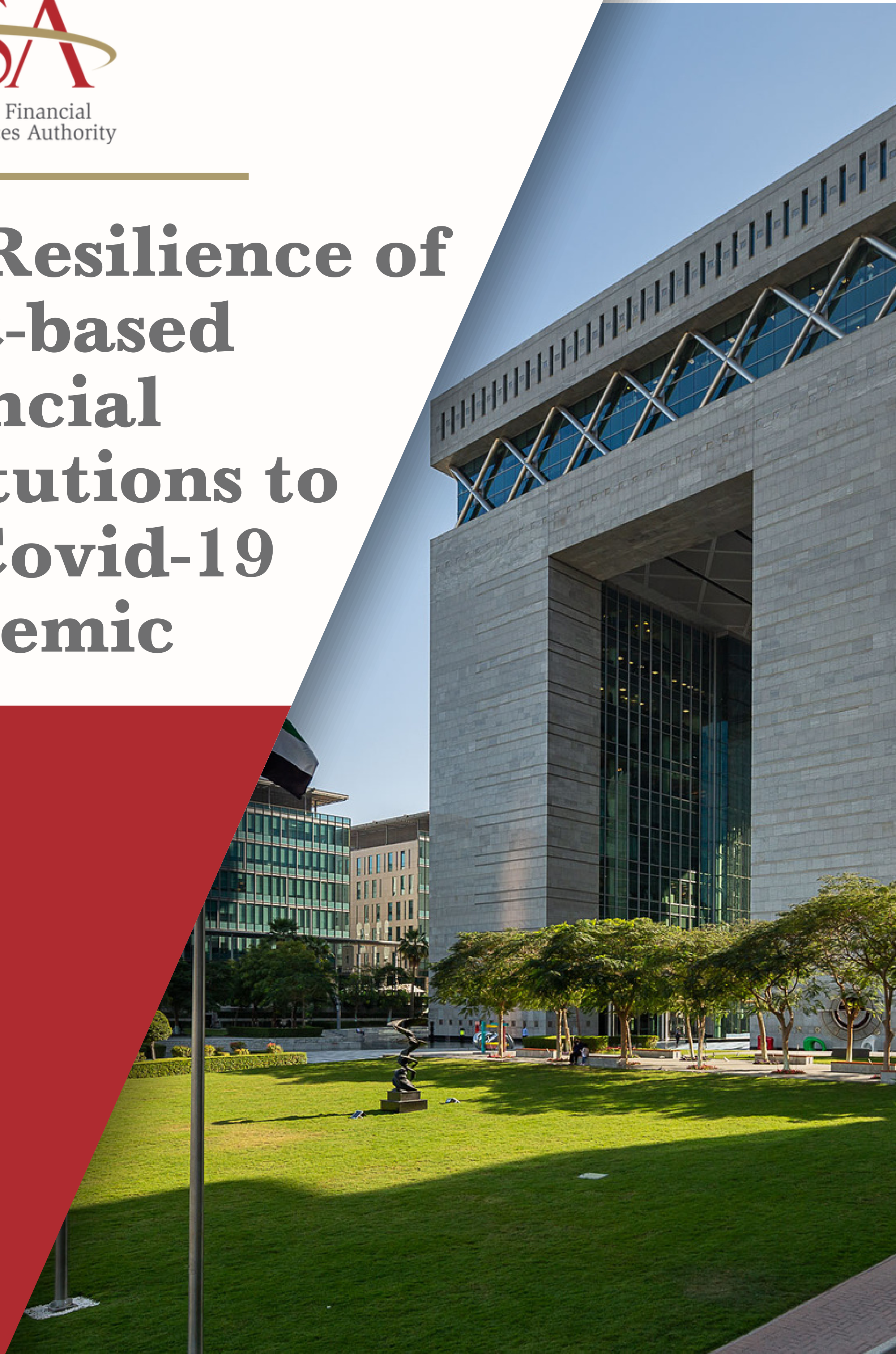
Dubai Financial
Services Authority

The Resilience of DIFC-based Financial Institutions to the Covid-19 pandemic



October 2022

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1. Note from the Chief Executive

