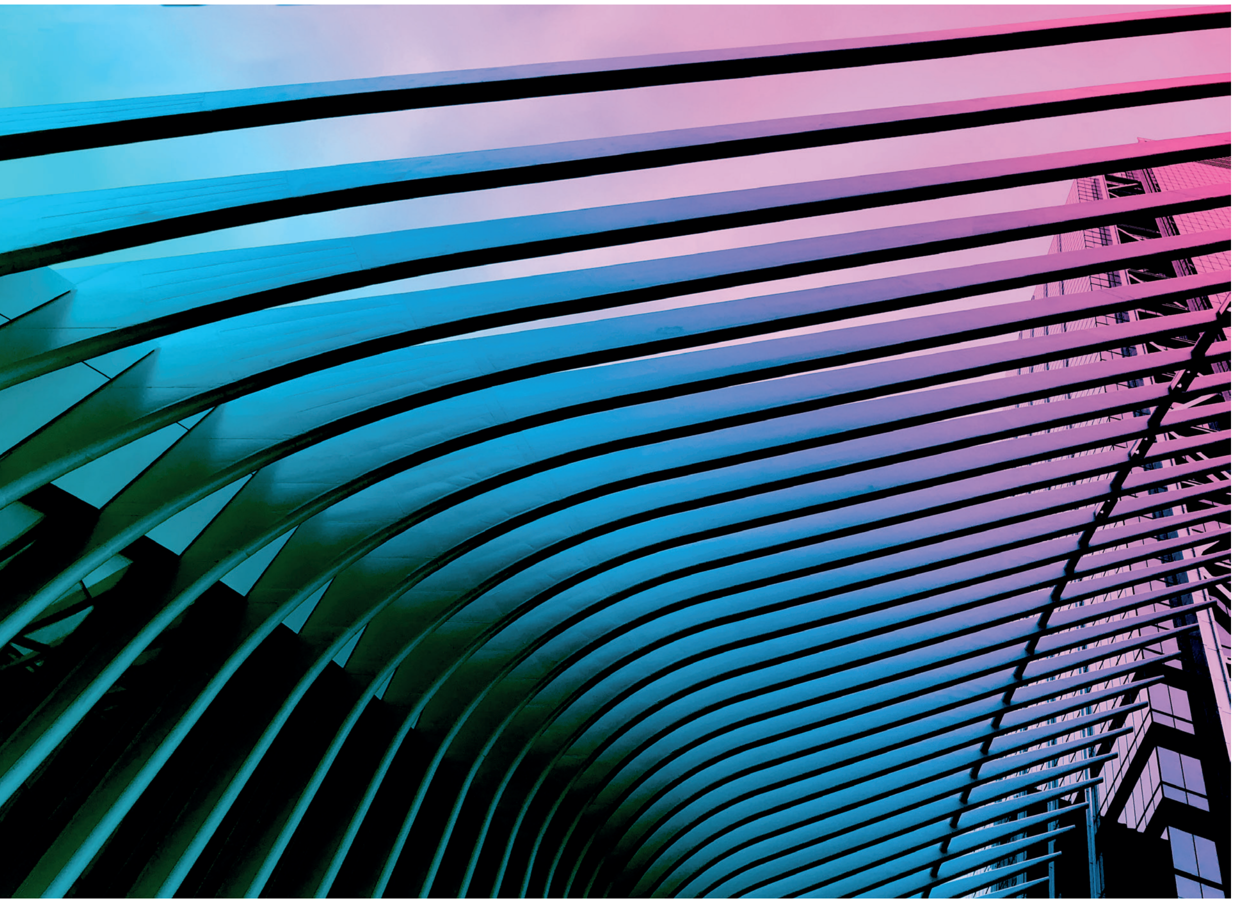

Addressing Credit Risk Uncertainty Through Collateral & Data

The importance of sound collateral management and data practices to manage loan loss uncertainty in the year ahead

Webinar Report

December 2020

Addressing Credit Risk Uncertainty Through Collateral & Data

Panellists at a recent *Regulation Asia* webinar highlighted the importance of sound collateral management and data practices to manage loan loss uncertainty in the year ahead.

In recent weeks, a wave of optimism has spread across global markets in response to the US election and promising vaccine news, boosting the share prices of banks that were hit badly at the onset of the Covid-19 pandemic.

Despite the adversities of the last few months, bank balance sheets have proven resilient, in large part due to regulatory reforms and policy tools developed in the aftermath of the 2008 global financial crisis.

Reforms such as loan loss provisioning under IFRS 9 and capital and liquidity standards under Basel III appear to have stood up relatively well in this first test of their efficacy. Meanwhile, governments worldwide have bolstered support to the banking sector through the widespread use of monetary and fiscal support measures.

However, it may still be too early to judge the longer-term success of these policy measures, as many of their impacts and unintended consequences may only become apparent with the passage of time, particularly as the full economic impact of the pandemic itself is yet to be felt.

Too early to judge

While more forward-looking loan loss provisioning standards under IFRS 9 have been hailed as an improvement on the older ‘incurred loss’ approach, questions remain over the standard’s pro-cyclicality, which can manifest in banks having to restrict lending at the very time when the economy needs it most.

