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Deputy Chief Executive

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The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Residential mortgage loans (RMLs)

The Hong Kong Monetary Authority (HKMA) has noticed a growing trend for authorized institutions (AIs) to make use of large cash rebates and, more recently, interest/repayment holidays to compete for new residential mortgage business. The HKMA is concerned that the overall risks of such practices to individual AIs are not being properly considered and may expose AIs to competitive pressures to expand the portfolio of high cash rebate mortgages. I am therefore writing to remind AIs of the need to monitor carefully the risks associated with such practices and to set out the treatment of cash rebates and interest/repayment holidays within the context of the 70% loan-to-value ratio guideline (the 70% guideline).

Cash rebates made available by AIs

The HKMA has been discussing with the industry the level of cash rebate¹ made available by AIs for their RML business. Rebates generally range from 0.5% to 1.5% of the loan amount, but in some cases, rebates of up to 8% or more of the loan amount are made available by individual AIs. Borrowers choosing to receive the larger cash rebate, however, are charged a higher mortgage rate for an initial period, generally the first three years.

¹ A lump sum payment is made in most of the cases but a few AIs have chosen to offer cash rebates in the form of interest holidays in which the cash rebate available to the borrower is used to subsidise the mortgage interest payments in the initial period of the RML.

The HKMA requires that each AI providing RMLs must have a clear policy on the maximum level of cash rebate to be offered to mortgage borrowers. The level of cash rebate should not be excessive. Cash rebates that are excessive undermine the spirit of the 70% guideline, which prohibits AIs from providing finance for the purchase of a residential property in excess of 70% of the value² of the property. In order to uphold the spirit of the 70% guideline, AIs are required to treat the entire amount of the cash rebate as part of the RML amount for the purposes of calculating the loan-to-value (LTV) ratio if the level of cash rebate is in excess of 1% of the loan amount.

If the level of a cash rebate is not in excess of 1% of the loan amount, the cash rebate is not required to be counted as part of the RML amount. However, disbursement of the cash rebate should only be made after the completion of the purchase of the property.

Cash rebates or interest/repayment holidays subsidised by property developers directly or indirectly

The HKMA is also aware of a recent trend where property developers have worked together with individual AIs to provide the following special mortgage packages to homebuyers:

- (a) in some cases, the developer concerned would pay a sum of money (hereinafter referred to as “cash rebate subsidy”) to an AI for each RML granted to the homebuyers of selected projects. The AI would then include the cash rebate subsidy as part of the cash rebate offered to the homebuyers. The total amount of cash rebate could be as high as 13% to 16% of the loan amount for individual cases;
- (b) more recently, individual developers have chosen to subsidise, in a lump sum or by instalments, the borrower’s interest payments or principal repayments so that the borrower is offered an interest/repayment holiday by the AI. The holiday period varies from case to case.

In our circular dated 20 December 2002, the HKMA made it clear that where a cash rebate or other discount is offered by a property developer to a homebuyer, the discounted price (i.e. after deducting the cash rebate or the discount offered by the developer from the purchase price) should be used as the basis for determining the risk exposure for the purposes of the 70% guideline. Consistent with this requirement, AIs are therefore required to use the lower of the discounted price (i.e. the purchase price less the cash rebate subsidy given by the property developer to the

² The lower of the purchase price or the valuation of the property.

homebuyers directly or indirectly, regardless of whether the subsidy is in a lump sum or by instalments) or the valuation of the property to calculate the LTV ratio for the purposes of the 70% guideline.

The HKMA has a further concern that such schemes involving a cash rebate subsidy offered by property developers may undermine the transparency of the transaction. The homebuyers may not be fully aware of the existence of the cash rebate subsidy and the extent to which the purchase price and the cash rebate might have been affected by it. AIs should ensure that adequate disclosure has been made to the borrowers in conformity with the spirit and objectives of the Code of Banking Practice (see section 2 of the Code).

Credit assessment

In line with the HKMA's circular dated 28 July 1997, AIs must carefully assess the repayment ability of RML borrowers. This is particularly relevant and important for cases where the RML borrowers are known to be seeking additional financing beyond 70% of value from other sources. AIs are expected to conduct their credit assessments on these customers carefully and prudently. In particular, they must obtain appropriate income proof from the borrowers and guarantors for assessment. Furthermore, these borrowers should be subject to reasonable test to ensure that they meet the debt servicing ratio (DSR) requirement. The following guiding principles should be observed by AIs:

- (a) the DSR to be observed by these borrowers should be no higher than 50-60% of income. The upper end of this range should be confined to high income earners only and prudent criteria should be set for borrowers qualified as high income earners;
- (b) all the known repayment obligations should be taken into account when calculating the DSR. To this end, adequate checks should be performed on the statements of the main bank accounts of the borrowers and guarantors. Moreover, AIs should make full use of the information obtained from a consumer credit reference agency to identify other repayment obligations of the borrowers and guarantors, unless there are other acceptable arrangements;
- (c) the income of other household members should not be taken into account in the DSR test unless such members have provided a formal guarantee or the property is being acquired jointly with those members;
- (d) in cases where different monthly instalment amounts are payable for different periods of a RML, the highest monthly instalment amount should be used for the DSR calculation; and

- (e) where the borrower is offered an interest/repayment holiday, the monthly instalment amount payable after the holiday period should be used for calculation.

For the avoidance of doubt, the term cash rebate used in this letter also includes other forms of monetary incentives or benefits (e.g. mortgage interest subsidies or reimbursement/subsidies of the legal fee, stamp duty, or commission for the property agents, etc.) given by AIs or property developers to the homebuyers.

The requirements of this circular shall take effect immediately but should not affect RMLs already approved. The HKMA will be conducting a round of on-site examinations on the RML business of individual AIs. We will assess the institutions' policy, practices and procedures for observing compliance with the 70% guideline, and the quality of their credit underwriting standards and risk management arrangements for such business. The assessment results will be taken into account when the CAMEL rating of the institution concerned is next reviewed.

Yours faithfully,

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Deputy Chief Executive

c.c. Chairman, Hong Kong Association of Banks
Chairman, DTC Association