Consultation Paper

FSB Principles for Sound Residential Mortgage Underwriting Practices

26 October 2011

FINANCIAL STABILITY BOARD

Table of Contents

Definitions

Definitions often differ across jurisdictions. For the purposes of these Principles, the following definitions are used:

Appraisal:	The act or process of developing an opinion of the collateral's value. Appraisal is a term used interchangeably with valuation.
Balloon payment:	The remaining amount of principal that becomes due and payable on the final instalment payment for a loan that is not fully amortised.
Collateral:	The property or property rights upon which the residential mortgage loan is secured.
Collateral management:	For purposes of these Principles, collateral management concerns all tasks and processes within the mortgage underwriting process where collateral is involved, e.g. appraisal of collateral, the constitution of collateral, review of its legal existence and enforceability and entry of collateral-related data in the lender's information technology systems.
Debt-to-income (DTI):	Annual or monthly debt servicing requirements as a percentage of annual or monthly income that is available to repay the debt.
Down payment:	Up-front payment of a portion of a purchase price, which reduces the balance of the loan against the property.
Equity:	Difference between the appraised value of the property and the total claims held against the property.
Loan-to-income (LTI):	Annual or monthly mortgage loan servicing requirements as a percentage of annual or monthly income that is available to repay the loan.
Loan-to-value (LTV):	The ratio of the amount of the loan outstanding to the appraised value of the residential property.
Mortgage:	A loan that is collateralised against a residential property, including purchase, home equity lines of credit (HELOCs) and refinancings.
Variable rate mortgage:	A loan in which the interest rate rises and falls possibly based on the movement on an underlying index. The term variable rate mortgages is used interchangeably with adjustable rate mortgages.

I. Introduction

In March 2011 the Financial Stability Board (FSB) published a thematic review of residential mortgage underwriting and origination practices.[1] Based on the findings of the review, six recommendations were set out, one of which asked the FSB to develop an international principles-based framework for sound underwriting practices. After providing sufficient time for implementation, the FSB will conduct a follow-up review to assess progress made in implementing the framework. Given that the underlying risks can differ across jurisdictions, the Principles are high-level rather than aimed at detailed international standards.

As the global crisis demonstrated, the consequences of weak residential mortgage underwriting practices in one country can be transferred globally through securitisation of mortgages underwritten to weak standards. As such, it is important to have sound underwriting practices at the point at which a mortgage loan is originally made. In response to the crisis, a number of FSB members have encouraged stricter underwriting practices so as to limit the risks that mortgage markets pose to financial stability and to better safeguard borrowers and investors. Internationally agreed Principles will help to strengthen residential mortgage underwriting practices and enable supervisors to more effectively monitor and detect the erosion of underwriting practices particularly when the housing market is booming.

The FSB Principles are intended to apply to loans to individuals (consumers) that are secured by a residential property (e.g. mortgage). However, some or all of the Principles may not necessarily be appropriate or applicable for certain niche forms of finance.[2] Jurisdictions should nonetheless seek to apply all Principles that are relevant. In all instances, a robust and effective assessment of individual affordability has to underpin any sustainable lending model. It is important to note that the Principles focus on the credit granting decision rather than wider issues of credit risk management.

Jurisdictions should ensure that entities that originate the mortgage, or own the resulting risk, adhere to these FSB Principles, including any entities involved in outsourcing of mortgage underwriting. The Principles span the following areas, some of which proved to be particularly weak during the global financial crisis that started in 2007: (i) effective verification of income and other financial information; (ii) reasonable debt service coverage; (iii) appropriate loan-to-value ratios; (iv) effective collateral management; and (v) prudent use of mortgage insurance. The report also sets out an implementation framework to promote minimum residential mortgage underwriting standards, and describes tools that could be used to monitor and supervise these standards.

In general, the range of residential mortgage underwriting practices reflects the distinct real estate markets, cultural differences and socioeconomic policies that shape each jurisdiction's mortgage market. Hence, these Principles should be implemented according to national

---

1 http://www.financialstabilityboard.org/publications/r_110318a.pdf.

