Mutuals Newsletter

March 2020

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Introduction

Coronavirus Pandemic

As crises and pandemics occur, appropriate preparedness and a proactive response can help your business navigate challenging times.

The recent outbreak of novel coronavirus (COVID-19) has introduced new challenges to the business environment which call for a measured, practical and informed approach from leaders.

The subjects below will help you understand your business' exposure to disruption caused by COVID-19, and could help you position your business to be more resilient.

- Building business resilience
- Supply chain disruptions
- Stakeholder management
- Financial reporting
- Liquidity assessments
- Funding solutions
- Legal implications
- Workforce mobility
- Cyber safety.

Please refer to the link below for more details in relation to these areas:

https://home.kpmg/au/en/home/insights/2020/03/business-implications-of-covid-19-coronavirus.html

In addition, it is also important for the Mutuals to stress test their loan portfolios in the time of crisis. In this newsletter, we will share with you steps and key factors to consider in stress testing a loan portfolio by KPMG Hong Kong, which has extensive experience in dealing with stress testing under pandemic scenarios.

Draft APRA Prudential Standard APS 117

APRA has been consulting on a revision to APS117 – its prudential standard for Interest Rate Risk in the Banking Book (IRRBB). The new standard is expected to take effect from 1 January 2021 and, for the first time, it will cover all ADIs.

The draft Standard imposes an IRRBB framework on all ADIs, effectively making explicit requirements that might otherwise be left open to interpretation in CPS220. Large ADIs already comply with many of these requirements, but smaller ADIs may need to adapt.

While many mutuals already have their IRRBB policies in place, the strength of adherence to the requirements still varies across the sector. APRA is therefore likely to use the opportunity of a new standard to harmonise the qualitative aspects of interest rate risk management. We anticipate four challenges that are likely to be particularly important for the mutual sector.

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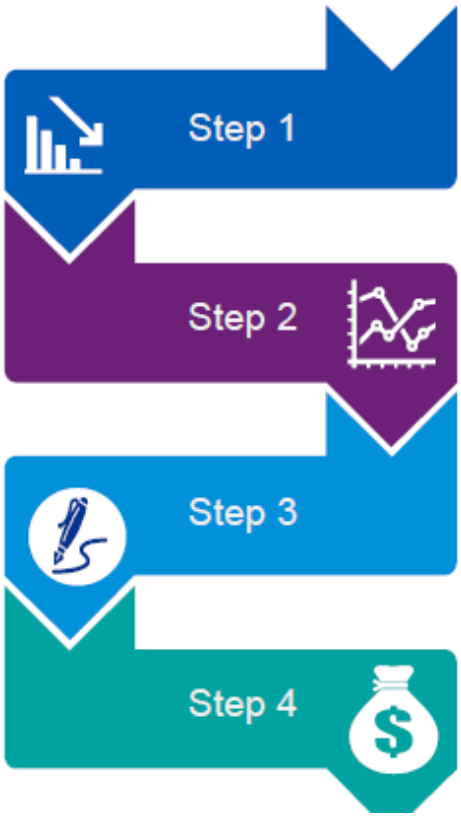
Stress testing loan portfolios during a pandemic

Loan portfolios may be abruptly impacted due to the coronavirus outbreak, which could lead to correlated increases in default risk, higher provision rates, and an overall increase in credit risk. We would recommend banks to run targeted stress tests to identify vulnerable credit, sectors and supply chains, and then take proactive action.

