Credit institutions' mortgage risk policy[1]

Within the model of commercial banking, which is followed by most Spanish credit institutions, the granting of mortgage loans for house purchase or for residential property development is one of the most extensive areas of business. Historically, this is an activity on which savings banks, in particular, have concentrated. However in recent years other institutions in the banking sector have increased their presence in this market, thereby increasing the level of competition and widening the range of products offered and the marketing strategies of the institutions offering them.

Over the last decade, a number of factors have contributed to the expansion of the residential mortgage market: demographic and sociological factors (population movements, changes in the family structure and in the types of housing required, rising demand for second homes by both residents and non-residents); market factors (rising land prices and construction costs, declining interest rates); quality factors (housing stock renovation and improvements); factors associated with saving (housing as an investment alternative).

The BE has in recent years offered its reflections in this area through the dissemination of various studies and analyses. Now it also wishes to offer some ideas on the risks incurred by credit institutions when granting mortgages (also applicable in many cases to other operations linked to the property sector), from the perspective of its supervisory responsibilities. For this purpose, a set of principles for institutions' policies in this area of business is outlined below.

1 The senior administrative body should adopt a policy for the assumption and management of mortgage risks that is explicit, active, effective and segmented

Good governance requires that the board and its specialised committees be directly involved in defining the risk assumption policies for the main areas of business. As is well known in the sector, the BE has for many years been arguing for this principle to be applied. Putting it into practice requires resolution and a high degree of professionalism and dedication on the part of directors. The BE views favourably all the efforts that banks have been and are currently making, because it considers that they are a consequence of the responsibility assumed by administrative bodies in relation to the progress and continuity of the banks concerned.

The policy has to be notified to all interested parties and must be monitored by the administrative bodies themselves. Hence the need for it to be clear and explicit, in writing and well documented with the relevant reports and opinions. It should also be sufficiently specific, to avoid the ambiguity of general ideas, having a real link with the business.

An active policy involves the directors adopting a specific position on the levels and characteristics of desired exposures, without accepting that such levels merely reflect the external factor of the demand situation.

[1] REPORT ON BANKING SUPERVISION IN SPAIN 2003. Chap. II.4, pages 97 to 100.

The definition of an effective policy ensures that it can be specified in detailed plans of action to guide decision making. Regular monitoring of its results and regular updating of its content will maintain its validity over time.

Finally, adequate segmentation will allow the different requirements of each type of transaction (credit to developers, financing of first homes, financing of second homes, subrogations, land financing, joint projects with developers, etc.) to be appropriately recognised.

2 A mortgage risk policy consistent with the general strategies of the institution

A solid bank is a complex structure of diverse elements (strategies, policies, organisation, resources, management and control systems, products, customers, etc.) that do not exist in isolation, but as a harmonious whole in which well meshed parts ensure efficiency and viability.

Hence the importance of the mortgage risk policy being consistent with the institution's banking model, with its general growth and expansion objectives, with the own-funds policy applied and the level of own funds, with the risk-adjusted return assumptions and with the medium and long-term financial strategy.

The banking model of each institution will shape its size, organisation, resources and the type of training of its managers. As is natural, the policies of the institution will have to fit in with such model, and every significant change will be preceded by a co-ordinated adaptation of the set of factors which make it up.

Other factors relating to the risk-assumption policy are the institution's growth and expansion objectives and own-funds policy. The growth of a company is affected by exogeneous variables (such as competition and demand for the products supplied), but it is not a variable that is independent of the decisions of management. On the contrary, it is a key element in the strategy of the institution, so that the factors mentioned will be taken into account in the design of the risk-assumption policies.

The mortgage risk policy is also framed by the risk-adjusted return objectives of the institution. As a result, one of its elements is the realistic setting of prices, so that they incorporate the risk premium on transactions and are compatible with the objectives referred to.

And, finally, it is essential for it to be consistent with the institution's financial strategy and its medium and long-term financing model. Mortgage transactions are characterised by their long average maturity, which has, moreover, increased in recent years for commercial reasons. They are therefore financial instruments that have a considerable impact on the institution's interest rate and liquidity risks. Interest rate risk will be present in fixed-rate transactions, but also, to a lesser extent, in floating-rate transactions, for the following reasons: first, the interest periods of lending transactions do not usually coincide with those of the financing, which tend to be shorter; and, second, because if the transations must be refinanced in future (as is frequently the case), the maintenance of margins between the lending and borrowing rates prevailing at the time the transaction was originally agreed is not guaranteed, since the spreads over the reference rates at which the institutions are refinanced may have widened.

Sustained very high rates of growth of mortgage lending may alter the conditions for the institution's structural financial equilibrium, making it necessary for the institution to resort increasingly to issuing securities on the market and exposing the institution to the risks arising from changing conditions (liquidity and prices) on securities markets over a lengthy time horizon. Accordingly, the administrative bodies of each institution should consider what mechanisms are needed to monitor changes in these risks, to control them and to limit them. These may include placing operating limits on the total level of market indebtedness and limits on the amount of debt maturing each year.

3 When defining mortgage-risk policies the principle of diversification will help reduce or modulate the total amount of risk assumed

Diversification is understood, first, from a general or sectoral viewpoint. The administrative bodies are responsible for analysing the risk incurred from the sectoral viewpoint and for monitoring those areas of economic activity in which the exposures are greatest. They are also responsible for assessing the business risk involved in excessive specialisation in a limited number of sectors.

