



Strengthening the legal framework in order  
to reduce Non-Performing Loans

**Financial Stability Directorate**  
**July 2018**



**DIRECTORATE OF FINANCIAL STABILITY**



# **PART I**

**Situation and challenges prior to the amendments of the legal framework**



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- The high level of Non-Performing Loans (NPLs) is the biggest challenge of the Cypriot economy and the banking system and it adversely affects banks' ability to perform their strategic role in channeling loans to the economy.
- The fact that the NPLs remain at high levels despite the recovery of the economy and the reduction of unemployment, is an indication of the ineffectiveness of the whole framework.
- The supervisory requirements of the relevant EU bodies (ECB and the Single Supervisory Mechanism etc) are becoming stricter - the additional capital requirements for banks with a large percentage of NPLs are expected to increase sharply in the coming years – non compliance with the additional requirements will have a highly adverse effect for the banking system and the economy.
- The framework prior to the amendments had proved to be ineffective - in fact it offered protection to strategic defaulters to the expense of the society and the economy.
- Strategic defaulters do not serve their loans at the expense of depositors, bondholders and shareholders.
- It is highly important that the efforts for addressing the NPLs challenge is strengthened. This requires the use of all available instruments (consensual restructurings which is the preferred solution, sales of loans, foreclosures for non cooperative debtors, etc.).
- Relevant legal and other procedures need to be more efficient, effective and transparent.



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# **PART II**

## **The quantitative dimension**



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### A. NON-PERFORMING EXPOSURES

	Mar-18	Dec-17	Dec-16	Dec-15	Dec-14
<b>Total Loans, € mln</b>	48.606	49.219	52,511	60,180	59,749
<b>NPEs €mn</b>	20.266	20.902	24,345	27,290	28,383
<b>NPE to Total loans</b>	41.7%	42.5%	46.4%	43.5%	46.1%
<b>NPEs €000</b>	20.265.922	20.902.202	24,344,630	27,289,517	28,382,601
<b>Impairments</b>	9.959.595	9.884.870	10,317,503	10,438,297	9,632,527
<b>Impairment/NPEs</b>	49.1%	47.3%	42.4%	38.3%	33.9%
	Mar-18	Dec-17	Dec-16	Dec-15	Dec-14
<b>NPEs €bn -incl. overseas</b>	20.3	20.9	24.3	27.3	28.4
<b>Total Restructured Facilities, €bn</b>	11.50	11.93	13.70	14.55	13.49
<b>% Restructured to NPEs</b>	56.7%	57.1%	56.4%	53.3%	47.5%
<b>Restructured/ Total Facilities</b>	24.6%	25.1%	26.6%	24.3%	22.5%



