QUALCO

E-Guide

Non-performing loans: Stepping up to European regulatory requirements

REGULATION

CONTENTS

INTRODUCTION

"The deliberate and sustainable reduction of NPLs in banks' balance sheets is beneficial to the economy from both a microprudential and a macroprudential perspective."

European Central Bank

Financial upheaval in the past decade has provoked much soul searching on the risks of lending to businesses and consumers alike. Desperate to avoid a repeat of the sub-prime crisis, regulators have changed the game when it comes to lender treatment of defaulted debt.

A year ago, the European Central Bank (ECB) published its final guidance to banks on non-performing loans, aiming to provide a consistent supervisory approach around the way banks identify, measure, manage and write off these debts.

While these guidelines set out best practice that the ECB expects creditors to follow, the practicalities of doing so are left to the lenders to handle.

It is imperative that technology used to manage NPLs is capable of rising to the challenge. QUALCO Collections & Recoveries (QCR) is ideally placed to meet those decision-making, analytical and operational needs.

QCR is an end-to-end debt collection and recoveries management application, supporting a wide range of financial activities and products at all stages of the collections cycle. This includes pre-collection, early arrears, late collection, third party assignments, legal action, forbearance, write-offs and collateral/ real properties management.

The following guide demonstrates the ways in which QCR tackles the ECB's requirements on non-performing loans, leaving lenders confident that they are stepping up to regulatory demands and free to concentrate on their core business and front-end lending.

Governance & Organisational Structure

"It is acknowledged that addressing non-performing loans will take some time and will require a medium-term focus."

European Central Bank

Under the guidance, banks are required to set up an appropriate organisational structure to oversee and implement their NPL strategies, define approval processes for their NPL workout decisions and ensure sufficient internal controls over the management processes for those loans.

They are expected to set up dedicated workout units to handle NPLs that must be separate from units responsible for loan origination. This is to eliminate potential conflicts of interest and ensure that these units have expertise in non-performing loans.

How QCR can help:

QCR's functionality captures the organisational structures used by banks. It allows the lender to define the roles assigned to employees and gives them control of access rights, including the tasks individual employees can perform.

The technology allows the bank to have the oversight needed and has a wide range of authorisation mechanisms, from the usual 'four eyes' principle to multi-layered approval processes. Particular segments of portfolios can be isolated and managed separately by external parties or specialist staff if required.

QCR also offers full support and tracing capabilities for the range of workout activities, contacts with borrowers, loan classifications, valuations, forbearance solutions or legal actions. This means lenders can feel confident that there are high levels of oversight across their NPL portfolios.

Portfolio Segmentation & Strategy

"A suitable operating model is based on analysing the bank's NPL portfolio with a high degree of granularity, resulting in clearly defined borrower segments."

European Central Bank

ECB guidance suggests banks work hard to reduce their levels of non-performing loans and that they operate a range of "realistic and ambitious strategies" to do so.

These strategies might include hold or forbearance solutions for customers in difficulty, active portfolio reduction through debt sale, change of exposure type or legal options.

To fulfil this requirement, lenders need appropriate management information systems and high-quality data, allowing them to segment their portfolios and decide which action to take on accounts. This could be division by asset class, borrower affordability or collateral coverage, for example.

Managing non-performing clients early is crucial in limiting the consequences of default for customer and lender. A key factor in the successful implementation of an NPL strategy is an "adequate technical infrastructure".

How QCR can help:

QCR enables complex collections and recoveries strategies in its Decision Engine environment.

Decision Engine allows lenders to enrich classification data through 'decision trees'. This uses 'decision workflows' to help lenders rate the risk of their exposures and deploy early warning indicators. Having this information enables appropriate action to be taken early in default.

QCR's segmentation functionality enables NPLs to be grouped into subsets, according to internal or external policies. Specific collections activities can then be applied to those groupings.

Further, QCR provides an environment where business rules and automated processes can be applied to loan segments. The user-friendly system allows lenders to easily design workflows for the management of their NPLs.

Decision Engine is based on a pre-defined and rich Criteria Library, consisting of over 400 criteria that can be further added to by banks.

OPERATIONS

"As execution and delivery of the NPL strategy involves and depends on many different areas within the bank, it should be embedded in processes at all levels of an organisation, including strategic, tactical and operational."

European Central Bank

The ECB's guidance calls for banks to embed their NPL strategies across all levels of the organisation. Non-performing loan workout units must support the full lifecycle of the NPL – from early arrears right through to recovery, legal action and foreclosure.

Best practice requires there to be different workout units for the different phases of an NPL's journey and for different portfolios if appropriate – for example, treatment of retail customers may differ from commercial.

