



EBA draft Guidelines on loan origination and monitoring

**The ECB and EBA's growing
scrutiny on credit standards**

October 2019

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01 Executive summary

The EBA's draft Guidelines on loan origination and monitoring are the new standard for credit underwriting in Europe.

The European Central Bank's (ECB) credit underwriting exercise and the European Banking Authority's (EBA) consultation on loan origination herald growing supervisory scrutiny on credit standards throughout the lending lifecycle.

European regulators and supervisors are paying increasing attention to this important driver of banking stability. Although this is not the first time that credit underwriting standards have been addressed at a European level, it is a strong reinforcement of required standards and will have a direct impact on banks' internal processes, IT infrastructure and governance.

As European banks are well aware, the ECB is already taking action on credit standards. In May 2019 it launched a credit underwriting exercise, requiring some directly supervised banks to complete a data template by 1 July followed by a quality assurance review. It is then expected that the ECB will conduct a deep dive analysis, possibly supplemented by requests for more granular data.

The ECB is not alone in its focus on credit underwriting. The EBA has also identified loan origination as a priority for 2019, and on 19 June 2019 published a consultation paper on loan origination and monitoring.

The EBA's draft Guidelines on loan origination and monitoring ('the Guidelines') are one of the most pro-active responses yet to the European Council's Action Plan on non-performing loans with the aim of reducing NPL inflows.

The Guidelines have the objective of improving practices and mechanisms in relation to credit granting in Europe, of ensuring more robust, prudent and uniform standards, and ultimately of improving the financial stability and resilience of the EU banking system. They are expected to be implemented in less than a year's time, on 30 June 2020.

Developed in response to the European Council's Action Plan on tackling non-performing loans (NPLs), the Guidelines are concerned with the prevention of new NPLs and are to be considered within the broader end-to-end lifecycle of loans, closely linking in with the EBA Guidelines on management of non-performing and forborne exposures in effect since 30 June 2019.

The Guidelines will have a major impact on the bank's day to day operations and governance.

The Guidelines are very extensive and set out a wide range of detailed requirements with which banks must comply, especially when lending to consumers or professionals. They consider both the prudential and consumer protection aspects of credit granting, and include elements such as environmental, social and governance (ESG) factors, green lending, anti-money laundering (AML) and countering the finance of terrorism, and technology-based innovation.

The Guidelines promote improved underwriting standards for new exposures (loans and lines of credit), and set expectations for the initial decision-making involved in granting credit. This includes the need to conduct exhaustive assessments of borrowers' repayment abilities at origination and throughout the life of the loan, and the need to gather and maintain the necessary relevant data. They also call for the regular monitoring of credit risks throughout the life of a loan and provide specifications of the minimum financial data and metrics that lenders must gather, validate, analyse, challenge, stress, record and report on. This not only applies to loan origination and monitoring, but also to the decisions banks take on loan pricing and the valuation of collateral.

The extensive requirements introduced by the Guidelines are likely to have a major impact on many banks' governance, business models, policies and procedures, data collection and management, early warning systems and day to day operations.

In particular, KPMG sees significant implications for banks' systems, processes and data management. The ECB's recent data-gathering exercise on credit underwriting gives an indication of the potential scale of data expectations by regulators regarding credit underwriting and management, and the likely implications for banks if these were to become a recurring request.

The EBA's Guidelines are very detailed and far-reaching, and banks have very limited time to implement the necessary changes. Considering the potential scale of the changes required and the limited timeline to comply, especially for areas such as technology and data, it is advised that banks begin their gap assessment and development of remediation plan and actions as soon as possible.

With our extensive experience, KPMG member firms are ideally placed to assist banks across the end-to-end loan life cycle, from performing gap analysis to designing and implementing change programmes.

SSM Supervisory Priorities 2020

"ECB Banking Supervision will continue to assess the quality of banks' underwriting criteria. On the basis of the comprehensive data collection that aimed to identify pockets of risks, ECB Banking Supervision will conduct a follow-up analysis with a view to acquiring a deeper understanding of banks' loan origination practices and processes. Depending on the findings, bank-specific actions may be considered. In addition, the quality of specific asset class exposures will be examined through dedicated on-site inspections in areas such as commercial real estate, residential real estate and leveraged finance."

02 Overview

Banks need to understand the background, status, timing and structure of the Guidelines and perform a gap analysis regarding the best practices outlined.

Background

The EBA developed the Guidelines in response to the European Council's Action Plan on tackling the continent's high level of non-performing loans. The Guidelines aim:

- To improve institutions' practices and frameworks around granting credit, to ensure they have robust and prudent standards for taking, managing and monitoring credit risk, and that newly originated loans are of high credit quality;
- To ensure that institutions' practices are aligned with consumer protection rules and treat customers fairly; and;
- To ensure that institutions have loan origination standards in place, reducing the chance of new performing loans from becoming non-performing in future.

The Guidelines introduce and detail new requirements for assessing borrowers' creditworthiness, based on the collection of relevant information and data. They also develop requirements to assess consumer information. They take into account the growing focus of environmental factors, green lending and technology-enabled innovation.

The Guidelines echo the ECB's supervisory priorities for 2019 and 2020. These aimed to assess the quality of underwriting criteria, with a focus on new lending and

renegotiations of former lending, and to examine the quality of banks' lending practices and standards with a view to mitigating potential risks. The ECB's recent credit underwriting review closely reflects these goals.

Institutions should consider proportionality when applying the Guidelines, in particular:

1. The size, nature and complexity of the institution when implementing the requirements relating to internal governance, risk management and control;
2. The type, size and complexity of the credit facilities being granted or monitored when implementing the requirements relating to creditworthiness assessment, loan pricing, collateral valuation and credit risk monitoring;
3. No proportionality applies to consumer protection aspects of the Guidelines (creditworthiness assessment of consumers). The consumer protection framework should be applied regardless of the size and complexity of the institution or of the loan.

It should be noted that the principle of proportionality is not specified further within the consultation paper.

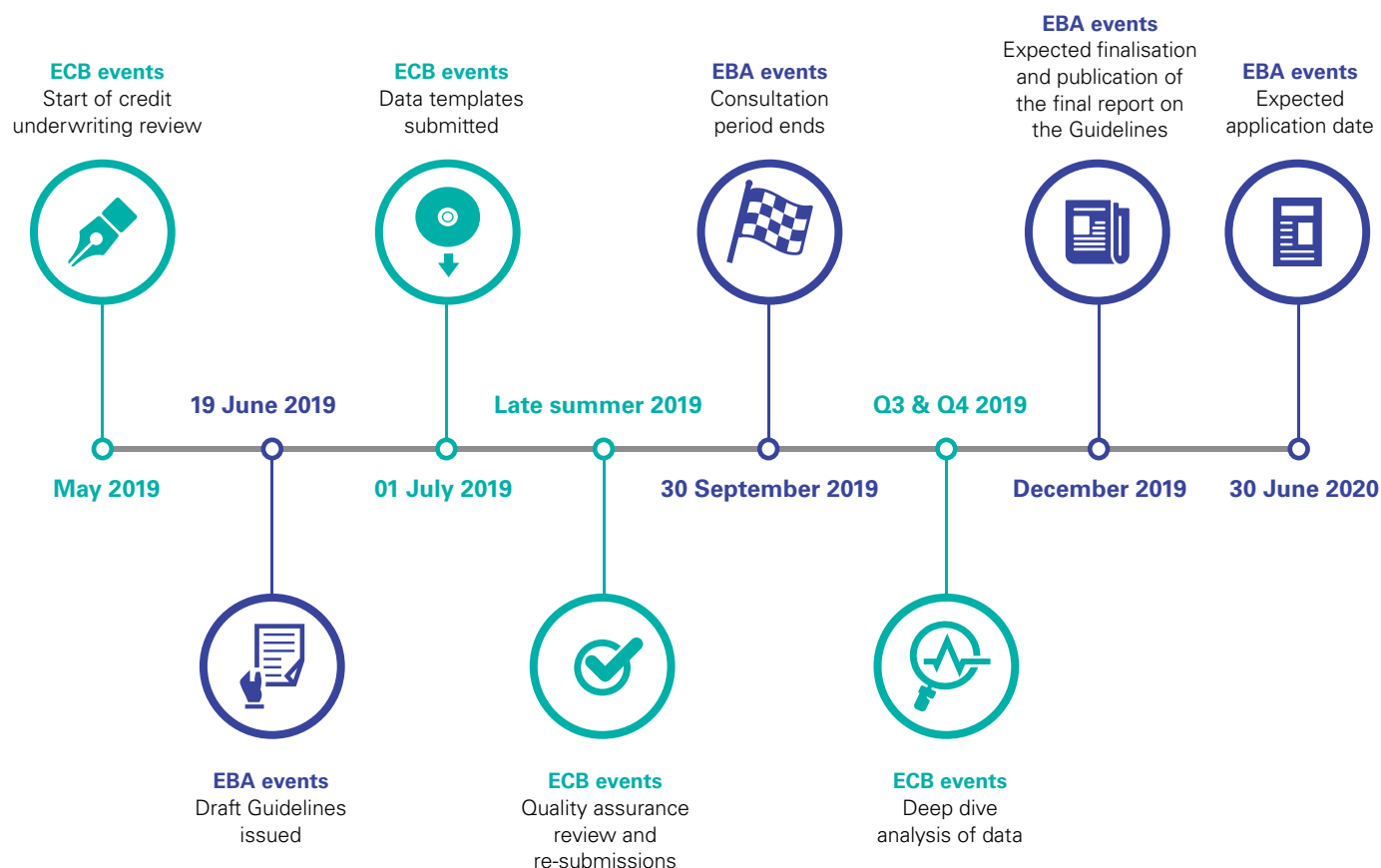
Status and scope

The following table provides a short summary of the Guidelines' status and scope.

