Monetary Authority of Singapore

THEMATIC INSPECTION OF RESIDENTIAL PROPERTY LOANS BUSINESS

MAS Information Paper
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1 INTRODUCTION

1.1 The low interest rate environment globally and continued income growth in Singapore had resulted in strong demand for residential properties. This may affect the decisions of property buyers and encourage them to borrow more than they can otherwise afford. When interest rates rise in future or if unemployment rate increases, the asset quality of banks can be adversely affected as borrowers who are highly leveraged may have difficulty servicing their debt obligations. Against this backdrop, it is important that banks maintain sound credit underwriting standards and remain prudent in their lending practices.

1.2 The Monetary Authority of Singapore ("MAS") conducted a thematic inspection of the residential property loans business of banks that are major players in this market, in late 2012. MAS noted that the banks have fundamental policies and procedures in place to assess the credit worthiness and repayment capability of a borrower. Most banks also have robust portfolio monitoring processes and subject their residential property loan portfolios to regular reviews and stress testing. Nonetheless, there are areas for improvement, particularly in banks' underwriting practices. Most of these areas relate to the assessment of a borrower's income and debt servicing ability, the use of debt servicing ratio ("DSR"), and the reliance on collateral as a primary source of repayment.

1.3 This report describes the key findings of the inspection, including instances of non-compliance with MAS' rules and regulations, and provides examples of lending practices that could be improved. It also highlights the sound practices observed. Banks should review the findings and sound practices detailed in the following sections and take steps to strengthen their credit underwriting standards and practices. Banks should also refer to the revised MAS Notice 632 on Residential Property Loans ("MAS Notice 632") and the new MAS Notice 645 on Computation of Total Debt Servicing Ratio for Property Loans ("MAS Notice 645") and its accompanying Guidelines on the Application of Total Debt Servicing Ratio for Property Loans under MAS Notices 645, 1115, 831 and 128 issued on 28 June 2013 ("Guidelines"). MAS Notice 645 and the Guidelines set out requirements and guidance on the use of Total Debt Servicing Ratios ("TDSR") in assessing property loans.

2 CREDIT UNDERWRITING STANDARDS

Computation of DSR

2.1 An accurate assessment of a borrower's ability to repay a loan is a fundamental component of sound credit underwriting. It should not be based on the assumption that the property against which the loan is secured will appreciate in value, or an expected sizable increase in the borrower's income earning capacity. It is therefore prudent to consider a borrower's debt servicing ability by aggregating his *total* debt obligations against his income, with the necessary verification to be conducted for both the debt and income elements.

Assessment of debt obligations

2.2 Most banks took into account borrowers' overall debt obligations and verified declarations to this effect by performing the necessary follow-ups, such as checks against the relevant credit bureaus. However, some banks computed their internal DSRs by taking into account only the loan which the borrower was applying, and ignoring other existing debt obligations of the borrower. There were also instances where banks failed to follow-up with borrowers who did not declare all their debt obligations, even though credit bureau records showed that the borrowers had outstanding loans with other banks. Such lapses would lead to an incomplete determination of the borrower's total debt obligations and consequently inaccurate assessment of the borrower's repayment ability.

Assessment of income

2.3 Most banks required borrowers to submit the most current income documentation and had clear guidelines on acceptable documentary proof of income. They also made an effort to distinguish between income that was recurring or fixed (e.g. salary) and non-recurring or variable (e.g. bonuses, allowances and commissions), and subjected the latter components to appropriate haircuts. Rental income was included only if it was verified with an existing stamped tenancy agreement with sufficient validity period, and subjected to appropriate haircuts.

2.4 However, there were instances where loan applications were assessed based merely on the borrowers' self-declarations of employment and income, without adequate verification of actual employment status or income documentation. As part of prudent risk management, banks should obtain and verify the borrowers' current employment status, relevant credit history, and any other financial information when assessing loan applications.

2.5 Some banks waived the requirement for documentary proof of income for re-financing applications. The banks represented that they had relied on checks with credit bureaus on the borrowers' repayment history to assess the borrowers' ability to continue servicing the loan. However, as the employment status and income level of a borrower can change over time, banks must obtain the most *current* documentary proof of income for all housing loan applications, including re-financing applications.

2.6 Another weakness noted was the inconsistent treatment of Central Provident Fund ("CPF") contributions in the internal DSR computation. Some banks included contributions into the borrower's CPF account when calculating total income, but excluded debt repayments serviced using CPF contributions from the calculation of total debt obligations, leading to an artificially lower DSR.

