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Opinion of the European Banking Authority on Good Practices for Responsible Mortgage Lending

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Abbreviations

EBA	European Banking Authority
ESRB	European Systemic Risk Board
FSB	Financial Stability Board
LTl	Loan-to-income
LTV	Loan-to-value

Definitions

Appraisal	A comprehensive assessment of the property characteristics, which will include determining an opinion of the value of the collateral. In some countries, the term is used interchangeably with the related term “valuation”.
Balloon payment	The remaining amount of principal that becomes due and payable on the final instalment payment for a loan that is not fully amortised.
Down payment	Up-front payment from the buyer for a portion of the purchase price, which reduces the balance of the loan against the property.
Equity	Difference between the appraised value of the property and the total claims held against the property.
Lending threshold	Any metric (specified by the creditor or the competent authority) used as a means of limiting the available credit. For example, loan-to-value, loan-to-income, debt-to-income etc.
Loan-to-income	Annual or monthly mortgage loan servicing requirements as a percentage of annual or monthly income that is available to repay the loan.
Loan-to-value	The ratio of the amount of the loan outstanding to the appraised value of the residential property.
Variable rate mortgage	A loan in which the interest rate rises and falls possibly based on the movement on an underlying index. The term variable rate mortgage is used interchangeably with adjustable rate mortgage.

Introduction and legal basis

1. Mortgage credit is a key element to allowing consumers to buy and retain their own home. However, mortgage credit can also give rise to risks for consumers, which need to be mitigated by consumers making responsible borrowing choices; by credit institutions taking responsible lending decisions; and by competent authorities protecting consumers from poor lending practices.
2. To ensure that potential risks associated with mortgage lending are managed adequately by credit institutions, and to contribute to the development of consistent practices in this area, it is desirable for the European Banking Authority (EBA) to adopt an Opinion on good practices for responsible mortgage lending (Opinion). The Opinion complements the provisions on responsible lending expected to be set out in the pending Directive on Credit Agreements Relating to Residential Property (also known as the Mortgage Credit Directive) and provides suggestions on how to give effect to these provisions.
3. The Opinion is addressed to competent authorities, as defined in Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions; covers supervisory and market practices; and is non-binding.
4. The EBA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.¹
5. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted the Opinion as set out in the pages overleaf.² This Opinion will be published on the EBA's website.

¹ OJ L331, 15.12.2010, p. 12.

² OJ L 177, 30.6.2006, p. 1.

Background

1. Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential property. Although the terminology and precise forms will differ among countries, the basic components tend to be similar and include: a property as the physical residence being financed; a creditor as the institution providing a loan; a mortgage as the security interest of the creditor in the property; a borrower as the person creating an ownership interest in the property; the principal as the original size of the loan that will go down as it is being repaid; and foreclosure or repossession as the possibility for the creditor to seize the property under certain circumstances.
2. A mortgage is likely to be the single greatest financial commitment the majority of consumers will enter into in their lifetimes.
3. However, mortgage credit can also give rise to risks, which can have various origins and can materialise to the detriment of borrowers, as well as to creditors and to the stability of the system more generally.
4. The previously accepted view amongst many regulators was that the prudential self-interest of credit institutions could be relied on. This was believed to ensure that any loan that was granted was also sustainable and affordable, to the benefit of consumers, creditors and the financial system. The financial crisis has prompted analysts to revisit this approach, cast the net more widely, and assess more comprehensively the origins of risks, the ways in which the risks can materialise, as well as the causal linkages between them, including:
 - a) how creditors' retail conduct might give rise to consumer detriment and pose a risk to consumer protection, for example as a result of misleading product disclosure, non-transparent pricing and product characteristics, and/or unsuitable advice;
 - b) how creditors' retail conduct might pose a risk also to creditors and to financial stability, for example as a result of imprudent lending standards which might lead to an expansion of creditors' balance sheets in the short term, but may fuel an 'asset bubble' in residential properties in the long run that could, if burst, have a substantial impact on creditors' viability as going concerns and financial stability more widely (unless costs are externalised and the system is supported through taxpayer and/or central bank support);
 - c) how creditors' prudential conduct might give rise to consumer detriment and pose a risk to consumer protection, for example as a result of the reliance on wholesale funding and mortgage backed securitisations, which allow underwriting creditors to move credit risks off their balance sheets, thus reducing their incentive to assess the affordability of loans for consumers; and finally