Full title	EBA draft Guidelines on loan origination and monitoring (Consultation Paper – EBA/CP/2019/04)
Publication	19.06.2019
Status	Open for consultation until 30.09.2019
Application date	30.06.2020
Target audience	National Competent Authorities and Financial Institutions
Scope	<p>Counterparty sector</p> <ul style="list-style-type: none"> – Lending to consumers: all lending for residential immovable property, other secured lending and unsecured lending; – Lending to professionals: all lending for SMEs Corporate, Commercial Real Estate, Real Estate Lending Development, Shipping Finance, Project and infrastructure finance. <p>Type of debt instruments/products</p> <ul style="list-style-type: none"> – For chapters 'Governance' and 'Monitoring' the scope of application includes all credit facilities (excluding debt securities) granted before and after the date of application; – For chapter 'Valuation' it includes all credit facilities (excluding debt securities) regarding initial valuation of new collateral after the application date and monitoring and revaluation of existing collateral after the application date; – Chapters 'Loan origination' and 'Pricing' only applies to loans and advances for new loans originated after the application date and existing loans where terms are renegotiated after the application date. <p>Types of borrower</p> <ul style="list-style-type: none"> – The scope of application covers professional clients and consumers for chapters 'Loan origination procedures', 'Pricing' and 'Valuation of immovable and movable property'. Chapters 'Governance' and 'Monitoring' covers all counterparties. <p>Types of collateral</p> <ul style="list-style-type: none"> – Requirements related to the valuation of collateral concern both movable property and immovable property but exclude financial collateral.
Out of scope of Chapters 5 & 6	Loans and advances to credit institutions, investment firms, financial institutions, insurance and reinsurance undertakings, central banks, sovereigns, central governments, regional and local authorities, public sector entities are excluded from the scope of application of requirements related to 'Loan Origination Procedures' (Chapter 5) and 'Pricing' (Chapter 6).
Options being considered by the EBA	<p>In drafting the Guidelines, the EBA has considered several policy options in three key areas:</p> <ol style="list-style-type: none"> Scope of application – Option 1b has been retained, meaning that the Guidelines apply not only to new lending but also to existing loans and credit facilities; Environmental factors and green lending – Option 2a has been retained, meaning that environmental, social and governance (ESG) factors should be included in credit risk and risk management policies and procedures; Valuation of immovable property collateral – Option 3b has been retained, meaning that advanced statistical models can be used for valuing immovable property collateral during re-valuation and monitoring, but not at loan origination.

Timeline

The anticipated timeline for the implementation of the Guidelines – and for the closely associated credit underwriting exercise being conducted by the ECB – is likely to prove demanding for banks and supervisors alike.



Summary structure

The structure and content of the Guidelines are summarised in the following table. In addition to these requirements, all chapters of the Guidelines state a range of requirements around the quality and quantity of data; the necessity for detailed loan-by-loan data; the robustness of IT infrastructure; and appropriate policies related to loan origination and monitoring.

Section	Content
Chapter 1	Compliance and reporting obligations
Chapter 2	Subject matter, scope and definitions
Chapter 3	Implementation

Section	Content
Chapter 4	<p>Governance requirements for credit granting and monitoring: Clarifies internal governance and control framework for credit granting and the credit decision-making process.</p> <ul style="list-style-type: none"> – Credit risk governance and culture – Credit risk appetite, strategy and credit risk limits – Credit risk policies and procedures – Credit decision-making – Credit risk management and internal control frameworks – Resources and skills – Remuneration
Chapter 5	<p>Loan origination procedures: Sets out requirements for the collection and documentation of data relating to borrowers' creditworthiness. Sets out requirements for creditworthiness assessments made after the application date (and for pre-existing loans, where terms are renegotiated or other specific triggers occur after the application date).</p> <ul style="list-style-type: none"> – Collection of information and documentation – Assessment of borrower's creditworthiness – Credit decision and loan agreement
Chapter 6	<p>Pricing: Sets out supervisory expectations for the risk-based pricing of loans.</p>
Chapter 7	<p>Valuation of immovable and movable property: Provides guidance on approaches to the valuation of immovable and movable collateral, both at the point of granting credit, and throughout the life cycle of a loan when monitoring and reviewing the value of such collateral.</p> <ul style="list-style-type: none"> – Requirements for valuation at the point of origination – Requirements for monitoring and revaluation – Requirements for valuers
Chapter 8	<p>Monitoring framework: Specifies requirements for the ongoing monitoring of credit risk and credit exposures, including regular credit reviews of professional borrowers.</p> <ul style="list-style-type: none"> – General requirements for credit risk monitoring framework – Monitoring of credit exposures and borrowers – Credit review of professionals – Monitoring of covenants – Stress testing in monitoring process – Use of early warning indicators in credit monitoring – Watch list
Annex 1	Credit granting criteria
Annex 2	Information collection and verification
Annex 3	Metrics for credit granting and monitoring

In the following section we explore the practical implications and challenges of the Guidelines for banks in greater detail.

Highlights of the key contents

At a high level, we view the following as being the most important requirements of the Guidelines for banks to implement:

Internal governance and control (Chapter 4)

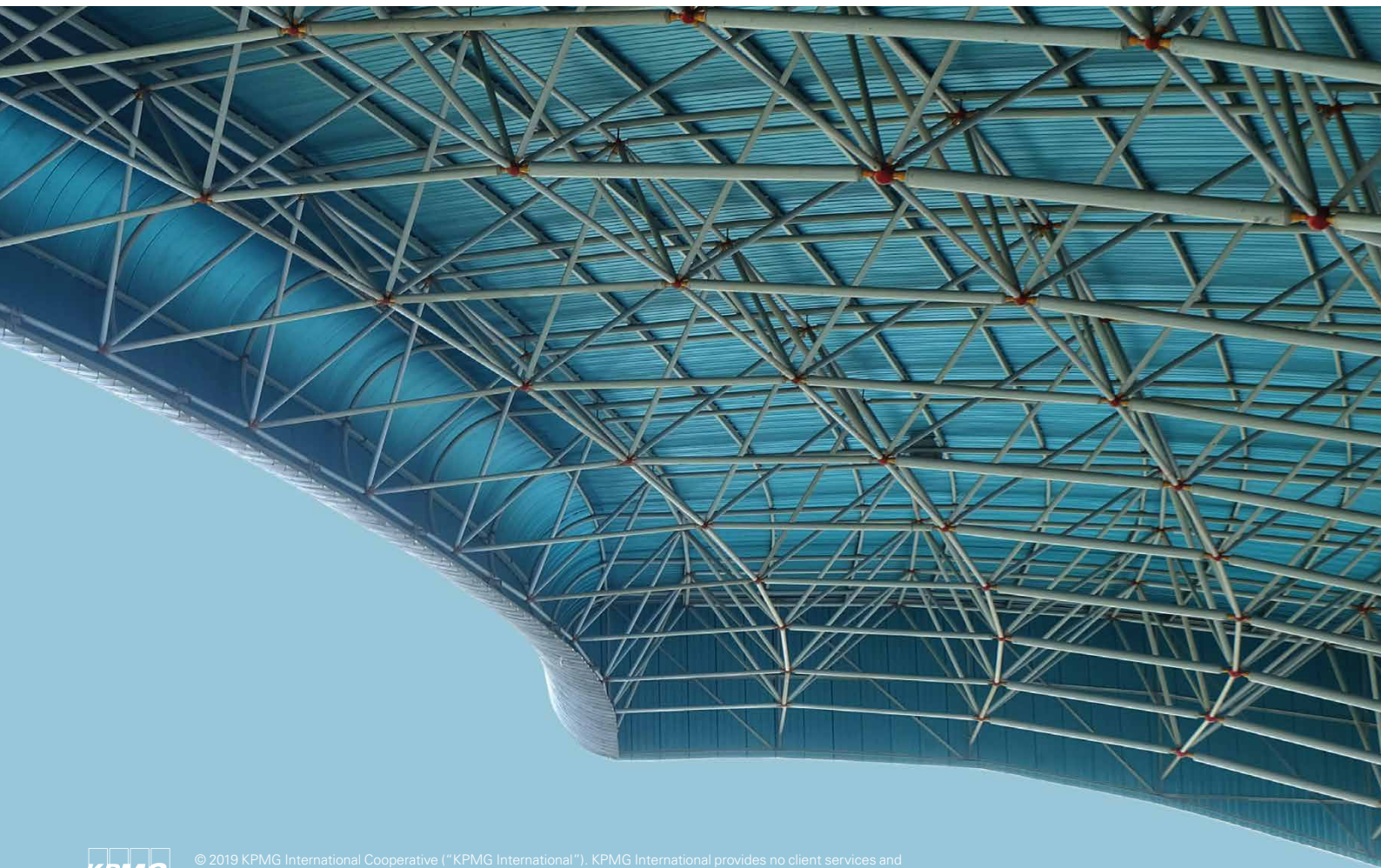
- The internal governance and control frameworks for credit granting and decision-making processes should build on the requirements of the EBA Guidelines on internal governance, including the setting of a credit risk culture as part of the overall risk culture.
- The Guidelines place a particular emphasis on the role of the second line of defence as part of a comprehensive credit risk management and internal control framework.

The credit risk appetite, credit risk strategy and the overall credit risk policy should be aligned to the overall Risk Appetite Framework (RAF). The credit risk appetite should consider top-down and bottom-up perspectives, both supported by a budgeting process.

Credit risk policies and procedures (Chapter 4)

- Emphasis on minimising the risk of internal or external fraud in the credit granting process, and that money laundering and anti-terrorist financing (ML/TF) risks are well understood and addressed.
- Need for a clear scope and definition for leveraged transactions as well as the institutions' risk appetite and strategy in this area.
- Provides specifications on technology-enabled innovation for credit granting. This includes capturing, managing and controlling the associated risks and managing the potential for bias in the credit decision-making process. The management body should also understand how technology-enabled innovation is used and how it impacts credit granting.

Requires institutions to incorporate environmental, social and governance (ESG) considerations into their policies and procedures, and to develop specific green lending policies and procedures for the granting and monitoring of such facilities where relevant.



Remuneration (Chapter 4)

- Provides specifications on remuneration, including the need for policies and practices for staff involved in granting, administration and monitoring of credits to promote prudent credit growth and appropriate risk-taking behaviour.

Loan origination (Chapter 5)

- Defines the types and extent of information to collect for loan origination for consumers and professional borrowers, including the need to verify the authenticity of data and to assess the plausibility of all information provided by the borrower.
- Defines a series of minimum credit granting criteria.

Borrowers' creditworthiness (Chapter 5)

- Requirements for assessing the creditworthiness of different types of borrowers and for various types of lending, before concluding a new loan agreement or amending an existing one.
- Includes the need for sensitivity analysis, reflecting potential negative scenarios in the future.
- The Guidelines will replace the existing EBA Guidelines on creditworthiness assessments under the Mortgage Credit Directive (MCD) – refer to Appendix for a summary of key interdependencies.

Pricing framework (Chapter 6)

- Requires institutions to establish a comprehensive pricing framework related to loan pricing principles, consistent with risk appetite and business strategies and considering the profitability perspective.
- Loan pricing is expected to consider costs items such as related to capital, funding, operation and administration, credit risk and any other real costs associated with the loan.

