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Transparency for non-performing loans – Learnings from the ECB ABS Loan Level Initiative

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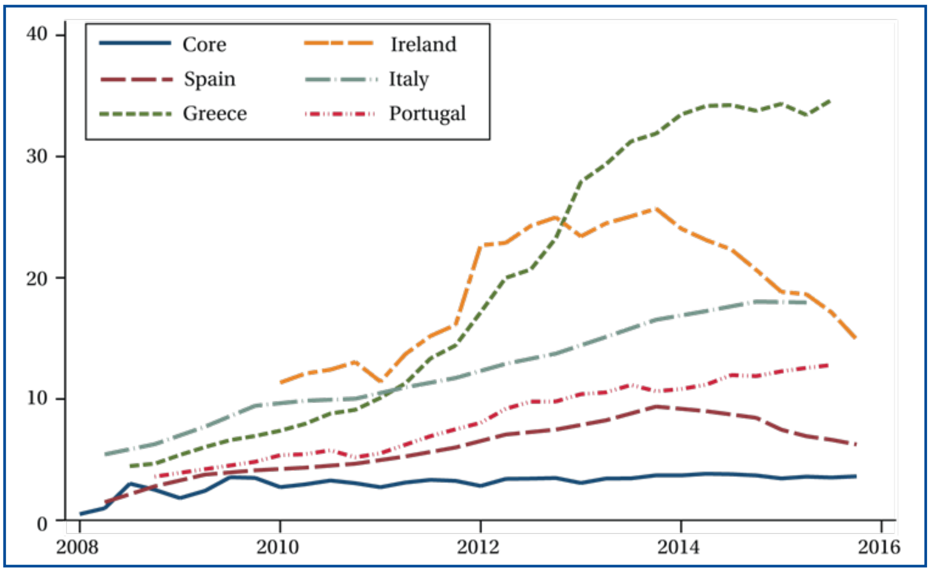
Abstract:

The level of non-performing loans (NPLs) in the books of many European banks continues to be an obstacle for the economic recovery in some European countries. Policymakers in the EU have recently made a renewed effort to address the NPL problem. Part of the solution is to improve transparency of NPL portfolios in order to mitigate asymmetric information and hence establish more efficient secondary markets for NPLs. This article provides an overview of current status and challenges for enhanced NPL transparency and summarises the lessons learned in the context of the ECB ABS Loan-level initiative.

Non-performing loans (NPLs) have recently again come to the forefront of a pan-European discussion on risks in the banking sector. While the focus in the media has been primarily on Italian banks such as Monte dei Paschi di Siena or Veneto Banca, NPL stock and developments across Europe (see figure 1) continue to concern European policymakers given the impact on bank balance sheets and their ability to lend to the real economy.

Figure 1. Non-performing loans (% of total gross loans)[1]



1 [Schoenmaker/Véron 2016, p. 20]

One aspect on which experts and policymakers agree is that there is still a lack of transparency and details of NPL reporting are rather patchy. The current data situation presents a real obstacle for a speedy resolution, specifically for the development of secondary markets for NPLs. According to European Commission Vice-President Dombrovskis, “high quality and comparable data on NPLs are indispensable for this, because investors need to know what they are buying”[2]. In this context, he asked the European Banking Authority (EBA) “to further investigate the possibility of issuing guidelines on NPL data standardisation”[3]. In addition, in July 2017 the Council of the European Union made transparency part of an action plan to tackle non-performing loans in Europe[4].

The need for enhanced transparency is driven by two key factors: First, for the development of secondary markets, transparency is not in itself the primary objective but rather a prerequisite for the provision of sufficient information for potential investors to close the bid-ask gap, which is currently jeopardising the development of an efficient secondary market for NPLs. Investors need to price in significant discounts in the absence of detailed information, which on the other hand makes it difficult for banks to obtain a price which is not too far from current book values. Second, while comprehensive asset quality reviews have been performed for many banks, enhanced transparency is still needed for supervision and policy making in order to get a better understanding of the potential severity of the NPL issue with a particular lender or the banking system as a whole.
As a general point, aggregated data will frequently not be sufficient to deliver the necessary level of transparency. Thus, loan level data is needed for a thorough assessment of the risk profile of a NPL portfolio.

The key challenges can be summarised as follows:

1. Historical lack of high quality and consistent data capture of the recovery and servicing efforts of banks and servicers leading to the need for conservative estimates in the NPL disposal process

2. Few participants have a database with accurate estimations of potential recovery values

3. Fragmentation across Europe given national reporting requirements driven by accounting and regulatory considerations. Moreover, insolvency and foreclosure laws vary significantly and lead to the specific challenge that the foreclosure status and timing is not easily comparable

The following paragraph looks at these challenges and the current status in more detail.

