

Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



Technical Workshop on the International Experience with Lending Databases (Mortgage Loan Servicing and Loss Given Default Databases)

MINUTES December 19, 2006

The Technical Workshop on the “International Experience with Lending Databases” was held on Tuesday, December 19, 2006, starting at 9 am, at Romanian Banking Association premises, under the chairmanship of Mr. Radu Negrea, RBA Secretary General.

The Technical Workshop was attended by representatives of the banking industry, delegates from the National Bank of Romania, as well as members of the SPI project on the Mortgage Loan Servicing and Loss Given Default Databases (see Table 1 with list of participants).

The aim of the Technical Workshop was to help the local stakeholders build a common understanding on the two lending databases starting from existing international hands on experience on the matter presented by experts from the Italian Banking Association (ABI)¹. The technical workshop discussed a broad range of topic closely linked to the banks information requirements, as follows:

1. Public credit registries databases

It was outlined that two types of credit registries coexist in Italy, located at the Bank of Italy: a) a credit registry where financial intermediaries report negative information regardless the threshold as well as positive information on loans, guarantees, personal guarantees above EUR 77,469; b) a credit registry where only positive information is reported for loans from EUR 30,987 to EUR 77,469.

The public credit registries offer to participating entities three types of services: personalized feedback, statistical feedback, and information on request. Regarding the

¹ Ms. Claudia Pasquini, Research Department, Italian Banking Association and Mr. Angelo Peppetti, Credit Department, Italian Banking Association

statistical feedback provided, it was stressed that Bank of Italy provides a monthly transmission to each participant containing series of statistical distributions arranged according to individual reporting categories and classifying variables (by aggregation of categories and variables such as branches of economic activity, site of registered office of the customer, characteristic of the reporting entities and size of loans). This information can constitute for banks valuable benchmarks in calibrating their internal scoring systems.

2. Lending databases

ABI experts outlined that two database initiatives have emerged in 2001 at the level of ABI's inter-banking working groups: a) an operational risk database and b) a loss given default (LGD) database. ABI is also currently considering the setting up of a mortgage loan servicing database.

The first two database structures were meant to support both banks and regulators. Benefits in setting up the databases were perceived by small and big banks alike, as the former had no clear idea on how to structure internal data collection and the latter had insufficient data needed for operational risk or LGD purposes.

In both cases, Bank of Italy assigned observers, based on the idea that the central bank participation from the inception of the project would facilitate the further validation of the information generated by the two databases.

The setting up of the two databases was preceded by the following actions:

- awareness raising through articles and seminars, 1-2 years before launching;
- running “open” working groups which at a certain point turned into smaller project working groups;
- establishing operating principles of the databases:
 - clear rights and duties of the consortium members:
 - only who sends data receives outputs
 - ability to respect the deadlines
 - ability to undertake data quality self assessment
 - small governance bodies but “open to all” technical committees
 - flexibility of the outputs;
 - high standards of confidentiality (largely relying on ABI's reputation and encrypted data flows);
 - low costs.

Speakers outlined that the banking industry database initiatives are important because:

- i) time series of a single bank might not be deep enough;
- ii) external data are useful for any kind of operational risk internal models;
- iii) Bank of Italy – provided data might never be at the granularity level that banks need for their internal LGD estimation (given that internal data are not sufficient);
- iv) average figures coming from data pooling initiatives could be useful for banks to “better sell” their portfolios during a securitisation of non-performing loans.

It was stressed that only the operational risk database was actually set up, as the LGD database initiative failed following the Bank of Italy decision to take over the development of the database. The mortgage loan servicing database is still at project stage.

2.1. Operational risk database (DIPO)

The database was necessary to enable banks to do a correct capital allocation, by collecting data on operational losses. In this case, ABI is the only custodian of DIPO, which relies on output flexibility, scaling solution flexibility, and low costs (budget for 2006 estimated at around EUR 200,000).

The following infrastructure is used for the management of DIPO:

Steering Committee (composed of a limited number of representatives of member banks). By invitation Banca d'Italia takes part as an observer;

Technical Committees (whose areas of analysis and study are determined by the Steering Committee, and which are open to all members);

Technical Secretariat (composed of representatives of ABI).

In addition, each member must identify a *DIPO co-ordinator* whose duties include making sure that the minimum quality requirements are maintained: accuracy, timeliness and accountability.

