BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP 44/16

Amendments to the PRA's rules on loan to income ratios in mortgage lending

November 2016

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Responses are requested by 10 January 2017.

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1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed amendments to the Housing Part of the PRA Rulebook in respect of the Financial Policy Committee's (FPC) Recommendation on loan to income (LTI) ratios in mortgage lending in the owner occupied market. The CP also provides additional clarification regarding the scope of the LTI policy.

1.2 The FPC's Recommendation in June 2014[1] was addressed to the PRA and the Financial Conduct Authority (FCA). It asked them to ensure that mortgage lenders limit the number of new residential mortgage loans made with an LTI ratio at, or greater than, 4.5 to no more than 15% of their total number of new mortgage loans (the LTI flow limit).

1.3 Since the FPC's Recommendation the PRA has continuously reviewed the implementation of the LTI flow limit. The implementation of the LTI flow limit has not raised significant operational challenges for firms. However, the current fixed quarterly nature of the LTI flow limit could make it harder for some firms to manage their business pipeline.

1.4 This CP proposes to amend the PRA's rules to change the current fixed quarterly limit into a four-quarter rolling limit. In addition, this CP contains additional clarification on the scope of the LTI flow limit regarding interest roll-up bridging loans and mortgages 'ported' to another property where there is no increase in the principal outstanding. The PRA will continue to work together with the FCA to monitor developments relevant to the LTI flow limit.

1.5 In addition, as outlined in the November 2016 Financial Stability Report (FSR)[2] the FPC reviews its Recommendations on a regular basis to assess whether they remain appropriate. In concluding the 2016 review of its housing Recommendations, the FPC agreed to maintain the LTI flow limit recommendation at its current calibration.

1.6 This CP proposes no change to the existing scope of the rules. 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.

Purpose

1.7 This CP proposes amendments to PRA rules using the power in section 137G of the Financial Services and Markets Act (FSMA) so that the LTI limit operates on a four-quarter rolling basis, replacing the current fixed quarterly basis.

1.8 In accordance with section 138J of FSMA, the PRA has published proposed rules for consultation as an appendix to this CP.

Background

The loan to income flow limit

1.9 The FPC has responsibility to identify, monitor and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial

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1 FPC Recommendation on loan to income ratios, June 2014, www.bankofengland.co.uk/financialstability/Pages/fpc/loanincome.aspx.
2 Financial Stability Report, November 2016, www.bankofengland.co.uk/publications/Pages/fsr/2016/nov.aspx.

system. Under its power of Recommendation the FPC may make recommendations to the PRA and FCA about the exercise of their respective functions.

1.10 The FPC recommended in June 2014 that '*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*'. The Recommendation addresses a common risk to which many PRA and FCA firms are subject, namely the macroprudential risks arising from the very high LTI elements of mortgage lending carried out by firms.

1.11 The primary purpose of the FPC's Recommendation is to constrain excessive levels of household indebtedness which could, following a shock, result in financial and economic instability. In addition, the PRA's implementation of the Recommendation may also help to address risks against the safety and soundness of firms.

1.12 The PRA consulted on proposals to implement the FPC's Recommendation in CP11/14.[1] In October 2014 the PRA set out the final policy in PS9/14 and made the rules comprising the Housing Part of the PRA Rulebook[2].

Quarterly Nature of the Limit

1.13 The LTI limit was first implemented on a quarterly basis due to data quality concerns and to aid the monitoring of the limit. However, the fixed quarterly nature of the LTI flow limit can affect firms' ability to manage their business pipeline, as lenders can generally control mortgage approvals, but not completions. In addition, the seasonal nature of the mortgage market could create difficulties for firms, particularly for smaller lenders. Given improvements in data availability and quality the PRA considers it is appropriate to change the LTI limit so it operates on a four-quarter rolling basis.

Responses and next steps

1.14 Since the proposal does not represent a change in the scope of the existing policy and gives firms additional flexibility to comply with the limit, the consultation period will be six weeks. This will allow for a swifter implementation of the change, subject to comments received.

1.15 This consultation closes on 10 January 2017. The PRA invites feedback on the proposal set out in this consultation. Please address any comments or enquiries to CP44_16@bankofengland.co.uk.

2 Proposals

2.1 In this CP, the PRA sets out its proposal for amendments to the Housing Part of the PRA Rulebook so that the LTI flow limit applies on a four-quarter rolling basis, instead of being applied on a fixed quarterly basis.