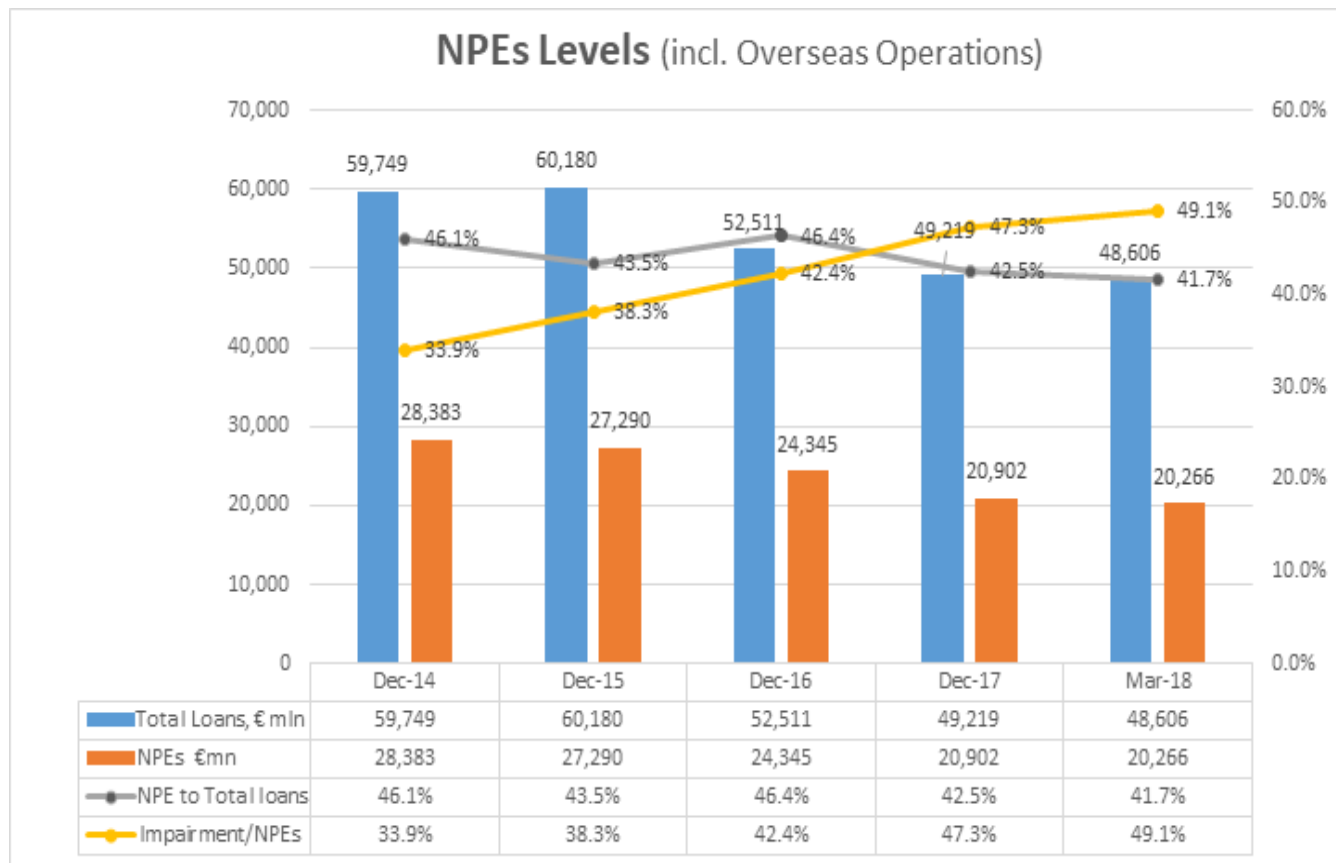
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- Non- Performing Loan (NPL) ratios have been falling in nearly all Member States, although the situation differs significantly across Member States.
- The overall NPL ratio in the EU declined to 4.6% (Q2 2017), down by roughly one percentage point year-on-year, and by a third since Q4 2014.
- Looking across the euro area, the NPL ratio continues to differ significantly from country to country. In the fourth quarter of 2017, Greek and Cypriot SIs had the highest NPL ratios (with country-weighted averages standing at 46.6% and 34% respectively). With 18.1%, Portuguese SIs had the third highest NPL ratio. Looking at the trend, the NPL ratio decreased significantly year-on-year for SIs in Cyprus (-6.3 pp), Ireland (-5.6 pp), Italy (-4.4 pp) and Slovenia (-3.2 pp). In the third quarter of 2017, the stock of NPLs for Italian SIs was €196 billion, followed by French SIs (€138 billion), Spanish SIs (€112 billion), and Greek SIs (€106 billion).

