Emirates NBD

EMIRATES NBD Q1 2017 RESULTS ANALYSTS & INVESTOR CONFERENCE CALL & WEBCAST

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Ladies and gentlemen, welcome to the Emirates NBD 2017 First Quarter Results Announcement, Analyst and Investor call and webcast. If we are all ready to begin, I will now pass the call over to our host, Mr Shayne Nelson, Group CEO of Emirates NBD.

Shayne Nelson

Thank you, Hala. I would like to welcome you all to the Emirates NBD results conference call and webcast for the first quarter of 2017. Supporting me in today's call is Surya, the Group's Chief Financial Officer and Paddy, our Head of Investor Relations. Together, we will review the operational and financial highlights of the first quarter of 2017. We will refer to the results presentation, which was made available to you earlier today after which you have the opportunity to ask questions.

If we go to slide three, 2017 started off on a stronger footing compared to last year, with improved confidence in the world economy, even as political uncertainty dominates the horizon and markets adjust to the new political realities in the US and the UK. Following the December rate hike, the US Federal Reserve continued its tightening cycle by hiking interest rates another 25 basis points last month, with markets expecting two more hikes this year. Higher and more stable oil prices at the start of 2017, coupled with stronger economic backdrop has boosted businesses in Dubai and the UAE as reflected by the Dubai Economy Tracker and the UAE PMI, which reached a 19-month high in March. Despite the headwind of a strong dollar, Dubai's tourism strategy remains on track to reach 20 million by 2020. In 2016, the number of tourists grew 5%, aided by the easing of visa entry rules for key markets such as China and Russia. A strong tourism and hospitality industry will support retail and related sectors. As a result, we expect GDP growth for the UAE to improve to 3.4% in 2017, with high growth expectations for Dubai. For the UAE and regional banks, key themes of liquidity and credit quality continue into 2017, albeit with an improved outlook. Liquidity conditions have improved within the UAE

and the system-wide AD ratio is strengthening too at 100.3% at the end of February compared to a four-year peak of 104.7% last year. Whilst our outlook remains cautious, we expect liquidity and funding costs to improve in 2017, helped by a more stable oil price and regional sovereign debt issuance.

As per credit quality, earlier concerns about the SME segment have abated as initiatives such as the one led by the UAE Banking Federation have helped improve a collaborative framework for SMEs to manage debt and for banks to continue to support SME lending. Concerns about the regional contract industry have also subsidised, given the improved liquidity conditions and outlook. Nevertheless, we continue to monitor the regional situation closely.

Other topics on the agenda for UAE banks this year will be VAT, the transition to Basel III and IFRS 9. Given our strong liquidity and capital position along with our healthy coverage ratio, we are well positioned and do not expect the new regulations, which are expected to take effect next year, to materially impact the bank's operations.

Against this backdrop, we made an encouraging start to the year with a solid set of Q1 results. Net profit is up 4% year-on-year underpinned by a coronel in expenses and an improved cost of risk. Margin improved in Q1 as rate rises flowed through to loan yields and funding pressures receded. Credit quality continues to improve as we actively manage our stock of legacy NPLs. We believe there is further scope for credit quality improvement. The bank's advances to deposit ratio at 92.5% remains well within our target range. Our strong retail franchise has enabled us to further grow our low cost CASA base. In 2017, we will continue to push ahead with our digital agenda and strengthen our retail offering. Earlier this year, we unveiled Liv., the UAE's first digital bank targeted at millennials. This will offer a differentiated digital experience for a new generation of customers. We are also very pleased to be ranked the UAE's most valuable banking brand and 75th worldwide in the banker's annual brand valuation league table. I was also delighted that our investment bank and asset management unit successfully completed the UAE's first IPO of 2017 with a launch of ENBD REIT.

Overall, I am pleased that despite a challenging but improving global environment, we delivered a solid performance. Cost control measures implemented last year have positioned us well going into 2017. In Q1, we have delivered higher margins helped by rate rises and an improvement in funding costs. We have a solid balance sheet, a prudent business model, and a focused strategy. This will allow us to take advantage of growth opportunities in our preferred markets and confidently face any challenges that resent themselves.

