BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP11/14

Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending

June 2014

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This Consultation Paper proposes changes to the PRA rulebook to implement the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending.

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1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed rules to implement the Financial Policy Committee's (FPC) recommendation on loan to income (LTI) ratios in mortgage lending. The recommendation is addressed to the PRA and the Financial Conduct Authority (FCA) and asks them to ensure that mortgage lenders limit the number of mortgage loans made at or greater than 4.5 times LTI to no more than 15% of their total number of new mortgage loans.

1.2 This CP is relevant to banks, building societies, friendly societies, industrial and provident societies, credit unions, PRA designated investment firms, and overseas banks in relation to their UK branch activities. The rules also require the above firms to apply the rules at UK subsidiary level in relation to firms not already caught by the rules.

Background

1.3 The FPC is charged with taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is required to publish a Financial Stability Report (FSR) twice a year which must identify key threats to the stability of the UK financial system.

1.4 As outlined in the June 2014 FSR[1], the recovery in the UK housing market has been associated with a marked rise in the share of mortgages extended at high loan to income multiples. Increased household indebtedness may be associated with a higher probability of household distress, which can cause sharp falls in consumer spending. Falls in consumption can in turn weigh on wider economic activity, increasing macroeconomic volatility in the face of shocks to income and interest rates. Furthermore, rapid growth in aggregate credit – which could be associated with a sharp increase in highly indebted households – is strongly associated with subsequent economic instability and the risk of financial crisis. Acting against excessive indebtedness will make the financial system more stable and will reduce the direct and indirect impacts on the firms that the PRA regulates. A more stable economy and financial system will thus help advance the PRA's objective of promoting the safety and soundness of firms.

1.5 In light of these views, the FPC decided at its June meeting to recommend to the PRA and the FCA that they take steps to ensure that lenders constrain the proportion of new lending at loan to income (LTI) ratios at or above 4.5 to no more than 15% of the total number of new mortgage loans. The recommendation addresses a common risk to which many PRA firms are subject, namely the macroprudential risks arising from the very high LTI elements of mortgage lending carried out by firms. Although a single firm undertaking very high LTI lending may not itself pose risks to the financial system, the aggregate effect of many firms undertaking such lending could pose such a risk. As such the measure supplements existing microprudential standards regulated by the PRA and FCA, such as the capital measures contained in the Capital Requirements Directive and Regulation (hereafter 'the CRD'). The measure is calibrated by the FPC on its current view of the outlook for the housing and mortgage market and is consistent with providing insurance against the possibility that underlying strength in the housing market turns out to be greater than expected.

The Recommendation

1.6 *"The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at Loan to Income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable."*

1.7 Under its power of *Recommendation* the FPC can ask the PRA and FCA to take measures to mitigate risks. Such Recommendations can cover any aspect of the activities of the regulators but cannot relate to a specified individual regulated entity[2].

[1] http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf

[2] The FPC can also make Recommendations to the PRA and FCA on a 'comply or explain' basis — in which case, the regulators are required to act as soon as reasonably practical. If one of these regulators were to decide not to implement a Recommendation, it must explain the reasons for not doing so.

The PRA's response

1.8 The PRA has considered the Recommendation and intends, subject to consultation, to implement the measure as soon as is practicable. The implementation will take the form of new rules, as the PRA believes this is the most effective way to ensure a consistent and transparent implementation of the Recommendation.

1.9 The PRA and the FCA will work together to ensure that their respective implementation proposals are complementary and co-ordinated.

1.10 The proposed rules are included in appendix one.

Statutory Obligations

1.11 In discharging its general functions of making rules and determining the general policy and principles by reference to which it performs particular functions, the PRA must, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of PRA-authorised persons and which facilitates competition in the markets for services provided by PRA-authorised persons (the secondary competition objective). It must also have regard to the Regulatory Principles, including proportionality.

1.12 The purpose of the FPC's recommendation is to constrain excessive levels of household indebtedness which could, following a shock, result in economic instability and so in turn threaten the safety and soundness of firms. The measure applies equally across all lenders although the PRA recognises that it may only constrain a very small minority of firms as the limit will only engage in relation to mortgages with very high LTI ratios. The policy is not expected to generate any material direct compliance costs to firms or the PRA. The limit is not expected to have a material impact on mortgage lending and housing transactions in the near term. Rather the policy guards against the risk of a build-up of excessive household indebtedness if the underlying strength in the housing market turns out to be greater than expected. The limit is set at a point which will restrain the future development of very high LTI lending and as such the impact on competition is estimated to be negligible.

1.13 The limit will also not constitute a prohibition on all very high LTI lending, so firms will still be able to offer these loans, but within parameters that support the safety and soundness of PRA regulated firms. The measure includes a *de minimis* threshold below which the rules will not apply, so small firms and small challenger banks in particular would not be subject to the burden of additional regulatory limits, provided their lending does not exceed the threshold.