The Covid-19 pandemic, and the response of governments around the world, has been unprecedented. Globally, millions of people were restricted from leaving their homes; cross-border travel was disrupted and in some cases, completely suspended; supply chains were disrupted, and in some cases, completely suspended; economic growth declined. The list of impacts goes on. It is nearly impossible to overestimate the pandemic's full impact.

The financial services industry experienced its own pandemic-related impacts. Crisis management plans were put to the test; remote working became the 'new norm;' and digital transformation went from being an organisational goal to a threshold condition for operational resilience. Financial institutions had to adjust their operating models to support digital engagement with staff and customers and increase their focus on staff health, safety, and wellbeing.

Financial services regulators had to adjust to similar operational challenges. We had to adjust our regulatory expectations and requirements and provide flexibility where it was necessary and feasible, while continuing to maintain appropriate regulatory standards and to meet regulatory objectives. Financial institutions had to think fast and creatively, and so did regulators.

Despite the challenges of the pandemic, financial institutions proved capable of meeting the challenges, and the global financial system remained resilient. Lending continued, investing continued, and innovation continued. The financial ecosystem of the DIFC was no exception, as financial institutions in the DIFC demonstrated readiness for the operational challenges brought on by the pandemic.

We observed that the majority of financial institutions in the DIFC had already begun digital transformation and were prepared to support operations in a remote working environment. Firms also quickly integrated the use of collaboration tools and shifted to the use of electronic onboarding and eKYC solutions.

At the DFSA, we learned a great deal about our own capacity to continue to operate effectively in a crisis and our capacity to adjust to new and different ways of doing things.

It is important, for the confidence of the industry, to do a stock take of the financial institutions operating in or from the DIFC and understand their overall resilience to the challenges of the pandemic. We undertook such an exercise, and this report summarises our findings.

2. Executive Summary

The Covid-19 pandemic significantly disrupted business operations globally, affecting firms' operational and financial resilience. In response, the DFSA offered temporary regulatory relief measures to applicants and Authorised Firms allowing modifications and waivers of certain regulatory requirements; and remained in constant contact with Firms and applicants throughout this period whilst continuously monitoring their performance.

The DFSA is publishing this Report to outline the impact of Covid-19 on Firms in the DIFC, whilst analysing their level of resilience throughout the pandemic, and the resulting progress thereafter.

This Report summarises the level of support Firms required from the DFSA and outlines the key trends in business activity observed across the banking, insurance, fund management, brokerage and innovation-related sectors. To summarise, these findings included:

- Banking – this sector demonstrated robust resilience and managed to continue to grow its operations while supporting the economy and client needs.
- Insurance – this sector witnessed an increase in the level of reinsurance capacity and the gross written premiums underwritten by DIFC reinsurers and underwriting agents.
- Investment and fund management – this sector demonstrated healthy growth in Assets under Management and growth in the number of active funds.
- Brokerage – this sector witnessed an increase in the number of brokerage Firms in the centre and an increase in the volume and revenue of trading activity.
- Innovation – The 2020 and 2021 ITL cohorts received the largest number of applications since the 2017 launch of the Programme.

Overall, the pandemic was a globally-challenging situation, but DIFC Firms proved able to withstand the impact of the pandemic. Business activity expanded and, aside from extensions to reporting deadlines, an immaterial number of Authorised Firms took advantage of regulatory relief measures.

This Report was prepared based on the information provided to the DFSA through quarterly and annual regulatory returns. Note that the Report addresses only key observations that are relevant in assessing the level of resilience of DIFC Firms. Therefore, this Report does not include all Covid-19 related matters.