2.2 The limit would still need to be complied with and monitored at the end of every quarter, but the relevant flows of loans for compliance with the limit would now be those during a rolling period of four quarters in total, instead of one quarter as currently applied. These four quarters refer to the immediate quarter under consideration and the three quarters preceding it (see paragraph 2.5).

1 PRA Consultation Paper 11/14 'Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending' June 2014: www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp1114.aspx.

2 PRA Policy Statement 9/14 'Implementing the Financial Policy Committee's Recommendation on loan to income ratios in mortgage lending', October 2014: www.bankofengland.co.uk/pra/Pages/publications/ps/2014/ps914.aspx.

2.3 The limit will continue to be monitored by the PRA using Product Sales Data (PSD) and the change would not affect PSD reporting practices.

Timing of implementation

2.4 The PRA is proposing that the change to the rules takes effect as soon as practical, with the aim that the first quarter in which the four-quarterly rolling limit would apply would be Q1 2017, subject to the responses to the CP. This would mean that starting from Q1 2017 the PRA would monitor the LTI flow limit on a four-quarter rolling basis, which for Q1 2017 would be incorporating data on flows from Q2 2016, Q3 2016, Q4 2016 and Q1 2017. It is important to note that compliance under a fixed quarterly limit (which is the current expectation) automatically implies compliance with the limit under a four-quarter rolling basis.

Worked Examples

Example 1: Comparing the current approach (quarterly limit) with the new proposal (four-quarter rolling limit)

2.5 Table 1 illustrates how the calculation relevant to the LTI flow limit under the current quarterly limit compares to the calculation under the new proposed changes. The table shows total loan flows by quarter (A to G) and total flows of loans with an LTI at or above 4.5 (a to g). The table shows that under the proposed changes, the relevant LTI limit calculation takes into consideration flows during the last four quarters, compared to flows during one quarter under the current limit. For example in Q1 of year 2, compliance with the LTI flow limit under a four-quarter rolling limit will be based on flows for Q2, Q3 and Q4 in year 1 and Q1 in year 2 (eg total loans flows A to D and total high LTI loan flows a to d). Under the current quarterly limit only flows in Q1 year 2 (d and D) would count.

Table 1: Comparing the current approach with the new proposal

Firm A's loan flows:

Quarters:	Q2 Year 1 **Q2 2016**	Q3 Year 1 **Q3 2016**	Q4 Year 1 **Q4 2016**	Q1 Year 2 **Q1 2017**	Q2 Year2 **Q2 2017**	Q3 Year 2 **Q3 2017**	Q4 year 2 **Q4 2017**
Total loan flows (volume)	A	B	C	D	E	F	G
Total loans with an loan-to-income >=4.5 (volume)	a	b	c	d	e	f	g

Firm A's calculation and compliance for the purpose of the LTI flow limit:

Quarters:	**Q2 2016**	**Q3 2016**	**Q4 2016**	**Q1 2017**	**Q2 2017**	**Q3 2017**	**Q4 2017**
Current Calculation: Percentage of flows with LTI>=4.5 under a ***quarterly limit***	a ÷ A <15%	b ÷ B <15%	c ÷ C <15%	d ÷ D <15%	e ÷ E <15%	f ÷ F <15%	g ÷ G <15%
Calculation under new proposal: Percentage of flows with LTI>=4.5 under ***four-quarter rolling limit***				(a+b+c+d) ÷ (A+B+C+D) <15%	(b+c+d+e) ÷ (B+C+D+E) <15%	(c+d+e+f) ÷ (C+D+E+F) <15%	(d+e+f+g) ÷ (D+E+F+G) <15%

Example 2: Numerical example of a case where a firm would be in breach of the LTI limit under the current approach, but would be compliant under the new proposal

2.6 The introduction of the four-quarter rolling-limit will allow firms to accommodate fluctuations and peaks in demand for high LTI mortgages. This is illustrated in Table 2. The table shows Firm A's total flows and flows of high LTI loans in the upper section of the table. In this example Firm A has issued 17.5% of its mortgages to high LTI customers during Q1 of Year 2, which could be due to fluctuations in demand. Under the current quarterly limit, Firm A would have been in breach of the LTI limit (as can be seen by the number highlighted in red).

