BANKING STAKEHOLDER GROUP

EBA/CP/2019/04 (deadline 30 September 2019)

EBA Consultation Paper on draft Guidelines on loan origination and monitoring

Comments by the EBA BANKING STAKEHOLDER GROUP (BSG)

Paris, 30th September 2019

Comments to the EBA/CP/2019/04, Consultation Paper on draft Guidelines on loan origination and monitoring

The EBA-Banking Stakeholder Group (EBA-BSG) welcomes the opportunity to comment on this Consultation Paper (CP) for the draft guidelines on loan origination and monitoring. The high level of non-performing exposure is identified as a problem that needs to be addressed. As a result, as the CP mentions, the European Council, in its July 2017 Action Plan, invited the EBA to "issue detailed guidelines on banks' loan origination, monitoring and internal governance which could in particular address issues such as transparency and borrower affordability assessment".

We welcome the approach taken by the EBA to have a dual focus combining requirements of prudential and consumer protection nature.

The response will follow the list of questions set out in the CP and will include, when applicable, specific comments on particular paragraphs according to each section covered by the questions.

Q1 - What are the respondents' views on the scope of application of the draft guidelines?

The EBA-BSG considers that the Guidelines (GL) should apply to ALL credit providers. The current drafting makes no distinction between credits proposed by banks or by non-banks, which is a very important element. Therefore, it would be important to make sure that the scope includes potential newcomers which may enter the credit market, making sure that the GL apply to them in respect to creditworthiness assessment processes.

Some members of the BSG are, however, of the view that in many respects the scope of application of the requirements is excessively broad. To cover many areas of loan origination processes, the guidelines overlap with and may contradict existing and forthcoming regulation which would make correct transposition and implementation by banks extremely challenging, e.g. MCD, CCD and GDPR.

Some members of the BSG believe that the Guidelines should apply only to newly originated loans, and not to existing loans before the application date. The regular credit review of a deal should not trigger any of the new requirements. Complying with the requirements regarding the collection of information is operationally unachievable for the stock of already existing operations.

The guidelines are appropriate in relation to significant-amount transactions, which justify the additional costs connected with further detailed creditworthiness analysis and wider information collection required. On the other hand, some of the required information may not be available at all for small and medium sized enterprises or individuals.

The BSG considers that the proportionality principle, as presented in paragraphs 12 to 14, is not properly considered in sections 1 to 8. Although the text states that the proportionality principle is included in the draft document, this is very often not the case and the guidelines do not apply such principle in practice nor they consider the materiality of risks. Indeed, the guidelines indicate in many instances things that banks "should" undertake "at least" or "as a minimum". While the use of "should" infers flexibility, the requirements are in fact more prescriptive than that. This is particularly relevant in terms of the level of application between banks (and how it will be applied by different supervisors) and within banks – retail and non-retail, risk-sensitive and non-risk sensitive business – especially with regard to the lists of documentation and information that have to be sourced. This lack of proportionality would give rise to significant costs for banks.

Q2 - Do you see any significant obstacles to the implementation of the guidelines by the application date and if so, what are they?

Given the changes the guidelines will imply as well as the costs and new processes that institutions will have to introduce, the timeframe proposed is unfeasible and an extension or phase-in is deemed necessary.

The requirements in the guidelines will significantly impact the credit granting and managing process, with substantial investments in terms of banks' organisational procedures. In particular, the greatest impacts will be on IT structure and staff training. The developments of credit-risk metrics incorporating ESG factors, especially regarding the forward-looking approach of risk measurement methodologies would require further time to implement. The same applies for the development of sustainable product catalogues and the establishment of processes inside credit risk policies and procedures for evaluating the proper use of sustainable credit facilities.

Q3 - What are the respondents' views on whether the requirements set in the draft guidelines are future proof, in particular in relation to technology enabled innovation (Section 4.3.2) and environmental factors and green lending (Section 4.3.3)?

When using technology-enabled innovation for credit granting purposes, the GL refers to the requirement to explain the outcome, understand the underlying model used and ensure its traceability, auditability, robustness and resilience. This set of characteristics (explainability, traceability, auditability, robustness and resilience) should be coherent with the main principles identified by the European Commission High Level Expert Group on Artificial Intelligence, as described in the Ethics Guidelines for Trustworthy AI, published on April 2019.

Some BSG members, however, believe that the recent developments and advances in "Artificial Intelligence" have led to a level of complexity where even the creators of these systems do not understand the process which lead to a specific decision or outcome on the part of the algorithm. For them, the use of such innovations should be limited to basic algorithms examining objective and neutral data, which carries no or little risk of discrimination. Adding any other criteria may lead to discrimination over race, gender, etc.