3. DFSA Regulatory Relief Measures

The DFSA announced several temporary regulatory relief measures on 7 April 2020 to give Firms the flexibility and support needed to withstand the stress of the pandemic. The regulatory relief measures expired on 31 December 2020, giving Firms sufficient time to adapt to the challenges of the pandemic. Approximately 49% of DFSA Authorised Firms used the relief measures. The regulatory relief measures, including the percentages of the Firms that used each kind of relief, are as follows:

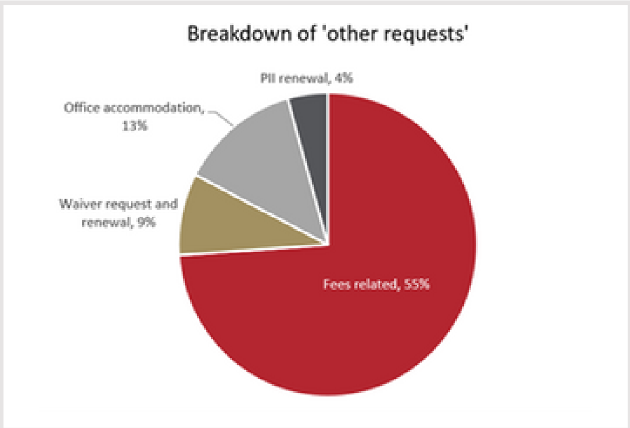
- All new authorisation applications were given a reduction in fees;
- 3% of applicant Firms requested an extension to the duration of the in-principle authorisation period, above the average number of extension requests;

- 35% of Firms requested an extension of time for filing a number of regulatory reports and returns, including account and financial statement auditor's reports;

- 3% of Firms requested flexible residency requirements for Authorised Individuals;

- 1% of Firms requested flexibility in certain capital requirements; and

- 5% of Firms submitted other requests as shown in the pie chart below:



As illustrated in the pie chart above, from the 5% of Firms and applicants that submitted ‘other requests’:

- 55% of requests were fee related, which included waivers of fees for Authorised Individual applications, late return fees, registration fees for Domestic Funds and listing fees for new SME issuers;

- 9% of requests were for waiver renewals;

- 13% of requests related to requests to work in flexible working spaces, with appropriate controls in place; and

- 4% of requests were for an extension to PII renewal.

Except for the number of requests for a filing extension, an insignificant number of Firms used the regulatory relief measures. Regarding the filing extensions, the majority of Firms requested extensions because of delays associated with third-party vendors, such as their external auditors.

4. Impact of Covid-19 on operational resilience of DIFC Firms

The DFSA maintained close and continuous monitoring and contact with Firms throughout the pandemic and paid close attention to the operational readiness and resilience of the DIFC Firms. Firms were requested to notify the DFSA in case of any material changes in their operations.

In 2020, the DFSA also reached out to a sample of Authorised Firms to participate in a study on the impact of Covid-19 on the Firms’ operational risk management. The following are the main findings of the study:

- there was no material change to DIFC Firms’ risk management practices;

- the approach to managing operational risks remained largely unchanged with only minor adjustments;

- the same processes were successfully replicated in remote working environments, using technology solutions to replicate traditional processes;

- adjustments were made to the business continuity plans to accommodate work from home scenarios to ensure business continuity; and

- there was an acceleration of digital adoption, particularly in the area of collaboration tools, digital onboarding, and eKYC.

The results from the study, findings from close and continuous monitoring, and interaction with the authorised Firms evidenced that DIFC Firms, in general, had adapted well to the pandemic and had taken the necessary precautions to ensure smooth operations. From an operational resilience perspective, the DIFC Firms had successfully managed to adapt to the "new normal".

This report will further look into the different industry sectors in the centre including banking, insurance, investments and funds, brokerage, and innovation-related sectors.

