INTESA SANPAOLO

Response to the EBA Consultation Paper on Draft Guidelines on loan origination and monitoring (EBA/CP/2019/04)

Deadline: 30 September 2019 **Answer disclosed**

Key points

The EBA draft Guidelines on credit origination and monitoring are welcome as they introduce high standards for EU banks and a level playing field for all institutions.

In this paper we would like to highlight some potential issues that would arise from the Guidelines as proposed and therefore we introduce some suggestions to improve their overall reach.

a) We suggest to **better define and clarify the scope of application**: it should be clearly stated that the Guidelines apply exclusively to loans granted after the application date, being understood that loans existing prior to such date would be exempted. Any potential enlargement of the scope to the loans in stock should be carefully considered and limited only to specific cases of renegotiations, as we suggested in the answer to question 1.

b) The proposed **date of application** of the draft guidelines: considering the complexity of the requirements introduced, together with the number of references to other pieces of regulation (level 1 and level 2) either under development or under evaluation for review (e.g. EU Taxonomy Regulation, Mortgage Credit Directive, etc.), a full implementation of the Guidelines by 30 June 2020 is not feasible to be achieved, especially for international and complex banking groups with international subsidiaries outside the Banking Union or in third countries.

   To this regard, clarification is sought about local transposition/compliance requirements, especially in case of a required application of the Guidelines at sub-consolidated and individual level. Therefore, a more appropriate timeframe for implementation would be not earlier than 31 December 2021, with further phasing-in where necessary (please see answer to Q3). A postponement of the date of application would also be aligned to the IRB roadmap.

c) We suggest a broader analysis by EBA together with market participants to assess the practicability of the proposed optional **templates on NPLs,** in particular assessing the availability of the required information for each asset class.

d) **Monitoring requirements** should be more precise and aligned with already existing ECB practices to avoid duplications. In any case the monitoring requirements should relate to newly originated loans only.

e) **Further granularity** of the borrowers' segment should be considered when defining the proportionality and implementation of the GLs. The practical/ operational implementation of the proportionality principle should be governed by specific provisions for **flexibility** within the text.

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

1. Existing loans only

The Guidelines should apply only to newly originated loans and in case of loans originated before the application date, only for increases of their amount or other substantial changes affecting their credit assessment or where a new credit decision is taken.

On the contrary, a regular credit review of a loan (e.g. annual review without any kind of modification to the loan structure and/or amendments) should not trigger any of the new requirements.

For instance, any other application of the Guidelines to loans originated prior to the application date is deemed not appropriate and disproportionate. In particular, it should not fall within the scope of the Guidelines i) any kind of renegotiation of terms (e.g. only market-driven renegotiation of the pricing, etc.) or ii) any loan, which require "specific actions triggered by the regular review of the borrower after the application date", covering, *de facto*, the existing stock, irrespective of whether subject to renegotiation or not.

In fact, for all these loans in stock, it is not operationally achievable to comply with the requirements regarding the collection of information, as there are no contractual obligations for the customers to provide additional documentation required by the bank if the contractual agreement itself is not modified or supplemented.

If renegotiations of loans were to be included in the scope of the Guidelines despite of implementation issues described above, these should be limited to those that meet simultaneously the following features:

a) require a specific credit decision approval; and

b) imply/ lead to a change of credit risk; and

c) to be implemented, they require signing with the customer a loan agreement, as an addendum to the existing contract.

Some examples of the renegotiations described above are: i) the renewal of a revolving credit facility with extension of the final maturity date; ii) the rescheduling/restructuring; modification of the nature and/or purpose of the credit facility; iii) the release/replacement of collateral with material impact on the overall riskiness of the transaction/ borrower credit risk profile, etc.

2. Consolidation level

In Section 2, on the scope of application, it is also mentioned that Competent authorities should ensure that institutions apply these Guidelines on an individual, sub-consolidated and consolidated basis in accordance with Article 109 of Directive 2013 / 36 / EU, unless Competent authorities make use of the derogations as defined in Article 21 and Article 109 of Directive 2013/36/EU (CRD IV).

