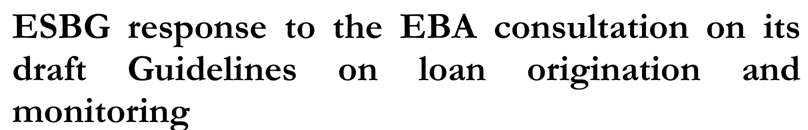
POSITION PAPER



ESBG response to the EBA consultation on its draft Guidelines on loan origination and monitoring

ESBG (European Savings and Retail Banking Group)

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on its draft Guidelines on loan origination and monitoring. We would like to share with you the following reflections that we hope will be considered by the EBA.

1. General remarks:

- Although the Guideline's rationale is comprehensible on the whole, in ESBG's view, the design of the current draft is not sensible. Pillar 2 Guidelines should be principle-based and proportional, which is actually not the case. Many requirements are too extensive and would therefore not allow for an efficient and risk-based handling of institutions' lending business, appropriate to the variable relevance and riskiness of particular loans.

- ESBG strongly recommends streamlining the loan origination guidelines by omitting too detailed requirements in order to enable a proportional application. If concrete listings of information, data, metrics etc. are kept, they should be marked as examples. Instead of „at least", the phrase „where relevant and appropriate" should be used in each case. Furthermore, the draft guideline contains too many redundant requirements, as other regulation is already in place (e. g. guidelines on Internal Governance, AML/CTF procedures; Remuneration). Merely referring to these guidelines would be sufficient.

- According to paragraph 15 („Background and rationale"), consumer protection rules shall not be subject to the application of the proportionality principle. The scope of application shall be open irrespective of the size of the institution and the amount/structure of the loan. Due to the importance of consumer protection, a binding application of the regulation for all institutions is important and sensible. Regarding the applicability to all loans, the requirements however are too extensive and not compatible with the customer's requests for a simple, fast and uncomplicated granting of a credit. In addition, the regulation goes beyond the Consumer Credit Directive (CCD), which, for example, only applies to loans from EUR 200 to EUR 75,000 (Art. 2 para. 2 lit. c CCD). The application of these extensive provisions to micro-loans would represent a considerable expense for the institutions and inevitably lead to an increase in costs for their customers.

- In regard to lending to professionals, the draft guideline's requirements on creditworthiness assessment are aligned to sizeable corporate financing. Yet, many institutions focus on lending to small and medium-sized enterprises, traders, freelancers and self-employed persons. For such credit facilities, the requirements are too extensive.

- In particular, the sensitivity analysis required for all clients would lead to very burdensome processes that are not appropriate for a credit decision on a single customer basis with insignificant risks (due to smaller credit amounts, short duration etc.). The Mortgage Credit Directive (MCD) requirements already provide for sensitivity analysis on an adequate level, there is no need for further requirements nor is there an empowerment to go beyond recital 55 of the MCD. Regarding lending to SMEs, credit financing might be jeopardised in general. Sensitivity analysis on the severe events stated in paragraphs 145 and 146 would, in most cases, generate the finding that the borrowers' repayment capacity might be endangered in specific potential circumstances. Shall institutions carry out many elaborate analyses just for refusing most loan applications in the end?

- Also from the customers' perspective, implementing the draft guideline's requirements would lead to several difficulties: too many and granular information/documentation requirements for a loan application, bureaucratic counselling interviews, longer examination periods and worse conditions

due to institutions‘ increased costs for loan origination and monitoring procedures. These effects would concern consumers and professionals likewise. Furthermore, shortages in loan origination could develop because of rising refusal rates – notwithstanding a constant risk situation.

- There are inconsistencies in the depth on which the proposed guidelines tackle the different aspects. Whereas some parts are more general/high level, others are far too prescriptive. The very detailed parts of the guidelines might, in some cases, lead to a check list approach when applying the provisions, which may defy the overall objective of ensuring a prudent approach to credit risk taking, management and monitoring. We see a risk that too prescriptive guidelines could lead to diverging application in practice, where some institutions and national competent authorities would focus on achieving the overall objective while others might apply more of a check list approach.

- Definitions should be coherent with existing legislation. In cases where there is an already existing definition in other acts of law, we suggest that reference is made to such existing definitions rather than repeating or modifying the definitions in these guidelines. In the proposed guidelines, there are several definitions which are not aligned with the applicable legislation, for example the definitions of risk (e.g. transition risk), definition of CRE and RRE, or other definitions in the area of IT or infrastructure. There are already established definitions of those concepts, for example in the "G20 Green Finance Synthesis Report", in BCBS document 239, or Article 4 of CRR. New definitions also give rise to the likelihood of inconsistency in reporting.

- All together, implementing the draft guidelines requirements could lead to a relocation of loan origination to unregulated market participants (e. g. shadow banking sector) and an erosion of institutions‘business models, especially of smaller and regionally active banks. Such effects would definitely not contribute to the stability of financial markets. Therefore, ESBG urgently advises the EBA integrating the remarks on proportionality („Background and rationale ", paragraphs 12 to 14) in the requirements, considering materiality aspects. All requirements on procedures and documentation need to be aligned with nature, scale, complexity and riskiness of the loan. Opening clauses should be added for less risky credit decisions, e. g. in retail banking.

- Even if industry feedback is going to be taken into account in the final guidelines, there would be far-reaching implications for the lending business and the corresponding processes, including IT support, staff qualification etc. Institutions therefore need two years to implement the guidelines (once the translated versions are available). In addition, the Consumer Credit Directive (CCD) and the Mortgage Credit Directive (MCD) are currently being evaluated, respectively reviewed. It cannot be ruled out that in this context changes to the credit assessment requirements for consumer loans will also take place. Implementing the requirements would involve considerable effort on the part of the institutions. The entry into force of the guidelines should therefore harmonise with the evaluation of these directives in terms of both content and timing. Therefore, the guidelines should enter into force on 30 June 2022 at the earliest.

- Finally, we believe that implementing the guidelines by 30 June 2020 is simply unrealistic and would mean no implementation period for institutions at all. Considering the complexity of implementing the EBA requirements as currently stated, we believe the requirements should enter into force at least 2 years after the publication of the translated versions of the final guidelines. Alternatively, a transitional period would be needed in case the original date remains as proposed by EBA.

2. Consultation questions:

Question 1: what are the respondent views on the scope of application of the draft guidelines?

The Guidelines (GL) should apply to all credit providers on a " the same service, the same rule" basis. Different requirements may distort markets and incentives, including banking sector digital transformation and development. Fintechs / BigTechs compete in coincident markets with the banking sector which may be restrained with unleveled regulations.

The guidelines (sections 5 and 6) should only apply to newly originated loans and credit facilities granted after the application date, and not to loans existing before that date. The regular credit review of a deal should not trigger any of the new requirements, as this is a mere internal procedure (see our comments on para. 10). Complying with the requirements regarding the collection of information is operationally unachievable for the stock of operations. Hence the sentence "Section 5 also applies to loan agreements where terms are renegotiated or which require specific actions triggered by the regular credit review of the borrower after the application date, even if they have been originated before the application date. " in paragraph 10 should be deleted.

The cost-benefit analysis decision on this is particularly confusing as it not only says that these guidelines apply to some existing loans (renegotiated and reviewed as in page 11), but it says they apply to "all existing credit facilities" (page 77). As the word "renegotiated" might imply a conceptual connection with the definition of forborne exposures, we underline that EBA guidelines have only an indirect effect on the current FBE practice, mainly as part of a change in the underlying credit management process rather than a direct application of the prescription to the FBE exposures (for which regulatory point of reference is the "EBA Guidance on NPLs management and FBE").

The draft guidelines take the approach of grouping credit assessment requirements according to the type of borrower, whereas some banks' processes for corporate lending are based on industries. Banks need to be able to align the credit granting process with the approach taken for modelling credit risk, and the guidelines should allow for this.

The guidelines are appropriate in relation to significant-amount transactions to large corporates, 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 consumers or small and medium enterprises. We would recommend applying the EBA requirements based on the customers' and loans' characteristics and/or a more granular differentiation based on exposure class. This would avoid implementation of unduly disproportionate requirements. This issue is particularly relevant in countries where the business environment is mainly characterized by SMEs. Consequently, the guidelines implementation could have negative effects on credit granting, if they are not properly calibrated to the business portfolio of banks.

We welcome the explicit statement that the guidelines should be applied in line with the proportionality principle but suggest that some sections of the guidelines are revised in order to allow for proportionate application in practice.

Moreover, for the determination of the scope for exclusion from application it is not clear if the scope is defined by groups of clients or single clients. There might be constellations where a group is defined as "financial institutions" or "sovereign", whereby its single group members are professionals (i.e. State-owned companies). In practice, credit decision on i.e. financial institutions, sovereigns, etc, are taken at group level and based on a different set of criteria and information, as required in this guideline. In order to ensure efficiency and effectiveness of the credit decision making processes, we would deem it as meaningful to include a clarification on the scope for exclusion from application of this guideline.