Similarly, while higher standards of regulatory capital and liquidity placed the banks on a strong footing going into the current crisis, they have also contributed to lower profitability and flexibility compared to pre-2008 levels.

Easing monetary policy has generally resulted in lower interest rates and, combined with fiscal support for households and businesses, may have averted an economic meltdown. However, low interest rates have put pressure on net interest margins for banks, while debt moratoriums have obscured any real sense of NPL formation on bank balance sheets.

Some of these issues will require serious evaluation by policymakers on the other side of this health crisis, but they serve to remind us that we are not yet out of the woods.

A better picture

These themes were discussed in a recent panel hosted online by *Regulation Asia* and Broadridge, in which industry specialists seemed to agree that credit costs will likely increase in the year ahead.

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- Yves Tomballe
Chief Risk Officer
MUFG Bank Singapore

"I think it all really depends on when we will be able to see an end to the pandemic," said Yves Tomballe, Chief Risk Officer at MUFG Bank Singapore. "Even though we've now seen a couple of vaccines coming to market, the widespread availability of these vaccines and their effective rollout will probably not be complete until the end of 2021."

"If that is the case, I think we're in for a lot more volatility and a lot more negative results across the economy before we see a real uptick. And given that most governments have been infusing liquidity into the market and providing banks with incentives to lend, the removal of these benefits will be crucial to gaining a better picture of the increasing risk of defaults in the market."

Reflecting this view, a straw poll conducted during the webinar found that 55% of attendees were expecting an increase in loan defaults in the coming 12 months to have a moderately negative impact on their banking book. About 9% anticipated a severe negative impact, while 11% expected little to no impact.

The remaining 25% of respondents said it was too early to say what the impact on their loan books would be, reflecting continued uncertainty around the pandemic and how soon governments, central banks and regulators will start winding down support measures.

The underlying data

For the foreseeable future, banks will have to keep their credit exposures in sharp focus, engaging with clients to understand the impacts of the crisis on their business models and their expected responses to various recovery scenarios, given that the impacts of the pandemic have fallen unevenly on individual businesses and industries.

"This is the first real test of global financial systems since the 2008 crisis," said Luke Nestor, founder of Rockall Technologies, which was recently acquired by Broadridge. "It remains to be seen how well banks have adjusted their systems and capabilities to be able to handle this particular crisis."

In particular, as lenders brace themselves for higher potential defaults in the coming 12-24 months, Nestor highlighted the importance of establishing sound collateral management processes, with a focus on the underlying data that allows banks to obtain accurate valuations and project actual loan losses in detail.

According to David Sharratt, Chief Operating Officer at Commerzbank's China unit, the ability to access data that enables a bank to obtain true and close-to-real-time valuations of collateral, as well as visibility on where it is located, is important for two main reasons.

First, it helps banks to determine how quickly they can liquidate collateral, if they need to. "In 2008, everyone thought they were supremely collateralised, but when it came to the liquidation of the collateral, it suddenly became a very slow trade," Sharratt said.

"The secret is to build around those legacy systems with the best API technology you can develop to ensure that the core system still functions but everything around it is still modern."

- Luke Nestor
Founder
Rockall Technologies
- a Broadridge business

Second, better data and visibility on collateral enables banks to better serve their clients. It provides banks "the ability to help clients rebalance their collateral so that they are optimising the collateral that they hold from a balance sheet and funding perspective."

Giving life

This generally means a shift away from purely internal assessments of collateral towards a greater use of third-party inputs, and this fits within broader expectations from regulators on credit risk management and valuation practices.

Recent guidance from MAS (Monetary Authority of Singapore) as well as a revised prudential standard on credit risk management from APRA (Australian Prudential Regulation Authority) both emphasise a greater focus on collateral and valuation practices as one of the ways to enhance credit decision-making and to mitigate credit risk.

Unfortunately, most banks have been slow to develop the system architecture needed to facilitate more data-oriented approaches to banking book collateral management, which often constrains their ability to obtain accurate valuations and conduct ongoing monitoring of collateral.

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In a second webinar poll, inflexible legacy systems were cited by more than half (54%) of attendees as being among the main challenges they had with managing banking book collateral, followed by difficulties in monitoring changes to collateral (43%), then difficulties accessing or integrating data (40%).

"To remove a core banking platform is like open heart surgery," said Nestor, who for 30 years has been integrating credit and loan systems with decades-old core banking systems. "The secret is to build around those legacy systems with the best API technology you can develop to ensure that the core system still functions but everything around it is still modern."

A case in point is COLLATE, a collateral management platform Nestor developed, which allows banks to fully integrate the internal and external data sources needed to track and value collateral. The platform maps banks' credit risk landscape, providing a complete picture of loan exposures at any level of granularity, while still preserving data lineage for even the most complex of loans through the entire credit lifecycle.

"It is possible to give life to your legacy technology as long as you build good systems around it," Nestor said.

More information about Broadridge's approach to managing banking book collateral is available here.

Alternatively, you can watch the on-demand webinar here.