

Banking Institutions' Provisioning Practices to Mitigate Elevated Credit Risk from the Pandemic

Banks faced considerable challenges in updating their assessments of credit risks and determining the appropriate level of provisions against expected credit losses (ECL) during the COVID-19 pandemic. Elevated levels of uncertainty have required banks to continuously reassess the reasonableness of forward-looking economic indicators embedded in ECL models. This has been further compounded by difficulties faced to ascertain the actual deterioration in borrowers' repayment capabilities, particularly among borrowers enrolled under the various repayment assistance programmes, due to the absence of more current repayment data.

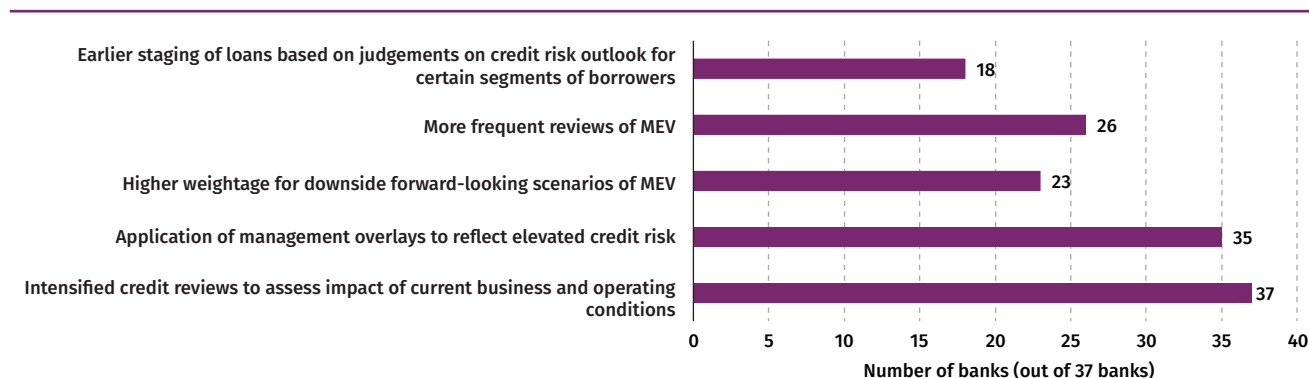
Reflecting these challenges, the Bank formally communicated its expectations of banks to exercise appropriate discretion in the application of accounting and regulatory capital standards in relation to ECL and the definition of default respectively. This took into account the exceptional nature of the COVID-19 shock, and the mitigating effects of substantial policy support measures, including repayment assistance, aimed at helping borrowers bridge temporary repayment difficulties and thus, preserve their debt-servicing capacity over the life of the financing. Consistent with this, the Bank clarified that in the absence of other factors indicating a significant increase in credit risk, the extension of repayment assistance to borrowers affected by the pandemic should not result in an automatic transfer of their financing to Stage 2 or Stage 3 that would, in turn, require banks to make provisions for lifetime losses under MFRS 9. Similarly, the assessment of 'unlikeliness to repay' under the definition of default for regulatory capital purposes should not be based solely on borrowers taking up repayment assistance but should instead be based on a more holistic assessment of relevant indicators and information available on the borrowers.

Against this backdrop, this box elaborates how banks have adapted to the challenges faced in the assessment of credit risks, while ensuring the adequacy of provisions against elevated credit risks due to the pandemic. It draws insights from a thematic review conducted by the Bank in the second quarter of 2021 involving 37 banking institutions.

Banks have adjusted their provisioning and credit monitoring practices to account for the potential increase in credit risk amid lower borrower visibility

All banks have incorporated a higher degree of stringency in their provisioning practices (Chart 2.10). This has taken various forms, including the earlier staging of loans based on judgements about the credit risk outlook for certain borrower segments; subjecting management judgements to stronger oversight; more frequent reviews of macroeconomic variables (MEV) with higher weightages assigned to downside forward-looking scenarios; and adopting greater conservatism in the determination of management overlays to reflect the continued economic uncertainty. Credit monitoring processes were also enhanced by harnessing alternative data, such as data on payment transactions to compensate for the inability or delays in obtaining updated financial information on borrowers. All banks also intensified credit reviews of vulnerable corporate borrowers through frequent virtual engagements, focusing on changes in business and operating conditions to obtain a better understanding of the pandemic's impact on borrowers' profiles.

