OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK
of 12 June 2018

Recommendation
on the management of risks associated with the provision of retail loans secured by residential property

I.
Purpose of the Official Information

As a macroprudential policy-making authority, the Czech National Bank (hereinafter the "CNB") is issuing a recommendation on the provision of retail loans secured by residential property. The CNB is issuing this recommendation on the basis of a recommendation of the European Systemic Risk Board (ESRB)[1], recommendations of other international authorities and EU legislation[2]. This CNB recommendation pursues one of the major intermediate objectives of macroprudential policy, namely to mitigate and prevent excessive credit growth and leverage.

In previous Financial Stability Reports, the CNB reported that conditions for a build-up of systemic risks in the financial sector may be created as a result of fast growth in loans secured by residential property combined with a concurrent easing of credit standards and rising residential property prices. The CNB therefore regularly analyses loans secured by residential property and the property market situation. Where it identifies rising and increased risks, it activates the relevant instruments and adjusts their settings in order to reduce the financial sector's vulnerability to potentially adverse developments in the economic environment and conditions on the property market with negative impacts on financial stability in the Czech Republic.

The main instruments listed in the ESRB recommendation[1] for pursuing the intermediate objective to mitigate and prevent excessive credit growth include requirements for the loan-to-value ratio and requirements for the loan-to-income ratio or the debt (service)-to-income ratio The ESRB recommendation also states that Member States should select and apply any additional macroprudential instruments taking into account their effectiveness and efficiency, to achieve each of the intermediate objectives. As regards the risks associated with the provision of retail loans secured by residential property, the instruments should ensure that credit standards comply with the criteria of sufficient tightness and prudence.

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[1] ESRB recommendation on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1).
[2] Financial Stability Board (2012): FSB Principles for Sound Residential Mortgage Underwriting Practices; European Banking Authority (2013): Opinion of the European Banking Authority on Good Practices for Responsible Mortgage Lending; Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

An assessment of information gathered by the CNB in the course of its pursuit of macroprudential policy and financial market supervision in recent years reveals that a spiral is emerging between residential property prices and property purchase loans in an environment of easy credit standards and historically low interest rates. This could become a source of systemic risk. In this Official Information, the CNB is therefore issuing a set of quantitative and qualitative recommendations for entities authorised as an entrepreneur to provide consumer credit.

II.
Scope of application

1. This recommendation applies on a solo basis to entities authorised as an entrepreneur to provide consumer credit under Act No. 257/2016 Coll., on Consumer Credit (hereinafter the "provider"). It applies to retail loans secured by residential property provided to natural persons (individuals) and to consumer credit provided to natural persons (individuals) who have a retail loan secured by residential property.

III.
Definitions

For the purposes of this recommendation:

1. a retail loan secured by residential property means a loan provided to one or more individuals which is secured by residential property;
2. a client means a natural person (individual) applying for a retail loan secured by residential property or who has a retail loan secured by residential property;
3. an expert opinion means the determination of collateral value by an expert;
4. an expert means a natural person who has the necessary qualifications, ability and experience to value property and who is independent of the business activity of loan provision;
5. the amount of a retail loan secured by residential property means the principal of the loan agreed in the loan agreement;
6. a client's debt in the context of a retail loan secured by residential property means, for the purposes of the calculation of the LTV ratio, the sum of the loan provided and the outstanding amount of the principal of any existing loans secured by the same property. A deposit of the same client with the same provider may be subtracted from the amount of the client's debt provided that the deposit is a part of the collateral pertaining to the loan;
7. a client's total debt means, for the purposes of the calculation of the DTI and DSTI ratios, the sum of the loan provided and the client's other secured and unsecured loans from the relevant provider, as well as loans from another provider;
8. collateral value means the value of the property as determined by a prudent assessment of the future marketability of the property by taking into account long-term sustainable

aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property;[3]

