

**GOOD PRACTICE GUIDELINES****Issued by Banking Regulation and Supervision Agency:****GUIDELINES ON LOAN ORIGINATION AND MONITORING PROCESSES****SECTION ONE****Objective, Scope, Basis and Definitions****Objective, Scope and Basis**

1. These Guidelines are intended to explain the good practices expected from banks in relation to credit risk management within the framework of Article 35 “*Purpose of risk management and establishment of risk management system*” of the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation System, published in the Official Gazette no. 29057 dated July 11, 2014.
2. The Guidelines have been prepared on the basis of Article 93 of Banking Law No. 5411 dated October 19, 2005 and Article 7/A “*Good Practice Guidelines*” of Regulation on Principles and Procedures Concerning Audits to be Performed by Banking Regulation and Supervision Agency, published in the Official Gazette no. 26236 dated July 22, 2006.
3. These Guidelines apply to the internal management arrangements and procedures of banks throughout their lifecycle of credits and in relation to loan origination processes. These Guidelines also apply to risk management practices, policies, processes and procedures concerning loan origination and monitoring of performing loans, as well as their integration into general management and risk management systems.
4. Section Two and section Six apply to all credit risks other than the borrowing notes of banks, derivatives and security finance transactions. Section Three and Section Four apply to retail and commercial loans. These sections do not apply to loans extended to banks, investment companies, financial institutions, insurance and reinsurance companies, central administrations, central banks, regional and local administrations and public institutions as well as preferential forborne loans and non-performing loans.
5. The institutions referred to as bank under the Law shall be subject to the principles set out in the Guidelines. The requirements of these Guidelines are expected to be applied on a consolidated and non-consolidated basis, taking into consideration the complexity and size of bank operations.
6. In order to make sure that these Guidelines are applied within the framework of the principle of proportionality, the criteria of loan magnitude, structure and complexity must be taken into consideration in Section Three; loan and collateral magnitude, structure and complexity in Section Five; the size, structure and complexity of the bank, the magnitude, structure and complexity of loan and the type, size and risk profile of borrower in section Six. For the purposes of this paragraph, banks must, in relation to retail loans, must make sure the objective of protecting consumers is not prejudiced, as specified in the Law on the Protection

of Consumers and Sections 3.1, 3.2.1, 3.2.2, 3.2.3 and 3.2.4 herein.

## Definitions

### 7. For the purposes of these Guidelines;

- a) “Environmentally sustainable lending” means lending to finance environmentally sustainable economic activities (These loans are part of the wider concept of ‘sustainable finance’, meaning any financial instrument or investment, including equity, debt, guarantee or a risk management tool, issued in exchange for the delivery of financing activities that meeting criteria for being environmentally sustainable).
- b) “Audit trail” means who accesses the records that will enable the step-by-step tracking of an operational or financial transaction from its start till its completion, and the associated information system.
- c) “Best effort deal” means a deal concluded between the intermediary bank and the security issuer allowing the intermediary bank to sell as many shares as possible at the agreed price,
- d) Financial sponsor: investment firm undertaking private equity investments and/or leveraged purchases of companies, to exit these investments in the medium term,
- e) “Ship financing” means means the financing of all activities involved in the building, acquisition and operation of ships and offshore installations, when the financial servicing of credit facilities is primarily dependent on the cash flow from operating or selling these ships or offshore installations, or when the collateral is structured around the ships or offshore installations, shipbuilding or various charter arrangements,
- f) “Source of repayment capacity” means the borrower’s total funds, cash flow and payment behavior considerations, as registered by the credit provider at the moment of the loan origination, covering all sources of cash inflows (such as income, regular private transfers — alimonies, rental income from real estate property, income from financial investments, income from private businesses or partnerships, income from other sources), funds (such as saving accounts, investment products) and regular expenses,
- g) “Leveraged transactions”<sup>1</sup> mean, regardless of whether they are classified in banking accounts or purchase-sale accounts within the framework of legal capital calculations, any transaction that meets at least one of the conditions of;

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<sup>1</sup> The designation of a financing as a “leveraged transaction” is made at loan origination, modification or refinancing.

- (i) all types of loan or credit exposure where the borrower's<sup>2</sup> post-financing level of leverage<sup>3</sup> exceeds a Total Debt to EBITDA ratio of 4 times and (ii) all types of loan or credit exposures where the borrower is owned by one or more financial sponsors,
- h) "Loan" means transactions complying with the definition of loan under Article 48 of Banking Law No. 5411,
- i) "Credit decision-maker" means a credit committee or committees and individual staff members with delegated credit decision-making powers, as set out within the credit decision-making framework specified in the banks' policies and procedures,
- j) "Club deals" mean deals based on leveraged purchase investments by multiple banks (leveraged syndicating investments),
- k) "Project finance" means the financing of all activities of legal entity customers<sup>4</sup> (including special purpose vehicles established for the project) involved in projects in which the financial servicing of credit facilities is primarily dependent on the cash flow from sales of the project, and all the assets of the project are pledged to the bank financing the project,
- l) "Risk group" means the risk group defined under Article 49 of Banking Law,
- m) "Single customer view" means a single, consistent view of all of a customer's assets and liabilities held at a bank on a consolidated basis, including information on all financial commitments, including their repayment history at the bank,
- n) "Commercial real estate" means any income-producing real estate, either existing or under development, including rental housing; or real estate used by the owners of the property for conducting their business, service or activity, either existing or under construction; that is not classified as residential real estate; and includes social housing,
- o) Total Debt: Total amount of liability (including used and unused commitment amounts) and any additional debt that may be allowed by loan agreements,
- p) "Management body" means the management body as defined in the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation Process.

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<sup>2</sup> Lending to real persons, banks, investment firms, public sector institutions and financial sector institutions will be excluded from the scope of leveraged transactions.

<sup>3</sup> Except in cases where it is assumed that the borrower cannot benefit from group support, if the borrower experiences financial difficulties, the leverage coefficient must be calculated at the consolidated debtor level. Any deviation from the consolidated-level calculations must be justified, and documented as necessary.

<sup>4</sup> Micro, small, medium and large enterprises.

## SECTION TWO

### **Internal Management for Loan Origination and Monitoring**

8. In addition to the provisions of Banking Law, Regulation on the Lending Operations of Banks, Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation System and the Guidelines on Credit Management by Banks, banks must also comply with the loan origination and loan monitoring provisions set out in this section.

#### **2.1 Credit Risk Management and Culture**

##### **2.1.1 Responsibilities of Management Body**

9. In relation to credit granting, the management body should;

- a. approve the bank's credit risk strategy, within the overall risk strategy and business strategy, to make sure that the bank's risk appetite framework, capital and liquidity planning, and where relevant, the internal capital adequacy assessment process (ICAAP) and internal liquidity adequacy assessment process (ILAAP) are in line with these strategies;
- b. set the credit risk appetite within the overall RAF, including credit-granting standards, qualitative statements, quantitative metrics and limits, and escalation thresholds, without business performance biases;
- c. approve the framework for the credit approval process, including, when relevant, the internal structures for credit granting and monitoring, and define the delegated decision-making authorities;
- d. ensure an effective oversight of credit risk quality, in particular at the point of credit granting, and provisioning;
- e. ensure adequate credit approval, monitoring and control processes, for the purposes of effective credit risk management;
- f. ensure that all staff involved in credit risk taking, and the managing, monitoring and controlling of credit risk, are adequately skilled, resourced and experienced;
- g. set, approve and oversee the implementation of the bank's risk culture, core values and expectations regarding credit risk;
- h. ensure that the remuneration framework, including any relevant performance targets, and the performance assessment framework for credit decision-makers who are identified staff remain aligned with the credit risk and credit risk appetite.

##### **2.1.2 Credit Risk Culture**

**10.** Banks should develop a credit risk culture as part of the overall risk culture through policies, communication and staff training, in accordance with the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation Process.

**11.** The credit risk culture should include an adequate ‘tone from the top’ and ensure that credit is granted to borrowers who, to the institution’s best knowledge at the time of granting the credit, will be able to fulfil the terms and conditions of the credit agreement, and is secured, when relevant, by sufficient and appropriate collateral, **where relevant, and considering the impact on the institution’s capital position and profitability, and sustainability, and related environmental, social and governance (ESG) factors<sup>5</sup>.**

**12.** Banks should ensure that a credit risk culture is implemented effectively across all levels of the institution, and that all members of staff involved in the credit risk-taking, credit risk management and monitoring processes are fully aware of it and they will be held accountable for their actions.

**13.** Banks should adopt policies and processes to monitor adherence of all staff members involved in credit-granting, monitoring and control processes to the bank’s credit risk culture (e.g. by means of self-assessments carried out by staff members). In situations in which there are noted deficiencies in the credit culture, evidenced either via a bank’s self- assessment or via supervisory actions, the bank should take well-defined, outcome-driven and timely actions to remediate these deficiencies. The credit risk strategy, credit policies and procedures should be tailored to mitigate any potential negative effects arising from a poor credit culture

## **2.2 Credit risk appetite, strategy and credit risk limits**

**14.** The credit risk appetite, credit risk strategy and the overall credit risk policy should be aligned with the bank’s overall risk appetite framework. The bank’s credit risk appetite should specify the scope and focus of the credit risk of the bank, the composition of the credit portfolio, including its concentration, and diversification objectives in relation to business lines, geographies, economic sectors and products.

**15.** The credit risk appetite should be implemented with the support of appropriate credit risk metrics and limits. These metrics and limits should cover key aspects of the credit risk appetite, as well as client segments, currency, collateral types and credit risk mitigation instruments. When relevant, credit metrics should be a combination of backward-looking and forward-looking indicators and should be tailored to the business model and complexity of the bank.

**16.** Banks should ensure that the credit risk appetite and associated metrics and limits are appropriately cascaded down within the bank, including all relevant group entities and business lines and units bearing credit risk.

**17.** For the purposes of managing concentration risk, banks should set quantitative internal credit risk limits for their aggregate credit risk, as well as portfolios with shared credit risk characteristics,

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<sup>5</sup> Environmental, Social and Governance refers to three central factors in measuring the sustainability and social impacts of investment made in a company or business. These criteria help better identify the future financial performance of companies.

sub-portfolios and individual borrowers. In cases of clients included in a risk group, the limits should also account for the consolidated and non-consolidated position and the position of the individual entities at the consolidated and non-consolidated levels.

### **2.3 Credit risk policies and procedures**

**18.** Banks should set out, in their credit risk policies and procedures, the criteria for identifying, assessing, approving, monitoring, reporting and mitigating credit risk, and the criteria for measuring the provisions set aside pursuant to the Regulation on the Principles and Procedures Concerning the Classification of Loans and Provisions to be Set Aside for These and the provisions set aside for the purposes of capital adequacy at the banks using the Approach Based on Internal Rating in the calculation of statutory capital adequacy. Banks should document the framework and update it regularly.

**19.** The objective required to followed in credit risk policies and procedures should be to promote a proactive approach to monitoring credit quality, identifying deteriorating credits early on and managing the overall credit quality and associated risk profile of the portfolio, including through new credit-granting activities.

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

**21.** Credit risk policies and procedures should include specific lending policies and procedures, with sufficient granularity to capture the specific business lines of the bank, for different sectors, in line with their varying complexities and sizes, and risks of different market segments related to the credit facility.

**22.** Credit risk policies and procedures should clearly specify:

- a. policies and procedures and rules for the approval of credit granting and decision-making, including appropriate authorization levels set in accordance with the credit risk appetite and limits;
- b. credit-granting criteria, taking into account the items referred to in Annex 1;
- c. requirements for the handling of information and data needed for the creditworthiness assessment, as set out in Section 3.1;
- d. requirements for the creditworthiness assessment, including a sensitivity analysis, as referred to in Section 3.2;
- e. requirements for exposure aggregation and credit risk limits and the management of credit risk concentrations;
- f. requirements and procedures regarding the acceptance and use of collateral and credit risk mitigation measures, to determine their effectiveness in minimizing the inherent risk of a credit facility — such requirements and procedures should be asset class-specific and product type-specific and should duly consider the type, size and complexity of the credit facilities being granted;

- g. conditions for the application of automated decision-making in the credit-granting process, including identifying products, segments and limits for which automated decision-making is allowed;
- h. a risk-based approach, addressing possible deviations from standard credit policies and procedures and credit-granting criteria, including:
  - i. conditions defining the approval process for deviations and exceptions and the specific documentation requirements, including the audit trail;
  - ii. criteria for rejections and criteria for the escalation of deviations/exceptions to higher levels of the decision-making authority (including overrides, overrules, exposures possibly approved as an exception to general lending standards and other non-standard business under a special process with different approval authorities);
  - iii. requirements for the monitoring of circumstances and conditions for an exceptional credit-granting decision, including requirements for their review by the relevant functions during the regular review of the application and compliance with policies and limits;
- i. requirements relating to what is to be documented and recorded as part of the credit-granting process, including for sampling and audit purposes — this should include, at a minimum, the requirements for the completion of credit applications, the qualitative and quantitative rationale/analysis, and all supportive documentation that served as a basis for approving or declining the credit facility.
- j. requirements for monitoring credit-granting activities (the internal control framework should ensure that it covers all phases after the granting of credit);
- k. where applicable, the criteria as set out in Sections 2.3.2, 2.3.3, 2.3.4, 2.3.5 and 2.3.6;
- l. criteria as set out in Section 2.3.1 and 2.3.7 herein.

