Loan Origination & Monitoring

Summary Insights

2021

Building a better working world

Building a better financial services industry

At EY Financial Services we train and nurture our inclusive teams to develop minds that can transform, shape and innovate financial services. Our professionals come together from different backgrounds and walks of life to apply their skills and insights to ask better questions. It's these better questions that lead to better answers, benefiting our clients, their customers and the wider community. Our minds are made to build a better financial services industry. It's how we play our part in building a better working world.

Minds made for building financial services

ey.com/fsminds

EBA has published its final guidelines on Loan Origination & Monitoring…

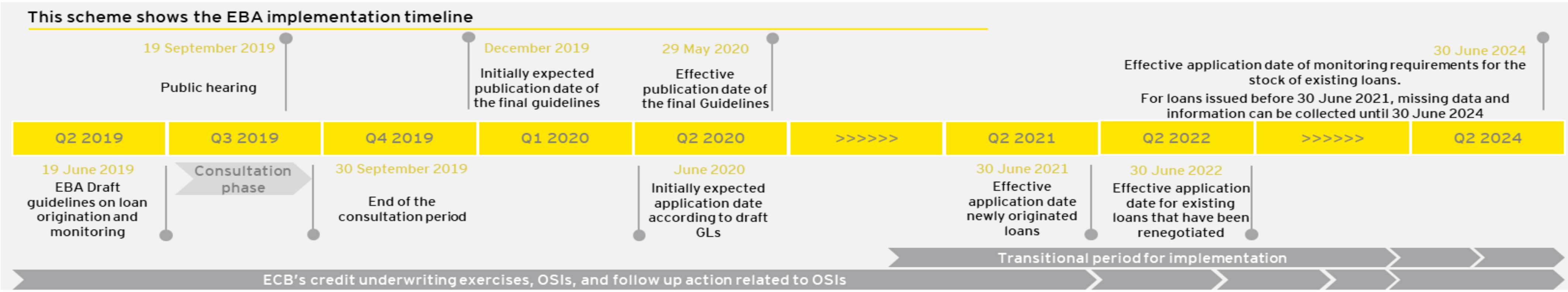
- **After consultation, on 26 May 2020, the EBA published its final guidelines on Loan origination and Monitoring** as part of European Council action plan to reduce the level of NPLs in the EU
- These guidelines **tackle the overarching scope of the end to end credit granting process with the following objectives:**
  - **Improve banks' practices and associated governance** arrangements, processes and mechanisms in relation to credit granting
  - Ensure that banks have **robust and prudent standards for credit risk-taking, management and monitoring, and that newly originated loans are of high credit quality**
  - Ensure that banks' practices are aligned with **consumer protection rules and respect fair treatment of consumers**
  - Ensure that banks make **reasonable enquiries and take steps to assess and verify the borrower's repayment capacity during the entire loan life cycle**

Overall potential impacts of the Final guidelines (*)

	Policies	Process	Data /IT	Overall
Governance requirements	High	Medium	Medium	Medium
Loan origination procedures	High	High	High	High
Pricing	Low	Low	High	Low
Collateral valuation	Low	Low	High	Low
Monitoring	Low	Medium	High	High

High *Medium* *Low*

(This is the general European impact, which will likely deviate for individual institutions and markets*



Context

… which interact with several regulatory frameworks and existing guidelines…

Overview of related regulatory guidelines

- EBA guidelines on loan origination and monitoring cover a very broad range of topics and regulations and specify/extend the scope of application of several regulatory frameworks and existing guidelines
- These guidelines also interact with several supervisory recommendations (OSI missions, deep dives…)

MCD

Introduce requirements for the borrowers' creditworthiness assessment together with the collection of information and data

CCD

Incorporate provisions for the creditworthiness assessment in relation to consumer credit

CRR/CRD package

Specify requirements on internal governance and credit and counterpart risk

EBA GL on Loan origination and Monitoring

EBA GL on internal governance

Provide details on:

- credit risk appetite, strategy
- credit risk policies and procedures
- credit decision-making process
- Internal control

EBA GL on stress testing

Explain requirements and scope of stress testing in monitoring process in line with the EBA Guidelines on institution's stress testing

AML Directive

Reinforce the control of money laundering and the financing of terrorism, in particular on assessment and management of ML/TF risks as a result of their credit granting activities

EBA and ECB GLs on NPL

Part of the EU Council Action Plan to address the NPL issue and ensures the sound credit risk granting and monitoring framework

IRB Repair ECB TRIM

Ensure consistency with internal model recalibration in particular for

- Risk drivers selection and use test
- Asset validation methodologies

- When implementing those guidelines, it is important to build a comprehensive framework taking into account other regulatory requirements and related internal projects.

Non exhaustive regulatory framework

MCD – Mortgage credit directive
CCD – Consumer credit directive
CRD – Capital requirement directive

… implementation will prove challenging across various topics

Overview of key challenges / *Potential impacts*

Topic	Overview of key challenges	*Policies*	*Process*	*Data / IT*
Governance requirement of credit granting and monitoring	▶ Ensure that the management framework of credit granting **defines management team responsibility and is aligned with their Risk Appetite framework** ▶ Clearly define powers and limitations **of each decision maker and set time limits for powers if relevant** ▶ **Include environmental, social and governmental (ESG) factors** in Governance, incl processes and policies	High	Medium	Medium
Loan origination procedures	▶ During granting process, the bank should collect a more extensive series of information in comparison to the current situation. This information must be properly documented and maintained accessible for all the duration. ▶ The **creditworthiness assessment must be based on tangible and objective criteria.** Guidelines specify a set of criteria to be considered, differentiated by typology of customer/product type, appropriately defined within the GL (KRI i.e. DSCR, LTV…). ▶ Additional "Limit values" must be set within the Policies and articulated with Risk Appetite framework ▶ Institutions should **assess the sustainability of the borrower's financial position**, by carrying out sensitivity analyses considering market or idiosyncratic events (e.g. increase in the cost of funding, decline in revenues or margins, adverse movements of assets prices etc.)	High	High	High

Pricing	▶ Ensure that **pricing policies reflect risk appetite, the institution's strategy and linked to the product's characteristics, clients types and their associated risks. The following elements to consider:**
	    ▶ Cost of capital on loans granted
	    ▶ Cost of funding
	    ▶ Operating and administrative costs
	    ▶ Credit risk costs; where necessary, using expected loss models
	▶ Consider profitability measures such as EVA, RORAC and RAROC
		Low	Low	High

Valuation of immovable and movable property	▶ Specify the **process for collateral valuation (movable and immovable) and re evaluation** ▶ Specify **rules for valuers, considering potential conflict of interests and use of external valuation** ▶ Institutions should ensure adequate **rotation of valuers for collateral valuation**	Low	Low	High
Monitoring framework	▶ Build an **effective monitoring framework, including early warning signals, supported by an adequate data infrastructure** ▶ Build and **infrastructure enabling data trail concerning the exposure, client and security through the whole lifetime of the exposure**	Low	Medium	High

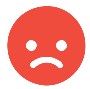
High *Medium* *Low*

Context

Data and reporting requirements represent an important challenge to address

	GL LOM references	*Highlights*	*Readiness*	*Indicative gaps observed**
Key Metrics	Annex 2	All useful credit information's for debtor assessment process		Limited information for the areas: • Real Estate • Shipping finance • Project and infrastructure
KRIs	Annex 1 & 3	Relevant metrics/parameters for the purpose of understanding the debtor's ability to repay in the origination phase and during credit life		Lack of metrics • Interest Coverage Ratio for RRE • Loan to Cost (LTC) and Rental Yield (RY) for CRE • "Normalization" of the definition of DSCR compared to EBA / ECB expectations • Development Permits on "building"

EWIs	Chapter 8.5 -Use of EWIs in credit monitoring	Early warning indicators to be implemented in order to prevent and anticipate potential deterioration of the debtor's credit quality		• Lack of EWI framework
				• Difficulty in intercepting the debtor:
				  • Legal actions in progress (independent of the Customer/Bank relationship)
				  • Sector and/or geographical crisis

EBA Transaction template	Chapter 4.3.7 - Data Infrastructure	Best practices in financial due diligence (FDD) and valuation of an NPL portfolio		Lack of information • Collateral cadastral data (e.g. number rooms, measurements, etc.) • Swap, Leasing and Enforcement • Balance sheet data (e.g. fixed and current assets/liabilities, etc..)

