Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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FPC housing consultation
Financial Stability Group
Room 1/34, HM Treasury
1 Horse Guards Road
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Dear Sir/Madam

The Financial Policy Committee's housing market tools

The Financial Services Consumer Panel welcomes the opportunity to respond to HM Treasury's consultation on the Financial Policy Committee's (FPC's) housing market tools.

The Panel is primarily concerned about potential regulatory overlap. As a result of the Government's proposals, there would be an interplay between, on the one hand, the strict, individually bespoke, affordability tests introduced as a result of the Mortgage Market Review (MMR) and, on the other hand, macroprudential interventions based on relatively crude measures of individuals' indebtedness. As a result of this overlap, there is a material risk that too many responsible, solvent borrowers would be denied access to mortgage finance ("arbitrary rationing") and that existing mortgagors who have become trapped by the MMR rules ("mortgage prisoners") would find it even harder to extricate themselves.

To mitigate these risks, the Panel believes the FPC should adhere to two broad principles:

- rely predominantly on macroprudential tools that work with the grain of the MMR;
- be well informed, *before* making macroprudential interventions, of the likely damage to existing and future mortgagors.

In general, the FPC should be in a position to get the most "macrobang" – improved financial stability that benefits all consumers - for the "microbuck" – the costs that come in the form of arbitrary rationing of solvent mortgage applications and the undesirable impact on mortgage prisoners.

We have three specific suggestions to make macroprudential interventions as cost-effective as possible:

1. The FPC should have the power to require lenders, through mortgage rules, to stress test mortgage applications against an FPC-specified change in house prices. This power can be applied symmetrically to guard against bubbles (lenders would be required to stress the application against a given fall, relative to market expectations, in house prices); and self-reinforcing loss cycles (lenders would be required to stress test applications assuming a given rise, relative to market expectations, in house prices). This measure could be applied consistently with

macroprudential adjustments to the interest rate stress test. This proposal would require legislative changes to enable the FPC to override normal mortgage rules.[1]

2. The FPC and FCA in collaboration should pre-emptively examine the welfare consequences of different macroprudential tools using, and improving upon, the cost-benefit welfare analysis deployed by the FSA in its 2011 MMR Consultation Paper. The aim would be to rank macroprudential tools, individually and in combination, in terms of their likely cost-benefit ratios.

3. Sunset clauses should apply to all macroprudential interventions to help guard against the danger that notionally temporary measures become permanent[2].

The Government evidently shares the Panel's concerns. It speaks of the potentially "significant impact on the availability of credit for borrowers and the distribution of credit across different sections of society". [3] The Government intends to exclude from the scope of the Loan-to-Value (LTV) and Debt-to-Income (DTI) limits, secured lending by the Government such as Help-to-Buy (HTB). Furthermore it is proposed that both the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) should carry out all procedural requirements, including consultation and cost benefit analysis (CBA), following an initial LTV or DTI FPC direction (the "first direction").

However, the Panel strongly doubts that these attempts to mitigate the unintended, or undesirable, consequences of macroprudential interventions will work in practice.

The mitigation afforded recipients of Government secured loans does not extend to other responsible borrowers who do not qualify; moreover, eligible customers who want to move or re-mortgage at the end of an initial HTB five-year period are more likely to become trapped if an LTV cap has been introduced. The Government proposes to exclude from the scope of the FPC tools those re-mortgages that do not involve an increase in principal. In practice, lenders uncertain of regulators' future judgements may well choose to play safe and apply the FPC directions to all re-mortgagors, a consequence of lenders' risk aversion already seen in their unwillingness to apply transitional easements afforded mortgage prisoners under the MMR.[4]

As it currently stands, the requirement to conduct a CBA is likely to prove ineffective. The intended disapplication of Sections 138I and 138J of the Financial Services and Markets Act 2000 (FSMA) means that the FPC direction subsequent to the "first direction" will in practice be a done deal.[5] In light of our extensive experience of CBA produced by the regulator and the [weak] illustrative CBA published by the FPC in respect of its June 2014 measures[6], we strongly doubt whether the quality of the regulators' CBAs would adequately help safeguard the [micro] consumer interest. The