We would also welcome a clarification that the scope of exclusion is to be applied on the group level (i.e. when the first principle is applied in the credit decision process in the sovereign segment). To avoid confusions and future discussions during the regulatory reviews, we propose to include a clarification in

the document that if a group is segmented as "financial institutions" or "sovereigns" whereby single group members belong to professionals (i.e. state owned companies), the whole group is to be excluded from the scope of the application of these guidelines.

Furthermore, we would like to include the following remarks:

Paragraph 14 (Proportionality):
The proportionality principle for lending standards (sections 5, 6, 7 and 8) is proposed to depend on the size, nature and complexity of the credit facility. In practice, there are further relevant factors, which influence the lending standards, that are meaningful to differentiate the lending standards, i.e. industries; national accounting standards (in many markets in the EU different national GAAP standards exists); local enforcement laws and market standards (vary in i.e. developed vs. emerging markets) and not solely the credit facility level. We think that harmonized lending standards can form a common baseline, but must allow for adaptation by individual banks to reflect the underlying accounting standards and legal framework, depending on the industry and customer segments. Therefore we deem it utmost important to clarify the use of the proportionality in this guideline in respect of the national legal and regulatory frameworks, national market characteristics or the risk level. It should be ensured that the proportionality principle allows for such adaptation by individual banks, depending on markets they are active in, in order to reflect the underlying accounting standards and legal framework, depending on the industry and customer segments.

We would welcome if the proposed proportionality principle can be extended as follows "Institutions should apply sections 5, 6, 7 and 8 of these guidelines in a manner that is comprehensive and proportionate to the size, nature, complexity of credit facilities <u>and where relevant, to the overall risk profile of customer segments</u>" .

Paragraph 17 (Definitions):

- The CRE loan definition is not in line with market standards and our understanding what a commercial real estate is and is viewed to be misleading and partially in contradiction to other requirements set in this guideline (i.e. in 5.2.5 point 125 "institutions should put emphasis on the borrower's realistic and sustainable future income and future cash flow and not on available collateral"). The phrase "real estate used by the owners of the property for conducting their business" would mean that the financing of production sites for a corporate client will lead to a classification as CRE loan. In addition, the phrase "and secured by a CRE property" eventually might lead to undesired practices, contradictory to strengthening of risk management standards in banking, e.g. to not collateralize a loan to avoid certain undesired regulatory obligations. Moreover, the proposed definition includes social housing, whereas the market practice include social housing in the residential real estate segment (purpose driven) as they might be not income producing.
- The treatment of social housing must also be aligned with the CRR.
  We propose to adapt the CRE and CRE loan definitions as follows:
  - *CRE (…) that is not classified as residential real estate (RRE);* ~~*and includes social housing*~~.
  - *A CRE loan means a loan extended (...)* ~~*or a real estate used by the owners of the property for conducting their business, purpose or activity (or set of such properties), either existing or under construction, and secured by a CRE property (or set of CRE properties)*~~.
- Furthermore, currently there is no **definition of a project and infrastructure finance** included in the guidelines. Due to the fact that there is a dedicated section of guidance to project and infrastructure finance in chapter 5.2.8, we propose to include a dedicated definition to point 17 to avoid potential misinterpretations.

- **Residential real estate loan definition** is only connected to "a natural person", which indicates that every residential real estate loan taken by professionals is to be included in CRE. We propose to amend the definition of the residential real estate loan included in para. 17 as follows:
  "means a loan ~~to a natural person secured by~~ extended for acquiring a residential real estate property"
- It is not explicitly stated that the guidelines only apply to consumer loans as defined in Directives 2008/48/EC and 2014/17/EU. The following definition should therefore be included in para. 17: "Consumer loan means loan under the scope of Directive 2008/48/EC and 2014/17/EU."
- Additionally, we believe social lending/social banking should receive special treatment under these Guideline, especially as there are some banks that serve other purpose than solely a financial success, i.e. improving financial stability and inclusion for people on low income or fostering development and enlarging the impact of social organization. **Social banking** is an important contributor to the local societies and their financial stability in a long-term. Social banking clients cannot be assessed based on full scope of application of these guidelines. Therefore we would deem it as meaningful to have a definition and dedicated chapter for social banking (see our proposal under question 9) in the guidelines. Otherwise some particularly vulnerable client segments as well as social organizations will be threatened by being further excluded from financial services. Moreover, disproportional regulatory requirements could result in higher loan costs for these vulnerable clients or financial exclusion of these segments. We propose the following definition to be included in the definitions in the paragraph 17: **"Social Banking"**: Providing financial services (incl. Lending) to financially excluded and vulnerable client segments (people at risk of poverty or social exclusion) and social organizations (non-profit sector, non-governmental organizations and social enterprises).

Paragraph 10:
Where only details are renegotiated or minor measures result from the regular review of existing credit agreements, a complete application of section 5 would be disproportionate and contradicts, for example, Art. 18 para. 6 MCD, which stipulates a creditworthiness check for existing loans only if there is a significant increase in the total amount of the credit. Only the conclusion of a new credit agreement due to substantial changes should lead to the application of Section 5. Introducing new criteria in existing loans may generate inconsistencies in the results of granting analyses given the tightening of the requirements compared to the initial concession. Moreover, such inconsistencies might be potentially difficult to explain to creditors

Finally, we believe that the application of section 6 (Pricing) should also be confined to newly originated or renegotiated loans.

Paragraph 15:
Creditors as defined in Article 4(2) of Directive 2014/17/EU and in Article 3 of Directive 2008/48/EC are addressees as well and should be added, in order to ensure a consistent application of the Guidelines' section 5.

<u>Question 2</u>: Do you see any significant obstacles to the implementation of the guidelines by the application date and if so, what are they?

We believe that implementing the guidelines by 30 June 2020 is simply unrealistic and would mean no implementation period for institutions at all, as the translated versions of the final guidelines won't be available much time before that date. Considering the complexity of implementing the EBA requirements as currently stated, that might include changes in institution's culture, processes as well as intense IT developments, it is therefore fundamental to allow for a longer implementation period or alternatively for a phase-in period. In any case, the requirements should enter into force at least 2 years after the publication of the translated versions of the final guidelines (see our general remarks). Alternatively, a transitional period would be needed in case the original date remains as proposed by EBA.

Specifically, the guidelines suggest an application date (30 June 2020) which is not suitable for certain fields, in particular green lending. For the green lending, the final version of the taxonomy is expected to be issued by the end of the year and is to become applicable by 1 January 2022 in order to give sufficient time to the market actors to perform the requested IT developments. The Benchmarking Regulation, which was to become fully applicable by 1 January 2020, has been revised in order to postpone the application date to 1 January 2022 – in line with the taxonomy.

Moreover, owing to the Consumer Credit Directive on-going evaluation, it seems difficult to have guidelines on points that are still discussed and may be reviewed in this context. First works preparing the Mortgage Credit Directive revision beginning, it seems also necessary to delay the time schedule of the present consultation on origination of mortgage credits. Therefore, the EBA should either decide to remove elements with regards to open contents mentioned above from the final guidelines or to add references of the related on-going regulations and modify the application date in a consistent way.

Finally, we would like to stress that, if adopted, the requirements in the guidelines would significantly impact the credit granting and managing process, with huge investments in all banking organisational procedures. In particular, the greatest impacts will be on IT structure and staff training. Banks will need enough time to adapt their investment and operational structure to the new standards. That's also why we believe the set deadline is not realistic in light of the proposed changes, which in our view go beyond the harmonisation scope of the guidelines.

<u>Question 3</u>: 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 4.3.3) and environmental factors and green lending (Section 4.3.4)?

Any requirements regarding sustainable or green lending set out here should not precede the further regulatory framework currently being created for ESG instruments. We would like to stress that any guideline requirements should be aligned with the Commission's Action Plan and regulatory initiatives that decided not to include credit provision activities in the scope of the taxonomy & disclosure regulations. We would like to recall that the EBA was tasked with a mandate to incorporate ESG factors in risk management and SREP (Art. 98 (8) CRD V). Thus, these considerations will be embedded into credit risk management and the loan origination processes.

We suggest that the proposed ESG risk related requirements (including climate risks) are deleted at this stage and that the matter is revisited at a later point in time, in line with the timeline set in CRD V. In any case, provisions regarding ESG risks should not be set effective before the beginning of July 2022. A substantial amount of work and resource spending is needed by banks in order to comply with the proposed ESG risk related requirements. That includes e.g. policy drafting, developing of various ESG risk assessment methodologies, defining processes, implementing the preceding into actual work streams and IT systems, testing the IT systems and improving them after tests, hiring of additional human resources and training of employees etc.

When the matter is revisited at a later stage, we propose that any guidelines should be coherent with the practice to talk about "sustainable" rather than "green". The first term is more encompassing and allows to refer to a wider breadth of initiatives that go beyond pure "green". Moreover, it is important that the regulations give banks a possibility to have several different approaches to ESG risks (including climate risks) because of the multitude of differing situations faced by banks. Acting that way banks will be able to focus on material ESG risk cases/industries and manage the most relevant risks.

