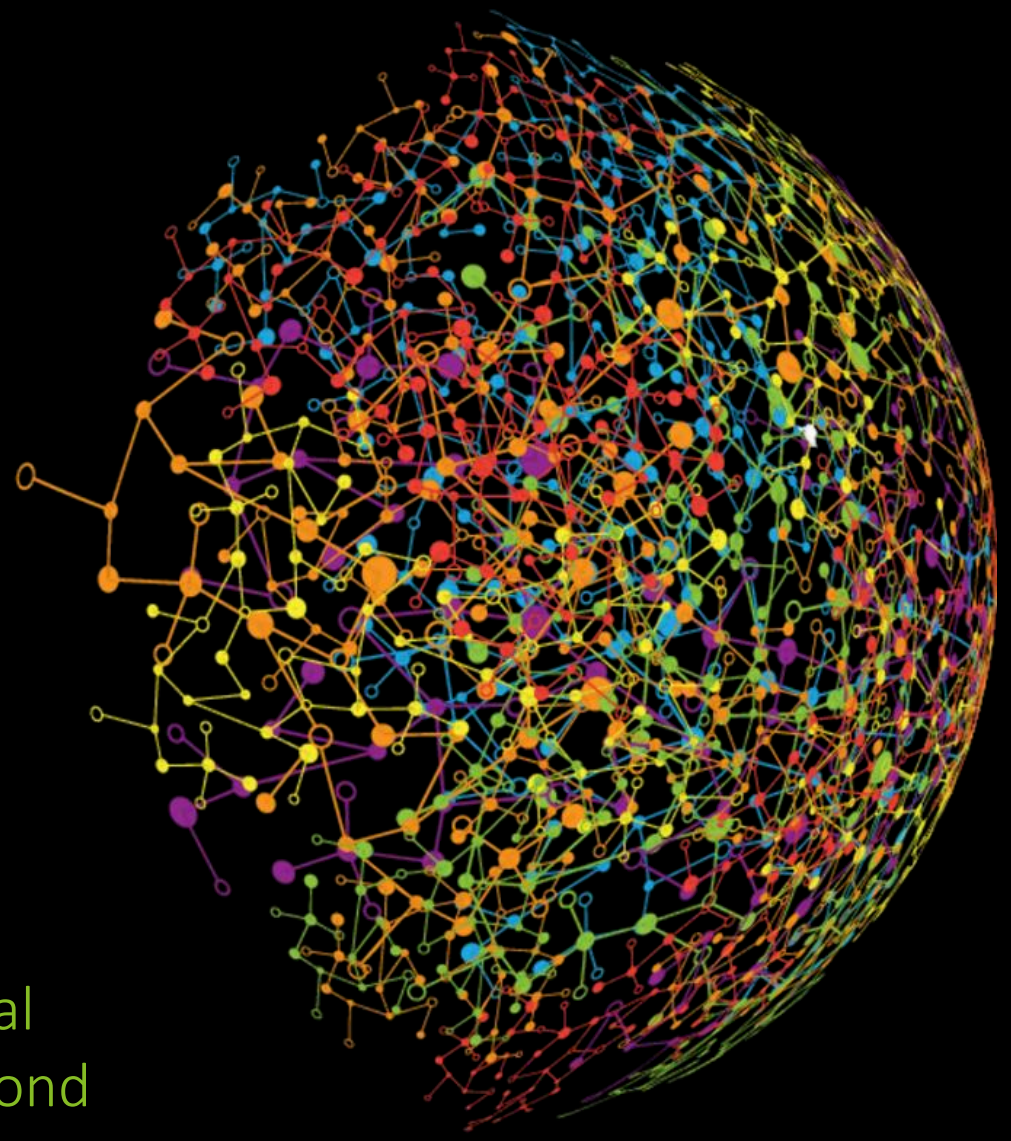
Deloitte.



