

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

9 December 2011

Dear Sir/Madam

FINANCIAL SERVICES CONSUMER PANEL RESPONSE TO FSB PRINCIPLES FOR SOUND RESIDENTIAL MORTGAGE UNDERWRITING PRACTICES

The UK's Financial Services Consumer Panel welcomes the opportunity to respond to the FSB's draft principles, particularly as it has recently engaged with the development of mortgage regulation in the UK and looks forward to providing input to the FSA's Mortgage Market Review consultation in the near future.

The Panel was established under the Financial Services and Markets Act 2000 by the Financial Services Authority to represent the interests of consumers. It is independent of the FSA and represents the interests of all groups of consumers.

In particular, the Panel has views on point 2.2 of your consultation on reasonable debt service coverage, that 'jurisdictions should ensure that lenders make reasonable allowances for normal living expenses and other recurring repayment obligations in the assessment of repayment capacity'.

We have concerns that the full costs and benefits of this proposal have not been properly addressed, and there is a real danger that rules made under the principle could be overly prescriptive, leading to unnecessary rationing of access to residential mortgages for customers who need them.

In particular, it is important that any rules for calculating repayment capacity should not unnecessarily penalise those consumers who fully intend to reduce their discretionary non-housing expenditure in order to pay off their mortgage. Therefore it should be explicit that any rules should refer only to committed and other non-discretionary expenditure rather than to the wider concept of 'normal living expenses'. It should be for the lender to judge whether the consumer would be able to service the mortgage, if necessary by reducing discretionary spending.

Therefore we suggest the following amendments to point 2.2:

Jurisdictions should ensure that lenders make reasonable allowances for ~~normal living expenses committed and other non-discretionary expenditure and other recurring repayment obligations~~ in the assessment of repayment capacity. *Lenders should be required to judge whether the consumer would be able to service the mortgage, if necessary by reducing discretionary spending. This could include, for example, establishing the borrowers' actual obligations, modelling ~~normal living expenses committed and discretionary expenditure~~ for households of similar composition and income, and specifying fixed ratios of repayment to some measure of gross or net income (e.g. debt-to-income ratio, loan-to-income ratio). In such cases, lenders should include these economic limits in their internal risk policies.*

The Panel recently published a six point plan for a sustainable and healthy mortgage market, and our views on this point are encapsulated in point three which states that lenders should be required to judge affordability and suitability for individual consumers. The full six point plan is attached, and we would be happy to discuss any of the issues raised in it in more detail.

Yours faithfully,

Adam Phillips
Chair, Financial Services Consumer Panel

Six point plan for a sustainable and healthy mortgage market

The Financial Services Consumer Panel has launched a six point plan for a sustainable and healthy mortgage market. The plan describes what the Consumer Panel wants to see from the FSA's Mortgage Market Review (MMR) set in the context of the reform of financial services regulation.

1 Effective regulation to help consumers

The pre-crisis house price boom gave rise to a significant amount of poor quality mortgage lending to people with high levels of debt and those who abused self-certification; they and others remain vulnerable to income and interest rate shocks. These problems highlight the need for more effective regulation of mortgages that avoids irresponsible lending while not overly constraining the market for millions of responsible borrowers.

To help consumers the FSA's policy needs to be based on a robust cost benefit analysis, which quantifies not only the compliance costs of the MMR and the benefits of fewer arrears and repossessions but also the costs imposed on creditworthy consumers who nevertheless have to settle for a less preferred property, or who are forced to rent.

2 Regulatory policy to take account of wider social and economic implications

An overly prescriptive regulatory approach could have serious implications for the unregulated buy-to-let market, the rental market and the market for social housing. The Panel is keen to see 'joined up thinking' on the MMR and its wider implications for housing policy.

3 Lenders required to judge affordability and suitability for individual consumers

Lenders should take responsibility for assessing whether consumers can repay according to their individual circumstances and ability, if necessary, to curtail discretionary spending, with an intelligent, tailored assessment of potential risks, rather than having overly prescriptive rules which could be unfair to some consumers. We doubt the need for an extra buffer on top of standard affordability tests for the credit-impaired, we dislike the restriction of maximum mortgage term to 25 years, a proposal which fails to recognise changing working patterns and increased longevity, and see interest-only mortgages as a legitimate product for some consumers, who may have a range of reasons for choosing them.

4 Transitional arrangements which take account of the implications of the changes for all segments of the market

The FSA needs to ensure transitional arrangements adequately provide for consumers who have historic mortgages that may now lie outside the responsible lending criteria. Whatever transitional arrangements apply, timing will be crucial: there is a danger that lenders will reject mortgages which they view as not complying with the MMR and so further restrict consumers' options during a period of general lending restraint. To avert this danger,

implementation of new affordability rules should be delayed until the housing market has demonstrably recovered.

5 A future regulatory structure responsive to consumers' needs

It is vital that the interests of consumers are adequately represented in the new structure. The Panel is concerned that the new Financial Policy Committee may not take adequate account of the consumer interest when making important decisions about the mortgage market. Instruments, such as loan-to-value caps, may be effective in stabilising the financial system but may additionally have serious adverse consequences for some consumers, limiting their options.

We propose that the FSA should pro-actively engage with the interim FPC to subject each macro-prudential instrument to a rigorous cost benefit analysis which takes account of the goals of financial stability *and* consumers' welfare. This preparatory exercise would facilitate the selection of preferred macro-prudential tools that would contribute most to financial stability while inflicting least direct damage on consumers, judged in terms of the impact on the availability and cost of financial services, including mortgages. Except in circumstances of immediate crisis, we would also expect the FPC, once fully operational, to consider in consultation with the Financial Conduct Authority, the consumer welfare implications of macro-prudential interventions.