I will now hand you over to Surya, to start going through the details of the presentation.

Surya Subramanian

Thank you, Shayne. I will speak through the financial results on slide four. Net profit for the group was AED 1.87 billion in the first quarter, which is 4% above the profit posted in the previous year. The increase in net profit was supported by 11% improvement in costs and a 23% reduction in impairment allowances, which helped offset lower income. Revenues improved 4% quarter-on-quarter, and net interest income was up 1% on the back of loan growth and improving margins. Non-interest income improved 13% on higher income from foreign exchange and rates, coupled with the absence of the impact from the Egyptian pound devaluation in November last year.

However, year-over-year, revenues declined 7% as net interest income was 3% lower due to a contraction in margins. Despite the 7% increase in core gross fee income, non-interest income declined 16% over the year, as significant one-off gains from the sale of an investment in Q1 2016 was not repeated. Total costs for quarter one at AED 1.1 billion improved by 11% over the previous year and by 7% over the previous quarter, as cost control measures implemented last year took effect. Absolute costs have now fallen for five consecutive quarters, and gives us headroom to invest in the right opportunities for future growth. Provisions for quarter one amounted AED 639 million, which is 23% lower than the previous year. This represents an annualised cost of risk of 80 basis points. In quarter one this year, the bank’s recovery unit was able to write-back or recover AED 364 million of impaired loans. This helped improve the NPL ratio to 6.3% while the coverage strengthened to 122.5%. The headline advances to deposit ratio at 92.5% remains within our target range and we are pleased to note that CASA proportions of deposits have risen to 56%. After delivering 2% loan growth in the first quarter, we expect to see mid-single-digit loan growth for the full year spread across all business lines. We expect deposit growth to be similar to loan growth as we manage the AD ratio in the 90-100% range.

Moving onto slide five on net interest income, we see that margins improved in the first quarter of 2017, as we start to receive the benefits of higher interest rates and an improvement in funding costs. Margins declined 29 basis points year-over-year, as the cost of deposits rose faster than the re-pricing of the loan book. Loan yields were the main contributor to the quarterly improvement in margins, as floating rates not loans are gradually re-pricing at higher rates. We have started to see an improvement in contribution from both deposits and Treasury as the cost of funding pressures recede and aided by a more stable liquidity outlook. We maintain our 2017 margin guidance of 2.35-2.45%. we expect the positive impact of rate rises to continue to flow through, we also anticipate further improvement in the deposit mix as expense deposits sourced during the middle of last year start to roll off.

Moving onto slide six which show the loan and deposit trends. We see healthy and improving deposit profile for the bank. Over the last year, we have grown deposits by 10% despite increased competition from regional banks. CASA grew by 6% in the first quarter of this year and now represents 56% of total

deposits. As mentioned in the last slide when I was talking about net interest margins, we proactively locked expensive one-year fixed deposits during the middle of last year. Should the existing favourable liquidity environment continue, we will be able to retire some of these expensive fixed deposits and further improve the deposit mix. Gross loans grew 2% in the first quarter, retail lending grew by 2% across a range of products, particularly mortgages. The Islamic book contracted by 2% due to tighter underwriting standards, and our corporate book grew 2% across real estate, financial institutions and trade sectors. We expect mid-single-digit loan growth for the whole of 2017.

Slide seven on funding and liquidity shows that advances to deposits ratio improved to 92.5% in the first quarter of 2017, as deposits grew by 3% against a 2% growth in loans. This demonstrates the bank's strong liquidity and underlines the value of the bank's well-diversified stable funding base. Emirates NBD remains well placed to meet relevant prudential liquidity requirements. In 2016, we took advantage of favourable market conditions to prefund a large proportion of debt maturing this year. AED 7.9 billion of expensive debt matured in quarter one, and we only issued AED 3.3 billion of private placements in four currencies with maturities between one and 10 years against these. The maturity profile for the remainder of 2017 and 2018 remains modest and affords Emirates NBD ability to consider public and private debt issuances opportunistically. Our liquid asset position remains strong and at AED 62.6 billion covers 15.7% of total liability.

