

EBA/CP/2014/42

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Consultation Paper

Draft Guidelines on creditworthiness assessment

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1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 4.

Comments are most helpful if they:

- respond to the question(s) stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 12.02.2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive summary

The Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive or MCD) was published in the Official Journal of the Commission on 28 February 2014 with a transposition date of 21 March 2016.

As set out in recital 6, the Mortgage Credit Directive aims to develop a more transparent, efficient and competitive internal market, through consistent, flexible and fair credit agreements relating to immovable property, while promoting sustainable lending and borrowing and financial inclusion, and hence providing a high level of consumer protection.

Article 18 MCD requires that, before concluding a credit agreement, the creditor makes a thorough assessment of the consumer's creditworthiness taking appropriate account of factors relevant to verifying the prospect of the consumer to meet his/her obligations under the credit agreement. Article 20 (1) MCD, in turn, provides that the assessment of creditworthiness shall be carried out on the basis of information on the consumer's income and expenses and other financial and economic circumstances which is necessary, sufficient and proportionate.

In order to ensure that these high-level provisions will be implemented and supervised consistently across the 28 EU Member States, and to support the transposition of the MCD, the EBA is issuing and consulting on draft guidelines. The Guidelines provide greater detail on how financial institutions should give effect to the relevant MCD provisions in Article 18 and 20(1), and thus contribute to the EBA's objective of achieving a convergence of supervisory practices for the Directives that fall into the EBA's scope of action.

The Guidelines establish requirements on the verification of the consumer's income; documentation and retention of information; identification and prevention of misrepresented information; assessment of the consumer's ability to meet his/her obligations under the credit agreement; allowance for the consumer's committed and other non-discretionary expenditures; allowance for potential future negative scenarios; and identification of groups of loans with higher risk profiles.

The Guidelines are based on the provisions of the *Opinion of the European Banking Authority on Good Practices for Responsible Mortgage Lending*, which was published on 13 June 2013, i.e. before the MCD was adopted, and which was reviewed by the EBA when developing the Guidelines. As a result, only relevant provisions within the Opinion were considered for these Guidelines. In addition, the Guidelines are aligned to the specific principles of the Financial Stability Board's Principles for Sound Residential Mortgage Underwriting Practices, which are relevant to the provisions under Articles 18 and 20(1) MCD.

3. Background and rationale

Background

The 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 (“Mortgage Credit Directive” or “MCD”) was adopted on 4 February 2014 and published on 28 February 2014. The deadline for Member States (“MS”) to transpose the provisions of the Mortgage Credit Directive into national law is 21 March 2016.

The MCD aims to develop a more transparent, efficient and competitive internal market, through consistent, flexible and fair credit agreements relating to immovable property, while promoting sustainable lending and borrowing and financial inclusion, and hence providing a high level of consumer protection (Recital 6 MCD).

For most consumers the commitment to a mortgage credit agreement is the most significant financial commitment that they will ever make. While the benefit to consumers of mortgage credit is the financial assistance that it gives them to acquire private ownership of residential immovable property, there are also risks associated with this lending which can result in detriment to consumers, to creditors and to financial stability generally, for example, the detriment caused by consumers’ inability to meet their obligations under the credit agreements.

The MCD states, in Recital 55, that it is essential that the consumer’s ability and propensity to meet the obligations under the credit agreement is assessed and verified before a credit agreement is concluded and that the assessment of creditworthiness should take into consideration all necessary and relevant factors that could influence a consumer’s ability to meet the obligations over its lifetime. The MCD, in Articles 18 and 20(1), sets out provisions on credit worthiness. Article 18 MCD requires that Member States shall ensure that, before concluding a credit agreement, the creditor makes a thorough assessment of the consumer’s creditworthiness. That assessment shall take appropriate account of factors relevant to verifying the prospect of the consumer to meet his obligations under the credit agreement.

In addition, Article 20(1) MCD provides that the assessment of creditworthiness referred to in Article 18 shall be carried out on the basis of information on the consumer’s income and expenses and other financial and economic circumstances which is necessary, sufficient and proportionate. The information shall be obtained by the creditor from relevant internal or external sources, including the consumer, and including information provided to the credit intermediary or appointed representative during the credit application process. The information shall be appropriately verified, including through reference to independently verifiable documentation when necessary.

In order to ensure that these high-level provisions will be implemented and supervised consistently across the 28 EU Member States, and to support the transposition of the MCD, the EBA is issuing and consulting on draft guidelines. The guidelines provide greater detail on how financial institutions should give effect to the relevant MCD provisions in Articles 18 and 20(1), and thus contribute to the EBA's objective of achieving a convergence of supervisory practices for the Directives that fall into the EBA's scope of action.

The Guidelines are based on the provisions of the *Opinion of the European Banking Authority on Good Practices for Responsible Mortgage Lending*, which was published on 13 June 2013, i.e. before the MCD was adopted, and which was reviewed by the EBA when developing the Guidelines.

Rationale

As the Directive sets out in Recital 55, it is vital that, prior to the conclusion of a credit agreement for residential immovable property, the creditor assesses and verifies the consumer's creditworthiness. Failure to do so can have negative consequences for the consumer, the creditor, and ultimately financial stability, as consumers may be unable to meet their commitments under the credit agreements and, as result, the level of defaults in a market may increase. In order for the EBA to be able to fulfil its statutory objectives of protecting consumers, ensuring the viability of financial institutions and contributing to financial stability, detailed guidelines on creditworthiness assessments are recommendable. These Guidelines provide assistance to MS in the transposition of Articles 18 and 20(1) MCD and assist competent authorities in giving effect to the provisions within this Article.

In recognising the importance of drawing on established international practice the EBA drew on the Financial Stability Board's Principles for Sound Residential Mortgage Underwriting Practices¹ ("FSB Principles") in the development of these Guidelines. The FSB Principles had previously been used in the development of the EBA instruments which pre-dated the Mortgage Credit Directive including the EBA Opinion on Good Practices for Responsible Mortgage Lending². In addition Recital 55 MCD advises that the MS should be encouraged to implement the FSB Principles. These Guidelines are therefore aligned to the specific FSB Principles which are relevant to the provisions under Articles 18 and 20(1) MCD.

¹ In April 2012 the FSB published its *Principles for Sound Residential Mortgage Underwriting*. This was preceded in 2011 by the publication of the thematic review of residential underwriting and origination practices. The aim of the principles is "to provide a framework for jurisdictions to set minimum acceptable underwriting standards".

http://www.financialstabilityboard.org/publications/r_120418.pdf

² In developing the Opinion the EBA conducted a survey of National Supervisory Authorities on responsible lending to identify the supervisory practices and market practices which were consistent with or supplemented the FSB Principles.

<https://www.eba.europa.eu/documents/10180/604499/EBA+Opinion+on+Good+Practices+for+Responsible+Mortgage+Lending.pdf>

Now that the Mortgage Credit Directive has been adopted, the EBA has decided to review the Opinion in light of the provisions of Articles 18 and 20(1) MCD. As a result, only relevant provisions within the Opinion³ were considered for these Guidelines.

³ The EBA will revise and update the original Opinion to ensure that the remaining practices from the original Opinion continue to be captured. The revised Opinion will be published alongside the final Guidelines.

4. Draft Guidelines on creditworthiness assessment

Status of these Guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (*the EBA Regulation*). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the Guidelines.

Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to whom guidelines are addressed to comply with these guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at financial institutions.

Reporting requirements

According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance by the transposition date of the MCD of 21 March 2016. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3).

Title I - Subject matter, scope and definitions

Subject matter

These Guidelines set out greater detail on how financial institutions should give effect to the relevant provisions in Articles 18 and 20(1) of Directive 2014/17/EU (Mortgage Credit Directive – MCD) and to the content of Recitals 55 and 56 MCD.

Scope

These Guidelines deal with the requirement set out in Articles 18 and 20 MCD to assess the consumer's creditworthiness in respect of credit agreements which fall under the scope of and as specified in Article 3 MCD.

These Guidelines are addressed to competent authorities as defined in point (2) Article 4 Regulation (EU) No 1093/2010 (Regulation establishing the EBA – EBA Regulation).

Definitions

For the purposes of these Guidelines the following definitions apply:

- a) *Balloon payment* means the remaining amount of principal that becomes due and payable on the final instalment payment for a loan that is not fully amortised.
- b) Definitions as set out in Article 4 MCD.

Outsourcing

In the case where the activity of the creditor is in whole or in parts outsourced to third parties, or carried out by another entity in other ways, creditors should ensure that in doing so they comply with the requirements established in the CEBS Guidelines on outsourcing⁴. This includes, in particular, guideline 2, which provides that “the ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management”.