COVID-19: Impact on Financial Institutions and How to Respond

April 2020

MAKING AN IMPACT THAT MATTERS since 1845

Content

- Regulatory Responses in Asia Pacific
- Impact of BNM's Relief Measure on Financial Institutions (FIs)
- Leadership in Crisis
- Other references

Selected Regulatory Responses in Asia Pacific

In comparison to neighbouring countries, Malaysia's response is bold, pre-emptive and forethoughtful of the repercussions of the COVID-19 outbreak to the economy.

Legends:

- Loans, NPL, Provisioning
- Capital
- Liquidity

HKMA welcomes measures by financial institutions to support customers affected by COVID-19

- HKMA welcomes voluntary initiatives from banks such as fee reduction in credit card facilities, principal moratorium for residential and commercial mortgages etc.
- HKMA has lowered the counter-cyclical capital buffer from 2.0% to 1.0% with immediate effect.

Allowance for banks to utilise regulatory buffers to assist customers affected by COVID-19

- Banks are advised to support the cash flow of corporate clients.
- Banks subjected to Basel international standards may use their capital buffer to absorb losses and maintain necessary funding.
- Banks subjected to Basel international standards may use their liquidity buffer to absorb the liquidity shock.

Measures to assist individuals, SMEs, and corporates affected by COVID-19

- Deferment of all loan repayments for a period of 6 months, effective 1 April 2020, and credit card outstanding balances can be converted to a 3-year term loan with reduced interest rates.
- Banks may drawdown on the capital conservation buffer of 2.5%.
- Bank Negara Malaysia (BNM) to supply daily ringgit liquidity to banks, and banks may operate below the minimum Liquidity Coverage Ratio (LCR) of 100%.

MAS welcomes measures by financial institutions to support customers facing the impact of COVID-19

- Individuals with mortgages may apply to defer principal and interest payments up to 31 December 2020, with lower interest rates on personal unsecured credit facilities.
- A new MAS USD Facility to provide up to US$60 billion of funding to support stable USD liquidity conditions.

Source: Deloitte Asia Pacific Centre for Regulatory Strategy

Disclaimer: Information updated as at 3 April 2020. Non-exhaustive.

Impact of Covid-19 for Banks

COVID-19 Timeline and BNM Measures Related to IFRS 9

General Timeline

1st MCO Period

2nd MCO period

3rd MCO period

18 Mar First MCO started 18 – 31 Mar

31 Mar First MCO ended

1 Apr 2nd MCO started

14 Apr 2nd MCO ended

15 Apr 3rd MCO started

28 Apr 3rd MCO to end

25 Jan Official first case identified in Malaysia

16 Mar Prime Minister announced Movement Control Order (MCO)

25 Mar Prime Minister announced first MCO extension (from 1-14 Apr)

10 Apr Prime Minister announced second MCO extension (from 15-28 Apr)

27 Mar IFRS & MASB released statement

25 Mar European Banking Authority (EBA) Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9

24 Mar Bank Negara Malaysia announced measures for COVID -19

BNM's Additional Measure for COVID-19 Related to IFRS 9

1. **Automatic moratorium on repayment /payment of loans /financing**
   - Moratorium period excluded in determination of period in arrears for the purpose of regulatory and accounting classifications
   - Loans / Financing that are granted moratorium solely based on this measure are not to be flagged as R&R in CCRIS
   - The R&R loans need not to be classified as credit impaired in CCRIS
2. **Liberalised lending/financing limits**
3. **Drawdown of prudential buffers**

No Direct Impact to MFRS 9

4. **MFRS 9 and financial reporting requirements**
   - FIs required to incorporate impact of COVID-19 into forward looking information for ECL calculation
   - Payment arrears during moratorium period should not automatically result in a stage transfer

Note: Information is as at 13th April 2020

Impact of BNM's Relief Measure on FI(s) (1/3)

Key Summary :

- **Deferment and Restructuring on loans/financing repayment and drawdown of capital conservation buffer.**
- Operate below the minimum requirement LCR of 100% and lower NSFR to 80%.
- Ensure proper forward looking information is incorporated for MFRS 9 provision to reflect current economic conditions.

