EBA/CP/2019/04

19 June 2019

Consultation Paper

Draft Guidelines on loan origination and monitoring

Contents

Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions raised in this consultation paper.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 30 September 2019. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation of the (EU) 2018/1725 European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

Executive Summary

The EBA developed the Guidelines on loan origination and monitoring in response to the European Council Action Plan on tackling the high level of non-performing exposures. The European Council, in its July 2017 Action Plan, invited the EBA to "issue detailed guidelines on banks' loan origination, monitoring and internal governance which could in particular address issues such as transparency and borrower affordability assessment".

The objective of the guidelines is to improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting in order to ensure that institutions have robust and prudent standards for credit risk taking, management and monitoring, and that newly originated loans are of high credit quality. The guidelines also aim to ensure that the institutions' practices are aligned with consumer protection rules and respect fair treatment of consumers. Through these objectives, the EBA aims to improve the financial stability and resilience of the EU banking system.

The guidelines specify the internal governance arrangements, processes and mechanisms as laid down in Article 74(1) of Directive 2013/36/EU (CRD) and further specified in the EBA Guidelines on Internal governance, and requirements on credit and counterparty risk as laid down in Article 79 of Directive 2013/36/EU in relation to granting and monitoring of credit facilities throughout their life cycle.

The guidelines introduce requirements for the borrowers' creditworthiness assessment together with the collection of information and data for the purposes of such assessments. The requirements to assess the creditworthiness of consumers and verification of consumer information are developed in accordance with Articles 18 and 20 of Directive 2014/17/EU (MCD). Furthermore, the guidelines also recognise the extension of the EBA scope of action in the review of the European Supervisory Authorities Founding Regulations, and incorporate provisions for the creditworthiness assessment in relation to consumer credit in accordance with Article 8 of Directive 2008/48/EC on consumer credits (CCD).

To support the dual focus of the guidelines bringing together prudential framework and consumer protection aspects of credit granting, in particular, the guidelines:

a. clarify internal governance and control framework for the credit granting and credit decision-making process, building on the requirements of the EBA Guidelines on internal governance (Section 4);

b. set out requirements for information and data collection from borrowers, documentation, and requirements for the borrowers' creditworthiness assessment (Section 5);

c. set out supervisory expectations for the risk-based pricing of loans (Section 6);

d. provide guidance on the approaches to the valuation of immovable and movable property collateral at the point of credit granting, and monitoring and review of the value of such collateral based on the outcomes of the monitoring (Section 7); and

e. specify the ongoing monitoring of credit risk and credit exposures, including regular credit reviews of professional borrowers (Section 8).

The EBA has developed these guidelines building on the existing national practices and supervisory experience, addressing also shortcomings in the institutions' credit granting policies and practices highlighted by the recent financial crisis. At the same time, guidelines also 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, anti-money laundering and counter-terrorist financing, as well as technology-based innovation.

For the implementation of these guidelines, the proportionality principle is interpreted and applied differently in relation to various sections of the guidelines. First, for the implementation of the requirements related to the internal governance, risk management and control, institutions and competent authorities should consider a proportionality principle that is based on the size, nature and complexity of the institutions. Second, when implementing the requirements for the creditworthiness assessment, loan pricing, collateral valuation and credit risk monitoring, competent authorities and institutions should consider the type, size, and complexity of the credit facilities being granted or monitored.

Next steps

The guidelines will be finalised following the completion of the public consultation. The guidelines will be translated into the official EU languages and published on the EBA website. The deadline for competent authorities to report whether they comply with the guidelines will be two months after the publication of the translations. The guidelines will apply from 30 June 2020.

Background and rationale

1. As part of the EU response to tackling the high level of non-performing exposures, the European Council in its July 2017 Action Plan[1] invited the EBA to "issue detailed guidelines on banks' loan origination, monitoring and internal governance which could in particular address issues such as transparency and borrower affordability assessment". The Council stressed that "these guidelines should leverage on existing national experiences where relevant".

2. Within the framework of the Council Action Plan the EBA already published Guidelines on management of non-performing and forborne exposures[2] and developed NPL transaction templates[3] with the view to improve data quality and information symmetry between institutions and investors in the NPL secondary markets in Europe. These previous initiatives aim to tackle problems around loans once they become non-performing, while the current guidelines on loan origination and monitoring have been developed in order to ensure that institutions have in place prudential loan origination standards in order to prevent newly originated performing loans from becoming non-performing in the future.

3. The guidelines specify the internal governance arrangements, processes and mechanisms as laid down in Article 74(1) of Directive 2013/36/EU (CRD)[4] and further specified in the EBA Guidelines on Internal governance[5], and requirements on credit and counterparty risk as laid down in Article 79 of Directive 2013/36/EU in relation to granting and monitoring of credit facilities throughout their life cycle. The guidelines also set out requirements for the creditworthiness assessment of borrowers together with collection of information and data for the purposes of such creditworthiness assessments. The requirements to assess the creditworthiness of consumers and verification of consumer information are developed in accordance with Articles 18 and 20 of Directive 2014/17/EU (MCD)[6].

4. The objective of the guidelines is to improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting in order to ensure that institutions have robust and prudent approaches to credit risk taking, management and monitoring, and newly originated loans are of high credit quality, whilst respecting and protecting the interests of consumers. Through achieving these objectives, the EBA aims at improving the financial stability and resilience of the EU financial system.

[1] EU Council Action Plan to tackle non-performing loans in Europe (https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/)

[2] EBA/GL/2018/06

[3] https://eba.europa.eu/risk-analysis-and-data/eba-work-on-npls

[4] OJ L 176, 27.6.2013 p. 338-436

[5] EBA/GL/2017/11

[6] OJ L 60, 28.2.2014 p. 34-85

Structure of the guidelines

5. The main body of the guidelines comprise five sections, where:

   a. Section 4 provides the details for the application of general internal governance framework as set out in the EBA Guidelines on internal governance in relation to credit granting process. This section looks into the topics of (1) credit risk governance and culture by also explaining the specific roles of the management body; (2) credit risk appetite, strategy and credit risk limits by explaining how these concepts fit into the institutions' overall risk appetite framework and strategy; (3) credit risk policies and procedures by setting out general and specific criteria to be considered in such policies; (4) credit decision-making process highlighting the principle of independence between different (e.g. business and risk) functions in decision-making; (5) setting out the requirements for robust and effective credit risk management and internal control frameworks as part of the institutions' overall risk management and control frameworks; (6) resources, skills and IT and data infrastructure institutions that need to be in place for prudent and robust credit decision-making process; and (7) the application of general remuneration requirements to credit risk granting with a view to mitigate excessive risk taking in lending activities.

      In Section 4, the guidelines also set out supervisory expectations for the institutions when their lending activities involve leveraged transactions, technology-enabled innovations, environmental factors and green lending, as well as on their data infrastructure.

      In these guidelines, the EBA is introducing prominently a green lending dimension, and is setting requirements for the institutions to consider environmental factors, green lending and associated risks in their credit policies and procedures. This is a significant step considering the importance of the topic for the EU, with the three ESAs separately being mandated to develop technical standards under the Joint Committee related to sustainability.

   b. The focus of Section 5 is loan origination practices. It specifies (1) collection and documentation of information and data from borrowers for the creditworthiness assessment; (2) assessment of borrowers' creditworthiness; and (3) setting out requirements for credit decision and loan agreements. The section covers lending to consumers and professionals including both secured and unsecured lending. A set of general requirements for lending to consumers is followed by asset class/product-specific requirements including lending to consumers secured by immovable property, lending to consumers secured by other property, and unsecured lending to consumers. Similarly, the section sets general requirements on lending to professionals. General requirements are followed by asset class/product-specific requirements, including commercial real estate, real estate development, shipping finance, project and infrastructure finance.

      Whilst all sections of the guidelines apply in relation to granting and monitoring of all credit facilities, excluding debt instruments, Section 5 and 6 apply in relation to loans and advances only. Furthermore, 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 and 6, as the creditworthiness assessment of these borrowers would significantly differ from the assessment of tradition private and corporate loans.

c. Section 6 sets out supervisory expectations for the risk-based pricing of loans listing a minimum set of risk-based elements that institutions should consider and reflect when pricing newly originated loans.

d. Section 7 looks at the requirements for the valuation of immovable and movable property collateral (excluding financial collateral) at the point of origination of credit facilities, as well as throughout the life cycle of the loans including monitoring and revaluation (i.e. review of the value of the collateral). In this section the guidelines spell out supervisory expectations for independent valuers to be used by the institutions for valuation and revaluation, in particular as regards their independence and for the use of statistical models for valuation, monitoring and revaluation purposes.

e. Section 8 of the guidelines focuses on supervisory requirements for the ongoing monitoring of credit risk and credit exposures, including regular credit reviews of professional borrowers. In this section the EBA also sets out supervisory expectations for the management information systems to be used for monitoring and the framework of early warning indicators, thus building the link between the ongoing monitoring and early detection of loans with deteriorating credit quality that are also covered in the EBA Guidelines on management of non-performing and forborne exposures.

6. The guidelines are supported by three annexes presenting a set of considerations for credit granting criteria (Annex 1), for the types of documents to be collected by the institutions for the purposes of creditworthiness assessment (Annex 2), and metrics that can be used in credit granting and monitoring (Annex 3).

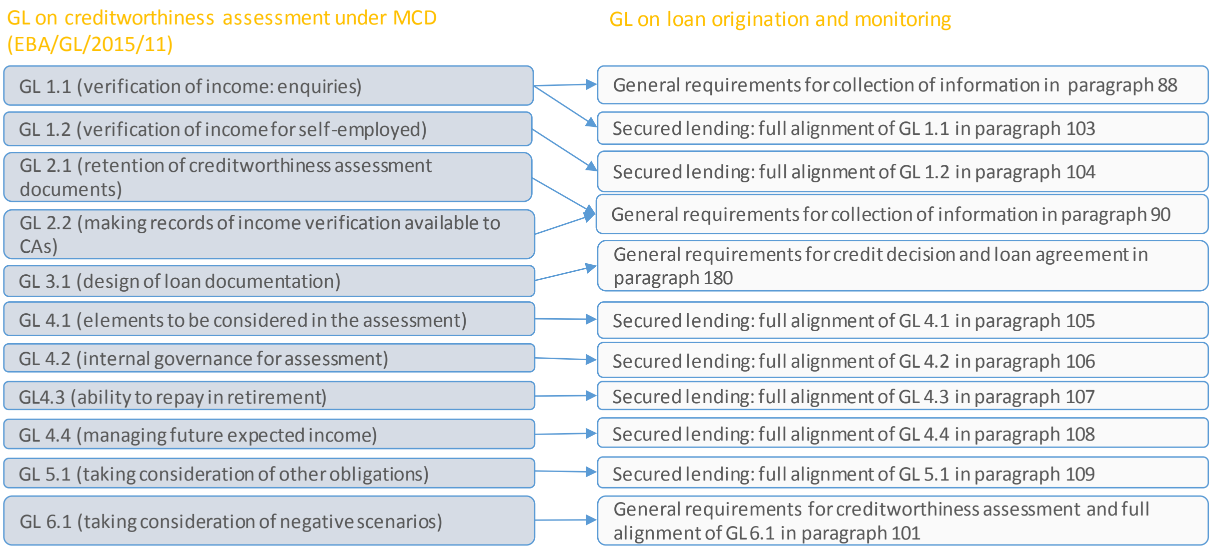
Interaction between prudential and consumer protection frameworks

7. Sound lending practices employed by the institutions and robust and effective assessment of the borrowers' creditworthiness at the point of loan origination is important both from a prudential point of view and consumer protection perspective. Failure to complete an accurate and thorough creditworthiness assessment may have negative consequences for the institutions and borrowers, and affect the overall financial stability, as borrowers may not be able to meet their contractual commitments under the loan agreements. As a result, the level of non-performing exposures in the markets may increase. The EBA statutory objectives include both prudential and financial stability as well as consumer protection. To this end, it is important that the guidelines reflect these objectives and address the issues of loan origination

and creditworthiness assessment both from prudential and consumer protection angles, as indicated in the Council Action Plan.

8. Consumer protection perspective of these guidelines is of particular importance when setting the requirements for the creditworthiness assessment in the context of lending to consumers and collection of information and data for such assessment (Sections 5.1.2, Sections 5.2.1 and 5.2.2). The requirements of these sections provide further details on the creditworthiness assessment of consumers and verification of consumer information as laid down in Articles 18 and 20 of Directive 2014/17/EU when dealing with lending secured by residential immovable property.

9. The EBA has previously issued guidelines specifying such creditworthiness assessment for credit agreements with consumers in respect of credit agreements which fall under the scope of Article 3 of Directive 2014/17/EU, i.e. credit agreements secured by residential immovable property – EBA Guidelines on creditworthiness assessment[7]. Given the dual focus of the Guidelines on loan origination and monitoring, the EBA decided to fully incorporate the EBA Guidelines on creditworthiness assessment into the new guidelines and repeal them with the effect from the date of application on these guidelines. The chart below illustrates how the EBA Guidelines on creditworthiness assessment is incorporated in the new guidelines.



10. Incorporation of the consumer protection aspects into these guidelines, and integration (and repeal) of the Guidelines on creditworthiness assessment under the MCD ensures that there is a comprehensive set of guidelines covering the creditworthiness assessment from prudential and consumer protection angles across different types of institutions, asset classes and loan products. This is of particular importance for institutions subject both to CRD, MCD and CCD (e.g. credit institutions offering loans secured by residential immovable property) that will need to implement only one set of guidelines on creditworthiness assessment.

[7] EBA/GL/2015/11

11. This consultation paper takes into account the EBA's scope of action, which has been amended through the review of the European Supervisory Authorities Founding Regulations, which has been adopted by the European Council and European Parliament in first reading and is due to be published in the Official Journal of the Union in the next months. The review brings both Directive 2008/48/EC on consumer credits (CCD) and Directive 2014/17/EU (MCD) into EBAs scope of action. The new EBA scope of action is intended to be applicable as of 1 January 2020, which means that the new scope is intended to be applicable before the application date of these guidelines.

Proportionality and implementation

12. The implementation of these guidelines is subject to the principle of proportionality, and the proportionality principle is interpreted and applied differently for various sections of the guidelines. First, for the implementation of the requirements related to the internal governance, risk management and control, institutions and competent authorities should consider a proportionality principle that is based on the size, nature and complexity of the institutions. For the purposes of such proportionality, the guidelines do not introduce any additional criteria and refer to the principle of proportionality defined in the EBA Guidelines on internal governance.

13. Second, when implementing the requirements for the creditworthiness assessment, loan pricing, collateral valuation and credit risk monitoring, competent authorities and institutions instead of size and complexity of institutions, should consider the type, size, and complexity of the credit facilities being originated or monitored, because this is the main driver that could give rise to disproportionate application of the guidelines.

14. The above differentiation in the application of proportionality aims to ensure that while even smaller and less complex institutions have a robust and effective credit granting process, loan origination and monitoring criteria are proportionate to the type, size, complexity and risk profile of the loans that the institutions are originating or credit facilities they are monitoring.

15. Consumer protection aspects set out in these guidelines when dealing with the creditworthiness assessment of consumers should not be subject to the application of the principle of proportionality. Consumer protection framework should be applied regardless of the size and complexity of the institutions or of the loan.

16. These guidelines apply from 30 June 2020 meaning that (1) the competent authorities should implement these guidelines by incorporating them in their supervisory processes and procedures, and (2) institutions should implement them in their business practices by 30 June 2020. It should be noted that the requirements for loan origination in Section 5 of these guidelines apply to loans and advances 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.

Draft guidelines

Draft Guidelines

on loan origination and monitoring

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010[8]. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.

