

## **DIRECTIVE ISSUED TO CREDIT INSTITUTIONS ON LOAN ORIGINATION PROCESSES**

### **BANKING LAWS OF 1997 to 2013**

**[66(I)/1997, 74(I)/1999, 94(I)/2000, 119(I)/2003, 4(I)/2004, 151(I)/2004, 231(I)/2004, 235(I)/ 2004, 20(I)/2005, 80(I)/2008, 100(I)/2009, 123(I)/2009, 27(I)/2011, 104(I)/2011, 107(I)/2012, 14(I)/2013, 102(I)2013]**

### **Directive based on article 41**

The Central Bank of Cyprus, by virtue of the powers vested on it by section 41 of the Banking Laws of 1997 to 2013, issues this Directive to credit institutions.

The Directive regulates aspects which relate to processes and practices followed by credit institutions in granting advances and loans to customers.

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## **PART I**

This directive prescribes **best practices** to be followed by credit institutions in their credit granting activities. These practices should immediately be embedded in credit institutions' internal guidance, policies and procedures.

Senior Management should ensure that these internal guidance, policies and procedures are communicated to the relevant staff in a transparent and clear manner and that staff involved in the loan origination process is adequately trained and experienced so as to apply the provisions of this Directive.

Credit institutions are required to proceed with all necessary changes and improvements to their IT systems so as to facilitate the implementation of this Directive.

### **1 Pre-contractual information for private individuals - Housing and consumer loans**

Credit Institutions are required to provide to all natural persons minimum information of the product the customer is interested in. The scope being to protect consumers and provide uniform and easily comparable information. The information should be provided in a standard written format. The form should at least provide the following information:

- Current date and duration of the offer.
- Short description of the product and the purpose of the facility.
- Amount and currency of the facility.
- Duration of facility.
- Number and frequency of payments.
- Nominal rate (indicate type of rate and duration of fixed period). Credit institutions should carry out scenarios for increase of interest rates or base rates, in order to calculate the increase in the instalment amount.
- Annual Percentage Rate of Charge (APRC) based on national regulation or effective rate, where relevant. The customer should be informed of the APRC on any kind of interest rate (fixed and/or variable) of the said product.
- Amount of each instalment for repayment of the loan, an illustrative amortisation table should be provided. The instalment amount should be broken down to show interest payment and capital payment. In case of a product with both fixed and variable interest rate, credit institutions should inform the customer about the instalment amount for each

interest rate.

- Form of security and any conditions related to the security. If the security is an immovable property, whether a valuation of the property is necessary and, if so, by whom it has to be carried out.
- Additional non-recurring costs, where applicable.
- Additional recurring costs.
- Whether there is a possibility of early repayment (if so, the conditions of early repayment including any penalty).
- Whether the customer is obliged to open a bank account in which customer's salary is to be deposited.

## **2 Customer Application**

Credit institutions should collect adequate information in order to properly assess the risks undertaken, the customer's ability to repay the facility, and the adequacy of collateral. Moreover credit institutions should verify the purpose of the facility.

### **2.1 Verification of customer's income**

The most important criterion which the credit institutions should consider, when assessing an application for granting a facility, is the customer's income and source of repayment and eventually customer's ability to repay.

The information to be obtained by credit institutions with regard to customer's income differs among natural persons and legal entities and is as described below.

#### **2.1.1 Natural person**

##### **2.1.1.1 Employees (private sector or public sector).**

All employees, either of private or public sector, should provide the following information regarding their income:

- Declaration of employment. The declaration should be signed by the employer and should state among other the current salary amount and date of employment and probable duration of employment (if applicable).

- Original salary slips for the last three months.
- Original bank statement for the last three months to verify salary (if salary is deposited in bank account).
- Income tax return submitted for the last two years.
- Income tax clearance of the last two years available.
- Latest annual social insurance statement.
- Documents supporting any other type of income (e.g alimony income, interest income, income from immovable property, income from welfare benefits, etc)

#### **2.1.1.2 Self-employed / freelancer**

- Confirmation of income by the customer's accountant if available.
- History of income or 3<sup>rd</sup> party verification for self-employed borrowers or seasonal or irregular sources of income.
- Proof of payment to income tax.
- Social insurance statement for the last two years.
- Income tax return submitted for the last two years.
- Income tax clearance of the last two years available.
- Documents supporting any other type of income (e.g alimony income, interest income, income from immovable property, income from welfare benefits, etc)

In case the guarantor is a natural person, credit institutions should request the same documents as mentioned above. Credit institutions are obliged to inform guarantors that the responsibilities emanating under their guarantee are exactly the same as those of the borrower. This information should be given before the guarantor signs the facility contract.

