DEEP IMPACT

New European guidelines on loan origination aim to improve financial institutions' practices throughout the loan cycle while also preparing them for future challenges.

SARA AMANDA O'KEANE
DIRECTOR, RISK ADVISORY
Deloitte Ireland

SEAN SMITH
PARTNER, BANKING LEADER
Deloitte Ireland

The final Guidelines form part of the response to the European Union's Action Plan regarding high levels of non-performing exposures witnessed throughout the global financial crisis (GFC), with non-performing loan (NPL) ratios remaining at pre-GFC levels in some countries at present.

The objective of the Guidelines, which differ significantly in some aspects to the previously published draft Guidelines issued 19 June 2019, is to:

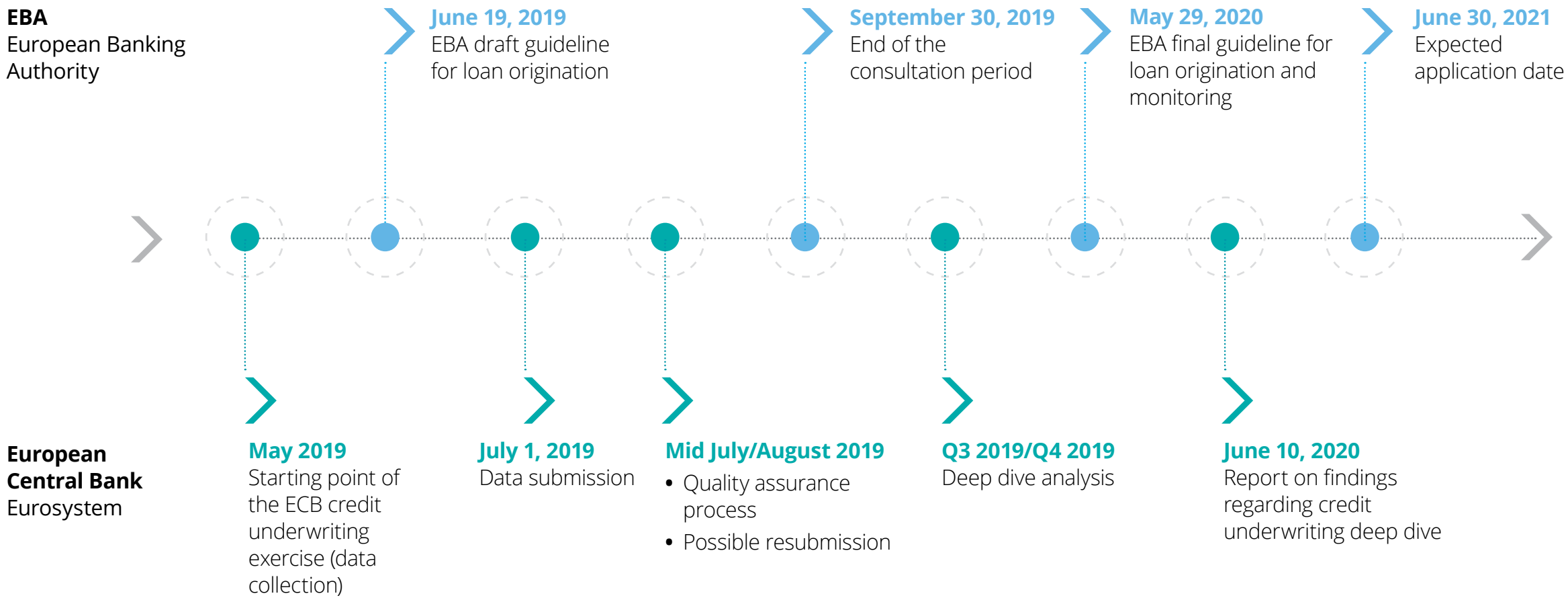
- Further improve institutions' practices and governance to ensure effective management and monitoring throughout the loan cycle;
- Prepare the banking sector for upcoming challenges within the EU banking sector (for example, sustainability, fintech etc.); and
- Improve profitability by ensuring that newly originated loans are of high credit quality, while respecting and protecting the interests of consumers.

The COVID-19 pandemic has heightened the necessity of maintaining good credit risk management standards to support lending to the economy. This also ensures the adequate identification and proactive management of situations where obligors may face financial difficulty. In May 2020, it was estimated that COVID-19 is set to drive €4bn in loan losses for the Irish banks[1].