1.14 In addition, when consulting on draft rules the PRA is required to consider the obligations set out below.

Impact on Mutuals

1.15 The PRA has a statutory requirement to state whether the impact on mutuals will be significantly different from the impact on other firms. UK mutuals have a wide range of business models. Some firms that specialise in very high LTI lending may have to adjust their business models going forward to meet the rule, while others may not face any impact. Many mutuals will fall below the de minimis threshold. Overall, we do not expect that the impact on mutuals will be significantly different to that of other firms in the mortgage market.

Equality and diversity

1.16 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. As part of this the PRA assesses the equality and diversity implications of any new policy proposals considered. This measure is not expected to have an impact on mortgage lending and housing transactions in the near term. To the extent that underlying strength in the housing market turns out to be greater than expected and the limit bites, it may impact those of a younger age more substantially as it is this group that is more likely to seek such mortgages. Unlawful discrimination does not occur if the less favourable treatment afforded to a particular group is a proportionate way of achieving a legitimate aim. The limit is not an absolute bar on all such lending and for the reasons set out in paragraphs 1.4 and 1.5 above, we are content that any less favourable treatment of younger groups pursues a legitimate aim and is a proportionate approach.

1.17 The PRA is also required to perform an economic assessment of the impact of its policy proposals which can be found in Chapter 3. A

summary of this analysis can be found in Section 5 of the FSR[3].

Responses and Next Steps

1.18 The proposed implementation date for these rules is 1 October 2014, as this is in line with current reporting cycles. To meet this date, the consultation period closes on 31st August 2014. The PRA welcomes views on the proposed approach for implementation. Respondents are requested to structure their responses in sections, as in the CP.

1.19 The PRA will publish a policy statement with feedback and finalised rules at the same time or before the rules come into effect.

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3 http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.

2 The LTI Flow Limit

2.1 The PRA is proposing to implement the FPC recommendation by creating a new Part in the PRA Rulebook. The proposed rules are contained in Appendix one.

2.2 The proposed rules would have the effect of limiting to no more than 15% of the total the number of mortgage loans completed by each lender at or greater than 4.5 times LTI. The limit is intended to restrict but not halt the extension of mortgage lending at such LTIs and can thus be thought of as a limit on the flow of very high LTI lending.

2.3 The PRA proposes that the rules come into effect on 1st October 2014. Firms should be aware that, if made, there will not be a long period between making the rules and them coming into effect. Firms are therefore advised to consider the steps necessary to prepare for compliance with the proposed rules. Likewise, the PRA would expect firms not to act in a way which might undermine the objective of the FPC recommendation in the interim, consistent with the PRA's Fundamental Rules.

2.4 The measure is designed to capture risks associated with excessive household indebtedness. It is not designed to capture all aspects of credit risk associated with the borrower or the other factors that a lender might take into account for the purposes of the lending decision. Lenders should continue to apply whatever criteria they feel are appropriate and commensurate with their risk appetite when taking individual lending decisions.

Summary

2.5 Firms are currently required to submit data on their mortgage lending to the FCA under SUP16.11[4] (hereafter 'Product Sales Data (PSD) return' or 'PSD reporting'). The PSD reporting periods are the four calendar quarters of each year beginning on 1 January. The limit will apply on a quarterly basis and firms will be determined to have complied or not complied with the limit on the basis of their PSD returns.

2.6 The limit would apply to the number of mortgages completed (volume) basis rather than on a pounds sterling (value) basis. The PRA recognises that the relationship between volume and value of high LTI lending may not be the same for all firms but will expect firms to explain any significant shift in current distributions as a result of this CP or the proposed rules. The PRA will keep the proportion of very high LTI lending on a value basis in aggregate and at individual firm level under review and will consider additional measures if appropriate.

2.7 Mortgage offers or decisions in principle do not count for the purposes of complying with the limit. Mortgage offers made or decisions in principle taken before the proposed rules come into effect but which complete after 1st October would count for the purposes of complying with the limit. Certain types of mortgages are outside the scope of the limit. These exclusions reflect the intended outcome of the policy, the nature of the limit itself or the relatively small volume these mortgages represent. Some of these exclusions may make the measure subject to leakage. We propose to keep such lending under review and will consider additional actions as necessary.

2.8 A *de minimis* threshold applies. The threshold test will be applied before the rules come into effect to determine which firms are in scope. The threshold test will be re-applied quarterly.

Implementation Details

Reporting and Definitions

2.9 The PRA proposes to use PSD returns to determine (i) whether a firm is below the *de minimis* threshold at the time the rules come into effect (ii) whether a firm is below the *de minimis* threshold on an ongoing basis and (iii) whether a firm has complied with the limit.

2.10 The PSD Data Reference Guide[5] provides guidance on 'loan' and 'income' which firms already use when submitting their returns. The PRA draft rules align with this guidance.

[4] http://fshandbook.info/FS/html/handbook/SUP/16/11

[5] http://www.fca.org.uk/your-fca/documents/gabriel/fsa-psd-data-reference-guide

2.11 The PSD definition provides for some discretion on the part of lenders as to the elements they take into account when calculating a borrower's or borrowers' income. The PRA considers that a firm's definition of income reflects a firm's own internal risk appetite as regards individual lending decisions. The PRA would therefore not expect firms to revise the way they complete their PSD return or how they define income as a result of this consultation or any rules coming into force without consulting their supervisor.

