What's next: Beyond the PSAK 71 Series

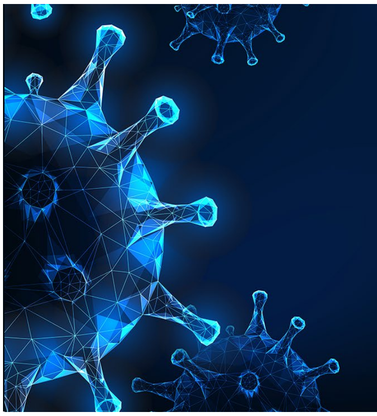
Companies are moving beyond PSAK 71 implementation

Under PSAK 71, risk management is governed in many ways. This includes using a principle-based quantitative approach, disclosing judgment calls, and considering interdependencies within the prudential requirements.

However, there is still much to do besides simply implementing PSAK 71, such as the economic management of expected credit loss (ECL) (e.g. refining product design, opting for shorter maturities to lower ECL, etc), methodical specifications (e.g. re-calibrating transfer criteria, adjusting the modelling of the tenor of exposure, specifying the liquidation strategy, etc.) and the interpretation of current economic trends.

Financial institutions (FI) and non-FI have dealt with the impact of applying PSAK 71 to their books and the requirements to further maximize the benefits of this exercise are gaining traction.

A lot of companies are using PSAK 71 as one of the triggers for a company-wide transformation in Risk and Finance. While this is an encouraging trend, the key questions remain the same. What is next? What should companies focus on after PSAK 71 implementation?



After three years of dealing with Covid-19, which has now become endemic, we have gained valuable insight into the upheavals in the financial markets. Stock markets have moved sharply and volatility has increased. Indonesia is now seeing only moderate economic growth, which has gone from 5.3% growth last year to just 4.9% in 2023. Domestic demand has been normalized following the post-pandemic jump last year, and experts have projected a global economic slowdown*.

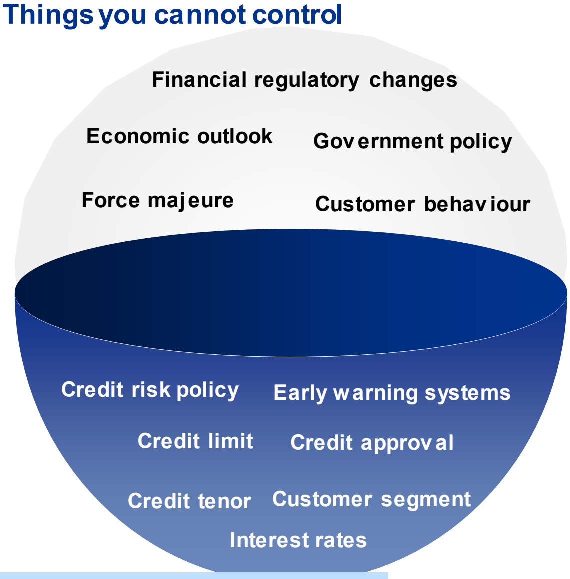
This is a golden opportunity to revisit critical areas for enhancement, aimed at providing stronger backing for institutions in executing their operational models. In this paper, we will elaborate on some of the key opportunities beyond PSAK 71 implementation that companies can tap into.

*Based on the World Bank's semi-annual Indonesia - Economic Prospects report, June 2023

1 Redefine credit products

Let's focus on what we can control to mitigate higher ECL!

Things you cannot control



Things you can control

Some of the key considerations for banks when reviewing internal business strategy and policy:

- Banks need to consider that the following factors have a higher impact on PSAK 71 when developing a new product or adjusting the characteristics of an existing product:
  - Collateral (secured vs. unsecured);
  - Maturity;
  - Customer segment;
  - Restructuring policy;
  - Product features (undrawn, prepayment, etc)
- Evaluate current portfolios according to their behaviors and establish a risk-appetite framework tailored to various segments, aimed at mitigating the risk and volatility associated with ECL.
- Assess customer behaviour based on their existing portfolio in stage 2 and 3 to help revise internal credit approval processes and policies.
- Incorporate forward looking components as early warning systems to monitor customer capacity and to give the bank a signal before the customer defaults.
- Redefine collateral disbursement & the collection process to reduce the impact of ECL if a customer defaults.

