Financial Conduct Authority

Guidance consultation

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

August 2014

Contents

1 Executive summary

1.1 This consultation sets out our – the Financial Conduct Authority's (FCA) – proposed general guidance in relation to the Financial Policy Committee's (FPC) recommendation on loan to income (LTI) ratios in mortgage lending. The recommendation is addressed to the FCA and the Prudential Regulation Authority (PRA). It asks the regulators 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 The PRA proposes to implement the FPC's recommendation by making a rule that applies 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.[1] The PRA rule also requires those firms to apply the rules at UK subsidiary level in relation to firms not already caught by the rules.

1.3 The FCA proposes to issue general guidance on its expectations of those mortgage lenders not caught by the PRA's rule. This consultation is, therefore, relevant to FCA-authorised mortgage lenders, in particular, those mortgage lenders with annual residential mortgage lending in excess of £100m, that are not a subsidiary of PRA-authorised firms described in paragraph 1.2.

2 Background

2.1 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.

2.2 In the June 2014 FSR, the FPC notes that the recovery in the UK housing market has been associated with a marked rise in the share of mortgages extended at high LTI 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

[1] See PRA Consultation Paper CP 11/14: Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending.

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 FCA regulates. This primarily advances our market integrity objective by reducing the chance of an unsustainable credit boom, which in turn leads to a more sound, stable, and resilient financial system. It is also compatible with our strategic objective of ensuring that the relevant markets function well.

2.3 In light of these views, the FPC decided at its June meeting to recommend that the FCA and the PRA take steps to ensure that larger lenders (i.e. with annual residential mortgage lending in excess of £100m) 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. 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 the underlying strength in the housing market turns out to be greater than expected.

2.4 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.

2.5 Given the number of FCA-authorised firms that are potentially in scope of the FPC recommendation (having excluded FCA-authorised mortgage lenders that are subsidiaries of PRA-authorised firms), we propose to issue general guidance on our expectations for firms to follow the recommendation. The general guidance will apply to mortgage lenders not caught by the PRA's rule.

3 Guidance summary

The recommendation

3.1 '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.'

3.2 We have considered the FPC's recommendation and this general guidance sets out what we expect firms to do to be consistent with that recommendation. We believe that issuing general guidance, and if appropriate, followed with supervisory action, is the most proportionate way to ensure that firms act in line with the recommendation. The proposed general guidance is set out in Annex I.

3.3 For firms in scope, the proposed general guidance suggests they should limit to no more than 15% 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 lending at such LTIs and can thus be thought of as a limit on the flow of very high LTI lending.

3.4 We propose that the general guidance comes into effect on 1 October 2014. Firms should be aware that, if issued, there will be no delay between issuing the guidance and it coming into effect and they may want to take account of that.

3.5 The FPC's recommendation 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, subject to other regulatory requirements such as those in the Mortgage Market Review[2], and commensurate with their risk appetite when taking individual lending decisions.

Equality and diversity

3.6 Under the Equality Act 2010, we must consider the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we assess the equality and diversity implications of any new policy proposals.

3.7 This measure is not expected to have an impact on mortgage lending and housing transactions in the near term. However, if the underlying strength in the housing market turns out to be greater than expected and the limit bites, the greatest impact is likely to be on first-time buyers, who tend to be younger borrowers, and will tend to apply for higher LTI mortgages, and on single income households.

3.8 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 2.2 and 2.3 above, we are content that any less favourable treatment of younger groups pursues a legitimate aim and is a proportionate approach.

[2] The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) 11.6

4 Guidance details

Reporting and definitions

4.1 We will monitor firms' mortgage lending on the basis of their Product Sales Data (PSD) returns. 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 should not be 15% or more of the sum of the former. Mortgage types that 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. We will determine whether firms should limit their mortgage lending with high LTI ratios on the basis of their PSD returns.

4.2 So we propose to use PSD returns to determine:

(i) whether a firm is above or below the de minimis threshold of £100 million per annum at the time the guidance come into effect

(ii) whether a firm is above or below the de minimis threshold on an ongoing basis and

(iii) whether a firm's mortgage lending has been consistent with the expectation on the LTI limit

4.3 The FPC is concerned about the increase in household indebtedness. This means that it is irrelevant whether the lender at the point of origination continues to hold the mortgage or has transferred or disposed of the asset. The overall increase in household indebtedness arose at the original lender. Therefore, for the purposes of this guidance, in circumstances where the original lender has transferred or disposed of the asset, the mortgage should still form part of the original lender's calculations.