2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by ([dd.mm.yyyy]). In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to compliance@eba.europa.eu with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to EBA.

4. Notifications will be published on the EBA website, in line with Article 16(3).

[8] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p.12).

2. Subject matter, scope and definitions

Subject matter

5. These guidelines specify the internal governance arrangements, processes and mechanisms as laid down in Article 74(1) of Directive 2013/36/EU[9], requirements on credit and counterparty risk as laid down in Article 79 of that Directive, and requirements in relation to the creditworthiness assessment of the consumer as laid down in Chapter 6 of Directive 2014/17/EU[10] and Article 8 of Directive 2008/48/EC[11].

Scope of application

6. These guidelines apply to the internal governance and procedures in relation to credit granting processes and throughout the life cycle of credit facilities. Furthermore, these guidelines apply to the risk management practices, policies, processes and procedures for loan origination and monitoring performing exposures, and their integration into the overall management and risk management framework.

7. Debt securities are excluded from the scope of application of these guidelines.

8. The requirements for internal governance and monitoring provided in Sections 4 and 8 apply in relation to all credit risk being taken by the institutions.

9. Sections 5 and 6 on requirements for loan origination and pricing cover the process of granting loans to consumers and professionals. Sections 5 and 6 do not apply to 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.

10. 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.

[9] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, (OJ L 176, 27.6.2013 p. 338-436)

[10] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010, (OJ L 60, 28.2.2014 p. 34-85)

[11] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, (OJ L 133, 23.4.2008 p. 66-92)

11. Section 7 applies to the valuation, monitoring and revaluation of immovable property collateral and movable property collateral, excluding financial collateral.

12. These guidelines apply to institutions as defined in point 3 of Article 4(1) of Regulation (EU) No 575/2013. Where the credit facility falls under the scope of Directive 2014/17/EU, Section 5 applies to creditors as defined in Article 4(2) of that Directive. Where the credit facility falls under the scope of Directive 2008/48/EC, Section 5 applies to creditors as defined in point (b) of Article 3 of that Directive.

13. 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. Competent authorities should also ensure that the institutions apply these guidelines at sub-consolidated and individual levels in line with the consolidated level group policies and practices, taking into account the characteristics of these institutions.

14. Institutions should apply section 4 of these guidelines in line with the proportionality principle described in Title I of EBA Guidelines on internal governance. Institutions should apply sections 5, 6, 7 and 8 of these guidelines in a manner that is comprehensive and proportionate to the size, nature and complexity of the credit facility.

Question for the consultation:

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

Addressees

15. These guidelines are addressed to competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 and to financial institutions as defined in Article 4(1) of Regulation No 1093/2010.

Definitions

16. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013, Directive 2013/36/EU, Directive 2014/17/EU, Directive 2008/48/EC, Commission Implementing Regulation (EU) No 680/2014, EBA Guidelines on internal governance under Directive 2013/36/EU[12], EBA Guidelines on connected clients under point 39 of Article 4(1) of Regulation (EU) No 575/2013[13], EBA and ESMA Guidelines on the assessment of the suitability of members

[12] EBA/GL/2017/11

[13] EBA/GL/2017/15

of the management body and key function holder[14], EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013[15], EBA Guidelines on remuneration policies and practices for sales staff[16], EBA Guidelines on outsourcing arrangements[17], and EBA Guidelines on institutions' stress testing[18] have the same meaning in these guidelines.

17. In addition, for the purposes of these guidelines, the following definitions apply:

Commercial real estate (CRE)	means any income-producing real estate, either existing or under development, including rental housing; or real estate used by the owners of the property for conducting their business, purpose or activity, either existing or under construction; that is not classified as residential real estate (RRE); and includes social housing. If a property has a mixed CRE and RRE use, it should be considered as different properties (based for example on the surface areas dedicated to each use) whenever it is feasible to make such breakdown; otherwise, the property can be classified according to its dominant use
Commercial real estate (CRE) loan	means a loan extended to a legal entity aimed at acquiring income-producing real estate (or set of properties defined as income-producing real estate), either existing or under development, or 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, or secured by a CRE property (or set of CRE properties)
Disposable income	means the borrower's total yearly disposable income as registered by the credit provider at the moment of the loan origination, covering all sources of income minus taxes (net of tax rebates) and premiums (such as for health care, social security or medical insurance), and before deduction of expenses

[14] EBA/GL/2017/12
[15] EBA/GL/2015/22
[16] EBA/GL/2016/06
[17] EBA/GL/2019/02
[18] EBA/GL/2018/04

Green lending	means lending dependent on climate and/or environmental criteria for the planned use of funds. It is part of the wider concept “Green finance”, meaning any financial instrument or investment – including equity, debt, guarantee, or a risk management tool issued in exchange for the delivery of positive climate-and/or environmental effects
Income producing real estate	means all immovable properties with income generated by their rents or profits from their sale
Income producing property under development	means all property still being constructed and intended to provide, upon completion, an income to its owner in the form of rents or profits from its sale; it does not include demolition of buildings or sites being cleared for possible development in the future
Loan	means loans and advances as defined in Annex V to Commission Implementing Regulation (EU) No 680/2014
Professional	means non-consumer
Residential real estate (RRE)	means any immovable property available for dwelling purposes, either existing or under construction, acquired, built or renovated by a natural person, including buy-to-let housing. If a property has a mixed use, it should be considered as different properties (based for example on the surface areas dedicated to each use) whenever it is feasible to make such breakdown; otherwise, the property can be classified according to its dominant use
Residential real estate (RRE) loan	means a loan to a natural person secured by a residential real estate property, independent of the purpose of the loan
Shipping finance	means financing of all activities involved in building, acquisition and operation of ships and offshore installations, where the financial servicing of credit facilities is dependent on the cash flow from operating or sales of such ships or offshore installations, or where the collaterals are structured around ships or the offshore installations, shipbuilding or various charter arrangements

3. Implementation

Date of application

18. These guidelines apply from 30 June 2020.

Repeal

19. The following guidelines are repealed with effect from the date of application of these guidelines:

    a. Guidelines on Creditworthiness assessment (EBA/GL/2015/11)

Question for the consultation:

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

4. Governance requirements for credit granting and monitoring

20. In addition to the provisions set out in the EBA Guidelines on internal governance, in particular in relation to the provisions under Title II and Title III thereof, institutions should apply further conditions in relation to credit granting and monitoring as set out in this section.

4.1 Credit risk governance and culture

4.1.1 Responsibilities of the management body

21. The responsibilities of the management body should at least include the following:

    a. defining credit risk appetite within the overall risk appetite framework (RAF), including lending standards, qualitative statements, quantitative metrics and limits;

    b. approving the institution's credit risk strategy, within the overall risk strategy, and business strategy to ensure that they are in line with the institution's RAF, capital and liquidity planning, and are in line with ICAAP and ILAAP, where relevant;

    c. defining the framework for credit approval process, including, where relevant, the internal structures for credit granting and monitoring, and defining delegated decision-making authorities;

    d. ensuring an effective oversight of credit risk quality and provisioning;

    e. ensuring adequate credit approval, monitoring and control processes, for the purposes of effective credit risk management;

    f. ensuring that all staff involved in credit risk taking, managing, monitoring and controlling of credit risk are adequately skilled, resourced and experienced;

    g. setting, approving and overseeing the implementation of the institution's core values and expectations in credit risk culture, within the overall corporate culture of the institution.

4.1.2 Credit risk culture

22. Institutions should set credit risk culture as part of the overall risk culture in accordance with the EBA Guidelines on internal governance.

23. The credit risk culture should provide an adequate 'tone from the top' and ensure that credits are being granted to borrowers who, to the institution´s best knowledge at the time of granting

the credit, will be able to fulfil the terms and conditions of the credit agreement and secured, where relevant by sufficient and appropriate collateral, where relevant, and considering the impact on the institution's capital position and profitability, and sustainability, environmental, social and governance factors.

24. Institutions should ensure that credit risk culture is implemented effectively and across all levels of the governance structure, including all members of staff involved in the credit risk taking, credit risk management and monitoring processes.

25. Institutions should adopt processes to monitor adherence of all staff members involved in credit granting, monitoring and control processes to the institution's credit risk culture (e.g. by means of self-assessments by staff members). In situations where there are noted deficiencies in the credit culture evidenced either via institution self-assessment or via supervisory actions, the institution should take well-defined, outcome-driven and timely actions to remediate those deficiencies. The credit risk strategy, credit policies and procedures should be tailored to mitigate any potential negative effects arising from a deficient credit culture.

4.2 Credit risk appetite, strategy and credit risk limits

26. The credit risk appetite, credit risk strategy and the overall credit risk policy should be aligned to the institution´s overall RAF. Institution's credit risk appetite should specify the scope and focus of the total credit risk of the institution, the desired composition of the credit portfolio, including geographical location of the borrower, types and geographic locations of collateral, economic sectors and the type of credit facilities, as well as the desired diversification and concentration.

27. When defining the credit risk appetite, institutions should ensure that both top-down (e.g. setting high-level targets) and bottom-up perspectives (e.g. operationalisation of these high-level targets). These perspectives should be also supported by an adequate budgeting process.

28. The credit risk appetite and strategy should include, where applicable, appropriate specific credit risk metrics and limits, which should be a combination of backward-looking and forward-looking indicators. Such indicators should include key aspects of the credit facilities including their geographical coverage, business lines, asset classes, sectors, client segments, currency, credit risk mitigation instruments and products. These indicators should be tailored to the business model and the complexity of the institution.

29. Institutions should ensure that credit risk appetite and associated metrics and limits are adequately cascaded down within the organisation, including all group entities and business lines.

30. For the purposes of managing concentration risk, institutions should set quantitative internal credit risk limits for their aggregate credit risk, as well as for portfolios with shared credit risk characteristics, sub-portfolios and individual borrowers. In the case of group entities and

connected clients, the limits should account also for the consolidated and sub-consolidated position and the position of the individual entities of the consolidated and sub-consolidated levels.

4.3 Credit risk policies and procedures

31. In the framework of credit risk policies and procedures, institutions should set out the criteria to identify, assess, approve, monitor, report and control credit risk, and criteria to measure allowances for both accounting and capital adequacy purposes. Institutions should document the framework and update it regularly.

32. The objective followed in credit risk policies and procedures should promote a proactive approach to monitoring credit quality, identifying deteriorating credits and shaping the credit quality and associated risk profile as a result of new credit granting activities, while at the same time making sure that money laundering and terrorist financing (ML/TF) risks associated with the granting and repayment of credits are well understood and addressed.

33. Credit risk policies and procedures should cover all lending activities, asset classes, client segments, products and specific credit facilities, credit risk management practices, and associated responsibilities and controls.

34. Credit risk policies and procedures should establish and identify specific lending policies and procedures at a sufficient granularity to capture specific business lines of the institution, for different sectors in line with their varying complexities and sizes, and risks of different market segments related to the credit facility.

35. Within the credit risk policies and procedures, institutions should specify at least the following:

    a. the framework on credit risk policies and procedures and rules for the approval of credit granting and decision-making including their authorisation levels within the institution;

    b. credit granting criteria; while specifying these criteria, institutions should at least consider items referred to in Annex 1;

    c. requirements for the collection, verification and analysis of information and data needed for the creditworthiness assessment as set out in Section 5.1;

    d. requirements for the creditworthiness assessment, including sensitivity analysis as referred to in Section 5.2;

    e. requirements for exposure aggregation and credit risk limits and concentration;

    f. requirements and procedures regarding the acceptance and use of collateral and credit risk mitigation measures and their effect on minimising inherent risk of a credit facility;

g. conditions for the application of automated decision-making in credit granting process, including identifying products, segments and limits for which automated decision-making is allowed;

h. requirements and associated procedures for the handling and approval of exceptions and breaches from the rules under the credit risk policies and procedures, e.g. overrides, overrules, exposures granted with an exception to credit risk policies and other non-standard business under a special process with different approval authorities;

i. requirements relating to what is to be documented and recorded as part of the credit granting process including for sampling and audit purposes. This should include at a minimum the requirements for the completion of credit applications, the qualitative and quantitative rationale/analysis and all supportive documentation that served as a basis for approving or declining the credit facility;

j. requirements for monitoring credit granting activities. The internal control framework should ensure that it is covering all phases after the granting of credit;

k. where applicable, the requirements as set out in Section 4.3.2, 4.3.3 and 4.3.4; and

l. requirements as set out in Section 4.3.5.

36. The credit granting criteria referred to in paragraph 35(b) should enable institutions to operationalise the credit risk appetite in consistence with the credit risk strategy and should provide input for evaluating the impact of the credit facility in request on the institution´s credit risk profile and credit risk capacity.

37. The requirements and procedures regarding the acceptance and use of collateral referred to in paragraph 35(f) should be asset class and product type-specific and should duly consider the type, size, and complexity of the credit facilities being granted.

38. Institutions should ensure that the credit risk policies and procedures are designed in a way to minimise the risk of internal or external fraud in the credit granting process. Institutions should have adequate processes in place to monitor any suspicious or fraudulent behaviour.

39. Institutions should review the credit risk policies and procedures on a regular basis and for this purpose should clearly identify the functions and staff members tasked with maintaining specific policies and procedures up-to-date and their roles and responsibilities in this regard.

4.3.1 Anti-money laundering and counter-terrorist financing policies and procedures

40. Institutions should also specify in their policies how they identify, assess and manage the money laundering and terrorist financing (ML/TF) risks to which they are exposed as a result of their credit granting activities[19]. In particular, institutions should:

    a. at the level of their business, identify, assess and manage the ML/TF risk associated with the type of customers they service, the lending products they provide, the geographies to which they are exposed, and the distribution channels they use;

    b. at the level of the individual relationship, identify, assess and manage the ML/TF risk associated with that relationship and any third party that might be associated with the credit facility, and the purpose of the credit. As part of this, institutions should take risk-sensitive measures to establish that the source of any funds the customer will use to service the credit, including cash or equivalents provided as collateral, are from legitimate sources. When establishing the legitimacy of the source of funds, institutions should have regard to the activity that generated the funds and whether this information is credible and consistent with the institution's knowledge of the customer and their professional activity.

41. Institutions should have internal processes to ensure that information obtained for purposes of creditworthiness assessment, such as those specified in Section 5.1 and Annex 2 of these guidelines also inform their AML/CFT processes.

42. Institutions should have policies and procedures for the disbursement of the loans ensuring that the disbursement is made in line with the credit decision and the loan agreement and ensuring that there are appropriate checks in place considering risks connected to ML/TF in line with institutions' obligations in relation to Anti-money laundering and counter-terrorist-financing (AML/CTF) requirements. Institutions should record clearly the necessary documentation for the disbursement following a positive outcome on the credit decision.

4.3.2 Leveraged transactions

43. As part of their policies and procedures, institutions should have in place an overarching definition of leveraged transactions. The scope and implementation of the definition of a leveraged transaction by the institution should be regularly reviewed to ensure that no undue exclusion has been made.

44. Institutions should define their appetite and strategy for leveraged transactions, including which types of leveraged transactions they are prepared to enter into, in a way that

[19] Directive (EU) 2015/849 requires credit institutions to put in place and maintain effective policies and procedures to prevent ML/TF and to detect and deter it should it occur. Institutions should also refer to the ESAs' Joint Risk Factors Guidelines (JC 2017 37) for further information on these points.

encompasses the various business units involved in such operations. In particular, institutions should define acceptable leverage levels, including at sector level, when relevant.

45. Institutions should establish a sound governance structure for leveraged transactions, enabling a comprehensive and consistent oversight of all leveraged transactions originated, syndicated or purchased by them.

