EBA Guidelines on loan origination and monitoring

APRIL 2021
The European Banking Authority (EBA) published on 29 May 2020 its final Guidelines on loan origination and monitoring, which are applicable to all credit institutions in Europe and impact all existing credit facilities including their refinancing as well as new credit facilities. It is expected that regulators outside EU will soon issue adjusted versions of EBA’s Guideline.

The Guidelines introduce best practices for robust and prudent standards for credit risk taking, management and monitoring, in addition to ensuring adequate practices in areas such as consumer protection and AML.

**Key areas**

- **Improve practices**
  - Improve institutions’ practices and associated governance arrangements, processes and mechanisms in relation to credit granting.

- **Consumer protection**
  - Build on statutory objectives to include both prudential and financial stability as well as consumer protection and to ensure that the institutions’ practices are aligned with consumer protection rules and respect fair treatment of consumers.

- **Ensure Prudential standards**
  - Ensure that institutions have in place prudential loan origination standards in order to prevent newly originated performing loans from becoming non-performing in the future.
The EBA’s comprehensive approach to loan origination

The Guidelines focuses on 5 chapters

- **Origination**
  - Set out requirements for information and data collection from borrowers, documentation, and requirements for the borrowers’ credit worthiness assessment.

- **Valuation**
  - Set out supervisory expectations for independent valuers and conditions that allow advanced statistical models to be used by institutions or the valuation, monitoring and revaluation of various forms of collateral.

- **Pricing**
  - Set out supervisory expectations for the risk-based pricing of loans, listing a set of risk-based elements that institutions should consider and reflect when pricing newly originated loans.

- **Monitoring**
  - Ongoing monitoring of credit risk and credit exposures, including regular credit reviews of professional borrowers.

- **Governance**
  - Clarify internal governance and control framework for credit granting and credit decision making-process, with a special view on AML, ESG incorporation and technology-enabled finance.

The guidelines aim to ensure that the credit-granting practices are aligned with **consumer protection rules and respect fair treatment of consumers.**
Key impacted areas
Banks need to quickly adapt

**ESG factors incorporation**
- The guidelines state new requirements to incorporate ESG factors and associated risks in their credit risk appetite and risk management policies, credit risk policies and procedures, adopting a holistic approach.
- In addition, institutions should take into account the risks associated with ESG factors on the financial conditions of borrowers.

**Technology-enabled innovation**
- When using technology-enabled innovation, institutions should be able to understand the models, measure, outcomes and impacts of used technology.
- The inherent risks should be adequately captured in the risk management and control frameworks.
- All the processes will be properly documented within dedicated policies and procedures.

**Anti-money laundering and counter-terrorist financing**
- During the loan origination process, institutions should consider enhanced processes to identify, assess and manage the money laundering and terrorist financing risk to which institutions are exposed.
- Institutions should ensure documentation of all related processes, to ensure that the disbursement of loans is made in line with the credit decision and the loan agreement.

**Risk based pricing**
- Loan 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 risk adjusted indicators, like economic value added (EVA), return on risk-adjusted capital (RORAC) and risk-adjusted return on capital (RAROC).
On 29 May 2020, the EBA issued its Final Report on Guidelines on loan origination and monitoring (EBA/GL/2020/06). The original application date has been postponed and the guidelines will now apply from 30 June 2021 (to newly originated loans).

In addition, the EBA allows for a series of transitional arrangements in the context of COVID-19 and the need for firms to continue to supply credit to the economy:

1. **Application of the GLs to newly originated loans**
   - Application of the Guidelines to newly originated loans
   - Application of the Guidelines to existing loans that have been renegotiated
   - Application of full monitoring requirements to the stock of existing loans

   **Timeline of implementation**
   - Application date is 30 June 2021
   - Publication
   - Application of the Guidelines to newly originated loans
   - Application of the Guidelines to existing loans that have been renegotiated
   - Application of full monitoring requirements to the stock of existing loans

   Two-year transition for the application of the guidelines to the renegotiated loans

2. **Application of the GLs to existing loans that have been renegotiated.** It should be noted that the requirements for loan origination in Chapter 5 of the guidelines will also apply to loans and advances that already exist on the application date for which the terms and conditions have been changed after the application date, following renegotiation or changed contractual terms. The application of the GLs to these loans however will only apply from 30 June 2022*.