Impact on Banks

1 Capital

It is widely expected that the global economy will be experiencing an economic downturn, and a prolonged recession could potentially have a severe impact on a financial institution's capital as its profitability and asset quality decline. A loan moratorium would help financial institutions address the potential deterioration of the following:

1) Profitability:

While BNM's loan moratorium is in place, interest and profit will continue to be charged on the outstanding balance. The aim of this package is to provide some relief to individuals and businesses who face temporary financial constraints arising from the COVID-19 pandemic.

Borrowers will have a chance to recover from the temporary financial constraints and resume paying after the end of the loan moratorium. This would help FI(s) mitigate potential loss in revenue and profit, that would otherwise have occurred without the stimulus package.

2) Asset Quality:

Without the stimulus package, asset quality would deteriorate and FI(s) may be forced into writing off large amount of loans, and incurring large amount of losses. However, BNM's loan deferment programme also means that the FI's banking book will remain healthy during the 6-month loan moratorium as borrowers' CCRIS records will not be adversely affected, and will remain similar as per the status as at March 2020.

While the six months loan moratorium provides temporary relief to borrowers to navigate through the economic setback, FI(s) must be mindful that this is just simply a deferment of asset-quality risk and should closely monitor their credit exposures as impairment charges may only take place in the next year if the current economy weaknesses stretch beyond the expected time period.

Impact of BNM's Relief Measure on FI(s) (2/3)

Key Summary :

- Deferment and Restructuring on loans/financing repayment and drawdown of capital conservation buffer.
- **Operate below the minimum requirement LCR of 100% and lower NSFR to 80%.**
- Ensure proper forward looking information is incorporated for MFRS 9 provision to reflect current economic conditions.

Impact on Banks

2 Liquidity

BNM's loan moratorium specifies that all deferment of loans and financing to be automatic and as a result, FI(s) will likely face liquidity crunch in the near future, with significant reduction in cash inflow and liquidity drying up in the money market. With liquidity drying up and FI(s) expected to continue supporting lending and financing activities, FI(s) will likely find themselves struggling to comply to the minimum liquidity requirement for LCR and NSFR.

However, as a measure to help FI(s) cope and navigate the impact of the loan moratorium, BNM has relaxed the minimum regulatory requirements for both LCR and NSFR ratios where FI(s) are to support continued lending while maintaining liquidity needs during this stress period.

Financial intermediation activities during this period is also supported by sufficient liquidity in the banking system with BNM continuing to supply daily ringgit liquidity to FI(s) via various tools under the open market operations.

BNM has also taken pre-emptive measures to boost liquidity through the recent reduction in the Statutory Reserve Requirement (SRR) ratio by 100 basis points, coupled with the additional SRR flexibilities granted to Principal Dealers.

The full extent of the impact of BNM's loan moratorium is unknown. While banks will be given ample time to rebuild their liquidity buffers until 30 September 2021, it is important that FI(s) perform comprehensive stress testing and scenario analysis to assess its vulnerability to different liquidity stress scenarios.

Impact of BNM's Relief Measure on FI(s) (3/3)

Key Summary :

- Deferment and Restructuring on loans/financing repayment and drawdown of capital conservation buffer.
- Operate below the minimum requirement LCR of 100% and lower NSFR to 80%.
- **Ensure proper forward looking information is incorporated for MFRS 9 provision to reflect current economic conditions.**

Impact on Banks

3 Provision

With the publications released by IFRS, MASB and direction provided by BNM, loans / financings under moratorium shall not be the key criteria in determining whether there is an increase in credit risk. Under IFRS 9, provision is computed to weather the expected loss that FIs will experience in the next 12 months, and reflective of the current economic condition. There were several key focus area that the Bank shall consider, including:

1) Staging criteria:

Under BNM's loan moratorium, it shall not be part of the staging criteria. Financial Institutions that are dependent on DPD information for staging purposes will be heavily affected as the DPD status will remain constant in the six- month period. This is when qualitative staging criteria will come in handy in assessing Significant Increase in Credit Risk (SICR). More advanced FI(s) can leverage on scoring system to continue monitoring the credit performance of each account.

