Banking & Payments Federation Ireland

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Response to the EBA Consultation Paper on draft Guidelines on Loan Origination and Monitoring

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1. Introduction

Banking & Payments Federation Ireland (BPFI) welcomes the opportunity to respond to the European Banking Authority's (EBA) Consultation Paper on draft Guidelines on loan origination and monitoring (the draft guidelines). BPFI and its members support the stated aim of the draft guidelines to ensure "*robust and prudent standards*" are in place in relation to credit risk, management and monitoring, and that credit advanced in the future is of a high credit quality. The additional aim of aligning consumer protection and AML requirements is further supported.

As in other EU Member States, several measures have been implemented in Ireland over the past decade in response to the emergence of non-performing loans as a result of the financial crisis. Legislative and regulatory requirements on consumer protection, debt management, mortgage arrears, insolvency and credit checking have been implemented and together go some way to ensuring a higher level of credit quality than pre-crisis.

BPFI remains committed to engaging in the consultation process, as appropriate, as the draft guidelines move to finality. Our understanding is that the final guidelines will be implemented at Member State level by national competent authorities on a comply or explain basis, and BPFI will continue to engage at that stage with the Central Bank of Ireland.

1.1 Summary Observations

It is important that banks are afforded the right to retain individual ***risk appetites*** and the freedom to set their own credit risk policies to some extent, and we would request that the EBA remains mindful of this in its work on the draft guidelines.

Acknowledging that the principle of ***proportionality*** applies to the requirements, the draft guidelines do not offer any indication of materiality thresholds or specific guidance on applying proportionality as it pertains to the nature and complexity of various categories of credit granting. It is a concern that that a disproportionate approach to creditworthiness assessment may emerge as a result.

The draft guidelines as written are extensive and broad-ranging in respect of what is captured within their ***scope***. The draft guidelines apply to consumers and professionals, and to the internal governance and procedures in relation to credit granting, throughout the life-cycle of credit facilities. Clearer distinction between the requirements as they apply to consumer credit and business or corporate credit would be useful in allowing for a better understanding of the full impact of the requirements.

Furthermore, in working to finalise the draft guidelines, BPFI would request that the EBA remains mindful of the existing regulatory and guidance frameworks, and works to ensure ***consistency*** of the draft guidelines with those already in place. For example, the draft guidelines as written introduce further requirements with regard to standards for valuations. Established guidance and standards already exist in relation to valuations, and it is important that duplication and inconsistency of requirements in this and other areas do not emerge as a result of the final guidelines.

2. Response to Consultation Questions

1. *What are the respondents' views on the scope of application of the draft guidelines?*

   In general, the draft guidelines as written are extensive and broad-ranging in respects of what is captured within their scope. The draft guidelines apply to consumers and professionals, and to the internal governance and procedures in relation to credit granting, throughout the life-cycle of credit facilities. Clearer distinction between the requirements as they apply to consumer credit and business or corporate credit would be useful in allowing for a better understanding of the full impact of the requirements. As currently written, the draft guidelines seem to apply across all credit granting, which varies greatly in amount and exposure/risk. Banks apply different risk appetite and different requirements to the different customer bases. Specifically, clarity is required regarding the definition of "*debt securities*", given that they are called out as being excluded from the scope of the draft guidelines.

   Acknowledging that the principle of proportionality applies to the requirements, the draft guidelines do not offer any indication of materiality thresholds or specific guidance on applying proportionality as it pertains to the nature and complexity of various categories of credit granting, the concern being that a disproportionate approach to creditworthiness assessment emerges as a result of the draft guidelines.

   The draft guidelines state that "*Section 5 applies to loans and advances that are originated after the application date of these guidelines. 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*." Our view is that the draft guidelines should only apply to newly originated loans after the application date of the draft guidelines and not to existing credit granted before the draft guidelines become effective. Specifically, a regular credit review of credit granted before the application date should not trigger the requirements of the draft guidelines. In addition, greater clarity is required regarding the application of the draft guidelines with specific reference to both performing and non-forbearance loans.