Chart 2.10: Banks' Provisioning and Credit Monitoring Practices to Account for Potential Increase in Credit Risk

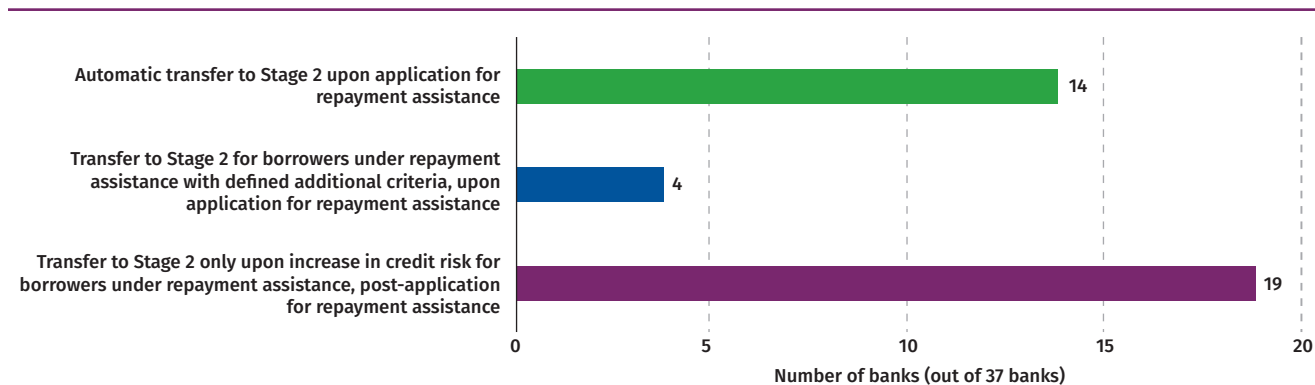


Source: BNM Survey to Banks

Staging classifications

For the retail portfolio, triggers used by banks to indicate a significant increase in credit risk remained reasonably prudent (Chart 2.11). Despite flexibilities provided for banks to make informed judgements on the relative importance attached to criteria normally used to indicate changes in credit risk, almost half (18) of banks covered under the review continue to consider repayment assistance as a key trigger for assessments of a significant increase in credit risk. For most of these banks, the approval of an application for repayment assistance automatically results in the transfer of the financing to Stage 2. In four banks reviewed, an application for repayment assistance would trigger a stage transfer for financing if it also met other indicators of heightened credit risks, such as pre-pandemic records of payment arrears, lower income levels and higher debt service ratios. In the remaining 19 banks, the assessment of a significant increase in credit risk for financing under repayment assistance is based on evidence of repayment behaviour during the repayment assistance period. However, in these cases, banks also consider the extent of a borrower's reliance on repayment assistance programmes to support debt servicing, for example, where requests are made by borrowers to further extend repayment assistance.

Chart 2.11: Banks' Staging Practices for Retail Borrowers under Repayment Assistance



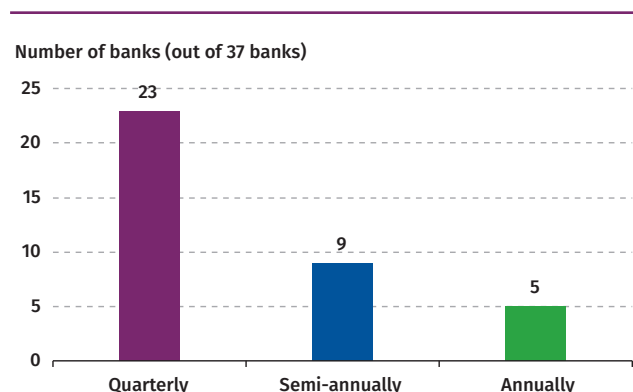
Source: BNM Survey to Banks

For the non-retail portfolio, staging classification practices remain largely unchanged from the pre-pandemic period. Borrowers continue to be assessed at the account level and are moved to Stage 2 or Stage 3 only upon observed evidence of a significant increase in credit risk. Banks with pre-existing policies that require the automatic transfer of rescheduled and restructured loans to Stage 2 have maintained practices consistent with these policies. Several banks were also more pre-emptive in classifying loans under Stage 3, resulting in higher provisions made for selected vulnerable corporates in economic sectors that were most impacted by the pandemic. Most banks have continued to observe the minimum period of sustained debt servicing by borrowers of no less than six months before allowing staging upgrades from Stage 2 to Stage 1 to take place. In all cases, staging upgrades are further subjected to additional reviews at the account-level to affirm that the borrower's debt-servicing capacity is likely to be sustained.