2) Probability-weighted outcome:

Most FI(s) have determined at least three different scenarios (base, good and bad) for ECL computation. Prior to the COVID-19 outbreak, a higher weightage has been allocated for base scenario. FI(s) may consider revising the weightage or update the forward-looking elements.

The PWO weightage should reflect the short-term outlook by introducing a temporary shock into the ECL calculations – should a higher weightage be given to the bad scenario, banks should assess if the bad outlook will persist in the future years.

3) Forward-looking model:

Most FI(s) have developed predictive models for Expected Credit Loss calculation using recent 5-10 years historical data, where GDP ranges from 4.35% to 7.40%. With the latest GDP forecast by BNM ranging from -2% to 0.5%, the performance of the models might be challenged and too volatile as the input are out of bounds during model development. Business judgment will play an important role at this period with sufficient and reasonable information and transparency.

In such an unprecedented situation, how can FI(s) be more resilient?

Five fundamental qualities of resilient leadership:

1. **Design from the heart… and the head**
   In crisis, resilient leaders express empathy and compassion for the human side of the upheaval.
2. **Put the mission first**
   Focus on what's important and resilient leaders are able to stabilise their organisation.
3. **Aim for speed over elegance**
   Perfect is the enemy of good, especially during crises when prompt action is required.
4. **Own the narrative**
   Powerful ways to acknowledge the fears that surface in time of crisis, while at the same time framing the opportunity that can be achieved if stakeholders come together and commit to overcome the challenges that stand in the way.
5. **Embrace the long view**
   The necessity of operating differently gives businesses the opportunity to understand what they can do.

Adjust

Adjust the parameters to produce a more reflective capital, liquidity, and ECL provision, focusing on the short term outlook and impact of the COVID-19.

Optimise

Revisit and optimise the RWAs and ECLs number, by incorporating the impact of COVID-19 and BNM's loan moratorium in the calculation process.

Respond

Set up an early warning system to help the FI be more pre-emptive and respond proactively in safeguarding its assets.

Prepare

Review the current capital and liquidity contingency menu of options, update with well-defined recovery indicators to have a smoother transition if similar crisis occurs in the future.

Adjust

How can financial institutions adjust the current provision to reflect the short term economic outlook?

MFRS 9 ECL Key Requirements:

Staging criteria

To consider qualitative criteria in assessing significant increase in credit risk. Although the Movement Control Order's impact differ across industries, the effect may be similar for certain groups of businesses in the same industry. Analysis can be performed to compare the potential change in default across different industries and geography.

Probability-weighted outcome

The COVID-19 outbreak is not a result of the financial system weakness and the impact may represent a temporary shock to the economy. As such, when assigning the weightage on the good, bad, and base case scenarios, FI(s) should assess if the economy slowdown is expected to persist in the future years. Should sufficient granular data be available, FI(s) may consider the following:

- Heavily affected industries / borrower may have heavier weightage on the bad scenario for longer periods (e.g. 2-3 years for tourism).
- Industries expected to rebound quickly may have heavier weightage on the bad scenario in the short term (e.g. 1 year for hypermarkets)

In the long-run however, the base case scenario may resume to having more weightage as the economy is expected to recover.

Macroeconomic variables

It is recommended for FI(s) to incorporate the latest economy outlook into a forward-looking model where possible. Depending on the model design, manual adjustments may be required for the model to reflect the impact of COVID-19.

Alternatively, if the required forward-looking elements cannot be reliably acquired, FI(s) may consider stressing the estimates or leveraging on the stress-testing forecast (e.g. increasing the standard deviations for the bad scenario and/or decreasing for the good scenario).

For future forecasting, FI(s) are to assess if the forward-looking elements shall resume the mean-reverting trend. Should the forward-looking elements experience a structural break, further analysis is needed to determine if the model is able to reflect the change using the new mean.