Regarding environmental factors and green lending, the BSG believes it would be necessary to align the guidelines and the timeline with the on-going work of the EC Action Plan on Sustainable Finance and the EBA mandates included in CRR2/CRD5 and relevant follow-up.

Q4 - What are the respondents' views on the requirements for credit risk policies and procedures (Section 4.3)?

We consider that the requirements for governance and for credit granting are too standardized and too prescriptive. It is important to underline that the CP does not clarify the difference between credit risk and creditworthiness assessment. According to the BIS: "Credit risk is defined as the risk that a counterparty will fail to perform fully its financial obligations, and can arise from multiple activities across sectors. For example, credit risk could arise from the risk of default on a loan or bond obligation, or from the risk of a guarantor, credit enhancement provider or derivative counterparty failing to meet its obligations". Credit worthiness assessment is defined in the MCD as "the evaluation of the prospect for the debt obligation resulting from the credit agreement to be met." More clarification is therefore needed.

Q5 - What are the respondents' views on the requirements for governance for credit granting and monitoring (Section 4)?

The detailed requirements on credit decision-making may limit proven and well-functioning lending activity.

Overall, the requirements are very much focused on credit risk and not so much on consumers and protecting their best interest (protecting them against loan sharks, payday lenders, debt collectors…). More focus should be put on suitability and what should be done to mitigate negative consequences of defaults from the point of view of consumers.

According to some BSG members, the GL could be drafted with a view to incorporate the concept of responsible lending. This should be composed of four key elements: Credit products are designed in a responsible way; The duty to assess the consumer's creditworthiness; The duty to assess the suitability of a credit or related product to the consumer; and Fair treatment of borrowers in difficulty.

The data collection by creditors should be carried in a way that is compliant with GDPR and non-discrimination regulation.

In par. 35.b - and to be added in Annex 1: credit granting criteria should guarantee a sufficient remaining income to allow, beside credit and contract reimbursement, to allow a decent life standard for the household. As such, a key information in data collection should be the household composition.

Paragraph 40 to paragraph 42 - the controls should only cover the search of potential third party and never cover the source of funds, beside in exceptional cases (politically exposed persons in case of high risk defined in a risks classification). A risks classification should be defined with the aim to have a thorough knowledge of the borrower in case of high risk (creditworthiness, analysis of the investment's profitability, the use of funds if possible…) and a detection of unusual transactions (particularly complex transactions, unusually large transactions or transactions which have no apparent economic or visible lawful purpose). The vigilance measures should not apply, if during the relationship which cannot be limited to the credit, there isn't any payment incident, any new application for credit, any change of IBAN or any material change. The specificity of non-purpose loans and of specialised providers of consumer credit which are not account holders should be considered.

According to some BSG members, in par. 41, it should be recommended that the process should only use quality proof information, not using data such as non-structured ones available on internet and social media. Other members believe that the progress in information technology and the development of large database will increase the precision of advanced statistical models and restrictions on the use of those models can hamper the development of the progress of valuation.

It is important to introduce in Section 4 the concept of "materiality" at portfolio level for a Bank. Individual credit files decisions ensure individual credit file quality and compliance with risk strategy and credit policies. In addition to decisions on individual credit files, credit risk limits ensure risk diversification and prevents concentration on portfolio with shared risk characteristics. Credit risk limits are only meaningful for material credit risk portfolios, when smaller, non-material, diversified portfolios should not require specific RAF limits.

Regarding the section 4.3.1 on Anti-money laundering and counter-terrorist financing policies and procedures, it would be useful adding the following to the end of paragraph 41: "Conversely, also information collected for KYC purposes may be used for creditworthiness assessment. For example, institutions may take into consideration also credit risks referred to beneficial owners". It might be worth emphasizing the principle of the usability of the information acquired for AML-CTF purposes also for granting and monitoring credit procedures and vice versa.

On par. 59, there is a reference to include geographic location of the borrower in decision making. According to some BSG members, this may result in discrimination of people based on where they live.

The tasks/areas set out in par. 76.b need to be clearer and more understandable.

Regarding par. 76.f, it requires a clearer definition for creditworthiness and credit risk, to ensure that the difference is clearly stated.

Par. 76.g also needs more clarity. What is the definition of "independent"? For instance, would credit rating agencies be considered "independent"? An example: is the German credit bureau Schufa score considered independent? Furthermore, the risk management function should be reviewed so that it is not confused as a second opinion of a nature identical to the first, otherwise there is a complete duplication of functions.