"Mitigating higher ECL is not only a risk management task, it also needs the collaboration of all parties from Business, Finance, and IT"

2 Redefine risk-based pricing

The general concept of risk based pricing is to reward good customers with preferable pricing and discriminate against the less creditworthy customers with less preferable pricing. There are two measurements of credit risk a company should consider before setting up its pricing components:

- Expected loss (the cost of business): Risk is incorporated into general provisions and can be estimated through Basel risk parameters.
- Unexpected loss (business risk): Risk is embedded in credit risk capital, and represents the potential volatility of actual losses relative to the probable level of loss.

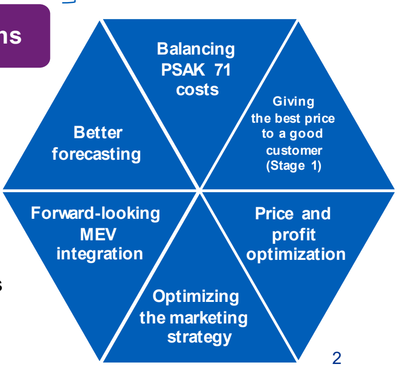
Pricing for investment instruments should also consider the risk premium (including the allowance under PSAK 71). Redefining the components of expected loss and aligning them with PSAK 71 figures that are more sensitive to economic conditions will help banks to be more proactive and competitive towards their customers.

1) Expected loss
2) Unexpected loss
3) Cost of funds
4) Direct/Indirect cost

Minimum pricing before the business unit margin

5) Business margins

Banks should consider incorporating an IFRS 9 model and shifting to **Risk-based Pricing.** This would have the following benefits:



3 Establish model risk management

Does your bank have appropriate governance?

Most banks have not developed models that can auto-calibrate to GDP figures of -2%, systemic loan payment holidays, loan forbearances, and extreme volatility in the financial markets. This therefore gives rise to the following questions: Are risk models still reliable during a crisis? What actions should be taken given their widespread usage in risk management, pricing, financial reporting, and business decision-making?

Additional governance and controls should also be put in place over modified processes and adjustments that may have been implemented to address deficiencies in the current model in this crisis.

Key components of a best-practice model management framework

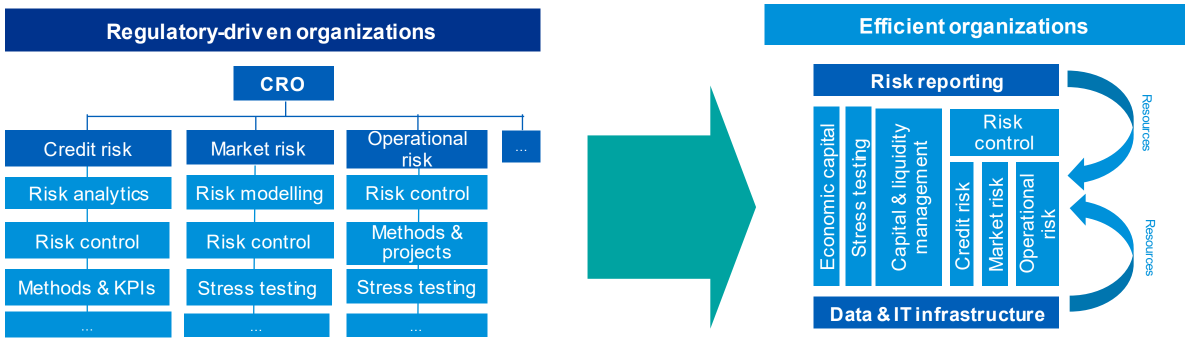
1	Governance	▪ Senior management oversight ▪ Clear definition of roles and responsibilities ▪ Escalation procedures ▪ Independent model validation and internal audit review
2	Model risk culture, strategy and appetite	▪ Instill an awareness of model risk across the organization ▪ Model strategy and approach ▪ A risk appetite framework ▪ Limits and early warnings signs for KRIs
3	Policies & procedures	▪ Develop policies and processes to evaluate and manage the exposure of the model ▪ Review and update internal documentation frequently ▪ Provide employees internal documentation for ongoing use to support model management

It is important to embed an appropriate risk culture throughout an organization. Usually, the risk function is responsible for writing a bank's model management framework. However in practice, it requires significant effort and accountability across the whole organization.

