Building a better working world

EBA draft guidelines on loan origination and monitoring

Impact on European banks

Minds made for transforming financial services

25 November 2019

Content

Transforming

The increase in the levels of Non-Performing Exposures (NPE) across the EU has been of concern for regulatory and supervisory authorities in Europe after the latest financial crisis.

Background and rationale

Elevated volumes of NPE have been reported in some European countries, hindering growth in an already week economic environment and limiting financial institutions profitability.

In July 2017, the European Council announced an action plan to tackle the issue. Within this action plan, the European Banking Authority (EBA) was invited to "issue detailed guidelines on banks' loan origination, monitoring and internal governance which could in particular address issues such as transparency and borrower affordability assessment". Two years later, the EBA launched a consultation for its Draft guidelines on loan origination and monitoring[1] on 19 June 2019 which constitutes one of the last components of this action plan.

Built on the existing national experiences, these guidelines aim at addressing shortcomings in the institutions' underwriting policies and practices and improve its associated governance arrangements, processes and mechanisms in relation to credit granting. European authorities aim to ensure that institutions have robust and prudent standards for credit risk taking, management and monitoring, and that newly originated loans are of high credit quality. Another main objective is to ensure that the institutions' practices are aligned with consumer protection rules and respect fair treatment of consumers.

The EBA draft guidelines consultation will run until 30 September 2019; the final guidelines that are scheduled for end-year 2019 and should apply from 30 June 2020 will replace the existing EBA guidelines on creditworthiness assessments under the Mortgage Credit Directive issued in June 2015. The EBA guidelines on loan origination and monitoring apply to all European credit institutions and all credit facilities, excluding debt instruments

This paper presents the context of the EBA draft guidelines and outlines what credit institutions should do to adequately prepare their implementation. It analyses the scope and structure of the guidelines and their articulation with the wider regulatory context. As the EBA tackles in detail a large panel of subjects related to credit origination and monitoring, this publication highlights the main areas of impact for banks and focuses on new regulatory concepts or requirements such as environmental, social and governance ones and technology-based innovation. For each area of impact, EY provides a set of recommendations to support banks compliance with the requirements and initiate a smooth transition towards a sound and effective credit origination and monitoring framework.

Context & overview

General overview

Scope

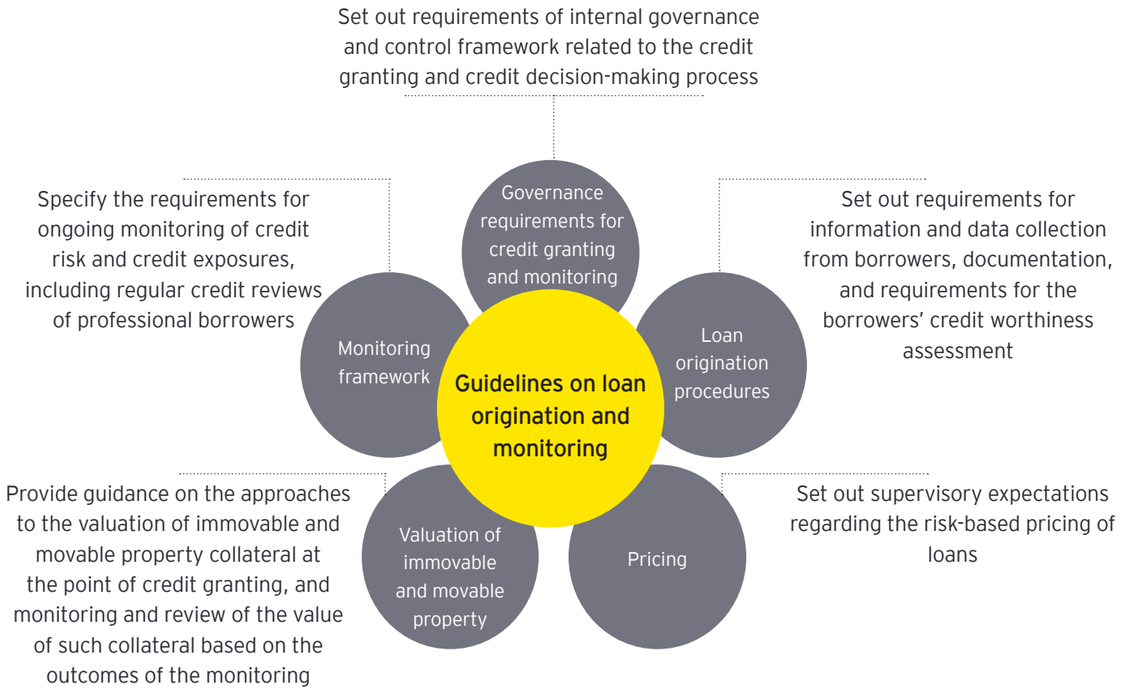
The EBA guidelines on loan origination and monitoring apply to all European credit institutions and all credit facilities, excluding debt instruments. They are composed of 8 sections; the background of the requirements is detailed in the three first sections and the specific requirements are highlighted in the following 5 sections.

