

To The European Banking Authority

From Dynamic Credit

Date 30 September 2019

Subject Response on consultation paper for draft guidelines on loan origination and monitoring

1. What are the respondents' views on the scope of application of the draft guidelines?

The scope of application of the draft guidelines is proportionate to the objective it is serving. As the objective of the draft guidelines is to 'improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting in order to ensure that institutions have robust and prudent standards for credit risk taking, management and monitoring and that newly originated loans are of high credit quality', ensuring that the scope of application includes credit institutions and investment firms seems proportionate to achieving that objective.

10. Applicability

This section specifically mentions that Section 5 does not only apply to loans and advances that are originated after the application date, but also to loan agreements where the terms are renegotiated or require specific actions triggered by the regular credit review of the borrower after application date. Here it is unclear what is considered a renegotiation of the terms of a loan agreement.

Regarding this specific topic, in the Netherlands the general practice is that only in case of a dismissal from joint and several liability and when adding a borrower to the mortgage, a new assessment is made with regard to the financial position of the borrower. A credit assessment is not executed in case of an interest rate reset or a change in a repayment type. Please refer to question 8 for further elaboration.

To avoid any misunderstanding, we propose to be more specific about the exact definition of renegotiation of the terms of a loan agreement.

2. Do you see any significant obstacles to the implementation of the guidelines by the application date and if so, what are they?

The current proposal in the draft guidelines is to apply them from 30 June 2020 onwards. Assuming the final form will be presented on 1 January 2020, this will give the institutions a period of 6 months for implementation.

The implementation of the guidelines will take time, especially the monitoring framework of Section 8. Depending on how certain aspects of this Section 8 should be interpreted (please refer to question 12), the set up of the monitoring framework should be decided upon and the process should be implemented. Specifically, this final step may take a lot of time, as IT platforms should be adjusted and additional staffing should be hired, educated and trained. Keeping in mind the elaborate requirements, implementation may take longer than 6 months. Therefore, we recommend a period of at least 12 months.

3. What are the respondents' views on whether the requirements set in the draft guidelines are future proof, in particular in relation to technology enabled innovation (Section 4.3.3.) and environmental factors and green lending (Section 4.3.4)?

With regard to technology enabled innovation the guidelines clearly mention the requirements for institutions when using this type of innovations. In the future, more of these technology enabled innovations might be developed, which will smoothen the credit granting process. These innovations should however not deteriorate the quality of the credit granting process. The requirements set should ensure that all risks when using these innovations are considered and are duly monitored.

With the increasing attention within the European Union on environmental changes, this may lead to potential changes in law and regulations that may affect consumers and financial institutions. It is a good thing to guide institutions to see how they can contribute in a positive way to these changes and taking into account risks of these environmental changes.

4. What are the respondents' views on the requirements for credit risk policies and procedures (Section 4.3)?

The guidelines are feasible.

5. What are the respondents' views on the requirements for governance for credit granting and monitoring (Section 4)?

The guidelines are feasible.

6. What are respondent's views on how the guidelines capture the role of the risk management function in credit granting process?

The risk management function should be able to control the risk taken when granting credit to borrowers. The role of the risk management function within the guidelines ensures that the risk management function has knowledge on the decisions taken when granting credit and is able to analyze the risks taken with credit granting and how to control/minimize these risks.

7. What are the respondents' views on the requirements for collection of information and documentation for the purposes of creditworthiness assessment (Section 5.1)?

The requirements laid down in Section 5.1 safeguard that when establishing the creditworthiness of the borrower, the assessment considers data that is supported by documentation. This will increase the quality of originated loans by, for example, preventing self-certified loans from being originated. Excessive documentation will however disrupt the loan application process and lead to higher costs for the institutions which will be charged to the borrower. A balance needs to be found between sufficient documentation being requested from the borrower and not disrupting to the loan application process.

Section 5.1 materializes the requirements for collecting and verifying a sufficient level of information and data to assess the creditworthiness of borrowers. It also refers to Annex 2 in which information and data is mentioned which institutions should consider collecting from the borrowers. To be even more specific, please consider specifying which considerations need to be made when determining whether a specific document is requested from the borrower. This would give the institutions guidance in how to determine whether a specific document mentioned should be requested.