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

   The implementation date of the draft guidelines of 30 June 2020 is unrealistic given the broad scope and detailed requirements of the draft guidelines.

   The draft guidelines as currently written will likely impact the majority of existing credit policies, require the development and implementation of new specific green lending policies and procedures in some cases, and the incorporation of movable property collateral requirements in credit policies and procedures. In order to comply, member banks will have to establish specific projects to plan and develop the necessary operational and IT system changes to comply with the guidelines including, among others, to meet the requirements regarding movable property collateral; the requirements to have a single customer view, which is further complicated in the case of member banks that are part of an overall group structure; the requirements for

independent qualified valuers or appropriately advanced statistical models and indices; and the requirement for inclusion of an external valuer's panel for movable property.

In consideration of the complexity of the requirements, it is necessary to allow for a longer implementation period or at least a phase-in period, with the final guidelines not applied before 31 December 2021.

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

Firstly, with reference to technology-enabled innovation, developments in the space such as open banking, digitalisation of credit granting, use of credit bureau for scoring, eID etc. are likely to provide alternative sources of information about income verification, credit rating and customer identification, and so will feature in the credit granting process more in the future. However, it is difficult to make any definitive comment at this stage given the uncertainty about future technology developments. Furthermore, it is unclear from the draft guidelines if the types of innovative solutions alluded to above are what the EBA views as "*technology-enabled innovation*" in the credit granting space.

In relation to environmental factors and green lending, despite being a nascent area, the banking sector recognises the importance of incorporating Environmental, Social and Governance (ESG) considerations into credit lending procedures and overall banking strategy. Banks are preparing for the legislative changes arising from the EC Action Plan on Sustainable Finance and as credit institutions, anticipate that direction from ESA's and from the Network for Greening the Financial System will be impactful on risk management policies and the overall approach to ESG. We assume that any specific EBA guidance regarding credit risk and "green" lending would be aligned with these developments.

On sustainable lending, the current taxonomy proposal for the classification of sustainable economic activities will, if successful, become fundamental in determining the degree to which such activities are sustainable. While lending is not included in the draft taxonomy legislation, we understand it could become very relevant for green lending facilities.

In Ireland, BPFI and members are working with government stakeholders to develop financial initiatives to support proposals to encourage retrofitting of homes. A clear understanding of the regulatory requirements regarding green lending and targets will be important in developing and rolling out such important initiatives.

With specific reference to the draft guidelines, the requirement under paragraph 49 (b) seem particularly onerous from the point of view of the borrower and may go so far as to deter borrowers from seeking sustainable finance. While project-based transactions can be easier to measure and assess against their environmental performance (Equator Principles, etc.), smaller transactions or SME lending are more complex to assess given the difficulties for smaller companies to have the relevant expertise to provide this kind of data to lenders. SMEs can constitute a significant loan portfolio for some banks and in the absence of adequate data for monitoring as required under the draft guidelines, sustainable lending cannot be offered.

4. *What are the respondents' views on the requirements for credit risk policies and procedures (Section 4.3)?*

   Generally, the draft guidelines state that the requirements are to be applied on an "*at least*" basis, which would seem to indicate that they are binding. However, not all the requirements listed will be applicable in all cases and so to apply on an "*at least*" basis will not be feasible at all times. We would ask that the EBA review this aspect of the draft guidelines to ensure member banks are not met with guidelines that cannot be implemented.

   Specifically, BPFI queries a number of paragraphs within Section 4.3:

   - In relation to leveraged transactions as per Section 4.3.2, it is unclear how the requirements in this paragraph are connected with the ECB guidance on Leveraged transactions (published May 2017). It is also unclear if the requirements apply to retail/consumers.
   - It is our view that the requirements under Section 4.3.4, paragraph 49 have the potential to have a significant credit risk policy impact on some member banks which do not currently have specific green lending policies.

   Other comments relating to Section 4.3 have been captured above in response to Q.3.

