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LOAN ORIGINATION AND MONITORING: EBA'S FINAL STEP TO THE BALANCE SHEET REPAIR JOURNEY

CONTENTS

INTRODUCTION

Back in 2014, the European Central Bank (ECB) performed its first comprehensive Asset Quality Review as a financial health check of the main European institutions' assets. As a result, the ECB launched the Balance Sheet Repair program in response to the high level of non-performing exposures (NPE) in Europe. As a first step, in 2018 the European Banking Authority (EBA) issued guidelines on management of non-performing and forborne exposure for banks to effectively manage and reduce their stocks of NPE. The EBA now aims to prevent these stocks from increasing again - by reducing inflows. To this effect the EBA issued the final guidelines on Loan Origination and Monitoring on 29 May 2020.

These guidelines set out extensive, detailed standards and principles for reinforcing banks' governance, processes and mechanisms in relation to credit granting and credit risk taking as well as management and monitoring. The guidelines will apply to loans originated both before and after the application date and will be subject to a number of proportionality principles.

Although the initial targeted application date of June 2020 has been postponed to June 2021 (for newly originated loans and advances), institutions nevertheless have very limited time to implement the EBA's guidelines which will have a major impact on their operational processes and data management framework and infrastructure.

This paper presents a summary of the main requirements of the EBA's final guidelines on Loan Origination and Monitoring, as well as an overview of the impact and key challenges for banks.

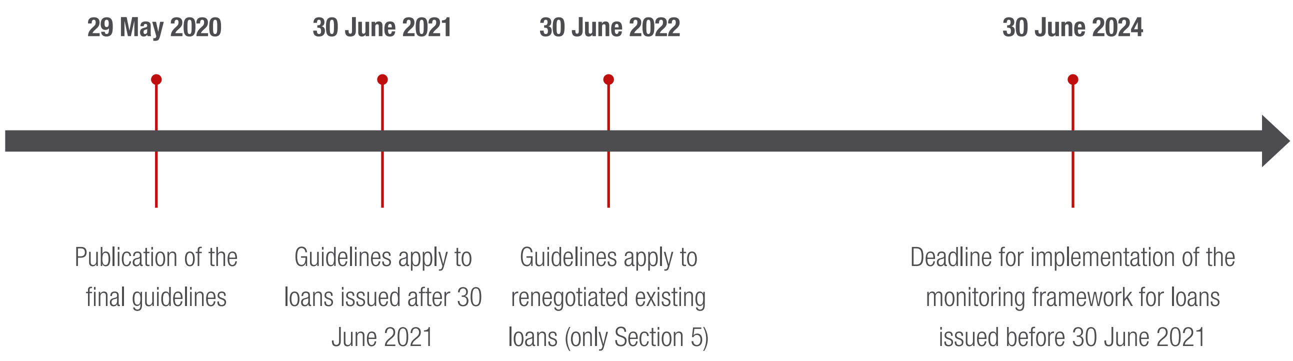
[1] https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring

BACKGROUND AND TIMELINE

The EBA has developed the new Loan Origination and Monitoring guidelines to address shortcomings in institutions' credit-granting policies and practices highlighted by past experiences. At the same time, these guidelines reflect recent supervisory priorities and policy developments related to credit granting, including environmental, social and governance (ESG) factors, anti-money laundering and countering terrorist financing, and technology-based innovation.

Initially intended to cover all loans (even those originated before the application date) on the same application date, the final guidelines acknowledge the difficulties institutions may encounter when complying with these guidelines in relation to renegotiated loans and existing loans. Therefore, the final guidelines exclude existing, non-renegotiated loans and advances from the stipulated requirements (apart from the monitoring framework) and introduce a three-phase implementation, including a transition period of three years intended to ensure the institutions' full readiness and enabling them to address possible data gaps (see timeline below).

