Dániel Homolya[1] and Gábor Szigel[2]: Banks' households credit collection procedures[3]

Owing to the significant deterioration in banks' loan portfolio, the management of problematic credits has come more to the fore more than earlier because there has been a considerable increase in the number of defaulted borrower, and there has also been an unfavourable change in the behaviour and payment ability of these clients. Therefore, in the summer of 2009 the MNB conducted a survey among domestic banks[4] and financial corporations dealing with factoring and debt management regarding the debt collection processes applied in the field of household lending.[5] The findings of the research reveal that, reacting to borrowers' increasing payment problems, banks significantly strengthened their resources allocated for credit collection, refined and changed their procedures, and strived to reach agreements with problematic borrowers more frequently than before. This is well reflected by the fact that the ratio of restructured loan agreements increased from 0 to 0.7 per cent for mortgage loans and from below 0.5 per cent to above 2.5 per cent for unsecured loans. Banks are making increased efforts to agree with debtors as prepayment of problematic deals through loan replacement fell to one-third to one-fifth of the amount experienced earlier confirmed by the data on final prepayments, the factoring market narrowed, and the success rate at real estate auctions remains low, below 15 per cent.

BANKS' DEBT MANAGEMENT AND CREDIT COLLECTION FUNCTION

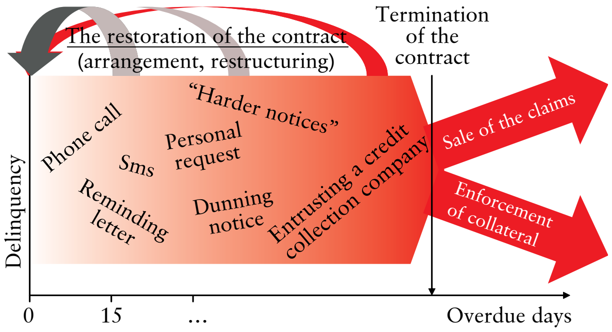
The objective of banks' credit collection is to persuade debtors who fail to meet their outstanding payment obligations to pay up their arrears, and, if it is not possible, to provide for coverage of the bank's receivables from the available collaterals. A debtor may be in default if *a)* he/she is *not able* (e.g. because of loss of income or unexpected high expenses), or *b) does not want* to pay (e.g. because he/she gives preference to his/her expenses of other types than to the instalment). Both reasons may be temporary or permanent. In the event of temporary difficulties, when the problems hindering the payment cease to exist, the borrower's payment ability may even be restored automatically. If the reason for non-payment is a permanent lack of the borrower's willingness to pay (he/she does not want to pay), the task of the bank's debt management is to influence the debtor's behaviour. The later a client starts to settle his/her accumulating arrears, the lower the chances are that he/she will be able to return to the 'right track'. If the reason for non-payment is a permanent lack of payment ability, the bank will be able to recover the amount of loan extended only through the enforcement of the collaterals.

Chart 1 is a stylised summary of the procedures of collection processes conducted by banks. Credit institutions usually try to contact the debtor in the first days following non-payment and warn her or him of the fact and consequences of default on payment. Most credit institutions notify their debtors by SMS, letter and phone call as well. The longer the time the client is in default and the worse the prospects for settling the debt are, the stricter the tone and style of the messages usually are. In the event that the client fails to pay in spite of such requests, the bank's staff pays a visit to the borrower. Banks often hire specialised debt collection companies to perform this task.[6] If they succeeded in reaching the borrower and the latter settles the debt, the deal returns to the 'normal track'. In the event that the client is unable to pay the accumulated debt in one sum, or to meet their earlier contractual obligations in an unchanged manner, they may bargain and reach an agreement with the bank to change the terms and conditions of the contract (for example, extension of maturity, provisional easing in repayment schedule). In

[1] Senior analyst, Financial Stability (e-mail: homolyad@mnb.hu)
[2] Analyst, Financial Stability (e-mail: szigelg@mnb.hu)
[3] The views expressed in the paper are those of the authors and do not necessarily reflect the official views of Magyar Nemzeti Bank, the central bank of Hungary.
[4] We contacted 12 banks during the survey. Budapest Bank did not report data, MKB and OTP reported only partially. The institutions that supplied data have a total market share of approximately 32-60 per cent in the various loan segments, so the sample can be considered representative. Of the companies engaged in factoring, we received data from 8 major market participants.
[5] The survey did not cover the debt management methods applied in the corporate credit business segment because the processes in that segment are less standardised, and banks have more experience in this respect as a result of the many real economy shocks since the early 90s, while household portfolios are considered to be relatively 'young'.
[6] In this case, the loans are not removed from the banking books of the bank; it is only under outsourced activity.