Financial entities or Groups located in the EU but operating also in third countries or outside the Eurozone (and outside the Banking Union in particular), might face great difficulties in complying with these Guidelines especially if they will be applied also at a sub-consolidated or individual level. This would harm the level playing field with other EU banks operating only within the Banking Union.

An application at sub-consolidated or individual level implies that the final EBA Guidelines must be transferred for implementation to non-EU jurisdictions, which have different Regulators. Those Regulators might decide not to implement the Guidelines or to comply with them only partially (eg. not comply with certain aspects/sections or setting a different implementation date). Under the first option, an application at sub-consolidated or individual level could not be achieved, while in the second case local transposition will require time and thus extend the duration of implementation well beyond the deadline proposed by the EBA.

3. Definition of categories of clients and proper calibration

The definition of "professional" clients should be revised to distinguish among the main existing segments (e.g. SME Retail, SME Corporate, Corporate), which is key for applying the requirements in section 5, together with the type, size and complexity of the credit facilities.

A full implementation of the Guidelines to certain segments could have negative effects on credit granting, if requirements are not properly calibrated to the business portfolio of banks. This is particularly relevant in countries where the business environment is mainly characterized by SMEs, whereby some of the requirements on documentation and certain metrics may not be collected or, respectively computed. Therefore, we would suggest introducing the possibility for materiality thresholds (institution and portfolio specific) that would exclude from the scope small companies characterized by small exposures, low complexity, limited ability to provide detailed info and forecast.

Section 2 should make clearer the fact that that the lists provided in the Annexes 1, 2 and 3 should be taken only as a reference to be complied with proportionality depending on the type, size, nature, complexity and risk profile of the credit facility. It should be clearly stated that these are not prescriptive lists to be complied with at all times for all types of lending. The 'background and rationale' should also be amended consequently.

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

The deadline for complying with the Guidelines is extremely challenging. To adequately implement their provisions, a postponement of the entry into force, and/or the introduction of appropriate phase-in periods is deemed essential.

Considering that the final version of the Guidelines should be published at the end of 2019, a postponement would allow banks to perform a comprehensive impact assessment and gap analysis on primary business processes, credit decision-making processes, IT infrastructures and the subsequent implementation into internal policies and procedures. All these processes are highly unlikely to be performed in such a short timeframe from the issuance of the GL to the announced application date (6 months). Moreover, if the scope of application of the Guidelines won't be modified and loans originated prior to the application will be included (see the answer to Q1), a postponement of the date is warranted.

Let us also remind that IT investment and processes require time and resources. The requirements of the GL implying IT modifications can in no possible way be achieved by 30 June 2020. This will result not possible in terms of effort, organisation and budgeting of IT investments.

The Guidelines request *inter alia* the implementation, in the risk management policies and procedures, of "ESG Factors and Green Lending". In this respect, the date of application of the Guidelines should also be aligned to the implementation of an EU framework on sustainable finance, in particular with the approval and application of the Taxonomy Regulation. Before further developments in the EU framework, avoiding any gold-plating of requirements and definitions linked to sustainable finance would be crucial for a correct, transparent and harmonised application of the Guidelines.

The Guidelines introduce important changes that will not only imply IT investments, staff training costs and other high operational costs, but they may also have a material impact on the IRB models - in addition to the consequences of the early application of the EBA Guidelines of the definition of default under Article 178 of Reg EU No 575/2013.

Therefore, we believe that the date of application of these Guidelines should be postponed and aligned to the implementation timeline of the IRB roadmap, considering also the postponement of some part of the IRB review. A more feasible implementation date should not be earlier than 31 December 2021, considering further phase-in periods for certain particular requirements (eg. ESG factors and green lending, please see below).

Q 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)?

a) ESG factors and green lending

These Guidelines respond to the 2017 European Commission Action Plan on NPL, but also to the Commission's Action Plan on sustainable finance.