Collateral valuation (Chapter 7)

- In addition to immovable collateral valuation, the Guidelines provide specific requirements for movable collateral valuation, including:
 - To be assessed by an independent qualified valuer or appropriate advanced statistical models.
 - To have a time bound rotation of appraisers for when such individual valuations are needed at origination.
 - To have adequate IT processes and systems in place, and accurate and sufficient data available as necessary for statistical valuation.

Stress testing in monitoring process (Chapter 8)

- Should conduct regular stress testing of credit portfolios (aggregate and relevant sub-portfolios) and individual exposures when appropriate (in line with the EBA Guidelines on stress testing).

Credit risk monitoring framework (Chapter 8)

- Should allow the gathering and automatic compilation of credit risk data without delay and with limited manual interface.
- Should enable a single aggregated, consistent and comprehensive customer view.
- Should allow tracking of the credit decision-making process and escalations, and include necessary Key Risk Indicators (KRIs) at asset type or portfolio level.
- Particular focus on quantitative and qualitative Early Warning Indicators (EWIs), including defined trigger levels with assigned escalation procedures and assigned responsibilities for follow-up actions.
- Must allow the generation of granular risk data, including for the needs of prudential and statistical reporting, stress testing and crisis management purposes.

Data (All chapters)

- Emphasis on data and information to be of adequate depth, breadth, accuracy, integrity, reliability, consistency, timeliness and traceability.
- Data and information should be sufficiently detailed and granular to capture specific loan-by-loan information and linking to borrower and relevant collaterals.
- Data collection and management are expected to consider the relevant data fields necessary for potential future NPL management, using the EBA NPL transaction templates.

03 Implications of EBA Draft Guidelines for EU Banks

The Guidelines pose major challenges for lenders' credit data and processes. This section summarises the key practical implications for banks.

At a very high level, we view the following as being the most important requirements of the Guidelines for banks to implement:

- Institutions must collect and verify sufficient information before concluding a loan agreement or significantly increasing the amount of a loan. Institutions should make reasonable enquiries in order to verify the authenticity of information. The EBA provides a prescriptive list of data to be collected at loan origination to be maintained and updated throughout the loan life cycle.
- Institutions should review and improve their data infrastructure to support the initial credit granting process, and ongoing credit risk management and monitoring throughout the life cycle of a loan.
- Institutions are required to collect loan-by-loan data at the point of origination so that borrower data and collateral data can be linked, supporting effective monitoring of credit risk and enabling an audit trail.
- Regarding credit decisions, institutions should focus on the debt capacity of the borrower, taking into account the sustainable future cashflow, the overall indebtedness and the debt service coverage ratio for the specific exposure. Collateral by itself should not justify the loan approval if debt capacity is insufficient.
- Institutions must address the potential risk of borrowers failing to meet their contractual commitments, which could affect the strength of the institution and financial stability at large. This means that institutions must monitor credit risk using Early Warning Indicators (EWIs) and Key Risk Indicators (KRIs) at loan origination and throughout the life cycle of the loan, as well as conducting sensitivity analysis and stress testing in order to reduce the likelihood of negative effects in future.
- Institutions need to align their credit risk strategy – and the implementation of this strategy via credit-granting decisions – with capital and liquidity planning, the ICAAP and ILAAP, and the broader risk appetite framework.

Practical Insights & Recommendations

These requirements will pose significant practical challenges for lenders. This is especially true when it comes to the aggregation, calculation, calibration, reconciliation and quality control of credit data and metrics.

In brief, we believe that most banks will need to take the following actions if they have not done so already.

1. Identify and address any gaps in their policies and procedures relating to the Guidelines, including:
 - Governance and credit risk culture regarding credit granting and decision-making;
 - Policies and procedures for valuing property collateral at the point of origination, during monitoring and when revaluing; and
 - Early warning systems to identify and tackle signs of declining credit quality.
2. Map the information that needs to be collected at the point of origination, identify which data are not currently collected and arrange for this to happen from 30 June 2020 onwards.
3. Identify, develop and maintain qualitative and quantitative EWIs and KRIs:
 - Collected from the point of origination and throughout the entire life cycle of a loan;
 - Defined and calculated consistently and in compliance with relevant regulations;
 - Based on data with a high level of quality; and
 - Regularly stressed in order to anticipate potential future negative effects.
4. Establish a comprehensive framework for loan pricing, including cost of capital, cost of funding, credit risk costs, operating and administrative costs, any other real costs associated with the loan.
5. Identify any aspects of technology infrastructures that may make it hard to comply with the Guidelines, and set up an action plan to address these weaknesses.
6. Establish a comprehensive monitoring system and a 'three lines of defence' model as described by the Guidelines, which specify escalation processes and follow-up actions.
7. Update the internal reporting framework in compliance with the Guidelines' requirements.

Indicative impact areas of the Draft EBA Guidelines

Chapters of the draft EBA Guidelines	Policies and procedures	Organisation structure and granting practices	Control system	KRIs setting up and Monitoring	IT system and data infrastructure
Governance requirements for credit granting and monitoring (Chapter 4)					
Loan origination procedures (Chapter 5)					
Pricing (Chapter 6)					
Valuation of immovable and movable property (Chapter 7)					
Monitoring framework (Chapter 8)					

Key

	High impact	Moderate impact	Low impact
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Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019

Highlights from KPMG's survey and the EBA Public Hearing

KPMG had the opportunity to gain deeper insights by conducting a tailored survey, speaking with a group of selected European banks to explore some of the anticipated challenges when implementing the Guidelines. Here we provide some highlights from these discussions, as well as additional clarification obtained during the EBA Public Hearing of 20 September 2019.

Implementation date: The main concern is with regards to the short timeline for implementation, which is deemed too ambitious by banks given the broad scope of application and numerous other ongoing regulatory projects (for example the new Definition of Default, Basel IV implementation and NPL regulation). It is however unlikely that consequential delays will be provided for the entry of effect of the Guidelines, considering that the EBA is under pressure to implement them rapidly under the European Council Action Plan.

Proportionality: While the Guidelines are not meant to be prescriptive and there is an understanding that one size does not fit all, some concerns have been raised on the wording around the principle of proportionality and how the specific requirements of the Guidelines should be considered within that principle. This raises the fear of supervisory interpretation and possible stricter implementation of the text, despite proportionality. Although the consultation paper already defines the principle of proportionality, there is scope for greater clarity in some areas.

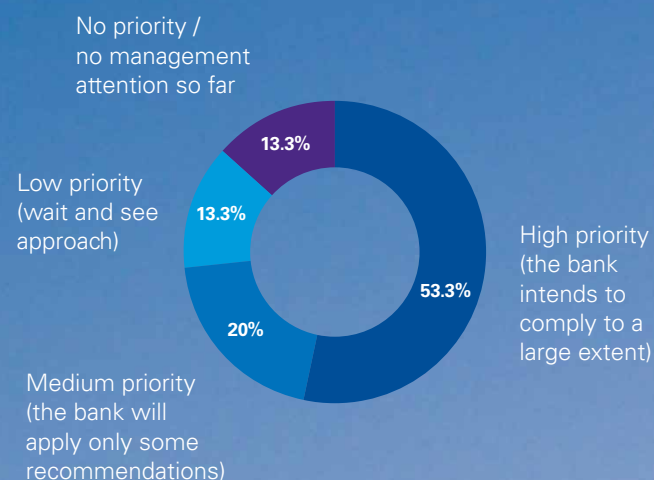
Optional: The information contained in the Annexes of the draft Guidelines should be viewed as industry best practices that banks can implement within their institutions, where applicable. We expect that the final Guidelines will clearly distinguish optional requirements from those that are mandatory.

Priority: A large majority of banks currently intend to prioritise the Guidelines as high or medium priority

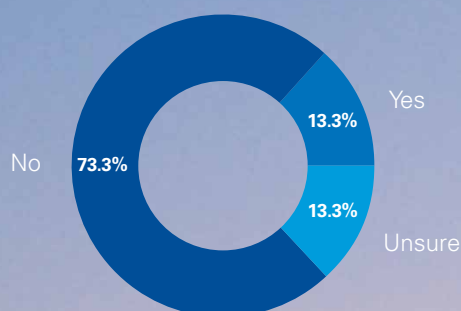
Implementation: More than 70% of our contacts surveyed think they will face difficulties to implement the Guidelines by 30 June 2020

Areas of impact: For banks, the main concerns regarding areas of impact are: credit risk metrics, models and validation, data requirements and IT systems.

What priority is the bank management applying to EBA Guidelines on loan origination and monitoring?



Do you think that your bank will have implemented the requirements by 30 June 2020?



Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019

What are the main areas of impact, ranked from most important to least important?

#1

Credit risk metrics, models and validation (inc. analysis of debt service coverage, sensitivity analysis, innovative and automated decision engine)

#4

Re-engineering of loan origination/credit processes

#2

Data requirements (e.g. credit criteria, KRIs, tracking of credit decisions)

#5

Time delays and increased operational costs for the credit decision process, due to stricter and more detailed regulatory requirements

#3

IT systems (e.g. credit decision engines, collateral management, early warning signals)

#6

Organisational structure within credit departments (e.g. 3 LoD model)

Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019



Key areas of consideration per chapter

Chapter 8 Monitoring framework

Monitoring requirements are highly data driven and require adequate, up to date, valid and complete data throughout the entire credit life cycle,

Greater automation requirements for the monitoring and reporting of credit risks, with possible need to enhance IT infrastructure, EWS and reporting templates – all with relevant and timely data,

Need to perform a Gap Analysis, and identify how and where the required information can be collected.

Chapter 4 Governance

Numerous documentation requirements, and the need to update lending standards,

Definitions of KRIs for different portfolios, in order to operationalise credit risk appetites through credit risk strategies,

Adjustments to the control framework and the distribution of tasks within the lending process may be needed to comply with the Three Lines of Defence model (3 LoD).

Chapter 5 Loan origination procedures

Collection and verification of relevant information for credit approval and reporting within the lending process,

Sensitivity and scenario analysis of the borrower's projected debt service capacity,

Required metrics and processes the creditworthiness assessment must apply,

Likely need to adjust credit policies, processes and procedures.

Chapter 7 Valuation

Workflow adjustments for initial individual valuation of assets (i.e. stricter requirements for valuation at loan origination and monitoring through the life cycle),

Requirements for appraiser rotation (for immovable collateral),

As for the EBA's Guidelines on non-performing and forborne exposures, there are additional requirements for immovable collateral.

