



EXPLANATORY NOTE ON THE EBA'S COMPREHENSIVE APPROACH TO LOAN ORIGINATION

EBA

EUROPEAN
BANKING
AUTHORITY

Non-performing loans and lending to the real economy

Banks' ability to lend to the real economy is significantly affected by the quality of their lending portfolios. Non-performing loans (NPLs – loans where the borrowers are not fulfilling their financial commitments to repay in accordance with their contractual agreements) negatively affect banks' ability to generate new lending into the real economy. Banks with high levels of NPLs on their balance sheets need to divert their resources away from profitable services to managing loans that provide no return. To manage their risks, banks also need to put money aside as a safety net to compensate for the losses incurring from NPLs.

Past financial crises have shown that NPLs can reach levels high enough to become a real problem for banks' business activities, financial stability and lending to the real economy (NPLs reached EUR 1.2 trillion in June 2015). The EU has put significant efforts into dealing with this high stock of NPLs, including bank recapitalisations and a comprehensive action plan that involved the EBA providing guidance on managing stocks of NPLs while future-proofing the system to improve the quality of future lending with loan origination guidelines.

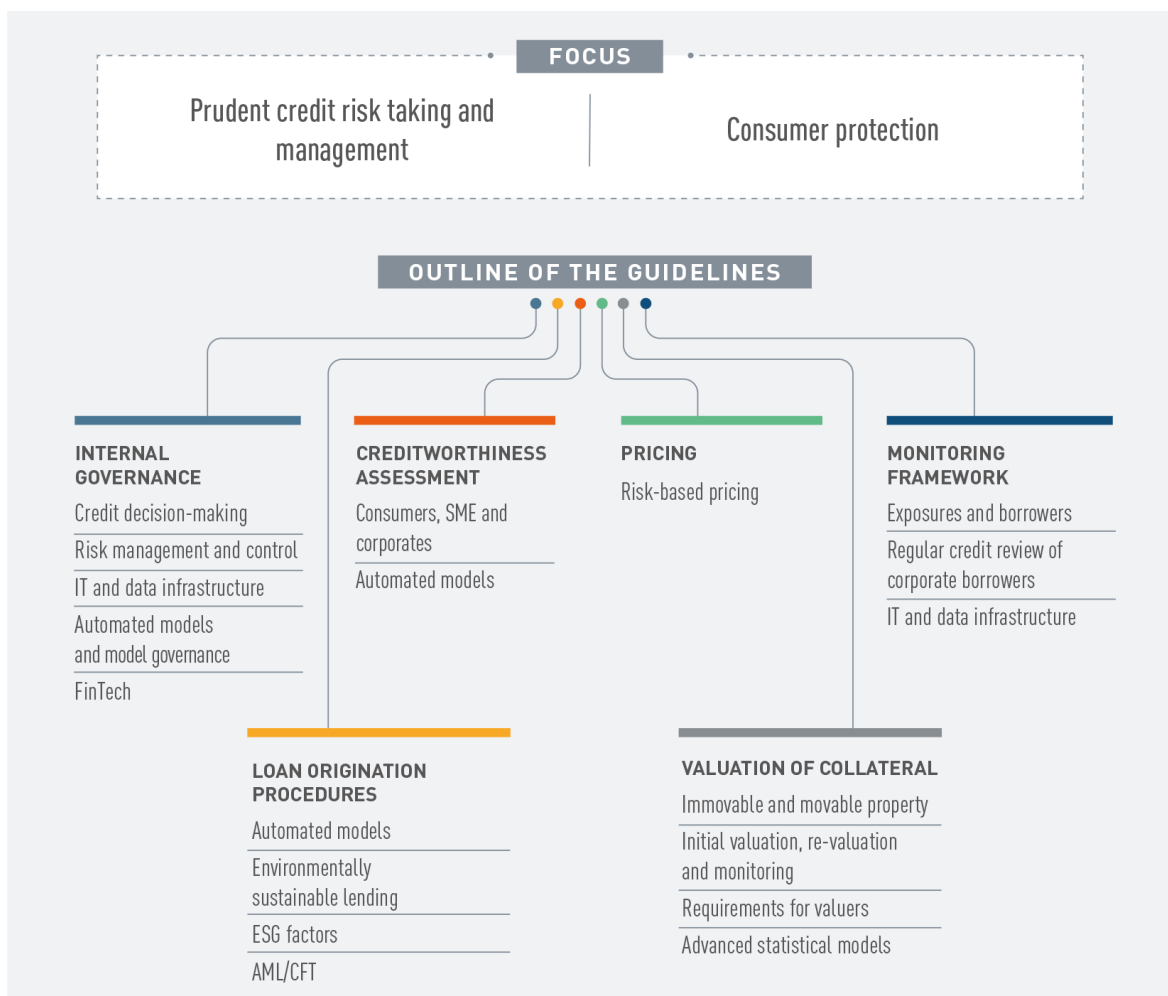
Why creditworthiness assessment?

