Consultation Paper

10/16 ★★★

Financial Services Authority

Mortgage Market Review:

Responsible Lending

July 2010

FSA®
Financial Services Authority

Contents

The Financial Services Authority invites comments on this Consultation Paper.

Please send your comments to us by the following dates:

- on questions 16 to 22 about interest-only mortgages and questions 33 and 34 about non-deposit taking lenders, by 30 September 2010; and
- on all other questions, by 16 November 2010.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2010/cp10_16_response.shtml).

Alternatively, please send comments in writing to:

Lynda Blackwell
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 0168
Fax: 020 7066 0169
E-mail: cp10_16@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

List of acronyms used in this paper

BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
CBA	Cost Benefit Analysis
CFEB	Consumer Financial Education Body
CML	Council of Mortgage Lenders
CP	Consultation Paper
CRD	Capital Requirements Directive
DCLG	Department of Communities and Local Government
DP	Discussion Paper
DSR	Debt Service Ratio
DTI	Debt-to-Income (ratio or multiple)
ECB	European Central Bank
EFS	Expenditure & Food Survey
ERC	Early Repayment Charge
FSMA	Financial Services and Markets Act 2000
GDP	Gross Domestic Product
GENPRU	General Prudential sourcebook
HMRC	Her Majesty's Revenue and Customs
IMLA	Intermediary Mortgage Lenders Association

LCS	Living Costs & Food Survey
LTI	Loan-to-Income (ratio)
LTV	Loan-to-Value (ratio)
MCOB	Mortgages and Home Finance: Conduct of Business sourcebook
MFI	Monetary Financial Institutions
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms and Insurance Intermediaries
MLAR	Mortgage Lending and Administration Return
MPPI	Mortgage Payment Protection Insurance
NIV	Non-Income Verified
OFT	Office of Fair Trading
ONS	Office of National Statistics
PSD	Product Sales Data
SEH	Survey of English Housing
SPV	Special Purpose Vehicle
SVR	Standard Variable Rate
TCF	Treating Customers Fairly
TPA	Third-party Administrator

1 Background and overview

Introduction

1.1 Our review of the mortgage market began in 2005 when we launched the first of two studies of the effectiveness of the mortgage conduct regime introduced in October 2004.[1] Those customer-facing reviews were complemented by a series of firm-facing thematic projects which also began in 2005. Those early reviews looked at responsible lending practices in the areas of sub-prime, interest-only, self-certified mortgages and lending into retirement.[2] At that early stage we were finding weaknesses in responsible lending practices and in firms' assessments of a consumer's ability to afford a mortgage, and had already started working with the industry to try and raise standards.

1.2 Events in the financial market from late 2007 onwards inevitably affected our work and brought a much wider remit, extending it beyond a narrow conduct focus to the wider prudential and macroeconomic context. As we have said previously, the mortgage market worked well for many consumers. But it was also clear that the existing regulatory framework had been ineffective in constraining particularly risky lending and unaffordable borrowing. Circumstances led lenders to feel insulated from losses arising from poor lending, largely as a result of being able to pass risks onto others (e.g. by securitisation) and also by the widely held expectations of continuing growth in property values. This resulted in relaxed lending criteria and increased risk taking, and increased competition pushed lending further along the risk curve with a rash of new market entrants (often non-deposit taking lenders) adding to this.

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1 Mortgage Effectiveness Review – Stage 1 report (September 2006) http://www.fsa.gov.uk/pubs/other/mortgage_review.pdf and Mortgage Effectiveness Review – Stage 2 report (March 2008) http://www.fsa.gov.uk/pubs/other/MER2_report.pdf.

2 The findings of these thematic reviews were widely communicated, for example, in press releases http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml, speeches http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/120.shtml and enforcement cases http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/094.shtml.

1.3 The continued boom in house prices and this ready availability of credit allowed many households to take on even more debt. This increase in mortgage borrowing included extended access to higher-risk groups, such as the credit impaired, who had previously been excluded. So far in this downturn we are seeing problems concentrated among such borrowers and characterised by apparently higher-risk lending practices.

1.4 With the Bank of England (BoE) Bank Rate at a historically low level the majority of borrowers currently enjoy lower mortgage rates. Together with the various government initiatives and improved lender forbearance, this disguises the full impact of unaffordable lending and the true extent of the vulnerability of many consumers to upward interest rate movement, as we discuss in Chapter 2.

1.5 Our approach to retail conduct of business regulation and supervision generally has undergone fundamental change. We will no longer intervene based solely on observable facts and we will no longer wait for our effectiveness and thematic reviews to highlight crystallised risks before acting. We are prepared to take a much more robust and interventionist approach to regulating firms and markets, intervening early where necessary to shape the market to deliver appropriate outcomes and address problems before they cause substantial consumer detriment.

1.6 In line with this new approach, this Consultation Paper (CP) sets out the changes we believe are needed to deliver a more responsible approach to lending in future, to ensure a sustainable market and one that works better for consumers. We believe that a robust and effective assessment of individual affordability has to underpin any sustainable lending model. This will address one potential cause of business failure as well as contributing to the fight against financial crime. By the same token, ensuring that individual borrowing decisions are responsible and affordable will also limit harm.

1.7 This CP also presages a more interventionist and robust approach to challenging unfair charging practices in the market. We indicated in the Mortgage Market Review (MMR) Discussion Paper (DP09/3) that we had work underway to help us develop a better understanding of charging and pricing structures in the market. This should enable us to identify and challenge unfair and excessive practices. The first stage of that work looked at arrears charges and this CP presents the outcomes of that review. It sets out proposed changes to our arrears-charging rules to clarify the approach we expect firms to be taking under our existing requirements.

1.8 There are two areas that we open up for further debate in this CP. One is our approach to regulating non-banks. The other is our approach to interest-only mortgages. We invite further debate and discussion on both topics to help inform our final proposals, which will be consulted on at a later stage.

1.9 The overall aims of the MMR are to have a mortgage market that is sustainable for all participants and to have a flexible market that works better for consumers. We believe that the proposals set out in this CP will go a long way to help deliver these aims.

European dependency

1.10 There continues to be considerable interest at a European level in the case for policy interventions in the retail mortgage market. A possible strategic initiative on responsible lending and borrowing was referred to in the European Commission's published work programme for 2010[3] and further discussions are planned.

1.11 We have closely engaged with the Commission and a number of key European stakeholders over the course of our review, to ensure a good understanding of our analysis and the national market issues that we are addressing. We will, of course, continue these discussions, drawing on the substantial evidence base we have for the UK market and our policy in light of this.

1.12 The uncertainty about the timing and form of any European policy intervention is not a reason for delaying policy proposals we consider necessary to address UK market detriment. However, the possibility of EU action represents a key and continuing dependency for our work.

Scope extensions

1.13 In DP09/3 we said it would be desirable to extend the scope of our current mortgage regulation in some aspects, both to ensure a high (and continuing) standard of consumer protection and to avoid potential gaming risks. These issues were further considered by the previous government in consultation on the case for extending FSA regulation for second charge lending, unregulated purchasers of mortgage books and buy-to-let.[4]

1.14 In the feedback subsequently published on this consultation[5], the previous government confirmed its intention to transfer responsibility for second-charge lending from the Office of Fair Trading (OFT) to us. It also said it was minded to bring currently unregulated purchasers of mortgage books within our scope, albeit that technical issues raised by respondents first required addressing.

1.15 While many respondents agreed that aspects of the buy-to-let market have given rise to significant detriment, the Treasury consultation revealed a range of views on the potential approach of regulation. Given this, there was a commitment to further consider the regulatory options and consult again.

1.16 The policy proposals within this CP address the mortgage market for which we are currently responsible. Any extension in that scope will be the trigger for specific consultation on our regulatory approach to that market.

3 Commission Work Programme: Time to act. European Commission. 31 March 2010
4 Mortgage regulation: a consultation. Treasury. December 2009
5 Mortgage regulation: summary of responses. Treasury March 2010

Structural change

1.17 The government recently announced its intention to change the regulatory structure in the UK. The FSA's prudential and conduct of business supervisory functions will be separated, with the prudential activities moving to form a new subsidiary of the Bank of England, and with our conduct of business activities moving to a new Consumer Protection and Markets Authority. The structural changes will not deflect us from delivering our reform of the mortgage market. We remain committed to delivering the programme of work set out in our business plan, which includes the MMR.

Overview of proposals

1.18 This consultation considers a range of issues related to responsible lending and the fairer treatment of consumers, in particular for arrears-charging practices. Our proposals are summarised in the remainder of this overview, and set out in more detail in the remaining chapters of this CP.

Affordability assessments – Chapter 2

1.19 We want lenders to lend to people who can repay, and consumers to take on mortgages that they can afford. To date lenders have had considerable flexibility in how they assess affordability, and in some cases firms have used inadequate criteria and over-relied on house prices. To address this we are proposing that lenders should assess the consumer's ability to repay for all mortgage applications, through an assessment of their income and expenditure, and to lend only where the mortgage is assessed as being affordable.

1.20 To ensure that lenders base this assessment on accurate information, we propose that lenders must verify income for all mortgage applications. This proposal effectively bans self-certification and fast-track mortgages where income is not verified. We are not proposing to be prescriptive about the type of evidence that lenders can use to verify income, but the evidence must be from a source independent of the consumer and should be sufficient to enable the lender to assess the risks posed by the consumer's individual circumstances.

1.21 When assessing expenditure, lenders will be free to undertake a line-by-line assessment of all expenditure for each individual applicant if this is their preferred approach. However, recognising concerns about the practical difficulties of gathering comprehensive and reliable expenditure data from consumers, we want to give lenders the flexibility to use statistical data and their own expenditure models. Where a firm chooses to go down this route, we would expect them to take into account committed and personal expenditure, and have a process in place for identifying and assessing outliers.

1.22 To prevent the stretching of affordability seen in the past, through the use of interest-only and the extending of mortgage terms, we are proposing that affordability assessments must normally be based on a capital and interest basis, even for interest-only mortgages; and on a maximum term of 25 years, even where the actual term is longer.

1.23 We also propose that affordability assessments test mortgage payments against interest rate increases, to ensure that, as far as possible, assessments are robust. We are proposing that the FSA should publish a guideline margin for firms to test against. We have suggested that this margin is set with reference to forward swap rates, but invite views on this. Alternatively we propose that firms may use their own margin where it is higher than ours.

1.24 To provide extra protections for impaired credit borrowers, who have been shown by our data to be at the highest risk of arrears and repossessions, we are proposing to apply a stricter affordability test. We are proposing that lenders apply a 'buffer' to their calculation of these borrowers' free disposable income and invite comment on an appropriate basis for that buffer.

1.25 We are also reconsidering our approach to interest-only mortgages, to address concerns around the use of interest-only where there is no repayment method in place. We are not consulting on proposed changes to interest-only mortgage lending in this CP but opening up a further discussion on the tightening of regulation in this area to help inform our final approach on which we plan to consult later in the year.

Product regulation – Chapter 3

1.26 In DP09/3 we suggested that there might be a case for prohibiting mortgage lending to borrowers exhibiting multiple high-risk characteristics, but at the time did not have sufficient evidence to justify any substantive proposals. We have since undertaken further data analysis.

1.27 The initial findings from this analysis, which factored in our proposed new approach to income verification, show that the dominant characteristic present in all high-risk lending combinations is whether the borrower has an impaired credit history. In light of this we have proposed additional protection for impaired credit borrowers.

1.28 Beyond this, we are not proposing to ban any particular high-risk combinations. Similarly, we are not proposing to ban loans with high loan-to-value (LTV) or high loan-to-income (LTI) ratios. Our view is that, at this stage, the evidence is not strong enough to justify an outright ban, which would be too blunt and would unfairly deny borrowers a mortgage without assessing their ability to repay. We propose instead to rely on affordability assessments.

Arrears charges – Chapter 4

1.29 In DP09/3 we proposed a more interventionist approach to monitoring and enforcing against excessive charging practices in the mortgage market, and committed to the Treasury Select Committee to undertake further work on this.

1.30 We have completed our review of arrears charges and we report the findings here and in Annex 2 of this paper. It is clear from the analysis that most lenders had not adequately considered the underlying costs when setting their arrears charges, even though our rules require this. We found significant variation between firms' assessment of costs and the fees they charged. The result was that firms were both over-charging and under-charging relative to their administration costs. Firms should be in no doubt that their arrears charges must not reflect more than underlying costs.

1.31 We are going to continue to expand our more intrusive supervisory approach to charges. We propose to apply our arrears charges rules to all charges related to payment shortfalls. We are also requiring firms not to charge a fee for missed payments (such as for an unpaid direct debit) more than once per month. In addition, we are proposing to clarify how arrears charges should be calculated and applied.

Responsible borrowing, better informed purchasing – Chapter 5

1.32 The problems that the MMR has highlighted stem not only from the actions of firms. The past market also included many examples of poor borrowing decisions, making it clear that regulation cannot rely on all consumers protecting their own best interests.

1.33 These poor borrowing decisions had two causes. Some consumers knowingly took on borrowing that caused them to be overstretched. For many others, the poor decisions resulted from inadequate understanding or knowledge.

1.34 Our changes to the assessment of affordability do more than place clear responsibility with the lender. They should also encourage consumers to engage more, for example by requiring them to provide proof of income. DP09/3 recognised the challenge of more generally raising understanding and knowledge among mortgage borrowers. The financial capability work described there is now being taken on by the Consumer Financial Education Body (CFEB), with several initiatives focusing on mortgage borrowers – especially among groups considered at higher risk.

Non-deposit taking lenders – Chapter 6

1.35 In DP09/3 we raised concerns about the role of non-deposit taking lenders (non-banks) in the rapid expansion of mortgage lending that fed rising house prices in the UK. We felt that the prudential reforms already underway or proposed for banks and building societies, combined with our proposed conduct of business changes, should help constrain the level and growth of higher-risk mortgage lending in future. We noted that the prudential reforms for banks and building societies would impact indirectly on non-banks – the question was whether we needed to do anything further on the prudential side specifically for non-banks.

1.36 Our continuing analysis of the impact of non-banks leads us to believe there is such a need and in Chapter 6 we discuss the idea of introducing a prudential regime for non-banks that incorporates some elements of the requirements applied in BIPRU[6] to banks and building societies. We also comment on the macro-prudential context for non-banks.

1.37 We are not consulting on any proposals at this stage. Instead we are inviting comments from stakeholders on the issues that we set out in the chapter. This will help inform our proposals which we will consult on later this year, if appropriate.

6 BIPRU is the Prudential sourcebook for Banks, Building Societies and Investment Firms.

Who should read this CP?

1.38 The proposals in this CP will be of special interest to consumers and their representatives, to firms and to trade bodies. We would also expect interest from those who supply services to firms, and from those with a wider interest in access to mortgage credit.

Consumers

1.39 This CP will be of interest to consumers who either have a mortgage or anticipate taking one out, as well as their representatives and to consumer groups. Responsible lending, with a proper assessment of individual affordability at its heart, is crucial to ensuring a mortgage market that is sustainable and that works better for consumers.

Next steps

1.40 We hope this CP will prompt further constructive engagement on the best means for ensuring responsible lending and borrowing, and also fair charging practices.

1.41 The feedback period on interest-only mortgages (questions 16 to 22) and non-banks (questions 33 and 34) runs until 30 September 2010.

1.42 The consultation period on all other proposals runs until 16 November 2010. We aim to publish a Policy Statement in Q1 2011. We will follow this paper with a further MMR consultation, later in 2010, on distribution and disclosure issues.

2 Affordability assessments

Background

2.1 In DP09/3 we outlined the conduct of business reforms we thought may be necessary to constrain irresponsible lending in the next economic upswing. This included our approach to the assessment of affordability. We have continued to develop our thinking in this area in response to feedback to DP09/3 and through continued discussion with industry and consumer representatives. In this chapter we outline our proposals for the assessment of affordability, including how income is evidenced. We also discuss our current thinking on interest-only mortgages and possible reforms to their sale. Finally we consider our approach to equity withdrawal.

2.2 A detailed cost benefit analysis of the proposals in this chapter is in Annex 1 Part 1[7]. A high-level cost benefit analysis of our current position on interest-only mortgages is in Annex 1 Part 2. The proposed rule changes are in Appendix 1 Part 1.

Affordability

2.3 We already require lenders to take account of a customer's ability to repay before entering into a mortgage. However, as we discussed in DP09/3, we consider that firms' failure to perform proper affordability checks underlies many of the issues in the mortgage market. We believe that there is considerable scope to strengthen our requirements to be more explicit about the standards we expect, particularly in relation to how affordability assessments are undertaken and the balance of responsibility between lenders and intermediaries.

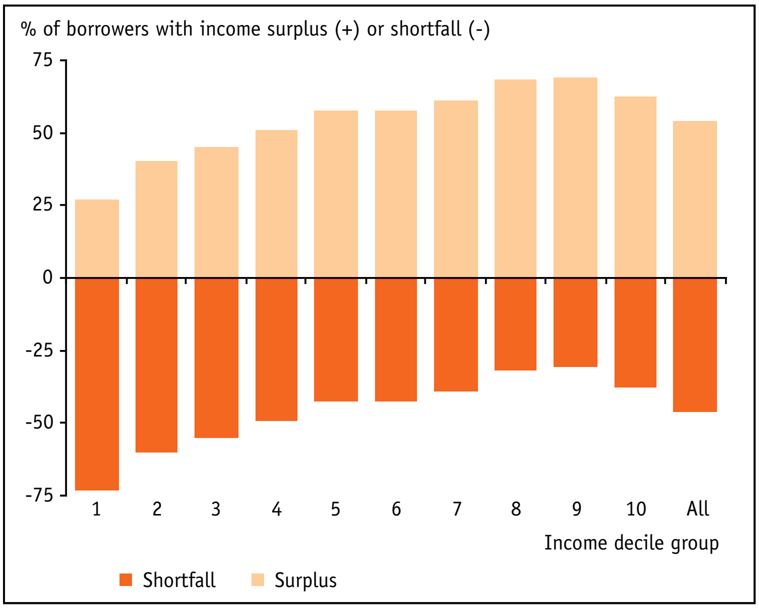
2.4 As noted in Chapter 1, although mortgage arrears have recently been high, we believe that the true scale of affordability-related issues for existing borrowers remains masked by historically low interest rates. Government initiatives to protect homeowners and improved lender forbearance have also played a part in reducing arrears and repossessions. This has led some to question whether affordability really is a problem and whether it is in fact necessary for us to take action.

7 Oxera was commissioned to assess the compliance costs and indirect costs of our proposals. The report is available on our website at: www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf

2.5 We have undertaken a detailed analysis of affordability, using data from the Living Costs & Food/Expenditure & Food Survey (LCF/EFS), and our Product Sales Data (PSD) and Arrears dataset.

2.6 We used a representative sample of 9,000 households holding a mortgage from the LCF/EFS covering the period 2005 to 2008, to calculate how much money borrowers had after mortgage payments and living costs were deducted from their income. As illustrated in Exhibit 2.1 our calculations indicate that 46% of these households had either no money or had a shortfall. For some people this situation could be temporary, but for others it may be a more persistent issue. The proportion of borrowers with a shortfall varied by income group, but while the lower income borrowers were affected the most, a significant minority of the households in the higher income groups also had a shortfall, as shown in Exhibit 2.1.

Exhibit 2.1: Proportion of households with income surplus or shortfall after living expenditure and mortgage payment, by income deciles group, 2005 to 2008

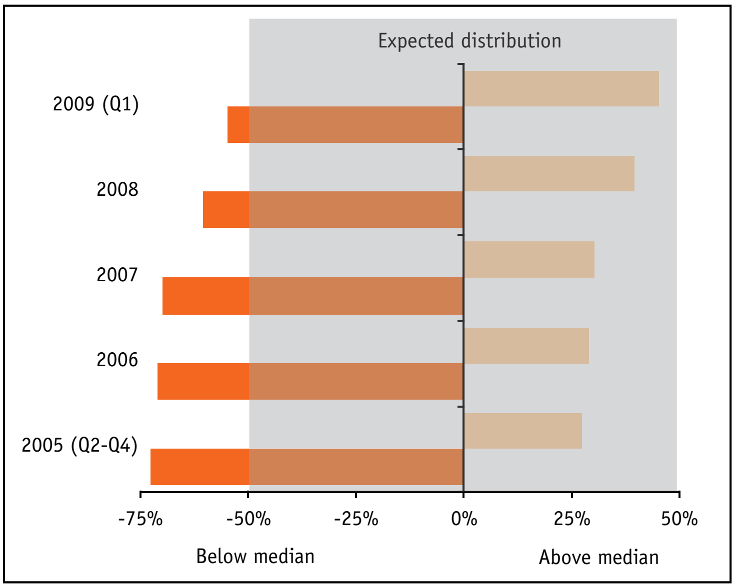


Source: EFS 2005 to 2008 datasets, FSA calculation

2.7 In the above analysis of LCF/EFS data, the expenditure is that of householders who already have a mortgage. We then applied this analysis of how much mortgage borrowers spend on non-mortgage expenditure to our PSD and Arrears dataset of 4.35 million mortgages, to estimate how affordable new mortgages sold between April 2005 and March 2009 were.

2.8 We worked out the amount of money that each borrower had left for non-mortgage expenditure after tax, national insurance and their mortgage payment. We then compared this amount of money with the median monthly mortgage expenditure of mortgage borrowers from LCF/EFS, in the relevant year and income group. We found that a significant minority of borrowers were unlikely to have had sufficient income for non-mortgage expenditure once mortgage payments were made. As shown in Exhibit 2.2 we mapped the data against the expected median amount of money available for expenditure (where we would expect 50% of borrowers to have expenditure above the median and 50% below), based on average levels of expenditure derived from the LCF/EFS. This analysis shows that a significant minority of borrowers fall outside the expected distribution, indicating that, for this group, income is not sufficient to cover mortgage payments plus average expenditure. Significantly, the proportion of cases falling outside the expected distribution reduced drastically in 2008 and almost disappeared by Q1 2009, as lenders tightened their underwriting criteria.

Exhibit 2.2: Money left for non-mortgage expenditure – expected and actual distribution



Source: FSA PSD and arrears dataset, EFS 2005 to 2008 datasets for median expenditure

2.9 When borrowers are financially stretched they have less capacity to save, making them particularly vulnerable to unfavourable life events or income shocks in the future. They may also take on additional debts to fund expenditure, which exerts more financial pressure in the long term. Two-thirds of borrowers have other debts in addition to their mortgages[8], and this proportion is likely to be higher for borrowers with mortgage arrears.[9] Many mortgage borrowers also obtain further advances, and from 2007 to 2009 further advances accounted for 22% of all new regulated loans, with an average loan size of £25,000.[10] Increasing indebtedness can conceal affordability issues for a relatively long period of time – for example, a further advance of £25,000[11] could cover an income shortfall of £600 a month for three years.

8 2008 NMG research survey 'the financial position of British households'

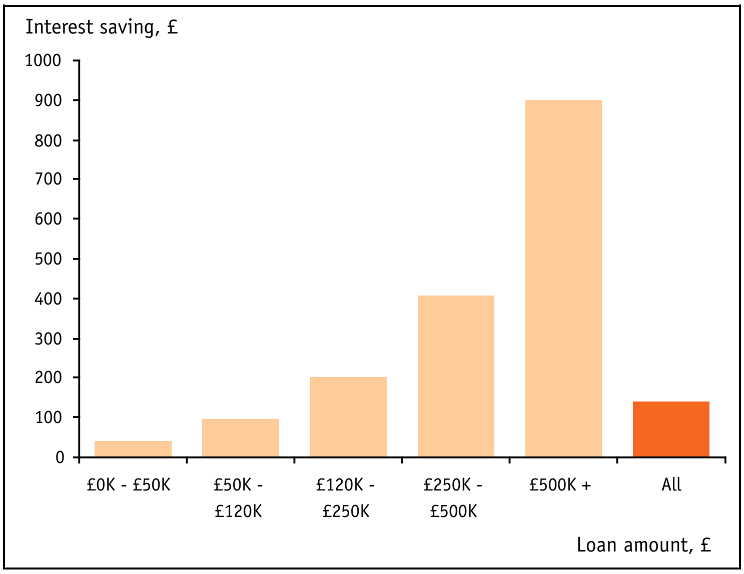
9 According to data shared with us by Citizens Advice, of those consumers who sought advice relating to arrears on their mortgage or secured loan from Citizens Advice Bureaux in England and Wales in April to June 2009, and whose detailed debt data was captured on their CASE database, around 87% had at least one other debt outstanding. 52% had a debt that might not show up in a credit record.

10 Data from MLAR

11 Assuming an interest rate of 5% per annum

2.10 Many borrowers who may be financially stretched have recently been protected by low interest rates, and may be enjoying a more comfortable financial position than they otherwise would have done. As shown in Exhibit 2.3 our data indicates that the median monthly reduction in mortgage payments for borrowers who obtained mortgages in 2007 and either reverted to the lender's Standard Variable Rate (SVR) or remortgaged in 2009 to 2010 was £140.

Exhibit 2.3: Mortgages taken out in 2007: median estimated monthly saving in 2010 due to low interest rates, £



Note: average interest rate at origination is 5.5%; average interest rate in Q1 2010 is 3.8%

Source: FSA PSD & Arrears dataset, PSD for average interest rate

2.11 Overall, this analysis suggests that a significant number of borrowers may be under financial pressure because of the level of their financial commitments and expenditure in relation to their income. It also supports the view that a modest increase in interest rates could lead to a significant increase in both households suffering financial distress, and lenders suffering increased losses. This highlights the importance of thorough affordability assessments in lending decisions.

2.12 Further details of this analysis of expenditure are set out in Annex 3.

Affordability assessments

2.13 In DP09/3 we outlined our view that lenders should carry out thorough affordability assessments for all mortgage applications, based on a consideration of a consumer's income and expenditure, with lending decisions based on the consumer's free disposable income.

2.14 Most respondents supported our proposal to make lenders ultimately responsible for assessing affordability, although some thought this would send a message to other parties involved in lending decisions, including consumers, that they had no part to play and were absolved of all responsibility.

2.15 Most were in favour of our proposals for tightening the assessment of affordability and agreed it was necessary for us to clarify what an affordability assessment should contain. Some lenders and trade bodies raised concerns over the reliability of affordability assessments as an indicator of default. Others had concerns over the degree of prescription for assessments, with some calling for greater prescription and standardisation, and others requesting more flexibility. Lenders in particular were concerned that the underwriting process would be lengthened and costs increased.

2.16 We have carefully considered this feedback, and have continued dialogue with the industry and consumer representatives. We have not significantly changed our approach. Our principal aim is to ensure that consumers take on mortgages that they can afford to repay, and we want to ensure that affordability assessments are robust enough to prevent consumers being foreseeably over-stretched. As we said in DP09/3, a mortgage is affordable if its level and terms allow the consumer to meet current and future payment obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears while allowing an acceptable level of consumption. Therefore, we propose that lenders should fully assess the consumer's ability to repay for all mortgage applications, in the light of their income, expenditure and outstanding debts; assessing borrowing capacity based on the consumer's free disposable income (i.e. income net of all expenditure), allowing for future increases in interest rates. The lender should lend only where it assesses that the consumer can afford to service the mortgage.

Income

2.17 We believe that to assess income reliably, the lender must have evidence that the declared income figure is accurate. Therefore, our affordability requirements are underpinned by income verification. Although lenders will be responsible for verifying income and assessing affordability, consumers will be more actively engaged with the mortgage application process, by providing evidence of their income to demonstrate to the lender they can afford the mortgage.

2.18 Income verification was one of the most controversial proposals in DP09/3, and respondents were polarised in their views. Those supporting the proposals, such as consumer representatives, intermediaries and some trade bodies, agreed that everyone should be able to verify their income, even where income sources are diverse or income streams irregular. They also saw benefits in terms of better assessment of affordability and fraud prevention. However, others raised concerns about the impact on the self-employed, the scope for increased use of fraudulent documentation, and increased administrative costs. Larger lenders and trade bodies were particularly concerned about the potential withdrawal of fast-track mortgages. Some respondents also argued that action was not required as the market has already adjusted by withdrawing self-certification products.

2.19 Non-income verified mortgages include both self-certified and fast-track mortgages, which can be characterised as follows:

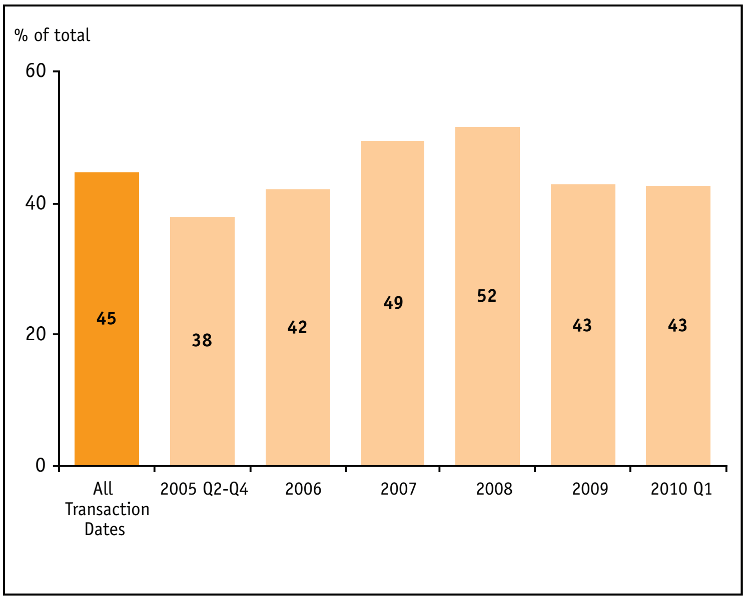
- **Self-certified mortgages:** this type of product is where the lender markets the fact that they will not check income. A premium price is usually paid for the greater risk incurred. Self-certified mortgages were originally aimed at the self-employed, but became more widely available over time to other groups including the employed.

- **Fast-track mortgages:** this is an accelerated process for processing mortgage applications deemed lower-risk, where at the lender's discretion evidence of income may not be required.

2.20 While non-income verified mortgages were originally aimed at niche audiences, such as the self-employed or the lowest risk applicants, they gradually became more widely used, with around half of all mortgages applications in 2007 and 2008 being processed without income verification. This is illustrated in Exhibit 2.4. While stringent criteria may have originally been applied to such applications, for example in terms of loan-to-values (LTVs), these criteria were relaxed over time. In 2007 15% of applications above 95% LTV did not have income verified, as shown in Exhibit 2.5.

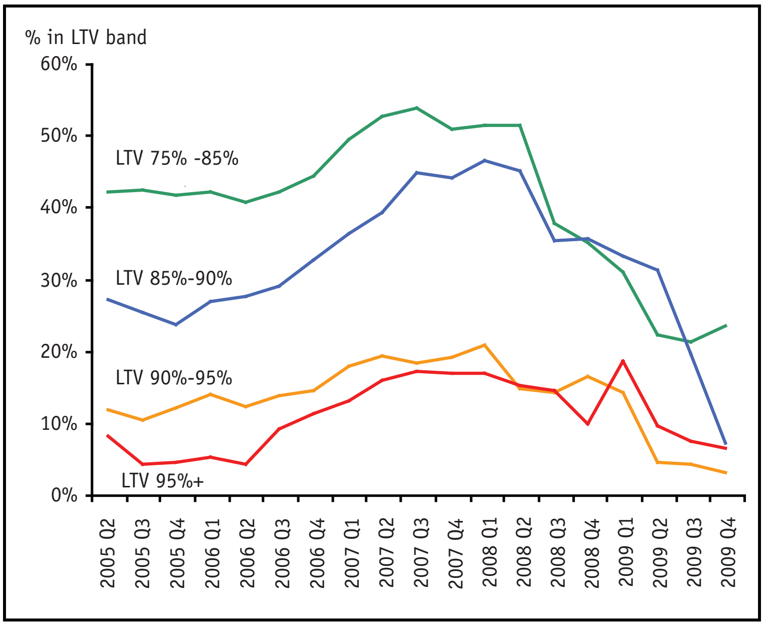
2.21 The only other countries we are aware of that have had a significant non-income verified market are the USA and Ireland, both of which experienced a boom in mortgage credit and house prices followed by a severe reduction in both. Other countries that have experienced similar market growth to the UK, but which had tighter regulatory standards and where the majority of mortgages were income verified, such as Canada and New Zealand, have fared better during the financial crisis and have experienced lower rates of arrears.

Exhibit 2.4: Proportion of mortgages where income was not verified



Source: FSA PSD

Exhibit 2.5: Higher-LTV mortgages where income was not verified



Source: FSA PSD

Our proposals

2.22 We are proposing that lenders must verify income for all mortgage applications. We will require lenders to obtain reliable evidence to confirm the income stated on the mortgage application form, so ensuring that affordability assessments are based on fact.

2.23 Although we are requiring lenders to verify income for all applications, to give lenders the flexibility to innovate and meet the needs of different market segments, we do not propose to be prescriptive about the following:

- **The means of evidencing income:** paper-based or electronic information sources may be used.
- **The source of evidence:** other than that it should be from a source independent of the applicant, such as from the applicant's employer, bank, accountant or HMRC; or accounts. Where the lender holds the applicant's current account they may utilise this information where appropriate.
- **The period of time that evidence of income must cover:** although in relation to variable sources of income, such as self-employed income, overtime payments, or bonuses, we will expect lenders to consider the variability of income over time, which may influence the period over which income is verified.

2.24 However, the evidence of income requested by the lender should be **adequate to appropriately assess the risks posed by the individual circumstances of the consumer**. It will be up to lenders to determine how they do this, but we would expect them to consider factors such as employment status, employment history and credit history.

2.25 While we are not proposing to be prescriptive about income verification, there are some methods of evidencing income which we do not consider to be acceptable.

These include declarations of affordability, where the applicant or a third party, such as an accountant, declares that the applicant can afford the mortgage payments, without providing any evidence of income (see proposed new MCOB 11.3.2R in Appendix 1 Part 1). And we would certainly not expect indirect evidence, such as providing headed paper or business cards, to be taken as verification of income.

2.26 We will expect lenders to be active in verifying income – and therefore, expect human intervention in the process to assess the credibility of the evidence provided and to guard against fraud. We consider that the requirement to verify income will reduce fraud rather than increase it.

2.27 HMRC ran a pilot scheme last year, where lenders who suspected the income details on a mortgage application were fraudulent were able to check whether the details provided matched information supplied to HMRC (such as tax returns, for example). During the pilot programme, eight of the lenders taking part reported that £111.4 million of mortgage fraud had been prevented. This illustrates the power of income verification in combating financial crime.

Fast-track mortgages

2.28 Some respondents to the DP, particularly larger lenders and trade associations, strongly supported the continuation of fast-track mortgage applications without income verification. They argued that this was appropriate for low risk applications, such as those with a low LTV and/or a good credit score, on the basis that such loans perform well, and in fact performance is comparable with (or even better than) income verified loans. They also argued that lenders undertake random sampling to test the accuracy of declared income and take appropriate action in cases where evidence of income could not be provided, or where income levels were inflated.

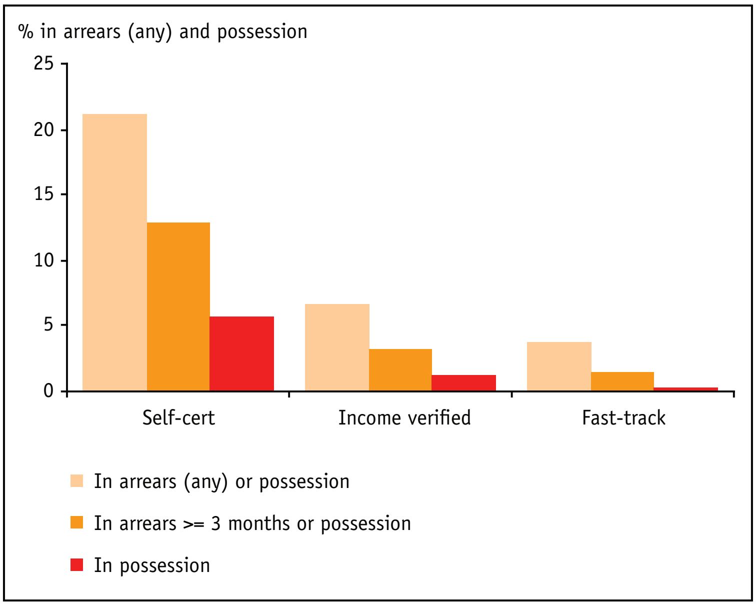
2.29 In DP09/3 we cited evidence from Moody's[12] to suggest that fast-tracking produces higher arrears rates than income verified mortgages. More recent research from Fitch Ratings[13] indicates that fast-track mortgages (in the prime sector) do not appear generically more risky than income verified loans, in terms of arrears.

2.30 We have since carried out our own analysis (see Exhibit 2.6) which shows that fast-track mortgages do have a lower rate of arrears and possessions than either self-certification mortgages or income verified mortgages, although fast-tracking did not perform equally well among all lenders, particularly for some smaller lenders, where performance was generally worse.

2.31 We recognise that much existing fast-track lending is of good quality, with poorer quality loans generally being channelled through the self-certification route. However, the absence of self-certified lending going forward is likely to heighten pressure to accommodate consumers who are unable (or unwilling) to prove income through alternative routes, such as fast-track.

12 Moody's Investors Service (2009), 'What drives UK mortgage loans to default'.
13 Fitch Ratings (2010), 'Default drivers among UK residential mortgage loans'.

Exhibit 2.6: Arrears performance, by type of income verification, August 2009



Source: FSA PSD & Arrears dataset

2.32 Although the industry is on the whole currently maintaining high standards for fast-track, we believe it is inevitable that as credit becomes more freely available these parameters will be relaxed by some lenders, particularly where there is opportunity to accommodate consumers who may have previously used the self-certified route. As this happens competitive pressure will grow for other lenders to follow suit. We know from past experience that this outcome is likely, given the increase in LTVs for fast-track we have seen during the credit boom, as is illustrated above in Exhibit 2.5.

2.33 Even where responsible parameters are set for fast-track lending, there is still scope for exploitation of the system. We saw this in the last boom where some fast-track schemes were overtly marketed to intermediaries as not requiring income verification, therefore becoming a substitute for self-certification. Intermediaries soon came to know where to place applications to minimise the chance of income documentation being requested. In the event that income verification was requested the application could be withdrawn and placed with an alternative lender.

2.34 To ensure a consistent approach across the industry – and to ensure that lending is responsible and borrowing affordable across the economic cycle – we are proposing to introduce income verification for all sales. While fast-tracking can continue in the sense that much of the application process can be automated, evidence of income must be obtained in each case.

Self-employed consumers

2.35 Some respondents to DP09/3 were concerned that our proposals would impact on self-employed consumers. We recognise that some consumers may have to wait longer before applying for a mortgage, including self-employed consumers with a new business, while they gather a track record of income. Evidence shows that starting a new business can be risky, with a large proportion of new start-ups failing shortly after being created[14] – so such a delay can be in consumers' interests. However, we still believe that, subject to such delays, it is possible for everyone to provide evidence of their income, although some lenders may need to train more staff so they can interpret evidence that self-employed consumers are likely to provide. We do not intend to prescribe the sources that lenders use to verify income. Possible sources of evidence for self-employed consumers include:

- audited accounts;
- tax assessments or other evidence provided by HMRC;
- bank statements; or
- confirmation of income from accountants.

Q1: Do you agree with our proposals for income verification?

Assessment of income

2.36 We are not proposing to be prescriptive around the types of income a lender may take into account when assessing affordability. Consumers may receive income from many sources, most commonly income from employment or from self-employment. However when making lending decisions lenders may take into account various other sources such as pensions, alimony or maintenance payments, and certain state benefits. We do not intend to prevent lenders from considering such legitimate sources of income.

2.37 The income of many employees is made up of various elements, such as overtime, commission and bonuses, and lenders usually take only a proportion of such income into account when assessing affordability. We do not propose to set limits on how lenders do this – it will be up to the lender to decide. However we do propose to require that the lender considers the variability of income over time in their assessment (proposed new MCOB 11.3.12R (2)(a)). The aim of this is to avoid the situation where a one-off sum or short term period of increased activity (e.g. leading to a temporarily increased income) has a disproportionate effect on the affordability assessment, masking the long-term unaffordability of the loan.

2.38 Similarly, where an applicant is self-employed we will expect the lender to consider the variability of their income over time, but we will leave the lender to decide how to do this, based on the risks posed by the applicant's circumstances.

2.39 We will expect lenders to verify the income that they are taking into account, whatever its source, by obtaining reliable evidence to confirm its credibility.

Q2: Do you agree with our approach to assessing income?

14 Source: ONS – see Exhibit 4.3 in Annex 3 for further details

Expenditure

2.40 As noted earlier, a mortgage is affordable if its level and term allow the consumer to meet current and future payment obligations in full, without recourse to further debt relief or rescheduling. Although consumers can reduce personal expenditure when they take on a mortgage, this can tend to be short lived as best intentions are overtaken by the demands of real life. Further debt is a significant cause of arrears, and while consumers cannot be prevented from taking on further credit commitments after taking on a mortgage, they are less likely to do so if it is within their means to make their mortgage payments.

2.41 We propose that lenders take expenditure into account when assessing affordability (see proposed new MCOB 11.3.6), including servicing of debts and general expenditure, according to the three categories of expenditure we outlined in DP09/3, and as illustrated in Exhibit 2.7, as follows:

- committed expenditure (such as tax, national insurance, utility bills and the servicing of debts);
- personal expenditure (such as food, clothing and recreation); and
- contingency expenditure (where the lender may make a prudent allowance for undeclared or underestimated expenditure).

2.42 Following discussions with industry stakeholders, we recognise the practical difficulties in gathering comprehensive expenditure data from consumers. We also recognise that many lenders have developed robust expenditure models based on statistical data. Therefore, we are proposing that lenders can choose to use statistical data, either derived from their own data or external sources, when assessing expenditure; or in the case of assessing levels of income tax and national insurance sources such as the tables published by HMRC. However, we expect this to be done robustly and with appropriate systems and procedures in place to recalibrate expenditure models as necessary. We will challenge lenders to explain the models that they use. We will also expect appropriate systems and procedures to be in place to identify outliers (such as consumers with unusually high expenditure).

2.43 The exception to this approach is outstanding credit commitments, whether secured or unsecured. We will require lenders to take reasonable steps to collect information on all such commitments. Lenders should then use this applicant specific data in the affordability assessment. This is already common practice.

2.44 In cases where credit commitments are to be repaid prior to or on completion of the mortgage then these commitments would not have to be included in the affordability assessment. However, we are concerned to ensure that, where a consumer says that they are repaying such debts from the proceeds of a mortgage taken out for debt consolidation, this actually happens. Therefore, we are proposing that lenders ensure that loans to be repaid from a mortgage advance are indeed cleared as intended, whether through direct payment by the lender or via a solicitor on completion (see proposed new MCOB 11.3.10R).

2.45 We have not included further advances in this proposal to ensure debts are repaid, as we understand that costs to the lender may be significantly higher where no solicitor is involved in the transaction, and significant changes to processes and/or systems may be required. We will gather more information on this to inform our thinking and may consult on extending this requirement to further advances in future.

Exhibit 2.7: Calculation of free disposable income

Gross income	Gross income (permissible items only)
Minus	
Credit commitments (secured or unsecured) for applicant(s)	Assessment based on customer specific information to determine servicing of secured and unsecured debt not being repaid by mortgage
Committed expenditure for applicant(s) and dependents	Assessment can be based on relevant statistical data, or in the case of income tax and national insurance, use of HMRC tables. Includes items such as: • income tax and national insurance; • utility bills, council tax, TV licence; • service charge, shared ownership rent; • insurance premium and pension contributions; • alimony and maintenance payments; and • nursery, school, college and university fees.
Personal expenditure for applicant(s) and dependents	Assessment can be based on relevant statistical data. Includes items such as: • food and drink; • clothing and footwear; • health and personal care; • transport; and • recreation and holidays
Contingency expenditure	Prudent allowance for missed or understated expenses (set according to the lender's discretion)
Equals	
Free disposable income	The maximum amount that the applicant(s) can afford to pay towards mortgage payments
Use assumptions to determine maximum borrowing capacity (i.e. maximum loan size)	
Assumptions	Capital and interest basis Maximum term of 25 years Take account of future interest rate increases using the FSA guideline rate (as a minimum – a higher rate can be used at the lender's discretion)

Q3: Do you agree with our approach to assessing expenditure? Do you foresee any practical issues?

Q4: Should lenders be required to ensure that credit commitments being cleared by debt consolidation are repaid as expected? Would there be significant additional costs in implementing this for further advances?

Free disposable income

2.46 Once income and expenditure has been established, expenditure is deducted from income to leave free disposable income. This figure indicates the maximum amount of money available for mortgage servicing, and indicates the upper limit on which mortgage payments are affordable (e.g. on an annual or monthly basis). From this the lender will be able to calculate maximum borrowing capacity, which represents the maximum affordable loan.

Q5: Do you agree with our approach to calculating free disposable income?

Maximum borrowing capacity

2.47 When calculating the maximum borrowing capacity we propose to require the lender to use the following assumptions to ensure affordability in every case:

- a capital and interest basis (except in specific circumstances);
- a maximum term of 25 years; and
- a check on continued affordability in the light of possible interest rate increases.

2.48 These assumptions are discussed in turn below.

Capital and interest basis

2.49 As we outlined in DP09/3, we are concerned that many interest-only mortgages have been taken out on affordability grounds, to maximise borrowing capacity, without adequately considering how the capital will be repaid. To ensure affordability we are proposing that lenders should normally assess affordability on a capital and interest basis, even where the mortgage is being taken out on an interest-only basis (see proposed new MCOB 11.3.15R(2)).

2.50 Some respondents to DP09/3 were concerned that this would exclude consumers who could not afford a repayment mortgage from the market. We believe steps must be taken to repay the capital and if a consumer cannot afford to do this then the mortgage is not affordable. We are not proposing that the cost of the repayment method must be included as a separate item of expenditure in the affordability assessment, because assessment of affordability on a capital and interest basis already includes consideration of repayment of the capital element of the loan.

2.51 Since the publication of DP09/3 we have given further consideration to the issue of interest-only, in light of the responses to the DP and developments in the market. This is discussed in more detail later in this chapter. As part of this we are considering whether there may be some limited exceptions where it may be appropriate to assess affordability on an interest-only basis, and we will consult on this in due course. However in the vast majority of cases we consider that affordability should be assessed on a capital and interest basis.