At the end of paragraph 76, we would recommend adding:

“Put in place preventive mechanisms for early detection of financial problems and set up a specific unit to explore solutions with customers in difficulty such as putting a loan reimbursement on hold, helping the customer with legal and administrative proceedings (obtaining social benefits, any benefits they may be entitled to given their difficult financial situation, such as unemployment benefits etc), liaising and cooperating with not for profit or independent, recognized, high quality debt counselling and debt advice services.”

Q6 - What are the respondent’s views on how the guidelines capture the role of the risk management function in credit granting process?

Risk management should not be interpreted as a function to be uniquely performed by the Risk Office. It can also be performed by other areas that have the required functional competencies provided segregation/independence with the commercial area is ensured. It could be areas such as credit management, rating, etc.

Par. 81 and 82 are missing a ban of quantitative targets as in art. 7 (4) of the MCD.

For par. 82.a, how would this work in practice? What is considered as "high quality"? This is too vague. First, given staff turn-over, it may not be possible to remunerate staff based on long-term criteria. Second, does "quality" refer to complying with prudential requirements or does it refer to a specific number of non-performing contracts or defaults from borrowers? For instance, in pay day lending institutions, while their default rates are high, they still comply with prudential requirements.

The same question can be raised for point b: how is “credit quality” defined in that context?

In point c, what is the “best interest” of the consumer? This must be further defined and clarified.

Regarding remuneration the GL should consider that banks have teams dedicated to higher risk segments, such as small SMEs, mass market in regions that may face high unemployment. These bank employees will by definition originate high-risk assets, and should not be penalised for dealing with fragile clients and regions. What is key is that they comply with the specific risk policy designed for their business segment.

Q7 - What are the respondents' views on the requirements for collection of information and documentation for the purposes of creditworthiness assessment (Section 5.1)?

Compliance with the collection of information and data as set out in Annex 2 should be proportionate to the type, size, nature, complexity and risk profile of the credit facility and of the client. Business plans (93.e) or financial projections (93.f) for instance are not available for all "professional firms" and their analysis not always relevant in case of short terms facilities (e.g. Trade Finance or Export Finance). It should be made clearer that Annex 2 is not to be understood as a prescriptive list to be complied with at all times for all types of lending. Wording "at least" in para 92 to 94 introduces ambiguity in the applicability of Annex 2 and could be understood as directly contradicting the principle of proportionality.

The loan origination in companies is not homogeneous, being more standardized in the smaller segments as well as more oriented to statistical criteria than to an individualized analysis. However, the guide does not establish differences and hardly refers to the size of the debtor. Moreover, on the contrary, it prescribes maximum criteria, typical of the individualized analysis, for all exposures and adds specific criteria for SMEs.

For most loans granted to SMEs - which represent a significant proportion of the loan portfolio for many banks - some information listed in Annex 2 lead to disproportionated collecting costs compared to the economic value of the financing transaction or to the added value in the creditworthiness analysis. The guidelines should make clear that some information listed in Annex 2 are examples and should be collected and verified only if they are relevant for the type of product, according to the proportionality principle. The expression "at least" seems not accurate as it implies that this information has always to be collected and does not allow for the application of the proportionality principle. Flexibility for very easy and small loans should be considered.

The same concerns apply to consumer loans that are typically of smaller amounts and shorter duration. It is disproportionate to ask the same kind of information and verification for a short-term loan of € 300, as for a loan of € 250.000. Loans under € 200- or of a duration less than 3 months are outside the scope of the Consumer Credit Directive which governs the provision of unsecured consumer loans in Europe. Moreover, the systematic collection of documentation is not fit to some distribution channels, such as credit at a distance or linked credits in shops. Consumers do not go shopping with their tax notice or pay slip.

Paragraph 91-94 - proportionality principle but also appropriateness should be highlighted. Very quick and automatized decision making are fully part of the good quality of small ticket leasing as it allows selecting the customers in the first instance instead of having to deal with customers which have seen their financing request refused by competitors.

In par. 91 employment should be understood more broadly as all type of professional activities. The current trend of moving away from traditional labour contracts (no end date) to temporary contracts should be taken into account. In addition, these factors should also be envisaged:

- household composition;
- budget remaining amount (after incompressible expenditures such as contracts (rent - energy/water,..., financial commitments, liabilities) for decent life (food, health, education, mobility…)

According to some BSG members, Par. 91.f is too vague and should be removed as it is open ended and could lead to abuses such as using nonconventional data from social networks and other sources.