- d) how creditors' prudential conduct might pose a risk to creditors and to financial stability, for example as a result of creditors' inadequate capital and liquidity levels to mitigate against the impact of 'bad loans'.
5. The risks and causal links described in the last of these four items have received the greatest regulatory attention internationally, with the previous prudential requirements set out in the Basel II accord being replaced by the more stringent capital, liquidity and leverage ratio requirements of Basel III. International regulatory responses to the risks that arise from the first three items, however, have been much less prominent.³
 6. Given that EBA's founding regulation⁴ has given the EBA the objectives to contribute to enhancing consumer protection (Articles 8(f) and 9) and to contribute to ensuring the stability, integrity and effectiveness of the financial system (Articles 4, 22, 23, and 24), and that the risks and causal mechanisms described above might undermine the EBA's ability to deliver on these objectives, the EBA has undertaken work to identify good practices for responsible mortgage lending across EU Member States.
 7. Good practices relate to the retail conduct of creditors towards their consumers that, if applied, will enhance consumer protection and will, as such, also contribute to ensuring the effectiveness of the financial system more generally. They are aimed at promoting common practices amongst competent authorities and are addressed to them as an Opinion under Article 29 of the EBA Regulation. Competent authorities are likely to want to consider how the good practices, alongside measures already in place or to be implemented (e.g. EU Directive on Credit Agreements Relating to Residential Property), might support their own national regulatory objectives.
 8. The good practices are based on the Principles for Sound Residential Mortgage Underwriting Practices (Principles) identified by the Financial Stability Board (FSB)⁵. The FSB carried out a peer review of national approaches to mortgage underwriting, which included several major European markets. Following this peer review, the FSB, again with input from European members, developed a set of principles intended to ensure sound underwriting standards, which it published in April 2012. The FSB work acknowledges "the distinct real estate markets, cultural differences and socio-economic policies that shape each jurisdiction's mortgage market". Consequently, the Principles are intentionally high-level rather than aiming to be detailed international standards.
 9. In order to promote the development of consistent supervisory approaches, the wording of the good practices in this Opinion closely follows that of the FSB Principles. As necessary, minor drafting changes have been incorporated to clarify that the identified actions are put forward as 'good practice'. In order to help the reader, cross-references are included to the relevant FSB Principles. Good practices that do not include such a cross-reference stem solely from the EBA survey described in paragraph 10.

³ See, for example, Joint Forum (2010) *Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations*

⁴ See OJ EU (2010), *Regulation (EU) No 1093/2010 of the European Parliament and of the Council*.

⁵ See FSB (2012), *Principles for Sound Residential Mortgage Underwriting Practices*

10. While the FSB Principles contain strong elements of consumer protection, they were deliberately developed with prudential objectives in mind. By focusing on the retail conduct of the FSB Principles, this Opinion seeks to supplement any prudential measures competent authorities may have already put in place.⁶
11. The evidence for this Opinion is drawn from an EBA survey of national supervisory as well as more general market practices in respect of both responsible lending and the treatment of borrowers in payment difficulties. On responsible lending, this survey collected information from competent authorities on the consistency between national practices and the FSB Principles. Authorities were also asked to identify national approaches to responsible lending that supplemented the FSB Principles, this information being used to identify additional good practices. In respect of the treatment of borrowers in payment difficulties, the EBA survey collected information on the national supervisory and market approaches to key consumer protection outcomes identified by EBA members. The result of this work is published in an Opinion separate to this.
12. The EBA survey identified also numerous *additional* practices on responsible lending, which are too specific to the particulars of national markets and regulatory approaches to be considered a good practice but which might nonetheless be helpful for individual competent authorities. They are therefore stated separately, as an annex to this Opinion.