Q6: Do you agree that affordability should generally be calculated on a capital and interest basis?

Mortgage term

2.52 We are also concerned about mortgages being taken out over extended terms on affordability grounds.

2.53 Our data shows that the average mortgage term for a capital repayment mortgage is 22 years[15], but this increases with LTV. This is to be expected to an extent, as younger consumers and first time buyers are likely to borrow more, and have a longer working life to repay. However, the data shows a clear upward trend in terms for higher LTV mortgages, as shown in Exhibit 2.8, with over 60% of consumers with LTVs of 95% or more with terms longer than 25 years in 2007. This indicates that terms may have been extended to stretch affordability. This trend would be likely to continue, particularly if our tightened requirements prevent interest-only loans being taken out to stretch affordability.

2.54 Therefore, while we are not proposing to prescribe the maximum term available for a mortgage, we do propose that affordability is calculated on a maximum term of 25 years.

Taking account of future interest rate increases

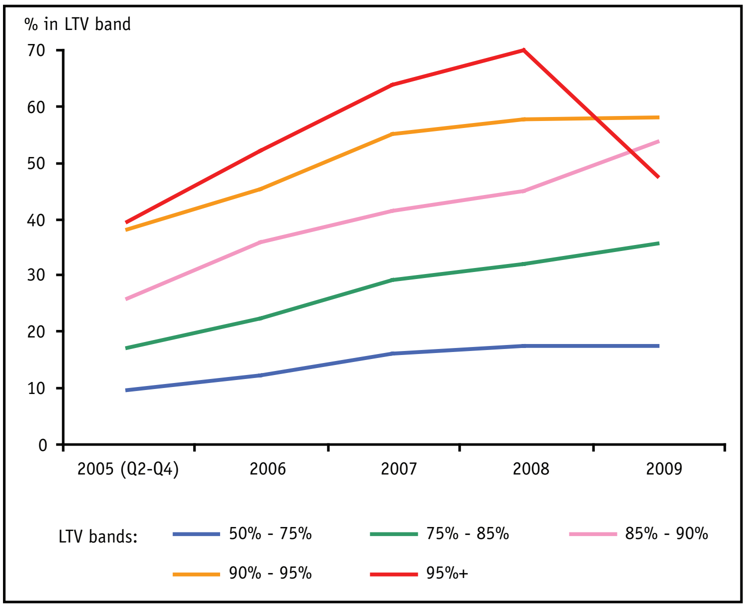
2.55 We want mortgages to be affordable, and as part of this we want to ensure, as far as possible, that consumers are protected against the possibility of being unable to meet their payment obligations in the future due to plausible increases in interest rates. This is of particular concern at the current time where interest rates are at an historic low, but is a relevant consideration across the economic cycle.

2.56 In DP09/3 we suggested that affordability should be tested at a rate of 2% above the lender's standard variable rate (SVR). We received some support for this, with a number of respondents indicating that they favoured, or indeed already carried out checks on this basis – although some thought that the differential should be higher. There was also support for consistency of approach across the market, although some thought that it was a matter for individual lenders to decide.

Q7: Do you agree that that affordability should be assessed on a maximum term of 25 years?

15 PSD data

Exhibit 2.8: Share of 'capital and interest' mortgage sales where terms exceeded 25 years, by LTV band – trend over time



Source: FSA PSD

2.57 We have considered this issue further, and believe that a flat margin of 2% above the lender's SVR is not sufficiently flexible to take account of economic circumstances, such as periods where interest rates are expected to rise or fall sharply. However, while we do not want to apply a margin that is too low, we also do not want to apply a margin that is unreasonably high and unnecessarily restricts affordability. It is not, of course, possible to predict future interest rates with any certainty, however there are methods of measuring how average rates are expected to move over a given period.

2.58 To address the problem of variability of rates over time, and to ensure minimum standards are adhered to across the industry, we are proposing that the FSA should publish a guideline margin for firms. We would publish this margin on our website, and review at regular intervals – for example on a quarterly basis. This rate would represent the minimum rate for lenders to use to assess the impact of interest rate increases on affordability, and would be applied to the higher of either the initial rate or the reversion rate of the mortgage being assessed (see proposed new MCOB 11.3.16R).

2.59 Our current view is that this rate should be set with reference to forward swap rates[16]. While swap rates can be volatile in the short term, comparison of the short and longer term swap rates and the associated trends give an indication of how rates may move over any given period, against which an appropriate margin can be set.

2.60 We are not proposing to prevent lenders from applying their own tests, as long as they can demonstrate that they are as least as robust as using the FSA guide margin.

16 Swap rates represent the cost of raising funds on the money markets, and reflect the market's expectation of what will happen to interest rates in the future.

> Q8: Do you agree with our approach to testing affordability against future interest rate increases, based on swap rates or any other appropriate guideline rate? Can you foresee any practical issues in the FSA setting a guideline margin for firms to use?

Maximum borrowing capacity

2.61 A lender will then use these assumptions to calculate the consumer's maximum borrowing capacity. We are not suggesting that lenders should lend the full maximum borrowing capacity; it simply represents the maximum amount that the applicant could afford to pay. Lenders may apply their own lending criteria to determine the maximum amount they are willing to offer, as long as it does not exceed the maximum borrowing capacity calculated according to the methodology outlined above.

2.62 Where a consumer has no borrowing capacity or a negative borrowing capacity (because their expenditure exceeds their income), then the lender should not make a loan.

Credit impaired consumers

2.63 As we outline in detail in Chapter 3, we have analysed the performance of 4.35 million mortgages originated between Q2 2005 and Q1 2009 by 33 lenders, examining which characteristics were the strongest predictors of arrears and repossessions. As might be expected, the dominant characteristic in all high-risk lending combinations was the borrower having an impaired credit history. This suggests that we need to take additional action to protect credit impaired borrowers and ensure they do not end up with a mortgage they cannot afford to repay.

2.64 Based on the definition we use for our regulatory reporting purposes, we consider a borrower with an impaired credit history is one who has met any of the following conditions:

- within the last two years, has had an sum equivalent to three months' payments overdue on a mortgage or other loan (whether secured or unsecured), except where the amount overdue reached that level because of late payment caused by errors by a bank or other third party; or
- has been the subject of one or more County Court Judgments, with a total value greater than £500, within the last three years; or
- has been subject to a creditors' Individual Voluntary Arrangement or bankruptcy order which was in force at any time within the last three years.

2.65 From PSD, in April 2005 to March 2010, those who were credit-impaired accounted for around 3.2% of regulated mortgage sales.

2.66 There are several reasons why borrowers may have an impaired credit history. Some may have been affected by a 'life event' that has had an impact on their finances, e.g. a divorce, illness or involuntary redundancy. Others may have an unaffordable lifestyle, and cannot meet their chosen level of expenditure from the income they receive. Some may have got themselves into an unmanageable level of debt commitments that they cannot finance from their income on top of their ordinary living expenses. According to data shared with us by Citizens Advice, of those consumers who sought advice relating to arrears on their mortgage or secured loan from Citizens Advice Bureaux in England and Wales in April to June 2009 and whose detailed debt data was captured on their CASE database, around 87% had at least one other debt outstanding. 52% had a debt that might not show up in a credit record.

2.67 While there is little that we can do to prevent the occurrence of 'life events', we think it appropriate to take action to reduce the likelihood that credit-impaired borrowers will get into difficulty in repaying their mortgage.

2.68 What we propose is to build in some provision, a 'buffer', into a credit-impaired borrower's affordability assessment to provide for debts that may not show up in a credit record (see proposed new MCOB 11.3.14 R).

2.69 The basis of the buffer and how it should be set needs further consideration. We could subtract a percentage from a credit-impaired borrower's free disposable income figure. Under our affordability proposals, if a borrower's free disposable income is established to be £1,000, that borrower would only be able to take out a mortgage with monthly payments up to that £1000. If that borrower were credit impaired, we could subtract, say 20%, from that free disposable income figure. This would mean that a credit impaired borrower would only be able to take out a mortgage with monthly payments up to £800, rather than £1000.

2.70 We have used 20% just as an example to start the debate about what might be an appropriate buffer. In considering what basis we could use to determine an appropriate figure, we looked at the performance of mortgages given to those with an impaired credit history, within our PSD and arrears dataset, where the borrowers were in arrears. We looked at those mortgages that were within their first 24 months and found that the weighted-average of the number of months' payments in arrears, divided by the total number of months since origination, was 14%. Put simply, those credit-impaired borrowers were, on average, in arrears on their mortgage payments by 14% within the first 24 months of their mortgage.

2.71 This could suggest applying a buffer of 14%. However, we have concerns about using this as the basis for determining an appropriate buffer as it is based on historic and incomplete data[17]. The average amount by which debts are under-reported in credit records could be another appropriate basis, though this may be difficult to establish. We would welcome views on this to help us determine an appropriate basis for such a buffer and how it could be set.

17 As we describe in the section on methodology in Annex 3, our PSD and arrears dataset is based on arrears rates as at 1 August 2009. Our dataset also understates the true performance of credit-impaired mortgages. The majority of these mortgages were sold by non-banks and the subsidiaries of building societies, both of whom sold on large tranches of their mortgage books, which do not feature in our dataset. The arrears performance of credit impaired mortgages is therefore understated.

2.72 Where they can get access to finance, credit impaired borrowers generally already face higher interest rates than those with a good credit history, reducing their overall borrowing capacity. Adding a buffer would reduce this further, and mean that some borrowers are likely to be able to borrow less than they wish. While this may not be a desirable outcome for the consumer, we consider that the evidence justifies this proposal on the grounds that it should protect the consumer from getting themselves into an unmanageable and undesirable situation in the future. Where credit-impaired borrowers demonstrate that they can manage their finances, their credit-history will be naturally restored and they can apply for a mortgage without being subject to this restriction at that time.

Q9: Do you agree with our proposal to impose an additional buffer on the calculation of free disposable income to protect credit impaired borrowers? What would be an appropriate basis for that buffer and how should it be set?

Foreseeable changes to circumstances

2.73 When assessing affordability, lenders should consider the applicant's ability to repay over the life of the loan. There are clearly limitations to this as a lender cannot predict future events, even to the extent of what the applicant does the day after the mortgage completes. However, there are circumstances that are foreseeable, and where this is the case the lender should take these into account. The most obvious example of this is retirement. This requirement is already in place (through the current MCOB 11.3.5G, which requires actual or reasonably anticipated income to be taken into account). We propose to strengthen this requirement from guidance to a rule (see proposed new MCOB 11.3.12R).

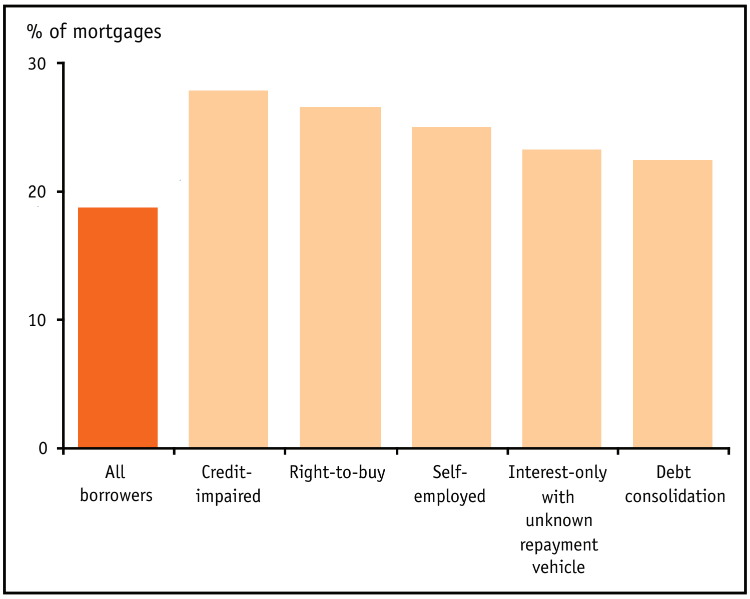
Lending into retirement

2.74 A significant number of mortgages extend into retirement. As illustrated in Exhibit 2.9, 19% of all new mortgages advanced in 2007 extended into retirement.[18] We are not proposing to restrict lending into retirement. However we do propose that when the loan term extends into retirement the lender verifies, as far as possible, income into retirement, to assess whether the mortgage is likely to remain affordable. We recognise that it is difficult to predict pension income, particularly when retirement is a long way in the future. However, the lender should satisfy themselves, as far as possible, that it is plausible that the level of income in retirement will be sufficient for the mortgage to remain affordable. This may be achieved, for example, by confirming that the applicant has a pension provision, confirming the details (e.g. by reviewing pension statements), and taking a view on the plausibility of the mortgage remaining affordable in retirement.

18 Assuming a retirement age of 65

2.75 We recognise that this method is not foolproof and there will always be an element of risk that the pension will not be sufficient, or that the applicant may cease paying into a pension at the expected rate. We are not suggesting that the lender is responsible if this happens, but we are requiring that lenders actively assess the consumer's ability to repay at the outset of the mortgage. In our view this approach is preferable to the current situation where often there are no checks at all as to whether the applicant has an income in retirement, and the lender relies on warnings to remind the borrower to ensure they can afford their mortgage following retirement.

Exhibit 2.9: Lending into retirement, 2007



Note: the retirement age is assumed to be 65; the data excludes lifetime mortgages.

Source: FSA PSD

Retirement age

2.76 There are some situations where an applicant may state their intention to work beyond the age at which the customer might be expected to retire. In such situations we will expect the lender to check the plausibility of this, for example by considering whether it is realistic for the applicant to continue to work in that particular occupation – and making further enquiries where they have concerns.

2.77 Our proposals on the verification of income are likely to have a particular effect on borrowers in or approaching retirement, who may be unable to prove an adequate income into retirement. However, we believe that this is a necessary and proportionate way of protecting a particularly vulnerable group of consumers, and therefore justified in terms of achieving our statutory objective to protect consumers.

Q10: Do you agree with our approach to lending into retirement?

Lender responsibility and intermediaries

2.78 Under our proposals lenders will be responsible for assessing affordability and verifying income. We are not suggesting that intermediaries will have no role in this process, and see no reason why they could not continue to collect documents to submit to the lender with the mortgage application. We will discuss the role of intermediaries and the mortgage sales process in more detail in our Consultation Paper on distribution issues later this year.

Exceptions to affordability requirements

2.79 Some lenders who operate very specific business models for high net worth clients may find our affordability proposals difficult to apply. Interest may roll-up instead of regular payments being made, and repayment may be from a source other than regular income, with terms negotiated on an individual basis. Our preferred approach is to deal with this on an individual basis with the firms involved, through modifications or waivers to certain rules as may be appropriate. However, we would like to know of any other situations where our affordability proposals would be problematic to apply.

> Q11: Are there specific atypical lending circumstances which you think merit an alternative approach to the assessment of affordability rather than being addressed through the possibility of rule modifications or waivers?

Lifetime mortgages

2.80 Lifetime mortgages are classified as regulated mortgage contracts, and therefore the proposals in this chapter would apply, but only where regular interest payments are to be made. In most cases, as interest is rolled-up and no regular payments made, we would not expect these requirements to apply.

> Q12: Do you agree with this approach to lifetime mortgages?

Home purchase plans

2.81 As regular rental payments can be made under home purchase plans, equivalent to the regular interest payments made under regulated mortgage contracts, the proposals in this chapter apply equally to home purchase plans to ensure that they too are affordable for the individual customer.

> Q13: Do you agree with this approach to ensuring affordability for home purchase plans?

Transitional measures

2.82 We recognise that, when implemented, our proposed strengthened affordability checks will affect some existing mortgage holders, who may not be able to remortgage or move house. They may be able to borrow less than they want, or may have their access to mortgage finance delayed (for example, if they have recently become self-employed). Similarly our proposal to assess affordability on a capital and interest basis may affect those existing interest-only borrowers seeking to remortgage in future but who cannot demonstrate affordability on a capital and interest basis over their remaining mortgage term.

2.83 Although we are consulting on our responsible lending proposals now, we have always been clear that final implementation dates will depend on how quickly the market recovers. We will not implement rules changes without first fully assessing the potential impact on the market.

2.84 Alongside this, we are carefully considering transitional measures to help mitigate any adverse effects on existing borrowers. We will provide further details of our proposals later in the year.

Q14: In addition to the questions above, do you have any other comments on our approach to responsible lending? Do you have any comments on the draft rules as set out in Appendix 1 Part 1?

Equality and diversity issues

2.85 It is possible that the proposals on the verification of income may have a disproportionate bearing on some groups with protected characteristics (e.g. race, religion) if they are more likely to be self-employed. We will be carrying out further analysis on whether this is the case and would welcome input from respondents.

Q15: Do you think our income verification proposals will impact any groups with protected characteristics (e.g. race, religion)?

Interest-only

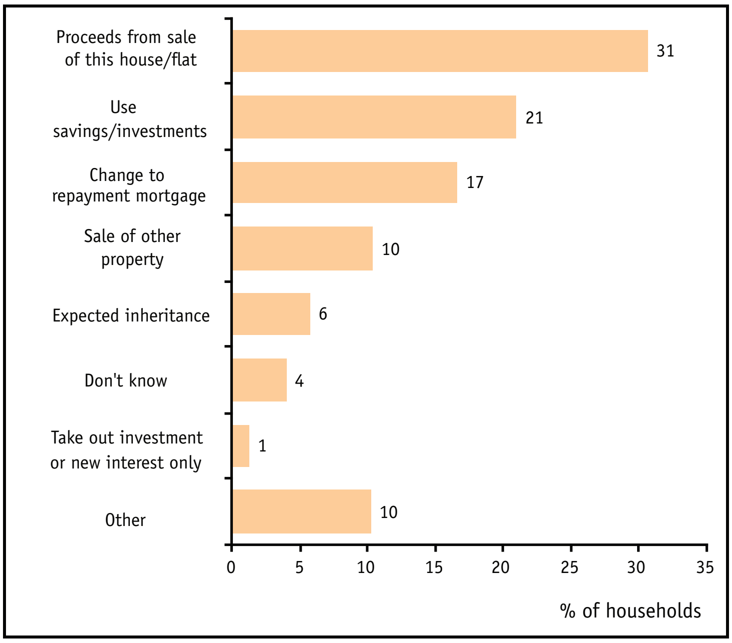
Background

2.86 Interest-only mortgages carry risks which, if not recognised, may cause detriment to both consumers and lenders. Consumers suffer if they are unable to repay their mortgage at the end of the term as they risk losing their homes. Lenders risk financial losses if mortgages are not repaid as expected.

2.87 Interest-only mortgages were originally aimed at niche groups of consumers, such as high net worth consumers, and those wishing to take advantage of specific types of tax break, where the mortgage was usually linked to an investment policy assigned to the lender. However, over time their availability has widened considerably, despite accompanying repayment vehicles enjoying a less favourable tax treatment, with few questions being asked as to why interest-only is required, or how capital will be repaid at the end of the term.

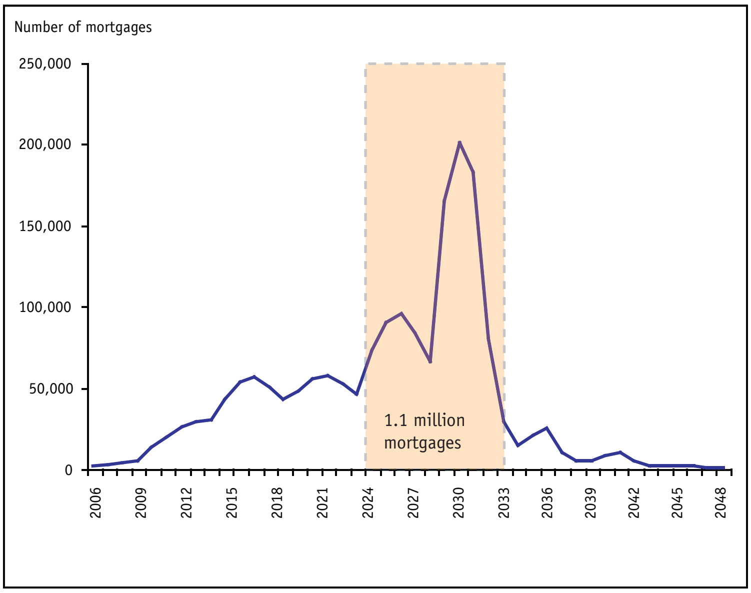
2.88 As stated earlier in this chapter, evidence suggests that interest-only mortgages have often been taken to extend affordability, with no firm plan in place to repay the capital. Our PSD data shows that at the height of the market almost 33% of all residential mortgages advanced in the UK were sold on an interest-only basis, with around three quarters of these having no specified repayment vehicle. As illustrated in Exhibit 2.10 many consumers with no repayment vehicle in place rely on future house price rises or uncertain life events to repay their mortgage, and some have no plan at all. Our data (shown in Exhibit 2.11) indicates that 1.1 million interest-only mortgages with no specified repayment vehicle originated between Q2 2005 and Q4 2009 are due to mature in the decade 2024-2033.

Exhibit 2.10: Owners with an interest-only mortgage and no linked investment: how they propose to repay the mortgage (2006/07)



Source: DCLG, SHE

Exhibit 2.11: Maturity schedule of interest-only mortgages with no known repayment vehicle originated in Q2 2005 – Q4 2009



Source: FSA PSD

2.89 This situation has been largely driven by competitive pressure among lenders to win new business, with interest-only criteria being relaxed across the industry. To a large extent lenders have been cushioned from the impact of this relaxation as they have been able to rely on the buoyant mortgage market for consumers to remortgage elsewhere long before reaching the end of their mortgage term. However, taking a short term view is no longer possible as economic conditions have restricted the availability of remortgages, and low standard variable rates have given consumers less incentive to remortgage. As a result we have recently seen a number of lenders taking action to restrict their criteria for new interest-only lending, and several respondents to DP09/3 called for us to go further than we had proposed to constrain future interest-only lending.

2.90 Fundamental to our approach to the mortgage market is the principle that consumers should be able to afford to repay their mortgages. This includes the capital as well as the monthly interest payments.

2.91 Therefore, in response to our concerns about interest-only mortgages, and the concerns of respondents and the market, we are reconsidering our approach to interest-only. We have had further discussions with firms and trade bodies specifically on this issue. Our current view is that interest-only should be used only where there is a genuine repayment method in place.

2.92 We set out below some further thoughts on this issue to facilitate further discussion. **We are not consulting on any rules changes in this CP. Instead, we will continue to discuss this issue with the industry. Those discussions and feedback to the questions posed below will help inform our final views on how we might amend our rules. We plan to consult on any rule changes that may be required later in the year.**

2.93 We have included a high level cost benefit analysis of our current position on interest-only mortgages in Annex 1 Part 2. A full cost-benefit analysis will be undertaken and included in the consultation on our final proposals.

2.94 Responses to questions 16 to 22 in this chapter regarding interest-only mortgages should be sent to us by **30 September 2010**.

Repayment strategy

2.95 Our current view is that for future sales, interest-only should only be offered where there is a valid repayment method in place. What we mean by a valid repayment method is a realistic plan to repay the capital that does not rely on house price inflation or unrealistic intentions to downsize to a smaller property at the end of the term; it is not restricted to investment vehicles such as endowments, Individual Savings Accounts (ISAs) or pensions.

2.96 In our view, lenders should check that there is a valid repayment method in place at the outset of the mortgage. Unless the repayment method is guaranteed, it would seem important for the lender to monitor the existence and adequacy of the repayment method through regular inspections throughout the life of the mortgage. This could happen through checking on the continued existence of the repayment method, perhaps on an annual basis, with the adequacy of the method checked, say, every five years. This would ensure that repayment problems are identified as soon as possible. Thought needs to be given to the position where the lender establishes that the repayment method no longer exists or does not appear to be adequate, and what appropriate remedial action would be. In such cases we would expect firms to consider transferring all or part of the mortgage to a repayment basis, rather than selling the borrower another repayment vehicle.

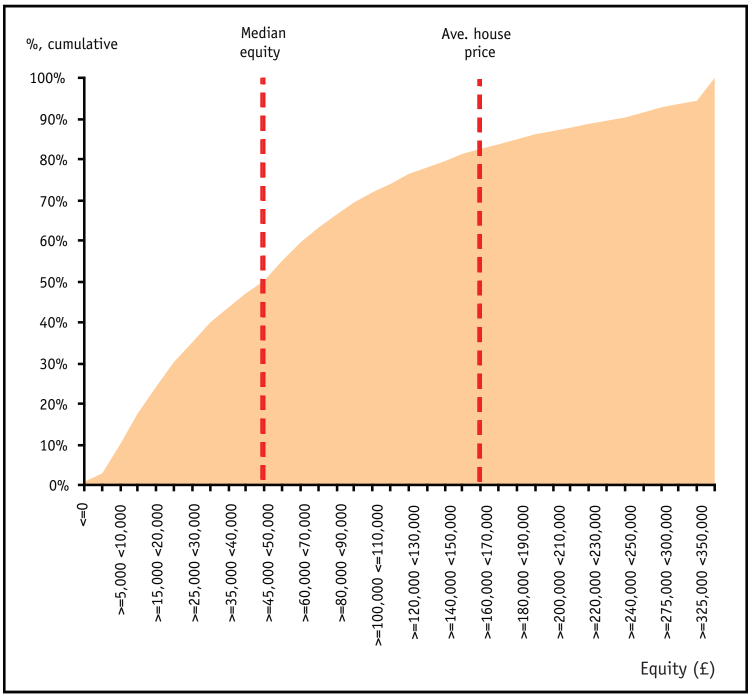
2.97 It is clearly not possible in the majority of cases to guarantee repayment of the capital at the end of the term (either because of the consumer's actions or wider market conditions). However we believe that by taking this proactive approach the potential for lenders losses would be mitigated to a much greater degree than has been the case in the past, and consumers would be more aware of, and committed to, the repayment method through the action of providing evidence on a regular basis.

Repayment methods

2.98 Recent market moves to restrict the types of repayment method accepted appear to us to be a sensible approach to addressing potential risks to firms and consumers. We agree that relying on rising house prices is not acceptable. Similarly, we recognise risks inherent in some other uncertain repayment methods.

2.99 An example of this is the 'sale of property'. This has often been put forward as a repayment method, but it is unlikely to be a realistic option for all consumers. As illustrated in Exhibit 2.12, our analysis shows that the median amount of equity that interest-only borrowers have at the outset of their mortgages is £50,000. This is unlikely to be sufficient to purchase another property outright. Even if significant house price inflation occurs over the term of the mortgage (which is not guaranteed) other properties are likely to have increased in value to a similar extent. However, there may be circumstances where the sale of property is a realistic option, for example a consumer with a large family house genuinely planning to downsize when their children leave home, where there is a relatively large amount of equity in the property.

Exhibit 2.12: Housing equity of borrowers with an interest-only mortgage – cumulative distribution



Source: FSA PSD & Arrears dataset, Nationwide for average house price

2.100 The question is then how to control this so that sale of property is accepted only where appropriate. There are several possible options. For example, we could:

- set a threshold below which the sale of property is accepted, either by setting a maximum LTV or a minimum amount of equity in the property at the outset. There would be practical issues to be resolved, such as where to set the LTV threshold, or the amount of equity required considering the wide variation in property prices over time and by region;
- set limits on the customer type allowed to use the sale of property as a repayment method, through perhaps a minimum level of income. Again there is a question of where to set such limits; or
- require lenders to check the plausibility of the repayment method on a case-by-case basis. However we know this approach has not worked well in the past, with the rigour of such assessments varying greatly between lenders.

2.101 Alternatively we could ban sale of property as a repayment method for interest-only, as some lenders have already done. However this would disadvantage those for whom this is a credible option.

Q16: How prescriptive should we be in defining a valid repayment method?

Q17: Should lenders be required to check that there is a valid repayment method in place at the start of the mortgage, and then periodically through the term of the mortgage? How do you think this should work? How often should lenders check on the repayment method?

Q18: Do you think there should be further controls on repayment methods? For example, how should the 'sale of property' be controlled to prevent it being used where it is not a realistic option? If a minimum LTV, amount of equity or income level was set, where and how should this be done?

Customer types

2.102 There are customer types for whom interest-only mortgages may be particularly relevant, such as:

- consumers who have investment properties or second homes that they can sell to repay the capital without risking their main residence;
- first time buyers who can afford the mortgage on a repayment basis but want to spend some of their income on home set-up costs during the initial period of their mortgage;
- older consumers who have a lot of equity in their property, who wish to repay the capital through selling their property, either on death (through a lifetime mortgage), or by downsizing to a smaller property;
- high net worth consumers who have the means to repay capital through realising their assets; and
- financially capable consumers who have made firm arrangements to repay the capital, such as through investments.

Q19: Do you agree that these customer types benefit from interest-only mortgages? Are there any other customer types that might benefit from interest-only?

2.103 Identifying specific customer types may drive out some possible exceptions to our wider approach to requiring that a repayment method must be in place.

2.104 First time buyers may appreciate the option of lower payments at the outset of their mortgage, while they set up their new homes. This option is currently available in the market through low-start mortgages where an initial interest-only period is followed by reverting to a capital and interest basis for the remainder of the term. This type of product meets a legitimate need, and the mortgage capital will be repaid when the mortgage reverts to a capital and interest basis. Therefore, for such consumers, we could consider allowing an initial interest-only period with no repayment method, for a maximum period of, for example, five years – subject to affordability being assessed on the higher capital and interest payment at the end of the interest-only period.

2.105 There is of course a risk of 'gaming' this, through recycling the initial interest-only period by remortgaging elsewhere. To control this, we could restrict this option to first-time buyer or home-mover products (it would be apparent to the lender if the borrower was in fact remortgaging). Alternatively we could accept that an initial interest-only period could be recycled, but control this by preventing this type of loan from being offered where the loan extends into retirement. This long-stop combined with a requirement to assess affordability on the capital and interest payment at the end of the interest-only period would prevent this type of product from being gamed to stretch affordability.

2.106 Alternatively we could consider options such as allowing lenders to offer products for first time buyers only where a proportion of the mortgage was repaid on a pure interest-only basis, limited to a certain LTV, with the rest on a repayment basis. However this would be more risky than the first option as there would be no guarantee that the borrower would be able to repay the capital, and would cause a bigger issue if such a product was obtained on a repeated basis as there is no method of repaying the capital for the interest-only portion of the loan. Careful consideration would also need to be given to defining an appropriate LTV. This may be problematic given the bluntness of lending thresholds and the fact that they do not accurately reflect a consumer's financial position or ability to repay.

Q20: Do you agree that some form of interest-only product without need for a repayment vehicle may be appropriate on a temporary basis for first-time buyers? If so, how should this be achieved? Would there be any specific impact on older consumers?

2.107 We set out in our proposals on affordability above that affordability should be assessed on a capital repayment basis, to ensure that repaying interest plus some means of repaying the capital is affordable. However, there may be exceptions to the general rule. An example may be where the lender is sure that the consumer can downsize and so there is no need for the consumer to make payments to contribute towards repaying the capital. In this specific situation it would appear reasonable to assess affordability on an interest-only basis. An example where this approach may apply is an older borrower with a low LTV, who wishes to borrow for a temporary period before trading down to a smaller property.

Q21: Do you agree that there are some limited circumstances where assessing affordability on an interest-only basis may be appropriate? If so, when? And should any additional controls be applied to prevent this being gamed on affordability grounds?

Interest-only and lifetime mortgages

2.108 We are not proposing that a repayment vehicle would be required where interest-only mortgage payments are being made for a lifetime mortgage.

Existing interest-only borrowers

2.109 As noted earlier, we recognise that any changes that we make in relation to the sale of interest-only mortgages will affect existing customers with interest-only mortgages, when they remortgage. We are carefully considering the effect of our proposals on existing mortgage holders, and will give further details of our proposals later in the year.

Interest-only as a forbearance method

2.110 We do not intend to restrict interest-only from being used as a forbearance method for customers in arrears, where appropriate, in line with requirements set out in MCOB 13.

Equality and diversity issues

2.111 It is possible that if we tighten the regulation of interest-only mortgages this may have a disproportionate bearing on some groups with protected characteristics (e.g. race, religion) if they are more likely to wish to take out such mortgages. We will be carrying out further analysis on whether this is the case and would welcome input from respondents.

> Q22: Do you think that any changes to our interest-only requirements will impact any groups with protected characteristics (e.g. race, religion)?

Equity withdrawal

2.112 We noted in DP09/3 that there may be risks to consumers from engaging in equity withdrawal; that is, increasing the borrowing that is secured on their dwelling without using this for house purchase or home improvement. While doing this has a number of impacts on the financial situation of the individual, by shifting what might be essentially ‘savings’ or ‘unrealised gains’ into consumption, the most concerning risk from a consumer protection perspective is where repeatedly-indebted individuals use equity withdrawal as a means of disguising and pro-longing their affordability problems, as we noted earlier. In these cases, individuals who are over-stretched by their financial commitments use their equity to repay debt and make up the shortfall. While this may restore their financial position in the short term, it is not a sustainable solution and often leaves them worse off in the longer term once this equity is depleted.

2.113 However, while we recognise these risks, we also recognise the benefits to consumers in being able to withdraw equity from their home. It can provide consumers with the ability to smooth income over their lifetime, deal with unexpected life events and have access to a relatively low-cost form of credit.

2.114 We consider that the changes to the affordability assessment that we have outlined above will significantly reduce the risk of consumers withdrawing equity when this is likely to be most harmful to them. If a consumer is using equity withdrawal to conceal a wider affordability problem, they would not be likely to meet the test for being able to increase their loan under our new rules. Balancing the benefits and the risks, we do not consider that there is a strong case for limiting equity withdrawal beyond this on consumer protection grounds and are therefore not proceeding with such a measure at this time, though we will keep this under review.

2.115 This is also not to rule out the use of limits on equity withdrawal as a macro-prudential tool if it is revealed to be necessary.

Q23: Do you agree that our enhanced affordability assessment will be sufficient to address the risks to individual consumers from equity withdrawal?

3 Product regulation

3.1 Until recently, the prevailing regulatory philosophy was that it was not necessary to directly regulate products. This approach was based on a number of assumptions, including:

a. well-managed firms would not develop excessively risky products;

b. well-informed consumers will only choose products that service their needs; and

c. regulation at the point of sale was sufficient.

3.2 Consistent with a wider change in the FSA's stance, DP09/3 set out a shift in our strategic approach to product regulation in the mortgage market. We recognised that consumers cannot always protect their own interests and, therefore, proposed to rely less on disclosure. We also said we would intervene where necessary to curb the sale of high-risk products and this would mean a targeted level of product regulation where appropriate.

3.3 In Chapter 2 we set out our proposals for income verification, which will ban non-income verified mortgages from the market. We do not think any further bans on products are warranted at this stage. As explained further in this chapter, we do not propose to ban products above defined lending thresholds (such as high loan-to-value (LTV) ratios) or to ban products sold to borrowers with multiple high-risk characteristics.

3.4 In our view, however, product regulation is not just about banning products. It is also about greater regulatory intervention concerning firms' product development and governance. For example, our approach on interest-only loans could be to ensure that firms identify the target market for which these products are suitable, and test how this product performs in a range of market environments. Similarly, our proposals in Chapter 4 for a more intrusive approach on how arrears charges are priced are a form of product regulation as it places limitations on product design. As explained in Chapter 2, we also see a role for product-specific rules around credit-impaired borrowers.

3.5 As a regulator, our focus in the past has often come too late in the product lifecycle, when consumer detriment has already crystallised. We believe it is important for us to intervene further up the value chain where necessary. Products need to be scrutinised and firms need to ensure that they have effective product governance arrangements in place. We are still considering whether to issue a Discussion Paper on our approach to product regulation across all our retail markets. If we do, then that Discussion Paper will consider whether any additional product regulation is warranted in mortgage markets.

Lending thresholds

3.6 In DP09/3 we concluded that the case had not been made (on consumer protection grounds) for an outright ban of loans above a defined loan-to-income (LTI), loan-to-value (LTV) or debt-to-income (DTI) ratio.

3.7 Although there was some evidence that high LTV, high LTI and high DTI lending had contributed to mortgage market issues, our initial analysis led us to conclude that these ratios did not accurately reflect a consumer's financial position and ability to repay. We explained that banning the sale of loans above certain thresholds would unfairly penalise consumers who are genuinely able to repay, and that in our view, what really matters is a proper assessment of affordability at an individual level. Nevertheless, we noted that our conclusions were tentative and could be reviewed in light of more detailed analysis of arrears and repossessions. Additionally, we did not rule out implementing such thresholds on macro-prudential grounds.

3.8 Respondents to the DP overwhelmingly agreed that the sale of loans above certain LTI, LTV, or DTI thresholds should not be banned. Most respondents said that such measures were too blunt and did not take individual circumstances into account. Respondents thought a more sophisticated approach to the assessment of affordability was desirable.

3.9 We have now completed further more detailed analysis of arrears and repossessions data. Consistent with our earlier analysis of PSD and arrears data published in DP09/3, we found that:

a. LTV ratios are a relatively consistent predictor of default;

b. LTI ratios are not a strong or consistent predictor of default;[19] and

c. DTI ratios could not be assessed as insufficient information was available on consumers' overall debts relative to incomes.

3.10 Further detailed analysis of this data, therefore, has not led us to change our views. We agree with respondents to the DP and do not propose to implement any ban of loans above defined LTI, LTV or DTI ratios on consumer protection grounds. We are, however, not ruling out implementing such thresholds on macro-prudential grounds.

19 Factors that can affect the strength of the correlation include: how the ratio is constructed; and whether other variables affecting affordability are controlled for.

Q24: Do you have any comments not made previously in response to DP09/3 on the case for not banning loans above defined LTI, LTV or DTI ratios?

Loans with multiple high-risk characteristics

3.11 Although we suggested in DP09/3 that across-the-board caps on any one ratio – whether LTV, LTI or DTI – were unlikely to be adequately targeted at consumers who could not repay, we said there may be a case to prohibit products with *combinations* of high-risk indicators.

3.12 At that time, we did not have sufficient evidence to justify any substantive proposals in this area. We noted, however, our appetite for prohibiting such lending if we were to establish that the default rates among borrowers exhibiting multiple high-risk characteristics were significantly higher compared to the market average. We said that we would be in a position to make a decision whether further action would be appropriate once we had carried out further analysis of transactional-level arrears data.

3.13 There was greater support for this proposal from respondents than for banning high LTV/LTI/DTI mortgages. However, most respondents were still against a ban on selling products with multiple high-risk characteristics, arguing that this would be a blunt and inflexible measure that could disadvantage consumers who could repay. Many also commented that 'toxic' lending was only undertaken by a small minority of lenders, who have now left the market and it would be disproportionate to penalise the whole industry.

3.14 Although most respondents did not support an outright ban, many still saw a need to address high-risk lending or 'toxic' products. Some suggested the issues would be addressed through the strengthened affordability assessments already proposed. Others suggested applying tighter supervisory controls to high-risk lenders, enhancing conduct of business requirements around these types of loans, or requiring compulsory Mortgage Payment Protection Insurance (MPPI) for these loans. These respondents argued that such alternatives would be less intrusive and better targeted than an outright ban.

3.15 We have now completed our further analysis of transactional-level arrears data. For the purposes of our risk combination analysis, we have excluded mortgages from the PSD and Arrears Dataset where income was not verified (as NIV mortgages would not exist in future under our proposals in Chapter 2). Further information on the analysis we carried out is set out in Annex 3. The table below (Exhibit 3.1) shows the risk combinations for which we found the greatest proportion of borrowers in arrears or in possession.

Exhibit 3.1

	Risk Combination	No. of risk characteristics	% of borrowers in arrears or possession
1	Credit-impaired, LTV>=80, Self-employed, Debt consolidation	4	42.4
2	Credit-impaired, LTV>=80, Self-employed, Right-to-Buy	4	40.6
3	Credit-impaired, LTV>=80, Self-employed	3	38.4
4	Credit-impaired, LTV>=80, Right-to-Buy	3	35.9
5	Credit-impaired, LTV>=80, Debt consolidation	3	35.5
6	Credit-impaired, Self-employed, Debt consolidation	3	33.8
7	Credit-impaired, Self-employed	2	32.3
8	Credit-impaired, Self-employed, Right-to-Buy	3	32.0
9	Credit-impaired, Right-to-Buy	2	30.0
10	Credit-impaired, LTV>=80	2	29.3
11	Credit-impaired, Debt consolidation	2	26.7
12	Credit-impaired	1	21.2

Source: FSA PSD and Arrears dataset

3.16 Our findings show that the dominant characteristic present in all of the highest-risk lending combinations is whether the borrower has an impaired credit history. We discussed our proposals for addressing this in Chapter 2.

3.17 We could simply ban some or all of the products identified in Exhibit 3.1. But an outright ban is too blunt an approach to distinguish between those borrowers who will and those who will not repay and would unfairly penalise some consumers.

3.18 We also have concerns about implementing a ban on the basis of characteristics such as whether a borrower is self-employed or in the right-to-buy market. Although there is a strong link between these characteristics and the likelihood of payment difficulties, we believe it would be unfair to deny these borrowers a mortgage without having assessed their ability to repay. These loans will still be impacted by our wider affordability assessment changes.

3.19 Additionally, there are significant implementation issues for banning such loans outright. For example, establishing that a mortgage is being used for debt consolidation is currently reliant on information supplied by the borrower. There would be a strong incentive for consumers to mis-represent the purpose of the loan in order to get a mortgage. Lenders would likely need to change their systems to verify what the mortgage was being used for. By comparison, data on credit-impairment is more readily available and easier to verify. Although data on credit-impairment is not infallible, it is available from third parties such as credit reference agencies. So it is easy for lenders to verify. Also, lenders already report data on credit impairment to us through their regulatory reporting.

3.20 Rather than ban these products, our preferred approach is to require borrowers who are credit-impaired to have an additional 'buffer' of protection against unforeseen circumstances as discussed in Chapter 2.

> Q25: Do you agree that we should not ban loans to borrowers with multiple high-risk characteristics but instead rely on robust affordability assessment requirements (including additional checks when the borrower is credit-impaired)?

4 Arrears charges

Background

4.1 In December 2007, in response to worsening market conditions, we commissioned a thematic review of lenders' compliance with our arrears handling rules.

4.2 The rules on arrears charging practices are set out in Chapter 12 of the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB). MCOB 12.4.1 R requires arrears charges to be a fair reflection of the additional administration costs faced by the lender. Despite this, our thematic work found evidence of lenders looking to recoup costs through arrears charges for activities that are unrelated to the additional cost of arrears handling.

4.3 In response to our thematic work on arrears handling practices generally, we referred a number of cases to enforcement. In five of these cases, excessive arrears charges formed part of the case.

4.4 We have since concluded two of these cases. Last year we fined GMAC RFC Limited a penalty of £2.8m.[20] Subsequently, in April 2010, we imposed a financial penalty of £1.225m on Kensington Mortgage Company Limited.[21] In both cases, the financial penalties were partly for excessive arrears charges. The firms were also required to provide redress to consumers who paid these excessive charges. The estimated cost of the redress package for all breaches was £7.7m for GMAC and £1.066m for Kensington.

4.5 In parallel, as part of our wider review of the mortgage market, we have been considering the case for regulatory reform. In DP09/3 we proposed a more interventionist and robust approach to charging practices in the mortgage market. This marked a strategic change, recognising, as already noted in DP09/3, that disclosure and transparency have not influenced consumer purchasing behavior as effectively as we hoped. Many consumers focus on initial payments or headline rates at the expense of other product features such as fees and charges. This is particularly the case where charges may only apply in certain circumstances and are incurred post-sale, as in the case of arrears charges. So firms have a degree of market power in setting arrears charges.

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20 www.fsa.gov.uk/pubs/final/gmac_rfc.pdf
21 www.fsa.gov.uk/pubs/final/kensington.pdf

4.6 In DP09/3 we proposed some immediate action to ban the continued application of a monthly arrears administration fee where a consumer is adhering to an arrangement to repay. We subsequently consulted on this proposal in January 2010 (CP10/2) and published a final policy statement in June 2010 (PS10/9).

4.7 We also explained in DP09/3 that we would conduct a more detailed analysis of arrears charges across the market and that we would look into the feasibility of establishing baseline figures for arrears charges.

4.8 We did not receive substantive comment from respondents to DP09/3 on arrears fees. There was a general view put forward by lenders that charges were not excessive and that there was no need to become more intrusive. In contrast, consumers and consumer groups generally believed that consumers were paying too much. However, respondents did not provide any evidence to substantiate these views.

Key findings from our review of arrears charges

4.9 We have now completed our review of arrears charges. The full factual findings from our review are set out in Annex 2.

Methodology

4.10 We used two key sources of information to inform our review.

4.11 Firstly, we reviewed tariffs of charges from 110 lenders current at November 2007, November 2008, and November 2009. These lenders hold approximately 93% of first-charge regulated mortgage contracts.[22]

4.12 Secondly, we reviewed a number of fee justifications from 26 lenders, covering 54%[23] of the first-charge regulated mortgage market. Because our objective was to get a better understanding of charging practices within the market, the sample did not consist solely of the largest lenders or lenders we suspected of non-compliance. Rather, we looked at a range of business models within the market. The fee justification sample includes eight banks, eight building societies and ten non-deposit taking lenders (non-banks). It comprises 21 small lenders and five large lenders, which we consider representative of the market as a whole.

Current requirements on firms

4.13 Currently, our mortgage rules require arrears charges to reflect the underlying administration costs. In particular, MCOB 12.4.1 R states that:

> '(1) A *firm* must ensure that any *regulated mortgage contract* that it *enters into* does not impose, and cannot be used to impose, a charge for *arrears* on a *customer* except where that charge is a reasonable estimate of the cost of the additional administration required as a result of the *customer* being in *arrears*.

22 Based on MLAR data Q4 2009
23 Based on MLAR data Q4 2009

(2) Paragraph (1) does not prevent a firm from *entering into a regulated mortgage contract* with a *customer* under which the *firm* may change the rate of interest charged to the customer from a fixed or discounted rate of interest to the *firm's* standard variable rate if the *customer* goes into *arrears*, providing that this standard variable rate is not a rate created especially for *customers* in *arrears*.'

4.14 In June 2009 we published examples of good and poor practice to clarify the standards that we expect from firms around arrears charges (see Exhibit 4.1).