ECL models

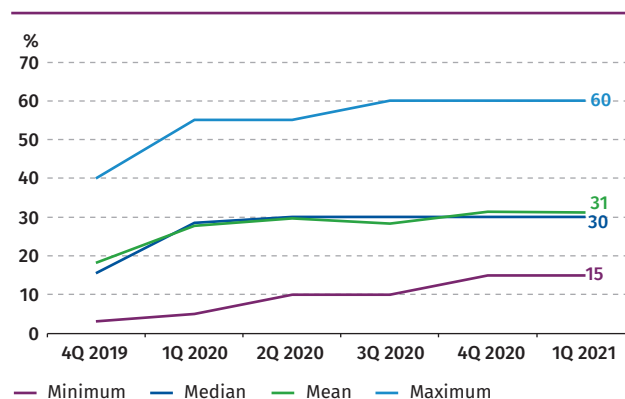
The majority of banks increased the frequency of revisions to MEV used in their ECL models, specifically GDP growth and unemployment forecasts, given the high and persisting degree of economic uncertainty experienced throughout the pandemic (Chart 2.12). Most banks also incorporated a higher degree of conservatism in their MEV forecasts relative to the pre-pandemic period, with a higher weightage (ranging between 15% and 60% across banks) applied to downside forward-looking scenarios (Chart 2.13). 14 banks further excluded probability of default data points in 2020 to mitigate data distortions caused by repayment assistance programmes. During this period, several banks have suspended any write-back of provisions based on ECL model outputs in order to preserve provisioning buffers against higher future expected losses.

Chart 2.12: Frequency of Revisions to MEV



Source: BNM Survey to Banks

Chart 2.13: Weightage for Downside Forward-looking Scenarios



Source: BNM Survey to Banks

Management overlays

The majority of banks have pre-emptively applied management overlays⁵ to bolster provisions for borrower segments judged to be of higher credit risk. This includes borrowers under repayment assistance and in economic sectors that have been more affected by the pandemic. The increased application of management overlays by banks reflects the higher uncertainties surrounding the determination of ECL estimates, as well as to provide additional buffers for borrowers under repayment assistance that could see a deterioration in credit risk going forward (including borrowers that remain in Stage 1). Cumulative management overlays set aside by banks currently represent about 40% of total provisions – the highest level since the implementation of MFRS 9. In the second quarter of 2021, management overlays provided by banks with significant retail exposures notably increased by an average of 34% in response to the successive expansion of repayment assistance programmes. In determining the quantum of management overlays, most banks apply higher probabilities of default and/or Stage 2-equivalent default probability assumptions for identified segments of borrowers under repayment assistance.

The pre-existing prudent provisioning practices of banks and adjustments made during the pandemic to account for the heightened level of uncertainty are expected to support the resilience of banks against potential risks of a significant deterioration in asset quality. Loan loss provisions are currently assessed to be adequate to buffer against conservative estimates of projected losses, including losses from exposures to sectors that have been more affected by the pandemic and more vulnerable borrowers that may continue to face difficulties servicing their debt when repayment support measures are gradually unwound. Banks are expecting to further increase provisions in the second half of the year following updated assessments of the impact of the FMCO and the extended duration of repayment assistance programmes. However, current buffers as well as projected earnings should enable banks to absorb such additional provisions. The conservative provisioning practices observed across banks provide further assurance that banks are reasonably well-positioned to withstand higher-than-expected credit losses in the event of more adverse credit developments.

⁵ Management overlays are additional provisions set aside on top of provisions derived from ECL models. It reflects adjustments to account for data deficiencies or uncertainties not adequately captured by the ECL models.