8. What are the respondents' views on the requirements for assessment of borrower's creditworthiness (Section 5.2)?

When assessing the borrower's creditworthiness, in the Netherlands, a legislative framework ('Tijdelijke Regeling Hypothecair Krediet') sets the requirements regarding the maximum debt to income and the maximum loan to value. Next to this legislative framework, the financial institutions issued self regulation which further specifies these requirements ('Gedragscode Hypothecaire Financieringen'). These rules, together with specific qualifications required for persons involved in the loan origination process, ensure that in the Netherlands the quality of the originated loans is high and the percentage of non-performing loans is low.

Recently published data from the Dutch Central Bank shows that in the Netherlands only 1% of the loans of households are in arrears for 90 days or more. This is the lowest within the whole of the European Union. This opposed to the fact that 61% of the population owns a home and has a mortgage loan. This is the highest percentage in the whole of the European Union. Furthermore, the total household debt in the Netherlands compared to their net yearly income is 250%, also one of the highest within the European Union. Based on these results, it can be concluded that despite that fact that the debts of households in the Netherlands are one of the highest within the European Union, payment morality of the borrowers is also the highest.

This steady performance can be predominantly attributed to the strict regulation regarding loan origination (specifically for mortgage loans) and required qualifications of people involved in the loan origination process. Even though we believe that the requirements regarding the assessment of creditworthiness of borrowers in the guidelines can contribute to the origination of high quality loans, we believe that on certain aspects the guidelines are rather unclear with regard to their intended scope of application or seem unreasonably strict. These requirements will be discussed separately below.

97. Before amending the existing loan agreement the creditworthiness of the borrower should be reassessed based on the collected relevant information

It is currently unclear what is considered to be an amendment of the existing loan agreement that would lead to a reassessment of the creditworthiness of the borrower, apart from a change in the loan amount. There are several processes that lead to a change compared to the original loan. Situations that can occur are, for example, a change in repayment type or a revision of the interest rate. Even though these are changes compared to the originally agreed terms, these do not justify a full creditworthiness assessment.

In the Netherlands, for example, we assess the repayment capacity of the borrower by a maximum DTI based on an annuity payment, regardless of the actual repayment schedule. This ensures that at origination it is already assessed whether a borrower has at least the capacity to repay based on an annuity schedule even when the actual repayment schedule is (partially) interest only. A linear repayment schedule is always a specific choice of the borrower and, when proven not affordable for the borrower, can be changed into an annuity payment. The monthly instalments in such a situation will only decrease. Furthermore, with regard to a revision of the interest rate, this will only be requested by the borrower if the new requested interest rate is lower or the borrower is willing and able to pay the higher interest rate. Only exemption to this, is the situation where a fixed rate period ends and the borrower needs to choose a new fixed rate period. To cover for this risk when the interest rate period is shorter than 10 years, either at origination or when issuing a further advance, the interest rate used for the affordability test is based on a fictive interest rate from the Dutch Financial Markets Authority, currently 5%. By doing this, borrowers with short fixed rate periods are tested against the scenario that interest rates increase significantly.

Based on the above mentioned, we consider that not every amendment of the existing loan agreement should lead to a new creditworthiness check of the borrower. Please consider to change this by specifying which changes are considered an amendment of the loan agreement and would thus require a new creditworthiness test.

98. The assessment of the disposable income

In the Netherlands, the maximum debt-to-income (DTI) ratio is subject to a prudent statutory limit as prescribed in the Tijdelijke Regeling Hypothecair Krediet. This maximum DTI is multiplied with the gross yearly income to determine the yearly payment capacity for a loan (based on an annuity payment). In principle, lenders follow the maximum DTIs and typically do not assess payment capacity of individual borrowers. The maximum DTI ratios are benchmarked every year by the national household budget agency (NIBUD) and the law is updated accordingly.

Please consider changing the definition of disposable income to show payment capacity for a loan after expenses. And allow for a national framework for maximum DTIs that does not require the lender to assess the payment capacity based on an income and expenses analysis for individual borrowers. It would be in line with the spirit of the guideline. And it would ensure that the current prudent framework in the Netherlands complies with the guideline.

99. Loan service to income and debt to income ratio

The ratios under b and c are unclear. The loan-to-income and debt-service-to-income ratios are well known and applied widely in the market. The loan-to-income ratio is generally defined as the loan (originated by the lender) divided by the income. The debt-service-to-income ratio is defined as the debt serviced (on the loan originated by the lender) divided by the income. The loan-service-to-income and debt-to-income ratios are unclear and do not seem to follow industry practice. To avoid any misunderstanding, please specify the definition or remove ambiguous ratios.