#### **2.1.2 Legal entity**

For all legal entities the following information should be collected.

- Audited financial accounts for the last three years. In case the customer has no audited financial accounts for the last three years, then recent unaudited financial statements should be provided (recent unaudited financial statements are those statements with reference date within 18 months from the date of facility application).

- Income tax return submitted for the last three years,
- Income tax clearance for the last three years available,
- Value Added Tax (VAT) statements submitted since last balance sheet date, if available.
- Quarterly financial accounts since last balance sheet date for listed legal entities.
- Financial accounts submitted to the registrar of companies, and quarterly trial balance since last balance sheet date for non-listed legal entities.
- Budgeted cash flows.

In case the guarantor is a legal entity, credit institutions should request the same documents as mentioned above. Credit institutions are obliged to inform guarantors that the responsibilities emanating under their guarantee are exactly the same as those of the borrower. This information should be given before the guarantor signs the facility contract.

Any inconsistencies between the different sources of income verification should be examined and if not legally justifiable should render the borrower ineligible for further assessment and the loan application should be rejected outright. This applies both during the assessment of natural persons as well as legal entities.

## **2.2 Assets of borrowers and guarantors**

For further assessment of borrowers and guarantors, credit institutions should also obtain the following:

- Statement of immovable property from land registry.
- Deposits with other credit institutions.
- Any other asset (eg shares, investments, etc)

## **2.3 Outstanding credit facilities with other credit institution.**

In case the applicant has any credit facility with any other credit institution, then relevant documents should be collected in order to verify the following information relating to the above mentioned facilities:

- Original facility amount.

- Current balance.
- Duration - maturity.
- Interest rate.
- Instalment amount - payment frequency - grace period (if any).
- Original bank statements of the facility account for the last three months.
- Security - type of collateral.

The above information should be collected in case the applicant and/or the guarantor is either a borrower or a guarantor to any facility granted by any other credit institution.

As soon as the Mechanism for the Exchange, Collection and Provision of data between the Authorized Credit Institutions is under full operation, then the above information may be collected from this Mechanism.

## **2.4 Loan documents**

Depending on the type of facility, credit institutions should request the following.

### **2.4.1 Personal loans - overdraft accounts to private individuals - credit cards**

- Loan/overdraft/card application fully completed and signed by all involved persons/entities, in the presence of staff of the credit institutions who should sign as witnesses to the signature.

### **2.4.2 Consumer loans**

- Loan application fully completed and signed by all involved persons/entities, in the presence of staff of the credit institutions who should sign as witnesses to the signature.
- Documents substantiating the purpose of borrowing, eg written offer to purchase a product / service, private contract for purchasing of product / service, proforma invoices, etc.

### **2.4.3 Housing loans**

- Loan application fully completed and signed by all involved persons/entities, in the presence of staff of the credit institutions who should sign as witnesses to the



signature.

- Purchase agreement contract (if applicable).
- Advance payment (if applicable).
- For the property to be financed and the property to be mortgaged the following documents are required:
  - Title deed.
  - Building permit.
  - Planning permit.
  - Topographical charts.
  - Building plans.
- In case of construction / renovation / completion, a detailed cost analysis.

#### 2.4.4 Facilities to legal entities

- Loan application, fully completed and signed by all involved persons/entities, in the presence of staff of the credit institutions who should sign as witnesses to the signature.
- Documents substantiating indicating the purpose of borrowing, eg written offer to purchase a product/service, private contract for purchasing a product / service, proforma invoices, bills of lading, etc.
- Advance payment and/or purchase agreement contract (if applicable).
- In case of project finance applicant should provide a feasibility study of the project which should include as a minimum:
  - A complete profitability study of the project.
  - Cost analysis.
  - Business plan.
  - Future forecast.
  - Worst case scenario analysis.
- In case of purchasing or construction / renovation / completion of immovable property applicant should provide for the property to be financed and the property to be mortgaged the following documents :
  - Title deed.
  - Building permit.
  - Planning permit.
  - Topographical charts.
  - Building plans.