4.4 The proposal is for the limit to apply at regulated entity level. The de minimis threshold and limit are also intended to be applied to each regulated entity separately.

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

4.6 If a firm extends 15% or more of its total number of new residential mortgages at LTI ratios at or greater than 4.5, we may, on our own initiative, require the firm to stop entering into high LTI mortgage contracts.

Pipeline lending

4.7 We propose that all new lending completed from 1 October should count towards the limit, regardless of when the mortgage offer may have been made or decision in principle issued.

4.8 Typically, lending decisions take between three and six months. We do not believe that lending decisions taken before the date of this consultation will have a significant impact on lenders' abilities to carry on their lending activities consistent with our expectations on the limit in the first quarter following the proposed implementation date (i.e. Q4 2014). This is because most mortgage offers made before we consulted will have completed before we issue the final guidance on this.

Exclusions

4.9 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.

Re-mortgages

4.10 Re-mortgages with no increase in principal (i.e. the original amount borrowed) do not constitute an increase in indebtedness. So, this type of re-mortgage, whether with the same provider or a new provider, is not counted towards the limit.

4.11 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 then we do not consider that this constitutes an increase in principal.

4.12 Re-mortgages with no increase in principal with the same provider are not captured by PSD returns and so firms do not need to take further action. Firms will still need to identify re-mortgages with a new provider with no increase in principal in PSD returns.

4.13 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 should 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.

Other exclusions

4.14 Lifetime mortgages and equity release products are excluded as they do not conform to the typical measures of loan and income.

4.15 Second charge mortgages are excluded for the present as they are not currently subject to PSD reporting, although they will be regulated from March 2016. 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. Although outside the limit, we expect firms to take the intended outcome of this limit into consideration when agreeing to second charge mortgages.

4.16 Buy-to-let mortgages are excluded as they are not a regulated mortgage product. We are conscious, however, that 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 we do not anticipate that this will become a material point of leakage but we expect firms to ensure that application verification procedures for buy-to-let products are robust.

De minimis threshold

Firms in scope on the day the guidance comes into effect

4.17 We propose that the general guidance comes into effect on 1 October 2014. On that day, we would expect 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 limit) equal to £100m or more over the following four reported quarters preceding the guidance coming into effect (i.e. Q3 2013, Q4 2013, Q1 2014, Q2 2014) to act in a way consistent with the expectations in the guidance. So a firm will be in scope of the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC. This is Condition A in the guidance. PSD reporting will be used to determine whether this total has been reached.

4.18 Lenders who have not completed regulated mortgage contracts equal to £100m or more in the four reported quarters (i.e. Q3 2013, Q4 2013, Q1 2014, and Q2 2014) will be outside of the scope of the proposed LTI limit at the date the guidance is proposed to apply.

Conditions for moving in and out of scope after the guidance applies

4.19 After the guidance comes into effect, PSD returns will be used to verify whether individual firms continue to meet the de minimis threshold test. So that firms do not move in and out of scope of the limit on a quarterly basis, the guidance proposes that certain conditions should apply. This also provides certainty for both the FCA and the firm on the expectations that are relevant.

4.20 If a firm's lending over two consecutive rolling periods of four quarters reach or exceed a value of £100m, it should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC. We intend to notify firms with lending approaching or reaching £100m over one four quarter period. We also intend to notify firms whose lending reaches or exceeds £100m over two consecutive rolling four quarter periods so that they will be aware that they are in scope of the expectations in the guidance. This is Condition B in the guidance.

4.21 Once a firm is in scope, the expectation is that a firm should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC unless its lending over two consecutive rolling periods of four quarters is less than £100m. A firm could fall into scope again if the value of its mortgage loans exceeds £100m for two consecutive rolling periods of four quarters.

Worked example

4.22 For the period 1st July 2013 to 30 June 2014 (Q3 2013 to Q2 2014), Firm X, Firm Y and Firm Z each submit four product sales data (PSD) returns. The cumulative total value of mortgages reported in those four returns for Firm X and Firm Y respectively is less than £100m and for Firm Z it is greater 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 guidance would apply. Firm Z is determined to be above the threshold and therefore in scope of the limit on the date the proposed guidance would apply. So Firm Z is expected to limit the number of mortgage loans at or above the LTI limit.