The scope of any ESG related requirements should also be applied in a way that respects the principle of proportionality. As an example, the requirements proposed in paragraph 49 are too burdensome and difficult to track given also the scope of the Non-Financial Reporting Directive and difficulties to gather

data from SMEs, which constitute a large loan portfolio for banks. It is important that any requirements in this area also work in a situation where a bank originates large number of sustainable loans (e.g. hundreds or thousands) in a year, compared to the relatively small numbers at present. Without adequate data for monitoring, sustainable loans cannot be offered. Also, we would like to suggest that any disclosure requirements do not require banks to publicly disclose such information about their sustainable lending targets etc. that is commercially sensitive.

More specifically:

Section 4.3.3 Technology-enabled innovation for credit granting:
We appreciate that the guidelines aim to reflect recent practices evolutions related to the technology based innovation. We only have one point to highlight regarding paragraph 47-d ; the wording should be refined in order to be consistent with the real needs of model monitoring. Therefore, we propose the following wording : "to verify and regularly monitor the related outputs and compare their performance with those of traditional methods/tools, except when an AI model is already natively explicable (for which a comparison with traditional methods is less/not relevant). Regarding black-box models, the comparison should be carried out at the development stage ("build") only or when the monitoring of the performances shows a decrease, and that a rebuild is needed."

Paragraph 47:
It is not exactly specified what is considered under "technology-enabled innovation for credit granting purposes", which may lead to different interpretations as the credit granting covers broad spectrum of activities. To avoid misunderstanding and be able to clearly define the scope of application of the regulatory expectations we propose a more detailed description what is considered as "technology-enabled innovation" in the view of this guideline. Furthermore:

- **Paragraph 47 c**: There are different tools in place that can be applied when developing a technology enabled innovation in the credit granting. One of those include machine learning, which is often used by the Fintech companies competing for the same clients as banks with quite good results. One aspect of the machine learning is its ability to modify itself while being used. I.e. machine learning is dynamic and does not require human intervention to make certain changes. Therefore when applying artificial intelligence for the purpose of credit granting, it will not be possible to fully understand and explain the entire underlying model, meaning each component of the model compared to other methodologies already in use for this purpose. However we agree that when applying artificial intelligence technology, banks need to ensure that the models are reproducible and auditable. We also agree that the banks must understand the structure of the artificial intelligence based models and be able to explain it, but due to the nature of the underlying technology, explanation of the each component of the model may not be possible to the same degree as this requirement could be interpreted. Therefore this requirement would hinder banks at applying the artificial intelligence for the innovation and therefore hinder them at keeping pace in terms of technology advancement with the growing competition of e.g. Fintechs.
  The nature and specifics of machine learning should be reflected when setting the requirements for application of the technology based innovation in a way that it does not limit its use in the credit granting process. Therefore we propose to add "to the extent that is proportionate given the purpose, size, complexity, term and potential risk associated with the loan."
- **Paragraph 47 d**: The requirement to compare the performance & outputs with traditional tools will lead to an inefficient and costly parallel world of two approaches. This requirement is in disproportion due to the unduly increased cost of maintaining two methods and potentially inhibits banks to take the generally high investment costs to establish "enabled innovation for credit granting". The main benefits like the resource efficiency and the valuable outputs could be diminished. Furthermore the requirement would lead to an additional burden for credit institutions which hinder them to keep pace in terms of technology advancement with the growing competition of e.g. Fintechs.

We understand the rational of back testing and comparing the outputs and performance of "technology enabled innovation" but these should be limited to the implementation and transition phase and not be a constant requirement during regular operations.

In general, ESBG recommends aligning the requirements of section 4.3.3 with the principles and recommendations of the relevant expert groups (regulatory obstacles to financial innovation - ROFIEG, High-Level Expert Group on Artificial Intelligence).

Section 4.3.4 (Environmental factors and green lending):
We understand and appreciate that the guidelines aim to reflect on the supervisory priorities and recent policy developments related to credit granting. In particular, the guidelines account for the growing importance of environmental, social and governance factors, and green lending. However, for the definition of the green lending proposed page 17 of the consultation paper, we strongly recommend this definition to be perfectly aligned with the definition of the taxonomy - which is to be approved by the European Commission by the end of the year (cf Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, already mentioned in our response to question 2). Therefore, the EBA should either add a clear reference to the taxonomy or ensure that the definition within the final version of these guidelines is exactly the same as the one provided by the final version of the taxonomy.

Page 67 – 69 – Annex 1:
Regarding the requirements proposed for Commercial real estate lending, at the beginning of the Annex 1 we propose to add "Where appropriate and possible to the extent necessary to reasonably assess the inherent risk". Additionally, some comments regarding specific criteria in this section:

- 2. the requirements should be separated:
  a. minimum levels of equity and
  b. market value
- 7. This point should be removed or supplemented with "where appropriate".
- 8. Not relevant for social housing as pre-selling requirements do not apply as for other types of CRE; the social housing is sold through the state supported price; tenders for a forward finance loan usually take place 2-3 years before the occupation of the property.

<u>Question 4</u>: What are the respondents' views on the requirements for credit risk policies and procedures (Section 4.3)?

In several instances, the Guidelines state the criteria listed are to be applied on a "at least" basis which would seem to imply they are binding. However, the criteria listed for example in Annex 1 may not apply in certain situations. As we have seen from the explanations given by the EBA in the Brussels roadshow, the lists of annexes are not binding. That should be clarified. The expression "at least" in para. 35 (b) is not appropriate and would not allow for a proportionate application of the guidelines and should therefore be omitted.

Regarding performing loans (paragraph 56), we believe that the data fields recommended in the EBA's NPL transaction templates are too extensive. This reference should therefore be omitted.

Paragraph 35 (Credit risk policies and procedures):
This requirement would mean that any exception, even the one that does not result in an elevated risk, has to undergo a special process with different approval authority. This requirement can be applied in the consumer business (mass business), where the borrowers form a homogeneous portfolio. The top segment of professionals is looking for tailor-made lending solutions that meet their individual requirements and therefore cannot be treated by strict rules but must be rather supported with a set of guidelines applied in a modular system.

Therefore, the requirement as set in para. 35 is not deemed meaningful for professionals, as not every exception to general (group-wide) risk policies immediately results in an elevated risk (especially if policies with lending standards cover diverse portfolios, which require an application of the "one size fits all" rule in order to achieve some degree of harmonization). Strict application of this requirement would result in some form of disproportionality, impairing the efficiency of the underwriting process that is viewed as not necessary for the achievement of the risk and regulatory objectives and may therefore compromise the competitive advantage of the banks. In addition, it could also result in a practice of setting limits and rules by banks that can rarely be breached or overridden, which we view as a contradictory trend to making sure that the bank's portfolio become less risky and safer, perceived to be the overall aim of all regulatory initiatives.

We propose to amend this requirement to clarify that only exceptions or breaches resulting in an elevated risk need to be approved in a special process with different approval authorities. It is well understood that each bank must explicitly set criteria which may lead to an elevated risk and define an approval process for those. A bank can decide also to not allow for exceptions and breaches of its policies.

Question 5: What are the respondents' views on the requirements for governance for credit granting and monitoring (Section 4)?

There are requirements regarding governance in already existing legal acts, such as GL 11, some of which are duplicated in the proposed guidelines. We suggest that aspects which are already regulated in other legal acts are not repeated or supplemented in these guidelines, but that reference instead is made to the existing relevant legal provisions.

We see a risk that the requirement on credit decision making may limit proven and well-functioning lending activities. Defining the organizational control and monitoring structures, policies and procedures on conflicts of interest based on the detailed requirements that appear to be set in the guidelines seems extremely inefficient and not addressing the accompanying risks. In more detail:

- Paragraph 59: Limitations in credit decision making in terms of number should be removed. Limiting the number of delegated credit decision would significantly impair the capability of the institution to timely process the requests from clients and does not reflect the quality / qualification of the staff that has been given the delegated approval authority and rather supports the decision making strongly relying on the organizational hierarchy.
- Paragraph 63 (a), allowing individual approval authorities only for small and non-complex transactions could significantly increase the complexity of the lending process. This could decrease the level of efficiency of banks. We propose a more open formulation.

Specifically, ESBG would have the following remarks:

Independence and minimisation of conflict of interest:
We appreciate that the guidelines make a clear reference to the EBA Guidelines on internal governance when dealing with the principle of independence and the minimisation of conflict of interest at paragraph 63. We want to highlight that the Guidelines on internal governance consider the independence of mind, strictly, and not the formal independence, being thus is aligned with the CRD IV (in particular its Article 91(8)). Therefore, requirements introduced at paragraph 63 points b and c, as they stand at present, go beyond what is provided for by CRD IV. Any sort of formal independence requirements should be removed from the guidelines. The guidelines should only refers to the independence of mind.