2 [European Commission 2017]

3 [European Commission 2017]

4 [European Council 2017]

Status and challenges for enhanced NPL transparency

1) Current framework and status – what is available

At this stage, there is no standardised pan-European NPL data template available. The EBA is currently undergoing some project work and it is expected that in 2018 such a template might be published. On the other hand, there are already a number of loan level templates which do include NPL reporting next to performing loans.

a) AnaCredit

Most prominent in this context are the reporting obligations for banks under the AnaCredit framework. AnaCredit includes specific data templates including a taxonomy which is applicable across Europe. The template is, however, not detailed enough to analyse loans with respect to exact recovery value and timing parameters. Moreover, given the start date in late 2018, there is not yet sufficient experience on data quality and consistency. In addition, the reporting obligations are, for the time being, only relevant for loans to legal entities.

b) ECB Loan-level initiative

The ECB's ABS loan level initiative triggered the creation of European DataWarehouse (ED) in 2012 as the first centralised data warehouse in Europe for the collection and dissemination of standardised loan level data for Asset-Backed Securities (ABS) transactions. Asset class specific templates include loan performance data and insofar also cover NPLs. As of July 1st, 2017, there were approx. 500,000 NPLs captured in its database. While ED has significant experience in managing loan-level data, the templates do not contain enough detailed information on NPLs in order to support NPL focussed transactions.

c) Rating agency templates

Some rating agencies have published specific templates for NPL transactions, either on a generic or country specific basis. While the templates provide more detail, they are not standardised and moreover do not cover reporting elements which are needed from a supervisory or policy perspective.

d) National reporting templates

Some jurisdictions have introduced national NPL templates. An example is the Bank of Italy NPL template with 57 data fields. Banks falling under the reporting obligation in Italy have to deliver completed templates on a semi-annual basis.

e) Asset manager or servicer specific templates

Some NPL servicers or asset managers have built up significant experience and use their own tailor-made reporting templates. These are typically very detailed on an asset class and country basis but cannot be easily standardised or used as a starting point for a pan-European template.

f) ECB guidance to banks on non-performing loans

ECB published in March 2017 their “Guidance to banks on non-performing loans”[5]. While it technically does not provide a loan-level template, the guidelines on NPL recognition and forbearance measures provide a blueprint for the development of a loan-level template based on the various regulatory (EU / EBA) as well as accounting standards (IAS / IFRS) in combination with specific guidance.

2) Challenges for NPL transparency

The overriding challenge for a standardised and efficient NPL template is the complexity inherent in NPLs themselves. While superficially it could be argued that certain loan or borrower specific data fields have become irrelevant once a loan has defaulted, in practice there are many nuances and the exact status of the loan (forbearance measures, status of legal proceedings etc.) plus the exact collateral situation require a significant number of data fields. In addition, there might be many loan and collateral combinations (e.g. 2 loans are secured by the same collateral but the collateral also secures a third unrelated loan) which necessitates data and identifier fields to make the various linkages transparent.

a) Fragmentation and national specifics for NPLs

Fragmentation across Europe given national reporting requirements is primarily driven by accounting and regulatory considerations. Moreover, insolvency and foreclosure laws vary significantly and lead to the specific challenge that foreclosure status, timing and likely recovery value are not easily comparable. While different reporting practices are also relevant for performing loans, for NPLs the differences are far greater. This fragmentation of reporting practices also makes it challenging to structure templates that achieve both a high level of comparability and a high level of detail needed in a national foreclosure environment.

b) Definition issues

The question what exactly characterises a non-performing loan is far from trivial. While the definition of “90+ days past due” is undoubtedly the most common measure, the interrelation between non-performing, default, impairment and “unlikely-to-pay” attributes is complex. The new ECB guideline issued in March 2017 gives a comprehensive overview and guidance on these relations. The guideline is, however, not universally applicable but primarily addressed to significant institutions (SI) under the Single Supervisory Mechanism (SSM). Insofar, it remains to be seen if a wider adoption will follow.

c) Focus on collateral and collection

Compared to a performing loan which will typically be valued at the notional or the fair value amount, NPLs have inherently much higher valuation variations given the larger number of factors that drive the valuations. This does not only extend to the collateral valuation but also timing, costs and expected cash flow elements. There will generally be a relationship between the number of relevant data fields and the accuracy of NPL valuations. However, given that some variables can only be estimated (such as e.g. foreclosure timing), even in the situation of fairly detailed and accurate data, there will be

5 [ECB 2017]

some margin of error. Another challenge is the existence of multiple loan and collateral combinations. Lenders must employ a detailed identifier system to link these combinations. For borrowers with multiple lending relationships, there is also the question how other lenders are secured, the relative percentages of NPLs and the workout strategy of other lenders.

d) IT setup, internal infrastructure and internal processes

From a practical perspective, this might be the biggest challenge as detailed data might not have been captured in the loan or collateral database. Moreover, data quality, specifically for collateral and recovery process, might be lower compared to other loan data fields. In order to achieve a high level of transparency, additional manual data capture might be needed, which will require decisions about the trade-off between more detailed transparency and the costs of obtaining such transparency.