⁶ See EBA (2013), *EBA Consumer Trends Report*

Scope of this Opinion

13. The Opinion applies to loans to consumers that are:
 - secured either by residential mortgage or by another comparable security commonly used in some EU markets on immovable residential property;
 - secured by a right related to immovable residential property; and
 - loans, the purpose of which is to acquire or retain rights in immovable residential property.
14. This Opinion is therefore relevant for the great majority of residential mortgage lending in most national markets. However, some or all good practices may not necessarily be appropriate or applicable for certain niche forms of finance. For example, borrowing by high-net-worth consumers should generally be considered within the scope of these good practices, but the good practices might not apply to such borrowing in the same way as they would to the bulk of mortgage lending. Equity release products (reverse mortgages) and bridging finance are explicitly designed to be repaid from the proceeds of the sale of the property, so some of the good practices will be less applicable to them (and such lending is excluded from the proposed Mortgage Credit Directive). Excluded from both the Directive and the scope of this Opinion, is buy-to-let borrowing. For equity release, bridging, and buy-to-let, competent authorities could choose to apply these good practices albeit not in the same way as they would to the bulk of mortgage lending.
15. Competent authorities should nonetheless seek to apply the good practices that are relevant, and may wish to follow the same approach for comparable lending that is beyond the scope described above. In all instances, a robust and effective assessment of individual affordability must underpin any sustainable lending model. It is important to note that the good practices focus on the credit granting decision from a consumer protection point of view rather than wider issues of credit risk management.
16. This Opinion is directed towards competent authorities. These authorities will typically have supervisory responsibility for credit institutions⁷. In some, but not all, Member States these authorities will also supervise mortgage lending done by non-credit institutions. Where this is the case, competent authorities are likely to also want to promote the adoption of these good practices since the nature of the creditor (i.e. whether it is a credit institution) will not alter the positive effect of the good practices. In view of this, any reference to “creditor” in this paper can be read as applying to both credit institutions and non-credit institutions. Competent authorities will want to consider the widest application of these good practices, consistent with their scope of supervisory responsibility, to minimise the risk of regulatory arbitrage.
17. In some cases the competent authority is not the supervisor for non-credit institutions, or there is no national regulation that applies to non-credit institutions. Competent authorities should bring this Opinion to the attention of the relevant supervisor where there is one. However, it will be purely a matter for the appointed supervisor, or any non-credit institutions where there isn't

⁷ As defined in EC (2006), *Directive of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (No 2006/48/EC)*

national regulation applying, to determine the regard, if any, they have to the good practices set out here.

18. Many creditors outsource some of their operations to another business. For the purpose of this Opinion the operations of this second business are not considered separately. Rather, as the agent of the creditor, it would be for that creditor to consider the identified good practice and how it might be reflected in the approach adopted by the business carrying out the outsourced activities.
19. The good practices in this Opinion should be understood as referring to data use to the extent permissible under national data protection laws.

Good practices for responsible mortgage lending

20. The good practices in this Opinion follow the same approach adopted by the FSB Principles. They reflect not only the FSB work but also the findings from the EBA survey of competent authorities. Considering the distinct real estate markets, cultural differences and socio-economic policies that shape each national mortgage market, the applicability, effectiveness and appropriateness of the good practices on responsible lending may vary across EU markets.
21. The relevance of each good practice should be individually assessed by competent authorities. The good practices that are based on the FSB Principles are seen as most relevant and desirable for consideration. The further examples identified as good practices have proven to be effective by several competent authorities and therefore might be of wider interest to other competent authorities.
22. This Opinion considers good practices on responsible lending under a number of distinct headings, namely:
 - the verification of information;
 - reasonable debt service coverage;
 - appropriate loan-to-value ratios; and
 - lending and supervisory processes and related good practices.

Verification of information

23. Prior to the financial crisis, it had become common practice in certain markets for some mortgage borrowing to be available without the consumer having to prove their income. These mortgages were typically marketed as self-certification mortgages. The subsequent performance of such mortgages has underlined a key aspect of sound mortgage underwriting – that the consumer should be able to demonstrate that they have the resources to repay the loan (and not simply be allowed to claim that they have these resources).