46. Institutions should ensure that all leveraged transactions are adequately reviewed, in line with institutions' risk appetite, strategies and policies and approved by relevant decision-making bodies. For transactions including syndication and underwriting risks, there should be specific approval requirements and processes in place.

4.3.3 Technology-enabled innovation for credit granting

47. When using technology-enabled innovation for credit granting purposes, institutions should *inter alia*:

    a. adequately capture in their risk management and controls framework the risks associated with the technology-enabled innovation in use;

    b. manage the potential for bias (e.g. as a result of using model of the technology-enabled innovation relying on certain types of data or data sources) in the credit decision-making process, ensuring that appropriate safeguards are in place for the integrity of data and systems;

    c. be able to explain the outcome, understand the underlying model of the technology-enabled innovation used and ensure its traceability, auditability, robustness and resilience;

    d. verify and regularly monitor the related outputs and compare their performance with the outputs of traditional methods/tools;

    e. properly document and periodically review the related processes and models of the technology-enabled innovation;

    f. ensure that the management body understands how the underlying technology-enabled innovation is used and impacts institutions' credit granting procedures;

    g. ensure that the credit risk management function understands and is able to explain the behaviour of the technology-enabled innovation in use.

4.3.4 Environmental factors and green lending

48. Institutions should include environmental, social and governance (ESG) factors as well as risks and opportunities related to ESG in their risk management policies, credit risk policies and

procedures. Institutions should adopt a holistic approach, and incorporate ESG considerations in their credit risk policies and procedures.

49. As part of their credit policies and procedures, institutions that originate or plan to originate green credit facilities should develop specific green lending policies and procedures covering granting and monitoring of such credit facilities. These policies and procedures should, in particular:

    a. provide a list of the green projects and criteria that the institutions consider as eligible as part of their green lending policy or relate to one or more generally accepted standard on what type of lending is considered to be green; and

    b. specify the process by which the institutions are evaluating that the proceeds of the green credit facilities they have originated are properly used. For professionals such process should include:

        i. collecting information about the climate related and environmental business objectives of the borrowers;

        ii. assessing the conformity of the borrowers' funding projects with the qualifying green projects and related criteria;

        iii. ensuring that the borrowers have the willingness and capacity to appropriately monitor and report the allocation of the proceeds towards the green projects; and

        iv. monitoring on a regular basis that the proceeds are allocated properly (which may consist in requesting borrowers to provide updated information on the use of the proceeds until the relevant credit facility is repaid).

50. Institutions should position their green lending policies and procedures within the context of their overarching objectives, strategy and policy related to sustainable finance. In particular, institutions should set up qualitative and quantitative targets to support the development and the integrity of their green lending activity and to assess the extent to which this development is line with or is contributing to their overall climate-related and environmentally sustainable objectives.

51. Institutions should in particular take into account risks associated with environmental factors and climate change in their credit risk policies and procedures. The risks of climate change for the financial performance of borrowers can be classified as physical risks or transition risks.

52. Transition risks are risks to the borrower that arise from the transition to a low-carbon and climate-resilient economy, and include:

a. policy risks, for example as a result of energy efficiency requirements, carbon-pricing mechanisms which increase the price of fossil fuels, or policies to encourage sustainable land-use;

b. legal risks, for example the risk of litigation for failing to avoid or minimise adverse impacts on the climate, or failing to adapt to climate change;

c. technology risks, for example if a technology with a less damaging impact on the climate replaces a technology that is more damaging to the climate;

d. market risks, for example if the choices of customers shift towards products and services that are less damaging to the climate; and

e. reputational risks, for example the difficulty of attracting and retaining customers, employees and investors if a company has reputation for damaging the climate.

53. Physical risks are risks to the borrower that arise from the physical effects of climate change, and include:

a. acute physical risks, which arise from particular events, especially weather-related events such as storms, floods, fires or heatwaves that may damage production facilities and disrupt value chains; and

b. chronic physical risks, which arise from longer-term changes in the climate, such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity.

Question for the consultation:

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)?**

4.3.5 Data infrastructure

54. Institutions should have appropriate data infrastructure to support the credit granting process and for the purposes of credit risk management and monitoring throughout the life cycle of the credit facilities (e.g. loan origination and creditworthiness assessment, risk assessment, credit review and monitoring). The data infrastructure should ensure the continuity, integrity and security of information on the exposure, borrower and collateral from the point of origination and throughout the life cycle of the credit facility.

55. The data infrastructure should be detailed and sufficiently granular to capture specific loan-by-loan information at the point of origination allowing linking data regarding the borrower with data regarding collateral to support effective monitoring of credit risk (see Section 8) and

enable effective audit trailing, operational and credit performance and efficiency measurement as well tracking of policy deviations, exceptions and overrides (including credit/transaction rating or scoring overrides).

56. For the purposes of data collection and management, institutions should consider using the relevant data fields from the EBA's NPL transaction templates[20].

Question for the consultation:

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

4.4 Credit decision-making

57. Institutions should establish a clear and well-documented credit decision-making framework that should set out a clear and sound structure for the credit decision-making responsibilities in the institution, including structures of credit committees and delegated credit decision-making bodies.

58. The structure of credit committees and delegated credit decision-making bodies should be in line with credit risk appetite, policies and limits and reflect the business model of the institutions.

59. The credit-decision making framework should clearly articulate decision-making powers and limitations of each committee or delegated credit decision-making bodies. These powers and limitations should account for the asset class, product type, type and quality of the borrower, geographic location of the borrower, economic sector and industry, and credit limits/maximum exposures. For the purposes of delegated credit decision-making bodies, institutions should set limits on the time period for the delegated powers and the number of delegated approvals.

60. The credit-decision making framework should also account for the involvement of credit risk function in the decision making and represent a good balance between the business and risk functions. The framework should also specify the working modalities of the committees and roles of its members, including such aspects as the voting procedures (unanimity or simple majority of votes).

61. When the credit risk management function and head of risk management function are represented in credit committees, the credit-decision framework should specify their mandates. In particular, if the institutions grant specific veto rights to head of risk management function, they should consider granting such veto right to the staff members representing risk management function at all levels of the credit decision making framework. Institutions should

[20] https://eba.europa.eu/risk-analysis-and-data/eba-work-on-npls

specify the scope of such veto right, the escalation or appeal procedures, and how the management body will be involved.

62. Individual delegated authority should be governed by a set of standards to support consistent risk based decision making. Where members of staff are delegated with a relevant authority level for credit decision purposes, there should be a well-defined framework to control the process, establish minimum applicability and professional suitability for such delegated authority. Individual delegated authority holders should be adequately trained and hold relevant expertise and seniority in relation to the specific authority level delegated to them.

4.4.1 Independence in credit decision-making

63. Institutions should ensure that the framework for credit decision-making is established with the principle of independence and minimisation of conflict of interest in line with the EBA Guidelines on internal governance. More specifically for the purposes of these guidelines institutions should ensure that any individual involved in credit decision-making such as members of staff and members of management body:

    a. should only have limited sole delegated credit authority for credit decisions for small and non-complex credit facilities. The specific criteria, exposure levels and associated aspects should be defined in the relevant delegation policy and be approved by the management body;

    b. should not take part in credit decisions in the following situations:

        i. any individual involved in credit decision-making has a personal or professional relationship with the borrower;

        ii. any individual involved in credit decision-making has an economic, political or any other interest, including direct or indirect, existing or potential, financial or non-financial, associated with the borrower; or

        iii. any individual involved in credit decision-making has political influence or political relationship with the borrower.

    c. any individual involved in credit decision-making, who have the personal or professional relationship with the borrower and those who are subject to remuneration schemes associated with the growth of new business, should be separated (including at the management body level) from any functions dealing with loan administration, including disbursement, and from the credit risk management function;

64. Notwithstanding the governance structures implemented in institutions to operationalise the credit decision-making process via delegated authority framework, all institutions are expected to have in place organisational control and monitoring structures, policies and procedures that

guarantee and embed independence in the credit decision-making process. These organisational control and monitoring structures, policies and procedures, and any mitigating measures should be clearly defined and easily understood and should address any potential conflicts of interest or issues regarding independence. Institutions need to ensure, via the decision-making governance structures, that there is sufficient oversight and independence in the credit decision making and credit granting processes within the institution.

4.4.2 Exception and escalation procedures

65. Institutions should establish a risk-based framework and policies for dealing with exceptions to and deviations from credit policies and procedures, their monitoring, record and reporting. The framework and associated policies should clearly define the approval process and procedures on how and under what circumstances and conditions a credit grating decision needs to be transferred to a higher credit decision-making level.

66. Institutions should ensure that staff members involved in credit granting and management escalate and report the full nature of exceptions to policies and breaches of limits internally to the appropriate governance body in accordance with the escalation procedure. The exceptions and breaches should be documented for the audit trail and revisited by the relevant functions in the regular review of the policies or limits.

4.4.3 Lending to affiliated parties

67. Institutions should ensure that lending to the parties affiliated with the institution, including, where appropriate, intra-group lending, are adequately reviewed to take account for associated risks and are subject to appropriate restrictions and scrutiny. Institutions should enter into such transactions on arm's length terms.

68. 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.

69. Lending to affiliated parties should be subject to appropriate internal decision-making and monitoring procedures in order to ensure the fairness of these transactions. Where appropriate, institutions should involve non-executive and independent members of the management body in the decision-making process.

4.5 Credit risk management and internal control frameworks

70. Within the overall risk management and internal control frameworks established in accordance with the EBA Guidelines on internal governance, institutions should implement a robust and comprehensive credit risk management and internal control frameworks, respecting *inter alia* the principles of accountability, segregation and independence of functions and responsibilities, challenge and assurance of outcomes.

71. The credit risk management and internal control frameworks should be integrated into the institution´s overall risk management and internal control frameworks as well as into the organisational and decision-making structure. Institutions should ensure that the credit risk management and internal control frameworks support robust and appropriate credit risk taking, analysis, and monitoring throughout the life cycle of a credit facility, including the design and development the specific product, sales and administration.

72. The frameworks should define, in a clear and transparent manner, the allocation of responsibilities and authority, including within and between business lines, internal units and functions. Institutions should clearly define functions responsible assigned to perform various tasks related to the credit design, origination and monitoring process, as specified in this section. These functions should be fully integrated into the institutions' overall risk management and risk control functions.

73. Institutions should establish regular and transparent reporting mechanisms so that the management body, its risk committee, where established, and all relevant units or functions are provided with reports in a timely, accurate and concise manner and can take action within their respective mandates to ensure the identification, measurement or assessment, monitoring and management of credit risk (see also Section 8).

74. Any organisational structures implemented by the institutions, given their size, complexity and level of application, should support and promote effective and prudent credit decision-making as described in these guidelines, and should consider the 'three lines of defence' model.

75. In particular, within the 'three lines of defence' the institutions should consider the following:

    a. the first line of defence, should be directly responsible for credit risk taking and managing the credit risks at the point of origination and on a day-to day basis in line with the institutions' policies, procedures and controls, taking into account the institution´s credit risk appetite, capacity and strategy. They should have sufficient system of internal controls in place to ensure compliance with internal policies and relevant external requirements;

    b. the second line of defence functions are independent from the first line of defence and responsible for controls of the credit risk taking and management process and the implementation of risk management and compliance measures;

    c. the third line of defence should perform regular control activities on the soundness and effectiveness of the credit risk monitoring framework, including the review of the first and second lines of defence.

76. For the purposes of setting out a robust and effective credit risk management and control frameworks, institutions should ensure that the framework adequately covers at least the following areas/tasks associated with the credit risk taking and decision-making process:

a. developing and maintaining credit granting and monitoring processes and procedures;

b. developing processes, mechanisms and methodologies for and defining an appropriate credit risk appetite, credit risk strategy and credit risk policies, including the overall cascading-down process for policies and procedures, and business strategy;

c. designing and running appropriate credit decision-making framework in accordance with the requirements set out in these guidelines, including providing independent (risk) opinion to the credit decision takers;

d. designing/defining and performing credit and credit risk monitoring and reporting, including design and use of early warning systems (EWS), credit portfolio and aggregate risk monitoring also in relation to ICAAP and any applicable regulatory metrics, e.g. large exposures rules;

e. commercial planning in line with the overall business strategy and credit risk appetite, including cascading them down the organisational commercial and risk objectives;

f. performing an assessment of creditworthiness and performing credit risk analysis for scoring/rating purposes;

g. providing independent/second opinion to the creditworthiness assessment and credit risk analysis;

h. assessing the appropriateness of allowances in accordance with the relevant accounting framework;

i. developing new credit products, also considering the requirements for the new product approval process, and ongoing monitoring of the appropriateness of credit products;

j. managing early arrears and NPEs and granting and monitoring forbearance measures in line with, where applicable, the provisions of the EBA Guidelines on management of non-performing and forborne exposures[21], and EBA Guidelines on arrears and foreclosure on Directive 2014/17/EU[22], and institution's internal policies;

k. performing stress tests on the aggregate credit portfolio as well as on relevant sub-portfolios and geographical segments;

l. monitoring of individual exposures through regular credit reviews, including sample reviews of credit lines;

m. ensuring the integrity and reliability of the internal ratings assignment process as described in Article 173 of the Regulation (EU) No 575/2013, where relevant for

[21] EBA/GL/2018/06

[22] EBA/GL/2015/12

institutions with permission to use an Internal Ratings Based approach, and the integrity and reliability of the rating scale and ratings assignment process used by the institution, for the institutions using standardised approach; and

n. performing assessment of quality assurance of credit assessment taking into account an appropriate sample size, including ensuring that credit risk is properly identified, measured, monitored and managed within the institution´s first line of defence and that relevant regular reporting reaches the institution´s management body.

4.6 Resources and skills

77. Institutions should have sufficient resources and staff allocated to credit risk taking, credit risk management and internal control. The organisational structure should be reviewed periodically to ensure that there are adequate resources, competencies and expertise within the credit risk management functions to effectively manage credit risk.

78. Institutions should ensure that the staff members involved in credit granting, in particular decision-making, credit risk management and internal control have appropriate level of experience, skills and credit-related competence.

79. Staff involved in credit granting and credit risk management and internal control should receive frequently adequate training, also considering changes in the applicable legal and regulatory frameworks. Training should be aligned with the institutions' credit culture and business strategy and should be conducted on a regular basis to ensure that all relevant staff is appropriately skilled and familiar with the institutions' credit policies, procedures and processes.

80. Delegated credit decision powers should only be allocated to staff that attain a sufficient level of training and experience to justify the proposed discretion. The level of credit decision power should be determined by the skillset and experience of the staff member, the nature and amount of the loan, the nature of the borrower, and the complexity of the risks associated with the credit facility.

4.7 Remuneration

81. In addition to the requirements on institutions' remuneration policies set out in Articles 74 – 75 and 92 of Directive 2013/36/EU and EBA Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services, EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013, Article 7 of Directive 2014/17/EU, institutions' remuneration policies and practices should be in line with the approach to credit risk management and reflect credit risk appetite and strategies. In the context of credit granting and credit risk management, remuneration policies and practices applicable to all staff engaged in the credit granting, credit administration and monitoring

should promote prudent credit growth and appropriate risk-taking behaviour, and should not encourage excessive risk taking. Remuneration policies and practices should be consistent with institutions' long-term strategies and credit risk appetite and should not create conflict of interest.

82. Institutions' remuneration policies and practices should in particular ensure that:

   a. variable remuneration of the staff involved in credit granting should be linked, among others, to the long-term quality of credit exposures;

   b. variable remuneration of the staff involved in credit granting that is linked to performance objectives/targets should include credit quality metrics and be in line with credit risk appetite; and

   c. remuneration policies and practices related to the staff's activities should take into account the rights and interests of consumers and should not incentivise any mis-selling practices.