Determination of loan tenure

2.7 Banks have differing practices for determining loan tenures for joint borrowers. Some banks based the loan tenure on the age of the youngest co-applicant, notwithstanding that the applicant may have little or no income. In such instances, the banks generally relied on the other co-applicants' debt servicing ability. One bank adopted a more conservative approach of applying the loan tenure based on the younger borrower's age only if his income constituted a reasonable proportion of the total combined income of all borrowers.

2.8 Going forward, banks are required to calculate the applicable loan tenure for the purposes of paragraph 17(n) of MAS Notice 632 using the income-weighted average age of the joint borrowers. When computing a borrower's TDSR (whether for cases involving joint borrowers or otherwise), banks are required to use the actual loan tenure in the loan application, rather than the maximum eligible loan tenure.

Inclusion of guarantors

2.9 Some banks granted loans to borrowers who were assessed to have little or no debt repayment ability, but had financial support from guarantors, typically family members, at the point of loan application. In some of these instances, loans were granted at the maximum allowable loan-to-value ("LTV") ratio based on the fact that the borrower had no other outstanding housing loans, despite the fact that loan approval was premised on the repayment capability of the guarantors, who had other outstanding housing loans. In other instances, loans were approved without adequate assessment of the debt servicing capability of the guarantors. In contrast, some banks adopted a more prudent approach of requiring the person providing the guarantee to be included as a joint borrower, rather than as a guarantor.

2.10 In cases where the bank assesses that the borrower is unable to meet the TDSR threshold for a property loan[1], banks are required to include the person providing the guarantee as a joint borrower rather than as a guarantor[2]. All debt obligations and income of the joint borrowers are then to be included in the TDSR calculation.

Lending based on Evidence of Liquid Assets

2.11 Banks had developed policies to assess property loan applications where customers were unable to meet the banks' internal DSR thresholds. Many banks would approve a loan application if the borrower was able to furnish evidence that he had a certain amount of liquid assets, as an indication of his ability to meet his loan obligations over the next 1 to 2 years. Banks did not normally require such liquid assets, which typically comprised cash deposits, to be pledged to or deposited with the bank. As a result, the borrower could potentially use the same pool of liquid assets as evidence of net-worth or repayment capacity to secure financing with several banks. Moreover, banks generally did not have rigorous processes for verifying the source of such assets.

2.12 A property loan is a long-term commitment, and banks should assess a borrower's ability to repay the loan over the longer term and not just for the immediate 1 to 2 years. It is generally not prudent for banks to rely solely on the borrower's assets as a primary criterion to approve the loan, particularly when the assets are not pledged to the bank, and could be utilised by the borrower for other purposes at any time. Indeed, one bank has stopped granting loans on this basis after performing an internal review and concluding that such a practice is unsound.

2.13 The assessment of a borrower's repayment ability should be performed in a holistic and prudent manner, taking into account all relevant factors, including the stability of the borrower's income sources and debt obligations, as well as an appropriate DSR threshold. If the borrower's assets are to be relied upon as one of the main sources of repayment, banks will be required to secure them and/or subject them to appropriate haircuts[3] in computing the borrower's TDSR to address the attendant risks. In addition, the bank should enquire about the source of funds and wealth to ensure compliance with MAS Notice 626 on Prevention of Money Laundering and Countering the Financing of Terrorism.

[1] This should minimally be set at the threshold stated in the Guidelines.

[2] As per paragraph 17(b)(ii) of the revised MAS Notice 632.

[3] These haircuts are provided for in the new MAS Notice 645.

Lending based on Low LTV

2.14 Banks had adopted policies that permitted them to approve loans on the basis of low LTV ratios, without having to verify a borrower's income or subjecting the borrower to the appropriate DSR thresholds. Banks considered the borrower's substantial upfront cash commitment in such cases as evidence of his willingness and ability to service the loan.

2.15 While LTV limits help control the loss exposure should a borrower default, they do not fully reflect the likelihood of borrower repayment since the latter would also depend on the borrower's ongoing financial capacity to meet his loan obligations. An assessment of the borrower's repayment ability would still be needed.

3 NON-COMPLIANCE WITH RESIDENTIAL PROPERTY LOAN RULES

3.1 This section highlights regulatory contraventions of MAS Notice 632 noted during the inspection. The findings show that there is room for improvement in terms of banks' compliance standards and mindset, insofar as residential property loan rules are concerned.