3. **Application of full monitoring requirements to the stock of existing loans.** Firms will be allowed to address possible data gaps and adjust their monitoring and infrastructure until 30 June 2024, in line with the application date of the full monitoring requirements to the stock of existing loans.

* Provided that the changes follow a specific credit decision approval, and if their implementation requires a new loan agreement with the borrower or an addendum to the existing agreement
Internal governance for credit granting and monitoring
Well defined and robust, with a strong focus on internal control

The Guidelines focuses on credit risk governance and risk culture, as a result, the responsibilities of the management body are very clear defined:

- Set credit risk appetite and credit approval process framework;
- Approve credit risk strategy;
- Ensure effective oversight and adequate credit approval/control/monitoring;
- Ensure that involved staff is adequately skilled and resourced.

AML and CTF policies and procedures

As per Directive (EU) 2015/849 institutions are required to put in place and maintain effective policies and procedures to prevent ML/TF and to detect and deter it should it occur. Thus, the Guidelines sets out specific requirements, in particular, institutions should:

- Identify, assess and manage the ML/TF risk associated with the type of customers they serve, their lending products and operated geographies
- Identify, assess and manage the ML/TF at the level of individual customer, including the assessment of credit purpose
- Integrate the creditworthiness assessment and AML/CTF management
- Ensure appropriate checks to monitor the loan disbursement and usage

Credit risk policies and procedures should be updated and should specify:

- Credit granting criteria
- Requirements for credit-granting monitoring
- Requirements for collateral usage
- Requirements for creditworthiness assessment
In a fast evolving society, institutions need to adapt to the demanding market and pay more attention to new technology. Thus, when using technology-enabled innovation for credit-granting purposes, institutions should do the following:

- Capture the inherent risk associated with technology-enabled innovation
- Ensure that the management body has sufficient understanding of usage, limitations and impact
- Understand the underlying models used
- Ensure fit for purpose models
- Ensure data quality and prevent bias in credit decision-making process
- Ensure performance of the model
EBA is taking action towards green lending

Environmental, social and governance issues will likely become a major factor in credit granting

Sustainable finance refers to any form of financial service integrating environmental, social and governance (ESG) criteria into the business or investment decisions for the lasting benefit of both clients and society at large.

- Climate change
- Greenhouse gas emissions
- Resource depletion, including water
- Waste and pollution
- Deforestation

- Executive pay
- Bribery and corruption
- Board diversity and structure
- Fair tax strategy

- Working conditions, including slavery and child labor
- Local communities, including indigenous communities
- Conflict and humanitarian crises
- Health and safety
- Employee relations and diversity
**ESG factors should be considered within loan origination and monitoring**

Policies and procedures should be updated

According to the Guidelines, **institutions should include environmental, social and governance (ESG) factors** as well as risks and opportunities related to ESG in their risk management policies, credit risk policies and procedures.

| 1 | **Provide a list of the projects and activities, as well as the criteria, that the institution considers eligible for environmentally sustainable lending** or a reference to relevant existing standards |
| 2 | **Specify the process by which the institutions are evaluating that the proceeds of the green credit facilities they have originated are properly used.** For enterprises such process should include: |

- collecting information about the climate-related and environmental or otherwise sustainable business objectives of the borrowers;
- assessing the conformity of the borrowers’ funding projects with the qualifying green projects and related criteria;
- ensuring that the borrowers have the willingness and capacity to appropriately monitor and report the allocation of the proceeds towards the green projects;
- monitoring on a regular basis that the proceeds are allocated properly.
Loan origination procedures to be enhanced
Collection of information and documentation

Loan origination process can be divided in 3 main phases:

1. Collection of information and documentation
   Institutions should have sufficient, accurate and up-to-date information and data necessary to assess the borrower’s creditworthiness and risk profile before concluding a loan agreement.