Exhibit 4.1

Good practice

- A policy is in place to minimise arrears charges, for example by not charging a monthly arrears management fee in cases where the borrower is maintaining an arrangement to repay arrears.
- Customers are advised of the charges incurred while the account is in arrears in the course of telephone contact, as well as in writing.
- Treating Customers Fairly (TCF) implications of fees and charges are considered in arrears-handling practices, for example:
  - when a Direct Debit request is refused, customers are informed and given time to rectify the situation before it is re-presented, therefore avoiding further unpaid Direct Debit fees being incurred;
  - where Direct Debit requests are repeatedly refused, the lender suspends the Direct Debit to avoid further unpaid Direct Debit fees being incurred; and
  - where a lender charges a non-refundable fee for arranging an appointment with a 'debt counsellor', customers are informed in sufficient time to be able to cancel the appointment before the fee is applied to their account.

Poor practice

- Arrears fees and charges are determined by benchmarking against those set by other firms, without reference to the firm's own costs.
- The lender does not undertake a regular assessment of fees and charges to ensure they are less than or equal to the additional cost of administering accounts in arrears.
- Arrears charges cover more than the administrative costs involved.
- Customers are in effect charged for specific arrears-related administrative tasks more than once. For example, through being charged task-specific fees on top of a monthly arrears management fee.
- When setting the level of arrears charges firms account for items that do not arise from administering arrears, such as advertising or Financial Ombudsman Service fees.
- Lenders using third-party administrators to carry out arrears handling set the level of arrears charges higher than the administrative costs involved to subsidise and reduce costs relating to other areas of their commercial arrangement with the third-party administrator.

Key findings

Quality of tariff information

4.15 Our review of tariffs found significant variation in the quality of the tariff information that we received. Some were unacceptably poor. Tariff information should clearly set out the amount of the charge and circumstances in which a borrower can expect to incur it.

Types of arrears fees

4.16 There are large differences between firms in the approach to charging customers for additional arrears administration costs. The following types of arrears fees were charged by the market in November 2009:

a. 52% of firms charged a monthly arrears fee or periodic fee for dealing with borrowers in arrears;

b. 54% of firms charged a fee for sending a letter to a borrower in arrears;

c. 5% of firms charged a fee for phoning a borrower in arrears;

d. 46% of firms charged for debt counsellor visits, and just under a third of these firms charged a fee if the borrower cancelled the visit or didn't attend; and

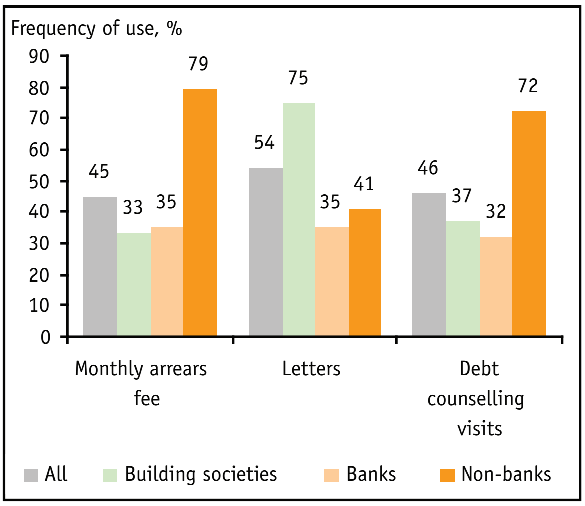
e. 11% of firms charged a fee for capitalising arrears.

4.17 The fees charged for litigation and repossession were particularly variable between lenders, which made comparisons difficult. Borrowers can incur very significant fees once a firm starts litigation for possession. For example, one major lender indicated that a borrower could incur approximately £1,600 in fees (plus 1.9% of the sale price). This figure is based on a straight-forward case where the borrower progresses straight through litigation to possession. We expect the figure would be higher where the borrower obtains a suspended possession order or goes to court more than once.

Type of lender

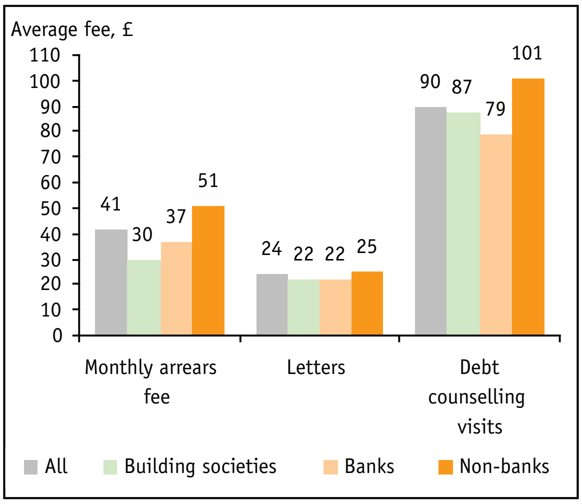
4.18 Our findings suggest that an important driver of mortgage arrears fees is the type of lender. For most of the fees we looked at, non-banks were more likely to charge fees (refer Exhibit 4.2), and charged higher fees (refer Exhibit 4.3).

Exhibit 4.2
Charging of fees by lender type (Nov 2009)



Source: FSA review of arrears charges

Exhibit 4.3
Average fee by lender type (Nov 2009).



Source: FSA review of arrears charges

Average fees charged

4.19 In recent years, there have been small but steady increases in arrears fees across the market (refer Exhibit 4.4). However, we found significant variation in the level of all types of arrears fees across the market. So we do not consider the average fee is good indicator of the amount a firm is likely to charge or what a borrower is likely to pay.

Exhibit 4.4
Average fees 2007 – 2009

Type of fee[24]	Nov 2007	Nov 2008	Nov 2009	Increase 2007-09
Monthly arrears fee	£39	£42	£41	5%
Letters[25]	£23	£23	£24	4%
Debt counsellor visits	£85	£87	£90	6%
Returned/un-paid cheque	£25	£25	£26	4%
Un-paid Direct Debit	£26	£26	£27	4%

Source: FSA review of arrears charges

Fee justifications

4.20 The quality of the detailed fee justifications provided to us was poor. We found that:

a. Some lenders were unable to break down their costs between the different types of arrears fees being charged. We expect lenders to be able to break down their relevant administration costs for each type of arrears fee charged;

b. Some lenders did not provide fee justifications for fees such as missed payments. When these charges are applied to borrowers in arrears, they must comply with MCOB 12.4.1 R and reflect underlying costs; and

c. Some lenders who had outsourced the administration of their mortgages were not able to access detailed servicing-cost information relating to their mortgage books.

4.21 It was clear from the fee justifications that most lenders had not adequately considered the underlying costs when setting their arrears charges. There were large differences between firms' assessment of their costs and the fees they charged. We found that some firms were over-charging and other firms were under-charging relative to their administration costs. Similarly, even within the same firm, some fees were in excess of the underlying costs, while other fees were below.

4.22 In most cases, under-charging was due to firms not having adequately assessed their own costs. But in some cases, under-charging was a deliberate choice by the lender to assist borrowers in arrears.

4.23 Allocation of costs and overheads was an area where we saw particularly poor practice. Overheads should only be recovered from borrowers in arrears if they have a substantial connection with the administration of borrowers in arrears and are not too remote.

4.24 In our assessment, there were genuine variations between the additional administration costs that lenders were incurring for the handling of borrowers in arrears. Aside from the different cost allocation methodologies that lenders adopted, there was significant

24 Firms that did not identify the amount and instead specified the charge as 'variable' were excluded from the average charge calculation. Where firms stated a range, the mid-point in the range was used for the purposes of the calculation. We used the same sample of firms for all three years.

25 Calculation excludes letters before legal action.

variation in the salaries of staff dealing with borrowers in arrears and the time spent by firms on arrears handling per case. Another significant factor driving cost variations was the extent to which arrears handling activities were outsourced or undertaken in-house.

Proposed approach going forward

4.25 We have considered the case for publishing baseline figures and have concluded that this would not be an appropriate solution to the issues we've found.

4.26 Setting baseline figures is a form of price capping, as it would set a benchmark by which both the market and we could easily identify the excessiveness of different types of arrears charges. While we accept that such an approach has advantages, we do not believe that it would ultimately benefit consumers in this case. Firstly, the key issue is that lenders do not understand their own costs, which would not be addressed by putting in place a form of price capping. Secondly, there are genuine differences in underlying costs between lenders. This makes it difficult to set an appropriate cost-based threshold for arrears charges across the market. Thirdly, it is common for firms to put their fees up to the cap in response to price caps. We believe a significant number of firms would increase their charges up to any baseline figure that we set, resulting in increased fees for borrowers.

4.27 Although we are not publishing any baselines, we are still publishing the findings of our review, including market figures on arrears charges. This will go some way to helping borrowers and consumer groups identify how a firm's arrears charges compare to the market. Additionally, tariff information from lenders on their fees is readily available.

4.28 Ultimately, individual firms must ensure their arrears fees are based on a reasonable estimate of their costs, as our rules already require. Instead of publishing baselines, we will be using the findings from our review to inform our more intrusive supervisory approach and we will continue to challenge individual firms on their arrears charges under MCOB 12.4. Firms that increase their arrears charges will be subject to particular scrutiny. We do not expect to see firms change their charging practices simply to align with the market averages we have published.

4.29 In addition, we propose to amend MCOB 12 to address particular issues of poor practice and to clarify how arrears charges must be calculated and applied. This is discussed further below.

Clarification of how firms should be calculating arrears charges under MCOB 12.4

4.30 We expect charges to be a fair reflection of the additional administration costs faced by the lender, not a way to increase profits or offset costs from other parts of its business. Firms have some discretion about how they recover the costs of administering arrears, but we will challenge firms where arrears charges appear excessive.

4.31 Although firms can recover their costs, this does not mean that firms should 'gold-plate' their operations for handling defaults. For example, firms should be using an appropriate grade of staff to deal with borrowers in arrears.

Attributable costs

4.32 Having found particularly poor practice on attributing costs, we propose to clarify our existing requirements.

4.33 Under MCOB 12.4.1 R, charges must reflect a reasonable estimate of the costs of the additional administration undertaken by the firm as a result of a customer being in arrears. Costs other than those should be treated as 'business as usual' costs and disregarded for the purpose of calculating arrears charges. Additionally, we expect firms to only include costs that they can objectively justify and that can be identified with reasonable precision. Some fee justifications we saw included 'miscellaneous' costs that could not be identified as relating to the administration of borrowers in arrears.

4.34 Some costs are clearly and directly attributable to the administration involved in dealing with borrowers in arrears, such as the costs of staff that deal solely with borrowers in arrears. We also accept that, as well as direct costs, there will be some overheads, shared with other functions of the business, associated with carrying out these administrative activities. However, these types of costs should only be attributed to borrowers in arrears if the overhead costs have a substantial connection with the administration of borrowers in arrears and are not too remote.

4.35 We consider that a reasonable starting point for allocating shared overheads is the ratio of full-time equivalent staff engaged in dealing with the administration for borrowers in arrears, to the number of staff with whom those overheads are shared. These overheads can then be apportioned between types of arrears fees, based on the time that is taken up on each arrears activity.

4.36 Examples of the types of shared overheads that can be attributed (subject to appropriate apportionment) are: premises costs, human resource costs and certain IT costs. Overheads and indirect costs that should not be attributed to arrears, as they are too remote from the administration of arrears, include the following:

a. Financial reporting – Two lenders were including costs relating to financial reporting. These are 'business as usual' costs that are incurred regardless of borrowers being in arrears;

b. Executive costs – Two lenders were charging for executive costs. We consider that these are too remote from the administration of arrears;

c. Funding costs – One small lender applied a wholesale funding cost of over £4 for every minute of staff time in its justification for monthly arrears fees. This was to recover the increased wholesale funding costs that this lender faced where mortgages went into arrears. We do not consider that funding costs are an administration cost;

d. Unrecovered fees – Some lenders sought to recoup bad debt write-offs or unrecovered arrears fees through their arrears charges. This cost should not be recovered from customers who do pay their arrears fees. This is an unacceptable level of cross-subsidisation; and

e. Bank charges – One lender included general bank charges in one of its fee justification exercises. Generally, bank charges should not be recovered through arrears fees and should be treated as a business overhead. The only obvious exception is a bank charge incurred directly by the lender for borrowers in arrears with failed Direct Debit and cheque payments. In this case, the failed payment must relate to the sums owed by the borrower under their mortgage contract.

4.37 We can accept some variation between the administration costs incurred and the fee charged, within reason, as long as the lender has based the fee on a reasonable pre-estimate of relevant costs. For example:

a. If firms set the same level of arrears charges for all borrowers, rather than on an individual basis, this can result in variation between fees and costs for an individual borrower. However, this type of variation is acceptable, as calculating fees on an individual basis would significantly increase the administration costs for consumers;

b. If firms calculate their arrears fee by spreading the expected costs over the expected number of borrowers in arrears, this can result in variation between the fees and costs, if the pre-estimated number of borrowers is different from the actual number. However, we accept that pre-estimating the number of borrowers that will go into arrears can be difficult and will sometimes vary from the actual number; and

c. Firms may have some short-term variations in cost patterns. However, it is also in the consumer interest for charges to be reasonably stable over time (provided they reflect the administration costs).

4.38 We would expect such variations to be actively kept under review by the lender. In the fee justifications we reviewed, none of these reasons explained the significant variations that we saw between fees and administration costs. Firms must ensure they fully understand the costs that their arrears charges are based on, and should be regularly reviewing their arrears administration costs so fees truly reflect a reasonable pre-estimate of the costs.

Arrears administration fees cannot be a percentage of the outstanding arrears or debt

4.39 Our arrears charges review identified two firms that were charging a percentage of the outstanding debt rather than a fixed fee. As administration costs do not increase in proportion to the outstanding debt, this practice does not reflect the administration costs incurred by the firm as a result of a borrower being in arrears. We propose to clarify MCOB 12.4.1 R to state this explicitly.

Appropriate use of quarterly or annualised arrears charges

4.40 We found some firms imposing quarterly or annualised arrears charges. Quarterly or annual arrears charges are not necessarily in breach of MCOB 12.4. However, they should not be charged to borrowers who only remain in arrears for a short period of time, as this would not reflect the administration costs incurred by the firm as a result of the borrower being in arrears.

> Q26: Do you have any comments on the above clarifications to MCOB 12.4.1 R or the draft Instrument in Appendix 1 Part 2 that gives effect to them?

Limiting the number of times missed payment fees are charged

4.41 We recently penalised Kensington Mortgage Company Limited[26] for re-presenting Direct Debits, and charging a fee each time, regardless of the number of times it had already been returned unpaid. In this instance, the number of times Direct Debits were re-presented to a single borrower was particularly excessive. However, our earlier thematic work on arrears handling suggests that this issue is not isolated and that there are wider issues about how many times borrowers in arrears incur missed payment charges.

4.42 It is already a requirement of MCOB 13.3 for firms to deal fairly with borrowers in arrears. We are proposing to strengthen our rules in this area by limiting the number of times fees for missed payments are charged. In particular, we are proposing to limit a firm from trying to take a payment more than twice per calendar month, unless they waive the administration charge for the additional attempts to take payment. This means that firms must not charge a fee for a missed payment (such as for an unpaid Direct Debit or for a bounced cheque) more than once per month.

4.43 The first attempt to take a payment will usually be in accordance with the agreed monthly repayment. Once the payment shortfall is discovered, we do not believe it is unreasonable for a firm to make a second attempt to recover the unpaid monthly amount. However, we consider that it is unreasonable and unfair to continue to try and take payments from a borrower in arrears (with the resultant charging of administration fees) more than twice a month. In most cases, this is unlikely to result in payment of the shortfall by a borrower and simply exacerbates their payment difficulties.

4.44 We recognise there may be rare instances where it is fair and reasonable to try and take a payment a third time within a calendar month. So the rule change will still allow lenders the flexibility to try and recover a missed payment more than twice a month, provided that they bear the administration cost in these instances.

4.45 Consumer detriment is also occurring where customers have Direct Debits presented and rejected over a number of months. To address this, we propose that, where Direct Debits have been repeatedly refused (for two months or more) due to

26 www.fsa.gov.uk/pubs/final/kensington.pdf

insufficient funds, the lender must reconsider whether the method of repayment is suitable for the borrower. The lender should suspend its failed Direct Debit fees while it undertakes its review.

Q27: Do you agree that we should amend MCOB 13.3 to limit the number of times fees for missed payments are charged?

Q28: Do you have any additional comments on the sections of the draft Instrument that limit the number of times missed payment fees should be charged?

Q29: How much time (if any) would your firm require to comply with the proposed changes to MCOB 13.3 around limiting missed payment fees?

Widening MCOB 12.4 and MCOB 13.3 to apply to all payment difficulties

4.46 Currently, MCOB 12.4 only applies to charges for ‘arrears’, which is defined as a shortfall equivalent to two or more payments. However, we have identified firms who are charging excessive monthly arrears charges as soon as there is a payment shortfall by a borrower.

4.47 In these cases, we have been unable to take action under MCOB 12.4.1 R to ensure such arrears charges are cost-based, as these charges technically fall outside of that rule. This gap creates an incentive for firms to front-load arrears charges into the first month to avoid our rules. We therefore propose to amend MCOB 12.4.1 R so that it applies to charges for payment shortfalls as well as charges for arrears.

4.48 We also propose to widen MCOB 13.3 to apply in all cases where a borrower is experiencing a payment shortfall. This rule currently requires a firm to deal fairly with customers in arrears, who have a shortfall equivalent to two or more payments. It sets out a number of specific obligations, such as a requirement on firms to make reasonable efforts to reach agreement with a customer over the method of repaying a shortfall. We consider that these obligations should apply, and that firms should treat customers fairly, regardless of whether the customer has one payment shortfall or two. Payment difficulties by a borrower should be addressed as early as possible by lenders.

4.49 To give effect to these changes, we have inserted a definition of payment shortfall into our rules. The term payment shortfall is used in a number of places in our Handbook but it is an undefined term. We consider that our proposed definition is consistent with the use of this term elsewhere in MCOB. Nevertheless, it is necessary to make some minor technical amendments to other parts of MCOB to reflect that payment shortfall is now a defined term.

Q30: Do you agree that we should widen MCOB 12.4 and 13.3 so it applies not just to arrears but to all payment shortfalls?

Q31: Do you have any additional comments on the draft Instrument that gives effect to this?

Q32: How much time (if any) would your firm require to comply with the proposed widening of MCOB 12.4 and MCOB 13.3 to payment shortfalls (noting that the record-keeping requirements in 13.3.9 R now apply to payment shortfalls)?

Collecting better information on arrears charges

4.50 We proposed in DP09/3 to collect better information on fees and charges as part of firms' regulatory reporting. We have not yet made any final decisions on this proposal, which will be swept into our wider review of data requirements mentioned in Chapter 10 of DP09/3. In the interim we will continue to annually survey firms' arrears charges.

Third Party Administrators (TPAs)

4.51 In some fee justifications we reviewed, the administration of mortgage arrears had been outsourced to a TPA. As we indicated in DP09/3, we are undertaking a review of our approach to TPAs. This review is not yet complete. For this reason, we are not commenting in this CP on the recovery of TPA costs as part of arrears charges or TPA arrears charging practices more generally. This will form part of our wider conclusions and proposals on TPAs, which will be published at a later date.

5 Responsible borrowing, better informed purchasing

Background

5.1 DP09/3 highlighted a developing body of evidence for questioning past assumptions about market rationality. Inevitably, much of the recent focus has been on lender and intermediary behaviours in an over-exuberant market. However, the problems in the mortgage market did not only stem from the irresponsible actions of firms. Importantly, detriment also arose from poor borrowing decisions made by a significant minority of consumers. The consumer behaviours seen provide a telling insight into what can and did go wrong, and what may reoccur without regulatory change.

5.2 Clearly, firms must give suitable advice and lenders must lend responsibly. But consumers also have an important role to play in the mortgage process – for irresponsible lending goes hand-in-hand with poorly informed or even irresponsible borrowing. We have a mortgage market where many consumers have regularly re-mortgaged, shopping around far more than seen in the investment market, for example. For many of these consumers, the market has worked well. But the level of mis-buying also highlights that some consumers are failing to properly engage and that we cannot rely on all consumers to be able to protect their own best interests. So, for example, we have seen:

a. the misuse of self-certification, where some consumers were willing to overstate their income in order to obtain a mortgage;

b. some consumers opting for interest-only products because it was the only way they could afford the amount they wanted to borrow, while having no credible plan in place for repaying the capital; and

c. many consumers focused only on the short-term mortgage cost – seduced by an attractive initial rate but unclear about longer-term affordability.

5.3 The Mortgage Market Review aims to tackle this in two ways, reflecting our view that the poor borrowing decisions are seen to stem from two different causes. There is clear evidence of some consumers knowingly taking on borrowing that causes them to be overstretched. Then there are poor borrowing decisions that result from inadequate understanding or knowledge.

Responsible borrowing

5.4 Any consumer considering giving false or misleading information when applying for a mortgage needs to understand that this is fraud. We have repeatedly made this point, for example in relation to self-certified mortgages, and this advice now features on Moneymadeclear™.

5.5 A probably more widespread failure of responsibility, and one no less concerning, is where consumers have simply had little regard to the risks associated with what for many will be their largest purchasing decision. We do not, of course, have a market in which all consumers have the financial skills and knowledge that allow them to protect their own interests. The financial capability initiatives discussed below have this as an objective. Yet even among relatively sophisticated borrowers, the past market was too often characterised by a misplaced focus on the amount borrowed or the initial monthly payment. Lost in this was a proper engagement with the consequences of a long-term borrowing commitment that includes the risk, if the worst happens, of a home being lost.

5.6 The greater intervention this CP proposes is no substitute for consumers fully engaging with their options and making rational purchasing decisions. By requiring any declared income to be verified, we are undoubtedly increasing firms' responsibilities to address the potential we see for mis-buying by consumers. The same is true for the robust assessment of affordability that must now be central to every lending decision. However, and equally importantly, we believe our proposed approach encourages consumers to consider more carefully their ability to service loans.

Financial capability

5.7 Chapter 6 of DP09/3 addressed the importance of financial capability initiatives in delivering to the better-informed consumer the decision-making tools necessary to ensure a fully functioning mortgage market. Respondents expressed considerable support for existing initiatives aimed at the mortgage market and, more generally, for ongoing financial capability work. While acknowledging that this work was likely to deliver most benefit over the longer term, respondents agreed that there was great merit in taking steps now to help consumers protect themselves better in the future. In particular, there is a role now for financial capability in providing support and guidance through times of difficulty.

5.8 Since the publication of DP09/3, responsibility for financial capability work has passed to the Consumer Financial Education Body (CFEB). The Financial Services Act 2010 required the FSA to establish CFEB, with a remit to enhance the public's understanding and knowledge of financial matters and improve their ability to manage their own financial affairs. CFEB is working towards a vision of better informed, educated and more confident consumers, who are able to take greater responsibility for their financial affairs and play a more active role in the market. This vision for financial markets obviously fits well with the objectives of the Mortgage Market Review, and CFEB and the FSA will continue working together closely towards these outcomes.

Moneymadeclear™

5.9 There is already a substantial amount of clear, impartial information on the Moneymadeclear™ website about mortgages. This frequently features prominently on the Moneymadeclear™ front page and forms the basis for the Mortgages and Homes hub page.

5.10 Responding to the issues highlighted by the Mortgage Market Review, CFEB is planning to add further information to Moneymadeclear™ on some of the drivers of increased rates of possession. This will supplement the actions already taken to inform and improve the understanding of consumers in the round, and especially those identified as being more vulnerable (for example, to the risk of falling into arrears).

Consumer awareness campaign: 'Stay on top of your mortgage'

5.11 One of the barriers to consumers engaging with finances can be the time they perceive it will take. To address this, CFEB has packaged up new and improved Moneymadeclear™ tools into five, fifteen and thirty minute toolkits on a dedicated campaign page.[27] These toolkits support a new CFEB initiative that aims to help consumers stay on top of their finances so they don't fall behind on their mortgage payments later. The 'Stay on top of your mortgage' campaign, launched earlier this month, is CFEB's first consumer campaign, and has the following key messages:

- interest rates are at a record low and this won't last forever – even a small increase can have an impact on your monthly mortgage payments – and if you're already stretched, this could mean you may struggle or get into arrears;
- health-check your finances now so you don't fall behind with your payments later – a small change now could make a big difference in the future; and
- Moneymadeclear™, from CFEB has a range of interactive tools that can help you.

5.12 In summary, CFEB's advice to consumers is:

- **know your deal** – be sure to understand your interest rate deal and the date your deal ends;
- **know your limits** – be realistic about what you can afford now and later; and
- **know your options** – be sure to understand the choices available if your circumstances change.

5.13 To support this advice the campaign includes new mortgage and cutback calculators to help consumers see how much their mortgage repayments are likely to change in the event of an interest rate rise, and help them to identify potential areas for savings in a matter of minutes. Or, if they have longer, consumers may find the budget planner and mortgage comparison tables helpful to give their finances a health-check and shop around.

27 www.moneymadeclear.org.uk/campaigns/mortgages.html

Money guidance

5.14 The money guidance pathfinder, in partnership with government, delivered information and guidance under the Moneymadeclear™ brand; by telephone, face-to-face and online. Initial results from the independent evaluation of the pathfinder show that the service has reached its intended audience, especially face-to-face with people who are 'vulnerable to the consequences of poor financial decision-making'. This includes some of the categories identified by Experian such as 'Credit-Hungry Families' with multiple high-risk characteristics that are most likely to fall into arrears. As Chapter 3 illustrates, such borrowers feature prominently amongst those who have taken out unaffordable loans.

5.15 Mortgages are the most popular topic on the web and phone; and credit and debt is one of the most popular in face-to-face sessions. Half of web users and 60% of phone and face-to-face users have taken action within two months of using the service. The full pathfinder evaluation is to be published soon. CFEB has now been tasked with delivering a national financial advice service. It will build on all CFEB's work so far, particularly the money guidance pathfinder

5.16 Some organisations, in response to the MMR and elsewhere, have called for making guidance or advice a requirement for some consumers before taking out a mortgage. We and CFEB are considering this suggestion further. More generally, we are keen to explore the scope for interested parties, including firms, to make referrals to Moneymadeclear™.

Triggers for arrears

5.17 The analysis for this CP confirms that certain types of consumer and product can be identified as being at higher risk of falling into arrears when the mortgage is taken out. However, it is also true that in many cases a life-changing event is what prompts the arrears. Therefore, CFEB is adopting a preventative approach to reach people with information relevant to their situation, when the trigger for arrears takes place but before it becomes a crisis.

5.18 The FSA Business Plan 2009/10 contained commitments to explore new ways to address the needs of certain groups in the downturn, including people facing unemployment and experiencing relationship breakdown. Both of these life events are known triggers for arrears and repossessions and both increase during an economic downturn. CFEB is taking these commitments forward in two ways:

a. **By producing new material –** CFEB has drawn up a handbook, and is delivering seminars in the workplace for people experiencing redundancy.[28] It has produced a new website for people going through divorce, separation or civil partnership dissolution.[29] Both these initiatives follow considerable work with stakeholders in the field and testing with consumers. CFEB continues to liaise with us and external stakeholders on the content, to make sure each product is clear on what consumers should do if in difficulty with their mortgage.

b. **By finding new ways to reach consumers affected by life events –** CFEB aims to make sure the new materials are available to consumers where it is convenient to them, at existing contact points for people in their situation. Therefore, the redundancy handbook is being distributed through channels, including JobCentre Plus, with 46,000 issued in the pilot phase this year. Key practitioners in the family relationship and support arena have agreed to signpost to the divorce and separation website, which as a result is receiving 3,500 visits per month. CFEB has also produced Your Guide to Retirement[30], intended to be given to consumers six to 12 months before retirement. Its method of distribution is currently being tested, but it will include relevant material on mortgage debt in retirement as well as equity release.

Court process

5.19 DP09/3 proposed working with partners in government to assess whether access to advice can be improved at key stages before repossession. While some respondents believed this point was too late to intervene, CFEB considers that advice at this crucial stage can have a substantial impact on immediate and longer-term consumer outcomes. Consequently, Moneymadeclear™ includes referrals to the Government's Mortgage Help schemes while in the other direction the Moneymadeclear™ 'Problems paying your mortgage' leaflet is being distributed through the government schemes and other channels.

28 Redundancy hub: www.moneymadeclear.org.uk/hubs/home_redundancy.html
29 Divorce and separation website: www.moneymadeclear.org.uk/divorce
30 Retirement guide: www.moneymadeclear.org.uk/hubs/home_retirement.html

6 Non-deposit taking lenders

Background

6.1 In DP09/3, we questioned whether there was a need to reform the prudential regulation of non-deposit taking lenders (non-banks). This chapter considers this question further, in the light of the market response to the MMR and our subsequent discussions with specialist lenders and other market participants. A high level cost-benefit analysis of the package of measures discussed in this chapter is at Annex 1 Part 2.

6.2 We are not currently consulting on proposed changes to the regulatory regime applying to non-banks. We are inviting further comments on the issues discussed in this chapter before finalising our views and, if appropriate, will consult on any proposed change of regime later in the year.

6.3 Responses to questions 33 and 34 in this chapter should be sent to us by **30 September 2010**.

Procyclicality

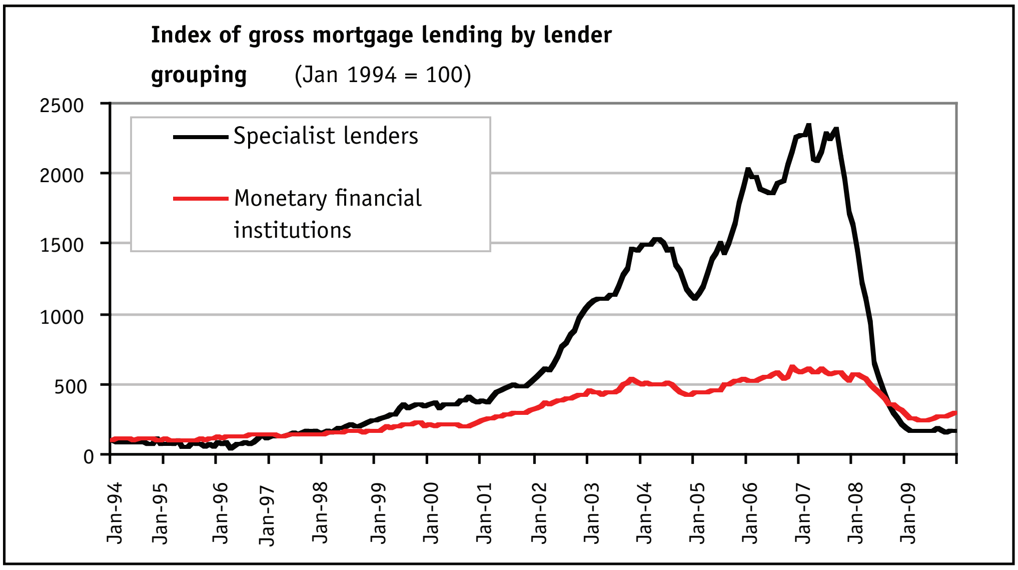
6.4 As we noted in DP09/3, specialist lenders have played an increasingly significant part in the UK mortgage market over the last 20 years. A main driver of the increase in mortgage lending was the expansion of non-banks, who traditionally entered the market to cover shortages in mortgage supply, using wholesale funding instead of deposit taking to finance their operations.

6.5 There is clear evidence of greater volatility in lending provided by entities not directly funded by deposits – such as subsidiaries of banks and building societies, Special Purpose Vehicles (SPVs) and non-banks.

6.6 Bank of England (BoE) data, shown in Exhibit 6.1 below, indicate that lending funded by such firms has been much more volatile than that retained on the balance sheet by 'Monetary Financial Institutions'.[31] The chart shows an index of gross mortgage lending and therefore illustrates the rate of growth of such lending relative to a base level of 100 in January 1994, for each of the lending sectors.

6.7 In the BoE mortgage lending statistics, specialist lenders are defined as all UK-resident mortgage lenders that are not monetary financial institutions. Under this definition, specialist lenders include both 'stand alone' specialist lenders and non-bank lending subsidiaries of monetary financial institutions. The specialist lender data also include mortgages held in SPVs, arising from securitisations by any type of lender, and so may overstate specialist lender activity.

Exhibit 6.1



(Note that 'specialist lenders' does not refer to the term 'non-bank' as used in this chapter)

Source: Bank of England[32]

6.8 Low barriers to entry encourage non-banks to enter the market during an upswing in prices.[33] This is a procyclical effect which can increase volatility of house prices and the size of housing bubbles. Research by NIESR[34] has identified an acceleration in real house price growth can be the most important factor contributing to the emergence of a financial crisis.[35]

31 The European Central Bank (ECB) defines Monetary Financial Institutions (MFIs) as 'resident credit institutions as defined in Community Law and other resident financial institutions the business of which is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account, to grant credits and/or make investments in securities'.

32 Trends in lending, February 2010, http://www.bankofengland.co.uk/publications/other/monetary/TrendsFebruary10.pdf

33 For example, some non–deposit taking mortgage lenders exhibited a hit and run tactic, aiming to take abnormal profits and then leave the market.

34 National Institute of Economic and Social Research, http://www.niesr.ac.uk/index.html

35 FSA (2009), Optimal regulation of bank capital and liquidity: how to calibrate new international standards, Occasional Paper 39.

6.9 In DP09/3, we estimated non-banks accounted for 15% of total regulated mortgage lending in 2007.[36] According to the Intermediary Mortgage Lenders Association (IMLA), the figure was approximately 7%[37]; however we believe the actual figure is likely to lie within the range of these estimates. IMLA estimates that non-conforming key market sectors (including key worker schemes and buy-to-let lending; lending at high LTVs, and lending to the self-employed, credit-impaired borrowers and first time buyers) amounted to approximately £35bn of regulated mortgages in 2007 and about 66% of this funding was provided by the specialist non-bank sector. Non-banks also accounted for approximately 20% of the buy-to-let market.

6.10 The expansion of non-bank lending was one driver of the increase in general mortgage lending that fed rising house prices in the UK. Conversely, a rapid exit can be forced on non-bank lenders in a downturn, for example, if wholesale funding becomes illiquid or too expensive. With the onset of the credit crunch and the resulting recession, the securitisation market has been largely closed. Unlike banks and building societies, which have benefited from government and Bank of England support programmes (e.g. the Special Liquidity Scheme and the Credit Guarantee Scheme), the non-bank sector has not had access to government support (because deposits are not at risk so the government did not deem that support was required). It has, therefore, been totally reliant on private funding and the re-launch of the wholesale funding market in order to originate new business. As a result, by 2009, most non-banks had pulled out of the market.

6.11 The quick entry and exit of such an important supply share has a particularly significant impact on mortgage borrowers in the UK who, particularly the credit impaired, switch mortgages frequently and depend on the continued availability of mortgage deals. We expressed concern in DP09/3 that the procyclical entry and exit of non-banks in the UK market produces market sustainability issues, reinforcing our view that, collectively, non-banks can bring instability to the market.

Degree of lending risk

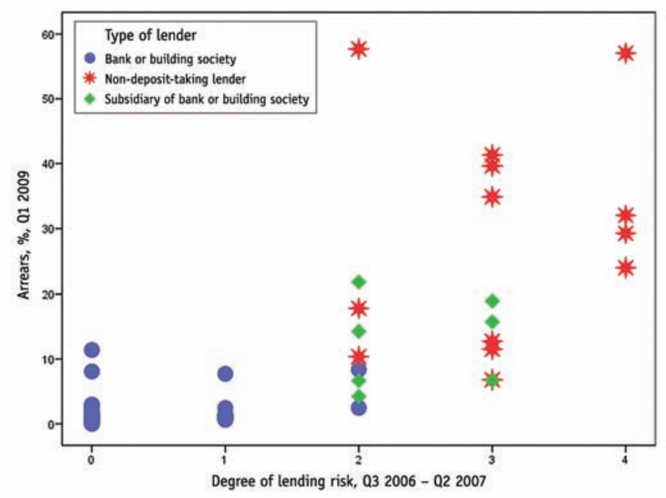
6.12 Given that they do not have direct access to deposits (and the associated lower costs of funding), non-banks do not focus on prime lending but on the non-conforming sector instead. Non-banks need to specialise in market segments where they can charge a premium to cover their higher funding costs which inevitably leads to higher arrears, irrespective of the quality of the credit underwriting. However, in the UK, non-banks have largely tended to fund using the originate-to-distribute model. Since this removes lenders' exposure to the credit risk of the originated mortgages, this encourages them to compete by weakening their lending standards. We expressed concern in DP09/3 about the arrears rates and the degree of lending risk apparently taken on by non-banks.

36 The estimate made certain assumptions about securitisation volumes of banks and building societies which were included in the underlying data sourced from the Bank of England.

37 Source: Response by IMLA to the MMR DP (December 2009)

6.13 There was some challenge to the arrears figures that we included for non-banks in the DP. We used our MLAR data, which showed arrears for non-banks and bank and building society subsidiaries of between 5% and 60% (see Exhibit 6.2).

Exhibit 6.2



Note: The degree of lending risk is a composite measure calculated based on the proportions of mortgages sold at high LTVs, no income verification, to credit impaired borrowers or with the purpose of debt consolidation.

Source: FSA PSD and MLAR

6.14 To check this data, we ran a regression analysis to determine the factors with highest impact on mortgage arrears. This showed that non-banks and building society subsidiaries have a similar and very significant impact on the probability of mortgages they originated in the period Q2 2005 to Q1 2009 being in arrears, compared with banks and building societies (see Exhibit 5.2 in Annex 3).

6.15 This analysis shows a prima facie case that there were some factors in both non-banks and subsidiaries of building societies that led to materially higher arrears rates even after certain key borrower characteristics were taken into account, notably, LTV, impaired credit status, whether the mortgage was self-certified or fast-tracked.

Impact of conduct of business proposals

6.16 The proposals discussed in Chapter 2 on income verification and affordability assessments, and in particular, the proposed enhanced requirements for credit-impaired borrowers are likely to have a larger impact on non-banks and prevent them undertaking certain types of risky lending. In general, policies which limit the scope for higher-risk lending across the market are likely to have a proportionately greater impact on non-banks and other specialist lenders as they do not originate prime-conforming mortgages.

6.17 We are also proposing to pay closer attention to the high-risk lending strategies of all firms through our business model analysis, both at authorisation and on an on-going basis. This will include greater scrutiny of business strategies, product development processes and underwriting methods and will be complemented by an enhanced supervisory approach focused on business models and underwriting quality. The attraction of this approach is that it will enable us to calibrate our response according to the weaknesses that are identified in particular firms. In addition to enhanced scrutiny at initial authorisation, the graduated range of regulatory responses could include requiring improvement in the relevant standards where there are concerns but without any additional penalty; through to limits on the lending growth in certain products; preventing a firm launching a new product whose risks were thought particularly significant; and ultimately blocking any new lending.

6.18 Notwithstanding the impact of the conduct of business proposals on non-banks, we believe there is a case for introducing a more risk-based prudential framework for them. In DP09/3, we discussed how the proposed changes to the capital requirements for banks and building societies would address the issue of insufficient capital and inadequate liquidity standards that had enabled relaxed lending standards and over-rapid credit expansion in a boom period. We indicated that these requirements would also indirectly have an impact on non-banks.

6.19 Our current view is that a case can be made in favour of our imposing enhanced capital requirements directly on non-banks. As we discuss in the high-level cost-benefit analysis in Annex 1 Part 2, increasing capital requirements and fitting those more closely to the lending risks run by non-banks may contribute to addressing concerns around the procyclical effects that non-banks can have and the degree of lending risk they run. Increased capital requirements could potentially constrain the level of non-bank lending. This should help reduce volatility in house prices which may in turn reduce the probability of a financial crisis.

A risk-based prudential regime

Current capital requirement under MIPRU[38]

6.20 The capital which a non-bank is required to hold is a function of the exposures retained on its balance sheet and its off-balance sheet commitments only. In the extreme case of the Originate–to-Distribute model, non-banks retained no or a negligible exposure to the assets they had originated. More commonly, the non-banks retained an exposure typically in the form of a subordinated position in the securitisation.

6.21 Under MIPRU, non-banks are required to hold 1% of balance sheet assets plus total undrawn commitments or £100,000 whichever is higher. Unlike the BIPRU[39] requirements, which are applicable to banks, building societies and non-banks that are part of banking or investment groups subject to consolidated supervision, the MIPRU requirements do not vary depending on the degree of risk attached to the assets. They also do not restrict the proportion of lower quality capital resources, such as subordinated loans, that can be held to meet the capital requirement.

38 MIPRU is the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries.
39 BIPRU is the Prudential sourcebook for Banks, Building Societies and Investment Firms.

6.22 As a result a non-bank would be required to hold capital (which could be composed solely of subordinated debt) equal to 1% of its assets even though typically those assets would include subordinated positions in their securitisations that often under BIPRU would be deducted or attract a higher risk weight. This indicates that the regulatory requirements under MIPRU are far below those imposed by BIPRU for the exposures which non-banks are likely to retain.

Retention requirement

6.23 The Capital Requirements Directive (CRD) has been amended to prohibit credit institutions from investing in securitisation positions unless the originator, sponsor or original lender has retained a net economic interest of at least 5%. The aim of the amendment is to remove the misalignment of incentives between the interests of investors in securitisations on the one hand and those that originate loans for securitisation and structure securitisations on the other. This requirement will apply equally to any non-bank seeking to sell securitisation positions to credit institutions subject to the CRD and will be effective from 31 December 2010.

6.24 Given that the same requirement will be rolled out to insurers and reinsurers under the Solvency II legislation, and to hedge fund managers under the Directive on Alternative Investment Fund Managers, we believe this will limit the extent to which non-banks will be able to use the Originate-to-Distribute model in the future.

6.25 However, it is important to note that the CRD amendments allow the originator to retain exposure to the securitised assets in a variety of ways. Essentially the originator can retain a ‘vertical slice’ of the securitisation structure or a subordinated exposure, a ‘horizontal slice’. If the originator adopts the former approach the amount of risk retained on the balance sheet would be relatively small. In addition, the requirements do not apply to whole loan sales.

6.26 The retention requirement will effectively force non-banks to hold a minimum position in the assets they securitise, but not necessarily to hold more capital against those positions. In our view, the MIPRU capital requirements are far below the economic capital that would be appropriate for such positions – those requirements would not even cover the expected loss in many junior positions in securitisations and certainly not in the unexpected loss even at a modest confidence level.

6.27 To remedy this, an appropriate approach may be to apply the securitisation framework in BIPRU Chapter 9 to the retained positions in securitisations that the non-banks hold on their balance sheet.

On-balance sheet credit risk

6.28 Alongside introducing the BIPRU securitisation framework, we also think it may be appropriate for non-banks to be subject to the standardised approach to credit risk for their on-balance sheet mortgage assets. (These requirements are set out in BIPRU Chapter 3). By way of example, for loans up to an 80% LTV this would give a risk weight of 35%, and therefore a capital requirement of 2.8%.[40]

40 The capital requirement of 2.8% is arrived at by applying the risk weight of 35% to the Pillar 1 capital requirement of 8% of Risk Weighted Assets under the Basel II framework and the CRD.

6.29 Again this is substantially above the MIPRU requirement. However, introducing a risk-based capital requirement for non-banks would support the overall objective of encouraging stronger risk management. Capital requirements should be more sensitive to risk, and reflect the likely losses in the exposures the non-banks retain.

6.30 Alongside the securitisation framework, we think there is a case for including a BIPRU Chapter 6 operational risk requirement and developing a liquidity requirement.

Operational risk requirement

6.31 A bank is required to hold capital to cover its operational risk losses and have appropriate qualitative systems in place to manage its operational risk (that is, the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk).

6.32 As a non-bank is also likely to run these risks, an operational risk requirement would seem an appropriate element of a more risk-based regime. This could follow the basic indicator approach[41] for operational risk (set out in BIPRU Chapter 6), unless the firm meets the relevant eligibility conditions and opts to apply the standardised approach[42] also set out in that chapter.

Liquidity requirement

6.33 Currently, there is no MIPRU liquidity requirement at the solo level, beyond the broad need for a firm to be able to meet its liabilities as they fall due. Non-banks that are subsidiaries of BIPRU firms, however, will experience the indirect effects of the liquidity regulation of their parent company.[43]

6.34 Non-banks have relatively simple business models. We, therefore, believe a potential liquidity regime could be based on the quantitative standards for simpler banks, building societies and full-scope BIPRU investment firms. This regime includes a standardised buffer ratio.

6.35 Most non-banks are also relatively small firms compared to most banks and we believe that the costs associated with implementing a complex liquidity regime may be disproportionately high for them. Supervising complex regimes is also disproportionately costly for us, compared to the limited systemic risk these firms are likely to represent. This suggests that a standardised liquidity buffer ratio may be more appropriate.

6.36 The most appropriate way for a non-bank to measure the adequacy of its liquid assets needs further consideration. This could be based on a time ratio – although the precise make-up of the approach would depend upon the exact nature and impact of stressed events.

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41 The capital requirement under the basic indicator approach is 15% of the three-year average of the firm's net interest income and its net non-interest income.

42 Under the standardised approach, a firm must divide its activities into a number of business lines and apply a percentage to the relevant business indicator for that business line. For a non-bank the relevant business line would be Retail Banking where the applicable percentage is 12% and the relevant business indicator is Net Income as for the basic indicator approach.

43 BIPRU firms that have MIPRU subsidiaries assess the liquidity stress impact on these subsidiaries to determine if and how they would be required to extend additional parental support in these conditions.

Eligible regulatory capital

6.37 We have considered what quality of capital should be regarded as eligible to meet more risk-based capital requirements. At present, under GENPRU[44] a bank must hold at least half of its capital for credit risk requirements in the form of Tier 1 and half of this must be core Tier 1.[45] By contrast, under MIPRU all of the regulatory capital requirement for a non-bank can be met using subordinated loans.

6.38 It should be noted that MIPRU includes a restriction on the amount of subordinated loans but only for an intermediary that holds client money. For such a firm, the subordinated loans and redeemable preference shares cannot exceed 400% of the share capital and reserves (excluding redeemable preference shares) less intangible assets.

6.39 We think there would be a good case for differentiating between banks and non-banks in terms of the quality of eligible capital. Non-banks do not have depositors, and are relatively small firms whose failure is likely to have fewer implications for financial stability than banks. It appears reasonable that non-banks should be able to rely to a greater degree on capital that can only absorb losses in gone concern (e.g. subordinated loans), rather than going concern loss-absorbent capital (e.g. share capital).