Prohibition of Interest-Only Loans

3.2 MAS Notice 632 prohibits the granting of interest-only loans secured by residential properties to individuals. Some banks had, however, granted loans which allowed borrowers to service only interest. In some of these instances, the contravention arose because of poor communication between the business and compliance units within the banks.

3.3 For the avoidance of doubt, the prohibition on interest-only loans applies to all loans secured by residential properties that are granted to individuals. Accordingly, construction and renovation loans granted to individuals that are secured by residential properties should not be granted on interest-only repayment terms.

Re-financing Facility

3.4 Several banks had misinterpreted the definition of a Re-financing Facility set out in MAS Notice 632 to include credit facilities secured by residential properties but not used for the purchase of those properties (e.g. mortgage equity withdrawal loans). By mis-characterising such loans as Re-financing Facilities, which are not subject to the LTV limits in MAS Notice 632, the banks had breached the regulatory LTV limits.

3.5 Banks are reminded that all credit facilities secured by residential properties that are granted to individuals are subject to the regulatory LTV limits under MAS Notice 632. These limits also apply when such credit facilities are re-financed.

4 OTHER FINDINGS

Systems and Processes

4.1 Some banks had promised their customers fast turnaround times for processing their property loan applications. While MAS is supportive of banks' efforts to innovate and improve efficiency to provide better customer service, banks are reminded that this should not come at the expense of performing a thorough and holistic assessment of a borrower's credit worthiness and repayment capability. Key performance indicators for credit approvers should not be focused on turnaround times, as this could place undue pressure on them to process loan applications without adequate consideration of all relevant factors that could impact a borrower's ability to service a loan.

4.2 There were also instances where a bank's systems were unable to aggregate multiple loan applications from the same borrower that were received by the bank within the same day. It is important for banks to aggregate loan applications so that their TDSR computations take into account all debt obligations accurately and loan applications can be considered by the appropriate approving authority within the bank.

Valuation Practices

4.3 Most banks have policies and procedures in place that affirmed the importance of effective collateral management and sound valuation practices on the mortgage business. Such policies and procedures included the requirement to conduct full valuation with on-site inspection of the property, processes to select and appoint a panel of external valuers, and periodic reviews of the performance of the external valuers, amongst others.

4.4 Typically, the mortgage acquisition function is the first to initiate contact with the valuer to request an indicative valuation. However, some banks have recognised the inherent conflict of interest to hold the bank's mortgage acquisition function responsible for obtaining valuations. These banks have implemented processes to ensure that the initial contact and subsequent follow-up to obtain the valuation reports are performed by a unit which is independent of the mortgage acquisition function.

4.5 However, there were instances where certain valuation policies, such as the need to regularly review the performance of banks' pre-approved panel of valuers,

were not sufficiently comprehensive[4]. There was also an instance where an external valuer was included in a bank's panel of valuers, despite adverse comments from the bank's risk management department on the valuer's performance. MAS expects all banks to review their valuation policies, and to have robust processes in place to ensure that property appraisals are realistic and substantiated.

Portfolio Monitoring

4.6 Most banks were observed to have robust portfolio monitoring processes in place. They would subject their residential property portfolios to close periodic reviews, and segment the portfolio by borrower profile and income, repayment status, DSR, LTV, property types, etc. Some banks also monitored concentration limits based on size of the housing units, districts and regions, and reviewed these limits periodically. In addition, banks subject their residential property portfolios to frequent stress tests.

[4] For instance, the policies did not provide guidance to staff on how the review of the performance of the panel of valuers could be performed. Prudent practices adopted by some banks include counter-checking valuations in the valuation reports with property price data from public databases; as well as having procedures in place to conduct additional reviews or request for additional reports where valuations provided differ from transacted prices of comparable properties significantly.

5 CONCLUSION

5.1. It is important that banks maintain sound credit underwriting standards and prudent lending practices to avoid the kind of excesses that had led to financial crises in other countries. Banks should ensure that they have appropriately assessed the ability of a borrower to service the loan over its lifetime, without causing the borrower undue hardship and over-indebtedness.

5.2. MAS expects banks to review their internal policies and processes in light of the findings contained in this report, and ensure that robust and effective assessment of borrowers' credit worthiness and repayment capability remain the guiding principle for their lending. Banks should act responsibly and uphold prudent underwriting, sound risk management as well as strong compliance standards.