ECL Key Components:

PD

Probability of default

To assess if the PD estimate is reasonable compared to a benign period or crisis period through benchmarking against previous crisis.

A comprehensive and up-to-date borrower database will provide valuable insights into identifying and differentiating risky borrowers in the portfolios or revising the current segmentation.

LGD

Loss-given default

To review haircut rates of impacted collaterals (cars, house) of which recoveries may be affected by the overall market sentiment and customers' purchasing power.

Not all collateral values and recoveries will be affected. For instance, fixed deposits or bonds. Such collateral types should retain the same haircut / loss rate.

EAD

Exposure at default

For non-revolving products – reporting entities should recalculate amortized schedule and balance affected by the loan moratorium.

For revolving products, to assess if there is any SICR and monitor borrower facility utilisation rate to adjust the EAD estimates where appropriate.

Optimise

How can an FI optimise ECL by re-looking into the customer lifecycle?

Integrating Risk Management throughout the Customer Lifecycle

Origination

- A-score scorecard optimisation
- Frequent and conservative calibration
- Cut-off strategy
- Collateral requirement

Customer management

- B-score scorecard optimisation
- Credit lines & renewal-terms policy
- Cross-selling & upselling opportunities
- Early warning signal

Collection

- Notification and reminders
- Preemptive R&R
- Early collections
- Collection scorecard to optimise recovery process

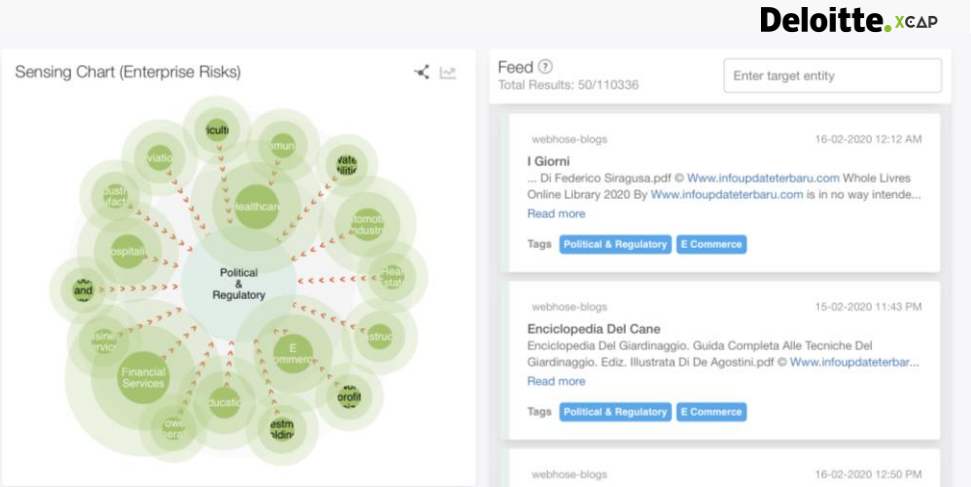
Recovery Management

- External debt collector
- Timely recovery for defaulted customer post default in ensuring more recoveries within LGD workout period.
- Policy enforcement

What to lookout for during a crisis?

- Focus on the payment behavior of customer. E.g. deep dive into customers profile who opt-out for moratorium to be calibrated into current models.
- Timely reminders and notifications for customer to pay off post moratorium to minimise movement of customers from stage 1 to stage 2.
- Offer R&R to customers who are having difficulties before turning to non-performing.
- Ensure timely recovery for non-performing customers to optimise the LGD calculation for subsequent months' ECL calculation.