- A detailed cost analysis (if applicable)

## 2.5 Additional information about the customer

- Credit institutions should obtain all necessary documents/evidence so as to comply with the requirements of the anti money laundering laws and directives.
- As in most cases the approving authority has no direct contact with the customer, front line officers should provide as much information as possible about the customer that cannot be determined from the accompanying documents. This may include:
  - information regarding customer's relationship with the bank, customer payment history for existing customers,
  - how the customer has selected the specific credit institution,
  - any information from the local market,
  - information gathered from the Central Information Register for the Issuers of Dishonoured Cheques (CIR),
  - information gathered from any other source that could be useful in assessing the customer's application.
  - once the credit register is operational, a printout of the report produced on the customer.

## 3 Loan appraisal / Loan approval

The appraising/approving authority has the responsibility to approve or reject a facility. Before reaching a decision it should take into consideration the provisions of the institution's credit policy and the various directives/circulars of the Central Bank of Cyprus.

As mentioned in 2.1 above the most important criterion which the credit institution should consider, when assessing an application for granting a facility, is the customer's income/future cash flows, and source of repayment and eventually customer's ability to repay. Therefore the appraising/approving authority should rigorously assess customer's financial data in order to decide on the customer's ability to repay the facility (re paragraph 3.3). The loan recommendation report should include a full analysis of the customer's repayment ability and a positive recommendation should be fully justified.

Furthermore the appraising/approving authority should consider the following:

### **3.1 Loan scope**

The appraising/approving authority should examine whether the true purpose of borrowing is disclosed and is relevant to customer's business or customer's profile and is not prohibited by the institution's credit policy.

The appraising/approving authority should set as a condition that facility funds should not be directed to the borrower, but to the service/goods providers e.g. in case of buying a car, the funds should be transferred directly to the seller, either by wire transfer or bank draft.

### **3.2 Own contribution**

When financing the purchase/ construction / renovation / completion of an immovable property, a credit institution should ensure that the buyer's own contribution is in accordance with the relative circulars of the Central Bank of Cyprus.

Customer's own contribution should not be made after facility full disbursement. It should either be made in proportion to the credit institution's contribution, or before any facility disbursement. In case where customer's own contribution for a housing loan is in the form of a grant to be received from the government, provided that the credit institution can substantiate that such grant is forthcoming, then the contribution can be paid when received and not in proportion with the loan.

### **3.3 Repayment ability**

In assessing customer's ability to repay his credit facilities, the credit institution should put emphasis on customer's income/future cash flows. Any kind of collateral which secures the customer's facilities should be considered as the credit institution's second way out in case of default and not as the primary source of repayment.

Income/future cash flows should be assessed against verifiable evidence as described under 2.1 above. Verbal representations from customers should be ignored.

### **3.3.1 Natural Persons**

In assessing the repayment ability of natural persons, credit institutions should consider the following:

#### **3.3.1.1 Recurring/steady total monthly income.**

Customer's recurring/steady total monthly income should be estimated as per excel worksheet titled "Section B - Income" of Appendix 2 - Part III - Personal Financial Statement (PFS) of the Directive on Arrears Management of 2013. For self-employed / freelancers that have no monthly salary, for the purpose of computing total monthly income, credit institutions should use the borrower's annual income divided by twelve.

Credit institutions should verify customer's recurring/steady total monthly income from the documents stated under 2.1.1.1 and 2.1.1.2 above. Income such as interest income, alimony and other, shall be taken into consideration, after the credit institution has confirmed that it is steady and recurrent.

It should be noted that, income emanating from overtime, bonuses and any other exceptional income should not be considered as recurring income and as such should not be taken into account. In cases where commission is a regular part of customer's income then the credit institution may consider it as customer's recurring income provided that evidence is obtained indicating that for the last six months, commission received is at about the same levels.

#### **3.3.1.2 Debt servicing amount to total monthly income**

Debt servicing amount is defined as the instalment amount of the facility to be granted plus all other instalments (loan, overdraft and credit card instalment) with all credit institutions. In case where loan instalments are gradually increasing then credit institutions should take into account the highest instalment.