9. a client's income means the amount of annual after-tax income prudently assessed as permanent on the basis of a provably documented income history for a sufficiently long period;
10. the LTV (loan-to-value) ratio means the ratio of a client's debt in the context of a retail loan secured by residential property under paragraph 6 to the collateral value under paragraph 8;
11. the DTI (debt-to-income) ratio means the ratio of a client's total debt under paragraph 7 to income under paragraph 9;
12. the DSTI (debt service-to-income) ratio means the ratio of the average annual expenses arising from a client's total debt under paragraph 7 to income under paragraph 9;
13. a client's ability to service the loan from his own resources means the indicator of the financial reserves of the client's household taking into account the household's income, common living expenses typical of the client's household and the household's expenses arising from all its financial liabilities, including the newly provided loan;
14. a loan with a non-standard repayment schedule means a loan negotiated with partial or full deferral of interest or principal payments, with gradually rising payments, with a temporarily reduced interest rate, or with a less frequent than monthly repayment schedule. For example, loans with decreasing payments, loans for construction where the loan was not drawn, restructured loans and loans where the postponement of repayment provably leads to a lower risk of non-repayment are not regarded as loans with a non-standard repayment schedule;
15. a buy-to-let loan means a loan where it can be assumed that the property will not be inhabited by the client or a family member of the client and will be inhabited on the basis of a rental agreement;
16. an intermediary means a person carrying on financial intermediation.

IV.
Recommendation A: Compliance with LTV limits for new retail loans secured by residential property

1. It is recommended that providers ensure that the LTV ratio of no retail loan secured by residential property exceeds 90%.
2. It is also recommended that providers ensure that new retail loans secured by residential property with an LTV of 80%–90% do not exceed 15% of the total amount of retail loans secured by residential property provided in any given quarter.

[3] If the loan is a retail loan secured by residential property for the construction or reconstruction of a house, the collateral value means the expected value of the completed house.

Providers should provide loans secured by residential property with an LTV in the given range only in justified cases, where a high probability of such loan being repaid has been identified and documented on the basis of a prudent assessment of the client's risk characteristics.

3. Providers should not circumvent the LTV limits through the concurrent provision of consumer credit relating to the residential property concerned above and beyond retail loans secured by property.[4]

4. Providers should determine collateral value for the purposes of calculating the LTV ratio in a conservative manner, taking into account the risk of property price overvaluation.

V.
Recommendation B: Assessment of clients' ability to service loans and withstand increased stress

1. When providing retail loans secured by residential property or other consumer credit to clients that have a retail loan secured by residential property, providers should, for the purpose of prudentially assessing clients' ability to service loans from their own resources,[5] monitor the DTI and DSTI ratios, set internal limits for the DTI and DSTI ratios and comply with the DTI and DSTI limits recommended in paragraph 2 of Article V and paragraph 3 of Article V.[6]

2. When providing a retail loan secured by residential property or other consumer credit to clients that have a retail loan secured by residential property, it is recommended to providers that the DTI ratio does not exceed 9 with effect from 1 October 2018. A DTI higher than 9 is deemed acceptable for loans provided in the current calendar quarter and representing a maximum of 5% of the total amount of retail loans secured by residential property provided by this provider in the previous calendar quarter.

   Providers should provide retail loans secured by residential property or other consumer credit to clients that have a retail loan secured by residential property with a DTI higher than 9 within the admissible 5% limit only in justified cases, where a high probability of such loan being repaid has been identified and documented on the basis of a prudential assessment of the client's risk characteristics.

3. When providing retail loans secured by residential property or other consumer credit to clients that have a retail loan secured by residential property, it is recommended to providers that the DSTI ratio does not exceed 45% with effect from 1 October 2018. A

[4] The provision of any consumer credit, secured or unsecured, the purpose of which is to ensure compliance with the recommended LTV limit for a new retail loans secured by residential property from other than a client's own resources, is considered circumvention of the LTV limits. In this context, providers should identify the amount of the client's debt using all available information when providing retail loans secured by residential property and other related loans.

[5] In this context, providers should identify the total amount of the client's debt using all available information when providing retail loans secured by residential property or consumer credit to clients that have a retail loan secured by residential property.

[6] If multiple clients apply together for a retail loan secured by residential property, it is recommended that providers take into account the income and debt of all these clients when calculating the DTI and DSTI ratios.

DSTI higher than 45% is deemed acceptable for loans provided in the current calendar quarter and representing a maximum of 5% of the total amount of retail loans secured by residential property provided by this provider in the previous calendar quarter.

