

Just in Time

EBA Draft Guidelines on Loan Origination and Monitoring *Main Features and Remarks*

Dec 2019

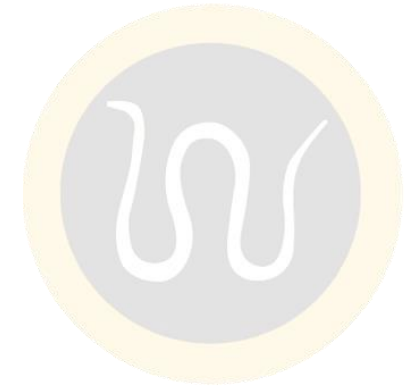
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01

Introduction



Introduction

- In June 2019 the European Banking Authority (**EBA**) published the **Consultation Paper on draft guidelines on loan origination and monitoring** ([EBA/CP/2019/04](#)) as a response to the [European Council Action Plan](#) on tackling the issues such as transparency and borrower affordability assessment.
- These guidelines must be implemented in business procedures of financial institutions by **June 2020** and should replace the existing EBA Guidelines on creditworthiness assessments under the MCD ([EBA/GL/2015/11](#)).
- The presentation highlights the **main innovations** of the proposed guidelines with specific **remarks** on:
 - Governance Requirements for Credit Granting and Monitoring
 - Loan origination procedures
 - Pricing Framework
 - Valuation of Movable and Immovable Property
 - Monitoring Framework
- On **Pricing Framework**, Iason has developed deep expertise on a *Business-to-Risk* integrated framework, the **Full-Risk Pricing Approach (FRPA)**, that serves both for EBA compliance and strategic tool for bank's managerial planning.

02

Governance Requirements for Credit Granting and Monitoring





Credit risk **governance**: define RAF, aligned with ICAAP and ILAAP



Credit risk **culture**: spread risk culture all over the institutions



Credit risk **appetite, strategy** and credit risk **limits**: RAF main instrument to define strategy, detail the operations to reach risk appetite defined on high level

Governance Requirements for Credit Granting and Monitoring

Overview 2/2



Credit risk **policies** and **procedures**: define framework, precise granting criteria, anti-money laundering and counter-terrorist financing, define leveraged transactions*, technological methods should not be used in credit granting phase and compared with traditional method in monitoring phase, develop green lending policies, data infrastructure supportive and efficient.



Credit **decision making**: define clear framework, independence and minimize conflict of interests, exceptions and escalations, lending to affiliated partners regulated.



Management and internal control: accountability, segregation and independence of functions and responsibilities, challenge and assurance of outcomes. Define comprehensive framework.

*ECB guidance 2017 define leverage transactions as: the borrower's post-financing level of leverage with a ratio between Total Debt and EBITDA over 4.0 or borrower is owned by one or more financial sponsors (investment firms that undertake a private equity investments with intention to exit on a medium-term basis).

Governance Requirements for Credit Granting and Monitoring

Just in Time

Remark 1/2



Unrealistic deadline: The provisions significantly change the origination and managing process of loans and therefore, many institutions deem the implementation deadline (June 30, 2020) to be unrealistic.



Imprecisions regarding the scope: should they apply only to newly originated loans, or should they cover the existing loans granted before the application date or regular credit review of a deal? In the latter case the implementation would be more costly.



Consolidation level: the chapter mentions that Competent authorities should ensure that institutions apply these guidelines on an individual, sub-consolidated and consolidated basis. Banks operating in third countries might face greater difficulties in complying with these guidelines at a sub-consolidated or individual level (especially those that operate outside of EU).

Governance Requirements for Credit Granting and Monitoring

Just in Time

Remark 2/2



Only high-level principles: the chapter is quite abstract and focused on defining high-level principles that can be adequately respected by the bank via few efforts. The only debatable topic is the one on not using highly-digitalized methods to evaluate collateral during the granting process but to put forward traditional and costly methods. Also, these standardized rules for the creditworthiness assessment provided in the guidelines may prevent the appropriate assessment of the high-risk borrowers and make banks reluctant to extend credit to innovative and entrepreneurial companies.