Slide eight on capital position shows that during the first quarter of 2017, our tier 1 ratio fell slightly to 17.8% and the total capital adequacy ratio declined to 20.2%. This decline in capital ratios was due to the annual dividend payment, more than offsetting quarterly retained profits, coupled with a modest 2% increase in risk-weighted assets. We expect, as with previous years, for profit generation to grow the capital base in the remaining quarters. We welcome the UAE Central Bank issuance on Basel III guidelines in March, which outlines minimum capital requirements and transitional arrangements. We await the release of the accompanying capital standards expected later this year to determine any impact on existing capital instruments. At this stage, and given the bank's strong capital base, we have no immediate plans to raise any tier 1 or tier 2 capital.

With that, I hand you over to Paddy to take us through the next few slides.

Patrick Clerkin

Thank you, Surya. Slide nine shows good growth in core gross fee income, reflecting our continuing efforts to develop are non-funded income base. Core gross fee income increased 27% quarter-on-quarter, and 7% year-on-year, due to higher income from foreign exchange and rates, coupled with higher credit card volumes. Total non-interest income improved 13% quarter-on-quarter and declined 16% year-on-year. The quarterly improvement is due to higher core fee income coupled with the impact from the Egyptian

pound devaluation last November. The year-on-year decline was due to the one-off sale of investments in early 2016 that was not repeated this year. Income from property declined on lower demand from bulk and individual property sales and a change in valuation of illiquid inventory. Total inventory stands at just over AED 1.5 billion. Although property sales from inventory have slowed, currency has continued to generate profit for the group.

On slide 10, we see that as a result of the cost reduction measures implemented in 2016, costs have declined for five consecutive quarters. Costs improved by 7% quarter-on-quarter whilst the cost-to-income ratio improved by 3.6% in Q1 to 30.9%. The quarterly improvement in costs is a result of a focus on key elements of marketing, service, legal and professional fees. The cost-to-income ratio is comfortably back within our desired target range of below 33%. We feel confident that the group's cost base is now right sized and enables us to invest to support future growth. We will maintain a strict discipline on spending as we look to manage the cost-to-income ratio within this longer-term target range.

Moving onto credit quality on slide 11, as mentioned earlier, the NPL ratio improved to 6.3%, impaired loans improved to AED 20.1 billion at the end of Q1, and during the quarter we had AED 364 million of write-backs and recoveries, and this along with routine provisioning has helped increase the coverage ratio to 122.5%. As with previous quarters, we do not give formal guidance on a target for NPLs. Our recovery unit continues to work on the existing stock of NPLs and are hopeful that they will be able to build upon the success they delivered in earlier quarters. Provisions for Q1 are AED 639 million, which is 23% lower than the equivalent quarter in 2016. This represents an annualised 80 basis points cost of risk, which is lower than the 83 basis points cost of risk observed in 2016. Total portfolio impairment allowances now stand at AED 7.4 billion or 2.19% of credit risk-weighted assets, and this comfortably exceeds the 1.5% Central Bank requirement, and provides some cushion for any future transition to IFRS 9.

On slide 12, we see that retail banking and wealth management revenues improved by 3% over the quarter and 10% over the year. Fee income grew 5% over the year and accounts for 37% of total RBWM revenue. Loans grew 2% led by mortgages, while deposits grew 5% led by continued growth in low cost CASA. The retail bank continues to lead the region in digital banking space, with the launch of a number of new products and services, such EVA, the region's first voice-based virtual assistant and paperless personal loan applications with same-day disbursement. Islamic banking revenues increased 14% quarter-on-quarter and held steady over the year, reflecting EI's efforts to enhance product mix, improve margins and focus on non-funded income. During the quarter, finance receivables declined 2% as EI tightened underwriting standards. Effective remediation has also led to a 60% improvement in provisions during the quarter. Customer accounts declined 1% in Q1 due to a shift from expensive

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Wakala deposits to CASA as EI continues to improve its liability mix and cost of funding. At the end of Q1, CASA represented 69% of EI's total customer deposits.