Chart 1

Stylized procedure of credit collection in households lending



Source: MNB. Own illustration.

this case, the deal is restored through a contract modification. However, it is important to emphasise that in this case the debtor's original debt is not cancelled; it is only rescheduled somehow. Accordingly, they do not pay less, only settle their debt in line with another schedule.

Finally, if no agreement is reached with the debtor, the bank terminates the loan agreement, and demands repayment of the outstanding debt in one sum from the debtor. The timing of the termination of the contract may vary by banks and types of transactions, but it usually takes place a minimum of 90 days following the first date of default on payment obligations. After termination of the contract the client still has some room for bargaining; for example, they may agree with the bank that they will pay the lump-sum debt in some months in instalments. However, this usually puts a much heavier monthly payment burden on the debtor than the original deal. If an agreement like this cannot be reached, legal action is taken, and the tougher period of collection begins. There are two typical ways of this: either the bank itself carries out the legal procedure – perhaps with the involvement of a third party company – until the distraint, or it sells the claims on the customer – at a much lower price than the nominal value – to firms specialised in debt purchase and collection.

There are various technical terms for this process in banking (collection, managing of problematic transactions, workout, collection), and a distinction is made between the soft and hard stages of the process. In the 'soft collection' phase, banks use warnings and are more open to amend and restructure the original loan agreement. In the hard collection phase banks already terminate the loan agreement and start to use legal means.

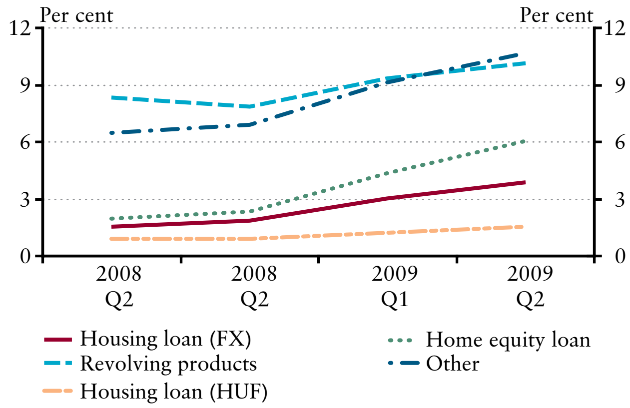
IMPACT OF THE CRISIS ON THE NUMBER AND BEHAVIOUR OF BORROWERS WITH OVERDUE LOANS

The proportion and also the absolute number of household borrowers with payment problems increased markedly in 2009 H1. At the banks responding to our survey,[7] the ratio of credit contracts with at least 90 days overdue grew 1.5-2.5 times higher in all types of transactions in a year (Chart 2). The deterioration was the strongest in the case of FX loans with real estate as collateral.

Based on all this we prepared an estimation regarding the increase in loans past due more than 90 days in the banking sector as a whole. According to our calculations,[8] between June 2008 and June 2009 the number of mortgage loans past due more than 90 days increased by approximately 25,000, and the number of unsecured loans with the same length of overdue was up by about 200,000. As a result, at end-June 2009 there were about 42,000 mortgage loans and approximately 500,000 unsecured, not already closed

Chart 2

Ratio of loans overdue for more than 90 days at the banks providing data for this part of the survey



Source: MNB.

[7] These data are in line with the developments observed – in other indicators – in the whole banking sector.