**23.** Within their credit risk policies and procedures and building on the credit risk strategy, banks should also take into account principles of responsible lending. In particular, banks should;

- a. consider the specific situation of a borrower, such as the fair treatment of borrowers that are in economic difficulties;
- b. design credit products that are offered to consumers in a responsible way;
- c. avoid attitudes that could manipulate the perceptions of consumers, with incomplete information or misleading information on the credit products offered (e.g., non-factual advertisement and marketing activities which do not reflect the facts about the credit products).

**24.** For the credit products that are offered to consumers, banks should ensure that the credit-granting criteria are not inducing undue hardship and over-indebtedness for the borrowers and their households.

**25.** In their credit risk policies and procedures dealing with credit decision-making as referred to in paragraph 22(a) and creditworthiness assessments as referred to in paragraph 22(d), banks should also specify the use of any automated models in the creditworthiness assessment and credit decision-making processes in a way that is appropriate to the size, nature and complexity of the credit facility and the types of borrowers. In particular, banks should set out appropriate governance arrangements for the design and use of such models and the management of the associated model risk, taking into account the criteria set out in Section 2.3.4, and the requirements relating to the design, validation and use of model, as set out in the Guidelines on the Evaluation Criteria to be Taken into Consideration in the Audits Performed by the Agency.

**26.** Banks should ensure that the credit risk policies and procedures are designed to minimise the risk of internal or external fraud in the credit-granting process. Banks should have adequate processes in place to monitor any suspicious or fraudulent behaviour.

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

### **2.3.1 Anti-money laundering and counter-terrorist financing policies and procedures**

**28.** Banks should also specify in their policies how they identify, assess and manage the money laundering and terrorist financing risks to which they are exposed as a result of their credit-granting activities<sup>6</sup>. In particular, banks should;

- a. at the level of their business, identify, assess and manage the money laundering and terrorist financing risks associated with the type of customers they serve, the lending products they provide, the geographies to which they are exposed and the distribution channels they use;
- b. at the level of the individual relationship, identify, assess and manage the money laundering and terrorist financing risks associated with this relationship. As part of this, banks should;
  - i. consider the purpose of the credit;
  - ii. consider the extent to which the association of a natural person or legal person that is neither the borrower nor the bank with the credit facility gives rise to money laundering and terrorist financing risks;

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<sup>6</sup> When defining these policies, banks must take into consideration the principles and procedures set out in the Law No. 5549 dated 11/10/2006 on Money Laundering and other applicable regulations.

- iii. in particular, in situations in which the money laundering and terrorist financing risk associated with the individual relationship is established, banks should take risk-sensitive measures to understand if the funds used to repay the credit, including cash or equivalents provided as collateral, are from legitimate sources. When considering the legitimacy of the source of funds, banks should have regard to the activity that generated the funds and whether this information is credible and consistent with the institution's knowledge of the customer and the customer's professional activity.

**29.** Banks should have internal processes to ensure that the information obtained for the purposes of creditworthiness assessment, such as the information specified in Section 3.1 and Annex 2 of these guidelines, also informs their anti-money laundering and countering financing of terrorism processes.

**30.** Banks should have policies and procedures in place to ensure that the disbursement of loans is made in line with the credit decision and the loan agreement. They should also ensure that there are appropriate checks in place to identify, assess and manage money laundering and terrorist financing risks, and that relevant records are kept, in line with banks' wider anti-money laundering and countering financing of terrorism obligations under Law No. 5549 on Prevention of Money Laundering and other applicable regulations

### **2.3.2 Leveraged transactions**

**31.** As part of their policies and procedures, banks should have in place an overarching definition of leveraged transactions that takes into consideration the level of leverage of the borrower and the purpose of the transaction, in line with the definition provided in the "Definitions" section of these Guidelines. This definition should encompass all business lines and units bearing credit risk.

**32.** The scope and implementation of the definition of a leveraged transaction by a bank should be regularly reviewed to ensure that no undue exclusion has been made.

**33.** Banks should define their appetite and strategy for leveraged transactions in a way that encompasses all relevant business units involved in such operations. Banks should define which types of leveraged transactions they are prepared to enter into, as well as acceptable values for parameters, such as rating note, probability of default, level of collateralization and leverage levels, including at sector level, when relevant.

**34.** Banks should define their risk appetite for syndicating leveraged transactions and derive a comprehensive limit framework, including dedicated underwriting limits and a granular set of sub-limits, detailing both maximum limits and the nature of transactions that the institution is prepared to participate in.

**35.** Banks should establish a sound governance structure for leveraged transactions, enabling a comprehensive and consistent oversight of all leveraged transactions originated, syndicated or purchased by them, including, when relevant, 'best efforts' deals and 'club deals', as well as standard bilateral loans to micro, small, medium-sized and large enterprises.

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

### **2.3.3 Technology-enabled innovation for credit granting**

**37.** When using technology-enabled innovation for credit-granting purposes, banks should;

- a. adequately capture, in their risk management and control frameworks, the inherent risks associated with the technology-enabled innovation in use. This should be commensurate with the business model, credit risk exposure, complexity of the methods and the extent of the use of technology-enabled innovation;
- b. ensure that the management body has a sufficient understanding of the use of technology-enabled innovation, its limitation and the impact it has on credit-granting procedures;
- c. understand the underlying models used, including their capabilities, assumptions and limitations, along with ensuring their traceability, auditability, and robustness and resilience;
- d. ensure that the models are fit for purpose, taking into account the identified task and other criteria, such as its performance and use. If explanations are required during the models' use, then consideration should be given to developing an interpretable model;
- e. understand the quality of data and inputs to the model and detect and prevent bias in the credit decision-making process, ensuring that appropriate safeguards are in place to provide confidentiality, integrity and availability of information and systems;
- f. ensure the performance of the model, including the validity and quality of its outputs, is continuously monitored and appropriate remediation measures are taken in a timely manner in the case of detected issues (e.g. worsening or deviating from expected behavior).

### **2.3.4. Models for creditworthiness assessment and credit decision-making**

**38.** When using automated models for creditworthiness assessment and credit decision-making, institutions should understand the models used, and their methodology, input data, assumptions, limitations and outputs, and should have in place:

- a. internal policies and procedures detecting and preventing bias and ensuring the quality of the input data,
- b. measures to ensure the traceability, auditability, and robustness and resilience of the inputs and outputs,

- c. internal policies and procedures ensuring that the quality of the model output is regularly assessed, using measures appropriate to the model's use, including back-testing the performance of the model,
- d. control mechanisms, model overrides and escalation procedures within the regular credit decision-making framework, including qualitative approaches, qualitative risk assessment tools (including expert judgement and critical analysis) and quantitative limits.

**39.** Banks should have adequate model documentation that covers;

- a. methodology, assumptions and data inputs, and an approach to detecting and preventing bias and ensuring the quality of input data,
- b. the use of model outputs in the decision-making process and the monitoring of these automated decisions on the overall quality of the portfolio or products in which these models are used.

### **2.3.5. Environmental, social and governance factors**

**40.** Banks should incorporate ESG factors and associated risks in their credit risk appetite and risk management policies, credit risk policies and procedures, adopting a holistic approach.

**41.** Banks should take into account the risks associated with ESG factors on the financial conditions of borrowers, and in particular the potential impact of environmental factors and climate change, in their credit risk appetite, policies and procedures. The risks of climate change for the financial performance of borrowers can primarily materialise as physical risks, such as risks to the borrower that arise from the physical effects of climate change, including liability risks for contributing to climate change, or transition risks, e.g. risks to the borrower that arise from the transition to a low-carbon and climate-resilient economy. In addition, other risks can occur, such as changes in market and consumer preferences and legal risks that may affect the performance of underlying assets.

### **2.3.6. Environmentally sustainable lending**

**42.** Banks that originate or plan to originate environmentally sustainable credit facilities should develop, as part of their credit risk policies and procedures, specific details of their environmentally sustainable lending policies and procedures, covering the granting and monitoring of such credit facilities. These policies and procedures should, in particular;

- a. provide a list of the projects and activities, as well as the criteria, that the institution considers eligible for environmentally sustainable lending or a reference to relevant existing standards on environmentally sustainable lending that define what type of lending is considered to be environmentally sustainable.
- b. specify the process by which the banks evaluating that the proceeds of the environmentally sustainable credit facilities they have originated are used for environmentally sustainable activities. In cases of lending to enterprises, the process should include;

- i. collecting information about the climate-related and environmental or otherwise sustainable business objectives of the borrowers;
- ii. assessing the conformity of the borrowers' funding projects with the qualifying environmentally sustainable projects or activities and related criteria;
- iii. ensuring that the borrowers have the willingness and capacity to appropriately monitor and report the allocation of the proceeds towards the environmentally sustainable projects or activities;
- iv. monitoring, on a regular basis, that the proceeds are allocated properly (which may consist of requesting that borrowers provide updated information on the use of the proceeds until the relevant credit facility is repaid).

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

#### **2.3.7. Data Infrastructure**

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

**45.** The data infrastructure should be detailed and sufficiently granular to capture specific loan-by-loan information, in particular actual credit-granting criteria applied at the point of origination, allowing data regarding the borrower to be linked with data regarding collateral, to support the effective monitoring of credit risk (see Section Six of these Guidelines) and enable effective audit trailing, operational and credit performance and efficiency measurement, as well as the tracking of policy deviations, exceptions and overrides (including credit/transaction rating or scoring overrides).

#### **2.4. Credit Decision Making**

**46.** Banks should establish a clear and well-documented credit decision-making framework that should set out a clear and sound structure for the credit decision-making responsibilities within a bank, including a description of the hierarchy of the credit decision-makers and their allocation within the bank's organisational and business structure and their reporting lines.

**47.** The structure of credit decision-makers should be in line with and integrated into credit risk appetite, policies and limits and reflect the business model of the institutions. The allocation of credit decision-makers to the organisational and business structure should reflect the cascading credit risk appetite and limits within an organisation and be based on objective criteria, including risk indicators.

**48.** The credit decision-making framework should clearly articulate the decision-making powers and limitations of each decision-maker and of any automated models for credit decision-making purposes, in line with the criteria for such models set out in Section 4.3.4. These powers and limitations should account for the characteristics of the credit portfolio, including its concentration and diversification objectives, in relation to business lines, geographies, economic sectors and products, as well as credit limits and maximum exposures. Where relevant, institutions should set time limits for the delegated powers or the size of delegated approvals.

**49.** When delegating credit decision-making powers, including limits, to members of staff, banks should consider the specificities of the credit facilities subject to this individual decision-making, including their size and complexity, and the types and risk profiles of borrowers. Banks should also ensure that these staff members are adequately trained and hold relevant expertise and seniority in relation to the specific authority delegated to them.

**50.** The credit decision-making framework should account for the risk perspective in the decision-making. It should also take into account the specificities of credit products and borrowers, including the type of product, the size of credit facility or limit, and the risk profile of the borrower.

**51.** The framework should also specify the working modalities of the credit committees and the roles of their members, including, when applicable, aspects such as voting procedures (unanimity or simple majority of votes).

**52.** If banks grant specific veto rights in relation to positive credit decisions to the head of the risk management function, banks should consider granting such veto rights to additional staff members within the risk management function for specific credit decisions, to ensure that such a veto can be exercised, if appropriate, at all levels of the credit decision-making framework below the management body. Banks should specify the scope of these veto rights, the escalation or appeal procedures, and how the management body will be involved, and should document such scope and procedures.

#### **2.4.1. Objectivity and impartiality in credit decision-making**

**53.** Banks should ensure that decisions taken by credit decision-makers are impartial and objective and not adversely affected by any conflict of interest, in line with the third paragraph of Article 51 of Banking Law, Regulation on Credit Transactions of Banks, and the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation Process. More specifically, for the purposes of these Guidelines, banks should ensure that any individual involved in credit decision-making, such as members of staff and members of the management body, should not take part in credit decisions if any of the following occurs:

- a. any individual involved in credit decision-making has a personal or professional relationship (outside the professional relationship when representing the bank) with the borrower;

- b. any individual involved in credit decision-making has an economic or any other interest, including direct or indirect, actual or potential, financial or non-financial, associated with the borrower;
- c. any individual involved in credit decision-making has undue political influence on or a political relationship with the borrower.