Chapter 6 Pricing

Increase connections between risk, management and asset and liability management technology,

Modelling and implementing a behaviour-based approach to pricing,

Consideration of expected (lifetime) credit loss as part of the specific risk cost calculation,

Ensuring transparency of any cross-subsidies between loans, borrowers or business units.





Learning from the ECB's Underwriting Exercise

The Guidelines require banks to collect and report many of the same data and metrics as those requested by the ECB during its recent credit underwriting review. It follows that banks' experience of completing the ECB's data template should give them a good idea of the challenges that the Guidelines are likely to pose, even if the Guidelines require far more granular detail.

As a reminder, some of the key challenges arising from the ECB's exercise were:

- **Data collection and consolidation.** The ECB requested data at a Group level. Banks faced a challenge to consistently collect and consolidate data from subsidiary entities' heterogeneous databases, which often have different data fields and definitions, and which can also differ depending on the country, e.g consumer credit. More specifically, 'income', 'net annual rental income', 'total debt for SME' and 'EBITDA' data was difficult to collect.
- **KRIs.** Calculation methods could differ within a banking group. Ratios and data definitions are not always compliant with ECB/ ESRB definitions. In addition, some of the KRIs requested by the ECB are not always collected by banks during loan origination (depending on national practices within a country) or may not be updated throughout the lifecycle.
- **Probability of Default.** The data templates asked for past and actual IFRS 9 one-year probabilities of default (PDs) and not lifetime PDs, to be taken into account when calculating historic parameters.
- **Parameters.** The ECB asked for portfolios' minimum and maximum PDs and LGDs at the time of loan origination, allowing it to identify which exposures banks classified as high and low risk when granting the loan, and to compare this with risk appetites and loan origination policies.
- **Performance.** Banks had to provide details on the performance of originated loans. In particular, the templates asked for a breakdown of loans originated from 2014 to 2018 that have since been classed as non-performing, as well as for loans that defaulted within 48 months of origination.
- **Portfolio Dynamics.** The ECB asked for data on portfolio dynamics in terms of EADs and IFRS 9 PDs. In particular it sought details on the effects of migration, impaired transfers and reclassifications.
- **Pricing.** The exercise raised difficulties in collecting and evaluating the pricing spread linked to PD.

Of course the above list is merely indicative. It's important to remember that the Guidelines pose some additional data-related challenges – such as the requirement to implement sensitivity analysis and stress testing.

04 EBA draft Guidelines on loan origination & monitoring

In this section we take a closer look at the core chapters of the Guidelines, set out what we see as being among the most important issues they raise, and make some recommendations for banks to consider.



Chapter 4 – Governance requirements for credit granting and monitoring

This section of the Guidelines sets out general conditions for the oversight of credit granting and monitoring. It explicitly states that these requirements should be applied in addition to the EBA's existing guidelines on internal governance.

We have grouped what we see as the key requirements under three sub-headings: **Policy**, **Processes** and **Monitoring**.

i. Policy

As an overall requirement, institutions should set out criteria for identifying, assessing, approving, monitoring, reporting and controlling credit risk, as well as criteria for measuring allowances for accounting and capital adequacy purposes. These should be documented within a framework of credit risk policies and procedures, and updated regularly.

As part of this process, managing bodies should review their credit policies and ensure that they meet the following requirements:

Review of credit risk limits

- Identify risk strategies, business models and credit risk appetite, all of which should be aligned with the institution's overall risk appetite framework (RAF);
- Include new internal indicators for the definition of RAF and RAS (such as loan to value, collateral value by geographic areas and FINREP segmentation);

Monitoring

- Include monitoring activities after the origination of loans;
- Define the data that must be collected for monitoring activities, for example by updating the list of internal indicators;

Granting

- Include the assessment of limits – such as concentration and aggregation limits – in credit approval processes; and
- Identify specific treatments for complex transactions (such as leveraged loans) or particular segments (such as residential property, commercial real estate or SME).

ii. Processes

The Guidelines require institutions to establish a clear and well-documented credit decision-making framework. This should set out a clear and sound structure for the credit decision-making responsibilities in the institution, including the structure of credit committees and delegated credit decision-making bodies. In particular, banks should take the following actions:

Reporting

- Establish regular and transparent reporting mechanisms so that the management body and all relevant bodies, units and functions receive timely, accurate and concise reports and can act within their respective mandates to ensure the identification, measurement or assessment, monitoring and management of credit risk;
- Define processes to collect and store data with the purpose of supporting credit risk management and monitoring throughout the life cycle of each credit facility;

Monitoring

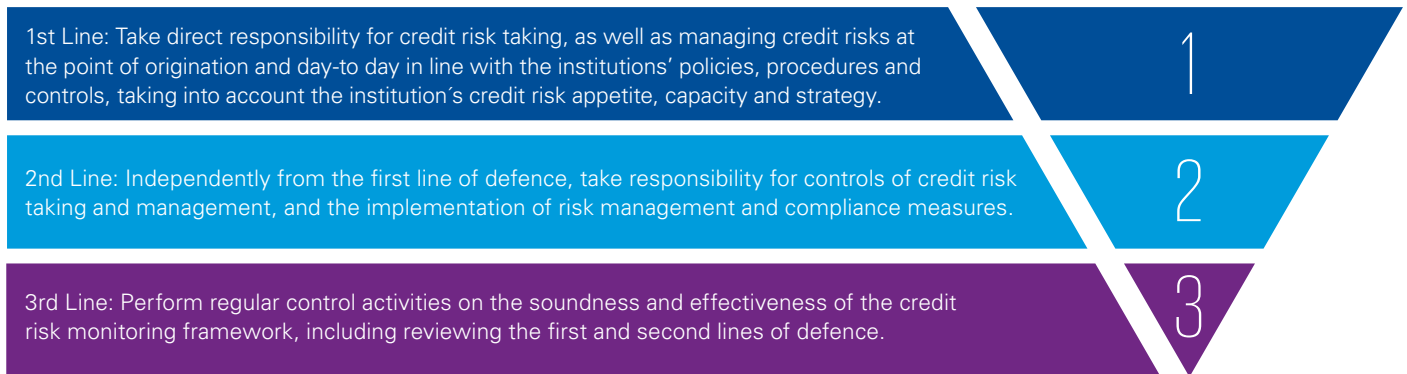
- Define processes to evaluate credit risk monitoring and reporting, including the design and use of early warning systems (EWS), also in relation to ICAAP and applicable regulatory metrics such as large exposures rules;
- Integrate portfolio analysis, with a specific focus on new business volume (new business vs stock performance analysis);

Granting

- Set out processes regarding the evaluation of robustness and consistency when defining credit risk appetite, as part of approving the institution's credit risk strategy within its overall risk strategy and business strategy;
- Ensure that all leveraged transactions are adequately reviewed in line with the institution's risk appetite, strategies and policies and approved by decision-making bodies;
- Implement an appropriate decision-making framework which, for specified activities (e.g. large exposures or particular geographies), requires an independent second opinion by the risk management function; and
- Review the development of new products and services, including on-going monitoring of the appropriateness of credit products.

iii. Monitoring

The Guidelines state that organisational structures implemented by institutions should not only support and promote effective and prudent decision-making but should also consider the ‘three lines of defence’ model. Within that model, the Guidelines suggest the following responsibilities:



Activities covered by credit risk management and internal control functions should include:

- Managing early arrears and NPEs, as well as granting and monitoring any forbearance measures in line with relevant EBA Guidelines where applicable;
- Commercial planning in line with the overall business strategy and credit risk appetite;
- Performing stress tests on the aggregate credit portfolio and on relevant sub-portfolios (such as geographical areas or types of exposure);
- Assessing the quality assurance of credit assessments, taking into account an appropriate sample size. This should include ensuring that credit risk is properly identified, measured, monitored and managed within the institution's first line of defence, and that relevant regular reporting reaches the institution's management body;
- Monitoring relevant risk parameters such as PD, LGD and EAD with reference to new business and existing portfolios, including assessing the impact of new business on the stock portfolio; and
- Monitoring and evaluating credit risks with reference to groups of connected clients.

The Guidelines also include environmental, social and governance (ESG) factors that banks are encouraged to consider in their credit risk policies and procedures.

In relation to this, banks will need to:

- Provide a list of green projects and the criteria that the institution considers when judging eligibility as part of its green lending policy and;
- Specify the process by which the institution:
 - evaluates that the proceeds of the green credit facilities they have originated are properly used, by collecting information about the climate and environmental related business objectives of the borrowers;
 - assesses the conformity of the borrowers' funding projects;
 - ensures that the borrowers have the willingness and capacity to monitor and report the allocation towards the green projects; and
 - monitors on a regular basis that the proceeds are allocated properly.

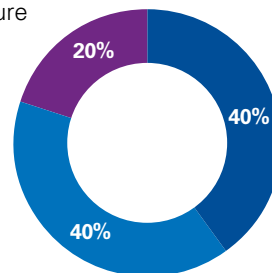
Internal governance has been identified by regulators as requiring considerable improvement across the European banking sector, and is expected to be a major area of scrutiny in 2020. While the governance requirements of these Guidelines are in line with the EBA Guidelines on internal governance (EBA/GL/2017/11), they also introduce additional lending-specific details. Internal governance needs to oversee the overall lending strategy, risk framework, business plan, risk appetite statement and limits, as well as the more detailed suite of policies and procedures used to manage and monitor credit risk. This requires robust embedding of internal governance mechanisms, and the support of relevant, high quality data and metrics. Banks are advised to ensure adequate documentation of policies and procedures, and to assess how they will comply with relevant internal governance principles in practice.

The Guidelines also require banks to make clear policy statements on environmental, social and corporate governance (ESG) and green lending if applicable. This aims to link the Guidelines to other ongoing work in Europe in these areas (for which further Guidelines can be expected in the future). It may be challenging to quantify risks in this area, and to precisely identify the consequences of any risk indicators. However it is worth noting that for green lending the Guidelines will only apply to institutions that already (or intend to) originate such lending.

With respect to the introduction of AML requirements, expectations are that data gathered at origination and updated throughout the life of the loan will also be used for AML purposes.

Which is the most critical impact concerning 'Governance'?

Implementation of a comprehensive 3 LoD structure



Documentation requirements and update of lending standards

Defining meaningful KRIs for different portfolios for operationalisation (Limitation) of credit risk appetite through the credit risk strategy

Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019

A key challenge identified will be to align and embed all these requirements in an effective manner, and to adequately document compliance.