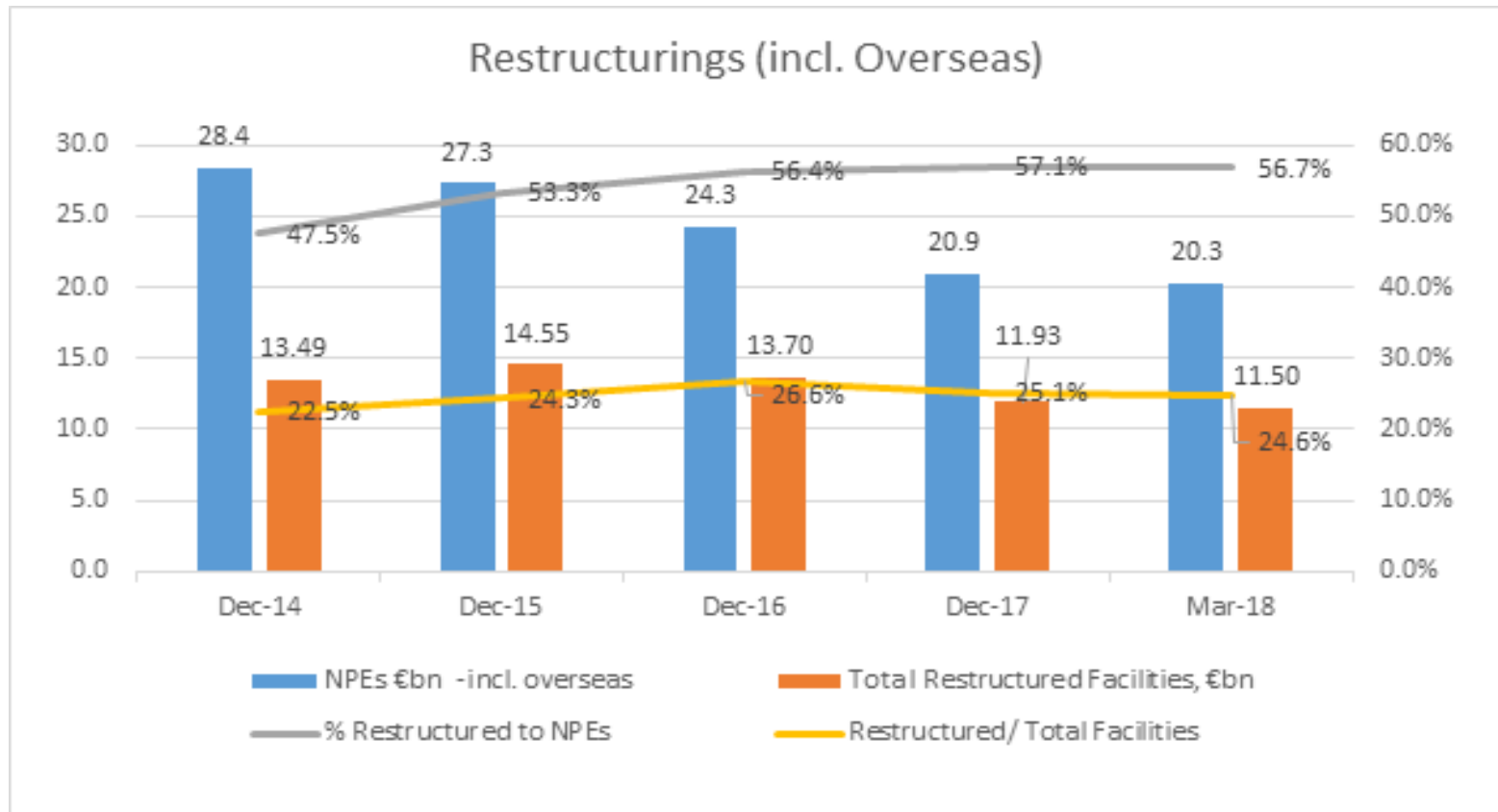


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## B. FORECLOSURES

		Number of mortgaged properties		Market value €000		Selling price €000	
		2016total	2017total	2016total	2017total	2016total	2017total
Immovable property for which a notification has been served to the mortgage debtor regarding the intention of sale of the property	Main residence/apartment	29	119	25,984	35,476	0	0
	Residential property /apartment (fully constructed or under construction)	218	547	70,637	170,136	0	0
	Commercial property (ready to use or under construction) including shops, offices, factories and farms	170	246	164,725	125,937	0	0
	Hotels and hotel apartments	7	6	28,530	12,325	0	0
	Plots	240	414	63,431	117,581	0	0
	Farmland and other land	868	1,259	158,160	245,620	0	0
	Other immovable property	26	34	9,681	20,137	0	0
	<b>Total</b>	<b>1,558</b>	<b>2,625</b>	<b>521,148</b>	<b>727,212</b>	<b>0</b>	<b>0</b>
Immovable property for which date of first auction has been set	Main residence/apartment	53	161	15,480	41,006	0	0
	Residential property /apartment (fully constructed or under construction)	72	292	20,197	73,688	0	0
	Commercial property (ready to use or under construction) including shops, offices, factories and farms	52	174	34,408	99,878	0	0
	Hotels and hotel apartments	4	32	15,200	26,158	0	0
	Plots	55	293	11,601	90,075	0	0
	Farmland and other land	350	1,146	51,981	149,774	0	0
	Other immovable property	0	23	0	12,702	0	0
	<b>Total</b>	<b>535</b>	<b>2,004</b>	<b>138,710</b>	<b>467,953</b>	<b>0</b>	<b>0</b>