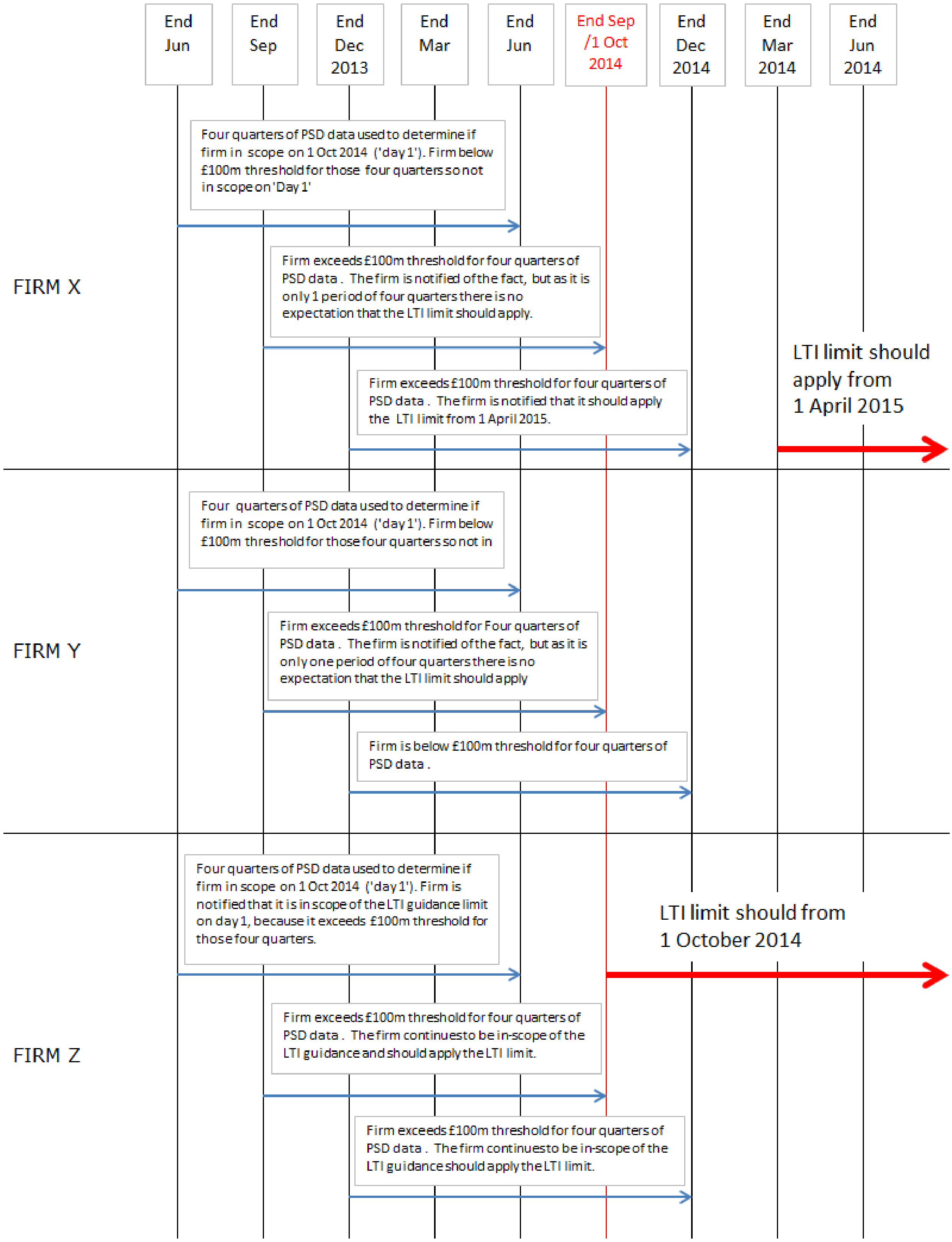
4.23 We repeat the threshold test when the Q3 2014 PSD returns are submitted. The relevant period is now 1 October 2013 to 30 September 2014 (Q4 2013 to Q3 2014). The cumulative total value of mortgages reported in those four returns for Firm X and Firm Y respectively is equal to or greater than £100m. We notify both firms of this fact but there is no expectation that the firms should limit the number of mortgage loans at or above the LTI limit at this stage. The cumulative total value of mortgages reported in those four returns for Firm Z is equal to or greater than £100m. Firm Z continues to be in scope of the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC.