Requirements regarding the "loan origination procedures" (Section 5) and "pricing" (Section 6) are not applicable to exposures to financial institutions, public sector and sovereign entities.

The "loan origination procedures" (Section 5) are applicable to exposures originated after the date of application of the guidelines but also to exposures where terms are renegotiated or requires specific actions triggered by the regular credit review after this date even if originated before.

The requirements of these guidelines are subject to the proportionality principle based on the size, nature and complexity of the financial institution for the purposes of governance principles (Section 4) and at the level of credit facilities for all other sections.

Structure of the guidelines



Timeline

Overall context

In addition to establishing prudent and robust standards for credit risk taking, monitoring, and management in a context of loan originating, these guidelines cover a very broad range of topics and regulations by specify/extend the scope of application of several regulatory frameworks and existing guidelines.

Guidelines on loan origination and monitoring

MCD (*)

Introduce requirements for the borrowers' creditworthiness assessment together with the collection of information and data for the purposes of such assessments in line with Articles 18 and 20 of Directive 2014/17/EU (2)

CRD

Specify requirements laid down in the Directive 2013/36/EU (1):

- Internal governance (Article 74(1))
- credit and counterparty risk in relation to granting and monitoring of credit facilities (Article 79)

MLV

Reinforce the control of money laundering and the financing of terrorism:

- specify in their policies how they identify, assess and manage the ML/TF risks to which they are exposed as a result of their credit granting activities

Remuneration

Give additional specifications on the general remuneration requirements (4) applied to credit risk granting with a view to mitigate excessive risk taking in lending activities.

CCD

Incorporate provisions for the credit worthiness assessment in relation to consumer credit in accordance with Article 8 of Directive 2008/48/EC on consumer credits (3)

NPL

Part of the EU Council Action Plan (5) to address the problem of non-performing loans in the banking sector.

First action was the publication of the EBA guidelines on NPE (6) to deal with NPE and forborne exposures.

Stress testing

Explain requirements and scope of stress testing in monitoring process in line with the EBA Guidelines on institution's stress testing (7)

Governance

Provide details on the application of the general internal governance framework (8) on:

- credit risk appetite, strategy
- credit risk policies and procedures
- credit decision-making process
- Internal control

(*) The MCD requirements will be replaced by the EBA guidelines on loan origination and monitoring

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- https://eba.europa.eu/documents/10180/2282644/Guidelines+on+institutions+stress+testing+%28EBA-GL-2018-04%29.pdf/2b604bc8-fd08-4b17-ac4a-cdd5e662b802
- https://eba.europa.eu/documents/10180/2164689/Guidelines+on+Internal+Governance+%28EBA-GL-2017-11%29_EN.pdf

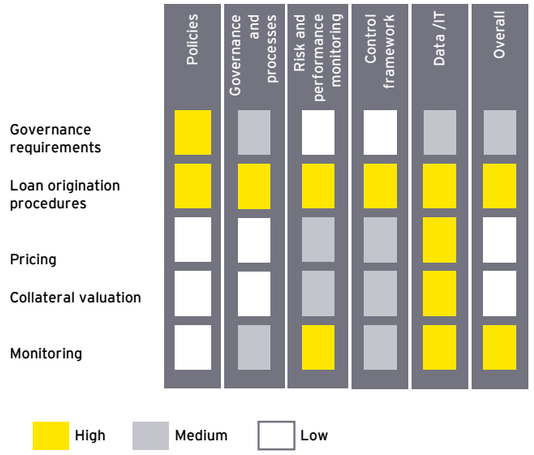
Impacts for banks

These guidelines tackle the overarching scope of the end to end credit granting process. European credit institutions will need to analyse the implications of EBA guidelines on origination and monitoring on their current practices.