**54.** Notwithstanding the governance structures implemented in banks to operationalise the credit decision-making framework, Banks should have policies, procedures and organisational controls in place that guarantee and ensure objectivity and impartiality in the credit decision-making process. These policies, procedures and organisational controls, including any mitigating measures, should be clearly defined and understood, and should address any potential conflicts of interest. Banks should ensure effective oversight of the decisions taken by credit decision-makers, including credit granting, to ensure their objectivity and impartiality

## **2.5. Credit risk management and internal control frameworks**

**55.** In accordance with the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation Process, banks should implement a robust and comprehensive internal control framework, including credit risk management, respecting inter alia the principles of accountability, segregation and independence of functions and responsibilities, challenge and assurance of outcomes

**56.** Risk management and internal controls for credit risk should be integrated into the bank's overall risk management and internal control frameworks, as well as into the organisational and decision-making structure. Banks should ensure that the internal control framework, including credit risk management, supports robust and appropriate credit risk taking, analysis, and monitoring throughout the life cycle of a credit facility, including the design and development of the specific product, sales and administration.

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

**58.** Banks should define, in a clear and transparent manner, the allocation of responsibilities and authority within the organization, including within and between business lines, units and functions, including risk management. To this end, banks should clearly define functions responsible for performing the various tasks related to credit risk taking and the credit decision-making process, specified in a way that does not lead to a conflict of interest and ensures the effective management of credit risk.

**59.** The business lines and units originating the credit risk should be primarily responsible for managing the credit risk generated by their activities throughout the lifetime of the credit. These business lines and units should have adequate internal controls in place to ensure adherence with internal policies and relevant external requirements.

**60.** Banks should have a risk management function, in line with the Regulation on the Internal Systems of Banks and Internal Capital Adequacy Evaluation Process, that is responsible for ensuring the proper controls of credit risk. The risk management function should be

independent of the business-originating units.

**61.** For the purposes of paragraph 58, banks should consider the following areas/tasks:

- a. developing and maintaining credit-granting and monitoring processes and procedures;
- b. defining and developing processes, mechanisms and methodologies for credit risk appetite, credit risk strategy and credit risk policies, including the overall cascading-down process for policies and procedures, and business strategy,
- c. designing and implementing an appropriate credit decision-making framework in accordance with these Guidelines,
- d. designing, defining and performing credit risk monitoring and reporting, including early warning systems, credit portfolio and aggregate risk monitoring, including in relation to ICAAP and any applicable regulatory metrics, (e.g. credit limits),
- e. performing an assessment of creditworthiness and a credit risk analysis for scoring or rating purposes,
- f. providing an independent/second opinion on the creditworthiness assessment and credit risk analysis for the purposes of credit decision-making, specifying in which circumstances, considering the specificities of the credit facility, its size and the risk profile of the borrower, this independent/second opinion is relevant,
- g. assessing the appropriateness of allowances in accordance with the relevant accounting framework,
- h. developing new credit products, also considering the requirements for the new product approval process, and ongoing monitoring of the appropriateness of credit products,
- i. managing early arrears and non-performing exposures, and granting and monitoring forbearance measures, in line with the provisions of the Guidelines on the Resolution of Troubled Loans and the bank's internal policies in relation to lending to consumers,
- j. performing stress tests on the aggregate credit portfolio as well as on relevant sub-portfolios and geographical segments;
- k. monitoring individual exposures through regular credit reviews, in accordance with the requirements set out in Section Six, including sample reviews of credit lines;
- l. ensuring the integrity and reliability of the internal ratings assignment process, as described in the Communiqué on the Calculation of Credit Risk Amounts through Approaches Based on Internal Rating, where relevant for banks with permission to use an internal ratings-based approach, and the integrity and reliability of the rating scale and ratings assignment process used by the bank, for the banks using the standardized approach;

- m. performing quality assurance of credit assessments, taking into account an appropriate sample size, and ensuring that credit risk is properly identified, measured, monitored and managed within the bank's business origination activities, and that regular reporting is communicated to the bank's management body.

## **2.6. Internal Audit**

**62.** The credit risk management framework, including internal control process, should be audited by the internal audit unit at least once a year. The internal audit should cover a review of compliance with all principles of these Guidelines.

## **2.7. Resources and Skills**

**63.** Banks should have sufficient resources and staff allocated to credit risk taking and, in particular, credit decision-making, credit risk management and internal control. The organizational structure should be reviewed periodically to ensure that there are adequate resources, competencies and expertise within the credit risk management functions to effectively manage credit risk.

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

**65.** Staff involved in credit granting, including credit decision-making, credit risk management and internal control, should frequently receive appropriate training, which includes considering changes to the applicable legal and regulatory frameworks. Training should be aligned with the banks' credit culture and business strategy and should be conducted on a regular basis to ensure that all relevant staff are appropriately skilled and familiar with the banks' credit policies, procedures and processes.

## **2.8. Remuneration**

**66.** As part of the requirements of Banks' remuneration policies set out in paragraph 9 off the Manual on Good Remuneration Practices in Banks, banks' remuneration policies and practices should be in line with the approach to credit risk management, credit risk appetite and strategies, and should not create a conflict of interest. Remuneration policies and practices applicable to staff, and in particular identified staff engaged in credit granting, credit administration and monitoring, should be consistent and not provide incentives for risk taking that exceeds the tolerated risk of the bank, and should be aligned with the business strategy, objectives and long-term interests of the bank. In addition, remuneration policies and practices should incorporate measures to manage conflicts of interest, with a view to protecting consumers from undesirable detriment arising from the remuneration of sales staff

**67.** Banks' remuneration policies and practices should, in particular, ensure that the performance and risk measurement process to determine the variable remuneration of the staff involved in credit granting includes appropriate credit quality metrics that are in line with the Bank's credit risk appetite.

## **SECTION THREE**

## **Procedures relating to Loan Origination Process**

### **3.1. Information and Documentation**

**68.** Banks should have sufficient, accurate and up-to-date information and data necessary to assess the borrower's creditworthiness and risk profile before concluding a loan agreement.

**69.** For the purposes of the creditworthiness assessment of consumers, Banks should have available, and use, information supported by necessary and appropriate evidence, in relation to at least the following:

- a. purpose of the loan, when relevant to the type of credit;
- b. employment and income status;
- c. source of repayment capacity;
- d. composition of a household and dependents;
- e. financial commitments and expenses for their servicing;
- f. regular expenses;
- g. collateral (for secured lending);
- h. other risk mitigants, such as guarantees, when available

Banks can consider the use of specific information, data items and evidence set out in Annex 2.

**70.** For the purposes of the creditworthiness assessment of legal entity consumers, banks should have available, and use, information, supported by necessary and appropriate evidence, in relation to at least the following:

- a. purpose of the loan, when relevant to the type of credit;
- b. income and cash flow;
- c. financial position and commitments, including assets pledged and contingent liabilities;
- d. business model and corporate structure;
- e. business plans supported by financial projections;
- f. collateral (for secured lending);
- g. other risk mitigants, such as guarantees, when available
- h. product type-specific legal documentation (e.g. permits, contracts).

Banks can consider the use of specific information, data items and evidence set out in Annex 2.

**71.** Banks may use the already available information and data for existing customers and borrowers, in accordance with the requirements of Banking Law, Law on the Protection of Personal Data and other applicable legislation, and when such information and data are relevant and up to date.

**72.** If the information and data are not readily available, banks should collect the necessary information and data from the borrower and/or third parties, including relevant databases, when relevant. For the collection of information and data on the borrower from third parties, banks should ensure that the requirements of Banking Law, Law on the Protection of Personal Data and other applicable legislation are met.

**73.** If banks have concerns regarding the accuracy and reliability of the information and data, they should make necessary checks and reasonable enquiries with the borrower and third parties (e.g. employer, public authorities, relevant databases), and take reasonable steps to verify the information and data collected. Before making such enquiries with third parties regarding borrower's personal data, banks should ensure that the requirements, in particular with regard to informing and seeking permission from the borrower, of Banking Law, Law on the Protection of Personal Data and other applicable legislation are met

**74.** Banks should have an accurate single customer view that enables an assessment of the borrower's ability to service and repay financial commitments. This single customer view applies to single borrowers, households, as appropriate, and members of consolidated groups for enterprises. The single customer view should be supplemented by the information provided by the borrower on the assets and liabilities held at other banks.

**75.** If the borrower is likely to face financial difficulties in meeting the contractual loan obligations, banks should request, from the borrower, reliable documentation demonstrating realistic projections of their ability to maintain solvency. In this case, both information from third parties, such as tax advisors, auditors and other experts, and information from borrowers may be used.

**76.** If a loan agreement involves guarantees from third parties, banks should have a sufficient level of information and data necessary to assess the guarantee and, when relevant, the financial position of the guarantor.

**77.** If the borrower has a risk group and, in particular, if the loan repayment relies on cash flow originating from other connected parties in the same risk group, banks should collect the necessary information on the related connected parties.

**78.** Banks should document the information and data that lead to credit approval, including the actions and assessments carried out by them, and maintain this documentation in an accessible form, readily available for competent authorities, for at least the duration of the loan agreement.

### **3.2. Assessment of borrower's creditworthiness**

#### **3.2.1. General provisions for lending to consumers**

**79.** Banks should analyse the loan application of the borrower in order to ensure that the application is in line with the banks' credit risk appetite, policies, credit-granting criteria, limits and relevant metrics, as well as any relevant macroprudential measures where applied by the designated macroprudential authority.

**80.** Banks should, in line with the Laqw on the Protection of Consumers, assess the borrower's ability and prospect to meet the obligations under the loan agreement, covering, in particular, an assessment of the borrower's source of repayment capacity, taking into account specificities of the loan, such as nature, maturity and interest rate

**81.** Collateral, in the case of secured lending, by itself should not be a predominant criterion for approving a loan and cannot by itself justify the approval of any loan agreement. Collateral should be considered the bank's second way out in case of default or material deterioration of the risk profile, and not the primary source of repayment, with the exception of when the loan agreement envisages that the repayment of the loan is based on the sale of the property pledged as collateral or liquid collateral provided.

**82.** When assessing the borrower's ability to meet obligations under the loan agreement, banks should take into account relevant factors that could influence the present and future repayment capacity of the borrower, and should avoid inducing undue hardship and over-indebtedness. The factors should include other servicing obligations, their remaining duration, their interest rates and the outstanding amounts, and repayment behaviour, e.g. evidence of any missed payments and their circumstances, as well as directly relevant taxes and insurance if known.

**83.** If the loan application is submitted jointly by more than one borrower, banks should perform the creditworthiness assessment on the basis of the joint repayment capacity of the borrowers.

**84.** If a loan agreement involves any form of guarantees from third parties, banks should assess the level of protection provided by the guarantee, and if relevant, conduct a creditworthiness assessment of the guarantor, applying the relevant provisions of these Guidelines, depending on whether the guarantor is a natural person or an enterprise.

**85.** For assessing the borrower's ability to meet obligations under the loan agreement, banks should adopt suitable methods and approaches, which may include models, as long as these guidelines are met. The selection of the suitable and adequate method should depend on the risk level, size and type of loan.

### **3.2.2. Lending to consumers in relation to residential immovable property**

**86.** This section further specifies factors relevant to assessing the prospect of the borrower to meet obligations under a loan agreement secured through residential immovable property. In relation to such loan agreements, banks should apply the provisions set out in this section, in addition to provisions set out in Section 3.2.1 of these Guidelines.

**87.** When necessary, in particular in cases of borrowers who are self-employed or have seasonal or other irregular income, banks should make reasonable enquiries and take reasonable steps to verify the information regarding the source of repayment capacity.

**88.** If the loan term extends past the borrower's expected retirement age, banks should take appropriate account of the adequacy of the borrower's likely source of repayment capacity and ability to continue to meet obligations under the loan agreement in retirement.

**89.** Banks should ensure that the borrower's ability to meet obligations under the loan agreement is not based on an expected significant increase in the borrower's income, unless the documentation provides sufficient evidence.

**90.** When assessing the borrower's ability to meet obligations under the loan agreement, banks should account for committed and other non-discretionary expenditures, such as the borrower's current obligations, including appropriate substantiation and consideration of living expenses, as calculated by taking into account the minimum subsistence amounts announced by TurkStat.

**91.** As part of the creditworthiness assessment, banks should carry out sensitivity analyses reflecting the relevant potential negative events in the future, including a reduction in income; an increase in interest rates in cases of variable rate loan agreements; negative amortization of the loan (deferral of part of the interest in the loan installment repayments) and balloon payments (payment of the whole debt all at once) or deferred payments of the principal or interest

**92.** In cases of foreign currency loans, banks should also factor into the assessment of the borrower's capacity to meet the obligations potential negative scenarios of the exchange rate between the currency of the borrower's income and the currency of the loan. Banks should also take into account and assess any hedging strategies and actual hedges in place, including natural hedges, to mitigate foreign currency exchange risk.