Enhance Risk Sensing with Sentiment Analysis

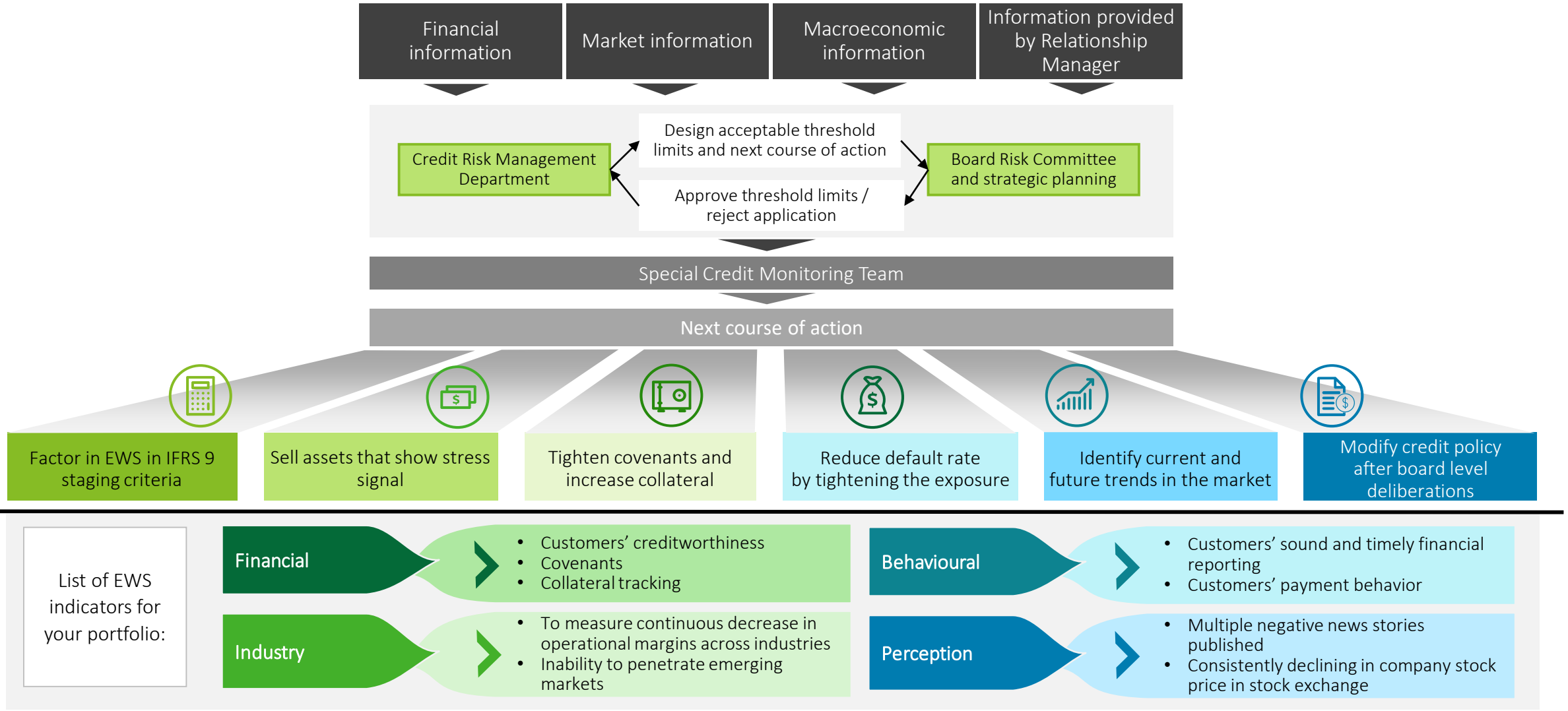


News announcements, analyst reports and business journalism provides vast amount of qualitative information on the current state and future economic outlook. Sentiment index can be derived by a systematic screening of public sentiment to unveil changing public opinions, latest market trend, and additional insights which may only be reflected in credit ratings months later. Use case for sentiment analysis includes:

- Rating models and Early Warning Signal
- Industry-trend analysis
- Stress-testing and Scenario Analysis

Respond

How Early Warning Signal (EWS) helps in safeguarding FI assets



Prepare

How will COVID-19 reshape the strategies of Recovery and Resolution Planning (RRP)?