2 For example, equity release products (reverse mortgages) and bridging finance are explicitly designed to be repaid from the proceeds of the sale of the property, so some of the Principles will be less applicable to them. Borrowing by high-wealth borrowers or purchasers of buy-to-let properties should generally be considered within the scope of these Principles, but they might not apply to such borrowing in the same way as they would to the bulk of mortgage lending (see Principle 6).

circumstances, and as appropriate to national institutional arrangements, whether through legislative, regulatory or supervisory measures, or through industry practices.

II. Principles

The *FSB Principles for Sound Residential Mortgage Underwriting Practices* aim to provide a framework for jurisdictions to set minimum acceptable underwriting standards. Jurisdictions should ensure that lenders adopt sound mortgage underwriting standards against which supervisors can monitor and supervise. The examples provided throughout the Principles should be interpreted as such, and jurisdictions should implement the Principles according to national circumstances.

1. Effective verification of income and other financial information

A borrower's underlying income capacity is a key input into effective mortgage underwriting. Jurisdictions should ensure that lenders verify and document each applicant's current employment status, income history, and other financial information submitted for mortgage qualification. While income verification can help to measure a borrower's "ability to repay", other financial information (e.g. credit scores, credit registers) can help to measure a borrower's historical "propensity to repay".

1.1 **Jurisdictions should ensure that lenders make reasonable inquiries and take reasonable steps to verify a borrower's underlying income capacity.** Lenders should obtain sufficient income history on the borrower and make appropriate efforts to capture any variability in the borrower's income by collecting and analysing sufficient income history. These income reports should be based on authoritative sources. For borrowers who are self-employed or entrepreneurs, lenders may require even more extensive history or third-party verification to document income and profit capacity.

1.2 **Jurisdictions should ensure that lenders maintain complete documentation of the information that leads to mortgage approval.** Lenders should document the income history collected for each applicant, including the steps taken to verify income, and maintain this documentation for a number of years after origination of the loan. A proper record with an adequate explanation should be readily available for supervisors. For example, the documentation could contain not only the total income in each year covered by the history but also income disaggregated into wage/salary and the more volatile components such as overtime, commissions, bonuses and equity pay, where variable pay is a significant part of the total income.

1.3 **Jurisdictions should ensure that incentives are aligned with accurate representation of borrowers' financial information.** The loan documentation requirements should be designed to help identify misrepresentation of information either by the borrower, the lender or the broker. When misinformation provided by the borrower is detected, lenders should have recourse as appropriate to the jurisdiction's legal system.

2. Reasonable debt service coverage

One of the most fundamental components of prudent underwriting is an accurate assessment of the borrower's ability to repay the mortgage. This is important to help ensure prudent mortgage underwriting standards minimise defaults and losses, and thus, promote stability of the financial system. Furthermore, it is an important factor in reducing the likelihood of consumer over-indebtedness and the negative social and economic impact of forced sales.

2.1 **Jurisdictions should ensure that lenders appropriately assess borrowers' ability to service and fully repay their loans without causing them undue hardship.** This could include appropriate substantiation of:

- income and assets, including their sources;
- past ability to save, as evidenced by a down payment sourced from the borrower's own resources and other savings;
- other servicing obligations, such as the level of other debt (secured and unsecured), interest rate, outstanding principal, evidence of delinquency;
- current and anticipated living expenses, such as household composition, utility payments, health expenditures, alimony or maintenance payments; or
- recourse to repayment capacity from other sources, including guarantees, income insurance, or government or social support payments.

Lenders should include within this assessment that the loan can be expected to be repaid, including principal, interest, taxes and insurance, within the specified loan amortisation period from the borrowers' own resources. Temporarily high incomes should be suitably discounted. If the loan term extends past normal retirement age, lenders should take into account the adequacy of the borrower's likely income and repayment capacity in retirement. The assessment should not be based on the assumption that the property will appreciate in value.