The final adoption and implementation of the above EU regulatory frameworks, and in particular the Taxonomy proposal for a Regulation, is deemed crucial also for an adequate implementation of requirements under section 4.3.4. The applicability of the two should be aligned. A harmonised and clear framework at the EU level would also make it easier for banks operating in third countries to comply with any requirement, considering that at present there is a number of initiatives and considerations on green lending and sustainable finance, but they vary across jurisdictions. In this context financial institutions are currently evaluating how to proceed towards the identification, measurement and monitoring of environmental factors and are assessing possible sources of accurate information, but the process is still at an early stage. Moreover, it should be considered that the main providers of ESG data so far have a low coverage of the scope.

With reference to par. 48 and 49 we suggest limiting the scope to non-SMEs corporates, applying not earlier than December 2021 credit risk policies and procedures only to large corporate lending and adopting a risk-based approach, i.e. considering the most material ESG related financial risk-cases and industry. In fact, larger corporates have a broader data set and higher possibility to produce in the future the required information, compared to the poorer capacity of SMEs.

With this respect, it should also be considered the scope of the Non-Financial Reporting Directive and that there are difficulties in gathering data from SMEs, which represent a huge part of EU banks' portfolios, especially in the Italian market. If SMEs were to be included in the scope of the GL with reference to ESG factors and green lending, a gradual phase-in period after 31 December 2021 should be envisaged.

With reference to par. 50, further clarifications are needed regarding the relationship between the qualitative and quantitative targets defined by each institution and their assessment and weight as part of the supervisory expectations.

Furthermore, transition risks, whose definition should be aligned by the one provided by the TEG, require a thorough analysis, ranging from a risk management, legal, market, technological as well as reputational perspectives.

Moreover, it should be clarified which paragraphs of the section 4.3.4 apply to all borrowers and which are only linked to green projects.

In general, we suggest the EBA to adopt a less prescriptive and high-level approach to consider further legislative developments and allow banks to adapt to them using a realistic timeline.

b) Technology enabled innovation

In our view, the regulatory approach -when dealing with innovation- should be "technology neutral", flexible and timely in order not to stifle innovation.

In light of these principles, we believe that this paragraph should be re-considered to avoid excessive compliance prescriptions when a specific technology for credit granting is used instead of traditional procedures.

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

Intesa Sanpaolo has regularly updated and improved its internal procedures in terms of credit granting and monitoring. In general terms, the EBA Guidelines outline a trend already undertaken by Intesa Sanpaolo in many respects.

However, an in-depth analysis is necessary to ascertain a potential implementation timeline. About automatic processes, it is necessary to better specify which kind of analysis is required to perform the comparison between automatic and manual processes (being understood that such analysis can't be performed at single position level and ex ante, but only at portfolio level and ex post).

It is important to clearly specify that criteria listed in the Annexes are not compulsory, as we highlighted in Q1. In fact, in this section, the current wording of the draft Guidelines state that the criteria listed are to be applied on a "at least" basis, which seems to imply they are binding. However, the criteria listed for example in Annex 1 may not apply in certain situations. Credit granting criteria described in Annex 1, containing limit ratios, cannot always be imposed in their entirety. In particular, acceptable loan-to-income and debt-to-income ratio limits may sometimes reduce the effectiveness of risk systems compared to using net income.

Moreover, the expression "at least" adopted by the EBA is not appropriate and may be misunderstood by Supervisors, as such the wording adopted in Paragraph 132 (d) - "at least considering which metrics [in Annex 3] would be applicable..." - is in our view more appropriate.

Concerning Anti Money Laundering (AML) and Counter Terrorist Financing (CTF), we note that to enhance the quality of general standards, it could be considered that the information acquired for AML-CTF purposes could also be used for credit granting and monitoring processes, and vice versa.

Finally, concerning the EBA's NPL transaction templates, even if we understand from par. 56 that the use of such templates is not compulsory, we point out that an *ad hoc* analysis on the proposed templates and a proper feasibility check should be carried out with lenders of the various EU jurisdictions dealing with different asset classes. In any case, we believe in this context and in any other piece of EU legislation, templates should remain optional and banks will choose the data set relevant for their actual portfolio.