[8] We based our calculations on the market share of banks provided data for our research, and applying these market shares we extrapolated the number of loans in default reported by them to the banking sector as a whole. Our findings are basically in conformity with the data recorded in the Central Credit Information System (CCIS (KHR in Hungarian) or, more exactly, with the developments experienced therein. By June 2009 the number of non-performing borrowers (natural persons) registered in the CCIS increased to 715,000, from the level of 550,000a year earlier. However, this indicator takes into account that a debtor may have more than one loan (while the data collected in our research are at transaction level), and the CCIS contains already closed deals as well (which are not older than 5 years). In addition, financial enterprises and savings cooperatives also have reporting obligations to the CCIS, while the data published by us refer only to the banking sector. Information received from BISZ Zrt. shows that developments concerning the developments of registered contracts related to mortgate loans in CCIS are in line with the data of our research.

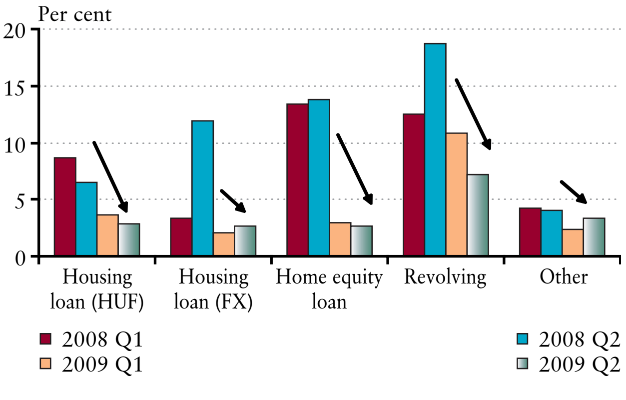
loan contracts overdue for more than 90 days in the banks' books.

The increasing number of clients in default posed two kinds of challenges for banks' divisions dealing with credit collection: firstly, they had to face a growing volume of problematic clients, and secondly, the characteristics of clients with overdue loans also changed (for example, because non-payment increased as a result of unemployment, clients' payment ability declined). Consequently, the debt management techniques applied previously became less effective.

The narrowing of refinancing opportunities also meant a perceivable problem for banks' debt management. Earlier, borrowers who got into trouble were able to temporarily handle their payment problems by rolling 'their loan over' (loan switching) to another financial service provider, i.e. by new borrowing, using the new loan to pay their earlier debt that had become problematic. Of course, this usually did not help these debtors over the longer term, because if their financial situation otherwise did not become arranged, they could again find themselves in default at the new lender as well. This procedure did not permanently improve portfolio quality at banking sector level either; there was improvement only in the books of the institution that 'got rid of' the bad debtor. This practice was also problematic because lending to clients in a situation like this could conflict with the principles of responsible lending, as the new financier – knowingly or unknowingly – may have extended a loan for the replacement of a debt that had not been in line with the client's repayment ability earlier either.[9]

Chart 3

Proportion of final prepayments within 3 months by loans overdue more than 90 days



Source: MNB.

However, the tightening of banks' loan supply in October made it more difficult to switch problematic loans to another financial service provider, thus the ratio of problematic loans settled with final prepayment declined considerably in all loan types (Chart 3). Final prepayments have fallen significantly not only in terms of their ratio but also in absolute value since the outbreak of the crisis.

BANKS' REACTIONS: CHANGES IN RESOURCES ALLOCATED TO AND METHODS APPLIED FOR DEBT MANAGEMENT ACTIVITY RELATED TO HOUSEHOLDS' CREDITS

As a result of the increase in the number of non-performing clients, the banks participating in the survey started to reinforce their debt management and collection activities. At the credit institutions surveyed, the number of personnel working at central collection divisions and call centres dealing with collection was up by 5-15 per cent compared to end-2008. In parallel with this, more debt collection tasks were delegated to sales personnel, who were less busy because of the decline in lending business activity.