On slide 13, we see that wholesale banking revenue improved 13% quarter-on-quarter and 4% year-on-year on the back of asset growth and improved cost of funds. Loans grew 2% in Q1 Due to growth in real estate, trade, and FI sectors. Deposits declined 3% during the quarter, reflecting efforts to optimise both the mix and cost of funding by reducing high yield deposits and building CASA balances. The focus in 2017 remains on enhancing the credit, the quality of customer service and share of wallet. This includes improved cross-sell of Treasury and investment banking products, and increased cash management and trade finance penetration. Global markets and Treasury's income improved by 729% quarter-on-quarter and 10% year-on-year. Sales revenue saw strong growth due to higher volumes in fixed income sales and foreign exchange products. The trading desk delivered a good performance from credit, derivatives, and foreign exchange trading.

With that, I hand you over to Shayne for his closing remarks.

Shayne Nelson

Thank you, Paddy. In summary, 2017 started off on a stronger footing compared to 2016. We have delivered a 4% improvement in net profit, underpinned by loan growth, a good control on expenses and improved cost of risk. After declining margins through 2016, it is pleasing to report an improvement in margins in the first quarter. We anticipate some further margin improvement as a positive impact of rate rises continues to feed through, coupled with a more favourable deposit mix. Costs remain firmly under control, and we have room to invest to support future growth. We have strengthened the bank's balance sheet with improved credit quality and liquidity and strong capital ratios. The bank continues to reinforce our digital leadership position in the region. We have rolled out multiple initiatives to enhance the banking experience of our wholesale and retail customers.

In terms of macro outlook, we expect the UAE's growth to improve to 3.4% in 2017, and Dubai expected to enjoy stronger growth. We, and the markets, expect some further increase of rates in 2017 and our balance sheet is positioned accordingly.

With that, I would like to open up to questions. Hala, please go ahead.

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QUESTIONS AND ANSWERS

Operator

We have a first question from Hootan Yazhari from Bank of America. Please go ahead.

Hootan Yazhari - Bank of America Merryl Lynch

Hi there gentlemen, a couple of questions. If we could start with the very strong loan growth that you have experienced and enjoyed relative to the system, you're taking market share. Is that a reflection of you pricing your loans more aggressively than others, or is there something else at play there? The second question regarding your cost-to-income ratio, obviously, coming in well below the 33% guidance that you highlighted, should we expect it to remain at the 31% level or should we be looking more towards an average of 33% for the full year. Thank you.

Surya Subramanian

Thanks very much for your questions. Just commenting on loan growth, I would say that we are about in line with market. If you look at GDP expectations for the UAE, it is 3% or slightly above or below depending on which analyst you speak to, and we are growing at 2% for the first quarter and expect, as we said, for the full year to be in the mid-single-digits. I would say we are growing in line with market, not too far away from it. Of course, in certain products, we are certainly beating the market in terms of market share. Our credit card offerings are quite good. In the digital space, we are doing much better. In getting current and savings accounts deposits, we are doing much better. But on the loan side, I would say we are trending with the market.

I will hand over to Shayne to comment on the cost-to-income ratio.

Shayne Nelson

I think that is a good question on the cost-to-income ratio. My view on that is it is actually a bit too low. On the reasons that we did a lot of the cost initiatives in 2016 was to deliver space for digital investment, and we will be expanding out our digital investment as we go through to 2017 and, in fact, it will be a multiyear programme. No, if I was modelling, I would suggest don’t mode at the current cost-to-income ratio, because I think you will find that we will accelerate our investment spending. We will continue to keep a very tough measure around staff costs, but we will be looking to invest further in the digital space as we go forward

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Operator

Our next question is from Chiro Ghosh from SICO. Please go ahead.

Chiro Ghosh - SICO

I have three quick questions. The first one is on the Forex income. I just want to get a sense that is this Forex income sustainable, considering that it was helped with currency fluctuation volatility in Egypt. That is my first one. the second one is I see that the Islamic financing loan book declined, because you are saying that you are taking a more strict risk management policy, so does it indicate that we might see more asset quality concerning the Islamic lending book that had been disbursed a couple of years back. That is my second. The third one is you were saying that the NIM will improve – from the guidance which you give, the NIM will improve – is it primarily driven by the fact that the more expensive deposits will leave the bank, or is it because you would be able to pass on higher interest rates through your assets to your loan book. Thank you.