Q8 - What are the respondents' views on the requirements for assessment of borrower's creditworthiness (Section 5.2)?

Throughout section 5.2 there are references to "reasonable enquiries" and "reasonable steps". It would be expected to have a clear and transparent definition of the enquiries and steps required and acceptable in this assessment. The current wording using "reasonable" leaves room for misuse of the enquiries and potential for abusive requests.

On par. 98, the definition of "disposable income" should be very clear in the GL. We recommend the OECD definition: "Household disposable income measures the income of households (wages and salaries, self-employed income, income from unincorporated enterprises, social benefits, etc.), after taking into account net interest and dividends received and the payment of taxes and social contributions."

Paragraphs 98 and 116 on Repayment capacity. For some BSG Members, this term should be considered as in a wider approach, where applicable, to assess the ability to meet obligations. According to the experiences of banks in Europe, the savings account, investment products, etc. are other sources of repayments beyond the income that may be considered on the ability to meet obligation assessment. Therefore, Some BSG members suggest to include in the definitions of section 2 the term "source of repayment capacity" which would not only consider the disposable income but also those alternatives sources of repayment such as saving accounts, investment products, etc. which allows paying the credit. The references to "income" should be replaced by "source of repayment capacity".

With regards to missed payments, this data should be treated very delicately. Missed payments may reflect many different situations: an unfortunate circumstance (forgetting to repay, missed correspondence or mail...), or a conflictual situation with a provider (for instance, an error in the amount asked to pay for utility bills and a consumer withholding payment until the problem is resolved, which may appear as a missed payment in the data, but is actually a problem of the provider).

Paragraph 99 (and some others) - Ability to meet obligation assessment. The guidelines try to limit concession decisions to a series of ratios. Thus, decision making cannot be judged solely by the value of certain ratios, which, could end up rejecting perfectly viable operations or accepting operations with good indicators at present without considering their future projection. This evaluation has to be made by the joint evaluation of all elements identified as relevant factors at the time of the concession.

In this respect, par. 99 should also mention a ratio related to “remaining income for decent life” per person in the borrower’s household. This is aligned with the content of par. 109 which mentions “appropriate substantiation and consideration of the living expenses”, which may become irrelevant if these expenditures are not connected with household composition. Using an automated analysis of inflow and outflow from the consumer's accounts via PSD2 may be relevant in this case, rather than trying to manually assess the expenditures of the borrower.

The definitions of “consumers” and “professionals” are also not adequate. For instance, for couples of consumers or joint accounts, it should suffice to fulfil the creditworthiness criteria on consolidated level. The same should apply for professionals who have a joint account. The category of “professionals” now appears to include from small businesses to multinational corporations. The requirements should respect the principle of proportionality and the level of granularity should be proportionate to the risk profile of the counterparty or class of counterparties.

On foreign currency loans, the provisions on par. 110 are especially relevant for financial institutions to provision for unpredictable and sudden events such as the CHF loans, and to insure against it, in order to enable consumers to keep reimbursing under the same conditions, instead of transferring all the risk to consumers and expecting them to repay.

On Paragraph 112 b) and c) – the requirements (similar to those included in paragraph 166 and 173 and 177) are excessively burdensome and difficult to fulfil. As a matter of fact, lenders have no data and cannot be responsible for assessing the quality of architects, engineers who take part in the property development. Furthermore, the certification of the costs associated with the development is not easy to obtain and it could be very expensive for the borrower. Here as well some more assessment and proportionality might need to be instilled.

Referring to par. 118, it is more relevant to assess the consumers' saving capacity since this reflects his left-over income after all current expenditure. With regards to missed payments, this data should be treated very delicately. Missed payments may reflect many different situations: an unfortunate circumstance (forgetting to repay, missed correspondence or mail...), or a conflictual situation with a provider (for instance, an error in the amount asked to pay for utility bills and a consumer withholding payment until the problem is resolved, which may appear as a missed payment in the data, but is actually a problem of the provider).

Paragraphs 131 to 135, 138 to 141 (SME specific) and Appendix 3: imposing to refer to a list of metrics to analyse a professional borrower's financial position, especially considering SMEs, is over-prescriptive and regressive. The requirement to « consider at least » some of the metrics listed, such as "cash conversion cycles", "cash flow generation", "projected capital expenditure"… is not compatible with credit granting processes of some leasing and factoring large scale, small amounts and short-term activities (for instance small equipment leases through vendor programmes).