101. Sensitivity analyses

The scope of the sensitivity analyses is unclear. Looking at the general Dutch practice of loan origination, the current creditworthiness assessment already takes into account certain negative scenarios. Examples of these measures include:

- When the fixed rate period of a loan is shorter than 10 years, the interest rate for the affordability test is set at an interest rate established by the Dutch Financial Markets Authority, currently 5%. (For perspective, the lowest 10 year fixed rate period NHG rate is currently 1.20%.) The higher rate is applied to compensate for future possible interest rate increases.
- When the borrower does not have an income which can be considered fixed (for example agency workers), the income is determined based on the average earned income of the last 3 years. This to determine the income capacity of the borrower.
- The affordability test is based on a full annuity payment regardless of the actual repayment schedule.

A borrower that is uncertain about its financial position can always engage a financial advisor to ensure that all adverse scenarios such as unemployment and disability are discussed extensively. These advisors can take the result into consideration by advising for example certain insurance policies.

As described, sensitivity analyses are already performed in the Netherlands. It is however unclear whether this is enough to comply with the scope of the guidelines or further steps are required. Please

clarify the scope of applicability of this sensitivity analyses. Should the sensitivity analyses of the lender include a possible decrease in the future and what should be the consequences when the loan would not be affordable in case of a possible income decrease? Also, a lender is generally not equipped to assess the employability of a borrower (in case of a stress scenario) so it cannot make a meaningful assessment of long-term stress scenarios.

107. Retirement age

In the Netherlands, the typical mortgage loan has a maturity of 30 years. Currently, when a borrower reaches the retirement age within 10 years, then an additional check is executed on the income at retirement age. If a lender must test affordability (the maximum DTI is defined by law in the Tijdelijke Regeling Hypothecair Krediet) for a borrower that reaches retirement age within the term of a mortgage loan, that means testing borrowers an age of 38 years and up. The current pension overview does not take into account any income increases in the expected pension income. Not even inflation. Income increases are uncertain and can therefore not be predicted but are in general expected for everyone over a sufficiently long time span.

Most borrowers are expected to have a higher pension allowance at retirement age than is expected 30 years before (at origination of the loan). Requiring lenders to test the pension income if retirement age is reached within the loan term would in the short run lead to rejecting all applications where this situation occurs. To avoid that situation, please clarify how 'taking appropriate account' should be interpreted by the credit institutions.

109. Actual obligations and living expenses

In the Netherlands the ability of a borrower to meet its financial obligations is not determined based on the actual obligations and living expenses. The affordability criteria prescribed by law in the Tijdelijke Regeling Hypothecair Krediet impose a maximum DTI. These ratios are determined considering information from the NIBUD on average living expenses of households. These DTI ratios are benchmarked yearly and adjusted accordingly. These ratios already take into account possible changes in living expenses in the future. For example, when requesting a loan, a borrower might be single without any children. At that moment living expenses may be low. When after a few years the borrower will get married and have a few kids, living expenses will increase. Determining the actual living expenses of a borrower can only be done via a snapshot of, for example, a month.

Financial obligations of borrowers may also change. Therefore, in the Netherlands the monthly financial obligations of the borrower are determined on 2% of the registered loan amount with Stichting Bureau Krediet Registratie (BKR). This is the institution that registers consumer loans which are financed via financial institutions. When the actual monthly obligation is higher or the borrower provides evidence of the actual lower monthly obligation and this monthly obligation is fixed for the duration of the loan, the actual monthly obligation is taken into account. By calculating the monthly instalments on a certain percentage, future changes in monthly obligations are taken into account.

Instead of taking into account the actual obligations and living expenses of a borrower, please consider to work with standardized, regularly reviewed ratios, to ensure clear guidelines and take into consideration possible changes in financial obligations.

9. What are the respondents' views on the scope of the asset classes and products covered in loan origination procedures (Section 5)?

184. Validity of the credit decision

The current wording does not reflect how origination of mortgage loans for consumers takes place. In line with the Mortgage Credit Directive, a binding offer is sent to the borrower after a positive credit decision has been made. The underwriting criteria prescribe a certain offer validity and some possibility for an extension. Most lenders allow for additional extensions if the loan is originated outside the offer period (for example if the transfer of a property is postponed). Since origination already involves extensive underwriting, reperforming the credit decision within such period is not reasonable and would unnecessarily increase the burden on the consumer. In addition, if the situation of the borrower has changed and the credit proposal is declined, there is often no way to get out of the purchase contract without incurring a fine of 10% of the purchase price (to be paid to the seller). Furthermore, it is rather arbitrary to state that on the last day of the offer period it is possible to execute the transaction, but one day later it is no longer possible and a reassessment has to be made since we are no longer comfortable with the creditworthiness of the borrower.

