

Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



TERMS OF REFERENCE

Joint Project: Lending Databases **Module 1: Mortgage Loan Servicing Database** **Module 2: Loss Given Default Database**

Project Co-Owners:

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Technical Anchor (TAN): Italian Banking Association

I. Background

The SPI Committee approved at its first meeting from September 2006, the undertaking of two database projects:

- Mortgage Loan Servicing (MLS) Database (to be finalized by March 2007) – proposed jointly by the RBA and NBR, whose ownership was subsequently assumed by RBA;
- Loan Loss Given Default (LGD) Database (to be finalized by June 2007) – proposed by the NBR.

The two related database projects are relevant to both banking industry and NBR as they can facilitate the implementation of the Basel II requirements, improve risk management, and enhance the tools for monitoring financial stability. Given the commonalities in terms of purpose and informational and technological requirements, it would be advisable to run the two database design and implementation modules in parallel in order to achieve the best learning and implementation synergies.

In order to ensure a coordinated approach, the Project Management Group (PMG) will be common. Each module will be assigned a separate project working group (PWG), whose composition will be determined based on the specificities of the module. The day-to-day activities of each of the two PWGs will be led by the common Project Managers (PM) and a dedicated Deputy Project Manager (DPM).

The present TOR outlines a consolidated approach that could be used in order to make the proposed databases an operational reality.

Background information Mortgage Loan Servicing Database (Module 1):

Basel II Capital Accord provides that loans fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, can be risk weighted at 35% (instead of 50%). In order to apply the 35% risk weight to loans for residential purposes, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, also based on the default experience for these types of exposure.

In parallel, Basel II provides that, in exceptional circumstances for *well-developed and long-established markets*, the mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises may have the potential to receive a preferential risk weight of 50% (instead of 100%) for the part of the loan that doesn't exceed the lower of 50% of the market value or 60% of the mortgage lending value of the property securing the loan. In order to apply this risk weight, two conditions have to be fulfilled: i) losses stemming from commercial real estate lending up to the lower of 50% of the market value or 60% of loan-to-value based on mortgage-lending-value must not exceed 0,3% of the outstanding loans in any given year; ii) overall losses stemming from commercial real estate lending must not exceed 0,5% in any given year.

The application of this more favorable regime for loans secured by mortgages would decrease the capital requirements and, most probably, also lending costs. In order to benefit of the New Accord on Capital provisions, the banking system should create and maintain an industry database that allows the calculation of the following ratios: default rate and recovery rates for loans secured by mortgages on residential real estate and, if endorsed by the National Bank of Romania, also on commercial real estate whose guarantee value is up to 50% of the market value respectively. The database should gather also information on the real estate market (market values of real estate properties).

Background information Loss Given Default Database (Module 2):

Loss Given Default (LGD) is an important credit risk exposure data requirement under Basel II, indicating the magnitude of the likely loss on the exposure, given key transaction characteristics such as the presence of collateral and the degree of subordination. Under the foundation methodology, LGD is estimated through the application of standard supervisory rules (the starting point proposed by Basel II is a 45% LGD value for most unsecured transactions and a 75% LGD applied to subordinated exposures). In the advanced methodology, the bank itself determines the appropriate LGD to be applied to each exposure, on the basis of robust data and analysis which can be validated both internally and by supervisors.

Thus, a bank using internal LGD estimates might be able to differentiate LGD values on the basis of a wider set of transaction characteristics (e.g., product type, wider range of collateral types) as well as borrower characteristics, potentially being able to reduce its capital requirements. However, banks wishing to use their own estimates of LGD will need to demonstrate to supervisors that they can meet requirements pertaining to the integrity and reliability of these estimates.

In order to comply with these features of the Basel II framework, the banks should set up a database containing loan-specific data, including transaction and cash flow information that would enable users to more accurately quantify the unique characteristics of loan credit risk. The LGD database would also provide a rich repository of loss experiences as most banks will not have enough internal observations to draw any meaningful conclusions.

In addition to its Basel II related functions, LDG is also a useful tool in assessing the adequacy of provisioning in the day to day management of the credit risk and provides to the authorities information that is relevant for financial stability monitoring purposes. At present, the National Bank of Romania developed only a model for corporate probability of default (PD), but the LGD was not yet approached. There is no evidence on whether the banks maintain individual LGD databases.

II - Objectives

To prepare a set of recommendations on the consensus-building, practical and technical steps that the banking system will need to take in order to set up databases that address mortgage loan servicing and loss given default information requirements. The preferred option is the purchase and adaptation of off-the-shelf solution(s). Should the alternative of designing a custom-made database be considered necessary, this assessment should include aspects on the consensus-building and technical steps (including “governance” of the actual development and management of the database) that would make the project a reality in a cost-effective manner and a useful timeframe. In addition, the LGD database set up will be supported by regulatory impact outlining the potential benefits for the banking industry.

III – Intended Strategy

The project management group (Project Owners, Project Manager, Deputy Project Managers supported by the SPI Secretariat) acts based on the mandate received from the SPI Committee to deliver the objectives of the projects. The two database modules will be run in parallel in order to achieve the best learning and implementation synergies.

