**EBA DRAFT GUIDELINES ON LOAN ORIGINATION AND MONITORING**

**RESPONSE BY THE FLA**

**About the FLA**

The Finance & Leasing Association (FLA) is the leading trade body for the asset, consumer and motor finance sectors in the UK. Our members include banks, subsidiaries of banks and building societies, the finance arms of leading retailers and manufacturing companies, and a range of independent firms.

In 2018, FLA members provided €154 billion (£136 billion) of new finance to UK businesses and households. €116.8 billion (£103.3 billion) was in the form of consumer credit, accounting for over a third of all new consumer credit written in the UK. €37.1 billion (£32.8 billion) of finance was provided to businesses and the public sector to support investment in new equipment, representing over a third of UK investment in machinery, equipment and purchased software.

Within the new finance total, €51.8 billion (£45.8 billion) helped consumers and businesses buy new and used cars, including over 91% of private new car registrations. In 2018 members provided over 23,500 new second charge mortgages, with a total value of €1.2 billion (£1.1 billion).

We are listed on the EU Transparency Register (02389833548-89).

**Executive Summary**

The FLA understands the rationale behind EBA’s draft guidelines. However, we perceive several adverse consequences:

* The purpose of guidelines or guidance is to interpret rules, whereas these appear to impose new duties. The EBA’s guidelines are prescriptive, lack flexibility, and are not sufficiently forward-looking to encourage innovation.
* The guidelines are designed for high value lending. This makes them more onerous for small-scale lending, often provided by smaller firms and/or new market entrants. This will be particularly the case in respect of loan origination guidelines set out in section 5 which will be extended to the vibrant non-banking sector in the UK.
* The guidelines pre-empt the European’s ongoing review of the Consumer Credit Directive and conflict with the FCA’s recent changes to creditworthiness and affordability assessments which are based on proportionality and offer flexibility to vary criteria according to, for example, product type, lending channel or amount of borrowing. The EBA’s prescriptive approach will likely raise the cost of credit and increase financial exclusion.
* Their application to leasing has no legal basis in EU consumer protection rules and would confuse the regulatory boundary in the UK which currently includes smaller business loans.
* The loan pricing requirements introduce rules for what is currently part of a firm’s commercial judgement.
* The proposals on valuations present a threat to established business models and would significantly increase costs for customers, while reducing market flexibility.
* The implementation timeframe for the guidelines is impossibly short and must be a minimum of 18 months following finalisation.

**Response to CP questions**

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

We understand the rationale for the EBA drafting guidelines on loan origination i.e. to ensure a seamless approach between banks’ approach to prudential standards and how they manage risk notably of their customers. However, in practice we envisage several problems.

The proposals appear to be targeted at high-value loans with significant manual oversight, and do not take account of lower value lending, often within non-bank institutions, where significant automation in the credit decision-making process is likely to be present. This automation saves time and cost for the customer. If its use were limited by this measure, this will stifle innovation within the industry.

The UK has a vibrant non-bank sector both in terms of consumer lending but also corporate lending neither of which are regulated for prudential purposes. These rules which apply only to banks would therefore create a two-tier system and could inadvertently discourage lenders from applying for a banking licence.

Paragraph 12 states that section 5 applies to firms within scope of the Consumer Credit Directive (CCD). The fact that these non-bank lenders will be expected to adhere to this part of the guidelines will increase their costs. These firms are often better placed to serve more specialised lending markets, thereby preserving competition and diversity to the benefit of customers. Some non-banks may exit the market, reducing consumer choice.

Many loans are originated by non-banks who may sell on their loan portfolio to a bank. Given the current scope, it is unclear whether these loans would be required to comply with the other sections of the guidelines. If they were, then this would make these deals much less attractive to non-banks in the first place thus further distorting market competition. Without clear guidance, the trade in loan portfolios would be seriously impaired by these proposals.

Along with the widening of scope, the application of the guidelines to ‘professional’ loans represents regulatory creep and pre-empts the outcome of negotiations on the European Commission’s review of the CCD which clearly only applies to consumers.

The EBA’s definition of ‘professional’ as being ‘non consumer’ is unhelpful as no definition of ‘consumer’ is provided. Under the UK Consumer Credit Act, the term ‘individual’ includes a sole trader, a small partnership (3 partners or less), and an unincorporated association. There is no definition of a “professional” borrower in the UK and this novel distinction is incompatible with the current regulatory framework which would require substantive legislative change to meet the proposed new requirements.

The credit granting criteria for professionals may not be sufficiently sophisticated to account for more complex lending, such as corporate loans. This sector is currently exempt from regulation and therefore imposing new requirements would require detailed consultation, alongside consideration as to how they would interact with the overall regulatory framework for financial services in the UK. This would result in significant regulatory change and a comprehensive Cost Benefit Analysis would be needed.

The term ‘requirement’ has no place in guidelines or guidance, the purpose of which is to interpret rules, and yet the consultation paper refers to ‘requirements’ 128 times. The term ‘should’ deployed more than 400 times, also presumes a statutory obligation.

The reference in paragraph 15 of the Background to the consultation paper specifically precludes taking a proportionate approach to creditworthiness assessment. This conflicts with the conclusion by the Financial Conduct Authority (FCA) in its recent review of creditworthiness and affordability assessments in the UK market (the largest in the EU), that a proportionate approach was necessary. Such an approach properly recognises the broad range of credit products available, customers’ differing circumstances and importantly credit risk. A one-size-fits-all approach disregards these important factors and would be inappropriate.

The assertion in paragraph 16 of the Background that loan origination guidelines be applied to renegotiated terms or credit reviews risks fuelling speculative activity from Claims Management Companies if they believe firms have not complied with new obligations. This also imposes very short timescales for businesses to prepare and to implement these practices by the proposed date of 30 June 2020.

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

The guidelines as currently drafted introduce wholesale changes which would require at least 18 months to two years to implement once the guidelines are finalised (presumably by the end of 2019). This will give national regulators the time to conduct their own consultations on what represent major changes for the mortgage, consumer credit and asset finance sectors. Firms will require time to introduce the necessary changes internally, for example to IT systems, documentation and internal structures (see response to question 6) and set budgets accordingly.

The date of the application for the guidelines pre-judges the outcome of the European Commission’s review of the CCD which is unlikely to be concluded before the end of 2020 at the earliest and even will be subject to scrutiny by the European Parliament and Member States.

From a UK perspective, the implementation deadline coincides with that for the UK and the EU to agree an approach to a future framework for financial services under the draft political declaration which accompanied the draft Withdrawal Agreement struck between former Prime Minister May and the EU. As the risk of ‘no deal’ increases, it remains to be seen how UK regulators will react to new obligations.

1. *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 and environmental factors and green lending?*

Paragraph 47 in respect of technology-enabled innovation appears to be at odds with the [Open Banking](https://www.openbanking.org.uk/) concept. This UK initiative bypasses banks’ information verification requirements as consumers take control of their own data and conflicts with paragraph 47b which requires firms to manage the potential for bias.

It is unclear how banks could incorporate into their policies and procedures the physical risks outlined in paragraph 53, which are not predictive within the context of lending business models.

Similarly, it is difficult to envisage how a firm could implement some of the environmental considerations outlined in the guidelines, especially in relation to the ‘tone from the top’ (paragraph 23). If this approach is adopted, then a mortgage lender could be placed in a position where it had to make decisions to lend based on factors such as a prospective borrower’s property being properly insulated, which would not ordinarily fall within its remit. This could increase the burden on lenders who may need to invest additional time and money into bringing these properties to the required standards and may also have a significant impact on the speed at which lending decisions are made in the future.

1. *What are the respondents’ views on the requirements for credit risk policies and procedures?*

The scope of paragraph 47 is not clear. For example, does it apply to all technology-enabled innovation in the credit granting process, or only to the final yes/no decision? Furthermore, would the paragraph apply if the technology were used only for a part of the process (e.g. evaluation of potential fraud risk) or if it were subject to manual override?

Paragraph 47d under section 4.3.3 of the guidelines in relation to credit granting appears to add a layer of complexity by requiring verification and regular monitoring of credit decisions. Firms regularly use automated processes to undertake these decisions and would therefore need to invest in additional manual interventions in order to meet these requirements (they already review applications manually on request).

Paragraph 47c is also too prescriptive and would preclude the use of artificial intelligence (AI). A recent [FCA insight paper](https://www.fca.org.uk/insight/explaining-why-computer-says-no) notes that there is a trade-off between being able to explain the outcome of a credit decision and the use of AI to inform these decisions. The paper concludes that the focus should be on ‘sufficient interpretability’, however the proposed rules here appear to go further.

1. *What are the respondents’ views on the requirements for governance for credit granting and monitoring?*

We would welcome a more forward-looking approach from the EBA. The guidelines are drafted on the assumption that all firms in scope use archaic credit risk underwriting processes, when many have automated these processes for decades. The tone of the guidelines is old-fashioned in nature and could restrict innovation.

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

The FCA’s Senior Managers and Certification Regime makes clear (SYSC 6.1) that non-banks must manage their compliance obligations but not to the same degree as for banks.

The definitions of ‘the three lines of defence’ at paragraph 75 are at odds with the well-established ‘three lines of defence’ standard used by firms in the UK. The use of the same terminology in the EBA guidelines may cause some confusion on which approach to use.

As regards the substance of paragraph 75, there is potential for overlap between the second line of defence’s responsibility for controls of the credit risk taking and management process with the duties of the first line.