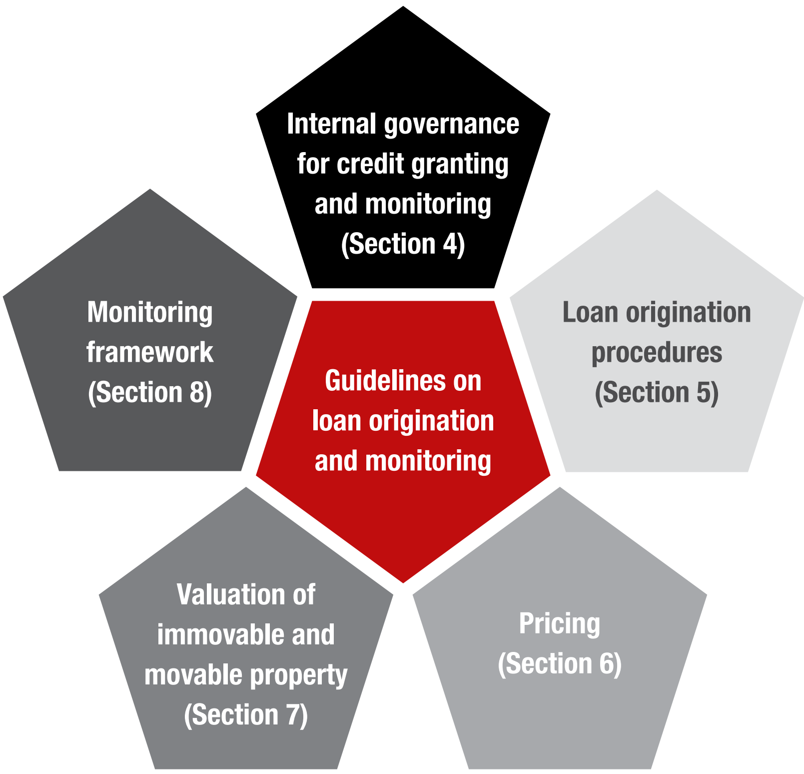
These new guidelines integrate former guidelines on creditworthiness assessment and consumer protection under the Mortgage Credit Directive (MCD) and the Consumer Credits Directive (CDD).



SCOPE

The requirements specified in the guidelines are structured in five sections (sections 4 to 8, with the first 3 sections serving as the introduction). Each section describes a set of obligations covering all loans and advances regardless of their origination date. Some instruments however are excluded from the requirements described in the sections below:

- The guidelines do not apply to **derivatives, debt securities and securities financing instruments**.
- Section 5 (loan origination procedure) and Section 6 (loan pricing) are not applicable to exposures to **financial institutions, the public sector and sovereign entities**.
- Section 5 (loan origination procedure) and Section 6 (loan pricing) are not applicable to **forborne and non-performing loans**.



KEY REQUIREMENTS PER SECTION

INTERNAL GOVERNANCE FOR CREDIT GRANTING AND MONITORING (SECTION 4)[2]

This section in the guidance clarifies the internal governance and control framework for the credit-granting and credit decision-making process.

There is a clear intention for placing credit risk at the heart of the overall risk culture and for working towards building a clear and thorough set of policies and processes dictating the adherence of all staff members involved in every process around credit granting.

The main requirements regarding the internal governance can be summarized as follows:

- Policies and procedures need to specify **a proactive approach** to monitoring credit quality, identifying deteriorating credit early and managing the overall credit quality and associated risk profile of the portfolio, including through new credit-granting activities covering all lending activities, asset classes, client segments, products and specific credit facilities.
- **The credit risk appetite**, credit risk strategy and the overall credit risk policy should be aligned with the institution's overall risk appetite framework. This should be made possible through appropriate credit risk metrics and limits that should cover the relevant group entities and business lines bearing credit risk within the institution.
- Accurately monitor and fully understand **internal and external fraud as well as money laundering and terrorist financing** risks associated with the credit granting process.
- Incorporate the risks associated with **the environmental, social and governance (ESG)** factors on the financial conditions of their borrowers, as well as their own risk appetite and internal policies. There is a special push from the EBA for institutions to work towards the development of a dedicated governance and procedure facilitating **green lending**.

FOCUS ON PROPORTIONALITY PRINCIPLES[3]

When developing and implementing internal governance arrangements, institutions should take into account their size and internal organisation, and the nature, scale and complexity of their activities.