It is worth noting that the European Central Bank (ECB) is also strengthening its approach in this regard with a focus on credit underwriting being a supervisory priority for a second year in a row. The ECB's report from June 2020 outlines findings on the topic with further detailed analysis anticipated this year across areas of perceived heightened risk via onsite inspections and follow up actions.

1. *The Irish Times* May 27, 2020.

Figure 1. Framework of the EU Council's Action Plan



Key areas of impact

The Guidelines were published much later than anticipated which reflects the depth of requirements and the volume of consultation comments provided by industry.

Given the changes, even banks that have already adjusted their loan origination and monitoring process to meet the draft Guidelines will have some distance to travel to meet the updates outlined in the final Guidelines.

The Guidelines were published much later than anticipated which reflects the depth of requirements and the volume of consultation comments provided by industry.

Even if banks have commenced work in recent months in light of the draft Guidelines, it is worth noting that the final Guidelines:

- Add a number of additional requirements to ensure the effective incorporation of ESG factors and associated risks into credit risk appetite, valuations and credit worthiness assessments;
- Differentiate pricing frameworks considerations based on types of loans and borrowers;
- Include additional monitoring requirements for banks engaged in syndicated leveraged finance transactions and the inclusion of qualitative factors in gauging repayment capacity;
- Replace the definition of professionals with micro and small enterprises and midsized to large enterprises;
- Specify criteria for assessing the credit worthiness of real estate, leverage finance and project finance;
- Further consider automation of models.

Figure 2. Indicative areas of impact of the EBA Guidelines

EBA guidelines	Credit policies and procedures	Organisational design	Control environment	KRIs and monitoring	Data infrastructure
Governance	●	●	◐	◐	◐
Loan origination	●	●	●	●	●
Pricing	●	◔	◕	◕	◐
Collateral valuation	◑	◔	◕	◕	●
Monitoring	◑	◔	◕	●	●

Focus areas within the Guidelines

The Guidelines comprise five sections which are summarised below.

1. Internal governance

In addition to the provisions set out in the EBA Guidelines on Internal Governance (EBA-GL-2017-11), banks must ensure they:

- Define a credit risk strategy within their overall business strategy to ensure alignment with the bank's risk appetite framework in addition to capital (ICAAP) and liquidity (ILAAP);
- Set a credit risk appetite which should be supported by appropriate credit risk metrics and limits covering client segments, currency, collateral types and credit risk mitigation instrument with backward and forward-looking indicators;
- Outline a credit risk appetite which specifies concentration and diversification objectives relating to business lines, geographies, economic sectors and products;

The new Guidelines also set out specific conditions for the application of automated decision-making models for creditworthiness assessment and credit decision making.

- Develop an appropriate credit risk management culture;
- Set out the anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements in the context of credit granting;
- Clearly define roles across the three lines of defence with regards to credit decision making process e.g., emphasising the principle of independence of different functions (e.g., business and risk) in decision-making;
- Set out the requirements for robust and effective credit risk management and internal control frameworks, as part of the institutions' overall risk management and control frameworks;
- Consider general remuneration requirements with regards to credit risk granting, with a view to mitigating excessive risk taking in lending activities.

This section of the Guidelines also introduces environmentally sustainable lending dimensions and defines requirements for institutions to take into account environmental, social and governance (ESG) factors with a view to environmentally sustainable lending and associated risks within their credit policies and procedures.

2. Loan origination procedures

As the title of the Guidelines would suggest, loan origination is the core chapter of the Guidelines focusing on the granularity of quantitative and qualitative information informing sound credit risk practices including:

- Additional requirements for collection of information from borrowers (consumers, micro and small enterprises or medium-sized and large enterprises), including the need to verify the authenticity of data and plausibility of all information provided by the borrower;

- Banks should enable a single aggregated, consistent and comprehensive customer view;
- In line with the European Commission's carbon neutral and green economy goals, the Guidelines require banks to take into account the impact of risks associated with ESG factors on the financial condition of borrowers.