Use of traditional models at origination: if a new methodology is properly back-tested against a traditional model its use should be allowed provided that the institution maintains both the new and the old model in place. This could be very difficult to put in practice since the two methods can have completely different drivers and may therefore, give different outcomes. Also, the question is what should the new banks which have no "old" model in place do?



New data and modelling requirements: the request to collect the data on anti-money laundering, environmental and social factors, governance factors, counter-terrorist financing, technology-based innovation, etc. can be burdensome in both bureaucratic and "know-how" terms. Do banks have access to such data and is the data available at all? For instance, the sustainability related data may not be available in long term. Also, if the data were available do banks have a sufficient know-how on assumptions and models used in quantifying these risks?

03

Loan Origination Procedures



Loan Origination Procedures

Overview



Collection of information and documentation: collect updated info on all risk-owners during all the credit phase (borrower, guarantee, guarantor), minimum required information needed for borrower's type



Assessment of borrower's creditworthiness: general requirements, minimum parameters and metrics, stress negative scenarios, assessment of financial position, business model & strategy, **guarantees and collateral for different borrower categories:**

- **Consumers**
- **Professionals**
- **SME**
- **Commercial Real Estate**
- **Shipping Finance**
- **Project and Infrastructure Finance**



Credit decision and loan agreement: collect info and decision-making process in document, compliance with risk policies, record of views, limit time for credit decision

Loan Origination Procedures

Remarks



Lack of proportionality: The note does not specify the application of the proportionality principle in the assessment of the creditworthiness of clients. However, the banks in practice apply very different processes between simple retail loans and sophisticated non-retail loans with significant exposure. To assure this differentiation (e.g., non-retail process and retail small business cannot be regulated under the same rule) the principle of proportionality should be applied (i.e., the so-called materiality of the transaction should be taken into account).



Obstacles for SME financing: previous issue is particularly relevant as European business environment is mainly composed by SMEs - in addition, considering that the majority of European SMEs depend on banks for their financing, this will hamper their possibilities to achieve their financing goals.