Shayne Nelson

I will take Emirates Islamic first. One of the big growth areas we had over the last few years in Islamic was in the SME space. Now, we have bigger SME books in both the conventional bank and the Islamic bank. The difference between the two is that the conventional bank was largely a very mature book, whereas Islamic was growing strongly, pretty much a new book. That obviously has different risk dynamics attached to it. We tightened underwriting standards in particular around the SME space given the losses that you saw last year in that area. No, I don't expect to be significant additional credit weakness in the Islamic side. It is actually doing well. We have seen a reduction both in the main bank and in the Islamic bank of SME delinquencies, so I think we're well positioned and that is when the majority of their issues came from in 2016. The other issue that that book had was around some of the fleet financing in cars and trucks, and we closed down the majority of that area as well, which is also affecting the risk profile within the book. So minor tweaks, but important tweaks for us from underwriting standards. The corporate standards remain exactly the same, as in housing loans etc, in particular we focused on a couple of areas which had built up quite a bit of steam in volumes, but we've actually pulled back from those sectors fairly aggressively.

Surya Subramanian

I'll take the question on NIM. Our guidance stands on 2.35 to 2.45% and when we gave the guidance last year, we were certainly expecting rate rises this year. In fact, the December rate rise, as you recall, had already happened against the guidance in the early part of the year. Since then, we've had one rate rise, another rate rise in March, and depending on who you speak in the market, there is anything from two,

some even say three more rate hikes this year, so there is an element of rate hike built in that margin guidance, but we have also anticipated that some of the liquidity pressures would normalise and our CASA engine would continue to grow. It's a mix of these three factors that gave us comfort last year that we could take the NIMs, which ended last year on 2.29%, we could take it up anywhere between 2.35 to 2.45%. Now, obviously the rate hike situation now may be looking a little bit more positive than it was in January when we gave the guidance, and depending upon how soon the loans re-price, we could look to see whether we revise our guidance in quarter two, but for the moment, we stay with 2.35% to 2.45%.

Shayne Nelson

Yes and I think it's an important thing to remember is the re-pricing of the loans, the especially the corporate loans, because a lot of them are based on 3-month, 6-month-, 12-month on EIBOR, so it takes a while for any price increases to flow through to the loan book.

Surya Subramanian

On the FX income, finally, while when you compare quarter four of last year with quarter one of this year, the big delta is clearly the absence of the Egypt evaluation that hurt quarter four of last year negatively. I would refer you back to slide nine of the presentation and if you compare with quarter one of last year, which didn't have the noise of the devaluation, Forex income was about 366 million compared to 410 million this quarter, so the underlying business, supported by our foreign exchange and derivative sales, our remittances, especially the direct remittance and other retail remittances products we have, and FX on the back of some of the corporate business we do, all that is trending strongly. Of course, if there is volatility in the Egyptian pound, some of that will flow through into our results, but short of that, the underlying would continue to maintain a steady growth.

Operator

We have another question from Deniz Gasimli from Goldman Sachs. Please go ahead

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Waleed Mohsin - Goldman Sachs

This is Waleed Mohsin from Goldman Sachs. Two questions from my side, first on cost to risk. Obviously, quite pleasing to see the improvement in the net cost of risk, but also the underlying gross cost of risk, even if we exclude the recoveries which have come through on board the conventional and Islamic side. I was just wondering to get a sense of how should we think about the normalised gross costs of risk for the bank, both in terms of conventional and Islamic book, given that the recoveries could be lumpy and could be volatile. If I look at the difference between the gross and net cost of risk, last year it was wider,

but during the first quarter as well we have around a 40-basis-point gap, 120 basis points off the gross cost of risk blended, 80 basis points in terms of net cost of risk, and the Islamic book still, despite coming down, has a gross cost of risk of around 340 basis points and the net being around 230 basis points. I just want to get a sense of how should we think about the normalised levels for the Islamic and the conventional book, especially in terms of the gross underlying cost of risk even before recoveries. That's my first question.