They will need to:

- Identify and address any gaps between their policies / procedures and the guidelines
- Ensure that the management framework of credit granting defines management team responsibility and is aligned with their Risk Appetite framework
- Include environmental, social and governmental factors in credit processes
- Define a list of required documents for creditworthiness assessment and criteria and conditions for loan granting
- Ensure that credit decisions to be taken only by people with appropriate experience
- Ensure that collateral valuation adhere to minimum frequency and are made by independent qualify appraisers
- Ensure that pricing policies take into account risk appetite, the institution's strategy and the product's characteristics, clients and their associated risks
- Build an effective monitoring framework, including early warning signals, supported by an adequate data infrastructure
- Build and infrastructure enabling data tracking concerning the exposure, client and security through the whole lifetime of the exposure

Overall estimated impacts of the Draft guidelines (*)



EBA guidelines on origination and monitoring reflect recent supervisory priorities and policy developments related to credit granting. Europeans credit institutions will need to take them into account when they enhance their credit granting framework.

Inclusion of ESG factors

EBA guidelines state new requirements to integrate sustainability within governance, policies, processes and data related to loan origination. Dedicated policies and procedures will be defined in order to set authorized projects and defined criteria for origination of green credit facilities. Banks will set qualitative and quantitative targets to support green lending activities. They should particularly take into account environmental factors and climate changes.

Anti-money laundering and counter-terrorist financing

When considering credit granting, Banks will have enhanced processes to identify, assess and manage the money laundering and terrorist financing risk to which they are exposed.

Governance, procedures and processes of loans disbursement should ensure the effectiveness and the compliance of checks considering risks connected to money laundering and terrorist financings.

Technology-enabled innovation

Banks which consider using technology-enabled innovation for credit granting purposes, should be able to understand the models, measure, outcomes and impacts of used technology. They should also be able to manage error risk and bias due to the given technology and data source. They will periodically perform comparison of the results of solutions based on innovations and results of traditional methods. All the processes will be properly documented within dedicated policies and procedures.

Risk based pricing

When defining the pricing of loans, this pricing should reflect cost of capital allocated, cost of funding, operating and administrative costs, credit risk costs based on historical losses and any other real costs associated with the loans. The profitability should be measured using economic value added (EVA), return on risk-adjusted capital (ROROC) and risk-adjusted return on capital (RAROC).

Why EY

EY's value proposition is to serve our clients delivering end-to-end projects, from design to implementation, from 'Build' to 'Run', combining all the relevant expertise, from Functional to IT skills leveraging on a network of multidisciplinary professionals across the world.

Regulatory support

Support banks in compliance with regulatory requirements, in preparation for supervisory inspections, and supervisory ad-hoc reports (e.g. loan tapes, deep dives ...)

Gap analysis

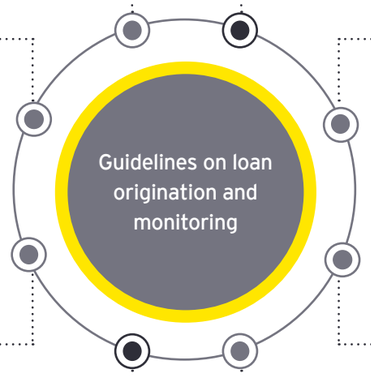
Support of the analysis of the EBA guidelines on loan origination and monitoring requirements Vs financial institutions current situation thanks to a deep know-how of credit-risk related and prudential subjects

Data

Assess data environment in order to enhance quality and design efficient infrastructure by leveraging on innovative technologies

ESG

Assist with the development and implementation of relevant ESG factors as criteria decision in the credit granting



Monitoring framework

Develop or transform the bank's monitoring framework using innovative solutions

Pricing

Develop the pricing transformation through a risk based pricing methodology and related profitability monitoring

Governance and change management

Define an optimal governance and operating models for credit underwriting framework, in line with bank's strategy and risk appetite

Collateral valuation

Assist in the valuation process in any types of collaterals through the whole credit lifecycle