2.12 The limit would apply to completed mortgages. It is irrelevant whether the lender at the point of origination continues to hold the mortgage or has transferred or disposed of the asset.

2.13 The limit applies at regulated entity level. PRA regulated firms are required to ensure that non-PRA regulated subsidiaries comply with the limit. The *de minimis* threshold and limit are applied to each regulated entity separately.

Calculation Periods

2.14 Compliance with the limit will be determined on a quarterly basis in line with PSD reporting periods. The first calculation period that the limit will apply to will be the fourth quarter of 2014.

2.15 The PRA will determine whether firms have complied with the limit on the basis of their PSD return for that calculation period. PSD returns provide data as to the number of residential mortgages completed and the number of those that have an LTI ratio of 4.5 or greater. The sum of the latter must not be 15% or more of the sum of the former. Mortgage types which are excluded from the limit will not count towards either the total new lending number or the number of mortgages at or above an LTI ratio of 4.5.

2.16 If a firm extends less than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5 there will be no carry over from one quarter to subsequent quarters of any 'un-used' lending capacity.

Pipeline lending

2.17 The first calculation period would begin immediately upon the rules coming into effect. All new lending completed during the calculation period would be counted towards the limit, regardless of when the mortgage offer may have been made or decision in principle issued.

2.18 Typically, the pipeline of lending decisions is between 3 and 6 months long. The PRA does not believe that pipeline lending decisions taken before the date of this CP will have a material impact on lenders' abilities to comply with the limit in the first calculation period as the majority of mortgage offers made prior to the publication of this CP will have completed prior to the rules coming into force.

2.19 There would likely be only a very short period between the rules being made and coming into force (proposed 1 October 2014). Firms should therefore begin any necessary preparations for the rules as mortgage offers made or decisions in principle taken now could count towards the limit if not completed before the rules come into effect.

Exclusions – Re-mortgages

2.20 Certain types of re-mortgages would be excluded from the limit. Excluded re-mortgages do not count towards either the total number of mortgages completed or the percentage of mortgages completed with an LTI ratio of 4.5 or higher.

2.21 Re-mortgages with no increase in principal do not constitute an increase in indebtedness. This type of re-mortgage, whether with the same provider or a new provider, is therefore not in scope of the limit.

2.22 Where reasonable fees or costs associated with the process of re-mortgaging such as survey, legal or other administrative costs are rolled into the re-mortgage the PRA does not consider that this constitutes an increase in principal.

2.23 Re-mortgages with no increase in principal with the same provider are not captured by PSD reporting and so no further action is required by firms. Re-mortgages with a new provider with no increase in principal will continue to need to be identified as such in PSD returns.

2.24 Re-mortgages with an increase in principal for home improvements, debt-consolidation, a combination of the two or other purposes are in scope of the limit and will be counted towards both the total number of mortgages completed

and the proportion of mortgages completed with an LTI ratio of 4.5 or higher.

Exclusions – Other

2.25 The following section sets out the types of mortgages that would also be excluded from the limit.

2.26 Buy-to-Let mortgages are excluded as LTI is not a meaningful metric and they are not subject to PSD reporting. The PRA is conscious however that some borrowers who are constrained by the flow limit might be encouraged to make fraudulent applications for Buy-to-Let mortgages. Given the severe penalties associated with mortgage fraud the PRA does not anticipate that this will become a material point of leakage but expects firms to ensure that application verification procedures for Buy-to-Let products are robust.

2.27 Lifetime mortgages and Equity Release products are excluded as they do not conform to the typical measures of loan and income.

2.28 Second Charge mortgages are excluded as they are not subject to PSD reporting. While second charge mortgage lending is currently relatively small and undertaken principally by regulated entities, we recognise it is an obvious source of potential leakage. The PRA and FCA will work together to keep the size of the second charge mortgage market under review and may consider additional actions if necessary. Although outside the formal limit, the PRA expects firms to take the intended outcome of this limit into consideration when agreeing to second charge mortgages.

2.29 Further advances are excluded as they are not subject to PSD reporting. If the rules are made, the PRA would expect firms to take the objective of this measure into consideration when agreeing further advances.

2.30 Excluded mortgages do not count towards either the total number of mortgages completed or the percentage of mortgages completed with an LTI ratio of 4.5 or higher.

2.31 The PRA plans to keep these types of mortgages under review and may take further action if it considers that the objectives of the rule are undermined.

De Minimis Threshold

2.32 A *de minimis* threshold applies. The rules proposed would apply initially to all lenders who have completed regulated mortgage contracts (excluding re-mortgages with no increase in principal, lifetime mortgages and other mortgage types excluded from the LTI flow limit) over the four reported quarters preceding the rules coming into effect (i.e. Q3 2013, Q4 2013, Q1 2014, Q2 2014) to the value of £100m or more. This is Condition A in the rules. PSD reporting will be used to determine whether this total has been reached. Lenders who have not completed regulated mortgage contracts equal to £100m or more in the preceding four quarters will be outside of the scope of the proposed flow limit at the date the rules come into effect. Although the limit will not apply to firms below the threshold the PRA will monitor lending at very high LTI ratios by these firms.