2.7 However, under the proposed change to a four-quarter rolling limit, it is the total loan volumes during the four quarters up to Q1 of Year 2 (Q2, Q3, Q4 of Year 1 and Q1 of Year 2) that are taken into account and the firm would not breach the limit. Table 2 shows that during those four quarters Firm A issued 670 mortgages with an LTI equal to or greater than 4.5. During the same period the total volume of mortgages was 4600. This would mean that 14.6% of Firm A's mortgages had an LTI equal to or greater than 4.5 (therefore in compliance with the 15% limit).

Table 2: Numeric example of new proposal

Firm A's loan flows

Quarters based on PSD reporting:	Q1 Year 1 **Q2 2016**	Q2 Year 1 **Q3 2016**	Q3 Year 1 **Q4 2016**	Q4 Year 1 **Q1 2017**	Q1 Year2 **Q2 2017**	Q2 Year 2 **Q3 2017**	Q3 year 3 **Q4 2017**
Total loan flows (volume)	1100	1200	1100	1100	1200	1000	1100
Total loans with an loan-to-income >=4.5 (volume)	100	140	160	160	210	100	90

Firm A's calculation for the purpose of the LTI flow limit:

Quarters based on PSD reporting:	**Q2 2016**	**Q3 2016**	**Q4 2016**	**Q1 2017**	**Q2 2017**	**Q3 2017**	**Q4 2017**
Current calculation: Percentage of flows with LTI>=4.5 under a ***quarterly limit***	**9.1%** (100 ÷ 1100)	**11.7%** (140 ÷ 1200)	**14.5%** (160 ÷ 1100)	**14.5%** (160 ÷ 1100)	**17.5%** (210 ÷ 1200)	**10.0%** (100 ÷ 1000)	**8.2%** (90 ÷ 1100)
Calculation under new proposal: Percentage of flows with LTI>=4.5 under ***four-quarter rolling limit***	-	-	-	**12.4%** 100+140+160 +160 ÷ 1100+1200+ 1100+1100	**14.6%** 140+160+160 +210 =670 ÷ 1200+1100+ 1100+1200= 4600	**14.3%** 160+160+210 +100 ÷ 1100+1100+ 1200+1000	**12.7%** (160+210+100 +90) ÷ (1100+1200+ 1000+1100)

3 Additional clarifications

3.1 The PRA considers that the following additional clarification on specific points could be useful to market participants:

Interest roll-up bridging loans

3.2 Interest roll-up mortgages are ones which, among other things, do not require borrowers to make interest payments during the life of the loan. For this type of loan total interest is paid

only at the end of the maturity of the loan together with the principal repayment. For this reason conduct rules[1] do not require firms to undertake an assessment of affordability (including of income) before entering into an interest roll-up mortgage.

3.3 In consequence, the PRA notes that interest roll-up mortgages are not currently covered by the LTI flow limit. This is in line with the intention of the policy. However, the PRA will continue to monitor this sector and may take action in the future if necessary.

Mortgages 'ported' to another property where there is no increase in the principal outstanding

3.4 As highlighted in PS11/14, re-mortgages where there is no increase in the principal outstanding are excluded from the LTI flow limit. It does not matter whether the re-mortgage is in relation to the same property or 'ported' to a different property so long as there is no increase in the principal outstanding. As a result firms should exclude them from the calculation of the share of loans with an LTI equal to or greater than 4.5 relevant for the compliance with the LTI flow limit.

4 The PRA's statutory obligations

4.1 Before making any rules, FSMA[2] requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- an explanation of the purpose of the proposed rules;
- a statement as to whether the impact of the proposed rules will be significantly different on mutuals from its impact on other persons;[3] and
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duties to act in a way that advances its general objective[4] and its insurance objective[5] (if applicable) and the PRA's duties under the secondary competition objective.[6]

Cost benefit analysis

4.2 This section sets out the analysis of the costs and benefits of changing the LTI flow limit from a quarterly limit to a four-quarter rolling limit.

4.3 The PRA estimates that the costs to mortgage lenders associated with this policy change are limited. The change may lead to minimal system changes if firms chose to make changes to comply with the new approach. A four-quarter rolling limit may also be marginally more difficult to embed in firms' systems than a quarterly limit, but the PRA does not expect the proposal to generate material additional compliance costs to firms.