Lessons learned in the context of the ECB ABS Loan-level initiative

Most of the challenges above were also relevant in the development of the ECB ABS loan-level initiative and European DataWarehouse (ED) as a designated repository has in the meantime almost 5 years of experience in this area. As part of its mandate, ED checks the collected loan level data for completeness and correctness and has developed a comprehensive data quality management system. The development of a customised loan level data quality system was vital to the improvement of data quality over time and will be even more relevant to tackle the issues faced in a NPL transparency project given the higher complexity. For a more detailed review of data quality matters, see our report "Quality of loan level data - lessons learned for the AnaCredit project"[6].

For the ABS loan level initiative, uniform and standardised definitions across Europe for the reported data fields are key points. Standardised data templates for different asset classes and corresponding data manuals (so called 'taxonomies') were jointly developed by representatives of the ABS industry, the ECB and national central banks with the ECB taking a leading role. The taxonomies contain explanations for each data field as well as examples. National characteristics of particular data fields have been taken into account where differences across countries were too significant to have a fully uniform definition. Each data template comprises mandatory as well as optional fields. In addition, further clarifications and examples are discussed on a specific ECB website in the form of "frequently asked questions (FAQ)".

At the beginning of its operations, ED noticed significant deviations between the delivered data and the exact definitions of the data fields. Over time, there have been material improvements but it took a significant amount of time and effort to achieve a satisfactory level of convergence in the data in terms of comparability. Key reasons for the divergence were national accounting and regulatory requirements in combination with the exact data not being available in the lender's database or not available in a format which allowed conversions according to the required definitions.

6 [European DataWarehouse 2016b]

While data quality has markedly improved overall, it is noticeable that for recovery data for defaulted loans progress has been slower compared to other areas. ED conducted a specific study for Spanish RMBS[7] (being the largest asset class) and found that for over 30% of foreclosed property the actual sales or acquisition value was not available:

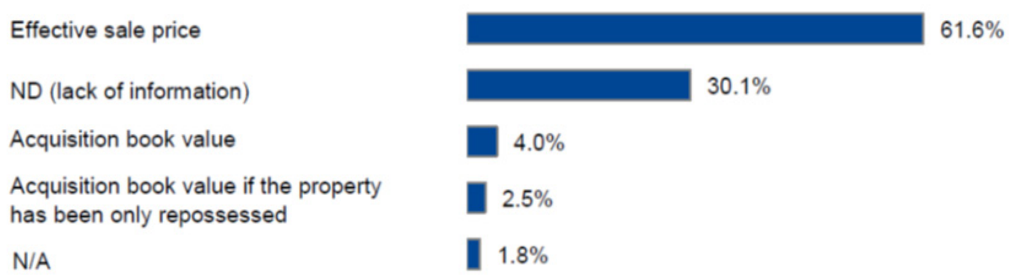


Figure 2. Availability of recovery information in Spanish RMBS data submissions[8]

The exact reasons are not easily traceable but one reason might be that lenders typically transfer defaulted loans to separate units for the work-out process which have different databases that are not connected to the main loan database. As a result, we would expect that for the reporting of NPLs, significant additional efforts have to be made to achieve a satisfactory level of detail.

An outline for enhanced NPL transparency

1) <u>Dimensions – what to consider when developing NPL transparency</u>

Building on the ABS experience, it is important to clearly define the various possible dimensions of the transparency project and decide on priorities. A first step is to identify the intended addressees of NPL reporting. Here we see broadly two types of addressees:

a) Regulators, central banks and policy makers for the analysis of NPL stock at bank level

b) Investors and other market participants analysing and evaluating NPL portfolios

For the first group accounting information (level of provisioning etc.) as well as the classification of NPL stock into various categories (forbearance, defaulted, unlikely-to-pay etc.) will be key points. For the second group accounting information at bank level might be interesting but exact collateral valuation and expected cash flows will be more important. A standardised pan-European template would ideally combine both elements and have separate sections for each addressee group.

