

## EBA Guidelines on loan origination and monitoring

APRIL 2021

## Scope of application

The Guidelines is focused on practices improvement and consumer protection

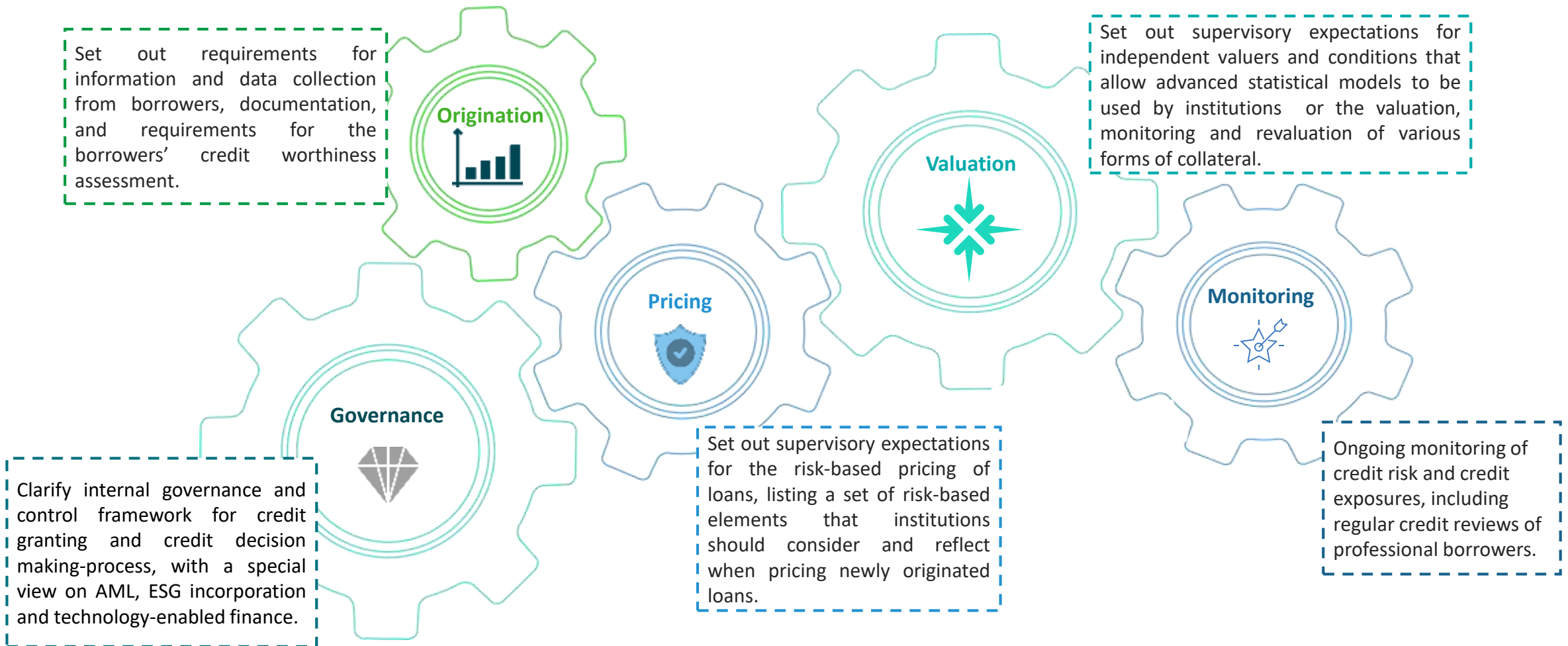
- ❖ The **European Banking Authority (EBA)** published on **29 May 2020** its final **Guidelines on loan origination and monitoring**, which are applicable to all credit institutions in Europe and impact all existing credit facilities including their refinancing as well as new credit facilities. It is 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.



# The EBA's comprehensive approach to loan origination

## The Guidelines focuses on 5 chapters

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).



