EBA/Op/2015/09

01 June 2015

Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties

Introduction and legal basis

1. Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive) ('MCD')[1] sets out provisions in the area of assessing the consumer's creditworthiness (Articles 18 and 20(1)); and arrears and foreclosure (Article 28). In order to ensure a uniform and consistent application of these provisions and with a view to establishing consistent, efficient and effective supervisory practices across the 28 EU Member States, the EBA has issued Guidelines on Creditworthiness Assessment[2] and Guidelines on Arrears and Foreclosure[3] ('the two sets of guidelines'). The two sets of guidelines provide greater detail on how to give effect to the relevant provisions of Articles 18 and 20(1) and Article 28 of the MCD.

2. Depending on their national regulatory objectives, the national competent authorities may also, while developing their regulatory approaches to comply with the specific provisions of Articles 18, 20(1) and 28 of the MCD and the two sets of guidelines, consider developing regulatory approaches on aspects that are wider in scope or are not directly dealt with in the provisions of Articles 18, 20(1) and 28 of the MCD and the two sets of guidelines.

3. To that end, the EBA wishes to support and assist the competent authorities through the collection and publication in this Opinion of regulatory and market practices, from across the

[1] Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive) (MCD) (OJ L 60, 28.2.2014, p. 34).

[2] http://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-creditworthiness-assessment

[3] http://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-arrears-and-foreclosure

membership of the European Union, in the areas of creditworthiness assessment and arrears and foreclosure.

4. The evidence for this Opinion is drawn from an EBA survey of national supervisory as well as more general market practices in respect of both responsible lending (creditworthiness assessment) and the treatment of borrowers in mortgage payment difficulties (arrears and foreclosure). On responsible lending, this survey collected information from the competent authorities on the consistency between national practices and the Financial Stability Board's Principles for Sound Residential Mortgage Underwriting Practices ('the FSB Principles')[4]. In respect of the treatment of borrowers in mortgage payment difficulties, the EBA survey collected information on the national supervisory and market approaches to key consumer protection outcomes identified by EBA members. The collected information was published in two opinions on 13 June 2013 ('the 2013 Opinions'): the EBA's Opinion on Good Practices for Responsible Mortgage Lending and the EBA's Opinion on Good Practices for the Treatment of Borrowers in Mortgage Payment Difficulties.

5. To take account of the MCD and the two sets of guidelines, the 2013 Opinions have been updated and revised to include only practices which are in addition to the specific provisions of Articles 18, 20(1) and 28 of the MCD and the two sets of guidelines. For example, the good practices on creditworthiness assessment include the wider scope of responsible mortgage lending. In addition, having regard to the benefits to both consumers and creditors and the importance of addressing mortgage payment difficulties early, even before arrears occur, the EBA has expanded its Opinion to include expected mortgage payment difficulties. Good Practice 13, in particular, relates to expected mortgage payment difficulties.

6. These good practices are intended as a support for the competent authorities in developing their national supervisory approaches. The good practices address credit agreements covered under the MCD. They should not be seen as an exhaustive list of good practices. Also, as an EBA opinion addressed to the competent authorities, they are legally not binding.

7. The EBA competence to deliver an opinion is based on Article 29(1) (a) of Regulation (EU) No 1093/2010[5].

8. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors[6], the Board of Supervisors has adopted this opinion.

---

[4] The Financial Stability Board published its high level principles in 2012 following a peer review of national approaches to mortgage underwriting. Available at: http://www.financialstabilityboard.org/wp-content/uploads/r_120418.pdf?page_moved=1

[5] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[6] Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11 December 2013 (Decision EBA DC 001 (Rev3)).

General proposals on good practices

9. As the good practices in this Opinion relate to two different areas of mortgage practice, they are set out under the following distinct headings:

    a. specific comments on creditworthiness assessment (Good Practices 1 to 12);

        i. the verification of information;

        ii. reasonable debt service coverage;

        iii. appropriate loan-to-value ratios;

        iv. lending and supervisory processes;

    b. specific comments on arrears and foreclosure including expected mortgage payment difficulties (Good Practices 13 to 17).

10. In the case where the activity of the creditor is in whole or in part outsourced to third parties, or carried out by another entity in other ways, creditors should ensure that in doing so they comply with the requirements established in the CEBS Guidelines on outsourcing[7]. This includes, in particular, CEBS guideline 2, which provides that 'the ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management'.

11. Given the consumer protection focus of this Opinion, it inevitably concentrates on the treatment of the consumer. However, the consumer's creditworthiness assessment and arrears and foreclosure can have important implications for others, not least any third parties acting as guarantors. The competent authorities may wish to ensure that when considering these good practices they also have regard to the interests of these guarantors, by extending to them the good practices concerned with the provision of information by creditors.