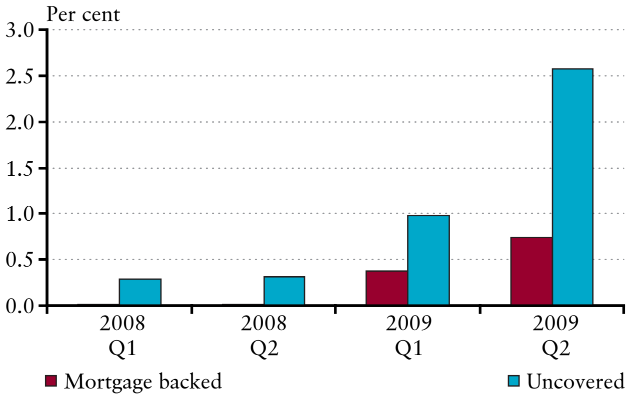
In addition to expanding their human resources, banks also tightened the criteria of entering the collection process. This mainly meant that in the soft collection stage they started to warn debtors earlier than before (although the criteria for getting into the hard collection stage and the default limit amount did not change significantly). At the same time, banks widened their set of means applied in the last one and a half years to be able to reach debtors through various channels (SMS sending became routine, personal visits became more frequent, and several banks started to apply reminder SMS messages sent before payment day). Banks also strengthened the systematic support of the collection process and made it more automated, and several credit institutions apply collection scoring systems, which mean that based on earlier behaviour of clients with overdue loans are classified into risk categories, and communication means of various intensity are applied according to collection scoring.

In addition to reinforcing the set of means applied for collection, banks – in accordance with their own interests as well, with an objective of loss reduction or at least smoothing – elaborated various debtor protection packages, the essence of which was that they showed more willingness than earlier to restructure the transactions of borrowers with overdue loans. In the course of this, the debtor could reach an

[9] Of course, exceptions from the above are those debt-clearing loans when the client replaced his existing debts with a loan with considerably lower interest rate (for example, car purchase loan, credit card debt replaced with mortgage loan or forint-denominated loan replaced with lower-interest loan denominated in Swiss francs).

Chart 4

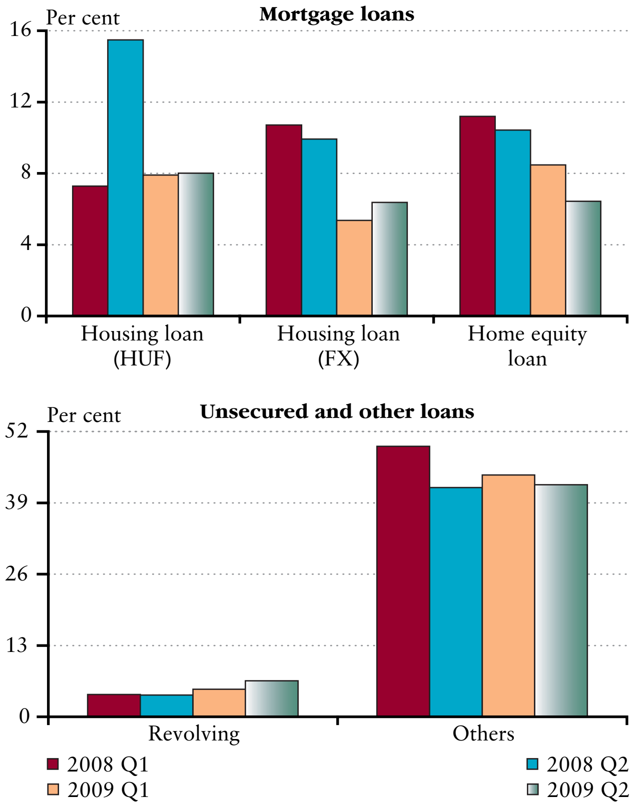
Share of restructured loans within the total number of transactions at the respondent banks



Source: MNB.

Chart 5

Proportion of terminated contracts within 3 months by loans overdue more than 90 days



Source: MNB.

agreement with the bank on the extension of the maturity of the loans or a temporary – not more than 1 or 2 years – lowering of the instalment, and the arrears of the debtor were often capitalised (i.e. the client did not have to pay the arrears, but they were added to the principal). As a result of banks' more flexible attitude, the ratio of restructured loans increased (Chart 4).