Overdraft instalment amount is calculated as follows: limit multiplied by the interest rate charged divided by twelve.

Credit card instalment amount is calculated as follows: limit multiplied by the percentage of minimum monthly payment.

Debt servicing amount should be limited, either:

- to 35% of borrower's total monthly income as defined in 3.3.1.1 above,
- the "Estimated Total Monthly Savings" as this is computed in excel worksheet titled "Section C - Expenditure" of Appendix 2 - Part III - Personal Financial Statement (PFS) of the Directive on Arrears Management of 2013.

Credit institutions are urged to complete the excel worksheet "Section C - Expenditure", in accuracy and use it as a tool in calculating the available income which will be the basis of ascertaining the loan instalment amount.

In case the credit institution exceeds the above set limit of 35%, the excess should be fully justified from the borrower's total income and provided that any excess from the prescribed percentage of 35% is outlined in detail in credit institution's credit policy. This limit should not in any case exceed either the 50% of borrower's total monthly income or the "Estimated Total Monthly Savings".

Guarantors' income should not be included in borrower's income when calculating the debt to income ratios.

### **3.3.2 Legal entities**

The ability to repay a facility is the main requirement for any funding. Therefore the assessment of future repayment capability is the most important factor to be considered in the assessment procedure when approving a facility.

In assessing the repayment ability of legal entities, credit institutions should consider the financial data from the documents stated in paragraph 2.1.2 above.

During the assessment procedure, credit institutions should carefully examine, challenge and substantiate the sources of repayment as these are submitted by the customer. After critical assessment, credit institutions should be satisfied with reasonable certainty that the estimated cash flows will materialise.

Projected cash flows should be compared with data from previous periods as depicted in customer's audited financial accounts. In cases where customer's predictions for future cash flows deviate substantially from the actual figures to date, then these predictions must be supported by reasonable evidence and realistic assumptions.

#### **3.3.2.1 Debt servicing amount**

Credit institutions are required to compute the debt servicing amount of the customer and ensure that the customer will be able to cover it, having followed the provisions of paragraph 3.3.2 above.

Debt servicing amount is defined as the instalment amount of the facility to be granted plus all other instalments (loan, overdraft and credit card instalment) with all credit institutions. In case where loan instalments are gradually increasing then credit institutions should take into account the highest instalment.

It is noted that guarantees for loan repayment given by developers in favour of buyers for the purchase of a house/flat, increases the developer's exposures and consequently the debt servicing amount.

Overdraft instalment amount is calculated as follows: limit multiplied by the interest rate charged divided by twelve.

Credit card instalment amount is calculated as follows: limit multiplied by the percentage of minimum monthly payment.

#### **3.3.2.2 Debt servicing sensitivity analysis**

Credit Institutions should carry out scenarios in order to assess the impact on debt servicing in case of increase of loan instalment due to increase of interest rate or any other cause. Scenarios should also be applied to future reduction in the cash flows generating capacity of the borrower.

These scenarios should be outlined in detail in credit institution's credit policy. The impact of these scenarios should be taken into consideration by the credit institution in its decision making.

### 3.4 Collateral

Collateral by itself should not be under any circumstance a criterion for approving a loan and cannot by itself justify the approval of any facility without compliance with the aforesaid lending criteria.

It is recommended, however, that credit institutions make efforts to collateralise all facilities as a safety net in case of future adverse deviations in servicing ability of borrowers. The level of collateral to be required on different types of facilities should be clearly specified in the institutions' credit policy, taking into account the minimum LTV ratios prescribed under 3.4.1.1.

When offering collateral, a customer is more committed in repaying his obligations to the credit institution. At the same time the credit institution will have a lower loss in case of customer's default, and lower credit risk as the collateral is an alternative source of repayment.

It is prudent that all collateral procedures are finalised and all accompanying documents are received by the credit institutions duly signed by the borrower, the guarantor, the collateral owner and the credit institution, before the disbursement of the facility. In case there is need to disburse a facility before the completion of the collateral pledging, approval from the appropriate approving authority should be obtained as specified in the institution's credit policy.

In case the credit institution grants a facility in foreign currency then the credit institution, where applicable, should register the charge in the same currency as the facility.