Good practice 1: *It is good practice to:*

- (i) *ensure that creditors make reasonable inquiries and take reasonable steps to verify a consumer's underlying income capacity. This would mean that creditors should obtain sufficient income history on the consumer and make appropriate efforts to capture any variability in the consumer's income by collecting and analysing sufficient income history. These income reports should be based on authoritative sources; and*
- (ii) *allow creditors to require even more extensive history or third-party verification to document income and profit capacity for consumers who are self-employed, entrepreneurs, or have seasonal or irregular sources of income (FSB Principle 1.1)*

Good Practice 2: *To supplement this, it is good practice to specify, or require creditors to specify, aspects of the income verification process, such as the information required, or the means of verifying income information, such as seeking documentary evidence of salary.*

24. Responsible lending practices require the necessary information to support and verify the declared income of the consumer. As well as requiring this information, there is a need for adequate records to be kept to substantiate the robustness of the checks made. This will allow creditors to review and ensure their own adherence to responsible lending principles - and also means that this could be subsequently demonstrated to the competent authority.

Good Practice 3: *It is good practice to:*

- (i) *ensure that creditors maintain complete documentation of the information that leads to mortgage approval. This should document the income history collected for each applicant, including the steps taken to verify income, and maintain this documentation for a number of years after origination of the loan; and*
- (ii) *ensure that a proper record with an adequate explanation of the steps taken to verify income is readily available for competent authorities (FSB Principle 1.2).*

Good Practice 4: *To supplement this, it is good practice to require creditors to specify their approach to income verification, and the records to be kept, as part of a policy on responsible lending [see the final section of this Opinion in respect of a potential good practice regarding lending policies and processes].*

25. The robustness of financial systems depends, at least in part, on their ability to prevent, combat or mitigate fraud risks. Mortgage lending is no different from this. Responsible mortgage lending

means that creditors have regard to the potential for false or misleading information to be used in mortgage applications, and should design their processes accordingly. Where fraud is identified, competent authorities may wish to consider the wider availability of sanctions (e.g. criminal law) to address this.

Good practice 5: *It is good practice:*

- (i) *for competent authorities to ensure that incentives are aligned with accurate representation of consumers' income and other financial information. The loan documentation requirements should be designed to help identify misrepresentation of information either by the consumer, the creditor or the credit intermediary;*
- (ii) *to consider, when fraud is detected, if it is appropriate to have recourse to the jurisdiction's legal system, where this is possible (FSB Principle 1.3).*

Reasonable debt service coverage

26. Verifying the income is just one element of a responsible lending decision. Basing a lending decision solely on the income without also having regard to commitments and expenditure provides no guarantee of consumer protection or the sustainability of the loan. To ensure these objectives, creditors need to capture additional information from the consumer. Creditors are also likely to need to make realistic assumptions about future circumstances. A responsible lending decision might be informed by an awareness of the potential for interest rate changes and foreseeable events (e.g. the likelihood of income changing where the mortgage extends into retirement).

Good Practice 6: *It is good practice:*

- (i) *to ensure that creditors, while taking into account data protection rules in their jurisdiction, appropriately assess consumers' ability to service and fully repay their loans without causing the consumer undue hardship and over-indebtedness;*
- (ii) *to ensure that creditors (a) establish appropriate processes to assess the consumer's ability to repay the loan; (b) review these processes at regular intervals; and (c) maintain up-to-date records of those processes;*
- (iii) *to ensure that creditors take into account all relevant factors that could influence the prospect for the loan to be repaid according to its terms and conditions over its lifetime. This should include an appropriate consideration of other servicing obligations, such as the level of other debt (secured and unsecured), the interest rate and outstanding*

principal on such debt, and evidence of delinquency. Creditors should also include an assessment of whether the loan can be expected to be repaid, including principal, interest, taxes and insurance, within the specified loan amortisation period from the consumers' own resources (income and assets⁸) without inducing undue hardship and over-indebtedness;

- (iv) to specify that temporarily high incomes should be suitably discounted. If the loan term extends past normal retirement age, creditors should take appropriate account of the adequacy of the consumer's likely income and repayment capacity in retirement; and*
- (v) to specify that the assessment of the consumer's ability to repay should neither be based on the assumption that the property will appreciate in value (unless the purpose of the loan is to construct or renovate the immovable residential property) nor on an expected significant increase of the consumer's repayment capacity (unless this is sufficiently certain)(FSB Principle 2.1).*

Good practice 7: *To supplement this, it is good practice to:*

- (i) specify aspects of the detailed assessment (such as the information to be gathered about the consumer's personal circumstances and financial situation) or assumptions to be used in the assessment (such as the maximum loan term);*
- (ii) specify, or require creditors to specify, lending thresholds that might act as a backstop to any individual assessment of affordability; and*
- (iii) clarify that the collateral value should be taken account of solely for prudential reasons and not for the assessment of affordability (unless there is a clear and credible reason for treating it differently).*

27. While it is possible to verify income, it is much more difficult (if not impossible) to verify the consumer's outgoings. Given this, it is reasonable to expect creditors to consider the range of available information (actual or modelled) to inform their thinking about the affordability of any mortgage a consumer applies for. This will require, in turn, having a view as to the 'available' income left with the consumer after meeting all their expenditure and commitments.

Good practice 8: *It is good practice to:*

⁸ Competent authorities may consider that where the assets include the mortgage collateral (and this is the consumer's main home) that responsible lending means the sale should release sufficient funds to repay the outstanding capital and interest and purchase another suitable property or follow another credible housing strategy.

- (i) *ensure that creditors make reasonable allowances for committed and other non-discretionary expenditures in the assessment of repayment capacity. This could include establishing the consumers' actual obligations, including appropriate substantiation and consideration of normal living expenses; and*
- (ii) *require that creditors should also include risk limits in their internal loan policies, such as specifying minimum levels of residual net income after meeting obligations or fixed ratios of repayment to some measure of gross or net income (e.g. debt-to-income ratio, loan-to-income ratio) (FSB Principle 2.2).*

Good practice 9: *To supplement this, it is good practice to encourage creditors to define a risk strategy as part of their business strategy (see the final section of this Opinion in respect of a good practice regarding lending policies and processes).*

28. In some mortgage markets the interest rate may be fixed for the entire term, or reset after an agreed period. However, many other mortgages have the potential for much more significant change during the term. Some mortgages offer an initial discount period, after which the interest rate increases. With variable rate mortgages the interest rate can change frequently, often as a result of a movement in an external reference rate. Foreign currency mortgages can introduce a further dimension of change, having both a variable interest rate and an exposure to exchange rate fluctuations. It is good practice for the assessment of affordability to have regard to changes of this kind, which are not predictable but where there is a clear likelihood that change may happen.

Good practice 10: *It is good practice to ensure that creditors make prudent allowances for future negative outcomes. Creditors should include an increase in benchmark interest rates in the case of variable rate mortgages or an unfavourable change (for a consumer) in the exchange rate in the case of mortgages granted in foreign currencies. As such, repayment capacity calculations could take into account the highest payment currently scheduled to apply during the term of the loan rather than solely utilising the first few payments at the prevailing interest rate or foreign exchange rate. Creditors also should consider the increase in future payments due to negative amortisation, balloon payment, or deferred payments of principal or interest (FSB Principle 2.3).*

Good practice 11: *To supplement this, it is good practice to:*

- (i) *consider the impact of stressed conditions, such as the affordability of payments in the light of potential increases in interest rate on variable rate mortgages;*

- (ii) *adopt a comprehensive disclosure approach to foreign currency lending, for example using scenarios to illustrate the effect of interest and exchange rate movement (such as in the ESRB Recommendation of September 2011)⁹; and*
- (iii) *specify criteria or a framework for creditors when stress testing affordability calculations.*

29. Responsible lending aims for the same outcome as responsible borrowing. One way of promoting the latter is to ensure that consumers are adequately informed about the features, risks and costs of any mortgage that may be of interest. If consumers are to be able to use and act on this information it needs to be plainly and simply presented, and given out in good time. And if the information is to be used to make a choice between two or more different mortgages it needs to be set out in a way that allows consumers easily to make comparisons.¹⁰

Good practice 12: *It is good practice to ensure that creditors provide consumers with sufficient information to clearly understand the main elements which are taken into account in order to determine a consumer's repayment capacity, the main characteristics of the loan including the costs, and risks associated with the loan in order to enable consumers to assess whether the loan is appropriate to their needs and financial circumstances. It is important that customer information be clear, concise, reliable, comparable, easily accessible, timely, and comprehensive (i.e. the information should also take into account the effect of variation in interest rates and the combined effect of the loan and any other product linked to it). This information should be provided to consumers without charge and effectively present the total cost of the mortgage during its lifetime, taking into account the loan terms (FSB Principle 2.4).*

Appropriate loan-to-value ratios

30. Loan-to-value (LTV) ratios are not used in all markets, as clearly demonstrated in the FSB peer review published in 2010¹¹. Rather, there is a mix of approaches, with some relying either on market practice or the regulatory incentive of a reduced capital requirement for lower LTV lending. The latter is consistent with the approach of the Capital Requirements Directive.¹²
31. Where LTV ratios are used, their purpose might be macro- or micro-prudential, as well as (or instead of) consumer protection. LTVs, and other lending thresholds, can add some consumer protection value. However, by their nature, they cannot replace the individual assessment of

⁹ ESRB (2011), *Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1)*

¹⁰ See, for example, EC (2001), *Commission Recommendation of 1 March 2001 on pre-contractual information to be given to consumers by lenders offering home loans (2001/193/EC)*

¹¹ FSB (2011), *Thematic Review on Mortgage Underwriting and Origination Practices - Peer Review Report*

¹² EC (2010), *Directive of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (2010/76/EU)*

loan affordability that should be at the heart of the consumer protection objective of ensuring responsible lending. This should be borne in mind when considering the good practices that follow in this section.

Good practice 13: *It is good practice to ensure that creditors adopt prudent LTV ratios with an appropriate level of down payment that is substantially drawn from the consumer's own resources, not from, for example another provider of finance, to ensure the consumer has an appropriate financial interest in the collateral (FSB Principle 3.2).*

32. Of course, wherever any reference is made to the LTV it is vital that this is properly established. A failure to properly establish the extent of the secured borrowing, or the effective (rather than notional) property value will restrict its usefulness.

Good practice 14: *Where national frameworks specify controls, standards or incentives on LTV (loan-to-value) ratios, it is good practice to ensure that creditors satisfy themselves that the LTV ratio takes into consideration the "real value" of the available equity, which could be calculated on the basis of (i) a robust and prudent approach to property appraisals;¹³ (ii) all loans that are collateralised against the same property or for financing part of the cost of the property. This should include loans provided alongside the main mortgage (e.g. top-up loans, renovation or decoration loans); and (iii) any increase in loan authorisation being subject to a full assessment of the consumer's repayment capacity and to an appropriate LTV ratio at the point of the new mortgage underwriting, and not rely on the excess equity. Any subsequent refinancing utilising a second charge or lien should lead to the calculation of a new LTV ratio where possible. Particular caution should be exercised about drawing down on the equity in the property if that would raise the current LTV ratio above the level originally agreed (FSB Principle 3.3).*

Lending and supervisory processes and related good practices

33. Consumers will vary greatly in their needs, personal circumstances and level of knowledge. These factors can make for differences in the risks that mortgage borrowing poses – both for them and for creditors. It is clearly open to creditors to limit mortgage availability to consumers who they see as having certain risk characteristics. Equally though, a creditor may choose to consider wider (or several targeted) consumer markets, and to adequately capture the different risks within their lending model.
34. Furthermore, not all mortgage lending will be suitable for all mortgage consumers, an obvious example being foreign currency mortgages which expose the less financially aware to significant unhedged risk. There are a range of potential responses to this, for example the creditor could have a product design process that sets clear parameters on the appropriate

¹³ The prudential interest in a robust approach to collateral management is addressed in detail in Principle 4 of the FSB principles

target market in order to avoid the risk of consumer detriment. Another approach might be for regulatory requirements to be used to set minimum acceptable standards.

35. Responsible lending is the result of creditors adopting and following a robust set of practices (a number of which are set out in this Opinion). These practices should operate in combination to deliver the desired outcome. So, for example, consumer protection will not be assured if the creditor verifies income information but then fails to, alongside this, consider the consumer's expenditure and commitments in a proper assessment of affordability. Creditors will want to ensure that they have the policies and procedures in place to ensure that their responsible lending approach is appropriately comprehensive and effective. Competent authorities will have a clear interest in understanding how creditors ensure their lending is responsible.

***Good practice 15:** It is good practice to consider whether absolute minimum levels of particular dimensions of mortgage underwriting standards should be imposed, below which no mortgage would be deemed acceptable, irrespective of the settings across the other dimensions. One consideration could be whether a particular product or contract feature is harmful to the consumer's interests (FSB Principle 6.3).*

***Good practice 16:** It is good practice to require creditors to identify groups of loans with a higher risk profile and that these loans be underwritten to a set of norms specific to them (FSB Principle 7.3).*

***Good practice 17:** To supplement this, it is good practice to require creditors to specify a responsible lending policy setting out their assessment of the risks and the practices and procedures that are in place to ensure that their lending is responsible.*

Annex: Additional approaches

1. On each of the four topic areas covered by this Opinion, the EBA survey of competent authorities identified a range of additional national approaches. The great majority of these were regulatory interventions, but in a few cases national authorities identified market practice that instead contributed to responsible lending.
2. Information on these approaches is included in this Opinion in the form of an Annex, so that competent authorities may consider the relevance for their own markets. The approaches are tailored towards the specifics of national markets and particular products and address issues that may be common to only one or a few competent authorities.
3. As a result, these approaches are put forward for information only and should not be seen as good practices. Similar to the good practices presented above, these approaches cover the verification of information, debt service coverage, loan-to-value ratios, and other practices.

Verification of information

4. Further practices identified by individual competent authorities were:
 - a) specifying the minimum period for which consumers should be asked to provide income information by creditors;
 - b) specifying the period creditors should keep records about the granting of the credit, and the information they used to do this;
 - c) requiring creditors to have a policy covering their approach to income verification, and requiring creditors to report regularly to their own management board on the compliance with their lending policies;
 - d) specifying the particular forms of information creditors should use to verify income;
 - e) specifying the particular sources of information creditors should use to verify income; and
 - f) promoting creditor use of contractual documentation that clearly specifies that any false or fraudulent declaration on the part of the consumer could lead to the cancellation and/or reimbursement of the mortgage.

Reasonable debt service coverage

5. Further practices identified by individual competent authorities were:

- a) using a specified minimum amount for living expenses for each household member as part of the creditworthiness assessment;
- b) specifying assumptions for the purpose of the assessment, e.g. a maximum loan term or that the repayments will come from income;
- c) defining the forms of income that it is reasonable to have regard to when assessing affordability (e.g. limiting or restricting the extent to which regard can be had to second incomes or discretionary bonuses);
- d) requiring the calculation of a reasonable loan load or debt-to-income maximum for each consumer;
- e) requiring a more conservative assessment (and stricter lending thresholds – where used) where the consumer's income might change considerably or the sustainability of income is doubted;
- f) that the intensity of the assessment of repayment capacity might depend on the risk content (e.g. there being a full credit assessment where the risk is greatest, but where the risk is less this could be approached on the basis of either a risk classification or an assessment based on a simplified procedure);
- g) promoting the use, by creditors, of robust and regularly reviewed credit risk classification systems;
- h) that while the credit decision should primarily be based on the creditworthiness of the consumer, the quality and value assessment of the collateral offered as coverage for credit risk is also of significance;
- i) that the creditor's assessment of affordability should look at the consumer's likely ability to repay the debt, over the duration of the agreement on the basis of information gathered on the consumer's personal circumstances and financial situation;
- j) that the creditor's assessment of affordability should look at the consumer's likely ability to repay the debt, over the duration of the agreement on the basis of information gathered on the consumer's needs and objectives;
- k) that creditors ensure the consumer is likely to be able to meet the financial commitment stemming from the mortgage on an on-going basis, and has the ability to repay in the manner required under the contract;