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

   - Under Section 4.4.1, paragraph 63 (a) references *"… credit decisions for small and non-complex credit facilities*." Clarity is required regard the definition of "*small*" and "*non-complex*".
   - Section 4.4.1, para 63 - Acknowledging the need to avoid any conflicts of interest, is there the potential for unintended consequences for such activities as staff lending/lending to connected parties where there may be personal relationships, but with mitigants in place such as segregation of responsibilities etc.?
   - Under Section 4.4.3, paragraph 67 references lending to affiliated parties. With regard to the draft guidelines, clarity is required regarding the definition and perimeter of affiliated parties. More generally, it is the view that the requirements on lending to affiliated parties are already met by the regulatory requirements of the Central Bank of Ireland's "*Code of Practice on Lending to Related Parties*", dated June 2013, from an Irish perspective and from a UK perspective by the "*Related Party Transaction Risk*" in the Prudential Regulation Authority Rulebook, 2014.
   - Section 4.5, para 71 - In the context of integrating the credit risk function into the overall risk management for an institution, is there an expectation that Credit Risk will be involved in the design and development of a financial product?
   - Regarding the definition of "*Disposable Income"*, specifically requirement to deduct insurance and health care premiums - some member banks would not deduct insurance premiums as standard to arrive at a figure for disposable income. While we are aligned with the principle

of calculating disposable income, the approach of arriving at a figure may differ between banks in some respects.

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

   The draft guidelines appear reasonable in this regard.

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

   While Section 5.1 is comprehensive and prescriptive, it does not adequately reflect that the information collected as part of a creditworthiness assessment will typically be tailored depending on the nature of the product, the size of the loan, and whether the credit being applied for is to an existing or new customer e.g., credit card exposure vs residential mortgage; small incremental increase to an existing SME vs a large loan to a new Corporate customer. Flexibility for straightforward, small amount loan applications should be considered e.g., member banks may have simplified processes for overdraft and credit card applications.

   We have set out below some comments relating to specific paragraphs:

   - The requirement set out in paragraph 85 regarding a single customer view would present a significant IT challenge for member banks, given the existence of legacy systems and the fact that some member banks form part of an overall group structure. While the benefits to be gleaned from a single customer view are clear, this could not be implemented within the timeframe currently proposed for implementation of the draft guidelines.
   - Clarity is required in relation to the requirements set out in Sections 5.1.1, paragraph 88 and paragraph 90. Specifically, does the detail on verification of supporting information and retention of same only relate to non-automated credit decisions? In addition, Section 5.1.3, paragraph 93 state that at least the listed items should be obtained. Not all of these requirements would be obtained for all applications. Clarity is sought to confirm automated decisions are out of scope of this requirement.
   - When dealing with a credit application for a borrower who is part of a bigger connection, a member bank would not necessarily collect information on all related/connected clients unless there was a dependence for repayment capacity. It would be normal practice for most member banks to look at the entire client and its related clients at annual review.
   - Overall, a number of concerns are raised in relation to Section 5 from a data protection and GDPR perspective. For example, paragraphs 88 and 89 refer. Further clarity is required on the definition of "*professional*" in the context of the document as this may impact on Data Protection rights. If the draft guidelines are adopted as currently written, clarity would be required from our national competent authority on the status as a legal basis for data collection – member banks are permitted to only collect data that is necessary and overreach of this obligation would be a concern.

- It is assumed that proportionality can be applied to the level of additional information from Annex 2 which should be sought. Clarity is sought with regard to whether or not the proportionality can be left to lender judgment? Section 5.1.2, paragraph 92 refers.