Defining the necessary credit risk metrics and limits for different portfolios, including the underlying Key Risk Indicators (KRIs), may also prove complex for some banks.

While the Guidelines provide the 'three lines of defence' model as an example, they require a reasonable risk management framework to be in place, including a feedback loop from credit monitoring back to loan origination and pricing. This was identified as potentially challenging for some banks to implement.

Chapter 5 – Loan origination procedures

This section of the Guidelines sets out a wide range of general and specific requirements for institutions to follow when originating loans to consumers and professionals. Unsurprisingly, these are centred on creditworthiness assessments. In simple terms, creditworthiness assessments should aim to verify the borrower's ability to meet the obligations of a loan, and to verify that the borrower's profile meets the lender's credit risk appetite, policies and limits.

There is not space here to review every detail of Chapter 5, which sets out detailed conditions for the information, metrics and techniques to be used when conducting assessments and making credit decisions. Instead, we have grouped what we see as the most important requirements under four headings. The following table summarises these at a high level:

 A. Relevant information	<p>Institutions and creditors should collect and verify sufficient relevant information in order to assess the borrower's creditworthiness before concluding a loan agreement, or before amending an existing loan or loan amount.</p>
 B. Scope of the creditworthiness assessment	<p>The creditworthiness assessment should cover, at a minimum, the borrower's income or operative cashflow, disposable income, financial situation and the source of their capacity to meet repayment obligations.</p>
 C. Metrics to be used	<p>Institutions and creditors should apply metrics that are relevant to assessing the borrower's ability to repay the loan, depending on the type of asset and lending product.</p>
 D. Sensitivity analysis	<p>When assessing borrowers' ability to meet their obligations, lenders should conduct sensitivity analyses reflecting potential negative scenarios including – for example – a reduction of income, an increase in interest rates or a significant shift in exchange rates.</p>

We now take a closer look at some of the Guidelines' key conditions under each topic area – for lending to consumers and professionals alike.



i. Relevant information

The Guidelines set out detailed requirements over the collection, analysis, management, governance and documentation of the data that institutions require in order to make credit decisions. The following diagram sets out some of the most important conditions.

Information and data collection

When assessing borrowers' creditworthiness, 'relevant information' should explicitly include:

- For all borrowers a comprehensive view on risk drivers which may rise from ESG-Risks,
- For consumers: purpose of the loan, employment, income, financial commitments, collateral (if secured) and any other risk mitigation factors,
- For professionals: purpose of the loan, income and cash flow, financial position and commitments, business model and corporate structure, business plans, financial projections, collateral and – if applicable – other risk mitigation factors and product-specific legal documentation.

Governance, credit risk policies and procedures

The collection and verification of information should be in line with institutions' governance, credit risk policies and procedures,

Institutions and creditors should document the information and data that lead to credit approval, including their actions and assessments – especially over income verification for debt service coverage.

Information plausibility assessment

Information should be accurate, timely and relevant to the asset class and specific product. It should also be proportionate to the purpose, size, complexity and potential risk of the loan,

Institutions and creditors should assess the plausibility of any information provided by the borrower, and make any necessary checks to verify its authenticity – such as enquiring to employers, public authorities or credit bureaus.

Comprehensive customer view

Institutions and creditors should have a sufficiently comprehensive view of the borrower's financial position, including all their credit commitments,

If the borrower is a member of a group of connected clients, information on all related parties should be collected in accordance with the EBA's Guidelines on connected clients.

Sectorial guidance

Appendix II of the Guidelines suggests information that institutions should consider collecting and verifying for different borrower and lending types types (such as shipping finance or commercial real estate).



ii. Scope of the creditworthiness assessment

In addition to the requirements over the collection and use of relevant information set out above, the Guidelines set out some overall scoping requirements when originating loans to consumers and professionals. The following table sets out some of the most important points.

Lending to consumers	Lending to professionals
<p>Lending against residential immovable property</p> <p>Lenders should make reasonable inquiries to verify:</p> <ul style="list-style-type: none"> – borrowers' underlying income capacity, income history and any variability over time; – the impact of retirement on borrower's income and repayment ability; and – the impact of other factors that could influence the repayment capacity of the borrower. <p>Other secured lending</p> <p>For property under development, lenders should assess:</p> <ul style="list-style-type: none"> – the borrower's plan related to the project; – information on the builders, architects, engineers, contractors and sub-contractors taking part; – projections of costs associated with the development certified by a qualified and reputable surveyor; and – all necessary permits and certificates, including the ability to obtain them as the project progresses. <p>Unsecured lending:</p> <p>Lenders should make reasonable inquiries to verify:</p> <ul style="list-style-type: none"> – borrowers' underlying income capacity, income history and any variability over time; – the impact of retirement on borrower's income and repayment ability; and – the impact of other factors that could influence the repayment capacity of the borrower. 	<p>All lending to professionals</p> <p>When assessing creditworthiness, lenders should:</p> <ul style="list-style-type: none"> – analyse the financial position and credit risk of the borrower; – verify if the borrower's profile matches their credit risk appetite, policies and limits; – analyse the borrower's structure, business model and strategy including its legal status, integrity and reputation; – investigate and manage any potential conflict of interest between the institution and the borrower; – use appropriate and specific metrics and indicators, in line with their credit risk appetite, policies and limits; – assess the borrower's credit scoring, in accordance with their credit risk policies and procedures; – consider all of a borrower's financial commitments, generating a single customer view; – assess the structure of the transaction including the risk of structural subordination and related terms such as covenants, leverage and dividend distribution; and – analyse the specifics of the loan and its contractual and financial features, such as maturity and interest rate. <p>Specific exposures</p> <p>The Guidelines also set out additional information for institutions to consider when originating particular types of lending such as commercial real estate, project finance, shipping finance or SME lending.</p>

iii. Metrics to be used

The Guidelines provide a list of metrics that, at a minimum, lending institutions are expected to use when conducting creditworthiness assessments. They are:

Lending to consumers	Lending to professionals
<ul style="list-style-type: none"> – loan to income ratio; – loan service to income ratio; – debt to income ratio; and – debt service to income ratio. 	<ul style="list-style-type: none"> – debt service coverage ratio; – EBITDA (earnings before interest, taxes, depreciation and amortisation); – interest coverage ratio; – loan to value ratio (for secured lending); – debt to equity ratio or leverage ratio; – loan to cost ratio; – return on equity; and – capitalisation rate (net operating income/market value).

Annex III of the Guidelines sets out additional metrics for institutions to consider applying to specific asset classes and types of lending products.

iv. Sensitivity analyses

The Guidelines require lenders to conduct sensitivity analyses reflecting adverse potential scenarios as part of their assessment of borrowers' creditworthiness.

For lending to consumers, examples of possible negative scenarios include a reduction of income; an increase in interest rates in the case of variable rate loan agreements; negative amortisation; balloon payments, or deferred payments of principal or interest.

For lending to professionals, sensitivity analyses are expected to account for variations in asset class and product type, and to be proportionate to the purpose, size, complexity, term and potential risks of the loan. Institutions are also expected to:

- Verify that financial projections provided by the borrower, together with underlying assumptions, are reliable and realistic
- Assess the sustainability and feasibility of the borrower's financial position and repayment capacity under potential adverse market and idiosyncratic events that may occur during the life of the loan (see table below).

Lending to professionals

Market events to consider	Idiosyncratic events to consider
<ul style="list-style-type: none"> – a macroeconomic downturn; – a downturn in the economic sectors where the borrower and its clients are operating; – a significant change in political, regulatory and geographical risk; – an increase in cost of funding, for example an increase in the interest rate by 200 basis points on all credit facilities of the borrower. 	<ul style="list-style-type: none"> – a severe decline in borrower's revenues or profit margins; – a severe operational loss event; – occurrence of severe management problems; – the failures of significant trading partners, customers or suppliers; – a significant reputational damage; – a severe outflow of liquidity, changes in funding or increase in borrower's balance sheet leverage; – adverse movements in the price of assets to which the borrower is predominantly exposed; – adverse movements in foreign exchange rates.



Banks anticipate difficulties in collecting and keeping accurate historical data, and in extracting information throughout the life cycle of a loan. The regulator should keep a balance between quantitative and qualitative information useful for the credit granting process. Many banks have had the ECB perform on-site inspections and credit underwriting exercises, which often highlighted difficulties in gathering KRIs.

The single customer view is also a challenge as in some countries there is no 'positive database', making it hard to obtain an accurate and up to date comprehensive view of all of a borrower's credit commitments. Nevertheless, the information could be collected both from the borrower and from all available databases (internal, external, government and agencies).

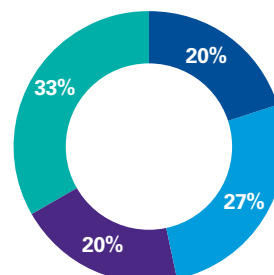
Banks surveyed expect that collecting and verifying information for credit approval and reporting as part of the lending process reporting is expected to be the main challenge. Collecting and keeping accurate historical data, and extracting information throughout the loan life cycle, are seen as particular difficulties.

The requirement to perform sensitivity and scenario analysis as part of creditworthiness assessments has also been identified as potentially challenging, particularly when it comes to using proportionality to limit the burden for some asset classes.

Which is the most critical impact concerning 'Loan origination procedures'?

Collection and verification of information within the lending process for credit approval and reporting

Requirements for the metrics and structure of the debt service capacity assessment



Gathering the information regarding the minimum requirements for the credit granting criteria

Sensitivity and scenario analysis of the projected debt service capacity

Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019

Chapter 6 – Pricing

This chapter of the Guidelines expects institutions to implement a comprehensive framework for the pricing of loans, and to ensure that this is well documented. Frameworks should reflect each institution's credit risk appetite, business strategies, profitability and risk perspective. They should also define approaches to pricing depending on the type and credit quality of borrowers.

Among other factors, the Guidelines suggest that loan pricing should take account of five key categories of costs (see table).

