Response to feedback received
Credit Risk

Introduction

Bank Negara Malaysia (the Bank) has issued the policy document on *Credit Risk* for banking institutions and insurers/takaful operators (collectively referred to as financial institutions). This policy document incorporates the proposals from the exposure draft, and has taken into consideration various feedback and suggestions received during the consultation period.

The Bank received more than 130 written responses from 69 respondents during the consultation period. Key comments received and the Bank's responses are set out in this document. Other comments and suggestions for clarification have been incorporated in the policy document.

Bank Negara Malaysia
22 January 2018

1. Credit risk assessment

a. Implicit support arrangement

Industry feedback

The Bank should consider reviewing the current prohibition for financial institutions to use implicit support arrangements[1] in credit decision making process[2]. The continued prohibition restricts the ability of financial institutions in exercising business judgment when making credit decisions.

There have been cases where implicit support arrangements proved to be effective as a loss mitigation tool. In such cases, strong internal practices were present to ensure that the outcome of the implicit support arrangement is effective. These include obtaining continuous attestation on the support provider's willingness to accord support in times of stress, periodic assessment of the strategic relationship between the support provider and the counterparty and financial capacity of the support provider.

The Bank's view

1.1 The prohibition has been in place since 2001 to prevent financial institutions from being heavily reliant on implicit support arrangements when approving credits. Such overreliance in many cases turned out to be ineffective in mitigating losses.

1.2 The Bank acknowledges the views put forward by financial institutions. Over the years, financial institutions have demonstrated improvements on various aspects of credit risk management infrastructures, processes and practices that can equip financial institutions in exercising reasonably prudent business judgment when making credit decisions. However, the exercise of prudent business judgment must be supported by adequate safeguards.

1.3 Taking these into consideration, the final *Credit Risk* policy document will not prohibit the use of implicit support arrangements. Such arrangements, however, must not be the sole factor assessed when performing credit risk assessment or when making credit decisions. Financial institutions are also required to establish adequate internal governance arrangements, policies, controls and reporting requirements on the use of implicit support (refer to paragraph 9.14 and 16.2 of the *Credit Risk* policy document).

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[1] Include implicit guarantee, letter of comfort or expectations of support.

[2] Include rating assignment to a counterparty, pricing or rate charged for a credit, terms and conditions of a credit and approval of a credit.

2. Credit risk measurement

a. Methodology

> **Industry feedback**
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> Estimation of probability of default (PD), loss given default (LGD), and exposures at default (EAD) should not be required for significant credit exposures[3] categorised as 'fair value through profit and loss' (FVTPL) under the Malaysian Financial Reporting Standard 9: Financial Instruments (i.e. trading portfolios). Such exposures are not subject to impairment provisions under MFRS 9.

The Bank's view

2.1 The requirement to estimate PD, LGD, and EAD for all significant credit exposures is intended to elevate the standards for estimating expected credit losses across financial institutions. The requirement also complements the implementation of the Malaysian Financial Reporting Standard 9: Financial Instruments (MFRS 9) that takes effect for financial year beginning 1 January 2018.

2.2 The Bank is aware that exposures categorised as FVTPL are not subject to impairment provisions under MFRS 9. For such exposures, changes in credit risk are already reflected in the market price of the instrument. Hence, any impairment would have been reflected in the profit and loss statement of the financial institution.

2.3 Despite this, granular estimates of PD, LGD and EAD for significant credit exposures categorised as FVTPL generally contribute towards improving the overall credit risk management process (for example, through better approval and pricing mechanisms, limit setting and monitoring).

2.4 The Bank acknowledges that for some financial institutions, the potential value-add may not be commensurate with the efforts required to develop in-house estimates of PD, LGD and EAD for FVTPL exposures. In such situations, financial institutions are expected to adopt an appropriate credit risk measurement methodology to estimate expected credit losses, having regard to the nature, scale and complexity of such FVTPL exposures.

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[3] Refer to a credit exposure or a homogenous portfolio of credit exposures that has a material impact on a financial institution's credit risk profile.

b. Validation

Industry feedback
The ability to perform validation may be constrained by unavailability of quality historical data and lack of in-house expertise. These challenges have affected the ability of some financial institutions to: a. assess appropriateness of underlying assumptions used in the credit risk measurement methodology; and b. back-test the outputs to ascertain the methodology's accuracy and discriminatory power.

The Bank's view

2.5 For banking institutions, the Bank expects these challenges to have been addressed as part of the implementation of MFRS 9, which became effective on 1 January 2018, given the same expectations imposed. For insurers/takaful operators, an extended implementation timeline is granted to allow for sufficient time to prepare and address any challenges before the effective date of the *Credit Risk* standards on 1 January 2021.

2.6 Where insufficient historical data is a constraint to perform validation, financial institutions may consider using relevant proxy data. In such cases, the financial institution is expected to periodically review the appropriateness of using such proxy and adopt its own internal data, whenever feasible.