2.33 After the rules come into effect, PSD returns will be used to verify whether individual firms continue to meet the *de minimis* threshold test. In order to prevent firms moving in and out of scope of the limit on a quarterly basis and to provide certainty for both the supervisor and the firm certain conditions will apply.

2.34 Should a firm's lending over two consecutive rolling periods of four quarters reach or exceed a value of £100m the proposed flow limit would apply. The PRA will notify firms whose lending reaches £100m over one four quarter period. The PRA will notify firms whose lending reaches or exceeds £100m over two consecutive rolling four quarter periods that they will be subject to the limit from the next quarter. This is Condition B in the rules.

2.35 Once the proposed rules apply, should a firm's lending over two consecutive rolling periods of four quarters be less than a value of £100m the limit will cease to apply until the value of lending again exceeds £100m.

Worked Example

2.36 For the period 1st July 2013 to 30 June 2014 (Q3 2013 to Q2 2014), Firm X and Firm Y each submit 4 PSD returns. The total value of mortgages reported in those 4 returns for Firm X and Firm Y respectively is less than £100m. On the basis of Condition A, Firm X and Firm Y are each determined to be below the threshold and

therefore out of scope of the limit on the date the proposed rules would come into effect.

2.37 The PRA repeats the threshold test when the Q3 2014 PSD returns are submitted. The relevant period is now 1st October 2013 to 30th September 2014 (Q4 2013 to Q3 2014). The total value of mortgages reported in those 4 returns for Firm X and Firm Y respectively is equal to or greater than £100m. The PRA notifies both firms of this fact.

2.38 The PRA repeats the threshold test when the Q4 2014 PSD returns are submitted. The relevant period is now 1st January 2014 to 31st December 2014 (Q1 2014 to Q4 2014). The total value of mortgages reported in those 4 returns for Firm X is equal to or greater than £100m and for Firm Y is less than £100m. On the basis of Condition B the PRA notifies Firm X that it will be within scope of the limit from the next applicable quarter (Q2 2015) beginning on 1st April 2015, however Firm Y remains below the threshold and out of scope of the limit.

3 Economic Analysis

3.1 This section sets out an analysis of the costs and benefits of introducing a limit of 15% on the proportion of new mortgage loans at loan to income (LTI) ratios at or greater than 4.5 times income, for owner-occupied mortgages. Section 5 of the June 2014 FSR includes an Impact Assessment of the FPC recommendation, with which the analysis presented here is consistent. This analysis also provides information on direct costs to the regulator and PRA regulated firms, impact on mutuals and impact on competition.

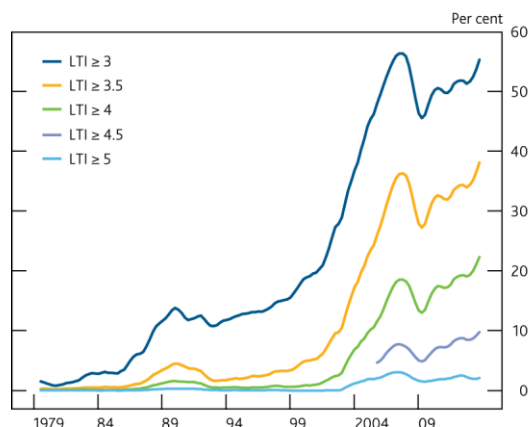
3.2 The purpose of the rule is to insure against the risk of a marked loosening in underwriting standards and a significant rise in the number of highly indebted households. By guarding against the risk of a build-up of excessive household indebtedness and so risks to economic and financial stability, it aims to support the safety and soundness of individual banks.

3.3 The policy is not expected to generate any material direct compliance costs to firms or the PRA. The limit is not expected to have a material impact on mortgage lending and housing transactions in the near term if the pattern of activity in the housing market unfolds broadly in line with the central case set out in the Bank's May Inflation Report. Rather the policy guards against the risk of a build-up of excessive household indebtedness if the underlying strength in the housing market turns out to be greater than expected.

Outline of the problem and policy tools considered

3.4 As discussed in Section 5 of the June 2014 FSR, the recent recovery in the UK housing market has been associated with a marked increase in the share of mortgages extended at high LTI multiples (Chart 1). If house prices rise faster than household income, the proportion of borrowing at high LTI ratios is likely to grow. The longer this continues, the larger the share of borrowing that would take place at high LTI ratios.

