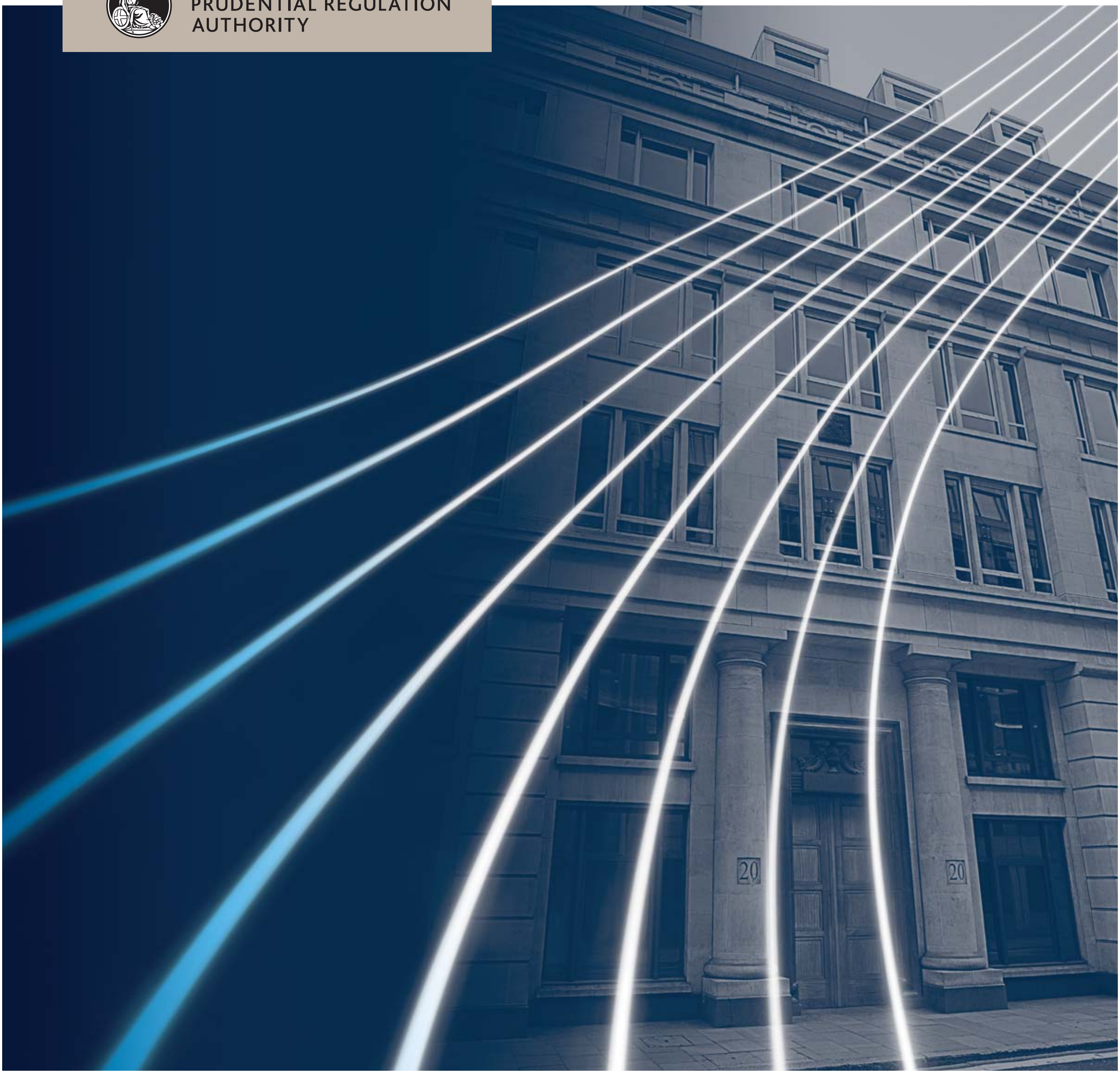
Policy Statement | PS9/14

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

October 2014

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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1 Summary

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to the responses to the draft rules consulted on in CP11/14 (the CP).(1) Appendix 1 of this PS contains the final rules implementing the loan to income (LTI) flow limit. This PS and rules are 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.

1.2 The PRA received a number of responses to the CP, which are addressed in more detail below. Changes are made to the *de minimis* threshold and the scope of application of the limit. A revision to the proposed notification of application has been reflected in the final rules. No other changes have been made to the proposals set out in the CP.

1.3 The final rules are set out in Appendix 1 of this PS.

2 Background to the consultation

2.1 In the CP the PRA set out proposals for implementing the Financial Policy Committee's (FPC's) recommendation that the PRA (and the Financial Conduct Authority (FCA)) take steps to ensure that mortgage lenders constrain the proportion of new lending at LTI ratios at or above 4.5 to no more than 15% of the total number of new mortgage loans.(2) The CP included draft rules necessary to implement the FPC's recommendation.(3)

2.2 As outlined in the FPC's June 2014 *Financial Stability Report*,(4) 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.

3 Feedback to responses

De minimis threshold

3.1 Several responses were received regarding the impact of the proposed policy on niche, typically small, lenders. In the CP, the PRA proposed a £100 million value *de minimis* threshold to ensure the LTI limit does not have a disproportionate effect on narrow segments of the market. Consultation responses highlighted that some niche lenders above the threshold would still be disproportionately affected.

3.2 As stated in the FPC record, this policy was designed as an '*insurance against the risk that there could be greater momentum in the housing market than currently anticipated*' and to that effect is not intended to be binding at this stage.(5) Responses related to niche lenders demonstrated that for them, the implementation of the LTI flow limit would be constraining, thereby immediately impacting their business model.