**93.** For loan agreements that relate to an immovable property that explicitly state that the immovable property is not to be occupied as a place of residence by the borrower or a family member, banks should apply the criteria set out in Section 3.2.3 of these Guidelines.

### **3.2.3. Other secured lending to consumers**

**94.** In relation to loan agreements secured by immovable property, other than those covered in Section 3.2.2, Banks and creditors should apply the provisions set out in this section, in addition to the provisions set out in Section 3.2.1.

**95.** If the property is still being constructed and intended to provide, upon completion, an income to its owner in the form of rents or profits from its sale, banks should assess the development phase and the phase after the completion of the development, when the project converts into an income-producing property. For the purposes of such loan agreements, banks should establish that;

- a. the borrower has a plausible plan related to the project, including estimates of all costs associated with the development.
- b. the borrower has access to builders, architects, engineers and contractors, who will take part in the development.
- c. the borrower has obtained or is able to obtain in the future all necessary permits and certificates for the development, as the project progresses.

**96.** For loan agreements that relate to an immovable property that explicitly state that the immovable property is not to be occupied as a place of residence by the borrower or a family

member, banks should assess the relationship between the future rental income from the immovable property and the borrower's ability to meet obligations.

**97.** As part of the creditworthiness assessment, banks should carry out sensitivity analyses to reflect potential negative market and idiosyncratic events of the borrower/loan in the future that are relevant to the type and purpose of the loan. These events may include a reduction in income; an increase in interest rates in cases of variable rate loan agreements; negative amortisation of the loan; balloon payments or deferred payments of the principal or interest; and, when relevant, deterioration in the marketability of the immovable property, an increase in vacancy rates and a reduction in the rental prices for similar properties. When relevant, Banks and creditors should also consider the implication of foreign currency exchange rate risk, as provided in paragraph 92.

#### **3.2.4. Unsecured lending to consumers**

**98.** This section further specifies the requirements to assess the creditworthiness of the borrower. In addition to provisions set out in Section 5.2.1, provisions set out in this section, banks should prepare loan agreements in compliance with the provisions of Law of Obligations, Law on the protection of Consumers and other applicable legislation.

**99.** In particular in cases of borrowers who are self-employed or have seasonal or other irregular income, Banks and creditors should make reasonable enquiries and take reasonable steps to assess and verify the source of repayment capacity.

**100.** Banks should ensure that the borrower's ability to meet obligations under the loan agreement is not based on an expected significant increase in the borrower's income, unless the documentation provides sufficient evidence.

**101.** As part of the creditworthiness assessment, banks, if applicable, should carry out sensitivity analyses to reflect potential negative events specific to the type of loan that may occur in the future. When relevant, banks should also consider the implication of foreign currency exchange rate risk, as provided in paragraph 92.

#### **3.2.5. Commercial lending to micro and small enterprises**

**102.** Banks should assess the borrower's current and future ability to meet the obligations under the loan agreement. Banks should also analyse the loan application of the borrower in order to ensure that the application is in line with the bank's credit risk appetite, policies, credit-granting criteria, limits and relevant metrics, as well as any relevant macroprudential measures, where applied by the designated macroprudential authority.

**103.** Banks should consider that cash flow from the ordinary business activities of the borrower and, when applicable within the purpose of the loan agreement, any proceeds on the sale of the assets are the primary sources of repayment.

**104.** When assessing the creditworthiness of the borrower, banks should put emphasis on the borrower's realistic and sustainable future income and future cash flow, and not on available collateral. Collateral by itself should not be a predominant criterion for approving a loan and cannot by itself justify the approval of any loan agreement. Collateral should be considered the bank's second way out in case of default or material deterioration of the risk profile, and not the primary source of repayment, with the exception of when the loan agreement envisages that the repayment of the loan is based on the sale of the property pledged as

collateral or liquid collateral provided.

**105.** When carrying out the creditworthiness assessment, banks should:

- a. analyze the financial position and credit risk of the borrower, as set out below;
- b. analyze the business model and strategy of the borrower, as set out below;
- c. determine and assess the borrower's credit scoring or internal rating, where applicable, in accordance with the credit risk policies and procedures;
- d. consider all the borrower's financial commitments, such as drawn and undrawn committed facilities with banks, including working capital facilities, credit exposures of the borrower and the past repayment behavior of the borrower, as well as other obligations arising from tax or other public authorities or social security funds;
- e. when relevant, assess the structure of the transaction, including the risk of structural subordination (bank's right to, and priority in, access to the company's assets) and related terms, e.g. covenants, and, if applicable, third-party guarantees and collateral structure.

**106.** Banks should carry out the creditworthiness assessment in relation to the specificities of the loan, such as nature, maturity and interest rate.

**107.** For assessing the borrower's ability to meet obligations under the loan agreement, banks should adopt suitable methods and approaches, which may include models, as long as these guidelines are met. The selection of the suitable and adequate method should depend on the risk level, size and type of loan.

**108.** If the borrower is a member of a risk group, banks should carry out the assessment at individual level and, where relevant, at risk group level, in accordance with the Banking Law and Regulation on the Loan Operations of Banks, especially when repayment is reliant on cash flow emanating from other connected parties in the risk group. If the borrower is a member of a group of connected clients linked to central banks and sovereigns, including central governments, regional and local authorities, and public sector entities, banks should assess the individual entity.

**109.** For lending activities with cross-border elements (e.g. trade finance, export finance), Banks should take into account the political, economic and legal environment in which the foreign counterparty of the bank's client operates. Banks should assess the buyer's ability to transfer funds, the supplier's capacity to deliver the order, including its capacity to meet the applicable local legal requirements, and the supplier's financial capacity to handle possible delays in transaction.

**110.** Banks should assess the borrower's exposure to ESG factors, in particular environmental factors and the impact on climate change, and the appropriateness of the mitigating strategies, as set out by the borrower. This analysis should be performed on a borrower basis; however, when relevant, Banks may also consider performing this analysis on a portfolio basis.

**111.** In order to identify borrowers that are exposed, directly or indirectly, to increased risk associated with ESG factors, Banks should consider using heat maps that highlight, for example, climate-related and environmental risks of individual economic (sub-)sectors in a chart or on a scaling system. For loans or borrowers associated with a higher ESG risk, a more intensive analysis of the actual business model of the borrower is required, including a review of current and projected greenhouse gas emissions, the market environment, supervisory ESG requirements for the companies under consideration and the likely impacts of ESG regulation on the borrower's financial position.

### *Analysis of the borrower's financial position*

**112.** For the purposes of the analysis of the financial position within the creditworthiness assessment as specified above, Banks should consider the following:

- a. both the current and the projected financial position, including balance sheets, source of repayment capacity to meet contractual obligations, including under possible adverse events, and, where relevant, capital structure, working capital, income and cash flow;
- b. where relevant, the borrower's leverage level, dividend distribution, and actual and projected/forecasted capital expenditure, as well as its cash conversion cycle in relation to the facility under consideration;
- c. where relevant, the exposure profile until maturity, in relation to potential market movements, such as exposures denominated in foreign currencies and exposures collateralized by repayment vehicles;
- d. where applicable, the probability of default, based on credit scoring or internal risk rating;
- e. the use of appropriate financial, asset class-specific or product type-specific metrics and indicators, in line with their credit risk appetite, policies and limits set out in accordance with Sections 2.2 and 2.3, including considering metrics in Annex 3 to an extent that is applicable and appropriate to the specific credit proposal

**113.** Banks should ensure that the financial projections used in the analysis are realistic and reasonable. These projections/forecasts should be at least based on projecting historical financial data forward. Banks should assess if these projections are in line with the bank's economic and market expectations. When banks have material concerns about the reliability of these financial projections, they should make their own projections of the borrowers' financial position and repayment capacity.

**114.** If applicable, banks should assess the financial position when granting loans to holding companies, both as a separate entity, e.g. at consolidated level, and as a single entity, if the holding company is not itself an operating company or banks do not have guarantees from the operating companies to the holding company.

**115.** When assessing the borrowers' financial position, Banks should assess the sustainability and feasibility of the future repayment capacity under potential adverse conditions that are relevant to the type and purpose of the loan and may occur in the duration of the loan agreement. These events may include a reduction in income and other cash flow; an increase in interest rates; negative amortisation of the loan (deferral of part of the interest in the loan instalment repayments); deferred payments of principal or interest; deterioration in the market and operating conditions for the borrower; and foreign currency exchange rate changes, when relevant.

### ***Analysis of the borrower's business model and strategy***

**116.** Banks should assess the business model and strategy of the borrowers, including in relation to the purpose of the loan.

**117.** Banks should assess the borrower's knowledge, experience and capacity to manage business activities, assets or investments linked to the loan agreements (e.g. specific property for mortgage loan secured by a lien on a commercial property).

**118.** Banks should assess the feasibility of the business plan and associated financial projections, in line with the specificities of the sector in which the borrower operates.

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

**120.** Banks should assess the presence of any potential key-person dependency with regard to the borrower and, when necessary, identify, together with the borrower, possible mitigation measures.

### ***Assessment of guarantees and collateral***

**121.** Banks should assess any pledged collateral that is used for the purposes of risk mitigation against the requirements for collateral set out in the Bank's credit risk appetite, policies and procedures, including the valuation and ownership, and check all relevant documentation (e.g. whether property is registered in appropriate registers). If applicable, banks should put in place systems and processes ensuring efficient monitoring and updating of key information on the liens and pledged collaterals (e.g., degree of pledge, amount of pledge, valuation amount in the valuation report and date of valuation, etc.).

**122.** Banks should assess any guarantees, covenants, negative pledge clauses and debt service agreements that are used for the purposes of risk mitigation.

**123.** When relevant to credit decisions, Banks should assess the borrower's equity and credit enhancements, such as mortgage insurance, take-out commitments and repayment guarantees from external sources.

**124.** If a loan agreement involves any form of guarantees from third parties, banks should assess the level of protection provided by the guarantee, and if relevant, conduct a creditworthiness assessment of the guarantor, applying the relevant provisions of these Guidelines, depending on whether the guarantor is a natural person or an enterprise. The creditworthiness assessment of the guarantor should be proportionate to the size of the guarantee in relation to the loan and the type of guarantor.

### **3.2.6. Commercial lending to medium-sized and large enterprises**

**125.** Banks should assess the borrower's current and future ability to meet the obligations under the loan agreement. Banks should also analyse the loan application of the borrower in order to ensure that the application is in line with the bank's credit risk appetite, policies, credit-granting criteria, limits and relevant metrics, as well as any relevant macroprudential measures, where applied by the designated macroprudential authority.

**126.** Banks should consider that cash flow from the ordinary business activities of the borrower and, when applicable within the purpose of the loan agreement, any proceeds on the sale of the assets are the primary sources of repayment.

**127.** When assessing the creditworthiness of the borrower, banks should put emphasis on the borrower's realistic and sustainable future income and future cash flow, and not on available collateral. Collateral by itself should not be a predominant criterion for approving a loan and cannot by itself justify the approval of any loan agreement. Collateral should be considered the bank's second way out in case of default or material deterioration of the risk profile, and not the primary source of repayment, with the exception of when the loan agreement envisages that the repayment of the loan is based on the sale of the property pledged as collateral or liquid collateral provided.

**128.** When carrying out the creditworthiness assessment, banks should:

- a. analyse the financial position and credit risk of the borrower, as set out below,
- b. analyse the organisational structure, business model and strategy of the borrower, as set out below,
- c. determine and assess the borrower's credit scoring or internal rating, where applicable, in accordance with the credit risk policies and procedures,
- d. consider all the borrower's financial commitments, such as non-cash loans and commitments, including working capital facilities, credit exposures of the borrower and the past repayment behaviour of the borrower, as well as other obligations arising from social security funds and other public authorities,

- e. where relevant, assess the structure of the transaction, including the risk of structural subordination (bank's right to, and priority in, access to the company's assets) and related terms, e.g. covenants, and, if applicable, third-party guarantees and collateral structure.

**129.** Banks should carry out the creditworthiness assessment in relation to the specificities of the loan, such as nature, maturity and interest rate.

**130.** Banks should assess the borrower's exposure to ESG factors, in particular environmental factors and the impact on climate change, and the appropriateness of the mitigating strategies, as set out by the borrower.

**131.** If the borrower is a member of a risk group, banks should carry out the assessment at individual level and, where relevant, at risk group level, in accordance with the Banking Law and Regulation on the Loan Operations of Banks, especially when repayment is reliant on cash flow emanating from other connected parties in the risk group. If the borrower is a member of a group of connected clients linked to central banks and sovereigns, including central governments, regional and local authorities, and public sector entities, banks should assess the individual entity..

**132.** For lending activities with cross-border elements (e.g. trade finance, export finance), Banks should take into account the political, economic and legal environment in which the foreign counterparty of the bank's client operates. Banks should assess the buyer's ability to transfer funds, the supplier's capacity to deliver the order, including its capacity to meet the applicable local legal requirements, and the supplier's financial capacity to handle possible delays in transaction.

**133.** In order to identify borrowers that are exposed, directly or indirectly, to increased risk associated with ESG factors, Banks should consider using heat maps that highlight, for example, climate-related and environmental risks of individual economic (sub-)sectors in a chart or on a scaling system. For loans or borrowers associated with a higher ESG risk, a more intensive analysis of the actual business model of the borrower is required, including a review of current and projected greenhouse gas emissions, the market environment, supervisory ESG requirements for the companies under consideration and the likely impacts of ESG regulation on the borrower's financial position.

#### ***Analysis of the borrower's financial position***

**134.** For the purposes of the analysis of the financial position within the creditworthiness assessment as specified above, Banks should consider the following:

- a. both the current and the projected financial position, including balance sheets and capital structure, working capital, income, cash flow and the source of repayment capacity to meet contractual obligations (e.g. debt-servicing capacity), including under both normal conditions and possible adverse events (within the framework of sensitivity analysis) (items to be analyzed should include but not be limited to free cash flow available for debt servicing of the facility under consideration);

- b. net operating income and profitability, especially in relation to interest-carrying debt;
- c. the borrower's leverage level, dividend distribution, and actual and projected capital expenditure, as well as its cash conversion cycle in relation to the facility under consideration;
- d. the exposure profile until maturity, in relation to potential market movements (e.g. exposures denominated in foreign currencies and exposures collateralized by repayment vehicles);
- e. where applicable, the probability of default, based on credit scoring or internal risk rating;
- f. the use of appropriate financial, asset class- or product type-specific metrics and indicators, in line with their credit risk appetite, policies and limits set out in accordance with Sections 2.2 and 2.3, including considering metrics in Annex 3 to an extent that is applicable and appropriate to the specific credit proposal.

**135.** Banks should ensure that the projections used in the analysis are realistic and reasonable and are in line with the banks' economic and market expectations. When banks have material concerns about the reliability of these financial projections, they should make their own projections of the borrowers' financial position and, when relevant, use them to challenge the projections provided by the borrowers.

**136.** Banks should also assess the borrower's capacity for future profitability, to measure the impact of retained earnings and hence the impact on equity, particularly in cases where the borrower has been unable to generate positive profits over time.

**137.** Banks should perform an assessment of the cash conversion cycle of the borrower, to measure the time it takes for the business to convert the investment in inventory and other resource inputs into cash through the sale of its specific goods and services. Banks should be able to understand the cash conversion cycle of a borrower to estimate working capital needs and identify recurring costs, in order to assess the ongoing capacity to repay credit facilities over time.

**138.** Banks should, when relevant, assess these financial metrics against the metrics and limits set out in their credit risk appetite, credit risk policies and limits, in accordance with Sections 2.2 and 2.3 of these Guidelines.

**139.** Banks should assess the financial position when granting loans to holding companies, both as a separate entity, e.g. at consolidated level, and as a single entity, (e.g., if the holding company is not itself an operating company or the bank does not have guarantees from the operating companies to the holding company).

***Sensitivity analysis in creditworthiness assessment***

**140.** Banks should assess the sustainability and feasibility of the borrower's financial position and the future repayment capacity under potential adverse conditions that may occur in the duration of the loan agreement. To this end, Banks should carry out a single- or multifactor sensitivity analysis, considering market and idiosyncratic events, or a combination of any of them.

**141.** This sensitivity analysis should account for all general and asset class and product-specific aspects that may have an impact on the creditworthiness of the borrower.

**142.** When carrying out a sensitivity analysis of the borrower's repayment capacity under negative future conditions, Banks should take into account the following events that are most relevant to the specific circumstances and the business model of the borrower.

*Borrower-Specific (Idiosyncratic) Events*

- a. a severe but plausible decline in a borrower's revenues or profit margins;
- b. a severe but plausible operational loss event;
- c. the occurrence of severe but plausible management problems;
- d. the failures of significant trading partners, customers or suppliers;
- e. a severe but plausible reputational damage;
- f. a severe but plausible outflow of liquidity, changes in funding or an increase in a borrower's balance sheet leverage;
- g. adverse movements in the price of assets to which the borrower is predominantly exposed (e.g. as raw material or end product) and foreign exchange risk;

*Market Events*

- h. a severe but plausible macroeconomic downturn;
- i. a severe but plausible downturn in the economic sectors in which the borrower and its clients are operating;
- j. a significant change in political, regulatory and geographical risk;
- k. a severe but plausible increase in the cost of funding, e.g. an increase in the interest rate by 200 basis points on all credit facilities of the borrower

*Analysis of the borrower's business model and strategy*

**143.** Banks should assess the business model and strategy of the borrowers, including in relation to the purpose of the loan.

**144.** Banks should assess the borrower's knowledge, experience and capacity to manage business activities, assets or investments linked to the loan agreements (e.g. specific property for mortgage loan secured by a lien on a commercial property).

**145.** Banks should assess the feasibility of the business plan and associated financial projections, in line with the specificities of the sector in which the borrower operates.

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

#### ***Assessment of guarantees and collateral***

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

**148.** Banks should assess any guarantees, covenants, negative pledge clauses and debt service agreements that are used for the purposes of risk mitigation. Banks should also consider if the value of the collateral is in some way correlated with the borrower's business or capacity to generate cash flow.

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

**150.** If a loan agreement involves any form of guarantees from third parties, banks should assess the level of protection provided by the guarantee and, if relevant, conduct a creditworthiness assessment of the guarantor, applying the relevant provisions of these guidelines, depending on whether the guarantor is a natural person or an enterprise. The creditworthiness assessment of the guarantor should be proportionate to the size of the guarantee in relation to the loan and the type of guarantor

**151.** If, in the syndicated lending or project finance transactions, the payment streams pass through a third party to the transactions, e.g. a designated agent, Banks (or mandated lead arrangers or their nominated agents) should assess the soundness of the agent. For cross-border lending and project finance transactions, the agent should be the sole issuer of any guarantees, letters of credit or similar documents issued on behalf of the supplier in the transaction.

#### **3.2.7 Commercial real estate lending**

**152.** When assessing the creditworthiness of the borrowers in cases of commercial real estate lending, in addition to the general criteria for the creditworthiness assessment set out in Section 3.2.5 and Section 3.2.6, banks should apply the specific criteria set out in this section. When assessing the creditworthiness of the borrowers in cases of lending for commercial real estate to be used by the borrower that owns the property for conducting business, banks should apply the criteria set out in Section 3.2.5 and Section 3.2.6 only.

**153.** Banks should assess and verify the borrower's experience in relation to the type, size and geographical location of the commercial real estate. When the borrower is a special purpose vehicle sponsored by another entity, Banks should assess the sponsoring entity's experience in relation to the type, size and geographical location of the commercial real estate.

**154.** Banks should carry out an assessment of the income-producing capacity of the property and an assessment of the prospect of refinancing. These assessments should account for the committed term of the commercial real estate loan under the loan application in question.

**155.** In the assessment of the borrower's repayment capacity, banks should assess, where relevant:

- a. the sustainability of the cash flow;
- b. the quality of the tenants, the impact of changes to current rental income on the amortization schedule, lease terms, maturities and conditions, and payment history of the tenant if already in place;
- c. reletting prospects, the cash flow required to service the loan in accordance with the loan agreement if there are needs for reletting, if applicable the performance of the asset in an economic downturn, and fluctuations in rental yields over time, to assess the presence of overly compressed yields;
- d. necessary capital expenditure on the property throughout the term of the loan.

**156.** In the assessment of the prospects of reletting any property, banks should account for tenants' demand for that property, having regard to the supply of comparable properties, the conditions and specifications of the property, the location of the property and the proximity to relevant infrastructure serving the property.

**157.** When interest-only loans are advanced for commercial real estate, banks should assess property cash flow to support a level of amortization equivalent to the projected economic life cycle of the property, to clear the principal amount and interest of the loan in the event of an increase in the loan to value for the property, or to a regular loan to value level in the relevant market. Banks should also consider such analysis when borrowers have additional credit enhancements (e.g. disposal assets that are legally enforceable in a reasonable time period).

**158.** For the purposes of the sensitivity analysis under adverse market and idiosyncratic events, Banks should, in addition to the events specified in Section 3.2.5 and Section 3.2.6, take into account the following, as applicable:

- a. reletting, including a change in the rental prices, lease length in relation to loan term service charges, an increase in vacancy rates, maintenance and refurbishment costs, rent-free periods and letting inducement
- b. risks and delays associated with refinancing;
- c. capital expenditure risk;
- d. other relevant criteria.

### **3.2.8 Lending for real estate development**

**159.** When assessing the creditworthiness of the borrowers in cases of lending for real estate development, in addition to the general provisions on the creditworthiness assessment set out in Section 3.2.5 and Section 3.2.5, banks should apply the specific provisions of this section

**160.** The creditworthiness assessment should cover, in line with the life cycle of the loan, both the development phase, including its stages, when relevant, and the phase after the completion of the development, when the project converts into a commercial real estate loan. The latter stage should be assessed as commercial real estate lending, in accordance with the provisions of these Guidelines.

**161.** In the assessment of the development phase, Banks should establish that the borrower:

- a. has a plausible business plan, including a rationale for the development and a projection of all costs associated with the development verified by an independent expert;
- b. has access to builders, architects, engineers and contractors for the development of the real estate;
- c. has obtained or is able to obtain in the future all necessary permits and certificates for the development, as the project progresses and before disbursement(s).

**162.** Banks should ensure that the calculation of costs associated with the development include contingencies for cost overruns. Planned contingencies should be included in the credit limit or equity. Banks should assess the level of cash reserves and liquidity profile of the borrower to ensure that the borrower has the capacity to fund unplanned contingencies for cost overruns and delays, if any, above the contingency sum.

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

**164.** Banks should carry out on-site visits, where relevant accompanied by a suitably qualified person, to verify the main components of the site, including access and site specificities, and retain a summary of the site visit in the file on the borrower

**165.** In addition to assessing the creditworthiness of the borrower, Banks, when relevant (e.g. in cases of margin calls), should assess equity investors in the project, focusing on assessing their financial position, relevant expertise and experiences in similar projects, as well as the alignment of interests between the equity investors and the Banks offering lending to the same project.

### **3.2.9 Leveraged transactions**

**166.** When assessing the creditworthiness of the borrowers in cases of leveraged transactions, in addition to the general provisions on the creditworthiness assessment set out in Section 3.2.5 and Section 3.2.6, Banks should identify excessive leverage at origination, defined as a ratio of total debt to EBITDA. Transactions with excessive leverage should remain exceptional, should be in line with a bank's risk appetite and form part of the credit delegation and risk management escalation framework of a bank.

**167.** Banks should conduct a comprehensive assessment of a borrower's capacity to repay or deleverage to sustainable levels of debt within a reasonable period of time.

### **3.2.10 Shipping Finance**

**168.** When assessing the creditworthiness of borrowers in the case of shipping finance, in addition to the general provisions on the creditworthiness assessment set out in Section 3.2.5 and Section 3.2.6 of these Guidelines, banks should apply the specific criteria set out in this section. In particular, Banks should assess the following:

- a. the vessel's earnings to costs (operation expenses, including insurance, wages, maintenance, lubricants and interest cost) ratio;
- b. the ratio of the vessel's current age to its expected useful life;
- c. to the extent possible, characteristics of the borrower's fleet in relation to the global fleet population (the size of the new build activity, the number of vessels laid up, the number of vessels scrapped for each segment and the age of the vessels will determine over-tonnage and influence freight rates);
- d. to the extent possible, vessel valuations with or without haircut (if those are included as a repayment source), to reflect selling costs, the time value of money and uncertainties regarding the liquidity and marketability of the asset, unless single valuations are not possible if vessels are operated as part of a larger fleet with widely different types of earnings.

**169.** Banks should also consider other factors, such as the supply and demand in the market for the type of vessel in question, present and future trade patterns for the type of vessel in question, the necessity for the loan to be non-recourse or have guarantees, or have a long-term charter with an acceptable end user, and if the ship owner can provide other securities, such as assignments of charters and insurances, charges of shares and cash collateral or mortgages of other assets, such as real property and sister vessels.

**170.** In the case of loans to shipbuilding, Banks should establish that the borrower;

- a. has a plausible business plan, including a rationale for the development and a projection of all associated costs verified by an independent expert;
- b. has access to builders, marine architects, engineers and shipbuilding contractors;
- c. has obtained or is able to obtain in the future all necessary permits and certificates for the development, as the project progresses.