6.40 Against this there is an argument that the cost of regulatory capital bites mainly when capital requirements have to be met with core Tier 1, because raising such capital is generally more expensive than subordinated debt. If capital requirements are to motivate better risk management, there is in our view a case for requiring non-banks to have some equity backing. At present, banks need only hold 25% of their capital requirement in the form of core Tier 1, although this minimum is likely to be increased following the conclusions of the Basel Committee's current consultation on capital standards for internationally-active banks.[46]

6.41 We have reviewed a sample of non-banks' balance sheets and from this it appears that their capital is predominantly in the form of either ordinary share capital or reserves (which is core Tier 1) or subordinated loans. They do not commonly hold non-core Tier 1 capital.

6.42 Given this, it may be appropriate for non-banks to have some equity backing, but at a lower level than is required for banks. One option would be to apply the restriction currently set out in MIPRU for intermediaries that hold client assets (as highlighted above). The effect would be that at least 20% of a non-bank's capital would have to comprise share capital and reserves[47] (i.e. the subordinated loans could not be more than 400% of the share capital and reserves). As a consequence, non-banks would no longer be able to meet their capital requirement entirely by subordinated loans. This capital could, however, be used to meet any of the capital requirements discussed above.

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44 GENPRU is the General Prudential sourcebook.

45 Core Tier 1 capital comprises ordinary share capital and reserves. Non-core tier 1 capital is preference share capital and hybrid instruments.

46 These standards are to be developed by the end of 2010 with the aim of implementation by the end of 2012.

47 This assumes that the firm has no intangible assets. Any such assets would need to be deducted in arriving at the "base" that is multiplied by 400% to calculate the amount of Tier 2 capital (i.e. subordinated loans) that can be included.

Summary of a possible risk-based prudential regime for non-banks

6.43 In summary, our current thinking is that an appropriate prudential regime for non-banks could consist of:

a. More risk-based capital requirements, incorporating:

 – a securitisation requirement;

 – a standardised credit risk requirement;

 – an operational risk requirement; and

 – an other assets requirement.[48]

b. Restrictions on the quality of eligible capital; and

c. A tailored liquidity requirement.

> Q33: Do you have any comments on this suggested regime?

Macro-prudential considerations

6.44 The government has announced that an independent Financial Policy Committee at the Bank of England, chaired by the Governor, will have the responsibility and tools to look across the economy at the macro issues that may threaten economic and financial stability and take effective action in response. Decisions have not yet been taken on the details of the macro-prudential policy tools that will be used in the UK and internationally. But one important component would be to build additional resources in the banking system in times of excessive credit growth that would then be available to absorb losses or sustain lending in subsequent downturns. For example, in its discussion paper on the role of macro-prudential policy (November 2009) the Bank of England stated that:

'The aim of macro-prudential tools would be to lean against the build-up of aggregate risk in the upswing, making firms more resilient and thereby lowering the probability of default across the financial system towards its social optimum. And, as important, these tools would aim to help to reduce impediments to risk-taking and lending during the downswing to support economic activity. If such tools were effective, the resilience of the system would thereby be strengthened in both phases of the credit cycle.'

48 It would make sense to apply the existing MIPRU capital requirement of 1% to any assets other than those covered by the securitisation and credit risk framework outlined in this chapter.

6.45 The Basel Committee on Banking Supervision (BCBS) is considering requiring banks to hold larger buffers of capital in periods of excess credit growth when system-wide risks are building. Another, potentially complementary, tool might be quantitative controls on credit growth such as limits in relation to borrower income; affordability; or the value of collateral. In principle, either tool could be used on an aggregate basis in relation to all credit exposures or targeted at exposures to particular economic sectors or markets, such as the mortgage market.

6.46 If the provision of credit by non-banks comprised a significant proportion of credit supply - as was the case in the UK mortgage market in the period up to 2007 – there would be an argument for extending such macro-prudential regulations to those firms. That would help to lean against the build-up of risks in the system. It might also limit the potential for risk exposures to shift from the banks to non-banks if regulators sought to build up capital buffers in the banking system for macro-prudential reasons.

6.47 We are not proposing that macro-prudential regulations should be applied to non-banks at this stage. But nor are we ruling out that possibility in future.

Q34: Do you have any comments on the macro-prudential considerations set out above?

Cost-benefit analysis: responsible lending

Executive summary

1. We carried out a full cost-benefit analysis (CBA) of the proposed rules and guidance set out in this CP. In this annex we summarise the main findings. The full CBA, including detail of the different methodologies we have used to estimate costs and benefits, follows this executive summary.

Drivers of unaffordable lending

2. As discussed in the Mortgage Market Review (MMR) Discussion Paper (DP09/3), lenders have incentives to ensure borrowers can repay their loans (e.g. though income verification, affordability checks, etc) so that they do not suffer undue losses if their borrowers default. However, lenders' incentives can change if they can insulate themselves from losses arising from defaults. Circumstances present before the crisis provide ample evidence of this: booming property prices, fierce competition in the mortgage market and ample availability of capital led some lenders to go deeper into the credit market, offering mortgages to higher-risk borrowers and lowering their affordability standards.

3. In DP09/3 we identified factors potentially driving unaffordable lending. These included high Loan-to-Value (LTV), non-income verified mortgages and lending to credit-impaired borrowers. In this CBA, we use mortgage and arrears transaction level data for the period 2005 to 2009 to formally identify the main drivers of unaffordable lending. Our results show that it was the combination of high LTV, lack of income-verification, lending to credit-impaired borrowers and limited disposable income (after debt payments) that drove unaffordable lending during this period. We found evidence of unaffordable lending leading up to the crisis, subsequently falling off during and after the crisis. Our empirical analysis strengthens the case for the proposed rules on income verification and affordability. However, the case for the proposals is incomplete without full consideration of the costs and benefits of the proposals. The main costs and benefits are as follows.

Costs to the FSA

4. We estimate the one-off costs for implementing the proposals to be in the region of £275,000. Ongoing costs for our supervisory resources will remain uncertain until we consult on the rest of the MMR proposals. Firms affected by these proposals will also be subject to our more intensive approach to supervision. However, costs of this more intensive supervision do not arise directly from the responsible lending proposals and therefore fall outside the scope of this CBA.

Compliance costs to firms

5. We commissioned Oxera to estimate the compliance costs to firms. We have published Oxera's report separately.[1] Oxera has estimated the average total incremental costs per mortgage sale at between £3 and £12.[2] This is due to incremental costs per sale of:

   - £4.50 for each mortgage sale for which income would be verified;
   - £18 for each mortgage sale for which income would be verified and where the income verification is complex; and
   - £17 for each mortgage sale for which affordability would be assessed.

6. Oxera estimated the total cost to industry of implementing the income and affordability requirements to be in the region of £3m to £15m. The total ongoing costs for the industry to maintain compliance with these requirements is estimated to be in the region of £5.8m to £20.3m per annum.

Indirect costs

7. We also asked Oxera to analyse potential adverse effects on the mortgage market as a result of our proposals, including competition effects. Their main findings are:

   - there should not be material adverse impacts on competition in the mortgage market;
   - reductions in the variety of mortgage products and application processes are not expected to be detrimental for most consumers, with those affected likely to apply for alternative types of mortgages; and
   - the proposals are likely to reduce demand for mortgages since some categories of customers will not be able to pass the new affordability test. This is not expected to be detrimental for most consumers.

Microeconomic benefits

8. The main benefit for consumers from the package of proposals stems from the reduction in costs of arrears and repossessions consumers would otherwise have

1 The report is available on our website at: www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf

2 The averages here take into account that only a certain proportion of mortgages sales will be affected by the proposed rules, since for a relatively large proportion of mortgage applications, income is already verified and affordability is already assessed.

incurred (which could be substantial given the arrears charges findings) and from the other associated losses to welfare that they avoid.

9. Using two scenarios for the impacts of the proposals, we estimate that between 0.1% and 4.1% of borrowers would have been excluded from the mortgage market had the proposals been in place from 2005 to 2009, and that between 13% and 17% of borrowers would have had to reduce the amount borrowed to pass the affordability tests and obtain a mortgage. The total value of lending would have decreased by between 3.4% and 9.6%.

10. We estimate this would have generated benefits to consumers in the region of between £475m and £520m for the four year period. This translates into a benefit per mortgage sale of between £60 and £70. This is largely a transfer from other parties, from firms through lost arrears revenue, and from those who would otherwise profit from sales of repossessed properties.

Macroeconomic impacts

11. Given the importance of mortgage lending to the growth of housing and credit bubbles, and their contribution to financial crisis, we have carried out a preliminary analysis of the effects of the proposals on financial stability and the net effect on the macroeconomy. In doing so, we have taken account of the prudential reforms already underway as a result of the Turner Review. Our preliminary analysis suggests that the responsible lending proposals increase financial stability and generate a net long-term increase in economic growth of up to 0.1% per year.

Timing and transitional issues

12. We are mindful the proposals should be introduced at a time and in a way that minimises unnecessary costs to the market. Oxera's and our own analyses indicate that the proposed requirements would bite more significantly during an upturn, when lenders are more protected from losses from defaults, than during a downturn. Introducing the rules during the downturn, when lender and intermediary behaviour more closely mirrors that required by the proposals, should reduce costs.

13. We will carry out a comprehensive analysis of transition arrangements in our consultation on these, which we currently plan to publicise later this year. In particular, we will be considering arrangements to minimise possible adverse impacts on consumers with existing mortgages who would be unable to pass the affordability tests.

Introduction

14. The Financial Services Market Act (FSMA) requires us to publish a cost-benefit analysis (CBA) of our proposed rules and guidance, defined as 'an estimate of the costs together with an analysis of the benefits' that will arise if the proposed rules are made. This CBA assesses, in quantitative terms where possible and in qualitative terms where not, the cost and benefits of the proposed requirements set out in chapters 2 and 4 of this CP.

15. Our standard approach to conducting CBA considers six possible impacts of regulation. These are: the direct costs to the FSA, the compliance costs to the regulated firms, and the costs or benefits to firms and consumers arising from the impacts of our proposals on the quantity, quality and variety of transactions and on the efficiency of competition. We refer to the last four as microeconomic impacts. Given the important role of mortgage lending in the economy, we have also considered the potential macroeconomic impacts of our proposals in this CBA.

16. We commissioned Oxera, an independent firm of economic consultants, to carry out some work for us. Specifically, we asked Oxera to produce estimates of the incremental compliance costs, to explore the strategic reactions of firms and to analyse the market impacts emerging from these reactions. We have published Oxera's report separately. It is available on our website at: www.fsa.gov.uk/pages/library/policy/cp/index.shtml.

17. This CBA compares the situation that will arise once our proposed requirements are in place with the situation had they not been introduced, i.e. the baseline. We have taken into account the fundamental prudential reform already under way and its potential impact on lending.

18. For each set of proposals, where possible, Oxera has estimated the incremental costs of complying with our proposals, taking as the baseline what firms currently do.

19. This annex contains:

- our empirical analysis of the drivers of unaffordable lending;
- our estimates of the direct costs of our proposals;
- a summary of the main findings of Oxera's work on the compliance costs of our proposals. Oxera's costs are allocated between one-off costs arising from the introduction of our proposals and the annual ongoing costs of maintaining compliance with them (unless otherwise stated, we have accepted Oxera's estimates of compliance costs):
- our analysis of microeconomic impacts; and
- our analysis of macroeconomic impacts.

20. In our analysis we have used the following sources of information: the Mortgage Lending and Administration Return (MLAR); Product Sales Data (PSD); the dataset on arrears and repossessions compiled with the help of the Council of Mortgage Lenders (CML); supervisory intelligence; findings from a number of studies and surveys commissioned by the FSA; and relevant academic research. We also used an

external academic to undertake a peer review of our empirical analysis on the drivers of unaffordable lending.

Drivers of unaffordable lending: empirical analysis

21. Lenders naturally have an incentive to ensure borrowers can repay their loans (e.g. through income verification, affordability checks, etc.) and to ensure that borrowers have sufficient equity in the transaction, so that there will not be undue losses if borrowers default. However, circumstances before the crisis enabled lenders to insulate themselves from such losses.

22. Before the crisis, property markets were booming and lenders maximised profit by increasing the amounts they lent to creditworthy individuals and to individuals previously excluded from the mortgage market. Widely-held expectations of growth in collateral values and an increased ability of lenders to pass risks to third parties (e.g. by selling securitised mortgages through liquid securitisation markets) reduced lenders' default risk to the mortgages they originated. These factors diminished lenders' incentives to ensure borrowers were able to repay their mortgages, which in turn encouraged unaffordable mortgage-lending growth in the mortgage market.

23. As discussed in DP09/3, the following features were present in the UK mortgage market in the years leading up to the current crisis:

    a) Risk-taking increased and due-diligence was reduced. This was incentivised by sustained increases in collateral values (growing house prices) and liquid securitisation markets where mortgage risk could readily be sold on to third parties. These insulated mortgage lenders from losses from borrower defaults;

    b) The tendency to relax criteria and increase risk was facilitated by intense competition among lenders. New entrants offered riskier products to gain a foothold in the market, which prompted incumbents to do the same. Some lenders competed to sell to customers with more adverse credit histories by relaxing their eligibility criteria. In some cases competition to offer non-income verified mortgages facilitated inflated reporting of income. The resulting large volumes of high-risk lending contributed to increases in house prices in a housing market where supply is already constrained and rigid;

    c) Some non-deposit-taking lenders (non-banks) and subsidiaries of deposit-taking lenders may also have played an important role in relaxing criteria, increasing mortgage leveraging levels and inflating house prices. The hypothesis that non-bank lenders significantly contribute to the procyclicality of mortgage lending and as a result have detrimental impacts on financial stability is considered in detail in Chapter 6;

    d) Some lenders and intermediaries benefited from consumers' behavioural biases and risk-taking preferences to sell foreseeably unaffordable mortgages and to increase mortgage-related charges;

e) In some cases intermediaries and borrowers took advantage of an information asymmetry with providers to inflate income in mortgage applications; and

f) As a general result, lenders increased lending amounts and extended mortgage lending to higher-risk borrowers, including some who had previously been excluded from the mortgage market. Increasing numbers of consumers, mainly those in higher-risk groups, borrowed at unaffordable levels. Risk was under-priced, particularly in the higher-risk sections of the market, through over-rated securitisations. The resulting over-rated securities were dispersed widely in the capital markets. This inflicted a negative externality on the market and was one of the factors contributing to the financial crisis.

24. To perform a more detailed analysis of the nature and extent of the market failures associated with unaffordable lending, and to facilitate later analysis of the proposals' effectiveness in tacking unaffordable lending, we carried out a detailed empirical analysis of the drivers of unaffordable lending. This was done using an extensive dataset of mortgage transactions data.

25. The mortgage transactions data used is Product Sales Data (PSD) from April 2005 to September 2009. This dataset contains information on 8.1m mortgage transactions and covers 200 mortgage providers. Since this data contains no post-sale information about mortgages, such as whether a borrower went into arrears, we matched this data with contemporaneous data collected on our behalf by the Council of Mortgage Lenders (CML) containing information on accounts in arrears (and others that had subsequently been repossessed). The CML dataset covers transactions for 33 of the firms identified in the PSD, and contains 277,000 transactions between April 2005 and March 2009 that were in impairment (arrears or repossessed) as of August 2009. The sample of lenders includes a selection of banks, building societies and specialist lenders, of different sizes and market focus. The resulting matched dataset comprises 4.5m observations, covering the lending activities of 33 mortgage providers and 12,000 intermediaries.[3]

26. The data was pooled by mortgage provider and intermediary. Segmenting in this way, with 33 mortgage providers and over 12,000 intermediaries, results in over 205,000 distinct loan pools. The idea behind the segmentation is that loans originated by a provider and intermediary will share similar characteristics.[4] Mortgages in each pool share the lending criteria of a particular lender and a business focus of an intermediary, as well as the self-selection of consumers who choose this distribution channel, including a particular intermediary.

27. As a next step in the analysis, we calculated the proportion of mortgages in impairment for each pool.[5] Each mortgage in the pool was assigned a likelihood of being in impairment equal to this proportion. Ranking mortgage pools in order of

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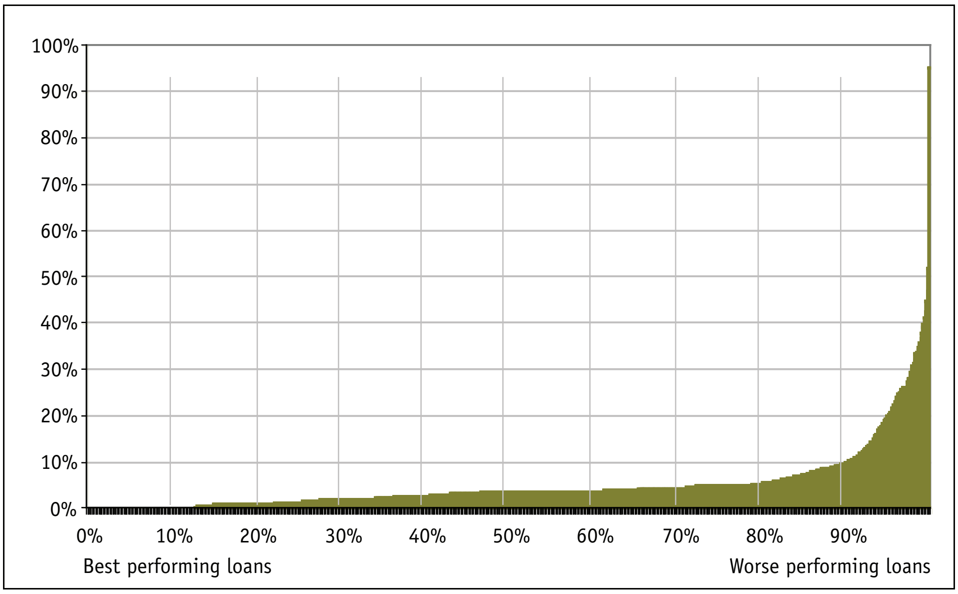
3 This data has some important limitations. First, loans are not evenly distributed over the period with greater numbers of loans for 2006 and 2007. Second, the data collected by CML provides information for mortgages in arrears and possession in August 2009. We do not have data about when arrears developed and we lack information about those mortgages that may have been in arrears earlier in the period but which exited arrears before August 2009.

4 Technically, segmenting controls for the variation arising from intermediary and provider.

5 A mortgage is taken to be in arrears if (i) months in arrears > 1, (ii) Arrears Balance > £100 and the outstanding Balance > £1,000. A mortgage is in impairment if it is in arrears or in possession.

increasing likelihood of impairment gives an indication of the distribution of riskiness among mortgages, as shown in figure 1.

Figure 1 Distribution of riskiness among mortgage pools



28. Figure 1 shows a large amount of mortgage lending to be relatively low risk with high-risk lending concentrated in a small proportion of mortgage pools. The best 30% of loan pools have a likelihood of falling into impairment of 1% or less. At the other extreme, the worst 10% of loan pools have a likelihood of falling into impairment of 10% or greater.

29. To identify the drivers of unaffordable lending from these data, we focused on characteristics that had already been identified as drivers of impairment in other relevant studies. In DP09/3 characteristics that we suggested might be important in contributing to lending becoming high-risk included:

- high LTV;
- no income verification;
- lending to credit-impaired, financially vulnerable or distressed borrowers;[6] and
- lending for the purpose of debt consolidation.

30. Other adverse characteristics that we expected to be important drivers of impairment include where loans have been originated:

- by specialist lenders rather than conventional; and
- where affordability assessments indicate that borrowers may have limited free disposable income.

31. For these variables, we investigated how the risk of impairment varied over the period of the sample. This permitted a preliminary identification of factors

6 'Credit-impaired' has a specific meaning as discussed in chapter 2.

associated with impairment, and an early indication of potential drivers of unaffordable lending.

32. This preliminary analysis was done by segmenting the loan book into two groups based on their risk of impairment.[7] Examining the characteristics for each group permitted the identification of characteristics that indicate borrowers are more likely to fall into impairment (arrears or possession):

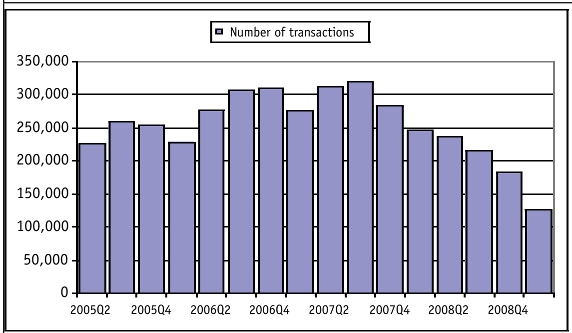
- Risk category 1: Likelihood of impairment ≤ 10%
- Risk category 2: Likelihood of impairment > 10%

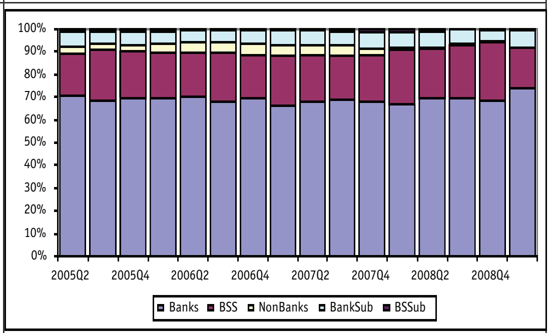
33. Figure 2 shows how loans in the two risk categories vary by type of mortgage provider. The left-hand charts present volumes of transactions; the right-hand charts present the corresponding breakdown of these loans by provider.[8]

Figure 2: Number of mortgages originated by provider-type

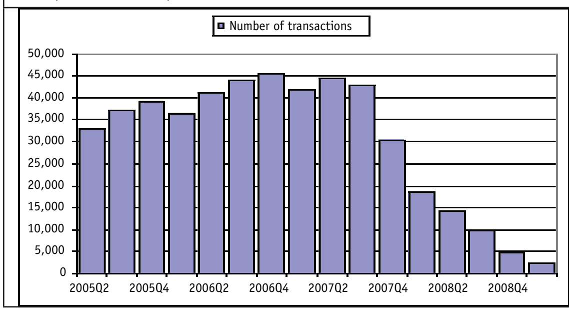
a) Number of loans — **b) Breakdown by provider**

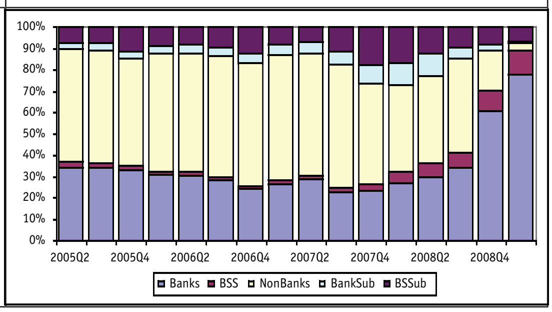
i. P(Impairment) ≤ 10%





ii P(Impairment) > 10%





34. The figures show that higher-risk lending was more prevalent in non-deposit-taking institutions. Non-banks account for less than 10% of the originated loans in the lower risk groups, while in the higher-risk group they account for 50% at the peak

7 In the actual analysis, four risk groups were considered. The two group categorisation presented here is coarser than the four groups used, but is presented here as it shows more clearly the relationships between risk of impairment and the relevant mortgage characteristics. Also, the purpose of the categorisation is purely analytical. The categorisation does not reflect a choice of risk threshold in the policy proposals.

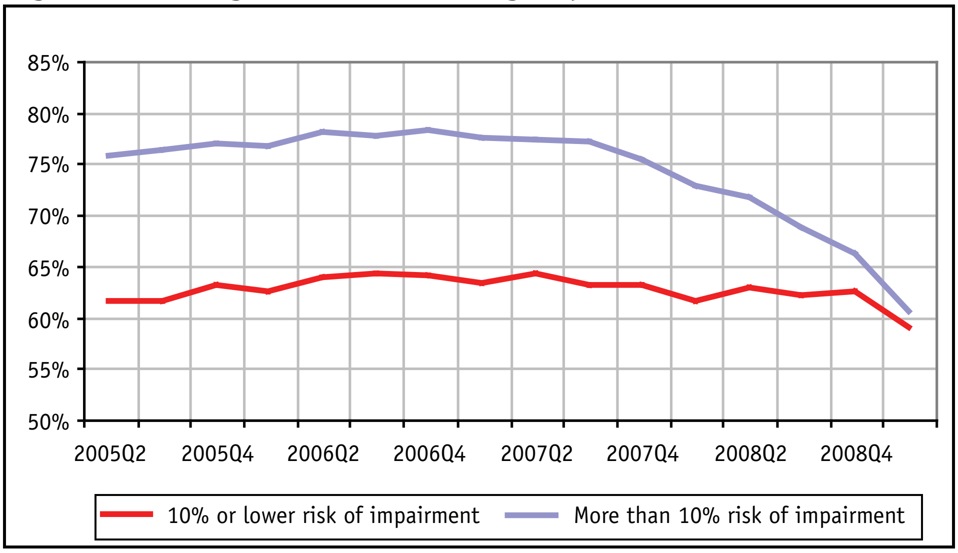
8 Figure 2 shows higher risk mortgages drop more steeply at the end of the period than lower risk mortgages. This is due in part to a drop in riskiness of mortgages, presumably from lenders tightening criteria during the crisis. However, a large part of this drop may potentially stem from a measurement issue. Since impairment is measured from the number of mortgages in arrears or repossessions in 2009, mortgages issued toward the end of the period have had less time to fall into impairment, so the measurement method is less able to capture high risk mortgages originated at the end of the period. A similar caveat applies for the drops in riskiness of mortgages observed at the end of the period in the other graphs presented in this section.

of the market.[9] This suggests that the selling of mortgages by non-banks may have been a driver of unaffordable lending.

35. Mortgage characteristics, such as the loan–to-value ratio (LTV), were also considered. There were several reasons for this. A borrower with a high LTV ratio has only a small amount of equity to extract from their property (either through remortgaging or selling) to overcome a payment difficulty. In addition, a high LTV may be an indication of a borrower's inability to save. Also, a higher LTV is associated with a higher interest rate payment and administrative costs that further impact on a borrower's ability to repay.

36. Figure 3 below shows that average LTV is greater for the high-risk group. The riskier group of impairment lies well above the other group with an average LTV close to 80% for the period preceding the crisis. This is consistent with DP09/3 where the correlation between higher LTVs and defaults was discussed. However, as discussed there, the role of LTVs is complex. There is also evidence that high LTVs are a less significant predictor of arrears for standard mortgages, rather than for credit-impaired and self-certified mortgages. This shows the importance of considering the combined role of potential drivers of unaffordable, as was done in the regression analysis carried out subsequently.

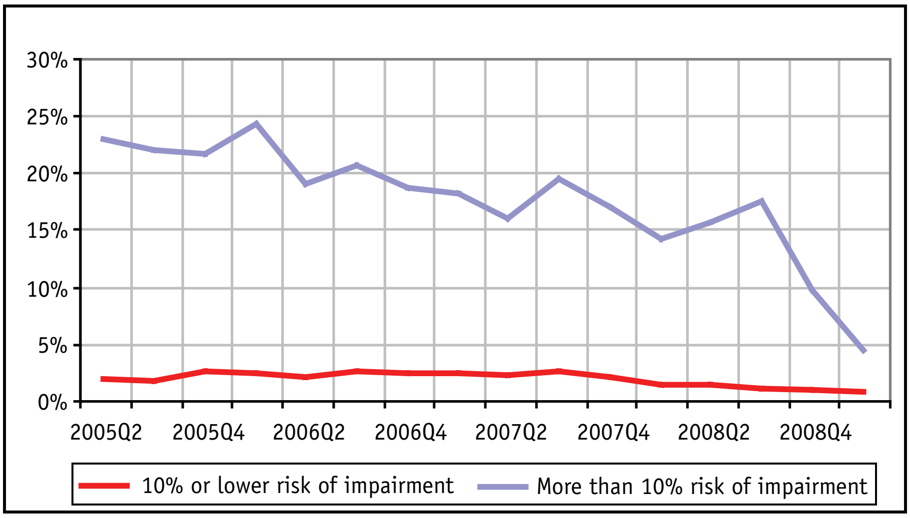
Figure 3: Average LTV across risk groups over time



37. Borrower characteristics were also investigated, such as whether mortgages were given to credit-impaired borrowers and whether borrowers provided income verification. Figure 4 set outs the proportions of loans that were credit-impaired for the two risk groups. It shows an association between being credit-impaired and having a higher risk of impairment. This provides evidence for credit impairment being a driver of unaffordable lending.

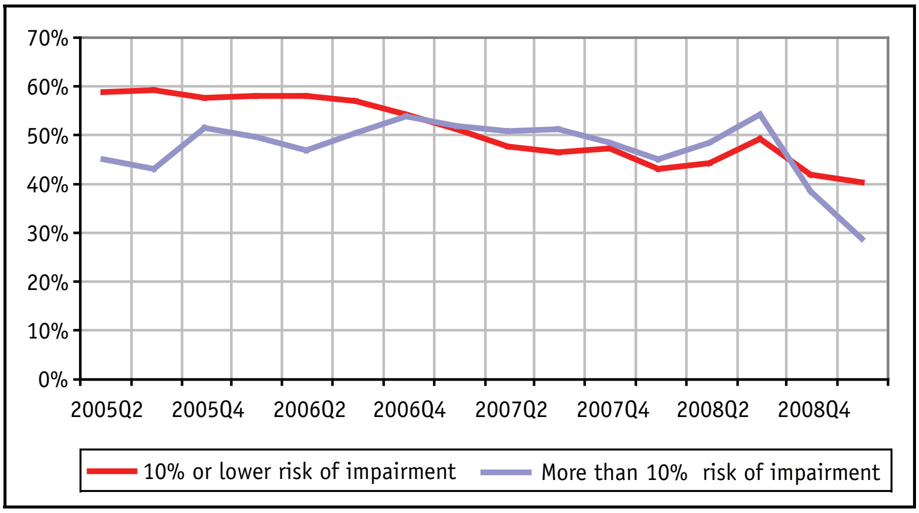
9 The graph also shows subsidiaries of building societies were predominantly focused on higher-risk mortgages.

Figure 4: Proportion of loans to credit-impaired borrowers (%)



38. As for income verification, figure 5 shows a slight negative correlation between income verification and higher risk of impairment in the period leading up to the crisis. It shows little correlation during the second half of the period. When considered in light of the evidence discussed in Chapter 2 – that fast track mortgages were not found to be higher risk than income-verified mortgages – it suggests that self-certified rather than fast track mortgages, are a source of risk for non-income-verified mortgages in the period leading up to the crisis.[10] When considered in light of the higher prevalence of self-certified mortgages in the period leading up to the crisis, it explains the higher risk for non-income-verified mortgages in the first half of the period shown in figure 5.

Figure 5: Proportion of loans that are income verified (%)



39. To complete the analysis and identification of the drivers of unaffordable lending, a regression analysis was carried out including factors that potentially could affect the probability of impairment. This has the advantage over the above analysis of controlling for the interaction of the potential drivers. In other words, it allows a

10 To discriminate between the impacts of self-certified and fast track mortgages in the analysis of income verification, these were considered separately in the subsequent regression analysis.

holistic analysis of the drivers of unaffordable lending to be carried out, avoiding potentially misleading conclusions that can arise if correlations are analysed separately. To do this, the variables identified in the preliminary analysis above were supplemented with other potential drivers of unaffordable lending, including relevant macroeconomic variables.[11]

40. This resulted in a equation for probability of impairment in terms of its driving factors:

Probability of impairment = f(credit-impaired & income non-verified, remortgage for debt consolidation, self-certified, LTV, intermediaries, interest-only, first-time-buyer, specialist lenders, right-to-buy[12], DSR, macroeconomic variables[13])

41. Overall, the identified drivers of unaffordable lending provide support for the view that consumer detriment from unaffordable lending was focused on financially vulnerable borrowers, for example right-to-buy or debt-consolidating borrowers. Borrowers over-stretched themselves, facilitated by weakened income verification standards, particularly self-certification. Interest-only mortgages may have been a particular avenue for unaffordable lending.[14] The identification of LTV and debt service ratio (DSR) as drivers suggests that, all else being equal, higher LTV and/or increased DSR tended to make impairment more likely.

42. Finally, the results are also consistent with the hypothesis that some specialist lenders focused on higher-risk lending and had weaker standards in the issuing of mortgages which aggravated unaffordable lending. This hypothesis is considered and discussed in greater detail in Chapter 6.

Risk of impairment and volumes of lending

43. Having identified drivers of unaffordable lending, it is natural to ask what the extent of unaffordable lending is. This is not a straightforward question to answer. In part, this is because of the challenges in defining unaffordable lending. What counts as unaffordable depends on the borrower's context and their needs. There are also different possible methodological approaches to measuring unaffordability; for example, approaches that take expenditures into account ('residual income' approaches) and those that attempt to measure the affordability of a loan by considering debt payments relative to a measure of income ('affordability ratio' approaches).[15] Another method is to measure unaffordability of mortgages from their impacts – for example, from levels of arrears or defaults on loans.

44. Ideally we would like to use the residual income approach as this takes expenditure into account. However, since we do not have data on households' expenditure at the

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11 Probability of impairment was then regressed against these variables using a logit model, with statistically insignificant variables removed.

12 A right-to-buy borrower is a borrower purchasing under the right-to-buy government scheme, which allows council tenants to purchase their properties at a discount.

13 In addition, the probability of impairment was dependent on the following macro-variables: level of regional deprivation (as captured by the Index of Multiple Deprivation), changes in the official Bank of England rate, changes in the level of GDP and changes in unemployment.

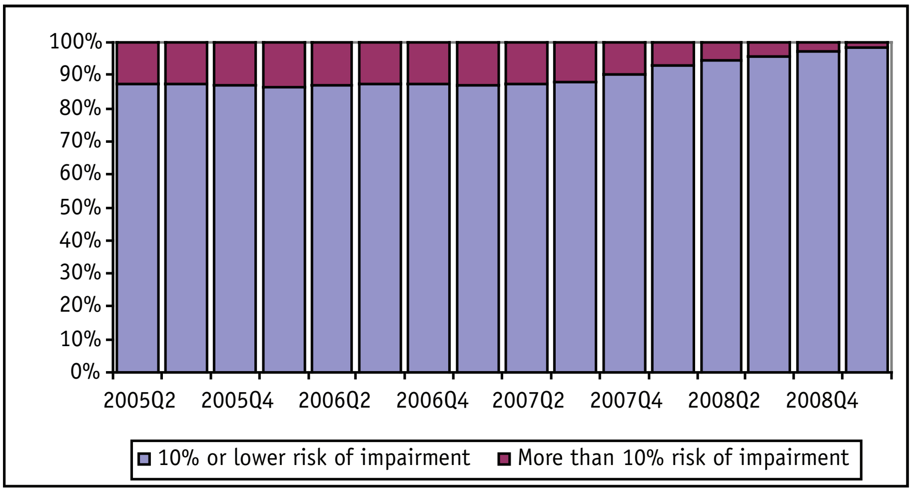
14 See Annex 1 Part 2 for consideration of interest-only mortgages.

15 For more on measuring affordability see Bramley, G. and Karley, N.K. (2005) 'How Much Extra Affordable Housing is Needed in England?', Housing Studies, 20, 5.

appropriate level of granularity, we use an approach in line with the third method above, based on the determinants of falling into impairment. In doing this, we take probability of falling into impairment as a proxy for how unaffordable a mortgage is – a mortgage that our model assesses as having a high probability of impairment is taken to be more unaffordable than one with a lower probability of impairment. We avoid stipulating a definition of unaffordable lending based on a particular threshold of impairment as this would be artificial and would not do justice to the concept of unaffordability that underpins our proposals. Nevertheless, to illustrate the volume of lending that might be classified as unaffordable we present some measures based on impairment risk below.

45. We analyse the extent of unaffordable lending using a couple of illustrative graphs. The first, figure 6, breaks lending in our pool of data down into the two risk groups above. It shows how the proportion of higher risk mortgages was higher in the period preceding the crisis, falling during and after the crisis.

Figure 6: Proportions of different risk lending over time (%)



46. If lending exceeding a risk of impairment were classified as unaffordable, then the volume of lending classified as 'unaffordable' decreases as the threshold of impairment risk for classifying loans as unaffordable loans is raised. Figure 7 shows the relationship for lending over the period of the data (2005 to 2009), while table 1 shows specific amounts of lending corresponding to some different possible thresholds.

Figure 7: Lending exceeding impairment risk thresholds

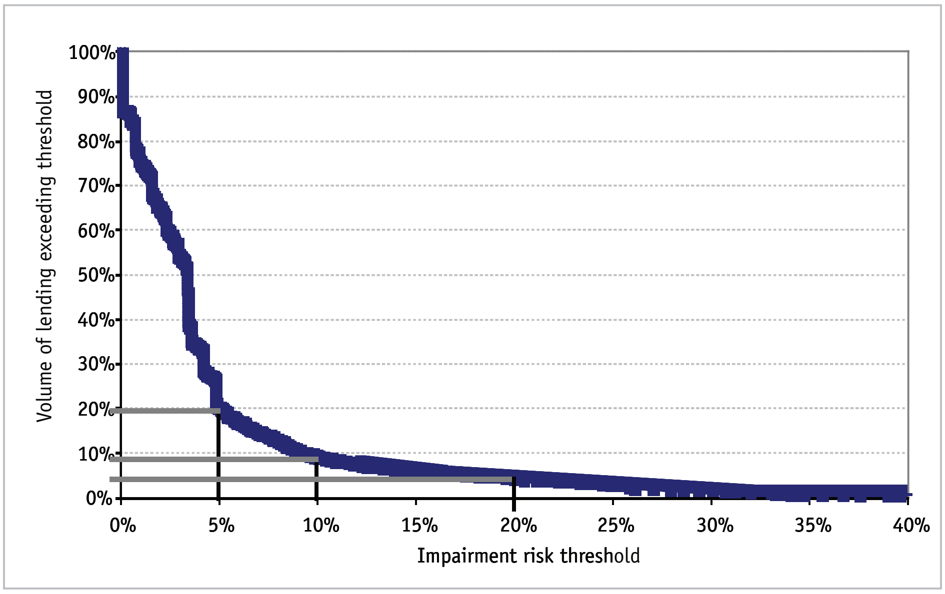


Table 1: Lending exceeding threshold for different thresholds of impairment risk

Impairment risk threshold	Lending exceeding threshold %	Lending exceeding threshold £bn
40%	0.6%	5
20%	4.5%	41
10%	8.7%	85
5%	18.4%	192

Cost benefit analysis

47. The market failure analysis and the associated empirical analysis strengthen the rationale for the responsible lending rules in this CP, which should reduce unaffordable lending and improve income verification. However, the case for the proposals is incomplete without a full consideration of the costs and benefits of the proposals. This section sets out detailed costs and benefits of the proposals.

Direct costs to the FSA

48. The direct costs of regulation to the FSA are those we incur as a result of introducing and implementing our proposals. Our proposals will impact supervision and enforcement, and we anticipate that additional resourcing needs will arise mainly from supervising implementation of the requirements and then supervising and enforcing compliance.

49. Our estimated costs are based on the working hypothesis that the following actions may be undertaken:

a) at the pre-implementation phase, preliminary communications and discussions with firms to ensure that they are aware of the regulatory regime changes and have a viable project in place to deliver;

b) a review of adequacy of the implementation project;

c) an assessment of embedding of regulatory requirements on a firm-by-firm basis – this would include reviewing implementation with management; assessing adequacy of systems and controls; reviewing management information; reviewing the internal audit output; and identifying shortcomings and feedback through the risk mitigation plan and close and continuous processes as appropriate;

d) thematic work to test compliance, including supervisors dealing with potential instances of non-compliance with the new requirements; and

e) once the implementation phase is complete, supervisors would move to a business-as-usual phase. Review of continued compliance would be included in firms' ARROW risk assessments.

50. As a result we expect the incremental costs to the FSA to be in the region of £275,000 for one-off costs. In addition, given the impact of the remaining MMR proposals on supervision, these estimates may need to be revised as we consult on these proposals later in the year.

51. Additional tasks such as initial and ongoing business model analysis will form part of our approach to more intensive supervision, and to ensure credible deterrence, consistent with our wider approach to supervision and risk assessment. However these costs do not arise directly from the responsible lending proposals. IS changes are not anticipated from the proposals.

Compliance costs

52. Oxera were commissioned to estimate compliance costs on firms, their identification and analysis of the compliance costs and indirect costs were informed by interviews with the industry and through a survey of lenders. Table 2 shows the sample coverage of the population of firms affected by the proposals. This was used to scale up their survey estimates to the population of firms that might be affected by the proposals.

Table 2: Survey sample of lenders

Value of outstanding mortgage assets (as reported in the FSA Mortgage Lending and Administration return)	Small and medium size lenders (outstanding lending <£9 billion)	Large lenders (outstanding lending >£9 billion)	Total
Sample	28	11	39
of which:			
banks	12	5	17
building societies	7	5	12
Non-deposit-taking lenders	9	1	10
Population (overall number of lenders)	305	26	331
Market coverage (by size of loan book)	14%	52%	49%

Source: Oxera analysis of survey data and FSA data

53. Oxera has estimated the total incremental compliance costs arising from our proposals on income verification and affordability to be in the range of £3m to £15m for one-off costs, and in the range of £5.8m to £20.3m per annum for ongoing costs.

Table 3: Total incremental compliance costs, industry total

	One-off cost	Ongoing cost
Income verification	Minimal[16]	£2.3m - £7.3m
Affordability	£3m - £15m	£3.5m - £13m
Total	£3m - £15m	£5.8m - £20.3m

Source: Oxera analysis of survey data and FSA data

54. Oxera have stated that there is significant uncertainty about these estimates, two of the sources of which are: the difficulty for lenders in estimating reliably the costs of the proposals at this stage when no detail planning has been undertaken; and sampling error.

55. We summarise below how the above compliance costs breakdown and what the main drivers of these costs are. Further details are available in Oxera's report published on our website: www.fsa.gov.uk/pubs/policy/oxera_mmr1016.pdf.

16 This reflects the results from Oxera's survey. However, the indicator of minimal one-off costs may be in part due to firms lacking detail on the income verification proposals.

Income verification compliance costs

56. Table 4 summarises the one-off costs and ongoing costs estimated by Oxera for the industry and per mortgage sale from our income verification proposals. They have used several scenarios to describe the situation when proposals are introduced. We report here the scenario where Oxera assume that income is not verified for 50% of the applications, including 15% (i.e. 30% of this 50%) that would require further investigation.

Table 4: Income verification compliance costs

	Average time required (min)	Hourly cost (£)	Cost (£) per mortgage application	Cost (£) per mortgage sale	% of mortgage sales affected	Industry costs (£)
Standard income verification	10	18	3	£4.50	35	£2.7m
Complex income verification	41	18	12	£18	15	£4.6m
Total					50	£7.3m

Source: Oxera using survey responses

57. Oxera has estimated the one-off costs of the verification proposals to be minimal. This is because in interviews, lenders indicated that they already verify income for some applications. This was confirmed by the survey evidence where only one lender provided an estimate of the one-off cost. The systems that lenders have in place may require some adjusting in places to ensure verification in all areas to the standards required by the FSA – however, this is expected to be minimal.

58. The ongoing costs for the industry depend on the proportion of applications for which income is currently not verified, the ease with which income can be verified for these cases, and the method of income verification.

59. Based on the responses received in the survey for lenders, Oxera estimates that verifying income will take on average an additional 10 minutes for a standard case and 41 minutes for a complex case. This results in an average ongoing cost per mortgage sale of £4.50 and £18 respectively.

60. The direct costs to consumers of the income verification requirement consist of the value of their time multiplied by the time required to produce copies of the payslip and bank account statement, or, in cases where this is not available or sufficient, relevant certificates etc.. Oxera have estimated these costs to be limited.

Affordability compliance costs

61. Table 5 summarises Oxera's estimate of the one-off costs and ongoing costs arising from the affordability proposals.

Table 5 Total costs of the affordability requirement

Total one-off cost to the industry	£3m – £15m
Average ongoing cost per mortgage sold	£17
Total ongoing costs per annum	£13.1m

Source: Oxera analysis based on survey data

62. A few lenders indicated in the survey that they expect to incur some limited additional costs, even though they already had some form of model or methodology for assessing affordability. For lenders currently using methodologies based just on income(s) this is unlikely to be compliant, so they will need to incur some additional one-off costs to develop a compliant methodology/system.

63. Lenders who will need to build a model will face incremental costs. A few lenders in the survey were able to estimate the costs of building a model to assess affordability. Oxera has used the costs of those lenders with existing affordability models to estimate the cost involved. They identify that large lenders tend to have larger system costs, due to the greater integration of mortgage application systems with other systems. For large lenders, the average one-off cost is estimated at around £700,000 (with an upper bound of £2.5m), while for smaller lenders the average was around £25,000 (with an upper boundary of £200,000).

64. Oxera estimates the ongoing costs of the affordability proposal in a similar manner to that of income verification, starting with the cost per application. The average time taken to assess affordability is in the region of 30 minutes, the average costs per application across the market is estimated by Oxera at around £11.50, and per successful mortgage sale, £17.

65. The above compliance cost estimates do not include estimates for the different proposals we are considering in relation to verifying repayment vehicles for interest-only mortgages. These costs will be estimated when we consult on draft rules. For high level costs and benefits related to this proposal see Annex 1 Part 2.

66. Stress-testing proposals are estimated by Oxera to have minimal cost implications. Most lenders' affordability models already include some form of stress testing, while other lenders may have to upgrade their models. Oxera estimated that it was unlikely the stress-test proposals would add materially to the compliance costs of an affordability model. The increased stress-testing requirements for credit-impaired mortgages were also not expected to be significant on the basis that it should be quite straight forward to identify credit-impaired customers.

Arrears charges compliance costs

67. There is already a requirement under MCOB 12.4 for lenders to ensure their charges are a fair reflection of the additional administration costs faced by the lender. This means that the further guidance that we intend to provide may not result in any incremental costs to firms. However, we have also found evidence of lenders looking to recoup costs through arrears charges for activities that are unrelated to the

additional costs of arrears handling. It is therefore likely that some lenders would have to undertake a fairly detailed cost analysis to make sure that their arrears charges (and other fees for payment shortfalls) are cost-reflective.

