

RECOMMENDATION OF BANCO DE PORTUGAL WITHIN THE LEGAL FRAMEWORK OF NEW CREDIT AGREEMENTS FOR CONSUMERS

Preamble

Banco de Portugal, as the national macroprudential authority, pursuant to its Organic Law, approved by Law No 5/98 of 31 January 1998, in its current version (hereinafter ‘Organic Law’), is entrusted with defining and implementing macroprudential policy, notably identifying, monitoring and assessing systemic risks, as well as proposing and adopting measures to prevent, mitigate or reduce these risks, so as to reinforce financial sector resilience.

Under these competences, Banco de Portugal considers that, in the current environment, household indebtedness is still high by international standards, and the financial system is highly exposed to credit relating to residential immovable property. In addition, this credit’s new business has increased strongly and the stock of consumer credit has grown significantly. Finally, the recent economic recovery, amid very low interest rates, considerable house price increases, and greater competition across institutions, has been accompanied by an easing of credit standards.

Taking into account the combination of the above factors, Banco de Portugal considers that banking sector resilience may suffer a negative impact, entailing risks for financial stability. Hence, in accordance with its mandate, Banco de Portugal deems it appropriate to issue a Recommendation on new credit agreements for consumers – covering credit agreements subject to the legal framework provided for in Decree-Law No 74-A/2017 of 23 June 2017 (hereinafter ‘Decree-Law No 74-A/2017’), and consumer credit agreements governed by Decree-Law No 133/2009 of 2 June 2009, as amended by Decree-Law No 72-A/2010 of 18 June 2010, No 42-A/2013 of 28 March 2013, and No 74-A/2017 of 23 June 2017 (hereinafter

‘Decree-Law No 133/2009’) – i.e. credit agreements relating to residential immovable property, credit agreements secured by a mortgage or equivalent guarantee, and consumer credit agreements. This Recommendation introduces limits for some of the criteria to be complied with by institutions in the assessment of the borrower’s creditworthiness when granting this type of credit.

This Recommendation, which is based on the ‘comply or explain’ principle, aims at reinforcing the institutions’ assessment of the borrowers’ creditworthiness so as to increase the financial system’s resilience, promoting its capacity to absorb potential adverse shocks.

In accordance with the provisions of Notice of Banco de Portugal No 4/2017 of 22 September 2017 (hereinafter ‘Notice No 4/2017’), the objective scope of this Recommendation excludes certain types of credit agreement, such as overrunning and credit agreements intended to prevent or address arrears situations. In addition, this Recommendation also excludes the case of credit agreements to be concluded for an amount equal to or lower than the equivalent to tenfold the guaranteed monthly minimum wage or the case of an increase in the total amount of credit during the lifetime of the agreement is available to the consumer for a period of up to three months.

Given a need to prevent possible disruptive effects in credit granting, there are some exceptions to the limits set out in the Recommendation. In any event, institutions shall comply with the provisions of Notice No 4/2017.

The Recommendation shall apply to agreements concluded from 1 July 2018 onwards.

Furthermore, this Recommendation reinforces the importance of promoting an adequate assessment of the risk inherent in these types of credit agreement, which was also addressed by a number of European Union and national legal initiatives governing credit agreements for consumers, notably Directive 2014/17/EU of 4 February 2014 on credit agreements for consumers relating to residential immovable property, partially transposed

by Decree-Law No 74-A/2017 and Decree-Law No 133/2009 of 2 June 2009, as amended by Decree-Law No 72-A/2010 of 18 June 2010, No 42-A/2013 of 28 March 2013, and No 74-A/2017 of 23 June 2017, governing consumer credit agreements.

To regulate a number of issues of Decree-Law No 74-A/2017 and Decree-Law No 133/2009, Banco de Portugal recently published Notice No 4/2017 laying down the procedures and criteria to be observed in the consumers' creditworthiness assessment by entities authorised to grant credit. This Recommendation liaises with this regulatory initiative by introducing limits for some of the criteria that institutions should comply with in the assessment of borrowers' creditworthiness when granting credit. It thus assumes that a consumer credit agreement shall only be concluded when the result of the borrowers' creditworthiness assessment shows that the obligations of the credit agreement can be complied with under the law. The limits introduced in this Recommendation correspond to caps and, as such, do not replace the institutions' compulsory assessment of the adequateness of the different indicators' values and other criteria used in the assessment of each borrower's creditworthiness.