Specific comments on good practices for creditworthiness assessment

12. The good practices in this Opinion address the assessment of creditworthiness in the wider context of responsible mortgage lending, and therefore reflect the FSB Principles and the findings of the EBA survey of competent authorities. Considering the distinct real estate markets, cultural differences and socioeconomic policies that shape each national mortgage market, the applicability, effectiveness and appropriateness of the good practices may vary across EU markets.

[7] See CEBS (2006), *Guidelines on outsourcing*, at https://www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf.pdf

Verification of information

13. Prior to the financial crisis, it had become common practice in certain markets for some mortgage borrowing to be available without the consumer having to prove their income. These mortgages were typically marketed as self-certification mortgages. The subsequent performance of such mortgages has underlined a key aspect of sound mortgage underwriting – that the consumer should be able to demonstrate that they have the resources to repay the loan (and not simply be allowed to claim that they have these resources).

Good practice 1: It is good practice to require that creditors, when verifying the consumer's income, expenses, and other financial and economic circumstances use necessary, sufficient and proportionate information that can be evidenced and that is provided by sources that are independent of the consumer.

14. Responsible lending practices require the necessary information to support and verify the declared income of the consumer. As well as requiring this information, there is a need for adequate records to be kept to substantiate the robustness of the checks made. This will allow creditors to review and ensure their own adherence to responsible lending principles – and also means that this could be subsequently demonstrated to the competent authority.

Good practice 2: It is good practice to require creditors to specify their approach to income verification and the records to be kept.

15. The robustness of financial systems depends, at least in part, on their ability to prevent, combat or mitigate fraud risks. Mortgage lending is no different from this. Responsible mortgage lending means that creditors have regard to the potential for false or misleading information to be used in mortgage applications. Where fraud is identified, the competent authorities may wish to consider the wider availability of sanctions (e.g. criminal law) to address this.

Good practice 3: It is good practice to consider, when fraud is detected, if it is appropriate to have recourse to the jurisdiction's legal system, where this is possible.

Reasonable debt service coverage

16. Verifying the income is just one element of a responsible lending decision. Basing a lending decision solely on the income without also having regard to commitments and expenditure provides no guarantee of consumer protection or the sustainability of the loan. To ensure these objectives, creditors need to capture additional information from the consumer. Creditors are also likely to need to make realistic assumptions about future circumstances. A responsible lending decision might be informed by an awareness of the potential for interest rate changes and foreseeable events (e.g. the likelihood of income changing where the mortgage extends into retirement).

Good practice 4: It is good practice to:

i. **specify aspects of the detailed assessment (such as the information to be gathered about the consumer's personal circumstances and financial situation) or assumptions to be used in the assessment (such as the maximum loan term);**

ii. **specify, or require creditors to specify, lending thresholds that might act as a backstop to any individual assessment of affordability.**

17. While it is possible to verify income, it is much more difficult (if not impossible) to verify the consumer's outgoings. Given this, it is reasonable to expect creditors to consider the range of available information (actual or modelled) to inform their thinking about the affordability of any mortgage a consumer applies for. This will require, in turn, having a view as to the 'available' income left with the consumer after meeting all their expenditure and commitments.

Good practice 5: It is good practice to require that creditors should also include risk limits in their internal loan policies, such as specifying minimum levels of residual net income after meeting obligations or fixed ratios of repayment to some measure of gross or net income (e.g. debt-to-income ratio, loan-to-income ratio). (FSB Principle 2.2)

Good practice 6: To supplement this, it is good practice to encourage creditors to define a risk strategy as part of their business strategy.

18. In some mortgage markets the interest rate may be fixed for the entire term, or reset after an agreed period. However, many other mortgages have the potential for much more significant change during the term. Some mortgages offer an initial discount period, after which the interest rate increases. With variable rate mortgages, the interest rate can change frequently, often as a result of a movement in an external reference rate. It is good practice for the assessment of affordability to have regard to changes of this kind, which are not predictable but where there is a clear likelihood that change may happen.

Good practice 7: It is good practice to ensure that creditors should include an increase in benchmark interest rates in the case of variable rate mortgages. As such, repayment capacity calculations could take into account the highest payment currently scheduled to apply during the term of the loan rather than solely utilising the first few payments at the prevailing interest rate or foreign exchange rate. (FSB Principle 2.3)

Good practice 8: It is good practice to specify criteria or a framework for creditors when stress testing affordability calculations.

Appropriate loan to value ratios

19. Loan-to-value (LTV) ratios are not used in all markets, as clearly demonstrated in the FSB peer review published in 2010[8]. Rather, there is a mix of approaches, with some relying either on market practice or the regulatory incentive of a reduced capital requirement for lower LTV lending. The latter is consistent with the approach of Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (Capital Requirements Directive)[9].

20. Where LTV ratios are used, their purpose might be macro- or micro-prudential, as well as (or instead of) consumer protection. LTVs, and other lending thresholds, can add some consumer protection value. However, by their nature, they cannot replace the individual assessment of loan affordability that should be at the heart of the consumer protection objective of ensuring responsible lending. This should be borne in mind when considering the good practices that follow in this section.