It is important to emphasise that in agreements of this type none of the debtor's debt is cancelled; it is only rescheduled. This usually entails an amendment to the contract as well (including the relevant contract amendment and notary fee in the case of mortgage loans). In these agreements, banks expected each client to undertake a minimum instalment amount, although most credit institutions were willing to suspend not only the principal repayment but a part of the interest payment as well for a transitional period. This, in turn, also means that the outstanding debt of the borrower continues to increase in the grace period. It is important to see that these kinds of restructurings help only those clients who can overcome their financial difficulties in the grace period. In the case of the others, facing the problem is only postponed until the end of the grace period, when the amount of 'normal' instalment is restored.[10]

In addition to the aforementioned debtor protection packages, banks gave more time as well to debtors to reach an agreement, which was reflected in the decline in the termination ratio of loan agreements; this was clearly the situation in case of mortgage loans (Chart 5). The underlying reason is that the real estate collateral eventually usually ensures the return of the receivable, and owing to the present unfavourable real estate market trends, the stagnating prices and increasing sales periods, early mortgage foreclosure was not the primary interest of banks either (moreover, taking the real estates acquired as collateral en masse to the market would have impaired the expected return by itself). However, in the case of unsecured loans – where the wealth of the debtor struggling with financial difficulties may only continue to decline as time goes by, reducing the chances of recovery of the claims for the bank – the proportion of contract termination did not decline significantly.

In the light of the expansion of the set of tools of collection it is worth examining how effective banks' efforts have proven to be. This is illustrated by Table 1 showing borrowers' 'migration matrices' by performance categories. The two lower matrices contain the migration matrix of housing FX denominated and home equity loans for 2008 Q2, while the two upper tables show the same for 2009 Q2.

[10] Besides banks' own initiatives, the programs, subsidies granted by the government and aiming at assisting those housing loan debtors who found themselves in a difficult situation as a result of the effects of the economic crisis have become available since end-July 2009. However, due to the short time that has elapsed, it is difficult to evaluate the effects of this programme, although according to anecdotal information excessive expectations vis-à-vis government measures may impair clients' payment discipline.

Table 1

Client migration between default categories for housing FX loans and home equity loans, by number of clients

Housing loans (FX)

		2009 Q2 end						
	Overdue category	**0**	**1–30**	**30–90**	**90+**	**Terminated**	**Other**	**Total**
2009 Q1 end	0	77.7%	4.0%	0.9%	0.0%	0.3%	0.6%	83.5%
	1–30	4.5%	3.6%	1.1%	0.4%	0.0%	0.1%	9.7%
	31–90	0.7%	0.7%	0.8%	1.0%	0.0%	0.0%	3.3%
	90+	0.2%	0.1%	0.1%	2.5%	0.1%	0.0%	3.0%
	Terminated	0.2%	0.0%	0.0%	0.0%	0.3%	0.0%	0.5%
	Total	**83.3%**	**8.4%**	**3.0%**	**3.9%**	**0.7%**	**0.8%**	**100.0%**

		2008 Q2 end						
	Overdue category	**0**	**1–30**	**30–90**	**90+**	**Terminated**	**Other**	**Total**
2008 Q1 end	0	79.6%	3.1%	0.6%	0.0%	0.6%	1.4%	85.3%
	1–30	5.0%	2.7%	0.8%	0.2%	0.1%	0.2%	9.0%
	31–90	0.4%	0.6%	0.7%	0.5%	0.0%	0.1%	2.3%
	90+	0.1%	0.1%	0.1%	1.1%	0.1%	0.1%	1.5%
	Terminated	1.5%	0.1%	0.0%	0.0%	0.1%	0.0%	1.8%
	Total	**86.6%**	**6.6%**	**2.2%**	**1.9%**	**1.0%**	**1.8%**	**100.0%**

Home equity loans

		2009 Q2 end						
	Overdue category	**0**	**1–30**	**30–90**	**90+**	**Terminated**	**Other**	**Total**
2009 Q1 end	0	67.2%	5.7%	1.4%	0.0%	0.2%	0.8%	75.3%
	1-30	5.3%	5.7%	2.1%	0.7%	0.0%	0.2%	13.9%
	31–90	0.8%	1.2%	1.7%	1.9%	0.0%	0.1%	5.8%
	90+	0.2%	0.2%	0.3%	3.4%	0.1%	0.1%	4.3%
	Terminated	0.2%	0.0%	0.0%	0.0%	0.4%	0.1%	0.7%
	Total	**73.6%**	**12.8%**	**5.4%**	**6.0%**	**0.8%**	**1.2%**	**100.0%**

