# OFFICIAL INFORMATION
# OF THE CZECH NATIONAL BANK
# of 1 April 2020

## 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 reveals that a spiral may be emerging between residential property prices and property purchase loans in an environment of easy credit standards and 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.
2. The applicability of paragraph 1 of Article IV and paragraph 2 of Article V of the Recommendation may be transferred to the provided group level on condition that the providers included in the group notify the CNB of this procedure, the CNB supervises the providers included in the group, these providers are a controlling and controlled entity or are controlled by the same controlling company, and a provider will be designated within the group to be responsible for collective compliance with paragraph 1 of Article IV and paragraph 2 of Article V of the Recommendation at the group level.
    a. In this case providers may set internal limits for the admissible exemption from the limits referred to in paragraph 1 of Article IV and paragraph 2 of Article V for the individual providers included in the group, notwithstanding the recommended limits of the admissible exemption laid down in paragraph 1 of Article IV and paragraph 2 of Article V. However, these internal limits of the admissible exemption should in no event exceed the recommended limits of the admissible exemption laid down in paragraph 1 of Article IV and paragraph 2 of Article V by more than one-third for the individual providers included in the group. At the same time, the management system within the group should ensure that the recommended limits of the admissible exemption referred to in paragraph 1 of Article IV and paragraph 2 of Article V are complied with at the group level. Compliance with the recommended limits of the admissible exemption laid down in paragraph 1 of Article IV and paragraph 2 of Article V at the group level will be assessed as the share of loans with the values of the ratios referred to in paragraph 1 of Article IV and paragraph 2 of Article V in the reference volume of retail loans secured by residential property provided by all providers included in the group pursuant to paragraph 2.b.a of Article II.
    b. The notification of the transfer of the applicability of paragraph 1 of Article IV and paragraph 2 of Article V to the group level shall be delivered jointly and simultaneously to the Czech National Bank by all providers for which compliance with the recommended limits of the admissible exemption referred to in paragraph 1

of Article IV and paragraph 2 of Article V is to be managed collectively at the group level. The notification shall include:

2.b.a) the designation of all providers to be included in the group for which internal limits of the admissible exemption may be set;

2.b.b) the assumed level of the internal limits of the admissible exemption set for the individual providers to be included in the group;

2.b.c) the designation of a provider within the group who will be responsible for collective compliance with the recommended limits of the admissible exemption at the group level.

2.c. If proceeding pursuant to paragraph 2.b of Article II, providers may manage compliance with the internal and recommended limits of the admissible exemption referred to in paragraph 2.a of Article II at the group level specified in the notification from the start of the quarter following the date of delivery of the notification to the CNB, but not longer than 2 years.

2.d. Should the facts contained in the notification change within 2 years of delivery of the notification to the CNB, the providers in question are obliged to immediately notify the CNB of the new facts pursuant to paragraph 2.b of Article II.

## 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 loan to purchase buy-to-let residential property means a retail loan secured by residential property to finance the purchase of residential property where the expected income from renting out this property is included in net income for the assessment of compliance with paragraph 2 of Article V;

16. an intermediary means a person carrying on financial intermediation;

17. the reference volume for retail loans secured by residential property is one-half of the sum of all retail loans secured by residential property provided in the previous two quarters or, for consumer credit not secured by residential property, one-half of the sum of consumer credit not secured by residential property provided in the previous two quarters to clients who already have a retail loan secured by residential property.

18. a loan to purchase additional residential property means a retail loan secured by residential property to finance a purchase of residential property where the expected

[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.

income from renting out this property is not included in net income for the assessment of compliance with paragraph 2 of Article V, provided to clients who already have one retail loan secured by residential property to finance the purchase of another residential property when submitting the application. If multiple clients apply together for a retail loan secured by residential property, it is recommended that providers take into account all existing retail loans to purchase residential property already taken out by at least one of these clients.

## IV.
## Recommendation A: Compliance with the LTV limit 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%. An LTV higher than 90% is deemed acceptable for loans provided in the current calendar quarter and representing a maximum of 5% of the reference volume of retail loans secured by residential property or the reference volume of consumer credit not secured by residential property. Providers should provide retail loans secured by residential property with an LTV higher than 90% 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 prudent assessment of the client's risk characteristics.

2. 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]
3. 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 consumer credit not secured by residential property 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

[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.

limits for the DTI and DSTI ratios and comply with the DSTI limit recommended in paragraph 2 of Article V.[6]

2. When providing retail loans secured by residential property or consumer credit not secured by residential property to clients that have a retail loan secured by residential property, it is recommended to providers that the DSTI ratio does not exceed 50%. A DSTI higher than 50% is deemed acceptable for loans provided in the current calendar quarter and representing a maximum of 5% of the reference volume of retail loans secured by residential property or the reference volume of consumer credit not secured by residential property.

   Providers should provide retail loans secured by residential property or consumer credit not secured by residential property to clients that have a retail loan secured by residential property with a DSTI higher than 50% 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. Providers should particularly prudently assess the loan applications of clients whose DTI ratio exceeds 8 and DSTI ratio exceeds 40%.

4. 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 consumer credit not secured by residential property 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.

[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.

## 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. If providers refinance consumer credit not secured by residential property for clients who have a retail loan secured by residential property and simultaneously increase the outstanding amount of principal by more than 10%, they should assess compliance with the DSTI ratio in accordance with Part V.

## 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: The provision of loans to purchase additional residential property and loans to purchase buy-to-let residential property

1. Providers are recommended to identify the purpose of the loan using all available information.
2. For credit risk management purposes, providers are recommended to identify and separately monitor the different characteristics of portfolios of retail loans secured by residential property to finance owner-occupied housing, retail loans to purchase additional residential property and retail loans to purchase buy-to-let residential property.
3. Providers are recommended to ensure that the LTV ratio of no loan to purchase buy-to-let residential property exceeds 60% if the DSTI indicator exceeds the ratio referred to in paragraph 2 of Article V under the admissible exemption from these limits referred to in paragraphs 2 and 3 of Article V.

4. When providing retail loans secured by residential property to finance the purchase of residential property to clients who already have a retail loan secured by residential property to finance the purchase of another residential property, providers should particularly prudently assess the asset and income situation of these clients.

## 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.

## XI.
## Final provisions

1. This Official Information describes the legal situation as of 1 April 2020. 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 31 March 2020. If major changes in risks to financial stability are identified, the CNB will be ready to adjust the relevant parameters of individual recommendations.

## XII.
## Effect

1. This Official Information shall replace Official Information of the Czech National Bank of 13 December 2019.
2. Providers may procced in accordance with this recommendation with immediate effect.

Deputy Governor
Tomáš Nidetzký

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