8. *What are the respondents' views on the requirements for assessment of borrower's creditworthiness (Section 5.2)?*

   As above, Section 5.2 is comprehensive and prescriptive, but it does not adequately allow for a differentiated approach depending on the nature and complexity of the customer borrowing requirement. Specifically:

   - Loan service to income is not always calculated (Section 5.2., para 99 refers). Clarity is sought as to how income is defined for this purpose.
   - The presumption is that the proportionality principle could be applied to the requirements of this section i.e., sensitivity analysis is not carried out on all loan applications and the duration and size of the facility are taken into account (Section 5.2.1, para 101; Section 5.2.3, para 114; Section 5.2.4, para 121 refer); Sector KPIs and pass/fail metrics are only applied based on size and duration of facilities, and are not assessed for every application (Section 5.2.5, para 126 (d) refers); not all of the financial metrics outlined are used in the assessment of all applications (Section 5.2.5, para 135 refers).
   - Clarity is required as to whether all the events listed in Section 5.2.5, paras 145 and 146 need to be considered.
   - Potential negative scenarios in the future may not be known at the time of credit assessment e.g., changes in taxation; therefore, clarity should be added to reflect these requirements "where known" (Section 5.2.4, para 121 refers).
   - Other observations include: prescriptive and onerous requirements of Section 5.2.5, paras 142-146 are unlikely be relevant in all cases; stressing for interest rates on a short term stocking loan for an Agri customer would not be a useful exercise; requirement under Section 5.2.5, para 131 for institutions to make their own projections is more suited to larger corporate/SME loans only; the intent of Section 5.2.5, para 133 is unclear.

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

   Some observations in relation to Section 5 include:

   - Section 5.2.3, para 115 – *Other secured lending to consumers* – the full scope of loan agreements secured by movable property is unclear.
   - Section 5.2.5, para 138-141 – *Specificities for assessment of the financial position of SMEs* – it is unclear if there is a differentiation between Professionals and SMEs.
   - Section 5.3, para 180 – *Credit decision and loan agreement* - the requirements seem to impose on lenders a responsibility for the possible misrepresentation of information provided by the

borrower. We propose an alignment of this with the requirements of Art. 18 (4) of the Mortgage Credit Directive (MCD).

10. *What are the respondents' views on the requirements for loan pricing (Section 6)?*

The draft guidelines seem reasonable in the context of loan pricing. Specifically, the metrics suggested for pricing measurement make sense as do the suggested inputs for consideration, and we agree with the proportionate comment in para 188.

With regard to para 190, BPFI is of the view that "*All of the transactions below costs should be reported and properly justified*" should be amended to read "*Material transactions and portfolios priced below costs should be reported and properly justified."*

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

Generally, the inclusion of requirements for valuations in these guidelines duplicates the requirements already in place, including in the ECB Guidance to banks on non-performing loans (published March 2017) and the Red Book and Blue Book standards. In Ireland, in the context of strengthened legal and regulatory supervision, the Central Bank of Ireland withdrew its previously published "*Valuation Guidelines*", which set out expected standards and best practice regarding the valuation process for credit institutions. While the guidelines are now withdrawn, there are expectations that certain lessons learned should be retained by credit institutions in this area.

The emerging overlap with regard to valuation standards is likely to lead to inconsistency and ambiguity, and the preference of member banks is for one set of standards to promote more consistent application across the industry. Furthermore, there needs to be clearer distinction between the valuation requirements as they apply to consumer credit and business/corporate credit.

Movable Property

- Further clarity is required on the definition of *Moveable Property*, the asset classes in scope and the acceptable valuation methodologies. The standards referred to in Section 7.1, para 193 do not cover all movable property (e.g., vessels & aircraft) and clarification on the standards to which these must be valued is required.

Immovable Property

- Valuations for immovable property collateral are completed by valuers in accordance with applicable International Valuation Standards (i.e., the RICS Valuation Red Book and the EVS Blue Book). Some of the requirements of the draft guidelines would seem to be in contradiction with international valuation standards e.g., properties that are not deemed generic in type/characteristic will be unable to get valuations by way of desktop/drive-by, even though these valuation approaches conform to international valuation standards.

- Materiality thresholds and relevant valuation approaches are not proposed in the draft guidelines but should be considered for loan origination and monitoring e.g., €300k threshold as outlined for NPEs in the *ECB Guidance to banks on non-performing loans (NPLs)*.
- Specific clarity is required on what is meant by "*adequate advanced statistical models accounting for individual characteristics of the property*". Section 7.2.1, para 211 refers.