Chart 1: New mortgages advanced for house purchase by LTI (a)(b)(c)(d)(e)



Sources: FCA Product Sales Data (PSD) and Bank calculations.
(a) Includes loans to first-time buyers, council/registered social tenants exercising their right to buy and home movers.
(b) The FCA PSD include regulated mortgage contracts only, and therefore exclude other regulated home finance products such as home purchase plans and home reversions, and unregulated products such as second charge lending and buy-to-let mortgages.
(c) Data from the FCA PSD are only available since Q2 2005. Before Q2 2005, data are from the discontinued Survey of Mortgage Lenders (SML), which was operated by the CML. These data are not directly comparable and shares are illustrative prior to Q2 2005. SML data covered only around 50% of the mortgage market.
(d) Prior to Q2 2005 the FCA PSD have been grown in line with the SML data.
(e) Data are shown as a four-quarter moving average to remove seasonal patterns.

3.5 Higher levels of indebtedness may be associated with a higher probability of household distress, which can cause a sharp fall in consumer spending. There is evidence, for UK households from the recent crisis for example, that the share of income attributed to consumption fell sharply for households with higher debt-to-income ratios[6] In addition there is evidence internationally that higher household debt to income ratios have been associated with larger falls in consumption.[7] Falls in consumption can in turn weigh on wider economic activity. Furthermore, rapid growth in aggregate credit – which could be associated with a sharp increase in highly indebted households – is strongly associated with subsequent economic instability and the risk of financial crisis.[8]

3.6 The resilience of UK banks and building societies to potential losses from mortgage lending and related sectors depends on lenders having sufficient loss-absorbing capital to cover both existing exposures and new lending. As set

[6] http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.
[7] Ibid.
[8] Ibid.

out in the FSR, the capital adequacy of UK banks has improved over the past year. And the FPC and PRA will undertake a full assessment of credit risks to major UK banks and building societies emanating from the housing market as part of the 2014 UK bank stress tests. In addition, the affordability tests introduced as part of the Financial Conduct Authority's Mortgage Market Review should discourage an increase in borrowers with extreme levels of indebtedness. But, as discussed in the June 2014 FSR, this will not limit an increase in the proportion of lending at high income multiples, at which borrowers are likely to be able to service their mortgages as interest rates rise, but for whom payments would become an increasingly large proportion of their income. That could make these borrowers, and the economy as a whole, vulnerable to shocks.

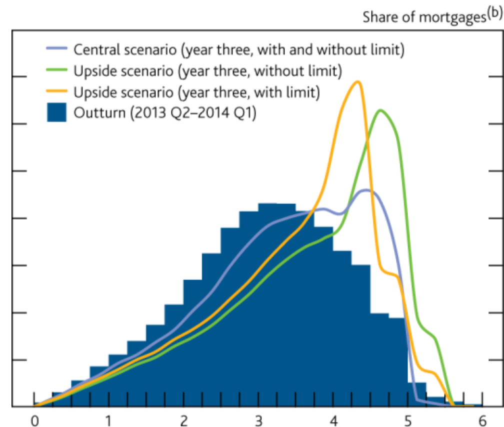
3.7 Alongside these measures, the proposed rule seeks to provide insurance against a significant rise in the proportion of highly indebted borrowers, which could lead to increased macroeconomic volatility. In doing so, it will increase the safety and soundness of firms. The FPC is pursuing this objective through the mortgage market because of the dominant role that mortgages play in household indebtedness.[9]

3.8 The proposed LTI flow limit will have a direct impact on mortgage lenders whose share of new lending with LTI ratios at or greater than 4.5 is above 15%. The policy will apply to all residential mortgage lending originated by PRA regulated entities, excluding advances on existing mortgages, re-mortgaging where no extra money is raised and lifetime mortgages. Second charge mortgage lending, further advances and Buy-to-Let (BtL) mortgages are excluded. In the past four quarters (Q3 2013 – Q1 2014) there were 107 PRA regulated active firms in the market.

Baseline for calculations

3.9 LTI ratios on new mortgages have been rising in the UK in recent years (Chart 1). To the extent that lenders' underwriting standards permit, further increases in house prices relative to incomes would likely see a continuation of this trend. Two scenarios help illustrate this possibility. The 'central' scenario is consistent with the Monetary Policy Committee's forecast in the May *Inflation Report*, while the 'upside' scenario illustrates one possible upside risk in which momentum in the mortgage market evolves in a manner similar to patterns seen in the UK in the early 2000s.

Chart 2: Illustrative impact of LTI flow limit on distribution of mortgages advanced in year 3 of the central and upside scenarios [(a)]



Sources: FCA Product Sales Data and Bank calculations.
(a) Uses data consistent with Chart 1. The annex to chapter 3 contains details of the loan-level modelling of the scenarios.
(b) Height of lines indicate frequency of population at given LTI. Area under each curve sums to 100%.

- In the **central scenario** annual house price inflation continues at current levels until mid-2015, following which it slows to a growth rate that is broadly in line with income from 2016. Income grows near its long-run average of around 4%. By the second quarter of 2015 total mortgage approvals pick up to an average level of 270,000 per quarter for the remainder of the scenario period – somewhat below their 1987-2007 average. The blue line in Chart 2 illustrates the distribution of LTI on the flow of lending that might be associated with this central scenario.

- In the **upside scenario**, mortgage approvals rise quickly to 350,000 per quarter and annual house price inflation rises to around 15%. Income growth is the same as the central scenario. The green line in Chart 2 illustrates the distribution of LTI on the flow of lending that might be associated with this upside scenario.