Questions for consultation:

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

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

5. Loan origination procedures

5.1 Collection of information and documentation

5.1.1 General requirements

83. Institutions and creditors should collect and verify a sufficient level of information and data necessary to assess the borrower's creditworthiness before concluding a loan agreement, or significantly increasing the loan amount.

84. The collection and verification of the information should be in line with institutions' governance, credit risk policies and procedures.

85. Institutions and creditors should have a sufficiently comprehensive view of the borrower's financial position, including an accurate and up-to-date comprehensive view of all the borrower's credit commitments (single customer view).

86. Information and data should be accurate, timely and relevant to the asset class and specific product, and proportionate given the purpose, size, complexity, and potential risk associated with the loan.

87. Where a loan agreement involves guarantees from third parties, institutions and creditors should collect sufficient level of information and data necessary to assess the guarantee, and, where relevant the financial position of the guarantor.

88. Institutions and creditors should assess the plausibility of any information and data provided by the borrower, and should make any necessary checks to verify the authenticity of information. When verifying a borrower's prospect to meet its obligations under the loan agreement, institutions and creditors should make reasonable enquiries to the borrower or third parties (e.g. employer, public authorities, credit register bureaux) and take reasonable steps to verify the information and data collected. Where, for the purposes of these guidelines, institutions and creditors make enquiries regarding borrower's personal data, institutions and creditors need to ensure that the requirements, in particular to inform and seek permission from the borrower, of Regulation (EU) No 2018/1725 are met[23], before making such enquiries to third parties.

89. If the borrower is a member of a group of connected clients, institutions and creditors should collect the necessary information on all related connected clients in accordance with the EBA Guidelines on connected clients, especially where reliance for repayment is placed on cash flow emanating from other connected parties.

[23] Regulation EU 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC, (OJ L 295, 21.11.2018, p 39-98).

90. Institutions and creditors should document the information and data that lead to credit approval, including the actions and assessments, in particular steps taken to verify income, carried out by the institutions and creditors, and maintain this documentation in an accessible form (readily available for competent authorities) for at least the duration of the loan agreement.

5.1.2 Specific requirements for lending to consumers

91. Institutions and creditors should collect and verify information in relation to at least the following:

    a. purpose of the loan, where relevant for the type of product;

    b. employment;

    c. income;

    d. financial commitments;

    e. collateral (for secured lending); and

    f. other risk mitigation factors, where available.

92. For the purposes of the collection and verification of information, institutions and creditors should at least consider collecting the information and data as set out in Annex 2.

5.1.3 Specific requirements for lending to professionals

93. For the purposes of the creditworthiness assessment of professionals, institutions should collect and verify information in relation to at least the following:

    a. purpose of the loan, where relevant for the type of product;

    b. income and cash flow;

    c. financial position and commitments, including assets pledged and contingent liabilities;

    d. business model and corporate structure;

    e. business plans;

    f. financial projections;

    g. collateral (for secured lending);

    h. other risk mitigation factors, where available; and

    i. product type specific legal documentation (e.g. permits, contracts etc.).

94. For the purposes of the collection and verification of information, institutions should at least consider collecting the information and data as set out in Annex 2.

95. Where the borrower has recently experienced cash flow or insolvency issues, institutions should request from the borrower reliable documentation demonstrating realistic projections of the ability to maintain or return to solvency within a reasonable period.

Question for the consultation:

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

5.2 Assessment of borrower's creditworthiness

5.2.1 General requirements for lending to consumers

96. The creditworthiness assessment should aim to verify the borrower's ability and prospect to meet the obligations under the loan agreement and also verify the borrower's profile is in line with the institutions' and creditors' credit risk appetite, policies and limits.

97. Institutions and creditors should use relevant information collected in accordance with Section 5.1 to carry out the assessment of the borrower's creditworthiness before concluding a loan agreement or before amending the existing loan agreement or loan amount.

98. The creditworthiness assessment should cover, at a minimum, an assessment of the borrower's income, disposable income, financial situation and source of repayment capacity to meet contractual obligations.

99. Institutions and creditors should apply the metrics and parameters that are relevant from the perspective of assessing the individual borrower's ability to repay the loan. Where appropriate, these metrics and parameters should include the following:

    a. loan to income ratio;

    b. loan service to income ratio;

    c. debt to income ratio;

    d. debt service to income ratio.

100. Institutions and creditors should apply metrics and parameters to have an accurate single customer view that enables the assessment of the borrower's ability to service and repay all its financial commitments.

101. When assessing the borrower's ability to meet obligations under the loan agreement, the institutions and creditors should carry out sensitivity analyses reflecting potential negative scenarios in the future, including, for example, a reduction of income; an increase in interest rates in the case of variable rate loan agreements; negative amortisation; balloon payments, or deferred payments of principal or interest.

5.2.2 Lending to consumers relating to residential immovable property

102. This section applies to loan agreements subject to national laws transposing Directive 2014/17/EU.

103. When verifying a borrower’s prospect to meet obligations under a credit agreement as referred to in Article 18 of Directive 2014/17/EU, the institutions and creditors should make reasonable enquiries and take reasonable steps to verify the borrower’s underlying income capacity, income history and any variability over time.

104. In the case of borrowers that are self-employed or have seasonal or other irregular income, the institutions and creditors should make reasonable enquiries and take reasonable steps to verify information that is related to the borrower’s ability to meet obligations under the loan agreement, including income capacity and third-party verification documenting such income, such as tax declarations.

105. When assessing the borrower‘s ability to meet obligations, institutions and creditors should take into account relevant factors that could influence the present and future repayment capacity of the borrower and without inducing undue hardship and over-indebtedness. The factors should, where relevant, include other servicing obligations, their remaining duration, their interest rates, and the outstanding amounts, evidence of any missed payments as well as directly relevant taxes and insurance, where known.

106. The institutions and creditors should establish sound processes to assess the borrower’s ability to meet obligations under the credit agreement and maintain up-to-date records of those processes. The institutions and creditors should review these processes at regular intervals.

107. If the loan term extends past the borrower’s expected retirement age, the institutions and creditors should take appropriate account of the adequacy of the borrower’s likely income and ability to continue to meet obligations under the loan agreement in retirement.

108. The institutions and creditors should ensure that the borrower’s ability to meet obligations under the loan agreement is not based on the expected significant increase in the borrower’s income unless the documentation provides sufficient evidence.

109. When assessing the borrower’s ability to meet obligations under the loan agreement, the institutions and creditors should account for committed and other non-discretionary expenditures, such as the borrower‘s actual obligations, including appropriate substantiation and consideration of the living expenses.

110. In case of foreign currency loans as defined in Article 4(28) of Directive 2014/17/EU, the institutions and creditors should also factor into the assessment of the borrower’s capacity to meet the obligations potential negative scenarios of the exchange rate between the currency of the borrower’s income and the currency of the loan. The institutions and creditors should also take into account and assess any hedging strategies, and actual hedges in place, including natural hedges, to mitigate foreign currency exchange risk.

111. For loan agreements which relate to an immovable property which explicitly state that the immovable property is not to be occupied as a place of the residence by the borrower or a family member (i.e. buy-to-let agreements) as referred to in point (b) of Article 3(3) of Directive 2014/17/EU, institutions and creditors should apply the requirements set out in paragraphs 112 to 114 in Section 5.2.3.

5.2.3 Other secured lending to consumers

112. For the loan agreements secured by immovable property, where the property is still being constructed and intended to provide, upon completion, an income to its owner in the form of rents or profits from its sale, the institutions and creditors should assess the development phase and the phase after the completion of the development when the project converts into an income producing property. For the purposes of such loan agreements, institutions and creditors should assess:

a. the borrower's plan related to the project;

b. information on the builders, architects, engineers, contractors and sub-contractors, who take part in the development;

c. projection of all costs associated with the development certified by a qualified and reputable quantity surveyor (or similar); and

d. all necessary permits and certificates for the development, including the ability to obtain them in the future as project progresses.

113. For loan agreements which relate to an immovable property which explicitly state that the immovable property is not to be occupied as a place of the residence by the borrower or a family member (i.e. buy-to-let agreements), the institutions and creditors should assess the relationship between the future rental income from the immovable property and the borrower's ability to meet obligations.

114. When assessing the borrower's ability to meet obligations under the loan agreement, the institutions and creditors should carry out sensitivity analyses reflecting potential negative market and idiosyncratic scenarios in the future, including, for example, deterioration in the marketability of the immovable property, increase in vacancy rates, reduction in the rental prices for similar properties. Institutions and creditors should also consider implication of foreign currency exchange rate risk, as provided in paragraph 110.

115. For loan agreements secured by movable property, the institutions and creditors should assess the purpose of the loan, the income capacity of the borrower to refinance the loan including any other relevant financial obligations that may affect the borrower's income capacity to meet his/her obligations.

5.2.4 Unsecured lending to consumers

116. When assessing a borrower's prospect to meet obligations under the loan agreement, the institutions and creditors should make reasonable enquiries and take reasonable steps to

assess and verify the borrower’s repayment capacity, including the borrower’s ability to keep up repayments without a significant adverse impact on their overall financial situation.

117. In the case of borrowers that are self-employed or have seasonal or other irregular income, the institutions and creditors should make reasonable enquiries and take reasonable steps to assess and verify information that is related to the borrower's ability to meet obligations under the loan agreement, including income capacity.

118. When assessing the borrower‘s prospect to repay the loan, the institutions and creditors should take into account relevant factors that could influence the borrower’s ability to meet obligations and without inducing undue hardship and over-indebtedness. The factors should include living expenses, other debt obligations, the interest rates, and the outstanding principal on other loan obligations; evidence of any missed payments; as well as any outstanding cost of relevant taxes and insurance, where known.

119. If the loan term extends past the borrower’s expected retirement age, the institutions and creditors should take appropriate account of the adequacy of the borrower’s likely income and ability to continue to meet obligations under the credit agreement in retirement.

120. The institutions and creditors should ensure that the borrower’s ability to meet obligations under the loan agreement is not based on an expected significant increase in the borrower’s income unless the documentation provides sufficient evidence.

121. When assessing the borrower’s ability to meet obligations under the loan agreement, the institutions and creditors should carry out sensitivity analyses reflecting potential negative scenarios in the future, including for example, reduction of income; changes in taxation; increase in (benchmark) interest rates in the case of variable rates applied; negative amortisation; balloon payments, or deferred payments of principal or interest. Institutions and creditors should also consider implication of foreign currency exchange rate risk, as provided in paragraph 110.

5.2.5 General requirements for lending to professionals

122. The creditworthiness assessment should aim to verify the borrower’s ability and prospect to meet the obligations under the loan agreement and also to verify whether the borrower’s profile is in line with the institutions’ credit risk appetite, policies and limits.

123. The requirements set out in this section apply to all lending activities towards professionals covering both unsecured and secured loans, including secured by movable or immovable property. The general requirements of the analysis of the borrower’s financial position and credit risk also applies to leasing.

124. Institutions should consider cash flow from ordinary business activities of the borrower, and where applicable within the purpose of the loan agreement, any proceeds on the sale of the assets as the primary source of repayment.

125. When assessing the creditworthiness of the borrower, institutions should put emphasis on the borrower’s realistic and sustainable future income and future cash flow and not on

available collateral. Collateral by itself should be under no circumstances a criterion for approving a loan and cannot by itself justify the approval of any loan agreement. Collateral should only be considered as the institution's second way out in case of default and not as the primary source of repayment, with the exception where the loan agreement envisages that the repayment of the loan is based on the sale of the property pledged as collateral.

126. When carrying out the creditworthiness assessment institutions should perform at least the following:

a. analyse the financial position and credit risk of the borrower as set out below;

b. analyse the organisational structure, business model and strategy of the borrower, including its legal capacity, integrity and reputation;

c. investigate and have the capacity to manage any potential conflict of interest between the institution as a creditor and the borrower;

d. use appropriate financial, asset class and product type-specific metrics and indicators, in line with their credit risk appetite, policies and limits set out in accordance with Sections 4.2 and 4.3;

e. determine and assess borrower's credit scoring or internal rating, where applicable, in accordance with the credit risk policies and procedures;

f. consider borrower's all financial commitments such as all drawn and undrawn committed facilities with the institutions, including working capital facilities, and credit exposures to the borrower so to ensure a single customer view of this borrower;

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

h. analyse the specific nature of the loan and its contractual and financial conditions (e.g. maturity, interest rate etc.).

127. For the purposes of the analysis of the financial position within the creditworthiness assessment as specified above, institutions should consider at least the following:

a. current and projected financial position, including income, cash flow and source of repayment capacity to meet contractual obligations, including under possible adverse events;

b. exposure profile until maturity in relation to potential market movements (e.g. exposures denominated in foreign currencies, exposures collateralised by repayment vehicles etc.); and

c. where applicable, probability of default based on credit scoring or internal risk rating.

128. If the borrower is a member of a group of connected clients, institutions should carry out the assessment at individual and group level, in accordance with the EBA Guidelines on connected clients, especially where reliance for repayment is placed on cash flow emanating from other connected parties.

129. For lending activities with cross-border elements (e.g. trade finance, export finance), institutions should assess the political, economic and legal environment in which the foreign counterparty of the institution´s client operates. Institutions should assess the buyer's possibility to transfer funds and the supplier's capacity to deliver the order, including its capacity to meet the applicable local legal requirements, and the supplier´s financial capacity to handle possible delays in transaction.

130. Institutions should assess the borrower's exposure to climate-related and environments risks as well as other ESG risks, e.g. the borrower's risk return profile vis-à-vis transition risks and appropriateness of the mitigating strategies should be analysed.

Analysis of the borrower's financial position

131. Institutions should ensure that the analysis of the borrower's financial position is based on tangible facts and not on an expected significant increase in the borrower's income unless there is sufficient evidence. Institutions should make their own projections of the borrowers' financial position and use them to challenge the projections provided by the borrowers.

132. For the purposes of the analysis of the financial position within the creditworthiness assessment as specified above, institutions should consider at least the following:

a. both current and projected financial position, especially the capacity to meet contractual obligations under possible adverse events (see also sensitivity analysis). Items to be analysed should include but not be limited to free cash flow available for debt servicing of the facility under consideration;

b. net operating income and profitability, especially in relation to interest-carrying debt;

c. the borrowers´ leverage level, dividend distribution, actual and projected capital expenditure as well as its cash conversion cycle in relation to the facility under consideration;

d. the use of appropriate financial, asset class and product type-specific metrics and indicators, in line with their credit risk appetite, policies and limits set out in accordance with Sections 4.2 and 4.3, and also at least considering which metrics in Annex 3 would be applicable in the specific credit proposal.

133. 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.

134. Institutions should perform an assessment of the cash conversion cycle of the borrower to measure the time duration for the business to convert the investment in inventory and other resource inputs into cash through the sale of its specific goods and services. Institutions should be able to establish the cash conversion cycle of a borrower to establish working capital needs and to establish recurring costs and assess the on-going capacity to repay credit facilities over time.

135. Institutions, where relevant, use at least the following financial metrics for the purposes of the creditworthiness assessment, and, where relevant, assess them against the metrics and limits as set out in their credit risk appetite, credit risk policies, and limits in accordance with Sections 4.2 and 4.3:

a. debt service coverage ratio;

b. EBITDA (earnings before interest, taxes, depreciation, amortisation);

c. interest coverage ratio;

d. loan to value ratio (for secured lending);

e. debt to equity ratio or leverage ratio;

f. loan to cost ratio;

g. return on equity;

h. capitalisation rate (net operating income/market value).