Section 4.1.2 (Credit risk culture):
We have concerns regarding paragraph 23 in its current wording ; it seems to imply that only low risk transactions should be booked. For a good financing of the economy, banks should keep the possibility to finance different levels of risk (low and in that case with rating and LGD reflecting this level of risk)

or higher risk. As long as these risks are adequately priced, the Expected Losses (which are covered by the margins generated by the loans) of the portfolios will cover the observed losses on those portfolios. Also, the willingness by the regulator of banks taking only low risk assets, together the finalized Basel III framework with F-IRB reclassification of some low risk portfolio or LGD input floors, would imply that banks' lending activity would be very much reduced as low risk transactions will be difficult to finance. Their low margins won't be sufficient to support overestimated levels of regulatory capital. Financing the economy implies, although being selective, to take different levels of risk, price them adequately, and maintain a good diversification of risks. Therefore we ask for clarifications from the EBA on the targeted objectives of paragraph 23.

Sections 4.1, 4.2, 4.3.1, 4.5, 4.7:
On Internal Governance, AML/CTF procedures and Remuneration, EBA guidelines already are in place. Repeating and specifying those requirements for credit risk is unnecessary in ESBG's view. Merely referring to these guidelines would be sufficient.

Paragraph 57:
The EBA's guidelines on Internal Governance do not require setting up credit committees. The phrase „where applicable“ should be added.

Paragraph 63:
We consider the requirements of para. 63 (b) and (c) as too far-reaching. Some theoretical interest could be deduced in any loan granting case, but this does not necessarily mean there is a conflict of interest that has to be managed or mitigated by the institution. Furthermore, a complete realisation would not be possible, as this would presuppose inter alia gathering all personal relationships and interests of staff members and borrower. In particular, the wording in para. 63(b)(i) is rather unfortunate as each account manger has a professional relationship with the borrower. This would mean that they cannot participate in the credit decision process which would be in contradiction with the requirement set out in para. 60 where a good balance between risk management and business is emphasised.

Paragraphs 67 to 69:
There is no definition for „affiliated parties“. If these shall be „related parties“ in the meaning of Art. 88 (1) CRD-V, this phrase should be used.

Paragraph 76:
From a risk perspective, not every single credit decision requires a second/independent opinion. To avoid misinterpretations, para. 76 (g), should be clarified as follows: "*providing information, in which cases an independent/second opinion to the creditworthiness assessment and credit risk analysis is required.*"

Paragraph 68:
The materiality principle based on the size, nature and complexity of the credit facility (see para. 14) shall not be applicable to section 4, in which the standards for lending to the affiliated parties are included in 4.4.3. Therefore this requirements reads that any lending to affiliated parties, including intra-group, even if the amount is rather minor (starting from €1) should be approved by the entire management body or its empowered committee, even if the amount is minor. Such interpretation of the rule is not practicable. Such lending should be subject to setting up appropriate approval authorities, which including de minimis rules and delegation, where appropriate. We propose the following amendment of para. 68 to allow for de minimis rules and delegation:

> "Lending affiliated parties, or any material changes of the terms of the existing credit facilities to affiliated parties should be subject to approval of the management body or a committee of the management body empowered to deal with affiliated party lending, <u>where appropriate</u>."

Paragraph 82 (Institutions' remuneration policies and practices):

Regulation only valid for (retail) staff with decision making competence and receiving a relevant bonus payment:

The draft guidelines of EBA currently define the scope as *'all staff engaged in the credit granting, administration & monitoring process'*. However, credit institutions are actually developing and close to launch a fully digital (automated and pre-approved), end to end process for customers in the Retail loan granting process. Checks and decisions are generally fully automated or centrally decided and the role of the account manager in the front office is in this context, in general, limited to collect informations and documents from the customer. Therefore, we request that the scope should be limited to the (retail) **staff with decision making competence and receiving a relevant bonus payment.**

Long term quality only influenceable in the first 12 months:

The long-term quality of a credit beyond 12 months is rather driven by macroeconomic factors and is not really influenceable by account managers. Therefore we need a clarification on how "long-term quality of credit" has to be seen in the variable remuneration of the sales staff, considering that whatever risk prevention role the account manager in the front office can perform relates mainly to fraudulent behavior measured by early warning types of KPIs, while the long-term quality of credit is mainly influenced by economic and social developments in the country.

Question 6: What are the respondent's views on how the guidelines capture the role of the risk management function in credit granting process?

While institutions appreciate the view to mitigate excessive risk taking in lending activities, they also have some questions and concerns regarding the underlying principles and the operational framework. More specifically and based on paragraph 82-a, institutions understand that they would have to link the remuneration of all the staff involved in credit granting to the long-term quality of credit exposure. Institutions need clarification regarding both the objectives and the expected operational framework. How are institutions expected to integrate the evolution of the quality of the commitments over the long term in a mechanism of variable remuneration components? While banks could consider favourably proposals to reinforce the obligation of means at the credit grant time and during the period of exposure, they do not see how this could be switched to an obligation of result assessed over the long term. In addition, the induced effects of such principles are hardly compatible with the financing of the economy: risk taking, possibility of downgrading and default of counterparts are embedded, in the credit granting process. Therefore, for paragraph 82-b, institutions would need to receive some clarifications regarding the type of metrics that EBA could consider as consistent with both the objectives and the actual credit process and monitoring.

We would also stress that the formulation in paragraph 60 could be misleading and should be reviewed. The risk management function may be consulted in the credit decision making but with a balanced approach (see paragraph 75).

Question 7: What are the respondent's views on the requirements for collection of information and documentation for the purposes of creditworthiness assessment (section 5.1)?

We suggest that this section of the guidelines is revised in order to better respect the principle of proportionality, as expressed in the scope of application section. It should be clarified that the list in Annex 2 is only examples of information that could be collected and verified, only if they are relevant for the type of client and product, according to the proportionality principle. The expression "at least" in paras. 92 and 94 should therefore be omitted. We also suggest that it should be made clear throughout the entire section, that the credit assessment requirements can be structured by institutions individually, according to the type, scope and risk content of the respective transaction.

For example, there are situations, e.g. for short term credits used to buy standard consumer goods, where it would be appropriate to base a credit worthiness assessment on information from a standard scoring model, in which case there is a limited need to collect further information about the client.

As another example, asking for the mandatory availability of business plans and projections from all clients is in clear contrast with the proportionality principle and the evidence that smaller (and therefore internally not structured) counterparties do not usually have managerial ability to develop such detailed documents. In such cases banks' assessment should be allowed to rely on most recent historical performances and few key budgeted figures (where available) with the aim to understand their future sustainability. Involvement of internal specialist functions for all transactions is in fact not sustainable.

The supervisor's expectations regarding the sensitivity analysis in paragraphs 101 (as well as paras. 114 and 121) should be clarified. The requirements must be properly delimited by the proportionality principle, as for limited proposals and retail consumers the requirements are not proportionate to the risk.

More in detail:

Paragraph 88:
Especially in the case of consumer loans with small amounts, information verification with an involvement of third parties is not necessary or sensible from both a risk and an effort point of view. In particular, it will not be in the interest of a borrower to inform the employer of every loan application. Enquiries to third parties can be an option for checking plausibility. However, they should not be mandatory. Overall, it should be made clear that the borrower has a duty to cooperate in the credit assessment. This implies, that he is obliged to provide complete and correct information in order to enable a lawful creditworthiness assessment. These results, among other things, from Art. 20 para. 3 MCD, which allows the lender to terminate a credit agreement if it is proven that the consumer knowingly withheld or falsified information. A plausibility check by the bank should only be necessary if there are reasonable doubts as to the accuracy of the given information.

Paragraph 90:
The requirement to retain all information/data for at least the entire duration of the loan agreement is not necessary and should therefore be deleted. In the case of consumer loans, the institution bears the burden of proof for a proper credit assessment. The retention of information/data for the duration of the contract term is therefore in the institutions' own interest. Regards loans to professionals, there are already commercial retention periods according to national standards.

Paragraphs 91-94:
The wording „at least" is contradictory to principle-based and proportional regulation and should each be replaced by „where relevant". The result of the creditworthiness check is decisive. In the case of small enterprises, traders, freelancers and self-employed persons, not all the information required is available. Usually, these borrowers are not required by national accounting standards to prepare balance sheets, so they also do not conduct detailed financial planning. The catalogue of information required in para. 93 and Annex 2 for checking creditworthiness should therefore only be collected and assessed where available and necessary, depending on the complexity and risk content of the credit agreement. Without such a clarification, we see the danger that auditors may require a compilation solely for loan application purposes.

The granularity of information requested and the level of experience required by the project of guidelines bear no comparison to what is presently required by the Mortgage Credit Directive or the EBA guidelines on creditworthiness assessment (EBA/GL/2015/11) ; The 2015 guidelines are actually 6 guidelines 2 pages long in total, and they establish the principles of solvency assessment performed through "reasonable enquiries" and by taking "reasonable steps", while the current project give only a very little place to

the lender assessment regarding its loan origination rules and policies. With respect to consumer credit, the breadth of information is ever more disproportionate.

