OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK
of 16 June 2015

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 the Czech credit and residential property markets were stable and were not a direct source of risks to financial stability. The CNB also stated that this situation was not necessarily permanent and it would therefore prepare and legislate for tools preventing the potential build-up of systemic risks in the banking sector. Such build-up usually occurs as a result of fast growth in loans secured by residential property combined with a concurrent easing of the interest rate or non-interest rate component of the credit conditions and rising residential property prices. The CNB regularly analyses loans secured by residential property and the property market situation. Where it identifies rising and increased risks, it is ready to activate the relevant instruments to reduce the financial sector's vulnerability to potentially adverse developments in economic activity 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 in relation to the financing of property purchases include a limit on the value of a loan relative to the underlying collateral, i.e. the loan-to-value (LTV) ratio. The LTV limit is set so as to reflect the possible volatility of property prices and the potential for such prices to fall during recessions or crises, so as to prevent borrowers from entering into commitments that significantly exceed the collateral value, and so as to ensure that even in bad times the

[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.

reduced property value will still serve as sufficient collateral. The ESRB recommendation[1] 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.

An assessment of information gathered by the CNB in the course of its supervisory work over the last two years reveals that credit institutions operating in the Czech Republic are mostly prudent when providing loans secured by residential property. However, there are signs of some easing of credit standards in this segment. A continuation of this trend, combined with low interest rates, strong balance sheet liquidity of credit institutions and property price growth, could become a source of systemic risk. In this Official Information, the CNB is therefore issuing a set of quantitative and qualitative recommendations for banks, foreign bank branches and credit unions. These recommendations, described below, define correct procedures and standards. They are aimed at enhancing existing internal risk management systems in such institutions and encouraging a prudent approach to providing of loans secured by residential property.

The CNB is issuing these recommendations as a preventive measure. Compliance with the recommendations does not preclude institutions from providing loans with a higher LTV in justified cases, i.e. in cases where other indicators considered in the application assessment process together indicate a high probability of the loan being repaid. It also allows institutions to tailor the conditions for the provision of individual retail loans secured by residential property to the risk profile of specific clients.

II.
Scope of application

1. This recommendation applies to banks, foreign bank branches and credit unions (hereinafter “institutions”) operating in the Czech Republic under Act No. 21/1992 Coll., on Banks, and Act No. 87/1995 Coll., on Credit Unions, on a solo basis. It applies to retail loans secured by residential property provided to natural persons (individuals).

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;
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 institution 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 LTI and DSTI ratios, the sum of the loan provided and the outstanding amount of the principal of any existing loans secured by the same property and other secured and unsecured loans to the client from the same institution, as well as loans from other institutions;
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 LTI (loan-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 annual expenses arising from a client's total debt under paragraph 7 to income under paragraph 9;
13. the indicator of 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

[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.

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 institutions ensure that new retail loans secured by residential property with an LTV of more than 90% do not exceed 10% of the total amount of such loans provided in any given quarter. Institutions should provide loans secured by residential property with an LTV of more than 90% 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.

2. It is also recommended that institutions ensure that the LTV of no retail loan secured by residential property exceeds 100%.

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

4. Institutions should determine collateral value for the purposes of calculating the LTV ratio in a prudent manner, proceeding in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council (in particular Article 208(3)) and Decree No. 163/2014 Coll., Articles 22(a) and 22(b) and Annex 3, paragraphs 5(f) and 9(c). The CNB expects institutions to take into account – in addition to expert opinions – the cyclical position of the economy and any property price overvaluation in accordance with Decree 163/2014 Coll., Annex 3, paragraphs 5(h) and 9(c).

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

1. When providing retail loans secured by residential property, institutions should prudently assess indicators of clients' ability to service loans from their own resources and set internal limits for such indicators. They can do so by, for example, setting limits on LTI, DSTI or similar ratios in their internal methodologies. If multiple clients apply together for a retail loan secured by residential property, it is recommended that institutions take into account the income and debt of all these clients when calculating these ratios.

2. This process should also involve an assessment of clients' ability to service loans under adverse conditions (i.e. stress-testing of clients' ability to service the loan), especially in

the event of a sizeable fall in income, a rise in lending rates 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).

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.[4]

3. Institutions 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.[4]

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

1. If institutions 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, institutions 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. Institutions 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, institutions should separately monitor credit risk and compare it with that on other retail loans secured by residential property.

[4] This does not apply to loans provided by building societies pursuant to Act No. 96/1993 Coll., on Building Savings Schemes.

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

1. For credit risk management purposes, institutions 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.

X.
Assessment of compliance with the recommendations

1. The CNB will regularly assess institutions' 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.

2. When assessing and verifying compliance with this recommendation, the CNB will take into account the specific characteristics of building societies due to the legal framework for building savings schemes.

3. The first assessment of compliance with recommendations A–F for the rest of 2015 after this recommendation takes effect will be conducted during the first half of 2016. When assessing compliance with the individual recommendations, the CNB will pay due regard to the time needed to adjust institutions' information systems and risk management systems.

XI.
Final provisions

1. This Official Information describes the legal situation as of 1 June 2015. 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 2015. 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.

3. This Official Information shall take effect on the date of its promulgation in the CNB Bulletin.

Vice-Governor
Vladimír Tomšík

Financial Stability Department
Responsible employee: Jan Frait, tel. 224 414 430