3.10 The details of how the scenarios have been modelled are explained in the annex to this chapter on page 13. Chart 2 shows the impact of these two scenarios on the distribution of LTI ratios in the flow of new lending in the third year

[9] Aggregate ONS data on household debt in 2013 indicate that mortgage lending was approximately 80% of total debt.

of each scenario (blue and yellow lines). The share of new borrowers with LTI ratios at or greater than 4.5 times income grows over the next three years if house price growth slows to meet income growth (central scenario) and it grows more rapidly if stronger house price growth is maintained (upside scenario).

3.11 The scenarios capture only mortgages advanced for property purchase (i.e. first time buyers and home movers), leaving aside re-mortgaging. This reflects the focus on aggregate household indebtedness, which does not change as households re-mortgage, unless they extract equity in doing so.[10] The rule will however apply to re-mortgages through which borrowers increase their debt.

Costs and benefits of the final policy design

3.12 This section considers the direct impact of the limit on firms and the PRA, as well as the impact on products and on competition. It also describes the broader macroeconomics effects arising from the policy.

Direct costs to regulators and firms

3.13 The proposed LTI rule would entail minimal incremental operational costs for both the regulator and firms in the market. It would rely on lenders' own pre-existing definitions of both 'loan' and 'income' and entails no changes to either the frequency of reporting or the manner in which firms complete templates for mortgage origination data. There is, in consequence, no change to the required mortgage origination data that supervisors already review as part of normal supervisory practice. And there is no increased frequency of review for supervisors. Firms may incur minor operational costs to change systems and controls necessary to monitor their share of very high LTI lending if they do not already monitor it for internal purposes.

Impact on mortgage approvals and net lending

3.14 In the event that the rule became binding for a lender, it could induce a range of responses. One potential response is that a sufficient number of borrowers reduce the amount they borrow to allow lenders to meet the LTI flow limit, perhaps with some incentives from lenders. Another response is that lenders reject sufficient borrowers with LTI at or greater than 4.5 to meet the LTI flow limit. While the ultimate outcome is uncertain, it is likely that it would lie between these two extremes. In the central scenario the impact on mortgages advances and net lending is likely to be minimal. In the upside scenario, modelling suggests that there would be a reduction in mortgage approvals of 0.2 million (of a projected 3.5 million over three years) and that net lending would be reduced by 2.5% of the stock over three years. The resulting distribution of LTIs is shown by the yellow line in Chart 2.

Macroeconomic impact

3.15 If house prices and mortgage approvals grow in line with the central scenario, the impact of the policy action is likely to be minimal. However, if there is more underlying strength in the housing market than in the central scenario, the proposed rule would be likely to restrict the availability of very high LTI mortgages to some households. The proposed policy might then reduce the level of GDP in the short term to the extent that it acts as a binding constraint on mortgage lending. However, even in the upside scenario considered in the June 2014 FSR, the size of the effect would be small (roughly 0.25%).

3.16 Set against these costs, the main benefits of the policy will be to reduce macroeconomic volatility and the likelihood and severity of financial instability. In the upside scenario considered in the June 2014 FSR, the introduction of the LTI policy would be expected to have two main effects. First, it would reduce the share of very high LTI lending. To the extent that such lending carries a higher probability of default than lending at lower LTIs, this will directly contribute to a safer and sounder banking system. And the level of household debt has been linked to increased volatility in household expenditure, as more heavily indebted households have to cut spending more in an economic downturn. Second, the policy may reduce the likelihood of rapid growth in aggregate credit, which is strongly associated with subsequent economic instability and the risk of financial crisis.

Impact on mutuals

3.17 UK mutuals have a wide range of business models. Some firms that specialise in very high LTI lending might have to adjust their business

[10] In addition, data problems and modelling complexity prohibit including this type of re-mortgaging in the analysis.

models going forward to meet the rule, while others might not face any impact. Many mutuals will fall below the de minimis threshold. Overall, we do not expect that the impact on mutuals will be significantly different to that of other firms in the mortgage market.

Impact on competition

3.18 Firms that predominantly underwrite very high-LTI lending and for whom the LTI flow limit is binding may have to revise their business strategies to comply with the rule. Overall, under the central scenario, the rule is not expected to be binding in aggregate, and there is sufficient lending capacity overall to avoid breaching the limit. Consequently, the current extent of competition for very high-LTI lending is not expected to change as a result of the rule.

3.19 In the upside scenario, the LTI flow limit is expected to have a limited impact in aggregate on supply in the very high LTI market segment. However, the scale of the impact is unlikely to be sufficient to reduce competition in the market for mortgages.

Risks to the rule

3.20 There are several potential leakages that could undermine this rule. Consumers could, for example, seek to supplement a lower LTI mortgage loan with unsecured or other forms of borrowing or a second charge mortgage, although lending undertaken at the time a mortgage loan is advanced will be taken into account under the affordability requirements of the MMR. Also European Economic Area (EEA) branches could provide additional supply in this market segment although recently they have not been active in this market. Mortgage brokers will play a role in directing consumers towards these potential sources of supply. To ensure the effectiveness of the rule, any additional supply from alternative sources will be monitored and potential further actions considered.