68. In interviews with Oxera, lenders indicated that it would be difficult to estimate the costs of assessing whether their arrears charges (and any other individual charges for payment shortfalls) are cost-reflective, and, if they turn out to be higher than the costs, the costs of making them cost-reflective. Some lenders indicated that it would not be straightforward to assess whether charges are currently cost-reflective. Other lenders, however, indicated that they already have systems in place to make sure that their charges are cost-reflective.

69. Some lenders have imposed limits on the number of missed payment fees that can be charged within a certain period of time (e.g. within a month). Nevertheless, lenders' current practice may not be in line with what we intend to propose and they therefore may have to make changes to their systems. Oxera's interviews indicated that for medium-sized lenders the costs of developing the model (covering arrears charges and other charges such as payment shortfall fees) would lead to one-off costs per firm unlikely to exceed £60,000, and ongoing costs (of an annual review once the model had been developed) in the thousands of pounds for each firm.

Compliance costs from proposals for debt-consolidation for re-mortgage and purchase transactions

70. When a consumer claims that they are repaying debts from the proceeds of a mortgage taken out for debt-consolidation, we want to ensure that this actually happens. Therefore, we are proposing that lenders ensure that loans to be repaid from a mortgage advance are cleared as intended. We believe that this proposal incurs minimal costs for remortgage and purchase transactions, as a solicitor will already be involved, and therefore debts can be repaid via the solicitor without significant changes to the lender's systems or processes.

71. We have not included further advances in this proposal at this stage as we understand that costs to the lender are significantly higher where no solicitor is involved in the transaction, and significant changes to processes or systems may be required. We will carry out further cost benefit analysis before including further advances in this proposal.

Costs and benefits from microeconomic impacts of the proposals

72. In addition to the direct impacts on firms, the proposals are expected to have a wide range of economic impacts that will impose costs and bring about benefits. The remainder of the CBA section considers these.

73. The proposals will impact borrowers in different ways. Borrowers will generally face added transaction costs (e.g. added search time, processing time for mortgage applications, costs to produce required documentation). Oxera have estimated the

increase in these costs from the proposals to consumers to be minimal and expect the proposals to have only a limited effect on consumers' mortgage shopping behaviour and their choice of distribution channel.

74. Otherwise, borrowers fall into three groups. The first group are those whose choice of mortgage is unconstrained by the proposals. These borrowers face no incremental costs (excluding minimal transaction costs) and receive no direct benefits from the proposals.[17]

75. The second group of borrowers are those who obtain a mortgage, but whose mortgage is diminished in size, or has some other changed characteristic, so that it meets new requirements. These borrowers may incur a cost from being limited to less preferable housing. They receive a benefit from being less likely to fall into arrears or being repossessed with their more affordable mortgage.

76. The third group of borrowers are those who cannot obtain a mortgage under the proposals. These will be borrowers who would either be ineligible under the new proposals (e.g. cannot provide adequate verification of income) or those who under the affordability assessment would be pushed to reduce the mortgage amount to a point where the mortgage becomes undesirable. For those funding a property purchase with the mortgage, they will incur a cost from staying in their original property or renting an alternative property instead of buying the property they prefer. For those remortgaging, they will incur cost from the foregone benefits of having a preferred new mortgage. This group of borrowers incurs benefits from avoiding the possibility of arrears and repossession that could have arisen with the new mortgage.

77. We now consider the economic impacts of the proposals in greater detail to both firms and to consumers.

Costs from impacts on the variety of mortgage products

78. The income verification requirement and the affordability assessment are likely to result in the reduction of types of mortgages available on the market. Although this reduction in variety of mortgages is not expected to be detrimental for most consumers, it will reduce consumer choice for borrowers who were relying on and are able to afford the products that will cease (e.g. the self-employed, applicants with non-standard characteristics such as a lack of regular income or temporarily low income, etc.). Important examples of this are the self-certified mortgages and the fast track process of mortgage lending. These will either be significantly constrained or prevented. However, most borrowers affected would be expected to apply for alternative mortgage products, limiting the loss of welfare they would otherwise incur by no longer having access to preferred mortgages.

17 These borrowers may benefit indirectly from other impacts of the proposals, for example from macroeconomic benefits such as improved financial stability. These benefits, however, are not considered here as they are taken into account elsewhere.

Costs from impacts on quantity of transactions

79. Oxera asked lenders whether mortgage sales would have been lower if the income verification proposals had been in force. A majority of lenders[18] indicated that their sales would not have been affected by the income verification requirement. However, some lenders indicated it would have had a cost. The average impacts of sales reported by lenders was a 6% reduction in mortgage sales had the income verification proposals been in place in 2009, and a 10% reduction had proposals had been in place in 2007.[19] Within the larger survey respondents, the average reduction for 2007 would have been 3%, with no large lenders responding that there would have been a reduction for 2009.

80. Mortgage sales could be affected by the income verification proposals via two primary drivers. Customers could be excluded from the market for their inability to prove income or mortgage lenders might decide not to offer a mortgage due to the expense of verifying income. Oxera's survey indicated that almost all of the expected reduction in sales volumes from income verification would be expected to arise from applicants being unable to prove income.

81. Oxera reports that this group is most likely to include self-employed people in their first years of business. These borrowers, who previously would have obtained a self-certified mortgage, may find it difficult to present adequate proof of income in the short term and, as a result, may be required to postpone a mortgage until they accumulate and gather a record of income. In the meantime, they will postpone moving from their existing property, or they will choose to rent accommodation during this period. Assuming that the costs of renting a house and the costs of mortgage on the house are unlikely to differ significantly, borrowers who are being delayed in their mortgages would not be expected to experience a monetary loss. However, these consumers would suffer some detriment from not owning a house during the delay. Though it would be desirable to measure this detriment, we have not done so due to data and other resource limitations.

82. In addition, income verification would slow down the fast track mortgage application process. From the survey, the average expected delay is estimated at three to four days (on average the fast track application process currently takes seven days).[20] Whether the income verification would indeed significantly slow down the fast-track process also depends on how consumers respond and how quickly they produce the relevant proof of income. However, the evidence from the survey suggests that this delay is unlikely to have significant effect on consumers' access to the mortgages.

83. The requirement to assess affordability may prevent some consumers from obtaining a mortgage. This is a desired effect of the proposal for borrowers who would otherwise not have been able to repay the mortgage had their application been approved.[21] However, there may also be people who do not pass the lender's

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18 78% of respondents in 2009 and 63% in 2007.

19 The larger reduction in 2007 can be attributed to the higher prevalence of self-certified mortgages at that time.

20 Depending on the lender's requirement, this time would be needed to receive a copy of the payslip and/or bank account statement (and to chase applicants if they fail to provide these).

21 We estimate the number of these borrowers who would be prevented from borrowing in the next section.

affordability test but who would have been able to afford the mortgage.[22] Though Oxera has not been able to estimate the size of this group, they do not expect the group to be substantial. These consumers will incur a cost from having to stay in their original property or renting an alternative property instead of buying the property they would prefer.

84. The affordability assessment will also lead some borrowers to obtain a smaller mortgage than that originally desired. In most cases this should be a desired effect of the proposals, pushing borrowers to limit their borrowing to affordable levels. However, as in the previous case, we would expect that some borrowers may be pushed to reduce their borrowing even though they could have affordably borrowed at their original amount. Both types of borrowers receive a benefit from the reduced likelihood of falling into arrears or being repossessed for the more affordable mortgage they obtain. Similarly, both types of borrower would be expected to buy less preferable housing, incurring a loss of welfare from this.

85. We have not estimated the loss of welfare to affected borrowers in having to settle for a less-preferred property (be it a rental or more affordable purchase) due to difficulties in measuring these effects. This is due to a lack of data on the distribution of preferences of consumers for owning and renting a house and a lack of detailed information on the supply and demand of housing.

Potential adverse impacts on efficiency of competition

86. The mortgage market is currently undergoing a period of transformation. Some of the changes observed over the past three years may be temporary, reflecting the current state of the economy. Other changes may shift the structure of the market over the long term and could potentially give rise to competition concerns. This uncertainty should be borne in mind when reading this section.

87. Although we expect there to be some impacts that affect competition in the mortgage market, the research carried out by Oxera suggests that, overall, the responsible lending proposals are unlikely to have a material adverse effect on competition.

88. Oxera's analysis also suggests that the proposed rules should not lead to profound changes to the competitive dynamics of the market. The proposals impose a new minimum standard in the market. Though this will affect the number of mortgages sold, the income verification and affordability proposals are unlikely to significantly change the price of mortgages.

Impact on market structure

89. Oxera found limited evidence of greater consolidation occurring in the market as a result of the responsible lending proposals. No survey participant reported being likely to acquire other distributors, with only 3% of survey participants reporting that they would be likely to acquire other product providers in response to the proposals.

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22 These may not pass the affordability test, for example, because they are in a period of temporary low income which will be followed by higher income in a few years, which the lender considered too uncertain to take into account. This group is not to be confused with borrowers who would not pass the affordability test because they cannot afford a mortgage. This latter group could be substantial, as shown in the projected impacts from our simulation model presented below.

90. Furthermore, Oxera also reported that most survey respondents (84%) indicated that they will not be changing the product focus of their business in response to the proposals. Similarly, the majority of survey respondents (69%) indicated that they do not envisage any shift in their customer focus in response to the proposals.

91. In the years preceding the crisis certain mortgage lenders – for example non-bank lenders – focused specifically on higher-risk borrowers. Though these lenders have largely exited the market as a result of the current crisis, the introduction of the proposals could impose additional barriers to entry for similar lenders in a future upswing.

92. The proposals on affordability assessment and income verification are unlikely to have a direct effect on lenders' decisions on whether to exit or enter the market. Only two of the respondents to Oxera's survey indicated that they would be likely to exit the market because of the proposals. However, since the proposals are likely to reduce the demand for mortgages – as some categories of customer will not be able to pass the new affordability and income verification tests – some lenders that have exited the market may not re-enter because of the reduction in demand for mortgages. However, Oxera was unable to provide an estimate of this effect.

93. The introduction of a higher capital requirement for non-deposit-taking lenders could potentially prevent a significant number of these firms from re-entering the market in the next upswing of the economic cycle. The costs and benefits related to this are discussed in Annex 1 Part 2.

94. Oxera conducted their analysis on the assumption that, where appropriate, there will be a transitional arrangement to the new system. Without such an arrangement, some existing mortgage borrowers may have difficulties passing the new affordability and income verification tests for some lenders. This may limit the choice of lenders for these people when they want to re-mortgage. As a result, it could diminish the competitiveness of the mortgage deal they obtain (from their existing lender or from other lenders). This issue could also be exacerbated if lenders that specialise in high-risk borrowers exit the market as a result of the proposals, or if those lenders that have already exited the market (due to current market conditions) become less likely to re-enter the market because of the proposals.[23]

Possible competitive advantage for deposit-taking lenders

95. The income verification requirement could give deposit-takers a competitive advantage over other lenders, at least when their (current account) customers apply for a mortgage. This is because deposit-takers can verify income by electronically checking their customers' current account details, without having to ask for a hard copy of their current account statement (which would be likely to take more time and require additional effort on the part of their borrowers).

96. Oxera considered this possibility and found that it is unlikely to significantly affect the competitive dynamics in the market. The evidence from the survey indicates that current account information is already being used as one of the main sources for

23 These issues and possible transitional arrangements will be presented in more depth in the next CP.

verifying income. Although the survey suggests that banks use current account information more than other lenders, some other lenders also use it. Although banks could in principle automate this, thereby speeding up the application process and/or making it easier for their customers, such a decision would not necessarily be driven by the introduction of an income verification requirement – it is something they could already do.

97. The costs of verifying income on the basis of payslips and/or copies of bank statements is estimated by Oxera to be relatively limited (£3 per standard and £12 for complex verification). Although checking current account data electronically is quicker and probably more cost efficient, it is unlikely to give banks such a cost advantage over other lenders that it would significantly affect competition.

98. Furthermore, the survey evidence indicates that deposit-takers already have some competitive advantage over other lenders. They can use their current account customer-base to cross-sell other products, such as mortgages. The incremental benefit of being able to verify income electronically may be relatively limited.

99. In addition, other methods to verify income may be introduced[24] that would be available to all lenders, i.e. deposit takers and non-deposit takers, making the verification of income on the basis of bank statements less important.

Relationships between lenders and intermediaries

100. Requiring lenders to undertake and be ultimately responsible for verifying income and for the affordability assessment could change the relationship between lenders and intermediaries. Oxera's analysis suggests lenders are likely to reduce the number of intermediaries they work with and rely more on their direct sales forces.

101. In the survey, lenders indicated that they, on average, expect a reduction of 29% in the number of intermediaries they work with. Although this would reduce the choice of consumers using an intermediary to some extent, each intermediary is still likely to have access to a sufficient number of mortgage lenders. Therefore, the reduction in the number of relationships between lenders and intermediaries may not significantly affect the degree of competition between lenders.

102. By giving lenders the responsibility to verify income and assess affordability, lenders would be expected to become more involved in the application process, which could lead them to prefer direct sales over introduced sales. Furthermore, due to current market conditions, there already appears to be a trend towards the use of direct sales forces. The survey suggests that this trend may be strengthened as a result of the proposed rules. When lenders were asked by Oxera whether they would set up a direct sales force or expand their direct sales force, 14% indicated that they had plans to do this.

103. However, Oxera analysis also suggests that the proposals could, in principle, increase the role of intermediaries in the value chain. For example, lenders are likely to implement affordability assessments in different ways. Intermediaries would be able to assist their customers (in particular those who are less likely to pass a standard

24 For example, see the discussion of the pilot scheme in Chapter 2.

affordability test because of their specific personal circumstances) in identifying lenders that would be willing to lend to them, and assist them in preparing the relevant evidence required for income verification.

Beneficial impacts on quantity and quality of transactions

104. The main benefit for consumers from the package of proposals will stem from the reduction in costs of arrears and repossessions and other associated detrimental impacts resulting from unaffordable lending. These arise from a better match between borrowing and the ability to repay.

105. These benefits would be expected from a combination of quality and quantity impacts. First, the responsible lending proposals should improve mortgage quality (the match) for certain borrowers. Otherwise unaffordable mortgages will be reduced in size to become affordable (improving their quality through a better match for the individual) and mortgages that would otherwise have been based on inflated reporting of income will be set up on more accurate information, improving their quality for both lender and borrower. Associated with this quality change is a reduction in the quantity of lending, most of it a reduction in unaffordable lending. This decrease in quantity should benefit borrowers, since the lower level of credit should more closely match what they can repay in the longer term, preventing or reducing the longer term detriment associated with unaffordable lending.

106. The analysis of the microeconomic benefits takes the following steps:

- estimating the reduction in mortgage lending due to responsible lending proposals;
- estimating the reduction in costs of arrears and repossessions for consumers and analysing the associated welfare effects of unaffordable lending; and
- estimating the benefits due to the proposals on arrears charges.

107. Consumers will also benefit in other ways from having a lower likelihood of falling into impairment. These would include, for example, a reduction in psychological detriment and a reduction in opportunity costs that would arise if essential expenditures were sacrificed to avoid arrears or repossession. Due to data limitations and the multiple methodological challenges measuring these benefits would pose we have not been able to reliably estimate these additional benefits here.

Estimating the reduction in mortgage lending

108. Unaffordable lending will be addressed in a concerted way by the proposals. Income verification and affordability requirements should ensure that lenders have the requisite information to make an informed judgement about the credit-worthiness of a potential borrower. It should help reduce inflated income that might otherwise have led to unaffordable mortgage applications. Together, these should help ensure that a borrower obtains a mortgage that is commensurate with their circumstances and that they can reasonably expect to pay back over the term of the mortgage at the point when it was sold.

109. To estimate this and other impacts, we have constructed a simulation model which builds on the empirical analysis of unaffordable lending and inflated income in the mortgage market.[25] This model provides a useful way of testing the impact of proposed policy changes on the underlying sample of borrowers.

110. The simulation model is used to estimate the impact the proposals would have had, had they been in place over the period from Q2 2005 to Q1 2009 (16 quarters). So the aim is not to project what the future impact would be; but rather the impact the proposals would have had over this period. This approach avoids the challenge of forecasting future mortgage lending and introducing uncertainty from a lack of information on a future baseline scenario where proposals are not enacted.[26]

111. The simulation model generates a distribution for mortgage transactions over the last business cycle. It simulates a baseline distribution of mortgage transactions in which proposals are not introduced, and a distribution where proposals are introduced. For each of these distributions expected arrears, repossessions and levels of mortgage lending are generated.

112. To run the simulation, it is necessary to precisely characterise the lending that will become non-compliant under the new proposals. Without this, it is not possible to quantify impacts or associated costs and benefits. Therefore, we have assumed as a working calibrating assumption that lending with a debt-service ratio[27] (DSR) exceeding a threshold will not meet the proposals. Two thresholds, 30% and 35%, are used to generate a range for costs and benefits and also to observe how impacts vary with severity of the proposals.

113. It is important to note that this choice of calibration is not a statement of policy, but rather an approximate method for measuring the impacts of the proposals for the purposes of the CBA given the data limitations we face on expenditure. The affordability assessment proposed does not specify a cap on debt-servicing ratios. As set out in the discussion in DP09/3 on the loan-to-income ratio (LTI), LTI and DSR measures are imperfect in that they are insensitive to borrower expenditures. The affordability assessment, in contrast, sets out requirements to ensure that an individual's expenditure is properly taken into account before granting a mortgage. During the consultation, we will explore other proxies for the impact of the proposals.

114. The DSR has nevertheless been used to calibrate the overall affordability impacts of the proposals because it presented, even though it does not take expenditure information into account, a positive relationship with probability of impairment (arrears or repossession) in the econometric analysis of the drivers of unaffordable lending.

115. The choice of the threshold of between 30% and 35% is also motivated from discussions with academics indicating conventional thresholds of affordability using DSRs have tended to lie between 25% and 40%.

25 An in depth discussion of this model and of the associated statistical analysis will be given in an occasional paper to be published during the consultation process.

26 In contrast, a forward-looking analysis is done in estimating macroeconomic impacts.

27 The debt-service ratio is the ratio of annual mortgage payments to annual net income after tax and national insurance.

116. The simulation also projects a certain proportion of the market as no longer being able to obtain a mortgage. This was modelled by assuming that mortgages which would require a decrease of 30% in the mortgage value to become affordable would not be granted. The rationale is that such mortgages are highly unaffordable and that reductions in mortgage size of such a drastic amount would be likely to prevent the borrower from buying a property that met their needs. This was a working assumption made to capture the possibility of exclusion from the market. Unfortunately, we did not have data available that would have permitted us to estimate this proportion. However, the assumption was made nonetheless because not modelling the exclusion of borrowers from the market would have significantly underestimated the impacts of the proposals.[28]

117. Following this approach, we simulated the impact of two scenarios:

Scenario 1: A mortgage is considered unaffordable if the debt service ratio is greater than 35%. If reducing to this level requires a reduction of less than 30% in the value of the mortgage it is reduced to have a DSR of 35%, if a greater reduction would be required the mortgage is prevented.

Scenario 2: A mortgage is considered unaffordable if the debt service ratio is greater than 30%. If reducing to this level requires a reduction of less than 30% in the value of the mortgage it is reduced to have a DSR of 30%, if a greater reduction would be required the mortgage is prevented.

118. For each scenario the simulation model projects the impacts on mortgage transactions in the period of the data (2005 to 2009) had the measures been in place then. It provides projections for the number of transactions that would have been prevented, the number of transactions where lending would have been reduced and the total reduction in the value of total mortgage lending.

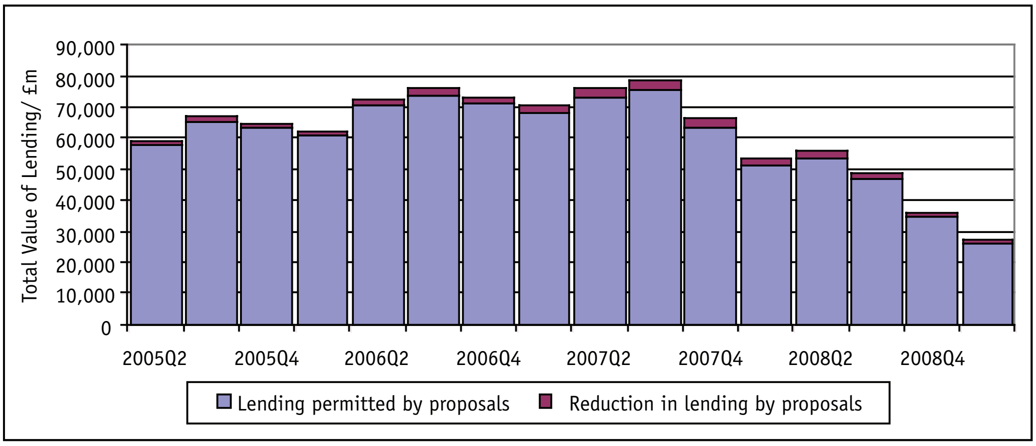
28 A mortgage that is prevented incurs a 100% drop in lending whereas a mortgage that is reduced to become affordable typically incurs a smaller reduction (as a percentage). For this reason omitting the possibility of exclusion would have led to significant underestimation of the impacts of the proposals on total mortgage lending.

Table 6 – Key projected impacts of the proposals

	Scenario 1 (DSR threshold of 35%)	Scenario 2 (DSR threshold of 30%)
Reduction in lending from mortgages reduced to become affordable[29] % of total lending	3.1%	3.8%
Reduction in lending from prevented mortgages % of total lending	0.3%	5.8%
Total reduction in value of lending % of total lending	3.4%	9.6%
% of mortgages transactions prevented	0.1%	4.1%
% of mortgages transactions that would have been reduced in mortgage amount	16.7%[30]	13.1%

119. Figures 8 and 9 show how unaffordable lending is curbed over the period for each scenario.

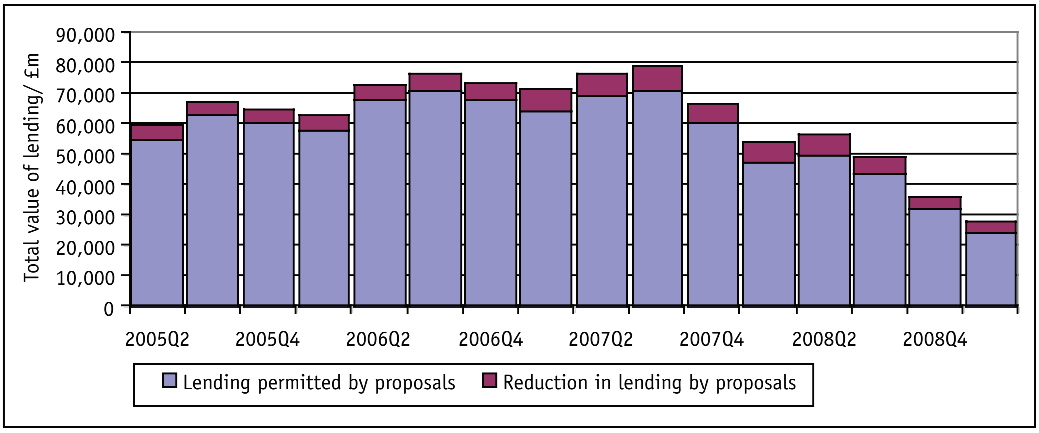
Figure 8: Lending reduction under Scenario 1 (DSR threshold of 35%)



29 Reductions in the value of lending in this table are the quarterly averages over April 2005 to March 2009.

30 This figure is higher than that for scenario 2 because some of the mortgages that would be reduced under scenario 1 are instead prevented under scenario 2.

Figure 9: Lending reduction under Scenario 2 (DSR threshold of 30%)



Estimating the reduction in costs of arrears and repossessions for consumers and the associated welfare effects of unaffordable lending

120. The main benefit is expected to arise from a reduction in unaffordable lending. Specifically the benefit is that consumers, who would have otherwise taken on an unaffordable mortgage, will face a reduced probability of arrears and repossessions and, as a result, lower expected costs associated with falling into arrears and having their property repossessed at a later date. Consumers will also suffer less associated welfare costs.

121. As discussed above, most borrowers affected by the proposals are still expected to obtain a mortgage, but a mortgage that will be diminished in size or have some other change, so that it meets new requirements. They receive a benefit from the reduced likelihood of falling in arrears or being repossessed for the more affordable mortgage they obtain. It is assumed that for these affected mortgages the probability of arrears and repossessions will decrease to the levels attributed to affordable mortgages.

122. Other potential borrowers affected by the proposals are those who cannot obtain a mortgage under the proposals. The borrowers in this group incur benefits from avoiding the possibility of arrears and repossession that could have arisen from this mortgage.

123. The simulation model allows one to calculate decreases in arrears and in repossessions that would have occurred over the period from 2005 to 2009. For those mortgages that were identified as unaffordable, the model estimates the reduction in arrears at 55,300 for scenario 1 (see section on estimating the reduction in mortgage lending) and 60,800 for scenario 2 and a reduction in the number of repossessions of around 16,900 for scenario 1 and 18,500 for scenario 2.[31]

31 In scenario 1 the proposals reduce more arrears than in scenario 2 because more impairment in scenario 1 is from arrears.

124. From the review of tariffs of arrears charges, we estimate the average costs per case in arrears at around £375.[32]

125. From the review of tariffs of arrears charges, enforcement cases and relevant literature we estimate the costs of repossession, including the costs of court proceeding commenced as £27,000.[33]

126. By multiplying the reduction in the number of arrears and repossessions by the expected cost of arrears (estimated at £375 per arrear) and the expected cost of repossessions (estimated at £27,000 per repossession), one arrives at an estimate of the expected benefit from the decrease in unaffordable lending of £475m and £520m (for scenario 1 and 2 respectively). In other words, had the proposals been in place, consumers would have incurred a benefit of between £475m and £520m over 2005 to 2009. This benefit is largely a transfer to consumers from other parties. The benefit arising from reduced arrears is a transfer from firms to consumers, the benefit from reduced repossessions is a transfer from those who would have profited from the sale of the repossessed property.

127. From these expected benefit figures one can calculate, by dividing by the number of mortgage transactions in 2005 to 2009, the expected benefit of the proposals per mortgage transaction. In these terms, if the proposals had been in place, there would have been an expected benefit of between £60 to £70 per mortgage transaction, under scenario 1 and 2 respectively.

The effectiveness of the proposed requirements (possibility of gaming)

128. As discussed above, Oxera's analysis indicates that the proposed rules do not change the incentives of lenders, those of intermediaries or the dynamics of competition. Lenders will also implement the proposals in different ways, leaving incentives for intermediaries and borrowers (in particular those less likely to pass a standard affordability test because of their specific personal circumstances) to look for lenders

32 This estimation is based on the following background information. In the calculations we distinguish between tariffs of banks, building societies and non-deposit-taking lenders for 2007 to 2009. We also distinguish between borrowers in arrears less than three months and those who are in arrears greater than three months. We included the following arrears fees and charges: monthly arrears fee, a failed or missed payment charge, a one-off fee of sending a letter to a borrower in arrears, a one-off debt counsellor visit for those who stay in arrears longer than three months. Typically lenders charge some of these fees but not all. Therefore we applied the weight of 50% to charges for arrears less than three months and 75% to charges for arrears greater than three months. Note that many of the affected (unaffordable) mortgages were originated by non-deposit-taking lenders where these fees and charges are often significantly higher. Litigation costs (such as administration costs in referring an account to solicitors to begin legal actions for taking a property in possession, letter before action and dealing with notice from borrower, costs of hearing to obtain possession order) are not included in arrears charges but in repossession costs.

33 This estimation is based on the following background information. We included the following fees: litigation and repossession administration fees, court fees, valuation fees, conveyancing fees, and estate agency fees. The average cost of litigation and repossession is around £3,000 and is based on the tariffs supplied by 12 firms as part of the charges work. These 12 firms cover 51% of the market. However, this estimate is likely to underestimate the costs of both litigation and repossession. There are a number of exclusions: (1) Early Repayment Charges (ERCs) and redemption fees are not included. In the case of ERCs, they are usually expressed as a percentage of the outstanding loan amount, which varies from borrower to borrower, and the amount also depends on how early the borrower repays; (2) some of the 12 firms in the sample identified that solicitors' costs were additional to the fees listed in their tariff but these could not be identified. Similarly, not all disbursements have been included (only the most typical ones); (3) in complex cases, a borrower will not necessarily follow a straight-forward process and as a result will often incur some additional charges over and above the ones included in our calculation; (4) there are a number of contingent charges that borrowers will incur depending on the circumstances of the case (e.g. tracing fees, surplus of distribution, possession insurance, unpaid ground rent, auction entry, debt recovery, etc.). The average loss on sale of repossessed property is £24,000 per repossession. From a survey of repossession cases and literature on the topic, we estimate that repossession properties sell for between 15% and 30% below their market average. For our calculations we take the lower estimate. We also used an average house price of £160,000.

with the most relaxed lending criteria. Lenders also still have an incentive to offer mortgages to those who would fail any affordability test if, as a group, these would be profitable to serve taking into account any regulatory penalty that might result from making these loans.

129. The extent to which these avenues will be used to bypass the new requirements depends on the implementation, supervision and enforcement of the rules. Oxera concludes that our supervision and enforcement actions and the Financial Ombudsman Service treatment of complaints by consumers with unaffordable mortgages are likely to be important in signalling to lenders the new minimum standard for lending. This will play an important role in determining the extent to which lending criteria could still be relaxed through competitive forces when the market recovers from the recent downturn.

Benefits due to the proposals on arrears charges

130. Our mortgage rules require arrears charges to be a reasonable estimate of the additional administration costs faced by the lender. For firms currently over-charging on arrears charges, this clarification could impose an ongoing cost in the form of lost revenue. This cost, however, would be transferred to affected consumers as a benefit.

131. Our review of tariffs of charges indicated that 52% of firms were charging a monthly arrears administration fee ('monthly arrears fee'), 54% of firms were charging a fee for sending a letter to a borrower in arrears, and at least 69% of firms were levying failed or missed payment charges.[34] In the fee justifications that we reviewed, we found that some firms were over-charging relative to their administration costs:

a) out of 11 firms reviewed, four firms over-charged on their monthly arrears fees. On average, the amount of over-charge was 10%.

b) out of five firms reviewed, four firms over-charged around 20-30% on missed payments (unpaid direct debit and unpaid cheque fees); and

c) there were instances of over-charging on other arrears fees but the proportion of firms over-charging relative to those under-charging was less significant.

132. By limiting the number of times missed payment fees are charged, consumers will benefit from the transfer from the firm of that arrears fee amount. From our arrears thematic work[35], we identified at least four firms who were charging missed payment fees more than twice per month. These four firms have a less than 1% share of the mortgage market, however. Although the customers of those firms would benefit from the transfer from the firm of the arrears fee amount, the evidence suggests that overall the proposal would have a limited impact on the market. In addition, the rule change will still allow lenders the flexibility to try to recover a missed payment

34 The review of tariffs of charges covers 110 lenders for 2007 to 2009 (93% of the regulated mortgage market) and a number of fee justifications from 26 lenders (54% of the market).

35 We commissioned a thematic review of lenders' compliance with our arrears handling rules in December 2007.

more than twice per month, provided they bear the administration cost in these instances. So the rule should not affect the effectiveness of debt recovery for firms.

133. From our dataset on arrears, we estimated around 130,000 borrowers to be within the first two months of missing a mortgage payment. The proposal to widen MCOB 12.4 to apply to all payment difficulties ensures that firms will not front-load charges onto the first two months to avoid our rules requiring arrears charges to be a reasonable estimate of the additional administration costs faced by the lender. However, the proposal should not have significant cost implications for firms. From the review, most firms do not differentiate their tariffs or fees depending on whether a borrower is in arrears for one, two, or more months (though some types of charges are contingent on certain events occurring). The proposal nevertheless provides a benefit to consumers by acting to prevent this practice from emerging.

134. There is a possibility that a number of firms who currently under-charge relative to their administrative costs would increase their charges up to any baseline figure that we set or report, resulting in increased fees for borrowers. Although such an increase would reduce the benefit of our proposals, from the review of tariffs of charges the instances and the magnitude of under-charging are limited. For this reason we do not expect the reduction in benefit to be significant.

135. Given genuine differences in underlying costs between lenders, supervisors may also face a challenge in identifying and tackling firms that are charging equal or below the average across the industry but above their administrative costs. Success in meeting this challenge will depend on the effectiveness of supervision and enforcement in identifying and dealing with instances on non-compliance with the rules and the Financial Ombudsman Service's treatment of complaints by consumers.

136. The benefit arising from reduced arrears is largely a transfer from firms to consumers. However, the proposals on arrears charges would provide a net benefit to consumers by marginally increasing the probability that they exit arrears earlier from the receipt of the reduction in arrears charges.

Benefits from proposals on debt-consolidation for re-mortgage and purchase transactions

137. Consumers will benefit from being more able to afford their mortgage, since the proposal should ensure that debts are repaid, as expected in the affordability assessment undertaken by the lender at the outset of the mortgage. The lender also benefits from the consumer being more able to make their mortgage payments.

Macroeconomic impacts

138. This CBA focuses on the microeconomic implications of the proposals. However, the macroeconomic implications of the proposals are also potentially significant. This section presents a preliminary cost-benefit analysis for the macroeconomic impacts. The analysis in this section is preliminary and may be developed further in future work.

139. The direct impact of the affordable lending proposals will be to restrict residential mortgage lending transactions i.e. some borrowers will be pushed to reduce the size of their mortgage loan, postpone their mortgage, or to not obtain a mortgage. The aggregate result will be a reduction in mortgage lending, most of which should be a reduction in lending that would otherwise have been unaffordable.

140. Reducing mortgage lending could have both positive and negative impacts on economic growth. By having lower or no mortgage payments, consumers will have additional disposable income that, depending on individual circumstances, may be directed towards paying rents, increasing savings or increasing consumption. Lenders, for their part, will be expected to re-direct the credit that would have been directed to unaffordable mortgage lending. Higher-risk lending to other groups might increase as banks and other mortgage lenders choose to invest in high-risk assets to substitute for the loss in higher-risk mortgage lending. The resulting changes to consumer expenditure, to the supply of credit and to lenders' balance sheets could have a wide range of macroeconomic effects.

141. Reduced mortgage lending would also be expected to dampen growth in house prices. This could smooth housing bubbles and reduce their detrimental impacts in subsequent housing crashes, raising economic growth over the longer term. Conversely, reductions in house prices could reduce collateral values, potentially reducing borrowing to households and businesses, reducing consumption and investment and potentially reducing economic growth in the shorter term. As with the impacts of lending changes, changes in house prices could have both positive and negative impacts.

142. We used a series of models to provide an estimate of the macroeconomic impacts, including net impact on economic growth:

a) The simulation model above was used to project changes in the total volume and value of mortgage lending.

b) The NiGEM model, a general equilibrium model of the global economy developed by NIESR[36] was used to estimate general macroeconomic impacts.[37]

c) The crisis model,[38] developed by the FSA in conjunction with NIESR, was used to estimate the change in a probability of a crisis over the business cycle.

d) The NiGEM and the crisis model taken together then project net macroeconomic impacts.

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36 National Institute of Economic and Social Research.

37 The NiGEM model also projected the change in house prices from the change in mortgage lending as part of its modelling the general macroeconomic impacts. This is not ideal, given that the NiGEM model does not model the direct impact of mortgage lending to house prices. Nevertheless it did project significant falls in house prices from the reduction in lending. In addition, the impact of a drop in lending on house prices was also modelled using the Oxford Economic Forecasting model, another model of the global macroeconomy. This gave similar house price impacts to those from NiGEM. Future work could focus in part on this issue, improving the modelling of house prices, either within NiGEM or using a separate model of house prices and mortgage lending.

38 For further details on the NiGEM, the crisis model (developed in conjunction with NIESR) and how the FSA has developed and is using these, see Occasional Paper 38 'Optimal regulation of bank capital and liquidity: how to calibrate new international standards', www.fsa.gov.uk/Pages/Library/research/economic/Occasional/index.shtml. A potential concern in using the crisis model here is that the proposals are intended to lead to a structural shift in the mortgage market. If this shift were to significantly change the relationship between mortgage lending and house prices, then this could affect the relationship between housing bubbles and financial crises, on which the crisis model was estimated.

143. For each of the two scenarios considered in the simulation model the projected reduction in residential mortgage lending was modelled in NiGEM and the crisis model to estimate its impact on net economic growth. This projected a range of net impacts of the proposals on growth from a negligible impact to a net increase of 0.1% to average yearly real GDP growth. Under both scenarios there was a small benefit to financial stability of the reduction in housing bubbles. However, in scenario 1 these benefits were offset by costs from other macroeconomic impacts.[39] The more substantial net benefit occurred in scenario 2 (DSR threshold of 30%), where the affordability requirements are stricter and the benefit from improving financial stability is greater.

144. These first estimates of the impacts were for the introduction of proposals given the current prudential measures. To consider the impact of the proposals once forthcoming prudential measures are introduced, the analysis was repeated assuming some of the prudential proposals currently under international debate had also been implemented. This projected a range of net benefits of the proposals from a negligible amount to a net increase of 0.05% to average real GDP growth. As before, scenario 2 was more net beneficial; in both scenarios the impact of the proposals on financial stability was reduced.

145. These estimates are for situations where prudential measures have been introduced that already address financial stability issues. This, we suspect, in part explains the small net beneficial macroeconomic impact observed for the responsible lending proposals, since proposals are being introduced in a context where prudential measures are already acting to smooth housing bubbles and reduce the probability of financial crises, reducing the potential for the responsible lending to increase financial stability. This is supported by the result that the addition of further prudential measures further weakens the beneficial impact of the responsible lending proposals on financial stability.

Transition and timing issues

146. We are considering when the proposals should be implemented and what transitional measures may be needed to facilitate their introduction.

147. On the issue of timing, we expect that it would be less difficult for lenders to adapt to proposals introduced during a trough of the business cycle rather than during an upswing. During the trough, lenders are already incentivised to be more conservative in their lending. As a result, lending standards are more likely to be closer to, or already satisfy, the new proposals for responsible lending. Introducing proposals in the trough, therefore, impacts lending in the mortgage market less, making the transition to the new responsible lending standards less costly in the long run. In contrast, during an upswing, the opportunity to increase market share and profit from increasing demand provides incentives for lenders to relax lending criteria and

39 Under both scenarios, house prices fell sharply and then regress to their baseline value in the long run. As a result the costs of the policy emerge in the short term while benefits accrue over the longer term.

to lend more. Imposing the proposals in this period would lead to more material changes to lending in a short period, thus imposing greater costs.

148. We are also considering borrowers who may be prevented from remortgaging if we implement them during a trough. This would include borrowers who would not have been able to obtain a mortgage if the proposals had been in place when their mortgage was obtained. It would also include borrowers who borrowed affordably but, due to changes in circumstances, can no longer afford a mortgage; these borrowers would be expected to be more numerous during a trough of the business cycle. These groups of borrowers could face undue detriment if proposals were introduced without some transitional provision to prevent their inability to remortgage being exploited. Given this, we are considering transitional arrangements focused specifically at these groups. The results from this work will be presented and consulted on in a forthcoming CP to be published later this year.

Q35: Do you have any comments on the cost-benefit analysis for our proposals on responsible lending & arrears charges?

High-level cost-benefit analysis on current position on interest-only mortgages and non-banks

Interest-only mortgage proposals

Compliance costs

1.1 The compliance cost for any proposals regarding interest-only mortgages will be estimated if and when we consult on draft rules. However, Oxera included questions in its survey gathering some information on what could drive the costs arising from these proposals. Very few lenders responded to the survey questions about the costs of verifying the existence and adequacy of a repayment plan. However, several lenders reported to Oxera that the costs could be significant, depending on the type of evidence that would be required to prove that a repayment plan indeed exists. These costs would probably vary by type of repayment plan.

Benefits

1.2 Interest-only mortgages carry risks that may cause detriment to consumers. As we discussed in Chapter 2, interest-only mortgages have often been taken to extend affordability, with no definite plan in place to repay the capital. It is likely that sales of interest-only mortgages will reduce materially as a result of any proposal. Tightening our interest-only requirements should benefit consumers by reducing the risk that they are unable to repay their mortgage at the end of the term, reducing the risk of losing their homes and associated welfare costs. We will carry out further analysis on these issues, which will inform any policy proposals in this area.

Potential indirect effects

1.3 Any proposal could deter a number of consumers from obtaining a mortgage who would have been able to repay the capital at the end of the term. Those consumers would incur a cost from staying in their original property or renting an alternative property instead of buying the property they prefer. In addition, any proposal could affect existing customers with interest-only mortgages, when they remortgage. These issues and possible transitional arrangements will be analysed and presented in more depth in further consultation.

1.4 A proposal to verify the existence of a repayment vehicle for interest-only mortgages could create incentives to have the same provider for the mortgage and the product to repay the mortgage. These providers could benefit through the introduction of automated systems to verify the existence and adequacy of a repayment vehicle. It could also increase switching costs for consumers who decide to remortgage with a different provider: either the borrower has to move the repayment vehicle to a new mortgage provider or face some costs of periodical re-verification. This could have some impact on competition in the market. However, Oxera analysis suggests that cross-selling opportunities already exist so the effects may not be material.

Non-bank proposals

Compliance costs

1.5 The impact of the package of measures discussed in Chapter 6 of this Consultation Paper cannot be determined at this point given their high-level nature but will be investigated as policy measures are developed. However, it is reasonable to believe that some of the proposed measures, such as increases in capital requirements for non-banks, could materially increase costs for such firms.

Benefits

1.6 Increased requirements are likely to lead to both an increase in the cost of the mortgages non-banks provide and a decline in the level of non-bank lending. Our preliminary analysis has found evidence that lending by non-banks may have an impact on house price growth. Decreasing levels of non-bank lending could potentially reduce volatility in house prices and, in turn, the probability of a financial crisis occurring.

1.7 As well as benefits from a reduced probability of financial crises, there could be welfare benefits from the potential reduction in volatility. Research by the London School of Economics has suggested that possible non-monetary welfare gains from higher capital requirements are greater than the welfare losses from reduced lending. The non-monetary welfare gains arise as consumers value a more stable financial system.[1]

Potential indirect effects

1.8 It is possible that policy measures on non-banks could have unintended adverse impacts on competition. In their response to DP09/3, the Office of Fair Trading (OFT) raised concerns that an increase in minimum capital requirements for high-risk mortgage lenders might have an adverse impact on competition in the mortgage market as it could increase entry and exit barriers to the market. Impaired competition may lead to a reduction in the supply of mortgages available. We will investigate the impact on competition in detail as policy proposals are developed.

> Q36: Do you have any comments on the high–level cost-benefit analysis on our current position on interest-only mortgages and non-banks?

1 FSA/LSE (2010), Quantifying the Benefits to Consumers of Having a More Stable Banking System.

Compatibility statement

Introduction

1.1 In this section we set out our view on how the proposals and draft rules in this CP are compatible with our general duties under Section 2 of FSMA and our regulatory objectives set out in Sections 3 to 6 of FSMA. This section also outlines how our proposals are consistent with the principles of good regulation (also in Section 2 of FSMA) to which we must have regard.

Compatibility with our statutory objectives

1.2 The policy proposals and draft rules in this CP contribute to all of our statutory objectives, more materially to some rather than others.

Market confidence

1.3 We believe that our policy proposals will improve the quality of lending. This is especially true with regard to the rigorous assessment of affordability. In turn, we would expect this to lead to a higher level of consumer confidence when borrowing.

Consumer protection

1.4 Currently, some consumers have suffered significant detriment stemming from a mortgage that is unaffordable. Our draft rules tackle this detriment. In addition, our changes clarifying the rules for arrears charges should prevent consumers incurring costs that do not stem directly from extra administration for the lender as result of the consumer's payment difficulties.

Reducing financial crime

1.5 The requirement for income to be verified in every case will supplement other measures expected of firms to minimise the risk of mortgage fraud.

Promoting public awareness

1.6 As well as imposing new obligations on lenders, the proposed requirements on income verification and affordability assessments will have the effect of highlighting to borrowers the importance of fully considering their purchasing decision. Alongside this, we will be working with CFEB to continue and extend a number of initiatives aimed at promoting greater understanding and knowledge among mortgage borrowers, as well as targeting particular assistance towards those at higher risk.

Financial stability

1.7 In comparison with the past, our proposals will mean a reduction in unaffordable lending. In some cases this will mean that mortgage borrowing does not happen, in others it will mean that the amount borrowed is reduced. This reduction in the volume of unsustainable borrowing will contribute to greater financial stability.

Compatibility with the Principles of Good Regulation

1.8 Section 2(3) of FSMA requires that, in carrying out our general functions, we consider the principles of good regulation. The proposals we set out in Chapters 3 to 5 fulfil all seven of our principles of good regulation:

a) The need to use our resources in the most efficient and economic way

1.9 As outlined in the CBA at the beginning of this Annex, we anticipate devoting additional resource to supervision and enforcement to ensure the delivery of our new requirements. In line with our approach elsewhere, we will use thematic tools to ensure efficient use of our resource.

b) The responsibility of those who manage the affairs of authorised persons

1.10 Our proposals clarify and strengthen the principle that the ultimate responsibility for assessing affordability rests with the lender. The approach in the draft rules allows firms to decide how to give effect to this.

c) The principle that a burden or restriction which is imposed should be proportionate to the benefits

1.11 The proportionality of our approach is addressed in the CBA at the beginning of this Annex. Our conclusion is that the cost of the specific proposals are significantly outweighed by the benefit, both in terms of the reduced detriment arising from unaffordable loans and the macroeconomic impact of more sustainable lending.

d) The desirability of facilitating innovation

1.12 Our proposals will constrain unaffordable lending, with an impact on innovation by firms that have moved higher up the risk curve. However, within these parameters the draft rules allow for innovation, firms being responsible for determining how best to verify income and robustly assess affordability.

e) The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

1.13 In developing our proposals we have had particular regard to international parallels, and especially the possibility of European intervention on responsible lending and borrowing. This remains a key dependency, as we are mindful of the need to minimise the number of changes for firms. Our assessment is that the changes we need to make now to address specific UK market issues will not have a materially damaging effect on the competitive position of the United Kingdom.

f) The need to minimise the adverse effects on competition

1.14 As explained in the CBA at the beginning of this Annex we believe our proposals will have minimal adverse effects on competition.

g) The desirability of facilitating competition

1.15 As explained in the CBA at the beginning of this Annex, we do not believe our proposals will have a material effect on the facilitation of competition.

Why our proposals are most appropriate for the purpose of meeting our statutory objectives

1.16 Our proposals draw on a comprehensive evidence base, and follow from extensive engagement with those interested in the mortgage market. We have previously reported on the feedback to the DP[1] and have taken account of these views in our further policy development. We have also had many helpful discussions with a wide range of stakeholders in the lead up to this CP, adding to our knowledge of the market issues and the complexities to be addressed.

1.17 We have undertaken specific analysis, both of the factors underlying subsequent loan arrears and repossessions, and the charges imposed on customers in payment difficulties. The findings from these analyses are described in Chapter 3 and 4 respectively.

1.18 Our policy proposals are fully informed by this evidence, analysis and debate. We believe the proposals described in this CP represent the most appropriate and proportionate approach to ensuring that lending and borrowing, that is sustainable and affordable. The proposals will benefit both firms and consumers by ensuring that affordability is at the heart of every lending decision. They will also protect consumers from the risk of unfair charges being imposed if they are in payment difficulties.

Q37: Do you have any comments on the compatibility statement?

1 FS10/1: *Mortgage Market Review: Feedback on DP09/3*. March 2010

Arrears charges analysis

Executive summary

1. This annex sets out the key factual findings from our review of arrears charges, which we discuss in Chapter four of this Consultation Paper.
2. We have used two key sources of information to inform our review of arrears charges:
   - a review of tariffs of charges from 110 lenders for 2007, 2008 and 2009 – these lenders hold approximately 93% of first-charge mortgage contracts;[1] and
   - a more detailed review of the fee justifications provided by 26 lenders, covering 54%[2] of the first-charge regulated mortgage market.

Key findings: review of tariffs

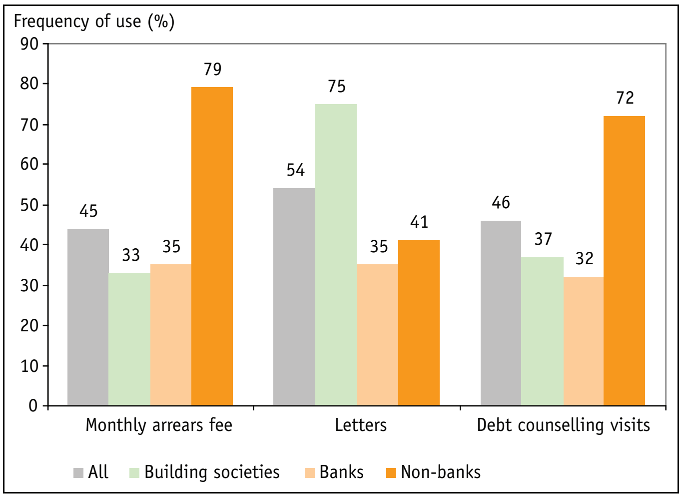
3. There was significant variation in the quality of the tariff information that we received.
4. Our findings show that in November 2009:
   - 52% of firms charged a monthly arrears fee or periodic fee for dealing with borrowers in arrears;
   - 54% of firms charged a fee for sending a letter to a borrower in arrears;
   - 5% of firms charged a fee for phoning a borrower in arrears;
   - 46% of firms charged for debt counsellor visits, and just under a third of these firms charged a fee if the borrower cancelled the visit or didn't attend;
   - 11% of firms charged a fee for capitalising arrears;
   - 97% of firms said they did not apply additional interest to borrowers in arrears; and

1 Based on MLAR data Q4 2009
2 Based on MLAR data Q4 2009

- the fees charged for litigation and repossession can be significant – one bank indicated a borrower could incur approximately £1600 in fees (plus 1.9% of the sale price).

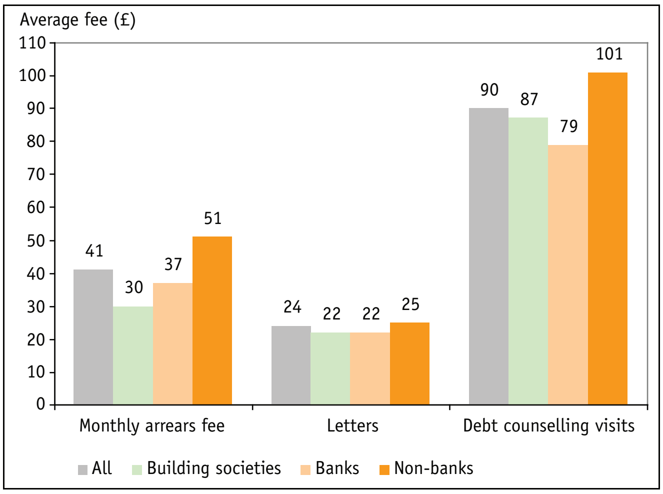
5. Our findings suggest that an important driver of mortgage arrears fees is the type of lender. For most of the fees we looked at, non-deposit taking lenders (non-banks)3 were more likely to charge fees (see Exhibit 1).

Exhibit 1: Charging of fees by lender type (Nov 2009)



6. Additionally, non-banks charged higher fees than banks and building societies (see Exhibit 2).

Exhibit 2 Average fees by lender type (Nov 2009)



7. In recent years, there have been small but steady increases in arrears fees across the market (see Exhibit 3). However, we found significant variation in the level of all types of arrears fees across the market. So the average fee cannot be considered a good indicator of the amount a firm is likely to charge.

3 This includes specialist lenders and subsidiaries of deposit takers.

Exhibit 3: Average fees 2007 to 2009

Type of fee[4]	Nov 2007	Nov 2008	Nov 2009	Increase 2007-09
Monthly arrears fee	£39	£42	£41	5%
Letters[5]	£23	£23	£24	4%
Debt counsellor visits	£85	£87	£90	6%
Returned / un-paid cheque	£25	£25	£26	4%
Un-paid Direct Debit	£26	£26	£27	4%

Key findings: review of fee justifications

8. Our Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) rule 12.4.1 R requires arrears charges to be based on a reasonable estimate of the cost of the additional administration required as a result of the customer being in arrears. However, we found that:

   - some lenders were unable to break down their costs between the different types of arrears fees being charged;
   - some did not provide fee justifications for fees such as missed payments, which are often applied to borrowers in arrears; and
   - some lenders who had outsourced the administration of their mortgages were not able to access detailed servicing cost information relating to their mortgage books.

9. It was clear from the fee justifications that most lenders had not adequately considered the underlying costs when setting their arrears charges. There was significant variation between firms' assessment of their costs and the fees they charged. We found that some firms were over-charging and other firms were under-charging relative to their administration costs. Similarly, even within the same firm, some fees were in excess of the underlying costs, while other fees were below.

10. We reviewed fee justifications for monthly arrears fees from 12 lenders, covering approximately 44% of the market. Our findings show that:

    - on average, monthly arrears fees made up approximately 70 to 75% of total arrears fee income received by these lenders;
    - for most deposit takers in our sample, mortgage arrears fee income accounted for less than 1% of total income;

4 Firms that did not identify the amount and instead specified the charge as 'variable' were excluded from the average charge calculation. Where firms stated a range, the mid-point in the range was used for the purposes of the calculation. We used the same sample of firms for all three years.

5 Calculation excludes letters before legal action

- for non-banks, arrears fee income ranged from 4 to 30% of total income;
- seven lenders were charging equal to or below costs, four firms were charging above cost, and we were unable to reach a conclusion on one fee justification; and
- of those lenders who were over-charging, the profit element ranged from 6 to 15% of the fee.

11. Of the fee justifications we reviewed for letters, phone calls and debt counsellor visits, we found that:

    - only one lender provided a robust fee justification for letters and was assessed to be charging below cost;
    - none of the three lenders we assessed were able to provide an adequate fee justification for phone call fees – one of these lenders has since removed the fee and another lender has reduced the charge by 50%; and
    - of the nine fee justifications we reviewed on debt counsellor fees (from lenders covering 43% of the market), eight firms were charging equal to or below the administration costs and one fee justification was unreliable.

12. We also reviewed fee justifications for missed payments, capitalisation fees, and fees for litigation and repossession. We found that:

    - four out of five firms were charging above the administration costs they incurred for missed payment fees;
    - the extent of over-charging for missed payment fees was significant, ranging from 13 to 64%;
    - of the four fee justifications we reviewed on capitalisation fees, two firms were charging above administration costs, one firm was charging below, and the fourth firm has since ceased to charge the fee;
    - four of the seven lenders we assessed were making a profit from one or more of their legal fees; and
    - three out of five lenders we assessed were making a loss on their repossession fees, one was making a profit, and one provided insufficient information to reach a conclusion.

13. In our assessment, there were genuine variations between the additional administration costs that lenders were incurring for the handling of borrowers in arrears. Aside from the different cost allocation methodologies that lenders adopted, there was significant variation in the salaries of staff dealing with borrowers in arrears and the time spent by firms on arrears handling per case. Another significant factor driving cost variations was the extent to which arrears handling activities were outsourced or undertaken in-house.

Methodology

14. We have used two key sources of information to inform the review of mortgage arrears charges in the market.

Review of tariffs of charges across the market for 2007, 2008 and 2009

15. To understand the charging practices of lenders in the market, and to identify outliers and increases in charges over time, we requested lenders to provide us with their tariffs of charges for 2007, 2008 and 2009.

16. For the purposes of our review, we have assumed that firms' charging practices are aligned to the tariffs of charges they provide to their customers. Electronic transactional level data, detailing every charge that every customer incurs, is not readily available and obtaining such data would have significantly delayed this review.

17. We reviewed tariffs of charges supplied by 110 lenders. These lenders hold approximately 93% of the first-charge regulated mortgage contracts.[6] The remaining 7% of the market either did not respond or did not provide complete tariff information for all three years. We consider that our sample of lenders is representative of the first-charge mortgage market we regulate.

18. In six cases, more than one tariff of charges was in operation for the same time period for the same firm.7 This was because:

- Firstly, a few firms had a separate tariff for a separate mortgage brand in operation within the same firm. Where this was the case, we have counted the brand as a separate firm for the purposes of the review.
- Secondly, a few firms had more than one third-party administrator administering their loan book with different fees being applied. In this case, we have averaged the fees being applied within that firm to obtain a representative figure of that firm's charges.
- Thirdly, one firm had different tariffs operating for prime and credit-impaired customers. As above, we averaged the fees applied to obtain a representative figure.

Review of detailed fee justifications

19. In addition to the review of lender tariffs of charges, we have also reviewed detailed fee justifications from 26 lenders, covering 54% of the first-charge regulated mortgage market.[8] This includes three firms whose arrears charging practices are currently under investigation by FSA Enforcement.

20. Because we aimed to better understand charging practices within the market, the sample does not comprise solely the largest firms or firms that we suspected of non-compliance. Rather, we looked at a range of business models and different lenders within the market. The fee justification sample includes eight banks, eight building

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6 Based on MLAR data Q4 2009

7 In most cases, each firm with an FSA FRN (Firm Reference Number) was counted as a separate firm for the purposes of our review.

8 Based on MLAR data Q4 2009

societies, and ten non-banks. The sample also includes a mixture of 21 small lenders and five large lenders.

21. Our review of fee justifications was restricted by the lack of quality information held and provided by lenders. Three factors have limited the level of available cost information supporting specific fees:

- Firstly, some lenders were unable to provide fee justification exercises for each of their arrears fees on a fee-by-fee basis. One large lender, for example, compared their arrears fee income with the relevant department costs, rather than allocating costs to each of the types of arrears charges.
- Secondly, some lenders did not provide fee justification exercises for costs such as missed payment fees.
- Thirdly, a number of lenders have outsourced the administration of their mortgage books to third-party administrators. For these lenders, very little detailed cost information was available.

Monthly arrears fees

22. Of the 110 tariffs reviewed from November 2009, 52% of firms were charging a monthly arrears administration fee (monthly arrears fee) or periodic arrears fee for dealing with borrowers in arrears. This is comprised of:

- 41% charging solely a monthly fee;
- 4% charging solely an annualised or one-off administration fee;
- 4% charging both an annualised/one-off administration charge and a monthly arrears fee;
- 3% charging a quarterly fee; and
- one firm charging a weekly fee.

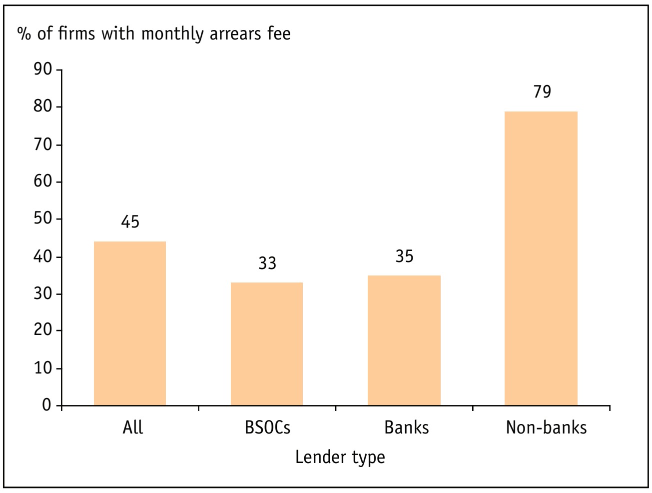
23. Looking at charging practices from November 2007 to November 2009, we found no significant change in the number of firms charging a monthly arrears fee. Similarly, there was no significant change in the number of tariffs with an annualised/one-off fee, a quarterly fee or a weekly fee. However, a number of individual firms have varied their charges. For example, one firm stopped charging a monthly arrears fee after March 2009.

24. Two firms were charging a percentage of the outstanding debt (subject to a maximum cap) rather than a fixed fee. We reviewed the underlying cost justification from one of these firms. Up until October 2009, this firm's arrears fee was based on a rate of 2% per month of the amount of arrears over 2 months, this was capped at a maximum of £100 per month. This could have been charged to a maximum of once per month. Further investigation showed that the average fee charged by this firm in the year ending 30 September 2009 was over £70, which was significantly higher than the attributable costs of £50 identified by the firm.

Charging of a monthly arrears fee by lender type

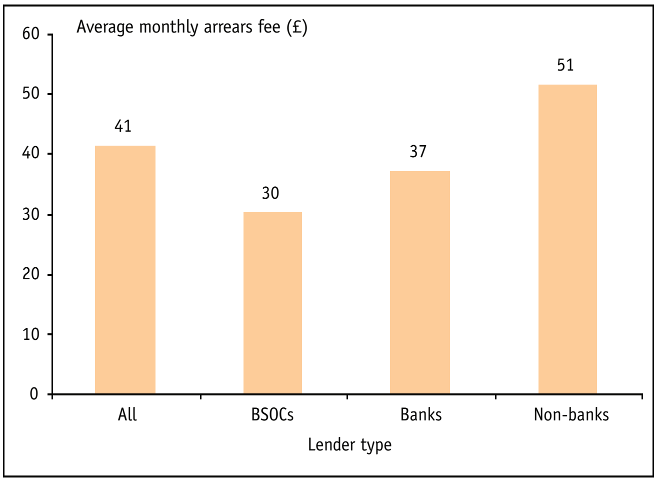
25. Charging monthly arrears fees varied significantly by lender type, with non-banks being significantly more likely to charge a monthly arrears fee than banks or building societies (see Exhibit 4).

Exhibit 4: Charging a monthly arrears fee by lender type (Nov 2009)[9]



26. Non-banks are also more likely to charge higher monthly arrears fees than banks or building societies. For example, in November 2009, non-banks had a significantly higher average monthly arrears fee when compared to banks and building societies (see Exhibit 5).

Exhibit 5: Average monthly arrears fees by lender type (Nov 2009)[10]



9 All tariffs with a monthly fixed arrears fee.
10 All tariffs with fixed monthly arrears fee, excl firms with both a one-off and monthly fee.

Firms that don't charge monthly or periodic arrears fees

27. Of the tariffs current at November 2009, 48% of firms did not charge a monthly or periodic arrears fee. These firms were predominantly banks and building societies, rather than non-banks.

28. Of the firms that do not charge for monthly or periodic arrears fees, 72% charge for letters and 7% charge for late payments. This suggests that the majority of firms who do not charge a monthly or other periodic arrears fee, recover their underlying costs through alternative types of fees.

29. Nevertheless, there appears to be a small number of firms that simply absorb the administration costs within their overall business.

30. We questioned one large and one small lender on why they don't charge a monthly arrears fee. The small lender noted that very few regulated mortgages per year come under the control of their Debt Management Department. They also said that:

> 'In most instances, the customer seeks to co-operate, and therefore we have taken the decision not to apply an additional administration cost to what is already a difficult position. In addition, the application of such fees would be a manual procedure, and at this juncture this is not considered cost effective given the scale of the book.'

31. Similarly, the large lender noted that their delinquency rates are low and the costs are accordingly low. They saw this as an incentive to ensure that responsible lending standards are maintained. They also said that:

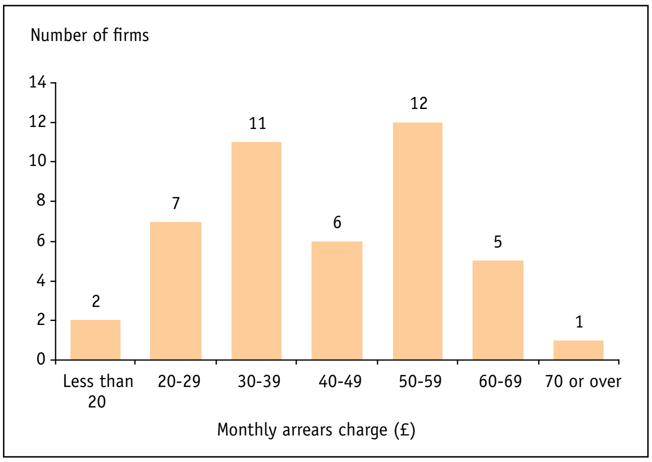
> '[We] do not believe that the application of fees and higher interest charges is helpful to the customer at a time of financial difficulty when they are at risk of losing their home.'

The average monthly arrears fee is £41

32. Of the firms that charged monthly arrears fees, the average fee charged was £41 per month in November 2009.

33. However, the amount varied significantly across the market, ranging from £10 to £175. Two-thirds were charging between £30 and £59, 14% were charging £60 or over and 20% were charging less than £30 (see Exhibit 6).

Exhibit 6: Frequency distribution of monthly arrears fees (Nov 2009)[11]



34. There has been a 5% increase in the average monthly arrears fee between 2007 and 2009. In November 2007, the average monthly arrears fee charged by these same firms was £39.

The fee justifications provided by lenders for monthly arrears fees

35. We reviewed fee justifications for monthly arrears fees from 12 lenders. As at December 200912, these lenders held approximately 44% of the first-charge regulated mortgage market. The monthly arrears fees of these 12 lenders ranged from £20 to £70.

36. Based on the detailed arrears information sent by these lenders, it appears that monthly arrears fees make up approximately 70% to 75% of the total arrears fee income received by lenders (though this varied from lender to lender). The proportion of arrears income compared to total income for non-banks was considerably higher than for deposit taking lenders. For most deposit-takers in our fee justification sample, mortgage arrears fee income accounted for less than 1% of their total income. For non-banks, arrears fee income was significantly more important to their total income, and ranged from 4% of total income to over 30% of total income.

37. The monthly arrears fee was the fee for which we received the most comprehensive fee justifications. Nevertheless, it is clear from the fee justification exercises that most lenders had failed to consider adequately the additional administration costs when setting their arrears charges. There was significant variation between firms' assessment of their costs and the fees they charged.

38. Of the 12 fee justifications for monthly arrears fees that we reviewed, we found that seven firms were charging equal to or below the administration costs they incurred and four firms were charging above the administration costs they incurred. Based on our assessment of the underlying costs, the over-charging included a profit element of 6 to 15% of the arrears fee. One cost justification had such large discrepancies in its methodology that we were unable to conclude what the genuine underlying administration costs were.

11 All tariffs with fixed monthly arrears fee, excl firms with both a one-off and monthly fee.
12 Based on MLAR data Q4 2009.

39. The variation in arrears fees is driven by two main factors, which are:

- the length of time that lenders' staff spend per fee raised; and
- the level and types of overheads and other costs included in the justification exercises.

40. The timings per charge (excluding two outliers) range from 43 minutes to 127 minutes (with the average being approximately 90 minutes). Part of this time represents non-productive time (such as holidays and training) and part of this time is based on mortgage arrears management time, which does not result in fees being charged.

41. In respect of overheads, 2 of the 12 lenders excluded overheads from their fee justification exercises, which we consider to be attributable to monthly arrears fees. However, 5 lenders attributed overhead costs that were excessive and remote from the additional administration required for handling of borrowers in arrears:

- One specialist lender, for example, included an overhead for a 'Management charge' of £29 for each monthly arrears fee raised in 2008. This related to the executive management of the firm;
- Another lender had adjusted their income levels for fee write-offs (i.e. where some borrowers in arrears had not paid the arrears fees due). In effect, this cost is being recovered from borrowers in arrears who do pay their arrears fees;
- One small lender applied a funding cost of over £4 for every minute of staff time in its fee justification exercise; and
- The same lender as above appeared to include some of its main business bank charges in its costs to allocate to the fee justification exercise.

Fees for letters

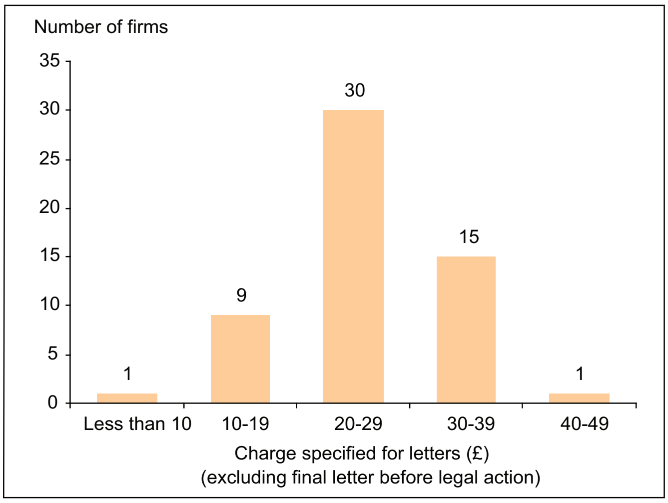
42. Of the tariffs supplied for November 2009, 54% of firms listed a fee for sending a letter to a borrower in arrears.

43. Of the tariffs that list charges for letters, 28% list a specific charge for final letters before legal action. However, many tariffs only provided limited information about the circumstances in which firms charge for letters.

44. In November 2009, the average fee charged by these firms per letter was £24. This excludes fees for final letters before legal action, which are significantly higher and often involve external solicitors.

45. Like monthly arrears fees, there was a significant amount of variation in the amount charged for correspondence fees [see Exhibit 7].

Exhibit 7: Frequency distribution of amount charged for letters/correspondence (Nov 2009)



46. In November 2007, the average fee for letters charged by these same firms (excluding final letters before legal action) was £23. This is marginally lower than the average of £24 in 2009.

47. Charging for letters varied significantly by lender type, with building societies being significantly more likely to charge for a letter to a borrower than banks or non-banks (see Exhibit 8).

Exhibit 8: Charging for letters by lender type (Nov 2009).

All tariffs	Building societies	Banks	Non-banks
54%	75%	35%	41%

48. However, non-banks were more likely to charge higher fees for letters. For example, in November 2009, the average letter fee charged by non-banks was £25, compared to £22 for banks and building societies.

The fee justifications provided by lenders for letters

49. Only one lender provided robust fee justification information for their charge for letters to a borrower in arrears. This firm provided information for a 'final collections letter' fee of £10. This was based on 54 minutes of activity (and so appears to relate to an individually tailored letter) with associated costs of £22. So, for this letter, the firm is charging below the administration costs it is incurring.

Fees for phone calls

50. On the tariffs supplied for November 2009, only 5% charged specifically for phone calls. The amount charged ranged from £20 to £35 per call.

The fee justifications provided by lenders for phone calls

51. We were provided with three fee justifications for arrears telephone call charges. None of these lenders were able to adequately justify that the fee was a reasonable pre-estimate of costs.

52. As a result of the fee justification exercise, one lender reduced its telephone charge by over 50%. However, the lender has included costs such as financing charges and bank interest in its fee justification. So the new charge proposed by the firm is still higher than the attributable costs.

53. Another lender who provided a fee justification exercise for telephone calls also charged a monthly arrears management fee. The timings for the different activities suggest that the lender has not double-counted costs. That said, the lender included staff costs, which appear extremely high compared to other lenders. When these costs are adjusted, it appears that the lender is making a profit from its arrears telephone charges, or a contribution to costs unattributable to arrears activities.

54. A further lender (with a telephone call charge of £25) responded that the charge was difficult to justify and that it had never been charged. This lender has now removed the charge from its tariff.

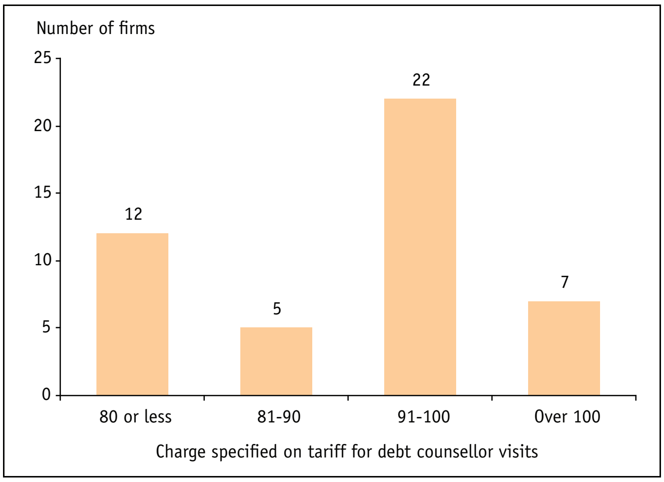
Fees for debt counsellor visits

55. Of the tariffs supplied for November 2009, 46% listed a charge for debt counsellor visits. Of these firms, the average fee was £90.13

56. Compared with monthly arrears fees and letter charges, there was less variation around the amount charged for these types of fees [see Exhibit 9].

13 Some firms did not identify the amount and instead specified the charge as 'variable'. These firms were excluded from the average charge calculation. Where firms stated a range, the mid-point in the range was used for the purposes of the calculation.

Exhibit 9: Frequency distribution of amount charged for debt counsellor visits (Nov 2009)



57. Again, non-banks had a higher average charge. Of the firms that listed a charge for debt counsellor visits in November 2009, the average charge by non-banks for a visit was £101, compared with £87 for building societies and £79 for banks. Non-banks were also more likely to charge for visits – 72% of non-banks listed a charge for debt counsellor visits compared with 32% of banks and 37% of building societies.

58. Of the tariffs that list a charge for debt counsellor visits, just under a third of the tariffs included a fee if a borrower cancelled the visit or didn't attend. The average fee charged by these firms in November 2009 was £58.

The fee justifications provided by lenders for debt counsellor visits

59. There were nine lenders who provided fee justifications for fees for debt counsellor visits. As at December 2009[14], these lenders held approximately 43% of the regulated mortgage market. Their fees for debt counsellor charges ranged from £67 to £110.

60. Of the information that we reviewed, we found that eight firms were charging equal to or below the administration costs they incurred. All of these firms were contracting third parties to provide debt counsellor services and were passing these costs onto the borrower without any additional profit element being added. The fee justification exercise for the ninth lender was not robust and could not be relied on.

61. We also asked ten lenders for further information on the fees they charged for cancellation of a debt counsellor visit. As at December 2009, these lenders held approximately 44% of the first-charge regulated mortgage market.[15] Their fees for cancellation charges ranged from £nil to £70.

62. Of these ten lenders, seven either charged the third party cost or made no charge. One of these lenders, who does not charge for arrears visits or cancelled arrears visits, explained that it absorbed the cost to provide a benefit to customers who

14 Based on MLAR data Q4 2009
15 Based on MLAR data Q4 2009

were struggling financially. Another lender, who did not charge for cancelled arrears visits, noted that:

> 'The aim of the process is to undertake a visit to the property … a single charge is made to the customer on receipt of the report-back form after a visit has been made'.

63. One of the ten lenders previously charged a fee that appeared to include a profit element but had changed their charging practice to only recover the third-party cost.

64. One small lender charged customers 6% higher than the third-party cost. However, the lender identified the following justifiable internal costs separately from the third-party cost: review of case to ensure referral criteria were met; completion of referral instructions; updating of customer notes; and applying the fee to the customer account.

65. Another small lender provided a fee justification exercise supporting its arrears visit cancellation fee, which related in most cases to a customer failing to attend an appointment. However, the staff cost rate used for this lender was double or more than the staff cost rate for other lenders, indicating that either the staff cost had not been calculated correctly or inappropriate staff grades were performing the work. Adjusting the staff rate to bring it to a more appropriate level reduced the cost below the fee being charged and indicated that the company was making a profit from this fee.

Failed or missed payments

66. Failed or missed payment charges are levied, either when a borrower fails to make their monthly mortgage payment on the agreed date, or when their payment is returned due to insufficient funds in their nominated bank account. They include the following: returned or un-paid cheque fees; declined or returned or unpaid Direct Debit fees; late or missed payment fees; and failed standing order fees.

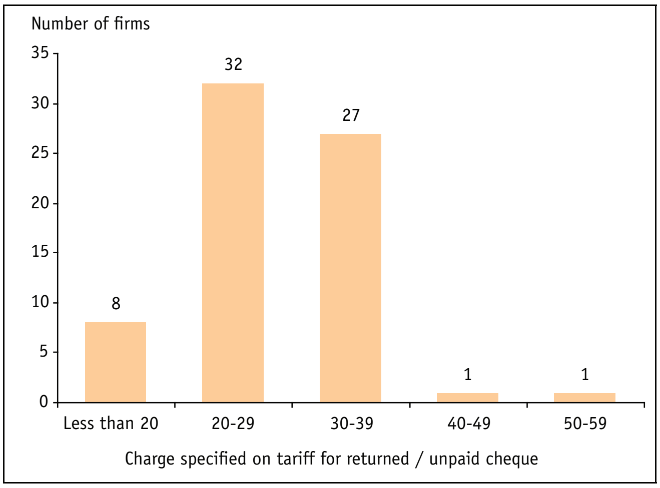
67. The most common type of missed payment fees listed were unpaid Direct Debit fees and unpaid/returned cheque fees. Of the firms that listed these fees on their tariff, the average charge was £27 and £26 respectively. In November 2007, the average fees charged by these same firms were slightly lower (see Exhibit 10).

Exhibit 10: Average fees for unpaid cheque / Direct Debits (Nov 2009 – Nov 2007)

Average fee	2009	2008	2007
Returned / unpaid cheque	£26	£25	£25
Unpaid Direct Debit	£27	£26	£26

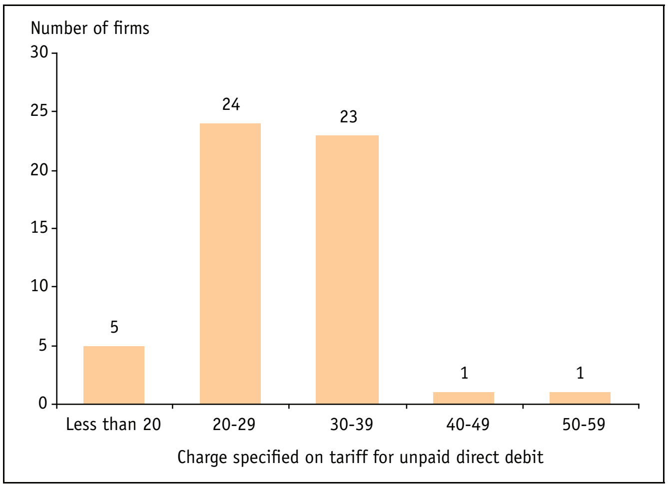
68. As with most other fees we looked at, there is significant variation in the amount charged, with many firms charging both under and over the average. For example, 58% of firms listing a fee for a returned/unpaid cheque charged less than £30, 39% charged between £30 to 39, and 2% charged £40 or over (see Exhibit 11).

Exhibit 11 Frequency distribution of amount charged for returned/ unpaid cheque fees (Nov 2009)



69. There was similar variation in the fees listed for unpaid Direct Debits (see Exhibit 12).

Exhibit 12 Frequency distribution of amount charged for unpaid Direct Debit fees (Nov 2009)



70. Banks were more likely to charge higher fees for missed payments than building societies or non-banks. On average, banks charged £32 for an unpaid Direct Debit in November 2009, compared to an average fee of £27 for non-banks and £26 for building societies.

71. We identified one firm who charged a £1.50 late payment charge for each day the borrower failed to make their payment. We were subsequently informed by this lender that, although this charge was listed on its tariff, it had never been charged to any of its customers.

72. We have also identified issues with the number of times that firms try to take a payment from a customer (and subsequently charge them for a missed payment) if it is being returned unpaid.

73. We recently penalised Kensington Mortgage Company for re-presenting a Direct Debit, and charging a fee each time, regardless of the number of times it had already been returned unpaid. Additionally, our arrears thematic work identified cases where lenders have tried to collect payments from borrowers for up to 12 months after they missed their first payment. As a result, for over a year borrowers were charged more than 24 separate missed payment fees, which are added to their arrears balance.

74. Between March 2007 and March 2008, we identified one lender who had collected revenue of £2,103,050 from failed payment charges.

The fee justifications provided by lenders for missed payments

75. Four lenders provided fee justifications for both unpaid/returned cheque fees and for unpaid/returned Direct Debit fees. One lender provided a cancelled Direct Debit fee justification as well as an unpaid/returned Direct Debit fee justification. The missed payment fees for these lenders ranged from £25 to £35.

76. Of the ten fee justifications provided by the five lenders, we found that four firms were charging above the administration costs they incurred. We assessed that the over-charging included a profit element ranging from 13 to 64%. The information for one firm was insufficient to make any conclusions. One firm has since suspended its 'returned payment fee' of £30 from 1 December 2009 to 'ensure that the charge accurately reflects the cost of processing'.

Fees for capitalisation of arrears

77. Capitalising arrears means that a borrower's arrears balance will be added to the outstanding mortgage, spreading the arrears over the remaining term of the mortgage. If arrears are capitalised, the lender will recalculate monthly payments using the existing interest rate and the new principal balance. So the borrower's monthly payment will usually go up.

78. Of the tariffs current in November 2009, 12 (11%) listed a charge for capitalising arrears. The average charge was £58. There was significant variation between lenders for these charges and they ranged from £20 to £100.

The fee justifications provided by lenders for capitalisation fees

79. We questioned four lenders further about their arrears capitalisation fees. From the information provided, the number of times this fee is charged is very low.

80. The detailed responses from the lenders sampled indicate that a considerable amount of time was spent by lenders in activities supporting the capitalisation of arrears fees, which would include in-depth discussions with the customer and considering the customer's ability to repay.

81. Two of the fee justifications we reviewed indicated that their additional costs are in excess of the fees charged. For example, one of the firms identified additional costs of £83, which is higher than their fee of £54. The third fee justification identified that their costs were £6.50 lower than the fee charged. The final lender in the sample, who was previously charging £100, has since ceased to charge a capitalisation of arrears fee.

Additional interest

82. We asked whether firms charged borrowers in arrears additional interest. Of the 58 responses, 97% said they did not apply additional interest to borrowers in arrears.

83. One firm said they apply a maximum of 2% p.a. additional interest in case of default in payment of interest or instalment. Another firm said arrears on regulated mortgages are charged at 5% per annum.

Fees charged for legal action and repossession

84. Of all the fees levied on borrowers in arrears, the charging practices around fees for legal action and repossession were the most varied between firms.

85. Borrowers can incur very significant fees once a firm starts litigation for possession. For example, in terms of overall fees typically incurred by a borrower, one bank indicated that a borrower could incur up to £1,614.25[16] in fees between the start of litigation and their house being repossessed (plus 1.9% of the property price at sale). This does not include any additional arrears charges they incurred before a firm commenced legal action for possession of the property.

86. It is common for firms to charge an administration charge once they have commenced litigation. For example, in November 2009, 57 firms indicated that they charged a one-off administration fee upon starting litigation or part way through to recover their costs. Fees ranged from £125 to £1,000. An additional five firms indicated that they charge a monthly administration fee. Of the five firms charging a monthly fee, four charge £50 and one firm charges £175. All five of these are non-banks whose mortgage books are being administered by third parties.

The fee justifications provided by lenders for legal action and repossessions

87. We assessed litigation fee justifications from seven lenders. Four of these lenders appeared to be making a profit from one or more of their legal fees.

88. We assessed repossession fee justifications for five lenders. For three out of the five lenders, the costs incurred by the firms were higher than the fees. For one of the

16 This is inclusive of the following charges £195 solicitor instruction fee, £70.50 stage 1 litigation fee, £223.25 for issuing court papers, £117.50 post judgement administration, £47 handling of eviction, £250 property sale and administration charge £365 conveyancing charge, £115 possession valuation, £231 possession insurance.

lenders there was insufficient information to conclude and for the final lender the company appeared to be making a profit from its repossession fee.

89. The time that lenders have seemingly spent repossessing properties is significant. One non-bank estimated that it spends about 700 minutes on each case. This included time spent by the lender and time spent by the third party administrator. It included: instructions to solicitors, systems work on notice of repossession (including notifying credit reference agencies), application of sales proceeds, release and check of funds, outbound calls, and scanning and indexing paperwork.

90. One major lender estimated that they spend 900 minutes on each case. They explained that:

> 'taking possession and administering a property over the average 6 months until completion of the sale requires estimates of a number of discrete activities, for example, the typical number of telephone calls, letters, enquiries, and failed offers to purchase.'

91. As noted earlier, the fees charged for litigation and repossession vary considerably. The main reason for this is that some lenders perform a substantial amount of the litigation work in-house and they have included these costs in their fee justification exercise. Other lenders have outsourced a lot of their legal work and pass on their external costs directly to the customer. One of the lenders that performed substantial litigation work in-house identified additional costs of £392 for every solicitors instruction fee raised, compared with another lender (that outsourced their litigation) who identified that a solicitor's instruction letter cost £62.

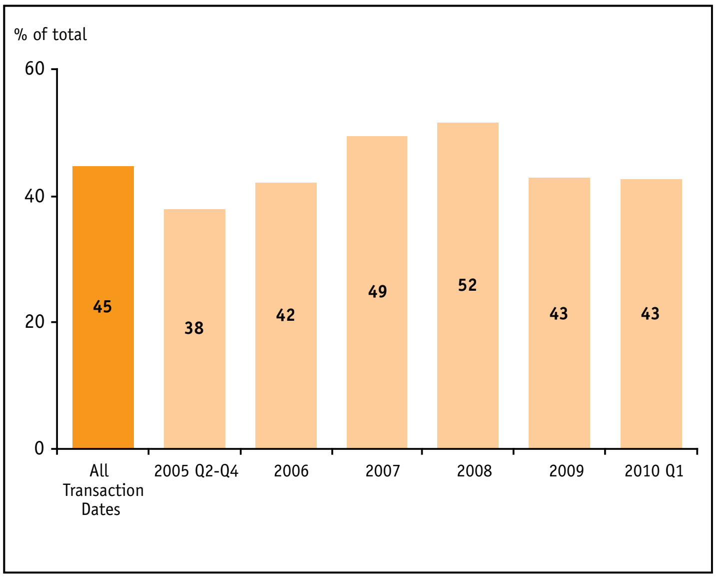
92. Again, it was clear that most lenders who provided fee justifications had not considered what their additional administration costs were before setting their charges.

Responsible lending data pack

1. Income verification

- In April 2005 to March 2010, income was not verified on 45% of all new mortgages.
- Income non-verified mortgages include fast-tracked mortgages and self-certified mortgages. Fast-tracking means that the lender does not necessarily ask for income documentation as the loan is considered low risk. Self-certification means that income documentation is not required as a product feature.
- Despite many lenders tightening lending criteria, income was not checked in 43% of all cases in Q1 2010.

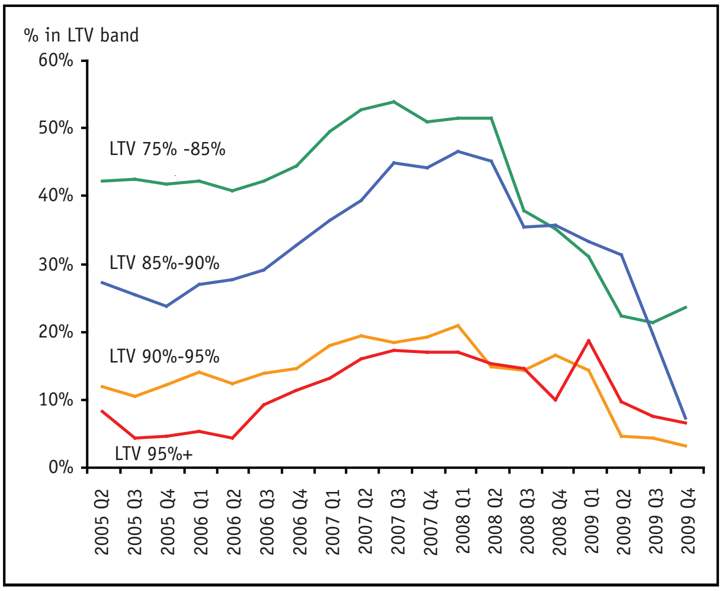
Exhibit 1.1: Proportion of mortgages where income was not verified



Source: FSA PSD

- While lenders may have originally intended to apply stringent criteria to fast-track applications, before the crisis lenders used fast-tracking for ever increasing Loan-to-Values (LTVs). For example, in 2007, income was not verified on over 15% of all loans with LTVs greater than 95%.

Exhibit 1.2: Higher-LTV mortgages where income was not verified



Source: FSA PSD

- On average, arrears and possessions on self-certified mortgages are considerably higher compared to those on income-verified mortgages.
- On average, arrears and possessions on fast-tracked mortgages are lower than on income-verified mortgages. However, this was not the case across all lenders.

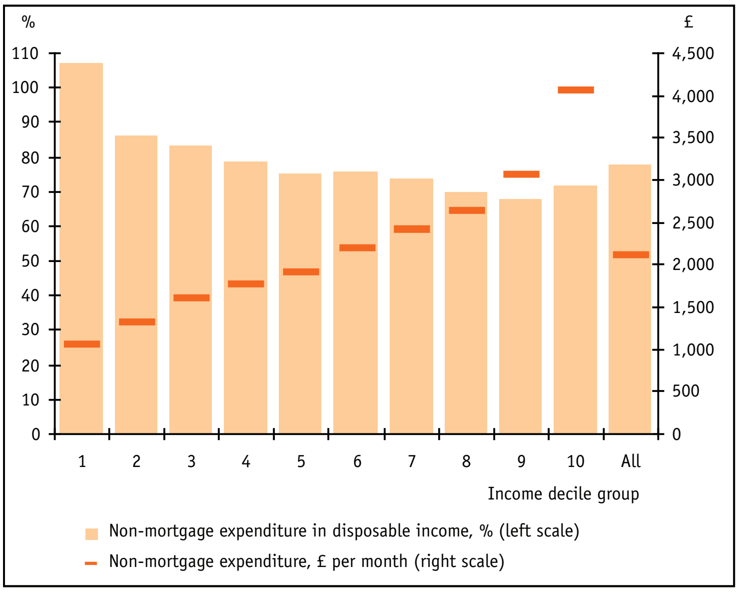
Exhibit 1.3: Arrears performance, by type of income verification, August 2009

Source: FSA PSD & Arrears dataset

2. Expenditure

- We do not collect data on expenditure of mortgage borrowers, so we have used an external source – the Living Costs and Food Survey (LCF)/ Expenditure and Food Survey (EFS). We looked at 9,000 households with a mortgage whose records are available in datasets from 2005 to 2008.
- The median non-mortgage expenditure of households was just over £2,100 per month, or 78% of their normal disposable income. On average, borrowers on the lowest income spent more of their disposable income on non-mortgage expenditure.

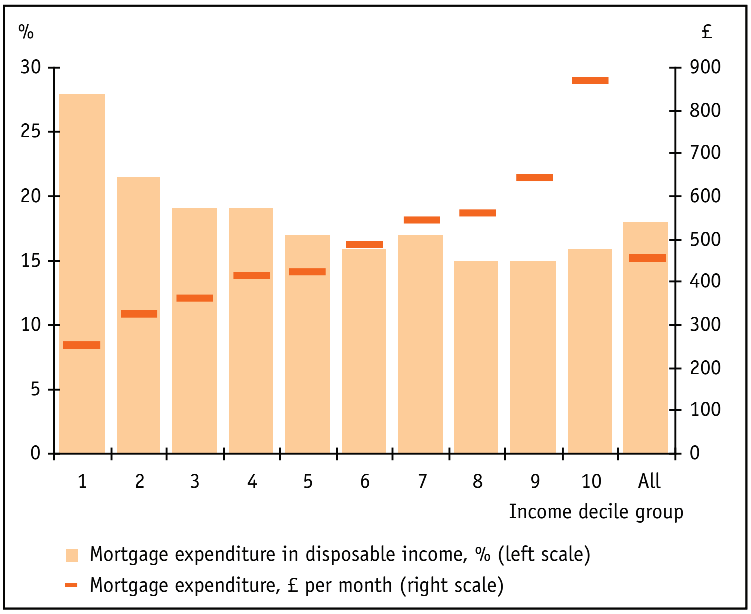
Exhibit 2.1: Median non-mortgage expenditure and median percent of non-mortgage expenditure in normal disposable income, by income deciles, 2005 to 2008



Note: see Table 7.1 for definitions of income defiles
Source: LCF/EFS 2005-2008 datasets, FSA calculation

- The median mortgage expenditure during the same period was 18% of normal disposable income. The lowest-income households spent the highest proportion of their income on mortgage payments (28%).
- This suggests that there is a significant number of households with a mortgage whose normal income may not be sufficient to cover their expenditure and mortgage payments in full. Such households would have to use credit or savings to supplement their incomes.