### **3.2.11 Project finance**

**171.** When assessing the creditworthiness of the borrowers in cases of project finance, in addition to the general provisions on the creditworthiness assessment set out in Section 3.2.5 and Section 3.2.6 of these Guidelines, Banks should follow the specific criteria of this section.

**172.** Banks should assess the primary source of repayment of the loan, which is the income generated by the assets (project) being financed. **Banks should assess the cash flow associated with the project, including future income-producing capacity once the project is completed, taking into account any applicable regulatory or legal restriction (e.g. price regulation, rate-of-return regulation, revenues being subject to take-or-pay contracts, environmental legislation and regulations affecting the profitability of a project).**

**173.** As far as possible, Banks should ensure that all the assets of the project and the present and future cash flow and accounts are pledged to the bank providing the lending or to the agent/underwriter in the case of a syndicated transaction/club deal. If a special purpose vehicle is established for the project, the shares in that special purpose vehicle should be pledged to the bank, to enable the bank/agent to take possession of the company if needed. In cases of syndicated transactions/club deals, inter-creditor agreements should regulate each creditor's access to pledged funds and assets

**174.** In the assessment of the development phase of the project, banks should establish that the borrower;

- a. has a plausible business plan, including a rationale for the development and a projection of all costs associated with the development verified by an independent expert;
- b. has access to builders, architects, engineers and contractors for the project;
- c. has obtained or is able to obtain in the future all necessary permits and certificates for the development, as the project progresses

**175.** Banks should ensure that the calculation of costs associated with the development, as provided by the borrower, includes contingencies for cost overruns. Such planned contingencies should be included in the credit limit or equity. Banks should assess the level of cash reserves and liquidity profile of the borrower or equity investors to ensure that they have the capacity to fund unplanned contingencies for cost overruns and delays, if any, above the contingency sum

**176.** In addition to assessing the creditworthiness of the borrower, banks should assess equity investors in the project, focusing when relevant on assessing their financial position, relevant expertise, experiences in similar projects, ability and willingness to support the project over the project's lifetime.

### **3.3 Credit decision and loan agreement**

**177.** In order to carry out a reliable and accurate creditworthiness assessment, banks should design relevant documentation regarding credit decisions and loan agreements in a way that helps identify and prevent a misrepresentation of the information by the borrower, credit intermediary or staff members of the bank that is involved with the assessment of the application.

**178.** The creditworthiness assessment performed in accordance with Section 3.2 of these Guidelines should be properly documented and used as the basis of the proposal to approve or decline the loan application by the relevant credit decision-maker. The documented outcomes of the creditworthiness assessment itself should be able to justify the proposal to approve or decline the loan application.

**179.** The decision to approve or decline the loan application (credit decision) should be taken by the relevant credit decision-maker, in accordance with the policies and procedures and governance arrangements set out in Section 2.3 of these Guidelines.

**180.** The credit decision should be clear and well documented and include all the conditions and pre-conditions, including those to mitigate the risks identified in the creditworthiness assessment (such as risks associated with ESG factors), for the loan agreement and disbursement. Systems and processes must be created to ensure that the views of the authorities involved in the credit decision process regarding the credit decision are recorded and are efficiently monitored as necessary.

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

**182.** Banks should sign loan agreement as an extension of the credit decision. The disbursement should take place only after the conclusion of the credit agreement, excluding exceptional cases for which a general framework is established.

## **SECTION FOUR**

### **Pricing**

**183.** Pricing frameworks should reflect banks' credit risk appetite and business strategies, including profitability and risk perspective. Loan pricing should also be linked to the characteristics of the loan product and consider competition and prevailing market conditions. Banks should also define their approach to pricing by borrower type and credit quality, and riskiness of the borrower (in the case of individual pricing) when appropriate. Banks should ensure that the pricing framework is well documented and supported by appropriate governance structures, such as a pricing committee, that are responsible for the maintenance of the overall pricing framework and for individual pricing decisions when relevant

**184.** Banks should consider differentiating between their pricing frameworks, depending on the types of loans and borrowers. For consumers and micro and small enterprises, the pricing should be more portfolio and product based, whereas for medium-sized and large enterprises the pricing should be more transaction and loan specific.

**185.** Banks should set out specific approaches to pricing promotional (low-interest) loans, when risk-based and performance considerations specified in this section do not fully apply.

**186.** Banks should consider, and reflect in loan pricing, all relevant costs until the next repricing date or maturity, including:

- a. the cost of capital (considering both regulatory and economic capital), which should result from the capital allocation in place, according to the established breakdowns (e.g. geography, business line and product);
- b. the cost of funding, which should match the key features of the loan (e.g. the expected duration of the loan, taking into account not only contractual terms but also behavioral assumptions, e.g. pre-payment risk);
- c. operating and administrative costs, which should result from cost allocation;
- d. credit risk costs calculated for different homogeneous risk groups, taking into account historical experience of recognizing credit risk losses and when relevant using expected loss models;
- e. any other real costs associated with the loan in question, including tax considerations, when relevant;
- f. competition and prevailing market conditions, in particular lending segments and for particular loan products.

**187.** For the purposes of pricing and measuring profitability, including cross-subsidization between loans or business units/lines, Banks should consider and account for risk-adjusted performance measures in a manner that is proportionate to the size, nature and complexity of the loan and the risk profile of the borrower. Such performance measures could include economic value added (EVA), return on risk-adjusted capital (RORAC) and risk-adjusted return on capital (RAROC), return on risk-weighted assets (RORWA), return on total assets (ROTA) and other measures that are relevant to the characteristics of the loan. Risk-adjusted performance measures may also depend on and reflect Banks' capital-planning strategies and policies.

**188.** Banks should transparently document and review the underlying cost allocation framework. Banks should establish a fair distribution of costs within the organization in order to ensure that business lines, and as far as possible individual loans, reflect the correct expected return corresponding to the risk assumed.

**189.** Banks should implement *ex ante* transaction tools and regular *ex post* monitoring, linking together transaction risk, pricing and expected overall profitability at an appropriate level, including business lines and product lines. All material transactions below costs should be reported and properly justified, in line with the policies and procedures established by the bank. The monitoring process should provide an input for the review of the adequacy of overall pricing from a business and risk perspective. If needed, Banks should take actions in order to ensure compliance with targets and risk appetite

## **SECTION FIVE**

### **Valuation of Collateral**

## **5.1. Valuation at the point of origination**

**190.** When a credit facility is secured by an immovable or movable property collateral, banks should ensure that the valuation of the collateral is carried out accurately at the point of origination. Collateral valuation process must be completed before loan disbursement. Banks should set out internal policies and procedures for valuation of collateral. These policies and procedures should specify the valuation approaches to be used by a valuer and the use of advanced statistical models for each type of collateral. Banks should ensure that these approaches are prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements, and are in line with the credit risk policies and procedures and conditions set out in Section 4.4 of these Guidelines.

**191.** Banks should ensure that the property collateral is valued in accordance with the Regulation on the Procurement of Valuation Services by Banks and the Authorization and Operations of Firms to Provide Valuation Services to Banks, published in the Official Gazette no. 29946 dated January 12, 2017, as well as applicable international national standards.

**192.** When applicable, Banks should take into account ESG factors affecting the value of the collateral (for example the energy efficiency of buildings).

### **5.1.1. Immovable property collateral**

**193.** At the point of origination, Banks should ensure that the value of all immovable property collateral for loans to consumers and micro, small, medium-sized and large enterprises is assessed by an internal or external valuer using full visit with internal and external assessment of the property. Collateral valuation process must be completed before loan disbursement.

**194.** Where the development level of immovable property markets is appropriate, the valuation of residential real estate by valuers can be supported through advanced statistical models. The valuer remains responsible for the valuation process and its result, while the advanced statistical models should be used as supporting tools, meeting the conditions set out in Section 5.4, and including a confidence measure to indicate the robustness of the value proposal and other relevant property-specific information. In this case, the value proposal should be assessed, reviewed and approved by the internal or external valuer, who should understand all inputs and assumptions considered in the model. If the confidence measure in the supporting advanced statistical model indicates low robustness, and/or other property-specific information gives rise to uncertainty about the value proposal, the valuer should choose a valuation method other than desktop valuation.

**195.** The external valuation service received by banks for the valuation activities should comply with the Regulation on the Procurement of Valuation Services by Banks and the Authorization and Operations of Firms to Provide Valuation Services to Banks and the valuation firms providing this service should have expertise in the related segments of the real estate sector.

**196.** Banks should ensure that the valuers provide an impartial, clear, transparent and objective valuation, and each valuation should have a final report providing the necessary information on the valuation process and property. The valuation report should clearly state who ordered the valuation and that the valuation has been requested for the purposes of loan application, renewal or contractual adjustments, or in the case of structural changes.

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

- a. the reference value of the collateral;
- b. the approaches, methodology and key parameters and assumptions that have been used to assess the value;
- c. a description of the collateral, including its current use or multiple uses if applicable, and the property type and quality, including age and state of preservation;
- d. a description of the location of the collateral, the local market conditions and the liquidity;
- e. the legal and actual attributes of the collateral;
- f. any known circumstances that may affect the value in the short term, affecting the degree of certainty or uncertainty.

**198.** Banks should critically review the valuation they receive, from the valuer, in particular focusing on aspects such as comprehensibility (whether the approaches and assumptions are clear and transparent), the prudence of assumptions (e.g. as regards cash flow and discount rates), and the clear and reasonable identification of comparable properties used as a value benchmark..

### **5.1.2. Immovable property collateral**

**199.** At the point of origination, Banks should ensure that the value of all movable property collateral is assessed through an appropriate and prudent approach that is proportionate to the nature, type and complexity of the collateral, by an internal or external valuer, advanced statistical models or other standard methods meeting the conditions set out in Section 5.4 of these Guidelines (such as indexation), taking into account the fair value as referred to in the second paragraph of Article 63 of the Communiqué on the Credit Risk Mitigation Techniques.

**200.** When applicable, banks should set out, in their policies and procedures, approaches for the purposes of this valuation, and specify internal thresholds and limits that require an individual valuation of movable property collateral at the point of origination to be performed by a valuer.

**201.** When banks use external valuers, they should establish a panel of accepted external valuers, covering specific property that is being used as collateral, that is relevant to the lending activities of the bank as well as the location of these activities. This panel of experts should be used for the valuation of large and complex movable property collateral, such as vessels, aircraft and plant machinery.

**202.** For movable property collateral that is subject to an individual valuation by a valuer, banks should ensure that they have obtained a clear and transparent valuation report documenting all elements and parameters that determine the value of collateral, as outlined in paragraph 197.

**203.** For movable property subject to a valuation by statistical models, banks should ensure that they have obtained a clear and transparent model outcome, specifying the value of the collateral. Banks should understand the methodologies, key parameters, assumptions and limitations of

the models used

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

## **5.2. Monitoring and revaluation**

### **5.2.1. Immovable property collateral**

**205.** When monitoring property values as laid down in the second subparagraph of the first paragraph of Article 21 of Communiqué on the Credit Risk Mitigation Techniques, banks should, for the purposes of these guidelines, also set up policies and procedures specifying the approach and the frequency of monitoring of immovable property collateral. These policies and procedures should account, when relevant, for the following elements:

- a. the type of property;
- b. the credit quality of the loan secured by property;
- c. the development status of the property;
- d. the value of the property;
- e. assumptions made in the appraisal;
- f. changes in market conditions.

**206.** Banks should set out appropriate frequencies for monitoring the value of the collateral, considering the type and value of the collateral at origination, and, in relation to the credit agreement, consider the following:

- a. the frequency of monitoring of properties and parts in development (e.g. unfinished buildings) should be higher than that of similar finished properties and parts;
- b. the frequency of monitoring of properties and parts with a high carrying amount or with a high LTV ratio should be higher than that of similar properties and parts with a low carrying amount or with a low LTV ratio;
- c. the frequency of monitoring of loans secured by immovable property or parts of the property with lower credit quality should be higher than that of similar loans secured by immovable property or parts of the property with higher credit quality

**207.** Banks should ensure that any indices and statistical models used to monitor the value of the collateral are sufficiently granular and that the methodology is appropriate for the type of asset and lending product and based on a sufficient time series of observed empirical evidence of previous transactions and appraisals of the collateral or similar collateral

**208.** Banks should have policies and procedures for the revaluation of immovable property collateral, specifying the approaches to revaluation (e.g. desktop valuation, drive-by valuation, full visit with internal and external assessment of the property, statistical models) for different types of immovable property collateral, ensuring that the approach or combination of approaches is prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements. Furthermore, banks should set out specific triggers (e.g. a change in the assumptions made in the appraisals), indicating when monitoring leads to

reevaluation or collateral needs reevaluation

**209.** When the conditions for a review in accordance with the second subparagraph of the first paragraph of Article 21 of Communiqué on the Credit Risk Mitigation Techniques are met, banks should update the value of the immovable property collateral by means of a reevaluation carried out by a valuer who is potentially supported by appropriate advanced statistical models that meet the conditions set out in Section 5.4 of these Guidelines and account for individual characteristics of the property and geographical area. Banks should not use these models as the sole means of the reevaluation.