7 RMBS: Residential mortgage-backed securities

8 [European DataWarehouse 2016a, p. 6]

Other dimensions to be considered are:

a) National versus pan-European data fields

Ideally the template would only have data fields which are comparable across jurisdictions. However, some data fields have to be defined in a national context given the legal and accounting overlay relevant for individual jurisdictions. Insofar the objective should be to maximise the number of pan-European fields while retaining a level of national data fields to account for additional detail, e.g. legal status.

b) Mandatory versus optional data fields

Reporting agents (i.e. banks and servicers) need to deliver all mandatory fields but optional fields can be added in case a reporting agent wants to deliver more detail to e.g. investors

c) Public versus private disclosure

Some information might be only accessible to regulators and central banks whereas less sensitive data fields might be disclosed to the market in general. Note that the term "public" in this context refers to a broader range of market participants rather than the public at large.

d) Anonymised versus personalised data

Given data protection legislation, personalised information cannot be made public but would only be available to selected public sector bodies in line with their mandate or to servicers which, in turn, have to ensure confidentiality in line with national data protection laws.

e) Asset classes

Different asset classes need to have different data fields. For example, a defaulted commercial real estate loan will need to have a multitude of data fields whereas a defaulted unsecured consumer loan will have relatively few. Templates, hence, need to be adjusted on an asset class basis.

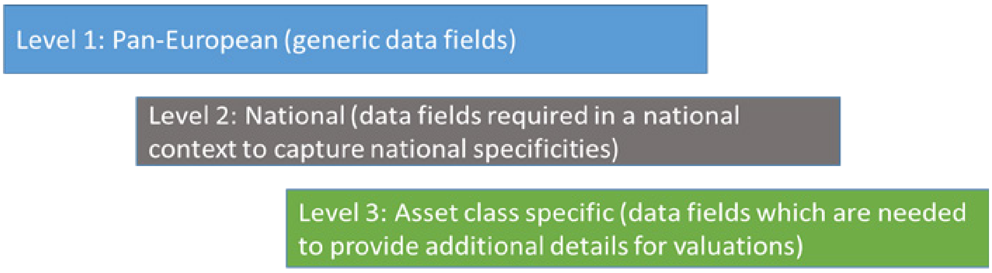
Given these various dimensions, NPL transparency will need to be multi-layered and templates need to find a good balance between a high level of detail, comparability and complexity costs.

2) Developing a European NPL template

Given the various complexities and dimensions as outlined above, a "one-size-fits-all" approach is unlikely to work in practice. On the other hand, an extremely granular approach with hundreds of data fields which might be adjusted on a national level would be also challenging as many lenders might not have sufficient data and comparability might be compromised. Looking at the various dimensions, a combination of existing approaches and templates is probably the best option to gain some traction and achieve some meaningful results within a relatively short time frame. In this context, the AnaCredit and ABS loan-level templates would be a good starting point from which to expand.

Looking at possible solutions to balance both the need for comparability with more detail, a hybrid approach is suggested which results in a multi-level template.

In our view at least 3 layers should be considered:



The layers follow a clear top-down approach with generic NPL fields at the top level:

- Level 1 would include data fields which can be applied in a consistent way across Europe based on e.g. EBA / ECB definitions
- Level 2 would include data fields which are important for NPL transparency but deviate on a national level (e.g. specific account and/or foreclosure status in a legal context)
- Level 3 would include data fields which provide details on an asset class level and which are relevant for servicers, investors or rating agencies to allow for more detailed valuations of collateral (e.g. DSCR, tenant schedules or NOI for commercial properties)

This tiering would also enable the splitting of complex NPL transparency issues into work bundles for which the template development could be shared between constituents. Thus, timing constraints could be better addressed. For level 1, we would expect that the template development would be primarily driven by supranational bodies such as EBA or ECB. Level 3, on the other hand, could be developed with more industry participation to allow practitioners to discuss and define what is needed in a detailed valuation context. Of course, in practice the lines will be somewhat blurred but, nevertheless, a layered approach will help to navigate the process.

Looking at other dimensions, for each layer it would need to be determined if the data is more generally available (public) or only accessible to specific addressees. In the graph below we assume that level 3 data will be less public than level 1 data. However, at level 1 some information will also be private and only available to supervisors.

A similar decision would need to be made with respect to the dimensions accounting versus cash-flow or mandatory versus optional data fields.

Conclusions

Looking at the current NPL situation in Europe, there is a compelling case for enhanced transparency, both from a supervisory as well as from a market development perspective. While NPL reporting is not new, and NPLs have been directly or indirectly addressed through reporting mechanisms such as AnaCredit, the ABS loan-level initiative or on a national level, there is no pan-European approach which allows for both better comparability and sufficient level of detail. Given the complexities of NPL transparency, which are based on a variety of factors, and range from national insolvency regimes, collateral valuation issues and IT shortcomings to NPL definition issues, a “one-size-fits-all” approach is likely to fail, at least in the short term. To balance timing, sufficient detail, national specificities and different addressees of NPL transparency, a multi-level template on a loan-by-loan basis is suggested. The multi-level template builds ideally on existing templates such as AnaCredit or ABS loan-level templates and adds NPL specific data fields. Over time, convergence in accounting, as well insolvency and foreclosure laws, will create a more unified approach and will result in significantly enhanced pan-European NPL transparency.

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IMPORTANT DISCLOSURES: