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Answers of the European Financial Congress[1] in relation to the European Banking Authority's Consultation Paper on Drat Guidelines on loan origination and monitoring[2]

Methodology for preparing the answers

The answers were prepared in the following stages:

Stage 1

A group of experts from the Polish financial sector were invited to participate in the survey. They received selected extracts of the EBA's consultation document and the consultation questions translated into Polish. The experts were guaranteed anonymity.

Stage 2

Responses were obtained from experts representing:

- commercial banks,
- regulators,
- consulting firms,
- the academia.

Stage 3

The survey project coordinators from the European Financial Congress prepared a draft synthesis of opinions submitted by the experts. The draft synthesis was sent to the experts participating in the survey with the request to mark the passages that should be modified in the final position and to propose modifications and additions as well as marking the passages they did not agree with.

Stage 4

On the basis of the responses received, the final version of the European Financial Congress' answers was prepared.

[1] European Financial Congress (EFC – www.efcongress.com). The EFC is a think tank whose purpose is to promote debate on how to ensure the financial security and sustainable development of the European Union and Poland.

[2] https://eba.europa.eu/documents/10180/2831176/CP+on+GLs+on+loan+origination+and+monitoring.pdf/3bc64e01-a4d1-4c7e-92d4-1dd84f4b234c

Answers of the European Financial Congress to the consultation questions

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

The policies and procedures for originating and monitoring credit risk-bearing transactions should include:

- <u>with respect to origination:</u> new and renewed transactions;

The introduction of regulations involving the monitoring of 'old lending portfolios' may require amendments and annexes to existing contracts. This can be troublesome especially for clients whose amended terms will depart considerably from the previous contract. In addition, a client may always refuse to amend the terms of contract, resulting in a no-win situation. Therefore, the Guidelines should apply to new acquisitions.

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

The very short time for adjustment coupled with the very broad scope of the Guidelines, which cover the entire credit process (including origination, creditworthiness assessment, collateral valuation and monitoring), could pose a risk.

The principle that movable assets should always be valued by a property valuer when accepting collateral will be ineffective and will significantly inflate the cost of funding for the client / bank. The bank should also retain the right to waive the valuation of assets accepted as collateral when they are treated as a comfort factor – it is not explicitly stated whether it will be possible.

Some guidance on IT solutions or statistical models may prove difficult to implement due to limited funding and time to implement the Guidelines. A number of other principles mentioned in the Guidelines are already in place and do not need any changes.

Additionally, we would like to point to the need to set up a transitional period, e.g. until 31 March 2021, to allow for the smooth implementation of the necessary adjustments of and amendments to credit regulations, technology (IT) changes, and any potential legal changes in the business environment (such as the approach to renewable energy projects).

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

The requirements are general enough to warrant a claim that even with imprecise predictions of climate changes and the pace and direction of developments caused by technical progress, they should not become outdated anytime soon.

The technology enabled innovation section (4.3.3) and the green lending section (4.3.4) are key, as they address the two main challenges faced by financial institutions today. These sections set out very basic requirements that will remain valid or even become more important in the risk assessment process.

The use of technology enabled innovation has become an increasingly common practice followed by banks in client risk assessment based on available (big) data sets on clients and credit operations on client accounts. Additionally, PSD2 solutions support market actors in obtaining broad access to information on clients' banking operations, which will additionally drive a wider use of technology enabled innovation in client risk assessment. The specificity of this innovation is that it uses large amounts of data and advanced risk modelling techniques. In the nature of things, credit approvals/pre-approvals for client group covered by those rating models will not be 'traditional' decisions and they will not be based on data typically required by banks from their clients. They will be largely based on complex algorithms for the assessment of client risk profile.

The requirements of Guidance Section 4.3.3 for environmental and green funding aspects are, for the most part, of a general nature, pointing to the need for banks to account for factors related to environmental protection, climate change and investment financing for 'green projects'. In this respect, the Guidelines should remain up-to-date in the future, but still they may need to be supplemented with regard to the assessment and monitoring of green funding risk. Currently, due to a too short time frame, there is not enough data yet for an overall assessment of green funding projects, in particular for the calibration of project risks – whether such investments carry the same, higher or lower risk compared to existing types of investments/sectors which receive funding. We are also unable to estimate the risk of climate change per se, and thus to deliver a full efficiency evaluation for individual investments, which could turn out to be difficult to complete in case of natural disasters. For corporate clients, too, it will be a challenge to provide new data and information required to assess such risks, as no common standards exist for environmental impact assessments of mitigation and adaptation projects. Therefore, specific environmental impact assessment procedures and standards developed by banks are likely to quickly become obsolete.

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

An important advantage of the requirements for credit risk policies and procedures (Section 4.3) is that they are comprehensive in nature, covering the entire area of bank loan origination and monitoring. From a practical perspective, however, in many instances it would be useful to clarify some requirements that are expressed in vague terms such as 'appropriate' or 'comprehensive'.

The Guidelines identify the elements to be considered in policies and procedures, but without specifying detailed requirements for each of them. This means that detailed requirements are not harmonised and will depend on the approach taken by individual supervisory authorities, on local standards, if any, and the Guidelines.

The requirements for credit risk policies and procedures (Section 4.3) do not offer any guidance as regards the level at which such policies and procedures are to be approved. The most sensitive documents, having the greatest impact on the quality of the credit portfolios (in particular on risk appetite levels and maximum DtI ratios), following approval by a bank's board of directors, should receive final approval from the supervisory board. In the case of less significant but still important documents, approval from the bank's board of directors is necessary.

The strict definition of requirements for acceptable levels of individual financial indicators listed in Annex 1 may give rise to certain concerns. With respect to the credit risk of large companies, which is assessed on a case-by-case basis relying on comprehensive information, the levels of individual indicators should be provided as an indication rather than strictly binding requirements.

Credit assessment of complex projects, large entities and groups of companies is based on much more information than it is in the case of SMEs, and individual solutions offered to clients require more in-depth analysis that goes beyond ratios. A rigid framework for acceptable indicators could hamper and delay the decision-making process in cases where some of the indicators exceed the procedure's predefined levels due to the nature of activities or specificity of a transaction.

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

As regards the management of credit granting and monitoring, the content of the Guidance is to be assessed positively. The aforementioned aspects are important from the perspective of risk management and capital adequacy and they build on the *EBA Guidelines on internal governance*. The implementation of the Guidelines will be challenging, as it will require a review of the entire credit process. Some elements may be new for banks (Technology-enabled innovation for credit granting as well as Environmental factors and green lending), but many of them already exist, which will require banks to verify them thoroughly.

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

The requirements of Guidelines Section 76 properly address the minimum risk management standard and are consistent with the applicable recommendations of national regulators and the practice of the Polish banking sector.

The concept for the organisation of the risk management function and internal control system presented in the Guidelines is, with respect to this function, consistent with the existing external regulations. In consequence, its full implementation will not require banks to undertake significant adjustment efforts.

We support the view as regards the need to maintain the independence of a risk management unit that does not directly benefit from decisions to extend the credit.

There may be some concerns as regards the content of paragraphs:

- 76 (g) – pointing to the need for the credit risk management system to include *"providing independent/second opinion to the creditworthiness assessment and credit risk analysis"*. Such provisions may exclude a credit risk management system where creditworthiness assessment is performed only by an employee of an independent risk unit, and as a result there is no second opinion. Therefore, the provisions concerning the second opinion should not be strictly applied to short-term, low-value and secured lending.

- 76 (i) – pointing to the need for the credit risk management system to cover the development of new credit products, which is a function of a business / individual business line.
- 76 (e) – pointing to the need for the credit risk management system to cover the function of *"commercial planning in line with the overall business strategy and credit risk appetite, including cascading them down the organisational commercial and risk objectives"*, which is the responsibility of either the bank's controlling services, or the business.

It seems advisable for the Guidelines to address the location of the collection function (soft and hard collection), because the current wording of Section 4.5 does not mention this function, and some local banking laws explicitly state that this function is a bank's risk domain.

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

The scope of information which, according to the draft Guidelines, is to be collected for creditworthiness assessment purposes is very broad and covers exhaustively all items that may be useful for assessing a client's creditworthiness. The fact that this part of the Guidelines takes such a broad perspective in itself deserves high appreciation. Nevertheless, it is appropriate to highlight two points.

Throughout Section 5, there are several lists of documents and information which a bank is to request when processing a credit application. The phrase 'at least' is used there, suggesting that the bank should require every item from a list, and that it may also require some additional materials. At the same time, paragraphs 86, 144, 155 and 186 contain a rational and direct reference to the principle of proportionality. This way an ambiguity is created, as on the one hand, the bank is expected to behave proportionally to its risks, products, and clients, and on the other hand, it is expected to request all items listed in a relevant paragraph of the Guidelines, as a minimum. This leads to a contradiction that would be best avoided by writing *where relevant*, or *where applicable* instead of *at least*.

However, it is known that the principle of proportionality, although very useful, is often abused and serves to circumvent legitimate requirements. It is unlikely that a small entrepreneur who applies for a low-value loan will present all the documents required under paragraph 93, as the full list provided in that paragraph is more relevant to larger clients and higher amounts. On the other hand, referring only to the principle of proportionality could lead to circumvention of the Guidelines. Therefore, two ways of proceeding could be worth considering. Firstly, like in the CRR, loans below a certain amount extended to entrepreneurs with an annual turnover below a certain threshold (which does not have to coincide with the CRR amounts) could be treated as consumer loans. Secondly, it could be expressly stated that national supervisory authorities can exclude certain documents from the list if an entrepreneur applies for a loan which is small in relation to the scale of his or her business. However, the bank could always request any additional documents.

Institutions should be free to define the scope of information necessary for the assessment of credit risk based on the principle of proportionality, due diligence and prudential requirements in the credit risk management process. The detailed lists of documents provided in the guidelines should be treated as an indication or optional recommendations, rather than a mandatory set of documents in each case.

For example, the requirement to provide a business plan and financial projections (paragraph 93 (e) and paragraph 93 (f)) will impose a disproportionate bureaucratic burden on banks regardless of exposure sizes, which will not add value, will not improve the quality of loan portfolios, and will only slow down processes and inflate the cost of credit processes instead. In the case of short-term working capital financing and/or a client with a stable financial situation operating on a relatively stable market, the delivery of projections should not be obligatory, neither should be the preparation of internal counter-projections by the bank. They should be used if they add value to the assessment of client creditworthiness, in accordance with the principle of matching analysis intensity to the type, scale and complexity of lending requested. Therefore, 'where applicable' should be inserted in paragraphs 93 (e) and 93 (f). This relaxation is particularly important, because the Guidelines repeatedly refer to the examination of future cash flows (in paragraphs 125, 127, 132 (a)). Despite the admission of the principle of proportionality, it may be difficult for banks to defend following these requirements only for certain transaction types.

Banks should be able to differentiate their requirements for collection of information and documentation for the purposes of creditworthiness assessment of entrepreneurs, for example depending on the entrepreneur's business scale, the scope of accounting records that he or she is required to keep under the laws applicable in his or her jurisdiction, the risk of the product requested and the bank's exposure relative to capital – this rule is not covered by the document. In the micro-enterprise segment, assessment of creditworthiness largely depends on the form of tax reporting. A vast majority of entrepreneurs use simplified forms of accounting, such as the tax card, lump sum tax on registered revenue or the revenue and expense ledger. Moreover, the Polish market has a large share of self-employed people, who carry out their activities in a form that is very similar to an employment contract. Such businesses have a single client to whom they provide 100% of their services. For them, the basic documents include revenue and expense records or tax returns. They do not file any documents such as balance sheets or income statements. The scope of documentation required should be adapted to what the company has available and to the kind of financing requested. The 'professionals' category is therefore too broad (being defined as non-consumer) and should be made more specific.

Additionally, please note that the verification of authenticity of all client-provided information in the credit process for retail clients is essentially impossible. For individual borrowers, most decisions are automated and based on simple, basic documents that confirm the client's income level. Other data is collected according to a client's declaration and is verified, as far as possible, against internal and external data sources.

The applicability of guidance on the scope of data verification will significantly complicate credit processes and considerably restrict the possibility of selling loans via remote channels (which conflicts with the process of digitising all business processes in the banking sector and beyond, but is what clients expect). In addition, it may encourage clients to seek out businesses which are not covered by banking regulations (lending companies, fintechs). Additionally, the Guidelines undermine the concept of processing applications in line with simplified creditworthiness assessment principles (Recommendation T of the Polish Financial Supervision Authority).

The data structure, mainly in terms of business activity, is not adequate for a simple CF process. An in-depth analysis of the borrower's related entities (e.g. within a single company) is not warranted, as a borrower financing his or her personal needs is liable for the repayment of the loan with their entire property.

The requirement to collect and document income information arising from Section 5.1.2, paragraph 91 of the draft Guidelines and its related Annex 2 could mean a significant change for credit institutions operating in Poland. For retail clients in Poland who meet the criteria of Recommendation T, there is a possibility to carry out a simplified assessment of creditworthiness and rely on the client's income and expense declarations, in which case the amount of income can be established based on the account history.

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

The answer to question 5 is valid here as well. The Guidelines contain a very detailed list of steps to be taken by a bank in assessing a client's application and creditworthiness. However, the Guidelines as they now stand add much less value than what could be achieved and, more importantly, than what the credit market needs today. It is not enough to include a list of required steps broken down by credit category only. This section needs to be made much more specific. Suffice to say, each credit category includes loans ranging from very low to very large amounts, with maturities from a few months to as much as 25 or 30 years. For instance, creditworthiness assessments would be different for a natural person buying a TV, a car, and an apartment. A loan for a small business buying a small machine would differ from a loan for a large property development project. Certainly, just like we proposed in our reply to Question 5, national supervisory authorities could be made responsible for adding more detail. This would make sense, as individual home markets and their respective actors are very different. But even in that case, Section 5 of the Guidelines needs considerable improvement.

The requirements described in Section 5.2 seem adequate for large and significant credit exposures. For smaller exposures and clients, banks should be able to adapt the scope of analysis on a case-by-case basis. When extending credit risk-bearing products, a bank always assesses the prospective creditworthiness (a prerequisite under the Banking Law), which does not mean, however, that the client always needs to provide the Bank with its, for example, cash flow (because cash flow estimates can be prepared by the bank), sensitivity analysis, financial projections, etc. In addition, some clients, by reason of their business scale and the standard reporting requirements they are subject to, would not be able to deliver the scope of data required by the Guidelines. Banks individually define the scope of and approach to creditworthiness assessment considering the specificity of the client, funding amount, risk of the credit transaction and the internal decision-making process to which the client will be assigned.

We would like to draw your attention to paragraph 112, which seems to be very restrictive. In particular, it seems appropriate to limit these requirements to situations where the rental income is significant in the context of creditworthiness assessment. However, even if that were the case, the analysis of the ability to obtain permits (item (d)) combined with the analysis of the ability of achieving the assumed revenue should be sufficient. In addition, it is not entirely clear why the guidance on other secured lending to consumers (5.2.3) does not refer in practice to the examination of the client's ability to repay, regardless of credit security. The guidance on unsecured lending, on the other hand, overlaps with certain items from the guidance on lending relating to residential immovable property, for example it seems that paragraphs 105 and 118 could be moved to the general guidance on assessment of consumer's creditworthiness.

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

The asset classes referenced in the guidelines – lending to consumers: mortgage lending, other secured, unsecured; lending to professionals: corporate financing, commercial real estate, shipping finance, finance of infrastructure projects – support a sufficiently different approach to each of the aforementioned client segments.

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

It seems advisable to clarify which specific metrics should be taken into account for given types and volumes of exposures.

A full implementation of these requirements would require banks to use relatively advanced management accounting methods in the context of internal capital and cost allocation. This could pose a huge challenge (in terms of organisation, cost and time) for many smaller banks, undermining their performance.

Banks expect to experience difficulties in the estimation of the value referred to in paragraph 187 (c) *operating and administrative costs resulting from cost allocation processes that involve all group entities*. Banks are already following the guidance, but at the aggregate level of a business line or product, and they do not have any methodology that would enable them to allocate these costs after the transaction. The same applies to paragraph 189, which refers to banks having cost allocation frameworks, implicitly allowing for disaggregation once a contract ends.

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

The requirements apply to all movables and immovables, which seems to be too rigorous an approach. The requirements of Section 7 should only apply to eligible collateral reducing capital requirements under the CRR, which should be incorporated in the Guidelines in relation to all of Section 7.

Paragraphs 196, 207 (b), 208 (b) and 208 (c) should be deleted. Even the CRR, which sets out requirements for monitoring of immovable property values in the case of eligible collateral reducing capital requirements, does not include any requirements related to deterioration of the client's situation, LTV level or transaction value. The aforesaid paragraphs impose additional obligations on banks in this respect, requiring them to incur additional costs.

Does paragraph 197 refer to a closed list of persons who are permitted to deliver valuations? Credit processes use a list of licensed individuals who are authorised to perform collateral valuations. To the best of our knowledge, any list of a bank's preferred valuers (a closed list of valuers) would be inconsistent with the national laws, in particular with the recommendations of the Office of Competition and Consumer Protection (UOKiK), Poland's competition authority.

We suggest an extension of the catalogue of tools serving to determine the market value of collateral (movable property). For many credit transactions, means such as invoices, purchase contracts, indices, industry price lists such as: Skocenbud, Eurotax, etc. or in-house valuations delivered by bank's employees or related companies specialising in specific asset financing (such as leasing companies) are considered sufficient for the verification of collateral value.

Institutions should have some leeway in their choice of data sources and tools to establish the value of movables. The external valuation requirement should be limited to individually significant exposures or transactions involving elevated credit risk, e.g. by analogy to immovable property, as referred to in the Regulation (EU) No 575/2013 of the European Parliament and of the Council, Article 208(3b) (EUR 3 million or 5% of own funds).

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

With respect to the proposed requirements for the monitoring framework (Section 8), the Guidelines correspond to the standard used by Polish banks. In our opinion, the proposed scope is sufficient.

All credit exposures are monitored throughout the period of credit to enable adequate anticipatory and early warning measures to be taken.

The provisions of Section 8 concerning the monitoring framework can be supplemented by consumer monitoring-related considerations. It should follow clearly from the Guidelines that with respect to consumers, the bank needs not require them to submit documents confirming current income levels, and monitoring can be based on the bank's own information and information retrieved from external databases. Similarly, in the case of exposures to SMEs, it should be possible to monitor clients with the use of behavioural analysis, information retrieved from external databases, etc. without requiring clients to provide detailed information about their financial situation.