

Markets and regulation: Game changers for credit risk

HOW BANKS ARE PREPARING FOR WHAT'S COMING NEXT

Tuesday, December 15, 2020



Ready for Next

Markets and Regulators combine to disrupt credit risk management

Regulatory demands are forcing change in the credit landscape, adding to the pressures of a highly uncertain economic outlook. What does this mean from a collateral management point of view?

Foreshadowed by Basel 4, financial regulators are focusing on improving credit risk reporting comparability and eliminating subjectivity – particularly when it comes to asset valuation. Banks are under pressure to monitor and manage complex credit portfolios over the full credit life cycle, supported by precise asset classifications and impartial valuations. Variance is emerging as regional regulators put in place their own measures to implement the many requirements of Basel 4.

At a granular level, regulators are looking for demonstrably independent valuations by appraisers that are unconnected to the deal. Valuations must be maintained and revalued on a regular basis. Quality, in-depth mechanisms are needed to ensure that the ongoing value of assets are actively monitored.

In the case of commercial real estate, the stakes are particularly high. Distressed properties are facing down valuations of 25% on averageⁱ as lenders come to terms with the impact of COVID-19 on the workplace and travel. Meanwhile longer-term challenges are arising as regulators indicate that it is now time to focus on climate change and the evolving environmental risk against property: fire, wind, drought, earthquake, etc.

Lenders need to be able to manage the ongoing risk of economic and environmental macro-trends at the individual asset level as well as the portfolio level. A reliance on legacy systems with byzantine system processes and data architectures makes this impossible to do effectively.

REGULATORS ARE GETTING PICKIER

While some recent regulatory changes are relatively minor, they do point to a trend – that the regulator is taking a wider perspective of risk and is increasing the granularity and objectivity of the data required. A recent Broadridge Credit Risk Webinarⁱⁱ discussed the combined impact of a severe CRE market shock and evolving regulatory demands.

“The dawn of data has arrived,” stated Carmen Hengst, COO Lending at First National Bank in South Africa (FNB). “We have had to reconstitute what we do and how we do it. The lineage between loan origination and collateral is key.” Supporting regulatory change and successfully managing credit risk are pushing the innovation agenda at many banks.

Credit risk modelling has become much more sophisticated over the last decade or so. Banks have the tools to fully support risk management in the

organization. This combined with high-quality data, protects the organization, if the risk taken is balanced. The modelling tools are critical, along with the underlying that feeds those models, to give a good overall sense of the risk at stake. Collateral is a key part of that story.

“Until recently, regulatory exams have been largely paper-based – regulators took random samples of files and checked collateral perfection and loan status on paper,” stated Luke Nestor, founder of Rockall – a Broadridge business. “The process is now data-driven and increasingly digital. Rather than relying on bank reports, regulators have the tool sets to enable them to dig deeper into what the banks report, to look at the data lineage, to look at proof of loans, to ensure that collateral has been assigned to the correct collateral pools and to the right loan pools. They want to see the raw data underpinning credit risk management at the bank – and do their own analysis on how well risk is being managed.”

A STRATEGIC APPROACH TO REGULATORY DEMANDS

LGD, LTV and LLP calculations have also evolved into a streamlined process requiring joined up and accurate data. As the regulator examines this data, they want to know that it has come directly from the correct input systems. The source of the data must be true, as opposed to coming from a remediation team tasked with correcting data so that it is in good shape for reporting purposes.

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Carmen Hengst, COO Lending
First National Bank

Luke Nestor also highlighted the example of ARPA, the Australian regulator, which has recently started to challenge local banks in relation to their collateral management. As banks address the changes needed, another series of issues arise: these banks know that fixing one problem, doesn't mean that the regulator won't be back to challenge the banks on previously unidentified adjacent problems. The bank's focus must shift away from expensive and cyclical data remediation towards better approaches to deliver and maintain the credit data granularity and lineage now expected by the regulator.

FNB has invested in system replacement – both for collateral and loan origination, said Carmen Hengst – “having a good understanding of what is happening in any dimension of the business is critical; a single, centralized collateral data repository is the ideal way to achieve this. Managing collateral through this common view is a clear layer of advantage over simply having the data: common processes are in place, the documentation is available, the bank can demonstrate to the regulators in real-time where the collateral is, rather than trying to remediate static views of the upstream data.”

CRE MARKET CRUCH – A LOOMING SYSTEMIC CRISIS?

CRE markets - and very importantly, related bonds and any other forms of collateralization on real estate - are undergoing something very similar to what happened in the 2008 credit crisis. At that time, credit risk pressure was primarily driven by retail lending or consumer mortgages. This time, there is a very real threat to commercial and income-producing real estate.

Current damage to the US CRE is being laid bare: hotels are especially hard hit, with some suffering write downs of up to 30% and 40%¹. This impact severely erodes any Loan-to-Value cushion originally built into CRE loans. Clearly, such a widespread deterioration across a key asset class represents an extreme stress on the system.

“New appraisals, loan arrangements and, sadly, the prospect of default, all point to the need for a systemic approach to managing collateral at this level,” according to Luke Nestor. “The perfection of collateral and clarity over who has what rights when it comes to a share of collateralized bonds becomes critical.”

As banks strengthen their systems to protect against crises like these in the future, it just makes sense to do things right.”

Luke Nestor, EVP Business Development
Broadridge Financial Solutions, Inc.

Granular management of collateral, especially in the case of complex loans – who owns what, which loan is senior to the others – and their relationships and linkages need to be closely managed and maintained. In addition, lenders need to look deeper into the commercial property associated with a loan – understanding not just the building and ownership, but also the tenancy agreements underpinning income projections and the cushion that is in place in the event of a key tenant vacating.