[2] As mentioned earlier, sections 1 to 3 are for introductory purposes

[3] These principles are similar to those set out in Title I of the EBA Guidelines on internal governance EBA/GL/2017/11

LOAN ORIGINATION PROCEDURES (SECTION 5)

This section sets out the general and specific requirements to assess the borrowers' creditworthiness and their ability to meet the institution's credit risk appetite, policies and limits. These requirements specify a creditworthiness assessment toolbox, in two steps:

- Collection of **all relevant information on the borrower**
- Assessment of the borrower's **creditworthiness and their ability to meet their obligations**

GATHER INFORMATION AND DOCUMENTATION		• Gather a client's specific relevant information, depending on the client's category • Perform assessment of the degree of plausibility of the information provided by the client • Thoroughly document data provided by the client as well as their accuracy assessment
CREDIT WORTHINESS ASSESSMENT PROCEDURE	QUALITATIVE ANALYSIS	• Perform qualitative assessment of the borrower's creditworthiness • Specific requirements are made depending on the type of the borrower (consumer, SME, large corporates) and the type of lending
	CREDIT WORTHINESS METRICS	Unlike the draft version, and taking into account the principle of proportionality, the final version of the assessment only provides **non-prescriptive metrics** in the appendix, depending on the type of borrowers. For example: • **For consumers**: Loan to income, debt to income, loan to value, etc • **For SMEs and large corporates**: EBITDA, debt to equity ratio, enterprise value, etc
	SENSITIVITY ASSESSMENT	• Conduct **sensitivity analyses** reflecting how the client's creditworthiness is impacted by a potential adverse scenario • Scenarios should be severe but plausible and should cover **market and idiosyncratic events** that are relevant to the type of borrower and the type and purpose of the loan

FOCUS ON PROPORTIONALITY PRINCIPLES

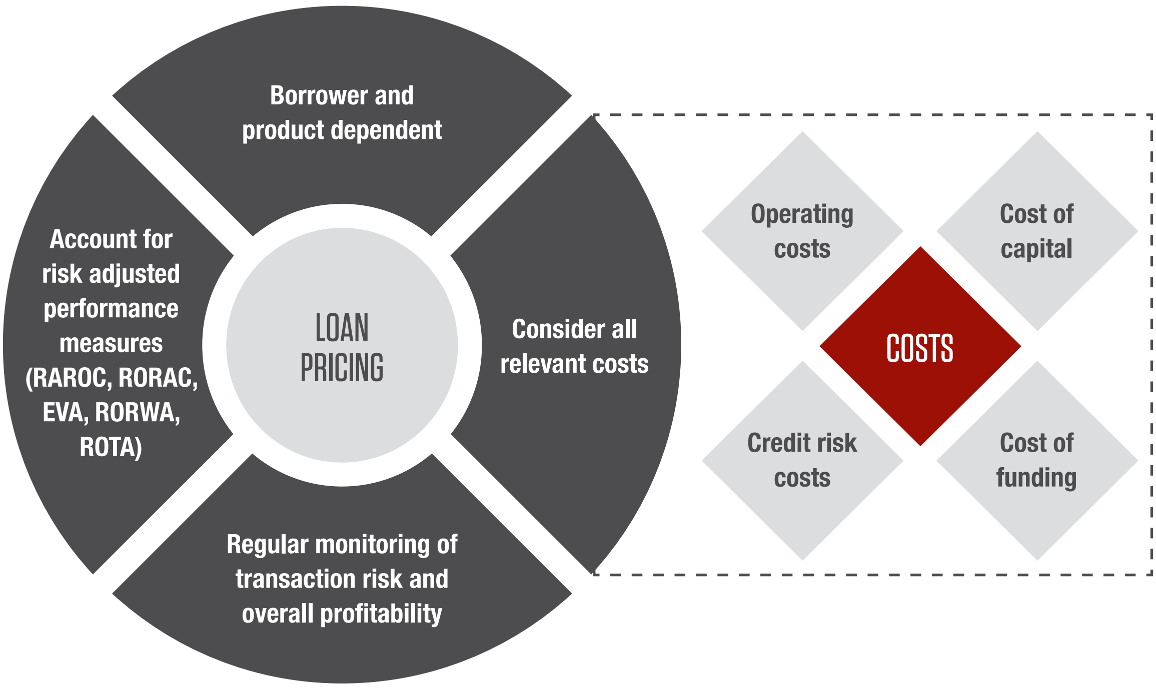
- The size, nature and complexity of the credit facility should be taken into account during the assessment of the borrower's creditworthiness.
- The guidelines provide clarification to the 'professional' category stipulated in the draft version, dividing it in the final version into 'micro and small enterprises' and 'medium-sized and large enterprises', with specific requirements for loan origination procedures in each category.
- The final version of the guidelines lifts the prescriptiveness regarding the creditworthiness assessment metrics. These are described as best practices in the annex section.