4.24 We repeat the threshold test when the Q4 2014 PSD returns are submitted. The relevant period is now 1 January 2014 to 31 December 2014 (Q1 2014 to Q4 2014). The cumulative total value of mortgages reported in those four 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, we notify Firm X that it will be within scope of the expectations of the guidance. So Firm X will be expected to adjust its mortgage lending activities to be consistent with the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC from the next applicable quarter (Q2 2015) beginning on 1 April 2015. However Firm Y remains below the threshold and out of scope of the expectations in the guidance on the LTI limit.

4.25 The cumulative total value of mortgages reported in those four returns for Firm Z is equal to or greater than £100m. Firm Z continues to be in scope of the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC.

4.26 This example is illustrated in the following diagram.

Illustration of worked example



5 How to respond to this consultation

5.1 We are asking for your written responses to this consultation by close of business on 5 September 2014. We cannot guarantee that we will consider any responses received after this date.

5.2 You can send your response by email to LTIratios@fca.org.uk or by post to:

Hillary Neale,
Policy, Risk & Research Division
The Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Annex I

THE FINANCIAL POLICY COMMITTEE'S RECOMMENDATION ON LOAN TO INCOME RATIOS IN MORTGAGE LENDING:

GENERAL GUIDANCE

A. Application and interpretation

Status of guidance

1. This is general *guidance* given under section 139A(1) of the Financial Services and Markets Act 2000 with respect to the functions of the *FCA*.

2. This *guidance* on the Financial Policy Committee's (FPC) recommendation on loan to income ratios primarily advances the *FCA's* market integrity objective as it leads to macroeconomic stability by reducing the chance of an unsustainable credit boom, which in turn leads to a more sound, stable and resilient financial system. Doing so is also compatible with the *FCA's* strategic objective by ensuring that the relevant markets function well.

3. This *guidance* sets out the *FCA's* expectations for following the FPC's recommendation.

Application

4. This *guidance* applies to a *firm* with *Part 4A permission* that includes *entering into a regulated mortgage contract* as lender, except if it is:

   (1) a *bank*; or

   (2) a *building society*; or

   (3) a *subsidiary undertaking* of a *bank* or *building society* with *Part 4A permission* that includes *entering into a regulated mortgage contract* as lender; or

   (4) an *insurer*; or

   (5) a *friendly society*; or

   (6) a *credit union*.

5. As this *guidance* applies only to a *firm* with *Part 4A permission*, it does not apply to an *incoming EEA firm* (unless it has a *top-up permission* that includes *entering into a regulated mortgage contract* as lender).

6. This *guidance* applies to an *overseas firm* only in relation to activities carried on from an establishment in the *United Kingdom*.

Interpretation

7. Interpretative provisions (including definitions in the *Glossary*) of the *Handbook* apply to this *guidance* in the same way they apply to the *Handbook*, except where a definition is otherwise provided in paragraph 9 that definition applies for the purpose of this *guidance*.

8. Where an expression in italics is not defined in the *Glossary*, it has the meaning given in paragraph 9.

Glossary of terms defined in this guidance

9. For the purpose of this *guidance*, the following definitions apply:

credit	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	any of the four calendar quarters of each calendar year.
high loan to income mortgage contract	a *regulated mortgage contract* under which the *credit* provided by a *firm* to an individual, or individuals jointly, is at, or exceeds, the *loan to income ratio*.
income	the gross annual income, before tax and 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.
loan to income ratio	a multiple of 4.5 times of an individual's *income* or individuals' joint *income*, at the time at which that *income* is assessed by a *firm* for the purpose of entering into a *regulated mortgage contract* with the individual or individuals.
re-mortgage with no change to the principal sum outstanding	a *regulated mortgage contract* in respect of which the following conditions are met: (a) the amount of *credit* provided under the *regulated mortgage contract* does not exceed that outstanding to: (i) the *firm*; or

(ii) 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*; and

(b) in determining the amount of *credit* provided, no account is taken of:

(i) arrangement fees;

(ii) professional fees and costs; and

(iii) administration costs.