Second, diversification is conceived of from an individual viewpoint. Besides complying with the legal limits, it is desirable for institutions to carry out their own process of internal reflection in order to put limits on the positions, in respect of all items (loans, credits, guarantees for purchasers' on account, shareholdings, etc.), that they are prepared to assume with each customer, economic group or group of customers with financial and trade relations.

And third, the policy defined will be more effective if it also takes into account the specific internal composition and distribution of the credit risk assumed with the property sector, considering aspects such as the nature of the property that forms the basis of the transaction (land, first home, second home, commercial premises, offices, etc.), the geographical situation, the type of product offered, etc.

A particular aspect is the volume of land financing, especially when there are town planning issues outstanding. It also needs to be decided whether the assumption of risks should be limited to the financing of projects of third parties or whether, through various means (incorporation of specialised subsidiaries, formation of multi-group companies with property developers, minority holdings in property companies), the institution wishes to participate in the actual execution of projects, assuming a portion of the business risks, including reputational risks.

4 The existence of mortgage security is no substitute for analysis of the counterparty or for information that may be lacking

As the BE has traditionally argued, a solid lending policy relates approval of the loan to the borrower's capacity to repay. The additional requirement for collateral aims to provide a sufficient level of defence against the eventuality that the customer has difficulty meeting its repayment obligations with the resources generated by its activity and its liquid assets. However, the collateral should not be the basis for the decision to approve or refuse the loan; the existence of mortgage security is no substitute for analysing the borrower or for information that may be lacking.

With regard to the financing of developments, it is important to assess the solvency of the developer and, since these transactions consist essentially of business projects, appropriate analytical techniques for project assessment need to be applied. Special consideration also needs to be given to the record and experience of the entrepreneur.

In the case of mortgage loans for house purchase, analysis of the transaction involves assessing the amount and the degree of certainty of current and expected household income (having particular regard to the employment situation), within the framework of an appropriate policy on the income-to-payment ratio. This is not merely a question of prudence, it also enables customers to be advised of the maximum financial burden it is reasonable for them to assume when making their purchase decision and on the product that best suits their profile.

Another important factor is the ratio of the amount of the loan to the appraisal value. Sometimes criteria in this respect are set in accordance with marketing policies, so it needs to be borne in mind that permissive policies in this area may significantly increase the expected losses in a mortgage loan portfolio.

In short, the application of appropriate criteria when transactions are studied and approved is a key factor in moderating the residual risk assumed by the institutions in this area of business.

5 The price of mortgages is a variable related to the level of risk assumed in each transaction

Bank supervisors have for many years been promoting the development by institutions of advanced credit risk management systems, not only through specific imperative requirements for adequate control measures in all areas of business, but also by establishing incentives in accounting and solvency rules. Among them, those contained in the statistical provision regulation and in the New Basel Capital Accord (Basel II) are worth mentioning.

Indeed, one of the challenges for the current banking system is to appreciate that the benefits of the development of advanced credit risk management models will not be fully harnessed until such models are co-ordinated or, rather, integrated into the institutions' own commercial practices. In short, the setting of the price of transactions is a factor directly related to effective risk premiums.

6 Appropriate systems for monitoring the mortgage portfolio, both from an individual (customer) and overall (sector) perspective

Putting into practice good systems for monitoring transactions, with the management and administrative bodies involved in their definition and oversight, helps to modulate the residual risk assumed in each area of business.

The monitoring of transactions naturally involves analysing events of default, but also, depending on the nature and importance of the various transactions, analysing the solvency and financial situation of debtors, monitoring business projects and monitoring the state and market value of the collateral.

And, from a global perspective, it involves the analysis of developments in the property sector. The preparation or commissioning from third parties of specialised reports, and analysis of the impact on the institution of different hypothetical situations may be very useful in this respect.

It is also worth mentioning that it is not appropriate to abandon the monitoring of mortgage risks transferred under securitisation transactions if residual risks (subordinated bonds, other financing of this nature, ordinary bonds, creditenhancements, lines of credit or liquidity, etc.) are retained.

7 Full transparency in customer relations and strict observance of rules to protect users

The financing of the purchase of a first home is an area of particular sensitivity from the social viewpoint, owing to the economic burden involved for households, to the time period over which the obligations incurred extend and to the fact that it often involves a customer relationship between the institution and the purchaser that extends to other products. Accordingly, it is important to follow a policy of particular transparency and to observe strictly the rules for the protection of users.

Moreover, the ombudsman of each credit institution must perform an active role not only in equitably resolving the cases brought before him, but also in identifying practices capable of being improved or areas in which greater training is needed within the company. This is also a matter of priority concern for the Legal Compliance Officer and the administrative bodies themselves, since the institution's reputational risk may be affected.

8 Conclusion

In conclusion, it is in the interest of credit institutions not to relax their criteria for granting mortgages (as regards the repayment capacity required, the level of collateral required, or the price) at times, like the present, of growing competition and increasing business volumes. Also, it is very encouraging that their senior administrative bodies are involving themselves in the adoption of risk assumption and management policies that are clear, active, effective and segmented; consistent with the general strategies of the institution; that take into account the current and expected situation of the capital available, monitoring the effects that the growth rates of activity may have in the medium and long term on the conditions for the institution's structural financial equilibrium and on the levels of interest, liquidity and business risk; that promote an appropriate diversification of risk by sector, customer and product; that ensure that collateral never replaces analysis of the borrower's repayment capacity and that the price is directly related to the effective risk incurred in each transaction; and that foster complete customer transparency.