In view of the above, pursuant to Article 16-A of its Organic Law, Banco de Portugal, as the national macroprudential authority, adopts the following Recommendation:

Article 1

Scope

1. This Recommendation shall apply to credit agreements governed by Decree-Law No 74-A/2017 of 23 June 2017 ('hereinafter Decree-Law No 74-A/2017') and Decree-Law No 133/2009 of 2 June 2009, as amended by Decree-Law No 72-A/2010 of 18 June 2010, No 42-A/2013 of 28 March 2013, and No 74-A/2017 of 23 June 2017 ('hereinafter Decree-Law No 133/2009'), with the following exceptions:
 - (a) Credit agreements in the form of overrunning, as defined in Article 4(1) (e) of Decree-Law No 133/2009;
 - (b) credit agreements intended to prevent or address arrears situations, namely through refinancing or consolidation of other credit agreements, as well as through the renegotiation of the terms and conditions of already existing credit agreements;
 - (c) credit agreements for an amount equal to or lower than the equivalent to tenfold the guaranteed monthly minimum wage;
 - (d) credit agreements concluded under the provisions laid down in Law No 63/2014 of 26 August 2014 and Law No 64/2014 of 26 August 2014;
 - (e) credit agreements in the form of an overdraft facility and other credit with no defined repayment schedule (including credit cards and credit lines).
2. This Recommendation also excludes increases in the total amount of credit agreements during the lifetime of the credit agreements referred to in the foregoing paragraph, provided that the total amount of credit agreements resulting from the increase is equivalent to tenfold the guaranteed monthly minimum wage, or the total amount of credit agreements resulting from the increase is only available to the consumer on a temporary basis, for a period of up to three months.

Article 2

Definitions

For the purposes of this Recommendation, the following definitions shall apply:

- (a) 'consumer' means a natural person acting with purposes other than those of his or her commercial or professional activity in the credit agreements covered by the provisions of Decree-Law No 133/2009 and Decree-Law No 74-A/2017;
- (b) 'credit agreement' means an agreement whereby an institution grants or promises to grant credit to a consumer under the form of a loan, payment deferment, revolving credit or any other equivalent financial agreement, including financial leasing, with the exceptions referred to in Article 1;
- (c) 'consumer credit' means the consumer credit agreements covered by Decree-Law No 133/2009;
- (d) 'debt service-to-income (DSTI)' means the ratio of the total amount of monthly instalments of a borrower's total amount of credit agreements to a borrower's monthly income, calculated pursuant to Article 4;
- (e) 'institution', credit institutions and financial companies having their head office or branches in Portuguese territory, which grant credit under the scope of this Recommendation;
- (f) 'own and permanent residence' means the residence where the borrower or he/she and his/her household have a stable centre of family life;
- (g) 'loan-to-value (LTV)' means the ratio of the total amount of credit agreements secured by immovable property to the purchase price or the appraisal value of the immovable property pledged as collateral for credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee, calculated pursuant to Article 3;
- (h) 'total amount of credit agreements' means the maximum limit or total amounts made available through a credit agreement to a borrower;

- (i) 'income' means the annual income of a borrower, less taxes and compulsory social security contributions, as per the latest tax statement and/or information on income received in the three months before the creditworthiness assessment, pursuant to the provisions of Article 7 of Notice of Banco de Portugal No 4/2017 of 22 September 2017.

Article 3

Calculation of the LTV – numerator and denominator

1. The calculation of the LTV shall consider in the numerator the amount of loan(s) secured by the same immovable property, and in the denominator the minimum between the purchase price and the appraisal value of the immovable property pledged as collateral.
2. The value of the immovable property shall be assessed by a real estate appraiser, pursuant to Article 18 of Decree-Law No 74-A/2017.
3. In the case of credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee for construction, the calculation of the LTV shall consider in the denominator the minimum between the land value plus the cost of renovation and the expectable appraisal value of the immovable property at the time of conclusion of the construction project.
4. In the case of credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee for renovation in immovable property purchased for less than two years, the calculation of the LTV shall consider in the denominator the minimum between the purchase value of the immovable property plus the cost of improvements and the expectable appraisal value of the immovable property after renovation.
5. In the case of credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee in which the time elapsed between the purchase of the immovable property and the granting of the credit is two or more years, the

calculation of the LTV shall consider in the denominator the appraisal value of the immovable property or, in the case of credit for renovation, the expectable appraisal value of the immovable property after renovation.

6. In the case of credit secured by immovable property which has not been purchased (e.g. gifts or legacies), the calculation of the LTV shall consider in the denominator the appraisal value of the immovable property.

Article 4

Calculation of the DSTI – numerator and denominator

1. The calculation of the DSTI shall consider in the numerator the monthly instalment calculated with all loans held by a borrower, as set out in paragraph 2 of this Article, and in the denominator the monthly income of a borrower, as set out in paragraph 3 of this Article.
2. The calculation of the DSTI numerator shall consider the instalments of all credit agreements already concluded, including instalments of credit agreements out of the scope of this Recommendation, provided that there is a defined repayment schedule, and the instalments of the new credit agreement. For the purposes of this calculation, the instalments of the new credit agreement are assumed to be constant, and the impact of an interest rate rise shall be considered for this agreement, in accordance with the provisions of an Instruction of Banco de Portugal.
3. For the calculation of the DSTI denominator subject to the limits set forth in Article 6(1) to (3), it is recommended that the annual income of a borrower be divided into 12 months. In the case of a borrower aged 70 and over at the planned expiry of the agreement, a reduction of income of at least 20% of current annual income shall be considered, weighted by the ratio of the number of years of the agreement in which a borrower is aged 70 and over to the total maturity of the agreement.