#### 3.4.1 Immovable property

If collateral is an immovable property then the appraisal/approving authority should:

- carefully and thoroughly examine the valuation report of the property so that all factors affecting the value of the property are adequately considered. In case the collateral is a property other than the one to be financed, then for both properties a valuation report is required.

- Set as precondition that the property is properly insured and the insurance contract is assigned to the credit institution (this does not apply in cases where the property is land).
- In case of a construction, demand a contractor all risk insurance, to cover the construction period of the project and that the insurance contract must be assigned to the credit institution.

#### 3.4.1.1 Loan to Value (LTV) ratio

In the case of financing the acquisition, construction and renovation of immovable property, credit institutions should apply the maximum LTV ratio as given below.

In determining the LTV ratio the following should be taken into account:

- in case of projects under construction the property value to be used for determining LTV is equal to the value of the land plus the cost of construction. Cost of construction should not include transfer fees, mortgage fees, advertising costs, administrative costs and similar costs which do not add to the value of the property.
- in the case of purchasing a property under construction, the value to be used for determining LTV is the value after the completion of construction works of the project and not the value of the property after the issue of title deeds.
- in the case that the bank allows for a grace period of interest, for example during the construction period, then the LTV ratio should be calculated using the increased balance of the loan after the capitalisation of such interest.
- in case the credit institution is in possession of more than one valuation, the value to be used for determining LTV should be the lowest value given in the valuation reports.

Maximum LTV can be satisfied with additional collateral (other property or blocked funds) but in case of the additional collateral being offered by a third party other than the parents, the brothers and sisters or the children of the borrower, the credit institution should examine the financial justification and ensure that this is not a way to bypass the LTV rules.

LTV ratio should not exceed:

- 80% in case the facility is granted for financing the primary permanent residence of the borrower. This also applies in cases where the primary permanent residence will



be constructed on land to be provided by the Government even if the land cannot be mortgaged. If a property is rented for any period during the year, then the criterion of permanent primary residence is not fulfilled and the LTV must be limited to 70%.

- 70% for all other property financing cases.

From the above maximum ratios the following are exempted:

- financing of the construction of the permanent primary residence which will be constructed on land to be provided by the Government and which cannot be mortgaged.
- financing of the acquisition/construction of own use property in industrial or small industrial zones or free zone property
- O/D limits to developers up to Euro 100 thousand for working capital purposes. For any amounts above this threshold the maximum LTV should be observed.

#### **3.4.2 Floating charges**

In case of granting a facility to a legal entity the credit institution should register a floating charge on company's assets. Assets under the floating charges should be properly insured.

#### **3.4.3 Other form of collateral**

For any other form of collateral, appraisal/approving authority should ensure that best practices are followed and the provisions of institution's credit policy are fully adhered to.

### **3.5 Pricing**

The pricing of a facility should take into consideration funding, other costs and credit risk should be reflected.

## **4 Loan Disbursement**

The credit institutions should ensure that all conditions of the facility approval are met prior to any disbursement. Furthermore, they must ensure that:

- Loan agreement/contract is prepared in accordance with the terms of approval and is

duly signed by the borrower, the guarantor, the collateral owner in the presence of the credit institution's staff which will act as witnesses and the credit institution's signatories.

- All other documents required (eg mortgage documents, property insurance, cash collateral pledging etc) are received before facility disbursement.
- In case of a facility with partial disbursements then the relevant provisions of paragraph 8 should be applied.

## **5 Facilities review**

The review of facilities is an important process through which the credit institution reassesses customer's ability to repay and its profitability with the customer, it obtains current information relating to customer's business and any problems encountered by the customer. During the review process credit institutions should update all documents mentioned in paragraph 2.

If within two months from the date requested, a borrower fails to provide the updates required this should constitute an event of default and the credit institution should demand immediate repayment.

The requirements in this section apply to borrowers without excesses/arrears on their facilities. For customers with excesses/arrears, the provisions of the Central Bank's Directive on Arrears Management should be applied.

### **5.1 Revolving facilities**

In case that a customer (either natural person or legal entity) has at least one revolving facility (credit cards are exempted) then a review of his facilities should be carried out at least every 12 months. In case the customer is a member of a group, as this is defined in Banking Laws of 1997 to 2013 and the Central Bank of Cyprus Directive for the Calculation of Capital Adequacy and Large Exposures of 2006 to 2011, then the whole group's facilities should be reviewed.