Q9 - What are the respondents' views on the scope of the asset classes and products covered in loan origination procedures (Section 5)?

Some BSG members consider that the scope of the asset classes, products and clients covered is very wide. The proportionality principle is key to section 5.2 and certain wordings should be modified for clarity sake on their applicability (for instance "at least" replaced by "where relevant" and "list not exhaustive"). A "one size fits all" approach might not be appropriate. In particular, for "consumer loans", using a common framework to regulate the loan origination for mortgage loans and for consumer loans is not adapted to those loans' characteristics, which are completely different in terms of amount, duration and impact on the borrower financial situation. The creditworthiness assessment of borrowers significantly differs for consumer credit (industrial approach where the human decision is often mainly based on the result of a scoring) and mortgage credit (more tailor-made approach).

Some BSG members consider that there needs to be a clarification in the credit decision making process between acceptance and refusal thresholds, linked to default rates. For instance, at which rate of default inside a specific risk pool does credit granting become predatory lending or irresponsible lending? Or, if inside a risk pool over 20% of consumers are considered to likely default on their loan, is this considered predatory lending? Taken from the creditworthiness perspective, it is important to define how much of the current borrowers' savings capacity can be taken up by the reimbursement of a credit without creating a substantial risk for the consumer, especially in the case of a financial shock (loss of employment, health problem, divorce etc). This needs to be set out in the GL, for instance in par. 182.

Also, on p. 182, it is important to factor in the constraints set out in macroprudential policy, where this is the case. Several EU MS have put forward macroprudential policy tools, some more binding than others, which restrict loan granting by setting limits on maturity and on ratios such as debt-to-service and loan-to-value. These Guidelines should reflect that credit decision is also bound by macro-prudential measures (in those jurisdictions where such measures are in place).

On p. 183, the information on the key features of a loan being offered to the borrower should include APR as this indicator is deemed to reflect the actual cost of a loan and is fundamental to compare different proposals (as referred to both in the CCD and the MCD).

Q10 - What are the respondents' views on the requirements for loan pricing (Section 6)?

Some BSG members believe that the overall Section 6 would represent a considerable interference with the conduct of business rules. This section could only be understood if seen as a set of best practices. Further clarification is needed. Pricing (methodology and profitability calculation) should continue to be flexible and based on individual methods / approaches.

Pricing of consumer credit should be carried out in a way to eliminate any risk of discrimination.

Par 187.b mentions that creditors should take into account behavioural assumptions in determining cost of funding. This needs more clarification.

Q11 - What are the respondents' views on the requirements for valuation of immovable and movable property collateral (Section 7)?

According to some BSG members all of these provisions in this section have a limit: that of pricing in the effect of the current non-traditional monetary policy (QE) which inflates the prices of real estate and the stock market, completely disconnected from fundamentals, and the impact it may have in case of a massive recession or burst of the "asset bubble".

Paragraphs 191 to 200 - the required valuation of the collateral as defined paragraphs 191 to 200 is not compliant with article19 of the Mortgage Credit Directive. The MCD requires the valuation to respect specific standards when the lender decide to do the valuation, but this valuation is not requested for granting the mortgage credit. We also highlight that requirements of regular monitoring of the collateral valuation are already into force if institutions want the collateral to be recognized as a guarantee for prudential indicators computation, or for re-financing as a covered bond.

On par. 204 the reference should be to par. 200 (not 2000).

Q12 - What are the respondents' views on the proposed requirements on monitoring framework (Section 8)?

Some BSG members believe that overall, the ongoing monitoring proposed in the guidelines appears overly complex. This framework represents a burden that is not justified in relation to the average size of the banks' portfolio loans. The monitoring activity shouldn't lead to undue additional reporting or disproportionate increase of the administrative obligations for banks, also considering that the requirements are already met through existing processes and reporting. Also, the outlined approach to early warning indicators and watch lists does not seem suitable for adequately taking into account the different characteristics of institutions and customer groups. The requirements appear in many parts only practical for corporate customers.

In general, in this section there is no mention of prevention measures, such as identifying consumers in financial difficulty before they default on their existing financial commitments, and a dedicated unit which deals with helping consumers in distress. The plan should also include the write-off of part or all of the debt. That should also be a part of the solution.

These GL should reflect the spirit of Article 28 of Directive 2014/17/EU (Mortgage Credit Directive) and Article 28 of Directive 2014/17/EU, e.g., setting out that lenders should exercise reasonable forbearance and try to prevent credit contacts from becoming non-performing.