4.4 The PRA considers that the change may, over time, lead to marginally more loans with LTIs at or above 4.5 relative to the status quo, but the initial calibration remains unchanged. The

1 MCOB 11.6.57R of the Financial Conduct Authority's Handbook.
2 Section 138J of FSMA.
3 Section 138K of FSMA.
4 Section 2B of FSMA.
5 Section 2C of FSMA.
6 Section 2H(1) of FSMA.

PRA estimates that under a rolling limit the system-wide share of loans with LTIs at or above 4.5 could have been at most 9.5% of the total in Q4 2015 compared to the 9.0% under the current fixed quarterly limit.

4.5 The PRA considers that the benefits associated with this change largely outweigh the costs. A move to a four-quarter rolling limit could allow firms to smooth seasonal fluctuations in demand and facilitate forward-planning of mortgage pipelines. This makes it less likely that a firm would inadvertently breach the limit. In addition, to the extent that smaller firms may be more likely to experience large fluctuations in demand, the change to a rolling limit may reduce the burden on smaller firms and hence facilitate effective competition in the market.

Compatibility with the PRA's objectives

4.6 The proposal does not influence the policy calibration, which the FPC agreed to maintain at its current level as outlined in the November 2016 FSR, so there is no incremental impact on the safety and soundness of firms.

4.7 The PRA has assessed whether the proposal in this consultation facilitates effective competition. Given that the initial policy calibration is maintained, there is no direct change on how the LTI flow limit impacts competition. The policy may support effective competitiveness to the extent that it increases firms' flexibility in dealing with volatility in the mortgage market, which may affect smaller firms the most.

Regulatory Principles

4.8 In developing the proposal in this CP, the PRA has had regard to the regulatory principles. Two of the principles described below are of particular relevance.

4.9 The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction. The PRA has had regard to this principle when developing the proposal in this CP, which keeps the regulatory restrictions on lenders constant.

4.10 The principle that the regulators should exercise their functions as transparently as possible. The proposal keeps the clarity of the PRA's rule unchanged.

Impact on mutuals

4.11 In the PRA's opinion, the impact of the proposed rule change on mutuals is expected to be no different from the impact on other firms.

Equality and diversity

4.12 The PRA has performed an assessment of the policy proposal and does not consider that the proposal gives rise to any additional equality and diversity implications, relative to those initially identified when the policy was first implemented.

Appendix

PRA RULEBOOK: CRR FIRMS, NON CRR FIRMS: HOUSING INSTRUMENT (NO. 2) 2016

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 2016

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

Commencement

E. The Annex to this instrument comes into force on [DATE].

Citation

F. This instrument may be cited as the PRA Rulebook: CRR Firms, Non CRR Firms: Housing Instrument (No. 2) 2016.

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

Annex

In this Annex, deleted text is struck through and new text is underlined.

Part

HOUSING

Chapter content

1. **APPLICATION AND DEFINITIONS**
2. **HIGH LOAN TO INCOME ALLOWANCE**

Links

1 APPLICATION AND DEFINITIONS

…

1.11 In this Part the following definitions apply:

…

relevant period

means, in relation to a *quarter*, the *quarter* and the three consecutive *quarters* preceding it.

…

2 HIGH LOAN TO INCOME ALLOWANCE

2.1 Unless 2.3 or 2.4 apply, a *firm* must ensure that by the end of each *quarter* in which this Part applies the number of *high loan to income mortgage contracts* it enters into in ~~a *quarter*~~ the *relevant period* does not exceed 15% of all *regulated mortgage contracts* it enters into in that ~~*quarter*~~ *relevant period*.

…

2.3 A *firm* that has allocated any part of its high loan to income allowance to another member of the *group* must ensure that the number of *high loan to income mortgage contracts* it enters into in ~~a quarter~~ the *relevant period* does not exceed the amount specified in 2.1, as reduced by the amount of the high loan to income allowance it has allocated under 2.2.

2.4 A firm that is part of a *group* must ensure that the number of *high loan to income mortgage contracts* it enters into in ~~a quarter~~ the *relevant period* does not exceed the amount specified in 2.1, plus any high loan to income allowance allocated to it under 2.2.

…

2.5 In this chapter, a high loan to income allowance is the number of *high loan to income mortgage contracts* a firm may enter into in ~~a quarter~~ the *relevant period* in compliance with 2.1 without the modifications in 2.3 or 2.4 applied