2.2 **Jurisdictions should ensure that lenders make reasonable allowances for normal living expenses and other recurring repayment obligations in the assessment of repayment capacity.** This could include, for example, establishing the borrowers' actual obligations, modelling normal living expenses for households of similar composition and income, and specifying fixed ratios of repayment to some measure of gross or net income (e.g. debt-to-income ratio, loan-to-income ratio). In such cases, lenders should include these economic limits in their internal risk policies.

2.3 **Jurisdictions should ensure lenders make prudent allowances for future negative outcomes.** Any decrease in economic activities can reduce the salary or wages of borrowers, and lenders should consider this when evaluating the borrower's debt servicing capacity, for example by assessing current savings and past ability to save (see section 2.1). Where a borrower has other pre-existing (variable) debts, consideration should be given to the highest expected payment on those other debts where this can be ascertained. Further, the increase in benchmark interest rates in the case of variable rate mortgages can significantly increase the monthly mortgage payment. As such, repayment capacity calculations should take into account the highest payment currently scheduled to apply during the term of the loan rather than solely utilising the first few payments at the prevailing interest rate, considering as well the increase in future payments due to negative amortisation, balloon payment, or deferred payments of principal or interest.

2.4 **Jurisdictions should ensure that lenders provide borrowers with sufficient information to clearly understand the basis for calculation of repayment ability, loan terms, costs, penalties, and risks prior to making a product choice.** It is important that customer information be clear, concise, reliable, comparable, easily accessible, timely, and comprehensive (i.e. the information should also take into account the effect of variation in interest rates and the joint effect of the loan and any other product linked to it).

3. Appropriate loan-to-value ratios

Collateralisation is an important dimension of mortgage underwriting standards. From an historical perspective, high-LTV ratio loans consistently perform worse than those with a high proportion of initial equity. While it is common for individual lenders to apply a cap on LTV ratios, it is not necessary for regulators and supervisors to mandate such a cap if they satisfy themselves that the underwriting standards are sufficiently prudent and are unlikely to be eroded under competitive pressure. However, jurisdictions may consider imposing or incentivising limits on LTV ratios according to specific national circumstances.

3.1 **Jurisdictions should ensure that their regulatory and supervisory frameworks appropriately incentivise prudent approaches to the collateralisation of mortgage loans.** However, the LTV ratio should not be relied upon as an alternative to assessing repayment capacity (see Principle 2 for more details).

3.2 **Jurisdictions should ensure that lenders adopt prudent LTV ratios with an appropriate level of down payment that is substantially drawn from the borrower’s own resources, not from, for example, another provider of finance.**

3.3 **Where national frameworks specify controls, standards or incentives on LTV ratios, these jurisdictions should ensure that lenders satisfy themselves that the LTV ratio takes into consideration the "real value" of the available equity, which could be calculated on the basis of:**

- a robust and prudent approach to property appraisals (see Principle 4);

- all loans that are collateralised against the same property or for financing part of the cost of the property. This should include loans provided alongside the main mortgage (e.g. top-up loans, renovation or decoration loans); and
- any increase in loan authorisation being subject to a full assessment of the borrower's repayment capacity and to an appropriate LTV ratio at the point of the new mortgage underwriting, and not rely on the excess equity. Any subsequent refinancing utilising a second charge or lien should lead to the calculation of a new LTV ratio where possible. Particular caution should be exercised about drawing down on the equity in the property if that would raise the current LTV ratio above the level originally agreed.

3.4 **Jurisdictions should ensure that lenders refrain from relaxing LTV ratios at the time of a boom in the property market.**

4. Effective collateral management

Collateral management and sound appraisal processes are essential to the mortgage business. The property and the appraised property value are of utmost importance for risk limitation and mitigation. Lenders may want to outsource certain tasks to external parties such as appraisers. However, jurisdictions should ensure that lenders are responsible for all tasks that are related to their mortgage underwriting.