While looking more carefully to annex 2 :

- Point 3 : Financial statements covering a reasonable period: in the case of specialized lending , where a new asset is being financed, there would be no existing financial statements covering the previous years.
- Data from credit registers or credit information bureaux (indicated at point 11 of the list) should cover at least the information on financial liabilities and arrears in payment. It does not seem within the EBA guidelines scope/power to regulate the nature (positive or negative) of the credit file implemented by a Member State.
- Point 14 requests evidence of the value of collateral : This point is linked to Section 7, so please see our response to question 11 of the consultation paper.
- Point 16 request information on the enforceability of collateral sound disproportionate if requested for any loan origination. Depending on the nature of the collateral (mortgage, privilege of the money lender – PPD, guarantee given by an insurance company or a financial institution) the terms for calling the collateral into play within a Member State should be sufficient while complementing information on the collateral itself requested by point 12. Also regarding lending to professional, point 16, information on the enforceability of collateral, in the case of specialized lending, substantial control of the collateral is achieved through different security packages. The power of this security package is notably to enable lenders to put a strong pressure on sponsors (who brought the equity), which makes a restructuring easier. The recovery generally best obtained through a restructuring is based on the future cash flows to be generated by the collateral on which the lenders have a substantial through different structures and security packages. The rating and LGDs based notably on the efficiency of such security package, in terms of future cash flows benefit, is assessed by the internal legal teams and front officers and validated by the risk department. Therefore, regarding the point 16, we suggest adding "in the case of specialized lending, description of the structure and security package of the transaction".
- Any point mentioning "evidence of" : As long as these information are in the credit applications or in the annual reviews memos, this should be considered as sufficient evidence. There should be no request of recording this information in IT data systems. For example, regarding item 6, bank should not be obliged to record the financial projections (balance sheet, profit or loss, cash flow) in data IT systems. Having the financial accounts of the borrower, as published by it, in a PDF version for example, should be considered as sufficient.

The requirement to make enquiries to third parties could be difficult to handle in practice from and operational and data protection point of view. The obligation to respect Regulation 2018/1725 in efforts to verify information is duly noted and goes without saying. However, the GDPR also requires the consumer to give consent to the bank in order for these enquiries to be made. If this consent is not given and the information provided cannot be verified, banks will not be able to comply with the guidelines. We therefore understand "reasonable" in paragraph 88 to mean that in such a case verification is not required.

Page 70 – 73 – Annex 2:
Diverse specific requirements (commercial real estate lending to professionals, real estate development lending, project and infrastructure lending should be supplemented by "where relevant" as some of the requested information depend on the type of a real estate; i.e. location specific review of supply and demand not relevant for social housing; Information on major tenants per property type, property age and location not relevant rented apartment construction.

- Lending to professional:

  3. In case of ring-fenced RE structures the submission of financing statements on a consolidated level is difficult / not possible from the contractual point of view

- <u>Commercial Real Estate Lending to professionals</u>
  1. submission of all contracts for particular property is currently not possible, also from the contractual point of view
  6. The requirement is partially unclear and creates confusion. We would welcome guidance on what the regulatory expectation is meant with the information on the rationale for the property. Additionally this rules should recognize that the bank internal, independent from the market evaluators/surveyors are considered as acceptable.
- <u>Real Estate development lending</u>
  5. submission of all contracts for particular development is currently not possible, also from the contractual point of view
  6. The requirement is partially unclear and creates confusion. We would welcome guidance on what the regulatory expectation is meant with the information on the rationale for the property. Additionally this rules should recognize that the bank internal, independent from the market evaluators/surveyors are considered as acceptable.
  7. In the real estate development lending states independent qualified and reputable quantity surveyor, whereas point 8 in the project and infrastructure finance states qualified and reputable surveyor.

<u>Question 8</u>: What are the respondent's views on the requirements for assessment of borrower's creditworthiness (section 5.2)?

We suggest that this section of the guidelines is revised in order to better respect the principle of proportionality, as expressed in the scope of application section.

We do not agree with the statement on page 11 that the consumer protection aspects set out in the guidelines when dealing with the creditworthiness assessment of consumers should not be subject to the application of the principle of proportionality and that the same consumer protection framework should be applied regardless of the size and complexity of the institutions or of the loan. The principle of proportionality is relevant when applying the consumer protection requirements and it would lead to negative effects for the consumer if the same level of protection would always be required. By way of example, the Supreme Administrative Court of one of our members' Country has in a ruling (ref. 5868-16) confirmed that creditors assessment of what information is relevant for the assessment of creditworthiness can vary depending on the size of the credit and other circumstances surrounding credit agreement. In the situation assessed by the Supreme Administrative Court, the credit agreement was for a limited amount, used to buy standard consumer goods and a credit assessment mainly based on a scoring model was considered to be sufficient.

The borrower's creditworthiness assessment process is disproportionate compared to credit facilities' size in most bank's portfolios. In general, we consider credit granting criteria set out in Annex 1 too detailed and it should be clarified that the criteria listed in the annex is only examples of criteria that could be relevant, depending on the type of client and credit product.

Furthermore, some of the requirements, e.g. in paragraphs 112 b) and c) and 166, are excessively burdensome and impossible or difficult to fulfil. E.g. lending institutions cannot be responsible for assessing the quality of architects, engineers who take part in the property development. The certification of the costs associated with the development is not easy to obtain and it could be very expensive for the borrower. We propose to eliminate these requirements.

The requirements in paragraphs 144 to 146 must be properly delimited by the proportionality principle; otherwise each credit decision must be accompanied by very complex information, by multiple stress tests - idiosyncratic, general, combined.

More in detail:

Paragraph 97:
The current wording contradicts Art. 18 para. 6 MCD, which stipulates a creditworthiness check for existing loans only if there is a significant increase in the total loan amount. The wording should be: "… *before concluding a loan agreement or significantly increasing the loan amount*."

Paragraphs 101, 114, 121, 143, 144, 145, 146 (sensitivity analysis):
The requirements on sensitivity analysis are generally too excessive (see our general remarks). In the case of unsecured consumer loans, individual sensitivity analysis are not necessary from a risk perspective due to the low credit amounts. Paras. 101, 114 and 121 should therefore be deleted. For real estate consumer loans, the MCD only stipulates that retirement, changes in the borrowing rate and exchange rate risks should be taken into account in the credit assessment. The sensitivity analysis requirements for real estate consumer loans should not go beyond the MCD.

For most decisions on lending to professionals, especially SMEs, freelancers and self-employed persons, the analysis required in paras. 143 to 145 are much too far-reaching. Market events as stated in para. 146 are already considered at portfolio level via stress testing and do not have to be carried out for every single borrower. It remains unclear how the institution should actually evaluate the results of the sensitivity analysis. In the current wording of para. 145, the analyses would almost always lead to the result that the borrower could get into problems. Should the loan application be rejected if one or more potential events might jeopardise the ability to repay the loan? If so, there would hardly be any positive decisions and a credit crunch would be triggered. If this is not the intention, the question arises again as to the meaningfulness and significance of such detailed analysis. These requirements should be deleted or confined to sizeable lending decisions and to idiosyncratic events with a high occurrence probability.

Paragraph 112 (b):
The requirements are not proportional and should therefore be deleted. Objects built by consumers are mostly small residential buildings. In some cases, construction management is also carried out by a third party (e.g. when purchasing a condominium for future letting). In the case of such financing, the institution also focuses on other income or assets of the borrower and does not have to check the entire operational construction management of the borrower.

Paragraph 128 (inter alia):
A focus on groups of connected customers in pillar 2 credit risk management should only be mentioned - if at all - as an option. We would like to refer here to the Executive summary of the EBA/GL/2017/15: „*The guidelines focus exclusively on the issue of connected clients as defined in Article 4(1)(39) of Regulation (EU) No 575/20132 and apply to all areas of that Regulation where the concept of connected clients is used, i.e. the large exposures regime …*)“.
An extension to pillar 2 is therefore expressly not intended. Our proposal to reformulate this paragraph: "*Where reliance for repayment is placed on cash flow emanating from other parties connected with the borrower, institutions should carry out an assessment of these parties, and, if appropriate, also at group level.*"
In this sense, **paras. 30, 89 and 231 (a) (iii)** must also be adapted

Para. 130:
We refer to our comments on section 4.3.4. In addition tot hat, ESBG deems the requirement to carry out analysis on the ESG risk exposure of every single professional borrower as much to far reaching under proportionality and materiality aspects. In most cases, analysis at portfolio or business sector level will be sufficient.

Paragraphs 132, 134 and 135:
Which indicators are available, relevant and economically meaningful for the evaluation of the financial situation depends on the respective applicant (size, industry) and, if applicable, the type of financing.

Proportionality clauses should therefore be supplemented. The key figures required in the draft are also partly not available at all for small companies, tradesmen, self-employed persons and freelancers (since they are not obliged to draw up balance sheets). A reference to national commercial law provisions should be included. If the guidelines are to list concrete indicators (which is contrary to the principle of principle-oriented regulations), these should only be referred to as examples.

Paragraphs 138 to 140:
In our understanding of proportionality, facilitations should be provided for SME financing, instead of additional requirements. The requirements are too excessive for small companies, self-employed persons, etc. We suggest deleting this section.