6 Balanced debate which overcomes the polarised views on the mortgage market

The MMR debate has become unhelpfully polarised between those organisations that represent the interests of vulnerable consumers and industry representatives who focus on the overall market. The Consumer Panel seeks to represent all consumer interests and is working with the FSA to achieve good consumer outcomes. A healthy market needs to achieve a balance between freedom for those who are able to repay their mortgages and understand the risks and those consumers who are vulnerable and need greater protection.

Background

The majority of the population aspires to own their home. The total value of the UK housing stock is around £3.8 trillion and there are around 11.3 million mortgages which account for four fifths of all consumer lending, so any change in the rules around the issuing of mortgages can have a very significant impact, not just on the wealth of particular individuals, but also on consumer confidence and the economy as a whole.

The FSA became responsible for the regulation of mortgages in January 2005, before that it was the responsibility of the Mortgage Standards Board. At the time the FSA took over regulation, it made few changes to the existing rules, but committed to a review after three years. As a result of the financial crisis, the mortgage market review was delayed until 2009 when the FSA issued a Discussion Paper (DP09/03). This created considerable interest and debate with 178 responses, an unusually high level. The subsequent Consultation Paper on Responsible Lending (CP 10/16) was contentious, with the industry and the CML, in particular, warning of dire consequences, and the Consumer Panel refusing to respond to some of the key issues because

of a lack of evidence presented on which it could base reliable answers to the questions posed. The FSA agreed that there was more work needed and is currently engaged in working through some of the key questions raised by the consultation. Initial answers are anticipated some time in July, although it is likely that there still be some further consultation needed.

Stronger regulation is definitely required to stamp out some of the reckless lending we have seen in the past few years.

- In 2008, secured debt amounted to 130% of households' disposable income, compared to just 80% in 2000.
- In 2007, nearly a third of mortgages taken out were interest only and most had no repayment vehicle in place.
- In 2010 Citizens' Advice Bureaux saw 115,000 cases relating to mortgage and secured loan arrears as well as countless ongoing problems resulting from vulnerable borrowers given mortgages they could never have afforded to pay from the outset or once the discounted periods ended.

However, the regulation of the mortgage market is not straightforward. The FSA in its Retail Conduct Risk Outlook this year highlighted the diversity of the mortgage market and the complex issues facing the regulator:

Mortgage arrears increased sharply between 2007 and 2009 but peaked in mid-2009 at rates less than half those faced in the early 1990's..... Within this overall favourable picture, however, there are important customer segment variations. Mortgage arrears are significantly higher in particular regions. There is also a tail of poor quality pre-crisis lending, with self-certification of income sometimes used to stretch apparent mortgage affordability, and arrears higher among credit-hungry customer segments able to gain credit through specialist lenders, even with impaired credit history. High arrears and default rates have also been experienced in Buy-to-Let portfolios¹.

In order to encourage responsible lending, the FSA proposed a series of requirements for checking affordability in CP10/16, most of which the Panel felt were overly prescriptive. For example, the FSA proposed that a 25 year repayment term should be used when calculating affordability and the Panel regarded the proposed formula for calculating free disposable income as one which would unnecessarily penalise those consumers who fully intended to reduce their discretionary non-housing expenditure in order to pay off their mortgage. The Panel believes that this formula should therefore be amended to refer only to committed and other non-discretionary expenditure. It should be for the lender to judge whether the consumer would be able to service the mortgage, if necessary by reducing discretionary spending.

In addition, the Panel believes:

- that interest-only mortgages are still legitimate products for some customers, who may have a range of reasons for choosing them;

¹ FSA Retail Conduct Risk Outlook 2011 pp25

- that increased longevity and different working patterns mean that it is not unrealistic for many people to consider a mortgage term of longer than 25 years;
- that an additional buffer for credit-impaired consumers is an inflexible approach which would not differentiate between consumers with very different circumstances;
- and that stress-testing against future interest rate changes may not necessarily be appropriate.

The scope and quality of the FSA's cost benefit analysis has a significant role, both in terms of setting out clearly the FSA's best estimate of the difference that will come about as a result of implementing the MMR and in the sense-checking and design of the MMR policy proposals. We believe the FSA analysis has to effectively quantify all the potential negative impacts of the MMR as well as the positive. So, for instance, the FSA analysis must fully account for the social and welfare impact on consumers, for example, those who have to settle for a less preferred property than they otherwise would have been able to afford if the MMR had not been implemented, as well as those who are deemed no longer able to afford to buy at all. Similarly, it is imperative that the FSA quantifies the impact on those who may be forced to sell their properties at a time not of their choosing and when market conditions are not favourable.

The Panel believes that in a well functioning mortgage market consumers should be able to shop around for affordable mortgage products that meet their individual needs. The total cost of a mortgage should be easily comparable across the market, with lenders competing for consumers' business on price and level of customer service. Intermediaries and lenders should be complying with FSA rules and principles, with those falling short being named, thus offering those firms treating their customers fairly a business advantage. And finally for any customers experiencing financial difficulty, firms should be treating them positively and sympathetically, with a solution to managing the mortgage arrears being developed on an individual basis.

The debate about the MMR highlights the challenges that may have to be faced by the separation of the business conduct regulator and the prudential regulator in the new structure (FCA v PRA) and the rather narrow role that has been conceived for the FPC, which can override both new organisations. In particular this calls into question the ability of the FPC to gain access to the necessary analytic resources which will be dispersed between the FCA and the Bank of England. It is not clear that the overview, which the FSA Board currently has, will be possible in the future world, where the responsibilities of the individual regulatory bodies will be much more closely defined.

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