[1] MCOB 11.6.5 (1) states that a lending firm "must not base its assessment of affordability on the equity in the property which is used as security under the regulated mortgage contract or is subject to the home purchase plan, or take account of an expected increase in property prices".
[2] Unless countered by a new FPC decision, a sunset clause would provide for the automatic cessation of an FPC macroprudential direction after a specified date.
[3] HM Treasury (October 2014), "The Financial Policy Committee's housing market tools", paragraph 4.56
[4] Woodall, L. (5 November and 10 November 2014), "Mortgage Lending in the post MMR world." speech given at the Council of Mortgage Lenders Conference, London.
[5] HM Treasury (October 2014), "The Financial Policy Committee's housing market tools" page 29. Sections 138I and 138J require the FCA and PRA respectively to consult and provide a CBA before making rule changes. Under the disapplication of these procedural requirements, both regulators would publish a CBA at the same time as the FPC direction is implemented.
[6] FPC (2 October 2014), "Financial Policy Committee statement on housing market powers of Direction from its policy meeting, 26 September 2014", Box 1 and appendix. Since no attempt was made to measure the micro-welfare costs, the FPC was not justified in its stark conclusion that its June package "comes at limited cost."

regulators do not have to meet HM treasury Green Book standards of CBA analysis and can too easily duck quantification of important costs and benefits on grounds of estimation difficulty.[7]

The Panel's perspective is informed by our knowledge of the consumer experience in the mortgage market and the impact of the Mortgage Market Review. During the development of the MMR, the Panel argued that the FSA, while rightly tightening up its previously lax approach, should nevertheless avoid overly-prescriptive regulation that would deny responsible borrowers access to mortgage finance and worsen the lot of mortgage prisoners. The Panel called successfully for a robust cost benefit analysis that weighed the welfare gains of individuals, spared default as a result of the prospective MMR affordability rules against the welfare losses of solvent consumers, denied access to mortgage finance. Having previously strongly resisted such analysis, the FSA conceded and developed the technology to examine this welfare trade-off, on which the Panel commented extensively.[8]

The Panel's second concern was the possibility of regulatory overlap between macro-prudential measures and the MMR. We were unsuccessful in our attempts to persuade the FSA properly to examine this risk. However, we were eventually successful in pressing our proposal that the MMR interest stress test should be used as a macro-prudential tool.[9] The stress test works with the grain of the MMR, since it directly impinges on individual applicants' ability to pay back their mortgage.

Broadbrush loan-to-income (LTI), LTV and DTI limits are far cruder. In its 2009 Discussion Paper and 2010 and 2011 Consultation Papers on the MMR, the FSA rejected use of LTIs and LTVs for consumer protection purposes. It found that LTIs were "not a strong or consistent predictor of defaults".[10] Lack of data meant that it was unable to assess the impact of DTIs.[11] The FSA found that there was a correlation between LTVs and subsequent defaults but said it was "very wary of having a single across-the-board LTV cut-off point for consumer protection purposes." Particular concern was expressed about the impact on first-time buyers.[12]

Our responses to your individual questions are recorded below.

Specific questions

Q1: Do respondents agree that the FPC should be granted a power of direction over DTI?

The affordability assessment which lenders must carry out prior to granting a mortgage loan, should be taking into account a borrower's stock of existing mortgage and non-mortgage debt. While lenders do not necessarily apply a hard limit to DTI (Debt To Income), to allow borrowers to become highly over-indebted would be deemed irresponsible.

[7] Under FSMA sub-sections 138I(8) and 138J(8), the FCA and PRA, respectively, are excused from quantification if, in their "opinion", the costs or benefits "cannot reasonably be estimated, or it is not reasonably practicable to produce an estimate". The regulators are required to explain the basis of their opinion.
[8] Consumer Panel (16 November 2010), "Mortgage Market Review: Responsible Lending"; Consumer Panel (30 March 2012), "Consumer Panel Response to CP11/31 *** Mortgage Market Review (MMR)".
[9] Ibid and Consumer Panel (3 April 2014), "Quarterly consultation – Mortgage affordability – Financial Policy Committee recommendation on interest rate stress tests". In September 2012, the Panel's recommendation was discussed with Lord Turner.
[10] FSA (July 2010) "Mortgage Market Review: Responsible Lending", CP10/16, paragraph 3.9.
[11] ibid.
[12] FSA (December 2011), "Mortgage Market Review: Proposed package of reforms", CP11/31, paragraph 3.16.

In addition, if overall indebtedness is to be considered, then it appears perverse to exclude student loans from the DTI calculation. Lenders must take student loans into account when making lending decisions, so for Government to exclude them from its own DTI calculations is inconsistent.

If the FPC requires a power of direction, it should carry out in collaboration with the FCA, a full and detailed cost-benefit analysis deploying the techniques pioneered by the FSA in its 2011 MMR CP. The FPC should not be allowed to 'experiment' with the various measures, potentially not allowing the effects of any caps or limits to be understood before implementing new or extended measures.

The Consumer Panel also notes the potential for 'leakage' to other forms of debt outside the proposed measures. There is a real risk of creditworthy consumers opting for alternative, sometimes more expensive forms of credit if they are refused further advances or re-mortgages with an increase in principal, for example. There is also a danger of cross-border leakage: the proposed macroprudential measures would not operate within the current formalised EU framework.