5. Impact of Covid-19 on resilience of the banks in the DIFC

5.1 Overview

The banking sector displayed sound resilience throughout the Covid-19 pandemic. Despite the challenges, DIFC banks maintained the growth path which they have sustained over the years. They managed to continue to provide necessary funding to the local economies in which they conduct their business activities and to continue to support client needs.

5.2 Financial Resilience

At the onset of the pandemic, immediate focus was on ensuring the availability of appropriate levels of liquidity. DIFC banks showed high-level resilience in that space. Deposits were held steady, then followed by growth as fund providers started looking for safety.

Attention then pivoted towards asset quality. A generally high quality well-diversified loan portfolio helped DIFC banks avoid much stress. Non-performing loans initially increased due to a slowdown of economic activity, and subsequently returned to average levels as business activities regained traction. Loan provisions had the biggest impact on profitability, resulting in a net loss booked for 2020. Changes to accounting standards, specifically the implementation of IFRS 9 in 2018, requires banks to provision for expected credit losses, taking into account economic forecasts. As the economic forecasts improved, loan provisions were reversed, contributing to a net profit booked for 2021, in-line with pre pandemic levels.

Capital levels remained strong. Throughout the pandemic, DIFC banks did not need to use any of the available capital buffers.

The pandemic had implications on liquidity, asset quality and general banking services. The banks managed this with contingency governance arrangements, allowing for enhanced management reports and prompt risk management actions.

Business decisions and action plans took into account the trajectories of favourable and un-favourable scenarios. This required active engagement between various functions to ensure the capacity to withstand adverse economic conditions.

6. Impact of Covid-19 on resilience of insurance Firms in the DIFC

The insurance sector in the DIFC consists of reinsurers, intermediaries and managing agents, who provide reinsurance capacity for the region, primarily in the general insurance segment. At the onset of the pandemic in 2020, our supervisory focus was to closely monitor the impact of Covid-19 and the government-mandated restrictions on the level of insurance claims, especially in health and business interruption.

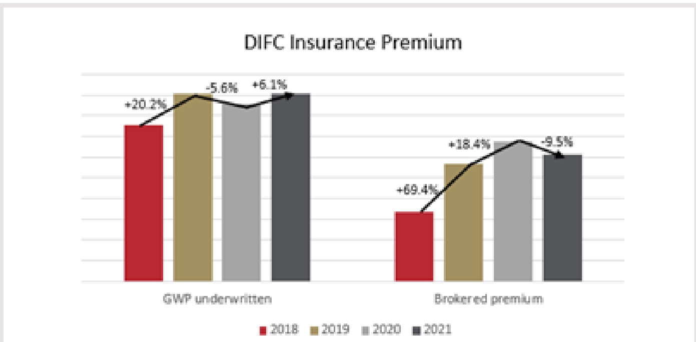
6.1 Overview

Overall, insurance Firms and intermediaries have been resilient in the face of Covid-19, both operationally and financially. However, it remains to be seen what the medium- and long-term economic impacts of Covid-19 will have on the overall demand and supply for insurance through the DIFC insurance market.

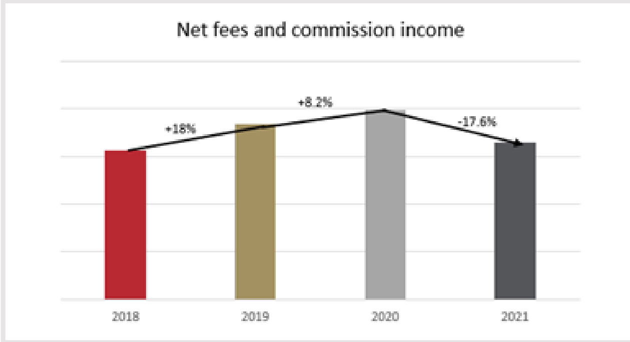
6.2 Financial impacts

On the premiums side, aggregate gross written premiums (GWP) from certain sectors such as aviation and marine were down in 2020. Energy, which is a key segment for the DIFC insurance market, was not as adversely affected as initially anticipated in early 2020. Volume declines were countered by premium rate increases. The hardening regional market is consistent with the global trend.