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		Number of mortgaged properties		Market value €000		Selling price €000	
		2016total	2017total	2016total	2017total	2016total	2017total
<b>Immovable property sold, during the first auction</b>	Main residence/apartment	0	1	0	692	0	801
	Residential property /apartment (fully constructed or under construction)	3	19	502	3,159	410	2,651
	Commercial property (ready to use or under construction) including shops, offices, factories and farms	4	4	1,733	865	1,403	692
	Hotels and hotel apartments	0	0	0	0	0	0
	Plots	3	12	1,108	1,631	1,058	1,367
	Farmland and other land	10	85	486	4,312	388	3,532
	Other immovable property	0	0	0	0	0	0
	<b>Total</b>	<b>20</b>	<b>121</b>	<b>3,829</b>	<b>10,659</b>	<b>3,259</b>	<b>9,043</b>
<b>Immovable property sold, during the second auction</b>	Main residence/apartment	0	0	0	0	0	0
	Residential property /apartment (fully constructed or under construction)	0	0	0	0	0	0
	Commercial property (ready to use or under construction) including shops, offices, factories and farms	1	2	283	1,688	227	1,150
	Hotels and hotel apartments	0	0	0	0	0	0
	Plots	0	2	0	130	0	116
	Farmland and other land	0	15	0	1,504	0	1,215
	Other immovable property	0	0	0	0	0	0
	<b>Total</b>	<b>1</b>	<b>19</b>	<b>283</b>	<b>3,322</b>	<b>227</b>	<b>2,481</b>



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- The table shows that foreclosures remain in low levels. In 2017, the total value of all the assets sold amounted to around 11.5 million. This shows that foreclosures framework proved to be an ineffective tool, largely covering strategic defaulters.



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### C. INSOLVENCY FRAMEWORK

Data shown (i) backlog in bankruptcies and liquidations & no of applications & cases completed for personal repayment plans (PRPs)

#### WORK LOAD JUNE 2017

Bankruptcies and Liquidations	Voluntary Liquidations	Debt relief Orders (DRO)	PRPs
11,248	4787	424/1200 (1)	9/71 (2)

#### Notes:

(1) From 2015 to 6/2017, 1200 applications were submitted and only 424 DRO's were issued.

(2) From 2015 to 6/2017, 71 applications were submitted, 9 were concluded and 36 were at the stage of examination.



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- The insolvency framework does not seem to have been utilized to the expected extent, probably due to weaknesses of the legal framework and also lack of awareness of the broad public.
- As a result, a debtor-friendly tool remains totally unutilized and inactive.



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### D. SALES OF LOANS

Sale of credit facilities of Credit Institutions concluded from the date the relevant Law was enacted until today :

	Total number of loans sold	Total gross value of loans sold
Sale from BoC to CDB, and sale from HB to B2Kapital	2023	€167mn



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- Sales of credit facilities remain at low levels. In many other countries, sales of loans to specialized organisations have substantially helped to reduce NPL levels, while credit acquiring companies have been able to provide borrowers with favorable repayment terms.