3.3 The PRA considers that it is appropriate to extend the *de minimis* threshold to apply on **either** a value **or** volume of lending basis. This means that lenders who extend less than £100 million in value **or** fewer than 300 in number of relevant regulated mortgage contracts(6) each year fall outside the scope of the policy. Although the limit will not apply to firms below the threshold the PRA will monitor the proportion of lending at high LTI ratios by these firms.

3.4 The PRA has decided to amend its proposals and will **not** notify firms if either of the threshold tests are met as lenders will be able to determine this for themselves from their submissions of the Product Sales Data.

Allocation of the high LTI allowance within a group

3.5 In the CP, the PRA proposed that the LTI flow limit would apply at the regulated entity level. Some respondents have raised concerns that this may disproportionately impact groups which contain more than one regulated entity that conducts mortgage lending. The PRA recognises that, as stated in the FPC's June 2014 *Financial Stability Report*, the FPC's primary interest in developing its recommendation is 'in ensuring that the proportion of very high LTI lending does not become excessive in aggregate'. The PRA therefore is content to allow a lender that is part of a group to allocate all

(1) *PRA Consultation Paper CP11/14*, 'Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending', June 2014; www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1114.pdf.
(2) 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 (2013/36/EU) and Capital Requirements Regulation (575/2013) (CRR) — jointly 'CRD IV'.
(3) '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.'
(4) www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.
(5) www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1407.pdf.
(6) As defined in the Housing Part of the PRA rules.

or part of its high LTI allowance to any other regulated entity within that group, as this should not affect the aggregate number of mortgages extended by that group. The PRA also acknowledges that some groups carry out their risk management functions at group level; giving firms the ability to apply the LTI limit across the group would assist these groups in monitoring risks arising from such lending.

Impact of changes to policy

3.6 The changes set out above will result in the LTI policy applying to fewer institutions than considered in the cost benefit analysis of the CP and results in a reduction of the costs of the policy. In addition, the changes mitigate the risk of a disproportionate impact of the policy on narrow segments of the market, thereby contributing to the PRA's secondary objective on competition. The PRA is of the view that the impact of the changes to the policy and rules on mutual societies is not significantly different to other lenders of similar nature and complexity.

Carry-over of unused lending capacity from one quarter to another

3.7 Some respondents thought that lenders ought to be able to roll over any underuse of their 15% limit from one quarter to the next with the aim of smoothing out seasonality or lumpiness in lending portfolios. The PRA considered this issue at the policy development stage and concluded that due to non-constant lending volumes carry-over risked complicating calculation of the limit. The PRA has therefore not changed its policy on this point.

Sunset clause

3.8 A number of respondents requested a commitment as to when the measure would be reviewed. The PRA intends to keep the operation of the policy under review as part of its normal functions. The FPC will also keep the recommendation under review and would adjust it if needed as circumstances change.

Relevant mortgages

3.9 A couple of queries were raised in relation to the types of mortgages which are in scope of the limit. The CP discussed the rationale for which mortgages are in scope of the limit in detail and the PRA is not changing its policy.

De minimis threshold

3.10 One respondent suggested a tapering of the *de minimis* threshold. The value of the threshold was recommended by the FPC and the PRA does not propose to implement a different threshold value. The PRA has clarified its rules to reflect that certain mortgages will be excluded for the purposes of both calculating the value of mortgages sold annually and the limit itself.

4 Commencement

4.1 These rules will come into force on 1 October 2014.

Appendix

1 PRA Rulebook: Housing Instrument 2014

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
1 October 2014

Annex A

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

Part

HOUSING

Chapter content

1 APPLICATION AND DEFINITION

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:

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

(2) 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:

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

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

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

(4) 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 total *credit* provided is or exceeds £100 million, but Condition A is not met if the *firm* entered into less than 300 *regulated mortgage contract*s in that period.

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, but Condition B is not met if the *firm* entered into less than 300 *regulated mortgage contracts* in each of those sets of four *quarters*.

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 (until Condition A or Condition B is met) if during both of two consecutive sets of four *quarters:*

(1) the *firm* has entered into *regulated mortgage contracts* under which the total *credit* provided is less than £100 million; or
(2) the *firm* has entered into less than 300 *regulated mortgage contracts*

in each of those sets of four *quarters*.

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

(1) a second set of four *quarters* ending on 30 September 2014 or on the last day of each subsequent *quarter*; and
(2) a first set of four *quarters* ending on the last day of the immediately preceding *quarter*.

1.11 In this Part the following definitions apply:

credit

means the cash loan provided by a *firm* under a *regulated mortgage contract*:

(1) at the time the *regulated mortgage contract* is entered into; or
(2) drawn down at a later date.

high loan to income mortgage contract

means a *regulated mortgage contract* under which the *credit* provided by a *firm* to an individual, or to individuals jointly, is or exceeds a multiple of 4.5 times the individual's *income*, or the individuals' joint i*ncome*, 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.

quarter

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

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:

(1) arrangement fees;
(2) professional fees and costs; and
(3) administration costs.

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*

must be disregarded.

2 HIGH LOAN TO INCOME ALLOWANCE

2.1 Unless 2.3 or 2.4 apply, 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.*

2.2 A *firm* that is part of a *group* may allocate all or part of its high loan to income allowance to any member of the *group*.

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* 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* does not exceed the amount specified in 2.1, plus any high loan to income allowance allocated to it under 2.2.

2.5 A *firm* must keep a record of any part of a high loan to income allowance it has allocated or received.

2.6 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* in compliance with 2.1 without the modifications in 2.3 or 2.4 applied.