Paragraph 156:
A due diligence is a very comprehensive examination which is carried out, for example, in the case of planned takeovers and mergers, and which is not generally needed in this context. We propose the following adjustment:
„*… institutions should assess the soundness of the agent or the designated entity.*“

Paragraphs 104 / 117:
In respect to the requirement to make reasonable enquiries and take reasonable steps to verify the borrower's ability to meet obligations (in particular related to self-employed or having seasonal or other irregular income) it is explicitly stated that such verification should include documentation of income, third party verification and tax declaration. In line with our comments on the proportionality principle to explicitly include next to considerations of the credit facilities also some client segments like i.e. social banking, the creditworthiness assessment of the vulnerable clients is based on the ability to prove "regular savings" as "income surrogate" in most cases. In order to adapt these guidelines also for other client segments like social banking, we would propose to explicitly allow the proof of "regular savings" as an adequate "income surrogate" within the creditworthiness assessment. Such proof over a pre-defined period (i.e. one year) can represent a very good surrogate for vulnerable client segments with irregular income.

Paragraph 126:
In principle we agree with the list of the requirements that need to be considered when carrying out the creditworthiness assessment. However some aspects listed as part of the considerations of the transaction structure in point g., i.e. leverage level, dividend distribution, capital expenditure, should be taken into account when performing the analysis of the financial position of the borrower as stipulated in a. and as defined in para. 132 of these guidelines. We propose the following amendment in para. 126 g: "assess the structure of the transaction including the risk of structural subordination and related terms such as covenants, ~~leverage level, dividend distribution, capital expenditure~~ and, if applicable, third-party guarantees and collateral structure; and"

Paragraph 129:
In those cases where all of these risk are explicitly taken over by external credit assessment's (ECA), the additional extensive assessment of these risks by a bank is rather of a limited value added. We would propose to amend the requirement to be only applicable in full if no ECA coverage is available.

Paragraph 131 et seqq:
In general we understand the rationale of the requirements for lending standards setting. Nevertheless banks define KRIs based on their risk appetite, business plans and risk strategy. Defining a list of mandatory KRIs would ignore the risk appetite, risk strategy and management expertise of the bank. Furthermore the creditworthiness assessment should be based on a sound internal framework which is comprehensive and creates a clear structure for individual easements based on their characteristics (market, products, industries). Therefore, as an example, the analysis of financial projections cannot be conducted in a "one-size-fits all" approach for all professional clients. A fully harmonized approach would not cover the

full spectrum of the heterogeneity of transactions in the market and other relevant legal requirements. Furthermore, in some cases financial projections of the client are not available to the extent required. In particular, stock listed companies are reluctant in principle to explicitly provide financial projections and budgets due to a risk that in case this information is publicly shared, any deviation triggers an ad-hoc announcement to the market. If such information is not provided by the client, we don't view it as meaningful and valuable if the bank itself tries to predict the forward-looking figures for the client. The reliability of such projections is questionable. Therefore in our view, other tools like sensitivity analyses (see paras. 142-146) of the guideline) or stress scenarios, where relevant, are sufficient to understand the client's key risks. We propose to add to the requirement defined in para. 132 "where appropriate and/or available". This would consider portfolio- and/or market-specific practices based on the local legal and accounting framework in line with principle of proportionality. As a consequence the ability to apply internal expertise and ensure that certain dynamics are monitored and analyzed regularly, identifying potential adverse developments early on and developing mitigating actions will be retained.

Paragraph 135:
Complementary to the comments raised for para. 131, the requirements defined in para. 135 read as a mandatory list of a minimum ratios to be considered in the creditworthiness assessment for all professional clients. However some of these ratios do not represent a meaningful metric for a creditworthiness assessment. For example:

- EBITDA strongly depends on the industry in which the customer operates and is not deemed as an appropriate indicator to compare risk profiles of clients across different industries and within the same client segments (i.e. large corporate);
- Return on equity and capitalization rate are indicators used by investors who seek for different levels of returns on investment depending on their appetite; in practice the benchmark is missing to assess i.e. which level of the return on equity is appropriate to ensure a long-term sustainability and viability of the company; especially now, when more and more companies abandon a singular focus on the interests of shareholders and instead pledged to "deliver value" to all stakeholders and are expected to manage multiple goals, like i.e. innovation, impact on climate change, and look beyond the single-minded focus of the financial bottom line. Moreover these ratios do not provide a meaningful information of the repayment capacity of the borrower as required in i.a. para. 127 and para. 160, which is a key component for a bank deciding if to provide a financing to the client.

In addition, the following ratios only apply to a certain type of facility:

- DSCR: only for project finance
- LTV / LTC: only RE financing

Furthermore, there are some other ratios that allow for better comparability of the client's risk profile across client segments and therefore have a wider scope of application:

- Equity ratio as an indicator of a balance sheet (capital) structure

Therefore the listed ratios cannot be understood as a minimum that must be applied when assessing the creditworthiness of any client. We propose omitting either the phrase "at least" or points (b), (g) and (h) of para. 135.

Paragraphs 142-146:
Complementary to the comments raised above regarding sensitivity analyses, we consider the requirements defined in this section meaningful only if the client provides the financial projections to the lender. Financial projections are not always provided by every client. As commented above, stock listed companies are reluctant in principle to explicitly provide financial projections and budgets due to a risk that in case this information is publicly shared, any deviation triggers an ad-hoc announcement to the market. Therefore we deem the requirements set in para. 142 et seqq. where utilized as meaningful. However the requirements defined in 144, despite the proportionality principle explicitly mentioned in this point, seem to contradict paras. 142, 145 and 146. Moreover, the events mentioned under para. 145 may be a direct consequence of the events mentioned para. 146 (e.g. point a macroeconomic downturn triggers a severe

decline in borrower's revenues [which is already covered in para. 145 a.], etc.) We propose the following amendment in para. 144: ~~*Such sensitivity analysis should account for all general and asset class and product type -specific aspects that may have an impact on the creditworthiness of the borrower*~~. *Sensitivity analysis should be proportionate given the purposes, size, complexity, term and potential risk associated with the loan*.

We propose the deletion of para. 146.

Paragraph 163:
This remark applies only if the definition of the CRE remains as currently included in the guideline – also see our comments to para. 17. For e.g. social housing „lease length in relation to loan term" is not a meaningful parameter in our view as although tenants could quit the contract by law, nevertheless due to the market demand, the vacancy rates are negligible. We propose to add "where appropriate" to the point 163.

Paragraphs 166b / 177b:
An assessment of all contactors, builders and architects that participate in the construction is currently not possible, also from the contractual point of view. Although the institution has to convince itself of the capabilities and capacities of the borrowers' construction and project development management, the existence of necessary permits, etc., it does not have to fully know the operational management or to evaluate all third parties involved. Therefore we recommend to add "where appropriate and possible to the extent necessary to reasonably assess the inherent risk" to these requirements.

Finally, the existing EBA Guidelines on creditworthiness assessments under the MCD (EBA/GL/2015/11) are based on reasonable enquiries and reasonable steps regarding the collection of information, either for the assessment of the consumer's income or his/her ability to meet his/her obligations under the credit agreement. In contrast, the project of guidelines is very prescriptive and detailed regarding financial elements to use for the assessment (see paragraph 98 : "income, disposable income, financial situation, source of repayment capacity to meet contractual obligations." at minimum). Paragraphs 101, 114 and 121 call for clarifications from the EBA regarding the sensitivities analyses. We wonder the rationale of requesting institutions to perform stress test based on negative scenario when granting any type of credit to retail (consumer credit or mortgage credit). Results provided by such computations are difficult to analyze and underlying hypothesis can be questionable as future is very difficult to anticipate except few circumstances (retirement for instance). Such stress scenario, automatically applied, will squeeze many consumers for wrong reasons, excluding them from the traditional banking sector, only as a precaution against NPL risk, while those NPLs are low in most of the Member States, and those NPLs usually are not linked to the "worst case" results provided by adverse stress scenarii but to life's hazards (unforeseen events). For mortgage credit where the property is still being constructed, but which are for renting purposes, paragraph 112 request the lender to assess the building phase by getting all costs associated with the development certified by a qualified and reputable quantity surveyor (or similar). In case of doubt, it is always possible to monitor the state of play of the works, but in most of the cases, the building phase goes as planned by the house construction contract or the off-plan sale (VEFA) terms which include an across-the-board scale according to the work progress and their own completion guarantee.

Question 9: What are the respondents' views on the scope of the asset classes and products covered in loan origination procedures (Section 5)?

Generally speaking, we consider section 5 to be too prescriptive and detailed, not allowing for a risk-based and efficient level of proportionality.

We well noted that loans and advances to credit institutions, investment firms, financial institutions, Insurance and reinsurance undertakings, central banks and sovereigns, including central governments, regional and local authorities, and public sector entities, are excluded from the scope of application of Sections 5 as the creditworthiness assessment of these borrowers would significantly differ from the

assessment of tradition private and corporate loans. However, the scope remains extremely large : mor gage loans, with a distinction between a financing of the house of the borrower and other financing, consumer loans, professional loans, commercial real-estate loans, promoters loans, shipping finance, pro ject and infrastructure finance…

In particular, for consumer loans, using a common framework to regulate the loan origination for mort gage 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. Therefore, the creditworthiness assessment of borrowers significantly differs from consumer credit (industrial approach where the human decision is often mainly based on the result of a scoring) and mortgage credit (tailor-made approach).