### **5.2 Non Revolving facilities**

In case that all customer's facilities are non revolving then they should be reviewed as follows:

### 5.2.1 Legal entities:

- a. At least every 12 months if the entity's and its connected persons total commitment is greater than or equal to €1M.
- b. At least every three years if the entity's and its connected persons total commitment is less than €1M and greater than or equal to €30K. In case that all entity's funded facilities or group's funded facilities (if the entity belongs to a group) are maturing in less than six months, then they may be exempted from the review.

### 5.2.2 Natural person

If the natural person is a member of a group in which there is at least one legal entity, then the facilities should be reviewed according to the provision for reviewing facilities to legal entities as mentioned in subparagraph 5.2.1 above.

Otherwise, the natural person's facilities should be reviewed:

- a. At least every 12 months if customer's together with his connected persons' total commitment is greater than or equal to €500K.
- b. At least every 3 years if customer's together with his connected persons' total commitment is less than €500K and greater than or equal to €30K. In case that all customer's (or group's) funded facilities are maturing in less than twelve months, then they may be exempted from the review.

For the provisions of paragraph 5:

- "connected persons" have the meaning of "group of connected customers" as this is defined in Banking Laws of 1997 to 2013 and the Central Bank of Cyprus Directive for the Calculation of Capital Adequacy and Large Exposures of 2006 to 2011.
- "total commitment" is the sum of customer's funded commitment and unfunded commitment.

## **PART II**

### **6 Special cases**

#### **6.1 Foreign currency lending - Lending in a currency different from the customer's income currency**

Credit institutions are required to provide borrowers with adequate information regarding the risks involved in foreign currency lending or in case the facility granted to a customer is in a currency different from his income currency. Such information should be sufficient to enable borrowers to take well-informed and prudent decisions and should at least encompass the impact on instalments due to fluctuations of exchange rates or of a severe depreciation of the currency of customer's income.

In case of foreign currency lending or in case the facility granted to a customer is in a currency different from his income currency, credit institutions should examine and evaluate the additional risks undertaken other than credit risk. For example the credit institution should take into consideration the risks emerging from, the fluctuation of the exchange rate, the interest rates increase, the country risk etc.

As stated in paragraph 3.3.1.1 and 3.3.2 above, the customer's income and the stability of that income is the main criterion for granting a facility. In case of foreign currency lending or in case of granting a facility in a currency different from the customer's income currency, it is difficult to compute, either the percentage defined in paragraph 3.3.1.2, or the accurate instalment amount, due to fluctuations in exchange rates. Therefore, facilities granted in foreign currency or in a currency different from the customer's income currency should generally be avoided especially for cases when the customers opt for such loans on speculative grounds.

A credit institution may grant a facility in foreign currency or in a currency different from the customer's income currency, as long as such cases are outlined in detail in credit institution's credit policy. In case it is not outlined in detail in the institution's credit policy then the consent of the Risk Management Unit is required. In such a case the credit institution must ensure that the contract signed with the customer gives the right to the institution to unilaterally change the facility currency upon certain trigger events (eg when the exchange rate exceeds a certain proportion), the contract should also require from the customer to provide extra collateral to improve LTV ratio in case of change of LTV due to

exchange rate fluctuations.

As Euro is the domestic currency, credit institutions must ensure that all offered products in a currency different than Euro are also offered in Euro.

## **6.2 Lump sum payment**

There are cases in which the repayment programme of a credit facility includes a lump sum payment amount so as to facilitate the scope of the facility as well as the smooth repayment of the facility. The need of a lump sum payment should be rigorously justified and the sources of lump sum payment should be prudently examined and evaluated and assumptions made should be realistic and based on market conditions prevailing at the time of approving the facility.

Especially in the case of financing a project (development financing) the credit institution may set a lump sum payment on loan maturity, so as to facilitate the smooth repayment of the loan as in such cases cash flows emanating from the project are usually expected on or after the completion of the project.

The credit institution should, with appropriate terms and conditions incorporated in the loan contract, be able to partially repay the loan, by decreasing the lump sum, with cash inflows from sales during the duration of the project, in a ratio same as the participation ratio of the credit institution in financing the project.