The second question, I wanted to focus a little bit on the regulatory changes, I wanted to get a sense if you can provide some colour on IFRS 9. We have seen some of the banks in the emerging market space talking about a 20-30% reset in provision reserves on the day of implementation. Obviously, given your capital levels, it doesn't seem to be an issue, but just wanted to get a sense of how much of a reset would you see on day one. The second part of this question, regulation, would be any further comments on the large exposures, any further discussions with the Central Bank or any guidance from them in terms of compliance with those large exposures.

Surya Subramanian

I will start with the regulatory changes on IFRS 9, as you mentioned, and then lead onto your cost of risk question.

If you look at the nature of our business post the financial crisis, the books have been growing relatively faster in the retail and SME space both for the conventional and the Islamic bank, and when you do provisioning, you know the retail and SME, especially the unsecured book, on a flow-through basis, specifically if it's unsecured 180 days past due you'll have already provided 100% of these, so the movement from an incurred loss IAS 39 to an expected loss in terms of IFRS 9, the impact is not going to be very huge for retail, because it flows through the books very quickly, so if there was a deterioration in the books last year, for example, it would flow through the books by quarter two of this year. We are generally seeing an improved credit environment.

As far as corporates are concerned – and my first comment was more general for the market because that's the trend we are seeing. As far as corporates are concerned, that is more specific to Emirates NBD. Given that we were quite severely affected during the global financial crisis, we have been steadily improving our book year-over-year. For us, in terms of both the outstanding balances and the nature of the risk on that book, the movement from incurred loss to expected loss is not much of a challenge, plus as Paddy mentioned when he was talking about capital earlier, we have about 3% of credit risk-weighted assets in our general provision historically for a variety of reasons and that would provide sufficient cushion against any movement that is warranted by IFRS 9.

In terms of your comment on the gross cost of risk and the net cost of risk, I like the way you have dissected and disaggregated the book. You're aware that we have stopped giving guidance on NPLs and coverage ratio for a few years now after we fixed our legacy problems, and all that we said is basically that directionally the cost of risk will continue to improve and on a net basis. We haven't disaggregated it in the way you have to give certain guidance, exactly for the reasons you've said. There is a lumpiness in some of the corporate recoveries. Retail tends to follow a pattern, whether it is for the losses or for the recoveries, but corporate tends to be lumpy and uneven both for the losses and the recoveries, and having said that, we do have a significant stock of impaired loans that are fully provided and something would keep coming out of it, as we keep trying; however, at a net 80 basis points' cost of risk, and this is a mix of cross corporate and retail. Retail would tend to be higher, corporates would tend to be lower, but for the bank, I would say we are getting closer to the normalised levels, because if you're at 50, you're very good; if you're at 200, like we were a few years back, we are not that good; at 80, we are still saying we expect the nets to continue to improve. That's about the best I can do for you at the moment, Waleed.

In terms of the large exposure rules, we continue to be in dialogue with the Central Bank and that is continuous work in progress.

Operator

Our next question is from Ryan Ayache from Deutsche Bank. Please go ahead.

Ryan Ayache - Deutsche Bank

A couple of questions for me. You mentioned in the call that VAT is something that, along with regulation, is an issue for UAE banks. I was hoping for a bit of colour on how precisely this might affect you whether directly or indirectly, your customers and so on and so forth. My second question is on the cost-to-income and you mentioned the investment in the digital banking, so back of the envelope, that 3% extra in terms of 30-33 of the cost-to-income, you're talking 400 million and change, so is that roughly what you're investing in digital and what kind of returns are you expecting on these investments? How quickly do they come through? How should we think about these investments that you're making? Finally, just to go back on similar things that Waleed just asked, but on IFRS 9, looking at the chart that you have on page 11 of your presentation and the trend of NPL ratio and coverage, the level of coverage you have now given, quite a high base of NPLs, it seems incredibly conservative, so given the 3.19% of provision versus credit risk-weighted assets, might you not be a beneficiary of IFRS 9 in some way?