**ΔΙΕΥΘΥΝΣΗ ΧΡΗΜΑΤΟΠΙΣΤΩΤΙΚΗΣ ΣΤΑΘΕΡΟΤΗΤΑΣ**



# **PART III**

## **Legal Framework**





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1. Arrears Management Directive of the Central Bank of Cyprus

2. Insolvency Framework

3. Sale of Loans

4. Securitisation

5. Foreclosure



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### WEAKNESSES OF THE INSTITUTIONAL AND LEGAL FRAMEWORK:



- ➔ Social and political reactions protect mainly strategic defaulters
- ➔ Time-consuming procedures in the justice system, complexity and high costs
- ➔ Reluctance of banks and borrowers to use the existing tools, due to perceived reputational cost



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### OBJECTIVES OF MAIN LEGISLATIVE AMENDMENTS:

1. Encourage restructuring of viable loans through the Arrears Management Directive of the CBC.
2. Encourage restructuring of non-viable loans that will become viable after a successful completion of the repayment plan, through the insolvency framework
3. Create an efficient secondary loan market that can help banks and debtors. The former will directly strengthen their liquidity, while the latter will be able to settle their debt at more favorable terms
4. Create an effective, efficient, and transparent foreclosure framework to act as a credible threat especially to strategic defaulters.
5. Introduce a provision that will enable electronic auctions.
6. Protection of vulnerable groups. The proposed amendments are well balanced. They do not seek to solve the problem at the expense of vulnerable groups. They are trying to make the debtor-friendly restructuring framework more effective, and at the same time address the problem of strategic defaulters.



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## **PART IV**

### **Description of main legislative amendments**



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## A. THE IMMOVABLE PROPERTY (TRANSFER AND MORTGAGE) (AMENDING) LAW OF 2018

### A1. FORECLOSURES

1. Clarification that old court decisions, judgment debts or arbitrations for sale of mortgaged property can be implemented under the new foreclosure procedure.

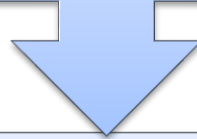
2. The reserved price remains at no lower of 80% of the estimated market value for the first auction and for the period of 3 months. If the property is not sold, the amendment aims to have another 3 months where the mortgage creditor will attempt further auctions or other methods of sale with the reserved price not lower than 50%. Furthermore, if the property is not sold, the amendment aims at the end of the sixth month (from the date of the first auction) to give the mortgage creditor the option to buy the property at the market price, based on a valuation conducted prior to the first auction or initiate a new valuation procedure in accordance with the provisions of the Law. If the mortgage creditor decides not to buy the property he/she can continue the efforts to sell the property, either by auctions or by other methods of sale, without any reserved price at any time thereafter.



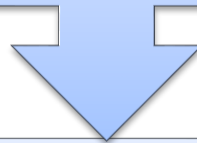
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3. Ensures that access to the property for the purpose of valuation is allowed by the mortgage debtor to the mortgaged creditor.



4. Servicing of notices, to the relevant stakeholders, is allowed through other means, if registered mail is not feasible.



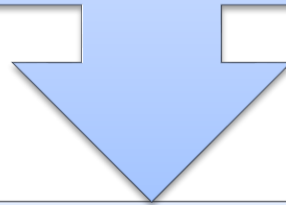
5. Amends provisions that are causing long delays in implementing the law and potentially defeat its purpose.



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6. The borrower ceases to have preferential treatment over the last bidder, during the procedure for the sale of his primary residence by auction: i) in cases the borrower has received a subsidy for the repayment of his loans and ii) the value of the primary residence does not exceed €350K.



7. A provision allowing e-auctions is introduced.



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### A2. SPLITTING OF MORTGAGES

The creation of a single mortgage which secured several loans was a widespread practice followed by mortgage creditors. In case of a sale of loan, the mortgage creditor is given the option of splitting the mortgage in sub-mortgages so as to be in a position to decide how the security will be distributed to cover the sold and unsold loans, determining their priority. It is also provided that any subsequent or preceding mortgages to the single mortgage (to be split) will remain unaltered and unaffected.

This provision does not affect the position of the borrower.

It is provided that the amount to be secured by the sub-mortgages as a whole does not exceed the amount secured by the original single mortgage. This will always happen after notifying the borrower of the intention to split the mortgage.





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## B. SALE OF LOANS

### I. The Sale of Credit Facilities and Related Matters Law.

1. Add definitions for completeness purposes.

2. The collateral is transferred without any fees.

3. The results of the transfer (transfer of rights, benefits, priority, continuation of proceedings, safeguarding of documents, right of set-off, etc) are regulated.