There is a danger of unintended consequences as a result of consumers having to try to 'fit in' with criteria. Too many restrictions will mean that consumers who can afford a mortgage will be excluded. Additional restrictions such as DTI and LTV will make it extremely hard to ever leave a lender or get on the property ladder.

Q2: Do respondents agree that the FPC should be granted a power of direction over LTV?

Loan to value caps, on their own, are blunt tools which are likely to result in lower mortgage approvals and/or a reduction in the size of loans advanced. This is likely to have a disproportionate effect on first time buyers, as well as having regional impacts.

There is nothing wrong with 95% LTV loans for some consumers, and the new affordability criteria brought in with the MMR are in place to ensure that no borrower could take out a high LTV mortgage who cannot afford it.

Given the FPC's objectives, it seems strange to exclude the Government's Help-to-Buy (HTB) mortgages, which invariably involve a high LTV mortgage as well as an equity loan on top. If these customers want to move or re-mortgage at the end of the initial HTB five year period, they are more likely to become trapped if an LTV cap has been introduced. Responsible lenders will need to take this possibility into account: under the MMR, mortgages should not be sold with an expectation that LTVs would fall due to rising house prices.

Q3: Do respondents agree with the proposed scope of mortgages to which the DTI and LTV limits could be applied? If not, please explain your reasoning.

The FPC recommendations seem to conflict with other Government policies. On the one hand, Government would like to intervene in a targeted way through schemes such as Help-to-Buy: equity loan, to *promote a better functioning housing market and make housing more accessible* often with high LTV loans. Yet on the other hand, for all other consumers it would like the ability to restrict high LTV lending.

In addition, as stated above, the Government's definition of debt, to be included in the DTI seems inconsistent. Not to include student loans is inconsistent with affordability assessments where student loans must always be included.

Q4: What are respondents' views on the appropriate treatment of business loans to individuals secured on the borrower's home?

No comment

Q5: What are respondents' views on the proposed definition of 'debt' for the purposes of the DTI tool?

As already stated in question 3, the proposal to exclude student loans is inconsistent with lenders' affordability assessments where student loans must always be included.

Q6: What are respondents' views on how (if at all) a borrower's assets should be taken into account in calculating that borrower's DTI ratio?

Lenders make their assessment of affordability through an assessment of the income, assets and committed expenditure of the borrower. Therefore for consistency these calculations should remain the same. Not to include a borrower's assets in the DTI calculation would not provide a true DTI ratio.

Q7: Do respondents agree with the proposed definition of 'income' for the purposes of DTI? If not, please explain your reasoning and provide an alternative definition if possible.

As set out above, definitions should remain consistent with those used by lenders already.

Q8: What are respondents' views on the appropriate treatment of existing buy-to-let mortgage debt, and income derived from rental yields (after costs) on buy-to-let properties?

No comment

Q9: Do respondents agree that the FPC should be able to apply DTI and LTV limits to a proportion of new mortgages calculated on either a value or volumes basis? If not, please explain on which basis the tools should apply and why.

As outlined above, the Panel does not support the use of LTI, DTI or LTV limits without a full and detailed impact assessment to understand which of the measures would have the desired effect. We strongly oppose the idea that the FPC could 'experiment' with the various measures, potentially changing both the measures and how they are calculated, without understanding the consequences or allowing enough time for one set of changes to take effect.

Q10: Do respondents agree with the Government's proposed approach in relation to re-mortgages and further advances on existing mortgages? If not, please describe an approach that you believe would be more suitable.

No comment

Q11: What views do respondents have regarding the potential impact of the Government's proposals?

As outlined previously, we have serious concerns around these proposals, which will increasingly deny responsible borrowers access to mortgage finance and worsen the lot of mortgage prisoners. We would expect to see both regional and customer-type impacts, with a whole raft of consumers across the UK who simply will not be able to afford to buy or move, as the affordability gap will become too large. The consumer is the one who will lose out under these proposals.

Q12: Do respondents agree with the Government's proposed approach in relation to procedural requirements? If not, please explain an approach that you consider would be appropriate.

We strongly disagree with the procedural requirements. The nature and quality of the CBA is not mandated, and the example given in the FPC Statement would not be rigorous enough or sufficient to examine the trade-off between achieving the desired financial stability effect and the welfare implications as outlined above.

The legal framework should specify that the CBA should examine the welfare trade-offs as well as the efficacy of the macroprudential tools as macro-stabilisers.

Any macroprudential tools proposed or implemented, should also come with an explicit sunset clause to help guard against permanent regulatory creep.

Yours faithfully

Sue Lewis
Chair
Financial Services Consumer Panel