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

The requirement set on credit decision making may limit proven and well-functioning lending activity.

In more detail:

- limitations in credit decision making in terms of time and number should be removed. The number of delegated credit decisions is not correlated to an increase in terms of risks undertaken by the bank (e.g. par.59 limitations on the number of delegated approvals);
- paragraph 63, allowing individual approval 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 to eliminate point a) par. 63 for all the banks that can ensure a credit process that includes an independent opinion released by the credit function (i.e. that ensures the independency of the overall judgment, limiting the discretion of the delegated role).

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

The requirement set out in the Guidelines for the Credit risk management and internal controls framework to provide an "independent risk opinion to the credit decision takers" (par 76c) and an "independent/second opinion to the creditworthiness assessment" (par. 76g) seems to require an ex-ante supervision of the risk management function within the credit process.

This approach, implying an active role performed by the risk control function during the lending phase, might be hardly applicable as:

- the prior involvement of the risk control function appears not fully coherent with the separation of responsibilities between the ex-ante first line of defence (lending functions) vs the ex-post second line of controls (risk management) and, ultimately, with the regulatory principle of segregation of duty;
- the need to have second opinion to the creditworthiness assessment might trigger process inefficiencies related to the duplication of activities and skills in charge of different functions, entailing *inter alia* also additional staff costs.

Moreover, such requirements would lead to the elimination of all delegated powers assigned to the bank network and, implicitly, they would hinder timeliness in decision-making to adequately serve the economy.

The institutions falling under the scope of the Guidelines should be allowed to assign (limited) credit prerogatives to the bank network when supported by clear and sound criteria and methodologies for the assessment and granting of loans and/or in relation to non-complex type of products.

We suggest replacing the "Risk management" definition with "Independent Risk Function" (as indicated in other Guidelines, i.e. Guidelines on Leveraged Transactions) to better fit banks' organizational structures so that the required functions will be performed by areas that have the required functional competencies as long as segregation / independence toward the commercial area is ensured.

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

Information requirements seem to be rather prescriptive and, if so, the implementation costs would be high and disproportionate. Moreover, a gap analysis will be needed and the EBA should consider that in setting the implementation date.

Please consider the complexity of banks' organisation, their size and their territorial presence with, as in Intesa Sanpaolo's case, thousands of branches serving retail clients, SMEs and Corporates. Of course, digitalisation of documents is a path already undertaken, however more time will be needed to complete the process.

For most of the loans granted to SMEs, which represent a significant proportion of Intesa Sanpaolo's loan portfolio, some information listed in Annex 2 lead to disproportionate collecting costs compared to the economic value of the financing transaction or to the added value in the creditworthiness analysis. The Guidelines should therefore make clear that information listed in Annex 2 are examples and should be collected and verified only if they are relevant for the type of product, according to the proportionality principle. Again, the expression "at least" used by the EBA does not seem accurate as it implies that this information has always to be collected and does not allow for the application of the proportionality principle. Flexibility for less complex loans should be applied.

Asking for the mandatory availability of business plans and projections from all professionals 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 types of transactions is in fact not sustainable. Excluding the need for business plans and projections based on the borrower segment, materiality and complexity of the loan should be the possible way forward to implement the GL.

Moreover, it is not clear what the verification activities (as defined in paragraph 86 and 88) consist of and what are the possible consequences for banks in case of an inadequate course of this activity or to the lack of relevant documentation.

We underline again that the Guidelines should better state the possibility for differentiated information packages for different borrower segments according to the business of the bank (e.g. SME Retail, SME Corporate, Corporate etc.).

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

In general, while sharing EBA's views on the requirements for the assessment of creditworthiness, we reaffirm considerations previously summarized with reference to available information and documents (point 97) and the need for a more appropriate application of the proportionality principle. Moreover, for professional clients, sensitivity analysis may not be performed on certain subjects, as smaller clients do not always provide banks with their own forward-looking projections. In these cases, flexibility is needed.