The members have to:

- follow the rules established in the DIPO Manual, report and update the data on losses, exposure indicators and business lines, which are subject to reporting under the DIPO Manual;
- must develop a formal process for data collection within six months from signing the Articles;
- pledge to take all actions necessary to ensure the quality, completeness and timeliness of the data on operational losses (quality certification);
- when requested by ABI, carefully check their data and respond as quickly as possible to requests for verification of anomalies.

2.2. Loss given default (LGD) database

The LGD database initiative started with the issuance of a white paper for PD estimation. This database initiative stopped at the data collection stage, when Bank of Italy announced that it would like to take over the database in order to do make such data reporting mandatory, together with credit registry data.

The database structure was established starting from the following principles:

- i) in the event of a debtor default, the amount actually recovered by the bank depends on a number of different factors;
- ii) the presence of securities, collateral or guarantee, on a claim paid out reduces the loss prospects, generally leading to higher recovery rates than those for non-secured claim;

- iii) 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;
- iii) bankruptcy procedures and/or a bank's internal credit-recovery procedures entail costs that contribute to reducing the effective recovery of the credit;
- iv) a distinction must be made between secured claims and those that are not secured, given that the corresponding loss given default rates are influenced by different factors.

A working group has been set up to design an appropriate database structure. The structure of the database has been conceived taking into account the high level of generality, which enables the estimation of both parameters necessary for the *IRB Advanced* approach and others used for purposes more closely tied to operations.

The following lessons have been drawn from the LGD database initiative:

- 1) a broad involvement is needed from various stakeholders: banks, data custodians, regulators;
- 2) a certain period of time is needed (in this case one year) to get the right awareness and spirit of collaboration; this was made possible by giving a general view of the management issue (i.e., not only for capital requirements);
- 3) the identification of all potential uses was necessary from the beginning;
- 4) the identification of a (easy) common data structure, a clear domain and tools to get the data uniformly collected is needed;
- 5) clear rules (right and duties) have to be established from the beginning;
- 6) confidentiality has to remain at the forefront of designing the database infrastructure;
- 7) it was useful to standardise the input via common software;
- 8) the output flexibility is important.

Speakers outlined that the database working group had also to take a decision on whether to buy an off-the-shelf database solution or to conceive an own database application. For costs reasons, ABI has opted for the latter solution, entailing very simple software, and an interface that is not web-based (for confidentiality reasons).

2.3. Mortgage loan servicing database

Speakers stressed that the key elements for a successful database are:

- establishing a compulsory system for data collection;
- raising awareness on the importance of the database;
- strict supervision of database setting up and operating;
- avoidance of free riding;
- upfront agreement on the most important elements needed for data collection: definition of the value of real estate; location and nature of real estate (commercial or residential); rank of mortgage; time of default, etc.

Concluding Remarks

The representatives of banks stressed that, at present, the most important challenge faced by Romanian banks is the adaptation of their internal data collection systems in order to respond to increased needs for adequate information for the day-to-day risk management and to Basel II information requirements.

Therefore, banks welcome the lending databases initiative and hope that it will provide the necessary support in meeting their data needs. At the same time, NBR is interested to remain engaged in the process of designing the databases structure as the central bank will need to validate the information used for Basel II purposes and could also benefit from the information provided by the two databases for financial stability monitoring purposes.

The following recommendations were made in respect to the Romanian lending database initiative:

1. Banks should **start by understanding the benefits** of setting up the two databases. This could start from gathering each bank's perspective on the perceived benefits (possibly by performing a survey) and then developing a common vision on the benefits, followed by an awareness-raising campaign;
2. The databases set-up should be a **joint effort** by the banking community and the NBR in order to ensure consistency with the central bank requirements;
3. Once the specific data needs are clear, it is important to agree on a **uniform set of definitions** for data collection purposes;
4. The database project working group should then focus on thinking how to **design an uniform database structure** and at the practical implementation solutions;
5. The database project working group could also think on how to **enhance the use of credit registers' databases**.

In practical terms, speakers made the following suggestions:

- give to all members the same software in which both formal and logical controls should be embedded (this can be obtained by a web-based application or by client server applications);
- the transfer of encrypted data flows between custodian and banks should take place on a protected web site;
- the main database should be under the Romanian Banking Association responsibility;
- give to all members the possibility to use manual or automatic data feeding;
- give to members access to each section with no respect to the section to which they have contributed;
- give access to data only to members and do not sell the data.

Speakers outlined that they will remain open to provide the project working group with any necessary information.

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