

# Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



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## SPI Secretariat Note On Italian Experience with the Loss Given Default Database

The present note outlines the main points of the document (attached) sent by the SPI project technical anchor (Italian Banking Association) on the Italian experience with setting up the loss given default (LGD) database. **The following considerations represent a useful reference for the local stakeholders in designing a LGD database according to banking industry needs and in line with regulatory requirements.**

### I. LGD Database General Approach

The LGD database approach should take into account a **dual perspective**:

- **Regulatory**, with the objective of identifying models that are consistent with the new regulations of the Basel Committee, therefore making them suitable for use in the Advanced Internal Ratings Based Approach –AIRB;
- **Managerial**, with the objective of providing valid reference frameworks that can also be applied, albeit in a simplified version, by those banks which, out of necessity or choice, will not adopt, at least initially, an Advanced Internal Ratings Based Approach.

*For more information see Chapter Two “The model for the LGD estimate”, section 2.1. “LGD in the context of the model for the management of risk”.*

### II. The Models for Calculating LGD

The following approaches are possible for calculating the LGD:

- **Deterministic approach**, which has the advantage of simplicity, but it is not free of problems regarding the approximate nature of the results produced;
- **Stochastic approach not correlated with the PD**, which explains the variability of the observed recovery rate as much as possible;
- **Stochastic approach correlated with the PD**, which assumes that there is a correlation between the recovery rates and the credit rating of the client.

**The approach embraced by ABI**, which is useful for both regulatory and management purposes, is based on the deterministic approach (since the stochastic approaches require massive resources in terms of quantity and quality).

*For more information see Chapter Two, section 2.2. A comparison of the “families” of models, distinguishing characteristics, differences and consistency with the real situation in Italy.*

### **III. Factors Influencing the LGD**

In the event of a debtor default, the amount actually recovered by the bank depends on a number of different factors:

- 1) The presence of securities, collateral or guarantee.**
- 2) The elapsed time between the onset of the default condition and the partial or total recovery of the amount lent** entails a financial cost that depends on the level of market rates.
- 3) Bankruptcy procedures and/or a bank’s internal credit-recovery procedures** entail costs that contribute to reducing the effective recovery of the credit.

*For more information see Chapter Two, section 2.3. Estimating the loss given default. The document provides LGD estimates for both non-secured and secured claims and also outlines the use of LGD in forecasting and how to integrate administrative costs in LGD estimation.*

### **III. The Architecture of the Database**

The database presented is articulated in three archives that are differentiated in logical terms:

- 1. The first archive contains all the information on the counterpart** that would be useful to repeat on every exposure referring to that same client. The indications include the status of the counterpart kind of default (both in terms of non accrued status/bad loans and from the Basel perspective). The key, therefore, is given by the identifier of the counterpart, linked with the ABI code, in the case of a centralized database (DB) centralized at the group level or in cases of data pooling.
- 2. The second archive contains the information on the securities (guarantees + collateral)** collected and on the related recovery flows generated. Given that the guarantees can be either specific or generic, there must be a link both with the identifier of the counterpart (always filled in) as well as the guaranteed exposure (missing in the case of the blanket guarantee).
- 3. The third archive holds the data on the exposures**, indicating the respective types, the detailed accounting positions and any actions undertaken towards recovery.

A monthly refresher of the three archives was planned, to be carried out under the following procedures:

- for the first archive (registry), a monthly record of data is collected for each counterpart;

- for the second archive (securities), a monthly record of data is collected for each security;
- for the third archive (exposures), a monthly record of data is collected for each type of exposure.

The structure has been selected on account of its high level of generality, which makes it possible to estimate both parameters necessary for the *IRB Advanced* approach and others used for purposes more closely tied to operations.

The creation of a data-pooling mechanism on a national level also involves selecting from among the fields belonging to the data structure proposed on the company level those which:

- represent minimum information to estimate LGDs (in other words, to minimize the burden of reporting for the participants);
- are characterized by the maximum possible precision and objectivity, prerequisites that are indispensable for the construction of a shared database containing qualitatively optimal data.

*For more information see Chapter Five “The architecture of the data structure”.*