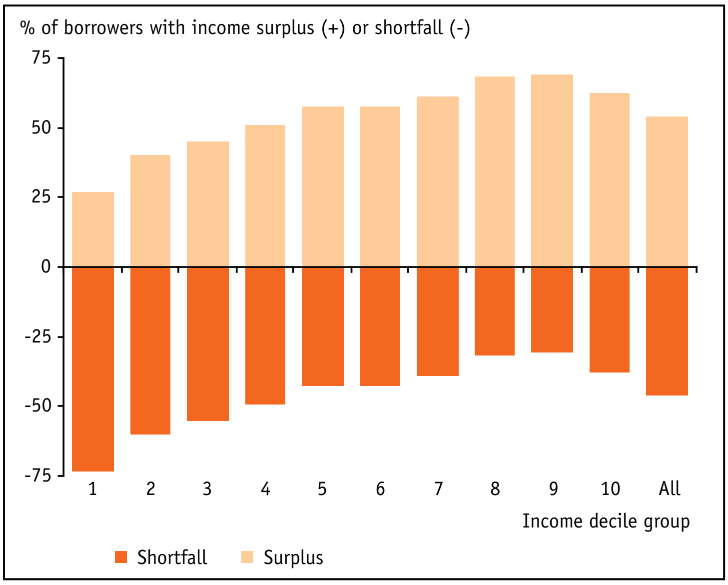
Exhibit 2.2: Median mortgage expenditure and median percent of mortgage expenditure in normal disposable income, by income deciles, 2005 to 2008



Source: LCF/EFS 2005-2008 datasets, FSA calculation

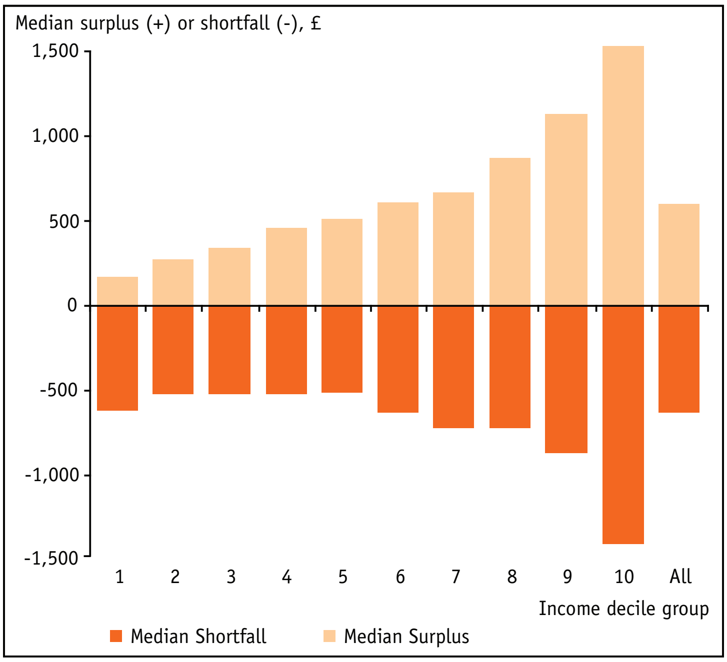
- We then worked out how much money mortgage borrowers had left after living expenditure and mortgage payments, by subtracting mortgage payments and non-mortgage expenditure from households' normal disposable income.
- Our calculation shows that 46% of households had no money left or had a shortfall that would have to be covered from savings or credit.
- For some borrowers the shortfall could be temporary (for example, if their expenditure was higher than normal when the data was collected). For others, the shortfall could persist.
- The proportion of borrowers with the shortfall varied by income group. While the lower-income borrowers were affected the most, even within the higher-income groups a significant minority of households had a shortfall.
- The median shortfall and the median surplus were around £600 per month.

Exhibit 2.3: Proportion of households with income surplus or shortfall after living expenditure and mortgage payments, by income deciles, 2005 to 2008



Source: LCF/EFS 2005-2008 datasets, FSA calculation

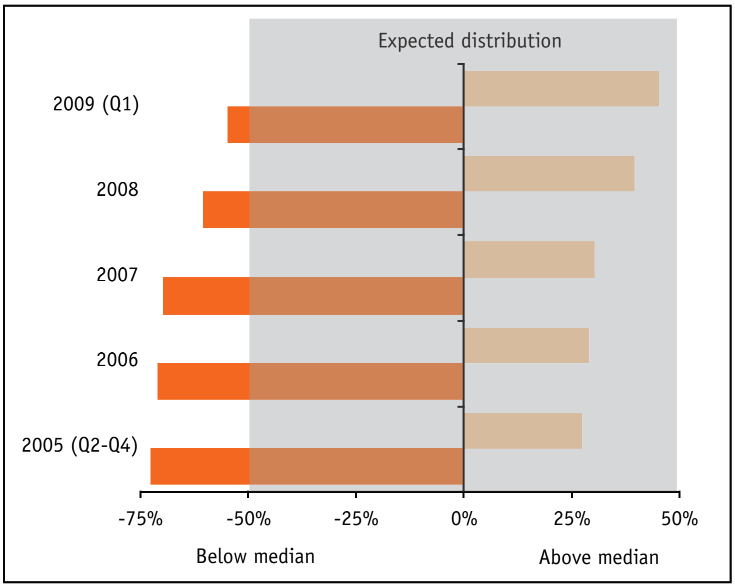
Exhibit 2.4: Median income Shortfall or Surplus, £ per month, by income deciles, 2005 to 2008



Source: LCF/EFS 2005-2008 datasets, FSA calculation

- The LCF/EFS data captures all mortgage holders, rather than those with a mortgage started in 2005–2008.
- To get an indication of the extent of mortgages taken out in recent years that were foreseeably unaffordable, we took the following steps.
- From our Product Sales Data (PSD) and Arrears dataset, we took the gross income as used by the lender when the mortgage was taken out. We then deducted from it tax, National Insurance and mortgage payments to work out the money available for each mortgage holder/household to spend on 'non-mortgage expenditure'.
- For foreseeably unaffordable loans, this amount of money available would be less than actual expenditure by that household. Unfortunately, actual expenditure data is only available by broad income groups (deciles).
- We compared the distribution of money available for non-mortgage expenditure from our PSD and Arrears dataset with the distribution of actual expenditure implied by the LCF/EFS data. They were not consistent for 2005 to 2007. On average, the money available was less than money spent, with more borrowers having less money available than the LCF/EFS data might imply they wanted to spend.
- This difference reduced in 2008 and almost disappeared in 2009 as lending criteria were tightened.
- Although we are unable to identify precisely all of the mortgages that were unaffordable, the data suggests that borrowers who had less money available for non-mortgage expenditure than the median for their income group, were more likely to develop arrears or to have their property repossessed.

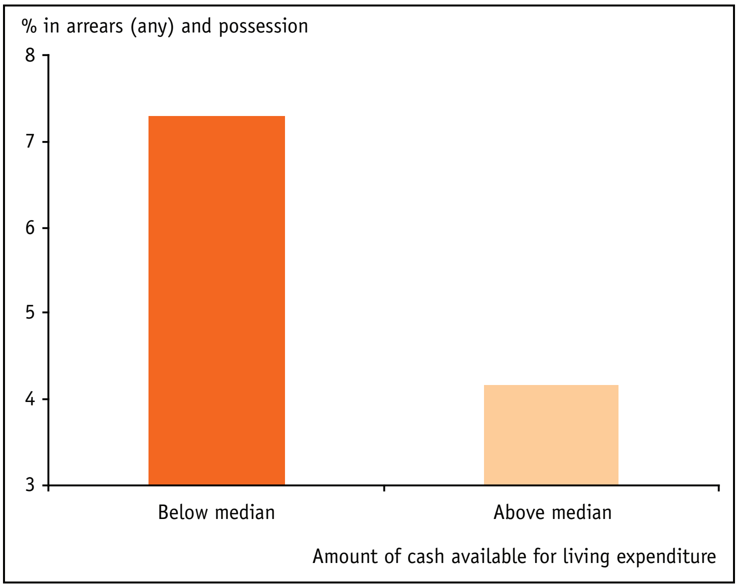
Exhibit 2.5: Money left for non-mortgage expenditure – expected and actual distribution



Note: see section 'Methodology' that explains this calculation and its interpretation in detail

Source: FSA PSD and Arrears dataset, LCF/EFS 2005-2008 datasets for median expenditure

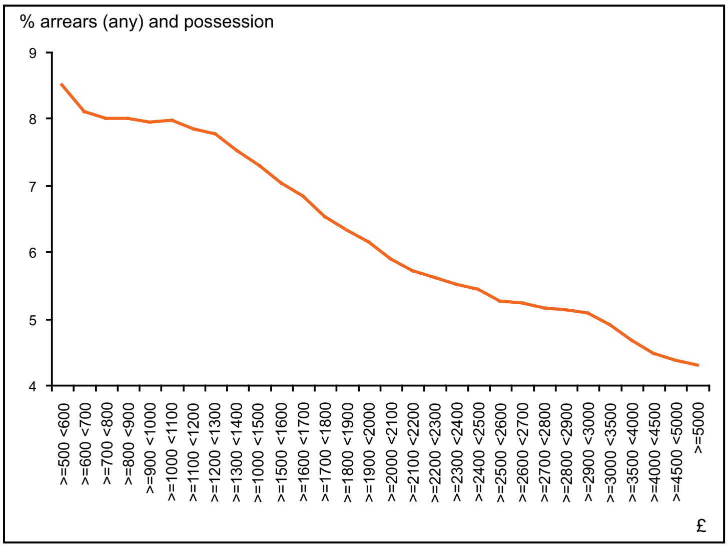
Exhibit 2.6: Amount of money left for non-mortgage expenditure in relation to median, and arrears and possession performance



Source: FSA PSD and Arrears dataset, LCF/EFS 2005-2008 datasets for median expenditure

- There is a link between the amount of cash available for living expenditure and mortgage arrears and possessions, which generally decrease as the ability to save improves.

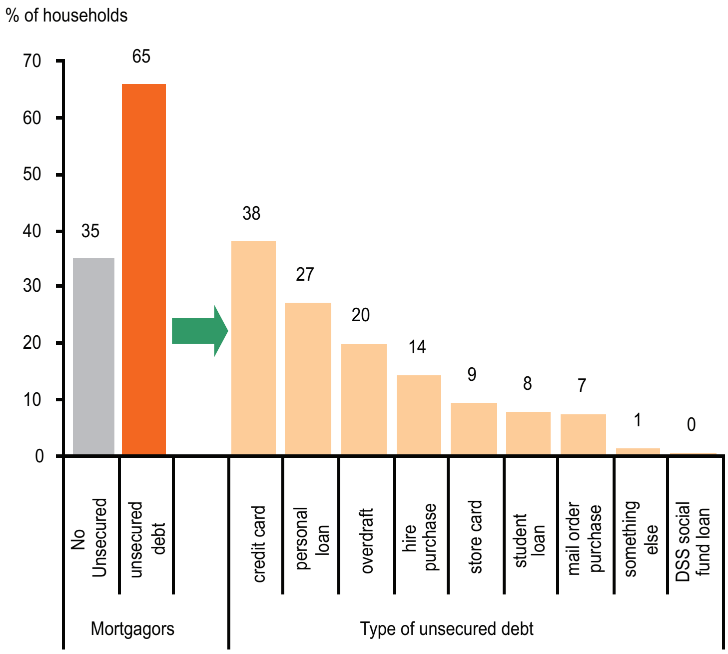
Exhibit 2.7: Monthly amount available for non-mortgage expenditure (£) and mortgage performance



Source: FSA PSD and Arrears dataset

- As consumers are generally reluctant to alter their lifestyles or spending patterns, many borrowers appear to have had to turn to further borrowing to maintain their preferred lifestyles.
- An NMG survey shows that two thirds of mortgage borrowers have other debts. According to Citizens Advice records, 87% of borrowers who are in mortgage arrears or secured loan arrears have other debts.
- It is also not uncommon for mortgage borrowers to obtain further advances on top of their mortgage. According to Mortgage Lending & Administration Return (MLAR), in 2007 to 2009, further advances accounted for 22% of all new regulated loans. The average size of the further advance was £25,000.
- Increasing indebtedness can conceal mortgage affordability issues for a long period of time. For example, for someone with an income shortfall of £600 per month, a further advance of £25,000 at 5%pa on an interest-only basis could cover the shortfall for three years.

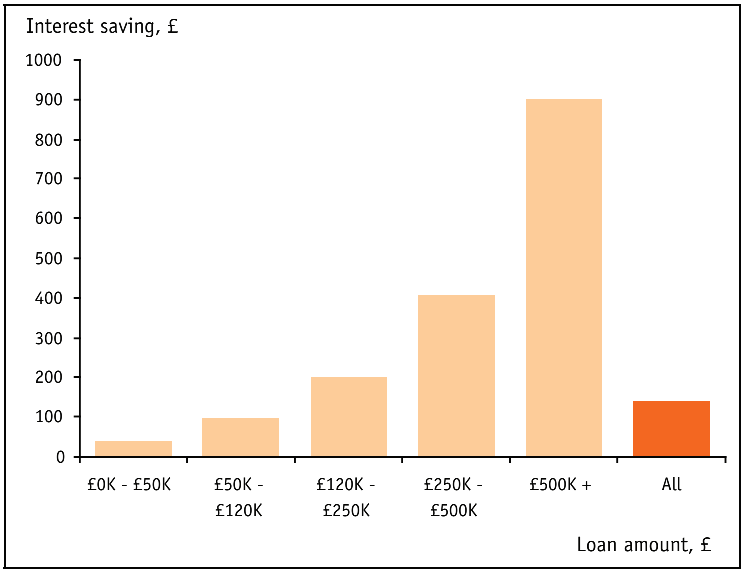
Exhibit 2.8: Unsecured debt holdings by mortgagors



Source: 2008 NMG Research Survey *The financial position of British households*, FSA calculation

- Because of historically low mortgage interest rates, many borrowers are currently enjoying a more comfortable financial position.
- For example, borrowers who obtained mortgages in 2007 and who remortgaged in 2009 to 2010, or stayed on variable rates of their lenders, could have had a median reduction in mortgage payments of £140 per month. The amount of saving varies greatly and is larger for borrowers with larger mortgages.
- This supports other economic commentary and analysis that suggests that there could be a significant increase in household distress and in losses for lenders following even a modest increase in the interest rates.

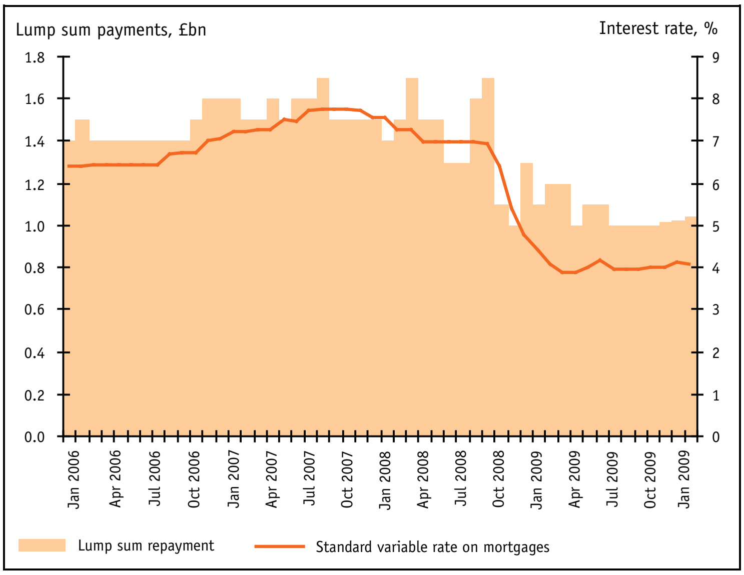
Exhibit 2.9: Mortgages taken out in 2007: median estimated monthly saving in 2010 due to low interest rates, £



Note: average interest rate at origination is 5.5%; average interest rate in January – March 2010 is 3.8%
Source: FSA PSD and Arrears dataset, PSD for average interest rate

- Despite mortgage interest rates having fallen to a historic low, there is no evidence to suggest that mortgage borrowers use the spare cash to make overpayments on their mortgages.

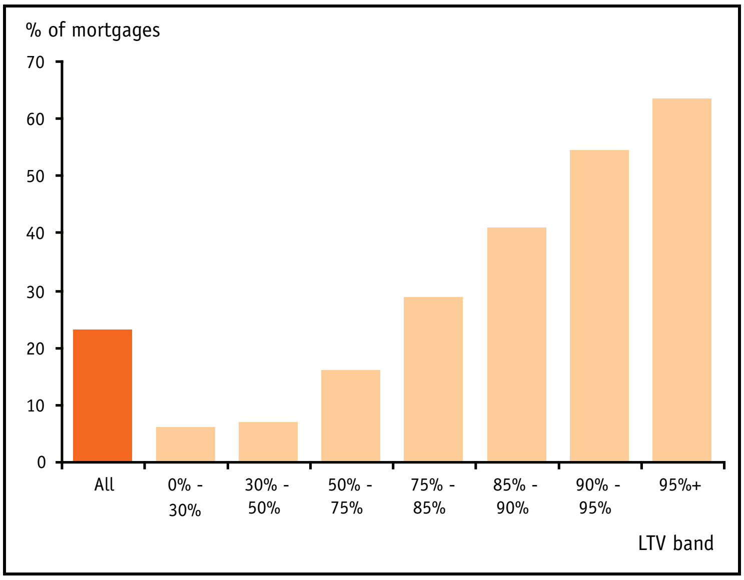
Exhibit 2.10: Lump sum mortgage payments (other than on redemption)



Source: BoE

- At the peak of the market in 2007, over 20% of all 'Capital and Interest' mortgages were for longer than 25 years.
- There is a link between the length of the mortgage term and the level of LTV – the higher the LTV, the more likely the consumer is to borrow for longer. For example, over 60% of consumers with high LTVs of 95% or more borrowed for longer than 25 years.
- Extending the term of a 'Capital and Interest' mortgage reduces the monthly payment (so, on the surface, makes the mortgage more affordable for the consumer). However, the total cost of repayment over the lifetime of the mortgage could increase quite significantly. For example, someone who borrows £100,000 for 25 years at 5%pa pays £585 per months and £175,500 over the 25 years. Someone who borrows the same amount but for 35 years pays £505 per month and £212,100 over the 35 years.

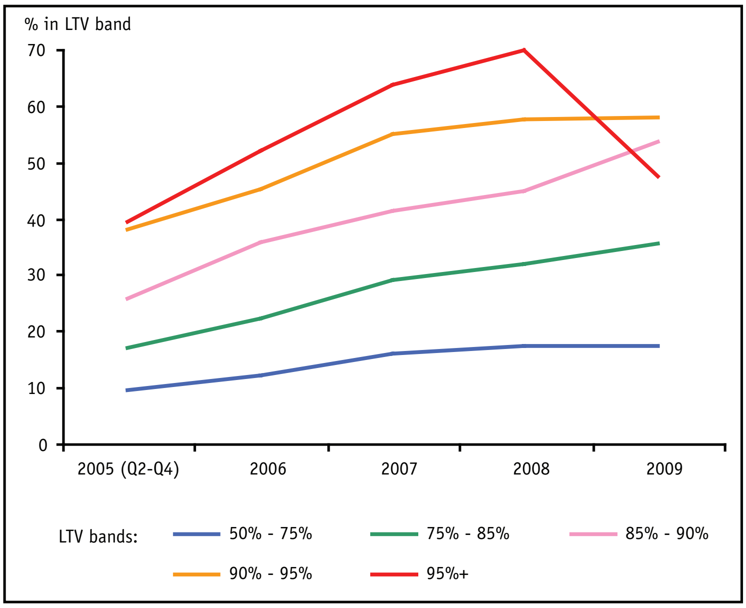
Exhibit 2.11: 'Capital and Interest' mortgage sales in 2007 where terms exceeded 25 years, % of the total by LTV band



Source: FSA PSD

- In the recent years, the share of mortgages with the terms exceeding 25 years has been increasing, particularly in the higher-LTV bands.

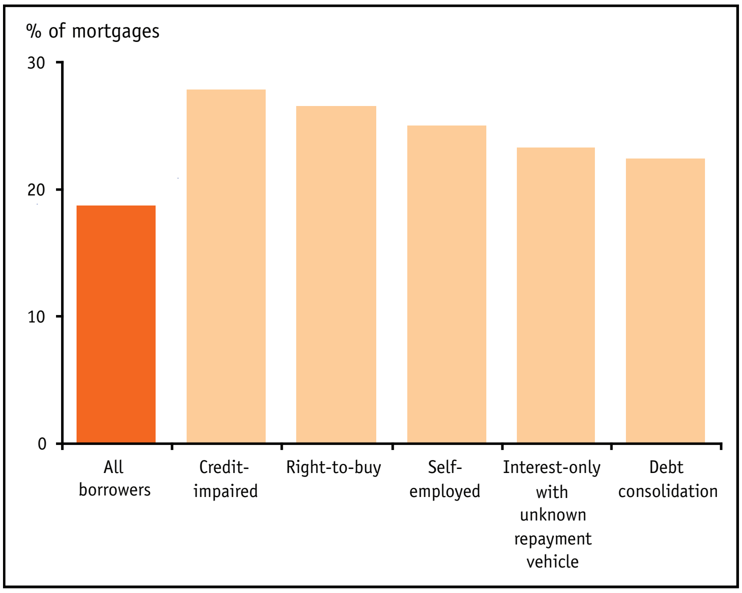
Exhibit 2.12: Share of 'Capital and Interest' mortgage sales where terms exceeded 25 years, by LTV band – trend over time



Source: FSA PSD

- In 2007, for 19% of all new mortgages, the length of the term was such that the payments were still to be made after the borrower had retired.
- For some types of borrowers, lending into retirement was even more common. For example, 28% of mortgages to credit-impaired borrowers were expected to be paid off after the borrower had retired.

Exhibit 2.13: Lending into retirement, proportion of mortgages in 2007

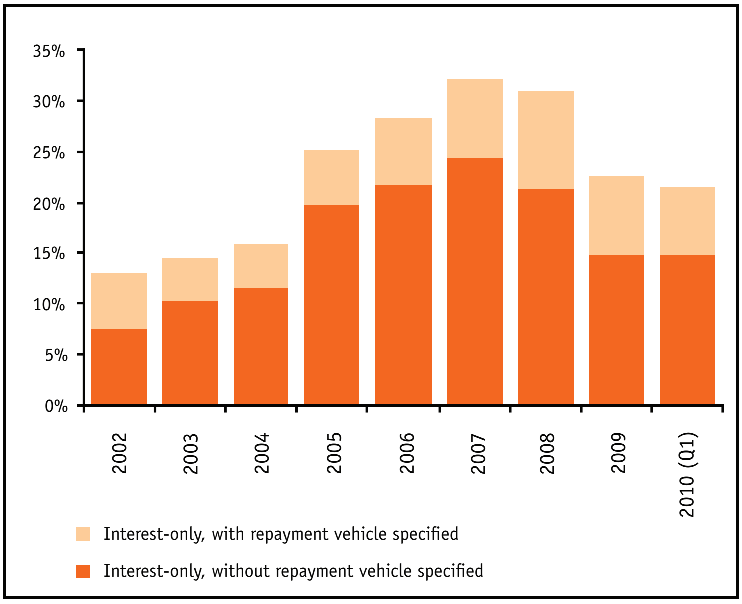


Note: the retirement age is assumed to be 65; the data excludes lifetime mortgages.
Source: FSA PSD

3. Interest-only mortgages

- The share of interest-only mortgages has been increasing. At the peak of the market, over 30% of all mortgages were interest-only.

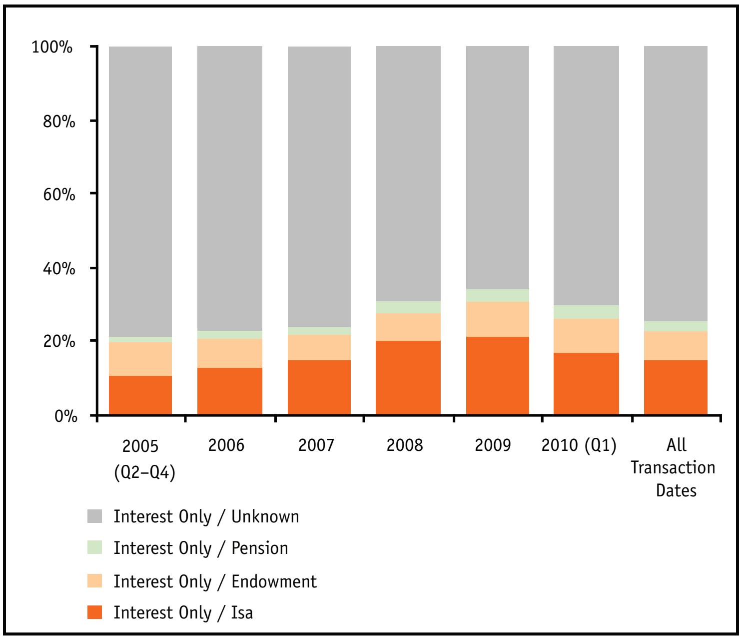
Exhibit 3.1: Interest-only mortgages advanced in the UK (% of total sales)



Note: In 2002-2004 – loans for house purchase only
Source: CML (2002-2004), FSA PSD (2005 to 2010)

- Around 75% of all interest-only mortgages do not have a specified repayment vehicle.

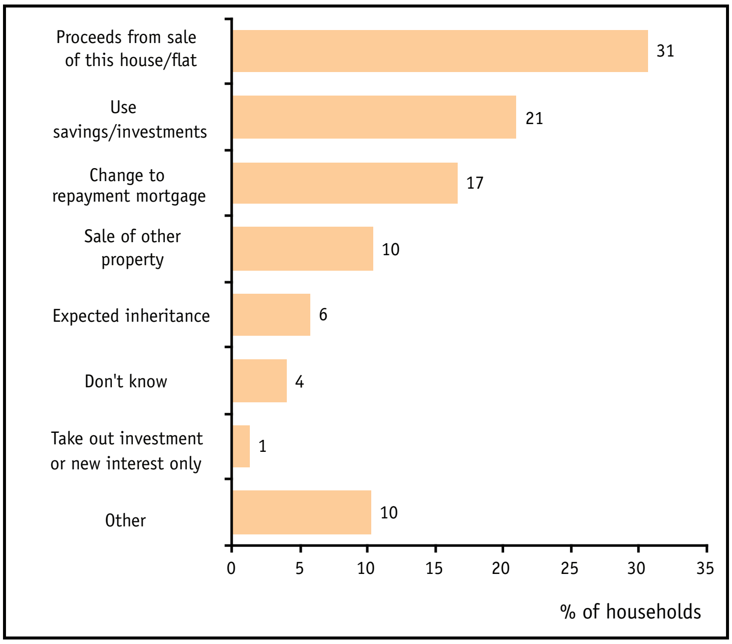
Exhibit 3.2: Sources of capital repayment for interest-only mortgages



Source: FSA PSD

- Many consumers with no repayment vehicle count on future house price rises or uncertain life events to repay their mortgage. Some have no plan at all.

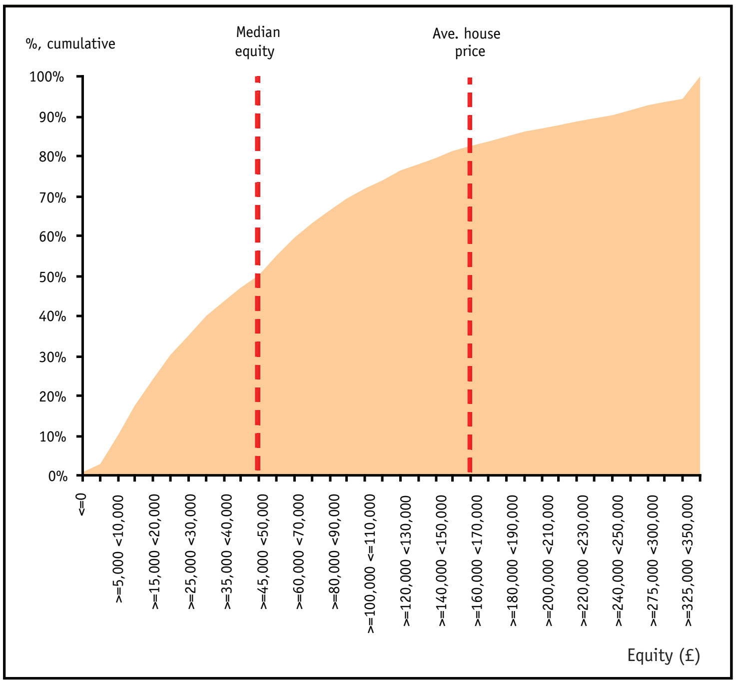
Exhibit 3.3: Owners with an interest-only mortgage and no linked investment – how they propose to repay the mortgage (2006/07)



Source: DCLG, SEH

- For those with no formal investment provisions, 31% of borrowers have the intention of paying off their mortgage out of the proceeds from the sale of their current house or flat (the most commonly-stated plan).
- While for some borrowers this could be a sensible plan, for most borrowers downsizing is not a feasible option, given the amount of equity they have in their current properties.
- Median housing equity, at the start of a mortgage, for a borrower with an interest-only mortgage and no repayment vehicle is just under £50,000.
- Given the current average house price of just under £170,000, the majority of borrowers with interest-only mortgages and no repayment vehicle would have not been able to repay their mortgage and to buy an alternative property out of the proceeds.

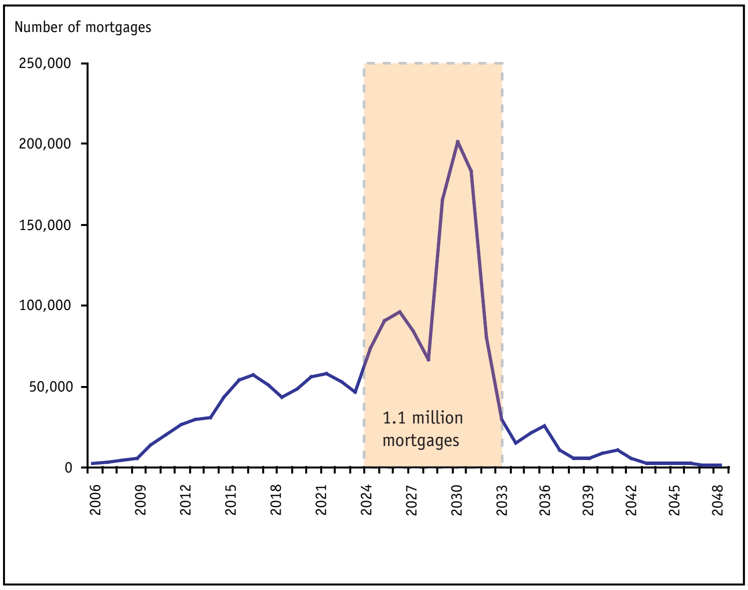
Exhibit 3.4: Housing equity of borrowers with an interest-only mortgage – cumulative distribution



Source: FSA PSD and Arrears dataset, Nationwide for average house price

- 60%, or 1.1 million interest-only mortgages with no known repayment vehicle, which were sold between Q2 2005 and Q4 2009, will mature in the decade of 2024 to 2033.

Exhibit 3.5: Maturity schedule of interest-only mortgages with no known repayment vehicle originated in Q2 2005 to Q4 2009



Source: FSA PSD

4. Risk combinations

- We ran an econometric model with the mortgage and borrower characteristics available in the PSD to identify the risk factors that were correlated with arrears and possessions.
- The following five factors were the strongest predictors of future financial difficulties:
  - impaired credit history of the borrower;
  - higher LTV (here, for illustration, we use LTV>=80%);
  - self-employment;
  - remortgage for debt consolidation; and
  - where a social tenant exercised right-to-buy.
- We then looked at combinations of these risk factors and identified 24 risk types – which we then sorted by the rate of possession – to identify products that resulted in the worst detriment for consumers and posed the highest risk to lenders. We have excluded mortgages where incomes were not verified from this analysis.
- In the high-risk combinations that we identified, lending to credit-impaired borrowers was the dominant factor.

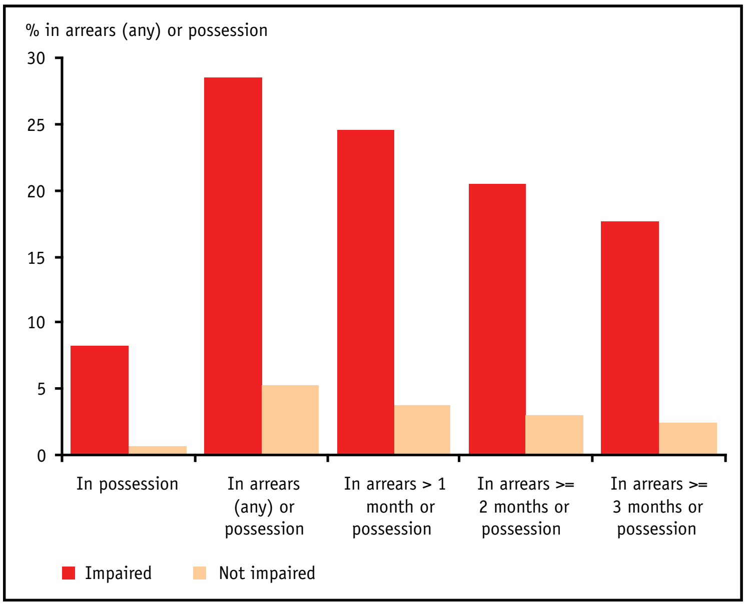
Exhibit 4.1: Risk layering (income-verified mortgages only)

Risk order, highest to lowest	Risk layering					% of borrowers in payment difficulties			Originated by non-banks, %
	Credit impaired	LTV>=80	Self-employed	Debt consolida tion	RTB	Possession	Arrears (any) or possession	Arrears >=3 months or possession	
1	Yes	Yes	Yes	Yes	No	21.4%	42.4%	33.1%	80.5%
2	Yes	Yes	No	No	Yes	17.0%	35.9%	28.3%	98.3%
3	Yes	No	Yes	No	Yes	16.4%	32.0%	22.7%	97.3%
4	Yes	Yes	No	Yes	No	16.3%	35.5%	25.2%	77.8%
5	Yes	Yes	Yes	No	Yes	15.8%	40.6%	30.6%	99.2%
6	Yes	No	No	No	Yes	15.5%	30.0%	22.5%	91.2%
7	Yes	No	Yes	Yes	No	13.8%	33.8%	22.9%	75.8%
8	Yes	Yes	Yes	No	No	13.6%	38.4%	27.7%	80.4%
9	Yes	No	No	Yes	No	10.7%	26.7%	17.9%	65.6%
10	Yes	Yes	No	No	No	9.4%	29.3%	19.6%	70.0%
11	Yes	No	Yes	No	No	6.4%	32.3%	19.7%	72.9%
12	Yes	No	No	No	No	4.8%	21.2%	12.5%	50.9%
13	No	Yes	Yes	No	Yes	4.8%	25.7%	14.5%	72.6%
14	No	Yes	No	No	Yes	4.4%	16.3%	10.1%	49.2%
15	No	Yes	Yes	Yes	No	3.8%	19.9%	11.1%	26.8%
16	No	Yes	Yes	No	No	3.0%	14.5%	8.7%	22.0%
17	No	No	Yes	No	Yes	3.0%	13.9%	7.5%	49.3%
18	No	Yes	No	Yes	No	2.1%	12.1%	6.2%	16.8%
19	No	No	Yes	Yes	No	1.3%	11.6%	5.3%	16.2%
20	No	Yes	No	No	No	1.1%	6.1%	3.3%	9.6%
21	No	No	No	No	Yes	0.9%	7.3%	3.5%	15.2%
22	No	No	No	Yes	No	0.4%	5.3%	2.0%	5.9%
23	No	No	Yes	No	No	0.4%	6.0%	2.5%	10.0%
24	No	No	No	No	No	0.1%	2.5%	0.6%	1.7%

Source: FSA PSD and Arrears dataset

- According to PSD, in April 2005 to March 2010, 3.2 % of regulated mortgage sales were to borrowers with one or more types of credit impairment.
- Nearly 30% of credit-impaired borrowers are in payment difficulties of some kind and over 8% had their property repossessed. The market rates could be higher, perhaps significantly, as the data on non-banks and on some subsidiaries of building societies that targeted the credit-impaired market is incomplete (we don't have data on the performance of loans that were sold to other firms).

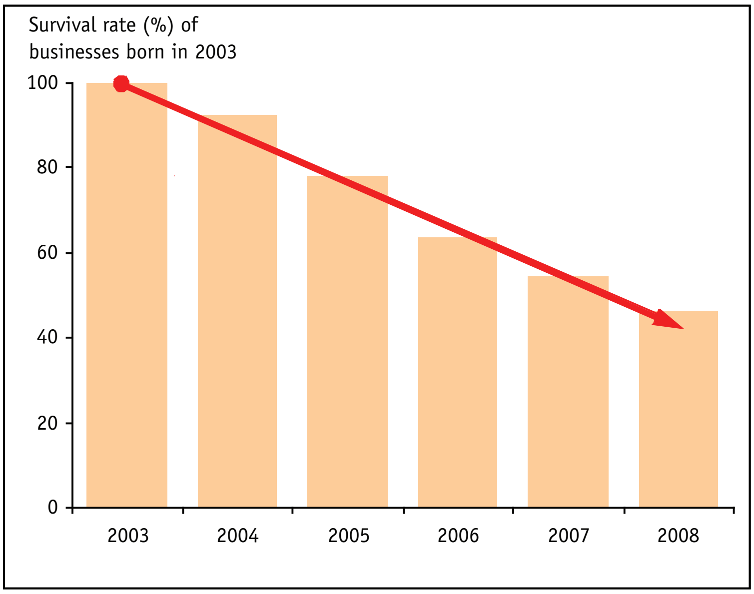
Exhibit 4.2: Arrears and possession rates by type of credit history



Source: FSA PSD and Arrears dataset

- Nearly 30% of all credit-impaired borrowers are self-employed, compared with 15% of borrowers with clean credit history. This is unsurprising, as a large proportion of new start-ups fail shortly after being created.

Exhibit 4.3: Survival rates of businesses born in 2003

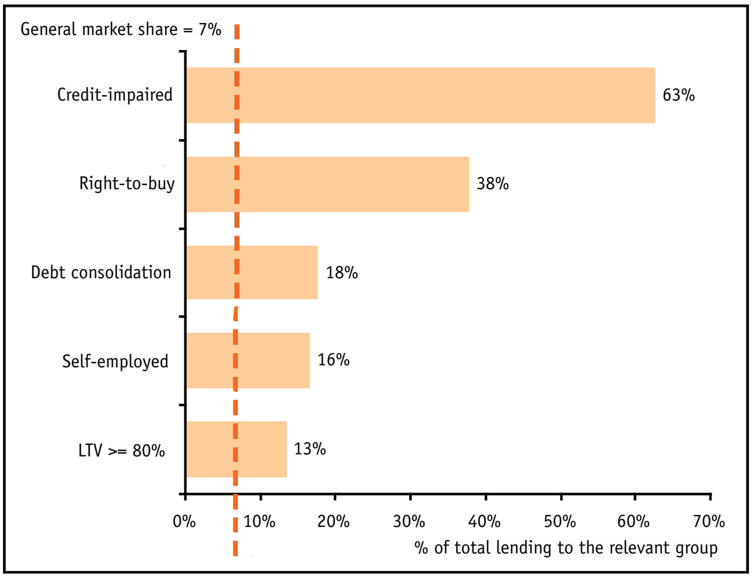


Source: ONS

5. Non-bank lenders

- Non-banks have provided approximately 7% of mortgages sold in 2005 to April 2009. Most focused on riskier borrowers, where the margins were higher.
- Our risk combinations analysis shows that some types of high-risk lending were almost entirely undertaken by non-banks (also see Exhibit 4.1).

Exhibit 5.1: Share of non-banks in higher-risk lending, by borrower/product type

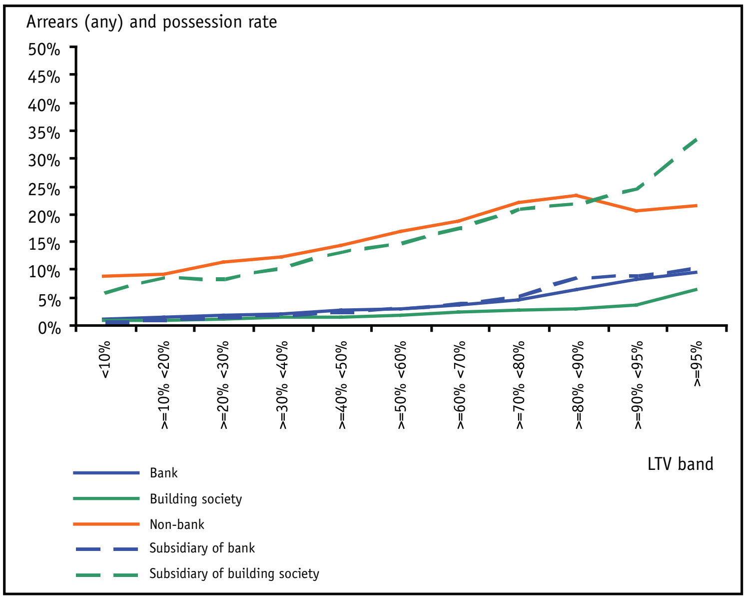


Source: FSA PSD and Arrears dataset

- Our evidence on arrears and possessions shows that non-banks performed considerably worse compared to banks and building societies. Subsidiaries of building societies, which targeted a similar market, performed as badly.
- In econometric models, origination by a non-bank has been consistently the strongest predictor of default, regardless of the other product or borrower-related risk factors controlled for. Some possible explanations for the comparatively worse performance of non-banks are poor underwriting practices and/or unaffordable lending.
- Exhibit 5.2 illustrates for products sold to borrowers with clean or impaired credit history. Our arrears and possessions data is limited to originated and retained loans only, so the 'true' performance of non-banks who sold a large proportion of their originations could be much worse than depicted.

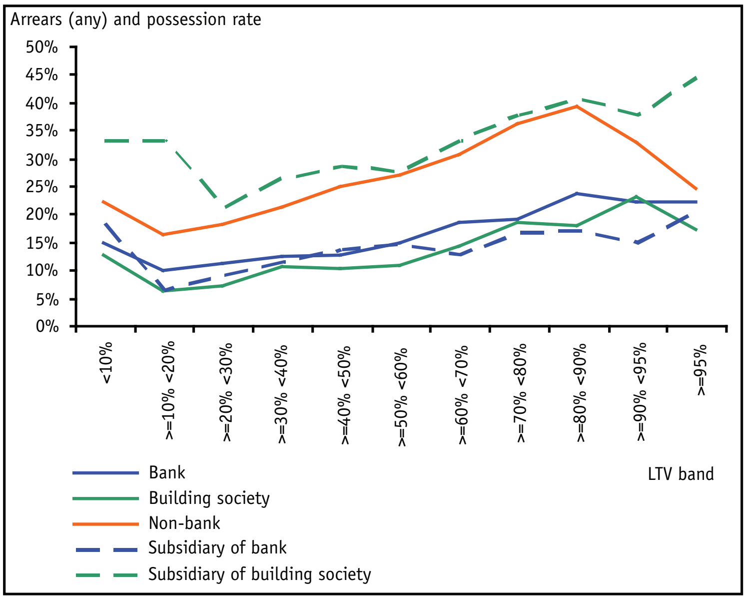
Exhibit 5.2: Mortgage performance by type of lender

(a) mortgages to borrowers with clean credit history



Source: FSA PSD and Arrears dataset

(b) mortgages to credit-impaired borrowers



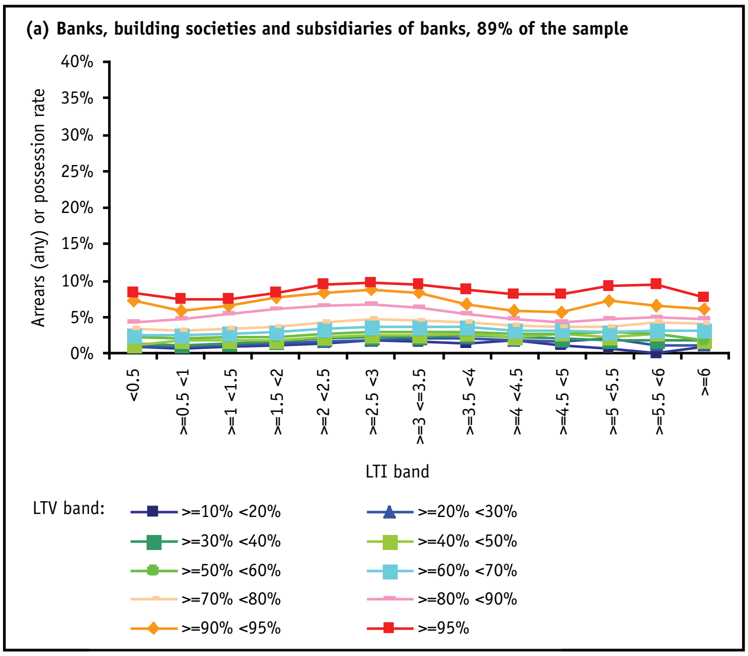
Source: FSA PSD and Arrears dataset

6. LTV and LTI

- We have looked at arrears and possessions performance of mortgages across different LTVs, LTIs and their combinations.
- Loan-to-Value (LTV) is a relatively consistent predictor of default: arrears and possession rates increase as LTV increases.
- Loan-to-Income (LTI) is not a good predictor of default. We found no compelling evidence to suggest that arrears and possessions increase consistently as the level of LTI increases. This is because LTI is a proportional coefficient that does not take the level of expenditure into account. Household expenditure does not increase in the same pace as the level of income. Therefore, there is no cut-off LTI level that is equally affordable or unaffordable for all. Generally, borrowers on lower incomes can afford lower LTIs and borrowers on higher incomes can afford higher LTIs.
- Exhibit 6.1 illustrates our findings on LTV and LTI combinations. For the mortgages originated by banks, building societies and subsidiaries of banks, there is a clear link between the higher LTV lending and defaults. However, the relationship between LTI and defaults is relatively flat for all LTV bands. For the mortgages originated by non-banks and subsidiaries of building societies, the relationship between LTV, LTI and defaults is less clear or consistent. This is because our data is incomplete, as we are unable to track performance of mortgages sold to other firms.