   Specific requirements for lending to borrowers:

   **Consumers**
   - Employment;
   - Income;
   - Regular expenses;
   - Household composition;
   - Financial commitments;
   - Collateral.

   **Enterprises**
   - Financial position;
   - Income and CF;
   - Business model;
   - Business plan and projections;
   - Financial commitments;
   - Collateral.

If the borrower is likely to face financial difficulties in meeting the contractual loan obligations, additional information should be collected, that would demonstrate realistic projections of their ability to maintain solvency.
Loan origination procedures to be enhanced
Creditworthiness assessment

**Loan origination process can be divided in 3 main phases:**

- **Assessment of borrower’s creditworthiness**
  Institutions should analyse the loan application of the borrower in order to ensure that the application is in line with the institutions’ credit risk appetite, policies, credit-granting criteria, limits and relevant metrics.

- **Analysis of the borrower’s business model and strategy**
- **Analysis of the borrower’s financial position**
- **Sensitivity analysis in creditworthiness assessment**
- **Assessment of guarantees and collateral**

**Financial metrics should be applied:**

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<thead>
<tr>
<th>Consumer lending</th>
<th>Lending to enterprises</th>
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<tr>
<td>Loan to income ratio</td>
<td>Debt service coverage ratio</td>
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<td>Loan service to income ratio</td>
<td>EBITDA</td>
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<td>Debt to income ratio</td>
<td>Interest coverage ratio</td>
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<td>Debt service to income ratio</td>
<td>Loan to value ratio</td>
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<td>Loan to cost ratio</td>
<td>Leverage</td>
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<td>ROE</td>
<td>Loan to cost ratio</td>
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<td>Capitalisation rate</td>
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Institutions should carry out a single or multifactor sensitivity analysis, considering market and idiosyncratic events, or a combination of any of them.

- **Idiosyncratic events**
  - Operational loss;
  - Liquidity outflow;
  - Etc.

- **Market events**
  - Macroeconomic downturn;
  - Increase of cost of funding;
  - Etc.

The Guidelines sets specific requirements for different types of consumer and enterprises (e.g. lending to SME or lending for real estate development).
Loan origination procedures to be enhanced
Credit decision and loan agreement

Credit decision and loan agreement
Institutions should design relevant documentation regarding credit decisions and loan agreements in a way that helps identify and prevent a misrepresentation of the information by all involved parties.

Loan origination process can be divided in 3 main phases:

A credit decision should:

- be well documented and provide a record of views and reservations;
- clearly articulate a maximum period for its validity;
- be taken by the relevant credit decision-making body in accordance with the policies and procedures and governance arrangements;
- ensure that utilisation of an approved loan is only allowed once all the approval conditions set out in the credit decision or agreement are fulfilled.
Risk-based pricing
Adequate pricing reflection should be considered

Pricing frameworks should reflect institutions’ credit risk appetite and business strategies, including profitability and risk perspective. Loan pricing should also be linked to the characteristics of the loan product and consider competition and prevailing market conditions.

Depending on the types of loans and borrowers, a differentiated pricing framework should be considered:

For **consumers, micro and small enterprises** the pricing should be more **portfolio based**.

For **medium-sized and large enterprises** the pricing should be more **transaction and loan specific**.

Institutions should consider and reflect in loan pricing:

- Cost of capital;
- Cost of funding;
- Operating and admin costs;
- Credit risk and other real costs.