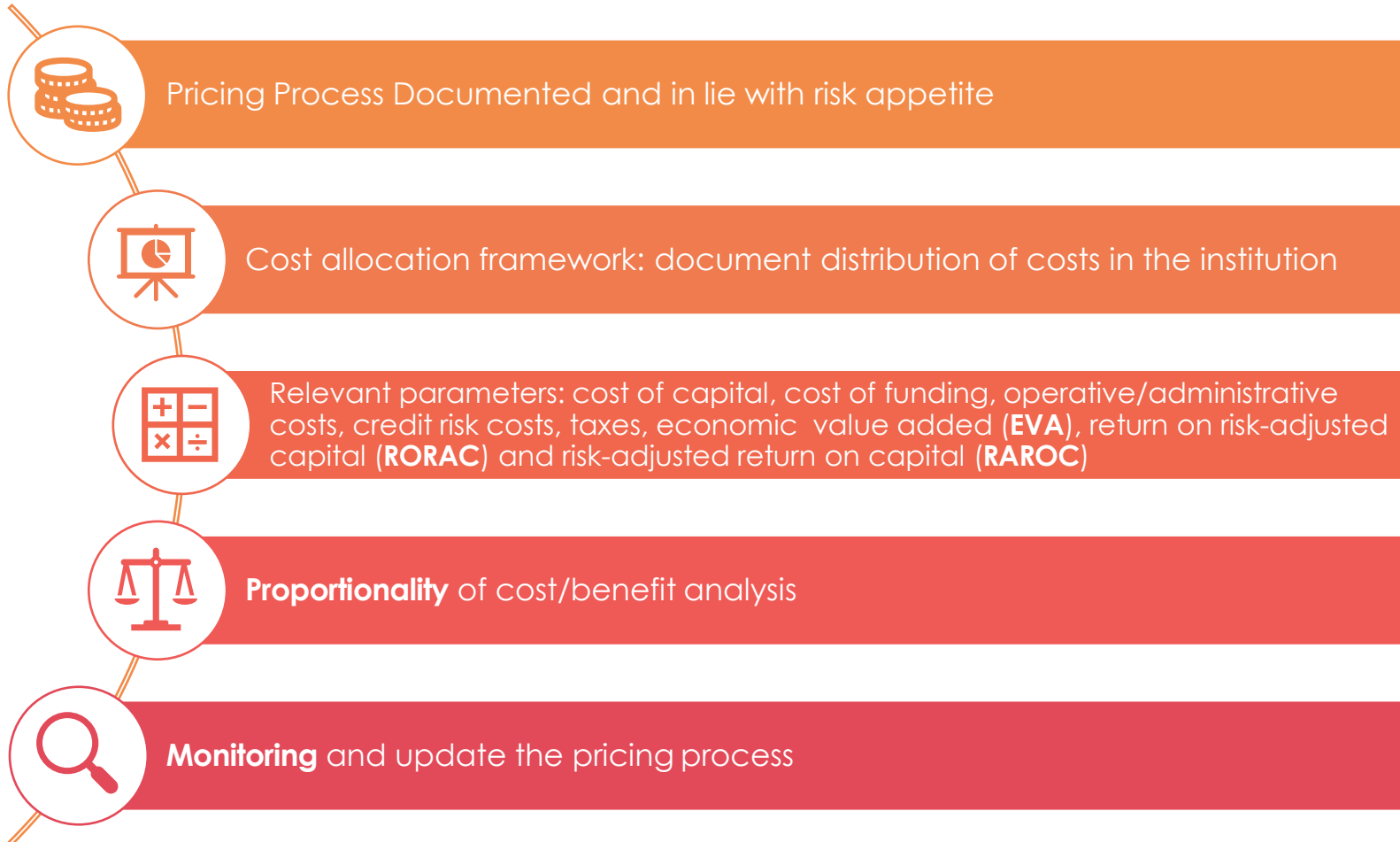
04

Pricing Framework



Pricing Framework

Overview



Pricing Framework

Remarks



Calculation of costs: EBA methodology requires to include in the pricing of loans all the costs and risks that the market does not account for. This implies that the banks should take a more mechanical approach towards pricing, rather than rely on bidding competition among institutions which could result in an excessive accumulation of risks in the medium to long term; i.e., banks need a strategic approach to get fair prices on their investment and then perform business decisions.



No implementation instructions: the note, however, does not give enough details on how the banks should implement this part of the guidelines, leaving too much room for interpretation. This may discourage banks to implement these rules because of risks of losing valuable clients and the risk of exclusion.

Iason Proposal

To overcome these remarks, **Iason** has implemented the **Full-Risk Pricing Approach (FRPA)** to the Banking Book:

- compliant with EBA's requirements on risk-based pricing of loans, FRPA is a **comprehensive framework** for the pricing of loans that considers both the **risk appetite** and the **business strategies** of a financial institution.
- FRPA is a **multi-layer approach** which allows to properly calculate the **Fair Rate on Investment (FRI)** accounting for all the production costs and **monitoring** a day-to-day evolution of **Profit & Loss (PL)**, providing *de facto* the top management with an effective approach to measure overall bank's profitability