Providers should provide retail loans secured by residential property or other consumer credit to clients that have a retail loan secured by residential property with a DSTI higher than 45% within the admissible 5% limit only in justified cases, where a high probability of such loan being repaid has been identified and documented on the basis of a prudential assessment of the client's risk characteristics.

4. Providers should particularly prudently assess the loan applications of clients whose DTI ratio exceeds 8 and DSTI ratio exceeds 40%, especially if the loan falls under the category referred to in paragraph 2 of Article IV.
5. Providers should assess clients' ability to service loans from their own resources under adverse conditions (i.e. stress-testing of clients' ability to service the loan), especially in the event of a rise in lending rates. To this end, providers should use an interest rate at least 2 percentage points above the planned interest rate. Providers should also take into account the impacts of a sizeable fall in income or a change in the conditions of clients who apply together for a retail loan secured by residential property (e.g. a divorce between spouses or a loss of income of one of the spouses or partners) on the ability to service the loan.

VI.
Recommendation C: Preventing an easing of credit standards by setting excessive loan terms or non-standard repayment schedules

1. The term of a retail loan secured by residential property should not exceed the horizon of economic activity of the client or the lifetime of the property. As a rule, it should not exceed 30 years.
2. The term of unsecured consumer credit provided to clients that have a retail loan secured by residential property should not exceed 8 years. This provision shall not apply to loans provided under the Building Savings Schemes Act.
3. Providers should not provide retail loans secured by residential property with a non-standard repayment schedule leading to a shift of the client's credit commitments to a later period.

VII.
Recommendation D: Prudent approach to increasing the outstanding amount of principal when refinancing

1. If providers refinance a loan secured by residential property and simultaneously increase the outstanding amount of principal, they should proceed in the same manner as in the case of new loans. In particular, if they increase the outstanding amount of a refinanced loan by more than 10% or CZK 200,000, they should separately assess compliance with all the prudential risk management principles and determine the current value of the pledged property.

2. For refinanced retail loans secured by residential property with an increase in the outstanding amount of principal, providers should separately monitor credit risk and compare it with that on other retail loans secured by residential property.

VIII.
Recommendation E: Lending through intermediaries

1. Providers should apply a prudent approach when working with loan intermediaries and consider the risks associated with the different interests of intermediaries which create potential for an excessive easing of credit standards.
2. For retail loans secured by residential property negotiated by intermediaries, providers should separately monitor credit risk and compare it with that on other retail loans secured by residential property.
3. Providers should not create such incentive schemes for intermediaries which ultimately create conditions for the emergence of systemic risks.

IX.
Recommendation F: Providing loans to finance buy-to-let purchases of residential property

1. For credit risk management purposes, providers are recommended to identify and separately monitor the different characteristics of owner-occupied and buy-to-let portfolios of retail loans secured by residential property.
2. Providers are recommended to improve the quality of risk management with regard to correctly determining the purpose of retail loans secured by residential property pursuant to paragraph 1 of Article IX.[7]
3. Providers are recommended that the LTV for loans to finance buy-to-let residential property with indicators of the client's ability to service the loan from his own resources with a higher risk level does not exceed 60%.

X.
Assessment of compliance with the recommendations

1. The CNB will regularly assess providers' compliance with recommendations A to F. To this end, it will conduct half-yearly surveys of the structure of newly provided loans. The results will be published in the Financial Stability Report.

[7] Providers should identify the purpose of a loan using all available information. If the client does not state this fact in his loan application, a loan for which income from real estate renting is included in income for assessing the client's ability to service the loan may be regarded as a loan for financing buy-to-let residential property. The purpose of a loan may also be indicated by, for example, the number of existing loans secured by residential property granted to the same client.

XI.
Final provisions

1. This Official Information describes the legal situation as of 1 June 2018. In view of potential legislative changes, the current legal situation should be taken into account when applying this Official Information.
2. This Official Information is based on an assessment of risks to financial stability in the period up to 1 June 2018. If increased risks to financial stability are identified, the CNB will be ready to tighten the relevant parameters of individual recommendations, or to expand the recommendations as a whole.

XII.
Effect

1. This Official Information shall replace Official Information of the Czech National Bank of 13 June 2017.

Vice-Governor
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