How QCR can help:

QUALCO's QCR is equipped to assist lenders with this endeavour, supporting in-house and outsourced collections options. It can assign accounts to in-house collections agents on an automated or manual basis, providing the functionality needed to take action. QCR integrates with diallers, pre-defined communications scripts and pre-defined solutions.

All agent activities are undertaken in a single environment, where all necessary information can be easily accessed, from customer contact data to detailed historical records of collection activities and relationships with other borrowers of the bank.

QCR can create letters, texts and emails to be sent in bulk on an automated or ad hoc basis.

A further feature of the system is its ability to allocate or recall accounts to third parties such as debt collection agencies or legal firms. These assignments define quantitative and qualitative criteria and the technology provides a mechanism for two-way data exchange and synchronisation.

Forbearance Solutions

"The key objective of granting forbearance measures is to pave the way for non-performing borrowers to exit their non-performing status, or to prevent performing borrowers from reaching a non-performing status. Forbearance measures should always aim to return the exposure to a situation of sustainable repayment."

European Central Bank

Banks must implement forbearance policies that align with borrower affordability and they must do so in a timely manner, says the ECB. The regulator lists 14 common short-term and long-term forbearance solutions but adds that these are not exhaustive.

In the new world of NPL management, banks are obliged to consider whether foreclosure will result in a higher net present value than pursuing cases legally – tracking the success and cost of the actions they are taking. They also need to undertake complete affordability assessments for borrowers, taking account of their other debts and commitments.

Segmentation is crucial for successful implementation of forbearance measures. The ECB recommends that banks use a net present value (NPV) approach to determine the best option for the borrower. They must measure the effectiveness and efficiency of these strategies.

How QCR can help:

QUALCO's QCR comes with the functionality needed to assess borrower affordability – both for individuals and businesses. This functionality is adaptable for different jurisdictions, policies and regulatory requirements.

QCR's Decision Engine also enables lenders to organise collections campaigns and strategies for each portfolio segment, giving collections professionals the right tools and range of actions for each.

The technology not only supports the ECB's 14 short and long-term forbearance measures, it gives a wide range of options based on factors such as step-up or reduced payment scenarios, discounts, maturity extensions or interest reductions.

QCR will simulate proposed repayment schedules, checking against alternative solutions to ensure the best option is deployed. It also provides the NPV calculations required under the ECB guidelines, ensuring the chosen forbearance strategy is financially effective.

When it comes to measuring efficiency and effectiveness, QCR drives banks to meet these targets by both increasing the volume of solutions and their likelihood of success as they are tailored to borrower circumstances.

Legal Actions & Dept Management Workflows

"This phase focuses on borrowers for whom no viable forbearance solutions can be found due to the borrower's financial circumstances or cooperation level."

European Central Bank

When no viable forbearance solution can be found for a borrower, the ECB requires banks to consider different liquidation options, including in-court and out-of-court procedures. Banks should apply sufficient internal control mechanisms to ensure liquidation is efficient and effective.

As definitions of the term non-performing loan (NPL) vary, the European Banking Authority issued a uniform definition of non-performing exposure (NPE). While this is only binding for supervisory reporting purposes, the ECB guidance says institutions are "strongly encouraged" to use it in their internal risk control and public financial reporting.

How QCR can help:

QCR offers a web-based environment for the end-to-end control and monitoring of operational or legal processes. This can be fully configured to a bank's needs and allows real-time information sharing with third party providers such as lawyers, bailiffs or insolvency practitioners.

Processes, workflows and legal actions such as lawsuits, payment orders, counterclaims and foreclosures can be modelled by defining stages of the process and the steps needed. Parallel stages can be run for actions that are concurrent and parameters set for transitions between stages.

Banks can define which users can perform these transitions as well as generating alerts when key steps need to be completed.

The QCR environment can also capture data on the lifecycle stages of non-performing loans and the evolution of loans (current, watch list, doubtful etc.). These data can be used as criteria to define targeted follow-up workflows, dunning campaigns throughout cure and probation periods or timely identification of NPLs that are no longer appropriate for forbearance measures and so require legal action.

Collateral Management

"Banks should be able to fully justify their assumptions, both qualitatively and quantitatively, and explain the drivers of their expectations, taking past and current experience into account."

European Central Bank

Banks should monitor the value of property on a frequent basis and apply adequate market discounts, says the ECB. This requires databases of transactions to enable the proper assessment, monitoring and control of credit risk, as well as comprehensive documentation.

How QCR can help:

QCR operates a fully configurable collateral management environment, where properties or other collateral owned by the bank can be registered.

A Collateral Registry captures qualitative and quantitative information for all commonly used asset types and collateral providers.

A Real Estate Registry (adhering to the principles of the Land Administration Domain Model) draws together all data to form a legal and commercial profile of each property. This includes: ownership rights; other interests in the property; present and historical price valuations; rights, restrictions and responsibilities over the property; web mapping and satellite imagery; still-images and videos.

