



Finalised guidance

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

October 2014

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1 Background

Basis for the Financial Policy Committee's recommendation

- 1.1 In June 2014, the Financial Policy Committee (FPC) noted that the recovery in the UK housing market was 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.
- 1.2 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.

The recommendation

- 1.3 *'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.'*
- 1.4 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 our mortgage rules¹, and commensurate with their risk appetite when taking individual lending decisions.

¹ The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) [11.6](#)

2 Summary of feedback received

- 2.1 We received six responses to our guidance consultation paper from both firms and trade associations. Respondents were supportive of the FPC's aims in issuing the recommendation.
- 2.2 Several respondents raised the same issues with both our proposed guidance and with the Prudential Regulation Authority's (PRA) proposed rules to implement the FPC's recommendation.

Key comments received

Impact on private banks and wealth managers

Some of the trade associations were concerned that there would be a detrimental impact on firms that provide mortgages primarily to high net worth individuals (HNWI) as a result of the guidance. Most of the lending that these firms do will be at a loan to income (LTI) of more than 4.5. They assess affordability by taking into account other assets as well as income. This could mean that LTIs appear artificially high as assets are not included in the calculation of LTI. In addition, HNWI often take our mortgages for purposes other than the purchase of a property, such as for business financing. It was also highlighted that the terms are much shorter than a typical mortgage and often no more than five years.

Respondents suggested that there will be an adverse impact on competition in this area. The amount of mortgage lending that these firms are able to do will be determined by the structure of any group that they are in. Private banks and/or wealth managers that are part of a group that has one authorisation have greater flexibility on how to allocate their lending. Firms that are part of a group where each brand has their own authorisation could be placed at a disadvantage.

A number of respondents suggested that there should be an exemption for HNWI, using the same definition as used for high net worth mortgage customer in the FCA and PRA Handbooks. A high net worth mortgage customer is defined as:

a customer with an annual net income of no less than £300,000 or net assets of no less than £3,000,000, or whose obligations are guaranteed by a person with an income or assets of such amount.

Another suggestion was that firms should have to write a certain number of regulated mortgage contracts before being impacted by the LTI cap.

Our Response

In light of these representations and following discussions with the PRA, we have set a threshold of the number of regulated mortgage contracts that firms have to write over four consecutive quarters before they are expected to behave consistently with the guidance on the LTI limit. Firms now should do both of the following over the relevant four quarters periods before they should limit the amount of high LTI lending that they do:

- Write more than £100m of regulated mortgage contracts, **and**
- Write more than 300 regulated mortgage contracts.

If a firm's lending over two consecutive rolling periods of four quarters be less than £100m or less than 300 regulated mortgage contracts, there is no expectation for the firm to limit the amount of high LTI lending that it does.

Firms may also apply the LTI limit at a group, rather than a regulated entity, level.

Sunset clause and/or review

The guidance should be subject to a 'sunset clause' or there should be a review of the need for the limits in 18 months. It should not become a permanent part of the mortgage market.

There should be a commitment to review the de minimis limit, the LTI limit and the percentage of mortgages allowed above the limit on a regular basis.

Our Response

The FCA will keep this guidance under review as part of its normal functions. In addition, the FPC has to regularly review the recommendations that it has made that are still relevant. It will be for the FPC to decide if the recommendation should be withdrawn and/or re-issued using different parameters.

Clarity on the types of mortgages that should be included

A couple of firms asked for clarity on the inclusion of the following types of mortgage lending:

- Regulated buy to let mortgage
- Regulated bridging mortgage
- Mortgage 'ported' from one property to another where there is no increase in the principal amount borrowed.
- Second charge lending

Our Response

The guidance on LTI limits applies to all regulated mortgage contracts, as defined in section 61(3) of the Regulated Activities Order 2000. This will include some bridging loans and a very small amount of buy-to-let lending.

Mortgages 'ported' from one property to another where there is no increase in the principal amount borrowed will count towards the LTI limit. We think that a very small number of mortgages will fall in to this category so it should not adversely affect firms.

Second charge mortgages currently fall under the FCA's Consumer Credit regime and are not a regulated mortgage contract. So they are not currently covered by this guidance. We have recently issued a consultation paper² on bringing second (and subsequent) charge mortgages into our mortgage regime when the UK implements the Mortgage Credit Directive (MCD) in March 2016, at which point we expect second charge mortgages to fall under the definition of a regulated mortgage contract. We will review this guidance closer to the time to confirm whether or not second charge mortgages will be covered by this guidance.

Clarity on the definition of a 'quarter' for the purposes of data collection

One respondent asked us to clarify if a 'quarter' was three months, such as January/February/March, or 13 weeks.

Our Response

We are happy to clarify that the intention is to use the same definition of a quarter as that used for [Product Sales Data](#) returns. These are the four calendar quarters of each year beginning 1 January, subject to each consecutive set of four quarters for purposes of the guidance being on a rolling basis.

