HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref.: B4/1C

13 August 2010

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Prudential Measures for Residential Mortgage Loans

The Hong Kong Monetary Authority (HKMA) has been closely monitoring the property market as residential mortgage lending is a major business of authorized institutions (AIs). We observe that property prices continue to increase recently and investment sentiment remains buoyant due in part to the current unusually low interest rate environment. There are also signs that investment activities are prevalent not only in the luxury property sector but are spreading to mass market properties. As a result of the continued rise in property prices, various indicators to gauge housing affordability are rising. The increased risks to the stability of the banking system, as well as the safety and soundness of individual institutions, cannot be underestimated.

In view of the latest developments, the HKMA considers that it would be prudent and justified for AIs to adopt more conservative underwriting standards for residential mortgage loans (RML). AIs are required to observe the following guidelines in undertaking RML business:

(i) extending the 60% maximum loan-to-value (LTV) ratio introduced last year to properties with a value from $12 million to $20 million (this means that all properties with a value of $12 million or above will from now on be subject to a maximum LTV ratio of 60%);

(ii) lowering the maximum LTV ratio for properties which are not intended to be occupied by the owners to 60%; and

(iii) standardising the limit on debt servicing ratios (DSRs) of borrowers to 50%, stress testing borrowers' debt servicing ability assuming a rise in mortgage rates of at least two percentage points, and limiting the stressed DSR to a cap of 60%.

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The above guidelines, except the requirement to perform stress testing of borrowers' repayment ability, should take immediate effect. To avoid causing hardship to borrowers who have signed a provisional sales and purchase agreement on or before the date of this letter, AIs may assess mortgage applications of these borrowers based on their existing underwriting criteria. As for the stress testing requirement, AIs will need to amend their lending processes and documentation so that it can be implemented by 15 September 2010.

Detailed guidance on the above guidelines can be found in the **Annex**. The Annex also contains best practices identified by the HKMA in its recent round of thematic examinations of major mortgage lenders. AIs should review their existing lending practices and, where appropriate, take immediate measures to incorporate these best practices into their lending processes and procedures. The HKMA will monitor compliance with the guidance in this letter through its routine onsite examinations and off-site reviews.

If your institution has any questions about this letter, please approach your usual contacts at the HKMA.

Yours faithfully,

Arthur Yuen
Deputy Chief Executive

Encl.

Annex

Prudential Measures for Residential Mortgage Loans

1. Extending the 60% LTV guideline to properties with a value from $12 million to $20 million

AIs should extend the 60% LTV guideline introduced last year to properties with a value from $12 million to $20 million. This means that all properties with a value of $12 million or above will from now on be subject to a maximum LTV ratio of 60%.

Properties with a value below $12 million will continue to be subject to a maximum LTV ratio of 70%. However, to avoid the anomaly that the maximum amount a purchaser of a property with a value of slightly below $12 million could borrow would be higher than that for a property valued at HK$12 million[1], the maximum loan amount for properties valued below $12 million should be subject to a cap of $7.2 million.

This requirement, as well as Requirements 2, 4 and 6 below, expect AIs to apply an LTV ratio lower than 70% under different circumstances. In cases where more than one of these requirements is applicable, AIs should apply the lowest LTV ratio dictated by the relevant requirement.

2. Lowering the maximum LTV ratio for non-owner-occupied properties to 60%

Mortgages in relation to properties which are not occupied by the owners are commonly regarded to be of higher risks than mortgages against owner-occupied properties. AIs are required to cap the LTV ratio for non-owner-occupied properties at 60%. Properties which are occupied by the owners' immediate family members (i.e. parents, spouse, children and siblings), and properties held through shell companies and occupied by the majority shareholders of these companies (or their immediate family members), are to be regarded as owner-occupied properties.

Borrowers should be asked to make a formal declaration as to whether they intend to occupy, or continue to occupy, the mortgaged property. Borrowers should be reminded of the possible legal consequences of making a false declaration (e.g. a borrower may commit the offence of fraud if he or she makes a false declaration to obtain a loan). The reminder should be incorporated into the loan application form and should be drawn to borrowers' attention. AIs are expected to take any false declaration seriously, and be prepared to pursue appropriate legal action if the case warrants it. The declaration form should be reviewed by counsel to ensure that the declaration is admissible evidence in legal proceedings.

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[1] Had there not been a cap of $7.2 million, a purchaser of a property valued at $11 million would have been able to borrow $7.7 million ($11 million x 70%), whereas a purchaser of a property valued at $12.5 million would only have been able to borrow $7.5 million ($12.5 million x 60%).

3. Standardising DSR limit to 50% and stress testing borrowers' repayment ability assuming a rise in mortgage rates of at least 2%

To provide cushion for borrowers to cope with possible increases in mortgage payments due to interest rate rises, AIs should standardise their DSR limit to 50%, irrespective of whether or not the borrowers are regarded as high income earners.

As stated in the HKMA's circular letter of 23 October 2009, AIs should assess the potential impact on borrowers' repayment ability if the current unusually low interest rates were to return to more normal levels, and maintain proper records of such assessments. The HKMA observed from the latest round of thematic examinations that different AIs have adopted different practices to comply with this requirement. Some AIs assumed an interest rate increase of less than 1% in their assessment. Some conducted the assessment on the basis of the whole mortgage portfolio rather than in respect of each loan application.