⁴ See CEBS (2006), *Guidelines on outsourcing*, at <https://www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf.pdf>

Title II- Requirements regarding creditworthiness assessment

1. Verification of the consumer's income

- 1.1 The creditor should make reasonable enquiries and take reasonable steps to verify a consumer's prospect to meet his/her obligation under the credit agreement including the consumer's underlying income capacity, the consumer's income history and any variability over time.
- 1.2 The creditor should use necessary, sufficient and proportionate information, that can be evidenced and that is provided by sources that are independent of the consumer.
- 1.3 In the case of consumers that are self-employed or have seasonal or other irregular income, the creditor should make reasonable enquiries and take reasonable steps to verify additional information that is related to the consumer's ability to meet his/her obligations under the credit agreement, including profit capacity and third party verification documenting such income.

2. Documentation and retention of information

- 2.1 The creditor should maintain complete documentation of the information that leads to mortgage approval, and maintain this documentation for at least the duration of the credit agreement.
- 2.2 The creditor should ensure that a record with an adequate explanation of the steps taken to verify income is readily available for competent authorities. The record should at least document the income history collected for each applicant.

3. Identification and prevention of misrepresented information

- 3.1 To reliably carry out creditworthiness assessments, the creditor should design loan documentation in a way that helps to identify and to prevent misrepresentation of information by the consumer, the creditor, or a credit intermediary.

4. Assessment of the consumer's ability to meet his/her obligations under the credit agreement

- 4.1 The creditor should assess the consumer's ability to meet his/her obligations under the credit agreement without causing the consumer undue hardship and over-indebtedness, while taking into account data protection rules that may apply in the relevant jurisdiction.
- 4.2 The creditor should establish sound processes to assess the consumer's ability to meet obligations under the credit agreement; review these processes at regular intervals; and maintain up-to-date records of those procedures.

- 4.3 The creditor should take into account relevant factors that could influence the ability of the consumer to meet obligations under the credit agreement without inducing undue hardship and over-indebtedness. The factors may include other servicing obligations, their interest rates, and the outstanding principal on such debt; evidence of delinquency; as well as directly relevant taxes and insurance.
- 4.4 If the loan term extends past normal retirement age, the creditor should take appropriate account of the adequacy of the consumer's likely income and ability to continue to meet obligations under the credit agreement in retirement.
- 4.5 The creditor should ensure that the consumer's ability to meet obligations under the credit agreement is not based on the expected significant increase of the consumer's income unless the documentation provides sufficient evidence.

5. Allowance for the consumer's committed and other non-discretionary expenditures

- 5.1 When assessing the consumer's ability to meet obligations under the credit agreement, the creditor should make reasonable allowances for committed and other non-discretionary expenditures, such as the consumer's actual obligations, including appropriate substantiation and consideration of the living expenses of the consumer.

6. Allowance for potential future negative scenarios

- 6.1 When assessing the consumer's ability to meet obligations under the credit agreement, the creditor should make prudent allowances for potential negative scenarios in the future, including for example, a reduced income in retirement; an increase in benchmark interest rates in the case of variable rate mortgages; negative amortisation; balloon payments, or deferred payments of principal or interest.

7. Identification of groups of loans with higher risk profiles

- 7.1 The creditor should identify groups of loans with a higher risk profile, and should take this into account when assessing consumers' creditworthiness.

Title III- Final provisions and implementation

Competent authorities should implement these Guidelines by incorporating them in their supervisory processes and procedures by 21 March 2016.

Overview of questions for consultation

Question 1: Do you agree with the proposed Guidelines? If not, outline why you disagree and how the Guidelines could be improved. Please respond separately for each of the seven Guidelines.

Question 2: Are there any additional requirements that you would suggest adding to the Guidelines? If so, outline the reason(s) for each proposed additional requirement.

5. Accompanying documents

5.1 Cost- benefit analysis / impact assessment

5.1.1 Problem identification

Irresponsible lending decisions and inappropriate creditworthiness assessments can cause detriment for consumers⁵ and create risks to the solvency of creditors and in the end to the stability of the broader financial system, as the financial crises in 2008 showed. In the aftermath of that crisis, on grounds that mortgage underwriting practices in one country could be transferred globally through securitisation, the FSB issued Principles for Sound Residential Mortgage Underwriting Practices⁶, in line with what the G20 mandated.