² [CP14/20](#) Implementing the Mortgage Credit Directive and the new regime for second charge mortgages

3 Changes to our guidance

3.1 We have amended the guidance to

- Show that firms should write a minimum volume, as well as a minimum value, of mortgages over four consecutive quarters before they are expected to apply the LTI limit.
- Allow the application of the LTI limit to be at group, rather than regulated entity, level.

3.2 To maintain constancy with the PRA rules that implement the FPC's recommendation, we have amended the definition of 'credit' in paragraph 10 of the guidance. It is now defined as being determined at the time the mortgage contract is entered into or drawn down at a later date.

Finalised guidance

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. The implementation of 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*.

Exclusions

7. 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*.

Interpretation

8. 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 10 that definition applies for the purpose of this *guidance*.
9. Where an expression in italics is not defined in the *Glossary*, it has the meaning given in paragraph 10.

Glossary of terms defined in this guidance

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

<i>credit</i>	the cash loan provided by a <i>firm</i> under a <i>regulated mortgage contract</i> :
	(a) at the time the <i>regulated mortgage contract</i> is entered into; or
	(b) drawn down at a later date.
<i>high loan to income allowance</i>	the number of <i>high loan to income mortgage contracts</i> that a <i>firm</i> may enter into in a <i>quarter</i> consistent with the expectation in paragraph 14 without any modification under paragraphs 19 to 21.
<i>high loan to income</i>	a <i>regulated mortgage contract</i> under which

<i>mortgage contract</i>	the <i>credit</i> provided by a <i>firm</i> to an individual, or individuals jointly, is at, or exceeds, the <i>loan to income ratio</i> .
<i>income</i>	the gross annual income, before tax and other deductions, of an individual taken into account by a <i>firm</i> to calculate the <i>credit</i> it will provide under a <i>regulated mortgage contract</i> .
<i>legal mortgage</i>	includes a legal charge, and in Scotland, a heritable security.
<i>loan to income ratio</i>	a multiple of 4.5 times of an individual's <i>income</i> or individuals' joint <i>income</i> , at the time at which that <i>income</i> is assessed by a <i>firm</i> for the purpose of entering into a <i>regulated mortgage contract</i> with the individual or individuals.
<i>quarter</i>	any of the four calendar quarters of each calendar year.
<i>re-mortgage with no change to the principal sum outstanding</i>	<p>a <i>regulated mortgage contract</i> in respect of which the following conditions are met:</p> <p>(a) the amount of <i>credit</i> provided under the <i>regulated mortgage contract</i> does not exceed that outstanding to:</p> <p>(i) the <i>firm</i>; or</p> <p>(ii) a different lender,</p> <p>under a previous <i>regulated mortgage contract</i>, or any other type of contract under which the obligation to repay the <i>credit</i> provided is secured by a <i>legal mortgage</i> on <i>land</i>; and</p> <p>(b) in determining the amount of <i>credit</i> provided, no account is taken of:</p> <p>(i) arrangement fees;</p>

- (ii) professional fees and costs;
and
- (iii) administration costs.

B. Guidance to firms

De minimis conditions

11. 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, but Condition A is not met if the *firm* entered into less than 300 *regulated mortgage contracts* in that period.
12. 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, 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*.
13. 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* ends 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 on the last day of each subsequent *quarter* that follow; and
 - (ii) followed by a second set of four *quarters* ending on 31 December 2014 and on the last day of each subsequent *quarter* that follows.

High loan to income limit

14. 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*, unless the *firm* has allocated or received *high loan to income allowance* under paragraphs 19 to 21.
15. 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 14 from the *quarter* beginning on 1 October 2014.
16. 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 14 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*.
17. 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 14 until Condition C is met.

Condition when expectation ceases

18. Condition C is that during both of two consecutive sets of four *quarters*:
 - (1) the *firm* has entered into *regulated mortgage contracts* under which the sum of *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*.

Allocation of high loan to income allowance within a group

19. 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*.
20. If a *firm* has allocated any part of its *high loan to income allowance* to another member of the *group*, the number of *high loan to income mortgage contracts* that it enters into should be reduced by the amount of the *high loan to income allowance* it has allocated.

21. If a *firm* that is part of a *group* has been allocated the *high loan to income allowance* of another member of its *group*, the number of *high loan to income mortgage contracts* entered into by the *firm* should not exceed the expectation in paragraph 14, plus any *high loan to income allowance* allocated to it.
22. The *FCA* expects a *firm* to keep a record of any part of a *high loan to income allowance* it has allocated or received.

Worked example

23. 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.

C. Monitoring

24. The *FCA* will use product sales data returns to monitor which *firms* meet the de minimis conditions in paragraphs 11 or 12.
25. When *firms* meet the de minimis conditions in paragraphs 11 or 12, the *FCA* will monitor their *regulated activity of entering into a regulated mortgage contract* for consistency with the expectation in paragraph 14, or as may be modified by paragraphs 19 to 21.
26. When a *firm* meets the de minimis conditions in paragraphs 11 or 12 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 14, or as may be modified by paragraphs 19 to 21, 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*.