Guidelines summary

Chapter 4

Risk based pricing

- Credit risk governance and culture
  - The role of the management body as regards the credit risk governance consists and is not limited to the definition of the credit risk appetite and the framework credit approvals an the approval of the credit risk strategy. It should ensure that all processes related to and people involved in credit risk management and ctulture are adequate.
  - A well defined and established credit risk culture should ensure that the credit granting process fulfills its fulfills its profitability objective while taking into consideration environmental, social and governance factors. The credit risk culture should be agreed upon and applied by all concerned staff.
- Credit risk appetite, strategy and credit risk limits
  - Credit institutions should insure that their credit risk appetite and strategy is aligned with the global Risk Appetite Framework and details all the characteristics related to the credit portfolio and borrowers. It should specify metrics to quantify and qualify theses characteristics and limits cascaded at all levels of the institution.
- Credit risk policies and procedures
  - The credit risk policies and procedures framework should aim at setting the rules and criteria of credit risk management and identifying its deterioration covering all aspects of the institutions' lending activities.
  - The guidelines specify the requirements that should be included in the credit risk policies and procedures among which: granting criteria, requirements for collection, credit-worthiness assessment, and exposure aggregation and concentration. Credit institutions should also include in these policies and procedures the requirements regarding money laundering and terrorist financing risks and related criteria, the requirements regarding leveraged transactions and their articulation with the risk appetite and strategy.
  - Environmental, social and governance factors, risks and opportunities should be included in institutions credit risk policies and procedures. For their green lending activities, they should issues specific policies and procedures also include the criteria of selection and assessment of such projects and the related processes in the context of their sustainable finance objectives, strategy and policy.
  - Credit granting criteria to be specified in credit risk policies and procedures are detailed in Annex 1.
- Credit decision-making
  - Credit institutions should establish a well-defined credit-decision making framework detailing the roles, responsibilities and limitations of credit committees and credit decision making bodies but also the level of involvement of the credit function.
  - This framework should be based on the independence principle avoiding the existence of conflicts of interests in the granting activities. Any deviation or exception from the credit policies and procedures should be mentioned within an established framework and policies detailing approval and escalation processes.
- Credit risk management and internal control frameworks: They should be integrated in the overall risk management and internal control frameworks respecting the criteria of accountability, segregation and independence of functions and responsibilities, challenge and assurance of outcome. This framework should specify the roles, responsibilities and interactions between functions and business lines respecting the three lines of defense principle.
- Resources and skills: Credit institutions should ensure that they have the sufficient and well-qualified staff and resources allocated to credit risk taking, credit risk management and internal control. These resources should be regularly trained and their organization structure periodically reviewed.
- Remuneration : Institutions' remuneration policies and practices related to credit risk should be in line with the credit risk appetite and strategies. In relation to credit granting, these policies and practices should encourage prudence and be averse to excessive risk-taking.

Chapter 5

Loan origination procedures

- General requirements on information collection
  - Institutions must collect and verify a sufficient level of information on the borrower and if applicable, the guarantor. The collection and verification must be in line with the institutions governance, credit risk policies and procedures. When verifying personal information, institutions must inform and seek permission from the borrower in accordance with Regulation 2018/1725. All information must be documented in a readily accessible form.
  - Information collected must include: Purpose of the loan, Income, Financial commitments, Collateral, Risk mitigation factors.
  - For consumers, it should include employment information. For professionals, it should also include business plan, corporate structure and legal documentation.
  - Information to be collected for the purposes of the collection and verification of information are detailed in Annex 2 of the guidelines.
- Assessment of borrowers credit worthiness
  - A credit worthiness assessment must be performed before concluding a loan agreement and must be accompanied by a sensitivity analysis. The income capacity must be assessed without accounting for any expected significant increase in the future and should consider living expenses of the borrower.

- A sensitivity analysis reflecting negative scenarios must also be performed. Sensitivity analyses should take into account adverse effect on revenues, costs, management, reputation, liquidity, leverage, economic situation, political situation, cost of funding etc.
- In case of professionals, cash flow from ordinary business activities should be considered and if applicable, proceeds from sale of assets financed.
- Collateral should not be the basis of a loan. It should only be a way out in case of a default, not a primary source of repayment. They must also investigate any potential conflict of interest between borrower and institution. In case of cross border transactions, political, legal and economic environment of the foreign countries should also be assessed. Institutions are also expected to analyse the effect of climate change and other ESG risks.
  - In assessing financial position of the borrower, institutions are expected to at least assess the financial metrics listed by the EBA. Holding companies should be assessed as both separate entities and single entities.
  - For professionals, especially in the sectors of construction, project finance, shipping, institutions should assess: Borrowers plan, Information on other stakeholders such as builders, architects, contractors etc, Projection of all costs associated, All necessary permits and ability to acquire them in the future.
- Specific Requirements
  - In addition to the above, the guidelines also list for commercial real estate lending, lending for real estate development, shipping finance, project and infrastructure finance.
- Credit decision
  - Lastly the creditworthiness assessment should be properly documented and used as the basis to approve or decline the loan. Credit decision should be well documented and should provide a record of views and reservations of the credit decision-making body members. In case of a decision to approve, the credit decision should contain information on the amortisation, price, covenants , required collaterals and validity duration of the decision.