Quickly identify vulnerable credit and sectors



Stress loan portfolios

- Design scenarios (i.e. travel bans, supply chain shocks, retail shocks)
- Stress underlying cashflow and debt service ratios for all obligors
- Transmit impact to loan level probability of default (PD)
- Calculate expected loss and RWA for each loan
- Re-run simulation based on a range of scenarios and aggregate result

Simulate impact on IFRS 9 loan loss provisions

- Simulate stage transfers due to increases in credit risk
- Input updated macroeconomic forecasts into IFRS 9 models
- Update PDs and loss given default (LGD) based on simulation results
- Calculate IFRS 9 ECL for each loan

Identify vulnerable credit and sectors

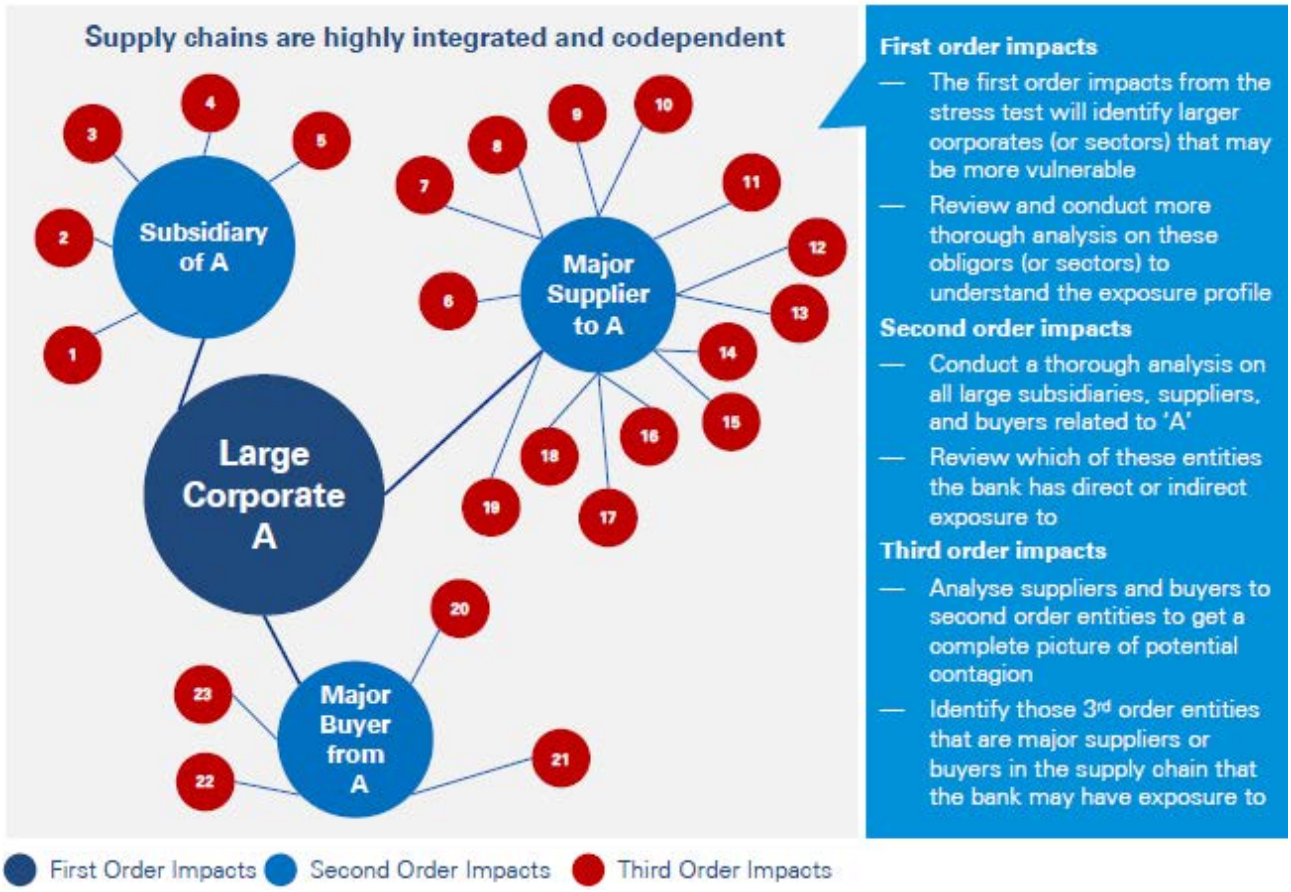
- Individually assess any loans where obligors appear highly vulnerable to hemorrhage cash as per the stress test results
- Sector analysis reviewing aggregated impact on RWA and IFRS 9
- Contagion impact and supply chain analysis for large corporates that appear more vulnerable, potentially leveraging new BELR analytics
- Review collateral and guarantees in place