Cost of capital	Cost of funding	Credit risk costs	Operating and administrative costs	Any other real costs
<p>The cost of capital allocated to the loan. This should reflect the breakdown of capital allocation, for example:</p> <ul style="list-style-type: none"> – By country – By business – By product 	<p>The cost of funding, which should match the key features of the loan, such as:</p> <ul style="list-style-type: none"> – The expected duration, not only based on the terms of the loan but also on behavioural assumptions 	<p>Credit risk costs calculated for different homogenous risk groups. For example, these could consider:</p> <ul style="list-style-type: none"> – Historical experience of credit losses – Expected loss models, where relevant 	<p>Operating and administrative costs, such as:</p> <ul style="list-style-type: none"> – The administrative costs associated with credit underwriting 	<p>Any other real costs associated with the loan, for example:</p> <ul style="list-style-type: none"> – Tax considerations, in the case of leasing transactions

In addition to taking account of these costs, institutions should ensure that pricing frameworks:

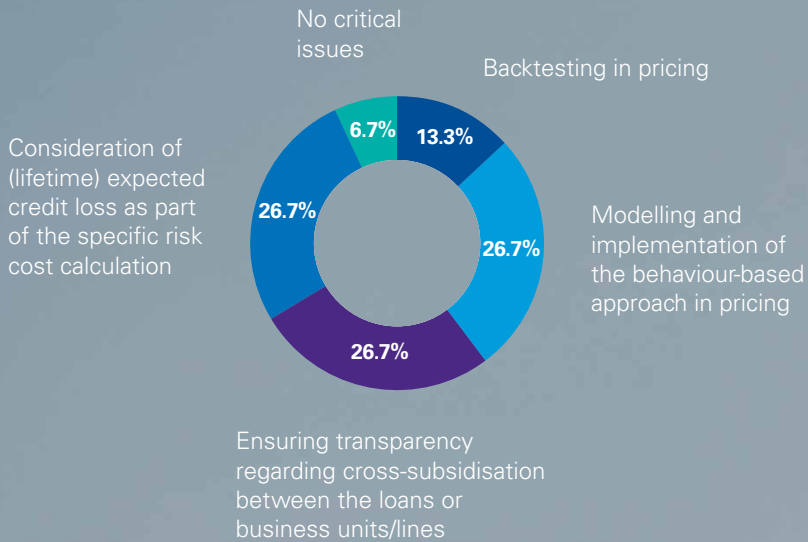
- Consider and account for risk-adjusted performance measures such as economic value added (EVA), return on risk-adjusted capital (RORAC) and risk-adjusted return on capital (RAROC), in a manner that is proportionate to the size, nature and complexity of the loan;
- Document and demonstrate the underlying cost allocation framework, including a fair distribution of costs between different activities and business lines; and
- Regularly monitor the links between transaction risk, loan pricing and expected overall profitability.

The Guidelines do not prescribe any specific pricing strategies, as these remain the business decisions of individual institutions. However the Pricing chapter may not be sufficiently detailed compared with other chapters, and some banks have requested further guidance.

The three main topics expected to have the greatest impact on pricing are:

- Modelling and implementing behaviour-based approaches to pricing;
- Ensuring transparency of any cross-subsidies between loan, borrowers or business units; and
- Consideration of expected (lifetime) credit loss as part of the specific risk cost calculation.

Which is the most critical impact concerning 'Pricing'?



Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019

Chapter 7 – Valuation of immovable and movable property

This section of the Guidelines sets out requirements for the valuation of loan collateral, whether immovable or movable, both at the point of origination and during the life cycle of the loan. These requirements are structured into three sections, as follows.

i. Requirements for valuation at the point of origination

Lenders are required, when using movable or immovable collateral, to ensure that they:

- Set out internal policies and procedures for valuation;
- Value collateral accurately at the point of origination;
- Do not have conflict of interest (appraisers);
- Establish a panel of accepted independent valuers with relevant expertise (if using external valuers);
- Value collateral in accordance with applicable international, European and national standards; and
- Have adequate technology and suitable data in place to support any statistical valuations.

The reference value of immovable property collateral should be the market value (MV) or mortgage lending value (MLV) in accordance with EU Regulation No 575/2013. Valuations of movable property should also take the requirements of this regulation into account.

When conducting their initial valuations, institutions also need to ensure they comply with specific requirements for immovable and movable property. The following table summarises some of the most important issues:

Immovable property collateral	<ul style="list-style-type: none"> – Policies & procedures: These should specify prudent, proportionate valuation approaches for different collateral types. – Valuation approach: All collateral should be valued by an independent qualified internal or external valuer. Desktop or drive-by valuations should only be used for collateral that is similar to examples already valued or revalued. – Lower repayment capacity: When borrowers' repayment capacity deteriorates significantly, lenders should assess the liquidity and enforceability of collateral, including time to recovery. – Reporting: At the end of valuation, lenders should obtain a clear and transparent final valuation report documenting all necessary information and all the factors determining collateral value.
Movable property collateral	<ul style="list-style-type: none"> – Policies & procedures: These should specify internal thresholds setting out when individual items of collateral must be valued by a valuer, rather than via statistical modelling. – Reporting: Lenders should obtain a clear and transparent valuation report or model outcome, documenting all the factors determining collateral value.

ii. Requirements for monitoring and revaluation

The Guidelines set out several requirements for valuing collateral throughout the life cycle of a loan. These include general requirements, such as maintaining adequate data and technology to support revaluations, and others that are specific to particular collateral types. The most important features include:

Immovable property collateral	<ul style="list-style-type: none"> – Policies & procedures: When monitoring values as laid down in Art. 208(3) of EU Regulation No 575/2013, lenders should set policies specifying their approach to monitoring collateral. – Collateral monitoring: Institutions should set out appropriate frequencies for monitoring collateral values, considering the type and value of collateral at origination and the relevant credit agreement. – Establishing triggers: Institutions should set out specific triggers indicating when monitoring leads to revaluation or when collateral needs revaluation. – Updating the value of collateral: <ul style="list-style-type: none"> – Where the conditions for a review in Article 208(3) are met, institutions should revalue collateral using a valuer or adequate advanced statistical models accounting for the individual characteristics of the property, if models are not the sole means of revaluation. – Where they are not met, institutions should revalue collateral using a valuer or adequate advanced statistical models accounting for the individual characteristics of the property. – When a valuer is used, desktop or drive-by valuations should only be used for collateral that is similar to examples already valued or revalued. – Institutions should ensure adequate rotation of valuers, i.e. two sequential individual valuations of the same immovable property by the same valuer should result in the rotation of the valuer, resulting in the appointment of either a different internal valuer or a different external valuer.
Movable property collateral	<ul style="list-style-type: none"> – Value monitoring: Institutions can use adequate statistical models and indices for monitoring; for revaluation, they may rely on assessment by valuers, statistical models and indices. – Policies & procedures: Lenders should set out their approaches to using valuers or statistical models, define the approach for revaluations done by valuers, and set out the frequency of monitoring and revaluating property collateral. – Updating the value of collateral: Policies and procedures should include criteria for individual monitoring of the value and revaluation of the movable property collateral by a valuer who possesses the necessary qualifications, ability and experience.

iii. Requirements for valuers

The Guidelines set out some requirements and standards with which valuers – and the institutions that use them – are expected to comply. The most important are:

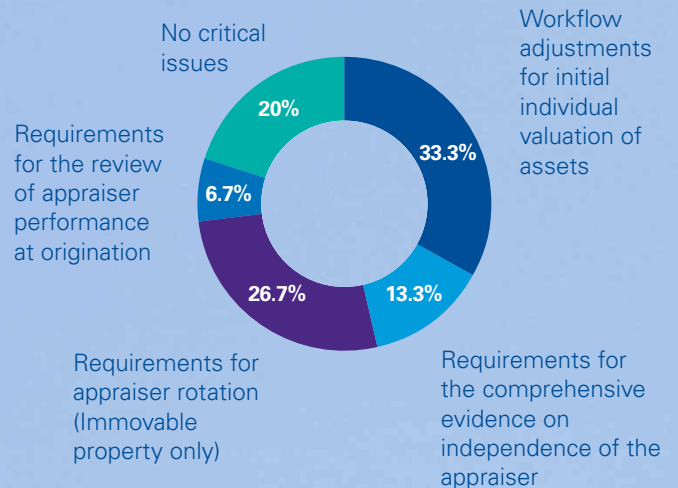
- Professional requirements: Every valuer should be professionally competent and qualified; have appropriate skills and experience; be able to demonstrate compliance with relevant regulations and standards; and have sufficient market knowledge.
- Independence: Lenders should ensure that the valuer's remuneration is not linked to the outcome of their valuation.
- Performance: Institutions should assess the performance – and especially the accuracy – of valuers on an ongoing basis. This should include reviewing the concentration of valuations and fees paid to specific valuers.
- Conflicts of interest: Lenders should ensure that valuers and their close relatives are not subject to any of several specified conflicts of interest.

The requirements around valuation processes at the point of origination, during ongoing monitoring and when re-valuing collateral are based on the Capital Requirements Regulation (article 208) and focus on policies, procedures and processes without any set standards for actual methodologies. This puts an emphasis on the competence of the valuers and aims to mitigate conflict of interest. Regarding the panel of external valuers to consider, the aim is to ensure that they are of good quality and that valuations are always executed to a high standard.

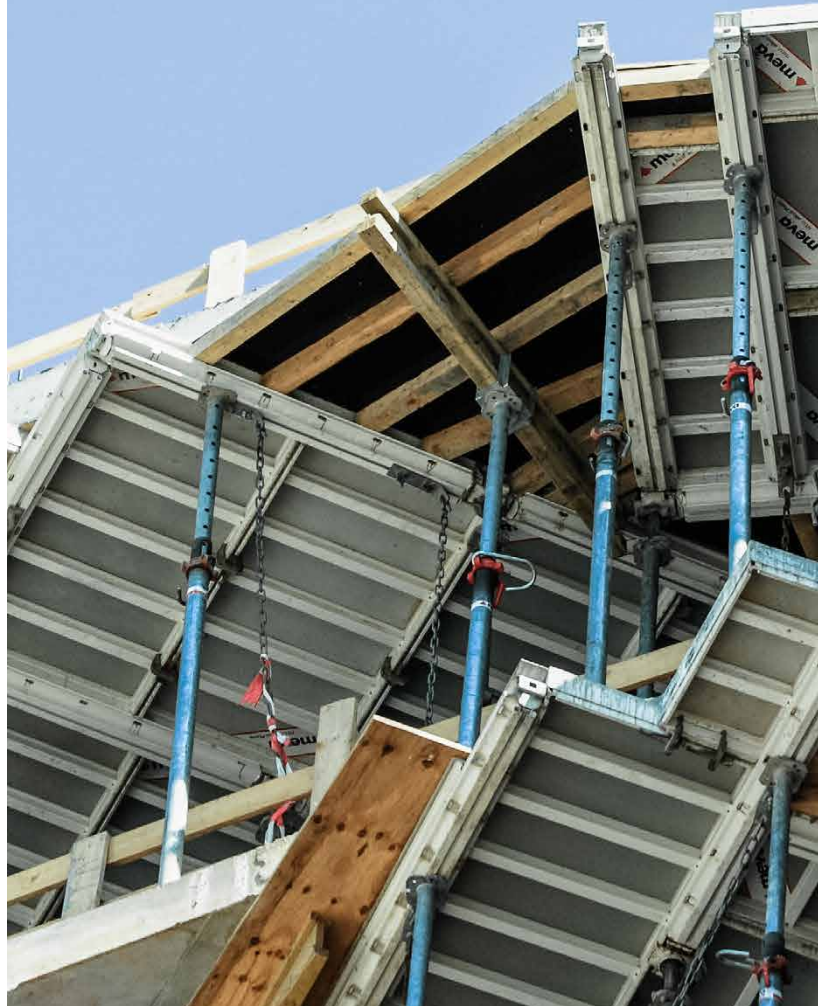
The workflow adjustment for individual asset valuations and the requirements for appraiser rotation regarding immovable property were identified as the most critical impacts by banks that we spoke with.