2.7 In addition, where the validation is performed by an external party, the financial institution must ensure that the validation process fulfils the requirements as set out in paragraphs 12.14 to 12.23 of the *Credit Risk* policy document.

3. Credit concentration risk

Industry feedback

The scope of correlation assessment as specified in the exposure draft is too broad (e.g. may include name, sector, and country correlation etc.) and may be too onerous. Therefore, there is a need for clarity on the type of correlation assessment that is required to be undertaken.

There are also concerns on the operational difficulty to undertake name correlation assessment for all credit exposures, particularly for retail credit portfolio which are voluminous.

The Bank's view

3.1 The requirement for financial institutions to assess correlations between credit exposures is to enable identification of chain reactions due to a counterparty defaulting on its credit obligations. Information on the degree and relativity of the financial institutions' credit concentration risk can contribute to the containment of cumulative losses through the establishment of meaningful internal limits with early warning indicators. These information will also be useful in developing the financial institution's risk appetite and credit risk strategy which could result in pricing adjustments, unwinding of existing credit exposures, increasing capital buffers or entering into additional credit risk mitigation arrangements.

3.2 The Bank takes note of the feedback from the industry. Paragraph 14.3 of the *Credit Risk* policy document clarifies that at a minimum, the financial institution must assess:

a. name correlation between significant credit exposures; and
b. correlations between sectors within its portfolio.

These expectations complement the requirements in the *Single Counterparty Exposure Limit* and the *Internal Capital Adequacy Assessment Process* policy documents, respectively.

3.3 For name correlation, the Bank expects that financial institutions continue to gradually build capacity and capability to assess correlation for all names over time. In addition, the financial institution should endeavour to also assess name correlation for all credit exposures that are considered material to it based on its risk tolerance, to manage concentration to a single counterparty.

4. Problem credits

a. Management of material problem credits

Industry feedback

Several respondents, mainly smaller and less complex financial institutions, highlighted that setting up a specialised team for managing material problem credits may be challenging given resource constraints. For such financial institutions, recovery actions can still be taken in an objective and timely manner through appropriate governance arrangements, including close monitoring of material problem credits and deliberation/approval of recovery actions at a committee level.

The Bank's view

4.1 The exposure draft proposed for material problem credits to be managed by a specialised team with relevant expertise. This proposal is based on the premise that dedicated resources with specific focus and specialised expertise will improve recovery outcomes of problem credits, particularly in terms of the amount of repayment collected.

4.2 The exposure draft also proposed for the specialised team to be independent from the credit approval authority or other officers involved in the credit decision. This is to ensure the continued objectivity of the financial institution's problem credit management function and minimise delays in taking recovery actions (i.e. prevents 'ever-greening' of problem credits).

4.3 The Bank views that the request to allow financial institutions to institute an appropriate governance arrangement to manage problem credits merit consideration, so long as the policy objective can be met. The final *Credit Risk* policy document requires that the governance arrangement put in place by financial institutions must be commensurate with the complexity, materiality and volume of problem credits. Financial institutions must also consider the availability of resources and adequacy of existing safeguards to avoid 'ever-greening' of problem credits. Financial institutions must ensure that problem credits are not solely managed by the originating credit officer or team.

b. Definition of problem credits

4.4 The Bank wishes to clarify that credits which are deemed to have experienced a significant deterioration in credit risk, whether due to counterparty-specific factors or those relating to macroeconomic and sectoral considerations include credits classified as Stage 2 under the MFRS 9.

5. Independent credit review

> **Industry feedback**
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> Financial institutions should be given the flexibility in determining the structure that can best demonstrate the effectiveness of the independent credit review (ICR) function, taking into consideration the size, nature of credit portfolio, governance arrangements and its business model.

The Bank's view

5.1 Since 2001, the Bank has accorded flexibility for the ICR function to be housed under Internal Audit as a temporary arrangement. This flexibility recognises the resource and talent constraints faced by the industry then. Over time, improvements have been observed in the talent supply within the industry that would enable dedicated resources to undertake post-approval credit reviews.

5.2 The Bank is cognisant of the various ICR structures in the industry currently and views that flexible ICR structure can be allowed subject to the financial institution demonstrating that the ICR's objectivity and effectiveness are preserved at all times (refer to paragraph 17 of the *Credit Risk* policy document).

5.3 In this regard, a financial institution must ensure that the ICR is undertaken by competent staff who are independent from credit origination and approval functions to avoid conflict of interest. The ICR function must have direct access to the Board Risk Committee and Board Audit Committee as well as the senior management to escalate issues and findings to prevent suppression of information. The Bank also reiterates that the ICR function, which forms part of the credit risk management process, must be subject to internal audit assessments, even if it is housed within the Internal Audit department.