Robust and comprehensive creditworthiness assessment of borrowers applying for new loans or changing the conditions of their existing loans (e.g. borrowing more) is at the heart of the banks' lending standards, and important for both the borrowers themselves and creditors:

- For borrowers, creditworthiness assessment focuses on assessing the source of their ability to repay and helps to understand if they will be able to repay the loan considering all other financial commitments. This is designed to prevent borrowers from taking on loans that they cannot afford and that will be detrimental to their long-term financial well being.
- For creditors, creditworthiness assessment helps to manage credit risk at the point of loan origination and ensure that the individual loans they grant, and the overall credit portfolio, are within their risk appetites and in line with credit and risk policies that contribute to the overall financial stability of the sector.

The EBA's comprehensive approach to loan origination

Creditworthiness assessment is the main element of the European Banking Authority's (EBA's) comprehensive approach to loan origination, bringing together prudential, governance and consumer protection requirements in the [*EBA Guidelines on loan origination and monitoring*](#).



The objective of the guidelines is to improve banks' credit-granting practices and governance arrangements in order to ensure that they have robust and prudent lending standards. This in turn should ensure that newly originated loans are of high credit quality and contribute in the future to lower levels of NPLs. **The guidelines also aim to ensure that the credit-granting practices are aligned with consumer protection rules and respect fair treatment of consumers.**

In order to achieve these objectives, the guidelines specify internal governance arrangements for credit decision-making, credit risk management at the point of credit origination, and monitoring of credit risk, building on the requirements of the [EBA Guidelines on internal governance](#). The guidelines clarify the use of automated models in credit decision-making and creditworthiness assessment and set out specific model governance requirements for such models.