136. Institutions should assess working capital facility taking into account the cash flow generation ability of the borrower to turn the working capital into a cash positive position on a regular basis. If this is not the case, the institutions should assess the capacity of the borrower to convert the working capital facility into a term loan and repay the term loan on a principal and interest basis.

137. Institutions should assess the financial position when granting loan to holding companies both as a separate entity, e.g. consolidated level and as a single entity, if the holding company is not itself an operating company or institutions do not have guarantees from the operating companies to the holding company.

Specificities for assessment of the financial position of SMEs

138. Institutions should carry out, where possible, an assessment of the borrower's debtor and creditor cash cycle, and aging profile using aged debtors and creditors information, in particular to understand how efficient the borrower is in collecting debtor monies owned and potential scenarios if some amount of the outstanding debtor monies may be uncollectable.

139. Institutions should assess the borrower's payment cycle to its creditors to establish whether creditors are being repaid on time and whether the borrower has any outstanding payments owing that could affect the repayment of the institution's credit facilities if called upon.

140. Institutions should assess the turnover of the borrower through the current account, if available. In order to investigate the patterned turnover of the borrower, institutions should, where possible and relevant:

a. compare the level of turnover in the current account to the turnover of the financial statements taking into account VAT considerations;

b. compare the level of relevant cash outgoings in the account compared to the financial documentation provided;

c. perform an assessment of the level of unpaid and/or fluctuations into arrears; and

d. assess the seasonality of the business activity and verify any other cash activity of the business within the current account performance history.

141. For micro-enterprises, which may not produce financial information for tax purposes until required, institutions should obtain sufficient information to establish a pro-forma financial position for the purposes of the creditworthiness assessment.

Sensitivity analysis in creditworthiness assessment

142. Institutions should verify that where utilised, financial projections provided by the borrower together with underlying assumptions are reliable and realistic.

143. Institutions should assess the sustainability and feasibility of the borrower's financial position and repayment capacity under potential adverse market and idiosyncratic events that may occur in the duration of the loan agreement.

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.

145. Institutions should take into account the following idiosyncratic events:

a. a severe decline in borrower's revenues or profit margins;

b. a severe operational loss event;

c. occurrence of severe management problems;

d. the failures of significant trading partners, customers or suppliers;

e. a significant reputational damage;

f. a severe outflow of liquidity, changes in funding or increase in borrower's balance sheet leverage;

g. adverse movements in the price of assets to which the borrower is predominantly exposed (e.g. as raw material or end product) and FX risk;

146. Institutions should take into account the following market events:

a. a macroeconomic downturn;

b. a downturn in the economic sectors, where the borrower and its clients are operating;

c. a significant change in political, regulatory and geographical risk;

d. increase in cost of funding, e.g. increase in the interest rate by 200 basis points on all credit facilities of the borrower.

Analysis of the borrower's business model and strategy

147. Institutions should assess the business model and strategy of the borrowers, including in relation to the purpose of loan.

148. Institutions should assess the borrower's knowledge, experience and capacity to manage business activities, assets or investments linked to the loan agreements (e.g. specific property for the CRE loan).

149. Institutions should assess the feasibility of the business plan and associated financial projections in line with the specificities of the sector in which the borrower operates.

150. Institutions should assess the presence of any potential key-person dependency within the borrower and identify suitable mitigation measures, which can be implemented, for example, via contractual covenants.

151. Institutions should assess the borrower's reliance on key contracts, customers or suppliers and how they affect cash flow generation, including any concentrations.

Assessment of guarantees and collateral

152. Institutions should assess any pledged collateral against the requirements for collaterals set out in the institution's credit risk appetite, policies and procedures, including the valuation and ownership structure, and check all relevant documentation (e.g. whether property is registered in appropriate registers).

153. Institutions should assess any guarantees, covenants, negative pledge clauses and debt service agreements. Institutions should also consider whether the value of the collateral is in some way correlated with the borrower's business or capacity to generate cash flows.

154. Institutions should assess the borrower's equity and credit enhancements such as mortgage insurance, take-out commitments or repayment guarantees from external sources.

155. Where a loan agreement involves any form of guarantees from third parties, institutions should asses the level of protection provided by the guarantee, and where relevant, conduct creditworthiness assessment of the guarantor applying the relevant provisions of these guidelines depending whether the guarantor is natural person or professional. The creditworthiness assessment of the guarantor should be proportionate to the size of the guarantee in relation to the loan, and type of the guarantor.

156. Where in the syndicated lending or project finance transactions, the payment streams pass through the agent or another designated entity, institutions should perform a due diligence of the agent or the designated entity. For cross-border lending and project finance transactions, the agent or the designated entity should be the sole issuer of any guarantees, letters of credit or similar documents issued on behalf of the supplier in the transaction.

5.2.6 Commercial real estate lending

157. When assessing creditworthiness of the borrowers in case of commercial real estate (CRE) lending, in addition to the general requirements for the creditworthiness assessment for professionals (Section 5.2.5), institutions should follow specific requirements of the current section.

158. Institutions should assess and verify the borrower's experience in relation to the type, size and geographical location of the CRE.

159. Institutions should carry out the income producing capacity of the property and the prospects of refinancing. These assessments should account for the committed term of the CRE loan under the loan application in question.

160. In the assessment of the borrower's repayment capacity, institutions should assess, where relevant:

   a. the sustainability of the cash flow;

   b. the quality of the tenants, the impact of changes to current rental income on amortisation schedule, lease terms, maturities and conditions – payment history of the tenant if already in place;

   c. re-letting prospects to both existing and future tenants, cash flow required to service the loan in accordance with the loan agreement, if there are needs for re-letting, where applicable performance of asset in downturn, fluctuations in rental yields over time – to assess presence of overly compressed yields; and

   d. necessary capital expenditure needs of the property throughout the term of the loan.

161. In the assessment of the future prospects of re-letting any property, institutions should account for the tenant's demand for that property having regard to the supply of comparable properties, the conditions and specifications of the property, the location of the property, and the proximity to relevant infrastructure serving the property.

162. Where interest only loans are advanced for CRE, as part of the repayment capacity assessment, institutions should assess property cash flow to support a level of amortisation equivalent to the amortisation levels to clear the principle amount and interest of the loan in the event of an increase in the LTV for the property.

163. For the purposes of the sensitivity analysis under adverse market and idiosyncratic events, institutions should in addition to the events specified in Section 5.2.5 take into account the following:

   a. re-letting including change in the rental prices, lease length in relation to loan term, service charges, increase of vacancy rates, maintenance and refurbishment costs, rent-free periods and letting inducement;

   b. risks and delays associated with refinancing; and

   c. capital expenditure risk and obsolescence risk.

Lending for real estate development

164. When assessing creditworthiness of the borrowers in case of lending for real estate development, in addition to the general requirements for the creditworthiness assessment for professionals (Section 5.2.5), institutions should follow specific requirements of this section.

165. The creditworthiness assessment should cover, in line with the life cycle of the loan, both the development phase, including its stages, where relevant, and the phase after the completion of the development when the project converts into CRE loan. The latter stage should be assessed as a CRE lending in accordance with the requirements of these guidelines.

166. The assessment of the development phase should cover:

    a. business plan, including documented rationale for the development supported by a location specific review of supply and demand in the market by a reputable estate agent with a relevant expertise;

    b. the background information, builders, architects, engineers, contractors and sub-contractors, who take part in the development;

    c. projection of all costs associated with the development certified by a qualified and reputable quantity surveyor (or similar);

    d. all necessary permits and certificates necessary for the development, including the ability to obtain them in the future as project progresses.

167. Institutions should ensure that the calculation of costs associated with the development include contingencies for cost overruns. Planned contingencies should be included into the loan amount or equity. Institutions should assess the level of cash reserves and liquidity profile of the borrower to ensure that the borrower has the capacity to fund unplanned contingencies for cost overruns and delays, if any, above the contingency sum.

168. Institutions should perform an assessment of the feasibility of any projected net sale proceed projection both in terms of value and volume of sales, and timelines.

169. Institutions should carry out on-site visits accompanied by a suitably qualified person to verify the main components of the site including access and site specificities and retain a summary of the site visit on the file of the borrower.

170. In addition to assessing the creditworthiness of the borrower, institutions should assess equity investors into the project, where relevant focusing on assessing their financial position, relevant expertise, experiences in similar projects, as well as alignment of interests between the equity investors and the institutions offering lending to the same project.

5.2.7 Shipping finance

171. When assessing creditworthiness of the borrowers in case of shipping finance, in addition to the general requirements for the creditworthiness assessment for professionals (Section 5.2.5), institutions should follow specific requirements of the current section. In particular institutions should assess the following:

a. vessel earnings to costs (operation expenses including insurance, wages, maintenance, lubricants and interest cost) ratio;

b. vessel's current age-to-expected useful life;

c. characteristics of the borrower's fleet in relation to the global fleet population (size of new build activity, number of vessels laid up, number of vessels scrapped for each segment and considering the age, will determine over - tonnage and influence freight rates);

d. vessel valuations with or without haircut (if those are included as a repayment source) to reflect selling costs, the time value of money and uncertainties regarding the liquidity and marketability of the asset.

172. Institutions should also consider other factors such as the supply and demand in the market for that type of vessel, present and future trade pattern for the type of vessel in question, the necessity for the loan to be non-recourse or with guarantees, and whether the ship owner can provide other securities such as assignments of charters and insurances, charges of shares or cash collateral or mortgages of other assets such as real property or sister vessels.

173. In the case of loans to shipbuilding, institutions should assess the following:

a. business plan, including documented rationale for the shipbuilding supported by a vessel type specific review of supply and demand in the market by a reputable expert;

b. background information, builders, architects, engineers, contractors and sub-contractors, who take part in the shipbuilding;

c. projection of all costs associated with the shipbuilding certified by a qualified expert;

d. all necessary permits and certificates necessary for the shipbuilding, including the ability to obtain them in the future as project progresses.

5.2.8 Project and infrastructure finance

174. When assessing creditworthiness of the borrowers in case of project and infrastructure finance, in addition to the general requirements for the creditworthiness assessment for professionals (Section 5.2.5), institutions should follow specific requirements of the current section.

175. Institutions should assess the primary source of repayment of the loan, which is the income generated by the assets (project) being financed. Institutions should assess the cash flow associated with the project, including future income producing capacity once the project is completed, taking into account any applicable regulatory or legal restriction (e.g. price regulation, rate-of-return regulation, revenues being subject to take-or-pay contract).

176. To the extent possible, institutions should ensure that all the assets of the project, and present and future cash flow and accounts are pledged to the institution providing the lending or to the agent/underwriter in the case of a syndicated transaction/a club deal. In case where a special purpose vehicle is established for the project, the shares of that special purpose

vehicle should be pledged to the institution to enable the institution/agent to take the possession of the company, if needed. In the case of syndicated transactions/club deals, inter-creditor agreements should regulate each creditor´s access to pledged funds and assets.

177. The assessment of the development phase of the project should cover:

a. business plan, including documented rationale for the project supported by a location specific review of supply and demand in the market by a reputable expert;

b. the background information, builders, architects, engineers, contractors and sub-contractors as applicable, taking part in the project;

c. projection of all costs associated with the project certified, where available, by a qualified and reputable expert;

d. all necessary permits and certificates necessary for the development, including the ability to obtain them in the future as project progresses.

178. Institutions should ensure that the calculation of costs associated with the development include contingencies for cost overruns. Such planned contingencies should be included into the loan amount or equity. Institutions should assess the level of cash reserves and liquidity profile of the borrower or equity investors to ensure that they have the capacity to fund unplanned contingencies for cost overruns and delays, if any, above the contingency sum.

179. In addition to assessing the creditworthiness of the borrower, institutions should assess equity investors into the project, where relevant focusing on assessing their financial position, relevant expertise, experiences in similar projects, ability and willingness to support the project over the project's life time.

Question for the consultation:

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

5.3 Credit decision and loan agreement

180. In order to carry out a reliable and accurate creditworthiness assessment, institutions and creditors should design relevant documentation regarding credit decision and loan agreement in a way that help identify and prevent misrepresentation of information by the borrower, credit intermediary or staff members of the institution that is involved with the assessment of the application.

181. The creditworthiness assessment performed in accordance with Section 5.2 should be properly documented and used as the basis of the proposal to approve or decline the loan application by the relevant credit decision-making body within the institutions and creditors. The documented outcomes of the creditworthiness assessment itself should be able to justify the proposal to approve or decline the loan application.

182. The decision to approve or decline the loan application (credit decision), should be taken by the relevant credit decision-making body in accordance with the policies and procedures and governance arrangements as set out in Section 4.3.

183. Credit decision should be well documented, provide a record of views and reservations, especially any dissenting views, of the credit decision-making body members'. In case of a decision to approve the loan application, the credit decision should contain the information on the key features of a loan being offered to the borrower, including information on the amortisation, price, covenants and required collaterals. Such credit decision should be also the basis of the loan agreement.

184. Credit decision should clearly articulate a maximum period for its validity. If an approved transaction is not executed within this period, a new credit proposal should be submitted for approval.

185. Credit decision and loan agreement should ensure that utilisation of an approved loan is only allowed once all the approval conditions as well as all preconditions set out in the credit decision or agreement are fulfilled.

Question for the consultation:

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

6. Pricing

186. Institutions should implement a comprehensive framework for the pricing of loans. Pricing framework should reflect institutions' credit risk appetite and business strategies, including profitability and risk perspective and should be linked to the characteristics of the loan product. Institutions also should define their approach to pricing by borrower type and credit quality and riskiness of the borrower (in the case of individual pricing), where appropriate. Institutions should ensure that the pricing framework is well documented.

187. Institutions should consider and reflect in loan pricing *inter alia*:

a. cost of capital allocated to the loans granted. Cost of capital should result from the capital allocation in place according to the established breakdown, e.g. country, business line, product etc.;

b. cost of funding, which should match the key features of the loan, e.g. the expected duration of the loan taking into account not only contractual terms but also behavioural assumptions;

c. operating and administrative costs resulting from cost allocation processes that involve all group entities;

d. credit risk costs calculated for different homogenous risk groups taking into account historical experience of recognising credit risk losses and where relevant using expected loss models; and

e. any other real costs associated with the loan, including tax considerations in the case of leasing transactions.

188. For the purposes of pricing and measuring profitability, including cross-subsidisation between the loans or business units/lines, institutions should consider and account for risk-adjusted performance measures such as economic value added (EVA), return on risk-adjusted capital (RORAC) and risk-adjusted return on capital (RAROC) in a manner that is proportionate to the size, nature and complexity of the loan.

189. Institutions should transparently document and review the underlying cost allocation framework. Institutions should establish a fair distribution of costs within the organisation in order to ensure that individual loans and business lines reflect the correct expected return corresponding to the risk assumed.

190. Institutions should implement a regular monitoring linking together transaction risk, pricing and expected overall profitability. All of the transactions below costs should be reported and properly justified. Monitoring process should provide input for the review of the adequacy of overall pricing from a business and risk perspective. If needed, institutions should take actions in order to ensure compliance with targets and risk appetite.

Question for the consultation:

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

7. Valuation of immovable and movable property

7.1 Requirements for valuation at the point of origination

191. Where credit facility is secured by an immovable or movable property collateral, institutions should ensure that the valuation of the collateral is carried out accurately at the point of origination. Institutions should set out internal policies and procedures for valuation that are in line with the institutions' credit risk policies and procedures.

192. The reference value of the immovable property collateral should be the market value (MV) in accordance with Article 4(76) of Regulation (EU) No 575/2013 or mortgage lending value (MLV) in accordance with Article 4(74) of that Regulation.

193. Institutions should ensure that the property collateral is valued in accordance with applicable international, European and national standards, such as European Group of Valuers' Associations (TEGoVA) European Valuation Standards and the Royal Institute of Chartered Surveyors (RICS) standards.