PRICING (SECTION 6)

This section details supervisory expectations for a comprehensive pricing framework for loans, listing a set of risk-based elements that institutions should consider and reflect when pricing newly originated loans.

It is expected that institutions should put in place a **pricing framework for loans in line with their risk appetite, business strategies, profitability and risk perspective.** Such a framework should incorporate pricing strategies that take into account the type of borrowers and of loans.

Moreover, the guidelines expect the pricing framework to consider the following building blocks:



VALUATION OF IMMOVABLE AND MOVABLE PROPERTY (SECTION 7)

This section provides guidance on the approaches to **the valuation of immovable and movable property** collateral at the point of **credit granting**, and the **monitoring** and review of the value of such collateral.

The requirements detailed in this section are similar to those described in the collateral valuation section of the EBA guidelines on non-performing and forborne exposures.

The requirements are summarized in the table below:

VALUATION AT ORIGINATION POINT	IMMOVABLE PROPERTY	• Independent internal or external valuation • Thorough procedures and valuation documentation • Accepted panel of external valuers	Valuation either through full visit of the property or by using advanced statistical models
	MOVABLE PROPERTY		Internal thresholds and limits that require an individual valuation of movable property collateral should be specified in the internal policies

MONITORING AND REVALUATION	IMMOVABLE PROPERTY	• Set policies describing the institution's approach to revaluating collateral
		• Define an adequate collateral value monitoring frequency
		• Actively monitor the accuracy of statistical models as well as the adequacy of the model with the type of asset and lending product
		• Define and document specific trigger indicating when collateral needs revaluation
		  • If the review conditions are met, review should be performed using a valuer and may be assisted with statistical models
		  • If the conditions are not met, the collateral value may be updated using a valuer or statistical models	

	MOVABLE PROPERTY	• For revaluation, institutions may rely on the assessment of valuers, statistical models and indices • For monitoring, institutions may rely on statistical models • Document the monitoring and revaluation policy, as well as the revaluation frequency • The revaluation policy should include criteria for individual movable property when relevant	

FOCUS ON PROPORTIONALITY PRINCIPLES

Institutions should take into consideration the size, nature and complexity of the credit facility and the collateral.

MONITORING FRAMEWORK (SECTION 8)

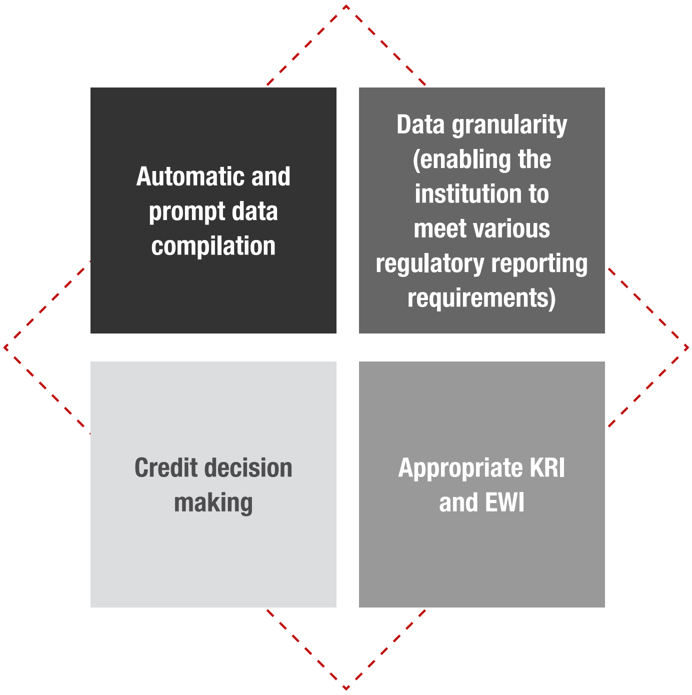
This last section focuses on supervisory requirements for the ongoing monitoring of credit risk and credit exposures, including regular credit reviews of at least medium-size and large enterprises.