Surya Subramanian

I will take the regulatory questions and hand over to Shane to comment on the investments in technology. I did not say that VAT is a concern. Rather it's something that we need to address and as we stand now, what we know is the GCC, including the UAE, will go live on VAT from 1 January of next year. Businesses have to register around the September timeframe of this year and the minimum turnover for that has been set at about $100,000, which is AED 375,000. That is a low threshold. It will pretty much capture everybody. While the draft law itself has not been shared with the public, typically from what we hear in conversation and consultation, the UAE will be following generally what is known as common practices across the world, which means banking services typically will be exempt for net interest income or, if you're talking in the Islamic context, the profit share portion, which means financial institutions will typically be subject to VAT on the services we provide, whether it's brokerage, asset management, credit card fees, chequebook fees, and so on and so forth, and against that we have to see what we have as offsets. There are some challenges for banks obviously, because we are part-exempt and that part of the regulation has also not come out.

However, as far as the rest of the economy is concerned, it's a 5% VAT, much better than those of you who have ever been shopping in the UK at 20% VAT. There is a likelihood that customers may frontend next year's purchases into the latter half of 2017 for large expenditure and that could give a boost to expenditure in probably the third and fourth quarters of this year, so there is an opportunity for all banks to finance those kinds of purchases. Of course, once you go into next year, cash flows in the system will be affected because of the collection of VAT and the periodic payments to the Government. Banks and corporates have to be mindful of that. There will be some kind of a sidestepping that needs to be done.

That's on VAT. As far as IFRS 9 is concerned, it's fair to say that the problem loans themselves don't change between IAS 39 and IFRS 9. That's called the stage three loans. The difference is really in the stage one and stage two where IFRS 9 has created the concept of lifespan expected losses on stage two loans, which are showing some signs of deterioration or weakness compared to the date of origination. That is where the bulk of the difference would come and that would vary from bank to bank depending on how they manage their earlier process, their migration from what is a normal loan on the date of origination to how it grossed through the credit grades before it becomes a non-performing loan. The portfolio impairment provisions that we've talked about under IAS 39 is against our good book, but it should be sufficient to cover, as I said, any impact of IFRS 9. In terms of whether there will be a write-back or not, it could be theoretically possible, but early to guess, because the economy has tended to slow down; it's still in growth mode, but it's slower than a few years back, so we constantly need to reassess all these parameters in our general provision model and, in fact, all these parameters also get into the IFRS 9

modelling sequence. There are multiple scenarios we need to look at, economic scenarios, in IFRS 9, whereas under IAS 39 we really didn't have to look at multiple economic scenarios.

I will hand over to Shane to talk about our investments.

Shayne Nelson

The question was really around digital. Our cost-to-income ratio guidance is 33 and we're pretty close to 31, so there's about a 2% gap there, so I think it's a good question, are you spending all that on digital? Well, I would say a sizeable chunk will be spent on digital would be my guidance. Our catch probably in the bank is 'digitise or die'. We are firm believers that we are leading in the digital space, but we need to do far better than we currently are. Some of the expenditure will be utilised for architectural rebuild. Like most banks in the world, we have legacy systems that aren't configured in a way that are digitally friendly. Rebuilding those systems and reconfiguring them is not a cheap exercise, but for the future, we absolutely need to do it.

We're also investing in things like bots, for example processing a bots. There is a lot of work we do, for example, in our 10-feet operation centres, which is a lot of it is key. We believe bots will be able to take over a substantial amount of that work. That will save costs in the long-term. We're also very focused on straight-through processing with digital. For example, now you can go into a branch and on tablets you can get a straight-through personal loan, which will be funded within the same day. We will be doing more and more of that. Our whole focus is to cut out from the process as many pieces of paper, and therefore people, as we possibly can and we will continue to do that. Our view of that is that is the future of banking. That is where we need to shave costs off, but more importantly, our customer focus is that we know the generation coming through and we know there's a huge demand for the digital capabilities right now. We will continue to build that. Some of it's hard to justify on the basis of what does it repay now. We would say that if you don't do it now, you may not have a future and, therefore, that's one of the reasons we're so focused on it.