Effort required for each RRP key components:

No.	Core components of RRP	Realignment post COVID -19
1.	Strategic analysis	Status Quo
2.	Governance	Status Quo
3.	Scenario analysis	Require realignment
4.	Recovery indicators	Require realignment
5.	Recovery options	Require realignment
6.	Communication plan	Require partial realignment
7.	Preparatory measures	Status Quo

Status Quo · Require realignment · Require partial realignment

4 key components recommended for realignment post COVID-19 :

Scenario analysis

Prior to the global COVID-19 breakout, it was difficult to imagine that a scenario to the degree of severity mandated by the Regulator could materialise. Now, it is apparent that Financial Institutions will need to take a step back and reconsider the definition of "Worst Case Scenario" as this virus has undoubtedly set a much higher bar.

Recovery indicators

Threshold for recovery indicators that have been set to act as early warning signals of an upcoming crisis will need to re-calibrated to recognise BNM's relief measures on banks (e.g. LCR<100%, NSFR <80%, eligibility to drawdown on capital conversation buffer of 2.5%)

Recovery options

The feasibility of a recovery option should be re-assessed in a three-pronged approach - crisis arising from the pandemic itself (Biological), the fear about the pandemic (Psychological) and its business implications (Economics) as many of the recovery options may no longer be feasible or its execution prolonged. (e.g. Sale of business portfolio when the routine operations of lawyers are disrupted).

Communication plan

Communication plans should emphasise the need for speedier responses and better planning to navigate the internal and external communication needs, when thrown into unchartered waters. (e.g. through use of dedicated crisis team and frequent dry runs).

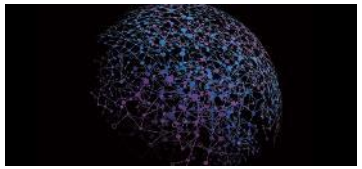
Combating COVID-19 with resilience

A collection of insights to help business manage and mitigate risks with COVID-19

The heart of resilient leadership: Responding to COVID-19

A guide for senior executives. Five fundamental qualities of resilient leadership distinguish successful CEOs as they guide their enterprises through the COVID-19 crisis. Learn specific steps that can help blunt the crisis's impact- and enable your organisation to emerge stronger.

https://www2.deloitte.com/global/en/insights/economy/covid-19/heart-of-resilient-leadership-responding-to-covid-19.html



COVID-19: Managing cash flow during a period of crisis

Cash flow management needs to be an integral element of a company's overall COVID-19 risk assessment and action planning in the near term. Management teams will need to evaluate their cash flow requirements, develop appropriate actions under various scenarios, and assess potential risks to their customer base and supplier network.

https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-COVID-19-managing-cash-flow-in-crisis.pdf

COVID-19: Managing supply chain risk and disruption

A decades-long focus on supply chain optimisation to minimise cost, reduce inventories, and drive up asset utilisation has removed buffers and flexibility to absorb disruptions – and COVID-19 illustrates that many companies are not fully aware of the vulnerability of their supply chain relationships to global shocks.

https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-COVID-19-managing-supply-chain-risk-and-disruption.pdf

Future of Work: Ways of working in uncertain times

To sustain and thrive in uncertain times brought forward by COVID-19, organisations must explore new ways of working. This has placed a spotlight on the need for corporate resilience and the ability to embrace virtual collaboration tools and practices.

https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/Future_of_Remote_Work_Final_031420.pdf

Business Continuity Management: With a zoom in on the health crisis response plan

An effective Business Continuity Management (BCM) programme is a critical component of successful business management. Experience shows that typically over 50 percent of businesses without an effective business continuity plan will ultimately fail following a major disruption.

https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/risk/lu-business-continuity-management.pdf

Deloitte.

Contact Us

Justin Ong
FSI Financial & Regulatory Risk Leader
Deloitte Malaysia
keaong@deloitte.com

Dr. Chee Wei Yen
FSI Financial & Regulatory Risk Director
Deloitte Malaysia
wechee@deloitte.com