The requirements for appraiser rotation for immovable property were also identified as an area that may present challenges for some banks.

Which is the most critical impact concerning 'Valuation of immovable and movable property'?



Source: Market observations on EBA draft guidelines on loan origination and monitoring, KPMG international 2019



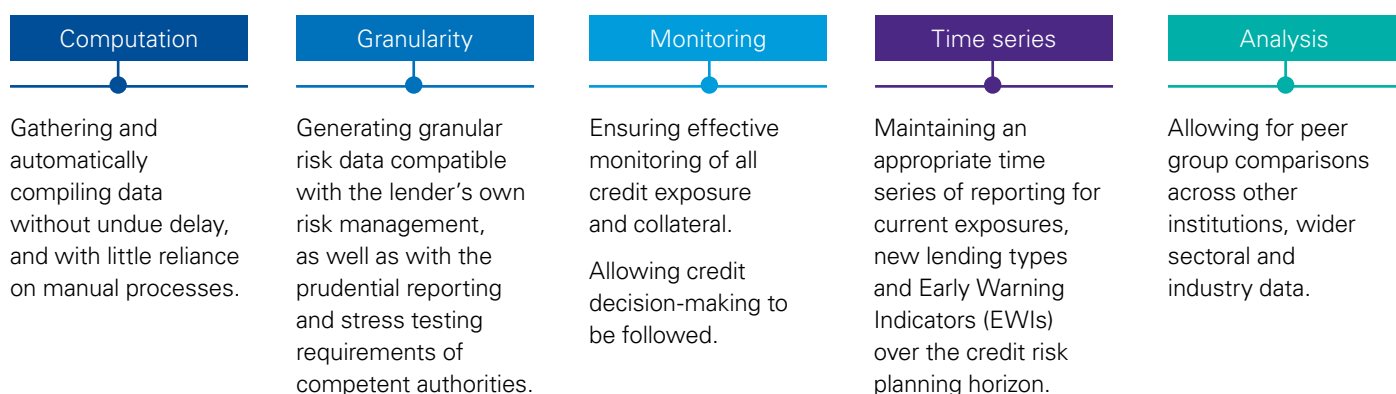
Chapter 8 – Monitoring Framework

The last major section of the Guidelines sets out detailed requirements regarding lenders' ability to monitor their ongoing credit risks.

At a high level, the guiding requirement is for institutions to have a robust and effective monitoring framework that allows them to manage and monitor credit risk exposures throughout their life cycle, in line with their credit risk appetite, strategy, policies and procedures. This framework must also be:


- Well defined and documented;
- Integrated into the institution's risk management and control framework;
- Supported by a data infrastructure that's adequate to keep credit risk information relevant and up to date; and
- Supplemented by reliable, complete, up-to-date and timely external reporting.

When it comes to designing and implementing the monitoring framework, the Guidelines ask that lenders consider the following factors:



The monitoring framework and data infrastructure should allow institutions to follow the credit-making process, including monitoring and reporting of all credit decisions, exceptions from the credit policies, and escalations to the higher levels of credit decision-making bodies.

The Guidelines also set out a range of requirements in terms of the credit risks monitored by the framework and the data the framework should use. The following table summarises some of the most important points.

 <p>Coverage areas</p>	<p>The monitoring framework's areas of coverage should at least include:</p> <ul style="list-style-type: none"> – Credit risk associated with both the borrower and the transaction, based on a number of factors specified in the Guidelines; – Total credit risk per country of ultimate exposure; – Total credit risk; and – Impairments, reversals of impairments, write-offs and other adjustments to the value of credit exposures.
<p>KRIs</p>	<p>The framework should include Key Risk Indicators (KRIs) specific to different asset types or portfolio levels. These should help to determine the lender's evolving credit risk profile and should be used to identify high risk areas of the loan book.</p>
<p>Relevant risk drivers</p>	<p>The framework should identify the relevant drivers of credit risk at the aggregate, portfolio and sub-portfolio levels. These drivers should be measured, analysed and monitored, and credit risk management functions should regularly report the outcome of this analysis to management bodies.</p>
<p>Credit risk data and data infrastructure</p>	<p>Credit risk data and data infrastructure must meet a range of requirements covering: (i) Depth and breadth; (ii) Accuracy, integrity, reliability and timeliness; (iii) Consistency; and (iv) Traceability.</p>

Turning to the more detailed requirements of Chapter 8, the Guidelines set out the following actions for institutions, grouped under six sub-headings.

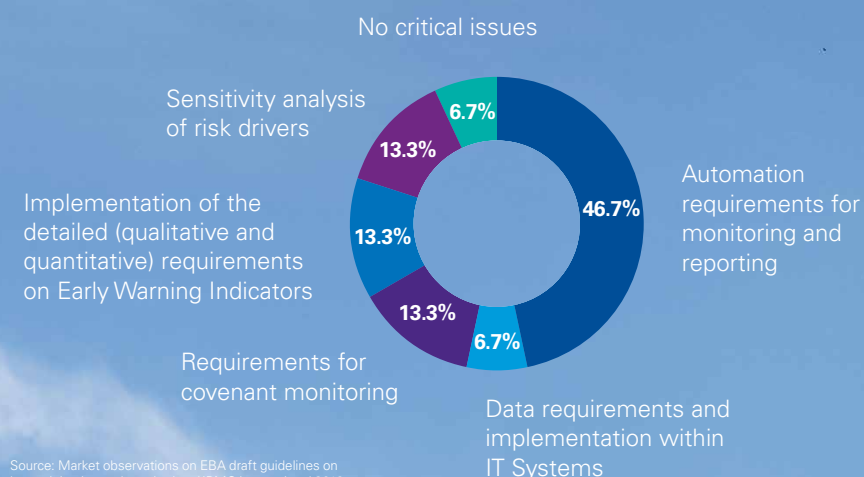
i. Monitoring of credit exposures and borrowers

- Monitor all outstanding amounts and limits under their credit facilities.
- Monitor whether borrower and collateral remain in line with the credit risk policies and conditions set at the point of origination.
- Monitor and assess the quality of credit exposures and borrowers' financial situations.
- Monitor all outstanding amounts under their credit facilities, and perform regular reviews on borrowers' payment performance.
- Base their monitoring on internal information regarding credit facilities and borrowers' payment practices, as well as using external sources.
- Consider using concentration measures for the values specified in their credit risk appetite, policies and procedures. This includes measures by product, geography, industry, collateral features, exposure quality and exposure maturity – particularly in past due 30, 60 and 90 day maturity buckets.

ii. Credit review of professionals

- Conduct regular credit reviews of professionals, with a view to identifying any changes in their creditworthiness compared to point of loan origination.
- Carry out more frequent reviews if a deterioration in credit or asset quality is identified.
- Verify that credit reviews are performed in accordance with credit risk policies and procedures, so that any outliers or exceptions are flagged for follow-up.
- Update relevant financial information periodically, and assess this against creditworthiness criteria, helping to identify the early warning signs of declining credit quality.
- Assess borrowers' existing debts and sensitivity to external factors such as exchange rate volatility.
- Monitor indicators of borrowers' ability to repay or refinance their debts.
- Review guarantors and their creditworthiness, as well as the enforceability of their guarantees and the time required to enforce them.

Which is the most critical impact concerning 'Monitoring framework'?



iii. Monitoring of covenants

- Monitor the requirements of collateral insurance in accordance with credit agreements.
- Monitor borrowers' adherence to covenants, using any deviations as early warning signs. This should include all relevant financial ratios specified in the covenants as well as warning signals from the late and/or incomplete submission of required information.
- Monitor non-financial covenants via close communication and covenant certificates, where applicable.

iv. Stress testing in monitoring process

- Conduct stress testing of credit portfolios (and individual exposures where relevant) in accordance with the EBA's 2018 Guidelines on stress testing, and at least annually.
- Conduct stress tests on the aggregate credit portfolio and relevant sub-portfolios at least, taking into account materiality and risk level.
- Review the stress tests' underlying assumptions regularly, and benchmark the results against credit risk appetite.
- As well as stress tests using macroeconomic scenarios, perform simpler sensitivity analysis using internal and external information to identify segments or exposures that could be affected by adverse shocks.

v. Use of Early Warning Indicators (EWIs) in credit monitoring

- Develop and regularly use quantitative and qualitative EWIs to aid the timely detection of increased credit risk. EWIs should cover the whole portfolio as well as industries, geographies and individual exposures.
- Identify EWIs that will help to detect potential declines in credit quality across risk buckets, before it occurs at transaction level. When EWIs reach defined trigger levels, take immediate action in accordance with assigned escalation procedures.
- Consider using a wide range of EWIs. A lengthy list provided in the Guidelines includes macroeconomic events, worsening of financial metrics, deviations from forecasts, altered credit ratings and financial market volatility.



vi. Watch list

- Establish a watch list for monitoring borrowers and exposures identified by EWIs and other means as having increased risk levels. The monitoring of the watch list should lead to specific reports being regularly reviewed by the head of risk, the heads of credit granting functions, and the management body.
- When monitoring the watch list, institutions should consider:
 - Analysing negative event or trends;
 - Reviewing borrower's credit ratings;
 - Initiating closer contact with borrowers, to request additional information;
 - Reviewing credit limits, analysing whether limits with undrawn amounts may be decreased or cancelled; and
 - Establishing specific action plans with borrowers to achieve full and timely repayment while ensuring fair treatment of individual borrowers.