Annex to Chapter 3: Details of the bottom-up estimation of loan distribution

3.21 This annex contains further details on the modelling of the LTI flow distributions under the central and the upside scenario.

3.22 The flow of lending in the scenarios is modelled at a loan level. The characteristics of recent borrowers are used to model future borrowers[11]. Incomes, deposits and property prices are translated into future nominal values using the aggregate assumptions described in the main text (with house price inflation different in the two scenarios). The size of each loan is inferred given the property price and the deposit for each borrower. The details of how deposits are calculated differ for different types of borrower:

- *First-time buyers:* deposits are inflated in line with incomes.
- *Movers:* deposits are inflated in line with house prices.
- *Help to Buy:* deposits are inflated in line with house prices.

3.23 For Help to Buy: Mortgage Guarantee borrowers, the population of 2014Q1 purchases is used, reflecting the very small number of advances agreed between the announcement of the scheme in late 2013 and the end of the year. For all other purchases, the population of purchases in the four quarters to 2014 Q1 is used as a starting point.

3.24 Absent further modelling intervention, some of the generated borrowers would breach typical maximum LTV and LTI criteria that lenders impose under current underwriting practices. The possible range of responses goes from dropping such a buyer from the scenario altogether to reducing their loan until they do meet lending criteria. The modelling takes an intermediate path. It assumes the following restrictions, based on the assumption that there is a hard limit at 95% LTV and a softer limit at an LTI multiple of 5:

a) If a borrower's LTI multiple is greater than 5, the purchase price is reduced by 10% – that is the buyer is assumed to be willing to purchase a property of slightly lower quality (since overall prices for all properties increase in line with the aggregate projection). The size of the borrower's deposit stays the same with all adjustment in the loan size.

b) If, even after the adjustment, a buyer still breaches either a 95% LTV threshold, or an LTI threshold of 5.5, then they are assumed not to get a mortgage and are dropped from the scenario[12]. This results in a small share of borrowers with LTI multiples greater than 5, similar to that seen in the recent flow of mortgage lending.

3.25 Compared to an unconstrained forecast, imposing these lending constraints removes around 0.5% of borrowers in the central scenario. A larger increase in house prices would lead to more borrowers being excluded.

3.26 In both scenarios, there is a pickup in the number of mortgages compared to the past four quarters. To generate the specified number of advances in each scenario, borrowers are drawn at random and duplicated. Buy-to-let borrowers are not explicitly modelled. The two scenarios use different approaches:

- Central scenario: The split between first-time buyers, movers and buy-to-let borrowers remains unchanged from the base period (the four quarters to Q1 2014). Within that total, the share of lending under the Help to Buy: Mortgage Guarantee scheme picks up in line with information about lenders' estimates.
- Upside scenario: Increasing numbers of first-time buyers are excluded due to the lending constraints biting for more borrowers reflecting higher house price inflation. The modelling assumes that there are no additional first-time buyers who can take their place. They are replaced with borrowers sampled from the population of movers. The share of

[11] The data comes from the FCA's Product Sales Database. It covers regulated mortgages (i.e. it does not include buy-to-let mortgages or second charge mortgages). Only mortgages for the purchase of property are used (i.e. re-mortgaging activity is disregarded).

[12] The cut-off is set at 5.5, rather than 5, to model a soft cap. This could be seen as consistent with lenders subjecting high LTI lending to greater scrutiny, rather than simply using hard caps. It should also be consistent with the Mortgage Market Review affordability test, which does not prescribe hard LTI caps.

buy-to-let investors is assumed to grow in line with movers.

Modelling the LTI flow limit

3.27 To apply an LTI flow limit it is necessary to model lender and borrower behaviour. As with the lending constraints applied in the central and upside scenarios, there are a range of possible responses. At one end of the spectrum, lenders simply reject enough borrowers with LTI multiples at or greater than 4.5 to satisfy the LTI flow limit. At the other, enough borrowers with LTI multiples at or greater than 4.5 reduce their LTI multiple to less than 4.5 in order to satisfy the limit. In this case, no borrowers are dropped from the scenario, but a fraction has their loan size reduced.

3.28 Again, the modelling takes an intermediate approach. It is assumed that lenders select some fraction, *a*, of borrowers to be eligible only for mortgages with LTI multiples less than 4.5. If these borrowers have a desired LTI multiple at or greater than 4.5, they are allowed to reduce their purchase price by 10% and resubmit their request.[13] Those lenders whose LTI is still at or greater than 4.5 are dropped from the scenario, while those that pass stay in. Lenders set the fraction, *a*, sufficiently high to make sure that enough borrowers either adjust or are dropped to meet the LTI flow limit.

[13] If a borrower has already reduced their purchase price at an earlier stage of modelling they do not reduce it further at this stage.