Overall, there was no significant decline in reinsurance capacity and no adverse impact on the level of GWP underwritten by DIFC reinsurers and underwriting agents. Interestingly, DIFC brokers were able to increase the level of brokered reinsurance business. The growth rate of the DIFC insurance premiums is illustrated in the graph below.



The graph below shows a healthy increase in revenue from fee and commission income for intermediaries through 2020, suggesting no adverse impact from Covid-19. However, 2021 saw a drop in income due to narrower margins and increased competition.



6.3 Claims

Impact on DIFC reinsurers and underwriting agents was minimal with respect to business interruption (BI) claims, due to pandemic exclusions.

BI claims arising from government-mandated lockdowns have resulted in a tightening of policy wording, clauses and exclusions to give more clarity and certainty on the risks covered going forward.

Medical claims arising from Covid-19 in 2020 were largely offset by a lower level of non-Covid-19 claims as individuals delayed non-critical hospital visits during the peak months of the pandemic.

However, there are notable increases in medical claims in 2021 due to resumption of elective procedures, but the solvency levels of insurers were not at risk. High frequency claims are generally back to pre-Covid-19 levels.

6.4 Financial resilience

Insurers continue to maintain healthy reserve levels and insurance intermediaries have maintained the necessary capital and liquid asset reserves to meet regulatory capital requirements.

7. Impact of Covid-19 on resilience of investment and fund management Firms in the DIFC

Authorised Firms, operating within the asset management space, conduct two lines of business. The first relates to discretionary portfolio management. The second line of business relates to the Financial Service of Managing a Collective Investment Fund (CIF) where, the Authorised Firm acts as the Fund Manager of the fund.

7.1. Overview

Most of the Firms manage assets and funds for sophisticated professional clients including sovereign wealth funds, corporates, institutions and ultra-high net worth individuals.

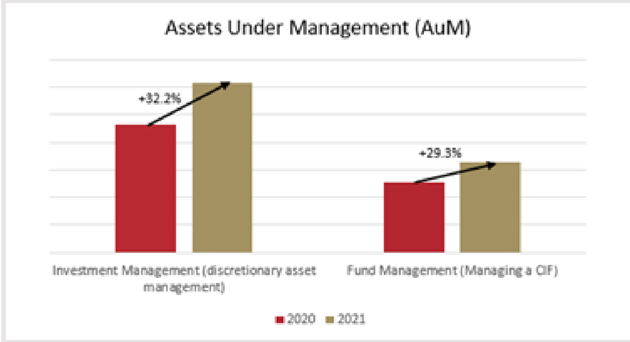
The Firms have continued to increase assets under management (AuM) in years 2020 and 2021. And the increase in AuM has resulted in increased fee income for the Firms. The cost-cutting measures introduced due to the pandemic have been removed and Firms have started hiring requisite staff. In all, the majority of the Firms successfully navigated the impact of the pandemic.

The DFSA also launched its Venture Capital Fund regime in Q4 2020. This was well-received by market participants. Six Venture Capital Fund Managers successfully obtained DFSA Authorisation by the end of 2021.

7.2 Assets under Management (AuM)

AuM is an important metric used to assess the health of Funds and Investment Managers as it has a direct impact on the Firms' earnings. Normally, in volatile times like the pandemic, Firms' major concerns are related to investor redemptions and withdrawals of their investments.

As is evident from the figures below, the total AuM managed out of the DIFC did not witness net withdrawals. Backed by a strong rebound in the market, the AuM registered an overall increase.



There has been organic growth in the number of active Funds incorporated in the DIFC, which increased by 26% from 2019 to 2020, and by 4.1% from 2020 to 2021

The DFSA has witnessed a 31% growth in activities related to both these lines of business in the year 2022 over the previous year.