In the EU, a variety of national regulatory provisions is aimed at addressing these problems. There remains, however, significant heterogeneity across Member States regarding the level and content of regulatory requirements, in particular with respect to the coverage of non-credit institution mortgage lenders. The lack of a harmonised framework currently leads to considerable scope for regulatory arbitrage and severely hampers the efficient functioning of the Internal Market. Being of non-binding nature, the existing EBA Opinion on Good Practices for Responsible Mortgage Lending falls short of solving this effectively and achieving the implementation of the relevant provision of the Mortgage Credit Directive.

5.1.2 Policy objectives

At the highest, most general level these Guidelines are intended to contribute to improving consumer protection in the EU, promoting the safety and soundness of the European banking system as well as the stability, effectiveness and integrity of the financial system in a broader sense. In addition, they should foster convergence of regulatory and market practices across the EU. More specifically, these Guidelines aim at transparent, efficient and competitive mortgage markets as well as flexible and fair credit agreements relating to immovable property by promoting creditors' sustainable lending decisions. At the technical level, the purpose of these Guidelines is to give Member States further detail on the provisions of Articles 18 and 20(1) of the Mortgage Credit Directive and to assist competent authorities in giving effect to those provisions.

5.1.3 Baseline scenario and options considered

To achieve these objectives, EBA could either

⁵ EBA: Consumer Trends Report (2014)

⁶ FSB: Principles for Sound Residential Mortgage Underwriting Practices (2012)
http://www.financialstabilityboard.org/wp-content/uploads/r_120418.pdf

- i. Keep the current Opinion on Good Practices for Responsible Mortgage Lending (Option 1)
- ii. Convert the practices of that Opinion which are relevant to Articles 18 and 20(1) MCD into Guidelines and revise the remaining parts of that Opinion (Option 2)

5.1.4 Analysis of costs

Option 1 represents the baseline scenario without any further regulatory intervention at European level. In that case, the above-mentioned problems of consumer detriment and risks to creditors' solvency as well as financial stability and suboptimal market outcomes would persist. There would not be any incremental costs, neither for NCAs, nor for mortgage creditors or borrowers caused by the non-conversion of the relevant practices of the existing EBA Opinion into Guidelines. At the same time, potential benefits to consumers, creditors and mortgage markets would not be reaped.

Survey

In order to inform the Impact Assessment of the adoption of Option 2, and in particular, the impact of these proposed EBA guidelines in terms of the compliance effort that will need to be made by financial institutions, the EBA gathered information from national competent authorities about the extent to which their existing national requirements already meet the Guidelines. The EBA received detailed responses regarding credit institutions (CIs) from 21⁷ national competent authorities and responses regarding non-credit institutions (NCIs) from 12 national competent authorities. In a number of MS, non-credit institutions do not provide mortgage credit, and in other cases it has not yet been determined which authority will supervise non-credit institutions when providing mortgage credit. Therefore, several MS did not include responses to the survey for non-credit institutions.

Table 1 below shows, for each guideline and for each creditor type (credit institution and non-credit institution), the extent to which existing national requirements meet, exceed or are lower than the proposed Guidelines, or whether there are no national requirements in place at all.

⁷ 1 competent authority did not respond under Guidelines 3.1 and 4.4.

**Table 1:
Overview of responses**

			Number of MS where proposed guidelines are already met		Number of MS where proposed guidelines are not currently met		Total responses	Percentage of MS where the proposed Guideline is already met or exceeded
			MS where the proposed Guideline is already met	MS where higher requirements than the proposed Guideline are already in place	MS where lower requirements than the proposed Guideline are in place	MS where no requirements at all are in place		
G1	1.1	CI	16	1	3	1	21	81%
		NCI	8	1	3	0	12	75%
	1.2	CI	16	0	4	1	21	76%
		NCI	9	0	3	0	12	75%
	1.3	CI	13	0	4	4	21	62%
		NCI	6	0	3	3	12	50%
G2	2.1	CI	14	2	4	1	21	76%
		NCI	5	1	3	3	12	50%
	2.2	CI	16	0	3	2	21	76%
		NCI	6	0	3	3	12	50%
G3	3.1	CI	12	0	5	3	20	60%
		NCI	5	0	3	3	11	45%
G4	4.1	CI	11	0	6	4	21	52%
		NCI	6	0	4	2	12	50%
	4.2	CI	15	0	4	2	21	71%
		NCI	6	0	4	2	12	50%
	4.3	CI	10	1	5	5	21	52%
		NCI	6	0	2	4	12	50%
	4.4	CI	10	0	5	5	20	50%
		NCI	5	0	2	4	11	45%
	4.5	CI	11	0	5	5	21	52%
		NCI	7	0	1	4	12	58%
G5	5.1	CI	13	0	6	2	21	62%
		NCI	7	0	1	4	12	58%
G6	6.1	CI	11	0	5	5	21	52%
		NCI	6	0	2	4	12	50%
G7	7.1	CI	9	0	5	7	21	43%
		NCI	5	0	1	6	12	42%

The following is a summary analysis of the likely cost impact to creditors in implementing each of the proposed Guidelines.