More specific observations on the content of Section 7 are included below:

- Section 7.1.1, para 195 - It appears that desktop/drive-by valuations will suffice for generic type valuations, but only where the valuer can confirm they have fully inspected a similar property. Can this be confirmed as the intention? It is worth noting also that there can be wide variation in how these approaches are deployed and the potential impact of this is worth considering in finalising the draft guidelines.
- Section 7.1.1, para 194 - needs to be amended to allow for Automated Valuation Models (AVMs).
- Section 7.1.1, para 199 - Irish market practice for residential mortgages is that the borrower chooses/orders the valuation from a panel approved by the Bank.
- Section 7.1.1, para 200 (c) - The line "*a description of the collateral, including its current and future use*" in this clause is ambiguous and may cause confusion if applied literately. Under the Red Book "*future use*" is only commented on in a valuation report if a possible alternative future use may alter the value of the property. Clarification is required that the Red Book approach is satisfactory.
- Section 7.1.1, para 201 - When taking security over a low value item (e.g., a car) under a Hire Purchase (HP) or Personal Contract Plan (PCP) agreement, what is the expectation in terms of valuing the security? Also, we would welcome clarity as to whether the use of industry data (e.g., CAP car values in the UK) would meet the requirement.

- Section 7.1.2, para 202 - Is it intended that the reference to internal thresholds and limits would only apply to valuations performed by a valuer for movable property?
- Section 7.1.2, para 204 - With reference within to para 200, how do immovable property valuation requirements align with those to be applied to movable property?
- Section 7.1.2, para 205 - Is the reference to "*statistical models*" intended to include internal desktop valuations, particularly where historic asset data may be limited?

- Section 7.2.1, para 207 (b) - Suggest removal of reference to IFRS9 Stage 1 or 2 and amending to "*e.g., with reference to the Institution's internal grading system*."
- Section 7.2.1, para 211 - The draft guidelines state "*institutions may update the value of the immovable property collateral through a revaluation carried out by a valuer or through adequate advanced statistical models accounting for individual characteristics of the property, where such models are not used as sole means for the revaluation*". With reference to the word "or", it would seem that models cannot be used as the sole means of revaluation. Clarification is required.
- Section 7.2.1, para 214 - The EBA might consider including a threshold to allow for a risk-based implementation of this provision, taking cognisance of the cost burden which may be passed on to the customer.

- Section 7.2.2, para 218 - The EBA might consider permitting institutions to apply their own internal threshold and/or limit for the monitoring and revaluation of individual immovable property.
- Section 7.2.2, para 219 - Does the EBA have a view on the frequency of monitoring and revaluation of movable property collateral?

- Section 7.3, para 222 - Specifically, in relation to point c, how is it proposed that banks will evidence that valuers "*… are familiar with and able to demonstrate ability to comply with, any laws, regulations and property valuation standards that apply to the valuer and the assignment*"?

- Section 7.3, para 224 - This paragraph requires assessment of various aspects of the valuation process. How is it proposed that banks will evidence the monitoring of the accuracy and concentration of valuations, and the fees paid to valuers?
- Section 7.3, para 225 (c) - The wording of this clause will cause issues for all institutions. It would seem that in the case of an actual, potential or current conflict of interest by connection to the valuer's family members, the valuer in question cannot be appointed. The ability to establish a line of sight on the valuers' first-degree relatives would be problematic industry wide. It is our view that the onus should be on the valuer to confirm such conflicts of interest at the outset, rather than placing any onus on a bank in this regard.

12. *What are the respondents' views on the proposed requirements on monitoring framework (Section 8)?*

Overall, the framework is very detailed and prescriptive, and for the most part, the expectations for monitoring are very clear. However, confirmation is required that qualitative factors in ongoing monitoring can be collected solely through documented credit review processes e.g., through additional funding requirements or annual reviews.

The principle of monitoring of covenants/covenant compliance certificates is a mature process in the corporate and large SME market, but the process is not as embedded or usual market practice in smaller-end SME market and not practical in retail (managed by exception) portfolios.