In the UK, the first line of defence has ownership, responsibility and accountability for directly assessing, controlling and mitigating risks for the firm; whereas, the second line of defence monitors and facilities the implementation of effective risk management practices. The third line of defence is usually made up of the internal audit function.

As currently drafted, the reference to the third line cited in the guidelines is geared towards a bank’s credit risk and would therefore not be appropriate for non-banks.

More broadly, as a result of these rules, lenders would need to invest a significant amount of time to cross-reference the proposed guidelines with their internal committees and policies. This could take some firms a lot of time to put into effect, especially where organisational structures are more complex.

1. *What are the respondents’ views on the requirements for collection of information and documentation for the purposes of creditworthiness assessment?*

The application of section 5 to non-banks will amplify the concerns set out in our response to questions 7, 8 and 9 and will, in particular, adversely impact smaller lenders (including those offering credit at the point of sale), digital start-ups and app-based lenders.

The concept of a ‘single customer view’ (SCV) cuts across the sophisticated models employed in the credit industry which are based on automated decision-making. In practice, there may be a series of different SCVs that illustrate the financial position of the borrower. We would welcome further clarification on the definition of this model.

Paragraphs 85 and 86 go further than the UK regime (contained within the FCA’s [Consumer Credit Sourcebook](https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKEwiu3daqgeTjAhUHHcAKHbAhABoQFjAAegQIAxAB&url=https%3A%2F%2Fwww.handbook.fca.org.uk%2Fhandbook%2FCONC%2F1%2F%3Fview%3Dchapter&usg=AOvVaw166KMw9Q-RtEf2cqopTVOR) (CONC)), in that it introduces an affordability assessment for corporate lending (given that this falls under loans to professionals), which is currently exempt from regulation. The key criteria for credit risk by this category of lenders, much of which is of high value, should remain the client’s propensity to default. Paragraph 85 also requires firms to have a “comprehensive view of all of the borrowers credit commitments”, which may not always be possible for the lender to ascertain in practice.

The ‘plausibility’ check specified in paragraph 88 assumes a level of human intervention, which does not work for the many firms that use automated credit decisioning. This check will add a layer of manual processing and risks firms having to duplicate their efforts, which could lead to a significant drain on available resources and increased costs for consumers.

Separately, the specific requirements for lending to consumers as enshrined in paragraph 91 and Annex 2 will presumably require written evidence which goes against the FCA’s recent changes to creditworthiness and affordability assessments which are predicated on proportionality. Such a prescriptive approach will likely raise the cost of credit and increase financial exclusion. It does not allow for sufficient flexibility to vary the affordability criteria according to, for example, product type, lending channel or amount of borrowing.

The list of information to be collected from consumers in Annex 2 is overly prescriptive and requires records to be kept that are not part of the normal UK credit granting process such as evidence of tax status or evidence of the insurance of collateral.

Where there is a novation of an agreement, for example from an individual’s own company to a sole tradership or to a larger partnership, many funders will not undertake a full affordability assessment as in many cases the risks to the funder are likely to be substantively similar as before the novation. This can be for many reasons including the same guarantor, the same directors being behind the business, or a similar type of business. This makes compliance with paragraph 95 superfluous.

Sometimes, after a loan book has been sold, customers may request novation from the new lessor. The new lessor may opt not to undertake full creditworthiness assessments on this process for the reasons stated above. This is a proportionate decision which ensures the customer can continue to benefit from the finance provided. If the new rules impose a requirement for greater creditworthiness assessments of these customers, it may discourage the sale of loan books and make novation, and the flexibility it provides to some customers, more difficult.

1. *What are the respondents’ views on the requirements for assessment of borrower’s creditworthiness?*

The EBA’s background to the draft guidelines emphasises proportionality but deliberately excludes creditworthiness assessments of consumers from this, which will adversely impact, for example, lenders’ ability to serve the market for small value loans. In contrast, the FCA has taken more pragmatic view which recognises the diversity of the credit market.

Paragraphs 98 and 99 are also overly-prescriptive, notably the introduction of metrics, such as debt-to-income ratio, that in the UK mortgage market, have been replaced by a regulator-prescribed, sophisticated affordability model based on disposable income. The impact will therefore be to constrain lending. Further clarity is required on how the conflicting approaches between the proposed guidelines and national models will operate together in practice.

The concept of ‘sensitivity analyses’ (implying several actions by the lender) in paragraph 101 will be onerous, particularly for smaller value loans and gives no flexibility for the lender to exercise discretion. For example, balloon payments which are a feature of personal contract purchases (PCPs) in the UK are priced into this model, whereby the consumer is given a guaranteed future value. Furthermore, assessing the borrower for a reduction of income goes far beyond conventional practice in the UK and could be extremely difficult to both evaluate and explain to a customer.