The PMG will ensure that the PWG members will have a meaningful representation, as follows:

Module 1 (MLS database)

1. experts from RBA Lending, Reporting and IT Technical Committees and from the National Bank of Romania, Regulation and Licensing Department, specialized in Basel II issues;
2. representatives of the real estate market data providers (to join the PWG at a further stage, as invited by PO/PM from the data providers identified by PWG).

Module 2 (LGD database)

1. experts from RBA Lending, Reporting and IT Technical Committees;
2. experts from the Financial Stability and Supervision Departments of the NBR.

In order to facilitate a common understanding and a smooth and efficient solution-finding process by the PMG, the SPI Secretariat/Convergence will:

- a. organize a workshop presenting relevant international banking industry experience in setting up and managing MLS and LGD databases and outlining possible options for local implementation;
- b. invite, on RBA's behalf, the Big Fours to provide domestic technical management assistance for the two modules of the project;
- c. explore the possibility of identifying a Technical Anchor (TAN) with extensive knowledge and experience in MLS and LGD databases to help the PMG set out a methodological approach for the two database modules; define the collaboration between stakeholders and outline their possible areas of contribution; and provide guidance on reaching the technical solutions.

The working hypothesis is that the identification of a market solution would be preferable to the design of custom-made databases. Therefore, to start with, the banks and the NBR should enquire on the existence of vendor-provided and managed databases. Each DPM will prepare a set of relevant documents to be shared with PWGs members consisting of:

- a. a summary document on the workshop discussions prepared by the SPI Secretariat to facilitate the transfer of knowledge;
- b. a document provided by NBR outlining the results of inquiries with other central banks on their experience with off-the-shelf MLS/LGD databases;
- c. a document prepared by the SPI Secretariat centralizing the contributions of individual banks on the experience of their parent entities with off-the-shelf MLS/LGD databases.

Each PWG should assess the features offered by these market solutions and their adjustment needs to the Romanian market realities, indicating the preferred option. The DPMs will communicate the options found to the other members of the PMG, which will analyze the feasibility of a solution that accommodates the requirements of both modules. Based on the findings of this analysis, the PMG may decide on how to structure and prioritize the activities of the two PWGs:

- if a common market solution is identified, the PWGs will prepare a single feasibility study for the preferred option;
- if a common market solution can not be defined, the PWGs will prepare separate feasibility studies for the two modules.

The PWGs will prepare an interim report for the RBA Board, presenting the off-the-shelf solution(s), together with its (their) corresponding costs and benefits (as outlined in the feasibility study(s)).

Should the RBA Board decide to go further with the off-the-shelf option(s) databases, the PWG will prepare a document(s) on the implementation phases, the main governance principles and rules to be followed in the database(s) management and on the ways of creating and maintaining cooperation relationships with potential data providers (e.g., the real estate market providers for MLS database). In case the PWGs will work on two off-the-shelf solutions, the PMG will ensure that the two modules are run broadly in parallel to achieve learning and implementation synergies.

Should the RBA Board decide that a custom-made database solution should be pursued, the PWG will prepare a feasibility study showing the major technical characteristics, the implementation phases and estimated length, the estimated costs, and will design the

main governance principles and rules to be followed in the database management and the cooperation relationships with the potential data providers.

Following RBA discussion, the PMG will prepare a summary document for SPI Committee consideration.

IV- Methodology: from kick off to the accomplishment of the project

Preparation of PWG 1st meeting (PM/DPM and SPI Secretariat) - November 15 – January 31

In order to facilitate a common understanding and a smooth and efficient solution-finding process by the PMG, the SPI Secretariat/Convergence will:

1. organize a workshop presenting relevant international banking industry experience in setting up and managing MLS and LGD databases and outlining possible options for local implementation;
2. invite, on RBA's behalf, the Big Fours to provide domestic technical management assistance for the two modules of the project;
3. explore the possibility of identifying a Technical Anchor (TAN) with extensive knowledge and experience in MLS and LGD databases to help the PMG set out a methodological approach for the two database modules; define the collaboration between stakeholders and outline their possible areas of contribution; and provide guidance on reaching the technical solutions.

The PM/DPMs/SPI Secretariat will request banks to ask their parent banks on the existence of vendor-provided and managed databases in the respective countries. TAN will be consulted on the detailed questions to be addressed: the provider, cost, time-frame for implementation, size of the managed databases, etc. In parallel, SPI Secretariat will ask NBR to approach ECB and other central banks in order to find information on the existence of vendor-provided and managed databases in the European banking system that are suitable from a supervisory point of view.

PO/PM will send to the PWGs members the SPI Committee Mandate Letter together with the following documents before the PWG 1st meeting:

- i. a summary document on the workshop discussions prepared by the SPI Secretariat to facilitate the transfer of knowledge;
- ii. a document provided by NBR outlining the results of inquiries with other central banks on their experience with off-the-shelf MLS/LGD databases;
- iii. a document prepared by the SPI Secretariat centralizing the contributions of individual banks on the experience of their parent entities with off-the-shelf MLS/LGD databases.
- iv. Draft TORs prepared by SPI Secretariat and endorsed by PO and PM/DPMs.