**210.** When the conditions for a review in accordance with the second subparagraph of the first paragraph of Article 21 of Communiqué on the Credit Risk Mitigation Techniques are not met, banks may update the value of the immovable property collateral by means of either a reevaluation carried out by a valuer or appropriate statistical models that meet the conditions set out in Section 5.4 and account for the individual characteristics of the property and geographical area.

### **5.2.2. Movable property collateral**

**211.** For the monitoring of movable property collateral, banks may rely on appropriate statistical models and indices. For the reevaluation of movable property collateral, banks may rely on assessment by valuers, statistical models and indices.

**212.** Banks should, in their policies and procedures, set out approaches to using a valuer or statistical models, define the approach (e.g. desktop valuation, drive-by valuation, internal and external assessment of the property) that is most suitable for the specific type of collateral for the reevaluations done by the valuers, and set out the frequency of monitoring and reevaluation of movable property collateral.

**213.** Banks' policies and procedures should include, when applicable, criteria for individual monitoring of the value and reevaluation of the movable property collateral by a valuer who possesses the necessary qualifications, ability and experience. Proportionate to the type, nature and complexity of the movable property collateral, such as aircraft, shipping, physical plant and machinery, these criteria should be related, at least, to the value of the movable property collateral during the origination phase, the lifespan, the condition of tangible assets, such as depreciation and maintenance, the necessity of physical inspection and certification.

**214.** Banks should have adequate IT processes, systems, capabilities and sufficient data for the purposes of any statistical model-based or index-based reevaluation.

### **5.3. Criteria for valuers**

**215.** Banks should ensure that a valuer carrying out the valuation or reevaluation tasks, in addition to the provisions laid down in the Regulation on the Procurement of Valuation Services by Banks and the Authorization and Operations of Firms to Provide Valuation Services to Banks,

- a. is professionally competent and meets any national or international requirements and accepted professional standards that apply to the valuer or for carrying out a particular valuation assignment;

- b. has the appropriate technical skills and experience to perform the assignment;
- c. has the necessary knowledge, i.e. knowledge of the subject of the valuation, the relevant property market and the purpose of the valuation;
- d. is independent from the credit decision process.

**216.** Banks should ensure that the fee or the salary of the valuer and the result of the valuation are not linked in a way that creates a conflict of interest.

**217.** Banks should assess the performance of the valuers, in particular the accuracy of the valuations provided (e.g. by back-testing on the value of the collateral through advanced statistical models). As part of such assessments, banks should also look at the concentration of valuations performed by and fees paid to specific valuers.

**218.** In order to mitigate any conflict of interest to the extent possible, banks should ensure that valuers who are going to carry out the actual appraisal of a given property and their first-degree relatives meet all of the following conditions:

- a. they are not involved in the loan application, assessment, decision or administration;
- b. they are not guided or influenced by the borrower's creditworthiness;
- c. they do not have an actual or potential conflict of interest regarding the property in question,;
- d. they do not have any direct or indirect interest in the property in question;
- e. they are not related to either the buyer or the seller of the property in question.

**219.** Banks should ensure an adequate rotation of valuers and define the number of sequential individual valuations of the same property that can be performed by the same valuer. Any further revaluations beyond this number should result in the rotation of the valuer, resulting in the appointment of either a different internal valuer or a different external valuer.

#### **5.4. Criteria for advanced statistical models for valuation**

**220.** Banks should set out, in their policies and procedures, the criteria for using advanced statistical models for the purposes of valuation, revaluation and monitoring the values of collateral. These policies and procedures should account for such models' proven track record, property-specific variables considered, the use of minimum available and accurate information, and models' uncertainty.

**221.** Banks should ensure that the advanced statistical models used are;

- a. property and location specific at a sufficient level of granularity (e.g. postcode for immovable property collateral);
- b. valid and accurate, and subject to robust and regular back-testing against the actual observed transaction prices;
- c. based on a sufficiently large and representative sample, based on observed transaction prices;

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

**222.** When using these advanced statistical models, banks are ultimately responsible for the appropriateness and performance of the models, and the valuer remains responsible for the valuation that is made using an advanced statistical model. Banks should understand their methodology, input data and assumptions of the models used. Banks should ensure that the documentation of models is up to date

**223.** Banks should have adequate IT processes, systems and capabilities in place and sufficient and accurate data for the purposes of any statistical model-based valuation or revaluation of collateral.

## **SECTION SIX**

### **Monitoring System**

#### **6.1 General provisions for the credit risk monitoring system**

**224.** Banks should have a robust and effective monitoring framework, supported by an adequate data infrastructure, to ensure that information regarding their credit risk exposures, borrowers and collateral is relevant and up to date, and that the external reporting is reliable, complete, up to date and timely.

**225.** The monitoring framework should enable banks to manage and monitor their credit risk exposures in line with their credit risk appetite, strategy, policies and procedures at portfolio and, when relevant and material, individual exposure levels

**226.** Banks should ensure that the credit risk monitoring framework is well defined and documented, is integrated into the Banks' risk management and control frameworks, and allows all credit exposures to be followed throughout their life cycle

**227.** Banks should consider, in the design and implementation of their credit risk monitoring framework, that;

- a. the system and data infrastructure provide the capability to gather and automatically compile data regarding credit risk without undue delay and with least possible reliance on manual processes;
- b. the system and data infrastructure are compatible with the own risk management system of the bank, allowing the generation of sufficiently granulated risk data that satisfy the Agency's requirements for macro-prudential and statistical reporting, stress tests and crisis management, with flexibility to provide additional information that may be requested as necessary;
- c. the system and data infrastructure ensure effective monitoring of all credit exposures and collateral, and allow the credit decision-making process to be followed;
- d. the system and data infrastructure ensure that banks maintain an appropriate time series of reporting for current exposures, new types of lending and early warning indicators (EWIs) over their credit risk planning horizon

**228.** The monitoring process should be based on a principle of follow-up action to support and

result in a regular and informed feedback loop, to inform the setting/review of credit risk appetite, policies and limits.

**229.** The credit risk monitoring framework should cover the following:

- a. the payment behavior of borrowers, including any deviations from the requirements of credit agreements, including late, missed or partial payments, as well as credit term extensions;
- b. credit risk associated with both the borrower and the transaction in relation to:
  - i. individual credit exposures and loss given default, when applicable;
  - ii. individual borrowers, including their exposure value, probability of default (PD) and credit rating, when applicable;
  - iii. risk group;
  - iv. portfolio;
- c. credit risk per geographical location and economic sector of ultimate exposure, when applicable;
- d. impairments, reversals of impairments, write-offs and other decisions regarding value adjustments for a credit exposure

**230.** The monitoring system and data infrastructure should allow banks to follow the credit decision-making process, including the monitoring and reporting of all credit decisions, exceptions from the credit policies, and escalations to the higher levels of credit decision-makers. To this end, within the monitoring framework, banks should ensure the implementation and application of relevant key risk indicators that are asset type or portfolio level specific, to determine the ongoing evolving credit risk profile of the portfolios and bank.

**231.** Banks should ensure that the credit risk monitoring framework and data infrastructure also enable a single customer view.

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

**233.** When monitoring credit risk, banks should have appropriate methodologies and practices, allowing the aggregation of credit risk exposures in business lines, portfolios, sub-portfolios, products, industries and geographical segments, and support the identification of credit risk concentrations. Banks should ensure that credit risk data and data infrastructure meet the following requirements:

- a. depth and breadth so that they cover all the significant risk factors — this should allow, inter alia, exposures to be grouped together in terms of shared credit risk characteristics, such as the sector to which the borrower belongs, the purpose of the transaction and the geographical location of the borrower/collateral, so as to enable an aggregate analysis

that allows the identification of the entity's exposure to these significant risk factors

- b. accuracy, integrity, reliability and timeliness of data;
- c. consistency, i.e. being based on common sources of information and uniform definitions of the concepts used for credit risk management and, when possible, accounting
- d. traceability, so that the source of the information can be identified.

**234.** Banks should ensure that operational metrics relating to credit risk governance are appropriate for their credit profile and applied proportionately.

## **6.2. Monitoring of credit exposures and borrowers**

**235.** As part of the monitoring of credit exposures and borrowers, banks should monitor all outstanding amounts and limits, and whether the borrower is meeting repayment obligations, as laid down in the credit agreement, and is in line with the conditions set at the point of credit granting, such as adherence to credit metrics and covenants.

**236.** Banks should also monitor whether the borrower and collateral are in line with the credit risk policies and conditions set at the point of credit granting. For example, whether the value of collateral and other credit enhancement techniques are maintained, whether any applicable covenants are maintained, and whether there has been a negative development in these factors or in other factors that affect the risk profile of the borrower and/or credit facilities.

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

**238.** The ongoing monitoring should be based on internal information regarding the credit facilities and borrowers' payment practices, as well as the use of external sources (e.g. Credit Registry Bureau data, information obtained directly from the borrower), when relevant.

**239.** In addition, banks should also monitor concentration measures against the values specified in their credit risk appetite, policies and procedures, including, where relevant, by product, geography, industry, collateral features (type, location), and quality of portfolios, sub-portfolios and exposures.

**240.** Banks engaged in syndicating leveraged transactions should implement internal standards and monitoring functions for these activities. Banks should identify transactions subject to failed syndications — that is, transaction that were not syndicated within 90 days following the commitment date. Banks should establish a dedicated framework to deal with these 'hung transactions' in terms of holding strategy, booking and accounting practices, regulatory classification and subsequent capital requirements calculation.

## **6.3 Regular credit review of borrowers**

**241.** Banks should also perform regular credit reviews of borrowers that are at least medium-sized or large enterprises, with a view to identifying any changes in their risk profile, financial position or creditworthiness compared with the criteria and the assessment at the point of loan origination, as well as reviewing and updating any relevant internal credit rating/scoring.

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

**243.** To this end, Banks should also, if appropriate, periodically update relevant financial information on the borrower and assess the new information against the creditworthiness assessment criteria established in accordance with Section 2.3 (credit risk policies and procedures) of these Guidelines. The collection and assessment of this information should support the bank in recognising the early warning signs of declining credit quality.

**244.** Banks should carry out periodic reviews for the purposes of the assessment of the borrower's risk of default and the potential need for the migration between risk categories and grades.

**245.** Borrowers' credit reviews should include an assessment of existing debt and borrowers' sensitivity to external factors, such as foreign exchange rate volatility, if relevant, that may affect the size of debt and repayment capacity, also in line with the sensitivity analysis requirements, as specified in Section 3.2.6 of these Guidelines.

**246.** Banks should assess risks associated with the refinancing of existing debt, monitoring loans with bullet repayment (repayment of the whole debt all at once) terms separately from other loans on a regular basis. They should analyse potential effects on a borrower's inability to roll over/refinance existing debt, and include inter alia a forward-looking macroeconomic outlook and access to capital markets as well as other types of debt structures. Banks should closely monitor the borrowers' ability to repay or refinance their debts throughout a loan's lifecycle regularly (e.g. through annual reviews) and not just when the borrower is approaching the end of a loan's term.

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

**248.** If applicable, banks should also review guarantors under the credit facility agreement regularly. In addition to the assessment of the guarantor's continued creditworthiness, an analysis of effectiveness of a guarantee should also take into account whether it remains to be legally binding, whether it remains enforceable and the time needed to realise the guarantee when payment conditions occur.

**249.** In addition to monitoring credit and financial metrics, banks should take into account information related to qualitative factors that could have a relevant influence on the repayment of a loan. These factors could include information on the quality of management, agreements/disagreements among shareholders, a shareholder's commitment to the borrower, forecast market growth, a company's pricing power, a cost structure and flexibility of costs, the trend, size and nature of capital expenditure and research and development expenditure, and the allocation between debt holders and servicers within the consolidated group of banks.

## **6.4 Monitoring of covenants**

**250.** Where relevant and applicable to specific credit agreements, banks should monitor and follow up on the requirements of collateral insurance, in accordance with the credit agreements or requirements of credit facilities.

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

**252.** Banks should also monitor non-financial covenants not only by collecting the covenant certificate, where applicable, but also by other means, e.g. through close contact with the borrower by the client executive.

## **6.5 Use of early warning indicators/watch lists in credit monitoring**

**253.** As part of their monitoring framework, banks should develop, maintain and regularly evaluate relevant quantitative and qualitative EWIs that are supported by an appropriate IT and data infrastructure that would allow the timely detection of increased credit risk in their aggregate portfolio as well as in portfolios, sub-portfolios, industries, geographies and individual exposures.