4. Allows access of credit buyers to the data exchange mechanism for purposes of assessing the borrower's indebtedness only after it has acquired credit facilities .



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### C. INSOLVENCY FRAMEWORK

**1. Definitions:** **a.** the definition of “Secured Debt” to clearly state that the loan is considered secured up to the market value of the security and the rest is unsecured **b.** The definition of Debt for the purposes of DRO is clarified in order for the tool to be more effective.

**2. Consensual PRP:** **a.** The eligibility criterion of 25% or more of the debts to have been made during a period of 6 months prior to the application is deleted and **b)** It is clarified that the duration of the monthly installments for repayment of secured debt may continue after the expiration of the PRP.

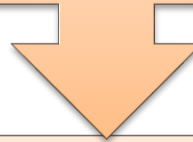
**3. Non consensual plan PRP:** **a.** sunset clause is removed (cut-off date was set for 07/05/2021) **b.** the qualification criteria to enter a non consensual PRP are broaden **c.** the criterion of loan balance ceases to exist **d.** the provision of compulsory sale of movable assets of the debtor subject to mandatory sale is increased from €35k to €50k.



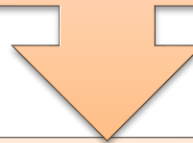
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**4. Liabilities due to governmental authorities:** obligations to governmental authorities will be also included in a repayment plan. Also regarding the repayment plans and Examinership the preferential treatment of debts to the Government or the local authorities ceases to apply.



**5. Due payments provided that the borrower has received a subsidy for the repayment of the loan:** if a debtor, who receives a subsidy for the repayment of his loan, still has due payments for a period of three (3) months, any protection from his creditors is terminated and is subject to enforcement measures by creditors for the collection of its debts.



**6. Protection of non-viable debtors:** The total maximum protection period against measures taken against a non-viable debtor whose financial situation has deteriorated in 2012 and 2013, and who has mortgaged its primary residence or business premises, since he has used all existing measures for restructuring, is limited to 12 months in total.



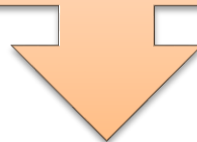
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**7. Insolvency Practitioners Fees:** The success rate of the repayment plan and Examinership proposal is increasing from 20% to 30%. A State Aid plan will also be prepared to this effect. A fee structure has been set for the coordinated Repayment Plan for natural persons and micro enterprises.



**8. Provisions for the treatment of guarantors:** removal of sunset clause (the cut-off date was set for 07/05/2021) of certain provisions relating specifically to the treatment of guarantors (in PRP, bankruptcy and examinership). The application of these provisions is extended for guarantee agreements signed after 2015 and until the date of application of the amending law.



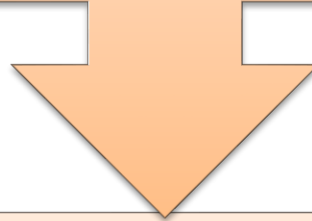
**9. Bankruptcy/Liquidation cases with no proceeds to pay:** A State aid plan will be prepared to provide the Bankruptcy Administrator and Liquidator who will undertake the processing of long standing loss making cases an extra administration fee payable upon completion.



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**8. Debt Relief Order:** The issuance of a Debt Relief Order allows the discharge of accumulated default interest that was charged from the date of application for a Debt Relief Order until the date of the issuance of the Debt Relief Order.



**9. Coordinated repayment plan for natural persons and micro enterprises:** Removal of the eligibility criteria that an insolvent debtor needs to have his/her primary residence mortgaged for a debt or obligation of a micro enterprise, to be admitted to the procedure of a coordinated Repayment Plan for natural persons and micro enterprises, and replaced instead with a requirement that the insolvent debtor exercises decisive influence on a micro enterprise.



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### D. SECURITISATION

1. An EU Regulation has recently been issued that covers the securitization framework, which promotes effectiveness and transparency of the whole framework.

The purpose of the draft law is to vest the Central Bank the power to authorise, regulate and supervise the activity of securitisations in order to ensure the proper functioning of the securitisation market.