		2008 Q2 end						
	Overdue category	**0**	**1–30**	**30–90**	**90+**	**Terminated**	**Other**	**Total**
2008 Q1 end	0	72.0%	4.0%	0.8%	0.0%	0.4%	3.2%	80.5%
	1–30	5.9%	3.8%	1.2%	0.3%	0.1%	0.8%	12.0%
	31–90	0.7%	0.9%	1.1%	0.7%	0.0%	0.2%	3.7%
	90+	0.1%	0.1%	0.2%	1.3%	0.1%	0.2%	2.1%
	Terminated	1.2%	0.1%	0.0%	0.0%	0.3%	0.1%	1.7%
	Total	**80.0%**	**8.9%**	**3.3%**	**2.4%**	**0.9%**	**4.6%**	**100.0%**

Note: For example, the tables show the percentage of transactions in default of 0 day (i.e. non-defaulting), 1–30 days, 31–90 days and over 90 days as well as terminated contracts on 31 March 2009 that belonged to the various default categories 90 days later, i.e. on 30 June 2009. The first and the third tables show 2009 Q2, while the second and the fourth relate to 2008 Q2.

Source: MNB.

As it can be seen in the tables, not only the ratio of borrowers with overdue loans, but also the chances of non-performing debtors to return to the performing (or overdue with shorter duration) categories also declined in 2009 Q2 compared to one year earlier. For example, while in 2008 Q2, in the case of home equity loans overdue of 1-30 days, nearly 50 per cent of all transactions became problem-free, the same ratio one year later amounted to less than 40 per cent.

However, this does not mean that the efficiency of banks' debt management and collection function deteriorated. The unfavourable changes in the migration matrix may rather be explained by the general deterioration in the payment ability of problematic clients (i.e. for example, the number of borrowers who fail to pay because of unemployment increased; for them, it is the lack of ability to pay that causes non-performance, and even with sophisticated debt management techniques the bank cannot help them). Presumably, if credit institutions had not changed anything in their respective debt management policies, the changes in the migration matrix would have shown an even more unfavourable picture.

UNSECURED PROBLEMATIC LOANS AT THE DEBT PURCHASE MARKET

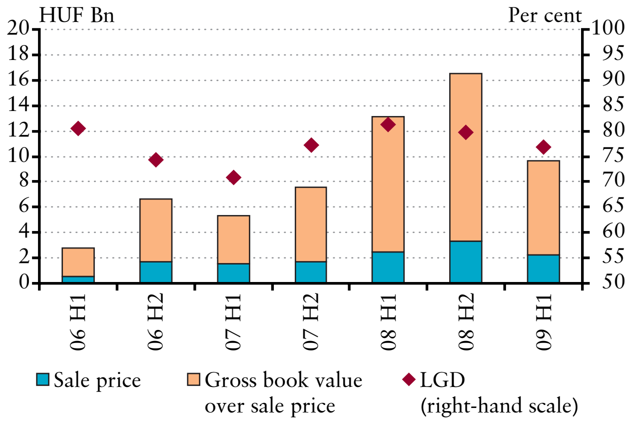
Before the crisis, many domestic credit institutions did not undertake the protracted difficulties of enforcement of rights by court and collection through distraint following termination of a loan agreement. They sold their terminated receivables to financial corporations specialising in debt management and debt purchasing ('factoring companies').[11] These companies become the beneficiaries of the thusly acquired claims, and they are entitled to require all those debt items from the debtor that the bank also demanded (i.e. not only the principal itself, but the transaction and default interest as well). The companies purchasing claims may require the debtor to meet their obligations stemming from the original loan agreement until they have met them completely or until they come to an agreement with the demanding company.

Although the volume of terminated loan agreements increased significantly in banks' books, in 2009 H1, debt purchasing companies were able to buy fewer claims than earlier. One of the underlying reasons is that, as a result of the narrowing of banks' loan supply, access to funding became difficult for some of the debt purchasers as well, and the return on and therefore pricing of problematic household loans became even more uncertain than before.

Chart 6

Sold (mostly unsecured) claims from households on book and sale price

(excl. OTP group)



Note: The LGD (loss given default) is calculated to the sold claims in the given half-year with the following methodology: LGD=(gross book value-sale price)/ gross book value). Therefore, this ratio shows the loss ratio of the bank for the stock in a given half-year.