One could also wonder if this EBA approach is timely while the European Commission has not yet drawn conclusions from the CCD evaluation exercise launched in June 2018. Paragraph 14 specifies the application of the proportionality principle based on the nature, size and complexity of the credit facility being originated (section 5). Paragraph 15 indicates that for consumer protection aspects when dealing with the creditworthiness assessment of consumers should not be subject to the application of the principle of proportionality. We need clarification of how those two paragraphs interact.

The consumer protection aspects seem to be the same for both consumer and professional lending, while professional are not to be covered by consumer protection, by nature.

More in detail:

5.2.5 General requirements for lending to professionals:
Paragraph 126 : We suggest adding "to the possible extent". For example, future capital expenditures to be spent by a borrower are not necessarily public and /or known by the bank.
Paragraph 127 : We suggest adding "to the possible extent". For example, projected financial position, income and cash flows are not necessarily known for a corporate loan (except for structured finance activities where these cash flows projection are part of the analysis).
Paragraph 130 : We suggest adding "to the possible extent" as banks might not have all the information regarding E&S risk related to the borrower.

Analysis of the borrower's position:
Paragraph 132 : we think that " at least " should be replaced by "to the possible extent", as projected financial position is not always available notably in the case of unsecured corporate loans.
Paragraph 133 : We need clarifications from the EBA regarding this paragraph.
Paragraph 135 : The term "where relevant" should be understood as "considering market practices". For corporate loans, generally DSCR are not calculated whereas they are calculated for project finance.
Sensitivity analysis

Assessment of guarantees and collateral:
Paragraph 153 : For banks in A-IRB we remind that correlation can exist between the borrower and the collateral and is not a prohibition for taking into account such collateral as long as internal models enable to take into account such possible correlation.
Paragraph 156 : We ask clarifications from the EBA as we do not understand such requirement regarding guarantees and LCs.

Section 5.2.8 (Project and infrastructure finance):
Paragraph 176 : There is already a definition of specialized lending in the CRR. Moreover, we consider that this paragraph goes too far and is too prescriptive as project finance security packages should be assessed as a whole in order to ensure that specialized lending conditions are met.

Section 5.3 (Credit decision and loan agreement):
Paragraph 181 : The information needed for the decision of the credit committee is generally included in the credit application. The availability of such credit applications should be considered as sufficient and no requirement of recording the detailed information in a data infrastructure should be considered here.

Paragraphs 181 to 183:
Not every credit decision must be made by a committee (see para. 62). In the retail business for example, decisions by an individual employee (authorised representative) or automated lending decision (subject to compliance with the requirements of section 4.3.3) may also be appropriate. These options must be supplemented.

Paragraph 184:
We understand the requirement of a maximum validity period as an internal requirement for the institution in connection with the subsequent monitoring (section 8.2) and follow-ups (credit reviews in accordance with section 8.3) and request clarification accordingly.
An requirement for a contractual time limit, however, would not be feasible for all types of credit (e.g. overdrafts/current account credits). Such credits are granted "until further notice". This practice is also in the interest of the borrower, who has planning security if the conditions for granting are met and does not have to submit a new loan application pro forma at regular intervals. In practice, so-called "advance decisions" are also taken. Appropriate opening clauses would have to be included for such credit agreements.

As mentioned in our response to Question 1, we deem it as meaningful to introduce a dedicated chapter for social banking. Please find below a draft proposal for the sub-section on social banking:

Paragraph 5.2.x:
1. The creditworthiness assessment for social organizations should consider the aspect of non-profit organization and assess the repayment capacity by the ability to decrease costs, create savings or generate additional income.
2. The creditworthiness assessment for other borrower in the segment Social banking should verify the ability and prospect to meet the obligations under the loan agreement. Regular savings (i.e. one year) and future income projections (i.e. related to training, education and qualification programs) can be considered as income surrogate for financially excluded and vulnerable clients.
3. Intuitions are encouraged to consider pro-active support for over-indebted clients. Combined debt advisory services and sustainable restructuring of loans should be considered for over indebted clients, in particular in case the non-performing is due to social causes (i.e. family member death, severe sickness / injury leading to inability to work or natural disaster) as alternative approach to enhanced loan selling activities.
4. Pricing should consider all costs as listed in 187 in chapter 6. but may neglect profitability targets for this customer segment.

- **Paragraph 133**: When assessing the borrowers´ capacity of future profitability, particular client groups (i.e. social banking clients) will not have profitability by the very nature of their business and applicable law (i.e. non-for-profit organizations, NGOs). When setting requirements for lending standards and assessing the capacity to generate positive profits over time, it must be ensured that organizations with high social impact are not excluded from the financial services. For client segments with the primary objective of producing positive and measurable effects for society (rather than generating profits), the borrower's repayment capacity is not be made in terms of the retained earnings and equity but the ability of such clients to reallocate their spending. We propose to amend para. 133 as follows:

"In cases where the borrower is unable to generate positive profits over time, institutions should also assess the borrower's capacity of profitability in the future to measure the impact of retained earnings ~~and hence the impact on equity~~, where relevant.

- **Paragraphs 142-146**: In addition, the requirements on a complex sensitivity analysis reflecting potential negative scenarios (combining idiosyncratic and market events) are not deemed meaningful for social banking clients and could result in stricter rejection criteria and exclusion of such clients from the financial services market.
  This requirement should be subject to the proportionality principle for social banking clients as proposed above (see para. 14).

<u>Question 10</u>: What are the respondent's views on the requirements for loan pricing (Section 6)?

We believe that the application of section 6 should be confined to newly originated or renegotiated loans (see our comments on para. 10).

We would also underline that the determination of margins is not done as a mechanical way but are the result of the process of bidding for a transaction, taking into account the risk of a given loan, and as well taking into account competition from other bidding financial institutions.

Finally, we would suggest the following modifications:

- **Paragraph 187:**
  The phrase "and reflect" should be omitted, as single cost factors can be negligible.

- **Paragraph 188:**
  Pricing-relevant factors are described in detail in para. 187. An additional consideration of risk-adjusted performance indicators on single loan level would be too far-reaching. Para. 188 therefore should be omitted.

<u>Question 11</u>: What are the respondent's views on the requirements for valuation of immovable and movable property collateral (Section 7)?

We suggest that this section of the guidelines is revised in order to better respect the principle of proportionality and existing well-functioning market practices. It is also important to ensure that this section of the guidelines is consistent with other union acts of law regarding valuation, e.g. the provisions in the Capital requirements Regulation (CRR) and the Mortgage Credit Directive, and do not impose stricter or different requirements.

The proposed guidelines do not seem not allow for the use of advanced statistical models for valuation purposes at origination, even though these models produce reliable results. Disallowing its use would in our view not contribute to making banks' standards more robust. Instead, it would result in additional costs, without direct benefits to the client and the bank. For asset classes where advanced statistical models have proven to be reliable, we advise EBA to allow a continuation of its use. If the EBA does not consider this to be appropriate throughout the union, the use of advanced statistical models could be allowed on a member state level, at the discretion of the relevant national competent authority.

The requirements proposed in section 200 are too prescriptive and there is a risk that they would lead to a check list approach, instead of ensuring a prudent valuation and documentation process, thus defying the objective of the guidelines.

The requirements in paragraphs 207 to 2013 would overhaul the current monitoring applied to collaterals subject to revaluation and the frequency of the update. Many banks have just modified their evaluation processes on the basis of the recent NPEs guidance. Any new changes would require high IT disburses and longer time for their implementation than what proposed in the guidelines. For example, performing full appraisals for revaluation purposes as set out in paragraph 213 instead of the current desktop ones, would significantly increase the appraisals' annual cost, and delivery time could be delayed. Additionally, mainly in case of NPE, the debtor/asset owner wouldn't permit an internal visit of the Real Estate asset. Also, the proposed parameters in para 208 to be used to structure the frequencies of monitoring are not necessarily the best. Market volatility and risk of deterioration regarding industry, technical infrastructure and location as well as respective market price developments are deemed more suitable. The institutions do have enough experience and market knowledge to judge on the best parameter reflecting the risk structure of their portfolio. Hence, parameter for determining different monitoring frequencies should not be predetermined by the EBA.

It is not always appropriate or even possible to require rotation of valuers, as proposed in paragraph 214. There is already a requirement for appraiser rotation for non-performing loans via EBA NPL Guideline. The processes of banks have just been updated to accommodate for this new rule. The expansion to all exposures would cause yet more changes just as processes have been updated. The existing requirement for only NPLs is assessed as appropriate, while we propose to remove clause 214 which is an expansion of existing rules.

An overall clarification should therefore be added that the requirements of this Section apply only to collateral that is included by the institution with a positive value in risk and own funds management. It is common and reasonable to accept certain types of collateral in order to improve the negotiating position vis-à-vis the borrower, but to abstain from the specifying a collateral value for management purposes.

