

A System of Provisioning in a Retail Bank

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Eurobanking 2009

A Short View on *readybank*

- Founded in 1929
- Owned by WestLB AG since March 2006
- About 300 employees
- Balance sheet total: 400 Mio. Euros
- Headquarter in Berlin, large office in Düsseldorf
- Specialised in consumer lending, main distribution channels:
 - local savings banks (strategic partnership)
 - automotive

Agenda

- **Provisioning on non-recalled loans:**
 - until 06/2008
 - today
 - future
- **Provisioning on recalled loans**

Provisioning until 06/2008

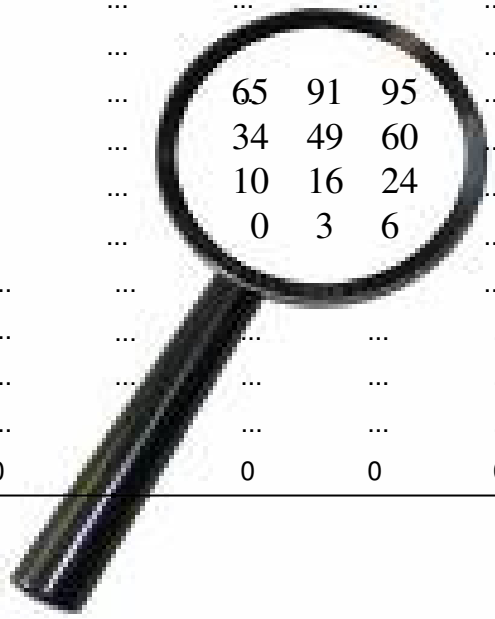
System for non-recalled loans

- The individual provision rate depends on:
 - Actual balance compared to initial balance.
 - Payments during the last 12 month compared to agreed instalments.
- Loans without individual provision (rate 0%) get a general provision (about 2%).
- Additional rule: Loans with an individual provision rate between 1% and 79% and a current dunning or a maturity of more than 72 month get 8% extra provision.
- System was recommended by the "Prüfungsverband deutscher Banken e.V." (Auditing Association of German Banks) and was in use at readybank since 2000.

Provisioning until 06/2008

Chart of individual provision rates

Individual Provision Rate (%)	actual balance to initial balance (%)										
	<=6	>6-12	>12-26	>26-36	>36-47	>47-58	>58-67	>67-76	>76-84	>84-92	>92-100
0	95
real >0-8,33
pay- >8,33-16,67
ments >16,67-25,00
to >25,00-33,33
agreed >33,33-41,67	65	91	95	...	...	...	...
instal- >41,67-50,00	34	49	60	...	...	...	...
(last 12 >50,00-58,33	10	16	24	...	...	...	...
month) >58,33-66,67	0	3	6	...	...	...	...
(% >66,67-75,00
>75,00-83,33
>83,33-91,67
>91,67-<100
>=100	0	0	0	...	0	0	0	0	0	0	0



Provisioning until 06/2008

Problems

- System reacts very slowly
- Collaterals are not taken into account
- Large difference between provision and EL¹ according to Basel II
- System is not state of the art

¹: Expected Loss

Provisioning today

The approach for non-recalled loans

- The loan portfolio is classed by
 - type of loan: cash or automotive (cars as collaterals)
 - days of arrears of client 1
 - number of extension agreements with client 1
- Based on historical data, the bad rate is calculated monthly for each class. (bad = recalled within 18 months)
- The last 6 months' bad rates are averaged for each class.
- Provision rate (class) = bad rate (class) * LGD¹ (automotive/cash loan)
- Exemption: 100% provision if client is insolvent or deceased.

¹: Loss Given Default

Provisioning today

An example

	days of arrear	number of extension agreements	bad rate (bad=recalled within 18 months)						weighted means of bad rates	LGD*	provision rate
			loan portfolio per								2009/01
			2007/01	2007/02	2007/03	2007/04	2007/05	2007/06			
type of loan	no arrear	none	...	...	...	...	...	...	...	80%	...
	no arrear	1	...	...	...	...	...	...	...	80%	...
	no arrear	2 or more	...	...	...	...	...	...	...	80%	...
	1 to 30 days	none	15%	13%	20%	17%	15%	10%	15%	80%	12%
	1 to 30 days	1	...	...	...	...	...	...	...	80%	...
	1 to 30 days	2 or more	...	...	...	...	...	...	...	80%	...
	31 to 90 days	none	...	...	...	...	...	...	...	80%	...
	31 to 90 days	1	...	...	...	...	...	...	...	80%	...
	31 to 90 days	2 or more	...	...	...	...	...	...	...	80%	...
	91 or more days	none	...	...	...	...	...	...	...	80%	...
	91 or more days	1	...	...	...	...	...	...	...	80%	...
	91 or more days	2 or more	...	...	...	...	...	...	...	80%	...

fictitious numbers

*depending on type of loan

Provisioning today

Advantages

- Collaterals are taken into account (by use of LGD)
- Specific provision for all loans – no general provision
- Better use for portfolio management (faster reaction)
- Less difference between provision and EL according to Basel II

Provisioning today

Problems

- There is still a difference between provision and EL according to Basel II
- Portfolio data used to calculate the bad rates is 18 to 24 months old:
 - No existing data to calculate bad rates in case of new products or changes in business strategy
 - Time lag in case of new/other policy rules or changes in economy
- Client 2 is not regarded (if existing)

Provisioning in future System for non-recalled loans

- New system scheduled for autumn 2009
- Main objective: No difference between provision and EL according to Basel II
- Close to Basel II-framework
- Uses Basel II-PD¹ from behavioural score and corresponding LGD
- If one of the clients is defaulted according to Basel II:
$$\text{provision} = \min(\text{actual balance}, \text{balance at default} * \text{LGD})$$
- If none of the clients is defaulted:
$$\text{provision} = \text{actual balance} * \text{PD} * \text{LGD}$$

¹: Probability of Default

Provisioning on recalled loans: Cash Value Method – the basic approach

For each loan the following steps are taken:

1. The payments of the last 12 months are summed up.
- or -
All payments after recall are extrapolated to 12 months.
2. These payments are extrapolated to 48 months.
3. The actual cash value of the assumed payments is calculated.
4. The provision is the difference between the principal claim and this cash value.



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