Good practice 9: It is good practice to ensure that creditors adopt prudent LTV ratios with an appropriate level of down payment that is substantially drawn from the consumer's own resources, not from, for example another provider of finance, to ensure the consumer has an appropriate financial interest in the collateral. (FSB Principle 3.2)

21. Of course, wherever any reference is made to the LTV it is vital that this is properly established. A failure to properly establish the extent of the secured borrowing, or the effective (rather than notional) property value will restrict its usefulness.

Good practice 10: Where national frameworks specify controls, standards or incentives on LTV (loan-to-value) ratios, it is good practice to ensure that creditors satisfy themselves that the LTV ratio takes into consideration the 'real value' of the available equity, which could be calculated on the basis of (i) a robust and prudent approach to property appraisals[10]; (ii) all loans that are collateralised against the same property or for financing part of the cost of the property. This should include loans provided alongside the main mortgage (e.g. top-up loans, renovation or decoration loans); and (iii) any increase in loan authorisation being subject to a full assessment of the consumer's repayment capacity and to an appropriate LTV ratio at the point of the new mortgage underwriting, and not rely on the excess equity. Any subsequent refinancing utilising a second charge or lien should lead to the calculation of a new LTV ratio where possible. Particular caution should be exercised about drawing down on the equity in the property if that would raise the current LTV ratio above the level originally agreed. (FSB Principle 3.3)

[8] http://www.financialstabilityboard.org/publications/r_110318a.pdf

[9] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:01:en:HTML

[10] The prudential interest in a robust approach to collateral management is addressed in detail in FSB Principle 4.

Lending and supervisory processes

22. Consumers will vary greatly in their needs, personal circumstances and level of knowledge. These factors can make for differences in the risks that mortgage borrowing poses – both for them and for creditors. It is clearly open to creditors to limit mortgage availability to consumers whom they see as having certain risk characteristics. Equally though, a creditor may choose to consider wider (or several targeted) consumer markets, and to adequately capture the different risks within their lending model.

23. Responsible mortgage lending is the result of creditors adopting and following a robust set of practices. These practices should operate in combination to deliver the desired outcome. So, for example, consumer protection will not be assured if the creditor verifies income information but then fails to, alongside this, consider the consumer's expenditure and commitments in a proper assessment of affordability. Creditors will want to ensure that they have the policies and procedures in place to ensure that their responsible lending approach is appropriately comprehensive and effective. Competent authorities will have a clear interest in understanding how creditors ensure their lending is responsible.

Good practice 11: It is good practice to require creditors to identify groups of loans with a higher risk profile and that these loans be underwritten to a set of norms specific to them. (FSB Principle 7.3)

Good practice 12: To supplement this, it is good practice to require creditors to specify a responsible lending policy setting out their assessment of the risks and the practices and procedures that are in place to ensure that their lending is responsible.

Specific comments on good practices for arrears and foreclosure, including expected mortgage payment difficulties

24. Even before the borrower is in payment difficulties there are usually warning signs for problem loans. Identifying and monitoring indicators, such as a borrower's request to reduce/delay a payment, could be a cost effective approach to prevent the borrower going into over-indebtedness.

25. Taking action to engage with the borrower, by providing support and information before the payment difficulties occur may prevent an arrears situation from developing, and where arrears do subsequently develop, early engagement may quicken the resolution of the arrears situation.

26. It is also important that borrowers are encouraged to engage with the creditor about any expected financial difficulties which may prevent them from meeting the scheduled repayment.

Good practice 13: It is good practice to ensure that, where applicable, creditors apply the EBA's Guidelines on Arrears and Foreclosure[11] to the treatment of borrowers in expected mortgage payment difficulties.

27. Where a creditor intends to involve a third party to collect debts on its behalf, it is important that this information is conveyed and explained to the borrower so that they have a clear understanding of the role and activities of the third party.

Good practice 14: It is good practice to ensure that creditors inform the borrowers in payment difficulties where they intend to involve a third-party debt collection agency in dealing with the borrowers.

28. The provision of information and assistance to the borrower is essential to a mutually beneficial resolution of the issue.

Good practice 15: It is good practice to ensure that creditors provide the following information in a timely manner to the borrower: information regarding the consequences of missing payments (e.g. legal procedures, costs, default interest rate, possible loss of property, etc.); and information about the timelines of the resolution process.

Good practice 16: It is good practice to ensure that where the payment difficulties persist, the creditor provides an updated version of this information to the borrower every quarter.

Good practice 17: It is good practice to consider the role for information or advice from the creditor in preventing or mitigating payment difficulties where:

- **there is evidence to suggest the borrower is potentially in difficulties; or**
- **the borrower has recently recovered from payment difficulties.**

Done at London, 01 June 2015

[signed]

Andrea Enria

Chairperson
For the Board of Supervisors

[11] http://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-arrears-and-foreclosure