Chapter 6

Pricing

- Credit institutions need to adopt a risk-based pricing strategy in line with their risk appetite and strategy. Therefore, the pricing framework should take into consideration the risk vs profitability equilibrium in defining loans' characteristics and institutions need to build their pricing approaches based on the type of borrowers and their riskiness.
- A sound pricing framework takes into consideration the variety of costs linked to the granting process : capital costs, funding costs, operating and administrative costs, credit risk costs, and all other types of costs linked to the loan type and characteristics.
- Requirements regarding loan pricing encompass documentation and monitoring of the pricing framework, cost-allocation and profitability measures in order to guarantee a relevant risk-based pricing.

Chapter 7

Valuation of immovable and movable properties

- Collateral valuation principles stated in the guidelines aim at ensuring that valuations are conducted accurately at the point of the loan origination but also that collateral value monitoring and revaluations are properly performed during the credit lifecycle. In addition to the distinction between valuation requirements at the loan origination and after, different requirements apply for movable and immovable properties. Nevertheless, the starting point of all principles stated in this section remain the article of regulation (EU) N° 575/2013 (CRR).
- Valuation approaches, methods, models, frequency of valuations and rules regarding appraisers selection and assessment need to be documented in credit institutions' internal policies and procedures.
- Valuation at the point of origination
  - Immovable property collaterals should be valued by independent and qualified internal or external appraisers. Different types of valuation approaches (e.g. desktop, drive-by, on location) can be adopted depending on the property and market characteristics.
  - In all cases, credit institutions should ensure that appraisers have the adequate level of expertise, independence and professional certifications and that valuations are duly justified and documented.

Chapter 8

Monitoring framework

- Credit Risk exposures monitoring should be in line with institutions' internal policies and procedures, strategy and risk appetite. In order to ensure that the monitoring framework is sound and reliable, it should be supported by a robust data environment and integrated into institutions risk management framework.
- Monitoring should be based on a framework and data infrastructure capable of automatically generating and treating timely and granular data for internal, external and regulatory reporting. It should also support the decision-making process and risk degradation detection through peer-profiles and sectorial analysis.
- The credit risk monitoring framework should cover the credit risk associated with the borrower, the transaction, total credit risk, and value adjustments of exposures (e.g. impairments and write-offs). It should be based on Key risk indicators (KRI) that allow the identification and monitoring of high risk in institutions lending activities.
- Data infrastructures supporting the monitoring framework should allow an aggregation of credit risk at different levels. Therefore, it should answer to requirements of depth, breadth, accuracy, timeliness, integrity, reliability, consistency and transparency.
- Credit monitoring should be based on both quantitative and qualitative metrics. Examples are detailed in annex 3.

- Monitoring of credit exposures and borrowers
  - It consists in the monitoring of outstanding amounts and repayments, alignment of borrowers and collaterals with policies and granting conditions. This monitoring aims at identifying changes in credit risk and should be based on both internal and external sources of information.
- Credit review of professionals
  - The credit review of professionals aims at identifying any
    changes in their creditworthiness since the origination and update their ratings accordingly. The proportionality principle applies to both the type of borrower and facility.
  - In cases of creditworthiness and asset quality deterioration, more frequent monitoring should be performed and duly documented according to credit risk policies and procedures. Institutions should also regularly compare financial information with the levels obtained at the moment of the creditworthiness assessment at origination, and also a study of the potential impact of external and macroeconomic factors on the borrowers creditworthiness.
  - A special attention should be paid to the refinancing capabilities of borrowers.
- Monitoring of covenants: The monitoring framework should ensure that borrowers respect both financial and non-financial covenants. Such monitoring should protect the institution in cases of breach.
- Stress testing in monitoring process
  - Regular stress testing (at least annually) should be part of the monitoring framework of credit institutions.
    The assumptions of stress test should be reviewed regularly and compared with Risk Appetite limits. Such stress-tests should be based both on macro-economic scenarios and simpler sensitivity tests.
- Use of early warning indicators in credit monitoring
  - Institutions should have in place an Early Warning Indicators (EWI) system allowing for the detection of credit risk deterioration for individual borrowers and portfolios or across smaller homogeneous groups.
  - The EWI framework should be based on triggers that initiate an escalation process and actions should be taken by the relevant teams and functions to assess the severity of the alert and act accordingly. When triggered, EWI should lead to a more frequent and duly documented monitoring and review.
  - This framework should be described in internal policies and procedures.
- Watch list: Credit exposures with an identified risk increase should be regularly monitored and reviewed by the heads of risk, the heads of functions involved in granting activities and the management body.

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