4 Establish Risk function transformation

Many banks used the time after the first wave of COVID-19 to assess the **status quo** and their aspirations for their risk function in terms of both **effectiveness and efficiency**, and to inform a strategic discussion of risk-targeting operating models in a disruptive future. This has helped CROs define **"red lines" of effectiveness**, in some cases leading to a reduction in the service catalogue, a re-calibration of the three lines of defense model, and a sharpening of the functional mandate. At the same time, CROs are identifying and prioritizing an increase in the **levers of efficiency** – especially in areas like risk reporting, data management, or process management.

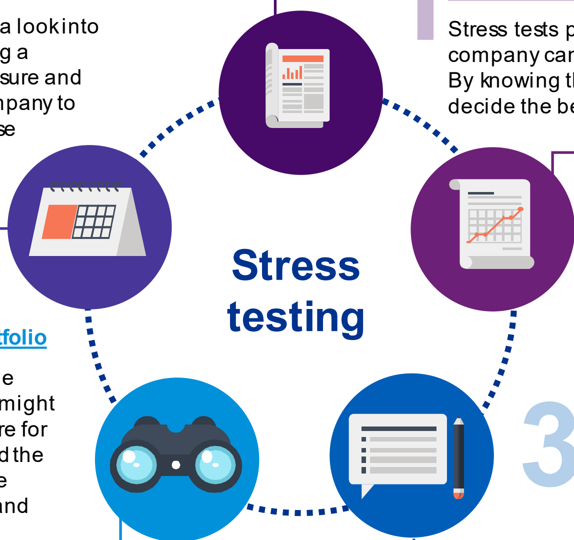
KPMG practitioners world-wide have observed that several economic and market challenges have put pressure on FI's CROs to increase their function's efficiency, whilst maintaining unprecedented levels of effectiveness. We have also done a survey on CRO transformation agendas that provides transparency to global risk leaders and financial services experts about the status quo and industry trends when preparing risk management plans for 2030.



5
Update Stress Testing Framework

What action can we take from the results of the stress test?

Banks may be abruptly impacted, especially in their loan portfolios, due to downturns in the economy, which could lead to correlated increases in default risk, higher provision rates, and an overall increase in credit risk. It is advisable to enhance stress tests to effectively pinpoint areas of vulnerability within credit, sectors, and supply chains. Subsequently, these insights can be leveraged to take proactive measures.



1 Assessing the capabilities of the entity under harsh conditions

Stress tests provide insights into how well a company can do in a harsh economic environment. By knowing this information, management can decide the best course of action for their company

2 Capital budgeting

Management can propose and budget the appropriate amount of capital, adjusted to forecasted macroeconomic variables, based on how well a company can do under adverse conditions.

3 Design risk appetite and risk profile

A stress test can be one of the factors in formulating a risk appetite and risk profile. For instance, to anticipate future economic downturns, the company can increase their risk appetite and focus on surviving for the long term

4 Managing the asset portfolio

Based on the results of the stress test, the company might manage their risk exposure for their asset portfolio to find the optimal portfolio given the company's risk appetite and profile.

5 Contingency planning

Stress tests provide a look into the future concerning a company's risk exposure and the ability of the company to survive under adverse conditions.

6
Business & capital planning

PSAK 71 may indirectly impact the capital calculation under Basel III.

As both Basel III and PSAK 71 measure credit risk, PSAK 71 models can impact the calculation of the minimum capital requirements. With the implementation of PSAK 71, the off-balance-sheet items of the entity will generate provision figures. Additionally, uncommitted instruments that adhere to regulatory definitions might be subject to PSAK 71 allowances. This, in return, may result in a decrease in RWA. Companies are recommended to re-assess their assets. For instance, strategic decisions should be made concerning off-balance sheet items, target markets, and other related items.

Changes in a company's asset portfolio and capital adequacy can impact their business returns. Therefore, they may need to adjust their business strategy. Changes to the composition of a company's asset portfolio and to their types of customers in turn may change capital adequacy and capital planning for the bank. Macro-economic variables may become one of the factors in calculating capital planning.

In KPMG's Capital Planning Cycle, segregated planning functions need to be merged into an integrated approach.

Finally..

PSAK 71 can prompt banks to have a more robust risk management system and better business capital planning.

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