4.1 **Jurisdictions should ensure that lenders adopt and adhere to adequate internal risk management and collateral management processes, which include sound appraisal processes.** Proper collateral management should include onsite inspections by lenders or appraisers; but onsite inspections could be exempted if the lender or appraiser is able to demonstrate that the risk posed, either by the nature of the property or the transaction, is lower than standard (see Principle 6).[3]

4.2 **Jurisdictions should ensure that lenders satisfy themselves that the claim on collateral is legally enforceable and can be realised in a reasonable period of time.** Borrowers should have or will have clear title to the property and the characteristics are as they have been represented. The types of property accepted as collateral and the related mortgage underwriting policies should be clearly documented. The property serving as collateral should be appropriately insured against damage.

4.3 **Jurisdictions should ensure that lenders adopt appraisal standards and methods (e.g. income approach, cost approach, or sales comparison approach) that lead to realistic and substantiated property appraisals.[4]** Property appraisals should be

[3] The risk standard could be defined based on an evaluation of aspects such as property value, LTV, availability of sales prices for comparable properties and diversification within the bank's collateral portfolio.

[4] Standards such as the International Valuation Standards by the International Valuation Standards Council or the Red Book by the Royal Institution of Chartered Surveyors could serve as a starting point.

supportable and therefore reflect the current price level and the property's function as collateral over the entire life of the mortgage**.** Property appraisals should not reflect expected future house price appreciation.

4.4 **Jurisdictions should ensure that lenders maintain adequate appraisal documentation for collateral that is comprehensive and plausible.** It should include an examination of all aspects relevant to the property value. The scope and extent of the appraisal report should be commensurate with the property value and inherent risks.

4.5 **Jurisdictions should ensure that lenders deduct significant incentives or benefits offered in the context of buying the property (e.g. vendor financing of down payments, sales and financing concessions) that may inflate the price of the property in the course of the appraisal process.**

4.6 **Jurisdictions should ensure that lenders require all appraisals to be prepared with appropriate professional skill and diligence, and that appraisers meet certain qualification requirements**. Appraisers, and providers of appraisal systems, should be independent from the respective mortgage acquisition, loan processing and loan decision process. In addition, they should not have an interest in the result of the appraisal.

5. Prudent use of mortgage insurance

Mortgage insurance is used in some jurisdictions as a form of credit support for mortgage loans, and a way to provide additional financing flexibility for lenders and borrowers.

5.1 **Jurisdictions should ensure that the use of mortgage insurance, where used, does not substitute for sound underwriting practices by lenders.** Lenders should conduct their own comprehensive and independent assessment of the borrower's capacity to repay and of the value of the property. In addition, mortgage insurers should have their own prudent underwriting practices consistent with the Principles in this framework. In particular, lenders should not consider mortgage insurance as a substitute for verification of income and minimum initial equity by borrowers, reasonable debt service coverage, and appropriate collateral management process.

5.2 **Jurisdictions should ensure that lenders carry out prudent and independent assessments of the risks related to the use of mortgage insurance, such as counterparty risk and the extent and details of the coverage of the mortgage insurance policies.** The effectiveness of mortgage insurance depends on the financial strength of the provider and a clear understanding of the policy coverage, which should be frequently monitored and assessed by the lender.

5.3 **Jurisdictions should ensure that all mortgage insurers be subject to appropriate prudential and regulatory oversight.** However, in the case of government entities, prudential or regulatory oversight may suffice**.** Through the use of mortgage insurance, credit risks, particularly those for high LTV loans, are transferred from lenders to insurers and often concentrate the risks to a smaller number of institutions.

5.4 **Jurisdictions should ensure that mortgage insurance, where used, represents an effective transfer of risks from lenders to insurers.** In particular, while mortgage insurance may be used by lenders for risk management or capital efficiency purposes, jurisdictions should ensure that captive mortgage insurers are subject to appropriate regulation and supervision.

6. Implementation framework

Underlying the FSB Principles set out above is an understanding that mortgage underwriting standards are multi-dimensional and interrelated. Lending standards should be applied in a coordinated way, leading to balanced combinations of dimensions that can vary with the national or economic context. Such an approach aims at preventing excessive build-up of risks (e.g. "risk layering"), avoiding one-dimensional policies that could exclude some creditworthy categories from housing finance, and dampening cycles that could arise from neglecting important dimensions, both in overheating phases (undue relaxation) or downturns (procyclical standard tightening). The following actions form a basis for addressing underwriting risk, although jurisdictions may employ alternative means to counter the build-up of excessive risk.

