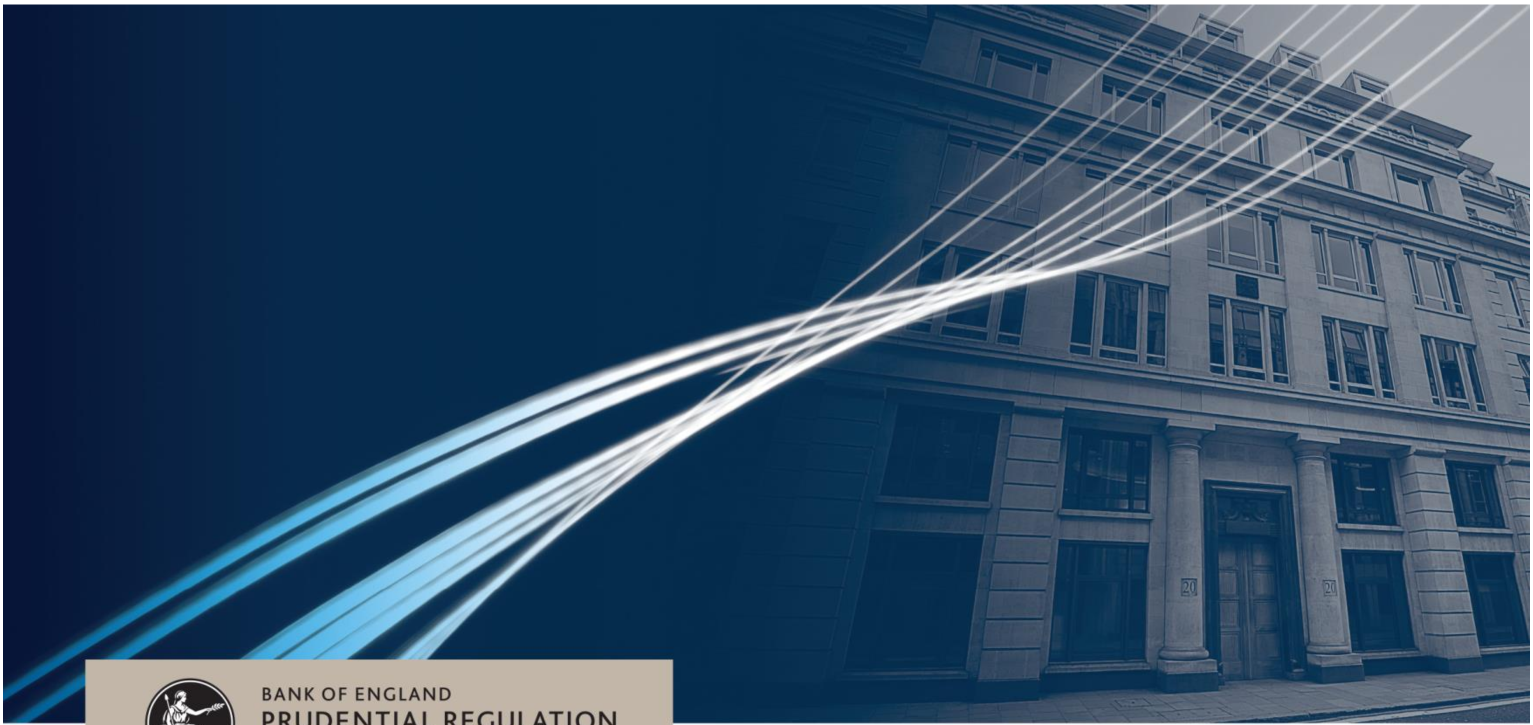

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP6/16

Amendments to the PRA’s rule on loan to income ratios in mortgage lending

February 2016

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP6/16

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

February 2016

The Bank of England and the Prudential Regulation Authority (PRA) reserve the right to publish any information which it may receive as part of this consultation.

Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure, in accordance with access to information regimes under the Freedom of Information Act 2000 or the Data Protection Act 1998 or otherwise as required by law or in discharge of our statutory functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England or the PRA receives a request for disclosure of this information, the Bank of England or the PRA will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England and the PRA.

Responses are requested by 11 March 2016.

Please address any comments or enquiries to:
Viji Viyakesparan
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP6_16@bankofengland.co.uk

Contents

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposal for amendments to the Housing Part of the PRA Rulebook in respect of second charge mortgage contracts.