- l) the consumer being given a statement of suitability explaining how the risk profile of the product is aligned with their own attitude to risk;
- m) the need for the creditor to consider documenting that the consumer is financially able to bear the risks attached to a foreign currency mortgage (which would include considering the impact of a severe depreciation of the local currency and an increase in foreign interest rates);
- n) the creditor having to provide numerical examples to illustrate the impact of increases in variable interest rates, or of currency fluctuations where the loan is a foreign currency mortgage;
- o) the value of the creditor adopting a more stringent assessment approach, e.g. in terms of lending thresholds, to mitigate the risks for consumers from foreign currency mortgages;
- p) requiring that consumers receive a clear explanation of the differences between fixed and variable interest rates;
- q) advising the consumer against taking out the mortgage where the assessment suggests it may not be sustainable;
- r) creditors providing general information on the range of products they offer;
- s) consumers receiving a suitable explanation of the main characteristics of the loans offered by the creditor, as well as their typical contractual effect and the consequences of payment default; and
- t) repeating key pre-sale information (amount, term, interest rate etc.) in the mortgage offer document.

Appropriate loan-to-value ratios

6. Further practices identified by individual competent authorities were:

- a) the existence of any down payment being one element of credit risk classification, where it is used;
- b) the consumer needing to certify that any down payment is from their own funds rather than from other borrowing;
- c) that the value of the collateral should be considered purely as a credit risk mitigant and not feature in the assessment of creditworthiness;

- d) that in the event of repayment being based on the sale of the asset, the assessment should consider changes in market value and liquidity rating to ensure that the asset will meet the credit liabilities;
- e) that beyond any ceiling on the mortgage (i.e. the loan-to-value) the consumer should be able to demonstrate their ability to pay the remainder and any costs associated with the mortgage;
- f) using guidelines for specifying a loan-to-value, beyond which a creditor can only lend where it can demonstrate through its own analysis that such lending is sustainable;
- g) ensuring the value and enforceability of collateral is generally assessed before a lending decision is made. This might include using existing information on collateral values if there is no indication of changes in value;
- h) requiring the creditor to have sight of an original valuation report for the security/collateral prior to granting the mortgage;
- i) specifying any limited circumstances where any lending thresholds used may be set aside, e.g. where there is credit insurance or where the lending is for the purpose of construction or renovation; and
- j) creditors having robust procedures for the selection or recruitment of appraisal professionals.

Lending and supervisory processes and related practices

7. Further practices identified by individual competent authorities were:

- a) encouraging creditors to define a risk strategy as part of their business strategy;
- b) making it the responsibility of the management board of the creditor to develop/approve the principles of risk management followed;
- c) requiring documentation of the credit granting process, indicating the individuals who performed the credit analysis, those who made the decision to grant (or not grant) the credit, and the reasons for any refusal;
- d) specifying maximum loan terms or that repayment should only be through income (including investment income);
- e) highlighting the inappropriateness of short-term mortgages (i.e. bridging loans) for consumers with payment difficulties given the absence of any plausible repayment strategy in such circumstances;

- f) specifying that mortgage contract terms that fail to comply with legal requirements are not effective;
- g) requiring mortgages beyond a specified term to be illustrated to the consumer both on any specified term and on the longer term desired by the consumer, so that a comparison can be made;
- h) requiring creditors to highlight the value of maintaining a cash reserve to consumers where the mortgage is close to the boundary of affordability; and
- i) identifying to creditors particular consumer groups or mortgage types where the risk characteristics are heightened, e.g. Consumers who are restructuring their debts, or who are in payment difficulties, first time buyers, or where the mortgage is for an investment property.

Done at London, 3 June 2013.

[signed]

Andrea Enria

Chairperson

For the Board of Supervisors