B. Guidance to firms

De minimis conditions

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

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

12. In this *guidance*, two consecutive sets of four *quarters* is computed as follows:

(1) a new set of four *quarters* starts at the beginning of each new *quarter*;

(2) the four *quarters* in each set run consecutively; and

(3) for the purpose of Condition B:

(a) the first set of four *quarters* end on [30 June] 2014 and the second set of four *quarters* ends on [30 September] 2014; and

(b) thereafter:

(i) a first set of four *quarters* ends on [30 September 2014] and each subsequent *quarter* that follow; and

(ii) followed by a second set of four *quarters* ending on [31 December 2014] and each subsequent *quarter* that follows.

High loan to income limit

13. If either Condition A or Condition B is met in relation to a *firm*, the *FCA* expects the number of *high loan to income mortgage contracts* that the *firm* enters into in a *quarter* not to exceed 15% of all *regulated mortgage contracts* it enters into in that *quarter*.

14. Where Condition A is met, the *firm* should carry on its *regulated activity* of *entering into a regulated mortgage contract* in a way that is consistent with the expectation in paragraph 13 from the *quarter* beginning on [1 October] 2014.

15. Where Condition B is met, the *firm* should carry on its *regulated activity* of *entering into a regulated mortgage contract* in a way that is consistent with the expectation in paragraph 13 from the start of the second *quarter* following the end of the final *quarter* relevant to the determination that Condition B has been met in relation to the *firm*.

16. Once either Condition A or Condition B is met, the *firm* should carry on its *regulated activity* of *entering into a regulated mortgage contract* in a way consistent with the expectation in paragraph 13 until Condition C is met.

Condition when expectation ceases

17. Condition C is if during both of two consecutive sets of four *quarters*, the *firm* has entered into *regulated mortgage contracts* under which the sum of ~~total~~ credit provided in each set of four *quarters* is less than £100 million.

Worked example

18. This paragraph explains the *guidance* by a worked example.

> For the period 1 July 2013 to 30 June 2014 (Q3 2013 to Q2 2014), Firm X, Firm Y and Firm Z each submit four product sales data (PSD) returns. The cumulative total value of mortgages reported in those four returns for Firm X and Firm Y respectively is less than £100m and for Firm Z it is greater 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 guidance would apply. Firm Z is determined to be above the threshold and therefore in scope of the limit on the date the proposed guidance would apply. So Firm Z is expected to limit the number of mortgage loans at or above the LTI limit.
>
> We repeat the threshold test when the Q3 2014 PSD returns are submitted. The relevant period is now 1 October 2013 to 30 September 2014 (Q4 2013 to Q3 2014). The cumulative total value of mortgages reported in those four returns for Firm X and Firm Y respectively is equal to or greater than £100m. We notify both firms of this fact but there is no expectation that the firms should limit the number of mortgage loans at or above the LTI limit at this stage. The cumulative total value of mortgages reported in those four returns for Firm Z is equal to or

greater than £100m. Firm Z continues to be in scope of the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC.

We repeat the threshold test when the Q4 2014 PSD returns are submitted. The relevant period is now 1 January 2014 to 31 December 2014 (Q1 2014 to Q4 2014). The cumulative total value of mortgages reported in those four 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, we notify Firm X that it will be within scope of the expectations of the guidance. So Firm X will be expected to adjust its mortgage lending activities to be consistent with the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit as recommended by the FPC from the next applicable quarter (Q2 2015) beginning on 1 April 2015. However Firm Y remains below the threshold and out of scope of the expectations in the guidance on the LTI limit.

The cumulative total value of mortgages reported in those four returns for Firm Z is equal to or greater than £100m. Firm Z continues to be in scope of the expectations of the guidance and should limit the number of mortgage loans at or above the LTI limit.

Exclusions

19. The following are excluded from the expectation on high loan to income limit set out in this *guidance*:

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

(2) *lifetime mortgages*.

C. Monitoring

20. The *FCA* will use product sales data returns to monitor which *firms* meet the de minimis conditions in paragraphs 10 or 11.

21. When *firms* meet the de minimis conditions in paragraphs 10 or 11, the *FCA* will monitor their *regulated activity* of *entering into a regulated mortgage contract* for consistency with the expectation in paragraph 13.

22. When a *firm* meets the de minimis conditions in paragraph 10 or 11 but has not carried on its *regulated activity* of *entering into a regulated mortgage contract* in a way that is consistent with the expectation in paragraph 13, the *FCA* may consider using its power under section 55L of the *Act* to, on its own initiative, require the *firm* to stop entering into *high loan to income mortgage contracts*.