The ‘sensitivity analyses’ in respect of secured lending (paragraph 114) are also burdensome and go far beyond the normal criteria for assessing Buy-to-Let mortgages and construction finance in the UK. The reference to the marketability of a property may be impossible to meet as not all properties are marketable.

The guidelines do not make any allowance for credit to be granted on the basis of a future increase in income, including a loan to finance higher education, as per the FCA’s rules (CONC 5.24.16).

Paragraph 123 applies the requirements for analysis of the borrowers’ financial position to leasing. A clear definition of “leasing” is not provided – for example whether this refers only to finance leases or to both finance and operating leases. It is also unclear how this will affect non-bank leasing. As stated above, this could create a two-tier system.

1. *What are the respondents’ views on the scope of the asset classes and products covered in loan origination procedures?*

The inclusion of lending to ‘professionals’ within the guidelines sets a dangerous precedent of regulation for what is supposed to be non-mandatory guidance. No evidence for the need to include leasing within the guidelines is presented (indeed except for regulated customers, leasing is not considered to be “lending money” by the FCA under their complaint-handling (DISP) rules).

The question of where Buy-to-Let agreements sits within the guidelines is unclear. Paragraph 113 classifies these as consumer loans but they can also be offered to limited companies, in which case they would be classed as professional loans. We would welcome further clarity on this.

As a general point, we suggest that the EBA use the model developed for [securitisation exposures](https://eba.europa.eu/documents/10180/2298183/Draft%2BRTS%2Bon%2Bhomogeneity%2Bof%2Bunderlying%2Bexposures%2Bin%2Bsecuritisation%2B%28EBA-RTS-2018-02%2B%29.pdf) (see p. 16). This would set out clearly which asset classes are within scope of the guidelines and which parts of the guidelines apply to which assets. This would also need to specify that if a Member State did not regulate a particular product type then this would be outside scope of the guidelines.

1. *What are the respondents’ views on the requirements for loan pricing?*

The loan pricing measures appear to be designed to bring together prudential and consumer protection measures. However, these serve different purposes and should therefore not be treated as part of a ‘one size fits all’ model.

The requirements are particularly problematic because they impose regulation on what is currently part of a commercial judgement. It would be particularly damaging to innovation and prevent firms introducing new models which usually operate at a loss initially.

If the matrix of prices described in paragraph 189 was applied to loans at an individual level it would be impossible to implement. Firms publish these matrices but the main basis is to ensure a positive rate of return (some loans will be above the bar, others below it).

Paragraph 187d conflicts with credit risk strategy for consumers which firms base on demographic groups rather than by product category.

1. *What are the respondents’ views on the requirements for valuation of immovable and movable property collateral?*

The requirements set out in paragraph 195 present a significant threat to existing business models based on automated valuations at the point of loan origination for immovable property. As currently drafted, these guidelines state that desktop or drive-by valuations can only be taken where the properties in question do not share similar characteristics to the ones already valued or revalued by the valuer. The implication is that, where this is not the case, a physical visit to the property would be required for every mortgage application that is granted.

Removal of automated valuations would also increase costs for consumers, who often bear the cost of valuations associated with many mortgage products. The need to take time off work, to open up a house to a valuer adds to even further inconvenience for borrowers. Taking speed, cost and convenience together, the requirement for a surveyor valuation would add considerable friction to the remortgage process and could result in consumer harm if, as a result, borrowers chose to remain on uncompetitive products with their existing lender – which could lead to some consumers ending up as potential ‘Mortgage Prisoners’. The guidelines do not appear to acknowledge the sophistication of existing practises within this market and could significantly increase application processing times.

The requirements for moveable property also introduce new unworkable duties. Leasing firms usually rely on members of staff to assess values of the assets they fund. They will have in-depth knowledge of the products they fund, especially in the case of vendor finance provided by equipment manufacturers. For example, a manufacturer of a very specific type of agricultural equipment, that also offers funding, is likely to be best placed to identify the future value of that equipment. Paragraph 225 (e) appears to suggest that anyone involved in valuation should be independent of the funder.

1. *What are the respondents’ views on the proposed requirements on monitoring framework?*

At paragraph 234, the proposed rules on the credit risk monitoring framework make reference to a SCV. As noted above, there may be some challenges for firms seeking to implement this as different approaches may be used in practice.

Overall, the monitoring framework reinforces many of the issues raised in our response, notably that the lack of flexibility in guidelines would hinder innovation, harm competition and disincentivise smaller lenders. It also potentially conflicts with existing FCA rules requiring consumer lenders to take steps to encourage customers to pay more, such as under the credit card persistent debt rules in CONC 6.7.27R to CONC 6.7.40G, irrespective of whether this increases the credit risk in the relevant portfolio.

**27 September 2019**