The scope of this Law is limited to the securitization of credit facilities or other form of receivables and / or exposures that were either originated or acquired by credit or financial institutions or that were acquired by credit acquiring companies.



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# **PART V**


## **Future actions**



## ΔΙΕΥΘΥΝΣΗ ΧΡΗΜΑΤΟΠΙΣΤΩΤΙΚΗΣ ΣΤΑΘΕΡΟΤΗΤΑΣ



 Issue a Ministerial Order to regulate any details regarding the operation of electronic auctions and the website.

 Create a framework to ensure that secured creditors can quickly recover collateral by creating an out-of-court mechanism so as in the future the accumulation of non-performing loans is avoided.





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# **PART VI**

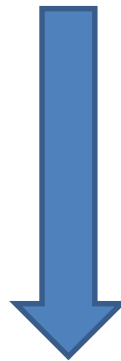
## **Conclusions**



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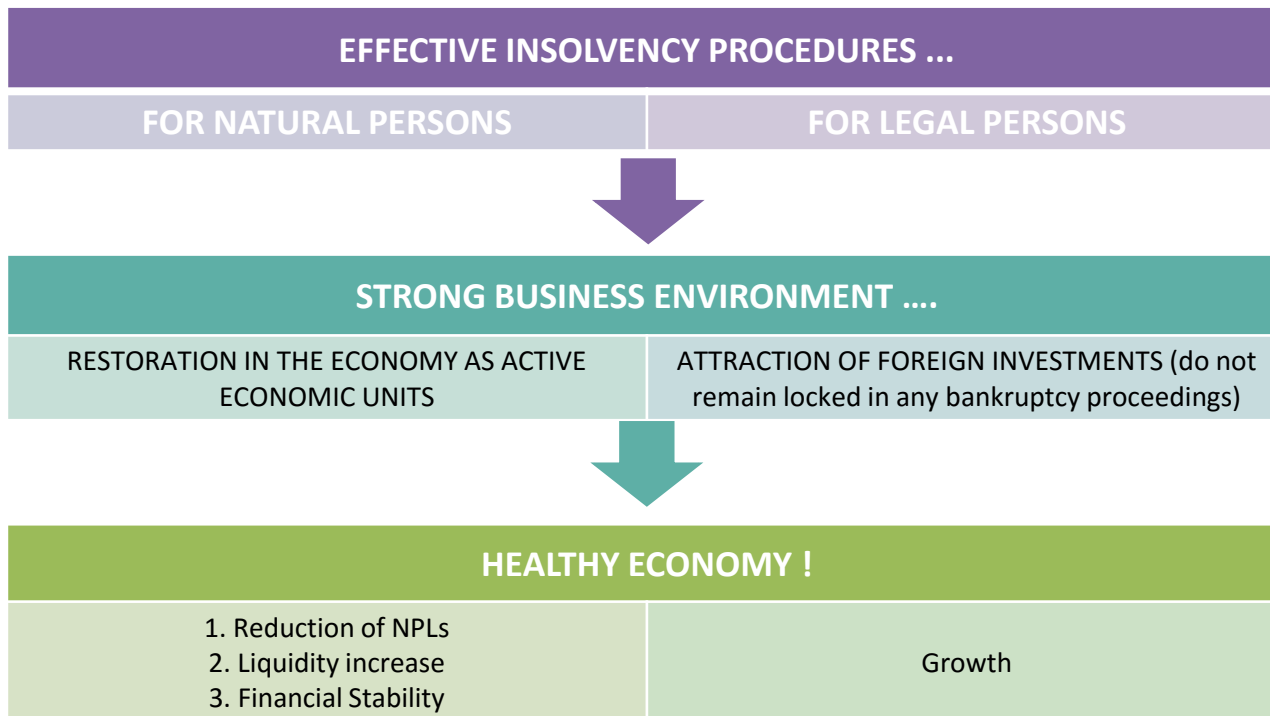


- The fact that the pace of restructurings has declined in recent months may be an indication that the NPL portfolio that has not been restructured so far is the most difficult.
- Both banks and borrowers should move forward with more drastic solutions that would safeguard a contribution of banks (creditors) with loan reductions, extension of repayment period and interest rate cuts, as well as the borrowers who will be required to be adhere to their new obligations.
- A delay in resolving the problem is at the expense of both parties and has an incalculable cost for the economy as a whole.