**254.** The EWIs should have defined trigger levels set with regard to the levels specified in credit risk appetite, strategy and credit risk policies, and have assigned escalation procedures, including assigned responsibilities for the follow-up actions. These escalation procedures should also include choosing exposures or borrowers for special monitoring, i.e. a watch list.

**255.** The EWI system should contain a description of the relevance of the indicators in relation to the characteristics of transactions and borrower types, or for homogeneous groups of portfolios, when appropriate.

**256.** On identifying a triggered EWI event at the level of an individual exposure, portfolio, sub-portfolio or borrower group, Banks should apply more frequent monitoring and, when necessary, consider placing them on a watch list and undertaking predefined measures and mitigation actions. Monitoring this watch list should lead to specific reports being regularly reviewed by the head of the risk management function, the heads of functions involved in credit granting and the management body.

**257.** When the actions include interaction with the borrower, Banks should have regard to their individual circumstances. The level of contact and communication with the borrower during payment difficulties should be commensurate to the information requirements.

**258.** As part of their ongoing monitoring of credit risk, banks should consider the following credit quality deterioration signals:

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

of individuals;

- b. known adverse changes in the financial position of borrowers, such as a significant increase in debt levels or significant increases in debt service ratios;
- c. a significant drop in turnover or, in general, in recurring cash flow (including the loss of a major contract/client/tenant);
- d. significant narrowing of operating margins or income;
- e. a significant deviation in actual earnings from the forecast or a significant delay in the business plan of a project or an investment;
- f. changes in the credit risk of a transaction that would cause the terms and conditions to be significantly different if the transaction were newly originated or issued at the reporting date (such as increased amounts of required collateral or guarantees, or a higher recurring income coverage of the borrower);
- g. an actual or expected significant decrease in the main transaction's external credit rating, or in other external market indicators of credit risk for a particular transaction or similar transaction with the same expected life;
- h. changes in the conditions of access to markets, a worsening in financing conditions or known reductions in financial support provided by third parties to the borrower;
- i. a slowdown in the business or adverse tendencies in the operations of the borrower that may cause a significant change in the borrower's ability to meet its debt obligations;
- j. a significant increase in economic or market volatility that may have a negative impact on the borrower;
- k. for transactions secured with collateral, a significant worsening of the ratio of their amount to the value of the collateral due to unfavorable developments in the value of the collateral, or no change or an increase in the outstanding amount due to the payment terms established (such as extended principal payment grace periods, rising or flexible instalments, extended terms);
- l. a significant increase in credit risk on other transactions of the same borrower or significant changes in the expected payment behavior of the borrower, when known;
- m. a significant increase in credit risk due to an increase in the difficulties of the group to which the borrower belongs, such as residents of a specific geographical area, or significant unfavorable developments in the performance of the borrower's sector of economic activity or increased difficulties in the group of related borrowers to which the borrower belongs
- n. known legal action that may significantly affect the borrower's financial position;
- o. the late delivery of a certificate of adherence, a waiver request or a breach with respect to the covenants, at least regarding the financial covenants, if applicable;
- p. negative bank-internal credit grade/risk class migrations in the aggregate credit portfolio or in specific portfolios/segments;
- q. an actual or expected internal credit rating/risk classification downgrade for the transaction or borrower or a decrease in behavioral scoring used to assess credit risk

- internally;
- r. concerns raised in the reports by the external auditors of the bank or borrower;
- s. one or more borrower-related facilities 30 days past due

### **6.5.1 Follow-up and escalation process on triggered EWIs**

**259.** When an EWI has been triggered for closer monitoring and further investigation, immediate action should be taken in accordance with the Bank's policies and procedures, as provided in Section 2.3 of these guidelines. The designated functions should perform an analysis in order to assess the severity of the triggered event and to propose suitable action and follow-up. This analysis should, without undue delay, be presented to the relevant credit decision-makers designated in the policy and procedures.

**260.** Relevant credit decision-makers should, based on the abovementioned analysis and other relevant accessible information, decide on the appropriate next steps. The decision should be documented and should be communicated to relevant parts of the bank for action and follow-up.

**261.** Triggering EWIs should lead to an increased frequency in the reviewing process, including discussions and decisions by credit decision-makers, and more intense information gathering from the borrower. The information gathered should be sufficient to support more frequent credit reviews of the borrowers.

## **Annex 1 – Credit granting criteria**

This annex provides a set of criteria to be considered in the design and documentation of credit-granting criteria, in accordance with these Guidelines.

### **Lending to consumers**

1. Customer acceptance criteria, i.e. customer types, customer age limits, customer credit record
2. Definition of acceptable income
3. Minimum requirements for collateral
4. Minimum requirements for guarantees
5. Maximum loan amounts
6. Maximum loan maturities
7. Amortization requirements (including interest rate type for the loans)
8. Risk-based limits (concentration, type of product, etc.)
9. Acceptable loan-to-value ratio limits (for secured lending)
10. Acceptable loan-to-income ratio limits
11. Acceptable debt-to-income ratio limits
12. Acceptable income-to-total-credit-obligation ratio limits (including for gross income, income after taxes and premiums, income after financial expenses, income after regular other expenses)
13. Acceptable maximum size of loan to repayment capacity
14. Compliance policy with macroprudential requirements, when relevant

### **Commercial lending**

1. Specification of geographical markets and economic sectors
2. Customer acceptance criteria, i.e. for specific PDs, external ratings, customer types, track record, etc.
3. Minimum requirements for revenues, cash flow and financial projections
4. Minimum requirements for collateral
5. Minimum requirements for guarantees and credit enhancements
6. Minimum requirements for acceptable covenants
7. Requirements for the drawdown of the loan to the borrower
8. Maximum loan amounts

9. Appropriate limits on partial recourse or non-recourse loans
10. Maximum loan maturities
11. Amortization schedules and standards for the acceptability of and limits on non-amortizing loans (where only interest is paid during installment periods, with principal paid all at once) and on the use of interest reserves and cash sweep structures
12. Risk-based limits (towards concentration, type of product, etc.)
13. Acceptable loan-to-value ratio limits (for secured lending)
14. Acceptable debt-servicing coverage ratio limits
15. Acceptable interest coverage ratio limits
16. Acceptable EBITDA limits
17. Acceptable leverage ratio limits
18. Acceptable debt-to-equity ratio limits
19. Acceptable loan-to-cost ratio limits
20. Acceptable cash-flow-to-debt-service ratio limits
21. Acceptable return on equity ratio limits
22. Acceptable capitalization rate (net operating income/market value) limits
23. Standards to address and mitigate risks associated with environmental risk
24. Compliance policy with macroprudential requirements, when relevant

### **Commercial real estate lending**

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

1. Specific forms of commercial real estate that a bank intends to finance (office, retail, industrial and multi-family residential, which is not owned and occupied by households; it can be defined as land, and the building(s) on it, that generates profit or income from capital gains or rents)
2. Levels of equity to be provided by the borrower and the market value of the CRE mortgaged property
3. Risk-based limits for lending for speculative development lending
4. Standards to assess the various stages of the CRE development/construction in relation to the loan drawdown

5. Minimum standards regarding requirements for performance bond<sup>7</sup> and payment bonds<sup>8</sup> and title insurance
6. Minimum standards to ensure a minimum level of oversight of the construction via a contracted presence and an on-site visit of suitable experienced professionals, e.g. architects, quantity surveyors and building site managers
7. Minimum standards to effectively assess the suitability and experience of any contractors or material suppliers
8. Minimum standards for pre-leasing/pre-selling requirements for CRE.

### **Shipping finance**

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

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

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<sup>7</sup> Bond guaranteeing that builders will comply with the contractual terms and conditions and provide performance at specific standards.

<sup>8</sup> Bond guaranteeing that builders will make payments to all workers, material suppliers and sub-contractors under their contractual obligations.

## **Annex 2 - Information and data for the creditworthiness assessment**

This annex provides a set of information, data items and evidence to be considered by Banks and creditors when collecting information for the purposes of creditworthiness assessment, in accordance with these guidelines. When relevant and more appropriate, e.g. when using automated models in credit granting, banks and creditors may use other types/sources of information and data of an economic or financial nature that are necessary for the assessment, in compliance with the applicable legislation.

### **A. Lending to consumers**

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

## **B. Commercial lending**

1. Information on the purpose of the loan
2. Where relevant, evidence of the purpose of the loan
3. Financial statements and accompanying notes on single entity and consolidated levels (balance sheet, profit or loss, cash flow) covering a reasonable period, audited or professionally verified accounts, where applicable
4. Aged debtor reports/statements
5. Business plan both for the borrower and in relation to the purpose of the loan
6. Financial projections (balance sheet, profit or loss, cash flow)
7. Evidence of tax status and tax liabilities
8. Data from Risk Center of Banks Association of Turkey and/or Credit Registry Bureau, covering at least the information on financial liabilities and arrears in payment
9. Information on the borrower's external credit rating, where applicable
10. Information on existing covenants and the borrower's compliance with them, where relevant
11. Information on major litigations involving the borrower at the time of application
12. Information on the collateral, if any
13. Evidence of ownership of the collateral, where applicable
14. Evidence of the value of the collateral
15. Evidence of insurance of the collateral
16. Information on the enforceability of the collateral (in the case of specialized lending, a description of the structure and security package of the transaction)
17. Information on guarantees, other credit risk mitigating factors and guarantors, if any
18. Information on ownership structure of the borrower for the purposes of AML/CFT

## **C. Commercial real estate lending**

In addition to the items specified in Section B above:

1. Information on rent levels, vacancy and tenants, including contracts for the particular property associated with the purpose of the loan
2. Information on the type of property portfolio

3. Evidence of vacancy and turnover rates for the portfolio, per property type, property age and location
4. Evidence of rent levels per property type, property age and location
5. Information on major tenants per property type, property age and location
6. Information on the rationale for the property associated with the loan, supported by a location-specific review of supply and demand in the market by a reputable estate agent with relevant expertise
7. Evidence of the value of the collateral and separate units of the property collateral, where applicable

#### **D. Real estate development lending**

In addition to the items specified in Section B above:

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

#### **E. Shipping finance**

In addition to the items specified in Section B above:

1. Evidence of experience in a similar type of vessel and segment
2. Evidence of ownership of assets with information on the vessels, e.g. name, registration number, type, age and size
3. Information on insurance and classification of assets by a classification society acceptable to the bank

4. Evidence of compliance with safety and environmental regulations governing the shipping industry

5. Information, based on market data, on each type of vessel and segment outlooks, e.g. geographical location of past and planned future trips
6. Evidence of off-balance-sheet obligations, such as chartered in vessels and forward freight agreement positions

**F. Project finance**

In addition to the items specified in Section B above:

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

### **Annex 3 – Metrics for credit granting and monitoring**

This annex provides a set of credit-specific metrics to be considered by banks when performing creditworthiness assessments and credit risk monitoring, in accordance with these Guidelines. Where relevant and more appropriate, banks may use other metrics for that purpose.

#### **A. Lending to consumers**

1. Loan to income
2. Loan service to income
3. Total debt to income
4. Total debt service to income
5. Loan-to-value

#### **B. Commercial lending**

6. Equity ratio (shareholders' equity divided by total assets)
7. (Long-term) debt-to-equity ratio
8. EBITDA
9. Debt yield (net operating income/loan amount)
10. Interest bearing debt/EBITDA
11. Leverage ratio (total debts/EBITDA)
12. Enterprise value (sum of market value of common stock, market value of preferred equity, market value of debt, minority interest, less cash and investments)
13. Capitalization rate (net operating income/market value)
14. Asset quality
15. Total debt service coverage ratio (EBITDA) over total debt service
16. Cash debt coverage ratio (net cash provided by operating activities over the average current liabilities of the company within a certain period of time)
17. Coverage ratio (total current assets divided by total short-term debt)
18. Future cash flow analysis
19. Return on assets
20. Debt service
21. Loan to cost (LTC)
22. Interest coverage ratio

23. Return on equity ratio (net income after interest and tax over average shareholders' equity)
24. Return on capital employed
25. Net profit margin
26. Turnover evolution

**C. Real estate development lending**

27. Fixed-assets-to-equity ratio
28. LTV
29. Location and quality of properties
30. LTC
31. DSCR for CRE activities
32. Occupancy rates evolution

*Profitability*

33. Rental income to CRE-related interest expenses

**D. Leveraged finance, asset-based lending and project finance**

34. § Value of acquisition goodwill
35. Ring-fencing
36. LTV
37. Adherence to business plan
38. Leverage ratio (total debt over EBITDA)
39. Repayment capacity

**E. Shipping finance**

40. Leverage ratio
41. Rating
42. Repayment from operating cash flow
43. Repayment from guarantor
44. Repayment from vessel's sale
45. Outstanding payments