1.2 From 21 March 2016 second and subsequent charge mortgage contracts will fall under the definition of a regulated mortgage contract. This change is part of the United Kingdom's implementation of the Mortgage Credit Directive (MCD), which applies equally to first and subsequent charge mortgages. The PRA's rules, which implement a Financial Policy Committee (FPC) recommendation, place a loan to income (LTI) flow limit on regulated mortgage contracts. Hence, the implementation of the MCD means that the LTI flow limit would automatically apply to second and subsequent charge mortgage contracts, which are currently exempt from the LTI flow limit.

1.3 This CP proposes to amend the PRA's rules in order to continue to exclude such second and subsequent charge mortgage contracts from the LTI flow limit at this time, with the intention to consult subsequently on including these loans in the LTI flow limit when loan level data becomes available in the course of 2017.[1] The PRA will continue to work together with the Financial Conduct Authority (FCA) to keep the size of the second and subsequent charge mortgage market under review.

1.4 In addition, the FPC has stated its intention to keep its recommendation under review.

1.5 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

Mortgage Credit Directive

1.6 The MCD comes into force on 21 March 2016 and introduces an EU-wide framework of conduct rules for mortgage firms. It is closely aligned with the United Kingdom's existing mortgage regulation. The MCD applies equally to first, second and subsequent charge mortgage contracts, so the government has decided that second and subsequent charge mortgage regulation should move from the FCA's consumer credit regime into the FCA's mortgage regime.[2] In this CP we refer to these additional mortgages as 'second charge mortgage contracts'.

The loan to income flow limit

1.7 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. Under its power of Recommendation the FPC can ask the PRA and FCA to take measures to mitigate risks.

1 From March 2016, second charge lenders will be required to report aggregate data on second charge mortgages on the Mortgage Lenders and Administrators Return (MLAR), and from April 2017, they will be required to report PSD loan level data.

2 www.fca.org.uk/firms/firm-types/mortgage-brokers-and-home-finance-lenders/mcd

1.8 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. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.'* The recommendation is a macroprudential measure, calibrated by the FPC on its view of the outlook for the housing and mortgage market in June 2014. 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.

1.9 The primary purpose of the FPC's recommendation is to constrain excessive levels of household indebtedness which could, following a shock, result in instability and so in turn threaten the safety and soundness of firms.

1.10 The FPC stated that the policy will be kept under review and will be adjusted as appropriate as circumstances change. If FPC were to amend its recommendation in the future the PRA would consult accordingly.

1.11 The PRA consulted on proposals to implement the FPC's recommendation in CP11/14.[1] In October 2014, PS9/14 set out the final policy,[2] including the new Housing Part of the PRA Rulebook.[3] The rule does not apply to several types of mortgage products.

Exemption of second charge mortgage contracts

1.12 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. Among the excluded products are second charge mortgage contracts. A second charge mortgage is a legal mortgage ranking in priority behind other mortgages (if any) affecting the land in question.[4]

1.13 The LTI flow limit applies to 'regulated mortgage contracts', as defined in Article 61(3)(a) of the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 (the Regulated Activities Order).

1.14 The definition of a regulated mortgage contract currently does not include second charge mortgage contracts. These have historically fallen into the regulatory regime set out in the Consumer Credit Act. The Mortgage Credit Directive Order[5] amends the definition of 'regulated mortgage contracts' in the Regulated Activities Order from 21 March 2016, so that it includes second charge mortgage contracts. Hence, bringing them into the scope of the FCA's mortgage regime.

1.15 Under the current wording of the PRA's LTI flow limit rule (Housing Part 1.11), the requirements apply in relation to 'regulated mortgage contracts' as that term is defined in the Regulated Activities Order. If no amendment is made, the LTI flow limit rule would automatically apply to second charge mortgages once they are included in the definition of a regulated mortgage contract in the Regulated Activities Order, from 21 March 2016.

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.
3 www.prarulebook.co.uk/rulebook/Content/Chapter/211180/07-01-2016
4 Where 'mortgage' includes charge and (in Scotland) a heritable security.
5 www.legislation.gov.uk/uksi/2015/910/contents/made

Purpose

1.16 This CP proposes amendments to PRA rules using the power in section 137G of the Financial Services and Markets Act (FSMA) to add to existing exceptions, so that the LTI limit rules do not apply in relation to regulated mortgage contracts that are second charge mortgage contracts. This is with the intention to consult subsequently on including these loans in the LTI flow limit when loan level data becomes available in the course of 2017.

1.17 In accordance with Section 138J FSMA, the PRA has published proposed rules for consultation as an appendix to this CP. Since the proposals retain the existing policy position and do not add new burdens to firms or any other person, there will be a four week consultation period.

Responses and next steps

1.18 This consultation closes on 11 March 2016. The PRA invites feedback on the proposal set out in this consultation. Please address any comments or enquiries to CP6_16@bankofengland.co.uk.