Concern was raised that the scope of application for new loans is too extensive as some of the data required is not available within the IT system for loans originated before the implementation date of these Guidelines.

The banks we spoke to clearly identified the automation requirements of credit monitoring and reporting as likely to have the greatest impact of the Monitoring Framework chapter. This reflects the likely need for many banks to upgrade their data infrastructure, Early Warning Systems and reporting templates.

As a minimum, this suggests that banks should perform a Gap Analysis focused on how they will collect the necessary information from existing systems.

05 How KPMG can help

Supported by a global network and the ECB Office, KPMG member firms can provide a range of support to banks as they implement the Guidelines.

KPMG Services

KPMG member firms offer a wide range of strategies, services and tools to support and advise banks on regulatory requirements relating to loan origination and monitoring. Member firms leverage a network of multidisciplinary professionals, stretching across Europe and beyond.

Governance and operational change

Definition of optimal governance and operating models for loan origination and monitoring, building upon banks' existing state for suitability and minimal disruptions.

Gap Analysis

Assessments of banks against the Guidelines, allowing for cost effective identification of critical shortfalls and possible targeted remediating actions. Refer to Appendix for more details of KPMG's Gap Analysis Tool.

Regulation

Assistance and support to banking clients in a broad range of areas, including: (i) analysing compliance with regulation and supervisory expectations; (ii) preparing arguments designed to resist audits in cases where simplifications are used; (iii) preparing for supervisory inspections; and (iv) provision of integrated reporting and monitoring systems.

Data Quality

Assessment of data adequacy and suitability, and provision of automated data remediation solutions.

Monitoring and stress test

Independent review of methodologies for Monitoring and Stress Testing, and advice on the adequacy of underlying processes, systems and tools.

Collateral valuation and portfolio pricing

Assistance in the valuation of any type of collateral. Pricing and analytics of the portfolio and underlying segments, to evaluate market values and define the optimum asset mix to sell.



ECB Office

The KPMG ECB Office was founded in 2014 in response to the introduction of the Single Supervisory Mechanism (SSM) which granted the European Central Bank (ECB) a supervisory role over more than 6,000 credit institutions in the Eurozone.

Interdisciplinary teams working in member firms around the globe assist banks in meeting the challenges of SSM supervisory standards, by combining expertise from across KPMG's international network of banking professionals and former regulators. The ECB Office utilises a 'hub and spoke' model. We are supported by a network of National Champions who disseminate information to member firms, engage with national supervisory authorities and banks, and relay information back to the ECB Office. The following table summarises some of the most important aspects of our work:

Central point of contact

The KPMG Office centralises all interaction with the central bank of the Euro area. The team regularly liaises with the ECB on an informal basis, as well as attending events and meetings with director generals.

Insights at your fingertips

The team collect information from across the banking industry in the form of benchmarks and meet with our clients to collect feedback on how banks are responding to ECB challenges.



Forums for discussion

To generate discussion within the market, the ECB Office hosts regular roundtables for industry experts to discuss banking supervisory issues. This also helps to facilitate dialogue between banks and the ECB.

Thought leadership

As one of KPMG's centres of excellence for financial services, the ECB Office frequently publishes topical articles, regulatory updates and in-depth reports on the latest issues relevant to banks under SSM supervision.

Compliance

The ECB Office has developed solutions to help banks better understand and comply with their supervisory obligations. These include platforms such as the NPL Gap Analysis and Peer Bank Benchmarking Tool.

In short, the ECB Office offers unique insights and support to KPMG's clients across Europe. Our team can help banks to understand how the supervisory mechanism functions, and how cooperation with national authorities works under the ECB's oversight. Running tailored research and working closely with banks' subject matter experts reveals insights into current and upcoming supervisory themes, allowing us to provide recommendations on how to respond to these challenges.

For further information please visit our webpage: www.kpmg.com/ecb

06 Appendix

Interdependencies with other Guidelines or requirements

Creditworthiness assessment

The EBA has previously issued Guidelines specifying creditworthiness assessment for credit agreements with consumers in respect to credit agreements that fall under the scope of Article 3 of Directive 2014/17/EU, i.e. credit agreements secured by residential immovable property – EBA Guidelines on creditworthiness assessment. The consumer protection perspective of these guidelines is of particular importance when setting the requirements for creditworthiness assessments in the context of lending to consumers and the collection of information and data for such assessments (Sections 5.1.2, Sections 5.2.1 and 5.2.2). The requirements of these sections provide further details on the creditworthiness assessment of consumers and the verification of consumer information as laid down in Articles 18 and 20 of Directive 2014/17/EU (MCD) when dealing with lending secured by residential immovable property.

Given the dual focus of the Guidelines on loan origination and monitoring, the EBA decided to fully incorporate the EBA Guidelines on creditworthiness assessment into the new Guidelines. The draft Guidelines are envisaged to replace the existing EBA Guidelines on creditworthiness assessments under the MCD (EBA/GL/2015/11), which the EBA issued in June 2015.

Stress test in monitoring process

Institutions should conduct regular stress testing (at least annually) on their credit portfolios, and, where relevant, individual exposures. Such stress testing should be performed in accordance with the EBA GL on an institution's stress testing.

Credit risk management/internal control frameworks – Data infrastructure

For the purposes of data collection and management, institutions should consider using the relevant data fields from the EBA's NPL transaction templates.

For the purposes of setting out a robust and effective credit risk management and control framework, institutions should ensure that the framework covers, inter alia, the management of early arrears and NPEs and granting and monitoring forbearance measures in line with, where applicable, the provisions of the EBA Guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06).

GL on creditworthiness assessment under MCD (EBA/GL/2015/11)	Draft GL on loan origination and monitoring
GL 1.1 (verification of income: enquiries)	GL 5.1.1 (Art. 88) – General requirements for collection of information
GL 1.2 (verification of income for self-employed)	GL 5.2.2 (Art. 103) – Secured lending: Full alignment of GL 1.1
GL 2.1 (retention of creditworthiness assessment documents)	GL 5.2.2 (Art. 104) – Secured lending: Full alignment of GL 1.2
GL 2.2 (making records of income verification available to CAs)	GL 5.1.1 (Art. 90) – General requirements for collection of information
GL 3.1 (design of loan documentation)	GL 5.3 (Art. 180) – General requirements for credit decision and loan agreement
GL 4.1 (elements to be considered in the assessment)	GL 5.2.2 (Art. 105) – Secured lending: Full alignment of GL 4.1
GL 4.2 (internal governance for assessment)	GL 5.2.2 (Art. 106) Secured lending: Full alignment of GL 4.2
GL 4.3 (ability to repay in retirement)	GL 5.2.2 (Art. 107) Secured lending: Full alignment of GL 4.3
GL 4.4 (managing future expected income)	GL 5.2.2 (Art. 108) Secured lending: Full alignment of GL 4.4
GL 5.1 (taking consideration of other obligations)	GL 5.2.2 (Art. 109) Secured lending: Full alignment of GL 5.1
GL 6.1 (taking consideration of negative scenarios)	GL 5.2.1 (Art. 101) General requirements for creditworthiness assessment and full alignment of GL 6.1

Internal governance

Institutions should apply further conditions in relation to credit granting and monitoring as set out in Chapter 4 of the EBA draft GL on loan origination and monitoring. This chapter applies in addition to the EBA GL on internal governance (EBA/GL/2017/11), in particular to provisions under Chapter 2 'Role and composition of the management body and committees' and Chapter 3 'Governance framework'.

GL on Internal governance (EBA/GL/2017/11) under Directive 2013/36/EU – CRD	Draft GL on loan origination and monitoring
GL 1 – Proportionality GL 2 – Role and composition of the management body and committees GL 3 – Governance framework GL 4 – Risk culture and business conduct GL 5 – Internal control framework and mechanisms GL 6 – Business continuity management GL 7 – Transparency	GL 4 – Governance requirements for credit granting and monitoring. Specific references to the GL on internal governance are made in the EBA draft GL on loan origination and monitoring regarding the Credit Risk Culture (4.1.2); Independence in credit decision-making (4.4.1) and Credit risk management and internal control frameworks (4.5).

KPMG gap analysis tool

Our approach



- Structured evaluation of supervisory requirements from the EBA/CP/2019/04
- System-supported evaluation of materiality according to fields of action
- Detailed and automated evaluation within the framework of an overall heat map

Expected benefits



- Individual: quick adaptation to the specifics of the bank and its business models
- Structured: system-supported self-assessment aligned with chapters and according to defined fields of action
- Efficient: time-saving self-assessment through clear questions, uniform impact assessment and automatic reporting
- Audit-resistant: Preparation for supervisory issues, generally in the SREP process; creation of transparency and prioritisation
- Targeted: Identification of the main problems (heat maps) and prioritisation of the fields of action
- Solution-oriented: Derivation of action plans for prioritised fields of action and a scheduled implementation plan

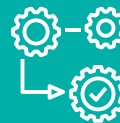
Interview



Chapter	Section	Question	Answer	Materiality	Field of Action	Impact	Reporting
1	1.1	1.1.1	...	...	...	...	...
2	2.1	2.1.1	...	...	...	...	...
3	3.1	3.1.1	...	...	...	...	...
4	4.1	4.1.1	...	...	...	...	...
5	5.1	5.1.1	...	...	...	...	...
6	6.1	6.1.1	...	...	...	...	...
7	7.1	7.1.1	...	...	...	...	...
8	8.1	8.1.1	...	...	...	...	...
9	9.1	9.1.1	...	...	...	...	...
10	10.1	10.1.1	...	...	...	...	...

The interview consists of up to 325 questions, divided according to the chapters of the draft guidelines, which can be answered via drop-down menu.

Tool supported process



	Datengrundlage	Organisationsstruktur	Finanzorganisation	Kreditportfolio	IT und Risikoprüfung	Interne Reporting
Kapitel der EBA-Leitlinien						
Kap. 4 Governance und Risikoprüfung	100%	85%	84%	81%		
Kap. 5 Kreditportfolio	77%		77%	75%		
Kap. 6 Risikoquantifizierung		100%	47%			
Kap. 7 Immobilien und sonstige Sachanlagen	100%		88%	70%	100%	
Kap. 8 Transaktionsgegenstände	67%			84%		20%

All results are aggregated and evaluated according to field of action level (in the tool) and thematic focus (in the report).

One-click reports



One-click creates a comprehensive results analysis in a PowerPoint file that can be individually commented and extended.

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CREATE. | CRT118167 | October 2019