05

Valuation of Movable and Immovable Property



Valuation of Movable and Immovable Property

Summary & Remarks

 Valuation at point of origination	 Monitoring and revaluation
<p>compliance with applicable international standards when valuing and institutions should set out internal policies and procedures for valuation, in line with the institution's credit risk policies</p>	<ul style="list-style-type: none"> ✓ set out appropriate frequencies for monitoring the value of the collateral considering the type and value of the collateral at origination; ✓ introduce policies and procedures for the revaluation of immovable property collateral specifying the approaches to revaluation and specific triggers indicating when monitoring leads to revaluation or a collateral needs revaluation
 Reference value	 Valuers
<ul style="list-style-type: none"> ✓ market value or mortgage landing value 	<ul style="list-style-type: none"> ✓ ensure adequate rotation of valuers (after two consecutive valuations, a valuer needs to be substituted); ✓ valuers' results should not be affected by their pay nor by some conflict of interest
 Movable property	<p style="text-align: center;">Remark</p> <p>No distinction among different loan types: when talking about the valuation of the movable and immovable collaterals no distinction is made between cash flow-based lending and asset-based lending. It feels disproportionate to apply all requirements to cash flow-based lending in which the collateral is mainly held for fall back purposes.</p>
<ul style="list-style-type: none"> ✓ very general requirements on the quality of data and understanding of statistical models in case of the use of models; also very general notes in case of the use of external valuers 	
 Immovable property	
<p>in case of significant deterioration in the repayment capacity, the revaluation is necessary</p>	

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Monitoring Framework



Monitoring Framework

Overview 1/2

Design and implementation of credit risk monitoring framework

ability to collect granular data on all exposures of the client over time

consistence with prudential statistical reporting requirements

ability to make cross-institutional comparisons

Monitoring framework elements

credit risk associated with the borrower and the transaction

credit risk associated with the country of ultimate exposure and impairments/writeoffs

consistence with prudential statistical reporting requirements

ability to make cross-institutional comparisons

Data features

accuracy, integrity, traceability, definition consistency over time etc.

Analysis of qualitative factors as well



Monitoring Framework

Overview 2/2

Credit review of professionals

identifying any changes in their financial position or creditworthiness by conducting periodical re-assessments of the factors affecting the riskiness of the particular client and by updating the data on the particular client

Monitoring of covenants

check borrower's adherence to covenants

Stress testing in monitoring process

regular performance of stress tests

Early warning indicators

define and monitor early warning indicators (EWIs) and their triggers for diverse client groups;

once the triggers are activated the institution should assess the severity of the event

Watch list

establish policies and procedures for monitoring credit exposures and borrowers with increased risk, including those identified through monitoring of EWIs;

the reviews should not only include the analysis of risk factors (credit scoring/rating, analysis of negative events, etc.) but also the establishment of appropriate action plans

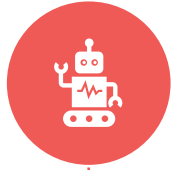


Monitoring Framework

Remarks



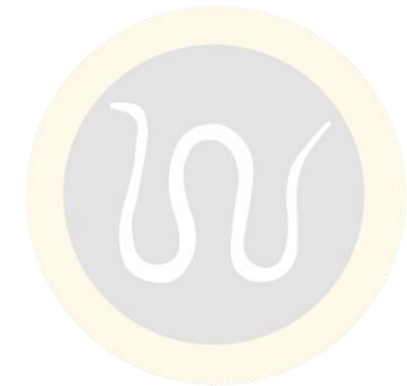
Disproportionality: the monitoring procedures proposed by EBA are disproportionate in relation to the average size of the banks' portfolio loans. For instance, the use of EWIs would be practical only for the corporate customers, but this is not specified in the GL.



Automatization of data management: the requirement to automatically gather and compile data regarding credit risk with minimal or no reliance on the manual processes is very costly in terms of IT development.

Company Profile

Iason is an international firm that consults Financial Institutions on Risk Management. Iason integrates deep industry knowledge with specialised expertise in Market, Liquidity, Funding, Credit and Counterparty Risk, in Organisational Set-Up and in Strategic Planning



This document was prepared in collaboration with Milica Antonijevic and Tancredi Mollica, who at the time were working for Iason Consulting.

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