Source: MNB.

In the past, banks typically sold the loans in default between one-half and two years at 10-30 per cent of the book value of the loan (Chart 6). Selling the loans was mainly typical of unsecured loans, while banks refrained from selling mortgage loans. We cannot see any change in this process as a result of the crisis. In the case of mortgage loans, by selling the real estate the bank can receive its claim within a foreseeable period of time, so this way of collection is more worthwhile for credit institutions than selling at a narrowed debt purchasing market. Therefore, sales may continue to be related to small-amount unsecured loans.

PROBLEMATIC LOANS WITH REAL ESTATE COLLATERAL AND THE TRENDS IN AUCTIONING

In the case of terminated mortgage loans, sooner or later the lender collects its receivable through the real estate applied as a collateral. This may also take place in co-operation with the debtor. In this case it is usually the borrower himself or herself who advertises its real estate for sale, then settles its debt with the credit institution from the purchase price (usually this is the most favourable solution for the borrower). Stipulating a buying option for the real estate is not typical of domestic banks (this rather happens with financial corporations); instead, open auctioning of the real estate (at a given minimum price) is usually stipulated in the loan agreements. Should the borrower fail to co-operate, the

[11] In the domestic professional jargon the term 'factoring' has come to stay for this type of service, although considering the content of transactions it would be more proper to use 'debt collection' and 'purchase of claims'.

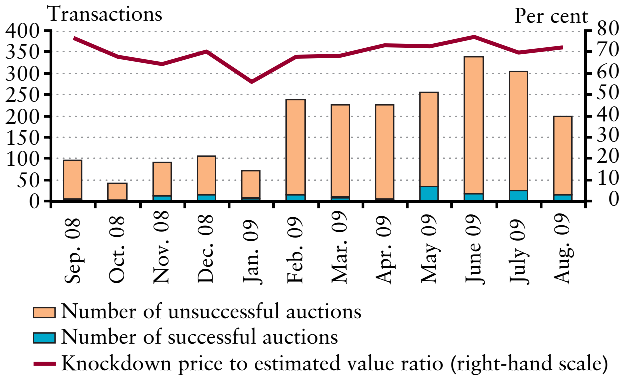
credit institution, with the involvement of specialised companies, is entitled to initiate the auctioning of the given real estate.

Based on a survey conducted among companies dealing with real estate auctions, the monthly average number of real estates offered for auctioning amounted to 75-100 between September 2008 and January 2009, while 200-300 real estates a month came under the hammer starting from February 2009 (Chart 7). However, this figure could be misleading as, on average, a mere 5-13 per cent of the advertised real estates were successfully sold by auctions in the months under review. Thus, the remaining ones may have been auctioned again and again in the subsequent months. Therefore, there is significant duplication in the data. Consequently, adding up the monthly values would result in a considerable overestimation of the number of real estates being auctioned.

Chart 7

Number of real estates offered for auctions and successfully auctioned, and the average knockdown price to estimated price ratio at the auction companies participating in the MNB's survey

(September 2008–August 2009)



Source: MNB.

There may be several reasons for unsuccessful auctions: firstly, it is presumed that this type of collateral enforcement is typical of real estates with less favourable features (as the debtor himself can also sell more valuable, more marketable real estates more easily himself), secondly, arising problems – for example the resistance of the debtor – may discourage many potential buyers. Considering the knock-down prices, the real estates are sold at an average 60-80 per cent of the estimated value at these auctions.

In the event that the direct auctions of the above type do not succeed, judicial enforcement takes place. However, this procedure may take a long time, even years. According to the data of the Chamber of Hungarian Court Bailiffs, in 2008 the total number of auctions of residential real estates amounted to 1500 in the judicial distraint phase, out of which there were 270 evictions. However, it should also be taken into account that these figures cannot yet reflect the effects of the crisis: as we have seen, with the mortgage loans, banks act in a more patient manner than earlier (termination within half a year was rare with mortgage loans anyway), they terminate contracts less often than before, and they try to better co-operate with the debtor. Therefore, the number of both direct and judicial auctions may increase only in the future.