8. Impact of Covid-19 on resilience of brokerage and trading Firms in the DIFC

8.1 Overview

The pandemic resulted in a swift crash and then a record-fast recovery of the stock market. Regardless of the fact that many small businesses struggled in these conditions, during an unprecedented year of volatility and movement, the markets moved higher after dropping to recent record lows in the beginning of April 2020.

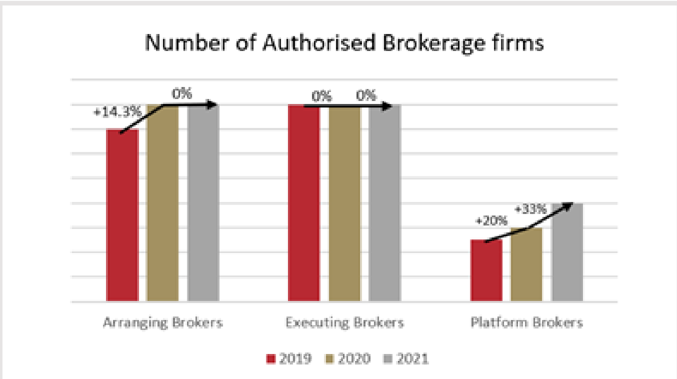
Trends that led to the positive momentum include:

- positive outcomes from the wide distribution of vaccines enabling the world economy to reopen;
- market participation from a new group of investors; and

- lack of social and travel opportunities, leaving people with time and money to invest.

8.2 Number of Authorised Brokerage Firms in 2019-2021

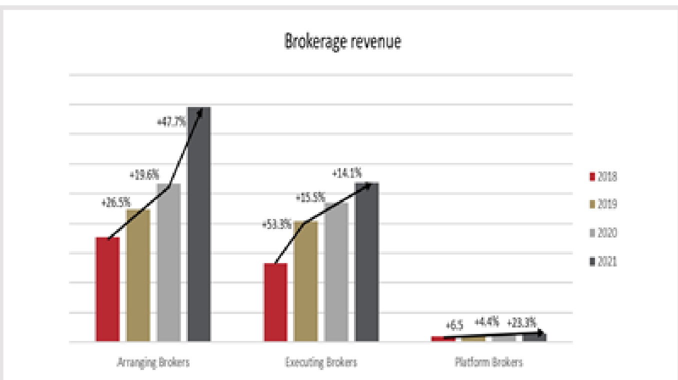
Historically, these market conditions and dynamics have signaled boom times for the brokerage and trading sector and analysis of the DIFC population reflects this. This is particularly evident when we focus on the latent effect of the pandemic which has led to us receiving much higher levels of applications from new market participants.



The data above shows that the sector maintained its presence in the DIFC with a 14% growth in the number of Authorised Brokerage Firms over the two-year period.

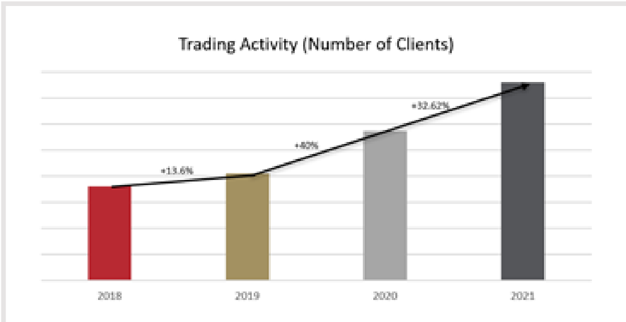
The DFSA has seen a surge in trading activity coupled with a large increase in applications and pre-applications, particularly for the provision of CFDs. This trend continued into 2021 where we saw the number of applications accelerate. We would therefore expect a futher significant rise in the population of this sector in 2022.