1.19 The PRA will publish a policy statement with feedback and finalised rules.

2 Proposals

2.1 In this CP, the PRA sets out its proposal for an amendment to the Housing Part of the PRA rulebook so that regulated mortgage contracts that are second charge mortgage contracts continue not to be subject to the LTI flow limit rules. This is with the intention to consult subsequently on including these loans in the LTI flow limit when loan level data becomes available in the course of 2017

2.2 The effect of the proposed amendment is to maintain the FPC's and the PRA's current policy towards second charge mortgage contracts under the LTI flow limit. A key factor for the PRA's decision to exempt second charge mortgage contracts was the lack of data for determining firms' compliance with the limit. The definitional change in regulated mortgage contracts does not bring an immediate substantive difference to the information available to monitor the recommendation. Hence, it still appropriate to keep second and subsequent charge mortgage contracts excluded from the LTI flow limit at this time.

2.3 The PRA will review this policy stance in light of upcoming improvements in data availability: This year firms will report aggregate data on second charge mortgages, and in the course of 2017, they will be required to report Product Sales Data (PSD) loan level data. The PRA and FCA will continue to work together to keep the size of the second charge mortgage market under review and may consider additional actions if necessary, for instance if firms appear to be using second charge lending to undermine the objective of the FPC recommendation.

Data availability for limit monitoring

2.4 The PRA's CP11/14 stated that *'second charge mortgages are excluded as they are not subject to Product Sales Data 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.'*

2.5 The PRA thus excluded second charge mortgage contracts from its original implementation of the LTI flow limit as they were not subject to PSD reporting. PSD reporting is used to determine (i) whether a firm is below the *de minimis* threshold on an ongoing basis and (ii) whether a firm has complied with the limit.

Ongoing monitoring of the second charge mortgage market

2.6 The PRA and FCA intend to keep the size of the second charge mortgage market under review to monitor whether the market grows and whether any firms appear to be using second charge lending to avoid exceeding the LTI flow limit. Forthcoming improvements in data availability on second charge loans will aid analysis by the FPC, the PRA, and the FCA.

3 The PRA's statutory obligations

3.1 Before making any rules, FSMA[1] requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons;[2]
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,[3] insurance objective[4] (if applicable), and secondary competition objective;[5] and
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with its duty to have regard to the regulatory principles.[6]

3.2 The PRA is also required by the Equality Act 2010[7] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.3 The proposal to maintain the current exemption for second charge mortgages would leave the current policy on second charge mortgage contracts unchanged. Thus it would not lead to incremental costs, benefits or competition implications.

Compatibility with the PRA's objectives

3.4 The proposal maintains the current policy stance, so there is no incremental impact on the safety and soundness of firms.

3.5 The PRA has assessed whether the proposal in this CP facilitates effective competition. The proposal maintains the current policy stance, so there is no impact on competition.

1 Section 138J of FSMA
2 Section 138K of FSMA.
3 Section 2B of FSMA
4 Section 2C of FSMA
5 Section 2H(1) of FSMA.
6 Sections 2H(2) and 3B of FSMA.
7 Section 149 of the Equalities Act 2010

Regulatory Principles

3.6 In developing the proposal in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance.

3.7 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 followed this principle when developing the proposal in this CP, which keeps the regulatory restrictions on lenders constant.

3.8 The principle that the regulators should exercise their functions as transparently as possible. The proposal adds clarity to the PRA's rule.

Impact on mutuals

3.9 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

3.10 The PRA has performed an assessment of the policy proposal and does not consider that the proposal gives rise to equality and diversity implications.

Appendices

1 Draft revisions to the PRA Rulebook

PRA 2016/XX

PRA RULEBOOK: CRR FIRMS, NON CRR FIRMS: HOUSING INSTRUMENT 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 Annex A to this instrument.

Commencement

E. Annex A of this instrument comes into force on 17 March 2016.

Citation

F. This instrument may be cited as the PRA Rulebook: CRR Firms, Non CRR Firms: Housing Instrument 2016.

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

Annex A

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

Part

HOUSING

Chapter content

Links

1 APPLICATION AND DEFINITIONS

1.11 In this Part the following definitions apply:

first charge

means a *legal mortgage* ranking in priority ahead of all other *legal mortgages* (if any) affecting the land in question;

regulated mortgage contract

has the meaning given in Article 61(3)(a) of the Regulated Activities Order, but:

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

(2) *lifetime mortgages;* and

(3) *regulated mortgage contracts* that are not *first charge regulated mortgage contracts*

must be disregarded.