In this section, the EBA also sets out supervisory expectations for **the management information systems** to be used for monitoring and the framework of **early warning indicators/ watch lists**, thus building the link between the ongoing monitoring and early detection of loans with deteriorating credit quality that are also covered in the EBA guidelines on management of non-performing and forborne exposures.

The guidance expects institutions to build a robust and effective monitoring framework that is:

- Well defined and documented
- Integrated into their risk management and control frameworks
- Allows for credit risk exposures follow-up through their life cycle.

The required monitoring framework should allow the following high-level features:



In terms of design, the EBA guidelines propose the following steps and requirements for an effective monitoring framework:

MONITORING

- Monitoring of credit exposures and borrowers
- Periodic assessment of creditworthiness for professionals
- Close assessment of financial and non-financial covenants
- Establishment of quantitative and qualitative EWI, with appropriate framework and trigger levels
- Monitoring of borrowers placed on the watchlist

ANALYSIS

- Stress testing on the aggregate credit portfolio and sub portfolios (removed from the final version)
- Periodic analysis of exposure concentration
- Analysis of various KRIs at each layer of granularity
- Analysis of triggered EWIs and assessment of the level of severity

DECISION MAKING

- Impairments, reversal of impairments, write-offs
- Follow-ups and escalations
- Increased frequency of credit review for watched borrowers
- More intense information gathering from borrower
- Money laundering/terrorism financing escalations

FOCUS ON PROPORTIONALITY PRINCIPLES

The EBA has clarified that the monitoring framework should be proportionate to the size, nature and complexity of the institution; the size, nature and complexity of the credit facility; and the type, size and risk profile of the borrower.

The EBA also acknowledges that there might be some data gaps when it comes to the monitoring of loans originated prior to the application of these guidelines and has introduced three-year transitional arrangements to address such data gaps.

IMPACT FOR BANKS

The EBA guidelines will have a major impact on institutions' credit frameworks and will require significant resourcing efforts to implement. In this section we outline the main impacted areas and challenges:

	KEY CHALLENGES
CULTURE AND GOVERNANCE	• Potential overhaul of the institution's policies and procedures • The necessity to incorporate ESG factors and AML/CT principles • Ensuring an adequate level of awareness and training, at business and support functions
DATA AND IT	• Capacity to collect the various data required as credit granting criteria and for creditworthiness assessment as well as for risk monitoring • Appropriate IT infrastructure enabling the swift and timely monitoring of early warnings and the subsequent escalation, and ensuring the fluid and compliant reporting to senior management and supervisors
MONITORING	• Specification of a set of quantitative and qualitative KRIs and EWIs that cover the full cycle of loans • A comprehensive monitoring system and a clear escalation action plan need to be defined and documented in the institution's internal policies
LOAN GRANTING PROCESS	• Significant effort is expected to implement the requirements around the loan granting procedure • A substantial challenge is also anticipated with the implementation of the required metrics and sensitivity analysis of the borrowers projected debt service capacity • A potential need to overhaul the existing credit policies, processes and procedures in order to comply with the guidelines
REPORTING AND OTHER IMPACTS	• The reporting framework needs to be adjusted to comply with the regulation • A significant workload is expected to perform the gap analysis in a short period of time • Institutions need to ensure consistency of practices across jurisdictions/legal framework/entities, taking proportionality into account

Considering the depth of the Loan Origination & Monitoring guidelines, their impact on credit granting and monitoring processes and the significant investment required in technology and data, institutions must begin the gap analysis and design a remediation roadmap as soon as possible. Given the tight deadlines, goals must be clearly defined and remediation actions prioritized to ensure success.

Capco has extensive experience in supporting clients with regulatory change, including the Non-Performing Exposures framework, from the current state assessment to design and implementation of a compliance framework.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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