The new Guidelines also set out specific conditions for the application of automated decision-making models for creditworthiness assessment and credit decision-making. In particular, banks should have in place:

- Measures to ensure the traceability, auditability, and robustness and resilience of the inputs and outputs;
- Internal policies and procedures ensuring that the quality of the model output is regularly assessed, using measures appropriate to the model's use, including back testing the performance of the model;
- Control mechanisms, model overrides and escalation procedures within the regular credit decision-making framework, including qualitative approaches, qualitative risk assessment tools (including expert judgement and critical analysis) and quantitative limits.

3. Pricing

The pricing section of the Guidelines defines the supervisory expectations for the risk-based approach, including the implementation of a comprehensive framework for the pricing of loans.

Banks will be required to differentiate between their pricing frameworks, depending on the types of loans and borrower. For consumers, micro and small enterprises, the pricing should be more portfolio and product based, whereas for medium-sized and large enterprises the pricing should be more transaction and loan specific.

For the purposes of loan pricing and measuring profitability, institutions should consider and account for risk-adjusted performance measures e.g. return on risk-weighted assets (RORWA), return on total assets (ROTA) and other measures that are relevant to the characteristics of the loan. Risk-adjusted performance measures should reflect the institutions' capital-planning strategies and policies.

The Guidelines also set out additional criteria for advanced statistical models used for valuation, revaluation and monitoring of collateral.

4. Valuation of the immovable and movable property

The valuation section of the Guidelines provides guidance regarding the valuation of immovable and movable property collateral at the point of granting credit, ongoing monitoring and review of the value of such collateral based on the outcomes of monitoring. This section presents the supervisory expectations for independent valuers as well as the conditions that allow for advanced statistical models to be used for the valuation, monitoring and revaluation of collateral.

The Guidelines also set out additional criteria for advanced statistical models used for valuation, revaluation and monitoring of collateral. Banks must ensure that advanced statistical models are:

- Property- and location-specific at a sufficient level of granularity (e.g., postcode for immovable property collateral);
- Valid, accurate and subject to robust and regular backtesting against the actual observed transaction prices;
- Based on a sufficiently large and representative sample, and observed transaction prices; and
- Based on up-to-date data of high quality.

5. Monitoring framework

The monitoring framework of the Guidelines specifies that a monitoring framework and data infrastructure should be put in place to provide automatic compilation of data regarding credit risk with minimal reliance on manual processes where feasible.

This section also outlines requirements with regards to:

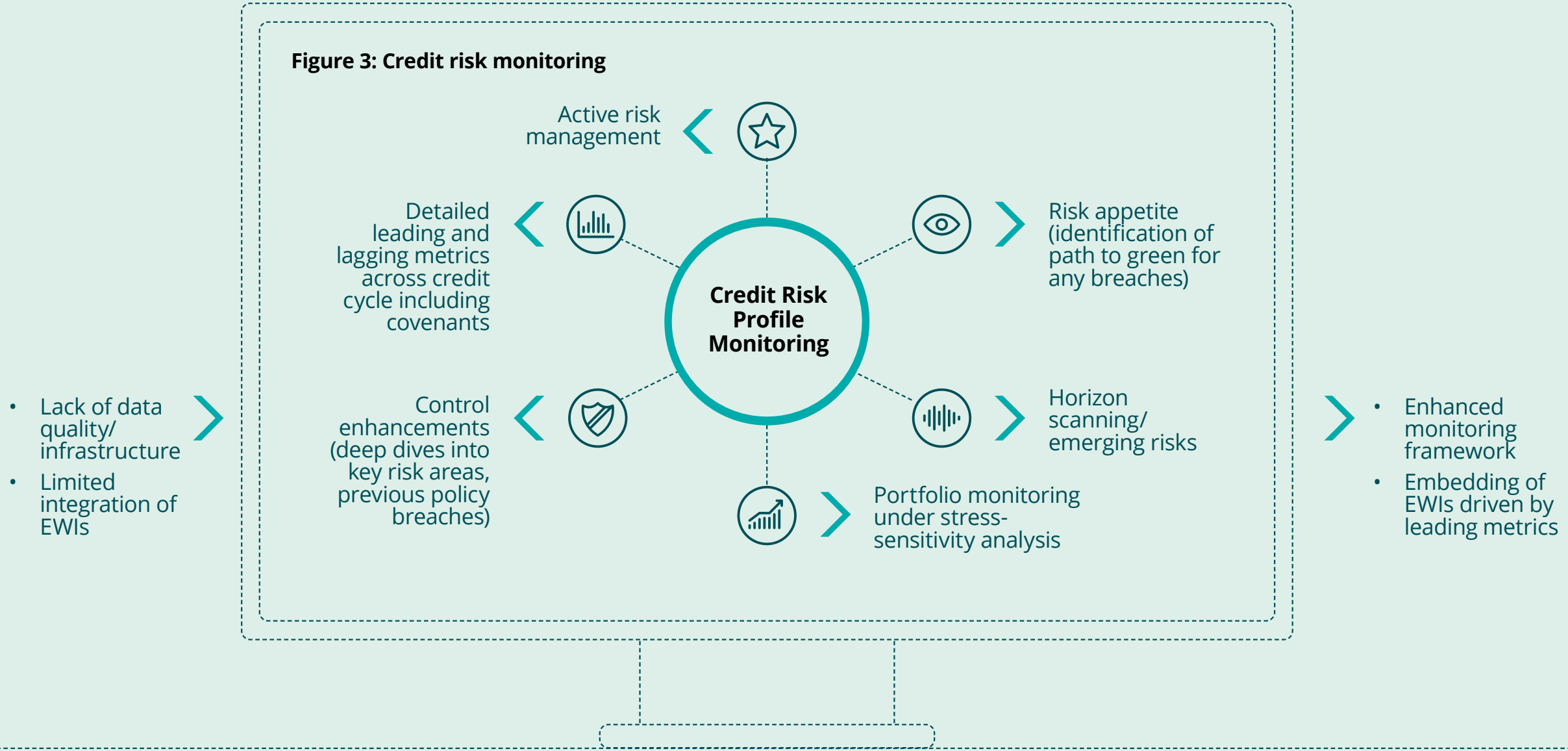
- Monitoring of credit exposures and borrowers;
- Regular credit review of borrowers;
- Monitoring of covenants;
- Use of early warning indicators (EWI) and watch lists; and
- Follow-up and escalation process on triggered EWIs.

Back-tested lending metrics, covenant compliance and other monitoring activities will result in the embedding of early warning indicators in processes, building clear linkages between the ongoing monitoring and early detection of loans with deteriorating credit quality.

In addition, Banks engaged in syndicating leveraged transactions are now required to implement internal standards and monitoring functions for these activities including:

- Identification of transactions subject to failed syndications i.e. transactions were not syndicated within 90 days following the commitment date;
- Establishing a dedicated framework to deal with these 'hung transactions' in terms of holding strategy, booking and accounting practices, regulatory classification and subsequent capital requirements calculation.

Figure 3: Credit risk monitoring



Linkage with IFRS9 requirements

The introduction of IFRS 9 and Expected Credit Loss (ECL) model revealed the need for higher granularity on credit risk data as well as business implications on lending practices including pricing considerations, product design and monitoring of credit risk.

The introduction of specific metrics based on IFRS 9 – Point in Time (PiT) – parameters, as required by the ECB's credit underwriting exercise, might change the perception over optimal lending growth and overall strategy depending on priorities set and time horizon. Advantages and disadvantages of IFRS 9 PiT parameters must be taken into consideration.

On the one hand, standard risk costs and equity costs are more precise when they move with an expected credit loss model over the next 12 months, more likely resulting in an accurate estimate of expected and unexpected losses. Moreover, the use of IFRS9 probability of default (PD) will enhance viability and foster common understanding within the bank since risk and the business will have a single point of reference when discussing credit risk.

On the other hand, the loan approval process may decline or drive away viable business, for example, higher risk profile clients who have a long-standing relationship with the bank and may overall be a steady source of risk-adjusted return. Furthermore, standard risk and equity costs will become more volatile based on IFRS 9 PiT risk metrics, creating unpredictability and uncertainty in the lending strategy.

Interaction between prudential and consumer protection frameworks

The Guidelines underline that the obligation of the creditor to assess the creditworthiness of a borrower is intended to protect consumers against the risks of over-indebtedness, bankruptcy and to ensure responsible lending. Whilst protecting the borrowers' interests, notably with regards to creditworthiness assessment, these Guidelines require institutions to take consumer protection into account within the credit risk policies and procedures, credit-granting criteria and within their design of the credit products that are offered to consumers.