The HKMA expects AIs to conduct the assessments on a portfolio basis as well as in respect of each loan application. Having regard to historical mortgage rate data, the HKMA considers that any assumption of interest rate increase of less than 2% would not be sufficiently prudent. AIs should therefore assess each borrower's repayment ability assuming an increase in mortgage rates of at least 2%.

The DSRs of borrowers calculated under the stressed interest rate environment should not exceed 60%. AIs may regard this requirement to be satisfied if there is scope for the borrower to extend the tenor of the loan to reduce the mortgage payment and bring his or her stressed DSR back within 60%. For the purpose of assessing whether the stressed DSR is within 60% under the extended tenor, AIs will be required to justify that the sum of the loan tenor and the borrower's age is reasonable taking into account the borrower's normal retirement age.

The HKMA's earlier guidance to use the prime-based interest rate cap or the prevailing prime-based mortgage rate to calculate DSRs in respect of HIBOR-based mortgage loans have generally been taken on board by AIs covered in the latest round of thematic examinations. This is a more prudent practice given the relatively high volatility of HIBORs, and should be followed by all AIs.

4. Adopting conservative underwriting criteria for lending based on borrowers' net worth

It is not uncommon for AIs to extend mortgage loans to borrowers who have no stable income or are unable to provide proof of income but have substantial amounts of assets relative to the size of the mortgage loan. This is typical asset-based lending and repayment of the mortgage loan hinges on the net worth declared by the borrower. To mitigate their risks, some AIs have adopted the following measures:

(i) setting the required amount of net worth relative to the size of the mortgage loan at an appropriately high level;

(ii) asking borrowers to declare their net worth in writing and undertaking suitable due

diligence to verify the information provided (e.g. conducting land searches and requiring sight of original bank or investment account statements);

(iii) limiting the LTV ratio for mortgage loans based on borrowers' net worth at a more conservative level (e.g. 60%); and

(iv) capping such lending at a specified percentage of the AI's mortgage portfolio and keeping the cap under regular review.

The HKMA considers the above to be prudent practices, which should be followed by all AIs engaged in residential mortgage lending.

5. Strictly enforcing the requirement on borrowers to declare their existing debt obligations

While the loan application forms of AIs generally contain a section requiring mortgage applicants to provide information about their existing debt obligations, it was noted during the thematic examinations that this section was sometimes not fully completed, and there was no evidence indicating that proper follow-up enquiries had been made with applicants. As stated in the HKMA's circular letter of 30 October 2009, AIs should require mortgage applicants to declare all their existing liabilities, perform reasonable checks and enquiries to ensure the veracity of the information declared, and maintain records of such checks and enquiries. In addition, AIs should request mortgage applicants to declare if they are applying for, or will shortly apply for, other loans. For example, a property investor who has acquired more than one property may apply for mortgage loans for different properties from separate banks.

In cases where information provided by an applicant reveals that he or she already has existing mortgages or is applying for other mortgages, the AI concerned should take into account the borrower's total debt repayment obligations in computing his or her DSR. Where any information provided by the applicant indicates that the property is not intended to be occupied by owners, the AI should limit the LTV ratio to 60% (see Requirement 2 above).

6. Subjecting property valuations to reasonableness tests and lowering the LTV ratio when appropriate

Some AIs have established checks in their systems to ensure that valuations obtained from outside valuers are prudent and reasonable. They will obtain an additional valuation if the value of the property is higher than a specified level (e.g. HK$15 million), and will use the lower valuation to calculate the LTV ratio. An independent unit (e.g. the Risk Management Department) is charged with the responsibility for conducting regular assessments of the reasonableness of the external valuations obtained. Some AIs exercise extra caution when using external valuations in relation to new property developments and uniquely packaged properties. They will apply a suitable discount to the valuations provided by outside valuers or adopt a more conservative LTV ratio if it is considered prudent to do so (e.g. where there are rampant speculative activities in relation to a new property development, which make it difficult to ascertain

the value of the properties, or where the valuation of the new development is substantially higher than prices of other properties in the vicinity). The HKMA considers these to be good practices, which should be incorporated into AIs' processes and procedures.

7. Strengthening management information system (MIS)

Although the AIs examined have generally developed MIS reports to assist management in monitoring the quality of residential mortgage loans on a portfolio basis, the sophistication of these reports needs to be enhanced. AIs should conduct a comprehensive review of their existing reports to see if they can achieve the following objectives:-

(i) identification of exceptional approvals;
(ii) identification of loans with characteristics indicative of higher risk of default (AIs should identify borrower behaviour characteristics that are indicative of higher default risk);
(iii) monitoring the AI's exposures to different types of properties (e.g. luxury vs mass market properties; owner-occupied vs investment properties; and commercial vs residential properties);
(iv) return analysis (e.g. the mortgage portfolio's performance under different interest rate scenarios);
(v) delinquency and charge-off analysis;
(vi) conducting stress tests on the portfolio; and
(vii) evaluating the AI's current underwriting criteria and pricing strategy.

<u>Implementation</u>

AIs should take immediate steps to implement the above requirements. Requirements 1 – 3 should take immediate effect, and Requirements 4 – 6 (including the requirement to stress test borrowers' repayment ability) should be implemented no later than 15 September 2010. The review of MIS reports referred to in Requirement 7 should be completed by the end of 2010 and any necessary enhancements should be implemented as soon as practicable.