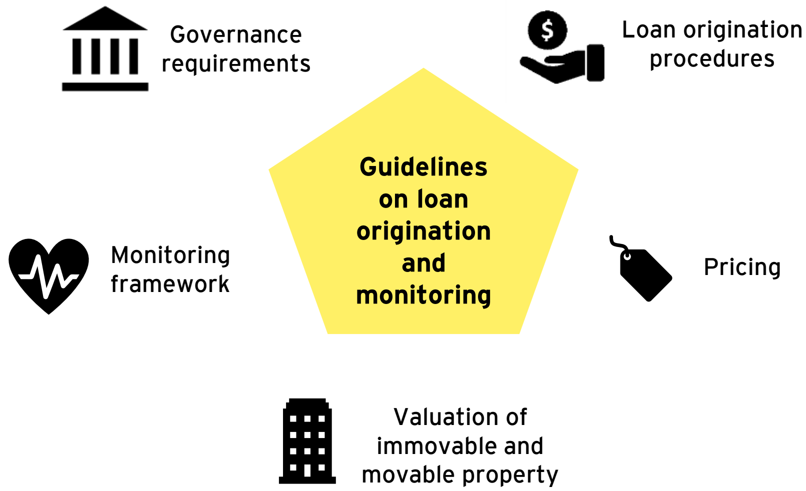
(Non exhaustive)*

Key Success Factors

Understand your starting position, and quickly move towards defining the to-be vision and necessary domain support

1. **Baseline:** Mobilisation of accelerated gap and impact assessment across existing credit processes, decisioning and monitoring activities

2. **Assess, Anticipate & Understand Dependencies:** Assess the GL implications on other Regulatory programmes e.g. BCBS 239, NPL Reporting and other credit risk initiatives. Assess data requirements and ensure appropriate stakeholder engagement / buy-in from other domains



3. **Plan:** Develop H-L implementation roadmap that is outcome orientated and themed according to business line/ownership (don’t design by GL Chapter). **Understand other strategic or regulatory Programmes (e.g. credit transformation, connected parties, DOD) and ensure delivery synergies i.e. ‘don’t dig the road up multiple times’.**

To learn how our EY team can help you prepare for these changes please get in touch

Cormac Murphy

Banking & Capital Markets, Sector Leader

+353 (0)1 221 2750

cormac.murphy@ie.ey.com

Cormac is the partner responsible for leading our EMEIA Banking Union campaign, as well as being the Head of the Banking Sector for EY Ireland.

Established in 2008, our unique FSO structure brings together 30,000 professionals across 19 major European countries and enables us to support FS clients on a fully integrated basis across the EU.

Since the establishment of the Irish International Financial Services Centre, Cormac has been providing consulting services to a wide range of multinational financial services institutions across banking, leasing and asset administration

Mark Brangam

Associate Partner, Risk Consulting

+353 1 479 4080

Mark.Brangam@ie.ey.com>

Mark is an Associate Partner in our Risk Consulting practice in Dublin with 15 years' experience in delivering high-value, complex risk, regulatory programmes across CRO, CFO and CDO.

Mark leads the delivery of risk transformation services across retail banks and he specialises in leading multi-competency teams to provide technical insights and support the organisational design and embedding of second line/third line functions aligned to regulatory expectations and peer practice.

His approach is always to partner with leadership and delivery teams to understand the unique client context in order to realise sustainable improvements, aligned to local and SSM regulations.