It is also true to say, at a more macro level, that financial stability may be impacted if borrowers are not able to meet their contractual loan commitments. In this context the performance of an accurate and thorough creditworthiness assessment is crucial in order to mitigate against the potential impacts on financial stability.

Proportionality principle

Firstly, for implementing the requirements regarding internal governance, risk management and control, a proportionality principle based on the size, nature and complexity of the institution or other relevant criteria, should be considered by the institution.

Secondly, for implementing the requirements regarding the creditworthiness assessment, collateral valuation and credit risk monitoring institutions should take into account the type, size and complexity of the credit facility being originated or monitored.

Moreover, the proportionality within the collateral valuation is also driven by the size, nature and complexity of the collateral and the relationship between the loan and collateral.

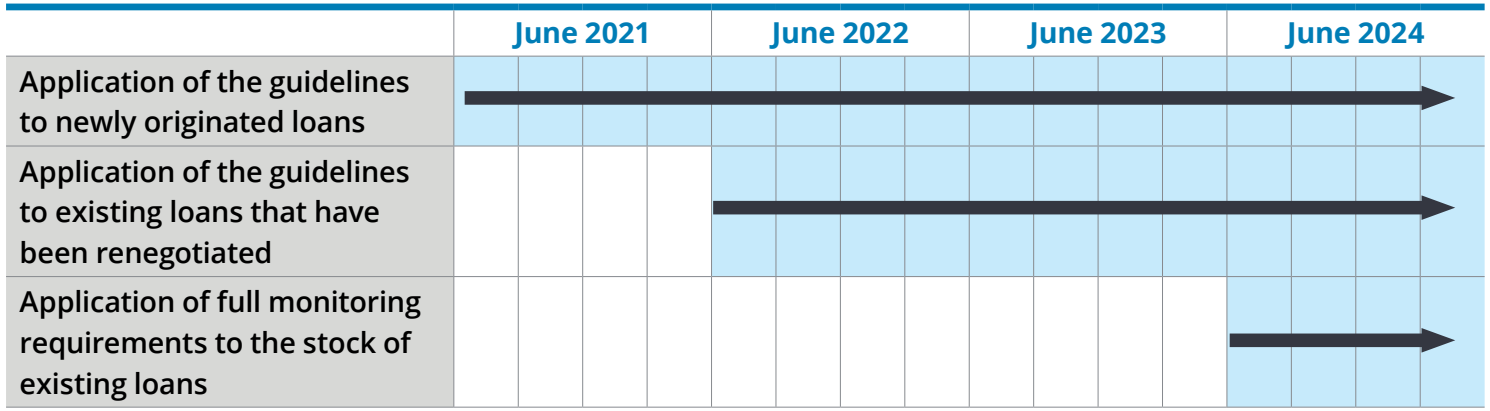
The differentiation regarding the application of the proportionality principle aims to ensure that loan origination and monitoring criteria are proportionate to the type, size, complexity and risk profile of the loans or credit facilities originated or monitored.

Application dates

These Guidelines will start to apply from 30 June 2021 with two further transitional deadlines as outlined in the graph below.

The timing of the two further transitional deadlines reflects consideration of the need for banks to focus on core operations today and to strengthen future lending given the unprecedented COVID-19 pandemic.

Figure 4: Implementation deadlines



Next steps

These forward-looking Guidelines which emphasise credit quality throughout the end-to-end loan cycle will have a considerable impact on banks' governance, credit risk processes, data, IT infrastructure, methodologies, lending practices and client interactions.

We would advise taking the following steps sooner rather than later given the uplift within these Guidelines:

- Reviewing any shortcomings or findings that were identified as part of the on-site inspections regarding credit underwriting;
- Performing a gap analysis against the Guidelines to identify shortfalls and provide a targeted roadmap to remediate any such shortfalls;
- Leveraging aspects of existing programmes for example, IFRS9, BCBS 239, Senior Executive Accountability Regime (SEAR) etc. as a starting point to build upon in order to meet the loan origination and monitoring Guidelines;
- Determining how the governance requirements as outlined in the Guidelines can be best interlinked with your existing governance and oversight structure;
- Understanding which businesses will be impacted the most to inform prioritisation;
- Assessing the adequacy and suitability of data in its current state.