7.1.1 Immovable property collateral

194. At the point of origination institutions should ensure that the value of all immovable property collateral irrespective whether it is pledged against the loans to consumers or professionals is assessed by an independent qualified internal or external valuer.

195. Institutions should set policies and procedures specifying the approaches to be used by the valuer (e.g. desktop, drive-by or full visit with internal and external assessment of the property) for different types of immovable property collateral ensuring that such approaches are prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements. For the valuation of an immovable property by a valuer, institutions may consider using desktop or drive-by valuation approaches only in the cases of valuing or revaluing immovable property collateral (e.g. RRE and CRE) that is of similar design, specifications and characteristics to the ones already valued or re-valued by a valuer, e.g. similar apartments in the same apartment block.

196. In the case of significant deterioration in the repayment capacity of the borrower, institutions should carry out an assessment in terms of the liquidity and enforceability of the collateral including time to recovery.

197. Where institutions use external valuers, they should establish a panel of accepted external valuers. The composition of the panel of valuers should ensure that valuers have relevant

expertise in areas of the property sector, which is relevant to the lending activities of the institution as well as the location of these activities.

198. Institutions should ensure that external valuers on the panel have adequate and valid professional indemnity insurance.

199. Institutions should ensure that the valuers provide an impartial, clear, transparent and objective valuation, and each valuation should have a final report providing the necessary information on the valuation process and property. The valuation report should clearly state who ordered the valuation and that the valuation has been requested for purposes of loan application only. Valuation should be carried out (internal valuation) or ordered (external valuation) by the institution, unless it is subject to a request from the borrower under certain circumstances.

200. At the end of the valuation process, institutions should ensure that they have obtained for each property collateral a clear and transparent valuation report documenting all elements and parameters which determine the value of the collateral, including all information necessary and sufficient for easy understanding of such elements and parameters, in particular:

a. the reference value of the collateral;

b. the approaches (e.g. full visit with internal and external assessment of the property or drive-by valuation), methodology and key parameters that have been used to assess the value;

c. a description of the collateral, including its current and future use, multiple uses if applicable, and the property type, its quality, including age and state of preservation;

d. a description of the location of the collateral, the local market conditions and the liquidity;

e. the legal and actual attributes of the collateral; and

f. any known circumstances that may affect the value in the short term.

7.1.2 Movable property collateral

201. At the point of origination institutions should ensure that the value of all movable property collateral, irrespective whether it is pledged against the loans to consumers or professionals, is assessed by an independent qualified valuer or appropriate advanced statistical models taking into account Article 229(3) of Regulation (EU) No 575/2013.

202. Institutions should set out in their policies and procedures approaches to using a valuer or statistical models for the purposes of such valuation, and specify internal thresholds and limits requiring individual valuation of movable property collateral at the point of origination to be performed by a valuer.

203. Where institutions use external valuers, they should establish a panel of accepted external valuers, covering specific property being used as collateral (e.g. vessels, aircraft, and plant machinery), which is relevant to the lending activities of the institution as well as the location of these activities.

204. For movable property collaterals that are subject to individual valuation by a valuer, institutions should ensure that they have obtained a clear and transparent valuation report documenting all elements and parameters which determine the value of collateral, as outlined in paragraph 2000.

205. For the movable property subject to the valuation by statistical models, institutions should ensure that they have obtained a clear and transparent model outcome, specifying the value of the collateral. Institutions should also have clear understanding of the methodologies, key parameters, assumptions and limitations of the models used.

206. Institutions should have adequate IT processes, systems, capabilities in place and sufficient and accurate data for the purposes of any statistical model-based valuation.

7.2 Requirements for monitoring and revaluation

7.2.1 Immovable property collateral

207. When monitoring property values as laid down in Article 208(3) of Regulation (EU) No 575/2013, institutions should set policies and procedures specifying the approach and the frequency of monitoring of immovable property collateral. These policies and procedures should account for the following elements:

a. type of property, e.g. RRE, CRE;

b. credit quality of the loan secured by property, e.g. IFRS9 Stage 1 or Stage 2;

c. development status of the property, e.g. in construction, finished product;

d. the value of the property, e.g. in gross carrying amount and LTV ratio;

e. changes in market conditions.

208. Institutions should set out appropriate frequencies for monitoring the value of the collateral, considering the type and value of the collateral at origination, and in relation to the credit agreement ensuring that:

a. the frequency of monitoring of properties and parts in development, e.g. unfinished buildings, is higher than that of similar finished properties and parts;

b. the frequency of monitoring of properties and parts with high carrying amount or with high LTV ratio is higher than that of similar properties and parts with low carrying amount or with low LTV ratio; and

c. the frequency of monitoring of loans secured by immovable property or parts of the property with lower credit quality is higher than that of similar loans secured by immovable property or parts of the property with higher credit quality.

209. Institutions should ensure that any indices and statistical models used to monitor the value of the collateral are sufficiently granular and that the methodology is adequate for the type of asset and lending product, and based on sufficient time-series of observed empirical evidence of previous transactions and appraisals of the collateral or similar collaterals.

210. Institutions should have policies and procedures for the revaluation of immovable property collateral specifying the approaches to revaluation (e.g. desktop valuation, drive-by valuation, full visit with internal and external assessment of the property, statistical models) for different types of immovable property collateral ensuring ensuring that such approaches are prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements. Furthermore, institutions should set out specific triggers indicating when monitoring leads to revaluation or a collateral needs revaluation.

211. Where the conditions for a review in Article 208(3) of Regulation (EU) No 575/2013 are met, institutions should 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.

212. Where the conditions for a review in Article 208(3) of Regulation (EU) No 575/2013 are not met, 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.

213. When the value of the immovable property is subject to revaluation by a valuer, institutions may consider using desktop or drive-by valuation approaches only in the cases of valuing or revaluing immovable property collateral (e.g. RRE and CRE) that is of similar design, specifications and characteristics to the ones already valued or re-valued by a valuer, e.g. similar apartments in the same apartment block.

214. Institutions should ensure adequate rotation of valuers, i.e. two sequential individual valuations of the same immovable property by the same valuer should result in the rotation of the valuer, resulting in the appointment of either a different internal valuer or a different external valuer.

215. Institutions' internal policies and procedures should indicate criteria for accepting advanced statistical model-based revaluations. These policies and procedures should account for statistical models' market experience, property-specific variables considered, use of minimum available and accurate information, and models' statistical precision.

216. Institutions should ensure that the advanced statistical models used for the purposes of revaluation of immovable property collateral are:

a. property-specific;

b. valid and accurate, and subject to robust back-testing;

c. based on a sufficiently large and representative sample; and

d. based on up-to-date data of high quality.

217. Institutions should have adequate IT processes, systems and capabilities in place and sufficient and accurate data for the purposes of any statistical model-based revaluation of immovable property collateral.

7.2.2 Movable property collateral

218. For the monitoring of movable property collateral, institutions may rely on adequate statistical models and indices. For the revaluation of movable property collateral, institutions may rely on assessment by valuers, statistical models and indices.

219. Institutions should in their policies and procedures set out approaches to using a valuer or statistical models, define on the approach (e.g. desktop valuation, drive-by valuation, full visit with internal and external assessment of the property) for the revaluations done by the valuers, and set out the frequency of monitoring and revaluation of movable property collateral.

220. Institutions' policies and procedures should include criteria for individual monitoring of the value and revaluation of the movable property collateral by a valuer who possesses the necessary qualifications, ability and experience. Such criteria should be related, at the minimum, to the value of the movable property collateral at the origination phase, life span, condition of tangible assets, such as depreciation and maintenance, necessity of physical inspections, and certification.

221. Institutions should have adequate IT processes, systems, capabilities and sufficient data for the purposes of any statistical model-based or index-based revaluation.

7.3 Requirements for valuers

222. Institutions should ensure that any valuer carrying out the valuation task meets the following conditions:

a. is professionally competent and has at least the minimum educational level that meets any national requirements and accepted professional standards for carrying out such valuations;

b. has appropriate technical skills and experience to perform the assignment;

c. is 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;

d. has the necessary knowledge of the subject of the valuation, the relevant property market and the purpose of the valuation.

223. Institutions should ensure that the fee or the salary for the valuer is not linked to the result of the valuation.

224. Institutions should assess the performance of the valuers on an ongoing basis, in particular accuracy of valuations provided. As part of such assessments, institutions should also look at the concentration of valuations performed and fees paid to specific valuers.

225. In order to mitigate any conflict of interest sufficiently, institutions should ensure that any valuers who are going to carry out the actual appraisal of a given property and their first-degree relatives meet the following requirements:

a. they are not involved in the loan application, assessment, decision or administration;

b. they are not guided or influenced by the borrower’s creditworthiness;

c. they do not have an actual or potential, current or prospective conflict of interest regarding the property in question, the valuation process and the result of the valuation;

d. they do not have any direct or indirect interest in the property;

e. they are not related to either the buyer or the seller of the property.

Question for the consultation:

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

8. Monitoring framework

8.1 General requirements for credit risk monitoring framework

226. Institutions should have robust and effective monitoring framework in place supported by an adequate data infrastructure to ensure that information regarding their credit risk exposures is relevant and up-to-date, and that the external reporting is reliable, complete, up-to-date and timely.

227. The monitoring framework should enable institutions to manage and monitor their credit risk exposures in line with their credit risk appetite, strategy, policies and procedures.

228. Institutions should ensure that the credit risk monitoring framework is well defined and documented, integrated into the institutions' risk management and control framework, and allows to follow all credit exposures throughout their life cycle.

229. Institutions should consider the following in the design and implementation of their credit risk monitoring framework:

    a. the framework and data infrastructure provides the capability to gather and automatically compile data regarding credit risk without undue delay and with little reliance on manual processes;

    b. the framework and data infrastructure allows for the generation of granular risk data that is compatible and used for the institution's own risk management purposes, but can also meet the requirements of the competent authorities for the regular prudential and statistical reporting, as well as for supervisory stress testing and crisis management purposes;

    c. the framework and data infrastructure ensures effective monitoring of all credit exposures, collaterals, as well as allows to follow the credit decision-making process;

    d. the framework and data infrastructure ensures that the institutions maintain an appropriate time series of reporting for current exposures, new types of lending, and early warning indicators (EWIs) over its credit risk planning horizon;

    e. allow for the use of peer group analysis and comparison across other institutions, where possible and appropriate, and wider sectoral and industry data.

230. The monitoring process should be based on a principle of follow-up action to support and result in a regular and informed feedback loop to inform the setting/review of credit risk appetite, policies and limits.

231. The credit risk monitoring framework should at least cover the following:

    a. credit risk associated with the both borrower and the transaction in relation to:

        i. individual credit exposures and LGD, where applicable;

ii. individual borrowers, including their exposure value, PD, credit rating, where applicable;

iii. group of connected clients;

iv. portfolio;

b. total credit risk per country of ultimate exposure, where applicable;

c. total credit risk; and,

d. impairments, reversals of impairments, write-offs and other decisions regarding value adjustments for a credit exposure.

232. The monitoring framework and data infrastructure should allow institutions to follow the credit decision-making process, including monitoring and reporting of all credit decisions, exceptions from the credit policies, and escalations to the higher levels of credit decision-making bodies. To this end, within the monitoring framework institutions should ensure the implementation and application of key risk indicators (KRIs) that are asset type or portfolio level specific to determine the on-going evolving credit risk profile of the institution.

233. Through these key risk indicators, institutions should monitor and identify high risk in lending activities in the loan book, such as the level of lending to non-investment grade rated borrowers, interest only/bullet repayments, the level of covenant absent or covenant-lite loans, lending with longer maturities, and other KRIs linked to the business lending of the institution.

234. Institutions should ensure that credit risk monitoring framework and data infrastructure should also enable a single customer view, i.e. aggregated, consistent and comprehensive representation of the data held by the institutions about their customers.

235. As part of the credit risk monitoring and reporting, institutions should identify the relevant drivers of its aggregate credit risk as well as the credit risk in its portfolios and sub-portfolios, taking into account macro-economic (including demographic) factors and the fact that credit risk drivers may change over time. Credit risk drivers should be measured, analysed and monitored, and the credit risk management function should report regularly the outcome of the analysis to the management body.

236. When monitoring credit risk, institutions should have appropriate methodologies and practices allowing for the aggregation of credit risk exposures at business lines, portfolios, sub-portfolios, products, industries and geographical segments and support the identification of credit risk concentrations. Institutions should ensure credit risk data and data infrastructure meets the following requirements:

a. depth and breadth, so that they cover all the significant risk factors. This should allow, *inter alia*, exposures to be grouped together in terms of shared credit risk characteristics, such as the institutional sector to which the borrower belongs, the purpose of the transaction and geographical location of the borrower, so as to enable aggregate analysis allowing identification of the entity's exposure to these significant risk factors;

b. accuracy, integrity, reliability and timeliness of data;

c. consistency, being based on common sources of information and uniform definitions of the concepts used for credit-risk management, and, where possible, accounting;

d. traceability, so that the source of information can be identified.

237. Institutions should ensure that operational metrics relating to credit risk governance are appropriate for their credit profile and applied proportionately. This includes any changes in the definitions of underlying lending metrics, material changes to rating scales or systems or credit risk policies/frameworks that help define/measure credit risk, and changing/altering product terms to avoid breaches of policy or exceptions.

238. In addition to monitoring credit and financial metrics, institutions should monitor also information related to qualitative factors that could have a relevant influence on the repayment of the loan. These factors could include amongst others information on quality of management, agreement/disagreement among owners, owner´s commitment to the borrower, forecasted market growth, company´s pricing power, cost structure and flexibility of costs as well as the trend, size and nature of capital expenditure and research and development expenditure, as well as allocation between the debt holders and servicers within the consolidated group of institutions.

8.2 Monitoring of credit exposures and borrowers

239. As part of the monitoring of credit exposures and borrowers, institutions should monitor all outstanding amounts and limits under the credit facilities and whether the borrower is meeting repayment obligations as laid down in the credit agreement. Institutions should also monitor whether the borrower and the collateral are in line with the credit risk policies and conditions set at the point of credit granting, e.g. whether the value of collateral and other credit enhancement techniques are maintained, whether any applicable covenants are maintained and, if there has been a negative development in these factors or in other factors that affect the risk profile of the borrower and/or credit facilities.

240. Institutions should continuously monitor and assess the quality of credit exposures and financial situation of borrowers to ensure that subsequent changes in credit risk, in respect of the initial recognition of the lending exposures, can be identified and quantified.

241. Institutions should monitor all outstanding amounts under their credit facilities and perform regular reviews on borrowers' payment performance. Institutions should also monitor whether the borrower is in line with the conditions set at the point of credit granting, such as adherence to credit metrics, covenants.

242. The ongoing monitoring should be based on the internal information regarding the credit facilities, and borrowers payment practices, as well as using the external sources (e.g. credit bureaux, directly from the borrower), where relevant.

243. In addition, institutions should also consider concentration measures against the values specified in credit risk appetite, policies and procedures, including by product, geography, industry, collateral features (type, location), and quality of portfolios and exposures, in particular past due loans in buckets of 30, 60, and 90 days past due.

8.3 Credit review of professionals

244. Institutions should also perform regular credit reviews of professionals, with a view of identifying any changes in their financial position or creditworthiness compared to the criteria and the assessment at the point of loan originations, as well as to review and update any relevant credit rating/scoring.