John Macdonald, Partner with FinTech Strategies indicated that a change in utilization of commercial real estate is an important trend likely to emerge post-COVID. In some markets, CRE is being repurposed into residential as demand for large offices and small apartments reduces, and demand for more spacious residential accommodation rises.

“These impacts are very challenging to model at the loan book level. Are these changes part of a cycle, or a more permanent, radical change in the long-term structure of the market?”

John Macdonald, Partner
FinTech Strategies

“This is a significant change since residential lease durations are typically much shorter,” said John. “Demand for accommodation in central metro areas is changing since people are working remotely, people no longer want to live in small apartments near offices. Working from home is driving demand for more space. Is this the death knell for the one-bedroom apartment, marking a long-term change in how CRE is used?” Barclays has recently speculated that only about 30% - 40% of its own real estate will be required long term in the future. They think that working from home is here to stay and estimate a reduction in demand for office space of 10%-20% in a post-Covid-19 worldⁱⁱⁱ.

BUILDING ROBUSTNESS TO HANDLE THE COMPLEXITY OF INCOME-PRODUCING RE

John Macdonald also highlighted the complexity involved in commercial lending, where intricate deals can involve corporate structures, subsidiary and parent companies, a myriad of borrowers, directors, guarantors and stakeholders. Without quality collateral management and data lineage, it is very difficult for the business to get a grasp on (i) which collateral is securing which loan, (ii) which accounts are under-secured or partially-secured, (iii) who is the true borrower, and (iv) who is the true guarantor, etc.

“Maintaining an accurate picture of the loan book in all of its complexity as it changes over time is a vital task for the bank – one that can add real value to the bank’s bottom line, provided they have the right systems and processes in place,” John added.

“Addressing credit transformation without addressing collateral results in a myriad of systems to support collateral management. This had a very high cost and a lot of dependency on individuals”, according to Carmen Hengst. “We focused on collateral management because it influences the whole life cycle of lending and application management as well as credit risk. Our investment reduced new product turnaround time, plus we had an estimated 15% improvement impact on our pre-Covid RWA and an estimated 20% effect on turnaround times.”

Carmen pointed out that having full control of collateral is more important than ever; re-evaluation becomes more relevant. As a result, FNB sees their investment in automation and data-driven processes as a competitive advantage, operationally and strategically. “Having clean, live data with lots of trigger points and analysis, all helps us to prepare for what is coming,” she concluded.

WHEN REAL ESTATE STOPS PERFORMING, WHAT HAPPENS NEXT?

As governments all over the world continue to print money, the full aftermath of the pandemic is not yet being felt. The overhang of unpaid loans will eventually hit, potentially putting banks under enormous pressure. Financial institutions need to be able to project out a year to see where the concentration risk may pose a problem and identify what can be done now to improve the situation.

“Obviously good collateral management can’t prevent world crises like COVID-19,” commented Luke Nestor. “Efficient collateral management - that is not only capable of explaining what is going on now but can track it going forward – can play a mitigating role.” In 2008/2009, the problem wasn’t only that asset values were falling dramatically and that bonds were going to

zero. Many banks simply did not have control over their loan collateral.

Today, robust collateral management systems are available to help the bank demonstrate that it is in control of the collateral securing the loan book. An accurate picture of the book, with all its complex and dynamic relationships and linkages, gives the control and the means to manage a way through whatever happens.

The challenge of consolidating into one system and the fact that missing data must be found or infilled in some shape or form is significant. For many banks, complicated legacy systems pose a real barrier to change. Collateral management is not an independent entity, it touches the whole life of credit, whether that be origination, maintenance, release, paydowns, servicing, etc. It sits within it as one of a series of solutions that talk to each other with data flowing to and from those solutions in a seamless way. As a result, banks that ask themselves “do we have a collateral problem” often result in a broader discussion that impacts the entire credit ecosystem. It is unusual to consider collateral on its own.

Aside from reporting pressures, clearly, good collateral is an asset to the bank. With continued digitization of loan collateral, the next likely stage of collateral optimization will go beyond just making sure that pure regulatory capital is being optimized. The role of collateral is transitioning, from most visible within the back-office reporting function to being a living, breathing part of the entire credit life cycle, that supports better front office decision making at every point of the loan.

“Clearly, we are facing something that has not been dealt with before. Banks are willing to accommodate borrowers in this new environment, but the reality is that they also need to protect shareholders and the capital base,” said John Macdonald. “A bank’s ability to address a specific customer need – versus a portfolio of needs – speaks to data quality and coverage and the ability to model that with the new normal.”

CONCLUSION

Regulation is forcing banks to become more digitized and data-oriented in terms of loan operations and systems. Dispersed legacy systems are being replaced with a single stand-alone collateral system in order to deliver data that can be aggregated and is fully usable across the bank’s credit systems.

Investment in a robust collateral data model has helped some banks realize significantly improved risk weightings and RWA, provides the basis to meet regulatory requirements and supports data-driven business decisioning.

Integrated with external valuation and environmental agencies, these systems can satisfy regulatory demand for high-quality credit data and lineage, and positively impact the bottom line.

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ⁱ Rennison, J. (2020). 'Destruction of value in US Real Estate revealed', *Financial Times*, 27 September. Available at: <https://www.ft.com/content/a34e131c-bf6f-4b7d-9a2c-84c632243e87>

ⁱⁱ Broadridge (2020, September 30), *The impact of an evolving regulatory landscape on credit risk management* [Webinar]. Available at: ADD LINK

ⁱⁱⁱ Rapoza, K. (2020). 'Is working from home here to stay?', *Forbes*, 28 September. Available at: <https://www.forbes.com/sites/kenrapoza/2020/09/28/is-working-for-home-here-to-stay/>

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