I hope that helps you out, but I can't give away what we think we're going to make out of certain products as our focus, because then everyone else would want to do the same thing. But I do see, just getting onto competition, the big difference that a bank of our scale has in the UAE market in particular is we have the scale to spend the money to do what we need to do in the digital and the processing space. We have the resources to do it. The question I have for the rest of the industry is how will they get the same strategic agenda that we do, because we have the capability to spend on what we think is a critical issue for the industry versus others.

Patrick Clerkin

We've had one question come in over the webcast from Akash at ASC Asset Management. I will pass this to Surya. Surya, Akash is just asking about other operating income and the entry other income. There has been a decline there from about 75 million to minus 70 million. Can you comment on that?

Surya Subramanian

This category often is a residual catchall category. In some quarters it's a positive number and in some quarters it's a negative number, because it is a net number of a few items. Things that go into it are things like cheque return charges, collection charges, inventory related expenses, and so on. The big movement this quarter typically is that we took a negative revaluation figure on illiquid property inventories that we hold. Paddy, you had earlier mentioned that we continue to make profits on the inventories that we sell, which is true, but there are one or two pieces of illiquid inventory that we hold and we decided to be prudent in the current market, and take a revaluation charge against that.

Operator

We have one further audio question from Shabbir Malik from EFG Hermes. Please go ahead.

Shabbir Malik

Just a quick question from me: do you have any plans to expand in Saudi Arabia or in Egypt when you make your outlook for the next three to five years?

Shayne Nelson

We were lucky enough to get three additional branches in Saudi recently, awarded by SAMA. We're the only foreign bank that has been awarded additional branches, other than one, within the country, so we will be opening up as quickly as we can in those new locations, which will be Jeddah, Aqaba, and another one in Riyadh, so that will give us good coverage in Saudi. Saudi for us is a market that we want to get bigger in and certainly it's one that we believe has plenty of potential. Notwithstanding, there have been some issues there of late around Government payments and cash flow, which has obviously affected our contractors there and that's no new news. It is a market that's a substantially bigger market than the UAE when it comes to GDP and population, so it's one that's very attractive for us. It's no secret that we were interested in Barclays in Egypt. It's a market that we believe has long-term value for us as an organisation and we continue to invest in our branch expansion and growth. We are long-term believers in Egypt, albeit that it's got some short-term economic issues surrounding it, but we have seen certainly their foreign

exchange reserves improving, and despite the devaluation of the currency, our business area is actually performing very well, so we're very happy with the performance of the operation there and we continue to want to invest in Egypt

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Patrick Clerkin

And there is one more question coming, again from Akash, just asking our CAR ratios, how do we expect those to change under Basel III? I'll pass that onto Surya.

Surya Subramanian

There was an add-on question whether the current ratios are at Basel III, so that's the easy one to answer. The Basel III regime has been announced by the UAE Central Bank, but not yet implemented. All banks in the system are still in the Basel II regime. As far as the delta itself is concerned, we have mentioned earlier that the key changes between Basel III and Basel II are really in the market risk space and whether or not you take the additional tier 1 into capital or not and they've raised some of the minimum ratios. For banks in the GCC, and definitely for us, the bulk of the demand comes from credit risk-weighted assets and not from market risks. So that part of the equation, the demand side of the equation doesn't really dramatically change, given that market risk for us is only about 2-3% of total capital demand. On the supply side of the equation, I did mention earlier we are waiting for the detailed capital standards. Once that is available, we will know whether our additional tier 1 securities are eligible or not. Currently in conversation, it appears and certainly in the Basel guidelines it shows that there is a potential for grandfathering provisions. We will know the details only when the standards are announced, so this is probably a question for quarter two or quarter three, once that becomes public.

Operator

We have no further audio questions.

Shayne Nelson

And there is no further web questions. So thank you very much for joining us today. And I'll hand you now back to the operator if you have any follow-up questions and we will conclude the call. Thank you very much for joining us.

Operator

For any further questions, please contact our Investor Relations Department, whose contact details can be found on the Emirates NBD website and on the Results press release. A replay of this call and webcast will also be available on the Emirates NBD website next week.

Ladies and gentlemen, that concludes today's conference call. Thank you all for your participation.

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