245. The review process and frequency should be specific and proportionate to the type of borrower and the type, size, and complexity of the credit facility, and should be specified in relevant policies and procedures. Institutions should carry out more frequent reviews if the they identify a deterioration in the credit and asset quality. The overall credit risk monitoring framework and data infrastructure should allow institutions to verify that the regular credit reviews have been performed in accordance with the credit risk policies and procedures, and for the identification of any outliers/exceptions to be flagged for follow up.

246. To this end institution should also, where appropriate, periodically update relevant financial information on the borrower and assess the new information against the creditworthiness assessment criteria established in accordance with Section 4.3 of these guidelines. The collection and assessment of this information should support the institution in recognising the early warning signs of declining credit quality.

247. Institutions should carry out periodic reviews for the purposes of the assessment of the borrower´s risk of default and the potential need for the migration between risk categories and grades.

248. Borrower's credit reviews should include an assessment of existing debt and borrower's sensitivity to external factors such as foreign exchange rate volatility, where relevant, that may affect the size of debt and repayment capacity, also in line with the sensitivity analysis requirements as specified in Section 5.2.

249. Institutions should continuously assess risks associated with refinancing of existing debt, monitoring loans with bullet/balloon repayment terms separately from other loans. They should analyse potential effects on borrower's inability to roll over/refinance existing credit facilities, and include inter alia forward-looking macroeconomic outlook, access to capital markets as well as other types of debt structures. Institutions should closely monitor indicators of borrowers' ability to repay or refinance their debts throughout the loan's life and not just for borrowers that are approaching the end of a loan's term without a verified repayment vehicle in place.

250. A regular credit risk review should take into consideration both the individual and the total risk profile of the exposure, including macroeconomic factors and specific economic sectors or activities and how the repayment capacity may be affected by these factors.

251. Where applicable, institutions should also review guarantors under the credit facility agreement. In addition to the assessment of the guarantor´s continued creditworthiness, the analysis of effectiveness of a guarantee should also take into account the enforceability and the time needed to realise the guarantee.

8.4 Monitoring of covenants

252. Institutions should monitor and follow up on the requirements of collateral insurance in accordance with the credit agreements or requirements of credit facilities.

253. Where applicable, institutions should monitor borrower’s adherence to the covenants agreed in the credit agreements. The borrower´s adherence to covenants, as well as the timely delivery of covenant compliance certificates, where applicable, should be utilised as early warning tools. An early detection of deviations is key to protecting the institution´s position towards the borrower and other possible creditors involved. The ongoing monitoring of financial covenants should include all relevant ratios specified in the covenants (e.g. net debt/EBITDA, interest coverage ratio, DSCR).

254. Institutions should monitor non-financial covenants also by means of collecting the covenant certificate, where applicable, but also by other means e.g. through close contact with the borrower by the client executive.

8.5 Stress testing in monitoring process

255. As part of their ongoing monitoring activities, institutions should conduct regular stress testing of their credit portfolios, and, where relevant, individual exposures. Such stress testing should be performed in accordance with the EBA Guidelines on institution’s stress testing[24] and at least annually by the credit risk management function as a means of anticipating potential impact a negative turn of events could have on credit exposures and institutions’ ability to withstand such impact. Institutions should conduct stress tests at least on the aggregate credit portfolio and on relevant sub-portfolios, taking into account materiality and risk level.

256. Institutions should review the relevance of the underlying assumptions of the stress tests on a regular basis and benchmark the results of the tests against the credit risk appetite.

257. In addition to stress testing based on the macroeconomic scenarios, institutions should regularly perform simpler sensitivity analyses based on internal and external information (e.g. market overview released by external providers regarding specific sectors or areas) for the early identification of segments or exposures, which could be affected by potential adverse shocks.

258. Sensitivity analyses should include an analysis of how the identified credit risk drivers may adversely affect the institution´s aggregate credit portfolio, as well as major sub-portfolios, and/or individual borrowers or credit exposures. Sensitivity analyses in relation to the original

[24] EBA/GL/2018/04

business plan should also be conducted on individual credits when monitoring large project finance and acquisition finance exposures.

8.6 Use of early warning indicators in credit monitoring

259. Institutions should develop, maintain and regularly evaluate, as part of their monitoring framework, relevant quantitative and qualitative early warning indicators (EWIs) for the timely detection of increased credit risk in their aggregate portfolio as well as in separate portfolios, industries, geographies and individual exposures. The EWIs should have a meaningful relevance to the monitoring of the institution's current position regarding its credit risk appetite, strategy and credit risk policies.

260. The EWIs should have defined trigger levels with assigned escalation procedures and including assigned responsibilities for the follow-up actions. The EWI framework should contain a description of the relevance of the indicators in relation to the characteristics of transactions and borrower types, or for homogeneous groups of portfolios, where appropriate.

261. On identifying a triggered EWI event at the level of an individual exposure, portfolio, sub-portfolio or borrower group, institutions should apply more frequent monitoring, and, where necessary consider placing them on a watch-list and undertaking predefined measures and mitigation actions. Where the actions include interaction with the borrower, institutions should have due regard to their individual circumstances. The level of contact and communication with the borrower in payment difficulties should be proportionate to the information requirements as defined in EBA Guidelines on arrears and foreclosure.

262. For the monitoring of groups of smaller credits with shared risk characteristics, institutions should identify specific EWIs in order to detect potential deterioration in credit quality across risk buckets before negative events occur at transaction level.

263. As part of their ongoing monitoring of credit risk institutions should consider the following indicators:

a. negative macroeconomic events (including but not limited to economic development, changes in legislation and technological threats to an industry) affecting the future profitability of an industry, a geographical segment, a group of borrowers or an individual corporate borrower, as well as the increased risk of unemployment for groups of individuals;

b. known adverse changes in the financial position of borrowers, such as a significant increase in debt levels or significant increases in debt service ratios;

c. significant drop in turnover or, in general, in recurring cash flows (including loss of a major contract);

d. significant narrowing of operating margins or in disposable recurring income;

e. deviation in actual earnings from the forecast (e.g. by more than 10%) or a significant delay in the business plan of a project or an investment;

f. changes in the credit risk of a transaction that would cause the terms and conditions to be significantly different if the transaction was newly originated or issued at the reporting date (such as increased amounts of required collateral or guarantees, or higher recurring income coverage of the borrower);

g. an actual or expected significant decrease in the main transaction's external credit rating, or in other external market indicators of credit risk for a particular transaction or similar transaction with the same expected life;

h. changes in the conditions of access to markets, or a worsening in financing conditions, or known reductions in financial support provided by third parties to the borrower;

i. slowdown in the business or adverse tendencies in the operations of the borrower that may cause a significant change in the borrower's ability to meet its debt obligations;

j. significant increase in economic or market volatility that may have a negative impact on the borrower;

k. for transactions secured with collateral, a significant worsening of the ratio of their amount to the value of the collateral, due to unfavourable developments in the value of the collateral, or no change or an increase in the outstanding amount due to the payment terms established (such as extended principal payment grace periods, rising or flexible instalments, extended terms);

l. significant increase in credit risk on other transactions of the same borrower, or significant changes in the expected payment behaviour of the borrower, where known;

m. significant increase in credit risk due to an increase in the difficulties of the group to which the borrower belongs, such as residents of a specific geographical area, or significant unfavourable developments in the performance of the borrower’s sector of economic activity, or increased difficulties in the group of related borrowers to which the borrower belongs;

n. known legal action that may significantly affect the borrower’s financial position;

o. late delivery of certificate of adherence, waiver request with respect to the covenants, where applicable;

p. negative institution internal credit grade/risk class migrations in the aggregate credit portfolio or in specific portfolios/segments;

q. actual or expected internal credit rating/risk classification downgrade for the transaction or borrower or decrease in behavioural scoring used to assess credit risk internally;

r. concerns raised in the reports by the external auditors of the institution or borrower;

s. one or more borrower-related facilities is 30 days past due.

8.6.1 Follow-up and escalation process on triggered EWIs

264. When an EWI has been triggered for closer monitoring and further investigation, immediate action should be taken in accordance with the institution´s policies and procedures as provided in Section 4.3 of these guidelines. The designated functions should perform an analysis in order to assess the severity of the triggered event and to propose suitable action and follow-up. This analysis should without undue delay be presented to the relevant decision-making bodies designated in the policy and procedures.

265. Relevant decision-making bodies should, based on the abovementioned analysis and other relevant accessible information, decide on the appropriate next steps. The decision should be documented and should be communicated to relevant parts of the institution for action and follow-up.

Triggering EWIs should lead to an increased frequency in the reviewing process, including discussion and decision at the decision-making bodies, and a more intense information gathering from the borrower. The information gathered should be sufficient to support more frequent credit reviews of the borrowers.

8.7 Watch list

266. Institutions should establish policies and procedures for monitoring credit exposures and borrowers with increased risk, including those identified though the monitoring of EWI – watch list. Monitoring of such watch list should lead to specific reports being regularly reviewed by the head of risk management function, the heads of functions involved in credit granting and the management body. Institutions should consider in the monitoring of watch list the following aspects:

a. analysis of negative events or trends, which may adversely affect a group of borrowers (including but not limited to economic, demographic or technological threats);

b. considerations of borrower's credit scoring/rating;

c. closer contact with borrowers with request for additional information, including financial projections;

d. review of credit limits, analysis of whether limits with undrawn amounts may be decreased or cancelled;

e. establishment of specific action plans with borrowers, where appropriate. Such plans should include concrete and timed measures to achieve full and timely repayment, subject to ensuring fair treatment of the individual borrower.

Question for the consultation:

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

Annex 1 – Credit granting criteria

Lending to consumers

1. customer acceptance criteria i.e. customer types, customer age limits, customer credit record
2. definition of acceptable income
3. minimum requirements for collaterals
4. minimum requirements for guarantees
5. maximum loan amounts
6. maximum loan maturities
7. amortisation requirements (including interest rate type for the loans)
8. risk-based limits (towards concentration, type of product, etc.)
9. acceptable loan to value ratio limits (for secured lending)
10. acceptable loan to income ratio limits
11. acceptable debt to income ratio limits
12. acceptable net disposable income to total credit obligation ratio limits
13. compliance policy with macroprudential requirements, where relevant

Lending to professionals

1. specification of geographic markets and economic sectors
2. customer acceptance criteria i.e. for specific PD's, external ratings, customer types, good track record etc.
3. minimum requirements for revenues, cash flow and financial projections
4. minimum requirements for collaterals
5. minimum requirements for guarantees and credit enhancements
6. minimum requirements for acceptable covenants
7. requirements for the drawdown of the loan to the borrower
8. maximum loan amounts
9. appropriate limits on partial recourse or nonrecourse loans
10. maximum loan maturities
11. amortisation schedules and standards for the acceptability of and limits on non-amortising loans and on the use of interest reserves and cash sweep structures

12. risk-based limits (towards concentration, type of product, etc.)
13. acceptable loan to value ratio limits (for secured lending)
14. acceptable debt servicing coverage ratio limits
15. acceptable interest coverage ratio limits
16. acceptable EBITDA limits
17. acceptable leverage ratio limits
18. acceptable debt to equity ratio limits
19. acceptable loan-to-cost ratio limits
20. acceptable cash flow to debt service ratio limits
21. acceptable return on equity ratio limits
22. acceptable capitalisation rate (net operating income / market value) limits
23. standards to address and mitigate risks associated with environmental risk
24. compliance policy with macroprudential requirements, where relevant

Commercial real estate lending

In addition to the general criteria for lending to professionals specified above, institutions should specify the following product type-specific criteria:

1. specific forms of CRE an institution intends to finance (office, retail, industrial and multi-family residential not owned and occupied by households. It can be defined as land, and the building(s) upon it, which generates profit or income from capital gains or rents)
2. the minimum levels of equity to be provided by the borrower the market value of the CRE mortgaged property
3. risk-based limits for lending for speculative development lending
4. standards to assess the various stages of the CRE development/construction in relation to the loan drawdown
5. minimum standards regarding requirement for performance and payment bonds and title insurance
6. minimum standards to ensure minimum level of oversight of the construction via the contracted presence and on-site visit of suitable experienced professionals, e.g. architects, quantity surveyors, building site managers etc.
7. minimum standards to effectively assess the suitability and experience of any contractors, subcontractors, or material suppliers
8. minimum standards for pre-leasing/pre-selling requirements for CRE

Shipping finance

In addition to the general criteria for lending to professionals specified above, institutions should specify the following product type-specific criteria:

1. purpose of the finance (i.e. shipbuilding, purchase, operating)
2. type of financing (mortgage-backed loans, newbuilding financing, unsecured / corporate loans, mezzanine etc.)
3. basic terms of the loan agreement (maximum duration based on the life of the vessel), maximum contribution, 1st lien as a rule, own participation depending on the riskiness of the finance etc.
4. minimum requirements for certificates needed (classification, pollution, safety etc.)
5. minimum requirements for acceptable registries / 'flags'
6. minimum requirements for acceptable classification societies

Annex 2 – Information collection and verification

Lending to consumers

1. Evidence of identification
2. Evidence of residence
3. Information on the purpose of the loan
4. Evidence on the eligibility for the purposes of the loan, where applicable
5. Evidence of employment including the type, sector, status (e.g. full-time, part-time, contractor, self-employed etc.) and duration
6. Evidence of income (including annual bonus, commission, overtime, where applicable) covering a reasonable period, including payslips, current bank account statements, audited or professionally verified accounts (for self-employed persons)
7. Information on financial assets and liabilities, e.g. savings account statements, loan statements indicating outstanding loan balances
8. Information on financial commitments such as child maintenance, education fees, alimonies
9. Evidence of tax status
10. Evidence of life insurance for the named borrowers, where applicable
11. Data from credit registers or credit information bureaux, covering at least the information on financial liabilities and arrears in payment
12. Information on the collateral
13. Evidence of the ownership of the collateral, where applicable
14. Evidence of the value of collateral
15. Evidence of the insurance of collateral
16. Information on the enforceability of collateral
17. Information on guarantees, credit risk mitigating factors and guarantors
18. Rental agreement or evidence of potential rental income for buy-to-let (BTL) products
19. Permissions and cost estimates, where applicable, for real estate building and improvement loans

Lending to professionals

1. Information on the purpose of the loan

2. Evidence on the purpose of the loan
3. Financial statements and accompanying notes on a single entity and consolidated level (balance sheet, profit or loss, cash flow) covering a reasonable period, audited or professionally verified accounts
4. Age debtor statements on borrower level
5. Evidence of the business plan both for the borrower and in relation to the purpose of the loan
6. Evidence of financial projections (balance sheet, profit or loss, cash flow)
7. Evidence of tax status and tax liabilities
8. Data from credit registers or credit information bureaux, covering at least the information on financial liabilities and arrears in payment
9. Information on borrower’s external credit rating, where applicable
10. Information on existing covenants and borrower’s compliance with them, where relevant
11. Information on major litigations involving the borrower at the time of application
12. Information on the collateral
13. Evidence of the ownership of the collateral, where applicable
14. Evidence of the value of collateral
15. Evidence of the insurance of collateral
16. Information on the enforceability of collateral
17. Information on guarantees, credit risk mitigating factors and guarantors
18. Information on ownership structure for the purpose of AML/CTF

Commercial real estate lending to professionals

In addition to the general criteria for lending to professionals specified above, institutions should consider collecting the following product type-specific information:

1. Information on rent levels, vacancy and tenants, including contracts for the particular property associated with the purpose of the loan
2. Information on the type of property portfolio
3. Evidence of vacancy and turnover rates for the portfolio, per property type, property age and location
4. Evidence of rent levels per property type, property age and location
5. Information on major tenants per property type, property age and location
6. Information on the rationale for the property associated with the loan supported by a location specific review of supply and demand in the market by a reputable estate agent with a relevant expertise

