In conducting the day-to-day supervision of authorised institutions, the Monetary Authority often receives questions on regulatory issues. This column publishes the supervisory response to questions which cover matters of general interest.

Q. What is the view of the HKMA on AI providing banking services through the internet to their customers?

A. The initial views of the HKMA on AI providing banking services through the internet are set out in a letter dated 7 July to all AIs. Briefly, the HKMA considers that before any real financial transaction occurs on-line, the parties concerned must have confidence that their transaction is secure. In other words, they must ensure the authenticity of the parties to the transaction and the integrity of the information being exchanged. AIs planning to offer their services through the internet should discuss their plans to do so with the HKMA in advance. This is to enable the HKMA to assess whether the institution's system for providing services through the internet is adequately sound and secure. The matters which the HKMA would like to discuss with the institution relating to an internet banking service include the related business plan, the contractual arrangements for liability arising from unauthorised or fraudulent transactions, the security arrangements, the procedures and safeguards for monitoring unusual transactions and detection and investigation of possible fraud, and the contingency plan for major breaches in the security of the system.

Q. The HKMA is concerned about the continued rapid growth of residential mortgage loans in the first half of this year. It has issued a letter to all authorized institutions recently to urge them to strictly apply existing lending criteria on mortgage lending. What is new in the letter?

A. The letter does not introduce any new requirements but it does set out in more detail certain key aspects of the existing requirements, e.g. on "top-up" loans and debt service ratio. These detailed requirements have been communicated to AIs on an individual basis but have not been published as general guidelines in the past. The full text of the letter, issued by David TR Carse to the Chief Executives of all AIs, dated 28 July 1997, is reproduced below.

Property Lending

I am writing to the Chief Executives of all authorized institutions in the light of the rise in residential mortgage lending and in other types of property lending which has occurred in the first half of this year.

According to the results of our monthly survey, residential mortgage lending by the 33 institutions included in the survey rose by 2.7% in June. The increase in the first half of the year was 34% (annualized). This rapid growth has helped to fuel the rise in property prices during the same period. The risk to the lending institutions increases in overheated market conditions if prices subsequently correct sharply. Rapid growth in lending also puts additional strain on balance sheets, as demonstrated by the deterioration in the Hong Kong dollar loan-to-deposit ratio during the course of this year.

The HKMA expects all lending institutions to adopt a prudent and responsible attitude to their property lending. In the light of market conditions during the first half of the year, we have considered whether some additional tightening of lending criteria is required. At present this does not seem necessary, though it is not ruled out for the future. The market has cooled recently in the light of the

Government's intention to increase the supply of residential property and to deal resolutely with speculation. What seems required at this stage therefore is that institutions should strictly apply existing criteria and should not be relaxing these.

It is not our intention to repeat all the HKMA's existing guidelines in relation to residential mortgage lending, but rather to emphasize and elaborate on certain key aspects as set out below.

1. Strict application of the existing 70% and 60% loan to value ratios

There are continuing reports that some institutions are offering "top-up" loans in relation to residential mortgages. Such loans may take a variety of forms, but for the purposes of this letter they are described as "personal loans". While in theory such loans are intended to be used for such purposes as to decorate the property or to buy furniture, in practice they may be used to help finance the downpayment on the property.

Such a practice is unacceptable and contrary to existing HKMA guidelines. To reduce the risk that borrowers are relying on such top-up loans to increase their leverage, the HKMA considers that:

- personal loans (eg for decoration purposes) should not be advertised, or offered to borrowers, as part of a "package" involving a residential mortgage loan.
- where a personal loan is granted, as a separate credit decision, to an applicant to whom the institution is in the process of also granting a residential mortgage loan, drawdown of the personal loan should only be permitted after completion of the purchase of the property. This will provide some assurance that the personal loan is not being used to finance the downpayment.
- any such personal loan should be on normal personal loan terms, and have a maturity no longer than a normal personal loan maturity.

2. Assessment of the borrower's ability to repay

All institutions must have a clearly defined and documented policy to assess the repayment capability of residential mortgage borrowers. This should include the use of a debt servicing ratio (DSR) test. The DSR is defined as the monthly repayment obligations of the borrower as a percentage of monthly income. The ratio should be no higher than 50-60% of income, though the upper end of this range should be confined to higher income earners.

As regards the calculation of the DSR, the following are the key points:

- the amount of the "debt service" should include all monthly repayments relating to the mortgage loan application under review and all other debt repayments known to the institution (eg arising from personal loans granted by the institution, co-financing loans provided by property developers and credit facilities from other institutions if these can be ascertained).
- to make a sufficiently comprehensive assessment of the amount of the debt service, institutions should conduct reasonable checks on the extent of the borrower's other financial obligations, eg by enquiring whether the borrower has other existing mortgages or by reviewing the borrower's bank statements/account records.
- where part of the full debt service cost incurred by the borrower is deferred for a period (eg because of an interest "holiday"), the full eventual servicing cost should be included in the DSR calculation right from the start.
- the current income of the borrower should be used in the DSR calculation and no allowance should be made for any expected future income increase.

- 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.
- the institution must obtain income proof such as a salary statement or tax return from the borrower or guarantor.

3. *No relaxation of prudential lending criteria*

Institutions should not compete for additional market share in a manner which exposes them to increased risk. They should not therefore compete by relaxing criteria such as the DSR test or by reducing charges for early repayment of loans (these charges help to protect lending institutions through their deterrent effect on speculation). In particular, they should not relax such criteria or charges in order to obtain a share of the mortgage financing for specific new property developments.

4. *Avoidance of undue property concentration*

It remains the HKMA's view that those institutions whose property exposure* is above the overall industry average of about 40% of loans, should be attempting to stabilize or reduce that percentage. This applies particularly to those local institutions whose property exposure is also high in relation to capital base (although it is not the HKMA's intention to set a formal guideline in this respect).

A specific way in which those institutions which have a higher than average percentage property exposure can attempt to stabilize that percentage is by not pursuing an aggressive pricing policy in order to attract new business. In other words, such institutions should not be market leaders in terms of any further reduction in the interest rate on residential mortgage loans.

The HKMA intends to monitor the property exposure of authorized institutions on a more forward-looking basis by asking the more active participants to supply figures for the budgeted growth in the various types of property exposure for future periods. It will expect institutions largely to adhere to their budgeted rates of growth.

Monitoring and enforcement

The HKMA expects all institutions to comply with these guidelines and those previously issued. It will monitor this through spot checks carried out by its on-site examiners, and it will take a serious view of non-compliance. The HKMA may use the statutory powers under the Banking Ordinance to refuse to grant approvals to non-compliant institutions (eg to open new branches) or to place restrictions on the business of such institutions or to take action against the management concerned.

We look forward to the co-operation of all institutions in ensuring that the banking sector is not exposed to excessive risk in its property lending.

* "Property exposure" includes loans to finance property development and investment, as well as residential mortgage loans.