Appendix 1: Proposed Rules

PRA 2014/XX

PRA RULEBOOK: HOUSING INSTRUMENT 2014

Powers exercised

A. The Prudential Regulation Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137G (The PRA's general rules); and
(2) section 137T (General supplementary powers).

B. The rule-making powers referred to above are specified for the purpose of section 138G (Rule-making instrument) of the Act.

Pre-conditions to making

C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority) ("FCA"), the PRA consulted the FCA. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: Housing Instrument 2014

D. The PRA makes the rules in Annex A to this instrument.

Commencement

E. Annex A of this instrument comes into force on [1 October 2014].

Citation

F. This instrument may be cited as the PRA Rulebook: Housing Instrument 2014.

By order of the Board of the Prudential Regulation Authority
[DATE]

Annex A

In this Annex, the text is all new and is not underlined.

Part

HOUSING

Chapter content

1. **APPLICATION**
2. **DEFINITIONS**
3. **HIGH LOAN TO INCOME LIMIT**

Links

1 APPLICATION

1.1 If either Condition A or Condition B is met, this Part applies to a *firm* with a *Part 4A permission* that includes entering into a *regulated mortgage contract* as lender, except:

(a) an *EEA Firm* with respect to an activity carried on in the UK under an *EEA right;* or

(b) a *firm* with a *Part 4A permission* that includes effecting or carrying out a contract of insurance as principal.

1.2 This Part applies to an *overseas firm* only in relation to activities carried on from an establishment in the *UK*.

1.3 A *firm* that is a *parent undertaking* must ensure that a *subsidiary undertaking,* which meets Condition A or Condition B, complies with the requirements of this Part in relation to activities carried on from an establishment in the *UK*, as if it were a *firm* subject to those requirements.

1.4 1.3 does not apply in relation to a *subsidiary undertaking* that:

(a) is an *EEA firm* with respect to an activity carried on in the UK under an *EEA right*;

(b) is a *firm* that is otherwise subject to this Part;

(c) is a *firm* with a *Part 4A permission* that includes effecting or carrying out a contract of insurance as principal*;* or

(d) does not have a *Part 4A permission* which includes entering into a *regulated mortgage contract* as lender.

1.5 Condition A is that in the set of four consecutive *quarters* ending on 30 June 2014, the *firm* has entered into *regulated mortgage contracts* under which the sum of the *credit* provided is or exceeds £100 million.

1.6 Where Condition A is met this Part applies from 1 October 2014.

1.7 Condition B is that during both of two consecutive sets of four *quarters* the *firm* has entered into *regulated mortgage contracts* under which the total *credit* provided in each set of four *quarters* is or exceeds £100 million.

1.8 Where Condition B is met, this Part applies from the start of the second *quarter* following the end of the final *quarter* relevant to the determination that the firm meets Condition B.

1.9 This Part ceases to apply, if during both of two consecutive sets of four *quarters* the *firm* has entered into *regulated mortgage contracts* under which the total *credit* provided in each set of four *quarters* is less than £100 million.

1.10 In this Chapter two consecutive sets of four quarters means:

(a) a second set of four *quarters* ending on 30 September 2014 or on the last day of each subsequent *quarter*; and

(b) a first set of four *quarters* ending on the last day of the immediately preceding *quarter*.

2 DEFINITIONS

2.1 In this Part the following definitions apply:

credit

means the cash loan provided by a *firm* under a *regulated mortgage contract* at the time the *regulated mortgage contract* is entered into and includes any part of a cash loan drawn down at a later date;

quarter

means any of the four calendar quarters of each year, the first quarter beginning on 1 January;

high loan to income mortgage contract

means a *regulated mortgage contract* under which the *credit* provided by a *firm* to an individual, or individuals jointly, is or exceeds a multiple of 4.5 times the individual's *income*, or the individuals' joint *income*, at the time at which that *income* is assessed by the *firm* for the purpose of entering into the *regulated mortgage contract*;

income

means the gross annual income, before tax or other deductions, of an individual taken into account by a *firm* to calculate the *credit* it will provide under a *regulated mortgage contract;*

legal mortgage

includes a legal charge and, in Scotland, a heritable security;

lifetime mortgage

has the meaning given in the PRA Handbook;

re-mortgage with no change to the principal sum outstanding

means a *regulated mortgage contract* under which the amount of *credit* provided does not exceed that outstanding to the *firm*, or to a different lender, under a previous *regulated mortgage contract,* or any other type of contract under which the obligation to repay the *credit* provided is secured by a *legal mortgage* on *land.* In determining the amount of *credit* provided, no account shall be taken of:

(a) arrangement fees;

(b) professional fees and costs;

(c) administration costs;

regulated mortgage contract

has the meaning given in Article 61(3)(a) of the *Regulated Activities Order.*

3 HIGH LOAN TO INCOME LIMIT

3.1 A *firm* must ensure that the number of *high loan to income mortgage contracts* it enters into in a *quarter* does not exceed 15% of all *regulated mortgage contracts* it enters into in that *quarter.*

3.2 The following are excluded from 3.1:

(a) *re-mortgages with no change to the principal sum outstanding;* and

(b) *lifetime mortgages.*