



HONG KONG MONETARY AUTHORITY
香港金融管理局

Circulars

30 Oct 2009

Best lending practices for residential mortgage loans

Our Ref.: B1/15C

30 October 2009

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Best lending practices for residential mortgage loans

As mentioned in my letter of 23 October 2009 on prudential measures for residential mortgage loans (RML), the HKMA has recently completed a round of thematic examinations on asset quality of selected authorized institutions (AIs), covering in particular, their residential mortgage lending business. This letter sets out the best practices on residential mortgage lending we observed in the thematic examinations. AIs are required to review and assess their lending practices, and where necessary, take immediate measures to bring them into line with the best practices described in this letter.

Computation of debt servicing ratio (DSR).

While AIs were generally in compliance with the HKMA's guidance on a DSR ceiling of no higher than 50%-60% (with the upper end of this range confined to high income earners only)¹, different methods were adopted in computing the DSR, resulting in some cases where the DSR was understated. To ensure prudent computation of the DSR, AIs should adopt the following practices:

- Rental income should be included as part of the borrower's income (i.e. included in the denominator in computing DSR) rather than netted off against the corresponding mortgage payments.
- A discount of at least 20% should be applied to the gross rental income to account for associated expenses (e.g. maintenance cost, property rates, management fees and property tax) and the period when the property is vacant.
- All liabilities subject to regular repayment should be included (e.g. other mortgages, personal loans). Potential borrowers should be requested to declare all such liabilities in their loan applications and adequate checks and enquiries should be performed to ensure that this is the case. These may include checking with the consumer credit bureau or commercial credit bureau, or the borrower's main operating bank account.

Proper records of such checks and enquiries should be maintained for review by internal audit or the HKMA.

- Als should have a definition of high income earners clearly defined if they have not already done so and should be able to justify why the threshold adopted is considered appropriate.

Income proof

Rental income claimed by the borrower should be supported by a properly executed tenancy agreement, rental receipt or relevant property tax return. Where this is not available, Als should have procedures to assess whether the rental amount claimed by the borrower is reasonable by making reference to independent sources, such as rental valuation made by the Rating and Valuation Department or independent commercial websites providing such information. Where rental income proof is not available, Als should consider whether the rental amount claimed by the borrower is acceptable and whether it is necessary to apply a discount higher than 20% as mentioned earlier to cater for the uncertainty of the rental income.

For borrowers who, by the nature of their occupations (e.g. freelancers, self-employed or sole proprietors), cannot provide objective income proof, Als should establish clear policies on the types of income proof surrogate or proof of wealth that will be accepted, and document the methods and assumptions adopted in assessing / estimating the borrower's repayment ability.

Property valuation

We have identified the following best practices in respect of property valuation in our thematic examinations:

- Where in-house valuations are used, there should be periodic checks against valuations done by outside parties to ensure that they are and remain prudent.
- Independent valuation, where used, should be obtained from a panel consisting of at least of two outside valuers. Policies and procedures should be established to check that the valuation provided by the outside valuer is prudent and reasonable. Where the valuations provided by an outside valuer are consistently higher than those provided by other valuers, the AI should assess whether the valuation provided by that valuer continues to be reliable.
- Regardless of whether a valuation is done internally or externally, Als should exercise caution in making reference to isolated transactions where the price deviates substantially from prices of properties in the vicinity. In general, unusually high prices of isolated transactions or uniquely packaged properties may have little reference value and should not be relied on.
- In respect of free valuation services provided to customers, Als must ensure that the underlying valuation models and assumptions are adequately prudent. Although valuations obtained from these services are "for reference only", Als should be mindful that there are potential property buyers and sellers who rely on these services as a major source of market information. Overly optimistic valuations may subject an AI to reputation risk.

Als should endeavour to apply the best practices highlighted in this circular as soon as practicable, if these are not being done already. The HKMA will monitor Als' progress in this regard through off-site review, which will be followed by another round of onsite examinations in the near future to ascertain Als' compliance with the requirements set out in this letter and the earlier circular of 23 October 2009.

Yours faithfully,
Y. K. Choi

¹The HKMA circular of 28 February 2005 on residential mortgage loans

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