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Source: Ministry of Energy, Commerce, Industry and Tourism, Cyprus



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**Why should the foreclosure mechanism be effective?**



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➤ **The problem of NPEs existed prior to the crisis.**

➤ **Alignment of motives for debtors and creditors towards restructuring**

Foreclosure is enforced as the ultimate solution, unless the debtor belongs in a vulnerable group and after all efforts for restructuring have been exhausted. Restructuring is the best outcome as it disengages economic players from the insolvency status, provides crucial liquidity to the financial market and promoted growth. Without an effective foreclosure tool, the motives of interested parties are misaligned towards other direction instead of exhausting all efforts for restructuring loans, suffocating the entire economy

➤ **Preventing the deterioration of the value of securities**

The low income from auctions make our claim that securities held by banks have a significant value, weak and unconvincing. The more impediments exist for the auctioning of securities the lower is their estimated value, putting pressure on the balance sheet of banks for extra capital requirements but also at the expense of debtors themselves who will be left owning more to the bank if the value of securities deteriorates.

➤ **Social justice and promotion of growth**

Foreclosure is aimed as a threat for strategic defaulters. Loans should be repaid by debtors and not depositors, holders of debt or shareholders of banks. It is a matter of natural justice.

A foreclosure mechanism that does not act as real threat for debtors that use luxury properties, while avoiding any repayment of their debts, and do not reveal their real income, punishes compliant debtors and depositors, by depriving valuable liquidity for investments and growth.



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**Why is the sale of loan framework necessary and does it contain safeguards?**



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### ➤ **Effective solution for the resolution of balance sheets of banks**

The new supervisory and regulatory framework for the financial sector, at European Level will lead, in the next few years, to very high capital requirements. The demands of supervision will be increased mainly due to the very high percentage of NPEs, while the rate of restructurings is not satisfactory. If banks are not able to meet these very high capital requirements through an effective solution for their NPLs, the robustness of the whole economy is at stake.

### ➤ **What safeguards exist;**

Credit acquiring companies are supervised and licensed by the Central Bank of Cyprus, ensuring they have sufficient capital and expertise for the management of the credit facilities. The credit acquiring companies suggest appropriate models to match the needs and profiles of the debtors and in general attempt to recover part of the loan at a percentage that allows for a profit margin for the new owner of the credit facility.

### ➤ **Why cant the bank sell the loan back to the debtor at a lower value?**

The market value of NPLs is always lower than the amount of the loan to reflect the fact that it is recognised that the full repayment of the loan is uncertain. If banks offer loans back to the debtors following a “haircut” of their value, there is serious risk of contagion, in other words even compliant debtors will have a motive to stop payments with the prospect of buying their loan at a lower value. The credit acquiring companies though, can, if they want, come to an agreement with the debtor for the sale of the loan. Most probably the loans will be dealt with as a single portfolio with a target to achieve a medium performance above the acquiring price.



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**Why is the Securitisation framework necessary?**





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- **Securitization** is the financing tool that allows the transferring entity (credit institution / credit acquiring company) to refinance through the transfer of a group of loans that it has granted to a Special Purpose Vehicle (SPV). Thereafter, the SPV converts the loan portfolio into bonds by issuing securities and channeling them to investors. In a securitization plan non-performing loans can also be included.
- **Advantages for the Transferring Entity:** a. Reduce financing costs b. Strengthening liquidity of credit institutions because low liquidity items are converted into cash c. Maintaining capital adequacy through the reduction of risk weighted assets d. Management of the risks of credit institutions from their loan portfolios by transferring part of the risks through the sale of loans.
- **Advantages for Investors of an SPV:** a. Higher returns (due to the inclusion of higher investment risk) b. Possibility to diversify the investment portfolio held by investors c. Protection of SPVs by removing the insolvency risk of the transferring entity.
- **Advantages for the Economy:** a. Development of the capital market b. Additional loan opportunities c. Source of funding for banks and companies. d. It is possible to reduce borrowers' borrowing costs.



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