Also consider risk-adjusted performance indicators for pricing and profitability, such as:

- Economic value added (EVA);
- Return on risk-adjusted capital (RORAC).
- Risk-adjusted return on capital (RAROC);

Institutions should implement ex-ante transaction tools and regular ex-post monitoring, linking together transaction risk, pricing and expected overall profitability at an appropriate level, including business lines and product lines.
Valuation of immovable and movable property
Collateral valuation and revaluation is the key

- Valuation at the point of origination
- Monitoring
- Revaluation

Valuation and revaluation of the collateral should be accurately carried. Institutions should take into account ESG factors affecting the value of the collateral, for example the energy efficiency of buildings.

- In a case of repayment capacity deterioration, a **re-assessment in terms of the liquidity and enforceability of the collateral** including time to recovery should be performed;
- **External valuers**: a panel of accepted valuers should be established;
- **Adequate IT processes, systems, capabilities in place and sufficient and accurate data** for the purposes of any statistical model-based valuation should be in place.
- **Appropriate frequencies for monitoring the value of the collateral**, considering the type and value of the collateral;
- **Adequate rotation of valuers**;
- **Internal policies and procedures should indicate criteria for accepting advanced statistical model-based revaluations**;
- **Movable property collateral monitoring**: institutions may rely on adequate statistical models and indices.
- **Specific triggers indicating when monitoring leads to revaluation or a collateral needs revaluation**;
- **Policies and procedures for the revaluation of immovable property** collateral specifying the approaches to revaluation (*e.g.* desktop valuation, drive-by valuation, full visit with internal and external assessment of the property, statistical models);
- **Adequate IT processes, systems, capabilities and sufficient data** for the purposes of any statistical model-based or index-based revaluation.
Monitoring framework to be enhanced
For a timely detection of increased credit risk

Institutions should have a robust and effective monitoring framework, supported by an adequate data infrastructure, to ensure that information regarding their credit risk exposures, borrowers and collateral is relevant and up to date, and that the external reporting is reliable, complete and up to date.

- Strong link to the overall IT and data infrastructure, and information collected at the point of origination;
- Granular framework to identify associated credit risk with the borrower, market risk, country risk, impairments, write-offs, etc. via key risk indicators;
- Feedback loop to inform the setting/review of credit risk appetite, policies and limits.

As part of their monitoring framework, institutions should develop, maintain and regularly evaluate relevant quantitative and qualitative EWIs that are supported by an appropriate IT and data infrastructure that would allow the timely detection of increased credit risk in their portfolio.

- Stress testing

  Together with simple sensitivity analyses, based on internal and external information

- EWIs*

  In combination with an adequate escalation process

- Watch list

  Credit exposures and borrowers with increased risk, including those identified through the monitoring of EWI
Implementation challenges
The implementation process will be quite challenging and resource consuming.

The main resources have to be allocated to:

- **Organisational structure within credit departments**: adjustments to the control framework and the distribution of tasks within the lending process may be needed to comply with the “three lines of defense” model;
- **Identify risk strategies, business models and credit risk appetite**, all of which should be aligned with the institution’s overall risk appetite framework (RAF).

- **Re-engineering of loan origination/credit processes**: **credit risk metrics, models and validation** (incl. analysis of debt service and loan coverage, innovative and automated decision engine);
- **Integration of ESG factors**;
- **Sensitivity and scenario analysis** of the borrower’s projected debt service capacity, that should cover, at a minimum: the borrower’s income or operative cash flow, disposable income, financial situation and the source of their capacity to meet repayment obligations.

- **Workflow adjustments for initial individual valuation of assets** (i.e. stricter requirements for valuation at loan origination and monitoring through the life cycle);
- **Performance**: assessing on an ongoing basis the performance and especially the accuracy of appraisals.
- **Requirements for appraisal rotation** in case of immovable collateral.

- **IT infrastructure** (e.g. credit decision engines, collateral management, early warning signals);
- **Quantitative and qualitative EWIs** to aid the timely detection of increased credit risk, that will cover the whole portfolio as well as industries, geographies and individual exposures.