7. Evidence of the value of collateral and separate units of the property collateral, where applicable

Real estate development lending

In addition to the general criteria for lending to professionals specified above, institutions should consider collecting the following product type-specific information:

1. Evidence of experience in similar projects and similar asset types e.g. offices, retail, industrial etc.
2. Information on any ongoing project being developed by the borrower
3. Evidence of planning and building permits
4. Information on builders, architects, engineers, contractors and sub-contractors
5. Evidence of contracts with contractors and relevant documentation on the development, including information on penalties, guarantees, cost of overruns
6. Information on the rationale for the development supported by a location specific review of supply and demand in the market by a reputable estate agent with a relevant expertise
7. Evidence of cost estimates and timeline, including contingencies for the development certified by an independent, qualified and reputable quantity surveyor (or similar)

Shipping finance

In addition to the general criteria for lending to professionals specified above, institutions should consider collecting the following product type-specific information:

1. Evidence of experience in similar type of vessel and segment
2. Evidence of the ownership of assets with information on the vessels, e.g. name, registration number, type, age and size
3. Information on insurance and classification of assets by a classification society acceptable to the institution
4. Evidence of compliance with safety and environmental regulation governing shipping industry
5. Information, based on market data, on each type of vessel and segment outlooks, e.g. geographical location of the past and planned future trips
6. Evidence on off-balance-sheet obligations such as chartered in vessels and forward freight agreement (FFA) positions

Project and infrastructure finance

In addition to the general criteria for lending to professionals specified above, institutions should collect the following product type-specific information:

1. Information on the business plan related to the project

2. Evidence of experience in similar projects
3. Information on any ongoing project being developed by the borrower
4. Evidence of planning and building permits related to the project
5. Information on builders, architects, engineers, contractors and sub-contractors
6. Evidence of contracts with contractors and relevant documentation on the development, including information on penalties, guarantees, cost of overruns
7. Information on the rationale for the development supported by a location specific review of supply and demand in the market by a reputable estate agent with a relevant expertise
8. Evidence of cost estimates and timeline, including contingencies for the development certified by a qualified and reputable quantity surveyor (or similar)

Annex 3 – Metrics for credit granting and monitoring

Corporate and SME borrowers

Solvency

1. Equity ratio (shareholders' equity divided by total assets)
2. Long-term debt to equity ratio (the accounting value of long-term debt divided by shareholders' equity)
3. Interest bearing debt / EBITDA
4. Enterprise Value (sum of market value of common stock, market value of preferred equity, market value of debt, minority interest, less cash and investments)
5. Asset quality

Liquidity

6. Total debt service coverage ratio (EBITDA) over total debt service)
7. Cash debt coverage ratio (net cash provided by operating activities over the average current liabilities of the company within a certain period of time)
8. Coverage ratio (total current assets divided by total short-term debt)
9. Future cash flow analysis

Profitability

10. Return on assets
11. Interest Coverage ratio
12. Return on Equity ratio (net income after interest and tax over average shareholders' equity)
13. Return on Capital Employed
14. Net profit margin
15. Turn over evolution

CRE and RRE development

Solvency

16. Fixed assets to equity ratio

17. LTV
18. Location and quality of properties
19. LTC

Liquidity

20. DSCR for CRE activities
21. Occupancy rates evolution

Profitability

22. Rental income to CRE-related interest expenses

Leveraged finance, asset-based lending and project finance

Solvency

23. Value of acquisition goodwill
24. Ring-fencing
25. LTV

Liquidity

26. Adherence to business plan
27. Leverage ratio (total debt over EBITDA)
28. Repayment capacity

Shipping

Solvency

29. Leverage ratio
30. Rating

Liquidity

31. Repayment from operating CFs
32. Repayment from guarantor
33. Repayment from vessel's sale
34. Outstanding payments
35. Asset / vessel quality

Accompanying documents

Draft cost-benefit analysis / impact assessment

As part of the Council's conclusions on the Action plan to tackle non-performing loans (NPLs) in Europe, issued in July 2017, the EBA has been mandated to issue detailed Guidelines on financial institutions' loan origination, monitoring and internal governance with focus on issues such as transparency and borrower affordability assessment.

Article 16(2) of the EBA Regulation provides that the EBA should carry out an analysis of 'the potential related costs and benefits' of any Guidelines it develops. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options.

A. Problem identification

The negative effects of the high level of NPLs in a substantial number of European Countries can pose risks of cross-border spillover of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole.

In addition to economic factors, NPLs levels are influenced by structural drivers such as institution's lending and monitoring policies, supervisory action and transparency of the market for collateral assets.[25]

In the pre-financial crises phase, substandard loan origination practices and weak monitoring played an import role in the build-up of NPLs stock in a number of Member States. Further, the lack of transparency in the market for collateral assets and of standardized valuation approaches has hampered confidence in the collateral system, which is essential to lending activities.

Policy objectives

The objective of the guidelines is to improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting in order to ensure that institutions have robust and prudent approaches to credit risk taking, management and monitoring, and newly originated loans are of high credit quality, whilst respecting and protecting the interests of consumers. Through achieving these objectives, the EBA aims at improving the financial stability and resilience of the EU financial system.

At a more specific level, these Guidelines aim at addressing the identified issues with the aim to foster and monitor sound credit origination standards, risk management and internal governance, to minimise NPL inflows in the future.

[25] Report of the FSC Subgroup on Non-Performing Loans (9854/17).

When drafting the present Guidelines, the EBA considered several policy options under three main areas.

Scope of application of Guidelines

Options considered

Option 1a: These Guidelines should apply to new lending only, i.e. loans and credit facilities that have been originated after the date of implementation of these Guidelines.

Option 1b: Theses Guidelines should apply to new lending's and also to loans and credit facilities that have been originated before the date of implementation of the Guidelines.

Baseline scenario

The current EU legislative framework for institutions' internal governance procedures for loan origination and monitoring consists mainly of Art. 74(1) of Directive 2013/36/EU and the EBA Guidelines on internal governance.

The institutions' current risk management practices, policies, processes and procedures for the origination of loans are laid down in Art. 18 and Art. 20 of Directive 2014/17/EU and the EBA Guidelines on Creditworthiness assessment (repealed with effect from the date of application of these guidelines). Further legislative requirements for credit and counterparty risk are laid down in Article 79 of Directive 2013/36/EU.

Assessment of Options and preferred Option

Under Option 1a, the monitoring of the performance of credit facilities and potential underlying collateral are based on the current EU legislative framework. The refinancing of existing loans will also follow the current standards and will not apply the standards for loan origination outlined in these Guidelines.

Under Option 1b, financial institutions will apply these Guidelines to all existing credit facilities, their refinancing as well as to new credit facilities.

It is expected that there are limited additional costs for a broader scope of application, as the amendment on internal practices, policies, processes and procedures of institutions and supervisory practices will be carried out for new loan originations and can accordingly be applied to existing loans.

Limiting the scope to new credit facilities is expected to have a negative effect on the effectiveness and the consistent application of loan origination standards within and across institutions and supervisors. This will hamper the creation of a level playing field and the convergence of supervisory practices. This status can prevail for a long time due to institutions' refinancing practices and outstanding loans with long maturity.

Option 1b has been retained.

Environmental factors and green lending

Options considered

Option 2a: Include environmental, social and governance (ESG) factors into risk management policies, credit risk policies and procedures.

Option 2b: Provide guidance on risk management policies, credit risk policies and procedures without considering ESG factors.

Baseline scenario

A diverse range of sector-specific market and policy factors has motivated the evolution of the sustainable finance agenda with financial institutions developing methodologies and implementing procedures to integrate environmental factors into risk management systems, including customer credit and lending evaluation. These developments are coherent with the risk environmental and climate factors pose for financial institutions as close to 50% of the exposure of Euro area institutions to risk is directly or indirectly linked to risks stemming from climate change.[26]

Approaches to incorporate those risks vary considerably in terms of scope and breadth of factors considered, governance and management, and relationship to broader sustainability strategies. Further barriers to sustainable finance, and more specific, green lending, are a lack of appropriate information flowing between the market and financial institutions and issues of policy coherence and regulatory alignment.[27]

The action plan on sustainable finance adopted by the European Commission aims to address those issues. The EBA role in achieving this plan has inter alia been outlaid in the revised banking package CRD V (revised CRD/ CRR). It mandates the EBA to assess the incorporation of ESG risks into the supervisory process (CRD Art. 98 amendment) and to assess the prudential treatment of assets associated with environmental or social objectives (CRR Article 50da amendment). In addition, it requires large institutions to publicly disclose ESG -related risks they are exposed to.

Assessment of Options and preferred Option

The adoption of ESG factors are expected create one-off costs for institutions to align their internal government arrangement or establish those arrangements to be compliant with these Guidelines,

[26] European Commission: Action Plan: Financing Sustainable growth, March 2018.

[27] UNEP: Greening the Banking System – Taking Stock of G20 Green Banking Market Practice, September 2016.

and will create on-going costs for monitoring their ESG-related activities. In relation to loan origination, those costs will be limited to financial institutions, which are active (or intend to be active) in green loan origination.

Supervisors are expected to face incremental costs to amend their practices such as rules, methodologies, manuals and to inform staff members and the sector regarding those changes.

Including ESG factors into the Guidelines, however, will support to counteract the fragmented landscape of approaches on ESG lending, which present a barrier to coherence and comparability across institutions. By providing additional clarification on climate change associated risks, the Guidelines support the creation of a clear understanding of green transactions.

Financial institutions are expected to benefit from the adoption of ESG factors into their loan origination practices as including and monitoring environmental factors will help them to streamline the processes develop and to ensure that environmental and social due diligence are incorporated in credit decisions. This will help to take those risks adequately into account and thereby avoid or mitigate financial losses, reputational risk, and social and environmental harm.

Further, the disclosure by financial institutions and borrowers of green performance information, including total green lending flows, and the degree of adoption and implementation of core practices, is expected to support system-level monitoring and encourage a level playing field.

As these Guidelines reflect the forthcoming EU policy actions to stimulate sustainable finance, compliance with these Guidelines is expected to support institutions' prudent treatment of ESG related loans throughout the life cycle of the loan by implementing adequate standards at the initial stage of the loan origination.

The harmonization between national-level and EU-level regulatory frameworks positively affects the capacity to advance new products. It is thereby expected to contribute to efficient and effective cooperation among competent authorities.

Option 2a has been retained.

Valuation of immovable property collateral

Options considered

Option 3a: Use of advanced statistical models for the purpose of monitoring of the value of immovable property collateral.

Option 3b: Use of advanced statistical models for the purpose of valuation of immovable property collateral for re-valuation and monitoring.

Option 3c: Use of advanced statistical models for the purpose of valuation of immovable property collateral at the loan origination, for re-valuation and monitoring.

Baseline scenario

The EU regulatory landscape for immovable property valuation in the context of loan origination and collateral monitoring currently addresses advanced statistical models under several aspects:

1) **Mortgage Credit Directive (MCD) – Article 19; Recital 26**
According to the MCD stats that valuation needs to meet valuation standards, in particular those developed by the International Valuation Standards Committee (IVSC), the European Group of Valuers' Associations (TEGoVA) or the Royal Institution of Chartered Surveyors (RICS).

2) **Capital Requirement Regulation (CRR) – Article 208(3) and Article 299(1)**
Under the CRR, statistical methods may be used to monitor the value of immovable property and to identify immovable property, which needs re-valuation (Article 208(3)). For re-valuation of collateral, statistical approaches can further be applied, in cases where Article 208(3b) does not apply, i.e. where there is no suspected material decline of the value of the immovable property and the loan is not exceeding EUR 3 million or is less than 5% of the own funds of an institution. Where Article 208 (3) does apply, a statistical model cannot be used as sole means of undertaking the review of the property valuation.

3) **EBA Guidelines on management of non-performing and forborne exposures – Chapter 9**

   The EBA Guidelines on NPLs state that immovable property valuation should be carried out according to applicable international, European and national standards. Valuation and re-valuation may be supported by statistical models.

4) **TEGoVA's European Valuation Standards (EVS) – EVIP 6**
Statistical methods may be used to monitor the value of the property and to identify property that needs re-valuation. The use of such methods is not allowed for the valuation at origination.

5) **RICS's Valuation - Global Standards – VPS 1**
The Red Book addresses advanced statistical models in relation to the nature and extent of the valuer's work, whereby the valuer's work can be based on valuation provided by advanced statistical models.

The majority of member states incorporate property valuation standards in their national regulatory framework. In at least seven member states additional guidelines apply, which detail the property valuation process beyond the EU specifications. The International and European Valuation guidelines provided by RICS and TEGoVA are explicitly incorporated in more than six of these regulatory frameworks.

Three member states specifically regulate the use of advanced statistical models. In six more member states, those models are recognised by competent authorities in ways of review or re-valuation of model standards, issue of advanced statistical model specific guidance or acknowledge of results provided by those models for regulatory reporting.

The majority of EU institutions use advanced statistical models for internal portfolio valuation, mortgage revaluation and mortgage monitoring. In at least six jurisdiction, advanced statistical models are also used to support loan origination.

Assessment of Options

A broader use of advanced statistical model throughout the life cycle of the loan may be beneficial for financial institutions from internal business perspective, as they can carry out this valuation methods for a range of valuation activities and thereby benefit from the quick and cost-efficient valuation.

In the future, it is expected that the progress in information technology and development of large property and transaction database will increase the precision of advanced statistical models. A strict restriction on the use of those models can hamper the development in this market and the overall progress of the valuation market.

However, from a prudential point of view, the use of those models at the stage of loan origination may create shortcomings in the risk management. The use of advanced statistical models at the points of loan origination, i.e. at the stage of first assessment of the asset, might not ensure a reliable value attributed to the underlying assets and therefore a robust valuation process. Sometimes insufficient level of transparency, adequate governance in relation to these methodologies employed by the models might not ensure that valuation is based on well-established and transparent market information coming from reliable sources.

Option 3b has been retained and summarised in Table 1:

Table 1: Use of advanced statistical models for the purpose of valuation of immovable property collateral

Valuation by	Initial valuation	Re-valuation		Monitoring
		Art. 208(3) applies*	Art. 208(3) does not apply**	
Valuer	✓	✓***	✓	✓
Advanced statistical models			✓	✓
Other statistical models including indexation			✓	✓

**This is whenever the price of the immovable property may have declined materially or for big loans of EUR 3 million or 5% of the own funds of the institution.*

***This is when there is no "suspected" material decline of the value of the immovable property and the loan is not exceeding EUR 3 million or less than 5% of the own funds of an institution.*

****A statistical model cannot be used as sole means of undertaking the review of the property valuation, implies that an advanced statistical model checked by a valuer is eligible.*

Questions for public consultation

1. What are the respondents’ views on the scope of application of the draft guidelines?
2. Do you see any significant obstacles to the implementation of the guidelines by the application date and if so, what are they?
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)?
4. What are the respondents’ views on the requirements for credit risk policies and procedures (Section 4.3)?
5. What are the respondents’ views on the requirements for governance for credit granting and monitoring (Section 4)?
6. What are the respondent’s views on how the guidelines capture the role of the risk management function in credit granting process?
7. What are the respondents’ views on the requirements for collection of information and documentation for the purposes of creditworthiness assessment (Section 5.1)?
8. What are the respondents’ views on the requirements for assessment of borrower’s creditworthiness (Section 5.2)?
9. What are the respondents’ views on the scope of the asset classes and products covered in loan origination procedures (Section 5)?
10. What are the respondents’ views on the requirements for loan pricing (Section 6)?
11. What are the respondents’ views on the requirements for valuation of immovable and movable property collateral (Section 7)?
12. What are the respondents’ views on the proposed requirements on monitoring framework (Section 8)?