Reference is made to the requirements of the CRR for various requirements of Section 7 (in particular paragraphs 192, 207 and 211). However, in Pillar 2 risk management it is not necessary to fully meet the CRR requirements in order to apply a collateral value. This should be clarified.

The required valuation of the collateral as defined paragraphs 191 to 200 is not compliant with article 19 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. Moreover, the valuation requested by the project of guidelines has to be performed through an "on-site" visit, and can't be made through automatized means, which is even more cumbersome.

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. The project of guidelines goes beyond the MCD requirements and the transposition in law of some Member States; even for a secure mortgage loan, the valuation of the housing is not requested at the loan origination stage. Such valuation is actually performed only in few cases, as for bridging loans when the cost of works is very high compared to the acquisition price.

Practically in most banks, thanks to a dense network of branches, advisors have a good knowledge the value of properties of their sector. A valuation, at the level of the Bank or beyond, should only be considered in cases where the property is atypical or of a significant amount.

The repayment capacity of the borrower is the major driver for the loan granting decision. In one of our members' State, the standard is to have an authorized surety organization to guarantee the mortgage credit. Therefore, the request of a systematic valuation of the housing in case of a decrease of the borrower's repayment capacity in even more less justified (paragraph 196).

Movable property collateral:
We remind that there are also guidelines for credit risk mitigation and requirements in the CRR. It seems difficult for banks to manage requirements on the same topics in different guidelines and regulatory texts. Paragraph 208: Asking for more frequent valuation of collateral in case of high LTV does not seem appropriate as generally a high LTV is granted for low risks assets. Paragraph 219 : For standardized assets such as aircrafts, these assets don't necessarily require a visit and external appraisers' valuation of half-life assets are considered as sufficient.

More in detail:

Paragraph 194:
Section 4.3.3 allows institutions to use technology-based lending procedures, subject to certain conditions. This should also be permissible for the initial valuation of real estate, especially in the retail business of private housing finance. In the valuation of residential real estate, statistical methods or semi-automated procedures can provide valid values and at the same time help to maintain or improve process efficiency. ESBG suggests including an opening clause at least for smaller residential properties.

Paragraph 199:
The requirement that the financing institution itself must have commissioned the valuer neglects constellations such as syndicated financing or the purchase of receivables from other banks in which another credit institution is or was the client for the property valuation. In such cases, the institution does not have to carry out the valuation itself or to commission the valuation; a review of the submitted valuation report is sufficient. This case design should be taken into account when formulating the last sentence.

Paragraph 200:
The data and information required in a valuation report are too far-reaching, especially for private housing finance. Simplifications of the documentation requirements would be appropriate. In general, the valuation of the property and the valuation of the collateral are not used in a clear manner. In one of our members' Country, for example, valuers only value the property, so a valuation report does not address the reference value of the collateral and its legal enforceability. The requirements should be streamlined in order to allow for such differences in national practices.

Paragraph 201:
Art. 229(3) CRR is not applicable to all institutions and only applies if collateral values are to be included in the determination of Pillar 1 own funds requirements. Apart from that, the CRR requirement is based on the market value, statistical models are not mentioned. The requirements for the valuation of movable assets (Sections 7.1.2 and 7.2.2) should generally be graduated according to the loan amount and the type of collateral. For example, a simple valuation method based on the purchase price or relevant valuation tables may be appropriate for automotive financing in the consumer credit business. Such standardised valuations of comparable goods do not have to be carried out by an independent valuer.

Paragraph 207:
The specifications made for the monitoring procedures are too detailed, usually orientation takes place only on the type and value of the property, as well as on material changes in market conditions.

Paragraphs 201 - 206:
The requirements for **movable property collateral** seem to be extensive for banks with small portion of such collateral; esp. the establishment of panels of external valuators and the implementation of advanced statistic models for each and every type of movables seems disproportional to the economic benefit of such a requirement. A more conservative valuation of such collateral (by applying bigger haircuts, limitation of valuation to defined types and age of the assets, etc.) may compensate such rules. We

would welcome if the rule is amended to allow for an introduction of materiality thresholds above which an expert valuation is to be mandatory.

Paragraph 214:
The rotation obligation for internal valuators shall be reconsidered as is not always practicable, especially in small banks that often have only one internal valuator and does not bring additional risk mitigation (the internal valuators have one superior who is responsible for the quality of their performance); rotation of external valuators is deemed meaningful. We propose to delete the rotation of internal valuators from the requirement.

Statistical methods for valuation of property:
The draft proposes that advanced statistical methods can only be used for valuation of property by monitoring, but not by origination. This is discussed in the draft on page 52-58 and page 79-82. If the draft guidelines are implemented as proposed, this could affect the lending process in some members' Countries. Banks will no longer be able to use statistical value assessments when granting loans. This will effect both the manual processes, and digital mortgage loan solutions. The EBA proposes not to allow for the use of advanced statistical models for valuation purposes at origination, even though these models produce accurate and reliable results. As pointed out in the consultation paper advanced statistical models are already in place in several countries and are used as a good and credible source of information. When advanced statistical models provide valuation proven to be of the same quality as physical valuations, they have the benefit of capturing changes in the market prices and present them in an objective manner for the credit institutions. This is achieved on the basis of large databases of property transactions and public registries. Disallowing the use of established advanced valuation models at origination where these have proven to be reliable will result in at setback for digitalization/technological development in the banking industry and negatively impact competition in the market. If banks are required to perform expensive physical valuations in a situation where the customer would like to refinance his or her mortgage loan this can lead to a disadvantageous "lock in" effect due to extra costs involved for the customer. In addition, such a solution will be significantly less effective and cost efficient for the financial institutions. Not allowing the use of advanced statistical models that have been proven to provide robust, accurate and transparent valuations will, in our view, not contribute to improving banks" risk management. Instead, it would result in additional costs, without direct benefits to the client and the bank. Thus, for asset classes where advanced statistical models have proven to be reliable, EBA should allow a continuation of its use (i.e. chose option 3c for valuation of immovable property collateral).

In addition, we propose to align requirements to ensure consistency. The rules should recognize that bank internal, independent from the market, evaluators /surveyor should be considered as acceptable.

<u>Question 12</u>: What are the respondents' views on the proposed requirements on monitoring framework (Section 8)?

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 and does not allow for the institution to determine its credit risk appetite. The monitoring activity shouldn't lead to undue additional reporting or disproportionate increase of the administrative obligations for banks.

The requirements regarding stress testing in the monitoring process should to be framed by the proportionality principle. Otherwise, using a transaction-by- transaction approach, there is the risk of burdensome procedures, information and reporting requirements.

We believe that more proportionality and materiality aspects must be included in this section. Requirements for the monitoring of borrowers and the credit review of professionals should allow institutions

to structure their procedures according to the type, scope and risk content of the credit facility respectively the portfolios.

More specifically:

- **Paragraph 263**: In general we understand and agree with the listed early warning indicators as potentially relevant aspects that should be considered when implementing the EWS framework. However the current wording of this requirement may be understood that all these indicators must be a minimum binding consideration when setting the early warning frameworks. Our comments should be understood under consideration of comments made above for paras. 14, 131, 132, 135, 142-146 and 163. In our view, the defined requirements do not allow for consideration of the principle of proportionality as needed in this context. In line with the current definition of the principle of proportionality in para. 14, the relevant considerations should be based on the size, nature and complexity of the credit facilities. However several of the proposed indicators are not relevant at the credit facility level but need to be considered at the portfolio and/or client level. In addition, several of these indicators strongly depend on the local accounting, market standards and laws, and the extent of the possible data collection, and therefore their relevancy, strength and correlation to the default may differ across portfolios, industries and clients. For some of the indicators, the data collection my not be possible due to the GDPR and/or information availability constraints. Therefore in our view, similarly to the requirements formulated in other parts of the guideline, relevant proportionality considerations must be properly reflected in relation to the proposed list of the EWS indicators. Moreover the current requirement strongly suggests that the EWS systems should be set up based on several single indicators but in practice there are early warning systems in use that are based on the statistical models and yet fulfill the requirements in regard of the early warning framework. This may strongly influence the efficiency of the early warning (watchlist) process as some manual (human) inputs may be necessary in order to fulfill this expectation, which is not deemed as meaningful and necessary for this purpose.

  As a result, we think that the current definition of the regulatory expectations for the early warning framework is unclear and has to be revised in order to avoid confusions.

  We propose to add the following proportionality considerations to this requirement defined in this point: As part of their ongoing monitoring of credit risk institutions should consider the following indicators "to the extent that is proportionate given the relevancy and predictive power of the indicators as well as the potential risk associated with the loan".

Finally, regarding the stress testing in monitoring process, Paragraph 256 indicates that institutions should benchmark the results of stress tests against the credit risk appetite. We would underline that stress testing is a difficult exercise and are somehow reductive. Modelling reality would require a high number of parameters. Stress tests are most of the time a best effort exercise. Although quantitative studies can be analysed, we believe that expert based judgement of experienced teams should remain the main driver of credit risk appetite.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.

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