4. This reduction in income shall not be considered if at the time of the creditworthiness assessment the borrower is already retired. As regards agreements with more than one borrower and in which information on aggregate income is only available for the group of borrowers, the age of the borrower with the earliest date of birth shall be considered for the purpose of calculating the reduction in income.

Article 5

Recommendation A: Limits to the LTV for credit agreements relating to residential immovable property and credit agreements secured by a mortgage or equivalent guarantee

1. Institutions are recommended not to grant credit relating to residential immovable property for the purchase or construction of own and permanent residence with an LTV of more than 90%.
2. Institutions are recommended not to grant credit relating to residential immovable property or credit secured by a mortgage or equivalent guarantee for purposes other than own and permanent residence with an LTV of more than 80%.
3. As regards credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee for purchasing immovable property held by the institutions themselves, these are recommended not to grant new credit with an LTV of more than 100%.
4. As regards property financial leasing agreements it is recommended that the LTV does not exceed 100%.
5. Institutions are recommended to classify the intended purpose of the credit agreement, notably own and permanent residence and other purposes.

Article 6

Recommendation B: Limits to the DSTI

1. Institutions are recommended not to grant credit that results in a DSTI of more than 50%.
2. Up to 20% of the total amount of credit granted by each institution in each year may be granted to borrowers with a DSTI of up to 60%.
3. Up to 5% of the total amount of credit granted by each institution every year may exceed the limits to the DSTI provided for in paragraphs 1 and 2 of this Article.
4. In the cases provided for in paragraphs 2 and 3 of this Article and in other situations exceeding the limits set forth in this Article, institutions shall justify which additional information was considered in the borrower's creditworthiness assessment, ensuring the use of suitable risk management criteria and their compliance with the law in terms of creditworthiness assessment.

Article 7

Recommendation C: Limits to maturity

1. It is recommended that the maturity of the new credit agreements relating to residential immovable property and credit secured by a mortgage or equivalent guarantee does not exceed 40 years.
2. It is recommended that the average maturity of the group of new credit agreements relating to residential immovable property and credit secured by a mortgage or equivalent guarantee granted during each year for each institution gradually converges, over four and a half years, toward 30 years. Gradual convergence shall mean an annual reduction, with a linear trend, of the differential between the average maturity of the new credit flows and 30 years, from the time of entry into force of the Recommendation to the end of 2022, thus avoiding an abrupt reduction in the average

maturity of credit relating to residential immovable property and credit secured by a mortgage or equivalent guarantee at the end of the convergence period.

3. It is recommended that the maturity of the new consumer credit agreements does not exceed 10 years from the date of entry into force of the agreement.

Article 8

Recommendation D: Regular payment requirements

It is recommended that credit agreements have regular principal and interest payments.

Article 9

Suitable risk management criteria

1. Institutions shall apply suitable risk management criteria in all credit transactions.
2. The limits introduced by this Recommendation correspond to caps and shall not replace these institutions' mandatory assessment of the adequateness of the different indicators' values and other relevant criteria used in the assessment of each borrower's creditworthiness. Hence, a consumer credit agreement shall only be concluded when the result of the borrowers' creditworthiness assessment shows that the obligations of the credit agreement can be complied with under the relevant applicable law.

Article 10

Assessment of compliance with the Recommendation

1. Institutions shall ensure that they have the suitable means and processes to comply with this Recommendation and to allow Banco de Portugal's timely access to the relevant data and information for monitoring the respective compliance.
2. Institutions shall report to Banco de Portugal any relevant information on the credit agreements under the scope of this Recommendation in order to allow Banco de

Portugal to monitor compliance with the provisions of Articles 5 to 8; otherwise institutions shall provide an explanation for non-compliance.

3. Banco de Portugal shall assess the explanations provided by the institutions and decide whether the provisions of Articles 5 to 8 were complied with or whether the explanation presented is adequate. In the event that the explanation is considered inadequate, Banco de Portugal may issue other measures within its competences as the national macroprudential authority.
4. Banco de Portugal shall monitor the implementation of this Recommendation at least once a year as well as the evolution of credit agreements for consumers excluded from the scope of this Recommendation.

Article 11

Date of application of the Recommendation

This Recommendation shall be applicable to agreements concluded from 1 July 2018 onwards. In 2018, the exceptions described in Article 6(2) and (3) shall consider transactions carried out between 1 July 2018 and 31 December 2018.