## **6.3 Grace period**

There are cases in which the repayment programme of a credit facility includes a grace period for capital or grace period for capital and interest so as to facilitate the scope of the facility as well as the smooth repayment of the facility. The need of grace period should be rigorously justified.

A credit institution in calculating the loan instalment with grace period, should take into consideration the fact that the interest accrued during the grace period is capitalised.

Grace period for capital or grace period for capital and interest, should, in general, not exceed 24 months, except in cases of a project with construction period more than 24 months. In case of a project, grace period should not exceed the construction period.

## **7 Housing Loans - Financing of immovable property**

In order to safeguard that the proceeds of a loan granted to a customer for the purchase of immovable property, are utilised for the repayment of the facility granted to a developer for the specific project, credit institutions must follow the procedure as described below:

- a. If the purchaser and the developer are customers of the same credit institution, then the credit institution should, after every disbursement from purchaser's loan, credit an amount, at least, equal to the percentage of credit institution's contribution to the project, in the loan account of the developer from which the specific project is financed. Confirmation of this transaction should be kept in the credit files of the purchaser and the developer.
- b. If the purchaser and the developer are not customers of the same credit institution, then the credit institution granting the loan to the purchaser should, after every disbursement from purchaser's loan, ensure that the developer's credit institution receives the amount disbursed (either by wire transfer or by a bank draft). The amount transferred should be in favour of the developer's credit institution and not in favour of the developer.

In case of wire transfer, details of payment should state the name of the purchaser, the name of the developer and details of the project. In case the credit institution issues a bank draft then it must accompany it by a letter stating the name of the purchaser, the name of the developer and details of the project.

The developer's credit institution after receiving the wire transfer or the bank draft should inform the purchaser's credit institution by a letter confirming that an amount of at least, equal to the percentage of credit institution's contribution to the project, has been credited in the loan account of the developer from which the specific project was financed. This letter should be kept in the purchaser's credit file together with a copy of the wire transfer or the bank draft.

## **8 Lending to Developers - Project Finance**

Lending to developers or project finance is of high risk and as such, credit institutions should make sure that relevant staff has the appropriate experience, qualifications and expertise to deal with it. Appraisal/approving authorities should examine and evaluate whether market conditions prevailing, for this type of development, are favourable and whether market

conditions will be favourable at the time of completion of the project.

In the case of granting facilities for development or project finance then the facility should be partially disbursed so that the credit institution ensures that the facility proceeds are utilised for the facility scope and be able to monitor the work in progress. This procedure should be followed even if the facility is secured by mortgage on a property other than the one financed, or by any other type of collateral.

The duration of the construction should be stated in the detailed cost analysis provided by the customer. The project should be divided into various main stages each one having a construction duration stated in the detailed cost analysis.

The institution's valuer/ quantity surveyor should approve:

- The total duration of the construction.
- The construction duration of each stage.
- The cost analysis of the project.

The different deadlines should be inputted in credit institution's IT system for monitoring purposes.

Lending to developers for construction / renovation / completion of immovable property should be fully settled within 12 months from project's completion date.

During the loan drawdown period, any new disbursements should be approved by the appropriate approving authority as this is outlined in credit institution's credit policy. In order to approve the new disbursement the appropriate authority should have in hand a work in progress certificate from the credit institution's valuer/ quantity surveyor which:

- certifies customer's own contribution for the previous stage,
- certifies that previous disbursement has been utilised for the project scope,
- certifies that the cost of the completed stage is the same as the budgeted cost,
- "current open market value" ("current OMV") of the project is of that amount so that "current Loan to Value" ("current LTV") is less than or equal to the LTV originally approved,

where current LTV =  $\frac{\text{total disbursed amount}}{\text{current OMV}}$

## 9 Valuers and valuation procedure

### 9.1 Valuers

- Credit institutions should require valuers to be with suitable experience qualifications and professional indemnity insurance.
- The immovable property should be evaluated by an independent valuer set by the credit institution and the credit institution should require valuers to disclose any material involvement in the property or whether there has been any previous material involvement in the property. The institution must assure that the valuer is not related to either the buyer or the seller of the property.
- Credit institutions should have a properly approved panel of valuers using appropriate selection criteria consistent with loan portfolio risk. Credit institutions should have an ongoing assessment of performance to enable each valuer to remain in the panel.
- The panel of valuers should contain expertise in various areas of property sector appropriate to the lending business of the institution eg. expertise in development sites, hotels, golf courses etc.
- Credit institutions should review valuer's professional indemnity.
- Credit institutions should ensure that no one firm of valuers has the bulk of their valuations eg. not more than 33% of all valuation reports.