# 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

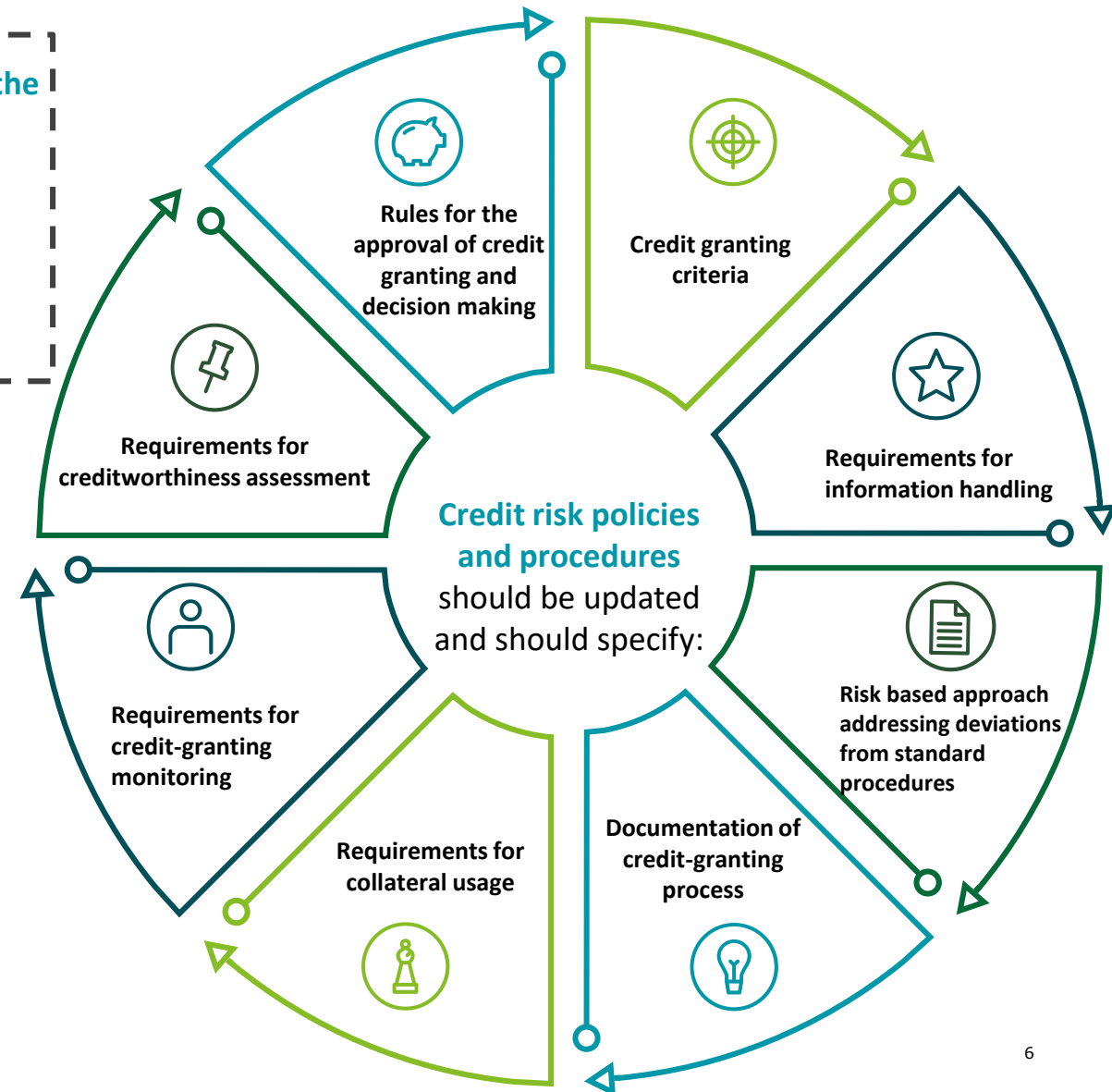
As per Directive (EU) 2015/849 institutions are required to put in **place and maintain effective policies and procedures to prevent ML/TF and to detect and deter it should it occur**. Thus, the Guidelines sets out specific requirements, in particular, institutions should:

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



# Internal governance for credit granting and monitoring

## Technology-enabled credit granting

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:



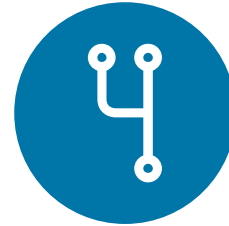
Capture the inherent risk associated with technology-enabled innovation



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



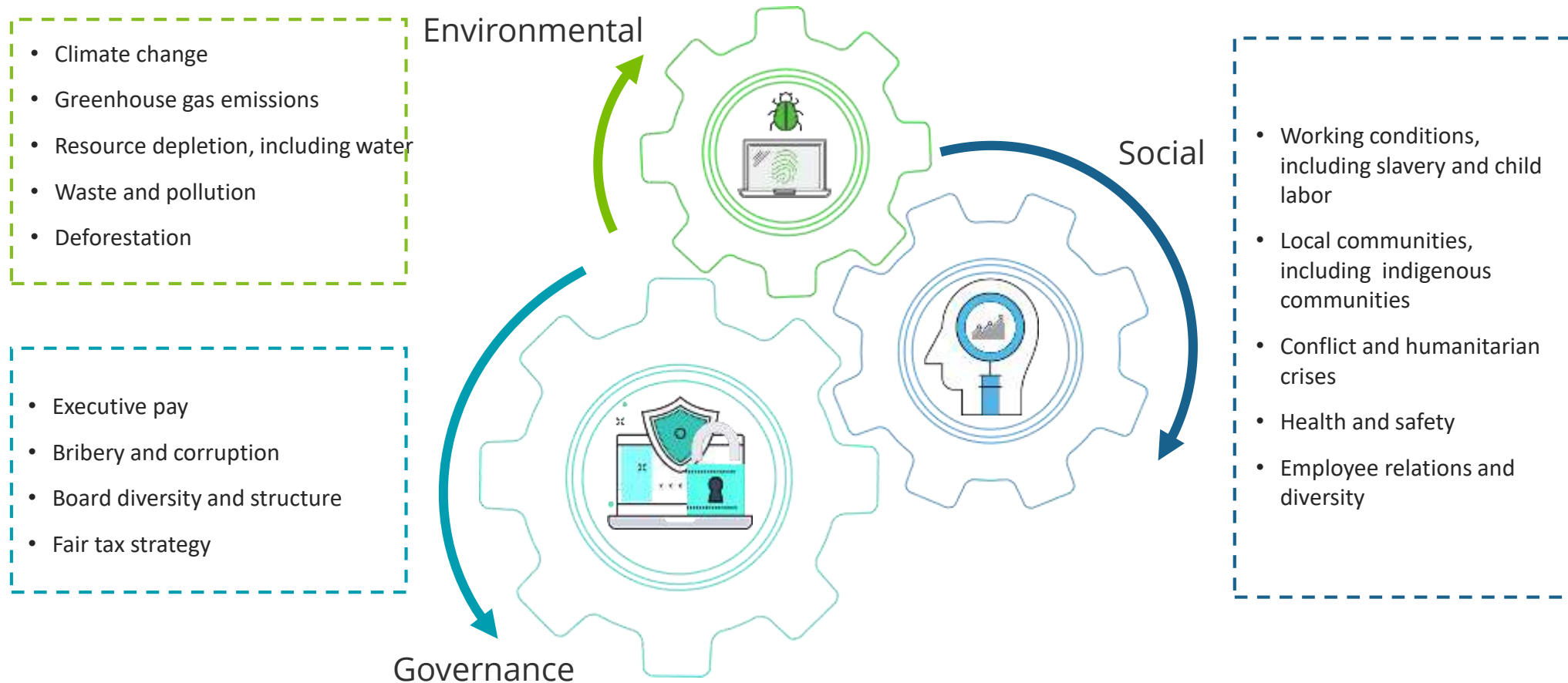
Ensure performance of the model



# 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.





# 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.**

**These policies and procedures should, in particular:**

**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

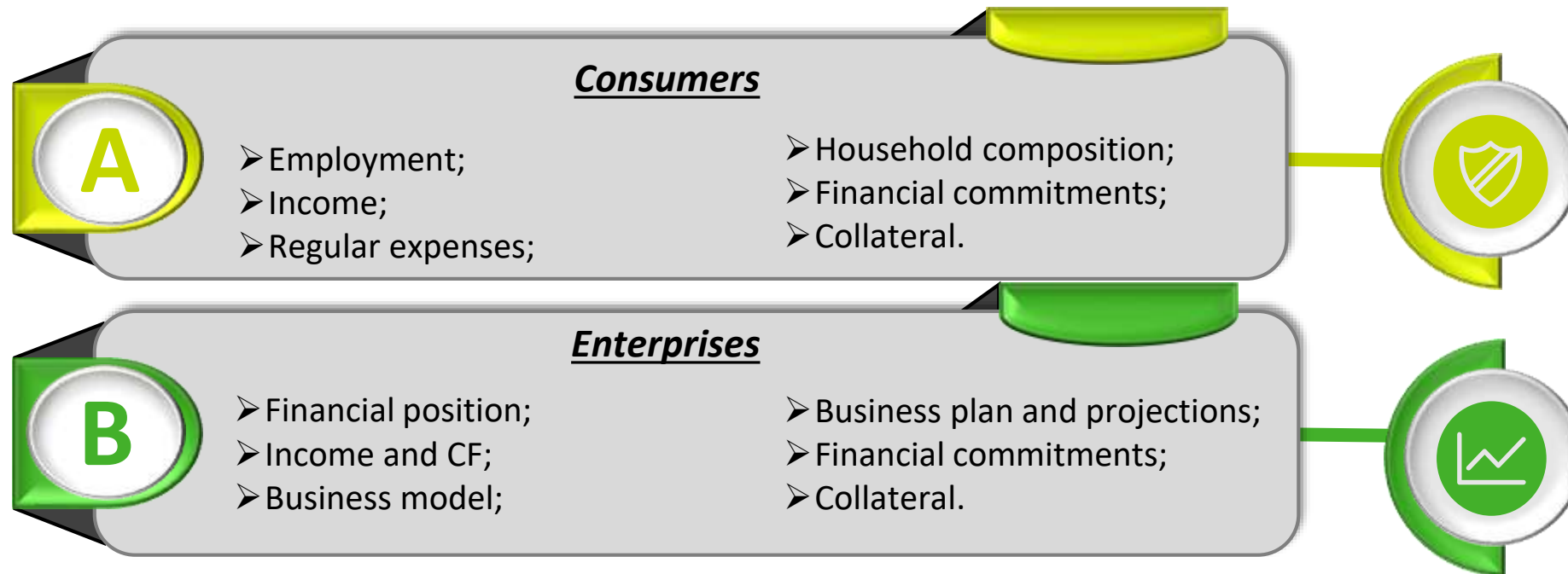
Loan origination process can be divided in 3 main phases:



### 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:



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:

2



### 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

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.

Financial metrics should be applied:

Consumer lending	Lending to enterprises
Loan to income ratio	Debt service coverage ratio
Loan service to income ratio	EBITDA
Debt to income ratio	Interest coverage ratio
Debt service to income ratio	Loan to value ratio
	Leverage
	Loan to cost ratio
	ROE
	Capitalisation rate

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

Loan origination process can be divided in 3 main phases:

3



### Credit decision and loan agreement

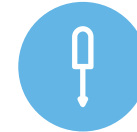
Institutions should design relevant documentation regarding credit decisions and loan agreements in a way that helps identify and prevent a misrepresentation of the information by all involved parties.