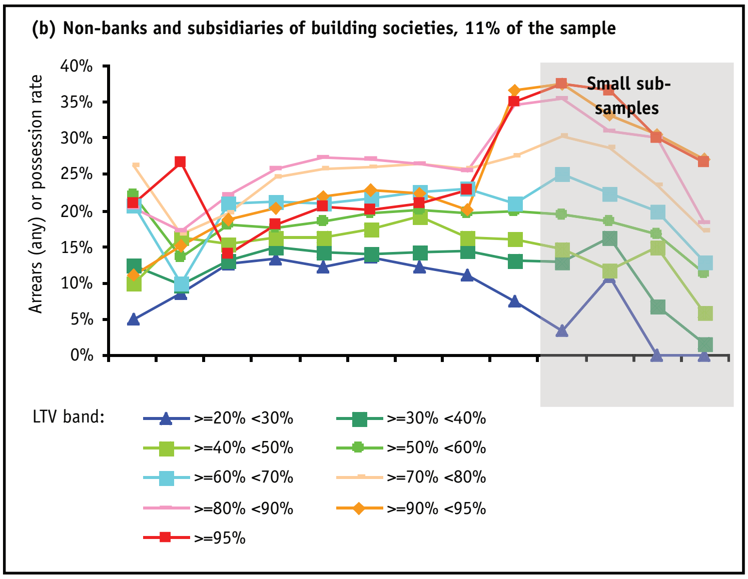
Exhibit 6.1: Link of LTV and LTI with arrears

(a) Banks, building societies and subsidiaries of banks (89% of sample)



Source: FSA PSD and Arrears dataset

b) Non-banks and subsidiaries of building societies (11% of sample)



Source: FSA PSD & Arrears dataset

7. Notes on data and methodology

FSA regulatory reporting

1. We have used statistics from the two reports on mortgage lending that firms are required to provide to us – Product Sales Data and Mortgage Lending and Administration Return.

2. **Product Sales Data (PSD):** Since 1 April 2005, product providers have been required to provide the FSA with transaction-level data on all sales of FSA regulated mortgage contracts. Between April 2005 and March 2010, around 200 firms reported on mortgage sales. Details of loans for house purchases and remortgages are captured by mortgage PSD, but data relating to further advances is not. Additionally, mortgage PSD only covers FSA regulated mortgage contracts and, therefore, excludes products such as second-charge lending, commercial and buy-to-let mortgages.

3. **Mortgage Lending and Administration Return (MLAR):** Since the beginning of 2007, some 300 regulated mortgage lenders and administrators have been required to submit an MLAR each quarter, providing aggregate data on their mortgage lending and administration activities.[1]

Arrears and possessions data

4. At present, we do not collect data on the mortgage performance of individual mortgage accounts as part of regulatory reporting, although the aggregate statistics are collected in MLAR.

5. To identify whether there is a link between the particular characteristics of a mortgage account and its subsequent performance (i.e. whether some particular factor makes it go into arrears or into possession), we collected from 33 firms data on the performance of individual mortgage accounts,[2] the characteristics of which had previously been reported to us through PSD. These 33 firms are representative of the whole market, including banks and their subsidiaries, building societies and their subsidiaries, and non-bank lenders.[3]

6. This data covers FSA regulated mortgages which were taken out between 1 April 2005 and 31 March 2009. The performance (whether the loan was in arrears or in possession) was measured on 1 August 2009. The data request only applied to mortgage accounts that were in arrears on that date, or where a possession order existed or possession had occurred by that date.

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1 Summary statistics from these returns are available on the FSA web-site:
PSD trend reports:
http://www.fsa.gov.uk/Pages/Doing/Regulated/Returns/psd/publications/index.shtml
Statistics on mortgage lending (MLAR):
http://www.fsa.gov.uk/pages/Library/Other_publications/statistics/index.shtml

2 The copy of the original data request to firms is available in DP 09/03, p. 92, at http://www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

3 Our sample contains around 70% of all mortgages sold during the reporting period.

7. Unlike possessions data that covers the entire period of 1 April 2005 to 1 August 2009, arrears data is static. This means that accounts that were in arrears in the past but were not in arrears on 1 August 2009 cannot be identified, for example:

- borrowers who had resolved their payment difficulties and were no longer in arrears;
- borrowers who had sold their property and paid off their mortgage and arrears;
- borrowers who had remortgaged to repay their arrears;
- borrowers whose arrears were capitalised; and
- borrowers benefitting from lenders' forbearance strategies (for example, where a payment holiday was granted).

PSD and Arrears Dataset

Description

8. We took the data on arrears and possessions provided by firms and matched it with the original PSD records using the unique Transaction Reference Numbers which are reported as part of PSD. This created a 'PSD and arrears dataset' of 5.4 million mortgages sold between 1 April 2005 and 31 March 2009, containing a wealth of information about the individual mortgages, their particular characteristics and how they had performed.

9. Some of the lenders included in our sample had sold large tranches of their mortgage books. It is not possible to identify those mortgages once sold and therefore not possible to assess their performance. This means that for some lenders, the actual arrears and possessions rates in our data set are understated.

10. To improve the quality of the data, we identified and removed the following accounts:

- Those that were closed following a remortgage. We were able to do so by identifying accounts where a mortgage was to the same individual (as measured by the date of birth) and secured on the same property (as measured by the postcode);
- Any mortgages which had started after 1 April 2009;
- Lifetime mortgages, as their underwriting criteria are different from those for mortgages for house purchase;
- Business loans secured on residential property, as we do not have complete underwriting data on these mortgages.

11. The resulting dataset contained 4.5 million mortgage accounts of which some 277,000 were in arrears or in possession.

12. Where the detailed analysis of incomes was required, we have disregarded mortgages where the level of income was considered not credible.[4] The resulting sample of useable cases was 4.35 million of which around 274,000 accounts were in arrears or in possession.

Derived variables

Arrears definitions

13. For this analysis, we define a mortgage as being *in arrears or in possession* if either of the following conditions were met:

    (a) the mortgage is in arrears of any amount or duration; or

    (b) the mortgage is in the lender's possession.

14. A mortgage is in arrears measured in months if all of the following conditions are met:

    (a) the arrears balance is greater than £100;

    (b) the loan balance is greater than £1,000; and

    (c) the duration of the arrears is greater than 1 month, greater than or equal to 2 months or greater than or equal to 3 months, as applicable (where duration is the arrears balance divided by the monthly contractual payment on a mortgage).

15. The mortgage is *in possession* if either of the following was reported:

    (a) the date of a possession order; or

    (b) the date of taking possession.

16. In order to calculate the contractual mortgage payment for arrears definitions, we used the mortgage balance, mortgage term and interest rate at the date of arrears reporting (1 August 2009). As the data on the mortgage term was not requested from lenders, we have assumed that the borrower remained on their original term, as reported in PSD, which we then reduced by the number of months that had passed since the mortgage was taken out. We also assumed that the borrower retained the same mortgage type that was originally reported in PSD.

Income tax and National Insurance (NI) contributions

17. For taxation purposes, where joint income is reported in PSD, we assumed that individual incomes were 50% of the total. Where the borrower type was 'self-employed' and the income was joint, we have assumed that the first borrower is self-employed and the second borrower is employed.

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4 We have identified some quality issues around the reporting of gross incomes data by lenders in PSD. The accounts where we questioned credibility of incomes were referred back to lenders for verification. Where we received resubmissions from lenders, we updated our dataset accordingly. In other cases, we used filters to remove the most obvious cases of non-credible incomes, for example, accounts with zero income, with extremely high or extremely low Loan to Income ratios, or where the reported gross income was significantly below the national minimum wage, or where we knew from the information provided by lenders that the income reported in PSD was not representative of the borrower's circumstance (for example, where borrower's parent acted as a guarantor). We have also disregarded incomes data of one lender who reported on a basis other than gross income in PSD.

18. Income tax and NI contributions were worked out using rates and personal allowances for the relevant tax year when the mortgage was originated. We took into account age-related personal allowances. We were unable to identify any non-taxable elements of incomes that could have been reported in PSD (such as interest on ISA or child benefits) – therefore, we calculated taxes and NI based on the total gross incomes.

19. We deducted Class 1 NI for employed borrowers and Class 2 and 4 NI for self-employed borrowers. We applied small earnings allowance to the NI contributions paid by self-employed borrowers where applicable. We have not deducted NI contributions for retired borrowers.

20. We have not applied Class 3 NI to any borrowers and have not estimated the amount of any contributions to pension funds, saving accounts, or to repayment vehicles for interest-only mortgages.

Contractual mortgage payments

21. Except for arrears definitions (see paragraph 15), we have calculated contractual mortgage payments based on the mortgage characteristics at origination, including the mortgage type, amount, term and interest rate. Where the mortgage type is a 'mix of interest-only and repayment' we have assumed that 50% is on a repayment basis and 50% is on an interest-only basis (the exact split is not collected in PSD). As mortgage interest rates are an optional reporting requirement and are not reported on 42% of all mortgages in our dataset, we have imputed the missing rates. These interest rates were estimated from the pool of 2.6 million mortgages with known interest rates using a linear regression model with 'interest rate' as a response variable and level of Loan to Value (LTV), type of credit history and type of lender as explanatory variables.

Amount of money available for non-mortgage expenditure

22. We have calculated the amount of money available for non-mortgage expenditure by deducting income tax, NI and the contractual mortgage payment from reported gross income.

Living Costs and Food Survey / Expenditure and Food Survey

23. The Living Costs and Food Survey (LCF), previously known as the Expenditure and Food Survey (EFS), is an annual survey conducted by the Office of National Statistics (ONS). It contains data on household expenditure and income[5] and is used to compute some key national statistics, such as the Retail Price Index (RPI) and household final consumption expenditure – the latter, in turn, feeds into the National Accounts and estimates of GDP.

24. We used the data collected in the 2005-2008 surveys to assess the expenditure of those borrowers with a mortgage.

5 LCF/EFS income data does not include use of savings or credit, payouts by insurance policies, proceeds from the sale of assets and windfalls (such as winnings from betting or legacies). Expenditure, however, might reflect these items. More information on the Survey data and limitations is available on the ONS website. For example, see http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=361.

25. We used the data on gross incomes[6] to construct income deciles, which are as follows:

Table 7.1 – LCS/EFS income deciles, £ per week

Income decile	2005		2006		2007		2008	
	min (>=)	max (<)	min (>=)	max (<)	min (>=)	max (<)	min (>=)	max (<)
1	…	318	…	322	…	351	…	372
2	318	443	322	455	351	488	372	507
3	443	540	455	565	488	601	507	630
4	540	630	565	646	601	697	630	734
5	630	731	646	740	697	798	734	837
6	731	831	740	847	798	930	837	972
7	831	963	847	978	930	1,064	972	1,104
8	963	1,147	978	1,156	1,064	1,266	1,104	1,313
9	1,147	1,469	1,156	1,460	1,266	1,562	1,313	1,701
10	1,469	…	1,460	…	1,562	…	1,701	…

26. We calculated the non-mortgage expenditure of households by deducting mortgage interest[7] from the total expenditure[8 9].

27. We then calculated whether there was an income shortfall or surplus by taking normal disposable income[10] and deducting from that non-mortgage expenditure and total mortgage payments.[11]

Methodology

Expenditure and mortgage affordability

28. There are many factors that define the level of household expenditure, such as family composition, the socio-economic status of the household and the type of tenure.[12] Household composition and socio-economic status, which are the strongest predictors of the level of household expenditure,[13] are not available in PSD.

6 Variable p344p 'Gross normal weekly household income'
7 Depending on mortgage type - variable B130 'Mortgage interest only - last payment' or variable B150 'Mortgage interest/principle - interest paid'
8 Variable P630tp 'EFS: Total Expenditure (anonymised)'
9 The list of expenditure items collected in LCF/EFS can be found in ONS publications. For example, see Table A1, items 1-13 in 'Family Spending: a report on the 2008 Living Costs and Food Survey' available at http://www.statistics.gov.uk/downloads/theme_social/Family-Spending-2008/FamilySpending2009.pdf.
10 Variable P389p 'Normal weekly disposable household income- anonymised'
11 Depending on mortgage type - variables B130 'Mortgage interest only - last payment', or B200 'Mortgage interest/principle – last payment', or B203 'Mixed mortgage - last payment'
12 For example, see Chapter 5 of the 'Family Spending: a report on the 2008 Living Costs and Food Survey' available at http://www.statistics.gov.uk/downloads/theme_social/Family-Spending-2008/FamilySpending2009.pdf.
13 We do not use age of the household reference person and the urban / rural location of the household because the impact of both is relatively small.

29. While there are no variables in PSD that could be used as a reliable proxy for household composition[14], the level of gross income, on the other hand, can be a useful alternative to the socio-economic status of the household.[15] We can also account for the differences in expenditure by tenure by simply looking at expenditure of the households with a mortgage from LCF/EFS.

30. In the absence of transactional-level data on non-mortgage expenditure in PSD, we are unable to assess with accuracy the retrospective affordability of individual mortgages. However, as the general structure of the PSD dataset, as measured by gross income deciles, is largely consistent[16] with the structure of the LCF/EFS dataset (which means that the socio-demographic structure of the two datasets is similar), we would expect that the distribution of expenditure of the households captured in PSD would be similar to that in the LCF/EFS, when controlling for the relevant year and income deciles.

31. We therefore calculated the median non-mortgage expenditure for each income decile and year from the LCF/EFS dataset and imputed it in the PSD and Arrears dataset.[17]

32. In the LCF/EFS dataset, given the definition of the median, 50% of households have non-mortgage expenditure below the median expenditure for their income group and year and 50% above. In the PSD and Arrears dataset, if all mortgages, on average, were affordable at origination, we would expect to see a similar distribution of the money available for non-mortgage expenditure around the LCF/EFS median non-mortgage expenditure (see paragraph 22 for an explanation of how this amount was worked out). However, if the distribution contained more or less than 50% of accounts on any one side, this could mean the following:

    - If over 50% of borrowers have more money than their benchmark expenditure median would require, this would indicate that, overall, there was surplus affordability in the market at the time of mortgage origination, i.e., most borrowers could meet their mortgage payments and non-mortgage expenditure in full and could save to provide buffer against possible income shocks in future (such as unemployment);
    - If, however, more than 50% of borrowers were below their benchmark expenditure median, then this would indicate that, overall, some mortgages were unaffordable, as some borrowers would have not had enough money for all of their expenditure, and therefore would have to use savings (if they had any) or further borrowing to supplement their incomes. Such borrowers would be unable to save and would become instantly vulnerable to any future income shocks (such as unemployment). If further borrowing is used to top up income, this would add to indebtedness and increase their vulnerability further.

14 The only variable that carries some of this information is 'income basis' which can be 'single' or 'joint' in PSD. However, it can not be used as a reliable measure of the household size as the number of household members supported from the stated income is not reported to us (for example, a declared single income of £30,000 can support a household that consists of one adult or a household that consists of two adults and three dependent children).

15 Indeed, it follows from our analysis of the LCF/EFS data that the level of gross income alone explains 36% of the variance in the level of household expenditure. The two variables are strongly correlated, with the Pearson correlation coefficient of 60%.

16 Apart from the 1st and the 10th income deciles, which are underrepresented and overrepresented respectively in our PSD and Arrears dataset.

17 For Q1 2009 PSD data, we use 2008 LCF/EFS medians, as 2009 LCF/EFS data was not available at the time of this publication.

33. We measured the extent of the difference by comparing the distribution around the median of expenditure collected in LCF/EFS with the distribution of money available for non-mortgage expenditure calculated from PSD. The results of this comparison are shown in Exhibit 2.5.

Risk combinations

34. We used multiple binary logistic regression to identify the risk factors that increase the probability of mortgage payment difficulties, using arrears and possession dummy as a response variable and mortgage and borrower characteristics available in PSD as explanatory variables. We then used combinations of the top five product and borrower-related risk factors to define 24 risk types.

35. The risk factors we took into account were an impaired credit history; right to buy; self-employment; a higher LTV (set at a LTV greater than or equal to 80%) and a remortgage for debt consolidation.

36. Although there are five risk factors in our analysis, the maximum number of risk factors that any particular account can exhibit is four. This is because in PSD 'Remortgage for debt consolidation' and 'Right-to-Buy' (RTB) categories do not overlap (i.e., if a borrower remortgages for debt consolidation purposes, it is not known if they have exercised their RTB in the past; similarly, if a borrower is exercising their RTB for the first time, it is not known if a part of a mortgage is being used for debt consolidation).

37. We have focused on accounts where income had been verified and therefore which would be unaffected by our income verification proposals discussed in Chapter 2. Given the data available in PSD, we are unable to identify reliably those individual accounts where the loan amount was unaffordable. Therefore, we have not removed such accounts from our analysis of risk combinations.

38. We have ranked the 24 identified risk types in descending order of possession rate, to identify those risk combinations where consumer detriment is largest. The results of this assessment are summarised in Exhibit 4.1.

Non-bank lenders

39. We used multiple binary logistic regression to establish whether there were any risks specific to non-banks that could not be explained by other available risk factors – product or borrower-related. We used arrears and possession dummy as a response variable and relevant dummies for each of the five lender types (banks, bank subsidiary, building society, building society subsidiary, and non-bank), together with the key mortgage and borrower characteristics available in PSD as explanatory variables. The results of this assessment are explained in Section 5.

Other sections

40. We have used various data sources available to us, internal and external, to describe the market in terms of means, medians, frequencies and trends. The relevant exhibits are accompanied with a brief explanation of the nature of the measure used and of how it was worked out.

Acknowledgements

41. We would like to thank the following organisations and individuals:

- ***Mortgage lenders***, for sharing transactional data on mortgage performance;
- ***The Council of Mortgage Lenders***, for collecting and cleaning the data on mortgage performance from lenders on behalf of the FSA and for providing access to historic data on the structure of mortgage lending prior to 2005;
- ***Citizens Advice Bureau***, for providing statistics on non-mortgage debts of borrowers in mortgage arrears and in other secured loan arrears;
- ***The Office of National Statistics***, for advising on limitations of the LCF/EFS Surveys and on use of variables;
- ***Professor Gwilym Pryce*** of Glasgow University, for providing comment on the methodology of PSD and Arrears data analysis.

42. The views expressed are entirely those of the FSA.

List of consultation questions

Q1: Do you agree with our proposals for income verification?

Q2: Do you agree with our approach to assessing income?

Q3: Do you agree with our approach to assessing expenditure? Do you foresee any practical issues?

Q4: Should lenders be required to ensure that credit commitments being cleared by debt consolidation are repaid as expected? Would there be significant additional costs in implementing this for further advances?

Q5: Do you agree with our approach to calculating free disposable income?

Q6: Do you agree that affordability should generally be calculated on a capital and interest basis?

Q7: Do you agree that that affordability should be assessed on a maximum term of 25 years?

Q8: Do you agree with our approach to testing affordability against future interest rate increases, based on swap rates or any other appropriate guideline rate? Can you foresee any practical issues in the FSA setting a guideline margin for firms to use?

Q9: Do you agree with our proposal to impose an additional buffer on the calculation of free disposable income to protect credit impaired borrowers? What would be an appropriate basis for that buffer and how should it be set?

Q10: Do you agree with our approach to lending into retirement?

Q11: Are there specific atypical lending circumstances which you think merit an alternative approach to the assessment of affordability rather than being addressed through the possibility of rule modifications or waivers?

Q12: Do you agree with this approach to lifetime mortgages?

Q13: Do you agree with this approach to ensuring affordability for home purchase plans?

Q14: In addition to the questions above, do you have any other comments on our approach to responsible lending? Do you have any comments on the draft rules as set out in [Appendix 1 Part 1]?

Q15: Do you think our income verification proposals will impact any groups with protected characteristics (e.g. race, religion)?

Q16: How prescriptive should we be in defining a valid repayment method?

Q17: Should lenders be required to check that there is a valid repayment method in place at the start of the mortgage, and then periodically through the term of the mortgage? How do you think this should work? How often should lenders check on the repayment method?

Q18: Do you think there should be further controls on repayment methods? For example, how should 'sale of property' be controlled to prevent it being used where it is not a realistic option? If a minimum LTV, amount of equity or income level was set, where and how should this be done?

Q19: Do you agree that these customer types benefit from interest-only mortgages? Are there any other customer types that might benefit from interest-only?

Q20: Do you agree that some form of interest-only product without need for a repayment vehicle may be appropriate on a temporary basis for first-time buyers? If so, how should this be achieved? Would there be any specific impact on older consumers?

Q21: Do you agree that there are some limited circumstances where assessing affordability on an interest-only basis may be appropriate? If so, when? And should any additional controls be applied to prevent this being gamed on affordability grounds?

Q22: Do you think that any changes to our interest-only requirements will impact any groups with protected characteristics (e.g. race, religion)?

Q23: Do you agree that our enhanced affordability assessment will be sufficient to address the risks to individual consumers from equity withdrawal?

Q24: Do you have any comments not made previously in response to DP09/3 on the case for not banning loans above defined LTI, LTV or DTI ratios?

Q25: Do you agree that we should not ban loans to borrowers with multiple high-risk characteristics but instead rely on robust affordability assessment requirements (including additional checks when the borrower is credit-impaired)?

Q26: Do you have any comments on the above clarifications to MCOB 12.4.1 R or the draft Instrument in Appendix 1 Part 2 that gives effect to them?

Q27: Do you agree that we should amend MCOB 13.3 to limit the number of times fees for missed payments are charged?

Q28: Do you have any additional comments on the sections of the draft Instrument that limit the number of times missed payment fees should be charged?

Q29: How much time (if any) would your firm require to comply with the proposed changes to MCOB 13.3 around limiting missed payment fees?

Q30: Do you agree that we should widen MCOB 12.4 and 13.3 so it applies not just to arrears but to all payment shortfalls?

Q31: Do you have any additional comments on the draft Instrument that gives effect to this?

Q32: How much time (if any) would your firm require to comply with the proposed widening of MCOB 12.4 and MCOB 13.3 to payment shortfalls (noting that the record-keeping requirements in 13.3.9 R now apply to payment shortfalls)?

Q33: Do you have any comments on this suggested regime?

Q34: Do you have any comments on the macro-prudential considerations set out above?

Q35: Do you have any comments on the cost-benefit analysis for our proposals on responsible lending & arrears charges?

Q36: Do you have any comments on the high–level cost-benefit analysis on our current position on interest-only mortgages and non-banks?

Q37: Do you have any comments on the compatibility statement?

Affordable borrowing and home financing draft instrument

AFFORDABLE BORROWING AND HOME FINANCING INSTRUMENT 2010

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 156 (General supplementary powers); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Affordable Borrowing and Home Financing Instrument 2010.

By order of the Board
[*date*]

Annex A

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

credit impaired customer	A *customer* who: (1) within the last two years has been overdue, in an amount equivalent to three months' payments, on a mortgage or other loan (whether secured or unsecured), except where the amount overdue reached that level because of late payment caused by errors by a bank or other third party; or (2) has been the subject of one or more county court judgments, with a total value greater than £500, within the last three years; or (3) has been subject to a creditors' individual voluntary arrangement or bankruptcy order which was in force at any time within the last three years.

Annex B

Amendments to the Mortgages and Home Finance: Conduct of Business Sourcebook (MCOB)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

The existing Chapter 11 is deleted in its entirety and replaced with the following. The existing text is not struck through and the new text is not underlined.

11 Affordable borrowing and home financing

11.1 Application

Who?

11.1.1 R This chapter applies to a *firm* in a category listed in column (1) of the table in *MCOB* 11.1.2R in accordance with column (2) of that table.

11.1.2 R This table belongs to *MCOB* 11.1.1R

(1) Category of firm	(2) Applicable section
mortgage lender	Whole chapter
home purchase provider	Whole chapter except *MCOB* 11.3.15R(2), *MCOB* 11.3.19R and *MCOB* 11.3.20R

What?

11.1.3 R This chapter applies if a *firm*:

(1) *enters into a regulated mortgage contract* or *home purchase plan* with a *customer*; or

(2) makes a further advance or varies an existing *regulated mortgage contract* or *home purchase plan* to make a further advance to a *customer*.

11.2 Purpose

11.2.1 G (1) This chapter requires a *firm* to treat *customers* fairly by requiring a *firm*, before deciding to enter into, or make a further advance on, a *regulated mortgage contract* or *home purchase plan* to assess the *regulated mortgage contract* or *home purchase plan* as affordable for the individual *customer*.

(2) The purpose of this assessment is to ensure that every *regulated mortgage contract* or *home purchase plan* is sustainable by requiring robust checks on the *customer's* ability to repay (in the case of a *regulated mortgage contract*) or pay (in the case of a *home purchase plan*) fully.

(3) This chapter aims to ensure that *customers* are not exploited by *firms* that provide finance in circumstances where the *customers* are self-evidently unable to repay (or pay) through income and have no alternative means of repayment (or payment).

11.3 Affordable borrowing and home financing

Affordability

11.3.1 R A *firm* must not enter into, or make a further advance on, a *regulated mortgage contract* or *home purchase plan* unless it has assessed the *regulated mortgage contract* or *home purchase plan* (or the further advance) as being affordable for the *customer*.

Income verification

11.3.2 R For the purposes of assessing the affordability of a *regulated mortgage contract* or *home purchase plan* (or further advance), a *firm* must verify a *customer's* current income, (and, if future income is relied on for affordability purposes, known future income) from evidence independent of the *customer*. The evidence used by a *firm* must be sufficient to allow the *firm* properly to assess affordability for that *customer*. A declaration by the *customer* or his representative of the affordability of the proposed *regulated mortgage contract* or *home purchase plan* is not sufficient for these purposes.

11.3.3 G Whether the available evidence is sufficient for the purposes of verifying a *customer's* income will depend on the individual circumstances of the *customer*, and will vary according to such factors as the nature of the *customer's* employment and length of service in a profession.

11.3.4 G (1) For the purposes of the verification of a *customer's* income:

(a) a *firm* may use information it already holds about a *customer's* current income; for example, where the *customer* holds a current account with the *firm;* and

(b) a *firm* may use information provided to it by a *home finance intermediary*, but the *mortgage lender* or *home purchase provider* will retain responsibility for its verification.

11.3.5 G (1) In order to comply with *Principle* 3, a *firm* will need to have adequate systems and controls in place to assess the authenticity of the evidence of income provided to it, and to guard against fraud.

Expenditure

11.3.6 R For the purposes of assessing affordability (see *MCOB* 11.3.1R) a *firm* must:

(1) consider the expenditure to which the *customer* is committed;

(2) consider the *customer's* likely personal expenditure (including for all dependants of the *customer*); and

(3) consider whether an allowance should be made for missed or understated expenditure of the *customer*.

11.3.7 G (1) Examples of expenditure to which a *customer* is committed for the purposes of *MCOB* 11.3.6R(1) include: servicing of secured and unsecured debt; income tax; national insurance; utility bills; council tax; shared ownership rent; insurance premiums; maintenance payments; school and university fees. This list is not exhaustive.

(2) Examples of a *customer's* personal expenditure for the purposes of *MCOB* 11.3.6R(2) include: food and drink; clothing and footwear; health and personal care; transport; recreation; holidays. This list is not exhaustive.

11.3.8 R For the purposes of the assessment of affordability (see *MCOB* 11.3.1R and *MCOB* 11.3.6R):

(1) where a *customer* has borrowed sums (whether on a secured or unsecured basis) which are not to be repaid either before the proposed *regulated mortgage contract* or *home purchase plan* transaction or using the sums borrowed as part of that transaction, a *firm* must take reasonable steps to establish the actual expenditure to which the *customer* is committed for the repayment of those sums and the payment of interest and fees on those sums; and

(2) in all other cases, a *firm* may rely on aggregated or statistical data rather than establishing actual expenditure, provided that the data used is reliable and appropriate in relation to the specific *customer*.

11.3.9 G A *firm* should have procedures in place for identifying any significant respects in which a *customer's* specific characteristics make the use of any aggregated or statistical data (see *MCOB* 11.3.8R(2)) inappropriate for that *customer*.

11.3.10 R Where a *customer* states an intention to repay prior borrowings (whether on a secured or unsecured basis) out of the sums advanced under a proposed *regulated mortgage contract* or *home purchase plan* (not including a further advance) a *firm* must ensure that those borrowings are repaid.

11.3.11 G A *firm* may ensure borrowings are repaid as referred to in *MCOB*

11.3.10R by making the payment direct to the debtor(s) as a condition of granting the *regulated mortgage contract* or *home purchase plan*.

Free disposable income

11.3.12 R (1) For the purposes of this *rule*, the *customer's* free disposable income is the amount (if any) remaining when the *customer's* expenditure has been deducted from the *customer's* income. A *regulated mortgage contract* or *home purchase plan* is not affordable for a *customer* (see *MCOB* 11.3.1 R) if it is foreseeable that, at any time during the term of the *regulated mortgage contract* or *home purchase plan*, the payments to be made under it by the *customer* for a particular month (or other agreed payment interval) will be equal to or more than the *customer's* free disposable income over the same interval.

(2) In assessing a *customer's* free disposable income over the term of a *regulated mortgage contract* or *home purchase plan*, a *firm* must:

(a) take into account any information it has about the variability of the *customer's* income over time;

(b) take into account any known or foreseeable future changes to income and expenditure, including (but not limited to) the effects of retirement on the income of the *customer*, where the term of the *regulated mortgage contract* or *home purchase plan* will extend into the *customer's* retirement; and

(c) where a *customer* indicates an intention to work beyond the age at which that *customer* may reasonably be expected to retire during the term of the *regulated mortgage contract* or *home purchase plan*, consider both whether it is reasonably plausible that the *customer* has that intention and whether, in the particular circumstances of the *customer*, the intention is reasonably capable of being realised.

11.3.13 G A *customer's* free disposable income is the upper limit of what the *customer* can afford to repay (or pay) each month (or other agreed payment interval) towards a *regulated mortgage contract* or *home purchase plan*.

11.3.14 R Where the *customer* (or, in the case of a joint *regulated mortgage contract* or *home purchase plan*, any *customer*) is a *credit impaired customer*, the *regulated mortgage contract* or *home purchase plan* is not affordable (see *MCOB* 11.3.1R) if it is foreseeable that, at any time during the term of the *regulated mortgage contract* or *home purchase plan*, the payments to be made under it by the *customer* for a particular month (or other agreed payment interval) will be more than [X][1] per cent of the *customer's* free disposable income over the same interval.

---

[1] The value of X will be determined following consultation

Assumptions

11.3.15 R In calculating the *customer's* payments under the *regulated mortgage contract* or *home purchase plan* for the purposes of assessing affordability (see *MCOB* 11.3.1R):

(1) a *mortgage lender* or *home purchase provider* must act as if the *regulated mortgage contract* is repayable (or the *home purchase plan* is payable) over a term of no more than 25 years (whatever the actual proposed term); and

(2) a *mortgage lender* must act as if the *regulated mortgage contract* is a *repayment mortgage* (even where it is actually proposed that it will operate, fully or partly, as an *interest-only mortgage*).

11.3.16 R (1) In calculating the *customer's* payments under the *regulated mortgage contract* or *home purchase plan* for the purposes of assessing affordability (see *MCOB* 11.3.1R), to protect *customers* against the possibility of increased payments due to reasonably likely increases in interest rates (or rents) over the term, a *firm* must add a margin:

(a) for a *regulated mortgage contract*, to the higher of the initial interest rate and the reversion rate which would be payable after any initial fixed or discounted term; and

(b) for a *home purchase plan*, to the maximum amount of known rent.

(2) For the purposes of (1), a *firm* may use either:

(a) the current guideline margin published by the *FSA* on its website at the time of the proposed transaction, or

(b) a margin which is higher than the margin in (a).

(3) This *rule* does not apply if the interest rate (or rent) payable by the *customer* is fixed for the whole of the proposed term of the *regulated mortgage contract* or *home purchase plan* and the terms do not permit the *firm* to switch the *customer* to a variable rate (or rent) at any point during the term.

11.3.17 G A *mortgage lender* should include details of the margin applied (see *MCOB* 11.3.16R) in the record required by *MCOB* 11.3.19R.

Interest-only mortgages

11.3.18 [Text to be the subject of future consultation]

Record–keeping

11.3.19 R (1) A *mortgage lender* must make an adequate record of the steps it takes to comply with the *rules* in *MCOB* 11.3.1R to *MCOB* 11.3.16R in relation to each *customer*.

(2) A *mortgage lender* must retain the record required by (1) for one year from the date at which the *regulated mortgage contract* is entered into or the further advance is provided.

Responsible lending policy

11.3.20 R (1) A *mortgage lender* must put in place, and operate in accordance with, a written policy setting out its processes and procedures for complying with the *rules* in *MCOB* 11.3.1R to *MCOB* 11.3.16R.

(2) A *mortgage lender* must make and keep up-to-date an adequate record of the policy in (1). When the policy is changed, a record of the previous policy must be retained for one year from the date of change.

Amend the following as shown.

12.5.4 R *Mortgage lenders* and *home purchase providers* are also subject to requirements relating to ~~responsible lending~~ affordable borrowing and home financing (see *MCOB* 11).

Schedule 1 Record keeping requirements

Sch 1.3G

Handbook reference	**Subject of record**	**Contents of record**	**When record must be made**	**Retention period**
~~*MCOB* 11.3.1R(2)~~	~~Ability of the *customer* to repay advance~~	~~Evidence to demonstrate that the *firm* has taken into account the *customer's* ability to repay~~	~~When the assessment of the *customer's* ability to repay is made~~	~~One year from the date on which the *regulated mortgage contract* is entered into, or the further advance provided~~
MCOB 11.3.19 R (1)	Affordability and income verification	The steps a *firm* takes to comply with the *rules* in *MCOB* 11.3.1 R to *MCOB* 11.3.16 R	When the steps are taken	One year from the date on which the *regulated mortgage contract* is entered into,

				or the further advance provided
MCOB ~~11.3.4R(2)~~ 11.3.20 R(2)	Responsible lending policy	A record of the *firm's* written policy setting out ~~the factors the *firm* will take into account in assessing the *customer's* ability to repay~~ its processes and procedures for complying with the *rules* in *MCOB* 11.3.1 R to *MCOB* 11.3.16 R	The date on which the policy is set	One year from the date on which the policy is replaced

Payment shortfall charges draft instrument

MORTGAGE AND HOME FINANCE: CONDUCT OF BUSINESS SOURCEBOOK (PAYMENT SHORTFALL) INSTRUMENT 2010

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 149 (Evidential provisions);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Mortgage and Home Finance: Conduct of Business Sourcebook (Payment Shortfall) Instrument 2010.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

Insert the following new definition in the appropriate alphabetical position.

payment shortfall	the outstanding amount to be paid measured against the amount of payments which have become due under a *regulated mortgage contract* or *home purchase plan*, including any *arrears* amount due.

Annex

Amendments to the Mortgages and Home Finance: Conduct of Business sourcebook (MCOB)

In this Annex, underlining indicates new text and striking through indicates deleted text.

...

7.5 Mortgages: statements

...

Annual statement: additional content for customers in arrears

7.5.8 G If a *firm* chooses to use the annual statement to provide a *customer* with a regular written statement in accordance with *MCOB* 13.5.1 R (Statements of charges), as described in *MCOB* 13.5.2G(4), it will need to include the actual ~~payment shortfall~~ *payment shortfall* in the annual statement.

...

7.8 Home purchase plans

...

Annual statement – additional content for customer in arrears

7.8.4 G If a *firm* uses the annual statement to provide a *customer* with a written statement relating to *arrears*, it will need to include the actual ~~payment shortfall~~ *payment shortfall* in the annual statement (see *MCOB* 13.5.2G(4)).

...

12.1 Application

...

What?

...

12.1.4 R The ~~arrears~~ *payment shortfall* charges and excessive charges requirements in this chapter will continue to apply to a *firm* after a *regulated mortgage contract* has come to an end following the sale of a *repossessed* property. The excessive charges requirements will continue to apply to a *firm* after a *home reversion plan* has ended. References in this chapter to *'customer'* will include references to a former *customer* as appropriate.

12.1.5 G The *FSA* will expect a *firm* to ensure that charges made to a *customer* arising from the sale of a *repossessed* property and charges arising in relation to a *sale shortfall* are not excessive and are subject to the same considerations as apply with respect to ~~*arrears*~~ *payment shortfall* charges under this chapter.

...

12.4 **~~Arrears~~ Payment shortfall charges: regulated mortgage contracts**

12.4.1 R (1) A *firm* must ensure that any *regulated mortgage contract* that it *enters into* does not impose, and cannot be used to impose, a charge ~~for~~ relating to ~~arrears~~ a *payment shortfall* on a *customer* except where that charge is a reasonable estimate of the cost of the additional administration required as a result of the *customer* having a *payment shortfall* ~~being in *arrears*~~.

(2) Paragraph (1) does not prevent a *firm* from *entering into a regulated mortgage contract* with a *customer* under which the *firm* may change the rate of interest charged to the *customer* from a fixed or discounted rate of interest to the *firm's* standard variable rate if the *customer* ~~goes into *arrears*~~ has a *payment shortfall*, providing that this standard variable rate is not a rate created especially for *customers* who have a *payment shortfall* ~~in *arrears*~~.

12.4.1A E The imposition of a charge ~~for~~ relating to a *payment shortfall* ~~*arrears*~~ on a *customer* who is adhering to an arrangement under which the *customer* and the *firm* agree that the *customer* will make payments of a set amount per month (or other agreed period) on agreed dates may be relied upon as tending to show contravention of *MCOB* 12.4.1R(1)

12.4.1B R When a *customer* has a ~~payment shortfall~~ *payment shortfall* in respect of a *regulated mortgage contract*, a *firm* must ensure that any payments received from the *customer* are allocated first towards paying off the balance of the shortfall (excluding any interest or charges on that balance).

12.4.1C G A *firm* should not impose a charge relating to a *payment shortfall* on a *customer* unless the *firm* is able to objectively justify that the charge is a reasonable estimate of the cost of the additional administration and is required as a result of the *customer* having a *payment shortfall*.

12.4.1D G (1) In calculating the additional cost of the administration required as a result of a customer having a *payment shortfall*, it is likely to be reasonable for the *firm* to take into account the following types of costs:

(a) providing information or documents;

(b) the costs of staff;

(c) premises costs;

(d) human resources costs;

(e) information technology costs

(2) In calculating the additional cost of the administration required as a result of a *customer* having a *payment shortfall*, it is not likely to be reasonable for the *firm* to take into account the cost of the following:

(a) preparing financial reports for the *firm*;

(b) executive staff;

(c) funding or capital;

(d) general bank charges that are not incurred as a result of a *customer* having a *payment shortfall*;

(e) unrecovered fees;

(f) advertising costs;

(g) regulatory fines.

(3) The cost of administration required as a result of a *customer* having a *payment shortfall* should not be calculated as a proportion of the amount of the *payment shortfall*.

12.4.1E G Firms should note that the lists of costs set out at *MCOB* 12.4.1D(1) and (2) are not exhaustive.

12.4.1F G In estimating the cost of the additional administration required as a result of the *customer* having a *payment shortfall*, a *firm* should consider the extent to which those costs are shared with the rest of its business.

...

13.1 Application

...

What?

...

13.1.5 G The *FSA* expects a *firm* to treat a *sale shortfall* in the same way that it treats a ~~payment shortfall~~ *payment shortfall.*

...

13.3 Dealing fairly with customers in arrears: policy and procedures

...

13.3.1 R (1) A *firm* must deal fairly with any *customer* who:

(a) ~~is in *arrears*~~ has a *payment shortfall* on a *regulated mortgage contract* or *home purchase plan;*

…

13.3.1A R (1) Where a *customer* has a *payment shortfall* in relation to a *regulated mortgage contract* or *home purchase plan*, a firm must not pass on to the *customer* the costs incurred as consequence of making more than two payment requests in any one calendar month.

(2) Where a *firm's* direct debit request, in respect of a *customer* who has a *payment shortfall* on a *regulated mortgage contract* or *home purchase plan*, has been refused for a continuous period of 2 calendar months due to insufficient funds the *firm* must:

(a) consider whether the method of payment remains suitable for the *customer*; and

(b) not pass on any costs to the *customer* which were incurred as a consequence of presenting direct debit requests during this period of consideration.

13.3.1B G *MCOB* 13.3.1AR(1) does not prevent a *firm* from making more than two payment requests where appropriate provided the costs incurred from the additional requests are not passed on to the *customer*.

...

13.3.2A R A *firm* must, when dealing with any *customer* in payment difficulties:

(1) make reasonable efforts to reach an agreement with a *customer* over the method of repaying any ~~payment shortfall~~ *payment shortfall* or *sale shortfall*, in the case of the former having regard to the desirability of agreeing with the *customer* an alternative to taking possession of the property;

(2) liaise, if the *customer* makes arrangements for this, with a third party source of advice regarding the ~~payment shortfall~~ *payment shortfall* or *sale shortfall*;

(3) allow a reasonable time over which the ~~payment shortfall~~ *payment shortfall* or *sale shortfall* should be repaid, having particular regard to the need to establish, where feasible, a payment plan which is practical in terms of the circumstances of the *customer*;

…

…

13.3.4A R In complying with *MCOB* 13.3.2AR(6):

(1) a *firm* must consider whether, given the individual circumstances of the *customer*, it is appropriate to do one of more of the following in relation to the *regulated mortgage contract* or *home purchase plan* with the agreement of the *customer.*

…

(d) treat the ~~payment shortfall~~ <u>*payment shortfall*</u> as if it was part of the original amount provided (but a *firm* must not automatically capitalise a ~~payment shortfall~~ <u>*payment shortfall*</u>); or

…

…

13.3.4D G In the *FSA's* view, in order to comply with *Principle* 6, *firms* should not agree to capitalise a ~~payment shortfall~~ <u>*payment shortfall*</u> save where no other option is realistically available to assist the *customer*.

...

13.3.6 G In relation to adopting a reasonable approach to the time over which the ~~payment shortfall~~ <u>*payment shortfall*</u> or *sale shortfall* should be repaid, the *FSA* takes the view that the determination of a reasonable payment period will depend upon the individual circumstances. In appropriate cases this will mean that the repayments are arranged over the remaining term.

...

Record Keeping: arrears<u>, payment shortfalls and </u>repossessions

13.3.9 R (1) A *mortgage lender* or *administrator* must make and retain an adequate record of its dealings with a *customer* whose account is in *arrears*, <u>has a *payment shortfall*</u> or ~~who has~~ a *sale shortfall*, which will enable the *firm* to show its compliance with this chapter. That record must include a recording of all telephone conversations between the *firm* and the *customer* which discuss the sums due.

(2) A *mortgage lender* or *administrator* must retain the record required by (1) for three years from the date of the dealing.

13.3.10 G The record referred to in *MCOB* 13.3.9R should contain, or provide reference to, matters such as:

(1) the date of first communication with the *customer*, after the account was identified as being in *arrears* <u>or having a *payment shortfall*</u>;

(2) in relation to correspondence issued to a *customer* in *arrears* <u>or with a *payment shortfall*</u>, the name and contact number of the employee

dealing with that correspondence, where known;

(3) the basis for issuing tailored information in accordance with *MCOB* 13.7.1R;

(4) information relating to any new payment arrangements proposed;

(5) the date of issue of any legal documents;

(6) the arrangements made for sale after the *repossession* (whether legal or voluntary); ~~and~~

(7) the date of any communication summarising the *customer's* outstanding debt after sale of the *repossessed* property; and

(8) the date and time of each call for the purposes of *MCOB* 13.3.9R(1).

...

13.4 Arrears: provision of information to the customer of a regulated mortgage contract

13.4.1 R If a *customer* falls into *arrears* on a *regulated mortgage contract*, a *firm* must as soon as possible, and in any event within 15 *business days* of becoming aware of that fact, provide the *customer* with the following in a *durable medium*:

…

(3) the total sum of the ~~payment shortfall~~ *payment shortfall*;

(4) the charges incurred as a result of the ~~payment shortfall~~ *payment shortfall;*

…

(6) an indication of the nature (and where possible the level) of charges the *customer* is likely to incur unless the ~~payment shortfall~~ *payment shortfall* is cleared.

...

13.4.3 G (1) …

(2) Where a *firm* provides information in *MCOB* 13.4.1 R when a ~~payment shortfall~~ *payment shortfall* occurs but before the *customer's* account falls into *arrears*, it need not repeat the provisions of the information in *MCOB* 13.4.1 R when the *customer's* account falls into *arrears*.

Customer in arrears within the past 12 months

13.4.4 R If a *customer's* account has previously fallen into *arrears* within the past 12 months (and at that time the *customer* received the disclosure required by *MCOB* 13.4.1 R), the *arrears* have been cleared and the *customer's* account falls into *arrears* on a subsequent occasion a *firm* must either:

(1) …

(2) provide a statement, in a *durable medium*, of the payments due, the actual ~~payment shortfall~~ *payment shortfall*, any charges incurred and the total outstanding debt excluding any charges that may be added on redemption, together with information as to the consequences, including *repossession,* if the ~~payment shortfall~~ *payment shortfall* is not cleared.

...

13.5 Dealing with a customer in arrears or with a sale shortfall on a regulated mortgage contract

Statement of charges

13.5.1 R Where an account is in *arrears*, and the ~~payment shortfall~~ *payment shortfall* or *sale shortfall* is attracting charges, a *firm* must provide the *customer* with a regular written statement (at least once a quarter) of the payments due, the actual ~~payment shortfall~~ *payment shortfall*, the charges incurred and the debt.

13.5.2 G …

(3) If an account in *arrears* is subject to a payment plan agreed between a *firm* and a *customer*, and the account is operating in accordance with that plan, the *firm* will still need to send the *customer* a written statement if the ~~payment shortfall~~ *payment shortfall* or *sale shortfall* is attracting charges.

(4) Information provided should cover the period since the last statement. *Firms* may use the annual statement to comply with *MCOB* 13.5.1 R, in which case the annual statement will need to be supplemented to include the actual ~~payment shortfall~~ *payment shortfall.*

...

13.7 Business loans

13.7.1 R Where the *regulated mortgage contract* is for a business purpose, a *firm* may as an alternative to *MCOB* 13.4.1 R(1) provide the following information in a *durable medium* instead of the *moneymadeclear* information sheet "Just the facts about problems paying your mortgage":

(1) details of the consequences if the ~~payment shortfall~~ *payment*

shortfall is not cleared;

(2) a description of the options available to the *customer* for clearing the ~~payment shortfall~~ *payment shortfall*, and

(3) details of sources of fee-free advice for business *customers*.

…

Schedule 1 Record keeping requirements

...

Sch 1.3 G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
…				
MCOB 13.3.9R	Dealings with *customers* in *arrears*, with a *payment shortfall*, *or* with a *mortgage shortfall debt*	Details of all dealings (including a recording of all telephone conversations) with the *customer*; information relating to any repayment plan; date of issue of any legal proceedings; arrangements made for sale of a *repossessed* property; and the basis of any tailored information where the loan is for a business purpose.	The date of the dealing.	Three years from the date on which the record is made.

...

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: http://www.fsa.gov.uk