As we said, in general, we consider credit granting criteria set out in Annex 1 as too detailed. Our suggestion is to simplify the list and consider the criteria as non-exhaustive and non-binding.

It must be clarified that the financial metrics (ratios) listed in paragraph 135 for the purposes of the creditworthiness assessment must not be always used, regardless of the characteristics and amount of the specific financial transaction.

In any case, possible difficulties may arise from the calculation of the DSCR (Debt Service Coverage Ratio): with reference to both cash flow availability for debt service (as business plans are not always provided) and to amortization profile of third parties debt.

In addition, it is necessary to specify how banks are required to document the use of these metrics for credit decision purposes and, to what extent, they have to be implemented in their rating system.

Regarding paragraph 166 (a), when faced with non-complex real estate developments, the opinion on the marketability could be provided directly within the appraisal, thus not requiring a "location specific review of supply and demand in the market by a reputable estate agent".

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

No further comments beyond what indicated in relation to questions 7 and 8.

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

Intesa Sanpaolo welcomes the EBA's approach on loan pricing, considering that the pricing strategy of institutions is not meant to be in the scope of the GL.

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

a) Movable property

Some EU National authorities (e.g. Croatian National Bank) have defined regulatory thresholds requiring individual valuation of movable property collateral at the point of origination to be performed by a valuer. The Guidelines should allow the institutions operating under the such jurisdictions to use regulatory thresholds instead of defining further internal ones.

b) Immovable property

With reference to paragraph 207 point (b), the requirement is deemed excessive if the change of frequency or approach when monitoring the value of an immovable property collateral is linked to changes from IFRS9 stage 1 to stage 2 or vice versa. Thus, the example ("e.g. IFRS 9 Stage 1 or Stage 2") should be cancelled. If need be, reference may be made to changes from "performing" to "non-performing" stage.

With reference to the requirement on the revaluation by a valuer of immovable property (ref. paragraph 213): in case of the review of an immovable property that should be valued by a valuer using the comparison approach, the valuer cannot perform a re-valuation neither with full valuation method nor with desk-top method, if he does not have adequate comparable data of similar immovable properties.

Furthermore, performing full appraisals for revaluation purposes instead of the current desktop or drive-by ones, would significantly increase the appraisals' annual cost, as well as delivery time could be severely delayed.

With regards to valuer's rotation principle stated in paragraph 214, it would be appropriate to specify that in case of Real Estate development financing, the rotation of valuers should be assured only in case of a new overall valuation of the immovable property. On the opposite, in case of activities ancillary to a valuation (e.g. inspection for verification of the work in progress), such activities should be performed by the same valuer that performed the original valuation and no rotation should be envisaged.

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

The principles outlined in the Guidelines concern many business areas of the bank. Therefore, it would be more appropriate to provide for a more precise and finalized application of the Guidelines to avoid the risk of operational duplication and double reporting.

Furthermore, monitoring requirements should be applicable on loans granted after the date of entry into force in order to (i) avoid double reporting system (i.e. one for the stock and one for the newly originated loans) and (ii) take into account that any IT implementation on the existing stock would require time, not consistent with the proposed 30 June 2020 deadline.

Please also consider that the sources of information are management data (connected with the origination and credit management) and statistical/prudential reporting for regulatory requirements. Both sources of information must be timely connected, but at the same time they must also be constantly aligned with the ECB initiatives and requirements, either in terms of granular collection of credit data (AnaCredit) or of aggregated data collection exercises (Credit Underwriting).

In fact, the ECB requirements are very detailed and banks have already made the investments necessary to be compliant for internal monitoring with the Supervisory Authority's requests. Therefore, we suggest that EBA Guidelines should be consistent with existing ECB monitoring data flows.

Concerning the use of early warning indicators in credit monitoring (paragraph 263), we see no major issues. Some attention should be paid in case of breach of covenants, which may also lead, in certain cases and where allowed by national law, to the termination of the contract with the client.