The QCR environment supports the efficient management of foreclosed assets and the appropriate promotion to commercial channels. A website supports this commercialization, providing a place where large volumes of properties for sale can be presented and offered to the public.

Reporting & Monitoring of NPLs

"Banks should closely monitor the relative and absolute levels of NPLs and early arrears in their books at a sufficient level of portfolio granularity."

European Central Bank

The ECB states that banks must monitor the NPL targets approved in their NPL strategies and operational plans against actual performance. A framework of key performance indicators (KPIs) should be used to allow progress to be measured.

In addition, banks should closely monitor their overall levels of NPLs and early arrears at a sufficiently detailed level. Key figures on NPL outflows and inflows should be contained in management reports, including loans moving into and out of NPL categories, those in probation, those performing and those in early arrears.

How QCR can help:

Analytics and reporting are at the core of QUALCO's expertise. QCR contains powerful reporting functionality that allows macro and micro monitoring of productivity, financial performance and collectability.

The embedded and powerful Analytics Engine offers:

• 10 different areas of analysis with more than 30 sub areas, covering the entire debt collection and recovery cycle.

• Interactive reporting to enhance decision making.

• A large number of dimensions and common practice outputs (for example: was-is analysis, vintage analysis, migration tables, probability of default or re-default evaluations) ensuring complete monitoring of collections processes and report generation.

• Built-in industry-specific KPIs (e.g. roll rates, conversion rates, portfolio penetration rates, collectability, etc.). These enable measurement, comparison and evaluation of the delinquency status of the NPL portfolio under management and its performance at any given time.

Support by High Tech Solutions

"One of the key success factors for the successful implementation of any NPL strategy option is an adequate technical infrastructure."

European Central Bank

The ECB is clear that one of the key success factors in the implementation of an NPL strategy is adequate technical infrastructure. All data must also be centrally stored in robust and secure IT systems.

How QCR can help:

QCR is ideal for banks looking to enhance their NPL processes and performance. It covers all aspects of debt collection and recovery. The QUALCO team has extensive experience in implementing large scale projects, using a dedicated team of specialist engineers and business analysts.

For banks, this means rapid implementation – typically 4-6 months including integration, customisation, migration, testing and roll out.

Integration with core banking systems is guaranteed to be seamless, and ready-made mechanisms integrate with third-party collection agencies and legal offices.

QCR allows quick and flexible development of new functions and interfaces and offers comprehensive remote and on-site support.

Lenders can have confidence that their obligations under ECB requirements are being fulfilled by the system.

Conclusion

"There is broad consensus on the view that high NPL levels ultimately have a negative impact on bank lending to the economy, as a result of the balance sheet, profitability, and capital constraints faced by banks with high NPL levels."

European Central Bank

European regulators are set on stringent measures to avoid further build up of non-performing loans. High volumes of bad loans have affected the ability of banks to provide new credit, slowing down recovery after a decade of financial crisis.

Technically, the NPL guidance issued by the European Central Bank is non-binding in nature. However, the ECB says banks should explain and substantiate any deviations upon supervisory request. In practice, lenders should be following the recommended approach.

This brings challenges, both operationally and technically. As demonstrated in this e-guide, QUALCO's QCR solution is ideally placed to meet these needs, providing the means to manage loans at any and all stages of the delinquency lifecycle.

Configurable, flexible analytics and reporting capabilities mean lenders can take the right approach for their non-performing loans, ultimately reducing their volume and freeing the bank to lend to firms and consumers.

Creditors need these capabilities to manage non-performing loans effectively and efficiently in today's market – and to be able to demonstrate adherence to best practice. The ECB says many banks have made notable progress and submitted credible strategies including reduction plans. However, some banks still need to improve.

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Collections & Recoveries

QUALCO Collections & Recoveries helps firms manage high volumes of non-performing assets effectively and compliantly. The technology uses data-driven analytics to predict customer behaviour and optimise treatment strategies. It manages debt portfolios through the entire lifecycle, from performing accounts to early delinquency and recoveries. The solution supports all banking products, from unsecured debt to mortgages and SME loans, as well as non-banking debt, such as telecoms, utilities and retail accounts.

QUALCO Collections & Recoveries is used by creditors, debt purchasers and debt servicers to manage accounts on both an inhouse and outsourced basis.

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QUALCO is an expert provider with more than 15 years' proven experience in enabling clients to take control of customer data across the entire credit lifecycle. Whether you are looking to modernise your internal collections platform, delve deep into the analytics of your entire debt portfolio to drive future strategy, or harness the power of external service providers, QUALCO has a solution to help you drive efficiencies and streamline your collections and recoveries operations.

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