### 9.2 Valuation report

The valuation report is a core document in credit risk decision and loan review process. Credit institutions should have clear policy and valuation guidelines which should be reviewed and approved by the Board of Directors on an annual basis.



- Valuation instructions to valuers should be clear and written.
- Valuation reports should be addressed to the credit institution and not the borrower.
- The method of the valuation should be made according to the type of the property and should be clearly stated in the valuation report. (eg a hotel may be evaluated using the cost or replacement method, or the future profitability method).
- Valuation process should be standardised which allows consistency and accurate analysis of a project and consistency across the credit institution loan portfolio.
- There should be clear policy and guidelines on frequency of valuations which should be based on Central Bank of Cyprus Directive for the Calculation of Capital Adequacy and Large Exposures of 2006 to 2011, risk profile of the exposure and its impact on bank's capital position.
- In case of material change (positive or negative) eg. zoning, planning permission, a revised valuation should be sought.
- Credit institution should have appropriate processes in place to flag out-dated valuations.
- Credit risk staff and relationship managerial staff should be trained in property valuations methods and processes.
- Credit institutions should set criteria specifying when more than one valuation should be obtained. Criteria should take into consideration both the facility amount and the property value.
- In the case of granting facilities for development or project finance then valuation report should clearly state the values and main characteristics of each unit - especially if this unit is to be sold separately.

### **PART III**

#### **10 Best practices**

The undermentioned points are recommendations to credit institutions, which they are urged to follow.

- There should be segregation of duties among the staff involved in the loan origination process. Especially front office staff should not have any approving authority. There should be no sales target on loan expansion set for approving authorities.
- Staff involved in the loan origination process should be experienced, qualified and with relevant expertise in the various lending categories eg real estate, project finance, energy,

shipping etc.

- In cases where the application relates to a transfer of relationship from one credit institution to another, the credit institution which is to grant the new facilities must be extremely cautious in assessing the real reason why the customer wishes this transfer. (Usually a “good customer” is not willing to change credit institution).
- The staff responsible for the facility disbursement must ensure that all relevant documents were received by the credit institution, are properly signed by all the involved parties, and that they fully comply with the approval conditions. Special attention should be given to security documents. If the approval given includes any conditions precedent to the disbursement of the facility, then an appropriate confirmation should be obtained that the applicant complied with all such conditions.
- As a basic principle non-performing facilities of legal entity A should not be taken over by legal entity B (legal entities A and B belonging to the same group), unless there are sound economic reasons for doing so and such action improves the servicing of the facilities.
- Credit institutions should avoid approving any excess to overdraft account, instead, they are advised to approve temporary limit which must be depicted in the credit institution’s computerised systems and fully justified before approved. Credit institutions should make all effort possible to eliminate any excesses.
- Accounts that have no limit should not have a debit balance. Credit institutions should make every effort possible to eliminate debit balances of such accounts.

## **11 Practices not allowed**

Credit institutions are not allowed to:

- Grant a facility with the facility proceeds placed in a deposit and pledged as cash collateral.
- Grant a facility for the purpose of buying the credit institution’s or its subsidiaries shares.
- Grant the borrower the option of suspension of any instalment per year. Suspension of instalments may be accepted only for housing loans with monthly instalments and for a maximum of two instalments per year. In case this option is granted the credit institution should make the assumption that the borrower takes advantage of this option every year

and the credit institution should calculate the total duration of the loan including the suspension months, and thus assess whether the total duration is in accordance with its credit policy.

## **PART V**

### **12 Cancellation of existing circulars**

The circulars relating to financing of immovable property dated 24/11/2003, 28/4/2004, 13/6/2006, 27/7/2006, 26/3/2007, 12/7/2007, 22/8/2007 and 27/5/2008 as well as all clarifications provided through electronic mail are hereby cancelled.

### **13 The Directive takes effect immediately**

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