holiday without interest and fees for personal loans, mortgages and car loans; and school fees paid by credit card qualify for an instalment plan of up to six months starting from 0% interest with processing fees waived.

IFRS 9 and expected credit losses (ECL)

Concerns have been voiced about the effect of the relatively new IFRS 9 standard (and 'current expected losses' under US GAAP) which may force banks to take earlier provisions against bad loans. IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining expected credit losses (ECLs) in different circumstances. Several assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment; banks should not continue to apply their existing ECL methodology mechanically.

The challenge for banks is to incorporate into their measurement of ECLs the forward-looking information relating to the economic impact of Covid-19 that is available, without undue cost or effort at the reporting date.



On 27 March 2020, the IASB issued guidance on accounting for expected credit losses applying IFRS 9 Financial Instruments in light of the uncertainty resulting from the pandemic. It set out that in assessing forecast conditions, consideration should be given both to the effects of Covid-19 and significant government support measures being undertaken. It is likely to be difficult currently to incorporate the specific effects of Covid-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. If the effects of Covid-19 cannot be reflected in model or post-model overlays, adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored.

Indeed, in the current environment, IFRS 9 and the associated disclosures can provide much-needed transparency to users of financial statements. Several prudential and securities regulators have published guidance commenting on the application of IFRS 9 in the current environment, including CBUAE, and IASB encourages entities whose regulators have issued guidance to consider that guidance.

Lending institutions will need to analyze any such arrangements carefully to determine the appropriate accounting, i.e. they will need to assess whether there has been a change in the contractual terms of a financial instrument and, if so, whether it leads to a derecognition gain or loss, or a remeasurement of its amortized cost; [IFRS 9.5.4.3] and whether the arrangement indicates a "Significant Increase in Credit Risk" (SICR) or a credit impairment, or results in a partial write-off of the loan. [IFRS 9.5.5.12]

Additionally, if a government provides assistance to a bank and this in turn enables the lender to provide support to its clients, then the lender will need to consider how to account for that assistance – in particular, whether government grant accounting under IAS 20 Accounting for Government Grants and Disclosure of Government Assistance is required.

Banks will need to explain the significant impact of Covid-19 and the risks arising and how it is managing those risks. Some examples of specific disclosures may include the following:

- Information about the bank's credit risk management practices and how they relate to the recognition and measurement of ECLs. A bank may have changed its risk management practices in response to Covid-19, e.g. by extending debt relief to borrowers or by following specific guidance issued by governments or regulators. [IFRS 7.35F]
- Information on the assumptions that the bank has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year. [IAS 1.125]

These are indeed challenging times with more time needed to adequately assess total impact, hence some regulators in the Gulf Cooperation Council (GCC) have exempted banks from publishing Q1 results.

Next steps

Banks would be well advised to now perform a gap analysis on their crisis management framework and operating needs, considering different time horizons. They will need to prepare their systems, organization structure, products, and digital assets to offer government stimulus support to clients. Equally important is reviewing their digital transformation plan to reassess priorities and assess the launch of new services and products. Organizations that are most likely to overcome the challenges presented by Covid-19 are those that foresee and best prepare themselves for significant credit portfolio deterioration and liquidity repercussions, and build strong, comprehensive contingency plans.

Emilio Pera
Partner
Head of Audit
KPMG Lower Gulf



Illustrative checklist to navigate the Covid-19 crisis



Governance and operations

Clients

- Have you identified and classified your clients? Have you identified the riskier clients?
- Have you identified the clients' immediate needs? What are the exposure and provisions? Is it possible to offer them new products or do they need to be restructured?

Suppliers

- Do you know where your key suppliers are located? Do they have contingency plans in place to ensure the continuation of supply?
- Do you have key outsourced services? Are they sufficient? Do they have contingency plans?

Physical logistics

- Do you have clear instructions for you employees in teleworking, clear rotation schedules for employees in the central services? Have you established extra hours policies?
- Have you created clear instructions for branches? Do you have defined branches safety instructions?

Contracts

- Have you reviewed your contracts with key customers and suppliers to understand your potential liability, and how best to manage your legal risks?
- How will you respond if suppliers invoke force majeure clauses?

Inventory

- Have you assessed your inventory cover? Do you need to ring-fence inventory for particular customers in the case of shortages?
- Do you have the ability to track shipments in real time and therefore manage customer expectations?

Customer loyalty and demand

- How will you set expectations with customers? How can you recover the experience in the future?
- How well do you know your customers? Are you likely to lose customers to competitors/alternatives?
- How will a drop in consumer demand impact your long-term growth plans?



Financial and external factors

Awareness and communications

- Do you have a communications plan?
- Have you communicated with relevant customers, employees and suppliers?

Workforce availability

- How will you deal with the impact on your workforce? How can you ensure the safety of your employees while trying to maintain "business as usual" activities? Have you assessed the cyber security and health and safety risks associated with employees working from home?

Technology and system resilience

- Have your third party IT suppliers been impacted? Will this impact your SLAs and system support?
- Does your workplace/communications technology allow you to reduce travel and enable remote working?

Commercial plans

- How will your change plans and programs be impacted? Will project deadlines and investments need to be delayed? What impact does this have on your strategy and business models?

Governance

- Are you adhering to travel bans, and how will this impact your board governance, meetings and the way you run your business?
- Do you have the technology in place to support remote working?
- For legal coverage, have you identified how to document the additional requirements to meet commitments?
- Have you established crisis reporting processes?
- Have you updated the delegation of authority framework?
- Have you created business governance backup plans?



Business impact

Cash flow

- Have you reviewed and revised cash flow, working capital management and demand predictions?
- Have you performed simulations of the liquidity regulatory indicators?
- Have you reviewed your contingency plans and have you updated it with new market restrictions?

Financial stability

- How will your financial stability be impacted from further stock market declines and restricted funding?
- Will the completion of your financial statements be delayed? Is this likely to cause a delay to your audit opinions and therefore market communications?
- Have you analyzed the Central Bank and other government banks' stimuli?

Government and public health requirements

- Do you have dedicated resource(s) reviewing public health requirements and other related government announcements and ensuring that you stay informed?
- Have you assessed your obligations as an employer to the health and safety of employees?

Commercial plans

- How will your change plans and programs be impacted? Will project deadlines and investments need to be delayed? What impact does this have on your strategy and business models?

Economy disruption

- How will you maintain trust with your customers and assure them that financial institutions are still safe?
- Are you prepared for massive withdrawals?
- How will a drop in cash inflows affect your cost base and profitability?
- Are you able to support your clients with new products?
- Are you able to offer clients the government stimulus, and if so, how much?