PWGs 1st meeting - mid February 2007

1. PWGs members discuss the summary document on the workshop, outlining the main features of the possible options;
2. PWGs members discuss the summary documents regarding the results of the investigations on the ready made solutions available/used in other countries;

3. PWGs members choose a preferred off-the-shelf solution, based on the adjustment needs to the Romanian market realities, and prepare an outline of a feasibility study;
4. PWGs members agree on TORs prepared by SPI Secretariat and endorsed by PO and PM/DPMs.

Follow up: PMG Meeting

PMG will discuss the solutions identified by the two PWGs and will ask for TAN opinion on a possible unique solution to accommodate the requirements of both modules.

Based on the findings of this analysis, the PMG/TAN will decide on how to structure and prioritize the activities of the two PWGs:

- if a common market solution is identified, the PWGs will be asked to prepare a single feasibility study for the preferred option;
- if a common market solution can not be identified, the PWGs will be asked to prepare separate feasibility studies for the two modules.

PM/DPMs will communicate the decision to PWGs members asking them to prepare the feasibility study/studies for the preferred off-the-shelf solution(s). The individual contributions will be sent to PM/DPMs/SPI Secretariat.

The PM/DPM/SPI Secretariat will prepare an interim report for the RBA Board and SPI Committee, presenting the feasibility of the off-the-shelf solution(s), together with its (their) corresponding costs and benefits (as outlined in the feasibility study(s)).

March, interim report presented to SPI Committee

The interim report will have to be sent to RBA Board for prior approval.

A. Should the RBA Board decide on the pursuit of the off-the-shelf solutions

PWGs 2nd meeting - mid-March

1. PWGs members acknowledge the RBA Board decision on the preferred solution(s);
2. PWGs members discuss the main governance principles and rules to be followed in the database management; the implementation phases of the project(s) and cooperation relationships with the real estate market providers and any other potential data providers;
3. PWGs members prepare outline(s) of an implementation paper(s) to present the agreed main governance principles, implementation phases and the cooperation relationships with data providers.
4. PM/DPMs establish **homework** for PWGs members: draft specific sections of the paper and send them to PM/DPMs/SPI Secretariat.
SPI Secretariat will centralize the individual contributions and send consolidated position papers on the implementation of the database projects.

Follow up: PMG meeting

In case of two off-the-shelf solutions, PMG will consult on the governance principles and rules in managing the databases and the implementation phases of the projects so as to ensure consistency between the two modules to be reflected in a single position paper.

PWG 3rd meeting - mid-April

1. PWGs members discuss and approve the position paper on the implementation of the database projects.

PM/DPM, with SPI Secretariat help, will finalize the position paper to be presented to the SPI Committee meeting.

B. Should the RBA Board decide on the pursuit of the custom-made solution with SPI Committee endorsement

PWG 2nd meeting - mid- March

1. PWG members acknowledge the RBA Board decision on the preferred solution and the SPI Committee guidance;

2. PWG members indicate the major technical specifications, implementation phases and types of costs involved;

3. PWG members prepare an outline of a feasibility study for this solution;

4. PM/DPM establish **homework** for PWG members: prepare the feasibility study for the custom-made solution. The individual contributions will be sent to PM/DPM/SPI Secretariat.

SPI Secretariat will prepare a centralizing document presenting the findings of the feasibility study and circulate it to PWG members before the PWG 3rd meeting.

PWG 3rd meeting - mid - April

1. PWG members discuss and endorse the feasibility study prepared for the custom-made solution, outlining its costs and benefits;

2. PWG members discuss the main governance principles and rules to be followed in the database management; the implementation phases of the project and their major technical characteristics; the cooperation relationships with the real estate market providers and any other potential data providers;

3. PWG members prepare an outline of an implementation paper to present the agreed main governance principles, implementation phases and their major technical specifications, and the cooperation relationships with data providers.

4. PM/DPM establish **homework** for PWG members: draft specific sections of the paper and send them to PM/DPM/SPI Secretariat.

SPI Secretariat will centralize the individual contributions and send a consolidated position paper on the implementation of the database project.

PWG 4th meeting - mid - May

1. PWG members discuss and approve the position paper on the implementation of the database project.

PM/DPM, with SPI Secretariat help, will finalize the position paper to be presented to the SPI Committee meeting.

V- Output

PWG 1st meeting

- PWGs members choose the preferred off-the-shelf solution(s);
- PWGs members prepare the feasibility study/studies for the preferred off-the-shelf solution(s);

- PM/DPMs write up interim report to SPI Committee.

PWG 2nd meeting

- PWGs members prepare implementation paper(s) if the off-the shelf solution(s) is(are) chosen;
- or
- PWG members prepare the feasibility study for the custom-made solution.

PWG 3rd meeting

- PM/DPMs, with SPI Secretariat help, finalize the position paper if the off-the shelf solution(s) is(are) chosen;
- or
- PWG members prepare an implementation paper if the custom-made solution is chosen.

PWG 4th meeting

- PM/DPM, with SPI Secretariat help, finalize the position paper if the custom-made solution is chosen.

VI - Project Team

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Project Working Group

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