Take early action preventative measures

- Proactively target customers and sectors that have shown to be weaker as per the stress test results
- Further refine relief measures based on target groups

Impact on supply chains could be highly correlated and severe

Disruptions to supply chain could last for many months according to some experts. It is important that the stress tests assist banks to identify vulnerable obligors that might be linked up to and reliant upon an entire supply chain ecosystem. The new HKMA requirements on Bank Exposure Limit Rules (BELR) require banks to conduct detailed analytics on supply chains (top suppliers and buyers) for large corporates. These analytics can be leveraged in the stress tests to identify which obligors in a given supply chain the bank has exposure to and how severe the impact might be. Other stress models that looks at contagion within industries/supply chains over multi-period stress events can be leveraged.



Source: *KPMG Hong Kong*

Draft APRA Prudential Standard APS 117

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The draft Standard imposes an IRRBB framework on all ADIs, effectively making explicit requirements that might otherwise be left open to interpretation in CPS220. Large ADIs already comply with many of these requirements, but smaller ADIs may need to adapt. They include:

- An IRRBB management framework that is clearly documented, articulates the ADI's risk appetite for IRRBB in both economic value and earnings, assigns accountabilities, and articulates responsibilities and reporting relationships to the Board;
- Board oversight of the IRRBB management framework;
- Active involvement of senior management in the implementation of the IRRBB management framework and policies with the executive committee;
- Sufficient resources dedicated to the management and measurement of IRRBB;
- An IRRBB risk management function;
- Assessment of IRRBB characteristics for new products;
- An IRRBB measurement system with comprehensive and detailed documentation;
- A stress testing program incorporating sudden changes in interest rates for both economic value and net interest earnings;
- Internal reporting of IRRBB exposures;
- Integration of the IRRBB measurement system into day-to-day risk management;
- Strict governance over the booking of the liquids portfolio;
- Comprehensive data collection as well as, testing and documentation that are transparent and verifiable; and,
- Independent review of the IRRBB management framework.

[1] A draft of the new standard is available here: https://www.apra.gov.au/sites/default/files/draft_prudential_standard_aps_117_capital_adequacy_interest_rate_risk_in_the_banking_book.pdf

Many mutuals already have these elements in place. But the strength of adherence to the requirements still varies across the sector. APRA is therefore likely to use the opportunity of a new standard to harmonise the qualitative aspects of interest rate risk management. We anticipate four challenges that are likely to be particularly important for the mutual sector.

- **Resourcing**. APRA expects risk management to have a strong and independent voice in relation to IRRBB. Not all mutuals have yet formed a clear second line risk function around interest rate risk management, and some will need to consider up-skilling, re-organising, or augmenting their resource base to meet expectations.
- **Board engagement**. Under the new standard, boards will need to play a visible and effective role in the management of interest rate risk. On boards where experience in interest rate risk could be deeper, training may be required.
- **Stress testing and limit setting**. All ADIs will need a comprehensive set of limits for both cash flow and economic value. Setting these limits is likely to prove challenging in the current low-interest environment. The prospect of negative interest rates will complicate stress testing and setting limits which cater for the risk of rising interest rates will be difficult to set at this stage of the business cycle.
- **Data and systems**. Good decision-making and oversight demands strong systems and reliable modelling. Many smaller ADIs will need to inject greater rigour into their modelling standards and handling of data. Where deficiencies exist in the underlying risk systems themselves, change is likely to be more extensive and it will need to begin sooner.

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