8.3 Brokerage revenue and trading activity (2018-2021)



Further evidence of the resilience of this sector is provided in the revenue data above. Despite the pandemic, these Firms have demonstrated significant continued revenue growth, across all models, and consistent growth year on year. This is consistent across asset classes. In both arranging broker and executing broker business models we have witnessed a greater than two-fold rise in revenue between 2018-2021. This illustrates the exponential growth in business across the different classes of the Broker population, showing a steep rise in transaction volumes in the period covering the pandemic.

The trend is also seen in the trading activity (as measured by the number of clients). Once again, we have witnessed a more than two-fold growth in the numbers of clients in the whole brokerage sector from 2018 to 2021.



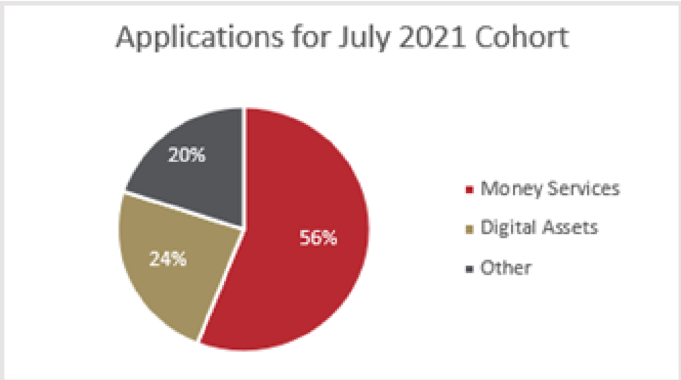
9. Impact of Covid-19 on resilience of innovative start-up Firms in the DIFC

9.1 Overview

The pandemic accelerated the shift to digitisation, resulting in greater demand for technology-enabled innovative financial services and products. In particular, an acceleration in online shopping and social-distancing increased demand for digital payments and contactless payments. To support growth in this sector, the DFSA published, in March 2020, the region's first comprehensive Money Services Regime. As a consequence of the accelerated shift to digitisation and the implementation of the new regime, we saw a surge in applications from innovative startups seeking to enter the Innovation Testing Licence (ITL) Programme, despite global restrictions on international travel and local lockdowns.

9.2 ITL Cohort Applications 2020-2021

In 2020, following the beginning of the pandemic, we offered two ITL cohorts. In total, we saw a 200% increase in the number of applications received in 2020 versus the number received in 2019. The number of 2020 applications were a 25% increase over the total number of applications received in 2017, 2018, and 2019 combined. The significant increase came predominantly from companies wanting to offer money services products and services. This trend continued in 2021.



9.3 Outlook on the upcoming 2022 Cohort

Given the spike in the number of ITL applications in 2020-2021, we predict the trend to continue through 2022, especially due to the new Crypto Tokens regime that is expected to be in place by the end of 2022.

In July 2022, we began accepting ITL applications on an open application basis, for all eligible business models.

Overall, the FinTech sector appears to be resilient and thriving despite Covid-19.

10. Concluding remarks

Covid-19 created systemically impactful challenges that changed the way businesses operate worldwide.

Adjusting to lockdowns, travel restrictions and shortages in labour were new and unique challenges that financial services businesses needed to overcome.

The DFSA, like other regulators around the world, understood that in order for some Firms to cope with the challenges, regulatory relief measures were needed, as well as close and continuous supervision and open dialogue.

Overall, the DIFC community remained resilient throughout the pandemic and has managed to adapt to the new reality. This was demonstrated across different sectors within the DIFC community, from big international banks to small start-up FinTech Firms.

Despite the pandemic being a global health and economic crisis, it paved the way for positive changes, such as the acceleration in digital adoption, the introduction of flexible working arrangements, and the importance of focusing on employee health and welfare.

As the independent financial services regulator in the DIFC, the DFSA continues its efforts to ensure that DIFC Firms comply with DFSA rules and regulations and remain resilient to exogenous system shocks.