### A credit decision should:

✓ **be well documented** and provide a record of views and reservations;



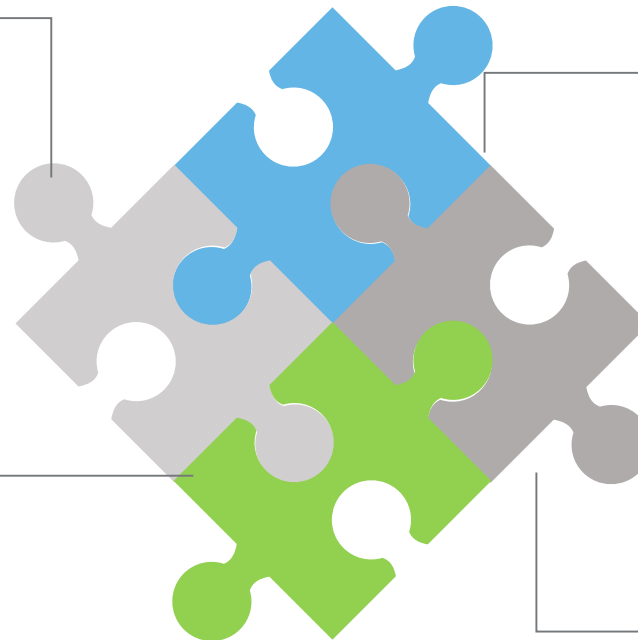
✓ **be taken by the relevant credit decision-making body** in accordance with the policies and procedures and governance arrangements;



✓ **clearly articulate a maximum period for its validity;**



✓ 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);

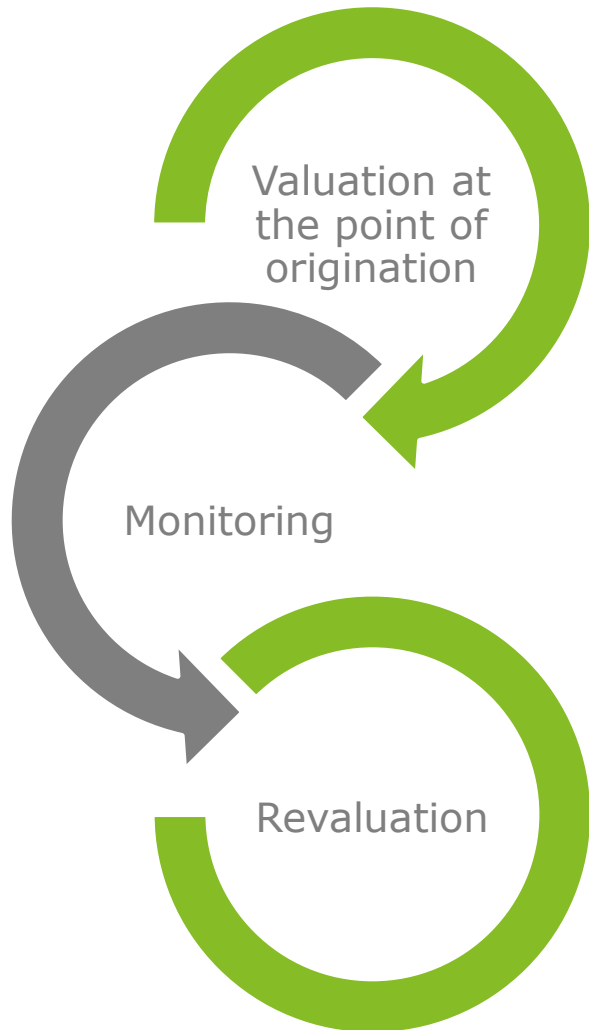


Institutions should implement ex-ante transaction tools and regular ex-post monitoring, linking together transaction risk, pricing and expected overall profitability at an appropriate level, including business lines and product lines.

# Valuation of immovable and movable property

Collateral valuation and revaluation is the key

Valuation 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.

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- **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.

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- **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.

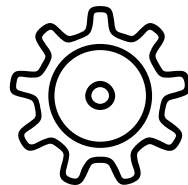


As part of their monitoring framework, institutions should **develop, maintain and regularly evaluate relevant quantitative and qualitative EWIs** that are supported by an appropriate IT and data infrastructure that would allow the timely detection of increased credit risk in their portfolio



### 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.





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