Please consider to make a clear distinction between the validity of the credit decision and the offer period in the wording of the guidelines.

10. What are the respondents' views on the requirements for loan pricing (Section 6)?

The guidelines are feasible.

11. What are the respondents' views on the requirements for valuation of immovable and movable property collateral (Section 7)?

In the Netherlands, there are many initiatives to make mortgage lending as cost efficient as possible. Some of the improvements that we have seen are:

- i) the single rate policy (the front book must be priced similarly as the back book so no teaser rates are allowed),
- ii) inducement prohibition (the lender cannot pay the financial advisor to ensure that conflicts of interest are mitigated),
- iii) using the social insurance registration to determine the employment and income (a government data source that can be downloaded from a website at any time),
- iv) using specialized third parties to determine income for self-employed borrowers (makes borrowers more flexible in the choice for a lender because eligibility for a loan is no longer determined by the level of sophistication of the lender to determine this type of income),
- v) determining the collateral value by taking the assessment for the immovable property tax (mostly up to 60% LTV),
- vi) AVM up to a LTV threshold (mostly up to 80-90% LTV).

These improvements make it easier for a borrower to purchase and mortgage a property or to refinance an existing mortgage loan. Limiting the use of AVM would increase the barriers for consumers again by imposing costs.

Allowing AVM models for origination up to certain LTVs decreases costs without significantly increasing risk for the lender. It makes the origination process more streamlined and mitigates subjectivity in the process. Costs savings for lenders will ultimately benefit consumers as more and more competition takes place on pricing and product criteria.

Requiring the lender to perform or order a valuation gives a false sense of security. In the Netherlands, the accuracy of a valuation is secured by having a certified valuer perform the valuation and having it validated by a validation institute. This ensures that only qualified professionals perform the valuation

and that the valuation can be challenged by a third party. This gives more security than imposing the requirement that the lender should order the valuation.

If the lender must order the valuation, the costs are borne by the lender and it would increase running costs or impose up front fees of a borrower. In addition, if a request is unsuccessful, another valuation must be done which imposes unnecessary costs on the borrower. All in all, allowing AVM for origination will increase efficiency and help lowering the boundary for refinances (and purchases).

For all types of loans with collateral, and especially CRE, allowing AVM at origination would decrease the subjectivity involved with originating loans in low-volume markets.

Please consider to allow AVM for origination. We advise to allow AVM for purchases in line with the reasoning above. If the prudential argument is decisive, please consider to at least allow AVM for refinances of existing mortgage debt. Also, the language in point 199 is ambiguous, specifically the last sentence after the comma is unclear about the circumstances that allow a deviation from the first two requirements.

12. What are the respondents' views on the proposed requirements on monitoring framework (Section 8)?

The idea of a monitoring framework is very good and will help some credit institutions with getting a framework in place. The monitoring framework seems to assume that credit risk exposure can be managed in all cases. Assuming a portfolio of (Dutch) mortgage loans, monitoring makes sense but managing the portfolio would not work. A borrower/loan that does not comply with – for example the initial – credit risk criteria would force the lender to take action. Mere non-compliance to the credit risk criteria is not in itself a reason to end the credit facility and force repayment (for example by putting the collateral to an auction). In that sense informing the lender that certain criteria are not met also involves following up which might not be in the best interest of the borrower.

There is no consumer friendly mechanism to enforce borrowers to periodically submit information. Would non-compliance be a reason to end the credit facility? It could give consumers a 'big brother is watching you' feeling.

Moreover, the requirements mentioned in the guidelines give a false sense of security and do not fully cover the problem. As the objective is attacking non-performing loans, the requirements with regard to monitoring should attack non-performing loans. For a lender it is important to be approachable for borrowers running into arrears. Frequently requesting borrowers for information regarding their income, collateral and expenses situations will have the opposite effect. When these borrowers will run into payment issues, they might not contact the lender for help which could lead to bigger issues.

We would therefore like to advise you, when attacking the problem of non-performing loans, to put more focus on the special servicing phase for non-performing loans, rather than trying to manage performing loans. A borrower that is complying with the loan agreement and for which the lender has no indications that covenants or conditions have been breached does not deserve to be bothered with an extensive monitoring burden.