G1: Verification of the consumer's income

In relation to points 1.1 and 1.2 under this Guideline, only 1 MS currently has no requirements at all on credit institutions. There is a smaller level of national requirements that correspond to Guideline 1.3 in that 4 MS have no requirements in place for credit institutions and 3 MS have none for non-credit institutions. Therefore in the majority of MS the implementation of this Guideline will result in no or limited cost impact on creditors.

G2: Documentation and retention of information

The majority of MS already have requirements on both credit institution and non-credit institutions in place that meet or exceed the two points under this Guideline. Of the remaining MS only 3 MS have no requirements on non-credit institutions and only 1 MS has no requirement on credit institutions regarding Guideline 2.1. 2 MS have no requirements on credit institutions and 3 MS have no requirements on non-credit institutions regarding Guideline 2.2. Therefore, creditors in a small number of MS will incur costs to implement this Guideline.

G3: Identification and prevention of misrepresented information

Costs will be incurred by creditors to design loan documentation to comply with this Guideline. However, this will not be the case in 12 of 20 MS where such a requirement already exists for credit institutions and in 5 of 11 MS where a requirement on non-credit institutions that meets this Guideline already exists.

G4: Assessment of the consumer's ability to meet his/her obligations under the credit agreement

Table 1 above shows a reasonably even spread across the five points under this Guideline with half of MS having requirements on credit institutions and non-credit institutions that meet or exceed this Guideline. Therefore creditors in half of MS will not incur any costs to implement this Guideline. In approximately one third of MS national requirements exist which are lower than draft Guideline 4. Therefore, only limited costs should be incurred by credit institutions in those MS because requirements (albeit lower than the Guideline) already exist.

G5: Allowance for the consumer's committed and other non-discretionary expenditures

13 of 21 MS already have requirements on credit institutions in place that meet the proposed Guideline. Similarly 7 of 12 MS have requirements on non-credit institutions that meet the proposed Guideline. Of the remaining MS 2 have no requirements at all in place for credit institutions and 4 MS have no requirements at all for non-credit institutions, thereby suggesting that creditors across most MS will incur no costs or limited costs to implement this Guideline.

G6: Allowance for potential future negative scenarios

Regarding Guideline 6, 11 of 21 MS already have requirements in place on credit institutions that meet or exceed this Guideline. In relation to non-credit institutions 6 of 12 MS have requirements in place on non-credit institutions that meet or exceed this Guideline. Therefore, it is likely that creditors will incur set-up costs in a number of MS to put in place measures to implement this Guideline.

G7: Identification of groups of loans with higher risk profiles

12MS do not already have requirements on credit institutions in place that meet this Guideline and 7 of 12 MS do not have requirements on non-credit institutions in place that meet this Guideline. There will therefore be costs to creditors to put in place a system to identify groups of loans with a higher risk profile and to take that information into account when assessing consumers' creditworthiness.

In summary, as Table 1 shows, there is already a high level of requirements in place across the MS that meet the proposed Guidelines. This means, therefore, that the cost to creditors to implement these Guidelines will be low generally across MS.

In addition, costs may need to be incurred by NCAs one-off for adjusting their legal frameworks and potentially also more intensive on-going supervision of mortgage creditors' lending decisions.

5.1.5 Analysis of benefits

Option 2, the conversion of the practices of the EBA Opinion relevant to Articles 18 and 20(1) MCD into Guidelines – and the revision of the Opinion's remaining parts –, would yield significant benefits. Mortgage consumers would benefit from improved, EU-wide protection including against the risk of over-indebtedness. Creditors would similarly benefit by a reduction of the probability of losses due to irresponsible lending decisions and inappropriate creditworthiness assessments.

5.1.6 Overall assessment and conclusion

Consequently, the conversion of the practices of the current EBA Opinion relevant to Articles 18 and 20(1) MCD into Guidelines and revision of the Opinion's remaining parts (Option 2) is the preferred option.