

**Excerpt from vwd: basel II special
dated January 22, 2003**

Mortgage banks tackle LGD grading

Frankfurt (vwd) – Provided they qualify for the IRB advanced approach, Basel II gives banks the option of estimating their own L(oss) G(iven) D(efault), i.e. the future losses to be taken into consideration for the equity backing required. To implement this, the average anticipated loss in the event of a defaulting loan is indicated as a percentage of the bank's existing exposure at the time of the loss.

“In our experience, depending on the structure of the relevant portfolio, the values calculated by banks themselves tend to be up to 50 per cent below those prescribed by the regulatory authorities,” explains Uwe Menninger, Deputy Head of Corporate Control at Deutsche Hypothekbank in Hanover. “By setting the prescribed LGD at a higher level (35 and 45 per cent respectively) in the foundation approach, the regulatory authorities have provided an incentive, as the first LGD estimates by the banks were lower.”

In addition to the subsequent capital savings in absolute terms, the capital employed is optimized, as depending on the level of segmentation, individual loans can be better differentiated. This is also of crucial importance when calculating the credit (risk) costs. “If prices are marked to market, the risks involved are adequately taken into account and bad financial management is avoided,” added Menninger.

Reliable loss estimation

Menninger also points out that, due to maturity adjustments, long-term property loans in the key accounts segment tend to be disadvantaged by comparison with short-term loans of, for instance, commercial banks operating in corporate client business (short-term maturities up to 2.5 years would be more favourably positioned while long-term maturities would be at a disadvantage). Menninger adds that this is the case “despite the fact that historic loan losses do not confirm this situation.” Banks are able to balance out this disadvantage by using more sophisticated LGD grading. However, the prerequisite for LGD grading and the associated ability to influence equity backing is that banks are in a position to provide reliable estimates of their future losses.

Given the fact that charges on property play a central role in property finance and that the sustained value of the charge on a property is reflected in the LGD, the Verband deutscher Hypothekbanken (Association of German mortgage banks, VDH) commissioned a consultancy firm to carry out an analysis of LGD on the basis of a common data pool of loan loss information, which is known as LGD grading. “LGD grading, which is based on information from individual banks that is gathered in a centralized data pool, fulfils an essential requirement for property financing under the advanced internal ratings-based approach of the New Basel Capital Accord,” said Christian Marburger, Head of Legal Affairs/Credit/Tax at VHD.

Establishing historic loss data

Grading indicates the level of the anticipated loss as a percentage, following the realisation of collateral in the event of a debtor defaulting on his loan repayment. According to Uwe Menninger, internal ratings-based systems, which form the basis for calculating the probability of default and therefore credit risks, are subject to “stringent regulatory requirements, in particular with regard to the validation of historic data, but also in terms of transparency, plausibility and suitability for implementation in the credit process.”

In order to achieve the most efficient risk-based pricing, credit risk and credit process management as well as to structure their portfolios with the highest level of efficiency, banks need to have comprehensive knowledge of such ratings systems, property cycles, sub-markets and achievable yields. This can only be obtained by establishing historic loss data for the various types of property in the different regions.

LGD grading for non-mortgage banks

Such data is being collected from all mortgage banks and entered in a centralized data pool. A property market forecast should be produced, which can help to predict how a specific type of property will develop in the relevant regional market in future. The VDH is planning to set up a separate centralized database, comprising data about actual transactions of the mortgage banks, which will therefore not be subject to the distortions inherent in individual estimates.

Christian Marburger from the VDH explains that LGD grading is currently in the implementation phase at the mortgage banks which are participating in the data pool. Recently, Hyp Real Estate Rating Services GmbH was established as a separate company, which will enable the system to be opened to other banks as well. Initial talks have already taken place with the central savings banks about their possible cooperation.

If the discussions prove successful, the data would extend beyond the mortgage bank sector, which in turn would increase the significance of LGD grading. However, the VDH confirms that the grading system is already highly reliable, as mortgage banks have a huge market share in property financing. According to Uwe Menninger, the data pool is not just limited to mortgage banks. “All banks dealing with property finance need to have this information for their future capital requirements and risk management,” he added.

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