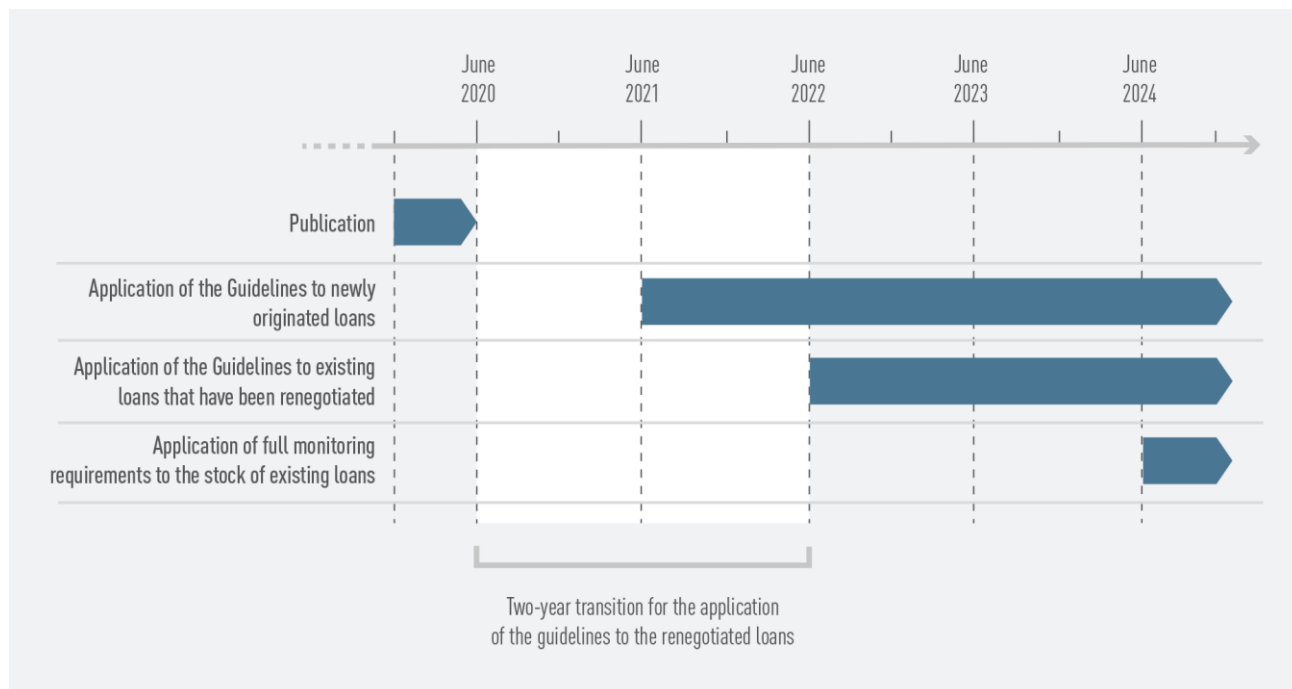
At their core, the guidelines set out the requirements for assessing the borrowers' creditworthiness and for handling the information and data needed for such assessments, differentiating between the creditworthiness assessment of consumers, micro and small enterprises, and medium-sized and large enterprises.

In the guidelines, the EBA also provides guidance on the valuation of collateral at the point of loan origination, as well as for the monitoring and revaluation. In these requirements, the EBA also clarifies the use of advanced statistical models.

The EBA has developed these guidelines building on the existing national experiences, addressing shortcomings in institutions' credit-granting policies and practices highlighted by past experiences. At the same time, these guidelines reflect recent supervisory priorities and policy developments related to credit granting, including environmental, social and governance factors, anti-money laundering and countering terrorist financing, and technology-based innovation.

Ensuring manageable and proportionate implementation of the Guidelines

The publication of the guidelines comes at the unprecedented time of the COVID-19 pandemic and therefore their implementation should reflect the balance between the needs for banks to focus on core operations today and to strengthen future lending. To address these exceptional circumstances, the EBA offers a three-phase implementation of the guidelines allowing additional time for institutions to deal with any COVID-19-related immediate operational priorities.



The guidelines will apply from **30 June 2021**. However, institutions will benefit from a series of transitional arrangements: (1) the application of the guidelines to the already existing loans and advances that require renegotiation or contractual changes with the borrowers will apply from **30 June 2022** and (2) institutions will be allowed to address possible data gaps and adjust their monitoring frameworks and infrastructure until **30 June 2024**. These transitional arrangements

should allow sufficient flexibility to respond to the specific needs of the existing borrowers in renegotiating their existing loans affected by the COVID-19 pandemic.

Implementation support

The EBA expects competent authorities to exercise their judgement and be pragmatic and proportionate in monitoring the implementation of the guidelines by institutions. This pragmatic approach should result in the authorities prioritising their response on the most material issues identified by the institutions in their gap analyses, taking into account the operational challenges and priorities institutions may have as a result of the COVID-19 pandemic, while facilitating the economic recovery efforts.

The EBA will also support the implementation of the guidelines by offering training to competent authorities. The EBA will also ensure cooperation between authorities and will work to promote information sharing on good practices.

Useful links

- [European Council Action Plan on tackling the high level of non-performing loans](#)
- [EBA Guidelines on loan origination and monitoring](#)
- [EBA work on non-performing loans \(NPLs\)](#)
- [EBA Consumer Corner](#)