6.1 **Jurisdictions should ensure that there is an effective framework of mortgage underwriting standards against which regulators and supervisors can monitor and supervise.** This framework could be set centrally by regulators or supervisors, in addition to requiring lenders to have board-approved mortgage underwriting policies. In either case, the framework should meet Principles 1 to 5 and have regard to the interconnectedness of these aspects and the opportunities for arbitrage.

6.2 **Jurisdictions should ensure that lenders consider more conservative underwriting criteria to compensate for situations where the underlying risks are higher.** For example, more conservative underwriting standards (e.g. LTV ratios or servicing requirements) could be considered where:

- there are considerable risks that an asset price bubble is building up in the property market as a whole or in specific segments or geographical areas;
- the property is for an investment or buy-to-let purpose, or for particular classes such as the luxury market;
- there is a lack of full recourse against borrowers; or
- other aspects of the underwriting standards are looser than the typical setting in the jurisdiction.

6.3 **Jurisdictions may want to impose absolute minimum levels of particular dimensions of mortgage underwriting standards below which no mortgage would be deemed acceptable, irrespective of the settings across the other dimensions.** For example, the supervisor could specify that initial LTV ratios above 100 percent are not acceptable under any circumstances or that stated income is not acceptable and lenders should always conduct due verification.

6.4 **Jurisdictions may want to require appropriate compensatory tightening in one or more dimensions to offset an easing in other dimensions.** For example, foreign currency denominated loans could be offset by tighter serviceability requirements; or prolonged processes to foreclose delinquent loans could be offset by lower LTV ratios.

6.5 **Jurisdictions may want to articulate the circumstances under which the supervisor would expect a material tightening of mortgage underwriting standards, either at an individual institution or across the whole industry.** For example, a supervisor could articulate that it reserves the right to demand tighter standards at a particular institution that has material weaknesses in its management controls.

7. Effective supervisory tools and powers

Jurisdictions should provide for appropriate monitoring and supervision of mortgage underwriting practices. Supervisors should consider the optionality embedded in the relevant loan terms and conditions, and the information used to verify that the loan meets the standard.

7.1 **Jurisdictions should give supervisors and regulators the authority to monitor, and where applicable to supervise, mortgage standards and practices.** These powers could include:

- collecting data on mortgage underwriting standards and other matters necessary to carry out their regulatory functions and ensure compliance with the framework they have articulated as set out in Principle 6, or requiring other agencies to collect data for this purpose on their behalf;
- directly specifying the data they will collect to fulfill this requirement; and
- requiring entities under their prudential and regulatory framework to be capable of tracking portfolios and originations according to the mortgage underwriting standards observed.

7.2 **Jurisdictions should consider subjecting the framework of mortgage underwriting standards described in Principle 6.1 to periodic review.** Any review should be responsive to reversal of trends to avoid amplifying cycles. A forward-looking approach should be developed as much as possible, taking into account the fact that significant delinquencies generally appear some years into the life of a loan.

7.3 **Jurisdictions may want to give supervisors and regulators the authority to require lenders to identify groups of loans with a higher risk profile and that these loans be underwritten to a set of norms specific to them within the overall framework described in Principle 6.** For example, they could require lenders not to process through automated systems loans extended to borrowers whose situations make risk assessment complex.

7.4 **Jurisdictions should ensure that supervisors or other authorities disclose an assessment of mortgage underwriting practices in their jurisdiction, including the set of entities that are not prudentially regulated, whenever significant changes have been detected.**

- The authority or authorities responsible for publishing such an assessment should have the powers to collect such data as are required to make that assessment, or to receive those data from the agency that is authorised to collect it.
- Jurisdictions should specify the relative level of oversight of different types of lenders according to their importance in the financial system and the risks they pose.